The Central Bank of the Russian Federation

FINANCIAL STABILITY REVIEW

July 2013

Moscow

All statistical data and calculations in this Review are given as of April 1, 2013 if available as of July 10, 2013.

Statistical data and text in the Russian and English languages are also available on the Bank of Russia's website.

For notes, comments and proposals relating to the Review's structure and content, please contact the Bank of Russia via e-mail: Reports@cbr.ru.

If using information from this Review, reference to the Bank of Russia is obligatory.

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Summary

The current state of the Russian financial sector looks stable as a whole in the event of a moderately negative scenario. Nevertheless, there is some deterioration in the environment of financial sector functioning in the past six months with regard to global risks and the economic situation in Russia.

Positive trends on financial markets fail to contribute to real economy rebound . An upturn on world financial markets in the period under review became apparent in the continued growth of stock indices in developed countries. This growth, however, did not lead to favourable trends in the real sector of the economy. On the contrary, statistical data indicate a slower global economic growth. In its April world economic outlook, the International Monetary Fund again lowered its forecast on global GDP growth (as well as the US and eurozone GDP). Therefore, stock market growth is caused by the continued quest for yields amid very accommodative monetary policies of the world's leading central banks and may in the longer term prompt the emergence of financial bubbles on the markets of developed and some emerging market countries.

The eurozone remains a potential catalyst of financial shocks. The Cyprus developments in the spring of 2013 have shown that it is early to speak about the European economy's exit from the crisis. Depositor forced participation in the bailout of two Cypriot banks has created a precedent, which may become a model action plan for the European authorities in the event of a crisis. The European Commission has warned of the risk of excessive imbalances in Spain and Slovenia where the private sector's big debt burden, along with the governments' limited ability to support national financial systems, makes these economies vulnerable enough. This year, new periods of instability could be observed on global financial markets under the impact of the European crisis, in particular, in the event of deterioration in the Spanish economy.

Capital flows and the presence of non-residents in the Russian financial market. Net private capital outflow from Russia slowed down in 2013 Q1: it fell from $34.7 billion in 2012 Q1 to $28.4 billion in the period under review. The larger part of capital outflow ($17.2 billion) was registered in the banking sector as Russian banks had to limit their open foreign exchange positions amid low demand for foreign currency loans on the domestic market and place funds raised by other sectors on external markets on their deposit accounts abroad. At the same time, the Russian market became more attractive for portfolio investors over the past year: according to the Bank of Russia estimates, the share of non-residents in federal loan bond (OFZ) portfolios rose from 7% as of July 1, 2012 to 25% as of April 1, 2013 (the figures indicate the lower bound of estimation). The current level of non-resident participation in the government bond market is close to the average value typical of emerging market countries (about 30%). However, negative consequences may follow, if this level continues to rise substantially: Russian credit institutions will see a decrease in the volume of highly liquid collateral on their balance sheets, while the Russian financial market will increase its dependence on the global market situation and foreign investor sentiments. In view of this, the Bank of Russia plans to regularly monitor non-resident activities on the OFZ market.

The slower development of the Russian economy amid the absence of growth drivers. In April, the Economic Development Ministry of Russia lowered its forecast on Russia's GDP growth in 2013 to 2.4%. In the previous year, the Russian economy grew largely due to higher consumer demand (with the outpacing growth of retail trade turnovers), which was caused, among other things, by a rapid expansion of lending, whereas the growth of fixed capital investment was gradually slowing down. Export volumes demonstrate a downward trend: in

2013 Q1, exports fell by 4.9% as compared to the same period last year. World prices of Russian export commodities (oil, metals) are declining as global economy growth is slowing. In these conditions, the economic efficiency of many Russian enterprises remains relatively low and it is more profitable for credit institutions to extend loans to households rather than these enterprises, especially considering a significant difference in loan rates (the average-weighted nominal interest rate on loans to non-financial organisations equalled 9.9% in 2013 Q1 as compared to that of 21.1% on household loans).

The accelerated build-up of household loan portfolios by a group of banks specialising in retail lending. The Financial Stability Review released in December 2012 singled out the risk of excessive growth of the household loan market as a major risk in the banking sector. In 2013, the expansion of lending to individuals slightly slowed down: household loans grew by 4.7% in 2013 Q1 as against 6.2% in January-March 2012. However, analysis of retail banks[1] that account for 32.0% of banking sector loans to individuals, shows that this group, on the contrary, quickly built up its loan portfolio. As of April 1, 2013, household loans provided by the sampled group of banks grew by 48.4%, an increase of 2.1 percentage points as compared to January 1, 2013.

The impact of faster household lending growth on systemic risks. High loan rates in consumer lending allow banks actively working on this market to set high household deposit rates, which makes the banking sector generally less sensitive to changes in the Bank of Russia interest rates. In the long term, the priority development of retail business by Russian banks to the detriment of lending to enterprises may generate high consumer loan risks as the solvency of the population is determined by the level of unemployment and wages, which ultimately depend on the financial standing of enterprises. Therefore, in the event of a sharp deterioration in the financial standing of enterprises, banks providing households loans at high rates may be confronted with a substantial growth in overdue loans and defaults.

The need for some banks to increase capital to ensure further growth of banking sector assets. In 2012 Q4, the level of banking sector capital adequacy grew from 13.1% to 13.7%. Its subsequent decrease to 13.4% as of April 1, 2013 was largely attributed to changes in the methodology of market risk calculation.[2] It cannot be ruled out, however, that in the medium term many banks will be unable to increase their assets at the same pace as they will be confronted with the need of recapitalisation to comply with the capital adequacy ratio. The new procedure for calculating bank capital[3] stipulates that banks should exclude gradually (at an annual rate of 10.0%) subordinated instruments that fail to meet Basel III requirements.[4] The share of subordinated instruments in bank capital equalled 24.1% as of April 1, 2013.

Banking sector liquidity situation remains stable. Banks have sufficient collateral to raise the Bank of Russia loans: as of April 1, 2013, refinancing potential against securities from the Bank of Russia Lombard List totalled about 4 trillion roubles; as a result, the market asset utilisation ratio stood at 38.0%. Banks could also raise 1.1 trillion roubles worth of loans against credit claims. As of June 1, 2013, the share of the Bank of Russia funds in bank liabilities contracted from 5.1% as of October 1, 2012 to 4.8%.

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[1] The selection of banks for the survey was based on the following set of criteria: the value of the household loan portfolio

[2] Bank of Regulation No. 387-P of September 28, 2012, “On the Procedure for Calculating Market Risk by Credit Institutions”.

[3] Bank of Russia Regulation No. 395-P of December 28, 2012, “On the Methods of Calculating and Assessing Bank Capital Adequacy”.

[4] Excluding subordinated loans received by banks as government support during the crisis of 2008-2009: these loans will be phased out from bank capital since January 1, 2018.

In 2013 Q1, stress tests of Russian banks' liquidity were held to assess the liquidity coverage ratio (LCR) intended for introduction from January 1, 2015 as part of Basel III implementation. As of April 1, 2013, the banking sector average ratio (taking into account the Bank of Russia potential refinancing under the conservative scenario of potential outflows) equalled 77% (the Basel Committee on Banking Supervision (BCBS) has set the ratio at 60% from 2015 and 100% from 2019). Eventually, the LCR is expected to be assessed on a quarterly basis. To comply with international liquidity standards, credit institutions will have to increase to some extent the share of their highly liquid asset portfolio[5] in the medium term.

[5] Cash, bank funds on correspondent accounts with the Bank of Russia, demand and overnight deposits with the Bank of Russia, bonds (except the bonds of financial institutions) rated BBB- and higher.

Chapter 1. Global Risks and their Impact on the Russian Financial Sector

1.1. Global Macroeconomic Risks

In 2012 Q4 and 2013 Q1, ***the risks of a slower global economic growth were still considerable*** due to persisting economic and financial imbalances. Macroeconomic statistics and consensus forecasts of GDP growth published by major financial institutions[6] indicate a slower world economic growth in 2012 and a weak recovery in the subsequent several years (Chart 1). The slow economic growth is primarily related to weak internal and external demand in many countries, which adversely affects the Purchasing Manager Index (PMI) in the manufacturing sector[7] (Chart 2).

The situation in the eurozone, which is experiencing a recession, remains a special concern: the crisis in the Cyprus banking system, which intensified in early 2013, testifies to persisting instability in the region (See Box 1 "Cyprus Financial Instability and its Impact on Russia"). As risks flared up again, the IMF and the European Commission downgraded their forecasts of eurozone GDP decline to – 0.3% in 2013 and many national regulators also lowered their GDP estimates.

At the same time, ***progress was registered in the period under review in the recovery of the global financial system as a result of regulatory action*** aimed at fighting the debt crisis and supporting economic growth.

The troika of international lenders (the European Commission, ECB and IMF) agreed in late 2012 a financial aid package for Greece stipulating easier lending terms and the allocation of a 49.1 billion-euro loan tranche, which had a positive effect on the cost of eurozone sovereign borrowings (yields on government bonds issued by problem countries stabilised). In addition, in April 2013, the Council of eurozone finance ministers (the Eurogroup) extended maturities of bailout loans for Ireland and Portugal by seven years.

The world's leading central banks continued to implement stimulus measures.

Deteriorating macro-economic prospects prompted the need for the European Central Bank to cut the interest rate on major refinancing operations: on May 2, 2013, the regulator was forced to reduce the loan rate from 0.75% to a record low of 0.5%. In addition, the ECB lowered the rate on its standing facilities from 1.5% to 1.0%.

These measures have helped the European banking system maintain a considerable volume of liquidity, despite early repayments in 2013 Q1 of the ECB's loans worth about 200 billion euros raised through three-year longer-term refinancing operations (LTRO). The improved liquidity situation could be evidenced by the low level of interest rates on overnight loans (Eonia) and three-month loans (Euribor).

[6] Global financial institutions, national banks, non-bank financial organisations, etc.

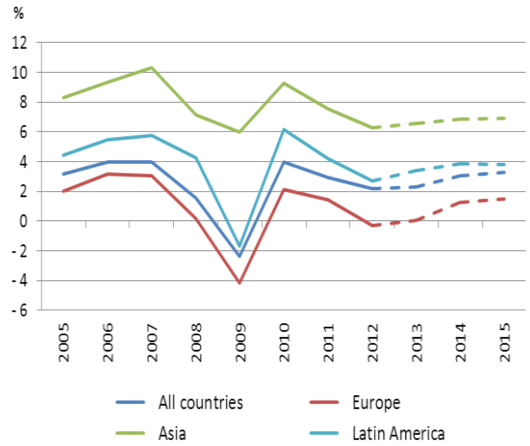
[7] The manufacturing PMI is based on a poll of the managers of leading industrial enterprises to indicate their attitude to current economic conditions and their business expectations. An index of over 50 points indicates production growth, while below 50 points shows a decline in business activity in the sector.

In April 2013, ***the Bank of England*** extended the funding for lending scheme (FLS)[8] for a year to January 2015. This scheme was designed to incentivise banks to lend more to small and medium-sized businesses. The scheme is eventually expected to contribute to lower borrowing costs and stimulate UK GDP growth.

In December 2012, ***the US Federal Reserve System (FRS)*** announced a new round of Treasury bond purchases ($45 billion a month starting from 2013) to stimulate economic growth and boost employment and reaffirmed its plans to continue buying $40 billion per month in mortgage-backed bonds as part of the third round of its quantitative easing policy. In addition, to increase the transparency of its monetary policy, the FRS pegged the level of its funds rate to macroeconomic indicators: it will stay within the range of 0-0.25% until the unemployment rate falls below 6.5% and inflation exceeds the 2% longer-term target for the next one-two years by more than 0.5 percentage point.

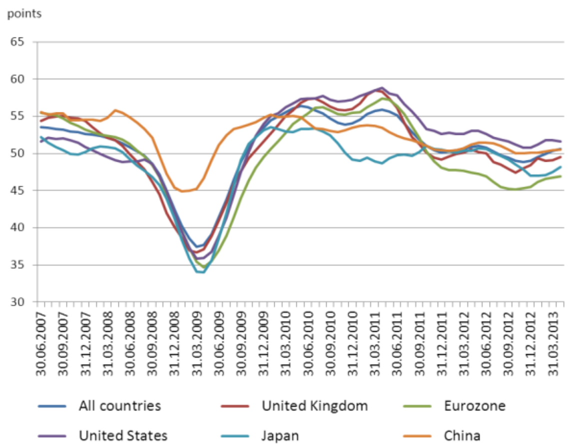
The Bank of Japan radically changed its monetary policy strategy towards achieving the inflation target of 2% in the 2015 financial year. To implement this task, the regulator took a decision at its April meeting to give up the overnight rate as the principal instrument of its monetary policy and switch to base money regulation, and also announced plans to increase the volume of the purchases of government bonds, including long-term securities.

Chart 1. GDP Growth (annual %, consensus forecast from 2013)



Source: Bloomberg.

Chart 2. Manufacturing PMI



Source: Bloomberg.

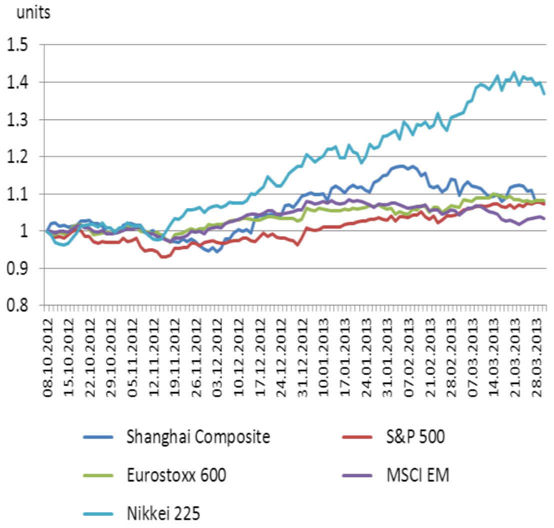
The situation in global financial markets in the period under review was characterised ***by the improvement of funding terms, the contraction of credit spreads, growth of stock indices, and increasing investors' risk appetite***. These improvements, however, are attributable entirely to stimulus measures being implemented by the world's leading central banks and do not reflect any significant positive shifts in the real sector of the economy.

In early 2013, the S&P 500 and Nikkei 225 exceeded levels achieved before the 2008 global financial crisis (the US index hit an all-time high at that time). Moreover, Nikkei 225 demonstrated the most rapid growth among the stock indices of major economies in the period under review (Chart 3). The Eurostoxx 600 climbed above the level registered before the flare-up of the debt crisis in the problem eurozone countries in mid-2011.

[8] The FLS allows credit institutions to exchange collateral eligible in the Bank of England's discount window facility for UK Treasury bills for a four-year period and use them to draw funds from the Bank of England or on the market.

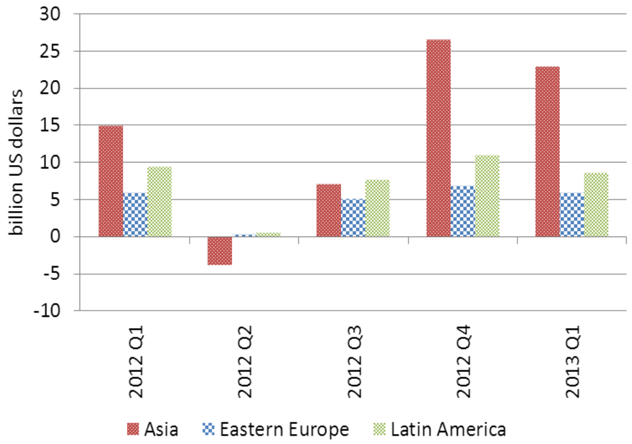
The growth of stock indices in emerging market economies was not so rapid due to investor fears over a slower economic growth. For example, China's GDP growth unexpectedly decreased to 7.7% in 2013 Q1. The emerging market countries registered a net capital inflow in the period under review (Chart 4); however, growth prospects in emerging markets considerably depend on the volatility of foreign capital flows, which may increase significantly,

Chart 3. World Stock Indices (October 8, 2012 = 1 unit)



Source: Bloomberg.

Chart 4. Quarterly Net Capital Inflow in Emerging Market Equity Funds



Source: EPFR.

if developed countries change the parameters of their monetary policies.

Regulatory measures implemented in the period under review should facilitate gradual recovery of global economic growth in the second half of 2013, ***although the impact of restraining factors will remain considerable.***

The factors that may increase risks **for eurozone economies** include the complexities of implementing budget consolidation reforms, a possibility of lower-than-expected domestic and global demand, and a slow or an insufficiently rapid implementation of structural reforms. These risks may weaken market participant confidence and, as a result, delay economic recovery. In addition, a deterioration of Spain's economic situation has become more likely. The European Commission has included Spain and Slovenia in the list of countries with excessive macroeconomic imbalances, following a survey conducted as part of the macroeconomic imbalance procedure, which was launched in 2012. Finally, the situation in Cyprus remains unstable.

In these conditions, the ECB has virtually used up the potential of using conventional monetary policy instruments to support the eurozone economy, which increases the possibility of introducing a negative deposit rate or applying unconventional measures. The efficiency of these measures, however, cannot be guaranteed. A negative deposit rate is unlikely to stimulate lending considerably because banks would probably keep funds on current accounts, as it was the case after the ECB cut the deposit rate to zero in July 2012.

In **the United States**, the macroeconomic situation is gradually improving amid stimulus measures taken by the FRS. Specifically, the US has registered a fall in the unemployment rate and a rebound on the residential property market. Nevertheless, the risk of a slower economic growth still remains due to the problems related to budget and debt sustainability. On March 2, 2013, the US President was forced to sign an order to sequester budget after negotiations with Republicans failed in the US Congress. The US debt ceiling suspended by the US Congress at the start of the year[9] came back into force on May 19, 2013. The debt limit was raised from the previous $16.4 trillion to $16.7 trillion. The US government will be able to refrain from new borrowings for several months only, which can delay the problem of raising the debt limit for some time but cannot eliminate the risks related to the deterioration of the US budget situation and a possible decrease in investor confidence.

Emerging market countries depend considerably on the foreign market situation. As interest rates in developed countries have stayed low in recent years, global investors have been increasing their investment in the assets of emerging market countries in search for higher yields, which results in the growth of asset prices and the reduction of risk premiums. A change in market participants' basic expectations may increase volatility of international capital flows and, as a consequence, trigger an outflow of foreign capital from emerging markets.

Box 1. Cyprus Financial Instability and its Impact on Russia

The Cyprus banking crisis was a central topic of international discussions in 2013 Q1.

In late March, after complex negotiations, the Cypriot authorities were forced to accept the Eurogroup's terms of involving depositors in the restructuring of the two largest problem banks – Cyprus Popular Bank (Laiki Bank) and Bank of Cyprus – in exchange for a 10 billion euro bailout loan (Tables 1 and 2). These banks sustained big losses as a result of the Greek crisis due to their large Greek bond portfolios.

The Cypriot Government's decision to involve depositors in the restructuring of banks has created a dangerous precedent. This means that similar terms may be set for other problem eurozone countries, if they turn to the troika of international lenders for financial assistance.

The impact of the banking crisis on the Cypriot economy is very considerable as Cyprus banking sector assets make up over 750% of the country's GDP, while Laiki Bank and Bank of Cyprus account for more than half of the assets.

Table 1. Restructuring Plan for Cyprus Major Banks

Cyprus Popular Bank (Laiki Bank)
Problem assets will be subsequently liquidated. Good assets (including deposits under 100,000 euros), together with the 9 billion euro sum provided as Emergency Liquidity Assistance (ELA), will be moved to Bank of Cyprus.
Bank of Cyprus
All deposits under 100,000 euros are protected. With regard to deposits of over 100,000 euros, it has been established that: - 37.5% of the value of deposits* will be converted into Class A new shares; - 22.5% of deposits will be frozen until the assessment of further details of the bank's restructuring plan (if necessary, these deposits may also be partially converted in the future into the Class A new shares); - the remaining 40% will accrue interest, of which only 10% will be repaid, while the other 30% will remain in the accounts until the bank does well. The holders of Class A shares will have a more privileged position as compared with the

[9] No Budget, No Pay Act of 2013.

bank's current shareholders.

The bank's capital is expected to be converted in the following manner:

- ordinary shares will be converted into Class D new shares;
- existing securities convertible into shares will be converted into Class C new shares;
- existing bonds will be converted into Class B new shares.

** The value of deposits remaining after loans extended by the bank to customers are deducted from the deposits. If the loan amount exceeds the deposit value, the funds on deposit accounts will not be returned to the customers.*

Table 2. Losses Estimated on Uninsured Deposits, billion euros

<table>
<tr><th>Indicator</th><th>Laiki Bank</th><th>Bank of Cyprus</th><th>Both banks</th></tr>
<tr><td>Total value of deposits (bank balance sheet data)</td><td>17.9</td><td>27.8</td><td>45.7</td></tr>
<tr><td>The value of deposits of over 100,000 euros (the Cyprus Government's estimate)</td><td>3.2</td><td>8.01</td><td>11.21</td></tr>
<tr><td rowspan="2">Depositor losses</td><td rowspan="2">2.56 with 80% write-down</td><td>3, if 37.5% is exchanged for shares</td><td>5.56</td></tr>
<tr><td>4.806, if 60% is exchanged for shares</td><td>7.366</td></tr>
</table>

The Cyprus Government had to impose some capital controls to prevent a massive capital flight from banks, which were due to reopen to customers after a closure for the period of bailout talks with the Eurogroup. The first decree on restrictive measures came into force on March 27, 2013, after which capital controls were gradually relaxed (Table 3).

Table 3. Restrictions on Capital Movement

(The Basic Provisions of the 17th Decree, Dated July 5, 2013)*

- Deposit withdrawal restrictions are imposed, allowing individuals to make cash withdrawals of no more than 300 euros and legal entities of no more than 500 euros on a daily basis (or the equivalent of these amounts in another foreign currency).
- Funds transfers between individual accounts at the same bank are limited to 300 euros.
- Bank cheques are not allowed to be cashed.
- Withdrawals of term deposits are not allowed before the expiry date.
- Transfers of funds within Cyprus are limited to 15,000 euros a month for individuals and 75,000 euros a month for legal entities.
- Monetary transactions within Cyprus for the purchase of goods and services for an amount of over 300,000 euros are allowed upon the presentation of relevant documents.
- Funds transfers abroad are restricted, with the exception of:
  - transfers made as part of core business activities, including transfers to make payment for imports (which requires the presentation of justifying documents, including authorisation from the Central Bank of Cyprus special commission for

transactions of over 500,000 euros);
  - transfers to make payments of salaries (upon the presentation of relevant documents);
  - transfers to pay tuition fees and accommodation expenses abroad (with a quarterly limit of 5,000 euros).

  Other transfers are limited to 5,000 euros per month.
- Cypriot citizens are not allowed to take more than 3,000 euros in cash (or the equivalent amount in another foreign currency) outside the country.

** In addition to this Decree, Cyprus has enforced a separate Decree regulating foreign bank activities (the Decree's original edition of May 10 included four banks, while the last edition of July 5 increased the number of banks to 16). For these banks, restrictions were lifted for transactions between the banks and their foreign customers, between the banks' foreign customers, and also between the banks and other organisations outside Cyprus on instructions of the banks' foreign clients.*

These measures have helped contain the banking crisis in Cyprus on a local scale. Nevertheless, as restrictions on capital movements are lifted, Cypriot banks are likely to see an outflow of funds from their accounts, in particular, a contraction in the volume of non-resident funds can be expected. These developments will intensify the risks of Cypriot bank increased demand for liquidity.

According to data of the Central Bank of Cyprus, the value of funds on deposit with Cypriot banks totalled 63.7 billion euros in March 2013, of which non-residents accounted for 22.4 billion euros, including 3.4 billion euros worth of investment from eurozone countries. The problem of liquidity shortage may intensify, if capital outflow exceeds bank capacity of raising funds from the ECB.

The Impact of the Cyprus Crisis on Russia

Russian residents' direct losses are limited to the amount of funds of over 100,000 euros deposited with the two problem Cypriot banks (Laiki Bank and Bank of Cyprus).
Credit risk materialisation for Russian banks is limited. According to balance of payments data, Russian banks' foreign claims to Cyprus residents totalled $55.9 billion as of April 1, 2013, or 3.5% of Russian banking sector total assets.

The restrictions imposed by the Cypriot authorities on capital movements (including cross-border capital transfers) no longer exert influence on the business of Russian subsidiary banks in Cyprus.

On May 10, 2013, the Cyprus Finance Ministry lifted restrictions on capital movements for the subsidiaries of VTB (Russian Commercial Bank) and Promsvyazbank (OJSC Promsvyazbank). The banks operate in a normal mode, freely effecting payments and conducting bank transfers, and also making settlements with customers both inside and outside Cyprus.

It should be noted, however, that the favourable terms of doing business in Cyprus were actively used by Russian non-financial companies, which now have to incur transaction costs related to the change of agreements, the structure of deals, etc., which may adversely affect their activities in the short term.

1.2. Global Financial Risks

Risks of Asset Encumbrance

The growth in encumbered assets share amid uncertain prospects for the development of the global economy is a major financial risk for both advanced and emerging economies. In addition to assets used as loan collateral, the category of collateralised assets includes assets pledged as security under REPO operations, collateral swaps and derivatives with their insufficiently predictable price dynamics. Therefore, uncertainty about both the total volume of assets encumbered by pledge and their value sensitivity to rating downgrades may adversely affect the sustainability of secured loan markets, and also the recovery of unsecured loan markets.

The problem of the increasing share of encumbered assets is especially serious for eurozone countries due to persisting risks of growth in mistrust among interbank loan market participants amid the continuing debt crisis. The issuance of secured bonds and large borrowings from the ECB increase the share of encumbered assets (especially in countries experiencing financial problems). The growth in the share of such assets both reduces possibilities for raising additional funds on secured loan markets and causes deterioration in the functioning of unsecured loan markets because creditors granting such loans find themselves less protected and, correspondingly, demand higher returns on their credit facilities.

Massive asset encumbrance would cause a crunch of encumbered asset markets, reduce asset liquidity and resilience and would not allow the holders of these assets to expect a prompt repayment of their loans because they would be unable in the event of a borrower insolvency to sell such assets within a short period of time at acceptable prices. Therefore, the increase in the share of encumbered assets in the total volume of market assets may create conditions when further asset encumbrance would not enhance the protection of creditor interests and, on the contrary, would lead to the accumulation of systemic market risk.

Risks of Financial Bubbles

As the central banks of developed countries continue their accommodative monetary policies, global investors are increasingly looking for higher yields, which may create speculative bubbles in some segments of the financial markets both in advanced and emerging market economies.

Investor growing appetite for riskier assets may, in the first place, lead to the overheating of the securities market, especially its corporate sector, considering the growing volume of corporate bond issues. Risks in this segment of the financial market may materialise through several channels: the overheating of the high-yield segment of the market, the growth in the share of securities with low credit ratings, a high probability of lower demand for corporate bonds, which may cause a slump in prices on the market. In emerging market economies, imperfect legislation and insufficient data disclosures by bond issuers increase the risks of speculative bubbles and may trigger more serious adverse effects in the event of an unfavourable scenario.

For many emerging market economies, the problem of overheating on mortgage loan markets is a cause for special concern. To prevent this overheating, the loan-to-value (LTV) and debt-to-income (DTI) ratios are used as macroprudential tools in Hong Kong, South Korea, Singapore, Thailand and the Philippines. These instruments are aimed at mitigating the risks of defaults on mortgage loans and regulating the level of household debt.

Risks of Protracted Low Interest Rates and their Subsequent Rise

Interest rates kept at a record low for too long could pose a serious challenge to global financial stability. Risks accumulated during this period may materialise, if interest rates rise.

The negative consequences of higher interest rates in major currencies for the financial sector may spread through three channels: market risk, which materialises through the devaluation of the portfolio of debt and equity securities, and also through losses on derivatives; credit risk (the increased cost of borrowings may trigger defaults and the growth in the share of problem loans because many banks in developed countries are currently refinancing the loans of financially distressed borrowers), and interest rate risk, which emerges from lower net interest income as market participants actively use short-term borrowings to finance long-term investment.

If the central banks of developed countries start to scale down their asset purchase programmes as they tighten their monetary policies through an increase in base rates, then the markets' response will intensify amid rising interest rates. If the central banks sell the assets, which they previously purchased on the market, this policy will reverse the yield curve towards the growth of long-term rates and will therefore produce a negative effect on the functioning of the debt and capital markets.

Higher interest rates may especially affect the sovereign debt markets of the countries with excessively high government debt levels. Moreover, a rise in longer-term interest rates will push up the cost of sovereign debt servicing in these countries, which may undermine their fiscal sustainability. In emerging market economies, the private debt market may face the biggest exposure as the debt burden of the private sector has risen substantially in recent years. It is obvious that a rise in interest rates will significantly increase the private sector's costs of financing its debt obligations.

The growing volatility of international capital flows may also considerably affect emerging market economies as a result of higher rates in major currencies as these countries will be confronted with the increased risk of foreign capital outflow from domestic markets. A change in base interest rates and market participants' expectations may trigger a considerable reduction in asset value and the devaluation of national currencies.

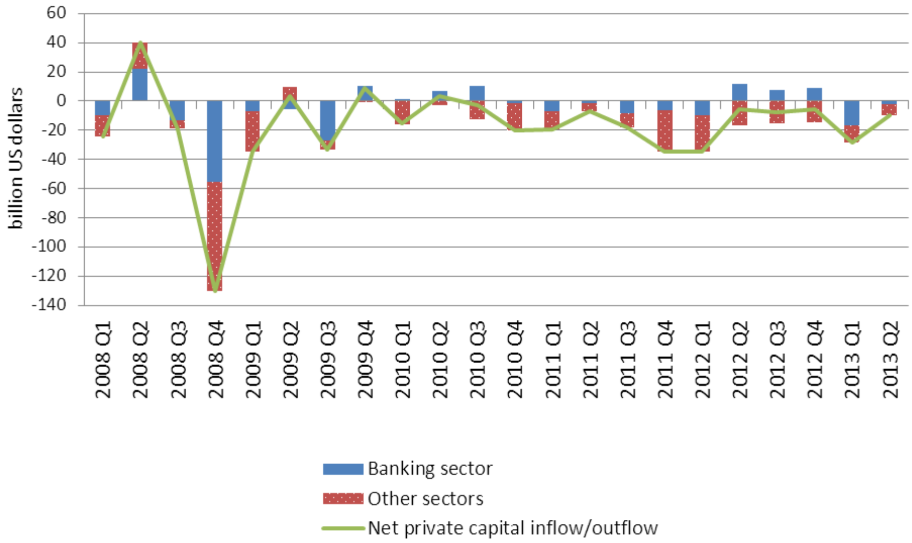
1.3. The Impact of Global Risks on the Russian Financial Sector

Risks of private capital outflow

As global economic growth is unlikely in the near future, a threat still persists that investor risk appetite will decrease. In the event of a recurrence of crisis developments in the global economy, first of all, in Europe, Russia is likely to see some increase in capital outflow. Considering the structure of the Russian economy and a large share of oil and gas revenues in the overall volume of export proceeds, a fall in energy prices is likely to further weaken the balance of payments.

After the crisis of 2008–2009, Russia has seen a steady net private capital outflow (Chart 5). In the period under review, net private capital outflow from Russia reached $34.3 billion, including $28.4 billion in 2013 Q1. Bank operations dominated the structure of net private capital outflow in 2013 Q1: net capital outflow totalled $17.2 billion, exceeding the level of 2012 Q1 by almost two-fold.

Chart 5. Net Capital Outflow (2013 Q2 – estimate)



Banking sector external liabilities grew by $7.5 billion. Credit institutions continued to raise funds on international markets largely in the form of Eurobond issues, the volume of which reached $6.0 billion (in 2012 Q1, they sold securities worth $3.4 billion). Bonds were mainly issued by credit institutions with state shareholding.

Bank foreign assets increased by $24.7 billion as compared to $10.2 billion in 2012 Q1 under the impact of several factors: a low demand for foreign currency loans on the domestic market, the placement of funds raised by other sectors[10] from external markets on Russian bank accounts abroad, and also the seasonal accumulation of foreign currency funds by residents on bank accounts at the start of the year.

[10] Other sectors include non-financial organisations, non-credit financial institutions, non-profit organisations servicing households, and households.

Operations by other sectors were almost balanced, with a negative result of $4.6 billion: foreign liabilities grew by $70.3 billion, while their external assets increased by $74.9 billion; net errors and omissions in the balance of payments totalled - $6.2 billion.

Corporate capital flows were largely influenced by operations related to the acquisition by state-controlled oil company Rosneft of a 100% stake in TNK-BP Ltd, which owned OJSC TNK-BP Holding. According to the financial statements presented by these companies, Rosneft transferred 18.5% of its shares and also almost $40 billion to TNK-BP's former owners under the deal. The first part of the transaction (the acquisition of 100% of TNK-BP Ltd) was recorded in the balance of payments as direct investment abroad amounting to $55 billion, while the second part of the deal was registered as a $15.7 billion inflow of foreign direct investment and an increase in the external debt.

The structure and dynamics of other sectors' private capital flows were also influenced by the increased activity of resident companies to issue Eurobonds, the volume of which was estimated at $10.2 billion in 2013 Q1.

The Assessment of the Russian Government Bond Market Exposure to Non-resident Risks

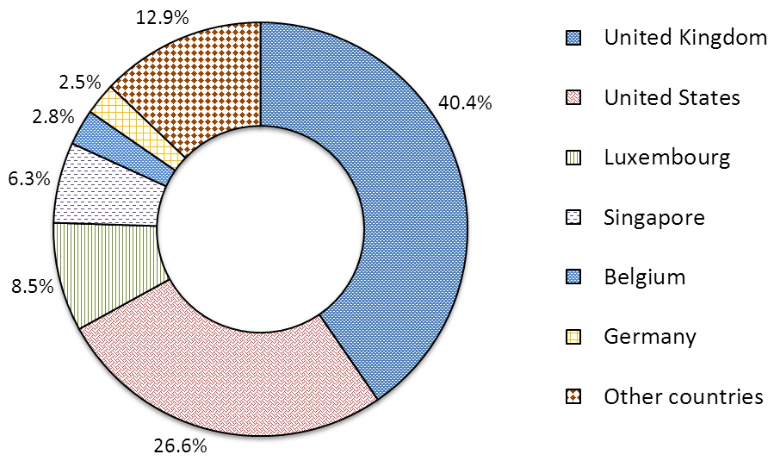
In 2013 Q1, an important event occurred on the government securities market, facilitating the development of financial market infrastructure. After necessary changes were made to the regulatory framework, the Euroclear global trading and settlement system started to offer post-trade services for OFZs. Now foreign financial institutions trading in OFZs will be able to make settlements and hold bonds using Euroclear Bank's account with the National Settlement

Depositary (NSD). Previously, non-residents also had access to the Russian sovereign debt market as they could open positions in Russia through subsidiaries or acquire rouble Eurobonds. However, they could not trade directly in instruments circulating on the domestic market as this was a market access barrier for investors facing institutional restrictions.

Market participants actively use OFZs as collateral both on the interdealer REPO market and in REPO operations with the Bank of Russia. Government securities account for about a third of the Russian banking sector securities portfolio. Developments on the OFZ market considerably influence both the money market and the banking sector as a whole through several channels: financial asset pricing, securities portfolio revaluation and current liquidity management.

Non-resident simplified access to the OFZ market has provided several obvious advantages. First of all, loans have become cheaper for the Finance Ministry of Russia. Average OFZ yields were 6.4% for one-year bonds and 8.5% for ten-year OFZs in the first half of 2012, whereas in the first half of 2013 these yields stabilised at new average quarterly levels of 5.7% and 7.1%, respectively. Secondly, the group of investors became more diversified as sovereign funds from Europe and East Asia joined the group of major OFZ holders. Thirdly, OFZs turned into global instruments, therefore internationalising the domestic debt market, an important stage in the promotion of the Russian rouble as a reserve currency. Major OFZ nominal holders using Euroclear services are registered in the United Kingdom, the United States, Luxembourg and Singapore (Chart 6).

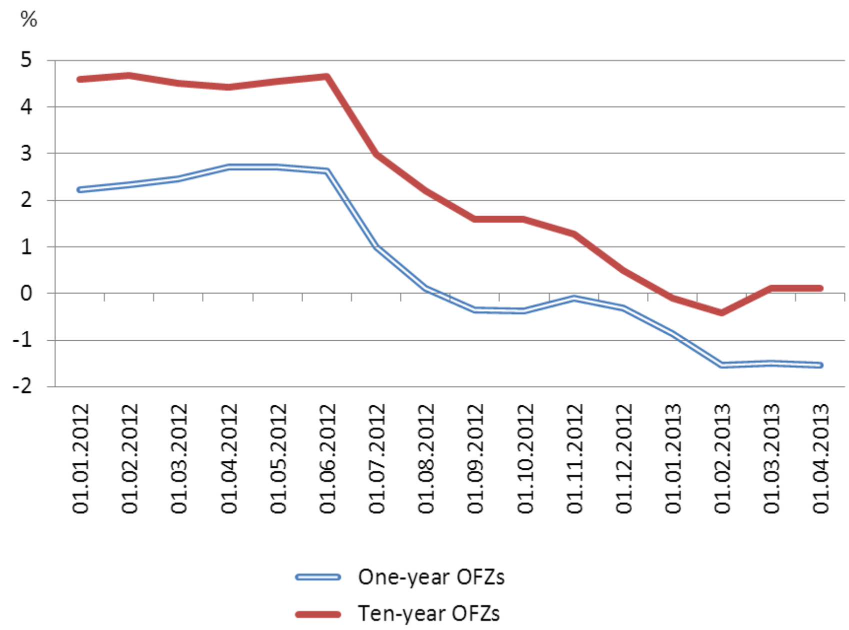
Chart 6. Regional Breakdown of OFZ Nominal Holders Registered



It should be noted, however, that the domestic debt market liberalisation for non-residents is fraught with certain risks. The most serious of them during the period of the growing presence of non-residents on the OFZ market are as follows:

- **The contraction of the volume of liquid assets available in the banking sector.** OFZs are used as collateral in the Bank of Russia refinancing operations, and also in interdealer transactions related to current liquidity redistribution within the financial sector. The level of government securities encumbrance on bank balance sheets amounted to 50% in the period under review. The transfer of a part of the OFZ portfolio to non-residents implies limited potential for resident financial institutions to build up their collateral resources.
- **OFZ negative interest rates.** The increased demand for government bonds has significantly reduced OFZ nominal and real yields. At the end of 2013 Q1, OFZ real yields stayed at -1.5% on one-year bonds and fluctuated near zero on ten-year OFZs (Chart 7). The current level of nominal yields is acceptable for non-residents, considering the low cost of their funding, while negative real rouble rates for Russian residents actually mean subsidising Russia's federal budget.
- **Distorted pricing on the corporate debt market.** OFZs are a benchmark for the private sector of the economy as they set minimum yields for rouble borrowings of major corporations and banks. A fall in interest rates on the government debt market caused a correction of yields on corporate bonds. In some cases, the cost of borrowings by issuers with ratings below investment grade fell to the level of interest rates on household rouble deposits at major banks, suggesting that investors could possibly underestimate bond investment risks, such as credit and interest rate risks, and also liquidity risk.

Chart 7. OFZ Market Real Yields



At present, the OFZ market is seen to become more dependent on external market developments and sentiments on global financial markets. It should be noted that in 1997–1998, non-resident dominance on the GKO market, along with weak government finances, triggered a collapse of the state debt market. In the event that external economic conditions deteriorate or foreign investors reduce their risk appetite as a result of negative developments in the eurozone, the OFZ market may face a price correction. First of all, this means for the banking sector a negative revaluation of the OFZ portfolio and the emergence of losses. Secondly, the OFZ value against which banks can raise liquidity may contract during a period of financial stress. Thirdly, non-resident exit from the market would step up speculative pressure on the foreign exchange market because non-residents would be expected to convert funds from OFZ sales into foreign currency.

Considering the OFZ market importance for maintaining financial stability, the Bank of Russia and the Finance Ministry of Russia have started to monitor foreign participant activities on the government securities market. According to estimates, OFZs held by non-residents accounted for at least 7% of the outstanding OFZ total volume as of July 1, 2012. In 2013, non-resident positions increased rapidly. As of February 1, 2013, non-residents accounted for 21% and as of April 1 – for already 25%[11] of OFZ portfolio (Table 4).

The Bank of Russia intends to hold regular consultations with representatives of the largest foreign OFZ holders to assess possible scenarios of their behaviour in unfavourable macroeconomic conditions.

[11] These estimates reflect the lower end of a possible range of estimates for the non-resident share on the OFZ market because available financial statements do not allow for estimating the share of non-resident OFZs placed on depositary vostro accounts of non-credit institutions offering custodian services, which is due to the absence of a resident/non-resident breakdown of transactions in the reporting Form "Information on Securities Accepted for Depository Services" of the Regulation on Reports by Professional Participants of the Securities Market.

Table 4. OFZ Holders as of April 1, 2013

Group of accounts	Par value, billion roubles	As % of total
On accounts of resident holders opened with the NSD	1,775	56
On accounts of non-resident holders opened with depositary credit institutions (except the NSD)	326	10
On accounts of resident holders opened with depositary credit institutions (except the NSD)	93	3
On vostro accounts of non-credit institutions opened with the NSD	519	16
On vostro accounts of non-residents opened with the NSD	472	15
Total	**3,185**	**100**

Note. *The calculation is based on data available in Section 1.3.1. "Securities Registered on Custody Accounts of the Depository's Customers" in reporting Form 0409711 "Statement on Securities" (for details, see the Bank of Russia Ordinance No. 2332-U of November 12, 2009, "On the List, Form and Procedure for Credit Institutions to Submit Financial Statements to the Central Bank of the Russian of the Russian Federation").*

The Impact of Global Financial Risks on the Russian Banking Sector

Highly accommodative monetary policies pursued by the world's leading central banks are creating favourable financial conditions for investment in the assets of emerging markets. Lately, global investors have made substantial investments in debt instruments, including Russian government bonds. At the same time, the Bank of Russia believes that it is premature to talk about a manifestation of **financial bubbles** on the Russian market.

The prices of financial assets in Russia considerably depend on world energy markets, which have demonstrated a considerable divergence from the dynamics of world stock markets since the start of the year. Despite the continued and steady growth of the stock indices of developed countries, world oil prices tended to decline in March–April 2013, preventing the Russian financial market from responding fully to monetary easing measures adopted in developed countries. Therefore, price trends on the Russian financial market largely reflect a slower global economic activity, which testifies to the absence of the signs of overheating on the domestic market.

The increase of the non-resident share in the Russian government bond market, as was mentioned above, testifies to the market liberalization for foreign investors. At present, this share is not critical and is only approaching an average level that is typical for emerging market countries (about 30%). At the same time, considering the potential threat of an increase of the non-resident share in the OFZ market, the regulator continues to monitor their investment, as well as **the level of banking asset encumbrance**. The risk of excessive asset encumbrance is expected to decrease, after the Finance Ministry of Russia enters the domestic foreign exchange market for purchasing foreign currency to replenish the Reserve Fund, which will improve the situation with rouble liquidity in the banking sector.

A high level of asset encumbrance may increase market risk in the event of global exits from monetary stimulus. At the same time, it seems **unlikely that the world's leading central banks will raise interest rates sharply at present**.

The direct short-term impact of higher base interest rates in major currencies on Russian bank foreign assets and liabilities will largely be determined by the nature of the yield curve shift. Considering that the average maturity of Russian bank foreign liabilities exceeds the average maturity of their foreign claims, Russian bank interest income from foreign operations will grow faster than their interest expenses, if the world's leading central banks raise base interest rates. Therefore, the direct impact of these measures in the short term is unlikely to be associated with Russian bank losses.

In the medium and long term, however, the decision by the world's leading central banks to raise base interest rates may lead to a rise in interest rates on loans to Russian borrowers, deteriorate their financial position and contribute to some increase in the level of credit risk.

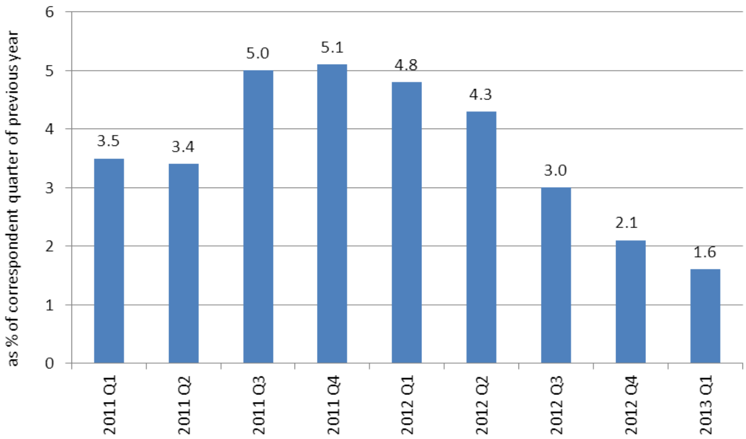
Chapter 2. Financial Stability of the Non-financial Sector

2.1. Macroeconomic Risks

Russia's economic growth continued to slow down in 2012 Q4 and 2013 Q1. According to Rosstat data, Russia's GDP increased only by 2.1% in 2012 Q4 as compared to the same period of the previous year and by 1.6% in 2013 Q1 (in the second and third quarters of 2012, Russia's economy grew by 4.3% and 3.0%, respectively), while actual output was close to its potential level (Chart 8). Industrial output expanded by 1.7% in 2012 Q4, year on year, and remained unchanged in 2013 Q1 from the same period of the previous year. According to estimates of the Economic Development Ministry of Russia,[12] the GDP will grow by 2.4% in 2013 (as compared to 3.4% in 2012) and the GDP actual volume will not exceed its potential level.

Domestic demand was the main factor of Russia's economic growth in 2012 Q4 and 2013 Q1 but this growth is slowing down largely due to the decrease in investment activity. Fixed capital investment showed a year-on-year increase of 2.1% in 2012 Q4 and 0.1% in 2013 Q1 (in 2012 Q2 and Q3, fixed capital investment grew by 10.5% and 5.3%, respectively, as compared to the same periods of 2011).

Chart 8. Real GDP Growth



Production growth was also restrained by global economic instability, including problems in the economy of the European Union as Russia's main trading partner (according to Rosstat data, the EU accounted for 50.0% of Russia's foreign trade in 2013 Q1). As a result, exports from Russia[13] continued to contract in 2012 Q4 and 2013 Q1, as compared to the same periods of the previous years, falling by 1.1% and 4.9%, respectively (in 2012 Q2 and Q3, Russia's exports decreased by 1.4% and 2.2%, correspondingly). Imports expanded, growing by 6.0% in 2012 Q4 and by 3.4% in 2013 Q1, year on year. Unless the European economy demonstrates steady improvements, the contraction of exports and the growth of imports will continue to restrict Russia's economic growth in the short term. A downward trend in oil prices may become an additional factor restraining Russia's economic growth: the average price of Urals oil equalled $111 per barrel in January–March 2013, whereas in April 2013 this price fell to $100 per barrel.

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[12] A forecast of Russia's social and economic development until 2016 (posted on April 12, 2013 on the website of the Economic Development Ministry of Russia).

[13] Based on the balance of payments methodology.

The impact of the above factors on industrial production in 2012 Q4 and 2013 Q1 caused output to contract by 11.4% in the manufacturing industry and by 2.9% in the mining sector.[14] Rosstat data suggest that insufficient domestic demand was the main factor restraining production growth in the manufacturing industry, while mining output was adversely affected by the high level of taxation.[15]

Restricted resources also impeded industrial production growth, which could be evidenced by low unemployment (according to Rosstat data, the number of jobless averaged 5.1% a month in 2012 Q4 and 5.8% in 2013 Q1) and the relatively high level of production capacity utilisation (Rosstat estimated the capacity utilisation rate in mining, manufacturing and electricity, gas and water production and distribution at an average of 65% in March 2013 and 63% in September 2012). A growth of real sector bank loans may help enterprises to build up their production capacities.

Meanwhile, the situation in many industries makes it impossible to consider a number of enterprises as reliable borrowers: production levels in the Russian economy have already exceeded the pre-crisis indicators, whereas the rate of return in some sectors (manufacturing industries, electricity, gas and water production and distribution) still remain below the 2008 level (Table 5). Due to the persisting low rate of return in some sectors of the Russian economy, banks extend loans to non-financial enterprises less actively, giving preference to retail loans.

Table 5. Production and Rate of Return by Key Type of Economic Activity

Economic activity	Industrial output growth in 2012, as % of 2008	Return on the sales of goods, products, works and services, %	
		2008	2012
Mining sector	5.4	27.6	31.1
Manufacturing industry	4.1	17.6	11.0
Electricity, gas and water production and distribution	0.4	4.7	4.6
Total	**5.4**	**14.0**	**9.7**

2.2. The Financial Standing of Non-financial Commercial Organizations[16]

The financial standing of non-financial commercial organizations (hereinafter referred to as enterprises) remained satisfactory in general in 2012, although less favourable as compared to 2011, which was attributable, among other things, to a considerable increase in differentiation of their financial situation. As before, the financial standing of enterprises in industrial production was the most favourable. In 2012, the position of Russia’s largest enterprises[17] remained quite stable, while the standing of enterprises with assets ranging from 100 million to 1 billion roubles deteriorated considerably. The financial standing of most enterprises was impaired by the shortage of funds to finance their operations.

[14] According to Rosstat calculations, in March 2013, the entrepreneur confidence index in the manufacturing industry in Russia was negative (-0.9%) but was higher than in many developed countries (for example, the manufacturing business confidence index was -9.8% in Germany and -16.6% in France in March 2013).

[15] According to a survey of business activity of enterprises in Russia (posted on the Rosstat website in March 2013).

[16] Analysis is based on official statistical data, and also the data obtained by the Bank of Russia from the regular polls of non-financial commercial enterprises in 79 Russian regions (as of April 1, 2013, the polls covered over 17,000 enterprises).

[17] Enterprises with assets of over 1 billion roubles.

Analysis of enterprises' financial results indicates that the trends of the development of the business climate[18] (Chart 9) and economic conditions[19] (Chart 10) in the non-financial sector in 2012 were virtually similar to trends in 2011, while the economic situation slightly deteriorated. Although the growth of risks to economic activity tended to slow down, they continued to exert considerable restraining influence on production. Market risks were largely related to the deterioration of the situation with finished goods inventories and the provision of enterprises with orders.

Chart 9. Business Climate Indicator in 2011–2013

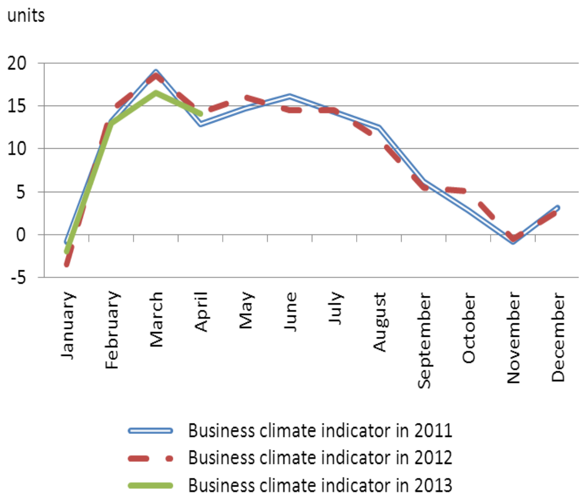
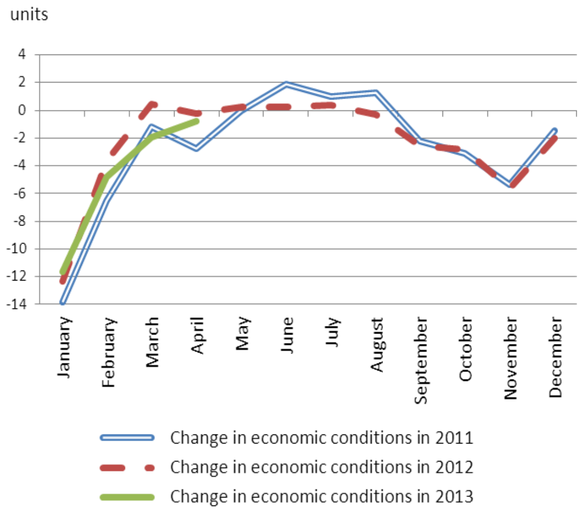


Chart 10. Economic Condition in 2011–2013



The assessment of the enterprises' financial standing in 2012 showed the following:

- The growth of assets resulting from the expansion of enterprises' activity (10.7%) was considerably slower than in 2011 (18.2%).
- Most enterprises (78% of the total number of entities covered by the survey) were profitable in 2012, although their profitability (6.8%) decreased as compared to 2011 (9.0%) under the impact of slower sales growth (revenue growth equalled 110.3% as compared to 121.0% in 2011), and also due to the deterioration of financial results.
- Enterprises' capital increased by 7.2%; however, the level of self-financing was largely unchanged both as a result of the deterioration of financial results and the low level of net profit capitalization (48.4%).
- The faster growth in liabilities (by 15.9%) did not lead to any significant increase in the debt burden on enterprises' capital, which remained generally moderate (0.76 roubles of liabilities per rouble of capital), while showing considerable differentiation, depending on the size of enterprises.
- The coverage of short-term liabilities with working assets (145.8%) remained fairly high, considering higher credit risk related to the existence of overdue and doubtful receivables.

[18] The Bank of Russia's Business Climate Indicator is a composite index which reflects actual and expected changes in production and demand determined by the assessments of enterprises (15,500 entities) covered by the Bank of Russia's monitoring. The index is based on the business climate index methodology of the IFO Institute for Economic Research (Germany).

[19] The indicator reflects a balance of answers to the question: "How has the economic situation changed in the sector as compared to the previous month?" The positive value reflects the prevalence of the answers "the situation has improved".

- Resources in the form of payables were the main source of activities. At the same time, the growth of the enterprises' need for borrowings both for current operations and investment was restrained by the deterioration of lending terms.
- Despite the increase in the funds volume by 12.0% in 2012 as a result of larger receipts and slower spending growth in the fourth quarter and an acceptable level of enterprises' solvency, funds deficit in the first nine months of the year and the growth of overdue payables by 5.5% over the year testifies to the existence of considerable liquidity risk for enterprises.

Table 6. Financial Indicators of Enterprises in Key Types of Activity in 2011 and 2012

Indicator	Agriculture, hunting and forestry		Industrial production		Construction		Wholesale and retail sale		Transport		Communications	
	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011
Debt burden (liabilities to capital ratio)	1.22	1.26	0.73	0.53	4.21	4.04	2.5	2.27	0.35	0.31	1.21	1.01
Current liquidity ratio (net of overdue receivables)	1.752	1.763	1.718	1.726	1.121	1.140	1.253	1.261	0.846	0.917	0.713	0.628
Instant liquidity ratio	0.628	0.649	1.128	1.173	0.656	0.654	0.860	0.863	0.616	0.666	0.597	0.531
Absolute liquidity ratio	0.084	0.070	0.158	0.131	0.102	0.133	0.113	0.161	0.213	0.296	0.180	0.159
Liability coverage with revenues (revenues as % of liabilities)	104.8	104.0	166.4	173.0	102.9	112.9	332.1	288.0	162.3	167.4	104.6	132.8
Annual return on assets, %	6.8	6.6	8.3	10.5	3.1	2.4	7.1	10.8	2.5	2.9	10.1	15.0
Annual net cash flow (as % of revenues)	0.8	-0.1	1.5	0.7	-0.7	4.4	-0.4	1.5	-2.4	7.0	1.8	0.1

The change in the economic situation and business climate, and also the enterprises' assessment of their economic position in 2013 Q1 were generally similar to those observed in 2012 Q1. At the same time, an assessment of indicators reflecting the dynamics of the production of goods and services in the non-financial sector in 2013 Q1, especially in January and February, suggests a deterioration of the economic situation. Industrial output in the three key types of economic activity – mining, manufacturing, and electricity, gas and water production and distribution – were considerably lower in 2013 Q1 than in the same period of the previous year. A similar trend was observed in agricultural output, freight transportation, retail trade turnover and the volume of paid services provided to the public.

Amid the deterioration in the dynamics of foreign trade, and the exports and imports of goods and services, and the continued downward trend in the orders on external markets, the volume of orders on the domestic market was observed to fall in 2013 Q1, which caused a more profound decrease in the demand for enterprises' products and services than in the same period of the previous year.

In 2013 Q1, downward trends developed in the provision of enterprises with working assets and monetary funds available during the quarter, which considerably aggravated the situation with overdue payables. The growth of the demand for bank services continued (although at a slightly slower pace as compared to the same period of the previous year), despite the persisting trend towards the deterioration of lending terms.

The enterprises' expectations of changes in their financial standing in 2013 Q1 were largely determined by the trends, which characterised the development of the non-financial sector in 2012. In 2013 Q1, enterprises considerably lowered their expectations concerning improvement in their financial standing. The predictive estimates of changes in the economic situation, provision of enterprises with orders and production dynamics generally follow the estimates of the previous years, although they suggest some deterioration signs.

The comparison of trends shows that no considerable deterioration can be expected in the financial standing of enterprises as a whole and in the key types of economic activity in 2013 Q1 as compared to the same period of the previous year, despite the effect of negative factors and the growth of risks in enterprises' activities. Liquidity risk remains substantial, although the situation with monetary funds has improved by late 2012. Considering the continued growth in the demand for banking services, credit institutions still need to pay high attention to credit risk.

2.3. Bank Loan Portfolio by Activity

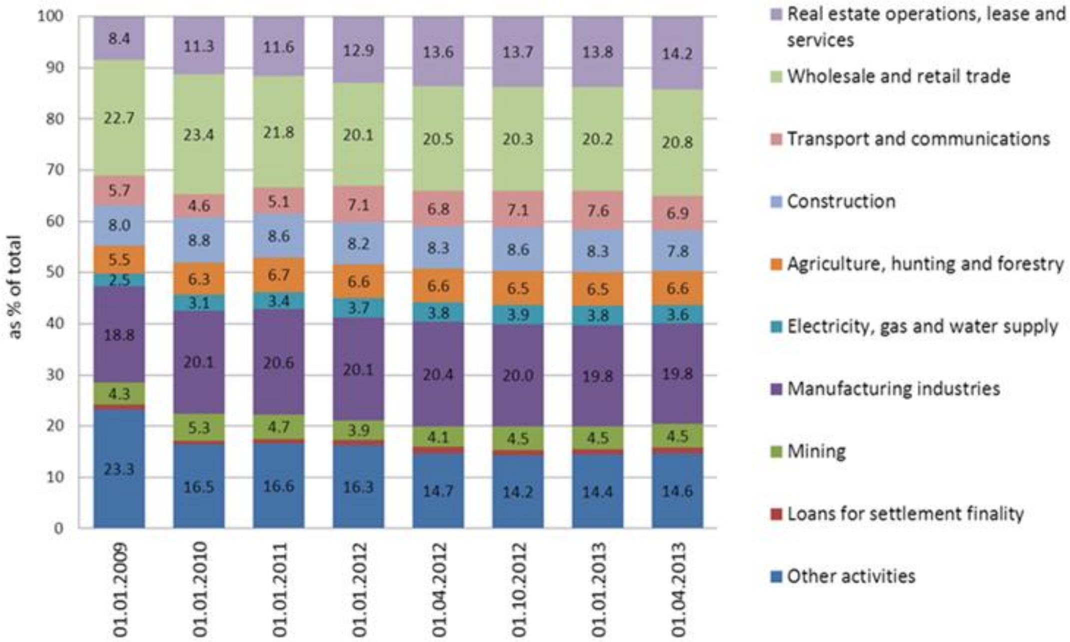
Russian banking sector's main borrowers are wholesalers and retailers, enterprises in the manufacturing sector, and also real estate, leasing and services companies. Overall, they account for about 55% of the bank corporate loan portfolio,[20] and also made the biggest contribution to the growth of the loan portfolio in 2012 Q4 and 2013 Q1 (Chart 11).

These segments of the loan portfolio, excluding loans to real estate, leasing and services companies, demonstrated a higher level of overdue debts than the corporate loan portfolio in general (4.6%) (Table 7). In particular, the share of overdue debt made up 6.2% in the portfolio of loans to wholesalers and retailers and 5.5% in the portfolio of loans to enterprises in the manufacturing industries.

In the past six months, a positive trend has been observed towards the contraction of overdue loans to trade companies (both in relative and absolute figures), largely as a result of the continued growth of retail trade turnover, which expanded by 4.9% in 2012 Q4, as compared to the same period of the previous year, and by 3.9% in 2013 Q1. For comparison, industrial output grew by 1.7% in 2012 Q4 and remained unchanged in 2013 Q1 year on year.

[20] In this section, the corporate loan portfolio means the total debt on loans to legal entities and individual entrepreneurs in roubles, foreign currency and precious metals.

Chart 11. The Portfolio of Bank Loans to Enterprises in Rubles and Foreign Currency (as of the beginning of the month)



The continued growth of trade turnover (in accordance with a forecast prepared by the Economic Development Ministry of Russia,[21] retail trade turnover is expected to increase by 4.3% in 2013), and positive dynamics in household loans may further improve the quality of the portfolio of loans to trade companies.

Overdue loans to manufacturing enterprises, on the contrary, increased: their growth equalled 15.6% and was faster than the loan growth (13.4%). Overdue loans rose amid a slower output in the manufacturing industries: in 2012 Q4 and 2013 Q1, it expanded by only 2.8% and 1.2%, respectively, as compared to the same periods of the previous years. A further deterioration of the situation in the manufacturing sector may adversely affect the quality of loans to enterprises engaged in this type of economic activity.

The highest level of overdue loans (7.3%) was registered in the segment of loans to agricultural enterprises, which is primarily explained by insufficient competitiveness of the Russian agrarian sector. Moreover, overdue loans continue to grow: their volume has risen by 8.8% in the past six months and by 35.0% in the past twelve months. This increase exceeds the growth of the portfolio of loans to agricultural enterprises, which testifies to materialisation of credit risk on outstanding loans. Nevertheless, in the estimates of the Economic Development Ministry of Russia, the standing of agricultural enterprises may slightly improve in 2013: a decline in agricultural output by 4.7% in 2012 is expected to be followed by a 6.3% growth in 2013.

Mining enterprises demonstrated the lowest level of overdue loans (1.6%). This can be explained by the fact that most borrowers are members of large vertically-integrated holding

[21] A forecast of Russia's social and economic development until 2016 (posted on April 12, 2013 on the website of the Economic Development Ministry of Russia).

companies, the situation on world commodity markets remains quite favourable and export revenues are fairly stable. In the short term, if the current conditions of mining enterprises' activities persist, their overdue loans will remain at a low level.

Table 7. Overdue Loans as % of Total Loans to Enterprises

Indicator	01.01.2008	01.01.2009	01.01.2010	01.01.2011	01.01.2012	01.04.2012	01.10.2012	01.01.2013	01.04.2013
Total, of which:	**0.9**	**2.1**	**5.8**	**5.4**	**4.7**	**5.0**	**4.8**	**4.6**	**4.6**
mining	0.8	0.7	1.0	0.9	0.7	0.7	0.7	1.4	1.6
manufacturing industries	1.2	2.3	5.9	6.3	5.4	5.4	5.7	5.5	5.5
electricity, gas and water supply	0.1	0.9	3.7	2.9	2.0	2.1	1.9	1.9	2.6
agriculture, hunting and forestry	1.0	1.9	4.3	5.6	5.6	6.3	7.1	7.1	7.3
construction	0.7	1.6	6.6	6.5	5.6	5.9	4.8	4.7	5.0
transport and communications	0.4	1.1	4.0	3.4	1.9	2.1	1.9	1.7	1.9
wholesale and retail trade	1.4	3.7	9.4	9.1	7.7	7.7	6.9	6.4	6.2
real estate operations, lease and services	0.3	1.0	4.0	3.6	3.4	3.6	3.3	3.3	3.2
other activities	0.6	6.0	4.1	2.3	3.2	4.3	4.2	4.0	3.8
loans for settlement finality	n/a	10.6	17.3	9.6	5.0	4.4	4.4	4.2	3.6

Box 2. Imbalances on the Commercial Property Market and their Impact on the Banking Sector Stability

A considerable part of banking sector assets in many countries is related to the commercial property market.[22] For example, the segment of commercial real estate lending in the United Kingdom accounts for about a half of the bank corporate loan portfolio.[23] Given the high concentration of risks in the banking sector related to the commercial property market, potential imbalances on this market may create additional threats to financial stability.

In the Russian banking sector, as of April 1, 2013, outstanding loans provided to legal entities (except banks) and individual entrepreneurs engaged in construction and real estate operations, lease and services (hereinafter referred to as commercial property loans) accounted for 22.0% of the total loans extended to legal entities (except banks) and individual entrepreneurs.[24] In addition, commercial real estate may be a pledge on loans to all sectors of the economy. Banks also finance commercial property operations through specially created subsidiaries or affiliated companies, actually becoming real estate owners. As a result, the Russian banking sector exposure to risks on the commercial real estate market is assessed as more serious than bank loans related to commercial property.

[22] Bank assets related to commercial property normally include loans extended to legal entities and individual entrepreneurs engaged in construction and real estate operations (developer activity), regardless of the type of collateral on these loans, and loans provided against commercial real estate to legal entities and individual entrepreneurs engaged in various sectors of the economy.

[23] Source: Bank of England, Financial Stability Report, December 2011.

[24] Source: the data of bank reporting Form 0409302. Commercial property overdue loans correspond to section K "Real Estate Operations, Lease and Services" of the All-Russian Classifier of the Types of Economic Activity (OKVED) and exceed the amount of overdue loans recorded under OKVED code 70 "Real Estate Operations". As a result the figure of 22% is a maximum assessment.

Therefore, the Russian banking sector is characterised by a fairly high concentration of risks related to the commercial real estate market.

As of April 1, 2013, overdue commercial property loans of Russian banks equalled 3.8%, below the level of overall overdue portfolio of loans extended to legal entities (except banks) and individual entrepreneurs (4.6%) but higher than the share of overdue housing mortgage loans (2.0%).

Commercial property space made vacant during a crisis reduces rental rates and the overall amount of rent payments, that are sources of loan redemptions. In addition, a rebound on the commercial property market is accompanied by growth in bank lending, whereas a decline and a continued post-crisis period on the market prompts the need for banks to restructure and refinance commercial property loans. According to expert estimates, 58% of global commercial property investors having bank loans in 2012 have restructured and (or) prolonged them or are holding negotiations with banks on this issue.[25] Commercial property market is characterised by relatively low liquidity, which complicates sales of pledged property or investment real estate. Statistical surveys also reveal a strong correlation between commercial property prices and the business cycle. Therefore, the commercial real estate market requires more time for recovery, while imbalances on the commercial property market have negative implications for banks. Commercial property loans will generate income for banks, if they use a balanced approach to assessing projects (borrowers), show good knowledge of the commercial real estate market situation and work out specific lending terms.

Accelerated growth of lending in construction may create imbalances on the commercial property market. As of April 1, 2013, debt on bank loans in the construction sector reached 1,554.7 billion roubles. From April 1, 2012 to April 1, 2013, the value of debt on loans grew by 9.6%, or 136.2 billion roubles in absolute figures as compared to 16.4% a year earlier (from April 1, 2011 to April 1, 2012). In addition, debt on loans in construction grew slower than the overall debt on loans of legal entities (except banks) and individual entrepreneurs engaged in all sectors of the economy: from April 1, 2012 to April 1, 2013, this indicator increased by 16.9%. A slower growth of lending in construction will eventually restrict supply growth on the commercial real estate market.

According to expert estimates, the volume of investment on the Russian commercial property market reached a record high of $8.7 billion in 2012 and in 2013 this investment is also expected to stay at a fairly high level (an estimated $7.5 billion).[26]

Construction of new offices contributed to the increase in the share of free office space in large cities. In Moscow, for example, the share of free office space grew from 3.2% in 2007 Q3 to 13.8% in 2013 Q1 (Chart 12). This share has been relatively stable since the beginning

[25] Sources: DTZ Money into Property Global, Deutsche Bundesbank.
[26] Source: Jones Lang LaSalle. Direct Purchases/Sales of Real Estate, Excluding Land Purchases, JVs, Direct Residential Sales to End Users).

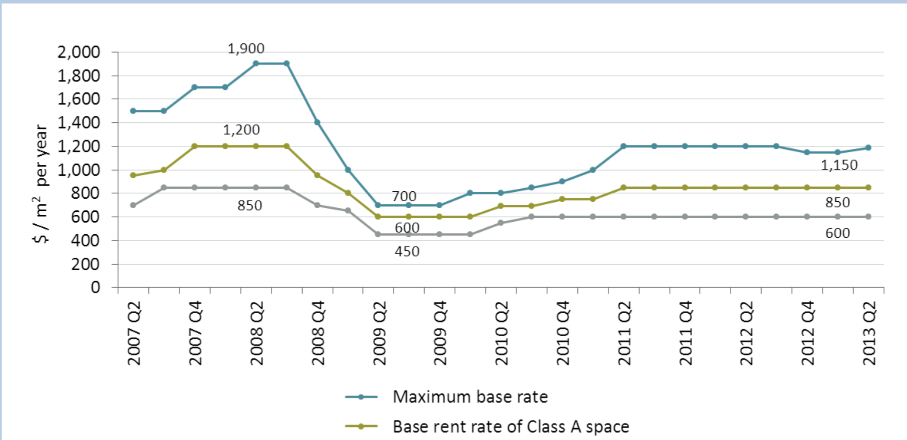
of 2010 and its decrease in some periods was compensated by the launch of new office premises. Office rental rates in Moscow stay below the pre-crisis levels and have been stable since mid-2011 (Chart 13). ***Overall, the dynamics of indicators determining demand and supply on the commercial property market testify to moderate imbalance risks on the market.***

In providing commercial property loans, banks can use best practices in reporting, contractual documentation, risk assessment and so on, for example, the standards and practices published by the Commercial Real Estate Financial Council (CREFC)[27] and the Loan Market Association (LMA).

Chart 12. Office vacancy rates in Moscow (2013 – forecast)

Source: Jones Lang LaSalle.

Chart 13. Rental Rates in Moscow (2013 – forecast)



Source: Jones Lang LaSalle.

[27] The CREFC-recommended standards: CREFC Investor Reporting Package (IRP, U.S. and EU Version), CREFC Special Servicing Disclosure Reports, Pooling and Servicing Agreement (PSA), CREFC Model Representation & Warranties, Principles-Based CRE Loan Underwriting Framework.
The CREFC standards at the stage of development: Term Sheet Standardization, Standardization of Master and Special Servicer Credit Rating Agency, Revise CREFC CMBS Loan Watch List Criteria, Best Practices for REO and Loan Liquidation Transparency Reports, CREFC Surveys, CREFC E-Primer.

In addition, banks can reduce the risk of loan portfolio concentration in the segment of commercial real estate by setting internal limits, depending on the total value of debt on loans and the bank capital. Along with limiting the aggregate position on commercial property loans, specific limits can be set on some of its parts that have common characteristics and show similar sensitivity to market developments.

Chapter 3. The Assessment of Banking Sector Systemic Risks

3.1. General Trends

Banking sector total assets grew by 8.7% in 2012 Q4 and 2013 Q1 to 49.8 trillion roubles. The growth of assets was largely caused by the increase in customer funds: household deposits, and funds of legal entities (except banks). The annual asset growth amounted to 20.0% as of April 1, 2013 and continued to exceed the growth rate of bank capital (17.1%). Five banks among Russia's largest banking institutions made the main contribution to banking sector capital growth. In the period under review, these banks contributed to 56.0% of the growth of bank capital in a group of banks with rising capital, whereas in 2012 Q2 and Q3 these five banks contributed 35.0%.

Capital adequacy ratio. The banking sector capital adequacy ratio slightly increased in 2012 Q4 but continued its slide in early 2013: it fell from 13.7% as of January 1, 2013 to 13.4% as of April 1, 2013. This decrease was largely attributed to changes in market risk measurement enforced from February 1, 2013 (in 2013 Q1, the value of market risk used for measuring the N1 ratio increased by 51.8%). Banks may face further pressure on their capital due to the planned introduction of new capital requirements. In particular, on March 1, 2013, the Bank of Russia Regulation came into force specifying a methodology of capital calculation and capital adequacy assessment for credit institutions to implement new capital quality and adequacy standards in compliance with Basel III requirements. From April 1, 2013 to January 1, 2014, banks will make calculations under the new requirements solely for informing the regulator and from January 1, 2014, capital adequacy ratios will be calculated for prudential purposes. The intended timeframe for implementing Basel III provisions was rescheduled from October 1, 2013 to January 1, 2014 to give banks more time to adapt to the new capital requirements and introduce Basel III simultaneously with the European Union and the United States.

Liability structure. In 2012 Q4 and 2013 Q1, household deposits grew faster than corporate deposits (12.9% and 5.9%, respectively). The difference in the growth rates, however, did not cause any substantial change in the liability structure. The share of deposits attracted from legal entities (except credit institutions) fell from 19.4% to 19.0% of bank liabilities, whereas the share of household deposits rose from 28.5% to 29.6%. In absolute terms in the structure of bank liabilities funds raised from the Bank of Russia contracted the most. In 2012 Q4 and 2013 Q1, banks reduced their debts to the regulator by 123.4 billion roubles (a decrease of 5.3%). As a result, the share of the Bank of Russia funds in bank liabilities fell from 5.1% to 4.5%.

Asset structure. The main changes in the asset structure are related to the bank loan portfolio. The growth of lending to non-financial organisations amounted to 10.0% in 2012 Q2 and Q3 and only 3.6% in 2012 Q4 and 2013 Q1. As a result, the share of loans to non-financial organisations contracted in bank assets from 42.5% to 40.5% as of April 1, 2013. Retail loans made the biggest contribution to the bank loan portfolio growth. Household loan portfolio growth is also slowing but remains relatively high (12.8%). As a result, the share of loans to households continues to increase (16.2% as of April 1, 2013 and 15.6% as of October 1, 2012). The interbank loan market rebounded: the growth of interbank loans amounted to 20.3% in 2012 Q4 and 2013 Q1. The share of this segment in the asset structure grew from 8.3% to 9.2%.

3.2. Household loans

The general state of the household loan market: volume, dynamics, segment analysis, yields

In 2012 Q4 and 2013 Q1, bank operations growth on the household loan market slowed down considerably: household loan portfolio increased only by 12.8% in the period under review, representing a decrease by 8.8 percentage points as compared to 2012 Q2 and Q3. The quarterly loan growth registered in 2013 Q1 (4.7%) was the slowest in the past two years.

Apart from the seasonal factor typical for the first quarter, the household loan market growth was largely restrained by slower economic development and business activity, as well as the low level of the bank capital adequacy ratio. To a certain extent, market growth was restricted by the Bank of Russia measures to regulate risks on the household loan market.[28] As a result, the annual loan growth decreased to 37.4% as of April 1, 2013 from 40.6% as of the same date in the previous year (Chart 14).

Despite the slower market growth, the volume of loans extended to households exceeded 8 trillion roubles as of April 1, 2013 and reached 16.2% of banking sector assets (15.6% as of October 1, 2012). At the same time, the annual growth of household loans is almost three times faster than the growth of loans to legal entities (except credit institutions), that account for 40.5% of assets.

Chart 14. The Value and Annual Growth of Household Loan Portfolio in 2011–2013

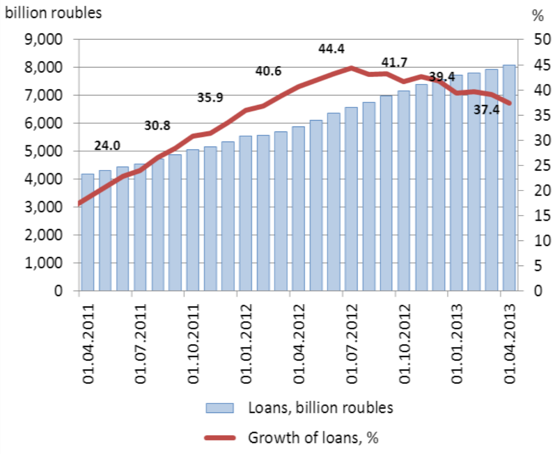


Chart 15. Annual Growth of Household Loans by Lending Segment

By April 1, 2013 the structure of the household loan market didn't change compared to the beginning of 2012 Q4: homogeneous loans in the segment of "other consumer loans"

[28] *Starting from March 1, 2013, the Bank of Russia raised minimum provisions for unsecured loans issued from January 1, 2013: to 2% for the portfolio of loans without overdue payments and to 6% for loans with overdue payments of no more than 30 days. It also introduced a new minimum reserve requirement for portfolios of loans with overdue payments of over 360 days (100%). For consumer loans extended after July 1, 2013, with the effective interest rate higher than 25% per annum, higher capital adequacy ratios will be applied.*

accounted for about 61.5% of total household loans, mortgage loans – 22.1%, auto loans – 10.1% and housing loans (except mortgage loans) – 6.3%.[29]

Despite a two-fold decrease in the rate of growth in household loans in the first three months of 2013, “housing loans” segment outpaced other segments in the growth of the loan volumes (12.6% in 2012 Q4 and 5.8% in 2013 Q1). In addition, quarterly loan growth rates were observed to slow down almost two-fold in early 2013 in the segment of mortgage loans (3.6% in 2013 Q1 compared to 7.0% in 2012 Q4) and auto loans (3.1% and 5.6%, respectively). Loan volumes in the segment of “other consumer loans” grew by 5.6% in 2013 Q1, or 1.5 times slower than in the previous quarter. At the same time, this segment is the leader by the annual growth of the homogenous loan portfolio (as of April 1, 2013, this growth amounted to 47.3%, representing a decrease by 9.7 percentage points as compared to the same period of 2012).

The volume of interest income received by banks from their operations with individuals in 2012 Q4 and 2013 Q1 (686 billion roubles) was by 21.5% higher than their income from lending activity in 2012 Q2 and Q3.[30] The average nominal interest rate on loans to individuals[31] rose by 0.71 percentage point in 2013 Q1 to 21.06%. The nominal interest rate also showed a substantial increase in January 2013 when it rose to 21.31%, registering the highest level since March 2010 (Chart 16). This trends were registered despite the fact that household credit activity is normally observed to decline in January. The actual yield on loans[32] over the same period slightly contracted to 17.6% due to the smaller volume of loans extended by banks amid the growth of problem loans (Chart 17).

Chart 16. Quarterly Average Loan and Deposit Rates for All Maturities

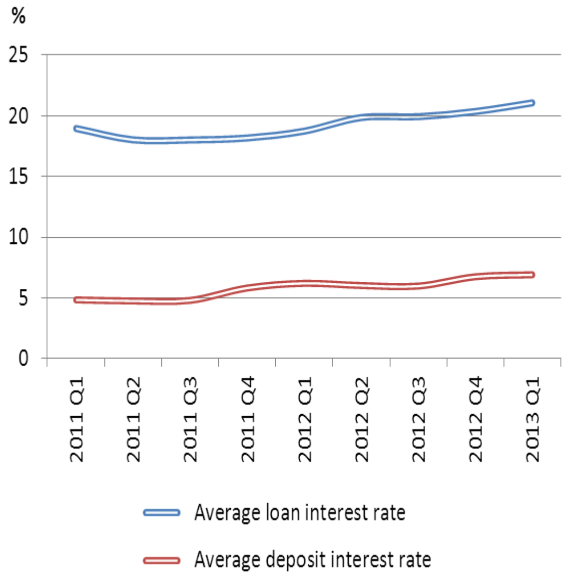
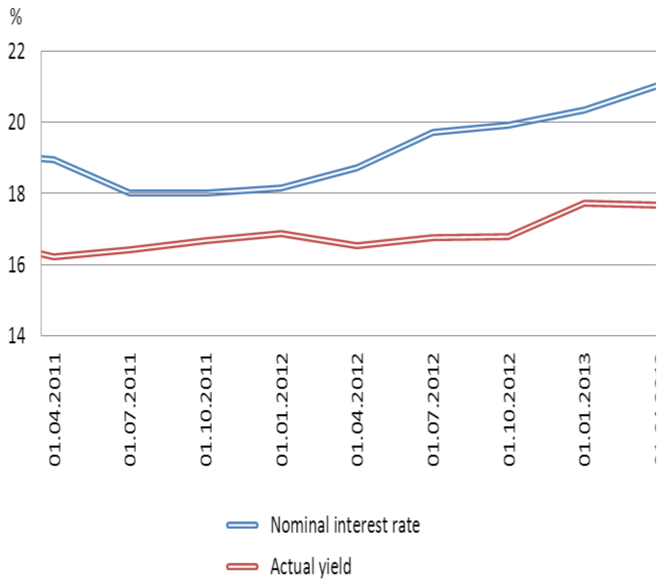


Chart 17. Yields on Household Loan Portfolio in 2011–2013



[29] Segment analysis of the household loan market was based on the reporting Form 0409115 “Information on the Quality of Bank Assets”. “Other consumer loans” comprise purpose/non-purpose loans issued in cash; loans extended via bank cards; POS credits (loans extended for the purchase of specific goods/services directly at points of sale) and other unsecured loans.
[30] Based on the reporting Form 0409102 “Bank Profit and Loss Statement.”
[31] The banking sector average-weighted interest rate on loans with all maturities extended to individuals as per reporting Form 0409128 “Data on Average-weighted Interest Rates on Funds Provided by Credit Institutions”.
[32] The ratio of interest income received by banks on loan operations with individuals to the average-quarterly volume of loans.

Quality of Household Loan Portfolio

The volume of overdue household loans totalled 344.4 billion roubles as of April 1, 2013, demonstrating an increase of 9.9% in 2013 Q1, that was almost two times faster than the household loans growth rate over the same period. Considering the growth rate of overdue loans in 2012 Q4 was negative and, consequently, substantially below the growth rate of the loan volumes, those indicators compared for 2013 Q1 testify to the materialisation of credit risk on outstanding loans amid a slower growth in the loan portfolio. As a result, the share of overdue loans amounted to 4.2% as of April 1, 2013 (4.4% as of October 1, 2012).

The share of problem and bad loans (IV–V quality categories) in the total volume of household loans was virtually unchanged from the beginning of 2012 Q4 and stood at 6.9% as of April 1, 2013. These loans demonstrated a substantial increase in their volume, that grew by 12.04% in 2013 Q1, whereas quarterly growth in the loan volume did not exceed 7.0% in the past three years and the average growth over this period equalled 1.85%. Actual loan provisions for IV-V quality categories loans totalled 5.6% of the household loan portfolio as of April 1, 2013 (as compared to 5.4% as of October 1, 2012). Therefore, about 80% of bad loans were covered by provisions.

Chart 18. The Value and Annual Growth of Household Overdue Loans

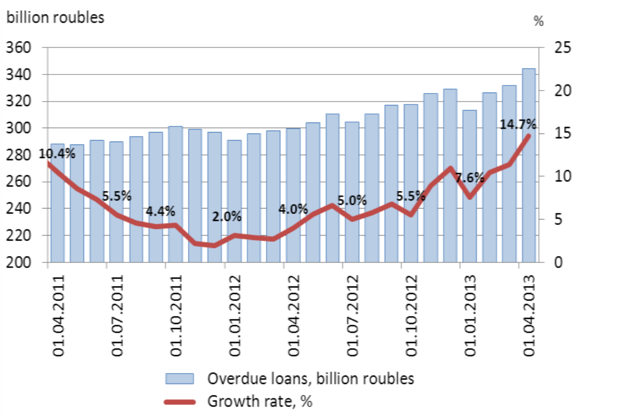
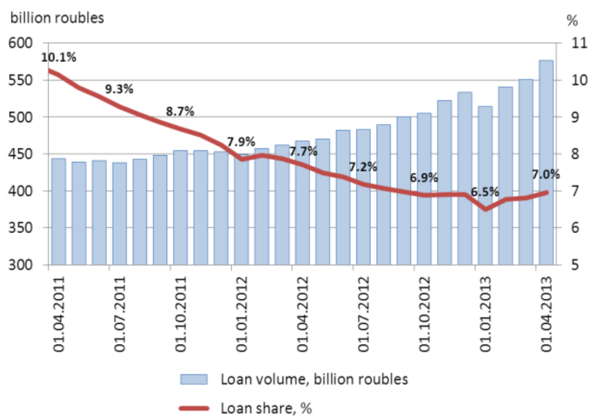


Chart 19. Loans of IV–V quality categories in Absolute and Relative Values



Faster growth in the volume of household loans increases the risk of market overheating and may eventually cause defaults on loans and a considerable deterioration in the loan portfolio quality, as unsecured consumer loans dominate the market. In the future, credit quality of bank portfolios can be expected to deteriorate further.

Active Participants on the Household Loan Market

Banks specialising in household loans were surveyed to analyse their activity in 2012 Q4 and 2013 Q1. As in 2012 Q2 and Q3, selection criteria for choosing banks for the survey were the following:

1) the value of the loan portfolio exceeds 5 billion roubles;

2) the ratio of household loans to bank assets is over 40%;

3) the share of interest income from household loans is over 50% in the total interest income.

As of April 1, 2013, the sample comprised 31 credit institutions (32 banks as of October 1, 2012). Their household loan portfolio accounted for 31.7% of the market and their assets accounted for 8.6% of banking sector assets (30.2% and 8.1%, respectively, as of October 1, 2012).

Results of the analysis of the sampled banks' activities in the period covered by the survey are the following:

- Growth on the household loan market generally tended to slow down, whereas the sampled banks demonstrated the opposite trend: the annual growth in loans accelerated from 46.5% as of October 1, 2012 to 48.4% as of April 1, 2013.
- In 2012 Q4 and 2013 Q1, the level of overdue loans of the sampled banks continued to be higher than the same indicator for the whole market (5.7% and 4.3%, respectively, as of April 1, 2013). At the same time, the number of banks with the level of overdue loans exceeding 6.0% increased to 7 (from 6 in the sample as of October 1, 2012).
- The level of loan loss provisions created by active market participants for loans of IV-V quality categories was 77.5% as of April 1, 2013, that was lower than the level of the market as a whole (80.4%).
- In 2012 Q4 and 2013 Q1, the liabilities structure of the sampled banks did not change significantly: as before, the main sources of liabilities were household deposits (51.2% as compared to 29.6% of banking sector liabilities as of April 1, 2013), corporate funds, excluding funds of credit institutions (14.7% and 20.2%, respectively) and credit institution funds (9.0% and 9.2%).
- As was the case on October 1, 2012, on April 1, 2013 the average value of the sampled bank capital adequacy ratio was higher than for the banking sector as a whole (15.6% as against 13.4%). A smaller number of sampled banks demonstrated downward capital adequacy ratio dynamics (19 out of 31 banks as of April 1, 2013 as against 22 out of 32 banks as of October 1, 2012).
- In 2013 Q1 the return on assets for the sampled banks continued to be higher than for the banking sector as a whole, averaging an annualised 5.7% compared to 2.1% for the banking sector. Growth was also registered in the number of banks showing the return on assets of over 10.0% (6 out of 31 banks compared to 4 out of 32 banks in 2012 Q3).
- The weighted average interest rate on rouble loans extended by sampled banks to individuals in 2013 Q1 rose to 27.5% (21.1% in the banking sector). At the same time, the average interest rate on household rouble deposits attracted by these banks slightly decreased to 7.1% (6.9% in the banking sector).

Owing to the active growth of the household loan market, banks with the increased concentration on consumer lending are now in the risk area. These banks finance their operations largely through household deposits, which may lead to negative implications. High loan rates allow these banks to set high deposit rates, this fact deteriorates the market position of banks that grant credits to the real sector of the economy at lower rates and increases risks of the deposit insurance system (and in the end taxpayer risks).

3.3. Results of Macro-model-based Stress Testing of the Banking Sector

The Bank of Russia conducts macro-model based stress testing on a semi-annual basis using the top-down approach. The calculation, that was made using reporting data as of January 1, 2013, covered all operating credit institutions and was based on two macro-scenarios with characteristics reflecting the estimates of the possible impact of negative global economic developments on the Russian economy. The worst-case scenario assumes a considerable slowdown of Russia's economic growth as a result of a slower global GDP growth and a fall in the world oil prices and other Russian export commodities by 25-30%. The slack economic development is accompanied by a moderate rise in interest rates on the Russian financial market and some decrease in stock indices. The extreme scenario (the worst possible development) envisages an even more significant contraction of GDP and large-scale changes on the financial market. The main characteristics of the scenarios are given in Table 8.

Table 8. Stress-testing Parameters

Indicator, %	Worst-case scenario	Extreme scenario
GDP growth	1.2	-5.0
Consumer price index	6.0	5.0
Growth of foreign direct investment	3.2	-9.0
Growth of household real money income	3.6	-1.0
Growth of the value of the dual-currency	10	20

The assessment of losses, that operating credit institutions may incur, was made relative to three major risks: credit risk, market risk and liquidity risk.

Calculations show that as of January 1, 2013, banking sector losses may amount to 1.5 trillion roubles (25% of banking sector capital) under the worst-case scenario and 2.6 trillion roubles (42% of capital) in the extreme scenario.

Stress test calculations assume that credit institutions will continue to operate even under stress conditions and conduct operations allowing them to generate income; however, the scope of this activity is adjusted for the level of stress. Therefore, the banking sector financial result adjusted for the above losses may amount to 600–700 billion roubles under the worst-case scenario and 100-150 billion roubles in the extreme scenario.

Calculations show that a capital deficit of about 450 billion roubles under the worst-case scenario may be experienced by 236 credit institutions and, correspondingly, a capital deficit of about 580 billion roubles in the extreme scenario may affect 308 credit institutions. As of January 1, 2013, these credit institutions accounted for 26% of banking sector assets under the worst-case scenario and 34% in the extreme scenario.

The stress tests indicate that banking sector capital adequacy ratio may decrease to 11.1% under the worst-case scenario and 10.6% in the extreme scenario. This means that the Russian banking sector can withstand serious shocks in the case of a crisis.

The macro-model-based scenario analysis in stress test calculations using reporting data as of January 1, 2013 also considered contagion risk (the so-called domino effect) on the interbank loan market as an additional condition for the above scenarios.

According to scenarios if this risk accures the number of banks experiencing capital deficit may reach from 37 to 54 banks (these banks hold from 1% to 7% of the banking sector assets), from 36 to 80 banks may experience liquidity shortage (from 4% to 9% of assets). The capital deficit may range from 20 billion roubles to 40 billion roubles and liquidity shortage – from 100 billion roubles to 200 billion roubles under the above scenarios.

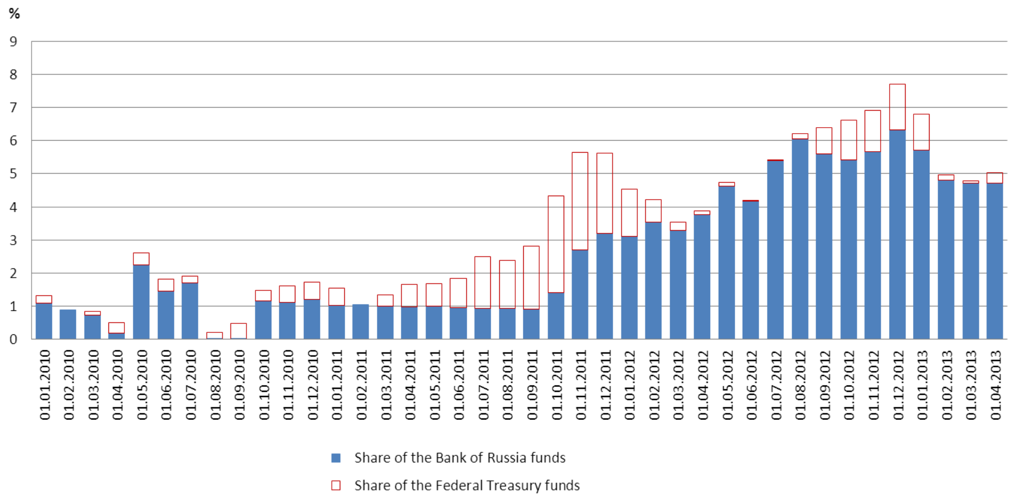
3.4. Banking Sector Liquidity Risks

Stabilisation of the share of the Bank of Russia and the Federal Treasury funds in banking sector liabilities

The increase in the share of the Bank of Russia and the Federal Treasury funds in the structure of banking sector liabilities, that was mentioned in the previous issue of this survey, continued in October-November 2012. As a result, the Bank of Russia and Federal Treasury funds accounted for about 7.7% of banking sector liabilities as of December 1, 2012 (Chart 20).

Absorption of a large volume of funds on budget accounts with the Bank of Russia was the main factor that increased the demand of credit institutions for the Bank of Russia refinancing in the first two months of 2012 Q4. Therefore, growth in the share of the Bank of Russia and the Federal Treasury funds in banking sector liabilities was primarily attributable to the specifics of Russia's fiscal policy and did not testify to any crisis events. For comparison: this share was considerably higher in the last two months of 2008 (8.6% as of November 1, 2008 and 10.0% as of December 1, 2008).

Chart 20. The Share of the Bank of Russia and the Federal Treasury Funds in Bank Liabilities



At the end of December 2012, the banking sector registered a considerable inflow of funds from the budget system. As a result, the share of the Bank of Russia funds in the banking sector liabilities had fallen to 5.4% by early January 2013 as compared to 6.0% as of December 1, 2012. The downward trend in the volume of debt to the Bank of Russia continued in January 2013 due to the seasonal contraction in the amount of money in circulation. In addition, the volume of funds deposited by the Federal Treasury with banks was considerably smaller in January 2013 (less than 100 billion roubles as of February 1, 2013 as compared to 504 billion roubles as of January 1, 2013), which was the consequence of the improved liquidity situation in the banking sector.

In February–March 2013, the share of the Bank of Russia funds in banking sector liabilities stood at the level of 4.7% – 4.8%. From February to late April 2013, banks used REPO operations with the Bank of Russia to replace loans extended against non-market assets and guarantees. As a result, the market asset utilisation ratio based on the polling data of 40 major banks[33] increased to 60% as of early May (for more details, see the Section "Bank Collateral Adequacy").

The share of Bank of Russia funds in banking sector liabilities was higher on average in the first four months of 2013 than in the same period last year. In the second half of the year, banks are expected to show traditionally stronger demand for liquidity due to the considerable absorption of banking sector funds on budget accounts. Considering that the market asset utilisation ratio has reached fairly high levels, it is likely that banks will soon return to using mostly medium-term refinancing instruments (loans against non-market assets and guarantees). Money market rates can be expected to stay at the level exceeding the Bank of Russia REPO auction minimum rate (the Ruonia interest rate stood at about 6% in April 2013) because the cost of borrowings based on medium-term refinancing instruments exceeds the cost of money raised in short-term REPO operations with the Bank of Russia (overnight and one-week maturity).

In general, as of early May 2013, the banking sector had sufficient unutilised potential for refinancing to cope with possible liquidity shocks. The polling results as of the end of April 2013 show that 40 largest banks accounted for about 1.1 trillion roubles of the unused potential of refinancing against market assets, while the unutilised potential of refinancing against non-market assets and guarantees was estimated at over 2 trillion roubles. Therefore, there are currently no prerequisites for systemic liquidity deficit, while liquidity risks for major credit institutions are insignificant.

Bank collateral adequacy

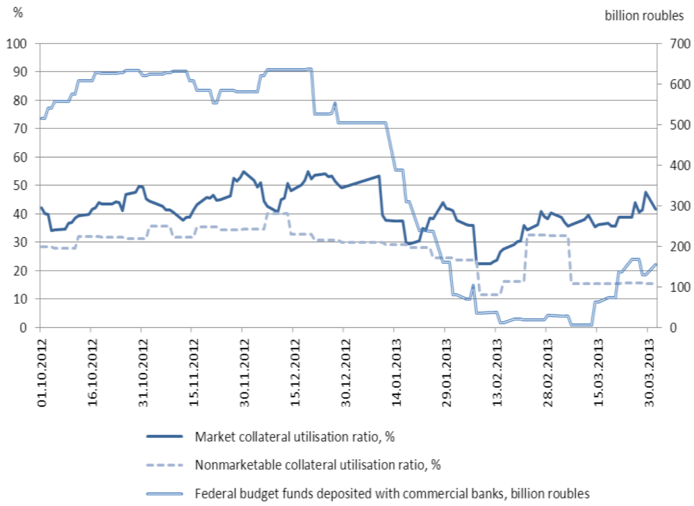
The Bank of Russia focuses on regular assessments of the refinancing potential due to the persisting large volume of bank debt to the Bank of Russia. For this purpose, the regulator uses the so-called collateral utilisation ratios – the ratio of bank debt to the Bank of Russia on a specific refinancing instrument to the overall volume of collateral, available for the use by banks to get refinancing through this instrument. At present, the Bank of Russia calculates two utilisation ratios:[34] the utilisation ratio of market assets (used for refinancing through REPO operations with the Bank of Russia) and the utilisation ratio of non-market assets and guarantees (used for refinancing through secured loans of the Bank of Russia).

[33] In addition to Russia's 30 largest banks in accordance with the list published on the Bank of Russia's website, from September 2012 the list of polled banks also includes 10 most active credit institutions on the money market outside the group of top thirty banks.
[34] The utilisation ratios are calculated using the data of a regular poll of the largest credit institutions. Therefore, the value of these ratios is an approximate estimate of collateral utilisation in the banking sector as a whole.

The growth of utilisation ratios indicates a decrease in the share of unutilised collateral in the overall volume of collateral available to banks for refinancing. Some credit institutions may start to experience difficulties with the Bank of Russia refinancing when the banking sector utilisation ratio is considerably less than one due to uneven collateral distribution.

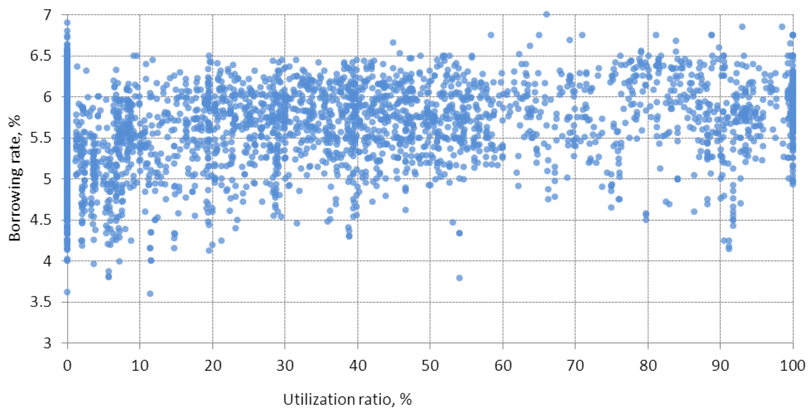
In 2012 Q4 and 2013 Q1, REPO operations with the Bank of Russia remained the main instrument of refinancing for credit institutions: their debt on this instrument varied from 800 billion roubles to 2.0 trillion roubles, while the market asset utilisation ratio ranged from 25% to 50% (Chart 21). The utilisation ratio of non-market assets and guarantees remained below the market asset utilisation ratio in 2012 Q4 and 2013 Q1 and varied between 15% and 35% during most of this period.

Chart 21. Collateral Utilisation Ratios and Federal Budget Funds Deposited with Commercial Banks in 2012 Q4 and 2013 Q1



Theoretically, the increase of the utilisation ratio may trigger growth in money market rates because credit institutions are likely to show higher demand for liquidity on the interbank loan market, once they have used up their possibilities of raising funds from the Bank of Russia against market assets.

Chart 22. Unsecured Rouble Borrowing Rates for Major Banks and the Utilisation Ratio in 2012 Q4 and 2013 Q1



The refinancing potential based on the polling data of 40 major banks and active money market participants stood at slightly less than 5 trillion roubles[35] as of April 22, 2013, while the volume of assets eligible for use as collateral, according to the banking sector's reporting data, totalled 5.3 trillion roubles (excluding the possibility of raising funds against guarantees) (Table 9).

At present, the potential to extend the REPO list with issued securities is limited: the REPO list covers about three-fourths of bond issues traded on the Moscow Stock Exchange and virtually three-fourths of the securities portfolio held by banks (by volume based on the current market value).

Table 9. The Volume of Assets (Including Guarantees) Potentially Available for Use for Bank of Russia Refinancing, trillion roubles

Assets	Polling data		Reporting data	
	as of January 1, 2013	as of April 22, 2013	as of January 1, 2013	as of April 22, 2013
Market assets	2.5	2.8	3.7	3.9
Non-market assets[36]	1.4	1.4	0.9	1.3
Guarantees	0.7	0.7	–	–
Total	**4.6**	**4.9**	**4.6**	**5.2**

According to estimates based on the April 2013 data, the value of marketable collateral held by credit institutions (adjusted to the Bank of Russia REPO discounts) expanded since 2012 Q3 due to the increased volume of debt securities included into the REPO list (their value was estimated at 3.4 trillion roubles in September 2012).

Table 10. The Value of Marketable Collateral Available to Banks as of April 1, 2013, trillion roubles

Collateral	Outstanding volume	On bank balance sheet	On bank balance sheet (conservative estimate)[37]
Debt securities	7.4	3.9	3.7
Equity securities	4.1	0.1	0.1
Total	**11.5**	**4.0**	**3.8**

Note. *The data were calculated taking account of the Bank of Russia REPO discounts; outstanding debt securities doesn't include Russian Eurobonds; conservative estimate recognises that some collateral is held by banks which are not engaged in Bank of Russia REPOs.*

[35] Taking into account the possibility of raising funds against bank guarantees.

[36] The estimate based on polling data comprises the volume of refinancing, which banks can obtain from the Bank of Russia in compliance with Bank of Russia Regulation No. 312-P of November 12, 2007, "On the Procedure for Extending Bank of Russia Loans to Credit Institutions Secured by Assets or Guarantees," taking into account acceptable security in the form of bills and credit claims, whereas the estimate based on bank statements comprises only the volume of refinancing against collateral already provided to the Bank of Russia.

[37] The data cover only banks engaged in the Bank of Russia REPOs.

3.5. Results of Stress Testing of Russian Banks' Liquidity to Assess the Liquidity Coverage Ratio under Basel III

In 2010, the G20 countries approved Basel III - the regulatory framework for banks developed by the Basel Committee on Banking Supervision (BCBS). Apart from changing the definition of capital and including additional capital requirements, the BCBS introduced two liquidity ratios: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). In January 2013, the BCBS issued finalised regulatory standards on liquidity (Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, January 2013).

Compliance with the LCR ratio should ensure that a bank, which is confronted with the withdrawal of borrowed funding in a stress scenario, has an adequate stock of unencumbered high-quality liquid assets to meet its liquidity needs over the next 30 calendar days. The numerator of the LCR is the stock of high-quality liquid assets (HQLA), that are divided in accordance with their quality by the Level 1 assets (cash, bank funds on correspondent accounts with the Bank of Russia and the highest quality securities, in particular, sovereign and central bank bonds, that are assigned a 0% risk-weight), Level 2A[38] and Level 2B[39] assets (Level 2 assets as a whole and Level 2B assets are limited to a maximum share of 40% and 15% of HQLA, respectively). The denominator of the LCR is total net cash outflows (outstanding balances of liabilities multiplied by the rates set by the BCBS net of cash inflows from receivables). The finalised LCR standards provide for the LCR implementation from January 1, 2015 but the minimum requirement will be set at 60% in the first year and rise by 10 percentage points each subsequent year to reach 100% on January 1, 2019.

As part of ongoing LCR monitoring (the monitoring period of 2011–2014), an assessment of LCR for Russian banks in 2013 Q1 was made. At present, this calculation is for information purposes only because LCR supervision reporting has not yet been introduced. Calculation are based on the most conservative assumptions stipulated by Basel III. In the future, LCR assessments are expected to be done on a quarterly basis.

As of April 1, 2013, the banking sector's LCR calculated in compliance with Basel III averaged 47%, while the option to include in the list of HQLA potential central bank refinancing (specifically, refinancing against securities from the Bank of Russia Lombard List and also against non-market assets) may increase this figure to 77%.

Analysis of the banking sector's HQLA structure (given potential refinancing from the Bank of Russia) showed the predominance of Level 1 assets, that accounted for about 59% of the banking sector's HQLA. This category comprised cash (21% of HQLA), correspondent accounts and "demand" and "overnight" deposits with the Bank of Russia (17%), and also securities (21% of HQLA), mostly government bonds. About 29% of HQLA are made up of the Bank of Russia potential refinancing against securities from the Lombard List that fail to meet the Basel III

[38] Level 2A assets include, in particular, corporate bonds (excluding obligations of financial institutions) with credit ratings of at least AA-, and also debt obligations of foreign governments, foreign central banks and multilateral development banks, which are assigned a 20% risk-weight under the Basel II standardised approach for credit risk.

[39] Level 2B assets include, in particular, corporate bonds (excluding obligations of financial institutions) with credit ratings between BBB- and A+ and common equity shares, which comply with the Basel II qualifying criteria.

criteria for inclusion in the group of Level 2B assets, and also against the pledge of non-market assets. Assets complying with the Basel III qualifying criteria for inclusion in Level 2B account for about 12% of HQLA. The share of Level 2A assets mainly comprising highly rated corporate securities (AA- and above, according to the S&P rating scale) is inconsiderable.

Funds provided by non-financial organisations account for about 44% of the banking sector outflows, followed by household funds (14%) and funds of financial organisations, excluding banks (13%). Outflows related to interbank loans account for about 8% of total outflows. Inflows from loans to customers categorised as “reliable” borrowers, and also inflows from interbank loans make the biggest contribution to the structure of inflows (about 90%).

Box 3. Consolidated Financial Stability Indicator

The consolidated financial stability indicator is aimed at measuring the ability of the financial system to perform its functions in a qualitative and continuous manner. The higher the indicator, the lower the risks of disruptions in the work of the financial system. The consolidated financial stability indicator was built up using the principal component analysis.

From the standpoint of disruption risks, the state of the financial system is characterised by three areas based on the effect of three major financial stability factors: the banking and market factors, and also the real sector factor.

The first factor aggregates six indicators: the bank capital adequacy ratio, the growth of overdue bank loans to legal entities (except credit institutions) and individuals, the rate of increase in the balances of correspondent and deposit accounts with the Bank of Russia relative to banking sector assets, banking sector return on equity, the rate of growth in banking sector assets, the market asset utilisation ratio (the share of securities accepted as collateral for the Bank of Russia refinancing in the total volume of market collateral available to banks participating in refinancing operations).

The market factor is also characterised by six indicators: the rouble/dollar exchange rate, the volume of Russia’s international reserves, MIACR o/n - the overnight interbank loan rate, Micex 10 - the index of the ten most liquid Russian stocks traded on the Moscow Stock Exchange, VIX - the volatility index measuring investor expectations of index swings on the Moscow Stock Exchange, CBONDS - the index of corporate bond yields. The real sector factor is characterised by four indicators: the consumer price index, the real output index, the growth of overdue loans to legal entities, and the rouble real effective exchange rate.

Data in each group of indicators are generalised using the first principal component of the principal component analysis. The data were preliminarily cleared of the trend and standardized for the purpose of the analysis.

The dynamics of financial stability factors are given in Chart 23. The consolidated financial stability indicator measuring the joint impact of factors on the state of the financial system is shown in Chart 24.

Chart 23. Financial Stability Factors

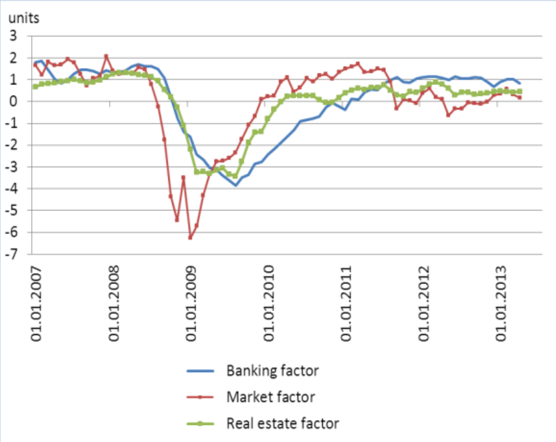
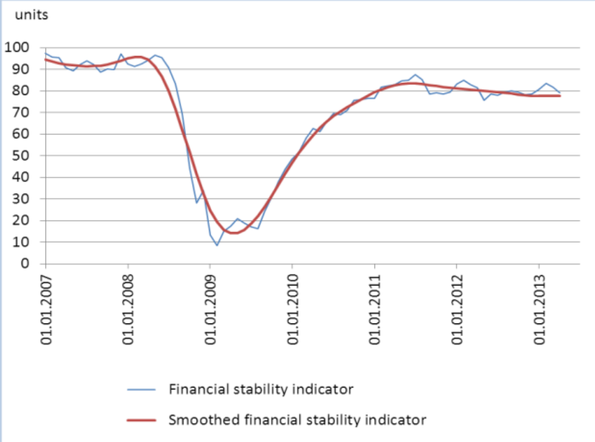


Chart 24. Consolidated Financial Stability Indicator



After the turmoil of 2008–2009, the banking sector factor increased significantly in 2010 amid a slight growth of the market factor. The real sector factor grew only in the first half of the year. In 2011, the banking sector factor continued to increase, while the real sector factor remained stable. In 2012, the banking and market factors stayed virtually unchanged; the market factor showed some decrease in the first half of the year and regained its values thereafter. In 2013, the banking and market factors slightly went down.

The fall of the financial stability indicator in 2011–2012 and early 2013 was primarily attributed to the dynamics of bank capital adequacy ratios, the credit quality of assets and the utilisation ratio.

Chapter 4. The Financial Standing of Non-bank Financial Intermediaries

4.1. Insurance Companies

In the first nine months of 2012, insurer assets reached 1.09 trillion roubles, increasing by 10.4% over the year.[40] The volume of insurer active operations expanded largely due to a rise in insurance reserves, that grew by 11.1% and accounted for 53.4% of liabilities as of October 1, 2012. High growth rates were also demonstrated by insurer capital and reserves, that rose by 17.8% over the year and made up 28.5% of the liabilities. At the same time, the volume of bonds and bills issued by insurers contracted by 86.5% and the volume of loans fell by 23.8%. Assets basically comprise money and deposits (31.0% of total assets, an annual growth of 15.3%) and the portfolio of securities, excluding shares (22.6% and 15.7%, respectively).

As of January 1, 2013, a total of 469 companies operated on the insurance market; over the previous year, the number of insurers shrank by 110 companies. The volume of premiums collected by Russian insurance companies reached a record high level of 812.5 billion roubles[41] (excluding obligatory medical insurance contracts). At the same time, the annual growth in premiums on the market has been observed to slow down gradually since mid-2012 (22.6% as of July 1, 2012, 22.0% as of October 1, 2012 and 21.5% as of January 1, 2013), whereas insurance payments have demonstrated a faster increase in their volumes (15.1%, 17.3% and 21.4%, respectively). The volume of insurance payments reached 370.8 billion roubles (Chart 25). As a result, the loss ratio characterising the relationship between insurance payments and premiums grew from 40.8% as of July 1, 2012 to 45.6% as of January 1, 2013.

Chart 25. The Volume and Annual Dynamics of Insurance Premiums and Payments

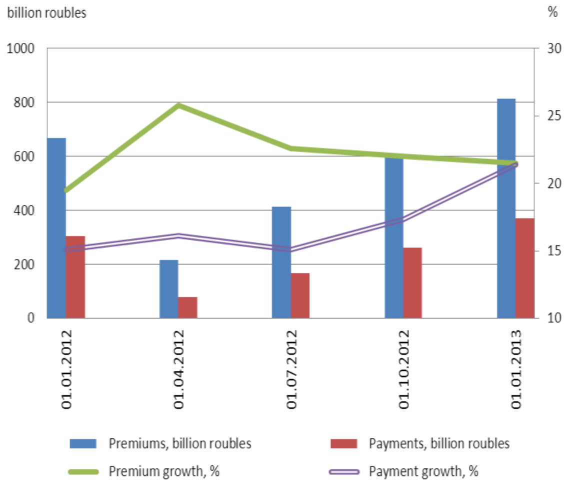
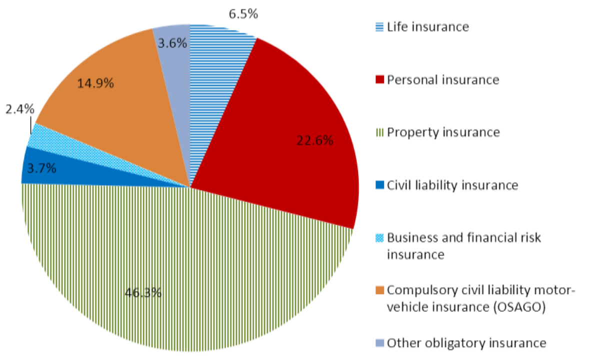


Chart 26. Russian Insurance Market Structure by Premium as of January 1, 2013



Insurance of hazardous production facilities (HPF) introduced in 2012 as compulsory insurance has so far brought no changes to the structure of the insurance market by type of insurance. As before, the Russian insurance market is dominated by voluntary insurance in terms of the volume of premiums collected by insurers (662.25 billion roubles, or 81.5% of the market as of January 1, 2013). Property insurance accounts for more than half of voluntary insurance

[40] Based on data provided under federal statistical survey reporting form No. 1-FS (SK) "Information on Insurer Borrowings and Investments" approved by Rosstat Order No. 308 of December 10, 2008.
[41] Based on data of the Federal Financial Markets Service of Russia.

(375.71 billion roubles, or 46.3% of the market as of January 1, 2013) and personal insurance contributes 183.9 billion roubles, or 22.6%.

Despite the dominance of voluntary insurance services on the insurance market, the main contribution to the market growth was made by obligatory insurance (it showed an annual growth rate of 35% as of January 1, 2013), specifically, compulsory civil liability motor-vehicle insurance (OSAGO), that saw an increase in premium volumes by 17.1% in 2012. The growth of this type of insurance slightly slowed down in 2012 Q4 due to the end of the effect of tariff revisions.[42] For comparison, the volume of premiums collected under voluntary insurance agreements grew only by 18.8%.

As the number of insurance market participants is decreasing due to their takeover by larger market players or as a result of the termination of their operations or the revocation of their licenses, insurers can achieve higher rates of voluntary insurance, if they pursue customer-focused policies, expand the range of insurance products, create and maintain their reputation of reliable insurers. Property insurance as the biggest segment of voluntary insurance by volume grew by 12.2% over the year largely due to a higher need for property insurance of citizens. First of all, the well-being of the population was observed to improve throughout 2012 and, consequently, citizens were increasingly willing to preserve the property they acquired. Secondly, active growth was registered on the market of mortgage lending, which requires mortgage insurance. The growth of volumes in voluntary insurance is facilitated by the development of business and financial risk insurance (as of January 1, 2013, the volume of premiums totalled 19.7 billion roubles) and life insurance (52.9 billion roubles); premiums in these two segments of voluntary insurance grew by 59.1% and 51.1%, respectively, in 2012. As is the case with voluntary property insurance of citizens, the rapid growth of life insurance can be explained by the considerable expansion of bank lending to individuals. Therefore, bank active policies on the household loan market have created additional possibilities for insurers. Amid comparatively high inflation, deposit rates and the public's distrust for the system of savings accumulation through insurance companies, further development of the life insurance segment outside the bank market requires tax incentives for individuals to use long-term insurance products with guaranteed yields.

Credit institutions remain the main partners of insurance companies both for the placement of funds and sales growth. Therefore, a major structural problem for the insurance market is the insufficient development of its own sales infrastructure: most insurers have managed to achieve the maximum growth of premiums by signing partner agreements with banks and brokers. As a result, most insurers lack their own developed sales networks and therefore have to pay high fees and have no direct access to their clients. The risks for these insurance companies are associated not only with a possible increase in fees but also with the fact that during 2012 some leading banks created and developed their own insurance organizations.

Insurance premiums dynamics will be eventually affected by the following factors:

- the persisting low rates of GDP growth, that, in turn, will cause a contraction of investment in production and construction and, therefore, a decrease in the volume of premiums from property insurance of legal entities;

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[42] Russian Government Resolution No. 574 of July 13, 2011, "On Amending Insurance Tariffs on Compulsory Civil Liability Motor-Vehicle Insurance, the Structure of Tariffs and the Procedure of their Application by Insurers to Calculate Insurance Premiums" revised individual coefficients of insurance tariffs (the coefficient for young and inexperienced drivers, the coefficient depending on the available data on the number of persons admitted to motor vehicle driving, etc.).

- slower growth of real wages, that will adversely affect the segments of citizen property insurance (in particular, motor own damage insurance) and travel insurance;

- slack growth of bank lending (in particular, mortgage and motor lending) and, as a result, the decrease in premiums in the segments of life and motor own damage insurance.

4.2. Non-government Pension Funds

In the first nine months of 2012, the volume of assets held by operating non-governmental pension funds (NPFs) reached 1.47 trillion roubles,[43] increasing by 32.6% as compared to the same period of 2011. High growth rates in the structure of assets were demonstrated by money and deposits (88% over the year); as of October 1, 2012, they accounted for 29.4%. The NPF portfolio of securities, except shares, made up 47.0% of total assets, increasing by 28.1% over the year, while the NPF portfolio of shares and other forms of shareholding accounted for 20.8% (3.9%).

Chart 27. The Structure and Annual Dynamics of NPF Own Assets

Source: The Federal Financial Markets Service.

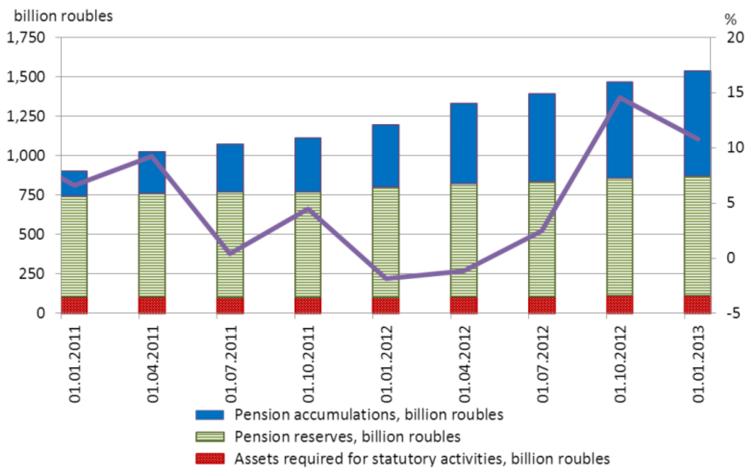
As of January 1, 2013, there were 134 funds operating on the pension market.[44] Over the previous year, the number of NPFs decreased by 12 funds, partly due to mergers and acquisitions. The number of NPFs operating on the market is expected to fall further due to new requirements enforced in 2012 for the size and structure of property necessary for statutory activities.[45] As of January 1, 2013, 25 funds (or 18.6% of all operating NPFs) possessed

[43] Based on data provided under federal statistical survey reporting form No. 1-FS (NPF) "Information on the Financial Operations of a Non-governmental Pension Fund" approved by Rosstat Order No. 308 of December 10, 2008.
[44] Based on data of the Federal Financial Markets Service.
[45] In August 2012, the Justice Ministry of Russia registered Federal Financial Markets Service Order No. 12-34/PZ-N of May 31, 2012, "On Endorsing the Procedure for Calculating the Monetary Value of Property Required for the Statutory Activities of a Non-governmental Pension Fund," which tightened some assessment criteria (in particular, property required for statutory activities must exclude bills and shares of closed joint-stock companies). In addition, legislative requirements were tightened from July 1, 2012 for the minimum size of property required for the statutory activities of NPFs involved in the compulsory pension insurance system. From this time, all NPFs attracting citizen pension accumulations must maintain the volume of

property required for statutory activities in the amount close to the requirement. Seven funds operating on the compulsory pension insurance market had the size of their property required for statutory activities below the level of 100 million roubles. Therefore, about 5.0% of all operating funds were close to losing their licenses (it should be noted that the revocation of licenses from these NPFs poses no systemic risk for the NPF market).

Due to the effect of the new requirements, the overall size of the property required for statutory activities on the NPF market increased by 10.8% in 2012 to 109.9 billion roubles as of January 1, 2013. In the first nine months of 2012, the size of the property required for statutory activities grew by 14.6% from the same period of 2011, showing the highest growth rate for the past two years. Despite the growing volume of property required for statutory activities, this indicator relative to the amount of fund obligations (the sum of pension reserves and accumulations, short-term and long-term liabilities) shrank by 1.37 percentage points over the year to 7.63% as of January 1, 2013.

Chart 28. The Volume and Quarterly Growth of NPF Accumulations and Reserves



Source: The Federal Financial Markets Service.

Non-governmental pension insurance (hereinafter referred to as NPI) remains the main segment of the NPF market by volume. However, the main source of the NPF market growth is compulsory pension insurance (CPI). As of January 1, 2013, pension reserves totalled 758.1 billion roubles, increasing by 8.2% over the year, while pension accumulations grew by 69.8% over the same period to reach 668.7 billion roubles. Given the persistence of the current trend, the volume of pension accumulations may exceed the amount of pension reserves in the medium term.

Under the amendments to the law on the pension system passed by the State Duma of Russia's Federal Assembly in November 2012, the funded component of pension will be reduced from 6% to 2% of the payroll from January 1, 2014. To keep their funded pension component at 6%, citizens will be required to sign compulsory pension insurance agreements with NPFs during 2013. At the same time, in January 2013 the Russian President Vladimir Putin proposed keeping a possibility for Russian citizens to freely decide on the redistribution of their funded pension

property required for their statutory activities at the level of at least 100 million roubles during the entire period of such operations. For other funds, the monetary value of property required for statutory activities must equal at least 50 million roubles from July 1, 2009.

component after 2014 as well and instructed the Russian Government to provide the necessary conditions. According to data of Russia’s Pension Fund, a total of 4.8 million people transferred their pension accumulations to NPFs in 2012. Therefore, eventually the volume of NPF pension accumulations will be largely determined by the citizens’ choice of the government or private pension scheme.

The NPF customer base is formed from three sources: 1) insured persons who have transferred the funded component of their future retirement pension to the NPF, or CPI participants; 2) participants who set aside additional pension on their own or with the support of employers (corporate NPFs), or NPI customers; 3) participants already receiving pensions from the NPFs. As of January 1, 2013, the number of CPI participants grew by 39.5% over the year to 16.6 million people, while the number of NPI customers increased by 2.8% to 6.8 million. The number of people receiving pensions under CPI and NPI pension schemes totalled 125,200 and 1.5 million people, respectively. Therefore, the social significance of the NPF market has been increasing in recent years.

The development of the NPF market is currently restricted by the following factors:

- The break-even requirement for the year-end. At present, NPFs are not allowed to register losses on customer accounts, i.e. they must show at least zero profits and cover losses with part of their property required for statutory activities. This in turn narrows the horizon of pension fund investments to one year, whereas pension funds across the world are considered as long-term investment by definition.
- The citizens’ right to choose or change the NPF, switch from the NPF to the Pension Fund of Russia (PFR) once a year. At present, the Russian Government is discussing a possibility to extend this term to several years to correspond to world practice. This move will help expand the NPF potential for investing pension funds into long-term assets.
- A limited list of instruments for pension accumulation investment. Pension accumulations can be invested, among other things, in the shares of Russian issuers only from the A1 top-level quotation list of the Moscow Stock Exchange. At the same time, there are a number of companies on the market, which are not blue chips but offer equities considered to be highly liquid and reliable.
- The absence of the system of pension guarantees. At present, the idea of creating the fund of guaranteed pension accumulations similar to the banking sector deposit insurance fund is being actively discussed at the Russian Government and among NPF market participants. The creation of this fund will most likely have a positive effect on the NPF market as a whole as this move will increase the citizens’ confidence in NPFs.

4.3. Management Companies Participating in Pension Accumulation Management[46]

The number of management companies (hereinafter referred to as MCs) participating in the management of pension accumulations was unchanged in 2012 Q4 and stood at 51. The volume of their own funds grew by 12.0% to 23.5 billion roubles.

Pension accumulations managed by MCs grew by 6.6% in 2012 Q4 to 1,677.3 billion roubles due to funds transferred from the Pension Fund of Russia, and also income received from investment activity. Almost 98.0% of pension accumulations managed by MCs remained concentrated in Vnesheconombank (VEB) state management company.

In 2012 Q4, MCs managing pension accumulations continued to implement mainly conservative investment strategies. Investments in OFZ, GSO and corporate bonds contributed over 90% to the growth of the securities portfolio. The shares portfolio changed insignificantly in the period under review (Table 11).

Table 11. The Securities Portfolio of MCs Managing Pension Accumulations

Type of assets	As of October 1, 2012		As of January 1, 2013	
	billion roubles	share, %	billion roubles	share, %
OFZ	396.5	33.5	412.7	32.3
GSO	510.4	43.1	534.6	41.9
Russia's external loan bonds	0.0	0.0	0.0	0.0
Russian regional government bonds	6.8	0.6	8.6	0.7
Municipal bonds	0.1	0.0	0.1	0.0
Corporate bonds	233.9	19.8	279.2	21.9
Shares	4.1	0.3	4.7	0.4
Mortgage-backed securities	31.4	2.7	36.1	2.8
Mortgage participation certificates	0.0	0.0	0.0	0.0
Units (shares, stakes) of index investment funds investing in foreign government securities, bonds and equities of other foreign issuers	0.0	0.0	0.0	0.0
Total	**1,183.2**	**100.0**	**1,276.0**	**100.0**

Source: The Pension Fund of Russia.

Revenues from investment activity totalled 46.1 billion roubles in 2012 Q4, or 44.3% of the growth in the net asset value (NAV) demonstrated by the MCs under review. The financial result from asset revaluation accounted for almost 75.0% of these revenues.

In 2012, 57 out of 58 investment portfolios, which MCs created using pension accumulations, showed positive yields. In the period under review, yields on pension accumulation portfolios ranged from -0.7% to 13.5% p.a. The VEB management company demonstrated yields of 9.2% p.a. on its extended securities portfolio, while yields on the government securities portfolio totalled 8.5% p.a.

[46] According to data provided by the Pension Fund of Russia.

4.4. Unit Investment Funds[47]

In 2012 Q4 and 2013 Q1, *the total net asset value (NAV)* of unit investment funds (UIFs) grew by 12.7% to 586.4 billion roubles largely due to closed-end UIFs (Chart 29).[48] Retail (open-end and interval) UIFs registered a 3.4% decrease in their NAV due to the net outflow of shareholder funds and the negative investment result. The share of closed-end UIFs in the total NAV rose by 2.9 percentage points to 82.9% as of April 1, 2013.

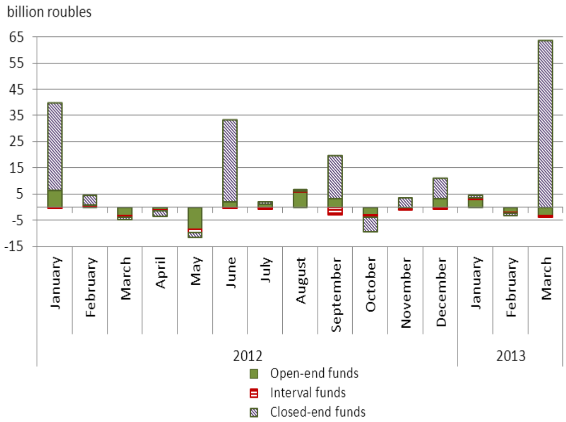
The largest NAV growth among UIFs (51.5%) in the period under review was demonstrated by real estate funds largely due to the net inflow of shareholder funds and the growth of the prices of real estate held by these funds. The biggest NAV contraction (28.1%) was demonstrated by open-end index UIFs, mainly because several large funds terminated their activity.

Retail UIFs registered *a net outflow of shareholder funds* in the amount of 1.8 billion roubles in 2012 Q4 and 2013 Q1 due to the investor persisting negative expectations about the cost of units. Among retail UIFs grouped by category, only bond funds registered a net inflow of shareholder resources in the amount of 6.3 billion roubles, with the bulk of this money flowing into UIFs, which pursued conservative investment strategies on the capital market.

The net inflow of shareholder funds into closed-end UIFs totalled 15.8 billion roubles in 2012 Q4, with over 60.0% of this inflow being provided by real estate funds.

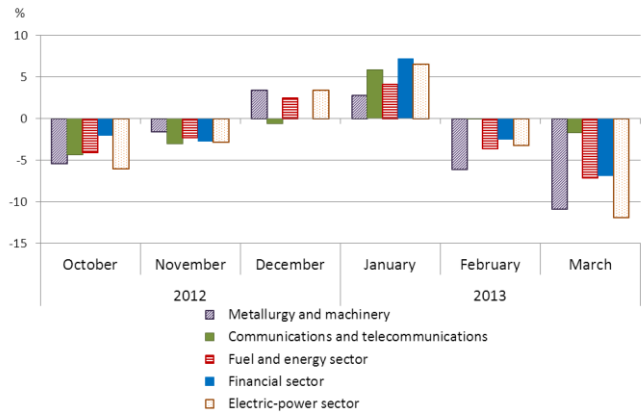
In 2012 Q4 and 2013 Q1, a total of 64.6% of retail UIFs registered a decrease in the *cost of their units*. The growth in the unit cost of these funds ranged from – 22.6% to 18.2%. The largest increase in the unit cost among retail funds grouped by category was demonstrated by bond UIFs (5.2%). Almost all equity UIFs with sectoral focus showed a decrease in the cost of their unit s (Chart 30).

Chart 29. Monthly Growth of UIF Net Asset Value



Source: Cbonds.ru.

Chart 30. Monthly Average Growth in the Unit Price of Retail Equity UIFs with Sectoral Focus



Source: Cbonds.ru.

[47] Based on data provided by the information agency Cbonds, unless specified otherwise.

[48] Here and below, the estimate excludes UIFs, which had the status of qualified investor funds as of April 1, 2013. Under Federal Law No. 334-FZ of December 6, 2007, "On Amending the Federal Law on Investment Funds and Some Russian Laws", qualified investor UIFs publicly do not disclose information on their activities.

The number of UIFs grew by 78 to 1,607 in the period under review largely due to the increase in the number of closed-end funds. The largest growth among UIFs grouped by category was demonstrated by real estate funds as their number rose by 31.

4.5. Broker-Dealer Firms

As of April 1, 2013, a total of 481 organisations other than credit institutions were licensed to carry out broker and (or) dealer activity (hereinafter referred to as broker-dealers).[49] The total assets of these organisations fell by 3.0% from October 1, 2012 to 608.9 billion roubles as of April 1, 2013. The top thirty organisations by asset account for 74.9% of all assets of brokers-dealers other than credit institutions. The largest share in the assets of broker-dealers is held by receivables that are due within 12 months and short-term financial investment (Chart 31).[50] The asset structure of broker-dealers did not undergo any considerable changes from October 1, 2012 to April 1, 2013 (Chart 32).

Chart 31. Asset Structure

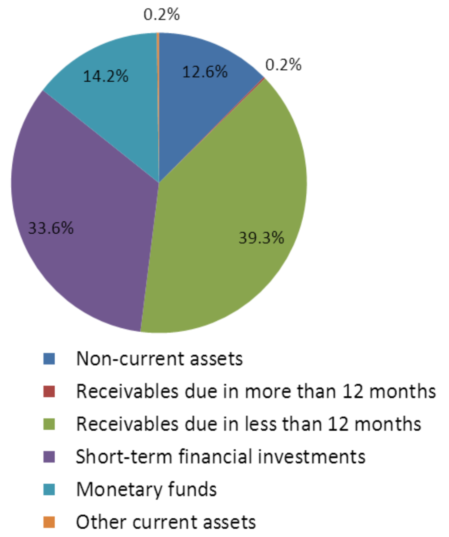
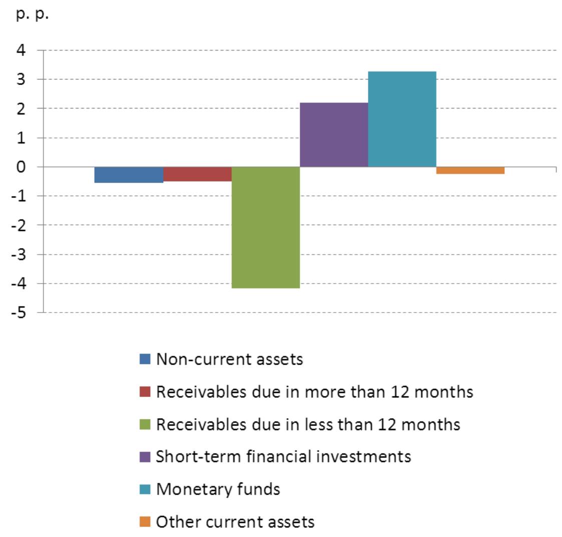


Chart 32. Changes in Asset Structure



The liability structure of broker-dealers is dominated by short-term liabilities (66.8%), while capital and reserves account for 27.1% (Chart 33). The liability structure did not undergo any radical changes from October 1, 2012 to April 1, 2013 (Chart 34). Total capital calculated using the methodology of the Federal Financial Markets Service of Russia equalled 20.7% of total liabilities of broker-dealers as of April 1, 2013, which virtually corresponds to the level registered at the end of 2012 Q3.

[49] The estimate is based on a list of organisations licensed to carry out broker and (or) dealer activity, as given on the website of the Federal Financial Markets Service, and reporting Form No. 1100 “Quarterly Report of a Professional Securities Market Participant,” which helps identify organisations other than credit institutions in the list.
[50] Based on the data of reporting Form 1100 “The Quarterly Report of a Professional Securities Market Participant.”

Chart 33. Liability Structure

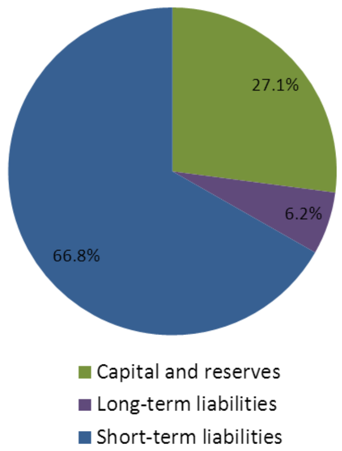
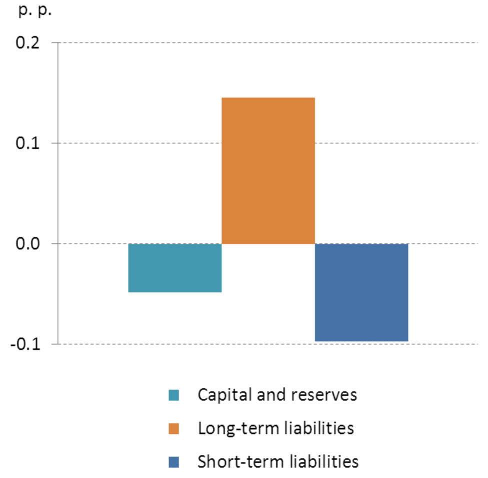


Chart 34. Changes in Liability Structure



"Other securities" portfolio, which included foreign securities and foreign bank ADRs and GDRs, showed the biggest change in the structure of the total broker-dealer securities portfolio, registering a decrease by 9.2% (Chart 36). At the same time, other securities remained the largest investment category in the securities portfolio of broker-dealers (33.4%), whereas the share of securities included in the quotation list equalled 28.0% (Chart 35).

Chart 35. Total Securities Portfolio Structure

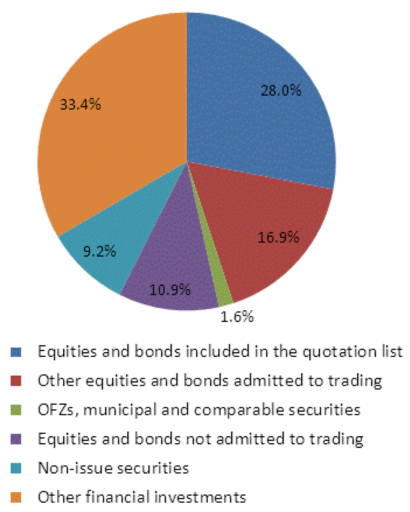
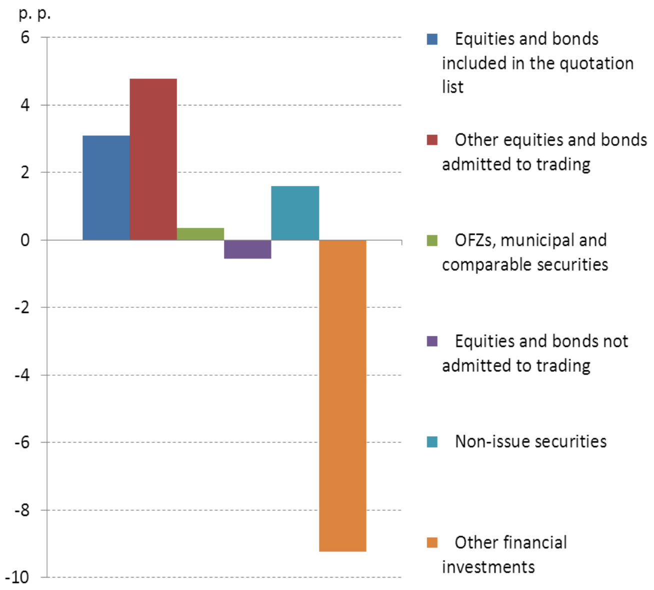


Chart 36. Changes in Total Securities Portfolio Structure



The volume of REPO positions opened by brokers and dealers on their own behalf (under the start leg of a REPO transaction, a broker-dealer transfers securities to the counterparty and receives cash) increased by 33.0% on the exchange-traded market from October 1, 2012 to April 1, 2013 and stood at 74.6 billion roubles. At the same time, the volume of reverse REPO positions (under the start leg of a reverse REPO transaction, a broker-dealer transfers cash to the counterparty in exchange for securities) grew by only 19.1% over the same period to 48.3 billion roubles (Chart 37). The volume of positions opened on client instructions considerably exceeded in the period under review the volume of positions opened by brokers and dealers on their own behalf (Chart 38). Therefore, financial sustainability of professional securities market participants depends not only on the "good faith" practices of money market operators but also on the solvency of their clients.

Chart 37. The Volume of Open Positions on Transactions Performed by Broker-Dealers on their Own Behalf

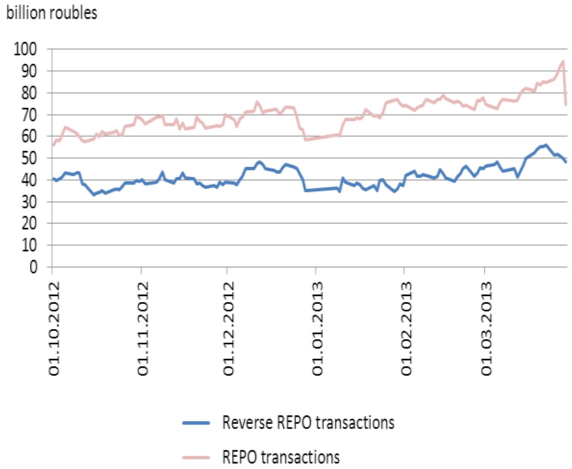
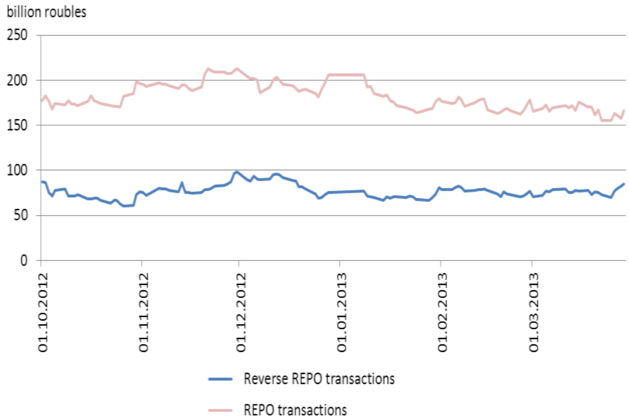


Chart 38. The Volume of Open Positions on Transactions Performed by Broker-Dealers on Behalf of their Clients



Eventually, to accurately assess and minimise systemic risks associated with the activity of broker-dealers, measures will be required to improve their financial reporting, and effective regulations, including the requirements set for the own funds of professional securities market participants.