RESEARCH AND INFORMATION DEPARTMENT
OF THE BANK OF RUSSIA

FINANCIAL STABILITY REVIEW

2010

MOSCOW
2011

Contents

The Financial Stability Review has been issued since 2001.
The Research and Information Department has prepared 12 issues.

Summary

In 2010, the Russian economy and its financial sector developed amidst more favourable external conditions than in the previous year. As the world's economic recovery continued, Russia's major trading partners increased their production of goods and services. Meanwhile, commodity prices improved for Russia's exporters. The international financial markets were relatively stable, although exchange rate and stock index volatility occasionally increased during the year. Net private capital outflow from Russia in 2010 declined significantly compared to the previous year, while the banking sector registered a net inflow of private capital. This stimulated growth in the supply of financial resources and, consequently, led to a reduction of the cost of borrowing in the domestic financial market. Amid the favourable external economic conditions and growth in domestic demand, output increased in most types of economic activity and the financial situation of Russia's non-financial organisations improved.

The sweeping measures taken by the government and the Bank of Russia to support the national banking sector during the acute phase of the financial and economic crisis had a lasting and favourable effect. This and the stabilisation of the situation in the non-financial sector were the most significant factors to lead to increased financial stability in the Russian economy.

As the macroeconomic environment stabilised, the financial situation and profitability ratios of most of the institutions of financial intermediation improved. The net financial result of Russian banks in 2010 increased by a factor of 2.8 compared with 2009. The main reason for this growth was that the loan portfolios of credit institutions stabilised in terms of quality, which allowed banks to significantly reduce their bad loan provisioning expenses. The financial situation of non-bank financial institutions improved more slowly, and did not allow them to overcome all of the consequences of the crisis. This was, in part, the result of the fluctuating inflow of customer funds and the lack of sustained demand for the services provided by these institutions.

Credit institutions improved the quality of their assets in 2010: their share of overdue loan debt and problem and bad loans contracted.

The further reduction of the Bank of Russia's refinancing rate and increased competition between banks seeking reliable borrowers led to a fall in interest rates on bank loans. An increase in the solvency of borrowers and a drop in interest rates on rouble-denominated household deposits have allowed banks to continue to cut the cost of providing credit to non-financial organisations; they embarked on this policy in late 2009, and began to cut the cost of certain types of loans to households. Since March 2010, credit institutions have eased up their lending conditions and expanded lending volumes, making credit more accessible to non-financial organisations. This growth in bank loans was buttressed by equity capital adequacy and a high level of banking sector liquidity.

The expansion of bank lending to households, especially in terms of car and mortgage loans, stimulated demand in the consumer goods market and gave a boost to bank borrower collateral insurance and life insurance. This, in turn, favourably impacted the development of the corresponding areas of the insurance business and the insurance market as a whole.

At the same time, the portfolio of bank loans to non-financial organisations and households grew slowly, as customers were afraid to increase their debt burden while the situation in the economy had not completely stabilised. In addition, some potential corporate borrowers, mainly big and reliable ones, raised funds by placing bonds instead of borrowing from banks. As various categories of investors demonstrated high demand for bonds that had been placed by reliable corporate issuers, the latter were able to raise significant funds in the stock market at a low price for long terms. As a result, they could not only finance new investment programmes, but also restructure their outstanding loan debts.

Credit institutions, for their part, compared the potential return and risk on loans with investments in bonds and preferred to put their spare funds in various types of bonds rather than increase lending; these included federal loan bonds (OFZs) as well as municipal and corporate bonds. The banks were attracted to these bonds mostly due to their high liquidity and because they could be used to secure funding from the Bank of Russia. At the same time, the build-up of investments in bonds makes banks increasingly dependent on stock market fluctuations and increases market risk.

The domestic foreign exchange market situation had a major effect on the financial stability of the Russian banking sector and the economy as a whole. In 2010, the principal sources of possible instability in the domestic foreign exchange market remained the destabilisation of world commodity and financial markets, and the volatility of cross-border capital flows. The post-crisis recovery of the world economy had a favourable effect on the domestic currency's stability. Therefore, the change that was made to the Bank of Russia's foreign exchange policy, which was designed to make the exchange rate mechanism more flexible during the gradual transition to a free-floating rouble, has not increased the volatility of foreign currency exchange rates against the rouble. The exchange rate risk for the banking sector and the Russian economy as a whole decreased in 2010, compared to 2009. At the same time, the banking sector continued to be exposed to foreign exchange risk due to, among other things, the mismatch that arose in 2010 between foreign currency-denominated loans and foreign currency deposits. To eliminate this imbalance, the largest banks raised their interest rates on currency deposits in the second half of 2010.

The improvement of the financial situation of Russian banks mitigated credit risk in the interbank lending market, the key sector of the Russian money market. Growth in banks' investments in bonds, which allowed banks to quickly mobilise liquidity through repo operations or by selling securities, ensured relatively low liquidity risk. As Bank of Russia interest rates fell, money market rates gradually declined and their volatility decreased, reducing the interest rate risk involved in money market transactions. Thanks to these factors, the Russian money market remained stable in 2010.

The favourable dynamics of the economic, social and political situation in the country were reflected in the upgrades of some ratings that were assigned to Russia and Russian issuers by national and international rating agencies. The sovereign rating assigned to Russia by the international agencies remained investment grade and was characterised as 'modest reliable'. Fitch Ratings' decision to raise the sovereign rating outlook from 'stable' to 'positive' in the 3rd quarter of 2010 may be seen as an indication that Russia's sovereign rating may be upgraded further. Overall, the ratings assigned to the Russian Federation and its regions, municipalities and financial and non-financial organisations by international rating agencies were comparable to those assigned to the countries of Central and Eastern Europe, as well as other BRIC countries (Brazil, India and China). Russia's rating also exceeded those of the other members of the Commonwealth of Independent States. However, Russia's ratings and country risk premium have not yet returned to their pre-crisis levels. This, in the opinion of foreign investors, may indicate that Russia has not yet completely restored its pre-crisis level of systemic stability.

As the country gradually overcame the consequences of the financial crisis, the government wound up the anti-crisis programme it had launched to support the country's credit institutions, and the Bank of Russia resumed the use of its standard instruments and procedures for regulating the banking sector.

Thus, the improvement of the external economic situation in 2010 and the implementation of anti-crisis measures allowed the Russian economy to retain stability. As economic modernisation and the expansion of Russia's demand for domestically produced goods drive the continuation of the recovery, they will enable the Russian economy to embark upon a path of sustainable growth and facilitate the smooth functioning of the Russian financial sector.

Chapter 1. General economic conditions

The recovery of the world economy, the improvement of Russia's external economic conditions and the implementation of anti-crisis measures in 2010 allowed Russia to preserve its social, economic and financial stability. Growth in domestic demand for internally produced goods has remained a weak component of economic growth so far.

* * *

In 2010, the world economy continued to recover from the crisis and international financial markets continued to improve. The rise in the leading industrialised economies and dynamic growth in the major emerging market countries caused the output of goods and services to increase in the world as a whole in 2010 (by 5.0%, according to the IMF) and in the group of countries that account for the bulk of Russia's foreign trade (by 3.7%).[1]

Inflation in Russia's trading partners in 2010 was contained by a number of fundamental factors, especially the negative output gaps in the world's leading economies, which are expected to remain for a long time. However, a rise in food and energy prices strongly impacted inflation rates in the countries of the world in 2010.

Measures that governments and central banks took to prevent the spread of a systemic crisis in 2008 and 2009 ensured relative stability in the financial markets.

The price situation in world commodity markets improved for Russian exporters throughout 2010. The average world market price of Russian oil gained 28.9% in 2010 year on year and reached US$78.2 per barrel. Worldwide prices of other Russian exports, except natural gas, also rose. Export prices grew faster in 2010 than import prices. The terms of Russia's trade with other countries also changed for the better. Exports of goods increased by a factor of 1.3. Imports recovered mostly due to the expansion of import quantities. The growth in imports of goods was approximately equal to the growth in exports. The trade surplus increased by a third and the current account surplus grew by a factor of almost 1.5 to total US$72.6 billion (Chart 1.1), or 5.0% of GDP (as against 4.0% a year earlier).

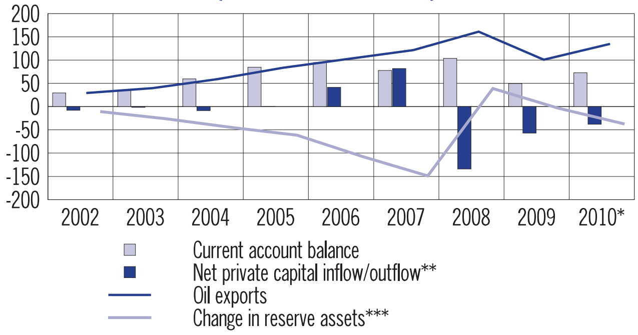
There were also changes in cross-border capital flows. The private capital outflow registered in the banking sector in 2009 gave way to an inflow: the resumption in the flow of foreign investments into this sector was accompanied by small investments made by Russian banks abroad. The flow of private foreign capital to other sectors of the economy declined by more than half, while investments abroad remained virtually unchanged from 2009. At the same time, investments in foreign currency outside the banking sector in 2010 decreased by an estimated US$14.4 billion (in 2009, they decreased by US$4.1 billion). As a result, the net outflow of private capital in 2010 contracted by a third, to US$38.3 billion. In the banking sector there was a net inflow of US$11.4 billion (in 2009, there was a net outflow of US$30.4 billion). Net private capital outflow outside banks increased by a factor of 1.9 to US$49.7 billion.

The increased foreign currency inflow across the current account and the reduction of capital outflow from the country in 2010 created the conditions for growth in international reserves. Compared to the previous year, they grew by US$39.9 billion (in 2009 they increased by US$13.2 billion year on year). As of the beginning of 2011, Russia's international reserves totalled US$479.4 billion. In 2010, Russia's international reserves were enough to finance imports of goods and services for 18 months, a figure that far exceeds the internationally accepted 3-month minimum level considered sufficient (Chart 1.2).

As borrowing increased, banking sector external debt grew by US$17.6 billion in 2010. The general government and monetary authorities increased their external debt by US$0.9 billion, whereas the external debt of other non-government sectors of the economy contracted by US$2.8 billion. The Ministry of Finance built up its foreign obligations by placing US$5.5 billion in Eurobonds, of which 90% were acquired by non-resident investors. In 2010, Russia's total external debt increased by US$15.7 billion to reach US$483.0

Chart 1.1

Balance of payments (billions of US dollars)



* Estimate.

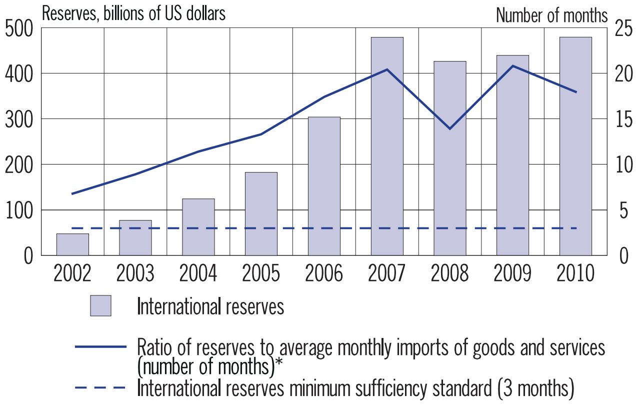
** "-" signifies net capital outflow, "+" signifies net inflow.

*** "+" signifies decrease, "-" signifies increase.

[1] *Aggregated GDP growth in countries that trade with Russia and have the largest proportion in the structure of Russian exports.*

Chart 1.2

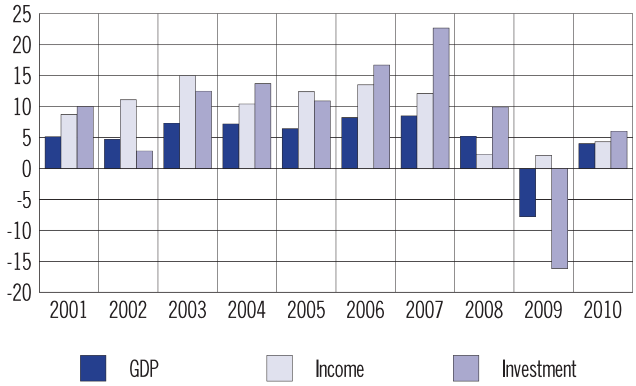
International reserves



** Estimate.*

Chart 1.4

GDP, fixed capital investment and real household disposable money income (as % of previous year)



billion (Chart 1.3). As the economy grew and the rouble appreciated, it was estimated that the country's debt burden decreased from 37.9% of GDP in 2009 to 33.0% of GDP in 2010, while the ratio of government external debt to GDP contracted from 2.5% to 2.4%, respectively.

In 2010, the Russian economy continued to recover from the deep recession caused by the world financial and economic crisis. The global economic recovery and improved terms of trade facilitated the expansion of Russian exports and shored up economic growth. Consumer and investor activity started to increase. Year on year GDP grew by 4.0% in 2010, whereas in 2009 it contracted by 7.8%. Output grew in all the major types of economic activity, except agriculture and construction. However, production has still not reached its pre-crisis level (Chart 1.4).

The number of employed increased amid economic growth in 2010 compared to 2009, but this figure failed to exceed its 2007 level. The total number of unemployed declined significantly. As of the end of December 2010, it stood at 7.2% of the economically active population as against 8.2% a year earlier (Chart 1.5).

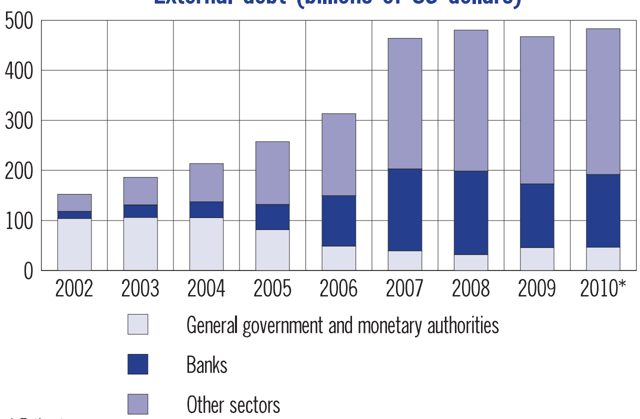
Slack demand and a strengthening rouble had a restraining effect on inflation in the first half of 2010. In July 2010, consumer prices were 5.5% higher than in July 2009, their lowest rate of growth since 1992. Core inflation ran at 4.4%. At the same time, the restraining effect of demand on inflation weakened as demand recovered (Chart 1.6).

Starting from August 2010, the growth in the price of food accelerated significantly because of the unfavourable weather conditions. In 2010, food prices rose by 12.9%; vegetable and fruit prices soared 45.6%. In December 2010, inflation accelerated by 8.8% year on year (as in 2009), while core inflation increased by 6.6% as against 8.3% a year earlier.

As foreign economic conditions changed for the better for Russian exports and domestic demand increased, the financial situation of Russian non-financial organisations improved significantly. In January-November 2010, organisations other than small businesses, banks, insurance companies and budget-financed institutions posted a net financial result of 5,543.5 billion roubles, an increase of 49.6% on 2009.

Chart 1.3

External debt (billions of US dollars)



** Estimate.*

Chart 1.5

Number of employed and unemployed (growth as % of corresponding month of previous year)

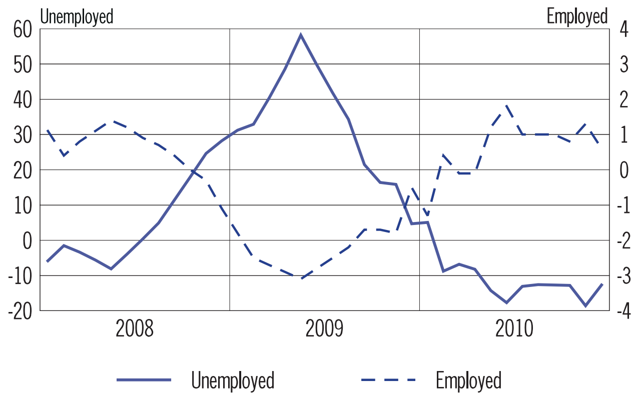


Chart 1.6

Consumer price and core inflation (as % of corresponding month of previous year)

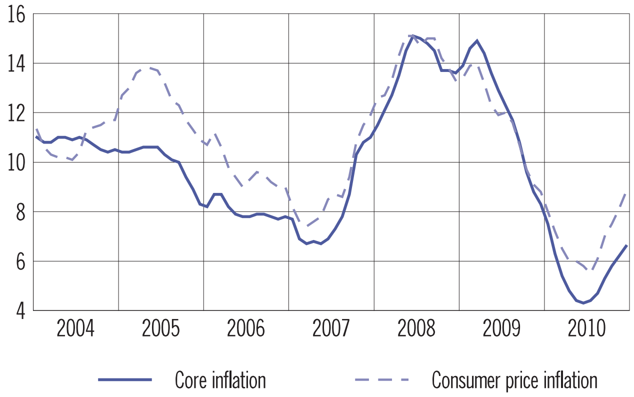


Chart 1.7

Relative deviations of JP Morgan Chase emerging markets spreads from pre-crisis level (%)*

** The arithmetic average of the index for January-August 2008 is assumed to be the pre-crisis level (EMBI+ Russia spread = 170 basis points, EMBI+ spread = 277 basis points).*

The stabilisation of the macroeconomic situation and the improvement of the financial situation of organisations led to growth in investment. In 2010, fixed capital investment increased by 6.0%, whereas in 2009 it contracted by 16.2%. However, it did not bring about growth in the construction sector.

Measures of state support contributed to the rise in household income. Pensions were raised on four occasions in 2010 and increased by 34.8% in real terms. Real disposable money income grew by 4.3% year on year. Household expenditures on goods and services increased by an estimated 4.4% in real terms. Household propensity for saving (including deposits and securities) also increased compared to 2009.

The country risk premium for Russia[2] was above its pre-crisis level for most of 2010 (Chart 1.7). This may signify that in the eyes of foreign investors, Russia has not yet restored its pre-crisis level of systemic stability and credibility. Continued recovery will allow the Russian economy to return to a path of sustainable growth.

[2] EMBI+ Russia (Emerging Markets Bond Index Plus Russia), or the average weighted spread between the yield on Russian eurobonds and the yield on US treasuries, is used as the country risk premium for Russia. It is calculated by investment bank JP Morgan Chase.

Chapter 2. Financial market stability and risks

2.1. Money market

The major potential threats to the stability of the Russian money market in 2010 were, as before, the possible turbulence in the world financial market, growth in exchange rate volatility and the erosion of confidence in the banking system. The measures taken in the preceding period to support Russian banks and mitigate banking sector liquidity fluctuations helped to ward off these threats and neutralise their possible consequences. In 2010, the effect of these measures, along with the stabilisation of the situation in the non-financial sector of the Russian economy, were the main factors that led to the improved financial situation of money market participants, the reduction of the level and volatility of interest rates, and the lessening of the main types of risk.

* * *

As the situation in the Russian banking sector stabilised, the measures that the state had taken to support banks were gradually phased out (see the box entitled *Banking Sector Liquidity and Bank of Russia Operations*).

The improvement of the financial situation of Russian banks amid the continued implementation of the cautious policy of creating a portfolio of highly liquid assets contributed to the reduction of credit risk in operations with Russian banks. The share of overdue debt in interbank loans placed in the domestic market contracted for most of the year and in certain months it was less than 0.1%, or close to its pre-crisis level (Chart 2.1). Nevertheless, the quality of the portfolio of interbank loans placed by Russian banks was not particularly good. This became clear in the middle of 2010 after the simplified procedure for assessing the quality of debt servicing (which had been introduced in late 2008) was cancelled. After the reclassification of loans, the share of interbank loans assigned to quality groups 3, 4 and 5 (doubtful, problem and bad) almost doubled, and by 1 October it had reached a four-year high of more than 0.7% of the portfolio of interbank loans placed by Russian banks.

The credit risk premiums included in interbank interest rates declined. In 2009, the spread between interest rates on overnight loans extended to banks with a speculative grade rating (MIACR-B) and loans to banks with an investment grade rating (MIACR-IG) reached nine percentage points, whereas in 2010 it did not exceed one percentage point; for most of the year it was less than half of a percentage point (Chart 2.2) (see the box entitled *The Effect of Operations Conducted by Banks with an Investment Grade Rating...*). The reduction of the risk premiums, for its part, made short-term loans more accessible for Russian second- and third-tier banks.

Interest rate volatility decreased in the main segments of the Russian money market in 2010 (Chart 2.3) and the interest rate risk involved in operations in this market declined accordingly. Russian banks had preserved a vast quantity of liquid assets, thus preventing sharp fluctuations in demand for rouble liquidity for most of the year. This, along with Bank of Russia operations designed to cushion banking sector liquidity fluctuations (see the box entitled *Banking Sector Liquidity and Bank of Russia Operations*) were the factors that contributed to the decrease in interest rate volatility.

As the historical volatility of interest rates lessened, the uncertainty of market participants' price expectations (implied volatility) decreased. This resulted in a decrease

Chart 2.1

Certain characteristics of the interbank loan portfolio (%)

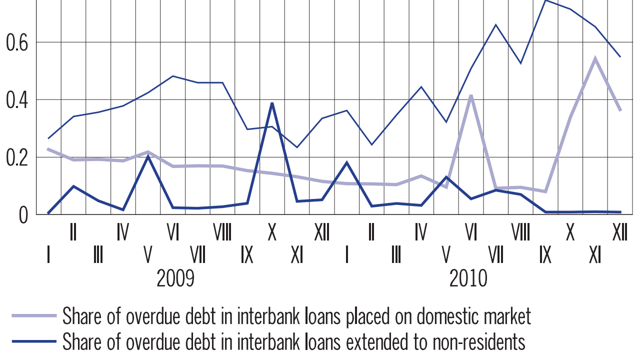
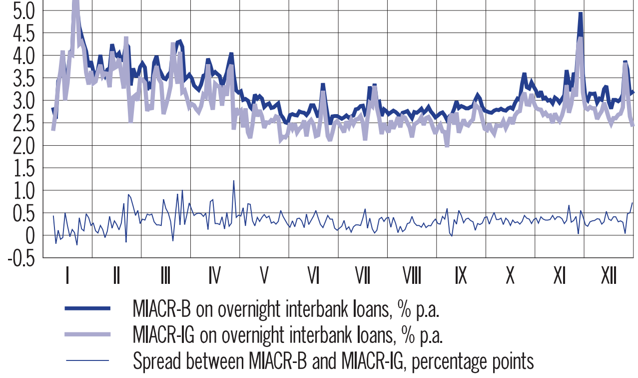


Chart 2.2

Average interest rates on rouble overnight interbank loans taken by banks with different credit ratings in 2010



Banking Sector Liquidity and Bank of Russia Operations

The large-scale anti-crisis measures taken by the Russian government and the Bank of Russia in 2008 and 2009 helped the economy overcome the shortage of liquidity and prevent banking sector instability.

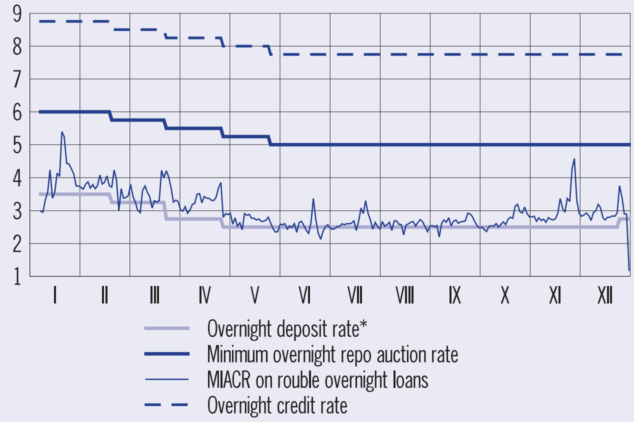
Against a background of slowing inflation and low inflationary expectations, the Bank of Russia in the first half of 2010 cut the refinancing rate and interest rates on some of its operations on four occasions, in order to encourage lending activity and economic growth and to stem the inflow of short-term speculative capital. As a result, money market rates fell, the situation in the banking sector improved and systemic risks lessened. In the second half of the year, the effective parameters of the interest rate policy were considered by the Bank of Russia as a guarantee of the acceptable balance between the major macroeconomic risks, and therefore it left the refinancing rate and interest rates on its operations unchanged. Due to the gradual increase in the risk of inflation later that year, the Bank of Russia raised deposit rates by a quarter of a percentage point on 27 December.

When it registered the first signs of improvement in the major macroeconomic and financial system indicators, the Bank of Russia began to gradually wind up the measures it had taken during the worst phase of the crisis. Specifically, it started to reduce the amount of liquidity it provided to banks and shorten the terms for which this liquidity was provided. In the period of April through September 2010, the Bank of Russia took decisions to suspend repo auctions, Lombard credit auctions, and loans secured by non-market assets or guarantees for terms of six months or longer. In addition, on 1 October 2010, it suspended the auctioning of unsecured loans provided to credit institutions for terms of more than five weeks, and on 1 January 2011, it halted all unsecured loan auctions.

In general, there was a surplus of banking sector liquidity in 2010, which was largely due to the interventions conducted by the Bank of Russia in the domestic foreign exchange market in the context of a strengthening balance of payments and an inflow of foreign currency. In this situation, the role of the instruments used by the Bank of Russia to absorb credit institutions' spare funds, notably, deposit operations and Bank of Russia bond (OBR) operations, increased significantly. In 2010, the average daily Bank of Russia liabilities to credit institutions for the liquidity-absorbing instruments totalled 1.3 trillion roubles (compared with 0.3 trillion roubles in 2009). Moreover, on certain days in May-July 2010 these liabilities reached 1.8 trillion roubles. The total volume of deposit operations in 2010 amounted to 35.3 trillion roubles and the volume of OBR operations stood at 1.9 trillion roubles (in 2009, these figures were 17.7 trillion roubles and 0.3 trillion roubles, respectively).

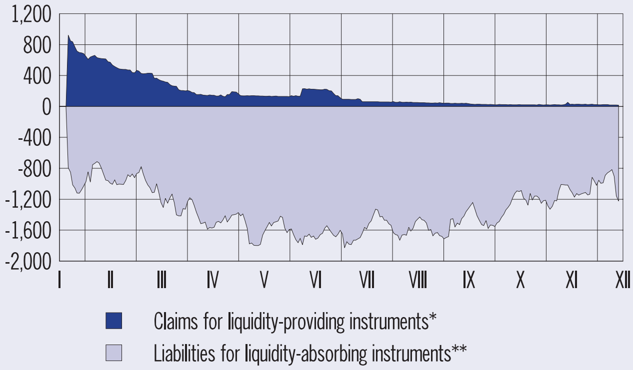
Credit institutions' demand for Bank of Russia refinancing contracted significantly in 2010. Bank of Russia claims on credit institutions relating to the liquidity-providing instruments decreased from 920 billion roubles as of 1 January 2010 to 17.5 billion roubles as of 1 January 2011. The total volume of liquidity provided by the Bank

Interest rates on major Bank of Russia operations and MIACR in 2010 (% p.a.)



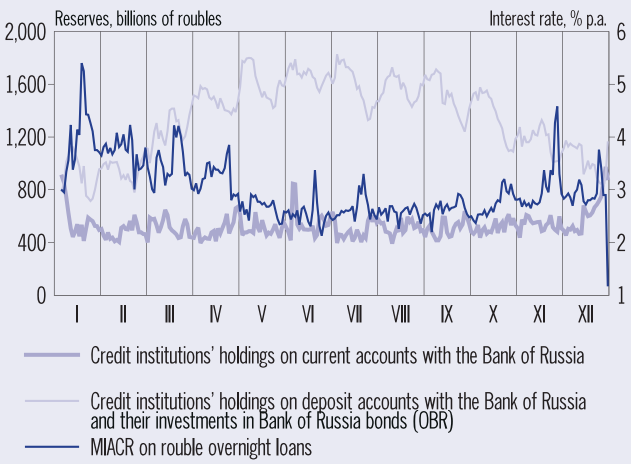
** 'Overnight' from 29 March 2010, 'tom-next' before 29 March 2010.*

Claims for liquidity-providing instruments and liabilities for liquidity-absorbing instruments in 2010 (billions of roubles)



** Bank of Russia claims on credit institutions with regard to repo operations, Lombard and overnight loans, loans secured by non-market assets or guarantees and unsecured loans.*
*** Bank of Russia liabilities to credit institutions with regard to deposit and OBR operations.*

Bank reserves and MIACR in 2010

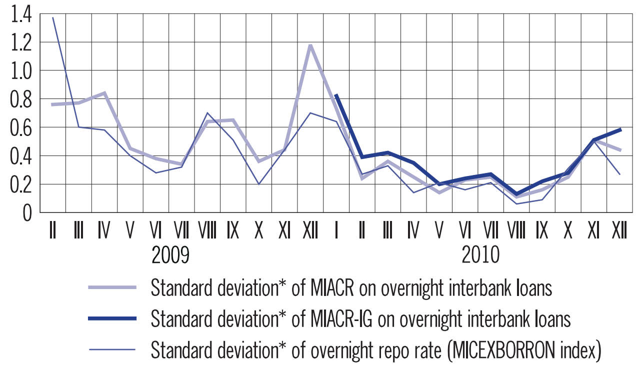


of Russia in 2010, including repos, overnight and Lombard loans, loans secured by non-market assets or guarantees, and unsecured loans, amounted to 2.8 trillion roubles (compared with 36.5 trillion roubles in 2009).

The refinancing of credit institutions and the measures taken by the Bank of Russia in 2010 to upgrade its monetary policy instruments (such as the introduction of overnight deposits) helped reduce interest rate volatility in the money market. As there was a surplus of banking sector liquidity for most of the year, the MIACR on rouble overnight loans approached the lower bound of the Bank of Russia interest rate corridor.

Chart 2.3

Interest rate risk indicators on Russian money market (historical volatility, percentage points)



** Calculated on a monthly basis.*

in the volatility of interest rate futures prices, and the stabilisation of the spreads between interbank offered interest rates for different terms (which reflect the expectations of changes in interest rates). In addition, spreads narrowed between the bid and offered interbank credit rates (MIBID and MIBOR, respectively).

As interest rate volatility declined, money market participants' demand for hedging instruments remained low. The average annual open position on interest rate futures on the RTS was less than 200 million roubles in 2010 (it accounted for less than 0.04% of total claims on rouble-denominated interbank loans placed by Russian banks).

As the world money market stabilised, Russian banks intensified their raising of funds in the world market (especially when the rouble appreciated against the US dollar in nominal terms). By the end of 2010, they had once again become net borrowers in operations with foreign banks, although the net borrowings of Russian banks in the world money market were small compared to the beginning of 2009. However, the growing share of net borrowings from foreign banks in Russian banks' liabilities may make the Russian banks more vulnerable to external shocks and become a source of systemic risk.

The Russian market in 2010, as before, was characterised by a high degree of concentration; the top 15 banks in the Russian interbank credit market accounted for 50-60% of total liabilities and claims in this market. Such a concentration of operations is a source of systemic risk to the market, because the deterioration of the situation of some large banks may lead to a collapse of the Russian money market as a whole. Fortunately, such a scenario is very unlikely because the top Russian banks (the major interbank market participants) are solid financial institutions that pursue relatively conservative financial policies.

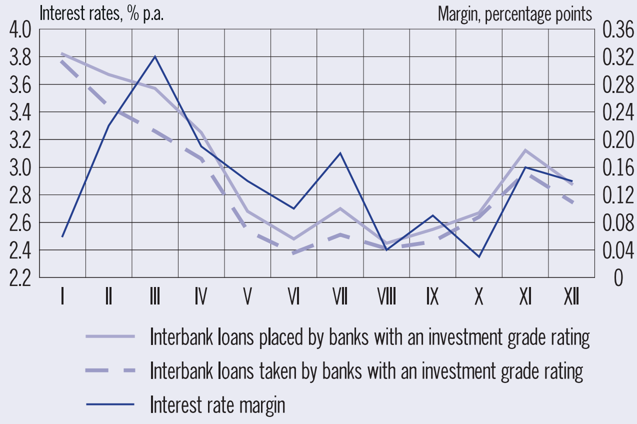
The Effect of Operations Conducted by Banks with an Investment Grade Rating on Russian Money Market Stability

Banks with an investment grade rating (highly rated banks) have a major role to play in ensuring the stability of the Russian money market. In 2010, these banks accounted for up to 50% of the total value of operations in the domestic money market, mostly operations with other Russian banks. The value of funds placed by the highly rated banks in other banks was comparable with the value of funds other banks placed with the highly rated banks, which means that the banks in this group played the part of market makers in the Russian money market.

The interest rate margin on operations conducted by the highly rated banks with other banks fluctuated significantly and gradually fell. This decline in the interest rate margin may testify to the lessening of credit and interest rate risk in the Russian money market.

Operations conducted by highly rated banks to raise and place interbank loans differed not only in terms of interest rates, but also in terms of the structure of

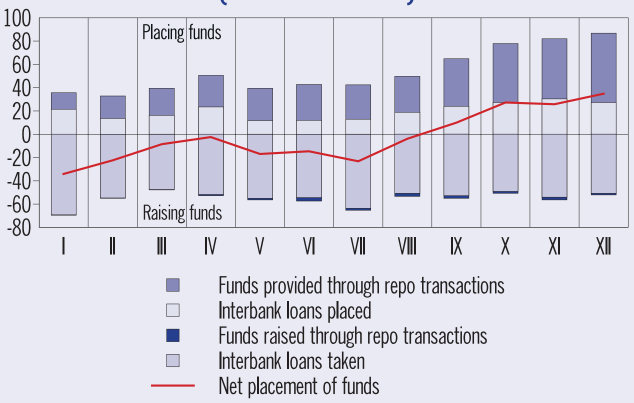
Interest rates on one-day interbank credit operations conducted by banks with an investment grade rating with other Russian banks in 2010



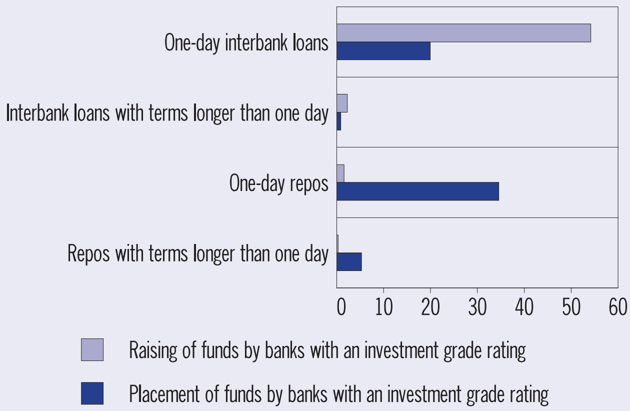
transactions by instrument and maturity. First, the highly rated banks mostly raised funds for the shortest terms (one-day interbank loans and repos accounted for over 95% of total funds raised). At the same time, funds were placed for longer terms (operations with terms of longer than one day accounted for up to 10% of interbank loans and repos placed by highly rated banks in other banks) and at higher rates. This tactic used by market makers was a source of liquidity risk for them. In the second half of 2010, when the highly rated banks became the net creditors in the domestic money market, the importance of this source of liquidity risk diminished.

Second, the market maker banks with high ratings used secured and unsecured money market instruments in different ways when raising and placing funds. Unsecured interbank loans accounted for most of the operations conducted by the highly rated banks to raise funds from other banks (over 95%). At the same time, repo operations accounted for more than 65% of operations conducted by the highly rated banks when they placed funds with other banks. This policy, which the market maker banks used, created some problems for the banks that had no investment grade rating, but at the same time it mitigated credit risk involved in the market makers' operations; this reduced the general level of systemic risk in the domestic money market. In addition, it encouraged Russian banks that had no investment grade rating to build up a portfolio of high-quality securities (securities that could be used as collateral in repo transactions) and thus contributed to the reduction of liquidity risk for these banks.

Average daily turnover of one-day interbank credit operations conducted by banks with an investment grade rating with other Russian banks in 2010 (billions of roubles)



Average daily turnover of operations conducted by banks with an investment grade rating with other Russian banks in 2010 (billions of roubles)



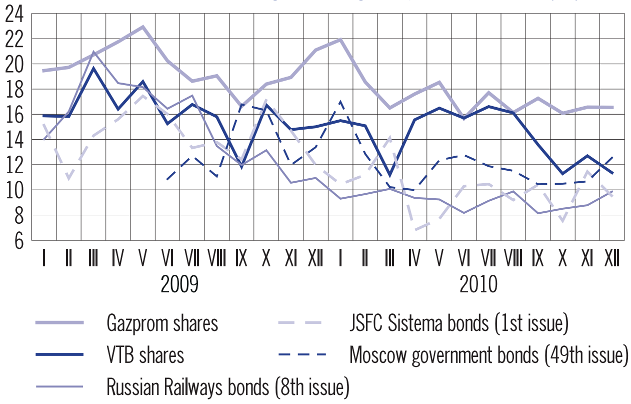
As before, in 2010 the Russian money market was linked to other segments of the Russian financial market, but the chance that instability would spread to the money market from other segments of the market was relatively small. The situation in the foreign exchange market continued to affect money market rates. When the rouble depreciated against the world's major currencies in nominal terms, demand for roubles rose in the domestic market. This was due to the growth of speculative investments in short-term foreign currency assets and the increased cost of external funding. This combination could lead to growth in money market rates. When the rouble appreciated in nominal terms, money market rates mostly declined. However, the scale of operations conducted by banks in the foreign exchange market in 2010 remained moderate *(see 2.2)*, while for most of the year, banks had a significant amount of liquid rouble funds. As a result, the foreign exchange market had little effect on the situation in the money market in 2010. In times of local surges in exchange rate volatility and increased uncertainty in exchange rate expectations, there was a moderate and short-term increase in interest rates and their volatility in the money market.

The situation in the money market was also affected by stock market fluctuations (due to the price dynamics of the securities used as collateral in repo deals). However, the high level of discounts on repo operations created obstacles to the spread of instability from the stock market to the money market via repo deals. After their sharp rise in late 2008 and early 2009, the discounts somewhat decreased in 2010 but nonetheless remained high. At the end of the year they reached 15% in stock trades and 10% in bond trades (Chart 2.4). As the maximum daily fall of the MICEX index in 2010 was less than 6%, this discount level was enough to minimise the risk that the collateral would devaluate in one-day repo operations, which dominated the market.

As before, the financial stability of Russian banks was not particularly dependent on the interbank money market situation. Although interbank loans were the main source of lending or funding for some banks, these were the third-tier banks. For the banks that were the

Chart 2.4

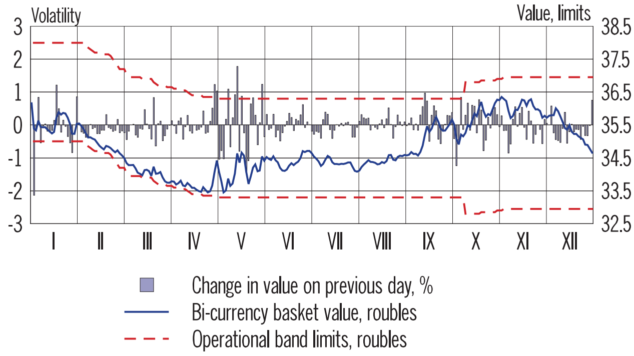
MICEX Stock Exchange average repo discounts (%)



Source: MICEX Stock Exchange, Bank of Russia Research and Information Department.

Chart 2.5

Exchange rate policy and short-term volatility of rouble value of bi-currency basket in 2010*



** Calculated at the official exchange rates set by the Bank of Russia.*

nucleus of the Russian banking system, the interbank money market was just a tool they used to manage short-term liquidity; this tool proved to be effective in fulfilling this function. Funds raised in the domestic money market accounted for less than 5% of these banks' liabilities and this served as a safeguard against the 'domino effect'.

2.2. Foreign exchange market

Rouble exchange rate dynamics evolved during the post-crisis recovery of the world economy, which mitigated the negative effect of external shocks on the rouble's stability, and the readjustment of the Bank of Russia's foreign exchange policy aimed at making the exchange rate setting mechanism more flexible. Rouble exchange rate volatility decreased significantly in 2010 and, as a result, exchange rate risk diminished for the banking sector and the Russian economy as a whole. The major threat to the stability of the domestic foreign exchange market that year, as in the previous years, was the possible destabilisation in world commodity and financial markets and the volatility of cross-border capital flows.

* * *

The situation in the domestic foreign exchange market had a major effect on the stability of the Russian banking sector and the financial market as a whole. The national currency's resilience to external shocks predominantly determined the investment preferences of both domestic and foreign investors.

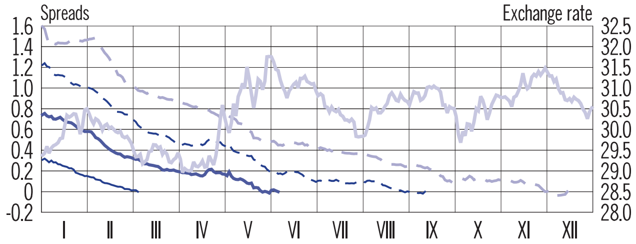
As before, the Bank of Russia adhered to the managed floating exchange rate regime, using the rouble value of a bi-currency basket as an operational benchmark (Chart 2.5). In addition to interventions conducted for the purpose of preventing the exchange rate of the rouble from becoming too volatile regardless of the fundamental factors, in 2010 the Bank of Russia conducted interventions to neutralise the domestic foreign exchange market participants' persistent expectations of the rouble's appreciation or depreciation. In April 2010, the Bank of Russia complemented the procedure for conducting interventions by the possibility of buying and selling foreign currency not only near the limits of the floating operational band, but also inside this band. The next step towards a more flexible exchange rate-setting mechanism was the expansion on 13 October 2010 of the floating operational band from 3 roubles to 4 roubles. The regulator's measures were carried out as part of the effort to upgrade the Bank of Russia's exchange rate policy mechanism and create the necessary conditions for a transition to a free floating rouble.

In addition to the global economic factors and the regulator's activity, exchange rate dynamics were affected by the exchange rate expectations of market participants. As a rule, when evaluating the exchange rate expectations one uses the dynamics of the spreads between the futures/forward rates and the current rates of foreign currencies against the rouble. It was noted that in 2010 this indicator provided little informative value: spreads demonstrated low volatility and did not react (by narrowing or widening) to the appreciation or depreciation of the rouble (Chart 2.6). This set of indicators underscored the uncertainty of foreign exchange market participants rather than the stability of exchange rate expectations, and showed that foreign exchange market participants had no clear picture with respect to further exchange rate dynamics.

Individuals' foreign cash operations provided a more informative indicator of the variability of exchange rate expectations. By and large, foreign cash market participants reacted adequately to the rate changes in 2008-2010. When the rouble depreciated, they purchased vast amounts of foreign currency and subsequently fixed their profits; when the rouble appreciated, they sold their foreign currency (Chart 2.7). The balance between foreign currency purchases

Chart 2.6

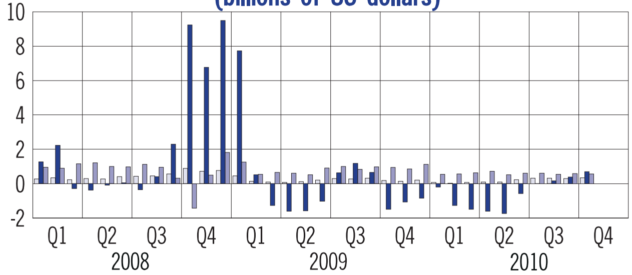
Futures spreads on contracts for US dollar exchange rate against rouble on MICEX* in 2010 (roubles)



* *Spreads smoothed in 11 points.*

Chart 2.7

Household operations with foreign cash (billions of US dollars)



* *"+" signifies that purchases exceeded sales.*
** *"+" signifies a net inflow of foreign exchange to accounts, "-" signifies a net outflow.*

and sales by households in the summer of 2010 may serve as an index of uncertainty about further exchange rate dynamics.

Despite the Bank of Russia's measures to make the rate-setting mechanism more flexible, the volatility of the rouble value of the bi-currency basket and the exchange rate of the rouble against the currencies it is comprised of, the US dollar and the euro, decreased considerably in 2010 compared to 2009 (Table 2.1). At the same time, the volatility of the rouble value of the bi-currency basket was lower than the volatility of the rouble's rate against each currency it is comprised of (as was the case before the crisis). The average daily absolute change in the rouble value of the bi-currency basket[1] decreased from 0.52% in 2009 to 0.33% in 2010, while the intrayear range of fluctuations[2] in the rouble value of the bi-currency basket narrowed from 6.13 roubles in 2009 to 2.90 roubles in 2010.

The US dollar remained the most important foreign currency in the domestic financial market in the period under review, as it retained its position as the principal currency with respect to foreign trade settlements and capital operations. The rouble/US dollar rate was more volatile than the rouble/euro rate and the rouble value of the bi-currency basket. Therefore, the marked decrease of rouble/US dollar exchange rate volatility in 2010 was the main factor that affected the reduction of foreign exchange risk in the domestic foreign exchange market as a whole. For example, the average daily absolute change in the US dollar/rouble rate in UTS trades for 'tomorrow' settlements decreased by a factor of 1.5 in 2010 compared to 2009, from 0.67% to 0.42%. The reduction was accompanied by the narrowing of the intrayear range of exchange rate fluctuations by a factor of 2.7, from 7.69 roubles in 2009 to 2.80 roubles in 2010.

The average daily change in the euro/rouble rate in UTS trades for 'tomorrow' settlements in 2010 stood at 0.37% as against 0.48% in 2009, a slightly smaller decrease than in the US dollar/rouble rate. At the same time, the intrayear range of fluctuations in the market euro/rouble rate remained practically unchanged at 5.62 roubles in 2010 (it was 5.63 roubles in 2009). This was the consequence of the gradual weakening of the euro against the rouble in the period of January through May 2010, rather than the high volatility of the rouble/euro rate.

The above volatility indicators for the rouble value of the bi-currency basket and the exchange rates of the major foreign currencies against the rouble testify to the gradual stabilisation of the foreign exchange market, and the marked reduction of exchange rate risk (the main risk in this segment of the money market).

In 2010, the aggregate turnover of the domestic interbank spot foreign exchange market was unchanged

Table 2.1

Annualised exchange rate volatility (%)

Exchange rate of the rouble	2007	2008	2009	2010
Against bi-currency basket*	1.2	5.2	12.4	7.2
Against US dollar**	3.2	8.1	14.6	9.0
Against euro**	2.9	8.3	10.6	8.1
Memo item:				
Euro against US dollar***	6.3	14.4	12.6	12.0

* *According to official exchange rates of the US dollar and euro against the rouble set by the Bank of Russia.*

** *According to exchange (UTS) rate in trades for 'tomorrow' settlements.*

*** *Interbank exchange rate on world currency market according to Reuters.*

[1] *The average daily absolute change (in magnitude) in the exchange rate is used as an indicator of the short-term exchange rate dynamics.*

[2] *The range of fluctuations in the market rate of a foreign currency (the rouble value of the bi-currency basket) is calculated as the difference between the maximum and minimum rates (values) in the period under review. The intrayear range of fluctuations is used as an indicator of the medium-term volatility of the exchange rate (bi-currency basket value).*

from the previous year, that is, it was far below its pre-crisis levels (the highest level of liquidity in this segment of the foreign exchange market was registered in 2007-2008). About 90% of operations involved the rouble/US dollar and euro/US dollar pairs of currencies. The share of rouble/euro operations contracted significantly in 2010. As in the previous years, the share of operations with other currencies was negligible. The slight change in the currency structure of this segment of the market had no effect on liquidity risk[3] in rouble/US dollar and euro/US dollar operations, which remained low. Although liquidity risk remained higher in transactions involving other currencies, it was not systemically important due to low levels of turnover.

In the exchange segment of the foreign exchange market, only two currency pairs, the rouble and the US dollar and the rouble and the euro, had a high level of liquidity. On the whole, the volumes of transactions in this segment of the foreign exchange market remained considerably smaller than in the over-the-counter segment of the market, but the exchange segment has retained its rate-setting significance.

An essential element of risk management is hedging based on derivatives, that is, the development of the futures segment of the foreign exchange market. The Russian currency futures market remained speculative in 2010 and did not fulfil this function. The reasons for this were the low level of liquidity (the futures segment accounted for just 4% of total domestic foreign exchange market turnover in 2003-2010), a limited set of instruments (both in terms of type and duration) and inadequate legislation.

In order to broaden the range of instruments, the RTS in 2010 offered market participants some new derivatives. The introduction of FORTS (RTS) pound sterling/US dollar (GBP/USD) and Australian dollar/US dollar (AUD/USD) futures and options on 1 December 2010 left market participants uninterested, due to the low liquidity of the market for the basic instrument. More promising from the viewpoint of hedging foreign exchange risk is the five-year USD/RUB futures contract, introduced on 2 September 2010, which has become the longest-term exchange contract in the Russian futures market. The introduction of this instrument met the wishes of market participants who needed long-term insurance against exchange rate risk. It may also interest participants who have US dollar-denominated assets and liabilities with comparable maturities. However, despite efforts to widen the range of instruments, the Russian currency derivatives market remained barely liquid and did not fulfil its function as a hedge of risk.

The imbalance between the foreign exchange positions (open foreign exchange positions) of credit institutions signals the existence of foreign exchange risk in the banking sector as a whole and may serve as a source of systemic risk and cause financial instability. The average value of the Russian banking sector open foreign exchange position in 2010 accounted for 1.3% of banking sector capital (1.7% in 2009). Under the limit set by the Bank of Russia to restrict foreign exchange risk,[4] the sum total of all open foreign exchange positions should not exceed 20% of the credit institution's equity capital. Bearing this limit in mind, in 2010 the mismatches in the foreign exchange positions in the banking sector as a whole testified to the presence of foreign exchange risk, but the level of this risk was low and it did not pose a systemic threat.

Prospects for the further reduction of foreign exchange risk are connected with the development of the risk hedging instruments, which is hindered by the low liquidity level of the futures segment of the domestic foreign exchange market.

2.3. Capital market

2.3.1. Bond market

The risk of Russian bond market destabilisation in 2010 arose from the expansion of the market portfolio of corporate bonds amid the continued defaults on the bonds of issuers with a low credit quality. It is mostly the prime issuers that increased their borrowing and the credit quality of the aggregate corporate bond portfolio improved as a result. Active bond placements by the federal and local governments encouraged investors to put their funds into these reliable debt instruments and contained the accumulation of risks in the corporate bond market.

* * *

In the primary market, the aggregate portfolio of government rouble and foreign currency-denominated securities grew the fastest, while the aggregate portfolio of regional and municipal rouble and foreign currency-denominated bonds increased at the slowest pace. Maximum absolute growth in the portfolio value was demonstrated by rouble and foreign currency-denominated corporate instruments, whereas minimum growth was registered in rouble and foreign currency-denominated regional debt securities.

Rapid growth in general government borrowings in 2010 posed no threat to the stability of the Russian financial market. Russia's domestic and external government debt to gross domestic product (GDP) ratio was less than 10% at the end of 2010, a low level by

[3] *Liquidity risk in the foreign exchange market is connected with the difficulty of finding a counterparty for the rapid execution of a conversion transaction on acceptable terms and conditions.*

[4] *Limits on open foreign exchange positions are set in compliance with Bank of Russia Instruction No. 124-I, dated 15 July 2005, 'On Setting Limits on Open Foreign Exchange Positions, the Methodology for Calculating them and the Specifics of Supervision over their Compliance by Credit Institutions'.*

Corporate Bond Default Risk Assessment

The analysis of the spreads between the yields on corporate and government bonds with a comparable duration has shown that market participants believed that the probability of default on corporate bonds in 2010 was far less likely than it had been in 2009. At the same time, the term structure of corporate bond yields has changed significantly. For example, in 2009 as the term to redemption approached, the speculative-grade corporate bond yield rose sharply because of the high default probability (as a result of issuers' inability to refinance their bonded debts in the short term). That's why the shape of the yield curve was descending (inverted). In 2010, the long-term corporate bond yield exceeded the short-term bond yield and the yield curve changed to ascending.

Average annual spreads between yields on corporate bonds of issuers with different credit ratings* and OFZ bonds (percentage points)

Duration, years	Financial sector						Non-financial sector					
	BBB-/BBB+		BB-/BB+		B-/B+		BBB-/BBB+		BB-/BB+		B-/B+	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010
0.5	2.8	2.3	5.8	3.1	11.4	5.8	2.1	1.1	5.8	2.5	18.2	4.7
0.75	2.8	2.1	5.0	2.9	7.8	5.7	2.3	1.1	5.3	2.3	11.4	4.6
1	2.8	2.0	4.4	2.7	7.1	5.7	2.5	1.1	4.9	2.2	7.6	4.5
1.25	2.8	1.9	4.0	2.6	6.5	5.6	2.6	1.1	4.6	2.1	6.0	4.4
2.5	2.8	1.7	3.0	2.3	5.7	5.5	3.0	1.1	4.3	1.8	3.5	4.1
3	2.8	1.6	2.9	2.2	5.9	5.4	3.1	1.1	4.8	1.8	3.3	4.0
4	2.9	1.5	3.0	2.1	5.9	5.4	3.3	1.1	5.4	1.6	3.5	3.9
5	3.0	1.4	3.1	2.0	5.9	5.4	3.4	1.1	5.7	1.6	3.8	3.8
7	3.1	1.2	3.0	1.8	5.8	5.4	3.6	1.2	5.8	1.4	3.7	3.9
10	3.3	1.1	3.0	1.7	5.7	5.4	3.8	1.2	6.2	1.3	3.6	4.0

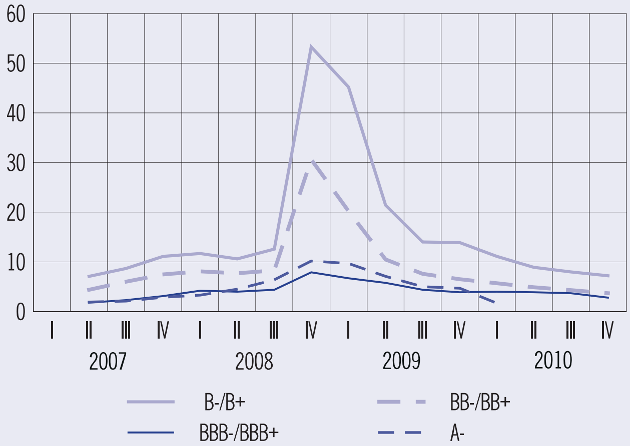
** If a corporate bond issue has been rated by S&P, Moody's or Fitch, the best rating is considered and adjusted to the S&P scale.*

Source: Bank of Moscow, Bank of Russia Research and Information Department.

The spreads between yields on risky and risk-free bonds consist of both credit and liquidity risk premiums. Therefore, the default probability assessment made on the basis of market spreads may be used as the upper limit of default probability of corporate bonds. The calculated risk-neutral probability of default on corporate bonds[1] issued by financial and non-financial sector issuers in 2010 declined to its 2007 level.

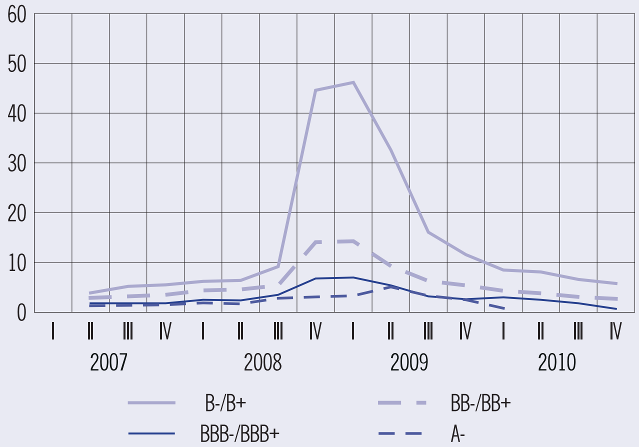
Default probability of corporate bonds by sector (%)

Financial sector



Source: Bank of Moscow, Bank of Russia Research and Information Department.

Non-financial sector

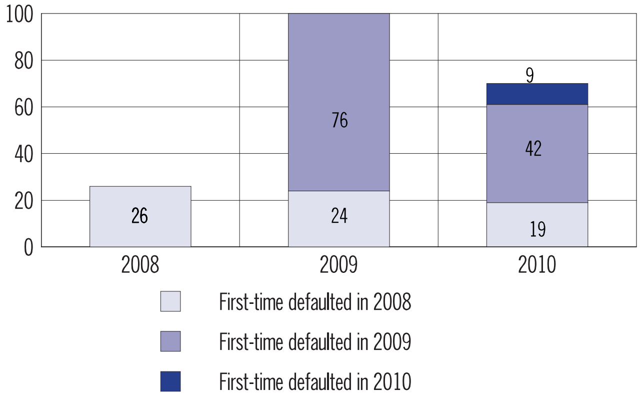


Source: Bank of Moscow, Bank of Russia Research and Information Department.

[1] Risk-neutral probability of default is assessed on the basis of the difference between the yields on corporate and government bonds in the secondary market:
$y - r_f \cong PD\,(1\text{-}RR)$, where
y is the risky (corporate) bond yield;
r_f is the yield of a risk-free bond (OFZ);
PD is probability of default during the year; and
RR is the recovery rate. The International Swaps and Derivatives Association (ISDA) has set RR for the Russian borrowers at 40% (according to business and financial news agency Bloomberg).
Risk neutrality signifies that risk-free investments with determined income and risky investments with the same expected income are equally attractive to the investor.

Chart 2.8

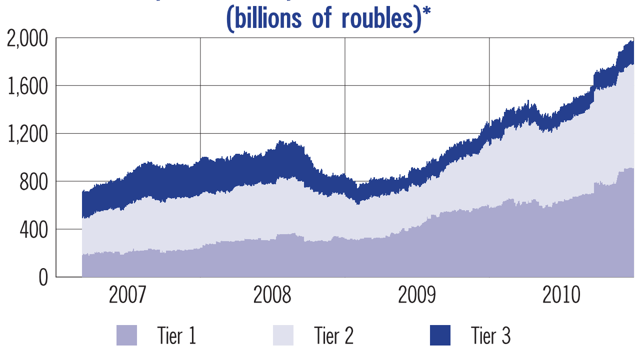
Corporate issuers' defaults in 2008-2010



* Source: news agency Cbonds.ru.

Chart 2.9

Corporate bond portfolio at actual value (billions of roubles)*



* The corporate bond portfolio consists of issues with a duration of more than 0.1 years, for which bilateral quotes were set for more than 3 days in the preceding 30 calendar days.
Source: Bank of Moscow.

international standards.[5] Russia's government debt service expenditures have been relatively small in recent years. The Russian government's sustained credibility allowed the leading international rating agencies to keep Russia's sovereign ratings unchanged; one of these agencies raised Russia's rating outlook (see *Addendum*).

In the regional bond market, one issuer increased its dominance (at the end of 2010, the Moscow government's bonds accounted for over 50% of the aggregate regional bond portfolio). Under the emergence of the debt problems of this issuer, the entire regional segment of the bond market may be destabilised. However, the likelihood of a default on Moscow government bonds is extremely small as the issuer's credit quality has not deteriorated in the period under review and it is confirmed by the stable financial status of the issuer and the long-term credit ratings assigned to it by the leading international rating agencies (see *Addendum*). The high liquidity and low yield of Moscow government bonds in the domestic exchange market in 2010 also bore out the reliability of this issuer's securities.

The topical problem in the corporate bond market in 2010 was that of defaults on instruments issued by companies with a low level of credit quality. Although the number of such defaults declined, it remained high (Chart 2.8). The highest credit risk was inherent in the bond issues whose issuers had difficulties with servicing their bonded debts during the past two years: they accounted for about 90% of the defaults registered in 2010 (see the box entitled *Corporate Bond Default Risk Assessment*).

Bonds issued by low credit quality issuers continued to be withdrawn from circulation as they were redeemed or reclassified as defaulted. Although investor demand for riskier high-yield assets rose compared to the second half of 2008 and 2009, third-tier issuers in 2010 managed to place a small number of new securities. As a result, the credit quality of the aggregate portfolio of outstanding corporate bonds has improved (Chart 2.9) and its credit risk diminished. The gradual reduction of credit risk on corporate borrowings has been confirmed by the improvement of the ratings assigned to Russian corporate issuers by leading international rating agencies (see *Addendum*).

Yields on different types of bonds declined at different rates; the spreads between them (which mostly narrowed) reflected this. The dynamics of the debt instrument yield, as well as the spreads between yields on different types of bonds, indicated that in 2010, securities market participants lowered their credit risk estimates.

The credit risk associated with certain groups of instruments varied widely in 2010; these variations depended on the corporate borrowers' creditworthiness. In the second half of the year, this risk on the portfolios

Chart 2.10

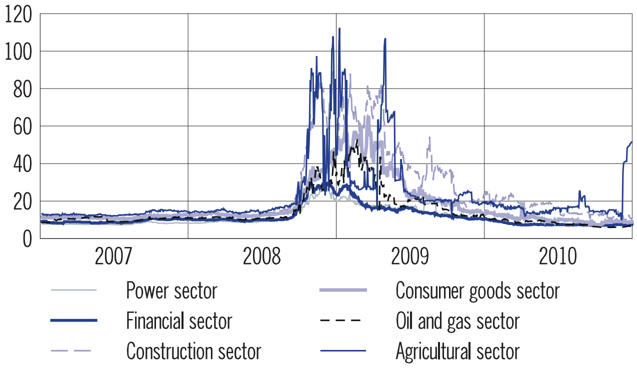
Spreads between yields on corporate bonds and OFZ-PD bonds in the secondary market (percentage points)

Source: Bank of Russia, Bank of Moscow, Bank of Russia Research and Information Department.

[5] *For example, according to the European Union standards set by the Maastricht Agreement (which was signed on 7 February 1992 and came into force on 1 November 1993), government debt should not exceed 60% of annual GDP.*

Chart 2.11

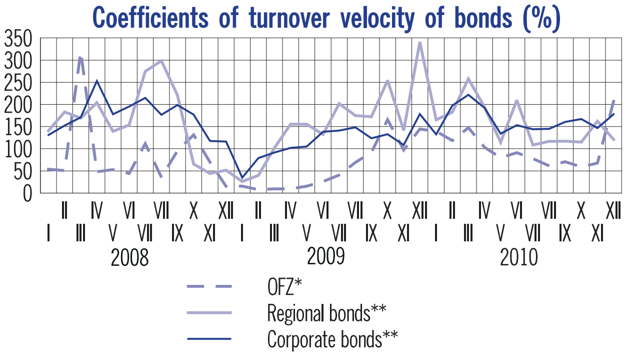
Secondary market corporate bond yields by type of economic activity (% p.a.)



Source: Bank of Moscow.

Chart 2.13

Coefficients of turnover velocity of bonds (%)



** Calculated as the ratio of monthly secondary trade turnover to the average monthly portfolio value (on an annualised basis).*
*** Calculated as the ratio of monthly secondary trade turnover to the outstanding volume, as of the end of the month (on an annualised basis).*
Source: MICEX, Bank of Russia Research and Information Department.

of bonds issued by all the three 'tiers' of issuers was mostly lower than it had been in 2007.[6] (Chart 2.10)

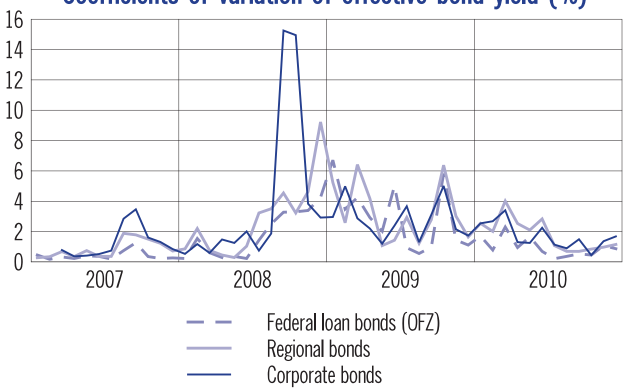
The stratification of the corporate bond market by industry, which increased in 2008 and 2009, decreased slightly in 2010 but remained significant nevertheless. Companies assigned to different types of economic activity differed, both in terms of the speed in the recovery of their output, and in terms of their ability to service their debts on time; the secondary corporate bond market indicators reflected this situation. The rates of decline in the yields of bonds issued by companies in various sectors of the economy differed significantly, as did their volatility (Chart 2.11). Throughout the period under review, investments in consumer goods and agricultural sector corporate debt securities were exposed to the highest credit risk while the investments in the financial, oil and gas, and power sector debt securities had the lowest credit risk.

The coefficients of variation of federal, regional and corporate bond yields continued to decline in the domestic market in 2010 (Chart 2.12). The range of fluctuations in the yields of the debt instruments under review narrowed, but remained considerably wider than it was before the crisis. Regional bonds demonstrated the biggest decline in yield volatility in 2010 compared to 2009, while the OFZ yield volatility decreased the least. The lessening of bond yield volatility in 2010 testifies to the fall of interest rate risk in operations involving these instruments.

A major characteristic of the bond market is the liquidity risk of securities (financial assets), that is, the risk that an asset will be difficult or impossible for its owner to sell in the secondary market quickly enough to prevent a loss. Turnover (the total value of transactions) in the OFZ,[7] regional and corporate bond markets grew

Chart 2.12

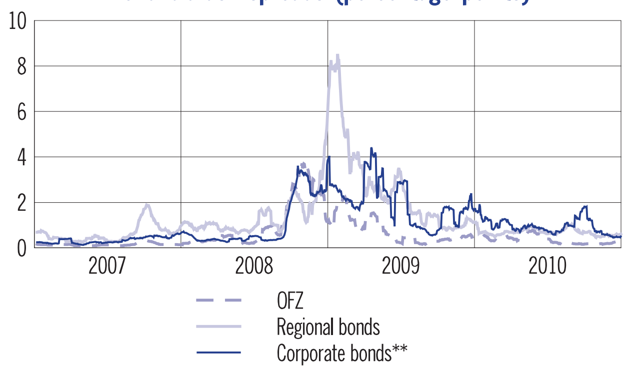
Coefficients of variation of effective bond yield (%)



Source: Bank of Russia, news agency Cbonds.ru, Bank of Moscow and Bank of Russia Research and Information Department.

Chart 2.14

Bond bid/ask spreads (percentage points)*



** 21-day moving average.*
*** Calculated by corporate bond issues included in Tier 1 Securities List A.*
Source: MICEX, Bank of Russia Research and Information Department.

[6] *The negative values of spreads are attributable to both the differences in compiling the index portfolios and the portfolios' duration. The OFZ-PD index portfolio consists of all the outstanding issues in this category, while the corporate bond index portfolio is composed of the most liquid bonds.*

[7] *In the main trading mode, excluding technical and negotiated deals.*

in 2010 year on year, reflecting market participants' increased activity and a reduction of liquidity risk.

Coefficients of turnover velocity[8] and their volatility in certain segments of the bond market fluctuated within a wide range in 2010 (Chart 2.13). Turnover velocity mostly declined and was extremely volatile on the federal and regional government bond markets during the year. Meanwhile, in the corporate bond market, the coefficient of turnover velocity remained at its December 2009-January 2010 level for most of 2010 and was less volatile than in other segments of the bond market. Corporate bonds had the highest turnover velocity, while OFZs had the lowest. Average coefficients of turnover velocity in the OFZ and corporate bond markets increased compared to 2009, reflecting growth in the liquidity of these segments of the market and, consequently, their stability.

As the situation in the Russian bond market improved in 2010, the liquidity of some instruments rose as compared with the preceding period. The dynamics of daily bid/ask rouble bond spreads, weighted by secondary trade turnovers, bear this out (Chart 2.14). The bid/ask spread provides one with some idea as to the costs incurred by counterparties in these transactions. The smaller the spread is on any given security, the greater its liquidity is. The average bid/ask spreads on OFZs and regional and corporate bonds contracted significantly in 2010.

Although the bond market liquidity indicators discussed above improved in 2010 compared to 2009, they have not reached their 2007 levels and this may serve as an indicator that all the outstanding bonds in the domestic market still have a low level of liquidity.

2.3.2. Equity market

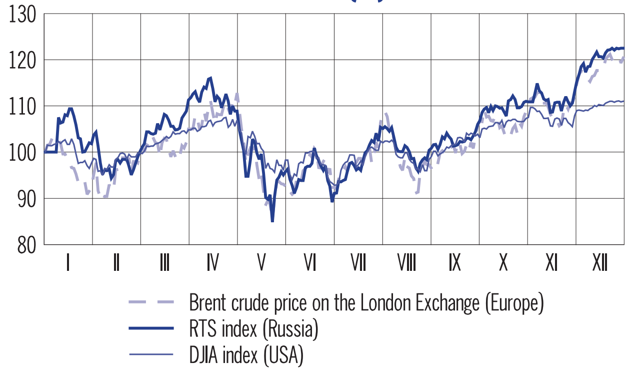
Favourable trends in the domestic financial market, such as the banking sector's increased liquid resources and the fall in interest rates, had a stabilising effect on the equity market in 2010. The sources of danger to the stability of the Russian equity market were, as before, its high concentration by issuer and by industry, a dependence on the external commodity and financial market conditions, and cross-border capital flow dynamics. Given these factors, the major types of risk in the equity market were moderate.

* * *

The risks involved in operations with shares are largely determined by the effect of external shocks, which affect the domestic stock market through changes in global investors' attitudes toward risk. The Russian equity market's dependence on the world financial market conditions and its equities segment is a major source of price risk. As in 2009, in 2010 the correlation

Chart 2.15

Evolution of RTS index, DJIA index and world oil price in 2010 (%)*



** Stock indices and oil prices as of 31 December 2009 = 100%.*

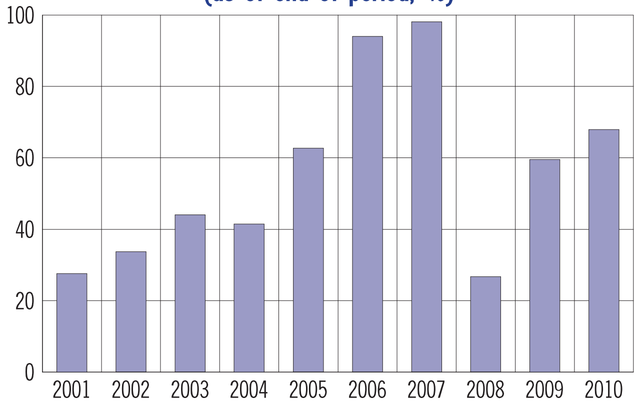
coefficient between the RTS index and the New York Stock Exchange's Dow Jones Industrial Average index (DJIA index) stood at 0.93 (Chart 2.15). In 2010, the VIX index (indicating volatility of the US stock market) and the country risk premium (the EMBI+ Russia and EMBI+ spreads), most commonly used as the risk aversion indicators, approached their pre-crisis levels. This reflected investors' optimism with respect to the global financial market and to emerging markets, which maintained the current level of share prices in the stock markets of these countries.

In addition, the effect of the outflow of foreign investor capital from the Russian equity market on the latter in 2009-2010 gradually lessened. This was due to the significant contraction of transaction volumes and the smaller size of the non-resident share of the secondary equity market compared to 2007-2008 (see the box entitled *The Effect of Cross-border Capital Flows...*).

The reduction of the price risk in the equity market was also facilitated by the lack of a definite trend in instrument price dynamics. This factor prevented the

Chart 2.16

RTS stock market capitalisation to Russia's GDP (as of end of period, %)



[8] *The ratio of total turnover to the average outstanding volume of bonds at their actual prices over the period (on an annualised basis).*

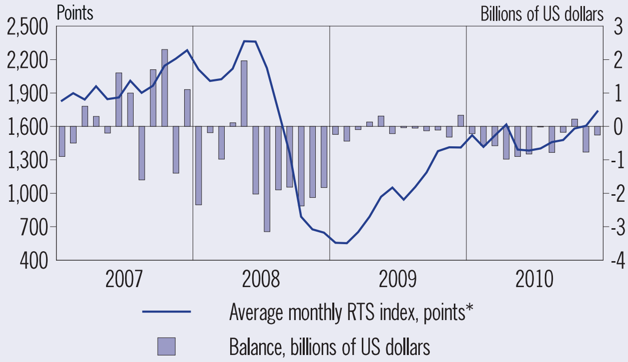
The Effect of Cross–border Capital Flows on the Russian Equity Market

The analysis of the effect of the changes in the direction of the non-resident capital flow on the movement (increase/decrease) of the Russian equity market price indices[1] in the period of January 2007 through December 2010 has shown that in 82% of all cases, the RTS stock index reacted to the inflow of foreign investor funds to the Russian stock market by growing in value. The result of the testing of the effect of the outflow of non-resident capital on RTS index dynamics turned out to be much worse: the index only declined in 63% of all cases. This fact is attributable to the effect of the abrupt contraction of the share and scale of non-resident operations in the secondary equity market in 2009-2010.[2]

The results of an analysis of RTS index dynamics in the period from 2009 through 2010 are consistent with the results of modelling. RTS index growth rates during this period were positive (129% and 23%, respectively), despite the fact that non-resident capital continued to flee from the domestic equity market.

Thus, the effect of cross-border capital flow dynamics on the Russian equity market conditions weakened as the market recovered from the crisis.

Balance of non-resident deals with equities in secondary trades on the MICEX Stock Exchange and RTS index



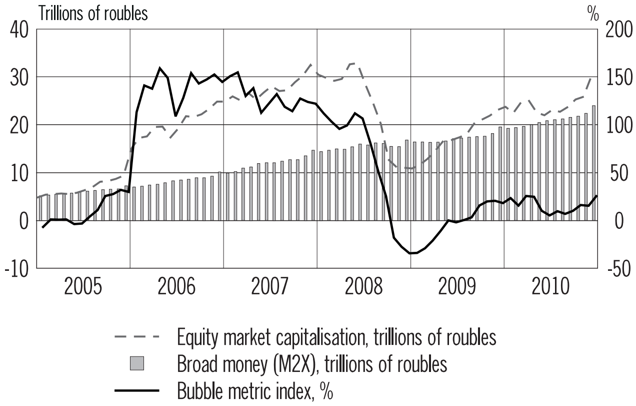
** Source: RTS, Bank of Russia Research and Information Department.*
*** Purchase volume less sale volume of equities in secondary trades on the MICEX Stock Exchange.*
Source: MICEX Stock Exchange.

[1] This dependence was tested by building a simple logistic regression model. Logit models are often used to predict the probability of a certain event (in this case, the rise/fall of the RTS stock index), depending on the predictor values (in this case, the balance of non-resident operations with shares in secondary trades on the MICEX Stock Exchange). To solve the problem, we introduced a dependent variable (y) and an independent variable (predictor). The dependent variable is developed on the basis of the monthly rates of growth in the average monthly values of the RTS index. This variable in the regression equation may assume only two values, 0 in periods when the index is rising and 1 in periods when the index is falling.

[2] Here and below, we use data on the share and volume of non-resident operations in secondary trades on the MICEX Stock Exchange.

Chart 2.17

Broad money, RTS equity market capitalisation and bubble metric index



emergence of a new share price bubble and thus made a sharp price downturn less likely in the medium term. The absence of any signs of the market overheating in the period under review was confirmed by the dynamics of some indicators used to predict price bubbles in financial assets. For example, the percentage ratio of the equity market's capitalisation to GDP in 2010 was considerably smaller than in the period from 2006 through the first half of 2008, when equity market prices were booming (Chart 2.16). The *bubble metric index*[9] in 2010 never topped the critical threshold level of 30%[10] and at the end of December it stood at 26% (Chart 2.17). The *alpha coefficients*[11] calculated for the most liquid shares on the MICEX Stock Exchange varied but remained close to zero, reflecting the adequacy of the price levels of these instruments in relation to their real value under the existing market conditions (Chart 2.18).

[9] The bubble metric index (BMI) was developed by Troika Dialog, an asset management company, and is a measure of the overheating/undervaluation of the stock market. It is the ratio between the capitalisation of the Russian stock market (MCAP) and broad money aggregate M2X:

$$BMI(\%) = \frac{MCAP - M2X}{M2X} \times 100.$$

[10] The developers of the bubble metric index believe that when the stock market's capitalisation exceeds the money supply index by more than 30%, the probability of a price correction in the stock market increases significantly.

[11] The alpha (α) coefficient is the measure of the increase/decrease in the price of a security, independent from the change in the composite price index (for a description of the index and the methodology used to calculate it, see the MICEX website). Stock market participants often use the alpha coefficient as a criterion when determining if securities are overvalued/undervalued. When this ratio is positive, it indicates that the security is overvalued by market participants, whereas a negative value indicates that the opposite is true.

The Use of Volatility Coefficients for the Analysis of Equity Market Participants' Price Expectations

In December 2010, the RTS Stock Exchange began to calculate and publish the Russian volatility index RTSVX.[1] The index is calculated using the implied volatility[2] of the options for RTS index futures contracts. Like the VIX index, which is used worldwide to measure investor fear in the US stock market, the RTSVX is an index of the price expectations of domestic options and equities market participants.

The analysis of RTSVX dynamics testifies to the reduction of price risk in the equity market in 2010. The average annual RTSVX in 2010 declined to 32.2% as against 60.1% in 2009 and 60.5% in 2008, and neared the 2007 level of 26.8%. At the same time, Russia's RTSVX index remained higher than the corresponding indicator in the US stock market.

RTS index and US and Russian stock market volatility indices

Source: RTS, Bloomberg.

[1] The methodology used to calculate the index and its historical series have been available on the RTS website since January 2006 (http://www.rts.ru/ru/index/rtsvx).

[2] Implied volatility is the assessment of the volatility of the basic asset by derivatives market participants on the basis of current option prices.

Chart 2.18

Alpha coefficients of most liquid ordinary shares on the MICEX Stock Exchange

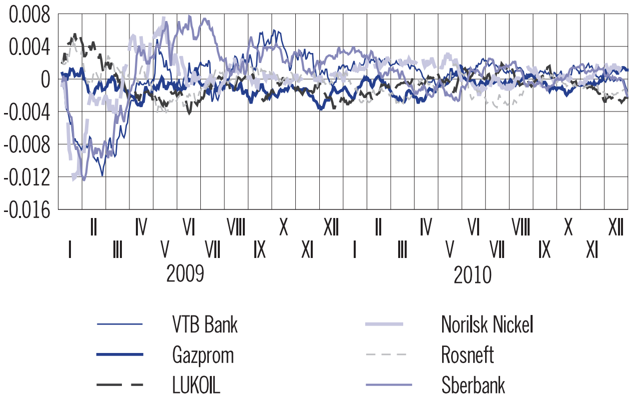
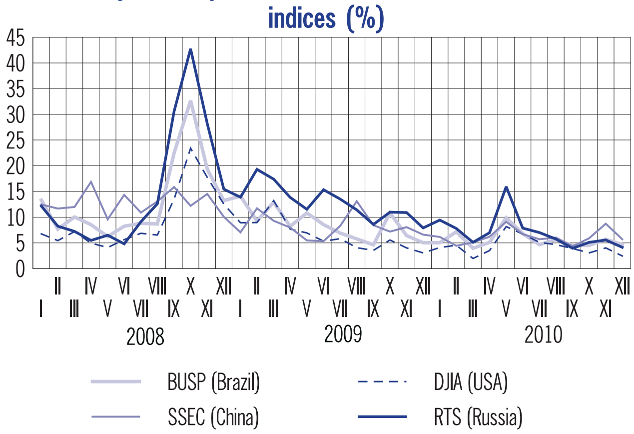


Chart 2.19

Monthly volatility of some of the world's stock market indices (%)



Although the price uncertainty remained in the Russian equity market, securities price volatility continued to subside, and in the last few months of 2010 it returned to its pre-crisis level, reflecting a reduction in price risk (Chart 2.19). The annualised volatility of the Russian MICEX and RTS stock indices in 2010 stood at 24% and 27%, respectively, as against 47% and 46% in 2009.

In addition to the dynamics of the aforementioned indices of historical volatility, the reduction of price risk in the Russian equity market in 2010 is confirmed by the decline of the RTSVX index (see the box entitled *The Use of Volatility Ratios for the Analysis...*).

The liquidity indicators of the exchange segment of the Russian equity market moved in different directions in 2010. For example, the bid/ask spreads of the most liquid equities of the first-tier issuers continued to narrow gradually, and in 2010 this metric averaged 0.07% as against 0.09% in 2009 (Chart 2.20). This contraction testifies to slight growth in the liquidity of the group of securities that account for the bulk of transactions with Russian shares. At the same time, the equity market's coefficient of turnover velocity declined, but it remained a little higher than it had been before the crisis (the annualised coefficient of turnover velocity in 2010 stood at 67% as against 94% in 2009 and 60% in 2007). This indicator allows one to evaluate the rate of inventory turnover in the equity market: the higher the coefficient of turnover velocity, the more liquid the respective segment of the market. The decrease of the coefficient of turnover velocity is attributable, on the one hand, to slack securities price dynamics during most of 2010; on the other hand, it is the result of the coefficient's rebound to its normal level after abnormal

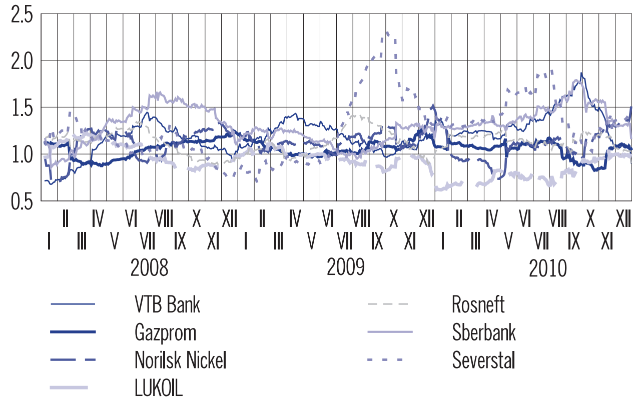
Chart 2.20

First-tier equity issuers bid/ask spread (%)*

* 20-day moving average.

Chart 2.21

Beta coefficients of most liquid ordinary shares on the MICEX Stock Exchange



growth during the 2009 share price boom.[12] The sharp rise in the turnover ratio in 2009 was also connected with the significant contraction of the average annual equity market capitalisation.[13]

The capital concentration in the equity market remained high in 2010. The stocks of the top 10 Russian issuers accounted for over 50% of the market capitalisation and about 90% of the total trade turnover of Russia's three leading stock exchanges: the MICEX Stock Exchange, the RTS and the St Petersburg Exchange.

On the MICEX Stock Exchange, the beta coefficients[14] of the most liquid equities of the largest issuers exceeded 1. This fact indicates that there was a large share of speculative transactions in the total equity trading volume (Chart 2.21). The equities issued by the largest banks, Sberbank and VTB Bank, had the highest beta coefficients. Investors' interest in short-term investments in Russia's principal partially state-owned bank equities remained stable. These two issuers accounted for about 42% of total trade turnover.

The equities of the largest oil and gas sector issuers continued to hold the second place in the secondary trade turnover on the aforementioned trading floors. They accounted for over 30% of the market capitalisation and about 35% of total trade turnover, making the Russian equity market dependent on the world oil market conditions. In 2010, the correlation coefficient between the RTS index and the price of Brent crude on London's ICE Futures Europe Exchange stood at 0.92 as against 0.93 in 2009 (Chart 2.15).

The high concentration of the equity market by instrument and industry, along with the high beta coefficients of the most liquid shares, continued to threaten the market by enhancing the risk of destabilisation. A sudden deterioration of the financial situation of one or several major issuers could negatively impact the equity market as a whole and should the major banking sector issuers face problems, they may spread to the other segments of the financial market. However, such a scenario is unlikely because the Russian market's major issuers are highly reliable and some of them are partially government-owned.

The negative impact of the equity market on other segments of the financial market was contained, as before, by the lack of Russian banks' interest in high-risk equities *(see 3.1)*. In 2010, investments in shares accounted for 3% of banking sector assets or less (Chart 2.22). At the same time, for some banks among the major equity market operators, the risk from investments in these securities remained high and posed a threat to the stability of these banks.

Chart 2.22

Investments in equities as a percentage of Russian banks' assets

* Most active equity market operators.

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[12] *The post-crisis recovery of an equity market may have some specific features. For example, abnormal growth of some market indicators, such as price and turnover growth rates, price volatility and turnover velocity.*

[13] *The annual share coefficient of turnover velocity is calculated as the ratio of the year's total secondary share trade volume on the MICEX Stock Exchange and on the RTS, to the average annual capitalisation of the equity market.*

[14] *Beta (β) coefficient is a measure of the risk of a security, which shows to what extent the change in its value is faster/slower than the movement of the composite price index (for the description of the ratio and methodology for calculating it, see the MICEX website). When β>1, the risk of investing in the security is higher than the overall market risk.*

Chapter 3. The financial situation and the soundness of financial intermediaries

3.1. Credit institutions

Notably in 2010, the Russian banking sector recovered from the crisis amid the phasing out of the government's anti-crisis measures. Most of the regulatory requirements the government had imposed on credit institutions, as well as the refinancing procedure and banking sector liquidity management instruments, have returned to their pre-crisis standards. Over the year, the rates of return on assets and the capital of the Russian banking sector increased, while credit institutions' profits surpassed their pre-crisis level. However, this growth in banks' profits was largely due to the sharp fall in expenses associated with loan loss provisions. The accumulation in banks' balances of deposits which were raised during the acute stage of the crisis at higher interest rates was what caused the contraction in the banks' net interest income (except yields on securities). Despite the improvement of the credit institutions' key performance indicators in 2010, banking sector risks remained relatively high.

* * *

Despite the termination of most of the government's anti-crisis measures, the key credit institution performance indicators in 2010 improved compared to 2009. Total banking sector assets grew by 14.9% as against 5.0% in 2009, while the aggregate credit portfolio grew by 11.6% (in 2009 it contracted by 0.2%) and the net financial result increased by a factor of 2.8 year on year. However, while by the beginning of 2010 the banking sector's relative macroeconomic indicators had improved amid a contraction in GDP, by the end of the year the ratio of total banking sector capital to GDP decreased by 1.2 percentage points to 10.6%, whereas the ratio of banking sector assets to GDP increased by 0.7 percentage points to 76.0%.[1]

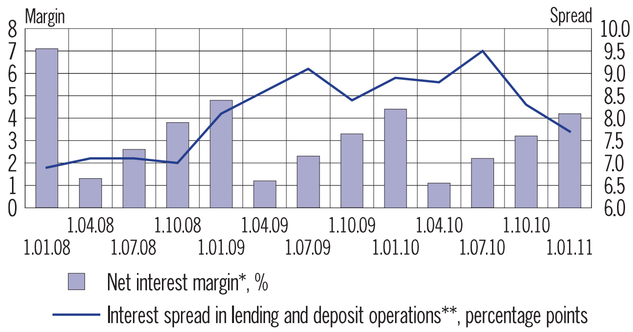
The balanced policy pursued by credit institutions in building their resource bases was a major factor that improved the stability of the Russian banking sector in 2010. The total value of household deposits increased by 31.2% as against 26.7% in 2009. Affected by the so-called 'post-crisis syndrome', people actively continued to increase deposits, especially those opened during the period when interest rates were higher. This is why in 2010, long-term deposits grew faster than short-term ones: deposits with terms of longer than one year grew by 33.2%, whereas deposits with terms of 31 days to one year increased by 16.8%. In addition, the indexation of social benefits in 2010 and the virtual lack, during the past two years, of a viable alternative to the bank deposit as a reliable instrument of saving were the most important growth factors for household deposits. The share of growth in savings in the form of bank deposits and securities in the structure of household income use in January-November 2010 expanded to 6.8% as against 3.2% in the same period a year earlier.

The creation of liabilities that resulted from the raising of household deposits at high interest rates set during the crisis led to the reduction of credit institutions' net interest margin,[2] which contracted to 4.2% in 2010 from 4.4% in 2009 (Chart 3.1). To prevent this indicator from declining further, some banks have cut deposit interest rates to their minimum (restrictive) level and cancelled their seasonal campaigns and special actions.

The average weighted interest rate on rouble-denominated household deposits with terms of up to one year[3] was considerably higher than the inflation rate until September 2010, and with terms from one year to three years until October. In 2010, the most attractive interest rates were offered by private, mostly small and medium-sized credit institutions, for which the aggressive build-up of deposits was a long-term goal rather than an anti-crisis measure. The share of household deposits in the total liabilities of these credit institutions is larger than the market average, as a rule (28.3% as of 1 January 2011). However, the banks in which household deposits account for more than 50% of liabilities include both private credit institutions and

Chart 3.1

Net interest margin and interest spread of Russian credit institutions



** Calculated on the basis of net interest income (reporting form 0409102).*
*** Calculated on the basis of credit and deposit interest rates (reporting form 0409128-129) over the month preceding the reporting date.*

[1] *According to preliminary data.*

[2] *Calculated as the ratio of net interest income (form 0409102) over the specified period to the average chronological value of assets over the same period.*

[3] *Here and below, the interest rate on lending and deposit operations conducted by banks (including Sberbank) in roubles, except call deposits.*

banks that are partly government-owned. It should be noted that the aggressive household deposit policy pursued by some banks has been caused by liquidity problems, which arise from the low rate of return on active operations, among other things. Household deposits are designed to conceal these problems, as it were, allowing the banks to meet their current obligations for a period of time. In 2010, the Bank of Russia set a 25% limit on the share of household deposits in banks' total liabilities.[4]

In certain periods of 2010, as the Russian rouble weakened, there was a slight rise in the foreign exchange risk involved in the creation of the resource base of credit institutions. When the rouble rate was unstable, people preferred to keep their savings in foreign currency-denominated bank deposits. In October and November 2010, the foreign currency component increased in total household and corporate deposits. As demand by non-financial organisations for foreign currency-denominated loans rose, credit institutions, for their part, sought to increase the volume of foreign currency they raised from households and corporations. For this purpose, in the second half of 2010, many credit institutions began to raise interest rates on household foreign currency-denominated deposits.

The gap between the bank assets placed for terms of longer than one year and the value of the corresponding long-term liabilities narrowed slightly in 2010. According to the data, as of 1 January 2011, the difference between the share of loans extended to non-financial organisations and households for terms of longer than one year in total assets (38.0%) and the share of long-term deposits taken from these counterparties in total liabilities (27.7%) stood at 10.3 percentage points as against 13.9 percentage points a year earlier.

As a result of the gradual economic recovery in 2010, the financial situation and, consequently, the creditworthiness of non-financial organisations and households improved, creating sustained conditions conducive to a revival of demand for bank loans. Credit institutions, for their part, abandoned their conservative policy of conducting active operations step by step. They began, segment by segment and region by region, to increase their lending to the real sector (see the box entitled *The Effect of the Changes in Bank Lending Policy...*). As a result, the loan debt of both corporate and retail customers started to grow in March 2010 (Chart 3.2). Over 2010, the value of loans extended to non-financial organisations increased by 12.1% (as against 0.3% in 2009) and reached 14,062.9 billion roubles, while lending to households grew by 14.3% (in 2009 it contracted by 11.0%) to 4,084.8 billion roubles.

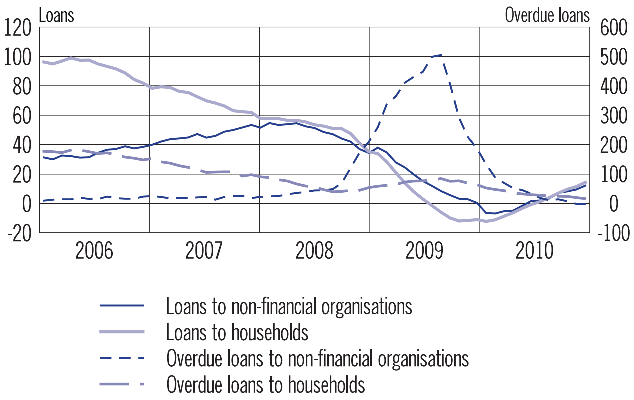
[4] *Bank of Russia Letter No. 116-T of 12 August 2010, 'On Risk Assessment in Active Deposit-taking Banks'.*

The corporate credit market in 2010 received a boost from government anti-crisis support measures, especially government credit guarantees. By 1 January 2011, non-financial organisations had received 132 federal government guarantees worth a total of 242.75 billion roubles, which accounted for 82.5% of the total value of the requested guarantees. These government guarantees were provided under credit agreements for a total amount of 448.03 billion roubles, or 3.2% of the total value of loans extended to non-financial organisations as of 1 January 2011. In the retail credit segment, the government actively implemented a programme to subsidise the interest rate on rouble-denominated car loans, at the rate of two-thirds of the Bank of Russia's refinancing rate, and carried out measures to support and stimulate the development of the mortgage market. According to data provided by the Ministry of Industry and Trade, 144,000 loans had been extended by 25 November 2010. This figure almost corresponds to the ministry's optimistic forecast of 150,000 loans, which it made early in the year. The debt on housing mortgage loans in 2010 increased by 11.6%, whereas in 2009 it contracted by 5.6%. As of 1 January 2011, these loans accounted for 27.6% of total debt on loans to households (see the box entitled *Housing Mortgage Lending Market Risks*).

Despite its pickup in 2010, the credit market has not yet fully recovered. Over the year, most of the banks increased their lending to non-financial organisations and households, mostly as a result of the refinancing and restructuring of loans extended earlier. However, this created latent threats which could affect the financial situation of credit institutions in the future. For example, independent experts' data indicate that about 80% of operations that were approved by the banks' credit committees by the end of 2010 were connected with relending. The share of restructured high-volume loans (loans exceeding 5% of the bank's capital) in total loans extended by credit institutions (loan debt and similar

Chart 3.2

Rates of growth in loans to the non-financial sector (as % of corresponding period of previous year)



debts) stood at 7.2%, or about 1.5 trillion roubles, as of 1 October 2010. The share of restructured high-volume loans in total large-value loans had expanded until April 2010, and as of 1 April reached 35.7%, but later it contracted to 30.6% (as of 1 September 2010).

Should lending rates rise, the presence of such loans in the banks' balance sheets may adversely impact these banks' interest incomes. In order to mitigate this risk, credit institutions tightened their non-price conditions for potential borrowers in 2010: they raised the requirements for the quality of collateral, security and solvency of the guarantors.

In 2010, the banking sector as a whole registered a slight improvement in credit quality. Overdue debt in the aggregate credit portfolio increased by 2.1% in 2010, whereas in 2009 it grew by a factor of 2.4. The share of overdue debt in the credit portfolio contracted from 5.1% to 4.7% in 2010. At the same time, the overdue debt situation somewhat differed by type of borrower. For example, the overdue debt of non-financial organisations contracted by 2.5% in 2010, whereas in 2009 it grew by a factor of 2.9, and its share decreased to 5.3% of the portfolio (as against 6.1% a year earlier). Overdue debt on loans to households increased by 16.2% (in 2009, it grew by 63.6%). The share of overdue debt on loans extended to households in the corresponding credit portfolio remained almost unchanged in 2010 (it was 6.9% as of 1 January 2011, and 6.8% as of 1 January 2010).

The share of problem and loss (non-performing) loans in total loans[5] contracted from 9.7% as of 1 January 2010, to 8.4% as of 1 January 2011. The level of the loan loss provisions made by credit institutions corresponded to the value of non-performing loans. As of 1 January 2011, this level accounted for 8.8% of the credit portfolio as against 9.3% a year earlier (Chart 3.3). Taking into consideration that the period of the relaxation of the rules and procedures for assessing the quality of loans and making loan loss provisions[6] ended on 1 July 2010, there is reason to say that the reduction in their value testified to the gradual stabilisation of the financial situation of borrowers. Nevertheless, the significant proportion of non-performing loans remaining in the banks' balance sheets posed a serious problem in 2010. As a consequence, in 2010 banks increased sales of these loans to outside non-bank organisations and transferred them to trust management and unit investment funds.

The ratio of the aggregate value of major credit exposures to total capital (N7 ratio) increased significantly from the beginning of 2010 (by 35.0 percentage points to 182.1% as of 1 October 2010), but it remained below the permissible maximum of 800%. In the opinion of analysts, including experts from Moody's, it was the large-volume loans and lending to related parties that continued to endanger the stability of the Russian banking sector in 2010. Therefore, in April 2010, Bank of Russia regional branches began to assess the risks posed by banks' operations with the actual (beneficiary) owners and parties affiliated with them. One of the main criteria used in making this assessment is compliance or non-compliance with the limit set on such operations at 20% of the bank's capital.

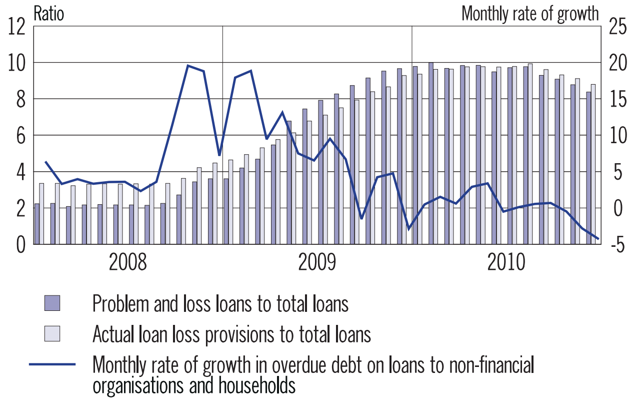
Banking sector credit risk taken into account when calculating capital adequacy[7] increased by 10.6% in January-September 2010, whereas in the same period of 2009 it decreased by 5.0%. This was due to the growth in total banking sector assets, especially lending operations and investments in securities.

The expansion by credit institutions of their securities portfolios is attributable to their desire to avoid an escalation in credit risk amid macroeconomic uncertainty and make additional income. In 2010, bank investments in securities increased by 35.3% to 5,829.0 billion roubles and their share in banking sector assets grew from 14.6% to 17.2%. Investments in debt obligations made up most of the securities portfolio (75.8% as of 1 January 2011) and their value increased by 30.8% to 4,419.9 billion roubles (this compares with 92.0% in 2009). At the same time, it is possible that this relatively slow rate of growth in the corporate credit portfolio in 2010 is connected with the decision of big non-financial organisations to raise funds by issuing bonds. However, the active investing of banks in securities may lead to growth in the risks taken into account when calculating equity capital adequacy.

In 2010, Russian credit institutions became more dependent on their external sources of funds. According

Chart 3.3

Quality of banking sector loan debt and actual loan loss provisions (%)



[5] *Here and below, according to data reported by credit institutions in reporting form 0409115 (section 1).*

[6] *Bank of Russia Ordinance No. 2156-U, dated 23 December 2008, 'On the Specifics of the Assessment of Credit Risk on Loans, Loan and Similar Debts'.*

[7] *This indicator represents the denominator in the N1 ratio calculation formula net of market risk.*

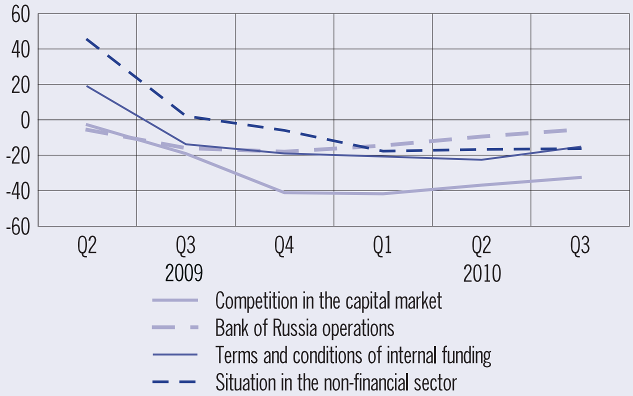
The Effect of the Changes in Bank Lending Policy on the Stability of the Russian Credit Market

The situation in the Russian economy in 2010 facilitated the easing of bank lending terms and conditions.[1] The factors which, in 2009, were mostly responsible for the tightening of the banks' terms and conditions for lending (the situation in the non-financial sector of the Russian economy and the terms and conditions for internal funding) had the opposite effect on bank lending terms and conditions in 2010.

There was no single trend in the dynamics of terms and conditions for bank lending in 2010: some lending terms and conditions were eased more than others, while still other were tightened. The reassessment of credit risk involved in operations in the credit market, including the reassessment of borrower credit risk for loans extended earlier, caused Russian banks to adopt a more conservative tactic for their operations in the credit market: banks sought to increase the share of prime borrowers in their credit portfolios. In the first half of 2010, despite the improvement of the situation in the non-financial sector, Russian banks continued to tighten their requirements for the financial situation of corporate borrowers. As a result, the range of potential borrowers narrowed, competition between banks remained high and this led to a further fall in credit rates. This tactic allowed banks to reduce credit risk, but the rate of return on banking sector assets declined. Since household deposits taken at high rates in 2008 and 2009 were one of the main sources of funds used to finance the extension of banks loans, this created the threat of the further contraction in the banks' interest margin.

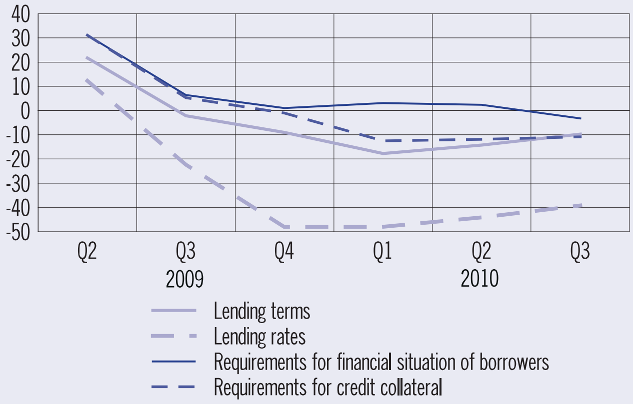
The danger of a fall in the banks' net interest incomes could be one of the reasons why they started to change their lending policies in the second half of 2010. They gradually switched to less conservative financial tactics and this was reflected in the expansion of the share of the banks that had eased up their requirements with respect to the financial status of borrowers, and a more cautious reduction of lending rates.

Indices of the effect of certain factors on terms and conditions of bank lending to large corporate borrowers*



** Positive values are factors contributing to a tightening of lending terms and conditions, negative values are factors contributing to their easing.*

Indices of change in some terms and conditions of bank lending to large corporate borrowers*



** A positive value signifies the tightening of lending terms and conditions, whereas a negative value signifies their easing.*

[1] According to data compiled in the quarterly survey of the lending policies of the largest Russian banks, participants in the credit market.

to a preliminary estimate, the Russian banking sector's external debt in 2010 rose by 13.9% year on year and on 1 January 2011 it reached US$144.8 billion, or 30.0% of Russia's total external debt. In January-April 2010, the Russian banking sector was the net creditor in operations with non-resident banks in the interbank money market. In May, the situation changed: Russian bank investments in the international money market declined, while foreign borrowing slightly increased. For most of 2010, the Russian banking sector remained the net borrower in relation to non-resident banks.

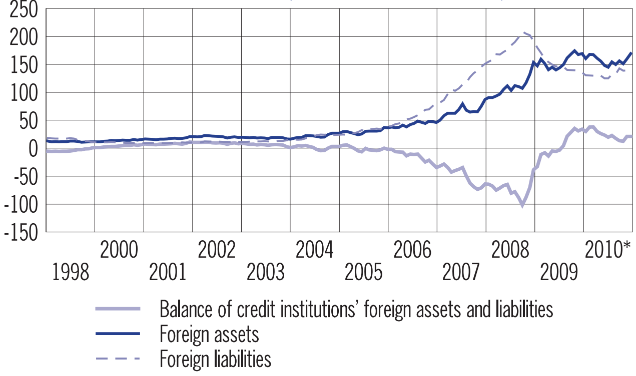
The Russian banking sector's foreign liabilities increased by 14.7% in 2010, while its foreign assets grew by 6.5%. The increase in the banking sector's foreign liabilities was caused by a slight rise in the real sector's demand for foreign currency-denominated loans and credit institutions' preparations for the 'peak' external debt payments of their corporate customers (Chart 3.4).

Despite being gradually scaled down, the anti-crisis measures of the Russian government and Bank of Russia continued to play a significant role in maintaining the stability of the Russian banking sector in 2010. However, their principal objective had changed dramatically: previously these measures had been designed to expand the range of mechanisms and instruments that could inject liquidity into the banking sector and budget funds into the economy, whereas now their purpose was to create stable macroeconomic conditions for long-term development.

Banking sector debt on one of the Bank of Russia's key anti-crisis instruments, unsecured loans, gradually

Chart 3.4

Balance of Russian credit institutions' foreign assets and liabilities (billions of US dollars)



** Preliminary data as of 1 January 2011.*

declined in 2010 and by 6 December these loans were almost completely settled. The total volume of problem debt on these loans, reclassified as overdue debt on Bank of Russia collateralised loans, was estimated at 46.5 billion roubles. By the end of 2010, there was practically no demand for Bank of Russia unsecured loans and as the Bank of Russia continued to phase out the refinancing instruments it had introduced during the acute stage of the crisis, it decided to suspend as of 1 October 2010 auctions of Bank of Russia unsecured loans with terms longer than five weeks and as of 1 January 2011, auctions of unsecured loans of all terms.

The only anti-crisis instrument ignored by Russian banks was the possibility to increase capital by purchasing federal loan bonds (OFZ), a programme for which the Russian government allocated 460 billion roubles in 2009-2010. It failed because it was oriented at big banks and had significant procedural limitations. In addition, in 2010 (compared to 2009) the situation with respect to the banking sector's recapitalisation became more stable and predictable.

Total banking sector capital increased by 2.4% in 2010 and reached 4,732.3 billion roubles as of 1 January 2011. Meanwhile, Sberbank's capital contracted by 5.4%, mainly as a result of the payment of 200 billion roubles by the bank on the 500-billion-rouble subordinated loan it had received from the Bank of Russia in late 2008. Sberbank's capital excluded, total banking sector capital grew by 5.6% in 2010.

Banking sector capital adequacy stood at 18.1% as of 1 January 2011 as against 20.9% a year earlier. As of 1 December 2010, six banks failed to meet the capital adequacy requirements (five banks as of 1 December 2009), and none of them ranked among the top 20 credit institutions. The share of assets of credit institutions that failed to comply with the N1 ratio in January-November 2010 fell from 1.2% to 0.2%.

As the authorised capital of credit institutions included in the equity capital calculation increased by 1.6% in January-November 2010, its share in total banking sector capital expanded from 25.4% to 25.6% in the same period. The importance of authorised capital as a source of growth in equity capital increased as the role of subordinated loans decreased.

In order to implement Federal Law No. 175-FZ, dated 27 October 2008, 'On Additional Measures to Strengthen the Stability of the Banking System in the Period until 31 December 2011', hereinafter referred to as Federal Law No. 175-FZ, the Bank of Russia in collaboration with the Deposit Insurance Agency (DIA) carried out measures to prevent the bankruptcy of 18 banks. By 1 December 2010, all the necessary measures had been completed in seven banks. Two of these had merged with other banks, and two had successfully undergone a financial rehabilitation programme and are now operating according to normal procedures. In three of the banks, household deposits and the equivalent amount of property had been transferred to financially sound banks; these three banks had had their banking licences revoked. As of 1 December 2010, the remaining 11 banks continued to carry out the bankruptcy prevention measures according to plans that envisaged the DIA's participation in these measures; one of these banks was supervised according to generally accepted procedures. In addition, as of 1 December 2010, bankruptcy prevention measures involving the use of government funds and the participation of other investors continue to be implemented in three banks. The decisions to rehabilitate these had been taken before Federal Law No. 175-FZ came into force (in October 2010, one of the rehabilitated banks merged with an investing bank).

In January-November 2010, the Bank of Russia revoked banking licences from 17 credit institutions (in the same period of 2009, it had revoked banking licences from 40 credit institutions). This was mostly because these credit institutions failed to comply with federal banking laws and Bank of Russia regulations or the equity capital requirements as of 1 January 2010 (pursuant to Part 5 of Article 11.2 of the Federal Law on Banks and Banking Activities) or failed to meet their creditors' pecuniary obligations.

As the banking sector recovered from the crisis, its profitability rose. In 2010, the banking sector's net financial result totalled 573.4 billion roubles, an increase by a factor of 2.8 on 2009. The rates of return on assets and capital went up and as of 1 January 2011 reached 1.9% and 12.5%, respectively (as against 0.7% and 4.9% a year earlier), but they have not returned to their pre-crisis levels. The decision to extend the moratorium on the banishment from the deposit insurance system of credit institutions that have temporarily allowed their financial results to deteriorate until 1 July 2011 contributed to banking sector stability.

Housing Mortgage Lending Market Risks

The housing mortgage lending market continued to recover in 2010. Compared to 2009, the value of new mortgage-backed loans tripled. The rise in mortgage lending activity was largely financed by several government programmes, some of them implemented in collaboration with the Agency for Housing Mortgage Lending (AHML) (such as mortgage loans for servicemen, subsidised loans to families with children, etc.), and was stimulated by the gradual meeting of deferred demand for housing in connection with the stabilisation of prices in the housing market.

The increase in new mortgage loans in 2010 was also facilitated by the following factors: banks had a plentiful supply of liquidity, constantly cut interest rates (this particularly applies to the banks that operate according to the AHML's standards) and eased the non-price terms and conditions for lending. Some banks made housing mortgage loans more accessible by opening new mortgage centres or reopening some of the mortgage centres that had been closed during the crisis, and allowing borrowers to use the value of their other property as the down payment on their mortgages. Floating interest rates gained wide acceptance, but having learned the lessons of the crisis, banks set limits on their maximum level.

Despite the rapid expansion of the volume of new housing mortgage loans, it was smaller than it had been before the crisis. Housing mortgage lending was limited by the financial instability of borrowers and the justified reluctance of credit institutions to cut interest rates on housing mortgage loans. According to the AHML's estimates, housing buyers now tend to rely on their savings rather than borrow. The share of housing mortgage loans in total household loan debt remained virtually unchanged at 27.6% as of 1 January 2011.

The recovery in the housing mortgage lending market was confirmed by the slowing of growth in overdue debt on these loans and the gradual stabilisation of its share in total housing mortgage loan debt. However, in 2010 the rate of growth in overdue housing mortgage loans (34.0%) was higher than the average rate of growth in overdue debt on household loans (16.2%). The share of overdue housing mortgage loan debt in total overdue household loan debt expanded over that period from 12.8% to 14.7%.

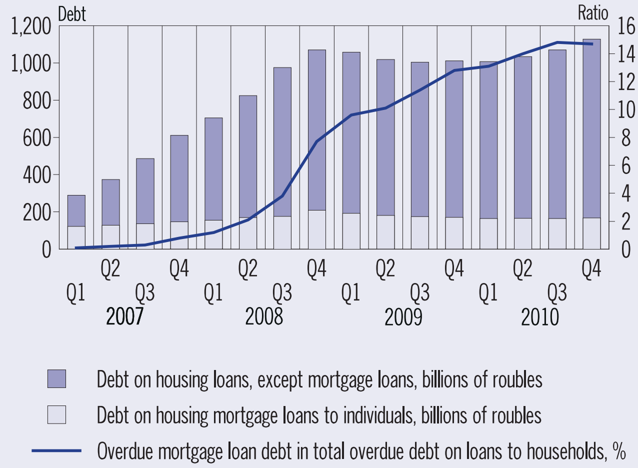
Because of excessive liquidity and high rates of return on housing mortgage loans in 2010, banks were not particularly interested in refinancing them; in the future this may limit possibilities for the extension of new loans. In the first half of 2010, credit institutions refinanced 29.3 billion roubles of housing mortgage loans (housing mortgage loan claims), a decrease of 13.3% from the same period in 2009. The share of refinanced loans in total housing mortgage loans contracted from 59.3% as of 1 July 2009 to 22.0% as of 1 July 2010. In 2010, Vnesheconombank did not begin to refinance mortgage loans under the government programme to boost the housing mortgage lending market.

At the end of the year, more and more banks launched especially risky mortgage programmes. This was mainly the result of the aggressive lending policies pursued by partly government-owned banks, which could raise relatively cheap funds. As competition built up, other banks had to ease their requirements for borrowers and scale up their operations in the high-risk subprime mortgage segment.

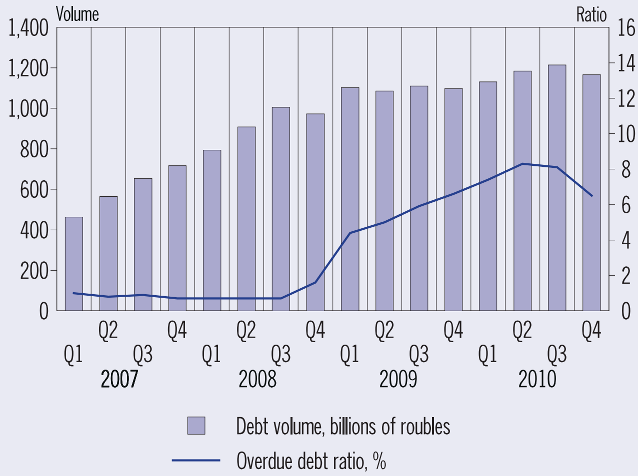
Experts claim that by November 2010, banks had virtually exhausted all possibilities for cutting interest rates on rouble-denominated mortgage loans. The reason is that credit institutions, aware of the substantial risks involved in loans with smaller down payments, started to include them in interest rates on the loans they extended. Experts believe that halting further housing mortgage loan interest rate cuts may soften the effect of the mortgage recovery experienced in 2010. Another argument in favour of the slowing of growth in housing mortgage lending is that not enough housing is being built, due to the unsound financial situation of construction companies.

According to Rosstat data, there was a 3.8% fall in the construction of new housing in Russia in January-November 2010, compared to the same period a year earlier. The net financial result decreased in the

Key housing lending market indicators



Construction companies' loan debt



construction industry, whereas losses increased; the rate of return on assets, products, goods and work fell. In addition, the solvency and financial soundness ratios in this industry were far below the recommended ones. The overdue loan debt owed by construction companies increased by 5.2% in 2010, while its share in total loans extended to these companies contracted from 6.6% as of 1 January 2010 to 6.5% as of 1 January 2011. According to experts' estimates, one in 5-8 bank loans extended to construction companies is past due and real estate property makes up a significant portion of non-core assets in banks' balance sheets. At the same time, one should bear in mind that many risks involved in lending to the construction companies are connected not only with the financial situation of the borrowers, but also with fluctuating market conditions and therefore, these risks often arise for reasons which banks are unable to control.

Although credit risk remains high, the number of new loans extended in 2010 to the construction industry increased by 25.9% year on year as against 8.7% on average in all types of economic activity. The share of loans extended to the construction industry in total loans extended to non-financial organisations (6.1% as of 1 January 2011) exceeded its pre-crisis level (5.5% as of 1 October 2008). Expert estimates indicate that restructured loans and loans extended for the completion of mortgaged construction projects accounted for a large portion of new loans.

Lending to the construction industry also expanded, due to the government programmes to stimulate the construction of low-cost housing. The implementation of the AHML's programme, dubbed Stimul, which guaranteed the buyout of housing that had been built, allowed banks to sign new contracts worth 25 billion roubles. Meanwhile the banks are adopting a more balanced risk management policy. Specifically, banks have established closer links with the construction companies they intend to extend loans to and are studying them more closely; they are evaluating the financial situation of the borrowers more carefully than they did before the crisis, as well as the borrowers' project portfolios, reputation in the market and the outlook for the sale of their finished construction products.

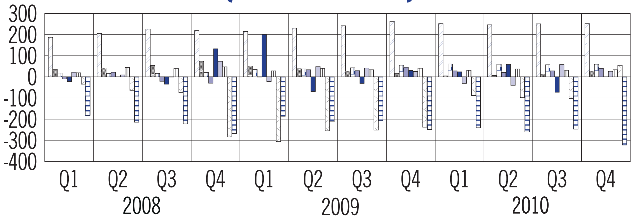
Thus, the probability of the widening of the gap between demand and supply in the housing market increased in 2010 amid high construction risks and the greater accessibility of mortgage loans. This poses a threat to the stability of the mortgage lending market.

Growth in profit and profitability is attributable, above all, to the more positive assessment by banks of the financial situation of their borrowers and, as a consequence, slower growth in loan loss provisions than in 2009, and the dissolution of a part of the provisions made earlier. In 2010, loan loss provisions increased by 6.1% (as against 116.0% in 2009) and were worth 1,642.0 billion roubles.

In order to earn an additional income, banks sought to increase the volume of loans they extended and reduce non-performing highly liquid assets. The ratio of the average value of the most liquid assets to the average value of total banking sector assets in 2010 stood at 8.0% as against 10.9% in 2009. The decrease is attributable to relative financial stability and the fact that banks did not have to keep significant liquidity reserves.

Chart 3.5

Key components of credit institutions' financial results (billions of roubles)



- Net interest income from operations with corporate entities
- Net interest income from operations with individuals
- Net interest income from securities
- Net income from securities trading except interest, dividends and revaluation
- Revaluation of securities, foreign currency funds and precious metals
- Net income from foreign exchange purchases and sales
- Net commission income
- Provisions for possible losses net of recovered sums
- Credit institution operating costs

As for the banking sector's positive financial results, the role played by certain components in bringing these about increased in 2010. These included net income from securities trading except interest, dividends and revaluation (which grew by 9.8% year on year), net interest income from securities (which grew by 40.5%), and net interest income from operations with corporate entities (which grew by 5.4%) (Chart 3.5).

The share of interest income (except interest on securities) in total banking sector income expanded to 10.1% in January-September 2010 (as against 7.6% as of 1 October 2009). The corresponding interest expenses of banks increased less, to 4.5% of total banking sector expenses as of 1 October 2010 (as against 3.3% as of 1 October 2009). Net interest income, except interest on securities, decreased by 2.9% in 2010 year on year, as the widening of the spread between non-financial customer credit and deposit rates slowed down. Net interest income from operations with individuals contracted the most in 2010 (by 61.9%).

3.2. Non-bank financial institutions

The financial situation of most of the non-bank financial institutions and their customers improved in 2010, stimulating growth in demand for the services of non-bank financial intermediaries and their supply and increasing the role of non-bank financial intermediation in the Russian economy. However, some of the risks that increased during the crisis continued to significantly affect the financial situation of non-bank financial *institutions. The non-bank financial institutions, for which investment was not a core activity, found themselves in a better position, while the institutions that specialised in securities trading were hit hardest.*

* * *

Growth in demand for insurance services had a favourable effect on the financial stability of Russian **insurance companies**[8] and helped the Russian insurance market recover from the main consequences of the crisis, which they registered in 2009. For example, the slowing of growth in insurance premiums has stopped. In January-September 2010, compared to the same period in 2009, insurance premiums increased at a rate of 7.2%, or 3.6 times faster than a year earlier. Growth in insurance claims slowed to its lowest rate in several years (4.3%) and for the first time since 2006, did not exceed growth in insurance premiums. This had a favourable effect on the financial capability of Russian insurers and testified to their increased efficiency (Chart 3.6). The improvement of the situation is partly attributable to the tightening by insurance companies of their insurance risk assessment criteria and their renunciation of price dumping policies.

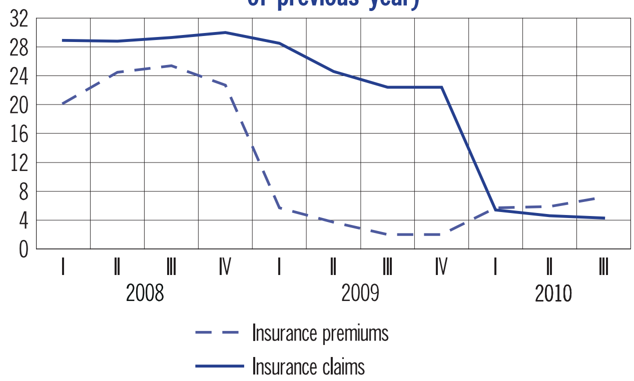
Compared to 2009, demand for voluntary insurance rose significantly in 2010. Total voluntary insurance premiums in January-September 2010 increased by 7.4% compared to the same period a year earlier (in January-September 2009, total voluntary insurance premiums fell by 11.6% compared to the same period in 2008). Maximum growth in insurance premiums was registered in voluntary life insurance (40.4%), although experts claim that in addition to the resumption of insurance service sales through banks, this increase may be attributable to the increased use, especially at the beginning of the year, of insurance schemes which allow insurance companies' customers to evade taxation.

Although the finances of insurance companies' customers improved, the risk of non-payment of insurance premiums under the contracts concluded with insurers remained high. The increased share of receivables in assets (in January-June 2010 it expanded by 1.4 percentage points to 21%) and of written-off receivables in total receivables (which grew by 8.4 percentage points to 11.4%) bears this out.[9] To mitigate this risk, insurers continued to offer deferrals for insurance premiums, a tactic that may eventually negatively affect their financial situation.

In 2010, Russian insurers vigorously built up their credit portfolio (in January-September it increased by 50.9%) with funds received from credit institutions and other organisations, including non-resident ones. The value of loans raised from non-residents in January-September 2010 more than doubled, while the value of loans raised from non-bank financial organisations increased by a factor of over 1.5. As a result, the ratio between the Russian insurers' own and borrowed funds increased by 8.0 percentage points to 19% as of 1 October 2010,[9] while some insurers, including some major ones, saw this ratio exceed 30%. Experts' data indicate that the insurers used loans to cover the cash gap and thus maintain financial stability. Experts have also come to the conclusion that insurance companies (artificially) overrated the quality of their assets in order to meet statutory requirements, thus distorting their actual financial situation.

Chart 3.6

Rates of growth in insurance premiums and claims (quarterly, as % of corresponding period of previous year)



In 2010, the financial potential of the Russian **collective investment market**[10] expanded but unlike in 2009, it grew mostly due to closed-end unit investment funds, or PIFs. Demand for the units of retail PIFs, which had been created to offer services to a wide range of private investors, remained unstable. However, this posed no tangible threat to the financial stability of the market as a whole, because as of 1 October 2010, these funds accounted for 25.1% of total PIF assets.

The financial situation of the retail segment of the collective investment market changed for the worse. In January-September 2010, compared to the same period in 2009, the rates of growth in the net asset value (NAV) of the retail PIFs slowed by a factor of 3.7 in open-end PIFs and by a factor of 4 in interval PIFs. The decline was largely the result of the contraction of returns on investments in securities and the closure of some funds.

The management companies took a series of measures to boost demand for the units of the retail PIFs in 2010. For example, they offered investors broader opportunities to buy units through point-of-sale terminals. However, the net inflow of shareholder funds to the PIFs in January-September 2010, estimated at 0.5

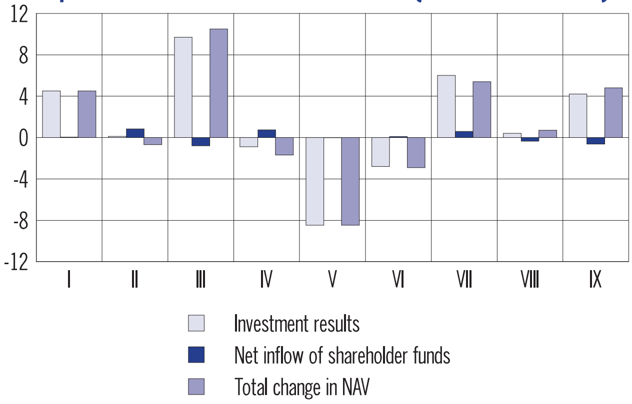
[8] *According to data provided by the Federal Insurance Supervision Service unless indicated otherwise.*

[9] *According to federal statistical observation form No. 1-FS (SK), approved by Rosstat Order No. 308 dated 10 December 2008.*

[10] *According to data provided by news agency Cbonds.ru unless indicated otherwise.*

Chart 3.7

Investment results and balance of sales of units of open-end and interval PIFs in 2010 (billions of roubles)



billion roubles, decreased by a factor of 3.5 compared to the same period in 2009 and, according to experts, was mostly the result of speculative investments.

The investment result of the retail PIFs was unstable in 2010 (Chart 3.7) and this serves as an indicator that significant investment risks are inherent in the PIFs. Nevertheless, most of them demonstrated growth in the period under review in the value of their shares, which often exceeded the inflation rate. The biggest rise in unit value (15.6% in January-September 2010) was registered by the equity PIFs.

The reduction of the net inflow of shareholder funds and the instability of investment results created conditions for the unscheduled sale of the assets of the open-end and interval PIFs. This created problems for the management companies in implementing their investment strategies and compelled these funds to scale down their long-term investments. As a result, the retail segment of the collective investment market lost some of its appeal for the management companies and this led to a fall in the number of retail PIFs.

The rapid growth of the closed-end PIFs was a factor that contributed to the stability of the collective investment market. In January-September 2010, their NAV increased by a factor of 1.7 compared to the same period in 2009, mostly due to the real estate and rental funds. Growth in the NAV of the real estate PIFs (by 32.9%) was mostly ensured by shareholder contributions to new funds, which increased in quantity by 91 in the period under review. The principal source of growth (by 62.4%) in the NAV of the rental PIFs was the relatively high investment results they achieved; this was due to the stabilisation of demand for the rent of office space and the gradual supply of the crisis-deferred demand of major customers for the rent of warehouses and industrial premises.

The amendments made to the Tax Code at the end of 2010 provided for the taxation of property contributed by shareholders as payment for their units in the PIFs, limiting possibilities for the use of closed-end funds for tax optimisation. The new procedure may provoke an outflow of shareholder funds from such funds, but at the same time it will make the Russian collective investment market healthier.

The investment opportunities of the **joint-stock investment funds**, or AIFs, expanded in 2010.[11] The aggregate NAV of these funds reached 5.7 billion roubles as of 1 July 2010, whereas the annualised rate of growth as of that date stood at 20.5%. The share of receivables contracted in the assets of these funds and the share of liquid investments expanded. As a result, the financial situation of the AIFs has improved and they have received broader opportunities for quickly reacting to changes in the market. Some AIFs registered growth by a factor of over 1.5 in their instant liquidity ratios[12] in 2010.[13]

The fall in the rates of return in some funds, caused by their weaker investment performance, given the more moderate year on year growth of the major Russian stock indices and the expansion of the share of long-term investments in assets, had a negative effect on the financial stability of the AIF market in the period under review. In the future, this may lead to a fall in the AIFs' profits and the slowing of growth in their NAV.

The value of funds transferred to the management companies for **individual trust management and other types of trust management**[14] contracted by 7.9% in January-September 2010 to 312.3 billion roubles. At the same time, in some companies funds in trusts decreased by more than 80% because of the opacity of their investment operations and unsound finances. The number of customers using individual trust management services fell by 7.7%.

According to experts' estimates, the rates of return from individual trust management in the period under review was lower than in 2009. The rates of return from the conservative individual trust management investment strategies of some management companies fell almost by a half in January-June 2010 compared to the same period of 2009 and stood at the maximum of 10% p.a.

Growth in **non-governmental pension funds** (NPFs)[15] in 2010 was mostly supported by the compulsory pension insurance segment of the market.

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[11] According to data provided by the Federal Financial Markets Service (FFMS) unless indicated otherwise.

[12] The instant liquidity ratio is the financial ratio calculated as the ratio of highly liquid current assets to short-term liabilities.

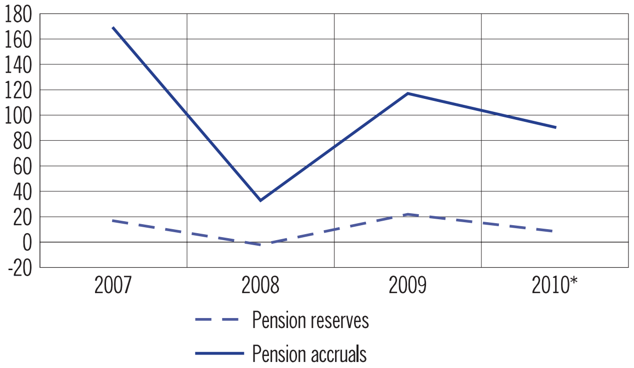
[13] According to data reported by the AIFs.

[14] According to the methodology used by rating agency Expert RA, individual trust management and other types of trust management include all types of trust management by management companies except the management of the funds owned by PIFs, the pension reserves of NPFs, the pension accruals of NPFs and management companies and insurance companies' reserves.

[15] According to data provided by the FFMS unless indicated otherwise.

Chart 3.8

Rates of growth in NPF pension reserves and accruals (over the year, %)



** January-September 2010.*

Non-governmental pension schemes remained mostly unpopular, largely because of the failure of the NPF retail programmes to curry favour with the public.

The number of people participating in the non-governmental pension insurance programmes remained virtually unchanged from a year earlier and as of 1 October 2010 it stood at 6.5 million, or 8.9% of the economically active population. One of the results for the stagnation of this indicator was the slowing of growth in total pension reserves in January-September 2010 compared with the same period of 2009 by 3.5 percentage points to 8.5%. The situation was compounded by the NPFs' significant buy-back payments to customers under the non-governmental pension insurance agreements that were cancelled during the crisis. In January-September 2010, buy-back payments totalled 3.4 billion roubles.

The funds transferred to the NPFs for management from compulsory pension insurance in 2010 grew faster than pension reserves (Chart 3.8). In January-September 2010, pension accruals increased by 89.0% to 146.9 billion roubles, mostly due to the transfer of funds from the Pension Fund of the Russian Federation. Growth in the pension accruals transferred to the NPFs resulted from the expansion of the agent networks (which attracted customers), the government programme for the joint financing of pensions and due to the positive investment results from their placement. The average rate of return on pension accruals in the top 20 NPFs in January-September 2010 was 12.6% p.a.

In 2010, the number of people covered by the NPF compulsory pension insurance programme (7.4 million) as of 1 October 2010 exceeded the number of people covered by the non-governmental pension programmes for the first time.

In addition to the NPFs, **pension accrual management companies**[16] made their contribution to the stability of the Russian compulsory pension insurance system in 2010. In January-September, all management companies demonstrated positive rates of return on pension accrual investments (from 5.7% to 31.6% p.a.), although some management companies failed to make up for the losses they had incurred during the crisis. As of 1 October 2010, about 20% of management companies registered negative rates of return on pension accrual investments over the past three years.

In January-September 2010, pension accruals in management companies increased by 52.5% to 752.3 billion roubles. As before, most of the funds were concentrated in the government-controlled management company VEB, which accounted for 97.6% of pension accruals as of 1 October 2010.

The financing of **leasing companies** improved in 2010.[17] The share of long-term loans increased in the structure of the sources of funds in January-September 2010, compared to the same period a year earlier. Some companies actively raised funds by issuing bonds. For example, in the 3rd quarter of the year, six leasing companies issued 22 billion roubles in bonds. As demand for the services provided by leasing companies rose, this contributed to the expansion of their activity. In January-September 2010, the total volume of new business[18] of Russian leasing companies grew by almost a third, while the value of the total leasing portfolio[19] increased by 8.3%. Nevertheless, both figures remained below their pre-crisis levels. The improved financing of the leasing business contributed to the increase in the average term of leasing agreements and made the services provided by the leasing companies more accessible. Experts have noted a rise in business activity in the long-term (over 5 years) leasing segment for the first time in several years. The main contribution to growth in the leasing market in 2010 was made by the subsidiaries of major Russian financial organisations, which have broader financial capabilities than other market participants. For example, as of 1 October 2010, VTB Leasing Company, VEB Leasing Company and Sberbank Leasing Company accounted for nearly 37% of the new business volume. The improved financing of the leasing companies' business and the expansion of the volume of services they provide created conditions to make the Russian leasing market more financially stable.

Federal Law No. 381-FZ, dated 28 December 2009, 'On the Principles of the Government Regulation of Trade

[16] According to data provided by the Pension Fund of the Russian Federation unless indicated otherwise.

[17] According to data provided by rating agency Expert RA unless indicated otherwise.

[18] New business volume is the volume of transactions in which the purchase of a plant for leasing under the leasing agreements or the receipt of an advance payment from the lessee occurred not earlier than the first day of the period under review and not later than its last day.

[19] A leasing company portfolio is the value of the lessees' debt to the lessor on current transactions net of debt that is more than two months overdue.

in the Russian Federation', which came into force in early February 2010, set limits on the maximum deferrals of payments in settlements relating to food products. This could have adversely impacted the services provided by **factoring companies**.[20] To remain financially sound, some factoring companies resorted to price dumping policies and eased their requirements for customers. This allowed them to expand the volume of factoring services by almost 16% and make them more attractive financially. The share of non-recourse factoring, the financial strategy under which the factoring company incurs a loss in the event of the debtor's insolvency, expanded by 13.0 percentage points to 23.4% as of 1 July 2010.

The measures taken also had a negative effect on the financial performance of the factoring companies. The total receipts from factoring services fell by almost 28% in January-June 2010 compared to the same period of 2009. The quality of the factoring companies' portfolio deteriorated. The share of bad assets in it increased to 12-15% as of 1 July 2010. Unlike the bank factoring companies, most of the non-bank factoring companies made no loss provisions for bad assets. This was not a violation of Russian law, but in the future it may lead to a worsening of the financial situation of the Russian factoring services market.

As the financial capabilities of borrowers increased in 2010, **pawnshop** credit risks decreased and this became one of the reasons for the easing of pawnshop lending terms and conditions. Average interest rates on loans fell and loan amounts grew. In Moscow, the minimum rate for regular customers was about 3% a month, while the maximum amount of the loan within the limits of the market value of the pledged asset reached 80-90%. The most common terms and conditions for pawnshop lending to other customers in the period under review were as follows: interest rates ran from 5% to 15% a month, the amount of the loan ranged between 60% and 80% of the market value of the pledged asset, and the term for which most of the loans were extended was up to 30 days.

The Russian Financial Monitoring Service reported that the expansion of pawnshop lending volumes was accompanied by a rise in the number of illegal operations involving the cashing of funds. In order to prevent the destabilisation of the financial market in 2010, the authorities carried out measures to detect and prevent illegal operations.

The Federal Law on Microfinancial Activities and Microfinancial Organisations, passed in July 2010, laid down the basic principles of pawnshop activities and set the procedure for and terms and conditions of pawnshop lending. Experts say that the new law will help standardise pawnshop lending procedures and make the business more transparent.

[20] *According to data provided by rating agency Expert RA unless indicated otherwise.*

Analysis of Russian ratings

Comparative assessment of sovereign ratings of Russia and other transition economies

In September 2010, Fitch Ratings confirmed Russia's investment grade ratings and changed its ratings outlook from 'stable' to 'positive'. The agency's experts believe that the Russian economy is successfully recovering from the global financial crisis and that the dynamics of its key macroeconomic and financial indicators testify to the lessening of its financial vulnerability factors. Other rating agencies, such as Moody's Investors Service and Standard & Poor's, did not change Russia's ratings. Thus, the investment grade ratings and 'stable' outlook assigned to Russia characterised its economy as 'lower medium grade' (Table 1).

When making the decision to retain Russia's investment grade rating, the rating agencies' analysts pointed out its current and capital account surpluses and growth in international reserves during the year. They also noted that there is low probability that Russia's sovereign ratings will be downgraded in 2011.

As for most of the Central and Eastern European (CEE) countries, the rating agencies also decided to leave their ratings unchanged; these countries' ratings were mostly in investment grade area. Economic instability in the European Union ruled out a major upgrade of the ratings and outlooks assigned to the CEE countries. Standard & Poor's and Fitch Ratings raised all Estonia's ratings by one notch, while Moody's and Standard & Poor's rated Montenegro for the first time. In December 2010, the three international rating agencies increased their rating activity: Standard & Poor's raised their ratings of Latvia and Kazakhstan, Moody's and Fitch Ratings downgraded their ratings for Hungary, Fitch Ratings raised its outlook for Latvia, Macedonia and Serbia from 'negative' to 'stable', and Moody's assigned ratings to Georgia.

The level of Russia's sovereign ratings is comparable with the ratings of the CEE countries, and its ratings are several notches higher than those of other member countries of the Commonwealth of Independent States (CIS). In 2010, Moody's assigned a 'speculative sovereign risk' rating to Moldova and recalled Turkmenistan's rating. Standard & Poor's and Fitch Ratings raised Ukraine's ratings by one notch. Judging by their international ratings dynamics, the CEE member countries of the European Union proved to be the most stable during the financial crisis (Table 2). Owing to their integration with the EU, their economies

Table 1

Russia's sovereign ratings

Date	Moody's			Standard & Poor's		Fitch Ratings	
	Government bond rating (FC/NC)	Country ceiling		Credit ratings		LT/ST IDR* (FC)	LT IDR* (NC)
		foreign currency bonds	foreign currency bank deposits	LT/ST (FC)	LT/ST (NC)		
1.01.01	B3/B3	B2	B3	B-/C	B-/C	B/B	B-
1.01.02	Ba3/Ba2	Ba3	B1	B+/B	B+/B	B+/B	B
1.01.03	Ba2/Ba2	Ba2	Ba3	BB/B	BB+/B	BB-/B	BB-
1.01.04	Baa3/Baa3	Baa3	Ba1	BB/B	BB+/B	BB+/B	BB+
1.01.05	Baa3/Baa3	Baa3	Ba1	BB+/B	BBB-/A-3	BBB-/F3	BBB-
1.01.06	Baa2/Baa2	Baa2	Baa2	BBB/A-2	BBB+/A-2	BBB/F3	BBB
1.01.07	Baa2/Baa2	A2	Baa2	BBB+/A-2	A-/A-2	BBB+/F2	BBB+
1.01.08	Baa2/Baa2	A2	Baa2	BBB+/A-2	A-/A-2	BBB+/F2	BBB+
1.10.08	Baa1/Baa1	A2	Baa1	BBB+/A-2	A-/A-2	BBB+/F2	BBB+
1.01.09	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB+/F2	BBB+
1.04.09	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.07.09	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.10.09	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.01.10	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.04.10	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.07.10	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.10.10	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.01.11	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB

** IDR is issuer default rating.*

Table 2

Sovereign ratings of emerging market economies (as of 1 January 2011)

Country	Moody's			Standard & Poor's		Fitch Ratings		Dagong
	Government bond rating (FC/NC)	Country ceiling		Credit ratings		LT/ST IDR* (FC)	LT IDR* (NC)	Long- term foreign currency rating
		foreign currency bonds	foreign currency bank deposits	LT/ST (FC)	LT/ST (NC)			
Russia	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB	A
Bulgaria	Baa3/Baa3	A1	Baa3	BBB/A-3	BBB/A-3	BBB-/F3	BBB	
Hungary	Baa3/Baa3	A1	Baa3	BBB-/A-3	BBB-/A-3	BBB-/F3	BBB	BBB-
Latvia	Baa3/Baa3	Aa3	Baa3	BB+/B	BB+/B	BB+/B	BBB-	
Lithuania	Baa1/Baa1	Aa2	Baa1	BBB/A-3	BBB/A-3	BBB/F3	BBB+	
Macedonia				BB/B	BB+/B	BB+/B	BB+	
Poland	A2/A2	Aa1	A2	A-/A-2	A/A-1	A-/F2	A	A-
Romania	Baa3/Baa3	A1	Baa3	BB+/B	BBB-/A-3	BB+/B	BBB-	BB
Serbia				BB-/B	BB-/B	BB-/B	BB-	
Slovakia	A1/A1	Aaa	Aaa	A+/A-1	A+/A-1	A+/F1	A+	
Slovenia	Aa2/Aa2	Aaa	Aaa	AA/A-1+	AA/A-1+	AA/F1+	AA	
Croatia	Baa3/Baa3	A1	Ba1	BBB/A-3	BBB/A-3	BBB-/F3	BBB	
Montenegro	Ba3	Baa1	B1	BB/B	BB/B			
Czech Republic	A1/A1	Aa1	A1	A/A-1	A+/A-1	A+/F1	AA-	
Estonia	A1/A1	Aa1	A1	A/A-1	A/A-1	A/F1	A	A
Azerbaijan	Ba1/Ba1	Baa2	Ba2	BB+/B	BB+/B	BBB-/F3	BBB-	
Armenia	Ba2/Ba2	Baa3	Ba3			BB-/B	BB-	
Belarus	B1/B1	Ba2	B2	B+/B	BB/B			
Georgia	Ba3/Ba3	Ba1	B1	B+/B	B+/B	B+/B	B+	
Moldova	B3/B3	B2	Caa1					
Kazakhstan	Baa2/Baa2	Baa2	Ba1	BBB/A-3	BBB+/A-2	BBB-/F3	BBB	BBB-
Ukraine	B2/B2	B1	B3	B+/B	BB-/B	B/B	B	B-
Brazil	Baa3/Baa3	Baa2	Baa3	BBB-/A-3	BBB+/A-2	BBB-/F3	BBB-	A-
India	Baa3/Ba1	Baa2	Ba1	BBB-/A-3	BBB-/A-3	BBB-/F3	BBB-	BBB
China	Aa3/Aa3	Aa3	Aa3	A+/A-1+	A+/A-1+	A+/F1	AA-	AAA

** IDR is issuer default rating.*

are recovering from the recession faster than most of the CIS member countries.

As for the four-member BRIC group of emerging market countries (Brazil, Russia, India and China), the long-term foreign currency ratings of Russia were three notches lower than those of China but two notches higher than those of India and Brazil. In November Moody's upgraded China's sovereign rating in connection with the country's fairly sustained economic growth.

In July 2010, the Dagong International Credit Rating Company, a Chinese private rating agency founded in 1994, published its sovereign ratings of 50 countries around the world for the first time. The A rating assigned to Russia, described as having 'a low level of financial risk', is higher than the ratings assigned to this country by other leading international rating agencies. China's rating is three notches higher than Russia's, Brazil's rating is one notch lower and that of India is two notches lower. Russian corporate issuers may find the Chinese agency's ratings useful in the event that they decide to expand their presence in the Chinese market.

In their analysis, experts with the rating agencies emphasised that the emerging market economies are gradually recovering from the recession, although their budget dynamics may be unstable.

Thus, the ratings and outlooks assigned by international rating agencies to Russia were commensurate with sovereign/country risk levels typical of most of the emerging markets at the time of the global recovery from the financial and economic crisis.

Ratings of regional issuers

As of 1 January 2011, 54 regional issuers had international agency ratings, compared with 47 issuers as of the beginning of 2010. All of the three leading international rating agencies assigned ratings to Moscow and St Petersburg. The ratings varied from the investment 'lower medium grade' (Moscow, St Petersburg and the Khanty-Mansi Autonomous Area) to the speculative grade 'highly speculative regional risk' (the Noginsk Municipal District of the Moscow Region).

After upgrading Russia's outlook rating, Fitch Ratings assigned long-term issuer default ratings (IDR) to Krasnoyarsk (BB), the Republic of Khakassia (BB-), the Ryazan Region (B+), Astrakhan (B+) and the Rostov and Tula Regions (BB-). Moody's assigned a long-term foreign currency rating to Krasnodar (Ba2), while Standard & Poor's assigned a BB rating to the Lipetsk Region and BB+ to the Chelyabinsk Region. The outlook ratings of all issuers are characterised by the leading rating agencies as 'stable'. In 2010, the rating agencies frequently reviewed the ratings and outlook ratings they assigned to Russia's regions and municipalities. The main trend in the revision of ratings and outlook was positive. Experts from the agencies say that this is connected with the dynamics of the factors affecting the level of financial stability of regional and municipal issuers. For the first time since the beginning of the crisis, the number of regional issuers with an international rating has increased and in 2010 agency experts did not recall ratings from any Russian region or municipality. This may serve as an indication that Russia's regions have become more attractive to investors.

In a report published in September 2010, analysts at Fitch Ratings noted that the global economic downturn revealed the differences in the ability of the Russian sub-federal issuers to resist the crisis. On the whole, the regions that were dependent on federal funds proved more resistant and their financial indicators were less volatile under the impact of external economic adversity. Regional and municipal issuers with stronger budgets were more dependent on the external trade situation and were therefore increasingly susceptible to revenue volatility. At the same time, agency analysis stressed the fact that the Russian regional and municipal issuers, on the whole, demonstrated that they were good at absorbing negative shocks.

Speaking about the regional and municipal issuers, Standard & Poor's experts noted the increased significance of Moscow, due to its differentiated economy, which is based on the service sector, as well as the high standard of living of Moscow residents, which far exceeds the national average.

Ratings of financial intermediaries and non-financial organisations

The ratings assigned to Russia's financial intermediaries and non-financial organisations by Moody's, Standard & Poor's and Fitch Ratings in 2010 reflected the business climate in the various sectors of the Russian economy as it was recovering from the crisis. Most of the ratings assigned to Russia's financial institutions and non-financial organisations tended to rise as the conditions that affected the Russian issuers changed.

At the end of 2010, 135 Russian **credit institutions** had ratings assigned to them by international rating agencies. This represents a mere 13% of the total number of operating Russian banks. Ten credit institutions had ratings assigned to them by all the three rating agencies, while 38 had ratings assigned by two agencies and 87 were rated by one agency. The highest ratings were assigned to the partly government-owned credit institutions or partially foreign-owned ones (VTB Bank, Bank of Moscow, VTB 24, Sberbank, ING Bank (Eurasia), Raiffeisenbank and Nordea Bank). All the three rating agencies in 2010 frequently assigned, recalled and revised their ratings, mostly upwards. Fitch Ratings carried out 51 rating actions, Moody's 40 rating actions and Standard & Poor's 48 rating actions. The agencies assigned 13 new ratings and recalled ratings from 10 credit institutions. Most of the rating actions were conducted with regard to the outlook ratings, which were most commonly upgraded. About 75% of the outlook ratings are 'stable' and 'positive'. Most of the positive rating actions were conducted in the 4th quarter of the year.

The crisis in the international financial market compelled Moody's to make some changes to its procedure for assigning ratings to financial intermediaries in 2010. The updated methodology allows the agency to take a consistent and standardised approach when assigning deposit and debt ratings to the banks. The so-called basic financial stability rating (FSR) is based on the assessment of the issuer's basic credit risk. It takes three factors into account: the rating of the supporting organisation (reflecting its ability to support the issuer), the probability of support, and the extent of dependence (correlation) between the rating of the supporting organisation and the basic rating of the issuer. Moody's analysts noted in 2010 that the agency was about to complete its revision of the Russian banking system's outlook from 'negative' to 'stable'. As a result, the outlook rating of some Russian financial intermediaries has been raised. At the same time, they emphasised that the Russian financial sector remained unstable.

In the period under review, Fitch Ratings carried out more rating actions connected with raising the outlook ratings and the IDR of Russian financial intermediaries than other international rating agencies (38 versus 28 by Moody's and 24 by Standard & Poor's). The change of the long-term IDR outlook, which has the same rating as the country rating (BBB), reflects the probability of an upgrade of Russia's country ceiling in 2011.

Rating agencies in 2010 took a closer look at the Russian credit institutions that actively lent to affiliated parties. Moody's analysts noted the high level of loans to related parties, which, according to their estimate, had reached 58% of tier 1 capital in a group of 100 major financial intermediaries (as against 35% at the end of 2007 and 45% in 2009). The experts say that this was a particularly serious problem for banks that were affiliated with financial-industrial groups.

At the end of 2010, Fitch Ratings released a special report entitled 'Russian Banks Start to Recover as Crisis Subsides', which noted the lessening of the manifestations of the crisis in the Russian banking sector alongside an improvement in asset and capital quality and increased liquidity from the inflow of deposits. Substantial improvements in the banking sector's infrastructure mitigated systemic risks in 2010. Starting in the beginning of 2010, Fitch Ratings has carried out a series of positive rating actions, which were prompted by better-than-expected banking sector performance indicators during the crisis.

According to Russian Federation Ministry of Finance Order No. 452 of 17 September 2009, 'On the Accreditation of Rating Agencies', three international agencies (Fitch Ratings, Standard & Poor's and Moody's Investors Service) and four Russian agencies (Expert RA Rating Agency (Expert RA); Analysis, Consultation and Marketing Rating Agency (AC&M); National Rating Agency (NRA); and Russian Rating Agency (RusRating)) were recognised as officially accredited agencies and were entered into the corresponding register. After the Russian agencies received their official accreditation, credit institutions' interest in getting their ratings increased significantly.

As of the end of 2010, 232 Russian credit institutions had been issued ratings by Expert RA, AC&M, NRA and RusRating. Expert RA was the most active, assigning ratings to 104 financial intermediaries. The NRA assigned ratings to 67 banks, while RusRating rated 50 banks and AC&M rated 37 banks. The ratings assigned by the national rating agencies ranged from 'very high level of creditworthiness' to 'satisfactory level of creditworthiness'. In 2010, the NRA assigned ratings to 14 credit institutions, Expert RA and AC&M rated 11 credit institutions each, and RusRating assigned ratings to five financial intermediaries.

In 2010, the Russian rating agencies often recalled ratings from banks. For example, Expert RA recalled the ratings of 36 credit institutions, AC&M recalled the ratings of 13 credit institutions and RusRating did so to four credit institutions. The main reasons for the rating recalls were cited in the agencies' press releases: ratings were recalled 'in connection with the expiration of the term of the rating' or 'in connection with the bank's refusal to support a public rating'. Experts with the Expert RA agency explained the outflow of customers by the problems of the issuers, which were unable to claim for Bank of Russia unsecured loans. As the crisis subsided, banks more often used the services of international rating agencies whose ratings enable them to gain a foothold in the international financial market.

The ratings assigned by the Russian rating agencies are difficult to compare because they use different rating scales and different rating grades. For example, the rating scale used by Expert RA has 10 levels, while the rating scales of the NRA and RusRating have 25 levels. In addition, the names of the ratings and, consequently, the importance of the risks analysed also differ.

Most of the **non-bank financial intermediaries** in 2010 either received issuer ratings or had their issuer ratings upgraded. High ratings were assigned to issuers that were affiliated with the government-controlled credit institutions and had their own market niches. The ratings of these non-bank intermediaries were comparable with the ratings of their parent organisations, as a rule, and depended on the extent of integration and importance of the institution within the financial group as a whole.

As of 1 January 2011, the international rating agencies had assigned ratings to 18 non-bank financial organisations and 18 insurance companies. Four non-bank financial organisations were rated for the first time in 2010, their ratings ranging from speculative (Fitch rated Sberbank Leasing as 'lower medium grade') to highly speculative (Standard & Poor's and Fitch Ratings rated Renaissance Financial Holdings Ltd as having a 'highly speculative risk level'). Nine non-bank financial organisations had their outlook ratings upgraded.

The gradual recovery of the national financial market from the financial crisis had a positive effect on the situation in the Russian **insurance market**. In 2010, three insurance companies were rated for the first time, while four insurance companies received rating upgrades and five had their outlook ratings raised. The ratings assigned to the Russian insurance companies were fairly high: a third of them were investment grade ratings and equalled the ratings assigned to the Russian Federation.

In November 2010, Fitch Ratings released a report entitled *Russian Insurance Sector Faces Challenging Recovery,* which emphasised that there were several reasons for the 'slow and stressful recovery' of this sector, including the 'severe local impact of the recession' and 'a more difficult operating environment'.

As of the end of 2010, Expert RA had assigned ratings to 64 insurance companies and the NRA had assigned ratings to 15 insurance companies. The investment grade ratings ranged from 'very high reliability' to 'acceptable financial stability'. The financial reliability ratings the Expert RA agency awarded to 22 non-governmental pension funds indicate that they possess 'very high reliability'; the ratings assigned to 16 leasing companies are at a slightly lower level ('sufficient financial stability').

The NRA and AC&M agencies assigned their individual reliability ratings to 38, and 5 **investment companies**, respectively. These ratings ranged from AAA ('maximum reliability') to BB+ ('modest first-level reliability').

Experts with the Russian rating agencies note that their ratings do not take sovereign country risk into account. This gives these agencies a number of advantages, such as the possibility of using a finer differentiation of ratings in comparison with the ratings assigned on the international scale. As a result, the ratings awarded by the Russian agencies are relatively high.

The trend to assign high ratings and outlook ratings to financial intermediaries is connected with the improvement of the situation in the financial sector, the increased significance of the Russian rating agencies and, consequently, the change in the issuers' strategy in selecting 'their own' rating agency.

The dynamics of the ratings and outlook assessments of the non-bank financial intermediaries match, by and large, the dynamics of the ratings and outlook assessments of the Russian Federation and its credit institutions. They reflect the gradual recovery from the recession and the improved impact of the business environment on the quality of assets, the resource base and the liquidity of non-bank intermediaries.

The financial stability of bank and non-bank financial institutions is tied to the solvency of the **non-financial issuers**. Therefore, the general trend of the agencies' rating actions with regard to the Russian non-financial issuers in 2010 was to assign upgrades. This activity was similar to the dynamics of the rating of the Russian financial intermediaries, and was a tendency typical of the post-crisis and post-recession recovery period. Most of the rating actions undertaken by the rating agencies connected with the assigning and upgrading of ratings and outlooks were registered in the 3rd quarter of the year.

As of 1 January 2011, international rating agencies had assigned ratings to 95 non-financial organisations as against 81 organisations as of the beginning of 2010. Fourteen issuers had ratings of all the three leading international rating agencies, 29 were rated by two of them and 52 by one.

The highest rating ('lower medium grade') was assigned to the state companies whose ratings and outlooks are tied to the sovereign ratings and outlooks for the Russian Federation. Non-government Russian companies have mostly speculative or highly speculative grade ratings.

As of the end of 2010, 61% of the 46 corporate issuers rated by Fitch Ratings had a 'stable' foreign currency IDR, 28% had a 'positive' rating and 11% had a 'negative' one. Fitch Ratings analysts noted that the main factor behind the dramatic positive shift in the structure of Russian corporate issuer ratings was the revision of the Russian Federation's sovereign rating outlook from 'stable' to 'positive'. This positive view of the financial soundness of Russian companies reflects the prospects for the expected consolidation of telecommunications companies under the umbrella of Rostelecom. The post-crisis and post-recession operating environment is also considered favourable for the national steel and chemical industries.

In the context of the post-crisis recovery, rating agency experts consider the raw material and power sectors, as well as the leading metallurgy and metalworking enterprises as potentially strong players, which are capable of favourably affecting the financial stability of credit institutions and non-bank financial intermediaries. In 2010, rating agencies mostly upgraded the outlook and ratings of Russian issuers: Fitch Ratings raised the outlook ratings of 21 non-financial organisations and the ratings of eight non-financial organisations, while Standard & Poor's upgraded the outlook of 13 issuers and the ratings of five issuers and Moody's gave outlook upgrades to four issuers and raised the ratings of three issuers.

One of the consequences of the crisis was the rise in the number of mergers and acquisitions and the consolidation and top-down integration of non-financial issuers in the emerging market countries, Russia included. For example, MTS, a communications company, has acquired Comstar, another communications company; meanwhile Megafon, a mobile communications company, has acquired a telephone operator, Synterra. Rostelecom continues to consolidate regional operator companies under its umbrella to create a national integrated telecommunications operator.

Fitch Ratings analysts predict the same trend in the Russian oil and gas sector, because Russian producers are intent on acquiring assets in the CEE countries for the purpose of enhancing top-down integration.

Rating agency experts have recalled ratings from six Russian non-financial issuers. They did so mostly at the request of the enterprises after their rating was downgraded to 'very high probability of default' (MMK, Mostransavto, JFC International).

After the accident at the Sayano-Shushenskaya Hydro Power Plant, Moody's analysts decided to downgrade the corporate issuer credit rating of RusHydro from Baa3 (lower medium grade) to Ba1 (non-investment grade speculative). Thus, the agency virtually barred the issuer from the international capital market.

Non-financial issuers' demand for rating services grew throughout 2010: for the first time since the beginning of the crisis, Moody's awarded ratings to nine such companies and Standard & Poor's and Fitch

Ratings issued ratings to five companies each. The range of industries in which companies are rated is expanding.

As of the end of 2010, Russian rating agencies had assigned ratings to 36 non-financial issuers. The ratings assigned by the Russian agencies were slightly higher than those awarded by international rating agencies. All of these ratings are investment grade ratings, ranging from 'very high creditworthiness' to 'acceptable creditworthiness'. Over the period under review, ratings were assigned for the first time to seven non-financial issuers, while 14 companies had their ratings recalled. All the four agencies assigned the investment grade rating 'above average reliability' to joint-stock finance corporation Sistema, integrated telecommunications operator Comstar and Moscow telephone operator MGTS, and recalled the ratings of Russian developer SISTEMA-HALS because of the company's refusal to go through the NRA's individual rating confirmation and monitoring procedure. Expert RA was the most active rating agency: it has assigned ratings to 19 issuers. It reassigned the 'high creditworthiness' rating to five companies and recalled the ratings of three companies. The NRA and AC&M assigned ratings to 14 non-financial issuers each, while RusRating rated four non-financial corporations.

According to the Basel Committee's recommendations (Basel II), transparency is a key element in the assessment of an issuer's financial soundness. During the crisis in the international financial market, Standard & Poor's included this factor as a separate index in its methodology for assigning long-term foreign currency ratings.

At the request of Russian non-financial companies, Standard & Poor's, the Russian School of Economics' Centre for Economic and Financial Studies and the RTS Exchange conducted a joint study of the information transparency of Russian companies in 2010. It has shown that compared to 2009, the transparency of Russian companies has increased, mostly due to the electric power companies.

The information transparency index calculated by Standard & Poor's experts shows what ratio of disclosed information about the company in the total volume of information is absolutely necessary from the viewpoint of an average foreign investor.

As was the case in 2009, the study involved the 90 leading Russian companies with the most liquid shares in the exchange market. In 2010, the aggregate information transparency index registered 57.5%, an increase of 1.7 percentage points on 2009. The index for 76 companies involved in the study in the previous year gained two points and reached 60%. Of these, 49 companies improved their index, while the rest changed for the worse. The highest transparency index (80%) among the 90 companies involved in the study remained unchanged from 2009, whereas the lowest index rose by 5 points to 25%. The average index for the top 10 companies increased from 75.6% to 76.7%.

The biggest growth in the information transparency index in the sample as a whole was that of the power sector companies: the average ratio rose over the year from 51% to 57%. The transparency index leaders are the telecommunications sector (72%), metallurgy (70%), credit institutions (69%) and machine-building (46%).

The information transparency index of partly government-owned companies was considerably higher. In 2010, companies in which the state controlled over 50% of the voting shares became 2.8 percentage points more transparent than private companies and 2.6 percentage points more transparent than the sampled companies.

The rating actions taken by the international and national rating agencies in 2010 were characterised by efficacy and objectivity: the positive ratings trend reflected the post-crisis recovery of the Russian economy.

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