THE CENTRAL BANK OF THE RUSSIAN FEDERATION (BANK OF RUSSIA)

FINANCIAL STABILITY REVIEW

2011

MOSCOW
2012

Contents

Summary

The influence of external shocks on the financial sector of the Russian economy changed progressively throughout 2011. In the first half of the year, as the terms of external trade improved and the real sector of the Russian economy demonstrated positive trends, the situation in the banking sector and the main segments of the Russian financial market remained relatively stable. Credit institutions retained considerable volumes of rouble liquidity and did not experience any special need for Bank of Russia refinancing instruments. In the domestic foreign exchange market, the supply of foreign currency exceeded the demand for it, shaping the trend towards the rouble's appreciation. Credit institutions built up their volume of lending as they lowered the interest rates for their lending operations and eased non-price conditions of bank loans. Russian securities were largely observed to grow.

From August 2011, however, the situation in the main segments of the Russian financial market started to deteriorate. The main reason for this was instability in the global financial market related to problems with U.S. government finances and the debt crisis in the eurozone. These factors intensified net private capital outflow from Russia, including the outflow of banking sector capital. As a result, demand for foreign currency increased, which caused a considerable depreciation of the rouble against the world's major currencies and intensified expectations that the national currency would be depreciated. The exchange rate risk in the banking sector slightly increased. In these conditions, the Bank of Russia altered its foreign exchange interventions, switching from the purchase to the sale of foreign currency to banks operating in the foreign exchange market; however, the volume of these operations remained insignificant.

The liquidity level of Russian banks was observed to decrease gradually in September-December 2011, which caused an increase in interbank credit rates. As banks showed stronger demand for liquidity, the Bank of Russia and the Ministry of Finance took measures to expand banks' access to funding instruments. The Bank of Russia narrowed the range of interest rates on its liquidity provision and absorption instruments, to restrict the increased volatility of money market rates.

In the securities market, investors' demand for rouble-denominated instruments decreased and the prices of equities and debt securities fell considerably. In order to mitigate the negative effects of the deterioration of the market situation, credit institutions reduced their investment activity in the securities market, while maintaining their activity in the segment of low-risk government debt securities, especially OFZ bonds. In these conditions, the growth in banking sector assets was largely achieved via loans extended to the real sector of the economy. These increased at a rate that was more than two times faster in 2011 than it had been in 2010. Credit institutions' losses from the revaluation of their securities portfolios had a negative impact on their financial result. Correspondingly, the banking sector's stock market risk increased. Nevertheless, Russian banks' losses on their portfolios of securities, including securities issued within countries that are gripped by the crisis, did not pose a threat to financial stability, especially due to the low volume of Russian banks' investment in the most risky securities.

As the major Russian stock market indices declined, most non-bank financial institutions reduced their equity holdings and built up their investment in fixed-income financial instruments, particularly bank deposits. Nevertheless, the investment results of non-bank financial institutions deteriorated: insurance companies received lower profits from investment activity, more than half of the private management companies posted negative returns on the investment of pension savings, and most unit investment funds registered a fall in the value of their units.

In 2011, the growth of credit institutions' equity capital accelerated. The capital adequacy ratio decreased as risk-weighted assets grew faster than bank capital and the Bank of Russia introduced higher risk weights for certain types of assets. Banks differed considerably in terms of their capital adequacy ratios, but across the banking sector as a whole, this indicator remained at a high level. As of 1 January 2012, there was not a single bank that failed to comply with the capital adequacy ratio. The economic position of most banks corresponds to the Bank of Russia's requirements for their sustainability.

As credit institutions showed slower rates of growth in loan loss provisioning and also built up their investments in more profitable financial instruments (bank loans), in 2011 they posted a record high financial result for the entire history of the Russian banking sector. The return on assets and the return on equity also increased, exceeding the 2010 level.

Changes in the conditions of the operation of the Russian financial sector made it necessary to improve the mechanism for ensuring financial stability. The measures that the Bank of Russia adopted in this area in 2011 were aimed, in particular, at developing instruments to analyse systemic risk. In 2011, the Bank of Russia launched quantitative assessments of possible global risk implications for the Russian banking sector. It continued to monitor money market risks, and also started to consider the issue of identifying systemically important banks and the expediency of applying special regulation and supervision regimes to them. Regular stress tests of the money market and the banking sector were held. In 2011, the Bank of Russia carried out work to implement legal norms aimed at ensuring the smooth and effective functioning of the payment system.

Despite the deterioration of the market situation in the second half of the year, the Russian economy remained stable as a whole in 2011: economic growth continued amid expanding domestic demand, inflation was observed to slow down and the federal budget was stable. As macroeconomic stability persisted, the greater vulnerabilities of certain financial market segments and the related increase in certain types of risk did not destabilise the banking sector.

Economic, social and political developments in Russia had their effect on the level of the ratings that were assigned to the country. The level of sovereign ratings assigned to Russia by international rating agencies remained investment grade and was characterised as 'good credit quality'. These ratings were comparable to those assigned to the countries of Central and Eastern Europe, as well as the other BRICS countries (Brazil, India, China and South Africa). They also exceeded, by several notches, the ratings of most of the CIS member countries. The rating activity taken by international and national rating agencies regarding the Russian sub-federal and municipal entities, financial and non-financial organisations in 2011 was largely positive. However, the ratings of Russia and Russian issuers have not yet returned to their pre-crisis levels.

Therefore, the Russian financial sector preserved its stability in 2011, despite the increased negative impact of external shocks. Considering that prospects for the development of the global economy remain highly uncertain, national regulators and domestic financial institutions themselves will continue to focus their attention on measures that are designed to maintain the stability of the Russian financial sector.

Chapter 1. General economic conditions

The Russian economy remained stable in 2011. Inflation stayed within the target parameters. The expansion of domestic demand contributed to economic growth. The volume of GDP reached its 2008 level. World oil prices, which were higher than the level projected in the budget, and the restricted growth in budget expenditure had a positive effect on the federal budget. At the same time, the unstable fiscal positions of some Russia's trading partners, as well as the concerns about unfavourable scenarios regarding the development of a sovereign debt crisis restricted the positive trends in the Russian economy. A large outflow of net private capital from Russia testified to investors' continued risk aversion and impeded efforts to maintain financial stability.

* * *

Business activity continued to recover in *the global economy* and in financial markets in 2011 from the crisis of confidence in securitised assets, which registered its most acute phase in 2008. However, along with these processes, there were growing threats to the stability of the international monetary and financial system, which were prompted by the unsteady condition of government finances in some member countries of the eurozone. Short-term investors increased their investment in less risky instruments at the expense of riskier assets; this affected cross-border capital flows and the financial markets of many countries, including Russia.

The second and third quarters of 2011 registered developments that shook confidence in the favourable prospects of the global economy and intensified investors' risk aversion. In May, tension increased over the inability of the Greek government to meet its obligations to private creditors without changing the original terms of public borrowings. A summit of the heads of state and government of the European Union (EU) held in July 2011 recognised the expediency of involving private creditors in the restructuring of the Greek government debt on a voluntary basis. In August, the United Stated passed a law that tied the increase in the U.S. debt ceiling to budget deficit cuts.

These events played a key role in the change of business sentiments and expectations in financial markets. They demonstrated that the stabilisation of public finance was becoming a key task for many countries. This factor increasingly complicates efforts to reach a path of sustainable economic growth, exacerbating the problems caused by the weak condition of the labour market and bank lending, as well as the impact of inflation on the dynamics of real incomes.

The prospects of fiscal policy tightening, coupled with the release of weak consumption data in the United States and the eurozone was a major reason in the second quarter of 2011 for the downward revision in the growth forecasts for the world's largest economies. The expediency recognised by private creditors for their voluntary participation in the restructuring of Greek government debt intensified concerns about unfavourable developments of a sovereign debt crisis in the eurozone. Given these conditions, the decision by Standard & Poor's in early August 2011 to cut the U.S. long-term credit rating from AAA, the highest grade, to AA+ triggered a sharp change in sentiments in financial markets.

In August-September 2011, exchange rate volatility intensified considerably and global stock market indices declined. Markets remained tense until the end of the year due to the government crisis in Greece, emerging difficulties in the ability of EU member states to agree on fiscal stability policies, the downgrade of credit ratings for some countries and speculative market activity. Capital outflow, prompted by investors' increased risk aversion, reduced the prices of assets in emerging economies and caused a devaluation of their currencies. The US dollar, the Japanese yen and the Swiss franc appreciated and gold prices increased. These financial market developments prompted the monetary authorities of many countries, starting in August 2011, to conduct interventions and carry out operations to provide necessary liquidity in the national and foreign currencies. These measures helped ease the tension caused by the outflow of short-term capital from the markets and funding difficulties.

In particular, the Eurosystem resumed operations to provide euro liquidity for a term of over three months. The European Central Bank (ECB) and the monetary authorities of the United Kingdom, Switzerland, Japan and Canada held coordinated operations based on currency swap agreements with the US Federal Reserve to provide liquidity in US dollars.

In 2011, the banking systems of foreign countries were not exposed to considerable stress, excluding the problems of certain institutions. However, the intended restructuring of the Greek government debt and the debt problems experienced by the governments of Portugal and Italy deteriorated the credit quality of bank assets in these and other countries, creating the danger of losses for the banking sector.

The European Union is taking measures to preserve financial stability. The EU countries are considering an additional aid package for Greece from the European

Financial Stability Facility[1] (EFSF) and the International Monetary Fund (IMF). The EU has increased the volume of guarantees for the use of EFSF financial resources. Banks from Greece, Ireland and Portugal continue to participate in the Eurosystem's auctions for the provision of liquidity, despite the deteriorated quality of their collateral (following the downgrade of the credit ratings of these countries). By mid-2012, the EU member countries intend to enlarge the Tier 1 capital of their banks to 9% of risk-weighted assets. Efforts are also underway to enhance EU fiscal policy coordination and harmonise the national legislations to prescribe an obligation for European governments to comply with the deficit-free budget rule.

External conditions for the Russian economy in 2011 developed amid the continued increase in business activity in Russia's trading partners and the influence of factors hampering the post-crisis recovery. The growth of demand in foreign economies created the prerequisites for stronger inflation, which was also considerably affected by the rise in global energy and food prices in the first half of 2011.

At the same time, the rates of unemployment reduction in the United States and the eurozone remained low after the recession. Higher inflation slowed the growth in real incomes. Tighter fiscal and monetary policies also affected economic growth rates.

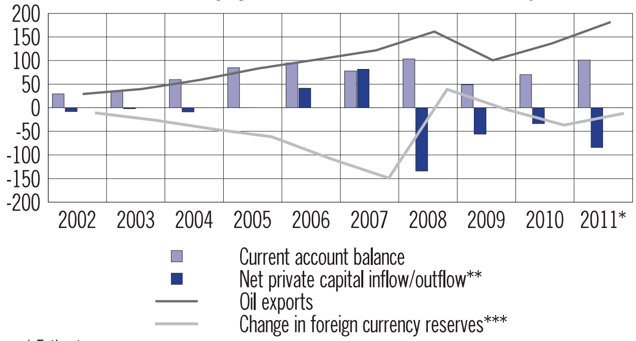
According to a preliminary estimate, the rates of growth in the GDP of Russia's major trading partners (with respect to their share in Russian exports) declined from 4.1% in 2010 to 3.3% in 2011. GDP growth rates slowed to 1.5% from 1.8% in the eurozone, to 1.7% from 3.0% in the United States and to 9.2% from 10.4% in China. The prices of energy products and agricultural goods decreased in the second half of 2011. The contribution of food and energy prices to consumer price changes weakened. The slowing of business activity growth in foreign countries also helped ease inflationary pressure in the second half of the year.

In January-July 2011, the monetary authorities of most countries took measures to tighten their monetary policies in order to restrain inflation and avoid instability in financial markets. The ECB raised its refinancing rate on two occasions. Overall, it was increased from 1.0% to 1.5% p.a. Monetary policies in major emerging economies, including China, India and Brazil, were also tightened.

In August, prerequisites emerged for policy changes due to the emerging prospects of slower economic growth and weaker inflationary pressure. Some countries cut their monetary policy rates, China lowered its required reserve ratios and the ECB reduced its refinancing rate again, to 1% p.a. The US Federal Reserve promised that substantial monetary stimuli

Chart 1.1

Russian external sector's main indicators (based on the balance of payments, billions of US dollars)



** Estimate.*
*** "-" signifies net capital outflow, "+" signifies net inflow.*
**** "+" signifies decrease, while "-" signifies an increase.*

would remain in the medium term. The Bank of England resumed operations to purchase securities by issuing money.

The price situation in world commodity markets improved for Russian exporters in 2011. The average world market price for Russian oil grew by 40% in 2011 year on year to $109.6 per barrel. The prices of other Russian export commodities increased. Export prices grew faster in 2011 than import prices. The terms of Russia's trade with foreign countries continued to improve. The exports of goods grew by 30% solely due to price growth, while Russian export quantities contracted. Conversely, growth in the imports of goods was mainly due to the expansion of import quantities. The rates of growth in the imports of goods slowed in the second half of 2011 to equal the rates of growth in exports following the results of the year. The trade surplus increased by 31% in 2011, while the current account surplus grew by 44% to total $101.1 billion (Chart 1.1) and was estimated at 5.5% of GDP as against 4.8% a year earlier.

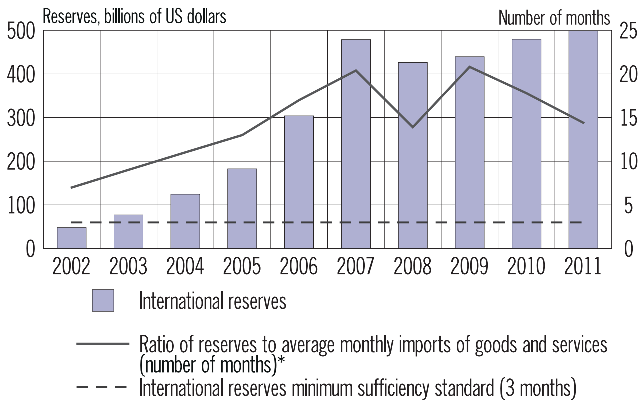
There were changes in the volumes of cross-border capital flows. In 2011, the outflow of Russian banks' capital increased considerably, while the volume of foreign borrowings contracted significantly: the total outflow of capital exceeded borrowed capital by a factor of 4.4. In other sectors of the economy, investments made abroad were 1.8 times larger than foreign private investment in the Russian economy. Investments in foreign cash outside the banking sector fell by $2.7 billion in 2011. As a result, net private capital outflow from Russia increased by a factor of 2.5 in 2011 to $84.2 billion. The net private capital inflow registered in the banking sector in 2010 ($15.9 billion) gave way to a net outflow of $26.2 billion in 2011. The net private capital outflow from the non-banking sector grew by a factor of 1.2 to $57.9 billion.

The foreign currency inflow across the current account was larger than net capital outflow in 2011, which

[1] *The European Financial Stability Facility is a financial stabilisation mechanism established for eurozone countries in 2010.*

Chart 1.2

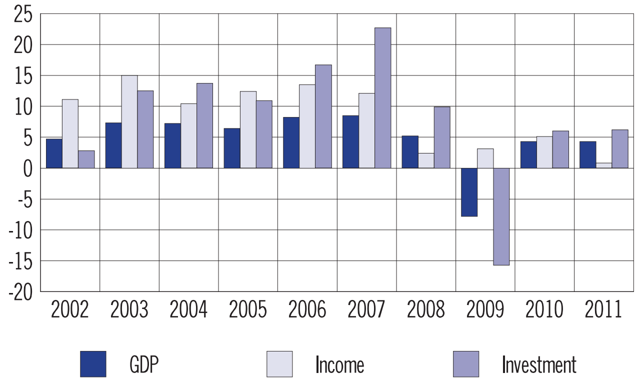
International reserves



** 2011 - estimate.*

Chart 1.4.

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



created conditions for growth in international reserves. Compared to the previous year, they grew by $19.3 billion (in 2010, they increased by $39.9 billion year on year). As of the beginning of 2012, Russia's international reserves totalled $498.6 billion. Russia's international reserves were enough to finance the imports of goods and services for 14 months, a figure that far exceeds the internationally accepted 3-month minimum level considered sufficient (Chart 1.2).

Russia's external debt grew by $50.0 billion to $538.9 billion in 2011: the banking sector's external debt increased by $19.8 billion and the external liabilities of other non-government sectors of the economy rose by $31.5 billion, whereas the external debt of the general government and monetary authorities contracted by $1.3 billion (Chart 1.3). As the economy grew, it was estimated that the country's debt burden decreased from 33.1% of GDP in 2010 to 29.5% of GDP in 2011, while the ratio of government external debt to GDP contracted from 2.3% to 1.8%, respectively.

In 2011, economic growth was largely supported by the expansion of domestic demand. In the second half of the year, the growth of investment and consumer demand accelerated. Year on year, the GDP increased by 4.3% in 2011; the same growth rate was registered in the previous year (Chart 1.4).

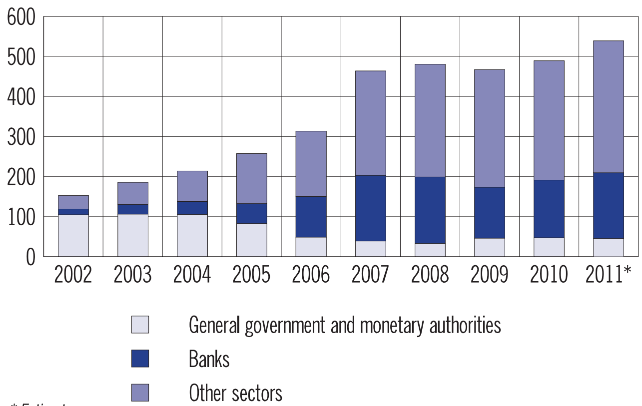
The number of employed increased amid economic growth in 2011 compared to 2010 and virtually reached its pre-crisis level. The total number of unemployed declined significantly. As of the end of December 2011, it stood at 6.1% of the economically active population as against 7.2% a year earlier (Chart 1.5).

In December 2011, consumer prices were 6.1% higher than in December 2010, their lowest rate of growth for this period (they grew by 8.8% between December 2009 and December 2010). The slower growth in consumer prices was mainly attributable to a considerable fall in vegetable and fruit prices (by 24.7%) following their dramatic rise in 2010 (by 45.6%). Core inflation ran at 6.6% in December 2011 compared with the corresponding month of the previous year (it also stood at 6.6% in December 2010 compared with December 2009) (Chart 1.6).

As foreign economic conditions remained favourable for Russian exports and domestic demand increased, the financial condition of Russian non-financial organi-

Chart 1.3

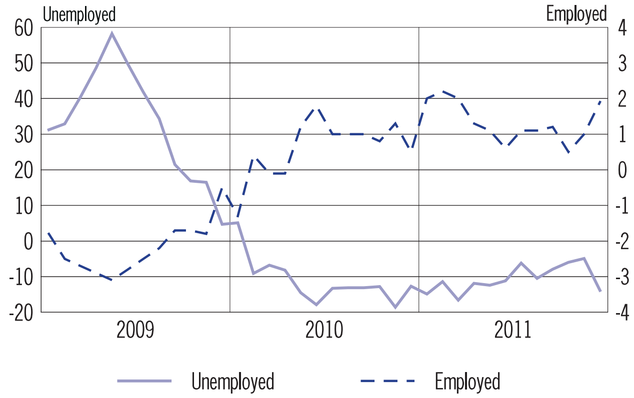
External debt (billions of US dollars)



** Estimate.*

Chart 1.5

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



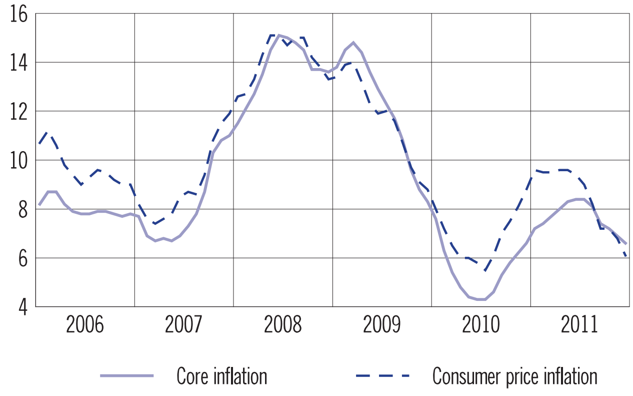
sations improved. In January-November 2011, large and medium organisations other than small businesses, banks, insurance companies and public institutions posted a net financial result of 6,947.6 billion roubles, a year-on-year increase of 23.1%.

Economic growth and the improvement of the financial condition of organisations contributed to the expansion of fixed capital investment, which increased by 6.2% in 2011 as against 6.0% in 2010. Construction activity rebounded considerably in the second half of the year and the volume of construction works increased by 5.1% in 2011 as a whole.

Household real disposable money income grew by 0.8% in 2011 year on year. The growth in real wages, further improvement of the labour market situation and the expansion of lending to households contributed to stronger consumer demand. Household expenditures on goods and services increased by an estimated 7.3% in real terms. The household propensity to save continued to decrease as the deposit rates were low. As the rouble exchange rate remained highly volatile in August-October 2011, the share of household expenditures on the purchase of foreign currency increased in the structure of household money income use in 2011.

Chart 1.6

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



Chapter 2. Financial market

2.1. Money market

The Russian banks that play a major role in the money market continued to follow conservative strategies in 2011, keeping their rouble liquidity at a high level. The situation in the money market remained relatively stable for most of the year, while the threats to financial stability were moderate. In the second half of the year, the Russian money market was hit by local turbulence amid destabilisation in the global financial market but remained stable as a whole, ensuring the redistribution of liquid funds among market participants.

* * *

The money market remained a key segment of the Russian financial sector in 2011. The average turnover of this market totalled 0.4 trillion roubles per day[1] in 2011, far exceeding the average turnover of all the other segments of the Russian financial market, except for the foreign exchange market. Given these conditions, the stable functioning of the money market was a key factor in enhancing the stability of the financial sector as a whole.

The situation in the Russian money market changed throughout 2011. In the first half of the year, most segments of the Russian financial market, including the money market, remained relatively stable. As the indicators of some bank assets remained at a high level (Chart 2.1), the demand for rouble resources and, correspondingly, the activity of money market participants were moderate. Interest rate volatility in the main segments of the money market declined.

In the second half of 2011, the situation in the main segments of the money market was observed to deteriorate. One of the reasons for this deterioration was the instability in the global financial market that was caused by the debt crisis in the eurozone. The increased uncertainty in the world financial market reduced the risk appetite of its participants, restricting the affordability of external funding for Russian banks. As of the beginning of 2011, Russian banks acted as net borrowers in the world interbank credit market: their liabilities to non-resident banks exceeded their claims by 0.35 trillion roubles. Subsequently, this indicator was observed to decrease gradually and the difference between Russian banks' claims and liabilities to non-resident banks remained insignificant for most of the second half of 2011.

[1] *Here and below, the daily volumes of the interbank credit market are calculated using a MIACR sample, while the daily volumes of the repo market are based on a sample of the MICEX BORR (Bond Repo) and MICEX EQRR (Equity Repo) indices.*

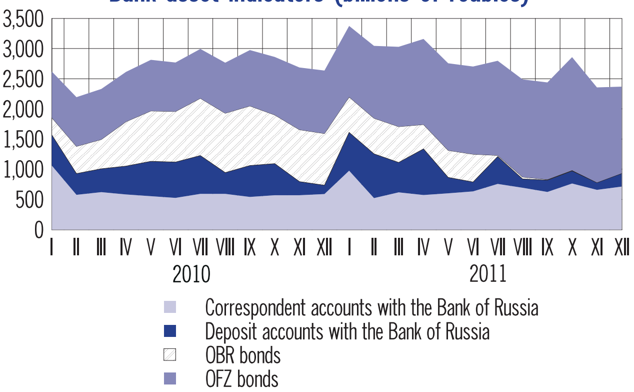
The demand for rouble liquidity was determined, among other things, by budget flow dynamics. In the first, second, and third quarters of 2011, the budget revenue plan was fulfilled faster than the plan for budget expenditure, which led to the accumulation of funds in government accounts. Although part of these funds returned to the banking system in the form of deposits placed by the Ministry of Finance with credit institutions, budget operations as a whole led to the withdrawal of rouble liquidity.

Average balances of credit institutions' funds in correspondent and deposit accounts with the Bank of Russia totalled 0.98 trillion roubles in July-December 2011, as against 1.25 trillion roubles in the first half of the year. However, this contraction in banks' liquidity was moderate (the balances of credit institutions' funds in correspondent and deposit accounts with the Bank of Russia averaged 1.09 trillion roubles in 2010). Moreover, the decrease in the balances of accounts with the Bank of Russia was partially offset by the expansion of the government bond portfolio (Chart 2.1), which allowed credit institutions to raise funds promptly through repo transactions. The value of credit institutions' investments in the debt securities of the Russian government (excluding bonds transferred under repo operations) averaged 1.6 trillion roubles in the second half of 2011, compared with 1.4 trillion roubles in the first half of the year. At the same time, as OBR bonds were redeemed, the value of banks' investments in the obligations of the Bank of Russia was observed to contract. By the end of October, OBR bonds had been fully withdrawn from circulation.

As credit institutions continued to hold considerable balances in correspondent accounts with the Bank of Russia and build up their portfolios of the most liquid and

Chart 2.1.

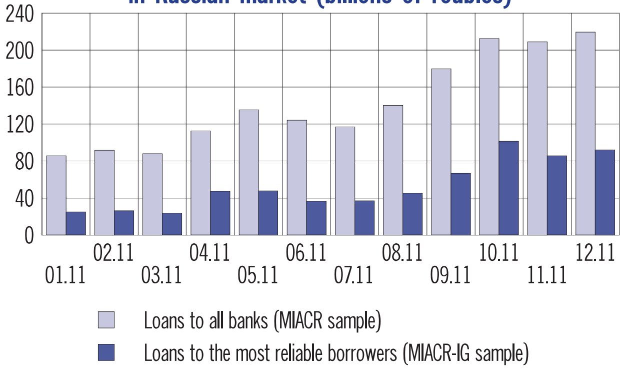
Bank asset indicators (billions of roubles)*



* *As of the beginning of the month.*
Source: Bank of Russia.

Chart 2.2

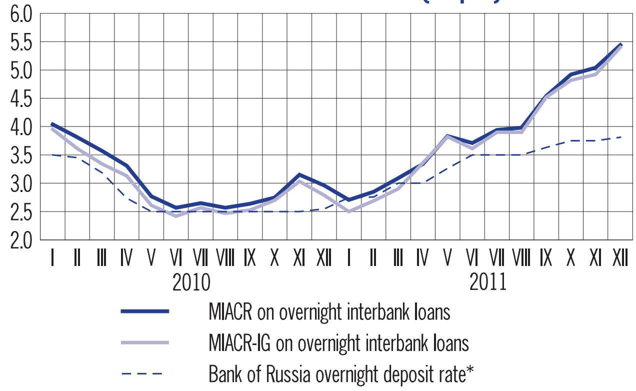
Average daily turnover of overnight interbank rouble loans in Russian market (billions of roubles)



Source: Bank of Russia, calculations by Bank of Russia Research and Information Department.

Chart 2.3

Interbank rouble credit rates (% p.a.)



** Bank of Russia "tom-next" deposit rate before 29 March 2010.*
Source: Bank of Russia, calculations by Bank of Russia Research and Information Department.

reliable bonds (while the Bank of Russia's refinancing operations remained accessible for banks), there was only a low probability that some credit institutions would experience a shortage of liquidity. In the period of growing demand for liquidity, banks intensified their raising of funds from the Bank of Russia, especially through repo transactions. Repo transaction-related Bank of Russia claims on credit institutions averaged 292 billion roubles in July-December 2011 (compared with less than 2 billion roubles in the first half of the year).

The demand for rouble funds was partially met through the redistribution of interbank loans between market participants. In the second half of 2011, the volume of transactions in the Russian money market increased considerably. The average turnover of the Russian rouble overnight interbank loan market, calculated using the MIACR sample, totalled 179.3 billion roubles per day in July-December 2011, which represents an increase of 67% compared with the turnover registered in the first half of the year (Chart 2.2). The average value of overnight interdealer repo transactions over the same period amounted to 228.5 billion roubles per day and was almost unchanged from the first half of 2011.

The lower level of bank liquidity in the second half of the year and the growing demand for refinancing instruments caused a moderate increase in money market rates. The MIACR on overnight interbank rouble loans grew by 1.4 percentage points in July-December 2011 from the first half of the year to 4.6% p.a. This rate equalled 5.4% p.a. in December 2011, its highest level since November 2009. The average spread between the MIACR and the Bank of Russia's deposit rate widened from less than 0.2 percentage points in the first half of 2011 to 1.0 percentage points in July-December 2011 (Chart 2.3).

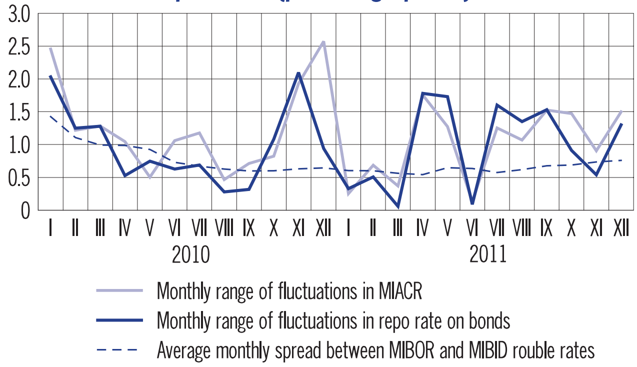
The growth of rates was accompanied by a considerable increase in their volatility. The average monthly range of fluctuations in the MIACR on overnight interbank rouble loans reached 1.29 percentage points in July-December 2011, exceeding the level registered in the first half of the year by a factor of almost two. The average monthly range of fluctuations in the overnight interdealer repo rate on bonds increased by a factor of almost 1.6 to reach 1.21 percentage points (Chart 2.4).

The growth of interest rate volatility in the second half of the year was only notable when compared to the low level that characterised the first half of the year: when compared with 2010, interest rate volatility remained moderate in the money market. The average monthly range of fluctuations in the MIACR on overnight interbank rouble loans was 1.27 percentage points in 2010, while the average monthly range of fluctuations in the overnight repo rate on bonds equalled 0.99 percentage points. The interquartile range of fluctuations in the MIACR on overnight interbank rouble loans narrowed from 36 basis points in 2010 to 26 basis points in 2011.

The analysis of Russian banks' balance sheets shows that the increase in money market rates and growth in their volatility were largely prompted by the local shortage of liquid funds and were not the signs of negative structural shifts or rising credit risks in the

Chart 2.4

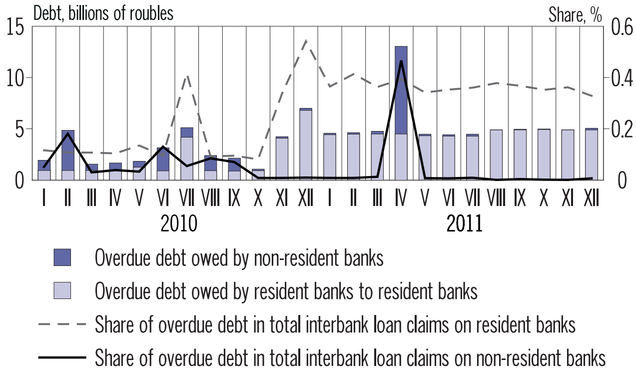
Volatility of money market rates on one-day rouble operations (percentage points)



Source: Bank of Russia, MICEX, calculations by Bank of Russia Research and Information Department.

Chart 2.5

Overdue debt in interbank operations*



** As of the beginning of the month.*
Source: Bank of Russia, calculations by Bank of Russia Research and Information Department.

money market. For most of 2011, overdue debt on interbank loans placed in the market remained at the level registered at the end of 2010 (Chart 2.5). The share of doubtful loans in the total value of interbank loans placed in the market was less than 0.6% of the total value of interbank loans placed by Russian banks throughout 2011. This was comparable with the level registered in the previous year.

The volume and rate dynamics by group of borrower banks that were observed in the Russian interbank loan market also evidenced that the credit quality of the portfolio of interbank loans did not deteriorate. In the second half of 2011, large banks with high credit ratings demonstrated the fastest growth in volume of operations for raising interbank loans. The share of operations to extend loans to banks with an investment grade credit rating (MIACR-IG sample) did not exceed 30% of the total volume of loan placements (MIACR sample) for most of the first half of the year. It grew to 32–37% in the third quarter and 41–48% in the fourth quarter (Chart 2.2).

These changes in the structure of operations may be caused by differences in the structure of banks' assets: major banks with high credit ratings normally hold a smaller part of their funds in highly liquid assets compared with second-tier banks and consequently demonstrate stronger demand for rouble resources during periods of liquidity shortage. They may also be caused by a flight to quality in connection with the reassessment of the risks associated with interbank lending (following which, banks are less willing to lend money to borrowers with low credit ratings).

The dynamics of the MIACR and MIACR-IG rates suggest that the first factor prevailed in the second half of the year. The MIACR-IG on loans to the most reliable borrowers grew faster than the average market MIACR and the spread between them was observed to narrow (Chart 2.3). If market participants had reassessed credit risks for the interbank credit market as a whole, risk premiums included in the rates on loans to second-tier banks would have been seen to grow. Likewise, the spread between the MIACR and MIACR-IG rates would have been observed to widen; however, this was not registered in the period under review.

The debt crisis in the eurozone could lead to higher credit risks on non-resident banks' liabilities to Russian banks because European banks account for a considerable portion of the funds placed by Russian banks in the global interbank credit market (see the Box entitled: 'Structure of Russian Banking Sector Claims on European Banks'). However, the share of overdue debt in non-resident banks' liabilities to Russian banks did not increase in the period under review (Chart 2.5).

The Russian market in 2011, as before, was characterised by a high degree of concentration; the top 30 banks accounted for over 70% of total liabilities and claims in the Russian interbank credit market. This high concentration may be a source of instability in the Russian interbank credit market, because the deterioration of the situation of some large banks could lead to the collapse of the Russian money market as a whole. Fortunately, such a scenario remains very unlikely because the top Russian banks (the major interbank market participants) are solid financial institutions and can normally rely on government support.

Therefore, the contraction in the banks' rouble liquidity and the increased uncertainty in external markets in the second half of the year caused some decrease in stability in the money market. In 2011, Russian banks – the largest money market participants – continued to pursue conservative financial policies, due to which the stability decrease in the second half of the year was moderate, while the average level of risk did not change significantly compared with the previous year.

Structure of Russian Banking Sector Claims on European Banks[1]

As of 1 January 2012, claims on European banks, including interbank loans and deposits placed by Russian banks, as well as the nostro accounts of Russian credit institutions, totalled: 1.4 billion roubles in claims to Irish banks, 107.4 billion roubles to Italian banks, 8.1 billion roubles to Greek banks, 10.6 million roubles to Spanish banks and 296.5 billion roubles to Cypriot banks. There were no claims to Portuguese banks.

The total claims of the Russian banking sector to the banks of these countries equalled 413.4 billion roubles or 1.0% of the total assets of the Russian banking sector.

[1] The Box was prepared by the Banking Regulation and Supervision Department.

2.2. Foreign exchange market[2]

In 2011, the serious threat to the stability of the rouble and the domestic foreign exchange market emanated from the volatility of cross-border capital flows and destabilisation of world commodity markets and financial markets. The pressure of negative fundamental factors increased exchange rate risks for the banking sector and the Russian economy as a whole. Possibilities for offsetting the negative effect of the growth in foreign exchange risk are connected with the development of risk hedging instruments. However, this is mainly hindered by the low liquidity level of the futures segment of the domestic foreign exchange market.

* * *

The intensifying debt crisis in the eurozone, coupled with the US sovereign rating downgrade and the ensuing rise in uncertainty over the further dynamics of the world's major currencies, caused a high level of volatility in the exchange rates between foreign currencies and the rouble. Exchange rate risk continued to prevail among the risks that accompany forex transactions. Conversion operations with foreign currencies other than the world's leading currencies and those of Russia's major trading partners were also significantly exposed to the liquidity risk caused by difficulties in searching for counterparties to promptly perform deals on acceptable terms in the domestic foreign exchange market.

The US dollar remained a major foreign currency in the Russian financial market in 2011. The market participants' interest in transactions with the euro also remained largely unchanged: the share of transactions with the euro against all currencies totalled 15.2%[3] in the aggregate turnover of the interbank foreign exchange market in 2011 (compared with 15.7% in 2010). The pound sterling retained third place among foreign currencies in the domestic foreign exchange market in the course of many years. In 2011, market participants showed increased interest in transactions with foreign currencies that were characterised by the highest level of stability and reliability (safe haven currencies). This interest resulted in the growth of transactions involving the Japanese yen and the Swiss franc, although the share of these currencies in the structure of the domestic foreign exchange market remained negligible and exerted no influence on the general level of liquidity risk in the foreign exchange market.

World energy prices (primarily oil prices) and the dynamics of cross-border capital flows remained the largest factors that influenced the stability of the rouble in 2011. In January-July 2011, the inflow of funds from foreign trade operations offset the net private capital outflow, causing the foreign currency supply to exceed demand in the domestic foreign exchange market and creating a trend towards the rouble's appreciation. In subsequent months, however, the intensified capital outflow was not offset by the inflow of foreign currency from foreign trade operations; this led to the weakening of the rouble.

The Bank of Russia's exchange rate policy in 2011 was aimed at keeping the volatility of the Russian national currency within acceptable limits. The Bank of Russia continued to use the rouble value of the bi-currency basket (0.45 euros and 0.55 US dollars) as the operational benchmark of its exchange rate policy. The Bank of Russia relied on the mechanism of the operational floating band of permissible value of the bi-currency basket, with the automatic correction of the band's limits, depending on the volume of currency interventions.

The Bank of Russia continued its work to consistently increase the flexibility of the exchange rate-setting mechanism. For this purpose, the Bank of Russia changed the parameters of its exchange rate policy mechanism twice in the period under review. In particular, the operational floating band was symmetrically widened from 4 roubles to 5 roubles on 1 March and widened again, from 5 roubles to 6 roubles, on 27 December. In addition, the value of accumulated interventions that cause the limits of the operational band to shift by 5 kopecks was reduced from $650 million to $600 million and from $600 million to $500 million, respectively.

The Bank of Russia only conducted operations to purchase foreign currency in January-July 2011,

Table 2.1

Bank of Russia interventions in domestic foreign exchange market in 2011 (billions of US dollars)

	Foreign currency purchase	Foreign currency sale	Total, net foreign currency purchase
January	0.8	-	0.8
February	4.6	-	4.6
March	5.4	-	5.4
April	3.7	-	3.7
May	4.5	-	4.5
June	4.0	-	4.0
July	5.1	-	5.1
August	1.2	0.7	0.5
September	-	7.6	-7.6
October	-	5.0	-5.0
November	-	1.6	-1.6
December	-	2.0	-2.0
Total	**29.3**	**16.9**	**12.4**

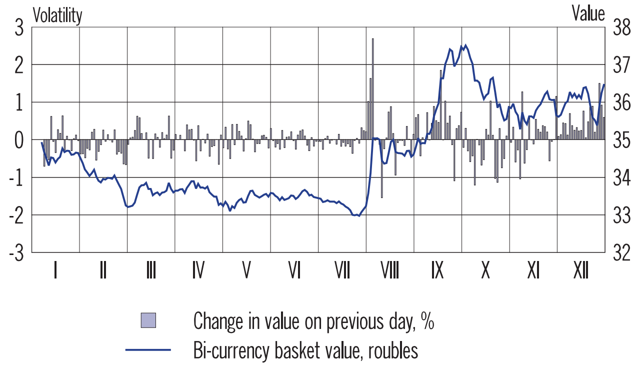
Source: Bank of Russia.

[2] *Materials of the Market Operations Department were used to prepare subsection 2.2.*

[3] *The proportions are calculated excluding a double count, which means that the proportions of operations with all currency pairs equal 100% when they are summed up.*

Chart 2.6

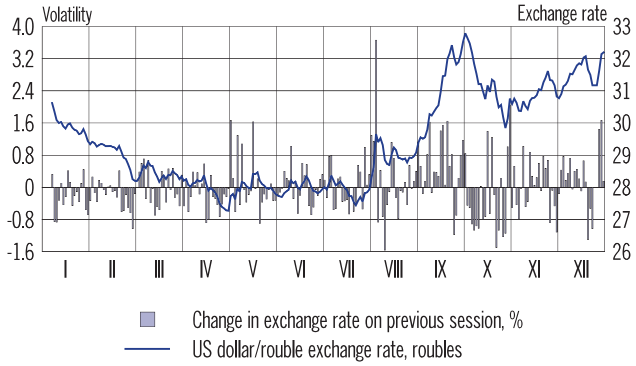
Short-term volatility of rouble value of bi-currency basket in 2011*



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

Chart 2.7

Short-term volatility of US dollar/rouble exchange rate in 2011*



** According to exchange rate of the US dollar against the rouble in trades for 'tomorrow' settlements.*

and switched to both the purchase and sale of foreign currency in August. It solely resorted to selling foreign currency from September through the end of the year (Table 2.1).

The growth in the rouble value of the bi-currency basket from August 2011, coupled with a noticeable increase in its volatility, intensified uncertainty in exchange rate expectations in the foreign exchange market. The short-term volatility of the rouble value of the bi-currency basket expanded to 0.34% in 2011 from 0.33% in the previous year (Chart 2.6).

The increase in exchange rate risk in the domestic foreign exchange market could also be evidenced by the volatility of the exchange rates of the world's major currencies against the rouble. In particular, the average daily change in the US dollar/rouble rate[4] in UTS trades for 'tomorrow' settlements went up considerably in 2011 compared with 2010: it increased to 0.51% from 0.42%, while the maximum daily change in this indicator stood at 3.66% as against 2.81% in 2010 (Chart 2.7). The range of fluctuations in the US dollar/rouble rate expanded considerably, growing almost twofold compared with the previous year (from 2.80 roubles in 2010 to 5.51 roubles in 2011). The coefficient of the exchange rate variation grew more than twice, from 2.19% in 2010 to 4.94% in 2011.

The considerable increase in rouble/US dollar rate volatility testified to the fact that the exchange rate risk for this type of conversion transactions had risen significantly. The growing volume of deals involving this currency pair (the lower liquidity risk) mitigated the foreign exchange risk only partially, considering that the domestic foreign exchange market had not yet returned to the pre-crisis volume. The aggressive purchases of US dollars (largely related to the withdrawal of capital from the Russian market) served as an additional destabilising factor in the domestic foreign exchange market.

[4] *The average daily change in the exchange rate is referred to as a short-term volatility indicator.*

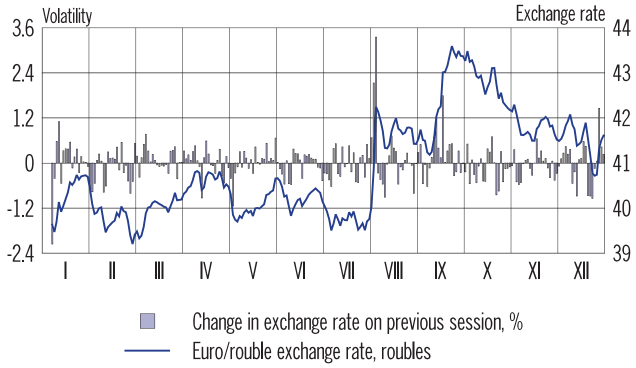
The average daily change in the euro/rouble rate in UTS trades for 'tomorrow' settlements stood at 0.35% in 2011 as against 0.37% in 2010 and was smaller than the average daily change in the US dollar/rouble rate (Chart 2.8). The maximum daily change in the euro/rouble rate increased from 2.14% in 2010 to 3.35% in 2011. At the same time, the range of fluctuations in the euro/rouble rate slightly decreased, from 5.62 roubles to 4.39 roubles, and the coefficient of variation lowered from 3.76% to 2.70%, respectively.

Despite the decrease in most volatility indicators for the rouble/euro exchange rate, there was no reduction in the exchange rate risk in operations with this currency pair as a whole. The unfavourable economic situation in the eurozone countries and the uncertainty about the prospects of the single European currency were the main factors of rouble/euro rate instability.

As was the case in previous years, credit institutions' long and short open foreign exchange positions were imbalanced in 2011. The average value of the Russian banking sector open foreign exchange position had not exceeded 2% of banking sector capital in the past few years. Under the limit set by the Bank of Russia to restrict

Chart 2.8

Short-term volatility of euro/rouble exchange rate in 2011*



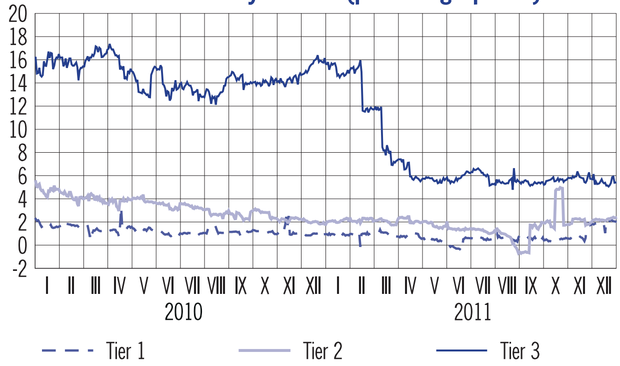
** According to exchange rate of the euro against the rouble in trades for 'tomorrow' settlements.*

foreign exchange risk,[5] 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 2011 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.

A significant factor allowing market participants to reduce foreign exchange risk is hedging based on derivatives; that is, the development of the futures segment of the domestic foreign exchange market. The weak development of the Russian futures market, its limited set of instruments, and also the speculative nature of most transactions involving currency futures reduce, in many ways, the market participants' abilities to hedge their risk.

Chart 2.9

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



Source: National Bank Trust (OJSC).

2.3. Capital market

2.3.1. Bond market

Thanks to the high issuing activity of the Russian Ministry of Finance in 2011, participants in the domestic bond market were able to build up their investment portfolios with the help of highly liquid government bonds, while reducing their share of riskier corporate debt instruments. Despite the growth of tension in some periods of 2011, the domestic bond market was stable as a whole.

* * *

In the domestic bond market, the portfolio of government securities grew faster than the portfolio of corporate bonds for the second consecutive year. The portfolio of government securities also demonstrated more considerable absolute growth in 2011.

Rapid growth in general government borrowing in 2011 didn't pose a threat to macroeconomic stability and the sustainability of the Russian financial market. As was the case in 2010, Russia's domestic and external government debt to gross domestic product (GDP) ratio was less than 10% at the end of 2011, which was considerably below the threshold level recommended by international financial institutions.[6] While some countries had their sovereign ratings downgraded by the leading international rating agencies over problems with repaying their government debt, Russia retained its credibility and investment grade ratings in the period under review (see Addendum). Russia's expenditures on government bond principal and coupon payments are diversified by maturity, which facilitates the Russian government's bonded debt service.

In 2011, the corporate bond market remained an important source of funding for companies in the real sector of the economy, as well as credit and financial institutions. The attractive cost of borrowing in the corporate bond market (corporate bonds' first coupon rates were lower than the rates on loans to non-financial institutions with comparable maturity) contributed to the expansion of the volume of primary placements and the growth of the market portfolio. After the 2008 crisis, investors have followed less risky strategies in the formation of their portfolios, giving preference to the instruments of reliable issuers. As was the case in 2010, the highest credit risk was inherent in bonds whose issuers had had difficulties servicing their bonded debts earlier. However, the number of defaults registered in 2011 contracted to 72 from 193 in 2010. As the corporate bonds of third-tier[7] issuers were gradually withdrawn from circulation (redeemed or reclassified as defaulted), the credit quality of the aggregate portfolio of corporate bonds improved in 2011 as compared with 2010.

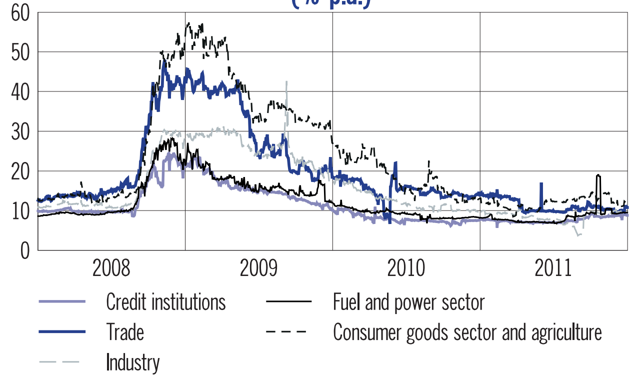
The price indicators of the domestic debt market reflected changes in both the economic and financial situation of participants in the Russian financial market. In January-July 2011, the yields on debt instruments in the secondary market were mainly observed to decline. The dramatic rise in bond yields between August and the first ten-day period of October was caused by the lower attractiveness of rouble-denominated instruments as compared with foreign currency. The rate of change in bond yields and their volatility differed in the government and corporate bond markets. The spreads

[5] *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'.*

[6] *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), aggregate domestic and external government debt should not exceed 60% of annual GDP.*

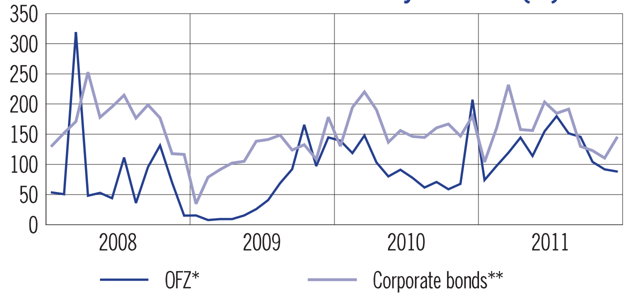
[7] *A corporate bond issuer/issue is conventionally assigned to a particular tier. News agencies and credit institutions that calculate their bond indices breaking them down into tiers use their own methodologies, based on their assessment of the issuer's credit quality and financial indicators, as well as the issue's liquidity.*

Chart 2.10
Corporate bond yields by type of issuers' economic activity (% p.a.)



Source: National Bank Trust (OJSC).

Chart 2.12
Coefficients of turnover velocity of bonds (%)



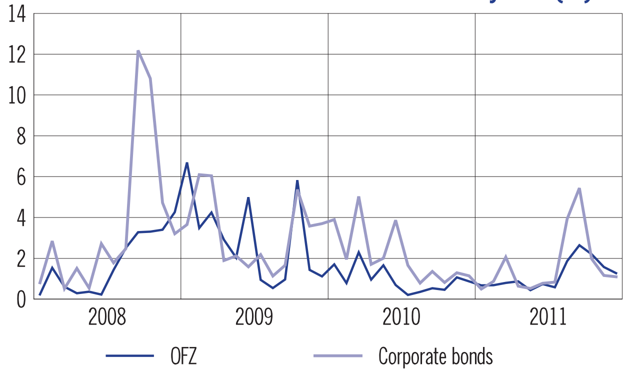
** Calculated as the ratio of monthly secondary trade turnover to the average monthly portfolio value (on an annualised basis).*
*** Calculated as the ratio of monthly secondary trade turnover to the outstanding volume as of the end of the month (on an annualised basis).*
Source: Bank of Russia, MICEX,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

between the yields on corporate bonds and federal loan bonds (OFZ) that included credit risk premiums (among other things) varied, depending on the credit quality of issuers (Chart 2.9). The lowest credit risk was that of the securities of first- and second-tier corporate issuers. Credit risk on third-tier bonds decreased significantly in 2011, but remained considerably higher than on the bonds of issuers with better credit quality. The spreads between the yields on the corporate bonds of issuers in different risk categories narrowed. In 2011, the average spread between the yields on first-tier and second-tier bonds equalled 0.73 percentage points, while the average spread between the yields on first-tier and third-tier bonds was 5.22 percentage points. As compared with 2010, both indicators decreased more than twofold.

The reduction of credit risk on the corporate borrowing of some Russian issuers has also been confirmed by the improvement of the ratings assigned to them by leading international rating agencies (see Addendum).

In 2011, the possibility of incurring losses from investments in corporate bonds was less contingent on the issuer's sector than it had been in 2010. The gradual

Chart 2.11
Coefficients of variation of effective bond yields (%)



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

recovery of production and the improvement of the financial situation of most non-financial organisations and the performance of credit institutions contributed to the growth in the prices of their bonds during most of the period under review. In 2011, the yields on the securities of issuers engaged in different types of economic activity stayed at the level of the first half of 2008, while debt securities in some sectors registered new record low yields (Chart 2.10).

The range of fluctuations in the yields on government and corporate bonds narrowed in 2011, which testified to the reduction of interest rate risk. The annual coefficients of variation of government and corporate bond yields decreased in the domestic market in 2011, when compared with 2010. However, in some periods of 2011, the monthly coefficients of yield variation were higher than their maximum levels registered in 2010 (Chart 2.11). The range of fluctuations in the yields of the debt instruments under review narrowed, but remained considerably wider than it had been before the crisis.

The liquidity risk of securities (financial assets), that is, the risk that an asset will be difficult or impossible for its owner to sell quickly enough in the secondary market, remained a topical problem for the capital market in 2011.

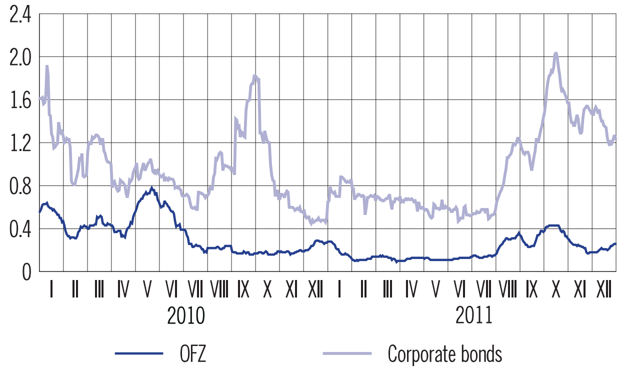
Coefficients of turnover velocity[8] and their volatility are important indicators which characterise bond market liquidity. In 2011, these indicators fluctuated within a wide range (Chart 2.12). OFZ[9] turnover grew in 2011 year on year, reflecting a reduction of liquidity risk.

Turnover velocity in the corporate bond market declined in 2011 year on year, reflecting an increase in liquidity risk in this segment as a whole. In January-July 2011, there was strong demand for both the bonds of first- and second-tier issuers, and the bonds of issuers

[8] The ratio of total turnover to the average outstanding volume of bonds at their actual prices over the period (on an annualised basis).
[9] In the main trading mode, excluding technical and negotiated deals.

Chart 2.13

Bond bid/ask spreads (percentage points)*



** 21-day moving average.*
Source: MICEX, calculations by Bank of Russia Research and Information Department.

with a low credit quality, which saw a gradual increase in the liquidity of their securities. From August 2011, the combination of negative external and internal factors led to the outflow of both foreign and Russian investors' funds from the domestic corporate bond market. Secondary trade turnovers contracted significantly. In August-December 2011, the liquidity of corporate bond issues assigned to different risk categories changed both ways. The possibility of conducting a deal quickly and at a minimal cost became a determining factor for market participants amid the shortage of freely available rouble liquidity. As a result, the turnover velocity of first-tier issuer bonds with a duration of up to one year started to grow rapidly, while the turnover velocity demonstrated by the bonds of third-tier issuers and some second-tier issuers began to decrease.

The change of the situation in the Russian bond market in 2011 influenced the liquidity of some instruments. The dynamics of daily bid/ask spreads on government and corporate bonds,[10] weighted by secondary trade turnovers, differed in their direction and volatility during most of 2011 (Chart 2.13). The average bid/ask spreads on OFZs and corporate bonds slightly decreased in 2011 compared with 2010, which testified to some reduction in the liquidity risk of the securities of the most reliable issuers.

Therefore, instability in the global financial markets, which intensified in the second half of 2011, caused some increases in risks in the domestic financial market, including the market for government and corporate bonds. However, considerable volumes of credit institutions' liquid rouble resources, the rouble's relative stability and high world oil prices mitigated the effect of negative external shocks.

2.3.2. Equity market

The main sources of danger to the stability of the Russian equity market in 2011 were external shocks represented by numerous turbulences in global capital market and considerable fluctuations in external commodity market conditions. Their impact was intensified by internal structural disproportions (the dominance of market speculators over conservative investors and the high concentration of capital by industry). The interaction of these factors increased price volatility in the Russian equity market. At the same time, the destabilising effect of external shocks was limited by certain positive factors: the relatively stable situation in other segments of the domestic financial market, the improvement of Russia's macroeconomic indicators and high world oil prices.

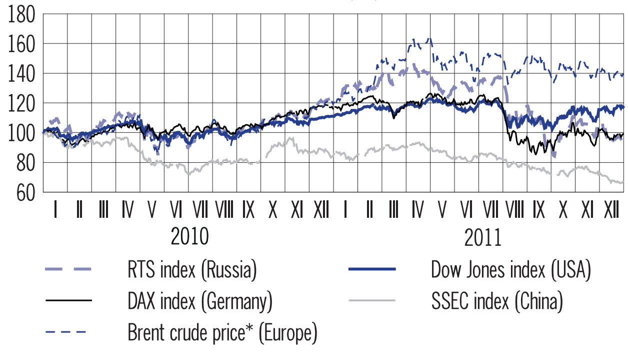
* * *

The uncertainty of market participants' price expectations and price volatility increased in all the segments of the global stock market in 2011, including the Russian equity market. Developed and emerging markets registered common trends, as demonstrated by the growing correlation between their main stock market indices (Chart 2.14). In particular, the correlation coefficients between Russia's RTS index and the stock indices of the other BRICS countries increased to 0.81–0.94 in 2011 from 0.57–0.78 in 2010. Growing global economic risks (associated with the expectations of slower global economic growth and debt problems in Europe and the US) had a destabilising effect on the dynamics of Russian and foreign stock market indices.

As was the case in previous years, RTS index volatility was higher than the volatility of stock indices of developed countries and the other BRICS countries, which testified to the persistence of higher price risks in the Russian equity market. The volatility of share prices was largely observed to increase in 2011 and its most rapid growth was registered in the second half of the

Chart 2.14

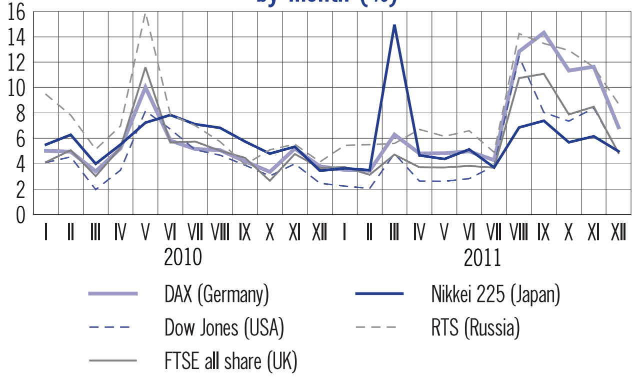
Evolution of world stock indices and world oil price in 2011 (%)*



** Stock indices and oil prices as of 31 December 2009 = 100%.*
Source: Reuters news agency, calculations by Bank of Russia Research and Information Department.

[10] *Calculations are based on corporate bond issues included in the MICEX Stock Exchange first-tier A quotation list.*

Chart 2.15
Volatility of some of the world's stock market indices by month (%)



Source: Reuters news agency, calculations by Bank of Russia Research and Information Department.

Chart 2.16
First-tier equity issuers bid/ask spread (%)*

** 20-day moving average.*
Source: Cbonds.ru news agency, calculations by Bank of Russia Research and Information Department.

year amid the intensified debt crisis in the eurozone, suggesting a dramatic rise in market (price) risk over this period (Chart 2.15). At the same time, the annual level of volatility was considerably lower than during the crisis and the post-crisis recovery of the Russian market in 2008–2009. The MICEX and RTS index volatility stood at 27% and 32%, respectively, on an annualised basis in 2011, as against 23% and 27% in 2010.

During most of 2011, the liquidity risk indicators of the exchange segment of the Russian equity market (the bid/ask spreads of the most liquid equities of the first-tier issuers and the equity market's coefficient of turnover velocity[11]) were comparable to the previous year's results. However, the bid/ask spreads widened considerably in August-October and December 2011, indicating the liquidity risk growth for most traded equities (Chart 2.16). At the same time, the average spread stood at 0.07% in 2011, matching its 2010 level. The equity market's annual coefficient of turnover velocity was also unchanged from 2010 and equalled about 66%. Consequently, the equity market's liquidity risk remained moderate during most of 2011.

The high concentration of exchange transactions with most attractive for investors first-tier equities was one of the sources of a systemic risk in the equity market in 2011. The stocks of the top ten 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). The six of the top ten accounted for over 40% of the market capitalisation and about 80% of the total trade turnover. Two of the six most liquid stocks were those of banking sector issuers (Sberbank and VTB Bank), while four were those of oil and gas sector issuers (Gazprom, LUKoil, Rosneft and Surgutneftegaz).

Sharp price volatility of the most liquid instruments (which usually enjoy constant demand from speculators) intensified negative sentiments in the equities market amid uncertainty with respect to price expectations. This triggered a massive sell-off of less liquid securities.

Negative price trends in the equity market spread to other segments of the financial market, particularly through the negative revaluation of credit institutions' securities portfolios. At the same time, the negative impact on the Russian banking sector was contained, as in previous years, by the Russian banks' lack of interest in high-risk equities. In 2011, investments in shares did not exceed 3% of the assets of the banks – the major equity market operators – and banking sector assets as a whole. As instability in the Russian equity market intensified, some credit institutions which ranked among the major equity market operators adopted more conservative financial strategies, gradually reducing the part of shares in their securities portfolios.

Therefore, in 2011 the Russian equity market remained one of the riskiest and most vulnerable to external shocks segments of the domestic financial market. It demonstrated this via its higher market (price) risk (registered in equity market in the second half of 2011) compared with other segments of the domestic financial market.

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[11] 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.

Chapter 3. Sustainability of financial intermediaries

3.1. Credit institutions

Relatively positive trends persisted in the development of the Russian economy in 2011. However, the volatility of cross-border capital flows, the growth of interest rates in the global and Russian money markets and the deterioration of the situation with Russian banks' funding reduced the volume of liquid resources in the banking sector in the second half of 2011. The fall in world and Russian stock market indices resulted in losses for credit institutions, due to the revaluation of their securities portfolios. Considerable fluctuations in the exchange rate of the Russian rouble against the world's leading currencies increased the exchange rate risk of banks' foreign currency transactions. The medium-term prospects of the Russian economy in general and the banking sector in particular remained highly uncertain amid persisting instability in world financial and commodity markets. Despite this, the Russian banking sector was quite successful in resisting these destabilising factors.

* * *

For most of 2011, Russia's banks didn't have any problems with liquidity. However, in the second half of the year, the level of banking sector liquidity slightly decreased (see Section 2.1). During the year, there was a persistent trend towards the reduction in the share of the most liquid assets[1] in the banking sector's total assets. This ratio stood at 7.1% on average[2] in August-December 2011 as against 8.0% in the first half of 2011. Nevertheless, the banking sector's main liquidity indicators remained higher than the minimum permissible levels. Non-compliance with the instant liquidity ratio (N2) and the current liquidity ratio (N3) was demonstrated only by some credit institutions[3] in isolated instances during 2011.

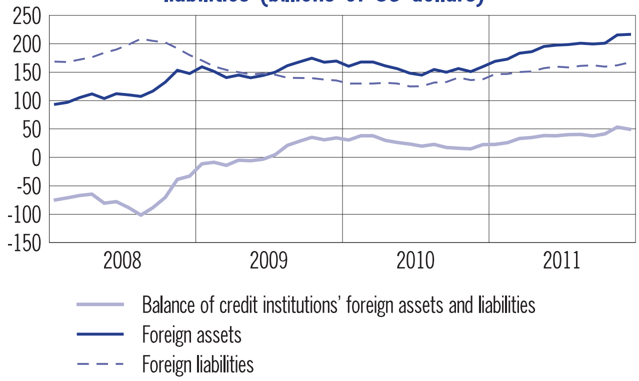
Russian banks were observed to build up their investments in foreign assets in 2011 due to the intensified expectations of the rouble's devaluation and the banks' need to accumulate funds to refinance their foreign liabilities. In January-November 2011, Russian banks' foreign assets grew by 31.5%. The higher cost of external funding limited the growth of the banking sector's foreign liabilities, which increased by 17.3% in January-November 2011. As a result, the credit institutions' net investment position grew by 122.8% in the period under review to 1,546.2 billion roubles as of 1 December 2011, or about 31% of the banking sector's total capital. This posed no threat to the stability of the banking sector, in accordance with international practice (Chart 3.1).

The structure of the banks' resource base, formed at the beginning of 2011, underwent certain changes towards the end of the year. The most significant change was the growing share of funds attracted from the Bank of Russia. This process was accompanied by the reduction of the role of funds raised from non-resident (foreign) banks and households. This, in turn, was offset by the growing share of financial resources attracted from organisations other than banks, through the placement of the Ministry of Finance's funds on deposit accounts with banks.

The increased risk of the eurozone countries defaulting on their sovereign debt kept volatility high in foreign financial markets. This considerably impeded the access of Russian banks (with the exception of large banking institutions) to external borrowing (see Section 2.1). The increased cost of external borrowing made Russian credit institutions refocus their attention on the internal resource base, which particularly stimulated the growth of interest rates on bank deposits (the maximum interest rate on rouble-denominated deposits offered by the ten credit institutions accounting for the largest volume of household deposits grew from 7.85% p.a. in mid-June 2011 to 9.41% p.a. in late December)[4].

Chart 3.1

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



Source: Bank of Russia.

[1] *Cash, precious metals and gems, balances of Nostro correspondent accounts, balances of correspondent and deposit accounts with the Bank of Russia.*

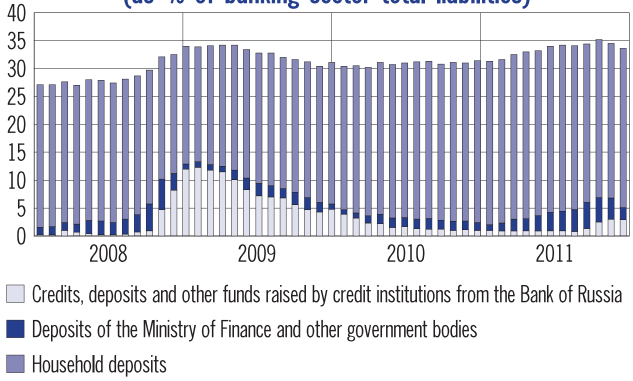
[2] *Average values of the banking sector's liquid and total assets were calculated as the average chronological value over the corresponding period.*

[3] *According to data provided by the Banking Regulation and Supervision Department.*

[4] *According to data provided by the Banking Regulation and Supervision Department.*

Chart 3.2

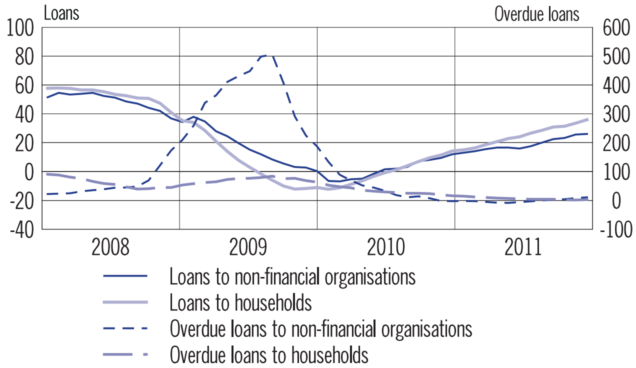
Components of banking sector resource base (as % of banking sector total liabilities)



Source: Bank of Russia.

Chart 3.3

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



Source: Bank of Russia.

Measures taken by the Bank of Russia and the Russian Ministry of Finance helped contain the funding risks of credit institutions that could have emerged in the second half of 2011 under the impact of deteriorating liquidity. The value of loans, deposits and other funds raised by credit institutions from the Bank of Russia grew by a factor of 3.7 in 2011 (it contracted by 77.1% in 2010). The Russian Ministry of Finance expanded the volume of funds provided at deposit auctions. This source of funding accounted for about 20% of the overall growth in the value of deposits and other funds raised by banks from legal entities other than credit institutions.

Growth in household deposits slowed from 31.2% in 2010 to 20.9% in 2011, due to relatively low interest rates and households' lower saving activity during most of 2011. Despite this, household deposits remained a stable source of internal funding for the banking sector (Chart 3.2). This factor helped mitigate funding problems in the sector. However, the share of deposits in the liabilities of some banks exceeded 80%, while interest rates on these deposits were higher than the average market rates. Partly as a result of this, the Bank of Russia continued to pay close attention to credit institutions that pursued aggressive policies to attract deposits; particularly credit institutions that offered deposits with interest rates above 10% p.a. and had the share of household deposits in their total liabilities in excess of 50%.

The situation in the Russian economy was quite stable in 2011, creating overall positive dynamics in the development of the domestic banking sector. Banking sector assets grew more intensively in 2011 than they had in 2010 (they increased by 23.1% in 2011 as against 14.9% in the previous year). This was largely due to the banks building up their loan portfolios. The aggregate value of loans, deposits and other funds placed by banks (hereinafter referred to as loans) grew by 29.6% in 2011 (by 11.6% in 2010). In 2011, banks were more active in building up the most profitable retail lending as compared with corporate and interbank lending. The value of loans extended to individuals increased by 35.9% in 2011 (by 14.3% in 2010), while the value of loans provided to non-financial organisations grew by 26.0% as against 12.1% in the previous year (Chart 3.3). The borrowers' increased creditworthiness and the relatively low lending rates were the main factors that drove the growth of the real sector's loan portfolio. The increase of mortgage and auto lending was additionally stimulated by government support measures.

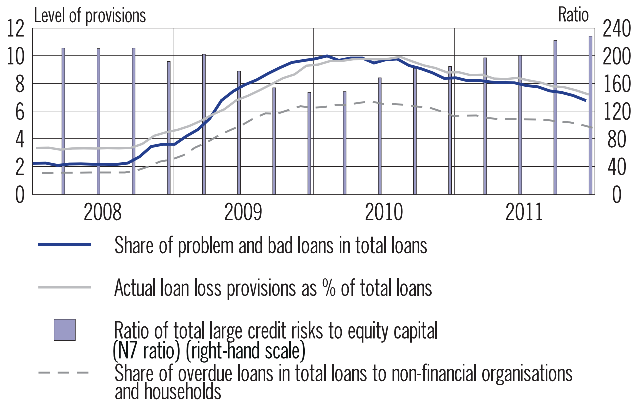
The banks' intensified activity in the credit market was accompanied by the improvement in the quality of the aggregate credit portfolio. The share of problem and bad loans in total loans decreased to 6.8% as of 1 January 2012. The ratio of loan loss provisions to the credit portfolio decreased in 2011 due to the improvement in the quality of loans. The volume of the loan loss provisions made by credit institutions fully covered problem debts. As of 1 January 2012, this volume accounted for 6.9% of the credit portfolio as against 8.5% a year earlier. Overdue loans grew by 9.4% in 2011 (2.1% in 2010) but their share in the aggregate credit portfolio contracted to 3.9% as of 1 January 2012. The deteriorated quality of the credit portfolio held by the Bank of Moscow JSC, which was placed under financial recovery procedures, was one of the main reasons for the growth of overdue debts in the banking sector as a whole from February 2011 (Chart 3.4).

Restructured loans[5] totalled 1,774.3 billion roubles (28.6% of the portfolio of large-value loans). Loans that had been restructured by the extension of the term of principal repayment (prolonged loans) amounted to 982.2 billion roubles or 15.8% of the portfolio of large-

[5] *Loan restructuring is understood to mean the extension of the term of principal repayment, the reduction of the interest rate, the increase of the amount of principal debt, the modification of the schedule of loan interest payment, the change of the procedure for interest rate calculation, etc.*

Chart 3.4

Certain characteristics of banking sector credit risk (%)



Source: Bank of Russia.

value loans as of 1 January 2012 (882.2 billion roubles or 16.6% as of 1 January 2011). They accounted for 2.4% of banking sector total assets as of 1 January 2012 as against 2.6% a year earlier.[6]

The Bank of Russia tightened the procedures for assessing the risks of credit institutions' investments in securities (particularly promissory notes), which helped contain the growth in the volume of the banking sector's corresponding operations. Banks' investments in securities grew by 6.6% in 2011 as against 35.3% in 2010. Banks especially built up their investments in low-risk government debt securities (particularly OFZ bonds). Debt securities issued by non-residents accounted for 13.5% of the banking sector's total portfolio of securities as of 1 January 2012. According to expert estimates, this level posed no threat to the stability of the banking sector, even in the event of issuers defaulting on their obligations due to the debt crisis in the eurozone.

The growth of the Russian banking sector's assets, amid the restricted access (for most banks) to capital markets, intensified the problem of raising additional financial resources for the build-up of bank equity capital. Credit institutions' equity capital grew by 10.8% in 2011 (2.4% in 2010). This growth was mostly ensured by the top thirty banks. However, as risk-weighted assets grew faster (by 36.7% in 2011) than bank capital, the banking sector's capital adequacy ratio (N1 ratio), which is viewed as one of the main indicators of credit institutions' financial soundness, was observed to decrease. It fell from 18.1% as of 1 January 2011 to 14.7% as of 1 January 2012. From 1 October 2011, the Bank of Russia introduced increased risk coefficients for certain assets. These included securities purchased by credit institutions, which exerted downward pressure on banking sector capital adequacy.

As of 1 January 2012, there was not a single bank that failed to comply with the N1 ratio (10%). However, the number of banks with a capital adequacy level of between 10% and 12% doubled in 2011 to 107 banks as of 1 January 2012. The share of these banks in the banking sector's total assets grew to 34.3% as of 1 January 2012 from 6.4% a year earlier.

The overall market risk[7] of the banking sector[8] increased by 14.2% in 2011 due to the growth of stock market and foreign exchange risks. The stock market risk increased due to the fall in global and domestic stock market indices. The foreign exchange risk intensified due to the growth of the exchange rate risk on banks' foreign currency operations under the impact of the rouble's high volatility against the world's major currencies in the second half of 2011. Interest rate risk continued to prevail in the structure of credit institutions' market risk (68.0% as of 1 January 2012), while the stock market and foreign exchange risks accounted for 26.0% and 6.0%, respectively.

The growth of lending operations was a factor that increased credit risk in capital adequacy calculations[9]. Credit risk grew by 36.2% in 2011 (11.2% in 2010). Credit risk accounted for 87.9% of the banking sector's overall risks as of 1 January 2012. The ratio of large credit risks to banking sector total assets exceeded 25% during most of 2011, which, in particular, could be explained by the fact that some banks actively lent to bank owners and related parties (Chart 3.4).

The development of lending, along with the continued slowdown in the creation of provisions for possible loan losses (to 3.8% in 2011 from 6.1% in 2010) contributed to the growth of profitability of the banking business. The banks' financial result was adversely affected by the high volatility of Russian stock market indices. This caused a dramatic fall in the positive revaluations of their securities portfolios, followed by unsteady growth in negative revaluations. The banking sector's financial result totalled 848.2 billion roubles in 2011 and exceeded the 2010 figure by a factor of 1.5 (Chart 3.5). The share of credit institutions' profits and funds in total banking sector capital increased to 43.8% as of 1 January 2012.

The rates of return on banks' assets and equity capital increased in 2011: they grew to 2.4% and 17.6%, respectively, as of 1 January 2012. These rates grew due to the increased increment of banks' profits, compared with the build-up of bank assets and capital. Bank capital growth was more moderate than GDP expansion. Preliminary estimates show that the ratio

[6] *The information on loan loss provisions and restructured loans was prepared by the Banking Regulation and Supervision Department.*

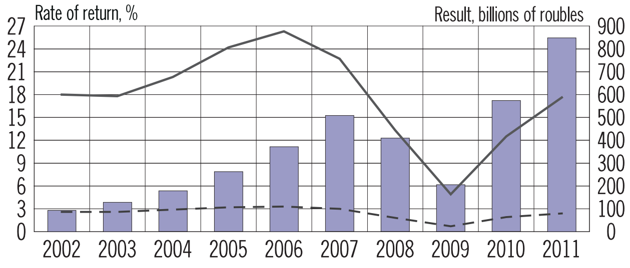
[7] *Market risk exposures taken into account when calculating the capital adequacy ratio (N1).*

[8] *The information on banking sector risks was prepared using material provided by the Banking Regulation and Supervision Department.*

[9] *This indicator represents the denominator in the N1 ratio calculation formula, net of market risk and operational risk.*

Chart 3.5

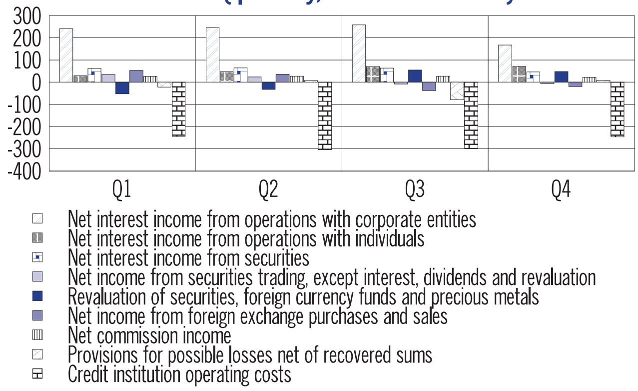
Rates of return on assets and equity capital and banking sector financial result



Source: Bank of Russia.

Chart 3.6

Key components of credit institutions' financial results in 2011 (quarterly, billions of roubles)



Source: Bank of Russia.

of total banking sector capital to GDP decreased by 0.8 percentage points in 2011 year on year to 9.6%, whereas the ratio of banking sector assets to GDP increased by 1.7 percentage points to 76.6%.

Credit institutions' net income from banking operations and other transactions increased by 13.9% in 2011, year on year. Net interest income accounted for about 35% of this increase. The growth of net interest income from operations with individuals accelerated to 328.7%, as banks actively built up their retail loan portfolios and cut interest rates on household deposits during most of 2011. The share of this type of income in total net interest income increased to 16.0% as of 1 January 2012, exceeding the previous year's figure fourfold. Net interest income from operations with corporate entities contracted by 8.9% and its share in total net interest income slightly decreased, and stood at 66.8% as of 1 January 2012 (Chart 3.6).

The economic situation of most Russian banks complied with the requirements for their sustainability, as defined in Bank of Russia Ordinance No. 2005-U, dated 30 April 2008, 'On the Assessment of the Economic Position of Banks'. In January-November 2011, most credit institutions were assigned to groups 1–3 according to their economic position. However, a considerable number of banks were in the borderline group, number three. In the second half of 2011, the number of such banks grew by a factor of 1.3 to 108 banks as of 1 December 2011, while their share in banking sector assets increased by a factor of 1.4 to 2.6% as of 1 November 2011. The share of banks assigned to groups 4–5[10] did not exceed 0.9% of total banking sector assets in 2011[11].

[10] *Banks that create a real threat to the interests of their depositors and creditors with breaches in their operations are assigned to group 4. Banks, whose condition will lead to the termination of their activities, unless measures are taken by their management bodies and owners, are assigned to group 5.*

[11] *According to data provided by the Banking Regulation and Supervision Department.*

The main reason for the revocation of banking licences (18 credit institutions had their banking licences revoked in 2011) was the credit institutions' failure to comply with federal laws on banking activities and Bank of Russia regulations. Banking licences were also revoked when they were unable to meet their creditors' pecuniary obligations.

According to the enactment of 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 (the DIA, a government corporation), carried out measures to prevent the bankruptcy of 19 banks.

By the beginning of 2012, all the necessary measures had been completed in 12 banks. Six of these had been reorganised by way of their merger with other banks or investors and three 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.

The remaining seven banks continued to carry out 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 January 2012, bankruptcy prevention measures involving the use of government funds and the participation of other investors continued to be implemented in one bank. The decisions to rehabilitate this bank had been taken before Federal Law No. 175-FZ came into force. This bank carried out its activities as part of the plan approved in accordance with Article 11 of Federal Law No. 175-FZ.[12]

Therefore, the main trends in the development of the banking sector in 2011 testified to its persisting financial stability. Despite instability in global financial markets and the deterioration in the liquidity of Russian banks, the domestic banking sector demonstrated growth in its loan portfolio and improvement of its quality. The sector built up its internal sources of funding, and banks increased profits and demonstrated profitability. At the same time, amid the stable functioning of the banking sector as a whole, some credit institutions were exposed to higher levels of risk, which was mainly attributable to the decrease in their capital adequacy ratios, their aggressive household deposit market policies and losses from operations with securities and foreign currencies.

Stress testing of the Russian banking sector[1]

In order to assess the systemic stability of the banking sector, the Bank of Russia held a stress test of Russian credit institutions. It was based on a scenario analysis and incorporated a macroeconomic model.

The macroeconomic model is a system of regression equations describing the influence of the macroeconomic environment (macroeconomic parameters) on banking sector indicators. Typical macroeconomic parameters include the oil price, the dollar exchange rate, GDP, inflation, household real income, etc. The banking sector indicators include the value of funds in the accounts of enterprises, household and corporate deposits, interbank loans from resident and non-resident banks raised and placed in the market, the value (revaluation) of securities, loans extended to households and corporate entities, and also the change in the share of bad loans[2] *in these loans. Taking into account the influence of macrofactors on major banking indicators, a quarterly balance simulation model is calculated for each credit institution to reflect the bank's behaviour in particular stress conditions. This modelling aims to reveal the amount of a credit institution's possible losses, and also the possibility of a capital shortage.*[3]

The stress test calculations take into account the time horizon of the stress conditions (currently set at one year), which allows banks to review their profit forecasts to adjust the amount of possible losses in a particular scenario.

As of 1 October 2011, stress tests covered all operating credit institutions. They defined macroscenarios based on characteristics calculated pursuant to the assessments made by major western investment banks to measure the impact of the possible deterioration in the debt crisis in Europe, and also pursuant to the Bank of Russia's own assessments. The scenarios envisage the possibility of a considerable slowdown in the growth of the Russian economy that could result from a fall in global oil prices, a fall in the price of other commodities exported by Russia, or increases in interest rates and some decrease in stock market indices.

Basic characteristics of scenarios

Indicator	Scenario parameters
GDP growth, %	from + 2.7 to – 1.0
CPI, %	5.0-6.0
Stock market index growth, %	from – 8 to - 17
Growth in interest rates on government securities (parallel shift in the yield curve), bp	200-350
Growth in interest rates on corporate securities (parallel shift in the yield curve), bp	500-1,000
Growth in the value of the bi-currency basket, %	10-20

The macromodel calculations suggest that in the event that the aforementioned scenarios are realised, banking sector losses net of potential profit[4] *may total from 837 billion roubles to 1.3 trillion roubles (from 17% to 26% of banking sector capital) as of 1 October 2012. Losses with account taken of potential profit may range from 220 billion roubles to 906 billion roubles (from 4.5% to 18% of banking sector capital).*

Given the results of the stress tests, the capital adequacy ratio across the banking sector may range from 12% to 14%, depending on the scenario. This testifies to the fact that the Russian banking sector is quite stable and can resist the potentially negative consequences of the European debt crisis.

It should also be noted that the stress test scenarios and results are not a forecast and only reflect possible consequences of the realisation of the above negative developments.

[1] *The Box was prepared by the Banking Regulation and Supervision Department.*

[2] *Bad loans are understood to mean loans assigned to quality groups 4-5 in accordance with Bank of Russia Regulation No. 254-P, dated 26 March 2004, 'On the Procedure for Making Loss Provisions by Credit Institutions for Loans, Loan and Similar Debts'.*

[3] *The capital shortage is understood to mean the value of funds required by credit institutions to comply with capital adequacy ratios.*

[4] *The profit before the loan loss provisions and revaluation of securities, which banks may presumably receive, if they continue their operations in stress conditions.*

[12] *Information on the revocation of licences and bankruptcy prevention measures was prepared by the Credit Institutions Licensing and Financial Rehabilitation Department.*

3.2. Non-bank financial institutions

The financial situation of the retail segment of the collective investment and individual trust management market deteriorated in 2011 amid the downward dynamics of Russia's major stock market indices. The non-bank financial institutions, for which investment was not a core activity, exhibited a high level of stability in the period under review.

* * *

Most types of non-bank financial institutions built up their equity capital and expanded their activities in 2011 to ensure their stability. In particular, higher insurance premiums increased the assets of Russian insurance companies by 6.7% in January-September 2011.[13] Mergers and acquisitions helped increase the capitalisation of insurance companies ahead of the tightening of legislative requirements for their minimum authorised capital in 2012. Among the non-bank financial institutions (for which investment was a core activity) in 2011, management companies and non-governmental pension funds (NPFs) involved in the compulsory pension insurance system demonstrated great financial potential. The aggregate value of pension accruals in these organisations grew by more than 70% in January-September 2011, mostly due to the transfer of funds from the Pension Fund of the Russian Federation.[14]

In 2011, most non-bank financial institutions expanded their customer bases, developed distribution networks and offered more varied services, as they faced more competition. In particular, insurance companies actively developed comprehensive insurance packages for their corporate customers; meanwhile, there was gradual recovery in the leasing of illiquid and expensive equipment that had been curtailed during the crisis. Meanwhile pawnshops offered easy lending terms for pensioners and large borrowers, and also extended the list of pledged assets accepted as collateral against loans.

However, the financial stability of non-bank financial institutions was negatively affected by the deterioration of their investment results amid the fall in the major Russian stock market indices. According to experts' estimates, insurers' profits from their investment operations fell by 7.3% in January-September 2011, year on year. In the retail segment of the collective investment market, almost 80% of all unit investment funds (PIFs) registered a fall in unit value in 2011. More than half of management companies registered negative rates of return on pension accrual investments in January-September 2011.

The PIFs, management companies and NPFs registered weaker demand for their services and, as a result, fewer financial possibilities. The value of funds transferred to management companies for individual trust management decreased by 14.7% in January-June 2011[15] due to the withdrawal of capital by investors who sought short-term investment opportunities and losses sustained by management companies from operations with securities. The aggregate value of the PIFs' net assets fell by 5.7% in 2011, which was partly due to the net outflow of shareholder funds from the retail PIFs.[16] The curtailment of corporate pension programmes and the cancellation of agreements between some private customers and the NPFs negatively affected the dynamics of pension reserves. Their growth hit a record low of 4.1% in January-September 2011 for the past few years.[17] Payments by the NPFs to their customers under the non-governmental pension insurance agreements that were cancelled totalled 1.3 billion roubles in January-June 2011.

As the situation in the Russian stock market deteriorated, the investment portfolios of most non-bank financial institutions registered a contraction in the share of investments in equities. They also registered an increase in the share of investments in fixed-income financial instruments, particularly bank deposits (see the box entitled: 'Specifics of Investment Operations by NPFs and Insurance Companies in 2011').

The departure from tax-saving 'schemes' for customers had a positive effect on the stability of the market for non-bank financial intermediation. In the insurance market, the share of 'scheme' business decreased to 5–8% as of 1 July 2011, according to experts' estimates. The number of real estate PIFs was almost unchanged in 2011 for the first time in the past few years, which was probably the result of legislative restrictions that curtailed investors' abilities to use funds of this category as an instrument of tax optimisation.[18]

A number of legal innovations were adopted in 2011 to maintain the financial stability of non-bank financial institutions. In order to prevent systemic risks in the insurance market and protect the interests of insurers' customers, restrictions were placed on the insured amounts covered by insurance contracts and

[13] *The data of the Federal Insurance Supervision Service and federal statistical observation form No. 1-FS (SK), 'Insurance Company Borrowings and Investments' were used to assess the activity of insurance companies, unless indicated otherwise.*

[14] *The data of the Pension Fund of the Russian Federation were used to assess the activity of management companies that participate in the compulsory pension insurance system, unless indicated otherwise.*

[15] *The data of the rating agency Expert RA are used to assess the activity of management companies that are involved in individual trust management, unless indicated otherwise.*

[16] *The data of the news agency Cbonds.ru are used to assess the performance of PIFs, unless indicated otherwise.*

[17] *The data of the Federal Financial Markets Service are used to assess the activity of NPFs, unless indicated otherwise.*

[18] *According to data provided by the National Managers' League.*

Specifics of investment operations by NPFs and insurance companies in 2011[1]

Non-governmental pension funds. *The assets held by the NPFs grew by 22.5% in January-September 2011 (they increased by 16.3% in January-September 2010). Pension reserves and pension accruals remained the main sources of the NPFs' growth: their aggregate value increased by 26.4% in January-September 2011 (by 19.2% in January-September 2010). The share of pension reserves and pension accruals in the structure of the NPFs' liabilities grew by 2.8 percentage points in January-September 2011 to 90.7% as of 1 October 2011.*

The ratio of the NPFs' property required to ensure their statutory activity to funds raised by the NPFs, fell by 2.9 percentage points in January-September 2011 to 9.7%, as of 1 October 2011.

The non-financial sector of the economy remained a priority investment area for the NPFs (38.2% of the NPFs' asset structure as of 1 October 2011): investment in this sector increased by 26.3% in January-September 2011 (by 22.4% in the same period of 2010). The growth of the NPFs' investment in the banking sector slowed to 10.7% in January-September 2011 from 25.5% in the same period a year earlier. As a result, the share of the NPFs' investment in the banking sector decreased by 2.4 percentage points in January-September 2011 to 26.8% as of 1 October 2011. Owing to the accelerated growth of the NPFs' investments in government securities (46.7% in January-September 2011), the share of investment in the general government sector increased by 1.0 percentage point in January-September 2011 to 5.6% of the NPFs' total investment.

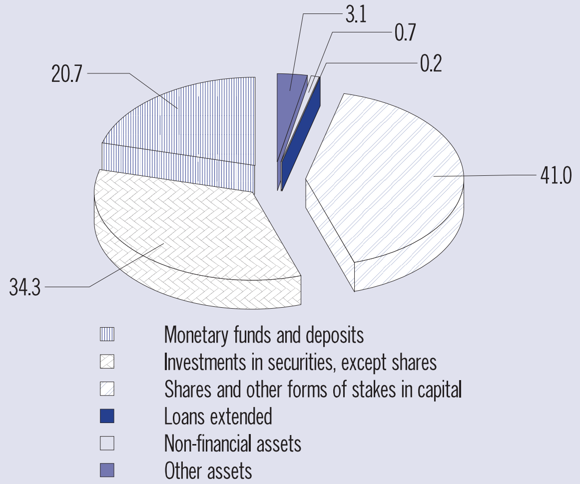
The NPFs focused on equity and debt securities when determining their investment policies. As of 1 October 2011, investments in equities and other forms of stakes in capital accounted for 41.0% of the NPFs' assets, while investments in debt securities made up 34.3%.

The securities of non-financial organisations prevailed in the structure of the NPFs' investments in securities as of 1 October 2011 (48.8%). In January-September 2011, the NPFs' investments in the debt securities of non-financial organisations increased by 53.0%, and their investments in equity securities grew by 7.5%.

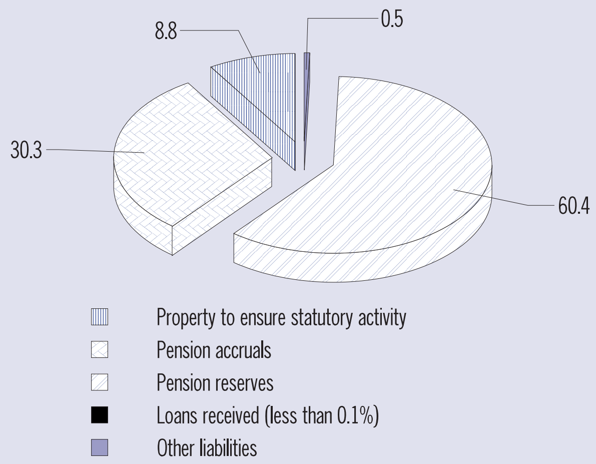
The NPFs had comparatively little interest in credit institutions' securities. As of 1 October 2011, deposits prevailed in the structure of the NPFs' investments in the banking system, with 64.5%, while investments in securities accounted for 12.2%. However, the value of the NPFs' investments in banking sector debt securities increased by 66.5% and in equity securities by 32.5%.

In January-September 2011, the NPFs' investments in the securities of non-residents grew by a factor of 8.2 but their share remained relatively low (0.8% of the structure of the NPFs' investments in securities, as of 1 October 2011).

Structure of NPFs' assets as of 1 October 2011 (%)



Structure of NPFs' liabilities as of 1 October 2011 (%)



Insurance companies. *In January-September 2011, insurance reserves increased by 13.4% (as against 11.0% in January-September 2010); the most growth (by 20.4%) was registered by compulsory medical insurance reserves. Insurance companies' capital and reserves grew by 1.7% in January-September 2011. Loans raised by insurance companies increased by 82.4% in January-September 2011, with loans received from credit institutions growing more than twice. The ratio between the insurers' own and borrowed funds dropped by 2.5 percentage points in January-September 2011 to 36.4% as of 1 October 2011.*

Investments in the banking system remained a core investment area for insurance companies in January-September 2011 (56.6% as of 1 October 2011). They increased by 9.8% over this period. Insurers' foreign assets grew by 35.0% in January-September 2011 and accounted for 12.5% of their investments as of 1 October 2011. The insurers' investments in the non-financial sector and the subsector of other financial organisations contracted in January-September 2011 (by

[1] *The Box was prepared by the General Economic Department.*

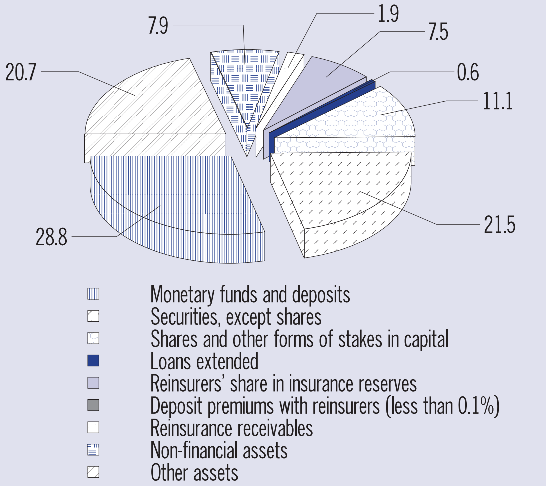
13.0% and 6.0%, respectively). This caused a reduction in their proportions in the asset structure of insurance companies (to 15.5% and 8.1% as of 1 October 2011).

The asset structure of insurance companies in 2011 was dominated by securities (32.7% as of 1 October 2011) as well as by monetary funds and deposits (28.8%).

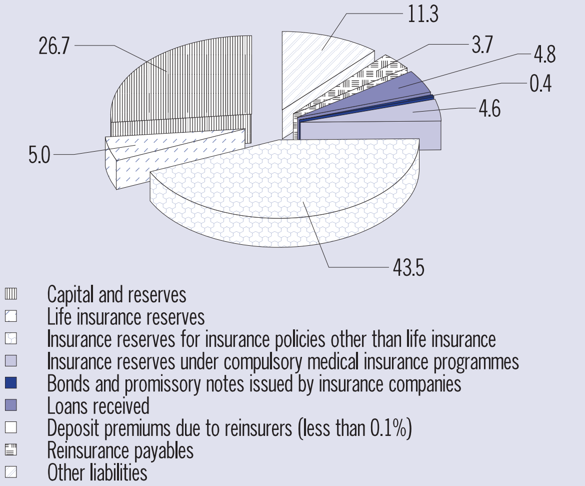
The insurers' investments in debt securities increased by 6.4% in January-September 2011 as a whole, whereas investments in shares dropped by 6.8%. The structure of debt securities held by insurance companies was dominated by investments in the securities of credit institutions, which increased by 4.4% in January-September 2011. While the insurers' investments in shares decreased, the volume of credit institutions' equity securities in these investments grew by 6.0%. Nevertheless, investing in securities issued by non-financial organisations remained a priority for insurance companies, even though this type of investment contracted by 11.0% in January-September 2011.

The insurers' investments in the securities of non-residents increased by a factor of 1.9 in January-September 2011. The most growth was registered in insurance companies' investments in shares, which grew by a factor of 2.4. Investments in the securities of non-residents increased by 3.7 percentage points in January-September 2011 to 7.7% of the insurers' investments in securities as of 1 October 2011.

Structure of insurers' assets as of 1 October 2011 (%)



Structure of insurers' liabilities as of 1 October 2011 (%)



a procedure was worked out for insurance companies to sell their insurance portfolios, if they experienced financial difficulties. The new rules affecting the signing of agreements on pension accrual management, under which management companies and NPFs must define their liability for possible losses from these investments, will also help protect pension accruals that are transferred from the Pension Fund of the Russian Federation to the NPFs.

Therefore, the market for non-bank financial intermediation remained relatively stable in 2011. The deterioration in the financial situation of the retail segment of the collective investment and individual trust management market was mainly attributed to the investors' reduced interest in the services provided by the corresponding non-bank financial institutions and the fall in revenues from operations with securities.

Chapter 4. Bank of Russia measures to ensure financial stability

4.1. Macroprudential policy in Russia and other countries during financial crisis[1]

The international community has recently demonstrated that it is aware of the systemic nature of financial instability risks. This and the authorities' experience in countering the effects of the recent financial crisis have underscored the need to consolidate regulatory and supervisory practices and achieve the task of macroeconomic stabilisation. Efforts to contain systemic risks constitute the main goal of **macroprudential policy**, for which special financial stability units are created in many countries to provide analytical support. In March 2011, the Bank of Russia established the Financial Stability Department, which is entrusted with the task of identifying and monitoring systemic risks. It is also responsible for coordinating the provision of anti-crisis support to the financial sector and using macroprudential policy instruments.

In the second half of 2011, the Bank of Russia's measures to ensure financial stability were largely prompted by the deterioration of the external economic situation, and the tighter conditions that affected the functioning of the Russian financial sector.

World economic growth failed to meet market expectations in 2011, which compelled market participants to fundamentally review both the prospects for future global economic progress and the scope of systemic risks. The financial market volatility and the spread of risks were caused not only by the exhaustion of government anti-crisis support measures (for example, the US Federal Reserve completed the second round of its quantitative easing policy in June 2011), but also by the unprecedented downgrades of sovereign credit ratings.

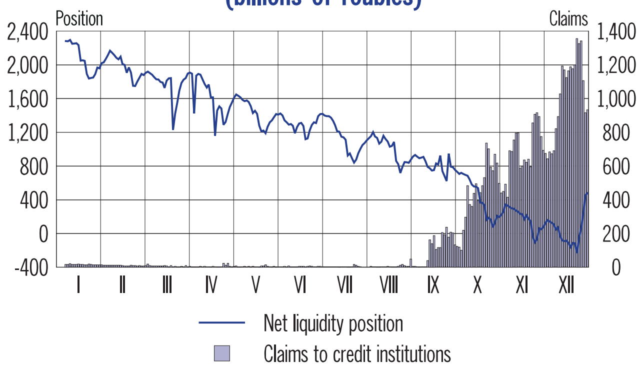
In August 2011, the international rating agency Standard & Poor's downgraded the credit rating of the United States, the world's largest sovereign borrower, in a landmark decision that prompted investors to refocus their operations on high-quality assets on a massive scale. As investors reduced their appetite for risk, the debt situation in some European countries, which also had their sovereign ratings downgraded on numerous occasions (along with the ratings of their largest banks), continued to deteriorate. The yields on sovereign debt securities and interest rates on the credit default swaps of problematic European countries, which included Italy (the eurozone's third largest economy), Greece, Portugal and Ireland, were observed to grow throughout 2011.

As problems intensified in many developed countries, the implications of this aggravation started to spread to large emerging economies. Given these conditions, macroprudential policies in these countries underwent considerable changes. The deterioration of the situation in international credit markets changed the direction of global capital flows, which made the task of restricting capital inflows somewhat less topical. In 2011, some central banks, which had taken steps previously to tighten their monetary policies, lowered their interest rates (in some cases, required reserve ratios). They also redirected their macroprudential policy instruments in order to stimulate lending and support the financial system.

Liquidity shortages also spread to the Russian banking sector, which turned from a net creditor to a net borrower as of the end of 2011, largely as a result of the Bank of Russia's operations to refinance credit institutions (Chart 4.1).

Chart 4.1

Banking sector net liquidity position and the Bank of Russia's claims to credit institutions in 2011 (billions of roubles)



Changes in the conditions that affect the functioning of the Russian financial sector prompted the need to improve the mechanisms used to ensure financial stability. The financial stability measures that the Bank of Russia took in 2011 were largely aimed at creating favourable conditions which would allow the sector to resist potential liquidity risks and interest rate risks; the Bank of Russia also employed these measures to further develop systemic risk analysis instruments.

4.2. Identifying the most significant channels of the spread of potential external shocks to the Russian financial sector

In 2011, the Bank of Russia started to quantitatively assess the consequences of the possible manifestation of global risks in the Russian banking sector. According

[1] *Subsections 4.1–4.4 were prepared by the Financial Stability Department.*

to the Bank of Russia's estimates, the eurozone debt crisis was the main source of external risk for Russian banks and the Russian economy as a whole in the year under review. It was considered as such because it had the potential to trigger a wide range of negative developments, such as the devaluation of the national currency, the growth of interest rates, the reduction of activity in the money market, a negative revaluation of financial assets, losses on bank loans, and so on.

In this analysis, the Bank of Russia identified several potential channels representing the spread of a shock which could be differentiated by the degree of their significance to the Russian economy, the time-frame of their impact's manifestation (short-term and long-term implications), and also by their mode of influence (direct and indirect channels). Direct channels included the risks associated with refinancing liabilities to European creditors, the withdrawal of capital by European banks from their Russian subsidiaries, and the depreciation of the portfolios of European government and corporate bonds on the balance sheets of Russian banks.

According to the Bank of Russia's estimates, the spread of external shocks through direct channels is limited and in general poses no systemic threat to financial stability. The situation could deteriorate in some large banks that are among the most dependent on the external financial sector. At the same time, the improvement of the financial situation of Russian banks after the 2008–2009 crisis helped them accumulate resources that would allow them to resist negative shocks and reduce their exposure to external threats.

Indirect channels for the spread of external shocks that could precipitate a crisis cover a whole range of impacts related to high capital mobility and the Russian financial market's sensitivity to external volatility. At the first stage, these channels could fuel a crisis by destabilising highly liquid markets, such as the forex, stock, and money markets. This could aggravate banking liquidity shortages and lead to the depreciation of the securities portfolios. At the second stage, the crisis shocks might result in the deterioration of the quality of loan portfolios and a shortage of bank capital. The spread of external shocks over a time horizon and within a financial system depends considerably on the timeliness of risk identification and the efficiency of the anti-crisis measures that are taken at an early stage. For this reason, as part of its measures to ensure financial stability in 2011, the Bank of Russia carefully scrutinised the monitoring of the situation in the money market, liquidity factors in the banking sector and certain credit institutions. It also paid a great deal of attention to the implementation of measures to develop mechanisms to enhance the provision of liquidity and expand possibilities for the refinancing of banks.

4.3. The continued risk monitoring and money market stress tests

In 2011, the Bank of Russia launched continuous monitoring of risks in the money market. Its first step was to look at the repo exchange market, which was the epicenter of the manifestations of the crisis in Russia in 2008. The Bank of Russia started to hold working meetings; when necessary, with representatives of major market participants.

Thanks to the improvement of the quality of financial instruments and the development of the financial infrastructure, the level of systemic risk in the money market has been lower in the past two years than the level registered in 2008–2009, during the height of the crisis. In particular, the credit quality of collateral accepted in repo transactions has improved, while market participants have increased the share of securities included in the Bank of Russia Lombard List in their portfolios. In addition, the development of the regulatory and contractual framework for repo deals reduced the probability of failure to execute transactions, and the market became less exposed to systemic risks.

At the same time, it should be noted that some systemic risk factors have remained largely unchanged in the repo exchange market in the past few years. These include:

– non-bank financial institutions, which are subject to less stringent regulation and are therefore potentially less stable, continue to be highly active in the market;

– as before, the market is characterised by a high concentration of participants (the top ten participants account for about half of the market);

– the share of customer transactions in the overall turnover of the repo market is observed to increase (in the event that customers fail to fulfil their obligations, banks and financial companies may also turn out to be insolvent).

All these factors testify to the need to closely monitor the market and risk spillover, identify weak links in the liquidity redistribution mechanism, and assess the scope of necessary financial support in the event of a potential crisis shock.

Regular stress tests of the money market that were held separately for the interdealer repo exchange market and the interbank credit market were a major focal point of work to ensure financial stability in 2011. By stress testing the interdealer repo exchange market, the Bank of Russia aims to assess the impact of potential upheavals (shocks) in the stock market on the market resilience, the financial position of its participants and the stability of the financial sector as a whole. The stress tests helped assess the exposure of the repo market to falling equity prices in the highly improbable (but plausible) scenario of a stock market crash.

The scope of financial stability measures largely depends on the condition of the interbank money market and the ability of banks to raise (place) funds in the interbank credit market. Due to the increased role of monetary instruments in the refinancing of the banking sector, the Bank of Russia focused its attention in 2011 on identifying the channels of liquidity distribution and assessing the efficiency of monetary transmission mechanisms that exist in the interbank credit market.

4.4. Changes in the parameters of monetary and macroprudential policy instruments

In 2011, the Bank of Russia carried out monetary and macroprudential policy measures which were prompted by the build-up of systemic risks in the operation of financial institutions. By carrying out these measures, the Bank of Russia primarily intended to broaden the possibilities and ease the conditions associated with the refinancing of the banking sector. The cycle of monetary policy tightening ended in the first half of 2011 due to negative developments in external financial markets and a considerable reduction in internal inflation risks. In the second half of 2011, the Bank of Russia sought to ensure the banking sector's smooth transition to the state of persistent liquidity shortages, restrict interest rate volatility and make the Bank of Russia's refinancing mechanisms more accessible.

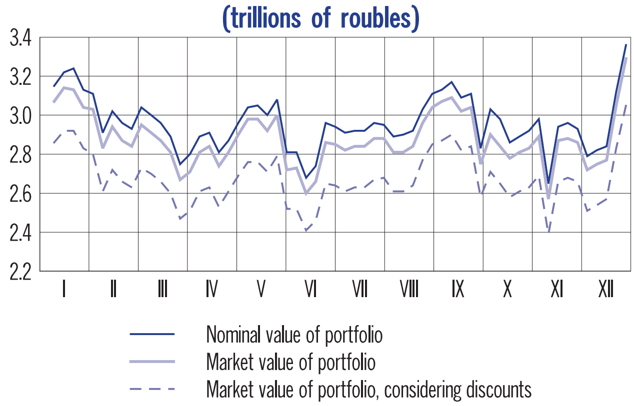
The Bank of Russia's efforts **to narrow the interest rate band** (the difference between the interest rate on liquidity provision instruments and the overnight deposit rate) were a significant measure that it employed in order to enhance financial stability. In September 2011, the Bank of Russia cut the minimum interest rate on its auction-based liquidity provision operations by 25 basis points and simultaneously raised the deposit rate by 25 basis points. It did so in order to limit interest rate volatility and restrain interest rate growth during a period of global risk escalation and an increase of tension in the domestic money market.

The Bank of Russia implemented **a package of measures to broaden the possibilities of the banking sector's refinancing,** which signified a major area of its work to restrain potential systemic liquidity risks. The package included measures to expand the potential of existing refinancing instruments, and also to introduce additional tools. In particular, starting from 26 August 2011, banks were given the possibility of obtaining loans from the Bank of Russia that were secured by gold, and on 1 November, the regulator restarted operations to extend loans secured by non-market assets or guarantees with a maturity of 91 to 180 days.

As an important step towards improving the banking sector's refinancing, the Bank of Russia changed the terms for the formation of the list of securities accepted as collateral for its liquidity provision operations, and also altered the securities selection criteria. On 5 December 2011, the Bank of Russia lowered the minimum requirements for the ratings of the issuers (issues) of securities that are used when decisions are made to include/exclude securities in/from the Bank of Russia Lombard List by two notches (to the minimum rating of B- under the classification system used by Standard & Poor's or Fitch Ratings, or B3 using the classification of Moody's Investor's Service).

Chart 4.2

Market value of securities accepted as collateral in repo transactions with the Bank of Russia in 2011 (trillions of roubles)



In addition, on 1 December 2011, the Bank of Russia raised the ratio used to adjust the value of federal loan bonds accepted as security for its loans from 0.98 to 1. It also lowered the amount of the initial discount, applied to calculating the value of collateral for Bank of Russia repo operations with a term of up to six calendar days with OFZs and Bank of Russia bonds, from 1.25% to zero.

Thanks to these measures, the Bank of Russia's potential for the refinancing of the banking sector, at present, covers the banks' current needs for liquidity. In particular, the market value of the securities registered on banks' balance sheets and available for repo transactions with the Bank of Russia (with discounted amounts taken into account) reached about 3 trillion roubles as of the end of December 2011 and considerably exceeded the size of the Bank of Russia's current claims on credit institutions (Chart 4.2). At the same time, some banks which experience the biggest problems with liquidity are very likely to lack the required collateral to obtain Bank of Russia loans.

Along with its prompt interventions in the money market and measures to provide required liquidity to banks, in 2011 the Bank of Russia also studied additional mechanisms and instruments of its macroprudential policy which was aimed at raising the resilience of financial institutions to adverse shocks and scaling down the Bank of Russia's interference in the functioning of the banking sector. In compliance with international initiatives (especially Financial Stability Board initiatives), the Bank of Russia started to consider the issue of identifying systemically important banks and the expediency of applying special regulatory and supervisory conditions to them, as well as financially rehabilitating these institutions.

As the situation in the global economy is likely to deteriorate in the coming years and increase instability-related risks in the Russian banking sector, a draft law was adopted in 2011 that extends the powers of the Bank of Russia and the Deposit Insurance Agency with respect to the financial rehabilitation of credit institutions until 31 December 2014. This measure will allow the regulatory agencies to continue to effectively apply the instruments which allow them to prevent the bankruptcy of problem banks and reduce potential losses that the Russian economy may sustain, if financial instability risks are realised.

4.5. Measures to ensure the stability of the national payment system[2]

The stability of the financial system largely depends on the continuous and effective operation of the national payment system. The system incorporates the sum total of entities and relations that are emerging in the process of making payments and settlements in the economy.

In 2011, in order to create the regulatory and legal framework required for the further development of an effective and reliable national payment system, Russia adopted Federal Law No. 161-FZ, dated 27 June 2011, 'On the National Payment System' (hereinafter referred to as Federal Law No. 161-FZ) and accompanying Federal Law No. 162-FZ, dated 27 June 2011, 'On Amending Certain Laws of the Russian Federation, due to the Adoption of the Federal Law 'On the National Payment System''. These laws reformulate one of the goals in the Bank of Russia's activities, that is to ensure the stability and development of the national payment system. Federal Law No. 161-FZ sets the legal and organisational framework for the national payment system and regulates the procedure for the provision of payment services (including money remittances and the use of electronic means of payment) and the activity of participants in the national payment system. It also defines the requirements for the organisation and functioning of payment systems, and the procedure for supervising and monitoring the national payment system. In 2011, the Bank of Russia started work to implement the provisions of the aforementioned laws.

In order to carry out measures to ensure the reliability of electronic money transfers and exercise control over the suppliers of these services the Bank of Russia, vested with the powers to regulate the activity of electronic money transfer operators, worked out a regulation setting the main requirements for electronic payment operators, and also the requirements for the list and content of internal documents required for the suppliers of these services to carry out their operations.[3]

The Bank of Russia defined the procedure by which electronic money transfer operators must exercise control over the activity of bank payment agents. It also established forms of control and the obligation for money transfer operators to document the results of their control over the activities of bank payment agents, and the monitoring of measures to rectify the exposed violations.[4]

The Bank of Russia sought to reduce possible systemic threats that could emerge from the concentration of relationships across a multitude of credit institutions that interact through the correspondent network of one credit institution. In the year under review, it developed recommendations intended to prepare credit institutions for implementing the systems to manage the risk of disturbances in the continuous functioning of payment and settlement channels.[5]

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[2] *Subsection 4.5 was prepared by the Settlements Regulation Department.*

[3] *Bank of Russia Ordinance No. 2695-U, dated 14 September 2011, 'On Requirements to Ensure the Reliability of Electronic Money Transfers'.*

[4] *Bank of Russia Ordinance No. 2693-U, dated 14 September 2011, 'On the Procedure for Money Transfer Operators, as Credit Institutions, to Control the Activities of Bank Payment Agents'.*

[5] *Bank of Russia Letter No. 67-T of 3 May 2011, 'On the Systemic Risk for the Settlement System'.*

Analysis of Russian ratings

Comparative assessment of sovereign ratings of Russia and other transition economies

Russia's sovereign ratings, assigned by international rating agencies Moody's Investors Service, Standard & Poor's and Fitch Ratings, were unchanged in 2011. They remained within the investment grade and characterised the country's position as 'good credit quality' (Table 1). When taking the decision to maintain Russia's investment grade ratings, analysts with the rating agencies pointed out that the level of risk in most segments of the Russian financial market was relatively stable.

As for the Central and Eastern European (CEE) countries, the rating agencies reviewed the ratings of these countries in different ways. Standard & Poor's took 23 rating actions, issuing 9 rating upgrades, Moody's performed 16 rating actions with 8 positive reviews and Fitch Ratings announced 18 rating actions with 10 rating upgrades. In the first half of 2011, all of the three leading agencies upgraded Estonia's ratings. Decisions were also taken to upgrade the ratings of Bulgaria (Moody's), Serbia (Standard & Poor's), Latvia and Romania (Fitch Ratings). At the same time, the unstable economic situation in the European Union resulted in the decision in December 2011 to downgrade the ratings of Hungary (Standard & Poor's), and also the rating outlooks on Bulgaria, Latvia, Lithuania and the Czech Republic (Fitch Ratings), as well as Slovakia and Estonia (Standard & Poor's). All the three rating agencies revised their rating outlooks on Slovenia downward. The level of ratings assigned to the CEE countries ranges from the 'high credit quality' investment grade (the Czech Republic) to 'highly speculative risk' (Macedonia and Montenegro).

In 2011, the rating agencies Standard & Poor's and Fitch Ratings upgraded their ratings of Kazakhstan and Georgia. Fitch Ratings also upwardly revised its rating outlook for Azerbaijan to positive. Moody's and Standard & Poor's downgraded their ratings and ratings outlooks on the Republic of Belarus to 'highly speculative risk' with a negative outlook.

Russia's sovereign ratings are comparable with those of the CEE countries, and several notches higher than the ratings assigned to most member countries of the Commonwealth of Independent States (CIS). Russia's ratings (Table 2) proved to be more stable in 2011, judging by the dynamics of rating actions.

Table 1

Russia's sovereign ratings

Date	Moody's			Standard & Poor's		Fitch Ratings	
	Government bond rating (FC/LC)	Country ceiling		Credit ratings		LT/ST IDR* (FC)	LT IDR* (LC)
		foreign currency bonds	foreign currency bank deposits	LT/ST (FC)	LT/ST (LC)		
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+
1.01.09	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB+/F2	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
1.07.10	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
1.04.11	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.07.11	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.10.11	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
1.01.12	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 2012)

Country	Moody's			Standard & Poor's		Fitch Ratings	
	Government bond rating (FC/LC)	Country ceiling		Credit ratings		LT/ST IDR* (FC)	LT IDR* (LC)
		foreign currency bonds	foreign currency bank deposits	LT/ST (FC)	LT/ST (LC)		
Russia	Baa1/Baa1	A2	Baa1	BBB/A-3	BBB+/A-2	BBB/F3	BBB
Bulgaria	Baa2/Baa2	Aa3	Baa2	BBB/A-3	BBB/A-3	BBB-/F3	BBB
Hungary	Ba1/Ba1	A3	Ba2	BB+/B	BB+/B	BBB-/F3	BBB
Latvia	Baa3/Baa3	Aa3	Baa3	BB+/B	BB+/B	BBB-/F3	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
Romania	Baa3/Baa3	A1	Baa3	BB+/B	BB+/B	BBB-/F3	BBB
Serbia				BB/B	BB/B	BB-/B	BB-
Slovakia	A1/A1	Aaa	Aaa	A+/A-1	A+/A-1	A+/F1	A+
Slovenia	A1/A1	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	AA-/A-1+	AA/A-1+	A+/F1	AA-
Estonia	A1/A1	Aaa	Aaa	AA-/A-1+	AA-/A-1+	A+/F1	A+
Azerbaijan	Ba1/Ba1	Baa2	Ba2	BBB-/A-3	BBB-/A-3	BBB-/F3	BBB-
Armenia	Ba2/Ba2	Baa3	Ba3			BB-/B	BB-
Belarus	B3/B3	B3	Caa1	B-/C	B-/C		
Georgia	Ba3/Ba3	Ba1	B1	BB-/B	BB-/B	BB-/B	BB-
Moldova	B3/B3	B2	Caa1				
Kazakhstan	Baa2/Baa2	Baa2	Ba1	BBB+/A-2	BBB+/A-2	BBB/F3	BBB+
Ukraine	B2/B2	B1	B3	B+/B	B+/B	B/B	B
Brazil	Baa2/Baa2	Baa1	Baa2	BBB/A-3	A-/A-2	BBB/F2	BBB
India	Baa3/Baa3	Baa2	Baa3	BBB-/A-3	BBB-/A-3	BBB-/F3	BBB-
China	Aa3/Aa3	Aa3	Aa3	AA-/A-1+	AA-/A-1+	A+/F1	AA-
South Africa	A3/A3	A1	A3	BBB+/A-2	A/A-1	BBB+/F2	A

** IDR is issuer default rating.*

As for the BRICS group of emerging market countries (Brazil, Russia, India, China and South Africa), the rating actions were characterised by positive dynamics. All the three international rating agencies upgraded the ratings of Brazil, and Standard & Poor's analysts raised China's long-term and short-term foreign and local currency ratings, while India's foreign currency deposit rating was upgraded by one notch. As a result, Russia's long-term foreign currency ratings were four notches lower than the ratings of China and were comparable to the ratings of the other member countries of this group.

In October 2011, the World Bank and International Finance Corporation (IFC) published a report entitled: 'Doing Business 2012'. The report ranked 183 economies, depending on **the assessment of their business environment** in 2011. The rankings are based on ten equally-weighted indicators: the time and cost of starting a business, dealing with construction permits, getting electricity, registering property, obtaining credit, protecting investors, quantitative parameters of taxes and the terms of tax payment, access to international markets, resolving insolvency, and labour market regulations. As compared with the previous rating published in June 2011 (the rankings are based on the 2010 results), Russia climbed four notches and ranked 120th. As for the CEE countries, the highest ratings are held by Latvia (21st place), Estonia (24th place) and Lithuania (27th place). The leading positions among the CIS countries are held by Kazakhstan (47) and Armenia (55). Tajikistan and Ukraine are at the bottom of the ranking, placing 147th and 152nd, respectively. As for the BRICS member countries, the highest rating is held by China (91), while Brazil and India are slightly behind Russia, holding the 126th and 132nd places, respectively. Russia is included, along with China and India, in the group of the 30 economies that improved the most in terms of the ease of doing business.

Ratings of regional issuers

In 2011, the rating agencies often reviewed ratings and outlooks for Russian subfederal and municipal issuers. Overall, there were 54 rating actions in 2011, of which 35 were rating upgrades.

As of 1 January 2012, 55 regional issuers had international ratings, compared with 52 issuers as of the beginning of 2011. Ratings ranged from the 'good credit quality' investment grade (Moscow, St Petersburg, the Khanty-Mansi Autonomous Area, the Yamal-Nenets Autonomous Area) to 'highly speculative regional risk' in the speculative-grade category (Tver Region, the town of Dzerzhinsk, Stavropol Territory).

In 2011, ratings were reassigned to seven subfederal territories, while six subfederal issuers had their ratings revoked or suspended. In most cases, the ratings were recalled at the issuers' request.

Analysts with Fitch Ratings believe that Russia's accession to the World Trade Organisation (WTO) will help expand and improve its activity as a nation and the activities of its regional and municipal entities. Most of Russia's regions will be able to diversify their economies, make them less vulnerable to fluctuations in the prices of raw materials and also get more widespread opportunities to enter global markets, which will further increase their ratings.

Ratings of financial intermediaries and non-financial organisations

The ratings assigned to Russian financial intermediaries and non-financial organisations by the international rating agencies Moody's, Standard & Poor's and Fitch Ratings in 2011 reflected the business climate in various sectors of the Russian economy. The overall dynamics of ratings assigned to economic agents such as financial institutions and non-financial organisations were upward and corresponded to changes in the activities of Russian issuers.

As of 1 January 2012, 136 **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. Nine credit institutions had ratings assigned to them by all the three rating agencies, while 38 had ratings assigned by two agencies and 89 were rated by one agency. Investment-grade ratings comparable with Russia's sovereign ratings were held by 21 credit institutions; most of them had state or foreign-owned stakes in their capital (specifically, VTB Bank, VTB 24, Sberbank, ING Bank (Eurasia), UniCredit Bank, Raiffeisenbank and Nordea Bank).

All the three rating agencies in 2011 frequently assigned, recalled and revised their ratings, mostly upwards. Moody's Investors Service carried out 67 rating actions, while Standard & Poor's carried out 30 rating actions and Fitch Ratings carried out 23 rating actions. The agencies assigned 17 new ratings and recalled ratings from 16 credit institutions. In the period under review, Standard & Poor's upgraded the ratings of 13 banks, while Moody's and Fitch Ratings revised upward the ratings of 10 and 5 banks, respectively.

The rating agencies mostly revoked their ratings due to the liquidation of issuers and when certain banks stopped doing business in Russia (Bank VTB North-West, BSGV, Barclays Bank), and also at the issuers' request (AMT Bank).

The crisis in the international financial market in 2008–2010 compelled the international rating agencies to make changes to their rating methodology. In the third quarter of 2011, Fitch analysts introduced **a new group of ratings of financial organisations' sustainability** to assess the stand-alone creditworthiness of these institutions. The long-term issuer default rating (IDR) will remain the basic rating for financial organisations and will be linked with the issuer's financial stability and support ratings. The financial stability ratings reflect the same key risks previously reflected by individual ratings but will have more grades. The new system will replace the scale of individual financial strength ratings (Bank Financial Strength Ratings – BFSR). Fitch will assign stability ratings only when it deems them appropriate.

In November 2011, Standard & Poor's revised **the Banking Industry Country Risk Assessments** (BICRA) on Russia to Group 7 from Group 8 for each of its components: the assessment of economic and industry risks, and the assessment of government support. The BICRA methodology was developed to assess and compare the banking systems of different countries. Within each individual country, the assessments cover financial institutions, both with and without ratings. The BICRA assessment requires financial intermediaries to take funds on deposit and/or extend loans. In accordance with the BICRA gradation, countries are grouped depending on the level of risks in their banking systems: from group 1 (countries with the lowest risk) to group 10 (countries with the highest risk). In addition to Russia, group 7 includes the banking systems of Bulgaria, Ireland, Morocco and the Philippines. The CIS countries are mostly rated as being in groups 8–10.

The improved methodology developed by the rating agency Standard and Poor's was designed, in the opinion of its analysts, to raise the quality of the agency's ratings. It primarily assesses the financial stability of banks in the event of the deterioration of the economic situation, and also the probability that they will obtain support from the government or from their parent companies. The new rating assessment methodology allowed Standard & Poor's experts to raise the long-term foreign currency ratings of 8 credit institutions by one notch; these included: Alfa-Bank, Globex Bank and Sviaz Bank (from 'BB-/B' to 'BB/B'), Krayinvestbank and Bank Rossiya (from 'B/B' to 'B+/B'), and also MDM Bank and Bank Uralsib (from 'B+/B' to 'BB-/B'). The long-term and short-term ratings of TransCreditBank were upgraded to investment grade (from 'BB+/B' to 'BBB-/A-3'). In the process of rating reviews, the agency also affirmed the ratings of BNP Paribas, Bank

Vozrozhdenie, VTB Bank, Gazprombank, SME Bank, Bank Petrocommerce, Raiffeisenbank, Rosbank, Russian Standard Bank and UniCredit Bank.

As of the end of 2011, 255 Russian credit institutions had been issued ratings by the national rating agencies Expert RA, AC&M, NRA and RusRating. The ratings ranged from 'very high level of creditworthiness' to 'satisfactory level of creditworthiness'. In 2011, the NRA assigned ratings to 18 credit institutions, Expert RA rated 16 credit institutions, AC&M rated 11, and RusRating assigned ratings to three financial intermediaries.

In 2011, the Russian rating agencies often recalled ratings from banks in connection with the expiration of the term of the rating and in connection with the bank's refusal to support a public rating. The agency Expert RA recalled the ratings of 12 credit institutions; NRA recalled the ratings of seven credit institutions and AC&M and RusRating revoked the ratings of five banks each.

The number of ratings assigned by the national rating agencies increased in 2011 compared with 2010, while the number of ratings recalled by these agencies decreased. This testified to the greater interest displayed by Russian credit institutions in the assessment of their financial stability by Russian analysts who were well familiar with the conditions that affect the operation of credit institutions in the country.

As for **non-bank financial intermediaries**, it was mostly the issuers that were affiliated with the government-controlled credit institutions and had their own market niches that received issuer ratings or had their issuer ratings upgraded in 2011. The ratings of these non-bank intermediaries were comparable with the ratings of their parent organisations, as a rule.

As of 1 January 2012, the international rating agencies had assigned ratings to 21 non-bank financial organisations and 19 insurance companies. In 2011, six non-bank financial organisations were assigned ratings that ranged from 'good credit quality' to 'highly speculative risk'.

In 2011, four insurance companies were assigned ratings, while one insurance company had its rating recalled and one insurance company received a rating upgrade. Four insurance companies had their outlook ratings raised. The ratings assigned to the Russian insurance companies by the international rating agencies in the period under review ranged from 'good credit quality' to 'highly speculative risk'. Investment-grade ratings were assigned to the state-owned insurance companies (Ingosstrakh) and those which had a foreign stake in their capital (Rosno). The level of ratings assigned to insurance companies mainly depends on the diversified portfolio of their insurance operations and the quantitative and qualitative characteristics of their customers. The rating actions taken with regard to insurance companies in 2011 were characterised by positive dynamics and reflected outlook upgrades.

As of 1 January 2012, the Russian rating agencies had assigned financial stability and reliability ratings to 120 non-bank financial institutions. In the period under review, ratings were assigned to 48 issuers, while 11 issuers had their ratings recalled. The ratings assigned by the Russian rating agencies varied from a 'very high degree of creditworthiness, low vulnerability to long stress' to a 'degree of creditworthiness slightly lower than the medium grade, moderate resilience to short-term stresses and high vulnerability to longer stresses'.

Reliability and financial stability ratings are only assigned to Russian insurance companies by the rating agencies Expert RA and NRA. As of the end of 2011, Expert RA and NRA had assigned their ratings to 68 and 22 insurance companies, respectively. The ratings assigned by these agencies ranged from a 'very high level of reliability' to a 'satisfactory level of reliability'.

The solvency of **non-financial issuers** exerts great influence on the financial stability of bank and non-bank financial institutions. The rating actions taken by the agencies with regard to Russian non-financial issuers in 2011 were similar to the rating dynamics of Russian financial intermediaries and mostly reflected upward trends.

As of 1 January 2012, the international rating agencies had assigned their ratings to 91 non-financial institutions. In 2011, Standard & Poor's carried out 40 rating actions, while Fitch Ratings and Moody's conducted 31 and 30 rating actions, respectively. About 60% of rating actions were positive.

The highest rating ('good credit quality') was assigned to state companies whose ratings and outlooks are tied to the sovereign ratings and outlooks for the Russian Federation. Private Russian companies have mostly speculative or highly speculative grade ratings.

In 2011, Standard & Poor's and Fitch Ratings upgraded the ratings and rating outlooks of eight non-financial issuers, while Moody's gave rating and outlook upgrades to 11 issuers.

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 influencing the financial stability of credit institutions and non-bank financial intermediaries. Analysts with Fitch Ratings note that steel-consuming companies demonstrated good economic and financial results in 2011. Growth in the demand for steel in the domestic market testifies to the post-crisis economic recovery of the production of cars and steel pipes, as well as the construction industry. At the same time, the agency's experts predict some increase in risks and volatility for metallurgical and mining companies from the CIS countries in 2012. As for Russia, the experts give the sector a positive forecast, although it may be revised downward due to close economic ties between the CIS member countries.

The range of sectors where companies receive credit ratings became wider. In particular, Fitch Ratings assigned ratings to Eurasia Drilling Company, (the largest independent provider of drilling services in Russia), and Miratorg agribusiness holding (which specialises in the production of pork). Moody's and Standard & Poor's assigned ratings to KOKS, a vertically integrated business group focusing on the production of commercial iron, including the extraction and processing of coking coal and iron ore.

In the period under review, growth continued in the number of merger and acquisition deals, as well as the consolidation and vertical integration of non-financial issuers from emerging market economies, including Russia. As the reorganisation of telecommunications companies was completed and some regional telecom operators merged with Rostelecom, experts from all the three international rating agencies recalled the ratings of the merged companies, while Standard & Poor's upgraded the parent company's long-term credit rating from 'BB' to 'BB+' with a stable outlook. At the same time, Standard & Poor's downgraded the rating of X5 Retail Group N. V. from 'BB-' to 'B+' and changed the outlook from 'rating under review' to 'stable' after the group took over some companies that had had their ratings recalled.

As of the end of 2011, the Russian rating agencies had assigned ratings to 47 non-financial issuers. The ratings assigned by the Russian rating agencies range from a 'very high level of creditworthiness' to an 'acceptable level of creditworthiness'. The national rating agencies assign ratings to Russian non-financial issuers taking into account risks associated with the issuers' operations in the domestic market. In 2011, the Russian rating agencies assigned ratings to 18 non-financial issuers and recalled the ratings of six organisations.

In the third quarter of 2011, the National Rating Agency presented a new rating for Russia, **the creditworthiness rating of microfinance institutions (MFI)**, which was approved by the National Partnership of Microfinance Market Players (NAUMIR). In the opinion of the agency's analysts, this rating both complements traditional credit ratings and takes into account such important conditions of the development of small and medium-sized businesses as the formation of the middle class, the narrowing of regional disproportions, and also the establishment and development of microfinance institutions.

The rating actions taken by the international and national rating agencies in 2011 were characterised by positive trends and reflected the level of stability of the Russian economy.

This issue has been compiled by the Research and Information Department jointly with the Banking Regulation and Supervision Department, the Credit Institutions Licensing and Financial Rehabilitation Department, the Financial Stability Department, the General Economic Department, the Market Operations Department and the Settlements Regulation Department.

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