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The Central Bank of the Russian Federation

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BANK OF RUSSIA FOREIGN EXCHANGE ASSET MANAGEMENT REPORT

Moscow

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Foreign Exchange Asset Management Report
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FOREWORD

This issue of the Bank of Russia Foreign Exchange Asset Management Report presents the results of foreign exchange asset management in January – December 2015.

Due to global financial markets's high price sensitivity to the actions of major market participants, including the Bank of Russia, data on Bank of Russia operations on foreign exchange asset management are published at least six months after the end of the reporting period.

Information on Bank of Russia foreign exchange assets is also published in the Bank of Russia Annual Report (data on foreign exchange reserve assets and gold assets) and on the website of the Bank of Russia (data on Russia's international reserves). Please note that any difference in the data provided between the reports is due to data composition and calculation methodologies only.

Terms shown in the text in italics are defined in the glossary.

Please send any feedback, including comments and suggestions regarding the contents of the report and data presentation to reservesmanagement@mail.cbr.ru.

PRINCIPLES OF FOREIGN EXCHANGE ASSET MANAGEMENT AND FINANCIAL RISK MANAGEMENT

The Bank of Russia's foreign exchange assets include government and non–government bonds of foreign issuers, deposits and nostro accounts balances, *reverse repo* operations, Russia's net position with the IMF, Russian Eurobonds and other claims on counterparties. These assets are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yen, *Special Drawing Rights (SDR)*, Swiss francs and yuan (herein after foreign currencies). Foreign securities purchased by the Bank of Russia through reverse repo transactions are excluded from the total volume of foreign exchange assets.

The objective of foreign exchange asset management is to ensure the best balance between the safety, liquidity and profitability of assets.

For the purpose of management, foreign exchange assets are grouped into single–currency portfolios. To assess the efficiency of the management of single–currency portfolios their returns are compared to *benchmark portfolio* returns.

Foreign exchange asset management takes into account the Bank of Russia's liabilities in foreign currencies (balances on foreign currency accounts of clients, mainly *government funds*). Foreign currency holdings expose the Bank of Russia to financial risks, such as credit risk, foreign exchange risk, interest rate risk and liquidity risk.

Credit risk means the risk of counterparties or issuers defaulting on their obligations to the Bank of Russia. Credit risk is constrained by various limits and requirements for the credit quality of counterparties and issuers, which must have a minimum *credit rating* of A under the Fitch Ratings and Standard and Poor's classifications and a minimum rating of A2 under the Moody's Investors Service classification.

Foreign exchange risk means the probability of a decrease in the value of net foreign currency assets (assets net of liabilities) due to foreign currency exchange rate movements. The Bank of Russia limits the level of foreign exchange risk by specifying a benchmark currency structure of net foreign exchange assets with target weights of eligible currencies and the limits of their deviations.

Interest rate risk is the probability of a decrease in the value of foreign exchange assets due to any unfavourable changes in interest rates.

The level of interest rate risk for the Bank of Russia's assets portfolios is measured by *duration*. The interest rate risk exposure is limited by setting the minimum and maximum durations allowed in each of the eligible currency portfolios. Additionally, the maturities of eligible securities, deposits and repo operations are limited.

Liquidity risk means the risk of losses due to insufficient funds to cover Bank of Russia current liabilities in foreign currencies. In order to lower this risk, the volume of liquid assets in each currency is maintained at a level exceeding the volume of liabilities in the same currency. The most liquid assets are government securities, which are the major component of foreign exchange assets. Sources of liquidity also include nostro account balances, credit lines, short–term deposits and repo operations, as well as cash inflows from coupon payments and redemptions of securities denominated in foreign currencies.

The Bank of Russia pays interest on the foreign currency accounts balances equal to the rate of return on indices composed of foreign countries' bonds. The Bank of Russia makes interest payments in rubles. Since the Bank of Russia has the right to issue currency, these obligations don't expose it to interest rate and liquidity risks.

The Bank of Russia has a multilevel collective system for investment decision–making.

The Bank of Russia Board of Directors sets the objectives of foreign exchange asset management, thelist of eligible investment instruments, and the target level of foreign exchange risk.

The Bank of Russia Committee in charge of investment strategy sets the levels of interest rate and credit risks and approves the lists of eligible counterparties and issuers.

The adopted investment decisions are implemented by the authorized divisions of the Bank of Russia. External managers are not involved in foreign exchange asset management.

MACROECONOMIC TRENDS IN 2015

The foreign currency exchange rates and government securities yields in major developed economies throughout the period under review were primarily driven by the ongoing sovereign debt problems in certain euro area member states, the China slowdown and *quantitative easing* (QE) programmes in euro area and Japan as well as by continued slump in oil prices.

America

In March 2015, the Fed modified its language by abandoning the "patient" wording, indicating the lift–off is on the cards. The FOMC also stressed the preconditions needed for a rate hike – further improvement in the labour market and reasonable confidence that inflation will reach the 2% target over the medium term.

In June–September 2015, the Fed revised its forecasts on the US economy downward (given negative spillovers from financial market turbu–lence and weakening EM economies).

In December 2015, the Fed concluded that the conditions for a hike stipulated in March were fi–nally met and opted for an increase of the target range for the Federal funds rate by 0.25 pp to 0.25–0.50%.

Expectations of the Fed lift–off led to USD strengthening against other major world curren–cies in 2015. At the same time, the US sovereign curve flattened with short–term rates moving no–ticeably up and the yield of US Treasuries with longer maturities remaining almost unchanged.

In January 2015, the Bank of Canada (BoC) unexpectedly cut its key rate by 0.25 pp to 0.75%. The BoC based its decision on the slump in oil prices that will put economic growth and inflation under pressure. In July 2015, the BoC futher low–ered the key rate by 0.25 pp to 0.50% amid still falling investments in energy sector and inflation howering near 2%.

In June 2015, Canada entered recession after GDP contracted by 0.7 and 0.3% in 1Q and 2Q respectively. However, by the end of 3Q the Ca–nadian economy was back on track with GDP growing by 2.3%, signaling an end to recession.

Canadian sovereign curve edged lower in 2015 due to BoC rate cuts, while loonie came under severe pressure from the oil prices continued slump.

Europe

At the meeting in January 2015, the ECB de–cided to start the purchase of euro area government bonds in March 2015 and finish it in September 2016. The amount of purchase should total 1.1 tn euros.

In June 2015, Greece missed the IMF payment amounting to 1.6 bn euros. The government announced a national referendum on 5 July on the issue of accepting international creditors' demands. Despite of the fact that the population of Greece rejected the international creditors' conditions, the government introduced its own reform agenda containing only minor differences from these conditions. Credit risk growth in the euro area contributed much to the weakening of the euro against the US dollar in the first half of the year.

Chart 1. Changes in the exchange rates to the US dollar, as % of start of period

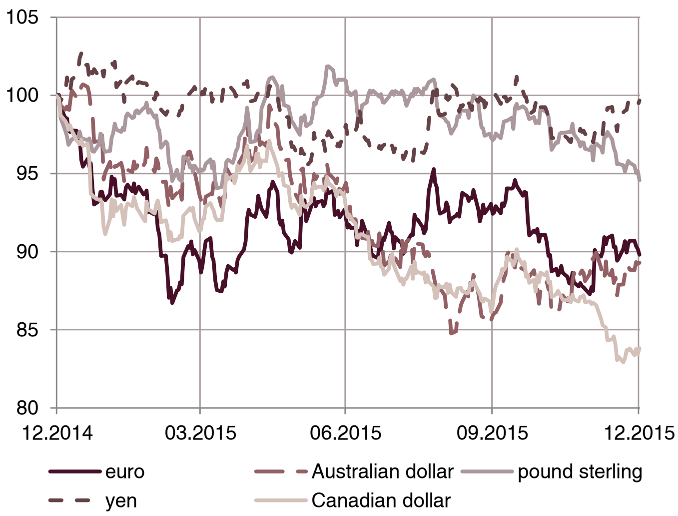
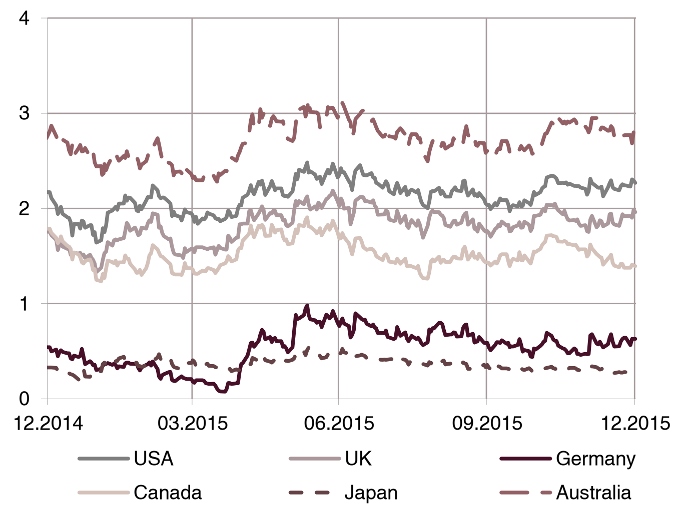


Chart 2. Yields to maturity on 10–year government bonds, % p.a.



The Swiss National Bank abolished the exchange rate ceiling of the Swiss franc, which caused a 15% surge of the franc against the euro. In December 2014 and January 2015, the bank cut the deposit rate from –0.25% to –0.75%.

In February and March 2015, the Riksbank lowered the repo rate from 0 to –0.1 and –0.25% respectively, and announced the purchase of government bonds totaling 30 bn Swedish kronas. In July 2015, the rate was lowered to –0.35%.

Australia and Asia

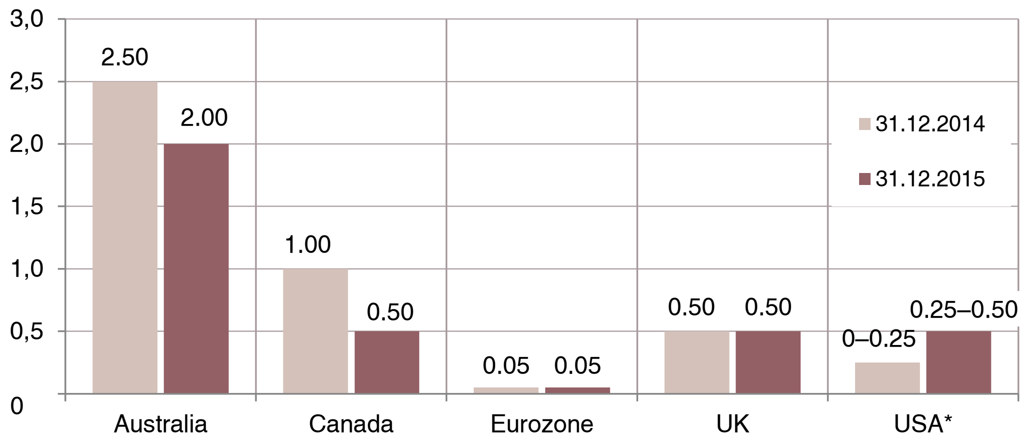
In February 2015, the Reserve Bank of Australia (RBA) cut its key rate by 0.25 pp to 2.25% first time since 2013. The major factors affecting the decision were the weak growth of internal demand, overvalued AUD and decline in inflation in the last quarter of 2014.

In the second quarter of 2015, the RBA cut its key rate again by another 0.25 pp to 2%. The motivation for the decision was mainly the same as at the February cut, but this time the governor of the RBA mentioned that he expected some period of rate stabilization.

The lack of clear plans for fiscal consolidation and poor macroeconomic performance forced Fitch rating agency to cut the sovereign rating of Japan from A+ to A in April 2015, while the rating cut of Standard & Poor's rating agency was from AA– to A+ in September 2015.

During the period from January 2015 to December 2015, the People's Bank of China (PBoC) cut its key rates five times. As a result of these cuts one–year benchmark lending rate was lowered by 1.25 pp to 4.35% and one–year deposit rate – by 1.25 pp to 1.5%. Also, deposit reserve ratio for major banks was cut four times over the same period from 20% to 17.5%. These actions can be explained by the attempts of economic authorities to revive moderating growth by monetary measures. In August 2015, the PBoC announced a new and more market oriented rule for CNY mid–rate setting. From now, the mid–rate was determined by the previous trading day closing rate. The new rule was accompanied by one–off devaluation of Chinese currency by 3%. At the end of 4Q, the PBoC completed process of interest rates liberalization by abandoning deposit rate ceiling.

Chart 3. Central banks key rates, % p.a.



* The Fed funds target rate was 0–0.25% as of 31 December 2014 and 0.25–0.50% as of 31 December 2015.

FOREIGN EXCHANGE ASSET MANAGEMENT IN 2015

In the period under review, Bank of Russia foreign exchange assets decreased by $15.9 billion to reach $340.3 billion (Table 1). The major driver of the decline was foreign currency exchange rate movements against the US dollar (Chart 4). The decrease of foreign exchange assets was also due to cash outfows from the clients' accounts with the Bank of Russia.

In January – December 2015, the government securities portfolios decreased as well as the amount of deposits and nostro account balances with the Bank of Russia (Table 1).

In 2015, the Bank of Russia started providing loans to Russian credit institutions in foreign currency secured by a pledge of claims under foreign currency loans.

Chart 4. Changes in foreign exchange assets in 2015, billions of US dollars

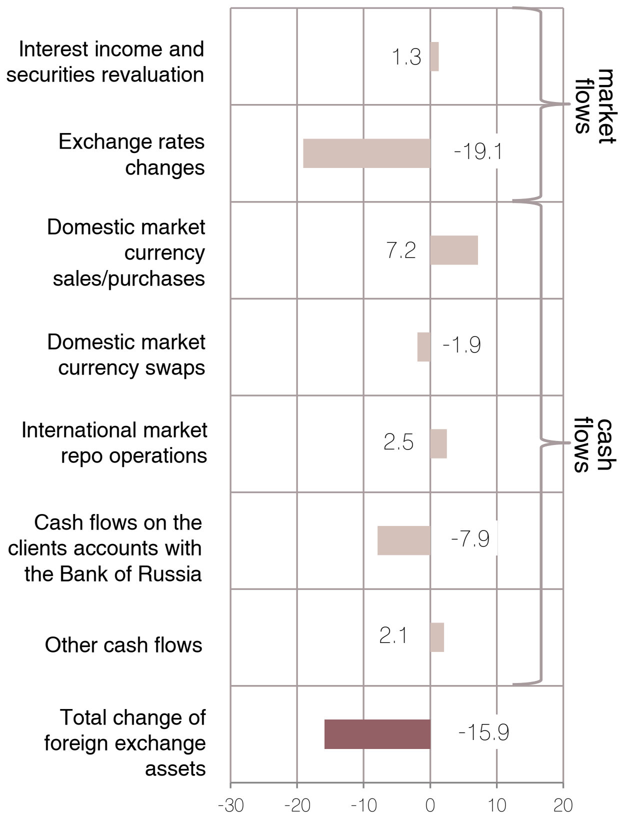


Table 1. Foreign exchange assets by asset class

Foreign exchange assets	As of 31 December 2014		As of 31 December 2015		Change in 2015, billions of US dollars
	billions of US dollars	Share of foreign exchange assets	billions of US dollars	Share of foreign exchange assets	
Government securities	283.9	79.7%	263.8	77.5%	-20.1
Deposits and account balances	42.3	11.9%	36.4	10.7%	-5.9
Non–government securities	4.9	1.4%	12.8	3.8%	7.9
Net position with the IMF	3.4	1.0%	2.6	0.8%	-0.8
Reverse repo operations	0.2	0.0%	2.6	0.8%	2.4
Claims on counterparties on foreign currency supply	1.6	0.5%	0.0	0.0%	-1.6
Claims on Russian credit institutions under foreign currency repo operations and loans	19.8	5.6%	22.2	6.5%	2.4
Total*	356.2	100.0%	340.3	100.0%	-15.9

* The total value may differ from the sum of asset classes values due to rounding.

Chart 5 shows the actual currency structure of foreign exchange assets as of 31 December 2015. Assets denominated in US dollars and euros re–tained the dominant position in the structure. In the fourth quarter of 2015, the Bank of Russia be–gan carrying out operations with assets in yuan.

Chart 6. Geographical structure of foreign exchange assets as of 31 December 2015

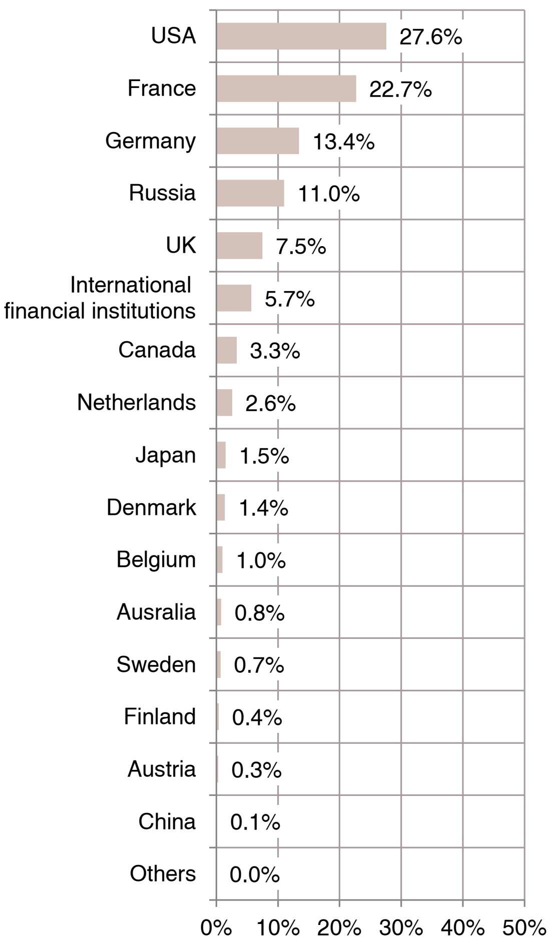


Chart 6 shows the geographical structure of foreign exchange assets by location (place of res–idence) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets. Russia's location in the geo–graphical structure at the fourth position was a result of Bank of Russia transactions on liquidity provision to Russian credit institutions in foreign currency (repo transactions and loans in foreign currency).

Chart 5. Foreign exchange assets by currency as of 31 December 2015

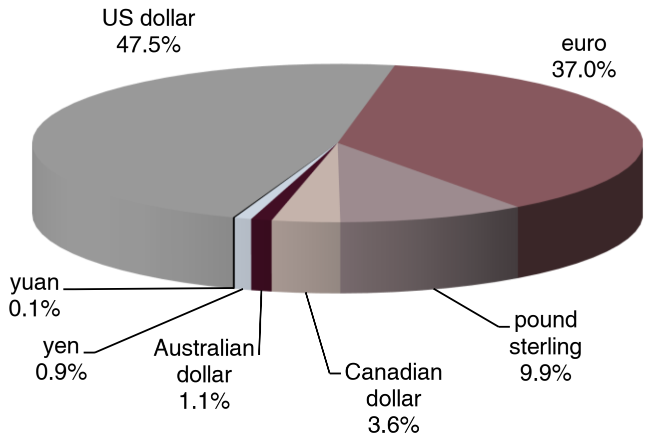
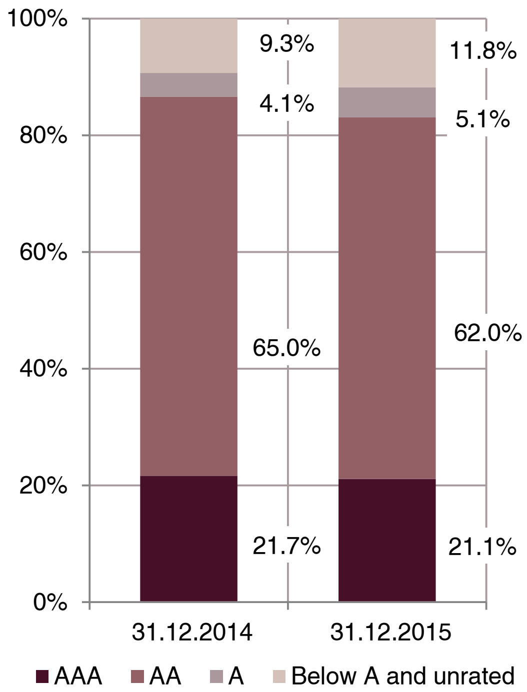


Chart 7 shows the distribution of foreign ex–change assets by credit rating as of 31 December 2014 and 31 December 2015. The Chart is based on Fitch Ratings. Standard and Poor's and Moody's Investors Service data, with the lowest credit rating grades used.

Chart 7. Foreign exchange assets by credit rating



Increase in the share of assets with 'Below A and unrated' rating as of 31 December 2015 was due to the provision of foreign currency to Russian credit institutions by the Bank of Russia.

Data on the return of the actual and benchmark single–currency portfolios of Bank of Russia foreign exchange assets are shown in Table 2.

Table 2. *Return on Bank of Russia foreign exchange assets* in 2015, % p.a.

Indicator	US dollar	euro	pound sterling	Canadian dollar	Australian dollar
Return on actual single–currency portfolios of foreign exchange assets	0.58	0.10	0.53	1.11	2.24
Return on benchmark single–currency portfolios of foreign exchange assets	0.28	0.08	0.51	1.08	2.21

GLOSSARY

Benchmark portfolio
A set of financial instruments in each reserve currency taken in appropriate percentage. Benchmark portfolios reflect the target distribution of Bank of Russia assets in each foreign currency.

Central bank key rate
A rate set by a central bank to impact interest rates in the economy. Usually a change to the key rate is a major monetary policy tool. Examples of key rates used by the leading central banks include:

- US Federal Reserve System (Fed) – A target for an interest rate at which depository institutions lend reserve balances to other depository institutions overnight;
- European Central Bank (ECB) – A minimum rate at ECB repo auctions;
- Bank of England – An interest rate on commercial bank reserves deposited with the Bank of England;
- Bank of Canada – A target for an interbank loan rate;
- Reserve Bank of Australia – A target for an interbank loan rate;
- Bank of Japan – Until April 2013, this was an overnight interbank loan rate. Starting from April 2013, the Bank of Japan has been targeting the monetary base instead of the interest rate.

Credit rating
A rating agency's assessment of the credit worthiness of a borrower and its ability to fulfill its financial obligations.

Currency swap
An agreement pursuant to which counterparties exchange payments in different currencies. The Bank of Russia enters into currency swap operations in order to supply Russian credit institutions with ruble funds using foreign currency funds as collateral.

Duration
A measure of the relative sensitivity of the value of a fixed-income instrument or a class of instruments to changes in the corresponding interest rates by one percentage point.

Government funds
The Reserve Fund and the National Wealth Fund of the Russian Federation including their foreign currency deposits with the Bank of Russia (in US dollars, euros, and pounds sterling).

Quantitative easing (QE)
A monetary policy used by central banks to stimulate the economy. To carry out QE, a central bank purchases government securities or other securities from the market or provides funds collateralised by financial assets in order to increase money supply.

Repo (reverse repo) transactions
Securities sale (purchase) transactions with an obligation of their repurchase (resale) at future date at a stated price.

Return on Bank of Russia foreign exchange assets
The holding period return is calculated using chain index based on a daily return. Daily return on a single-currency portfolio is calculated as the ratio of aggregate (realised and unrealised) returns of the portfolio to its market value as of the end of the previous day.

SDR (Special Drawing Rights)
An international reserve asset. created by the IMF to supplement the existing official reserves of member countries. It is a potential claim on the freely usable currencies of IMF members. The SDR rate is determined based on the dollar value of a four-currency basket made up of the US dollar, euro, yen, and pound sterling.