



Bank of Russia

The Central Bank of the Russian Federation



No. 3

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**BANK OF RUSSIA
FOREIGN EXCHANGE
ASSET MANAGEMENT
REPORT**

Moscow



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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 2014.

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)*, and Swiss francs (hereinafter, 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 unfavorable 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 foreign currency accounts balances equal to the rate of return on indices composed of foreign bonds. The Bank of Russia makes interest payments in rubles. Since the Bank of Russia is an issuer, 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, the list 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 authorised divisions of the Bank of Russia. External managers are not involved in foreign exchange asset management.

MACROECONOMIC TRENDS IN JANUARY – DECEMBER 2014

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 Eurozone member states, the China slowdown and *quantitative easing* (QE) programmes in both the USA and Japan.

In January 2014, the US Congress reached an agreement on the budget expenditures for 2014, with the main result being the decision to carry on with health care reform. The Federal Open Market Committee took decisions in January, March, April and June 2014 to reduce the amount of bond purchases by \$10 bn.

In February, the United States suspended the limit on government borrowing until 15 March 2015. As a result, Fitch Ratings affirmed the United States at AAA and changed the rating outlook from negative to stable.

In the second quarter of 2014, the US unemployment rate fell below the 6.5% target which the Fed had previously considered necessary for raising the key rate. In March 2014, the Fed stopped unemployment targeting maintaining the inflation target of 2%.

US GDP growth in the second quarter of 2014 was the highest since the end of 2011 (4.6%). This supported market participants' expectations for the Fed rate hike cycle beginning in 2015.

In November 2014, the Federal Open Market Committee decided to end the QE programme. At the December meeting, the Fed dropped the pledge to keep interest rates near zero for a "considerable time" and instead said that it "can be patient" about the timing of monetary policy tightening. This change in wording led to rising in expectations for a rate hike as soon as in the middle of 2015.

At the beginning of the second quarter of 2014, the Japanese Government implemented a tax reform with the sales tax increasing by 2 percentage points. This mostly impacted consumer demand, which began to decline since April. As a result, in the second quarter, the economy of Japan showed negative growth year on year.

Rating agencies noted the improved creditworthiness of some European countries. Moody's Investors Service raised the sovereign rating of Spain from Baa3 to Baa2 and that of Ireland from Ba1 to Baa3 (investment grade). Moody's Investors Service also revised the outlook for Germany (Aaa), Austria (Aaa) and Luxembourg (Aaa) from negative to stable. Standard and Poor's revised the outlook for Belgium (AA) from

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

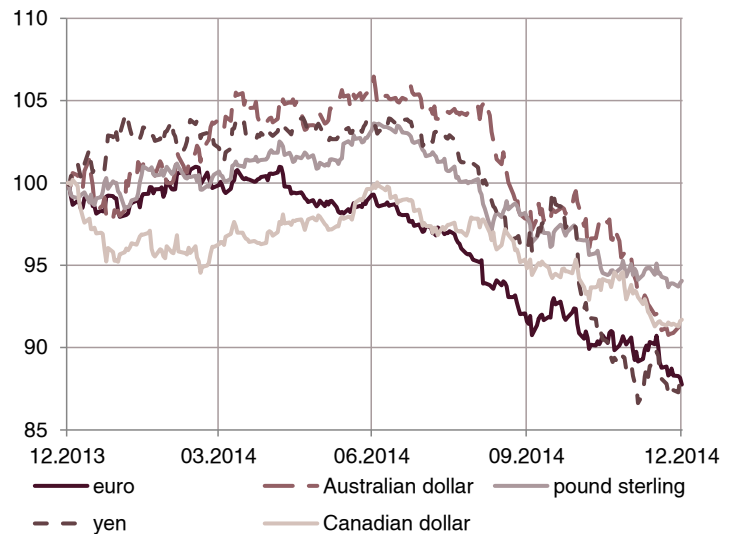
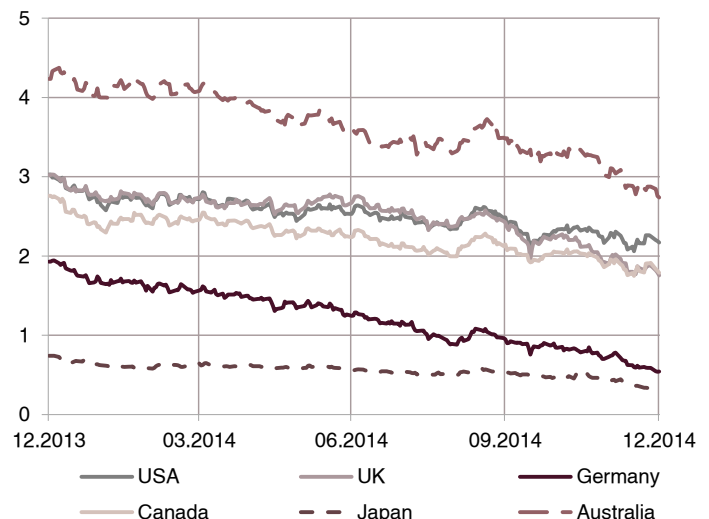


Chart 2. Yields to maturity on 10-year government bonds, % p.a.



negative to stable. These decisions were based on the stabilisation of situation in the peripheral countries of the Eurozone, the lower probability of new bailouts and the start of the economic growth in the Eurozone.

In the second quarter of 2014, economic growth in the Eurozone slowed down due to a number of reasons including the conflict in Eastern Ukraine. The Greek economy emerged from recession and among the major countries in the region only Italy remained in recession. In June 2014, the ECB lowered its interest rate from 0.25% to 0.15% to maintain economic growth and overcome deflationary pressure. At the same time, the deposit facility rate was set below zero at

–0.10% for the first time. Moreover, the regulating body introduced a series of stimulus measures:

- launching the programme of targeted longer-term refinancing operations (TLTRO), which assumes providing liquidity to banks in order to stimulate lending to the Eurozone real economy. The amount of the programme may total 400 bn euros;

- suspending the sterilization of liquidity injected under the Securities Markets Programme (SMP) by means of the ECB deposit facility;

- preparation of the ABS purchase programme;

- extending the validity term of the expanded list of assets that can be used as collateral for ECB operations until September 2018.

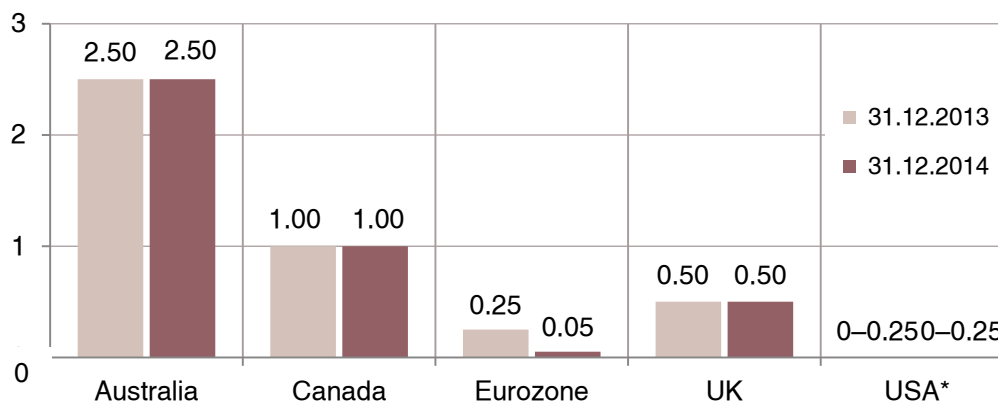
In September 2014, the ECB cut the key rate (from 0.15% to 0.05%) and the deposit facility rate (from –0.1% to –0.2%). In December 2014, deflation began in the euro area, prices fell by 0.2% on the previous year. Despite the fact that deflation

hampered the domestic consumption growth, the ECB delayed the start of the programme for 2015.

In the fourth quarter of 2014, due to the weak economy performance the Bank of Japan (BoJ) announced an increase of Qualitative and Quantitative Easing programme through the purchases of government bonds. The amount of purchases was increased from 60–70 tn yen to 80 tn yen annually and the average maturity of the BoJ's portfolio was extended from 7 to 10 years. Japan's prime minister postponed the second sales tax hike from October 2015 to 2017 and dissolved the lower house of Parliament. In the middle of December 2014, the ruling party won the snap elections that were considered as a confidence vote for the policy of the government.

The lack of clear plans for fiscal consolidation and poor macroeconomic performance forced Moody's rating agency to cut the sovereign rating of Japan from Aa3 to A1 in November 2014, while Fitch rating agency placed Japan's A+ rating on negative watch in December 2014.

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



* The Fed funds target rate is 0–0.25%.

FOREIGN EXCHANGE ASSET MANAGEMENT IN JANUARY – DECEMBER 2014

In the period under review, Bank of Russia foreign exchange assets decreased by \$111.4 billion to reach \$356.2 billion (Table 1). Major reasons behind this reduction were currency interventions on the domestic foreign exchange market (Chart 4). The decrease of foreign exchange asset was partially caused by foreign currency exchange rate movements (Chart 1).

In January – December 2014, investments in government bonds decreased as well as the amount of deposits and nostro account balances with the Bank of Russia (Table 1).

From October 2014, the Bank of Russia began to enter into repo transactions with Russian credit institutions in order to provide foreign currency liquidity to market participants.

Chart 4. Changes in foreign exchange assets in January – December 2014, billions of US dollars

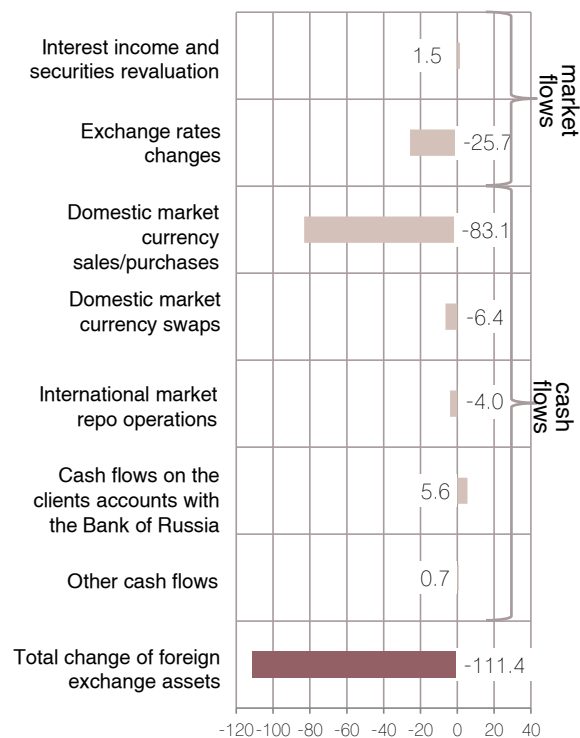


Table 1. Foreign exchange assets by asset class

Foreign exchange assets	As of 31 December 2013		As of 31 December 2014		Change in 2014, billions of US Dollars
	billions of US dollars	Share of foreign exchange assets	billions of US dollars	Share of foreign exchange assets	
Government securities	390.4	83.5%	283.9	79.7%	-106.5
Deposits and account balances	63.5	13.6%	42.3	11.9%	-21.2
Non-government securities	3.5	0.7%	4.9	1.4%	1.4
Net position with the IMF	4.4	0.9%	3.4	1.0%	-1.0
Reverse repo operations	5.8	1.2%	0.2	0.0%	-5.6
Claims on counterparties on foreign currency supply	0.0	0.0%	1.6	0.5%	1.6
Claims on Russian credit institutions under foreign currency repo operations	0.0	0.0%	19.8	5.6%	19.8
Total*	467.6	100%	356.1	100.1%	-111.4

* 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 2014. In the period under review, the share of assets denominated in euros increased. The share of portfolio in US dollars went down, while the share of assets in Swiss francs and yen remained insignificant.

Chart 5. Foreign exchange assets by currency as of 31 December 2014

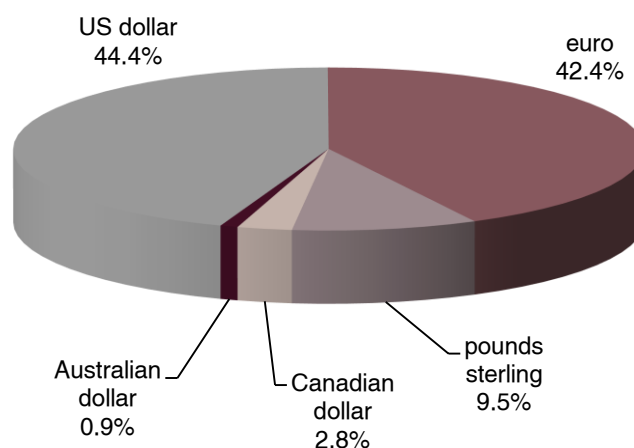


Chart 6. Geographical structure of foreign exchange assets as of 31 December 2014

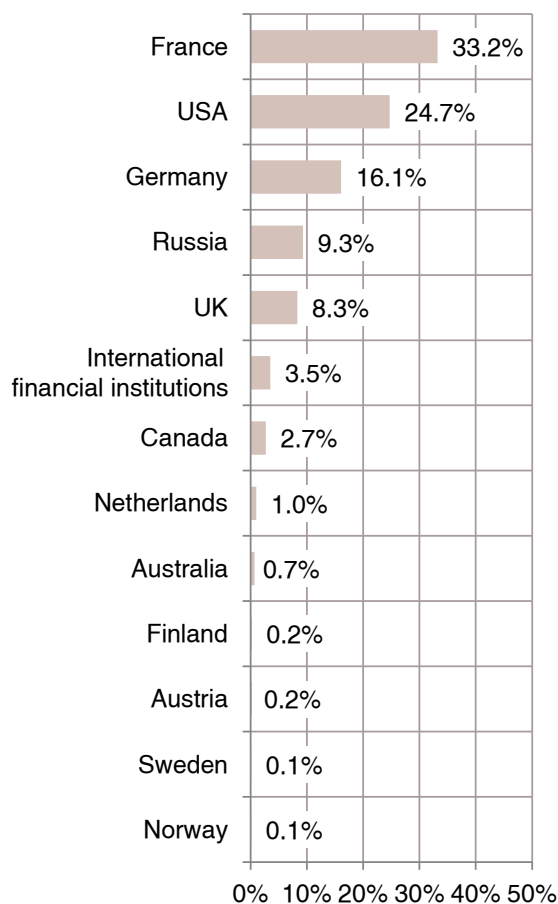
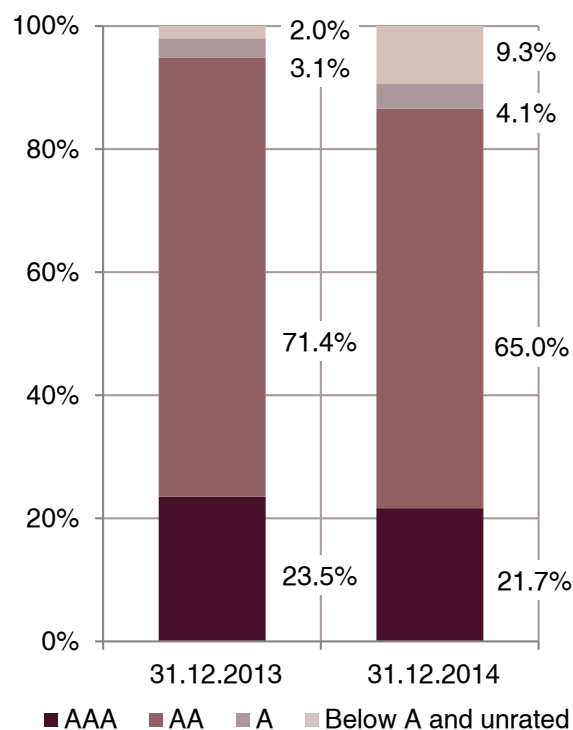


Chart 6 shows the geographical structure of foreign exchange assets by location (place of residence) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets. The increase of Russia's share in the fourth quarter of 2014 was due to the start of Bank of Russia refinancing operations of Russian credit institutions in foreign currency (foreign currency repo operations).

Chart 7 shows the distribution of foreign exchange assets by credit rating as of 31 December 2013 and 31 December 2014. 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



'Below A and unrated' group comprises Russian Eurobonds, obligations of Russian credit institutions on foreign currency repo transactions and Russia's position with the IMF.

A reduction in the share of assets with AAA and AA rating and growth in the share of assets with A rating and below are related to the de-

crease in the portfolios of government securities of foreign issuers and foreign currency provision to Russian credit institutions under repo operations.

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 January – December 2014, % p.a.

Indicator	US dollar	euro	pound sterling	Canadian dollar	Australian dollar
Return on actual single-currency portfolios of foreign exchange assets	0.13	0.39	0.99	1.21	2.96
Return on benchmark single-currency portfolios of foreign exchange assets	0.29	0.38	0.94	1.18	2.91

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	<p>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:</p> <ul style="list-style-type: none">• 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 <i>monetary base</i> 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.
Flight to quality	Investors' sale of higher-risk assets in favour of purchasing safest possible assets (as government bonds issued by developed countries) due to a lower risk appetite.
Gross government debt	The value of a central government's outstanding debt in the domestic currency and in foreign currencies. The debt amount is not adjusted to the value of government foreign exchange assets.
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).
Monetary base	The total amount of money that is either circulated in the hands of the public or in commercial bank deposits held in the central bank's reserves.
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.