Bank of Russia
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 October 2013 – September 2014.

Due to global financial markets' 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 (herein–after, foreign currencies). Foreign securities purchased by the Bank of Russia through reverse repo transactions are excluded from the total vol–ume of foreign exchange assets.

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

For the purpose of management, foreign ex–change assets are grouped into single–currency portfolios. To assess the efficiency of the man–agement 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 for–eign 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, for–eign 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 cur–rency 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 devia–tions.

Interest rate risk is the probability of a de–crease 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 Rus–sia'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. Additional–ly, 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 cur–rency 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 ex–change assets. Sources of liquidity also include nostro account balances, credit lines, short–term deposits and repo operations, as well as cash in–flows 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 ru–bles. Since the Bank of Russia is an issuer, these obligations don't expose it to interest rate and li–quidity 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 manage–ment, 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 imple–mented by the authorized divisions of the Bank of Russia. External managers are not involved in foreign exchange asset management.

MACROECONOMIC TRENDS IN OCTOBER 2013 – SEPTEMBER 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* programmes in both the USA and Japan.

In September 2013, the politically split US Congress failed to approve the federal budget for the 2014 fiscal year (starting 1 October 2013) and to agree on raising the debt ceiling. As a consequence, the USA experienced a government shutdown from 1 to 16 October and the threat of a technical default rose. A day before the borrowing limit was to be reached (on 16 October) the US Congress extended government funding until 15 January 2014 and suspended the debt ceiling until 7 February 2014. The period of uncertainty preceding this resolution led to a *flight to quality* by international investors and to a rise in short–term interest rates.

In November 2013, amid weak economic growth and low Eurozone inflation, the ECB eased its monetary policy by cutting the *key rate* from 0.5% to 0.25%. Standard and Poor's lowered France's rating from AA+ to AA, noting insufficient labour market reforms and declining competitiveness. The agency's experts also pointed to excessively high budget expenditures coupled with high taxes that did not allow for budget consolidation by means of further tax increases.

In December 2013, the Federal Open Market Committee decided to reduce the amount of monthly bond purchases by $10 bn following a significant improvement in the labour market (unemployment fell to 7% in November) and the deal on the federal budget agreed in the US Senate.

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, while maintaining the inflation target of 2%.

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

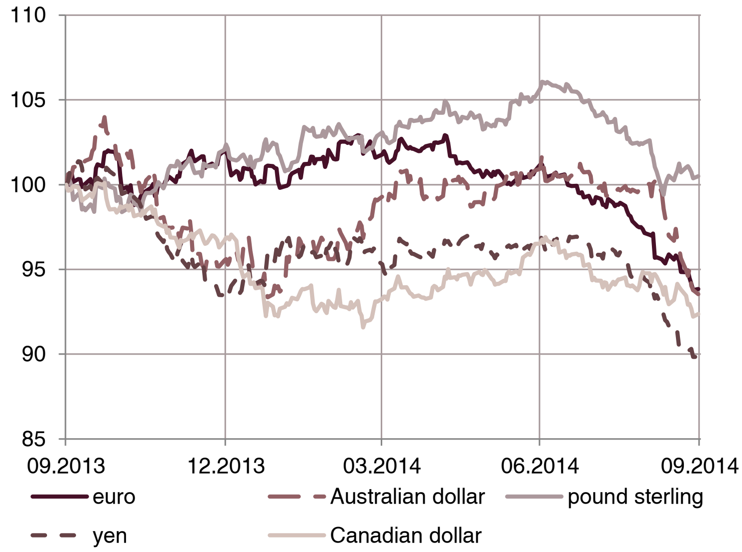
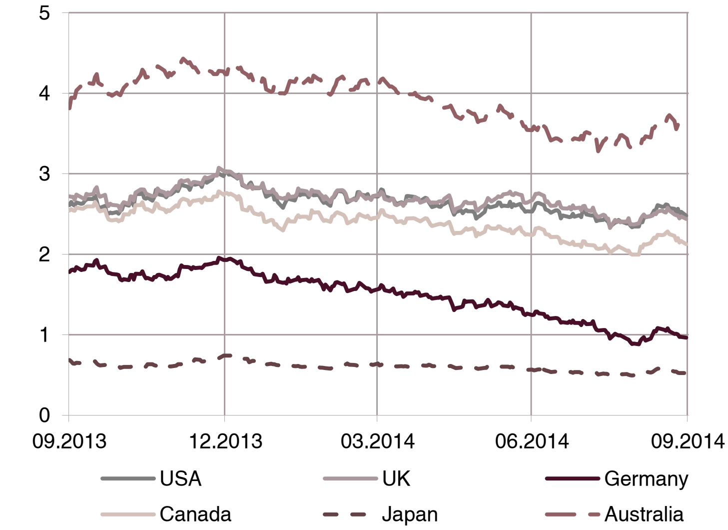


Chart 2. Yields to maturity on 10–year government bonds, % p.a.



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.

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

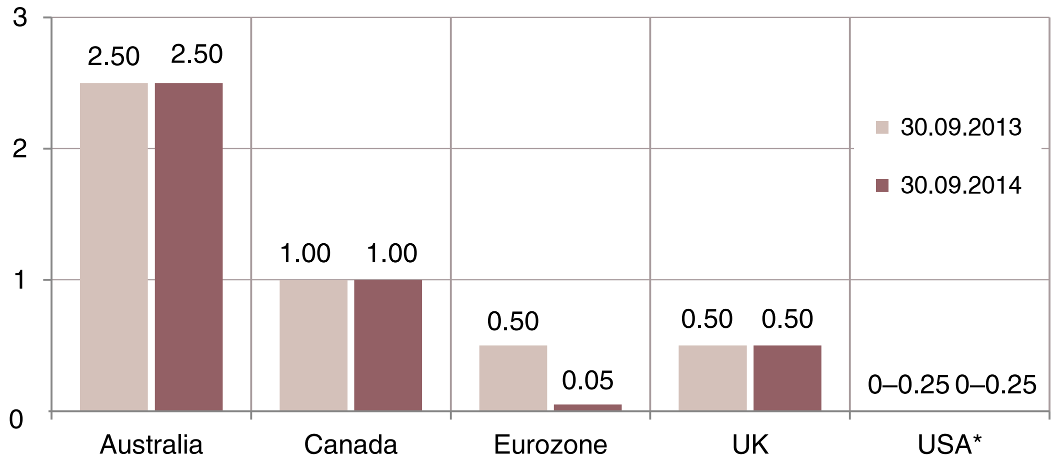
Ba1 to Baa3 (investment grade). Moody's Investors Service also revised the outlook for Germany (Aaa), Austria (Aaa) and Luxembourg (Aaa) from negative to stable. Standard and Poor's revised the outlook for Belgium (AA) from negative to stable. These decisions were based on stabilization of the situation 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, 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 launched a series of stimulus measures:

- launching the programme of targeted longer–term refinancing operations (TLTRO), which assumes providing liquidity for banks aimed at lending to the Eurozone non–financial sector. 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%).

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



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

FOREIGN EXCHANGE ASSET MANAGEMENT IN OCTOBER 2013 – SEPTEMBER 2014

In the period under review, Bank of Russia foreign exchange assets decreased by $73.3 billion to reach $406 billion (Table 1). The major reason behind this reduction was currency interventions on the domestic foreign exchange market (Chart 4). The decrease of foreign exchange assets was partially offset by foreign currency exchange rate movements against the US dollar (Chart 1).

In October 2013 – September 2014, payments on behalf of clients were an additional factor behind the decrease of foreign currency assets by $1.1 billion.

Over the period under review, investments in government bonds decreased as well as the amount of deposits and nostro account balances with the Bank of Russia, while investments in non–government bonds slightly increased (Table 1).

Chart 4. Changes in foreign exchange assets in October 2013 – September 2014, billions of US dollars

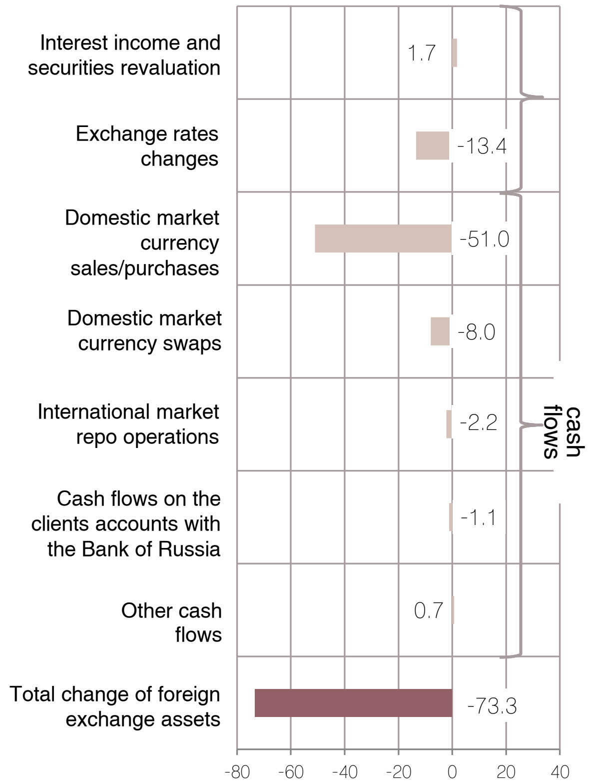


Table 1. Foreign exchange assets by asset class

Foreign exchange assets	As of 30 September 2013		As of 30 September 2014		Change in October 2013 – September 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	392.8	81.9%	341.0	84.0%	–51.8
Deposits and account balances	70.7	14.7%	54.1	13.3%	–16.6
Non–government securities	3.7	0.8%	5.1	1.3%	1.4
Net position with the IMF	4.6	1.0%	4.0	1.0%	–0.6
Reverse repo operations	7.6	1.6%	1.2	0.3%	–6.4
Total*	479.3	100%	406.0	100%	–73.3

* 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 30 September 2014. In the period under review, the share of assets denominated in euros and pounds sterling increased. The share of assets 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 30 September 2014

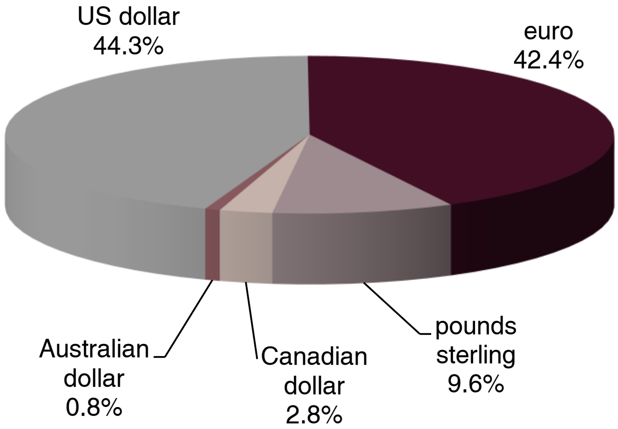


Chart 6. Geographical structure of foreign exchange assets as of 30 September 2014

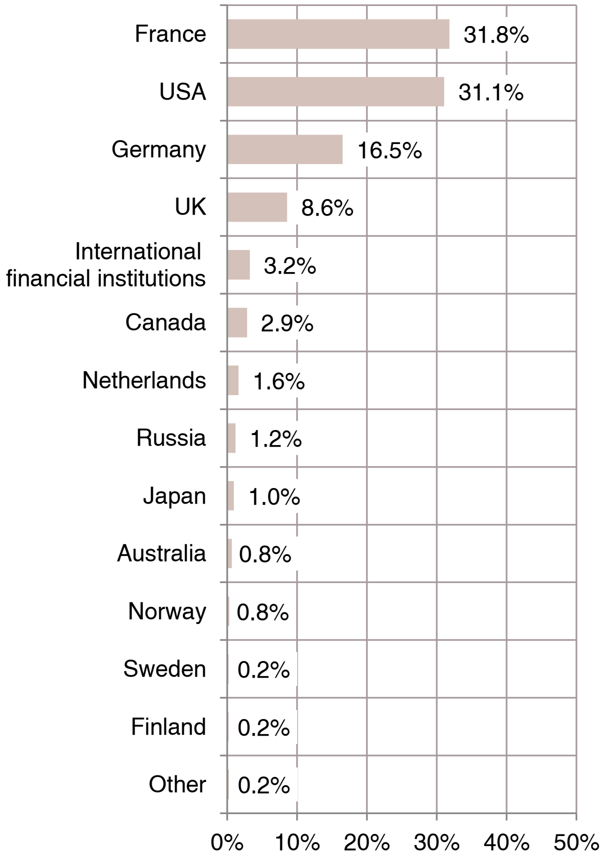
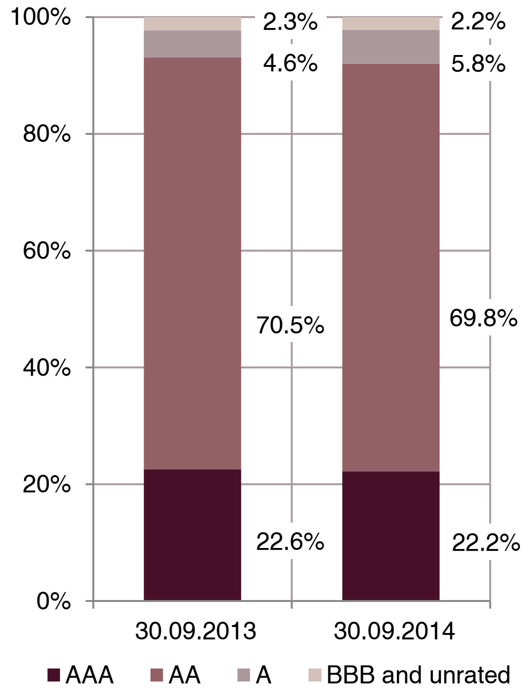


Chart 6 shows the geographical structure of foreign exchange assets by location (place of residence) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets.

Chart 7 shows the distribution of foreign exchange assets by credit rating as of 30 September 2013 and 30 September 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



'BBB and unrated' group comprises Russian Eurobonds with BBB rating and assets that are not rated, such as Russia's position with the IMF.

A reduction in the share of assets with AA rating and growth in the share of assets with A rating are related to the decrease in the government securities portfolios and increase in the deposits of banks with relatively low ratings.

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 October 2013 – September 2014, % p.a.

Indicator	US dollar	euro	pound sterling	Canadian dollar	Australian dollar
Return on actual single–currency portfolios of foreign exchange assets	0.31	0.40	0.51	1.22	2.65
Return on benchmark single–currency portfolios of foreign exchange assets	0.28	0.39	0.47	1.20	2.60

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.

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.