## Summary

In 2014 Q4 – 2015 Q1, the Russian financial system faced a number of challenges: oil price fall, high debt redemptions, and credit ratings downgrade, which collectively resulted in considerably higher market volatility. However, measures implemented by the Bank of Russia and the Russian Government during that period stabilised the situation relatively quickly. The financial system turned out to be resilient to external shocks due to, inter alia, the measures aimed at improving banking regulation and financial market development implemented in the past few years.

Not all the risks faced by the global and Russian financial systems were predictable. In particular, in the first six months of 2014, almost no analyst forecasted a considerable drop in oil prices observed in the second half of 2014. This episode confirmed that it is necessary to increase the financial sector resistance to key threats, develop risk management practices, and ensure availability of instruments in the central bank and the government to efficiently solve arising problems, in particular, the availability of sufficient foreign currency reserves at the central bank's disposal in order to carry out FX refinancing operations and interventions. The current level of foreign currency reserves in Russia meets all generally recognised criteria of foreign currency reserve adequacy. However, conditions in Russia require a more conservative approach that should take account of the possibility of prolonged restricted access to the foreign markets and the necessity to cover potential sizeable capital outflows for two to three years. Accordingly, the Bank of Russia has launched a policy to gradually replenish the international reserves to the target level of US$ 500 billion.

In December 2014, against a backdrop of falling oil prices, considerable external debt repayments amid sanctions and general deterioration in economic situation, the Russian financial market experienced high volatility and ruble depreciation against the US dollar and the euro (in 2014 Q4, the ruble value of the dual-currency basket calculated at the official Bank of Russia exchange rates rose by 39.7%). It was accompanied by capital outflow from Russia, mostly due to the increased corporate and household demand for foreign currency. Banking sector liquidity deteriorated: the value of household deposits declined considerably (the maximum accumulated decline from 1 November to 25 December 2014 stood at 5.1%, adjusted for exchange rate revaluation), money market interest rates rose. For broker-dealers interest rates on interdealer repo exceeded 27% p.a. in the certain period. At the same time, the financial system did not face the liquidity crisis: the decline in household deposits during this period was offset by a considerable increase in corporate deposits (10.9%) and growth in the volume of the Bank of Russia refinancing operations (43%). This allowed banks to preserve most of their positions in the money market, including broker funding.

Large-scale anti-crisis measures taken by the Bank of Russia and the Russian Government[1] contributed to a relatively fast stabilisation of the situation, and starting from February negative trends were overcome. Amid higher attractiveness of ruble savings, households started selling foreign currency and deposit growth resumed (also facilitated by an increase in the deposit compensation limit from 0.7 million rubles to 1.4 million rubles in December 2014). The situation in financial markets improved due to better external conditions: growing prices for Urals crude (from the minimum of US$43 per barrel in January to US$60-65 per barrel in early May 2015), and mitigation of geopolitical risks after the Trilateral Contact Group worked out a package of measures to implement the Minsk Agreements on 12 February 2015. As a result, from February to April 2015, the ruble value of the dual-currency basket decreased by

[1] Bank of Russia press release, dated 17 December 2014, 'On Bank of Russia Measures to Maintain Stability of the Russian Financial Sector'; Order of the Government of the Russian Federation No. 98-r, dated 27 January 2015.

27%. Despite the fact that the two leading rating agencies (Standard & Poor's and Moody's) downgraded the Russian sovereign rating to the speculative grade, the Russian government bond market still attracted foreign investors: from mid-March to 1 May 2015 their investments in federal loan bonds (OFZ) rose by about 50 billion rubles. After a surge during the period of increased market volatility observed in December 2014 OFZ yields returned to the level of last November.

The maximum external debt repayments of non-financial companies and banks were scheduled for 2014 Q4 – 2015 Q1, in the following periods repayments are considerably lower. Companies and banks have substantial FX liquidity buffer to repay external debts. The volume of funds borrowed by credit institutions under the Bank of Russia refinancing operations in foreign currency amounted to US$ 36 billion (as of 9 June 2015). According to the Bank of Russia estimates, the remaining limit (US$ 14 billion) is currently sufficient to ensure stable situation with FX liquidity in the domestic market. Besides, as market conditions improve, Russian borrowers return to external markets: from November 2014 to April 2015, non-financial companies raised subordinated loans and issued Eurobonds for US$ 6.1 billion (data provided by Cbonds), and credit institutions – for US$0.7 billion. Domestic placements are actively conducted. The volume of ruble-denominated corporate bond placements stood at 1.8 trillion rubles from November 2014 to April 2015. Nevertheless, the following risks remain within the upcoming quarters.

### *External Risks*

In the short term, the US Fed's discount rate is expected to be increased from the level of 0-0.25% at which it stood for the past seven years. Although this event is expected, tighter monetary conditions in the United States may result in moderately negative consequences for the emerging markets: currency depreciation, higher bond yields, and capital outflow. Accommodative measures in the euro area where the signs of economic recovery have begun to emerge can to a certain extent smooth negative consequences of tighter Fed policy for emerging markets. At the same time, uncertainty about the situation in Greece that fails to coordinate its plan of social and economic reforms with international lenders to receive the next tranche of loans contributes to increased volatility of global currencies.

The uncertainty about oil price dynamics still persists. In the recent months the price growth has been driven by the expected decline in oil supply, however, the observed price growth increases profitability of oil production for shale fuel producers in the USA and Canada. Besides, possible increase in exports from Iran when other OPEC countries preserve their shares in output may impede the balance between supply and demand in the market. At the same time, the current price for Urals crude (US$60-65 per barrel) is quite acceptable with regard to both creditworthiness of the Russian oil companies and fiscal sustainability of the state budget.

### *Non-financial Organisations' Risks*

Against a backdrop of the economic downturn, Russian companies have to optimise their business processes, in particular, capital investments and borrowings. Amid ruble depreciation and a decline in revenues debt burden continued to grow: according to consolidated statements for 2014 of 150 major companies, the average net debt to EBITDA ratio increased from 1.9 to 2.2.

The financial standing of oil and gas companies will remain stable even in case of the most unfavourable situation in the commodity markets (oil price at US$40 per barrel). The ruble depreciation will compensate for a decline in export revenues, and changes in the tax burden resulting from the 'tax manoeuvre' are inessential under the current conditions. At the same time, elevated risks are relevant for the following industries: construction, operations with real estate and leasing. Amid shrinking household demand for housing and deteriorating financial standing of commercial property tenants, some construction and developer companies have sizeable loans denominated in foreign currencies, while their FX income is limited. Accordingly, the transfer of lending to this sector and lease payments into rubles will facilitate higher resilience to currency risks in this sector.

### *Banking Sector Risks*

The key problem of the banking sector in the coming year will be credit risks amid negative GDP dynamics. Due to the decline in business activity in most industries the growth in the share of bad loans is already observed. The following industries show considerable growth of overdue loans from early 2015: construction, agricultural machine and equipment building, and trade. Amid high debt burden of the corporate sector the quality of corporate loan portfolio will continue deteriorating.

The situation in the unsecured consumer lending continued to worsen in the past six months: 2015 Q1 saw negative debt growth (-5.2%), return on equity of banks specialized in retail lending stood at -6.8% as of 1 April 2015. However, the analysis of the credit quality of loan vintages shows that banks tightened lending standards considerably in 2014. The share of bad loans can be expected to peak (16.5-17.0%) in 2015-first half of 2016, afterwards the situation will improve.

Credit risk results in considerable drop in banking sector profits due to the higher loan loss provisions hampering banks from increasing their capital. At the same time, the programme of recapitalisation of banks through the DIA will provide tangible support to the banking sector.

A package of regulatory easing measures implemented in December 2014 contributed to the elevated level of banking sector capital adequacy by 1.5 pp. As the situation in the financial market stabilised, the contribution of these loosening measures reduced to 0.5-1.0 pp by 1 April 2015. The Bank of Russia decided to gradually exit from anti-crisis regulatory measures; however, to avoid adverse pressure on banks' ratios some regulatory easing measures were extended[2].

The surge in the interest rates in the Russian economy in 2014 Q4 increased interest rate risk of the banking sector emanated from a considerable negative difference between assets and liabilities of banks sensitive to interest rate fluctuations on the horizon of up to 30 days. Factors conditioning this difference are high dependence of banks on short-term funding, depositors' propensity to transfer funds to more profitable deposits, and a low share of loans at floating interest rates. The reduction of the key rate by the Bank of Russia in 2015 decreases considerably the expected losses from interest rate risk, however, to reduce vulnerability to this risk in future, banks can be recommended to improve their interest rate risk management practices.

### *Non-bank Financial Institutions' Risks*

The segment of non-bank financial institutions does not bear any considerable risks to financial stability due to its small size (about 6% of total assets of the financial system). At the same time, the Bank of Russia monitors risks which could have a negative impact on non-bank financial institutions' ability to perform their functions with proper quality and continuity.

In 2014, the compulsory motor third-party liability insurance market saw certain difficulties due to inadequacy of insurance tariffs and existing court practice. In response to the growing loss ratio of

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[2] The Bank of Russia press release, dated 15 May 2015, 'On Anti-crisis Measures in Banking Regulation'.

motor insurance, many insurers decided to optimise their regional networks, reduce or sell their retail portfolios, or abandon the market. The situation began to improve after a series of adjustments to compulsory motor third-party liability insurance tariffs in conjunction with liability limits extension.

After several years of uncertainty about the future of pension accumulations, the Russian Government decided to preserve them in the pension system and resume the accumulations from 2016. This decision will ensure a stable inflow of long-term money to the economy and will contribute to lower volatility in the Russian stock market.