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Central Bank of the Russian Federation

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BANK OF RUSSIA FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT REPORT

MOSCOW

Bank of Russia
Foreign Exchange and Gold Asset
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FOREWORD

This issue of the Bank of Russia Foreign Exchange and Gold Asset Management Report presents the results of asset management in 2016.

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 and gold asset management are published at least six months after the end of the reporting period.

Information on Bank of Russia assets is also published in the Bank of Russia Annual Report (management of reserve assets in foreign currency and gold) 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.

Unlike previous issues of the Bank of Russia Foreign Exchange Asset Management Report, all metrics and breakdowns in this issue include assets in gold.

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.

1. PRINCIPLES OF FOREIGN EXCHANGE AND GOLD 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 sovereign Eurobonds and other claims on counterparties. These assets are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yuans, yen, Swiss francs and *Special Drawing Rights* (SDR) (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.

Bank of Russia assets in precious metals are managed separately from foreign exchange assets. Bank of Russia gold assets comprise monetary gold, stored at vaults within the territory of the Russian Federation.

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 S&P Global Ratings 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, the list of eligible investment instruments and the target level of foreign exchange risk.

The Bank of Russia collective body, which is in charge of investment strategy and which reports to the Board of Directors, 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 and gold asset management.

2. MACROECONOMIC TRENDS IN 2016

The foreign currency exchange rates and government securities yields in major developed economies throughout the period under review were primarily driven by the concerns of the global economy slowdown following the outcome of the EU membership referendum in the UK as well as by the stance of the Fed monetary policy. Besides, the financial markets were also affected 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.

USA and Canada

In 1Q-3Q16, the FOMC abstained from raising the Federal funds rate; and a number of FOMC members on several occasions said about the need of a smoother, than previously anticipated, path of the key rate with less hikes in 2017–18 amid the sluggish labour market recovery and unfavourable external factors. As these factors dissipated by end-year, in December 2016, the Fed raised the target range for the Federal funds rate by 0.25 pp to 0.50–0.75% that resulted in US dollar appreciation in 4Q against other currencies, thereby off-setting its depreciation in 1Q-3Q. The US yield curve shifted notably upwards after D. Trump's win in US presidential elections that led to a spike in expectations of large fiscal stimulus and a substantial rise in government debt levels and inflation.

The Canadian dollar appreciated relative to the US dollar in 1Q-2Q16: the Canadian currency came under pressure due to severe deterioration in trade balance with BoC holding the key rate unchanged, but recovering oil prices helped the Canadian dollar to overcome its weakness. In the 2H16, the Canadian dollar moved sideways with the currency fluctuations mainly attributable to the changes and expectations of the Fed monetary policy.

Europe

In February 2016, the UK government announced the UK referendum on the European Union membership for 23 June. The concern over the exit of the UK from the EU and breaking economic relations with other

Chart 1

Changes in exchange rates and gold to the US dollar, as % of start of period

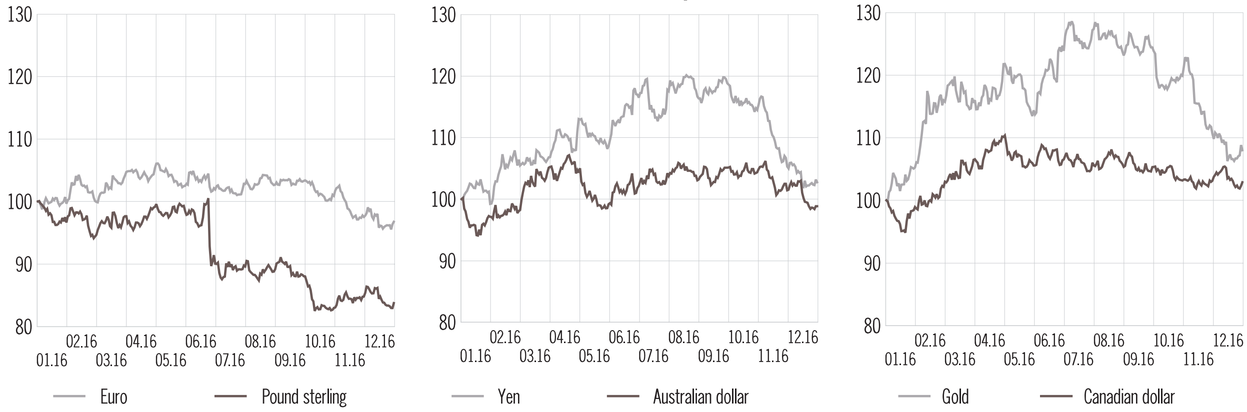
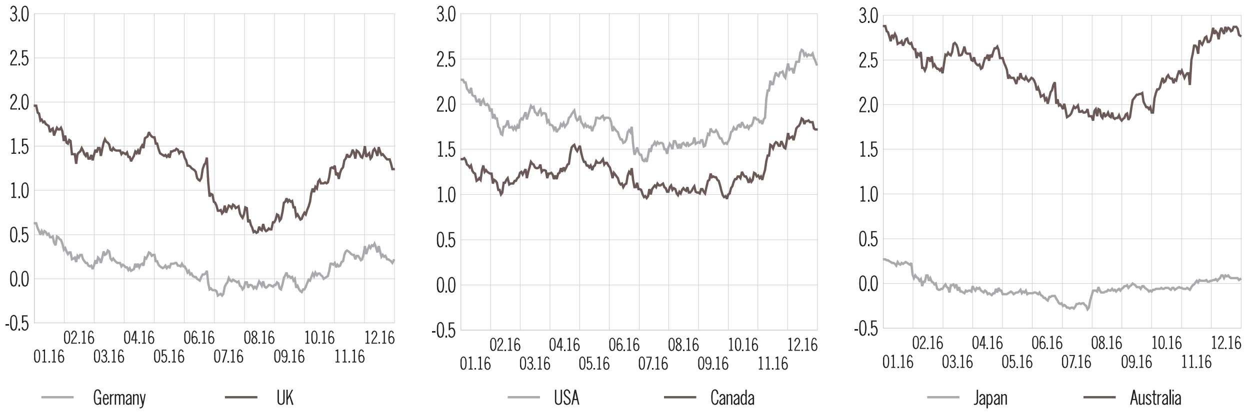


Chart 2

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



European countries caused the depreciation of the pound sterling against the US dollar in late 2015 – early 2016. On 23 June, the majority of British citizens voted for leaving the EU, which led to a dramatic depreciation of the pound sterling against the US dollar. In November, the London High Court ruled that the UK exit from the EU was unlawful without a parliamentary approval, which caused a slight appreciation of the British pound against the US dollar.

Amidst higher political uncertainty and concerns about economic slowdown fueled by the referendum results, the Bank of England strengthened its monetary stimulus. In August 2016, it cut the key rate from 0.5% to 0.25% and expanded the asset purchase programme.

In March 2016, the European Central Bank (ECB) cut the main refinancing rate to 0% and the deposit facility rate to –0.4%. The monthly purchases under the asset purchase programme were expanded from 60 bn to 80 bn euros. Moreover, a new series of targeted long-term refinancing operations (TLTRO II) has been launched since June 2016. These measures matched the market expectations and didn't cause significant euro depreciation. In December 2016, the ECB decided to continue its quantitative easing programme until the end of 2017, while contracting the monthly purchase amounts to 60 bn euro from April 2017.

Australia and Asia

The Reserve Bank of Australia (RBA) cut its key rate twice by 0.25 pp in May and August 2016 thus lowering it to 1.5%. The main reason for the two rate cuts was low inflation fluctuating below target levels for several quarters.

In mid-February 2016, the Bank of Japan (BoJ) adopted negative interest rate on reserves that exceeded required ones, and in September announced a targeting of long-term rates on government bonds as a new instrument of monetary policy. The reasons for second decision were a significant flattening of sovereign curve and the absence of impact from *quantitative and qualitative* easing programme on inflation.

The absence of clear signals from the BoJ on further monetary policy easing, the Fed's postponed rate hike and the result of UK referendum supported yen's sound appreciation, but subsequent increase in US rates led to yen's depreciation to the levels observed in the beginning of the year.

In 2016, the People's Bank of China (PBoC) cut its deposit reserve ratio for major banks from 17.5% to 17.0%. This measure can be explained by the attempt of economic authorities to revive moderating growth and to stimulate bank lending to the real sector. It became the last one in a series of monetary easing measures that had been launched in late

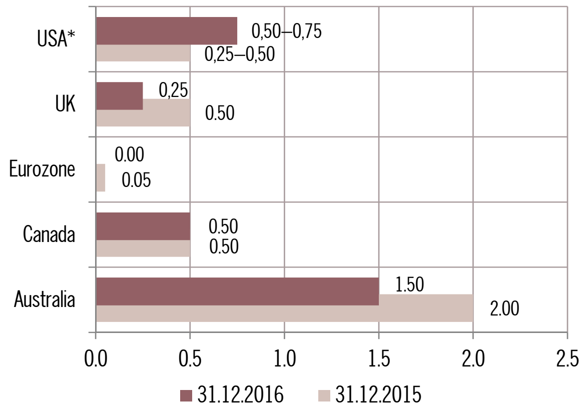
2014. Chinese currency was under pressure during the whole year and depreciated by 6.6% against the US dollar because of vague perspectives of future economic growth in China.

Gold

In 1Q-2Q16, the increase in the value of gold was caused by both the weakening of the US dollar against other major currencies amid expectations of a slower pace of Fed rate hikes and the '*flight to quality*' effect on the back of the UK opting to leave the EU. In 3Q16, the price of gold was flat, while in October-December 2016, it fell significantly due to more hawkish Fed rhetoric followed by a rate hike and US presidential election results, which were transformed by the market into expectations of accelerating economic growth.

Chart 3

Central banks key rates, % p.a.



** The Fed funds target rate was 0.25–0.50% as of 31 December 2015 and 0.50–0.75% as of 31 December 2016.*

3. FOREIGN EXCHANGE AND GOLD ASSET MANAGEMENT IN 2016

In the period under review, Bank of Russia foreign exchange and gold assets increased by $ 2.0 billion to reach $ 389.6 billion (Table 1). Domestic market gold purchases together with gold's price changes had a positive impact on the value of assets, while currency exchange rate changes and cash outflow on the clients' accounts with the Bank of Russia produced a negative effect (Charts 1 and 4).

Over 2016, government securities portfolios and claims in foreign currency on Russian credit institutions under repo transactions significantly decreased. The amount of deposits and nostro account balances with the Bank of Russia and portfolios of securities of foreign issuers that are expected to be supported by governments increased (Table 1).

In 2016, assets denominated in US dollars and euros retained the dominant position in the structure of Bank of Russia reserve assets in foreign currency and gold. The category 'Others' includes assets in Canadian (3.4%) and Australian (1.0%) dollars, as well as assets in yen (0.1%), yuan (0.1%) and Swiss francs (0.0%).

Chart 6 shows the geographical structure of assets by place of residence of counterparties or issuers of securities. Russia's location in the geographical structure at the fifth position was a result of Bank of Russia transactions on liquidity provision to Russian credit institutions

Table 1

Foreign exchange and gold assets by asset class

Foreign exchange and gold assets	As of 31 December 2015		As of 31 December 2016		Change in 2016, billions of US dollars
	billions of US dollars	Share of assets, %	billions of US dollars	Share of assets, %	
Government securities of foreign issuers*	239.3	61.7	202.7	52.0	-36.6
Gold	47.2	12.2	59.0	15.1	11.8
Deposits and account balances with foreign counterparties	36.4	9.4	65.3	16.8	29.9
Claims in foreign currency on Russian counterparties and issuers	26.4	6.8	16.5	4.2	-9.9
Non-government securities of foreign issuers**	20.3	5.2	32.1	8.2	11.8
International organizations' securities	12.7	3.3	10.8	2.8	-1.9
Reverse repo operations with foreign counterparties	2.6	0.7	1.2	0.3	-1.4
Net position with the IMF	2.6	0.7	1.9	0.5	-0.7
Claims on foreign counterparties on foreign currency supply	0.0	0.0	0.1	0.1	0.1
Total* **	**387.5**	**100.0**	**389.6**	**100.0**	**2.0**

** Securities issued by a foreign government or foreign issuers with explicit government guarantee.*
*** Securities of foreign issuers that are expected to almost certainly receive government support due to the special role or importance of their organisations in the economy of the country or region (implied guarantee).*
**** The total value may differ from the sum of asset classes values due to rounding.*

Chart 4

Changes in foreign exchange and gold assets in 2016, billions of US dollars

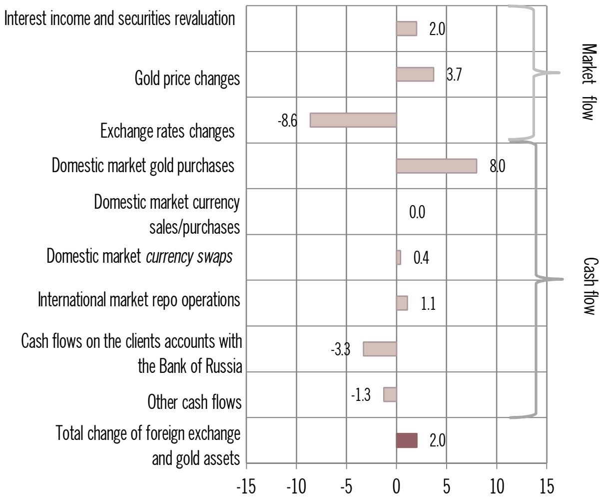


Chart 6

Geographical structure of Bank of Russia foreign exchange and gold assets (%)

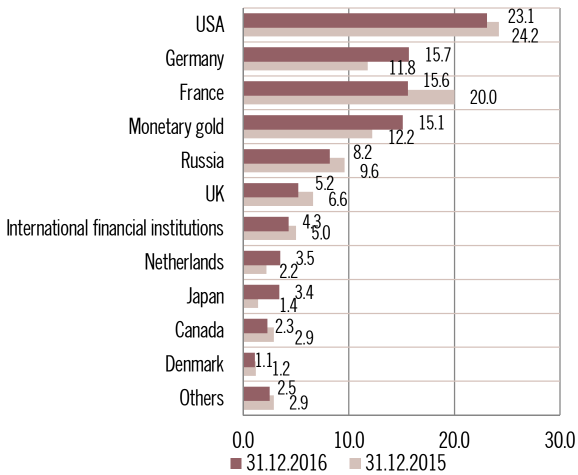
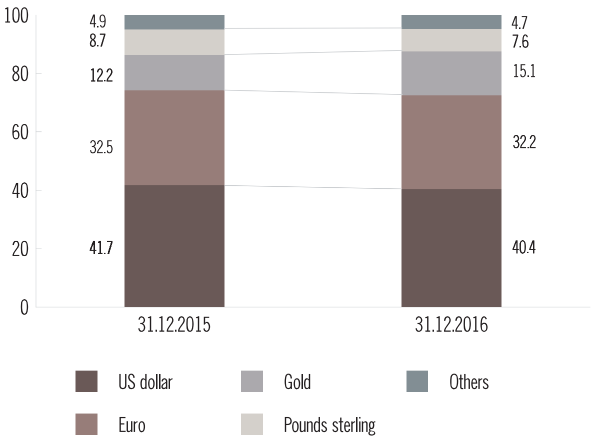


Chart 5

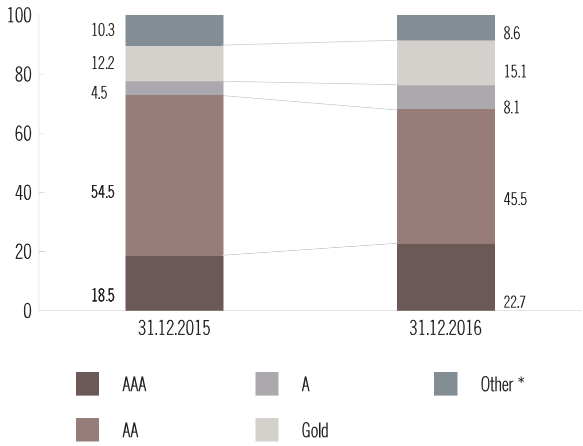
Bank of Russia foreign exchange and gold assets by currency*, % of market value



*The distribution takes into account unsettled conversion transactions.

Chart 7

Bank of Russia foreign exchange and gold assets by credit rating



* Mainly claims on Russian counterparties and issuers and Russia's net position with the IMF.

Table 2

Return on Bank of Russia foreign exchange assets in 2016, % p.a.

Indicator	US dollar*	Euro	Pound sterling	Canadian dollar	Australian dollar	Yuan
Return on actual single-currency portfolios of foreign exchange assets	0.95	-0.06	0.92	0.49	2.14	1.71
Return on benchmark single-currency portfolios of foreign exchange assets	0.53	-0.07	0.88	0.35	2.01	1.47

**A significant excess of the actual return over benchmark return is due to the fact that the profitability of the instruments included in the actual portfolio (Russian Eurobonds, repo transactions and loans in foreign currency with Russian credit institutions) exceeds the return on the instruments of the corresponding benchmark portfolio.*

in foreign currency (repo transactions and loans in foreign currency).

Chart 7 shows the distribution of assets by credit rating. The Chart is based on Fitch Ratings, S&P Global Ratings and Moody's Investors Service data, with the lowest credit rating grades used.

Decrease in the share of assets with 'Other' rating as of 31 December 2016 was partly due to the reduction of credit institutions refinancing in foreign currency.

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

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 (BoJ) – BoJ is targeting an annual amount of asset purchases (since 2013), the level of 10-year JGB yields (since 2016) and is applying a negative interest rate to the reserves of financial institutions held in BoJ accounts (since 2016)
Credit rating	A rating agency's assessment of the creditworthiness 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 more risky assets and purchase of less risky assets (primarily, government bonds of developed economies) caused by a decrease in risk tolerance.
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 and qualitative easing (QQE)	A monetary policy used by central banks to stimulate the economy. To carry out quantitative easing, 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. Qualitative easing refers to the shift in the composition of assets on the central bank's balance sheet to less liquid and more risky assets, given the overall balance of the central bank does not change.
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 on 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 five-currency basket made up of the US dollar, euro, yen, pound sterling and yuan (from 1 October 2016).