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The Central Bank of the Russian Federation

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Banking sector liquidity and financial markets

Facts, assessments and comments

Moscow

Cut-off date:
‘Banking sector liquidity and money market’* section – 7 August 2018;
‘Foreign exchange and stock market’ section – 31 July 2018.
‘Credit and deposit market’ section – 1 July 2018.

* Reserve requirements are an important part of the Bank of Russia’s set of tools for managing banking sector liquidity and money market rates. Therefore, analyses of the effectiveness of the Bank of Russia’s monetary policy operational procedure should take into account required reserves averaging periods. In July 2018, this is the period between 11 July 2018 and 7 August 2018.

A soft copy of the informational and analytical material is published on the Bank of Russia website (*http://www.cbr.ru/DKP/).*

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Banking sector liquidity and financial markets: facts, assessments and comments
(July 2018)

- ***July 2018 saw a slight decline in the structural liquidity surplus following major tax payments that proved in excess of the volume of funds banks received through the budget channel, with other liquidity factors also impactful.***
- ***Liquidity outflow from the banking sector narrowed the spread between overnight interbank rates and the Bank of Russia key rate.***
- ***The cost of FX borrowing shrank as a result of export FX revenue inflow to banks, the Ministry of Finance's redemption of the eurobond issue and elevated demand for ruble liquidity at the end of the month.***
- ***Investors' expectations over the future path of the key rate and inflation remained unchanged in July. The market expected the Bank of Russia's decision to keep the key rate unchanged and did not respond with any considerable quotation movements.***
- ***The period between late July and early August in the Russian market is a time dividend payments are made. With its impact on the ruble exchange rate being overall neutral, payments to investors within this period may send the ruble higher and then lower.***
- ***In the second quarter of 2018, short- and long-term rates on bank operations showed mixed dynamics. Short-term rates climbed somewhat amid a slower shift to neutral monetary policy, whereas long-term rates continued to go down.***
- ***With interest rates holding at the current level, deposits remain an attractive saving instrument. However, as consumption expanded, growth of deposit portfolio slowed down, suggesting that households continue to gradually abandon the saving behaviour model.***
- ***Banks continued to increase retail lending, with mortgage lending being the main focus, as the quality of credit portfolios showed significant improvement. The mortgage market was also supported by interest rates, which hit a fresh all-time low by the end of 2018 Q2.***
- ***Corporate lending proceeded on a moderate expansion path, with a recovery emerging in lending to wholesale operators and retailers, in a sign of both growing propensity to consume and a gradual rebound in lending to sectors most sensitive to a changing business climate.***

Banking sector liquidity and money market

The structural banking sector liquidity surplus decreased somewhat in July 2018. This was caused by considerable tax (including quarterly VAT) payments and the transfer of dividends to the Bank of Russia by Sberbank early in the month. Liquidity outflow driven by these factors proved much higher than total proceeds from budget expenditures, Federal Treasury operations and local authorities depositing temporarily available funds with banks, as well as the Ministry of Finance's FX purchases in the domestic market. In this environment, banks considerably reduced their correspondent account balances at the end of July. Furthermore, certain credit institutions resorted to Bank of Russia loans secured by non-marketable assets, to average required reserves.

Major tax payments supported interbank money market rates, similar to the previous averaging period. On certain days of the tax period overnight interbank rates exceeded the key rate while holding within the Bank of Russia interest rate corridor.

A considerable liquidity outflow from the banking sector in late July also caused late delivery of some banks on their reserve requirements. On the last operational week of the averaging period they chose to keep a liquidity cushion. Due to this factor bids at the last Bank of Russia's one-week deposit auction in the period considerably undershot the established limit. Though it put temporary downward pressure on market rates, this effect was mitigated by the Bank of Russia's absorption of excess liquidity at *fine-tuning* deposit auctions.

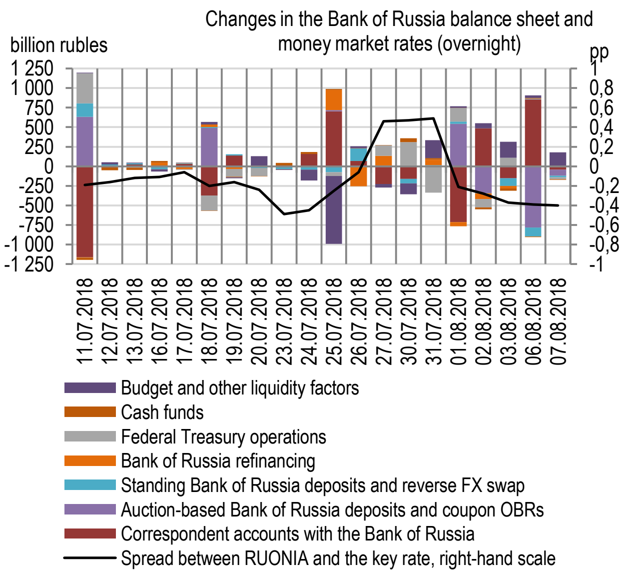
The spread between short-term rates in the interbank segment of the money market and the Bank of Russia key rate continued to shrink in the July averaging period (see Chart 2). For the lack of considerable liquidity inflow in June and July, banks were less uncertain about their future cash flows. This made the Bank of Russia's deposit auctions more attractive and, consequently, brought money market rates closer to the key rate. This suggests that the banking sector continues to adjust to a considerably increased structural surplus registered in the 2017-2018 period.

That said, the structural liquidity surplus will continue to increase in 2018. **However, the Bank of Russia revised its estimate for the end of 2018 downwards compared with the June commentary forecast (by 0.1 trillion rubles to 3.7-4.1 trillion rubles).** This is associated with the July decision to raise banks' required reserve ratios on FX liabilities by 1 pp for the purpose of further dedollarisation of bank balances.

Interest rate spreads in the FX swap and interbank segments narrowed in July. This was driven, among other things, by significant inflows of export revenues into Russian banks' accounts, amid a slightly decreased amount of FX purchases by the Ministry of Finance under the fiscal rule. In addition, some market participants reduced their demand for FX liquidity after the Ministry of Finance redeemed a large issue of eurobonds. The associated inflow of foreign currency allowed them to reduce dollar-denominated borrowings in the swap segment, leading to a somewhat narrower spread. The basis was also contracted by high tax payments which boosted demand for rubles in the swap segment. The increase in non-residents' long ruble positions registered in July failed to have a considerable effect on FX liquidity position.

Chart 1

Liquidity outflow after considerable tax payments boosted money market rates



Source: Bank of Russia calculations.

Table 1

In July 2018, the structural liquidity surplus shrank due to liquidity outflow through the budget channel

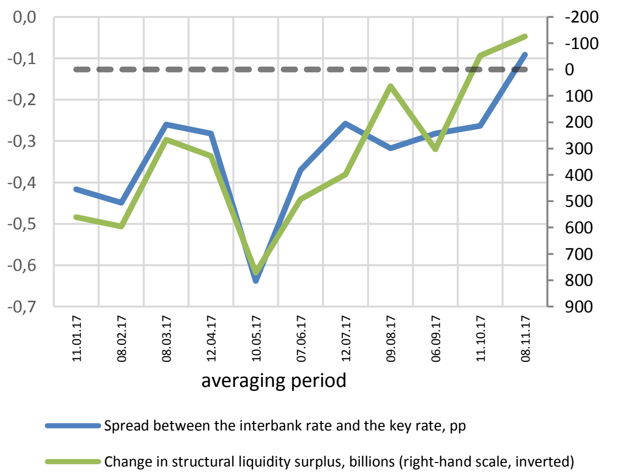
(trillion rubles)	July 2018	January-July 2018	2018 (forecast)
1. Liquidity factors *(supply)*	**-0.5**	**1.0**	**[1.7; 2.0]**
- changes in balances of general government accounts with the Bank of Russia, and other operations*	-0.5	0.8	[2.1; 2.3]
- change in cash in circulation	-0.1	-0.2	[-0.6; -0.5]
- Bank of Russia interventions in the domestic FX market and monetary gold purchases	0.0	0.3	0.3
- regulation of bank required reserves with the Bank of Russia	0.0	0.0	-0.1
2. Change in free bank reserves (correspondent accounts) *(demand)*	**-0.5**	**0.0**	**[0.3; 0.4]**
3. Change in banks' claims on deposits with the Bank of Russia and coupon OBRs	**0.1**	**1.1**	**[1.2; 1.8]**
4. Change in outstanding amount on Bank of Russia refinancing operations (4 = 2 + 3 – 1)	**0.2**	**0.2**	**[-0.1; 0.1]**
Structural liquidity deficit (+) / surplus (-) (as of the period-end)	**-3.4**		**[-4.1; -3.7]**

** Including the Ministry of Finance's operations to buy (sell) foreign currency in the domestic market, settlements on the Bank of Russia's sell/buy USD/RUB FX swaps, and other operations.*

Source: Bank of Russia calculations.

Chart 2

Lack of considerable inflows to the banking sector helps it adjust to increasing structural liquidity surplus



Source: Bank of Russia calculations.

Table 2

Market participants' expectations over the key rate remained virtually unchanged

1. Expectations based on market indicators* *interest rate (instrument)*	*October 2018*	*December 2018*
- MosPrime 3M (FRA)	7.34 (7.29)	7.39 (7.31)
- RUONIA (ROISfix)	7.01 (6.85)	6.97 (6.98)
- RUONIA (futures)	7.02 (7.03)	7.02 (7.02)
- RUONIA (OFZ-PK)		7.27 (7.22)
2. Analysts' expectations for the key rate*	*As of 25 October 2018*	*As of 31 December 2018*
- Bloomberg survey	7.25 (7.0)	7.25 (7.25)
- Reuters survey	7.25 (7.25)	7.25 (7.25)
3. Imputed inflation rate (OFZ-IN) *(until 16 August 2023)*		4.61 (4.53)

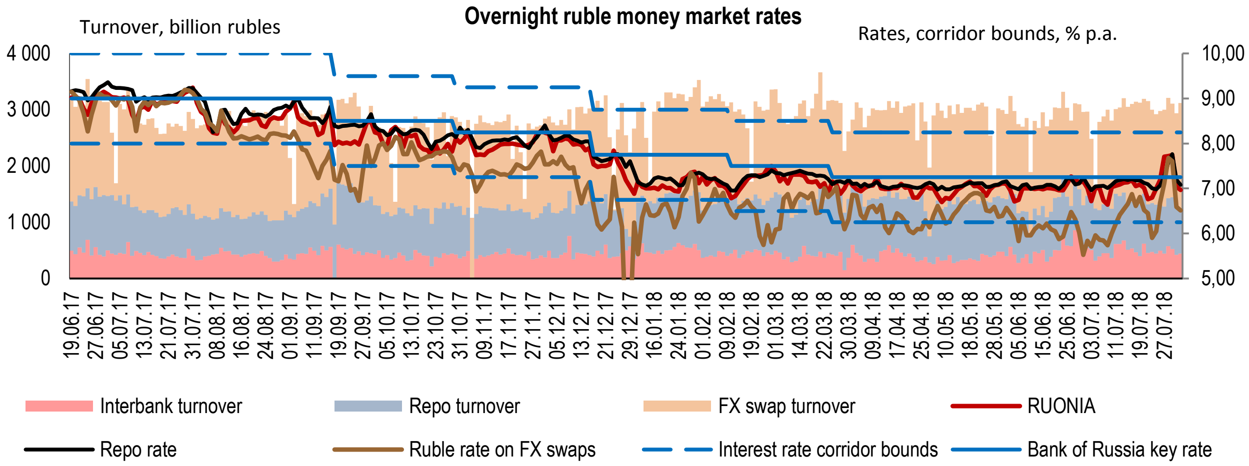
** Data as of the end of previous month are given in brackets.*

Source: Bank of Russia calculations.

Investors' expectations over the future path of the key rate remained unchanged in July. The market expected the Bank of Russia's decision to keep the key rate unchanged and did not respond with any considerable changes in financial instrument quotations. Inflation expectations followed a similar path (OFZ-IN), staying at the previous month's level.

Chart 3

In July 2018, the spread between overnight ruble rates in the interbank segment and the Bank of Russia key rate continued to narrow



Source: Bank of Russia calculations.

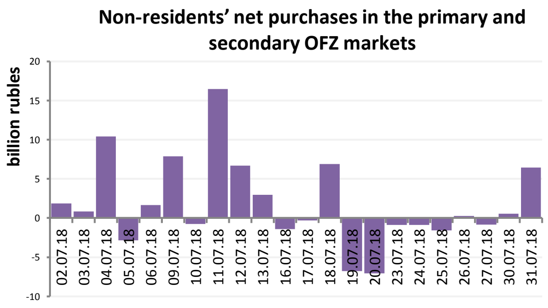
Foreign exchange and stock market

Russian foreign exchange and stock markets remained stable in July. Instrument prices in these segments changed insignificantly at month-end. However, there were both upside and downside movements in market conditions over the month. External factors determined the state of the Russian market.

The first half of the month mostly saw an increase in equity and bond prices and the ruble exchange rate. This was associated with the upcoming meeting of the Russian and US leaders which, as investors expected, would have improved the relations between the two countries and brought progress in the easing of sanctions against Russia. Foreign investors resumed active purchases of Russian sovereign bonds in that period. The stock exchange data suggest that the net inflow of non-residents' funds in OFZs totalled 44.6 billion rubles in the 1-13 July period. This caused the ruble to appreciate by 1-1.5%.

Chart 4

Non-residents actively bought OFZs in the run-up to the meeting of the Russian and US leaders



Source: Bank of Russia calculations.

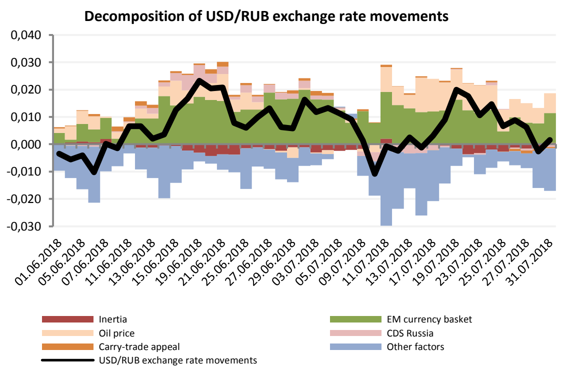
In the second half of the month, investor sentiment deteriorated as the news appeared that certain US senators proposed sanctions on Russia's sovereign debt. The news made some investors reduce their investments in OFZs. These developments, along with the drop in global oil prices in the first half of the month, weakened the ruble to the values registered early in the month.

The likelihood of tougher sanctions expanded Russia's CDS spread in the second half of the month by 10-15 bp, whereas the CDS in other emerging market economies (EMEs) largely declined. As a result, the spread between the average EMEs' CDS and Russia's CDS started to increase gradually, after shrinking to zero in the late June – early July period.

The period between late July and early August in the Russian market is a time dividend payments are made. This year's approved dividends exceeded the previous year's payments by roughly 30%. Large dividend payments may result in considerable movements in the value of the ruble. This is associated with the fact that some exporters sell foreign currency to fund dividend payment. Thereby, the ruble is strengthened. At the same time, a considerable share of Russian equity holders is foreign investors. The dividends they receive are converted into foreign currency, thus weakening the ruble. According to the Bank of Russia's estimates, these mutually offsetting effects and dividend payment have an overall neutral effect on the ruble. This means that after all payments and conversions are made, the ruble exchange rate remains at the same level (save for other shocks). At the same time, the decomposition of USD/RUB exchange rate movements in June and July shows several periods of the ruble's appreciation and depreciation which fundamental factors cannot explain (Chart 5, 'Other factors'). Some of them may be associated with dividend payments.

Chart 5

Dividend payments might affect the ruble exchange rate ('other factors')



Source: Bank of Russia calculations.

Credit and deposit market

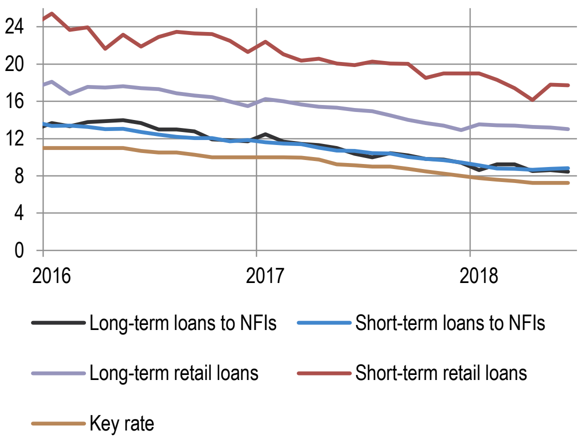
In the second quarter of 2018, short- and long-term rates on bank operations showed mixed dynamics. Between April and June 2018, interest rates on short-term loans rose somewhat: by 0.32 pp on retail loans and by 0.05 pp on corporate loans. That said, long-term rates continued to decline.

These dynamics of short-term interest rates are explained by a number of factors. First, the unstable external economic environment and the uncertainty over the effect of the VAT increase on inflation expectations made **the Bank of Russia revise the timeframes of the planned transition to neutral monetary policy.** Whereas the Bank of Russia supposed previously that monetary policy would take a neutral stance in 2018, with the balance of risks shifted towards proinflationary risks, the July meeting of the Bank of Russia Board of Directors considered that **the transition to neutral monetary policy was most likely in 2019.**

Chart 6

A slower transition to neutral monetary policy delayed loan rate reduction

Interest rates* on banks' credit operations and the key rate, % p.a.



Source: Bank of Russia calculations.

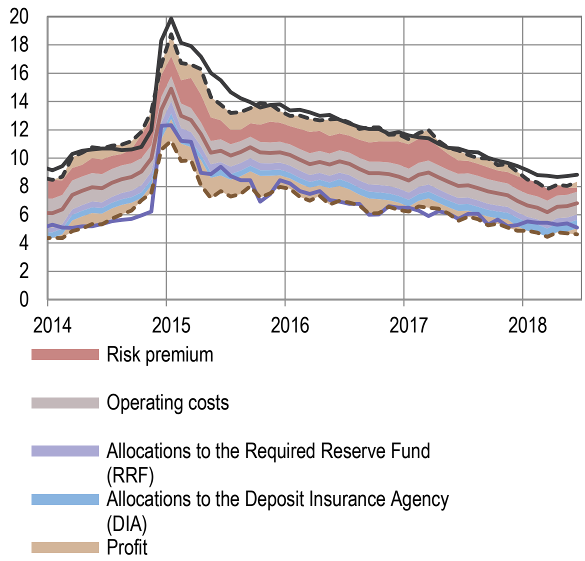
Second, **short-term rates on loans were also supported by banks' urge to keep their depositors without accumulating excessive expensive long-term liabilities.** This manifested itself in an upward shift in the short-term deposit rate and, consequently, the short-term lending rate, from the equilibrium determined by a transfer curve.

The decline in the long-term rates that continued into the second quarter of 2018 resulted from a slower response to the key rate cut and the remaining expectations of a complete transition to neutral monetary policy in the long term.

Chart 7

The limited potential of deposit rate cut contains the reduction of lending rates

Rates on bank operations for up to one year



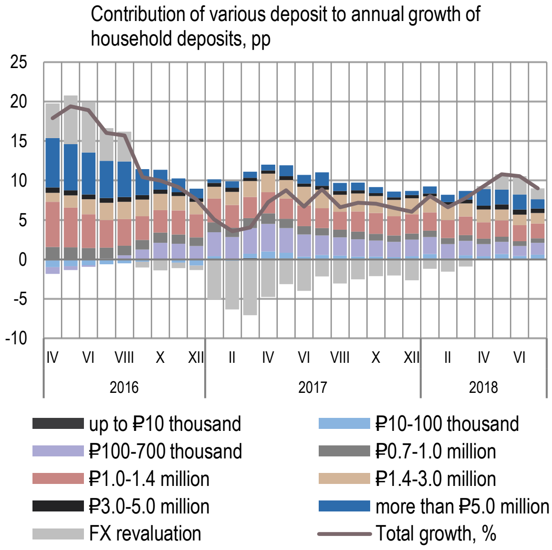
Source: Bank of Russia calculations.

With interest rates holding at the current level, deposits remain an attractive saving instrument. However, as consumption expanded amid the recovering economic activity, **growth in the deposit portfolio slowed smoothly. This suggests that households are gradually abandoning the saving behaviour model. The Bank of Russia estimates that these developments pose no considerable proinflationary risks.** As of the end of the second quarter of 2018, annual growth in the retail deposit portfolio (adjusted for FX revaluation) totalled 7.1%, slowing by 1.5 pp compared with the start of the year. **The slowdown of deposit growth was comparatively even in key segments of the deposit market.**

The expanding retail segment of the credit market is another indicator of a gradual change in households' behaviour. Mortgage lending expectedly remained the main lending driver. In the second quarter of 2018, mortgage lending continued to grow due to both the increase in the number of loans and the average loan amount. The mortgage market was supported by banks' persistently conservative approach, low credit risks in this market segment and interest rates which hit a new all-time low by the end of the second quarter of 2018 (the weighted average rate on the newly issued ruble mortgage loans stood at 9.48% p.a. this June).

Chart 8

Deposit portfolio growth slowed down



Source: Bank of Russia calculations.

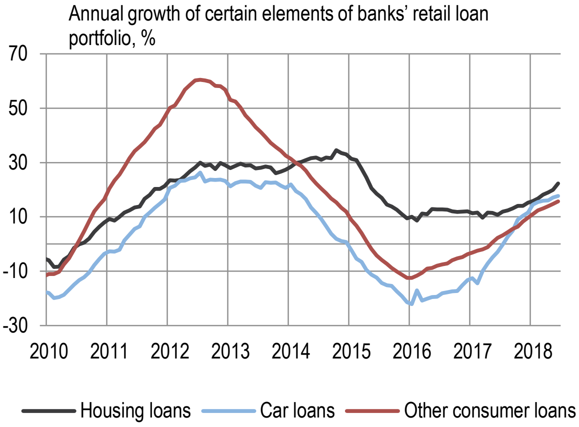
Unsecured consumer lending continued to expand in the second quarter of 2018 along with mortgage lending. This resulted not only from households' increasing propensity to consume but also from seasonal factors associated with long holidays in May and forthcoming summer vacations. As a result, annual growth of consumer loan portfolio totalled 17.0% as of 1 July 2018, falling behind the similar indicator in the mortgage lending market.

In the medium run, potential growth of consumer lending is limited due to its expanding replacement with mortgage lending (mortgage lending accounted for a half of the increase in the retail loan portfolio in the past six months) **and tighter regulation (effective since spring and to become effective in autumn[1])** of some categories of unsecured consumer loans.

Another process associated with gradually expanding consumption is a recovery in lending to wholesale and retail sellers, which started in the first half of this year. This trend also suggests a gradual recovery in lending to sectors most sensitive to changes in business environment.

Chart 9

Lending continues to expand across all types of retail lending



Source: Bank of Russia calculations.

Corporate lending demonstrated ongoing moderate growth in the second quarter. As of 1 July 2018, the increase in the portfolio of loans issued to resident companies totalled 5.2% in annual terms (adjusted for FX revaluation). The overall increase in corporate and retail lending registered in the second quarter was in line with the Bank of Russia forecast.

The lending dynamics in the retail segment came along with improved loan portfolio quality, including thanks to banks' balanced approach to selecting borrowers and their better payment discipline. As a result, the share of overdue loans shrank in the second quarter by 0.6 pp to 6.1% of the retail loan portfolio. Furthermore, **the value of overdue loans in the retail loan portfolio proved lower than in the corporate loan portfolio.**

The decline in the share of overdue loans in the portfolio of loans to non-financial organisations was contained by riskier lending to construction companies and wholesale and retail sellers, as well as 'technical growth' in overdue loans associated with asset reclassifications of banks under resolution.

Moderate growth in corporate lending also results from relatively tight non-price bank lending conditions continuing into the second quarter of 2018. These suggest that banks' balanced approach to selection of borrowers is expected to remain.

[1] The introduction of increased risk ratios on unsecured consumer loans depending on the total cost of credit issued after 1 May 2018 and after 1 September 2018.

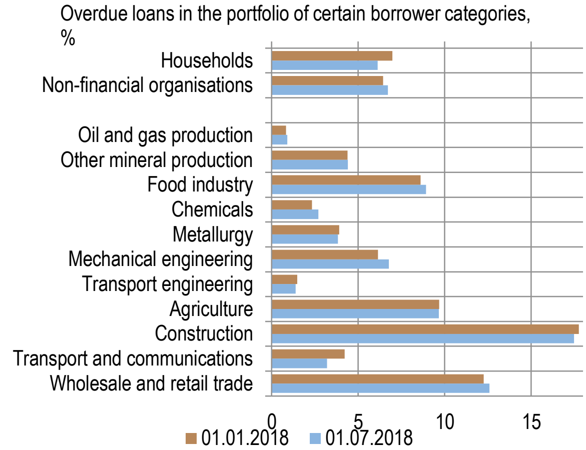
Therefore, **the easing of bank lending conditions** registered in the second quarter of 2018 for all categories of borrowers **was gradual and mainly driven by lowering interest rates.**

Against the backdrop of these dynamics of lending and interest rates, banks' net interest income continued to grow, and a fresh all-time high (799.6 billion rubles) was hit. At the same time, the 2018 Q2 financial result shrank somewhat mostly due to the increase in loan loss provisions in banks under financial resolution.

The trends registered in financial markets are overall in line with the Bank of Russia's forecasts and shape the conditions for inflation to settle close to the target level.

Chart 10

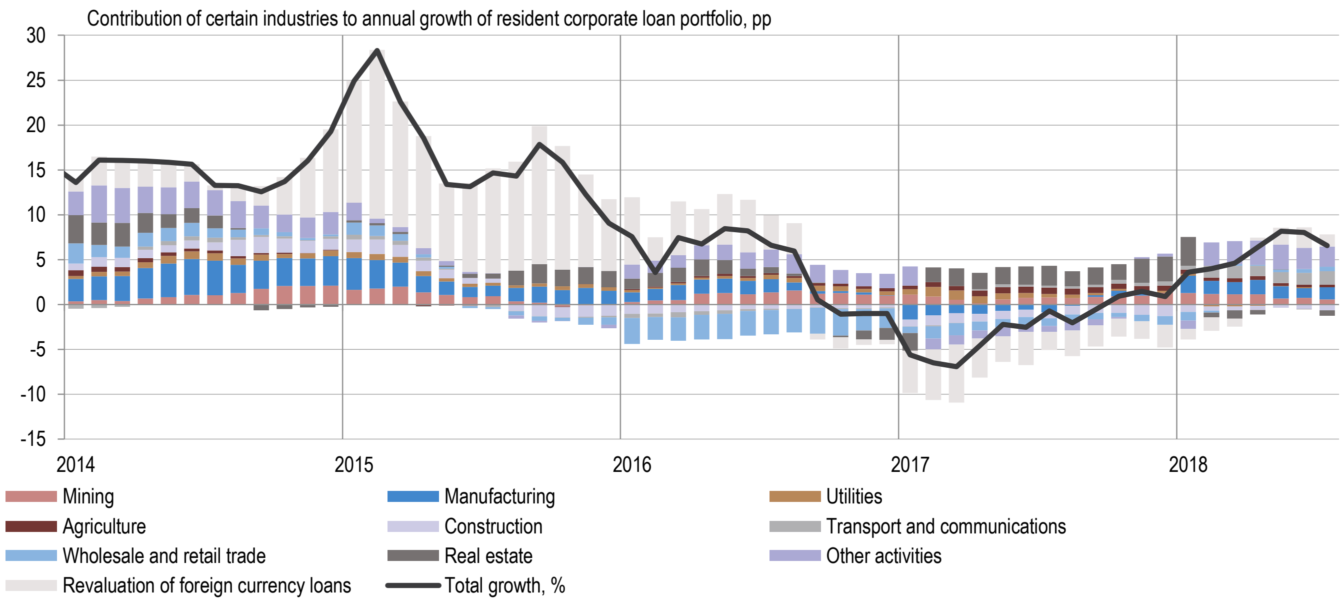
The quality of loan portfolios in certain market segments remains varied



Source: Bank of Russia calculations

Chart 11

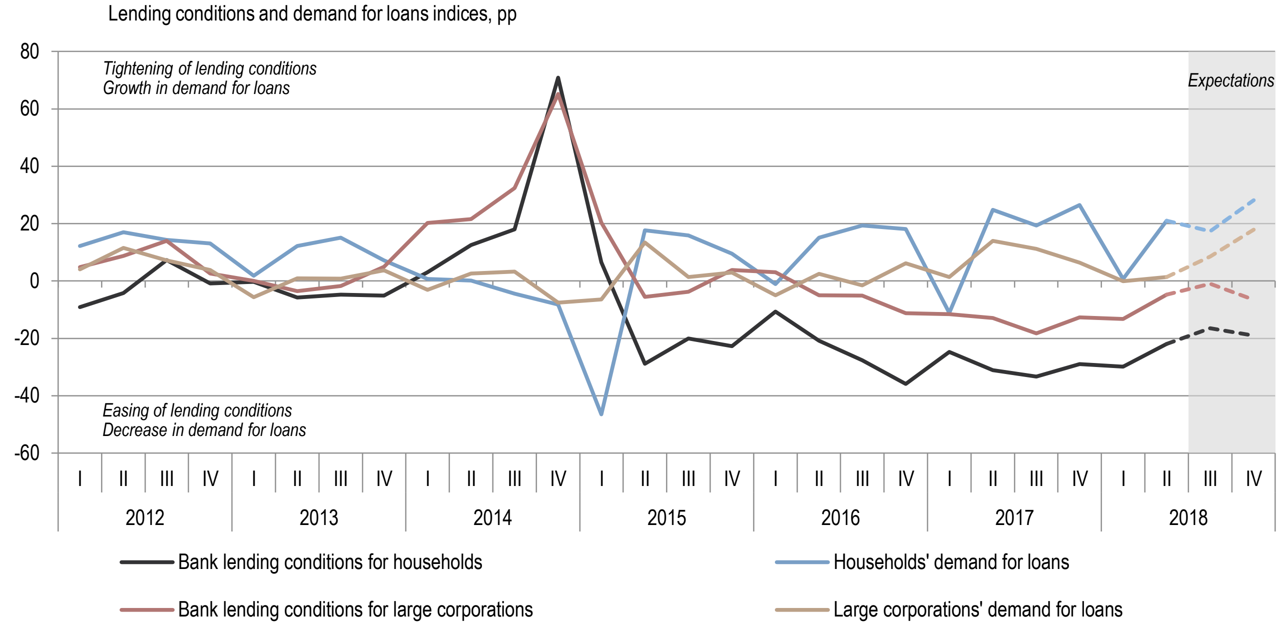
Lending activity demonstrates smooth growth



Source: Bank of Russia calculations.

Chart 12

The easing of bank lending conditions continues due to lowering interest rates



Source: Bank of Russia calculations.

Table 3

In July 2018, the banking sector's structural liquidity surplus decreased somewhat

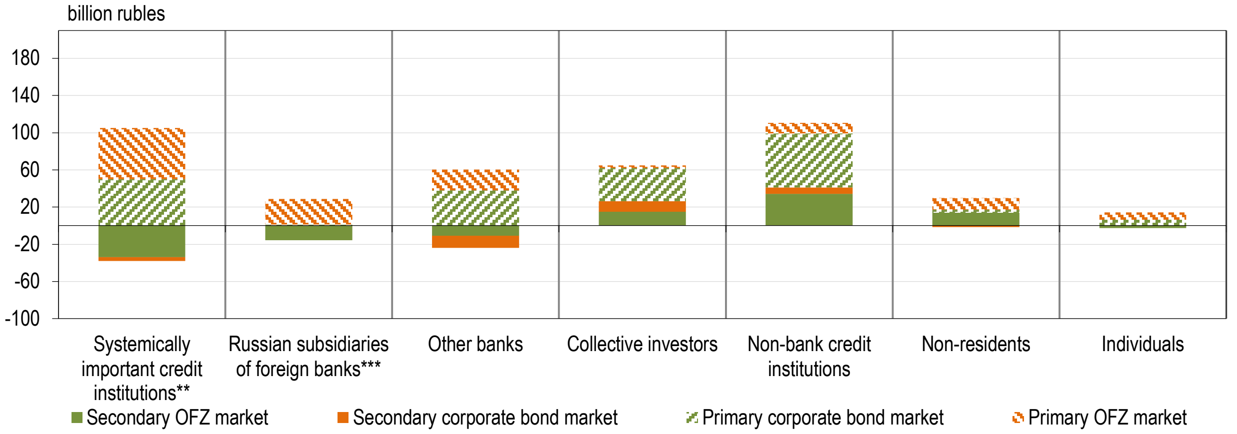
(opening, trillions of rubles)	1 August 2018	1 July 2018	1 January 2018
Structural liquidity deficit (+) / surplus (-)	**-3.4**	**-3.5**	**-2.6**
Bank of Russia standard monetary policy instruments			
Bank of Russia claims on credit institutions	**0.2**	**0.0**	**0.0**
• Auction-based facilities	**0.0**	**0.0**	**0.0**
- repo and FX swap	0.0	0.0	0.0
- secured loans	0.0	0.0	0.0
• Fixed interest rate facilities	**0.2**	**0.0**	**0.0**
- repo and FX swap	0.0	0.0	0.0
- secured loans	0.2	0.0	0.0
Credit institutions' claims on the Bank of Russia	**4.0**	**3.8**	**2.7**
• Deposits	**2.5**	**2.7**	**2.4**
- auction-based	2.2	2.4	2.1
- fixed interest rate	0.2	0.3	0.2
• Bank of Russia bonds	**1.5**	**1.1**	**0.4**
Standing reverse facilities other than the Bank of Russia's standard monetary policy instruments*			
• Net claims of credit institutions and the Bank of Russia	**0.3**	**0.3**	**0.1**

** These transactions include the Bank of Russia's special-purpose refinancing instruments, Bank of Russia loans issued under irrevocable credit lines, and USD/RUB and EUR/RUB sell/buy FX swaps.*

Source: Bank of Russia calculations.

Chart 13

Exchange data suggest that non-residents increased investments in OFZs due to large purchases at the beginning of the month*



** The chart shows bond purchases by different types of investors on the primary and secondary stock markets in July 2018. Data for the secondary market reflect net purchases (purchases net of sales).*
*** Systemically important credit institutions.*
**** Without systemically important banks.*
Sources: Moscow Exchange, Bank of Russia calculations.

Table 4

July saw no considerable movements in stock market quotes

Stock market indicators					
Segment	Indicator	As of 31 July 2018 COB*	Change**		Average 2017*
			month	monthly average	
Equity market	MICEX index	2321.1	1.1	1.9	2321.1
	RTS index	1173.1	1.6	1.9	1173.1
Bond market	OFZ	7.57	4.0	11.8	7.57
	Corporate bonds	7.83	15.0	17.8	7.83
	Regional bonds	7.65	12.0	20.7	7.65
Foreign market	Russia-43	5.11	-20.7	-33.8	5.11
	UST-10	2.96	10.0	-2.7	2.96
Risk appetite indicators	RVI	22.7	0.5	-0.5	22.7
	EMBI+ Russia	185.0	-31.0	-27.0	185.0
	EMBI+ EM	377.3	-30.3	-9.3	377.3
	CDS	131.6	-9.6	-7.7	131.6

** Points for equity and RVI indices, % p.a. for bonds, basis point (bp) for other indicators.*
*** In % p.a. for equity indices, points for RVI, and basis points (bp) for other indicators.*
Sources: Bloomberg, Moscow Exchange, Cbonds.ru, Bank of Russia calculations.