December 2012

Financial Stability Review

The Central Bank
of the Russian Federation
(Bank of Russia)

All statistical data and calculations in this Review are given as of October 1, 2012 if available as of December 1, 2012.

This Review is released in electronic form in PDF format in the Russian and English languages on the Bank of Russia's website in the Internet.

For notes, comments and proposals relating to the Review's structure and content, please contact the Bank of Russia via e-mail: Reports@cbr.ru.

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Address to the Readers

Dear readers,

We offer **a revised version of the Bank of Russia's Financial Stability Review** (hereinafter referred to as the Review). Similar reports on the problems of financial sustainability have become widely spread among central banks. Monetary authorities release a large number of publications (including annual reports, monetary policy reports, etc.), while **financial stability reviews have their specific features** as they focus on systemic risks, proposals on their regulation and mitigation and assessments of the financial system as an aggregate whole.

Following novations in the central banks' activities related both to the global reform of financial regulation and the growing importance of financial stability issues, the Bank of Russia is improving the format of its Review. It will now focus on current challenges and possible threats to stability rather than on the general state of the financial sector. We intend to make its structure flexible enough, and it will change depending on systemic risks profile. Such an assessment by the regulator, which possesses a wide range of information and is broadly knowledgeable about systemic risks in the banking sector and the financial system as a whole, will allow market participants to **better analyse their risks** and consequently will contribute to **financial stability**.

The Review will be published twice a year, based on the results of the first and third quarters (the Bank of Russia's Annual Report and Banking Supervision Report are published on an annual basis). The six-month periodicity will help both cover intra-year data and characterise medium-term trends, while the Bank of Russia's key reports generalise long-term trends in the Russian economy and banking sector.

In conclusion I would like to note that analysis of systemic risks, which is the Review's focus, corresponds to the legislative goals of Bank of Russia's activities: developing and strengthening the Russian banking system, and also protecting and ensuring stability of the rouble[1]. The disclosure of information on the assessment of current systemic risks will in our view help draw the attention of financial intermediaries and their customers to potential imbalances in the financial sector and prevent negative developments and threats through the provision of timely information to market participants.

Alexey V. Ulyukaev,

First Deputy Chairman of the Bank of Russia

[1] *Article 3 of Federal Law No. 86-FZ of July 10, 2002, "On the Central Bank of the Russian Federation (Bank of Russia)".*

Summary

Main Conclusions

The situation in the Russian financial system remains quite favourable today, which is facilitated by positive macroeconomic conditions, primarily, high oil prices (the price of Urals oil averaged $108.6 per barrel in the second-third quarters of 2012). At the same time, amid general slowdown in the global economy, Russia's GDP growth is decelerating (annual growth slowed from 4.9% in the first quarter to 4.0% in the second quarter of 2012, while a preliminary estimate for the third quarter is 2.9% according to Rosstat). Continued net private capital outflow ($23.3 billion in the second-third quarters of 2012) along with the current account surplus is creating conditions for stability of the national currency amid the scaling down of the Bank of Russia's interference in exchange rate-setting process.

In the second-third quarters of 2012, the balance sheet totals of financial institutions continued to increase. As of October 1, 2012, the banking sector, which accounts for over 90% of the financial system's assets, demonstrated high annual rates of growth in bank assets (19.3%), while their value reached 45.9 trillion roubles. Russian banks' profits hit a record high of 750.1 billion roubles as of the reporting date. Nevertheless, owing to structural reasons, the sustainability of Russian credit institutions is largely determined by the situation in the real sector of the economy, primarily, in mining. Banks remain exposed to risks from deterioration in external economic conditions, including the flare-up of the European crisis, a sharp slowdown of economic growth in major countries and a fall in energy prices.

Banking Sector Growing Demand for Refinancing

Credit institutions' debt to the Bank of Russia tended to grow in the second-third quarters of 2012. The credit institutions' increased demand for Bank of Russia's refinancing was due to the positive budget balance and, consequently, the placement of banking sector funds to general government accounts with the Bank of Russia. The growing volume of Bank of Russia's refinancing offsets the contraction of funds in banking sector correspondent accounts with the Bank of Russia occurring under the impact of autonomous banking liquidity factors.

In response to a growing demand for liquidity the Bank of Russia eased in the second quarter of 2012 the requirements for the list of securities accepted as collateral for repo transactions (hereinafter referred to as the List). Nevertheless, the market asset utilisation ratio in bank portfolios (the share of assets from the List[2] pledged in repo transactions with the Bank of Russia) increased from 26% as of April 1, 2012 to 42% as of October 1, 2012.

As of October 1, 2012, the share of Bank of Russia's funds in credit institutions' liabilities rose from 3.5% as of April 1, 2012 to 5.1%.

The potential volume of banking sector refinancing against market assets stood at about 3.5-3.9 trillion roubles as of October 1, 2012. At the same time, banks that lack sufficient market collateral for required funding operations have a possibility to obtain loans from the Bank of Russia against the pledge of credit institutions' non-market assets and guarantees.

Further extension of the list of securities accepted as collateral for repo operations and Bank of Russia Lombard loans is limited because the List already covers almost three fourths of the volume of securities available on bank balance sheets. At the same time, it is necessary to take into account the fact that an

[2] *The volume of available collateral is calculated only for credit institutions, which held repo transactions with the Bank of Russia in the reporting period.*

increase in securities issuance in the fourth quarter of 2012 and in 2013 will facilitate possibilities for the List extension.

Decrease in Bank Capital Adequacy

Russian banking sector total capital adequacy steadily tended to decline in the reporting period. As of October 1, 2012, the annual growth of banking sector capital slowed from 16.2% as of April 1, 2012 to 15.5%. The growth in the capital of five banks accounted for a considerable share of banking sector capital growth (35.3%).

The slowdown in the growth of banking sector capital was attributed to supplementary provisions for loan impairment, losses from the negative revaluation of foreign currency-denominated assets, current-year losses and dividend payments. In recent years, banks have been increasing the volume of payouts to owners: about one-fifth of banking sector profits (over a fourth of profits of Russia's largest banks) was channeled into dividend payments in 2011. This dividend payout ratio is more typical of developed countries where the growth of bank assets is considerably slower.

As bank capital grew slowly, the total banking sector capital adequacy level fell from 14.7% as of April 1, 2012 to 13.1% as of October 1, 2012. The current bank capital adequacy level looks acceptable so far: according to estimates as of the end of September, the minimum capital adequacy ratio allowing banks to cover potential losses in 1% of extreme events ranges from 12 to 12.7%. These estimates relate to the banking sector as a whole. Modelling results indicate that in order to keep the required level of their sustainability, some banks must take measures to maintain the capital adequacy ratio at higher levels.

Outpacing Growth of Consumer Lending

Faster growth in lending to individuals continued in the second-third quarters of 2012: the annual growth of household debt to the banking sector reached 41.7% as of October 1, 2012 and almost approached the pre-crisis level, while the debt of non-financial organisations to banks grew by 16.9%.

To some extent, this rapid growth in consumer lending is seen as offsetting weak lending dynamics during the crisis and in the subsequent few years. The ratio of household debt on bank loans to annual money income is still considerably lower in Russia (23.0% as of October 1, 2012) than in developed countries (98.4% in the eurozone). Steady growth in consumer and mortgage lending requires the corresponding growth of household money income that allows for the acceptable level of the debt burden. However, already today the ratio of household loan repayments and incomes in Russia (19.9% as of October 1, 2012) is higher than in many developed countries, which is explained by shorter lending terms and higher interest rates. The share of overdue loans remains stable and is even decreasing slightly, which is largely explained by a rapid growth of the loan portfolio. Nevertheless, in this situation the regulator is required to pay close attention to risks of credit institutions specialising in consumer lending. These banks normally finance their lending operations through funds taken on household deposits. At the same time, the high cost of consumer lending allows banks to set high interest rates on individual deposits, which in turn affects the deposit competitiveness of banks specialising in lending to the real sector of the economy.

1. Global Economic and World Financial Risks

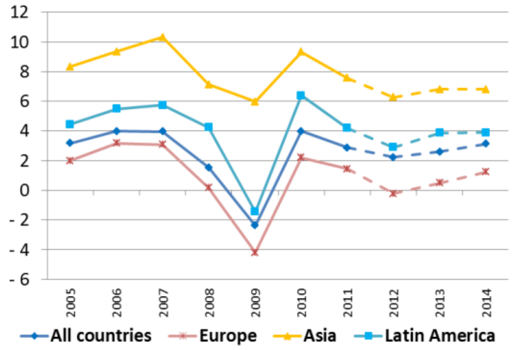
1.1. Risks and Economic Prospects in Leading Countries

World financial markets remained highly unstable in the second-third quarters of 2012 due to both economic and political risks. Amid the global economic slowdown, the eurozone governments and leading central banks are taking stimulus measures to support economic growth and fight the debt crisis, while international organisations are working out measures to strengthen the financial system (See Box 1 “Major International Initiatives in Macroprudential Policies”). However, the complex process of decision-making and problems accompanying their implementation are reducing investor risk appetite, thus keeping investments in “safe haven” assets at a high level.

Macroeconomic statistics and consensus forecasts of GDP growth published by international economic organisations and leading analytical agencies indicate the slowing of world economic growth in 2012 and a weak recovery in the subsequent two years (Chart 1). The situation is especially alarming in the European region, in particular, in problem eurozone countries where recession is accompanied by the need to carry out budget consolidation programmes.

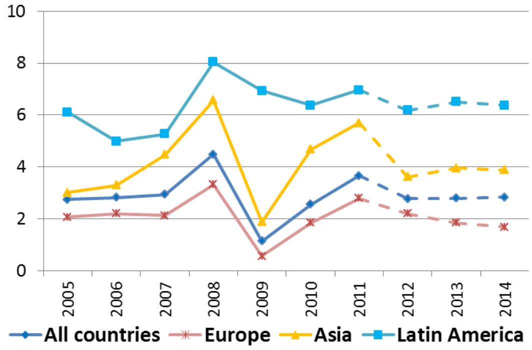
Weaker global production and consumer activities slowed the growth of prices on commodity markets in the second quarter of 2012, while stock market indices have tended to rise since the start of the year. A consensus forecast on slower inflation (Chart 2) creates conditions for central banks to ease their monetary policies and implement other measures to stimulate economic growth.

Chart 1. GDP Growth
(annual %, consensus forecast from 2012)



Source: Bloomberg.

Chart 2. Inflation Growth
(annual %, consensus forecast from 2012)



Source: Bloomberg.

The US Federal Reserve has implemented large-scale stimulus measures to boost employment: in July, the Fed extended its Operation Twist[3] programme to late 2012 and in September it launched the third round of quantitative easing[4] and also extended the period of keeping interest rates near zero to mid-2015. Despite the overall positive economic effect from these measures, they may exert upward pressure on inflation. Fiscal tightening may become a considerable obstacle for the US economy’s recovery in the near future. Tax hikes and budget spending cuts totalling about $600 billion will automatically take effect from January 2013, unless the US Congress reaches a compromise on an alternative decision. In this connection, the

[3] *Operation Twist implies extending the maturity of the Federal Reserve’s portfolio by selling shorter-term securities and buying assets with longer maturities to reduce long-term interest rates in the US economy.*

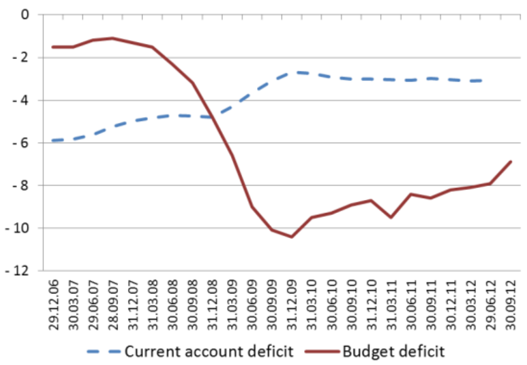
[4] *The programme envisages $40 billion monthly mortgage bond purchases.*

problem of the twin deficit (the budget deficit and current account deficit – Chart 3) may exacerbate in the US.

In addition, the Bank of England and the Bank of Japan have repeatedly announced further expansion of their asset purchase programmes this year. In Japan, this move was prompted by the need to restrain the exchange rate of the Japanese yen to the US dollar (Chart 4). The risks of lower export competitiveness due to the US dollar's depreciation in the wake of new rounds of US monetary stimulus are also typical for many developing countries.

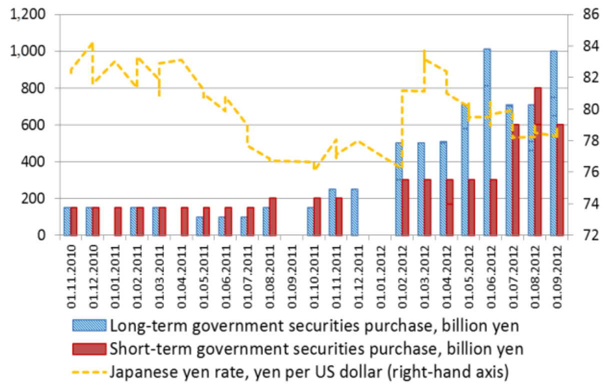
The lowering of key rates in the most rapidly growing economies (China, India and Brazil) is quite indicative of ongoing economic problems. Although the deterioration of some macroeconomic indicators in China has become a major factor of slower global economic growth (China's annual GDP growth decelerated from 11.9 to 7.4% and its annual export growth from 48 to 11.6% between mid-2010 and the third quarter of 2012), the situation in the country is manageable and is unlikely to create unfavourable shocks for the global economy.

Chart 3. US Budget and Current Account Deficit (% of GDP)



Source: Bloomberg.

Chart 4. Bank of Japan's Government Securities Purchase and Japanese Yen Rate



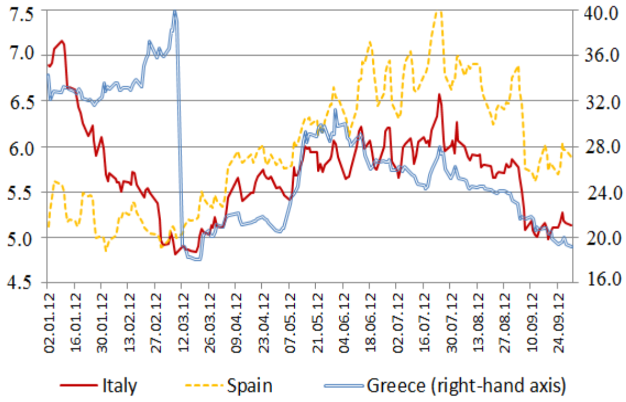
Source: Bloomberg.

Risks related to the eurozone sovereign debt crisis remain high. The restructuring of Greece's debt in March 2012 had a positive effect on the cost of sovereign borrowings but political disagreements resolved with difficulty in subsequent months and the complexities of implementing the Greek budget consolidation programme caused yields on Greek bonds to continue rising until June (Chart 5).

The situation is also deteriorating in eurozone large problem countries, particularly, in Spain. The country is confronted with recession, the growth of unemployment and budget deficit and problems in the banking sector. Spanish banks have increased their debts to the Eurosystem by seven times over the past year (as of August 1, 2012), after which the share of the central bank's funds in their liabilities rose to 11%. Budget consolidation policy in these conditions is a hardly realisable task, which may intensify the debt crisis rather than settle the existing problems. In this situation, the ECB took an important decision in September 2012 to launch outright monetary transactions of purchases on the secondary market to buy the bonds of eurozone countries applying for financial assistance. For the purchases of sovereign bonds on the primary market, the funds of the European Stability Mechanism are intended to be used. This decision, backed by Germany, eased the tension on sovereign bond markets.

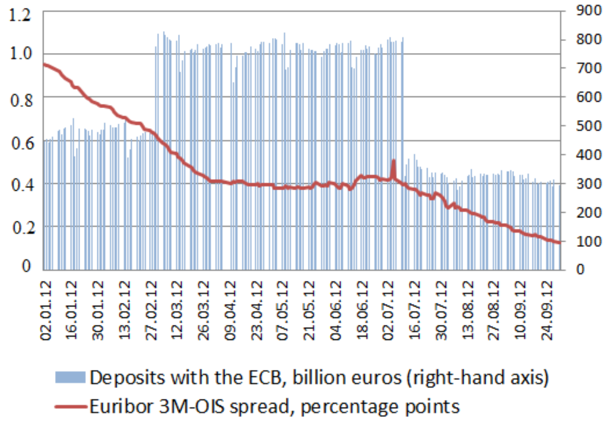
The tension on the European interbank loan market has also eased in the past few months under the impact of the ECB's decision to cut interest rates to an all-time low of 0.75% on lending and 0% on deposit operations (Chart 6). Now the creation of the European banking union is viewed as the most important condition to stabilise the region's banking sector. At their summit on October 18-19, the EU member states agreed to approve by January 1, 2013 the required legal framework for creating the Single Supervisory Mechanism, in which the ECB will play a central role.

Chart 5. 10-year Government Bond Yields of Certain Problem Eurozone Countries (%)



Source: Reuters Datastream.

Chart 6. Euribor 3M-OIS Spread and Value of Funds Deposited by European Banks with ECB



Sources: ECB, Bloomberg.

Box 1. Major International Initiatives in Macroprudential Policies

The 2008 financial crisis has revealed the need to enhance the macroprudential focus of regulatory approaches to financial institutions. The key areas of reform are regulation, supervision and financial recovery of systemically important financial institutions[5] designed to raise their sustainability and minimise the risk of using public funds for their rescue.

In November 2011, the Basel Committee on Banking Supervision (BCBS) published the methods of identifying global systemically important banks (hereinafter referred to as global banks) and defined the first list of 29 global banks. By today, crisis management groups have been set up for virtually all global banks to include representatives of supervisory authorities from banks' basic host countries and also financial recovery and restructuring measures are being discussed. Supervisory authorities are to sign cooperation agreements and develop operational insolvency resolution plans for 29 global banks by mid-2013. On November 1, 2012, an updated list of 28 global banks was released to exclude three banks from the previous list and add two new ones. Specific deadlines for the planning of financial recovery and restructuring measures have been set for the banks on the updated list, which range from six months to two years, depending on various aspects. From 2016, increased capital requirements will apply for global banks defined in 2014 (a capital adequacy surcharge of 1%-2.5%). Currently, the Bank of Russia is drafting methodological recommendations for credit institutions to develop their own recovery plans.

The Financial Stability Board (FSB) has carried out work jointly with the BCBS to adapt approaches to identifying and regulating global banks to national systemically important banks (hereinafter referred to as national banks) and after public discussions published in September 2012 the guidelines of regulating national banks' activities. National regulators have been recommended to elaborate and approve the methods of assessing the systemic importance of banks, envisage the public disclosure of their main approaches and define specifics of supervision of national banks. As compared with global banks, international standards do not set any minimum capital adequacy surcharge for national banks and its determination is the competence of national regulatory authorities.

On November 1, 2012, the FSB published its third report on progress in the work to increase the intensity and efficiency of supervision of all systemically important financial institutions. It contains additional recommendations on supervisory powers, regulatory requirements for internal risk management systems of these institutions, corporate governance and internal controls. As part of supervision of national systemically important banks, the Bank of Russia has started to study the quality of corporate governance at major Russian credit institutions, their risk management systems and also the practices of bonus payments, taking into account international recommendations.

In April 2012, the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions published Principles for Financial Market Infrastructures, stipulating a list of standards aimed at increasing their resilience to crisis developments on the market, in particular, to defaults by financial market participants. The Bank of Russia plans to take these Principles into account in its assessments of the quality of risk management at credit institutions performing the functions of a central counterparty.

In compliance with the recommendations of G20 leaders, in 2012 the FSB carried out a research into the parallel banking sector[6] of a wide group of countries. The FSB also worked out recommendations for the regulation of its segments (money market funds, securitisation, repo transactions and securities lending).

[5] *Systemically important financial institutions are financial institutions characterised by large volumes and the complexity of their operations, systemic interrelationship and the difficulty of their substitution.*
[6] *The parallel banking sector is a system of loan intermediation involving organisations and spheres of activity outside the perimeter of the regulated banking system.*

1.2. Possible Crisis Transmission Channels in the Russian Financial System

The Russian economy is quite strongly exposed to the risk of impact from the global economic slowdown, exacerbation of the sovereign debt crisis and increased instability on world financial markets. Owing to the specifics of the Russian economic structure and a high share of oil and gas revenues in overall export revenues, a fall in energy prices, capital outflow amid non-residents' large presence on the equities market and, as a result, the weakening of the country's balance of payments are the major factors that can cause deterioration in the Russian financial sector.

After the crisis of 2008-2009, Russia is registering steady net private capital outflow. In the first quarter of 2012, net private capital outflow remained high ($34.6 billion), while in the second quarter of the year it dropped to $9.7 billion but still remained substantial. Estimates show that net private capital outflow will amount to $13.6 billion in the third quarter of 2012. Capital export by international and Russian investors may intensify, if crisis trends further develop in the global economy and investors reduce their risk appetite.

However, the scenario of a large-scale shock similar to the 2008 developments is hardly probable owing to the fact that leading central banks are continuing their stimulus policies, large foreign banks have increased their capital levels, while regulators and supervisory authorities are better informed of relationships between financial market participants. However, if an unfavourable event occurred (for example, a sharp deterioration of the eurozone sovereign debt crisis), the Russian financial system would be confronted with a number of negative short-term and medium-term consequences.

In the shot term, the following negative consequences could be expected:

1) The rouble's depreciation is likely to increase the demand for foreign currency amid economic agents' devaluation expectations.
2) The expectations of the rouble's depreciation may provoke non-residents to close their positions and exit from the Russian financial market, which would trigger mass sell-offs of financial assets.
3) Mass sell-offs of financial assets would cause downward stock market index dynamics and, as a result, negative revaluations of market participants' securities portfolios.
4) Depreciation of securities portfolios would increase tension on the money market and most likely entail interest rate growth.
5) Restricted access to liquidity may prompt European banks to expand the volumes of funding from Russian subsidiary banks in the short-term.
6) The growing tension on the world market is likely to increase the risks of Russian banks related to their foreign debt refinancing[7].
7) Considering that the non-financial sector has built up external borrowings in recent years, restricted access to foreign markets would increase their demand for Russian banks' lending and, consequently, limit access for small and medium-sized businesses to bank loans on the domestic market.
8) It is not ruled out that Russia could see some outflow of individual funds from bank deposits (as the minimum deposit insurance compensation has been increased, the scope of this process is likely to

[7] *The current situation with the Russian banking sector foreign debt does not pose a serious threat to financial stability (see Box 2 "Banking Sector Foreign Debt").*

be smaller than during the last crisis when the maximum contraction of household deposits totalled 8%).

9) The outflow of individual funds from bank deposits could be accompanied by the conversion of a part of rouble deposits into foreign currency ones, which would increase the share of foreign currency deposits in the total value of banking sector funds borrowed from individuals.

10) Difficulties may emerge with the substitution of funding raised by banks through the issuance of securities (as of October 1, 2012, the value of bonds due for redemption this year totalled 61.9 billion roubles, while the value of claims that may be presented through offer redemption options by the end of the year amounts to 186.3 billion roubles).

In the medium-term, the growth of credit risks in the banking sector may prompt losses related to the deterioration of loan quality and the increase in the number of borrower defaults. In particular, the growth of unemployment and the loss of part of household income may increase the share of household overdue loans. Should the share of problem and bad loans increase in the overall volume of loans from the current level (6.5% as of October 1, 2012) to the maximum level registered in Russia during the crisis of 2008-2009 (9.5%), further provisions for possible losses on these loans may reach 903.1 billion roubles (16.5% of the banking sector capita). In addition, the banking sector may be affected by the deterioration of the macroeconomic situation, the fall of the GDP growth rates and the increase of the budget deficit.

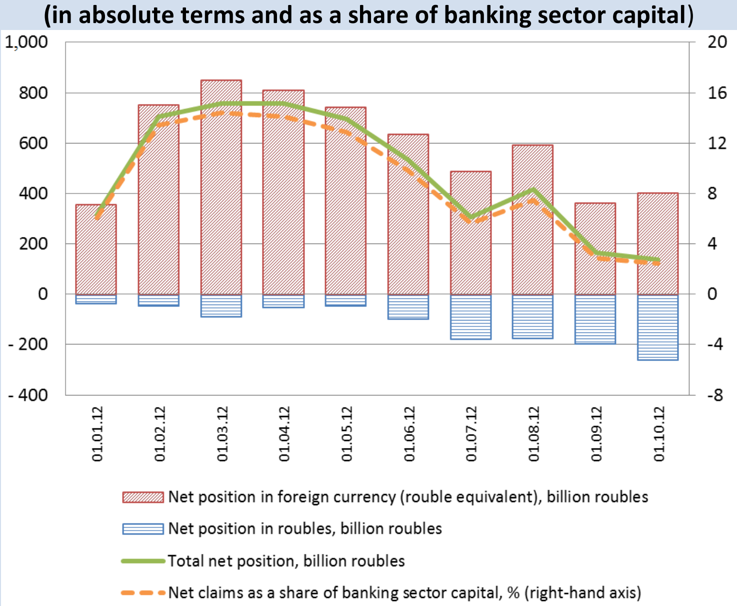
Box 2. Banking Sector Foreign Debt

In the second-third quarters of 2012, the volume of funds raised by Russian banks and non-financial companies from foreign creditors through syndicated loans and the issuance of Eurobonds contracted by $1 billion compared to the same period of 2011. According to data provided by Cbonds news agency, the volume of syndicated loans raised by banks in the second-third quarters of 2012 totalled $3 billion ($9.3 billion in the same period of 2011). At the same time, the volume of Eurobonds placed in this period amounted to $5.3 billion, whereas in the same period of 2011 there were no Eurobond placements. Bank external debt increased by 9.4% to $185.2 billion in the second-third quarters of 2012 as compared with a 5.5% growth in the same period of 2011. For comparison: the debt of non-financial enterprises grew by 2.9% to $358.4 billion as against 4.0% in the same period of 2011.

The volume of pending debt repayments by banks in the fourth quarter of 2012 ($12.7 billion) and in 2013 ($31 billion) is smaller than in previous periods. Overall, the situation with the Russian banking sector foreign debt does not pose a serious threat to financial stability also due to the fact that banks remain net creditors of non-residents. At the same time, Russian banks' claims on non-residents are normally short-term (maturities for up to six months accounted for 51% of the volume of claims as of October 1, 2012), while their liabilities are long-term (82% of liabilities with maturities of over six months).

In the second-third quarters of 2012, the Russian banking sector claims on non-residents grew by 3.4% in rouble equivalent (from 5.0 trillion roubles to 5.1 trillion roubles), with rouble-denominated claims on non-residents declining by 2.3% and foreign currency claims growing by 4.7%. Russian banks' obligations to non-residents in rouble equivalent increased by 18.7% over this period (from 4.2 trillion roubles to 5.0 trillion roubles). The narrowing difference between claims and obligations reduced the Russian banks' total net position on non-residents to 2.5% both in absolute terms and as a share of banking sector capital (Chart 7).

Chart 7. Russian Banks' Net Claims (Liabilities are Subtracted from Claims) on Non-residents (in absolute terms and as a share of banking sector capital)



2. Financial Stability of the Real Sector of the Economy

2.1. Macroeconomic Risks

The annual GDP growth started to decelerate in the second-third quarters of 2012. In the third quarter, Russia's GDP grew by an estimated 2.9%, according to Rosstat, after its growth by 4.0% in the second quarter and by 4.9% in the first quarter.

The slower annual GDP growth can be explained by the loss of a part of the harvest due to the drought (agricultural output fell by an annualised 5.4% in the third quarter of 2012), and also by the fall of investment demand (output in the construction sector declined by an annualised 2.7% in the third quarter). The base effect also played a considerable role in the slowdown of economic activity as compared with the previous year. In the second half of last year, Russia registered a record high harvest, and also a sharp acceleration of investment by the fuel and energy sector. As compared with this period, economic performance indicators in the second half of 2012 begin to turn negative.

According to Bank of Russia estimates, the domestic output of goods and services was close to its potential (natural) level in the third quarter of 2012. This result was obtained using of the HP-filter. The absence of excessive demand in the economy is also evidenced by the dynamics of non-food prices, excluding petrol prices (least of all exposed to the influence of volatile and administrative factors), which registered a lower growth.

The Russian economy's 2012 growth may be slightly slower as compared with 2011 (the IMF expects Russia's GDP to grow by 3.7% in 2012 as against 4.3% in 2011) and the medium-term growth rates are expected to remain at this level. Internal development factors will play an increasingly important role in this process. In particular, investment activity is expected to increase. According to Rosstat estimates, annual fixed capital investment increased by 7.2% in the first-third quarters of 2012 as compared with 5.0% over the same period of 2011.

2.2. Enterprises' Financial Standing[8]

The financial standing of enterprises was satisfactory in general in the first half of 2012, although less favourable as compared with the same period of 2011. At the same time, enterprises' financial standing differed substantially both by sector and the size of their assets. The most favourable financial situation with enterprises was registered in industrial production and the most complex in construction and transport. In the first half of 2012, the standing of Russia's largest enterprises[9] remained quite stable, while that of other enterprises was to a considerable extent complicated by the shortage of funds.

The improvement of the business climate (Chart 8) and the economic situation (Chart 9) in the first half of 2012 allowed enterprises to increase their assets (104.3%), with 73% of them operating at a profit. However, asset growth resulting from activity expansion was slower than in the first half of 2011 (107.3%). This was largely explained by the fact that production tended to grow due to the demand for output and services on the domestic market, while orders on the foreign market were observed to decrease. In addition, the improvement of the economic situation in the second quarter of 2012 was weaker than in the second quarter of 2011.

[8] An enterprise (a non-financial organization) represents a legal entity or its subdivision which is registered at the territory of the Russian Federation, conducts business (ecocnomic) activity and belongs to the non-financial sector of the Russian economy. Analysis is based on the data obtained by the Bank of Russia from the monitoring of enterprises in 79 Russian regions. As of August 30, 2012, the monitoring covered 8,527 enterprises in 79 regions.

[9] Enterprises with assets of over 1 billion roubles.

Chart 8. Business Climate Indicator (BCI)[10] in 2011-2012

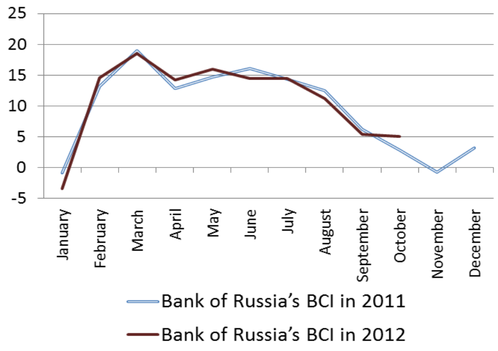
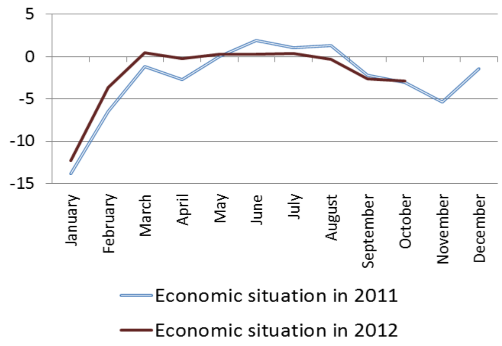


Chart 9. Economic Situation[11] in 2011-2012



The enterprises' profitability fell to 3.9% in the first half of 2012 from 6.3% in the same period of 2011 under the impact of slowing sales growth, and also due to the deterioration of financial performance largely affecting the largest enterprises.

Enterprises' capital increased by 1.8% in the first half of 2012 as against 8.7% in the first half of 2011. The slower growth resulted from the deterioration of financial results and the low level of net profit reinvestment.

The faster growth in liabilities (109%) did not lead to any significant increase in the debt burden[12], which measured 0.57 roubles of liabilities per rouble of capital for Russia's largest enterprises, 1.8 roubles for large and medium-sized enterprises and 1.55 roubles for small businesses as of July 1, 2012.

Revenues received by enterprises in the first half of 2012 covered 75.9% of the average accumulated volume of liabilities, the highest level for this period. The insufficient level of revenues earned by enterprises in agriculture and construction to cover their liabilities was to a certain extent due to the seasonally low production activity in the first quarter.

The coverage of current (short-term) liabilities with working assets[13], which generate cash flows to enterprises in subsequent periods, remained full as of July 1, 2012, with sufficient excess, despite the downward trend. Communications and construction companies were the sole exception (Table 1).

Current liabilities were fully covered by cash, money equivalents and monetary claims (receivables and short-term financial investment)[14] mainly at Russia's largest enterprises. Other enterprises had the ability to cover their current liabilities with these types of assets by 55-63%; moreover, the volume of their cash and monetary claims was smaller than the size of short-term payables, which suggested the need of these entities for additional funds to repay their liabilities.

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[10] *The Bank of Russia's Business Climate Indicator is a composite index which reflects actual and expected changes in production and demand determined by the assessments of enterprises (15,500 entities) covered by the Bank of Russia's monitoring. The index is based on the business climate index methodology of the IFO Institute for Economic Research (Germany).*

[11] *The indicator reflects a balance of answers to the question: "How has the economic situation changed in the sector as compared with the previous month?" The positive value reflects the prevalence of the answers "the situation has improved".*

[12] *The ratio of long-term and short-term liabilities to enterprises' capital.*

[13] *Current liquidity ratio.*

[14] *Instant liquidity ratio.*

Construction companies were in the most difficult position. With their high debt burden, these companies have insufficient coverage for their obligations and quite a low reserve of available assets from the standpoint of their ability to immediately repay their liabilities[15]. The position of transport and communications companies was complicated by the unsatisfactory capital structure because the volume of investment resources (capital and long-term liabilities) was insufficient for creating investment (non-working) assets. As a result, these companies were likely to use their short-term borrowings as non-working placements, thus increasing the risk of failure to make timely repayments.

Table 1. Financial Indicators of Enterprises in Key Types of Activity in the First Half of 2012

	Agriculture, hunting and forestry	Industrial production	Construction	Wholesale and retail trade	Transport	Communications
Debt burden (liabilities to capital ratio)	1.19	0.55	4.22	2.49	0.31	1.39
Current liquidity ratio (net of overdue receivables)	1.79	1.85	1.10	1.25	0.95	0.60
Instant liquidity ratio	0.64	1.27	0.639	1.03	0.611	0.428
Absolute liquidity ratio	0.08	0.14	0.06	0.10	0.14	0.13
Liability coverage with revenues (revenues as % of liabilities)	48.8	79.8	42.5	166.9	78.7	56.8
Return on assets (%)	35	4.4	1.3	3.6	1.8	7.6
Net cash flow (as % of revenues)	1.4	0.6	-7.9	-2.2	-12.6	1.0

The volume of enterprises' cash flow in the first half of 2012 was insufficient for spending despite their profitable operations, which caused them to cut their expenses by 10.6%[16]. The cash flow deficit[17] amounted to 7.1% of expenditure volume, except for enterprises in the industrial, agricultural and communications sectors where the cash flow shortage was normally typical of small and medium-sized businesses amid net cash inflows into enterprises as a whole. The cash flow deficit was prompted by enterprises' considerable current and investment expenditures amid expanding output and increasing investment activity in the first half of 2012.

The contraction of money stock amid the growth of liabilities caused some decrease in enterprises' solvency, which, nevertheless, remained at an acceptable level as a whole. As of July 1, 2012, enterprises had the ability to immediately repay 12.5% of their short-term liabilities with available funds as compared with 15.6% as of January 1, 2012. Naturally, enterprises continued their borrowing practices, including raising funds from credit institutions.

The enterprises' expectations of changes in the economic situation in the subsequent months of 2012 largely related to the improvement of their financial standing and growth of the demand for banking services. The predictive estimates of changes in the economic situation, provision of enterprises with orders and production dynamics do not suggest any substantial deterioration and correspond to the yearly trend. Despite a probable improvement in the cash flow situation, enterprises remain exposed to serious liquidity risks. Considering the expected growth of the demand for banking services, closer attention will have to be paid to credit risk.

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[15] *The ability to immediately repay current liabilities with the stock of available assets is reflected by the absolute liquidity ratio.*

[16] *The balance sheet item "Cash and Money Equivalents".*

[17] *The ratio of net outflow and spending.*

2.3. Bank Loan Portfolio by Sector

Enterprises in the manufacturing sector and wholesale and retail sale companies remain the banking sector main borrowers. As of October 1, 2012, loans to enterprises in these sectors of the economy made up 37.5% of the bank loan portfolio, with the share of these loans slightly increasing as compared with the same period of the previous year (36.9%).

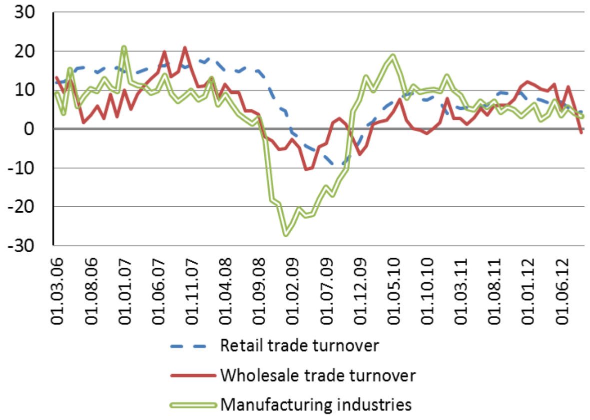
Chart 10. Portfolio of Bank Loans to Enterprises in Roubles and Foreign Currency (as of start of the month, as % of total)

Output at enterprises in the manufacturing industries continues to slow down. In the second and third quarters of 2012, production at these enterprises grew by an annualised 4.7 and 4.5% respectively as compared with 5.8% and 5.7% in the same periods of the previous year.

It should be noted that the steepest production decline in the crisis of 2008-2009 was typical of manufacturing enterprises (the largest contraction of 27.1% on an annual basis was registered in January 2009).

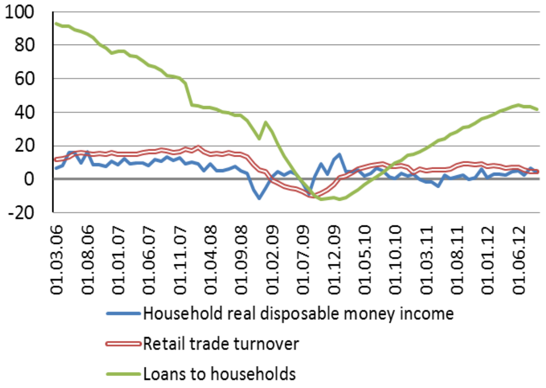
The average annual growth of retail trade turnover was slightly slower in the second-third quarters of 2012 (5.8%) as compared with the same periods of the previous year (6.8%). Positive dynamics of bank lending to individuals and household real disposable money income, and also a record low unemployment rate are the factors that support retail trade and, consequently, the financial standing of retail trade enterprises. The moderately steady growth of these indicators is the basis of the stable financial standing of retail trade enterprises.

Chart 11. Trade Turnover and Manufacturing Output (as % of corresponding period of previous year)



Source: Rosstat.

Chart 12. Household Purchasing Power and Retail Trade Turnover (as % of corresponding period of previous year)



Sources: Rosstat, the Bank of Russia.

The share of mining enterprises in the bank loan portfolio is traditionally small and is lower than the share of mining in gross value added (10% in 2011). This can be explained by the fact that mining companies are frequently part of large holding companies, which can raise cheaper loans from foreign banks and float bonds on financial markets. At the same time, this sector exerts large influence on the business of Russian banks because it largely determines the situation in other sectors of the economy. In particular, it creates considerable demand for the output of manufacturing industries. Tax receipts from mining companies make up a considerable part of federal budget revenues (in particular, oil and gas export revenues accounted for 50.6% of federal budget revenues in January-August 2012).

In addition, large mining and manufacturing enterprises are shareholders of a number of banks. Given the unfavourable economic situation, the position of shareholders themselves may be decisive when they take decisions on financial support.

The volume of loans extended to small and medium-sized enterprises (hereinafter referred to as SME) totalled 3,476.2 billion roubles in April-September 2012, or 23% of the total amount of loans provided to corporate entities and individual entrepreneurs. Of this amount, 333 billion roubles, or 2.2% of the total volume of loans extended to corporate entities and individual enterprises were loans granted to individual entrepreneurs. Loans extended to the SME by Russia's top thirty banks[18] made up 16% of the total volume of loans, which they provided to corporate entities and individual entrepreneurs.

[18] *Here and below, a list of Russia's 30 largest banks corresponds to the list given in the Bank of Russia's website as of the reporting date.*

3. Assessment of Banking Sector Systemic Risks

3.1. General Trends: Asset Growth, Change in the Balance-sheet Structure

Banking sector total assets grew by 10.4% in the second-third quarters of 2012 to 45.9 trillion roubles. The annual asset growth amounted to 19.3% as of October 1, 2012 as compared with 21.2% in the previous year. Taking into consideration the current trend, the annual growth in banking sector assets may fall far below 20% in the fourth quarter of 2012 and in the first quarter of 2013.

The annual growth in the assets of Russia's 30 largest banks decelerated from 24.3% as of April 1, 2012 to 20.4% as of October 1, 2012 and approximately matches the average growth rate in the banking sector as a whole.

The bank resource base did not undergo any radical changes in the second-third quarters of 2012. As the volume of corporate deposits and other funds attracted from corporate entities (except for credit institutions) grew faster (19.7%) than the volume of household deposits (9.0%), the structure of funds raised by banks slightly changed as compared with the previous six-month period. Funds raised from organisations (except for credit institutions) accounted for 19.4% of bank liabilities as of October 1, 2012 as against 17.9% as of April 1, 2012, while the share of household deposits made up 28.5% as compared with 29.0% as of April 1, 2012.

Funds raised in foreign currency demonstrated faster growth than rouble-denominated resources. Deposits and other funds attracted from corporate entities (except for credit institutions) in foreign currency grew by 27.2% in the second-third quarters of 2012, while household foreign currency deposits rose by 12.0%.

Credit institutions' borrowings from the Bank of Russia demonstrated faster growth in the second-third quarters of 2012 (+60.0% over the six-month period) than the credit institutions' other major items of capital raising. Banking sector debt to the Bank of Russia totalled 2,350.6 billion roubles as of October 1, 2012, after reaching a historic high of 2,576.9 billion roubles on August 1, 2012. The share of Bank of Russia funds in the structure of banking sector liabilities increased from 3.5% as of April 1, 2012 to 5.1% as of October 1, 2012. The share of interbank loans in bank liabilities slightly decreased, from 9.9% as of April 1, 2012 to 9.4% as of October 1, 2012. A considerable role in the expansion of the bank resource base was played by budget funds deposited with banks, which reached 514.9 billion rubles as of October 1, 2012. The growth rate over the reporting period reached 106.2% due to the low base effect.

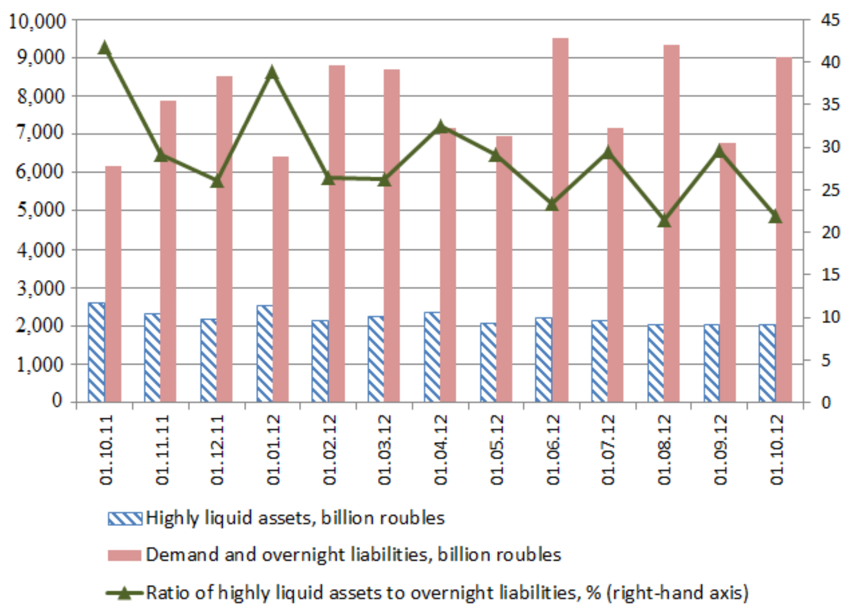
Slower increase in banking sector assets was due to the decelerating growth of lending to non-financial institutions. The average annual growth in lending to non-financial organisations totalled 24.1% in the fourth quarter of 2011 and the first quarter of 2012, whereas in the second-third quarters of 2012 this growth decelerated to 22.4%. As the household loan portfolio demonstrated high average annual growth rates in the second-third quarters of 2012 (42.9%), its share in bank assets increased from 14.2% as of April 1, 2012 to 15.6% as of October 1, 2012. Investment in securities grew by 4.9% in the second-third quarters of 2012. Therefore, the structure of bank assets changed in favour of the retail market in the second-third quarters of 2012.

3.2. Banking Sector Growing Demand for Refinancing

In the second-third quarters of 2012, banks demonstrated growing demand for Bank of Russia refinancing instruments. The excess of budget receipts over budget expenditures was the main factor of liquidity withdrawal from the banking sector. This factor, along with the decrease in federal budget free funds to zero with credit institutions by early June 2012, led to the growth of banking sector debt to the Bank of Russia.

The ratio of highly liquid assets to demand and overnight liabilities[19] demonstrates a downward trend (Chart 13).

Chart 13. Ratio of Highly Liquid Assets to Demand and Overnight Liabilities

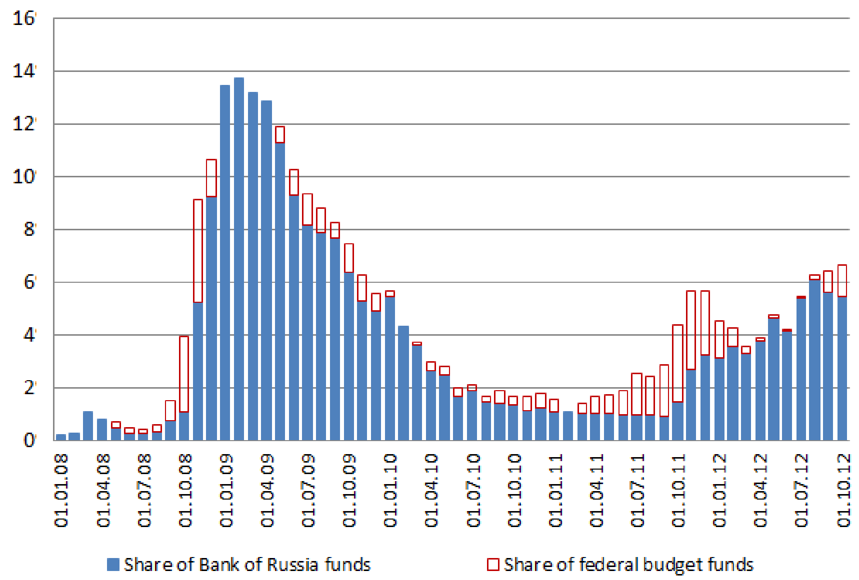


Bank of Russia Growing Share in Bank Liabilities

The steady trend of the increasing share of Bank of Russia funds in banking sector liabilities has been observed since September 2011. This share grew from 0.9% on September 1, 2011 to 6.1% on August 1, 2012 and reached its highest level for the past two years (Chart 14). In the last two months of the third quarter, the share of Bank of Russia funds in bank liabilities slightly decreased (to 5.1% as of October 1, 2012) largely due to the resumed practice of placing federal budget free funds with credit institutions.

[19] *For the purpose of this calculation, highly liquid assets comprise cash, precious metals, correspondent accounts with the Bank of Russia and funds in the accounts of the settlement centre for the organised securities market, demand and overnight deposits with the Bank of Russia, and also government bonds. The data on demand and overnight liabilities are based on reporting form No. 0409125 "Information on Assets and Liabilities by Terms of Demand and Maturity".*

Chart 14. Share of Bank of Russia and Federal Budget Funds in Bank Liabilities (%)



However, the level registered as of August 1, 2012 (1.5%) is considerably lower than in the period of 2008-2009 when the share of Bank of Russia funds in banking sector liabilities was close to 14%.

Risks Associated with Maturity Mismatch between Bank Assets and Liabilities

The problem of the maturity gap between assets and liabilities arises when a bank funds long-term active operations with short-term resources. This practice generates an interest rate risk, when new loans may be obtained at higher interest rates, and also a refinancing risk.

The practice of raising funds from the Bank of Russia mainly involves the interest rate risk. The refinancing risk is considerably less typical of Bank of Russia operations as compared with market obligations when a bank can hardly predict whether its creditor will prolong the loan agreement or forecast the volume of bonds investors may submit to exercise their early repayment options. A bank willing to get refinancing may take part in Bank of Russia repo auctions or resort to fixed-term standing facility operations. The only restricting factor is that credit institutions must comply with certain criteria (in particular, credit institutions must have eligibility status at least matching the 2nd qualification group to obtain secured loans from the Bank and Russia and demonstrate the absence of any shortfall in payments to required reserves) and in case of a considerable deterioration in banks' financial standing their access to Bank of Russia loans may be lost. In addition, in the event of a serious shock on the stock market and a plunge in the cost of collateral, banks may fail to offer sufficient security for debt refinancing in full. However, these developments at the systemic level are possible only under an extremely tight scenario which is unlikely. Currently, 88% of credit institutions, which account for 97% of banking sector assets, have a possibility to get refinancing from the Bank of Russia.

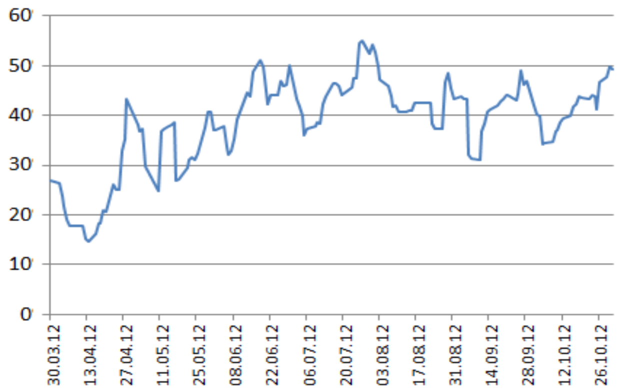
Risks Associated with Excessive Growth of Encumbered Assets and Collateral Deficit

Refinancing from the Bank of Russia increases the level of encumbrance on credit institutions' assets used as collateral (pledge) in their refinancing operations with the Bank of Russia.

Banks use three groups of assets to obtain funds from the Bank of Russia: market assets in the form of securities, non-market assets in the form of credits and other claims on non-bank borrowers and also interbank guarantees.

As of October 1, 2012, the volume of collateral, which banks may use for refinancing from the Bank of Russia against market assets, was estimated at 3.5-3.9 trillion roubles[20] (taking into account discounts on repo transactions and correction factors for Bank of Russia loans). The market asset utilisation ratio[21] reached 42% as of October 1, 2012 as compared with 26% as of April 1, 2012 (Chart 15). At the end of July 2012, the market asset utilisation ratio hit a record high of 55%, while its subsequent decrease was due to the placement of federal budget free funds with credit institutions.

Chart 15. Market Asset Utilisation Ratio (%)



Since October 2011, the Bank of Russia has been holding weekly polls of the treasuries of Russia's 30 largest banks[22] to gather information on their expected liquidity flows and possibilities to raise funds on the market and from the Bank of Russia. In the second-third quarters of 2012, the volume of assets accepted as collateral by the Bank of Russia changed insignificantly in this group of banks. The potential of refinancing against market assets remained virtually at the same level, while the potential for refinancing against non-market assets and guarantees grew by about 250 billion roubles. As a result, the market asset utilisation ratio of polled banks increased considerably from April 1, 2012 to September 28, 2012 (from 33 to 50%), reaching the highest level in early August 2012 (over 60%). The utilisation ratio of non-market assets changed insignificantly (30% as of April 1, 2012 and 28% as of October 1, 2012).

[20] The lower limit corresponds to the collateral of banks participating in repo operations with the Bank of Russia, while the upper limit indicates the collateral available to all credit institutions.

[21] The market asset utilisation ratio was calculated for banks, which participated in repo operations with the Bank of Russia in the second-third quarters of 2012. The utilisation ratio is calculated as a percentage of encumbered assets to the overall volume of assets accepted as collateral in Bank of Russia operations. The Bank of Russia calculates two market collateral utilisation ratios: one for largest banks based on polling data and the other for the banking sector as a whole based on bank statements.

[22] From September 2012, the list of polled banks also includes 10 most active credit institutions on the money market outside the group of top thirty banks.

The potential of banking sector refinancing totalled no less than 5.7 trillion roubles[23] as of October 1, 2012. Russian credit institutions utilised less than half of the total amount of assets available for raising funds from the Bank of Russia, which allows the regulator to further expand banking sector refinancing.

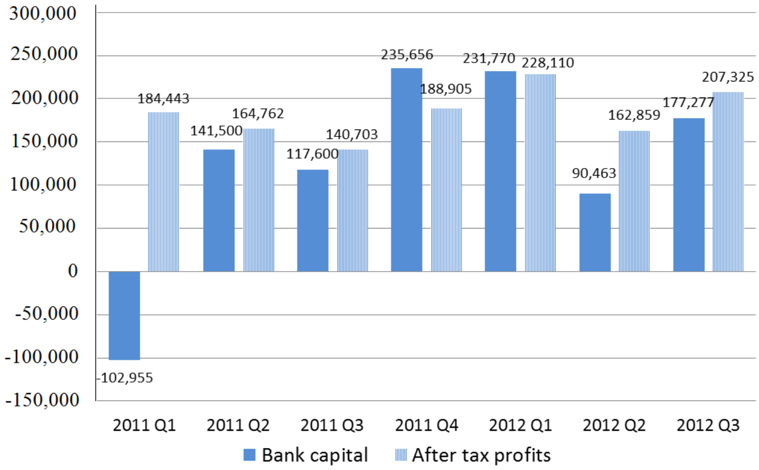
Therefore, despite high collateral utilisation ratios demonstrated by some banks, the risks of the excessive growth of asset encumbrance and the collateral deficit currently look insignificant for the banking sector as a whole.

In case of further growth in the demand for refinancing and the emergence of collateral shortage in repo transactions with the Bank of Russia, banks may use other sources of rouble liquidity: refinancing against non-market assets and guarantees and currency swap operations with the Bank of Russia. The potential increase in the volume of federal budget free funds deposited with credit institutions may become an additional liquidity source.

3.3. Decrease in Bank Capital Adequacy

As of October 1, 2012, banking sector capital reached 5.6 trillion roubles. The annual capital growth slowed from 16.2% as of April 1, 2012 to 15.5% as of October 1, 2012 and was far behind the increase in banking sector assets.

Chart 16. Bank Capital and Profit Change (million roubles)



The structure of banking sector capital changed insignificantly in the second-third quarters of 2012. As before, the larger part of bank capital was formed through reinvested profits (43.7% as of October 1, 2012)[24]. Core capital accounted for about 70% of banking sector capital.

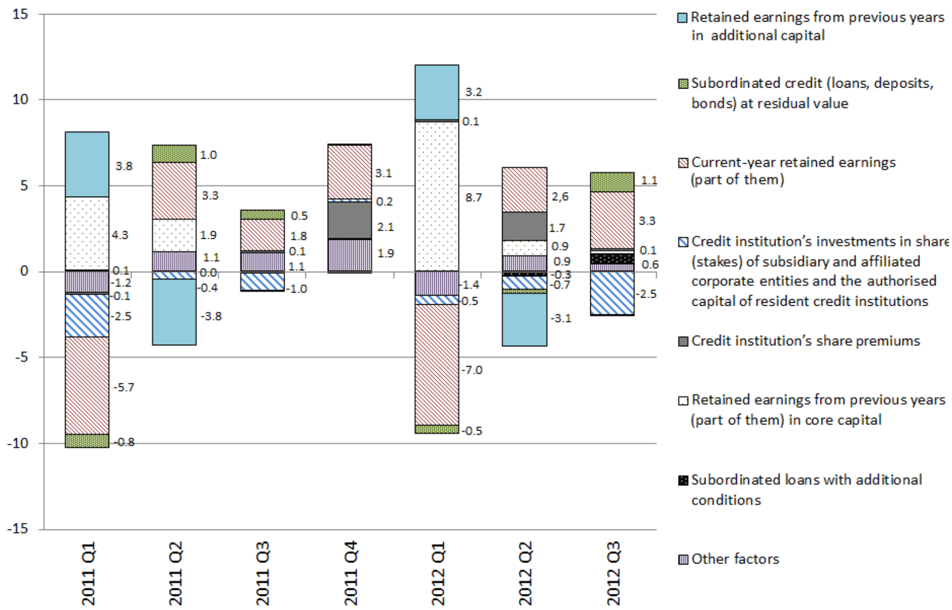
Five banks made the main contribution to the increase in banking sector capital in the second-third quarters of 2012: these banks' capital grew by a total of 130 billion roubles (by 21% in the second-third quarters of 2012), contributing 35.3% to banking sector capital growth.

The decrease in banking sector capital was largely due to the creation of supplementary loan provisions, losses from negative revaluations of foreign currency-denominated assets, current-year losses and dividend payments.

[23]*This figure excludes the volume of possible refinancing for banks outside the polled selection against non-market assets and guarantees.*

[24] *For more details on reinvested profits, see Box 3 "Profit Reinvestment in the Banking Sector".*

Chart 17. Banking Sector Capital Growth (% over period)



Credit institutions' capital dynamics in the third quarter of 2012 were influenced by retained earnings of the current year and previous years, and also by subordinated loans (Chart 17). In the absence of new issues of equity instruments, the role of share premiums in capital growth decreased.

As of October 1, 2012, the volume of subordinated instruments (loans and deposits) registered in additional capital was estimated at 1.2 trillion roubles at their residual value (60.3% of banking sector additional capital). In addition, the volume of subordinated instruments with additional conditions included in core capital totalled 43.2 billion roubles in September 2012 (1.2% of banking sector core capital). The share of subordinated instruments in capital was virtually unchanged in the second-third quarters of 2012 and stood at 21.7%.

The Basel III [25] rules envisage a phased-out exclusion of subordinated instruments from the calculation of credit institutions' capital beginning with January 1, 2013. The par value of each instrument as of January 1, 2013 will be accepted as the basis for such exclusion. Beginning with January 1, 2013, additional capital sources will be capped at 90% of their nominal amount, with the cap for subordinated instruments included in capital decreasing by 10% of their nominal value with each subsequent year.

As part of its work to implement new international requirements for capital, the Bank of Russia has drafted documents on the transition of Russian banks to capital and capital adequacy calculations in compliance with Basel III. The new requirements are expected to come into force from April 1, 2013, while the process of derecognising ineligible capital instruments will start from May 1, 2013. Initial calculations will be made solely for analytical purposes, while credit institutions' capital and capital adequacy will be used for prudential supervision beginning with bank reports as of October 1, 2013.

[25] *Basel III: A global regulatory framework for more resilient banks and banking systems // Basel Committee on Banking Supervision. December 2010 (revised June 2011). P. 28-29.*

Box 3. Profit Reinvestment in the Banking Sector

Retained earnings of previous years traditionally dominate banking sector capital growth, forming part of additional and core capital. In recent years, banks have been channelling substantial amounts of after-tax profits into payments to their owners.

Analysis of profit distribution based on the Russian Accounting Principles indicates that dividends accrued from 2011 profits made up 26.6% of profits remaining at banks' disposal (it was only during the first year of the crisis that banks pursued more restrained dividend policies, when the ratio of accrued dividends to reinvested profits was 8.9% in 2008 (Table 2). This level, in general, corresponds to the practice of dividend payments by banks in developed countries. In emerging market economies, the ratio of dividend payments is normally lower and averages 7.0% in India's banking sector, for example.

In the group of 15 selected banks, which belong to the list of Russia's 30 largest banks and do not pay interim dividends, the ratio of dividends paid in 2011 to the after-tax profit for 2010[26] equalled 27.1%.

Table 2. Dividends and Reinvested Profits

Indicator	2008	2009	2010	2011
Dividends accrued for reporting year, billion roubles	38.2	46.1	125.0	137.3
Reinvested profit of reporting period, billion roubles	429.7	212.9	508.7	515.3
Accrued dividends to reinvested profits of reporting period, %	8.9	21.7	24.6	26.6

Note:

Dividends for 2011 were calculated as the amount of dividends accrued in 2012 (the sum of credit turnovers, item 60320 "Dividend Settlements with Shareholders (Participants)" of reporting form No. 0409101 for the period from January 1, 2012 to October 1, 2012), plus interim dividends accrued in 2011 from the 2011 profits (item 32001 "Dividend Distribution among Shareholders (Participants)" of form No. 0409102 as of January 1, 2012), minus interim dividends accrued in 2012 from the 2012 profits (item 32001 "Dividend Distribution among Shareholders (Participants)" of form No. 0409102 as of October 1, 2012).

Reinvested profits of the reporting year are the sum of credit turnovers under item 10801 "Retained Earnings" based on the data of reporting form No. 0409101 for the period from January 1, 2012 to October 1, 2012.

In the second-third quarters of 2012, the banking sector capital adequacy ratio[27] continued to decrease and currently stands at the minimum level since the late 1990s. As of October 1, 2012, bank capital adequacy stood at 13.1% as compared with 14.7% as of April 1, 2012. The number of banks with capital adequacy of 15-16% shrank considerably (the share of these banks' assets in banking sector total assets was less than 1% as of October 1, 2012 as compared with 30% as of April 1, 2012), while the number of banks with capital adequacy of 11-13%, on the contrary, rose substantially (the share of their assets in bank total assets grew from 43% as of April 1, 2012 to about 70% as of October 1, 2012) (Chart 18).

The average capital adequacy ratio in the group of Russia's 30 largest banks decreased from 13.3 to 12.4% (Chart 19).

[26] *The amount of dividends declared and paid out by banks during the year was determined using the data of IFRS-compiled statements; after-tax profit is indicated in annual reporting form No. 0409807 "Profit and Loss Account (Published Form)".*

[27] *In terms of capital adequacy, the Russian banking sector is close to developed countries (see Box 4 "Capital Adequacy Comparisons for Different Countries").*

Chart 18. Density of Bank Distribution by Capital Adequacy, Share of Banking Group's Assets in Total Assets of Operating Banks (%)

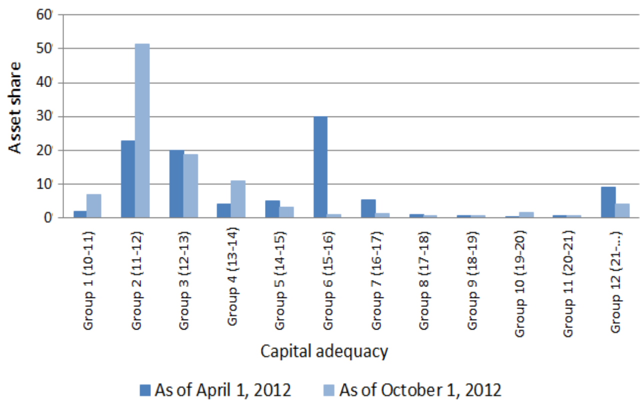
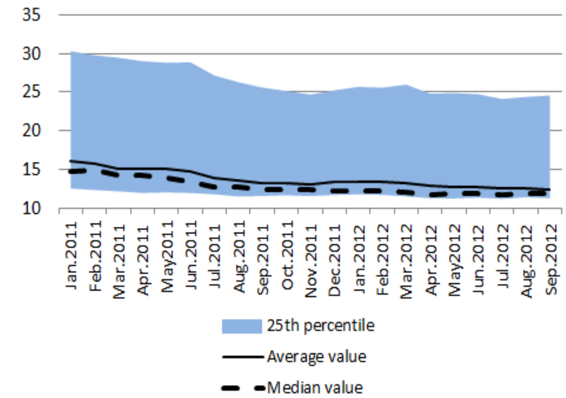


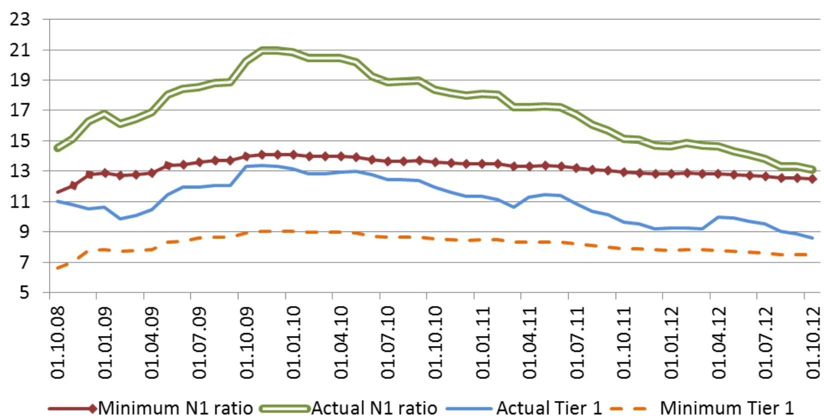
Chart 19. Capital Adequacy Ratio of Top 30 Banks (%)



Factor analysis of capital adequacy helps determine factors that exert influence on this indicator. In the second-third quarters of 2012, the extent of asset risk tended to decrease gradually. However, the slowing of capital growth velocity amid a rapid increase in assets was more considerable and continued the downward trend in capital adequacy.

An estimate made as of October 1, 2012 shows that the minimum calculated value of banking sector economic capital[28] adequacy allowing banks to cover potential losses in 1% of extreme events[29] should range from 12.0 to 12.7% (the actual capital adequacy level is equal to 13.1%), while core capital adequacy should vary between 7.0 and 7.7% (the actual core capital ratio equals 8.6%, Chart 20). At the same time, given the current pace of growth in capital and risk-weighted assets, capital adequacy may fall to 12.7% in the first quarter of 2013, which corresponds to the upper limit of the minimum calculated economic capital adequacy.

Chart 20. Banking Sector Actual and Calculated Capital Adequacy (%)



[28] *Economic capital is capital required to cover unforeseen losses over a specified time horizon at a given confidence level (Range of practices and issues in economic capital framework // Basel Committee on Banking Supervision, Bank for International Settlements. March 2009. P. 9).*

[29] *The calculation is based on the RoRWA model proposed by the BCBS to determine the minimum capital level enabling banks to withstand a severe but probable shock (Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach // Basel Committee on Banking Supervision. October 2010).*

Box 4. Capital Adequacy Comparisons for Different Countries

By capital adequacy (13.1%), the Russian banking sector is close to developed countries (Table 3) and is slightly below the average level in the G-20 group of countries (14.7%). Seven more countries from the group (Australia, China, France, India, Italy, Japan and South Korea) have their capital adequacy levels below the G-20 average level.

By core capital adequacy (8.6%), the Russian banking sector is also in the group of countries with this indicator below the G-20 average (11.8%). Apart from Russia, this group also comprises nine more countries (Argentina, Australia, China, France, India, Italy, Japan, South Korea and South Africa).

Table 3. Bank Capital Adequacy by Region[30] (%)

Region	Average value	Median value
Developed countries	14.8	15.1
Central and Eastern Europe	16.4	16.7
CIS countries	19.6	17.7
Asian developing countries	17.5	17.2
Central Asia and North Africa	17.4	15.5
Sub-Saharan Africa	16.2	14.7

Source: IMF.

3.4. Outpacing Growth of Consumer Lending

General State of the Market: Size, Dynamics, Segment Analysis, Rate of Return

Household lending remains the most dynamically growing segment of banking business. The volume of loans extended to individuals reached 7.2 trillion roubles as of October 1, 2012, demonstrating an annual growth rate of 41.7% (30.8% over the same period of 2011). The growth of household lending is almost 2.5 times faster than the growth of lending to non-financial organisations (16.9% over the past 12 months to October 1, 2012).

On the one hand, this situation is explained by the growth of consumer demand driven by rising household income and low unemployment. In the first-third quarters of 2012, household spending[31] exceeded household money income by 266.6 billion roubles, whereas in the same period last year household income grew faster than spending (by 291.8 billion roubles). In addition, the share of household money income allocated for savings[32] in the first-third quarters of 2012 stood at 8.1% as compared with 9.4% in the same period of 2011. As a result, Russian citizens' savings are currently at a record low. On the other hand, many credit institutions refocused on retail lending to raise the profitability of their business and this factor increased supply on the market and made loan products more accessible.

At the same time, the growth of lending to households showed the signs of a slowdown in the third quarter of 2012 for the first time since early 2010. In particular, annual lending growth was by 2.7 percentage points slower as of October 1, 2012 than as of July 1, 2012 (Chart 21). The slower dynamics were largely

[30] *Based on the latest reporting data provided by the countries.*
[31] *Based on the monitoring data "Results of Russia's Social and Economic Development in January-September 2012" prepared by the Economic Development Ministry of Russia.*
[32] *Based on the preliminary data "Social and Economic Situation in January-September 2012" prepared by the Federal State Statistics Agency (Rosstat).*

attributed to the decrease in the rate of growth in loans extended in foreign currency, which fell by 23.7%[33] from October 1, 2011 to October 1, 2012). Rouble loans demonstrated mixed dynamics in the third quarter of 2012: the annual growth of these loans amounted to 46.8% as of July 1, 47.2% as of September 1 and 46.4% as of October 1, 2012.

In addition, Rosstat data indicate that the consumer confidence index reflecting aggregate consumer expectations dropped by 2 percentage points in the third quarter of 2012 from the second quarter of 2012 to minus 6%. Household quite cautious sentiments regarding changes in their personal finance and the economic situation may eventually slightly restrain their desire to obtain loans. The lending growth potential is also limited due to the decrease in the general level of banking sector capital adequacy and the impact of Bank of Russia planned measures to restrain systemic risks on the household lending market (raising the minimum provisions for unsecured consumer loans without overdue payments and with overdue payments for no more than 30 days, establishing increased risk ratios for unsecured consumer loans carrying high interest rates).

As of October 1, 2012, homogeneous loans accounted for 94.6% of the household loan volume, of which “other consumer loans”[34] made up 57.3%. A considerably smaller share is held by mortgage loans (21.3%), auto loans (9.8%) and housing loans (excluding mortgage loans) (5.6%). All the segments under review demonstrated substantial growth. In particular, the portfolio of homogeneous loans in the segment of “other consumer loans” grew at an annual rate of 58.3% as of October 1, 2012, representing an increase by 16.04 percentage points as compared with the same period of 2011. Over the same period, the portfolios of other segments increased by an average of 30% (Chart 22). The volume of loans in the segment of “other consumer loans” almost doubled due to easy borrowing terms amid the persisting consumer behaviour model, on the one hand, and the credit institutions’ desire to get high returns, on the other hand. Bank choice between long-term secured (mortgage and housing loans) and short-term unsecured (consumer loans) lending are also influenced by the maturity of their liabilities.

Chart 21. Value and Annual Growth of Household Loan Portfolio in 2011-2012

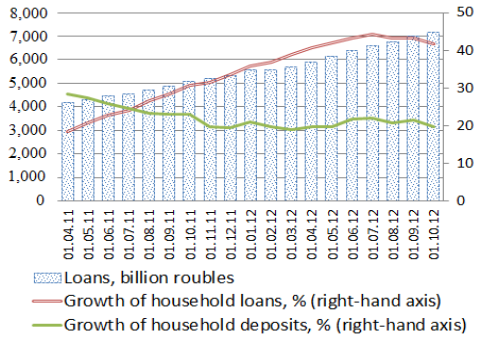
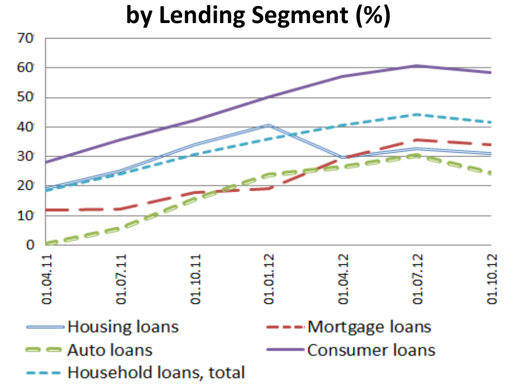


Chart 22. Annual Growth of Household Loans by Lending Segment (%)



[33] *With adjustments for the change in the rouble exchange rate against the bi-currency basket over this period, the growth rate fell by 10.3%.*

[34] *Segment analysis of the household loan market was based on reporting form No. 0409115 “Information on the Quality of Credit Institutions’ Assets”. “Other consumer loans” comprise target/non-target loans issued in cash; loans extended via bank cards; POS credits (loans extended for the purchase of specific goods/services directly at points of sale) and other unsecured loans.*

Banks with the increased concentration on highly risky consumer lending are in the risk area. These banks accumulate substantial amounts of credit risk on their balance sheets, while the absence of the securitisation market in Russia prevents them from lowering their risks through their transferring from their balance sheets to other transaction participants (first of all, investors).

The volume of interest income received by banks in the third quarter of 2012 increased by 46.5% on the same period last year, which was primarily attributable to a rapid growth in the loan portfolio and, secondly, to the increase in the average level of interest rates driven by the rise in the cost of funding and the share of the riskier segment of lending. The average nominal interest rate on loans[35] rose by 1.2 percentage points over the past twelve months to 19.9% in the third quarter of 2012, while the actual yield on loans[36] extended to individuals amounted to 16.8% in the third quarter of 2012 as compared with 16.4% in the same period of 2011. In the crisis period (the fourth quarter of 2008 - the second quarter of 2009), the gap between the nominal interest rate and the actual yield averaged 6.3 percentage points. The highest spread of 7.3 percentage points was registered in the first quarter of 2009 due to a rapid increase in the share of overdue debts, lower lending volumes, higher interest rates and the deterioration of the macroeconomic situation as a whole. In the past two years, these levels have been seen to move closer to each other steadily. However, beginning with the fourth quarter of 2011, the situation started to change. The rate gap in the third quarter of 2012 amounted to 3.1 percentage points (Chart 24).

Chart 23. Average-quarterly Bid and Offer Rates for All Maturities (%)

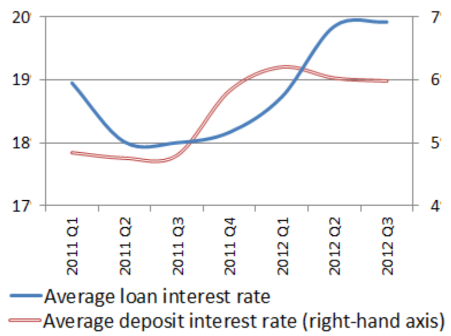
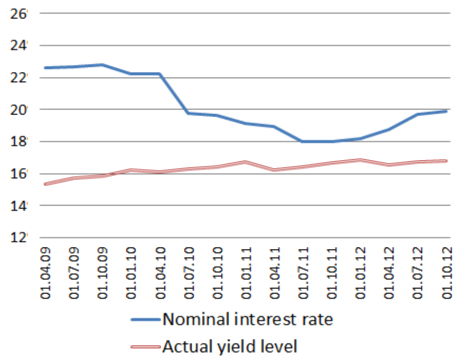


Chart 24. Yields on Household Loan Portfolio in 2009-2012 (%)



Household Debt Burden[37]

Household money income totalled 27 trillion roubles[38] as of October 1, 2012, showing an 8.6% increase over the year. Despite the growth of household money income, the household debt to annual money income ratio also continues to rise: it grew by 5.3 percentage points to 23.03% as of October 1, 2012 year on year (Chart 25). For comparison, this ratio in the 17 eurozone member countries equalled 98.4% in 2011, according to Eurostat data. Therefore, household consumption in these countries is financed with loans to a larger extent than in Russia.

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[35] *The nominal interest rate is the banking sector average-weighted interest rate on loans with all maturities extended to individuals as per reporting form No. 0409128 "Data on Average-weighted Interest Rates on Funds Provided by Credit Institutions".*

[36] *The ratio of interest income received by banks on loan operations with individuals to the average-quarterly volume of loans.*

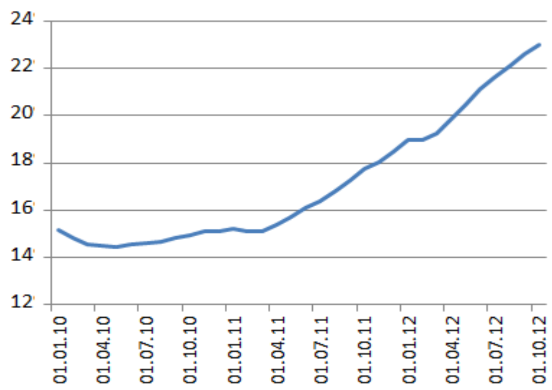
[37] *Households in this section mean resident individuals, including individual entrepreneurs.*

[38] *Based on the monitoring data "The Results of Russia's Social and Economic Development in January-September 2012" prepared by the Economic Development Ministry of Russia.*

The current debt burden, calculated as the ratio of total principal and interest payments on household bank loans to money income, excluding mandatory payments, increased from 16.6% as of October 1, 2011 to 19.9% [39] over the year (Chart 26).

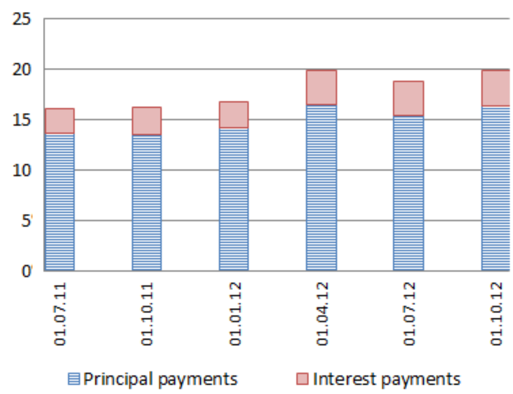
For comparison, the debt burden for other countries published by the IMF as part of financial stability indicators, was lower in Italy (10.8%), the US (10.9%), France (13.1%) and Spain (14.9%) and higher in Romania (20.2%) and Brazil (22.3%) as of the end of 2011. The higher debt burden in Russia as compared with developed countries is explained by the specific structure of the household loan market (the large share of short-term loans, and also the higher level of interest rates).

Chart 25. Household Debt to Annual Money Income (%)



Sources: Rosstat, the Bank of Russia.

Chart 26. Household Current Debt Burden (%)



Sources: Rosstat, the Bank of Russia.

Household financial sustainability requires a balanced growth of lending and money incomes, which implies a gradual increase in the ratio between the volume of household loans and annual money income, given that the current debt burden is maintained at an acceptable level. In turn, the decrease in the current debt burden along lending growth provides possibilities for lower interest rates on bank loans and longer loan maturities.

Quality of Household Loan Portfolio

Bank reporting data indicate that the quality of loans extended to individuals continued to improve in the second-third quarters of 2012, which could be evidenced by the reduction of the level of overdue debts. At the same time, the banking sector has not yet reached pre-crisis levels. The faster growth in the household loan portfolio resulted in the reduction of the share of the portfolio's overdue debts, which fell to 4.4% as of October 1, 2012 from 5.09% as of April 1, 2012 and matched the level registered in February 2009.

In the second-third quarters of 2012, the monthly ratio of receivables to opening balances of household overdue debt accounts reached 12% (the average monthly Chart for the same period of last year was 10%). Despite this growth, this ratio has not yet reached the crisis indicators and is at an acceptable level. In 2008-2009, the monthly ratio of receivables to opening balances was as high as 19-20%.

At the same time, an alarming trend is the growth of homogeneous loans with overdue payments of 91 or more days in the segment of "other consumer loans": in the past 12 months, their volume increased by 24%, whereas the overall volume of consumer loans over the same period grew by 58% (for comparison:

[39] *The calculation of total principal and interest payments on bank loans is based on reporting forms No. 0409302, No. 0409101 and No. 0409102. The calculation excludes data on loans, the rights of claims on which were reassigned to other banks and debt collection agencies, and also loans obtained by households outside the banking sector.*

loans with overdue payments decreased by 1.7% in the same period of 2011, while the volume of all loans grew by 42.3%). At the same time, the growth of loans with overdue payments in the other segments of lending was negative in the third quarter of 2012 (Chart 27). The quarterly growth of consumer loans with overdue payments of 91 or more days reached the highest level for the past two years and stood at about 12%. With the further increase in the volume of loans extended to individuals, the latent accumulated credit risk will begin to manifest itself, largely affecting the POS loan portfolio, which has been developing actively in the past few quarters.

The share of problem and bad loans (category IV-V loans) in the overall volume of household loans contracted from 7.7% as of April 1, 2012 to 6.9% as of October 1, 2012. Nevertheless, bad loans continue to grow in absolute terms. Since October 1, 2011, the volume of these loans rose by 11.2% to 505.5 billion roubles as of October 1, 2012. Actual loan provisions for category IV-V loans totalled 5.4% of the household loan portfolio as of October 1, 2012 (as compared with 7.1% as of October 1, 2011). In addition, it is necessary to take into account the fact that the current level of problem debts has been formed amid the relatively favourable economic situation (the increase in household income, the record low unemployment and the reduction of wage arrears) but the quality of loans may fall sharply, if the economic situation deteriorates.

Chart 27. Annual Growth in Loans with Payments of 91 and More Days Overdue, by Segment (%)

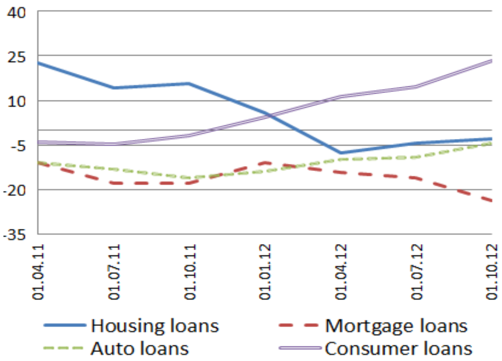
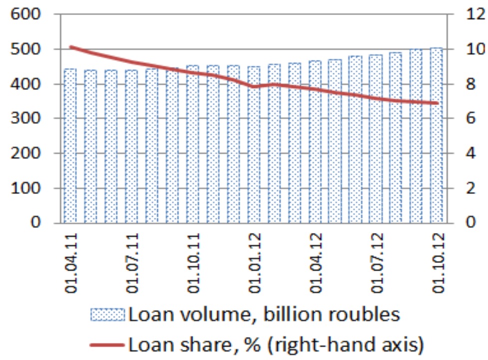


Chart 28. Category IV-V Loans in Absolute and Relative Values



Active Participants on Household Loan Market

As household lending demonstrates substantial growth rates as compared with other segments of banking operations, the sustainability and quality of loan portfolios held by market participants specialising in this segment was analysed to assess systemic risks. The selection of banks for the survey was based on the following set of criteria: 1) the value of the household loan portfolio exceeds 5 billion roubles; 2) the ratio of the household loan portfolio to bank assets is over 40%; 3) the share of interest income from the household loan portfolio is over 50% in the bank total interest income.

As of October 1, 2012, the sample comprised 32 credit institutions. The share of the sampled bank household loan portfolio on the market is 30.2% and their assets account for 4.7% of banking sector assets. From the standpoint of loan portfolio growth, the sampled banks demonstrated indicators above the market trend: the annual growth in their household loan portfolios reached 46.5% as of October 1, 2012 as compared with the 41.7% increase in the household lending sector as a whole.

The assessments indicate that the level of overdue debts on the sampled bank household loan portfolios is higher than on the market as a whole (5.6% as compared with 4.4% as of October 1, 2012). At the same time, the level of overdue debts on the household loan portfolios held by four of the sampled banks is high and ranges from 10.1% to 19.1%.

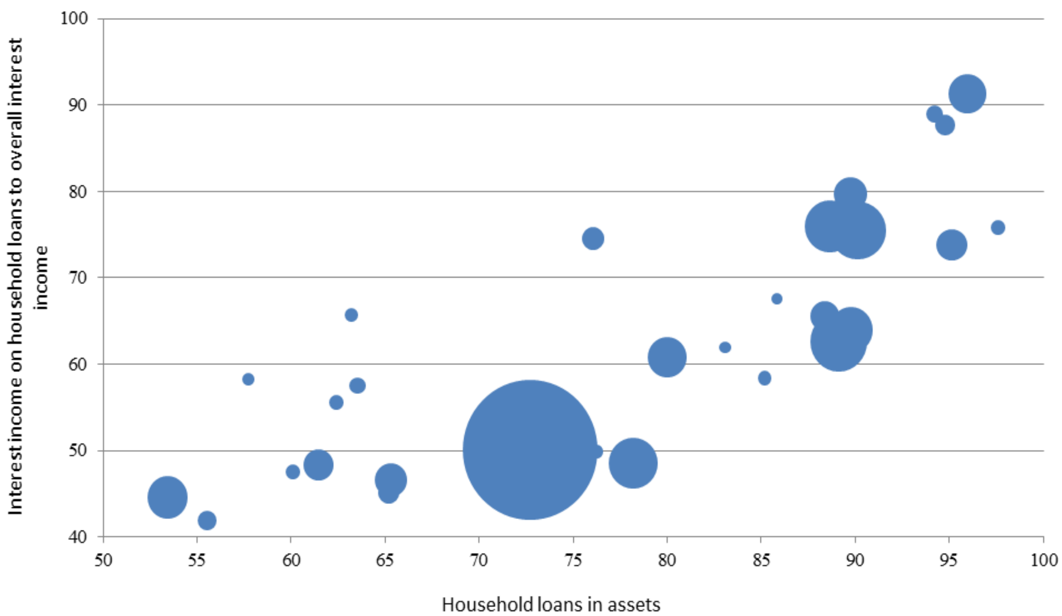
As of October 1, 2012, the share of problem and bad loans (category IV-V loans) in the sampled bank portfolios of homogeneous loans was 8.6%, while the ratio of provisions created for these loans to the portfolio volume was 6.4%.

As a whole, the structure of the sampled bank sources of liabilities is narrowly diversified. In particular, about a half of this group's liabilities was formed by household deposits (49.8% as compared with 28.5% of liabilities in the banking sector as a whole). The other sources of funding comprise corporate funds (15.2% as compared with 19.4% of banking sector liabilities) and credit institution funds (10.4% as against 15.3% of banking sector liabilities). The share of Bank of Russia funds in the sampled bank liabilities is insignificant. Over the year, the structure of borrowings made by the active participants on the consumer lending market changed inconsiderably.

Amid the decrease in banking sector capital adequacy, special attention was paid to analysis of the sampled bank capital adequacy levels. As of October 1, 2012, 22 out of 32 sampled banks demonstrated downward annual capital adequacy dynamics. The average value for the sampled banks was 14% as compared with 13.1% in the banking sector as a whole.

The return on assets (ROA) earned by the sampled banks averaged an annualised 5.9% in the third quarter of 2012. ROA of four out of 32 sampled banks exceeded 10%. The return on assets in the banking sector as a whole is lower at 2.3% on an annual basis. The average-weighted interest rate on rouble loans extended by sampled banks to individuals in the third quarter of 2012 equalled 25.4%. At the same time, the average interest rate on household rouble deposits attracted by these banks amounted to 7.8% in the third quarter of 2012, with interest rates on household deposits offered by six banks from the sampled group exceeding 10.0%.

Chart 29. Relationship of Interest Income and Household Loan Portfolio in Bank Assets Based on Credit Institution's Size[40] (%)



[40] *The diameter of the circle is proportional to the amount of bank's assets.*

Therefore, the following risks can be identified:

- The level of provisions formed by active participants on the consumer lending market for problem and bad loans is lower than banking sector provisions for these loans. Most banks from the sampled group have a low level of provisions for category IV-V loans and a substantial share of overdue debts on the household loan portfolio, which may testify to risk underestimation. Currently, the share of overdue debts is decreasing amid the growth of loans extended to individuals, which in turn conceals the true quality of the loan portfolio.
- The activity of banks specialising in consumer lending and financing their credit operations through funds taken on household deposits may be a source of negative external effects. High loan rates allow these banks to set high deposit rates, which, in turn, deteriorates the deposit market competitiveness of banks crediting the real sector of the economy at lower interest rates and increases the risks of the deposit insurance system (and in the end taxpayer risks).
- If bank capital remains at the current level, it may prove to be insufficient to cover losses on loans, if credit risk materialises.

Bank of Russia's Measures

Given the persistence of current household loan market dynamics, the Bank of Russia will use both regulatory measures and measures aimed at enhancing risk management transparency to mitigate systemic risks in the banking sector.

At present, Bank of Russia regulatory measures envisage the possibility of making amendments to Regulation No. 254-P of March 26, 2004, "On the Procedure for Credit Institutions to Make Provisions for Loans, Loan and Similar Debts" to raise minimum reserve requirements for household loans. In addition, increased risk ratios are planned to be set for unsecured consumer loans with a high full cost to calculate bank capital adequacy.

A closer study of the social and economic characteristics of citizens with heavy debt burdens will be facilitated by the Bank of Russia's cooperation with credit bureaus. The procedure for this interaction is currently being discussed. The Bank of Russia also supports the adoption of amendments to the law on credit bureaus designed to extend a list of organisations obliged to provide information and a list of data submitted to credit bureaus both by corporate entities and private individuals.

3.5. Results of Macro-model-based Stress Testing of the Banking Sector

Macro-model-based stress testing with scenario analysis over the time horizon of one year was made using reporting data as of July 1, 2012. The calculation, which covered all operating credit institutions, was based on one macro-scenario with characteristics reflecting the estimates of the possible impact of Europe's debt crisis on the Russian economy, and also considering the state of the economy as of the date of the stress test (Table 4).

Table 4. Stress-testing Parameters

Macroeconomic indicators (one-year horizon)	Value
Average Urals crude oil price, $/barrel	60
National currency depreciation to US dollar, %	20
Consumer price index (on the corresponding period of last year), %	103.8
Gross domestic product growth (on the corresponding period of last year), %	-2.9
Growth of interest rates on government securities (parallel shift in the yield curve), basis points	350
Growth of interest rates on corporate securities (parallel shift in the yield curve), basis points	1,000

The assessment of losses, which operating credit institutions may incur, was made relative to three major risks: credit, market and liquidity risks. In addition, the conservative assessment of credit risk on renewed loans envisaged the creation of additional provisions for the portfolio of these loans, with the calculated loan loss reserve equalling 100% of the portfolio value. The scenario analysis also considered possible flows of resources into a bank, revenues from active operations adjusted for stress conditions, and also access to Bank of Russia refinancing (for banks, which have this possibility).

The calculations show that a capital deficit of 455 billion roubles in the first year of the stress development may be experienced by 199 credit institutions, which account for 34.5% of banking sector assets. In this situation, credit risk remains the major source of potential losses.

Banking sector capital adequacy may decrease to 11.5%, which suggests that the Russian banking sector remains relatively stable as a whole and can withstand possible negative consequences of the European sovereign debt crisis.

4. The Financial Standing of Non-bank Financial Intermediaries

4.1. Insurance Companies

The growth of household real disposable money income in 2012 influenced the financial market, including insurance business. According to Rosstat data, 64.9 million insurance contracts[41] were concluded in the first half of 2012 (excluding obligatory medical insurance (OMI) contracts), which represented an 11.4% increase on the first half of 2011. As before, the structure of insurance contracts by type of insurance was dominated by voluntary insurance agreements (70% as of July 1, 2012), in particular, accident and health insurance (37.7%). As for obligatory insurance, the largest share is held by civil liability insurance of motor vehicle owners (29.2% of the overall number of contracts signed as July 1, 2012).

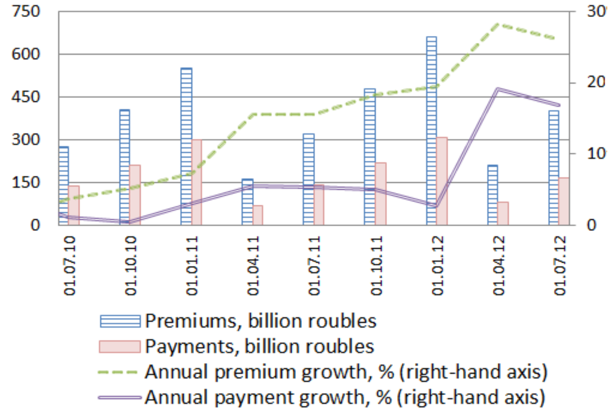
In the segment of voluntary insurance, the most rapid growth in the first half of 2012, as compared with the same period of 2011, was registered in life insurance, where the number of insurance contracts increased by 50%. This growth was partly due to the expansion of operations on life insurance of borrowers amid the increase in consumer and mortgage lending. The fastest growth in obligatory insurance was registered in the segment of personal insurance of passengers (tourists and excursionists), which expanded by 208% as compared with the first half of 2011.

Insurance premiums (excluding OMI)[42] collected by Russian insurers in the first half of 2012 totalled 400.1 billion roubles, while insurance payments (excluding OMI) reached 167.9 billion roubles. The share of obligatory insurance in the structure of insurance premiums increased from 16.7% to 21.5% in the first half of 2012 as compared with the same period of 2011 largely due to the property insurance of vehicle owner civil liability (14.2% of the total volume of insurance premiums as of July 1, 2012). Voluntary insurance is also dominated by citizen property insurance, which accounted for 20.3% of the total volume of insurance premiums as of July 1, 2012. The largest share in the total volume of insurance payments is also held by property insurance (51% as of July 1, 2012), with property insurance of citizens accounting for 28% of all insurance payments and property insurance of corporate entities making up 20%. Therefore, insurance property is the most popular type of insurance both by insurance premiums and payments.

Amid the continued accelerated growth of insurance premiums, insurance payments also demonstrated relatively high growth rates in the first half of 2012: as compared with the first half of 2012, the growth rates of premiums and payments stood at 26.1% and 17.0%, respectively, registering the highest levels for comparable periods since early 2008. Despite large insurance payments, most insurance organisations posted positive financial results for the first half of 2012. The share of loss-making organisations was 16.5%[43] of the total number of operating insurance companies in the first half of 2011, whereas in the first half of 2012 this proportion fell to 12.4%.

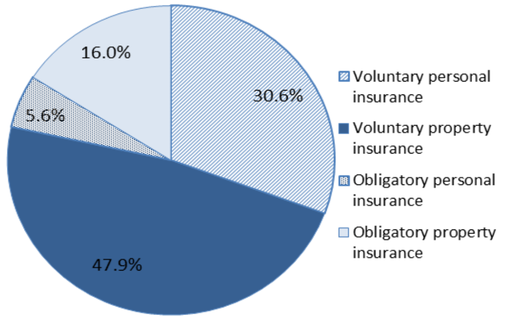
[41] *Based on data provided under federal statistical surveillance reporting form No. 1-SK "Main Performance Indicators of Insurance Companies in Russia (by Type of Insurance)".*
[42] *In compliance with Federal Law No. 326-FZ of November 29, 2010, "On Obligatory Medical Insurance in the Russian Federation", from January 1, 2012 funds designated for the payment of medical services are regarded as target financing.*
[43] *Based on data provided under the federal statistical surveillance reporting form "Financial Result of Insurance Organisations by Form of Ownership".*

Chart 30. Insurance Premiums and Payments in 2010-2012



Source: Rosstat.

Chart 31. Russian Insurance Market Structure by Premium as of July 1, 2012



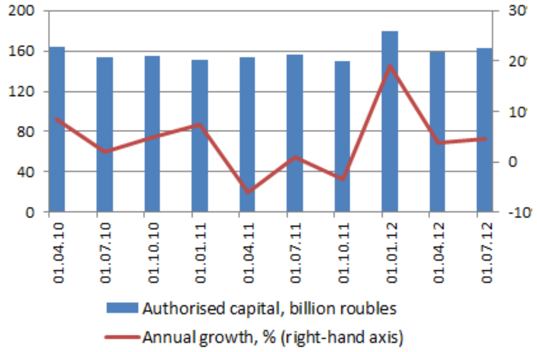
Source: Rosstat.

From January 1, 2012, increased requirements for the minimum authorised capital of insurance organisations[44] came into force. These changes were introduced into legislation in 2010 and stepped up merger and acquisition deals on the market and prompted insurers to build up their authorised capital before the regulatory requirements came into force. As a result, the total authorised capital of insurance organisations had reached 179.8 billion roubles by early 2012. In the first half of 2012, it contracted to 162.9 billion roubles (as against 155.7 billion roubles as of July 1, 2011). The growth of total authorised capital was adversely affected by the revocation of insurance licences during this period. From early 2012 to July 1, 2012, the insurance market shrank by 49 companies to 530 insurers (46 insurance companies had their licences revoked during the whole of 2011). The exit of some players from the market is related to their merger into larger insurers or the termination of business by small firms, which had no significant effect on the overall volumes of premiums collected by insurers. Insurance of hazardous production facilities (HPF) introduced in 2012 as compulsory insurance also stimulated the intensification of M&A deals on the insurance market, especially for insurers with the experience of work on the HPF market[45].

[44] *Under Federal Law No. 4015-1 of November 27, 1992, "On Organisation of Insurance Business in the Russian Federation", the minimum authorised capital of an insurer involved solely in medical insurance is set at 60 million roubles. The minimum authorised capital of other insurers is determined proceeding from their base authorised capital of 120 million roubles, which is raised by higher coefficients for some types of insurance business (2 for life insurance and 4 for reinsurance).*

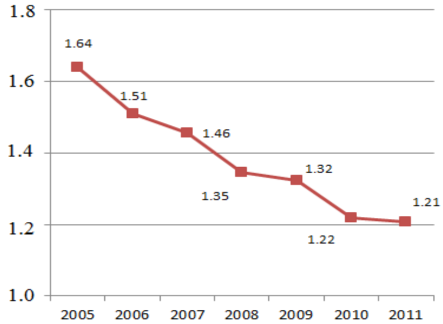
[45] *In addition, some other changes occurred in the regulatory and legal framework for the insurance market in 2012, in particular, changes related to the bankruptcy procedure, higher requirements for insurer financial sustainability, the practice of determining capital structure, establishing the legal framework for introducing internal controls and internal audits at insurance companies, and amendments to Federal Law No. 260-FZ of July 25, 2011, "On State Support of Agricultural Insurance and on Amending the Federal Law on Agriculture Development".*

Chart 32. Russian Insurer Total Authorised Capital Volume and Dynamics



Source: Rosstat.

Chart 33. Insurance Premiums to GDP in 2005-2011



Source: Rosstat.

In the first half of 2012, insurance companies' assets reached 1.06 trillion roubles[46], increasing by 9.6% over the year and by 4.2% over the six-month period. Almost a third of insurer assets are composed of cash and deposits, which rose by 13.6% over the year to 325.7 billion roubles as of July 1, 2012. The other major asset group (30.8% as of July 1, 2012) is insurer investments in securities, which registered an annual growth of 1.7%.

The highest growth rates in the structure of insurer liabilities were demonstrated by unearned premium reserves (16.8% over the period from July 1, 2011 to July 1, 2012) and loss reserves (16.2%). At the same time, the volume of bonds and bills issued by insurers contracted by 97.2% over the same period and the volume of loans fell by 19.2%.

4.2. Non-government Pension Funds

There were 139 non-governmental pension funds (hereinafter referred to as NPFs)[47] operating on the pension market as of September 14, 2012, or 10 funds less than in the previous year. NPF own funds grew by 30.2% over the year to 1.4 trillion roubles as of July 1, 2012.

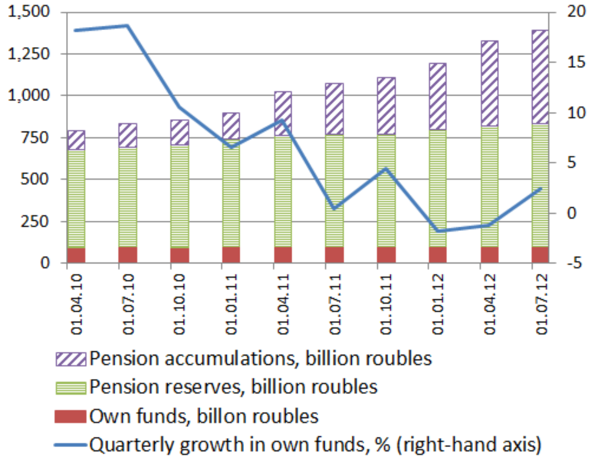
Non-governmental pension provision (hereinafter referred to as NPP) remains the main segment of the NPF market by volume: pension reserves totalled 732.1 billion roubles in the first half of 2012, exceeding pension accumulations by 31% (this ratio was over 200% in the previous year).

However, the main source of the NPF market growth is compulsory pension insurance (CPI): pension accumulations rose by 85.2% from July 1, 2011 to July 1, 2012 to reach 558.3 billion roubles, while pension reserves increased by 9.4% over the same period. Pension reserve dynamics were affected by payments resulting from the cancellation of NPP agreements, and also by the increase in the number of pension recipients. Federal Law No. 242-FZ of December 3, 2012, "On Making Amendments to Some Russian Laws on Payments from Pension Accumulations" postponed until January 1, 2014 the redistribution of 4% out of 6% of the payroll, currently diverted to the funded component of pension, for the insurance component of pension, while granting citizens the right to choose between funded and insurance pension schemes. Therefore, next year may become a record year both in terms of growth in pension accumulations and the level of competition among pension funds in this segment.

[46] *Based on data provided under federal statistical surveillance reporting form No. 1-FS (SK) "Information on the Areas of Insurers' Borrowings and Investments" as approved by Rosstat Order No. 308 of December 10, 2008.*

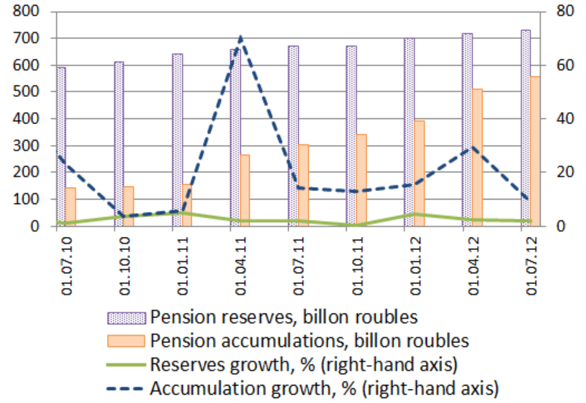
[47] *Based on the data of the Federal Financial Markets Service "A List of Non-Governmental Pension Funds with Permanent Licences".*

Chart 34. Structure and Dynamics of NPF Own Assets in 2010-2012



Source: The Federal Financial Markets Service.

Chart 35. Volume and Quarterly Growth of Pension Accumulations and Reserves on NPF Market



Source: The Federal Financial Markets Service.

The customer base in the CPI segment also demonstrated high growth rates. As of July 1, 2012, about 15.6 million people in the CPI segment transferred their pension accumulations to NPFs, which represented an annual growth of 40.8%. For comparison, the number of NPP participants increased by less than 1% over the period under review to 6.7 million people. The low rates of growth in the NPP segment are largely explained by the fact that its development is driven by corporate programmes, most of which had been prepared already by 2008.

The growth of the volume and customer base in the CPI segment is occurring along with an amount increase in the average customer account, which serves as an indicator of social significance of the NPF market for the population. In particular, the larger the amount of funds in pension accounts, the more thoughtful citizens are about their accumulations. The average customer account in the CPI segment increased by 31.6% in the first half of 2012, year on year, to 35,700 roubles, whereas the average account in the NPP segment grew by 8.4% to 109,100 roubles. Therefore, the NPF market is becoming increasingly important in the CPI system and, consequently, requires market participants' enhanced responsibility for their policies of investing pension accumulations.

As of July 1, 2012, funds required for statutory activities (an analogue of own funds (capital) for NPFs) totalled 102.6 billion roubles. Despite the growth of the NPF own funds by 2.5% from July 1, 2011 to July 1, 2012, the ratio of own funds to the sum of fund obligations[48] fell from 10.3% to 7.8%. In addition, 87 funds (or 58% of all operating funds) had the level of their own funds below the statutory level (100 million roubles) as of July 1, 2012. The planned requirements by the Federal Financial Markets Service for the procedure of assessing own funds[49] may cause many operating non-governmental pension funds, including large entities, to recalculate their property. At the same time, the effects of these innovations will be much more serious for small NPFs. Considering a high social significance of NPFs and their role in citizen pension provision, regulation and supervision in this sphere require further development, including measures to improve approaches to assessing and regulating the resilience of NPFs to various risks.

[48] *Fund obligations are the sum of pension reserves and accumulations, loans received by these funds, and other obligations related to pension reserves and accumulations.*

[49] *New methodology developed by the Federal Financial Markets Service for assessing own funds implies that all the assets forming the pension fund property will be weighed at a certain discount depending on their risk.*

4.3. Management Companies Participating in Pension Accumulation Management

The number of management companies (hereinafter referred to as MCs) participating in the management of pension accumulations was unchanged in the first half of 2012 and stood at 51 as of July 1, 2012. The volume of their own funds grew by 31.5% to 20.9 billion roubles. Pension accumulations managed by MCs grew by 8.5% to 1,478.0 billion roubles[50]. As of July 1, 2012, almost 98% of pension accumulations managed by MCs were concentrated in Vnesheconombank (VEB) state management company.

In the first half of 2012, MCs managing pension accumulations mainly implemented conservative investment strategies. The aggregate investment portfolio showed an increase in funds in the accounts and deposits of credit institutions, and also a growth of investment in corporate bonds. The volume of investment in shares changed insignificantly in the period under review. Government securities in the form of OFZ and GSO bonds remained the main investment for MCs managing pension accumulations.

In the first half of 2012, 45 out of 58 investment portfolios, which MCs created using pension accumulations, showed positive yields (as against 42 out of 60 investment portfolios a year earlier). Yields on pension accumulation portfolios ranged from -8.3% to 11.1% p.a. in the period under review. The VEB management company demonstrated yields of 8.3% p.a. on its extended securities portfolio, which were by 0.6 percentage points higher than the yields on the government securities portfolio.

4.4. Unit Investment Funds

The number of unit investment funds (hereinafter referred to as UIFs) grew by 144[51] in the first-third quarters of 2012 to 1,614 funds as of October 1, 2012 largely due to the increase in the number of closed-end funds. The largest growth among UIFs was demonstrated by real estate funds as their number increased by 77. MCs managing the assets of UIFs numbered 322, or 13 companies less as compared with the beginning of 2012.

The net asset value (NAV) of UIFs increased by 3.6% in the first-third quarters of 2012 to 493.2 billion roubles as of October 1, 2012, largely due to closed-end funds[52]. Retail (open-end and interval) UIFs registered a 1.8% increase in their NAV (Chart 36) but this growth had no considerable effect on the market as a whole due to a small share of these funds in the total NAV.

The largest NAV contraction among retail funds was demonstrated by interval equity UIFs (by 21.1%) largely due to the cessation of the activities of some funds, and also the outflow of shareholder money. In the segment of closed-end funds, the fastest NAV growth was registered among rental UIFs largely due to the inflow of shareholder money into new funds.

In the first-third quarters of 2012, almost 70% of retail UIFs registered a net outflow of shareholder money. In the same period of 2011, 45.5% of funds reported a net inflow of shareholder resources. Open-end equity funds registered the largest net outflow of shareholder money (7.6 billion roubles) among retail UIFs. Investors transferred part of their money from these funds into open-end bond UIFs. The net inflow of shareholder money into closed-end funds in the amount of 34.3 billion roubles in the period under review was largely generated by UIFs specialising in art treasures, real estate and rental funds.

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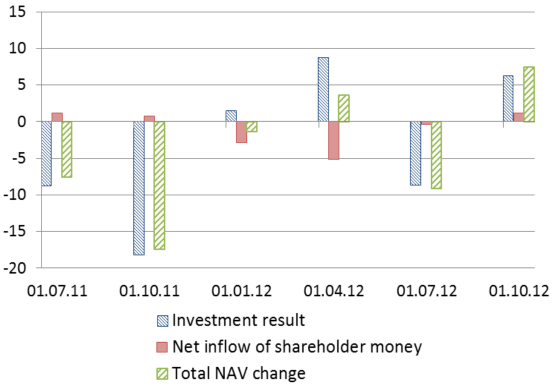
[50] *According to data provided by the Pension Fund of Russia.*

[51] *According to data provided by the National Manager League.*

[52] *Based on data provided by the Cbonds.ru news agency, unless specified otherwise. Here and below, the estimate excludes UIFs, which had the status of qualified investor funds as of October 1, 2012. Under Federal Law No. 334-FZ of December 6, 2007, "On Making Amendments to the Federal Law on Investment Funds and Some Russian Laws", qualified investor UIFs publicly do not disclose information on their activities.*

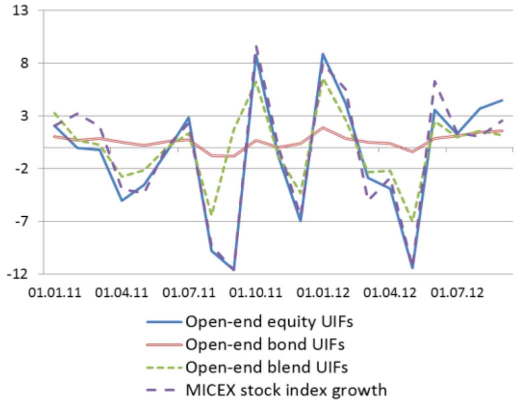
In the first-third quarters of 2012, almost 80% of open-end and interval UIFs increased the cost of their units (as compared with 15.0% of funds in the same period of 2011). The largest increase in the unit among retail funds was demonstrated by equity funds (by 3.5%), while bond funds showed the most stable unit cost dynamics in the period under review (Chart 37). In the segment of equity funds with sectoral focus, the fastest growth in the unit cost was registered by UIFs investing in communications and telecoms stocks.

Chart 36. Investment Result and Balance of Unit Sales of Open-end and Interval UIFs (billion roubles)



Source: Cbonds.ru.

Chart 37. Average-monthly Growth in the Unit Price of Retail UIFs (%)



Sources: Cbonds.ru, Moscow Exchange, the Bank of Russia calculations.