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BANK OF RUSSIA FOREIGN EXCHANGE ASSET MANAGEMENT REPORT

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FOREWORD

This issue of the Bank of Russia Foreign Exchange Asset Management Report presents the results of foreign exchange asset management in October 2015 – September 2016.

Due to global financial markets' high price sensitivity to the actions of major market participants, including the Bank of Russia, data on Bank of Russia operations on foreign exchange asset management are published at least six months after the end of the reporting period.

Information on Bank of Russia foreign exchange assets is also published in the Bank of Russia Annual Report (data on foreign exchange reserve assets and gold assets) and on the website of the Bank of Russia (data on Russia's international reserves). Please note that any difference in the data provided between the reports is due to data composition and calculation methodologies only.

Terms shown in the text in italics are defined in the glossary.

Please send any feedback, including comments and suggestions regarding the contents of the report and data presentation to reservesmanagement@mail.cbr.ru.

PRINCIPLES OF FOREIGN EXCHANGE ASSET MANAGEMENT AND FINANCIAL RISK MANAGEMENT

The Bank of Russia's foreign exchange assets include government and non–government bonds of foreign issuers, deposits and nostro accounts balances, *reverse repo* operations, Russia's net position with the IMF, Russian sovereign Euro–bonds and other claims on counterparties. These assets are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yen, *Special Drawing Rights (SDR)*, Swiss francs, and yuan (hereinafter, foreign currencies). Foreign securities purchased by the Bank of Russia through reverse repo transactions are excluded from the total volume of foreign exchange assets.

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

For the purpose of management, foreign exchange assets are grouped into single–currency portfolios. To assess the efficiency of the management of single–currency portfolios their returns are compared to *benchmark portfolio* returns.

Foreign exchange asset management takes into account the Bank of Russia's liabilities in foreign currencies (balances on foreign currency accounts of clients, mainly *government funds*). Foreign currency holdings expose the Bank of Russia to financial risks, such as credit risk, foreign exchange risk, interest rate risk and liquidity risk.

Credit risk means the risk of counterparties or issuers defaulting on their obligations to the Bank of Russia. Credit risk is constrained by various limits and requirements for the credit quality of counterparties and issuers, which must have a minimum *credit rating* of A under the Fitch Ratings and S&P Global Ratings classifications and a minimum rating of A2 under the Moody's Investors Service classification.

Foreign exchange risk means the probability of a decrease in the value of net foreign currency assets (assets net of liabilities) due to foreign currency exchange rate movements. The Bank of Russia limits the level of foreign exchange risk by specifying a benchmark currency structure of net foreign exchange assets with target weights of eligible currencies and the limits of their deviations.

Interest rate risk is the probability of a decrease in the value of foreign exchange assets due to any unfavourable changes in interest rates.

The level of interest rate risk for the Bank of Russia's assets portfolios is measured by *duration*. The interest rate risk exposure is limited by setting the minimum and maximum durations allowed in each of the eligible currency portfolios. Additionally, the maturities of eligible securities, deposits and repo operations are limited.

Liquidity risk means as the risk of losses due to insufficient funds to cover Bank of Russia current liabilities in foreign currencies. In order to lower this risk, the volume of liquid assets in each currency is maintained at a level exceeding the volume of liabilities in the same currency. The most liquid assets are government securities, which are the major component of foreign exchange assets. Sources of liquidity also include nostro account balances, credit lines, short–term deposits and repo operations, as well as cash inflows from coupon payments and redemptions of securities denominated in foreign currencies.

The Bank of Russia pays interest on the foreign currency accounts balances equal to the rate of return on indices composed of foreign countries' bonds. The Bank of Russia makes interest payments in rubles. Since the Bank of Russia has the right to issue currency, these obligations don't expose it to interest rate and liquidity risks.

The Bank of Russia has a multilevel collective system for investment decision–making.

The Bank of Russia Board of Directors sets the objectives of foreign exchange asset management, the list of eligible investment instruments, and the target level of foreign exchange risk.

The Bank of Russia Committee in charge of investment strategy sets the levels of interest rate and credit risks and approves the lists of eligible counterparties and issuers.

The adopted investment decisions are implemented by the authorized divisions of the Bank of Russia. External managers are not involved in foreign exchange asset management.

MACROECONOMIC TRENDS IN OCTOBER 2015 – SEPTEMBER 2016

The foreign currency exchange rates and government securities yields in major developed economies throughout the period under review were primarily driven by the ongoing sovereign debt problems in certain euro area member states, the China slowdown and *quantitative easing* (QE) programmes in euro area and Japan as well as by expectation and outcome of the UK referendum on the EU membership.

USA and Canada

In December 2015, the Fed concluded that the conditions for a hike (further improvement in the market climate and the regulator's confidence in inflation's returning to the 2% level over the mid–term horizon) stipulated earlier that year were finally met and opted for an increase in the target range for the Federal funds rate by 0.25 pp to 0.25–0.50%.

In 1Q–3Q16, the FOMC abstained from raising the Fed funds rate and substantially lowered the appropriate level of the rate for the end of 2016. The result was a correction in the US dollar, which weakened relative to other major currencies and lower rates for US Treasuries with longer maturities.

Canadian economy moved out of a technical recession in 3Q15. In order to sustain the economic recovery the budget with large fiscal stimulus was approved by the new Canadian government, thus reducing the necessity for the BoC to ease its monetary policy further. The BoC refrained from altering its monetary policy stance in 1Q–3Q16 despite a severe slump in GDP level in 2Q16 attributed mainly to Alberta wildfires. The central bank noted that it sees this as an isolated event with no lasting impact for the economy.

The stability of BoC monetary policy and recovering oil prices helped the Canadian dollar to fully overcome its past weakness (observed in late 2015) relative to the US dollar.

Europe

In February 2016, the UK government announced the UK referendum on the European Union membership for 23 June. The reason for the referendum had been the growing discontent of the population over the EU migration policy and toughening banking sector regulation. The concern over the exit of the UK from the EU and breaking economic relations with other European countries caused the depreciation of the pound sterling against the US dollar in late 2015 – early 2016. On 23 June, the majority of British citizens voted for leaving the EU, which caused a dramatic depreciation of the pound sterling against the US dollar.

Amidst higher political uncertainty and concerns of economic slowdown caused by the referendum results, the Bank of England strengthened its monetary stimulus. In August 2016, it cut the key rate from 0.5% to 0.25% and increased the asset purchase programme by 10 billion pounds for corporate bonds and 60 billion pounds for government bonds.

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

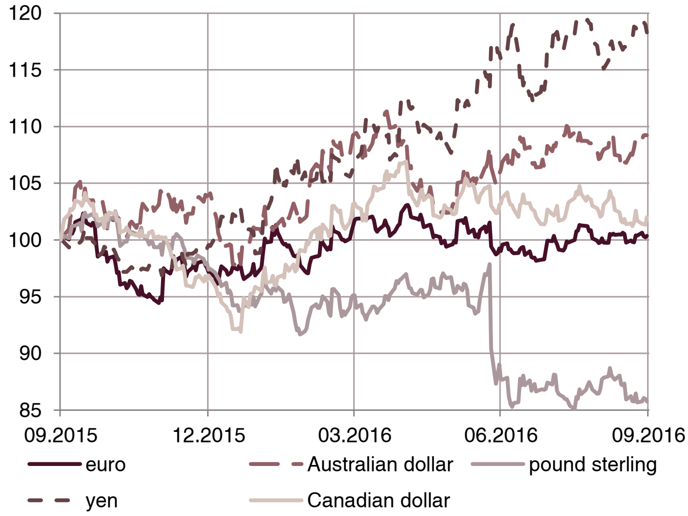
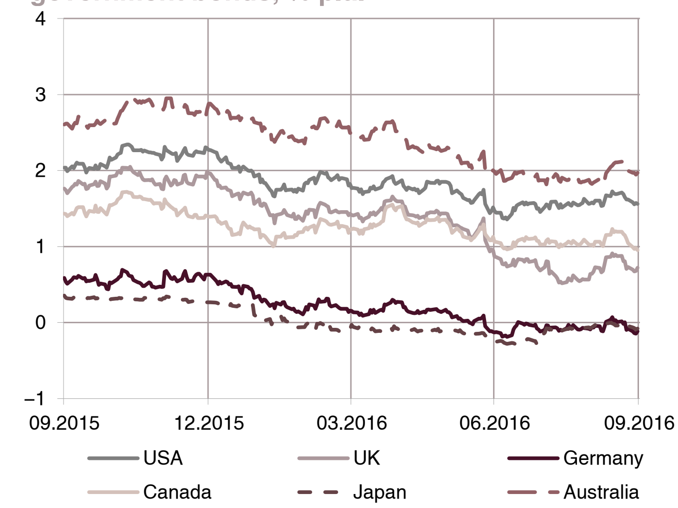


Chart 2. Yields to maturity on 10–year government bonds, % p.a.



In March 2016, the European Central Bank (ECB) cut the main refinancing rate to 0% and the deposit facility rate to –0.4%. The monthly pur–

chases under the asset purchase programme were expanded from 60 billion to 80 billion euros, investment grade euro–denominated bonds issued by non–bank corporations in the euro area were included in the list of eligible assets. Moreover, a new series of targeted long–term refinancing operations (TLTRO II) were launched since June 2016. These measures matched the market expectations and didn't cause significant euro depreciation.

In June 2015 and February 2016, the Riksbank lowered the repo rate from –0.35% to –0.5%.

Australia and Asia

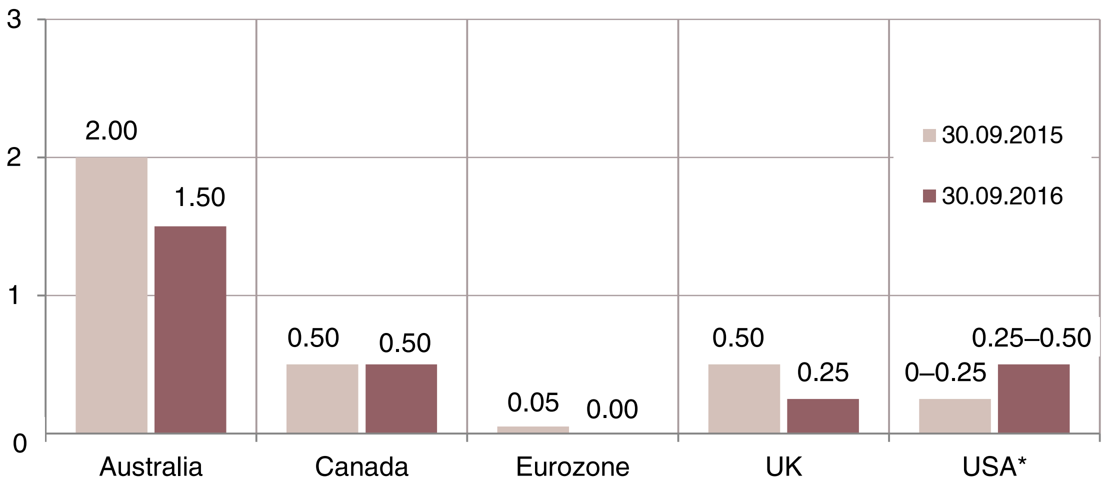
The Reserve Bank of Australia (RBA) cut its key rate twice by 0.25 pp in May and August 2016 thus lowering it to 1.5%. The main reason for the two rate cuts was low inflation fluctuating below target levels for several quarters.

In mid–February 2016, the Bank of Japan (BoJ) adopted negative interest rate on reserves that exceeded required ones in order to stimulate credit to real sector and to combat the decline in inflation. In September, the BoJ announced a targeting of long–term rates on government bonds as a new instrument of *quantitative and qualitative easing* programme. Such measure should both help to reach the BoJ's inflation target at 2% (by maintaining long–term rates low) and prevent further sovereign curve's flattening that could produce a negative impact on the banking sector.

The absence of clear signals from the BoJ on further monetary policy easing, the Fed's postponed rate hike and the result of UK referendum supported yen's marked appreciation. Over the period from December 2015 to September 2016, Japan's currency appreciated to the US dollar by more than 18%.

During the period from October 2015 to September 2016, the People's Bank of China (PBoC) cut its key rates. Both one–year benchmark lending rate and one–year deposit rate were lowered by 0.25 pp to 4.35% and to 1.5% respectively. Also, required reserve ratio for major banks was cut twice over the same period, from 18.0% to 17.0%. These actions can be explained by the attempts of economic authorities to revive moderating growth by monetary measures. In December 2015, the PBoC announced that CNY mid–rate setting would be determined relative to the basket of currencies instead of the US dollar alone. In 4Q, the PBoC completed process of interest rates liberalization by abandoning deposit rate ceiling. In winter of 2015–2016, the market pressure on the yuan led to its gradual depreciation. During that period the monthly reduction in PBoC international reserves reached $100 billion.

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



* The Fed funds target rate is 0.25-0.50%.

FOREIGN EXCHANGE ASSET MANAGEMENT IN OCTOBER 2015 – SEPTEMBER 2016

In the period under review, Bank of Russia foreign exchange assets decreased by $4.4 billion to reach $341.0 billion (Table 1). Major reasons behind this decline in foreign exchange assets were foreign currency exchange rate movements against the US dollar and cash outflows on the client accounts with the Bank of Russia (Charts 1 and 4).

In October 2015 – September 2016, the amount of claims on Russian credit institutions under foreign currency repos and foreign currency loans decreased significantly. The amount of de–posits and nostro account balances with the Bank of Russia increased (Table 1).

Chart 4. Changes in foreign exchange assets in October 2015 – September 2016, billions of US dollars

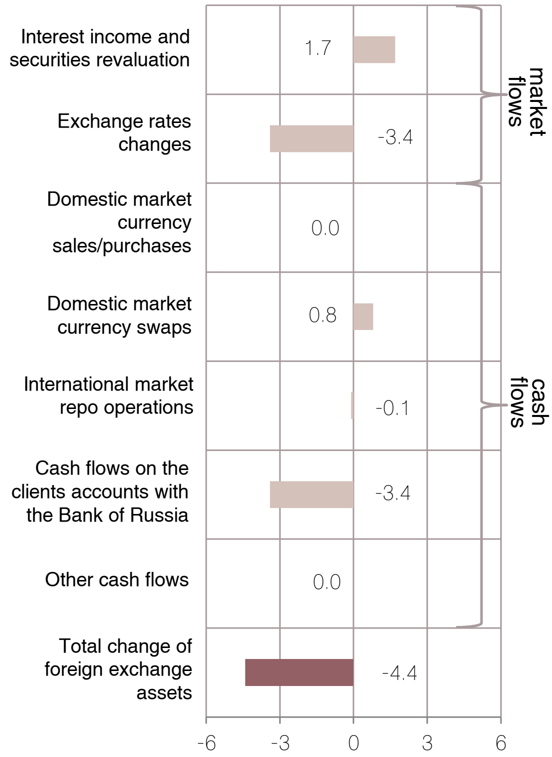


Table 1. Foreign exchange assets by asset class

Foreign exchange assets	As of 30 September 2015		As of 30 September 2016		Change in October 2015 – September 2016, billions of US dollars
	billions of US dollars	Share of foreign exchange assets	billions of US dollars	Share of foreign exchange assets	
Government securities	258.4	74.8%	253.6	74.4%	–4.8
Deposits and account balances	44.0	12.7%	63.6	18.6%	19.6
Non–government securities	10.9	3.1%	8.7	2.6%	–2.2
Net position with the IMF	2.7	0.8%	2.0	0.6%	–0.7
Reverse repo operations	2.8	0.8%	2.2	0.6%	–0.6
Claims on counterparties on foreign currency supply	0.0	0.0%	1.0	0.3%	1.0
Claims on Russian credit institutions under foreign currency repo operations and loans	26.8	7.8%	9.9	2.9%	–16.9
Total*	345.4	100%	341.0	100%	–4.4

*The total value may differ from the sum of asset classes values due to rounding.

Chart 5 shows the actual currency structure of foreign exchange assets as of 30 September 2016. Assets denominated in US dollars and euros retained the dominant position in the structure.

Chart 6. Geographical structure of foreign exchange assets as of 30 September 2016

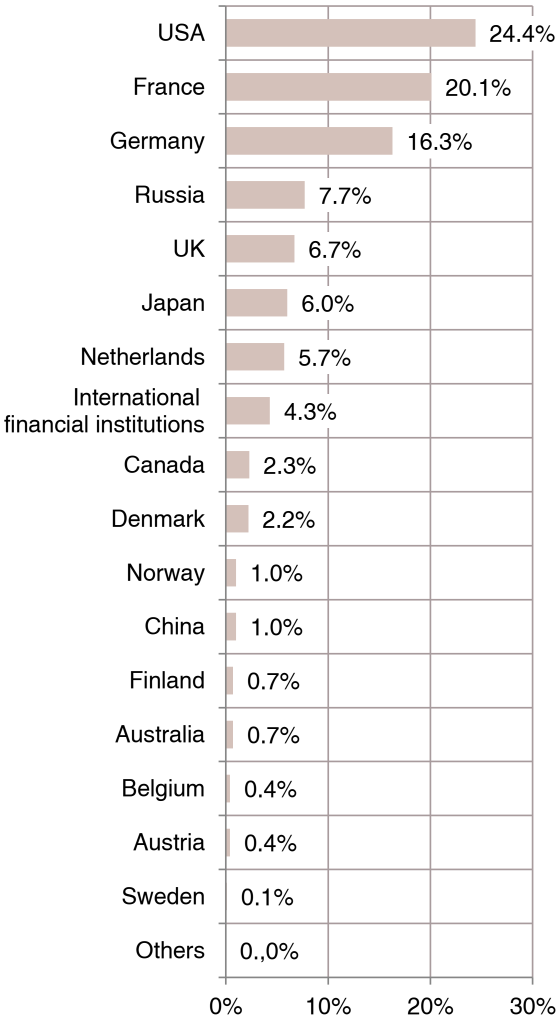


Chart 6 shows the geographical structure of foreign exchange assets by location (place of residence) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets. Russia's location in the geographical structure at the fourth position was a result of Bank of Russia transactions on liquidity provision to Russian credit institutions in foreign currency (repo transactions in foreign currency).

Chart 5. Foreign exchange assets by currency as of 30 September 2016

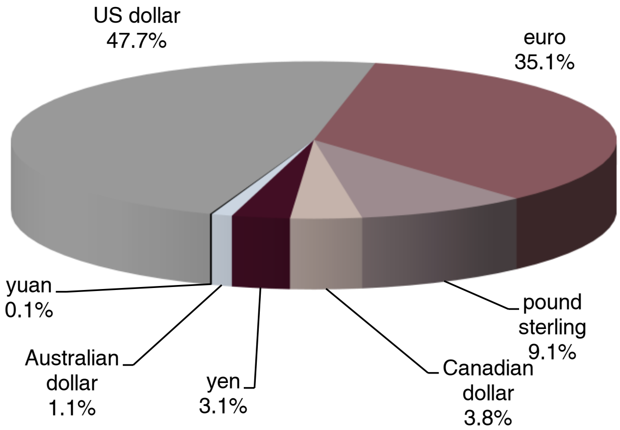
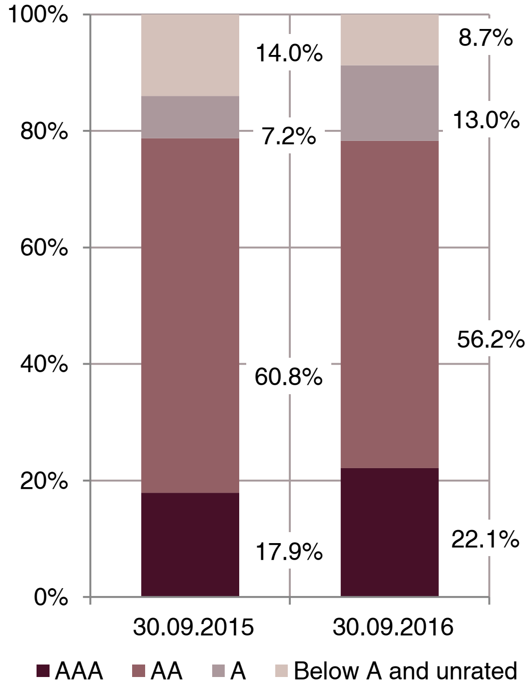


Chart 7 shows the distribution of foreign exchange assets by credit rating. The Chart is based on Fitch Ratings, S&P Global Ratings and Moody's Investors Service data, with the lowest credit rating grades used.

Chart 7. Foreign exchange assets by credit rating



Decrease in the share of assets with 'Below A and unrated' rating as of 30 September 2016 was partly due to the reduction of credit institutions refinancing in foreign currency.

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

Table 2. ***Return on Bank of Russia foreign exchange assets in October 2015 – September 2016, % p.a.***

Indicator	US dollar	euro	pound sterling	Canadian dollar	Australian dollar
Return on actual single–currency portfolios of foreign exchange assets	0.74	0.04	0.91	0.66	2.21
Return on benchmark single–currency portfolios of foreign exchange assets	0.58	0.03	0.85	0.54	2.09

GLOSSARY

Benchmark portfolio

A set of financial instruments in each reserve currency taken in appropriate percentage. Benchmark portfolios reflect the target distribution of Bank of Russia assets in each foreign currency.

Central bank key rate

A rate set by a central bank to impact interest rates in the economy. Usually, a change to the key rate is a major monetary policy tool. Examples of key rates used by the leading central banks include:

- US Federal Reserve System (Fed) – A target for an interest rate at which depository institutions lend reserve balances to other depository institutions overnight;
- European Central Bank (ECB) – A minimum rate at ECB repo auctions;
- Bank of England – An interest rate on commercial bank reserves deposited with the Bank of England;
- Bank of Canada – A target for an interbank loan rate;
- Reserve Bank of Australia – A target for an interbank loan rate;
- Bank of Japan – Until April 2013, this was an overnight interbank loan rate. Starting from April 2013, the Bank of Japan has been targeting the monetary base instead of the interest rate.

Credit rating

A rating agency's assessment of the creditworthiness of a borrower and its ability to fulfill its financial obligations.

Currency swap

An agreement pursuant to which counterparties exchange payments in different currencies. The Bank of Russia enters into currency swap operations in order to supply Russian credit institutions with ruble funds using foreign currency funds as collateral.

Duration

A measure of the relative sensitivity of the value of a fixed–income instrument or a class of instruments to changes in the corresponding interest rates by one percentage point.

Government funds

The Reserve Fund and the National Wealth Fund of the Russian Federation including their foreign currency deposits with the Bank of Russia (in US dollars, euros and pounds sterling).

Quantitative and qualitative easing (QQE)

A monetary policy used by central banks to stimulate the economy. To carry out quantitative easing, a central bank purchases government securities or other securities from the market or provides funds collateralised by financial assets in order to increase money supply. Qualitative easing refers to the shift in the composition of assets on the central bank's balance sheet to less liquid and more risky assets, given the overall balance of the central bank does not change.

Repo (reverse repo) transactions

Securities sale (purchase) transactions with an obligation of their repurchase (resale) at future date at a stated price.

Return on Bank of Russia foreign exchange assets

The holding period return is calculated using chain index based on a daily return. Daily return on a single–currency portfolio is calculated as the ratio of aggregate (realised and unrealised) returns on the portfolio to its market value as of the end of the previous day.

SDR (Special Drawing Rights)

An international reserve asset created by the IMF to supplement the existing official reserves of member countries. It is a potential claim on the freely usable currencies of IMF members. The SDR rate is determined based on the dollar value of a basket made up of the following currencies: US dollar, euro, yen, pound sterling and yuan (from 1 October 2016).