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BANK OF RUSSIA FOREIGN EXCHANGE ASSET MANAGEMENT REPORT

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Foreign Exchange Asset Management Report
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FOREWORD

This issue of Bank of Russia Foreign Exchange Asset Management Report presents the results of foreign exchange asset management in July 2013 - June 2014.

Due to the highly price sensitivity of global financial markets 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 indicators provided between the reports is due to calculation methodologies only.

Terms shown in the text in italics are defined in the glossary. We would ask you to send any feedback, including comments and suggestions regarding the contents of the report and its presentation to e-mail: reservesmanagement@mail.cbr.ru.

PRINCIPLES OF FOREIGN EXCHANGE ASSET MANAGEMENT AND FINANCIAL RISK MANAGEMENT

The Bank of Russia 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 Eurobonds and other claims on foreign counterparties. These assets are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yen, *Special Drawing Rights (SDR)*, and Swiss francs (herein after 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 their assets safety and liquidity.

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 exposes the Bank of Russia to financial risks, such as credit risk, foreign exchange risk, interest rate risk and liquidity risk.

Credit risk is understood as the risk of counterparties or issuers defaulting on their obligations to the Bank of Russia. Credit risk is subject to 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 Standard and Poor's classifications and a minimum rating of 'A2' under the Moody's Investors Service classification.

Foreign exchange risk is understood as 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 sets limits on 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 and correspondingly, the prices of financial assets.

The level of interest rate risk for the Banks of Russia assets portfolios was measured by *duration*. The interest rate risk exposure was 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 is understood 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, being 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 has a multi-level collegiate system for investment decision-making.

The Bank of Russia Board of Directors sets the objective of foreign exchange asset management, a 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 authorised divisions of the Bank of Russia. External managers are not involved in foreign exchange asset management.

MACROECONOMIC TRENDS IN JULY 2013 – JUNE 2014

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 Eurozone member states, the China slowdown and *quantitative easing* programs in both the USA and Japan.

In the third quarter of 2013 there were market expectations of an early tapering by the Fed of its quantitative easing program (involving monthly asset purchases in the amount of $85 billion). These expectations led to the depreciation of most currencies against the US dollar. The September 2013 Fed meeting left the asset purchase volume unchanged, which resulted in the US dollar depreciation.

In July 2013, France lost its top grade assigned by Fitch Ratings due to high unemployment and *government debt* (the agency was the last of the three major international rating agencies to have cut French ratings). Spain exited its recession in the third quarter of 2013 with GDP growth amounting to 0.1% compared to the previous quarter.

In August 2013, the Reserve Bank of Australia cut its rate from 2.75% to 2.5%.

In September 2013, the politically split US Congress failed to approve the federal budget for the 2014 fiscal year (starting October 1st 2013) and to agree on raising the debt ceiling. As a consequence, the USA experienced a government shutdown on 16th October and the threat of a technical default rose. A day before the borrowing limit was to be reached (on October 16th) the US Congress extended government funding until January 15th 2014 and suspended the debt ceiling until February 7th 2014. The period of uncertainty preceding this resolution led to a *flight to quality* by international investors and to a rise in short-term interest rates.

In November 2013, amid weak economic growth and low Eurozone inflation, the ECB eased its monetary policy by cutting the *key rate* from 0.5% to 0.25%. Standard and Poor's lowered France's rating from 'AA+' to 'AA', noting insufficient labour market reforms and falling competitiveness. The agency's experts also pointed to excessively high budget expenditures coupled with high taxes that did not allow for budget consolidation by means of further tax increases.

In December 2013 the Federal Open Market Committee decided to reduce the amount of monthly bond purchases by $10 billion following a significant improvement in the labour market (unemployment fell to 7% in November) and the deal on the federal budget was agreed in the US Senate.

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

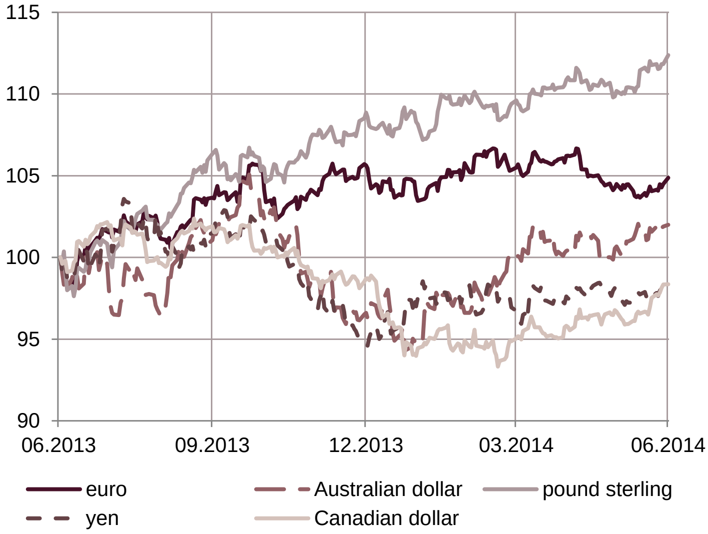
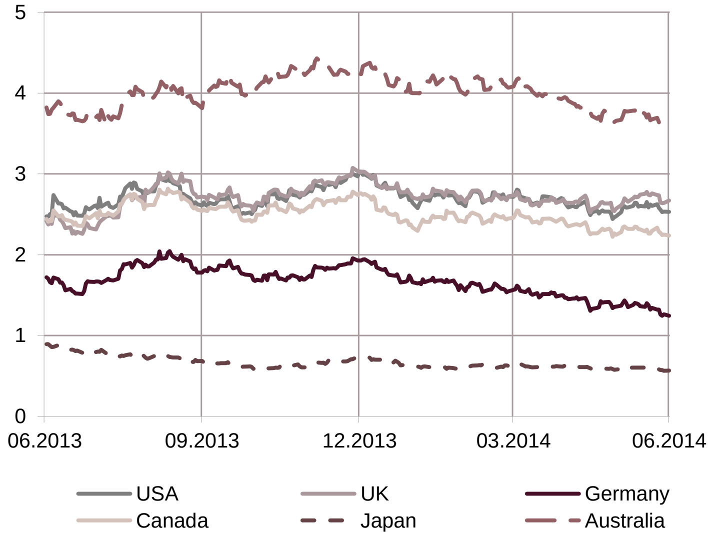


Chart 2. Yields to maturity on 10-year government bonds, % p.a.



In January 2014, the US Congress reached an agreement on the budget expenditures for 2014, with the main result being the decision to carry on with health care reform. The Federal Open Market Committee took decisions in January, March, April and June 2014 to reduce the amount of bond purchases by $10 billion. In February, the United States suspended the limit on government borrowing until March 15th 2015. As a result Fitch Ratings affirmed the United States at 'AAA' by raising the rating outlook from negative to stable.

In the second quarter of 2014 the US unemployment rate fell below the 6.5% target which the Fed had previously considered necessary for raising the key rate. In March 2014 the Fed stopped unemployment targeting maintaining the inflation target of 2%.

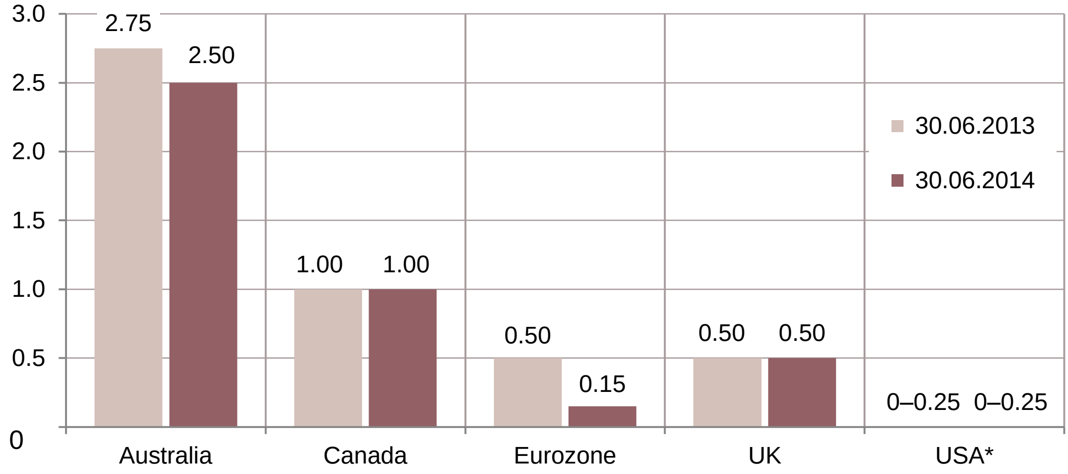
US GDP growth in the second quarter of 2014 was the highest since the end of 2011 (4.6%). This supported market participants' expectations for the Fed rate hike cycle beginning in 2015.

Rating agencies noted the improved creditworthiness of some European countries. Moody's Investors Service raised the sovereign rating of Spain from 'Baa3' to 'Baa2' and that of Ireland from 'Ba1' to 'Baa3' (investment grade). Moody's Investors Service also revised the outlook for Germany (Aaa), Austria (Aaa) and Luxembourg (Aaa) from negative to stable. Standard and Poor's revised the outlook for Belgium (AA) from negative to stable. These decisions were based on stabilisation of the situation in the peripheral countries of the Eurozone, the lower possibility of new bailouts and the start of the economic growth in the Eurozone.

In the second quarter economic growth in the Eurozone slowed down due to a number of reasons including the conflict in Eastern Ukraine. The Greek economy emerged from recession and among the major countries in the region only Italy remained in recession. In June 2014, the ECB lowered its interest rate from 0.25% to 0.15% to maintain economic growth and overcome deflationary pressures.

At the beginning of the second quarter of 2014 the Japanese Government implemented a tax reform with the sales tax increasing by 2 percentage points. This mostly impacted consumer demand, which began to decline since April. As a result, in the second quarter, the economy of Japan showed negative growth year on year.

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



* Fed target rate is 0–0,25%.

FOREIGN EXCHANGE ASSET MANAGEMENT IN JULY 2013-JUNE 2014

In the period under review, Bank of Russia foreign exchange assets decreased by $45.9 billion to reach $429.6 billion (Table 1). The major driver of the decline was currency interventions on the domestic foreign exchange market. The decrease was partially offset by inflows of funds to Federal Treasury accounts with the Bank of Russia, as well as by foreign currency exchange rate movements, and by income from Bank of Russia operations (Chart 4).

In July 2013 - June 2014, the amount of deposits and nostro account balances with the Bank of Russia increased against a decrease in government securities portfolios as well as the volume of reverse repo operations (Table 1).

Chart 4. Changes in Foreign Exchange Assets in July 2013 - June 2014, billions of US dollars

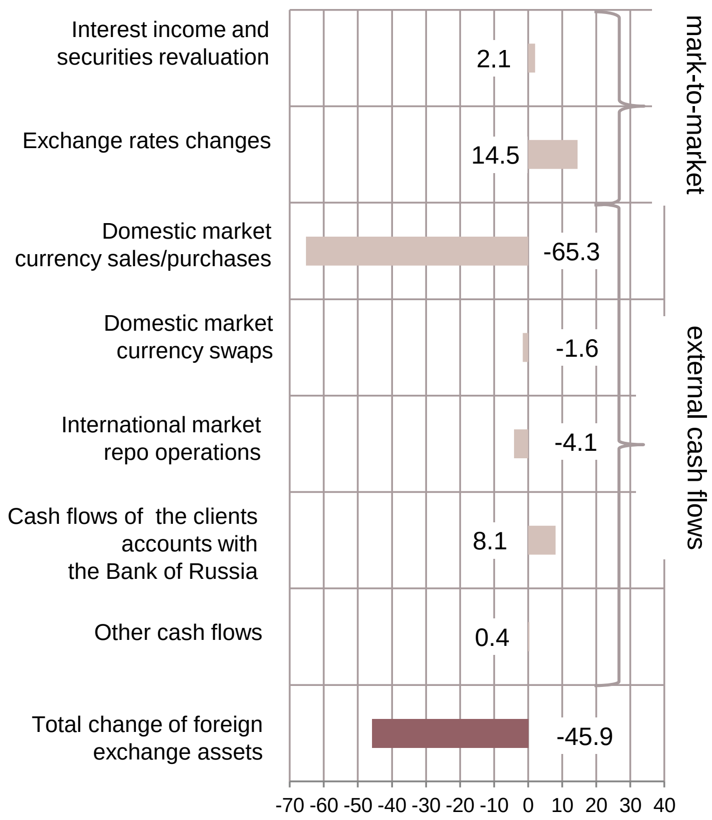


Table 1. Foreign exchange assets by asset class

Foreign exchange assets	As of 30 June 2013		As of 30 June 2014		Change in July 2013–June 2014, billions of US dollars
	billions of US dollars	Share of foreign exchange assets	billions of US dollars	Share of foreign exchange assets	
Government securities	389.9	82.0%	347.3	80.8%	-42.6
Deposits and account balances	68.0	14.3%	71.5	16.7%	3.5
Non-government securities	3.5	0.7%	4.4	1.0%	0.9
Net position with the IMF	4.6	1.0%	4.4	1.0%	-0.2
Reverse repo operations	9.5	2.0%	1.9	0.5%	-7.6
Total	475.5	100%	429.6	100%	-45.9

Chart 5 shows the actual currency structure of foreign exchange assets as of June 30th 2014. In the period under review the share of assets denominated in euros and Canadian dollars increased. The size of the portfolio of Canadian Government securities was expended accordingly. The share of assets in US dollars and yen went down and the share of assets in Swiss francs remained insignificant.

Chart 6. Geographical structure of foreign exchange assets as of 30 June 2014

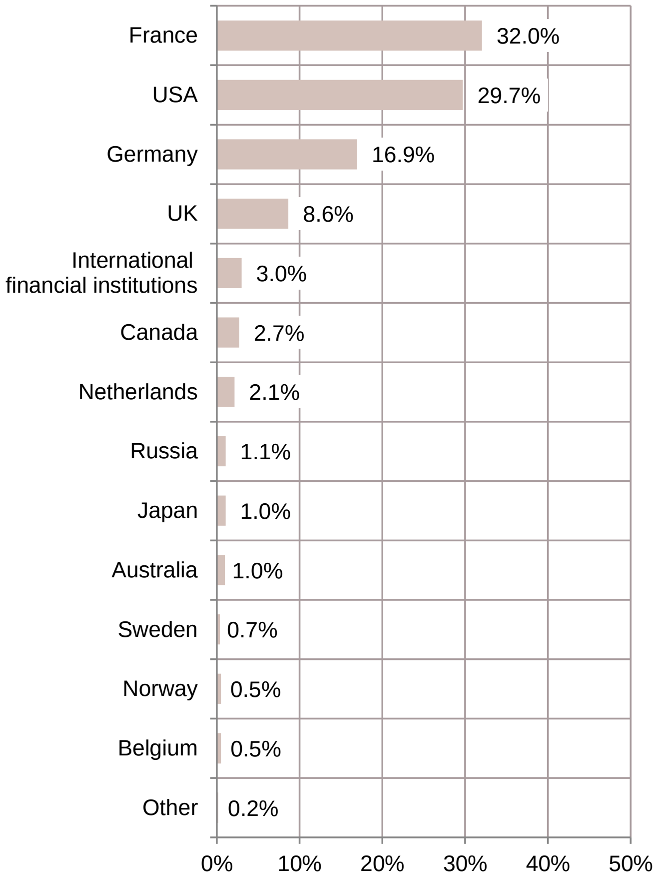


Chart 6 shows the geographical structure of foreign exchange assets by location (place of residence) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets.

Chart 5. Foreign exchange assets by currency as of 30 June 2014

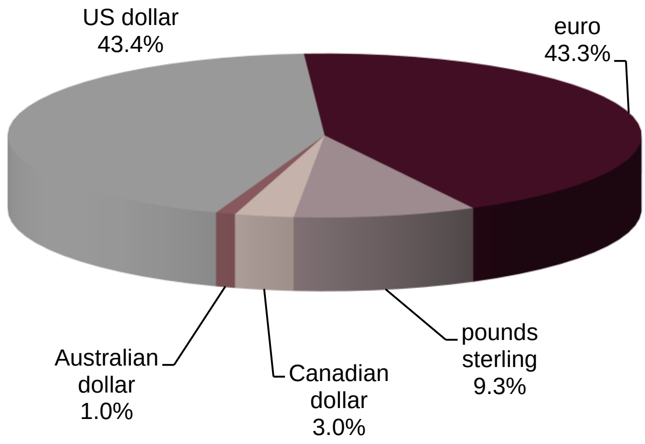
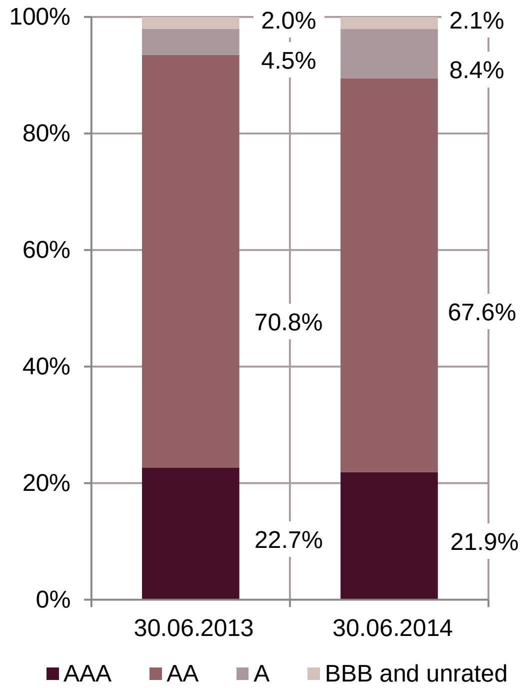


Chart 7 shows the distribution of foreign exchange assets by credit rating as of June 30th 2013 and June 30th 2014. The Chart is based on Fitch Ratings, Standard and Poor's and Moody's Investors Service data with the lowest credit rating grades used.

Chart 7. Foreign exchange assets by credit rating



'BBB and unrated' group comprise Russian Eurobonds with a rating of 'BBB' and assets that are not rated, such as Russia's position with the IMF.

A reduction of the share of assets with 'AA' rating and the growth the share of assets with 'A' rating are related to the decrease in the government securities portfolios and the increase of the bank's deposits with a relatively lower ratings.

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 July 2013 - June 2014, % p.a.**

Indicator	US dollar	Euro	Pound sterling	Canadian dollar	Australian dollar	Yen
Return on actual single-currency portfolios of foreign exchange assets	0.52	0.38	0.24	1.32	2.77	0.05
Return on benchmark single-currency portfolios of foreign exchange assets	0.38	0.37	0.22	1.31	2.73	0.03

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 credit worthiness of a borrower to fulfill its financial obligations in general terms.

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 rouble funds using foreign currency funds as collateral.

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

Flight to quality
Investors' sale of higher-risk assets in favour of purchasing safest possible assets (as government bonds issued by developed countries) due to a lower risk appetite.

Gross government debt
The value of a central government outstanding debt in the domestic currency and in foreign currencies. The debt amount is not adjusted to the value of government foreign exchange assets.

Monetary base
The total amount of money that is either circulated in the hands of the public or in the commercial bank deposits held in the central bank's reserves.

Quantitative easing (QE)
A monetary policy used by central banks to stimulate the economy. To carry out QE, 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.

Repo (reverse repo) transactions
Securities sale (purchase) transactions with an obligation of a subsequent repurchase (resale) during a specified period at a stated price.

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 four-currency basket made up of the US dollar, euro, yen and pound sterling.

Bank of Russia foreign exchange assets return

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 of the portfolio to its market value as of the end of the previous day.