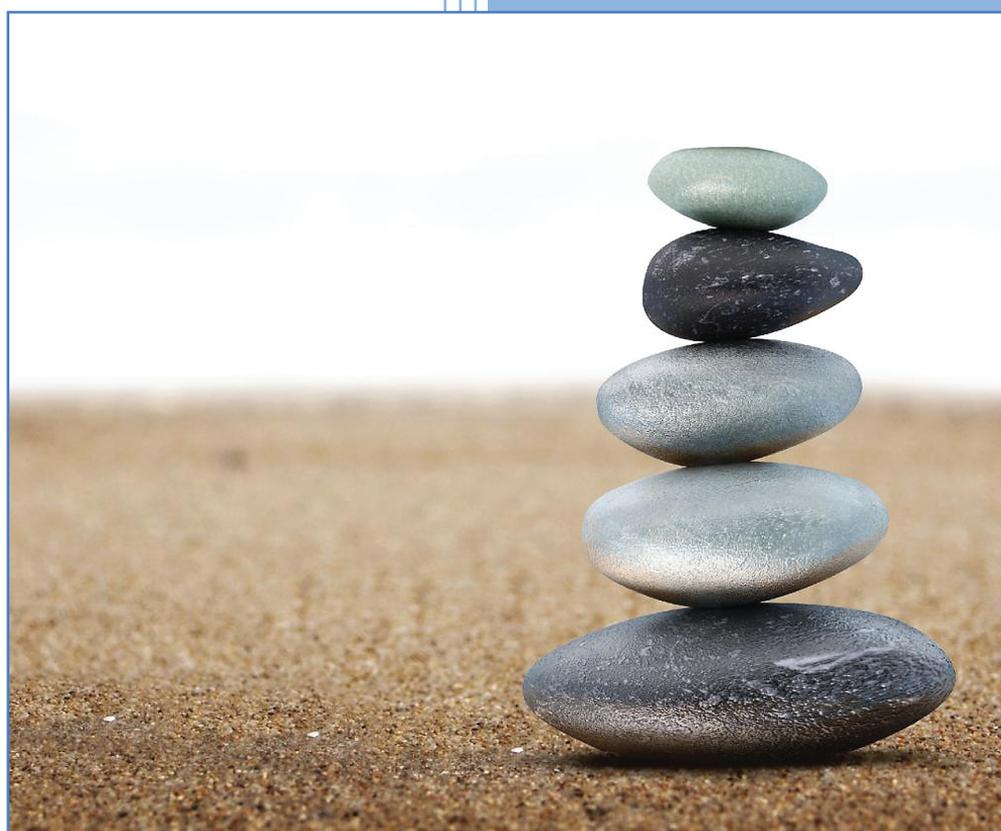


December 2013

Financial Stability Review



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

The Central Bank of the Russian Federation

FINANCIAL STABILITY REVIEW

December 2013

Moscow

All statistical data and calculations in this Review are given as of October 1, 2013 if available as of December 2, 2013.

The Review text and statistical data in the Russian and English languages are also available on the Bank of Russia's website.

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.



*If using information from this Review,
reference to the Bank of Russia is obligatory.*

Contents

Summary	5
Chapter 1. Global Economic and Financial Market Risks.....	7
1.1. Risks and Economic Prospects in Leading Economies	7
1.2. Commodity Market Developments	9
1.3. Advanced Economies' Exit from Quantitative Easing Policies: Possible Implications for Russia	11
<i>Box 1. Growth of Non-resident Portfolios of Federal Loan Bonds</i>	13
Chapter 2. Financial Sustainability of the Non-financial Sector	15
2.1. Macroeconomic and Sectoral Risks	15
2.2. The Financial Standing of Non-financial Commercial Organisations	18
Chapter 3. The Assessment of Banking Sector Systemic Risks	21
3.1. Household Loans	21
<i>Box 2. The Survey of the Largest Retail Banks</i>	23
3.2. Growth of Refinancing Volumes and Systemic Liquidity Risk	24
3.3. The Deterioration in the Banks' Profitability and its Causes	27
<i>Box 3. Market Indicators of Risk</i>	29
<i>Box 4. Deleveraging Trends for Foreign Banks' Subsidiaries in Russia</i>	31
Chapter 4. The Financial Standing of Non-credit Financial Organisations	33

List of illustrations

Chart 1. Annual GDP Growth (consensus forecast from 2013)	7
Chart 2. S&P GSCI Commodity Index Dynamics by Category (02.01.2007 = 1 unit)	9
Chart 3. S&P GSCI Composite Commodity Index and MSCI EM Stock Index Dynamics	9
Chart 4. Monthly Aluminium Alloy Exports and Imports	10
Chart 5. Monthly Steel Alloy Exports and Imports	10
Chart 6. US Federal Reserve's Federal Funds Rate	12
Chart 7. Current Account Balance and External Debt of Some Emerging Economies	12
Chart 8. OFZ Market Volume and Non-resident Share in 2012–2013	14
Chart 9. Yields of Emerging Economies' 10-year Bonds (response to the FOMC meeting, June 19, 2013)	14
Chart 10. Real GDP Annual Growth Breakdown by Component	15
Chart 11. Russian Labour Market Seasonally Adjusted Indicators	16
Chart 12. Fixed Capital Investment by Sector (first half of 2013 on corresponding period of previous year)	16
Chart 13. Prices of Specific Components of Metallurgical Production	17
Chart 14. Mineral Fertilizer Prices (DTN Fertilizer Index)	18
Chart 15. Business Climate Indicator in 2011–2013	19
Chart 16. Change in Economic Conditions (exporter enterprises) in 2011–2013	19
Chart 17. Interest Rates on Real Sector Bank Loans and OFZ Bonds	20
Chart 18. The Value and Annual Growth of Household Loan Portfolio	21
Chart 19. Annual Growth of Household Loans by Lending Segment	21
Chart 20. The Value and Annual Growth of Household Overdue Loans	22
Chart 21. Annual Growth of Loans with Overdue Payments of 91 Days or More	23
Chart 22. Surveyed Banks' Loans by Segment.....	24
Chart 23. Bank Debt on the Bank of Russia Refinancing Instruments and Federal Treasury Funds Deposited with Banks in January–October 2013	25
Chart 24. Current and Expected Utilisation Ratios in 2013–2014	25
Chart 25. Russian Banks' HQLA	27
Chart 26. Banking Sector Profitability Indicators.....	27
Chart 27. Banking Sector Return on Assets (ROA) by Country	27
Chart 28. Factors Contributing to Change in Banking Sector Return on Assets	28
Chart 29. Banking Sector Profit for 12 Months (before tax).....	28
Chart 30. Russian Banks' Spread on Five-Year CDS Contracts	30
Chart 31. Sampled Banks' Assets	32
Chart 32. The Volume and Annual Dynamics of Insurance Premiums and Payments.....	33
Chart 33. Russian Insurance Market Structure by Premium in First Half of 2013	34
Chart 34. The Volume and Annual Growth of NPF Accumulations and Reserves	35
Chart 35. The Structure and Annual Dynamics of NPF Own Assets	35

List of tables

Table 1. Production of Goods and Services, as % of corresponding period of previous year	16
Table 2. Financial Indicators of Enterprises in Key Types of Economic Activity in the First Half of 2013 and 2012	19
Table 3. Russian Banks' Quoted Shares and Depository Receipts	29

Summary

The Russian financial sector remained relatively stable in 2013 Q2 and Q3. Banks and other market participants calmly lived through the period of increased global financial market volatility in May–June caused by the expectations of a quick tapering of the US monetary stimulus programme. At the same time, the expectations that the US Federal Reserve would start to scale down its quantitative easing programme in 2014 contributes to higher market volatility. The US actual exit from quantitative easing may add to negative global market response, if monetary tightening in the United States is accompanied by weak economic dynamics in other regions, primarily, in the eurozone. The nature of global economic recovery will largely determine the situation in Russia also due to the country's strong dependence on the prices of oil and other commodities. Internal threats to the Russian financial system come from the deterioration of loan portfolio quality and higher volumes of bank encumbered assets. On the whole, bank systemic risks seem moderate. Enhanced risk management, including the development of international standards-based regulation, facilitates greater sustainability of credit institutions.

The period of global economic recovery is being drawn out, despite the continued accommodative policies being pursued by the leading central banks. In October, the International Monetary Fund (IMF) lowered its forecast of global GDP growth from 3.2% to 2.9% in 2013 and from 3.8% to 3.6% in 2014. China's economy is expected to slow down considerably in the coming years: the IMF estimates that China's GDP will grow by an average of 7.0% annually as compared with the previous 9.8% (on average over the 15-year period from 1997 to 2011). At the same time, a positive impulse of this growth will not necessarily contract for other countries: China's GDP growth is stronger in absolute terms than in the previous years while the country is increasingly concentrating on domestic demand rather than on exports.

Global financial markets responded so strongly to the statements by US Federal Reserve officials in June that the monetary authorities of some emerging economies were forced to use emergency support instruments to stabilise the situation on domestic financial markets. The reaction of the Russian financial market, particularly, the federal loan bond market, was moderate and prompted no special response measures from the Bank of Russia. Nevertheless, the US actual exit from the QE3 programme may exacerbate the situation in the global economy and on the world financial market. Risks may spread in other economies, including Russia, both through a direct impact on the financial system (materialisation of interest rate risk due to higher interest rates and market risk because of the depreciation of assets and national currencies and, as a consequence, credit risk materialisation) and through an influence on the economy (lower oil prices would adversely affect the current account of the balance of payments, budget revenues, etc.). But at the same time, under the most probable base scenario, in 2014, global and Russian economy growth rates are expected to accelerate.

The quality of bank loan portfolios tends to deteriorate. In 2013, lower business activity was observed in most of the key sectors of the Russian economy, with a growth slump demonstrated by metallurgy due to the deterioration of the situation on the world metals market.

If macroeconomic risks intensify, some Russian non-financial companies may become vulnerable due to their low profitability and a high debt burden. Though interest rate risks look limited for non-financial organisations in general, a rate hike may considerably reduce the financial sustainability of most heavily leveraged enterprises.

The rates of corporate external debt growth exceed the rates of financing received by companies in the form of bank loans and bond issues. The Bank of Russia estimates that the external debt of other sectors¹ increased by 22.3% as of October 1, 2013 year on year, with most of this debt denominated in foreign currency, which exposes some companies to foreign exchange risk.

Apart from the corporate sector factor, higher credit risk in the banking sector is caused by the deterioration of consumer loan quality. The volume of household overdue loans increased by 22.8% in 2013 Q2 and Q3 to exceed the level of 400 billion roubles as of October 1, 2013. The annual growth in homoge-

¹ The data are based on the statistics of the external debt of the Russian Federation compiled for the section "Other Sectors," which includes the debt of non-credit financial companies and individuals in addition to the external debt of non-financial organisations. At the same time, non-financial organisations account for most of the external debt in this section.

neous unsecured loans with overdue payments of 91 days or more totalled 70.7% as compared with 38.9% as of April 1, 2013. The deterioration of the quality of loans and the growth of provisions are to a larger extent observed among market participants focused on consumer lending.

The banking sector's lower profitability restricts the potential of capital build-up and requires more cautious dividend policies in the future. The banking sector's lower profitability was mainly caused by the growth in loan loss provisions, which has registered a steadily negative contribution to profitability dynamics from the beginning of the year. A further possible fall in the banking sector's profitability would restrain banks' possibilities to increase their capital. In this relation, banks and their shareholders can be advised to review dividend policies and increase reinvestment rates, which showed some decrease in 2012 as compared with 2011.

The growth of encumbered liquid assets would require banks to use the Bank of Russia refinancing against the pledge of non-marketable assets more actively. The level of market asset encumbrance ranged from 40% to 60% in the period under review. Loans provided to the banking sector at auctions against the pledge of non-marketable assets restricted the growth of this indicator. A forecast of the Bank of Russia monetary indicators for 2014–2016 suggests that the level of encumbrance of market assets accepted by the Bank of Russia as collateral may exceed 60% by the end of 2015 in the event of a further growth in gross credit extended by the Bank of Russia to credit institutions, provided that the collateral structure remains unchanged. In view of this, it is advisable for banks to expand their potential of using non-marketable assets for the Bank of Russia refinancing.

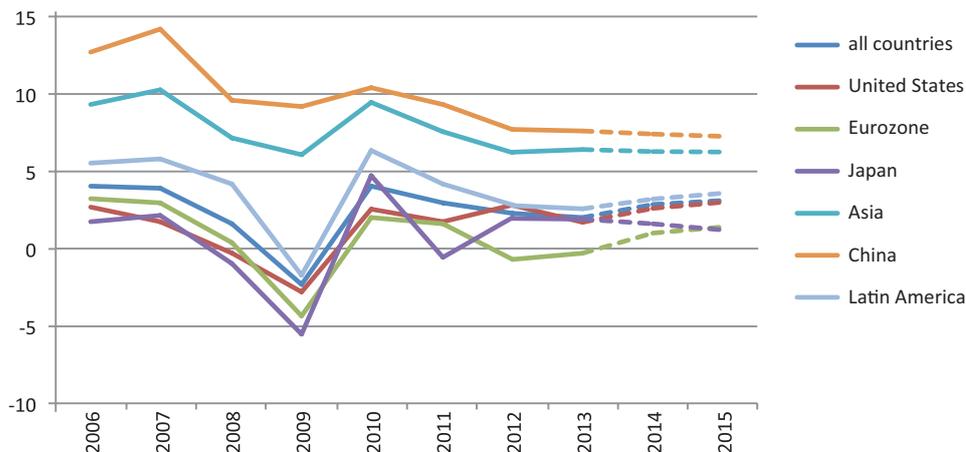
Chapter 1. Global Economic and Financial Market Risks

1.1. Risks and Economic Prospects in Leading Economies

The US Federal Reserve's possible exit from its QE programme caused considerable disturbances on world financial markets in 2013 Q2 and Q3. In particular, weakened investor optimism prompted a significant outflow of foreign capital from emerging economies. Despite the Fed's decision in September 2013 to maintain the key parameters of its monetary policy (including its unconventional support for the economy), the expectations of a change in the Fed's policy persist. The increase of these expectations, as well as the actual QE tapering, will most likely be accompanied by a recurrence of volatility upsurges on financial markets. This process will considerably affect emerging economies due to a high degree of their vulnerability to external shocks and the existence of structural imbalances.

Market participants have developed the expectations of a longer period of weak growth in the major emerging economies. Therefore, despite positive trends in the US economy and some improvement in the economic situation in Europe, the prospects of global economic growth are observed to deteriorate. In its World Economic Outlook,² the IMF lowered its forecast on global GDP growth from 3,2% to 2.9% in 2013 and from 3.8% to 3.6% in 2014. The forecast remained unchanged for advanced economies (1.2% and 2.0%, respectively) and was downgraded for emerging economies (from 5.0% to 4.5% and from 5.5% to 5.1%, respectively). Macroeconomic statistics and a consensus forecast on GDP growth published by major financial institutions³ acknowledge weak global economic growth and its slowing in developing Asian countries in the next few years (Chart 1). Therefore, the impulse of global economic growth is expected to move from developing to advanced economies.

Chart 1. Annual GDP Growth (consensus forecast from 2013), %



Source: Bloomberg.

The main contribution to global growth in the short-term perspective will most likely be made by the **United States** where the economy is recovering at a moderate pace (GDP grew at an annual rate of 2.5% and 3.6% in 2013 Q2 and Q3) amid a lower pressure from budget consolidation measures (budget cuts launched from March 2013) and the persistently favourable conditions on financial markets (due to low interest rates and stimulus measures). At the same time, political risks remain a concern because a temporary decision on the US Treasury Department's borrowing authority passed in October 2013 put off only for a short time (until February 7, 2014) the problem of raising the government debt ceiling.

The signs of an improvement in the economic situation appeared in **Europe**: the eurozone finally came out of a recession (the region's GDP grew by 0.3% and 0.1% in 2013 Q2 and Q3, respectively, as compared with the previous quarter), although the real sector's weak indicators, budget and debt risks and the

² World Economic Outlook. IMF, October 2013.

³ Global financial institutions, national banks, non-bank financial organisations, etc.

banking sector insufficient stability remain the key problems of many countries in the monetary union. The Federal Reserve's QE tapering may eventually pose a considerable risk. Problem countries will be confronted with the growing cost of sovereign debt servicing at a rate hike, which may disrupt their fiscal sustainability.

In these conditions, the need to maintain the market's confidence in the eurozone financial system requires commitment to accommodative monetary policy from the European Central Bank (ECB). In July 2013, the ECB announced that its interest rates would remain low "for an extended period." This formulation actually means that the regulator is moving away from the conventional "no-precommitment" policy to the policy of forward guidance. In November 2013, the ECB lowered its base rate from 0.5% to 0.25% due to a higher deflation risk. The ECB also does not rule out the necessity of a new round of long-term refinancing operations (LTRO) as the depletion of excess liquidity spent on repayments of long-term loans previously issued by the ECB may put an upward pressure on borrowing costs (as of December 11, 2013, banks repaid 403 billion euros out of 1,018 billion euros owed). In the future, European banks' persistently strong demand for credit facilities will also be influenced by the Basel III liquidity standards: the liquidity coverage ratio requirements (LCR) will come into force from 2015.

In **Japan**, the launch of the programme of qualitative and quantitative easing and the implementation of fiscal stimulus measures are expected to end deflation and see a gradual recovery of Japan's economy, although the positive effect of these policies in 2014 will most likely be restrained by fiscal tightening (a consumption tax hike).

The dynamics of major macroeconomic indicators in **China** in 2013 Q2 and Q3 demonstrate time and again that after the period of accelerated growth observed in the past few decades, the country is switching to a new development stage characterised by a slower GDP growth.

China's annual GDP growth has stabilised at 7.5%–8.0% over the past 18 months, with an official growth target set at 7.5%. China's GDP grew by 7.8% and 7.5% in 2013 Q2 and Q3, respectively. China's export and import growth has been slowing since early 2010 while inflation, which has increased over the year, remains relatively low (3.1% as of the Q3 end). The IMF expects China's GDP to grow by an average of 7.0% annually in the coming years against the previous 9.8% (the average figure for the 15-year period from 1997 to 2011). China's slower economic growth will be determined by the aggregate effect of the following factors.

1. The contraction of global economic demand.
2. Domestic structural changes:
 - the transition from the extensive growth model oriented to exports and mainly focused on a heavy industry to a higher role of domestic demand and the more balanced development of economic sectors;
 - the country is witnessing negative changes in the demographic trends that were the key growth factors in the previous years: population ageing, the falling share of the working-age population, a slower migration of labour from the countryside to urban factories;
 - considerable growth observed lately in production costs (wages, leases) combined with falling labour productivity.
3. Economic policy measures being implemented and planned, including steps to reduce chronic overproduction in heavy industries reliant on government subsidies and establish higher environmental and qualitative production standards.

These trends in the development of the real sector are aggravated by a number of risks typical of the Chinese financial system:

1. A considerable growth in the volume of the shadow banking system providing, according to various estimates, from 30% to 50% of all loans, which may increase credit risks and create asset market bubbles.

2. The substantial debt burden of local authorities accumulated as a result of an attempt to mitigate negative consequences of the 2008–2009 crisis, several rounds of stimulus measures and an easy access to cheap loans.

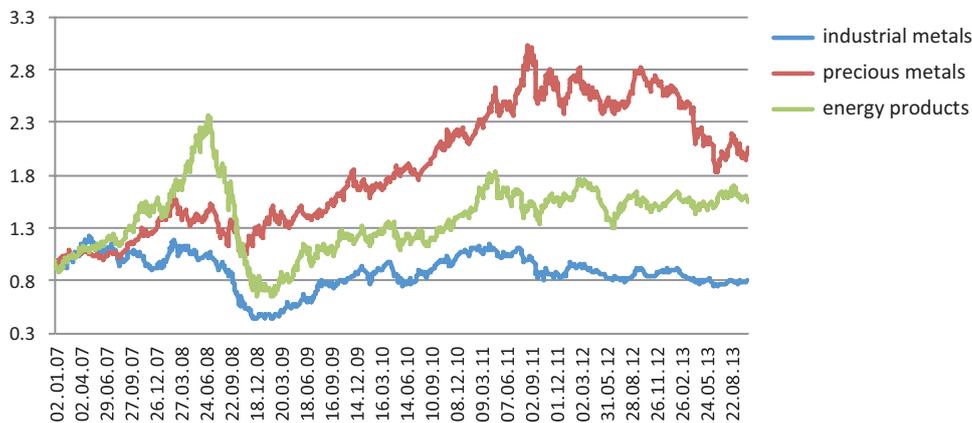
3. Uncertainty over the ability of the banking system, which demonstrated stable rates of growth in profitability at the stage of the economy’s accelerated development, to function steadily amid a slower economic growth and the government’s policy of liberalising China’s financial markets.

Therefore, China’s transition to a new development model is prompted both by the overall slowing of the global economy and structural changes in the Chinese economy. At the same time, the implementation of economic policy measures may be accompanied by additional risks.

1.2. Commodity Market Developments

Since 2011, world commodity markets have demonstrated a fall in prices, in particular, the prices of industrial (aluminium, steel, copper, nickel, etc.) and precious (gold, silver, platinum, etc) metals, and relatively stable energy prices (Chart 2). Oil prices in 2013 have steadily stayed slightly above \$100 per barrel, except for April, when they fell below this level by \$2–5 per barrel amid higher risks of US stimulus tapering.

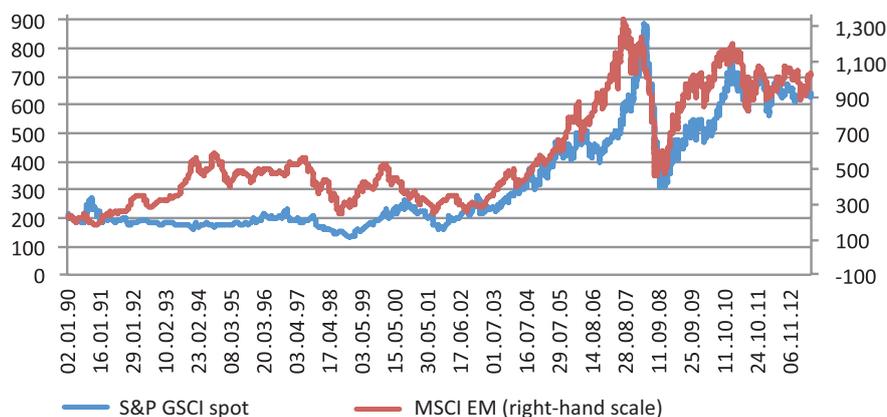
Chart 2. S&P GSCI Commodity Index Dynamics by Category (02.01.2007 = 1 unit), units



Source: Bloomberg.

Commodity market price dynamics are traditionally **determined by fundamental macroeconomic indicators: changes in the global demand and supply depending on the state of the world economy.** The rapid growth of emerging economies in the 2000s as a result of a considerable inflow of foreign capital was a key factor of commodity market price increases, which can be evidenced by a higher correlation between the S&P GSCI composite commodity price index and the MSCI Emerging Markets stock index (Chart 3).

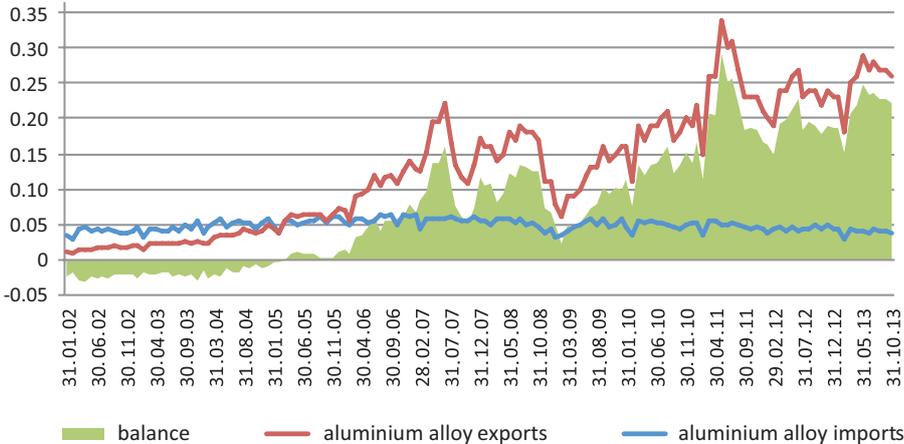
Chart 3. S&P GSCI Composite Commodity Index and MSCI EM Stock Index Dynamics, points



Source: Bloomberg.

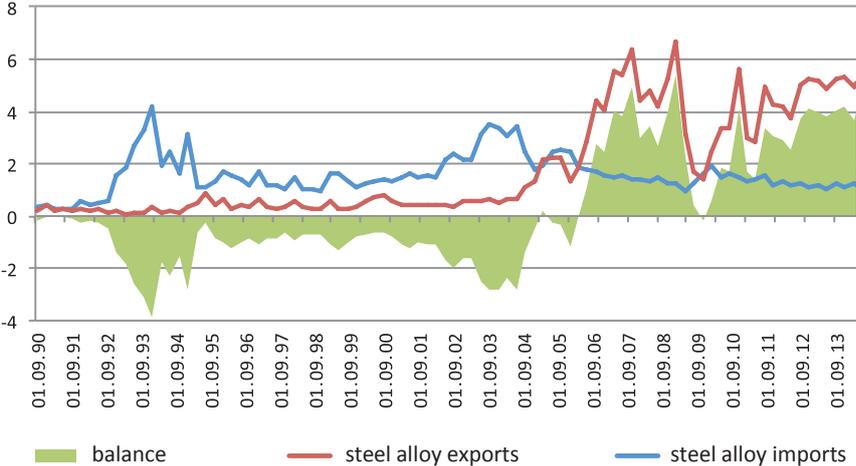
However, since 2011, global demand, in particular, the demand for industrial metals, has started to fall gradually behind global supply. **On the supply side**, overproduction observed in China’s heavy industries played a considerable role in the fall of metal prices. In particular, China, for example, is the largest producer of aluminium and steel alloys. According to data of the World Aluminium Institute and the World Steel Association, China’s monthly production of primary aluminium and crude steel in October 2013 totalled 1.9 million tonnes (as compared with the world output of 4.2 million tonnes) and 65 million tonnes (as compared with the worldwide production of 134 million tonnes), respectively. Year on year, China’s monthly aluminium and steel production grew by 13.6% and 9.2%, correspondingly. Moreover, in recent years, China has turned from a net importer of aluminium and steel alloys into a net exporter of these products (Chart 4 and Chart 5). Despite statements by China’s authorities about planned measures to tighten environmental standards and reduce financing (including subsidies) for this sector, the problem of overproduction is unlikely to be resolved radically in China in the next two years.

Chart 4. Monthly Aluminium Alloy Exports and Imports, million tonnes



Source: Bloomberg.

Chart 5. Monthly Steel Alloy Exports and Imports, million tonnes



Source: Bloomberg.

A fall in the world prices of industrial metals in recent years can also be explained by **a decline in global demand** – first, amid the development of the eurozone debt crisis, and then due to a slower economic growth in the largest emerging economies (first of all, in China). Nevertheless, despite slower GDP relative growth rates, China’s growth will continue to generate a strong positive impulse for the world economy. A quicker recovery in advanced economies will also serve as a positive factor.

At the same time, **the QE tapering** may adversely affect world commodity prices due to increased price sensitivity to monetary policy measures. Historical data indicate that a start of quantitative easing in the

United States in late 2008 became a breaking point in the price dynamics of practically all commodity markets. At this moment, the markets of oil, aluminium, copper and other commodity groups bottomed out and demonstrated a steady recovery until the end of the programme's first round. A steady upward trend was observed during the programme's second round, which gives grounds to suggest that unconventional policies of the world's leading central banks have a strong impact on these markets. At the same time, the exit from the QE1 and QE2 programmes was accompanied by a fall in commodity prices instead of stabilisation. In view of this, there are risks that the Fed's policy of tapering its QE3 bond purchase programme will be accompanied by a considerable fall in bull's interest and will therefore lead to a continued downward price correction on these markets.

The reform of the warehouse network unveiled by the London Metal Exchange (LME) on November 7, 2013 and set to be implemented from April 1, 2014, may lead to a fall in aluminium prices. The reform is designed to cut the queues of consumers waiting for the physical delivery of non-ferrous metals, primarily aluminium, which is the LME's leader by trading volumes. The LME decided to link deliveries from warehouses to shipments so that the maximum waiting time from the metal purchase to its delivery (the queue) does not exceed 50 calendar days (currently, consumers have to wait for 200–300 days on average, according to media reports). For queues of greater than 50 days, metal load-out must exceed metal load-in. The new warehousing rules may force warehouses to sell promptly excess aluminium stockpiles, which currently total about 2 million tonnes out of 5.4 million tonnes stored by the LME.

Analysis of factors influencing the dynamics of commodity prices should also take into account the fact that since the early 2000s commodity markets have registered considerable changes in the institutional structure related to the development of derivatives and a higher role of financial intermediaries (the so-called market financialisation). Commodity speculators appeared on the markets and commodity bubbles started to emerge in some market segments. According to surveys conducted by the United Nations Conference on Trade and Development (UNCTAD), the share of institutional investors in the volume of positions on the commodity derivatives markets grew from 25% in the 1990s to 85% in 2012. These changes have considerably increased price volatility on commodity markets, i.e. short-term price movements have largely started to depend on the expectations of financial market participants engaged in commodity derivatives trading. At the same time, some international studies indicate that market expectations have a weak long-term effect on the trend and long-term commodity prices continue to depend on fundamental macroeconomic indicators.⁴

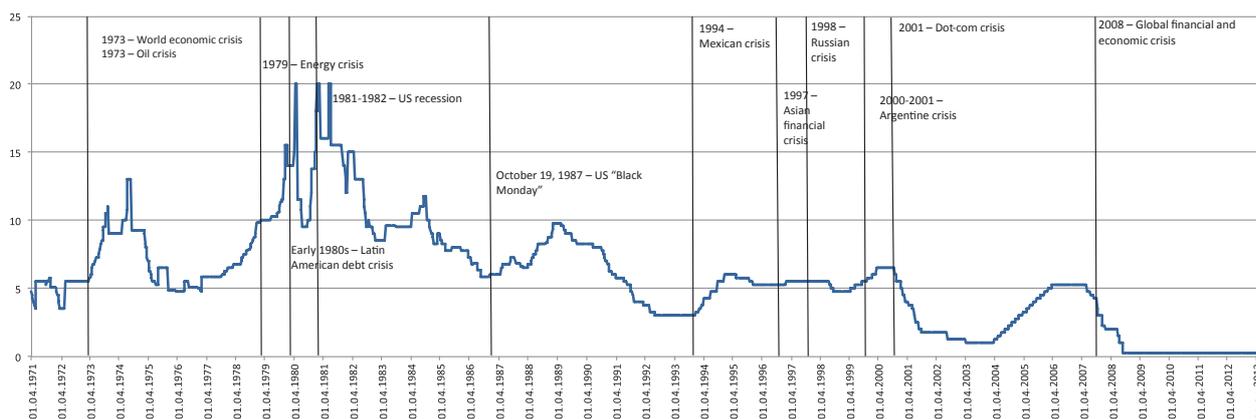
1.3. Advanced Economies' Exit from Quantitative Easing Policies: Possible Implications for Russia

As the world economy demonstrates uneven growth, some advanced countries, first of all the United States, can be expected to start scaling down quantitative easing policies earlier than others. In this case, the eurozone, which is demonstrating weak economic growth, would be forced to implement additional stimulus measures to limit negative pressure on long-term rates. The response of emerging economies' regulators would depend on the degree of the economies' sensitivity to the risks of foreign capital outflow. In 2013, many central banks in emerging economies were forced to start tightening their interest rate policies due to the increased risks of the national currencies depreciation.

In general, the US QE tapering may have quite considerable implications for the global economy owing to the following reasons. First, the US monetary tightening at many historical stages was accompanied by world financial market turmoil or the deterioration of the economic situation in some countries. Second, the leading central banks are currently maintaining record low base rates and therefore market participants would find it more difficult to adapt to tighter conditions than in the previous periods of monetary tightening. Finally, it is important to take into account the fact that unlike the two previous rounds of quantitative easing when the US Fed defined their timeframes and market participants were prepared for their completion, the last third round was announced without any limits on its duration or volume.

⁴ *Commodity Market Financialisation: A Closer Look at the Evidence. RBA Bulletin, March Quarter 2012.*

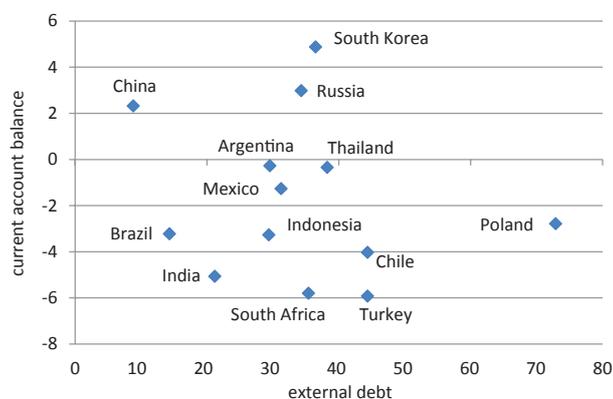
Chart 6. US Federal Reserve's Federal Funds Rate, %



The Federal Reserve's QE3 tapering will primarily prompt the growth of long-term rates in the country because short-term rates are separately targeted by the regulator. The yield curve reversal towards the growth of long-term interest rates may adversely affect the debt markets. The markets of sovereign borrowings by the countries with excessively high state debt may become especially sensitive to higher long-term rates. Eurozone problem countries may be hit the hardest.

A serious threat for emerging economies is posed by risk materialisation through the financial system (interest rate, market and credit risks) and the deterioration of the balance of payments. In both cases, the situation is aggravated by a high degree of emerging economies' dependence on external financing, which can be evidenced by a current account deficit demonstrated by a large number of these countries and a considerable volume of external liabilities (Chart 7).

Chart 7. Current Account Balance and External Debt of Some Emerging Economies, % of GDP



Source: Bloomberg.

Foreign capital outflow as a result of the US QE tapering may either prompt materialisation of risks related to interest rate hikes in an effort to keep currencies from depreciation or realisation of risks related to devalued currencies. Depreciation may trigger inflation growth and create problems with foreign debt repayment. Market responses to June statements by US Federal Reserve Chairman Ben Bernanke on the possible reduction of stimulus measures have shown that the national currencies of many emerging economies are strongly exposed to devaluation risks. Some central banks were forced to start foreign currency interventions in the summer of 2013 while a number of countries lifted restrictions on foreign capital inflows. The private debt market may also suffer as the private sector's debt burden has risen significantly in recent years, first of all in Asian countries. It is obvious that a rate hike will considerably push up the private sector's debt financing costs.

Russia's positions with regard to sovereign and private debt risks look quite stable. Russia is among the countries with the lowest relative state debt levels in the world. As of October 1, 2013, Russia's internal state debt amounted to 7.7% of GDP (several times lower than the debt of the other BRICS countries); the country's domestic corporate debt (non-financial organisations' liabilities on loans extended by Rus-

sian banks and loans raised from bond issues) stood at 36.5% of GDP while Russia's total external debt⁵ equalled 35.2% of GDP, of which the private sector (banks and other sectors) accounted for 31.3% of GDP.

Rate hikes can be expected to have a limited impact on the Russian banking sector net incomes from operations with foreign assets and liabilities owing to a low level of maturity mismatches. The influence of interest rate risk on the non-financial sector is also limited (for details, see Chapter 2. Financial Sustainability of the Non-financial Sector).

Importantly, rate hikes may also trigger the growth of financial market volatility. As interest rates in developed countries have stayed low in recent years, global investors have been increasing their investment in the emerging countries assets in search for higher yields, which resulted in the growth of asset prices and the reduction of risk premiums. A change in base rates and market participants' expectations may considerably reduce the value of assets on emerging markets.

The Bank of Russia has assessed the consequences of potential depreciation of the Russian banks' stock portfolio. As of September 1, 2013, debt securities portfolios accounted for 11% of the banking sector assets while equity securities portfolios made up 1%. Securities portfolio revaluation may have a potentially strong impact on some banks and the banking sector. A stress scenario assumes the growth of yields by 200 bp on Russian government bonds and by 350 bp on other obligations, as well as a decrease in the price of equities by 25%.

The analysis results have shown that the greater part of the banking system is generally resilient to negative developments on the stock market from the standpoint of bank capital adequacy. The capital adequacy ratio (further down – CAR) of the banking system is estimated at 12.1% after the stress as compared with 13.4% as of October 1, 2013.

In addition, the Federal Reserve's monetary policy tightening may create negative consequences through the swap market because these operations carry foreign exchange and interest rate risks. The main instruments on the Russian swap market in 2013 Q2 and Q3 were interest rate swaps, which made up more than half of the market volume, and cross currency swaps accounting for about a third of the market. The main currencies were the rouble and the dollar, which made up over 90% of all transactions. Market participants mostly conducted medium-term operations.

The Bank of Russia estimates that domestic banks' losses from interest rate swaps will not exceed 10 billion roubles if interest rates grow by 200 bp and the rouble depreciates by 30%. In the future, however, market participants' risks may increase, considering the dynamic development of the interest rate swap market.⁶ It is important to note a significant share of non-residents on the market: a foreign company or the subsidiary of a foreign bank holding company registered in Russia acted as a counterparty in more than 95% of these transactions. Operations on the market are mostly focused on intra-group swaps.

The above estimates indicate that Russian banks' potential losses through the interest rate channel are moderate. At the same time, the estimated fall of the CAR below 10% as demonstrated by specific banks in stress testing of their interest rate risk is in many instances related to a low bank capital adequacy before the stress rather than to the scope of negative portfolio revaluations.

Box 1. Growth of Non-resident Portfolios of Federal Loan Bonds

The structure of the holders of Russian government bonds was mostly determined by the type of issued securities. Eurobonds were purchased by foreign investors while federal loan bonds (OFZ) circulating on the domestic market were fully acquired by residents. In early 2012, non-resident portfolios of OFZs totalled only 4% of the market's nominal value.

The situation started to change in the second half of 2012 ahead of the domestic government securities market liberalisation. Nominee accounts opened for foreign clearing and settlement organisations at the Russian central depository in early 2013 virtually fully removed the so-called infrastructural pre-

⁵ The external debt was recalculated at the rouble exchange rate effective as of October 1, 2013.

⁶ The market volumes grew from 3.14 trillion roubles as of April 1, 2013 to 4.08 trillion roubles as of September 1, 2013. The market volumes are calculated as the aggregate amount of the nominal values of interest rate swap transactions; cash flows generated by these instruments are normally tens of times lower than the market volumes during the year.

mium: the yields of OFZs circulating on the Russian market came close to the yields of rouble-denominated Eurobonds listed on the London and Berlin stock exchanges (the yields of similar OFZs were previously higher by about 100 bp). The market liberalisation was accompanied by the growth of foreign investment: the volume of OFZs held by non-residents had reached 25% of the market's nominal value by September 2013.

The growth of non-resident OFZ portfolios testifies to the efficiency of market liberalisation measures and the increasing confidence of foreign investors in Russia. At the same time, non-resident growing presence inevitably increases the domestic government debt market's dependence on external economic conditions and global financial market participants' sentiments.

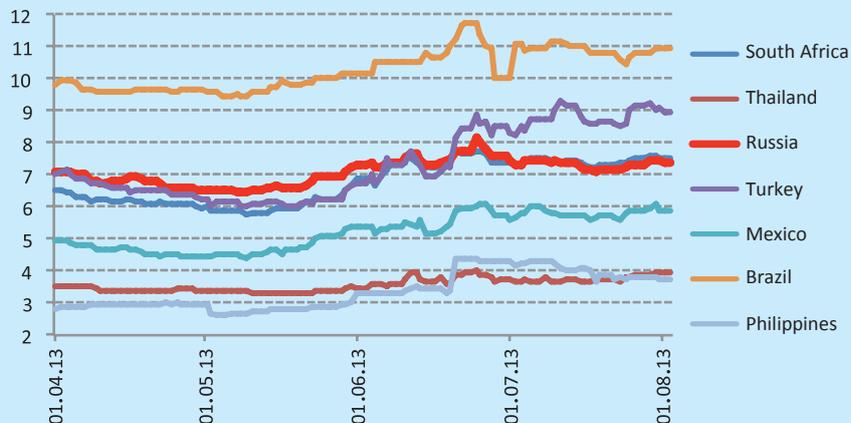
Nevertheless, the yields of Russian government bonds are presently characterised by a relatively high level of stability. Thus, the response of OFZ yields to the results of the June 19, 2013 meeting of the US Federal Open Market Committee (FOMC) was generally similar to the reaction of yields on the government securities of other emerging economies but yield volatility in Russia was lower and OFZ yields were quicker to return to the previous level (Chart 9). In view of this, there are grounds to believe that the present stage of the sovereign debt market development in Russia, as well as the current level of foreign investors' presence, ensure fair pricing and the market's stability.

Chart 8. OFZ Market Volume and Non-resident Share in 2012–2013



Sources: Ministry of Finance of the Russian Federation, Bank of Russia.

Chart 9. Yields of Emerging Economies' 10-year Bonds (response to the FOMC meeting, June 19, 2013), %



Source: Bloomberg.

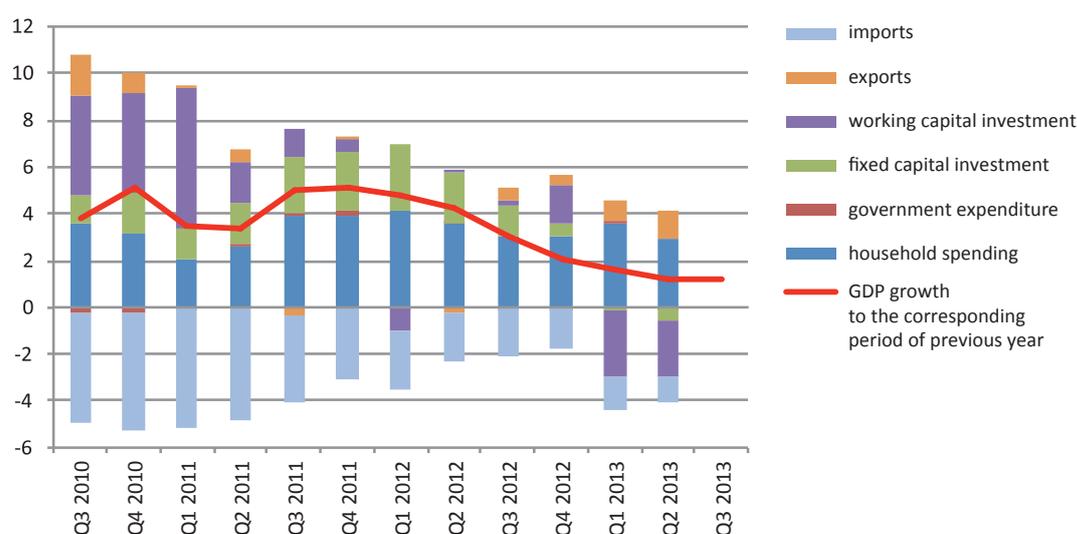
Chapter 2. Financial Sustainability of the Non-financial Sector

2.1. Macroeconomic and Sectoral Risks

The Russian economy continued to slow down in the period under review. According to Rosstat data, Russia's GDP fell by 0.2% in 2013 Q1 quarter on quarter and by another 0.3% in Q2. Russia's GDP annual growth totalled only 1.6% in Q1 and 1.2% both in Q2 and Q3, respectively.⁷

Ministry of economic development of the Russian Federation expects GDP to grow by 1.4% in 2013, with some growth acceleration to 2.5% in 2014 amid a general recovery of the world economy. GDP stagnation stems from both cyclical factors related to a slower growth in the countries that are Russia's major trading partners, and internal structural factors.

Chart 10. Real GDP Annual Growth Breakdown by Component, %



Source: Rosstat; Bank of Russia calculations.

Private consumption remained the main factor of economic growth in Q2 and Q3 (2.3 pp of the annual GDP growth of 1.2% in Q2). However, the contribution of this factor can be expected to decrease amid a slower growth in household real income (3.4% in Q1, year on year, and 1.7% in Q2). The unemployment rate remains quite low so far but is beginning to increase while the growth of wages is starting to slow down (seasonally adjusted real wages reached their highest level in April–July 2013) amid the exhaustion of the potential for recovery growth. In addition, the consumer confidence index⁸ indicates a deterioration of the economic situation both in 2013 Q2 (-6 pp) and Q3 (-7 pp).

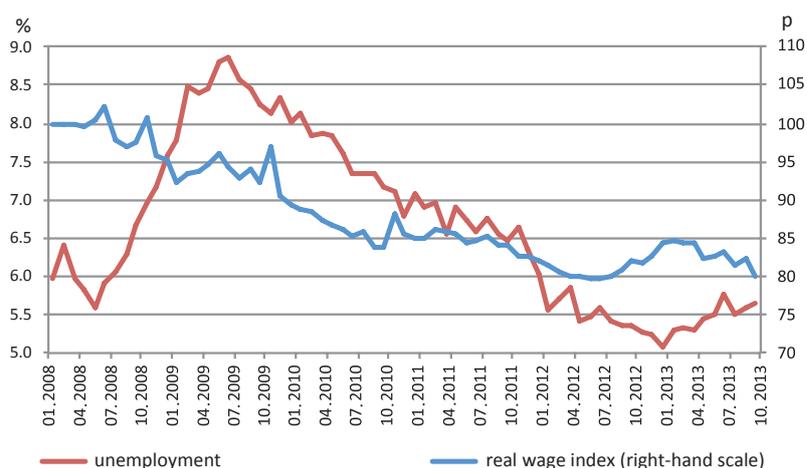
Fixed capital investment continues to contract: it fell by 1.4% in January–September 2013 as compared the same period of the previous year. Mining and pipeline transport companies demonstrated the largest contraction in absolute terms: they accounted for about three-fourths of the fall in fixed capital investment in the first half of the year. Despite an upward oil price trend (the price of Urals crude grew from \$105 to \$114 per barrel in April–August), oil and gas companies were seen to restrict their investment plans amid reduced global demand (mainly for crude oil) and falling profits.

Exports provided support to the country's GDP as a whole: according to Rosstat data, exports grew by 4.0% in real terms in 2013 Q2 year on year. Further prospects of economic growth in Russia will largely depend on export dynamics, as well as fixed capital investment, which in turn will be influenced by developments in the key economies and on global financial markets.

⁷Based on Rosstat preliminary data.

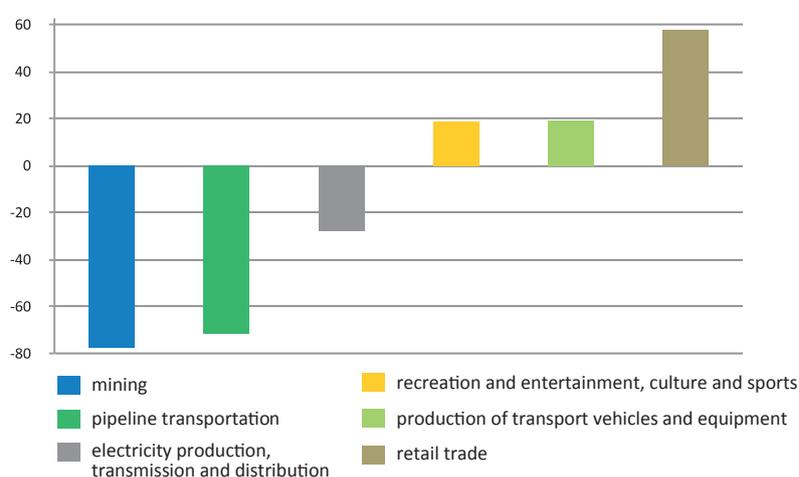
⁸The index is an arithmetic mean of 5 special indices: past and expected changes in personal finances, past and expected changes in Russia's economic situation and the prospects for large purchases. The special indices are calculated as the difference between the shares of respondent positive and negative assessments, excluding neutral assessments.

Chart 11. Russian Labour Market Seasonally Adjusted Indicators



Sources: Bloomberg; Bank of Russia calculations.

Chart 12. Fixed Capital Investment by Sector (first half of 2013 on corresponding period of previous year), billion roubles



Source: Rosstat; Bank of Russia calculations.

Business activity contracted in most of the key sectors of the Russian economy in January–September 2013 (Table 1), in particular, in industry and construction.

Table 1. Production of Goods and Services, as % of corresponding period of previous year

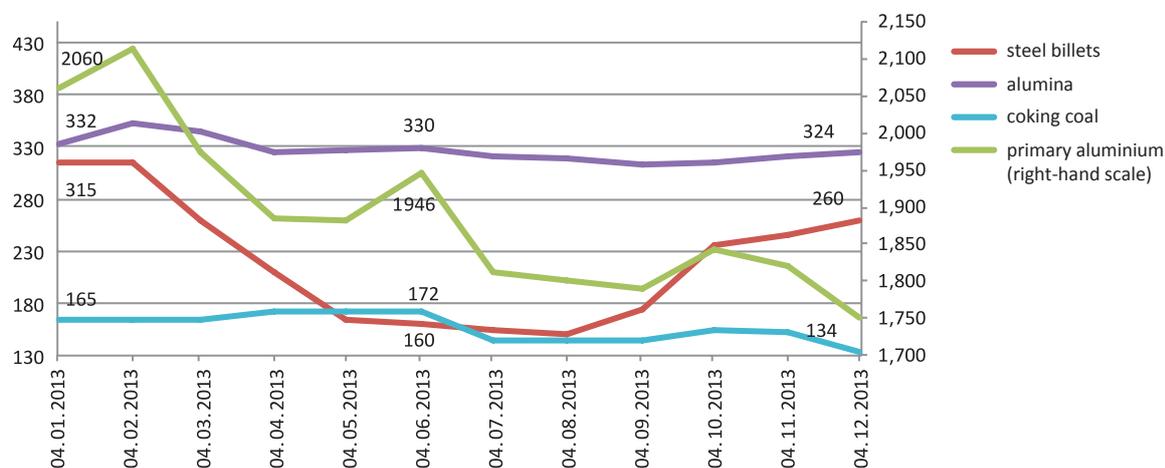
	January–September 2012	January–September 2013
Industrial production	102.9	100.1
Mining	101.0	101.1
Manufacturing industries	104.5	99.7
Electricity, gas and water production and distribution	101.3	99.5
Agriculture	97.1	101.8
Construction	102.3	98.9
Freight turnover	103.2	99.6

Source: Rosstat.

Metallurgy showed a considerable contraction in production growth rates due to the deterioration of the world metals market, namely, the reduction of global demand for metal products and excessive supply. In particular, Rosstat data show that metallurgical production and the output of finished metal products declined by 1.7% in the first nine months of 2013 as compared with the same period of the last year.

Excessive supply on the world market prompted a considerable fall in metal prices. Russia's exports of both ferrous and non-ferrous metals and articles made of them contracted by 12% in terms of value in January-September 2013. Estimates show that most of Russia's largest metallurgical companies receive about 50–80% of their revenues from exports. It is obvious that these companies will be unable to offset their losses from lower export revenues on the domestic market amid the contraction of investment in industry as a whole.

Chart 13. Prices of Specific Components of Metallurgical Production, US \$ per tonne



Sources: Metal Bulletin, Bloomberg, London Metal Exchange (LME).

Highly leveraged companies are especially hard hit by the deterioration of the external market situation. These companies have suffered considerable losses from the fall in the prices of aluminium, nickel, coking coal and other commodities (Chart 13). Due to the shortage of their own sources for current debt repayment, the companies are forced to dispose of their assets, reduce their capacities in Russia and abroad, negotiate with creditors on the postponement of debt payments and refinance a part of their liabilities with new loans.

The chemical sector was among the few manufacturing industries, which demonstrated positive dynamics in January-September 2013. Chemical production grew by 3.9% in the period under review as compared with the same period last year. At the same time, the output of mineral fertilizers, which account for a substantial share of Russian chemical exports, registered some decline as it fell by 0.5%. This reduction was attributed to a lower output of potash fertilizers, which fell by 3.1% while the production of other mineral fertilizers (nitrogen and phosphorous fertilizers) was observed to rise.

In general, the situation in the mineral fertilizer sector was not favourable due to the depreciation of the national currencies in the largest fertilizer importing countries, the fall in agricultural prices and the withdrawal of Uralkali from a joint venture with the Belarusian Potash Company⁹. The prices of all key fertilizers have declined considerably since the start of the year. Despite production growth demonstrated by most of Russia's largest mineral fertilizer companies, the reduction of exports¹⁰ and the fall in prices will adversely affect these companies' financial results for Q3 and the first nine months of 2013. At the same time, most of Russia's largest fertilizer exporters maintain an acceptable level of leverage (the net debt/EBITDA ratio does not exceed 2) and sufficiently high profitability (at least 25%)¹¹, i.e. they have a certain safety margin in the event of a further market deterioration.

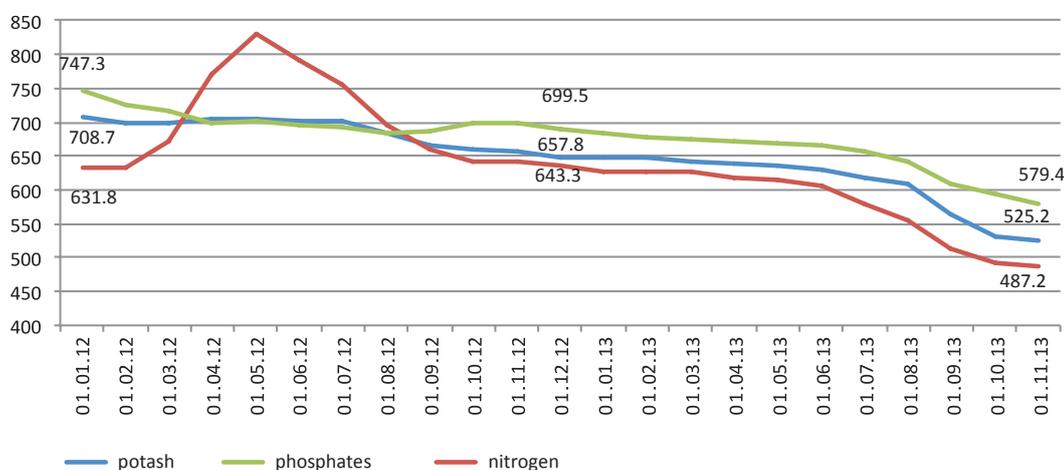
⁹ Potash producer Uralkali changed its sales strategy to focus on sales volumes rather than prices. Uralkali, which holds about 20% of the world potash market and boasts the lowest production costs in the segment, initiated tight price competition in the sector, which caused a considerable fall in potash prices.

¹⁰ In particular, Russia's potash exports decreased by 36.3% in January–September 2013 as compared with the same period of the previous year.

¹¹ The calculation was made using the indicators of Russia's five largest mineral fertilizer producers. Net debt was determined as a company's financial debt net of cash and cash equivalents; EBITDA was calculated as the sum of a company's operating profit, amortisation and depreciation. Profitability was assessed as the EBITDA to the company's revenues ratio.

The situation in **the automobile industry** was relatively unfavourable. The aggregate output of motor vehicles, trailers and semi-trailers grew at an annual rate of 2.1% in January–September 2013. At the same time, the industry’s two key sectors producing cars and trucks registered a reduction in output by 2.5% and 5.5%, respectively.

Chart 14. Mineral Fertilizer Prices (DTN Fertilizer Index¹²), US \$ per tonne



Source: Bloomberg.

Construction is one of the sectors that are especially sensitive to the domestic economy and external market conditions. Most of the Russian construction companies are traditionally characterised by high leverage (net debt/EBITDA ratio estimated for several construction companies that publish financial reports stays in the range between 2 and 3 and is possibly considerably higher for non-transparent companies) and this factor may make firms vulnerable, if the market situation deteriorates. A slower economic growth may negatively affect effective demand for both commercial and residential property.

Lending to industries and construction accounts for a considerable part of the banking sector loan portfolio. The deteriorating financial standing of companies in these sectors may reduce the quality of bank assets. Borrowers with a potentially unstable financial position are highly leveraged companies, which are unable to repay their debt through cash flow from operating activities and are forced to look for external sources of financing to service and repay their liabilities, which will possibly be problematic, if negative trends persist in the economy. The need to increase provisions for possible losses on these loans may put a further pressure on bank capital adequacy and profitability.

2.2. The Financial Standing of Non-financial Commercial Organisations¹³

The financial standing of non-financial commercial organisations remained satisfactory in the first half of 2013, although it had deteriorated considerably as compared with the same period of 2012. The deterioration was primarily observed among large enterprises.¹⁴ Industrial enterprises had the most solid financial position.

The business climate¹⁵ was observed to improve slower in the period under review than in the previous years (Chart 15). To a certain extent, this was attributable to the deterioration of economic conditions.¹⁶ In particular, the business climate deteriorated sharply for exporters (Chart 16) and economic activity risks exerted even more considerable pressure on production.

¹² The US-based DTN is the largest provider of real-time services for corporate clients in the agrochemical sector. The DTN Fertilizer Index features an average retail fertilizer price using data from grain exchanges in eleven states.

¹³ Analysis is based on official statistical data, and also the data obtained by the Bank of Russia from regular surveys of non-financial commercial enterprises in 79 Russian regions (as of August 31, 2013, the surveys covered over 17,000 enterprises).

¹⁴ Enterprises with assets of over one billion roubles.

¹⁵ The Bank of Russia 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 monitoring. The index is based on the business climate index methodology of the IFO Institute for Economic Research (Germany).

¹⁶ 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.”

Chart 15. Business Climate Indicator in 2011–2013, pp

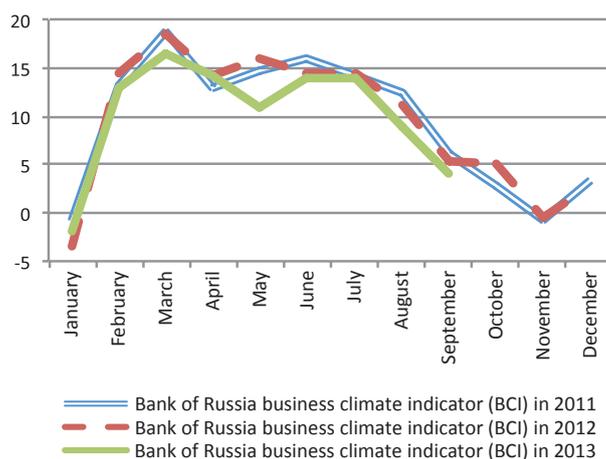
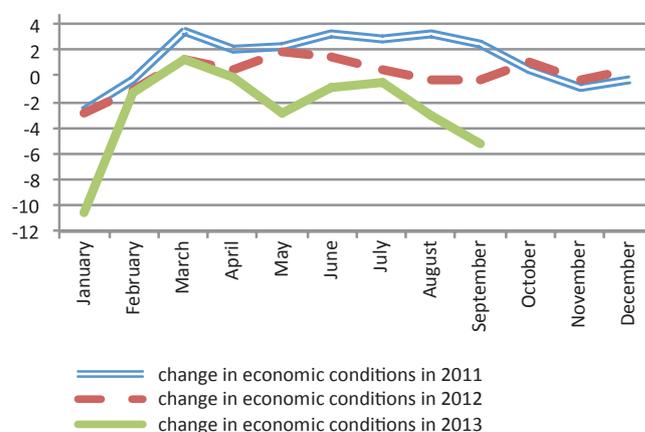


Chart 16. Change in Economic Conditions (exporter enterprises) in 2011–2013, pp



The analysis of enterprise activities in the first half of 2013 showed the following.

- The growth of assets equalled 108.2% as against 104.4% in the same period of 2012.
- Enterprises' capital increased by 1.6% (as compared with 1.9% in the same period of 2012); however, enterprises with assets of less than 100 million roubles registered a reduction in their capital.
- A fast growth in liabilities (by 19.4%) led to a significant increase in the enterprises' leverage, which remained generally moderate (0.7 roubles of liabilities per one rouble of capital). At the same time, the leverage ratio of enterprises with assets of less than one billion roubles exceeded 1.5 roubles per one rouble of capital.
- The coverage of liabilities with current assets and revenue remained fairly high, considering enterprises' higher credit risk related to the growth of overdue receivables. At the same time, the coverage of liabilities with revenue was considerably lower than in the same period of 2012.
- Enterprises' profitability declined amid the deterioration of their financial results.

Table 2. Financial Indicators of Enterprises in Key Types of Economic Activity in the First Half of 2013 and 2012

Indicator	Agriculture, hunting and forestry		Industrial production		Construction		Wholesale and retail trade		Transport		Communications	
	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012
Leverage ratio (liabilities to capital ratio)	1.24	1.19	0.65	0.55	4.42	4.16	2.8	2.61	0.37	0.32	1.58	1.39
Current liquidity ratio (net of overdue receivables)	1.690	1.791	1.737	1.846	1.071	1.099	1.161	1.247	0.911	0.952	0.998	0.597

Absolute liquidity ratio	0.069	0.079	0.178	0.135	0.043	0.062	0.092	0.107	0.118	0.138	0.165	0.133
Liability coverage with revenue (revenue as % of liabilities)	43.4	49.4	74.3	79.9	36.3	43.1	142.9	158.5	72.2	76.4	47.3	56.9
Return on assets (%) in the first half of the year	2.1	3.5	3.2	4.4	0.8	1.3	2.1	3.5	1.0	1.7	7.2	7.6

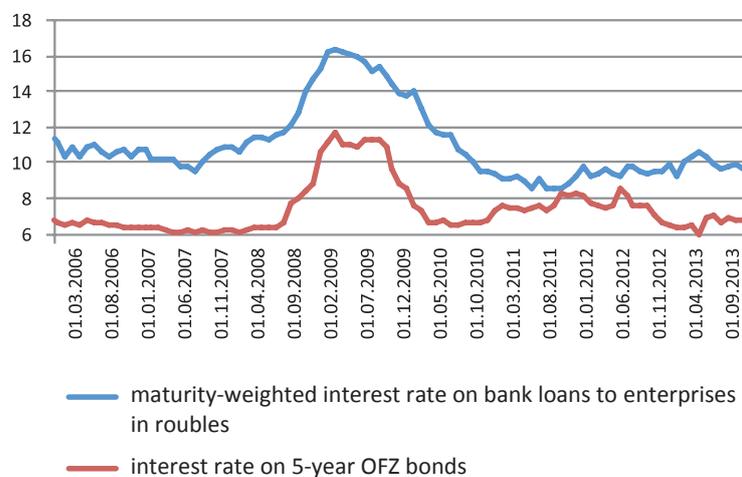
Sensitivity of Non-financial Sector Financial Result to Yield Curve Growth

Potential vulnerability of non-financial commercial organisations is determined by financial result sensitivity to the interest rate shock. The growth of interest expenditures in the event of higher costs of borrowings for the real sector will reduce enterprises' financial result.

In the crisis period of 2008–2009, the share of the enterprises' financial result before the deduction of interest expenditures fell in Russia's nominal GDP from the average historical level of 17–18% to the minimum level of 12% of nominal GDP due to the reduction of revenues and the growth of expenditures unrelated to debt service. The Bank of Russia estimates that the maximum interest rate on bank corporate loans, beyond which the real sector would face a negative financial result in a crisis scenario, stands at about 19% (for loans with a maturity of up to one year). The estimate assumes the growth of interest rates on all loans (including ones already extended to enterprises) and the persistence of the increased rate level in the medium term.

Considering a strong correlation between debt market interest rates and bank loan rates (Chart 17), growth in the cost of borrowings for the real sector may be prompted by a negative shock on the government bond market. An increase in the yield of the 5-year zero-coupon OFZ bond by 100 bp causes a growth of corporate loan rates by an average of 160 bp. This means that the loan rate may rise from the current level of about 10% to the maximum level of 19%, if the OFZ yield curve shifts by 600 bp.

Chart 17. Interest Rates on Real Sector Bank Loans and OFZ Bonds, % p.a.



Taking into account the dynamics of OFZ rates in the crisis period of 2008–2009, such a large and continued shift in the yield curve is hardly probable at present. Therefore, a conclusion can be made that the non-financial sector is sufficiently protected against a possible growth in the cost of borrowings, despite a deterioration on external markets.

Chapter 3. The Assessment of Banking Sector Systemic Risks

3.1. Household Loans

Excessive growth of the household loan market was highlighted in the previous issues of the Financial Stability Review as a major banking sector risk. The Bank of Russia implemented a number of regulatory measures to restrict growth and minimise risks on the consumer loan market. At present, the growth of household lending has slowed down: as of October 1, 2013, its annual growth had reached the two-year minimum of 31%. However, the growth of household loans is 2,4 times faster than the growth of lending to non-financial organisations. In addition, the loan portfolio quality is deteriorating while the household debt burden is rising, which requires careful monitoring of consumer lending and, possibly, additional regulatory measures.

Unsecured loans¹⁷ still account for the largest share of the household loan market, exceeding by almost 3-fold the volume of mortgage loans, which make up the market's second largest segment (5.9 trillion roubles and 1.9 trillion roubles, respectively, or about 63% and 21% of the total volume of household loans). At the same time, a faster growth is demonstrated by housing lending (the segment of housing loans¹⁸ grew by 45.2% over the year, whereas the segment of unsecured loans expanded by 34.5%). The growth of this segment is primarily explained by the low base effect. The segment's dynamics were probably influenced by a higher new housing construction and increased demand for the acquisition of housing at the stage of construction.

Chart 18. The Value and Annual Growth of Household Loan Portfolio

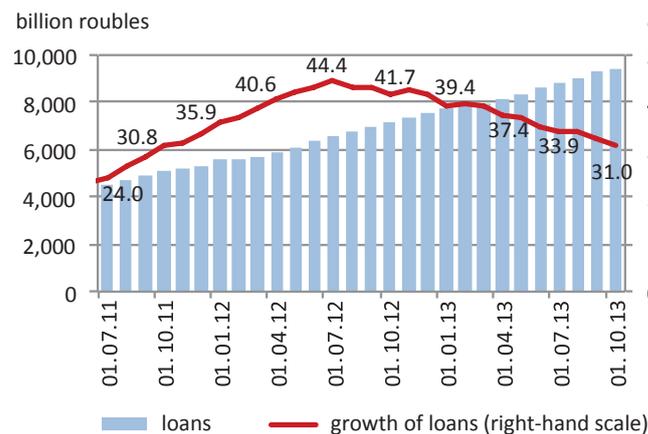
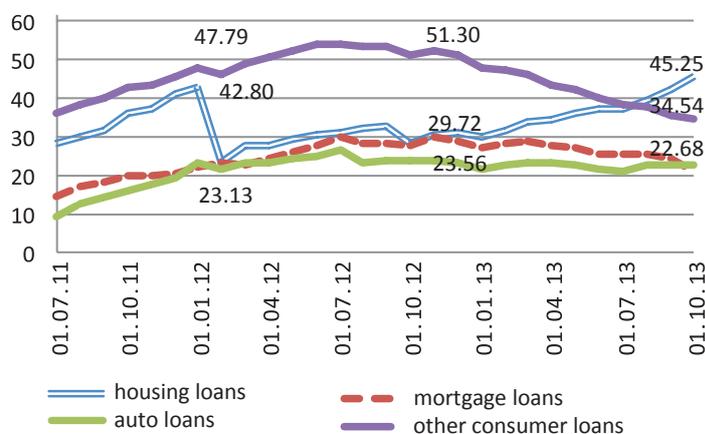


Chart 19. Annual Growth of Household Loans by Lending Segment, %



¹⁷ The segment of "other consumer loans" is based on the data of the reporting Form 0409115 "Information on the Quality of Bank Assets."

¹⁸ Housing loans comprise loans issued to individuals for the acquisition and development of land intended for housing construction, the construction and reconstruction (repairs) of housing and the purchase of housing, including housing loans issued against the pledge of real estate in accordance with Federal Law No. 102-FZ of July 16, 1998, "On Mortgage (Pledge of Real Estate)" before state registration of agreements on the pledge of real estate (mortgage agreements).

From 2014, measures are planned to further increase loan loss provisions and risk weights for unsecured loans to slow the growth of consumer lending to a more comfortable level of 20–25% per year, which corresponds to the annual growth rates of the basic sources of funding, such as household and corporate deposits. Banks continuing to issue loans actively (including loans at high rates) will have to raise loan loss provisions, and also build up their capital to meet enhanced capital adequacy requirements.

In order to mitigate consumer lending risks The Bank of Russia also considers it important to implement the following measures.

1. Setting limits on the maximum effective rate (further down – ER) for unsecured loans to individuals. It is advisable to limit the ER by legal setting the ER maximum permissible excess for a loan agreement over the ER average market level,¹⁹ which will be calculated by the Bank of Russia. The cap on the deviation from the ER average market level is designed to limit the cost of household debt service (usurious rates), which will help reduce the household debt burden, and also raise the banking sector sustainability by restraining the issue of loans to the most risky borrowers.

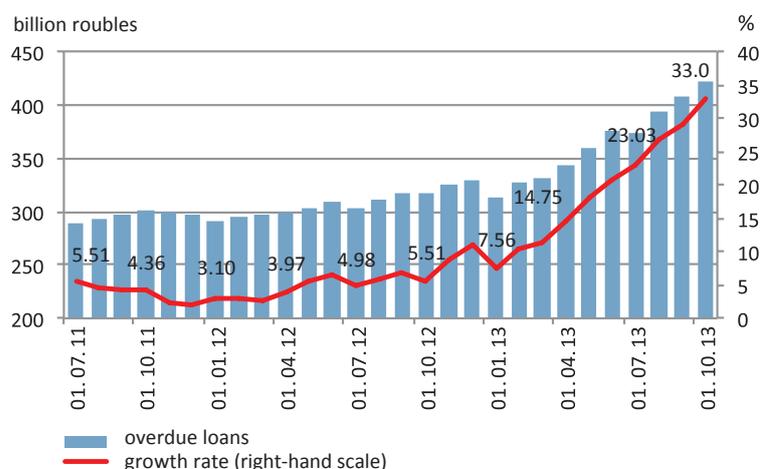
2. Extending the set of information contained in a borrower’s credit history, in particular, by including data on the value of the pledge, the effective rate and other information.²⁰ Credit institutions are currently increasing the number of credit inquiries about potential clients for loan approval amid the growth of the household debt burden. These amendments to the law will help improve the transparency of information on the borrower’s liabilities to credit institutions, which may contribute to the overall reduction of credit risks.

The Quality of Household Loan Portfolio

The quality of the household loan portfolio deteriorated considerably in the period under review (Chart 16). The annual growth of overdue loans exceeded the growth of the household loan portfolio for the first time in the past two years (33% as against 31%, respectively). The share of overdue loans reached about 4.5% as of October 1, 2013. The continued deterioration of the household loan portfolio quality amid the growth of the household credit level may create additional systemic risks.

The growth of unsecured loans with overdue payments of 91 days or more accelerated considerably as compared with the previous period (Chart 20). This can be partly explained by fairly risky credit policies pursued by credit institutions in 2011–2012. Another reason for the substantial increase in overdue debt is a slower growth of household income. The volume of disposable money income remained virtually unchanged in 2013 Q2 and Q3 as compared with 2012 Q4 and 2013 Q1. At the same time, household spending on debt service rose to almost a quarter of income as compared with less than 20% a year ago.²¹

Chart 20. The Value and Annual Growth of Household Overdue Loans



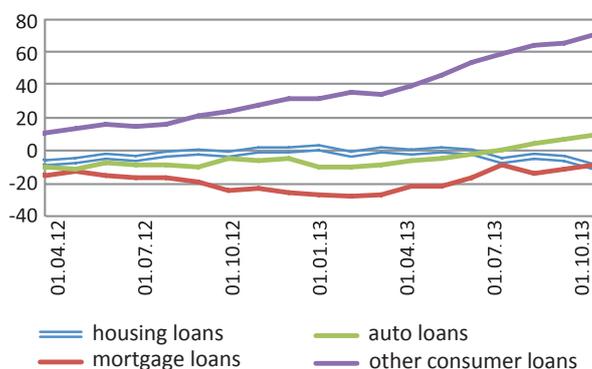
¹⁹ The loan total cost may currently amount to over 38% on the market of unsecured lending (see the Box: “The Survey of the Largest Retail Banks.”)

²⁰ On July 8, 2013, Russia’s Economic Development Ministry published a draft Federal Law “On Amending the Federal Law “On Credit Histories and Some Russian Laws”. On September 4, 2013, this draft was submitted to the Government for consideration.

²¹ The ratio of principal and interest payments on loans to household disposable money income reached 24.1% as of October 1, 2013 compared to 19.6% as of October 1, 2012.

The growth of overdue loans, and also Bank of Russia's tighter regulatory requirements will most likely cause the increase in the volume of assignment claims under loan agreements with individuals. The volume of these transactions is expected to rise by about 40% in 2013 as compared with the previous year.²²

Chart 21. Annual Growth of Loans with Overdue Payments of 91 Days or More, %



Active Participants on the Unsecured Loan Market

Analysis of the activity of credit institutions specialising in unsecured consumer lending²³ characterised by higher default risk shows that the share of homogeneous unsecured loans with overdue payments of 91 days or more increased considerably and stayed above the sector's level (12.1% and 7.2%, respectively, as of October 1, 2013). At the same time, the average CAR of these banks was below the banking sector's CAR (12.1% and 13.4%, correspondingly). In addition, most of the sampled banks (18 out of 29) registered a reduction of this ratio in the period under review.

The return on assets (ROA) for the sampled banks declined in 2013 Q3 but still remained above the market level: their ROA averaged an annualised 2.22% (3.04% as of April 1, 2013) as against the banking sector's 2.01% (2.13%). ROA mainly decreased due to higher expenses on loan loss provisions.

The growth of unsecured lending in the sampled group of banks specialising in this segment is slowing down; the largest contraction in the annual growth rate (-8 pp) was registered in Q3 after increased risk weights were introduced for calculating the CAR. According to Bank of Russia estimates, which take into account a survey of some major market players, the growth of consumer lending in the sampled group of banks may drop to 30% in the medium-term perspective (up to one year).

The sampled banks are already witnessing a considerable growth in overdue loans. The deterioration of loan quality is most likely to continue. The decrease in the quality of assets and, correspondingly, the growth of provisions will put pressure on bank capital and profitability. This will especially affect banks that continue to issue consumer loans actively, including loan at high interest rates.

Box 2. The Survey of the Largest Retail Banks²⁴

Since the end of 2012, in order to raise the transparency of household loan market risks the Bank of Russia has been holding quarterly questionnaire surveys of personal loans extended by the largest retail banks.

Analysis of the activity of the largest banks on the household loan market showed that the debt burden measured as the ratio of the number of existing loans to the number of bank borrowers was unchanged in 2013 Q3 quarter on quarter and stood at 1.18 loans.

²² As estimated by the National Bureau of Credit Histories.

²³ The selection criteria for choosing banks for the survey were the following: the value of unsecured loans is over 10 billion roubles; the ratio of unsecured loans to bank assets is over 20%; the share of interest income from household loans is over 35% in the total interest income. As of October 1, 2013, the sample comprised 29 credit institutions, with their aggregate unsecured loan portfolio amounting to 2.4 trillion roubles, or 40.1% of the unsecured loan market as a whole.

²⁴ The analysis is based on the data of a quarterly survey of the current outstanding debt on loans extended to individuals by the largest retail banks (the survey involved 21 banks as of October 1, 2013 and covered 56% of the household loan market).

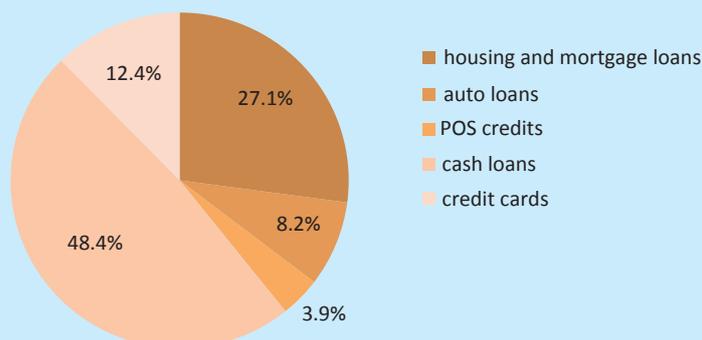
At the same time, household debt burden of the surveyed banks, measured by the DTI,²⁵ increased: in Q2, borrowers spent about one-fourth of their income on debt servicing, whereas in Q3 this spending increased to almost one-third of their income. Considering that one and the same borrower may be a customer of various banks, these indicators (the number of loans per borrower and the DTI) are actually higher.

At present, the main customer of the largest retail banks have a monthly income of 20,000–40,000 roubles. At the same time, as was the case in the previous quarter, the surveyed banks are expanding the volumes of lending to persons with fairly high monthly income (from 75,000 roubles or more). Possibly, credit institutions are adjusting their household lending strategies in favour of more reliable borrowers.

All the segments of household lending are witnessing a decrease in the bank average ER for loans issued over the quarter. The survey participants mentioned increased risk weights depending on LTC that were introduced from July 1, 2013 as one of the reasons for the decrease in the ER. The ER for unsecured lending averaged over 38%. The highest ER level is typical of the credit card segment (43% in Q3).

Although the loan portfolio of the largest retail banks is dominated by cash loans (48% as of October 1, 2013), the segment of credit cards registered the fastest growth in Q3 (by 12.5%). The largest share of overdue loans is observed in the segment of POS credits²⁶ (14.41%) and particularly this segment registered a high level of debt assignment (about 7% of the total debt on a loan) in Q3. Overall, the total volume of assignment of claims that were ceded across all segments (mostly to non-bank organisations) amounted to 2.3% of the total loans.

Chart 22. Surveyed Banks' Loans by Segment



3.2. Growth of Refinancing Volumes and Systemic Liquidity Risk

Banking Sector Potential for the Bank of Russia Refinancing

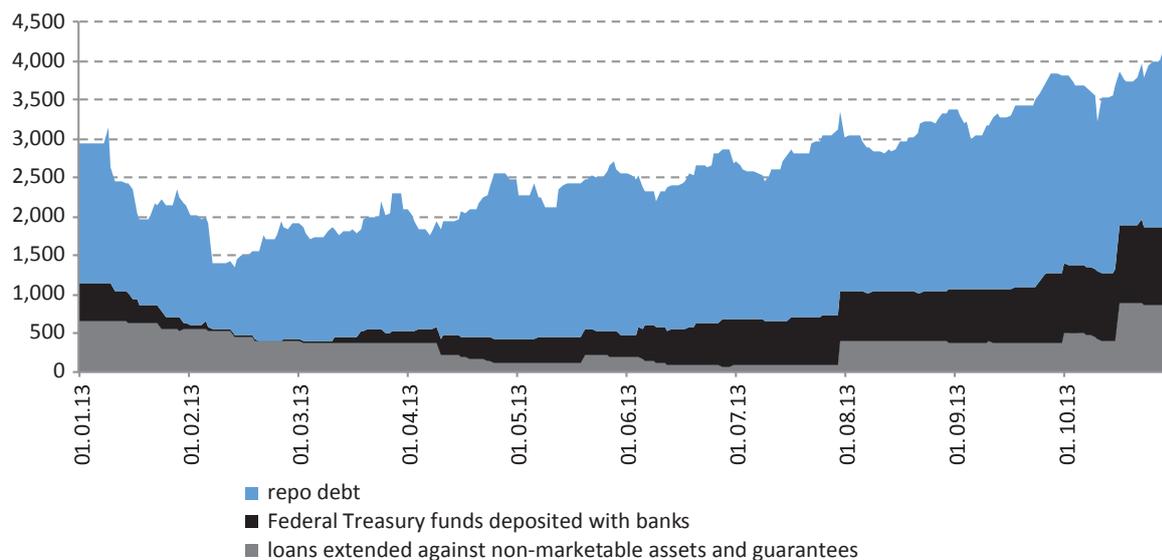
The Bank of Russia focuses on regular assessments of the refinancing potential due to the persisting large volume of bank debt to the Bank of Russia. For this purpose, the regulator uses the so-called collateral utilisation ratios – the ratio of bank debt to the Bank of Russia on a specific refinancing instrument to the overall volume of collateral available for the use by banks to get refinancing through this instrument. The growth of utilisation ratios indicates a decrease in the share of unused collateral in the overall volume of available collateral. A high utilisation ratio testifies to a limited volume of collateral available in the banking sector.

In 2013 Q2 and Q3, repo operations with the Bank of Russia remained the main instrument of refinancing for credit institutions: their debt on this instrument varied from 1.2 trillion roubles to 2.6 trillion roubles (Chart 23) while the market asset utilisation ratio mostly ranged from 40% to 60% (Chart 25).

²⁵ The DTI (debt-to-income ratio) is the ratio of the amount of borrowers' loan payments (including principal and interest payments) over the past quarter to the borrower's quarterly income stated (announced or declared) by the borrower at the time of the loan provision. The data include only information on an individual's debt to a respondent bank rather than the individual's total debt to all creditor banks.

²⁶ The segment of POS credits comprise loans issued to individuals for the purchase of specific goods (household appliances, clothes, furniture, etc.) or services (travel vouchers, etc.) directly at trade outlets and points of sale (shops, shopping centres, service companies, etc.).

Chart 23. Bank Debt on the Bank of Russia Refinancing Instruments and Federal Treasury Funds Deposited with Banks in January–October 2013, billion roubles

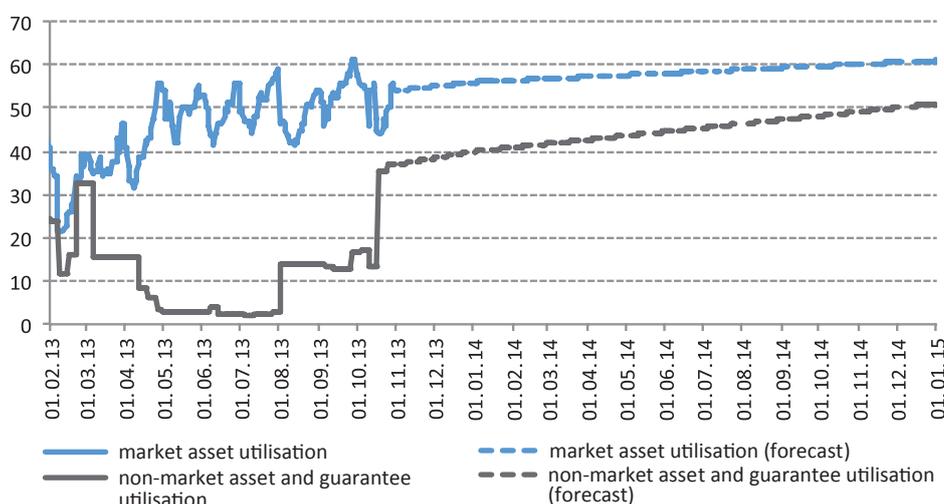


From July 2013, the Bank of Russia started to hold auctions for providing liquidity against non-marketable assets and guarantees at a floating interest rate to reduce the volume of marketable collateral involved in the Bank of Russia refinancing operations and increase the efficiency of the inter-bank loan market. The first two auctions held in July and October 2013 provided over 830 billion roubles of liquidity to banks (about one-third of the maximum repo debt). In general, the loan auctions helped reduce the volume of encumbered securities in the banking system, extend the maturities of borrowings from the Bank of Russia and ensure more even liquidity distribution among market participants.

According to estimates as of September 1, 2013, the value of marketable collateral held by credit institutions (adjusted to the Bank of Russia repo discounts) expanded by 400 billion roubles to 4.2 trillion roubles (by an annualised 20%) since 2013 Q1 due to the increased volume of debt securities included into the repo list. The volume of outstanding debt securities from the repo list (with an allowance for the Bank of Russia repo discounts) grew by 500 billion roubles (by an annualised 15%) over the same period. The potential refinancing against non-marketable assets stood at 1.3 trillion roubles as of the end of 2013 Q3 (based on a poll of the treasuries of the largest banks).

While the potential refinancing operations against marketable assets expanded, the market asset utilisation ratio was observed to grow in Q2 and Q3 due to a faster growth of bank debt on the Bank of Russia repo operations. Banks should continue participating in the auctions for refinancing against non-marketable assets at a floating rate in order to restrain a further growth of the market asset utilisation ratio.

Chart 24. Current and Expected Utilisation Ratios in 2013–2014, %



Bank debt to the Bank of Russia is currently growing faster than the refinancing potential. This trend can be expected to continue in 2014. In particular, a forecast of monetary programme indicators for 2014–2016²⁷ indicates that gross credit to banks will increase to 4.8–5.1 trillion roubles by the end of 2014, i.e. by 45–55% over two years (in early 2013, gross credit amounted to 3.3 trillion roubles), which will cause a corresponding increase in the volume of collateral used in the Bank of Russia refinancing operations.

Results of Stress Testing of Russian Banks' Liquidity to Assess the Liquidity Coverage Ratio under Basel III

In January 2013, the Basel Committee on Banking Supervision (BCBS) issued finalised regulatory standards on liquidity (Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools). The BCBS document defines the procedure for calculating and monitoring the Liquidity Coverage Ratio (LCR).

The LCR will be introduced from January 1, 2015. Compliance with the LCR ratio should ensure that a bank, which is confronted with the withdrawal of borrowed funds in a stress scenario, has adequate stock of high-quality liquid assets to meet its needs over the next 30 calendar days.²⁸ The implementation of LCR standards will be phased: the minimum requirement will be set at 60% in 2015 and rise by 10 pp each subsequent year to reach 100% in 2019.

The Bank of Russia is currently drafting a Regulation on the procedure for LCR calculation and the corresponding bank reporting form to implement international liquidity standards in the Russian Federation. In addition, as part of LCR monitoring (during 2011–2014), quarterly stress tests of the banking sector are held to calculate the LCR ratio. This calculation is for assessment purposes because LCR supervision reports have not been introduced yet. The calculations are based on the most conservative assumptions stipulated by Basel III.

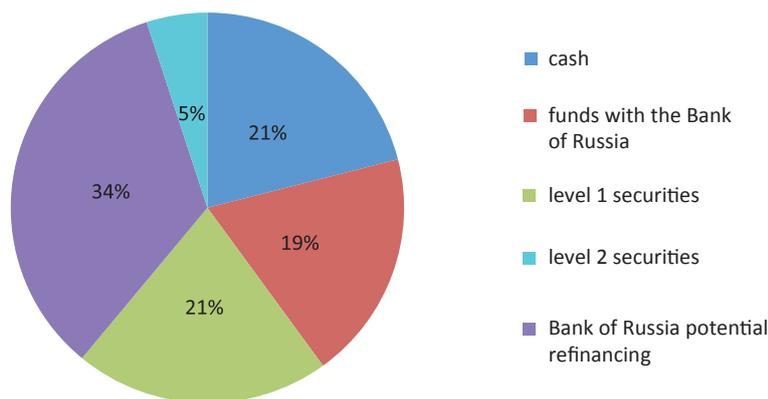
In 2013 Q2, the Russian banking sector LCR averaged 47.8%, which virtually corresponds to the level registered in the previous quarter (47.0%). For countries that do not have sufficient HQLA, the BCBS standards allow banks to access contractual committed liquidity facilities from the relevant central bank and to include them within HQLA. The Bank of Russia is currently considering the possibility of introducing this instrument. The inclusion of the Bank of Russia potential refinancing in HQLA may increase the LCR to 84% (77% as of April 1, 2013). The growth in the LCR in Q2 2013 was caused by the increased non-marketable assets which can be used as collateral in the Bank of Russia refinancing operations (300 billion roubles).

The structure of the banking sector HQLA (taking into account potential refinancing) did not undergo any considerable changes in 2013 Q2. The HQLA are dominated by Level 1 assets, which account for about 61% of banking sector total HQLA. This category comprises cash (21% of HQLA), correspondent accounts and demand and overnight deposits with the Bank of Russia (19%), and also securities (21% of HQLA), mostly government bonds. The Bank of Russia potential refinancing against securities from the Bank of Russia Lombard List, which are not eligible for Level 2 assets under Basel III, and also refinancing against non-marketable assets comprise about 34% of HQLA. The assets, that are eligible for inclusion in of Level 2 HQLA under Basel III, account for about 5% of HQLA (Chart 25).

²⁷ See the Guidelines for the Single State Monetary Policy in 2014 and for 2015 and 2016.

²⁸ The LCR is calculated as the ratio of the value of high-quality liquid assets (HQLA) to total net outflows over the 30-day period. High-quality liquid assets are divided in accordance with their quality by the Level 1 and Level 2 assets (Level 2 assets are in turn classified as Level 2A and Level 2B assets). Level 2 assets are included in the value of HQLA with the application of required haircuts and cannot comprise more than 40% of the HQLA. A net outflow is defined as the difference between the amount of outflows and inflows. Total inflows are subject to an aggregate cap of 75% of total outflows.

Chart 25. Russian Banks' HQLA



There were also no considerable changes in the structure of the banking sector potential outflows and inflows: as before, the funds of non-financial organisations accounted for the largest share of outflows while interbank loans made the biggest contribution to inflows.

3.3. The Deterioration in the Banks' Profitability and its Causes

The downward trend in banking sector profitability, which started in 2012, is continuing. In particular, the return on assets (ROA) fell from 2.3% as of January 1, 2013 to 2.0% as of October 1. Similar dynamics was observed for the return on equity (ROE), which decreased from 18.2% to 16.3% in the period under review (Chart 26).²⁹ At the same time, Russia continues to outpace such emerging markets as Brazil, India, Poland and the Czech Republic by banking sector profitability indicators and is far ahead of developed economies with regard to these indicators (Chart 27).

Chart 26. Banking Sector Profitability Indicators, %

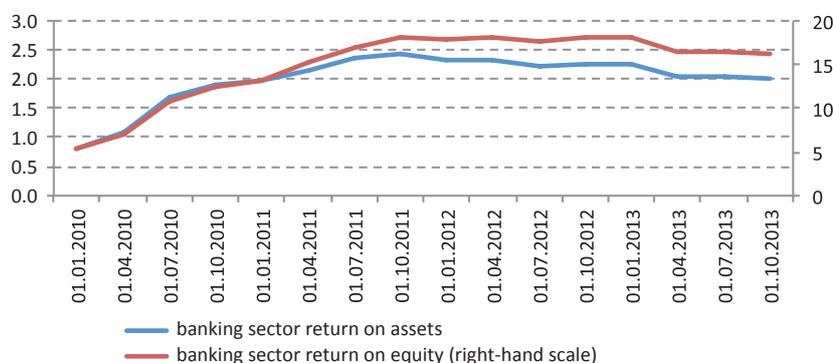
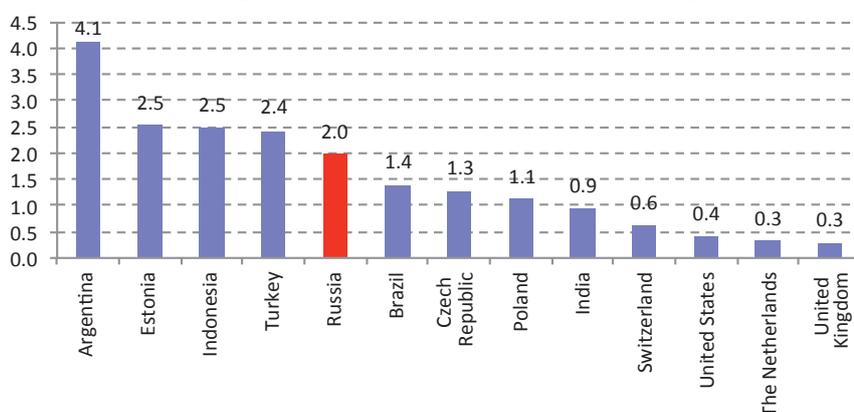


Chart 27. Banking Sector Return on Assets (ROA) by Country, %



Sources: The International Monetary Fund, the Bank of Russia.

²⁹ The indicators are calculated as the ratio of the financial result (before taxation) received for the past 12 months preceding the reporting date to the average amount of assets (equity) over the same period.

Banking sector profitability measured by ROA decreased mainly because since early 2013 banks have had to increase loan loss provisions. The contribution of loan loss provisions to profitability dynamics has become steadily negative since the start of the year. This factor reduced ROA by 0.7 percentage points (Chart 28). The growth of bank provisions was caused by the deterioration of bank loan portfolio quality and the Bank of Russia tighter reserve requirements for the portfolios of homogeneous unsecured loans extended to individuals since January 1, 2013.

As of October 1, 2013, the banking sector profit before tax for the past 12 months increased by 7.2% to 1.05 trillion roubles year on year. Net interest income was the main factor of profit growth (Chart 29).

Chart 28. Factors Contributing to Change in Banking Sector Return on Assets, bp³⁰

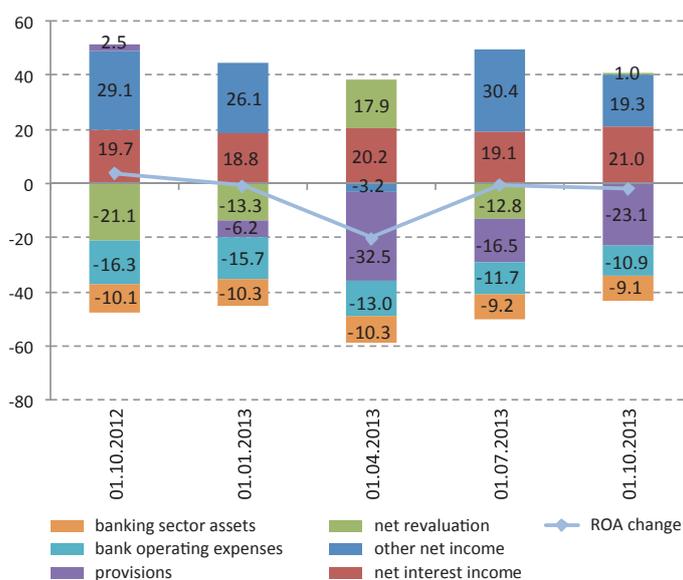
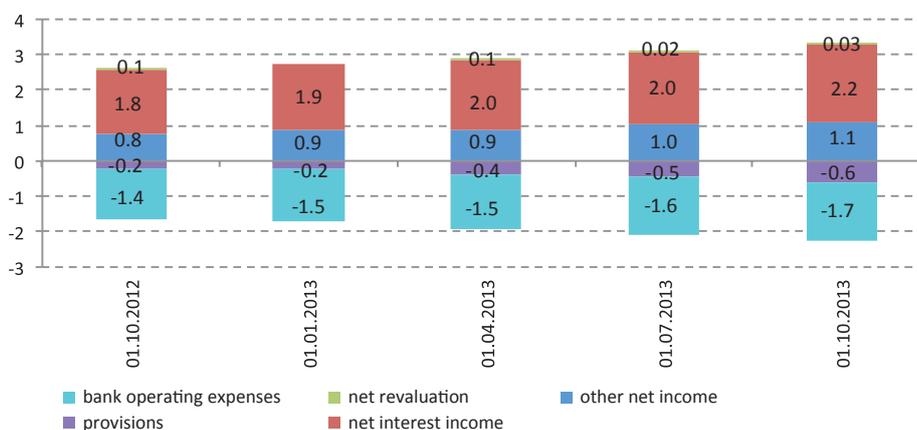


Chart 29. Banking Sector Profit for 12 Months (before tax), trillion roubles



The interest income structure is demonstrating a steady trend towards the replacement of income from corporate lending with income from household loans.³¹ In addition, a trend has been observed since early 2013 towards a slower growth of interest income on funds provided both to individuals (from 42% as of January 1 to 24% as of October 1, 2013) and corporate entities (from 18% as of January 1 to 10% as of October 1, 2013). This trend can be attributed to lower interest rates on bank loans as a whole and a slower growth of unsecured loans to households.

³⁰ Other net income comprises net income from banking operations, securities transactions, stakes in the capital of other organisations, net operating income, net other income net of the amount of formed (recovered) provisions. Provisions are determined as the difference between the amount of recovered and newly formed loan loss provisions.

³¹ As of October 1, 2013, corporate lending accounted for about 66% of interest income while household loans made up 34%.

The growth of interest expenses on corporate funds slowed from 24% as of January 1 to 14% as of October 1, 2013 mainly due to the overall reduction of deposit rates. The growth of expenses on issued debt obligations is also slowing (from 64% as of January 1 to 15% as of October 1, 2013) due to a low issuance activity of banks and a fall in yields on newly issued debt.

As a result, the lower rates of growth in interest income were fully offset by a slower growth in interest expenses, which can also be evidenced by the unchanged quarterly contribution of net interest income to profitability (0.2 pp).

Bank operating expenses are the main item reducing profit before tax. Personnel costs account for the largest share in these expenses (50%). At the same time, the growth of this expense item is slowing to some extent. In particular, this growth decreased from 19% as of October 1, 2012 to 11% as of October 1, 2013. The slower growth in personnel costs reduced the quarterly contribution of bank operating expenses to profitability dynamics from 0.2 pp in 2012 to 0.1 pp in 2013.

The contribution of net revaluation to profitability was primarily determined by revaluation of funds denominated in foreign currency while the effect of securities revaluation was inconsiderable. Analysis showed that the dynamics of this factor were to a larger extent influenced by the dynamics of the rouble/US dollar and rouble/euro exchange rates. From early 2013 to October 1, 2013, net revaluation contributed a total of 0.1 pp to profitability dynamics.

In 2014, the growth of provisions due to the deteriorating quality of bank assets, and also higher loan loss provision requirements will continue to exert pressure on profitability. In the short term, profitability will also be determined by the rouble exchange rate dynamics influencing foreign currency revaluations.

Box 3. Market Indicators of Risk

As of October 1, 2013, the Russian banking sector was represented by a small number of issuers on the stock market. The leaders in market capitalisation and exchange trade turnover were Sberbank of Russia and banks from VTB Group.³²

Table 3. Russian Banks' Quoted Shares and Depositary Receipts³³

No.	Bank, security type	Ticker	Stock Exchange	IPO/trading start date	Market capitalisation, billion roubles	Average daily trading volume, ³⁴ million roubles	Free float, %	P/B	P/E	Market capitalisation / RWA
1	Sberbank, o.s.	SBER	MoEx	July 2007	2,231.4	8,881.3	47.7	1.30	6.48	0.16
	Sberbank, ADR	SBRCY	LSE and other	July 2011		6,046.9				
	Sberbank, p.s.	SBERP	MoEx	July 2007		781.3				
2	VTB, o.s.	VTBR	MoEx	May 2007	556.1	1,854.5	39.1	0.64	5.81	0.11
	VTB, GDR	VTBR	LSE and other	May 2007		1,914.7				
3	Bank of Moscow, o.s.	MMBM	MoEx	August 2008	224.0	0.2	n/a	1.13	6.38	0.15
4	Nomos Bank, o.s.	NMOS	MoEx	April 2011	107.6	5.9	n/a	1.05	7.97	0.13
	Nomos Bank, GDR	NMOS	LSE	April 2011		54.9				
5	TCS (TCS Group Holding Plc, Cyprus), GDR	TCS	LSE	October 2013	106.3	n/a	n/a	0.99	n/a	n/a
6	Rosbank, o.s.	ROSB	MoEx	January 2006	90.1	0.3	8.7	0.73	10.30	0.13

³² Sberbank's average daily trading volume on the Moscow Exchange amounted to 9.6 billion roubles in September–October 2013 while its market capitalisation stood at 2,312.0 billion roubles (taking into account preferred shares). At the same time, the Sberbank's ordinary share is the leader by trade turnover on the Russian stock market. VTB daily trading volume totalled 1.9 billion roubles (the fifth stock by trading volume) while its market capitalisation stood at 556.1 billion roubles.

³³ Abbreviations used in the Table: o.s. – ordinary share, p.s. – preference share, GDR – Global Depositary Receipt, ADR – American Depositary Receipt, MoEx – the Moscow Exchange (MICEX and RTS), LSE – the London Stock Exchange, NASDAQ – the National Association of Securities Dealers Automated Quotation System (stock exchange), RWA – risk-weighted assets, IPO – initial public offering.

³⁴ The security average daily trading volume in September–October 2013.

7	QIWI (QIWI Plc, Cyprus), ADR	QIWI	NAS-DAQ	May 2013	67.8	146.5	n/a	24.15	n/a	n/a
8	Bank Saint-Petersburg, o.s.	BSPB	MoEx	November 2007	20.9	9.0	58.4	0.40	3.59	0.05
9	Uralsib Bank, o.s.	USBN	MoEx	December 2011	16.2	0.2	5.1	n/a	38.00	0.04
10	Vozrozhdenie, o.s.	VZRZ	MoEx	May 2007	9.4	2.3	31.3	0.42	5.38	0.05
	Vozrozhdenie, p.s.	VZRZP	MoEx	May 2007	0.2	0.1				

Sources: Bloomberg, stock exchange data.

The **P/B** multiplier (calculated as the ratio of the market capitalisation of a bank to its capital) stays in the range of 0.4–1.3 for leading Russian banks, which is generally comparable with the values of leading foreign banks. For comparison, the market value of the largest West European banks is 0.7–1.3 times of their capital while this ratio for banks in the Asian region (China, Japan) is 0.8–1.2 and for the largest US banks it varies in the range of 0.7–1.5.

The **P/E** multiplier (the ratio of a bank's market capitalisation to its earnings) is generally lower for the leading Russian banks than for foreign banks and stays in the range of 5.4–8.0. For comparison, the P/E ratio ranges from 13.0 to 18.6 for West European banks and from 8.2 to 11.1 for US banks.

Credit default swap (CDS) prices are an additional market indicator characterising the financial standing of banks. A typical debt insurance swap, which is a risk hedging instrument, is signed for a period of five years. The possibility of purchasing Russian banks' CDSs exists only on the over-the-counter-market for a small number of agents. As of the end of October 2013, the price of five-year CDS contracts was 210 bp for Sberbank, 205.2 bp for Russian Agricultural Bank, 297 bp for VTB Bank, 301.7 bp for Bank of Moscow and 337.7 bp for Alfa Bank. In general, their dynamics was similar to the price dynamics of Russia's five-year CDSs, demonstrating a growth by 110–150 bp in May–June 2013 and a fall by 40–70 bp in 2013 Q3. The largest decrease was registered in the price of Alfa Bank's CDSs and its premium fell as compared with other banks.

Chart 30. Russian Banks' Spread on Five-Year CDS Contracts, bp



Source: Bloomberg.

A slower growth of loans to non-financial organisations and a fairly high saturation of the unsecured consumer lending segment, in which the Bank of Russia has taken a number of preventive measures, are reducing the possibilities for banks to raise income quickly. At present, an increase in capital through the issuance of shares is an important and at the same time a complex task for many market players.

Box 4. Deleverage Trends for Foreign Banks' Subsidiaries in Russia

Survey results³⁵ and data on some major foreign banks indicate that deleveraging (the increase of capital in liabilities through the reduction of assets and debt obligations), which foreign banks started to actively in 2011, is continuing.

The need to comply with new international capital and liquidity requirements under Basel III is a key driver of bank deleveraging. In particular, a reduction in risk-weighted assets allows banks to raise the CAR to the recommended levels. In turn, banks have to increase the share of high-quality liquid assets on their balance sheets and change the funding structure in favour of more stable funding sources to comply with the liquidity ratios.³⁶ A shortage of high-quality liquid assets on the financial market and a significant rise in the cost of stable funding sources (which is mainly typical of emerging markets) will force banks to scale down the scope of their activities (and, correspondingly, the volume of their claims and liabilities) to meet new liquidity requirements.

Considering that credit institutions with non-resident stakes operating in Russia are already implementing or planning deleveraging, these banks' asset dynamics were analysed for the past two years (i.e. after the finalised version of the international requirements for capital quality and capital adequacy was published).³⁷ Analysis results allow for making the following conclusions.

The asset growth rates of banks with non-resident stakes were considerably lower than in the banking sector as a whole in the period under review: 12.6% as against 41.4%, respectively. The asset analysis by country showed a reduction in the assets of subsidiary banks, the parent companies of which were located in Italy: their assets decreased by 10.0% over this period (Chart 31).

The asset analysis of the largest banks revealed that the most considerable asset reduction, apart from the Italian banks, was demonstrated by two banks, the parent companies of which were located in Germany, and the subsidiaries of the French, Cypriot and Scottish financial groups.³⁸ The assets of most of these banks decreased due to a considerable reduction in financing from non-resident banks (from parent companies in some cases). As a result, most banks reduced the volume of lending to the corporate sector and individuals.

Practically all the banks with negative asset dynamics showed an increase in the CAR in the period under review while this ratio for the banking sector as a whole was observed to decrease.

The above trends observed in the activity of some of the largest banks with foreign stakes may testify to the fact that their parent companies are purposefully reducing the scope of their operations in Russia in the process of deleveraging efforts. Russian banks with non-resident stakes are likely to continue shedding their assets in the medium-term perspective as the deadline for the full implementation of the Basel III standards comes closer. In particular, some European banks estimate that it will take them at least another five years to complete the deleveraging process.

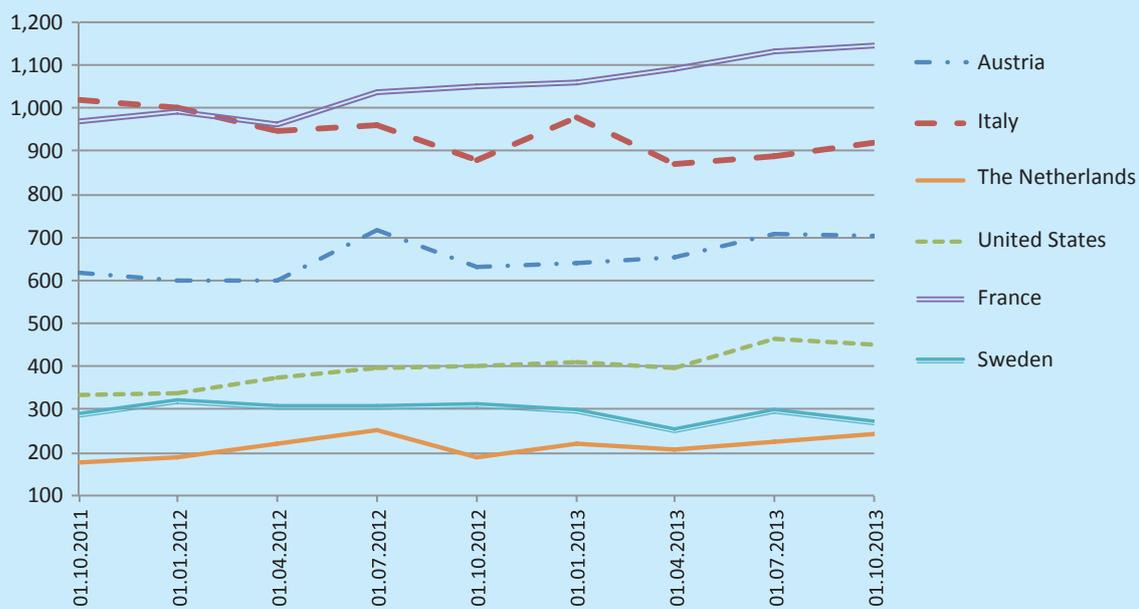
³⁵ *The Deloitte Bank Survey 2012. Capital gain, asset loss. European bank deleveraging.*

³⁶ *The Basel Committee on Banking Supervision introduced two liquidity ratios: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).*

³⁷ *Analysis covered a sample of 51 banks with non-resident stakes of over 20% in their authorised capital (direct or indirect shareholding). As of October 1, 2013, the assets of the sampled banks accounted for about 8.5% of banking sector total assets. Most of the sampled banks' assets comprised the assets of the subsidiary banks of financial institutions from France (24.8%), Italy (19.9%), Austria (15.2%), the United States (9.7%), Sweden (5.9%) and the Netherlands (5.2%).*

³⁸ *The assets of these banks account for about a quarter of the assets of the banks with non-resident stakes and these assets decreased by around 12% over the year.*

Chart 31. Sampled Banks' Assets, billion roubles



Chapter 4. The Financial Standing of Non-credit Financial Organisations

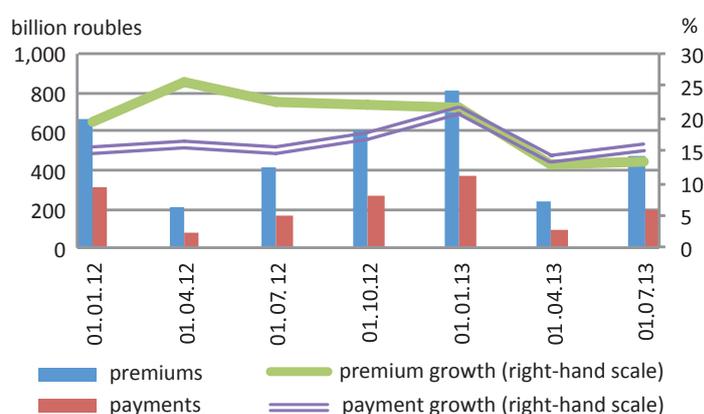
Insurers³⁹

As of July 1, 2013, a total of 454 insurers operated on the insurance market; during the year, their number shrank by 76 companies.

In the first half of 2013, insurer assets reached 1.18 trillion roubles (1.83% of annual GDP), increasing by 11.3% over the year (9.6% over the same period of 2012). As in the previous years, the main asset categories comprised cash and deposits (30.1% of assets), and also securities portfolios, except equities (20.5%). In the period under review, insurers slightly increased their equities portfolios and other shareholdings (from 10.1% to 10.5% of assets), which demonstrated fairly high annual growth rates (25.3%).⁴⁰

The annual growth in premiums⁴¹ on the insurance market slowed down considerably. In particular, the volume of premiums collected by insurers increased by 13.3% in the first half of 2013 year on year to 467.54 billion roubles.⁴² In the first half of 2012, the volume of premiums increased at an annual rate of 22.6%. The insurance market growth was mainly restrained by the lower rates of economic development and a slower growth in lending, particularly, household lending, and the tighter requirements for insurer capital.

Chart 32. The Volume and Annual Dynamics of Insurance Premiums and Payments



Source: The Bank of Russia Financial Markets Service.

As before, the Russian insurance market is dominated by voluntary insurance in terms of the volume of premiums collected by insurers (374.9 billion roubles, or 80.2% of the market as of July 1, 2013). This segment made the main contribution to the growth of premiums whereas in 2012 the market growth was driven by obligatory insurance. In particular, the biggest contribution to the premium growth in the first half of 2013 was made by such voluntary insurance segments as property insurance, personal and life insurance. The volume of premiums collected by insurers increased by 14.2% under voluntary insurance and by 9.6% under obligatory insurance in the first half of 2013 year on year.

During 2012, the annual growth in the volume of premiums collected by insurers exceeded the growth of insurance payments, whereas in 2013 the situation changed. In the first half of 2013, the volume of insurance payments increased by 15.4% as compared with the same period of 2012. As a result, the loss ratio characterising the interlink between insurance payments and premiums grew from 40.8% as of July 1, 2012 to 41.6% as of July 1, 2013. Further growth in insurance payments amid a slower economic growth may cause a deterioration in the financial standing of companies, in particular, insurers highly focused on one type of insurance, for example, auto insurance (the annual growth of insurance payments in this segment was above the market level and amounted to 25% in the first half of 2013).

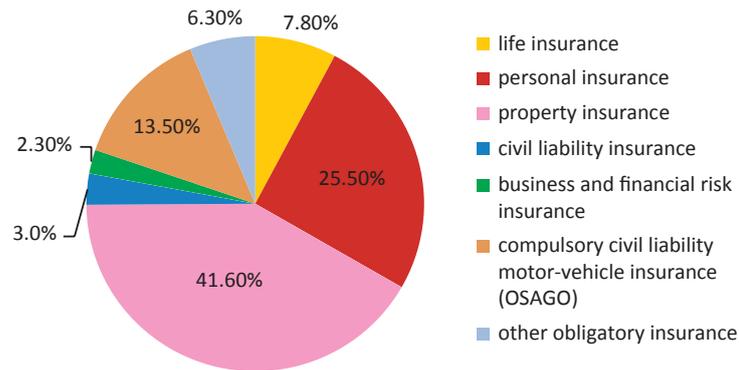
³⁹ Based on the data of the Bank of Russia Financial Markets Service, unless specified otherwise.

⁴⁰ Based on data provided under federal statistical survey reporting Form No. 1-FS (SK) "Information on Insurer Borrowings and Investments" approved by Rosstat Order No. 308 of December 10, 2008.

⁴¹ Excluding obligatory medical insurance.

⁴² Based on the January–June 2013 data provided by 435 insurers to the Bank of Russia Financial Markets Service under statistical reporting Form No. 1-S "Information on Insurer Main Indicators".

Chart 33. Russian Insurance Market Structure by Premium in the First Half of 2013



Source: The Bank of Russia Financial Markets Service.

The adoption of Federal Law No. 234-FZ of July 23, 2013, “On Amending Russian Law on the Organisation of Insurance Business in the Russian Federation”⁴³ was one of the latest key events on the insurance market. The Law introduced amendments, which:

- authorise the Bank of Russia to exercise surveillance over the activity of insurance market participants;
- simplify the rules of access for foreign companies to the Russian insurance market;
- assign control over insurer assets to a specialised depository;
- introduce a binding procedure for organising internal controls and internal audit.

The Law also sets requirements for the maintenance of the single state register of insurance entities, obliges insurers to inform consumers about their activities and insurance terms.

Legislative changes in the insurance market operation will help raise the market attractiveness in the medium term. At the same time, a slower growth in household income⁴⁴ will be a restraining factor in the development of the insurance market.

The growth of household lending, which is continuing, albeit at a more moderate rate than in the previous year, will remain a key driver of growth on the market as a whole in the short term (until the end of 2013).

Non-government Pension Funds⁴⁵

As of July 1, 2013, there were 126 non-government pension funds (NPFs) operating on the pension market, of which 95 funds were focused on compulsory pension insurance. The total number of NPFs decreased by 17 funds over the year, including ten funds, which operated as insurers on the compulsory pension insurance market. The number of NPFs decreased partly due to mergers and acquisitions and tighter requirements enforced in 2012 for the size and structure of property required for statutory activities. Although the number of market participants decreased, the NPF total assets grew by 27.8% over the year to 1.79 trillion roubles (2.8% of annual GDP).⁴⁶ During this period, the overall size of the property required for statutory activities on the NPF market increased by 5.4% to 108 billion roubles. At the same time, this indicator relative to the amount of fund obligations (the sum of pension reserves and accumulations, short-term and long-term liabilities) shrank by 1.47 percentage points over the year to 6.45%.

In 2013, the volume of pension accumulations (compulsory pension insurance, CPI) exceeded for the first time the amount of pension reserves (non-government pension provision, NPP): these indicators totalled 897.5 billion roubles and 783.4 billion roubles, respectively. As of July 1, 2013, pension accumulations grew by 60.8% over the year (an average growth rate of 93.9% over the last two years) while pension reserves increased at an annual rate of 7.0% (an average growth of 9.3%).

⁴³ The Federal Law was adopted by the State Duma on July 5, 2013 and approved by the Federation Council on July 10, 2013.

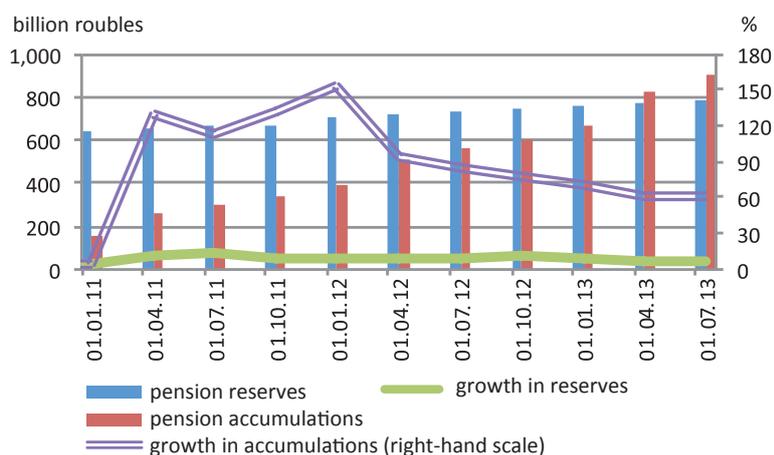
⁴⁴ In late September, the Economic Development Ministry revised downward its forecasts on the growth of household income, real disposable money income, as well as real wages.

⁴⁵ Based on data of the Bank of Russia Financial Markets Service, unless specified otherwise.

⁴⁶ Based on data provided under federal statistical survey reporting Form No. 1-FS (NPF) “Information on the Financial Operations of a Non-government Pension Fund” approved by Rosstat Order No. 308 of December 10, 2008.

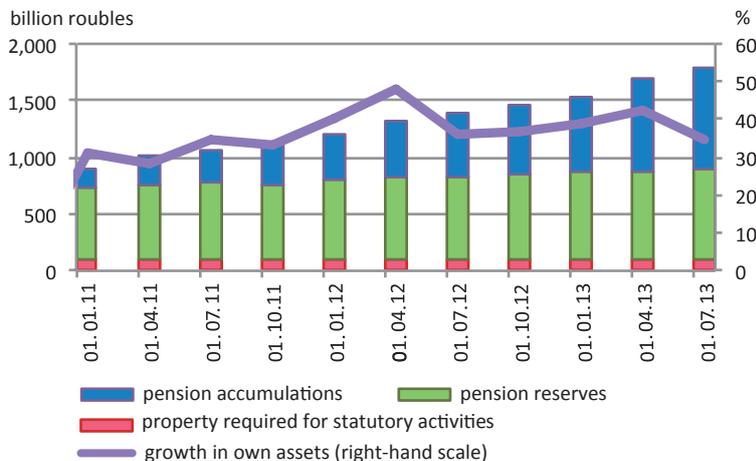
Therefore, compulsory pension insurance became the dominant segment of the NPF market amid stagnating non-government pension provision, namely, the volume of pension premiums additionally paid to NPFs by citizens or their employers as part of corporate programs. The number of persons insured under CPI schemes reached 20 million people, increasing by 30% over the year while the number of NPP participants remained unchanged at 6.7 million people. From the outset, the NPP market developed due to corporate programs offered by the largest companies, in particular, from the oil and metallurgical sectors, which eventually remained the main participants on this market. At the same time, these programs at companies with smaller assets and workforce are not common.

Chart 34. The Volume and Annual Growth of NPF Accumulations and Reserves



Source: The Bank of Russia Financial Markets Service.

Chart 35. The Structure and Annual Dynamics of NPF Own Assets



Source: The Bank of Russia Financial Markets Service.

Considerable changes are expected on the market of non-government pension funds from 2014. In the autumn of 2013, the Russian Government submitted a package of bills, which envisage the following:

1. Obligatory transformation of NPFs into joint-stock companies during two years.⁴⁷

From January 1, 2014, a ban will be imposed on the establishment of new NPFs in the form of non-profit organisations. All NPFs operating on the CPI market must be corporatised before January 1, 2016 and all the other NPFs – before January 1, 2017. This measure will help raise the transparency of funds and market attractiveness for investors. This will also facilitate mergers and acquisitions as founders will clearly understand the principle of entering into or withdrawing from particular structures. At the same

⁴⁷ Draft Law No. 361766-6, "On Amending the Federal Law on Non-government Pension Funds and Some Russian Laws" was submitted by the Russian Government to the State Duma on October 17, 2013.

time, not all the funds will be able to transform themselves into joint-stock companies due to enhanced requirements for the NPF activity and the market volume will be seen to contract.

2. The establishment of the system of insured persons' guaranteed rights.⁴⁸

Measures are planned to create a two-tier system of protecting insured persons' rights, which will comprise CPI reserves set aside by each NPF, as well as the national fund of guaranteed accumulations to embrace all CPI market participants (including the Pension Fund of the Russian Federation). The Deposit Insurance Agency government corporation is expected to be responsible for the system operation, including national fund management.

3. The cancellation of pension accumulation transfers to NPFs until NPFs complete the process of their transformation into joint-stock companies and join the system of insured persons' guaranteed rights.⁴⁹

Before the process of corporatisation is over, citizens' contributions to the funded component of pension equalling 6% of the payroll will be transferred to the insurance component of pension. CPI payments made to NPFs in 2013 will be transferred to the Pension Fund of the Russian Federation for temporary management until NPFs complete their transformation into joint-stock companies. The draft law's financial feasibility study notes that the implementation of this measure will make it possible in 2014 to recognise premiums in the amount of 243.9 billion roubles as revenues of the Pension Fund of the Russian Federation and reduce federal budget transfers by the same amount.

4. Extending until late 2015 the citizens' right to choose the size of their contributions to the funded component of pension at the level of 0 or 6%.

Citizens for whom pension contributions will be made for the first time starting from 2014 will have five years to make their choice. Until this choice is made, funded pension contributions will be automatically transferred to the insurance part of pension.

These changes are likely to cause some contraction of the NPF market both by the volume of pension contributions and the number of funds.

⁴⁸ Draft Law No. 359513-6 "On Amending Some Russian Laws Due to the Adoption of the Federal Law on Guaranteeing Insured Persons' Rights in the Compulsory Pension Insurance System of the Russian Federation in the Process of Forming and Investing Pension Accumulations, Establishing and Making Payments from Pension Accumulations" was submitted by the Russian Government to the State Duma on October 18, 2013.

⁴⁹ Draft Law No. 364004-6, "On Amending Some Russian Laws on the Issues of Compulsory Pension Insurance with Regard to the Insured Persons' Right to Choose Pension Provision Option" was submitted by the Russian Government to the State Duma on October 19, 2013.