Changing patterns of financial intermediation: implications for central bank policy

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Abstract

The most prominent changes in Russian financial intermediation in recent years were related to the growing role of domestic financial markets. These developments have presumably increased the efficiency of the Bank of Russia's interest rate policy and the efficiency of monetary transmission in general. The relative importance of banks has been growing steadily. Although the debt securities market has also developed, banks still play the dominant role. Banks effectively respond to the provision of systemic liquidity by the Bank of Russia, as evidenced by the stable share of highly liquid assets in their total assets. The Russian banking sector shows a high level of stability, which is additionally confirmed by periodic stress tests.

Keywords: central bank policy, financial intermediation, financial markets

JEL classification codes: E58, O16

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A. The role of banks

1. How did the relative importance of banks and market-based financing change in EMEs over the past decade?

Over the past decade the relative importance of banks has been growing steadily. Although the debt securities market has also evolved (eg in 2014, the domestic corporate bond market was characterised by high issuance from Russian companies), banks still play the dominant role.

2. How has the composition of assets and liabilities of domestic banks changed? What does this imply for the liquidity, maturity and credit risks banks face as well as their credit extension decisions (pricing etc)? In particular, what is the structure of their lending (eg (i) households vs corporates; (ii) fixed vs variable rate; (iii) collateral practices; (iv) domestic vs foreign currency) and how has it changed? How has the degree of competition evolved? And what has been the role of government-owned banks/financial intermediaries?

The composition of assets and liabilities is presented in Tables A1–A5 (sent to the BIS on 8 December 2014).

As of 1 January 2014, state-controlled banks accounted for the majority (51.4%) of banking sector total assets. The share of large private banks amounted to 28.8%. The share of foreign-controlled banks in the banking sector's total assets was 15.3% (among them, the share in banking sector total assets of banks in which decisions taken are influenced by Russian residents was 5,9%). .

The funding base of credit institutions expanded mainly due to funds in customer accounts (household deposits are an important source of funding). Funds from the Bank of Russia became an important source for expanding the funding base in the reporting period: their value increased by 70% in 2013, primarily due to their considerable growth (90%) in the second half of the year, while their share of banking sector liabilities grew from 5.4% to 7.7%.

The banks effectively adapt to the provision of systemic liquidity by the Bank of Russia, as evidenced by the stable share of highly liquid assets in banks' total assets. The Russian banking sector shows a high level of stability, which is confirmed by periodic stress tests.

In 2013, banks continued to build up their loan portfolios, but the dynamics and structure of loans saw a number of changes. The total value of loans to non-financial organisations and households increased as their share of banking sector assets grew by 0.5 percentage points to 56.5%. The value of loans and other funds provided by banks to non-financial organisations rose by 12.7% over the reporting period (the same growth rate as in 2012). The growth rate of consumer loans remained high last year. Their value increased by 28.7%. For most of 2013, the interbank loan market showed a higher growth rate than in 2012, mainly due to more intensive business with non-residents. The value of interbank loan claims increased by 21.3%.

The structure of the corporate lending market remained unchanged in 2013: state-controlled banks accounted for more than 50% of the market.

Consumer lending is one of the most competitive segments of the banking services market; state-controlled and private banks maintain a virtually equal presence.

In 2013, banking concentration indicators continued to increase. The share of the top 200 credit institutions in terms of assets in banking sector total assets barely rose in the reporting year, amounting to 94.9% at the end of the year as against 94.3% in 2012; this indicator has grown by 1.1 percentage points over the last five years (2009 to 2013). In 2013, the share of the five largest banks in terms of assets expanded from 50.3% to 52.7% and over a five-year period, their share has increased by 4.8 percentage points.

Quantitative estimates of concentration that are commonly used internationally, particularly the Herfindahl-Hirschman Index (HHI) dynamics, show that in terms of banking assets, the concentration level in 2013 remained moderate.

The average of the most liquid assets as a share of the banking sector's total average assets increased from 7.4% in 2012 to 7.6% in 2013. Funds held in bank deposit and correspondent accounts with the Bank of Russia amounted for more than 30% of the most liquid assets. Traditionally, at the beginning of the year the amount of these funds grows substantially. The share of assets maturing in excess of one year in total assets assigned to Quality Category I increased from 28.5% to 39.5% in 2013. The share of liabilities maturing in excess of one year in total liabilities also grew, from 23.0% to 24.7%.

The credit risk exposure of Russian banks was determined to a significant extent by the quality of loans issued to non-financial organisations. These accounted for 55.7% of total loans issued as of 1 January 2014. Overdue loans to borrowers from this group increased by 1.0% in the reporting period, while lending rose by 12.7%. Overdue loans to non-financial organisations decreased from 4.6% to 4.2% during the reporting year. For rouble-denominated loans, this figure fell from 5.3% as of 1 January 2013 to 4.9% as of 1 January 2014, and for loans denominated in foreign currency, it went down from 2.2% to 1.9%.

3. How have international banks' business models (eg centralised vs subsidiary) evolved since the 2008 financial crisis? Does the nature of a bank's business model influence the supply of credit during periods of adverse external shocks?

Since in Russia foreign banks are allowed to open only subsidiaries, their business model has not evolved much since 2008. At the same time, foreign banks have deleveraged, mainly due to the introduction of the Basel 2.5 and Basel III capital requirements. After the publication of the final Basel III capital rules in October 2011, the annual growth of foreign banks' assets fell from 37% to 6% (while the average assets growth rate in the banking sector amounted to 20%).

B. The role of debt securities markets

4. What is the structure of the debt held in the form of securities, both sovereign and corporate (size, maturity, fixed/flexible rate, collateral, currency) and how has it evolved? How has the relative importance of domestic and international debt issuance changed?

The Russian securities market comprises such main segments as government, regional (sub-federal and municipal) and corporate bond markets. Corporate bonds (placed both in the domestic and international debt markets) account for 69% of the total bond market portfolio as of the end of November 2014 compared with 66% as of the end of 2009.

The market has successfully overcome the after-effects of the global financial crisis. Despite its exposure to serious external shocks, the Russian debt market remained relatively stable during the period from 2009 to 2014 and continued to perform its function of redistributing financial resources in the national economy.

The domestic bond market expanded rapidly in the period under review. In 2013, the annual volumes of government, regional (sub-federal and municipal) and corporate bonds that were floated in the domestic market reached record highs (of 0.8, 0.1 and 1.7 trillion roubles respectively).

Government borrowing in the domestic market is the main source of federal budget deficit financing. The measures taken in 2012 to liberalise the federal loans bond (OFZ) market have increased investors' interest in OFZ bonds, allowing the Russian Ministry of Finance to improve the structure of the portfolio of outstanding government bonds. As a result, secondary trading volumes in OFZ bonds have grown considerably. The volume of secondary government bond operations (including transactions conducted by non-residents) has increased substantially, ahead of OFZ settlements via international depositary and clearing systems.

The corporate bond market in Russia (both internal and external segments) is one of the youngest and the fastest-growing segments of the debt securities market (by quantity and volume of bond placements). The strongest demand in the primary and secondary segments of the corporate bond market was for the securities of top-quality issuers, for whom bond issuance represents an important source of funding and an alternative to bank borrowing.

At the same time, over the past few years the volume of Russian corporate bonds issued in the external market has grown at a faster pace than the volume of corporate bonds outstanding in the domestic market. The strong interest of Russian companies in issuing corporate eurobonds can be attributed to their lower cost and the longer average term of external borrowed funds. By the end of November 2014, the value of eurobonds issued by Russian non-bank corporations in the external market (denominated in US dollars) had grown by 1.6 times as compared with the end of 2009.

In 2014, as a result of geopolitical and economic risks, the domestic bond market saw a sharp fall in issuing activity and a rise in bond yields. The par value of domestic bond market portfolio growth slowed down by two times in 2014 compared with a similar indicator in 2013. In December 2014 the yields of federal loan bonds as well as the yields of regional and corporate bonds rose by 7–8 percentage points compared with the end of December 2013.

5. In addition, a major development over the past five years has been the shift of borrowing by EME non-bank corporations away from banks to international debt markets. What are the implications of this for the financing of firms?

The main sources of long-term financing for Russian non-bank corporations are the domestic credit market and the local corporate bond market. These financing sources are supplemented by borrowing in the international debt markets.

The ratio of bank loans of non-financial organisations to GDP was 36.4% as of September 2014 compared with 32.3% as of the end of 2009. The value of Russian non-bank corporations' eurobonds outstanding in the external market was equivalent to 5.1% of GDP, up from 4.3% in 2009, while that of Russian non-bank corporations bonds in the domestic market was equivalent to 3.7% of GDP, down from 5.1% in 2009.

6. What would be the impact on bank and non-bank corporations' balance sheets of a potential tightening of global financing conditions?

Just like other emerging market economies (EMEs), Russia is exposed to the risks of tightening global financing conditions. When the leading central banks increase their key policy rates, EMEs may face capital outflows, an increase in credit spreads, a reduction in financial asset prices and the depreciation of their national currencies.

In 2014, external financing conditions for Russia tightened in response to the sectoral sanctions imposed by a number of advanced economies targeting a group of Russian banks and state-owned companies. Thus, as of 1 December 2014, the average weighted yield on corporate eurobonds stood at 8.4%, which is 297 basis points higher than at the start of the year.

Under current conditions, the Russian financial sector is already facing constraints on access to external financing. As a result, greater importance is being placed on internal sources of economic growth. In parallel, the limited capacity of the domestic market coupled with the discernible upward trend in inflation has caused rouble-denominated bond yields to rise.

The average weighted yield on corporate rouble-denominated bonds went up by 511 basis points to 13.5% over the 11-month period. Thus, financing conditions have already tightened significantly in Russia. Therefore, we do not expect that an increase in the key policy rates of the leading central banks (eg those of the US Federal Reserve System and the Bank of England) will have any substantial direct impact on the Russian economy.

7. What is the share of corporate deposits in the total bank deposits? To what extent has it been affected by international debt issuance by non-financial corporations? What other interactions between banks and non-bank corporations' balance sheets are likely to be important from the viewpoint of monetary and financial stability?

The share of deposits and other funds raised from legal entities (except credit institutions), including transferable deposits in total bank deposits, as of the end of 2013, accounted for nearly half of all deposits and remained unchanged.

There is no evidence of any interaction between international debt issuance by non-financial corporations and the share of corporate deposits in total bank deposits.

C. Implications for monetary policy

8. How have recent changes in financial intermediation affected the transmission mechanism of monetary policy in EMEs (eg size and speed of pass-through of changes in policy rates, responsiveness of overall credit conditions and asset prices, impact on debt service ratios and, through these, on the macroeconomy)?

The most prominent changes in Russian financial intermediation in recent years were related to the growing role of domestic financial markets (determined by both the slow growth in external debt and the transition to a floating exchange rate regime by the Bank of Russia). These developments have presumably increased the efficiency of the pass-through of the Bank of Russia's interest rate policy and the efficiency of monetary transmission in general.

At the same time the role of the Bank of Russia's interest rate policy has increased significantly. The share of the Bank of Russia's credit in total banking sector liabilities rose from about zero pre-crisis to more than 10% in 2014. The pass-through of the Bank of Russia's policy rate on market interest rates and other domestic financial market indicators is estimated to be faster and more pronounced. The fact that domestic lending has become the primary source of money creation and an important factor in aggregate demand formation suggests that the macroeconomic efficiency of monetary policy has increased.

9. How has it changed the sensitivity to global monetary and financial conditions?

While external financial conditions have been unstable, the national financial system and the Russian economy as a whole have proved to be less vulnerable to these changes. Due to the increased relative importance of interest rate policy over exchange rate policy, the money supply and domestic financial conditions in general are less dependent on the dynamics of the exchange rate.

The rouble exchange rate has showed a perceptible reaction to the fluctuations of interest rates in developed markets, to risk aversion (risk-on/risk-off) and to global capital flows as well as to recent political tensions. Meanwhile, the reaction of the domestic real sector and demand for foreign currency (dollarisation) have eased as the market has adapted to a more flexible exchange rate. Estimated exchange rate pass-through on domestic inflation has fallen from about 0.3 percentage points (per 1% change in the nominal effective exchange rate) pre-crisis to 0.1–0.15 percentage points more recently.

10. How should monetary policy adapt to the changes in financial intermediation? For instance, to what extent should it react to sharp changes in risk premium in EME debt markets (through interest rate and/or balance sheet measures) and respond to broader vulnerabilities?

Changes in external economic conditions posed a serious challenge to monetary policy in 2013–14. The US Federal Reserve's tapering of accommodative measures and the virtual shut-down of access to foreign capital markets in the second half of 2014 have affected the dynamics of our financial market indicators, leading to large-scale capital outflows from Russia and rouble depreciation. This dynamic became the key pro-inflationary factor. The Bank of Russia has responded to these challenges by seeking to restrict the negative influence of external conditions on the economy.

Aiming to dampen the fluctuations of the rouble exchange rate in 2014, the Bank of Russia carried out large-scale foreign exchange interventions in line with established rules. In January–October 2014, net sales of foreign currency by the Bank of Russia amounted to $70.5 billion. The largest sales of foreign currency by the Bank of Russia occurred in March and October, when pressure on the rouble exchange rate was particularly strong.

The restrictions imposed by certain countries on access to foreign financial markets for a number of Russian organisations were an additional factor that made for increased tension in the domestic FX market and contributed to a deterioration in the banking sector's ability to manage foreign exchange liquidity, and they also posed a risk to the stable functioning of domestic financial markets. To limit these risks, in September and October 2014, the Bank of Russia introduced two new types of operations with foreign currency: USD/RUB buy/sell FX swaps and FX repos.

In November 2014, the Bank of Russia abolished its exchange rate mechanism, which had implied the conduct of regular interventions in line with established rules.

This, in fact, signified a transition to a floating exchange rate regime. The move has also allowed the Bank to counter speculation on the FX market. If financial stability comes under threat, the Bank of Russia can intervene in the domestic FX market; however, such operations will be irregular. In early December 2014, due to the rouble's significant deviation from its fundamental level and the excessive increase in its volatility, which posed a threat to financial stability, the Bank of Russia intervened in the FX market on several occasions.

The rouble depreciation observed at the end of 2013 and in 2014 led to a further acceleration in consumer price growth and an increase in inflation expectations. In order to limit inflation risks, restrain inflation expectations and resist growing inflationary pressure, the Bank of Russia raised its key rate several times in 2014, by a total of 11.5 percentage points to 17%.

11. To what extent do macroprudential policies influence the transmission mechanism of monetary policy? How far do they complement or substitute for interest rate policies?

The monetary policy objective is to maintain low and stable inflation. However, the development of the financial sector, which provides the monetary policy transmission mechanism, may be attended with the build-up of imbalances in different segments of the market. In this case, macroprudential policy tools may prove most efficient for systemic risk prevention.

The procyclicality of the financial system may be often recognised as one of the most common undesirable side-effects of monetary policy, as low interest rates are apt to stimulate increased risk appetite. . Under these conditions, macroprudential constraints are applied to iron out potential imbalances, for instance those associated with overheating in the consumer and mortgage lending segments of the financial markets.

Since 2013, the Bank of Russia has successfully implemented a set of risk mitigation measures focusing on the unsecured consumer lending segment of the market. In mid-2012, the annual growth rate of unsecured consumer lending exceeded 60%.

Measures to cool down the market included a requirement to increase the minimum loan loss provisions or reserves held against potential unsecured consumer loan losses and an increase in the risk ratio for calculating the capital adequacy ratio with regard to loans with high effective interest rates. After the macroprudential policy measures were implemented, the annual growth rate of unsecured consumer lending fell to 15.3% as of 1 October 2014.

Prospective measures targeting the mortgage lending segment of the market are currently under discussion. Mortgage lending growth is running at 33.7% year on year. There is no evidence of a housing bubble for the moment: the share of non-performing loans (NPLs) is low (1.5%), while the rate of house price growth remains lower than the inflation rate. But a substantial amount of loans with a high LTV (of more than 70%) gives some cause for concern.[2] Under these conditions, the Bank of Russia is planning to set differentiated risk ratios for loans depending on the LTV ratio.

[2] The LTV is calculated as the ratio of the loan amount to the property value as of the date of the loan issue.