Ksenia Yudaeva: The policy of the Bank of Russia for ensuring financial stability in an environment of economic recovery

Speech by Ms Ksenia Yudaeva, Deputy Governor of the Bank of Russia, at the Forum on Financial Stability "The policy of the Bank of Russia for ensuring financial stability in an environment of economic recovery", Moscow, 13 April 2017.

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Dear colleagues, it is my pleasure to welcome you all to the Forum on Financial Stability, which has by now become a tradition. In the last few quarters we have witnessed the beginnings of fundamental change in both the economy and financial markets. The economy has adapted to balance of payments shocks and started on a path of recovery, and the level of volatility in financial markets has gone down significantly. The relatively calm climate we now find ourselves has led to a decrease in risks that had been building up, but such a climate could nevertheless bring in new risks and lead to the creation of so-called bubbles in certain markets. The Bank of Russia must continue to be on the alert, and ready to adopt the necessary measures as they are called for. And so, through our analysis of the potential for implementing macroprudential instruments and macroprudential stress testing, that is exactly what we are doing now. Myself and a number of my colleagues will be delving deeper into these issues, and I would like to take this opportunity to highlight a few myself. I will be talking about issues like the present state of the Russian economy and the impact this has on financial stability; key challenges facing the world today; the current situation in the banking sector; and finally I would like to go into more detail on some policy measures undertaken by the Bank of Russia for the express purpose of mitigating risks in the Russian financial system as a whole.

1) On key risks and the current state of the Russian economy

First of all I would like to draw your attention to a number of improvements in the Russian economy that began to take place in 2016. GDP moved into growth from the third quarter of 2016, and we expect that the positive effects of this change will continue to be felt. According to our assessment, the GDP will see growth of 1-1.5% in 2017, and 1-2% in 2018–19. It is worth noting that in recent years indices of business activity have grown considerably and now sit at the highest levels of the last 9 years: in industry the PMI rose from 49.8 points in January 2016 to 52.4 points in March 2017; in the service sector – from 47.1 to 56.6 points over the same period. Economic recovery has contributed to the reduction of current credit risks in the banking and financial sectors as a whole.

Inflation is falling even more quickly than expected. The annual rate of consumer price growth fell to 4.3% in March 2017, down from 12.9% in December 2015. However, it should be noted that the slowdown in inflation was aided significantly by one-off factors such as the strengthening of the ruble thanks to higher oil prices and last year’s good harvests.

Through the concerted efforts of OPEC and other oil producers, the oil market has become more stable in recent months and oil prices have increased. Oil prices have gained a firm foothold over a relatively broad range. This provides more stability in understanding long-term trends. Nevertheless, the range of scenarios that could evolve in the near future remains quite wide. As you will doubtless be aware, the baseline scenario adopted by the Bank of Russia assumes that oil prices will adjust to a level of US$40–45 per barrel in the short or medium term. However, the alternative scenario we have forecasted assumes a gradual increase in the price of oil, and this too seems entirely possible.

Under highly volatile conditions in the terms of trade it is very important to have a budget that is not susceptible to external fluctuations, including those arising from the commodity supercycle. Last year we adopted a programme of fiscal consolidation to aid in the stabilisation of budget expenditures. Beginning this year an interim fiscal rule has taken effect, under which oil and gas revenues resulting from the higher than expected cost of base-level oil are directed to the Reserve Fund. The full implementation of this fiscal rule will contribute to a reduction in the risks to financial stability associated with fiscal volatility and commodity cycles.

On the subject of the Bank of Russia's monetary policy, the existing balance of risks allows for a gradual lowering of interest rates to take place, however monetary policy should still remain moderately tight. This is due to the need to maintain inflation at a level close to the target, and to reduce inflation expectations in the medium term, taking into account the internal risks and potential volatility of external factors. The steadiness of changes to interest rates, and the attendant high level of predictability in monetary policy, leads to a reduction in the risks posed to financial stability.

2) On capital flows and global risks

For the most part, the situation in Russia reflects overall improvement in sentiment on global markets in the context of a revival in economic activity in the leading economies. We have begun to see clear signs that economic dynamics are being restored not only in the U.S., but also in the Eurozone, where the economic situation has been unstable for a long time. In general, the indices of economic activity PMI for both the leading economies and the global economy as a whole currently sit at 6-year highs. The upward swing of the economic cycle is gaining momentum.

These conditions have led to increased optimism of global market participants and growth in capital inflow on the markets of emerging economies. Many countries, including Russia, have seen improvement in the index of attractiveness of carry trade (carry-to-risk). This index reflects the rate differential between sovereign obligations, with regard to risk measured against the volatility of the exchange rate. The recent growth of this index for Russia is associated not so much with change in the rate differential, but with the lower volatility of the ruble, which has already matched the level of a large number of emerging markets with successfully implemented inflation targeting policies, and that of some developed countries.

In response to these changes, questions have arisen regarding the volume and potential sustainability of capital inflows to Russia. It should be noted that statistics do not confirm the hypothesis that carry traders have brought about a mass influx of funds on the Russian market. According to the latest balance of payments assessment published by the Bank of Russia, the main foreign exchange earnings in the first quarter of this year were related to the current account, and amounted to US$22.8 billion. Net private capital outflow in the first quarter of 2017 – amounting to US$15.4 billion – was actually a reflection of this influx, as the Russian banks, having received export revenue in their accounts, incorporated this revenue as foreign assets, primarily in the form of deposits in correspondent banks. Therefore, the strengthening of the ruble that we saw in the first quarter of 2017 can in large part be attributed to inflows of foreign currency through foreign trade channels, and in small part to other factors, such as carry trade operations.

Statistics show that the total volume of capital inflow is not huge, however in some markets the share held by non-residents has recently increased. Such markets include the OFZ market, information about the share of non-residents in that market is regularly published on our website. According to these statistics, the share of non-residents investing in the OFZ market rose 2 percentage points from October 2016, reaching 29% by 6 April 2017. This is hardly a substantial increase. The yield of OFZ has remained fairly constant since October 2016, despite the fact that the volume of net borrowing by the Ministry of Finance in this period has been quite large. This is indicative of the fact that the main players in this market are Russian banks, and that competition with foreign investors allows the yield of OFZ to be kept from growing, despite increase in supply.

In our opinion, based on the experience of recent years, a significant portion of the inflows of foreign capital to the OFZ market can be considered to be quite stable. This is connected to the beginning of Russia's economic recovery and an increase in the level of trust investors have in the policies which are in place. However, from the point of view of financial stability we cannot completely disregard the possibility of capital outflow from the OFZ market if external or internal shocks were to take place. The Bank of Russia conducted a survey of foreign investors regarding their investment strategy in Russian sovereign bonds. The results of the survey show that a significant portion of investors buying OFZ admit that these may be sold prior to maturity. Such risks need to be taken into account and their impact on the economy reduced through clear and predictable policy.

This is important because the situation on global markets remains fragile and volatile while uncertainty persists in a number of factors. Such factors include what format a British exit from the European Union will take, at this point still unclear; the possible negative consequences that will result from changing economic and trade policies in the United States; and the aggravation of political risks in Europe. The heightened risk of negative developments in the Chinese economy, given the high degree of debt load in the economy and increase in the number of corporate defaults over the last year, may also prove to be an important factor. However, seeing as total capital inflow is considered to be small, risks to financial stability associated with the possible outflow of this capital remain quite low.

The excessive optimism currently experienced in global financial markets may also be a cause for concern. The value of many assets is being overestimated by investors and increased global political risks are not being taken into account.

Political risks lead to greater uncertainty in economic policy. If we look at the indices of uncertainty in economic policy, we can see that they have reached their maximum values. This means that along with improving the prospects for economic growth, it is necessary to take into account possible changes in the functioning of financial markets and potential spikes in volatility.

3) On currency risk and measures for the deforexation of the economy

In a climate of lowered yet still high volatility in oil prices, currency risks continue to be potentially significant. From the point of view of currency risk management, I would like to highlight the need, on the one hand for further deforexation of the balance sheets in the banking sector, and on the other for limiting foreign exchange risks in the non-financial sector of the economy.

The issue of deforexation of the banking sector was raised at the Forum on Financial Stability last year, with particular emphasis placed on foreign currency lending to those sectors and companies that do not have sufficient foreign exchange reserves. This problem primarily arises in relation to companies from the construction and real estate sectors. As you know, the Bank of Russia made a number of changes to regulation in order to limit the risks associated with such lending, and to ensure that banks have a capital buffer for these loans. Today we will summarise our intermediate results and progress we have made so far.

From the beginning of 2016 to March of this year, outstanding foreign currency loans went down by almost US$28 billion. This was partly offset by an increase in outstanding ruble loans, which grew to 514 billion rubles. We can also see a decrease in foreign currency lending, mainly in those industries where companies lack so-called natural hedging. Once again this refers to businesses in the construction and real estate industries, as well as wholesale and retail trade. For exporter companies the situation remains unchanged, and banks continue to make foreign currency loans to them.

In 2014–2015, exporters' external debt presented a significant potential risk to financial stability. The high number of maturing loans was a cause for concern, and we were carefully monitoring the schedule for upcoming repayments. This spike in external debt repayments has since passed. In the first quarter of 2017, the 27 largest companies repaid a combined total of US$9.8

billion in external debt. They will repay a further US$16.5 billion by the end of 2017 (April – December), which is 22% less than the payments made in the same period of the previous year (US$21.1 billion).

Now, given the recovery in economic activity in the world and in Russia, as well as the increase in attractiveness of Russian borrowers, there is the potential risk that these borrowers will accumulate excess foreign currency debt. This risk is emphasised by the fact that far from all of the exporter companies can claim to have a comprehensive natural hedge against currency risks. In some cases companies raise foreign currency debt which is not fully covered by inflows from export activities. In 2008–09 and 2014–15, the Bank of Russia's assets were used to refinance external loans which had been raised by commodity companies. It is therefore essential to keep monitoring the risks of excessive external debt accumulation, for which purpose the Bank of Russia has instated monitoring of companies' foreign currency debt levels.

Among the many tools for macroprudential risk management are the measures taken by the Bank of Russia towards the deforexation of the economy. Given that in Russia, phases of the financial cycle largely correlate with phases of the commodity cycle, we think these measures need to be countercyclical – allowing banks to accumulate capital during periods of credit expansion and then use it as a cushion in periods of credit crunch. This approach will smooth out the sharpness of fluctuations in the financial cycle and reduce financial stability risks.

4) On credit risk in the banking sector

First of all, it must be noted that for the most part credit risks in the corporate segment did in fact come to pass. If we look at the statistics, over the past six months the share of overdue loans has remained virtually unchanged, coming to 6.7% on 1 March 2017. The share of bad loans in banking portfolios also remains unchanged (sitting at 8.7%, excluding rehabilitated banks, in contrast to the previous level of 8.6%).

The largest share of bad debt is to be found in the construction sector (27.3%), real estate transactions (13.5%) and wholesale and retail trade (15.1%). To a large extent, the realisation of risks in these sectors was caused by the reckless actions of not only borrowers, but also banks providing foreign currency loans to borrowers who do not have foreign currency earnings.

The second point I would like to address is how banks manage risks that arise. The main tool of credit risk management for borrowers already experiencing financial difficulties is restructuring. In 2016, the Bank of Russia began collecting operational data from banks, analysis of which showed that banks actively use restructuring in their operations. The areas in which banks make concessions to borrowers are, once again, foreign currency loans to construction and real estate companies, as well as ruble loans to coal companies which faced difficulties in 2013–15 due to the decrease in coal prices. It is worth noting that the process of restructuring loans does not affect the stability of the banking sector, as the loans in question generate sufficient reserves.

To summarize, I would like to note that the banking sector is entering a new phase, wherein priority will shift from active work on the debt problem to the task of finding new clients and projects for lending. The Bank of Russia's job in this case will be to carry out macro-level monitoring to ensure compliance with banking standards for taking on risk.

With regard to consumer lending, since the second half of last year we have seen an increase in new loans, a decrease in the share of bad loans, and a gradual recovery in the market. Yelizaveta Danilova will go into this in more detail in her report. In view of declining market interest rates, we have decided to alter the scale of the differentiated risk ratios depending on the total cost of credit. However, low interest rates on consumer loans could lead to a new boom in the market for unsecured consumer lending. To deal with this, the Bank of Russia is studying different approaches to the regulation of borrowers' debt burden, in particular the relation between income and total monthly loan payments.

A number of countries actively use this type of regulation. In order for debt load information to be incorporated into regulation, banks must be able to obtain information in a timely manner about borrowers' total debt, their payments on existing loans and their income. In February we put out a consultative paper on the calculation of debt ratios, which banks have since made a lot of important comments on. We are now studying these comments and working on developing specific approaches.

Among the other tools and risks that require particular attention, I would like to turn now to interest rate risk and macroprudential stress testing.

5) On interest rate risk in the banking sector

At present, interest rate risk in the Russian banking sector is low. This is largely thanks to the fact that after market stabilisation which took place in 2015 and the period following, the economy learned to adapt to external shocks, and confidence in implemented monetary policy grew. Amid slowing inflation and decreasing interest rates on bank loans and deposits, banks have been able to increase their margins of interest. This in turn has contributed to growth in net interest income, which reached a three-year peak in the fourth quarter of 2016 to exceed 700 billion rubles.

Despite low interest rate risk for Russian banks, it is important not to forget the need for improvement in systems of risk management. In terms of inflation targeting, interest rates are quite heavily dependent on inflation behaviour and can significantly impact the value of credit institutions' assets and liabilities, as well as their interest margins. When taking this into account, the challenge of effectively managing banks' interest rate risk becomes very important.

Recently, particular attention has been paid to this issue by the world's leading central banks. A year ago, in April 2016, the Basel Committee on Banking Supervision (BCBS) released their benchmark standard, dedicated to the management of interest rate risk in banking books. This standard describes advanced methods of evaluating interest rate risk in banking books in detail, such as sensitivity testing of the net present value (NPV) and of the economic value of equity (EVE) in terms of interest rate risk. Moreover, the BCBS standard devotes special attention to the assessment of non-standard instruments vulnerable to interest rate risk, that is, instruments without a defined maturity date (in particular, demand deposits), and instruments with built-in optionality (in particular, loans with an early repayment option).

In order to evaluate to what extent the methods of interest rate risk assessment and management used in Russian banks are consistent with international best practice, the Bank of Russia conducted a survey of 27 of the largest banks about how their systems of interest rate risk management and assessment are currently organised. In general, there is pronounced variation in the methods used by surveyed banks to assess interest rate risk.

Among the respondents we can find both banks applying advanced methods close to BCBS standards, as well as banks using the Bank of Russia's regulatory methodology. This is a natural consequence of the differences in banks' sizes, their business models and the structure of their assets and liabilities, and does not represent a disadvantage. At the same time, it can be expected that the BCBS standards of interest rate risk assessment will be reflected in Russian banks' regulation practice in the near future. In this regard, we now recommend that banks study and incorporate those methods of interest rate risk assessment proposed by the BCBS.

I recommend you to look at the results of this survey of banks published on the Bank of Russia's website in the form of a consulting report. We are awaiting comments and suggestions from the banking community on the conclusions drawn.

6) On macroprudential stress testing

And finally, coming to the end of my talk I would like to say a few words about the Bank of

Russia’s plans for the development of macroprudential stress testing. The European Central Bank recently published an extensive document on this subject, and similar work has also come from the Bank of England and Bank of Japan. It is fast becoming standard analytic practice for central banks in ensuring financial stability.

Why has macroprudential stress testing become so relevant? There are several reasons. As you will be aware, the Bank of Russia has long been engaged in stress testing of the banking sector. Traditionally this instrument has been used in the supervision of banks, in order to understand the risks posed to individual banks and the banking sector as a whole. However, across the globe we can see a new trend of conducting cross-sectoral stress testing, i.e. stress testing which is applied not only to the banking sector, but also to other related sectors, as they may also be carriers of systemic risk, be exposed to systemic risk from banks or, conversely, pass this risk on to banks. Such sectors include insurance companies, pension funds and professional market participants. And, importantly, in this type of stress testing intermediaries’ involvement in financial groups and holding companies is taken into account.

Work on macroprudential stress testing has already begun at the Bank of Russia, and we have already taken the first steps in this direction. In 2017, the Bank of Russia began to publish its “Review of Financial Market Risks”, instead of the previously published “Money Market Review”, and the results of comprehensive stress testing of the financial market can be found in this new edition. Reflected in this work is the interaction of different categories of financial intermediaries in different financial market segments by means of network analysis tools.

Further steps to be taken involve linking financial sector risks to shocks to the real economy, in which the effects of stress may be further exacerbated due to the feedback effect. At the end of this year, we will present the results of macroprudential stress testing in our “Financial Stability Review”. In the future, we will be able to use this to further develop the measure and calibration of macroprudential tools.

So, in this short presentation I have tried to present you with our understanding of the current situation in the Russian market from the point of view of financial stability. My colleagues will take some of these issues up in more detail. We are ready to answer any questions you may have.