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Russia's financial system is still experiencing a higher than pre-crisis level of stress

Analysis of the current state of the RF financial system

- **Since February 2016, Russia's financial system has been in the stable mode.** Now that two years have elapsed since the liquidity crisis on the Russian interbank market and the shock devaluation of the RUB, inflation expectations and credit risk perceptions of the majority of borrowers have significantly decreased.
- **The level of stress experienced by the financial system still exceeds that of 2011–2013.** The heightened stress is rooted in the oil market volatility and domestic recession. The observed volatility of oil prices and apprehensions of their prospective fluctuations can give a new impetus to the growing uncertainty about the dynamics of exchange rates, inflation, interest rates, and economic growth. Internal structural consequences of the recent economic downturn are yet to be overcome, although they are becoming much more predictable and are therefore generating less risk.
- **Changes in the interaction mechanism between the banking system and the Bank of Russia will not affect the systemic risk level.** Transitioning to the surplus liquidity mode and positive real interest rates on short-term lending and deposit transactions will not create additional stresses for the financial system, as it will be implemented gradually over time.
- **The most stressful 2016 event for Russia will very likely remain the January oil prices drop below USD 28/bbl.** Despite the high volatility of the exchange rate and the stock market, this event was not accompanied by money market instability.

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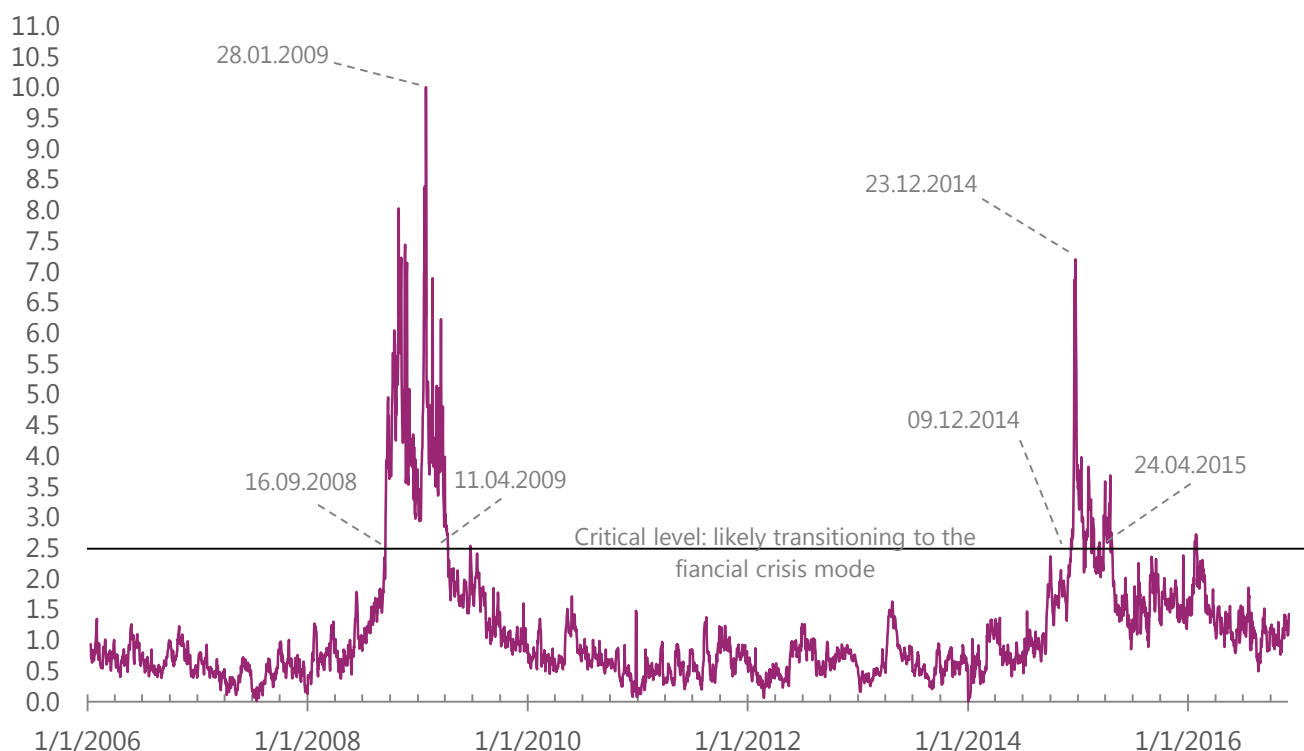
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Figure 1. ACRA-developed financial stress index



Source: ACRA estimates

Key manifestations of financial stress:

1. Uncertainty about fundamental values of financial assets or commodities: correlates with the volatility of financial instrument prices and forces market participants to more actively and expeditiously respond to any new information (even when irrelevant).
2. Lack of information about the behavior of other market participants: can lead to misinterpretations of price dynamics and sudden expectation adjustment episodes.
3. Asymmetry of information about asset quality (Seller Knows More) or borrower quality (Borrower is Better Informed): occurs as a result of a growing quality spread and exacerbates problems of adverse selection and moral hazard, which in turn lead to eroded trust and more reluctant lending.
4. Flight to quality: growing probability of losses forces investors to choose less profitable and less risky investments, which often triggers rapid changes of their relative prices.
5. Flight to liquidity: fewer lending opportunities create additional incentives for choosing more liquid assets required to meet the demand for coverage.

For details, please refer to [the Principles of Calculating the Financial Stress Index for the Russian Federation](#). Up-to-date values of the Index are regularly published on the ACRA website: www.acra-ratings.com.

Russia's financial system returned to the stable mode in February 2016

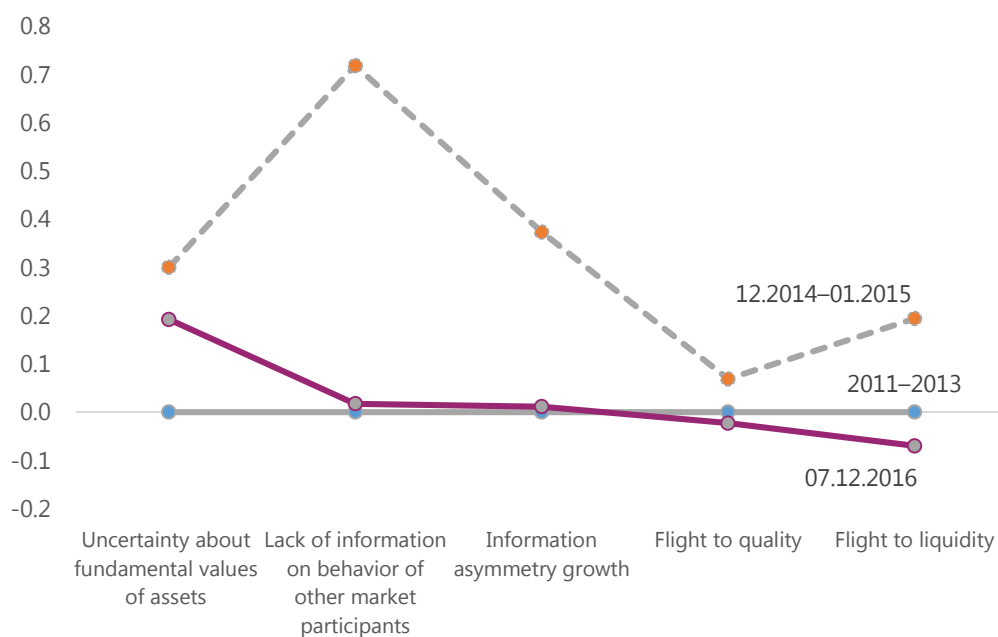
The financial crisis that broke up in September 2008 pushed Russia's financial system into a seven-month recession, after which it fairly quickly transitioned into a stable mode. The acute onset of the December 2014 crisis that followed the earlier shocks of that year, lasted for four months before sailing into an eight-month period of uncertainty. Presently, the stress level continues to exceed the 2011–2013 indicators. The process of normalization had been essentially completed by mid-2015, although individual indicators did not rebound until mid-2016.

Yield spreads between various borrower types, which characterize the perception of relative credit risk, have returned to their typical 2011–2013 values (e.g., the average difference between the charged for short-term borrowings by banks and the state is currently under 1.5 pps, although six years ago it reached 3-4 pps).

The time structure of the yield curve has approached its normal value: the rate inversion has disappeared for almost all maturities except for short-end, which mirrors expectations of the Bank of Russia lowering its key rate within the 12-month horizon. Average inflation, which affects the expectation levels and spreads about interest rates, again amounts to 0.6% month-on-month and continues to slide. Its downward trend has been emulated by the inflation expectations that are now forming a stable trend.

The volatility of the stock market and the RUB exchange rate have also returned to its typical 2011–2013 values, having decreased against the average annual value of 2015 by 1.5 and 2 times, respectively.

Figure 2. Correlation between current, normal,¹ and shock levels of financial stress



Source: ACRA estimates

¹ For clarity, each sub-index value was set at zero for the crisis-free period of 2011–2013.

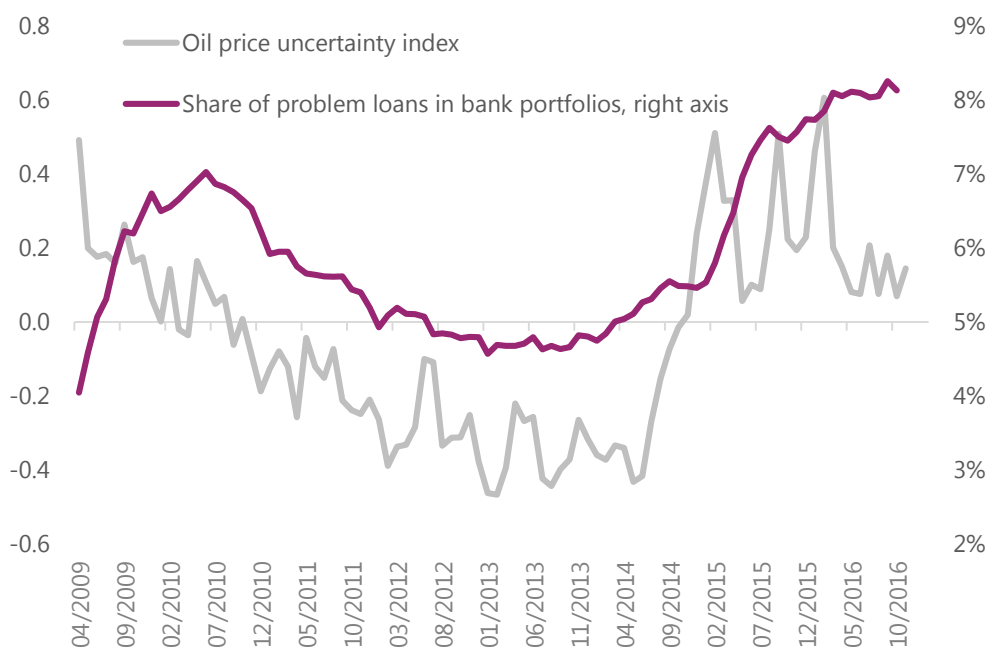
Oil prices and consequences of the economic meltdown are potential sources of a new stress

On November 30, 2016, in Vienna, the OPEC countries agreed to adjust oil production (for Russia, the daily cutback amounted to 0.3 mln bbl).

The increased oil price volatility (see Figure 3) is related both to the supply shock of 2013–2014 and the uncertainty about global economic growth and demand for energy resources on the whole (growth expectations for a number of developing countries are revised with a downward adjustment). In addition, ongoing negotiations of oil exporting countries on coordinating efforts in the area of reducing oil extraction take place both in and out of public view, while contractual performance depends on both economic and the less predictable political factors. The existence of a stable spread between prices spot contract market prices and forward prices reflects the increased probability of oil price changes in the foreseeable future. That said, episodes of sudden oil price variations due to structural reasons lead to the most significant fluctuations of the financial stress level in the RF (see Appendix 1), since they initiate simultaneous revaluations of fundamental values of a number of financial and non-financial assets. Despite this risk, under ACRA's base case scenario, the uncertainty caused by the oil price volatility will be decreasing gradually over the next 12 months, making a positive effect on the Russian financial system.

Figure 3. Two potential sources of new stress

The oil price uncertainty index incorporates spot price volatility and the spread between spot and forward prices.



Sources: ACRA estimates

The adjustment of the RF economy to the new trade balance structure occurred mainly in the form of sliding real incomes, while domestic recession and growth of import prices impeded investments. The ensuing result was a notable growth of problem loans in bank portfolios: the first factor affected loans to individuals, while the second one heaved a blow to the investment demand sector. The credit quality of a tangible share of borrowers remains low and is on a downhill course with respect to specific borrower groups. According to ACRA estimates, this state of affairs exacerbates the probability of the economy transitioning to the financial crisis mode if affected by an exogenous shock, although presently, it cannot act as its standalone cause.

Transition to the structural liquidity surplus mode will not create risk as long as the Bank of Russia rates remain adequately high

A structural liquidity surplus is the banking sector's persistent demand for the allocation of available funds through operations with the Bank of Russia.

The Ministry of Finance plays an increasingly important role as a source of liquidity for the banking system. This comes as a result of the Reserve Fund being the preferred source of financing the Federal budget deficit (as opposed to market-based financing). The Bank of Russia makes sure to adjust its monetary policy in such a way as to put a crimp on excess liquidity, which may accelerate inflation and have an adverse effect on the stock and currency markets by spurring the growth of stock indices and crippling the RUB.

In the absence of an adequate response from the Bank of Russia, an extended liquidity surplus has the power to distort investment incentives within the financial system and lead to excessive risk-taking by investors and lenders. Materialization of these risks can ignite a systemic crisis similar to the mortgage crisis in the U.S. The fundamental mission of the regulator when facing the risk of excess liquidity is to create strong enough incentives for encouraging banks to invest in their risk-free instruments. This is one of the reasons why the Bank of Russia is emphasizing the need to maintain positive real short-term interest rates on its operations in the years to come. If this intention is realized, the structural liquidity surplus will not put the Russian financial system in jeopardy of a new crisis.

The basic tools for implementing the Bank of Russia's monetary policy under the current conditions are its weekly deposit auctions and own bond placements planned for 2017. Theoretically, liquidity volumes can be managed by controlling the reserve ratio or the amount of cash, as well as by engineering exchange market interventions. A great variety of liquidity management options and their factual unlimited use makes it a loss control over short-term rates or excess liquidity highly unlikely. The Bank of Russia's objective will be made more attainable by the predictability and inertia of government spending in instances of punctual execution of the adopted federal budget.

Appendix 1.

Events that could presumably affect the financial stress level in 2016

Comparison of the observed dynamics of ACRA's financial stress index and characteristics of its typical volatility allows for a conclusion whether index growth over a time interval can be interpreted as a reflection of actual financial stress dynamics or simply as "noise". By crisis-free standards, any relatively large absolute index gains are rare, therefore if they occur in the wake of potentially influential events, such gains may indirectly indicate the existence of a causal link with the preceding events. Table 1 shows examples of such "indicative" gains and interpretations of the index dynamics following a series of 2016 events that are presumably able to affect the level of financial stress in the RF².

The post-event growth of the financial stress index does not necessarily mean that it was the event in question (and only the event in question) that caused the altered state of the financial system.

The title of the most stress-inducing 2016 event in Russia will likely be kept by the January oil prices drop below USD 28/bbl. Despite the high volatilities of the exchange rate and the stock market, the oil price drop was not accompanied by money market instability. In the aftermath of the January event, the financial stress index kept oscillating around the bar, values above which are usually observed at times of the economy transitioning to the financial stress mode.

Table 1. Example of calculating the "significance" of financial stress index gains³

| Date | Event | Frequency of Index growth of such magnitude in crisis-free periods | | |
|------------|---|--|--------|---------|
| | | 1 day | 1 week | 2 weeks |
| 20.01.2016 | Oil prices drop below USD 28/bbl | 16% | 1% | 45% |
| 28.01.2016 | The FRS decides to maintain its rate level | 71% | 2% | 13% |
| 23.06.2016 | Brexit referendum results are made public | 1% | 11% | 48% |
| 27.07.2016 | Unexpectedly high figures of U.S. oil reserves are released into the media | 9% | 33% | 72% |
| 08.11.2016 | The U.S. announces its presidential election results | 67% | 11% | 29% |
| 30.11.2016 | The OPEC reaches an agreement on coordinated oil production by member countries | 10% | 59% | — |

Source: ACRA estimates

² For more on the interpretation of the financial stress index dynamics, please refer to ACRA's Procedure for Calculating the Financial Stress Index for the Russian Federation.

³ Color-marked are "significant" index growth instances that occur less frequently than in 25% cases in crisis-free periods.

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