

**RESEARCH AND INFORMATION DEPARTMENT
OF THE BANK OF RUSSIA**

FINANCIAL STABILITY REVIEW

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Contents

Chapter 1. General economic conditions	1
Chapter 2. Financial market and its instability	7
2.1. Interbank money market.....	8
2.2. Foreign exchange market.....	10
2.3. The securities market.....	12
2.3.1. Domestic bond market.....	12
2.3.2. Equity market.....	16
2.4. Derivatives market	18
Chapter 3. Financial condition and soundness of financial intermediaries	22
3.1. Credit institutions	22
3.2. Non-bank financial institutions	29
Chapter 4. Analysis of Russian ratings	32
4.1. Comparative assessment of sovereign ratings of Russia and other transition economies...	32
4.2. Ratings of sub-sovereign issuers	34
4.3. Ratings of financial intermediaries	34
4.3.1. Ratings of credit institutions	34
4.3.2. Ratings of non-banking financial intermediaries	35
4.4. Ratings of non-financial organisations	36
Appendices	39

Chapter 1. General economic conditions

The external conditions for the Russian economy deteriorated considerably in 2008. Risks increased due to the unfavourable situation among the economies of Russia's trade partners, unstable world prices of Russia's major export commodities, crisis-related factors in foreign financial systems and in financial markets, capital outflow, and foreign exchange rate volatility.

The business cycle in the leading industrial countries among Russia's trading partners switched from the upswing phase to the downturn phase. A contraction of GDP for two consecutive quarters (the international criterion for a recession) was registered from April to September 2008 in Germany, Italy and Japan. According to estimates, the GDP contraction in the United States and Great Britain, observed in the third quarter, continued into the fourth quarter (under the US methodology for determining business cycle phases, the recession in the US started in December 2007). Recessions among the most developed countries adversely affected the situation in other countries – Russia's trade partners in Europe and Asia – as a result of weakening demand for their exports of industrial products and raw materials, and a decrease in foreign capital inflow. According to estimates of the International Monetary Fund (IMF), the global economy's growth declined from 5.2% in 2007 to 3.4% in 2008.

The cyclical declines in the economies of Russia's trading partners were aggravated by the crisis in the financial sectors of foreign economies, first and foremost, in the United States. Among the factors behind the crisis were overinvestment in construction, and the large-scale practice of issuing mortgage loans without proper monitoring of borrowers' creditworthiness. Mortgage lending risks intensified at the start of 2007 following an increase in interest rates and a fall in real estate prices. The growth of mortgage defaults resulted in considerable losses sustained by financial institutions directly from lending operations and also (predominantly) due to the liquidity crunch and a slump in prices in the market of mortgage-backed securitized assets, including bonds issued by the US federal mortgage agencies Fannie Mae¹ and Freddie Mac². The large-scale use of borrowed funds by financial institutions to carry out transactions in these markets turned this into a systemic crisis. The globalisation of financial markets made the crisis spread on a global scale.

The crisis developed in several stages. In the first half of 2007, overdue debts on mortgage loans increased, while liquidity in the markets of mortgage-

backed securities declined. In the third quarter of 2007, the shortage of liquidity spilled over to money markets (for the most part, US dollars in the United States and other countries). From August 2007, interest rates on interbank loans started to grow on the US and European markets as banks showed their distrust for counterparties and assets provided as loan collateral. Monetary authorities' measures to increase the supply of liquidity in more flexible terms temporarily eased tensions in the markets at the beginning of 2008. However, in March 2008, the threat of bankruptcy of US Bear Stearns investment bank made the systemic nature of risks in the US financial sector appear obvious. Systemic risks intensified following the bankruptcy of a large US investment bank, IndyMac Bank, in July 2008, the placing of the federal mortgage agencies Fannie Mae and Freddie Mac under conservatorship in early September, and the bankruptcy of Lehman Brothers investment bank in September 2008.

At the end of the third and the beginning of the fourth quarters of 2008, tensions in the financial sectors of developed economies reached their peak. This situation accelerated the fall in prices of financial assets, and exacerbated fears that banks could cut back on lending to the real sector of the economy (during the crisis, banks showed increasing conservatism in loan provision). Enterprises began massive layoffs, and the total value of households' assets decreased, intensifying the decline in consumer activity.

Throughout 2008, the main factors influencing world equity markets were negative ones, such as slower economic growth, financial sector losses, and periodically intensifying liquidity shortages. Under these conditions, share placements on the primary market fell as a whole, and the volume of transactions for the merger and acquisition of non-financial corporations declined. As for financial institutions, the crisis stimulated the raising of additional capital and triggered large-scale processes of consolidation and nationalisation. The bankruptcy of Lehman Brothers prompted sharp falls in stock markets in the second half of September, which continued in the fourth quarter on reports that other financial institutions were experiencing problems, and as a result of negative trends in the real sector of developed economies. Share prices in emerging economies declined as investors sought to minimise risks.

The crisis reduced primary placements of debt securities on world capital markets, including their international segments. The markets of securities backed by mortgages and other assets shrank dramatically. In the second half of 2008, bond placements by US

¹ Fannie Mae – Federal National Mortgage Association.

² Freddie Mac – Federal Home Loan Mortgage Corporation.

mortgage agencies declined. There was a considerable decline in corporate bond issues with speculative-grade ratings, due to widening spreads between interest rates on these instruments and the yields of assets with low credit risks. The increased credit risk aversion during the crisis also affected primary placements of debt securities by corporations with investment-grade credit ratings, especially in the second half of the year. International capital markets witnessed a drop in net issues of debt securities by borrowers registered in emerging economies.

In the international foreign exchange market, the US dollar continued to depreciate in the first half of 2008 against the currencies of most countries that are Russia's trade partners. However, the US currency appreciated sharply in the second half of the year. Over the year (December on December 2007), the dollar gained over 7% against the euro. The dollar depreciated in the first half of the year, as the US Federal Reserve eased its monetary policy. However, after the dollar/euro rate approached \$1.6 to the euro in late April and early May, US and euro-zone government and central bank officials made a number of statements to the effect that the dollar's further weakening was not in the interests of any of the world's major economies.

In mid-July, when the European Central Bank raised its refinancing rate, the dollar fell again to around \$1.6 to the euro, but soon started to appreciate. From August, the dollar's growth accelerated. The US financial market, as the largest and the most developed, continued to be viewed as a safe haven for short-term investment amid crisis conditions. Investors' desire to minimise risks changed the direction of financial flows, contributing to the dollar's growth, on the one hand, and capital outflow from emerging economies, on the other. Even relatively developed economies experienced problems linked to capital outflow. This was the cause of the fall in value of the South Korean won. Turkey, Poland, Romania, India and Brazil also experienced difficulties as their currencies depreciated considerably.

Unfavourable conditions emerged among countries exporting raw materials, including energy products. According to estimates of the International Energy Agency, oil consumption in member states of the Organisation for Economic Cooperation and Development (OECD) fell by more than 3% in 2008 due to the economic slump. Although global oil consumption remained largely unchanged in 2008 according to preliminary estimates, oil prices, which had earlier registered a steep rise, could not increase further as demand growth came to a halt. The outflow of short-term capital from the market of oil delivery contracts, prompted by investors' desire to minimise risks, caused a sharp fall in world oil prices in the third and particularly the fourth quarters of 2008.

The average yearly price of Brent, Dubai and WTI oil blends increased by 36.4% in 2008 compared to the previous year. This growth came from the increase in oil prices in the first half of 2008, whereas in the second half of the year world oil prices fell. In December 2008, the average monthly prices of Brent, Dubai and WTI blends were 53.8% lower than in December 2007 and 68.9% lower than their record highpoint registered in July 2008. In the second half of 2008, prices of non-ferrous and precious metals declined, while the fourth quarter saw a fall in steel prices.

The dynamics of imported inflation for the Russian economy showed varying trends in 2008. Inflation among the countries that are Russia's trade partners remained high in the first half of the year, largely due to prices of energy products and foodstuffs. Food price growth was driven mainly by the increase in world grain prices. In the second half of the year, imported inflation slowed, and consumer prices in some of the countries that are Russia's trade partners went down in the fourth quarter. Prices of agricultural products and non-food raw materials declined in the second half of the year.

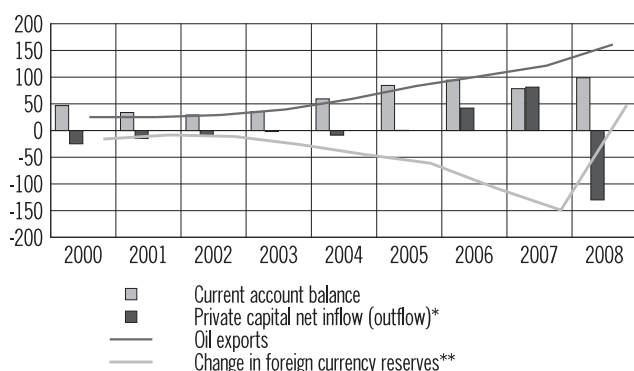
The policies of foreign central banks were largely determined by the task of countering negative trends in financial sectors, which was a priority goal for the US Federal Reserve and the Bank of England. In January-September 2008, the Federal Reserve cut its federal funds rate from 4.25% to 2.0% p.a., while the Bank of England reduced its refinancing rate from 5.5% to 5.0% p.a. At the same time, monetary policies in some countries were considerably influenced by the need to combat rising inflation. In particular, in July 2008 the European Central Bank raised its refinancing rate from 4% to 4.25% p.a.

In the fourth quarter of 2008, monetary policies focused on the priority task of preventing a systemic banking crisis and deflation. By the end of the year, the US federal funds rate had been reduced to 0-0.25% p.a. (this was the first time a target range had been established for the federal funds rate), the refinancing rate of the European Central Bank had been cut to 2.5% p.a., and the Bank of England's refinancing rate to 2.0% p.a. The Bank of Japan cut its overnight loan rate from 0.5% to 0.1% p.a. In the fourth quarter, interest rates on monetary policy instruments were reduced in many other countries, including Canada, Australia, New Zealand, Switzerland, the Scandinavian countries, and the leading emerging economies (China, India, South Korea and Turkey).

With the easing of monetary policies in 2008, LIBOR rates for deposits in US dollars with maturities from one month to one year dropped by 2.0-3.9 percentage points (on average, from December to December 2007), by 1.3-1.7 percentage points for deposits in euros, by 2.5-4.1 percentage points for deposits in British pounds

Chart 1.1

Balance of payments (billion US dollars)



* "-" denotes net capital outflow, "+" denotes net capital inflow.

** "+" denotes decrease, "-" denotes growth.

and by 1.6-2.1 percentage points for deposits in Swiss francs. The liquidity crunch in money markets (credit risk aversion during particular periods) affected the fluctuations of spreads between LIBOR rates and yields on short-term government securities. Spreads widened in March due to the developments surrounding Bear Sterns. As the scope of the financial crisis widened, spreads started to increase sharply in September, and this growth continued through October.

During the crisis, foreign central banks, primarily the US Federal Reserve, worked out new approaches to regulating banks' liquidity. In particular, they extended lending periods for banks, as well as their collateral lists. The Federal Reserve launched a programme of loan auctions characterised by a more flexible approach to loan collateral and interest rates as compared with traditional mechanisms. Central banks signed foreign currency swap agreements allowing one central bank to borrow in the currency of the other to carry out foreign exchange interventions and eliminate the shortage of that particular currency in the domestic money market. The US and Great Britain created mechanisms for banks to temporarily substitute low liquidity assets for government securities.

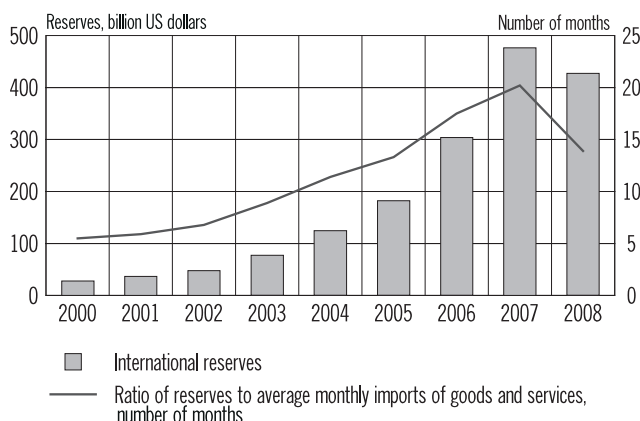
To prevent a systemic banking crisis, the governments of many countries took measures to broaden guarantees on bank deposits, recapitalize banks, buy-out toxic assets, and provide targeted assistance to system-building financial institutions, including the nationalisation of some of them. In the United States, a total of \$700 billion was allocated under the Emergency Economic Stabilisation Act adopted in October 2008 to overcome the effects of the economic and financial crisis in 2008-2009.

The Russian economy also experienced the negative effects of the global financial crisis, especially in the second half of 2008.

The world market conditions for Russian exporters improved in the first half of 2008. However, in the second half of the year, world prices of oil and other

Chart 1.2

International reserves



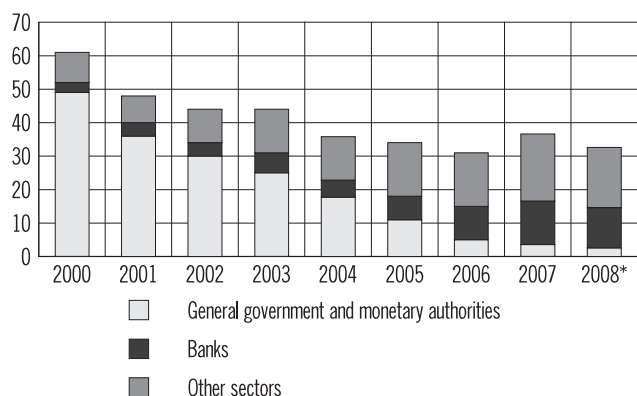
commodities declined sharply. At the same time, although world prices of Russia's Urals oil blend fell from \$129 per barrel in July to \$38 per barrel in December, the average annual price of Russia's crude was 35% higher than in the previous year, standing at \$93.9 per barrel. Commodity exports in 2008 grew faster than imports, and Russia's trade surplus increased by 33% as compared with 2007.

The current account surplus, despite its considerable contraction in the fourth quarter (to the average quarterly level of 2003), increased in 2008 by 30%, year-on-year, to \$98.9 billion, and as in the previous year, was estimated at 5.9% of GDP (Chart 1.1).

Due to the turbulence in global financial markets, the Russian private sector's foreign liabilities (according to balance of payments data) contracted in the fourth quarter, while their growth in 2008 totalled \$99.6 billion (\$215.6 billion in 2007). The biggest slowdown in growth of foreign liabilities was registered in the banking sector (to \$9.0 billion), while growth in the liabilities of other sectors decelerated to \$90.6 billion (compared to \$144.7 billion in 2007). The value of foreign direct investment in the structure of capital inflow into the non-banking sector in 2008 slightly increased, while the value of loans and credits declined by about 50%, and the value of liabilities in the form of portfolio and other investments decreased. Private capital outflow from Russia rose considerably, growing 160% to \$66.4 billion in the banking sector and by almost 60% to \$147.6 billion in other sectors of the Russian economy. Higher purchases of foreign currency in the fourth quarter of 2008 (over \$30 billion) considerably influenced growth in the value of other sectors' assets. Foreign currency accruals outside banks increased by \$24.8 billion in 2008 (having contracted by \$15.7 billion in 2007). Net outflow of private sector capital in 2008 totalled \$129.9 billion, standing at \$165.8 billion in August-December (net inflow of private sector capital equalled \$83.1 billion in 2007).

Chart 1.3

Foreign debt (as % of GDP)



* As of October 1, 2008

As of January 1, 2009, Russia's international reserves had contracted 10.8% from a year before to \$427.1 billion. However, their total value would be sufficient to finance the imports of goods and services for almost 14 months, more than the 3-month minimum sufficiency level (Chart 1.2).

The Bank of Russia implemented its exchange rate policy proceeding from the need to curb inflation and prevent unjustifiably sharp swings in the ruble exchange rate. The managed floating exchange rate regime allowed the regulator to ease the negative external economic effects on the Russian financial system amid persisting instability in world financial markets.

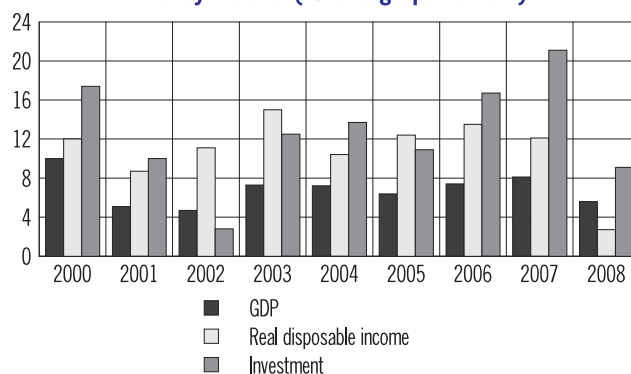
In the second half of the year, as investors intensively withdrew money from Russian assets, pushing up demand for foreign currency, the Bank of Russia took measures to prevent excessive weakening of the ruble. From mid-2008, the Bank of Russia began consistently widening the band of the ruble's permissible fluctuations against the bi-currency basket to create conditions for a more flexible exchange rate policy.

The ruble's nominal effective exchange rate fell 3.8% in December 2008, as compared with the same period a year earlier, falling 12.7% against the dollar and 5.6% against the euro. In real terms, the ruble depreciated 1.1% against the dollar and appreciated 5.0% against the euro during the same period, while the ruble's real effective exchange rate rose 4.3%.

The Russian Government's foreign debt was repaid and serviced on time, contracting in the first nine months of 2008. However, the private sector's foreign liabilities continued to grow. As of early October 2008, they had increased 19.0% from the beginning of 2008 to \$497.8 billion (banks' foreign liabilities grew to \$198.2 billion, and the foreign debt of other sectors rose to \$299.6 billion). The ratio of Russia's aggregate foreign debt to GDP fell from 35.8% as of January 1, 2008 to 32.3% as of October 1, 2008, with the private sector's liabilities decreasing from 32.2% to 29.8% of GDP,

Chart 1.4

GDP, fixed capital investment and real household disposable money income (% change per annum)



and the liabilities of general government and monetary authorities declining from 3.6% to 2.6% of GDP. As in previous years, long-term liabilities accounted for a larger part of the private sector's foreign debt (Chart 1.3).

The build-up of Russia's private sector foreign debt in the past few years has illustrated the increased dependence of domestic banks and companies on international financial markets and the world economic situation, and has negatively affected the financial standing of some Russian banks and enterprises amid deepening global financial crisis, which has sharply restricted access to world capital markets.

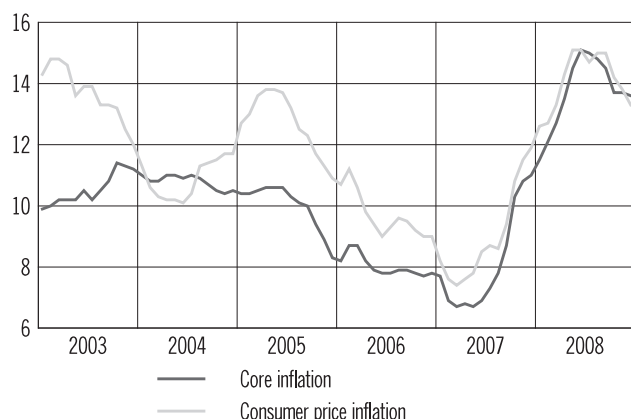
The worsening situation in global financial markets in the second half of 2008, reduced economic activity, declining oil prices and increased private sector's capital outflow from Russia negatively affected the country's economic results in 2008. Growth in output, fixed capital investment, and real household disposable money incomes slowed considerably in 2008 as compared with 2007. Russia's GDP grew 5.6% in 2008 as compared with 8.1% in 2007 (Chart 1.4).

Consumer prices continued to grow rapidly in the first half of 2008, and inflation exceeded the level of the same period of 2007. In the second half of 2008, inflation slowed largely due to a good grain harvest, a slower increase in food prices, lower world energy prices, and decelerated growth in domestic and external demand.

Nevertheless, food and non-food prices, and the prices of paid services provided to the public, grew faster in 2008 than in 2007. As a result, inflation measured 13.3% in 2008, exceeding the previous year's figure by 1.4 percentage points. Core inflation stood at 13.6% in 2008 as compared with 11.0% in 2007 (Chart 1.5).

The financial standing of Russia's non-financial companies remained stable in January-September 2008. In the first nine months of 2008, large and medium-sized companies (excluding small businesses,

Chart 1.5
Consumer and core inflation (% , year on year)



banks, insurance companies and budget-dependent organisations) posted a net financial result of 4,440.8 billion rubles, or 25.7% more than in the same period of 2007.

The rate of return on the sale of goods, products, works and services³ increased from 12.2% in January-September 2007 to 13.6% in January-September 2008. As in previous years, the highest rate of return in 2008 was registered in export-oriented sectors, and also in communications.

In the third quarter, profits declined. Losses across the economy increased by 210%. Losses grew fastest among financial companies. The volume of their losses for the first nine months of 2008 grew by a factor of 93.3 to 323.7 billion rubles as compared with the same period of 2007 (losses had been rapidly increasing since the start of the year), rendering this type of activity unprofitable. Economic activities such as logging, and the production, transmission and distribution of thermal power, also became unprofitable in January-September 2008. Losses also mounted considerably in air transport (by 4.7 times), wholesale and retail trade (by 4 times), petroleum product transportation via pipelines (by 3.8 times), and also in most manufacturing industries.

Although in most classes of economic activity the trend towards a decline in the share of loss-making organisations continued, the proportion of such organisations in the economy as a whole increased by 0.3 percentage points in January-September 2008, year on year, to 27%.

The value of outstanding bank loans and credits increased 33.0% in January-September 2008 (53.0% in the same period of 2007). The largest volume of loans went to manufacturing industries (32.7%); wholesale and retail trade, repairs of motor vehicles, motorcycles, household appliances and personal articles (22.6%); and transport and communications (11.9%). Outstanding bank loans and credits accounted for 50.2% of the

³ Profits (losses) from sales as % of revenues from the sale of goods, products, works, and services.

liabilities of large and medium-sized organisations as of the end of September 2008 (from 49.7% as of the same date a year ago). The largest share of outstanding bank loans and credits in the total volume of liabilities was registered in oil pipeline transportation (85.7%), the coke industry (74.5%) and the production of metallic ores (78.3%). The smallest volume of bank loans and credits was used in gas pipeline transportation (3.2%).

The share of non-payments in the debts of large and medium-sized Russian organisations on bank loans and credits decreased from 0.7% as of the end of September 2007 to 0.5% as of the end of September 2008.

The turmoil in financial markets and lower export revenues in the second half of 2008 weighed on investment activity. The value of fixed capital investment increased 9.1% in 2008 (compared to 21.1% in 2007). The largest funds were invested in the development of transport and fuel and energy production.

Fixed capital investment in January-September 2008 was largely financed with borrowed funds (57.2%), of which budget funds accounted for 16.8%. The share of bank loans in investment financing sources increased from 10.2% in January-September 2007 to 11.0% in the same period of 2008.

As economic activity declined, growth in real household disposable money income slowed. In 2008, this figure grew by 2.7%, compared to 12.1% in 2007.

The stratification in the income levels of the population remained considerable, a factor that could intensify social problems. In 2008, as in the previous year, the wealthiest 20% accounted for 47.9% of total incomes, while the least wealthy 20% accounted for 5.1%. The large divergence in incomes is also evidenced by the increase of the funds ratio⁴ (from 16.8 times to 16.9 times), and in the Gini coefficient⁵ (from 0.423 to 0.424).

Household spending on the purchase of goods and services increased considerably in 2008 as compared with 2007, from 69.6% to 73.1%. In real terms, consumer spending increased 10.3%.

As ruble devaluation expectations intensified, household spending on the purchase of foreign currency increased considerably, and in the fourth quarter of 2008 an outflow of funds from household deposits was registered. As a result, the share of money spent on the purchase of foreign currency increased in 2008 as compared with 2007, rising from 5.2% to 7.9%, while

⁴ The funds ratio is the ratio between average money income levels of the highest-income 10% of citizens, and the lowest-income 10%.

⁵ The Gini coefficient (the income concentration index) measures the deviation of the actual income distribution from an equal distribution. A Gini coefficient close to 0 indicates an equal income distribution, while a Gini coefficient of above 0 and closer to 1 indicates increasing income stratification.

the share of incomes deposited in savings accounts fell from 9.6% to 6%.

The results for 2008 were largely determined by positive trends in the first half of the year. Russia's main macroeconomic data had worsened by the end of the

year. The government's measures to support the financial sector and real production mitigated the adverse effect of the global financial crisis on the Russian economy. Nevertheless, the starting conditions for the national economy's development in 2009 deteriorated.

Chapter 2. Financial market and its instability

Over the past few years, the deepening integration of the Russian financial sector into the global financial system has increased its vulnerability to external shocks. As a result, the deterioration of the situation in leading foreign economies and the escalation of the global financial crisis in 2008 had a destabilising effect on the Russian financial market, and complicated the financial situation of its participants.

The global liquidity crunch resulted in an outflow of private capital from emerging economies, including Russia, due to growing demand for liquidity in advanced economies and investors' higher risk aversion. Capital outflow from Russia took the form of fund withdrawals by foreign portfolio investors from Russian assets, including the domestic stock market.

The malfunctioning of the global capital market severely affected the ability of Russian corporate borrowers (banks and non-financial companies) to raise capital in foreign markets to finance projects in Russia, and to repay foreign loans received earlier. Under these conditions, the volume of outstanding foreign loans subject to repayment by Russian borrowers started to exceed the volume of new loans received from non-residents, showing another side to capital outflow. At the same time, the possibilities of raising capital in the domestic market were not sufficient for Russian corporate borrowers to substitute foreign sources of financing. As a result, the domestic capital market registered imbalances between supply and demand, considerably pushing up the cost of borrowing and significant distinction of loan rates for borrowers with different credit ratings. This situation greatly restricted subprime borrowers' access to financial resources.

The dramatic decline in prices in world commodity markets significantly reduced export revenues, and worsened the financial standing of large Russian raw materials companies. The latter factor, combined with instability in the world's major stock markets, also adversely affected the Russian stock market, where instruments issued by Russian oil and gas companies accounted for a major part of its market capitalisation.

As the fundamental conditions for the functioning of the Russian economy worsened (capital outflow, falling prices of Russian export commodities), the prerequisites emerged for the depreciation of the national currency. As a result, ruble-denominated financial instruments became less attractive, adversely affecting the corresponding segments of the domestic financial market.

Bad news from foreign economies also played a negative role. Reports of bankruptcies, or of the

dramatically deteriorating financial condition of major transnational banks and corporations, gave an additional impulse to negative trends in the Russian financial market.

The negative impact of external shocks on the Russian financial market in 2008 increased due to the existence of certain structural factors that were not directly related to the global financial crisis. These factors included the limited presence of conservative and long-term investors in the Russian stock market, the underdeveloped nature of mutual investment funds, the prevalence of speculators over strategic investors, the dependence of Russian banks and non-financial companies on foreign borrowing with a large amount of accrued liabilities to foreign creditors, and the exposure of the Russian stock market to developments in global financial and commodity markets.

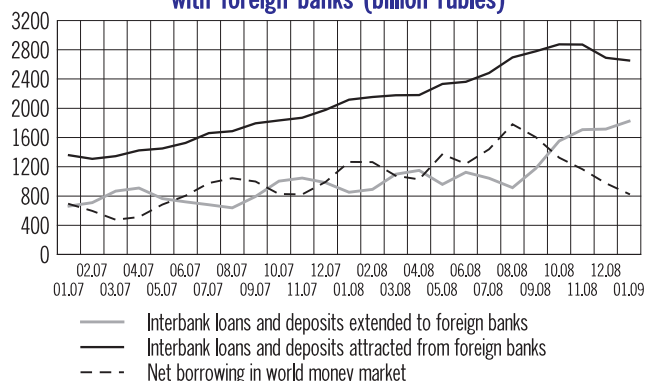
As a whole, the situation in the Russian financial market considerably deteriorated in 2008 as compared with the previous year. However, the development of the domestic financial market continued throughout the year.

In January-July 2008, the market situation was relatively stable, after the first stage of the liquidity crunch in the global financial market ended in the second half of 2007. In August-December 2008, the Russian financial market experienced the greatest shock in the past 10 years. Financial turmoil affected all market segments. The segments of the Russian financial market that were most highly integrated into the global financial system proved to be especially vulnerable. Despite the increased number of stock trading suspensions during the extreme period of market turbulence, defaults on obligations by market participants, and the forced closing of outstanding trading positions in some of its segments, the Russian financial market as a whole maintained its viability, and its key segments continued to function.

Prompt and large-scale anti-crisis measures taken by the Russian Government and the Bank of Russia (Appendix 1) had a stabilising effect on the Russian financial market amid the global financial crisis. During the most acute stage of market destabilisation (October-November 2008), massive short-term liquidity injections into the money market through Bank of Russia expanding the refinancing of banks, and the placement of freely available budget funds and financial resources of government development institutions (state corporations) into deposit accounts with commercial banks, helped ease tensions in the money market. The conclusion of agreements between the Bank of Russia and banks on compensating for a share of losses from

Chart 2.1

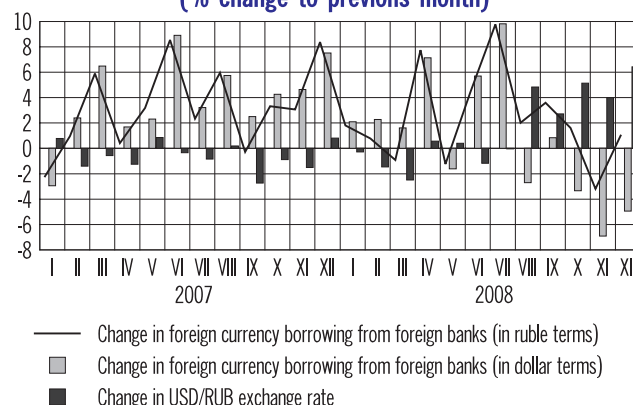
Russian banks' loan and deposit transactions with foreign banks (billion rubles)*



* As of the start of the month.

Chart 2.2

Foreign currency borrowing from foreign banks (% change to previous month)



transactions in the interbank money market also played a positive role. Investment from the National Welfare Fund into Russian shares and corporate bonds also helped the domestic stock market.

2.1. Interbank money market

The interbank money market in 2008 was influenced largely by external factors. The growing volatility of cross-border flows of private capital, limited access to external borrowing, and generally declined confidence in financial institutions, caused an increase in liquidity risk, as well as foreign exchange risk and interest rate risk in interbank credit operations carried out by Russian banks. As a result, the financial condition of Russian banks deteriorated, while credit risks in the interbank money market rose.

The sound financial condition of Russian credit institutions in the first half of the year, combined with active measures from monetary authorities, limited the damage sustained by Russian banks from the materialisation of the above-mentioned risks in 2008. However, interbank credit risks may increase considerably if instability in external markets persists in the medium-term.

In 2008, Russian banks continued to act as net borrowers in the global financial market. Despite the deterioration of the conditions in the world financial market, some of them continued to build up foreign borrowings. As a result, during most of 2008, there were periods of growth and decline in net borrowings from non-resident banks, without any prevailing trend. Borrowings from foreign banks contracted only in the fourth quarter of 2008, due to the ruble's sharp depreciation against foreign currencies. As of the end of 2008, Russian banks' net borrowings from foreign banks totalled 0.83 trillion rubles, which was 35% less than at the beginning of the year (net borrowings grew 83% in 2007) (Chart 2.1). The large volume of accrued liabilities on loans raised from foreign banks was a major factor behind the encroachment of the crisis into Russia,

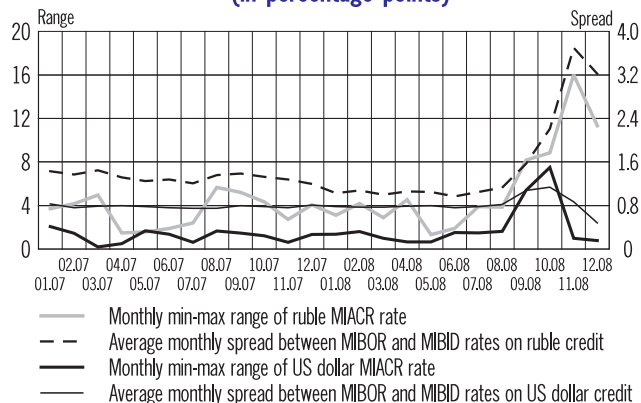
and was a source of liquidity risk, and also interest rate risk and foreign exchange risk.

The disturbances in external markets diminished opportunities to raise new funds from foreign banks. At the same time, Russian banks' more cautious financial policies reduced the efficiency of the distribution of funds within the banking sector through the Russian interbank money market. Borrowings by second- and third-tier banks in the interbank money market fell sharply.

A bank's inability to cover liquidity gaps using interbank credit can undermine its obligations, and cause serious harm to its business. This is why Russian banks were forced to immobilize a portion of their liquid assets, in order to insulate themselves against liquidity gaps. This practice further reduced loan supply in the interbank money market, and increased liquidity risk. Under these conditions, the efficiency of the interbank money market continued to decline. In particular, interbank credit rates increased sharply in the second half of 2008, despite a considerable volume of liquid ruble funds remaining in the Russian banking sector as a whole.

The turbulence in the interbank money market was to a large extent caused by increased volatility of interbank credit rates. Growing liquidity risk in the interbank money market, weakened mutual confidence of its participants, considerable fluctuations of foreign exchange rates, and correspondingly of speculative demand for foreign currency, and price volatility in the stock market, prompted sharp swings (including considerable intraday fluctuations) in demand and supply in the Russian interbank money market, and as a result, strong volatility of interbank credit rates on ruble loans. The interbank money market's reduced efficiency limited the Bank of Russia's ability to restrain fluctuations of interbank credit rates. As a result, the interest rate on overnight ruble interbank credit fluctuated within an average monthly range of 5.8 percentage points in 2008, as compared with 3.5 percentage points in 2007. Higher volatility of interbank credit rates increased the

Chart 2.3
Volatility of ruble interbank overnight credit rates
(in percentage points)



uncertainty of market participants' price expectations, widening the spread between interbank bid and offered interest (Charts 2.3, 2.4).

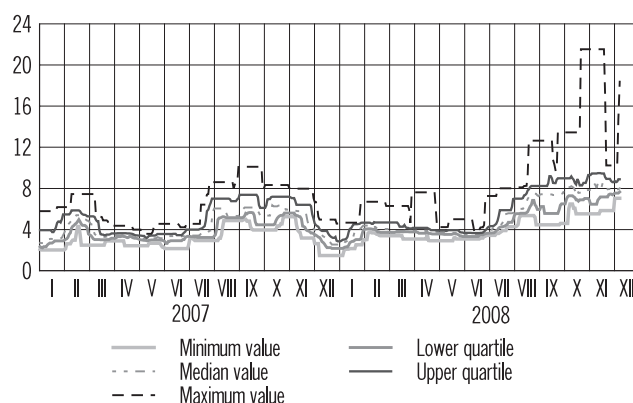
Small and medium-sized banks were the most exposed to interest rate risk. The borrowing cost for these banks saw the largest volatility, and grew the fastest in periods of ruble liquidity shortages (Chart 2.5).

The volatility of interest rates on interbank credit in US dollars also increased in 2008. Due to the world money market turbulence, deviations between market interest rates and discount rates widened, while the monetary authorities of foreign countries stepped up their activities, changing their discount rates on numerous occasions. This situation affected the Russian interbank foreign currency money market. The average monthly range of the fluctuations of the interest rate on interbank overnight credit in US dollars widened from 1.2 percentage points in 2007 to 2.1 percentage points in 2008. The bid-offer spread on interbank credit in US dollars also increased.

Divergences between the term structure of foreign assets and interbank credit liabilities were an additional source of interest rate risk for Russian banks. The shortest-term credits (with maturities of up to 30 days) accounted for 50% of loans and deposits extended by Russian banks to non-resident banks during the entire period, while the structure of funds raised from foreign banks was dominated by long-term loans. For this reason, as interest rates in the world money market declined, Russian banks' revenues from funds extended to foreign banks decreased faster than the cost of servicing their foreign liabilities. However, as Russian banks remained net borrowers in foreign markets, interest rate risk linked to lower rates in the world market was limited.

Foreign exchange risk in the interbank money market increased in the second half of 2008 as foreign exchange rate volatility intensified, while Russian banks continued to carry out large volumes of operations with foreign banks. As Russian banks act as net borrowers in the world money market, raising funds largely in foreign

Chart 2.4
Dispersion of ruble overnight MIACR rate (% p.a.)*



* For 20 business days moving window.

currency, foreign exchange risk for the Russian banking system is therefore largely due to the depreciation of the ruble's nominal exchange rate against foreign currencies, primarily the US dollar, as over 80% of Russian banks' external foreign currency liabilities are denominated in that currency.

The ruble's nominal exchange rate against the US dollar grew for most of the first half of 2008, creating favourable conditions for external borrowing by Russian banks. In August-December, the dollar appreciated sharply against the ruble, as a result, despite foreign debt repayments by Russian banks (the reduction of foreign currency-denominated liabilities to non-resident banks in dollar terms), the debt burden on Russian banks (i.e. the ruble value of these liabilities) continued to grow (Chart 2.2). However, potential losses from changes in the ruble cost of foreign currency-denominated interbank credit were distributed unevenly among market participants. Compared to small and medium-sized banks, large Russian banks had greater possibilities to coordinate their interests with the interests of foreign counterparty banks, by partially transferring foreign currency risk to them. Consequently, ruble-denominated interbank credit accounted for 23% of all credits obtained by the largest 30 Russian banks from non-resident banks in 2008, as compared with 18% for other Russian banks.

In the second half of 2008, international rating agencies assigned negative outlooks to the ratings of many Russian banks, and also downgraded the credit ratings of certain Russian banks. However, the ratings of the majority of active participants in the Russian interbank credit market remained unchanged, suggesting that the credit risk of Russian banks' liabilities (including interbank credit) continued to be assessed as low.

Although formal signs continued to indicate moderate credit risk, interbank money market participants gradually increased credit risk assessments throughout 2008. The deterioration of the financial position of some Russian banks (KIT Finance Investment Bank, Svyaz-Bank, Sobinbank, Globex Bank), which

Chart 2.5

Average interest rates on ruble overnight interbank credit attracted by banks with different credit ratings (% p.a.)

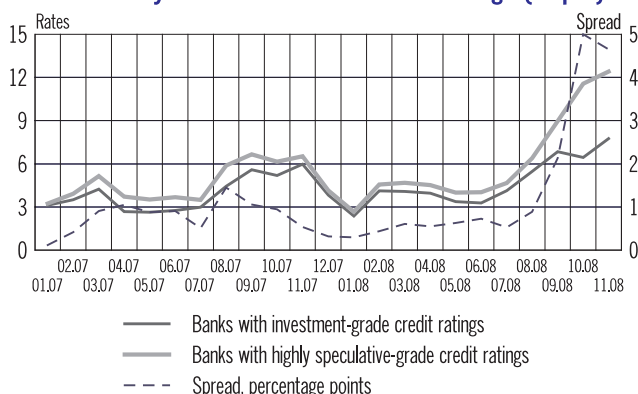
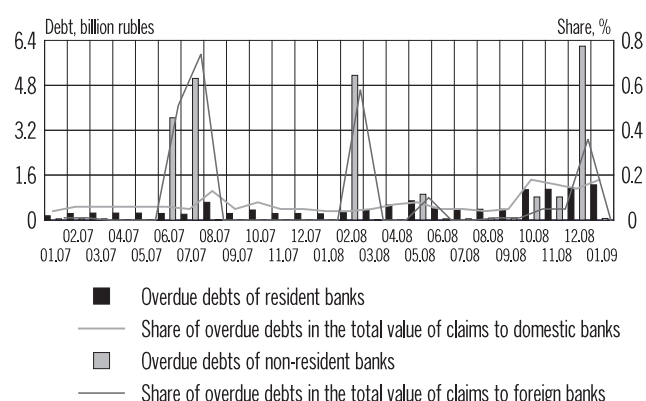


Chart 2.6

Overdue debt in interbank money market transactions*



* As of the beginning of the month.

were forced to agree to takeovers by other banks or non-financial companies, along with news about the world financial turmoil, weakened mutual confidence between Russian interbank money market participants.

This process particularly affected second- and third-tier banks. Interest rates on credit raised by these banks grew at an accelerated rate. Banks cut the volume of lending to small and medium-sized banks. As a result, the average share of the top 30 banks in the total value of loans obtained by Russian banks in the domestic market grew from 36% in 2007 to 59% in 2008.

The growing share of credit to first-tier banks in the total volume of interbank credit is one of the factors maintaining the relatively low credit risk of granted interbank loans. In particular, the average share of overdue debt in the total volume of interbank credit extended to resident banks was 0.09% in 2008, as compared with 0.06% a year earlier. The share of overdue debt in the structure of non-resident banks' liabilities to Russian banks fell from 0.11% in 2007 to 0.10% in 2008 (Chart 2.6). As before, the credit quality of the portfolio of interbank credit extended by Russian banks remained high in terms of credit risk groups⁶ in 2008. Standard credit accounted for an average of 96.3% in January–November 2008, as compared with 94.9% in 2007 (Chart 2.7).

On the whole, the interbank money market stability deteriorated considerably in 2008. Liquidity risk increased the most, and interest rate risk and foreign exchange risk also grew considerably. Credit risk in the Russian interbank market remained moderate as market participants switched to more conservative financial policies. Risks in the Russian banking system were spread unevenly. The growth of risks particularly affected small and medium-sized banks, while risks in money market transactions of large banks remained moderate.

⁶ The classification of credit by risk groups was established by Bank of Russia Regulation No. 254-P, dated March 26, 2004, «On the Procedure for Making by Credit Institutions Provisions for Possible Losses on Loans, Loan and Similar Debts».

2.2. Foreign exchange market

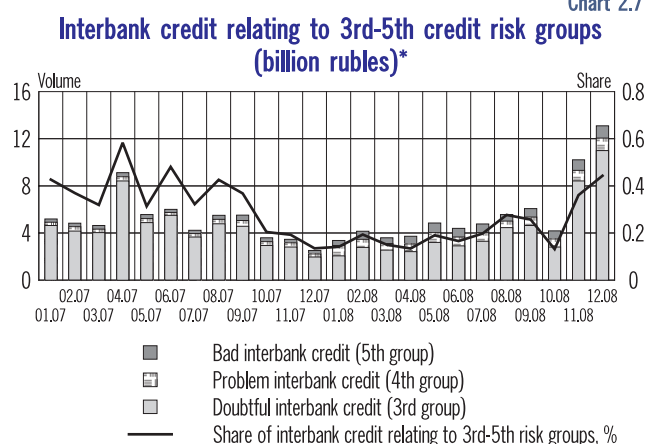
As uncertainty over further trends in the exchange rates of major world currencies increased in 2008, the exchange rate risk resulting from the volatility of foreign currency exchange rates to the ruble was considered to be the highest among risks accompanying foreign exchange transactions. The least significant form of foreign exchange risk was liquidity risk related to difficulties in finding a counterparty to effectively perform a foreign exchange transaction on acceptable terms. Liquidity risk increases considerably in foreign exchange transactions involving foreign currencies other than major world currencies, and the currencies of countries that are Russia's main trade partners.

As previously, the US dollar was the major foreign currency in the Russian financial market in 2008. Although the Bank of Russia used the bi-currency basket as the operational target for its exchange rate policy and stepped up interventions in the euro/ruble segment, the relative volume of deals involving the euro in the domestic foreign exchange market slightly decreased (the share of operations with euros «against all currencies» in the volume of trading in the foreign exchange interbank market declined from 16.1% in 2007 to 15.7% in 2008)⁷. This trend disrupted the positive dynamics of the past few years, when operations involving euros were characterised by growing liquidity.

As the domestic foreign exchange market became subject to turmoil, the short-term volatility of the ruble value of the bi-currency basket increased considerably (from 0.05% in 2007 to 0.15% in 2008), even though its structure was unchanged (from February 8, 2007, the bi-currency basket has been composed of 0.55 US dollars and 0.45 euros) (Chart 2.8). The ruble's weakening in nominal terms (the increase in the ruble value of the bi-currency basket), which began in August 2008,

⁷ The proportions were calculated excluding double count, i. e. the sum of proportions of transactions with all the pairs of foreign currencies equals 100%.

Chart 2.7



* As of the beginning of the month.

raised foreign exchange market uncertainty. At the same time, the ruble value of the bi-currency basket continued to be considerably less volatile than the exchange rates of each of the basket's foreign currencies against the ruble.

Tension in the domestic foreign exchange market was also visible in the volatility of the exchange rates of major world currencies against the ruble (both short-term and medium-term indicators). This volatility reached its peak in August-December, whereas in the first half of the year it had grown insignificantly.

In particular, the average daily change⁸ in the USD/RUB exchange rate at the Single Trading Session (STS) in «tomorrow» trades jumped by more than twice in 2008 as compared with 2007 (0.37% as against 0.16%), with the maximum daily change reaching 2.12% (0.65% in 2007) (Chart 2.9). As a result, the monthly averages of daily changes in the USD/RUB exchange rate increased considerably, widening from 0.11-0.24% in 2007 to 0.17-0.67% in 2008.

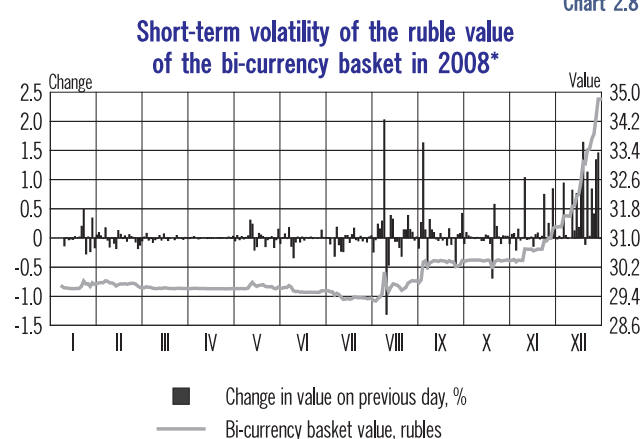
As for the medium-term USD/RUB exchange rate volatility indicators in STS «tomorrow» transactions, the intra-month range⁹ of the USD/RUB exchange rate's fluctuations jumped from an average annual figure of 0.36 rubles in 2007 to 0.85 rubles in 2008. Range's monthly figures varied from 0.34 to 1.77 rubles in 2008 (0.13-0.76 rubles in 2007). The coefficient of variation of USD/RUB exchange rate grew from 2.48% in 2007 to 6.37% in 2008.

The multiple increases in the volatility of the USD/RUB exchange rate illustrate the sharply increased exchange rate risk for USD/RUB transactions. Further expansion of the volume of USD/RUB deals (the reduction of liquidity risk) limited foreign exchange risk only partially, and failed to neutralise the adverse effects

⁸ The average daily exchange rate change is used as short-term volatility indicator.

⁹ The range of exchange rate fluctuations is calculated as the difference between the highest and lowest exchange rates for the period under review.

Chart 2.8



* Calculations are based on USD/RUB and EUR/RUB official exchange rates set by the Bank of Russia.

of the deteriorating conditions in the global financial market. Large-scale purchases of US dollars in the domestic foreign exchange market, linked both to the withdrawal of capital from the Russian market and to expectations of the US currency's further appreciation, also aggravated tension in the domestic forex market.

The average daily change in the EUR/RUB exchange rate in STS «tomorrow» transactions equalled 0.34% in 2008 as compared with 0.14% in 2007, or slightly less than the average daily change in the USD/RUB exchange rate. The daily changes in the EUR/RUB exchange rate varied from 0.17 to 0.97% in 2008 (0.10-0.20% in 2007).

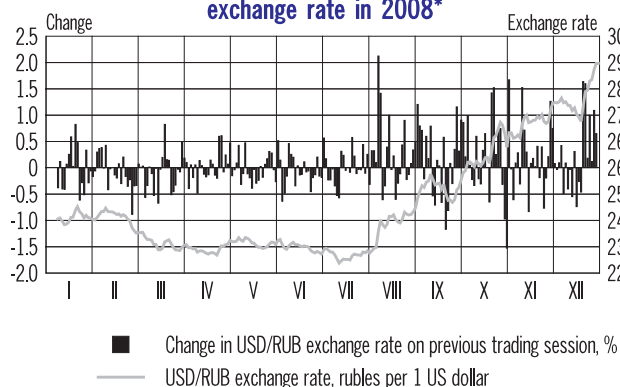
The intra-month range of the EUR/RUB exchange rate fluctuations jumped from an average annual figure of 0.36 rubles in 2007 to 1.24 rubles in 2008, and its monthly figures varied widely (from 0.40 to 6.33 rubles). The coefficient of variation of EUR/RUB exchange rate grew from 1.36% in 2007 to 2.94% in 2008.

Exchange rate risk increased considerably for deals with euros in the Russian foreign exchange market in 2008. This trend, along with uncertainty over the EUR/RUB exchange rate evolution and the euro's weakening against the dollar, did not contribute to any considerable expansion of trading volumes in ruble/euro deals, which significantly limited the possibility of reducing liquidity risk.

Two foreign currencies, the British pound and the Japanese yen, which saw considerable reductions in their liquidity risk in 2007 through the expansion of trading volumes, provoked little interest among market participants in 2008. The average daily volume of interbank trade in these currencies saw a steady decrease. As a result, the share of operations with the British pound «against all currencies» and the share of operations with the Japanese yen «against all currencies» declined considerably in the total trading volume in the domestic interbank foreign exchange market. Thus liquidity risk for transactions with these currencies increased. This trend was a result of foreign exchange

Chart 2.9

Short-term volatility of the US dollar/ruble exchange rate in 2008*



* At the US dollar/ruble exchange rate for "tomorrow" transactions.

market participants' enhanced interest in US dollars, especially in the second half of the year, when the US currency showed steady growth.

In 2008, as in previous years, long and short foreign exchange positions opened by credit institutions were not matched. The average net foreign exchange exposure of the banking sector as a whole has accounted for less than 1% of bank capital over the past few years (0.57% in 2008 and 0.66% in 2007). The total value of all net outstanding foreign exchange positions in currencies must not exceed 20% of bank's equity capital (the limit set by the Bank of Russia to reduce foreign exchange risk¹⁰). For this reason, slightly mismatched long and short outstanding foreign exchange positions of domestic banks did not affect aggregated exchange rate risk exposure of the Russian banking sector significantly in 2008.

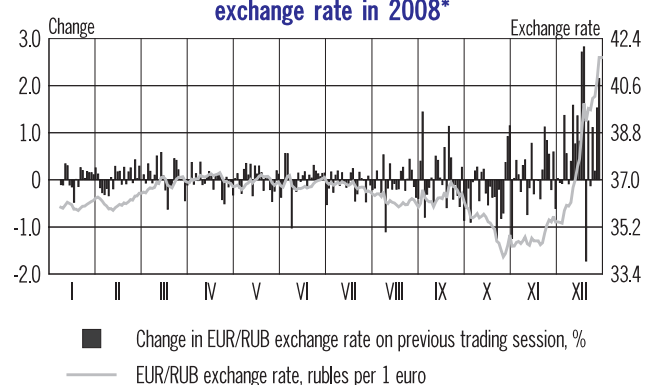
The development of the forward segment of the domestic foreign exchange market is a major factor that could influence foreign exchange risk. Forward transactions in advanced economies are used for risk hedging or arbitrage. Most forward transactions in the Russian forex market, however, are speculative. The underdeveloped nature of the Russian forward market greatly restricts market participants' ability to hedge risks.

The risk levels of transactions in the domestic foreign exchange market increased considerably in 2008, due to higher exchange rate risk. The Bank of Russia's measures to stabilise domestic foreign exchange market (including planned purchases of foreign currency in the first six months of the year, and its large sales from August onwards) made it possible, to some extent, to smooth sharp fluctuations of the exchange rates of

¹⁰ Open foreign exchange position limits are defined in accordance with Bank of Russia Instruction No. 124-I, dated July 15, 2005, «On Setting Open Foreign Exchange Position Size (Limits), the Method of their Calculation, and the Specifics of Supervision Over their Compliance by Credit Institutions».

Рисунок 2.10

Short-term volatility of the euro/ruble exchange rate in 2008*



* At the euro/ruble exchange rate for "tomorrow" transactions.

major foreign currencies against the ruble, but failed to prevent the ruble's devaluation.

Despite the fast growth of exchange rate risk in USD/RUB trades, which was not neutralised by reduced liquidity risk, USD/RUB transactions continued to be the least risky in the domestic foreign exchange market in 2008. Exchange rate risk and liquidity risk in deals with other currency pairs remained higher, and risks for most currency pairs (except for the euro/dollar) increased.

2.3. The securities market

2.3.1. Domestic bond market

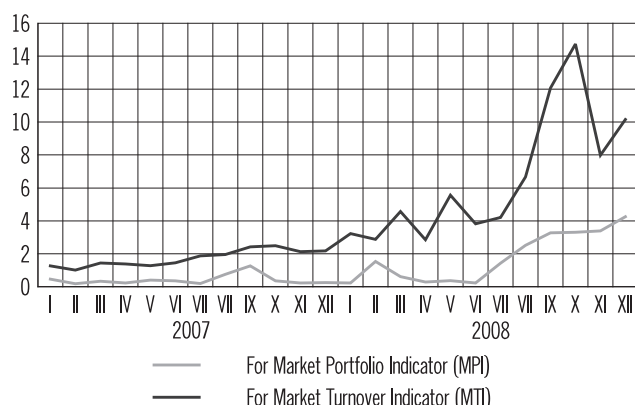
Government bond market. In 2008, the market of government securities continued to be less vulnerable to external shocks than other segments of the Russian capital market. The Russian Government maintained domestic public debt at an economically safe level, optimizing its structure and maturity. In addition, the Bank of Russia carried out operations with ruble-denominated government bonds (OFZ) in the open market, enabling it to prevent a slump in the OFZ bond market in 2008, despite increased risk of transactions with government bonds.

Interest rate and liquidity risks continued to be the main risks in the domestic government debt market in 2008. Trades in OFZ bonds are conducted only on the MICEX, the principal trading floor of the organised securities market, so operational risk for transactions with government bonds is minimal.¹¹ There is virtually no issuer default risk (credit risk) in this segment of the Russian financial market, as the borrower is represented by the Government, which maintains a strong solvency position.

¹¹ Operational risk arises from the unauthorised use of a bank's funds in the trading system to credit clients; from other actions by a bank's brokers to the detriment of the bank that carries out both its own operations with government bonds and provides broking services to its clients; and also from the conclusion of deals with incorrect parameters due to their erroneous entry into the trading system.

Chart 2.11

Coefficients of variation of OFZ yields (%)



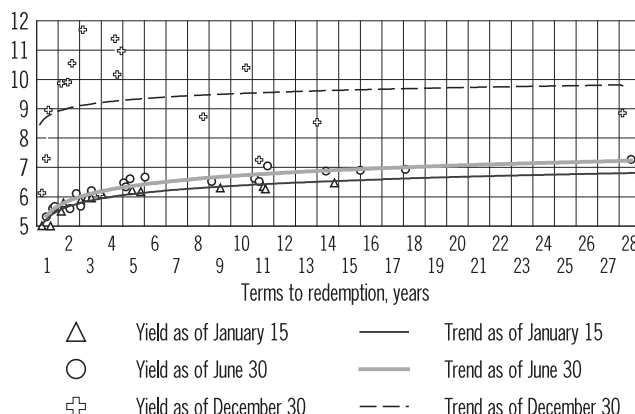
In previous years, the conservative policies of major market participants restricted liquidity in the OFZ bond market, creating liquidity risk of some bond issues in cases where such market participants changed their individual strategies. The presence of conservative investors and the extremely small share of non-residents prevented a large-scale capital outflow from the Russian government debt market in 2008.

Considerable fluctuations in the volume of available ruble funds among capital market participants, which affected demand for assets, combined with uncertainty over price developments in the Russian securities market, significantly increased the volatility of yields on debt instruments, including government bonds in 2008. In February 2008, the volatility of yields on the OFZ bond market surged to the September 2007 levels, when the Russian capital market was hit by the first wave of the global financial crisis. Starting from July 2008, as tensions in the Russian capital market increased, the volatility of OFZ yields grew rapidly, surpassing the February 2008 level by more than twice in September-December 2008 (Chart 2.11). Daily yield indicators registered an annual coefficient of variation of 11.24% for the Market Portfolio Indicator (MPI), and 18.80% for Market Turnover Indicator (MTI) in 2008 as compared with 0.95% and 2.05% respectively in 2007. OFZ yields (MPI) fluctuated within a range of 307 basis points in 2008, as compared with 40 basis points in 2007. The range of fluctuations of OFZ yields (MTI) broadened from 73 basis points in 2007 to 827 basis points in 2008. The average daily absolute change in yields of government bonds (MTI) increased by 43.1 basis points in 2008 as compared with 2007, to reach 55.2 basis points. The rapid growth in volatility of OFZ yields considerably raised interest rate risk in transactions with OFZ bonds.

The OFZ yield curve retained its rising slope in January-August, reflecting relative price stability in the domestic government debt market amid negligible yield fluctuations. During this period, the spread between

Chart 2.12

OFZ yield curve in 2008 (% p.a.)



the yields of medium-term and long-term bond issues slightly increased, while the premium for the risk of investment in these assets barely grew, staying at the minimum level. From September onwards, OFZ yields no longer depended on the maturity of debt instruments (Chart 2.12).

The OFZ bond market is viewed as liquid when it shows resistance to the impact of certain transaction prices on the average market price of debt instruments. The daily spread (weighted by secondary trading volumes) between the maximum and minimum prices of transactions with government bonds on the MICEX (in the main trading mode) showed some growth in OFZ liquidity in January-July. However, OFZ liquidity considerably declined in August-December, when the spread widened significantly and its volatility reached a highpoint. The average spread increased by 6 basis points in 2008 as compared with the previous year, to 11 basis points (Chart 2.13).

OFZ market liquidity also reflects trading volumes and turnover velocity. In 2008, aggregate OFZ secondary market turnover value (transactions in the main trading mode¹² and negotiated deals) contracted 32.4% to 3.7 billion rubles per day. As in the previous year, quasi-market (negotiated) deals prevailed in the OFZ secondary market in 2008. Transactions in the main trading mode decreased 18.9% to 1.15 billion rubles, while value of trading in negotiated deals fell 37.1% to 2.55 billion rubles per day. The OFZ average market portfolio at market prices increased 10% in 2008.

Turnover velocity of OFZ bonds declined in the period under review, while the volatility of OFZ turnover velocity increased considerably as compared with 2007. The OFZ bond market registered its smallest turnover velocity in January-August, when the OFZ market portfolio grew faster than turnover. In September-November, OFZ bond turnover velocity increased due to the Bank of Russia's operations to purchase OFZ

¹² All data here and below apply to OFZ trading on the MICEX without technical transactions.

Chart 2.13

Weighted average spread between OFZ bond maximum and minimum prices in 2008 (basis points)

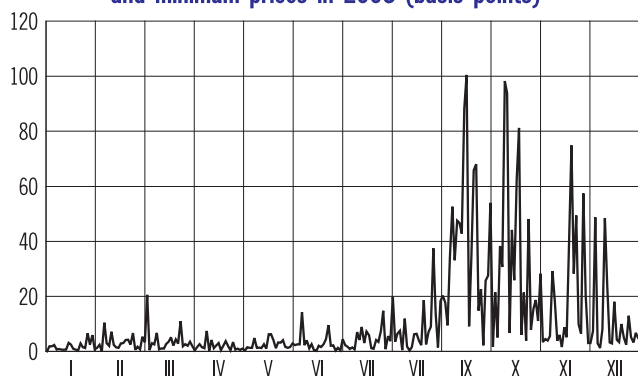
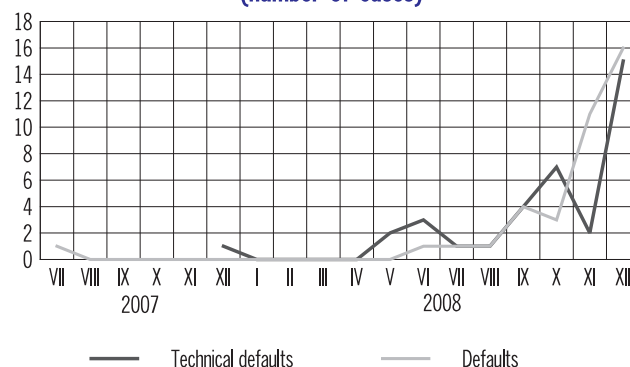


Chart 2.14

Defaults on corporate bonds in 2007-2008 (number of cases)*



*No defaults on corporate bonds were registered in the first half of 2007.

bonds in the open market to replenish liquidity among market participants. The average government bond turnover velocity (in the main trading mode) decreased by 0.03 percentage points at par from the 2007 level, to reach 0.11% in 2008. The dynamics of OFZ bond trading volumes and turnover velocity suggest higher liquidity risk in the domestic government bonds market in 2008.

OFZ bonds became somewhat more attractive instrument, as financial market participants showed interest in them as a collateral in repo transactions¹³. The volume of such deals with the Bank of Russia increased 160%, while inter-dealer repo transactions with OFZ bonds grew by more than 20 times in 2008 as compared with the previous year.

Liquidity and interest rate risks therefore increased considerably in the Russian government bond market in 2008, whereas in 2007 they had declined.

Corporate bond market. The corporate bond market conditions changed considerably throughout the year.

In January-March, the situation in the corporate bond market deteriorated amid capital outflow from Russia. In the second quarter of the year, as capital flowed into Russia, the corporate bond market partially restored its positions. During this period, the aggregate volume of new bond placements in the primary market grew, and the terms to maturity of bond issues increased. The trade turnover of corporate bonds in the secondary market rose, while by and large their yields declined.

In the second half of 2008, the resumption of capital outflow from the Russian financial market, increased mutual distrust among market participants, and the less favourable terms of borrowing, deteriorated the situation in the corporate bond market. Demand for corporate bonds decreased considerably, as their

yields rose swiftly and their liquidity declined. In the fourth quarter of 2008, primary placements mainly consisted of large corporate bond issues of top issuers, and short-term commercial papers (with maturities of up to one year). The majority of these debt instruments were purchased at agreed prices by a narrow group of investors at auctions for the placement of corporate bonds and commercial papers.

The developments in the Russian corporate bond market in 2008 showed that credit risk linked to potential losses from issuers' refusal or failure to honour their debt obligations (issuer default risk) became the most serious risk to investment in corporate bonds.

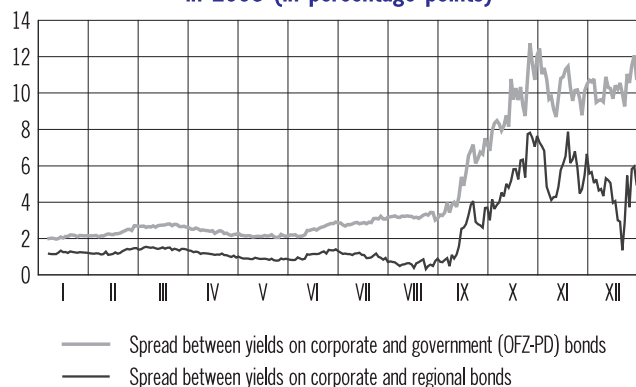
Until 2008, the Russian corporate bond market had not registered a single case of a large default by an issuer. During the period of stability, issuers encountered no difficulties in servicing their debt. However, as interest rates rose and confidence weakened among market participants, issuers – in particular with low credit ratings – had faced problems in refinancing of their loans. As the number of issuers and outstanding issues in the corporate bond market grew, along with the number of planned redemptions and earlier expected buy-back offers, the likelihood of default increased.

From May 2008, some third-tier corporate borrowers started to experience difficulties in refinancing their bonded debt. The payment burden on coupon income, buy-back offers and redemption of principal were registered in second half of 2008 (Appendix 2). As the market situation deteriorated, investors considerably raised credit risk assessments on corporate bonds. Bond holders opted to close their positions in debt securities. As banks cut the limits of credit to certain categories of borrowers, technical defaults by issuers other than top-rated borrowers began on a large scale. In May-December 2008, the corporate bond market registered 72 technical defaults, including 37 issuer defaults (Chart 2.14). During this period, credit risk on the bonds of issuers with low credit ratings increased considerably.

¹³ There are no risks in repo transactions with the Bank of Russia. In inter-dealer repo deals, credit risk transforms into liquidity risk. To minimise liquidity risk, securities that are accepted as collateral in inter-dealer repo transactions are traded at a discount.

Chart 2.15

Spreads between yields on different types of bonds in 2008 (in percentage points)



The spread between the yields of corporate bonds and risk-free debt instruments is one of the measures of credit risk for corporate bonds. Yields and investment risks are always higher for corporate bonds than for government and regional bonds with similar maturities. During periods of market turmoil, spreads between the yields on debt obligations of borrowers with different credit ratings increase. In particular, in January-August 2008 the average spread between the yields of corporate and government bonds stood at 2.5 percentage points, while the average spread between yields of corporate and regional bonds was 1.1 percentage points. In September-December 2008, the spreads widened considerably to 8.7 and 4.4 percentage points respectively (Chart 2.15).

The higher credit risks for corporate bonds in 2008 can also be seen in the evolution of corporate issuer credit ratings (for details, see subsections 4.3, 4.4).

From August 2008, demand for corporate bonds declined. Issuers sought to increase the attractiveness of their debt instruments to keep investors from presenting securities for early redemption under the terms of buy-back offers. For example, they offered a higher rate on coupon/coupons falling due after a buy-back offer date, or a premium above the par value of bonds when the next offer was settled. These measures contributed to growth in yields of corporate bonds in the secondary market. This growth accelerated during periods when investors were quitting the Russian capital market in large numbers, selling corporate bonds at any price.

Corporate bond yields grew in January-March 2008, slightly declined in April-May and the first half of June, failing to compensate for previous growth, and then started to rise swiftly. Yields of the most liquid corporate bonds¹⁴ reached 21.9% p.a. in December 2008 (the highest level since calculations of this indicator began in July 2003). The range of fluctuations of this indicator broadened from 126 basis points in 2007 to 1,379

¹⁴ Calculated by the news agency Cbonds.ru on the basis of a group of issuers.

Chart 2.16

Coefficient of variation of corporate bond yields in 2008 (%)



basis points in 2008. From September 2008, yields on corporate bonds of reliable issuers exceeded interest rates on bank loans with similar maturities, making the corporate bond market unattractive as a source of borrowing for most Russian companies in the real sector of the economy, as well as credit institutions and non-bank financial companies.

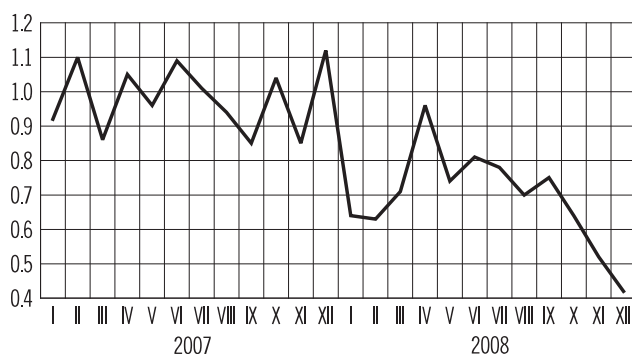
The volatility of yields on corporate bonds grew swiftly, exceeding in September-December the January-August level by more than four times (Chart 2.16). The average coefficient of variation of daily yields increased from 1.4% in 2007 to 3.7% in 2008. Interest rate risk resulting from bond yield fluctuations due to changes in the market situation or issuers' actions increased considerably in 2008.

Throughout 2008, liquidity risk related to bond holders' limited ability to sell bonds on acceptable terms showed mixed dynamics. During periods of growth in corporate bond yields (declines in corporate bond prices), the supply of corporate bonds considerably exceeded demand, increasing liquidity risk. In periods of lower yields on corporate bonds, purchase bids exceeded selling supply, reducing liquidity risk.

The measures used to assess the liquidity of the corporate bond market (trade turnover, number of trades, turnover velocity and other indicators) show that liquidity risk increased in 2008 as compared with 2007.

Secondary bond market turnover declined in 2008, even though the market portfolio value of corporate bonds increased 40% during the year, and the settlement of buy-back options accounted for a part of secondary trade turnover. The aggregate value of secondary corporate bond turnover on the MICEX declined 3.1% in 2008 as compared with 2007, and average daily turnover decreased 3.9% to 10.53 billion rubles at actual value. The turnover velocity of corporate bonds (the ratio between average daily secondary turnover at market price and average annual amount of outstanding corporate bonds at par value) dropped

Chart 2.17
Turnover velocity of corporate bonds (%)*



* Calculated as the ratio of average daily secondary trade turnover to market portfolio value as of the end of the month.

0.30 percentage points in 2008 as compared with 2007, to 0.69% (Chart 2.17). The number of trades in corporate bonds increased 8.2%, while the average value of transaction declined 7.7% in 2008 as compared with the previous year. The evolution of the daily bid-ask spread for corporate bonds reflected its low level and moderate volatility in January-March, some growth in volatility in April-July, and its sharp widening combined with substantial volatility growth in August-December (Chart 2.18).

The Bank of Russia expanded its Lombard list on many occasions in 2008, in particular through the inclusion of securities with lower issuer/issue ratings, which helped boost corporate bond liquidity. Market participants can use corporate bonds included in the Bank of Russia Lombard list as collateral to manage their liquidity with repo transactions, both with the Bank of Russia and with other counterparties. The value of repo deals with corporate bonds increased many times in 2008.

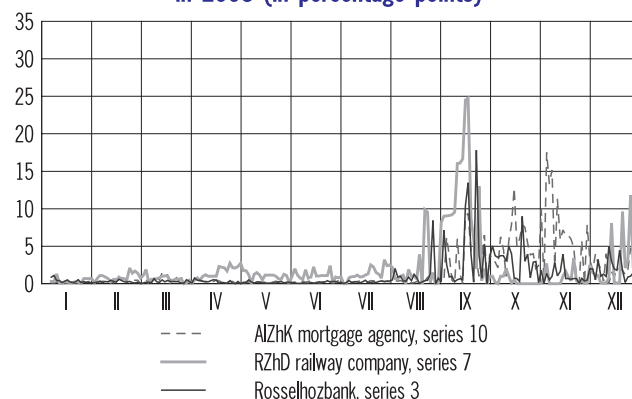
Breakdown of issuers by industry showed that the bonds of metals, engineering and construction companies were the worst affected by the crisis. Negative reports on declining output and investment programme cuts sent signals to potential investors of higher investment risk in the bonds of issuers in these sectors.

The situation in the corporate bond market therefore deteriorated considerably in 2008 as compared with the previous year. Credit risk saw the largest increase, while interest rate and liquidity risks also rose. The risks of investment in the bonds of various issuers differed considerably. Second- and third-tier bonds were especially vulnerable to default risks, while risks on the bonds of issuers with high credit ratings increased to a lesser extent.

2.3.2. Equity market

The inflow of foreign portfolio investment onto the domestic stock market in previous years, which

Chart 2.18
Bid-ask spreads for the most liquid corporate bond issues in 2008 (in percentage points)



grew as Russian foreign exchange laws were liberalised, contributed to the development of the Russian equity market, but also increased its dependence on global financial markets.

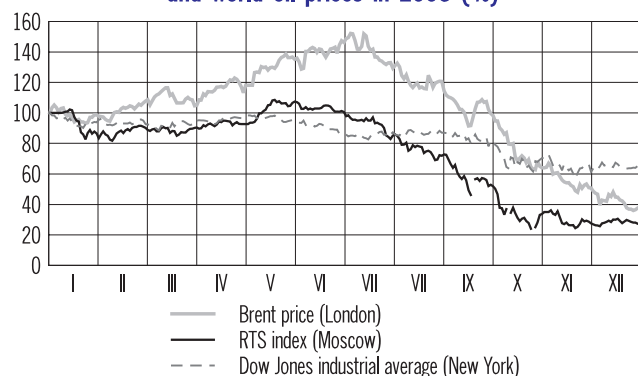
During all these years, foreign investors focused largely on the most liquid Russian shares, the larger part of which were undervalued compared to similar foreign securities. The active purchase of Russian liquid stocks by non-residents stimulated stronger demand for these instruments from Russian investors, and rapid growth in their prices from mid-2005 onwards. However, this process was dominated by speculative transactions in the Russian stock market, as non-residents made mainly short-term investments. Stock prices frequently rose due to bullish speculation. By the end of 2007, such transactions had created bubbles in the prices of some liquid assets and the threat of a sharp decline in stock prices in 2008.

From August 2007, global investors started to withdraw their funds from emerging economies, including Russia, pushing stock prices down. Sales of Russian stocks by non-residents were limited in the second half of 2007, whereas in 2008 they grew in scale. The psychological factor played a special role, in that any negative news from foreign financial markets was perceived as a sign that the situation in the Russian equity market would deteriorate, provoking a wave of sales both by foreign and Russian equity market participants. The correlation coefficient between the RTS index and the Dow Jones Industrial Average doubled in 2008 as compared with 2007 to 0.94 (Chart 2.19), illustrating the increased dependence of Russian stock indices on the stock indices of advanced economies.

As in previous years, the Russian equity market continued to depend heavily on world commodity markets in 2008, as shares issued by domestic oil and gas companies account for more than a half of the domestic stock market's capitalisation. This disproportion adversely affected the general liquidity of the domestic

Chart 2.19

Change in RTS and Dow Jones equity indices and world oil prices in 2008 (%)*



* Stock indices and oil prices as of December 31, 2007 are taken to equal 100%.

stock market, contributing to high volatility of share prices, and a prevalence of speculative investors in the market. The Russian equity market was therefore quite vulnerable to the shock of world oil price declines. The correlation coefficient between the RTS index and Brent oil prices on the London's ICE Futures Europe Exchange stood at 0.88 in 2008.

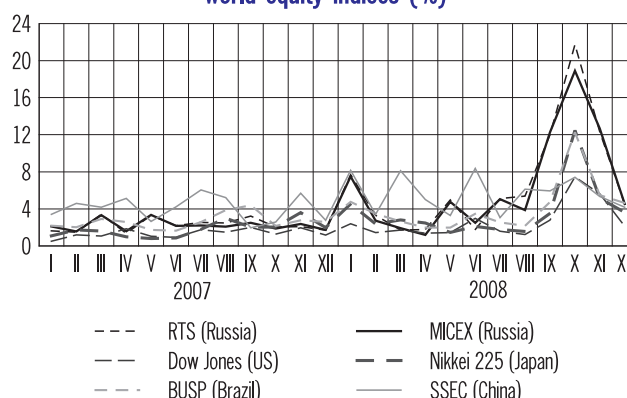
The situation in the Russian equity market started to deteriorate from the beginning of 2008. Foreign portfolio investment outflow from the domestic stock market in January-March prompted the first dramatic decline in share prices in 2008. In January-February, the MICEX and RTS stock indices fell 17% and 18% respectively as compared with the end of 2007. In April-May, as the situation in the world commodity markets improved, Russian share prices rebounded. Foreign portfolio investors continued to be the main generators of demand for Russian shares during that period, as they made short-term investments in the most liquid equities of major Russian commodity companies. As a result, Russia's major stock indices came close to their record highs by mid-May, and on May 19, 2008 the RTS index reached its highest level for the entire period of its calculation.

The most severe turmoil in the Russian equity market was observed in August-November 2008. As negative trends in the global financial market intensified and world oil prices declined, capital outflow from the Russian stock market increased, pushing down the prices of Russian securities and stimulating new share sales. Inadequate risk management in short sales, leveraged and unsecured transactions, and also in repo operations with shares, created additional downward pressure on share prices. The active use of high-risk schemes in repo deals with shares by market participants, combined with the dramatic fall in share prices, increased the number of counterparty defaults in such transactions.

In the second half of 2008, the volatility of Russian share prices increased considerably. In September-November, the average monthly coefficients of variation

Chart 2.20

Coefficients of variation of selected world equity indices (%)



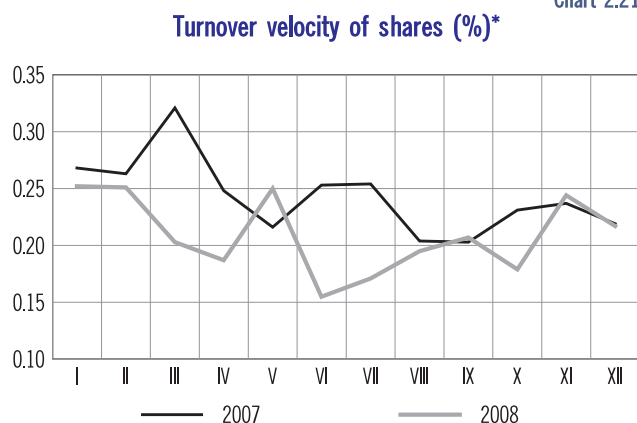
of the MICEX and RTS daily indices reached its peak for the second half of the year, measuring 12.0-21.7%. The average coefficient of variation was 6.5% for the MICEX index and 6.9% for the RTS index in 2008 (2.2% and 2.3% respectively in 2007). The volatility of indices of Russia's major stock exchanges considerably exceeded the volatility figures of foreign stock exchanges (Chart 2.20).

The Federal Financial Markets Service of Russia had to suspend trading on the MICEX and the RTS on many occasions in September-November to reduce share price volatility and prevent their dramatic decline. However, by the end of November the major domestic stock indices had fallen more than 3 times in comparison with the level seen in mid-May.

In late October, the Russian Government allocated financial resources to state-owned corporation Vnesheconombank (VEB) from the National Welfare Fund to make investments in Russian financial market instruments. As VEB purchased Russian shares in secondary market trading, the situation in the Russian stock market somewhat stabilised. From late November, dramatic declines in securities prices came to a halt, and their volatility decreased considerably.

In mid-September, the Federal Financial Markets Service also imposed a ban on leveraged trading in Russian shares to restrict price fluctuations in the stock market. However, this measure had a dual effect. While the situation tended to stabilise, and the volatility of share prices decreased, trading activity declined dramatically. In the second half of September, portfolio investors shifted their interest to foreign stock exchanges trading in depositary receipts (ADRs, GDRs) representing Russian shares. To restore liquidity of the Russian stock market, the regulator lifted its ban on leveraged trading, but imposed some restrictions on these transactions. Despite these measures, share turnover in the Russian stock exchanges continued to decline rapidly due to lack of demand.

Chart 2.21



* Based on data provided by the MICEX, the RTS and the news agency Cbonds.ru.

The liquidity of the stock market's exchange-traded segment decreased on the whole in 2008 as compared with 2007. In particular, the share turnover velocity (calculated as the ratio between the average daily secondary share turnover on the MICEX and the RTS, and the daily average of the MICEX and the RTS aggregate stock market capitalisation) declined from 0.24% in 2007 to 0.21% in 2008. The most significant decline in share turnover velocity was observed in June-October 2008, suggesting increased liquidity risk during that period (Chart 2.21).

The Russian equity market therefore experienced its most severe decline in the second half of 2008. The scale of its decline in terms of intensity and duration was comparable to the consequences of the 1997-1998 crisis (Chart 2.22). A dramatic fall in Russian share prices in June-November 2008 devalued the securities portfolios of Russian stock market participants, and deteriorated their financial positions. Large financial companies and banks with considerable investment in high-risk assets were hit especially hard. Some of them were pushed to the verge of bankruptcy, and were bought out by financially stable institutions. Considerable losses were also sustained by companies that used Russian shares

as collateral for external and internal borrowings. The dramatic drop in share prices forced them to carry out considerable additional expenditure to restore the value of their collateral for loans. At the same time, investors who adhered to prudent investment strategies retained sufficient volumes of liquidity, and managed to survive amid these unfavourable market conditions.

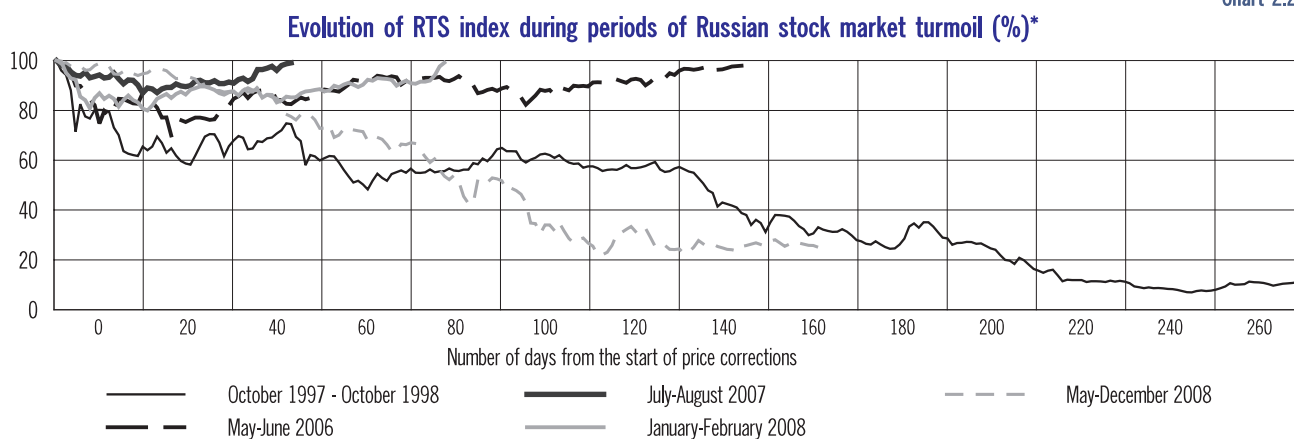
Share issuers were also affected by the turbulence in the Russian equity market. As the share prices of Russian companies plunged, investors swiftly increased their risk assessments for transactions with these shares, and the investment environment in Russia deteriorated. This situation restricted the possibilities for Russian companies to raise money both by using shares as loan collateral and by making public share offerings on domestic and foreign stock exchanges. At the same time, the small volume of outstanding Russian shares partially protected companies from hostile takeovers amid a dramatic fall in the market value of their shares.

2.4. Derivatives market

Fluctuations in the prices of derivatives were a key factor in assessing the vulnerability of the derivatives market in 2008. Market (price) risk increased sharply in 2008. Risks related to market infrastructure (settlement and legal risks) showed mixed dynamics over the year. Settlement risk was inconsiderable in the first half of the year. However, as the situation in the Russian stock market deteriorated, it increased in the segment of exchange-traded equity derivatives. Liquidity risk was characterised by similar evolution, while legal risk in the derivatives market was unchanged from the previous year.

The market's development in 2008 can be divided into two stages. In January-July, the derivatives market continued to develop dynamically. The growing price volatility of underlying assets (foreign exchange rates, interest rates and securities prices) increased market participants' demand for risk-hedging instruments. The aggregate exchange trade turnover of derivatives

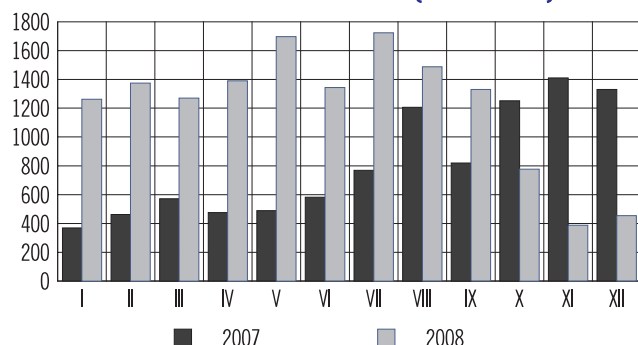
Chart 2.22



* The RTS index figures as of the date preceding the onset of a downward price correction on the stock market: October 22, 1997, May 6, 2006, July 23, 2007, January 14, 2008 and May 19, 2008 are taken as equaling 100%.

Chart 2.23

Monthly exchange trade turnover of Russian derivatives market (billion rubles)*



* Source: FORTS, SPCEX, MICEX, MICEX Stock Exchange and St Petersburg Stock Exchange.

almost trebled in the first half of 2008 as compared with the same period of 2007. Liquidity and settlement risks were low in the derivatives market during this period (Chart 2.23).

In August–November 2008, as the price volatility of underlying assets grew sharply, trade turnover and open interest in futures and options on single stocks and stock indices contracted considerably as compared with January–July (especially for options). Amid great uncertainty about future prices and low liquidity, market participants closed their positions in equity derivatives, as hedged risks on underlying assets. Transactions conducted in the derivatives market were mainly speculative. As a result, major risks – price, settlement and liquidity risks – increased considerably in the futures and options market during this period (Chart 2.24).

As the decline in prices in the Russian stock market slowed in December, the volatility of equity futures prices decreased, while trade turnover in equity derivatives slightly increased.

The steep rise in the price volatility of underlying assets in the second half of 2008 exacerbated price risks in derivatives transactions – stock, exchange rate and interest rate risks, depending on the underlying asset.

Chart 2.24

Average monthly open interest in exchange-traded derivatives (million contracts)

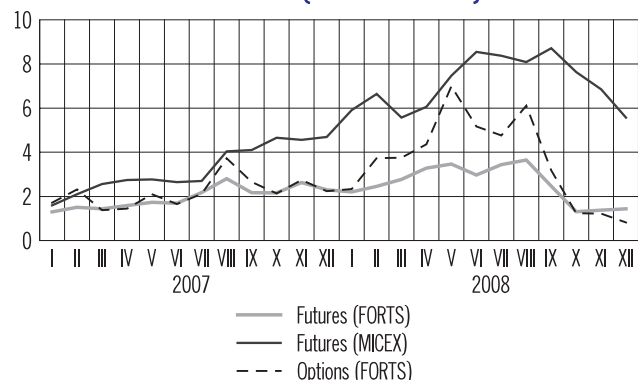
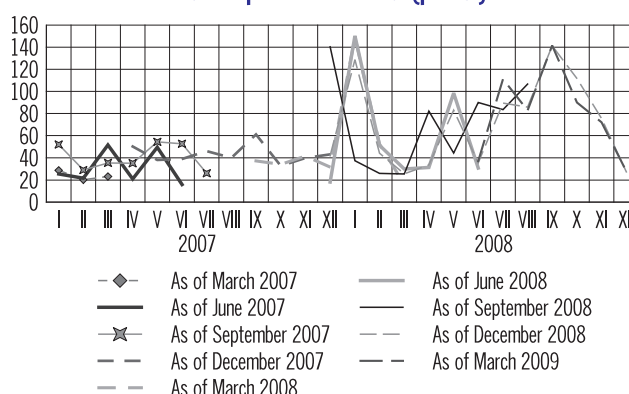


Chart 2.25

Average absolute deviation of RTS index futures prices in FORTS (points)



As Russian share prices plummeted, stock futures and stock index futures were the most vulnerable to price risk during this period. The tense situation in the equity segment of the derivatives market in the second half of 2008 could be seen in the rapid growth in the price volatility of major exchange-traded derivatives – RTS index futures. In the first half of the year, the coefficients of variation of futures prices on RTS index contracts with delivery in March and June 2008 were 5.8% and 7.6% respectively. In the second half of the year, this coefficient on contracts with delivery in September and December 2008 rose to 10.7% and 45.4% respectively. At the same time, the range of fluctuations of futures prices on RTS index contracts with delivery in September and December expanded sharply. In September, the broadest monthly range of fluctuations of futures prices on December contracts was registered for 2008, totalling 715 points.

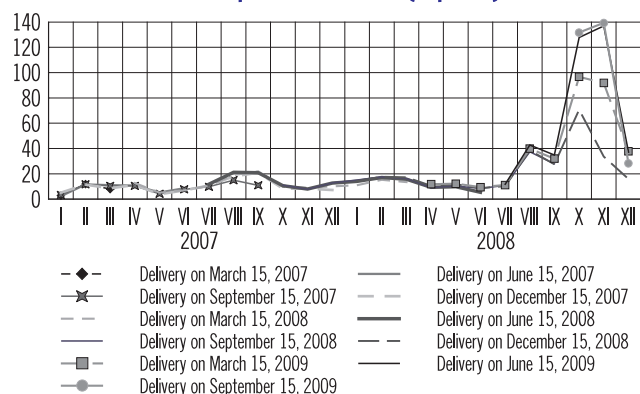
The average monthly absolute deviation of futures prices on RTS index contracts in the FORTS trading system, which is used as a volatility indicator, increased considerably in 2008 (Chart 2.25), from 61.1 points (the 2007 highpoint) to 141.2 points last year on the most liquid December RTS index contracts.

Exchange rate risk on currency derivatives also rose in 2008, due to considerable fluctuations in the US dollar/ruble nominal exchange rate in the second half of 2008. In particular, the average monthly absolute deviation of futures prices of the US dollar against the ruble on the MICEX increased considerably in 2008. The largest average absolute deviation on the most liquid December contracts on the US dollar/ruble exchange rate was 20.9 kopecks in 2007 as compared with 70.6 kopecks in 2008 (Chart 2.26). The coefficient of variation of the US dollar/ruble futures prices on December contracts was up from 2.3% in 2007 to 6.0% in 2008.

There are significant difficulties in assessing interest rate risk (on interest rate futures) in 2008, as operations with these contracts were terminated from November

Chart 2.26

Average absolute deviation of US dollar/ruble exchange rate futures prices on MICEX (kopecks)



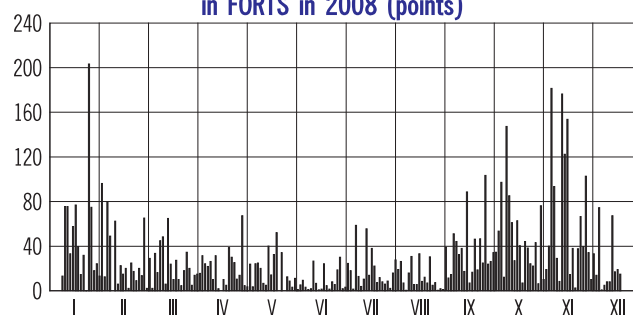
due to their low liquidity and higher volatility of interest rates in the spot market in the second half of 2008. However, the trend of rising interest rate risk was clearly visible in August-November.

An evening trading session (from 18:00 to 23:50 Moscow time) was introduced to the FORTS system in May 2008, allowing futures market participants to react swiftly to world markets movements after the end of the FORTS main trading session. This measure enabled market participants to manage price risks arising from the opening of trading sessions with a gap (when opening prices differed considerably from closing prices of the previous day). During the first months after the evening session was introduced, gaps in the prices of RTS index futures at the close of evening sessions and the opening of main trading sessions narrowed to some extent. However, from September onwards, as Russian share price volatility increased, the effect of levelling off gaps became less evident (Chart 2.27).

As volatility in the Russian financial market leapt in the second half of 2008, settlement risk in the derivatives market increased considerably. Nevertheless, the exchange market confirmed the reliability of the existing risk management system on the main Russian exchanges trading in derivative contracts. Although the derivatives market had always been considered the most complex and potentially risky market, and the value of open interest (market participants' mutual outstanding obligations) on leading Russian exchanges in mid-2008 reached a record high for the entire history of the market's development in Russia, no instances of defaults were registered until the end of the year. During days on which trade was suspended on the Russian organised stock market, futures trading was not halted, except for September 18, 2008, when stock index, stock and bond futures were not traded. On such days, the prices of derivatives contracts were the sole price indicators in Russia of domestic shares, along with the quotations of ADRs for the shares of Russian issuers traded on foreign exchanges.

Chart 2.27

Gap* of RTS index December 2008 futures before and after the introduction of evening trading session in FORTS in 2008 (points)



* Absolute difference between the closing prices of a FORTS evening session (main session before May 26, 2008) and the opening prices of a main session the next day.

During the period of the most severe downturn in the Russian stock market (August-October), the leading futures exchange (FORTS) was forced to close the positions of four clearing members. During this period, the limits to the fluctuations of prices on the most liquid futures contracts (on the RTS index, the shares of Gazprom, VTB Bank, and gold and silver) were increased on many occasions, and the exchange repeatedly raised as an emergency measure the value of the basic margin for many instruments. In particular, the margin was raised from 7.5% to 12.5% of the contract value for RTS index futures, from 12.0% to 15.0% for futures on Gazprom shares, and from 12.0% to 20.0% for futures on the shares of Sberbank and VTB Bank¹⁵.

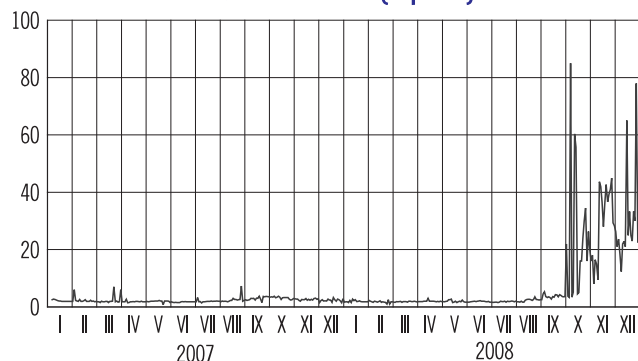
An interim clearing session in the FORTS system played a positive role in reducing settlement risk on futures contracts. During periods of sharply heightened volatility, the system of prompt reassessment of requirements on market participants and interim clearing made it possible to send a timely signal to the market on increased risks, and enabled the exchange to require additional margins for obligations. As a result, even companies which encountered problems in the futures market at such times managed to honour their obligations.

MICEX, the second largest stock exchange for trade in derivatives, also took measures to control risks in the futures market. On July 30, 2008, a reserve fund of 2 billion rubles was established on MICEX to make futures transactions more reliable and cover possible risks.

Insufficient market diversification of instruments is a major source of liquidity risk in the Russian derivatives market. Equity futures remained the most developed segment of the exchange-traded derivatives market, accounting for 61% of aggregate trade turnover of the Russian futures and options market in 2008. Futures and options contracts on single stocks and stock indices

¹⁵ For the period of New Year holidays (from December 22, 2008 to January 11, 2009), the basic margin in the FORTS system was temporarily raised to 15-60% of the futures contract value.

Chart 2.28
Average bid-ask spread for US dollar/ruble exchange rate
futures on MICEX (kopecks)



* For terms from 1 to 3 months.

made the largest contribution to growth in derivatives market trade turnover in the first half of 2008, while RTS index futures were the most liquid instruments among exchange-traded derivatives (50% of aggregate futures and options trade turnover in 2008). As Russian share prices plummeted in August-December 2008, the equity segment of the exchange-traded derivatives market registered its steepest declines in trade turnover and open positions, and correspondingly, its most rapid growth in liquidity risks.

At the beginning of 2008, liquidity risks for the futures on the most liquid stocks of Russian issuers (Gazprom, Lukoil, Norilsk Nickel and Sberbank) and RTS index options were relatively low. Liquidity risks for less liquid futures contracts (on second-tier stocks, bonds, and RTS sectoral indices) were considerably higher. By the end of 2008, however, liquidity risks had increased sharply for all exchange-traded instruments.

Liquidity risk for currency futures were on the whole lower in 2008 than in the previous year. The volume of transactions involving the most liquid currency futures – contracts for the US dollar/ruble exchange rate

– increased 60% in 2008 as compared with 2007. Trading activity in currency futures declined considerably in November. However, in December trade in these instruments again intensified. Other currency futures (contracts on euro/dollar, euro/ruble pairs) were characterised by low liquidity in 2008, due to negligible and unstable trade turnover on these instruments.

From the end of September, as the US dollar appreciated against the ruble in nominal terms, the bid-ask spreads for futures on the US dollar/ruble exchange rate, and the volatility of these spreads, grew significantly, suggesting higher liquidity risks for currency futures during that period (Chart 2.28).

In the second half of 2008, many investors withdrew their funds from the Russian equity market and invested a portion of their capital in precious metals (particularly gold). During this period, Russian futures on gold became considerably more attractive as an investment instrument, as evidenced by growth in trade turnover, and insignificant volatility of bid-ask spreads on gold futures. Correspondingly, liquidity risk for gold futures as major commodity futures declined in 2008 as compared with 2007.

Legal risk in the Russian forward market was unchanged from the previous year, as no significant legislative acts were adopted in 2008 to regulate the derivatives market.

Nevertheless, government bodies and the professional community took a number of measures in 2008 to solve legislative problems in the regulation of the derivatives market. In particular, three professional organisations – the National Foreign Exchange Association (NFEA), the Association of Russian Banks (ARB) and the National Association of Stock Market Participants (NASMP) – continued elaborating a standard framework Agreement on Futures Transactions (Derivatives) to improve the market's legal environment and contribute to its stable operation.

Chapter 3. Financial condition and soundness of financial intermediaries

Financial stability on the market of financial intermediaries deteriorated in 2008, particularly in the last months of the year, but there were no global threats to its development.

The liquidity crunch caused by the tightening of terms for external borrowing, capital outflow from the domestic financial market, and the confidence crisis on the interbank credit market, reduced the volume of credit provided by banks to non-financial organisations and households. As a result, insurance companies cut back on operations relating to the provision of insurance coverage on consumer loans and loans extended against collateral. The growth in the banking sector's financial result slowed due to the credit crunch, and also as a result of the negative revaluation of banks' securities portfolios, and losses from operations with them caused by falling stock market prices. The deterioration of the stock market indices also prompted an outflow of capital from retail unit investment funds and generated losses from their investment activities. Insurance companies and non-government pension funds were forced to change the structure of investment portfolios in favour of less risky financial instruments, which cut their investment incomes. Management companies allowed considerable devaluation of pension assets assigned to them for trust.

The main factors adversely affecting the dynamics of household bank deposits were declining confidence in the banking sector, slower growth in real household disposable money incomes, high inflation and mounting devaluation expectations. Prompt measures to raise guarantees for bank deposits and interest rates on them helped avoid panic and a massive run on household deposits. The redistribution of household funds withdrawn from retail unit investment funds into bank deposits also contributed to maintaining stability on the deposit market.

The altered environment in which credit institutions carried out their crediting operations did not cause a drop in the volume of loans to non-financial borrowers as a whole. To a large extent, this was due to financial support provided by the Government and the Bank of Russia to credit institutions. In particular, the Bank of Russia lowered required reserve ratios for banks, cut their deductions to the deposit insurance system to raise their liquidity, and extended funds to credit institutions through the refinancing mechanism to help them repay and service their foreign loans. In addition, the Government provided subordinated loans to banks for the purpose of their further capitalisation. The financial leverage of the Deposit Insurance Agency state

corporation was broadened to prevent the bankruptcy of banks and help them in their financial rehabilitation, while the charter capital of the Agency for Housing Mortgage Lending was enlarged to maintain the system of mortgage loan refinancing. Non-bank financial intermediaries, in contrast to credit institutions, did not receive government support, and therefore had to take their own measures to overcome effects of the crisis in their activities.

3.1. Credit institutions

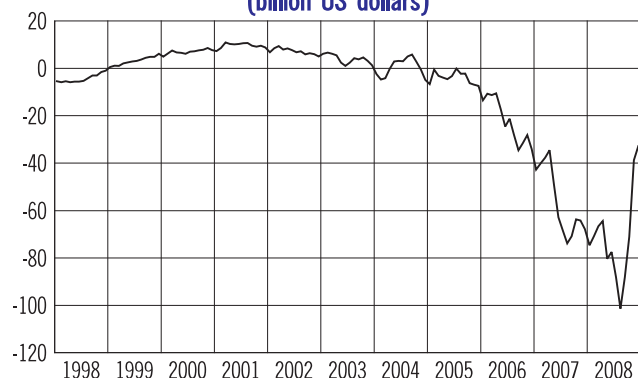
The mounting external financial and economic threats intensified problems in the Russian banking sector and reduced its financial stability in 2008. The domestic banking sector's main indicators deteriorated in 2008 as compared with the previous year: annual growth in total banking sector capital slowed from 57.8% to 42.7%, banking assets from 44.1% to 39.2%, loans to non-financial sector from 53.0% to 34.5%, and household deposits from 35.4% to 14.5%.

The worsening situation in world financial markets in 2008 revealed a major threat to financial stability in the banking sector – the rapidly growing dependence of Russian banks on foreign sources of financing (Chart 3.1). In 2001-2007, credit institutions' foreign liabilities (net of shareholdings) grew rapidly. By January 1, 2008, they had increased by 18 times, and approached \$170 billion or 20.5% of total banking sector liabilities. Russian banks' foreign assets (net of shareholdings) grew slower than their foreign liabilities over the same period, expanding by seven times to \$94 billion, or 11.4% of total banking sector assets. Credit institutions continued to build up their foreign liabilities until August 2008. As the liquidity crisis intensified on world markets, foreign capital – largely speculative funds – started to flow out of Russia. At the same time, Russian credit institutions' access to international borrowings was considerably restricted, and they encountered increasing difficulties in refinancing their previously obtained foreign loans. The situation was aggravated by the persisting differentiation among Russian banks in terms of market capitalisation and financial standing, as only a small group of major banks maintained their ability to borrow externally despite the increased cost. As a result, banks' foreign liabilities contracted by 13.6%, or \$28 billion in dollar terms, in August-November.

The reduction in external sources of financing was accompanied by rapid growth in Russian banks' foreign assets. In August-November 2008, the value of Russian banks' foreign assets increased by 37.4%, or by \$40 billion in dollar terms. Credit and loans to foreign

Chart 3.1

**Net foreign assets of credit institutions
(billion US dollars)**



counterparties accounted for \$11 billion of this sum, while deposit and other accounts with non-resident banks made up \$27 billion and foreign currency cash contributed \$2 billion. The build-up of foreign assets by Russian banks intensified the negative trends of capital outflow from Russia. In view of this situation, the Bank of Russia advised credit institutions against building up their foreign assets, except in cases when the growth of foreign assets was conditioned by an increase in foreign liabilities, or when foreign assets grew as a result of larger investment in non-residents' debt securities included in the Bank of Russia Lombard list and in the bonds issued by the European Bank for Reconstruction and Development. The Bank of Russia took into account the results of the fulfilment of these recommendations when it set limits on credit institutions' participation in unsecured loan auctions. In particular, from December 15, 2008, the Bank of Russia reduced lending limits for one in four of the 136 banking institutions admitted to auctions, due to their failure to meet the regulator's recommendations.

The imbalance that emerged in the second half of 2007 between annual growth in the volume of credit to non-financial borrowers and the domestic funding base (household deposits and non-financial organisations' funds on deposit, settlement and other accounts), increased in 2008. The volume of banking loans to non-financial borrowers grew by 2.9 trillion rubles in January-July 2008, of which only about 56% was financed through growth in the volume of funds attracted from non-financial organisations and households. From early 2008, credit institutions started to reduce their own liquid funds to eliminate this imbalance. In particular, in January-July credit institutions cut the volume of funds on correspondent accounts with the Bank of Russia by 31.3%, funds on deposit accounts with the Bank of Russia by 44.8%, funds placed in cash, precious metals and gems by 12.5% and funds on correspondent accounts with credit institutions by 3.6%. As a whole, the growth in funds obtained from organisations and individuals contributed 58.1% to the increase in the

volume of loans to the non-financial sector in 2008 (as compared with 83.5% in 2007). The imbalance between growth in the volume of crediting and domestic funding, and the widening of this imbalance, is an important signal of higher threats within the banking sector that could materialise under conditions of general macroeconomic instability.

The gap between the volume of bank assets with maturities of over one year, and the volume of long-term liabilities, widened in 2008. According to data as of January 1, 2009, the difference between the share of loans extended to banks, non-financial organisations and households for terms of over one year (long-term loans) in total assets (39.1%) and the share of long-term loans and deposits raised from banks, non-financial organisations' deposits and household deposits in total liabilities (26.8%), increased from 9.9% in 2007 to 12.3% in 2008. These figures reflected higher share of long-term credit through short-term finance sources, which aggravated the liquidity problem in the banking sector.

The impact of the above-mentioned factors in 2008 increased the shortage of credit institutions' liquid funds. As of October 1, 2008, the ratio of highly liquid assets to total assets contracted by 0.6 percentage points to 11.5%, and the ratio of liquid assets to total assets dropped by 1.9 percentage points to 22.9%.

Russian credit institutions made efforts to counter the threat of a liquidity shortage, which intensified in August, by forming a liquidity reserve in the form of fund placements on correspondent accounts with credit organisations, and also in the form of cash. The ratio of highly liquid assets to demand deposits (N2 ratio) was up from 48.4% as of the beginning of the year to 54.7% as of early October. The ability of banks to make immediate repayments of on-demand obligations consequently improved. However, the build-up of highly liquid assets differed by group of bank. The largest Russian banks registered the most rapid increases in their highly liquid assets. In particular, the top thirty Russian banks contributed over 80% to growth in balances on correspondent accounts with Russian credit institutions in the third quarter of 2008, whereas many small and medium-sized banks continued to experience problems with the mobilisation of liquid financial resources. In October-November, the number of credit institutions failing to comply with the N2 ratio increased from 2 to 14 organisations.

The troubles experienced by some banks in the fulfilment of their obligations as a result of liquidity shortages provoked an increasing mistrust of credit institutions among households. In addition, the devaluation of the Russian ruble, which began in August 2008, stimulated a conversion of household savings into foreign currency cash. As a result, credit institutions were confronted with the problem of replenishing their

Chart 3.2

Household deposits (% change with respect to corresponding period of the previous year)

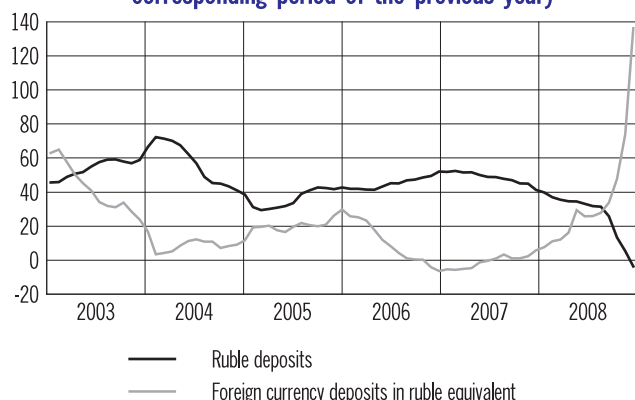
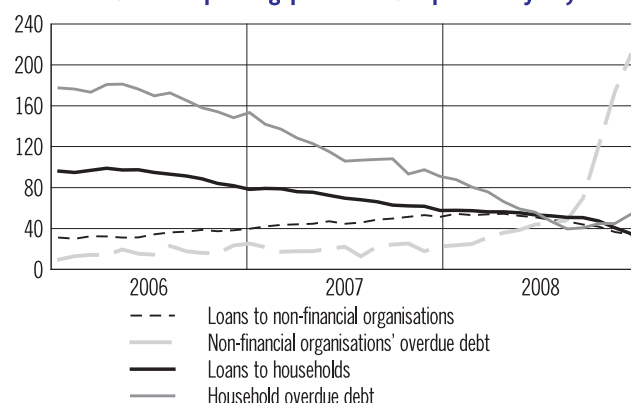


Chart 3.3

Loans to non-financial sector (% change with respect to corresponding period of the previous year)



funding base with household deposits. In January-August 2008, the value of household deposits increased by 15.9%, considerably less than the figure of 19.8% in the same period of 2007. The value of household deposits decreased by 7.6% in September-November, but registered a 6.9% increase in December. As a whole, the value of individuals' deposits grew by 14.5% in 2008 as compared with 35.4% in 2007 (Chart 3.2).

The volume of deposits and other funds (hereinafter referred to as deposits) raised from corporate entities (except for credit institutions) increased by 40.5% in 2008, as compared with 64.0% in 2007. The dynamics of corporate deposits in April-October 2008 were considerably influenced by deposits placed by the Ministry of Finance of the Russian Federation with domestic banks through auctions held during that period. In November 2008, an outflow of corporate funds from bank deposits was registered (minus 10.4%) largely due to the termination of deposit auctions by the Ministry of Finance. The growth in the volume of corporate deposits seen in December failed to compensate for this decline.

As the results of international research show, withdrawals by depositors of funds from their bank accounts for two consecutive quarters can sharply increase the risk of a liquidity shortage in the banking sector. The outflow of household and corporate deposits in September-November 2008 aggravated the liquidity shortage problem and undermined the financial stability of some banks. This required the injection of additional resources into the capital of these banks, or measures from the Bank of Russia and the Deposit Insurance Agency towards their rehabilitation. In some instances, the Bank of Russia had to revoke the licences of distressed banks as a means of reacting to this situation.

The terms of funding, which had changed from the second half of 2007, and also expectations of growth in the number of insolvent borrowers, prompted banks to review their credit strategies and introduce more conservative approaches to assessing borrowers' creditworthiness. As a result, growth in the volume of

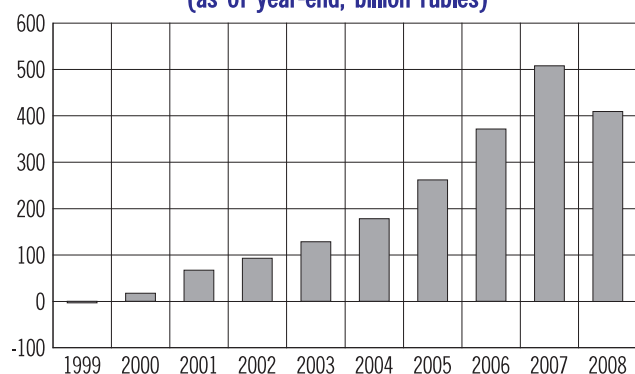
loans and other funds (hereinafter referred to as loans) provided to non-financial organisations and households contracted by a factor of more than 1.5 in 2008 as compared with the previous year to 34.3% and 35.2% respectively (Chart 3.3). The volume of mortgage loans grew 59.4% in the first nine months of 2008, as compared with 107.9% in the first nine months of 2007. From October 2008, some credit institutions almost entirely halted the provision of consumer loans and mortgage loans, or raised interest rates on them to prohibitive levels. However, from the standpoint of maintaining the financial stability of credit institutions, the current growth of credit volumes is still high, as international practice has shown that an annual increase of more than 20% in the volume of outstanding credits creates a threat of deterioration in asset quality, particularly during a stage of economic recession.

Despite the slowdown in growth of aggregate loan volumes, the share of credit operations in the structure of banks' assets grew by 6.6 percentage points in January-September 2008 to 77.4%. This was partly due to the redistribution of funds from securities portfolios exposed to volatility; their share in banks' assets decreased during this period by 2.5 percentage points. A large share of credit in active operations influences the stability of credit institutions. International research shows that a share of credit investment exceeding 80% in the structure of bank assets creates a potential liquidity shortage threat.

However, a swift decline in bank crediting, as well as fast growth, has a number of negative consequences. These include rising outlays of non-financial organisations, lower profit due to the higher cost of borrowing, and slower production growth resulting from reduced supply of credit to finance fixed and working assets. This situation is further aggravated for economic entities (non-financial organisations and households) that finance current spending and investment growth not through additional income but through accelerated new borrowing, used to refinance previous loans (Ponzi schemes). The suspension of bank

Chart 3.4

Credit institutions' financial result*
(as of year-end, billion rubles)



* Current year profits net of losses.

credit to these economic entities means the virtual loss of their solvency, and as a result, poses credit risks for banks that earlier extended loans to them.

From September 2008 onwards, the quality of the corporate credit portfolio sharply deteriorated. Growth in overdue debt on loans to non-financial institutions was 9.2 times higher in 2008 than in the previous year, reaching 209.4% from 22.6%, while the share of overdue debt in total loans to non-financial organisations as of January 1, 2009 reached a two-year highpoint of 2.1%.

Growth in overdue debt on loans to individuals contracted in 2008 by almost half as compared with the previous year, from 90.9% to 53.9%. However, the share of overdue debt on these loans increased from 3.2% to 3.7%. At the same time, a high concentration of retail credit risk was registered at several large banks specialising in consumer lending. In particular, banks ranked between 6th and 50th in terms of assets accounted for 63.1% of total overdue debt on loans to individuals as of December 1, 2008, with the share of household overdue debt in these banks standing at 5.2%. The share of overdue debt on loans to individuals in the total volume of retail loans extended by Sberbank increased from 0.9% to 1.7% in 2008. The quality of outstanding housing mortgage loans extended by Russian banks deteriorated. The share of overdue debt on mortgage loans increased by a factor of 3.9 from the beginning of the year to 0.5% as of October 1, 2008.

The share of problem and bad loans in the total volume of loans remained unchanged in the first nine months of the year, standing at 2.5% as of October 1, 2008. As yet, this proportion does not pose a threat to the banking sector's financial stability. The ratio of the aggregate large credit risk to capital (N7 ratio) remained at a low level (211.1%), dropping only 0.8 percentage points from the beginning of the year. Banks' provisions for possible loan losses as a percentage of the total volume of loans extended by banks was also almost

unchanged in the first nine months of the year, standing at 3.5% as of October 1, 2008.

The threat of the ruble's considerable depreciation adversely affected the sustainability of the Russian banking sector. In January-November 2008, exchange rate risk calculated on credit institutions' open positions in foreign currency and precious metals increased as a percentage to total capital from 3.6% to 4.4%, and as percentage to aggregate market risk from 9.3% to 11.1%.

The growth in banks' foreign currency liabilities made banks to place these funds on short-term deposits with foreign banks to hedge their foreign currency risks, hence intensifying capital outflow. From December 1, 2008, Russian credit institutions that were admitted to unsecured loan auctions held by the Bank of Russia were allowed to open accounts in US dollars and euros with the Bank of Russia, to prevent capital outflow and to broaden credit institutions' ability to manage their short-term US dollar and euro liquidity. As of January 1, 2009, the volume of funds placed by credit institutions on foreign currency correspondent accounts with the Bank of Russia totalled \$25.8 billion.

At the same time, the threat of a deterioration in the quality of foreign currency loans provided to retail clients grew. To minimise this threat, since the fourth quarter of 2008 Russia's major retail banks have been implementing programmes for foreign currency loan refinancing for private clients. Previously, foreign currency loan refinance operations required a considerable increase in provisions for possible loan losses, since loans extended to repay previous debts are classed as bad loans (5th category of quality) and require provisions of 100% of the loan value. Given this situation, the Bank of Russia softened temporarily, until December 31, 2009, the procedure of risk assessment for loans extended by banks, to create more favourable conditions for lending to non-financial organisations and households. In particular, credit institutions were allowed, from October 1, 2008 onwards, to keep their assessment of the quality of loan repayment unchanged in cases when overdue debts on loans were extended by 30 calendar days, loans were restructured, or loans were used to repay previous credit.

Due to the reduced stability of the Russian banking sector in 2008, its financial performance deteriorated as compared with 2007 (Chart 3.4). From January to August 2008, the return on assets averaged 2.9% in the Russian banking sector, but plunged to 1.8% as of January 1, 2009 (Chart 3.5). These figures are not critical for the banking sector: international research shows that one sign of a financial crisis is when the return on banking sector assets falls to 1%. The return on bank capital declined moderately in January-August 2008, from 22.7% to 20.3%. However, by January 1, 2009

Chart 3.5

Measures of profitability of banking sector (%)

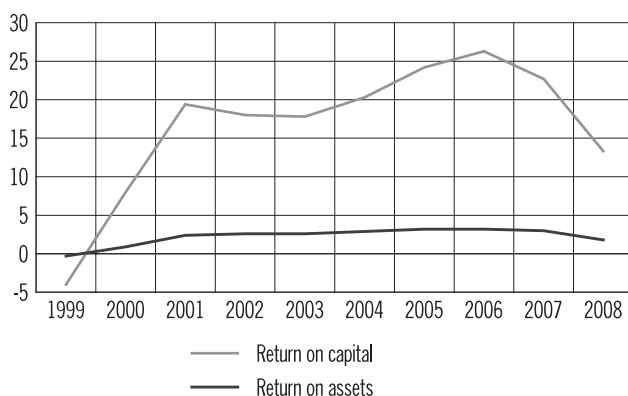
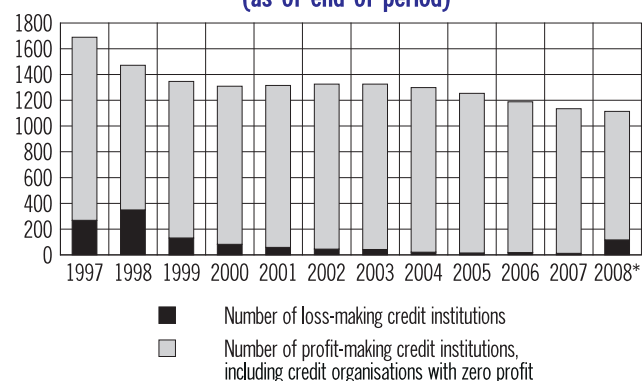


Chart 3.6

Number of profit-making and loss-making credit institutions (as of end of period)



* As of December 1, 2008.

it had plunged to 13.3% following a dramatic fall in the banking sector's financial result. The accelerated growth of banking sector capital as a result of government support measures was another factor behind the lower return on capital.

The banking sector's aggregate financial result (current year profits net of losses) fell 19.4% in 2008 as compared with 2007. The banking sector's aggregate profits totalled 285.7 billion rubles and aggregate losses 1.2 billion rubles in the first half of 2008. However, the banking sector's financial result declined by a factor of 2.3 in the second half of the year as compared with January-June 2008. The banking sector operated at a loss in the short period in the second half of 2008: banks' expenditure exceeded revenues by 40.8 billion rubles in October-November. However, in December credit institutions posted a positive financial result, largely due to the ruble's depreciation against the bi-currency basket. The banking sector's positive financial result amounted to 54.4 billion rubles in the fourth quarter of 2008. However, almost a third of banks, including some major banks, posted losses in December. The number of loss-making banks increased by 10.5 times in the first 11 months of 2008 to 115, or 10.3% of operating banks (Chart 3.6).

The banking sector's financial result contracted largely due to extra provisions for possible losses in the fourth quarter, as well as negative revaluation of securities, and losses from securities operations (Chart 3.7).

Aggregate provisions for possible losses (taking into account recovered sums) grew faster in 2008 than in 2007. Provisions are made to compensate for losses in the event of a default on debt, and consequently, to maintain a bank's financial stability. Quarter-on-quarter comparisons of provisions for possible losses confirm the progressive deterioration of the quality of bank loans in 2008, which hit its lowest level in the fourth quarter. Provisions for possible losses in the fourth

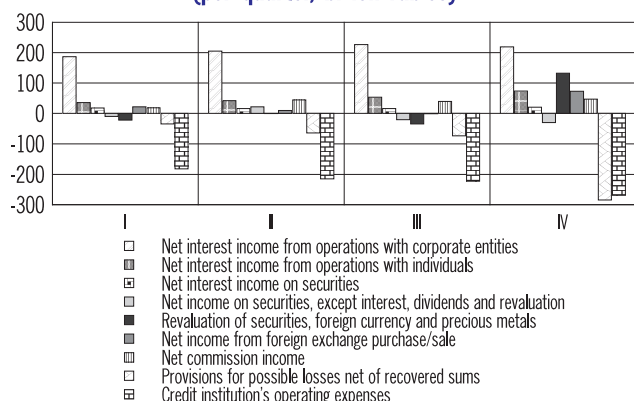
quarter increased 3.8 times from the third quarter, 4.4 times from the second quarter, and 8.3 times from the first quarter.

Net revaluation of securities in bank portfolios was negative in 2008 (minus 54.2 billion rubles), showing the biggest losses – in the amount of 70.0 billion rubles – in the third quarter of the year. In the fourth quarter, these losses were mitigated by the alterations to the procedure for accounting securities in bank portfolios. In particular, banks were allowed to account securities at the acquisition cost, or at the price effective as of July 1, 2008, if they were acquired in the first half of 2008. This measure enabled many credit institutions to reduce their losses.

Revenues from operations with purchased securities, net of interest, dividends and revaluation, were smaller than corresponding expenditures in 2008. As a result, these operations generated 41.3 billion rubles in losses. The second half of 2008 was on the whole a period of loss-making operations (minus 50.2 billion rubles). Losses in the banking sector could have been larger if banks had not reduced their share of equity investment in total bank assets in January-August 2008 (by 1.5 percentage points to 9.6%). Many large banks cut the volume of their security portfolios significantly from the beginning of the year, to minimise their dependence on this volatile source of revenue amid falls in the main stock indices.

Net interest income continued to be a steadily growing component of the banking sector profits in 2008. Credit institutions' net interest income except for income on securities grew by a factor of 1.5 in 2008 year on year to 1,042.4 billion rubles, largely due to growth in the cost of loans to borrowers, especially private individuals. However, credit institutions' net interest income from operations with corporate entities slightly declined in the fourth quarter from the third quarter, suggesting a contraction in the volume of loans extended to them. Conversely, growth in net interest income in operations

Рисунок 3.7
Key components of credit institutions' financial result in 2008
(per quarter, billion rubles)



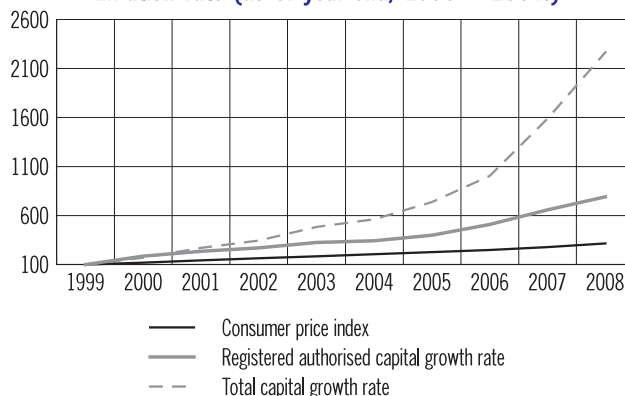
with individuals accelerated quarter-on-quarter amid the faster increase in the interest rate margin on these operations.

The average annual interest rate margin had remained stable in the Russian banking sector over the past few years, generally equalling no less than 6.0%. In international practice, a level of 2% is considered critical. From the second half of 2007, Russian banks started to raise the cost of credit to respond to the deterioration in external borrowing conditions. As a result, interest rate margin dynamics registered an upward trend from the third quarter of 2007. In 2008, banks' average interest rate margin increased 0.9 percentage points year on year to 7.2%. Credit institutions therefore took measures to offset growth in risks related to the ability of existing and potential borrowers to repay loans in the event of a financial downturn.

The results of 2008, particularly the fourth quarter, suggest that growth in banking sector revenue, and correspondingly the financial result, was largely driven by foreign exchange operations, as well as positive revaluation of foreign currency funds. In particular, net income from foreign currency purchase/sale totalled 73.3 billion rubles in the fourth quarter of 2008 alone, and reached 103.1 billion rubles for the year as a whole. Net income from revaluation of foreign currency funds amounted to 139.5 billion rubles in 2008, of which almost 90% was registered in the fourth quarter.

Credit institutions' mounting losses, along with the shortfall in share premiums, slowed growth in the banking sector capital base (Chart 3.8). Banking sector total capital increased by 42.7% in 2008 as compared with 57.8% in 2007. For the first time in the past four-and-a-half years, credit institutions with negative capital appeared in October 2008, with total negative capital exceeding 48.8 billion rubles (as of December 1, 2008). The total registered authorised capital of credit institutions grew by 20.4% in 2008 as compared with 29.2% in 2007, largely due to the deteriorating the situation on the domestic and external markets

Chart 3.8
Banking sector capital growth rates as compared with
inflation rate (as of year-end, 1999 = 100%)



for public share offerings by Russian banks. Growth in banking sector capital slightly accelerated from October 2008, as the Russian Government provided support to the domestic banking sector by extending subordinated loans to system-building banks.

The negative trend of faster growth in credit institutions' total assets relative to capital continued in 2008. The average capital adequacy ratio of the Russian banking sector as a percentage to risk-weighted assets decreased from 15.5% to 14.5% in January-September. However, financial stability support measures helped to bring this ratio up to 16.3% as of December 1, 2008. The capital adequacy ratio of the largest 30 banks in terms of assets fell from 14.3% to 12.4% as of October 1, 2008, but eventually grew to 14.8% as of December 1, 2008. On the one hand, these indicators are higher than the ratio set by the Bank of Russia (10%) and the minimum capital adequacy ratios in most transitional economies (8%). On the other hand, among the major domestic banks are both banks with high rates of capitalisation, and banks with capital adequacy ratio slightly above the statutory level. The latter group includes mainly banks with a high share of retail operations in their assets. Their policy of accumulating risky assets, including credit investments, without a corresponding increase in their equity capital (to address potential risks) will pose a threat to their financial stability.

In addition to lower capital adequacy ratios, the problem of so-called fictitious capital, i.e. capital that is not supported by assets of proper quality, also poses a threat to stability in some banks. Over the past few years, the Bank of Russia has taken active measures to deal with the problem of fictitious capital, through exposing equity capital falsification schemes used by commercial banks of different sizes in their balance sheets. In particular, in 2008 the Bank of Russia exposed at least two dozen instances where banks used so-called «mirror» notes, i.e. unbacked exact copies of outstanding promissory notes, to form their equity capital. Also, during its bankruptcy prevention measures the Deposit Insurance Agency

exposed poor-quality capital in some of the banks that defaulted on their obligations as the financial situation deteriorated.

The level of the banking sector's financial stability is measured by the number of banks with stable financial state. The share of credit institutions (including non-bank credit organisations) with stable financial state, i.e. institutions that did not experience any difficulties, or which experienced only isolated difficulties, was 96.3% of the total number of credit institutions. From mid-2008, the Bank of Russia switched from classification of banks by financial state to classification by economic standing. The number of banks referred to the first two groups (i.e. those with the best economic standing) contracted from 1,021 to 922, and their share in the total number of banks from 94.6% to 85.6% in the third quarter of 2008.

The main threat to the banking sector's stability in a crisis is posed by banks classed in the 3rd-5th groups. In the third quarter of 2008, the number of banks which posed – or could pose – a real threat to their depositors and creditors in the short-term, increased threefold to 151, while their share in the total number of banks grew 8.8 percentage points to 14.0%. At the same time, the number of banks in a condition that would force them to halt banking activities if their management bodies or shareholders were to fail to take immediate action (group 5), rose from 5 to 16 in July-September. The share of assets held by banks in the 3rd-5th groups grew from 0.2% to 5.0% of banks' assets. This indicates a deterioration in the banking sector's stability, as the bankruptcy of one bank, and all the more so of several banks, can trigger a «contagion effect» and destabilise the situation in the banking sector as a whole.

The process of licence revocation from unviable banks accelerated in the fourth quarter of 2008. In particular, the Bank of Russia revoked more licences from banks than in all the previous months of the year (19 as compared with 15). At the same time, the number of licences revoked from banks in 2008 was considerably smaller than in 2007 (34 as compared with 51). However, the number of licences revoked from banks that defaulted on obligations to creditors and clients increased considerably in 2008.

To prevent growing distrust between banks and panic among depositors arising from defaults of certain banks on their obligations, financial assistance was provided to these banks with the help of institutions with government shareholding. Eventually, centralised approaches were developed to prevent bankruptcy among banks confronted with financial difficulties, with the help of the Deposit Insurance Agency and the Bank of Russia. As a priority, problem banks that are important for the development of the country or its regions will receive assistance. State support can be provided to the largest 50 federal and 150 regional organisations in terms of

the volume of household deposits. The system of banks' financial recovery is already operating, and has yielded positive results. As of January 1, 2009, 14 distressed banks underwent financial rehabilitation measures.

Financial recovery measures in the banking sector included the reorganisation of problem banks through mergers and acquisitions, with the participation of more viable institutions that contributed to the consolidation of bank assets (Appendix 3).

The main indicators of the banking sector's financial soundness deteriorated in 2008, but failed to reach a level suggesting a large-scale crisis in the banking system. The Russian banking sector's weakened condition is evidenced by enhanced risks linked to the emergence of liquidity shortages among individual banks, and also by imbalances between assets and liabilities in terms of maturity, and banks' inadequate funding base.

The Russian banking sector's dependence on foreign borrowing declined towards the end of the year. Nevertheless, foreign capital remained a considerable source of banks' resource base. If the situation in world financial markets deteriorates further, this factor may pose a threat to the financial stability of the banking system.

Measures taken by the Bank of Russia helped to stabilise short-term liquidity in the banking sector by the end of 2008. However, the problem of long-term financing shortages persists amid continuing uncertainty in world financial markets. For some non-financial organisations, bank credit continues to be inaccessible.

The Government and the Bank of Russia are taking unprecedented measures in terms of the scale of their support of the banking system. As a result, the banking sector has received a large volume of liquidity, and partially compensated for the contraction in foreign sources of banks' funding. Thanks to the measures, growth in the volume of household deposits was resumed, and an upward trend in the provision of loans to non-financial organisations was not interrupted.

Major system-building banks, particularly banking institutions with government shareholding, contributed to efforts to ease the crisis. These banks helped the government to implement financial support measures, kept the deposit market stable, and supported redistribution of funds in the economy, including through interbank money market.

On the whole, the banking sector is responding adequately to external threats to its stability. However, unless the confidence crisis is overcome, the banking system's stability is unlikely to be restored. If the global financial crisis aggravates in 2009, negative trends in the Russian banking sector can be expected to intensify. Banks would be likely to see further slowdowns in the growth of their profits, assets and capitalisation, and would cut the

volume of lending to non-financial organisations, while their funding base would be expected to contract. The deteriorating financial condition of borrowers amid the credit crunch could intensify the problem of bad debt.

3.2. Non-bank financial institutions

In mid-2008, the ratio of the unit investment funds' net assets, the non-government pension funds' own property and the authorised capital of insurance companies to GDP changed negligibly from the beginning of the year, standing at 2.2%, 1.7% and 0.4% respectively. The effects of the world financial crisis had different impacts on the financial performance of various non-bank financial institutions, due to the specifics of their activities.

In the first nine months of 2008, the number of insurance companies fell 5.0% to 814, and their total authorised capital contracted 2.7% to 153.6 billion rubles¹⁶. One reason for this was the revocation of licences from insurance companies for breach of insurance business requirements, including the minimum authorised capital requirement. The exit of such companies from the market contributed to its financial rehabilitation.

The aggregate value of insurance premiums increased 25.4% in the first nine months of 2008 compared to the same period of 2007 to 711.9 billion rubles, while the aggregate value of insurance claims climbed 29.3% to 434.5 billion rubles. In the second half of 2008, the development of the insurance market decelerated. The aggregate value of insurance premiums grew 11.0 billion rubles slower in the third quarter of the year than in the second quarter. Growth slackened considerably in the segments of personal insurance (9.3 billion rubles) due to cuts in organisations' social spending, and liability insurance (1.1 billion rubles) due to reduced economic activity.

However, the development of the life insurance segment accelerated. The value of insurance premiums in this segment grew 8.3% in the third quarter as compared with the second quarter of 2008 (this growth decelerated 42.2% in the third quarter of 2007 as compared with the second quarter of that year), largely due to the increased investment attractiveness of life insurance as a financial savings instrument. Nevertheless, this segment's influence on the financial possibilities of the insurance market as a whole remains insignificant. Firstly, life insurance in Russia accounts for only 2% of aggregate insurance premiums (in some countries this share reaches 15%), and life insurance premiums are used by insurance companies as a major source of financing for their long-term investments. Secondly, life insurance operations were carried out by an insignificant number of insurance companies: as of October 1, 2008,

the largest 10 insurance organisations accounted for over 70% of insurance premiums.

As the development of some segments of the insurance market slowed, the market's high concentration remained an additional factor supporting its financial stability. The top 10 insurance companies accounted for more than half of insurance premiums in the first nine months of 2008.

According to independent experts' estimates, classic insurance operations grew at an annual rate of 25% in 2008, and accounted for over 90% of the insurance market, excluding compulsory medical insurance. Operations using various tax optimisation schemes for clients are expected to contribute 7-12% in the next few years, and therefore cannot be viewed as posing a threat to the insurance market's financial stability.

Mounting losses in the segment of compulsory civil liability auto insurance (OSAGO) were among the main problems experienced by the insurance market. The loss ratio, calculated as the ratio between insurance claims and insurance premiums, rose from 55.1% as of October 1, 2007 to 57.7% as of October 1, 2008 for this type of insurance. However, according to FISS estimates, only 30 small insurance companies faced the financial troubles. Therefore this situation is unlikely to affect seriously the financial stability of the OSAGO segment and the insurance market as a whole.

As of July 1, 2008, investments in equities accounted for 9% of insurance companies' assets, debt securities made up 18%, and government and municipal securities 4%. The fall in securities prices will affect the profitability of insurance companies' investments. However, lower investment income will not have a considerable impact on the financial results of insurance companies' activities. Firstly, insurance companies derive most of their income from their core activities. Secondly, as compared with banks and unit investment funds, insurance companies are insulated against dramatic declines in investment funding, as clients cannot withdraw insurance premiums on most types of insurance.

Measures taken by the FISS to expose violations in insurance activities helped the market to recover and maintain its stability in 2008. In the first half of 2008, the FISS conducted 110 audits of insurance companies and exposed 105 violations, of which 21% were violations related to Federal Law No. 115-FZ «On Countering the Legalisation (Laundering) of Criminally Obtained Incomes and Financing Terrorism» and 13% were violations related to failure to comply with financial stability and solvency requirements. Following the results of audits, 49 insurance licences were revoked in January-September 2008.

In order to maintain financial stability in the insurance market, the FISS formulated a new procedure

¹⁶ According to data provided by the Federal Insurance Supervision Service (FISS), unless indicated otherwise.

for assessing the solvency of insurance companies. Under this procedure, an insurance company which faced the financial problems must work out a programme for its financial rehabilitation, and receive approval for the programme from the state regulator. The FISS will assess the procedure for implementing measures under this programme, rather than compliance with solvency ratios. Supervision measures therefore prioritise the real financial standing of an insurance company, rather than formal compliance with financial stability requirements.

In early October, the FISS conducted monitoring of the largest 16 insurance companies' assets to analyse the insurance market stability in crisis conditions, and came to the conclusion that the situation in the market did not raise any particular concerns. In response to falling stock market indexes, insurance companies increased the share of cash in their assets, and cut investments in equities. In addition, some large insurance companies have been gradually withdrawing their assets from problem banks, and consolidating them in state-run banks.

According to FISS estimates, the insurance market could have a dramatic fall in insurance premiums (by 25-50%) on certain types of insurance in the results for 2008, particularly in insurance of credit institutions, construction companies, and voluntary auto insurance. The Finance Ministry expects growth in the value of per capita insurance premiums to decline from 24.9% in 2007 to 17.6% in 2008.

Amid falling stock markets, the main indicators of the collective investment market in 2008 were among the lowest in the history.

The net asset value (NAV) of unit investment funds (PIFs) dropped by 11.7%¹⁷ in the third quarter of 2008 as compared with the second quarter. In the first nine months of 2008, this indicator decreased 1.7% (having grown 57.5% in the same period of 2007).

The largest contraction in NAV was registered by retail PIFs, which provide services to a broad range of private investors. The NAV of open-end PIFs fell 42.1%, and interval PIFs 48.2%. The relative stability of the mutual investment market as a whole was attributable to closed-end PIFs, as their NAV increased 11.5% in the first nine months of the year and their share in aggregate NAV grew from 76.0% as of January 1, 2008 to 86.2% as of October 1, 2008.

Net inflow of funds to PIFs declined threefold in the first nine months of 2008 from the same period of 2007, to 76.8 billion rubles. Net capital inflow to closed-end PIFs totalled 87.9 billion rubles (largely to real estate funds), but more than halved as compared with the first nine months of 2007. Retail PIFs, largely open-ended funds, have an aggregate net capital outflow (in contrast to the net capital inflow observed a year earlier). According to expert estimates, Russian private investors

were withdrawing funds from PIFs to transfer it to the less volatile assets, giving preference to bank deposits offering higher yields than PIFs.

The overwhelming majority of open-ended PIFs posted negative yields in the first nine months of the year. According to preliminary estimates, average yields totalled minus 46.8% for equity funds, minus 5.0% for bond funds, and minus 33.7% for mixed investment funds.

New requirements for the asset structure of PIFs were adopted in 2008 to improve the transparency of their investments and broaden their investment potential. In particular, these requirements oblige PIFs to halve the share of their investment in certain non-core assets, and at the same time allow them to form four new categories of funds: rent, credit, commodity market and hedge funds. The units of credit and hedge funds, as well as direct investment and venture (high-risk investment) funds are intended exclusively for qualified investors. The broadening of investment areas creates additional possibilities for manoeuvring stakeholders' funds and receiving extra income.

According to expert estimates, the negative changes observed on the collective investment market in 2008 could reduce the number of management companies, primarily at the expense of companies experiencing financial difficulties. The number of merger and acquisition transactions involving management companies is expected to grow, a process that will increase market concentration and enhance the market's financial stability.

As non-government pension funds exhausted possibilities for their development, largely due to their use of corporate client schemes and failure to win the trust of individuals, growth in their financial potential remained slow. In the first nine months of 2008, the aggregate value of non-government pension funds' own property grew 7.5% (as compared with 9.3% in the same period of 2007), while pension reserves expanded 7.2% (as compared with 9.4%)¹⁸. The largest 20 funds, mainly corporate institutions, concentrated over 90% of the market's aggregate assets. The number of participants in non-government pension funds was almost unchanged at 6.8 million people as of October 1, 2008. The average non-government pension grew 10.8% in the first nine months of the year to 1,245.9 rubles, but remained three times smaller than the government pension.

As in the previous year, pension payments grew faster than pension contributions in 2008. If this trend persists, non-government pension funds may encounter difficulties in fulfilling their financial obligations. Pension payments grew almost twice as fast (28.7%) than pension contributions (16.0%) in the first nine months of 2008, as compared with the same period of

¹⁷ Based on data provided by Cbonds.ru news agency.

¹⁸ Based on data provided by the Federal Financial Markets Service, unless indicated otherwise.

2007. Experts say the persistence of this disproportion suggests the presence of problems in the system of non-government pension provision, and will require non-government pension funds to review more actively their client schemes in favour of retail clients.

As stock indices have plummeted, while corporate securities continue to account for a considerable share in the structure of investment portfolios, non-government pension funds will probably fail to post high yields on pension reserves investments by the results of 2008, which will affect their financial stability. The share of investments in corporate securities increased 9.1% in the first nine months of 2008 to 55.0%, with shares accounting for half of these funds, as was the case at the beginning of the year. The proportion of investments in bonds rose 11.0 percentage points to 25.2%, and investments in bank deposits grew 2.9 percentage points to 11.3%.

The expansion of non-government pension funds' participation in the compulsory pension provision system helped them maintain their financial stability. The aggregate value of pension savings transferred to non-government pension funds for management increased 49.2% in the first nine months of 2008 to 39.9 billion rubles. However, in the third quarter of 2008, the value of pension savings contracted 7.3% for the first time during the entire period of non-government pension funds' participation in the compulsory pension provision system. This contraction can be attributed to revaluation of assets, in which pension savings were invested.

Due to the unfavourable situation on the stock market, almost all management companies holding pension accruals on trust showed negative yields in the first nine months of 2008 (in the same period of 2007, 49 out of 63 investment portfolios held by management companies posted positive yields).

The management company of government-controlled Vnesheconombank (VEB), which accounts for 96.7% of aggregate pension savings, showed investment yields of 1.97% p.a. in the first nine months

of 2008. This figure is lower than in the same period of 2007 (5.64%). However, its positive value shows that the VEB management company managed to maintain the value of pension savings assigned to it for trust, thus fulfilling one of the most important requirements of domestic pension legislation.

Russian legislation allows management companies holding the pension accruals of non-governmental pension funds in trust to invest no more than 70% of these resources in the stock market. Many of them capitalised on this opportunity. According to expert estimates, these investments may depreciate by more than 1.5 times by the end of 2008. However, non-government pension funds and management companies have the possibility to replenish their depreciated pension savings, as accumulated pension payments will start after 2020 when citizens entitled to them reach the eligible age.

* * *

The main factors affecting the financial stability of non-bank financial institutions in 2008 were the reduced demand for insurance products, the outflow of capital from retail PIFs, and losses on pension reserve investments by private management companies. This was attributable to more moderate growth in real household incomes, the decreased activity of credit and non-financial institutions, and the deterioration of the situation on the stock market. Unlike banks, non-banking financial institutions did not receive support from the government's anti-crisis package. Under these circumstances, many of them were forced to review their strategies on the market to maintain their financial stability. Non-bank institutions that do not have sufficient financial potential and are unable to respond promptly to changes in the social and economic situation will probably fail to adapt to the new environment, and will have to leave the market. However, the market of non-bank financial institutions is small as compared with banks, so this situation is unlikely to affect the financial stability of the Russian economy as a whole.

Chapter 4. Analysis of Russian ratings

4.1. Comparative assessment of sovereign ratings of Russia and other transition economies

In 2008, leading international rating agencies reviewed their ratings and rating outlooks on Russia. Rating actions varied, reflecting the rating agencies' opinions on the conditions and trends influencing country risks. In particular, Moody's Investors Service retained Russia's A-2 country ceiling for foreign currency obligations, and in mid-July upgraded the «country ceiling for foreign currency bank deposits» and the «government foreign currency bonds rating» from Baa2 to Baa1, with a stable outlook on all the ratings. However, Standard & Poor's downgraded its foreign currency credit rating from BBB+/A-2 to BBB/A-3, and its rating outlook from stable to negative, while Fitch Ratings changed its outlook for Russia's long-term foreign currency issuer default rating (IDR) from stable to negative (Table 4.1).

In the opinion of analysts from Moody's, Russia and China are outside the area of the highest sovereign/country risk, as they have so far been able to maintain banking liquidity using their own funds. Analysts from Standard & Poor's explained their decision to lower Russia's rating and rating outlook by a decline in the country's international reserves and investment flows. As the crisis gripped the global financial market, Fitch reviewed the sovereign ratings of 17 emerging market economies that had been previously assigned investment-grade ratings. In particular, the ratings of 13 sovereigns were affirmed and four downgraded, and the rating outlooks on seven countries, including Russia, were revised.

In their rating actions on Russia, the international rating agencies proceeded from the fact that despite

the difficulties generated by the crisis on the global financial market, the country had a sufficiently strong balance of payments, a large volume of national welfare funds, and international reserves. Analysts from the rating agencies also pointed to the rapid growth in the volume of corporate debt accumulated by financial and non-financial issuers, the relatively tight timeframes for foreign debt repayments, and lower world energy prices. These factors have been causing a contraction of international reserves and capital inflows, while generating problems with external fund raising.

The rating agencies actively reviewed their ratings and rating outlooks on Central and Eastern European (CEE) countries, the Baltic States, and the Commonwealth of Independent States (CIS) (Table 4.2). The highest ratings – the highest reliability (Moody's) and very high reliability (Standard & Poor's, Fitch Ratings) – continue to be held by Slovakia and Slovenia. The ratings of other CEE countries were downgraded, but remained within the investment-grade category. All three rating agencies revised their rating outlooks on the Baltic States from stable to negative, and lowered their ratings on Latvia and Lithuania, which nevertheless remained at investment-grade level. The CIS countries were assigned ratings ranging from middle-reliability in the investment-grade category (Azerbaijan, Armenia and Kazakhstan) to the category of very strong likelihood of default on obligations (Moldova).

As a result of rating actions by the rating agencies, Russia's ratings stayed within the investment-grade category in 2008, and characterised the country's financial stability as mid-level reliability. The level of Russia's sovereign ratings is comparable with the ratings of CEE countries, and is several notches higher than the ratings assigned to other CIS countries. The rating

Table 4.1

Russia's ratings assigned by international rating agencies

Date	Moody's (long-term rating)				Standard & Poor's		Fitch Ratings	
	Country ceilings		Government bonds		Long-term/ short-term foreign currency rating	Long-term/short- term local currency rating	Long-term/ short-term foreign currency IDR*	Long-term local currency IDR*
	foreign currency bonds	foreign currency bank deposits	foreign currency	local currency				
1.01.02	Ba3	B1	Ba3	Ba2	B+/B	B+/B	B+/B	B
1.01.03	Ba2	Ba3	Ba2	Ba2	BB/B	BB+/B	BB-/B	BB –
1.01.04	Baa3	Ba1	Baa3	Baa3	BB/B	BB+/B	BB+/B	BB+
1.01.05	Baa3	Ba1	Baa3	Baa3	BB+/B	BBB-/A-3	BBB-/F3	BBB –
1.01.06	Baa2	Baa2	Baa2	Baa2	BBB/A-2	BBB+/A-2	BBB-/F-3	BBB
1.01.07	A-2	Baa2	Baa2	Baa2	BBB+/A-2	A-/A-2	BBB+/F-2	BBB+
1.01.08	A-2	Baa2	Baa2	Baa2	BBB+/A-2	A-/A-2	BBB+/F-2	BBB+
1.01.09	A-2	Baa1	Baa1	Baa1	BBB/A-3	BBB+/A-2	BBB+/F-2	BBB+

* IDR – issuer default rating.

Table 4.2

Sovereign ratings assigned to Central and East European and CIS countries (as of January 1, 2009)

Country	Moody's			Standard & Poor's		Fitch Ratings	
	Government's foreign currency/local currency bonds	Long-term foreign currency bonds	Long-term foreign currency bank deposits	Long-term/short-term local currency rating	Long-term/short-term foreign currency rating	Insurer default long-term/short-term foreign currency rating	Insurer default long-term local currency rating
Russia	Baa1/Baa1	A2	Baa1	BBB+/A-2	BBB/A-3	BBB+/F2	BBB+
Bulgaria	Baa3/Baa3	A1	Baa3	BBB/A-3	BBB/A-3	BBB-/F3	BBB
Hungary	A3/A3	Aa1	A3	BBB/A-3	BBB/A-3	BBB/F3	BBB+
Latvia	A3/A3	Aa1	A3	BBB-/A-3	BBB-/A-3	BBB-/F3	BBB
Lithuania	A2/A2	Aa1	A2	BBB+/A-2	BBB+/A-2	A-/F1	A
Macedonia				BBB-/A-3	BB+/B	BB+/B	BB+
Poland	A2/A2	Aa1	A2	A/A-1	A-/A-2	A-/F2	A
Romania	Baa3/Baa3	A1	Baa3	BBB-/A-3	BB+/B	BB+/B	BBB –
Serbia				BB-/B	BB-/B	BB-/B	BB –
Slovakia	A1/A1	Aaa	Aaa	A+/A-1	A+/A-1	A+/F1	A+
Slovenia	Aa2/Aa2	Aaa	Aaa	AA/A-1+	AA/A-1+	AA/F1+	AA
Croatia	Baa3/Baa3	A1	Ba1	BBB+/A-2	BBB/A-3	BBB-/F3	BBB+
Czech Republic	A1/A1	Aa1	A1	A+/A-1	A/A-1	A+/F1	AA –
Estonia	A1/A1	Aa1	A1	A/A-1	A/A-1	A-/F1	A
Azerbaijan	Ba1/Ba1	Baa2	Ba2			BB+/B	BB+
Armenia	Ba2/Ba2	Baa3	Ba3			BB/B	BB
Belarus	B1/B1	Ba2	B2	BB/B	B+/B		
Georgia				B/B	B/B	B+/B	B+
Kazakhstan	Baa2/Baa1	A2	Ba1	BBB/A-3	BBB-/A-3	BBB-/F3	BBB
Moldova	Caa1/Caa1	B3	Caa2			B-/B	B
Turkmenistan	B2/B2	B1	B3				
Ukraine	B1/B1	Ba3	B2	B+/B	B/B	B+/B	B+

actions taken by all three rating agencies on Russia were more positive. In their opinion, the country has relatively strong economic potential.

As the crisis on the global financial market deepened, Standard & Poor's drew up, and published for the first time in March 2008, a new indicator – the Cyclical Sensitivity Index (CSI). The CSI is designed to gauge the relative financial vulnerability of countries to slower growth in the US economy and world economic growth as a whole. The CSI index was calculated for 18 European countries that are outside the euro zone and have credit ratings not higher than A+, including Russia. The index, calculated on the basis of several economic factors, puts the countries under inspection into five clusters, characterising the dependence of their economies on the global financial market. The first group comprises countries with a CSI index of above 2.30; the index ranges between 2.0 and 2.30 for the second group; from 1.35 and 2.0 for the third group; from 0.5 and 1.35 for the fourth group; and below 0.5 for the fifth group.

Standard & Poor's analysts hold the view that crisis-related events on the global financial market affected the economies of Central and Eastern Europe, the Baltic States, the CIS and Russia. The agency's experts note

that some countries in the region show an increasing dependence on the inflow of foreign direct investment, especially into the real estate sector, which is helping them to bridge the large current account deficit in the balance of payments. The most vulnerable countries currently include Georgia, Bulgaria, Montenegro, and to a lesser degree, Turkey and Ukraine. The agency notes in its press release that foreign direct investment flowing into emerging market economies in Central and Eastern Europe is channelled in many cases, with the exception of four countries (Hungary, Poland, the Czech Republic and Slovakia), into sectors that turn out goods for domestic consumption. In the medium-term perspective, these investments increase the current account deficit of the region's countries and make them increasingly dependent on external financing. In terms of the agency's CSI index range, Russia is referred to the third group, which comprises countries with relatively moderate sovereign risk, and corresponds to the BBB credit rating category (mid-level reliability).

Fitch Ratings analysts have developed a ranking of emerging market economies according to their vulnerability to inflationary shocks. The vulnerability index is based on inflation dynamics, the degree of overheating in the domestic economy, monetary conditions, and the

importance of the local government debt market to sovereign issuers. Of the 73 Fitch-rated emerging markets, the most vulnerable economies according to the index are currently: Jamaica (1), Ukraine (2), Kazakhstan (3), Bulgaria (4), Suriname (5), Latvia (6), Lithuania (7), Ghana (8), Vietnam (9), and Sri Lanka (10).

Emerging economies are heavily represented in the upper part of the sovereign vulnerability list, as they show rapid growth of credit to the private sector, large current account deficits, and relatively high short-term sovereign debt. As a result, they are exposed to shrinking capital inflows, including from foreign parent banks. Relatively open trade can also be added to the list of factors increasing the financial vulnerability of these countries.

Russia holds 19th place in the Fitch vulnerability list, with a «no change» outlook for 2009. Russia is also the least exposed among BRIC countries (India ranks 35th, Brazil 40th and China 52nd).

International rating agencies say that a possible intensification of the global financial crisis could prompt them to review their sovereign ratings and rating outlooks. Their rating actions are likely to apply primarily to the Baltic States (as of the end of October 2008, their rating outlooks were negative), Hungary, Kazakhstan, Croatia, Bulgaria, Romania, and Ukraine.

On the whole, rating actions taken by international rating agencies on Russia reflected general trends typical of the majority of neighbouring countries.

4.2. Ratings of sub-sovereign issuers

As of January 1, 2009, ratings had been assigned to 49 regional issuers, as compared with 39 as of the beginning of 2008. All three rating agencies assigned ratings to four constituent parts of the Russian Federation: the cities of Moscow and St Petersburg, and also the Vologda Region and the Republic of Tatarstan. Most issuers (37) have ratings assigned by only one agency.

Regional issuers have speculative-grade ratings ranging from Ba2 (speculative risk) to B- (a high degree of speculative risk).

In 2008, Standard & Poor's and Fitch Ratings upgraded the ratings of nine and seven regional issuers respectively. At the same time, Standard & Poor's lowered its ratings on five issuers, and Fitch Ratings on one issuer. On 19 regional issuers, no rating actions were taken.

The ratings of the Moscow Region were downgraded to SD (Standard & Poor's) and B3 (Moody's). The region's ratings were placed on Negative Watch list, reflecting its weakened capacity to repay debts. The SD (selective default) rating indicates that the borrower selectively defaults on its obligations, i.e. on specific obligations, while continuing to make timely and full payments on other debt obligations.

In the second half of 2008, Moscow's long-term foreign currency credit rating was downgraded to the

mid-level reliability of BBB (Standard & Poor's) with a negative outlook (Standard & Poor's and Fitch Ratings). The outlooks on all of St Petersburg's ratings were lowered from stable to negative (Fitch Ratings). The changes in ratings and/or rating outlooks on Moscow and St Petersburg reflect the dynamics of Russia's sovereign risk, and also the cities' more active operations on the global financial market as compared with other constituent parts of the Russian Federation.

In December 2008, Moody's published the results of its Joint Default Analysis (JDA) – a methodology applied since October 2006 to assess credit risks of regional and local governments (RLGs). This methodology not only analyses the creditworthiness of RLGs, but also assesses the likelihood of extraordinary support from a higher level of government to prevent a default.

The application of JDA methodology to regional and local governments in the EMEA (Europe, the Middle East and Africa) region upgraded 55 ratings, affirmed 85 and downgraded three. In particular, across Russia the ratings of five regional issuers were raised, and four regional issuers were affirmed.

In view of the time lag between rating agencies' responses to economic changes, it can be concluded that further active rating actions on Russian regional issuers are highly probable. There is no single trend in the change of ratings on regional issuers. These changes are linked to specific regions, and depend directly on the dynamics of their financial and budgetary indexes.

4.3. Ratings of financial intermediaries

4.3.1. Ratings of credit institutions

As of the end of 2008, international rating agencies had assigned ratings to 132 credit institutions, as compared with 113 at the beginning of the year, or 11.9% of the total number of operating banks. Twelve credit institutions had ratings from all the three rating agencies, 35 had ratings from two agencies, and 85 had ratings from one agency.

The investment-grade category includes, primarily, credit institutions with government stakes (OAO Bank VTB, OAO Bank VTB North-West, OAO Bank of Moscow, VTB 24 (ZAO), Gazprombank (OAO), OAO Russian Bank for Development (RBD), OAO Russian Agricultural Bank, Sberbank of Russia OAO), and credit institutions with foreign stakes in their capital (Joint Stock Commercial Bank Absolut Bank (ZAO), ZAO Commercial Bank DeltaCredit, ZAO Raiffeisenbank, OAO Joint Stock Commercial Bank Rosbank, OOO Rusfinance Bank, ZAO BSGV, ING Bank (Eurasia) ZAO, and others). In the opinion of international rating agencies, these issuers carry the highest likelihood of support from the government, or from parent companies represented by foreign financial structures and banking holding companies. This can be observed in Fitch's support

ratings on Russian credit institutions ranging from «1» (an extremely high probability of external support) to «3» (the provider of support has the minimum long-term rating floor of BB-). The lowest support rating «5» indicates that support from a higher-level organisation or government is possible, but cannot be relied upon.

Financial intermediary institutions showed the strongest demand for the rating services of international rating agencies in the first half of 2008, when banking activity was relatively stable, as the influence of the global financial market on the Russian financial sector was comparatively moderate.

The most active efforts in 2008 were taken by Moody's, which had assigned ratings to 104 credit institutions by the end of the year. Most of these institutions were banks with speculative-grade ratings (88 as against 16 with investment-grade ratings). Of these banks, 16 credit institutions were assigned long-term foreign currency bank deposits ratings, and also financial strength ratings ranging from Baa1/D (mid-level reliability) for ING Bank (Eurasia) ZAO to C/E (very high likelihood of default on obligations) for OAO Commercial Bank Gazinvestbank. Eventually, the ratings and/or rating outlooks on some of these banks were reviewed and changed. In mid-December, Moody's downgraded long-term foreign currency bank deposits ratings on OAO Commercial Bank Gazinvestbank and OAO Tyumenenergobank from Caa1 to C, which indicates the highest probability of default on obligations. The rating downgrade followed the revocation of licences from these banks on December 4, 2008 by the Bank of Russia.

During 2008 as a whole, Moody's revised its ratings on a large number of Russian credit institutions on many occasions to reflect changes in the financial sector. The largest number of rating actions, relating mainly to outlook downgrades, was observed in the period from mid-August to December.

Fitch Ratings employs a relatively liberal approach in assigning ratings to Russian credit institutions. As of January 1, 2009, Fitch had assigned long-term and short-term IDRs, support and individual ratings to 55 Russian financial intermediaries, most of which (42 banks) corresponded to the speculative risk level. Fitch's ratings on Russian credit institutions range from the investment-grade category A- (reliability above the mid-level) to the highly speculative category CCC (high likelihood of default on obligations). The largest number of rating actions to downgrade outlooks on Russian credit institutions to negative occurred in November 2008. Among the Russian banks with Fitch's Issuer Default Ratings, positive outlooks were not assigned to any credit institution.

By the end of 2008, Standard & Poor's had assigned credit ratings to 32 Russian credit organisations. Six banks received investment-grade ratings, while the

ratings of the other 26 banks were in the category of speculative risk. The ratings assigned by S&P ranged from BBB+ (mid-level of financial stability) to B- (very high likelihood of default on obligations).

Long-term and short-term foreign currency credit ratings were upgraded for nine Russian banks and lowered for six credit institutions in 2008. In September and October, Standard & Poor's downgraded its outlooks for seven and 13 banks respectively.

As the crisis on the global financial market worsened and spread, Fitch Ratings made changes to its methodology of assigning ratings to credit institutions as part of the regular review and update of its rating criteria. In particular, the criteria for the assessment of financial intermediary institutions were adapted to the developments on the global banking market over the past few years. In the procedure of risk management assessment, closer attention was paid to funding and liquidity indexes, as the liquidity shortage amid the crisis could prompt banks to default on their obligations. In addition, the agency introduced its own capital adequacy quantitative ratios. Analysis shows that the assessments by Fitch Ratings are closer to the opinion of experts from Moody's.

In the opinion of rating agencies, the operations of Russian financial intermediary institutions were more unstable in 2008 than in recent years. The rating agencies reacted swiftly to changes in the situation, providing the market with timely assessments of financial stability of Russian credit institutions and the banking system as a whole. In its methodology, Standard & Poor's assesses the risk of problem loans irrespective of the terms and methods of repayment. The agency's analysts predict moderate growth in this indicator in 2009, if there are no sharp changes in the macroeconomic and financial situation.

Moody's analysts believe that many Russian credit institutions failed to take timely measures to adjust their management strategies. In particular, they failed to cut the growing volume of crediting and increase the volume of highly liquid assets.

All three rating agencies emphasize that the regulator is taking considerable efforts to resolve current liquidity problems and to prevent the bankruptcy of credit institutions that play an important role on the Russian banking market.

4.3.2. Ratings of non-banking financial intermediaries

As of January 1, 2009, international rating agencies had assigned ratings to 17 non-banking financial institutions, and to 15 insurance companies.

During the year, five non-banking financial institutions were for the first time assigned credit ratings, ranging from the investment-grade category A3 indicating reliability above the mid-level (OAO Housing

Mortgage Lending Agency) to the highly speculative selective default category (OAO Mosobltrustinvest). Ratings were upgraded for five and downgraded for three non-financial financial organisations.

All three agencies changed their ratings on Vnesheconombank. Its ratings were raised by Moody's and Standard & Poor's within the investment-grade category, while Fitch Ratings lowered its outlook on the bank.

Ratings were assigned to two insurance companies – OAO Alfa Strakhovanie (Fitch Ratings) and OAO Sogaz (Standard & Poor's and Fitch Ratings).

Negative outlooks were assigned to the overwhelming majority of non-banking financial intermediaries in 2008:

a) issuers that obtained ratings for the first time – OAO Finans Leasing (Moody's), OAO Mortgage Corporation of the Moscow Region and OOO Element Leasing (Standard & Poor's);

b) rated issuers – OAO Financial Leasing Company (Moody's), OOO Veles Capital Investment Company and OOO Uralsib Leasing Company, with the rating outlook changed from positive to negative; Vnesheconombank, OAO VTB-Leasing Finance, Renaissance Capital Holdings Ltd. and ZAO Troika Dialog Investment Company, with the rating outlook changed from stable to negative (Standard & Poor's). The long-term and short-term Issuer Default Rating of Renaissance Capital Holdings Ltd. was placed on Watch Negative (Fitch Ratings).

The ratings and rating outlooks on non-banking financial intermediaries are largely consistent with the rating dynamics of the Russian Federation and credit institutions, and reflect the growing pressure of the deteriorating business environment on the quality of non-banking intermediaries' assets, as well as their funding base and liquidity. The support of such companies by parent structures, along with their financial flexibility and brand awareness, are expected to help them overcome difficulties on the market and ensure timely debt repayment.

4.4. Ratings of non-financial organisations

As of January 1, 2009, international rating agencies had assigned ratings to 82 non-financial organisations as compared with 79 as of the beginning of 2008. Of these, 13 issuers had ratings from all three rating agencies, while 34 had ratings from two agencies and 35 from one agency. Changes to the ratings of Russian non-financial organisations were mixed in 2008. The ratings of 18 companies were upgraded, while those of 11 non-financial organisations were downgraded. In the first half of 2008, there was a general improvement in rating agencies' opinions on the creditworthiness of certain major Russian companies, mainly in the oil and gas sector. In particular, ratings were upgraded for the following 14

issuers: OAO Gazprom, OAO Gazprom Neft, OAO Joint Stock Company Transneftproduct, OAO Oil Company Rosneft, OAO Tatneft, OAO Mineral and Chemical Company EvroChim, OAO NOVATEK, Golden Telecom, Inc., OAG Megafon, OAO Svyazinvestneftekhim, ZAO Joint Stock Company Alrosa, OAO Severstal, OAO FGC UES, and Vodokanal of the St Petersburg State Unitary Enterprise. The increased activity of corporate issuers on the market of external borrowings in the first half of 2008 ensured stable demand for the services of rating agencies. As a result, first-time ratings were assigned to 15 companies engaged in various activities, in particular the real estate development, industrial production, oil and gas, telecommunications, information and energy sectors.

In contrast with financial intermediary organisations, non-financial corporate issuers depend on consumer demand, the cost of energy and fossil fuels, and also on the continued financing of their production cycle. At the same time, some of them are facing competition from foreign companies in similar segments of the market. The decline in Russia's industrial output resulting from the crisis has affected the financial standing of companies in various sectors. Typical problems facing most issuers in the second half of 2008 were: substantially decreased economic activity, difficult access to capital markets, and obstacles in loan refinancing. As these trends developed, the ratings of 11 Russian non-financial organisations, mainly companies engaged in real estate development, machine-building, trade, intermediary, information and transport services, were downgraded. Different rating actions were taken on chemical and oil and gas enterprises. The creditworthiness of issuers engaged in water supply, and also of some metals and telecommunications companies, slightly improved in 2008.

Another trend that developed in the second half of 2008 was the waiving of ratings by some Russian issuers. Ratings were withdrawn from 12 companies, including Golden Telecom Inc., which had its ratings withdrawn by two agencies. Rating analysis was most frequently terminated on the initiative of company managements (seven issuers) or due to corporate reorganisation (three issuers). In one instance (Severnaya Verf ship-building plant), the rating was recalled due to the issuer's failure to provide timely consolidated financial statements and to give full disclosures on future operations. At the time of their withdrawal, the ratings of most companies that gave up cooperation with rating agencies either ranged from CC to CCC+ (OAO RBC Information Systems, OAO Caustic, OAO Plastcard and Maretex) or corresponded to the slightly higher B category (OAO Chelyabinsk Pipe Rolling Plant, Avenue Osteuropa GmbH, OAO Otechestvennie Lekarstva).

Moody's recalled ratings from four companies (of which three were withdrawn from September to

December), Standard & Poor's from seven companies (of which six were recalled in the third quarter) and Fitch Ratings from two companies (in December 2008).

In terms of the level of ratings assigned in 2008, the rating agencies were most positive in their judgements on the financial stability of oil and gas companies, whose ratings were closely related to Russia's sovereign ratings. A relatively strong financial performance in the first half of 2008 contributed to the rating upgrade for OAO Gazprom Neft, and also to the assignment of an investment-grade rating to OAO Tatneft (Moody's). Reverse trends were observed in December, following which Moody's and Standard & Poor's lowered their ratings on JSC Transneft and also the rating outlooks on a number of companies. As of January 1, 2009, negative outlooks were assigned to OAO JSC Transneft and OAO Gazprom (Standard & Poor's), and also to OAO TNK-BP Holding (Fitch Ratings). The outlooks on six oil and gas companies were downgraded from positive to stable.

The long-term foreign currency credit rating assigned by Standard & Poor's to Alrosa, which holds a considerable share of the global diamond market, was raised to investment grade in early 2008. However, it was lowered to the previous level in November with a negative outlook, after the issuer's subsidiary Alrosa Investment Group announced the acquisition of a stake in the authorised capital of KIT Finance Investment Bank, which was experiencing financial difficulties.

Demand for metal products underwent a global decline in the fourth quarter of 2008. As a result, Russian steel and metallurgical companies were forced to reduce production, and their ratings went down. In May, Moody's assigned a B1 long-term foreign currency credit rating to the Chelyabinsk Pipe Rolling Plant, but recalled the company's ratings in October on the request of the company's management. In October, Standard & Poor's lowered its ratings on steel pipe producer TMK, and in the fourth quarter downgraded its rating outlooks on Mastercraft Ltd., OAO MMK and OAO Severstal, while keeping their ratings unchanged.

In the machine-building industry, Moody's lowered the ratings of the Irkut aircraft-building corporation from Ba1 to Ba2 and the outlook on the ratings of ZAO Sukhoi Aircraft Holding Company from stable to negative, which was evidence of the relatively weak financial performance of the sector's companies amid the crisis.

The ratings of Russian electric power companies are on average two notches lower than the investment-grade level. The activities of electric power companies are linked with high economic risk, and depend on coal deliveries and the volatility of energy prices. In 2008, Moody's and Standard & Poor's lowered the long-term credit ratings of OAO Irkutskenergo. All three rating agencies lowered their rating outlooks on four companies that registered a considerable deterioration in liquidity in the fourth quarter. The world's largest electric

power monopoly, RAO UES of Russia, was reorganised in 2008 through fragmentation and the spin-off of assets corresponding to various areas of its activities. As a result, the company's ratings were recalled. In the opinion of rating agencies, the electric power sector in Russia became less exposed to liquidity factors than in the West, following the completion of the sector's reform.

Chemical producers demonstrated their relatively heavy dependence on the market situation amid the crisis. The liquidity and profitability indicators of OAO Kazanorgsintez deteriorated. As a result, the company's Issuer Default Rating was lowered from B to CCC (Fitch Ratings) and the long-term foreign currency credit rating from B- to CCC+ (Standard & Poor's). The ratings of OAO Mineral and Chemical Company Evrochim, assigned by Standard & Poor's and Fitch Ratings, were upgraded from BB- to BB due to the company's strong financial results. The Issuer Default Rating of OAO Svyazinvestneftekhim was raised from BB+ to BBB-investment grade following a similar IDR upgrade for the Republic of Tatarstan in April 2008.

Developers and construction companies were among the most vulnerable businesses amid the crisis. In the first half of the year, this group of issuers demonstrated strong demand for the services of rating agencies. Ratings were assigned to three companies: OAO Kamskaya Dolina (B-, Standard & Poor's), Avenue Osteuropa GmbH (B3, Moody's) and OAO OPIN (B1, Moody's and B, Fitch Ratings). Most companies in this sector had negative rating outlooks by the end of 2008. Rating actions on these companies were either rating downgrades (OAO Sistema-Gals, PIK Group of Companies) or expectations of further rating revisions (OAO Sistema-Gals, OOO Mirax-Group, Avenue Osteuropa GmbH).

The largest number of ratings (17) were assigned to telecommunications companies. During 2008, these ratings were mainly upgraded (OAO Megafon, Golden Telecom, Inc., OAO Comstar-UTS, OAO MGTS (Moscow City Telephone Network), OAO MTS, and OAO Rostelecom). However, in the fourth quarter rating outlooks were downgraded for six companies, in line with general trends on the Russian telecommunications market.

Trade and intermediary companies, which are particularly sensitive to the accessibility of funding sources, demonstrated high vulnerability to the changing external environment in 2008. The financial standing of most issuers in this group was determined by trends observed in related sectors. In particular, falling demand for the products of metallurgical enterprises weakened the creditworthiness of metals distributor Maretex (the rating from Standard & Poor's was downgraded from B- to CCC+). Ratings were lowered by one notch for OAO Sunway Group and OOO JFC International (Standard &

Poor's) and auto dealer Rolf (Moody's). However, the rating of OAO Kopeika Trading House was upgraded from CCC- to CCC+ (Standard & Poor's) due to the credit agency's improved opinion on the company's potential to receive support from its major shareholder.

The ratings and outlooks on companies engaged in food production or food imports were lowered in 2008 for various reasons, in particular as a result of the deteriorated economic situation and weaker data on activities (OAO Wimm-Bill-Dann Food Company), and also due to defaults on debt obligations (OAO Nutrinvestholding; Standard & Poor's downgraded its long-term foreign currency credit rating from B to SD). The ratings of natural juice producer OAO Lebedyansky was placed on Watch Positive after the company announced the sale of a controlling stake to PepsiCo and Pepsi Bottling Group.

Among issuers in the transport sector, the most significant changes were to the ratings of Mostransavto Passenger Motor Transportation Enterprise of the Moscow Region. At first, these ratings were lowered from CCC+ to SD (Standard & Poor's) due to the company's failure to repay current debts, and then upgraded to CC after debt repayment.

The rating actions taken by the international rating agencies in the first half of 2008 reflected trends initially observed in 2007, and were related to the upgrade of ratings on companies characterised by stable and consistent development and the improvement of their financial and operational indicators. As the crisis intensified in the second half of 2008, both current and projected assessments of the financial standing of Russian issuers were lowered. Under such circumstances,

ratings were downgraded primarily on issuers that were especially vulnerable amid crisis conditions due to their insufficient financial flexibility and inability to find sources of financing for current activities.

The outlooks of international rating agencies suggest that the ratings of some Russian issuers could be lowered further in 2009, since even if there is a gradual stabilisation of the economy, ratings will only rebound to their pre-crisis levels with a considerable time lag.

Ratings assigned to issuers with varying credit capacities are a key indicator of independent assessments of their financial stability for foreign and domestic financial market participants. The large number of rating actions taken by leading international rating agencies in 2008 reflects changes in the status of Russian issuers due to increased instability on the global financial market. Not all the issuers were satisfied with the international ratings and rating outlooks assigned to them, which prompted a recall of these ratings on the request of the issuers. In view of this, there is a growing need for Russian experts to provide assessments of their financial stability, which would enable a comparative analysis of Russian issuers' ratings. In this situation, the development of the national rating industry is an instrumentally positive factor. In December 2008, the Bank of Russia took a decision to recognize the ratings of Russian rating agencies RusRating (not lower than A-), AK&M (not lower than A) and Expert RA (not lower than B++) to assess the creditworthiness of banks to extend unsecured loans. This decision will give an additional stimulus to the development of the rating services market in Russia.

Appendices

Appendix 1

Timeline of key events in the Russian and global financial markets and anti-crisis measures in 2008

Date	Event
January 22, 2008	The main stock indexes in the BRIC countries, Germany and Japan fall 7.4-12.0% over two days with India and China leading the decline
February 1, 2008	The Agency for Housing Mortgage Lending tightens terms for the repurchase of mortgage loans
February 4, 2008	The Bank of Russia raises the refinancing rate by 0.25 percentage points to 10.25% p.a. The interest rates on Bank of Russia credit and deposit operations with credit institutions, and currency swap and repo operations, are also raised by 0.25 percentage points
February 4, 2008	ZAO VTB 24 announces an increase in the maximum mortgage crediting term to 50 years
February 25, 2008	Russian Government Resolution No. 76, dated February 15, 2008, "On the Placement of Temporarily Excess Funds of the State Corporation – Fund of Assistance to the Reformation of the Housing and Utilities Sector" is published
March 1, 2008	Required reserve ratios for Russian banks' obligations to non-resident banks are raised by 1 percentage point to 5.5%, and for other obligations by 0.5 percentage points to 4.5-5.0%
March 3, 2008	ZAO UniCredit Bank raises rates on foreign currency-denominated mortgage loans by 0.6-1.6 percentage points
March 6, 2008	The Bank of Russia revokes the licence of ZAO Rybkhobzbank over its inability to meet creditors' claims
March 10, 2008	ZAO Raiffeisenbank raises interest rates on loans secured by real estate assets by 0.5-1.0 percentage points
March 11, 2008	The international rating agency Standard & Poor's raises its outlook on Russia's long-term ratings from stable to positive
March 14, 2008	The European Union summit devoted to the global financial situation comes to an end. Summit participants decide to tighten financial market regulation
March 16, 2008	US investment bank Bear Stearns, which has seen its financial standing deteriorate dramatically, is taken over by JP Morgan Chase with the financial support of the US Federal Reserve
March 19, 2008	The Bank of Russia issues Letter No. 24-T, dated March 13, 2008, "On Raising the Efficiency of Work to Prevent Doubtful Operations," requiring more effective financial control over importers
March 24, 2008	OAQ Sberbank of Russia lowers interest rates on mortgage loans by 0.5-1.25 percentage points
March 27, 2008	The Consultative Council for Monetary Policy, Banking Regulation and Supervision under the Bank of Russia Chairman holds its first session at the Bank of Russia
March 31, 2008	The European Central Bank announces a new 50 billion-euro intervention on the credit market and the extension of lending terms
April 5, 2008	Russian Government Resolution No. 227, dated March 29, 2008, "On the Procedure for the Placement of Federal Budget Funds on Bank Deposits" comes into force
April 12, 2008	Federal Law No. 46-FZ, dated April 8, 2008, "On Amending Article 30 of the Federal Law 'On Banks and Banking Activities'" is published. The law obliges credit institutions to disclose the full cost of loans to retail borrowers
April 21, 2008	The Bank of England launches an unprecedented programme worth 50 billion British pounds to provide emergency aid to private banks
April 28, 2008	The Bank of Russia raises the refinancing rate by 0.25 percentage points to 10.5% p.a. The interest rates on Bank of Russia credit and deposit operations with credit institutions, currency swap and repo operations are also raised by 0.25 percentage points
May 14, 2008	In addition to its operations on the domestic foreign exchange market to restrict intraday fluctuations in the value of the bi-currency basket, the Bank of Russia launches regular foreign exchange interventions
May 15, 2008	The Agency for Housing Mortgage Lending tightens the terms for the disbursement, monitoring and repurchase of mortgage loans
May 22, 2008	Marta Finance announces a technical default on its bonds worth 752 million rubles
June 2, 2008	Following the results of the IMF mission's work in Moscow, its head, Paul Thomsen, says Russia will not be seriously affected by the turbulence on global financial markets, and world oil prices will stay at a relatively high level
June 10, 2008	The Bank of Russia raises the refinancing rate by 0.25 percentage points to 10.75% p.a. Interest rates on Bank of Russia credit and deposit operations with credit institutions, and currency swap and repo operations, are also raised by 0.25 percentage points
June 12, 2008	Bank of Russia Ordinance No. 2008-U, dated May 13, 2008, "On the Procedure for Making Calculations and Bringing the Full Cost of Loans to the Attention of Retail Borrowers" comes into force
June 12, 2008	Minnesco-Novosibirsk woodworking company defaults on its obligations worth 34 million rubles
June 12, 2008	OAQ Sberbank of Russia raises interest rates on ruble-denominated mortgage loans by 1.25-1.75 percentage points. Interest rates on ruble mortgage loans are also raised by OAQ Uralsib (by 0.3-0.9 percentage points) and ZAO Commercial Bank DeltaCredit (by 0.5 percentage points)
June 12, 2008	OAQ Alfa-Bank lowers interest rates on ruble mortgage loans by 0.5-0.7 percentage points and OAQ URSA Bank by 2.0 percentage points
June 14, 2008	A meeting of G-8 finance ministers comes to an end. The meeting addressed the global financial crisis and measures to overcome it
June 16, 2008	Minnesco-Novosibirsk defaults on its obligations to repurchase bonds worth 435 million rubles
June 21, 2008	Hyperfinance LLC fails to place bonds worth 5 billion rubles at par value
June 23, 2008	West Siberian Resources Invest fails to place bonds worth 5 billion rubles at par value
July 1, 2008	Required reserve ratios for Russian banks' obligations to non-resident banks are raised by 1.5 percentage points to 7.0%, and for other obligations by 0.5 percentage points to 5.0-5.5%
July 10, 2008	US mortgage bank IndyMac Federal Bank is declared insolvent
July 11, 2008	The Urals oil blend price hits a record high of \$140 per barrel

Date	Event
July 14, 2008	The Bank of Russia raises the refinancing rate by 0.25 percentage points to 11.00% p.a. The interest rates on Bank of Russia credit and deposit operations with credit institutions, and currency swap and repo operations, are also raised by 0.25 percentage points
July 16, 2008	The international rating agency Moody's Investors Service upgrades Russia's credit rating and country ceiling for foreign currency deposits from Baa2 to Baa1 with a positive outlook
July 17, 2008	OAO Alfa-Bank lowers rates on certain mortgage programmes by 1.0-3.5 percentage points. In addition, the Bank raises the maximum size of its loans, and lowers requirements for down-payments on loans
July 17, 2008	OAO OTP Bank raises the maximum size of mortgage loans
July 28, 2008	OAO Gazprombank suspends its initial public offering (IPO) on the stock exchange
July 30, 2008	Mail.ru suspends its IPO on the London Stock Exchange due to the unfavourable situation on the world capital market
August 2, 2008	Marta Finance defaults on bonds worth 155 million rubles
August 7, 2008	Derzhava-Finance defaults on its obligations to repurchase bonds worth 199 million rubles
August 18, 2008	After payments to the Reserve Fund, its value reaches the 2008 designated volume of 3.5 trillion rubles. Other oil and gas revenues will be paid into the National Welfare Fund
August 21, 2008	West Siberian Resources Invest fails to place bonds worth 5 billion rubles at par value
August 25, 2008	OAO Bank Vozrozhdenie and VK-Invest fail to place bond issues (both bond issues have par value of 5 billion rubles)
August 27, 2008	Moscow Efes brewery fails to place bonds worth 6 billion rubles at par value
August 28, 2008	The Bank of Russia revokes the licence of Moscow-based Premier Joint Stock Commercial Bank over its failure to meet creditors' claims
September 1, 2008	The Bank of Russia switches to a daily practice of setting the maximum size of funds provided at overnight repo morning auctions
September 1, 2008	Required reserve ratios for Russian banks' obligations to non-resident banks are raised by 1.5 percentage points to 8.5% and for other obligations by 0.5 percentage points to 5.5-6.0%
September 1, 2008	ZAO VTB 24 raises its interest rates on mortgage loans by 0.5 percentage points
September 4, 2008	OAO Sberbank of Russia and OAO VTB 24 raise interest rates on loans to corporate borrowers
September 4, 2008	SZLK-Finance defaults on coupon payments and its obligation to repurchase bonds (defaults on obligations worth over 1 billion rubles)
September 7, 2008	The largest US mortgage agencies FNMA (Fannie Mae) and FHLMC (Freddie Mac) are nationalised after their financial standing deteriorates dramatically
September 10, 2008	Bank of Russia issues Letter No. 111-T, dated September 3, 2008, "On Raising the Efficiency of Work to Prevent Doubtful Operations of Credit Institutions' Clients," recommending improved control over transactions used for illegal export of capital from Russia
September 15, 2008	The Agency for Housing Mortgage Lending tightens terms for the disbursement, monitoring and repurchase of mortgage loans, and makes its refinancing rate dependent on the market situation
September 16, 2008	Lehman Brothers Holdings Inc., one of the largest US investment banks, files a court petition for bankruptcy and protection against creditors
September 16, 2008	The financial standing of American International Group, Inc. (AIG), the world's largest insurance company, and Merrill Lynch & Co., Inc., a major US investment bank, deteriorates sharply. Merrill Lynch & Co., Inc. is taken over by Bank of America Corporation, while AIG is nationalized
September 16, 2008	Share prices plummet on the Russian stock market. The MICEX index closes 17% down and the RTS index 11% down. Trading on the MICEX and the RTS is suspended over the dramatic fall in share prices
September 17, 2008	Major stock indexes in advanced economies fall by as much as 8.0% over three days. Most stock indexes in the BRIC countries are down 7.2-24.9%
September 17, 2008	KAMAZ-Finance fails to place bonds worth 6.5 billion rubles at par value
September 17, 2008	The Finance Ministry of Russia asks system-building banks (OAO Sberbank of Russia, OAO VTB and OAO Gazprombank) to take federal budget funds on deposits for terms of three or more months to maintain liquidity of the Russian banking system
September 17, 2008	Trading in shares on the MICEX and the RTS is suspended until September 19
September 18, 2008	The Federal Financial Markets Service issues an instruction for Russian stock market participants prohibiting "short" sales of securities, margin transactions, and also the sale of securities acquired in margin deals
September 18, 2008	An extraordinary meeting of the president of Russia with government members and the chairman of the Bank of Russia decides to take a number of measures to stabilise the economic situation (to lower export duties on crude oil and reduce required reserve ratios)
September 18, 2008	The Bank of Russia lowers required reserve ratios on all categories of liabilities by 4 percentage points
September 18, 2008	The Bank of Russia lowers rates by 0.5-1.0 percentage points on its main operations, to provide liquidity to credit institutions
September 19, 2008	The international rating agency Standard & Poor's downgrades Russia's sovereign credit rating outlook from positive to stable
September 19, 2008	ZAO VTB 24, which previously extended mortgage loans without down-payment, sets a minimum mortgage down-payment of 20% of the purchase price
September 22, 2008	OAO Russian Railways delays the IPO of its subsidiaries Refservice and Transcontainer
September 23, 2008	The Deposit Insurance Agency cuts the percentage of contributions paid by banks each quarter into the mandatory deposit insurance fund from 0.13% to 0.10% of the calculation base
September 23, 2008	OAO Svyaz-Bank, a joint stock commercial bank hit by financial difficulties, is taken over by Vnesheconombank at a symbolic price of 100 rubles (for 90% of the bank's shares). The Bank of Russia places a deposit of 60 billion rubles with Vnesheconombank
September 29, 2008	The financial standing of major world banks deteriorates sharply. The banks Bradford & Bingley Plc (Great Britain) and Fortis (Belgium) are nationalised. Wachovia Corp., one of the largest US investment banks, is taken over by Citigroup Inc.
September 30, 2008	Trading on the Russian stock exchanges is suspended for one day after sharp fluctuations of share prices
October 1, 2008	OAO Gazprombank suspends plans to raise a syndicated loan, due to the unfavourable situation on global capital markets

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Date	Event
October 1, 2008	OAQ Sberbank of Russia raises interest rates on household credit programmes by 3.75 percentage points and consumer and specialised credits by 0.5-1.5 percentage points
October 1, 2008	OAQ Russian Railways delays the planned placement of Eurobonds, and as a result cuts its investment programme for 2009-2010
October 1, 2008	OAQ Sberbank of Russia raises interest rates on all types of credits to individuals by 0.75-1.5 percentage points
October 1, 2008	ZAO Raiffeisenbank, JSCB Absolut Bank (ZAO) and OAQ Alfa-Bank suspend their mortgage loan programmes on the primary market due to increased risk of the loss of collateral
October 2, 2008	Metalloinvest suspends an IPO due to the unfavourable market situation
October 3, 2008	Major stock indexes fall 12.0-16.7% over five days in Russia, Brazil and the US
October 3, 2008	The RTS stock exchange suspends trading three times in one day due to sharp volatility in share prices
October 3, 2008	US President George Bush signs the Emergency Economic Stabilization Act of 2008, authorising the government to spend up to \$700 billion to bail out the national banking system
October 3, 2008	OAQ Alfa-Bank raises mortgage loan interest rates by 4.0-4.5 percentage points
October 4, 2008	ZAO VTB 24 announces a suspension of the acceptance of applications for loans to buy new housing. In addition, the bank raises interest rates on other mortgage loans by 0.4-0.7 percentage points
October 6, 2008	Russia's largest internet search engine Yandex suspends an IPO at Nasdaq due to the unfavourable situation on the global capital market
October 8, 2008	Following instructions from the Federal Financial Markets Service, trading on Russia's stock exchanges is suspended until October 10
October 8, 2008	The struggling KIT Finance Investment Bank (ZAO) is acquired by investment group Alrosa and OAQ RZHD for a symbolic price of 100 rubles (for 90% of the bank's shares)
October 9, 2008	A group of central banks (the ECB, Federal Reserve, and the central banks of Great Britain, Canada, Switzerland, Sweden and Austria) lower their discount rates by 0.5 percentage points in a coordinated action
October 9, 2008	Vegetable oils producer Ruskiye Masla defaults on an obligation to repurchase its bonds worth 0.99 billion rubles
October 10, 2008	The Bank of Russia publishes Letter No. 123-T, dated September 30, 2008, which temporarily eases the requirements for registration of individuals' non-cash transfers
October 10, 2008	Smooth declines in oil prices are followed by a steep drop. In the preceding 10 trading days, the price of Urals blend fell 28%
October 10, 2008	Over five days, major world stock indexes (including Russian indexes) plunge 12.8-24.3%, with the decline led by Japan
October 10, 2008	The MICEX and the RTS suspend trading in shares until October 13
October 10, 2008	Agro-industrial company Arkada defaults on a obligation to repurchase its bonds worth 1.16 billion rubles
October 11, 2008	A meeting of the G-8 finance ministers agrees a package of measures to prevent destabilisation of the global financial system (in particular, refinancing and support for secondary markets)
October 12, 2008	A Paris meeting of leaders from 15 eurozone countries approves a bank bailout programmes worth a total of 1.87 trillion euros (\$2.55 trillion)
October 13, 2008	Royal Bank of Scotland plc (Great Britain) is nationalised after deterioration of its financial standing
October 14, 2008	Federal Law No. 174-FZ, dated October 13, 2008, "On Amending Article 11 of the Federal Law 'On Insuring Household Deposits with Russian Banks'" comes into force to increase maximum insurance compensation to depositors to 700,000 rubles
October 14, 2008	Federal Law No. 171-FZ, dated October 13, 2008, "On Amending Article 46 of the Federal Law 'On the Central Bank of the Russian Federation (Bank of Russia)'" comes into force, empowering the Bank of Russia to extend unsecured loans for terms of up to six months to Russian credit institutions
October 14, 2008	Federal Law No. 173-FZ, dated October 13, 2008, "On Additional Measures to Support the Financial System of the Russian Federation" comes into force, allowing the provision of loans to Russian companies and banks in the amount of up to \$50 billion and 0.95 trillion rubles
October 14, 2008	Federal Law No. 172-FZ, dated October 13, 2008, "On Amending Article 174, Part II of the Russian Federation Tax Code" comes into force to establish the monthly periodicity of VAT payments
October 15, 2008	The Bank of Russia publishes Letter No. 128-T, dated October 9, 2008, "On the List of Organisations," which expands the list of institutions whose promissory notes may be accepted as collateral for Bank of Russia loans
October 15, 2008	The Bank of Russia lowers required reserve ratios on all categories of liabilities to 0.5%
October 15, 2008	The Bank of Russia cuts rates on some operations to provide liquidity to credit institutions by 0.5-1.0 percentage points, and also resumes repo operations for a term of 90 days
October 15, 2008	The Bank of Russia raises interest rates on credit institutions' deposits with the Bank of Russia by 0.5 percentage points to 4.25-4.75% p.a.
October 16, 2008	The Bank of Russia revokes the licence of commercial bank Unitbank (ZAO) over the bank's failure to meet creditors' claims
October 17, 2008	Bank of Russia Regulation No. 323-P, dated October 16, 2008, "On the Provision of Unsecured Loans by the Bank of Russia to Credit Institutions" comes into force
October 17, 2008	Bank of Russia Ordinance No. 2084-U, dated October 3, 2008, "On Amending Bank of Russia Regulation No. 312-P, Dated November 12, 2007, 'On the Procedure for the Bank of Russia to Extend Asset-Backed Loans to Credit Institutions'" comes into force, expanding the group of assets accepted as collateral
October 17, 2008	The Bank of Russia lowers requirements for the ratings of the issuers of bonds included in the Bank of Russia Lombard list
October 17, 2008	Russian Presidential Decree No. 1489, dated October 17, 2008, "On the Russian President's Council for the Development of the Russian Financial Market" comes into force
October 20, 2008	The Bank of Russia caps the volume of funds provided to credit institutions in Bank of Russia currency swap operations
October 20, 2008	X5 Retail Group announces planned personnel cuts

Date	Event
October 21, 2008	Russian Government Resolution No. 766, dated October 15, 2008 comes into force, allowing the government to invest money from the National Welfare Fund on the domestic market
October 21, 2008	A meeting of CIS finance ministers reaches an agreement on coordinated monetary and tax policies
October 21, 2008	The Russian Government allocates 175 billion rubles to Vnesheconombank from the National Welfare Fund to invest in the instruments of the Russian financial market
October 21, 2008	ZAO Globexbank, hit by financial difficulties, is acquired by Vnesheconombank for a symbolic price of 5,000 rubles (for 99% of the bank's shares). The Bank of Russia places a deposit of \$2 billion with Vnesheconombank
October 21, 2008	OAO Sberbank of Russia publishes its development strategy until 2014, envisaging personnel cuts of 20-30%
October 22, 2008	Bank of Russia publishes Order No. OD-728, dated October 17, 2008, increasing adjustment ratios used to calculate the value of assets accepted by the Bank of Russia as collateral on loans extended to credit institutions
October 22, 2008	The struggling Rossiysky Capital joint stock commercial bank (OAO) is acquired by OAO National Reserve Bank (NRBank) for a symbolic price of 5,000 rubles (for 99% of the bank's shares)
October 23, 2008	Vnesheconombank signs agreements with ZAO VTB 24 and OAO Russian Agricultural Bank on granting them 11-year subordinated loans worth 200 billion rubles and 25 billion rubles respectively at a rate of 8% p.a.
October 23, 2008	The Bank of Russia revokes the licence of ZAO Russian Banking House over the bank's failure to meet creditors' claims
October 23, 2008	The Bank of Russia raises interest rates on credit institutions' deposits with the Bank of Russia by 0.5 percentage points to 4.75-5.25% p.a.
October 24, 2008	Over three days, major stock indexes in developed economies fall 10.1-17.8%. Over the same period, most stock indexes in the BRIC countries are down 18.6-23.4%, with the decline led by the Russian market. US and China stock indexes lose no more than 8.2%
October 24, 2008	The RTS and MICEX suspend trading in shares until October 28
October 27, 2008	Bank of Russia Ordinance No. 2104-U, dated October 23, 2008 comes into force, simplifying the procedure for the provision of loans to credit institutions that are parties to the deposit insurance system
October 28, 2008	Federal Law No. 176-FZ, dated October 27, 2008 comes into force, allowing the Bank of Russia to conduct exchange transactions with corporate securities
October 28, 2008	Federal Law No. 175-FZ, dated October 27, 2008, "On Additional Measures to Strengthen the Stability of the Banking System Until December 31, 2011" comes into force, authorizing the Bank of Russia to apply measures to prevent the bankruptcy of banks
October 28, 2008	The international rating agency Standard & Poor's downgrades the ratings of the Moscow Region and companies in the Moscow Region from BB to B-
October 28, 2008	GAZ Group announces the halt of its main assembly lines over declining demand
October 28, 2008	Struggling OAO Sobinbank and its subsidiary banks — OAO Bank Finservis (49% of its shares held by Sobinbank) and OOO Russian Mortgage Bank (100% of its shares held by Sobinbank) are taken over by ZAO Gazenergoprombank. The Central Bank of Russia places a deposit of 13.7 billion rubles with ZAO Gazenergoprombank
October 28, 2008	Oil producer Lukoil announces plans to cut its 2009 investment programme by \$7 billion
October 29, 2008	OAO VEK Bank amid considerable financial difficulties, is placed under control of the Deposit Insurance Agency. The Central Bank of Russia transfers 8 billion rubles to the Deposit Insurance Agency for the bank's rehabilitation
October 30, 2008	A meeting of the council of the Shanghai Cooperation Organisation (SCO) heads of government discusses possible SCO coordinated actions to deal with the global financial crisis
October 31, 2008	Vnesheconombank starts to refinance Russian companies' liabilities to foreign financial institutions, with over \$6 billion going to a range of businesses
November 1, 2008	The Bank of Russia publishes Order No. OD-775, dated October 30, 2008, expanding the range of assets used as collateral for Bank of Russia loans
November 1, 2008	Bank of Russia Ordinance No. 2107-U, dated October 29, 2008, "On Assessing the Financial Standing of Banks to Decide on the Expediency of Participation of the Deposit Insurance Agency in Measures to Prevent their Bankruptcy" comes into force
November 1, 2008	OAO Sberbank of Russia cuts the term of emergency loans from five to three years, and their maximum value from 750,000 to 500,000 rubles. Also, Sberbank's Srednerussky Bank tightens mortgage credit terms, raising requirements for borrowers' minimum down-payment and minimum age
November 1, 2008	Marta holding declares a default on \$100 million Eurobonds
November 5, 2008	The Bank of Russia Board of Directors approves a standard Agreement between the Bank of Russia and a credit institution on the Bank of Russia's compensation for a part of the losses (expenses) incurred by the credit institution in transactions with other credit institutions
November 5, 2008	The Bank of Russia increases the maximum term of unsecured loans to six months
November 6, 2008	The Bank of Russia signs an agreement with OAO MDM-Bank, ZAO Raiffeisenbank and OAO Sberbank on payment of compensation to these credit institutions for a part of losses (expenses) resulting from deals on the interbank market
November 6, 2008	ChTPZ Group announces planned large-scale personnel cuts at the Chelyabinsk Pipe Rolling Plant (to 2,200 people) and at the Pervouralsk New Pipe Plant (to 2,700 people)
November 7, 2008	Russian Prime Minister Vladimir Putin approves a "Plan of Action to Improve the Situation in the Financial Sector and Certain Sectors of the Economy"
November 7, 2008	Sorus Capital defaults on coupon payments and its obligation to repurchase bonds (default on obligations of over 1.1 billion rubles)
November 10, 2008	Fitch Ratings downgrades Russia's sovereign rating outlook from stable to negative
November 10, 2008	OOO Potensial Bank, whose financial standing has deteriorated dramatically, is taken over by ZAO Solidarnost Bank
November 11, 2008	Sakharovaya Kompania, AirUnion and Polesie declare an issuer default on obligations worth a total of over 110 million rubles
November 11, 2008	The Bank of Russia revokes the licences of ZAO Ekonatsbank and ZAO Mira-Bank over their failure to meet creditors' claims
November 11, 2008	The MICEX suspends trading in shares until November 13
November 11, 2008	The ruble falls 30 kopecks against the bi-currency basket to 30.7 rubles

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Date	Event
November 12, 2008	The Bank of Russia raises its refinancing rate by 1 percentage point to 12% p.a. The rates on Bank of Russia deposits and other operations to provide funds to banks are raised by 1 percentage point
November 12, 2008	The RTS suspends trading in shares until November 13
November 13, 2008	ZAO Russian Development Bank whose financial standing has deteriorated dramatically, is taken over by Financial Corporation Otkrytie
November 14, 2008	OAQ Alfa-Bank takes a decision to cut limits for mortgage and auto loans in 2009 to \$150 million (as compared with \$700-750 million in 2008)
November 14, 2008	The Bank of Russia revokes the licence of OAQ Lefko-Bank (joint stock commercial bank) over its failure to meet creditors' claims
November 14, 2008	OAQ GasenergoBank, whose financial standing has deteriorated dramatically, is taken over by OAQ ProBusinessbank
November 14, 2008	Mobile operator MTS announces plans to cut capital expenditure by \$0.5 billion in 2009
November 16, 2008	The G20 summit on the global financial markets and economic situation comes to an end. The G20 leaders adopt a declaration on measures to overcome the economic crisis, and global financial system reform
November 16, 2008	RTM company defaults on its obligation to repurchase Eurobonds worth \$55 million
November 17, 2008	ZAO Nizhegorodpromstroibank, whose financial standing has deteriorated dramatically, is taken over by OAQ Sarovbusinessbank
November 17, 2008	RusHydro hydropower company announces plans to reduce personnel by 17%
November 19, 2008	Eurokommerz factoring company fails to place three new bond issues worth a total of 15 billion rubles at par value
November 20, 2008	AirUnion RRG defaults on its obligation to repurchase bonds worth over 1.56 billion rubles. SpetsStroy-2 and Parnas-M declare issuer defaults on bonds worth a total of over 60 million rubles
November 21, 2008	The Bank of Russia expands banks' access to refinancing by changing rating requirements for them (banks are allowed to use the ratings of Russian rating agencies along with international ratings)
November 24, 2008	Russian Government Resolution No. 1665-R, dated November 19, 2008 is published. The Resolution allows the government to make a contribution of 75 billion rubles to the authorised capital of Vnesheconombank to carry out measures to support the Russian financial sector
November 24, 2008	The ruble falls 30 kopecks against the bi-currency basket to 31.0 rubles
November 25, 2008	VimpelCom mobile operator announces a drop in capital expenditure of \$0.9 billion for the first nine months of 2008 and its refusal to pay dividends for 2008, to enable swift repayment of foreign liabilities
November 26, 2008	Bank of Russia Ordinance No. 2129-U, dated November 17, 2008, "On Securities Reclassification by Value Category" is published. The Ordinance makes it possible to reclassify securities at their market value as of July 1, 2008
November 26, 2008	Nutrinvestholding delists its shares on the RTS to minimise expenses
November 26, 2008	The Moscow government holds auctions for the purchase of apartments from developers to support the construction sector
November 26, 2008	OOO Bashinvestbank, whose financial standing has deteriorated dramatically, is taken over by OAQ Binbank
November 26, 2008	Agro-industrial company Arkada declares an issuer default on obligations worth 112 million rubles
November 27, 2008	Federal Law No. 224-FZ, dated October 26, 2008 is published. The law cuts profit tax from 24% to 20%, exempts imported technological equipment without Russian equivalents from VAT charges, increases the amount of tax deductions on the purchase of housing by Russian taxpayers, and sets a special procedure for deferrals and extended payment schedules for federal taxes
November 27, 2008	The Bank of Russia revokes the licence of OAQ Kurganprombank (joint stock commercial bank) over the bank's failure to meet creditors' claims, and also revokes the licence of OAQ Integro commercial bank after its capital adequacy ratio drops below 2%
November 27, 2008	KD Avia-Finansy defaults on its obligation to repurchase bonds worth 0.99 billion rubles
November 28, 2008	The Bank of Russia publishes Letter No. 01-15/6980, dated November 27, 2008, advising banks against increasing their net foreign currency balances, and warning that banks that fail to comply will have their unsecured loan limits lowered
November 28, 2008	The Bank of Russia publishes Letter No. 149-T, dated November 27, 2008, "On the Inclusion of Securities in the Bank of Russia Lombard List"
November 28, 2008	OAQ Nizhny Novgorod Bank, whose financial standing has deteriorated dramatically, is placed under the control of the Deposit Insurance Agency
November 28, 2008	The ruble falls 30 kopecks against the bi-currency basket to 31.3 rubles
November 30, 2008	According to Rosstat data, the number of jobless in Russia stood at 5.0 million people as of the end of November 2008, as compared with 4.6 million as of the end of October 2008 and 4.2 million as of the end of November 2007)
November 30, 2008	According to Rosstat data, Russian companies' wage arrears doubled in November to 7.8 billion rubles
December 1, 2008	The Bank of Russia raises its refinancing rate by 1 percentage point to 13% p.a. The rates on Bank of Russia deposits are raised by 1 percentage point, and the rates on Bank of Russia other operations to provide funds to banks are increased by 1.0-2.75 percentage points
December 1, 2008	Norilsk Nickel publishes its 2009 development strategy, stipulating a capital expenditure cut of 24% to \$1.69 billion
December 1, 2008	Gazprom Neft puts on hold several Russian and foreign projects involving geological prospecting and oil production
December 1, 2008	Vnesheconombank decides to extend subordinated loans to OAQ AlfaBank, OAQ Nomos-Bank and OAQ Bank of Khanty-Mansiysk worth a total of over 15 billion rubles
December 1, 2008	OAQ Sberbank of Russia raises interest rates on household deposits and savings certificates by 1.0-2.5 percentage points
December 2, 2008	The Russian advertising company IMS Group announces plans to delist its shares on the London Stock Exchange and Sweden's Aktie Torget following a plunge of its stock
December 4, 2008	The Bank of Russia revokes the licence of OAQ Gazinvestbank and OAQ Tyumenenergobank over their failure to meet creditors' claims
December 5, 2008	The ruble falls 30 kopecks against the bi-currency basket to 31.6 rubles
December 7, 2008	OAQ Bank of Moscow announces plans to reduce personnel by 10%

End

Date	Event
December 8, 2008	The international rating agency Standard & Poor's downgrades Russia's long-term foreign currency rating from BBB+ to BBB and short-term foreign currency rating from A-2 to A-3
December 8, 2008	OAQ Bank 24.ru, whose financial standing has deteriorated dramatically, is taken over by OAQ Probusinessbank
December 8, 2008	Sitronics announces plans to cut capital expenditure in 2009
December 10, 2008	The Bank of Russia publishes Letter No. 162-T, dated December 10, 2008, "On the Inclusion of Securities in the Bank of Russia Lombard List"
December 11, 2008	Within two days, issuer defaults on four corporate bond issues worth over 1 billion rubles are declared
December 11, 2008	The ruble falls 30 kopecks against the bi-currency basket to 31.9 rubles
December 12, 2008	The Bank of Russia signs agreements with 10 banks on compensating losses on interbank credit
December 14, 2008	The Bank of Russia expands the list of Russian rating agencies whose ratings are taken into account when admitting banks to unsecured loan auctions
December 15, 2008	The Bank of Russia lowers the limits of unsecured loans for 34 banks due to their failure to comply with the recommendations of Letter No. 01-15/6980
December 15, 2008	The Bank of Russia confirms its readiness to extend unsecured loans for terms of up to 1 year
December 15, 2008	Oil producer Lukoil announces plans to cut investment in foreign projects in 2009
December 15, 2008	The ruble falls 30 kopecks against the bi-currency basket to 32.2 rubles
December 17, 2008	The ruble falls 45 kopecks against the bi-currency basket to 32.65 rubles
December 18, 2008	Within two days, issuer defaults are declared on four corporate bond issues worth more than 400 million rubles
December 18, 2008	The ruble falls 45 kopecks against the bi-currency basket to 33.1 rubles
December 19, 2008	The draft law on the appointment of Bank of Russia representatives to banks receiving state support is adopted in its second reading. The law will allow the Bank of Russia to control the use of state aid
December 19, 2008	The Bank of Russia revokes the licence of ZAO Baltcredobank and OAQ ZelAK-Bank over their failure to meet creditors' claims
December 22, 2008	Diamond producer Alrosa gives up plans to place Eurobonds
December 22, 2008	The ruble falls 30 kopecks against the bi-currency basket to 33.45 rubles
December 24, 2008	Oil Company Alliance fails to place bonds worth 7 billion rubles at par value
December 25, 2008	The ruble falls 40 kopecks against the bi-currency basket to 33.85 rubles
December 25, 2008	OAQ Sberbank of Russia halts the provision of foreign currency loans to individuals
December 25, 2008	The Bank of Russia publishes Letter No. 01-15-3/7850, dated December 25, 2008, recommending that credit institutions restrict the build-up of foreign assets and foreign currency purchases in January-March 2009
December 25, 2008	The Russian Government approves a list of enterprises with annual output of over 15-16 billion rubles and personnel exceeding 4,000 people to enjoy a special regime of credit support
December 26, 2008	The Bank of Russia revokes the licence of OAQ Elektronika joint stock commercial bank and the licence of OOO Capital Credit commercial bank, over their failure to meet creditors' claims
December 26, 2008	Rosneft oil company fails to place three new bond issues worth a total of 45 billion rubles at par value. DOMO-finance fails to float two new bond issues worth a total of 7 billion rubles at par
December 26, 2008	The ruble falls 45 kopecks against the bi-currency basket to 34.3 rubles
December 28, 2008	Polymetal mining company announces plans to cut outlays on geological prospecting and equipment replacement by 30-40% in 2009
December 28, 2008	Tatneft oil producer announces plans to cut investment in foreign projects in 2009
December 29, 2008	Russian Government Resolution No. 964, dated December 20, 2008, "On the Procedure for Granting Subsidies from the Federal Budget to Commercial Banks in 2008-2009 to Compensate for Expenses and Lost Income Resulting from Credit Operations with Air Companies, with Regards to that Part not Compensated by Income from the Sale of Property Provided under a Pledge Agreement as a Credit Guarantee" comes into force
December 29, 2008	The ruble falls 50 kopecks against the bi-currency basket to 34.8 rubles
December 31, 2008	Bank of Russia Ordinance No. 2156-U, dated December 23, 2008, "On the Specifics of Assessing Credit Risk on Loans and Similar Debts" comes into force. The Ordinance cuts required reserve ratios on loan losses for the period from January 1, 2009 to December 31, 2009

Based on data provided by the Bank of Russia External and Public Relations Department, and the news agencies Reuters, Cbonds.ru, Interfax, PRIME-TASS and Rosbusinessconsulting.

Appendix 2

Non-payments on corporate bonds in 2008*

Date of default	Issuer, bond issue No.	Volume of outstanding liabilities, million rubles
12.06.08	Minnesco Novosibirsk, 1	34.0
2.08.08	Marta-Finance, 3	155.4
02.09.08	SZLK-Finance, 1	57.3
17.10.08	Agroholding-Finance, 1	24.7
1.11.08	Marta holding (Eurobonds)	USD 100 million
6.11.08	Sorus Capital, 1	35.9
11.11.08	Sakharnaya Kompania, 1	69.8
11.11.08	AirUnion, 1	41.1
11.11.08	Polesie, 1	4.9
20.11.08	Spetsstroy-2, 1	33.6
20.11.08	Parnas-M, 2	26.9
26.11.08	Agro-industrial company Arkada, 4	112.2
7.12.08	Marta-Finance, 2	60.2
10.12.08	Matritsa Finance, 1	1,200.0
10.12.08	OAo Elektronika, joint stock commercial bank, 2	16.2
11.12.08	TOAP-Finance, 1	58.9
11.12.08	OAo Eurokommerz commercial bank, 2	239.3
12.12.08	Incom-Lada, 3	54.8
18.12.08	AirUnion RRG, 1	139.6
19.12.08	Volga Textile Company, 1	69.8
19.12.08	OAo Eurokommerz commercial bank, 3	141.8
19.12.08	OAo Eurokommerz commercial bank, 1	59.8

* Default on bond redemption is written in bold, other issuer defaults refer to failed coupon payments.

Appendix 3

Main acquisitions of distressed banks in 2008

Merger agreement (change in Charter)	Buyer	Target of transaction	Transaction price	Note
23.09.08 (change in the Charter as of 1.12.08)	VEB	90% of OAO Svyaz-Bank joint stock commercial bank	5,000 rubles	VEB spent 60 billion rubles from the Bank of Russia deposit to meet liabilities
8.10.08	Alrosa investment group and OAO RZhD	Both with 45% stakes in OAO KIT Finance Investment Bank	100 rubles	OAO KIT Finance Investment Bank obtained from OAO Gazprombank a credit line of 30 billion rubles, which was increased to 41 billion rubles on November 27, 2008
17.10.08	VEB	99% of ZAO Globexbank	5,000 rubles	The Bank of Russia granted VEB a deposit of \$2 billion at LIBOR+1%
21.10.08 (1.01.09)	OAO Promsvyazbank	51% of Yarsotsbank	n/a	With the approval of the Bank of Russia
22.10.08	OAO NRBank (joint stock commercial bank)	51% of OAO Rossiyskiy Kapital (joint stock commercial bank)	5,000 rubles	With the support of the Bank of Russia
28.10.08 (1.01.09)	ZAO Gazenergoprombank	100% of OAO Sobinbank	0 rubles	As an additional measure to secure the interests of Sobinbank's clients and depositors, the Bank of Russia placed a long-term deposit of 13.7 billion rubles with ZAO Gazenergoprombank. On December 29, 2008, a part of the deposit in the amount of 6.9 billion rubles was returned ahead of schedule
28.10.08	ZAO Gazenergoprombank	49% of OAO Bank Finservis (owned by OAO Sobinbank)	0 rubles	
28.10.08	ZAO Gazenergoprombank	100% of Commercial Bank Russian Mortgage Bank (owned by OAO Sobinbank)	0 rubles	
29.10.08	Deposit Insurance Agency	OAO VEFC Bank	-	The Deposit Insurance Agency received 8 billion rubles from the Bank of Russia for the bank's rehabilitation
10.11.08 (13.10.08)	ZAO Solidarnost Bank	100% of OOO Potentsial Bank	n/a	With the support of the Deposit Insurance Agency
11.11.08 (1.01.09)	ZAO Sinara Group	100% of SB Gubernsky Bank (OAO)	0 rubles	With the support of the Deposit Insurance Agency for the merger with OAO SKB-Bank
13.11.08 (1.01.09)	OOO Financial Corporation Otkrytie	100% of ZAO Russian Development Bank	n/a	With the support of the Bank of Russia and the Deposit Insurance Agency, Financial Corporation Otkrytie spent 6 billion rubles on the rehabilitation of the Russian Development Bank
14.11.08 (1.01.09)	OAO Probusinessbank joint stock commercial bank	OAO Gasenergobank	n/a	With the support of the Deposit Insurance Agency
17.11.08 (1.01.09)	OAO Sarovbusinessbank (joint stock commercial bank)	75% of ZAO Nizhegorodpromstroibank	n/a	With the support of the Deposit Insurance Agency
26.11.08 (4.12.08)	OAO Binbank	76% of OOO BashInvestbank	n/a	With the support of the Bank of Russia and the Deposit Insurance Agency
28.11.08 (1.01.09)	OAO Promsvyazbank	85% of OAO Nizhny Novgorod Bank	n/a	With the support of the Deposit Insurance Agency
1.12.08 (1.01.09)	OAO Alfa-Bank	85% of OAO Severnaya Kazna	n/a	
8.12.08 (1.01.09)	OAO Probusinessbank joint stock commercial bank	OAO Bank 24.ru	n/a	With the support of the Deposit Insurance Agency
31.12.08	ZAO Gazfinance ¹	Soyuz joint stock commercial bank (OAO)	0 rubles	With the support of the Deposit Insurance Agency

¹ a 100% subsidiary of OAO Gazpromregiongaz integrated in Gazprom Group.

Based on data provided by the State Register of Credit Institutions, the Deposit Insurance Agency, and the news agencies Reuters, Interfax, PRIME-TASS and RosBusinessConsulting.

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