Bank of Russia Governor Elvira Nabiullina speaks at 27th International Financial Congress

Good afternoon, distinguished colleagues.

I am pleased to welcome you to the International Financial Congress. This year, the congress is titled ‘The Financial System: Stability for Growth’. This subject was no random choice.

More than ten years have passed since the global financial crisis. However, ten years after, we are still unable to maintain that the global economy has indeed returned to a steady growth path and that its growth does not need to rely on stimulus measures.

We should certainly analyse what triggered this long crisis. It would be premature at this point in time to confirm that the therapy worked. I think time will put everything in its place.

My view is, much of the responsibility for the financial crisis, which had such long-lasting and profound implications for the economy and welfare across many nations, rightly lies with inappropriate financial regulation. It was regulation (specifically, insufficient regulation) that failed to prevent the accumulation of risks in financial institutions; these risks subsequently translated into the real economy, having affected almost all countries, as a result of globalisation. The countries with loads of inherent weaknesses were particularly affected.

All this attests to the crucial importance of proper regulation and regulators’ resistance (or resilience) to calls for looser regulation, allegedly for the sake of economic growth the financial sector could facilitate; its crucial importance stems from the objective to prevent risk accumulation that may first go unnoticed but subsequently prove disastrous.

It is little wonder that a major overhaul of financial regulation came as a response to the crisis. Once the crisis erupted, the need for this overhaul was virtually universally agreed. The tightening in financial regulation has drastically reshaped the financial sector, and these changes are ongoing. This overhaul came as a real crisis response, a response that changes the rules of the game and reduces the risks of a reoccurrence of the crisis.

In this context, loose monetary policy, as is known, was mainly intended to keep the economy and financial markets afloat and prevent a descent into recession.

In other words, loose monetary policy is a policy of adjustment, while a financial regulation overhaul is a policy of change. Obviously, a financial regulation overhaul alone is not all it takes.

The loose monetary policy stance was meant to gain time to implement the necessary structural reforms and do away with internal imbalances, each country having its own imbalances.

Having bought some time, have we delivered these reforms? Probably, the answer to that is low labour productivity, underinvestment and excessive debt accumulated across many countries – which all threaten financial stability. Now and then we hear talk of yet another crisis coming soon.

The accumulated imbalances are too strong, and monetary policy is not omnipotent. The acute phase of the crisis was followed by a long period of low growth. It was not until last year that the global economy was seemingly getting out of this state. We saw global growth rates approach 4% a year; unemployment across advanced economies reached a 40–50 year low. However, it must be kept in mind that this growth occurred in parallel with monetary policy with a continued accommodative focus. One example is the European Central Bank that is still buying assets.

Now is certainly the right time to discuss the takeaways from the post-crisis decade. While even admitting that current productivity and investment data do not support the assumption that the crisis played a 'clean-up' role and that the economy emerged stronger after the crisis, might we claim that the global financial system has become sufficiently stable? Which consequences of the crisis are still in play, and what new problems are emerging?

These are probably the types of questions regulators ask themselves in advanced economies and emerging markets. These questions are also very current for Russia where the financial market is, by global standards, in early stages of development.

Nevertheless, it is safe for us as a regulator to say that the financial system is now steadier than it was ten years ago, more so, steadier than even 4 years ago, that is in 2014. Here comes the question we should ask ourselves: What needs to done to make sure a more stable financial system becomes a growth driver for the economy?

There are three key factors that will drive the development of the financial sector and its capabilities to encourage much-needed economic growth.

The first one is global economic developments.

The second one is sustaining macroeconomic stability in Russia; this includes low inflation, low debt and a balanced budget.

And, finally, number three, the paces of structural reforms and the resulting paces of economic growth.

Let me speak about these factors in more detail.

Last year we saw a fairly encouraging picture in global economic developments.

However, the inevitable normalisation in monetary policy in advanced economies will cause capital flows, essentially untied from fundamental factors at the time of cheap liquidity, to head for the safe havens of assets with a risk-free history. Capital flow will also become more responsive to underlying weaknesses or strengths of a particular economy.

Currently, rising interest rates, primarily in the dollar debt market, combine with a U-turn in capital flows to create tensions in a number of emerging market economies that are macroeconomically vulnerable. Also, volatility in global financial markets is rising.

The matters are further complicated by political risks of various kinds. We are seeing growing populism in some countries, a rise in protectionism with the risk of a full-fledged trade war, a more intense application of unilateral financial sanctions by some states – to the effect of growing financial stability risks, adding to the already heightened market volatility.

Experience suggests that, to keep economic growth opportunities, an emerging market economy can only address these problems through macroeconomic stability, an imbalance-free market without excessive debt loads, and a healthy financial system that has a good safety cushion in the form of capital and liquidity.

In recent years, these issues have topped the Bank of Russia’s and the Government’s agendas. This is why the strengthened external risks are a warning against neglecting macro stability, a further argument for efforts to bolster it.

Last year, we delivered on our inflation target for the first time, consistent with our commitments dating back to 2014 – the year we switched to inflation targeting. We are now working to fix this result, that is, to make sure that low inflation is the order of the day. The Bank of Russia's monetary policy objective for the near future is therefore to sustain inflation close to 4%.

As you know, the inflation implications of the Government's recent measures are under discussion. I have commented on this subject at the recent Global Economic Forum. In this connection I want to emphasise once again that our monetary policy is configured in a way that enables us to cope with the inflationary effects of these measures.

We do not rule out a short-term acceleration in inflation, in some cases, to a mark slightly above 4%. We realise it is not always expedient to crack down on inflation without damage to economic growth. Should inflation deviations occur, they should be limited and short-term. So ultimately inflation should come back to 4%.

Steady inflation will come with reduced volatility of interest rates as inflation expectations decline and become anchored. This is the area, specifically anchoring, where much remains to be done. Based on the past month's figures, price spikes in individual products, petrol in the first place, together with exchange rate volatility, continue to make a strong impact on inflation expectations. Inflation expectations remain to be anchored.

The fiscal rule is undoubtedly the Government's major contribution to macro stability. The fiscal rule protects budget costs from oil price swings, enabling stable funding for priority areas. It is also key to the stability of other macroeconomic data including the real exchange rate.

Consequently, from the macroeconomic prospective we see no meaningful risks to the financial system in the future.

Let me now proceed to economic growth rates. Obviously, financial sector and economic development are interrelated. Strong economic growth strengthens the financial system, and vice versa.

When formulating monetary policy, we look into our regular potential economic growth projections. 1.5–2% growth, observed currently, with unemployment rate at an all-time low, is approximately the growth rates our economy can deliver in the medium term with its structure unchanged. What we have seen so far is that the inertia scenario is continued, and the established trends persist.

Nevertheless, we look forward to the specific package the Government is due to propose to deliver on the presidential address. We expect this package to help accelerate economic growth; beyond increased budget spending in priority areas, these measures will unlock the potential of private investment and entrepreneurship, ultimately boosting economic growth potential. Certainly, we will see the impact of these measures manifest itself gradually – which is a factor our financial organisations should consider.

What implications will these two factors combined, external and internal, have for the financial sector?

First. The still low growth rates and unclear growth points are undoubtedly a challenge for the financial system. The financial system has by now responded with explosive growth in consumer and mortgage lending; the latter is the only loan market where the Russian economy is far behind its peers. However, sooner rather than later this process will lead to the emergence of risk given that households' debt loads are beginning to grow. We will watch how the situation unfolds and take action to block any potential bubbles in this market segment.

We are also seeing increasingly less bad debt on corporate balance sheets. This trend will help create better lending conditions for production companies. It is critical to make sure that financial institutions are ready for this so they could use these new opportunities. To that end, we need banks to develop specific competencies that include the capabilities to assess new and small companies' potential, to assess new projects and to develop project and investment finance instruments.

We expect the financial sector to partner with business in search for new growth points. New financial technology including big data could become an important tool to develop these competencies and expertise. Importantly, the state support package is primarily intended for financial institutions where this expertise is engrained.

Second. The imminent monetary policy normalisation involves a slowdown and, ultimately, a stop in the interest rate reduction process. It is not impossible that interest rates could be revised upwards to counter proinflationary risks. Financial institutions have seen a decline in interest rates for the last ten years. The trend reversal should come as no surprise and bring about no excessive interest rate risks. It is not early at this point in time to contemplate the workings of price-setting in financial instruments, given that the interest rate trend is set to change course.

Moving on. The high external risks suggest the period of low volatility belongs to history, and we are in for more volatile global markets. We have to manage these risks. We should not try and pass these risks on to the ultimate borrower or investor, as is often the case. Experience shows this strategy will backfire, with credit risks realising for the lender itself. In this context, what comes to the fore is the skill of constructing instruments with these risks factored in, a sense of exposure hedging.

Finally, the macroeconomic situation, together with rapidly advancing disruptive technologies will spell the need for the financial sector to do better in cost management and improve its operating standards and procedures.

A change in financial entities' business models – which we believe will be driven by these factors – will lay the groundwork for faster economic growth, adding to the stability of financial organisations in the medium term. We intend to apply incentive-based regulation more widely to accelerate this transition.

Incentive-based regulation tends to be understood as the opposite of neutral regulation on the assumption that the use of regulatory measures to change business models in the financial sector could bring risks to the financial system.

But then, let us look into the banking system. We witness even major banks being used only as vehicles to finance their owners' businesses, to essentially provide funding for mergers and acquisitions, rather than that for promising economic projects. It stands to reason this poses a threat to the economy and the financial market itself. This is why we will only benefit from regulation that stimulates conventional banking. This is particularly relevant in the current context as the recovered banking system is expanding lending across all its segments, and this upward trend is set to hold.

The right development path for lending suggests that it fosters sustainable economic growth and insures against loss should non-performing projects be funded. This means our future regulatory policies are meant to solid economic growth and discourage any practices that may lead to the accumulation of these risks.

Which practices are in question? First. We have taken action to discourage dollarisation of banks' balance sheets, and more such action is coming. We need to drive a further systemwide reduction in foreign currency risks.

Second. The currently dominant mortgage finance is in our view fraught with the risks of bank balance sheets accumulating a lot of non-core or non-performing assets. The nascent non-core asset fund worth of about 2 trillion rubles is a direct consequence of this problem. When banking lending is tantamount to lombard lending, it does not matter to banks who their borrowers are. So long as there is a collateral, banks can afford to skip the analysis of a borrower's real operations. Eventually, credit may be available to projects of questionable quality. This is why the collateral reform we are discussing is intended to reduce the share of lombard lending and become a natural stimulus for lending to finance high quality projects. Evidently, this is our top priority.

Third, I will discuss our efforts to combat loans being extended to bank owners. These efforts have been ongoing for quite a while, and we carry on. Unable to contribute to economic growth, such captive banks will soon be gone.

Fourth. I refer to a risky situation when loans are issued to holding companies instead of those with real business operations. Alternatively, this can be the case when debt loans arising from change of control are passed on to the operating business so it assumes liabilities for their repayment. These loans undermine such companies' financial positions: their leverage is growing but loans do not go towards business development. Incidentally, almost all assets we collected in the non-core asset fund are overleveraged. They underwent change of ownership more than once, and each change in control came with more debt. We need to break this vicious circle.

Fifth. As the financial market evolves, its various segments, both regulated and unregulated, grow increasingly interrelated. These include banks, insurance companies, pension funds, professional securities market participants and leasing companies. They form groups with formalised ownership relations but, more often such groups are based on informal business relations. Unscrupulous players tend to use regulatory arbitrage both across sectors and across financial institutions within one and the same sector. Cross investment, concealed financial support to organisations within one sector by another, transferred risks, transactions intended to conceal from the regulator the real object of investment, the misuse of public trust in a bank for large-scale risky sales of non-banks products – all these are practices we intend to do away with.

There are several ways how we will be doing this. For one, we will harmonise banking and non-banking regulation to dispose of regulatory arbitrage. We will also expedite the integration of supervision of the banking and non-banking sectors, elaborating the practice of a regulator's reasoned judgement.

Given the takeaway, especially last year's, from financial resolution, we intend to review the concept of supervision of banking and financial holding companies. To cite one example, had the supervisory body's and the provisional administration's authority extended, beyond Otkritie bank, to the whole group, it would have been much easier to track down and recover the finds embezzled through the holding company.

Sixth. Fair value, exchange-based price setting and prevention of market manipulation. A separate block of issues that are becoming increasingly important is related to correct establishment of exchange prices of traded securities. We see examples of price manipulation, artificial share price inflation, incorrect market-making, rigged trades through the exchange...

It all means that the market mechanism is being abused. And of course, separate measures must be taken here, because formally the deals look like market and the price looks like market but in practice they are not.

Another issue is the high concentration of credit exposure per borrower or a group of related borrowers. We have a corresponding ratio in place, the N6, that banks sometimes rather skilfully try to circumvent.

Many banks still genuinely believe that it is better to be the main or the only creditor of an enterprise. But in practice, the high concentration of exposure to a single highly leveraged borrower threatens the stability of banks themselves. In this case, the bank becomes its client's hostage. It has to agree to multiple restructurisations, waive collateral or guarantee enforcement. Therefore, this year we will discuss with banks the issues related to the review of approaches to the concentration risk with regard to determining the related parties and the N6 ratio calculation. We believe that the right ways to mitigate this significant risk and to increase banks' stability include the development of syndicated lending (for which the regulatory basis has already been established) and further consolidation of the banking sector.

And the last thing concerning regulatory development. We have a clear understanding that the tightening regulation both at the international level and with the national specifics entails further costs for banks. But we have to do this in order to mitigate the risks for the stability of the financial system and to get rid of the accumulated problems. And of course, we would like to stop practising 'petty' or 'selective' regulation constantly closing this or that loophole in the legislation that unfair bankers try to use. Because the costs of our doing so are borne by bona fide market participants. However, this will not be possible, in our opinion, while the liability for violations in the financial market remains low, while unfair bankers know that they can hide abroad and, as I have already mentioned, get to keep their non-bank assets. For example, during the four years that the article imposing criminal liability for misreporting has been in force, only four persons have been prosecuted. 30 criminal cases have been initiated. Therefore, we have introduced amendments that will increase the effectiveness of this article.

And the second thing, the right to a professional judgement for the regulator, the Bank of Russia, to take supervisory decisions. It is not the first year that we raise this issue, and we understand that without the right to a professional judgement we will always be in the catch-up mode because we have to formally prove each violation. Unfair players invent a new trick, we patch this loophole, increase regulatory costs for bona fide participants, and this cycle repeats over and over again. Once we have the right to a professional judgement, the supervision will take less time and the costs for clients and the society in general will be lower.

We believe that an increased liability of owners and managers and the right to a professional judgement will lead to lower regulatory and supervision costs, creating conditions for real, consultative supervision and establishing partner relationships between the regulator and bona fide banks.

Apart from the regulatory issues, I would like to say a few words on another very important topic, which is competition in the banking sector. The Bank of Russia will pay due attention to this topic. However, I would like to point out that the quality of competition does not directly depend on the number of banks, in our opinion. Yes, many banks have lost their licences, but they significantly distorted the competition by conducting illegal operations, providing loans primarily to their owners, and attracting funds from borrowers and creditors at inflated rates.

This work has not been completed yet, but we can say that most active banks are currently operating fairly and comply with the regulations. Playing by the rules is the basis of fair competition.

It is important that different categories of banks and financial institutions operate in the conditions of market competition. Therefore, banks and financial institutions should find their own niches. A small bank will hardly be able to compete with major market players without any support.

In order to promote competition, the Bank of Russia has developed a concept of proportional regulation. Let me remind you that 2018 is the year when banks with the capital of less than 1 billion rubles must switch to the basic licence. Their number today is 192 (almost 150 have announced their intention to switch to the basic licence). But I would like to note that their aggregate assets account for just 1% of the total assets of the banking system, i.e., these banks are really small.

We will support small regional banks because it is these credit institutions that can provide the highest quality services to such an important segment of the economy as individual entrepreneurs and small business. The significant simplification of regulation and reporting for banks with a basic licence is done so that they could focus on this business segment.

Moving on. Our activity in the financial rehabilitation sphere. It is also aimed at improving competition in the banking sector. The fact that, until recently, systemically important banks included institutions with a chronic shortfall of capital (or virtually complete capital loss) and liquidity not only violated fair competition but also materially weakened the banking system.

Since last summer, the Bank of Russia has been applying a new resolution mechanism to large banks by entering into their operational management for a very short time and temporarily (and I would like to stress that) becoming their controlling shareholder. Today, we can say with confidence that the new resolution mechanism allows rehabilitating even a large bank or a financial group that is systemically important for a region or the economy as a whole within a very short period of time (6 months instead of 10 to 15 years as it used to be) and doing so without the risk of destabilising the financial system.

Currently, all three major banks that we took for resolution through the Consolidation Fund have been fully recapitalised and are continuing to serve their clients.

In addition to maintaining business continuity, recapitalisation, restructuring of non-core and non-performing assets, development strategies have been drafted for these banking groups in accordance with their capabilities and their role in the economy.

Therefore, we can conclude that this complicated task of rehabilitating the largest players of our banking system has been, for the most part, completed.

The Bank of Russia focuses on returning the maximum amount of funds directed at the financial rehabilitation. As we have said before, and not once, we intend to do it not only by selling the bank and working with non-core and non-performing assets but also by forcing former owners to cover losses and return the assets that they have withdrawn.

Currently, legal collection is the only damage recovery mechanism provided by law that the state can use when rehabilitating banks.

We have suggested and are suggesting that the mechanism of subsidiary liability is used. We have not yet reached an understanding regarding this issue but we will keep persuading our colleagues.

Acting within the existing regulatory framework, the Bank of Russia will continue to file claims against former owners. Along with the new opportunity to recover damages during the resolution (the regulatory changes regarding the procedure for calculating such damages are to enter into force in a few days), we propose to discuss two additional mechanisms:

– firstly, it is the mechanism to block assets for the amount of the Bank of Russia's claims for the litigation period (to prevent the withdrawal or liquidation of assets during long legal proceedings);

– and secondly, to implement the initiative to prevent the owners and top managers of banks undergoing resolution from leaving the country (until the end of legal proceedings). Unfortunately, bankers keep escaping abroad and re-unite with their earlier withdrawn assets.

But I would like to end the banking part of my speech on a positive note. Although we have to talk about the unpleasant things that exist and that we will deal with, I think it is fair to communicate to the banking sector our clear intentions. Fortunately, we have reasons for positive thinking as well. As I have already said, the banking sector is stable, it is developing, showing good profit, capital and liquidity, there are all opportunities to improve lending that is on an upward path. And we really believe that, as a result of our work aimed at clearing the banking sector, the most part of unscrupulous banks have already been ousted from the market. For this reason, we now, on the one hand, can expect that there will be fewer insured events for the deposit insurance system and, on the other hand, we have an opportunity to expand the functionality of the deposit insurance system, because we are practically coming out of the situation, about which many banks told us, when good banks have to pay for bad ones.

We consider it possible to expand the deposit insurance system in order to promote the trust in banks of both the public and business. We think it is necessary to speed up the process of adoption of the draft law that extends the insurance to include small business. This draft law is currently being reviewed by the State Duma.

Regarding individuals, we deem it justified to increase the compensation amount when the depositor is not able to manage its risks for objective reasons. Moreover, we see in practice that in socially sensitive situations, such as coming into an inheritance, sale and purchase of an apartment, receipt of insurance payments and social benefits, the amounts accumulated in the account can exceed the insured 1.4 million rubles. And here we have all the reasons to specify individual cases and to increase the compensation amount. These are joint suggestions developed together with the Deposit Insurance Agency.

Also, after a vibrant public discussion of the practice of challenging transactions when a credit institution is undergoing bankruptcy (and this practice became very sensitive for depositors), the Deposit Insurance Agency suggested amendments to the legislation aimed at providing additional protection for bona fide depositors.

This includes increasing the threshold amount, up to which deposit compensations to individuals will not be challenged, to 10 million rubles.

We support these proposals.

And let me say a few words about other financial market sectors because, really, talking about the banking sector usually takes more time. Regarding the non-banking sector. I know that yesterday there were productive discussions and all these topics will be discussed in detail on the sidelines of the congress. I would like to point out several general things. How do we see the development of non-bank financial institutions?

This year, the first stage of the implementation of the single financial market development strategy is coming to an end. And tomorrow, during the plenary session, we will be discussing the Guidelines for the Development of the Russian Financial Market for the next three-year period.

However, we can draw some conclusions.

During the previous period, we were naturally focused on cleaning the market. We had a large programme, ‘Clean Register’, that involved ousting such market players that were not performing any actual activity, were unstable, or conducted illegal operations. We were tightening regulation where it was clearly below the risk level. The system of guaranteeing pension savings was introduced for non-governmental pension funds. In insurance, a risk-based approach was used to significantly improve the regulation and supervision, and measures were taken to stabilise the situation with OSAGO. In the microfinance sphere, proportional regulation was introduced and microcredit and microfinance companies were separated.

We have been developing the bond market and will continue to do so. And we see that it is developing at quite a good pace.

In general, we are confident in the long-term stability of the financial market and its individual segments. We are also sure that our regulation and supervision will be able to mitigate the risks of potential spreading of problems, should they arise in certain financial institutions or market sectors.

Now, when the situation in the financial market is rather stable and interest rates are falling, consumers in search of higher yields are becoming more interested in instruments that provide an alternative to deposits, and we are noticing this interest. Therefore, the financial market development policy should be focused on the consumer, their interests, rights, and protection from excessive risk. The customer-oriented approach and trust must become, if you wish, the ideological basis for the development of the financial market.

We are building our Guidelines for the Development of the Russian Financial Market for the next three years on the following reference points.

First. Competition and financial inclusion. Based on modern technologies, the infrastructural solutions that we are creating together with the market (that is, primarily, remote authentication for financial consumers), financial inclusion will be expanding. Moreover, competition in the market will also be increasing because traditional bottlenecks, such as office or branch networks, will be losing their importance. The financial services marketplace, of which prototype we will demonstrate today, is one of the steps aimed at increasing financial inclusion and providing new opportunities for financial institutions to enter new markets.

Second. This is, of course, the improvement of the climate of confidence in the financial market and the protection of consumers' rights. We want both individual and corporate customers to trust financial institutions. We will eliminate misselling that leads to the disappointment of consumers with the financial market. For this purpose, we are building a conduct supervision framework, so that consumers would not be disappointed by entering the financial market and purchasing certain products. We will also use the business reputation institution more actively and increase the personal liability of the management. Our nearest task is to create an alternative mechanism for the resolution of disputes between consumers and financial institutions. You know that the law establishing the financial ombudsman institution has just been adopted.

I must say that, in order to promote confidence, it is very important to have standards and common business rules followed by all market participants. And here self-regulatory organisations play a very important role. Standards are being developed currently in most financial market segments. It is self-regulatory organisations participating in this process that are actively promoting such standards and will be responsible for their members' compliance with them.

In conclusion, I would like to say a few words about important and somewhat difficult things. Every year, at the Financial Congress, we try to provide you, the market, with the maximum possible information on how we assess the situation, how and why we establish priorities, on innovations that we intend to implement. In theory, my talks each year should be shortening because regulation should be stable and the rate of implementing innovations must decline. However, there are certain topics that we repeated over and over, last year and the year before, but their implementation, unfortunately, has been delayed. So I have repeated them again and will repeat in the future. And I would like to assure you that we intend to finish all the things that we have started.

I have spoken about many of them. I will only add about the implementation of individual pension capital. It is a key issue for both future pensioners and the economy. We have been working on this system for a long time, we are sure of its viability, and we will keep working with the government and lawmakers on its adoption as soon as possible.

I would like to wish you interesting work during the congress, useful discussions and, hopefully, optimism, despite all those issues that we are talking about and that we should be talking about in order to move forward to resolve them. In spite of these issues we, certainly, have reasons to be optimistic with regard to the development of the financial sector and with regard to the role of the financial sector in the economy. We have come a long way in overcoming difficulties. And now is the time for the financial industry to make more and more contributions into the development of the economy and into increasing its growth.

I would like to thank you and move on right to our panel session without a break.

7 June 2018