Foreign Banks Expansion to Russian Banking Sector: Interim Summation, Perspective Analysis Effort

Mikhail E. Mamonov¹, Oleg G. Solntsev²

This article is focused on analysis of foreign banks expansion to Russian banking sector and its influence on sector's basic indicators. It compares banking sectors of developing countries to find out the most attractive ones for further increasing of foreign investment. Then it analyses the possible interconnection between intensity of foreign direct investment inflows on emerging markets and economic conjuncture in developed countries. The article pays special attention to the positioning of foreign banks in Russian market to make known its possible competitive strategies.

Key words: foreign banks, investment attractiveness, bank strategy, banks clusterization, foreign direct investment (FDI) intensity

JEL classification: G11, G15, G21

Foreign banks expansion on Russian market was one of the most discussed themes in period before August 2008 which regards the development of domestic financial sector.

Non-residents’ share in authorized capital of Russian banks increased twice and came to 23% in year 2006-2007. In the same period share of assets controlled by non-residents (with more than 50% non-residents’ share in capital) in aggregate assets of banking system increased by 9 pct, coming to almost 18%.³ For comparison: in the year 2004-2005 this increase came only to 1 pct.

This kind of expansion caused a lot of questions. How stable is the process? How long will it last? On which level of foreign banks invasion to the domestic market will market saturation come? It should be said, that not only Russia is involved to the process – many emerging markets (in countries of Latin America, Central and East Europe etc.) felt its consequences over the last decades. The latter are considered in following researches: Detragiache, Gupta (2004); Levy Yeyati, Micco (2006); Vrnikov (2006).

The financial markets crisis of developed countries which had begun in the middle of year 2007 complicated the analysis of situation, made these questions hard to answer. On the one hand the crisis raised attractiveness of financial sectors of countries with emerging markets (including Russia) which came to be considered by foreign investors as “safe heavens” for some time. On the other hand, in the matter of crisis large transnational banks had to direct resources for saving their own financial stability. This led to limitation of their resources for 1)

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¹ Center of macroeconomic analysis and short-term forecasting, Moscow, Russia
² Center of macroeconomic analysis and short-term forecasting, Moscow, Russia
³ hereinafter – without non-residents (off-shore companies) depending on residents too much
international M&A operations in the new countries and 2) investment in development of international branches.

A new wave of the world financial crisis, which had begun in the third quarter of the year 2008, quickly turned to tsunami which blown away the “safe heavens” from the developing markets. The climate for banking business in these countries got worse dramatically. At the same time local bank valuation decreased manifold thereby it became easy for the global strategic investors to enter the domestic markets and come to the fore there. Under the assumption what local markets’ medium-term prospects are positive the latter term is even able to raise investment attractiveness of local banks.

The contraditoriness of the situation makes it difficult to answer the questions about stability and perspectives of foreign banks expansion to the Russian market in the new climate.

We have tried to find an approach for understanding these perspectives by analyzing the following aspects:

- correlation between intensity of foreign direct investment (FDI) inflows to emerging markets and economic conjuncture in developed countries;
- Russian banking sector “profile” and banking sectors of the other countries with emerging markets: dynamic indicators, profitability and risks;
- classification of non-residents subsidiary banks operating on the Russian market by the development strategy types.

An aim of the research is to answer the following questions:

- Could the foreign investments in the next 2-3 years become a factor which will support the capitalization level of the Russian banking system and thereby mitigating the crisis negative influence?
- Should the strengthening of competition between foreign capital banks and private Russian capital banks to be expected on the Russian banking services market? And if it should - in which segments?

1. **Investment attractiveness of banking sector in Russia in pre-crisis period (before year 2008)**

Cross-country studies have shown that in pre-crisis period Russian banking sector was one of the most attractive for investments among the similar sectors in the countries with
emerging markets. On the one hand it was one of the most fast-growing and profitable sectors. On the other hand, modest credit risks were typical for Russian banking sector.

Russia was one of the three leaders of banking assets’ growth rate among large countries, both developed and developing, for the last 2-3 years (Fig. 1–4). Only Kazakhstan and Ukraine had better results in pre-crisis period.

**Fig. 1. Growth rate of banking sector’s assets in Russia, Eastern Europe and Turkey (%)**

*Notes:*
Россия – Russia; Болгария – Bulgaria; Чехия – Czech Republic; Венгрия – Hungary;
Польша – Poland; Словакия – Slovakia; Турция – Turkey

*Source:* data IMF, calculations CMASF

**Fig. 2. Growth rate of banking sector’s assets in Russia and CIS (%)**

*Notes:*
Россия – Russia; Украина – Ukraine; Казахстан – Kazakhstan

*Source:* data IMF, calculations CMASF
**Fig. 3. Growth rate of banking sector’s assets in Russia and East Asia (%)**

*Notes:*
- Россия – Russia; Китай – China; Индия – India; Индонезия – Indonesia;
- Корея – Korea; Малайзия – Malaysia; Тайланд – Thailand

*Source:* data IMF, calculations CMASF

Russia had highest return on assets (ROA) ratio at banking industry at least for 5 years among large countries with emerging markets. It gave up its leading position to Mexico in year 2007. At the same time Russia was one of the countries with highest return on equity (ROE) ratio at banking sector along with Poland, Brazil and Mexico.
According to ratios describing inclination to credit risks (capital adequacy and rate of stale debt), Russia was in better situation than majority of Eastern Europe countries (Fig. 6). However it was inferior to some developing countries of other regions (Brazil, Mexico and Chile).

**Fig. 5. Profit-to-asset ratio for banking sector in Eastern Europe and in Turkey (%)**

Notes: 
Russia – Россия; Bulgaria – Болгария; Czech Republic – Чехия; Hungary – Венгрия; Poland – Польша; Slovakia – Словакия; Turkey – Турция

Source: data IMF, calculations CMASF

**Fig. 6. Rate of stale debt in banks of Russia, EE and Turkey (%)**

Notes: 
Russia – Россия; Bulgaria – Болгария; Czech Republic – Чехия; Hungary – Венгрия; Poland – Польша; Slovakia – Словакия; Turkey – Турция

Source: data IMF, calculations CMASF
Dynamics and profitability of Russian banking system were much higher than in developed countries. According to the level of credit risk our country did not look worse nominally as well. However, high level of credit portfolios concentration, difficult process of debt collection, poor transparency of borrowers and other institutional “flaws” leveled this advantage much. Institutional “flaws” did not affect much the level of bad debts and capital adequacy only because of beneficial economic conjuncture for Russian borrowers.

This kind of Russian banking sector “profile” made it rather attractive for global banks investments. It made it possible to expect good results not only in specialized product and client niches but also in sphere of mass standard banking services.

But the crisis entering Russian market in year 2008 will change the situation for sure. Credit, market and liquidity risks worsened dramatically. Money and credit contraction process beginning in the second part of year 2008 will continue at least for a year. It will cause an extremely weak and almost stagnant dynamic of key banking services market in the short run. At the same time surge of demand for specific «crisis» banking services which are difficult for foreign banks to adopt (credits backed by commercial notes, netting of debts, cash-out schemes etc.) may be expected.

High profitability of the operations may become the only one serious competitive advantage for investment to Russian banking sector.

2. Interdependence between intensity of FDI inflows to the emerging markets and economic conjuncture of the developed countries

Strong interdependence between economic growth in developed countries and amount of FDI from those countries - including investment to the developing markets (Fig. 7) - has been observed from the end of the last decade of XX century. This point is indicated in researches (Claessens, Demirguc-Kunt, Huizinga (2001)) which show analogous results. According to this interdependence and taking into account recession in USA, Europe and Japan one may suppose that in 2008-2009 amount of FDI from those countries will drop to local minimum of year 2001 or even lower.

Undoubtedly, reduction of FDI inflows from developed countries will affect banking sectors of majority of countries with emerging markets including Russia. At the same time increase of FDI from the other countries with emerging markets may be expected, in the first place from Asian countries. However it is next to impossible that this increase will balance developed countries investment contraction.
One may separate out three stages in the history of FDI to Russian banking sector for the last five-six years (Fig. 7):

- before the middle of year 2006 – weak increase stimulated by general positive estimate of Russian economy and financial sector’s prospects;

- from the end of year 2006 to the middle of year 2007 – rapid growth acceleration, abrupt change to brand new level. This stage was stimulated by Russian stock market expansion which had lead to substantial reevaluation of Russian banks’ assets. Moreover, key mega-deals played important role – Rosbank’s large share buying by Societe Generale, IPO of VTB and SPO of Sberbank;

- from the middle of the year 2007 to the end of the year 2008 – FDI increase deceleration, conditioned by influence of the world financial crisis.

Though in the end of the third quarter of 2008 an increase of FDI to Russian banking sector had been continuing, however, it was undoubtedly under its own inertia and was caused by conclusion of previous deals.

According to the discussed dynamic of Russian market investment attractiveness and influence of the world financial crisis one may expect that new forth stage in the history of FDI to the Russian banking sector will start from the beginning of the year 2009. It will be characterized by multiple contraction of FDI amount, active re-allocation and consolidation of
Russian banks’ shares between narrow group of global banking groups, growing role of profit capitalization in the own capital building sources of non-residents’ subsidiary companies.

**Fig. 8. FDI to the Russian banking sector (Q/Q, $ mln)**

*Notes:*
1 этап – 1 stage
2 этап – 2 stage
3 этап – 3 stage

*Source: data CBR*

Substantial slump of amount of FDI to the banking sector, expected in the new stage of development will cause the situation when FDI will hardly become a factor supporting capitalization level of Russian banking system. Even intensive FDI inflow in the end of 2006 – the first part of 2008 could not stop the process of decrease of the ratio of Russian banking system equity capital to its assets (Fig.9). It should not be expected also that FDI will help to stop this process in the current harsh conditions.
Fig. 9. Ratio of banks’ equity capital to assets (without Sberbank and VTB), share of banks fully owned by foreigners in the assets of Russian banking system (Q/Q; %)

Notes:
Отношение капитала к активам – Ratio of capital to assets
Доля активов иностранных банков в активах банковской системы – Share of foreign banks’ assets in the assets of Russian banking system

Source: data of CBR, calculations CMASF

3. Foreign banks’ positioning on Russian market

202 banks with non-resident capital contribution was registered in the beginning of the year 2008. In 61 banks non-residents controlled 100% of the capital.

Asset concentration level between non-residents’ subsidiary banks was medium-high. 20 biggest foreign banks owned more than 85% of aggregate assets of banks fully owned by foreigners.

Table 1

<table>
<thead>
<tr>
<th>Number in the ranking by the assets</th>
<th>Bank</th>
<th>Assets, bln rubles</th>
<th>Share of net foreign assets (assets minus liability) in assets, (%)</th>
<th>Share of net credit (credits minus deposits) PP and LP* in assets, %</th>
<th>Share of net IBC given to residents in assets**, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Raiffeisenbank Austria</td>
<td>435.3</td>
<td>-21.9</td>
<td>16.2</td>
<td>-2.8</td>
</tr>
<tr>
<td></td>
<td>Bank Name</td>
<td>PP</td>
<td>LP</td>
<td>IBC</td>
<td>ER</td>
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<td>-----</td>
</tr>
<tr>
<td>2</td>
<td>UniCredit bank</td>
<td>368.3</td>
<td>-14.8</td>
<td>10.4</td>
<td>-5.6</td>
</tr>
<tr>
<td>3</td>
<td>Citibank</td>
<td>150.2</td>
<td>-8.6</td>
<td>-36.2</td>
<td>9.9</td>
</tr>
<tr>
<td>4</td>
<td>Absolute bank</td>
<td>134.4</td>
<td>-35.4</td>
<td>34.8</td>
<td>1.0</td>
</tr>
<tr>
<td>5</td>
<td>Societe Generale</td>
<td>106.8</td>
<td>-42.1</td>
<td>38.8</td>
<td>-7.9</td>
</tr>
<tr>
<td>6</td>
<td>ING bank (Евразия)</td>
<td>81.5</td>
<td>-4.4</td>
<td>5.0</td>
<td>-5.4</td>
</tr>
<tr>
<td>7</td>
<td>Home credit bank</td>
<td>73.7</td>
<td>-31.5</td>
<td>58.1</td>
<td>-0.7</td>
</tr>
<tr>
<td>8</td>
<td>OTP bank (former Investsberbank)</td>
<td>65.3</td>
<td>-5.6</td>
<td>-1.7</td>
<td>-1.6</td>
</tr>
<tr>
<td>9</td>
<td>ABN AMRO bank</td>
<td>54.5</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>10</td>
<td>Credit Europe bank</td>
<td>54.5</td>
<td>-49.0</td>
<td>60.9</td>
<td>-1.6</td>
</tr>
<tr>
<td>11</td>
<td>Rusfinance bank</td>
<td>50.4</td>
<td>-52.9</td>
<td>81.9</td>
<td>1.7</td>
</tr>
<tr>
<td>12</td>
<td>Commerzbank Eurasija</td>
<td>49.2</td>
<td>-56.4</td>
<td>57.2</td>
<td>-3.6</td>
</tr>
<tr>
<td>13</td>
<td>Deutsche Bank</td>
<td>49.2</td>
<td>39.2</td>
<td>-42.2</td>
<td>-10.1</td>
</tr>
<tr>
<td>14</td>
<td>BNP Paribus bank</td>
<td>39.4</td>
<td>-46.6</td>
<td>55.3</td>
<td>-10.5</td>
</tr>
<tr>
<td>15</td>
<td>Swedbank</td>
<td>36.7</td>
<td>-72.2</td>
<td>65.9</td>
<td>6.5</td>
</tr>
</tbody>
</table>

* PP – physical person, LP – legal person.

** IBC – Interbank credit. Net interbank credit given is a sum of credits, deposits and account balances given to banks-residents minus sum of credits, deposits and account balances obtain from banks-residents

Source: banks’ balance sheets, calculations of Center of macroeconomic analysis and short-term forecasting

There are 3 main types of strategy which determine positioning of foreign banks on internal market of banking services:

- Universal (multi-product or multi-clients). Bank tries to expand its presence in all promising sectors of banking activities. It may not have any key competitive advantages in any sector but it aims to achieve them in the future.

- Specialized (mono-product or mono-clients). Bank has key competitive advantage in some client or product niche (mortgages, auto credits, plastic cards etc). This market or client niche has promising growth prospects which justify bank’s narrow specialization. Once bank consolidated its position it is trying to save its competitive advantages in the future and this lets him to get maximum benefit from expected extension of the chosen segment;

- Mixed (either multi-product and mono-clients or mono-product and multi-clients). Bank either takes into account its present competitive advantages and focuses on one type of clients giving them wide range of services or it provides wide range of clients with one type of service. This choice is explained by the difficulty of identifying fast-growing narrow niches or by ineffectiveness of trying to embrace the unembraceable.

Similar methods of identifying strategy of foreign banks applied in the researches of (Bikker, Haaf, (2001a, 2001b); Levy, Micco (2003); Schargrodsky, Sturzenegger (2000).

Analysis of balance sheets, programs and declarations of the top-management of large banks fully owned by foreigners helped to make a clusterization by types of realized strategies (table 2). In addition discrimination of the banks sample in 3 groups by the criteria of “role in outer space interaction” was made (see Fig. 10):
1. Banks providing with net capital inflow from external markets to internal
2. Banks providing with net capital outflow from internal markets to external
3. Banks taking neutral position from internal-external market capital re-allocation point of view.

<table>
<thead>
<tr>
<th>Strategy type</th>
<th>Product niche</th>
<th>Universal</th>
<th>Specialized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal</td>
<td>Raiffeisenbank (1)</td>
<td>UniCredit bank (2)</td>
<td>Citibank (3)</td>
</tr>
<tr>
<td></td>
<td>Absolute bank (4)</td>
<td>Societe Generale (5)</td>
<td>ABN AMRO bank (9)</td>
</tr>
<tr>
<td></td>
<td>Credit Europe bank (10)</td>
<td>Swedbank (HANSA group) (15)</td>
<td>ICICI bank (18)</td>
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<tr>
<td></td>
<td>Credit Suisse bank (20)</td>
<td>Garanti bank - Moscow (23)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total: 11 banks (cluster 1)</td>
<td>Total assets: 1.365 bln rubles</td>
<td></td>
</tr>
<tr>
<td>Specialized</td>
<td>OTP bank (former Investsberbank) (8)</td>
<td>Morgan Stanley bank (21)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total: 2 banks (cluster 2)</td>
<td>Total assets: 77 bln rubles</td>
<td></td>
</tr>
<tr>
<td>Universal</td>
<td>ING bank (6) – LP**</td>
<td>Commerzbank Eurasija (12) – LP</td>
<td>Deutsche Bank (13) – LP</td>
</tr>
<tr>
<td></td>
<td>BNP Paribus bank (14) – LP</td>
<td>Dresdner bank (19) – LP</td>
<td>Svenska Handelsbanken (27) – LP</td>
</tr>
<tr>
<td></td>
<td>Total: 6 banks (cluster 3)</td>
<td>Total assets: 240 bln rubles.</td>
<td></td>
</tr>
<tr>
<td>Specialized</td>
<td>Home credit bank (7) – PP**</td>
<td>Rusfinance bank (11) – PP</td>
<td>Calyon Rusbank (16) – LP</td>
</tr>
<tr>
<td></td>
<td>DeltaCredit bank (17) – PP</td>
<td>WestLB Vostok bank (22) – PP</td>
<td>Gorodskoi Ipotechnii Bank (24) – PP</td>
</tr>
<tr>
<td></td>
<td>HSBC bank (25) – PP</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total: 7 banks (cluster 4)</td>
<td>Total assets: 212 bln rubles</td>
<td></td>
</tr>
</tbody>
</table>

* There are places at bank assets ranking in the brackets.
** PP – physical person, LP – legal person.
Source: Center of macroeconomic analysis and short-term forecasting
Fig.10. Net credit given to legal and physical person, net foreign assets of banks (ratio to assets, end of year 2007)^4

Notes:
Доля чистого кредита ФЛ и ЮЛ в активах, % – Share of net credit PP and LP in assets, %
Доля чистых иностранных активов в активах, % – Share of net foreign assets in assets, %
Нейтральная позиция – Neutral position
Чистый отток капитала на внешние рынки – Net capital outflow to external markets
Специализированные банки – Specialized banks
Универсальные по продуктам, специализированные по клиентам – Multi-product and mono-clients
Специализированные по продуктам, универсальные по клиентам – Mono-product and multi-clients
Универсальные банки – Universal banks

Свёбэнк - Swedbank
Русфинанс Банк - Rusfinance bank
Городской ипотечный банк - Gorodskoi Ipotechnii Bank
Кредит Европа Банк - Credit Europe bank
ХКФ Банк - Home credit bank
Коммерцбанк (Евразия) - Commerzbank (Eurasija)
БНП Париба - BNP Paribus bank
ВестЛБ Восток Банк - WestLB Vostok bank

^4 Yellow are the banks which steadily (for 2 years) played the same macroeconomic role – provision of Russian markets with net capital inflow, provision of external markets with capital outflow, neutral position
Clusterization of the banks controlled by non-residents leads to following conclusions.

- Universal strategy was the main field for competition among Russian and foreign banks at pre-crisis period. Approximately ¾ of foreign banks’ aggregate assets were held by banks following this strategy in Russia. As time went by more and more foreign banks chose the strategy. Same topics were discussed at (Gelos, Roldos (2004). Among Russian banks this strategy was most popular as well. As a result presence expanding of foreign banks was accompanied by strengthening of competition with Russian private banks and mild crowd out of the latters including market of basic banking products and services for mass client.

- During pre-crisis period foreign banks primarily were sources of capital inflows to Russian market. Same conclusions were made by (Vernikov, 2006) as well. For most of them net investment from abroad became important source of active operation funding for internal markets. It made the process of their expansion responsive to instability on foreign financial markets.

- During the crisis period universal strategy oriented on standard products and wide range of clients may become inefficient. Mass markets are most inclined to contagion effects. In addition as was mentioned before dynamics of many key markets (like deposits from households, retail and corporate credits) probably will be weak during next 1-2 years because of the credit and monetary contraction.

Banks with foreign capital which took universal strategy probably will have to choose among next decisions.

- «Freezing» expansion to internal markets, using funds accumulated on internal markets for net capital outflow to external markets (including support of the parent companies).
• Return to specialized and combined strategies, e.g. more active positioning as banks working with multinational companies doing business in Russia and with Russian business owned by foreigners.

New conditions will give Russian banks some respite from fight for borrowers with foreigners. At the same time fight for depositors and corporate clients may get tough.

4. Preliminary conclusions

Conducted analysis argues what in next couple of years foreign banks expansion on Russian banking sector will fall dramatically.

In this situation foreign capital should not be seen as a factor which helps to recapitalize Russian banking system and mitigate crisis consequences.

Also it should not be counting on subsidiary banks of non-residents as on a significant source of borrowed resources on Russian market may be except for inflows of short-term capital aiming for high return.

At the same time there might be some strengthening in the process of re-allocation of Russian assets among different groups of foreign banks.

Subsidiary banks of non-residents will look for loyal clients and protected from crisis product and client niches. Competition level between Russian and foreign banks on mass markets of banking services (e.g. retail banking and deposits) will fall dramatically.

Subsidiary banks of non-residents will try to use their role of the “bridge” between Russian and foreign markets as a main competitive advantage by providing services to the clients working for both sides.

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