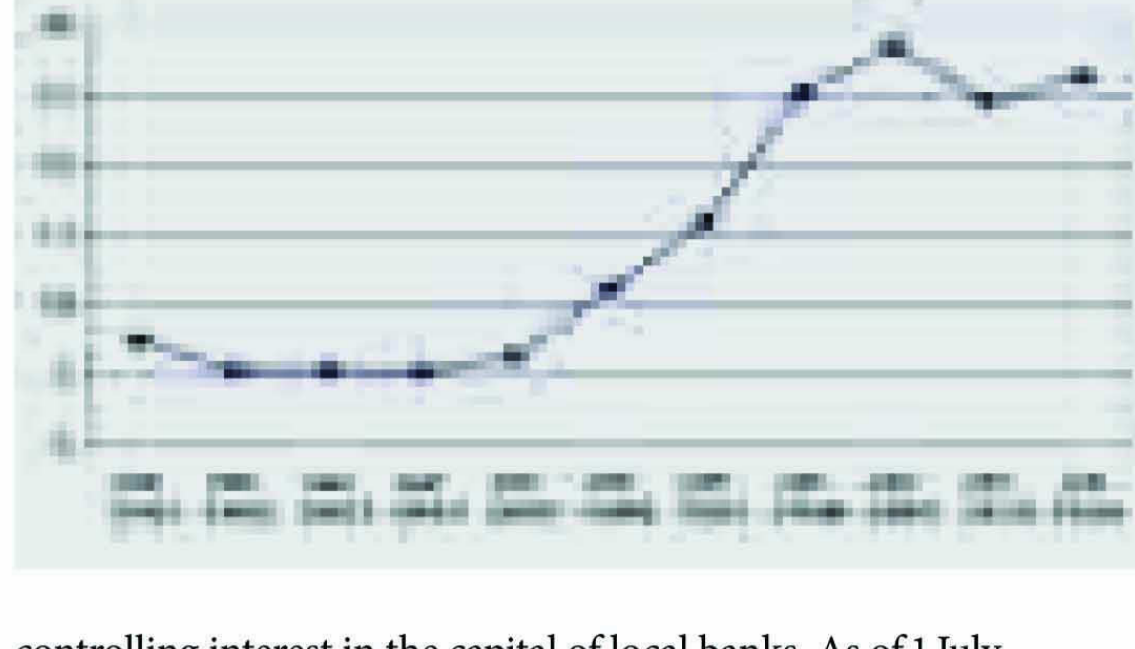


Increased Presence and New Structure of Business

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Graph 1 Share of foreign investors in the total authorized capital of the Russian banking system, %
(Source: Bank of Russia)



Year	Banks with participation of foreign investors	100% foreign ownership	> 50% foreign ownership
1997, January	152	13	10
1998, January	145	16	10
1999, January	142	18	12
2000, January	133	20	12
2001, January	130	22	11
2002, January	126	23	12
2003, January	126	27	10
2004, January	128	32	9
2005, January	131	33	9
2006, January	136	41	11
2007, January	153	52	13
2008, January	202	63	23
2009, January	221	76	26
2010, January	226	82	26
2010, July	219	81	24

Table 1: Foreign banks in Russia

Over the last decade foreign banks increased their presence in Russia as seen in Diagram 1. Their fastest growth has been observed since 2005 and in the first quarter of 2009 their share reached a high of 31.19% of the total authorised capital of the Russian banking system. As the economic and political situation after the 1998 crisis stabilized and the economy and personal income grew stronger so did the demand for banking services. All these have led to a greater presence of foreign banks in Russia.

Banks originated from Western Europe and the USA are the main investors in the banking sector of Russia. However, in recent years Asian banks and the credit institutions from CIS countries became more active in the Russian market.

Foreign banks use different strategies to achieve their goals in Russia through portfolio investments or acquiring

controlling interest in the capital of local banks. As of 1 July 2010, out of 219 credit institutions with participation of foreign investors 24 were controlled by non-residents (e.g. >50% ownership of initial capital) and 81 were owned entirely by foreign investors.

Over the last two decades foreign banks operating in Russia have reviewed their methods of expansion as the barriers to foreign banking capital entry have been eased, the investment attractiveness of the country has improved and the banking market has been developing.

In the 1990s, foreign banks expanded their presence primarily by opening representative offices, which, however, are not the operating affiliates of parent banks, or establishing subsidiaries (greenfield investments). Takeover of local credit institutions (brownfield investments) as a method of expansion was not popular due to restrictions on the purchase of the already existing banks and the unwillingness of foreign credit institutions to improve weak local facilities.

Often the establishment of a new credit institution (greenfield investments) is driven also by the strategy of a parent bank. In transition economies some banks, for example Citibank, Societe Generale, ABN Amro opened their subsidiaries in the first years of banking system transformation. This method of foreign network development results from the necessity to service their traditional clients -- transnational corporations -- under the 'follow the client' strategy.

From the mid 2000s, along with the establishment of subsidiaries the purchase of already existing credit institutions in Russia has become more frequent. The rising expansion of foreign banks was mainly caused by, first, the liberalisation of banking legislation that has simplified merger and acquisition deals. Second, the stabilisation of the economic and political situation in Russia fuelled the interest of foreign credit institutions in the development of banking business in this country. So, foreign investors are acquiring the already existing local banks with their vast branch networks to expand their retail operations. This was also necessitated by the fact

that in Russia a license for transactions with physical persons is issued only two years after the registration of a credit institution.

The establishment of branches as a form of commercial presence has not become popular in Russia. Historically, two branches of foreign banks (Anelik, Bank Austria) were operating in this country. However, later they were transformed into subsidiaries. Though at present the establishment of branches is not formally prohibited, the Bank of Russia actually does not issue licences for their establishment.

Foreign banks operating in the Russian banking market pursue diverse strategies. In the 1990s they occupied a narrow niche in the corporate lending market and were involved in transactions in the securities market. Their operations in the retail market were limited. In the 2000s, the subsidiaries of global banks expanded the range of services to become universal banks (Citibank Raiffeisenbank, Unicredit). Some foreign banks are engaged in providing services only to legal persons (Deutsche Bank, Dresdner Bank) or physical persons (DeltaCredit, Rusfinance Bank, Home Credit and Finance Bank) or in developing investment banking (Nomura, Morgan Stanley, Goldman Sachs).

As intermediates between the national and global markets, foreign banks in Russia are becoming a channel for redistribution of capital between countries. Before the 2000s, the foreign banks primarily served as a channel for capital outflow. However, later this tendency became reversed. The increase of foreign liabilities of the foreign banks became an important source of their expansion in the Russian market.

The foreign banks use borrowings from the global capital market for lending and investment operations. They are active players in the interbank lending market. So, in 2009 they accounted for 31.7% of this market, and in some years for 33%. According to the experts of the Centre for Economic Research of the Moscow Financial Industrial Academy, the foreign banks exert a stabilising effect by redistributing liquidity in the banking system of Russia.¹

Banks with foreign capital have their own specifics in conducting credit operations in Russia. Their main customers are transnational corporation branches and the largest Russian enterprises and thus they occupy the most attractive niche in the corporate lending market. However, bank subsidiaries generally act as intermediaries between a borrower in Russia and the parent bank. The creditors are generally foreign banks which do not always use the intermediation of their subsidiaries and grant loans to Russian producers through cross-border operations.

At present, the activity of foreign banks in Russia has the following characteristics. First, they primarily act as intermediates between Russian and international financial markets. However, the major lenders of Russian corporations are non-resident parent banks based abroad. Second, the proportion of foreign banks acting as financial intermediates in the Russian market (14.8% of total loans granted to non-financial corporations) match their presence in the banking sector (18.3% of total banking assets). Third, their role in capital distribution between economy sectors is limited as their major clients operate across few industries, also because of the diminishing diversification of the Russian economy.

Now, it is possible to review the interim performance of the foreign banks during the financial crisis. When the crisis was in full swing, the proportion of non-residents in the Russian banking system varied considerably. By 1 April 2009 their proportion in the total authorised capital of the banking sector reached an all-time high of 31.19%. That was chiefly due to the fact that some parent banks channelled their resources to increase the initial capital of

their subsidiaries in Russia and build up their reserves. However, by 1 January 2010, the proportion of foreign banks had dropped significantly, to 24.53%. Although non-residents kept increasing the authorised capital of their banks, its growth rates (21.6% in 2009) were lower than those in the entire banking sector of Russia (41.2% in 2009). That was caused by a substantial injection of public funds into the banking system both directly (an increase of 45 billion roubles in the initial capital of RosSelkhozBank) and through the Deposit Insurance Agency and Vnesheconombank (the initial capital of the East European Finance Corporation Bank increased by 10 billion roubles, Svyaz Bank by 70 billion roubles).²

The 2008-2009 crisis affected the non-resident expansion in the Russian banking market either in method or scale. From 2005, to penetrate the market, foreign investors preferred to acquire the existing credit institutions, but in 2009 their focus shifted to registering new banking institutions (Vietnam-Russia Joint Venture Bank, Goldman Sachs Bank, Sumitomo Mitsui Rus Bank, Hellenic Bank).

The crisis frequently gives an opportunity to takeover banks cheaply. However, non-residents remained essentially dormant in Russia. First, the liquidity crisis in international markets decreased the volume and number of merger and acquisition deals. Second, the active consolidation of the Russian banking system created a great deal of interest from the largest national credit institutions (often state-owned) that have access to the resources of the Bank of Russia. Third, it is remarkable that the largest foreign players are already present in the Russian market while the Russian banks with a noticeable market share are not offered for sale. In the long run that might lead to the arrival of small foreign banks in the Russian market.

At the same time, 2008 and 2009 saw the closing of deals that had started before the financial and economic crisis in Russia. It is expected that the crisis will in some way slow down the expansion of foreign banks. Merger and acquisition deals are forecast to escalate in 2010, but the investors will be small-sized foreign banks or credit institutions from the countries which are poorly represented in Russia.

Some banks with foreign participation announced their intention to withdraw from the Russian market. Swedbank planned to sell all or part of its share in the subsidiary banks of Russia and Ukraine, but so far has only laid off some of their staff. The intention to quit the market was associated with the losses of their parent company, which, on the one hand, is not able to support its subsidiaries and, on the other hand, sells its assets abroad to cover losses incurred in other markets. The external factors also lie behind the sale of non-profile assets in Russia by ING Bank, which has phased out the life insurance project and sold the ING Non-State Pension Fund. For comparison, the 1998 crisis had a considerably greater impact on the decision of foreign banks to quit the Russian market and was caused primarily by losses incurred in this country. Such was the decision taken by investment banks like Lehman Brothers, Goldman Sachs, Merrill Lynch and Nomura.³

The crisis caused the foreign banks to cut their regional development programmes in Russia. In 2008, the number of bank branches with 100% foreign ownership increased by 73 to 242, while in 2009 their number decreased by one.⁴

The banks with foreign participation, which account for about 45% of all external loans granted to the banking system, cut borrowings from abroad. At the beginning of 2009, borrowed from the international capital markets were channelled to the Russian interbank lending market to a lesser extent than when the banking

1 Foreign bank subsidiaries in Russia. The Industrialist of Russia. Special issue, 2007

2 Source: The Bank of Russia. www.cbr.ru

3 Foreigners take subsidiaries out of Russia. Kommersant, 14 May 2009

4 Source: The Bank of Russia, www.cbr.ru

market was operating under normal conditions. The review of the foreign banks in terms of their share in the lending market shows that the proportion of the foreign banks has been growing in the shrinking interbank lending market. In fact, 105 foreign-owned credit institutions account for one third of the above market.

Banks with foreign participation as well as credit institutions with Russian capital have reduced the range of products that involved long-term funding or discontinued to offer them. The number of credit lines to borrowers has decreased. Besides, some foreign banks have altogether suspended granting mortgage loans in roubles or foreign currency (GE Money Bank, HFC Bank, ICICI Bank Eurasia).

The crisis also affected the pricing policy of the banks with foreign participation as well as Russian banks. During the 2008 liquidity crisis, the banks with foreign participation dramatically increased loan rates, in particular mortgage rates, up to the prohibitive level.

The profit-earning capacity of the banks with foreign participation sharply distinguishes them from other credit institutions. As of 1 July 2009, their total net profit amounted to almost 38 billion roubles against 6.8 billion roubles across the sector.⁵ HFC Bank, ING Bank, Credit Europe Bank, Unicredit have become the most profitable. On the one hand, this huge gap is explained by Svyaz Bank amounting to 55.7, VTB to 26.5, KIT Finance to 11.6 billion roubles). On the other hand, the foreign banks appeared to be more resistant to the crisis due to their conservative strategy, tight control over expenditures, a relatively low level of bad debts and reserves.

The financial performance of the non-resident banks was also strong in 2009. So, foreign-owned banks, accounting for 18.3% of total Russian banking sector assets, earned almost 30% of its profits.

Banks with foreign participation as distinguished from Russian banks reduced their foreign currency assets. From January to

March 2009, net foreign assets shrank from minus 18.4 to minus 24.4 billion dollars.⁶ The role of the Bank of Russia in this development was significant as it maintained the month average value of foreign assets and the average total value of net currency position of credit institutions. The Bank of Russia restricted the increase of foreign currency assets and ordered to keep foreign currency on its non-interest bearing accounts. These measures were introduced to prevent the weakening of the rouble and targeted the non-resident banks.

During a crisis, the banks with foreign participation expect to receive assistance from their parent credit institutions. The experience of the 1998 and 2008-2009 crises evidences a significant increase in the authorised capital of the banking sector. In the first quarter of 2009, the non-residents increased investments into the authorised capital of the existing credit institutions by 13.4% mainly by increasing the authorised capital of their subsidiaries, as did, for example, Banca Intesa, DeltaCredit, JP Morgan Bank International, Raiffeisenbank, DeltaCredit, etc. To some extent, this approach solves the problem as to how subsidiary credit institutions in a global crisis could be assisted - through the central bank of the host country or parent companies? In Russia assistance is primarily provided by those parent banks which have access to the liquid resources in the national markets. This distinguishes Russia from Central and Eastern Europe (CEE) where foreign credit institutions prevail in their banking sectors. Some West European countries whose banks are present in CEE prohibit providing assistance to the offices abroad where the parent banks received funding from the government.

The largest banks with foreign participation are in a more favourable position than many private Russian banks as they have the opportunity to receive assistance from their parent companies and enjoy the refinancing mechanism of the banking system offered by the Bank of Russia.

Table 2: Selected indicators of credit institution with foreign participation relative to indicators of operating credit institutions, % (Source: Bank of Russia)

	1.07.98	1.01.00	1.01.05	1.01.08	1.01.09	1.01.10
Credit institutions with foreign participation over 50%						
Assets	6,7	10,6	7,6	17,2	18,7	18,3
Own funds (capital)	5,0	10,3	7,8	15,7	17,3	23,8
Correspondent accounts with non-resident banks	6,4	9,9	14,0	23,2	17,0	15,6
Loans and other placements with non-financial organisations	8,8	9,8	6,1	15,5	16,6	14,8
Loans, deposits and other placements with credit institutions	14,6	31,8	15,8	22,2	25,0	31,7
Individual deposits	0,7	1,8	3,0	8,9	10,3	12,0
Funds raised from organisations	7,1	14,7	9,2	17,8	18,8	18,5
Profit (loss) of the current year	-	-	10,0	16,4	19,7	29,8
of which 100% foreign-owned credit institutions						
Assets	4,7	6,0	5,9	11,6	13,0	11,3
Own funds (capital)	3,4	6,2	6,3	11,1	12,2	15,4
Correspondent accounts with non-resident banks	3,2	4,2	7,6	15,6	12,1	9,0
Loans and other placements with non-financial organisations	6,9	7,6	4,6	10,7	11,6	9,1
Loans, deposits and other placements with credit institutions	8,4	13,0	11,4	18,6	21,6	23,8
Individual deposits	0,2	0,7	2,4	5,0	5,4	6,2
Funds raised from organisations	3,3	6,5	6,0	10,9	12,6	11,1
Profit (loss) of the current year	-	-	8,0	10,7	14,8	27,4

5 Nonresidents hit an all-time high. RBK Daily, 20 August 2009

6 Mamonov, M. The banking system hit by the crisis: structural shifts and adaptation of key bank groups. The Centre of Macroeconomic Analysis and Short-Term Forecasting, 2009