



TRUSTED
SOURCES

Russia's banking boom

Trusted Sources > Russia > Financial

25 Jan 2007

Overview

A powerful feature of post-communist transition is the appearance from scratch of fundamental sectors which were non-existent under central planning. As the experience of Russia in the last five years has shown, the financial services sector provides the most dramatic and, for investors, exciting example of this phenomenon.

Russia's banking boom - with not only balance sheets but also profitability increasing by 33% a year since 2002 - is demand driven. Future investment returns in the sector and, more broadly, the sustainability of the Russian economy's present phase of investment-led growth, will hinge on the adequacy of the supply side response. This will require more competition, depending in turn on strong privately-owned banks. Our trusted source, who runs one such bank, provides insight into the competitive environment. The practical portfolio investment conclusion is that stock picking now moves to centre stage.

Context

A demand driven story. Adequacy of the supply side response hinges on competition

Trusted Judgements

The rapidly expanding market is wide open, but competitive pressures are beginning to be felt. Service quality is the key

> **Michel Pehirin**, CEO of MDM Bank

Wrap

Level playing field with state banks and easier mergers are the public policy keys. The present 'no brainer' investment proposition presented by Russian banks will need to become more discriminating

Context

The explosive growth of the Russian banking sector (now mirrored also in several other former Soviet countries) has at last reached its rightful place at the forefront of the equity investment scene. Dominating the sector with around 40% of all loans and deposits is the majority state-owned Sberbank, which has been the top performing stock in the latest bull market in Russian equities. Other, less liquid banking stocks have performed even better.

Ballooning balance sheets must be supported by more capital, which until now has been raised outside the capital markets - with the exception of a few subordinated loans. But equity investors are set to take up the baton from fixed income investors, as several Russian banks are planning new public share issues - led, once again, by Sberbank. Its 14% share capital increase through a secondary public offering expected in February would, if fully placed, raise around \$12 billion at the present share price.

Demand side the key driver

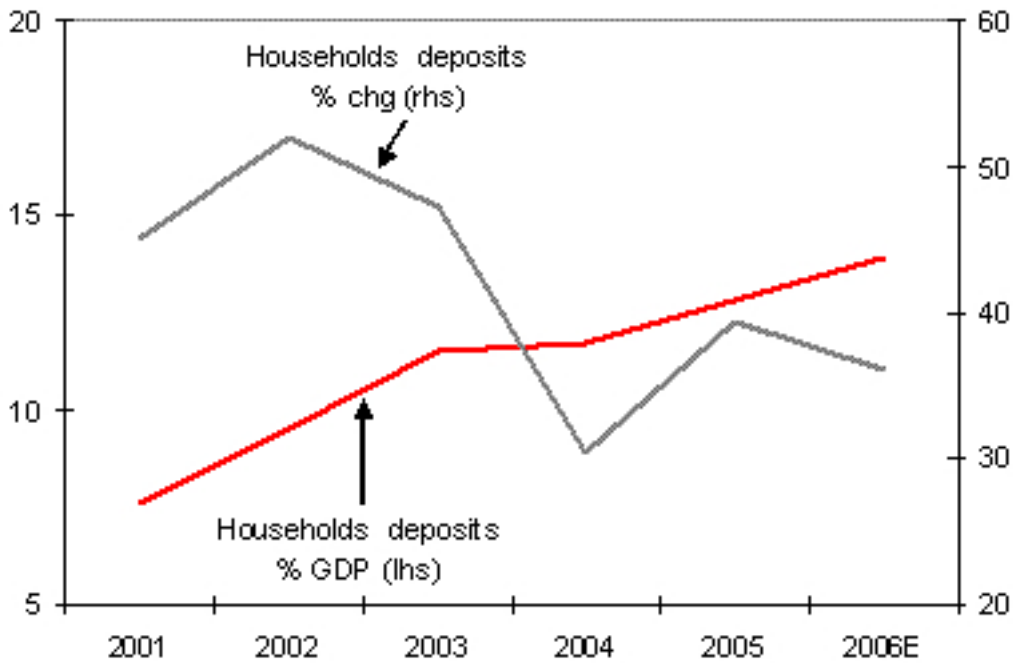
This market excitement has been catalysed by an important regulatory change first mooted back in 2001 but which, with the usual snail's pace of most structural reform, was finally enacted last December. This is the removal of the requirement for foreign investors to have the Central Bank's permission to buy stock in a Russian bank.

In general, however, top-down regulatory improvements have not been the main driver of Russia's banking boom. To be sure, important and essential reforms have been steadily implemented, especially during Putin's second term since 2004. Highlights here have been the deposit insurance scheme (replacing the previous state guarantee for household deposits in Sberbank alone) and the compulsory use of international accounting standards (entailing, in particular, proper NPL provisioning levels). But the underlying stimulus has come from the demand side.

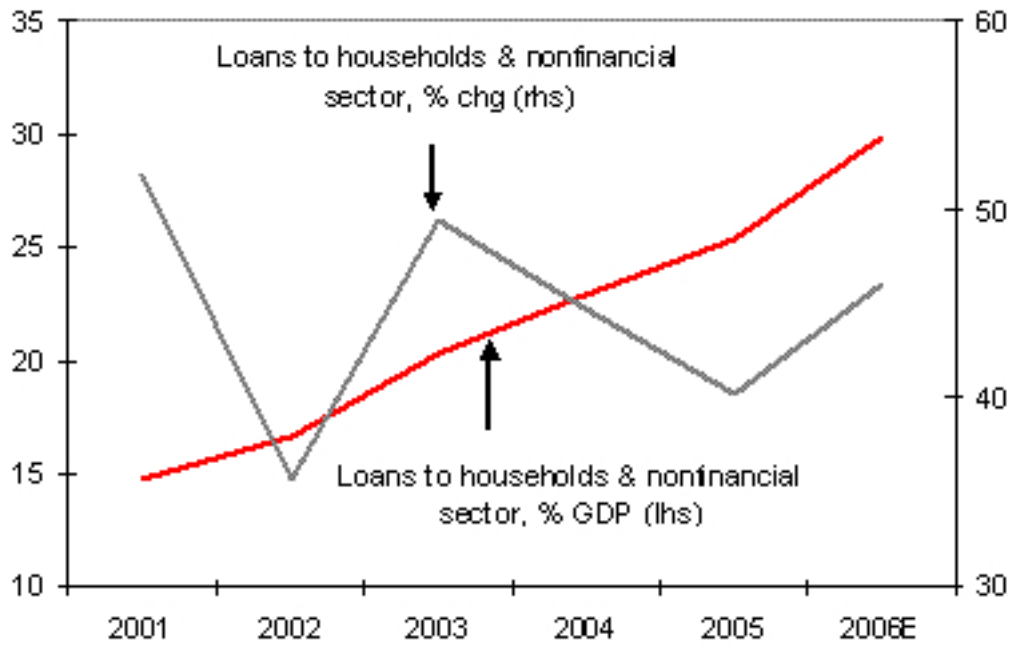
The key here is not only strong GDP growth and rising incomes, but also underlying public confidence. The main obstacle to financial deepening throughout the 1990s and into the present decade was not even the lack of confidence in the banks themselves, but rather the general public alienation from the state. The public's long preferred savings instrument was dollar cash to avoid tax and as a defence against further devaluations and monetary confiscations. This preference was displaced by growing demand for financial services thanks to the general stability and, more specifically, the tax reforms of the Putin years. The gradual legalisation of payrolls has resulted in wages being paid into bank accounts.

The other major demand stimulus for financial services has been the exhaustion of spare capacity and consequent transition from 'catch-up' growth to investment-led growth. Recently released data on domestic investment for the first three quarters of 2006 showed that the jump to +12% yoy from the equivalent figure of 9.4% a year earlier was financed not by government spending (as may have been supposed from all the talk about the new national projects and infrastructure fund), but rather from increased bank lending.

The new buoyant demand for financial services is visible in a sustained surge in household deposits, while the stock of loans as a percentage of GDP doubled to 30% in the five years to 2006 (see two charts below).



Source: CBR



Source: CBR

Supply side up to the task?

But is the supply side equal to this remarkable financial deepening? Will the present structure of the Russian banking sector serve Russia's top policy priority of promoting longer-term investment?

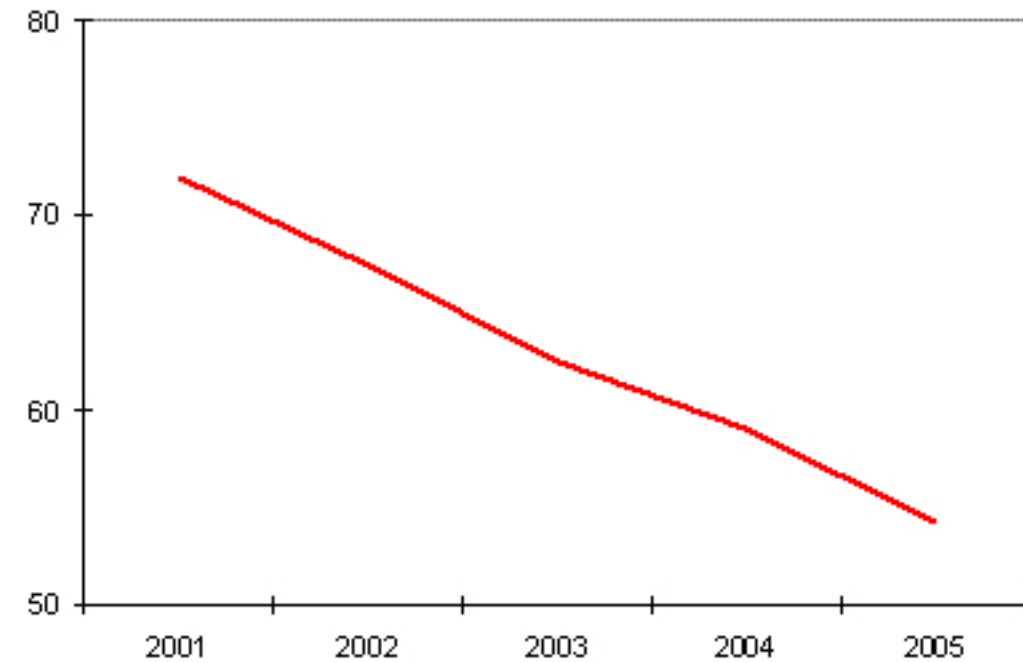
The most common concerns here are the dominance of two majority state-owned banks, Sberbank and VTB, and to some extent the small market share of foreign banks. This structure can be seen at a glance in the ownership and asset share of the key top fifteen banks - .

Looking around the emerging market universe, it is difficult to conclude that the participation of foreign banks is essential to promoting banking efficiency and soundness. What matters most is competition. The lack of competition in Russia is only partly due to the dominance of state banks. A mixed banking structure, such as Russia's, should not be an obstacle to greater efficiency. The essential ingredient for real competition is strong privately-owned banks (which in Brazil, for example, are world class).

President Putin himself appears to be focussed on this. In November 2006 remarks to a State Council session on financial services, he castigated the banking sector for failing to meet the country's needs for access to banking services and for long-term investment. Putin was really zeroing in here on the privately owned banks - even suggesting that the country's accession to the WTO expected in 2007 (which, as now agreed with the US, will effectively remove existing restrictions on foreign entry into the domestic banking market) does not leave them much time to become really competitive. He concluded that both business and the state share an interest in promoting greater competition.

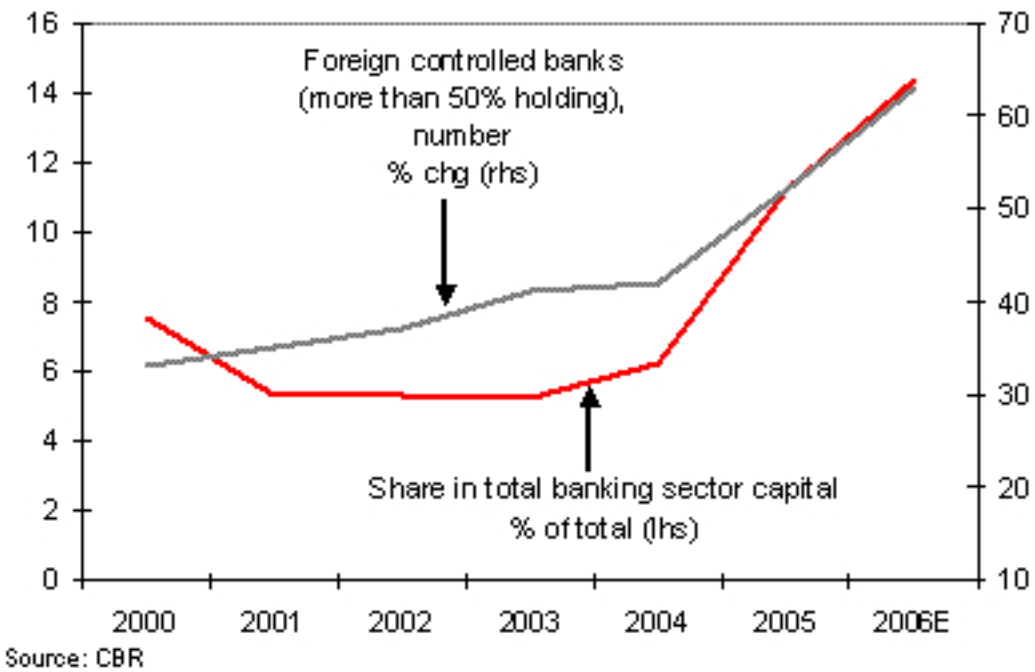
The relative weakness of privately-owned Russian banks can be traced back to the pounding they received in the 1998 financial crisis. It is only in recent years that they have begun to overcome that legacy. This revival has been helped by the introduction of a sector-wide deposit guarantee scheme (see chart below for the decline in Sberbank's share in household deposits), but is mainly due to financial deepening - which has produced 33 per cent average annual earnings growth in the period 2002-6.

Sberbank's percentage share in household deposits



The cause of competition should also be helped by the gradual expansion of foreign banks into the Russian marketplace (see chart below).

Foreign banks in Russia



Trusted Judgements

Michel Pehirin, CEO of MDM Bank

Although there has been rapid growth in the banking sector, there are still plenty of opportunities for banks to expand. Competition is rising, but the market is large and competition is not the main restraining factor on banks' activities at the moment. Margins are still relatively attractive.

The key to succeeding in the market is the ability to deliver top quality service; this is the most important factor for success, more so than pricing or the ability to offer a broad range of products, though these are clearly important.

Foreign banks bring a focus on providing top quality service when they first arrive in this market, and they are especially well placed to deliver this in the fast-expanding retail segment. Quality of retail service was long neglected by privately-owned banks, though Alfa Bank - with its 'Alfa Express' retail brand - was a successful pioneer in improving this picture. Others have since followed, by targeting quality service as a key factor for success - VTB, for example, with its 'VTB-24' brand. At MDM too, we are making a serious push into this market, with a new modern branch network. So the competition is to provide the best service.

The key to understanding what is happening in the market is to realise that personal incomes are rising rapidly. So there is a constant new supply of "bankable" clients for the banks to target. With so many new entrants to banking, quality of service is still the key to success.

While the overall market still offers a number of attractive opportunities, one can see extremely competitive conditions developing in certain segments. For example, the provision of payroll management services has now become a very competitive product area. Companies are putting their payroll business out to competitive tender and banks hoping to secure this business must also be able to provide a full range of corporate banking services.

In terms of new developments in the banking market, factoring is now growing rapidly, as is securitisation. This has led many banks to go to the market to issue debt and equity in order to fund the rapid expansion of their balance sheets. The rapid growth of lending also raises concerns about credit quality. There has not been deterioration in credit standards of the banks at the corporate banking level - banks are looking very closely at every new corporate loan. It is more likely that problems, if they arise, will turn up in the retail loan book. Despite the attractive margins on such business, there is also real credit risk.

As for prospects for the overall structure of the sector, the banking system will see consolidation among the largest Russian privately-owned banks. This consolidation will likely include more tie-ups with foreign banks (such as the recent case of Rosbank and Societe Generale), for which there are strong mutual incentives - in the foreigners' case, mergers with local banks being seen as an easy way to gain entry to a very attractive market. Meanwhile, there will be a steady decline in the numbers of smaller banks. The top two state banks will still account for the bulk of the market, some 55-65 percent, and will remain majority state owned for the foreseeable future.

Government policy on the structure of the banking sector looks stable. The government will likely let competition take its course without fear that large state banks will see their position eroded. A mixed banking system, with a dominant role for several state-owned banks competing with strong private and foreign banks is their preferred model.

Wrap

Michel Pehirin's testimony is particularly valuable not only for coming from the current head of one of Russia's top privately-owned banks, but also given his almost unparalleled experience among senior foreign commercial bankers in Russia (before joining MDM in 2006, he spent five years running Raiffeisen Bank's Russian subsidiary, one of the first successful foreign entrants into the domestic retail market).

He portrays a market in sustained and rapid expansion (especially in retail - 'more and more bankable individuals'), allowing participants plenty of scope to make the most of this opportunity without being stifled by competition. This reflects the powerful reality of rapid financial deepening, which from both the macroeconomic and investment strategy point of view is perhaps the single most important new story out of Russia in the past three years or so.

Seen in this perspective, exposure to the banking sector - and financial services more broadly - is an investment 'no-brainer'. Economic growth and rising incomes ensure steady growth in demand for financial services, while making it increasingly profitable to supply those services. At the same time, the strength and efficiency of the banking sector will be an essential factor for sustaining economic growth at its present clip.

The sector will only achieve the necessary efficiency if competitive pressures are real. Here, Pehirin's account is also reassuring - while at the same time contrasting with his overall message that this buoyant market offers plenty of room to all players. For, as he signals, competition is intensifying all the while. His mention of payroll management for companies as a particularly competitive segment makes perfect sense, since this is the fastest way for banks to build retail market share. More significant still is his general point that 'with so many new entrants into the market' (which means numbers of domestic banks which have long held licenses, but only recently have started trying to provide anything resembling normal banking services to corporate and retail clients), the competition hinges on providing true quality service.

As far as public policy is concerned, the lack of radical steps - e.g. to break up Sberbank and promote higher foreign participation - will not be fatal in itself to the cause of promoting competition in the banking sector. The essential condition is to create an environment in which privately-owned banks can flourish. This means ensuring a level playing field (the point of the deposit insurance scheme) and lowering the regulatory hurdles to mergers and acquisitions. This last point was made by Putin himself in his last big policy statement on the banking sector (see the 'Context' section above for reference), in which he called for reduced red-tape around bank mergers (i.e. leading to larger and stronger private sector banks).

As competition develops, the 'no-brainer' investment proposition of getting exposure to the Russian banking sector will give way to a need for careful stock picking, starting with the series of new share issues from banks now in the IPO pipeline.