Every banker in Russia still remembers 1998 with a certain amount of horror. A burgeoning budget deficit led to the default of the Russian government and to the collapse of the ruble. With Russian banks unable to fulfill their obligations stemming from ruble forward contracts, the meltdown of the banking system ensued in just one morning. Crowds of enraged and desperate citizens tried in vain to rescue their savings, and Russian banking was thrown back to an era when people stored money under their mattresses and businesses had to finance themselves.

Of course, all that happened eight years ago. Many would argue that Russia today is a different country, one with a highly promising economy that carries far fewer business risks than it once did. Indeed, Russia—much like other large developing markets such as China and India—looms as a possible new frontier for growth-minded financial institutions seeking cross-border expansion. But like the long Russian winter, the road could be an arduous one.

To be sure, Russia has attributes that many international banks would find attractive. The country has shown robust GDP growth over the past seven years, ranging from 5 to 10 percent annually, and the government has been running a budget surplus since the turn of the century—allowing it to pay debts early and build up significant currency reserves. Much of this growth has been fueled by the country’s booming oil-export business, but other commodities have also contributed: Russia is one of the largest global exporters of gas, nickel, palladium, steel, and aluminum.

Russia’s banking sector has benefited in kind, with assets expanding at nearly 30 percent annually and showing few signs of slowing down. Banks have also been bolstered by the “catch-up” effect from the late 1990s—first, the remonetization of the economy (replacing barter schemes), then the return of confidence in the banking sector and consequent increase in the use of banking services by both corporate and retail clients. Earnings growth has been considerable, with the top 15 Russian banks recently posting an average return on assets of 2.7 percent and an average return on equity of 16 percent.

Of course, the Russian banking system carries with it a dose of uncertainty as well. Most financial institutions are so-called pocket banks, whose business is conducted largely with the industrial groups that own them and whose sometimes questionable business models have attracted the attention of increasingly vigilant state authorities, prompting closures. One crackdown in the summer of 2004, involving allegations of money laundering and other wrongdoings, led to both the interbank market drying up for a time and a degree of nervousness among retail clients. But foreign and state-owned banks, rightfully regarded as safe havens, ultimately benefited—seeing their market shares in retail deposits rise while those of second- and third-tier players declined.

In our view, the entry of foreign players, along with overall consolidation, will be key trends in Russian banking over the next few years. (See the exhibit on the next page.) Both foreign banks and large private-sector Russian banks will grow at the expense of captive and smaller regional institutions by exploiting their superior value propositions and their power to make acquisitions. The first step for any foreign bank wishing to gauge the possibilities in Russia, however, is to survey the landscape and form an idea of where the best opportunities lie.
Assessing the Potential

The Russian banking landscape is highly fragmented. There are more than 1,200 banks in the country, and even the largest privately owned institutions hold no more than 4 percent of the market. State-owned banks—most notably the retail giant Sberbank—hold about 50 percent of the market and are considered reliable, although they are also perceived to be somewhat inert and overly bureaucratic.

When it comes to products, simple offerings such as straight loans and deposits prevail. Technologies are somewhat simplistic, with corporate loans usually extended against collateral rather than against forecast cash flows. Fee-based products play a negligible role, rendering many Russian banks overly dependent on interest and trading income. Also, most banks are organized by region rather than by business segment, which sometimes leads to an insufficient focus on the customer.

Gaps such as these may provide substantial opportunities for major foreign banks whose funding, brand reputation, product expertise, customer service skills, and risk management experience are often superior to those of their Russian counterparts. In our view, the following areas hold significant potential.

Corporate Banking. Although large-cap lending is becoming less profitable owing to intense competition and declining rates, margins of 10 percent or more can still be achieved in the mid- and small-cap markets. Many firms in these categories are still underserved by banks and are happy to get a loan even at relatively high rates. As the owner of a Moscow-based service firm that generates $20 million in annual sales recently told us, “After ten profitable years on the market, I have found for the first time a bank willing to extend a loan to my business.”

Retail Banking. Retail banking was a nonissue in Russia until several years ago because most banks—choosing to pursue quicker returns rather than make long-term investments in branch networks—focused on large-cap lending and trading. More recently, however, the retail segment has become the top priority for many of the top 15 Russian banks, as well as for a few foreign challengers. Most efforts currently focus on a few key products such as consumer loans and deposits, whereas other offerings such as mortgages and credit cards are just beginning to gain traction. In terms of regional outlook, modern banking is currently concentrated in Moscow and Saint Petersburg, whereas the rest of the country is underserved.

Investment Banking. This segment is already experiencing strong growth. And as the financing needs of Russian companies rise, there
should be a steady stream of both bond and equity issues. While the issues for foreign markets (especially London) are already firmly in the hands of foreign institutions, Russian investment banks still dominate the local scene. On the equity side, the RTS index has surpassed 1,000, and the market capitalization of listed companies has grown from around $230 billion at the end of 2004 to around $490 billion at the end of 2005. On the fixed-income side, there have been almost $9 billion in new issues of corporate bonds since the beginning of 2005.

Private Banking. The proverbial oligarchs in Russia are well catered to. But there is an ever-growing upper-middle class consisting mainly of entrepreneurs and senior managers that is not well served. People in this category—who often have between $300,000 and $1 million (or more) in assets to manage—typically invest independently, perhaps into real estate or their own businesses. Sometimes they resort to bank deposits. This is illustrated by the fact that in most major Russian banks, about 50 percent of retail deposits are held by less than 5 percent of the clients. Banks that can develop a viable advisory business, coupled with a wide range of both domestic and international products, will be well positioned in this segment.

Asset Management. This segment is still in its infancy but has strong growth potential. If deposit rates continue to fall and growth in real estate prices slows down, the search for alternative investments could bolster retail asset management—while the developing insurance sector could provide momentum on the institutional side. One way that asset managers can grow is by trying to supply a wider range of products to foreign investors.

What International Players Should Know

International banks considering a foray into Russia are faced with a fundamental question: Is it better to build a position from the ground up or to buy a position that already exists? As with most developing markets where both opportunity and risk are abundant, there are pros and cons to each approach.

Building a position, owing to somewhat onerous regulatory requirements, is time consuming. A Russian subsidiary must first be registered, followed by an application for a banking license. From start to finish, obtaining a license can take up to one and a half years for newcomers, and opening a branch can take six to nine months more. Then, of course, there are the challenges of visibly differentiating your bank from foreign players that are already present—and, when it comes to retail banking, figuring out a way to approach such a vast country in a cost-efficient and manageable way.

Yet there have been notable success stories. Raiffeisen Bank, the Austrian cooperative bank, started retail banking operations in Russia six years ago—a time when most Russian financial institutions did not take the retail business seriously. With its clean, spacious, centrally located branches, Raiffeisen soon set the standard for top-segment retail banking in the Moscow market. Among the results have been a number of (mostly) foreign copycats and a successful IPO of Raiffeisen’s Eastern European business, including subsidiaries in Ukraine and in more than ten Central European countries.

Another example is the corporate banking business of International Moscow Bank (IMB), a subsidiary of HypoVereinsbank (Germany) and Nordea (Scandinavia). IMB, currently the ninth-largest bank (and the largest foreign bank) in the Russian market, has been successful at serving the Russian businesses of its home-market
clients. IMB has also employed a clever expansion strategy: establishing representative offices in various regions, mostly to do lending and leasing, and then converting the offices into fully operational bank branches once the business warrants it. IMB now has a presence in 17 regions in Russia.

The other basic approach to entering Russia, acquiring an existing business, may take considerably less time but carries other possible complications. For example, a large part of many banks’ business is based on personal relationships—which could be lost after an acquisition, leaving the buyer with an empty shell. Processes and accounting transparency are often inefficient, leading to acquirers inheriting a host of hidden problems. Even Russian acquirers of Russian banks, more often than not, have had problems integrating their new properties.

Because of such pitfalls, there have been relatively few acquisitions of Russian banks by foreigners so far. But those acquisitions that have gone through have all had the following in common: the acquired banks were small players with simple and transparent business models that focused on a specific product and distribution approach. In addition, none of the acquired banks were affiliated with a financial industrial group. Examples include GE Consumer Finance’s purchase of the personal-loan specialist DeltaBank; Société Générale’s acquisition of the mortgage specialist DeltaCredit; Deutsche Bank’s purchase of the investment bank United Financial Group; and Banca Intesa’s acquisition of the microfinance specialist KMB-Bank. While all of these transactions are too recent to judge their overall success, we believe that a wave of consolidation will occur in the Russian banking market as both foreign players and large private-sector Russian banks test the acquisition waters. This trend can already be observed in Ukraine, where foreign entrants are even more aggressive.

Is the Time Ripe?

Entering Russia will be no cakewalk. There are clearly political and economic risks. The former include the government’s perceived heavy-handedness in some economic affairs—illustrated by its seizure of the oil giant Yukos’s assets amid allegations of tax evasion and money laundering—and the uncertainty surrounding the end of President Vladimir V. Putin’s second term in 2008. The latter involve, for example, Russia’s exposure as a major commodities exporter to a downturn in the global economy.

Yet similar risks exist in many developing countries where banks that establish positions relatively early stand to benefit greatly in the long run. Russia, like China and India, has too much potential to be ignored.1

In our view, international financial institutions seeking further cross-border expansion should consider the following factors when thinking about Russia:

- Profitability in the Russian banking sector is growing, and most indicators suggest the trend will continue.

- The relative youth of Russia’s modern banking industry offers a chance to sidestep some of the traditional approaches to Western banking. For instance, instead of investing massively in a branch network, foreign banks in Russia can utilize modern direct-distribution channels and agent systems. Another route might be to use financing for items such as consumer electronics and furniture to up-sell credit cards to bor-

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rowers who prove reliable. Players that come up with the most creative solutions will be well positioned to succeed.

- Partnerships or small-scale acquisitions provide a way of minimizing time of entry. But acquirers should emphasize due diligence and try to nurture client relationships before taking the plunge. Foreign banks can benefit greatly from the consolidation that is expected to come.

- Russia is a product/segment banking market and will continue to be one for some time. Rather than considering only a universal banking approach from the outset, foreign banks should also consider setting up highly focused (ideally monoline) businesses first—and trying to excel at those—in order to establish their international brand locally.

A number of leading global financial institutions have already made moves into Russia. Many more are considering it and will likely enter Russia sooner or later. Those banks that wait too long, however, may never see the long Russian winter bloom into spring. They may find themselves without even a small piece of a vast new expanse of growth and profitability—while their competitors reap the benefits.

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