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THE FUTURE OF RUSSIAN BANKING: FINDING STRENGTH THROUGH ADVERSITY

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The future of Russian banking: Finding strength through adversity

A rude awakening: Boom turns to crisis

By Yury Spektorov

In recent years, Russia has been one of the world's most dynamic banking markets: from 2003 to 2007, bank assets grew at roughly 40 percent per year. Russia has also emerged as one of the most volatile banking markets across the globe: in October 2008, retail deposits decreased by roughly 5 percent to 6 percent, with privately owned banks losing nearly twice that amount. Over the past four months, liquidity problems led to the near-collapse of Kit Finance, Svyaz Bank, Sobin Bank, and Globex, reflecting inadequate risk management. Credit also contracted dramatically as Russian banks hoarded liquidity. Most Russian banks are simply not lending.

The current financial crisis sweeping across Russian banking has exposed institutional weakness. In 2007, assets per employee at the top-five Russian banks were a dismal €0.9 million—nearly *16* times less than that of the top-five European banks. More employees have not meant more customer satisfaction; Russian banks score low on customer satisfaction when compared with international norms.

On the horizon: A wave of consolidation

Market forces are pushing Russian banks toward an industry wide overhaul that could improve efficiency and performance. One key trend is consolidation. Russia has approximately 1,200 banks, but many are simply too small to be effective players. Excluding Sberbank, which accounts for roughly 25 percent of industry assets, the average Russian bank has only €340 million in assets, far less than average banks in leading Eastern European markets such as Poland (€3.6 billion) and Czech Republic (€3.8 billion). Of the top 60 banks in Russia, only half have enough retail branches to cover all of Russia's major retail markets. With Russia's Deposit Insurance Agency only rescuing banks of "social importance," many small, weak banks may be allowed to fail—which will further spur an acquisition wave.

The state led the first round of consolidation through the acquisition of distressed banks. In October, state-owned bank VneshEconombank acquired Globex and Svyaz Bank, and Gazenergoprombank purchased Sobin Bank. The private sector has also joined in. Examples include a recent merger announcement by MDM Bank and URSA Bank, the acquisition of Severnaya Kazna by Alfa Bank, and moves by Binbank to acquire Bashinvestbank.

Bain's survey of the industry reveals broad potential for more successful mergers & acquisitions. One key factor encouraging acquisitions is that valuations are low. Price-to-book ratios hovered at around 1 to 1.2 in mid-November 2008. These consolidations will rearrange Russia's banking industry. The role of state-owned banks is likely to grow for three reasons: the government purchase of distressed banks; the recent shift in share of deposits to state banks; and the fact that state banks will not be allowed to fail.

Next step: Reform to return to the core

Banking consists of a few core activities such as attracting deposits, offering credit, managing risk well enough to earn a profit, and performing efficiently such that value is created. The current crisis has demonstrated that many Russian banks have not performed these core activities well enough.

As the competitive landscape shifts, private as well as state-owned Russian banks will have to set their house in order if they are to become top-performers. In recent months, VTB , UralSib and the Bank of Moscow announced layoffs to trim a bloated workforce. Market leader, Sberbank, also plans to raise labor productivity through limited hiring in the face of twenty to twenty-five percent annual growth, and natural employee turnover. Sberbank expects its workforce to fall from the current level of 260,000 employees to 210,000 in 2014.

Banks that are able to strengthen their core activities will find the path to profitability first. There is a large, untapped market currently in commercial banking. In the coming months, many solid, second-tier Russian companies will need funds to survive. Banks that are able to focus on these opportunities and manage risk will be positioned to take leadership roles in the industry.

Going forward: Room for growth

Despite the current crisis, there is strong potential for growth in the Russian banking industry. The Russian market remains fundamentally underserved. In 2006, the World Bank estimated that 60 million Russians used no financial services. In 2007, banking assets equalled just 60 percent of Russia's GDP, compared with an average of 85 percent across Central and Eastern Europe, and 250 percent in the G7 countries.

Bain expects growth rates of 15 to 20 percent in the Russian market for bank services through 2020. Asset management, leasing and mortgages are among the numerous underdeveloped financial products that will feed the industry's hunger for growth over the next few years. The gradual rise of Russian wages to European levels will fuel the demand for consumer and commercial financial services. Already, international players such as Societe Generale, Raiffeisen International and UniCredit have made major acquisitions in Russia to benefit from the anticipated growth in banking services. When the dust settles, a more robust and efficient Russian banking industry will emerge, and should prosper from continued growth in financial services.

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