Emerging cross-border activities

The banking landscape in the CIS is extremely uneven, as Kazakhstan and Russia possess the most developed banking sectors. As of January 1, 2009, assets to GDP ratio stood at 67.5% in Russia and 74.7% in Kazakhstan. Other countries’ banking sectors are significantly less developed, both in relative and absolute terms. Kazakhstan’s banking sector grew extremely rapidly until the third quarter of 2007, when it started to struggle as foreign credit sources ran dry. Russia lags one or two years behind Kazakhstan in terms of regulation, concentration, and the development of banking services and products. However the absolute size of its banking sector is understandably much higher.

<table>
<thead>
<tr>
<th></th>
<th>Russia</th>
<th>Belarus</th>
<th>Kazakhstan</th>
<th>Uzbekistan</th>
<th>Kyrgyzstan</th>
<th>Tajikistan</th>
<th>Armenia</th>
<th>Georgia</th>
<th>Ukraine</th>
<th>Moldova</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of banks</td>
<td>1,172</td>
<td>31</td>
<td>37</td>
<td>30</td>
<td>22</td>
<td>12</td>
<td>22</td>
<td>20</td>
<td>184</td>
<td>16</td>
</tr>
<tr>
<td>Assets ($ billion)</td>
<td>126.6</td>
<td>8.6</td>
<td>98.8</td>
<td>6.5</td>
<td>1.5</td>
<td>1.8</td>
<td>3.3</td>
<td>5.6</td>
<td>120.4</td>
<td>3.7</td>
</tr>
<tr>
<td>Capital ($ billion)</td>
<td>153.2</td>
<td>5.5</td>
<td>16.2</td>
<td>1.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.8</td>
<td>1.0</td>
<td>15.8</td>
<td>0.7</td>
</tr>
<tr>
<td>Assets/ GDP (%)</td>
<td>67.5</td>
<td>49.2</td>
<td>74.7</td>
<td>24.6</td>
<td>29.7</td>
<td>35.0</td>
<td>28.1</td>
<td>43.0</td>
<td>97.5</td>
<td>38.7</td>
</tr>
</tbody>
</table>

The previous years witnessed a number of formal integration initiatives in the post-Soviet ‘Eurasian’ space. These have yet to bear fruit. At the same time, the largest economies (Russia, Ukraine, and Kazakhstan) enjoy acceptably open economic regimes, concerning cross-border investments in the financial sector. Neither existing quotas on foreign capital, nor restrictions on the staffing policies, represent substantial obstacles for big players. While it is too soon to talk about a formal integration of financial sector in the CIS, market players used the favourable conjuncture of the recent years, in order to take the first steps in boosting their cross-border activities.
Kazakh Pathfinders

It is not accidental that Kazakh banks were the first to begin expanding abroad; the Kazakh banking system is the most advanced in the CIS, due to early regulatory reforms and advanced regulatory supervision. In addition, the banking system is more concentrated and technologically advanced. Until the beginning of 2009, there were no state-owned banks, and the two largest institutions, BTA-Bank and Kazkommertsbank, were also largest private banks in the CIS (acquisition of BTA by the state has changed the banking landscape significantly; the largest Russian private banks, Alfa and the newly merged MDM and URSA may also challenge the lead of their Kazakh counterparts). Kazakh banks were ready to go abroad, following their clients, a few years before other CIS banks were established enough to follow suit.

The natural direction of foreign investments was in other Central Asian states and Russia, with the latter taking the lead due to the huge economic potential and relatively open economy. Kazakh banks had also ventured into Ukraine, Georgia and other CIS states. In 2005-2007, practically all of the largest banks opened foreign operations. The leading BTA operates through four subsidiary banks in Russia, and also owns banks in Belarus, Ukraine, Georgia, Armenia, and Tajikistan. Kazkommertsbank entered the Russian soil through its subsidiary, Moskommertsbank, which was particularly active in financing real estate and mortgages. To characterise its activities in Russia, it is sufficient to state that Moskommertsbank possessed the third largest mortgage portfolio in the country at the end of 2007.

In 2007, the assets base of these banks grew by 30%; however, 2008 saw a significant contraction of portfolio, as the banks faced the impossibility of funding activities abroad and started transferring money back home to support their core operations. Other Kazakh banks also went abroad, albeit on a smaller scale. The more conservative Halyk Bank has subsidiaries in Chelyabinsk as well as in Moscow. Alliance Bank bought the small Starbank in Russia in 2007, after unhappily rejecting plans to absorb the much larger Petrokommerts. ATF-Bank and Bank Centrecredit, also established subsidiaries in Russia.

...The Russians are Coming, Finally

There are two reasons why the Russian banks were slow in following suit. First of all, the resurgence of the Russian economy provided ample opportunities at home, and the banks were busy expanding their retail networks and building local portfolios at an unprecedented speed. Secondly, Russia lagged behind Kazakhstan in the regulatory and structured qualities of its banking system. Nonetheless, by 2007, a handful of Russian banks were also prepared for foreign expansion. These were the largest banks: Sberbank, VTB, Gazprombank, Bank of Moscow, Alfa-bank, and Rosbank. The directions of expansion were quite natural: Kazakhstan, Ukraine, Belarus, and Armenia, i.e. the countries with significant Russian economic interests.
The Russian presence in Kazakhstan demonstrates this. Sberbank bought a small Texaka-Bank as early as 2006. After a period of inaction, the bank was strongly recapitalised and started rapidly building its assets portfolio. The long-term goal of the bank is to enter the top ten of the Kazakh banking system. This mission would seem achievable for Sberbank. On the contrary, VTB, for which the expansion in the CIS makes a vital part of the bank’s mid-term strategy, has yet to enter the Kazakh market. The bank’s initial strategy centred on buying an active business in the country, however, despite the deteriorating conditions, Kazakh bankers are unwilling to part with their controlling stakes at a low price, while VTB was not ready to pay 2.5–3 book values (for instance, it negotiated over Temirbank). Finally, exasperated, VTB declared its intention to build the business from scratch. Presumably, buying a bank as a strategy option is still on the cards for later. Finally, Alfa-bank has a subsidiary in Almaty, which is rather well established (it was the first of the Russian banks to enter the market) and pursues a conservative policy.

Russian banks are the main foreign banking presence in Belarus, where there are subsidiaries of Gazprombank, Bank of Moscow, Rosbank and others. In 2007, the role of Russian banks in the Belarusian banking system grew as a result of several acquisitions. For example, Vneshtorgbank bought out Belvnesheconombank, while Mezhtorgbank was taken over by Alfa Bank. Ownership of Slavneftebank, formerly controlled by a Russian oil company, will also be transferred to Russia’s VTB.

...Cornered by Competition from East and West

It is not safe to assume that Kazakh and Russian players are the only ones interested in expanding in the CIS area. The CIS countries’ are hugely underbanked and are considered among the most attractive in the world to enter. Russian, Ukrainian, and Kazakh banks (the most open and largest) were aspired until 2008, with prices overreaching four book values. These markets remain attractive in the long term. Again, the Kazakh banking system provides a great example. As a matter of fact, the laurels for the largest purchases go not to Russia but to the West (Italian UniCredit having bought ATF-Bank) and East (Korean Kookmin gradually acquiring control over Bank CentreCredit). The Ukrainian banking system provides a similar picture. Perhaps the only market where Russian financial players do not face any substantial foreign competition is Belarus.

...And Interrupted by Crisis

The CIS banks were not given much time for uninterrupted investments in the neighbouring countries. The 2007-2008 crisis largely limited the potential to invest abroad and compelled the banks to concentrate on core markets. In addition, the deteriorating quality of assets became a worrying
issue for M&A. We discuss the near- and mid-term prospects of mutual investments in the last section of this article.

The Scale of Cross-Border Investments is still Low

The patterns of mutual investments in the CIS banking sector have been consistent with world experience. The first reason behind setting up foreign subsidiaries was servicing mutual trade and investments in other sectors (‘follow your client’ strategy). Only later did a handful of banks adopt a more embracing approach, targeting the full-scale expansion and universal banking with retail and SMEs as viable business sectors. For Kazakhstan’s BTA Bank and Russian VTB, such expansion is a strategic centrepiece; Sberbank and Kazkommertsbank are also serious about this strategy. Another characteristic is the visible asymmetry of mutual investments, with Kazakhstan and Russia in the lead and other countries serving as mere recipients. What is perhaps more unusual is the speed at which the CIS banks developed their foreign networks: after all, the whole story took place within three to four years.

As a result, the cross-border investments in the authorised capital of the CIS banks grew approximately threefold within 2005-2008. However, their relative weight and role is still negligible. In the EurAsEC space, foreign capital is a dominant presence in the banking system only in Kyrgyzstan, while its role in other EurAsEC countries is minimal.\(^1\)

Prospects

Looking into 2009 and 2010 is an exercise in forecasting through an obscure glass. The scope of the world recession and the dynamics of oil price (on which the overall prosperity of Russia, Kazakhstan and a few other CIS countries strongly depend) will have a decisive impact on the health of local banks, including the quality of assets as well as the M&A stories.

Nevertheless, with a certain degree of moderation, we can sketch a few trends for 2009, suggesting that the cooperation and penetration in the banking sector will slowly increase even in the difficult times, driven by the logic of mutual trade and economic efficiency. Our considerations are supported by the observation that institutional integration has not stopped. E.g., in December 2008, Russian and Kazakh counterparts established a new commodity exchange platform, which was christened the Eurasian Trade System (ETS). The newcomer foresees substantial trade volumes in grain and petroleum-based fuels in 2009.

• Let us begin with the two most active players, Russia and Kazakhstan. Russian banks will continue looking abroad, albeit on a modest scale. Potential directions are Kazakhstan, Belarus, and Ukraine. In Kazakhstan, Sberbank’s subsidiary plans a 40% growth of assets into 2009. 2008 witnessed an extremely rapid growth and, as of November 1, Sberbank Kazakhstan’s assets amounted to $800 million, with its own capital standing at $283 million. The effect of the 2007 capitalisation by Sberbank still leaves ample room for asset growth. Its association with the well-respected Russian state bank has helped the Kazakh subsidiary actively attract local depositors and grow its deposits base from virtually zero to almost $200 million within a year. In our opinion, Sberbank’s operation in Kazakhstan is well positioned to deliver promised growth and enter the top ten of Kazakh banks in the foreseeable future.

While Sberbank actively builds up its assets and expands the branch network, VTB still needs to set up a subsidiary in Russia’s southern neighbour. Buying a bank at a sensible price still remains a strategic option. The newly merged MDM and URSA banks (forming the second-largest private banking institution in Russia with stronghold in the Urals and Siberia) would naturally benefit from presence in the southern neighbour. Tsesna-bank might serve as a particularly attractive take-over target due to its strong presence in Northern Kazakhstan. Alliance, as well as Temirbank, remains on the radar screens as potential takeover targets with extensive retail networks. BTA, after its nationalisation, may also be sold to a foreign investor.

• The foreign expansion of Kazakh banks faces two contradictory pressures. On the one hand, in the time of severe crisis the Kazakh authorities are keen to see their banks concentrating on Kazakhstan, not elsewhere. In any case, there are substantial barriers to the outflow of capital. On the other hand, where banks go, there trade goes, and there is a substantive economic rationale behind expanding service capabilities in the CIS countries and China. Thus, we expect Kazakh banks to lower their foreign presence in terms of assets while simultaneously continuing organisational activities such as setting up rep offices, creating necessary infrastructure etc. Again, let us mention that along with the CIS state West China will stay high on the priority list.

• 2008 witnessed an unprecedented level of state support action in the banking sector of the CIS countries, most importantly Russia and Kazakhstan. Governments rightly identify banks as providers of blood in the veins of national economies and support them subsequently by injecting necessary liquidity, taking care of distressed assets and also by direct intervention. It is evident that, at the time of economic contraction, banks will be actively discouraged to channel the state assistance funds into other
countries through foreign expansion, however tempting it might be in the long term.

- There is a distinctive trend of going beyond the tight boundaries of the post-Soviet space. As trade flows expand, there is a pressure to set up subsidiaries in China, Mongolia, India and other non-CIS Eurasian states. It is likely that we see the development of this nascent trend even in the difficult times, as it demands organisational capabilities and can be accomplished without substantial injections of capital. Sistema-controlled MBRR-Bank going to India (where Sistema is building a big mobile network) and Khalyk-Bank setting up subsidiaries in Western China and Mongolia (where the bank’s clients do business) are vivid illustrations.

- Out of the larger CIS markets other than Russia and Kazakhstan, three larger countries demonstrate various threats and opportunities. First, crisis provides major players with an opportunity to buy into Ukrainian banking sector at very distressed prices. Of course, only players who can sustain losses in the short term can afford such investment in 2009, notwithstanding potential long-term gains from the second-largest CIS market for financial services. One of the first instances of the sort is VEB rescuing the Ukrainian Prominvestbank. Secondly, the partial opening of the lucrative Uzbek market is to be expected in the medium-term perspective (not necessarily in 2009). Russian and Kazakh banks are eyeing this opportunity. They possess fair chances to succeed in the challenging environment of the state-controlled economy. Third, Russian financial institutions are likely to build up their weight in the Belarus banking sector, thus strengthening economic and political ties between the two countries.

- Last but not least, the CIS banks do not operate in an international vacuum. The crisis has reduced – but not wiped out – the attractiveness of the CIS market for larger international players from both West and East. By buying banks in various countries, international players can gain their place among the principal providers of inter-state financial services in the CIS.

To sum up, the story of cross-border investments in the CIS banking sector remains unfinished. The banks are compelled to halt their foreign expansion and, in some cases, partially retract in terms of assets. At the same time they do not stop non-capital-intensive cross-border activities. The process of setting subsidiaries and rep offices as well as creating necessary infrastructure abroad goes on, while the banks wait for better times to achieve substantial growth of capital and assets. We will see the next chapter of the story rapidly unfold as soon as access to the international financial market eases up.