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Mutual Investments in the Banking Sector in Eurasia: Ready... Steady... Wait

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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 October 1, 2008, the assets to GDP ratio stood at 50% in Russia and at 66.5% in Kazakhstan (having fallen from their peaks of 60% and 90% respectively). The 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, but then it started to struggle as foreign sources of loan financing ran dry. Russia lags one or two years behind Kazakhstan in terms of regulation, concentration, and development of its banking services and products, but in absolute terms Russia's banking sector is understandably much bigger.

Table 1. Banking Sector in The CIS Member States (as of 1 October 2008)

	Russia	Belarus	Kazakhstan	Uzbekistan	Kyrgyzstan	Tajikistan	Armenia	Georgia	Ukraine
Number of banks	1126	31	36	28	22	12	22	21	181
Assets, $ bn	968.5	5.8	103.3	6.2	9.3	0.8	18.5	7.6	35.4
Capital, $ bn	124.1	0.9	16.4	1.0	1.6	0.2	2.1	0.5	3.9
Assets/GDP, %	49.9	10.2	66.5	28.1	10.4	7.5	17.0	38.4	21.1

Source: National and Central Banks of respective countries

In the past years we witnessed a number of formal integration initiatives on 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 with regards to cross-border investments in the financial sector. Neither existing quotas on foreign capital, nor restrictions on staffing policies, represent substantial obstacles to big players. While it is too soon to talk about formal integration of the financial sector in the CIS, market players used the favourable conjuncture of the recent years to take the first steps to boost their cross-border activities.

Kazakh Pathfinders

It is not accidental that the Kazakh banks were the first to begin their expansion 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. There are no state-owned banks, and the two largest institutions, BTA-Bank and Kazkommertsbank, are also the largest private banks in the CIS (this may change however, as the State plans to acquire up to 25% of the top-four banks by March 2009; the Russian largest private banks, Alfa and the newly merged MDM and URSA may also challenge the lead of their Kazakh counterparts). A few years before other CIS banks were strong enough to expand, the Kazakh banks were ready to go abroad to follow their clients.

Naturally, the main direction of foreign investments was to 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 and Georgia. 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 set foot upon 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 say 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%; 2008, however, saw a significant contraction of the portfolio, as the banks faced difficulties with funding activities abroad and started transferring money back home to support their core operations. Other Kazakh banks also expanded abroad, albeit on a smaller scale. The more conservative Khalyk Bank has subsidiaries in Chelyabinsk, as well as in Moscow. In 2007 Alliance Bank bought the small Starbank in Russia after unhappily rejecting plans to absorb the much larger Petrokommerts. ATF-Bank and Bank Centercredit, rated as the 5th and the 6th banks respectively, have 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 its regulatory proceedings and the 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 direction of their expansion was quite natural: Kazakhstan, Ukraine, Belarus, and Armenia, i.e. the countries of significant economic interest to Russia.

The Russian presence in Kazakhstan demonstrates this trend. Sberbank bought a small Texaka-Bank as early as 2006. After a period of inactivity, the bank was strongly recapitalised and rapidly started building its assets portfolio. The long-term goal of the bank was 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 into 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 was focused on buying active businesses in the country. Despite deteriorating market conditions, however, the Kazakh bankers were 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, there were negotiations over Temirbank, the 7th bank in the Kazakh market. 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, which was the first of the Russian banks to enter the market, has a well-established subsidiary in Almaty and pursues a conservative policy. Russian banks represent the main foreign banking presence in Belarus, where there are subsidiaries of Gazprombank, Bank of Moscow, Rosbank and others. In 2007 following a number of acquisitions, the role of Russian banks in the Belarusian banking system increased. 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 the Kazakh and Russians are the only players interested in expanding to the CIS area. The CIS countries are hugely underbanked and are considered among the most attractive markets in the world. Until 2008, the largest and most open banks from Russia, Ukraine, and Kazakhstan were aspired to enter these countries with offer prices overreaching four book values. These markets remain attractive in the long term. Again, the Kazakh banking system provides a great example: the laurels for the largest purchases went not to Russia but to the West: Italian UniCredit acquisition of ATF-Bank; and to the East: Korean Kookmin gradually acquiring control over Bank CenterCredit. The Ukrainian banking system gives 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 has significantly limited the potential to invest abroad and compelled the banks to concentrate on their core markets. In addition, the deteriorating quality of assets became a worrying issue for M&A. We discuss the near-term 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 the world trends. The first reason behind setting up foreign subsidiaries was to service mutual trade and investments in other sectors (the 'follow your client' strategy). Only later did a handful of banks adopt a more embracing approach, targeting full-scale expansion and universal banking with retail and SMEs as viable business sectors. For Kazakhstan's BTA Bank and Russia's VTB, such an 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 are still negligible. In the EurAsEC space, foreign capital has a dominant presence in the banking system only in Kyrgyzstan, while its role in other EurAsEC countries is minimal[2].

Prospects

Looking into 2009 is an exercise in forecasting through obscure glass. The scope of the world recession and the dynamics of the 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

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[2] Abalkina, Anna (2008) *Preconditions and Prospects for Banking Integration in the Eurasian Economic Community*, in: Vinokurov, Evgeny (ed.) EDB Eurasian Integration Yearbook, EDB: Almaty, p. 109. Available at http://www.eabr.org/eng/publications/IntegrationYearbook/

observation that institutional integration has not stopped. For example, in December 2008 Russian and Kazakh counterparts established a new commodity exchange platform, 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 to look 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 \$715m, with its own capital standing at \$283m. 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 \$200m within a year. In our opinion, Sberbank's operations in Kazakhstan are 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 (this merger formed 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 takeover 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.

- The foreign expansion of Kazakh banks faces two contradictory pressures. On the one hand, in the time of a 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, trade follows, 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. For example, Starbank, a small Russian subsidiary of Alliance, a retail specialist and the fourth bank in Kazakhstan in terms of assets, filed a request to the federal authorities in Russia to participate in the restoration of smaller banks for an amount in the region of \$20-30m. 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 in 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 seem 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.

- 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 to unfold rapidly as soon as the access to the international financial market widens.