Russian banks square up to the West

The strength of growth markets compared to the anaemic climate in the West has been routinely highlighted since the start of the financial crisis. Over the last year, evidence of that strength has shown up in banks' capital markets activities — in Russia in particular, local banking muscle is being flexed. Francesca Young finds out what the effect has been on other financial institutions operating in the region, and what is next for the sector.

VISITING MOSCOW IS GETTING easier. Immigration forms are automated at Domodedovo now, the visa application process is becoming (subtly) simpler, and restaurants mostly have English translations available. Similarly, its banking sector is becoming more internationally focused: the state-owned banks are leading the charge towards globalisation.

VTB took great strides in its international expansion in 2012, setting up offices in Dubai, Bulgaria and New York to add to its London hub and Hong Kong office. Sberbank has started to follow, riding the wave of its merger with Troika Dialog, making experienced hires for its London office and buying businesses such as Volksbank in Austria and Denizbank in Turkey.

Rivals have noticed the change. "The Russian banks' presence has certainly improved," says Zdenek Turek, chief executive of Citi's business in Russia, the CIS and Central Europe. "VTB Capital is now a formidable competitor and Sberbank has made a major step this year in its capital markets products and methods with its acquisition of Troika."

The strong bid for EM assets over the year has driven down these banks' cost of funds, making lending easier to corporates and other clients. But, as officials at VTB and Sberbank point out, the risk weighting that Russian banks are forced to apply when lending to Russia and the CIS is much smaller than the international banks. That would make their offering competitive even if rates were to rise.

For the moment, foreign banks are more concerned about VTB eating into their market share than Sberbank, although some say that they see those state-controlled banks as one entity in terms of competition. Although Russian clients are now regularly including either Sberbank CIB or VTB Capital on the mandates for their deals, the two are not often seen together and very few sole mandates to these banks are granted. Typically a Russian Eurobond mandate will include one of these to ensure that the local investor base is captured, and at least one foreign bank alongside it.

"Sberbank's move into capital markets and investment banking seems more as a challenge to VTB rather than to the internationals," says Albert Sagiryan, Goldman Sachs's Moscow-based investment banking co-head of financing group for Russia and the CIS.

Both VTB and Sberbank say they are not targeting pure international business — their focus is on strengthening the financial link to Russia, whether that be using their international offices as a distribution channel for Russian issuers, or an origination point for clients that want to access Russian funds.

"The Russian banks' presence has certainly improved"

Zdenek Turek, Citi

Turek says that despite the stronger local competition, there is still room for local banks of medium size as well as the foreign banks that have historically been focused on Russia, such as Citi, Deutsche Bank and JP Morgan.

"There's been some pull-back from some of the foreign banks that are less intent on conquering these markets," says Turek. "But the core foreign banks in Russia have not been retreating."

UBS, ING and HSBC are among the banks that have rescaled their businesses in Russia. But JP Morgan is one where there has been no resizing of the Russian operation. Dmitry Gladkov, head of DCM for Russia at the US bank, reckons that because the market has been growing, there is easily enough fee-paying business to make Russia still worth pursuing.

"The pool of business available in Russia is larger than it ever has been," says Gladkov. "There are more large corporates and more large banks that need to access the bond markets. The market saw 21 deals from Russia in 2012. A few years ago, there were only three or four deals a year."

What about the smaller locals?

While the increased international presence of Sberbank and VTB has helped promote Russia as a more developed market in which to do business, Russia's local banks are getting nervous about the strength of its two banking giants.

Sberbank, for example, now accounts for 15.4% of the loan market in Russia, including syndicated loans and trade finance, according to Dealogic data. VTB takes 12.5% of it. In domestic bonds, VTB Capital takes a 23.2% market share and Sberbank 17.2%.

"Sberbank is a huge bank," says one origination banker in London. "JP Morgan's assets, for example, are a much smaller proportion of GDP in the US than Sberbank's in Russia. It's a challenge for the regulator to make sure that they don't crowd out others.

"The Central Bank of Russia talks a lot about fostering competition in the retail and corporate space. The pressure is on the medium tier of banks, but then Nomos is growing, PSB is profitable and Alfa Bank has just been upgraded to investment grade by Fitch, so they seem to be doing OK."

Those smaller, privately owned banks seem aware that the long term viability of their business could be threatened, with the two giants' funding costs much lower and their balance sheets dwarfing theirs. But they say that there are still some advantages in being smaller.

"The competition is not fair, but we've got used to it," says Anna Belyaeva, vice-president, director of the financial institutions and international capital markets department at Promsvyazbank in Moscow. "We're very much still alive and able to grow. There are things other than pricing that our clients find important and we can provide those, such as speed and flexibility."

She says that — in contrast to the argument usually voiced by international bankers — VTB and Sberbank are considered to be competing with the large international banks such as HSBC and JP Morgan, not with the smaller private banks.

"We're happy to let Sberbank and VTB compete with the other international banks rather than us. We occupy a different niche," she says. "We're one of the top arrangers of rouble bonds for example and there is still good growth potential in that market."

Closing in on consolidation

With nearly 1,000 banks in Russia, consolidation has been long expected. But whether that consolidation is imminent is debateable, although the Central Bank of Russia's enthusiastic plans to implement Basel III could play a part.

"I'm not sure how much consolidation will actually happen," says Turek. "It could be triggered by some sort of regulatory change. Not all banks are systemically important. As long as the top 100 are fine, it will not be a critical process in the banking system."

If consolidation does go ahead, the question is how it will happen. Bankers in the region say that they expect some mergers as well as some banks simply to be left to sink entirely as new, more stringent regulations are brought in.

"There will likely be a further consolidation of the Russian banking sector and further some banks may simply disappear as regulations become stricter," says Goldman's Sagiryan. "Sberbank is probably one of only a few banks that has enough capital to make acquisitions, but it's not clear why they would want to grow further in Russia."

VTB and Sberbank, however see themselves playing little part in the consolidation of the banking sector. VTB says that it has already played its role in that process, acquiring Bank of Moscow in 2011 in a move that weighed on VTB's capital position and was widely criticised at the time — a hole in Bank of Moscow's balance sheet was later discovered, requiring a $13bn central bank-led bailout.

Sberbank meanwhile, says the bank only makes acquisitions if it is sensible to do so, and as Russia's largest bank, it does not need to expand further within the country. Also, because it holds the deposits of over 100m individuals, the government will not push it into any move that would weaken its financials.

Tier two reliance under fire

But the central bank's desire to implement Basel III soon has already started making waves in the capital markets. It was an exceptionally busy autumn for Russian banks in the Eurobond market, with a particular focus on raising tier two funding. The race was on to print lower tier two deals before the end of 2012 because new subordinated debt looks likely to be more expensive when the central bank shifts to Basel III capital calculations, potentially this year.

But although the flood of deals was easily digested — some $5.85bn of tier two was printed in October last year alone — Moody's warns that the trend of subordinated issuance is credit negative for the sector.

The rating agency said in October that it was worried that because Russian banks were reluctant to dial back their lending growth or to deleverage, at the risk of jeopardising their earnings, they were using subordinated debt issuance to fuel loan growth. However, as they issue more subordinated debt, banks' overall capital quality has declined because their share of tier two capital is growing.

Only VTB printed a hybrid tier one from Russia in 2012, but Sberbank has started its privatisation, raising $5.2bn from a 7.58% sale of the bank in September.

Promsvyazbank was one of the issuers to print subordinated debt in that rush but Belyaeva says that she disagrees with the need for Moody's warning. "This was really the last chance to borrow tier two debt relatively cheaply," she says. "But the capacity of tier two is quite limited and we won't see a lot of these transactions going on in the future. Capital has become a scarce thing for Russian banks, but equity markets are quite limited at the moment.

"We tried and then postponed an IPO as we could not achieve the pricing that was acceptable to the bank and its shareholders, but it's still a strategic priority for us. The increase in tier two in the system is a temporary thing and should fade in 2013."

Gladkov at JP Morgan agrees, saying that as soon as the start of 2013, the ratios could start to look healthier. "Most banks will be booking profits into tier one at the end of 2012, so they start the year better capitalised, which will take some of the pressure off when Basel III comes," he says.

Some of the Russian banks have become a force to contend with. But a shake-up of the system is due and the landscape could change a lot over the coming few years. The Central Bank of Russia will have to work hard to ensure that the Russian banks' race for international banking success does not stop those changes being made in an orderly fashion. |

Russian international DCM bookrunner ranking: Jan 1 - Nov 23, 2012 Source: Dealogic

Rank	Bookrunner Parents	Deal Value $m	Deal Value $m	No.	Share %
1	VTB Capital	7,251	2,581	13	11.9
2	JP Morgan	5,236	2,842	10	13.1
3	Citi	4,952	1,246	4	5.7
4	Sberbank	3,392	171	2	0.8
5	BNP Paribas	3,202	2,397	7	11.0
6	Deutsche Bank	2,289	1,637	8	7.5
7	Gazprombank	2,253			
8	Credit Suisse	2,056	415	4	1.9
9	Crédit Agricole	1,907			
10	UBS	1,533	900	5	4.1
	Total	**42,961**	**21,749**	**30**	**100.0**