Russian banking enters new phase

Ben Aris in Moscow

Things have changed in Russia's banking sector since the crisis and life has got a lot tougher for the commercial banks.

Gone are the heady days where banking capital was growing by 40% a year or more and there was plenty of cash for everyone to expand. Since the 2008 global crisis, the sector's growth has slowed to half that rate (and even slower in Moscow), while the big state-owned banks have got their act together and are now providing stern competition to the smaller commercial banks. But by combining a focus on quality, service and seeking out profitable niches, the best of the commercial banks are recovering fast and are optimistic about the future. However, the emphasis has changed from growth to profits.

Promsvyazbank (PSB) has long been a leading commercial bank in Russia, which made money by focusing on Russia's legions of mid-sized companies that are still big by European standards, but not big enough to attract the attention of the state-owned banking behemoths. PSB was hit hard by the crisis along with everyone else and had to completely rethink its retail strategy, but since last year the bank's return on equity (ROE) has been improving.

“Last year was our most successful in the last five years,” says Alexandra Volchenko, first vice-president at PSB. “Our return-on-equity (ROE) was 17-18% pre-crisis, but fell heavily in the worst of the turmoil. But thanks to our new strategy that focuses more on small- and medium-sized businesses, retail banking and corporates, we have recovered and are now growing strongly.”

"Last year's phantom crisis led to a great deal of volatility"

Volchenko says PSB’s 2012 profits were the highest ever at over RUB8bn ($270m) and the ROE has rebounded, rising from 11.2% in 2011 to 14% in 2012. "Our goal is to reach 20% ROE and I am confident we can do it in the next few years," says Volchenko, a petite but ebullient woman who exudes energy and hails from Yekaterinburg, the former home of the Russian mint.

The key to the bank's growth has been to outperform its rivals by offering better quality of service, commanding lucrative niches and simply being better than the state banks. At the core of PSB's strategy is its corporate banking.

"Corporate banking in Russia has become very, very competitive and so you have to compete on quality of service, not just the margins, which have been shrinking," says Volchenko. "You need to be quick and visible to your customers." The bank's success at identifying some lucrative niches has also helped. The corporate business generates others like trade financing, factoring, payroll, private and retail banking to owners/employees, not to mention the fee-based income from providing corporate services. Although the bank is ranking 8th in the country in terms of assets it is number two in trade finance and factoring, number four in SME lending and number six for retail deposits, making PSB one of the biggest privately owned commercial bank in the country. Corporate business remains vital for the bank accounting or about 80% of the bank’s loan book and 62% of its deposits.

Navigating a phantom crisis

Last year was a difficult year for everyone, as the recovery from the 2008 meltdown stalled across the entire European continent. There was a "phantom crisis": banks felt the pain as if Western Europe had had another financial collapse, but no collapse actually happened, says Volchenko.

"In the first half of last year there was a significant improvement, but as time went on the cost of funding was being driven up," says Volchenko. "However, at PSB we made a strategic decision early on to diversify our funding base, so as the cost of market-based money rose we could rotate and make more use of our deposit based funding in the second quarter. We were also able to attract significant inflows of deposits and current accounts in the last four or five months of the year – about RUB50bn – which helped keep our costs down and profitability high."

In Russia's banking sector these days big is beautiful. Several international banks like Barclays and HSBC entered the market at the height of the boom years in the middle of last decade, but they didn't have time to build enough business. Following the crisis, the slowdown in asset growth squeezed margins and many of these banks pulled the plug. PSB has been lucky to gather enough momentum to get to a size where it can weather the storms of the last few years. "Importing European models to Russia brings benefits, but at the end of the day the market here is still immature and you have to be alive to the realities of the market," says Volchenko. "This gives Russian banks the edge."

To maintain the bank's growth, PSB has also turned to the burgeoning SME sector. The bank was an early member of the European Bank for Reconstruction and Development's highly successful SME loans programme, and today PSB has some 73,000 SME customers of which 11,000 have also taken loans from the bank. "In 2012, this segment was worth approximately RUB1bn. It is a huge potential market, not just for lending, but also for fees and services," says Volchenko. "Russia can't just focus on commodities. The development of entrepreneurialism is key for the development of the country as a whole."

SME development is high on the government's political agenda and PSB is playing its part. In January the bank launched a RUB300m venture capital fund to finance SME start-ups, which will be invested through to 2014. The fund plans to invest into 50-70 small companies in traditional, not high-tech, spheres that need expansion capital. The state agency to support SME development, OPORA, is also a participant in the fund. "The fund is not a big one, but it is designed to support our customers and we will expand it if it is successful," says Volchenko.

New rules

The prospects for this year are a bit better as confidence slowly returns. Corporate lending in particular surprised analysts by accelerating in February: sector-wide corporate lending was up 15% on year. But even with a recovery, banks are going to see growth at a slower pace going forward after the Central Bank of Russia (CBR) imposes stricter prudential rules on the sector. "Last year's phantom crisis led to a great deal of volatility and to the CBR decision to accelerate the implementation of tougher regulations," says Volchenko.

"These new rules will affect banks' willingness and ability to lend to consumers"

Russia will introduce the so-called Basel III regulations that shift the focus to providing more reserves for when things go wrong. Recommendations to increase risk weightings are effective from the start of this year and will become compulsory from start of next year, which will hit big lenders to consumers especially hard. "These rules will affect banks' willingness and ability to lend to consumers," says Volchenko. "The upshot will be to slow retail lending from the second half of this year. But at PSB we decided to create a cash cushion in the first half of this year."

PSB took advantage of rules that allow subordinated debt to be added to the bank's capital, something that will be phased out under the new regime. The bank raised $600m in subordinated debt and another $120m as a perpetual bond in February.

However, all of Russia's banks will need to boost their capital in the new slower growing Russia. The sector as a whole will need to raise $100bn of fresh capital over the next three years to meet the new stricter capital rules, Alexei Simanovsky, the CBR's first deputy chairman, said in March.

The sector's capital increased by 16.6% in 2012 to RUB6.1 trillion ($203bn) including the RUB1 trillion of profit banks earned – a record. "This means banks can cover a considerable part of their requirement for capital with their profits," Simanovsky said. "The funds of domestic and foreign investors can also be used for this purpose. But rapid growth in bank lending, especially in the household sector, which grew by just under 50%, continues to put pressure on the sector."

Retail lending has slowed a little, but still expanded by just under 40% in February. However, analysts are expecting growth in retail lending to slow to about 25% this year.

Volchenko says the game has changed and banks need to get ready for the new reality. In the boom years, returns of 18% to 25% on equity was usual, says Volchenko. But now returns have fallen, owners are more cautious about injecting more capital into their banks.

“The return on equity of the bank is more important as shareholders won’t want to invest if the returns are poor and banks won’t attack capital unless they know what to do with it. Our return on equity has shown solid improvement on a very consistent basis this year rising from 5.9% two years ago to 11.2% in 2011 and 14.0% in 2012. We expect continuing improvement this year, especially with the contribution of our retail business and very good performance of our credit process and controls,” says Volchenko.