

# KIER DISCUSSION PAPER SERIES

## KYOTO INSTITUTE OF ECONOMIC RESEARCH

Discussion Paper No.801

“Foreign banks’ entry into the Russian market:  
motivation, entry modes and strategies”

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December 2011



KYOTO UNIVERSITY  
KYOTO, JAPAN

# Foreign banks' entry into the Russian market: motivation, entry modes and strategies

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## Abstract

The present paper analyses motivation, entry modes and strategies of foreign banks entering into the Russian market. The share of foreign assets in the banking sector is gradually increasing, proving the fact that more and more foreign banks show their interest in the Russian banking sector. What lies behind this growth? The article shows that motivation for entry is similar to some other developing and transition economies (both PUSH and PULL reasons exist) and presents some peculiar features concerning the modes of entry and strategies. It is shown that recently organic strategy growth is gradually replaced by M&A.

**Keywords:** *foreign banks, motivation, entry modes, strategies, M&A*

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## Introduction

Financial liberalization plays an important role in establishing sustainable financial system. The discussion about access of foreign banks to financial (banking) systems of developing and transition economies is relatively new. In 1990s in the beginning of transition period from planned to a market economy, many American economists stressed the importance of establishment of a stable financial system by the development of capital markets, while many European researchers on economics claimed for the development of efficient banking sector. Needless to say, that both these controversial at first sight approaches considerably influenced on the financial system of transition and developing economies and were used as an institutional base for its creation. In particular, Central and East European Countries (CEEC) followed the approach of establishing a solid banking system. Gradual financial liberalization in these countries allowed opening domestic banking markets for foreign investors, as the result foreign banks received control and dominance in the region which in most cases resulted in creation of a stable banking sector from the institutional point of view. In countries like Estonia foreign share participation in banking assets amounts to almost 100% (Vernikov, 2002).

Needless to say, that in Russia the problem of foreign banks activity is a prominent issue as well. The share of non-residents in the banking sector is gradually increasing and some economists are apt to consider the repetition of the Eastern-European scenario (dominant position of foreign banks in national economies) in Russian conditions.

The present paper aims to investigate activity of foreign banks from the point of view of both home country and host country (Russia). While acknowledging the role of multinational banking theory (MNBs)<sup>1)</sup> in investigating multinational (foreign) banks' activity primarily from the viewpoint of a home country, we stress the indispensability to examine specific conditions of the host country.

The structure of the paper is as follows. In the first part we outline the general situation with foreign investments into the Russian banking sector and shortly present indicators showing foreign banks' participation in the Russian banking system. Here some remarks should be made about the definition of a *foreign bank*. In the present paper we consider a bank to be a foreign one, if it is registered as a banking institution in a foreign country. This definition is used by the Russian Central Bank (CBR) and also common in some other countries (e.g. Japan). Therefore, entry modes like

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<sup>1)</sup> Multinational bank theory (MNBs) emerged from the theory on multinational corporations (MNCs) developed by many researches, such as Rugman (1981), Dunning (1992), Bryant (1987), and so on. Researchers on foreign banking and multinational banking recently apply the term "theory of multinational banking" in their studies, though initially United Nations Center on Transnational Corporations introduced the term "multinational bank" in 1981. According to their definition multinational bank is "a bank having more than 5 affiliates or subsidiaries abroad and organizing commercial banking activity". But due to the diversification and complication of the banking transactions at the present stage of development of banking activity in general, we argue that this definition needs some revision. In essence, any foreign bank doing business abroad nowadays can be categorized as a multinational one to some extent (Gorshkov, 2011).

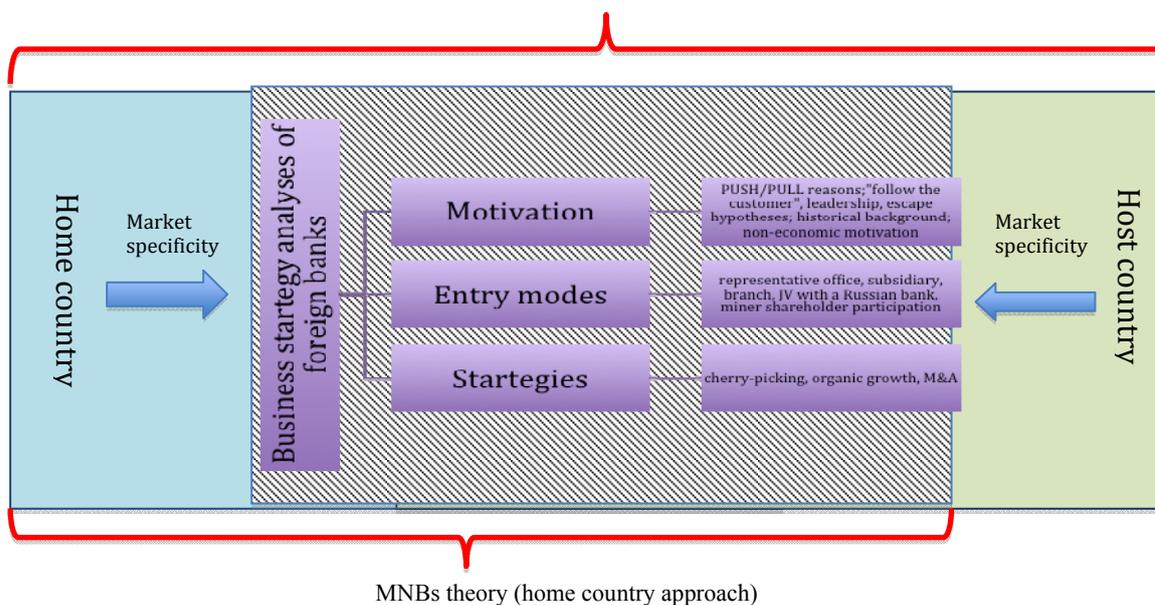
representative offices are also considered to be foreign banks though normally in the host countries they are not engaged in banking operations<sup>2)</sup>.

From the second part of the paper we gradually conduct the analysis of foreign banks' activities from the point of view of both home and host countries. Usually for investigation of foreign banks' activity the theory of multinational banking (MNBs) is being applied, but we argue that the *theory of foreign banking*<sup>3)</sup> allows making a better analysis from the view of a host country (for details refer Figure 1).

Nevertheless, some peculiar strategies of foreign banks by their home countries are obvious and we also included them into the subject of the research. Keeping these assumptions in mind, we examine motivation of foreign banks' entry in part 2, modes of entry in part 3 and evolution of foreign banks' strategies is being presented in part 4 of the present paper. Some qualitative and quantitative analyses of foreign banks in the Russian market proving the increasing presence of foreign banks in Russia have been covered in some other studies (Rozhinskiy, 2006, 2008; Bobkova, 2007; Khandruev, 2008; Gorshkov, 2011). Nevertheless, we also present some statistical data about activity of foreign banks in Russia.

**Figure 1 – Conceptive representation of the foreign bank theory**

Foreign banking theory (home country and host country approach)



Source: made by author

<sup>2)</sup> There are two definitions of a foreign bank: juridical and a quantitative one. Foreign bank (juridical definition) – the bank that is registered in accordance with the foreign country's legislation (non-resident). Bank with foreign participation (less than 50% shares), bank controlled by non-residents (more than 50% shares). Foreign bank (quantitative definition) – classification of banks in accordance with the share of foreign investments. For details see Vernikov (2006).

<sup>3)</sup> Some researches stress the importance of analyzing the activity of foreign banks in national economies (Vernikov (2002,2004,2006), Rozinskij (2006, 2008, 2009). The theory of foreign banking as a definite concept is not widely acknowledged, but while acknowledging the importance of MNBs approach, we argue in the paper that this approach allows a proper investigation of foreign banks' behavior from the viewpoint of a host country.

## **1. Foreign investments into the Russian banking sector and foreign banks' activity**

In Russia the process of liberalization in the banking started in 1990s. Many domestic banks were created and some foreign banks got access to the Russian market. At first, the Central Bank of Russia (CBR) strictly restricted the activity of foreign banks. In 1990s the upper limit of foreign capital participation was established to 12%, procedure of licensing was implemented, some operations of foreign banks were actually prohibited (Presidential Act No 1924 on "Temporary prohibition of foreign banks' activities with Russian physical and juridical entities" dated by 17.11.1993). At present, the activity of foreign banks is being regulated by federal law "Banks and banking activity" (1996) and by regulative acts of the CB (e.g. Regulation No 437 "About procedures of registration of financial institutions with non-residents capital" dated by 23.04.1997). These documents generally stipulate three major conditions (regulations) for foreign banks' activity in Russia: 1) negative stance towards creation of branch offices (actual prohibition), 2) upper limit of foreign capital participation in the capital of banking system (12% during 1990s, in the process of negotiations for WTO accession it was agreed to raise the limit to 50%, though no official documents have been signed), 3) licensing system and issuing of permissions for the start-up activities of foreign banks.

Before examining the activity of foreign banks on the Russian market, let us present the general situation with foreign investments into the Russian banking sector. Two ideas are expressively shown in many research studies about the role of foreign investments (foreign banks) in the Russian banking sector: overestimation vs. underestimation. We do not argue the background of the two in the present paper, both of them having their arguments, but we mainly support the idea that despite the fact of gradual increase of non-residential share in the market, the magnitude of their actual activity remains quite slow (data supporting this idea will be presented below). For a start, Table 1 represents international investment position of the Russian banking sector and the data shows that foreign investments are increasing (excluding years of crisis and recovery from it, but the general trend is positive). However, the share of FDI is very low, other investments sharing a majority. Other investments may include financial credits of foreign investors to the banking sector of Russia, syndicated loans, cross-boarder lending schemes, others. Having these figures in mind, the activity of foreign banks is hardly to depict, due to the fact that the vague character of the overall picture of the investment position (net investment position is negative, meaning that Russia is a net debtor in the banking sector). However, the general trend for the FDI inflow is positive, proving the fact that foreign share in banking assets is increasing. But the total level of foreign investments into financial sector is still very low and amounts to 3-4%<sup>4)</sup>.

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<sup>4)</sup> Analytical data for 2009 from [www.kmpg.de](http://www.kmpg.de). Majority of investments still flow to natural resource industry, industrial sector, trade and other sectors (the web-site accessed 15.01.2011)

**Table 1 - International investment position of the Russian banking sector  
(million US dollars)**

	2005	2006	2007	2008	2009	2010
<i>Assets</i>	25,989	39,182	65,351	96,843	167,825	165,965
FDI from Russia	818	1,498	1,570	2,533	3,413	5,062
Portfolio investments	3,714	6,964	7,645	12,855	15,774	26,258
Other investments	21,304	30,669	55,914	80,032	143,336	132,423
Financial derivatives	153	51	222	1,423	5,302	2,222
<i>Liabilities</i>	37,337	60,009	123,927	214,771	206,259	179,123
FDI to Russia	3,020	4,975	9,127	20,682	22,670	25,911
Portfolio investments	3,756	6,858	17,171	36,445	12,160	26,516
Other investments	30,372	48,124	97,451	156,769	161,033	121,614
Financial derivatives	189	52	178	875	10,396	5,082
<i>Net investment position</i>	-11,348	-20,827	-58,576	-117,928	-38,434	-13,158

Source: Central Bank of Russia (CBR), www.cbr.ru

To be more specific, below we focus on the foreign banks as participants in the Russian banking sector. In case of Russia the size of banking sector is relatively small and for a long time it was dominated by the state (Kievskiy, 2008). It functions inefficiently even after the financial liberalization reforms performed in the 1990s, but besides this fact the foreign share in banking assets and capital is increasing (Table 2). The banking sector at present is still presented by state-owned banks such as Sberbank and Vneshtorgbank whose share in total banking assets and capital is very high, but gradual competition from foreigners' side is likely to happen.

Below we consider the role of the foreign banks in deposits, corporate lending and retail banking. The role of foreign banks in deposits is not high, foreign share in deposits of the banking system amounts to 12%. In TOP-30 deposit banks there are only two foreign banks, Raiffeisen (Austria) stands on the 6<sup>th</sup> place, Citibank is on the 26<sup>th</sup>. Deposit scale of Raiffeisen constitutes only 1/29<sup>th</sup> of that of Sberbank, proving the fact that state-owned banks and Russian private banks remain predominant position in deposit activities.

Corporate loans of foreign banks were common even during 1990s and continued positive growth in 2000s. In 2003 the sum amounted to 38 billion US dollars. But the role of foreign banks in project financing, syndicated loans is immense (for details refer to Gorshkov, 2010). Some banks are trying to establish strong positions in retail banking (Russfinancebank (5<sup>th</sup> place), Raiffeisen (9<sup>th</sup> place), Societe Generale (20<sup>th</sup> place, Citibank (22<sup>d</sup> place). In general, the common trend for foreign banks is the following: 1) foreign banks are mostly engaged in traditional banking activities (deposit, lending, foreign exchange activity); 2) foreign exchange activity (foreign currency operations) amounts for around 60% of total profits; 3) some foreign banks establish business providing non-traditional banking services<sup>5)</sup>; 4) scales of cross-

<sup>5)</sup> For example, internet banking (Omnibank (50% shares belong to Japanese SBC Holding), consulting, investment banking (Deutschebank, Citibank).

boarder financing, syndicated loans, project finance should be also considered when accessing the role of foreign banks in the Russian market (Gorshkov, 2010).

**Table 2 - Some indicators of foreign banks' activity in Russia**

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Number of banks with FP	123	128	131	136	153	202	221	226	220
incl. share of more than 51%	-	-	-	-	13	23	26	26	31
100% foreign share	-	-	-	-	52	63	76	82	80
<i>Commercial banks with foreign participation of more than 51% (%)</i>									
Assets	8.1	7.4	7.6	8.3	12.1	17.2	18.7	18.3	18.0
Equity (Capital)	7.1	6.6	7.8	9.3	12.7	15.7	17.3	17.0	19.1
Corporate loans (companies)	7.1	6.1	6.2	7.4	10.0	15.5	16.6	14.8	15.1
Private loans (households)	2.3	2.3	3.0	3.4	6.2	8.9	10.3	12.0	11.5
<i>Commercial banks with 100% foreign participation (%)</i>									
Assets	5.6	5.6	5.9	8.0	9.0	11.6	13.0	11.3	11.0
Equity (Capital)	5.4	5.4	6.3	9.0	10.1	11.1	12.2	11.0	12.1
Corporate loans (companies)	5.5	4.6	4.6	7.3	7.9	10.7	11.6	9.0	9.2
Private loans (households)	1.5	1.5	2.4	3.3	4.1	5.0	5.4	6.2	5.3

Source: Central Bank of Russia (CBR), [www.cbr.ru](http://www.cbr.ru)

Below we focus on the motivation, entry modes and strategies of the foreign banks in Russia examined by both PUSH and PULL factors (host and home country approach).

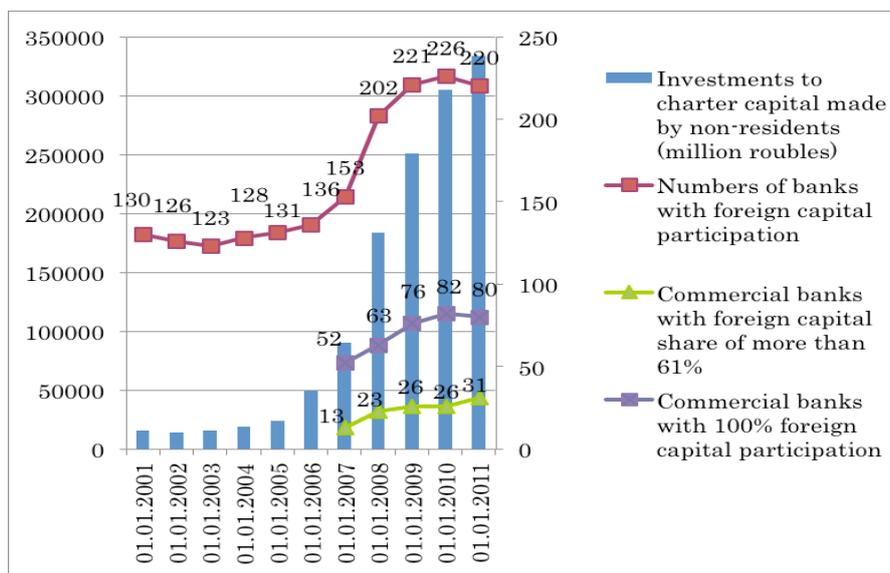
## 2. Motivation of entry

As of January 2011 220 foreign banks operated in Russia. The number of foreign banks decreased in comparison to the previous year, but not very considerably. In general from 2000s the number of foreign banks is steadily increasing. Major indicators of foreign banks' activity as shown in Table 1 were also increasing. Therefore, it is possible to conclude that the interest of foreign banks in the Russian market was obvious. But what lies behind this growth? On the institutional level there were not so many changes during 2000s, but foreigners showed a high interest in entering into the Russian market.

During Soviet Union times the position of the state towards foreign banks' entry was quite negative, therefore it was very difficult for foreigners to invest into the banking sector (Rozinskiy, 2007). The Russian government changed this course of actions and started the policy of promoting of foreign investments. Thus, foreign

banks received more opportunities to enter into the Russian market. In addition, high economic growth in 2000s also facilitated the process of entry.

**Figure 2 – Number of foreign banks and investments of non-residents into the banking sector**



Source: made by author on the base of statistic data of CBR, www.cbr.ru

When analyzing the motivation of foreign banks' entry from the view point of a home country and host country, it is important to investigate so-called *PUSH* and *PULL* reasons.

After the transformation in 1990s there operated a lot of foreign banks in Russia: International Moscow Bank (1989, Germany and Finland), Home Credit Bank (1990, Czech Republic), Calyon Rus Bank (1991, France), Bank of China (1993, China), Credit Suisse Bank (1993, Switzerland), Absolut Bank (1993, Belarus), Raiffeisen Bank (1996, France). These banks share up to 50% of all 100%-foreign owned banks at present. Despite the fact that during this period the financial system was very fragile and instable, banks tried to enter the market mostly motivated by so-called *PUSH* reasons (originating in the host country or in management of banks). In this sense the strategy of banks correspond to the one in other developing countries<sup>6)</sup>. Nevertheless, the *PUSH* reasons for motivation to Russian market differed a bit from the other developing economies, due to the fact that there was no such motivation as escape from domestic financial regulation, increased competition or drastic drop in domestic profits in home countries. *PUSH* reasons for entering Russian market were mostly composed by such motivation as *political interactions and historical ties* between Russian and some home countries of foreign banks. This fact explains the entry choice of banks like Bank of China, Bank of Scotland, French banks, etc.

In many cases foreign banks are attracted by high economic development growth of home countries. This was also true for Russia during 2000s when most of banks

<sup>6)</sup> For details for other developing economies see studies of Vernikov, 2005).

entering the market were driven by so-called *PULL reasons*. High development growth attracted not only banks, but also some foreign companies. In order to provide financial services to their customers, banks were subject to enter the market as well. This so-called “*follow the customer*” strategy was particularly typical for many Japanese banks. For Mitsubishi-Tokyo UFJ and Mizuho Corporation the main goal for establishment of a affiliated bank in Russia was to provide full support to Japanese companies and make investment into big projects. Deposit activities, operations with individuals are not yet a priority. Same is true for the Sumitomo-Mitsui Banking Corporation that opened an office in Moscow only in 2009. The reasons for this slow movement of Japanese banks are insufficient development of infrastructure, lack of transparency of the Russian economy, hindrances when entering the market. In comparison to the European banks, the Japanese banks operating on the Russian market are less competitive and prefer to stick to the “main bank “ features when establishing relations with their clients. Though some banks like Toyota Bank (2008) trying to establish retail banking (automobile loans) or SBI Holdings (2010) that invested 50% into Russian Obibank in order to launch internet banking business claim for other reasons for motivation of entry into the Russian market among Japanese banks<sup>7)</sup>.

Needless to say, that to explain the motivation of entry of foreign banks to the Russian market only by *political* and “*follow the customer*” hypotheses is very difficult. Toyota putting efforts into development of retail banking is not the only foreign bank working in this direction. High economic growth before the 2008 crisis and gradual recovering from its consequences stipulated higher level of consumption, which was partially driven by retail bank loans. Some foreign banks like American Express Bank(2005), Mercedes Benz Bank(2007), Rabobank(2008), Volkswagen Rus(2010) decided to expand their business to Russia. We can consider this group of banks to be motivated by so –called *PULL reasons* (originated in a home country).

Moreover, there are many factors (macroeconomic and structural imbalances of the economy, lack of creditability towards financial institutions, high country risk, etc.) that stipulate high potential banking profits of the Russian banking market. Therefore, among the *PULL reasons* there is also so-called “*high risk-high return*” motivation of entry. Many banks that entered during 2000s or those that entered before, but decided to expand their business even more can represent this group of banks. For example, for Raiffeisen Group (Austria) the Russian market is the second largest one after Austria. Initially the Group entered in 1996, but in 2000s Raiffeisen changed its motivation completely and started building the huge network in order to increase its presence in Russia. By investing into Russian Rosbank, the management of Raiffeisen tries to establish strong system of retail banking<sup>8)</sup>.

Maintenance of the image of a foreign bank can be also one of the motivations of entry. For banks operating globally, not having an office in new emerging economies like China, India, Brazil or Russia, is always a problem of own banking image (Vernikov, 2002).

Historical and political reasons might be also the decisive one for making the decision of entry. For example, Societe Generale first operated in Russia in 19<sup>th</sup> century and officially established a representative office in 1973. Needless to say, it is

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<sup>7)</sup> Such as exploring new business opportunities, a change towards leadership.

<sup>8)</sup> For detail see website of Raiffeisen bank, Vernikov (2004), etc.

also one of the most successful foreign banks in Russia nowadays<sup>9)</sup>. Some other motivations for entry are presented in Table 3<sup>10)</sup>.

**Table 3 – Motivation of entry of foreign banks into the Russian market**

Motivation	PUSH/PULL reasons	Example
High risk-high return	PULL	Raiffeisen (Austria), Societe Generale (France), BNP Pariba Group (France), ING Group (Holland), Deutsche Bank(Germany), Bank of Cyprus (Cyprus)
Development of retail banking	PULL	Toyota Bank (Japan), Mercedes Bentz (Germany), American Express Bank (USA)
Preservation of “global bank” status	PUSH	City Group (USA)
Banks having strong relations with Russian companies and individual customers aiming to establish a profound network on the Russian market	PUSH	Raiffeisen (Austria), Societe Generale (France), ING Group (Holland)
Support of foreign companies operating in Russia (leadership strategy)	PUSH	Eurasia Tokyo-Mitsubishi UFJ (Japan), Sumitomo-Mitsui Europe (Japan), Mizuho Bank(Moscow) (Japan), Toyota Bank (Japan)
Escape of costs, rising competition, loss of profits in a home country	PUSH	Establishment of a subsidiary is very costly and risky in Russia. Examples of banks used this motivation are not common
Non-economic, historical reasons (importance of the past)	PUSH/PULL	These reasons are common for entry at early stages. There are some studies showing that banks like Sociate Generale or Gredit Lyonnais already operated in Russia in 19-20 th centuries.

Source: made by author with references by Vernikov (2002,2004,2005); web-sites of foreign banks; Rosia NIS Keizaikenkyujyo. *Rosia no ginkou, kinyuu bumon no saishinijyō*, March 2007, Shadanhoujin Rosia NIS Boekikai Rosia NIS Keizaikenkyujyo, pp.96 (in Japanese)

From data presented in Table 3 and the above analysis let us stress the following.

Firstly, foreign banks entering Russia in general use the same motivation reasoning as in other developing countries, though escape from regulation in home countries or low domestic profits are not necessarily behind this entry motivation. Secondly, both *PUSH* and *PULL reasons* were identified among the motivation of banks. *PULL reasons* driven by high economic growth which attracts foreign investments and stipulates foreign banks’ entry. At the same time we stressed the fact that *PUSH reasons* are also quite strong. Thirdly, there are multiple reasons for entry. Banks tend to change their motivation in accordance with the changing conditions (i.g. after the collapse of the Soviet Union some banks reconsidered their motivation for stay on the

<sup>9)</sup> Societe Generale started operating in Russia in 19<sup>th</sup> century. In those days it provided consulting services and financed Russian companies. In order to expand its business in 1901 Societe Generale opened a branch in St.Petesburg (Severniy Bank) and organized financing of the Russian economy. 10 years after Severniy Bank was emerged with Russian-Chinese Bank and Russian-Asian Bank was formed. In 1914 this bank was the leading one among all other banks operating in Russia, its shares in assets amounted to 84% of those of Societe Generale. In 1917 due to the Russian revolution the activity of the bank was stopped. In 1973 a representative office in Moscow was established, and during 1990-s following the financial liberalization, Sociate Generale opened a subsidiary in Russia (from the materials of the website of Societe Generale).

<sup>10)</sup> More detailed analysis is presented in Gorshkov(2010), master course paper of the author.

Russian market). Fourthly, we identified non-economic reasons for initial entry (political, global image of banks, historical ties) and stressed their importance. In general, with the change of the economic structure of Russia, many banks tend to change their motivation and strategy as well. It is possible to assume that the “leadership” hypothesis is gradually replacing “follow the customer” one.

### 3. Entry modes of foreign banks

Foreign banks entering the Russian market use different entry modes. If we use the wide definition of a foreign bank (juridical one), it is possible to divide 4 types of entry modes at present: *subsidiary, JV with a Russian bank, minor shareholder participation and representative office*.

Representative office is the most common entry mode for starting a business in Russia for many foreign banks. Although representative office doesn't provide banking services, it helps the parent banks in home countries to collect information about Russian market and provide it to its clients. After a few years a representative office is usually converted into a subsidiary (Russian juridical entity). Most of the banks operating in Russia used this approach, because establishment of a subsidiary requires a lot of preliminary work (licensing by CBR, accreditation of documents, etc.). The typical situation for Russia is that foreign banks tend to create 100% foreign share subsidiary, i.g. owned by a parent bank. There is still mistrust and low transparency level of property rights protection. In 2011 the number of 100% foreign share banks amounted to 80<sup>11)</sup>.

Establishment of branches is not common. Only one foreign bank branch was established in 1990 by Armenian bank “Anelik”, but even it was converted into a subsidiary in 2003. Law does not officially prohibit branches, but due to some bureaucracy restrictions, there are not very common. When establishing a subsidiary the key question for many foreign banks is the problem of right of control and management. Participation as minor shareholder or intention to acquire more than 50% shares is a key dilemma for the management of many foreign banks. As statistical data shows, majority of banks prefer to establish 100% foreign owned subsidiaries due to low transparency of property rights law in Russia

Joint venture business among Russian and foreign banks is also not very common. Therefore, it is possible to conclude that entry modes of foreign banks are stipulated by sensibility of ownership and property rights issues.

As for the participation as a minor shareholder, as of January 2010 there were 118 banks that amounted to more than a half of banks with foreign participation: 33 banks with less than 1% foreign share, 60 banks where foreign investments amounted to 1-20% and 25 banks with foreign share participation 20-50%. On the one hand banks try to follow the strategy “*ownership right=dominance*”, but on the other hand they agree to be a minor shareholder, but to be presented on the market (Vernikov, 2002). The entry modes are therefore representing this dual structure (100% control vs. minor participation).

Another interesting fact proving the increasing participation of foreign banks as minor shareholders is the degree of shares controlled by non-residents in main state-

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<sup>11)</sup> Official statistic of the CBR.

owned banks. In Sberbank the shares controlled by non-residents amount to 32%, in Vnestorgbank Bank of New York International Nominees control 16% of shares. Both these figures are being very compelling investments and state the relatively liberal nature of the Russian banking system.

#### **4. Strategies of foreign banks**

In general, the strategies of foreign banks in the Russian market are similar to the ones in other developing economies aiming to get stable profits. In particular, banks try to acquire a market niche, develop new market segments, and expand their business. All these actions substantially define the behavior of foreign banks. In case of entry into the developing countries foreign banks normally use two strategies: *organic growth*<sup>12)</sup> and *acquisition of rivals (M&A)*. In most cases in countries where privatization reforms in the banking sector were made, M&A was a dominant strategy of foreign banks (Rybin, 2007). In Russia, on the contrast, privatization of the banking sector by foreigners was a very slow and complicated process; therefore banks that entered the market in 1990s such as Raiffeisen or Citibank mostly used the “*organic growth strategy*” and started their business from scratch.

*Organic growth strategy* is very moderate and limited one. One the one hand, it allows to escape problems with management, dissolve differences in the process of integration of business of home and host countries, but on the other hand it has demerits like low speed of implementation and high level of costs. In Russia a huge amount of financial resources is needed for starting-up a new business. Foreign investments often have to pay an expensive “entrance fee” when entering into the Russian market. Moreover, factors like excessive segmentation of the market, regional diversity, strong positions of domestic (both state and private) banks, make it difficult for foreign banks to set up their businesses with the usage of organic growth strategy and acquire the dominant or competitive position (Vernikov, 2002).

In contrast to the organic strategy growth, in 2000s M&A became more common. It is hard to conclude that banks do not use the organic growth strategy (some banks like Deutsche Bank, Michinoku (Mizuho at present) still follow it), but the number of banks expanding their presence on the Russian market by M&A is increasing.

From the theory we know that motivations for M&A are expansion of market share, increase of capital, intensification of competition. Same idea is true for the Russian market. M&A are increasing very fast becoming one of the process of reforms in the banking sector. Economic growth requires huge amount of inflows of money, but Russian banking sector is unable to fulfill this demand. M&A are a possible solution for resolving the problem of obsolete banking technologies, and intense competition from foreign banks allows speeding up the process of development of the Russian banking sector (Rybin, 2008).

Below we analyze the dynamic of M&A in a financial sector in Russia. Increasing M&A cases and raising market prices of deals testify the positive dynamics of M&A strategy in Russia in the banking sector (see Figure 3, 4). In 2006 M&A in the financial sector amounted to 7.1% of all M&A deals and in 2008 this figure became

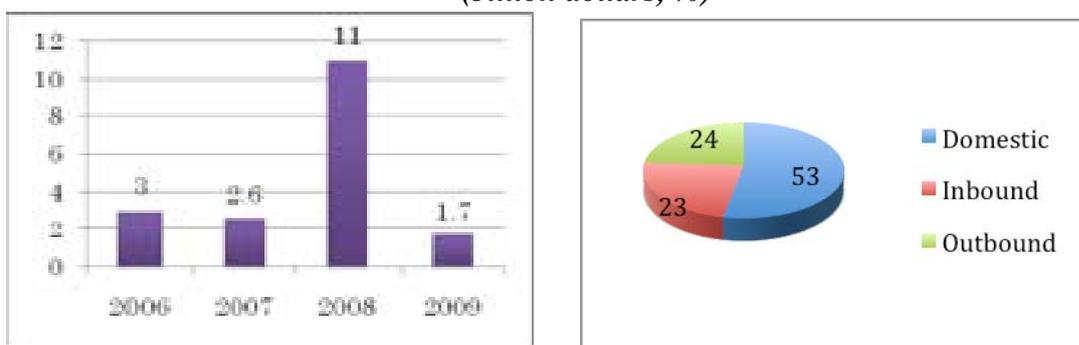
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<sup>12)</sup> Organic growth strategy is the one aiming expansion of business and is fully based on the internal resources of a foreign bank. It is normally very costly and takes a lot of time to implement.

9%. M&A trends accompany the general dynamic of foreign capital participation in the economy of Russia (most deals out-in) (Rybin, 2008).

M&A process in Russia can be divided into several steps. Before the introduction of market mechanisms and until the financial crisis of 1998, participation of foreign capital in the banking sector was limited, which is different from the situation in Latin America and CEEC. Russian Central Bank determined the upper limit of participation of foreign capital and aimed to control the banking sector. During this period banks operating in Russia tended to use organic growth strategy. Raiffeisen, Austria Bank had plans to expand their business to CEEC and CIS. Banks like Chase Manhattan, ABN Amro Bank used the “*follow the customer*” approach and supported foreign companies operating in Russia. During this period because of imperfection of institutional base and negative attitude towards foreign investments, M&A was not common. Banks preferred to create 100% foreign owned subsidiaries (Kulik, 2006; Rybin, 2007, 2008).

**Figure 3(left), 4(right) – M&A in the Russian financial sector 2006-2009 (billion dollars, %)**



Source: www.kpmg.de M&A in Russia, accessed 15.01.2011

In 2003-2004 Russian economy showed positive sign of growth, investment climate improved, linkages between banks increased that resulted in a higher transparency of the business rules in Russia. As the result many foreign banks made decision to come to the market. Although there still remained some negative trends from the first stage like low level of transparency of the banking sector as the whole, economical and institutional barriers, problem of WTO accession.

Nevertheless, during 2003-2004 foreign banks started using M&A as the method to get access on the market more and more often. Gradually the *green-field investment type* gave place to the *brown-field one*. Banks acquired at this stage were mostly the ones that already had a small share of foreign capital or the medium-sized one that were quite strong in a particular banking sector. In literature this period of M&A is called the “potentially covered period of M&A” (Rybin, 2007).

In 2005-2006 the potential period of M&A growth in banking was changed by an open stage. M&A cases and market deals drastically increased, targets for merger and acquisitions were shifted to larger banks, banks with a strong retail network and some small banks. For example, Societe Generale (France) bought 20+1% shares of Rosbank which has a strong retail customer network in 2006. Raiffeisen also acquired Investbank that has a very strong retail and regional presence. Reasons for acquiring banks with developed retail network are obvious: escape of initial costs of investment

for developing a segment<sup>13)</sup> and of course entry into the potentially profitable market segment<sup>14)</sup>. Regional banks as the rule have a strong brand name and have a good reputation among the established group of customers, therefore acquiring of such a partner for a foreign bank is a good deal. Acquisition of small-sized banks can be explained by the desire of banks to escape transaction costs of establishing a direct subsidiary (licensing by the CBR, other administrative and institutional procedures)<sup>15)</sup>.

In 2007-2008 Russian banking sector was showing positive dynamics. In 2007 69 M&A cases were registered in the financial sector with the total market value of 2.6 billion. Domestic transaction amounted to 53% in 2009, deals out-in amounted to 28%, showing positive trends in foreign banks' entry. Despite the existing deterrents (low transparency of the banking system, etc.), not only foreign banks, but also financial groups and investment funds started implementing M&A in the Russian market<sup>16)</sup> (Rybin, 2007, 2008).

Financial and economic crisis in 2008 significantly influenced on the dynamics of M&A transactions. In 2009 the number of M&A cases in the banking sector decreased, total market transactions value experienced a drop by 84.5% (from 11 billion to 2 billion dollars). In 2010 the positive dynamics of M&A was restored followed by the gradual recovery of financial liquidity of the banks that suffered the consequences of the crisis.

On the other side, domestic wave of M&A is of some interest and can be explained by enlargement of banks in order to fulfill the restrictions on minimum capital requirements (Russia is gradually increasing the upper limit of the charter capital of banks). M&A cases when large Moscow banks acquire regional banks that are strong in retail banking became more common. Most M&A are friendly ones and are driven by the necessity to resolve problems of low capitalization of Russian banks.

Alongside with this, Russian banks also show high interest in expanding their business abroad. This feature is a peculiar one and explains to some extent the specificity of the Russian market. Some domestic banks being a part of large financial industrial groups (Gazprombank) have potential to acquire assets of banks abroad. But in majority of cases due to the problem of undercapitalization, Russian banks tend to acquire even less capitalized banks of CIS countries. In 2005 the total market transaction value of deals out-in with the participation of Russian banks amounted to 113 million dollars and further increased in 2006. In 2007 banks like Slavneft (Belarus), Areksimbank (Armenia) were acquired<sup>17)</sup>. Russian banks used dual motivation for entering into the CIS markets: providing support and financial services to Russian companies operating in CIS countries (e.g. *"follow the customer"* approach) and showing interest in potential development of the region (*PULL reasons*).

In general, it is possible to conclude that M&A in Russia show a different strategy of foreign banks from that of evolutionary one (*"organic growth"*). Number of M&A in the Russian financial sector is increasing, this new strategy of development of foreign banks has some specific features: 1) targets of M&A shifted from medium-sized

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<sup>13)</sup> Buying a competitor with an established network is easier.

<sup>14)</sup> Boom of retail banking in Russia stipulated by high economic growth.

<sup>15)</sup> Major M&A transactions are listed in Gorshkov (2010), Bogdanov (2008).

<sup>16)</sup> For example, Merrill Lynch invested in TIB Holding that had an affiliated financial institution in Russia)

<sup>17)</sup> In 2006 Vneshtorgbank acquired 98% of shares of AKB Armiya (Ukraine), Sberbank bought 100% shares of TechsakaBank (Kazakhstan).

banks to regional (local) ones, 2) increase of banks with strong retail business network, 3) dominance of friendly M&A, 4) dominance of domestic M&A driven by the problem of undercapitalization, 5) increase of in-out M&A by Russian banks. As the result, the concentration of capital in the banking sector is increasing both by foreign and domestic capital. Russian large banks acquire small-sized domestic banks, while foreign banks are more interested in medium-sized banks having wide and stable regional networks. M&A strategy is chosen by foreign banks in order to escape costs of permission acquirement from CBR, costs of establishment of an affiliate and some other transaction costs. Moreover, M&A strategy is used to establish retail banking in Russia (Kulik, 2006), as it helps to become competitive at once in contrast to the strategy of organic growth. Therefore, it is possible to conclude the strategy of foreign banks on the Russian market is gradually changing; the shift towards M&A financed by parent banks is becoming more obvious.

## 5. Conclusion

High economic growth in Russia in 2000s and positioning of Russia as an emerging economy with a stable growing economy resulted in a foreign investment boom that was extended into the banking sector. Foreign banks entering Russia stimulate the inflow of FDI into other sectors and indirectly contribute to the improvement of investment climate of Russia. Foreign banks bring new banking technologies and financial products into the Russian market. Therefore, their positive impact is significant.

Needless to say, that with foreign banks entering the Russian market, the banking sector itself is subject to transformation and changes. Some of them include reduction or merging of small-sized banks, increase of the minimum capital requirement rates, growing banking assets and capital. Despite the fact that Russian banking sector was liberalized in 1990s, its development is often considered as immature in comparison to other developed economies due to the fact that there are problems with market quality, low level of banking infrastructure and moreover non-fulfillment of intermediary function<sup>18)</sup> by majority of banks.

Some other specific features of the Russian banking sector are its extra-segmentation, strong presence of the government, concentration of all operations towards large-sized banks, existence of huge amount of small-sized banks, undercapitalization of the banking sector, regional differences.

Despite the fact that there are obviously some negative features for FDI participation in the banking sector, more and more banks are showing interest in the Russian market. As it was shown in the present paper, foreign share in total banking assets, capital, deposits and lending is increasing. Some foreign banks try to develop traditional banking services (deposit, lending, settlement of accounts) competing with state-owned and Russian private banks, others prefer to entry into the particular market segments (retail banking (Toyota Bank) or investment banking (Deutsche Bank)). Share of foreign banks in traditional banking services is still quite low and

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<sup>18)</sup> Intermediary function – one of the three traditional banking functions, meaning the role of banks in attracting financial resources in the form of deposits and their allocation among other industries in the form of investments. For Russia both deposits and lending rates are quite low in comparison to other countries. Companies tend to attract financing directly from capital markets or use internal resources.

their role is rather limited, but foreign banks' participation in syndicated loans, project financing, cross-boarder lending is quite high.

The motivation of entry into the Russian market could be explained by both *PUSH* and *PULL reasons*. Non-economic motivation (political, historical, support of global image) comprising the *PUSH reasons* together with high economic growth and improved investment climate (*PULL reasons*) fully represent the specific features for foreign banks entry into the Russian market in 2000s. From the example of foreign banks shown in the present paper, we found that there are multiple reasons for entry and that motivation for entry is subject to change in accordance to the structure of market or trends in economic growth. In other words, foreign banks influence considerably on the Russian banking sector, and in turn economic development of host country and specific features of its banking sector also influence on the background of foreign banks' motivation.

Mutual relationship between foreign banks motivation and banking sector of a particular country can be fully expressed in analysis of entry modes and strategies of foreign banks. As for the entry modes, in accordance with the Russian legislation there are such types as *representative offices*, *JSC*, *subsidiaries*, *participation as minor shareholders*. Representative offices are fulfilling banking operations; therefore they are not counted as financial institutions in Russia. But for the purpose of entry modes analysis it is worth including them as initial forms of entry<sup>19)</sup>. On entering into the Russian market, majority of banks established representative offices and later converted them into subsidiary (*evolution of forms of entry*). Legislative and institutional restrictions and limitations of the Russian banking system, position of the government and some other factors significantly affect decision-making process about entry modes of foreign banks.

In addition, in terms of strategy, it was shown in the present paper that foreign banks gradually substitute the "*organic growth*" approach by *M&A*. *M&A* is common not only in the form out-in, but also in-out and in-in, meaning that activity of foreign banks considerably influence on the internal structure of the Russian banking sector.

Motivation, entry modes and strategies significantly influence on the banking sector in Russia and should be examined from both home country and host country approaches. Russian banking market is very specific, and in understanding the basic activities of foreign banks it is necessary to explore this specificity in close relation with the viewpoint of home country. In short, the theory of foreign banking, although not theoretically deeply shaped, might be found a sufficient one in achieving these goals.

Leading role of state-owned banks at some development stage of the banking sector is necessary, but it cannot last for long. Expanding needs of economy in investments evoke many changes in the structure of the banking sector itself. Growing presence of foreign banks is one of the examples of these changes. Despite the fact that the role of foreign banks in Russia is quite limited, from the point of view of institutional transformation, increased competition and technology transfer the essence of foreign banks is very important. Russian banking system is moving towards further liberalization, though at present it is hard to imagine Eastern Europe scenario (domination of foreign banks in the banking sector). Coexistence of state-

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<sup>19)</sup> Wide definition of a foreign bank. Representative offices while not being financial institutions are counted as initial forms of entry.

owned banks and growing presence of foreign banks driven by specific motivation for entry and using various entry modes and strategies, these two, contradictory at first sight, actors of the banking sector, lead the Russian banking market at present and this picture of the banking sector is unlikely to change in the near future.

**Note**

The present paper is a part of the master course thesis of the author on the topic “Russian banking sector and foreign banks activity” (in Japanese), submitted in February 2011 at Graduate School of Economics, Kyoto University. For further info refer to the thesis specified.

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