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The WTO and the Customs Union: What Consequences for the Russian Banking Sector?

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Summary

Russia is now a member of World Trade Organization (WTO) and of the Eurasian Customs Union between Russia, Belarus and Kazakhstan. Questions remain over how this new global and regional integration will affect the competitive environment of the Russian banking services industry. This paper shows that the mere entry of Russia into the WTO will not cause significant additional growth in the inflow of foreign investment into the Russian banking system. Changes in the structure of the Russian economy will lead to bankruptcy of some banks that are unable to diversify their business sufficiently. Credit institutions that do not have state backing or strong business clientele will have to find new niches associated with the sale of banking services to less well-off segments of the population.

An earlier version of this paper was presented at a conference organized by Ifri in the framework of the Eurasian Trade Task Force (ETTF), 31 May 2012. The ETTF addresses the different commercial and economic integration projects in Eurasia and their impact on domestic and foreign policies of the states concerned.

Competition in Russia’s Banking Sector

Banking has developed into probably the most competitive of sectors in Russia's modern economic history. On the one hand, this is due to the liberal conditions set for the registration of new banks, and, on the other hand, the relative transparency of the banking sector (given Russia's economic and political realities). This is reflected in particular in the emergence of a significant number of private credit institutions: according to the Bank of Russia there were 2 378 registered credit institutions in January 2000, of which 1 349 were active.[1]

There are also a number of important factors that contributed to the emergence of many independent market players, namely their relatively high profitability and the absence of market saturation. The growing private sector of the Russian economy represented a high demand for banking services, which could not be met by existing lenders—who as a rule were constituent parts of the former, Soviet financial system. At the beginning of the twenty-first century, the growing Russian economy began to show increasing demand for higher quality services, leading to a stiffening of competition and some consolidation in the banking sector. As a result, at the beginning of 2008 there were still 1 136 remaining active credit institutions, falling to 975 by April 2012. Note that in parallel to the reduction in the number of Russian banks there was an increase in the number of banks with foreign participation (see Table 1), which has also had a positive effect on the growth of competition.

Table 1. Growth in the number of Russian banks with the equity of non-residents (beginning of year)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total	126	123	128	131	136	153	202	221	226	220	230
Including											
Share over 50 %	35	38	41	42	52	65	86	102	108	111	113
Share 100 %	23	29	32	33	41	52	63	76	82	77	77

Source: Bank of Russia.

This study was supported by the Basic Research Program at the National Research University—Higher School of Economics (HSE) in 2012.
Translated from Russian by Joe Carter.

[1] For more details of creation and evolution of Russian banking sector, see : S. Aleksashenko *et al.*, “Bankovskij krizis: tuman rasseivaetsya?” [Banking Crisis: Mists Clearing?], *Voprosy ekonomiki*, 1999, No. 5.

During two decades of continuous economic growth, the banking system was able to attract the country's best young people who could not find similar employment in other sectors of the economy. High wages[2] and good career prospects contributed to this. In other sectors management positions in the remaining Soviet-era enterprises were occupied by the old staff, whereas newly formed banks offered energetic young people faster career progression. Another important factor for the sector development was the continued tightening of regulatory requirements for credit institutions by the Bank of Russia. Improving the system of prudential regulations, accounting reform, the increasing complexity of financial statements contributed to the banking sector being the most transparent in the Russian economy.

The 2008 economic crisis has led to important institutional changes in the Russian economy in general and the banking sector in particular. As a result of incautious risk taking, several large banks linked to public officials went bankrupt. These included Sviaz-Bank, Globex, Kit-Finance and Mezhprombank: almost all of them were nationalized. It should be noted that this situation was only possible due to the lack of real independence of the Central Bank of Russia, its subordination to supervisory authority of the “power vertical” that exists in Russia, as well as the weak political weight of the Bank of Russia’s leadership in comparison with high-ranking officials and representatives of large businesses. The steps taken by the Russian authorities to overcome the crisis led to a significant increase in the state's share of the banking system and in the economy as a whole.[3] Thus, in mid-2009 in an interview with RIA Novosti, the deputy head of Russian Economic Development Ministry A. Klepach estimated the presence of the State in the economy at around 50%.[4]

Since then, Russian government policy has resulted in the increase of both direct and indirect state involvement in the economy. Since it is difficult to pursue an active industrial policy without possessing the appropriate financial infrastructure, the state has also increased interventions in the banking system via state-controlled banks. According to our estimates, the share of state-owned banks in terms of total assets in the banking system at the federal level alone increased from 48.6% at the beginning of 2008 to 55.9% in January 2012. Therefore, the Russian economy, including its banking sector finds itself divided between a growing public sector and stagnating private sector in terms of customers served. Against this backdrop, competition in the banking system has intensified

[2] According to the Russia Federal State Statistics Service (Rosstat), in 2011, average monthly salaries in banking and finance were the highest of any sector of the economy, at RUB 50,120 (1 250 euros) per month. By comparison: overall the average salary was RUB 20,952 (525 euros), mineral mining RUB 46,271 (1 155 euros), machinery and equipment manufacturing RUB 20,102 (500 euros) and in the education sector RUB 14,075 (352 euros). Rosstat, <www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/population/wages/#>.

[3] A detailed analysis of the anti-crisis measures was conducted by S. Aleksashenko, V. Mironov and D. Miroshnichenko, “Rossijskiy krizis i antikrizisniy paket: tseli, masshtaby, effektivnost” [Russian Crisis and Anti-crisis Measures: Objectives, Scale and Efficiency], *Voprosy Ekonomiki*, No. 2, 2011.

[4] RIA Novosti, 2 July 2009, <http://ria.ru/economy/20090702/176090252.html>.

between public and private banks, on the one hand, and among private banks on the other hand.

In these circumstances, it can be assumed that increased global and regional integration of Russian economy will not have significant consequences for the banking sector. Public sector dominance and the lack of a truly independent Central Bank are the primary determinants of this situation.

There are two channels of influence of Russia's entry into the WTO and reaching economic integration within the Customs Union on the state of competition in the Russian banking system:

– Growth of direct competition associated with the arrival of foreign banks in the Russian market;

– Reinforced indirect competition by promoting structural changes in the Russian economy.

In this study, we examine potential changes in the institutional and economic environment, and the manner in which they could affect the level of competition in the Russian banking sector via the two mechanisms identified.

More Foreign Banks in Russia?

Russia's entry into the WTO came with a set of pre-agreed conditions; in the banking sector, these focused on three fundamental positions:

– Foreign banks cannot open branches in Russia, they must be registered as a Russian legal entity;

– There are quotas for foreign capital allowed into the Russian banking system;

– This quota does not include acquisition of shares in Russian state banks under the privatization program of large state companies (Sberbank, for example).

The prevention of foreign banks opening subsidiaries in Russia creates a level playing field in the banking business for Russian and foreign banks in Russia, at least in terms of regulation and oversight. All banks operating in the Russian Federation play by the same rules. The admission of foreign subsidiaries in the Russian market was envisioned in the first version of the current law "On Banks and Banking," but it would lead to a distortion of the competitive environment because of differences in regulations and account reporting requirements. For example, the system of accounting and reporting in Russia is very different from those adopted in other countries for those banks that currently have wholly owned subsidiaries in Russia. Leaving aside the question about the pros and cons of particular accounting systems, a Russian legal entity has to submit several times the volume of reports to the Central Bank than eurozone credit institutions are required to in their countries. This naturally leads to increased costs of doing business: that is, the cost of a Russian bank to prepare the required array of financial documentation is substantially higher than European banks, which undoubtedly affects both their productivity and competitiveness. Therefore, the existence of two different regimes would lead to economically unjustified competitive advantages of one group of market participants over another.

Thus, the conditions of Russia's accession to the WTO preserve the existing rules of the game and its impact on the competitive environment can be regarded as neutral. In the mid-2000s, the problem of direct admission of foreign bank subsidiaries to the Russian market was actively discussed by industry experts. For example, I. Sergeev, a specialist in the Financial Department of ABN AMRO Bank, commented that some of the relative benefits for subsidiaries of foreign banks could be reduced by adapting the legal regulations.[5] One of the most difficult questions would be the formal absence of their own capital for branches of foreign banks, while Russian banks would be at a disadvantage, being forced to comply with the mandatory standards over size of capital. But, as the experience of other countries shows, provisions in the legislation can be introduced equalizing the playing field between Russian credit institutions and branches of foreign banks. For example, in Hungary outlays of foreign bank for the creation of branches are considered as its starting capital.

The agreement reached between the Russian Federation and the WTO on the terms of admission stipulated a quota of a 50% share of foreign capital in the Russian banking system. This has the potential to affect the level of competition in the banking sector. However, the official statistics of the Bank of Russia at the beginning 2012 stated that the total number of credit institutions with foreign participation amounted to 230 (see Table 1) and the share of foreign capital in the total registered capital in the banking system for the same date amounted to 27.7%. The share of foreign capital in the Russian banking sector is on a downward trend: it decreased by 0.4% last year, having reached its apex in early 2009 with 28.5%.

When one moves from the statistics to the situation in a real business environment, one finds that in recent years several European banks have curtailed their operations in Russia. The most illustrative cases include the discontinuation of the retail divisions of HSBC and Barclays bank. While different, these two cases have something in common—both banks failed to gain a critical mass of retail customers because of fierce competition from veteran market players, both Russian and foreign. Experience has shown that successful entry into the Russian market by foreign banks is only possible after the careful selection of products on offer and clear identification of target customers. HSBC and Barclays overestimated the credit-worthy demand for their services, not taking into account the fact that Russia as a whole is still a relatively poor country.[6]

For newly established foreign banks in Russia, one of the biggest challenges will be to find a niche and try to win market share. This is confirmed by successful entrances in the Russian retail banking market in the past decade by Credit Europe Bank (a division of FIBA International Holding, Turkey), and Home Credit Bank (controlled by PPF Group, Czech Republic), who successful providing services to a segment of the market associated with the sale of credit services to the lowest earning segment of the population. Of course, for any company to come into any competitive market implies solving the same problems. However, one must initially have a business plan tailored to the specific conditions of countries with an affluent population and a developing economy. A head start can be

[5] Information Agency “Prime-TASS,” 25 August 2005, <www.wto.ru/ru/opinion.asp?msg_id=13411>.

[6] In terms of household purchasing power parity, only two EU countries in 2008 were lower than in Russia: Bulgaria and Romania (77% and 84% of the Russian level, respectively). In addition, incomes in Russia are very unevenly distributed: the Gini coefficient (index of income concentration) for Russia was 42%, according to the latest data available. In contrast, for the EU median Gini coefficient was 31.2%; only Bulgaria registered a level greater than Russia (45.3%).

obtained by subsidiary banks with personnel who understand the specific elements of these environments.

Returning to the statistics of foreign presence in Russia's banking sector, we note that the proportion of foreign capital in the total registered share capital is currently almost twice lower than the maximum fixed by the agreement on accession to the WTO and the trend is negative. Taking into account all these factors, the impact of this limitation is light, at least for the foreseeable future. The problems facing potential investors into the Russian market should also be remembered, particularly those facing eurozone banks. It seems that the current euro crisis is unlikely to be overcome in the next few years, removing the probability of any large-scale expansion by European banks in the Russian market for the time being.

It should be noted that Europe is now the main source of investment in Russian economy. According to official figures from the Bank of Russia (Table 2), at the start of 2011 combined FDI from European countries as a proportion of capital invested accounted for three-quarters of all foreign investments (excluding offshore tax jurisdictions). One of the main motivations for the arrival of a bank in a foreign market is the presence of its corporate clientele. For this reason, European banks have traditionally been more present in Russia than banks from other regions.

Table 2. FDI contribution share by country, January 2011 (capital)[7]

Country	Share (%)
Germany	20.9
Sweden	17.6
France	11.6
Austria	7.2
UK	4.6
Finland	4.7
Switzerland	5.3
US	4.8
Belgium	1.8
Japan	1.9
P.R. China	1.1
South Korea	2.0
Denmark	1.1
Spain	1.4
Italy	1.0
Czech Republic	1.2
Kazakhstan	0.8

Source: Bank of Russia, author's calculations.

The data primarily reflect the current profile of Russia's foreign trade. Russia's position in the international division of labor does not attract the levels of FDI from major economic centers such as the US, Japan,

[7] Excluding investments from offshore jurisdictions.

China and other regions, that would encourage their expansion in the Russian banking market.

At the same time, one should not underestimate the importance of a subtle and subjective matter: the differences between states in corporate culture. In particular, this factor plays an important role for banks from Asia. Attempts by some Japanese and Chinese banks to operate in Russia suggest that the lack communication between the top management of the country of origin of capital and Russian staff is a significant obstacle. Currently, banks from Japan, China and South Korea in Russia have an almost negligible presence. Those subsidiary credit institutions that do exist are very limited in their range of transactions, serving only a small number of customers from their countries of origin. Thus, the difference in corporate culture, combined with the volume of trade, does not raise expectations for active capital inflows into the Russian banking sector from those regions.

Nevertheless, continuing economic development in Asia, especially China, will inevitably raise the question of mutual penetration of Russian and Chinese banks in each other's markets. Also, this trend will be reinforced by China’s policy to promote the Yuan as a regional—and later global—currency. An example of a step in this direction is a recent decision by the People's Bank of China, which allowed Russian credit institutions to open accounts in the Chinese commercial banking sector, which can be used for inter-bank transactions in Yuan. However, even this step has been limited, since only Yuan gained in trading on the Moscow stock exchange (MICEX-RTS) can be deposited in these accounts.

Another deterrent to direct Chinese investment in subsidiaries in Russia by Chinese banks is the strict control exercised by the Chinese authorities over the financial sector. Therefore, Beijing’s political desire to invest is a prerequisite for any serious Chinese expansion into the Russian banking sector. Evidently, this would have a considerable impact on the sector’s competitive environment. At present, there is no indication that such a decision to expand will be taken in the near future. Thus, the most likely scenario is the lack of significant growth in the presence of Chinese banks over the next five years in the Russian market; however, this does not preclude such an increase with adoption of the relevant political decision by the Chinese leadership.

Based on the foregoing, it can be stated that the current quota for foreign bank participation in the Russian banking system is unlikely to be reached in the foreseeable future. The primary reasons for this are the current lack of significant interest in the Russian market from investors from most centers of the world economy, their domestic economic problems and constraints of the national authorities imposed on potential investors.

During the negotiations with the WTO Working Group on Russia’s accession, the Russian Federation succeeded in furthering its interests in this area: conditions pertaining to the quota of 50% ownership were further relaxed via amendments to rules regarding the calculation of quotas. This quota will not apply to shares acquired by non-residents in the capital of the Russian state banks in the framework of their privatization. As a result, potential investments in the largest state-owned institutions will not be affected by this provision.

In summary, the documents agreed upon during the negotiations on Russia's accession to the WTO leave significant room to expand the presence of foreign banks in the Russian market, both through the creation of Russian subsidiaries of foreign credit institutions, and by carrying out the capitalization of existing ones. This creates a legal framework for the inflow of foreign direct investment in the Russian banking sector. But, in the short term, one can hardly expect such an influx due to the current economic realities in Russia and in the countries where investment is most likely to originate.

Potential Economy-Wide Changes

If the Russian banking system is not sufficiently attractive to non-residents at present, can it be assumed that the country's accession to the WTO and expected economic growth as a result will make it any more so? What impact will these changes have on competition between credit institutions already in place? To answer these questions, it is necessary to explore the mechanism of indirect effects on competitive conditions in the banking sector, resulting from accession to the WTO and membership of the Customs Union with Belarus and Kazakhstan.

The banking sector and WTO membership

On this issue, the author has relied primarily on the simulation results obtained by T. Rutherford and D. Tarr (2006),[8] as well as a recent study conducted jointly by Ernst & Young and the New Economic School (2012).[9] Note that an applied general equilibrium model was used in both studies to obtain quantitative estimates of the consequences of Russia's WTO accession. The use of such a model has allowed the authors to carry out a quantitative analysis of the impact of WTO accession on the structure of the Russian economy. However, given the characteristics of such an analysis, the general equilibrium model does not cover all aspects of the financial system. Therefore, they cannot directly address the questions of key interest: the impact of WTO on the banking sector in general and the question of competition in particular.

However, it must be noted that the authors of these studies did not set out to assess the impact of accession on the banking system. Their goal was the calculation of changes in industrial output, employment by sector, and the impact of changing legislation on export and import volumes.

However, the conclusions of these studies based on general equilibrium models are a good source of overall understanding of the potential impact on the banking system of Russia’s entry into the WTO.

[8] T. Rutherford and D. Tarr, “Regional Impacts of Russia’s WTO Accession,” World Bank, July 2006, <http://siteresources.worldbank.org/INTRANETTRADE/Resources/Internal-Training/287823-1116536061368/Regional_ImpactsOfRussiasAccessionToTheWTO.pdf>.

[9] Ernst & Young/New Economic School, “WTOrichna dlya Rossii ? Vstuplenie Rossii v VTO: analiticheski obzor” [WTO, Minor for Russia? Russian Accessions to the WTO, Analytical Insight], April 2012, <www.ey.com/Publication/vwLUAssets/WTO-Russia-April-2012/$FILE/WTO-Russia-April-2012.pdf>.

Rutherford and Tarr’s 2006 results were very similar to the results and main conclusions of the 2012 Ernst & Young/New Economic School study, even though the latter had incorporated up-to-date data on the future level of effective import duties. The only shortcoming of these studies is the weakness and incomprehensiveness of the Russian regional statistics upon which they are based, but three main conclusions can be made:

1. The cumulative effect of changes in tariffs and improved access to foreign markets for Russian producers in the short term will be 0.5% of the level of aggregate production.

2. The uneven sectoral distribution of this effect. The biggest beneficiaries would be non-ferrous and ferrous metallurgy, chemicals and petrochemicals industries. The biggest losers would be wood processing; cellulose and paper production; and wood products, textile and mechanical engineering.

3. Achieving the maximum overall positive effect will only be possible by improving the country's investment climate and the implementation of relief measures to help some regions.

The second point is the most important for the banking sector: the principal winners and losers of accession to the WTO. It is noteworthy that the sectors where companies get the maximum benefit from greater integration of Russia into the international division of labor are primarily those that already have high production levels and are already present on international capital markets. The existing structure of the Russian economy is characterized by the coexistence of large industrial enterprises, especially those related to mining and processing of natural resources, on the one hand, and small banks, on the other. Due to their small size and insufficient domestic capital, these banks are unable to fully serve the needs of the large industrial enterprises. As a result, Russian banks tend to serve a smaller customer base, mainly consisting of companies operating in the domestic market. The major exporters have recourse to major foreign banks, and can also call upon “captive banks” in Russia.[10] This particular configuration means that additional benefits from Russia’s entry into the WTO will not lead to significant institutional changes in the banking system.

Another matter is the deterioration of economic conditions for sectors of the economy primarily focused on the domestic market, and as a rule, smaller companies. Reduced production at these plants will worsen the financial situation of banks that serve them both through the growth of the credit risk of the enterprises themselves, and through increasing the risks of retail lending employees of these enterprises: especially those living in “monotowns” (cities which depend entirely on one industry or factory). Thus, after Russia's WTO accession bankruptcies, especially of regional banks with undiversified client bases are to be expected. The effect of this upon the competitive environment within the banking sector will be contradictory: on the one hand, it may reduce competition between banks in some local markets, but on the other may boost competition for

[10] A captive bank is a wholly or partially-owned subsidiary of a company that serves the interests of just one legal entity.

the remaining solvent customer base. The same processes can already be observed, but they will be intensified due to changes in economic conditions following Russian accession to the WTO.

In addition, we can expect changes to the operational structure of Russian banks. The studies cited above indicate the relative benefits from these changes for low-skilled workers, which are the mainstay of the banks that specialize in lending to the poor. These banks stand to be the main beneficiaries of the predicted income growth for this segment of the population.

No analysis of competition in the Russian banking system would be complete if it ignored the clear division between state and non-state entities, which is the site of the fiercest competition within the sector. Based on the findings obtained in modeling the impact of Russia's accession to the WTO, we can assume that increased competition is expected particularly in the private sector as the biggest reduction in the customer base will also occur there. The state's economic role (through state-owned banks) will see slower rates of decline. For the most part, additional cash flows from the country's accession to the WTO will accumulate in the captive banks of private and state companies, and will not have a significant positive effect on the banking system in general.

The banking sector and the Customs Union

The formation of the Customs Union between Russia, Belarus and Kazakhstan took place between 2007 and 2011, in parallel with the last years of negotiations on Russia's accession to the WTO. The actual influence that the establishment and operation of the regional organization had on the Russian banking system was neutral. In other words, the harmonization of customs and other legislation of the three countries did not lead to significant changes in the configuration of the Russian banking sector. The reason for this is that the impact on the Russian economy of the Customs Union was too small to have serious consequences for the cash flows between member states. To evaluate the potential impact in the long term, we can examine just how significant any flow of direct investment from the Customs Union member states into the Russian banking system could be. First let us consider a statistical analysis of the three economies in question (see table 3).

Table 3. GDP of the Customs Union in 2011, (billion US$)

Belarus	48.9
Kazakhstan	186.3
Russian Federation	1852.4

Source: CIS-STAT, author's calculations.

The above data show that the Russian economy is ten times larger than Kazakhstan's and almost forty times that of Belarus. Given the differences in the size of their economies, the potential investment in Russia from the other two countries of the Customs Union is modest to say the least. Moreover, it is unlikely in these countries will bring additional investment resources for the expansion of their banks in Russia in the near future. To confirm this hypothesis, we can refer to one of the key indicators for the investment potential of the banking sector: the per capita level of deposits with credit institutions (see table 4).

Table 4. Deposits in member state credit institutions (US$ per capita)

	2007	2008	2009	2010	Q1 2011
Belarus	514	648	681	808	828
Kazakhstan	751	773	793	902	939
Russian Federation	1420	1677	1651	2235	2396

Source: CIS-STAT.

As can be seen from the data, since 2007 per capita cash deposits in Russian banks in dollar terms increased by 70%, while the increase in Kazakhstan amounted to only 25%. The data for Belarus deserve closer examination. According to official data, growth in deposits was comparable with Russia (a little over 60%). However, one should bear in mind that since release of the data Belarus experienced a near triple devaluation of the national currency, resulting in a drop of Belarusian ruble against the US dollar from 3054 RUB/US$ at the end of March last year to reach 8020 RUB/US$ at the end of March 2012. If calculations take into account such a massive devaluation, not only was there no increase in the value of per capita deposits from 2007 to the first quarter of 2011, but they decreased by almost 40%. Thus, we can safely say that not only the economic weight of the Customs Union member states, but also key indicators for banking system resources indicate that the two countries in the Customs Union lack the potential to enhance their influence on the Russian banking system.

On the contrary, we should note that the reverse process is currently underway: Russian banks are expanding to the markets of Belarus and Kazakhstan. In 2009, Sberbank of Russia acquired one of the largest banks in Belarus—Belpromstroibank—and VTB opened a subsidiary bank in Kazakhstan. However, the arrival of Russian banks on these markets is a highly politicized issue, especially in Kazakhstan.

Conclusion

It is clear from this study that if there is any growth in competition within the Russian banking system following Russia's WTO accession and the establishment of the Customs Union, it will be almost exclusively due to internal economic changes.

One should not expect a stronger presence of foreign banks in Russia, due to the current lack of interest from foreign players to expand in Russia. In addition, limitations imposed by national governments restrain the growth of foreign investment in the Russian banking sector. This applies to European countries that have traditionally invested in Russia, but also to China.

Possible structural changes in the Russian economy could lead to a change in the level of competition in regions where sectors are economically depressed, which would be the losers as a result of changes in the conditions of foreign trade. The likely failure of banks linked to these sectors will reduce the availability of banking services in these regions. At the same time this will see competition for the remaining solvent customers intensify. These processes primarily affect private banks; state-controlled banks won't experience any significant additional pressure.

As a result, the income growth of unskilled workers within sectors of the economy that stand to benefit from Russia's accession to the WTO, will stimulate additional growth for the banks working with low-yielding sectors of the population, primarily in the sale of loan products.

The Customs Union will continue to have no impact on the Russian banking system because of the competitive weakness of the banking systems in Belarus and Kazakhstan. The influence of general economic dynamics caused by the deepening of cooperation between the three countries within the Customs Union will be insignificant compared with the influence of Russia's accession to the WTO.