

RETAIL BANKING

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Abstract

The retail finance sector is currently one of the most competitive in the banking industry. However, in order to succeed in such a dynamic market place the skills required to be a successful retail banker are many and varied: ability to demonstrate a deep understanding of consumer needs and revenue generating methods, ability to develop new market entry and customer retention strategies, application of new business models and translating them into revenue generating projects and programmes.

A successful product development, effective distribution and efficient marketing programme can make a real difference to the retail bank's performance and impact on its bottom line.

I. BANKING MARKET IN RUSSIAN FEDERATION AND MACRO-ECONOMIC FACTORS

The Russian banking market is the largest and one of the most dynamic in Europe. The sector is still highly fragmented, with 1 350 institutions, including 50 foreign-owned banks.

The economy has shown robust GDP growth over the past seven years, ranging from 5 to 10 percent annually. Given the healthy State finances and high commodity prices, such growth seems set to continue for the foreseeable future.

The main reason for the development of the Russian banking system has been the constant growth of the Russian economy. However, in reality the Russian banking market has even greater growth potential. Although total bank assets in Russia have recently shown annual growth of close to 30% they currently represent just 45% of GDP. This figure compares with 74% in Poland, 117% in Czech Republic and 260% in Germany.

There would therefore appear to be very substantial latent demand to be met in the future. Drivers of demand for corporate banking services will include increased expenditure on infrastructure and reinvestment in aging industrial plant and equipment. Retail demand will be driven by

increasing prosperity, especially among the growing middle classes and the young.

An investment in the Russian market from the side of foreign players is rather interesting and attractive.

The proportion of the market held by the top 10 banks has remained more or less constant for several years. The market is dominated by three state-owned banks (Sberbank, Vneshtorgbank and Gazprombank) that control over 50% of the market. The proportion of the banking market controlled by foreign banks was still less than 10% in 2005. Despite significant increase in 2006 it remains relatively low by comparison with other emerging markets. (The average in Central and Eastern Europe is closer to 70%). The Central Bank of Russia (CBR) recognises the need for additional capital in the banking system and seems willing to see the proportion of foreign ownership increase. Banks of good international standing are therefore made welcome.

Currently the two main financial centres are Moscow and, to a lesser extent, St. Petersburg. Scandinavian banks such as Sampo and Hansabank (Swedbank group) have shown a particular interest in St. Petersburg and the North-East of the country, because of the greater cultural and geographical proximity to their home markets.

However, the largest transactions have involved Moscow based banks: notably the acquisitions of Investsberbank, Impexbank and Orgresbank by Hungary's OTP, Austria's Raiffeisen International and Nordea respectively. Raiffeisen had already been a significant player on the Russian market for a number of years. However, the purchase of Impexbank's extensive branch network has transformed the scale of its retail business.

Societe Generale is another Western European bank which has shown its commitment to the Russian market. It has a strong presence on the fast growing consumer finance and mortgage sectors, through Rusfinance and Delta Credit. The group is also developing its BSGV branch banking network and has at the same time acquired an initial 20% stake in Rosbank, with an option to take full control.

Two major Italian groups, Intesa and Unicredito, are likely to become more significant players on the retail banking market, following their acquisitions of KMB Bank and IMB Ban

respectively, even though each of these banks has historically been more focused on the corporate or SME market than retail. More recently two of the major British banks, HSBC and Barclays, have also declared their interest in the Russian retail banking market.

Elsewhere, Citigroup has one of the best known retail banking franchises, while GE Money is building slowly on its acquisition of Delta Bank. India's ICICI is promoting aggressively its consumer finance brand and the Japanese can be expected to become significant players on the car finance market (see below).

The increasing number of M&A deals in the banking sector is not all driven by the arrival of foreign players. We have also seen consolidation among local institutions, either through merger (e.g. Uralsib) or acquisition (Vneshtorgbank's acquisition of Guta Bank).

Many of the leading banks have declared a general intention to expand their presence in the regions. However, further development of the banking system in specific regions will be closely related with the economic development of each of those regions.

Regional markets have historically been dominated by Sberbank and a few strong regional banks (AKBars, Chelindbank, ...). Groups such as Uralsib will no doubt also continue to exploit their strong regional roots and credentials. More recently, Alfa Bank has been successfully rolling out its Alfa Bank Express concept in the regions since late 2005. Some other Moscow based banks now appear to be following the same strategy.

II. GROWTH SECTORS

The volume of consumer loans has grown exponentially in recent years and Russian banks are in a constant search for additional resources to be provided to their clients.

Initial growth in consumer finance came through loans offered in the big retail stores and retail chains and in auto loans. However, each of these segments is becoming increasingly competitive. With many banks now competing for the same opportunities, retailers are able to negotiate increasingly favourable terms for granting access to their customers. In the same way, the leading automobile brands are looking to increase their revenue from finance activities, in line with their international operating models. Some are renegotiating their alliances with the banks, in order to expand the range of financial services offered to their clients. Others are in the process of establishing their own Russian banking or finance subsidiaries.

Other areas of growth in consumer banking include personal instalment loans, often sold through press advertising and administered through call centres, and credit cards. The penetration of credit (as opposed to debit) cards on the Russian market

remains low by international standards, with credit cards representing just 5% of all cards in issue.

The mortgage market is growing fast but from a very low base. In Russia mortgage loans represent some 10% by value of all retail loans, compared with more than 50% in Central and Eastern Europe and even higher figures in the remainder of the European Union. The development of a secondary mortgage market is expected to increase future liquidity.

Not surprisingly Moscow has been the most active residential property market, followed by St Petersburg.

Concerning the financing future growth, there have been given the rapid growth of both corporate and retail loan portfolios, many banks are looking to develop the new sources of financing, such as Eurobonds and securitisation, or are seeking to attract international investors, either through IPOs or as strategic partners. We are also beginning to see the first signs of interest in the Russian banking sector from private equity houses.

As a result of the above we are seeing increased transparency, not only around the ownership of many banks but also around their revenue streams. Internal competition for funds within the larger, diversified groups is also leading to increased focus on capital allocation models.

III. BARRIERS TO ENTRY AND RISKS

Foreign players entering the market have two possibilities: establishment of a greenfield operation or acquisition of an existing bank. Either way, the application and approval process can be laborious and time consuming. The greenfield option avoids the risks associated with an acquisition. An acquisition allows a bank to become fully operational more quickly. (This is especially true on the retail sector, because a newly licensed bank cannot open accounts for retail customers in its first two years of operation). Some new entrants choose to pursue the greenfield operation and possible acquisitions in parallel, in case they cannot find a suitable acquisition target.

Another popular route is to take a minority stake in an existing bank, with the option to move to full control in due course. This mitigates the risk to the acquirer, who can get to know the target better and begin to exercise influence, before being committed to the full transaction. For its part the seller may achieve a higher average price for its shares than would have been realised in a single transaction at the outset.

Once registered, the new bank must comply with the regulations and reporting requirements set by the CBR. These are very extensive and sometimes make it difficult for the foreign banks to make full use of the business processes already adopted in other countries. In addition, some products (leasing, bancassurance ...) do not enjoy in Russia the favourable tax status seen in other markets.

Historically, many foreign banks may have been discouraged from entering the Russian market because of perceived political and other risks. However, few banks now expect to see a repeat of the 1998 financial crisis. Most commentators do though anticipate some periods of turbulence, such as arose with the short-lived run on some private banks in 2004.

IV. OPPORTUNITIES

We have already referred to opportunities for expanding consumer finance services, including growing the base of issued credit cards. Other possibilities might include widening the car loan product line, extending the term of standard car loans, development of trade-in schemes and car loans refinancing.

The onshore private banking market is also attracting increased investment from both local and international banks, as the number of wealthy Russians grows and greater economic stability encourages more of this wealth to stay in the country. For similar reasons, we expect to see increased focus on savings and investment products such as mutual funds.

More generally, there is still great scope for improvement in the level and quality of banking services. Queues in bank branches are commonplace. Customers are often required to interface with two or more bank employees, in order to complete even simple transactions. Some basic payment products, such as standing orders and direct debits, are still not widely available.

On the other hand the Russian market is ahead of some European markets in the use of more modern technologies, including telephone banking and SMS alert services. This is not surprising in a country which readily adopts new technologies. (A PricewaterhouseCoopers survey completed in 2005 found that more than 50% of the population in the main urban centres of Moscow and St Petersburg would be willing to take up internet banking services).

Finally, many banks are showing increased interest in the insurance sector and we can expect to see further movement in this direction. As yet Uralsib has been the most active advocate among large

Russian groups of the financial supermarket concept. Alfa Group is a top 10 player on both the banking and insurance markets. Russian Standard has built a substantial insurance business on the back of its consumer finance customer base but to a large extent remains a mono-line credit life insurer. Bank of Moscow has made a number of recent investments in the insurance sector. It is quite possible that we shall in the coming years see one or more fully integrated banking and insurance groups emerge on the Russian market, either from among the companies named above or from newer entrants to the market.

V. FUTURE PROSPECTS

In the conclusion it is actual to mention about the future expectations: there is a possible continued rapid growth in the retail banking sector, driven by continuing growth in the Russian economy and the release of latent demand for banking services, from both individuals and small and medium enterprises. The size and demographics of the Russian Federation are large and varied enough to offer critical mass in all areas of financial services. Also there is an expectation that the Russian market will quite soon acquire the characteristics of a more mature market, with many specialist niche players operating alongside the larger universal banks. The leading players in today's market will certainly enjoy some first mover advantage. However, for the reasons already discussed and despite their success to date, they will struggle to meet the total market demand. Newer arrivals will still therefore have the opportunity to carve out a significant market position.

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