Foreign Banks in Russia: Entry Mode, Early Evolution, and Lending Behavior

Alexandra K. Theodossiou
Texas A&M University-Corpus Christi

This paper analyzes the evolution of foreign capital entry into the Russian banking system and documents the current characteristics and lending behavior of 100% foreign-owned banks in Russia. Using the lessons from the recent rapid foreign banking expansion in Russia, I show that the liberalization of Russia's banking system and the attractiveness of its market opportunities were essential determinants for foreign bank entry. I find that country of origin matters in foreign bank lending preferences. In general, foreign banks from developed home countries focus on lending to Russian corporate customers while foreign banks from emerging markets follow the "follow the customer" strategy.

Keywords: bank, foreign, lending, Russia

INTRODUCTION

The increasing presence of foreign capital in the banking systems of many emerging markets represents several theoretical and practical issues in the academic finance literature, regulatory policies, and bank management. This paper contributes to the discussion of the causes and consequences of foreign banks' expansion into emerging markets' banking sectors by providing an in-depth examination of foreign banks' first entry, characteristics, and lending activities in Russia. Specifically, I trace the early evolution of foreign-owned banks and foreign capital in Russian banking during the 1993 – 2008 period, the limitations for foreign banks entry in the initial entry years, and the reasons for their rapid expansion in the latter part of the examination period. I also describe the main characteristics of 100% foreign-owned banks and empirically examine the patterns of their lending behavior.

Most emerging market countries have allowed foreign banks to play a protagonist role in their economic transition. As documented by Naaborg, DeHaan, DeHaas (2003), foreign banks play a dominant role in most Central and Eastern European transition economies: after the privatization of the banking systems in these countries, the market share of foreign banks rapidly increased from 7.5% in 1994 to 64.4% in 2000. Other empirical evidence shows that most banking system assets in Poland, the Czech Republic, Hungary, Bulgaria, Slovakia, Estonia, and Lithuania were controlled by foreign banks (De Haas and Naaborg, 2006).

In contrast to other Central and Eastern European transition economies, Russia did not have a significant foreign bank presence. The visible expansion of foreign-owned banks and foreign capital has started only recently. In the last five years of the examination period, the industry's share of foreign charter capital increased from 6.19% at the end of 2004 to 28.49% in 2008. Despite this fast growth, the overall number of foreign banks' presence in Russia remained relatively low. In 2008, only 102 out of 1,058 Russian banks were majority-controlled by foreign investors, and only 72 of these banks were 100% foreign-owned. Although many significant players in global banking have established daughter banks in

Russia, the share of foreign-controlled banks in total assets was only 18.7%. For comparison, according to official Central Bank of Russia (CBR) statistics, 24 state-controlled banks accounted collectively for 40.6% of the total system assets. In contrast, the remaining 933 banks and 40.7% of the banking assets were majority controlled by domestic private owners.

Following the financial liberalization and worldwide integration of financial markets, the importance of foreign banks as significant sources of financing for emerging economies has increased dramatically (Claessen, Demirguk, and Huizinga, 2001). The financial markets of emerging economies are underdeveloped. Their banking industries are not well prepared to deal with the influx of foreign entrants operating in highly competitive environments. Legislators in those economies are then left with the difficult task of enacting regulations that will protect domestic banks while allowing and seeking the entry of foreign banks. On the one hand, foreign banks can improve the efficiency of the domestic financial system through increased competition (Buch, 1996). On the other hand, they may push domestic banks out of vital and profitable lending segments and clientele since foreign banks may choose to compete in specific market segments and ignore others (Clark, Gull, D'Amato and Molinari, 2000; Barajas, Steiner, Salazar, 2000). In the case of Russia, regulators are still struggling with the challenge of allowing more vital foreign capital to enter the country through foreign banks while at the same time protecting the domestic national banking industry from foreign bank competition.

In the Russian regulatory framework, a foreign bank is a commercial bank if it is 100% owned by foreign investors, operates in Russia, and is registered and licensed as a Russian bank. To document the distinct characteristics of foreign-owned banks in Russia, I empirically examine two samples – the population of all 100% foreign-owned banks in 2007 (N = 62) and the subsample of foreign-owned banks that publicly disclose their financial statements (N = 40). I find that foreign-owned banks compete with local banks in the same market segments. They focus their lending operations on Russian customers, with an average ratio of loans to Russian borrowers to total loans of 92.5%. This result suggests that the "follow the customer" hypothesis does not apply to the Russian setting and that foreign banks enter the Russian markets to service local customers. I also find that country of origin matters as foreign banks from developed countries allocate higher loan amounts to Russian borrowers than foreign banks from emerging markets. I also find that the primary recipients of foreign banks loans in Russia are Russian corporate borrowers. The results suggest that foreign banks are direct competitors to the domestically owned Russian banks in specific segments.

My paper makes several contributions to the finance literature in general and, more specifically, the banking literature. First, it is the first empirical study that documents the role of foreign banks in the critical and largely unexplored Russian banking sector. Second, I discuss the interplay between the Russian regulators' incentives to bring additional capital to the credit-hungry corporations and the competing incentive to protect the national banking system from foreign competition. I provide evidence that specific regulations may have a chilling effect on potential foreign entrants, even though primarily declarative. Third, I document several distinct non-financial characteristics of foreign-owned banks in Russia, including their legal status, organizational form, licensing, location preferences, financial transparency, and deposit insurance membership. I also compare these characteristics to the characteristics of domestically owned Russian banks. Fourth, I extend the existing literature on the foreign banks' activities in their host countries by showing that foreign banks enter the Russian market not to satisfy the needs of existing customers of their own country of origin ("follow the customer" explanation) but rather to compete directly with Russian banks in the lending to local firms' segment.

The paper is organized in the following way. The next section describes the early evolution of foreign-owned banks in Russia, the limitations for their entry in the initial years, their current role in the Russian banking system, and the reasons for their rapid expansion in the recent period. It is followed by a literature review regarding foreign banks, the risks they face, their motivations, and their impact on the banking industries of their host countries. The following section describes my steps for collecting data, methodology, and acknowledging limitations. In the next section, I describe the non-financial characteristics of my sample banks and report my findings on the factors that influence foreign bank lending behavior. In the last section, I make concluding remarks and discuss the policy implications of my findings.

FOREIGN-OWNED BANKS IN RUSSIA: EARLY EVOLUTION, REGULATIONS, AND THE LOCAL MARKET OPPORTUNITIES

The Russian banking system represents an interesting case of expanding foreign capital into emerging markets. Foreign banks can either enter the Russian market by establishing a daughter bank registered as a Russian bank or acquiring stakes in existing Russian banks. Foreign branching is prohibited in Russia. All foreign-owned banks operating in Russia have complied with the Russian banking regulation and licensing requirements. The procedures for opening a bank are identical for domestically and internationally owned banks. The official justification for the ban on foreign branching is that the government and CBR want to provide an equal playing field for domestic and foreign banks. What is implied by this rationale is that they want to shield domestic banks from the direct and uneven competition with branches of large and well-established international banks. In addition, if such branching is allowed, the regulatory power of CBR will be diluted since foreign branches are governed by regulations of their own country rather than CBR or Russian government regulations.

The Russian banking system assets have grown dramatically in the last years of the examination period, at an annual growth rate of about 40%. As a result of this pronounced growth, the relative size of the banking system is also gradually expanding. In 2000, the bank assets in Russia accounted for a modest 32.3% of the GDP. By the end of 2008, the ratio of bank assets to GDP has more than doubled to reach 67.5%. In absolute terms, the banking sector assets increased from 2,363 billion of Russian rubles in 2000 to 28,022 billion of rubles in 2008. In addition to fast and sustained growth, the sector maintains high profitability, and there are several banking markets segments still in the initial stages of development. These segments, including retail lending, mortgage market, securitization, and regional banking operations, exhibit high potential for further growth. The increased profitability and potential of still unexplored segments create an attractive financial market filled with opportunities for foreign capital. In sum, the recent expansion of foreign banks in Russia is the combined result of the country's global integration, financial market opportunities, and the gradual liberalization of the country's banking system.

Foreign participation in Russian banking has undergone several significant developments since the nineties. The opening-up of the Russian banking sector to the foreign capital remained a hotly debated topic for several years, especially during the early years of economic transition. The process can be divided into two stages. During the first stage, from 1993 to 2003, the role of foreign-owned banks in the Russian banking system was negligible. The share of foreign participation was relatively low and stable at about 5 to 6% of the aggregate capital. At the very beginning of this period, there were also regulatory restrictions on the level of foreign capital in the country's banking system and on the scope of foreign banks' operations in Russia. These prohibitive and restrictive regulations were abolished in 1996. The events of the 1998 financial crisis in Russia and the temporary increase in the relative share of foreign bank capital are attributed to the failure of some large Russian banks during the same period. The second stage, the past five years of the examination period, is characterized by a rapid increase in foreign bank entries.

Below I provide more details on the foreign banks' entry and operations in each of the two stages. Table 1 reports the CBR statistics on the evolution of the foreign presence in the Russian banking sector over the 1997 – 2008 period, as measured by the foreign share in the overall banking system charter capital and the number of banks with different levels of foreign control. 1997 is the first year for which systematic CBR statistics are available.

It is evident from Table 1 that the fastest-growing segment of foreign-owned banks is the 100% foreign-owned segment. The number of 100% foreign-owned banks doubles from 1997 to 2003 and doubles again between 1997 and 2008. Even more pronounced is the growth of foreign capital share that almost triples between 1997 and 2003 and between 2003 and 2008. During the examination period 1997 to 2008, the number of 100% domestically owned banks declined from 1,552 to 837 and the corresponding market share from 91.5% to 79.1%. The data support the increasingly important role of foreign banks in the Russian banking industry.

Even when the initial protectionist limitations were eased by the end of 1996, the foreign banks were not very active in penetrating the Russian banking system due to its low investment attractiveness and high economic and political risks. At the end of 1996, there were 133 banks with some foreign capital in Russia, and only 15 of them were 100% foreign-owned. The cumulative share of foreign capital did not exceed 3%. At that time, the country's banking sector was attractive only to a few international banks specializing either in CIS and Eastern Europe operations or following important corporate customers from their home countries. Foreign banks were also active in investing in the Russian government securities and were almost absent in the retail services segment. Therefore, the 1998 financial crisis and the default on the short-term government securities have further undermined the attractiveness of the Russian banking sector to foreign capital.

TABLE 1
FOREIGN CAPITAL PRESENCE IN THE RUSSIAN BANKING SYSTEM: 1997 – 2008

Year	Market Share of Foreign Capital %	Distribution of Banks by The Level of Foreign Ownership												All Russian Banks	
		100%		From 50% To 100%		From 20% To 50%		From 1% To 20%		Less Than 1%		None			
		N	%	N	%	N	%	N	%	N	%	N	%	N	%
1997	4.13	16	0.9	10	0.6	32	1.9	34	2.0	53	3.1	1,552	91.5	1,697	100.0
1998	6.35	18	1.2	12	0.8	35	2.4	30	2.0	47	3.2	1,334	90.4	1,476	100.0
1999	10.71	20	1.5	12	0.9	34	2.5	30	2.2	45	3.3	1,216	90.1	1,349	100.0
2000	7.51	23	1.8	12	0.9	32	2.4	30	2.3	44	3.4	1,181	90.1	1,311	100.0
2001	5.30	23	1.7	12	0.9	18	1.4	33	2.5	40	3.0	1,193	90.4	1,319	100.0
2002	5.29	27	2.0	10	0.8	15	1.1	33	2.5	38	2.9	1,205	90.7	1,328	100.0
2003	5.22	32	2.5	9	0.7	15	1.2	29	2.3	43	3.4	1,150	90.0	1,278	100.0
2004	6.19	33	2.6	9	0.7	15	1.2	24	1.9	50	4.0	1,118	89.5	1,249	100.0
2005	11.15	41	3.4	11	0.9	14	1.2	22	1.8	48	4.0	1,069	88.7	1,205	100.0
2006	15.90	52	4.5	13	1.1	12	1.0	29	2.5	46	4.0	990	86.6	1,143	100.0
2007	25.08	63	5.8	23	2.1	21	1.9	55	5.0	40	3.7	890	81.5	1,092	100.0
2008	28.49	76	7.2	26	2.5	24	2.3	64	6.0	31	2.9	837	79.1	1,058	100.0

Overall, the share of foreign capital in the Russian banking system in the first period was relatively stable at around 5 to 6%. The spike in foreign bank share in 1999 was caused by the 1998 financial crisis when many large domestically owned Russian banks lost a substantial percentage of their capital, causing an increase in the relative capital share of foreign banks. In the next two years of post-crisis recovery, domestic banks increased their capital levels, and the share of foreign capital returned to its pre-crisis levels.

Second stage: 2004 – 2008. The gradual improvement in Russia's macroeconomic situation, the decrease and stabilization of economic and political risks, and the high growth of the country's banking system presented foreign banks with an attractive large and primarily unchartered new market. These factors led to a rapid increase in the entry of foreign banks into the Russian banking system. The beginning of the second period is also associated with a shift in the entry mode. Before 2003, foreign banks entered the Russian market mainly by establishing daughter banks. After 2003, the prevailing entry mode was the acquisition of controlling stakes in existing Russian banks. Additionally, foreign-owned banks started forming banking groups and expanding into other Russian regions. The first foreign banking group in Russia was initiated by Societe General, which established two daughter banks (Bank Societe General East and Rusfinans Bank) and acquired three Russian banks. Other such banking groups include Raiffeisenbank, UniCredito, and Banca Intesa.

As shown in Table 1, the first visible changes in the share of foreign capital occurred in 2005. During the year 2005, the number of 100% foreign-owned banks increased from 33 to 41 while the share of foreign capital almost doubled (from 6.19% to 11.15%). By the end of 2008, the number of 100% foreign-owned banks reached 76; even more importantly, the cumulative share of all foreign capital in the system further increased to 28.49%, from 4.13% in 1997. The scope of foreign banks operations in the Russian market has also changed dramatically. In the first stage, foreign banks entered the Russian market to provide financial services to their customers who originated in their home country ("follow the customer hypothesis") and provide lending services to leading Russian corporations. However, the second wave of entry coincides with the retail lending boom in Russia, and foreign-owned banks also started focusing on retail lending.

The increased presence of foreign banks revived the debate about the pros and cons of opening the Russian banking system and allowing more foreign banks to operate in it. The primary concern was that most local private banks and the Russian banking system were still small by international standards. Consequently, they would not be equal players in a freely competitive environment alongside major international banking players. A direct result of this concern is that Russia was reluctant to allow foreign branching since it can ultimately lead to the domination of the national banking system by foreign capital.

Foreign-owned banks have several advantages compared to domestic private banks, mainly better access to cheaper and longer-term funds. Other significant potential comparative benefits of foreign-owned banks include better reputation and managerial expertise. Although the parent companies of foreign banks operating in Russia are not legally liable for the latter's failure beyond their invested capital, a conjoint reputational effect motivates parent companies to support their daughter banks at times of crisis.

The primary concern of the Russian banking industry and its regulators was that the availability of lower cost of financing and the subsequent extension of loans with lower interest rates by foreign banks would ultimately increase competition and force domestic banks, who did not have access to such cheap funds and had not yet adapted to highly competitive environments, away from the most attractive banking segments, including lending to large corporate clients, and will force them to focus on riskier lending segments. These factors can decrease the stability of the country's banking system. Additionally, the higher levels of banking competition can lead to a decrease in profitability in this sector. The competing view was that increased participation of foreign-owned banks could provide better access to credit-hungry Russian corporate and retail borrowers and ultimately lead to better bank management practices and risk management technologies even for domestic banks. The effects of increased competition will eventually lead to an overall better banking and economic system.

LITERATURE REVIEW

An early and widely cited theory regarding the motivation for foreign banks' entry into other countries' banking systems has been the "follow the customer" explanation (Grubel, 1977). According to the theory, foreign banks enter the banking systems of other countries to serve the financial needs of their existing home-country customers as the latter expand their businesses in these new countries. The well-established relationships between foreign banks and their corporate clients from their origin countries enable them to keep their monitoring costs below what banks operating in the domestic markets can (Bhattaharya, 1993).

Along the same lines, Walter, 1988 proposes a similar theory for the motivation of foreign banks but reverses the order of entry. According to Walter, foreign banks are "leading" their customers. Suppose the economic and political relationships between the two countries are strong. In that case, foreign banks originating in one country and wanting to operate in the other gain valuable insight and knowledge of the other country's financial and legal systems. This knowledge enables foreign banks to provide their home-country corporate customers with the necessary tools and expertise to expand in the second country.

While traditional foreign bank entry theories emphasize servicing the financial needs of existing corporate customers from the foreign banks' countries in the new markets, several studies offer alternative explanations for foreign banks' expansion. Claessen, Demirguk, and Huizinga (2001) maintain that the profit margins of foreign-owned banks operating in developing countries are higher than those of the domestic banks in the host country. The opposite is true for foreign banks operating in developed countries. It suggests that foreign banks enter underdeveloped financial markets to compete directly with the domestic banks of their host country. As global competition forces banks to keep their profit margins low, the new emerging markets offer an attractive alternative to operating only in their own country or other developed countries.

The banking systems of Central and Eastern European and Baltic transition economies represent an interesting case of a rapid post-privatization entry of foreign banks. The role of foreign banks in the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia, as documented by the European Central Bank and shown in De Haas and Naarborg, 2006, is that of a protagonist. In 2003, foreign-owned banks' asset share ranged from a low of 36% for Slovenia to a high of 97.3% for Estonia. Overall, the average asset share for all eight countries was above 77%. Further evidence of the degree of penetration and importance of foreign banks in the global environment of emerging economies is provided by Domanski (2005). Between 1990 and 2004, the asset share of foreign banks in Central and Eastern Europe increased from an average of about 6% to an average of about 85%. For the same period in Asia, the asset share of foreign banks decreased slightly from 32% to 29%. For emerging economy countries in Latin America, the asset share of foreign banks increased from 7% to 46.5%. The previous statistics show that foreign banks were most important for Eastern and Central European emerging economies during the reporting period.

The empirical evidence regarding the effect of foreign bank penetration in the banking industries of emerging market economies has been mixed. Clarke et al. (1999, 2001, 2002) find that the entrance of foreign banks in the banking industries of emerging economies in Latin America negatively affected the credit disbursal to small and medium enterprises because of foreign banks' risk aversion and their preference on lending to relatively large corporate clients. There is, however, an implicit benefit even to medium and smaller enterprises. As foreign banks provide more capital for large corporate borrowers, their participation frees domestic bank capital and makes it available to medium and small enterprises. In addition, Bhaumik and Piesse (2008) find that foreign banks can "cherry-pick" the best (less risky) borrowers. On the other spectrum, Claessen, Demirguk, and Huizinga, 2001, find that the entrance of foreign banks in developing countries increased the level of competition and led to a reduction of overhead costs and profit margins for the domestic banks of their host country. The authors maintain that this fact supports the notion that domestic banks adapt to the new competitive environments and increase their efficiency. They also find that the number of foreign banks is more important than their capital share in their host country.

DATA AND METHODOLOGY

To analyze the characteristics and lending behavior of foreign-owned banks in Russia, I employ two samples – the population of 100% foreign-owned banks in 2007 and a subsample of banks from the same list that publicly disclosed their financial statements, available through the CBR website. As of 2007, there were 63 foreign-owned credit institutions in Russia, including 62 banks and one non-bank credit company. The list of all 100% foreign-owned banks in 2007 is obtained from the CBR Review of the Russian Banking Sector. For each bank in the list, I identify its foreign investors' country of origin, bank license type, organizational form, deposit insurance status, financial transparency, and geographic location. I use these data to compare the non-financial characteristics of 100% foreign-owned banks to all other Russian banks. To further analyze the effect of country of origin, I also distinguish whether the bank owners originated from an emerging or a developed market economy.

My supplementary data set includes all foreign-owned banks in 2007 that publicly disclosed their detailed financial statements. This dataset contains 40 foreign-owned banks or 64.5% of all foreign-owned banks in Russia in 2007. I use this subsample to examine the financial characteristics of foreign banks in general and their lending patterns. I recognize that my second sample may suffer from the selection bias problem as it contains only financially transparent banks. However, these are the only data available for the analysis.

For each foreign bank in the sub-sample, I collect data on assets, liabilities, and capital structure and construct several financial ratios that allow us to describe foreign bank lending behavior once I control the size, capitalization, and deposit-taking intermediation. I am specifically interested in two dimensions of the foreign banks' lending priorities: (1) corporate versus retail lending and (2) lending to non-resident (foreign) versus lending to resident (local) customers in Russia. The first characteristic of foreign bank lending is measured as the ratio of loans to firms to total loans. The second characteristic of foreign bank lending behavior is measured as the ratio of loans to Russian customers to total loans. To construct these ratios, I utilize the definitions of the Russian Accounting Standards for banks that distinguish loans to residents and loans to non-resident firms and individuals.

I analyze foreign banks' lending preferences in Russia in both the univariate and multivariate frameworks. In the latter case, I employ two dependent variables described above: the ratio of loans to Russian customers and loans to firms. In the multivariate regression framework, I also control for the leading financial and non-financial bank characteristics and bank owner type by the country of origin – developed versus the emerging market.

FOREIGN BANK CHARACTERISTICS

In this subsection, I conduct a series of proportions tests to examine whether statistically significant differences exist in the distribution of non-financial bank characteristics between 100% foreign-owned and all other Russian banks. The difference in proportions is tested using the Chi-square test. Table 2 reports the distributions and univariate comparison tests between foreign-owned banks and other Russian banks in 2007 using several observable characteristics, such as bank legal form, license type, deposit insurance status, geographic location, and financial transparency. The latter characteristic depends on whether a bank publicly discloses its financial statements. Overall, the test results in Table 3 reveal that foreign-owned banks represent a distinct group in the Russian banking sectors. The results of the Chi-square test support that the proportions of banks for all analyzed characteristics between the two samples are statistically significant at 0.01 level. Below, I discuss all these differences in more detail.

Legal Form

There are three business legal forms in Russia – open joint-stock company, closed joint-stock company, and private company. The open joint-stock company is the only legal form that allows the bank to issue publicly-traded stock and, therefore, has higher disclosure requirements. An open joint-stock bank is required to publicly disclose its annual report, affiliated party's registry, balance sheet, and income statement. It also has a mandatory annual audit. However, the same disclosure requirements are voluntary for most closed joint-stock companies. A closed joint-stock bank can distribute its shares only through a closed subscription, and the number of its shareholders is limited to 50. The "closeness" of this form is further reinforced by the preemptive right of its existing shareholders to buy any newly issued shares. The third possible form, a private bank, is the typical limited liability partnership company. As shown in Table 3, only 6.5% of foreign-owned banks are open joint-stock companies, compared to 41.5% in the sample of all other Russian banks. About two-thirds of foreign-owned banks are organized as closed joint-stock companies (compared to only 24.2% in the sample of all other banks), and the remaining 30.7% are organized as private banks. This evidence suggests that foreign-owned banks tend to prefer the closed legal forms for their operations in Russia that do not impose high disclosure requirements.

Financial Transparency

The relatively low transparency of foreign banks in Russia is further supported by the distribution of financially transparent and non-transparent banks in the two samples. Only 64.5% of foreign-owned banks compared to 87.6% of other Russian banks publicly disclosed their detailed financial statements at the end of 2007. This difference is statistically significant at the $p<0.001$ level.

License Type

The Russian banking regulation has a hierarchical set of bank licenses. The most advanced bank license in Russia is the so-called General license. The General license is the least restrictive regarding the range of bank services. It does not impose any limitations on the bank's legal cross-border operations and the establishment of corresponding direct relations with foreign banks abroad. The license for operations in foreign currency imposes restrictions on the number of bank direct correspondent relations. The most restrictive license allows operations in rubles only and prevents banks from corresponding direct relations with foreign partners and operations in foreign currencies. As expected, all foreign-owned banks in Russia are licensed for foreign currency operations, while 37.8% of foreign-owned banks are granted the most advanced, General license.

Deposit Insurance Membership

After introducing the Deposit Insurance System in Russia, membership in this system became mandatory for all banks working with retail deposits. As reported in Table 3, the proportion of foreign-owned banks that did not enter the Russian de novo deposit insurance system and, therefore, is not allowed to attract new retail deposits is relatively high compared to other Russian banks: 29.0% versus 16.0%. This difference in proportions is also statistically significant at the p=0.01 level.

Location

Finally, Table 3 reveals that foreign banks cluster in Moscow. About 90.3% of foreign banks are headquartered in the capital, and only 9.7% of them are headquartered outside Moscow, in other Russian regions. The distributions between centrally located and regionally located other Russian banks is more even – 47.2% versus 52.8%. This observation suggests that the large-scale expansion of foreign banks into the vast Russian regions did not start yet.

TABLE 2
COMPARISON OF NON-FINANCIAL CHARACTERISTICS OF 100% FOREIGN-OWNED AND DOMESTIC RUSSIAN BANKS

Non-financial characteristics of foreign-owned and Russian banks	100% foreign-owned banks (N = 62)		All other Russian banks (N = 1,030)		Differences in distribution	
	N	%	N	%	χ^2- statistic	*p*-value
Legal form:					51.65	0
Open joint-stock	4	6.5	427	41.5		
Closed joint-stock	39	62.9	249	24.2		
Private	19	30.7	354	34.4		
Financial transparency:					26.24	0
Transparent	40	64.5	902	87.6		
Non-transparent	22	35.5	128	12.4		
License type:					14.91	0.001
General license	24	38.7	276	26.8		
Operations in foreign currencies	38	61.3	680	66		
Operations in rubles only	0	0	74	7.2		
Deposit insurance status:					7.1	0.008
Member	44	71	865	84		
Non-member	18	29	165	16		
Location:					35.69	0
Moscow	56	90.3	486	47.2		
Other regions	6	9.7	544	52.8		

Table 3 provides further details on the characteristics of 100% foreign-owned banks in Russia (2007) by disclosing these bank owners' countries of origin. Most foreign-owned daughter banks operating in Russia (37 out of 62) have parents headquartered in developed countries. The remaining 25 banks are owned by parent companies headquartered in emerging markets. The evidence in Table 3 also shows that the country list is heavily dominated by Western European banks, which is like the CEE countries' banking markets. French, German, and Italian banks have taken the opportunity to enter the Russian banking market. Overall, 29 out of 37 entrants from developed markets have European owners. The data also reveal that some major international players are still under-represented. In particular, the U.S. and the Asian banks are relatively less represented in this market. The distribution of entrants from emerging markets further reveals that most of these banks originate from countries with close economic, political, and cultural ties with Russia.

TABLE 3
DISTRIBUTION OF 100% FOREIGN-OWNED BANKS BY COUNTRY OF ORIGIN

Country of origin	All foreign-owned banks (N = 62)	Financially transparent foreign-owned banks (N = 40)
Developed economies:	37	22
France	7	5
Germany	5	3
USA	5	1
Italy	4	3
Japan	3	0
Netherlands	3	3
Sweden	3	2
UK	2	0
Austria	1	1
Belgium	1	1
Denmark	1	1
Finland	1	1
Switzerland	1	1
Emerging economies:	25	18
Cyprus	4	2
Turkey	4	4
China	2	1
India	2	1
Kazakhstan	2	2
Armenia	1	1
Azerbaijan	1	1
BVI	1	1
Chernogoria	1	0
Czech Republic	1	1
Iceland	1	1
Iran	1	0
Slovak Republic	1	1
South Africa	1	1
South Korea	1	0
Uzbekistan	1	1

THE LENDING BEHAVIOR OF FOREIGN BANKS

This section examines the structure of Russia's 100% foreign-owned banks lending operations. I am interested in identifying bank-level factors that influence the following two choices in their lending behavior: (1) lending to firms versus retail lending and (2) lending to Russian firms and individuals versus lending to foreign customers. I am particularly interested if the country of origin plays a role in foreign banks' lending patterns. The answers to these questions should shed more light on the role and strategies of foreign-owned banks in the Russian banking sector and have important policy implications.

From the population of all 100% foreign-owned banks, I create a subsample of banks that disclosed their financial statements publicly. The second and final sample consists of 40 such banks. The last column of Table 3 shows the distribution of my final sample by foreign bank country of origin. The developed and emerging markets entrants are equally well represented, with 22 and 18 banks correspondingly. To address the possibility of selection bias, I also test for differences in the non-financial characteristics of my final sample banks and their population (the results are not reported), and I find that the second sample is highly representative of its population. The only statistically significant difference between the population of foreign-owned banks and the final sample is that the latter has a much higher proportion of deposit insurance members than its complementary population, which did not publicly disclose its financial statements (90.0% versus 36.4%).

I test for the determinants of the foreign bank lending preferences in 2007 using the OLS multivariate regression framework. The two dependent variables are loans to Russian borrowers to total loans and the ratio of loans to firms to total loans. The independent variables are identical in both models and include country of origin, size, capitalization, loans to assets ratio, deposit insurance status, license type, legal form, and location.

Table 4 reports summary statistics for continuous (financial) regression variables. The descriptive statistics in Table 4 suggest that foreign-owned banks in Russia are heavily oriented towards lending to Russian borrowers: the average bank in the sample allocates about 92.5% of its loans portfolio to Russian firms and individuals, and the median is even higher at 96.55%. This finding rejects the theory of "follow the customer" as an explanation for the motives of foreign banks entering the Russian market and disagrees with Pomerleano and Vojta (2001). They find that Japanese and Korean banks follow their customers abroad. Furthermore, the distribution of sample bank loan portfolios between firms and individuals reveals that foreign-owned banks in Russia are more active in lending to firms than in lending to individuals: the average ratio of loans to firms to total loans is 78.47 (the median is 89.35%). This evidence suggests that foreign-owned banks in Russia focus on lending to Russian corporate borrowers. Therefore, they choose to aggressively compete with domestically owned Russian banks in this important lending segment. The finding agrees with similar results of Buch (2000) for German banks expanding abroad, Clarke et al. (2000), and Barajas et al. (2000) for Argentina and Colombia, respectively.

TABLE 4
SUMMARY STATISTICS FOR FINANCIAL CHARACTERISTICS OF FOREIGN-OWNED BANKS

Foreign bank financial characteristics	Mean	Std. Dev.	25^{th} percentile	Median	75^{th} percentile
Loans to Russian borrowers (as % of total loans)	92.54	13.84	91.12	96.55	99.99
Loans to firms {as % of total loans)	78.47	27.01	66.67	89.35	99.43
Size (Log of bank assets in thousands of Rubles)	16.38	1.85	14.89	16.39	17.72

Foreign bank financial characteristics	Mean	Std. Dev.	25^{th} percentile	Median	75^{th} percentile
Loans to assets (%)	48.49	23.60	29.23	57.56	66.45
Capital to assets (%)	15.19	15.22	5.88	9.97	19.49

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The regression results, including estimated coefficients and t-statistics for robust standard errors, are reported in Table 5. The results suggest that the type of country of origin (1 for emerging, 0 otherwise) has a statistically significant effect on the lending behavior of foreign banks in Russia. Other things being constant, banks from emerging markets are less oriented towards lending to Russian customers than banks from developed countries. In other words, banks from emerging markets appear to pursue the "follow the customer" strategy more than banks from developed markets that have relatively more pronounced orientations towards the penetration of the local market. The estimated coefficient value suggests that banks from emerging markets, on average, allocate about 10% less of their loan portfolio to Russian borrowers (firms and individuals) than foreign banks that entered from developed countries.

TABLE 5
THE DETERMINANTS OF FOREIGN-OWNED BANKS LENDING BEHAVIOR IN RUSSIA
OLS REGRESSION RESULTS

Explanatory Variables	Dependent Variable: Loans to Russian borrowers as % of loans		Dependent Variable: Loans to firms as % of loans	
	(1)		(2)	
	Coefficient Estimate	*t*-Statistic	Coefficient Estimate	*t*-Statistic
Emerging market origin	-9.85**	-2.42	-24.20**	-2.32
General license	-2.34	-0.43	6.11	0.57
Open joint-stock bank	-1.74	-0.64	13.91*	1.84
Moscow location	0.67	0.16	25.63**	2.20
Deposit insurance member	-9.77	-1.65	-12.47	-0.80
Size	-0.48	-0.24	-6.60	-1.43
Loans to assets ratio	0.15	1.20	-0.27	-1.34
Capital ratio	0.02	0.11	-0.03	-0.08
Constant	106.56***	2.99	198.03**	2.51
N	40		40	
R^2	24.65%		34.41%	
F-statistic	1.43		1.88	

Note: ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively

The estimation results for the second model further reveal that foreign banks from emerging market economies tend to lend less to corporate borrowers than foreign banks from developed countries. Other things being equal, foreign daughter banks headquartered in Moscow and foreign daughter banks registered as open joint-stock companies exhibit a higher propensity to lend more to firms. Overall, the results in Table 5 suggest that the level of economic and financial development (emerging vs. developed) of the foreign banks' home countries is essential in explaining foreign bank lending behavior.

CONCLUSION

This paper analyzes the evolution of foreign banking in a country-specific setting and identifies determinants of these banks' lending behavior. Using a cross-section of 100% foreign-owned banks in Russia in 2007, I show that the economic type of the foreign banks' country of origin is an essential factor of its lending behavior. I also find that even after the lifting of prohibitive regulations, foreign bank presence in Russia remains below the levels of other emerging economies. Most foreign banks in this country are registered as closed joint-stock companies and, therefore, have minimal disclosure requirements. Foreign-owned banks in Russia typically hold General licenses, are in Moscow and have a relatively low share of banks that entered the de novo deposit insurance system.

My analysis of sample banks' lending behavior reveals that foreign banks do not pursue the "follow the customer" strategy but compete directly with domestic banks for Russian corporate clients. I also find that foreign entrants from emerging markets allocate a significantly lower share of their loans portfolio to Russian borrowers than foreign banks entering from developed countries. These findings have important policy implications.

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