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Inward Foreign Entry of Banks into Russia's Banking Sector

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Abstract: In this paper, we chronologically define two periods of foreign entry by examining inward banking FDI into Russia's banking sector on the example of banks with 100% foreign capital participation: the 1990s and 2000s. Using a sample of 78 foreign banks, we analyse their geographical distribution by home country, structure of ultimate owners and functional role in the market. Our result defines six cluster groups of foreign banks depending on entry motivations. Further, we explore the impact of Russia's institutional environment on the motives for engaging in banking FDI and provide evidence to support the hypothesis that offshore capital is present in the form of 'quasi-foreign' and 'pseudo-foreign' banks. We argue that 'pseudo-foreign' banks represent cases of round-tripping banking FDI that aim to escape the imperfections of the institutional environment in Russia.

Keywords: foreign banks, motivation, Russia, offshores, round-tripping FDI

JEL Classification Numbers: F23, F30, G20, G21

1. Introduction

High economic growth in the 2000s and Russia's position as an emerging country with a stable, growing economy resulted in a foreign investment boom that extended into the banking sector. Foreign banks bring new banking technologies and financial products into the Russian market. Therefore, their positive impact is significant.

The increase in foreign investments into the banking sector reflects the general trend of inward FDI into Russia's economy, which amounted to USD 51.4 billion with developed economies, mainly EU members, being the largest sources of inward FDI (UNCTAD, 2013). The investment flows from *offshore financial centres (OFC)*[1] and *special-purpose vehicles (SPE)*[2] are salient, with the majority representing *round-tripping foreign direct investments (FDI)*[3] from Cyprus, the Netherlands and the British Virgin Islands. Specialists of UNCTAD (2012), many Russian and foreign scholars (Kuznetsov, 2013a, 2013b; Kheyfets, 2007, 2008; Hanson, 2010; Mizobata, 2014) also point to the fact that a strong correlation of inward and outward investment flows exists between Russia and these territories.

In fact, the growing presence of both financial and non-financial FDI in emerging and transition economies has always been the subject of many scholars. Numerous studies aim to explain the determinants or motives of FDI into these economies. Some of these studies agree on one very important issue – that traditional motives of FDI, such as resource-seeking and market-seeking motives, no more fully explain the behavioural patterns of multinational corporations or multinational banks in emerging and transition economies, largely because of the existence of idiosyncratic institutional arrangements comprising the market specificity of these regions. Thus, analysis of FDI for the selected group of countries shifted to synthesising traditional theories with institution-based views (Peng et al., 2008; Meyer et al., 2009; Li, Y., Yue, Q., 2014). There are neither precise (universal) definitions of what is in fact understood by institutions nor any universal acknowledgements of whether home or host countries' institutions have a prevailing effect in determining foreign investors' motivations, entry modes, organisational forms and strategies. Nevertheless, a sort of general consensus on their significant role and possible impact on motives of FDI is incontestable.

Ample studies exist that target issues of foreign banks, their roles in Russia's banking sector and their impact on Russia' economy as a whole. However, with respect to analysing foreign banks in Russia from the viewpoint of motivation, an obvious dearth of literature sources exist, even those focusing on traditional motives of banking FDI. Some of these related studies include Vernikov (2003), who concludes that high potential market profitability, support of a global image or 'presence for the sake of presence', support of corporate clients and motivation of a noneconomic nature are the primarily drivers of foreign banks' entry into Russia's banking market; Mamonov and Solntsev (2008, 2009), who analyse product placement strategies of foreign banks and Rybin (2007, 2008a, 2008b), who analyse issues related to mergers and acquisitions (M&A) in the banking sector.

In addition, the institution-based view of motivation and the behavioural patterns of banking FDI in Russia are scarcely presented in the literature despite the fact that the financial market is the sector in which the role of institutions is generally dominant. One study emphasising the significant role of the historical context as a motive for European banking FDI into Russia is that of Rybin (2010). In our opinion, considering the role of the institutional environment and its possible impact on inward banking FDI into Russia is important; therefore, in this study, we assume market specificity (market quality) – idiosyncratic features of Russia's banking sector as general examples of the institutional environment. In addition, we argue that strong relations with OFCs and SPEs, particularly in the form of round-tripping FDI, might be regarded as by-products of institutional settings that influence FDI motives. Although studies exist that underline the round-tripping character of inward and outward FDI into Russia's economy as a whole (Ledyaeva et al. 2013), little is known about the volume of round-tripping FDI and the offshorisation level of Russia's banking sector. We aim to fill this gap in the literature.

The purposes of this paper are threefold. First, by selectively and not comprehensively analysing issues related to the motivation of foreign banks, we aim to present a three-dimensional picture of the foreign bank segment in Russia's banking system, namely chronological, geographical and functional. Second, we consider how the institutional environment influences the motives of foreign banking FDI. Third, using a sample of 78 foreign banks with 100% foreign capital participation, we aim to test the hypothesis of whether a round-tripping effect exists in Russia's banking sector and argue that round-tripping as both a problem and a solution for Russia's economy is largely a by-product of the institutional environment.

The remainder of this paper is as follows. In Section 2, we provide a brief overview of the general trends in inward banking FDI. Section 3 presents the chronological, geographical and functional pictures of foreign banks in Russia's market and introduces a typology of entry motivation. Section 4 considers how the idiosyncratic features of Russia's banking sector and Russia's market specificity influences the entry of foreign banks. In Section 5, we discuss the issues of offshorisation and round-tripping FDI in the Russian banking sector. Section 6 concludes.

2. Inward entry of foreign banks into Russia's banking sector: Brief outline

Macroeconomic statistics on the international investment position of Russia's banking sector published by the Central Bank of Russia (CBR) show that Russia was a net debtor in the period 2005–12. Inward investments into the banking sector amounted to USD 216 million, with other investments (including lending) accounting for more than 72%. FDI and portfolio investments had approximately the same volume. In comparison to 2005, inward FDI into the banking sector increased almost 10 times, underscoring the further gradual expansion of foreign banks into Russia (Gorshkov, 2013, p. 82). Table 1 shows that the majority of these investments, as in the case of outward banking FDI, originate in OFCs and the Commonwealth of Independent States (CIS).

The share of foreign banks in the total charter capital of Russia's banking sector amounted to 27.7% in 2012. Although state-owned banks dominate the market through both direct and indirect control methods, the increase in the foreign share is a sign of improvement in the liberalisation process of the financial sector. Russia's accession to the World Trade Organization (WTO) in 2012 fostered this liberalisation process, although the protocol on the accession of members has a rather limited effect on the banking sector. Foreign banks do not operate in Russia in the form of branches, and their presence in the market is limited to a Russian legal entity or a representative office. Russia reserves the right to limit foreign investors' capital participation in domestic legal entities to 50%, excluding foreign investments before January 1, 2007. Thus, the foreign share in the total charter capital might exceed the established quota.

Table 2 shows the dynamics in the number of foreign banks with foreign capital participation during 2000–14. The number of foreign banks in this period almost doubled and numbered 245 as of 1 April 2014. The share of foreign banks in assets, equity, corporate loans and deposits is generally increasing but remains rather low.

As of March 2013, only a few foreign banks were included in the Russia's top-30 in terms of deposits: ZAO[4] 'Raiffeisen' (Austria) – 5th place; ZAO 'Home Credit and Finance Bank' (Czech Republic) – 8th place; ZAO 'Promsvyazbank' (Netherlands, dispersed ownership) – 10th place and ZAO 'Rosbank Societe Generale Group' (France, less than 100% shares) – 13th place. ZAO 'Citibank' is in the top 40. The deposits of ZAO 'Raiffeisen' (Austria) account for only 1/28th of that of OAO 'Sberbank', proving that state-owned banks and Russian private banks remain predominant in deposit activities. As of April 2012, ZAO 'Raiffeisen' was in 5th place, proving a high level of trustworthiness of individual Russian clients.[5]

Table 1. Inward investments into the banking sector and non-banking corporations in 2007-11 (USD million), balance of operations

Years	2007	2008	2009	2010	2011	Main destinations in 2011 (share in total investments, %) TOP 5 destinations for both abroad and CIS
Foreign investments	55,073	75,002	36,500	43,288	52,878	Cyprus (23.8%), British Virgin Islands (13.8%), Netherlands (13.3%), Ireland (10%), Luxemburg (7.8%), Germany (4.1%), Bahamas (3.5%), France (3.42%), Sweden (3.4%), Austria (3%), St. Kitts and Nevis (2.5%), Azerbaijan (0.24%), Ukraine (0.21%), Belarus (0.2%)
Non-CIS	54,708	74,737	36,102	43,201	52, 521	
CIS	366	265	398	87	357	
Participation in capital	27,119	35,015	8,121	9,895	9,729	Netherlands (24%), Bahamas (18.8%), Germany (12.3%), St. Kitts and Nevis (11.3%), British Virgin Islands (10.1%), Switzerland (7.5%), Austria (4.4%), Azerbaijan (0.9%), Ukraine (0.6%), Belarus (0.5%)
Non-CIS	26,804	34,902	7,949	9,759	9,522	
CIS	315	113	172	136	208	
Reinvestment of earnings	23,389	33,449	15,434	18,644	20,077	Cyprus (47%), British Virgin Islands (18%), Sweden (6.2%), Gibraltar (5.8%), Bermuda (4.2%), Austria (3.35%), Ukraine (0.3%), Azerbaijan (0.06%), Belarus (0.04%)
Non-CIS	23,384	33,353	15,383	18,630	20,003	
CIS	4	97	51	14	75	
Other capital	4, 565	6,538	12,945	14,749	23,072	Ireland (22%), Cyprus (20%), Netherlands (19.5%), Luxemburg (15.2%), British Virgin Islands (11.4%), France (4.6%), Belarus (0.21%), Azerbaijan (0.12%)
Non-CIS	4,519	6,482	12,770	14,812	22, 997	
CIS	46	56	175	-63	75	

Source: compiled by author. Data retrieved in September 2012 from www.cbr.ru

Table 2. Number of banks with foreign capital participation and their share in total assets, equity, corporate loans, and deposits of Russia's banking sector in 2000-14

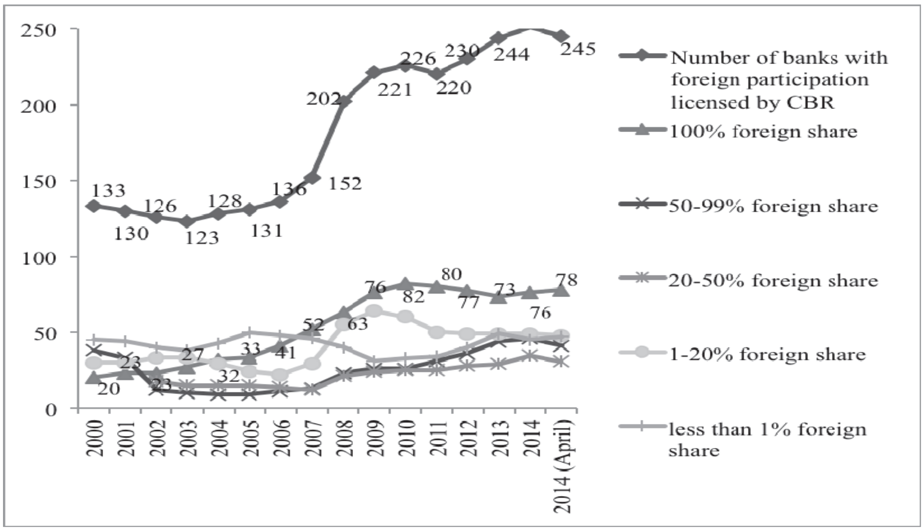
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2014 (April)
Number of banks with foreign capital participation licensed by CBR	133	130	126	123	128	131	136	152	202	221	226	220	230	244	251	245
100% foreign share	20	23	23	27	32	33	41	52	63	76	82	80	77	73	76	78
50-99% foreign share	38	33	12	10	9	9	11	13	23	26	26	31	36	44	46	41
20-50% foreign share			18	15	15	15	14	12	21	24	25	25	28	29	35	31
1-20% foreign share	30	30	33	33	29	24	22	29	55	64	60	50	49	49	49	48
Less than 1% foreign share	45	44	40	38	43	50	48	46	40	31	33	34	40	49	45	47
Banks with foreign capital participation of more than 50%																
Assets	-	-	-	8.1	7.4	7.6	8.3	12.1	17.2	18.7	18.3	18.0	17.4	17.8	15.3	-
Equity (Capital)	-	-	-	7.1	6.6	7.8	9.3	12.7	15.7	17.3	17.0	19.1	17.9	19.3	17.3	-
Corporate loans	-	-	-	7.1	6.1	6.2	7.4	10.0	15.5	16.6	14.8	15.1	14.6	14.2	12.0	-
Deposits (households)	-	-	-	2.3	2.3	3.0	3.4	6.2	8.9	10.3	12.0	11.5	11.2	13.5	12.5	-
Banks with 100% foreign capital participation																
Assets	-	-	-	5.6	5.6	5.9	8.0	9.0	11.6	13.0	11.3	11.0	10.3	9.8	9.0	-
Equity (Capital)	-	-	-	5.4	5.4	6.3	9.0	10.1	11.1	12.2	11.0	12.1	11.3	11.4	11.1	-
Corporate loans	-	-	-	5.5	4.6	4.6	7.3	7.9	10.7	11.6	9.0	9.2	8.5	7.5	7.2	-
Deposits (households)	-	-	-	1.5	1.5	2.4	3.3	4.1	5.0	5.4	6.2	5.3	5.2	6.1	6.2	-

Source: compiled by author based on CBR "*Obzor bankovskogo sektora Rossijskoj Federacii*" [Review of Russia's banking sector], various years

In contrast to deposit rates, foreign banks' corporate lending activities are more significant. Making corporate loans by foreign banks became a common business in the 1990s and maintained positive dynamics in the 2000s. In 2003, the total volume of corporate lending was USD 38 billion. Some banks are attempting to establish strong positions in retail banking[6], whereas other banks prioritise corporate lending to private companies as their core business in Russia.[7] In general, foreign banks tend to provide short-term corporate loans.

Despite a low amount of shares in major indicators, particularly when compared with state-owned banks, foreign banks are present among the following top 30 banks in terms of net profits as of 1 March 2013: ZAO 'Raiffeisen Bank' (Austria) – 4th place; ZAO 'Sovkombank' (Netherlands, dispersed ownership) – 6th place; ZAO 'Home Credit and Finance Bank' (Czech Republic) – 9th place; ZAO 'UniCreditBank' (Austria) – 11th place; ZAO 'Citibank' (United States) – 12th place; ZAO 'Deutsche Bank' (Germany) – 16th place; ZAO 'RosEvrobank' (United Kingdom) – 20th place and ZAO 'Absolut Bank' (Belgium) – 29th place. Thus, foreign banks constitute approximately 30% of the most profitable banks in the list of top 30 banks.

Figure 1. Number of banks with foreign capital participation classified by the amount of foreign share (2000-14)



Source: compiled by author based on the CBR statistics

Figure 1 shows that, as of 1 April 2014, 78 banks were 100% foreign owned, and in 41 banks the foreign share amounted to 50–99%. These two groups represent banks under direct foreign control. Thirty-one banks have foreign share of 20–50%; in 48 banks, foreigners hold 1–20% of the shares and in 47 banks, the foreign share is less than 1%. The proportion of banks with a minor foreign share is high because many banks still prefer to be 'observers' in banks' management teams and gradually explore the market potential. Nevertheless, the increase in the number of banks with less than 50% foreign share also proves a gradual financial liberalisation of the banking sector. Minor shareholding is contrasted by the number of banks with 100% foreign participation (78 banks) and banks with foreign participation of 50–99% (41 banks) participation. Both groups significantly expanded in comparison to 2000 (Table 2).

Thus, the majority of banks (31.8%) have 100% foreign share participation. However, CBR statistics show that Russian residents significantly influence management decisions in 13 banks with 100% foreign share (16% of all banks in the group); therefore, they are not 'purely' foreign.

Another interesting feature is demonstrated in the distribution of organisational forms of banks. Two hundred banks with foreign capital participation (81.6%) are registered as joint stock companies (JSC), including 66 banks (26.9%) as a closed JSC and 45 banks (18.4%) as a limited liability company (LLC).

The territorial concentration of foreign banks in Moscow city (155 banks, 63.3%) generally reflects the heterogeneity in the territorial distribution of domestic credit organisations among federal districts of Russia with polarisation towards the Central Federal District (Moscow). As a result, foreign banks tend to establish few domestic branches. As of 1 April 2014, only 24 banks with 100% foreign capital participation had as many as 92 domestic branches, with most of them concentrated in the western part of Russia.

To summarise, concluding that the presence of foreign banks is gradually increasing is possible, and is proven by banks' increasing shares of assets, capital, loans and deposits in Russia's banking sector. Despite the fact that the overall scale of activities of foreign banks on the market in terms of absolute volume is limited, many foreign banks prove to be relatively successful in the market, although they must withstand severe competition with state-controlled banks.

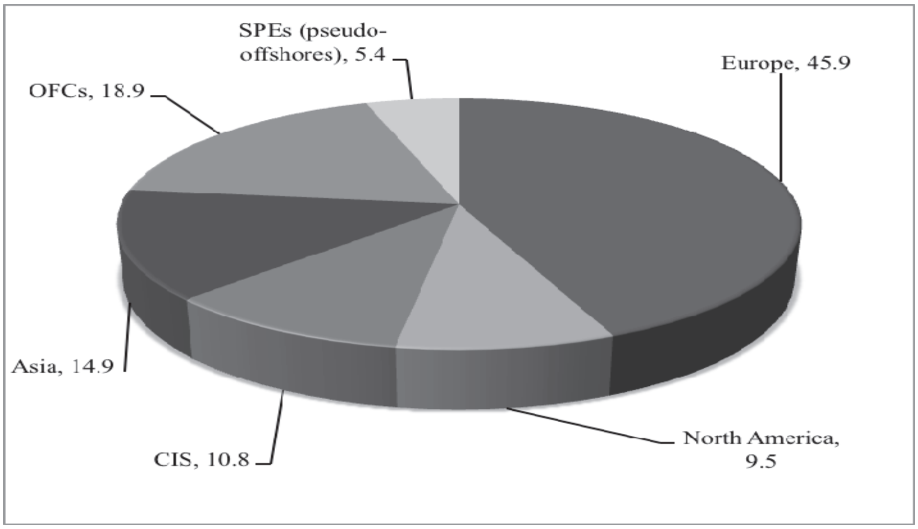
3. Distribution of foreign banks by home country and motives for foreign entry

In this section, we aim to present the geographical, chronological and functional pictures of foreign banks' entry, define motivations of entry and test the hypothesis of whether a round-tripping effect exists in Russia's banking sector.

Our final sample included 78 banks with 100% foreign capital participation as obtained from the list of banks on the CBR homepage.

Figure 2 presents the results of our analysis and Table 3 provides a detailed description. The analysis of ultimate shareholders shows that, in terms of geographical distribution by home country, Europe is the main region from where foreign banks penetrate the Russian market with a total share of 45.9%, followed by OFCs (18.9%), Asia (14.9%), CIS (10.8%) and North America (9.5%). However, when the so-called pseudo-offshores (countries with features of SPEs) are included, the share attributed to OFCs substantially increases to 24.3%.

Figure 2. Geographical distribution of banks with 100% foreign capital participation as of April 1, 2014, %



Source: compiled by author based on the CBR statistics

Table 3. Geographical distribution of banks with 100% foreign share as of April 1, 2014

Region	Major destinations by home country
Europe (34)	United Kingdom (2), Switzerland (2), Netherlands (3), Italy (1), Austria (2), France (5), Germany (5), Norway (1), Sweden (2), Czech Republic (2), Serbia (1), Albania (1), Turkey (4), Lithuania (1), Denmark (1), Israel (1)
North America (7)	United States (7)
CIS (8)	Armenia (1), Kazakhstan (5), Azerbaijan (1), Uzbekistan (1)
Asia (11)	India (2), China (3), Japan (4), South Korea (1), Iran (1)
SPEs (4)	Netherlands (2), United Kingdom (2)
OFCs (14)	British Virgin Islands (1), Cyprus (13)

Note: number of banks is shown in ( ).

Source: compiled by author

In general, the geographical distribution by home country corresponds to the macro analysis of inward FDI into the banking sector of Russia, for which a disproportionate share is attributed to OFCs. In the purest sense, foreign banks from OFCs or SPEs are not genuinely ‘foreign’, and some represent cases of indirect FDI, such as round-tripping FDI, reinvestment of Russian capital and investment through SPEs. Thus, discerning the identity of the ultimate owners is difficult. In other words, such quasi-foreign banks enter directly from OFCs (offshore regions as final destinations of inward FDI) or pseudo-foreign banks are funded by round-tripping Russian capital. Our result shows that the actual number of banks directly influenced by Russian residents is higher than the official statistics published by CBR (13 banks with significant influence from Russian shareholders, 16% from the total list of foreign banks with 100% participation as of 1 April 2014), hence providing evidence of offshorisation of the banking sector and the existence of the round-tripping effect.

European home countries investing in Russia's banking sector include Germany (five banks), France (five banks), the Netherlands (five banks), the United Kingdom (four banks), Turkey (four banks), Switzerland, Austria, the Czech Republic and Sweden (two banks each). Some countries have only one locally incorporated institution in Russia, namely Italy, Finland, Norway, Lithuania, Serbia, Denmark and Israel. The top two countries having in terms of the number of locally incorporated banking institutions are Germany and France, with the most prominent player on the market being ZAO 'Raiffeisen Bank' (a subsidiary of Raiffeisen International [Austria]). Three German banks specialising in automobile loans represent Germany, namely OOO[8] 'BMW Bank', OOO 'Mercedes-Benz Bank RUS', OOO 'Volkswagen Bank RUS' and OOO 'Deutsche Bank', which provide investment banking services, and ZAO 'Kommerzbank (Eurasia)' and OAO[9] 'RosEvroBank'. French banks are represented by ZAO 'BNP Paribas', ZAO 'Credit Agrikol Corporate and Investment Bank', OOO 'Bank PSA Finance Rus', ZAO 'Natiksis Bank' and ZAO 'ONEY BANK' (Table 4).

To identify motives for FDI, we examined the homepages of 78 banks with 100% foreign capital participation, investigated their history of entry and identified the latest date of their M&A activity. This information is important because some banks might change their shareholder structure over time. Our results present foreign entry motives into Russia's market analysed using final up-to-date investments. Classification of foreign banks by motivation of entry is presented in Table 4.

Table 4. Classification of foreign banks by motivation of entry

Group 1. First pioneers from Europe and the United States
<u>*Number of foreign banks in the group:*</u> 16 (21%) <u>*Motives for FDI:*</u> historical, cultural, geographical context, Soviet legacy (both PULL and PUSH) <u>*Entry Mode:*</u> Greenfield investments <u>*Entry strategy:*</u> Organic growth <u>*List of banks in the group:*</u> ZAO "Bank Credit Swiss" (Switzerland, 1993); ZAO "BNP Paribas Bank" (France, 2002); ZAO "Danske Bank" (Finland, 1996); OOO "JP Morgan International Bank" (United States, 1993); OAO "DNB Bank" (Norway, 1990); OOO "Deutsche Bank" (Germany, 1998); ZAO "ING Bank (Eurasia)" (Netherlands, 1993); ZAO "Kommertz Bank (Eurasia)" (Germany, 1998); ZAO "Royal Bank of Scotland" (United Kingdom, 1993); ZAO "Credit Agrikol' Corporate and Investment Bank" (France, 2002 [1991]); ZAO "Raiffeisen Bank" (Austria, 1996); ZAO "Citibank" (United States, 1993); OOO "HSBC Bank" (United Kingdom, 1996); OOO "UBS Bank" (Switzerland, 1996); OOO "Non-banking credit organization "Western Union DP Vostok" (United States, 1994); ZAO "UniCredit Austria" (Austria, 2007 [1989])

Group 2. Supporters of economic and trade relations

Number of foreign banks in the group: 18 (23%)

Motives for FDI: geographical proximity to CIS and other countries; foreign banks established under government agreements (both PULL and PUSH)

Entry Mode: Greenfield investments

Entry strategy: Organic growth

List of banks in the group: ZAO "Asia Invest Bank" (Uzbekistan, 1996); OOO "ICICIC bank" (India, 1994); OOO "Anelik RU" (Armenia, 1990[2003]); OOO "Bank BTSK Moscow" (Kazakhstan, 2007); ZAO "Chinese Bank ELOS" (China, 1993); OOO "MBA-MOSCOW" (Azerbaijan, 2002); ZAO "Garanti Bank-Moscow" (Turkey, 1995); OAO "Evrazijskij Bank" (Kazakhstan, 1992); ZAO "Ziraat bank" (Turkey, 1993); ZAO "Ishbank" (Turkey, 2011 [1994]); OOO "Commercial Indo Bank" (India, 2003); ZAO "Mir Business Bank" (Iran, 2002); OAO "Moskommerzbank" (Kazakhstan, 2001); OAO "NBK-Bank" (Kazakhstan, 2004[1996]); ZAO "Trade and Industrial Bank of China" (China, 2007); ZAO "Woori Bank" (South Korea, 2007); OOO "China Construction Bank" (China, 2013), ZAO "YAPI CREDIT BANK MOSCOW" (Turkey, 1993)

Group 3. Second wave from Europe, the United States, and Asia

Number of foreign banks in the group: 16 (21%)

Motives for FDI: market potential of Russia, high-risk/high return; "market-seeking strategy" (PULL)

Entry Mode: Greenfield investments

Entry strategy: M&A

List of banks in the group: OOO "American Express Bank" (USA, 2005); OOO "Atlas Bank" (Serbia, 2007); ZAO "Inteza" (Italy, 2009 [1992]); OOO Goldman Sachs (United States, 2008); ZAO "Denizbank" (Turkey/Austria, 2003 [1998]); ZAO "J&T Bank" (Czech Republic, 2007 [1994]); OOO "Ikano Bank" (Sweden/Turkey, 2013); OAO "Capitalbank" (Lithuania, 2011); OOO "Morgan Stanley Bank" (United States, 2005); ZAO "Natiksis Bank" (France, 2002 [1990]); OOO "ONEY BANK" (France, 2013); OAO "Renta-Bank" (Israel, 2010 [1994]); OAO "SEB" (Sweden/Latvia, 2006 [1995]); ZAO "FORA Opportunity Russian Bank" (Albania, 2010 [2005]); OOO "Home Credit and Finance Bank" (Czech Republic, 2002); OOO "Non-banking credit organization "PayPal RU" (USA, 2013)

Group 4. Followers of the home country's business

Number of foreign banks in the group: 3 (4 %)

Motives for FDI: following home country's business (PUSH)

Entry Mode: Greenfield investments

Entry strategy: Organic growth (MizuhoM&A)

List of banks in the group: ZAO "Bank of Tokyo-Mitsubishi UFJ (Eurasia)"(Japan, 2006); ZAO "Mizuho Corporate Bank (Moscow)" (Japan, 2006 [1999]); ZAO "Sumitomo-Mitsui Rus Bank" (Japan, 2009)

Group 5. Followers of the automobile business

Number of foreign banks in the group: 7 (9 %)

Motives for FDI: following home country's business (PUSH)/market potential for auto loans in Russia (PULL)

Entry Mode: Greenfield investments

Entry strategy: Organic growth/M&A)

List of banks in the group: OOO "Bank PSA Finance RUS" (France, 2008); ZAO "RN Bank" (Netherlands, 2013 [1989]); OOO "BMW Bank" (Germany, 2008); OOO "Mercedes Benz Bank RUS" (Germany, 2007); ZAO "MS Bank Rus" (Netherlands – Japanese Mitsubishi Group related, 2013 [1994]); ZAO "Toyota Bank" (Japan via Germany, 2007); OOO "Volkswagen Bank Rus" (Germany, 2010)

Group 6. Offshore banks and round-tripping Russian banking FDI

Number of foreign banks in the group: 18 (23 %)

Motives for FDI: quasi-foreign banks: PULL, pseudo-foreign banks: institutional environment (both PUSH and PULL)

Entry Mode: Greenfield investments

Entry strategy: Organic growth/M&A)

List of banks in the group:

1. *Offshore banks (quasi-foreign banks):* ZAO "Investicionnij Bank Kubani" (Cyprus, 2008 [1999]); ZAO "RUNETBANK" (British Virgin Islands/Cyprus, 2005 [1994, Ukrainian capital]); OOO "Hellenik Bank" (Cyprus, 2009); OOO "UNIASTRUM BANK" (Cyprus, 2008 [1994]); OOO "Evroinvest" (Cyprus, 2001)
2. *Round-tripping Russian banking FDI (pseudo-foreign banks):* ZAO "Alef Bank" (UK, 2004 [1992]); OAO "Bank Premier Credit" (Cyprus, 2013 [1994]); OAO "RESO Credit" (Cyprus, 2004); OOO "VESTA" (Cyprus/Panama, 2009 [1993]); OOO "Inbank" (Cyprus, 2009 [1992]; OAO "Probusinessbank" (Cyprus, 2013 [1993]); OAO "Promsvyazbank" (Netherlands, 2008 [1995]); OAO "RosEvroBank" (UK, 2011 [1994]); OOO "Investment Commercial Bank "Sovkombank" (Netherlands, 2012 [1990]); ZAO "Tinkoff Creditnie Systemy" (Cyprus, 2007 [1994]); OOO "Financial Standard" (Cyprus, 2010 [1990]); OAO "Fleksinvest Bank" (Cyprus, 2008 [1994]); OAO "Commercial bank "UNISTREAM" (Cyprus/UK, 2006)

Note: 78 banks as of April 1, 2014 (CBR data)

Source: compiled by author

Chronologically, it is possible to define two periods of inward foreign entry: the 1990s and the 2000s. Banks in Group 1 and Group 2 (with some exceptions) in our result entered Russia's market during 1990s. First, pioneers from Europe and the United States (16 banks) were driven by the historical, cultural and geographical context and the Soviet legacy that generally followed an organic growth strategy and entered in the form of greenfield investments. This group is mostly represented by banks from Europe with quite a successful entry by Austrian banks. Austrian banks were a sort of a bridge between Western and Eastern Europe and, because small and medium-size Austrian banks hardly withstood the competition in the developed markets of Europe and the United States, Austrian capital was predetermined to enter CEE markets (Rybin, 2010, p. 33). ZAO 'Raiffeisen Bank' and ZAO 'UniCreditBank' provided retail services from the beginning of their entry into the market, giving them a strong market position today.

Banks from the CIS (Kazakhstan, Azerbaijan, Uzbekistan) and Asia (China, India, South Korea, Iran, Turkey) constituted Group 2 and entered the market under government agreements to support economic and trade relations between Russia and home countries.

Foreign investors who entered the market in the 2000s were primarily attracted by the market potential of Russia's banking market. We classify them into Group 3, the second wave from Europe and the United States that aimed to develop credit card, investment banking, corporate and retail businesses. These banks are driven by high market potential and high-risk/high-return market-seeking strategies (*PULL factors*, those originating in the host country [Russia]).

Although Groups 4 and 5 chronologically relate to Group 3 and are regarded as its subgroups, we define them separately for the motivation analysis. Group 4 banks, represented by followers from Japan (three megabanks), entered the market by following their domestic clients and recently changed their specialisation. Thus, PUSH factors represent major triggers for the penetration of Japanese banks into Russia's market. The foreign entry of many Japanese companies stipulated the foreign entry of Japanese banks, which might be explained by the fact that the Japanese banking system is a typical example of relationship banking, for example, through specific features of the home country. Regardless, the motivation of entry of Japanese banks has changed in recent years, fuelled by interest in market potential (gradual shift toward PULL factors).

Group 5 is represented by foreign banks specialising in automobile loan businesses in Russia, including seven banks from Germany, France and Japan.[10] These banks specialise in automobile loans of related automobile producers located in their home countries. In other words, these banks 'import' domestic institutions of their home countries. Their strategy somewhat differs from that of automobile manufacturers, such as Hyundai (South Korea), Honda (Japan) and Suzuki (Japan), which prefer to establish finance programs with the participation of Russian domestic banks, such as OAO 'Sberbank' and OAO 'Gazprombank', or with other locally incorporated banks with foreign capital participation, such as ZAO 'Raiffeisenbank', ZAO 'Unicredit Bank' and OOO 'Rusfinance Bank'. For German and Japanese banks, maintaining finance programs within the Group in host countries is extremely important; thus, they 'import' financial institutions from their home countries. Interestingly, Japanese automobile manufacturers prefer to enter the Russian market through European countries: Toyota entered through Germany, and Renault, Nissan, Infinity, Datsun and Mitsubishi organised auto loan businesses in Russia through the Netherlands. The increase in the number of banks providing auto loan services is fuelled by the domestic demand for foreign cars in Russia.

Group 6 is comprised of 18 banks from both pure offshores (quasi-foreign banks) and offshore banks with Russian citizens as the ultimate owners (pseudo-foreign banks). Some of these banks have strong positions in the market and are actively engaged in capital procurement for Russian banks and companies. However, many foreign banks in this group are not genuinely 'foreign' because they represent round-tripping Russian FDI in the banking sector and their motivations for foreign entry differ. Pseudo-foreign banks also regularly change their shareholder compositions from 'foreign' to 'domestic' owners (both are Russian capital) to secure their assets.

4. Foreign banks and the institutional environment of Russia's banking sector

The peculiar features revealed in a brief general overview of foreign banks' entry into Russia's banking market, together with the motivation for entry, might largely be attributed to the institutional environment of Russia as a host country. The environment comprises market specificity features (market quality of Russia) and specific features of Russia's inward and outward banking and non-banking FDI, idiosyncratic features of Russia's banking sector.

The most common features characterising the general market quality in Russia are as follows: non-transparency of legal actors and ultimate shareholders, direct and indirect state participation in corporate sectors, weak protection of property rights, an 'ownership=dominance' concept, administrative barriers, language barriers, high levels of bureaucracy, corruption, a lack of business transparency and complicated juridical procedures, complex hierarchical structures, weak corporate governance, high transaction and entry costs, weak banking and market infrastructures and low law enforcement.[11] The Global Competitiveness Index of Russia in 2013–14 was 4.2 (64th out of 148 countries). The lowest parameters are the quality of institutions (126th place), goods market efficiency (121st place), financial market development (121st) and business sophistication (107th). Low scores for financial market development are largely explained by factors such as difficulty with the availability and affordability of financial services, low levels of financing through local equity markets, difficulty in accessing loans, low soundness of banks (124th place), ineffective regulation of securities exchanges and few protections of legal rights (a score of 3 out of 10) (World Economic Forum, pp. 326–327).

Specific features of Russia's banking and non-banking FDI are summarised as follows: 1) increase in the stock of both inward and outward FDI; 2) higher outflow than inflow of total FDI, making Russia the largest exporter of capital among the BRICs; 3) Europe as a host and home destination for Russian FDI, followed by CIS (neighbouring effect); 3) a large proportion of OFCs and SPEs in the form of round-tripping and 4) interconnection between inward and outward FDI and a parallel economy (Kheyfets, 2007), which explains the strong correlation among the domestic and international sectors of the economy.

Idiosyncratic features of Russia's banking sector are its over-segmentation, strong government presence, concentration of all operations towards large-sized banks, a large number of small banks, undercapitalisation of the banking sector, regional differences, unbalanced revenue structure of the banking sector (high proportion of revenue from foreign exchange operations), problems with long-term financing, low productivity levels, restricted competition, fragmentation of the banking sector and strong dependence on external international markets, low transparency of credit organisations, offshorisation of the banking sector and Russia's economy as a whole.

Thus, foreign banks entering Russia's market are subject to the effects of this institutional environment. The important issue is how all of these factors influence the behavioural patterns of foreign banks. Related examples are provided.

First, as previously stated, the role of foreign banks in providing long-term investments is weak, which also reflects the general situation of a dearth of long-term borrowings in Russia. Foreign banks concentrate on providing short-term financing and domestic credit to financial institutions experiencing undercapitalisation problems. Concentration, over-segmentation and consolidation of the banking sector between state-owned and large privately held banks lead to a situation in which foreign banks find it difficult to compete with the three state giants, namely OAO 'Sberbank', OAO 'Vneshtorgbank' and

OAO 'Gazprombank' (a private bank with strong indirect government participation) and must find their niche in the market. Territorial discrepancies (the majority of Russian banks operate in the European part of Russia) predetermine the choice of location by foreign banks, with the majority of them being concentrated in Moscow city.

Low productivity of the banking sector results in higher efficiency of foreign banks when compared with their domestic rivals. However, even for locally incorporated banks with foreign capital participation, achieving the top three status is troublesome despite the fact that some foreign banks prove to be very efficient and have high ratings and credibility from Russian citizens. The trustworthiness of the banking system in Russia is generally low; however, many foreign banks have relatively higher rankings and are frequently viewed as more sound and credible financial institutions.

Another example is the fact that undercapitalisation of the banking sector significantly impacts the activity choices of foreign banks in Russia. Many banks serve as intermediaries to finance domestic financial institutions rather than participate in the corporate sector. The banking sector's dependence on external financing is rather high, and even higher for the corporate sector.

The balance sheets of foreign banks also show unbalanced revenue structures of the banking sector that are inclined towards a high share of profits from foreign exchange operations.

In addition, market quality issues, such as low business transparency and little protection of ownership rights, prompt a majority of foreign banks to establish businesses from scratch (organic growth) and largely in the form of 100% subsidiaries or with minor shareholder participation, with JSC as the most preferable form of organisational representation.

5. Offshore issue: A problem or a solution for Russia's economy?

The offshore issue in the Russian context is perhaps the most vivid example of the impact of the institutional environment (in particular, market quality). As noted by Ledyaeva et al. (2013, p. 10), the round-tripping issue has two stages: outward FDI from the home country to the foreign country and re-investment back to the home country. In the case of Russia, round-tripping FDI is implemented through OFCs and SPEs.

Largely, institutional imperfections or institutional constraints are accountable for outward banking and non-banking FDI. Versatile factors make OFCs attractive to foreign capital[12] for both the corporate and the financial sectors. In the case of Russia, many studies assume that the reasons for round-trip investments are tax avoidance/evasion and corruption money laundering (Perez et al., 2011; Ledyaeva et al., 2013). Thus, offshores are viewed as a problem of Russia's economy because they are considered to channel illicit FDI flows in the form of money laundering and/or corrupt funds.

In contrast, OFCs and SPEs are major investors in the banking and corporate sectors of Russia's economy and their share in capital participation, reinvestment of earnings and other capital is high. Cyprus, although officially excluded from the list of offshore regions, is still the major destination for channelling capital 'in' and 'out' of Russia's economy, with many Russian companies operating on the island by applying various financial schemes.[13] Cyprus' leading role is not contingent, and the complex system of money flows in Russia frequently called 'the parallel economy'[14] is applied by corporate, financial and state sectors. In a sense, capital transfers through offshores with a high share of earnings reinvestment might be regarded as the institutional context that characterises Russia's market.

As was shown in our analysis of the inward foreign entry motivations of 78 banks with 100% foreign capital participation, the role of banks in round-tripping FDI is very significant. The share of OFCs and SPEs is even higher if banks with less than 100% foreign participation, such as OOO 'Rosprombank' (50.04% of shares belong to Cyprus Popular Bank) and ZAO 'Uniastrum Bank' (80% of shares belong to the Bank of Cyprus) are included in the analysis. We presume that the offshorisation of Russia's banking sector intensified in the 2000s, with both Russian banks hiding their ultimate shareholders in offshore regions and offshore banks investing into relatively stable medium-size banks with sound asset structures.

Although Russia's institutional imperfections explain why capital flows are directed to OFCs and SPEs, another interesting issue must be considered: why does capital circulate back in the form of round-tripping and what are the advantages to hiding genuine Russian banking capital in the form of pseudo-foreign banks? Although Ledyaeva et al. (2013, p. 17) did not directly target banking FDI, they estimated that approximately 80% of firms in the financial sector are established by round-trip investors. They also argued that because the policy for foreign investors in Russia is rather restrictive, access to special privileges for foreign investors is unlikely to be the motivation for round-tripping FDI (as might be the case in China). Companies established through round-tripping FDI enjoy a sort of institutional arbitrage – moving abroad allows using OFCs as a 'home base', providing access to a more developed financial infrastructure. Moreover, knowledge of Russia's institutional context puts those companies in a superior position over companies established by genuine foreign investors (Ledyaeva et al. 2013, p. 53–54).

We believe that the findings previously noted provide useful insights into explaining the motives of pseudo-foreign banks. In fact, in our analysis of 18 banks registered in offshore regions, 13 are categorised as pseudo-foreign banks that are, in fact, not genuinely 'foreign' but are ultimately owned by Russian shareholders. Thus, the share of round-tripping in the banking sector in our result is estimated at 72%. Needless to say, the motivation of entry of this group of banks might largely be explained by the intention of Russian investors to do business in Russia; however, given the impact of the institutional environment, the capital is first pushed to escape to offshore regions with the intention of camouflaging its genuinely Russian origin, and then it is pulled back as round-tripping FDI attracted by potential market possibilities that appear attractive to Russian investors. In this sense, offshore regions are a solution for Russia's economy because they represent a sort of by-product to escape the institutional environment, decrease transaction costs and mitigate market risks.

6. Conclusion

The motives of both banking and non-banking inward FDI in emerging and transition economies are always difficult issues. Theoretical and empirical research aimed to disclose the driving forces behind the motivation of foreign banks to enter these markets. Recently, traditional market-, research-, efficiency-seeking theories are moving towards the direction of synthesising with institutional approaches. Institution-based theories pose new questions for FDI theory, among which one is of particular interest: whether institutions of home or host countries shape the motives and entry choices of foreign banks.

Despite the fact that we found proof for traditional theories that explain the motives of foreign banking FDI in Russia, e.g., market-seeking (high risk–high return), the results of our empirical study also suggest that these theories cannot solely explain entry motivation, entry modes, organisational representation and strategies of foreign banks in Russia because of the existence of a complex institutional environment. Regarding the role of the institutional environment, we draw the following conclusions.

First, mutual relationships and significant roles of the institutional environment and foreign banks' motivation are vividly expressed through an analysis of entry modes, organisational representation and foreign banks' strategies and functional roles in the market. After entering Russia's market, a majority of banks established representative offices and later converted them to subsidiaries as a result of existing legal restrictions on the establishment of branches. In addition, market quality and the idiosyncratic features of Russia's banking sector predetermined banks' organisational structure in the form of 100% ownership and minor shareholdings. The institutional environment is also accountable for the organic growth strategy choice of many foreign banks entering in the 1990s, whereas the 2000s are marked by a wave of M&A activity following the financial liberalisation process.

Second, institutional environments have a heterogeneous impact on banking FDI motives. On the one hand, presumably, they significantly affected the motivation of the foreign banks that entered during the 1990s – non-economic motives (support of the global image), historical and cultural contexts, Soviet legacy, geographical proximity (gravity model), support of economic relations between home countries and Russia – and were initial driving forces that stipulated the motivation of foreign banks. On the other hand, banks that entered during the 2000s primarily used traditional FDI motives (market-seeking, market-potential [PULL factors]). Needless to say, the initial motives for entry change over time.

Third, the effect of the institutional environment on the sample foreign banks originating in OFCs and SPEs is interesting to consider. We used our original typology and found that 23% of banks have OFCs and SPEs as their home country destinations and classified those banks as quasi-foreign and pseudo-foreign. We also found proof that the round-tipping effect in the form of pseudo-foreign banks is present in Russia's banking sector. In fact, round-tripping banking FDI might follow traditional FDI motives: using offshores to camouflage their identity is a way to escape imperfections in the institutional environment. Nevertheless, as other research showed, the possibility that illegal motives exist for FDI for this group of banks cannot be fully eliminated.

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Notes

[1] Offshore financial centres (OFCs) are sometimes referred as tax havens in the literature (Schwarz, 2011), although some studies slightly distinguish between the two categories depending on regulatory quality (Dharmpala, 2009). For the purposes of this paper, we omit the discussion on the appropriate definition of this phenomenon of the global complex financial system and simply apply UNCTAD's list of countries, which includes the following offshore regions and tax haven territories: Andorra, Gibraltar, the Isle of Man, Liechtenstein, Monaco, Bahrain, Liberia, Seychelles, the Cook Islands, Maldives, the Marshall Islands, Nauru, Niue, Samoa, Tonga and Vanuatu, Anguilla, Antigua and Barbuda, Aruba, Barbados, Belize, the British Virgin Islands, the Cayman Islands, Dominica, Grenada, Montserrat, the Netherlands Antilles, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, the Turks and Caicos Islands and the United States Virgin Islands (UNCATD, 2012, p. 8). Flows to OFCs amounted to USD 80 billion in 2012 and generally grow at 6% annually (UNCTAD, 2013, pp. xiv).

[2] SPEs are established for specific purposes or have a specific legal structure in countries that provide specific tax benefits. Both OFCs and SPEs channel funds to and from third countries. SPEs channel more than USD 600 billion of investment flows, and the number of countries providing favourable tax treatment to SPEs is increasing (UNCTAD, 2013, pp. xiv–xv).

[3] Transfer of funds abroad to bring some or all of the investment back as a foreign investment (Kalotay, 2005).

[4] ZAO is an acronym for Zakritoe Akcionernoe Obshestvo (closed joint stock company).

[5] Deposit ratings as of 1 March 2013 were as follows: OAO 'Sberbank' – 1st place (RUB 6497 million); ZAO 'VTB 24 – 2nd place (RUB 999 million); ZAO 'Gazprombank' – 3rd place (RUB 296 million); 'Alfa-bank' – 4th place (RUB 291 million); ZAO 'Raiffeisen' – 5th place (RUB 220 million). Retrieved in January 2014 from www.banki.ru/banks/ratings.

[6] ZAO 'Home Credit and Finance Bank' (Czech Republic) – 3rd place; ZAO 'Rosbank Societe

Generale Group' (France, less than 100% shares) – 4th place; ZAO 'Raiffeisen Bank' (Austria) – 10th place; ZAO 'UniCredit Bank' (Austria) – 12th place; ZAO 'Promsvyazbank' (Netherlands, dispersed ownership) – 22nd place; ZAO 'Citibank' – 32nd place. Retrieved in January 2014 from www.banki.ru/banks/ratings.

[7] Bank rankings in terms of corporate loans as of 1 March 2013: OAO 'Sberbank' – 1st place; OAO 'VTB' – 2nd place; OAO 'Gazprombank' – 3rd place; OAO 'Rosselhozbank' – 4th place; OAO 'Alfa-Bank' – 5th place; OAO 'Moscow Bank' – 6th place; ZAO 'UniCredit' (Austria) – 7th place; ZAO 'Promsvyzbank' (Netherlands, dispersed ownership)' – 9th place; ZAO 'Raiffeisen Bank' (Austria) – 10th place; ZAO 'Rosbank Societe Generale Group' (France, less than 100% shares) – 13th place. Retrieved in January 2014 from www.banki.ru/banks/ratings.

[8] OOO is an acronym for Obshetsvo s Ogranichennoj Otvetstvennostiu (limited liability company).

[9] OAO is an acronym for Otkritoe Akcionernoe Obsestvo (closed joint stock company).

[10] This group may also be regarded as 'followers' of the automobile business of their home countries. We separate them into a different cluster group. ZAO 'Toyota Bank' was established by Toyota Kreditbank GmbH (99.75%) and Toyota Leasing GmbH (0.25%) and, therefore, represents a German FDI. However, for the purpose of our motivation analysis, we consider this FDI as representing Japanese investments through Germany.

[11] The Global Competitiveness Report 2013–14 (p. 326) also presents the following most problematic factors for doing business in Russia that might be regarded as general market quality issues: corruption, high tax rates, tax regulations, inefficient government bureaucracy, difficulties with access to financing, inflation, an inadequately educated workforce, inadequate infrastructure, crime and theft, insufficient capacity to innovate, a poor work ethic in the national labour force, restrictive labour regulations, policy instability, government instability, poor public health and foreign currency regulations.

[12] Some of these include: 1. differences in tax systems, tax optimization: the tax rate on dividends in Cyprus is only 5% versus 9% in Russia; the corporate income tax rate in Cyprus is 10% versus 20% in Russia); banks registered in offshore regions are released from paying taxes on transactions in which commercial papers are issued by both foreign and domestic offshore companies; offshore companies may be used as nominal shareholders of valuable assets and are, thus, not subject to taxation in home countries; 2. the possibility of applying Anglo-Saxon legal rules that provide strict standards of confidentiality on the disclosure of ultimate owners and beneficiaries; 3. loose restrictions on the disclosure of the origins of money (e.g., Russian capital in Cyprus); 4. cultural, historical proximity (no visa requirements for Russians in Cyprus, transparent management, the generally positive attitude of Cyprus businessmen toward Russian capital); 5. the presence of a sound financial system in offshore regions with strong protection of ultimate owners; 6. low language barriers (English and Russian speakers in Cyprus are quite common); 7. capital flight as an intention to secure the secrecy of Russian investors' identity to maintain the security of investments and/or assets; 8. illicit money flows: tax evasion, money laundering.

[13] Some of the mechanisms include the following: 1. provision of loans (credits) to companies or banking institutions registered in Cyprus with further transfer of these financial resources to third countries; 2. establishment of companies in Cyprus with major financial accounts allocated to Western Europe; 3. loans (credits) to companies registered in Cyprus in return for 0% interest rates on the bills of exchange (e.g., OAO 'Rusgidro') and others (Ekspert, 2013, No.12, p. 15–21).

[14] Ninety-five per cent of large Russian MNCs have affiliations with offshores (Kheyfets, 2008); nine out ten transactions take place through offshore regions (Kompaniya, 18 March 2013, p. 40).

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