

## Sector Briefing

# Financial & Legal Services Opportunities in Russia

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### Why Russia?

**Russia has a young financial & legal services sector that offers a range of opportunities for international and domestic companies, particularly in the light of Russian Government plans to develop International Financial Centre in Moscow.**

Like all major economies, Russia was affected by the recent global financial crisis. However it is widely agreed that the Russian government handled the crisis in the banking sector well, moving quickly to provide timely loan guarantees and, unlike in other countries, state support for the banking sector did not involve the acquisition of equity stakes. Only a small number of banks were taken into state ownership during the crisis.

On 21 April 2010 Russian President Dmitry Medvedev called on the government to speed up the opening of **an international financial centre in the country's capital Moscow**. The President stressed that the centre would have an important role to play in the country's economic development as well as for the global financial system. The new project has a number of goals to achieve. Firstly, **it aims to attract foreign finance and carve out a place for Moscow in international finance**. Secondly, **the project will boost the Russian rouble**, which ultimately it is hoped will become one of the world's trusted currencies that other countries may choose as a form of foreign reserve. Thirdly, if Moscow succeeds in emerging as one of the world financial centres, **the financial**



**system is set to benefit immensely from integration into world markets.** However, Medvedev himself has pointed out some roadblocks that may hinder the progress of the project. These include **an opaque and politically dependent judiciary; incapacitating state bureaucratic red tape, rampant corruption as well as the necessity of boosting the development of credit and banking system**. Against this background the Russian government has a mammoth task as it has to not only complete this project but also oversee much larger reforms across the country.

### **UK Financial Services, aided by UKTI, has a good story to tell.**

Cumulative British investment in Russia was worth nearly \$20 billion - and that of Russia in the UK \$2.8 billion. Russia would welcome more British investment in Russia, and not just in the natural resource sector.

- UK banks are among the most successful British investors in the Russian market. Many are here already (HSBC, Barclays, RBS), and they are all growing their operations.
- The Big Four dominate the accountancy market
- London remains to be the first place of destination for Russian companies' IPOs.

- Russian market is dominated by international law firms because the most popular law in Russia is English Law.

## Opportunities

There are opportunities for UK companies in banking, insurance, pensions, legal services, capital markets, accountancy sectors and PPP.

The top priorities for Russian Government now are Russian financial markets and establishment of International Financial Centre in Russia. The experience of London in promoting financial services, and its history of openness in terms of welcoming business are of great interest for Russia. UK experience on issues ranging from alternative dispute resolution and arbitration; derivatives markets and its integration into stock exchange; to business process integration on two or more exchanges in different jurisdictions, and dual listings are of particular interest to Russia.

## Banking

**Russia has a lot of banks, 1124 by the central bank's last count, but of these the top 100 account for 90% of the total banking sector assets; the top 30 account for 75%. The central bank has been reducing this large number of banks by raising minimum capital requirements year on year,** causing smaller banks to either be bought out, or to exit the market. Aside from these smallest banks, on the whole most Russian banks are well capitalized, already exceeding the higher capital requirements brought in under Basel III regulations. However, other elements of the Basel II (and III) regulations Russia are less well implemented. Russia is likely to try and implement Basel II and III regulations jointly over the next few years. The central bank runs a number of pilot projects, including with some of the largest banks, as preparation for full implementation.

Enormous Opportunities. Prior to the crisis, Russia was the fastest growing banking sector in the world, and there is still huge potential for upside growth – both providing banking services to the majority without accounts, and expanding services for those who do. Experts estimate that **banking assets could grow by nearly 22% year on year to 2013, with returns on equity reaching pre-crisis levels of 20%** by this point.

There is **huge potential for increases in productivity.** It takes 1.6 minutes to make a cash withdrawal in the US, but 6-8 minutes in Russia. Total labour productivity in the banking sector in Russia is ten times lower than the US.

**Lending to the SME sector** could be a particularly strong growth area. At present bankers understand that the SME sector is crying out for affordable and accessible credit but lack the tools to adequately assess the risk.

Some parts of the Russian government are keen to seize on this potential, with ambitious plans to turn

Moscow into an international financial centre. **The government is considering legislation to modernise banking legislation, encourage a greater use of IFRS, and measures to increase transparency.** Structural Risks and Problems. To achieve its growth potential however, the banking system has many obstacles to overcome. On many standard measures, much of the sector is inefficient. The central bank has stepped up efforts to monitor the activity of banks, and is slowly reducing the total number of banks (by raising capital requirement ratios). As a result around 100-200 are expected to exit the market each year, but at this rate **it will still be 5-10 years before the total number of banks is close to the consensus of what is a sensible number of banks for Russia (around 200).** The crisis demonstrated **the risk of non-performing loans (NPLs), particularly the difficulty of measuring their extent.** Russian Accounting Standards (RAS), under which banks report, mean that only the portion of the loan that is non-performing needs to be reported. Thus the full scale of exposure to problem loans remains hidden.

While liquidity is now plentiful, most banks are struggling to get this into the real economy. The fall-out from the crisis means that many companies are not yet investing again. Furthermore **existing loans are being paid back early by firms who no longer want the funding,** decreasing the overall volume of 'good' loans a bank has, and so worsening the quality of its book.

**Other firms are eager to borrow (particularly SMEs). But Russia's banking sector is ill-equipped to accurately estimate risk.** This tends to lead to under-lending, exacerbated by the crisis, and the ensuing problems with NPLs. While some small entrepreneurs can borrow against personal collateral, it is practically impossible for firms to do the same. Implications for the UK. **UK banks are among the most successful British investors in the Russian market. Many are here already (HSBC, Barclays, RBS), and they are all growing their operations.** Despite the difficulties of operating here, all view Russia as a key growth market..

**The UK is also a good potential source of expertise.** A lack of products and technology holds the banking sector back. But there is no native expertise to develop them. UK financial services experts are well placed to provide this, as well as investment expertise, legal, back office, products and more.

The moves from many banks, and the state this year, to **issue bonds on the international market also provides opportunities.** The UK remains the first port of call for most Russian companies. Although competition is emerging (especially in Hong Kong and Frankfurt), most Russians continue to view the UK as the best centre for expertise and capital.

## Pensions

At present **total pension assets in Russia stand at 2.8% of GDP** (\$47 billion, \$331 per capita). The

world average is around 70% of GDP showing just how underdeveloped the pensions market in Russia is. **With the recent government reform of the pension system, private pensions market is now becoming the biggest opportunity.** A boom in private pensions would also be a gain for Russia. The economy desperately lacks long money to invest domestically rather than relying on the often fickle global markets. A deep and liquid domestic pension market would be an ideal source of this, and a vital part of any modern international financial centre – something to which Russia aspires.

Opportunities. The potential gains in the pensions market are huge. Chile underwent a major pension reform in the 1980's, providing the model from which Russia based its own 2002 reforms. From a low base Chile's pension assets today are around 68% of GDP, representing around \$110 billion of private sector money (for a much smaller population). **Were Russia to follow Chile's path, by 2030 this could be a market worth over \$1 trillion** (the one trillion figure is if Russia followed Chile's path exactly, an unlikely outcome in the near future, but even so, a moderate increase from the current 3% of GDP that pensions make up would be a huge opportunity)

Barriers to entry. There are significant barriers to entry. **Bureaucratic listing and accreditation requirements** take a huge amount of time, money and leg work to clear. Russian accounting standards, used as well as IFRS, add to operating costs. And **the lack of awareness of pension products in the general population** make realising these opportunities an uphill struggle.

Opportunities for UK business. For many Russians **private sector (pillar 3) pensions will need to become an increasing part of their retirement plans.** The personal investment funds set up by the state, provide some opportunities for UK firms. While individuals are free to invest this money in a range of products, in practice only 5% do so leaving 95% in the default, low yielding, government account. With around \$4 billion accrued so far in these individual accounts, better education and utilisation of this could provide a fair income stream to the private sector as a relatively easy win.

## Insurance

**There are over 700 insurers but the top 10 collect up to 54% of Gross Written Premium.** In 2009, the number of insurers reduced from 786 to 702 - one reason being that the requirements of **minimum capital have been raised.** Interfax states that the new requirements to the minimal size of the charter capital of insurance companies **will leave only 45-50% of companies in the market,** although this will **not have a depressing impact** on the insurance market as a whole because a little over half of the companies secure 92% of the aggregate premium collection. The bill (passed on 14 April 2010) increased the minimal required size of the charter capital of general insurance

companies from **30million to 120million roubles and 480 million for reinsurance companies.**

Opportunities. Penetration rate of insurance remains low on both private and corporate levels compared to more developed economies and the market represents **enormous growth opportunities for insurance players.** Moreover, the financial crisis will have some positive impact on the sector as **unqualified and undercapitalised players will fail,** leaving those that remain more transparent and customer friendly. The **total amount of premiums collected grew at a Compound Annual Growth Rate of around 24.5% between 2005 and 2008.** It is expected that the introduction of laws on compulsory property insurance will boost the overall insurance market in future, as well as **government support, economic growth and rising income level.** There will be **limited demand** for insurance products in the **short term** because of the global economic crisis, but the market holds **strong potential** for the **medium term** as real income begins to recover.

Many **factors holding back the market are being addressed,** albeit slowly, such as: **non-risk insurance 'schemes' have been attacked by regulatory authorities.** Regulatory requirements for insurance company capital and solvency are being raised, scarcity of skilled personnel (actuaries, underwriters, claims, handling specialists, top managers) is less acute than in the past.

Continuing Concerns. Some of the **factors holding back the market still remain:** ownership structures are not transparent and corporate governance is still weak, under-developed broker sector, unfavorable tax treatment for brokers, lack of efficient distribution networks, lack of trust in financial institutions more generally.

## Legal Services

**The Russian market is dominated by international law firms, mainly because the most popular law in Russia is English Law. In M&A 80- 90 per cent of large transactions use UK law. Loan agreements are often in English Law.** So UK law advice is in big demand. Foreign firms brought knowledge, improved standards and a sense of bigger picture but this has also led to market saturation. There is a tendency for things to be overcrowded in Russia.

Opportunities. The Russian market generates many large contracts utilizing English law to facilitate international transactions and arrangements. There are therefore significant opportunities for UK legal firms to enter the Russian market or to form alliances with existing domestic players.

Restrictions. **Discussion currently underway** in the Russian Ministry of Justice concerning rights of audience **could create previously unseen restrictions on international lawyers in Russia.** The nature of the proposal is opaque, but new regulations are expected to stipulate that lawyers with rights of audience be advocates and register with the local bar. The measure

is being billed as improving regulation in Russian legal profession.

UK legal companies in Russia. Legal companies such as Allen & Overy, Clifford Chance, Freshfields, Linklaters, as well as other major legal firms, e.g. SNR Denton, Lovells, Herbert Smith, Baker & McKenzie all have significant presence in Russia.

## Capital Markets

**Capital markets in Russia are between 1/2 and 2/3 of the size of emerging market peers**, therefore there are considerable opportunities for growth.

There are two main stock exchanges in Russia: RTS and MICEX. RTS is privately owned, while MICEX is owned by the Central Bank of Russia (30%) and the rest of private investors. On the 1st of February a Letter of Intent was signed between shareholders of RTS Stock Exchange and MICEX indicating in a non-binding way the intention of the MICEX shareholders to acquire a controlling stake in RTS. The LOI provides for fixing legal and business terms of the deal subject to approval by all the interested parties by the 15th of April 2011. By this time a plan will be drawn up setting a timeline for the deal stages and detailing how the joint entity will look like. A prospective merger of the two major market operators is called for by the ambition to build a powerful exchange infrastructure in Russia that would meet the needs of market participants and would be competitive on the international level.

Current topics. The key issues are currently: **Equity IPOs: London remains to be the first choice of destination for Russian companies to raise money abroad.** In November 2010 London Stock Exchange welcomed Russia's largest rail freight operator, Transcontainer to its Main Market. Transcontainer, which raised \$400 million at admission, is the third Russian company to join the Main Market just in one month (November 2011), taking **the total money raised by new Russian companies in November to over \$1.7 billion.** Leading food retailer O'KEY and Internet company Mail.ru, also both conducted successful IPO's that month, raising \$420 million and \$912 million respectively. It is a clear sign of recovery from the crisis. As for International IPOs in Moscow, Alexander Voloshin, the head of the working group in charge of creating the International Finance Center in Russia expects **large international IPOs in Moscow within the next couple of years, maybe a little earlier.** Moscow is a city where no large international-level IPO has ever been held. A lot remains to be done to develop the financial sector in Moscow. Russian Government is taking the following steps: **plan to improve the legislation, regulation, develop financial infrastructure, and improve corporate governance, plan to improve tax legislation, judicial system reform as applicable to the financial industry.**

**In September 2010 the major Russian bank Sberbank announced its plans to organize two RDR**

**issues in coming 6 mths in Russia:** one for a foreign company and one for a Russian company. Sberbank is actively engaged in preparing those projects and believes issuance of RDRs will be a key step in creating an international financial center in Russia.

In February 2011 it was announced by the deputy minister of finance that **Russia is preparing a RUB 60bn (USD 2bn) RUB-denominated Eurobond issue in the nearest future due to favorable conditions on the foreign debt market.** The Ministry's goal for the Reserve Fund and National Welfare Fund should remain untouched in 2011, while federal budget deficit is covered from foreign and domestic borrowings. **In 2010 Russia issued USD 2bn worth of five-year Eurobonds yielding a coupon rate of 3.625% and USD 3.5bn worth of ten-year Eurobonds yielding a coupon rate of 5%.** Russia placed the sovereign Eurobond on the international market for the first time after almost a 12-year break. Experts believe the bond issue is a key test of foreign investor appetite for Russia.

Opportunities for the UK. Promotional opportunities: possible development of the international trading of Bonds via London; possible development of cross border 'over-the-counter' derivatives markets between London and Moscow.

## Accountancy

**With the strengthening of the regulatory regime as well as increased business activity, auditing services are in greater demand.** Russian accounting rules ("RAR") are not yet in line with international financial reporting standards – there is gradual harmonization. An annual statutory audit is mandatory for all companies meeting certain criteria, including banks and other credit institutions, insurance companies, commodity and stock exchanges, investment funds, charitable and other (non investment) funds. However, in contrast to Western norms, **consolidated accounts are treated as secondary to stand-alone statutory financial statements of a company and are often not prepared;** consolidated accounts are also not subject to mandatory statutory audit.

International Presence.

**The Big Four dominate the accountancy market.** In the professional training arena, the **Association of Chartered Certified Accountants ("ACCA") is the most well known and established organisation in Russia.** Other organisations, such as the Chartered Institute of Management Accounting ("CIMA") and the Institute of Chartered Accountants of England and Wales ("ICAEW") have begun to establish themselves in Russia.

## PPP

In order to meet the infrastructure improvements required by the Russian government and its population, the implementation of Public-Private Partnerships

(“PPPs”) is becoming increasingly important within social and industrial infrastructure projects at the federal, regional and local levels. The Russian government is keen to develop PPP projects, given the major infrastructure projects planned for the next decade. **The next step for Russia is to utilize PPP for smaller projects and in new sectors; education and health (particularly kinder gardens and school).** Four such projects are currently on the implementation stage.

#### Opportunities

There is an opportunity to share UK experience and expertise in this sector.

**St Petersburg is piloting the only current PPP projects in Russia as part of the city’s drive to develop its economic capacity.** The latest PPP project approved in St. Petersburg was the **Yanino PPP waste processing plant** (a Greek company won the tender)..

Among other PPP projects in St.Petersburg are: **Pulkovo airport, Light Tram, West Speed Diameter.** Those projects are on the implementation stage. The bidding for those projects involved construction companies from Europe, the United States and Australia; UK involvement has been mainly within the legal and technical advice arenas, although a UK company was awarded the architectural remit to design Pulkovo airport in September 2007.

## Major events and activities

### **Lord Mayor visit to Russia**

The Lord Mayor of the City of London, Alderman Michael Bear, will visit Russia 26 June – 1 July 2011. Seminars, high-level meetings and networking events will take place throughout the visit. If you would like further information on the events planned or are interested in applying to join the accompanying business delegation please contact a member of the UKTI Russia team.

### **Financial & Legal services seminars and visits.**

Major activities coming up include: a visit by Richard Alderman, Director of the UK Serious Fraud Office (May 2011); English Law Week in Russia (June-July 2011).

Please contact a member of UKTI Russia team if you would like further information on speaking and sponsorship opportunities.

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