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Fast VTB Growth Raises Eyebrows

By Howard Amos

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A Russian flag hanging from VTB Capital's imposing offices in London, formerly home to the British bank Lloyds. **Josephine Amos**

LONDON — If you stand outside the colonnaded entrance to the Bank of England, the home of Anglo-Saxon finance in the heart of London, you will have difficulty ignoring an enormous Russian flag hanging from the building across the street.

The flagpole on which it is suspended extrudes from the offices of VTB Capital, the investment-banking arm of state-controlled VTB. The prestigious London address is the former home of Lloyds, the British bank founded in the 18th century.

Millions of dollars have been poured into VTB Capital since it was set up in 2008. As well as London, it has operations in New York, Hong Kong and Dubai. Its rise during a period of financial crisis and political pressure on the banking industry has defied international trends.

The blossoming of VTB's investment-banking division provides an indicator of the growth and global ambition of Russia's second-largest bank in terms of assets. VTB — which is 75.5 percent owned by the government — has been at the heart of the state's expanding presence in the domestic financial market along with its giant sister Sberbank.

But industry insiders and ex-employees who spoke to The Moscow Times were critical of the bank. The ousted head of Bank of Moscow, which was acrimoniously acquired by VTB last year, said VTB was little more than an extension of the government run by individuals seeking their own personal enrichment.

Observers worry that the dominance of state-owned banks is stifling competition, noting that several foreign banks have downsized their Russian operations over the last two years, including HSBC, Barclays, Santander and Swedbank. One of HSBC's flagship Moscow retail-banking outlets, on 1 Tverskoi Bulvar, is now a Sberbank office.

Ten years ago VTB — known as Vneshtorgbank in Soviet times — controlled assets worth $6.3 billion. But by last fall this figure had ballooned more than 30-fold to almost $200 billion, according to VTB management board member Yekaterina Petelina. While corporate clients have traditionally served as its backbone, VTB has been pushing to expand its base of depositors by making inroads into the retail-banking market.

Crisis Brings Boom

The 2008 economic crisis was a watershed moment for the bank when, along with other state lending institutions, it received massive financial assistance from the Russian taxpayer.

"A crisis is always an opportunity for us," Petelina told The Moscow Times. "If you look at history, you will see that Russian state banks have always gained market share during crises."

An aggressive hiring and expansion program over this period also put VTB Capital on the map. "VTB built its investment-banking franchise by buying talent during the last crisis while most banks were just fighting to survive," said Jason Hurwitz, a financial analyst at Alfa Bank, the country's largest private bank.

Acquisitions have always been a critical part of VTB's growth. Of the bank's 12 major buyouts in the last decade, two were in 2011. The $3 billion purchase of TransCreditBank, Russia's 13th-largest bank by assets, was relatively uncontroversial.

Bailing Out Bank of Moscow

But the hostile takeover of Bank of Moscow, Russia's sixth-largest, led to criminal charges against former top managers Andrei Borodin and Dmitry Akulinin and the biggest bailout in Russian banking history amid accusations that VTB had spectacularly failed to perform proper due diligence.

The Bank of Moscow saga even drew fire from Prime Minister Vladimir Putin. Putin initially told VTB chairman Andrei Kostin that a $3.3 billion secondary public offering by the bank in February was "proof of the trust in the Russian financial system." But the praise turned to criticism less than eight months later when Putin gave Kostin a public dressing-down during VTB's annual showpiece investment conference in October.

"You wormed your way into the mess, and now you don't know how to clean yourself up," Putin said sternly to a packed hall of investors. "And then you come to the government, saying 'Save me! Help me!'"

The problem was that VTB announced in July that it had detected a black hole at the heart of Bank of Moscow's balance sheet that required emergency funds to prevent a financial meltdown on the scale of U.S.-based Lehman Brothers. It ended up receiving $14 billion in state-backed loans at a below-market rate of interest.

Investors were spooked by the scale of the apparent miscalculation, combined with a July downgrade of Bank of Moscow by credit-rating agency Moody's and a drop in its share price. To allay the concerns, Kostin, 55, was forced to make urgent trips to New York and London. He told CNBC News at the time that he did not regret the deal, optimistically declaring that it would end up being "a sad story with a happy end."

David Bonderman — co-founder of the private equity fund TPG, which invested heavily in VTB's February share offering — joined the bank's supervisory council after the scandal. "Privatization does push for more transparency and efficiency," said Petelina, the VTB executive.

Borodin Sees Conspiracy

Borodin, meanwhile, fled Russia amid accusations that he had enriched himself on the job and bitterly complained that he had been forced to sell his stake in the company for below its real value. He is now wanted by Russian prosecutors on an international arrest warrant in connection with loans totaling $415 million that the bank extended to Yelena Baturina, wife of former Mayor Yury Luzhkov.

In an e-mail interview, Borodin accused unspecified people in the Kremlin of manipulating VTB to orchestrate the Bank of Moscow takeover for their own gain.

"Behind this deal was a political decision to gain control over Bank of Moscow as well as the desire of certain individuals to make a profit," Borodin said. "VTB was simply representing the state.

"Now the state fully controls one of Russia's largest and most successful banks," he said. "And, in addition, the record state bailout package ... appears to have benefited VTB and other shareholders."

In a November interview with Vedomosti, Borodin suggested that President Dmitry Medvedev himself had ordered and overseen VTB's takeover of the bank. VTB now controls 94.84 percent of Bank of Moscow, it said in a statement on Dec. 29.

Backed by the Finance Ministry, VTB has placed the blame for the bailout fiasco squarely at the feet of Borodin and other former Bank of Moscow senior managers. Kostin, appointed to head VTB in 2002, has accused Luzhkov, who founded Bank of Moscow, of providing political cover for the related-party loans by preventing "unwelcome questions."

Bank of Moscow, with about 6 million clients, will "remain a separate legal entity with its separate brand," unlike TransCreditBank, which will be fully subsumed into VTB's retail arm, VTB24, Petelina said.

She said mismanagement at Bank of Moscow had left a lot of potential for growth. "The productivity of its branches is five to eight times lower than the productivity of VTB24's branches," she said.

Prioritizing Interests

VTB's acquisition of Bank of Moscow reinforced suspicions in the minds of some people in the finance industry that the bank gives priority to vested state and personal interests.

"VTB is a very good reflection of how business in Russia occurs today, which is on the one hand state ownership and on the other direction by individuals who are much more concerned about their own wealth than about the benefit to the country or the owners of the institution," said one banking insider who requested anonymity to speak candidly.

A senior executive at a private Russian bank who left VTB dissatisfied after a year there said he had found little internal cohesion. Most of the top executives were working for themselves and were not able to properly function as part of a team, he said, speaking on condition of anonymity because he was not authorized to speak to the media.

Question marks continue to hang over the bank's priorities, said Richard Hainsworth, director of RusRating, an independent bank-rating agency. "Will the strategy that is published be the one that is implemented, and to what extent is the strategy driven by government concerns, management ambitions or shareholder value?" he asked.

VTB is well known for its generous salaries. According to a November 2011 Forbes survey, VTB has the two highest-paid managers in Russia. Yury Solovyov, a former Deutsche Bank executive recruited to head VTB Capital, receives an annual paycheck of $25 million — the largest paycheck in the country. Mikhail Kuzovlev, in charge of restructuring Bank of Moscow, takes second place with an annual income of $15 million, Forbes said.

Profits, Not Dividends or Acquisitions

VTB's profits have been climbing. After posting a $2 billion loss in 2009, VTB rebounded to a $2 billion profit in 2010. In May, Kostin said profits in 2011 should be about $3 billion, rising to $5 billion this year. VTB's first-half net profit was $1.85 billion, a 113.5 percent year-on-year rise. Profit in the third quarter was $607.3 million.

The bank's share price has not matched the growth in profits. After the bank's first public offering — an $8 billion "people's IPO" in 2007 — the share price plummeted, reaching one-sixth of its value within a few months and embittering the 120,000 investors who had bought equity. The share price has never recovered. Launched at 14 kopecks a share, it is currently about 6.2 kopecks (see graph).

Kostin said last year that he regretted aspects in the way the IPO was conducted, yet argued that it marked a "drastic change" for VTB. He has pledged to return the share price to its 2007 levels by 2013.

Echoing concerns about recent Sberbank acquisitions in Eastern Europe, analysts have warned that an overly aggressive expansion by VTB will draw away value from shareholders. "VTB should be focusing on increasing earnings before making new acquisitions," said Bob Kommers, a financial analyst at Deutsche Bank. "Investors would like to see better earnings."

VTB has noticeably toned down its rhetoric on its appetite for big takeovers. In May, Kostin told the Financial Times that, "if and when we see a good opportunity, we'll be buying." His language softened appreciably after the Bank of Moscow shock. He told The Wall Street Journal last week that he was "a bit skeptical about the ability of a Russian bank to be successful" in European markets.

Petelina, the VTB executive, said that while the door to acquisitions abroad was not completely closed, they were not a priority. "We don't talk about volumes at any price any more. We are talking about efficiency, we are talking about profit and return on equity," she said.

But some observers said a wholesale foreign acquisitions binge would be difficult for VTB to resist if the euro-zone debt crisis worsens and energy prices remain high.

A senior Western banker in Moscow said state-owned banks would probably need to look outside Russia given their profit generation and the potential for them to take advantage of the weakened state of affairs in Europe.

If such a scenario does unfold, it would provide another platform from which to observe the peculiarities of VTB's structure and management in comparison to Sberbank. Russia's largest lender, headed by former Economic Development and Trade Minister German Gref, is near to closing an estimated $1 billion deal to acquire Austria's Volksbank International.

Asked what sets apart the two ostensibly similar state financial giants, analyst Hurwitz emphasized that VTB is controlled by the government, while Sberbank is 60.3 percent held by the Central Bank — a technical, but significant difference.

VTB is also about half the size of Sberbank and has significantly fewer depositors.

"Sberbank is the crown jewel of the state-owned banks," Hurwitz said, "and seems to be run with a reasonably conservative mandate, not as a tool for the government."

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