

The Russian Bank Card Market

Introduction

The first plastic card in Russia was issued in 1989; however, over the next 10 years plastic bank cards in Russia were still treated as an exotic phenomenon. By the end of 2001, a little over 10 million cards had been issued. Five years later, plastic card issuance became the fastest growing segment of the Russian banking services market.

Russian credit card market is emerging at the intersection of two growing markets – the plastic (debit) card market and the consumer credit market. In the first four years of the 21st century, debit bank cards turned into a mass product due to salary transfer schemes offered by the banks.¹ By the end of 2004, the number of plastic cards held by individuals has increased fivefold² and exceeded 54 million, reaching the ratio of 0.4 cards per capita. Banking experts predict that the market will keep growing at the same pace which might mean that by the end of 2006 the number of plastic bank cards per capita in Russia will have leveled with that of some European countries, such as France, for example, with 0.7 cards per capita.

The share of revolving credit cards issued in Russia constitutes, however, a rather small portion in the growing stream of bank cards. Revolving credit cards first appeared on the Russian banking services market in 2005, and even despite their high rate of growth,³ the total number of credit cards issued in the first quarter of 2005 was no more than 4% of the total number of plastic cards in Russia. To compare, the share of credit cards in the total number of plastic cards issued in Great Britain constitutes 93%, in Spain 80%, in Egypt 62%, in France 57%, and in Romania 11%.⁴

The superior rate of growth of revolving credit cards is in part a result of the recent phenomenal growth in the Russian consumer credit market, where the volume of lending has been increasing two-fold each year for the past 5 years, recently exceeding 1 trillion rubles (approximately \$37 billion). This constitutes 20% of the total volume of bank-procured credit. Although the volume of lending via plastic cards is only 0,2%⁵ of the total volume of consumer credit, many banks specializing in consumer credit have been switching from one-time special-purpose consumer loans to general-purpose revolving credit cards, which they consider a much more universal instrument of consumer finance.

¹ This service provides for automatic transfer of employees' salary to their bank accounts with a plastic card access.

² According to the Central Bank of the Russian Federation <http://www.cbr.ru/regions/Cards.asp?m=1&RGN=&more=yes&Year=2005>

³ In 2005-2006 the growth rate of credit cards issuance has been higher than that of the debit cards (REFERENCE?)

⁴ Credit card market – development prospects. Journal: Banking in Moscow, 3(135) 2006. <http://www.bdm.ru/arhiv/2006/03/24-25.htm>

⁵ According to GE Consumer Finance, <http://finansmag.ru/enews/16306>

1. Macroeconomic and Institutional Conditions.

In stark contrast to the turbulent 1990s, from 2000 to 2005, the Russian economy has exhibited macroeconomic stability and strong economic growth. Real GDP increased on average by 7% per year, inflation decreased from 20.2% in 2000 to 10.9% in 2005, the increase of real income of the population amounted on average to 10.7% a year, and fixed asset formation increase was 10.7% a year. Stability and growth were accompanied by significant changes in the banking sector. These include the increase in the financial security of the banking system: at the beginning of 2006, banking sector assets comprised 45% of the GDP (compared to 32.3% as of 1 January 2001), capital – 5.7% (compared to 3.9%), credits extended to non-financial businesses and organizations – 25.2% (compared to 11%).⁶ The Russian government and the Ministry of Finance of the Russian Federation designed and approved the Development Strategy of the Banking Sector in Russia for the period ending in 2008. Provided that the measures outlined in the strategy are carried out successfully, the banking sector resources will increase to 56-60% of the GDP, capital – to 7-8%, credits – to 26-28%.

Besides, the Russian government managed to legislate and implement the deposit insurance system (DIS), which guarantees individual depositors that they would be reimbursed if their bank failed or its license has been revoked by the Central Bank. The guarantee is currently limited to an amount not exceeding 100,000 rubles [approximately \$3700]⁷, but is likely to be increased in the nearest future as the amendments to the law have already been submitted to the State Duma.

The first stage in the DIS implementation has been completed by the beginning of 2006 with the inclusion of 931 banks. Their cumulative liability amounted to 2.8 trillions rubles covering more than 99% of personal savings kept in banks in the Russian Federation.⁸ Implementation of the Deposit Insurance System significantly increased people's confidence in banks, and had a positive effect on the dynamics of the banking deposits market: in 2005 personal savings kept in banks grew by 39% reaching 2,817 billion rubles.

In addition, Russian legislators passed several other banking laws aimed at promoting consumer credit markets further, most notably the law on credit histories and Amendments to the Tax Code of the Russian Federation. One of the obstacles to the greater popularity of credit cards was the treatment by the Russian Tax Code of grace period, interest-free period following a credit card purchase, widely enjoyed by Western credit card holders. According to Russian laws, these would be considered interest-free loans, a source of “financial profit,” and a subject to taxation. As a result, Russian credit card issuers typically started charging interest immediately following the charge on the card, which allegedly limited consumers' interest in obtaining and using credit cards. Amendments to the Tax Code effective from January 2005 granted tax exemption on outstanding credit card balances during grace period opening up opportunities for issuing full-fledged credit cards.

⁶ Banking sector of the Russian Federation Review, No. 42, April 2006, Table 1. www.cbr.ru/analytics/bank_system/obs_060301.pdf

⁷ Exchange rate: \$1 = 27 rubles

⁸ Citizens Bank Deposit Market 2005 Review, State corporation Deposit Insurance Agency, 2005, page 4 <http://www.asv.org.ru/insurance/analytics/obzor/>

Federal Law on Credit Histories was adopted in December 2004, and it mandated all credit organizations to submit their current borrowers' credit histories to at least one credit bureau (provided that individuals gave their consent to disclose such information). Since Russian lawmakers envisioned credit reporting as a system consisted of multiple for-profit credit bureaus, the Central Bank was obligated to form Central Catalogue of Credit Histories, which would contain information about the particular location of each individuals borrower's credit history. The system went in to full compliance with the law on 1 March 2006.

The Federal Financial Markets Service (FFMS) was appointed to register and supervise credit bureaus in Russia. It has already registered 14 bureaus in the state register⁹, which provided the Central Catalogue of Credit Histories with approximately 1 million entries. According to Alexei Volkov, deputy head of FFMS Stock Market Makers Review Agency, around 100 organizations have claimed to operate a credit history agency. However, in Volkov's opinion, only 20 of these organizations will eventually obtain official accreditation.¹⁰

The share of foreign capital in the banking sector in Russia remains small (11.5% share), but it is predicted to increase to 25% by the beginning of 2007. The majority of foreign banks currently operating on the Russian territory are involved in retail banking.¹¹ Over the last 3 years, the share of retail lending extended by foreign banks has risen from 3.8% to 8.5%

2. The structure of the market for retail banking in the country

The banking system of Russia has changed a great deal since the 1980s. At the end of the 1980s the monobank system was reorganized into 6 banks: Central Bank and five specialized banks (Sberbank, the only retail bank, which channeled population's savings into financing the state budget; Agrobank, which financed expenditures of the agricultural sector; Stroibank, which extended long-term loans to enterprises; Zhilsotsbank, intended to finance construction and maintenance of municipal housing and Vneshekonombank, which represented the state in operations with foreign currency, manage the currency reserves and extend credit to exporting enterprises.)

The collapse of the Soviet Union and the start of the radical market reforms opened up opportunities for the rapid growth of non-government banking institutions: the very first ones were registered in 1988, and by 1994 almost 3,000 new banks were organized. Following the financial crisis of 1998, the number of lending organizations was reduced: as of March 1, 2006 there were 1197 banks and 47 non-banking lending organizations operating in Russia¹².

One of the peculiar characteristics of the Russian banking system is that most of the banks are very small. The average size of assets of a Russian commercial bank (Sberbank excluded) amount to \$100 million, whereas in South Korea the figure is \$4 billion, in Great Britain \$5 billion, in Japan \$45 billion. Yet, but the degree of concentration in the banking sector is very

⁹ As of March 2006 http://www.fcsm.ru/catalog.asp?ob_no=24284

¹⁰ <http://www.rg.ru/2006/03/07/kredit.html>

¹¹ <http://www.bankir.ru/news/newsline/12.04.2006/50487>

¹² Bank Statistics Bulletin , Central banks of the Russian Federation, 2006, No. 3(154), page 82.

high. The two largest banks, Sberbank and Vneshtorgbank (both state-owned) have over 30% of the functioning banking assets, over 60% of the population's bank deposits, and claim up to 30-40% of the banking profits (five largest banks control 44% of the total assets).¹³ Banks are also concentrated geographically: more than half are located in Moscow, while the number of regional banks as of January 1, 2006 is 641, and their share of the total assets is 16%.¹⁴

On the whole, the Russian banking system remains underdeveloped. In comparison with other countries with a similar per capita income, total banking sector assets account for 45% of GDP in Russia, while in Brazil, Turkey, and Chile they constitute 60-70%, and in Thailand and Malaysia 120%.¹⁵ Only one third (32%) of Russians over 18 years of age have a bank account or a savings deposit. Another 27% use banks for other services, such as paying utility bills, obtaining consumer loans, or transferring money. The remaining 41% make no use of banking services at all.¹⁶ More than half of the Russian households have no savings spending all of their monthly income on current expenses. Confidence in banks remains low: only about a quarter of the Russians consider savings in banks safe and profitable, while 52% regard bank savings as too risky. Notably, 90% of those who are ready to entrust their money to a credit institution would only place it with state-owned Sberbank.

Although consumer lending in Russia currently accounts for 5% of the GDP, the rate of growth in the sector is very high. In 2005, the volume of loans issued to individual borrowers rose 1.8 times (from 616.5 to 1092.8 million rubles), exceeding both the rate of growth of total bank assets (36%) and of banks' overall credit portfolios (40%) (CAN YOU ADD A FIGURE HERE?). Moreover, consumer borrowing is becoming a more popular financial transaction than household savings. From the mid-2005, the amount borrowed monthly by Russian households started to equal the amount of household deposits. The tendency of households to save decreased in 2005, savings comprising only 11.6% of people's incomes.¹⁷

This newly acquired taste for consumer borrowing is reflected in the retail sector. In 2005, 17% of retail sales of cellular phones were financed with consumer loans.¹⁸ According to a major retail network Mir, at the end of 2000 hardly 20% of goods were sold on credit, whereas five years later almost half were.¹⁹ Overall, the share of retail credit purchases increased 2.8 times in 2005 compared with 2004, while the interest rate in most cases exceeded 28% per year, and in some programs even reached the level of 55-60% per year.

¹³ As of 1 April 2006 Overview of the Banking Sector of the Russian Federation No. 3, May 2006, table 6

¹⁴ Regional Banks Rating as of 2005 <http://rating.rbc.ru/article.shtml?2006/03/28/11004120>

¹⁵ A.Ivanter, Expert No. 38 (484), 10 October 2005 <http://old.expert.ru/expert/ratings/exp200/exp2005/38-banki.shtml>

¹⁶ According to the November 2005 poll by VCIOM (All-Russia Centre for the Study of Public Opinion) sponsored by the Agency for Insuring Bank Deposits, *Lichnye Dengi* April 18, .2006 <http://www.personalmoney.ru/txt.asp?rbr=199&id=479835>

¹⁷ Russian Economy Overview, Tsentr Razvitia (Development Center), 2005, page 17

¹⁸ According to research conducted by "Evroset"

¹⁹ http://www.ip-online.ru/articles/a_4152.shtml

According to the leading Russian pollster VCIOM, between 2003 and 2005, 33% of the people applied at least once for bank credit – most commonly to finance audio and video equipment (16%). Yet mortgage remains practically inaccessible – only applied for by 1% of those polled.

Financial literacy and the use of bank services are characteristic of the middle-class way of life. Estimates of the size of the middle class in Russia vary significantly, depending on the definition of the term. According to the assessment of the Independent Institute of Social Policy, in 2003 only 20% of the population could be rated as the middle class. This estimate defined as middle class anyone who satisfied two of the three main criteria: (1) material status and relation to property, (2) social and professional status, usually based on education and (3) self-identification. If self-identification were the only criterion use, the size of the middle class could be extended to 45% of the population.

Official poverty data also indicates a rise in the well-being of Russians: according to Goskomstat, the State Statistical Office, the number of Russians below poverty line dropped from 29% in 2000 to 18% in 2004.²⁰ Although subjective assessments of poverty in Russia are much higher,²¹ they have also been on the decline: in 2005 43% of the population regarded themselves as poor, whereas five years earlier, in 2000 this share was 65%.²²

Russia's Central Bank reports that by 1 January 2006 Russian banks have issued 54.5 million plastic bank cards. In 2005, the volume of card transactions amounted to 2.8 trillion rubles, 94% of this amount accounted for money withdrawals whereas 6% for non-cash purchases (SOMEWHERE HERE WE NEED TO INSERT A FIGURE, FOR INSTANCE OF GROWTH OF THE NUMBER OF CARDS AND TRANSACTION VOLUME OVER THE LAST SEVERAL YEARS). The number of cards per capita is rather small so far – only 0.4. About 20% of the Russian population owned plastic bank cards in 2005.

The majority of the plastic cards in Russia are debit cards, they accounted for 95.5% of all issued plastic cards as of 1 October 2005, 4.4% of cards were credit cards and 0.1% prepaid cards.²³ The majority of debit cards were issued through salary transfer schemes i.e. a switch from cash salary payments to direct bank deposits. Vneshtorgbank reported that 80% of their plastic card were issued through such salary transfer schemes.²⁴

In the 1990s, credit cards (really, overdraft debit cards) were only available only to the banks' most privileged clients. Starting in 2000, the situation changed and the Russian banks started

²⁰ http://www.gks.ru/free_doc/2005/b05_13/06-01.htm

²¹ Subjective assessments of poverty are estimates of the share of the population who, according to the polls, have monthly incomes that are below what these people believe is the poverty line.

²² <http://www.levada.ru/dynamicabed.html>

²³ From the speech delivered by O.V. Prestenko, the head of Retail Payments Development Board of Payment Systems Department of the Bank of Russia, at the 8th Moscow International Payment Cards Forum <http://www.sbercard.com/press/research/>

²⁴ From the interview with Alexander Kuryatnikov, the head of Vneshtorgbank's Retail Services and Payment Transactions Development Department <http://www.prime-tass.ru/news/print.asp?id=356&ct=interviews>

issuing credit cards to the majority of their clients. In the first two or three years, less than ten Russian banks issued credit cards. The year 2004 witnessed significant growth in the number of banks that included credit cards among their retail products. By the end of 2004, credit cards were being issued by 40 banks and the number of credit cards grew six-fold over the course of that year.

The year 2005 was marked by the most rapid change on the credit card scene when Russian banks were given an opportunity to extend the grace period. Many banks added revolving credit cards to their product lines and salary transfer schemes were supplemented with overdraft options. By February of 2005 the first credit card with grace period was issued by Citibank, which later was followed by such banks as Avangard bank, National Development Bank (NDB), Russian Development Bank (RDB) and Impexbank.

As a result, according to banking experts, the share of “credit” cards in the total number of cards issued increased significantly (at the expense of cards issued through salary transfers), their share growing faster in 2005 than in several previous years. For example, the share of salary cards for Rosbank in 2005 was only 27%. For International Moscow Bank, half of its 114,000 cards issued in 2005 were salary cards and another half credit cards.²⁵ The experts predict that credit cards will become the priority in 2006 and thus will replace consumer loans. The number of credit cards may reach 15-20 million by 2008, which will exceed today's 1.8 million ten-fold.

Despite the fact that the debit card market and the credit card market develop in-parallel, leaders of these two market segments are not always the same. For instance, Sberbank of Russia, the leading bank on the plastic card market as well as on the consumer loan market, does not currently offer revolving credit cards. It is usually the case that banks specializing in consumer lending place great emphasis on revolving credit cards whereas banks offering salary transfer schemes favor overdraft cards.

Until 2003, domestic payment systems (Zolotaya Korona, Sberbank’s own brand Sberkart, Union Card) prevailed on the Russian market. Today, 67% of card transactions in Russia are with international cards (Visa, MasterCard, AmEx) and while domestic cards only account for the remaining 33%.²⁶ Visa International issued 41% of all cards in 2005 and is in the lead, followed by MasterCard/EuroCard with 20% and Sberkart, Zolotaya Korona, STB-card and Union Card with 9%, 6%, 5% and 8% respectively. Visa and MasterCard also have the largest ATM network. Overall, the two leading brands, Visa and MasterCard, account for 60.2% of all transactions and 59.8% of all plastic cards issued in Russia. ANOTHER GOOD PLACE FOR A FIGURE OF THE CHANGE IN THE NUMBER OF DOMESTIC AND INTERNATIONAL CARDS OVER THE LAST SEVERAL YEARS

While international card brands currently dominate, domestic systems could potentially challenge their leading position because domestic cards are much cheaper for both cardholders and bank-issuers. For instance, it is believed that Sberbank is capable of creating a domestic

²⁵ <http://bankir.ru/analytics/cards/cards/4/51314>

²⁶ Overview of the Plastic bank cards market http://research.rbc.ru/rev_full.shtml?97/6604097

payment system based on its already developed brand SBERKART. Unlike most international cards, SBERKART cards have a built-in microchip where account information is stored. Regular magnetic strip cards require well-developed telecommunication infrastructure to support on-line authorizations, a persistent problem in Russia. Microprocessors work off-line and can directly compete with small daily cash payments which account for 85% of payments made by the population. SBERKART requires a terminal the size of a pocket calculator. Such a terminal does not require a communication circuit or an external power source; therefore SBERKART can be used in any retail location, even a small kiosk. The number of cards issued by Sberbank increased 6.9 times – from 1.5 million to 10.3 million, and the number of ATMs increased 8.8 times, between 2000 and 2004. In 2006, Sberbank issued one fourth of all the plastic cards in Russia; had the largest card service network in Russia covering more than 2500 cities and towns in 79 regions, and the largest number of ATMs in Eastern Europe – more than 5 thousand.²⁷ SBERKART cards accounted for every third ruble spent by Russian plastic card holders. Thus, Sberbank alone can potentially challenge market dominance of international payment systems.

Growth in the infrastructure supporting plastic card use is lagging relative to card issuance and in absolute terms. While the number of cards issued increased 52% over a period between October 2004 and October 2005, the growth in POS-terminals, ATMs and cash-dispense outlets only stood at 37%. The comparison of the number of ATMs and POS terminals per capita with the countries of the euro zone and the European Union underscores that the Russian market is behind by a factor of ten.²⁸ DO YOU HAVE LONGITUDINAL DATA SO THAT A FIGURE CAN BE COMPOSED OF THE GROWTH RATE OF THE NUMBER OF CARDS AND OF INFRASTRUCTURE ?

Distribution of cards varies greatly across Russia. Moscow and the Moscow region have the largest number of circulating plastic cards – 1.043 cards per capita as of 1 October 2005, whereas in St. Petersburg and Tumen regions (ranked second and third) this ratio is 1.6 times lower: 0.660 and 0.614 cards per capita respectively. Primorky krai (15th place) has three times fewer plastic cards per capita than Moscow region residents.

In the last few years Russian banks introduced plastic cards that combine their usual functions with various discounts, bonuses and loyalty programs. Citibank, for instance, issued a credit card co-branded with a cellular phone provider Megafon which provides certain bonuses to Megafon subscribers. Credit card holders of Russiy Standart are given discounts at "Arbat Prestizh" and "Mir" store chains and can accumulate points when paying for a Russian air-carrier Aeroflot services. Russkiy Bank issues a Diners Club VIP Russian Week card which provides its holders with discount on bonuses and VIP services at mountain skiing resorts. MDM-Bank cardholders are given discounts in "Sedmoi Kontinent" supermarket chain, when purchasing an apartment through MIAN real estate agency or when making car repairs or buying spare parts at "BorisKhof". Avandgard plastic cards holders have discounts in "Sport-City" store chain and such sport bars as "Liga Chempionov" and "Yakitoria".

²⁷ Russian Business Newspaper (Rossiyskaya biznes gazeta) of 19 July 2005, article "Welcome to the payment pool" by M.Dubrova <http://www.rg.ru/2005/07/19/sberkart.html>

²⁸ <http://www.sbercard.com/press/research/cardmarket.php>

Several banks issue cards co-branded with charity organizations. For instance, Slavyanky bank branch in St. Petersburg began issuing Diners' Club card co-branded with the World Wildlife Fund. Holders of these cards do not only enjoy all the services provided by Diners', but also contribute 0.5% of each purchase towards the WWF program that aims at protecting the Amur tiger and the Far Eastern leopard from extinction.

It usually takes between three and five days for a card to be issued, but if it is needed urgently some banks can offer Visa Instant Issue and Maestro Prepaid cards that are given to their holders upon opening a bank account. These cards do not bear the owner's name and are issued by Alfa-Bank, Mezhdunarodny Moskovski Bank, Vneshtorgbank-roznichnye uslugi, Bank of Moscow, Impexbank, MDM-Bank, Delta-Bank.

Smart cards with build-in microprocessor are issued by 22 and serviced by 14 credit organizations in the Visa system, and by 12 organizations in the MasterCard system. Among them are Sberbank, Bank Vozrozhdenie, Vneshtorgbank, Moscow Credit Bank, SDM-BNK, Zenit, and the Bank of Moscow.

Another technological innovation involves text messages sent to cardholders' cellular phones with the amount, time and place of each transaction. This service prevents against fraud and is offered by Sberbank, Absolut-Bank, Zenit, and a few others.

The use of cell phones to pay for services is less widespread. In Moscow, Sberbank, Alfa bank and Moscow Bank of Reconstruction and Development are the only banks that allow their clients to pay for services through their cell phones. In addition, there is a system of cell phone payments, SimMP, based on another platform (Gorod), which is supported in 54 cities and towns of Russia with the exceptions of Moscow and St. Petersburg. Gorod allows to pay for municipal services, intercity and international calls, home and cell phones, periodicals subscription, insurance premiums and even investments.

Internet banking is growing in popularity. In 2002 there were only 12 banks providing some forms of Internet banking services, among them Autobank, Guta-bank, 1st OVK, SDM-Bank, etc. In 2006 the number of such banks increased and now includes Alfa-Bank, MDM-Bank, International Moscow Bank, Promsvyazbank, Citibank, and a few others. Citibank representatives claim that in the first two months over 80% of the bank's new clients use Internet to access their account information, and later more than 60% of their clients become active users of Internet banking.²⁹ While there is no official data on internet banking users in Russia, experts estimate that this service is used by a few tens of thousands of people. In this respect Russia is far behind the USA, Western and Eastern Europe, China and India.

3. Information sharing among the banks.

The volume of consumer lending in Russia grew by 19.7% in 2004-2005, which prompted international rating agency Fitch to lower Russia' rating in its February 2006 report on banking

²⁹ http://www.expert.ru/economy/2006/04/internet_banking/print

system risks.³⁰ ANOTHER FIGURE OF THE GROWTH OVER THE LAST SEVERAL YEARS?

Fitch's conclusion regarding increased risks corresponds with the rapidly growing overdue balances on outstanding consumer loans. Over the course of 2005, they increased 2.77 times and exceeded 20 billion rubles,³¹ surpassed the growth rate of consumer lending. As a result, 2.1% of borrowed credits were in default in February 2006. But the official data do not reflect the real situation with "bad debts". Evgeny Bernshtam, founder of "Sekvoya" collecting agency argues that there are no banks in Russia with less than 5-6% of bad credits in retail banking. The most severe problems occur in banks that specialize in express loans,³² where the rate of bad loans can be as high as 10%.³³ Express lending relies on simplified credit assessment schemes with the hope that high interest rates on such loans will compensate for defaults.

Unlike the developed market economies, in Russia with its relatively young banking system, and in the absence of substantial retail lending experiences and working credit bureaus it has been virtually impossible to create scoring models due to the lack of necessary data about behavior of consumers. It is equally impossible to use scoring models developed in the USA or in Europe because reliable borrowers' characteristics in Russia are different from those in countries with highly developed market economies. For instance, due to widespread practice of shadow salaries income data reflected in accounting documents are incomplete. Income does not correlate as strongly with education as it is in Western countries and, therefore, education cannot be one of the instruments in evaluating income. Spatial segregation of the population is nonexistent in Russia, thus the place of residence also does not reflect one's financial situation.

The first credit bureau in Russia was organized by the Association of Russian Banks in 2003 in the form of non-commercial partnership comprising several dozens banks with 60% of the cumulative credit portfolio of Russia's banking system (in March 2005 it transformed into the National Bureau of Credit Histories). In October 2004, Russia's Interfax Information Services Group, data and service provider for the financial market and UK-based Experian, world leader in the sphere of information business solutions that created credit bureaus in 12 countries including the USA and Great Britain, created credit bureau "Experian-Interfax" with 50% share each.

According to the current law, credit bureaus can be created by private citizens, an organization, or a bank, though one party's share cannot exceed 50%. This allowed large banks to create their own pocket bureaus. For example, Sberbank and Russkiy Standart, the leaders in consumer lending, already created their own credit bureaus. Although Sberbank signed an agreement regarding information exchange with the National Bureau of Credit Histories Bureau (NBCH), it will only provide NBCH with the information on bad debts. According to Kazmin, the head of Sberbank, positive credit histories will be stored only in "Infocredit", the bureau that was created

³⁰ Fitch deems risky annual increase of more than 15%

³¹ *Russian banks in retail business*, overview of "RusRating" rating agency, October 2005

³² Express credits are the credits for purchase of goods, which are extended by the banks in the places where the goods are sold: such stores as M-Video, Mir, IKEA, etc. Credit capacity of a client in express banking is determined in 20-30 minutes.

³³ <http://www.personalmoney.ru/txt.asp?id=463018&rbr=199>

by Sberbank itself at the beginning of 2005. The leaders of consumer lending market are not interested in sharing positive account information with other banks. While registered bureaus are obliged to provide account information to interested credit organizations, "pocket bureaus" can price their clients' credit histories very highly making it unprofitable for other banks to obtain them.

In the absence of a working credit reporting system interbank information exchange takes place through informal ties between employees of banks' security departments responsible for verifying new applicants' data. Information about cases of fraud or bad debts can be shared through these interbank ties. There is also a "black list" of passport numbers that were used in fraudulent credit applications.

Interbank cooperation on processing of card transactions is also low. In 2003-2005 many Russian banks, even those that are not among the leaders of the plastic card market, opened their own processing centers. This tendency reflects the lack of trust among banks, and the desire of many banks to expand their card business and the range of related services.

4. Rules and conditions for credit cards issuance by the banks (based on the analysis of banks' advertisements and application materials).

Formally, in accordance with the Civil Code, a citizen of Russia is deemed financially responsible starting at the age of 18, and a few banks, one of them is Alpha Bank, do issue credit cards to 18 year olds. But the majority of Russian banks issue their cards to people over 21-22 years of age (the Bank of Moscow, BIN Bank, Deltabank, Impexbank, Raiffeisenbank, Citibank, Sobinbank, Financebank, Uniastrum), most likely to eliminate undergraduate students. Some raise their minimal age to 23 (Russkiy standart) or even to 25 (Absolut Bank, MDM). But age is not only an obstacle for young people, but for the elderly too. Some banks use the formal retiring age as a cut off point, and in some cases women lose the ability to have a credit card issued earlier than men, as they may retire at 55, whereas men only at 60. Citibank sets the upper age limit at 60, Russkiy Kredit bank at 65, and Rosbank is willing to issue overdraft cards even to working pensioners.

In addition to age limitation, there are rules regarding minimum income. Generally, to get a credit card one has to have a permanent income of no less than \$300 a month (HOW DOES THAT COMPARE TO AVERAGE INCOME IN MOSCOW?). Alpha bank, which caters mostly to younger people, and Uniastrum bank, whose target clientele are lower layers of the middle class, set a lower minimal income of \$200 a month. Absolut bank does not issue cards to people with income less than \$700. And practically all the banks specify that successful applicants should have their current job for no less than 3-6 months (in the case of Absolut bank, a year). Not a single bank requires co-signers that would guarantee payments in lieu of the applicant, but many banks only issue credit cards to their own current or past customers (even if holders of a salary card under a direct salary deposit agreement with their enterprise). Car or real estate ownership can improve bank's impression of applicant's creditworthiness. Many banks require official reference from the place of work indicating income (form 2NDFL) or a bank-provided form filled out by the accounting department and signed and sealed by the employer. Citibank accepts cellular phone bill receipts to confirm 'gray' income. To confirm employment, some banks ask for a copy of the work history book signed by the employer.

To confirm their identity applicants are required to present their passports and some other ID. If only passport is available, some banks can still issue a credit card but with a small credit limit.

All of the banks insist that applicants should have permanent residency registration and permanent employment in the geographic area where they apply.

Processing of a credit application and the issuance of the card usually takes 7 to 10 days (EARLIER YOU SAID 3 TO 5!!). Application forms can be filled out in the bank office, with a consultant in the retail location, by telephone or via the Internet, and the card can be received in the bank office or in the retail location.

The bank determines the size of the credit limit, but in some cases, such as for instance in Impexbank, the applicant may request the desired credit amount. Citibank advertisements claim maximum credit limit of 750,000 roubles (\$25,000), Bank of Moscow, BIN Bank, MDM-bank, Alpha-bank, Impexbank, Raiffeisenbank, Rosbank set the limit at \$10,000 (or euro), Deltabank and Zenit at 90,000 roubles, Master bank at \$5,000. But practically it is difficult to get the maximum credit limit because in most cases it depends on the borrower's income. For instance, in the case of revolving credit cards from MDM-bank or Alpha-bank, credit limit equals 200% of the monthly income. For overdraft on debit cards, its size cannot exceed monthly income (90% in Raiffeisenbank, and 50% in SDM).

Unlike most American and West European banks, where interest rates are set at the level of 15-20%, in Russia it may exceed 50% per year. The effective credit rate, i.e. such that includes all the extra charges and commissions by the bank, is not always clear from bank advertisements. For example, Home Credit and Finance Bank (ranked third by volume of consumer lending) advertises credit cards with a 28% annual interest rate, but with a 1.8% monthly commission for account maintenance the borrower actually has to pay 40% a year. Likewise, Russkiy Standart (second by volume of consumer lending after Sberbank) uses formula "29% annually plus 1.9% monthly," and Rosbank "24% annually plus 1% and 30 rubles monthly."³⁴

To stimulate cardholders to use cards for non-cash payments (rather than cash advances), banks charge between 0.5% to 2% fees on cash advances on credit cards while card use to pay for goods and services is free. Russkiy Standart set a record by charging 7.9% for cash advances on its cards and then reducing it to 'only' 4.9%. However, there are some exceptions, too: Vneshtorgbank does not charge fees on cash advances.

5. Strategies to assess creditworthiness used by Russian banks.

The major problem of developing credit card markets from the banks' point of view is uncertainty. Who and on what conditions should be issued cards?

During the period when the interviews were conducted (July 2004 – March 2005) Russian banks were using several different methods of assessing creditworthiness including expert evaluations, rules and scoring systems. Credit scoring was not used in Russia in the same way it was developed and applied in the West. There were a few cases of banks turning to international

³⁴ <http://www.rosbank.ru/ru/services/persons/credit/consumer/?id411=1103&i411=1>

sellers of credit scoring solutions that offered models developed with the data collected in Eastern Europe. However, these scoring models were never used unmodified; instead Russian banks adapted them to their own expert perceptions of clients' characteristics in groups targeted for credit card products. As a result, they produced a version of a point system (rather than a true scoring model) based on the experience of Eastern European markets.

All the banks unanimously agreed that the main goal of creditworthiness assessments was minimizing defaults rather than calculating profitability of prospective applicants or learning about how to improve the model. Minimizing defaults was viewed as the most conservative strategy and the one that was favored by banks' upper management. While risk department specialists understood that in order to optimize their risk assessment strategies it was necessary to learn about what distinguishes bad clients from good ones, they favored this approach as the most prudent in the highly risky environment of an emergent market.

In addition to screening customers to minimize defaults, banks also tried to compensate for possible losses with high interest rates. However, market competition limited their ability to raise interest rates.

The standard procedure involves a meeting of the applicant with a bank's employee, where the applicant fills out an application form and presents the originals of the required documents. The application is then passed on to the bank's security service and to the credit risks evaluation department. The security service verifies the authenticity of the documents provided by the applicant and the information stated in the application; the credit risk department calculates a credit line that is suitable for this client if the security service confirms the authenticity of the documents and the information integrity. Since it takes 7-10 days to obtain a credit card the banks have enough time to verify the most important information in 100% of cases. Usually they authenticate passport, place of work, place of residence, ownership certificates on real estate or a vehicle. If such an examination shows that the applicant produced a fraudulent passport, put down the incorrect place of residence or work or allowed for any other discrepancy the application will be rejected. One of the banks interviewed requires that the applicant be contacted by the bank's employee at one of the phone numbers provided in the application (it cannot be a mobile phone number). If the employee fails to reach the applicant, such an application will be rejected irrespective of the applicant's level of income.

The card can issued only after the security service's approval. The size of the credit line is determined on the basis of the applicant's income. All the interviewed banks agreed that evaluating income is the most difficult task. The main problem is the prevalence of "grey" incomes, not reflected in official employer-provided 2NDFL forms. That is why the banks have to work out a mechanism which allows estimating the additional income. There is a wide variety of such mechanisms.

- In many banks an applicant has to bring a note from his/her workplace stating the monthly income certified by the accounting department.
- Property ownership (real estate, vehicles) information can be used to evaluate income, however, only real estate that has been purchased by the applicant rather than privatized free of charge is considered.

- Information regarding the applicant's expenses, for example, his/ her payment for mobile telephone services, can also be taken into account.
- Some banks use information concerning the applicant's family members' income to estimate the additional income. Even though none of the banks uses a guarantor system when opening a credit card (i.e. family members will not be legally bound to pay in lieu of the applicant), banks assume that there is a system of mutual support within a family and, if the applicant is unable to pay s/he may turn to other members of the family for help.
- The opposite is true as well: if there are many dependents in the applicant's family, his or her expendable income decreases, and bank's income estimate decreases as well. Some banks use the difference between income and expenditures to determine credit limit, and ask applicants to state not only their incomes but also regular expenses such as alimony payments, rent, or payments on other loans.
- The banks can also estimate income based on the information regarding applicants' education, position, and area of expertise. If this amount does not vary significantly from the one the applicant stated in the application it is also taken into consideration.
- Finally, when banks make a decision about issuing a credit card to their own clients they estimate income based on the account activity.

In one of the banks we were told that their point system estimates how fast an applicant can find a new job if s/he is fired or resigns from the old one by giving more weight to applicants with qualification of high demand and those who were hired on a competitive basis. But banks are not only interested in applicants' ability to pay, which depends on their income level, but also in their willingness to pay on time. Since it is hard to measure directly (no applicant will ever tell the bank that s/he is a not a very reliable person and does not always pay his/her debts), banks have to resort to indirect measures of applicants' trustworthiness, such as information from phone or utilities companies on how accurately the applicant pays his/her phone bills, rent and utilities fees. The applicant's credit history is also verified to the extent possible via informal ties between banks' security departments.

When asked about defaults the majority of banks reported that their rate is low. Most clients pay even in the absence of an effective system of debt collection. If a cardholder is late on a payment for the first time, banks usually wait. If there are good reasons for the overdue payment, the cardholder does not try to disappear and the balance is paid within the next month, the bank applies no sanctions, not even those that are stated in the client's credit agreement. However, if the client makes no payment during 2-3 months, the bank starts searching for the cardholder. Bank representatives first make a phone call, and if the borrower can be reached offer to resolve the problem without legal action, i.e. to restructure the debt. However, if the cardholder refuses to pay or tries to avoid the bank, the case is passed to the bank's security service that tried to convince the borrower by means of telephone calls and personal visits to return his/her debt. Some banks resort to the services of collector's firms, which by and large use the same methods – phone calls and personal visits reminding borrowers to pay. If this strategy does not help the case is supposed to go to court.

However, the bankers interviewed stated that they did not resort to court decisions very often doing their best to settle the case before it went to court. The reason for such attitude is that while it is fairly easy to prepare the necessary documents and to achieve positive ruling of the court, it is close to impossible to attain its execution. That is why the banks stated that they prefer personal negotiations with a client regarding debt restructuring to legal action. Since the number of unpaid debts is relatively small the banks resort to legal action only in cases of great sums of money.

There are several types of strategies used by Russian banks on the credit card market. The first one is conservative – the banks implement a credit card in order to make their product mix more complete and give it to their own customers using expert judgments and point systems to assess creditworthiness of prospective cardholders. Their goal is not to conquer the market, but to provide their regular customers with the service they need so that they are not forced to seek it at another bank.

The second strategy is moderate, and is based on an attempt to acquire a market share and to use the credit card as a lure for new customers. In this case banks employ point systems to evaluate creditworthiness but plan to switch to a scoring system in the nearest future. In order to achieve this goal the banks take steps towards creating credit bureaus and customers' databases.

The third strategy is a risky one. Its primary goal is not to develop effective methods of assessing creditworthiness, but to prevent most obvious cases of fraud while setting very high interest rates to compensate for future losses, thus making good reliable borrowers pay for bad ones.

One of the peculiarities of the modern Russian credit card market and the consumer credit market in general is the fact that despite high interest rates and deceitful advertisements by many banks that concealed the real cost of credit to the consumer, it was this third, risky strategy that turned out to be the most successful in 2005. The banks that pursued it experienced a significant client inflow and high profit due to high interest rates. The quality of their credit portfolios was relatively high since those banks being pioneers of the credit card market used aggressive marketing and attracted many good borrowers with little knowledge about the actual interest rates. In addition, economic growth fueled increasing demand for consumer credit. And banks that chose a careful, wait-and-see attitude as their strategy found themselves in a less advantageous position having lost market share as well as profits.

The situation is starting to change. High interest rates have attracted many new banks to issuing credit cards making the market more competitive and providing more choices for the borrowers. Borrowers are also becoming savvier, many of them learning about the real price of credit first-hand. In addition, important changes are happening in the legal sphere. The law on credit histories and amendments to the Tax Code were adopted. The banking community has been advocating for a personal bankruptcy law. In the nearest future Russian banks will have to start sharing information through credit bureaus and develop and apply scoring model since only the improvements in assessing creditworthiness will prevent the crisis of mounting unpaid debts in the atmosphere of borrowers' growing financial competence and increased market competition.

What do banks see as the main problem(s) of credit card market development in their country?

One of the central problems in the Russian credit card market is the lack of effective interbank information sharing. In most countries of the world, creditors regularly exchange information on the solvency of borrowers via credit bureaus of credit histories. The experience of the Western markets indicates that the need for credit bureaus arises when borrowers are geographically mobile, the market is huge and there are no banks monopolizing the market. All of those conditions are absent in Russia. Geographical mobility of borrowers is limited and means at best moving to Moscow or St. Petersburg from other cities. The market is at present limited and mainly comprises of people living in the capital and large cities of Russia. In addition, the market is dominated by Sberbank: as of 1 January 2006 it accounted for 48% of the total volume of consumer lending. If we add to it the fact that trust among banks is low today, it is clear that the prospects of setting up efficient credit bureaus in Russia are not very bright.

Another problem is that cards continue to be used for cash withdrawals rather than to pay for goods and services. And despite the rapid growth in the number of cards issued, there have been no significant changes in the way that cards are used. According to the Central Bank of the Russian Federation, the share of non-cash payment for goods and services in the total number of card transactions remained practically unchanged for the past three years comprising 15.3% in 2001, 15.2% in 2002, 12.9% in 2003 and 14.9% in 2004.³⁵ And the share of non-cash transactions in Moscow and the Moscow Region did not greatly differ from the average share for Russia. This is largely a consequence of the fact that for a long time the growth in card distribution has been achieved as a result of salary projects, where the card was only used twice a month to get cash on paydays robbing banks from merchant discount – a percentage they get from every non-cash card transaction.

The third and final problem is the inefficiency of legal actions to collect on credit card debts as discussed above (it is also fundamentally unprofitable owing to the usually relatively insignificant amount of credit card balances).

At present the Russian credit card market is going through the stage of fast growth with banks competing for their share and the risk of defaults increasing. The strategy of charging high interest rates to compensate for future defaults has outlived itself as competition in the market forces banks to lower rates. Improving the quality of assessment of applicant's creditworthiness involves introducing scoring methods and setting up an effective institution of interbank information exchange via credit bureaus. The latter process however is hampered by a low degree of trust in institutions among the banking community, and by Sberbank's near-monopolistic market position.

³⁵ Banking Overview, No. 3(69), 2005