

New Strategies to Finance Small Enterprises in Russia

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Abstract

Restricted access to finance is often stated as one of the main obstacles to the development of the SME sector in Russia. In this paper, we propose a new lending strategy that allows private banks to profitably increase financing of this sector in spite of being at a disadvantage compared to the state-owned Sberbank. By building a reputation for tough liquidation in cases of financial distress private banks can overcome information asymmetries by self-selection. However, this strategy can only work if (i) bankruptcy law allows for easy liquidation, (ii) the banking industry can sustain positive profit margins, and (iii) interest rates are not too high.

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1 Introduction

The importance of the small business sector for the long-term performance of countries in transition is now generally recognized. The World Bank's Report *Ten Years in Transition* even claims that if the share of employment and value added by small enterprises does not exceed a critical threshold, economies do not take off in terms of sustainable growth. In this sense, the report blames the overall poor performance of the Russian economy during the nineties not least on the failure to develop the sector of small and medium-sized enterprises (SME). However, the causality is difficult to establish. The poor performance of the SME sector may have caused slow economic growth, but it may also be yet another symptom of the underlying deficiencies of the transition process. In any case, it appears beyond doubt that the economy would gain from a more vigorous SME-sector.

After a period of considerable growth in the first half of the 1990s, the SME sector in the Russian Federation has stagnated since the mid-90s. The number of small enterprises is now commonly stated at about 1 Mio., but exact figures must be interpreted with care. Many small firms that are registered have long ceased to operate while others work in the informal economy and are not recorded in official statistics. The *Russian SME Observatory Report* (Russian SME Resource Centre (2002)) finds 843.000 small enterprises in 2001. Including the figures for individual entrepreneurs, the report infers a 'pronounced positive trend' in the development of the sector. However, this trend is reversed when only enterprises are considered, as is shown by table 1 below. In comparison, a *Goskomstat* census conducted in 2000 was able to identify 631.000 small firms in the Russian Federation, which can be considered a bottom line.

Previous research identified various reasons for the dismal growth record of the sector: high tax burden, insufficient legal protection, excessive administrative requirements, and — as one of the most severe impediments — restricted access to finance. In Russia, the common problems of small business lending are magnified by the undercapitalization of the private banking sector, lack of relevant experience, and underdeveloped and distorted financial markets. The state-owned Sberbank continues to dominate the deposit side and has lower refinancing cost than private banks, which would have to provide the lions share of SME-lending if the situation was to improve

substantially.

As the figures in table 2 show, access to start-up capital is still the most severe problem of entrepreneurs who want to set up a business. The situation has improved somewhat since 1997, when banks were primarily interested in government bonds. However, difficulties to ensure finance are still stated more often than problems related to the operational side of a new business, such as finding a location and equipment etc. Finance-related problems such as *lack of resources for investment* and *insufficient working capital* appear to decrease in relative significance compared to more directly operations-related issues, once operations are set up (see table 3). The low number of firms mentioning *conditions of credit* as a problem should not be misinterpreted as that credit conditions were favorable in general, since only few firms actually received commercial credit and could therefore report problems with the terms of loans (see also *SME Observatory Report*).

Another question the OECD survey put to entrepreneurs was how difficult they estimated a given task to be solved. Among the tasks perceived as ‘very difficult to solve’, *Access to bank credit* ranked fifth behind problems with the authorities and operations-related issues. However, 32.9% of financially stable and 51.6 % of unstable firms classified credit access as ‘very difficult’, showing that obtaining external funds is still a considerable problem.¹ Again, this result is supported by the *SME Observatory Report*. On

¹It should also be noted that any such survey is by nature only conducted among the firms that succeeded to establish a business, i.e., it includes a bias towards those entrepreneurs that finally ensured start up capital, access to credit etc. To estimate the share of business ideas that failed to be realized due to finance-related problems is an interesting task but is beyond the scope of this paper.

Table 1: Change in number of Small enterprises (incl. individ. entrepreneurship), 1992-2001

	1998	1999	2000	2001
Individual entrepreneurs, thousand units	3.599	3.875	4.237	4.497
Small enterprises, thousand units	868	891	879	843
Farms, thousand units	270	261	262	262
Total, thousand units	4.737	5.027	5.378	5.602

Source: Russian SME Observatory Report, July 2002

Table 2: Difficult problems for small businesses: Start-ups

	2001	1997
Start up capital	54.2	78.5
Finding place of work	47.2	31.3
Finding equipment	31.9	20.1
Establishing links with customers	26.4	25.7
Finding employees	22.2	4.2
Respondents were asked ‘What were the most difficult problems for you in founding and starting the operation of your enterprise?’ Respondents could choose up to three answers. The figures give the percentage of respondents choosing each category. <i>Source:</i> 2001 OECD survey in the regions of Irkutsk, Tula and Udmurtija		

Table 3: Difficult problems for small bus.: Day-to-day operations

	2001	1997
Low purchasing power of consumers for your main products	39.9	55.8
High level of competition	26.4	20.4
Lack of resources for investment	22.8	23.1
Rental conditions	22.1	19.7
Insufficient working capital	21.5	31.3
...
Conditions of credit	9.9	5.4
Respondents were asked ‘Which factors are the greatest obstacles to the operation of your business today?’ Respondents could choose up to three replies. The figures give the percentage of respondents choosing each category. <i>Source:</i> 2001 OECD survey in the regions of Irkutsk, Tula and Udmurtija		

one hand, the report finds that many Russian SME still seek considerable funds from related persons instead of bank loans, an effect that is more pronounced for small than for medium-sized enterprises. On the other, those SME that require loan funding find it primarily aggravated by ‘very high interest rates, unrealistic collateral requirements [...], [and] limitations on the duration of the loan [...]’. To summarize, the results of both surveys indicate that access to external finance is still considerably hampering the development of the SME sector. The significance of the problem may further increase as company profits are shrinking since 2000/01 and the availability of internal funds is reduced.²

²According to Goskomstat (2002), cross-section company profits shrank by 3,7% from January to July 2001 compared to the same period in 2000 and by 34,1% from January

While there is ample evidence of the difficulties of SME to raise external funds, it is not clear whether this problem can be addressed by specific interventions on the part of the state or development agencies. Obviously, certain characteristics of small business can make it more costly for banks to lend to the sector. First, problems of asymmetric information are usually more severe for small and start-up firms, that is, small business finds it more difficult to comply with requirements for transparency and to communicate business plans effectively. Second, the fixed costs of loan processing are harder to recover with small loan volumes. Finally, private banks have to compete against the state-owned Sberbank, which has lower refinancing cost due to its state guarantee on deposits and (implicitly) on other liabilities. Therefore, the evidence of financial constraints revealed in standard questionnaires on SME finance may simply reflect the inherent difficulty of the task.

In this paper, we argue that, notwithstanding the higher cost of SME lending, there exists a potential in the Russia market to profitably increase lending to the sector which is currently not exhausted. This claim is supported by evidence collected in interviews with experts in this market as well as by theoretical analysis. We propose a lending strategy for private banks which allows them to overcome information asymmetries in the market by inducing firms to separate by self-selection. This leads to an improvement of the private banks' borrower pool. Thus, focusing on lower risk clients private banks are able to profitably lend to SME in spite of the lack of transparency and the cost-disadvantage they face vis-a-vis the state-owned Sberbank. The strategy requires a credible commitment to liquidate firms on the onset of financial distress. With this reputation, the interest rate has to be set so that for low-risk firms the gains from the lower rate outweigh the higher expected cost of liquidation, while for high-risk firms they do not. Then, private banks attract a better pool of borrowers, which enables them to obtain profits in equilibrium, to broaden their capital base and to extend their loan portfolio. Apart from fostering the SME sector, this would contribute to the stabilization of the banking sector.

However, the feasibility of such a strategy requires a long-term perspective on the part of the banks. It depends critically on the overall interest rates, and thus on the macroeconomic stabilization policy, the perspectives on

to July 2002 compared to 2001.

bank restructuring and the bankruptcy law. We defer the discussion of the policy implications to the last section.

The remainder of the paper is organized as follows. Section 2 analyzes the problems of small business financing in Russia in more detail. Section 3 develops the elements of the lending strategy. Section 4 concludes and provides policy implications.

2 Impediments of Lending to SME - evidence from expert interviews

In this section, we consider the relevant terms of a loan, in particular the collateral requirement, the duration of the loan and the interest rate. We base our analysis on the results of previous research and expert interviews we conducted with representatives of KMB Bank, Commerzbank and ING as well as a written statement from Probusiness Bank.³ It will turn out that the western banks hold a very different view from that of most surveys and of their Russian counterpart.

Let us first consider collateral requirements. Previous research identified the lack of collateral as "one of the most important hindrances in small enterprise development" (Takis 2002). High taxes and administration costs that are due upon liquidation of assets and the uncertainty regarding the seizure of assets lead to common collateral requirements of about 200%. Probusiness Bank largely confirmed this point, stating that lack of sizeable liquid assets was one of the most common reasons for loan applications to be refused. However, other sources doubt the conventional view. KMB Bank claims that among its loan applicants, collateral poses a problem only to firms that either do not trust their own business enough to offer as much collateral as they could or that want to finance investments that exceed the capacity of their firm. In this respect, meeting collateral requirements could be seen as to signal the integrity of the manager and the feasibility

³KMB Bank is by far the most active lender to SME in the Russian market and the only one with significant activities in Russia's regions. Commerzbank is a long-term market observer, as well as is ING, which is also active in the investment banking business. ING provided us with a general market overview rather than information on SME lending. Probusiness Bank is a Russian bank with activities focusing on Moscow and Moscow Region.

of the business plan.⁴ In addition, Commerzbank as well as KMB Bank suggested that bankruptcy procedures are better than often claimed, which raises the value of collateral. Although bankruptcy procedures might take considerable time to be completed and the seizure of some classes of collateral such as primary residence is subject to restrictive rules, recovery rates are quoted as to range from 50% to 90% for small firms.⁵ However, the current Law on Insolvency has often been blamed for allowing creditors to initiate bankruptcy procedures too easily or even unwarranted. This point has recently been addressed by the ratification of a new law, which raises the hurdles for creditors to file for bankruptcy of a debtor. Whether this law improves the protection of borrowers or mainly complicates bankruptcy procedures will only be revealed after full implementation.

The second important feature is the duration of the loan, which is very short for almost all loans to SME. It usually ranges from a few months to one year for ruble-denominated loans and from 1 to 3 years for dollar loans. Impeding firms' investments into fixed assets, the main reason for these short durations is that the majority of banks' liabilities such as deposits or inter-bank loans are also short-term. On that point, all interviewees agreed. Commercial banks increasingly attempt to attract medium-term deposits through offering favorable rates, but the success of this strategy to date seems modest, not least due to the dominating position of Sberbank in the market for deposits.⁶

The third relevant feature is the interest rate of the loan. On average, it ranges from 13-17% p.a. for USD-loans and 22-30% p.a. for RUR-loans. High interest rates are often stated by firms and entrepreneurs as impeding access to finance, an evaluation that is supported by the above fig-

⁴It should be noted that KMB Bank mostly referred to cases of personal liability of the entrepreneur. To loans of higher volume and limited liability of managers, e.g., in medium-sized firms, these results might not fully be applicable.

⁵Lambert-Mogiliansky, Sonin and Zhuravskaya (2000) suggest that alliances between regional authorities and managers of large enterprises use bankruptcy procedures to expatriate outside investors, while they find no evidence that political interests affect bankruptcies of small enterprises. This supports the view that recovery rates are on average higher for small firms than they are for big ones.

⁶However, Goskomstat data show that there is a trend towards medium-term deposits. Growth rates for deposits of 180 days and above are higher than for short-term deposits. The trend is particularly pronounced for household deposits (ruble and foreign currency deposits), a segment of which Sberbank holds more than 70% market share.

ures. However, when considering the rates for ruble loans, one should take into account inflation rates of approximately 15% p.a.⁷ Neither KMB-Bank nor Commerzbank considered high rates as hindering investment activity. Probusiness Bank, in contrast, stated high rates as one of the problems of SME when applying for bank finance, in particular for RUR-denominated loans.⁸

The above analysis confirms the view of previous works and surveys in that imperfections in the loan market lead to comparatively high credit costs for small firms. However, we also find evidence supporting our view that profitable lending opportunities are left unexploited in the Russian market. In particular:

- Available market data, surveys etc. confirm that there is considerable demand for small loans that is not met by the banks;
- At least some experts with the market hold the view that small firms are able to cope with the prevailing loan terms;
- The *SME Observatory Report* and other surveys point out that successful small enterprises can obtain high profits in Russia, such that the comparatively high credit costs don't provide sufficient explanation for tight loan rationing.

Previous research offers explanations for why Russian commercial banks may in general be reluctant to lend to the SME sector. One point that is frequently made (and was also quoted to us) is that they lack the technology and well trained staff that is necessary to make loans of small size a profitable business (see, e.g., the *SME Observatory Report*). However, this problem

⁷Note that the IMF Country Report (April 2002) quotes 8.3% as the median real lending rate in transition countries. This is for loans across all firm sizes and risk classes.

⁸One can think of some additional reasons for why KMB Bank and Probusiness Bank have different views on lending to SME. First, KMB Bank is possibly approached by a different kind of firm than Probusiness Bank. KMB does most of its business in Russia's regions while the activities of Probusiness are concentrated in the Moscow area. Second, KMB was set up to lend to small enterprises only, so that its business strategy focuses on this sector. Probusiness follows a broader strategy and does not have such a strong focus on SME. Third, KMB grants loans starting from less than USD 1.000 while Probusiness' minimum loan volume is USD 50.000. It is therefore likely that the two banks are not exactly lending to the same segment.

can be solved through relatively modest investments and is in fact addressed not least by technical assistance projects.⁹ In addition, KMB-Bank and a few others (e.g., EBRD, Delta Credit) provide evidence that lending to SME can be a highly profitable business (see also Tacis 2002, SME Observatory Report). With repayment rates of more than 98%, the quality of small-loan portfolios is well above the average of loan portfolios of Russian banks.

We conclude that the supply of loans to SME in Russia is inefficiently low and that this is in parts due to a lack of adequate long-term business strategies of Russian commercial banks. This analysis is shared and was brought to our attention by people who are familiar with and active in the market. In the following section, we propose a new strategy for Russian private banks that allows them to profitably lend to SME despite the information asymmetries that prevail in the market and lower funding cost of Sberbank.

3 Strategy for Lending to SME

Our theoretical analysis can be related to recent research on the financing decisions of firms that focuses on the role of banks as flexible providers of funds. Berlin and Loeys (1988), Chemmanur and Fulghieri (1994) and Bolton and Freixas (2000), among others, emphasize the advantages that bank loans have over securities in that they lower the probability of inefficient liquidation and reduce the bankruptcy cost of firms. This advantage results, first, from banks being able to monitor borrowers at lower cost than individual bond holders (Diamond (1984)), and second, from the fact that the renegotiation of bank loans is easier than the restructuring of a dispersed bond issue (Lummer and McConnell (1989), Hart and Moore (1995) and others). Chemmanur and Fulghieri (1994) explicitly model the competitive advantage banks can establish over bond markets by building up a reputation for renegotiating loans of firms in financial distress. Our model draws on these results but is different in structure to account for the particularities of the situation in Russia. First, we restrict our focus to bank loans. In Russia, as in many transition economies with underdeveloped financial markets, issuing bonds or equity is a feasible source of funding only for a few blue-chip

⁹Projects of technical assistance that addressed this point were, for example, the World Bank's *Management & Financial Training Project* (1994-99) and the *Financial Institutions Development Project* (1994-2002).

companies. Second, when considering loan renegotiation by banks, we focus not only on direct returns but also on returns from reputation effects. In this respect, our approach draws on the work of Chemmanur and Fulghieri, but we obtain the opposite result. Rather than establishing a reputation for renegotiation, we will show that in the particular conditions prevailing in Russia, banks have an incentive to establish a reputation for liquidating all firms in financial distress. This effect results mainly from the virtual absence of a bond market and the corresponding different outcome of the self-selection process of firms.¹⁰ Our analysis is also close in spirit to that of Sharpe (1990) in that it draws on the idea of *implicit contracts* based on the reputation of lenders. We will see that similar to Sharpe and the works of Shapiro (1983) and Allen (1984), loan rates must exceed marginal costs in order to make the liquidation policy credible.

3.1 The Model

We analyze lending strategies in a simple model of asymmetric information about borrower risk. The financial sector is composed of two types of banks, state-owned Sberbank and privately-owned commercial banks. We capture a central feature of the Russian loan market by assuming that Sberbank has lower funding costs than private banks due to a state guarantee it gives on deposits.¹¹ There are two types of firms in the market, safe (s-) and risky (r-) ones. Each firm has an investment project with positive net present value that requires external funding for 2 time periods and yields output x if successful. Firms are assumed to be unable to access financial markets directly, that is, to issue bonds or equity. The investment (loan) volume is normalized to 1, entrepreneurs have no wealth. Financial distress can be caused either by a temporary liquidity shortage of economically viable firms, in which case a firm could recover if its loan was extended, or by accumulated losses of unprofitable firms. By tradition and political pressure, the dominant state bank is obliged to consider the renegotiation of loans

¹⁰The outcome is also influenced by the assumption of higher funding costs for private banks, see below. If we relax this assumption, building up a reputation for renegotiation may *also* be a profitable strategy for private banks, but it does not influence the quality of our results.

¹¹For most short-term household ruble deposits, of which Sberbank holds 70-80%, it pays 1-3% less on interest than the average for commercial banks. (IMF 2002)

to enter the market through pursuing the same renegotiation strategy as the state bank it is not competitive due to its higher funding cost.¹³ If, instead, it commits to immediate liquidation of all distressed firms without monitoring and builds up a reputation for toughness, we will show that it can enter the market successfully and obtain positive profits in equilibrium. This might seem counter-intuitive as the expected value of monitoring is higher than the liquidation value. However, as the result of self-selection, only safe firms apply for the loans of the private bank, which increases its returns and compensates it for the losses from ex-post inefficient liquidation and a lower interest rate.

3.2 Self-selection of Firms

When economically viable firms enter into financial distress, it is efficient that the bank renegotiates (extends) their loans. However, this requires that the bank assesses the condition of the firm to avoid accumulating bad loans. Let q denote the conditional probability that an economically viable firm in financial distress is identified as 'viable' and its loan is renegotiated. If a bank considers renegotiation (i.e., it monitors distressed firms), then $q > 0$, if it does not, $q = 0$. A loan contract D is then defined by a renegotiation policy q and a repayment R , $D = \{q, R\}$. As R can always be expressed in terms of principal and interest, $(1 + r)I$, we refer to it also as interest. If the private bank commits to liquidation of all distressed firms, it offers a contract $D_{pr} = (0, R_{pr})$ while the state bank offers $D_{st} = (q, R_{st})$. Firms separate by self-selection if all safe firms prefer D_{pr} to D_{st} , whilst all risky firms prefer D_{st} to D_{pr} . In particular, it must hold that

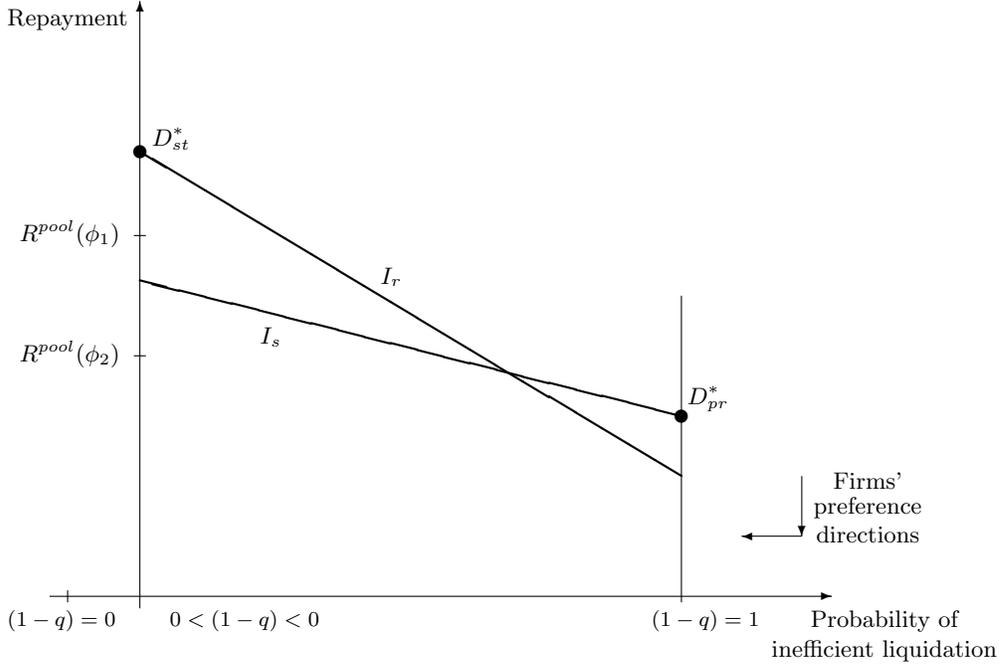
$$J_s^{pr} > J_s^{st} \quad \text{and} \quad J_r^{pr} < J_r^{st} \quad , \quad (1)$$

$$J_i^j = (1 - p_i)(x_i - R_j) + p_i p_{v|d} q (1 - k) x_i \quad ,$$

where J_i^j denotes the return of firm i under the loan contract of bank j , $i \in \{s, r\}$, $j \in \{pr, st\}$, and $p_{v|d}$ denotes the conditional probability that a firm in distress is viable.

¹³We do not assume any other significant cost advantages of the private bank such as in monitoring or other operational costs.

Figure 2: Equilibrium Loan Contracts



As safe firms have a lower distress probability than risky firms, for a given decrease in the interest they accept a bigger increase in the probability of inefficient liquidation, conditional on distress. We illustrate this relation graphically in figure 2. In a q - R -space, r -firms have steeper indifference curves than s -firms. Thus, in equilibrium, there exists a pair of contracts such as D_{pr}^* and D_{st}^* , which fulfills equation (1) and leads to the separation of firm types.¹⁴

The private bank sets a repayment R_{pr} which is sufficiently low such that the saved interest payments outweigh the higher expected costs of inefficient liquidation for safe firms. But it is also sufficiently high such that mimicking safe firms by choosing D_{pr} is not a profitable strategy for risky firms. That is, interest savings do not outweigh costs of inefficient liquidation for r -firms. In graphical terms, D_{pr}^* must not lie below the point where I_r intersects the vertical line through $(1-q)=1$, as otherwise the self-selection mechanism breaks down. As usual, the existence of a separating equilibrium requires

¹⁴The existence of this equilibrium requires the share ϕ of safe firms to comply with a parameter condition. The interested reader is referred to the more detailed analysis in Matthey (2003).

restrictions on the parameters, in particular that the fraction of high risk firms is not too small. Graphically, it has to be ensured that the minimum repayment a bank has to charge in a pooled borrower market with renegotiation ($R^{pool}(\phi)$) in Figure 2) lies above the point where I_s intersects the ordinate, as is the case for ϕ_1 . If, however, the share of high risk firms is too low, an equilibrium fails to exist.¹⁵

3.3 Policy Credibility

The described self-selection mechanism crucially depends on the credibility of the banks' strategies on the onset of financial distress. Following Sharpe (1990), we will call these policies *implicit contracts*. The state bank's commitment to monitoring is public knowledge. Because the monitoring process has a higher expected return than liquidation, the implicit contract to evaluate distressed firms is self enforcing. However, as the state bank is vulnerable to political pressure, it is also "state-enforced". For the private bank, credibility has to be achieved through reputation building. The implicit contract offers higher returns at present at the price of lower (expected) returns in the future.¹⁶ The bank threatens with liquidation in order to deter risky firms from applying for its loans. However, sticking to the threat to liquidate distressed firms without monitoring leaves both players, bank and viable firm, worse off in the short run. Although the bank can execute the liquidation threat because distress gives it power over the firm, short-term rational behavior would induce it to monitor all firms, as the expected return from monitoring exceeds the liquidation value. Given rational expectations, risky firms would anticipate the bank's deviation from its liquidation policy and free-ride.

¹⁵In particular, external parameters are assumed to be such that

$$R_{pr_{max}} = R_{st} - \frac{p_s}{1-p_s} p_{v|d} q (1-k) x_s > \frac{r_{pr} - p_s y}{1-p_s} = R_{pr_0} \quad , \quad (2)$$

i.e., the maximum repayment the private bank can charge in order to obtain separation, $R_{pr_{max}}$, is higher than the zero-profit repayment, R_{pr_0} . r_{pr} denotes the funding cost of the private bank, R_{st} is the repayment of the state bank's loan contract.

¹⁶In this sense, our model is opposite to that of Sharpe (1990). In his model, the bank promises to charge good firms lower rates in the future than its partial information monopoly would permit. In turn, it charges all firms higher rates at present. This means that the implicit contract promises good firms a higher return in the future at the price of a lower return at present.

To make foregoing short-term profits from monitoring profitable, and thus credible and self-enforcing, it is crucial that banks develop a long-term horizon. In particular, in order for reputation building to be worthwhile, the discounted profits from lending to safe firms in the future have to exceed the expected losses from inefficient liquidation of economically viable firms today, i.e., it requires that

$$p_{v|d}q(kx_s - y) - C_E < \sum_{t=0}^{t_{max}} \frac{1}{(1+i)^t} \Pi_{pr,t}^{sep} \quad , \quad (3)$$

where t_{max} denotes the planning horizon,¹⁷ i the discount rate and $\Pi_{pr,t}^{sep}$ the bank's profits at date t if separation is obtained.¹⁸ Equation (3) shows that in order for the separation mechanism to work, three conditions have to be fulfilled. First, the private bank's profits from lending to safe firms in the future have to be sufficiently large. These profits increase when monitoring is difficult (high cost C_E / low precision q). In this sense, the strategy appears to be well suited to the shortage of trained credit officers and the intransparency of firms in Russia. Second, the bank's planning horizon has to be sufficiently long, and third, the discount rate has to be sufficiently low. In other words, reputation can only be sustained in a competitive environment if the discounted value of economic rents that are earned up to the planning horizon exceeds the loss from inefficient liquidation. If this condition is met, the bank has an incentive to carry out its threat, which

¹⁷Note that the planning horizon in our model is not a fixed moment in time but a finite number of periods. This means that the planning horizon moves forward with time passing by. In any period when reputation building/sustaining is considered, the planning horizon is equally far away. A final period is never reached. This is different from Sharpe (1990) and others, that assume banks to exist for an infinite number of periods. However, the moving planning horizon (planning period) in our model has the same effect of removing the problem of backward induction. For discounting future profits it is only relevant "how far ahead banks look".

¹⁸Equation (3) is based on the assumption that if the private bank renegotiated a loan once, its reputation of toughness would be so badly damaged that a big enough number of risky firms was immediately attracted by the lower repayment such that non-negative profits could not longer be obtained. This might seem a strong assumption (and to a certain extend is a simplification). One argument for this is, that banks in general are expected to renegotiate loans. Thus, if a bank, even though it built up a reputation for toughness in the past, renegotiates once, most firms will assume that now "everything is back on track" and the bank remarkably loses bargaining-power in future negotiations of loans in financial distress.

makes this threat credible and deters risky firms from applying for the loan with the lower interest.

4 Conclusions and Policy Implications

Increasing investment in small and medium-sized business, developing corporate law including bankruptcy law, and the development of the banking sector towards stability and competition are issues that are high on the agenda of economic policy in Russia. Our research shows that these issues are linked. In spite of the dominant position of the state-owned Sberbank, and informational problems in lending to small and medium-sized business and in particular business start-ups there is room for private banks to finance this sector and at the same time broaden their capital base. However, the mechanism of self-selection through reputation building that underlies this strategy depends on adequate policies in the areas of bankruptcy law, banking reorganization and interest rates.

Bankruptcy law needs to provide both, a framework for lenders to liquidate borrowers quickly and at reasonable cost, and protection of firms against unwarranted liquidation by lenders eager to take over control of the firm. The former is necessary to make liquidation a realistic and credible alternative to renegotiation, while the latter reduces the probability of inefficient liquidation to cases of actual financial distress, limiting its expected cost. However, as our analysis has shown, even liquidations which are inefficient ex-post can be efficient ex-ante as they make self-selection of borrowers possible. Under the current legal provisions, two particularly critical points must be noted. The first is the use of primary residence as collateral, which is often hindered by the difficulties with relocating the residents. The second is the inefficient court system, which commonly results in lengthy delays before a court rule is obtained. In addition, the current law has been criticized for allowing creditors to initiate bankruptcy procedures against a debtor too easily and even unwarranted. This point has explicitly been addressed by a new Law on Insolvency (Bankruptcy), that President Putin signed into law on October 26, 2002. Under this new law, thresholds for bankruptcy claims are raised and periods required to file an action with an arbitrazh court (i.e., the period after a court order is sent and the debtor is given notice) are extended. Whether these provisions provide better protection of debtors

against inappropriately acting creditors can only be assessed after their full implementation. However, the authorities implementing the law should ensure that the liquidation process in general is not protracted or compounded and that creditor rights are not weakened. Otherwise it will become even more difficult to lend to SME as information asymmetries cannot be solved through self-selection.

The role of Sberbank, the large number of commercial banks and their inadequate capital base are recurrent issues in the current debate about banking reform. Our analysis shows that the privileged position of Sberbank may be less of a problem than it may appear at first glance. There is still room for profitable activities by new entrants. This is good news, as it is doubtful whether revoking the state guarantee for Sberbank is in fact desirable or even politically feasible. Given the poor record of Russian private banks, it is not surprising that many Russians confide only in Sberbank. Hence, any change in the bank's status might heavily affect the behavior of depositors, without delivering measurable gains due to stronger competition. It is the large number of banks and their insufficient capital base which is the major obstacle to the proposed lending strategy. With many banks in the market, it will be difficult to maintain the positive profit margins required for reputation building to be worthwhile. Even though a competing bank cannot undercut the interest rate directly without sending the wrong signals to potential borrowers (i.e., attract risky firms), strong competition may erode profits through provoking inefficiently high expenditures on support activities such as advertisement, maintenance of a high number of outlets etc. For this reason, and because our analysis suggests that efficient lending can be achieved without a fully levelled playing field, the main concern for the restructuring of the banking sector should be to improve financial health rather than to intensify competition. Hence, active restructuring aiming at a lower number of banks with better capital ratios is warranted. While a market-based process of consolidation is under way in the banking sector, there is a risk that banks, highly uncertain about their prospects of long-term survival, will focus unduly on short-term goals. By actively consolidating the sector, rather than leaving this task to the market, the transition will be faster and the remaining banks will be able to start investing in long-term assets such as reputation.

Finally, as with any investment, reputation building is only worthwhile if

interest rates are not too high. Hence, economic and monetary policy must work towards stable and low real interest rates. Otherwise, banks will value profits only in the very short run. As our analysis shows, high interest rates hurt SME twice. First, they raise capital cost in the usual way, as they do for large and well-known firms. Second, they aggravate incentive problems by destroying the mechanisms by which information problems in credit markets can be overcome.

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