

**DO EXISTING DEVELOPMENT BANKS HELP OR HINDER ATTRACTING MORE  
DEVELOPMENT FUNDS TO THE RUSSIAN SME SECTOR?**

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## Abstract

This study addresses two questions: the first is whether the activity of development banks has positive real effect on the attraction of more funds into the Russian SME sector, and the second is whether the interaction of them can have any distortive role. My analysis shows that the activity of development banks in whole has positive effect on the SME financing, which perfectly coincides with their mandate. However, their real impact raises some doubts. As for the analysis of interactions, I find that the activity of some of development banks actually triggers “crowding out” effect, which is an evidence of their negative role. While the latter cannot be addressed by any viable policy recommendation, the former activity can be significantly improved in several ways, which were also mentioned in this study.

*Keywords: development banks, Russia, RSBF, SME financing, EBRD, EDB, KfW, IFC, IIB, SME bank*

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## **List of abbreviations**

AfDB – African Development Bank

AsDB – Asian Development Bank

BAS – Business Advisory Services

BDC – Development Bank of Canada

BNDES – Banco Nacional de Desenvolvimento Economico e Social

BSTDB – Black Sea Trade and Development Bank

DB – Development Bank

DFI – Development Financial Institution

EBRD – European Bank for Reconstruction and Development

EDB – Eurasian Development Bank

EGP – The Enterprise Growth Programme

EIB – European Investment Bank

FMO – Nederlands Fin.– Maatschappij voor Ontwikkelingslanden NV

GDR – Global Depository Receipts

IADB – Inter–American Development Bank

IBRD – International Bank for Reconstruction and Development

IPO – Initial Public Offering

IFC – International Financial Corporation

KfW – Kreditanstalt für Wiederaufbau

LIBOR – London Interbank Offered Rate

MBD – Multilateral Development Bank

NDB – National Development Bank

NPL – Non–performing loan

IDB – Interstate Development Bank

IFRS – International Financial Reporting Standards

JBIC – Japan Bank for International Cooperation

OeEB – Oesterreichische Entwicklungsbank AG

OECD – Organization for Economic Cooperation and Development

SME – Small and medium-sized enterprise

SME bank – The Russian bank for Small and Medium Enterprises support

SPV – Special Purpose Vehicle

SRBF – Small Russian Business Fund

VEB – Vnesheconombank

## INTRODUCTION

Small and medium-sized enterprises (SMEs) are the backbone of the economy of all developed countries, so according to the Organization for Economic Cooperation and Development (OECD), 95% of all enterprises in its member countries account for the SME sector (OECD, 2012). That is why it is not a surprise that this sector is also a key source in the field of employment, where on average more than 60% of all employment in the private sector (in some countries, such as South Korea, much higher – 87.7%) is concentrated. It also supports regional development and social cohesion (Dalberg, 2011). In this sense, the decision of many developing countries and transition economies to set up a goal on the development of SME sector seems to be a quite logical step. Some theoretical articles suggest that nowadays SMEs are considered as *nostrum*, covering the economy (see Reddy, 2007).

Recent globalization and trade liberalization have opened up both new opportunities for SMEs and challenges for them. Only a small number of SMEs are able to take advantage of these opportunities and to cope with the challenges. While the majority of SMEs in developing countries and transition economies are not able to benefit from globalization, being under the pressure from cheaper imports and foreign competition (de Mel S. et al., 2011). The situation in these countries is significantly aggravated by underdeveloped capital markets, as the result, SMEs do not have enough access to funds because they are trapped in so-called “missing middle”, i.e. situation when large firms have better access to credit products of domestic banks and international capital, and financial needs of microenterprises are met in some extent by non-bank microfinance institutions, while demand of SMEs on financial resources stays uncovered somewhere in the middle (Perry, 2011).

At the same time, it should be explained why commercial banks are reluctant to SME financing (especially toward the provision of highly needed medium- and long-term funds). It is mostly connected with the lack of official information, which SMEs are able to provide to commercial bank, as well as lack of collateral. That is why, in order to be involved in this sector and estimate the risk of quite opaque agents, commercial bank has to be geographically close to its customers for having access to the soft



information, i.e. information not expressed in official documents. Traditionally only small local banks have such opportunity.

Nevertheless, there are several more reasons:

- Banks are tempted to service far more profitable segments of the market in which they can make money without incurring additional risk appeared in the SME financing. Banks in countries with immature financial systems often encounter less competition and lower costs, and therefore can earn attractive profits by lending to large public and private players.
- Servicing this segment, banks incur high administrative costs per unit of credit (which in many respects is occasioned by the existing requirements for capital adequacy and Basel II (Balling et al., 2009)), because of the small size of loans.
- In general, banks face the problem of providing long-term capital. Banks in developing countries often rely on short-term liabilities (such as deposits). Therefore, issuing long-term loans to borrowers (including SMEs), banks bear significant risks, because of mismatch in the timing of payment of loans and deposits.
- Banks also have difficulty in the provision of financing in foreign currency. SMEs seek financing in the currencies that match their income flow. As an illustration, if a company receives income in EUR, it tends to get financing in the same currency, and if, on the contrary, the firm's revenue is denominated in the local currency, it seeks to avoid the loan in EUR. Banks in developing countries sometimes face restrictive local regulations and the availability of local currency, which makes financing in foreign currency more difficult to implement.
- Banks need special skills to provide various loan products for SMEs. The lack of these skills leads inadequate risk management, and hence low levels of repayment and profitability.

High costs, lack of skills and high risks of investing in SMEs lead to increased interest rates and collateral requirements. Sometimes commercial banks require more than 150% of the loan amount as collateral and interest rates in some regions can be thus 5–6% higher than the world average (Dalberg, 2011). Because of that SMEs try to find alternative sources of capital, for instance, trade credit, loans from friends (relatives), financing from the state.

In this situation, government always tries to help SMEs. For example, in industrialized countries, there is still quite a long tradition of providing subsidized loans and grants to all types of SMEs in order to increase their competitiveness. At present, many countries prefer to support the realization of their export potential, improve the access to technology for SMEs, issue loans, and provide insurance against exchange risk. Sometimes their activity even spreads across countries. So, the program Phare, focused on SME support and initially was conducted only in the members of the European Union (EU), but in April 1999, was also extended to the candidate countries to join the EU (Dickinson, 2008).

Nowadays even some developed countries, for instance, France and USA are going to establish special state-owned banks focused exclusively on SME financing. Some developing countries *a fortiori* did not remain on the sidelines and even set up development banks engaged exclusively in SMEs' servicing (for example, in India the Small Industries Development Bank (SIDBI) was established and in Turkey – Halkbank). Thus not surprisingly this activity became quite important for the financial institutions not directly related to the SME support – for instance, the first program implemented independently by the German Kreditanstalt für Wiederaufbau (KfW) in 1971 was exactly a program focused on the SME support – SME Programme, which was refinanced using only the funds raised from the capital markets. As well as some prominent International Financial Institutions (IFIs), for instance, International Financial Corporation (IFC), the European Bank for the Reconstruction and Development (EBRD), Asian Development Bank (AsDB) also did not remain aloof from this issue.

For the Russian economy SME development is critical. Today's structure of economy is based on such giants as Gazprom, Rosneft, Norilsk Nickel and other companies, profitability (and thus the budget revenues) of which is highly determined by macroeconomic environment. That is why in turbulent times it creates an additional pressure on the economy. Furthermore, for the country's competitiveness, it is important to develop knowledge-intensive industries, which needs to be done in Russia, but the only way for implementing it is in the development of SME sector as SMEs are the main providers of innovations.

Nowadays, the Russian SME sector accounts only for 20–25% of its GDP, in comparison, for example, with 50–70% in Europe (SME bank, 2012). While the market of SME financing estimated at 147

billion USD,<sup>1</sup> includes mostly small loans with the following characteristics – approximate size is about 163.4–228.76 thousand USD<sup>2</sup> and terms up to 2–3 years (Expert RA, 2012), which is apparently not enough for the development of SME sector. Hence guided by this logic, government created the Russian bank for the SME support (SME bank) which actually started to operate in 2011 despite the fact that initially it was established in 1999.

The importance of SME development is also supported by the presence several more development banks operating in this segment in Russia. Among them are both aforementioned ones – KfW, IFC, EBRD and several different – International Investment bank (IIB), the Black Sea Trade and Development Bank (BSTDB), the Eurasian Development Bank (EDB), the Nederlands Fin.–Maatschappij voor Ontwikkelingslanden NV, Oesterreichische Entwicklungsbank AG (FMO), the German Investment Corporation (DEG). However, these entities are not static, they do interact with each other and the direction of this interaction is quite different. This arises two major questions:

- Does the activity of these institutions have any real effect in the provision of more funds to the SME sector?
- Can the interactions of development banks have distortive effect on more SME financing?

Previous research provides little insight to answer these questions. The problem of the efficiency of the activity of DBs has been discussed by Kornai (1979), La Porta, Lopez de Silanes, and Shleifer (2002), Rodrik (2004), Yeyati et al. (2004). However, all these studies were primarily focused on the state participation in the economy in general and development banks were only one part of such story, while this research is focused on a particular industry (SME sector) as well as has strong country facet. The second question has not been even raised in the literature as development banks were usually considered separately without inclusion of any interactions between (among) them especially ones, which can potentially have any negative aspect. In this study, I provide a detailed analysis to address these questions.

<sup>1</sup> Портфель кредитов МСБ в РФ вырастет в 2012 г. на 23%, до 5 трлн руб – Райффайзенбанк. 2012. Bankir.ru. 23 октября. <http://bankir.ru/novosti/s/portfel-kreditov-msb-v-rf-vyrastet-v-2012-g-na-23-do-5-trln-rub-raiffeisenbank-10029907/> [Portfolio of SME loans in Russia will grow in 2012 by 23%, up to 5 trillion rubles – Raiffeisenbank.].

<sup>2</sup> Here and further – all currencies were for consistency converted into USD using exchange: 1:30 for RUB, and 3:4 for EUR.

Hence, the structure of the *Thesis* is organized as follows: *Chapter 1* gives some overview of the activities of development banks based on their role and its change in time, funding, some of their basic activities, financial results, and also regulation and supervision; *Chapter 2* and *Chapter 3* are devoted to the description of two strategic groups of development banks operating in Russia mostly as static agents or dynamic ones with respect to their past; *Chapter 4* covers primarily the dynamics – the interactions of development banks and the future direction of development of both of these groups, *Conclusion* is devoted to the summary of obtained results and some policy recommendations.

## CHAPTER 1. The overall activity of national and interstate development banks

This *Chapter* is intended to provide some general overview on the essence of development banks starting with explanation which institutions can be attributed to this category, whether there are any groups of such institutions, and why their role as well as attitude of economists toward their existence changed across time. Then *Chapter* moves to the present and describes their funding, products and financial performance. As this study *inter alia*, aimed at provision of some policy recommendations, regulation and supervision of these institutions are also considered.

### 1.1. General overview on the development banks and their classification

According to the methodology of the World Bank, a national development bank (NDB) is

“a bank or financial institution with at least 30 percent state-owned equity that has been given an explicit legal mandate to reach socioeconomic goals in a region, sector or particular market segment.” (de Luna–Martínez and Vicente, 2012, p.4).”

In principle, this definition can be implemented to the case of interstate development banks (IDBs) with the only crucial difference – the latter fully belongs to the group of countries (e.g., BSTDB) or even some international institutions (e.g., EBRD).

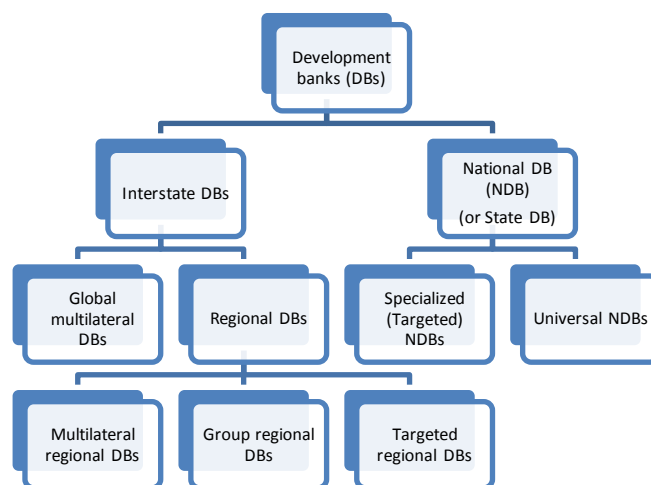
Ideally, the development bank (DB), along with the task of eliminating the market failure and financing projects with maximum impact on socioeconomic development (projects with high social effects – externalities), should also encourage financial institutions to provide a stable, long-term financing to the enterprises, especially in the sector of SMEs (primarily through the B-loans, i.e. loans issued to final borrowers through financial intermediaries as oppose to A-loans issued to final borrowers directly by DB, and using co-financing schemes). They have quite cheap in comparison with commercial banks funding due to their ability to use high ratings obtained from the international rating agencies, to borrow at low interest rates, and access to public and private deposits and savings. At the same time, it is quite crucial mistake to think that DBs try to allocate these cheap sources guided only their policy mandate (i.e. without considering at all the quality of the potential borrower), because they do also have some business model and always consider some minimum level of profitability, which they need to sustain. Thus they often do have quite sophisticated procedures on risk assessment and impose

quite high criteria on their partner banks, this is an explanation to the fact that their balance sheets often include quite low level of non-performing loans (NPLs), though with some exceptions. As for example, in the case of IIB, which became bankrupt because of irresponsible policy in loans' issuance.

Several general features about the activity of modern DBs are the following (Mathur, 2003; Throne, 2009):

- I. Their activity is complementary toward the activities of financial institutions (principle of non-competition with the private players in the market);
- II. They focus on providing medium and long-term financing (mostly through the B-loans);
- III. They pursue the objectives of the economic policy of the state (group of countries) but have independent management;
- IV. Their resources are directed to the development of pre-defined priority areas;
- V. They are mostly involved into wholesale operations rather than retail ones (which will be discussed below);
- VI. Development banks are getting very complicated structures including the whole group of institutions specialized in development of certain areas. For instance, some NDBs were created as highly specialized banks (e.g., for the development of certain industry), but then were split into a smaller number of banks with no obligations to develop specific areas (although there is still very powerful special type of NDBs – export-import banks, but in some countries (e.g., Brazil, Germany, Russia) they are included into a group of NDBs).

Based on several dissertations (see Kuleshov, 2004; Shkolyar, 2004), I classified the existing development banks according to the composition of their states-owners and their main objectives (see *Figure 1*).



**Figure 1. Classification of development banks**

Source: created by the Author

First of all, the whole set of DBs can be divided into two broad categories – *interstate* and *state (national) development banks* (they mainly will be two main subjects for the next subchapters). There are several countries not necessarily concentrated in some particular territory in the ownership structure of the first group. In the second one, respectively, there is only one state-owner.

Secondly, the subset of NDBs can be split into two groups: *specialized and universal NDBs*, where the former includes banks, which activity concentrated in lending of some particular sectors, areas and economic activities (e.g., Agriculture bank of Turkey, Export–import bank of the United States, SME Development bank of Thailand). As a rule, the latter includes larger banks, which service neither particular sector nor special category of borrowers. Moreover, these banks often consist of the group of specialized banks (e.g., Brazilian Banco Nacional de Desenvolvimento Economico e Social (BNDES), Russian Vnesheconombank (VEB)). At the same time, if the activity of NBD is also spread to the other countries, they should be called *bilateral development banks* (e.g. KfW, FMO, OeEB).

Thirdly, the subset of interstate development banks (IDBs) can be divided into two categories: *global multilateral* and *regional development banks*. The first group includes financial institutions responsible for the realization of the concept of sustainable development on a global scale (e.g., World Bank). The second group, in turn, consists of three main types of institutions: *multilateral regional development banks*, *group regional development banks*, *targeted regional development banks*. Nevertheless, before giving a detailed description of these subgroups, the difference between

“multilateral” and “interstate” should be specified. If the bank was established by several states, it is called “interstate”, but if in the establishment of the bank a number of international financial institutions also participated, then this bank should be called “multilateral” (Shkolyar, 2004). It is quite obvious that the latter term is narrower and is included in the former one.

*Multilateral regional development banks* include institutions which promote economic progress of developing countries and transition economies located in a particular area (that is why in my opinion, World Bank should be excluded from this category) – for example, African Development Bank (AfDB), Asian Development Bank (AsDB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IADB). An important feature of these banks is the fact that they use the experience of the World Bank in the sphere of the issuance of credit instruments, assessment and implementation of projects, application of the rules for spending (Kuleshov, 2004).<sup>3</sup> *Group regional development banks* consist of banks, which are responsible for certain sub-regional tasks (integration, infrastructure, trade facilitation) from own resources of the regional member countries and focused primarily on the private sector development (e.g., the European Investment Bank (EIB), EDB, BSTDB). The establishment and functioning of *targeted regional development banks* is determined by ideological considerations (e.g., Islamic Development bank; IIB, which initially was created for a development of socialist countries).

The given classification will be serve as the further basis for the next subsections, where describing different activities, I will firstly describe them from the point of view of NDBs and only after that – from the view of IDBs, because of the presence of significant differences between these two groups of institutions and inability to integrate them into a single group.

## 1.2. Historical overview on the activities of development banks

Development banks began to appear en masse in Europe after World War I and played an important role in the development of several countries, for instance, Belgium, Hungary, Italy and Poland.

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<sup>3</sup> One could argue that EBRD can be excluded from this category, but it is multilateral institution since the owners of this bank are international entities (European Union and EIB) and it is regional since its activity is concentrated in a particular territory (e.g., it does not support projects in Latin America or Africa). However, according to several dissertations (see Shkolyar, 2004), in a broad sense one can still simply call AfDB, AsDB, IADB and World bank multilateral development banks.



Their activity was focused on providing long-term loans to relatively new industries: steel, iron and shipbuilding – sectors, which were able to ensure accelerated economic growth. At the same time, among the owners of these institutions were also private financial intermediaries, and the charters of development financial institutions had begun to include the possibility of supplementary finance, which led to the spread of co-financing (de Aghion, 1999).

The period after World War II brought the next wave of development financial institutions' building, among them perhaps the best known and most successful institutions at the moment – the World Bank (through the establishment of the International bank for Reconstruction and Development – prototype of the rest multilateral development banks), the German KfW and the Japan Development Bank (JDB).<sup>4</sup> They were established in order to manage government funds for reconstruction; later their activity was focused on long-term financing and the provision of additional guarantees for commercial loans to borrowers with limited ability to pay (e.g., SMEs). At this time, in many less developed countries similar government institutions were established in order to administrate loans provided to the country by the World Bank or provide long-term financing for new industries. Despite the fact that the loans provided by these DBs were relatively small in size, they had played a significant role in the dissemination of skills in the area of financial operations and capital in the years of limited access to financial resources (Özturk et al., 2010). But the most significant shortcoming in their work was the low level of interaction with the commercial banks, which hindered the transfer of knowledge on long-term projects' financing between public and private players. Only two institutions – KfW and JDB – were obliged to cooperate with commercial banks mainly through the implementation of co-financing schemes (de Aghion, 1999).

Quite new entities – development banks with owners concentrated in a particular territory – appeared in 1960–1970s, which were lately called *regional development banks*; among them are: IADB (1959), AfDB (1963), AsDB (1966).<sup>5</sup> Initially they were established because of the need to solve problems specific to a territory (Braaten, 2012). These banks were responsible for financing of agriculture, social

<sup>4</sup> It should be also pointed out that JDB is not the first development bank established in Japan, because in 1902 the Industrial development bank of Japan had appeared (Yasuda, 1993).

<sup>5</sup> In a broad sense, these three plus EBRD make up the category of regional development banks, which is not quite correct, as it will be stated below.

sector (education, health, etc.) and poverty alleviation. After the energy crisis occurred in 1970s, they started to focus on investments in the hydrocarbon and other energy resources in developing countries. In 1980s their activity was concentrated in implementation of structural and sectoral programs aimed at large-scale reforms in economic policy and the quality of management in a particular sector as well as the whole economy (Mistry, 1995).

Theoretical views were consistent with empirical evidence at that time. Some prominent development economists, for example, Alexander Gerschenkron, Arthur Lewis and Gunnar Myrdal tended to agree that the state should play a key role in the banking sector, especially in countries with significant capital constraints, where development banks can help to alleviate capital scarcity and promote entrepreneurial action to ensure economic growth. In literature this approach was called the *industrial policy view* and was further developed by modern economists (e.g., Rodrik, 2004; Yeyati et al., 2004), according to which development banks cannot only boost the overall number of projects, but also increase capital investments and the overall profitability of firms.

Nevertheless, the years of the dominance of this concept were over with the adoption of the Washington Consensus (1989), when the economic policies of many countries accepted the paradigm of neo-liberalism – the belief in the self-correcting power of the market. The so-called *political view* began to dominate not only in literature, but in reality, which is mostly connected with the emergence of two hypotheses: *the soft-budget constraint hypothesis* and *the rent-seeking hypothesis*. The former means that development banks tend to bailout companies that would otherwise fail (or “zombie” companies, see Kornai, 1979), i.e. describes a moral hazard problem. The latter argues that state-owned banks are tool for maximization personal objectives of politicians or engagement in patronage deals with politically-connected industrialists (La Porta, Lopez de Silanes, and Shleifer, 2002), which means that subsidized credit or cheap equity is provided to the projects which would be normally funded and launched using market sources of capital.

As a result, public financing of priority sectors began to decline, and the situation in many countries was aggravated by significant fiscal deficits caused by activities of some entities including development banks (Thorne and du Toit, 2009). Many of these banks were not only poorly managed and

regulated by the state, but were not also integrated into the financial system properly. Even well-managed banks had to follow very contradictory objectives – on the one hand, to maintain financial stability and, on the other hand, simultaneously achieve socially significant results; these contradictions had led to privatization, restructuring or liquidation of many development banks, which led to the appearance of the term – the “paradox of development banks”. Its essence is in fact that their failure occurs mainly in poor countries with weak economic and political systems, where their activity is a necessary component of the mechanism of economic policy.

However, the state-owned financial institutions in many countries not only survived, but were still actively involved in the development of the economy. This was caused mainly by two factors: first, along with the collapses, there were some successful examples of the activity of development banks, and secondly, in the countries, where banks were liquidated or privatized, market failure persisted, and it had to be addressed (Thorne and du Toit, 2009). DBs were actively involved in the process of transition of the whole national economy. For example, the Brazilian BNDES was actively involved into the wave of reforms on privatization and liberalization implemented by the governments F.C. de Mello (1990–1992) and F.E. Kardoso (1995–2002) in the 1990s through the preparation and implementation of privatization, loan purchasers of state property, the purchase of minority interests of some former state enterprises (Lazzarini et al., 2011).

Development banks played an important role during the recent global financial crisis, when many NDBs were responsible for performing of countercyclical role, not only by correcting the market failure through the issuance of loans to private firms (both in general and in certain segments, such as lending to SMEs), but also by funding projects that create new jobs, allowing to solve one of the main objectives of economic policy – combating unemployment. In many countries DBs were responsible for the bailout of large companies facing financial problems. It was shown in several articles that the activity of development banks during the crisis ensured a substantial part of short-term economic growth (see Griffith-Jones et al., 2008; 2011). One of the most important roles of MDBs in this period was and still is to smooth fluctuations in private capital markets in middle-income countries (Griffith-Jones et al.,

2008). Due to the abovementioned activities, interest to the development banks as the structures that can act as a stabilizer of the economy during the crisis was renewed.

### 1.3. Ownership, capital structure and funding

The state in various forms (federal or local government, various ministries) is the shareholder of NDBs. Notwithstanding, according to this criterion, DBs can be divided into three groups:

1. DBs, 100% owned by the state (e.g., VEB in Russia, the German KfW, the Development Bank of Canada (BDC), which by the way also pays dividends to the Government). Many NDBs keep funds in a special account at the Central Bank, the Treasury, or the Ministry of Finance; in this case they are more likely to be development funds<sup>6</sup> rather than banks.
2. DBs with state participation from 51 to 100% (the rest belongs to the private sector). It includes, in particular, Banque de l'Habitat de Cote d'Ivoire, Finagro (Colombia).
3. DBs, the role of public participation in the authorized capital of which is less than 50%, for instance, Sri Lankan DFCC (de Luna–Martínez, Leonardo Vicente, 2012).

Earlier in international practice there were some NDBs which included DFIs of foreign countries as shareholders in addition to the country–founder. For instance, the Dutch FMO, the British Commonwealth Development Corporation, the German DEG and IFC were shareholders of the National Bank of Kenya. However, eventually non–Kenyan shareholders withdrew.

Shareholders of MDBs are member governments. Among the shareholders of geographically defined regional development banks are governments of some developed countries, formally located outside the territory of bank's activity. For example, 15.65% of subscribed capital of AsDB belongs to the U.S. and Japan. It is not surprising, because poor developing countries have limited access to financial resources. In exchange of capital, they have to pay by the fact that rich developed countries, holding a significant part of the capital of the regional development banks, also have a greater voting power and thus actually control these banks (Carrington and Lee, 2008). That is why some of their critics consider

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<sup>6</sup> It should be noted that this term has nothing in common with the one addressed in the title of this *Thesis*, as it represents an institution, while it title the question is about flows of money.

that these entities become policy extensions of member countries rather than agents of development (Ben–Artzi, 2006).

The capital structure of typical NDB is the same as the capital structure of typical commercial bank, whereas the capital structure of the MDBs deserves special attention. It is composed of both borrowed funds and assets of the founding members. The latter, i.e. subscribed capital of the bank, is divided into two parts: *paid-in capital*, which is used to provide credit products and *callable (or guarantee) capital*, which exists in the form of guarantees to cover the risk of loans to developing countries, and is used only in the event of borrower default (Mistry, 1995). The ratio between these two types of capital usually is 1:9 (Braaten, 2012). Callable capital serves for a very specific and at the same time, extremely important objective – it provides a high rating from international rating agencies and thus allows borrowing at low rates from capital markets (which will be discussed below).

Subscribed capital is used in the calculation of the maximum amount of loans that MDB can provide in the form of loans and guarantees. As an illustration, this ratio (so-called “maximum gearing ratio”) for the World Bank is 1:1. Usable capital, a special part of paid-in capital, is the share of capital provided by the member of the OECD, or countries with high credit rating, some member states of the Organization of Petroleum Exporting Countries (OPEC), some of the newly industrialized countries (NIC) with current account surplus and large reserves (Mistry, 1995). *General capital increase* occurs in the case when bank has reached the credit limit and aims to increase it, the share of the participating countries remain unchanged. *Selective capital increase* is aimed at increasing both the comparative weight and voting power of some member states in total structure of shareholders.

As for NDBs, there are several various ways of raising capital by them (i.e. funding):

- A. Private and public deposits and savings;
- B. Borrowing from other financial institutions;
- C. Funds in the domestic and international markets capital (including issuance of Eurodollar bonds, local currency bonds, which are often issued under the government guarantee);
- D. Equity capital;
- E. Funds from the state budget (de Luna–Martínez, Leonardo Vicente, 2012).

Given the fact that, as noted earlier, the direction of DBs' investments by definition is far beyond the purely market-based projects, it is logical that the sources of funding of DB cannot be purely market (Dmitriev, 2012). However, sometimes they are market-based, for example, in 2012 the British HSBC bank issued a loan (40 million USD) for EDB which will be spent on the support of commercial banks of its member countries.

In this sense, some authors (for instance, Rudolph, 2007), believe that the involvement of the private funding is not desirable for the DBs, because it creates competition with commercial banks and erases the boundary differences between public and private players. Interestingly, the DBs raising capital in this way do serve individuals, i.e. they are mostly retail banks (de Luna–Martínez, Leonardo Vicente, 2012). Apparently, these are banks involved in microfinance (this term refers to the issuance of loans for small amounts, as an example, the average loan size in the Bangladeshi Grameen Bank is 389.69 USD<sup>7</sup>).

Nevertheless, this does not prevent them from attraction of state deposits through special state funds and temporary income of states, in particular, from privatization. As an illustration, much of Brazilian BNDES is formed by the resources of the Workers Assistance Fund (Fundo de Amparo ao Trabalhador, FAT) and the Program for Social Integration/Public Servants Fund (PIS–PASEP). The source of these funds is fixed tax deductions from the salary paid by the employer to the budget, which, in turn, is placed at a reduced rate in the form of deposits in the BNDES for a period of 30–40 years, which exceeds the duration of any market funding sources, and thus creates the basis for the stable operation of the bank with the most complex projects with long payback periods (Dmitriev, 2012). Moreover, some DBs manage government funds, for instance, in Russia – pension savings and the National Welfare Fund, in the Netherlands – the Infrastructure Development Fund and the Access to Energy Fund, in Brazil – resources of the National Development Fund, for managing funds of which BNDES annually pays Federal long-term interest rate (TJLP), reaching a maximum of 6% per year and dividends from equity investments operations (Lazzarini et al., 2011).

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<sup>7</sup> **Grameen Bank at a Glance.** 2011. Grameen bank. Available at: [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=26&Itemid=175](http://www.grameen-info.org/index.php?option=com_content&task=view&id=26&Itemid=175).

As mentioned earlier, during the turbulent times NDBs act as agents of the state to rescue large companies and financial institutions. For example, in 2008 the Central Bank of Russia had put in the VEB deposits that were strictly targeted and designed for the rehabilitation of two Russian banks – Globex bank and Svyaz-bank. VEB annually pays for using these funds about 440 million USD in 2011 (Dmitiev, 2012). In 2010 the Brazilian BNDES was awarded a grant in the amount of 17 billion USD, 83% of which were used in the form of Financial Treasury Bills to purchase shares of the oil company Petrobras (BNDES, 2010).

In the recent study conducted by the World Bank (see de Luna–Martínez and Leonardo Vicente, 2012), the official representatives of 91 banks from 60 countries were asked questions about funding. It was found out that raising funds from the capital markets is a well-established international practice, but before implementing such operations there is a need for formal approval from the government, especially in the event that requires a state loan guarantee. Nonetheless, it is officially forbidden for some institutions, such as Financiera Rural of Mexico, to raise funds both from the capital markets, and public deposits. So that, the government tries to protect itself in the event of bank failure.

Raising funds through government grants or transfers is also an important source of funding for NDBs. But getting such help does not always mean dependence on public funds. In particular, the German KfW receives transfers from the government to subsidize interest rates for certain groups of borrowers. But there are still DBs (mainly in developing countries), such as Vietnam Bank for Social Policies (VBSP), which operate only with financial assistance from the state. VBSP provides loans at interest rates much lower than the market ones, and for some credit products the rates are even lower than the interest rates on bank's deposit products. That simply means that a bank operates with a negative interest rate spread.

NDBs may also issue bonds or borrow from other financial institutions. This is also a very successful activity for NDBs due to their high ratings (as it is shown in *Table 1*). For example, KfW is the largest issuer of corporate bonds in Europe (Dmitriev, 2012). This is often done with the help of government guarantees, which reduce the cost of funding and, therefore, interest rate for end-users (de Luna–Martínez and Leonardo Vicente, 2012).

Table 1. Credit ratings of development banks

IDBs	Ratings (Moody's/Standard&Poor's/ Fitch rating)	NDBs	Ratings (Moody's/Standard&Poor's/ Fitch rating)
AsDB	Aaa/AAA/AAA	VEB	Baa1/BBB/ BBB
AfDB	Aaa/AAA/AAA	KfW	Aaa/AAA/AAA
IADB	Aaa/AAA/AAA	BNDES	Baa1/BBB/BBB
EBRD	Aaa/AAA/AAA	BDC	Aaa/AAA/–
EIB	Aaa/AAA/AAA	China Development bank	A+/A1/A+

Source: obtained from rating agencies and development banks (their websites presented in APPENDIX 1)

Interstate development banks also borrow in international capital markets through public bond issues. Debt securities issued in the form of global bonds, bonds in local currencies of participating countries (kangaroo bonds, samurai bonds, yankee bonds), project bonds. DBs also actively use derivatives, as an illustration, AsDB, while financing projects in local currency, often raises funds through a cross-currency interest rate swaps. It should be also noted that DBs are innovators in the supply of such financial instruments: for example, kangaroo bonds were first issued in 1970 by ADB, and the World Bank was the first institution that issued a currency swap in 1981. Recently, the interstate development banks have begun to issue thematic bonds: water bonds (issued by AsDB for financing projects under the Water Financing Program), bonds for poverty alleviation (released in 2010 by IADB on the Asian financial markets to finance programs in the Caribbean and Latin America), climate bonds (issued by EIB to invest in renewable energy and energy efficiency projects). These tools are quite attractive for investors because these DBs have sufficient high credit ratings from the international rating agencies (see Table 1).

However, only large DBs (both interstate and NDBs) with high ratings can afford to use such tools, whereas bonds issued by small DBs are illiquid and in order to attract investors, they have to offer higher interest rates. And since every unsuccessful attempt can seriously harm the reputation of this small DB, which will significantly complicate the path of borrowing, such banks are very careful with bonds issuance.<sup>8</sup> It should also be noted that certain limits on borrowing exist, so that for every ruble of

<sup>8</sup> Pavoni, Silvia. 2010. "Development banks take capital route". The Banker, 28 May. (<http://www.thebanker.com/Regulation-Policy/Politics-Economics/Development-banks-take-capital-route?ct=true>).



the share capital of VEB there should be no more than 4 rubles of borrowed funds, and the amount of the latter for AsDB cannot exceed the amount of its share capital (callable capital and paid-in capital) and reserves established by the bank.

Resources borrowed from capital markets and the founding members with current account surplus at market rates are called “*hard loans*” or “*hard lending windows*”. Nowadays as a rule they are accumulated in several funds established for different purposes: for the investment in sustainable development (Climate Investment Funds, AfDB), for the financing of SMEs (Inter-American Investment Corporation, IADB), to attract the inflow of foreign direct investments (Unit investment fund of the Islamic Development bank).

In contrast, IDBs (main multilateral development banks – AfDB, AsDB, IADB and the World Bank with exception of EBRD) also resort to the *soft-loan window*, i.e. cheap resources of multilateral development funds (for instance, the African Development Fund) or associations typically having different legal status and funding. Except for IADB, where Fund for Special Operations (FSO) is an integral part of its institutional structure (Shkolyar, 2004) and which is the only institution having soft-loan mechanism since its establishment (Braaten, 2012). These funds were initially created in the image of the International Development Association of the World Bank. They are not banks. Most of their resources were generated by the accumulation of reserves, net income and contributions of large non-regional members. Nevertheless, even borrowing countries make minor, nominal contributions to these funds (associations) in order to fix the membership in these organizations, get a right for a loan and some voting power.

Financial architecture of funds resembles the structure of the Multilateral donors clubs, cooperating in the continued provision of resources that are provided on concessional terms with a long maturity period (35–40 years) and some grace period. Such loans typically contain a grant element (75–85%), so-called “*soft-window borrowings*” and do not allow charging interest rate, which is substituted by some annual servicing fee. These funds are financed entirely by contributions from donor countries (usually with replenishment once in 3–4 years) and may not involve borrowing from the capital markets (Braaten, 2012).

#### 1.4. Sectors, clients and financial products

As for the activity of DBs, according to de Luna–Martínez and Leonardo Vicente (2012), most NDBs operate in the traditionally attractive for commercial banks sectors, such as trade and services, industry and manufacturing, agriculture, construction (including housing and energy), environmental protection (which plays an increasingly important role in their functioning), infrastructure (which is historically traditionally important for all development banks). And only a few of them are concentrated in financing of the socially important areas (de Luna–Martínez and Leonardo Vicente, 2012), and also provide loans in case of emergency (e.g., emergency lending in China). On this basis, DBs, as it was mentioned before, are universal, as BNDES or the Development bank of South Africa (DBSA), or specialized, as SIBDI, Afreximbank. However, some of the seemingly universal DBs are prohibited to provide financial services to some certain sectors, in particular, lending to oil and gas production is prohibited for the Russian VEB (Dmitriev, 2012).

Activity of IDBs is also concentrated in financing of large infrastructure and other development projects (mostly social development projects – health, education, creation of social safety net). Recently, they have been increasingly lent to governments for policy reforms. IDBs provide loans at market rates (non–concessional financial assistance) to middle–income and some creditworthy countries with low income, but also loans on preferential terms (concessional financial assistance) to low–income countries (Nelson, 2011).

The activity of NDBs is concentrated on the work with SMEs, large private companies, state enterprises, and other financial institutions.<sup>9</sup> IDBs traditionally operate with government agencies, but recently they increasingly began to provide more funds to the private sector, especially it concerns such institutions as IFC, IBRD and EBRD. For example, IBRD has recently raised the share of the loans issued to the private sector from 10 to 20% of overall bank's equity (Pavoni, 2010).<sup>10</sup>

As for the funds to the private sector, they can be issued in two ways – directly to companies or individuals (for example, to women–entrepreneurs or indigenous people, who want to set up their own

<sup>9</sup> By *intermediaries* (or *vehicles*) I further will mean only commercial banks, the consideration of other organizations as leasing and factoring companies remains beyond the scope of this work.

<sup>10</sup> By the way, the Bush Administration tried to push EBRD to focus exclusively on private lending but European countries opposed this initiative, as the result 60% of its activity is now concentrated on private sector (Braaten, 2012).

business), or through other financial institutions (usually commercial banks, which are called “vehicles”). The first is traditionally called *wholesale banking*, the second one – *retail banking*, which factually is the same as B– and A–loans, respectively. Not all DBs can afford to use the latter, because in that case they should have an extensive branch network, but the interest rates on such loans are lower than if they were made available through financial intermediaries, but the credit risk is still borne by the DB. Wholesale banking includes operations provided through financial intermediaries and allow them to reduce the operating costs, because the selection and evaluation of potential borrowers is carried out by private financial institutions, as well as part of the credit risk. Such scheme also leads to the increase in the supply of credit resources in certain sectors and for certain types of customers. The role of DB is often reduced to just the role of lender of the record, i.e. the initiator of the loan. Overall, the level of NPLs in the balance sheets of DBs working in a wholesale scheme is lower than in the retail DBs (de Luna–Martínez and Leonardo Vicente, 2012).

The products provided by DBs to private sector include: unsecured loans (for intangible assets), loans for new activities, syndicated loans, bridge or short–term loans, loans for working capital, long–term loans (project finance), shareholding and subordinated loans, etc. As a rule, most of them are loans at a fixed or floating interest rate with the 10–year maturity. DBs often buy shares of various commercial banks and companies, but as it will be shown later (in *Chapter 3*), it is a common mistake to think about them as purely passive investors, in fact their role is significantly different. There are several advantages from this operation for both commercial banks and development banks themselves. For commercial bank, for example, it is a significant opportunity to improve their corporate management, credit rating; to get access to international financial markets, to increase the value of the bank and to attract strategic investors (i.e. investors usually buying blocking packages, providing some capital and influencing decision making process). Whereas the main interest of DB is to make profit from this transaction.

As for the other activities, IDBs pay considerable attention to the provision of local currency debt usually using three ways: loans denominated in local currency; risk–management swaps or structured finance. DBs can also provide guarantees, and conduct leasing and factoring operations

(mostly NDBs). At the same time, the activity of DBs recently went far beyond the scope of just interaction with commercial banks or clients, because nowadays some of them are also involved (for example, IFC) into the support of private equity and investment funds, especially funds which are run by the first time managers. Improving its efficiency through bringing their standards and policy requirements to the funds, DBs promote the growth of the fund and attract other investors. Non-financial services include strategic consulting, advisory services in mergers and acquisitions (M&A), technical regulations – obtaining certificates of conformity, engineering operations, and some banks (e.g., BNDES) even act as underwriters. This area is especially developed among DBs involved into wholesale operations (de Luna–Martínez and Leonardo Vicente, 2012).

### 1.5. Asset quality and profitability

Critics of the activities of DBs state that the balances of these banks contain a significant amount of non-performing loans. Conversely, according to de Luna–Martínez and Leonardo Vicente (2012), for about 50 out of 90 banks the level of NPLs on the balance sheet was less than 5%, what is more, 64% of the share of toxic assets was below the average for the whole national banking systems of the countries where DBs operate. Another argument against the activities of DBs – their unprofitability – also has not been confirmed in practice. As it is shown in *Table 2*, neither in the study of NDBs, where 74 of the 90 institutions reported the profit, nor in case of IDBs.

*Table 2. Financial results of the IDBs in 2011*

IDB	Profit (million USD)
AsDB	594
AfDB	252
EBRD	240
IADB	836
EIB	3186

*Source:* obtained from financial institutions

The explanation for that can be given as following: DBs are not charitable institutions, besides clear mandate on development, they do have some business model which is based on choosing at least self-liquidating projects, i.e. projects with recoverable revenue (Kapur, 1997). But in practice, actually, such giants as IFC and EBRD work only with banks or projects with strong potential (thus even chosen

banks are called “small but beautiful”, i.e. perspective), that is why they do perform quite well. For example, EBRD demonstrated such a high level of profitability that in 2007 there was a serious discussion on start paying dividends to the participating countries and the USA as the main shareholder of EBRD insisted on terminating the Bank at all. Nevertheless, when the financial crisis occurred in 2008–2009, the countercyclical role of EBRD was extremely needed. It even expanded its activities for the first time to several territories, for instance, Turkey and Mongolia and increased the volumes of support of national banking systems of the EU member states, and as a result, 2009 was the year when EBRD declared loss.<sup>11</sup>

### 1.6. Regulation and supervision of development banks

There is no institution responsible for regulation and supervision of IDBs. This function is mostly laid on the shoulders of its members; consequently, it will be excluded from the further consideration. As for the institution responsible for regulation and supervision of NDBs, it is, as a rule, an organ for the regulation and supervision of the whole banking sector of the country. In this case, banks are required to follow all rules and standards set for commercial banks. At the same time, in some cases (for example, National Development Bank of Palau, SME Development Bank of Thailand, Uganda Development Bank) these functions are performed by different ministries (industry, trade, construction, etc.), or other state institutions, which are not able take into account the peculiarities of the DBs and hence assess the risks associated with their activities.

The DBs involved into retail operations in a large number of cases are subject to the same regulations as the commercial banks, compared with the DBs operating in the sphere of wholesale banking (de Luna–Martínez and Leonardo Vicente, 2012). However, it should be also noted that researchers agree that the most correct decision which can be made by the government is to supervise and regulate the activities of DBs by the Central Bank, but with some relaxation of restrictions in the area of capital adequacy (Thorne and du Toit, 2009), because the Basel principles mostly account for their procyclical role, which in turmoil period leads to a significant decline in lending, while the role of

<sup>11</sup> Reuters: финансовый кризис вдохнул новую жизнь в Европейский банк реконструкции и развития. 2009. Banki.ru. 13 мая. <http://www.banki.ru/news/lenta/?id=1189396> [Reuters: Financial crisis has breathed new life into the European Bank for Reconstruction and Development.].

DBs is exactly the opposite – they need to eliminate market failure by playing a countercyclical role. Some researchers, for example, Fletcher and Kupiek (2004), believe that only commercial activity should be a subject to the Basel principles, while the others – Gottshak and Sen (2006) – suggest that the activity DBs in each segment should not be subject to this regulation at all.

Moreover, the state regulation and supervision can also be supplemented by market-based measures, such as credit ratings. As a rule, large DBs are claimed to obtain credit rating from the international rating agency (de Luna–Martínez, Leonardo Vicente, 2012). Credit ratings, despite the fact that technically they are not a part of the external management, allow both the state and DB itself to evaluate the quality of its financial management. In turn, the World Federation of Development Financing Institutions of the Asia–Pacific region has created its own system of rating for DBs (Thorne and du Toit, 2009). But still, the most reliable credit ratings are that provided by the "big three" agencies – Standard & Poor's (S&P), Moody's, Fitch Ratings (hereinafter – Fitch).

In this *Chapter* I showed that development banks are special entities with clear mandate on development of the whole economy or some particular sector. The main comparative advantage of such institutions analogous to commercial banks is in their opportunity to obtain cheap funding. However, they are forbidden to use this advantage so that to create an any form of competition with market players, because they need to act as catalysts of activities in which market underperforms. Nowadays their activity is mainly concentrated in the private sector, but usually their role is fulfilled through financial intermediaries. At the same time, many of them perform quite well as they do have some specific business model. These institutions are weakly regulated (even at national level) and the only reliable external measure of their financial management is their credit rating.

## CHAPTER 2. The first strategic group of development banks

This *Chapter* is aimed at description of the activities of DBs included in the first strategic group. It starts with the general characteristic of these institutions and then it considers in detail activities of IIB, KfW and SME bank with respect to the development of the Russian SME sector.

### 2.1. Basic characteristic of the first strategic group

Development banks operating in Russia in the segment of SME financing can be divided into two broad categories – the first group includes banks issuing loans to SMEs without any special mandate on development of the financial sector, the second group of DBs includes those which consider SME financing as an intermediary stage towards the achievement of the other goal – the improvement of efficiency of commercial banks (or mainly their value). *This Chapter* is devoted to the primary investigation of the functioning of the former strategic group (or the first group for simplicity) whereas in *Chapter 3* the latter one (or the second group) will be considered. By *strategic group* I mean financial institutions, which perform the same mandates, use quite similar business models, have close strategies and possible ways of further transformation.

The first group of DBs operating in Russia is formed by one NDB – the Russian bank for Small and Medium Enterprises support (SME bank), one bilateral DB – the German KfW and one targeted regional DB – IIB. The main distinguishing feature of this group in comparison with the other one is that these banks operating through commercial banks do mostly consider the volume of loans obtained by the final borrowers without paying too much attention to the quality of these loans and without having special mandate on financial sector's development.

Different economic agents with which DBs interact in the process of their functioning can be ordered in the following way according to their importance for bank (in a descending order): clients (borrowers), vehicles (intermediaries) and partners (see *Figure 2*).



*Figure 2. Relative importance of different economic agents for the first strategic group of development banks*

*Source: depicted by the Author*

However, among considered three DBs, this scheme perfectly works only with the case of the SME bank as it tries to provide SMEs with as cheap loans as possible even setting up the upper limit for the vehicles (usually small regional banks which have access to soft information). At the same time it does perform the goal on stimulating the demand by arranging workshops on the development of financial literacy for them or does concern about the final borrowers when providing sources for commercial banks.

The hierarchy for the IIB when it will start normally operating as development bank will be the same because it also cares mostly about SMEs and even plans to provide equity investments to them. But now economic agents are ranged by the Bank in the following manner: partners–vehicles–clients that can be explained by the fact that IIB does not have any technology in making choice about vehicles and does not actually have good reputation. Thus it has to invest money through partners (i.e. other DBs), which have criteria imposed on vehicles and start setting up relations with commercial banks in order to obtain reputation and some experience. It should be noted that KfW does not quite follow the proposed scheme and will actually never follow because it considers partners as the most important link in the chain as all the financing is provided through them, similarly as KfW does not have any mandate on the development of the financial sector, then SMEs should be the second priority for it.

For this group in this classical representation, partners, typically belonging to the same strategic group, play quite insignificant role as they do not play the role of co–financiers in the sense that they have quite little incentive to provide syndicated loans for commercial banks. The interaction appears in the form of information cooperation, provision of guarantees or in the form when one DB allocates



funds through the other one, but it is a peculiarity of business model of the former DBs. This typical model often appears because of some intergovernmental agreements.

Profitability is indeed quite significant factor in the activities of this group of DBs but they just set it up on some acceptable level without achieving goal of its maximization. The actual analysis starts with minor player – IIB, representing a unique case of DB, which is currently in a transition period and then two major players – KfW and SME bank will be considered.

## 2.2. International Investment Bank

IIB is a targeted regional development bank established in 1970 to promote the development and deepening the mutual economic cooperation, initially, of the socialist countries. After some of its founders – Hungary and Poland – left the Bank, the share of Russia increased to 58%. Among other shareholders are – Bulgaria, Romania, Czech Republic, Slovakia, Vietnam and Mongolia. The Banks' headquarter is located in Moscow and it operates without any license from the Russian Central Bank and without paying any taxes to its member countries. In 1993, the IIB has made default on its obligations to the Western creditors and restructured debt only in the mid–2000s. Then Russia repaid its debt in the amount of 710 million USD, and now the only unresolved debt is Cuban in the amount of 106.7 million USD. The IIB more or less fully restarted its activities only in 2005, focusing on investments in small–scale projects in some member countries, mainly in Russia, Mongolia, Romania and Bulgaria.<sup>12</sup> Russia has repeatedly proposed its partners to create on IIB's basis a regional development bank with a capital of 780 million USD, but the project has been never realized.

Nowadays the Bank is in quite difficult situation, because of large amount of outstanding debts (124.2 million USD) in its portfolio (with 140 million USD – paid–in capital, 1.3 bln – guarantee capital) and the absence of credit rating from any of International rating agencies. In 2013 the IIB announced its readiness to raise funds from the financial markets by placing bonds denominated in rubles (up to 6.6 million USD) on the Moscow stock exchange in several tranches. There are also ongoing negotiations with the Central banks of Russia and Vietnam on the receipt of subordinated loans from them (on 133

<sup>12</sup> Киселёва, Елена. «Топ–менеджер ВЭБа отдохнет в соцлагере. Николай Косов может возглавить МИБ». 2012.Коммерсант. 10 августа. <http://kommersant.ru/doc/1998780> [Kiseleva, Elena. "Top–manager of VEB will take rest in the socialist camp. Nikolay Kosov can lead IIB".].

million USD).<sup>13</sup> That is why one can assert that this Bank is currently going through the initial stage of its functioning, thus it is not ready yet for direct cooperation with commercial banks preferring operating through other DBs mainly the SME bank with the parental organization – VEB – of which in 2013 an agreement on SME financing was signed.<sup>14</sup>

Nevertheless, the IIB Bank has plans on its further substantive activity in the segment of SME financing. Clear criteria toward vehicles had not yet been formulated. There are no restrictions on trade sector financing as well as no sectoral priorities. IIB is not ready to lend commercial banks on purpose on SME financing but instead it will cooperate with them in the form of syndicated loans thus bearing risk together with them (see *Figure 3*).



**Figure 3. Credit products on SME financing of IIB**

Source: obtained from IIB

The second distinction is that it is planning to finance SMEs directly by providing equity investments. Therefore, it is likely that the Bank will further put a lot of effort on proper estimation of SMEs' activities and their risks (the future plans of which will be actually considered in *Chapter 4*), which confirms the initial proposition formulated in the beginning of this *Chapter* about the fact that clients will play the most significant role for this type of DBs.

<sup>13</sup> МИБ намерен разместить рублевые облигации на 2 млрд рублей. 2013. Banki.ru. 30 января. <http://www.banki.ru/news/lenta/?id=4504196> [IIB intends to place ruble bonds for 2 billion rubles.].

<sup>14</sup> Международный Инвестиционный Банк прокредитует малый и средний бизнес в России. 2013. Banki.ru. 17 января. <http://www.banki.ru/news/lenta/?id=4455146> [The International Investment Bank will issue loans to small and medium-sized enterprises in Russia.].

### 2.3. Kreditanstalt für Wiederaufbau

KfW is bilateral development bank, established in 1948, 80% of which are owned directly by the Federal Government and 20% – by the States of Germany. KfW has repeatedly occupied high positions in the ranking – the World's 50 Safest banks – of the Global Finance magazine and it was recognized as the safest bank on the world in 2012.<sup>15</sup> There is still no doubt in the high reputation of the Bank even despite the scandal occurred in 2008, when three top-managers were accused of transferring funds to the Lehman Brothers after it had already filed papers to start the process of bankruptcy. The damage amount for KfW was 400 million USD.<sup>16</sup>

There are three important branches of the Bank – KfW IPEX Bank GmbH (mainly export–Import bank), which became independent under the pressure of European Commission because it violated the main principle of DBs' functioning – non-competition with private market players; the German Investment Corporation (DEG) which mostly behaves as DBs from the second group (i.e. with the primary goal on the financial sector development) and KfW Development Bank – classical DB operating mostly in international arena. This *Subchapter* covers the activities of last of aforementioned ones (which later for convenience will be called just KfW). KfW has no financial interactions with final borrowers (i.e. it does not provide A-loans).

The main peculiarity of this Bank is that in Russia it almost does not lend money directly to commercial banks (with some exceptions as, but they appeared only because of the guarantees of VEB), instead this function is performed by SME Bank or even by EBRD, which have large staff and methodology in imposing strict criteria to their partner banks and working with them, can reallocate money in a better way than consisting only of three people in the Moscow branch of KfW. Interaction with EBRD was performed under until recently functioning special German–Russian intergovernmental program called the Russia German Small Business Programme (DKMUP). Having obtained funds from KfW, EBRD had found partner banks, provided them loans and after that specially established together with private German consulting company IPC GmbH the Small Russian Business Fund (SRBF) was

<sup>15</sup> **The Global Finance Magazine.** 2012. The World's 50 Safest Banks 2012. Available at <http://www.gfmag.com/tools/best-banks/11661-worlds-50-safest-banks-april-2012.html#axzz2UW7aiHP3>.

<sup>16</sup> ФРГ: полиция проводит обыски в помещениях банка KfW.2008.Banki.ru. 22 октября. <http://www.banki.ru/news/lenta/?id=685189> [Germany: the police carry out searches in the premises of KfW.].

responsible for the interaction with commercial banks in the spheres of risk assessment and marketing. Since its start, program had provided funds in the amount of 399 million USD to 13 partner banks (with maximum issued loan to final borrower up to 332.5 thousand USD) with more than 250 basic seminars and advanced training.<sup>17</sup> However, since January 2013 this program was terminated because of intergovernmental agreement signed by the Russian Prime–Minister Dmitry Medvedev and the German Chancellor Angela Merkel in 2011, which included the creation on International Fund for support of innovative SMEs<sup>18</sup> (it will be considered in *Chapter 4*). It has not been established yet but it is expected that the Fund will amount up to 1.33–1.6 billion USD.<sup>19</sup>

It should be noted that interaction between VEB and KfW has long history, which factually had started in 2006 when VEB was created in the image and with the help of KfW. In 2010 KfW issued 133 million USD–loan on SME financing to SME Bank.<sup>20</sup> In 2010 and 2011 VEB provided two bank guarantees on KfW’s loans to Spurt bank (16.25 and 32.8 million USD respective in 2010 and 2011) and NBD bank (10.8 million USD in 2010).<sup>21</sup> In 2012 this interaction led to the creation of program implementing by SME Bank – SME Baltic (see *APPENDIX 2*).<sup>22</sup>

## 2.4. The Russian bank for Small and Medium Enterprises Support

The Russian SME bank (former the Russian development bank), part of Vnesheconombank's group, is a NDB, which was created in 1999. The main activity of the Bank declared by itself is aimed at financing SMEs operating in the manufacturing and innovation, contributing to the development of the

<sup>17</sup> ДКМУР. 2013. KfW. Available at <http://dkmur.ru/en/>.

<sup>18</sup> Сидибе, Пьер. «Россия и Германия создадут фонд поддержки среднего бизнеса». 2011. Известия. 18 июля. <http://izvestia.ru/news/494872> [Sidibe, Pierre. “Russia and Germany will create the Fund for the support of medium–sized enterprises”].

<sup>19</sup> Вклад ВЭБа и KfW в фонд поддержки МСП может составить по 150 млн евро. 2013. Banki.ru. 29 ноября. <http://www.banki.ru/news/lenta/?id=3415007> [The contribution of VEB and KfW contribution to the Fund for SME support could reach 150 million euros.].

<sup>20</sup> KfW предоставил кредит РосБР на 4,125 млрд рублей для поддержки малого и среднего бизнеса. 2010. Banki.ru. 17 декабря. <http://www.banki.ru/news/lenta/?id=2530767> [KfW has provided a loan to the Russian Development Bank on 4.125 billion rubles to support small and medium–sized businesses.].

<sup>21</sup> ВЭБ предоставил гарантии банку KfW в обеспечение обязательств НБД–Банка и АКБ «Спурт». 2009. Banki.ru. 29 апреля. <http://www.banki.ru/news/lenta/?id=1920353> and <http://www.banki.ru/news/lenta/?id=3420875> [VEB has provided guarantees to KfW for the purpose of securing obligations of NBD bank and Spurt bank.].

<sup>22</sup> ВЭБ предоставит гарантию KfW на 31,8 млн долларов по кредиту Спурт Банку. 2011. Banki.ru. 30 ноября. <http://www.banki.ru/news/lenta/?id=3083453> [VEB will provide a guarantee to KfW of 31.8 million loan of Spurt Bank.].

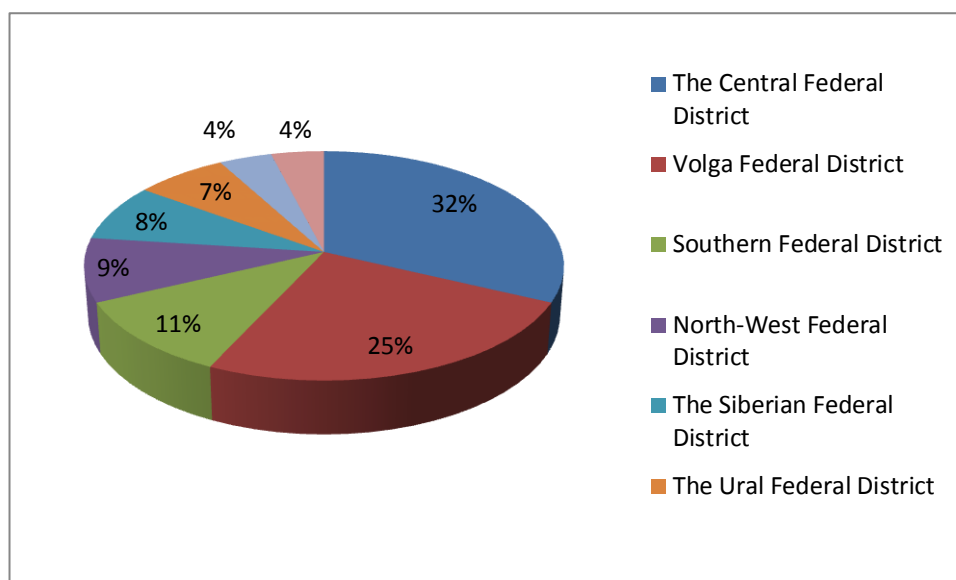
real sector of the economy, jobs' creation and tax revenues' increase.<sup>23</sup> It does not have any license from the Central bank and does not pay any taxes. It provides only loans to commercial banks, not to final borrowers directly (i.e. only B-loans) though the main peculiarity of this bank is that there are special programs for final borrowers realizing by the group of its partner banks (see *APPENDIX 2*). All of these programs are aimed at provision of medium- and long-term financing (up to 7 years) to non-traded sector of the economy and interest rates ranging between 12.5–14.5%. Some programs have also regional component – they are aimed at supporting certain geographical areas (SME–Baltic) or territories with undeveloped or absent demand (SME–Regional Growth). The margin for banks is fixed in the frames of 4–5% and average interest rate on realizing programs is 12.5–12.7% whereas the average in the market is about 15–17%.<sup>24</sup> Some programs (e.g. SME–Stimulus and SME–Regional Growth) offer only minimum limit on borrowing making banks borrow excessive amount of money which in turn lead to high return of unspent limits and probably creates incentives for banks to use scoring methods in order to reallocate huge sums of money as fast as possible and thus higher levels of NPLs.

SME bank currently has 134 partner banks and this level is constantly increasing by 10–15 new banks every year. The share of innovative, modernization and energy efficiency projects is approximately 43%, whereas the total share investment loans is just 18% in the whole banking sector (according to Expert RA<sup>25</sup>). Regional structure of portfolio is depicted in *Figure 4*, which shows that more than the half of overall activity in SME financing is not surprisingly concentrated in the Central and Volga Federal Districts, where the overall economic activity is concentrated. It is also regulated by so-called “*regional limits*” (up to 33 million USD) set by the Ministry of Finance for each region depending on the number of SMEs in the region which in turn is divided among partner banks – each of them gets *regional quota* – sum up to which this particular bank can issue loans in a particular region.

<sup>23</sup> Российский банк развития переименовали. 2011. Lenta.ru. 22 июня. <http://lenta.ru/news/2011/06/22/rbr/> [The Russian development bank was renamed.].

<sup>24</sup> Отчет о реализации программ МСП Банка. 2013. МСП Банк. Available at: [http://mspbank.ru/ru/analytical\\_center/analytical\\_reports/programm\\_realization/](http://mspbank.ru/ru/analytical_center/analytical_reports/programm_realization/) [Report on realization of the SME bank's programs.].

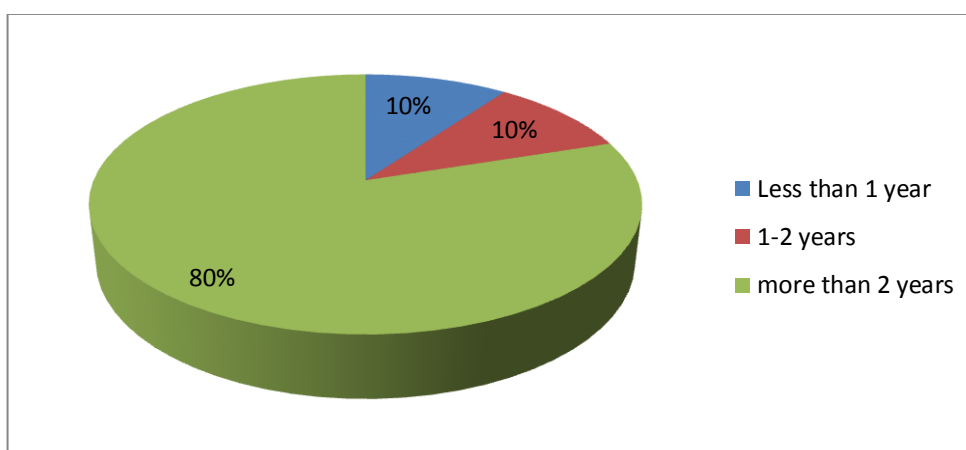
<sup>25</sup> Эксперт РА. 2012. Кредитование малого и среднего бизнеса в России: время “кредитных фабрик”. [Expert RA. 2012. SME lending in Russia: time for credit factories].



**Figure 4. Geographical distribution of activities of SME bank's partners (2012)**

Source: SME bank

The term structure of SME portfolio realizing by SME bank's partners is represented in *Figure 5*. It should be noted that medium- and long-term loans prevail, which actually diverges with market trends – according to Expert RA, 63% of the whole volume of issued SME loans have terms less than 1 year, which allows concluding that SME bank tries somehow cope with existing “missing middle”. However, its activities as in line with overall market sentiments are mainly targeted at small-scaled businesses (approximately 78% of all issued loans in 2012), and therefore one can assert the presence of the market failure for medium-sized enterprises. At the same time, 65% of the total allocated funds in 2012 were accounted for lending to trade and services sector, which quite unlikely have something in common with innovations.



**Figure 5. The term structure of activities of SME bank's partners (2012)**

Source: SME bank

It should be noted that the SME bank imposes quite high requirements toward its vehicles. They can be divided into four groups:

- a) *General requirements* – license from the Bank of Russia; current long-term credit rating assigned by S&P, Fitch or Moody's; presence of a positive audit report; the absence of sanctions from the Bank Russia; existence of experience in SME lending;
- b) *Non-financial criteria* – goodwill, no pending legal proceedings, absence of negative credit history in SME Bank;
- c) *Financial criteria* – value of equity not less than 230 million RUB (7.67 million USD), capital adequacy ratio – min 10.2% (required by the Bank of Russia – 10%), compliance with other mandatory requirements imposed by the Central bank, share of NPLs in the loan portfolio is less than 12% and etc.;
- d) *Optional criteria* – considerable potential of bank in SME lending, experience in interaction with the International financial institutions, SME bank or Vnesheconombank.

Banks are not allowed to spend obtained sources on purchase the securities, the acquisition of shares in the authorized capital of the companies or repayment of previously received loans, loans, notes. It is also required to inform final borrowers about the fact that bank provide loans under the program of SME bank (otherwise it can be fined on up to 3,000 USD).

SME Bank performs very important function for SMEs – it tries to raise the level of financial literacy of them by constantly providing different events, for example, in Cheboksary SME bank with assistance from the local government provided workshop called the “Key for innovation” for entrepreneurs, where they obtained information about all the possibilities of financing of their business with the SME bank's funds. For those who cannot participate online seminars are organized.

Nevertheless, the share of SME Bank in the lending market is just about 1.5%. At the same time, according to Expert RA and the Bank of Russia, in the market of long-term lending to SMEs it takes higher share – 5.2%. But relatively small scale of operations is not the only drawback in activity of SME bank. Several more need to be mentioned. First of all, according to Expert RA, SME bank seems to be captive, i.e. lending to related parties is accounted for more than 12% of assets in accordance with

International Financial Reporting Standards (IFRS), for which this indicator is equal to 19.4%.<sup>26</sup> It is not surprising that maximum risk per borrower (N6 indicator) falls on retail division of the second largest Russian bank – VTB, which provides quite risky strategy in issuing loans for SMEs using scoring methods up to 6 million RUB (20,000 USD), while according to some bank analysts the maximum sum allowable issued with scoring is about 1 million RUB (3,300 USD). That is why VTB together with Sberbank demonstrate the highest level of NPLs in the whole banking system. Secondly, non-zero limits set up to each region by the Ministry of Finance create incentive for SME bank to use money in the way in order to execute the plan, it sometimes provides money to unreliable vehicles. This explains the situation, which had happened with the Dagestan Express bank. In February 2013 the Central bank revoked the license of which, and, as the result, SME bank lost 274 million RUB (9.13 million USD).<sup>27</sup> Thirdly, the aforementioned term structure of issued loans showed the presence of short-term loans in the credit portfolio of partner banks, but together with mandatory requirements concerning the calculation of real economic impact of such loans on the overall performance of firms and their productivity, it shows why the statistics provided by the SME bank does not seem to be quite reliable. Because final borrowers have to mention at least some effect filling the forms asked by lenders even if it is factually zero. Finally, high share of loans attributable to trade sector (circa one third) is unlikely to be associated with real innovation and modernization, which asserts that some commercial banks can use sources to provide cheap funds to borrowers at lower than in the market interest rates which indeed distorts competition among commercial banks. *De jure* loans to trade sector at the expense of SME bank are forbidden, but the *de facto* they still exist. However, prior to the mid-2012 the situation was more obvious because no sectoral restrictions on the “SME Refinancing” program allowed commercial banks to use funding for trade sector financing.<sup>28</sup>

<sup>26</sup> **Плотнова, Ольга.** «Банки могут увеличить кредитование связанных с ними заемщиков». 2013. Ведомости. 22 марта. [http://www.vedomosti.ru/finance/news/10325751/kredity\\_dlya\\_svoih](http://www.vedomosti.ru/finance/news/10325751/kredity_dlya_svoih) [Platonova, Olga. “Banks can increase the level of affiliated borrowers”].

<sup>27</sup> **Алексеевских, Анастасия и Татьяна Ширманова.** «Дочка» ВЭБа оставила в закрытом дагестанском банке 274 млн рублей». 2013. Известия. 18 февраля. <http://izvestia.ru/news/545182> [Alexeevskih, Anastasia and Tatiana Shirmanova. “The branch of VEB left 274 million rubles in closed Dagestan bank”].

<sup>28</sup> ВЭБ и KfW подписали меморандум о взаимопонимании по фонду поддержки МСП. 2011. Banki.ru. 19 июля. <http://www.banki.ru/news/lenta/?id=3768091> [VEB and KfW signed the Memorandum of Understanding on the Fund for SME support.].



In this *Chapter* I showed that DBs included in the first strategic group not surprising try to help attracting more funds to the Russian SME sector. While this may be true, here the “but” comes. As this group of DBs, while performing the task given by government to allocate funds to the SME sector, sets as primary goal to issue as much loans as possible without caring too much about their quality. Thus the case with the bankruptcy of their vehicles appeared and thus it is almost sure that there is a very tiny real effect of such loans on the economy (in oppose to the official statistics which is highly unreliable).

## CHAPTER 3. The second strategic group of development banks

This Chapter is guided by exactly the same logic as the previous one with one crucial distinction – it is devoted to the activities of the second strategic group, starting with the general description of the group it moves to the particular cases including four banks – BSTD, EDB, IFC and EBRD.

### 3.1. Basic characteristic of the second group

The second strategic group of DBs is formed by three bilateral development banks – the German DEG, the Netherlands FMO and the Austrian OeEB, the consideration of which though will be beyond the scope of this analysis because of their relatively insignificant role in the market and the lack of official information about their activities. Thus *this Chapter* will be focused on the review and analysis of four DBs – the global MDB – IFC, the multilateral regional development bank – EBRD, and two group regional development banks – EDB and BSTDB. This group of banks significantly differs from the one described in *Chapter 2* in the sense that besides clear mandate on development of the economy, they are also responsible for the financial sector development, that is why the development of SME sector cannot be considered without the development of financial sector as they go hand in hand in the operation of this group of DBs. The latter goal is not limited by issuance of loans to raise capital of the vehicles, but they also buy the shares of commercial banks. By *status investor* in this context I mean an institution the presence of which as a shareholder increases the value of the bank in two ways: either it provides some additional capital and technical assistance of bank hence making the latter more efficient and also participates in actual management, or its value increases automatically as it is a signal for other investors (including strategic) that bank deserves some trust. These investors can buy blocking packages of the bank or just some small fraction of shares.

By the analogy with the *preceding Chapter*, the relative importance of different economic agents is represented in *Figure 6*.

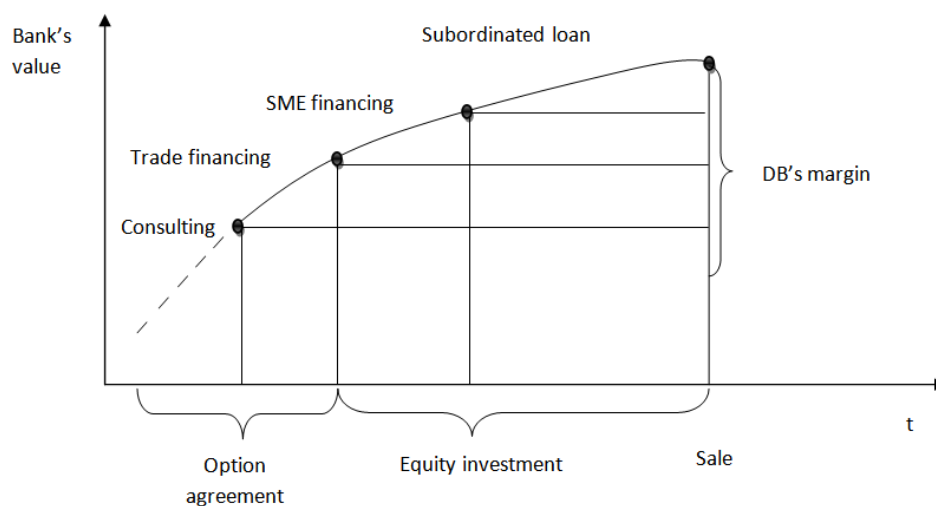


**Figure 6. Relative importance of different economic agents for the second group of development banks**

*Source: depicted by the Author*

The most important type of economic agents for this group of DBs is vehicles (i.e. commercial banks), in this sense DBs can be considered as “teachers” for commercial banks helping the latter achieve a higher level of efficiency – mitigate risks properly and provide the most demanded by clients products (it is not surprising that the main motto of the RSBF is “*know your client*”). There is also a certain cycle of relations between DBs and vehicles which will be presented further. Partners (i.e. other DBs) are also important for this group of banks as they often become co-financiers of vehicles in forms of syndicated, subordinated loans and even in shareholding. Clients (i.e. final borrowers) though very important but DBs as a rule do not interact with them (i.e. they do not provide A-loans) except for EBRD which realizes two programs targeted directly at entrepreneurs – The Enterprise Growth Programme (EGP) and Business Advisory Services (BAS), however, there is no information about how it actually performs in reality.

Classically there are four stages of interaction between development banks and their partner banks, which are represented in *Figure 7*.



**Figure 7. Stages of relations between development banks and vehicles**

*Source: depicted by the Author*

Once development bank chooses “small but beautiful” (often regional) commercial bank, it starts to look narrowly to its target by firstly provides short-term trade financing to it and some technical assistance. When DB feels that its client is ready for a more difficult task, provision of long-term sources – SME financing – comes. The next stage of interaction can be subordinate loans' provision which can also come simultaneously or even after DB becomes a shareholder of commercial banks.

The investment horizon typically should last for 5–7 years, after which commercial bank reaches the desired level of efficiency (which is actually controlled by reaching the agreed level of covenants) and holds IPO as the result of which DB sells all its shares. Nevertheless, in practice DB estimates the efficiency as the level of the bank's value and when DB sees that it reaches some appropriate level, just sells with always high premium to capital in comparison with initially paid one. At the same time, commercial banks often have to sell their shares to DBs with low premium to capital through concluding optional agreement on purchase of their shares at early stages of interaction with DB. As for the end of shareholding, it turns out that commercial banks do not become public (it is mainly connected with the conditions of the Russian banking sector which will be discussed later), instead they are under the threat of losing their independence as the result of the arrival of a strategic investor, usually – foreign bank, seeking for an expansion of its activities into a new market. Whereas for DB such transaction in any case becomes quite profitable (which will be shown further). Now the actual analysis starts with minor players – BSTDB and EDB and then two major players – IFC and EBRD – will be discussed.

### 3.2. The Black Sea Trade and Development Bank and the Eurasian Development Bank

BSTDB is a group regional development bank created in 1997 by eleven countries. The activities of the Bank are aimed at the promotion of enhancement of regional trade cooperation, stimulation of cross country projects' creation and support all the activities that contribute to sustainable development through private and public enterprises. The special focus is made on the support of SMEs (though without necessary requirement on innovation or energy efficiency) and trade financing through financial intermediaries (no A-loans). At the current period, the total amount of investments in the Russian economy is approximately 380 million USD, which makes it the first country by volume of approved (20.7%) and signed operations (20.9%). The Country Strategy for Russia on the 2011–2014 period implies an annual increase on 42.7–62.7 million USD. There is a Technical Cooperation Special Fund assisting in business plans' creation, maintaining accounting records in accordance with IFRS, etc.

BSTDB is quite unique in the sense that it publishes the criteria imposed on its vehicles, which consist on three parts – Qualitative, Quantitative sections and Other (see *APPENDIX 3*).<sup>29</sup> The main peculiarity of this Bank is that it imposes some criteria on export and import transactions, which is quite consistent with the overall mandate of the Bank.

According to the information obtained from BSTDB, there were only 24 transactions (mostly with regional banks) since 2001 covering mostly SME and trade financing without any activity concerning shareholding. The average size of the loan is about 16.5 million USD (see *Figure 8*).<sup>30</sup> It had clear upward trend till 2009. The number of vehicles picked in 2006–2007 and was equal to five. The highest level of investments provided to commercial banks was observed in 2007–2008, which asserts the countercyclical role of the Bank.

<sup>29</sup> **The Black Sea Trade and development bank.** 2012. Financial sector policy.

<sup>30</sup> Here and further: the average size of the loan was calculated across trade, SME, syndicated and subordinated loans, thus the actual amounts spent on equity investments were not included.

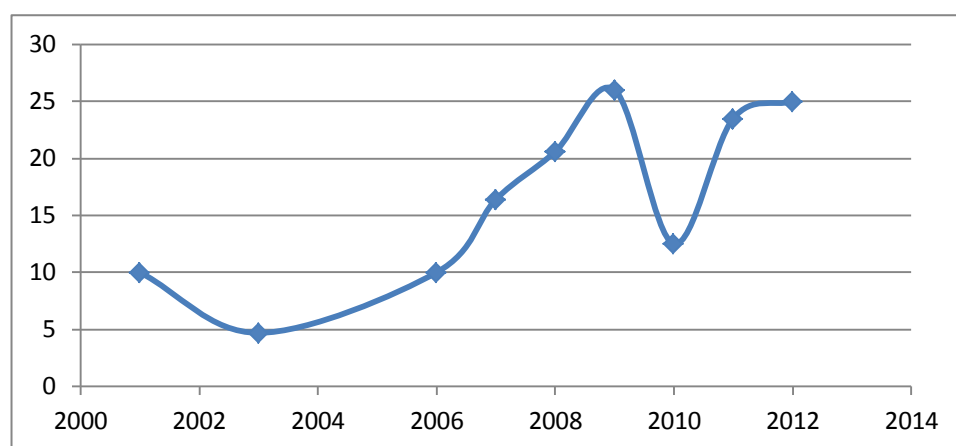


Figure 8. The average size of loan per vehicle issued by BSTDB

Source: The Author's calculations

EDB is a group regional development bank, which was founded in 2006 copying the structure and activities of EBRD. There are currently six member countries – Armenia, Belarus, Kazakhstan, Kyrgyzstan, Russia and Tadjikistan. The main mission of the Bank is

“an achievement of sustainable development of the countries, expansion of trade and economic cooperation between the countries by its investment activity.”<sup>31</sup>

Among the key priorities for the Bank are: infrastructure development, development of value-added manufacturing, and energy-efficiency.

The half of overall activity of the Bank is accounted for Russia, whereas the financial sector development is only 13.2% of its operations,<sup>32</sup> this is explained by the strong presence of EBRD and IFC in Russia as the programs proposed by the banks are almost the same. EDB currently works with three Russian banks (see Table 3), two of them are permanent partners of IFC and EBRD (NBD bank and Center-Invest bank), that explains the absence of any technical assistance for vehicles.

Table 3. Partner banks of EDB in Russia

Year	Commercial bank	Amount (million USD)	Term
2011	BTSK–Moscow	15	3 years
2012	Center–Invest bank	5	
	NBD bank	5.3	
2013	Center–Invest bank	5	

Source: obtained from EDB

Loans issued by EDB to its partner banks can be used for stimulation of modernization, innovation, development of export activity and working capital fulfillment of SMEs. Interest rates can be

<sup>31</sup> EDB. 2013. Available at: <http://www.eabr.ru/r/about/>.

<sup>32</sup> ЕАБР в цифрах и фактах. 2013. ЕАБР. Available at: [http://www.eabr.ru/general/upload/docs/finreport/fact%20sheet\\_ru.pdf](http://www.eabr.ru/general/upload/docs/finreport/fact%20sheet_ru.pdf) [EDB in facts and figures.].

both fixed (for RUB–denominated loans) and floating (for USD–denominated loans). There are no restrictions on cooperation with state–owned banks as it is in EBRD and IFC. Several special criteria are imposed to its partner banks, among them are: registration on the territory of one of member countries, the presence of SME loan portfolio, banking licenses, the absence of sanctions by the regulatory authorities, annual audited financial statements, etc.

It looks surprisingly *prima facie* that EDB is a shareholder in two Russian commercial banks – NOMOS bank (5%) and Knanty–Mansiisky bank (5%), but closer investigation shows that it is quite logical as the Chairman of the Board of Directors, Igor Finogenov was a shareholder and President of the NOMOS bank, and Knanty–Mansiisky bank is the part of the NOMOS bank group. Though EDB in this situation is not involved into a decision–making process on the operational or strategic issues, and even does not provide Tier 2 capital in the form of subordinated loans as well as NOMOS’s IPO had no relation to EDB.

### 3.3. International Financial Corporation

International Financial Corporation (IFC) is an International Financial Institution, part of the World Bank Group, which was founded in 1956 and is responsible for private sector development. However, it is not a charity institution, instead it defines its activity as:

“we play a catalytic role by demonstrating the profitability of investments in emerging markets”.<sup>33</sup>

Russia is a member of IFC since 1993 and the fourth–largest country on the volume of transactions carried out by it. For the entire period of functioning of IFC in Russia, 270 projects were implemented totaling 10.1 billion USD, 30% of which were accounted for syndicated loans. Overall there are several strategic priorities for IFC in Russia: infrastructure, value–added manufacturing, financial sector development, sub–national finance, agribusiness, health care and education.<sup>34</sup> IFC is a technical advisor for the G–20 on SME financing and also manages the Global SME Finance Innovation Fund, thus the development of this segment is a key priority for IFC (especially energy–efficient, innovative businesses

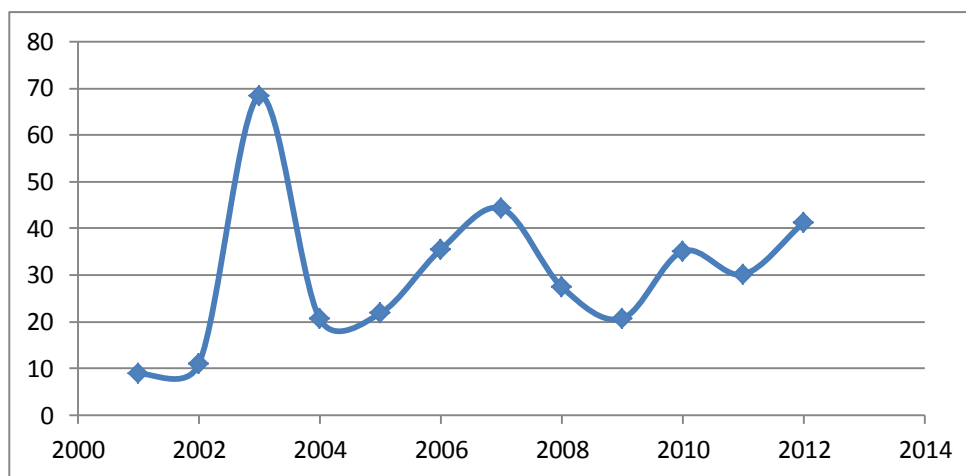
<sup>33</sup> IFC. 2012. Annual Review . P.4.

<sup>34</sup> IFC in Russian Federation. 2013. IFC. Available at: [http://www1.ifc.org/wps/wcm/connect/region\\_\\_ext\\_content/regions/europe+middle+east+and+north+afrika/ifc+in+europe+and+central+asia/countries/russian+federation+country+landing+page](http://www1.ifc.org/wps/wcm/connect/region__ext_content/regions/europe+middle+east+and+north+afrika/ifc+in+europe+and+central+asia/countries/russian+federation+country+landing+page).

and provision of banking services for women–entrepreneurs). Nevertheless, it has no direct financial interactions with SMEs (i.e. no A–loans) helping them only through commercial banks. IFC also provides its vehicles with some advisory services under the IFC’s Global SME Banking Advisory Services Program covering strategy, market segmentation, product development, risk management, etc. IFC interacts with regional commercial banks and does not control interest rates and terms of loans, which are set up on the market level by vehicle. All loans are medium– or long–term and are issued in RUB or USD.

In comparison with BSTDB and EDB, it is not much known about the activity of IFC in Russia as there is not much information about the precise procedure of how it chooses partner banks and the imposed on them criteria. However, as IFC carefully watches for its reputation, it must be assumed that it is conducted with a special care, thus its partner bank must have high level of transparency. For example, in 2007 prior to sign agreements about issuance of loan to Absolut bank, IFC claimed to disclose information on the owners of the bank.<sup>35</sup>

The number of partner bank of IFC is substantially larger than in the cases of BSTDB or EDB, the maximum number of them was eight in 2005 and 2010 (eight for each), the lowest was observed in 2006, 2008 and 2011 (three for each). The average size per one vehicle is larger than EDB and BSTDB provide. The pick of it was observed in 2003 (see *Figure 9*) and was equal to 68.3 million USD. 2005 and 2012 were the years them the maximum across the period number of purchase of shares was observed – three for each of them.



*Figure 9. The average size of loan per vehicle issued by IFC*

Source: The Author’s calculations

<sup>35</sup> Старостина, Наталья. «Абсолют Банк раскрывается». 2007. RBC daily. 17 января. <http://www.rbcdaily.ru/finance/562949979113070> [Starostina, Natalya. “Absolut bank is uncovering itself”].



The stages of interactions with commercial banks are the same as it was described in the beginning of this *Chapter* and includes issuance of loans both before getting a shareholder and at the moment of it, but not after sale of shares. Overall 12 operations of shareholding occurred since 2002 (see *Table 4*). Typically IFC buys shares with premium to capital equal to two, whereas price of the shares on the open market could be up to 2.5–3.5.<sup>36</sup> IFC behaves as a *status investor*, and it does not use the strategy of purchase of blocking shares and as a rule does not have seats at the Board of Directors, it rather prefers to provide technical assistance to banks, then to control them.

*Table 4. Equity investments by IFC*

Year of purchase	Commercial bank	Share (transaction amount)
2002	KMB bank (Banka Intesa)	10% (3 million USD)
2002	Russian Standard	10.44%(10 million USD)
2003	Deltacreditbank	9%(6 million USD)
2005	Absolut bank	7.5% (10 million USD)
2005	Locko bank	15% (19.86 million USD)
2006	Primsotsbank	12.35% (7.19 million USD)
2007	ATB	10% (20.13 million USD)
2008	Rospromstroy bank	20% (22 million USD)
2009	SKB bank	15% (1.5 million USD)
2010	CB Otkrytie (Vostochny Express Bank)	17% (100 ml USD)
2011	Transcapitalbank	7.7%(35 million USD)
2012	Credit bank of Moscow	7.5% (98.57 million USD)

Source: obtained from IFC

As for the sales of shares, it should be pointed out that IFC is quite successful in this operation. Overall there were five transactions (see *Table 5*). In case of the Russian Standard bank the initial purchased share was not the same as sold one because of smearing of capital occurred as the result of additional issue of shares.

*Table 5. Transactions on sales of shares of commercial banks by IFC*

Year of sale	Commercial bank	Share (transaction amount)	Buyer
2005	Deltacredit bank	9% (7 million USD)	Societe Generale
2005	KMB bank	10%	Banka Intesa
2006	Russian Standard bank	6.42%	Rustam Tariko
2007	Absolut bank	7.5%	KBC Group
2010	Primsotsbank	12.5% (2 million USD)	N/A

Source: obtained from IFC

<sup>36</sup> Чайкина, Юлия. «IFC поведет ЛОКО-банк в розницу». 2006. Коммерсант. 14 апреля. <http://www.kommersant.ru/doc/666734> [Chaykina, Julia. "IFC will lead LOCKO bank to retail".].

All these transactions were quite successful especially one with the Russian Standard bank, when the selling price ten times exceeded the purchase price (with the premium to capital equal to 3.5).<sup>37</sup> But the most successful one was the sale of the shares of Absolut bank to the Belgian KBC group with the premium to capital equal to 3.8–4.1.<sup>38</sup>

All sales were held within the four–year period after the actual purchase of the shares, which makes me think that propositions in the literature about the role of IFC only as an organization preparing bank for IPO (which usually takes 5–7 years) are wrong. As a rule, IFC buys the shares following two goals – either to hold shares of the bank and later sell them at a bargain price to any other strategic investor (mostly foreign bank) at the appropriate moment or to hold shares and try to prepare bank for IPO though it is unclear whether IFC knows which strategy it will follow or not. The fact remains that there is no bank among commercial banks in which IFC has been a shareholder for a period enough for a preparation for IPO (i.e. Locko bank, ATB and Rostpromstroy bank) which is going to hold IPO. For example, the representative of ATB explains it in the following manner – the capital of the bank is about 350 million USD and it is reasonable to hold IPO only in case of a threefold increase in capital.<sup>39</sup> It can be the case if there is an investor offering a reasonable price for any of those banks, IFC is likely to sell its shares without waiting for IPO.

### 3.4. The European Bank for Reconstruction and Development

EBRD is a regional development bank founded in 1991 in order to assist the development of market economies and democracies in the post–Soviet world. It is currently owned by 64 countries and two intergovernmental institutions – the EIB and the European Community. It provides project financing for banks and businesses and also assists in privatization, restructuring of state–owned firms and municipal services’ improvement. Approximately one third of its operations are concentrated in Russia,

<sup>37</sup> Банк «Русский Стандарт». 2013. RBC. Available at: <http://www.rbc.ru/companies/russianstandard.shtml> [The Russian Standard bank.].

<sup>38</sup> Абсолют Банк. 2013. Banki.ru. Available at: <http://www.banki.ru/banks/bank/absolutbank/> [Absolut bank.].

<sup>39</sup> Аксёнов, Евгений. «Азиатско–Тихоокеанский банк из Благовещенска растёт втрое быстрее и вдвое прибыльнее рынка». 2012. Эксперт. №29. <http://m.expert.ru/expert/2012/29/kazhdyiy-dvadtsatyy-kreditnyiy-rubl-za-uralom-budet-nash/> [Aksenov, Evgeny. “Asian–Pacific Bank is growing three times as fast and twice more profitable than market”.].

one third of which, in turn, cover the development of SMEs and financial institutions.<sup>40</sup> Russia became a key region for the Bank as in 2010 it was decided to terminate the project financing in former republics of the USSR and the socialist countries that joined the EU.<sup>41</sup>

Overall there are four strategic priorities for EBRD in Russia:

- Diversification of the Russian economy;
- Supporting modernization and innovation through SME support;
- Assisting privatization and development of private sector;
- Promoting the development of Russian regions.<sup>42</sup>

Therefore, the development of SME sector is one of the key priorities in the activity of EBRD. Though it provides some direct technical assistance to them, the main role of EBRD in SME financing is to support their trade, energy efficiency and innovation activities. In order to make this sector attractive for commercial banks and teach them how to work with quite opaque new sector, EBRD hires special companies through the organization of tenders, which later work with commercial banks. There are three main directions of such technical assistance – overall consulting on the volumes of SME in credit portfolio of the commercial bank (currently providing by the Frankfurt School of Finance and Management), seminars for employees and online training (both providing by German consulting company IPC GmbH). The last two directions are performed within the RSBF, which was created in 1994 with the assistance of G7 and Switzerland. Through 40 partner banks more than 700,000 small loans were issued worth over 11 billion USD in 427 Russian cities and towns (60% of which with population less than 100,000 citizens). Overall 11,000 bank employees were taught the basics of the so-called “Credit technology” – special program created by IPC GmbH and successfully spread in the market. The main peculiarity of this approach is in implementation of client-oriented approach in working with micro- and small enterprises based on the analysis on cash flows of businesses as opposed to traditionally unified scoring methods. All bank-leaders use somehow this technology even Sberbank and VTB 24 which were once vehicles of EBRD in 2004 and 2006, respectively.

<sup>40</sup> EBRD. 2013. Country strategy for Russia. P.5.

<sup>41</sup> Мазин, Евгений. «Мастер кредитной импровизации». 2006. Газета. 22 августа. <http://www.banki.ru/news/bankpress/?id=198932> [Mazin, Evgeny. “The master of credit improvisation”.].

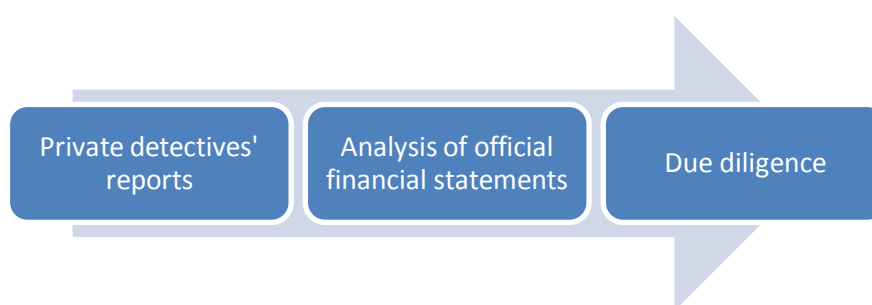
<sup>42</sup> Focus areas in Russia. 2012. EBRD. Available at: <http://www.ebrd.com/pages/country/russia/focus.shtml>.

EBRD has high reputation in the market even despite the scandal erupted in 2011 with Elena Kotova – the former executive Director for Russia on the Bank’s board of Directors, who was accused of acceptance of 1.33 million USD bribe for approval of 133 million USD loan from EBRD to one Russian company.<sup>43</sup> Thus it also imposes high criteria toward its vehicles, but they are unclear as there is no official information as well as in the dialogues with representatives the only thing which was able to learn is that besides financial criteria, EBRD also carefully examines the structure of shareholders, which is actually confirmed by public interviews of some of its former employees.

Before 1999 EBRD had used quite formal approach toward evaluation of partner banks relying mostly on data obtained from official statistics, auditors and international rating agencies. But after massive bankruptcies this approach had been substantially changed. Since then before making the final decision thorough study of vehicles is being conducted including their shareholders and managers. EBRD even hires private detectives in order to check business and personal reputation of potential business partners. As Gennady Melykhan recalls:

“However, we did not fully trust these reports of detectives, but used them based on our own knowledge and common sense.”<sup>44</sup>

The second stage of the approach is critical analysis of the official financial statements. And only after these two steps – due diligence (see *Figure 10*) is performed. That is why negotiations typically last for several years and approximately only one out of three candidates obtains financing.<sup>45</sup>



*Figure 10. Stages of vehicles’ choice by EBRD*

*Source: depicted by the Author*

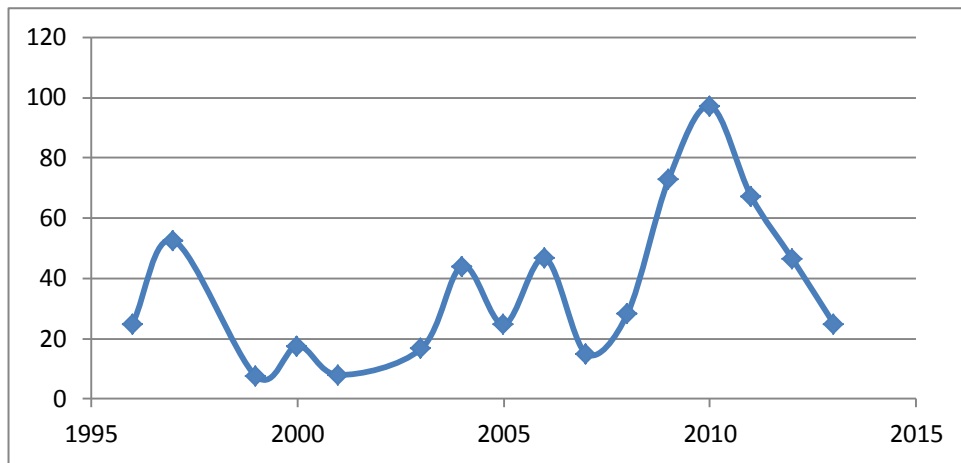
<sup>43</sup> Киселёва, Елена, Владислав Трифонов, Олег Сапожков и Алёна Миклашевская. «В ЕБРР идет выемка российских сотрудников». 2011. Коммерсант. 4 февраля. <http://www.kommersant.ru/doc/1578863> [Kiseleva, Elena, Vladislav Trifonov, Oleg Sapozhkov, Alena Miklashevskaya. “There is a seizure of the Russian employees in EBRD”].

<sup>44</sup> Тулин, Дмитрий. «Как реформировать банковский надзор». 2011. Slon.ru. 9 августа. <http://www.banki.ru/news/bankpress/?id=3140532> [Tulin, Dmitry. “How to reform the banking supervision”].

<sup>45</sup> Как ЕБРР блокирует банки. 2008. Bankir.ru. 7 апреля. <http://bankir.ru/publikacii/s/kak-ebrr-blokiruyet-banki-1379441/> [How EBRD blocks banks].

Not only approach toward the decision making about vehicles has been changed substantially since the beginning of EBRD's functioning in Russia. Based on the statistics obtained from the Bank's website, it should be noted that initially in 1996 it preferred to work with large banks from Moscow region, some of them were state-owned (e.g. Sberbank, Roseximbank, etc.), some of them – private (e.g. Tokobank, Avtobank, etc.). After the Russian crisis in 1998 occurred EBRD decided to focus on SME development, which led to the decision of changing mandate of created in 1992 the Russian Bank for Project Finance into the Small Business Credit Bank ("KMB Bank" or "KMB"), which happened in 1999 involving the help of the aforementioned partner of EBRD – the German IPC GmbH company. Huge loan portfolios of its vehicles facing financial troubles at that time were put into this bank. After these turmoil years EBRD fully returned to its activities only in 2003. Since then it started to focus mostly on the development on regional commercial banks, which due to their access to soft information are more effective in SME lending. These banks have potential and as a teacher EBRD tries to determine ones which are able to reveal it with certain help from outside ("small but beautiful" banks). It stopped working with state-owned bank and the only reason why the RSBF worked with Sberbank and VTB 24 was that they have prefix "commercial" in their names.

EBRD as development bank performs a countercyclical role – the overall volume of its operations increased substantially in the turmoil periods (1997, 2004 and since 2008) as well as their average level as it is depicted in see *Figure 11*. The largest number of commercial banks was observed in 2006–2007 (15), the lowest – in 1999–2001 (1–2). As a rule, loans larger than 60–70 million USD were syndicated or subordinated loans before 2009 (with minor exception concerning VTB 24 received twice in 2006 on 150 million USD each). Since 2009 some commercial banks (e.g. Banka Intesa, MDM bank, Credit Europe, etc.) started to receive funding on SME financing on large amounts (75–174 million USD). There is no information about terms, but they are usually up to 5–7 years. Loans are typically issued in RUB, EUR or USD. Interest rates are also published but they are usually fixed or floating (with some interest rate over MosPrimeRate or LIBOR), but the interest rates for final borrowers are usually set up at the market level and EBRD does not control for it in comparison with the SME bank.



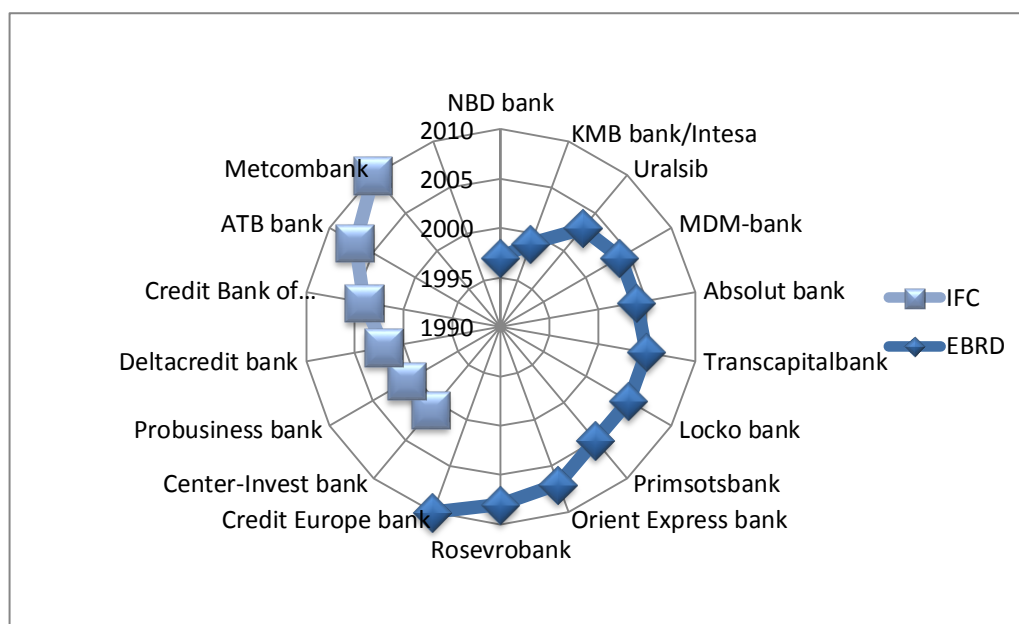
**Figure 11. The average size of loan per vehicle for EBRD**

Source: calculated by the Author

Among the traditional partners of EBRD in syndicated loans are other DBs (mainly IFC) and some commercial banks – Commerzbank AG, Credit Suisse AG, HSBC Bank, ING Bank, The Royal Bank of Scotland, Raiffeisen Zentralbank, etc. EBRD in these transactions plays the role of lender of the record.

It should be noted that there is a pool consisting of 53 commercial banks with which DBs of the whole considered in this *Chapter* group interact, and EBRD in this situation is not only a bank with the maximum number of interactions encompassing 39 commercial banks (versus 30 in IFC, 14 in BSTDB and 3 in EDB), but it also performs the role of a pioneer in this market.

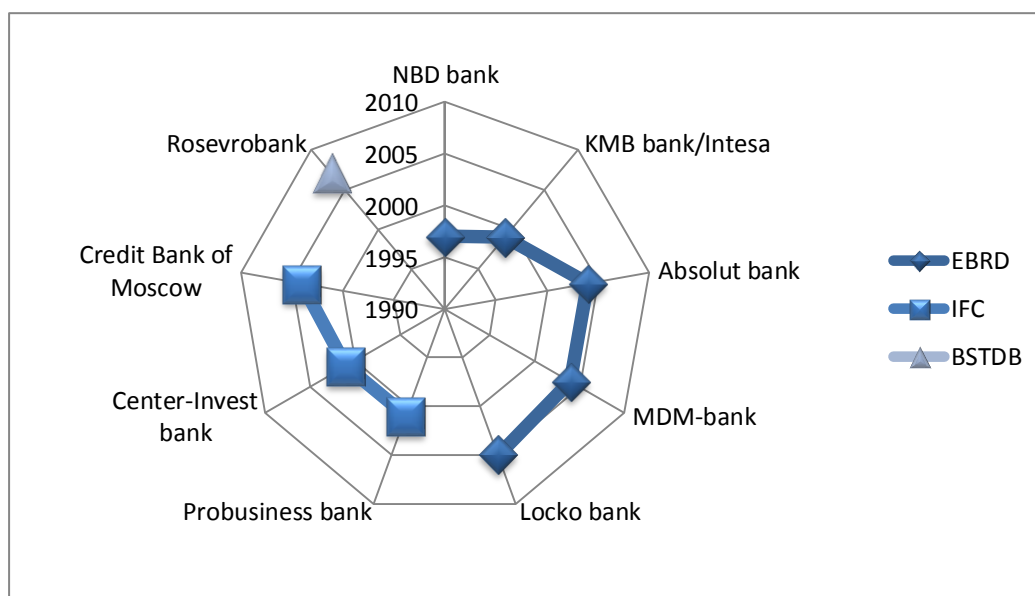
Basically two situations were considered: first one includes commercial banks being vehicles for EBRD and IFC (20 in total) during the considered period; second one includes partner banks of EBRD, IFC and BSTDB (8 in total). *Figure 12* and *Figure 13* show that in most cases (11 out of 20 for EBRD/IFC and 5 out of 9 for EBRD/IFC/BSTDB) EBRD was the first development bank with which commercial banks started to interact.



**Figure 12. The beginning of cooperation commercial banks with different development banks (case of EBRD and IFC)**

*Source: created by the Author*

In case of three development banks (which can be actually potentially expanded to four including EDB as both its partners – NBD bank and Center-Invest are also depicted here), it is clearly seen that IFC and EBRD firstly choose “small but beautiful” bank, start interactions with them and this serves as a signal to other DBs about reliability of these banks. The willingness of commercial banks to interact with different DBs can be explained by the fact the marginal cost of interaction with one new DB is almost zero as all the procedures and requirements for DBs are the same, but commercial bank gains more reputation with more DBs as partners, has an opportunity to attract one of them as a status investor (or attract external strategic investor) and also has opportunity to obtain more funding (as there are can be limits on one borrower for the DB set up by the Board of Directors).



**Figure 13. The beginning of cooperation commercial banks with different development banks (case of BSTDB, EBRD and IFC)**

Source: created by the Author

The scheme of interaction between EBRD and its partner banks in whole is the same as it was described at the beginning of this paragraph, but some peculiarities exist. Based on the analysis of 19 commercial banks in which EBRD was or is a shareholder (see *APPENDIX 4*), it can be stated that, as in the case of IFC, sometimes purchase of share in commercial bank occurs together with the provision of other sources – SME financing (Center–Invest bank, Primshots bank, SDM bank and Transcapitalbank) or subordinated loans (International bank of Moscow and Promsvyazbank).

In almost all cases there was some interaction before in the form of different loans, but shareholding in Uraltransbank and Orgesbank was not accompanied by any interaction before or after purchase. This can be explained by the fact that EBRD knew Orgresbank as the former provided trade guarantees for the latter, and this commercial bank before had interactions with other financial institutions – KfW (SME financing in 2006) and permanent partners of EBRD in syndicated loans – Bankgesellschaft Berlin AG и Commerzbank AG. The absence of any loans is connected with the fact that the Scandinavian bank Nordea decided to settle in the Russian market through Orgresbank and all long-term funding was provided by it. The situation with Uraltranbank is less clear. On the one hand, the absence of interactions with EBRD prior to shareholding can be explained by that this bank worked with several export credit agencies (ECAs) – German HERMES, Italian SACE, which automatically proves its



reliability. At the same time, according to the information obtained from the web–page of Uraltransbank, it had obtained several loans from IFC and KfW in 2009. On the other hand, according to the same source, EBRD provided SME and trade financing in 2002 to this bank, and funding for financing agribusiness in 2009, while this may be true, there is no information in EBRD’s database as well as amounts of this transactions are not specified by Uraltransbank.

EBRD behaves as *status investor*, but in a form slightly different from IFC, it traditionally followed the strategy of buying a blocking stake in a commercial bank (>25%), which actually has been changed since 2008. Irrespective to its share, EBRD always gets a seat in the Board of Directors and its representative heads the Audit Committee. EBRD also has a right to block certain decisions of its management bodies especially in case of change of control over the organization. EBRD is not responsible for dealing with operational issues, hence scandals in controlled bank are not a rarity. For example, in 2010 Uraltransbank and Transcapital bank were accused of fraud. The former issued loans to employees of almost bankrupt Baranchinsky Electromechanical Plant totaling more than 4.33 million USD and the latter was involved into a fraudulent scheme with cashing out payrolls.<sup>46</sup> And in 2013, Primotsbank was fined by the Regulator for money laundering.<sup>47</sup> As EBRD performs a countercyclical role, in turmoil 2009 it increased the volume of operations in recapitalization of its banks, for instance, the share of EBRD in Transcapitalbank increased from 25% to 28.6%, Center–Invest bank and Bank Saint–Petersburg received 1.17 and 2.5 million USD as subordinated loans.<sup>48</sup>

Overall, there are several benefits for commercial banks as EBRD being shareholder:

- i. An opportunity to increase Tier 2 (through subordinated loans) and Tier 1 capital (through equity investments);
- ii. Access to international financial markets (e.g. URSA bank (which was merged with MDM bank in 2007) provided credit–notes placement in 2005 only due to EBRD reputation);

<sup>46</sup> ЕБРР впал в транс–схему.2010. RBC daily. 30 августа. <http://www.finnewsline.ru/2010/08–30.html> [EBRD was trapped into trans–scheme.].

<sup>47</sup> ЦБ наказал Примсоцбанк и Региональный Коммерческий Банк за нарушение закона об отмывании.2013. Banki.ru. 19 февраля. <http://www.banki.ru/news/lenta/?id=4583372> [The Bank of Russia punished Primotsbank and regional commercial banks for violation of the law on money laundering.].

<sup>48</sup> Пашутина, Елена и Юлия Локшина. «Институт свернул развитие». 2010. Коммерсант. 10 февраля. <http://www.kommersant.ru/pda/kommersant.html?id=1319302> [Pashutinaya, Elena and Julia Lokshina. “The intuition terminated development”.].

- iii. Credit rating's improve (e.g. credit rating of regional SKB Bank was improved by Fitch to B– (the level of Moscow banks) and by Moody's – to B2 stable) and higher disinclination of international rating agencies toward its changing even in case of financial difficulties (e.g. in 2006 Fitch confirm rating of Uraltransbank despite worsening financial performance due to public support from EBRD<sup>49</sup>);
- iv. Reduction in cost of obtained sources due to the absence of fees to EBRD;
- v. Significant increase in bank's value.

The last point seems to be one of main reasons for EBRD being shareholder. Overall there were six cases when EBRD sold its shares (see *Table 6*) in Russia. It is important to point out that sometimes EBRD sells its shares gradually and in some cases (e.g. with KMB bank) it stays as a shareholder. However, after complete sale all interactions are over.

*Table 6. Sales of shares in vehicles*

Year of sale	Commercial bank	Share (%)	Buyer
1996	Tokobank	9.6	Tokobank
2001	Avtobank	15	Interros Group
2005	KMB bank	75	Banca Mesa Group
2007	International Moscow Bank	10	Bank Austria Creditanstalt
2007	Kedr	18.75	Valentina Kozub
2008	Orgresbank	9	Bank Nordea

*Source:* obtained from EBRD

There is no official information about the amounts of transactions, but according to analysts they are highly profitable. For example, EBRD invested 33 million USD in the Moscow International bank (including three additional issues of the shares), and in 2007 it sold its shares for 229 million USD. Traditionally it buys shares with two-time premium to capital, which is quite low estimate. It is not surprising since commercial bank gets lots of additional benefits from this interaction, but the most impressive is the fact that conditions are often negotiated at the initial stages of partnership, and when its value increases commercial bank has to execute the terms of the agreement, otherwise it has to pay a fine.

<sup>49</sup> Кудинов, Василий, Елена Мязина и Людмила Черных. «Именем ЕБРР». 2006. Ведомости. 30 марта. <http://www.banki.ru/news/bankpress/?id=143340> [Kudinov, Vasily, Elena Myazina and Ludmila Chernyh. "In the name of EBRD"].

For example, EBRD received option on purchase of 10.44% shares of the Russian Standard bank in 2002 after issuing 10–million USD loan to it. Two years later, EBRD decided to execute the agreement but the value of the bank increased substantially and its owner, Rustam Triko, was ready to sell this amount of shares for 600 million USD to BNP Paribas instead of claimed by EBRD 170 million USD. Thus the Russian Standard had to pay 4–million USD penalty to EBRD. The French bank contrarily further refused to buy this bank, but it was soon sold to IFC. The only known bank which could sell at the higher then in the option agreement price was Orgresbank, but it happened due to the entry into the capital another major player – the Scandinavian bank Nordea. At the end, EBRD bought 12.49% shares for 43.7 million USD instead of initially planned 15% for 30 million USD.<sup>50</sup>

Traditionally EBRD sells its shares to foreign banks seeking to enter the Russian market (Italian Banka Intesa, Austrian Creditanstalt and Scandinavian Bank Nordea). However, in 1996 Tokobank purchased its shares because of pressure from the Bank of Russia and in 2001 owned by oligarchs structure bought Avtobank. The purchase of the shares of Kedr bank by private investor was explained by the fact that EBRD tried to avoid reputational risks caused by the emergence of minority shareholders.<sup>51</sup>

As in case of IFC, none of the banks primarily in which EBRD has been a shareholder for more than five years (NBD bank, Uraltransbank, Center–Invest bank, MDM bank, Primsotsbank, Transcapitalbank, SKB bank, Spurt bank, Promsvyazbank) announced IPO (or flotation) in any form except for Promsvyazbank which had to postpone its plans because of too low price for the Global depository receipts (GDR) offered by investors (10 USD instead of expected 10–12 USD).<sup>52</sup> It should be pointed out that the Russian banks are in general do not tend to hold IPO, for example, based on the analytical report of the PricewaterhouseCoopers covered Russian IPOs since 2005,<sup>53</sup> it can be seen that

<sup>50</sup> Как ЕБРР блокирует банки. 2008. Bankir.ru. 7 апреля. <http://bankir.ru/publikacii/s/kak-ebrr-blokiruyet-banki-1379441/> [How EBRD blocks banks.].

<sup>51</sup> Максимова, Марина и Альберт Кашкаров. «ЕБРР и East Capital покинули банк «Кедр». 2012. RBC daily. 13 января. <http://www.rbcdaily.ru/finance/562949982511737> [Maksimova, Marina and Albert Kashkarov. “EBRD and East Capital left Kedr bank”].

<sup>52</sup> Белкина, Екатерина и Иван Шлыгин. «Промсвязьбанк отложил IPO, посчитав слишком низкой цену размещения». 2012. RBC daily. 16 октября. <http://www.rbcdaily.ru/finance/562949984934443> [Belkina, Ekaterina and Ivan Shlygin. “Promsvyazbank postponed IPO because of too low offering price”].

<sup>53</sup> PwC. 2012. Обзор IPO российских компаний за 2005–2012 гг. С. 5–7. [PwC. The review of IPOs in the Russian market 2005–2012.].

only five commercial banks were involved in these transactions: state-owned giants – Sberbank (2007) and VTB (2007), Bank Vozrozhdenie (2007), Bank Saint-Petersburg (2007) and NOMOS bank (2011). That can be explained by the fact that there are some disadvantages for a company to be public: they as rule have lower efficiency of decision-making; the quality of decision-making can be also reduced by the fact that the interests of minority shareholders can be quite different from interests of major shareholders. The process of getting public is always accompanied by significant costs spent on organization of a system of communication with the existing and potential investors. Moreover, growing risks of hostile takeovers appear, which may also deter banks from the step toward IPO. While the most important incentive for commercial bank to become public is an opportunity to determine the market price of the business, which further can become a starting point in the negotiations with strategic investors.<sup>54</sup> Nevertheless, in case of status investors which provide additional capital as IFC and EBRD, the incentive toward IPO significantly decreases. Together with relatively small size of these banks' capital (<1 billion USD) and the fact that they still have opportunity both to obtain funding in the form of subordinated loans (Tier 2 capital) and funds through the issuance of bonds (guaranteed by the DBs), it can be explained why banks are not in a hurry to enter foreign markets.

This *Chapter* shows that the activity of development banks of the second strategic group is not surprisingly able to help attracting more funds to the SME sector. For example, the role of EBRD in this whole process was so much important that its “Credit Technology” method became the fundamental pillar of proper risk assessment for commercial banks issuing SME loans in Russia and factually triggered their activity in servicing this sector. Nevertheless, this group of DBs has also clear mandate on development of the banking sector, that is why the priority of some DBs is not actually SME financing itself but an exercising of successful equity transactions, hence I can conclude that they do help as they still allocate some amount of funds to SME financing, but with some extent.

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<sup>54</sup> Бүздалин, Алексей. 2007. «IPO как альтернатива стратегической бесперспективности». Бизнес и банки. №4. [Buzdalin, Alexey. 2007. “IPO as an alternative to strategic deadlock”].

## CHAPTER 4. Development banks in dynamics: the case of interaction and future transformation

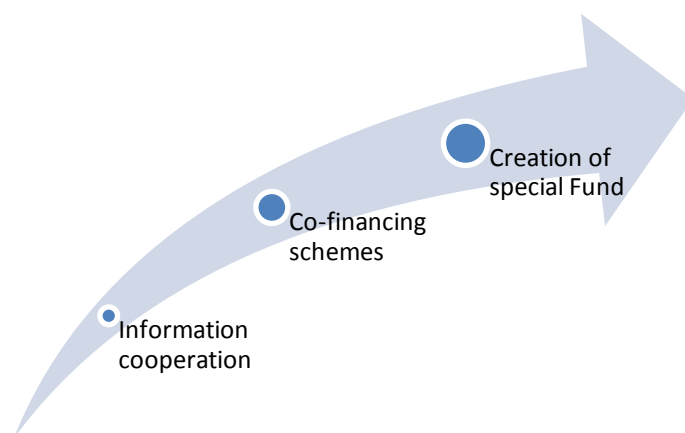
This *Chapter* is aimed at keeping track on some exiting dynamics in activities of development banks, thus it firstly considers different forms of interactions of DBs both within and between strategic groups and then it moves to the analysis of their future roles – both announced and expected.

### 4.1. Development banks in cooperation

Based on the analysis conducted in the preceding *Chapters*, I can assert that DBs perform their role in SME financing and definitely try to help attracting more development funds, if by the latter I mean the money of commercial banks which would never have been assigned to SMEs without DBs (as this money mostly assigned in the form of medium– and long–term loans, which apparently have primary goal on development).

Nevertheless, my analysis would be quite narrow without focusing on several more moments. First of all, by *development fund* I also mean the money provided by other DBs to the SME sector through their vehicles. And that is why their role can turn to be both positive or negative and this is exactly my logic in considering the case of DBs' interaction – cooperation and competition. Another important issue is in DBs' themselves, as it was depicted in *Chapter 2* and *Chapter 3*, DBs help, but only in some extent, because some of them do not consider the quality of issued loans (the first strategic group) and for the others – SME support as just an intermediate goal and they mostly concern about equity investments, for this reason, it is interesting to check in which direction they are going to transform, in order to create some tangible recommendations on how to make them more helpful in case of SME support and whether it is actually possible to make such recommendations for both groups. Thus guided by this logic, I first consider the case of interaction in the forms of cooperation and competition and then I will try to analyze the future activities of DBs from both strategic groups.

Cooperation<sup>55</sup> is quite common form of interaction in case of DBs and it is performed in three main directions as it is depicted in *Figure 14*.



*Figure 14. Basic forms of development banks' cooperation*

*Source: created by the Author*

During the interviews with representatives of some of DBs, it was found out that DBs actively share information about their partner banks, it mainly concerns DBs belonging to the same strategic group – for example, EBRD and IFC, EBRD and BSTDB, IFC and EDB. It is not a surprise that EBRD is a key node in this scheme because as it was described in *Chapter 3*, it has the most debugged mechanism of decision making about vehicles, the details of which are held in the strictest confidence. There is also a presence of some information cooperation between two groups – for example, since 2010 the SME bank organizes Forum “SME – contribution to the new economy” devoted to peculiarities of SME financing in the sphere of innovation, modernization and energy efficiency, where the representatives from EBRD, KfW and IFC deliver their reports.<sup>56</sup>

The second form of cooperation includes participation of DBs in co-financing schemes – syndicated, subordinated loans, equity investments; and also provision of guarantees. For example, VEB stimulates the activities of these DBs through the provision of guarantees, the SME bank is not involved into this activity as it does not provide such operations though in 2010 VEB offered guarantees to EBRD

<sup>55</sup> There should be some clarification on the fact that such form of interaction when one DB factually provides funding to the other DB, which then distributes funds to the commercial banks, is not a form of cooperation but the certain business model of that particular DB. By *cooperation* I mean the process of horizontal mutually beneficial interaction between market players as opposed to vertical interaction in the previous case.

<sup>56</sup> МСП Банк проводит II ежегодный форум «Малый и средний бизнес – вклад в новую экономику». 2011. Bankir.ru. 29 ноября. <http://bankir.ru/novosti/s/msp-bank-provodit-ii-ezhegodnyi-forum-malyi-i-srednii-biznes-vklad-v-novuyu-ekonomiku-10011978/#ixzz2UNZFLkor> [The SME bank conducts II Annual Forum "SMEs – contribution to the new economy."].

on loans which could have been issued by the latter to the SME bank, but EBRD refused to participate in this activity.<sup>57</sup> Some of these agreements are performed at the intergovernmental level and are part of agreements on the overall economic cooperation between countries. For example, in 2011 VEB and the Austrian OeEB agreed on the mutual SME support on the Russian–Austrian business forum in the presence of the President of Austria Heinz Fischer.<sup>58</sup>

The participation of several DBs in co-financing schemes the issuance of syndicated and subordinated loans is usually performed as a part of the Framework Agreement for Cooperation, which allows to participate in syndicated loans (including loans to commercial banks) and also gives access to the sharing of experience in the structuring of transactions, due diligence, etc. For example, such agreements had been already signed between IFC and EDB, IFC and FMO, IFC and EDB.<sup>59</sup> For DBs without strong presence in Russia it is also a chance to expand their activities both performing their mandate on development but fully relying on the risk assessment conducted by DB with considerable experience (but it is not the same as the form of business model of KfW discussed in *Chapter 2*). For instance, FMO and EBRD provided 3.33–million USD syndicated loan to the Center–Invest bank on the energy efficiency in 2007,<sup>60</sup> and in 2008 FMO participated in the issuance of subordinated loan on 50 million USD to the Vozrozhdenie bank with DEG.<sup>61</sup>

As it was stated in *Chapter 3*, EBRD and IFC are successful *status investors* for the commercial banks, that is why they also cooperate shareholding them. For example, in 2007 they bought 25.2%+2 shares of Primsofsbank.<sup>62</sup> What is more, they try to get options on the purchase of the shares in

<sup>57</sup> ЕБРР может выделить РосБР кредит на 200–500 млн долларов. 2009. Banki.ru. 16 сентября.<http://www.banki.ru/news/lenta/?id=2251658> [EBRD may allocate 200–500 million USD for the Russian Development Bank.].

<sup>58</sup> ВЭБ и австрийский ОеКВ договорились о совместной поддержке малых и средних предприятий. 2011. Banki.ru. 19 мая. <http://www.banki.ru/news/lenta/?id=2951898> [VEB and Austrian OeKB agreed on the support of the small and medium-sized enterprises.].

<sup>59</sup> IFC и ЕАБР подписали базовое соглашение о сотрудничестве. 2011. Bankir.ru. 14 марта. <http://bankir.ru/novosti/s/ifc-i-evraziiskii-bank-razvitiya-rasshiryaut-vozmojnosti-finansirovaniya-na-razvivauschihsya-rinkah-9237280/> [IFC and EDB had signed the Framework agreement for Cooperation.].

<sup>60</sup> Банк «Центр–Инвест» и KfW инвестируют 12 млн. евро в энергоэффективные проекты на Юге России. 2008. Bankir.ru. 11 июня. <http://bankir.ru/bank/news/93354/1171648#ixzz2UNWa6Fy9> [Center–Invest bank and KfW invest 12 million euro into energy-efficient project in the Southern Russia.].

<sup>61</sup> Банк «Возрождение» привлёк субординированный кредит на \$ 50 млн. 2008. Bankir.ru. 4 августа. <http://bankir.ru/novosti/s/bank-171vozrojdenie187-privek-sybordinirovannii-kredit-na-50-mln-1107225/#ixzz2UNcjSLrz> [Vozrozhdenie bank attracted subordinated loan on 50 million USD.].

<sup>62</sup> ЕБРР и IFC купили пакет Примсоцбанка. 2007. Banki.ru. 2 апреля.<http://www.banki.ru/news/lenta/?id=282569> [EBRD and IFC bought a blocking stake Primsofsbank.].

commercial banks together or issue subordinated loans with the possibility of further conversion into shares as in case of Probusinessbank.<sup>63</sup>

The highest form of cooperation which though has not been performed yet in Russia is the creation of special Fund. As it was already mentioned in *Chapter 2*, there are ongoing negotiations between the representatives of VEB (but it will be implemented, of course, through SME bank) and KfW on the creation of such Fund. It is interesting to point out it could have appeared in 2010, when VEB and KfW agreed to create such entity for provision of equity investments for innovative SMEs,<sup>64</sup> but this idea found its expression only now. The creating Fund will have waterfall distribution of payments to the investors based on different risk bearing by them. The Fund will provide both A- and B-loans to SMEs using comprehensive set of tools including loans, mezzanine financing, and equity investments. The priority sector for the Fund will be innovative SMEs with the loan on one borrower up to 26.6–39.9 million USD.

However, whether this Fund will really assist the attraction of development funds to the SME sector is unclear as if it helps only SMEs created in conjunction with the German side, it will not solve the problem with current SME financing as the scope of such operations is quite low.<sup>65</sup>

## 4.2. Development banks in competition

DBs do not interact only by cooperation, but also by competition with each other, despite all kinds of denial on the part of their representatives. It mostly arises within one strategic group – the second described – and concerns its major players – IFC and EBRD, behavior of which also affects the activities of all the rest DBs. Two basic situations concerning their actual competition can be considered:

- I. When both DBs issue loans to the same regional commercial bank, in which only one of them is a shareholder. The second one tries to obtain actual information about the final borrowers in order to share this information with other commercial bank operating in the

<sup>63</sup> Кобзева, Оксана. «Инвестиционный дуэт». 2006. Бизнес. 22 марта. <http://www.banki.ru/news/bankpress/?id=140805> [Kobzeva, Oksana. "Investment duo"].

<sup>64</sup> ВЭБ и KfW создадут ЗПИФ для инноваций. 2010. Banki.ru. 25 июня. <http://www.banki.ru/news/lenta/?id=2041875> [VEB and KfW create Closed Mutual Investment Fund.].

<sup>65</sup> Литвинова, Анастасия. «Для поддержки малого бизнеса KfW и ВЭБ создают фонд на 1 млрд евро». 2011. RBC daily. 23 августа. <http://www.banki.ru/news/bankpress/?id=3173227> [Litvinova, Anastasia. "KfW and VEB create 1-billioneuro Fund for small businesses' support"].



same region, in which the second DB may or may not be a shareholder, but which is considered as major vehicle for it.

- II. While both working with the same commercial banks, DBs usually put a lot of effort on the complete usage of their credit limits by the commercial banks. Thus in case of a situation when vehicle returns some funds to one DB but completely used credit limit issued by other DB (and here their actual cooperation arises), the first one carefully claims for a feedback and try to make some concessions to its vehicles in order to predict and avoid such situations. Probably it is an explanation of the fact why terms, interest rates and other conditions of IFC and EBRD are so similar.

While searching for the information for this study, I found out one more interesting example of competition. In 2012 IFC issued syndicated (with EBRD) loan to the Vostochny Express bank on SME financing and expansion of its regional network. As the result of the latter, several branches of this commercial bank appeared (and appear) in several small Russian towns – for example, in Osinniki (Kemerovo region) with the population of 44,983 citizens.<sup>66</sup> At the same time, this particular town was included into the list of monocities of the SME bank, which even specially created one program – the SME Regional Growth – for the development of the SME financing in territories with almost absent supply of banking services. As a result, among six commercial banks there are two with development funds – Vostochny Express bank (IFC and EBRD) and Uralsib bank (SME bank), and apparently they compete as both have special programs on purchase of the equipment. The latter though has strong comparative advantage in interest rates as there are subsidized. In this case it is unlikely that Orient Express bank will offer funds at interest rates equal or below 14% (which is the upper limit for Uralsib bank) because of the margin which will be significantly lower as issued by IFC and EBRD funds are more expensive. Thus currently Orient Express bank is worse off in this situation.

There is also some presence of *the crowding out effect* of development funds existing because of the activity of EBRD and IFC. The main peculiarity of which is in the fact that it is observed only in the second strategic group. On the one hand, it occurs in direct form, i.e. some DBs had to leave the market.

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<sup>66</sup> Осинники. Официальный сайт Администрации города. 2013. Администрация города Осинники. Available at: <http://osinniki.org/>.

For example, FMO decided to nullify its activities in the Russian market. Though official representatives of the Bank state that the decision was triggered by the Russian investment grade, but last time the investment rating had been downgraded is 2008 (by S&P from BBB+ to BBB<sup>67</sup>), which is unlikely could influence the decision of FMO. Some experts from commercial banks speak in favor of the version that FMO just could not provide funds at the price which is competitive in comparison with other DBs – mainly IFC and EBRD as they belong to the same strategic group and have the dual mandate, because it could not estimate the risk properly and they do not have a strong presence in Russia (even in terms of regional office). And at the same time FMO had quite narrow access to cooperation with major players. Therefore, nowadays its priority shifted to the Caucasian region (Armenia, Azerbaijan and Georgia), where EBRD, IFC, BSTDB and FROM created SEAF Caucasus Growth Fund for small business support.<sup>68</sup>

On the other hand, this effect can be expressed indirectly in the change of strategies of some of incumbent players. EBRD and IFC also made the shift in the priorities of EDB, which does not expand its activities in Russia and operates only with three commercial banks, instead focusing more on Kazakhstan market where competition among DBs is much lower. This is explained by the fact that EDB does not have such a debugged mechanism on decision making about vehicles, thus it has to operate only with current partners of EBRD and IFC. At the same time, it does not provide any technical assistance toward its vehicles and as it does not have such highly recognizable status as EBRD or IFC in the eyes of other strategic investors, it is unlikely that it can earn much money on equity investments (i.e. its presence is unlikely automatically increase bank's value), thus EBRD and IFC restrict in some sense the potential activity of EDB.

But EBRD and IFC are able to hamper the transaction of small DBs. For instance, BSTDB had an intention to become *status investor* and it was going to convert its 20–million USD subordinated loan issued to the Credit bank of Moscow to shares, but the transaction was cancelled out because additional issue of shares was jointly bought by EBRD and IFC.

<sup>67</sup> S&P понизило инвестиционный рейтинг России. 2006. Голос России. 10 декабря. [http://www.km.ru/news/sp\\_ponizilo\\_investicziornyj\\_rejt](http://www.km.ru/news/sp_ponizilo_investicziornyj_rejt) [S&P downgraded Russia.].

<sup>68</sup> **International Financial Institutions support small businesses in Caucasus.** 2012. EBRD. Available at: <http://www.ebrd.com/pages/news/press/2012/120330b.shtml>.

Based on the aforementioned material it can be stated that different forms of interactions of DBs influence differently the dynamics of development funds obtaining by the SME sector. The presence of competition among DBs asserts that the potential amount of development funds which DBs are ready to provide could have been large in some extent. At the same time, cooperation help the attraction of funds because DBs expand their activities into new market segments (i.e. support of innovative SMEs) or vehicles by sharing risks with each other and also improve further efficiency through the exchange of experience. Both interactions arise mostly within one strategic group, which can be explained by similar roles played by the actors within groups but not between them.

#### **4.3. Shifting the priorities: the first strategic group**

The future role of the DBs from the first strategic group will be considered first and then I will focus on the role of EBRD and IFC. Unfortunately, the direction of future activities KfW is quite unknown except for the part of its cooperation with VEB which had been already discussed and some opinions of experts that in Russia the activity of KfW will be mostly focused on the development of agribusiness.

Analyzing the future activities of the two players from the first strategic group, it can be stated that both the SME bank and IIB tend to expand their activities in the future mostly by provision of direct loans to SMEs including syndicated with commercial banks loans. The activity of the SME bank will concentrate mostly on the development of previously uncovered areas of activity, which are quite unattractive to commercial banks – innovative firms and start-ups. The strategy of the IIB does not imply the development of any particular segment in the SME sector but involves significant presence in the capital of SMEs by making equity investments. In order to implement these plans, both banks need to create significant territorial network of representative offices which they do not have now, both of them will take time and entails significant costs.

At the same time, in my opinion, the main drawback in all strategies of these banks is that they do not take into account the presence of any peculiarities in the development of some particular sectors, all their programs are universal, but SME sector is very sensitive and any interaction with it requires great care – one small mistake can destroy the business. This drawback is highly connected with another

one – DBs do not create programs which would be focused on the cultivation of business – from small to medium and large – accounting for their needs. But some of them actually would overlap with ones offered by commercial banks (e.g. trade financing), and violate the main principle of the functioning of DBs, thus the SME bank cannot offer the whole bunch of such products directly, but its partners cannot provide them either because they have quite weak association with the needs of growing business (lack of competency), or they basically do not have enough funding to provide such bunch of products or some of them just obtain cheap funding from the SME bank and satisfy with a fixed margin. That is why the possible solution from this situation would be not to create any special Fund focused on medium-sized business as the most constrained now (as even state support does not cover loans from 5 to 33.3 million USD as exactly the gap between the upper limit of the loan of SME bank and the lowest one for VEB), but to provide some technical assistance toward commercial banks in order to improve their efficiency, the absence of which in my opinion is the main drawback in the activities of the banks of the first type. My analysis onwards will cover the actual review of the strategies of this type of the DBs – SME bank and IIB.

According to the new strategy for 2012–2015, there are three basic scenarios for transformation of activity of SME bank:

1. The realization of the current scheme of lending through its 134 partner banks. According to the forecasts, the volume of credit market for innovative companies will reach 5.73 billion USD by the end of 2015 and the market share of SME bank will be 11%. The current share of SMEs in this market, according to estimates, is 4.5%.
2. The Bank starts providing A-loans for innovative businesses without any additional funds from the Government. On the contrary, it will unlikely allow to create a system of loan market for innovative companies and in this case according to the estimates, the market share of the Bank will reach 11.7% by the end of 2015, and the market overall will grow to 6.27 billion USD due to the elimination of partner banks in a chain and an increase in volume of lending.
3. The SME bank gets 1.07 billion USD as an additional capitalization from VEB and the Federal budget, it will allow to create a market for lending start-ups with the volume of 8.07 billion USD,

and the Bank will take a quarter of this market with 1.93 billion USD in loans. The additional funding will be obtained from VEB which annually transfers 10% of its profits in SME bank, and 0.67 billion USD – from funds which are now directed to the regional authorities to subsidize SMEs.<sup>69</sup> The mechanism of this scenario is called the "innovative elevator." The funds will be invested directly in SMEs at all stages of their life cycle. This scenario is considered as a priority for the Bank, it also suggests active cooperation with different state institutions responsible for creation of the knowledge-based economy, among them – different venture funds, the innovative Fund "Skolkovo" and the Russian Foundation for Technological Development of SMEs. Together with the latter two, it plans to fund applied research and the creation of industrial samples. By cooperating with venture funds, SME bank will provide companies with the means for patent research.

By *innovation* the Bank means:

"An introduction to the use of new or significantly improved product (goods and services), as well as a new sales method or a new organizational method in business practices, workplace organization."<sup>70</sup>

Range of businesses, which by this definition can be attributed to the innovative, is fairly broad, thus it explains that such company should have a patent on scientific and technical development and the range of purchased equipment should not be older than 5 years. For these companies the SME bank will offer loans at rates that are only 1.5 times higher than the refinancing rate (now approximately 12.4% per annum, the average market rate is about 18%).

Nevertheless, according to the expert estimates, it is not obvious in reality which of the scenarios is optimal. Both the second and the third ones bear too high risks, which will not be covered by low interest rates on innovative loans, but with the first one the Bank will not obtain any optimal growth. The second one will not allow creating a stable market for business lending. The third scenario highly depends on the government financing and it is also not clear how large the expected proportion

<sup>69</sup> МСП Банк просит в бюджете 20 миллиардов на инновации. 2013. Bankir.ru. 1 февраля. <http://bankir.ru/novosti/s/msp-bank-prosit-v-byudzhete-20-milliardov-na-innovatsii-10035922/> [The SME bank asks for 20 billion rubles from the state budget.].

<sup>70</sup> «Дочка» ВЭБа обещает раздать стартапам 58 млрд рублей. 2013. Известия. 11 февраля. [http://www.siora.ru/news/detail/novosti\\_rapmsb/dochka\\_veba\\_obeshaet\\_razdat\\_startapam\\_58\\_mlrd\\_rublej/](http://www.siora.ru/news/detail/novosti_rapmsb/dochka_veba_obeshaet_razdat_startapam_58_mlrd_rublej/) [The VEB's branch promises to assign SMEs 58 billion rubles.].

of the "good" borrowers in this segment is and what should be their minimum profitability. At the same time, this scenario is very close to the Research & Development (R&D) Funds, which are focused on the initial stages of the development of new products or technologies and their introduction into production. The Bank also adds the third and most difficult stage of financing – pre-sowing. Thus, controlling risks at all stages, and realizing the growth potential, SME bank will be able to "grow" for itself clients for further financing.<sup>71</sup>

With the second and the third scenarios, the SME bank is planning to share 15–25% of credit risk with its partner banks by providing syndicated loans with them. In this case, some of the projects will obtain financing by 100% (now the upper limit is 75%), and it is expected that interest rates for the final borrowers will go down though the funding for partner banks will increase from 5.5 to 9.75%.<sup>72</sup> Sector of innovative companies is quite unattractive for commercial banks, because of special methods for risk assessment which should be implemented. Not many of commercial banks have such methods and as a result, the default rate in this segment is quite high now and is equal to 8.0–8.5%.<sup>73</sup> Moreover, commercial banks usually reject projects not because the project will not generate enough cash flows but because of the fact that borrower cannot provide enough collateral for loan, thus the participation of the SME bank is needed.

However, the SME bank imposes too high requirements to the borrowers; as a result, the mitigation of the part of the risk is unlikely to change the situation. At the same time, the risk assessment also provided by the SME bank can lengthen the time of the application, which can be critical to the borrower. The role of SME bank in the whole process of decision making will be changed because it will have not only to consider the overall stability of partner bank but also to participate in the internal procedures for the determination of credit limits for borrowers in order to avoid situations

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<sup>71</sup> Ibid.

<sup>72</sup> **Баязитова, Александра.** «Государство пошло на риск». 2013. Коммерсант. 1 февраля. <http://www.kommersant.ru/doc/2117375?isSearch=True> [Bayazitova, Alexandra. "The state has to take risk".].

<sup>73</sup> **Борисяк, Дарья.** «Дефолт на паях с МСП банком». 2012. Ведомости. 21 сентября. <http://www.banki.ru/news/bankpress/?id=4119973> [Borislyak, Darya. "Default on shares with the SME Bank".].

when partner bank issues loan on 25% more only because this part of risks will be covered by the SME bank.<sup>74</sup>

Turning to the second DB from this group – IIB, it can be stated that according to the new strategy for 2013–2017, SME financing will become one of the priority activities for it. Operations will include both the provision of B-loans for commercial banks and direct financing to SMEs in the form of equity investments. However, as in case of the SME bank, the IIB will share risk with commercial banks by participating in syndicated loans to SMEs. The Bank will also put an effort on cooperation with National and International Financial Institutions on SME and trade financing, which has been already started, for example, in 2013 VEB and IIB concluded an agreement on provision of funds to SMEs through the subsidiary of the latter – the SME bank<sup>75</sup>.

The Bank as it has been already mentioned in the *Chapter 2* has to cope with a difficult financial situation caused by its activity in the financing projects on leftovers. With the half of NPLs it was decided to work by organizing an affiliated company – the IIB Capital, which will factually perform a role of a collection agency,<sup>76</sup> and actually in future can be also useful in the event of a bankruptcy of final borrowers. The overall business model of the Bank will be modified by the implementation of the system of performance indicators and transition to a modern system of budgeting. The organization structure of the Bank will be also changed, and it is most likely that in the foreseeable future it will have regional offices. It is being discussed the issue of renaming the Bank in order to give it a sonorous name and further focus on generation a corresponding brand and good reputation without an association with its difficult past.

Quite recently after a huge scandal with Cyprus and the Russian deposits, more and more discussions concerning the creation of offshore in Russia were held. However, in whole this topic will remain beyond the scope of this work, it should be mentioned that IIB was proposed to become such an

<sup>74</sup> **Баязитова, Александра.** «Государство пошло на риск». 2013. Коммерсант. 1 февраля. <http://www.kommersant.ru/doc/2117375?isSearch=True> [Bayazitova, Alexandra. “The state has to take risk”].

<sup>75</sup> Международный Инвестиционный Банк прокредитует малый и средний бизнес в России. 2013. Banki.ru. 17 января. <http://www.banki.ru/news/lenta/?id=4455146> [The International Investment Bank will issue loans to small and medium-sized enterprises in Russia].

<sup>76</sup> Акционеры Международного инвестиционного банка одобрили стратегию развития и бизнес-план на ближайшие три года. 2012. Бизнес ТАСС. 30 ноября. <http://www.biztass.ru/news/id/49080> [Shareholders of IIB approved the strategy and business plan on three years.].

offshore organization<sup>77</sup> and it is likely that it will not be a subject to the law on banking secrecy. But only this measure will not allow to bring back the Russian money and it is needed to cut taxes for companies and banks operating through IIB,<sup>78</sup> in case of success the IIB will obtain funding in which it now needs so much in order to achieve all its goals including expansion of SME financing.

#### 4.4. Shifting the priorities: the second strategic group

As for the second strategic group, unfortunately there is quite a few information about the future role of BSTDB and EDB. But in my opinion, the only way how they can actually help attracting more funds to the SME sector is focusing mostly on the foreign economic activity of SMEs as they have mandate on trade facilitation and as export financing is quite weak in the Russian banking sector. On the contrary, I can analyze in detail the future activities of the major players – EBRD and IFC.

As it was stated in *Chapter 3* they are quite similar institutions as for their shareholders, performing roles, using mechanisms and offering products. It is not surprising that they share information about partner banks and closely cooperate with each other (though there is some evidence of competition between them) and, thus as to their future role in the market, it will be also quite similar, and they should be considered together. They are able to implement the proposed activities together drawing on the experience and competence of each other. Their activities can be potentially expanded in two directions (not actually, mutually exclusive ones), which will allow them to focus on what they do best but in a larger scope – to increase an efficiency (or health) of the whole banking system by: additional capitalization of regional commercial banks and buying up the NPLs of the commercial banks. There were some attempts to implement these activities, but none of them is currently working, which in principle does not detract from their merits.

The case of additional capitalization starts with the fact that the activity of both institutions is concentrated on the development of small regional banks, which are quite constrained in terms of capital as their profitability is not enough for increasing capital, they cannot raise enough funds from

<sup>77</sup> The term “*offshore*” in this case simply means not a territory or jurisdiction, but the place where people or organizations are able to secretly and safely put their money. However, according to the International practice, it is exactly an area but not an institution with a special financial and corporate legislation.

<sup>78</sup> Королёва, Анна. «Офшор в законе». 2013. Эксперт. 18 апреля. <http://expert.ru/2013/04/18/ofshor-v-zakone/> [Koroleva, Anna. “Offshore-in-law”].



external capital markets and the monetary authorities provide quite weak policy in this direction, the situation is aggravated by the intentions of the Russian Ministry of Finance to increase the minimum level of capital from current 6 million USD to 33.3 million USD by 2015.<sup>79</sup> Therefore, all the activities of DBs in the sphere of additional capitalization of the banks have an utmost importance as the existence of the entire regional banking system is at stake.

There were some efforts undertaken in past in this direction. For example, in 2009 IFC had an intention to spend 1 billion USD on provision of additional capitalization to commercial banks. However, this initiative was further abandoned because of the fact that actually IFC could still buy shares of regional commercial banks (potentially 13 more according to the estimates<sup>80</sup>) even without the Fund, imposing quite strict criteria toward them as it is usually done by IFC. As the result, either not the entire amount of funds could have been capitalized or it could have had to invest into Moscow-based commercial banks (i.e. large banks). Thus this Fund could not have led to the emergence of more accessible resources to small commercial banks as there was no incentive for IFC to issue loans to the banks which could not have received them without this Fund.

Hence quite a logical step from the Russian Ministry of Finance appeared in 2011 – it proposed the establishment of the joint Fund for similar purpose. The planned amount of funds invested by the Ministry of Finance of the Russian Federation is 500 million USD, the SME bank – 250 million USD, IFC – 50 million USD and approximately 100 million USD will be additionally obtained by 100 million USD from other investors – mostly pension and sovereign funds, with which there are ongoing negotiations. This might be true that EBRD can also potentially be involved in the activity of this Fund. There are currently 30 candidate commercial banks for the participation in the program. Officially there are several requirements toward them: the bank must be private (not state-owned); there should be no presence of foreign investors in the capital and the bank needs to provide statements in accordance with IFRS.<sup>81</sup>

<sup>79</sup> Минфин: надо увеличить минимальный капитал банков. 2012. ВЕСТИ Экономика. 21 марта. <http://www.vestifinance.ru/articles/9099> [The Ministry of Finance: We need to increase the minimum level of bank's capital.].

<sup>80</sup> Дементьева, Светлана и Ксения Дементьева. «IFC дает \$1 млрд на докапитализацию российских банков». 2009. Коммерсант. 30 апреля. <http://www.banki.ru/news/bankpress/?id=1005557> [Dementieva, Svetlana and Kseniya Dementieva. "IFC provides \$ 1 billion for capitalization of Russian banks".].

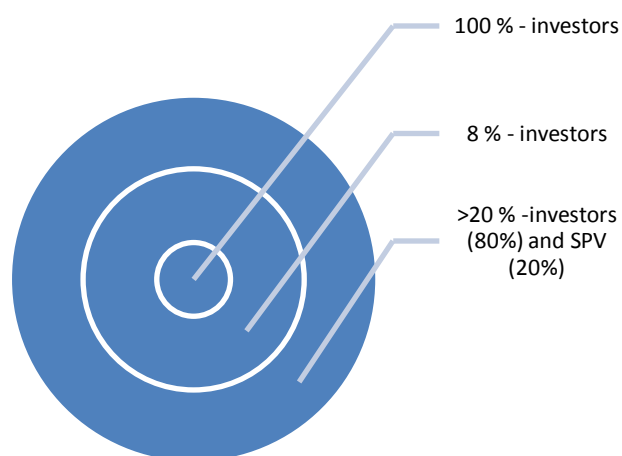
<sup>81</sup> Старт проекта IFC по докапитализации средних банков РФ переносится на полгода. 2011. Banki.ru. 22 декабря. <http://www.banki.ru/news/lenta/?id=3483827> [The start of the IFC's project on additional capitalization of medium-sized banks will be postponed by half a year.].

For managing the Fund the Special Purpose Vehicle (SPV) company will be created, subsidiary of IFC, which actually has an experience in this activity. For example, it currently manages three similar Funds – IFC Capitalization Fund created with Japan Bank for International Cooperation (JBIC), Africa Capitalization Fund and IFC African, Latin American, and Caribbean Fund (IFC ALAC Fund).

It is planned that invested funds will be used to provide financial services for real sector of the Russian economy, non-financial companies and SMEs. SPV will buy shares (including preference shares and convertible preference shares), subordinated debt and other similar tools of raising capital. However, as it is an indirect tool, it is unclear what will be the real effect of this Fund to the SME sector and banks can just have incentives to allocate money in the most convenient for them way – i.e. allocating money in their habitual way without shifting the priorities. And the real effect of the Fund will be in just overall provision of so much scarce capital in Tier 2 form.

The planned period of functioning of the Fund is eight years starting from the moment of termination of raising funds with the possibility of extension for two years. During the first 3–5 years SPV will invest borrowed funds, and by the end of this period – pay to the investors from the sale of the assets. In order to increase the capitalization of the acquired assets, SPV will also provide advisory services in the area of risk management, introduction of new technologies, enhance marketing and management capabilities of banks, raising the standards of corporate governance.

The profit distribution is depicted on *Figure 15*. It suggests that investors in any case will receive a full refund of invested amounts. In case if Fund generated income exceeding the amount of the initial investment, the distribution of it shall be as follows. First of all, it will be directed to the investors in the amount ensuring the internal rate of return of investment, equal to 8% per annum. If actual income exceeds this amount, then the rest is divided between investors (80%) and SPV (20%). At the same time, there is a commission for the SPV, which is up to 2% of the aggregate amount of initial investments and in the future – up to 2% of the amount of actual investments.



**Figure 15. The proposed profit distribution of profits generated by the Fund**

*Source: created by the Author*

The second direction concerns the activity of EBRD and IFC in terms of buying up of the NPLs of the commercial banks, despite the fact that there were some attempts in the past this activity had not been performed by them yet. It is a very real issue for the Russian banking sector as the level of NPLs reached 10.5% of all loans (or 70 billion USD), 80% of which are in Top–30 the largest banks,<sup>82</sup> which can be explained by their excessive activity in using scoring methods for risk assessment. The idea to create special governmental entity responsible for purchase of toxic assets on loans to legal persons had been already discussed in the public; in contrast, both the Ministry of Finance and the Central bank spoke out against this idea, because it would increase the risks for the whole banking system.<sup>83</sup>

That is why, as a solution to the existing problem, IFC decided to invest up to 100 million USD into purchase of toxic assets of the Russian banks, as the result, in 2010 it concluded two agreements – with the EOS Group on the purchase of debt on consumer loans (according to the estimates they will be able to eliminate up to 2 billion USD of NPLs) and the Varde Partners on buying up the debts of legal persons. There were several negotiations with 5–6 commercial banks on purchase of portfolios of up to

<sup>82</sup> IFC в рамках совместных проектов купит в РФ проблемных активов на 700 млн евро. 2010. Banki.ru. 22 сентября. <http://www.banki.ru/news/lenta/?id=2265587> [IFC under joint programs buys toxic assets on 700 million euros.].

<sup>83</sup> Максимова, Марина, Антон Вержбицкий и Кирилл Ячеистов. «IFC лезет в российские долги». RBC daily. 22 сентября. <http://www.banki.ru/news/bankpress/?id=2264881> [Maksimova, Marina, Anton Verzhbitskii and Kirill Yacheistov. “IFC gets into Russian debts”.].

2 million USD, the main problem though was uncompetitive price.<sup>84</sup> For example, when collective agencies were buying toxic assets with 90–% discount, EOS offered 93–97%.<sup>85</sup> Nevertheless, the exact amount of transaction is unknown, but it makes me think that it was significantly lower than it was initially expected.

The creation of the special SPV company, responsible for purchase of toxic assets, was actually proposed to the EBRD in 2008 by the Association of Regional Banks of Russia. SPV was planned to issue bonds as funding sources and the inclusion of its securities into the Lombard list of The Bank of Russia could have created incentives for investor in buying them. The banks' resolution was planned to be conducted through affiliated with EBRD banks by simply buying the shares of banks with high level of NPLs,<sup>86</sup> and then working with them by providing additional technical assistance and participating in strategic management. However, this idea has not been implemented yet, in this case it is most likely that the Russian Ministry of Finance could propose IFC and EBRD to create SPV (responsible only for the purchase of shares) in partnership, in which IFC and EBRD would choose potentially treatable banks with high level of NPLs and then implement all their knowledge in the sphere of risk management, marketing and corporate governance to make them efficient.

This *Chapter* shows that DBs can both help and hinder attracting more development funds to the SME sector. The first one appears as the result of their cooperation with each other within each of the group as well as between them. And as the result of their strategies, for the first group SME sector will remain the priority and they will even expand their activities by closer cooperation (or I would say performing higher level of integration) through creation of special Fund aimed at SMEs and assisting SMEs directly. The latter though raises some doubts about the efficiency of these operations and definitely needs some significant changes in DBs' activities. Whereas I cannot assert this about the second group of DBs (they do help but this help will diminish) and from my point of view it will not be a

<sup>84</sup> IFC в рамках совместных проектов скупит в РФ проблемных активов на 700 млн евро. 2010. Banki.ru. 22 сентября. <http://www.banki.ru/news/lenta/?id=2265587> [IFC under joint programs buys toxic assets on 700 million euros.].

<sup>85</sup> Старт проекта IFC по докапитализации средних банков РФ переносится на полгода. 2011. Banki.ru. 22 декабря. <http://www.banki.ru/news/lenta/?id=3483827> [The start of the IFC's project on additional capitalization of medium-sized banks will be postponed by half a year.].

<sup>86</sup> Григорьева, Елена. «Доктор ЕБРР». 2008. RBC daily. 20 октября. <http://www.banki.ru/news/bankpress/?id=680209> [Grigorieva, Elena. "Doctor EBRD".].

big surprise to find out in decade that EBRD and IFC will be responsible exclusively for the health of the banking sector without helping banks in expansion toward certain sectors.

Nevertheless, as the result of the analysis I also found that development banks do hinder attracting more funds to the SMEs. This is a clear result of competition within the second group. This “*crowding out effect*” is observed between EBRD and IFC – on the one hand and the rest – on the other hand.

## CONCLUSION AND POLICY RECOMMENTATIONS

In this *Thesis*, I analyzed the effect of the activity of development banks on the development of the SME sector in Russia. My analysis showed that contrary to their officially stated mandate on the attraction of more funds to the SME sector and despite some cooperation between DBs that is observed in the market and may be regarded as a proof of accomplishing their mission, very often the real goal of development banks is not to support SMEs, but to gain profits from the equity investments in the commercial banks.

To show this, I divided all the existing DBs into two strategic groups. The first group consists of IIB, KfW and the SME bank. For this group the SME support is an ultimate goal, but their activity faces significant constraints as for them the maximization of the volume of assigned loans prevails over the actual economic impact of these loans, thus SMEs have to create fake statistics in order to have opportunity to obtain such funds. For the second strategic group consisting of BSTDB, IFC, EBRD, FMO, DEG and OeEB, SME support is just an intermediary stage towards the opportunity to exercise a highly profitable transaction. Not surprisingly their actual strategies are also quite different. The first group sees its future role in direct interactions with SMEs, whereas the activity of second one will likely shift towards the improvement of the health of the banking sector, without any primary concern on the SME support.

I actually found that for the whole economy it is good to have two different strategic groups of development banks called to perform the same role – to cope with the “missing middle” by helping in every possible way to encourage commercial banks to provide SME financing, but in order to do it in a more effective way and increase the amount of funds assigned to SMEs, I am able to propose several policy recommendations. For the first strategic group of DBs, I would recommend to focus on the creation of closer interactions within the group. Especially it concerns interaction between major players – IFC and EBRD – and some small DBs – mostly BSTDB and EDB, which do not have good tools on risk assessment and enough experience in this sphere, this is exactly the reason why they are not able to determine “small but beautiful” commercial banks by themselves.

For the second group of DBs (mostly I propose recommendations for SME bank and IIB), the only solution to achieve their goals is the creation of several regional branches (at least one for each Federal District), since, as it has been mentioned earlier, SME financing is a specific sector and it is impossible to assess risks properly without being close to the client. As for the SME bank precisely, I would also recommend to abolish the minimum level of funds on one region (regional limits) in order not to create a perverse incentive for the Bank to allocate money even in case of there is no vehicle of required quality.

Another improvement can be achieved in a shift of their priorities in the hierarchy of economic agents; in this sense, I would propose to put more emphasis on interactions with vehicles and to provide some technical support to them as some DBs from the second strategic group make with a great success. Moreover, a creation of a system directed on the improvement of financial services to SMEs would give the DBs an opportunity to improve the efficiency of the whole banking sector, as employees often change their jobs (that was exactly the reason why “Credit technology” became so successful and why commercial banks started to finance SMEs in a much larger volume). Finally, DBs should create programs on a sectoral basis (as opposed to today’s general programs) and it also concerns the activity of creating between VEB and KfW Fund that would consist of concrete and detailed requirements on the impact that issued loans need to produce in each given case. Today, these requirements are not sector-based, they are inevitably too general to assess the real impact of each loan, and thus they create an incentive to SMEs to produce unreliable statistics.

One important issue revealed in this study is the existence of competition between development banks – mostly between major and minor players from the second strategic group. This undoubtedly hinders the attraction of funds to SME sector by crowding out the activities of small DBs, hampering their transactions and forcing them to shift their activities from Russia to other countries where competition is not that strong. In the case of the first group of DBs, the competition problem will most likely appear in the form of their competition not with each other, but with commercial banks, since they will both be financing SMEs directly. This would be a serious problem since it violates the main principle of the work of DBs: non-competition with market players. At this point, it is difficult to

predict or to estimate the scope of this competition, notwithstanding this raises an important question for future research. This problem can be analyzed, for example, using the methods of industrial organization; unfortunately I cannot specify the exact model as no data for such an analysis exists at present.



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## APPENDICES

### APPENDIX 1. List of referred institutions

#### International organizations:

- *Organization for Economic Cooperation and Development* (<http://www.oecd.org/>)

#### Development banks:

- *African Development Bank* (<http://www.afdb.org/>)
- *Asian Development Bank* (<http://www.asdb.org/>)
- *Banco Nacional de Desenvolvimento Economico e Social* (<http://www.bndes.gov.br/>)
- *Black Sea Trade and Development Bank* (<http://www.bstdb.org/>)
- *Business Development of Canada* (<http://www.bdc.ca/>)
- *China Development Bank* (<http://www.cdb.com/>)
- *European Bank for Reconstruction and Development* (<http://www.ebrd.org/>)
- *European Investment Bank* (<http://www.eib.org/>)
- *Nederlands Fin.– Maatschappij voor Ontwikkelingslanden NV* (<http://www.fmo.nl/>)
- *Inter–American Development Bank* (<http://www.iadb.org/>)
- *International Investment Bank* (<http://www.minbank.ru/>)
- *International Financial Corporation* (<http://www.ifc.org/>)
- *Kreditanstalt für Wiederaufbau* (<http://www.kfw.de/>)
- *Oesterreichische Entwicklungsbank AG* (<http://www.oe–eb.at/>)
- *Russian Bank for Assistance of Small and Mid–sized Enterprises* (<http://www.msp.ru/>)
- *The World Bank* (<http://www.worldbank.org/>)
- *Vnesheconombank* (<http://www.veb.ru/>)

#### Credit Rating Agencies:

- *Expert RA* (<http://www.raexpert.ru/>)
- *Fitch* (<http://www.fitchratings.com/>)
- *Moody's* (<http://www.moody's.com/>)
- *Standard and Poor's* (<http://standardandpoors.com/>)



## APPENDIX 2. Programs for SMEs proposed by the SME bank through its intermediaries

Program and parameters	Conditions for vehicles	Conditions for clients
<b>SME–Stimulus</b>		
<i>Purpose</i> – credit support of SMEs engaged in non–trading activities through partner banks with high credit ratings.		
Term	1–5 years	6 months–5 years
Amount	Min 500 million RUB (or 16.7 million USD)	Min 150 thousand RUB and not more than 60 million RUB (or 5 th – 2 million USD)
Interest rate	9.25–10%	Max 14.25%
<b>SME–Regional Growth</b>		
<i>Purpose</i> – credit support of SMEs in regions with low or absent demand for financing, monocities and areas affected by emergencies.		
Term	1–3 years	6 months – 3 years
Amount	Min 500 million RUB (or 16.7 million USD)	Max 60 million RUB (2 million USD)
Interest rate	8.5%	14%
<b>SME–Idea</b>		
<i>Purpose</i> – credits support for SMEs implementing innovative projects in order to ensure the scientific and technological development of the Russian economy, the competitiveness of exported goods, works and services in the global market and improve quality of life.		
Term	2–7 years	2–7 years
Amount	60–150 million RUB (2–5 million USD), max – 85% of project cost	60–150 million RUB (2–5 million USD), max – 85% of project cost
Interest rate	7%	Max 12.5%
<b>SME–Maneuver</b>		
<i>Purpose</i> – implementing modernization projects in order to ensure the scientific and technological development of the Russian economy, the competitiveness of exported goods, works and services in the global market and improve quality of life.		
Term	2–7 years	2–7 years
Amount	60–150 million RUB (2–5 million USD), max – 85% of project cost	60–150 million RUB (2–5 million USD), max – 85% of project cost
Interest rate	8%	Max 12.5%
<b>FIM–Target</b>		
<i>Purpose</i> – financing of SMEs for the implementation of innovative, modernization and energy efficiency projects		
Term	Max 5 years	1–5 years
Interest rate	8.5%	Max 12.5%
<b>Refinancing of non–trade sector</b>		
Term	1–5 years	6 months–5 years
Interest rate	10%	N/A
<b>SME–Baltic</b>		
<i>Purpose</i> – financing of SMEs engaged in non–trading activities, the implementation of innovative, modernization, energy efficiency projects, resource or environmental projects in Kaliningrad, Leningrad, Novgorod, Pskov territories and St. Petersburg.		
Term	1–5 years	Min 1 year
Interest rate	5.5%	N/A

Source: obtained from SME bank

### APPENDIX 3.Criteria imposed on vehicles by BSTDB

Section	Subsection	Requested information
Qualitative	Ownership Structure	List of shareholders and the existence of some guarantees from them
	Operational Framework	Regulatory ratios with the Central bank, laws on collateral enforcement, etc.
	Management and organizational structure	Information about Supervisory Board, the Board of Directors, organizational structure of the Bank, plans on restructuring, etc.
	Operations and market position	Information about subsidiaries, branches, sub-branches, products, services, market share, operational budget, strategic plan, etc.
	Information technology	IT structure, core banking system, etc.
Quantitative	General financial information	Audited financial report in accordance with the IFRS
	Capital adequacy ratio	CAR for three years, Tier 1, Tier 2 capital, etc.
	Loan portfolio	Credit risk limits, portfolio monitoring, etc.
	Securities portfolio	Equity investment, institution's investment and trading policy, etc.
	Funding, liquidity and foreign exchange risk	Liquidity gap analysis, interest rate analysis, etc.
Other	Trade finance activity	Export and import transactions

Source: obtained from BSTDB

#### APPENDIX 4. Shareholding of commercial banks by EBRD

Year of purchase	Commercial bank	Share (transaction amount)	Other products
1994	Tokobank	14% (35 million USD)	Loan in 1996
1996	Avtobank	15% (20 million USD)	Subordinated loan
1997	NBD bank	25%+1	Syndicated loan on SME financing in 2007
1999	KMB bank/Banka Intesa	37%	Loans on SME financing in 2009 and 2012
2001	International Moscow bank	10%	Loan on medium-term investments in 1996, Subordinated loan – 2000 and 2004, Syndicated loan in 2004, Equity investment – 2004 and 2006
2003	Uraltransbank	25%+1 (8 million USD)	–
2004	Center-Invest bank	27.45% (3.2 million USD)	SME financing in 2004, 2006, 2007 and 2013; equity investment – 2005
	MDM bank	5.2%	Mortgage financing in 2005, syndicated loan on SME financing in 2006, subordinated loan in 2006
2005	Primsotsbank	12.5%	SME financing in 2005, equity investment in 2006
2006	Kedr	18.75%	SME financing in 2007
	Orgresbank	12.5% (43.6 million USD)	–
	Transcapitalbank	28.59%	SME financing in 2005 and 2011; mortgage financing in 2005, syndicated loan in 2010, equity investment – 2011
	SKB bank	26% (30.07 million USD)	Subordinated loans in 2006 and 2007
	Spurt bank	28%	SME financing in 2005
2008	Promsvyazbank	11.75% (153 million USD)	SME financing in 2005 and 2010, subordinated loan in 2005 and 2011, syndicated loan on regional expansion in 2007, equity investment in 2011
2011	SDM bank	15% (11.7 million USD)	SME financing in 2011
	Bank St.Petersburg	6.1%	Syndicated loan in 2008, subordinated loan in 2009, SME financing in 2010
	Rosevrobank	11% (30–50 million USD)	SME financing in 2008
2012	Credit bank of Moscow	7.5%	Syndicated loan on trade and SME financing in 2009

Source: obtained from EBRD