Chapter 6

Access to finance for SMEs and entrepreneurship in the russian federation

Although recent state interventions have significantly increased the supply of external financing to SMEs and entrepreneurs, further increases in the scale and sophistication of financial markets for SMEs and entrepreneurship will be critical for the growth of SMEs and entrepreneurship in the Russian Federation. This chapter examines the nature of the SME and entrepreneurship finance gap and how policy is seeking to address it in the Russian Federation, covering bank loans, microfinance, and equity finance. It makes a number of recommendations for further improvements, including strengthening the operational arrangements of credit guarantee funds, expanding credit history information and credit bureaus, and increasing the remit of the public Vnesheconombank and SME Bank to cover new financial products and roles such as education in SME financing for investor institutions.

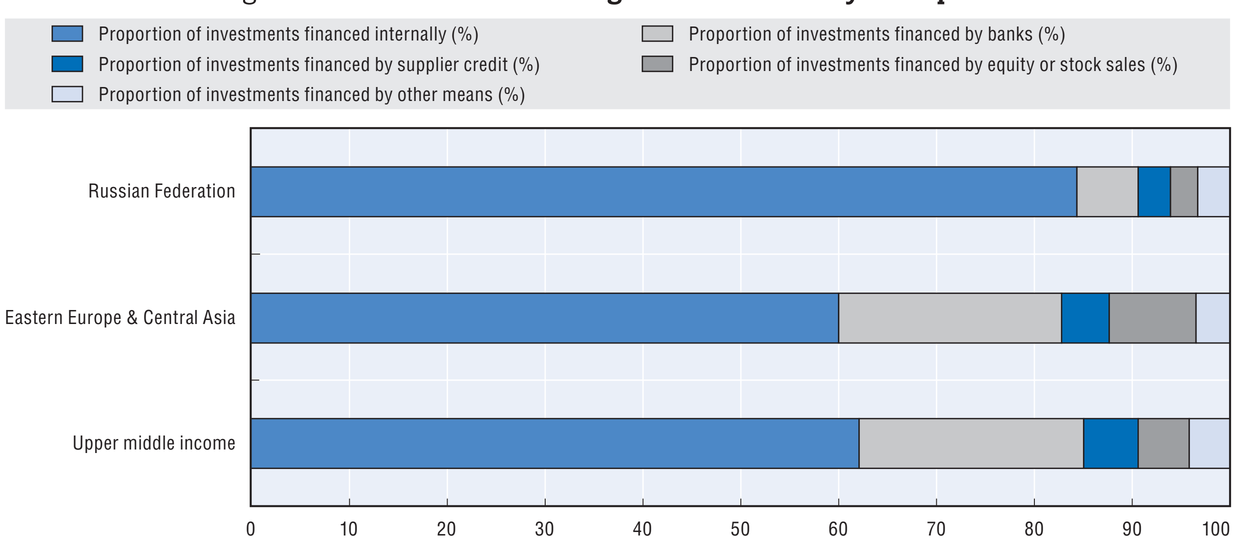
The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Over-reliance of SMEs on internal funding

Although SMEs and entrepreneurs can draw on their own resources for investment and working capital, such as reinvested profits, the personal savings or credit card borrowing of owners, or borrowing from friends and family, a strong reliance on internal funding tends to be associated with relatively low growth in the SME economy (OECD, 2006). Internal finance is not enough to enable all SMEs to access the finance they need for start-up and growth and to respond, when required, to fluctuations in their liquidity. Furthermore, in general internal funding tends to come at a high price. It is therefore concerning that SMEs in the Russian Federation depend disproportionately on internal sources of finance compared with firms elsewhere in ECA and Upper Middle Income countries.

As shown in Figure 6.1, according to the IFC/World Bank Enterprise Survey, internal sources of finance accounted for 84% of the investments of firms surveyed in the Russian Federation in 2012, compared with only 60% elsewhere in ECA and 62% in Upper Middle Income countries as a whole. By contrast, bank financing, trade credit and other forms of external financing were used infrequently. External financing also represented a relatively small share of the total working capital of surveyed enterprises in the Russian Federation compared with ECA and Upper Middle Income countries as a whole (Figure 6.2).

Figure 6.1. **Sources of financing for investment by enterprises**



Source: World Bank/IFC (2012) Enterprise Surveys: Russian Federation Country Profile 2012. Washington DC World Bank Group.

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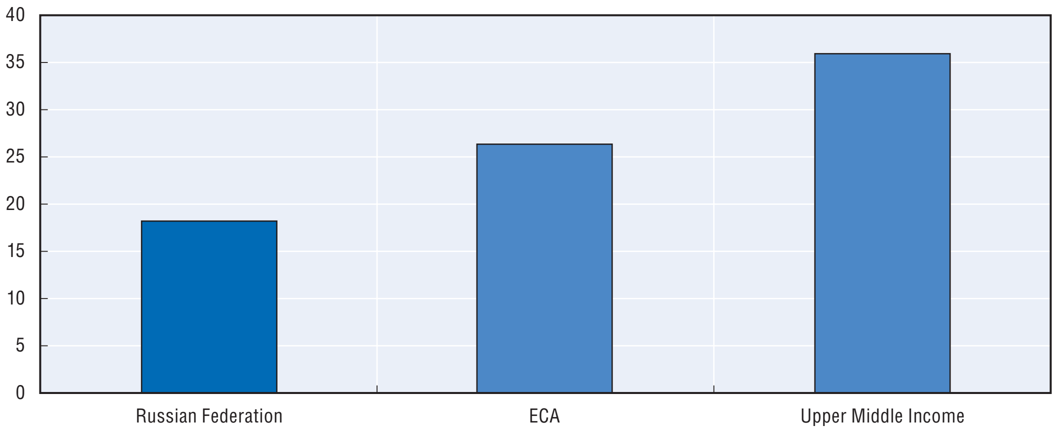
This chapter examines issues affecting the availability of external funding for SMEs and entrepreneurs in the Russian Federation in the areas of bank lending, microfinance and equity, including the actions being taken by government and the public development bank to improve the situation. It proposes relevant interventions in finance supply, finance demand and intermediation.

Figure 6.2. **External financing as a percentage of working capital**



Source: World Bank/IFC (2012) Enterprise Surveys: Russian Federation Country Profile 2012. Washington DC World Bank Group.

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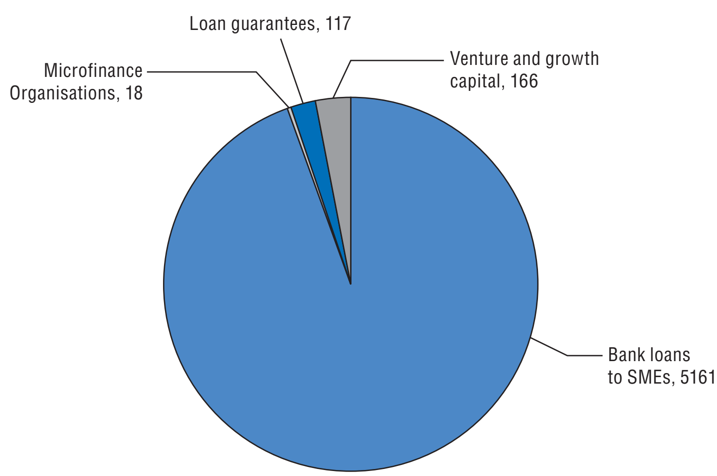
Bank lending for SMEs and entrepreneurs

Limited SME access to bank lending

Bank loans are by far the most important source of external financing for SMEs in the Russian Federation (Figure 6.3), as is the case in most other countries. However, there are a number of problems affecting the access of SMEs and entrepreneurs to access bank loans, which helps explain their relatively large dependence on internal finance sources.

Figure 6.3. **Key sources of external capital for SMEs in the Russian Federation, 2013**

Figures in billion RUB



Source: Based on data from OECD (2015a) *Financing SMEs and Entrepreneurs 2015: An OECD Scoreboard*, OECD Publishing, Paris; Russian Microfinance Centre (2013) *Measures to Promote Microfinance in the Russian Federation. www.rmcenter.ru/files/Concept_Access_en.pdf*.

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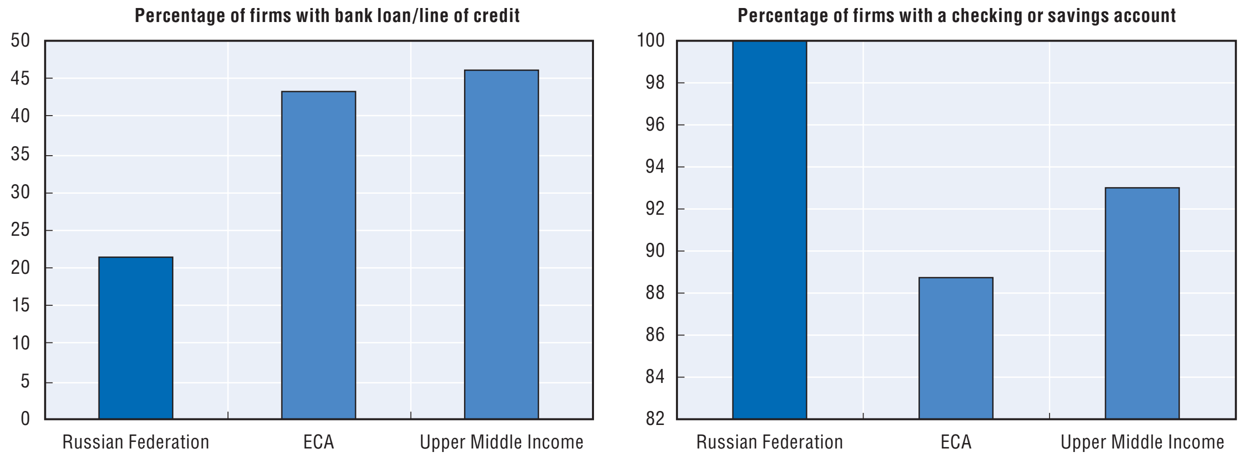
As shown in Figure 6.4, enterprises surveyed by the IFC/World Bank in the Russian Federation in 2012 were significantly less likely to have bank loans than enterprises in ECA or Upper Middle Income countries in general, although they were more likely to have deposit accounts. Furthermore, information from SME Bank indicates that approximately 45 per cent of SME loan applications were rejected across the Russian banking system in 2011.

Figure 6.4. **Use of financial services from banks, 2012**



Source: World Bank/IFC (2012) Enterprise Surveys: Russian Federation Country Profile 2012. Washington DC World Bank Group.

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There are also barriers to SME access to bank lending with respect to the costs, duration and conditions of loans where they are offered. Interest rates for approved SME loans tend to be high. Nominal interest rates were typically 14-17 per cent and real rates were typically 7-10 per cent in 2012. The vast majority of bank loans were also short term. SME Bank indicates that only 7-10 per cent of loans granted to SMEs across the banking system were for more than three years in 2012, while the State Credit Guarantee Agency has recently estimated that there is an unmet demand for long term loans by SMEs for investment purposes ranging from some RUB 365 billion to RUB 670 billion. It is also typically obligatory for an SME or new enterprise to offer collateral in order to obtain a loan, while the ratio of collateral value to loan value tends to be high and assets such as accounts receivable and vehicles are not generally acceptable. This makes it difficult for enterprises without significant eligible collateral to obtain external financing. Even where collateral can be obtained, banks may be reluctant to take it because of long and expensive legal procedures for foreclosure on collateral (Barre, 2005).

Overall, high loan refusal rates, high interest rates, short loan term periods and the need for high values of collateral are likely to stifle new enterprise start-ups and SME growth projects for which returns are not expected to be particularly large and rapid. Moreover, a vicious circle may be in operation in which the high interest rates and short term lending promote high-risk high-return entrepreneurial strategies, encouraging lenders to further protect themselves through high demands for collateral and high interest rates.

Substantial increases in bank lending

Given the shortage of external financing amongst Russian SMEs and the problems they face in accessing bank lending, it is very positive that bank lending to SMEs and entrepreneurs has increased dramatically in the Russian Federation in recent years, although there is still much more to be done. As shown in Table 6.1, the stock of SME loans increased from RUB 2.5 billion to RUB 5.2 billion from 2008 to 2013 and the SME share in new loans to businesses increased from 19% to 23% from 2009 to 2013. Although some of this increase may be attributed to recovery from the global financial crisis in 2008-09, there is also evidence of a longer term growth trend; according to Barre (2005) bank lending to SMEs increased ten-fold from 2000 to 2005 and Lugovskaya (2010, p. 301) reported that SME lending also increased between 2005 and 2007.

At least in part, the increase in bank lending reflects strong state-driven efforts to expand the market, as suggested by the increase in the value of loans to SMEs with government guarantees to RUB 250 billion in 2013 from only RUB 67 billion in 2010 (Table 6.1).

Table 6.1. **Bank lending to SMEs in the Russian Federation, 2008-13**

Indicators	Units	2008	2009	2010	2011	2012	2013
Outstanding business loans, SMEs (stock)	RUB million	2 522 995	2 647 973	3 227 570	3 843 458	4 494 204	5 160 644
Outstanding business loans, total (stock)	RUB million	12 996 829	12 412 406	13 596 593	17 061 389	19 580 176	22 242 321
SME loan share	%	19	21	24	23	23	23
New business loans, SMEs (flows)	RUB million	..	3 014 572	4 704 715	6 055 744	6 942 525	8 064 759
New business loans, total (flows)	RUB million	..	19 091 541	20 662 219	28 412 267	30 255 044	36 224 567
SME new loan share	%		16	23	21	23	22
Government loan guarantees, SMEs	RUB million	..	18 226	32 460	58 954	87 400	116 900
Government guaranteed loans, SMEs	RUB million	..	38 917	66 824	122 747	185 000	249 000
Non-performing loans, SMEs	%	4.27	7.56	8.80	8.19	8.39	7.08
Non-performing loans, total	%	…	5.83	5.43	4.74	4.57	4.31
Interest rate, SMEs	%	..	..	..	..	..	13.10
Interest rate, large firms	%	14.1	13.8	9.8	10.6	10.6	11.1

Source: OECD (2015a) Financing SMEs and Entrepreneurs 2015: an OECD Scoreboard, OECD Publishing, Paris.

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Difficulties in assessing loan applications

One of the issues constraining bank lending to SMEs and entrepreneurs in the Russian Federation is the high costs and workloads for banks to assess the risk of loans to SMEs and entrepreneurs and monitor their performance relative to the size of the loans made. In the case of the Russian Federation, the general problem of small lending balances in the context of the fixed cost of loan administration is exacerbated by an onerous administrative burden with respect to the estimation of loan loss provisioning, which diverts personnel from loan adjudication and monitoring. In addition, the imputed taxation scheme reduces SME borrowers' motivation to be transparent since it does not require the majority of entrepreneurs to provide financial statements. This lack of transparency increases the difficulties for banks to judge the risks of loans using easily available company financial data.

At the same time, lack of an SME lending tradition in the Russian Federation has hampered the emergence of skilled and experienced staff and the use of efficient lending technologies in banks for lending to SMEs and entrepreneurs. While international development banks such as the European Bank for Reconstruction and Development and the International Financial Corporation have sought to respond by providing training for SME loan account managers in the Russian Federation, much of this learning is confined to the large state-owned banks and has not been of sufficient scale to address the problems. Furthermore, while a few of the larger banks have developed credit scoring algorithms based on their own experience, the vast majority of banks do not have access to credit scoring tools. This problem is exacerbated by the lack of public credit registry information, which limits the ability of banks and other investors to assess SME credit risk for lending purposes. A private bureau, the National Bureau of Credit Histories, started operations in 2006 and provides coverage of 59% of borrowers, compared with typical coverage of credit bureau information of 67% in OECD countries and 33% in ECA countries (World Bank/IFC, 2014). However, there appears to be a limited level of awareness or willingness to use this source of information in the banking industry.

Volatility, uncertainty and lack of securitisation

There are also a number of reasons for the predominance of short-term financing over long-term financing in SME bank lending in the Russian Federation. These include:

- A high and variable rate of inflation (13.3 per cent in 2008; 8.4 percent in 2011; 5.1 per cent in 2012, 7.8% in 2014).
- Under Russian Federation law, individual depositors can terminate any deposits without notice, so reliability of long-term deposits is limited.
- The 2008 global financial crisis prompted a substantial increase in interest rates, which led the state to make injections of relatively less expensive short-term credit through state-owned banks, resulting in a steep yield curve. Enterprises were therefore more likely to use short-term financing for long-term projects.
- Corruption creates uncertainty even about successful borrower firms' future prospects and erodes the trust of entrepreneurs in the banking system in the event, for example, that bribes need to be paid to secure a loan.
- Banks also face considerable uncertainty as to what forms of fees and commissions they may charge. For example, RSBF (2012, p.12-15) reports that the Russian Supreme Arbitration Court has ruled that "commissions which do not produce any additional value or other positive effect for the customer cannot be understood as services" and that has resulted in a high degree of uncertainty about what types of fees are and are not permissible.
- There is an incomplete inter-bank lending market, which limits lenders' ability to refinance long-term loans to SMEs. There is little standardisation across the system (for example, loan contracts differ across banks and even among different branches of larger banks), which limits the scope for securitisation. Legislation to provide for securitisation has been introduced but does not appear to have proceeded.

The short-term nature of lending that these factors brings about is a constraint to SME investment, growth and sustainability. SME growth requires that SMEs add to the stock of producer assets, working capital (inventories and accounts receivable), and human capital (especially for firms in the services sector). In OECD countries, these forms of real capital are generally obtained by incremental external financing, most often in the form of long-term bank lending. This is a market that, in the Russian Federation, requires remediation.

Microfinance for SMEs and entrepreneurs

Large and growing microfinance market

Microfinance involves the provision of retail financial services in small amounts (e.g. less than 300% of a country's per capita GDP) by non-bank financial institutions to customers who lack access to conventional finance. As well as lending to households to reduce poverty, microfinance can play an important role in supporting people in setting up and running micro and small businesses. Indeed, in the Russian Federation this entrepreneurship function appears to have been the dominant motivation for the introduction of microfinance (Buyske, 2007). Because bank financing is very limited for start-up and small firms in the Russian Federation, the establishment of a system of microfinance organisations provides an alternative means of supporting SME development. Additional advantages as compared with bank lending include simplified reporting and documentation requirements, the option of non-traditional forms of loans (solidarity guarantees, group lending, etc.), and comparatively accessible financial resources and convenient services. However, micro finance is not a substitute for the long-term financing required by growth-oriented enterprises.

The numbers of micro finance institutions (MFIs) in the Russian Federation are growing rapidly. In 2008, there were approximately 2 300 MFIs with an aggregate loan portfolio of approximately RUB 25 billion. By 2012, this had grown to 3 570 providers collectively managing a portfolio of approximately RUB 35 billion (Russian Microfinance Center, 2013). They include credit cooperatives funded by their members, who are also the eligible loan recipients (approximately 1 200, the largest category), specialised NGO-type microfinance institutions including co-operatives, state-supported funds, and commercial non-bank financial institutions operating on a for-profit basis, including high price payday loan operations. Approximately 70 per cent of the MFIs lend to SMEs. Approximately 20 per cent of the business loans they make are to start-ups and 80 per cent to more established small enterprises.

The state-supported funds manage a portfolio of approximately RUB 12 billion through approximately 70 regional and 60 municipal micro finance organisations. The funds are primarily provided through the federal Ministry of Economic Development and Vnesheconombank and channelled through regional and municipal governments, which appoint supervisory boards that in turn appoint a credit committee and fund manager. Collectively, the state-supported funds had advanced approximately 20 000 loans at the end of 2012, of which RUB 7.9 billion was outstanding. The loans focused on start-up enterprises (less than one year since registration). Approximately 33 per cent were to firms in the retail sector, 18 per cent to manufacturing firms, and 12 per cent to firms in the agricultural sector. The 2011 loss rate was 7.6 per cent. The state-supported MFIs also provided some degree of training and business education to loan recipients.

Positioned in small, short-term and high-interest loans

The microfinance sector currently plays an important role in offering finance to start-ups and micro and small firms in the Russian Federation, which to some extent mitigates the current gap in bank lending. However, it should not be seen as a long-term substitute for bank lending because it cannot meet the demand for longer-term, lower cost SME finance.

Although there are many organisations, micro finance only reaches a relatively small proportion of the population of SMEs that need loan finance. It is estimated that even in Moscow and St. Petersburg, where microfinance organisations have the strongest implantation, they cover only about 10 per cent of the demand, while in many regions there is very little coverage at all (Russian Microfinance Center, 2013). While it makes sense to fill these main regional gaps, micro finance should not be used as a substitute for bank lending because the loans are generally very small and short term, and therefore appropriate only to the finance needs of the smallest SMEs and start-ups. In 2012, the typical business loans of Russian MFIs ranged between RUB 60 000 to RUB 900 000, with maturities of typically six months to one year (Russian Microfinance Centre, 2013). The average loan from state-supported MFIs was of the order of RUB 450 000, and again the vast majority were for less than one year.

Micro finance is also relatively high cost, which will hold back the rate of SME investment and growth compared with cheaper sources. As a whole the sector charges real interest rates of around 15 to 20 per cent, and although the state-supported funds typically have lower rates, of around 10 per cent annually, this partly reflects the use of stricter lending criteria. High costs are intrinsic to the business model of the sector, which although being very accessible, needs to charge high rates because of the fixed cost element on small loan balances.

Improving regulation and governance

Measures could also be taken to improve the regulation and governance of the microfinance sector in order to favour the growth of the most efficient and fair organisations and ensure the sustainability of the system. One particular issue is that it can be difficult for borrowers to distinguish predatory lenders (including payday loan companies) from reputable institutions.[1] This has prompted the Russian Microfinance Center to outline a series of measures that would help borrowers to distinguish between payday lenders and responsible MFIs and establish protections for clients of payday lenders. These include:

- Payday lenders licensed as MFIs should be separated from the other MFIs in the state register.
- Reporting to credit bureaus should be mandatory for all payday lenders and MFIs.
- The Russian Central Bank and Federal Financial Markets Service should regularly publish average interest rates on retail credit products offered by banks, payday lenders, MFIs and credit cooperatives and establish that interest rates higher than 200 per cent of the average are to be considered usurious (and labelled clearly as such, though not prohibited).
- Payday lenders should be restricted in their ability to raise funding from individuals (something other MFIs are permitted to do under Russian law, but within limits).
- All MFIs should be members of self-regulated organisations, to reduce instances of unethical market conduct.

In addition, the sustainability of the microfinance sector could be strengthened and interest rates reduced somewhat through technical assistance to support MFIs to develop credit scoring systems to assess more effectively the risk of clients.

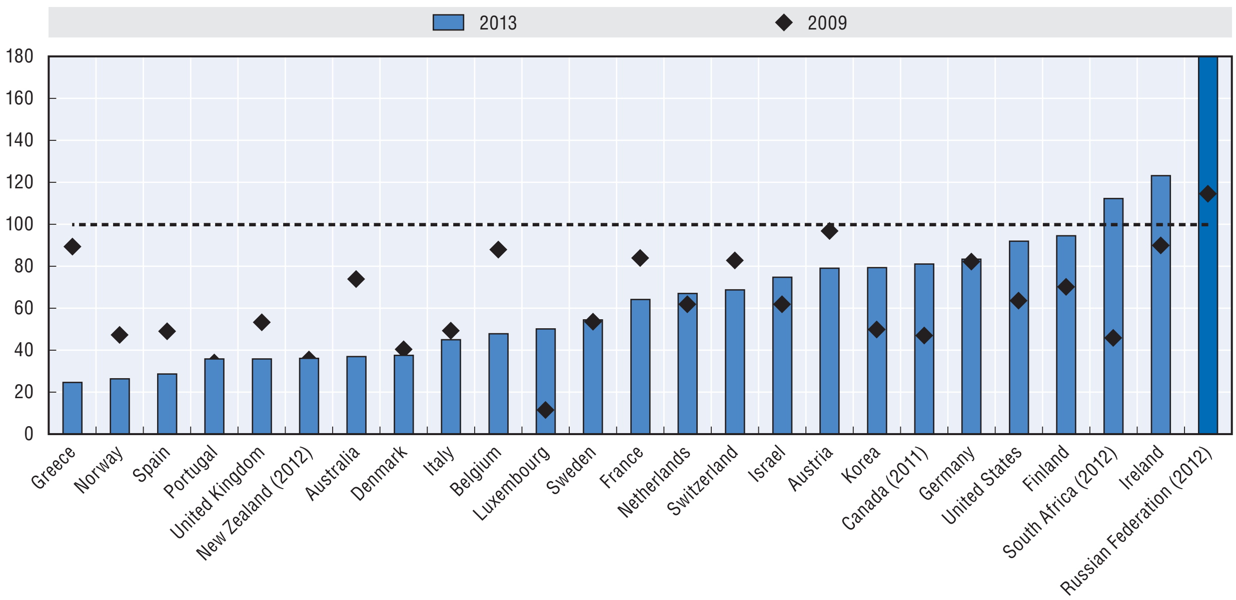
External equity financing

Rapid growth in venture capital

Seed and early stage venture capital investment (i.e. equity capital that is not channelled through stock markets) has increased significantly in the Russian Federation, from approximately USD 108 million in 2007 to USD 398 million in 2012. This rate of growth exceeds that of comparator countries for which data are available (Figure 6.5).

Figure 6.5. **Growth in seed and early-stage venture capital investment flows**

Index 2007 = 100



Source: OECD (2014), Venture capital trends: Index 2007 = 100, in Entrepreneurship at a Glance 2014, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/entrepreneur_aag-2014-graph89-en*.

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Table 6.2 shows the evolution of private equity and venture capital investment in the Russian Federation from 2009-12, broken down by stage of investment.[2] [3] It illustrates that only a minority of venture capital (less than ten per cent) was invested in early stage firms. Total investment in the expansion, restructuring and later stages involved only 58 investee companies but comprised USD 3.75 billion of the USD 4.15 billion invested in 2012. However, the growth has involved all investment stages. Furthermore, as shown in Table 6.3, the number of active funds increased from 80 in 2008 to 155 in 2012 and the stock of outstanding private equity and venture capital investment increased from USD 14.3 billion in 2008 to USD 26.4 billion in 2012.

Table 6.2. **Recent private equity and venture capital activity in the Russian Federation**

Million USD, flows

	2009		2010		2011		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Seed & Start-up	13	2.6	22	0.9	129	4.2	129	3.1
Other early stage	110	21.7	132	5.2	143	4.6	269	6.5
Expansion	314	61.9	2 258	89.8	980	31.8	2 037	49.1
Restructuring	70	13.8	3	0.1	7	0.2	353	8.5
Later stages	0	0.0	100	4.0	1824	59.2	1 364	32.9
Total	508	100.0	2 514	100.0	3083	100.0	4 152	100.0

Source: Russian Private Equity and Venture Capital Market Review: 2013 Yearbook (2014). Russian Venture Capital Association, Moscow.

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The federal government has been an important player in developing the venture capital sector through the establishment in 2006 of the Russian Venture Company, as a federal government financed fund-of-funds seeking to stimulate venture capital investment in the high-technology sector. This enabled the establishment of regional venture capital funds in 19 regions in 2006, which had increased to 22 regional funds by 2011. The Russian

Venture Company held approximately RUB 20 billion under management in 2011 and had made cumulative investments of approximately RUB 4.2 billion. During 2011, 15 companies received investments of approximately RUB 1.4 billion, mostly at early stages of development but with 15% of deal volume at the restructuring stage.

Table 6.3. **Capitalisation of private equity and venture capital funds in the Russian Federation 2008-12**

USD million (stocks)

Year	Amount	Number of active funds
2008	14 327	80
2009	15 192	87
2010	16 787	91
2011	20 092	97
2012	26 419	155

Source: OECD (2014b) Financing SMEs and Entrepreneurs 2014, OECD Publishing, Paris.

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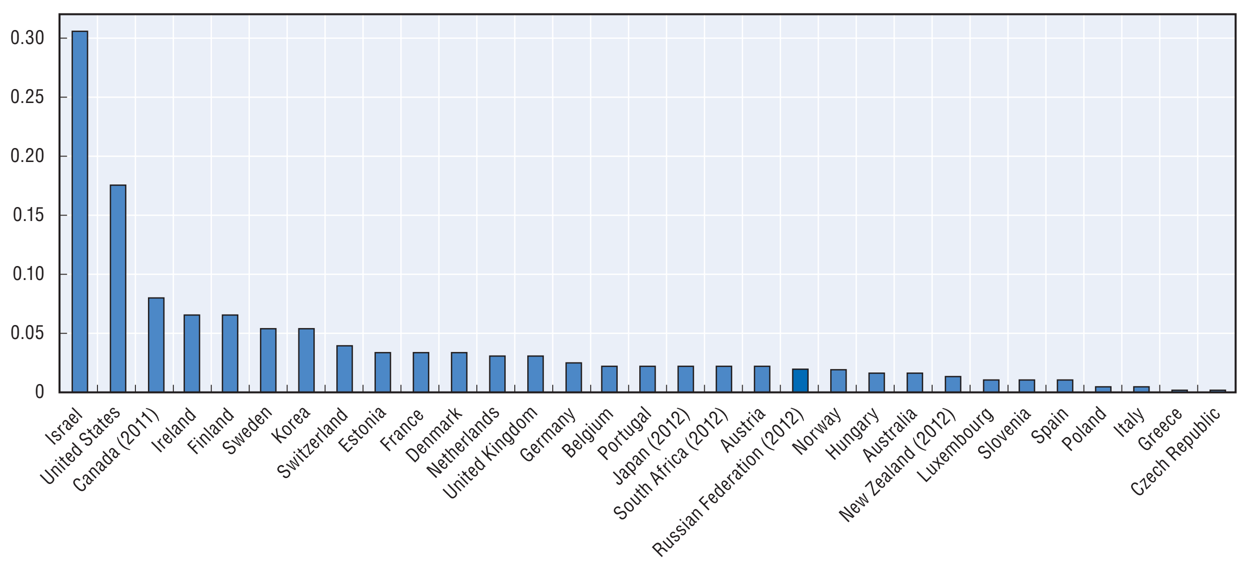
As a result of these recent trends, total flows of private equity and venture capital investments in the Russian Federation have reached levels associated with many OECD countries (Figure 6.6). The sectoral distribution of investments is shown in Figure 6.7, indicating that there are external equity investments in quite a wide range of sectors.

Figure 6.6. **Private equity and venture capital investments as a proportion of GDP**

Flows, percentage of GDP



Note: Includes later stage investments as well as seed and early stage investments.

Source: OECD (2014), Venture capital investments as a percentage of GDP: Percentage, 2013, in Entrepreneurship at a Glance 2014, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/entrepreneur_aag-2014-graph88-en*.

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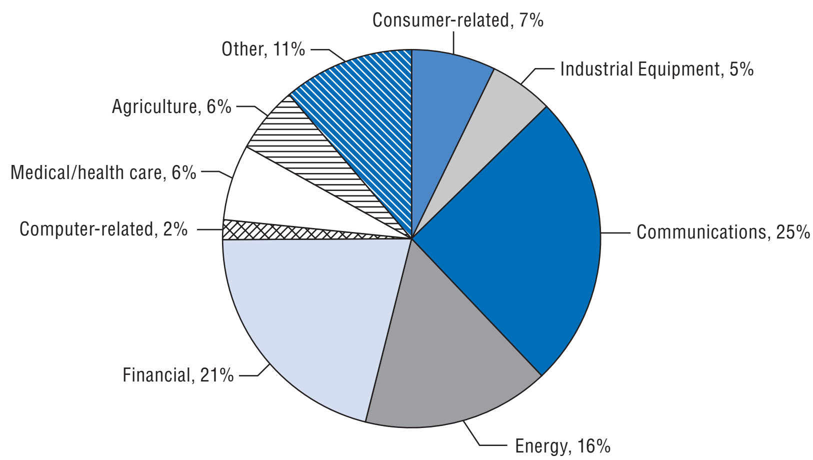
With a stock of USD 26.4 billion and a flow of USD 4.15 billion of private equity and venture capital investment in 2012, it does not appear that, overall, there is a shortage of external equity investment. These data suggest that at least six years of supply are under management. It may be true that there are shortages of venture capital supply in certain regions, particularly given that a substantial proportion of total venture capital is associated with the Skolkovo initiative in Moscow. However, any shortfall in the overall scale of venture capital investment compared with other countries at the current time may be more a consequence of a shortage of demand from investment-ready growth-oriented SMEs than problems in supply, quite possibly reflecting an upstream lack of bank lending for early stage and growth-oriented enterprises. On the other hand, with longer-term actions to expand the pipeline of promising firms coming through for seed and early stage venture capital investments a further long-term growth in the scale of investment could be required.

Figure 6.7. **Sectoral distribution of Russian Federation private equity and venture capital investments, 2012**



Source: Russian Private Equity and Venture Capital Market Review: 2012 Yearbook, (2013). Russian Venture Capital Association, Moscow.

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Small venture capital fund sizes

Venture capital funds are nevertheless of relatively small size in the Russian Federation. Of 120 venture capital management companies, the Russian Venture Capital Association classifies 34 as "large," that is, holding more than USD 150 million under management (the largest fund holds USD 2.2 billion). Collectively, these large funds managed USD 15.6 billion. At the small end of the spectrum were 53 management companies, each with less than USD 50 million under management, collectively managing USD 1.38 billion. The remaining 33 funds each held from USD 50 to USD 150 million under management, for a total of just over USD 3 billion. Compared with other countries, this fund size distribution is skewed towards the small end of the spectrum. Given evidence that small funds face significant difficulties in achieving sufficient portfolio spread, scale economies, and funding packages for larger early and follow-on investments, which affects their performance (Murray, 2007; Nitani and Riding, 2013; Söderblom and Wiklund, 2005), this suggests a need to focus any future public interventions aimed at the sector on expanding and consolidating existing funds rather than creating new ones.

Nascent business angel sector

Business angel finance involves investments of their own money by cash-rich and experienced entrepreneurs directly into the equity of growth-oriented start-up companies. Business angels tend to take minority stakes in the enterprises they invest in, play key mentorship roles in the management of the enterprises, seek a return through the sale of the companies through an Initial Public Offering or merger or acquisition, maintain a small portfolio of investments in enterprises, and reinvest some of the returns in other enterprises. The business angel sector is still at a formative stage in the Russian Federation, but could play an important role in the future, not only in offering financing, but also by offering skills, networks and mentoring to high potential enterprises, if a boost is given to the sector with appropriate public sector interventions.

Initially, public actions are needed to improve legal protection for minority shareholders in order to facilitate the entry and exit of angels from their investments and the ability to influence the management of the enterprises they invest in (Kashirin, 2007). Business angel investment also needs to be recognised in wider investment regulations. For example, although business angels invest their personal wealth as individuals they could nonetheless be considered professional investors for the purposes of regulation, giving them more flexibility to operate.

Angel investing is inherently local. Research shows that the small scale inherent in business angel investment, coupled with angels' need to monitor and mentor their investments, militates strongly in favour of local investment activity. Accordingly, the development of business angel networks in many countries has followed a two-stage process. In the first stage, angel investing at the local level needs to be fostered. Often, this aspect has been accomplished by local or regional economic development agencies that often create local angel-entrepreneur "matchmaking" facilities. This is a process that could be encouraged through federal government financial support and guidance. In the second stage, local networks are connected through a national organisation (see the example in Box 6.1). The role of the national organisation is to provide visibility for angel investing, disseminate best practices, and linkages with government bodies and other initiatives that foster entrepreneurship. This is especially important in the geographically diverse Russian Federation.

Box 6.1. **National Angel Capital Organisation, Canada**

The approach

In Canada, the National Angel Capital Organisation (NACO) acts as an umbrella organisation to support local business angel networks. It "accelerates a thriving, early stage investing ecosystem in Canada by connecting individuals, groups and other partners that support angel-stage investing. NACO provides intelligence, tools and resources for its members; facilitates key connections across networks, borders and industries; and helps to inform policy affecting the angel asset class" (*https://nacocanada.com/about/what-we-do/*).

Results

The following are among the outcomes of the NACO initiative:

- NACO prepares and publishes an annual Report on Angel Investing Activity in Canada. It analyses trends in angel investing and provides a perspective on the national angel market.
- NACO, often working with a counterpart US-based organisation, provides considerable professional development for angels and angel groups. Workshops include: Angel Investing – An Overview; Valuation of Early Stage Companies; Trends in Raising Capital; Due Diligence; An In-Depth Look at Term Sheets; Mentoring and Governance; Starting an Angel Organisation.
- NACO also seeks to represent the national angel community with industry and government partners, seeking to better inform the development of salient policy frameworks and to promote angel investor groups in the context of Canada's innovation and entrepreneurial ecosystem.
- Additional resources that NACO provides for its members include summaries of best practices in angel investing.

Box 6.1. **National Angel Capital Organisation, Canada** (*cont.*)

Success factors

Because NACO acts as a national umbrella organisation for geographically-dispersed local angel groups, success is dependent on the involvement of its various partners. Success depends on fostering trust and value-added for the participants.

Relevance to the Russian Federation

Both Canada and the Russian Federation are characterised by strong geographical dispersion of population and the presence of many local concentrations of wealth and economic activity. Local business angel networks can match with this geography. A national confederation of angel groups can help support such local angel groups.

Further information

https://nacocanada.com/

Source: National Angel Capital Organisation, Canada

Accordingly, public authorities can play a role in funding the set up and/or operational costs of local business angel networks in the Russian Federation and supporting the creation of a national umbrella business angel organisation. Local business angel networks can not only recruit business angels but also help them connect to high growth potential start-ups, increase the awareness of the opportunities for obtaining angel investment among high growth potential start-ups, facilitate the creation of business angel syndicates to undertake certain investments together and support sharing of information and analysis among angel investors. They also raise the visibility of business angels to the officials running public SME support programmes, which in the Russian Federation are often not aware of angel investment.

An important first step has already been taken through the formation in 2006 of the National Union of Business Angels of Russia (RUSSBA) as a non-profit partnership established with the support of the Russian Private Equity and Venture Capital Association and the Chamber of Industry and Commerce of Russia. RUSSBA comprises private and institutional investors who invest in innovative and high technology companies, and assists business angel activity in the Russian Federation through programmes, projects and events, and analysis and information activities. It can also play a role in matching potential investee companies with potential investors. Public support could help expand or replicate this approach. It could also help develop online matching services, which are increasingly being tested in other countries, although elements of face-to-face contact will still be needed.

Another approach to building the business angel sector that could be considered in the Russian Federation is increasing the amount of financing that business angels are ready to channel to growth-oriented start-ups. One method is to offer tax incentives to investors in SME equity, for example by exempting investors from capital gains tax on returns from investments made in start-ups if they meet certain conditions, such as a minimum period of investment or reinvestment of returns in another start-up. Another method is to co-invest public resources together with those of angels, for example through joint investments with business angels or business angel syndicates by state-supported venture capital funds. An example of this type of approach is the Angel CoFund in the UK, which invests amounts of GBP 100 000 to GBP 1 million in SMEs with high growth potential in partnership with syndicates of experienced business angels (OECD, 2015b).

Business angel support should be seen as an important part of any public programmes for high-growth entrepreneurship, including the package of support offered by innovation incubators and programmes for the commercialisation of university research. As well as network creation and co-investments, support for business angels as part of these broader programmes could provide training, coaching and mentoring to potential business angels in how to make effective investments and contribute effectively to start-up company development as well as activities to build the awareness of high growth potential start-ups on how to access business angel funding and how to make their projects "investment ready".

Key cross-cutting public interventions

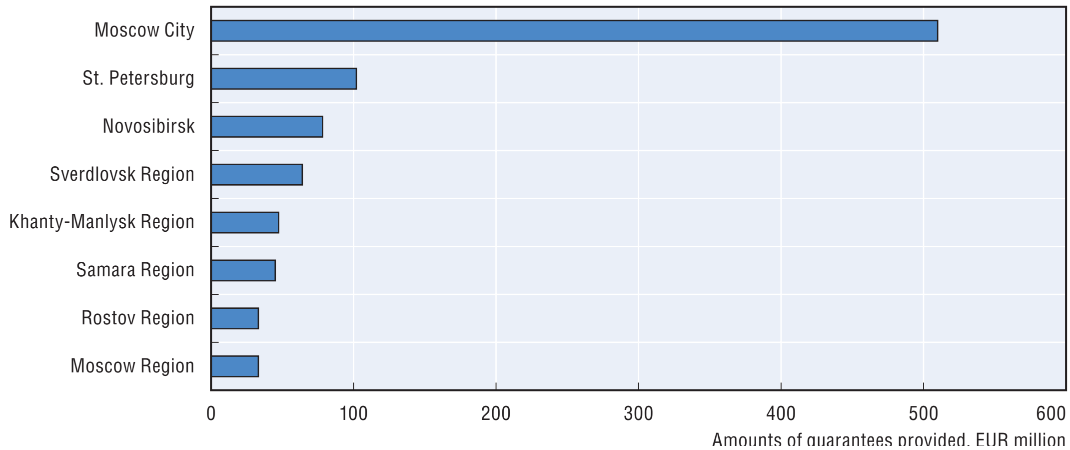
Role of credit guarantee programmes

An important public policy intervention that can help to build up credit to SMEs and entrepreneurs is the award of public credit guarantees to banks and microfinance institutions for lending to SMEs and start-ups that would not otherwise obtain financing, thus providing an alternative form of reliable collateral. Credit guarantee programmes are widely used by national and local governments and public development banks to facilitate access to finance for enterprises that may otherwise be "constrained by information asymmetry, limited credit history and under-collateralisation" (OECD, 2015c, p. 37).[4]

Credit guarantees provide governments with an efficient means of levering state resources in order to achieve much larger amounts of SME lending than could be achieved by direct state lending because the public costs are limited to the administration of the programme and covering a part of the defaults from the minority of firms that does not repay loans. In some credit guarantee programmes, fees paid by borrowers partly offset these costs. Intervention through guarantees, rather than direct loans or subsidies, also helps extend the reach of public policy to a wider range of SMEs by accessing firms that approach banks but may not approach public agencies or be aware of public schemes. For banks, the attraction is that the guarantee reduces some of the high risks of dealing with SMEs and entrepreneurs and enables them to build their experience and capacities in this area. The use of credit guarantees in the Russian Federation would therefore assist with a gradual withdrawal of the state from the banking business and from direct state lending and subsidies to SMEs by strengthening the offer of commercial credit.

In 2006, the federal SME support programme established credit guarantee funds in each region of the Russian Federation. In most cases, regions and municipalities provided 30% of the resources while the federal Ministry of Economic Development provided 70% (in certain regions, including Moscow and St. Petersburg, the financing ratio was 50/50). The funds provide partner banks with guarantees of up to 70% of the loan amount for periods of more than one year. The fixed annual fee for the issue of a guarantee is one-third of the Central Bank refinancing rate. The total resources in the regional funds were RUB 33 billion in 2013. At that time a cumulative 33 000 guarantees had been provided to authorised banks with an assumed credit risk of RUB 117 billion, enabling a total SME loan amount of over RUB 249 billion. Figure 6.8 illustrates the scale of capitalisation of the largest of the loan guarantee funds, showing the Moscow Loan Guarantee Fund as the largest (see Box 6.2). Subsequently, in July 2013, SME Bank established its own guarantee mechanism aimed at supporting lending to medium-sized enterprises.

Figure 6.8. **Scale of operations, Russian Federation loan guarantee programmes, 2013**



Note: Data at 1 January 2013.

Source: Moscow Loan Guarantee Fund (2013).

StatLink http://dx.doi.org/10.1787/888933272076

Box 6.2. **Moscow Loan Guarantee Fund**

The Moscow Loan Guarantee Fund demonstrates how credit guarantee schemes are able to lever government expenditures to help SMEs obtain bank loans and foster competition in the financial market for SMEs. It is the largest of the regional credit guarantee funds, with a capital of RUB 7.5 billion in 2013, and as such is able to exploit economies of scale. It co-operates with approximately 40 partner banks.

The Fund operates by sharing risk with the financial institution that makes the loan and the borrower. To access the guarantee, a borrower SME applies to one of the commercial banks with which the Fund is in partnership. If the bank is favourably disposed to granting the loan application but the borrower has insufficient collateral, the borrower and the bank apply for a guarantee to the Fund. If approved, a tripartite agreement (lender, borrower, guarantor) is signed, the fee for the guarantee is paid and the loan is approved. The maximum liability of the Fund is limited to 70% of the principal debt and interest amount, but not more than RUB 70 million.

Between 2006 and 2013 the Moscow Loan Guarantee Fund provided RUB 26 billion in loan guarantees, which enabled SMEs to obtain RUB 54 billion in bank loans. The majority of these loans were additional in the sense that they would not otherwise have been granted. It is estimated that an additional RUB 40.8 billion in lending was generated at a gross public cost of approximately RUB 1.3 billion, which was the cost of honouring defaults on the loans (including during the 2007-08 financial crisis period). This cost was offset to some extent by the fees paid for use of the scheme. The recipient SMEs were also able to grow, hire additional employees and add to the tax base as a result of their additional operations.

Source: Information supplied by Moscow Loan Guarantee Fund

A further major step was taken in 2014, with the establishment alongside the regional funds of the Federal Credit Guarantee Agency, with a registered capital of some RUB 37 billion. The main mission of this new national agency is to guarantee long-term SME investment loans by accredited banks, with a target of providing guarantees worth some RUB 170 billion supporting total SME loan amounts of some RUB 300 billion by 2016. This represents a doubling of the guaranteed loan amounts from the existing regional funds. In this endeavour, the agency will set up guarantee portfolios (composed of direct guarantees, counter guarantees and syndicated guarantees) for credits from banks and other financial institutions to businesses with turnovers of less than some RUB 750 million. The guarantees are unsecured liabilities worth up to 70% of the loan amounts for terms of up to 15 years and 120 days (88 months) for eligible SME investment projects, including premises, plant and equipment and innovation projects associated with new products and markets. The Agency has been working with some 27 accredited partner banks, but plans to increase this number. It promises quick decision making for banks on the award of the guarantees (a targeted 10-day review period).

As well as increasing the volume of SME lending, the Federal Guarantee Agency aims to reduce interest rates on SME loans by agreements with banks on interest rates charged and to enable banks to start securitisation of SME loans to help build a secondary market. Further tasks will be support for leasing production equipment, providing capital to microfinance institutions, refinancing existing SME loans and providing capacity building and technical support for strengthening of the regional and municipal loan guarantee funds, including through developing and implementing common national standards and procedures for guarantee support and risk management.

In starting up the operations of the Federal Credit Guarantee Agency and strengthening the existing regional and municipal funds, it will be important to make good choices about the key parameters of the schemes. These parameters include (OECD, 2013):

- *Eligibility*. Loan guarantees are typically targeted to SMEs. Accordingly, most schemes limit the size of loan or guarantee available. Some programmes limit guarantees to particular industry sectors and set limits on the size of eligible borrower firms. Some schemes allow guarantees for loans to support working capital while others do not.
- *Per cent of loan guaranteed*. Guarantees typically range from 50 to 85 per cent of the outstanding loan balances, but the guarantee percentage varies widely across programmes.
- *Fees*. In some programmes borrowers pay a fee to the guarantor. Fees may be up front or over the courses of the loan or both.
- *Others*. Other parameters can include whether or not guarantees are re-insured; the extent to which the guarantor is involved in loan adjudication; and whether the programme is based on a pre-determined guarantee fund or whether the guarantor provides funding on an on-going basis.

Particular attention should be paid to how the parameters used by schemes in the Russian Federation influence the extent to which guaranteed loans are additional to loans that would otherwise have been made and the extent to which the schemes are financially sustainable without placing excessive burdens on state resources. A further consideration is the need to achieve efficiency and take advantage of economies of scale. While the larger credit guarantee programmes, e.g. in Moscow and St. Petersburg are perhaps able to take advantage of such efficiencies, this cannot be said of many of the smaller regional programmes. These smaller programmes might be better integrated into the national credit guarantee system or consolidated into a smaller number of regional programmes. Robust evaluations will be important in providing information to assist in the programme designs. In addition, it makes sense to learn from the experience of other countries. Box 6.3 reports, for example, on the experience of the Canada Small Business Financing Program (CSBFP).

Box 6.3. **Small Business Financing Programme, Canada**

The approach

The Canada Small Business Financing Programme (CSBFP) is a credit guarantee scheme that facilitates debt financing for higher risk SMEs, firms that would not normally receive financing. Since its launch in 1961, the programme has assisted more than 500 000 Canadian businesses to start, expand, modernise or improve.

To receive a guarantee, an SME first needs to seek financing from one of more than 1 500 eligible private sector commercial lenders. The prospective lender could reject the loan application or decide to finance the SME using its own conventional products. However, if the project appears too risky for a conventional loan but nonetheless appears to have fairly good chances of success, the lender could decide to make a loan backed by a CSBFP guarantee. To be eligible, the loan value must be smaller than USD 350 000 and go to an SME with annual revenues below USD 5 million. The loans are normally for acquiring real property and equipment and making leasehold improvements.

The CSBFP (through Industry Canada) is liable to pay up to 85% of eligible losses on defaulted loans registered under the programme. To help offset the cost of losses, it charges the lender an upfront fee of 2% of the value of the loan and an annual fee of 1.25% of the outstanding balance, which is remitted by the lender through the interest charged to the borrower. The programme caps the variable interest rate that lenders can charge SMEs at no more than 3% more than their prime rate (and caps fixed interest at the single-family mortgage rate plus 3%). These measures aim to ensure that while riskier loans are simply refused any financing and less risky loans are taken on directly by the banks without guarantee, intermediate investment projects which are riskier, often due to a lack of collateral, but appear viable, can go ahead with a guarantee. The CSBFP does not provide working capital financing.

Results

One of the primary objectives of the CSBF programme is to be additional ("incremental"), i.e. to finance loans that would not otherwise be available. It has been estimated that 75 per cent of the loans made would not otherwise have been provided (Riding et al., 2007).

A second primary objective of the programme is to achieve cost recovery over time, i.e. revenues from fees should offset the cost of claims for defaulted loans. The following table summarises the recent experience. The lending volume facilitated by the programme was approximately USD 1 billion per year at a loss rate of approximately 8 per cent. The gross government costs of the losses were to a large extent offset by the fees from borrowers. Overall, each dollar expended by government facilitated 12 dollars of private sector lending.

In addition, the programme aims to deliver social benefits that outweigh the costs, e.g. in terms of jobs created and additional taxes paid. Chandler (2012) has estimated that participation in the CSBFP in 2004 would have increased an enterprise's growth in salary, employment and revenues by 12, 12, and 7 percentage points, respectively, between 2004 and 2006. Furthermore, the CSBFP programme would have induced the incremental creation of approximately 5,000 new jobs during that period, comprising almost four per cent of all new jobs created in that period by SMEs.

Success factors

The achievement of substantial economic development benefits at low public cost reflects the leveraging of large volumes of additional private lending. The fact that it is private lenders themselves that must bring forward loan proposals to the programme helps achieve outreach to SMEs, while the need for SMEs to pay additional fees and for banks to take a share of the risk reduces the incentive to include non-additional loans.

Relevance to the Russian Federation

Credit guarantee programmes have been adopted by more than 60 nations. However, in many cases the programmes have either lacked sustainability or placed unacceptable financial burdens on the guarantors.

Box 6.3. **Small Business Financing Programme, Canada** *(cont.)*

OECD (2013) argues that the design of the programmes is paramount, with key parameters including the coverage ratio, term of the guarantee (i.e. length) and pricing. The CSBFP has been successful in developing criteria that have delivered a sustainable and effective programme for Canada.

Table 6.4 **Canada Small Business Financing Programme Activity, 1995-2011**

Year of disbursement	Loan Volume (USD million)	Number of loans	Claims Paid (USD million)	Number of claims	Losses (% of loan volumes)	Claims (% of loans)
1995-96	2 243	34 607	230	5 384	10.3	15.6
1996-97	2 010	30 855	185	4 372	9.2	14.2
1997-98	1 966	28 911	164	3 661	8.3	12.7
1998-99	1 607	22 445	142	2 936	8.8	13.1
1999-2000	1 343	17 614	115	2 367	8.6	13.4
2000-01	1 159	14 439	100	1 975	8.7	13.7
2001-02	898	11 008	65	1 268	7.3	11.5
2002-03	948	11 229	64	1 192	6.7	10.6
2003-04	996	11 040	76	1 369	7.7	12.4
2004-05	1 035	11 078	81	1 410	7.9	12.7
2005-06	1 081	10 719	103	1 520	9.5	14.2
2006-07	1 024	9 592	97	1 368	9.5	14.3
2007-08	987	8 929	95	1 223	9.7	13.7
2008-09*	896	7 751	57	717	6.4	9.3
2009-10*	950	7 510	39	467	4.1	6.2
2010-11*	1 009	7 405	17	193	1.6	2.6
Total	28 951	405 005	2 286	48 496	7.9	12.0

*Note that many of the loans disbursed in recent years remain outstanding and claims on such loans may yet be received.

StatLink http://dx.doi.org/10.1787/888933272343

Further information

www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/Home

Source: Riding et al. (2007); Chandler (2012); information supplied by Industry Canada.

Potential of credit bureaus

In advanced SME finance markets, banks, microfinance organisations and other investors can purchase credit assessments of loan applicants from one or more central credit bureaus that typically provide more than 95 per cent coverage. Credit assessment bureaus can provide lenders with valuable information about a prospective borrower's credit history and behaviour towards creditors, which facilitates the use of credit scoring methods to increase the effectiveness and efficiency of lending decisions. Box 6.4 gives the example of the use of the Beacon Score credit scoring by a microfinance institution. However, according to World Bank data, private sector credit bureau coverage in the Russian Federation is only 59 per cent. This suggests the need for government action to increase access to credit data to enable banks and other credit organisations to assess the riskiness of individual and business borrowers based on credit histories and other parameters.

Box 6.4. **The use of Beacon Score credit scoring methods**

The approach

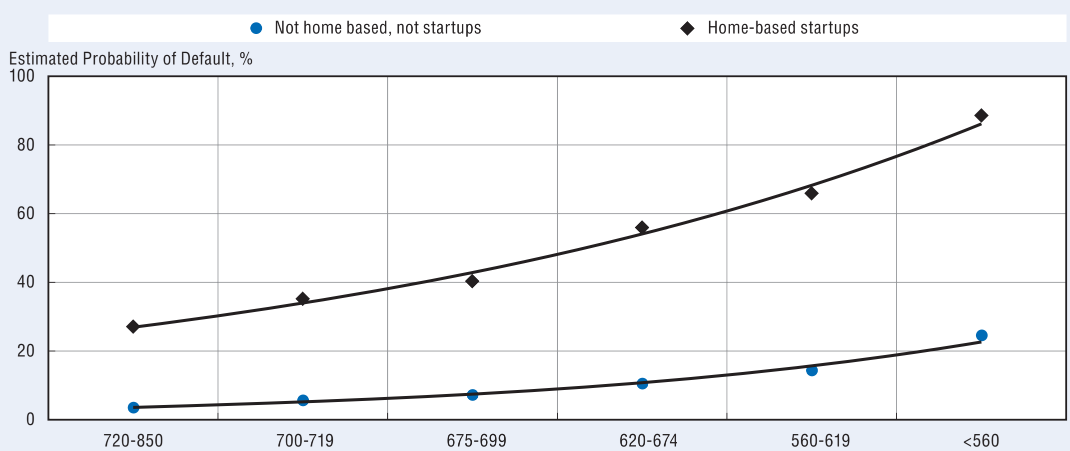
Beacon Scores are based on five criteria (approximate weightings in parentheses): past payment history (33%); amount of credit owing (33%); length of time credit established (12%); search for and acquisition of new credit (12%); types of credit established (10%). The following table illustrates how Beacon scores might be interpreted:

Beacon Score Range	Grade
720-850	Excellent
700-719	Very Good
675-699	Good
620-674	Fair
560-619	Bad
<560	Very Bad

The Alberta Women Entrepreneurs (AWE) programme uses Beacon Scores obtained from Equifax Canada, a private sector credit bureau, as an input into its decisions on the allocation of its USD 5 million loan fund. The fund provides term loans of up to USD 150 000 to eligible female residents who wish to start, expand or purchase a business. Loans have flexible repayment options and are repayable with terms of up to 5 years at a rate equal to three percentage points above the bank prime rate. Loan administration fees are 1% of the amount loaned to a maximum of USD 500.

Results

The graph below shows the relationship between Beacon Scores and actual patterns of loan defaults experienced by AWE. Higher Beacon Scores are associated with a lower probability of default. Thus the use of the scores has been important in increasing the sustainability of the programme. However, context is also important. For example, probabilities of default are higher for home based than non-home based firms and for younger than older firms.



Success factors

Taking into account Beacon Scores in lending decisions is rapid and cheap for AWE. However, the score is not the sole criterion used. In particular, in the case of AWE, a business advisory service has been coupled with the micro lending, which provides a useful means of discouraging the start-up of non-viable enterprises and increasing the chances of success of those businesses supported financially.

Box 6.4. **The use of Beacon Score credit scoring methods** *(cont.)*

Relevance to the Russian Federation

Simple credit scoring could increase the efficiency and viability of SME lending by banks and microfinance institutions in the Russian Federation on condition that credit information on individual borrowers is available. This can be promoted by encouraging state-supported credit bodies to share their data with a central credit information database or bureau.

Further information

www.awebusiness.com/pages/home/default.aspx

Source: Information from *www.beaconscore.ca* and Alberta Women Entrepreneurs initiative.

The fact that state-owned banks hold a majority of banking assets in the Russian Federation provides a unique opportunity to facilitate an expansion of credit bureau information. By requiring that state-related credit organisations (state-owned banks, MFIs and loan guarantee programmes) pool information with each other through an independent intermediary credit bureau organisation, a considerable store of credit histories could be created that all financial institutions could consult on a fee-paying basis. Over time, and by involving private sector banks, the initial database could be increased, allowing system-wide shared data on the credit histories of individuals and SME borrowers from which lending technologies such as credit scoring could be developed. In the longer term the repository could be devolved to one or more private sector credit bureaus.

Such an initiative would make all participants in the banking marketplace better off: lenders' risk assessments would be improved, allowing them to price to risk; borrowers would gain the ability to pay risk-appropriate interest rates rather than simply being denied credit. The cost of establishment of the repository should be relatively low and the bureau would eventually operate on a sustainable basis. Moreover, independent assessments of loan risk classifications may also enable banks to reduce their reserve requirements and more easily be in compliance with banking regulations. The establishment of credit bureaus has been accomplished in many other countries, and information providers such as D&B and Equifax are examples of private sector firms that operate as credit bureaus.[5] However, it is absolutely essential that credit bureau data must adhere to the highest legal, ethical and moral standards. To the extent that credit bureau data are not free from corruption the exercise would be worthless.

The public development bank: Vnesheconombank and SME Bank

Vnesheconombank

Some governments have created public sector financial institutions, including development banks, to provide financing for economic development. Several such institutions focus primarily on investments in infrastructure (for example, Spain's Instituto de Crédito Oficial), but they may also serve as institutional settings for SME and entrepreneurship finance. In the Russian Federation, the Vnesheconombank (VEB) development bank plays an important role in SME and entrepreneurship financing, largely through its SME Bank subsidiary, as well as supporting infrastructure investment, providing financing and insurance for Russian industrial exports and managing Russian state debts and pension funds and intervening as needed in the economy (as it did during the 2008-2009 debt crisis). Officially known as the State Corporation Bank for Development and Foreign Economic Affairs, the state is its sole shareholder and supports the bank directly by the state budget.

As far back as 1922, VEB was the only bank in the former Soviet Union entrusted with export-import and foreign currency transactions. VEB participated in the “London Club” (1997) and “Paris Club” (1999) restructuring discussions and was appointed in 2002 as the agent responsible for managing the Russian State Pension Fund (with RUB 740 billion in assets as of 2010). In 2008, VEB was mandated to provide anti-crisis assistance for the Russian economy, which included the bailout by acquisition of two Russian Federation commercial banks, Globexbank and Sviaz-bank. Acquired at a cost of RUB 213 billion Globexbank and Sviaz-bank currently operate as subsidiaries of VEB.[6] Profits from the operations of the two rescued institutions are used to repay the cost of the bailout.

Table 6.5 compares VEB with other development banks on key facets of its operation, although its total assets are relatively small. It has a strong record of performance compared with these banks. Its net margin exceeds that of its peer group and it has a return on equity of between 4.1 and 8.4 per cent over the period 2007-12.

Table 6.5. **Salient comparisons of public development banks**

	Russian Federation	China	Germany	Brazil	Japan
Ratings	Baa1/BBB/BBB	Aa3/AA-/A+	Aaa/AAA/AAA	Baa1/BBB-/BBB	AA3/AA-
State support	Implicit	Implicit	Guarantees all obligations	Implicit	Guarantees some obligations
Supervision	Government	State council	Ministry of Finance	Ministry of Economic Development	Ministry of Finance
Total assets (USD billion)	74.7	775.6	520.1	372.5	183.3
Capital adequacy ratio	13.9%	10.9%	17.6%	22.3%	20.4%

Source: Information provided by Vnesheconombank.

SME Bank

The support provided by VEB for SME and entrepreneurship financing is largely channelled through its SME Bank subsidiary. SME Bank, does not engage in direct lending to SMEs; rather, it provides indirect financing to 134 partner banks (mainly regional banks) and 141 non-bank organisations, which in turn make loans to qualifying SMEs. Essentially, SME Bank refinances loans advanced by the partner banks and other organisations by lending to partner banks on relatively attractive terms that then allows the partners to provide financing onwards to SMEs. To do so, SME Bank uses more than 20 credit products to provide capital for lending, leasing, factoring, credit cooperatives and microfinance companies. Table 6.6 illustrates the parameters of a sample of these credit products.

SME Bank has assisted 38 000 SMEs through these programmes. Furthermore, some 62% of the loans based on SME Bank programmes were granted for maturities of over 3 years, which is important given the virtual absence on long term lending available to SMEs in the Russian Federation. The average lending rate was 12.7% in 2013, but for innovation projects the average lending rate was 11.7%.

In July 2013, SME Bank established its own guarantee mechanism to support medium-sized enterprises. Guarantees are extended from the federal budget to VEB, which in turn extends guarantees to SME Bank, which extends guarantees to a pool of banks which provide financing for medium-sized enterprises. Guarantees will cover 50% of the loan amount, up to RUB 1 billion. Terms are for from 2 to 10 years.

Table 6.6. **Sample SME Bank credit products**

Product Name	Loans to partner banks			Partner bank loans to SMEs		
	Form	Term (years)	Rate (% p.a.)	Form	Term (years)	Rate (% p.a.)
Stimulus	Single issue	1-5 years	9.25%	Loan or LOC with limit	6 months to 5 years	14.25% (Maximum)
SMEs - idea[7]	LOC* with limit	< 7 years	6.75%	Loan or LOC with limit	2-7 years	12.25%
SMEs regional growth	LOC with limit	1-3 years	8.25%	Loan or LOC with limit	6 months to 3 years	Maximum margin of 5.5%
SMEs - manoeuvre	LOC with limit	< 7 years	8.00%	Loan or LOC with limit	2-7 years	Maximum margin of 4.5%
FIM	LOC with limit	< 5 years	8.25%	Loan or LOC with limit	1-5 years	< 12.25%
Refinance	Single issue	1-5 years	10.00%	Loan or LOC with limit	6 months to 5 years	Not pre-specified
Microfinance	LOC with limit, < RUB 30 million	1-3 years	9.75%	Loan or LOC with limit; < RUB 10 million	3 months to 3 years	19.5%
Leasing	LOC with limit< RUB 15 million	< 5 years	10.00%	Financial lease; > RUB 150 000; < RUB 150 million; < 80% of value of leased asset(s)	3-5 years	< 18.0%

Note: *LOC: Line of credit.

Source: Information provided by Vnesheconombank.

In addition, VEB has developed various agreements with international partner development banks. For example, VEB and KfW in Germany signed a Memorandum of Understanding in 2012 for the establishment of a National Entrepreneurship Support Fund with the support of the European Investment Fund. Initial funding is USD 300 million, but with a target of USD 900 million. The Fund plans to provide the following financial instruments:

- Direct long term loans to SMEs for 1-3 years denominated in RUB.
- Long term loans to commercial banks for financing of SMEs.
- Subordinated loans granted to banks with a value of RUB 50 million per bank.
- Mezzanine financing and direct investments in SMEs.

There are nonetheless some problems in finalising these agreements because of sanctions from some foreign countries. In addition, sanctions are affecting the refinancing of capital in VEB and SME Bank and the availability of state revenues for onward lending. In this context, even greater attention needs to be paid to getting the maximum impact from the public SME financing available from SME Bank by making an efficient selection of projects and product types and focusing on making domestic private markets work.

Overall, VEB and SME Bank are playing a critical role in helping address the demand for investment capital among SMEs and entrepreneurs. For example, there is evidence that the injection of financial support to SMEs through SME Bank was able to reduce the negative impact of the crisis in terms of access to credit, although it did not result in a statistically significant impact on employment growth in the SME sector (NISSE, 2010). However, even with their interventions a substantial SME finance gap remains. For example, the SME Bank programmes involve less than RUB 100 billion compared with an annual flow of lending to SMEs across the Russian Federation of more than RUB 6 500 billion, even if the market share of SME Bank is higher in some areas: 12% of microfinancing, 3% of leasing and 5% of factoring. This suggests a need to expand the scale of VEB operations in a number of areas of SME and entrepreneurship financing support.

There is also a need to expand the scope of VEB and SME Bank activities in terms of introducing new products and services. In a recent review of 55 public financial institutions, (OECD 2015c) identifies 37 with financial products for SMEs and entrepreneurs. Table 6.7 summarises the SME and entrepreneurship products that they offered compared with those of VEB and SME Bank. It is evident that although VEB and SME Bank are involved in providing loans, loan guarantees and non-financial assistance such as advice and training to SMEs and financial institutions there are a number of other SME financing activities that they do not undertake that are offered by several other international public financial institutions, including new types of equity, hybrid debt-equity and securitisation products. Finnvera in Finland, described in Box 6.5, is an example of a development bank that is successfully supporting SME and entrepreneurship financing and has a number of features that could provide inspiration for the further development of VEB and SME Bank activities.

Table 6.7. **SME finance products offered by selected public financial institutions**

Institution	Direct				Indirect		
	Soft loans	Debt (loans)	Hybrid debt-equity (subordinated)	Equity	Loan Guarantees	Securitisation	Non-financial assistance (e.g. training)
EBRD	..	✓	..	✓	✓	..	✓
NIB	..	✓	..	..	✓	..	..
EIF	..	✓	..	✓	✓	✓	..
Australia, EFIC	..	✓	..	..	✓	..	..
Austria, AWS	✓	✓	..	✓	✓		✓
Belgium, Fonds Bruxellois de Garantie	..	✓	✓	✓	✓	..	..
Belgium, PMV Flanders	..	✓	✓	✓	✓	..	..
Belgium, SOLWFIN Wallonie	..	..	✓	✓	..	..	..
Brazil, BNDES	..	✓	..	✓	✓	✓	✓
Canada, BDC	..	✓	✓	✓	..	✓	✓
Chile, Banco Estado	..	✓	..	..	..	..	✓
Chile, Corfo	..	✓	..	..	..	..	✓
Colombia, Bancoldex	..	✓	..	✓	..	..	✓
Costa Rica, SBD	..	✓	..	..	✓	..	✓
Czech Republic, CMZRB	✓	✓	✓	..	✓	..	..
Denmark, Vaekstfonden	..	✓	..	✓	✓	..	✓
Estonia, Kredex	✓	✓	..		✓	..	..
Finland, Finnvera		✓	..	✓	✓	..	✓
Germany, KfW Mittelstandsbank	✓	✓	✓	✓	✓	..	✓
Greece, ETEAN	..	..	..	✓	✓	..	..
Hungary, MFB		✓			✓	..	..
Slovak Republic	..	✓	..	..	..	..	..
Hungary, Venture Finance Hungary	..	..	..	✓	..	..	..
Israel, SMB			..	..	✓	..	✓
Italy, MedioCredito Centrale	✓	..	..	..	✓	..	..
Korea, SBC	..	..	..	..	✓	..	✓

Table 6.7. **SME finance products offered by selected public financial institutions** *(cont.)*

Institution	Direct				Indirect		
	Soft loans	Debt (loans)	Hybrid debt-equity (subordinated)	Equity	Loan Guarantees	Securitisation	Non-financial assistance (e.g. training)
Mexico, NAFIN		✓	..	✓	✓	..	..
Netherlands, NL	✓	✓	✓	✓	✓	..	✓
Norway, Innovation Norway	✓	✓	..	✓	✓	..	✓
Peru, Cofide	..	✓	..	..	✓	..	✓
Russian Federation, VEB/ SME Bank	..	✓	..	..	✓	..	✓
Slovak Republic, SZRB	✓	✓	..	..	✓	..	..
Slovenia, SID	✓	✓	✓	✓	✓	..	✓
Spain, ICO	..	✓	..	✓	✓	✓	..
Sweden, ALMI	..	✓	..	✓	..	..	✓
Turkey, TKB	..	✓	..	✓	✓	..	..
United States, SBA	..	✓	..	✓	✓	..	..
Uruguay, BROU	..	✓	..	..	✓	..	✓

Source: OECD (2015c) The Role of Public Financial Institutions in Fostering SMEs Access to Finance. OECD Centre for Entrepreneurship, SMEs and Local Development, Paris.

Box 6.5. **SME and entrepreneurship financing by Finnvera Development Bank, Finland**

The approach

Finnvera is the public development bank of Finland, a state-owned enterprise that provides financial services to satisfy three mandates: to support the development of enterprises, especially SMEs; to promote exports and the internationalisation of enterprises; and to contribute to the achievement of the government's regional policy goals. It aims to offset shortcomings in the supply of financial services by taking higher risks than commercial lenders whilst sharing risks with private financial providers.

Finnvera operates a range of direct business loans programmes including micro loans, loans to women entrepreneurs, loans to support voluntary environmental investments by SMEs, contra-cyclical loans, and loans to support internationalisation. It also operates a variety of loan guarantee programmes. The standard programme offers guarantees of 80% of the credit for loans or bonds granted by banks, finance companies or insurance companies. Another programme guarantees 60% of a micro-loan of up to 85,000 EUR. Finnvera also provides counter-cyclical loan guarantees and acts as Finland's official export credit agency, offering guarantees to banks for export credits.

Veraventure, a Finnvera subsidiary, manages Seed Fund Vera, which makes direct equity investments in enterprises. A company can apply for venture capital financing from Veraventure online. It must be: (1) a small enterprise registered in Finland; (2) organised as a limited company; and, (3) in the process of establishment or at an early stage. The Board of Seed Fund Vera, based on a presentation by the management team, makes decisions as to the approval/rejection of applications. Veraventure also acts as a fund-of-funds by investing in Finnish regional venture capital funds organised as limited companies. Investments take the form of equity. Veraventure also administers a business angel network known as SijoittajaExtra (InvestorExtra) through which early-stage growth enterprises can apply for venture capital financing directly from business angels and through which individual investors can find investment opportunities in growing early-stage enterprises.

Box 6.5. **SME and entrepreneurship financing by Finnvera Development Bank, Finland** *(cont.)*

Results

Finnvera's activity in 2009 involved EUR 593 million in loans, EUR 474 million in guarantees, and EUR 127 million in export guarantees. It provided loans and loan guarantees to 3 457 start-ups and 1 246 growth enterprises and made equity investments in 116 companies. This was associated with the creation of 9 214 new jobs.

Success factors

The success of Finnvera is associated with good governance arrangements. These include regular evaluations of the cost effectiveness of programmes in achieving public investment and ongoing monitoring of capital adequacy and the transparent appointment of a Board of Directors from people nominated by the Ministry of Employment and Economy, the Ministry of Finance and the Ministry for Foreign Affairs.

Problems and responses

The global financial crisis led to problems for SMEs and entrepreneurs to obtain working and investment capital from commercial banks. Accordingly, in 2009, the Finnish Parliament agreed amended legislation on Finnvera to:

- Increase the Government's commitment to compensate Finnvera for credit and guarantee losses from EUR 2.6 to 4.2 billion for domestic financing and from EUR 7.9 to 12.5 billion for export financing.
- Increase the amounts of Finnvera loans and guarantees from EUR 210 million to 860 million and from EUR 10 million to 124 million for counter-cyclical loans and guarantees.
- Increase the shareholders' equity of Seed Fund Vera by EUR 22.5 million and that of Veraventure by EUR 7.5 million.
- Make a subordinated loan of EUR 50 million to keep the capital adequacy of Finnvera at a minimum of 12 percent. Another 30 million EUR was reserved for the same purpose in the State budget for 2010.

The existing skills, experience and infrastructure of Finnvera was critical in enabling the state to intervene rapidly through its public bank in mitigating the effects of the financial crisis on SMEs and entrepreneurs.

Relevance to the Russian Federation

Finnvera has a mandate that is much like that of VEB and SME Bank in the Russian Federation but has a wider range of SME and entrepreneurship financing initiatives. Loan guarantees, export credit and venture capital initiatives such as those operated by Finnvera could be a useful complement to the existing activities of VEB and SME Bank.

Further information

www.finnvera.fi/eng

Source: OECD (2015c) The Role of Public Financial Institutions in Fostering SMEs Access to Finance. OECD Centre for Entrepreneurship, SMEs and Local Development, OECD Publishing, Paris.

Conclusions and recommendations

The most important short to medium-term challenge for SME and entrepreneurship financing in the Russian Federation is to correct a situation in which the proportions of SMEs with access to a bank loan and the volumes of bank loans remain substantially below those in the OECD area and in ECA and Upper Middle Income countries generally, despite recent increases driven by public interventions. The weakness of bank lending in the Russian Federation has led to the emergence of a substantial private sector driven microfinance market, and to some extent, a reliance of new firms and SMEs on government subsidies such as grants for equipment leasing for their investments. However, these palliatives are not sufficient. The financing amounts available through these means are of small scale, and the microfinance loans are short term and expensive, with interest rates often higher than 25 per cent annually. Increased coverage of bank lending among SMEs together with larger and longer term loans will be needed to cover the working capital needs for the growth and day-to-day operations of SMEs and to finance long-term asset expansion in new and growing firms.

In large part, the current situation can be attributed to a historical context that has left the banking sector largely without the resources of experience, expertise and technologies for SME and entrepreneurship lending. Where bank lenders are unable to assess the risk of potential SME borrowers and make informed decisions about which loans to make and which to reject they are driven to rely on credit rationing. The government can help correct this historic weakness by building the SME lending capacities of banks at the same time as their incentives to lend. One of the most important tools for this purpose is the use of loan guarantees offered to private sector banks and microfinance institutions. This provides both an immediate stimulus to lending and helps build the experience of banks and other financial institutions with SME lending in the longer term. There has recently been an upward trend in guaranteed loans in the Russian Federation stemming from the activities of regional and municipal loan guarantee funds, the introduction of loan guarantees for medium-sized enterprises by VEB and SME Bank and the creation in 2014 of a Federal Credit Guarantee Agency which should double the volumes of loan guarantees in the system by 2016. It will be important in strengthening the loan guarantee system to pay close attention to the design and operation of the national, regional and municipal schemes to secure high levels of additionality of loans and sustainability of loan guarantee schemes, which implies a need for the use of evaluation as well as provision of capacity building support for the local schemes.

A further potential government intervention that could be critical in raising the volume of lending by banks, microfinance institutions and others would involve expanding the availability and use of credit information on SME borrowers for lending decisions. One of the key problems that banks face in lending to SMEs is lack of information on the associated risks. In part, this reflects the fact that SMEs do not have to prepare standardised financial statements (which are not required by the tax system) and because there is not yet an effective credit bureau from which all banks can benefit. While the use of credit scoring is now almost universal in advanced countries as a way of assessing loan demands effectively and cheaply, it is rare in the Russian banking system. This information gap leads banks to be extremely conservative in their lending decisions. Together with a strengthening of the legal system with respect to investor protection, the government could increase lending by pooling credit information on firm and individual borrowers from state-linked credit programmes and sharing this information with other state entities and private banks through an independent intermediary organisation. This could enable banks and microfinance institutions to assess small business lending opportunities more efficiently using credit scoring, which would boost lending amounts and reduce interest rates. It could eventually lead to the establishment of one or more full-fledged credit bureaus drawing on both state and private sector lending information and supported by fees paid for the credit information supplied.

These efforts could be reinforced with a set of measures to build the capabilities of bank staff in SME and entrepreneurship financing and increase financial and business literacy among Russian Federation entrepreneurs. This calls for support of a major training programme in SME lending for bank staff that could be managed through the creation, perhaps through Vnesheconombank, of a centralised institute for banking education, one that includes SME lending as a key focus. The institute would be mandated to provide distance, online, and classroom educational programmes to bank staff and other financial services professionals, such as those involved in MFIs and those managing loan guarantee programmes. It would develop and provide educational materials related to SME banking and would be supported by the banking industry. One approach might be to affiliate such an institute with a university that also offers degrees in business education. At the same time, relatively low levels of financial and business literacy among Russian Federation entrepreneurs makes their businesses more susceptible to poor management decisions, which is a frequent reason for the failure of many SMEs and the risk perceived by prospective lenders. To address this, it will be important to expand efforts to provide entrepreneurship education in the formal education system and to offer business training, advice and counselling to existing SME managers and potential entrepreneurs.

Whilst banks should gradually take over the bulk of SME and entrepreneurship lending from the public and private microfinance sector in the Russian Federation, microfinance institutions will still have their role to play in providing lending for very small amounts. It is therefore important that existing weaknesses in the microfinance sector are addressed. In particular, measures should be envisaged to fill regional gaps in microfinance coverage and encourage some consolidation in the sector to increase the scale of individual institutions. In addition, supervisory changes should be made to assist borrowers to distinguish the very high interest rate lenders from other MFIs and reduce any abuses.

The supply of venture capital and private equity does not appear to be presenting a major problem for the development of high growth potential SMEs and entrepreneurship at this time. Rather the supply of seed and early-stage venture capital and private equity appears to be constrained by a lack of growth-oriented enterprises to invest in, which reflects weaknesses in upstream bank lending and a need to orient the innovation system more towards commercialisation of research. However, it is important to encourage more balance in the size distribution of Russian Federation venture capital funds by encouraging the emergence of a fewer larger funds. There is also scope to boost the emerging business angel financing sector with measures including support for the creation of business angel networks, tax incentives for angel investments and co-investment with angel investors by public organisations such as venture capital funds.

VEB and SME Bank are critical players in the development of a larger and more sophisticated financial market for SME and entrepreneurship financing in the Russian Federation. In particular they can help stimulate a shift in state financial support to SMEs and entrepreneurs from direct grants and loans towards leverage of private sector resources through expanded loan guarantees and new activities in the areas of venture capital and business angel investment. They also have a central role to play in efforts to provide staff in banks, MFIs, loan guarantee funds and other financial institutions with more extensive education in SME finance. They can also play a role in increasing financial literacy on the demand side of the financial market, in particular by helping raise investment readiness in growth oriented SMEs. In these respects the public development bank could be a key player in the establishment of a new national institute for financial education. It could also be a major player in the development of a national credit information system. For these tasks, the roles of VEB and SME Bank should be interpreted more broadly than in the past in order to complement the supply of credit to the banking system for SME lending with other financial and non-financial products as found in the leading public financial institutions in the world.

The following key recommendations are therefore offered to improve SME and entrepreneurship financing in the Russian Federation:

Key policy recommendations on SME and entrepreneurship financing

- Expand bank lending to SMEs and entrepreneurs and increase the scale and terms of loans made by increasing the leverage of public investments (favouring loan guarantees over direct subsidies to SMEs or lines of credit to banks for onward lending), increasing credit history information in the SME lending market and building an inter-bank SME lending market by encouraging standardisation of loan contracts and implementing legislation to provide for securitisation.
- Promote the sustainability and additionality of the loan guarantee system by using evaluation evidence and information from international experience to set the appropriate design parameters for the national, regional and municipal credit guarantee funds as well as by providing capacity-building support to local funds and encouraging consolidation of smaller funds.
- Develop a national credit information system that enables banks, microfinance institutions and finance providers to assess the riskiness of SME borrowers based on their credit histories and other parameters. Require that all state-supported credit organisations contribute credit information to an intermediate credit information organisation and share the resulting database with private banks and financial institutions on a fee-paying basis.
- Fill outstanding gaps in the regional coverage of microfinance institutions, offer capacity-building support to microfinance institutions in SME lending and introduce new reporting and supervisory measures to help borrowers distinguish between payday lenders and responsible institutions.
- Channel public investments in venture capital towards expanding existing funds rather than creating new funds.
- Boost the business angel sector through measures such as strengthening legal protection for minority shareholders, recognising business angel investment in regulations, supporting the creation of business angel networks, offering tax incentives for angel investments, providing public co-financing for projects with angel investors and offering awareness, training and mentoring support in angel investment to potential angels and high growth enterprises.
- Augment the scale of the SME lending interventions of the public development bank, VEB and its SME Bank subsidiary in the short to medium-term, particularly in encouraging longer-term and larger loans to start-ups and growth-oriented SMEs.
- Expand the remit of the activities of VEB and SME Bank to enable them to introduce new financial products in the area of equity, hybrid debt-equity and securitisation instruments, and new non-financial products, including hosting a national institute for financial education (offering distance, online, and classroom-learning programmes to financial services professionals, such as those involved in banks, credit guarantee programmes, microfinance institutions and venture capital funds), and supporting the development of a national credit information system by advancing the availability of credit rating tools, technologies and data.
- Design all measures to improve the financing system for SMEs and entrepreneurship so as to avoid the possibility of systemic corruption.

Notes

1. For example, the Consultative Group to Assist the Poor reports that "promotional booklets found in post offices in several major Russian cities were advertising microloans in the amounts starting from USD 100 that, if taken for one week, would cost 2772% *per annum* (and a "special offer for low-income pensioners" – at 2598%)." *www.cgap.org/blog/interest-rates-microloans-russia-how-much-too-much;* accessed March 22, 2013).
2. It is important to distinguish between "private equity" and "venture capital". Private equity typically comprises investments in traditional later-stage and established businesses and is seldom of interest to growing SMEs. Venture capital, classically, is investment in early-stage, high-risk ventures with growth potential.
3. Data in this section were extracted from Russian Venture Capital Association (2013). Because data from this source were based on a survey of Russian Federation Venture Capital firms, to which not all firms replied, these data arguably understate private equity and venture capital activity.
4. A few examples of national government run programmes are those of the United States Small Business Administration, the Canada Small Business Financing Program and the United Kingdom Enterprise Finance Guarantee. Finnvera in Finland and BPI in France are examples of schemes run by public development banks.
5. Interfax and D&B established a joint venture in 2008 to operate in Russia and the CIS countries, providing access to the D&B global business database and analytical services for credit risk assessment. However, domestic credit history data from within the Russian Federation needs to be expanded substantially.
6. In addition to Globexbank and Sviaz-bank, VEB also operates subsidiaries Roseximbank (0.39% of total VEB assets), VEB Leasing (6.46% of total VEB assets), VEB Capital (0.34% of total VEB assets), and SME Bank (3.66% of total VEB assets). Two additional subsidiaries, Belvnesheconombank (1.64% of total VEB assets) and Prominvestbank (5.77% of total VEB assets) operate in Belarus and Ukraine, respectively. Recently, EXIAR, the Russian Federation export credit agency began operation with VEB as the sole shareholder.
7. Loans advanced under the terms of the "idea" and "manoeuvre" programmes are targeted to the financing of SMEs for the implementation of innovative projects (idea) and modernization (manoeuvre); "regional growth" loans are targeted to SMEs in regions in which demand for credit is low.

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