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SME LENDING DECISIONS – THE CASE OF UKRAINIAN BANKS: AN INTERNATIONAL COMPARISON

In this paper we use three Ukrainian bank case studies to test and extend a conceptual model of risk assessment in bank lending to SMEs. Derived from research in Germany and the UK the model postulates that factors in the external, operating and internal environments of individual banks can influence risk assessment decisions.

Introduction and Background

In the words of The World Bank in its 2008 report, *Finance for All?*

Empirical evidence suggests that it is through improving access (to finance) for enterprises that financial sector development makes an important contribution to economic growth. (World Bank, 2008, p. ix).

In developed and developing economies the focus on provision of finance to SMEs is strong since such focus benefits the economy, the banks that seek asset growth and profitability and the entrepreneurs attempting to raise finance to bring their business dreams to life. SMEs represent around 90% of all firms in developed economies (Baas & Schrooten, 2006, p. 127) but account for a far lower proportion of GDP and employment.

It is the nature of the SME or start-up business to lack capital. Without access to equity or capital markets and often having exhausted founders' savings these firms obtain finance from banks.

In this paper we use three Ukrainian bank case studies to test and extend a conceptual model of risk externalisation in bank lending to SMEs. The model was constructed using qualitative data from interview and case study research in Germany and the UK and postulates that factors in the external, operating and internal environments of individual banks can influence risk externalisation decisions. Whilst systems and procedures can look superficially similar the reasons for loan application procedure design can differ between national settings.

There is strong evidence of credit growth in Ukraine since 2000 and a commensurate rise in both lending and quasi-lending such as leasing activities (Enoch, 2007, p. 4; Zelenyuk, 2007, p. 20). Since the banking crisis of the late 1990's Ukrainian banks have seen a huge growth in size and significance of loan assets. This represents a greater proportion of bank activity in banks outside Kyiv but, in 2002, accounted for around 75% of all banking activity (Bahrii, 2002). Some of the lending activity was promoted and funded by bodies such as EBRD, TACIS and USAID. These initiatives targeted micro-businesses and provided additional regulations regarding loan size and allocation.

By 2007 the growth rate of SMEs in Ukraine had slowed from high 1997 levels of 41.5% (Ministry of Statistics, Ukraine, 2008) to between 4% and 6% officially although unofficial estimates were higher at 6-10% a year (Cheryevko, 2007, p. 16). The number of Ukrainian SMEs per 1,000 of population is still far below that of European neighbours (IFC, 2007, p. 22), sug-

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gesting scope for future growth. Growth occurs despite the reported top-heavy and bureaucratic barriers to business formation generated by the various permit and license requirements of central government (IFC, 2007, p. 8; Balcerowicz, 2006, p. 6).

Research themes

Baas and Schrooten (2006, p. 129) identify four types of lending types in the interactions between banks and SMEs. The types are identified in Table 1

Table 1. Comparing lending types

Lending type	Risk orientation
Relationship lending	Internalisation / co-operative
Financial Statement lending	Externalisation / transactional
SME credit score lending	Externalisation / transactional
Asset backed lending	Externalisation / transactional

According to the literature in this area the approach of any one bank will rely on a number of key factors including the institutional environment, the structure of the banking industry (size and number of banks and the level of competition) and the sociological influences on lending managers.

Access to finance depends heavily on the institutional environment in the individual country. In the most developed environments, UK and US, for example, an increasing trend towards transactional lending is supported by the development of good credit registries (World Bank, 2008, p. 9). However, reliable SME information is rare and costly, factors that would lead many lenders to select a relationship approach, rather than a transaction based one, gaining competitive advantage over the longer-term (Baas and Schrooten, 2006, p. 130). Relationships can help lenders to acquire «soft» information that is, typically, not amenable to credit registry collection and display.

The UK banking market is dominated by a small number of large banks (Cruickshank, 2000, p. 145). This would normally translate into a transaction based approach to lending since the set-up and monitoring costs are lower (Deschenes, 2008, p. 22) and a focus on Financial Statement («gone concern») lending (Berry et al., 2004, p. 118). The UK banks display a fairly quantitative approach to risk assessment and although «soft» information is acquired in the loan application process this is considered to be subjective and unreliable (Lane and Quack, 2001, p.34). The oligopolistic competitive structure and the lack of longer-term «soft» data would also suggest a greater reliance on collateral (Voordeckers and Steijvers, 2006, p. 3083) and an externalisation of risk. In their paper based on a study of Belgian bank records Voordeckers and Steijvers also suggest that taking collateral also forms a useful barrier to entry to other lenders.

Paradoxically, however, UK based SMEs have one of the lowest average number of banking relationships in Europe – each having facilities with 1-2 banks. This suggests that whilst UK banks do not consider their interactions with SMEs as a «relationship», the SMEs do. Individual SMEs typically get all of their banking services (credit, transaction processing etc) from one bank (Berry, 2006). In mainland Europe the number of relationships is greater as different services are sourced from different providers. Berry (2006), considers that the structure of the banking industry is a strong determinant of the propensity for SMEs to «shop around».

In Germany the «Hausbank» relationship banking paradigm (Lane and Quack, 2001; p. 11; Behr and Guttler, 2007, p. 196) is well described in the literature. This traditional approach, with its emphasis on longer-term relationships with SMEs is seen as beneficial since it reduces both information asymmetry over time and any hold-up problems. The «Hausbank» paradigm creates a co-operative atmosphere between bank and SME. The German banking market is much

more fragmented than in the UK. Whilst large banks exist they do not dominate the SME market. Regional and local banks, often acting co-operatively, combine local knowledge and good access to funding. SMEs have little incentive to switch banks since switching and search costs increase when a new relationship has to be forged.

Lane and Quack (2001, p. 5) also describe German banks as hierarchical and bureaucratic. Individual managers are given a relatively low level of discretion for loan decisions and, although the German approach is more qualitative and subjective than that of UK banks, it is supported by a highly standardised procedure for evaluating risk. In addition, the focus on «soft» data should mean a lower reliance on collateral.

The UK and German systems have been dichotomised in this narrative in order to categorise features sensibly and, later, to compare these with Ukrainian experience (see Table 2). In reality banks in UK and Germany show similarities too and, as markets open up within Europe, features of «relationship» banking can be seen in the UK and «transactional» banking in Germany (Lane and Quack, 2001, p. 34).

Table 2. Comparing key features of UK, German and Ukrainian SME lending

	UK	Germany	Ukraine
Number of banks	Few	Many	Many
Size of banks	Large	Medium - Small	Medium - Small
Institutional type	Market led	Hierarchical / bureaucratic	Hierarchical / bureaucratic
Lending type	Transaction	Relationship	Transaction oriented
Loan term	Short-term	Longer-term	Short - term
Managerial discretion	High	Low	Low
Collateral	Any available	Business assets	Any available
Risk handling	Externalisation	Internalisation	Internalisation
Risk sharing	Little evidence	Collective	No evidence

Data collection

The Ukrainian empirical data for this paper was collected during three interviews with lending bankers in Kyiv in September 2007. Whilst this is not put forward as a representative sample of all Ukrainian banks it provides three case studies from which broad generalisations can be drawn. The similarities found between the three banks also suggest that the processes and procedures used in other banks are comparable since they result from a similar appreciation of the environment within which lending decisions are made.

The sample banks were selected to provide examples from large, medium and small institutions. The banks, themselves selected the interviewee. Two interviewees performed Head Office functions and so were able to describe the Head Office and branch procedures well. The final interviewee was a retail branch director who had day-to-day dealings with loan applicants.

Amongst the sample banks were a foreign owned institution and a Ukrainian institution that had access to EBRD micro-finance funding (this feature provides an additional level of regulation since loans must be within EBRD guidelines).

All interviews were conducted using a question template designed to elicit a description of the loan sanctioning process. The questions were identical to those used in a research project in the UK and Germany (Stevenson, 2008), allowing some broad comparisons to be made with these markets too. The questions followed broad themes (echoed in Lane and Quack, 2001) covering:

- Loan allocation and specification
- The loan process within the bank

- The level of managerial discretion
- The selection of borrowers
- Rewards and incentives for managers
- Wider loan allocation considerations (e.g regulation) and
- Underlying bank values

The design of questions was such that environmental, operational and resource based issues would all be highlighted as the loan application process was described. The conceptual model arising from the literature in this area suggests a layered «onion skin» paradigm, based on the work of Bronfenbrenner (1979). The «onion skin» concept is illustrated in Figure 1

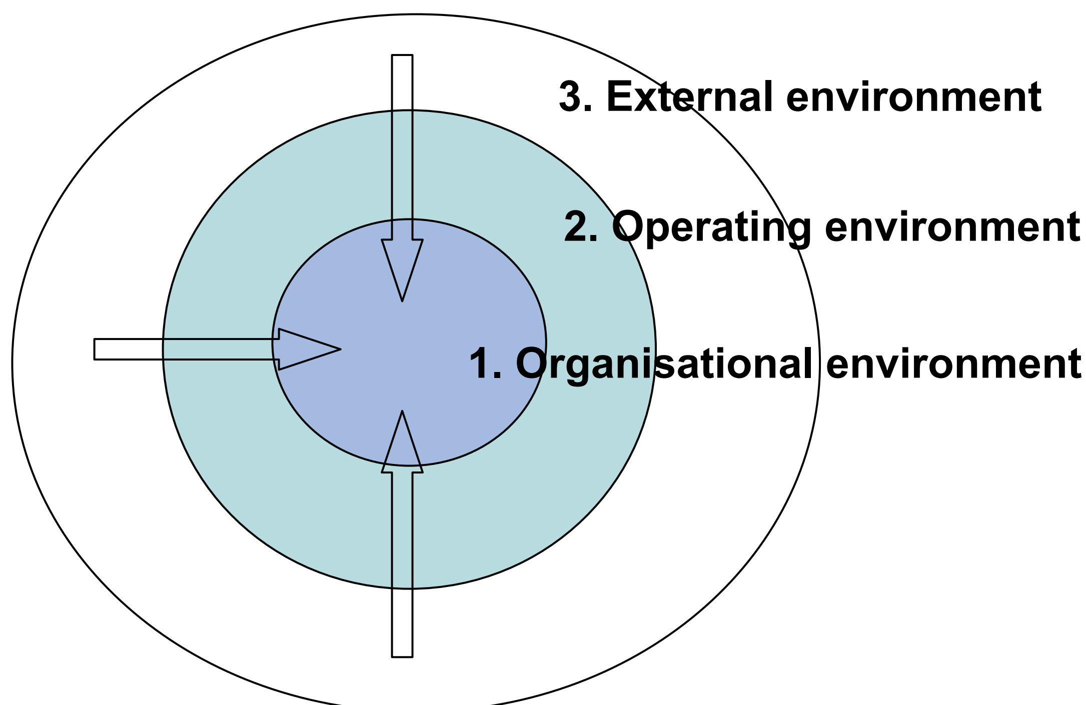

Figure 1. A conceptual model of environmental influence

The model suggests that decisions, processes and «cultural norms» within an organisation are influenced by the strategic resources of that organisation, the competitive environment within which it operates and the political / economic / regulatory regime within which it exists. In the context of lending to SMEs the focus of the model is risk. Risk emanates from all areas of the environment – external and internal and loan assessment procedures are designed to identify, assess and manage risk.

The process followed was to send copies of the interview questions to participants in advance. The interview questions were available in both English and Ukrainian. The interviews were conducted in the language preferred by the interviewee: Russian, in one case, Ukrainian in another and English in the third. In order to ensure accuracy of response recording, however, all interviews were recorded using manuscript notes, transcribed in English and translated into Ukrainian for verification by the interviewee. All interviewees were open and co-operative and in all cases the interview extended beyond the 40 minutes to 1 hour time originally allocated.

The final stage of this process took a number of months but by early 2008 all interview transcripts were approved. No amendments were made but neither did any bank give permission for their name to be associated with the research.

Analysis of the interview transcripts was undertaken using a three-stage coding process that sifted the raw transcripts for themes, collated the themes into a smaller number of key areas and, finally, linked these areas with the overall conceptual model or risk. It is important to note that

whilst the interviews were structured using common questions it is the responses given that were analysed. The strength of any qualitative research methodology is that the conclusions are reliable and robust and that the interpretation of the empirical data is able to be replicated.

Analysis of findings

Overall the approach of the Ukrainian banks interviewed was very risk averse, hierarchical and bureaucratic (see Table 2) but balanced the needs of portfolio and asset growth with the characteristics and needs of the market. In terms of international comparison Ukrainian banks can be likened more to German banks than their UK counterparts – although the reasons for these similarities have different sources.

External factors such as national and international regulation played a small part in influencing the corporate mission of growth and asset quality. Participants reported little regulation and even less encouragement from national government. In the UK and Germany a government backed loan guarantee scheme operates for SMEs that lack collateral, there is no similar scheme in Ukraine. Thus the shareholders of each bank, through the medium of the corporate strategy and risk appetite, exercised overall influence on setting asset quality levels but required asset growth too. In a growing market this is possible, provided that the bank's offer remains competitive.

Some economic factors, such as the ownership and control of certain industries by illicit organisations, provide clear risk signals. No respondents mentioned the economy in a negative way, all emphasised economic growth in Ukraine and their desire to support this for both patriotic and economic reasons.

Despite growth in the economy, markets in Ukraine are seen as immature, revealing little cost / price or differentiation based competition. Respondents used standard interest rates decided at Head Office level. Some discounts for existing customers were available and showed the importance of client retention. However, increased risk was dealt with by accepting additional collateral (above the normal 1:1.7 ratio) – typically real-estate. This reveals a similar «externalisation» attitude as in the UK although UK banks also use increased interest rates to defray additional monitoring costs too.

All respondents saw the value of differentiating their offer in the market. Speed of decision making was seen as most important to clients although the bureaucratic risk assessment system adopted by the banks was a strong barrier to providing swifter decisions. One respondent revealed plans to grant branch sanctioning authority and to reduce the need for Head Office intervention but the environment was not yet stable enough to implement this.

Internal procedures within each respondent bank were very similar. Loan officers at branch level have overall responsibility for data and information gathering on prospective clients and providing basic reports on the client history. Any negative information or observations at this stage is enough to decline the loan. The impression gained was that the default response to a loan request was «no», with a more positive response only after the completion of the due diligence process.

Initial «filtering» excludes business start-ups and concentrates only on those ventures with a track record (this ranged from 6 months to a year of business activity). Branch interviews and client business visits aid the data gathering process. A detailed web of questions used in client interview establishes the «true» picture of the business as distinct from the position revealed in official and tax records. Loan officers then submit applications to a branch based credit committee that provides an objective review of the data collected.

The next stage of the process is to send acceptable applications to Head Office for further investigation by security specialists and ultimate approval by a Head Office Credit Committee. Much of the due-diligence process is designed to reduce the information asymmetry problems

and in so doing, reveals the degree of risk assessment that is internal to the bank (even if risk is ultimately externalised).

Incentives for loan officers appeared to encourage the bank objectives of growth whilst the due-diligence process emphasised the need for asset quality. Bonuses paid largely reflect accounts opened and loans granted as well as asset quality.

Conclusions

This small study has delivered some clear findings, not only relating to the excellent level of co-operation of Ukrainian banks in the research but also to the risk environment within which they operate. The conceptual model devised for German and UK banks proves to be an excellent template through which Ukrainian experience can be compared.

National and international regulation and political influence play a small part in the loan decision process. Ukrainian banks appear to be driven by their own corporate mission but are mindful of the checks and balances required to avert future bad debts. The immature and relatively unstable environment in Ukraine produces very similar behaviour in all respondent banks and although banks can see how competitive advantage can be gained in the future they are reluctant to differentiate themselves yet.

The key differences between the UK, German and Ukrainian evidence are, therefore in the external environment, the nature and maturity of credit registry systems and accounting and reporting procedures. The design of the risk-averse due-diligence procedures and the hierarchical sanctioning of loans are products of the risk environment. Although this design architecture looks similar to that found in Germany the reasons for this are risk related rather than the more strategic «relationship» related motives of German banks. At present Ukrainian banks are still in «transaction» mode but have the intention to build relationships with clients in the longer term.

The key comparison with the UK is the heavy reliance on accounting data and the externalisation of risk via the acquisition of collateral. Ukrainian banks, however, give more weight to the «soft» information discovered through their detailed and forensic examination of SME clients. The additional transaction costs associated with this approach appear acceptable to Ukrainian banks in the face of such different risk conditions.

The huge growth in demand for credit (Enoch, 2007) provides the Ukrainian context with very different «adverse selection» risks to those in UK or Germany. Larger numbers of SMEs making credit requests provide additional risks that due diligence procedures must cope with. The overall conclusion is that whilst Ukrainian banks expend considerable effort in assessing credit risk ex ante they still externalise risk ex post through their propensity to take any available collateral.

As with any individual research project there are limitations with this research, largely due to the small sample size and the original focus of the conceptual model. Future research could usefully focus on the key environmental factors of the availability of good quality accounting and credit information and the creation of credit registries.

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