The New Economy: Entrepreneurship --- Russian Credit Programs Spur Small Enterprise --- Foreign Backers Help Competition Thrive --- EBRD and U.S.-Russia Investment Fund Change the Lending Landscape

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NIZHNY NOVGOROD, Russia -- The triangular mirrors and chrome accents in Nadezhda Ivanova's beauty parlor are as trendy as those in any London salon, and Ms. Ivanova is happy to share the credit with Western taxpayers.

After years of fighting to borrow from Russian banks, Ms. Ivanova received a $40,000 (48,312 euros) loan in 1999 from the European Bank for Reconstruction and Development's Bank for Lending to Small Businesses -- known by its Russian acronym as KMB.

Ms. Ivanova opened a beauty academy and cafe with the money and refurbished her salon here. Future plans include the acquisition of second building where she plans to put amputees, including Afghanistan and Chechen war veterans, to work making hair extensions and other products.

"With this bank, it took two weeks to get the loan," she said. "They rescued me."

The expansion of small businesses in Nizhny Novgorod and other cities across Russia is due in large part to two large foreign investors -- the EBRD and the U.S.-government financed U.S.-Russia Investment Fund. Both say they have been vindicated after more than five years of lending to clients perceived as high risk.

Working through partner banks and, in the case of the EBRD, through its own microlending institution, the institutions have achieved two goals in one: offering Russia's small entrepreneurs unprecedented access to credit while spurring competition for clients among the country's commercial banks.

Borrowers like the quick approval times, emphasis on the lender-client relationship and cheaper rates -- around 15% a year, compared with as much as 90% demanded by some Russian banks in years past. Russian banks, meanwhile, have been attracted by repayment rates of around 98%.

"The idea is to stimulate competition, show some best practices in lending," said Christoph Freytag, chief operating officer of the EBRD's KMB Bank. Other banks, he said, "use us as a kind of ratings agency."

Few debate the importance of expanding credits to small entrepreneurs. But some analysts caution that the foreign money could underwrite risky loans by subsidizing lending that most commercial banks wouldn't normally consider to be profitable in the first place.

While small businesses have been the motor of economic development in most Western countries, the sector has been woefully underdeveloped in Russia, where banks traditionally favored larger, politically well-connected companies.

Russia has six small businesses for every 1,000 in the population, compared with more than 50 such businesses in Poland, World Bank Vice President for Europe and Central Asia Johannes Linn said last spring.

Both the EBRD and U.S.-Russia Investment Program, which works through its management arm, Delta Capital Management, have been active in Russia since the mid-1990s, issuing loans of up to $150,000 and, in the case of the EBRD, micro-credits of up to $30,000.

The credits, with terms of up to two years, can cover short-term trade finance or longer strategic investments. As businesses grow, they can qualify for larger loans.

Faced with the collapse of a number of its partner banks in the wake of the 1998 financial crisis, the EBRD opened the future KMB in July 1999. At the same time, it kept its largest partner, state-owned savings bank Sberbank, and several smaller regional lenders that compete against KMB in their markets.

Delta Capital Management, which also lost several partner banks in the crisis, works with 26 lenders in 13 cities, overlapping with the EBRD in fewer than half.

While the events of 1998 proved disastrous for the reputations of many Russian commercial banks, they reflected much more favorably on small businesses. Although many EBRD and Delta clients found it challenging to meet their dollar-denominated loan payments in the wake of the devaluation of the ruble, nonperforming loans were kept to a minimum.

"The crisis was the best thing that could have happened to us," said James Cook, Delta Capital's senior vice president. "It was really a good demonstration to commercial banks of how well they could diversify their risks," with smaller borrowers.

By August, the EBRD had issued a total of 40,000 loans valued at $465 million. Delta Credit, which has loaned $54 million since 1995, offers both loans and leasing credits, with the latter directed toward purchase of equipment.

In addition to offering smaller clients previously inaccessible funds, the programs allow more established companies to refine their reputation as borrowers.

In a refurbished workshop on the grounds of a metal parts factory in Moscow, the Vitrina A advertising group concocts marketing designs and store promotions for a roster of clients that includes Coca-Cola Co. and Philip Morris Cos.

The firm, which set up operations in 1995 with an initial investment of $50,000, expanded quickly, purchasing its factory for $3 million by 1996, said General Director Vadim Kulikov.

"Up to then, we had enough of our own funds and we didn't worry about finding money," Mr. Kulikov said. "But we began to work with financiers fairly actively by 1996, and decided we needed a credit history."

The company took its first $150,000 credit line that year from Probusinessbank, initially an EBRD partner bank and later an affiliate of Delta Capital's program. In the three years since, Vitrina A has repaid its loans each year and is developing a strategic borrowing plan with Probusinessbank that will include auto and mortgage loans for the company's employees.

The foreign lenders' straightforward approach is a welcome change from the "degrading" system of verifications imposed by Russian banks, Mr. Kulikov said. Local banks, he added, have had to change their tune to solicit the most attractive clients.

As Russia's economy has improved over the past two years, larger Russian commercial banks and regional institutions have recognized the appeal of small business lending and raced to catch up.

Sberbank and Probusinessbank, principal partners of the EBRD and Delta Capital, respectively, were among the first to issue their own loans in addition to offering credits through the foreign lending programs.

Probusinessbank's own credit program, which lends at slightly higher rates of 18% to 24%, makes up some 30% of its total loan portfolio said Oleg Safronov, head of the bank's small business center. The credits the bank issues from its own resources are used largely for turnover capital, while the longer Delta Capital loans take the form of investment finance, he said.

But some analysts question the incentives the programs offer Russia's still struggling banking sector.

"If you have a nonmarket-oriented body lending money, you're distorting the system," said Kim Iskyan, banking analyst at Renaissance Capital investment bank in Moscow. Subsidizing entrepreneurs with foreign money creates "artificially low prices" and undercuts "truly market-oriented banks," he added.

Probusinessbank's Mr. Safronov acknowledged that Delta Capital and the EBRD get their funds more cheaply then Russian commercial banks, which rely on short-term deposits and must limit the term of their loans to less than a year.

"The more banks that get involved in lending to small businesses the better," KMB's Mr. Freytag said. "The only thing I fear is when the quality of loans offered becomes worse."

At least one bank, he said, has tried to lure KMB clients with longer loans and lower collateral requirements.

Other analysts, however, said foreign-currency exposure is the programs' main danger.

"The fundamental unfairness is that the EBRD as the stronger partner is in a better position to take on risk," said Richard Hainsworth, Moscow representative of ratings agency Thomson's Financial Bankwatch.

The EBRD hopes to issue ruble-denominated bonds next year that, officials say, will help mitigate the currency-exposure risk for their small business borrowers.

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