

When good signals go bad

The 2nd Russian banking failure

Lívia Markóczy

Andrew Spicer

Livia.Markoczy@ucr.edu

Andrew.Spicer@ucr.edu

The A. Gary Anderson Graduate School of Management
University of California, Riverside

Main argument

Some practices that work well in the West may go awry when they applied in a country with weak or underdeveloped institutions.

We argue that signals that are relatively accurate reflections of quality in the West may not only not work in other environments but may be the ones that are most likely to be transmitted by counterfeits or mimics.

Limits on transferring practices

Constraints:

Cultural Hofstede (1980); Welsh et al. (1993)

Legal and regulatory Kostova (1999); Kostova and Roth (2002); Kostova and Zaheer (1999); Khanna and Palepu (1997)

But

Sometimes locals are eager to adopt a practice and there are no cultural or legal barriers to implementing it, but things still go wrong.

This can happen when...

This can happen when a practice depends on features of an institutional environment which is not present in the new location.

We argue based on data from 199 Russian banks that this is what happened in the Russian banking system at the end of nineteen-nineties.

Quality and Signals

- Theoretical framework: signaling theory
- Investors tend to look for high quality partners, products and services for their money.
- An economic partner is high quality if it is accountable, have a long term earning potential and trustworthy (competence and integrity)

Quality and Signals, cont.

- Quality is often not directly observable, but needs to be derived from indicators (signals).
- By signal we mean a piece of information that is conveyed by an entity concerning its quality that is not directly observable (Gambetta 2004).

Some notation

An Originator, O , sends a Signal, S , which is received by a Recipient R . There is a Cost, $C(O, S)$, to O for sending S . And there is an Interpretation cost, $I(R, S)$ to R for interpreting S .

Quality signals of quality

A useful signal of quality is one which

1. Is cheap to interpret ($I(R, S)$ is small).
2. Is much cheaper for an honest sender to send than for a dishonest one to send ($C(O_h, S) \ll C(O_d, S)$).
3. Sending and interpreting signals does not have to be deliberate or conscious.

Signals of Quality

- Amazon.com took out expensive print advertising in the early days of on-line retail
- Michael Spence has an advanced degree from a prestigious university (and a Nobel Prize, too)
- That used car comes with a substantial warrentee
- This peacock has a very healthy looking tail
- That bower bird has decorated his bower with lots of blue things

The problem of mimicry

- False signalers may fool “signal receivers” by mimicking signals of quality (Akerlof 1970, Spence 1973)
- Mimicry here is not simply about copying best or legitimate practices, but is rather about fooling transaction partners about one’s quality
- Problem for honest signalers: how to distinguish themselves from the mimics

The wasp stings; others mimic



Wasp



Moth



Beetle



Fly

Courtesy Peregrine Productions

<http://www.bombus.freeserve.co.uk/mimicry.htm>

Two equilibria

Distinguishing equilibrium when honest signalers have signals that allows them to distinguish themselves from the mimics

Pooling equilibrium when no usable signals exist that can distinguish honest signalers from the mimics

The main points

- Salient parts of the signaling system by which westerners judged the viability of banks were imported into Russia. This system failed miserably because the practice tacitly relied on institutional conditions not present in Russia.
- When importing a successful practice it is important to have a deep understanding of why the practice works, and what its success depends on.

Signals and institutions

- In the West well developed legal and regulatory conditions (institutions) increase the cost of mimicry (e.g., accounting standards) and aid the honest signalers in developing signals that distinguishes them from the mimics (e.g., auditing, accreditation).
- These institutions are not always available elsewhere, and thus signals that are relatively accurate reflection of quality in the West may not be so in other countries.

Western signals of quality

- Costly advertising (signal long term orientation)
- Ratings by a credible third party

Mimicry in Russia

- Costly advertising is possible if most money is spent on advertising without spending money on developing capabilities. Thus, banks intending to “take the money and run” can spend *more* on advertising than honest banks.
- Without clear accounting standards and enforcing agencies third parties may need to base their information on unreliable sources. The banks can lie about their books. Those ready to lie will have better looking books.

Western investors (lenders)

We hypothesize that Western investors rely on

- Advertising
- European Bank for Reconstruction & Development (EBRD) rating
- State scrutiny (tailored regulation)
- Rating Information Center (RIC)

to make investment decisions.

Local investors

We hypothesize that local investors rely on

- Western investors
- EBRD rating
- State scrutiny (tailored regulation)
- Rating Information Center (RIC)

Banks that lost their licences

- We hypothesize that banks that advertised most, had the highest EBRD ratings, participated in stricter state regulation, and rated highest by RIC were most likely to lose their licences, even after controlling for their founding year, size, and ownership profile.

Western Lending

Predictor		Step 1	Step 2
Step 1	Assest Size	.487***	.233***
	Founding year	-.143*	-.040
	Ownership	.061	.049
Step 2	Advertising		.343***
	RIC Rating		.052
	Regulation		.229***
	EBRD		.156**
	ΔR^2		.260
	ΔF		27.985***
Overall	R^2	.269	.556
	F	27.326***	34.185***
	df (regress/residual)	3/195	7/191

$N = 199$; $p^* < .05$; $p^{**} < .01$; $p^{***} < .001$

Local individual investment

Predictor		Step 1	Step 2
Step 1	Assest Size	.226***	.251***
	Founding year	-.251***	-.228*
	Ownership	.003	.011
Step 2	Advertising		.116
	RIC Rating		.098
	Regulation		.245**
	Western Loans		.157*
	EBRD		.183*
	ΔR^2		.078
	ΔF		3.806**
Overall	R^2	.143	.221
	F	10.826***	6.730***
df (regress/residual)		3/1995	7/190

$N = 199$; $p^* < .05$; $p^{**} < .01$; $p^{***} < .001$

Logistic Regressing: Losing a license

Predictor		Step 1	Step 2
Step 1	Assest Size	.209**	.073
	Founding year	-.200**	-.152*
	Ownership	.060	.070
Step 2	Advertising		.146*
	RIC Rating		.100
	Regulation		.139†
	EBRD		.150*
	$\Delta\chi^2$		13.101**
Overall	χ^2	18.544***	31.645***
	df	3	7

$N = 199$; $p^\dagger < .10$; $p^* < .05$; $p^{**} < .01$; $p^{***} < .001$

Moral

You can not just transport some salient features of successful practices without deep understanding of why these practices work in the first place.