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Government Initiatives to Decrease Indebtedness and their Possible Implications

The FINANCIAL -- Indebtedness has been one of the main problems on which the Government of Georgia (GoG) has been focusing recently.

To reduce the level of indebtedness in the country and to protect borrowers' rights, the GoG has adopted several laws and regulations. We have highlighted the following four GoG initiatives in this regard:

Initiative 1. From 15 January 2017, for financial organizations the annual effective interest rate cap was set at 100% and from 1 September 2018, the maximum annual effective interest rate on loans has been reduced from 100% to 50%.

Initiative 2. On 7 May 2018, the National Bank of Georgia set a new regulation, according to which a total amount of consumer loans issued by a commercial bank without detailed analysis of the consumer's solvency must not exceed 25% of the supervisory capital of that particular commercial bank.

Initiative 3. On 1 June 2018, the National Bank of Georgia set a rule for real estate appraisal for commercial banks, according to which real estate has to be visited and assessed before a loan can be issued and the appraisers must be suitably qualified and independent. The rules for real estate appraisal have been defined based on International Valuation Standards (IVS).

Initiative 4. From 1 September 2018, fees, penalties and other financial sanctions for violations shall not exceed 0.27% of the remaining principal amount of the loan for each day and the sum of interest payments, any fees, penalties and other financial sanctions shall not exceed 1.5. times the remaining principal amount of loan. So, in the event of violations, financial organizations cannot fine a borrower perpetually.

The above-mentioned initiatives are expected to decrease indebtedness in Georgia. Besides these initiatives are expected to have an important influence on the financial sector in Georgia. The possible implications of these initiatives are as follows:

Financial Organizations' Loan Portfolios are Expected to Decrease

A significant proportion of Georgia's population is self-employed (44.5% of Georgia's active workforce), and of those who are self-employed only small share can declare their income. Moreover, the monthly income for 47% of households in Georgia is below 500 GEL.

Because of the new rule –setting the upper limit of consumer loans without detailed analysis of solvency -issuing loans to these groups (self-employed, low income households etc.) will be limited and, consequently, commercial banks' retail loan portfolios are expected to decrease gradually. However, the fact that not every commercial bank in Georgia has reached 25% ceiling yet, this effect is expected to occur gradually.

Aside from commercial banks, other financial organizations' (such as microfinance organizations, pawnshops, and online loan companies) loan portfolios are also expected to decrease due to the effective interest rate cap. As a rule, loan portfolios for such financial organizations are more risky, so they charge higher interest rates, sometimes resulting in the annual effective interest rate exceeding 50%. This is not the case only for consumer loans but also for business loans, especially for small- and medium-sized enterprises (SMEs) lending from microfinance organizations. Therefore, the issuing of loans for such risky borrowers is also expected to decline gradually.

Financial Organizations' Profits are Expected to Decline

As noted above, a significant proportion of Georgia's population is unable to declare their income, and the retail loan portfolios of commercial banks are expected to decrease gradually. The share of retail loans in total commercial banks' loan portfolios exceeds the share of corporate loans (in 2017, this accounted for 54.2%) and the share of retail loans in total profits of commercial banks is high. Due to the above-mentioned initiatives, revenues from financial sanctions are also expected to decline while the cost of assessing borrowers' incomes and real estate is expected to increase. Therefore, because of the above-mentioned factors, commercial banks' profits are expected to decline. However, we have to take into account another anticipated effect, namely that because of the 25% supervisory capital ceiling reducing the number of risky loans issued by banks, various costs associated with such loans such as management, monitoring and collection are expected to decrease.

For financial organizations, apart from commercial banks, the interest rate cap will be very restrictive as explained above. The decrease in the number of loans issued and decreased revenues from interest income and financial sanctions are expected to result in decreased profits for these organizations.

Some Financial Organizations may Leave the Market

Aside from commercial banks, other financial organizations (such as microfinance organizations, pawnshops, and online loan companies) are expected to be more

sensitive about decreased loan portfolios and decreased profits, and may result in some of them having to leave the market.

Other Implications

As loans issued to individuals are anticipated to decrease, there will be more resources available to finance the business sector, so access to finance is expected to increase for SMEs. However, shareholders at financial organizations usually set different performance target ratios such as return on equity (ROE), and as financial organizations' profits are anticipated to decrease, there is some risk that, to make up for such a decrease, interest rates may increase on other products.