Appendix 2: High Interest Rate Spread in Georgia

1.1 Introduction

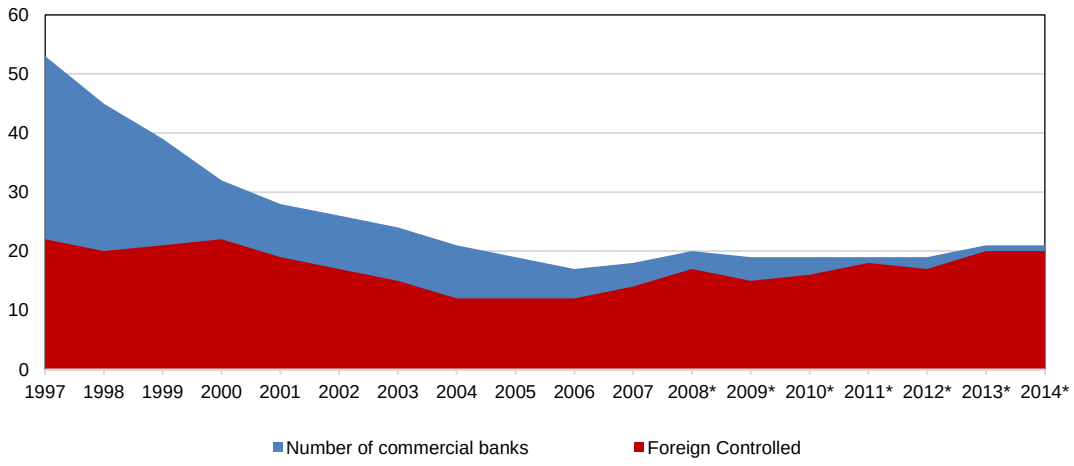
Earlier in the report, we identified the cost of finance as one of the main constraints for the development of private enterprise in Georgia. Indeed, as growth diagnostic analysis has shown, both the real lending rate and interest rate spread in Georgia are quite high relative to other countries in developing Europe and Central Asia. In addition, Georgia has a very high risk-premium on lending – this despite a rather low share of non-performing loans in the banks' portfolio. The combination of these factors suggests that the **high cost of finance has been driven mainly by the perceived credit risk of the private sector** in Georgia.

This diagnosis, however, may be too general for most practical applications. After all, perceived credit risk is rather a symptom of a broader spectrum of bottlenecks that exist in the economy. Our aim in this section is to provide a closer analysis of factors behind the high interest rate and interest rate spread in Georgia[1]

1.2 Georgian Banking Sector: Competition, Credit Constraint, and the Role of Foreign Ownership

The Georgian banking sector ownership structure has been changing in recent years. More than a decade ago, bank ownership was mostly concentrated in the hands of local individual investors. Currently, foreign banks are majority owners in large domestic banks (Figure 48).

Figure 48: Foreign Capital Participation in Georgian Banking Sector, 1997-2014



* At the end of the year

[1] In this section we concentrate mainly on the issues that have not yet been raised elsewhere in the report. Whenever possible, we provide reference to the relevant sections in the main body of the report.

Source: National Bank of Georgia

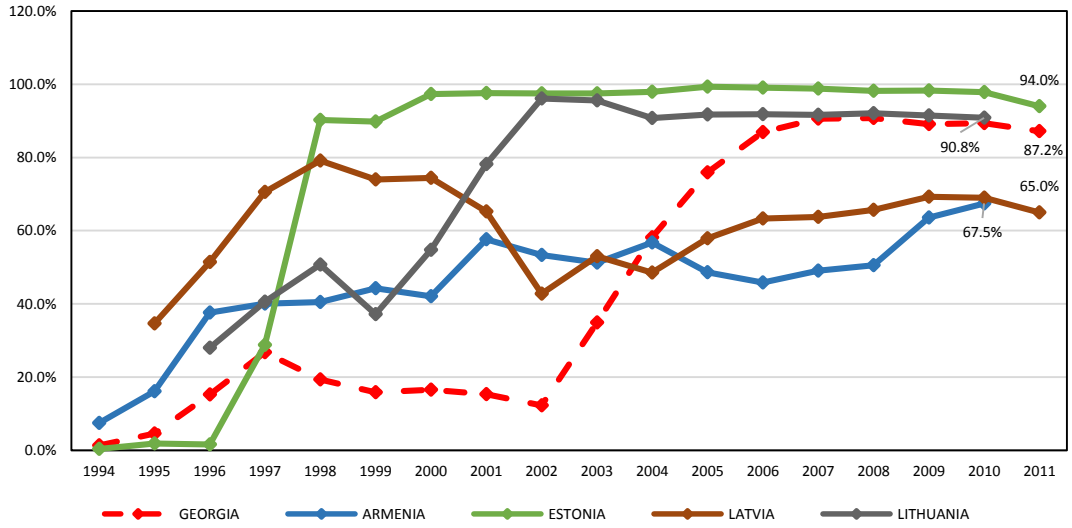


Figure 49: Share of Foreign Ownership (Bank with Foreign Owned Assets > 50%)

Source: European Bank for Reconstruction and Development (EBRD) bank survey.

As Figure 49 illustrates, this trend is not unique to Georgia. The costs and benefits of foreign ownership have been discussed extensively in economic literature.

On the one hand, as some researchers argue, the increasing trend of foreign participation in Georgia could reflect a build up of trust towards the Georgian financial sector on the part of foreign investors. This can provide an opportunity for better integration into the global financial market. Sound and experienced global investors bring their expertise to the local market, which in turn can lead to product diversification, better risk governance and improved corporate governance practices (Clarke et. al [2006]), Cull et. al [2010]).

On the other hand, one of the main risks of foreign bank penetration in the developing countries lies in its effect on credit availability to SMEs. For example, a number of studies emphasize the risk-averseness of the foreign owned banks and claim that capital generated by this processes will be distributed among relatively low risk firms, operating in already developed sectors (Allen et al [2001], Berger et al [2002]).

In Georgia accessing credit for small and medium-sized firms is indeed problematic. Access to finance was named as the first and the second biggest obstacle experienced by private sector firms in 2008 and 2013, respectively.[2]

The analysis of long-term trends in interest rate spreads corroborates the evidence that cost of finance is a long-standing problem in Georgia (Figure 38, main text). The question, however, is whether foreign ownership of banks contributes to this problem.

[2] Based on World Bank Enterprise Survey (ES) data about Georgia for 2013 and Business Environment and Enterprise Survey (BEEPS) data provided by EBRD and the World Bank

1.3 Foreign Capital Participation: World Experience and the Case of Georgia

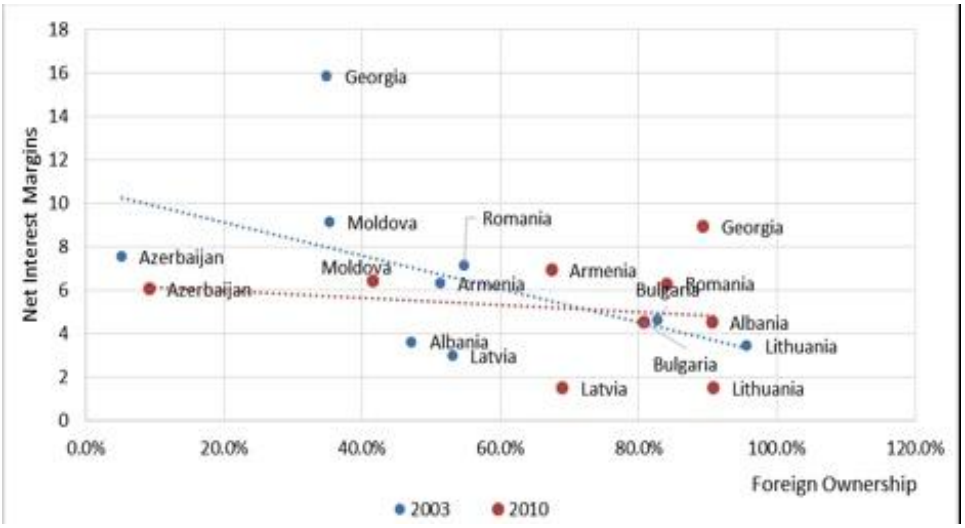
As we mentioned earlier, foreign ownership of the banking sector may bring a number of important benefits as well as threats. Based on the data from Georgia and other developing economies, how important are the threats?

One indicator to consider is the interest rate margins of the banks. If indeed the foreign owned banks tend to be more risk averse, the interest rate margins would tend to be higher.[3]

Figure 50 shows the correlation between net interest margins (World Bank data) and foreign bank assets share (EBRD bank survey data).[4]

First rough conclusion based on the data is that countries with high participation of foreign capital are characterized by smaller net interest margins (downward sloping blue and red trend lines). In 2003 the effect of foreign asset participation on interest margins seems to be bigger than in 2010.

Figure 50: Net Interest Margin vs Foreign Bank Assets Share, 2003 and 2010



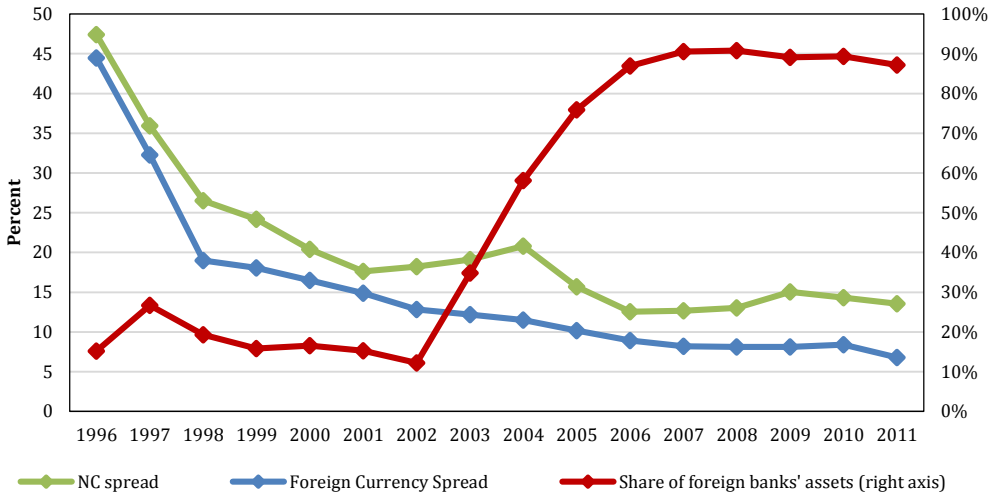
Source: World Bank, EBRD banking survey

A closer look at the Georgian data in Figure 51 reveals that interest rate margins on both national and foreign currencies were decreasing at about the same pace between 1998-2002,when the share of foreign assets was declining, and between 2002-2011, when the share of foreign capital in the banking system increased dramatically. This leads us to conclude that the evolution of interest rate margins of the Georgian banks was largely unrelated to the level of foreign bank participation.

[3] The interest rate margin is defined as the difference between interest income earned and paid out relative to the amount of interest-earning assets. Therefore, higher risk aversion among the banks would lead to both the increase in risk premium on the lending rates, and to the lower amount of interest-earning assets.

[4] Foreign ownership is defined as banks with assets under foreign ownership > 50%) for some European and Eastern Asian countries in 2003 (blue dots) and 2010 (red dots).

Figure 51: Interest Rate Spread in NC and FX and Foreign Bank Assets Share, 1996-2011



Source: World Bank, EBRD banking Survey.

1.4 Bank Concentration and Competitiveness

Earlier in the report we summarized the evidence and argued that banking sector concentration does not necessarily imply lack of competitiveness. One reason is that the banking industry as a whole is characterized by increasing returns to scale, where larger financial institutions achieve higher cost effectiveness than smaller ones. In a relatively small financial market like Georgia it would be unrealistic to expect low industry concentration in the banking sector.

Competitive behavior among Georgian banks is further evidenced by the relatively high number of bank branches per 1000 adults (Figure 40, main text). If the banks did not compete with each other for the customer base, there would be less need for opening and operating costly bank branches.

Another argument against foreign bank participation is that risk aversion of foreign-owned banks hinders development of new and start-up industries, and can lead to high concentration of lending only in a few high-return sectors.

As discussed earlier in the report, Georgian banks' regional and sectoral diversification continues to be very low and the sectoral gap between the bank lending allocation and value added is also apparent.

1.5 Can the low diversification of loans over sectors be explained by high foreign bank participation?

Recent work of Haselmann and Wachtel (2007) finds some noticeable differences in balance sheet characteristics among bank ownership groups. Foreign owned banks are more risk averse than domestic owned or state owned banks. However these differences are not too large. According to the study, the overall performance of banks is homogenous irrespective of foreign ownership, and there are no clear groups of banks with excessive risk taking behavior.

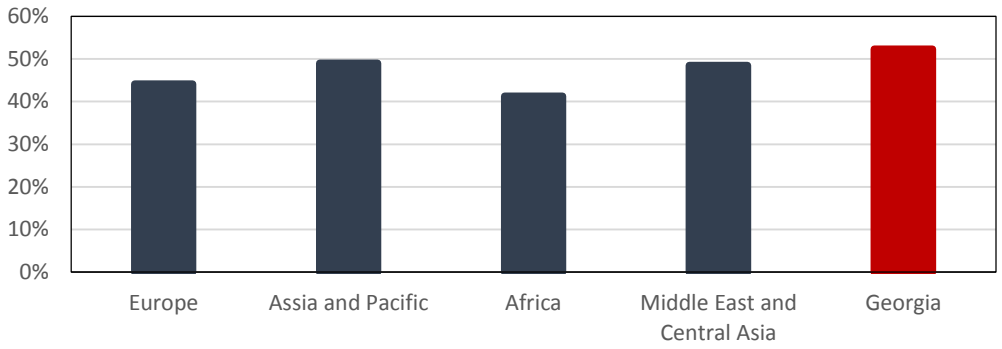
However, Haselmann and Wachtel emphasize that bank's "taste on risk" mainly depends on the banking environment. Improving the legal environment is associated with higher risk taking behavior on the part of banks, which could be reflected subsequently in lower interest rate spreads. Hence, it is important for the regulators to monitor risk taking behavior of financial institutions, even as they improve the legal environment in which the banking system functions.

To conclude, we do not find direct evidence that higher foreign bank participation has increased the interest rate spread in Georgia. Besides, existing literature claims that risk aversion of foreign banks and local banks does not differ significantly and low diversification can be a systemic problem unrelated to foreign participation.

1.6 Operating Costs

In the data we observe that Georgian banks incur the biggest share of non-interest expenses as personnel costs. Figure 52 shows the personnel expenses as a share of non-interest expenses. Clearly, personnel expenses in Georgia are higher than the European average.

Figure 52: Personnel Expenses to Non-interest Expenses, 2012 Q4



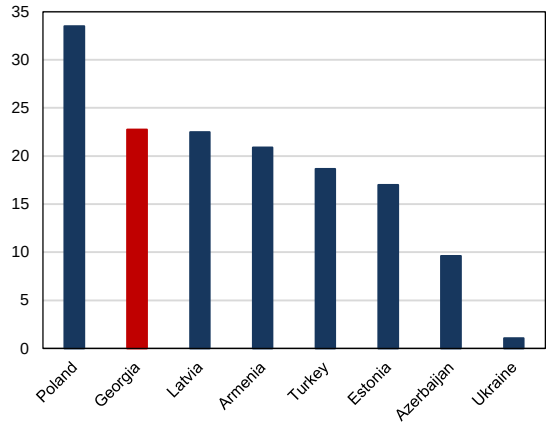
Source: IMF Financial Soundness Indicators

Relatively high personnel costs reflect the above average expenses required to maintain staff in the banking branches throughout the country. The environment with low internet penetration coupled with low financial literacy implies high costs to commercial banks. The heavy reliance on the traditional ways to conduct bank transaction makes banks more labor intensive and contributes to the high costs of financing. In this respect, Georgia is behind many peer countries in the region.

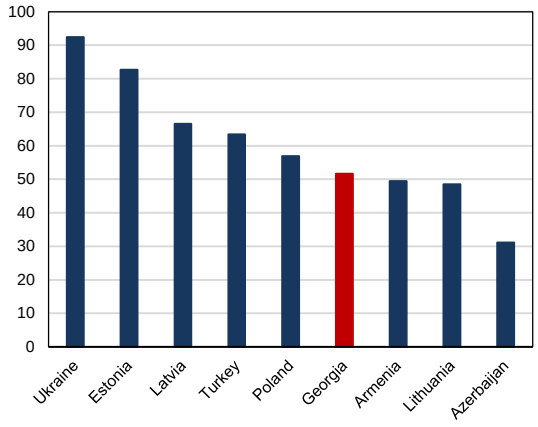
Figure 53 illustrates the extent of Georgia's reliance on bank branches rather than ATMs for conducting financial transactions.

Figure 53: Commercial Bank Branches and ATMs per 100,000 adults, 2012

Commercial bank branches per 100,000 adults, 2012



ATMs per 100,000 adults, 2012



Source: IMF Financial Access Survey,2012

The high number of bank branches in Georgia may also reflect low financial participation rates among the population.[5] Countries with lower financial participation rates have to maintain the personnel and branches to attract and serve new customers. On the other hand, for countries with high financial participation rates (e.g. Ukraine, Estonia), ATMs are sufficient for serving the existing customer base.

In addition, high wage costs of Georgian banks are a function of the high premiums on qualified labor. Despite high rates of tertiary education, the quality of human capital is a well known problem in Georgia, and is exacerbated by the fact that primary education especially in science and mathematics compares poorly with other countries in Eastern Europe.[6]

Major banks in Georgia try to overcome the personnel problem by establishing their own training centers for middle management, which raises the overall costs of operation. Compensation for top management is high due to high wage premiums for local professional staff with specialized knowledge, and the keen competition among banks for middle and top management.

Another important factor contributing to high cost of finance in Georgia is low financial reporting standards among Georgian companies, which was discussed earlier in the report. The substandard financial reporting significantly complicates loan evaluation for commercial banks leading to higher administrative costs and lower asset quality.

[5] In particular, Georgia has a lower number of depositors per 1,000 adults than the peer countries of Ukraine, Latvia and Estonia, according to IMF Financial Access Survey, 2012.

[6] According to the Trends in International Mathematics and Science Study (TIMSS), Georgia's average score in mathematics in 2011 is 450 points, falling below the TIMSS center-point score of 500 and below most of the peer countries including Ukraine, Lithuania, Romania, Hungary.

While high operating cost might be part of a broader problem, they are not the only explanation for the high interest rate spreads in Georgia.

1.7 Regulatory Environment and the Cost of Funds

Earlier in the report we emphasized that the regulatory environment in the Georgian financial industry is rather conservative. The National Bank of Georgia (NBG) capital adequacy standards for higher quality core capital are more conservative than Basel I requirements. In addition to stricter capital adequacy standards, Georgia applies stricter standards for non-performing loans, requiring banks to hold higher levels of provisional capital to compensate for the potential losses.

As a result, the Georgian banking system proved to be quite resilient during the financial crisis of 2008. However, while these requirements improve the financial system's stability in the face of adverse shocks, they also increase the cost of funds for the banks and drive up the interest rate spreads.

1.7.1 Are stricter prudential requirements justified in the Georgian context?

As we have mentioned already, the banking sector in Georgia is highly concentrated. This means that even in the absence of a deposit insurance scheme, some banks may be considered as "too big to fail". Implicit bailout guarantee may increase the risk taking behavior of large banks in the absence of adequate regulatory mechanisms.

It seems that the stricter prudential regulations are driven in part by the desire to ward off banking risk and maintain public trust in the stability of the country's financial system.

Fostering of trust along with efforts to increase financial system participation could go a long way towards reducing the cost of funds. Higher participation would increase the rates of domestic savings available to the banking system, and reduce the currently high levels of both deposit and loan dollarization.

1.8 Macroeconomic Risks, Firm-level Risks and Asset Quality Concerns

The state of the country's macroeconomic environment is a potential driver of the high interest rate spread. The threats associated with large and increasing government budget deficit, high external debt burden, unstable inflation, high unemployment rate, unsustainable fiscal environment or macroeconomic policy uncertainty can all add to the perceived risks of doing business in the country, which would lead banks to increase the lending rates over the deposit rates.

Since overcoming the worst of the 2008 crisis, Georgia has prided itself on the relatively stable macroeconomic environment. Most of the country's macroeconomic indicators showed signs of stability, while the weaknesses have been managed with relative success.

As mentioned in the growth diagnostics analysis, overall Georgia's macroeconomic, fiscal, and monetary indicators have been encouraging. These positive developments were sustained over a number of years and were maintained recently despite the transfer of power in the government. Prudent macroeconomic policies have likely contributed to the steady albeit slow decline in the interest rate spread since 2003.

The good news for Georgia is that the interest rate spread is showing a downward trajectory over the years. The bad news is that despite the stable macroeconomic environment one can observe prolonged periods of stagnation and even a recent increase in the spread. Also, the interest rate spread in Georgia still remains about 2.5 percentage points above the average for Europe and Central Asia developing countries.

In the absence of obvious macroeconomic triggers, what are the possible drivers of high interest spreads?

The recent *Growth Diagnostics: the Case of Georgia* study (Babych and Fuenfzig [2012)]) highlighted property rights problems as one of the binding constraints to growth and one of the main drivers behind the high spreads. There has been plenty of anecdotal evidence of the instances of property rights violations in Georgia. Yet, there is no substantial evidence of systemic widespread violations, especially as compared to Georgia's regional partners.

In Georgia, given the history of violent power transfers since independence, the latest round of presidential and parliamentary elections have raised concerns about property rights protection. The political uncertainty, which accompanied elections in 2012-2013, has contributed to the perception of risk. However, observing the evolution of the interest rate spread over 2012-2013, one may notice that the spread remained nearly constant during this period of political and policy uncertainly. This may indicate that other considerations, namely the structural problems in the economy played a more important role.

The issues of low human capital, high unemployment and informational asymmetries have been already discussed in the report. Another important bottleneck to consider is lack of sectoral diversification of the Georgian economy. In this respect government policies to support industrial development and flow of foreign investment into economically and socially important sectors (e.g. industry, transportation, agriculture) would be crucial.

1.9 Summary of Findings

To summarize, several key factors may be influencing the high cost of bank finance in Georgia. These are:

- Foreign ownership and banking sector competitiveness
- High operating costs of the banking sector
- Regulatory environment and cost of funds
- Macro-level risks, firm-level risks and asset quality concerns

One of the central conclusions of our report is that **foreign ownership and high concentration in the banking sector are unlikely to be the principal drivers of interest rate spreads in Georgia.**

Overall, we do not find evidence of correlation between higher rates of foreign participation and interest spreads.

The banking sector concentration in Georgia is indeed high, but does not necessarily imply low competitiveness or monopolistic pricing of financial products, as long as barriers to entry into the financial sector remain low. This is the argument we had advanced earlier in the growth diagnostics analysis.

Cost inefficiencies and high perceived lending risk are the main drivers behind the high interest rate spreads in Georgia.

We conclude that unusually high operating costs of banks are most likely driven by high wage premiums on qualified workforce, issues with financial literacy among the existing and potential clients, problems with internet access, low financial participation by a large share of the population. These factors necessitate the operation of high-cost banking branches, while the reliance on ATMs for financial transactions remains low.

In addition, as we had mentioned earlier in the report, while the number of non-performing loans in Georgia remains low, the perceived risk of lending is rather high. **The risks of operating in the Georgian market is related to a number of structural problems in the economy. In particular, small market size and low industrial base of the country leads to low diversification of credit portfolio, exacerbating lending risks.**

High lending rates are further perpetuated by **adverse selection problem**, which leaves banks to choose from a more risky pool of clients – the type of clients who could offer high returns and operate with lower credit maturities. Not surprisingly, bank lending has been concentrated in the wholesale and retail trade industry, which, according to 2012 data, contributes about 10% to the overall GDP but commanded about 45% of the overall lending flow in that year. This trend is not specific to 2012, but reflects more general tendencies in sectoral lending over the course of several years.

As far as feasible policy actions to alleviate the structural bottlenecks to reduce the cost of finance, the current analysis supports a spectrum of medium-term and long-term measures outlined in Section 4.4 of the report.