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of Economics
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MS IN FINANCE CAPSTONE PROJECT

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General overview

Paper description

This Capstone project is prepared for Big4 audit company representative in Georgia - Ernst &Young (thereafter - EY). The project refers to retail finance issues in Georgia, which stands for current judgement point in the country, thus reveals interesting for the client to have an overview of the sector with an emphasis on the past 4-5 years. Project work is complemented by plenty of data tables and charts.

The project is comprised of several parts, such as retail finance development trend analyses in Georgia, cost of retail finance and comparative analyses of peer countries, savers and borrowers' statistics analyses in Georgia and in peer countries, typical investment decision scenarios that savers or borrowers face nowadays, financial education importance and behavior issues based on survey conducted. The survey as part of Capstone work was organized in July 2018 year with participation of 65 respondents, age 20+, residents of Georgia, non-financial / non-banking / non-economist professionals, successfully working in various fields. Survey consisted of financial education and behavioral 10 tests in total with multiple choice answers.

Retail finance uses and sources

It is no longer innovation that households are large contributors to banks' funding base, for instance based on consolidated 2017 year-end data, project work shows that household savings (ignoring regulatory reserve requirements) fills up 48% of total loan portfolio which is solid source of funding, among them individual / household GEL funding covers 35% of the same currency retail loan portfolio and in USD 161% respectively.

Scoping 2013-2017 years, designed chart in project paper shows that even during the last 5 years, despite of local currency devaluation effect (49% in USD, 30% in EUR), household savings and borrowings grew sharply. Therefore, modern commercial banks in Georgia have developed various saving and lending products, including mortgages, credit cards, quick installments, etc. "Buy today and pay later" concept successfully appeared on the market in previous decade and pushed retail finance activity through various simplified products.

Meantime interest rates in USD lending started decreasing and loan contractual duration increasing. This tendency incentivized individuals/households to take mortgages intensively. On the other hand, this fact enhanced real estate development industry, mostly in Tbilisi, Batumi and mountain resort Bakuriani. Families started acquiring real estate either for living purposes or investment. Mortgage loans used to disburse in U.S. dollars because of its cheap repayment price and longer term. But tracking past 3-4 years, national currency devaluations challenged borrowers' creditworthiness, as the major income of the population is denominated in national currency and they are exposed to currency risk.

Cost of retail finance in Georgia

As lending rates matter for borrowers, it is interesting to look at the relevant rates in emerging countries. For this reason, recently ISET Policy Institute (http://iset.tsu.ge/) conducted survey about cost of retail finance products in Georgia and in several emerging markets. The rates are given in national currencies.

Findings suggest that the cost of credit in Georgia is lower than in some CIS countries that have been covered by the survey (namely, Kazakhstan, Russia, Ukraine and in many cases Armenia) while it is somewhat higher compared to a cohort of Central and Eastern European Countries (CEE). Higher interest rates compared to the CEE countries can be attributed to several factors. Among these factors can be named relatively high central bank policy rates and relatively high interest rates on term deposits. Both factors increase cost of funds in commercial banks, driving the interest rates upward.

Macroeconomic improvement in Georgia, bond issuing in national currency GEL by IFIs and delivering to financial system as long-term funding, as well as pension plan reform, play key role to support long term and low-cost retail finance in national currency.

In 2013-2017, savings and borrowings in national currency more than doubled, which is of course a good tendency, but there is a significant gap between cost of finance in GEL and USD. Nevertheless, National Bank of Georgia has incentivized financing activity in GEL since capital adequacy and minimal reserve requirements in GEL is much less costly than in USD (major foreign currency in financial transactions in Georgia).

Major contributors in retail lending pricing are: cost of funding (strength of local currency and trust of population to hold long term saving in local currencies), cost of risk (expected loss of retail

credit pool), cost of banking regulation, operational costs. Typically, banks consider ways to reduce operation costs and stay efficient in parallel with lending interest rate reduction.

Regarding to this topic, paper talks about trends in retail finance services: digitalization, self-service areas, fintech, etc.

Investment decisions

Mortgage takes almost half of the retail lending activity in Georgia, that became not only housing opportunities for living purpose, but people also consider buying apartments as investments, with its revenue streams from rent and terminal value in case of selling the asset. Thus, we can say that intensive acquisitions in real estate in Georgia became an alternative investment opportunity for savers as well as for borrowers in young age when they are in active working phase with stable income and consider borrowing and investing in real estate a smart idea for retirement purpose.

Some people in Georgia consider bank deposit interest rates as riskless but too low and wish to increase their investment IRR as well as diversify and accumulate real assets for retirement. In order to disclose clearer typical financial decisions many of us face, I designed several cases. Illustrated below are 3 typical investment scenarios with the same duration of 12 years:

Scenario 1: A person invests all saving $35,000 amount in purchase of 40 sq. meter newly built apartment located in active district of Tbilisi and renovates it for long term rent $3,000 per annum.

Scenario 2: A person borrows 70% from bank and fills up 30% with saving to buy apartment with the same parameters as in scenarios 1. Rent income totally serves loan principal and interest payments (annuity) over 12 years.

Scenario 3: A person deposits in a bank all $35,000 saving with 4% annually compounding interest over 12 years.

In all three scenarios, terminal value (TV) equals $35,000 with assumption that residence real estate market price will not go upward.

The lowest IRR bears bank deposit (4,9% versus 10,26% and 10,55%) and for this reason nowadays in Georgia some people prefer to invest in real estate. Besides, tourism and expat increase statistics in the country solidly encourage such scheme of long-term investment.

Savers and Borrowers

Following Global Findex 2014-2017 report, we can see percentage of population that saved or borrowed last year in sampled emerging countries. Population in Georgia tilted to borrowing behavior than saving in 2017. For instance, if we take Lithuania data for comparison purposes

(where GDP per capita is 4 times larger but GINI index is close to Georgia's index), there is a huge gap between saving numbers but little difference between borrowing numbers.

Overall, Georgia is above the mean in borrowing (mean=20.2) and much below the mean (mean=18) in saving data.

Responsible finance policy initiatives

Finance regulator – National Bank of Georgia and afterwards Ministry of Finance triggered high level of household financial obligation as part of systemic risk. As regulator states, household debt continues to grow rapidly and requires attention to prevent households' over-indebtedness. As of January 2018, household debt is 32% of gross domestic product and is close to the median of the same indicator in comparable countries. However, the indicator has been increasing rapidly in recent years. Especially should be noted increase in the share of households, that have high credit burden relative to their income.

Certainly, households should have access to credit, but it is important to establish the responsible lending rules and practice. Number of actions have been taken in that direction. Consumer side finance skills are not strong enough to have liberal lending environment and bear systemic threat of household over-indebtedness, clearer lending frames were introduced for implementation by financial regulator.

Conclusion

Overview of retail finance issues in Georgia can be used in audit or advisory services as market picture / benchmark. Also, financial knowledge gap in population gives opportunity to the client to develop commercial training program regarding personal finance skills and behavioral influencers.

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