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The impact of Responsible Lending Policies for Individuals on Banking Competition

Abstract

Following the transition to a market economy, the banking sector in Georgia has changed radically, becoming virtually state-independent business and one of the most successful economic reforms in the country. Nevertheless, there is still a process of concentration/consolidation of banks, the identity of prices for banking products and services, the difficulty of establishing a place for a new player in the market, etc., which limits the elements of interbank free competition. The above may be caused by the lack of proper regulatory mechanisms by the state. It is a fact that the existing mechanisms and procedures of administration in the relevant direction need to be refined; particular attention should be paid to sharing of foreign experience in interbank competition, analysis of new legal regulations implemented in the banking sector of Georgia, revealing the role of the state in improving the country's interbank competition policy in responsible lending to individuals.

Keywords: *Individual, Responsible Lending, Banking Sector, Banking Regulations, Banking Competition.*

Introduction

The world, including Georgia, as a result of the pandemic created by the coronavirus in 2020, faced a new challenge, which affected both the health care system and the country's economic development. In order to prevent the spread of the virus, most of the activities in the field of production and services were suspended, state borders were closed, which, in the first place, led to the closure of the service sector. In particular, individuals or legal entities working in the tourism sector, most of whom were using commercial bank loans, were suddenly left without income (Shonia N., Kopaliani I. (2019). As a result of the pandemic situation, the Georgian banking sector was able to quickly switch to online services, which really was not enough to prevent a financial crisis. The global pandemic has posed several challenges to the Georgian banking sector, namely: Liquidity risk; risk of reduction of credit investments; increased risks in the direction of lending - uncertainty arising in the business sector on the background of the pandemic and the difficulty of predicting the profitability of their activities; increased risk of lending to individuals in the consumer lending sector amid the risk of job losses; risk of mortgage market crisis; risk of deterioration in the quality of loan portfolios; risk of reduction of interest and non-interest income; profit reduction risk (Shonia N., Kopaliani I., Didbaridze M. 2019). Against the background of these difficulties, the National Bank has taken consistent decisions to minimize the economic impact of the pandemic on the Georgian banking sector, as it is known that the negative effects on the banking sector in a chain reaction will have a negative impact on the country's entire economy.

Research Methodology

Both qualitative and quantitative methods (in-depth interviews were conducted with the top managers of 5 commercial banks to study the results of the *introduction of various forms of free consulting services*, and group interviews were conducted with 10 large clients of one of the banks to find out the quality of the bank services) were used during the study. Namely, methods of observation, comparison, economic analysis, survey, content analysis and monographic research.

Research Results

The crisis caused by the 2020 pandemic clearly shows how important the resilience of the country's economy to economic shocks is. The fact is that the banking sector is the most sustainable and well-capitalized sector in our country's economy. We can say that under the current supervision, it has met a common challenge - a pandemic, with sufficient mobilization, sufficient reserves and adequate buffers, as well as the measures taken by the National Bank of Georgia were consistent and absolutely adequate. All of the above helps Georgian commercial banks to continue lending to the economy smoothly, which will ultimately help the country's economy to overcome the crisis faster and with less losses.

The specific decisions that the National Bank has promptly developed and implemented across the country since the global pandemic are not directly related to interbank competition, but do take into account elements of avoiding bank concentration. In particular, it ensures that all operating banks have equal support mechanisms and tools to neutralize the negative consequences, which will not give the leading banks a chance to take advantage of the current situation and gain additional advantages over low-rated banks.

Among the new regulations implemented in the banking sector, we will single out the innovation in lending to individuals, which was approved by the National Bank at the end of 2018 and came into force on January 1, 2019. A similar type of regulation has recently been introduced in several European countries, for example: Hungary, Sweden, Denmark, Lithuania, the Czech Republic, Estonia and others. As the National Bank explains, the purpose of the *"Regulation on Lending to Individuals"* is to promote the stable and sustainable functioning of the financial system of Georgia and to encourage sound lending. The provision applies both to individuals and to individual entrepreneurs (if their loan obligation does not exceed GEL 2 million), as well as to cases where an individual provides collateral to another individual or legal entity to secure a loan. Adherence to the new regulation based on the principles of free competition is required for commercial banks, microfinance organizations and any lending entities. It has been proven that microfinance organizations in the financial market have positioned themselves in a rather liberal credit policy, which has had a somewhat negative effect on the solvency of the population and their social status in general (Shonia N., Mushkudiani Z., Kopaliani I. 2018).

The adoption of the law was preceded by a period of several months of preparation and discussion of working versions of the law with representatives of a commercial bank. The need to tighten lending to individuals was due to the difficult social situation of the population and the increase in the share of unpaid and problematic liabilities against this background. According to the available statistics, for the second half of 2018, about 650 thousand citizens were registered in the black list of the Credit-Information Bureau "Creditinfo", who were deprived of the opportunity to carry out any economic activity.

Banking sector regulations have been tightened since May 1, 2018, paving the way for the next large-scale changes. Most importantly, the banks were instructed to conduct a full-fledged analysis of the borrower's solvency. We should also mention the project implemented by the National Bank together with the Government of Georgia for the adequate redistribution of currency risks, on the loan package issued before January 1, 2015, within the framework of which borrowers were allowed to convert a currency loan into GEL at a preferential rate.

The process of closing a total of 55 service centers by commercial banks can also be explained by the expectation of the abovementioned and announced regulations from January 2019. According to the statistics of the National Bank of Georgia, in December 2018, compared to the same period of the previous year, the service centers of commercial banks decreased from 847 to 792. On this background the number of branches increased, though only by one unit from 134 to 135. The unfortunate trend that followed the regulation was the process of employee optimization in some banks at the beginning of the year.

The following main directions and key issues can be distinguished from the regulation on *responsible lending of individuals* effective from 01.01.2019:

Income Assessment - A study of a borrower's income to assess the financial viability of a loan. Confirmed income types, such as salary, rent, dividends, etc., are defined by the *Lending Regulations*. Banks also have the right to develop and agree with the National Bank on the principle of counting unconfirmed types of income.

Loan to Collateral Ratios (Collateral Coverage Ratio) – The regulation defines the maximum allowable ratio of monthly loan repayment to monthly confirmed income (PTI) and the maximum ratio of real estate value (LTV) of the loan amount pledged. See. Table 1-2.

Table 1. Maximum loan servicing ratios (M**aximum debt service ratio)**

Monthly net income	For un-hedged borrowers Maximum/contract maturity	For hedged borrowers Maximum/contract maturity
< 1, 000	20% / 25%	25% / 35%

> = 1, 000 – 2,000 <		35% / 45%
> = 2, 0000 – 4, 0000 <	25% / 30%	45% / 55%
> = 4, 000	30% / 35%	50% / 60%

Source: https://www.nbg.gov.ge/uploads/01/281_.PDF
But, the loan collateral ratio varies between national and foreign currencies (see Table 2).

Table 2. Maximum Loan Rate Ratio (maximum loan-to-value ratio)**(LTV)**

For loans issued in GEL	For loans in foreign currency
85%	**70%**

Source: https://www.nbg.gov.ge/uploads/01/281_.PDF

Table 1 shows that the loan collateral ratio is calculated by category of hedged and non-hedged borrowers. Hedging is a method of insuring currency risks and in this case, the borrower is hedged if his net income is not less than the net income required to service the loan in the same currency. A non-hedged is considered to be a borrower whose monthly net income and loan obligation are in different currencies.

Calculation principles – When the borrower's monthly income is different or regular income of different periodicity is recorded, income is taken as the maximum value between the median and average figures for the respective period.

Sanctions - The National Bank has imposed fines in case of violation of the regulation.

Credit institutions are required to agree with the National Bank and then issue loans before launching a different loan product, including the terms of existing student loans. It is also important to note that cases of refinancing without increasing the liability of loans issued before 1 January 2019 have been left out of the statute, which allows commercial banks to attract borrowers by offering competitive terms.

This provision obliges a person to register in the National Bank if more than 20 individuals have taken a loan from him, because in such a case the person is considered a lender. At the beginning of the year, a trend was revealed, that the above registration has been avoided by lenders, this, in addition to civil liability, also carries the risk of a return on financial resources..

The fact is that the terms of the regulation significantly reduce the scale of retail sales of products by banks to individuals. It is noteworthy that it mainly concerned consumer-type loans, with which the market was highly saturated. Demand for consumer loans without limits can increase and the money supply in the form of these types of loans has been growing over the years. As a result, we came to the conclusion that the economy of the country could not benefit from this excess consumer lending, because these types of loans do not serve the development of business, employment problems and the production of any wealth in the country. The vast majority of consumer loans are used to purchase various types of consumer goods, that are typically imported and not created by our national production. Consequently, money flows out of the country automatically, has no economic effect, and does not participate in the accumulation of wealth within the country. This was one of the main factors that led to the *restriction of excess consumer lending*.

As expected, the regulation had a direct impact on sales of electrical and household goods stores. The fact is that 90% of retail sales in this sector were installment purchases and amid a catastrophic reduction in installments, sales also declined. Some banks, such as *JSC VTB Bank Georgia*, have canceled installments of products altogether. Due to the new restrictions, the sales of apartments in the development sector at the initial stage of regulation, compared to January 2018, are reduced by 30% for some companies and by 70% for others, although prices are still high. But, it would be wrong to draw conclusions and generalize only with the data of the first month of 2019; it also took some time for the banks to adjust to the new regulation. Besides, January is always characterized by passivity. Nevertheless, we still want to compare the lending rates of individuals by commercial banks in January 2017-2020 (see Table 3).

Table 3. Volume of consumer loans issued by commercial banks (thousand GEL)

Volume of consumer loans of individuals			
31.01.2017	31.01.2018	31.01.2019	31.01.2020
2,777,376	3,765,391	3,912,446	4,105,527

Source: https://www.nbg.gov.ge/index.php?m=306 Consumer loans (balances)

The table shows that despite the new banking regulations, the volume of lending to individuals has increased according to consumer loans. However, compared to the January 2017-2018 data, the January 2019-2020 data are insignificant. If in January 2018 it increased by 35.5% compared to January 2017, in January 2020 it increased by 4.9% compared to January 2019. It should also be noted that interest rates on these loans have also increased over the years and only decreased by 0.1% in January 2020 (see Table 4).

Table 4. Average annual weighted interest rate on consumer loans of individuals

Average weighted annual interest rate on consumer loans (in percent)			
31.01.2017	31.01.2018	31.01.2019	31.01.2020
15	16,5	16,9	16,8

Source: https://www.nbg.gov.ge/index.php?m=306 Consumer loans (balances)

Also interesting is the volume of real estate loans to individuals (Table 5)

Table 5. Real Estate Loans Issued to individuals (Thousand GEL)[1]

	The amount of loans secured by real estate at the end of the month		Loans issued during the month	
	In national currency	In foreign currency	In national currency	In foreign currency
31.01.2017	968,899	4,590,154	88,313	150,219
31.01.2018	2,111,640	4,379,656	203,688	153,808
31.12.2018	2,888,912	5,816,785	213,538	395,186
31.01.2019	2,893,624	5,708,234	95,507	79,634

[1] https://www.nbg.gov.ge/index.php?m=306

31.01.2020	4,520,426	5,869,879	162,396	174,928

Source: https://www.nbg.gov.ge/index.php?m=306 Real Estate Loans

The table shows that real estate loans to individuals in both national and foreign currencies are growing over the years, only compared to December 2018, there is a decrease in January 2019, which is especially noticeable in foreign currency loans.

The National Bank later eased the above regulation and amended the Regulation on Lending to Individuals, *National Bank Order № 44/04 "On Approval of the Regulation on Lending to Individuals" March 13, 2020*[2]. The change, which came into force on April 15, 2020, implies less interference in banks' lending micromanagement and allows them to become more flexible and increase operational efficiency in line with lending growth, namely:

- ✓ Banks were given the freedom to determine the rules for determining the income of a self-employed person through an internal procedure;
- ✓ Only for loans issued/to be issued in GEL, the amount of loan service ratio limits was changed and two thresholds were set (currency remained unchanged) (see Table 6):

Table 6. Loan service ratio

Income (net)	PTI ratio - loan in foreign currency	PTI Ratio Loan
<1,000	20%	25%
>=1,000	30%	50%

Source: https://www.nbg.gov.ge/index.php?m=340&newsid=3881

- ✓ The maximum term of the mortgage loan has been increased from 15 to 20 years;
- ✓ For borrowers with income earned abroad, the LTV loan collateral ratio has been reduced from 60% to 70%;
- ✓ Individuals with loans exceeding GEL 1 million (before the change it was GEL 2 million) will no longer be affected by this regulation.

It should be noted that the regulation was necessary to relieve the population from the burden of excessive lending. A large proportion of borrowers were unknowingly taking out credit products, which often led them not only to a financial crisis but also to the loss of residential real estate. Before the regulation was introduced, there were many cases when the confirmed income of the borrower was only 700 GEL, and the monthly payment for all loan obligations was 500 GEL. To avoid this in the long run, the National Bank has developed a financial education strategy for the population starting with high school education, while in the short run it has mechanically restricted access to over-lending.

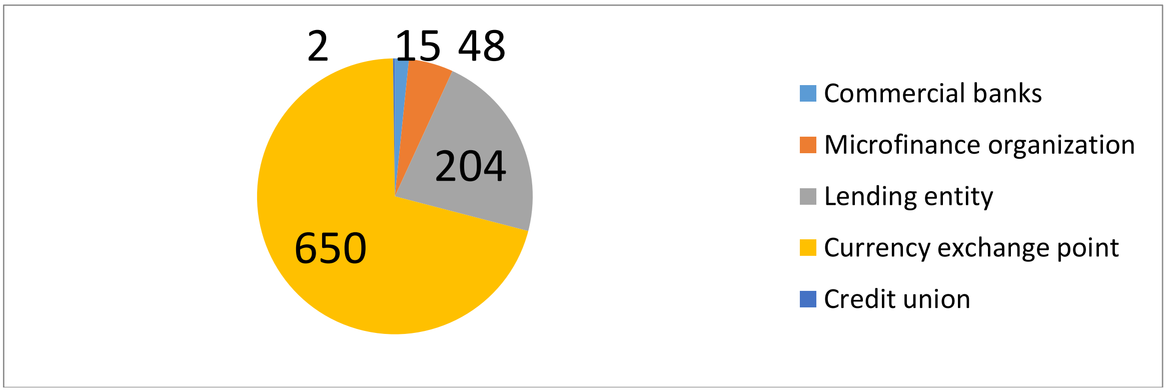
It should also be noted that the problem of over lending came from microfinance organizations and especially from online lending entities more than from banks. Since 2008, the online lending process has not been regulated by the NBG, so until 2017, when the effective interest rate ceiling was set at 100/150%, the rate of loans issued by them even exceeded 700%. In fact, these companies served to impoverish the population and facilitate the outflow of money from the country. This is confirmed by the fact that at the end of 2018, only 25% of the unpaid loans covered by the *Cartu Fund* were bank liabilities, and the rest belonged to the non-banking sector. By 2017, there are 75 such

[2] https://matsne.gov.ge/ka/document/view/4822603?publication=0

companies in Georgia, in 2018 their number was reduced to 25, and after the 2019 regulation, virtually only units remained on the market.

As of December 31, 2019, the banking and non-banking sector of Georgia is represented by the following participants (see Figure 1).

Figure 1. Share (participation) of the banking and non-banking sector in the Georgian financial market



Source: https://www.nbg.gov.ge/uploads/publications/annualreport/2020/erovnuli_banki_211020.pdf

From the enactment of the responsible lending policy of individuals to the present day, based on statistics, we see that this regulation has really served to the stability of the financial market and price stabilization, and at the same time, in terms of lending to individuals, both the banking and non-banking sectors were put on an equal footing. We should also mention the results of the larization measure carried out by the National Bank: From January 15, 2017, loans to individuals up to 100 thousand lari are issued only in national currency, and from January 24, 2019, loans up to 200 thousand lari are issued to individuals and legal entities only in national currency. The result is that by the end of 2018, the dollarization rate of loans has decreased by 9% compared to 2017 and stands at 57%. As for the dollarization of deposits, it is reduced by 8% and at the end of 2018, is 63%. Even more important is the issue of dedollarization of individuals, here the rate is reduced by 11% and is 47.7%.

We can conclude that the goal which was the basis of this regulation was actually achieved in the first year; Positive trends were identified in terms of reducing financial stability risks; The quality of loan portfolios is gradually improving; In the mass of total loans, the volume of loans with high credit burden and loans in foreign currency decreases, which was the cause of financial problems for a fairly solid part of the population. Most importantly, the enactment of this regulation has resulted in the transfer of additional loan resources to lend to small and medium-sized businesses, thus significantly increasing the bank funding for the segments that generate wealth in the country and produce national products.

Conclusion

The year of the global pandemic was preceded by one of the best years for the banking sector in Georgia. Despite the rule of responsible lending to individuals effective from January 1, 2019, which, according to some assumptions at the beginning of the year, led to a reduction in credit portfolios in the banking sector and consequently a decrease in the profitability of the banking sector, 2019 was one of the best years in the Georgian banking space. At the end of 2019, the total loan portfolio of commercial banks amounted to GEL 32 billion, so the annual growth of loans was 16.3% without the effect of the exchange rate. During the year, the dollarization rate in loan portfolios decreased sharply, also, the interest rate on foreign currency denominated loans reached a historic low. In general, that year, net interest margin and non-interest income decreased. However, the increase in efficiency due to growth and scale, as well as the improvement in asset quality and the reduction of certain contingencies, had a positive effect on profitability, with 13 of the 15 banks ending the year with high profits; Only 2 banks were at a loss - Silk Roadbank and Pasha Bank.

Banks maintained the profitability trend in the first month of 2020, in just one month, banks' profits increased by 41.7% to 90 million GEL, but the first (747 million GEL), the second (486 million GEL), and the third quarter (85.9 million GEL) ended with losses. According to the data of the first half of 2020, all banks are at a loss, only one bank - "Silkroad Bank" finished with a profit of 0.25 million GEL in the first half of the year. However, it should also be noted that prior to provisioning, the vast majority of banks make a profit, i.e. the core operating activities of the banks are still profitable; in particular, the 10-month interest income in figures is 4 billion GEL, which is 9.16% more than the same period last year; to add to that, the income from physical loans has increased by 3% compared to the previous year's data.

Credit Portfolios - despite the simplification of banking regulations for lending to individuals by the National Bank on April 15, 2020, the adverse events caused by COVID-19 significantly reduced the volume of credit investments, compared to the mark set by commercial banks in the annual business plan data in early 2020. Overdue loans increase the required reserve ratio, which in turn further reduces the profits of commercial banks. In case of restructuring, commercial banks can no longer offer borrowers to maintain their existing reserves, which is a negative factor for the borrower as well as the bank, as it affects his credit history, also, certain types of restructuring automatically include capitalization of the %-s, accrued on the existing loan and increase of the loan interest rate. These mitigating regulations are not directly related to interbank competition, however, elements of avoiding bank concentration are taken into account, which will not give leading banks a chance to absorb any of the low-ranking banks.

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