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A Feasibility Study of Establishing A Wholesale Lending Facility in the Republic of Georgia (D.1.1)

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EXECUTIVE SUMMARY

This study analyzes the feasibility of establishing a wholesale lending facility in the Republic of Georgia, specifically to facilitate loans between commercial banks and micro finance institutions (MFIs) by issuing guarantees. The guarantees would be either through the USAID Development Credit Authority (DCA) or be issued based upon collateral provided to a local financial institution that would act as manager of the facility.

Information for the study was gathered through direct meetings with the MFIs, local banks engaged in micro finance, consultants and projects supporting micro finance and from a meeting of micro finance stakeholders. In addition, there is a wealth of studies on micro finance including reports from GMSE, KfW, IFC and DRC.

At present there are a large number of MFIs operating in the country that would benefit from the proposed lending facility. Many of them have a strong desire and institutional capacity to increase their activities in the coming years. Non-governmental/non-profit MFIs would benefit most from such a facility because they cannot take deposits and are not well positioned to obtain external financing such as credit lines from EBRD. In addition, current issues regarding the tax treatment of MFIs make their legal status somewhat unclear and thus hamper their ability to independently raise capital.

Although the facility would benefit the MFIs and increase the amount of capital available for micro and small businesses, there are other sources of capital for the MFIs that are more attractive in the near term. The primary sources of capital in the next few years will be grants from USAID and USDA. In addition, the German KfW Development Bank is planning a wholesale facility for MFIs and rural lenders with up to Euro 6 million and the Danish Refugee Council has already established a smaller wholesale lending facility. Until these low cost sources of capital are exhausted, it is unlikely that the MFIs would be interested in capital on commercial terms.

It should be noted that establishing a guarantee facility and obtaining the necessary capital would take at least one or two years before it is actually in operation. At this time, most of the identified sources of capital should be fully utilized and the MFIs will be better positioned to seek commercial sources.

BACKGROUND

Micro finance in Georgia

Micro finance in Georgia is currently fairly well developed, although many of the institutions providing micro-finance are still developing as independent and strong institutions. There are both commercial and non-profit institutions providing group as well as individual credit from $200 to $20,000 that can all be considered micro-finance providers. These groups have been operating for several years and some have been extremely successful.

Micro finance institutions

The primary micro finance institutions are commercial banks, non-governmental organizations (NGOs), and some credit unions as well as one grouping of four credit cooperatives. The type of finance provided as well as the terms offered show that the market is diverse and somewhat segmented, both geographically and by type of borrower or financial product. However, it is clear that the sector is beginning to experience competition that will force these groups to offer better services and lower costs to their clients or be pushed out of the market.

In terms of loan volumes, the main group providing micro finance is the commercial banks, led by ProCredit. Together, these banks provide the bulk of micro-finance in the country. ProCredit, a commercial bank backed mainly by international financial institutions including IFC and EBRD, was created specifically to provide micro and small business financing and has expanded rapidly. Given their large branch network and financial resources of their shareholders, there is little doubt that they will continue to expand both the types and amounts of financial products and services.

There are four other commercial banks that are engaged in micro-finance, each with an outstanding portfolio of at least $1 million. EBRD directly supports three of these banks by credit lines and an in-country consultant assisting them specifically in micro-finance. The fourth bank is conducting micro-credit operations on their own, but stated that their strategic focus is not on providing retail micro finance products.

The next most active group in terms of loan volume is the NGOs including FINCA, World Vision and others. This group focuses on providing micro credit and has little ambition of competing in other segments such as medium enterprise finance. The table below only details the four largest NGOs, but there are another eight NGOs operating in the country with smaller operations. It should be noted that the top four NGOs dominate their grouping and are the ones most likely to receive continued support from donors.

The other major group working in micro-finance are credit unions, but they have a dismal record of operations and there is little hope that they could be sufficiently reformed in the near term to expand and be worthy of additional capital. There are a large number of credit unions, numbering almost 50 spread around the country. There is talk of another World Bank project to revitalize this sector, but details are scant.

The portfolio amounts listed in the table below are numbers provided by the institutions themselves. The target group of MFIs has a combined portfolio of over $12 million and represents more than 25% of the current micro finance market.

Micro Finance Portfolio Data

Name	Status	$US millions
ProCredit	Commercial Bank	$15.0
Bank of Georgia	"	6.0
United Georgian Bank	"	3.0
Tbil Universal	"	1.7
TBC Bank	"	1.0
Agro-Business Bank	EC Owned	1.6
Constanta	*NGO*	*4.0*
FINCA	"	*1.9*
World Vision	"	*1.2*
Other MFIs	"	*1.7*
Georgia Rural Development	*Cooperative*	*2.5*
Credit Unions	44 total	0.5
	Total	**$40.10**

Demand and supply issues

Demand

All of the various institutions providing micro finance expressed interest in additional capital. Estimating the true market demand is somewhat difficult, because it will be driven by the performance of the overall economy as well as the development of the MFIs themselves. The following table shows the projected increase in portfolios as reported by the main MFIs. Given the profit limitations of these MFIs, the majority of the increase in capital would need to come from external sources.

MFI Capital Requirements

MFI	2004	2005	2006	2007
Constanta	475,000	475,000	475,000	475,000
GRDF	940,500	1,045,000	665,000	665,000
FINCA Georgia	380,000	665,000	1,425,000	2,137,500
World Vision	475,000	1,425,000	1,900,000	1,729,000
All other MFIs	1,210,300	1,116,250	1,434,500	1,543,750
Total	3,480,800	4,726,250	5,899,500	6,550,250

From this survey data, $20 million in additional capital will be required to meet the projected expansion of the MFIs during the next three years.

A more thorough demand analysis was done in a November 2003 study commissioned by KfW[1]. This study estimated a total demand for micro-finance of $59.2 million. However, the study did not include potential demand for mortgages or other types of finance that are currently not common to

[1] Georgia Microfinance Feasibility Study, Business and Finance Consulting GmbH

Georgia. Should a market of 5,000 mortgages be created with an estimated value of $5,000 each, this creates a need for $25 million in additional capital, which would dramatically increase the total capital required.

A leasing study completed by the IFC Georgia Business Development Project from March 2004 indicated that small companies are seeking average fixed asset financing of $5,232 and that small companies could easily require $500,000 in financing and medium companies another $3.9 million.

The total unmet demand for capital is quite large for the entire micro finance sector. However the demand by most MFIs for capital on commercial terms is obviously less than the demand for either grants or concessionary loans. Most interviewees responded that they could pay commercial terms for additional capital, but this would be a secondary source for them.

Some of the larger MFIs have not reached financial self-sustainability – a strong indication of their actual ability to pay for capital on commercial terms. Many of the smaller MFIs are institutionally weak and might not be able to borrow funds on commercial terms. This situation should change in the next few years as the MFIs become stronger with longer operating histories. In addition, it is already clear that some of the smaller MFIs may never reach a critical mass and may be forced to merge in order to survive and grow. The Danish Refugee Council is working with five MFIs to form a consortium to obtain additional capital, training and other resources.

Supply

The present supply of commercial funding for MFIs is limited mainly due to the perceived risks. Most banks consider MFIs too risky to lend to or do not understand how to analyze their operations, thus limiting their interest in providing funding. Two of the smaller MFIs did receive loans from a local commercial bank, but the amount was very limited.

The “risk” concerns of commercial banks can be effectively addressed by the use of guarantees. Over time, commercial sources of funds will learn that MFIs that are well run and sustainable can be good borrowers. The banks will then overcome their current perceptions of the risks associated with MFIs.

Another limitation is that banks currently engaged in micro finance consider MFIs to be competitors, and will most likely not lend to MFIs in the near future. This situation could change if the banks recognize that MFIs can also be good borrowers and are not competing due to geography or the type of borrower served.

It should be noted that banks presently derive a majority of their available loan capital from short-term deposits. Although these funds are relatively low cost, their duration make them poorly suited for the banks to lend long-term. As a result, banks are currently making a majority of their loans in the 6 – 12 month range where interest rates are relatively high.

Increases in deposits, especially term deposits, is important to increase liquidity and should also serve to reduce interest rates on loans as banks compete for borrowers. This should occur as banks consolidate and people begin to view banks as safe places to save and invest. The banks will then view lending to MFIs as relatively more attractive.

Another option for commercial funding is to issue a bond where the proceeds would be used to make loans to MFIs. Any long-term bond would need to have guarantees to ensure sufficient demand, but this could be easily done through the DCA program.

Although at present only the Ministry of Finance and National Bank issue bonds, one local bank is working on a bond issue where the proceeds will fund small and medium enterprise loans. The success of this bond issue would be the best indication of the feasibility of an MFI bond issue.

Finally, there is a large amount of grant and other funding available for Georgian MFIs in the next three years. Most of this is going to be in the forms of grants and all MFIs interviewed indicated that this is their preferred source of capital in the near term. Some of this may be channeled to commercial banks for their micro finance portfolios, but the majority of it will be provided to the MFIs.

Identified Capital Sources

Donor	Amount (millions)	Timeframe
USDA	$8.0	2004 – 2005
KfW	7.2	2005
USAID GMSE	5.0	2004 - 2007
World Bank[2]	2.0	2004 - 2005
Danish Refugee Council[3]	0.3	2004
Total	**$22.50**	

Legal and regulatory issues

There are no legal or regulatory impediments to establishing a guarantee facility. However, National Bank of Georgia capital and risk requirements would limit the amount of guarantees that the facility could issue. For each $1 of collateral provided to a guarantee facility, the bank would be able to issue guarantees worth $5. This "multiplier" could be increased or reduced depending on the longer-term loss experience of the facility. Assuming $2 million of capital, the facility could guarantee $10 million in loans. If the guarantees only cover 50% of the loans, the total loans mobilized would be $20 million.

The MFIs do face some serious legal issues, primarily concerning their tax status. NGOs by law are not supposed to be primarily engaged in commercial activities. If they are found to be primarily commercial, they can shut down and liquidated. Also, the law on grants stipulates that grants may not be used for commercial purposes, although its application is unclear.

The GMSE project is currently working to address these issues, partly by working on a tiered licensing system that would clarify the tax status of MFIs. In addition, this new licensing system would allow the MFIs to expand their product and service offerings, which would likely increase their demand for outside capital.

Competitive issues

The large amount of grant and other funding that will be available in the next several years poses near-term threat to the feasibility of a guarantee facility. However, following that period, there will likely be an increase in demand for capital and the MFIs should then be better positioned to afford the associated costs.

[2] The World Bank is proposing a $2 or 3 million loan fund targeting rural finance.
[3] DRC works with a group of 5 MFIs in western Georgia, focusing on IDPs.

The grant funding creates two issues that cannot be overlooked. First, the direct issue is that MFIs will always choose the lowest cost funding sources, thus grants will be preferred to commercial capital. The second issue is more indirect, in that grant funds tend to make the institutions focus less on sustainability and not be commercial oriented. This could spoil the market for commercial funding from a demand perspective.

The other competitive issue is the dominance of commercial banks, especially ProCredit, in the micro finance market. Although these commercial banks have advantages in terms of capital sources and market position, the MFIs will continue to work with financially underserved parts of the economy and will not necessarily be directly competing with the banks in their markets.

ASSUMPTIONS

Evolution of MFIs in Georgia

The MFIs in Georgia are going through a phase of institutional development and growth. There are currently a relatively large number of MFIs and it is likely that some of them may fail and others may merge for competitive reasons. This reduction in the number of MFIs should further strengthen the remaining institutions.

MFIs are currently looking to expand their products and services and a new licensing system being addressed by the GMSE project should help to open the doors for the MFIs to further expand. Allowing the MFIs to accept deposits, even on a limited basis, could dramatically change the way that they raise capital and increase their customer base.

MFIs are also being supported financially and technically through different sources and this support will continue in the next few years. As the institutions become more sustainable both operationally and financially, they will be looking to reduce their dependence on technical assistance and grant funding and will logically turn to commercial sources of funding.

Cooperation and competition with banks

Currently cooperation with commercial banks is limited to providing basic account services. However, one bank made a few small loans to MFIs in the country and would like to develop this line of business further.

Most of the banks interviewed consider the MFIs to be direct competitors, especially those banks that are active in microfinance. These banks have access to capital at relatively low cost, with most deposits in the banking system being either demand or short-term at low or no interest cost. For this reason, the banks will continue to be attracted to microfinance due to the relatively high portfolio yields.

It should also be noted that banks historically were heavy purchasers of treasury bills, but the yields on these securities has been dropping in the past few months. If treasury yields continue to fall, banks will increasingly be seeking profitable investments for excess liquidity.

Target MFIs

This study focused on those parts of the microfinance industry that do not currently have ready access to capital. For the purposes of this study, it was assumed that commercial banks do have adequate access to capital either from deposits or from credit lines with international financial institutions.

The history of the credit unions in Georgia has also ruled them out as a potential user of a guarantee facility.

It was also assumed that MFIs are serving different markets and serve different purposes than commercial banks. Therefore, this study focuses solely on supplying additional capital to the NGO/non-profit MFIs.

USAID and other donor institution intentions

There is a lack of donor cooperation and coordination that could pose a threat to the creation and sustainable operation of a wholesale lending facility. Some of the donor groups have very different ideas about sustainability and the target beneficiaries and their programs could easily be competing with one another.

The major groups including USAID, World Bank, KfW, EBRD and the Danish Refugee Council should work to coordinate their activities with micro finance to avoid unintended negative consequences.

It should also be clearly stated that the guarantee facility is intended to mobilize commercial funds and not to secure donor or international financial institution capital.

FINDINGS AND RECOMMENDATIONS

There is clear evidence that MFIs could benefit from commercial sources of capital, and that the main limitation is the perceived and actual risks of lending to MFIs. The proposed guarantee facility would address this primary constraint for MFIs.

Criteria for selecting a facility administrator

The administrator of the guarantee facility must be selected carefully. The institution selected should be sufficiently capitalized and institutionally strong to ensure continued operation of the facility and to safeguard the capital provided. The administrator would ideally be a financial institution that is not engaged in micro finance to avoid any perceived or genuine conflicts of interest.

At the present time, there is not a clear choice among the commercial banks to act as administrator, since the largest banks are already very active in the micro finance market.

The ideal administrator would have the following characteristics:

- Is well versed in finance and banking in Georgia
- Has experience managing guarantees
- Does not currently have micro finance operations (either wholesale or retail)
- Is interested in supporting the micro finance sector indirectly

Methodology for guarantee issuance

Guarantees should serve to facilitate capital movement from commercial sources (including banks, insurance companies, or other sources) to MFIs. The intent would be to support all MFIs, but particularly those that, due to size or other reasons, are finding it difficult to access additional capital. The guarantee should be viewed as a catalyst to mobilize capital and to keep the cost of capital low.

A guarantee facility would require several million dollars in capital and based on the multiplier effect, would leverage up to ten times the capital amount in loans to MFIs. Alternatively, a bond issue or other large loan made through a bank or other financial intermediary could be guaranteed through the DCA program. In this case the facility administrator would act as a wholesale lending facility and on-lend the proceeds directly to MFIs. The latter would be considerably more expensive and intensive to operate than a straight guarantee facility, but would require far less capital.

One important principal should be that the guarantee facility and the borrower share in the risk of the loan and share in the guarantee fees. Guarantees of 50% are available through DCA, and this split is recommended for the guarantee facility as well. Should the borrower require less than a 50% guarantee, the administrator should be able to comply with this request.

The administrator would sign an agreement or contract with USAID to ensure that the proper framework is established and followed for issuing guarantees. USAID country strategy and policy issues should be considered to ensure compliance and alignment with programmatic goals.

USAID should establish clear parameters for what organizations would be allowed to utilize the facility. In addition, minimum standards should be established for any MFIs wishing to utilize the facility. These standards should include:

- Financial and operational sustainability
- External audits by recognized auditing firms
- Credit rating by recognized agency
- Appropriate financial disclosure to USAID
- Agreement on the ultimate use of the borrowed capital
- No history of delinquencies or defaults to commercial capital sources.

Participation, reporting, or other requirements should be kept to a minimum so that the program is actively utilized. USAID should ensure that the capital provided is well protected from waste and abuse, but it must also ensure that the capital is fully utilized to issue guarantees.

The guarantees would be issued on a fee basis to cover the administrative costs of the program. The fees would be paid directly to the administrator and would be established as a percentage of the total amount guaranteed and the duration of the loan. USAID should agree with the administrator about the level of fees to ensure that they are adequate to cover the costs of administration, but are not placing an unnecessary burden on the borrowers. The fee structure should be reviewed on an annual basis and any necessary adjustments made. The interest earned on the collateral capital could be used to partially offset the fees paid by the borrower, or to increase the capital base.

The borrowers should be free to negotiate the terms of the loan directly with the lender. This is important as the MFIs seek to become more independent and locally managed.

Sources of additional capital

In addition to establishing the guarantee facility, an investigation should be done for appropriate sources of capital. The search should focus both on the internal Georgian market, for Lari denominated debt, and in the international market for US dollar of Euro denominated debt. The MFIs themselves should be able to access capital denominated the same as their lending activity.

A marketing campaign should be conducted in the country targeting banks, insurance and other financial institutions to educate them about micro finance, the institutions involved, and the mechanics of the guarantee facility.

It is not envisioned that the facility would negotiate the loans, but would help to increase knowledge and interest in lending to MFIs.

Sunset provisions

It is assumed that such a guarantee facility could be used indefinitely, but that USAID wishes to eventually remove what are essentially subsidized guarantees. After several years of shared experience with MFIs and commercial funding sources, the guarantees should no longer be critical to the ability of MFIs to access capital. In addition, the fees paid by the MFIs will add to their borrowing costs and those institutions strong enough to borrow without guarantees will do so.

A clear plan with agreed timetable should be established to liquidate the fund. The proceeds from the facility should be disbursed to those MFIs that utilized the facility based upon their utilization. A proxy for utilization would be the total fees paid by the MFIs, assuming the fees are based on the guarantee size and duration. Any MFI that either defaulted or were delinquent in repayments of their loans should not be eligible to receive proceeds from the liquidation.