



MAPPING NON-BANK PRODUCTS, PRACTICES AND INTERESTS IN SMEs

FINAL

Tuesday, April 19, 2011

This publication was produced for review by the United States Agency for International Development. It was prepared by Deloitte Consulting LLP.

MAPPING NON-BANK PRODUCTS, INTERESTS AND PRACTICES IN SMEs

FINAL

USAID ECONOMIC PROSPERITY INITIATIVE (EPI)

CONTRACT NUMBER: AID-114-C-10-00004

DELOITTE CONSULTING LLP

USAID/CAUCASUS

TUESDAY, APRIL 19, 2011

DISCLAIMER:

The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

ABSTRACT

Since Georgia started on-going development towards formation of free and competitive economic system, various areas of private sector reached significant results. Nevertheless, numerous small and medium enterprises owing to external or internal factors, besides other obstructions, are experiencing difficulties in terms of access to finance. According to the 2010 UNDP survey, 43% of businesses failed due to absence of free capital, when 66% of respondents reported that bank loan was the main option for start-up and expansion.

Within the scope of EPI executed a consultancy regarding financial instruments offered to SMEs by non-banking sector. The assignment comprises a thorough description of the supply of financial products as well as distinguishes between demand-side and supply-side constraints to access to finance for SMEs.

From the point of view of mentioned constraints for the both supply and demand sides' consultancy accordingly oversaw issues, like legislative gaps, expensive funding, low management, market knowledge, and similar.

Keywords: access to finance, small and medium enterprise, non-banking sector, microfinance institution, insurance, private pension fund, leasing.

DATA

Name of Component: Crosscutting.

Author: Giorgi Darchia

Practice Area: Access to Finance.

Key Words: Access to Finance, Small and Medium Enterprise, Non-Banking Sector, Microfinance Institution, Insurance, Private Pension Fund, Leasing.

ABBREVIATIONS

MFI	Microfinance Institution
SME	Small and Medium Enterprise
BAG	Business Association of Georgia
GSMEA	Georgian Small and Medium Enterprises Association
LAG	Leasing Association of Georgia
GIA	Georgian Insurance Association
NBG	National Bank of Georgia
MIF	Ministry of Finance of Georgia
AMI	Association of Microfinance Institutions
GOG	Government of Georgia

TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
MFIS ASSESSMENT	2
LEASING ASSESSMENT	6
INSURANCE ASSESSMENT.....	9
PRIVATE PENSION ASSESSMENT	12
KEY FINDINGS	14

EXECUTIVE SUMMARY

Since Georgia started on-going development towards the formation of a free and competitive economic system, various areas of private sector have achieved significant results. Nevertheless, owing to various factors, numerous small and medium enterprises are experiencing difficulties in terms of access to finance. According to the 2010 UNDP survey, 43% of businesses failed due to the absence of free capital, when 66% of respondents reported that a bank loan was the main option for start-up and expansion.

The USAID-funded Economic Prosperity Initiative (EPI) is 40.4 USD million, four year program designed to strengthen country's economic development and ensure its sustainability. The overall goal of the project is to improve enterprise, industry, and country-level competitiveness by identifying and targeting key external and internal factors to enhance the growth rates and efficiency of enterprises in the economy. A subset of that goal is to increase capacity of the Georgian financial market.

Within the pool of generally renowned non-banking financial institutions, investment funds, factoring companies and asset-based companies are those which have not achieved tangible growth in Georgia. On the other hand, financial institutions like MFIs, leasing and insurance companies as well as private pension funds can be considered relatively well-developed segments of the non-banking financial sector, which despite legislative and other constraints.

In order to map the inventory of financial products available for SMEs, EPI closely cooperated with key players of the non-banking financial sector. EPI conducted meetings with representatives of Georgian National bank (regulatory board) and chairpersons of key associations (GSMEA, AMI, GIA, LAG). This report was prepared through of the examination of related legislation and other materials, as well as through interviews of key participants in the market. The selection of organizations was based on the following criteria: assets, market share, experience and awareness, geographical coverage, and number of employees.

This document is a deliverable for "Work Plan Level 16610", "Action #90", which comprehends an inventory of all above mentioned products to be used as a baseline data for the access to finance strategy.

MFIs ASSESSMENT

Registration and operation of MFIs are regulated by the Civil Code of Georgia and Georgian Law on Microfinance Organizations (18/Jul/2006). According to this law, a microfinance institution (MFI) shall be incorporated as a Limited Liability Company or Joint Stock Company, that, on the basis of its application, is registered by the National Bank of Georgia (NBG) and performs activities provided in the above mentioned law under NBG supervision. If the NBG determines that an MFI has violated laws, it shall warn the MFI or make a decision to terminate the MFI's registration.

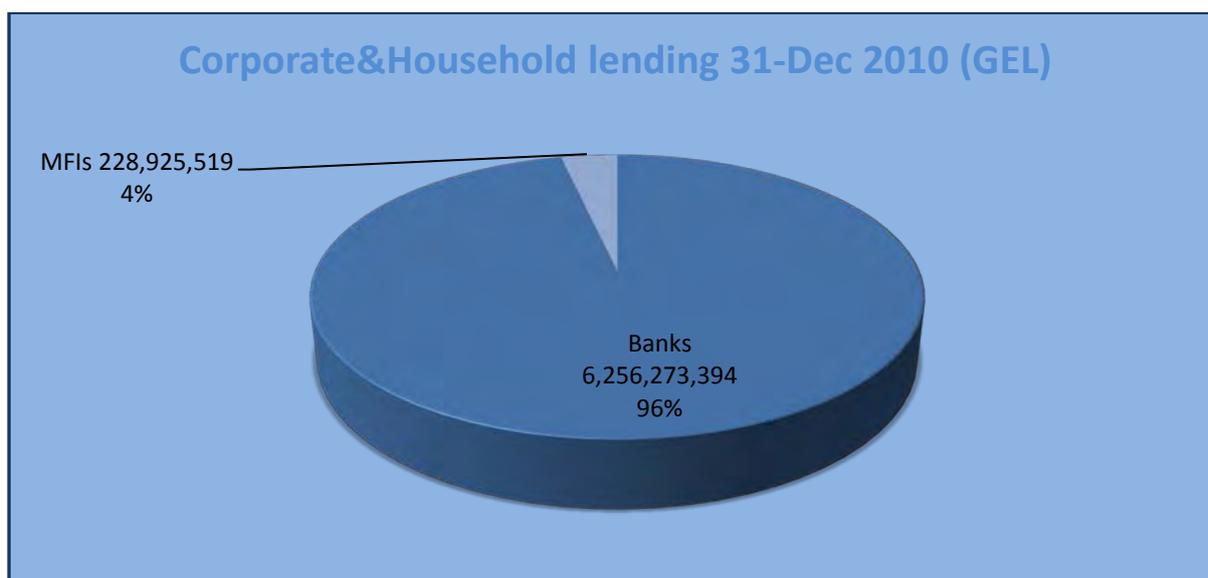
For MFIs it is mandatory to create a supervisory board to which the regulations set by the Law of Georgia on Entrepreneurs with respect to the supervisory board of the joint stock company apply.

MFIs are authorized to perform only the following activities:

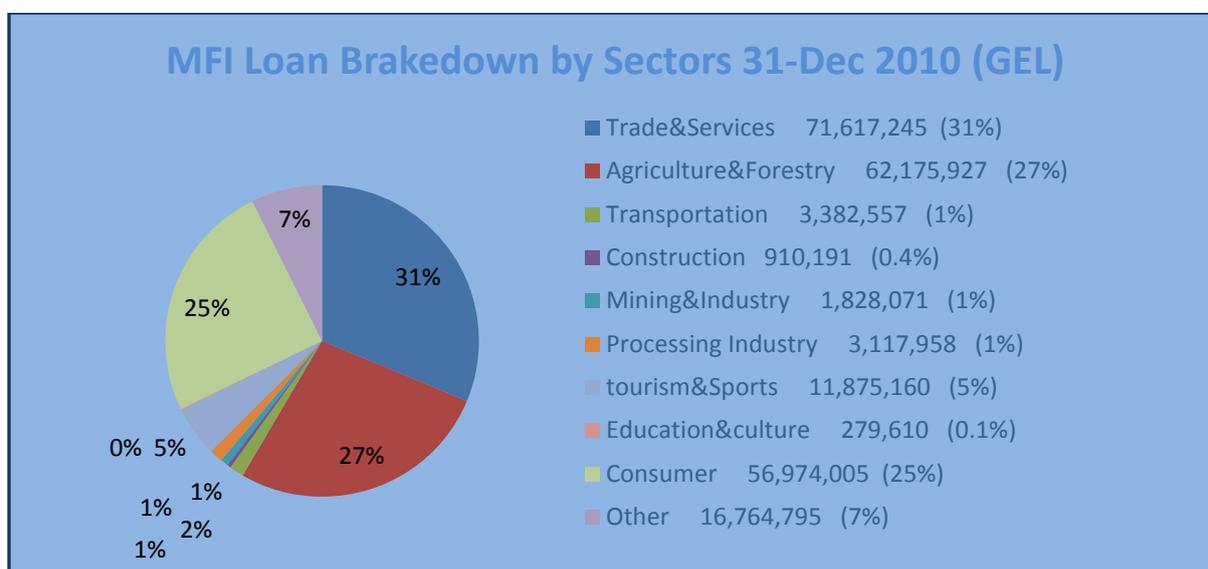
- Disburse loans (up to 50,000 GEL per customer) including consumer, collateral, mortgage, unsecured, group and other types of loans to physical persons and legal entities;
- Make investments in government and public securities;
- Implement money remittances;
- Perform functions of an insurance agent;
- Render consultation services related with micro lending;
- Accept loans (credits) from resident and non-resident physical persons and legal entities;
- Own stake in share capital of a legal entity, the total amount of which should not exceed 15% of the share capital of the given MFI;
- Other financial services and operations provided in the Georgian legislation, including micro-leasing, factoring, foreign exchange and promissory note operations, issuance of bonds, realization, redemption and other related transactions.
- The charter/share capital for MFIs should not be less than GEL 250,000.
- The law prohibits a MFI to accept deposits from physical persons and legal entities.

Disagreements between suppliers and consumers of financial products regarding product rates and terms are common in financial markets worldwide. The gap between the two positions is generally minimized with proper legislation, sufficient knowledge, and instrument sophistication. However, an underdeveloped financial market like Georgia suffers currently from legislative gaps, low management, lack of market awareness, and other issues.

There are currently 51 registered MFIs in Georgia and their market share is as follows:



Source:NBG.



Source:NBG.

Due to poorly designed legislation there is no distinction between pawnshops and actual MFIs that are aiming to credit enterprises and care about their reputation, which is harmed by consumer loans disbursed by pawnshops under the collateral of gold. Although the main problem regarding legislation is that, any Limited Liability Company is allowed to disburse a loan without any ceiling limit as opposed to MFIs that is permitted to lend up to 50,000 GEL per collateral. Besides, LLCs do not have a liability of minimal charter capital of 250,000 GEL, what is an obligation for MFIs.

In comparison with banks, MFIs experience disadvantage in terms of fundings as they can not receive deposits and the income from loans lent to them is an object to taxation for creditors. Also MFIs do not enjoy loan loss provisions, to write off bad

loans as an operational expenditure. All these factors and a lack of proper supervision make MFIs less attractive to foreign investors. Consequently, cheap financial resources are not available for them. This is obviously reflected in the high interest rates of microcredits.

It should be noted that, high rates on SME loans originate not only from expensive funding and legislative gaps, but also from market conditions and a high level of demand, making it possible for MFIs to disburse overpriced loans. It should also be mentioned that banks often do not finance those sectors with relatively high risks (e.g. agricultural sector) as opposed to MFIs, who are providing loans to all sectors and justify their high rates with having high risks. As GSMEA reports, there is a need for the credit foundation to offer credits to SMEs with a relatively low interest rate in order to force banks and MFIs to decrease interest rates.

The Association of Development and Support of Microfinance Organizations of Georgia has represented MFIs' interests since August 2009. This non-profit institution has already achieved several results that have allowed MFIs exclusive rates to get information from Credit Info Georgia and a special 25% discount for audit services conducted by BDO Georgia for association members. Recently, MFIs, jointly with the banks, have gained a registered preferential right in the registry, that gives them an opportunity to receive compensation from mortgage sales, despite competition with government organizations. This was another result of the association's support.

In order to summarize non-banking financial instruments available to SMEs and distinguish basic constraints of market development, EPI cooperated with the largest MFIs in terms of their assets, market share, experience, network of branches and number of employees. This list of MFIs includes Alliance, Credo, Crystal, Fingaro, Finca, and Lazika. Information about each MFI is summarized in the table below.

Summary of SME Lending - MFIs:

MFIs:	Alliance	Finagro	Lazika	Credo	Finca	Crystal
Number of branches	5	6	6	17	29	14
Total Portfolio (Mil)	2.5 (GEL)	4 (GEL)	13.2 (GEL)	60 (GEL)	26 (USD)	14 (GEL)
Loan Amount (GEL)	892,652	100%	13,227,653	28%	50%	6,926,184
Interest Rate (GEL)	26 - 48%	16 - 36%	18 - 40%	20 - 36%	23 - 42%	18 - 36%
Loan Amount (USD)	1,599,436	80% (USD indexed)	34,334	72%	50%	7,127,547
Interest Rate (USD)	26 - 48%	16 - 36%	18 - 40%	20 - 36%	23 - 42%	18 - 36%
Maturity (Months)	1 - 36	3 - 24	3 - 48	1 - 60	3 - 36	4 - 36
Max. Loan Denominated in GEL	50,000	50,000	50,000	50,000	50,000	50,000

Average Loan Denominated in GEL	3,500	3,500	1,500	1,800	Different on Various Sectors	2,700
Administrative Fee	1.8 - 2.5%	1.5 - 2.5%	2%	Around 3.5%	Around 2%	1.5 - 2.5%
Effective Loan Rate	37%	-	35.63%	38,80%	-	34.50%
Appliance of Interest Rate	Declining Balance	Declining Balance	Both (D.Bal. & Flat)	Declining Balance	Declining Balance	Declining Balance
Number of Outstanding Loans	688	1,732	8,917	49,080	29,203	7,846
Loan Approval Ratio	70%	10%	95.5%	65%	-	91%
PAR	3%	3.50%	2%	0.30%	0.07%	0.50%
Collateral	Guarantor-up to 5,000. collateral-over 5,000 (GEL)	Non Collateral up to 2,000(USD). Lend can be taken as Collateral	Mortgages, Movable Property, Solidarity Guarantor	80% is non-collateral	Non collateral up to 10,000 (USD)	Non collateral up to 10,000 (GEL)
Sectors	Trade, Services, Production, Agriculture, Other sectors	Agriculture, Production, Trading, Services, Consumer	Agriculture, Trade, Services, Production, Housing	Agriculture, Trade, Services, Household, Tourism, Others.	Agriculture, Trade, Services, Others.	Agriculture, Trade, Services, Household, Production, Others.
Major Constraints (Supply Side)	Lack of Cheap Funding, Legislative gaps.	Lack of Cheap Funding,	Absence of Deposits, Provision for Bad debts	Absence of Deposits, Provision for Bad debts.	Absence of Deposits, Provision for bad debts, Lack of Local Currency Funding	Lack of Cheap Funding. Absence of Deposits.
Major Constraints (Demand Side)	High rates, Poor market awareness, Absence of collateral	-	-	-	-	Poor Market Awareness

Source:MFIs

LEASING ASSESSMENT

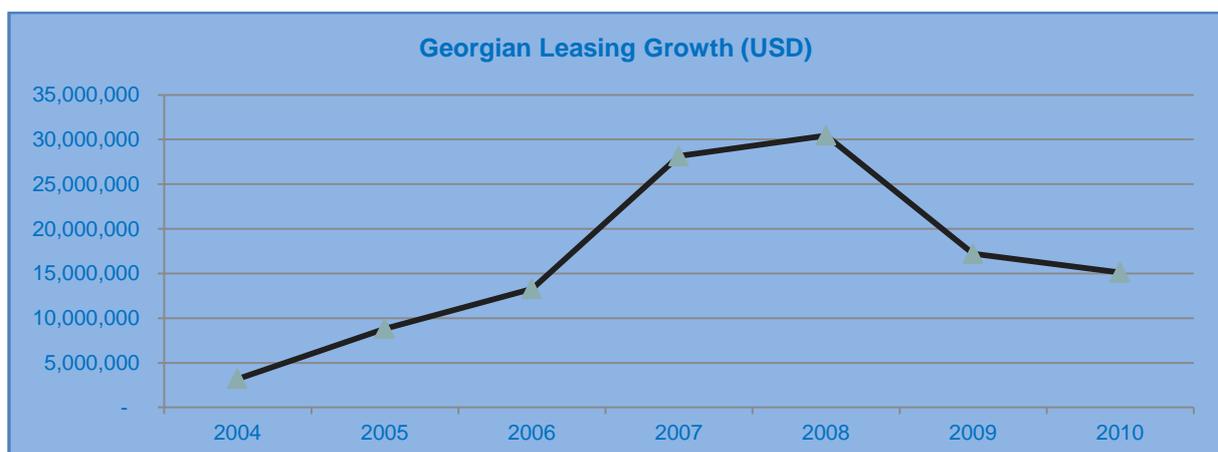
There are several leasing companies registered in Georgia, but only three of them (TBC Leasing, Alliance Group Leasing and Georgian Leasing) have performed actual leasing operations so far. Leasing companies operate according the “Georgian law on Promotion of Leasing Activities” and the Civil Code. In terms of legislation, there are numerous obstacles for leasing development:

- Discrepancies between Tax Code and Civil Code
- Probability of double interpretation of law
- Absence of 100% amortization of fixed assets
- Lack of allowance for bad debts
- Complicated method for appreciation of fixed assets
- Complex scheme for calculating the amount of property tax
- The leasing of medical equipment is not released from the property tax
- Requirement of weak capitalization (3:1)
- The limitation on minimum interest rate in the leasing contracts

In addition to the supply side constraints, there are several obstacles from the demand side as well:

- Lack of market awareness
- Psychological factor (do not finance if do not own)
- Customers have an advance plan to use an object of leasing for short -term and give it back before maturity

These are basic factors for the Georgian leasing growth, the performance of which is as follows:



Source:Leasing Association.

The plurality of various constraints is certainly reflected on leasing dynamics. Portfolios of the previously mentioned leasing companies have been decreasing for more than two years, which has caused decrease of professionals as well. Despite the fact that most customers prefer bank loans to leasing, Georgian lessors' services cover a wide range of industries:

Data for Benchmarking				
30.09.2010	TBC Leasing	Georgian Leasing Company	AG leasing	Total
	GEL	GEL	GEL	GEL
Assets	18,890,227	19,269,690	4,945,788	43,105,705
Equity	5,251,754	5,560,666	1,984,043	12,796,463
Portfolio	12,132,252	11,007,047	3,558,927	26,698,226
Maximum Amount (USD)	500,000	NO limit	NO limit	
SME Portfolio	12,132,252	11,007,047	3,558,927	26,698,226

Industry breakdown

<i>Consumer</i>			9.85%
<i>Education</i>			0.84%
<i>Agriculture</i>	0.07%	0.00%	0.00%
<i>Communication</i>	0.10%	9.85%	0.00%
<i>Construction and real estate</i>	27.02%	13.47%	29.37%
<i>Distribution</i>	4.25%	4.36%	0.00%
<i>Food & Beverages production</i>	12.88%	4.62%	5.24%
<i>Light Industry</i>	6.90%	4.39%	3.21%
<i>Medicine</i>	8.38%	13.32%	0.00%
<i>Mining of Natural Resources</i>	7.40%	5.62%	1.44%
<i>Other</i>	3.79%	2.99%	1.66%
<i>Polygraph</i>	9.87%	3.22%	6.88%
<i>Power Engineering</i>	0.00%	3.22%	0.00%
<i>Road Construction</i>	3.46%	13.04%	16.04%
<i>Service</i>	4.45%	16.49%	2.69%
<i>Trade</i>	7.93%	5.07%	0.00%
<i>Transportation</i>	3.49%	0.35%	22.78%

Source:Leasing Association

The Association of Georgian Leasing Companies, together with the Business Association of Georgia and EPI, have developed a draft of leasing-related amendments in the Tax and Civil Codes aimed at improving the overall environment for leasing, in collaboration with the Ministry of Finance, NBG, and the Ministry of Justice.

It should be noted that the conditions and terms of leasing correspond directly to the Georgian financial market if we consider that pricing relies on the current legislation in place and important aspects from the demand side. SMEs' access to leasing instruments should be measured in comparison with other financial products offered by both banking and non-banking sectors, as leasing is an alternative and rival model of services provided by institutions (banks and MFIs) with larger capacity than local leasing companies.

Summary of Leasing to SME

Leasing Company:	TBC Leasing	Georgian Leasing	AG Leasing
Number of branches	1	1	5
Interest Rate	17 – 19%	Up to 16%	24 – 36%
Annual Increase	7 – 11%	4 – 7%	8 – 15%
Max. Maturity (years)	5	5	5
Administrative Fee	No Fee	No Fee	0.5 – 2%
Approval Rate	70%	85%	60%
Major Constraints (Supply Side)	Legislative restrictions	Legislative restrictions, Lack of Secondary Market for Fixed Assets	Lack of Secondary Market for Fixed Assets.
Major Constraints (demand Side)	Psychological Factor, Market Awareness.	Market Awareness, Plan of Premature Use.	Market Awareness

Source: Leasing Companies.

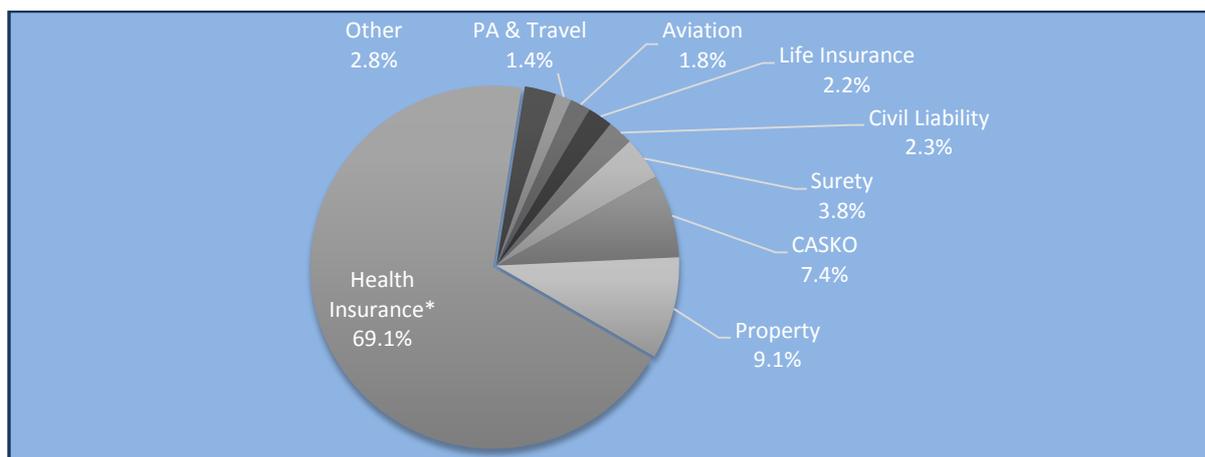
INSURANCE ASSESSMENT

There are seventeen (17) registered insurance companies in Georgia, which operate according to the Civil Code and Georgian Law on Insurance (2/May/1997).

- Insurance Company Aldagi BCI
- International Insurance Company Imedi L
- Insurance Company GPI Holding
- Insurance Company Cartu
- International insurance Company Irao
- Insurance Company Vesti
- Chartis Insurance Company
- Insurance Company IC Group
- Tao Insurance
- Insurance Company Partner
- Medical Insurance Group Archimedes Global Georgia
- Standard Insurance
- Insurance Company Alpha
- Insurance Company Mobius
- Ardi Group Insurance
- PSP Medical Insurance
- Insurance Company Unison

The portfolios of a majority of companies consist mostly of health insurance, as this area is currently the driver for Georgian insurance development.

Market shares by product 2010 3 Qs



Source: Insurance companies.

The types of insurance products and their level of sophistication are determined by a prolonged and sustainable demand. As the performance of the Georgian economy has been dictated by an unstable environment in the region, most small and medium enterprises suffer from unsteady trends. Frequent cases of suspension or termination of businesses prevents the development of a sustainable demand of insurance products from private sector.

The clearest example of this issue was the case when the government of the Russian federation prohibited the import of Georgian wine. Prior to this export interruption, local wine makers commonly used insurance products, as demand on their production was stable and the only threat to revenue was natural disaster. This stimulated one of the leading insurance companies to purchase a special device, which could reveal dishonest farmers by establishing whether the vineyard was damaged because of a natural disaster, such as hail, or inappropriate care of the harvest. After the closure of Russian market Georgian farmers could not afford the expenditures for crop insurance and consequently local insurers abandoned this instrument.

This demand related constraint is also common for other sectors. The overall purchasing power of the population is low and they seek cheap products and services, which in most cases do not include insurance expenses. This is reflected in the overall demand and thus hinders the growth of insurance, as supply and demand side constraints are interdependent.

However, there are components for local SMEs, which require the permanent use of insurance products and most of Georgian insurers provide them accordingly. Most common products offered to SMEs are:

- Property
- Liability
- Health
- Transport Risk
- Legal Insurance
- Legal Cost Proceeding
- Financial Risk
- Pension Fund

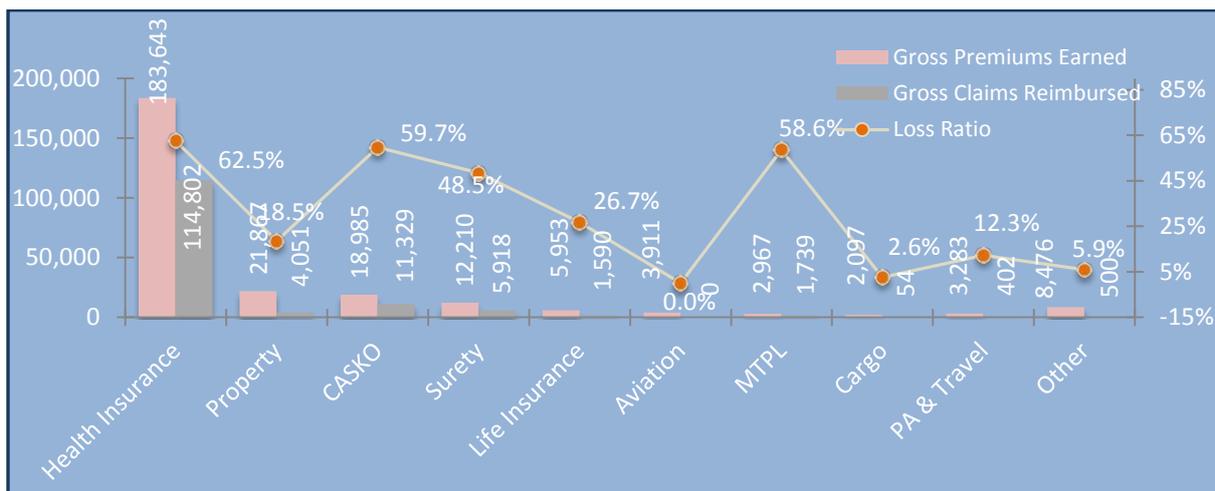
Types of Insurance Offered to SMEs

Property	Liability	Health	Transport	Legal	legal Cost Proceeding	Financial Risk	Pension
Movable, Immovable, Business Interruption	Third party liability Employers' liability	Makes any health care treatment accessible	Any vehicle, Third party liability Personal	Ensures against legal expenses	Ensures costs related to civil and administrative	Protects from claims against enterprise imposed by a	Provides with free choice of payment

Losses, Warehouse stock, Machinery, Cargo.	Carrier's liability	to employees.	accident sustained by driver and passengers	and provides with legal advice	proceedings	third party for financial compensations	options, contribution levels and pension types.
--	---------------------	---------------	---	--------------------------------	-------------	---	---

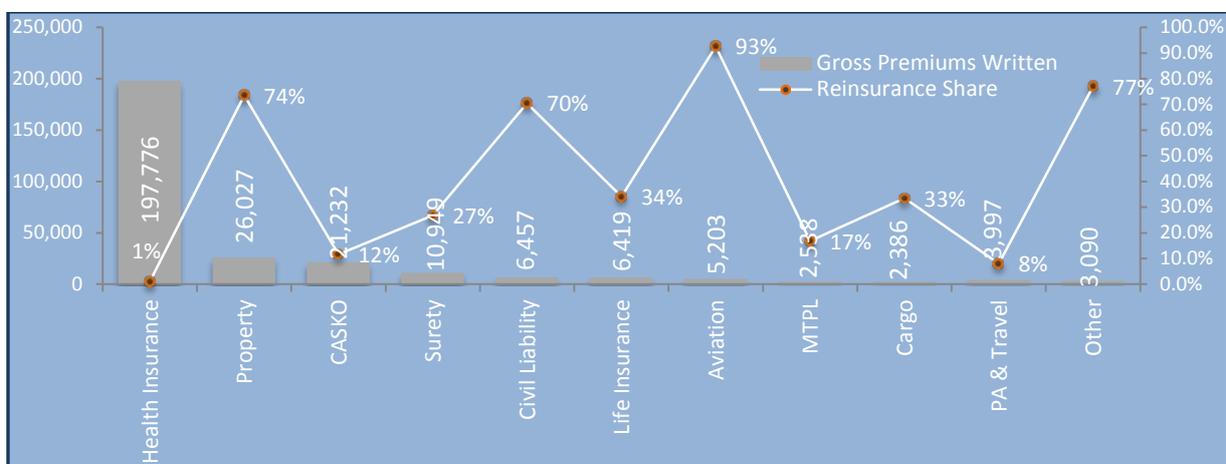
In terms of the earned premiums and shares of reinsurance, most of local Insurance companies manage their portfolios rather efficiently, as they have a strong partnership with the world's leading reinsurers.

Market Data: Gross Premium earned vs. Gross Claims Reimbursed 2010 3Qs. (000' GEL)



Source: Insurance Companies.

Market Data: Gross Premium written/Reinsurance Share 2010 3Qs. (000' GEL)



Source: Insurance Companies.

PRIVATE PENSION ASSESSMENT

Out of seventeen (17) Georgian Insurance companies only six (6) operate private pension schemes and only three (3) of them are more or less active in their practice.

The following is a list of the registered private pension schemes:

- JSC Insurance company Aldagi BCI
- JSC Insurance company Imedi L
- JSC Insurance Company GPI Holding
- LTD Insurance company Irao
- LTD Insurance company Tao
- LTD Insurance company Partner

Summary of activities of Private Pension Schemes 2010 3Qs (GEL)

Company:	aldagi BCI	Imedi L	GPI Hold.	Tao	Irao	Partner
Contributions	1,238,768	558,157	14,848	0	0	0
Number of Valid Agreements	216	11,431	7	0	0	0
Number of Participants	5,306	11,420	38	0	0	0
Number of Participants, Receiving Pension	0	0	0	0	0	0
Pension Paid	0	0	0	0	0	0
Amounts Withdrawn from Pension Schemes	601,060	357,097	192	40,105	0	0
Pension Reserves	4,764,875	2,690,375	234,818	0	0	0
Income from Investment of Reserves	423,902	231,192	17,948	0	0	0

Source:NBG.

Such a low level of development is driven by the absence of proper regulation and other constraints, outlined below:

- Lack of mandatory enrollment
- Absence of tax incentives for contribution

- Allowance for underage withdrawal
- Complicated rule for fund investment
- Lack of investment infrastructure

Most of the previously mentioned constraints are comprised of sub-issues, such as the terms of compulsory enrollment, the amount of tax incentives and investment options. Solutions of these issues can be achieved through joint efforts of both the private and public sectors.

However, there are several pension schemes offered to enterprises by insurers:

PERMANENT PENSION SCHEME

Under this scheme, a participant is entitled to receive payments from the beginning date (according to the Georgian law, pension age for male individuals is 65 years and 60 years for female individuals) until the end of his/her life.

TERM PENSION

This scheme implies payments from the beginning date until specific time as defined by the participant.

ONE-OFF PENSION

Under this arrangement, the participant is entitled to receive some part of pension in a lump sum payment, whereas the remaining part will be paid out either through Permanent or Term Pension arrangements.

It also should be mentioned, that each private pension fund allows their participants to transfer savings to other institutions.

KEY FINDINGS

The basic obstacle for non-banking financial sector's capacity growth is high rates on financial products. That is due to various factors including:

- Poorly designed Legislation
- Absence of cheap funding
- High risks
- Lack of investment infrastructure

Demand side constraints include the following:

- Low level of financial management
- Lack of financial market awareness
- Wrong perception regarding financial instruments

In addition to these issues, the low development of certain financial instruments (leasing and insurance) is driven by the absence of sustainable demand, which remains low as the economy remains unstable. In terms of leasing, the absence of a secondary market for fixed assets restricts growth as well. Regarding private pension funds, poorly designed legislation results in underdevelopment. Some of the supporting associations (e.g. AMI) related to all of these areas do not have the means to adequately provide support, which is another contributing factor to the lack of growth of the sector.

CONCLUSION

The key determinant of non-banking financial sector development is a sustainable demand on financial products, which can be achieved along with the overall growth of the private sector. However, there are also legislative and infrastructural issues, as well as the demand side constraints. The solution is to increase the capacity of the entire financial market in Georgia.

RECOMMENDATIONS

- Develop and support amendments for laws regulating activities of financial institutions (MFIs, Leasing companies, Private Pension Funds).
- Provide technical and material assistance to supporting associations accordingly.
- Conduct trainings for SMEs in order to increase their managerial knowledge and market awareness regarding financial instruments.
- Carry out steps for increasing of insurance capacity with respect to Agricultural sector.
- Advise GOG to establish a special board for development of Private Pension Policy.

**USAID Economic Prosperity Initiative (EPI)
6 Samghebro St.
Tbilisi, Georgia**

Phone: +995 32 43 89 24/25/26

Fax: +995 32 43 89 27