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FINANCIAL INCLUSION, FINANCIAL LITERACY, AND FINANCIAL EDUCATION IN GEORGIA

Yaroslava Babych,
Maya Grigolia, and
Davit Keshelava

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Yaroslava Babych is assistant professor of economics at the International School of Economics of Tbilisi State University, ISET Policy Institute. Maya Grigolia is a senior researcher and Davit Keshelava is a researcher, both at the ISET Policy Institute.

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Please contact the authors for information about this paper.

Email: y.babych@iset.ge, m.grigolia@iset.ge, d.keshelava@iset.ge

Asian Development Bank Institute
Kasumigaseki Building, 8th Floor
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

Abstract

In this paper, we provide a comprehensive overview of the current state of financial inclusion and financial literacy in Georgia based on the latest literature, statistical evidence, and recent surveys. The paper reviews current government policy initiatives and strategy documents aimed at improving financial access of SMEs and households; analyzes the state of the regulatory framework in Georgia; focuses on the causes behind the current low levels of financial inclusion and financial literacy among the young, the poor, and the rural population; and provides policy recommendations to comprehensively address the financial inclusion problem in Georgia.

Keywords: economic development, financial stability, financial literacy, financial inclusion, financial education

JEL Classification: G20, G21, G23, G28

Contents

1. INTRODUCTION

Financial inclusion, broadly defined as the access of households and firms (in particular low income and SMEs) to financial services,[1] has become one of the most important issues in modern development discourse. While cross-country studies can offer a bird's-eye view of the general patterns that are common across countries, each developing country has its unique set of problems related to the financial inclusion of vulnerable households and small/medium size businesses. In this respect Georgia offers an interesting case study.

Georgia is a country of 3.7 million,[2] situated in the South Caucasus, bordering the Russian Federation, Turkey, Azerbaijan, and Armenia. After gaining independence in 1991, the country experienced the deepest economic collapse among the transition economies, exacerbated by several wars and refugee crises. Following the Rose Revolution of 2003, the country's economy and in particular its financial system has also undergone deep structural transformations, increasingly attracting foreign capital participation.[3]

The National Bank of Georgia (NBG) managed to establish and maintain a rather strong micro and macro-prudential regulatory system, slowly restoring trust in commercial banks.[4] The structural transformation of the banking system implied consolidation, reducing the number of players on the market.[5] At the same time, the number of people serviced by the commercial banks was rising continuously as well.[6] In this respect, Georgia's indicators outperformed the average for Europe and Central Asian countries (excluding the high-income countries).

Despite impressive progress in financial access across several dimensions, Georgia remains one of the countries with the highest poverty rates in the region.[7] Various surveys, including the quarterly Business Confidence Index run by ISET-PI, also indicate that access to finance remains one of the biggest obstacles to doing business for SMEs. Thus, the question of whether the poorest population and small businesses remain underserved by the financial system, and what are the obstacles to greater financial inclusion for these groups remains open. One possibility is that access to finance is impeded by low incomes of households and low profitability of small businesses. In this regard, the question is whether policy-makers have access to

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[1] N. Yoshino and P. Morgan, Overview of Financial Inclusion, Regulation and Education, Working Paper No, 591, ADBI Working Paper Series, 2016.

[2] National Statistics Office of Georgia (Geostat). Population statistics, 2017 http://www.geostat.ge/index.php?action=page&p_id=152&lang=eng

[3] In 1995, just three out of 211 banks were foreign-controlled, while in 2016 the vast majority (11 out of 19 commercial banks) had 50% or more foreign capital participation.

[4] While NBG tightly controlled commercial banks, the non-bank financial institutions were much less regulated until recently. The details of the regulatory environment will be discussed in Section 6 of the paper.

[5] The number of banks operating in Georgia reduced from 211 in 1995 to just 19 in 2016, with the two largest banks currently controlling 60% of the total assets of the banking system.

[6] For example, the number of borrowers from commercial banks per 1,000 adults grew from 32 in 2004 to 680 in 2015, and the number of commercial bank branches per 100,000 adults rose from 9.3 to 31.9 during the same period.

[7] Poverty rates have been coming down substantially in recent years (Ref: World Bank, World Development indicators). Despite this, the country' poverty headcount ratio at $3.10 per day substantially exceeds the corresponding rates for the whole region (25.27% of the population in Georgia, vs. 6.24% in ECA countries) and even for the neighboring countries, such as Armenia (14.62% of the population in Armenia).

medium-term solutions to this problem, and whether greater financial literacy levels could improve the situation for poorer households and small firms.

This paper provides an overview of the current financial sector situation in Georgia and investigates the obstacles to financial inclusion based on an analysis of the available statistical data, the most recent studies and reports on the subject, as well as the results of the most recent surveys.

2. OVERVIEW OF THE GEORGIAN FINANCIAL SYSTEM

2.1 Sources of Financial Services for Individuals and SMEs

In the last 27 years, the Georgian financial system has undergone substantial structural changes. The level of financial access for individuals and SMEs has also changed quite dramatically.

Despite the fact that **between 1996 and 2017 the number of banks in the country decreased** from 174 to just 16, access to banking services via bank service points (branches) increased more than three times (from 242 bank branches in 1996 to 826 in 2016). **The number of registered microfinance organizations increased drastically** from two in 2004 to 81 in 2016. Unfortunately, until 2013 no data was gathered by NBG on non-regulated financial lending institutions, such as pawnshops. The first survey of pawnshops in 2013 accounted for 1,307 organizations around the country[8].

Currently (2016 and 2017), financial services in Georgia are provided by 16 banks, 11 non-bank depository corporations (e.g. credit unions), 14 insurance corporations, of which two are private pension schemes, 81 microfinance organizations, 1,307 pawnshops, [9] the stock exchange, six brokerage companies (securities dealers), 124 money remittances units, and 1,200 active foreign exchange bureaus. **The overall size of the financial sector in Georgia has grown quite impressively**. In 2000 total assets of financial corporations accounted for 31.8% of GDP, in 2016 this share was already 127.4% of GDP. The most rapid growth spurt occurred between 2005 and 2007 (total financial sector assets grew 1.4 times in absolute terms, increasing from 38.5% to 63% of GDP). Since the growth spurt, financial sector assets grew at a steady pace of 17% per year on average.[10] The total assets of microfinance organizations in particular grew from 0.02% of GDP to 8.03% of GDP in just 10 years (between 2006 and 2016).

Despite the impressive growth in the microfinance sector in recent years, **the financial system remains largely dominated by commercial banks**. They account for 70% of the financial sector's total assets.[11] Other financial corporations, like insurance companies, microfinance organizations, and pawnshops account for about 8% of total financial sector assets. Of these, 80% are controlled by microfinance organizations.

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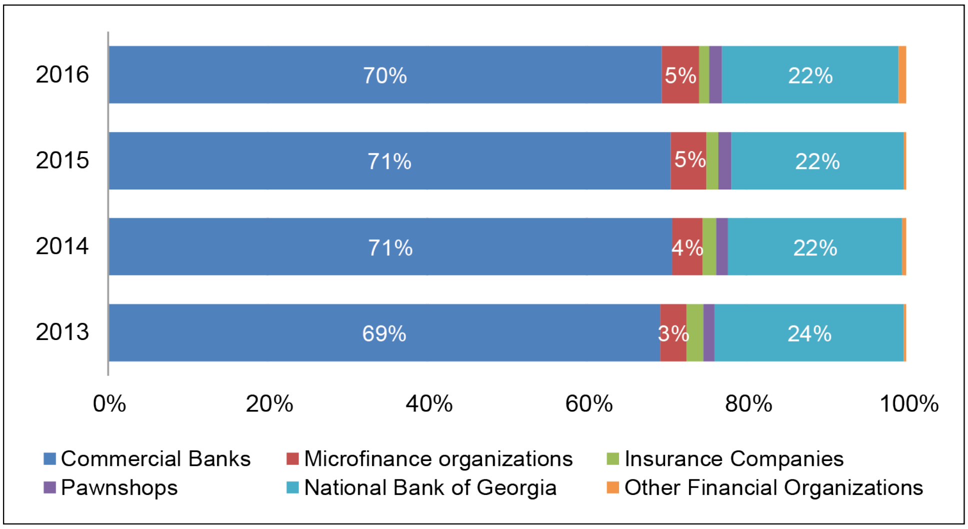
8 Pawnshop Survey. National Statistics Office of Georgia, 2013. http://www.geostat.ge/cms/site_images/_files/english/finance/Pawnshop%20survey%20results.pdf

9 2013 survey data.

10 Excluding the year of the financial crisis, 2009.

11 NBG, 2016 data.

Figure 1: Share of Financial Sector Assets Controlled by Different Financial Organizations in Georgia



Source: NBG.

2.2 Deposits

The market for deposits in the country is also dominated by commercial banks. Non-bank depository institutions, such as credit unions, account for a tiny proportion (0.0326%) of the total deposits in the economy. The value of total deposits in commercial banks (both in domestic and foreign currency) amounted to GEL18.7 billion ($7.75 billion) by the end of Q3 2017, the same variable for non-bank depository institutions amounted to only GEL6.1 million ($2.5 million).

Other financial institutions, such as microfinance organizations, are barred by law from taking deposits. However, they are allowed to enter into loan agreements with private individuals and firms. Such loan agreements typically offer significantly higher interest rates on both foreign and domestic currency than regular bank deposits.[12]

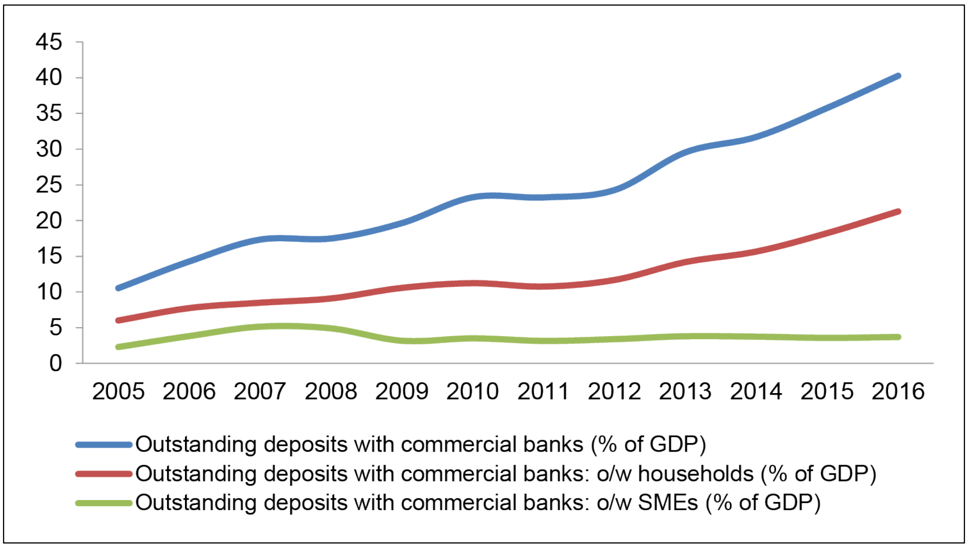
In the last 12 years, the number of commercial bank deposit accounts per 1,000 adults has been growing steadily; in 2005 there were 366 household deposit accounts per 1,000 adults, in 2016 this figure already reached 1,798 – a five-fold increase.

The indicators of access to deposit accounts have shown improvement over the years, but more so for households than for SMEs.

As the figures above indicate, outstanding deposits of SMEs with commercial banks, as a share of GDP, remained flat for the last 8 years (at the level of 3.1% to 3.7% of GDP), while household deposits grew impressively from 6.02% to 21.28% of GDP. While it is difficult to pinpoint the exact reason for this phenomenon, the low level of financial literacy may play a role here. Another concern is that remaining in the "shadow" of mainstream economic activity is still the preferred way of doing business for SMEs.

[12] Since July 2017, microfinance organizations can only enter into such loan agreements with customers if the amount of funds loaned exceeds GEL100,000 or an equivalent in US dollars. This regulation helped move large amounts of de-facto deposits from microfinances to commercial banks. For microfinances it means that they will increasingly rely on commercial bank loans for liquidity.

Figure 2: Outstanding Deposits with Commercial Banks, % of GDP (Total, Household, SMEs)



Source: IMF Financial Access Survey (FAS).

2.3 Lending

Commercial banks in Georgia also dominate the market in the total amount of loans issued. The amount of loans granted by banks to non-government, non-financial sector, and households *is roughly 13 times the amount of loans granted by the microfinance institutions.*[13] Overall, microfinance organizations lent GEL1.4 billion by the end of 2016 (equivalent to $0.59 billion[14]), while the commercial banks' total non-financial sector loans amounted to GEL18.9 billion ($8.0 billion). **In absolute terms, banks dominated the market in lending to households.** By the end of 2016 the microfinance organizations' loan portfolio was about GEL1.4 billion (the vast majority of these loans are to households and small business clients), while the commercial banks' household lending was GEL8.9 billion ($3.76 billion).

In relative terms, commercial banks' loans to households comprise just above 50% of their total loan portfolio. In contrast, the microfinance organizations' portfolio consists almost entirely of household and small business lending.

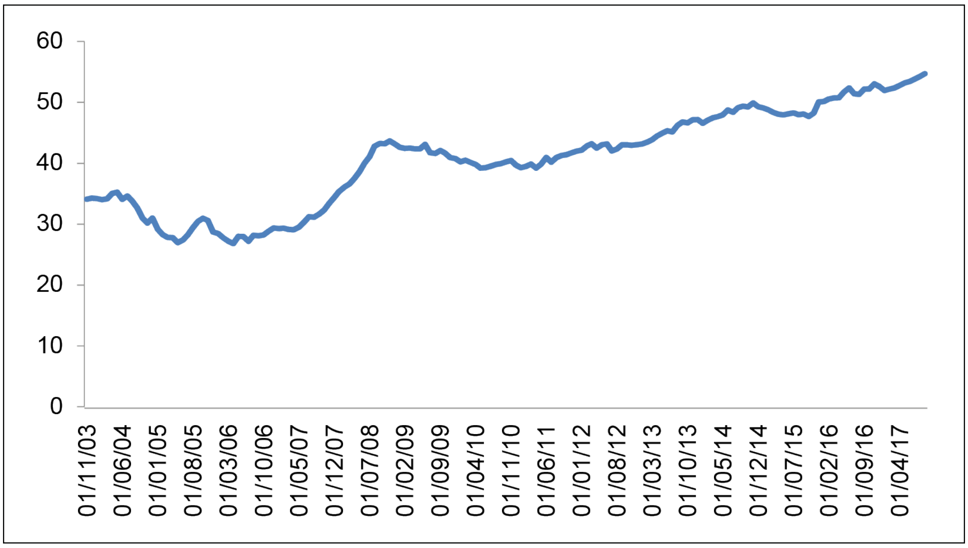
The figures on micro lending presented here do not include pawnshops. The pawnshops are periodically surveyed by the National Bank of Georgia,[15] which allows us to judge the relative size of the pawnshop lending market. For example, in the **2013 survey pawnshops had in total GEL310 million** ($186 million) in outstanding loans, whereas **the microcredit institutions in 2013 had about twice as much – GEL620 million** (or $373 million).

[13] For example, at the end of 2016 the total loans of the commercial banking sector amounted to GEL18.9 billion, while the loans of microfinances amounted to GEL1.4 billion.

[14] GEL amounts converted to dollars at the average annual exchange rate for the corresponding year.

[15] The pawnshop survey is scheduled to be repeated in 2017–2018.

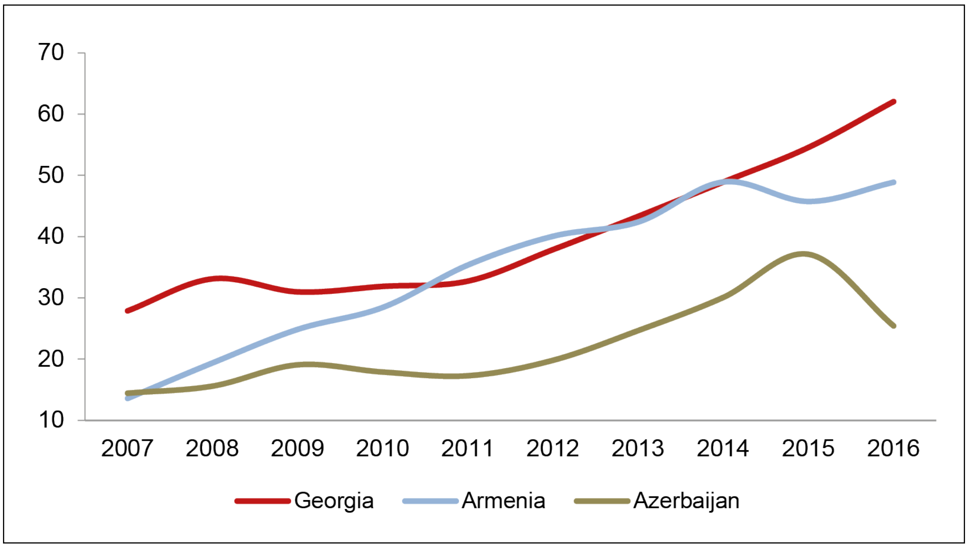
Figure 3: Household Loans as a Share of Total Loans of the Commercial Banks
(%)



Source: NBG.

According to the most recent data, **Georgia has the highest and fastest growing domestic credit to private sector as a share of GDP in the South Caucasus**. Since 2015 the country has been ahead of both Armenia and Azerbaijan. Private credit expanded to 62% of GDP in 2016, as Figure 4 below indicates.

Figure 4: Domestic Credit to Private Sector, % of GDP in the South Caucasus Countries



Source: IMF International Financial Statistics (IFS).

To a large extent, the growth in credit reflects borrowing by households. In particular, household debt has been rising since 2005, slowing down in 2009, and picking up again from 2011(following roughly the same pattern as the expansion of household loans in Figure 3). Overall, the household debt to GDP ratio has risen from 2.2% in 2001 to 30% in 2016.

2.4 Insurance

The market for insurance in Georgia is still quite small. The share of assets held by insurance companies is small, both relative to the size of the economy and the size of the financial system. For example, both in 2016 and in 2017, the gross earned market premium was just 1.086% of GDP. Health insurance holds the largest market share (49.7% of the total gross written insurance premiums), followed by Road Transport insurance (16%), and Property insurance (15.7%)

2.5 Pensions Services

In Georgia, the **size of the market for private pension schemes is very small.** All citizens above 60 years old (female) and 65 years old (male) receive a government pension of GEL160, which currently constitutes about 17% of the average wage in the country.

Despite the small income replacement rate of the current government pension, private pension schemes are not very popular, which is primarily due to the low incomes and low savings rates of the households.[16] In 2017, there were three private pension schemes in Georgia with 22,507 participants. By the end of Q2 2017, the combined pension reserves of these companies were GEL 24 million, which constituted only 0.07% of 2016 GDP.

Currently in Georgia, a supplementary (pillar II) Pension Savings System (with matching government and employer contributions) is seen as a way to improve the adequacy of the current pension scheme and stimulate long-term saving behavior. The draft law of the system is ready and is planned to come into force from the third quarter of 2018. Due to the low capacity for saving from labor income and high risks associated with political distortions and investments in the long run, questions regarding the risks and challenges related to this reform remain open.

2.6 Capital Markets

Georgia has only one organized security market – the Georgian Stock Exchange (GSE), founded in 1999. The stated market capitalization as of 3 January 2018 was $1.286 billion (around 8.5% of 2017 GDP), while daily turnover in January 2018 amounted to $11,185.[17]

The GSE operates two listed tiers (tier A and B) and an “admitted” tier. Companies must satisfy special requirements to be listed in A or B tiers. As of 8 January 2018, there were only three companies on the A list level (EBRD, Silknet, and Bank of Georgia); six securities were on the B listed level (Georgian Leasing Company, M2 Real Estate, Nikora Trade, Nikora, Liberty Bank, and Teliani Valley), while the “admitted” tier contains 97 securities. Only a few Georgian companies are listed on international stock exchanges. For example, as of March 2017, the equities of several Georgian companies like the Bank of Georgia (BGEO),[18] TBC Bank Group (TBCG LN),

[16] The rate of savings for old age is particularly low in Georgia. According to Financial Inclusion Indicators for 2014, in Georgia only 0.9% of the adult population saved for old age, compared to 12.5% in lower middle-income countries, and 11.7% in ECA developing countries.

[17] Source: Georgian Stock Exchange. http://www.gse.ge/en/about-gse

[18] It is worth mentioning that the Bank of Georgia (BGEO) was divided into two independent companies: Bank of Georgia Group (commercial bank) and BGEO Investment. Both of these companies will be listed on the London Stock Exchange.

and Georgian Healthcare Group (GHG LN), were actively traded on the London Stock Exchange.[19]

According to the recent literature assessing the development of the capital markets,[20] the Georgian equity market remains underdeveloped. There are several reasons for this. First, company owners are unwilling to give up their stakes and thus seek other sources of finance. Second, the cost of equity still remains high. Third, equities are considered to be much riskier investment opportunities for banks, retail clients, or other investors.

Despite the fact that the bond market should be relatively more attractive for firms and investors, as the cost of debt is lower than the cost of equity, bonds are still not the main source for attracting finance in Georgia. For instance, there were only six bond issuers in 2015 and this number increased only slightly, to eight in 2016. Some bonds (including those issued by resident legal entities in local currency) can be used by commercial banks as collateral for receiving refinance loans[21] from NBG.

The main legislative acts that regulate activities in the capital market are the “Law of Georgia on Entrepreneurs” and “Law of Georgia on the Security Market.” Recently Georgia prepared and approved a capital market development strategy and introduced new standards on: a) independent board members and audit committee; b) disclosure requirements for related party transactions and management compensation, and c) protection of minority investors. Furthermore, the Georgian government is planning to improve corporate governance standards by making the publishing of annual reports[22] based on the *International Financial Reporting Standards (IFRS)* mandatory for Georgian companies.[23]

2.7 Remittances

Remittances constitute an important part of Georgian national income. Studies estimate that about **1 million people benefit from remittance transfers from abroad**.[24] In recent years, the **amount of remittance transfers fluctuated between 12% and 10.5% of the country’s GDP**.[25] This number is much higher than the Eastern Europe and Central Asian (ECA) countries’ average of 1.4%. In 2016, Georgia was in 29th place among countries by the share of remittance transfers in GDP.[26] To the extent that remittances play a crucial role in alleviating poverty among the most vulnerable households and in supplementing the overall income and savings, their potential role in the country’s financial system is very significant. Yet, according to the 2007 EBRD survey data, only 1% of remittance recipients had a savings account in a bank, and

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[19] All of these three companies are listed in a premium equity listing category.

[20] For example: Asian Development Bank, “The Georgian Capital Market – Diagnostic Study and Recommendations,” 2015; Ministry of Economy and Sustainable Development of Georgia, “Capital Market Development Strategy,” 2016he; United States Agency for International Development (USAID), “Regulatory Impact Assessment Georgian Law on Securities Market,” 2014 by etc.

[21] Which represents one of the main instruments for commercial banks to manage liquidity.

[22] This new initiative will come into force step-by-step starting in 2018 for large and medium entities and 2019 for small and micro businesses.

[23] G. Paresishvili, *Georgian Capital Market Development* (Tbilisi: Georgia Stock Exchange, 2017).

[24] Source: Georgian National Public Opinion Survey on Remittances, July 2007, EBRD. Retrieved from http://www.ebrd.com/downloads/sector/etc/surge.pdf

[25] NBG, Balance of Payments data.

[32] World Bank data, 2018. ECA countries group refers to Europe and Central Asia (excluding high income countries).

about 11% of recipients had no bank account at all (despite the fact that 81% of the recipients had a “positive view” of banks in Georgia).[27]

Most remittance transfers were sent and received via money transfer operators (25% of senders and 35.6% of recipients). The **shares of remittance transfers sent or received via money transfer operators is about twice as high in Georgia than in other lower middle-income countries or the ECA region.** There are currently 106 registered money remittance transfer units in Georgia, according to the NBG data.

In 2014, about 22.1% of adult Georgians received money from abroad. Of these recipients, only 10% received transfers via financial institutions, while more than a third (35.6% of the recipients) used a money transfer operator. This may have to do with the fact that a vast majority of remittances come from the Russian Federation, thus official financial ties with Georgia are much weaker (and more expensive) for political reasons.

2.8 Technologies Driving Financial Sector Development

Georgia’s financial sector technologies are now in the stage of active growth. The following range of financial technologies is available for the general population and SMEs in the country: debit and credit cards, e-money accounts, mobile banking and mobile money accounts, e-wallets and mobile wallets, ATMs, POS terminals, payment service provider (PSP) terminals, and electronic signature services. These systems are used for making payments, receiving deposits, and transfers (including remittance transfers and salaries).

Distance banking services are among the most commonly used technologies, which include internet banking, telephone-banking, mobile-banking, and SMS-banking. Today, seven commercial banks have licenses for internet-acquiring from international payment systems and successfully serve their clients.[28] According to recent data from the Global Payment Systems Survey, the number of debit cards in circulation increased threefold in the last 5 years (from 2.5 million in 2010 to 7.3 million in 2015). As of December 2017, there were 8.3 million debit and 0.8 million credit cards issued in Georgia. Georgians actively use electronic payments to pay public utilities and purchase goods.[29]

Despite the significant progress made in recent years, according to the Global Payments Systems Survey (2016),[30] **the usage of financial technologies in Georgia is currently well below the regional average** (a detailed description and analysis is provided in the next section). For example, according to the Financial Inclusion survey of the World Bank, in 2014 the percentage of adults with a **debit card was 39.7% of the population, which is more than 10 percentage points lower than in the rest of Europe and Central Asia**.

[27] Georgian National Public Opinion Survey on Remittances, July 2007, EBRD.

[28] National Bank of Georgia. Electronic systems work with internationally recognized security technologies – 3 levels of card authentication (3D Secure).

[29] These goods are mainly purchased from Amazon, Alibaba, Aliexpress, and eBay.

[30] The Global Payments Systems Survey is provided by the World Bank.

Interviews with the representatives of financial institutions (commercial banks and Monetary Financial Institutions (MFIs)) confirm these findings. Financial executives in Georgia point to the low usage of financial technologies, such as ATMs, mobile, and e-banking, but the trend is improving rapidly. One of the reasons behind this is the relatively low internet usage in the country – **only 50% of the population reported to be internet users in 2016** (this is below the 62% in Armenia, 78.2% in Azerbaijan, and 63.7% in Europe and Central Asia developing countries). Also, as mentioned before, a very low percentage of Georgian youth are using banking services. However, as more and more young people enter the job market, the number of financial technology users is increasing, underlying the positive trend in usage.

The low usage of financial technologies increases the cost of doing business for banks. The share of personnel expenses and the share of fixed assets and inventory expenses in total expenses in the Georgian banking system have not changed much in the last 15 years and amounted to 24% and 5% respectively in 2017.

2.9 P2P Lending and Crowdfunding and Cryptocurrencies

In Georgia, new financial technologies include P2P lending platforms (e.g. among the most popular ones is Mintos.com), which work with various loan originators in Georgia. Unfortunately, as mentioned earlier, there is a conspicuous lack of reliable data on the size of this market. Based on the incomplete data obtained from the website of the P2P platform, the effective APR charged to borrowers by loan originators can be from 24% to 236%.[31] The interest rates offered to P2P investors range from 15.8% to 11.4%.[32] The amount of loans originated by these companies since founding range from €45 million to €203 million.[33] Such operations are typically outside the regulatory reach of the National Bank of Georgia. The online lenders are governed by the Civil Code of Georgia, which was recently updated to prohibit predatory lending.[34]

Similar to P2P lending, crowdfunding could potentially provide small investors with access to investment opportunities by raising funds from a large number of individuals or investors through online web-based platforms. However, this type of non-traditional funding is associated with a number of risks (fraud; asymmetric information; short-term nature of investments, etc.). Currently, there is very little reliable data available on crowdfunding opportunities for small enterprises in Georgia, and the market for crowdfunding is largely underdeveloped. Thus, **crowdfunding still remains outside of the regulatory realm of NBG**. However, Georgian government has already announced legislative amendments that will make it easier to finance investment projects using crowdfunding platforms.

The worldwide cryptocurrency boom reached Georgia quite early. The country managed to become a leader in mining cryptocurrencies due to cheap electricity, a liberal legislative system, and government-awarded privileges. According to a Global Cryptocurrency Benchmarking Study carried out by the Cambridge Center for Alternative Finance, in 2017 **Georgia was in the second place globally in terms of energy consumption for mining cryptocurrencies. Cryptocurrencies are not specifically regulated in Georgia**, although they have gained such popularity in the

[31] Information on loan originators from Georgia retrieved from the mintos.com website https://www.mintos.com/en/loan-originators/

[32] Ibid.

[33] Ibid.

[34] See Section 5 of this document for a more detailed description of the relevant changes to the Civil Code of Georgia.

country that NBG issued a special statement, warning citizens about the risks associated with cryptocurrencies. In this statement, NBG clearly indicates that cryptocurrencies are not a legal means of payment in Georgia and there is no agency that protects citizens against risks.[35] However, regulators have welcomed the use of blockchain technologies. In 2016, the Georgian government,[36] even started to use blockchain technology for storing the registration data of the Georgian Public Registry's land and real property. Furthermore, the Georgian Ministry of Justice plans to introduce blockchain for business registration.

Improving financial technologies and access to them is one of the most important challenges for the Georgian financial system. Higher demand for internet banking and other distance banking services will reduce the operational costs of commercial banks, reduce interest rates, and improve access to finance for individuals and firms through regulated financial institutions.

3. STATUS OF FINANCIAL INCLUSION FOR INDIVIDUALS AND SMES

Different studies on financial inclusion, in particular cross-country studies, tend to use a wide variety of indicators to measure financial inclusion. Mostly the choice of indicators suitable for cross-country analysis depends on data availability. The set of indicators typically used in the financial access literature can be grouped into the following categories:

Access indicators (the number of ATMs, bank branches per 1,000 adults, the number of PSP branches, etc.); **Outreach indicators** (such as geographical and demographic penetration of financial services); **Usage indicators** (number of debit and credit accounts, the volume of deposits and lending to SMEs and households, etc.); **Quality indicators** (disclosure requirement, dispute resolution, cost of usage).

In this section, we will summarize the status and identify the main trends in financial inclusion for both individuals and SMEs in Georgia and put these trends in a wider regional context.

3.1 Access Indicators

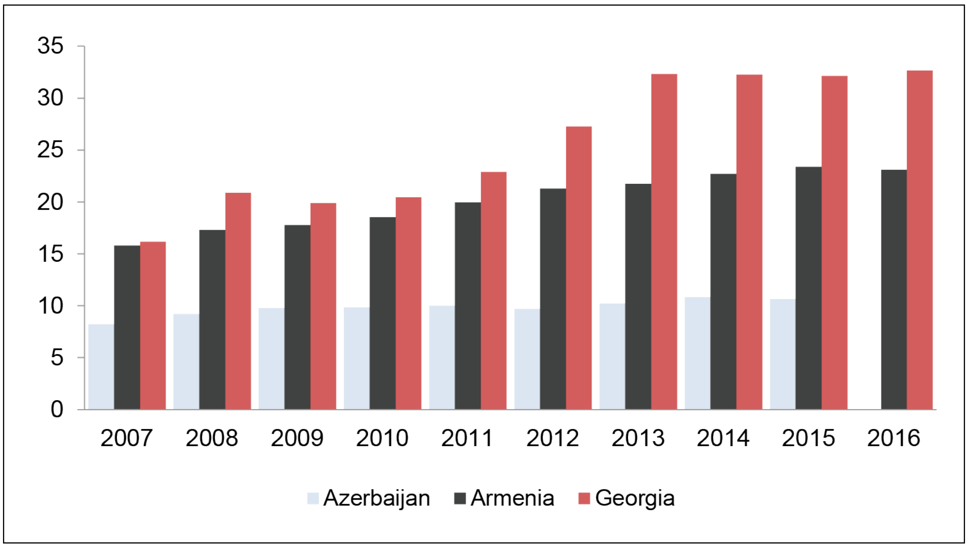
3.1.1 Access to ATMs, Banks, and Payment Services

The figures below compare the number of commercial banks' branches and ATMs per 100,000 adults in the South Caucasus. **Among the South Caucasus countries Georgia is clearly leading in terms of access to commercial bank branches, and the number of ATMs per 100,000 adults.**

[35] Source: https://jam-news.net/?p=88795

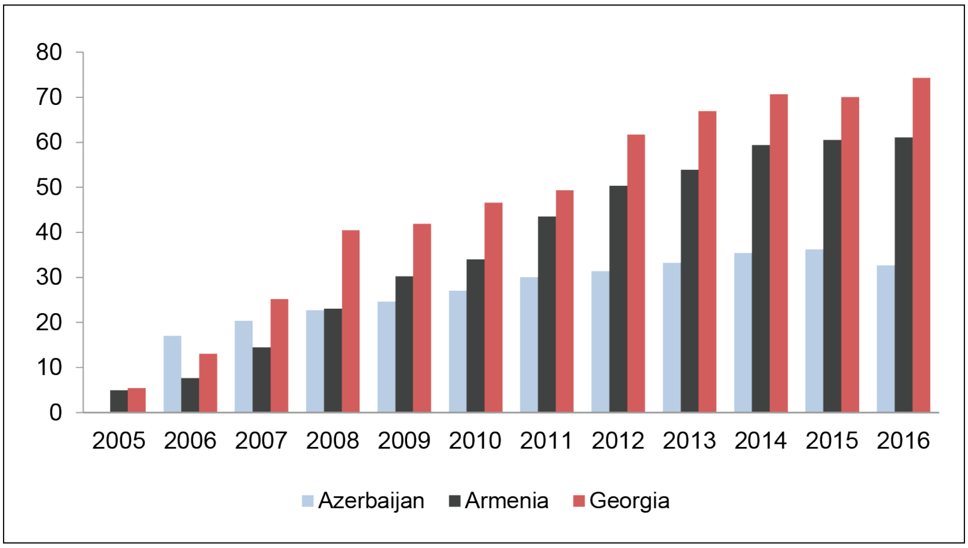
[36] In partnership with Bitfury. Bitfury, the world's leading Bitcoin mining company that owned 15% of total Bitcoin generation in 2016.

Figure 5: Branches of Commercial Banks per 100,000 Adults in the South Caucasus



Source: Financial Access Survey, WB.

Figure 6: The Number of ATMs per 100,000 Adults in the South Caucasus Countries



Source: Financial Access Survey, WB.

Other indicators of financial access have also been evolving quite rapidly. For example, the number of POS terminals has increased three-fold in the last 5 years. The number of branches of Payment Service Providers (PSP) has also increased quite dramatically, from 641 to 1,769 in 5 years.

3.1.2 Geographic and Demographic Outreach

One of the first indicators of geographic outreach in financial services is the number of bank branches and ATMs available outside the major cities (Tbilisi, Batumi, and Kutaisi). The data shows a clear improvement in the absolute number of ATMs and bank branches available in the regions (the number of ATMs outside the three major cities rose from just 31 in 2005 to 674 in 2016; the number of bank branches grew from 141 in 2005 to 427 in 2016). Yet, a **significant share of the population in the regions of Georgia remains underserved**. According to the latest (2014) Census figures, the Georgian population in the three largest cities accounts for 36.5% of the total population. In the same time, **the bulk of access to financial services was concentrated in the largest cities**. This can be illustrated by the simple fact that the share of ATMs in the three largest cities compared to the total number of ATMs in the country was about 70% in 2016, much higher than the share of the population living in these cities. The share of ATMs in the three largest cities was even higher in 2005, reaching 83% of the total. Similarly, the share of bank branches in the three largest cities is about 56% of the total, although, as mentioned earlier, the share of the population living in the largest cities is about 36.5%.

3.2 Usage Indicators

3.2.1 Deposit or Savings Accounts

Table 1 below gives a snapshot of the deposit/savings account access status for the adult population in Georgia, 2014, in comparison with the ECA region and lower middle-income countries.

Table 1: Select Financial Inclusion Indicators for Georgia, 2017

Financial Inclusion Indicators for Georgia (2017)	Country Data	Europe & Central Asia (excluding high income)	All Lower Middle-Income Countries
Accounts (% age 15+)			
All adults	61.2	65.3	57.8
Women	63.6	62.5	53.0
Adults belonging to the poorest 40%	46.1	56.3	50.7
Young adults (% ages 15–24)	30.7	50.1	49.4
Adults living in rural areas	55.1	61.7	57.6

Source: Global Financial Inclusion Survey, WB.

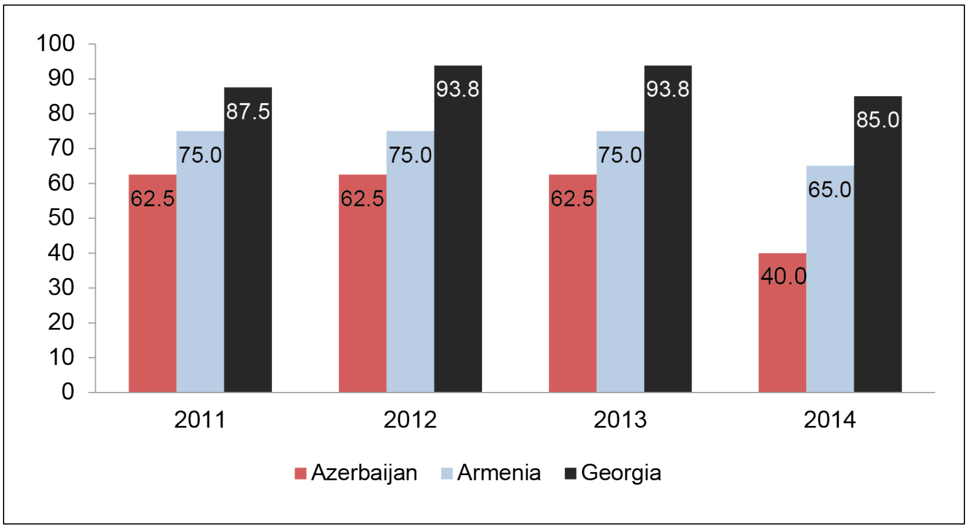
The most striking feature of financial inclusion in Georgia is the **low percentage of young adults with deposit or savings accounts (30.7%, as compared to 50.1% in the ECA region- almost 20 percentage point difference in 2017).** Even though, the current situation shows a dramatic improvement from 2014, when the data showed that only 9.9% of young adults in Georgia had a deposit or a savings account. This result is likely driven first by the low rate of economic activity among youth (57.6% of the 20–24 age cohort in 2016 were economically active) and high rate of unemployment in this cohort (30% in 2016). Secondly, lack of economic independence leads to the lack of financial inclusion among the youth.

As the data in Table 1 indicates, **adults belonging to the poorest 40% of the population are also underserved** compared to the regional average (ECA) and to the indicator for lower middle-income economies. On the other hand, **the share of women with deposit or savings accounts in Georgia is about 63.6%.** This number is higher than in other low middle-income countries (53% of the population), and also higher (by about one percentage points) than in the ECA region.

3.2.2 Credit Usage Indicators

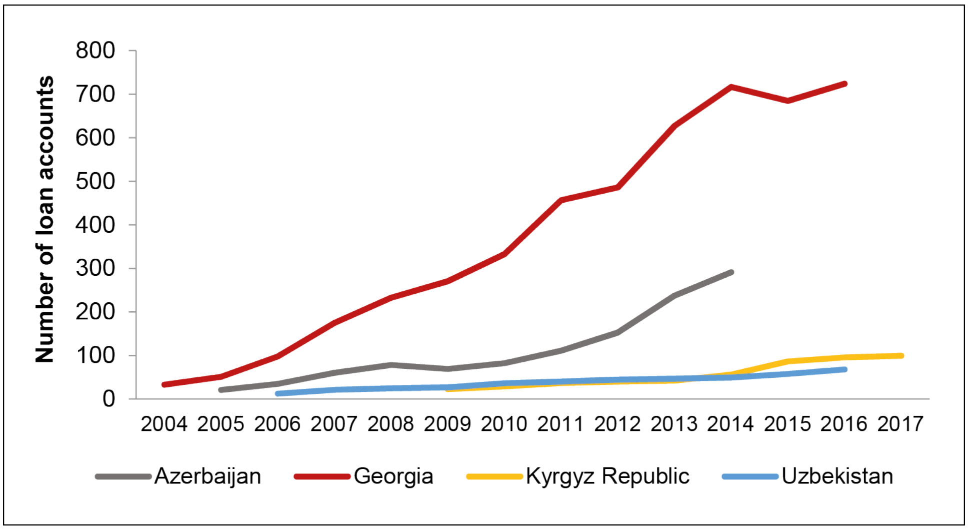
In terms of access to credit, **Georgia is one of the countries with the greatest ease of access in the South Caucasus.**[37]

Figure 7: Getting Credit: Distance from the Frontier in the South Caucasus Countries



Source: G-20 Financial Inclusion Indicators.

Figure 8: Borrowers from Commercial Banks per 1,000 Adults



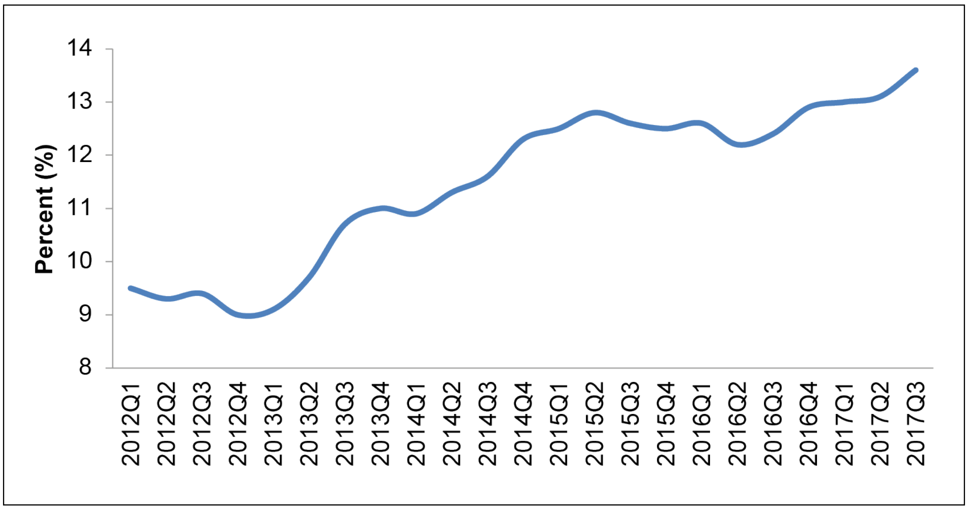
Source: IMF Financial Access Survey (FAS).

[37] According to G-20 Financial Inclusion Indicators, the Getting Credit indicator measures "the strength of credit reporting systems and the effectiveness of collateral and bankruptcy laws in facilitating lending. Measured as 'distance to frontier'... This measure shows the distance of each economy to the WBG Doing Business 'frontier,' which represents the best performance observed on each of the indicators across all economies in the sample since 2005…. An economy's distance to frontier is reflected on a scale from 0 to 100, where 0 represents the lowest performance and 100 represents the frontier. For example, a score of 75 in DB 2015 means an economy was 25 percentage points away from the frontier constructed from the best performances across all economies and across time." Source: G-20 Financial Inclusion Indicators note, GPFI Global Partnership for Financial Inclusion. Retrieved January, 2018 from http://datatopics.worldbank.org/g20fidata/home#void

Georgia is ahead of Azerbaijan and some Central Asian countries on the number of borrowers from commercial banks per 1,000 adults.

Yet, in recent years the indebtedness of households (measured by principal payments to income ratio) grew rapidly. In 2015, the debt service to income ratio reached 12.8%. The debt service to income started declining in 2015–2016[38] only to increase again following another round of GEL depreciation reaching a record high of 13.6% in the third quarter of 2017.

Figure 9: Household Debt Service: Principal Payments to Income Ratio



Source: NBG.

In addition, the amount of real estate and movable property repossessed by microfinance firms has increased very sharply in 2013 and then again in 2015 (from GEL2.5 million in Q1 2013 to GEL16.7 million in Q3 2017 – more than 6.5 times). The rapid increase of defaults was most likely due to the fact that most of these loans were denominated in US dollars, creating currency mismatch problems for indebted households.

Despite the fact that household finance indicators showed clear signs of stress, in particular after Q1 2015, **non-performing loans (NPL) as a share of the total loans of commercial banks remained quite low and stable** (the average NPL was 7.6% between Q1 2015 and Q2 of 2017, based on the more conservative NBG methodology for tracking NPLs. According to the IMF methodology the NPL share was just 3.3% on average in the same period). This discrepancy suggests that financially vulnerable groups of population still remain outside the realm of bank lending.

Thus, in Georgia the rapid growth in consumer credit prompted concerns about the sustainability of credit expansion. Georgia's main financial concern was not so much about access to credit, but about making sure that borrowers were protected and were making informed decisions. Since then, the **government of Georgia and the NBG called for stronger consumer protection measures, pushed for rapid de-dollarization of small and medium-size loans and stepped up the efforts to promote financial literacy.** Sections 5 and 6 of the paper examine these issues in greater detail.

38 Most likely the decline was caused by the fact that fewer households qualified for loans from banks in that period.

3.3 Financial Inclusion of SMEs

As mentioned earlier, while the financial access indicators for households were growing rapidly, the same indicators for SMEs stayed largely the same. According to the World Bank Enterprise Survey 2013 data, **20.4% of SMEs identified finance as a major constraint (in the ECA region this figure for SMEs is 16.4%).**

Outstanding loans to SMEs accounted for only 7.5% of GDP in 2016, while outstanding loans to households account for 26% of GDP in the same year. The share of SMEs with a bank loan or line of credit constituted 30.3% of the firms, the same percentage as in the ECA region and 2 percentage points higher than the world average.

This indicates that while **receiving a loan per se may not be a problem for SMEs in Georgia (as compared to the ECA region and other countries), securing the desired amount of funding may be problematic.** From the table one can see for example that only 7.2% of SMEs reported their recent loan application rejected, while the figure is much higher, 14.6%, in the ECA countries.

Table 2: Enterprise Survey for Georgia, 2013

Indicators, Enterprise Survey, 2013	Georgia All Firms	Georgia SMEs	Europe & Central Asia SMEs	All Countries, SMEs
Percentage of firms with a bank loan/line of credit	35.8	30.3	32.7	28.3
Proportion of loans requiring collateral (%)	95.6	97.9	75.7	77.3
Value of collateral needed for a loan (% of the loan amount)	223.3	232	197.9	217.5
Percentage of firms whose recent loan application was rejected	**4.6**	**7.2**	**14.6**	**14.9**
Percentage of firms using banks to finance investments	22	15.3	22.3	23.2
Percentage of firms identifying access to finance as a major constraint	**18.3**	**20.4**	**16.4**	**27**

Source: World Bank Group.

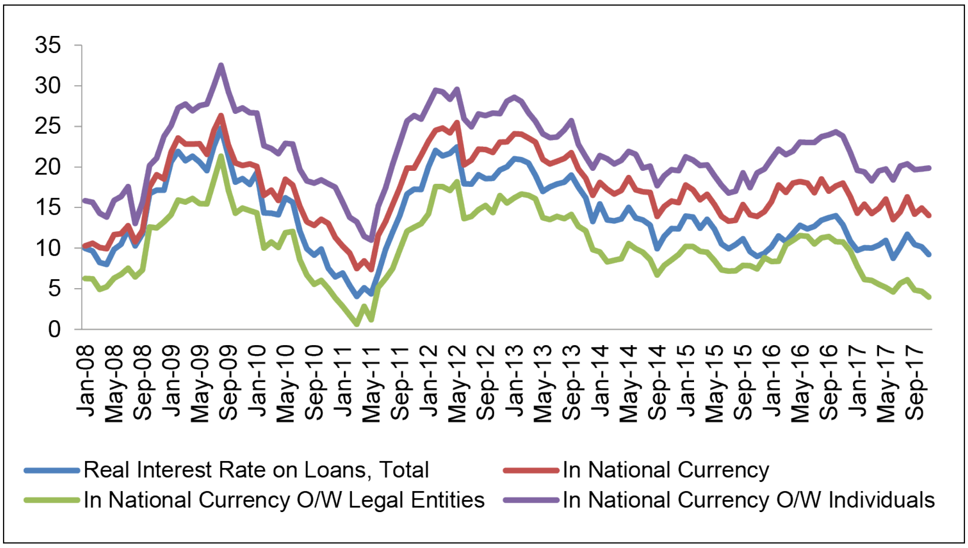
Finally, an important indicator of financial access for both households and firms is the cost of funds, in Georgia's case the cost of funds is largely determined by interest rates on loans charged by different financial institutions. Figure 10 below indicates that real interest rates on loans have been on a declining trajectory since 2012.[39] Real interest rates went up again briefly in 2015 following the regional crisis and devaluation of GEL, then started falling again from September 2016, when the currency value stabilized.

From January 2017 a new law prohibited the issue of loans in foreign currency for loan amounts below GEL100,000 (this was part of the de-dollarization campaign by NBG and the government). Since most banks and microfinance organizations raise funds in US dollars, the cost of financing lari loans has increased. According to interviews with bank and MFI executives the **cost of hedging the currency risk on a lari loan increased from 3–4% to over 10%.** Part of these cost increases could be passed on to the consumers in the form of higher interest rates, although some financial institutions opted to keep lending interest rates at about the same level in

[39] The prominent dip and a sharp rise in real interest rates during the years after the financial crisis of 2008–2009 was largely driven by the behavior of the inflation rate, which fell in September 2009 and rose sharply again until May 2011.

order to avoid raising the risk of their customer pool. The interest rates on loans in foreign currency, on the contrary, decreased.

Figure 10: Market Real Interest Rates on Loans in National Currency, by Category



Source: NBG.

3.4 Summary

To summarize the results of this section, **Georgia has been improving rapidly on a number of financial inclusion indicators,** in particular in the access to payments systems, new financial technologies, number of savings/deposit accounts, and credit to households. For households, the main concern is not so much the access to credit, but rather **low levels of income, low levels of savings, provision for retirement, and low levels of financial literacy**.

The SMEs in Georgia report problems with access to finance. According to the data, access to deposit and savings accounts is high for SMEs, but in fact SMEs save very little. Moreover, while the number of SMEs with loans and lines of credit from the bank is reasonable (on a level with the world and regional average), **SMEs may be credit constrained in the sense that the amount of funds they can secure from banks is seen as insufficient for the development of the business.** Interviews with commercial bank and MFI executives point largely in the same direction – many SMEs would like to borrow more than their financial situation could allow.

4. BARRIERS TO FINANCIAL INCLUSION

4.1 Supply Side Barriers

The supply side barriers to financial inclusion refer to the factors which limit the ability of financial institutions to extend deposit, savings, and/or credit to households and businesses. Among them the literature distinguishes between market driven, regulatory, and infrastructure-related barriers.

Among the main markers of ***market-driven barriers*** to financial inclusion identified in the literature are:

- relatively **high maintenance costs** of small deposits and loans;
- **high costs of providing financial services in small towns and rural areas** (e.g. transport-related problems);
- **information asymmetry** on the market (lack of credit data about the clients and/or lack of usable collateral);
- lack of **convenient access points** to financial services.

Among the markers for ***regulatory barriers*** are:

- strict **requirements for opening branches and ATMs**;
- strict **identification requirements** which can limit access of poor households;
- **restrictions on foreign ownership** may restrict the entry of financial institutions, including MFIs.

The ***infrastructure barriers*** could be inferred from:

- lack of **reliable payments and settlements system**;
- limited availability of **phone access** (either fixed or mobile phones);
- lack of **convenient transport** to ATMs;
- lack of reliable **internet connection**.

From the data presented in the previous section, small town and rural areas in Georgia may indeed be underserved in terms of access to financial infrastructure, such as ATMs, bank branches, etc. Georgia is behind the regional average (Europe and Central Asia) in access of rural, and particularly poor households to financial services, such as deposit accounts.[40] The existing data, unfortunately, does not provide a clear answer as to the drivers behind low financial inclusion figures.

We have conducted a series of interviews with the executives of large commercial banks and MFIs in Georgia to better assess the issue of supply-side barriers. According to the interviews, the **cost of servicing small loan and deposit accounts is not the main obstacle to financial inclusion**. The costs of **providing services outside major cities** and servicing the lower-income population may indeed be higher, especially for MFIs which mainly serve households, including lower income households. For MFIs, about 6 percentage points of the interest rate on household loans are due to operational cost requirements. Thus, **the operational costs are estimated to contribute about one-quarter to the total cost of credit.** This includes the need to maintain and train staff (one of the large MFIs with a loan portfolio of GEL150 million maintains 50 branches around the country and a staff of around 800 employees).

[40] Table 1 indicates that 46.1% of adults belonging to the poorest 40% of the population have deposit accounts, which is about 5 percentage points lower than in other lower middle-income countries, and 10 percentage points lower than in the ECA region. About 55% of adults in rural areas are served with deposit accounts, which is close to 7 percentage points lower than in the ECA region, but the percentage of the rural population served is about the same in other lower-middle income countries.

Informational asymmetry is less of a problem for MFIs, who adhere to a relationship-based banking model. Even commercial banks in Georgia have largely avoided this problem thanks to the **credit database maintained and shared among the financial institutions**. The subscribers to the database can see whether a particular physical person or a company has ever defaulted, the number of defaults, and the size of defaults. The presence of a customer's name in the database is not an automatic reason to disqualify a loan application, and financial institutions look at the pattern of defaults or amount of defaults to assess the client's creditworthiness.[41]

Transport and access to financial services is not a major problem, considering that large MFIs and the commercial banks oriented on servicing small deposits and loans (e.g. Liberty Bank, which services government-provided pension plans for the elderly population) have already established extensive networks outside of the major cities, relying on the so-called mobile branches to reach their client base. The **regulatory barriers to access in Georgia are probably least problematic,** as there are no strict requirements on operating branches and ATMs, and no restrictions on foreign ownership for financial institutions (which could limit the amount of foreign funds entering the market). The current regulations on **identification requirements are indeed cited by the banks as one of the problems for increasing financial access.** According to regulations, opening a bank account requires the physical presence of a customer (business or a household client) in the branch to sign the required documents. Although e-signature technology is available, it cannot be used at present to open a deposit account.

The **infrastructure barriers, such as poor internet connection, lack of phone (mobile or landline) network, transport, etc. are not a major concern for the financial institutions**. The number of mobile subscriptions in Georgia is quite high – 129 per 100 persons in 2016, which is higher than in other countries of the South Caucasus and higher than in the region (Europe and Central Asia's average is 125 per 100 persons). Internet coverage is available throughout the country, although internet usage in Georgia is not as widespread as mobile phone usage. According to World Bank data only 50% of the population in Georgia use the internet, as compared to 73.9% in the ECA region, 62% in Armenia, and 78.2% in Azerbaijan.

While the **use of mobile or internet banking may not be widespread, the usage is rapidly improving**, suggesting that there **is large potential for including a larger share of the population in the financial services.**

4.2 Demand Side Barriers

Demand side barriers to financial inclusion consist of all the factors that can limit the demand of households for financial services. The major factors include but are not limited to the following aspects:

- **low income levels of the population;**
- **lack of knowledge (low levels of financial literacy);**
- **lack of trust towards financial institutions;**
- **institutional aspects, for example, bankruptcy law, assessment of creditworthiness, etc.**

[41] See Section 5 for more information on CreditInfo, the private credit bureau in Georgia.

The demand side barriers to financial inclusion are indeed very prominent in Georgia.

In particular, **the low income levels** of the population can be named among the most important barriers. One piece of evidence in this regard is the high share of the population in Georgia living on less than $3.10 per day. The share of the population below this threshold in Georgia was 34.8% on average between 2005 and 2015. In 2015, the rate was 25.3%[42]). Such high poverty rates are not common in other countries in the region. Armenia, for example, has a comparable GDP per capita,[43] but the share of the population living on less than $3.10 per day was on average 20% in the same period of time, and only 13.5% in 2015.

Several surveys[44] which touched upon the savings behavior of households in Georgia reveal that only a small share of the population manages to save money in some form (the estimates in different years range from as low as 16% in 2011 to 37.9% in 2016). In addition, the surveys reveal (OECD/INFE survey) that 61% of Georgians were unable to make ends meet at least once in the last 12 months, and 45% resorted to borrowing. The Savings Behavior Survey (2011),[45] which makes a distinction between rural, urban, and Tbilisi responses, showed that in villages the percentage of household who currently had savings was lower (12% vs. 16% overall). The same survey revealed that people with a monthly family income of GEL700 (about $424 at the time) were three times more likely to save money than people with income below that level.

Low financial literacy is another serious barrier which is discussed in more detail in Section 6 of the paper. **Lack of trust towards the financial system** is not a big problem in Georgia. The country enjoys high levels of popular trust in banks, which is confirmed in several surveys. For example, according to the ISET-PI/TBC survey of financial literacy, 79% of the surveyed population unconditionally trust the banks with their money, while 85% of the population would not entrust their money to other financial institutions (e.g. credit union or microfinance). This result is corroborated by evidence from the World Gallup Poll (2013)[46] which showed that in Georgia 62% of respondents reported to have confidence in the banks. In fact, **Georgia's trust in banks was 5th highest among European countries.**

One survey result that stands apart from these findings is the Caucasus Research Resource Center (CRRC) poll Caucasus Barometer of 2015. In the survey one of the questions people were asked was "how much you trust or distrust Georgian banks?" As many as 34% of respondents fully or somewhat distrusted Georgian banks. The reasons for this result are discussed in more detail in the financial literacy section of the paper.

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42 World Bank data.

43 According to World Bank data, $3,606 in Armenia to $3,853 in Georgia in 2016

44 Among them: Saving Behavior Assessment Survey in Georgia, 2011, ACT Research, Saving Banks Foundation for International Cooperation, January and February 2010–2011, Tbilisi, Georgia https://nbg.gov.ge/cp/uploads/research/sbfic.pdf ; ISET-PI and TBC Bank Financial Literacy Survey in Georgia, 2016 (available only in Georgian); Georgian National Public Opinion on Remittances, EBRD-ETC initiative, January 2007. OECD/INFE International Survey of Adult Financial Literacy Competencies, OECD 2016, Financial Literacy and Financial Inclusion Study, NBG and EFSE DF, November 2016, Georgia

45 Savings Behavior Assessment Survey in Georgia. Tbilisi, Georgia: ACT Research, 2011.

46 http://news.gallup.com/poll/162602/european-countries-lead-world-distrust-banks.aspx

The institutional aspects, such as adequate bankruptcy law, assessment of creditworthiness, etc. do not feature very prominently and are largely overshadowed by the other factors (low incomes and low financial literacy levels). Interviews conducted in the course of this study with microfinance organizations suggested that microfinances do not automatically exclude people from borrowing on the basis of low credit score and tend to look at the entire credit history and current circumstances of the household before making a decision on lending.

5. REGULATORY FRAMEWORK AND FINANCIAL INCLUSION

5.1 Regulatory Framework and Policies to Promote Financial Inclusion for SMEs and Households

Currently in Georgia there is no official document outlining the country's financial inclusion strategy. **Greater financial access to SMEs**, however, is a stated priority for the government in several strategic documents, such as Georgia 2020 Socio-economic Development Program,[47] and in SME Development Strategy of Georgia 2016–2020.[48] According to the SME development strategy document, improving access to finance for SMEs would be achieved via the following policy actions:

- improving financial literacy among SMEs
- training to help SMEs conduct financial reporting and meet the IFRS requirements
- increase knowledge of fundraising among SMEs
- attract SME-oriented private equity funds to Georgia
- via existing programs, like "Produce in Georgia" enhancing existing schemes of SME financing via commercial banks and MFIs
- Improve SME financing through grants.

Currently, the government program that is specifically aimed at SMEs is the Micro and Small Business Support Project of Enterprise Georgia.[49] The project offers financial assistance to startups as well as expanding companies in the form of grants between GEL5,000 and GEL15,000. The project started in 2016, and in total 5,313 entrepreneurs were supported by an average grant of GEL7,276 per project.[50]

[47] Social-economic Development Strategy for Georgia "Georgia 2020", Government of Georgia, 2016 http://www.mrdi.gov.ge/sites/default/files/social-economic_development_strategy_of_georgia_georgia_2020.pdf

[48] SME Development Strategy for Georgia 2016-2020, Government of Georgia, 2016 http://www.economy.ge/uploads/files/2017/ek__politika/eng_sme_development_strategy.pdf

[49] Enterprise Georgia is a government agency established under the Ministry of Economy and Sustainable Development. It is mandated to facilitate private sector (and in particular SME) development through a variety of financial and technical support mechanisms, as well as export support.

[50] A different program, "Produce in Georgia," that is aiming at financial, technical, and infrastructural support of enterprises covers SMEs only partially. The requirements of the program apply mostly to medium and large size companies. The program has three main components: (i) access to finance component (co-financing the loan interest and supporting with the secondary collateral); (ii) technical support (supporting the enterprise with training and consultations); and (iii) infrastructural component (transfer state property to the beneficiary for GEL1).

The same agencies are implementing different projects with smaller scale and specific objectives. For example, Enterprise Georgia is supervising a separate project for the promotion of hospitality. APMA[51] is involved in agro insurance, garden development, and other agriculture-related programs. In addition, the Georgia's Innovation and Technology Agency is implementing financing programs for startups only in the field of commercialization of innovative projects. So far six startups were supported by the program. All these **programs partially cover SMEs in certain sectors**, but unfortunately **do not act as a holistic mechanism for the support of a wide variety of SMEs in the country.**

As far as financial access of households is concerned, Georgia has a comprehensive financial education strategy developed by the National Bank of Georgia.[52] The strategy is described in more detail in Section 6 below. The country, however, does not have any government-managed debt relief programs to help alleviate existing debt burden.

5.1.1 Deposit Insurance

A deposit insurance scheme was launched in Georgia in 1 January 2018. According to the scheme, all bank deposits in Georgia are insured for up to GEL5,000[53] ($2,066 equivalent).[54] The economic literature suggests that explicit deposit insurance might increase depositors' confidence and prevent bank runs. However, the deposit insurance scheme also gives commercial banks incentive to undertake unnecessary risks (the "moral hazard" problem) and increase lending and borrowing spreads.[55]

The direct effect of the newly introduced deposit insurance on financial stability is likely to be quite limited, as Georgia already has a successful regulatory framework[56] that has proved to be resilient toward large negative shocks on the financial market.[57] Large commercial banks that currently dominate the financial market, already enjoy implicit deposit insurance.[58] The newly introduced deposit insurance, however, may have an effect on people with lower levels of financial literacy. For them, a deposit insurance scheme may deliver a much clearer guarantee of trustworthiness than any refinement of regulatory framework (such as the introduction of Basel III).

5.1.2 Credit Data

In the early years of transition (till 2005), Georgia had neither a private nor a public credit bureau which would assess creditworthiness of individuals and legal entities. In 2005, "CreditInfo Georgia" was created as a joint venture between CreditInfo International and three large commercial banks (Procredit Bank, TBC Bank, and Bank

51 Agricultural Projects Management Agency.

52 National Strategy for Financial Education in Georgia, the National Bank of Georgia, 2016 https://www.nbg.gov.ge/cp/uploads/stategy/FinLit_Strategy_ENG.pdf

53 "Who is Insured?" Deposit Insurance Agency of Georgia, 2017, http://diagency.ge/en/who%20is %20insured

54 Converted using the exchange rate of Q3 2017.

55 Carapella, Francesca, and Giorgio Di Giorgio. Deposit insurance, institutions and bank interest rates, Columbia University Discussion Paper series. Columbia University Academic Commons, 2003, https://doi.org/10.7916/D8K64W87.

56 Based on the most recent Basel III regulatory framework.

57 The case in point here is the regional crisis of 2014–2015, which saw a sharp depreciation of regional currencies, but the Georgian banking system remained stable.

58 Since in Georgia the two largest commercial banks account for the majority (60%) of total financial sector assets, the likelihood of a bailout in case of a banking crisis is quite strong.

of Georgia).[59] By February 2017, the database of "CreditInfo Georgia" was providing information about more than 2.5 million individuals (88.6% of the adult population[60]) and 70,000 companies[61]. The coverage increased to 95.7% of the adult population in 2017. This is higher than the same measure for countries in the European Union in 2017 (54.2%) and ECA developing countries (40.6%).

5.2 Structure of Regulatory Framework

In Georgia, the basic relationships between lenders and borrowers are regulated by the **Civil Code of Georgia**, while the main institution responsible for handling supervision of the financial sector in the framework of the financial stability is the National Bank of Georgia.[62] One of the main responsibilities (and targets) of NBG is to contribute to the stable functioning of the financial sector. Therefore, NBG has been granted full authority to carry out supervision of activities of **commercial banks** and **non-bank financial institutions**: *credit unions, microfinance organizations, securities registrars, brokerage companies (excluding insurance brokers), stock exchanges, etc.* Central Bank is also authorized to regulate money transfer agents and foreign exchange bureaus to prevent legalization of illicit income and circulation of forged money.[63]

The Organic Law of Georgia on the National Bank of Georgia also defines the notion of the Qualified Credit Institution – a legal person (excluding commercial banks) that satisfies at least one of the following criteria:

- Attracts funds from more than 400 people;
- The amount of funds attracted exceeds GEL5 million ($2.07 million equivalent).

The supervision of insurance companies and pension schemes is conducted by a separate agency, State Insurance Supervision Service of Georgia.[64] **Other financial institutions, including pawnshops and online loan providers are outside of NBG supervision and are regulated only by the Civil Code of Georgia.**

5.3 New Regulations Affecting Consumer Protection and Access to Finance

At the end of 2016, the Georgian Parliament approved the law on an amendment to the Civil Code of Georgia. The Georgian Government introduced the following additional regulations related to lender liabilities, interest rates on loans, and restrictions on attracting new funds:

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59 International Risk Partnership (IRP). *Review of CreditInfo Georgia and the Georgian Economy.* Tbilisi: IRP, 2017.

60 World Bank database about private credit bureau coverage (% of adults).

61 Society and Banks. *Role of the Credit Bureaus in Development of the Financial Sector of Georgia.* Tbilisi: Society and Banks, 2017

62 The functions and responsibilities of the NBG as a supervisor are defined in Articles 95 and 96 of the Constitution of Georgia, Organic Law of Georgia on the National Bank of Georgia, and other laws, regulations, orders, and rules.

63 Organic Law of Georgia on the National Bank of Georgia.

64 State Insurance Supervision Service of Georgia was established as a separate legal entity of public law since March 2013. Until then this entity was a department of the National Bank of Georgia.

- **Effective annual interest rate of the loan shall not exceed 100%, including the extension of the loan term**. This regulation (**interest rate cap**) aims to *protect borrowers from the excessively high interest rates (mainly charged by online loan providers).*
- The total amount of any fees related to the loan provision, any cost of the loan agreement, penalties imposed on each day for any violation of the loan agreement, and any form of financial sanctions shall not exceed the annual 150% of the residual amount of the loan principal of the loan provided according to the agreement.
- **Loans up to GEL100,000 for individuals (not legal entities) shall be issued only in national currency.** Loans that are issued in the national currency but indexed or linked to a foreign currency shall not be considered as national currency loans. *This regulation aims to facilitate de-dollarization of loans and further reduce foreign currency (FX) risks for borrowers.*

The efforts to impose interest rate caps and de-dollarize lending aimed to protect consumers became a political issue after a series of lari devaluations of 2013–2016. The unintended consequences of these regulations could be the **higher cost of hedging instruments for banks and MFIs; higher domestic currency interest rates for households, and, consequently, less affordable loans for households.** On the other hand, **lending in foreign currency for legal entities, such as SMEs, could become cheaper.** This would be particularly advantageous for export-oriented SMEs.

6. FINANCIAL EDUCATION AND FINANCIAL LITERACY IN GEORGIA: WHAT DO WE KNOW?

Financial literacy is indeed seen by many stakeholders (commercial banks, MFIs, the National Bank of Georgia) as the **key to improving the financial well-being of households in Georgia**. Since several waves of lari devaluation hit borrowers in 2013–2016, the Georgian Government has been pushing for tougher consumer protection and sweeping de-dollarization measures, while the National Bank of Georgia was also advocating for the improvement of financial literacy levels among the general population.

As part of the effort to establish a baseline for financial literacy outreach in the country, a number of studies and surveys have been undertaken. Among them, were 1) the financial literacy survey conducted by the ISET Policy Institute, together with the TBC bank and TNS[65]; 2) the financial literacy study conducted by NBG[66]; and 3) the OECD/INFE International Survey of Adult Financial Literacy Competencies.[67] The main results of these surveys are summarized below.

[65] http://iset-pi.ge/index.php/en/private-sector-projects/completed-projects/1360-financial-consciousness-research-in-georgia-geo

[66] Financial Literacy and Financial Inclusion Study. The report was prepared by Sonar for the National Bank of Georgia, November 2016.

[67] https://www.oecd.org/daf/fin/financial-education/OECD-INFE-International-Survey-of-Adult-FInancial-Literacy-Competencies.pdf

6.1 Financial Literacy

6.1.1 ISET-PI TBC Survey

In this survey, a nationally representative sample of 1,000 persons were interviewed in 2016. The literacy questions assessed knowledge about simple and compounded interest rate, inflation, financial risks, and effective interest rates (fees and commissions attributed to credits and installments). One of the surprising findings was that **only 5.8% of the surveyed population answered all four questions correctly**; 42% of the population's knowledge fell in the moderate range (two or three correct answers), while the remaining 52% exhibited low levels of financial literacy (one or no correct answers).

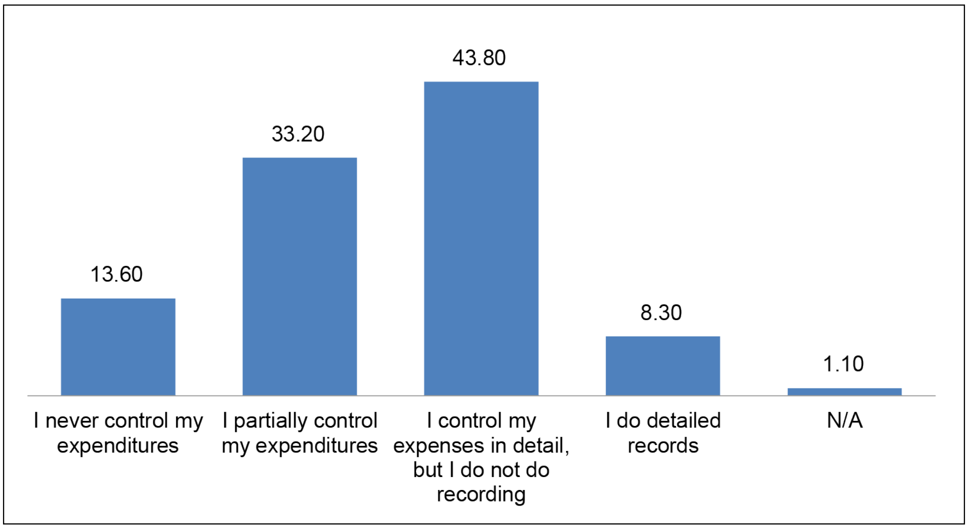
The country survey indicated strong regional disparities in financial literacy, particularly between the capital city and other areas of the country. **This likely mirrors the differences in access to finance**. The Georgian survey finds that financial literacy is significantly higher in the capital, Tbilisi (81% of the population with high financial literacy level, are from Tbilisi).

It is difficult to say whether lack of financial literacy is an obstacle for greater financial access or vice versa, but generally, **people with lower educational attainment were less likely to answer questions correctly:** 78% of the respondents with all correct answers, held a university or equivalent diploma. Also, **respondents with only primary and secondary education were more likely to report the "do not know" option.** Yet, despite the low levels of financial literacy revealed in the survey, **only 14% of the population admitted a lack of knowledge in finances.**

6.2 Financial Attitudes and Behavior

Recording expenditures is not used as a tool to control finances – only 8.3% of the population conduct detailed recording of expenditures.

Figure 11: Attitudes toward Expenditure
(%)



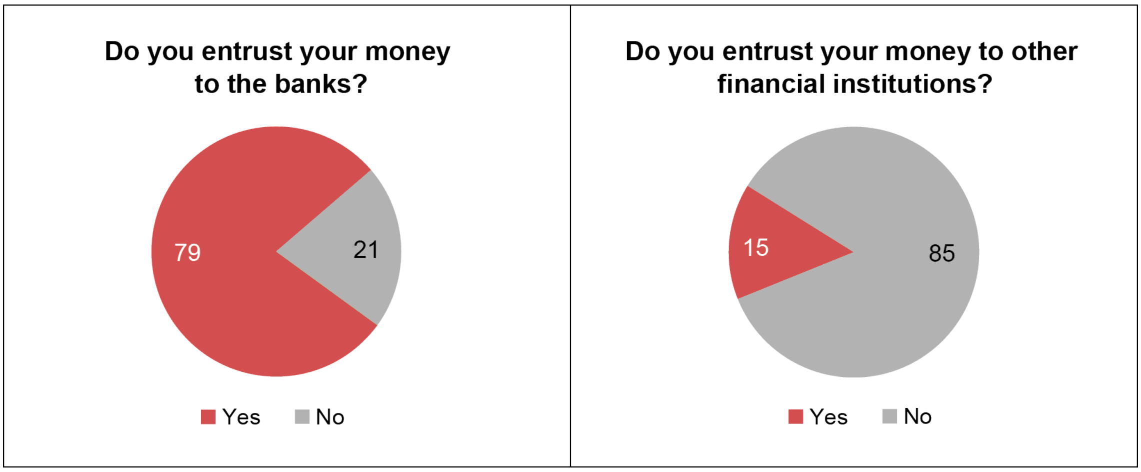
# of respondents: 1000.

Source: ISET-PI TBC Financial Literacy Survey.

The population of Georgia tends to be disciplined in tax obligations; 86% of the respondents reply that they do not delay tax payments. Also, they are very cautious about buying new things – 68% state that they think and analyze if they can afford the purchase before they buy. The reason for this pattern of cautious behavior is likely to be the low levels of income rather than high levels of financial literacy.

According to the survey, trust toward the banking system in Georgia is one of the highest in the region and even in the EU area; 79% of the surveyed population unconditionally trust the banks, while 85% of the population do not entrust their money to other financial institutions (microfinances, credit unions, etc.). The conservative regulation of the banking system by NBG, has led to a stable and credible banking system, while the non-regulated part of the financial sector is seen as unreliable in the eyes of the population. **This result should be treated with caution,** however. As mentioned before, trust in the banking system greatly depends on the question that is being asked. For example, if a question is asked about trust in the banking system in general, the percentage of positive responses is lower[68] (this may be because people do not trust banks to provide them with fair lending terms, although they may trust them with the deposits).

Figure 12: Trust in the Banking System
(%)



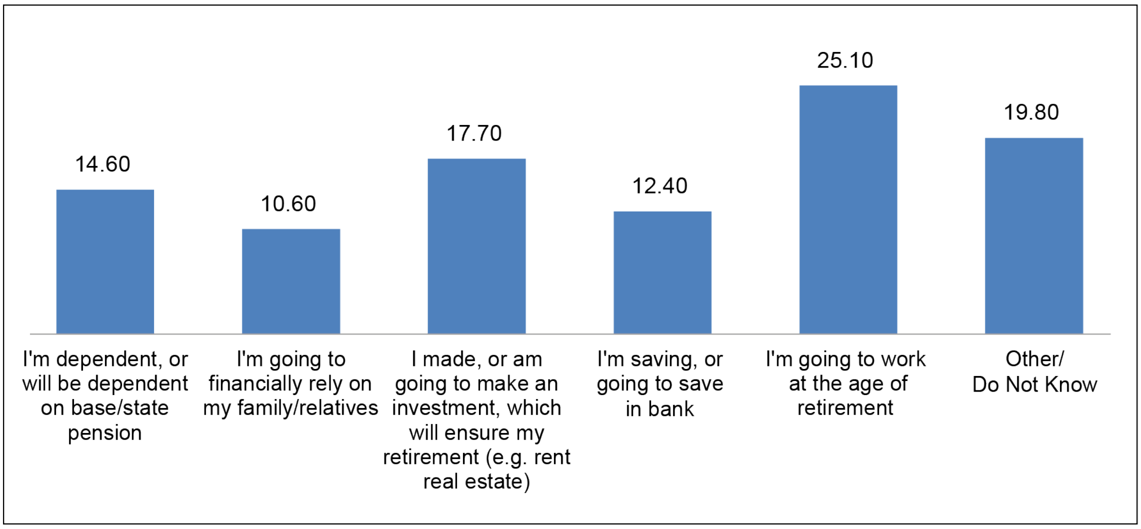
Source: ISET-PI TBC Financial Literacy Survey.

Despite the high credibility of the regulated part of the financial market, **long-term financial planning and bank saving are not common among the respondents.** Only 12.4% of respondents are saving for retirement purposes; 14.3% of the population will be totally dependent on the basic state pension, which is about at the minimum subsistence level in Georgia. 25.1% hope to have a job during his/her retirement.

Several findings in the survey indicate that **together with the low level of financial literacy, low income remains one of the main obstacles to more sophisticated financial inclusion of the population**. Only 35% of the respondents managed to save during 2015, while 57% took a loan during the same period. Among those who managed to save, 30% made a deposit saving, while 44% kept their cash outside the bank – the cash savings were most likely intended for very short-term goals/purposes, not contributing to long-term planning of the future.

68 CRRC Caucasus Barometer, 2015, http://caucasusbarometer.org/en/cb2015ge/TRUBANK/

Figure 13: Taking Care of Life in Retirement
(%)



# of respondents: 1000.

Source: ISET-PI TBC Financial Literacy Survey.

According to the OECD/INFE International Survey of Adult Financial Literacy Competencies,[69] **Georgia is amongst the countries where families have trouble making ends meet**. To compare, the shares of the population who were unable to make ends meet at least once in the last 12 months were as follows: Thailand (64%), Georgia (61%), Belarus (57%), Albania (54%), and Turkey (50%). Furthermore, at least four in ten respondents resorted to borrowing to make ends meet in Thailand (45%), Georgia (45%), Turkey (42%), Albania (41%), and Belarus (41%). This indicates a **high level of financial fragility in these countries, possibly due to low and/or fluctuating incomes.**

Another important aspect of financial literacy is familiarity with financial products. Even though the use of financial products in Georgia is not low, a significant share of the population does not understand the intricacies of various financial products. According to the study/survey conducted by NBG in 2016,[70] people tend not to shop around for best offers on financial products and take the first available deal that is offered to them.

The NBG survey further characterized the segments of population in Georgia according to their financial attitudes and behavior. According to the survey only 11.7% of the population can be characterized as ***Business minded*** – i.e. distributing monthly income, making at least small savings, setting long-term financial goals. The financial literacy score was the highest (65.6 out of 100) in this segment of the population. ***Financially responsible*** people (demonstrate practical financial behavior, who meet financial responsibilities, maintain close control of their finances, etc.) comprise just over one third of the population – 34.3% – and have the second highest financial literacy score (63 out of 100). Unfortunately, the remainder of the population (54%) can be characterized as either ***Financially fearful*** (21.6% – characterized by poor financial capabilities, fear towards financial affairs), ***Burdened by debt*** (16% – hardly

[69] https://www.oecd.org/daf/fin/financial-education/OECD-INFE-International-Survey-of-Adult-Financial-Literacy-Competencies.pdf

[70] Financial Literacy and Financial Inclusion Study. The report was prepared by Sonar for the National Bank of Georgia, November 2016

make ends meet, deeply in debt), ***Enjoy spending*** (11% – live for today only, focus on short-term goals) or ***Shopaholics*** (5% make spontaneous financial decisions). People in these categories had the lowest financial literacy scores ranging from 57.7% (burdened by debt category) to 49.2% (enjoy spending category).

As these surveys show, Georgia has a long way to go to reach the level of the OECD average in financial literacy, behavior, and attitudes. To this end, the National Strategy for Financial Education in Georgia[71] has been developed by the NBG and has been implemented since 2016. In the following section of the paper we will summarize the main points of the strategy.

6.3 Financial Education Strategy of Georgia

Besides the goal of the overall improvement in financial well-being of the Georgian population, the strategy's aim is to protect consumers' rights. The following are three strategic focus points to help achieve the goals of financial education:

- **Raise awareness of the benefits of financial education** – by enhancing awareness of the importance of financial education in society, and stimulating a greater demand for and use of financial education initiatives;
- **Enhance coordination and collaboration among stakeholders** by optimizing resources for achieving synergy, extending the impact and reach of education initiatives, sharing experience and good practice;
- **Extend opportunities to learn** – by encouraging life-long learning of financial matters, starting from an early age, and making financial education initiatives available through diversified venues, settings, and languages.

To coordinate this effort, the NBG established a Steering Committee comprised of different types of stakeholders including the financial institutions (banks and MFIs), universities, Civil Society, and other government entities for the implementation of the strategy. The Committee's goal is to evaluate existing and future programs, raise initiatives, and provide advisory, financial, and technical assistance.

According to the Strategy, the high-need, vulnerable segments were identified:

- **The young generation – pupils and students;**
- **Unemployed population;**
- **People employed in large companies and organizations;**[72]
- **Rural population;**
- **People facing special life events (such as the birth of a child, wedding, university education, etc.)**

The guideline for activities under the Strategy for 2017–2019 has been drafted, but is not yet enforced. The activities include training, awareness raising campaigns, and communication using various channels. It is planned to integrate financial literacy topics in the national curriculum in schools (in math classes and in civil education classes). The pilot of the program, "school-bank," is already in action and NBG is delivering training for pupils, as well as trainings for teachers in 11 public schools.

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[71] http://nbg.gov.ge/cp/uploads/stategy/FinLit_Strategy_ENG.pdf

[72] Arguably, these people are not financially vulnerable, but are easy to target by financial education programs at low cost.

7. CONCLUSIONS AND RECOMMENDATIONS

7.1 Main Takeaways from the Study

7.1.1 Adequate Access, but Low Usage of Financial Services in Georgia

On a number of financial inclusion indicators, Georgia is outperforming the ECA developing countries cohort (in particular in terms of access indicators, such as the number of ATMs, bank branches, POS terminals). Yet, in terms of usage of financial products and technologies, Georgia is still very much behind the peer group of countries. Strikingly, the percentage of young adults with deposit or savings accounts is very low compared to the regional average (only 9.9%, as compared to 50.1% in the ECA region). This result is likely driven by the low rate of economic activity among youth and a high rate of unemployment in this cohort. The lack of economic independence leads to a lack of financial inclusion among the youth. The same factors are likely to be responsible for the low usage of financial technologies, such as internet and mobile banking. Once the current youth cohort becomes integrated into the economic life of the country, the usage of modern financial technologies is expected to increase.

7.1.2 Poor Households Remain Underserved

Despite rapidly growing indicators of access to financial services (such as deposits and credit), a significant cohort of the population remains underserved. This concerns mainly poor and to some extent rural populations. Only 46% of poor adults have a deposit or savings account as opposed to 61% of adults overall. The rural population has adequate (country average) indicators of usage, but is much more likely to be engaged in low-income subsistence agriculture, less likely to have accumulated savings, and have lower financial literacy scores. In addition, rural inhabitants dominate the segment of the population that can be described as “financially fearful,” according to the NBG financial literacy survey.

7.1.3 Access to Credit has been Growing Rapidly for Households, but Not SMEs

Indicators of financial access among SMEs have remained largely the same since 2012. At the same time, credit to households, in particular credit secured by real estate, has been expanding rapidly in the past few years. Indebtedness of households has been growing rapidly as well. While the ratio of non-performing loans to total loans in commercial banks remained stable, the data from microfinances is different – the value of repossessed property increased sharply around the time of the lari devaluation[73]. This suggests that the financial strain was experienced mostly by households who did not, for various reasons, qualify for a loan from a commercial bank. In addition, credit score distribution data from the country’s only credit bureau, which covers 88.6% of the adult population, indicates that the distribution is skewed towards the high-risk category. There are notably more MFI clients in the E3 category than bank clients, as banks have much stricter requirements for giving credit. Rapid growth in consumer credit prompted concerns about the sustainability of credit expansion. Thus, the government of Georgia and the NBG called for stronger consumer protection measures, pushed for rapid de-dollarization of small and medium-size loans and stepped up efforts to promote financial literacy.

73 NBG Statistics. Assets and Liabilities of Micro Financial Organizations. https://www.nbg.gov.ge/index.php?m=304

7.1.4 Financial Literacy Levels can be Described as Inadequate for the Given Level of Financial Sector Development

In Georgia, the financial sector has been developing and growing quite rapidly. Yet, various financial literacy indicators show that the majority of the population is only familiar with basic financial concepts, like simple interest, inflation, risk and return, etc. Yet, slightly more complicated questions about calculating a simple interest on a deposit or detecting the effect of compounding remain challenging. There is evidence that Georgians choose financial products without "shopping around," and are in many cases unaware of various financial products available to them.

7.1.5 Low Levels of Financial Literacy in Conjunction with Low Incomes are Among the Main Obstacles to Greater Financial Inclusion

Financial literacy and financial inclusion go hand in hand. People with higher levels of financial literacy tend to save more, are more aware of various financial products, are more responsible borrowers. The data we have analyzed for the purposes of this study points to the conclusion that financial literacy is correlated with income and education levels. While there may be a causal relationship in the direction from financial literacy to income level (as financial literacy may proxy ability), one can imagine the reverse causation as well: low income levels may be in part responsible for low levels of financial inclusion and thus, indirectly, lead to lower levels of financial literacy.

7.2 Recommendations

The analysis of various financial inclusion indicators and financial sector policies in Georgia leads us to conclude that the country's problems with financial inclusion of the poor, young, and rural population stem from low income levels as well as low levels of financial literacy.

As the Georgian authorities navigate different policy options to improve financial inclusion for households and SMEs, they have to keep in mind that **financial literacy, general education, and income levels are interrelated concepts,** and it will not be possible to fully address one aspect of the problem (e.g. financial literacy) without simultaneously addressing the issues related to general education and the lack of stable incomes.

The government **needs to develop a comprehensive national strategy for financial inclusion** of the population (currently lacking) which will address different aspects of this problem, including consumer protection, education, employment opportunities, and, last but not least, financial literacy. In particular, **promoting employment among youth** could go a long way towards their greater financial integration and more responsible financial behavior in the future.

Greater financial access for SMEs remains a challenge. SMEs face a chicken and egg problem, where they find it hard to grow without greater access to finance, while banks are reluctant to lend in excess of what the financial situation of these firms would currently allow. The solution to this problem could be to experiment with different approaches, which do not necessarily imply interest rate subsidies or collateral pledges. Education programs and training for SME entrepreneurs may be a way to solve the problems of low financial reporting standards as well as other structural problems that plague the SME sector.

As far as regulatory issues are concerned, the recent steps by the government to promote consumer protection, de-dollarize the economy, and increase the level of financial literacy are adequate and timely. **Policy-makers, however, need to be cautious about changes that can affect both consumers and providers of financial services**. Financial inclusion is driven by both demand and supply factors – thus, the efforts to de-dollarize lending to households can also create a higher cost of hedging instruments for banks and MFIs, higher domestic currency interest rates, and, consequently, less affordable loans for households.

Finally, **policy-makers need to stay vigilant and informed about the new financial technologies that appear on the market** that can potentially affect vulnerable population groups. In this respect, the recent changes in the Civil Code to keep effective interest rates capped were an adequate response to rapidly growing predatory lending practices. Yet, policy-makers need to develop the means to keep an eye on various segments of the financial market, not just commercial banks or microfinances, in order to detect problems before they arise. One of the instruments employed could be more frequent surveys about lending, borrowing, and savings behavior and practices of households and SMEs.

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