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**Informal Lending
in the Kyrgyz Republic
(Pilot Survey Results)**

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Analytical Paper of the National Bank of the Kyrgyz Republic

Informal Lending in the Kyrgyz Republic
(Pilot Survey Results)

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The views represented in this paper belong completely to the author and do not compulsorily reflect the viewpoint of the National Bank of the Kyrgyz Republic. This paper reflects the pilot survey results, the results obtained are not representative and cannot cover the sample and general population.

Summary

An informal lending market in the Kyrgyz Republic indicates its imperfection. Physical accessibility of unregistered lenders, mobility of funds issuing and absence of the formal requirements for the borrowers are the main reasons for popularity of the services provided by them.

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Introduction

Ensuring the safety and reliability of the country's³ banking system is the priority objectives of the National Bank of the Kyrgyz Republic, while mobilization of the population's monetary resources in the country's banking and financial institutions is the main condition for reducing the interest rate of credit resources and increasing their availability. The banking and microfinance sectors of the Kyrgyz Republic are the most dynamically developing sectors of the economy. There is an annual growth in the bank's deposits, loans and microloans to demonstrate growth in the financial resources of the market participants and an increase of public confidence in the financial institutions. At the end of 2017, the total loan portfolio of the banking and microfinance sectors increased by 16.0 percent compared to the same period in 2016 and amounted to KGS 120 billion, deposits at the end of 2017 amounted to KGS 133.1 billion (+13.6 percent compared to 2016).

Besides the formal lending market, there is a parallel informal market: loans provided by the relatives and friends, private commercial lenders and pawnshops being the popular sources of borrowings and loans.

Traditionally, high level of financial transactions outside the banking and payment system is believed to be associated with distrust in the financial institutions, lack of access to the banking services and low financial literacy. The public confidence in the financial institutions contributes to the growth of the resource base, the inflow of investments, and has a favorable effect on the financial stability and the economic growth. However, there was no empirical work conducted in the Kyrgyz Republic regarding research of the households' investment decisions that face a choice: investment in a bank or investment in assets (for example, purchase of real estate, foreign exchange, cattle, lending, etc.).

The world practice demonstrates that purchase of cattle is often a popular investment vehicle in developing countries, and some banks have even introduced the cattle-banking service (Bote and Hare, 2014). Knowledge about the behavior and motivation of the households in making such decisions would contribute to improvement of the banking instruments, increase of public confidence and, as a result, mobilization of domestic investment in the financial sector (Alieva, 2008).

The Kyrgyz Republic is a country with a strongly expressed culture of kinship, where traditional institutions play an important role, and sometimes even replace the official institutions of the state. Informal monetary relations (sherine, yntymak⁴) or informal lending is a widespread practice among the population and, generally, people first look for financing from their relatives/acquaintances, and in case of refusal from them, they turn to the credit organizations or usurers. Therefore, the field of informal lending is unexplored and is of interest from the point of view of legal regulation.

An increase in the number of pawnshops in the republic⁵ demonstrates demand among the population for private loans, despite the high interest rates and sometimes semi-legal operation (many pawnshops and private lenders work without registration).

International practices demonstrate that an increase in the number of pawnshops is often associated with a low level of access to the banking services and low financial literacy

³ Law of the Kyrgyz Republic "On the National Bank of the Kyrgyz Republic, Banks and Banking Activity" No. 207 dated December 16, 2016.

⁴ Sherine is a "black cash" game: a group of people gathers together to receive in sequence money collected from all people participating in the game. In fact, this is a kind of interest-free loan. Yntymak is a form of relationship when a circle of close people allocates a fixed amount for a certain event.

⁵ In 2006 – 148 pawnshops, 2007 – 181, 2008 – 196, 2009 – 231 (according to the National Bank), 2010 – 410, 2017 – 277, 2018 – 296 (according to the NSC KR). Licensing of the pawnshops by the National Bank was terminated on September 8, 2009, licensing of the pawnshops by the State Service for Regulation and Supervision over the Financial Market under the Government of the Kyrgyz Republic was initiated in July 2017.

(IBIS World, 2014). Meanwhile, according to the US Department of the Treasury, pawnshops are an important source of information about the health of the country’s financial system (US Department of the Treasury, 2010). This experience can be considered as informal (usurious) lending.

Currently, there is no information in the republic to reveal cause-effect relationships, the scale and other dynamic financial indicators of the informal lending sector, there is no social portrait and motivation of such borrowers. The availability of such information would contribute to understanding the needs of the population for financial products, improving the banking and microfinance instruments, regulating a significant amount of cash flows and thereby increasing the sector transparency.

The purpose of the survey is to obtain basic information about informal lending (kinship, commercial, etc.) among the population of the Kyrgyz Republic (pilot survey on the example of Chui oblast and Bishkek city).

The survey objectives are:

- to study informal credit relations among the borrowers and the informal lenders;
- to get information about the interest payment, maturity, and repayment of informal loans for the population and the entrepreneurs.

Data⁶ and Methodology

100 respondents were interviewed to conduct a pilot survey, including households, private entrepreneurs (sellers/distributors in the markets)⁷ and usurers in Bishkek city and Chui oblast.

Table 1. Distribution of Respondents by City and Gender.

No.	Target group	Gender	Bishkek	Kara-Balta	Kant	Sokuluk	Tokmok	Total
1	Households	Male	4	3	4	3	4	38
		Female	5	4	3	4	4	
2	Private entrepreneurs	Male	4	4	4	4	3	37
		Female	5	3	3	3	4	
3	Usurers	Male	4	2	2	2	2	25
		Female	3	2	3	2	3	
4	Total		25	18	19	18	20	100

The survey was conducted by the “face-to-face” method for the private entrepreneurs and the “snowball” method for the households and the usurers⁸.

Households. The share of the respondents, who use the services of the commercial banks or the microfinance organizations (MFOs), was the most significant. It was more difficult to find those who had experience in using the services of informal lending.

Private entrepreneurs in the markets. This target group was mainly found in the markets, the place of its operation. The entrepreneurs turned out to be a more responsive group of the respondents and actively participated in the survey. Several respondents tried to assist in finding the usurers. Others were not ready to point to the usurers because of the risk that in the future this could affect their activities, due to deteriorated relations with the usurers.

Usurers. Personal contacts and acquaintances were used to interview this target group. The representatives of the specified group refused to participate in the survey due to reluctance to register their activities and fear of displaying thereof. Some respondents interrupted interviewing mid-way, considering the questions to be sensitive.

⁶ Field work was carried out by Erfolg Consult LLC, tel.: 0312 97 90 96, erfolg.consult@gmail.com.

⁷ The number of applications for loans during the last 12 months was the determining factor for sample.

⁸ The “face-to-face” method is personal communication between an interviewer and a respondent, the “snowball” method is a method when a respondent recommends other people for the survey related to the topic of the survey.

Survey Results

Households

The salaries, as well as entrepreneurial and agricultural income, are the main source of income for most households. In terms of income, more than half of the respondents were those who have money to buy food and clothes, however this is not enough to purchase household items.

Purchase of household appliances, furniture, cattle, seeds, payment for agricultural work was lending purpose for 32 respondents. A significant share of the surveyed households, in case of need for money, turn to the usurers, acquaintances, relatives, friends or other private persons. The reasons for using informal lending, according to the households, are the short terms for issuing money without the need to collect documents, and provide pledged collateral.

Generally, the loan amount of households did not exceed KGS 30 thousand. The bulk of the respondents were provided with the loans with a maturity of up to three months and an average interest rate of 14.0 percent per month. The respondents noted that the main disadvantage in the activities of lending institutions (commercial banks, MFOs⁹, pawnshops) is the high interest rate compared to lending provided by the individuals (relatives, acquaintances, friends).

In addition, a significant disadvantage of the usurers' activity is the short term of lending, while the households' representatives expressed the opinion that the commercial banks, the MFOs and the pawnshops should decrease the interest rates to provide an opportunity for formal lending.

The entrepreneurs and the households indicated that they are forced to turn to the usurers to pay off the existing debt, since the commercial banks and the MFOs did not issue loans for such purposes. Generally, the farmers and the peasants are provided with informal loans to purchase cattle, seeds and pay for agricultural work. The entrepreneurs mainly choose the commercial banks due to the legal arrangement of a loan. The public sector workers and the farmers experience severe difficulties in repaying the loans. The households living on welfare take out loans to buy food. For example, the majority of the respondents in Kant town indicated that they borrowed money to repay a previous loan. The women minimize the risks and tend to notarize the loans, while the men only need a receipt or a word of honor.

Private Entrepreneurs

Most of the interviewed entrepreneurs were from Bishkek city. A significant share of the entrepreneurs earns up to KGS 20 thousand per month. The respondents answered that they borrowed money (from KGS 30 thousand to KGS 60 thousand) to replenish working capital. For example, the entrepreneurs turn to the usurers because of the instant money issuing without the need to collect documents and due to trust-based relations. The entrepreneurs who applied to the commercial banks or the MFOs for loans noted that they received loans at relatively low interest rates compared to the individuals. The loan amount reached up to KGS 30 thousand. The overwhelming majority of the respondents take a loan with a maturity of up to three months and an interest rate of up to 11.5 percent per month. The entrepreneurs also noted that the commercial banks, the MFOs and the pawnshops should reduce the interest rates, and the usurers should increase the lending periods.

If we look in the context of settlements, for example, the residents of Sokuluk town, on average, need a little more borrowed funds every month to replenish working capital and do business compared to the residents of other settlements. The entrepreneurs of Bishkek

⁹ Microfinance organization.

city primarily apply for loans to the relatives, friends, acquaintances, while in other settlements they turn to the usurers. The entrepreneurs in Kara-Balta town formalize the loans, while in other settlements they take loans on the pledge of the word. The overwhelming majority of the entrepreneurs in Kant town responded that the interest rate on the last loan was 8.3 percent per month, which is lower compared to other settlements.

Store owners, the distributors and the service providers primarily use formal loans to replenish working capital, however they also borrow money from the relatives and friends.

The entrepreneurs providing services would like to have a grace period and a longer maturity when they take loans from the usurers. The entrepreneurs with higher income generally use formal lending methods.

Usurers

The interviewed usurers primarily live in Bishkek city. Generally, the main source of income for the majority of the respondents is entrepreneurial. The usurers provide loans in the amount from KGS 20 thousand to KGS 50 thousand. The average monthly rate of the usurers for the clients is approximately 11.15 percent.

The usurers mainly issue loans in KGS at their own expense. The overwhelming share of the respondents were engaged in this type of activity from one to three years. Primarily relatives, acquaintances and friends apply for a loan. The overwhelming share of the usurers responded that they prefer to issue loans against receipt. 25 usurers among 26 interviewed usurers answered that they had not officially registered their lending activities and were not ready to do so. The main reason for the usurers' informal activity is the desire to avoid the inspections and the control of supervisory authorities.

Generally, the usurers find the clients through the acquaintances. According to the usurers themselves, the reason for using their services is instant money issuing. The usurers do not experience any difficulties with loans repayment.

Informal relations of the usurers are characterized as follows. For example, unemployed and retired people experienced difficulties with repayment of funds provided by the borrowers. The usurers with income from the agricultural activities provided loans at lower interest rates, in contrast to the entrepreneurs who worked in the markets. More wealthy usurers provide loans for a longer period. The size of loans provided to the public sector employees was smaller compared to the entrepreneurs.

The survey results showed that the lowest interest rate - 10.0 percent was in Bishkek city and Sokuluk town.

Table 2. Monthly Interest Rate on Usurious Loans

№	Settlement	Households	Private entrepreneurs	Usurers
1	Bishkek	12.2	10.6	10.0
2	Kant	14.7	8.3	12.0
3	Kara-Balta	15.0	15.0	12.5
4	Sokuluk	17.9	13.6	10.0
5	Tokmok	11.3	10.1	12.0
	Average value	14.2	11.5	11.3

Conclusion

The pilot survey confirmed the existence of an informal lending market in the Kyrgyz Republic. This indicates the market imperfection, the potential for growth in formal lending, and the need to take further measures on the part of the regulator for its legal regulation¹⁰.

The interviewed respondents-borrowers have the experience in informal relations (with the usurers, acquaintances, relatives, friends, etc.) and formal relations (with the commercial banks, MFOs, pawnshops). The survey results show that the main reasons for using informal lending services are the instant money issuing without the need to collect documents, the availability of funds (for borrowings from the acquaintances, friends and relatives), and trust-based relations.

A distinctive feature of a usurious loan is its short-term nature – from one to three months. The average cost of a usurious loan was, depending on the settlement, 10.0-12.0 percent per month, the households were credited at approximately 14.0 percent, the entrepreneurs – at 11.5 percent, the usurers lent money at 11.2 percent. Thus, the average annual rate fluctuated within 120.0-168.0 percent.

The survey of the usurers caused some difficulties. The usurers' refusal to provide assistance is associated with such reasons as: the trend not to advertise their activities, lack of registered activity, the desire to avoid inspections and not pay taxes.

It is difficult to estimate the volume of shadow lending, however, the following information is very important for the regulator and the credit organizations: having an idea of this kind of lending market, the reasons why economic agents do not use the services provided by the official lenders. The regulatory authorities can develop new requirements for the organizational and legal forms of usurious activities with a minimum administrative burden (easy entry to the market and exit therefrom, declaring financial transactions, etc.), for example, on the basis of a voluntary/compulsory patent to withdraw “cash” flows from the shadow.

On the other hand, administration of informal lending can have a negative effect. Thus, regulation of the usurers may condition an increase in the administrative burden, which will increase the time input of the entrepreneurs and the administrative costs. Therefore, it can result in increased cost of usurious microloans and decreased supply of microloans. From the point of view of the demand for such microloans, the borrowers may be deprived of prompt and non-documentary loans. Thus, disposal of the usurious market being rather popular will demonstrate the ineffectiveness of regulatory intervention to result in certain losses or losses of all participants.

The possibility of introducing p2p lending¹¹ service in the Kyrgyz Republic on the basis of an electronic platform, where, on the one hand, there are lenders, and, on the other, borrowers, can be considered as an alternative to the usurious loan system. Prevalence and the volume of lending confirm the popularity of such lending. For example, the borrowers raised USD 16 billion on the platform of Lending Club, the largest American p2p company. USD 30 billion were issued through the SoFi platform during 2011-2017. In 2016, the volume of loans of the British company Zopa amounted to about GBP 670 million.

¹⁰ There is a positive experience in India when “low-cost loans were offered through a government-led self-help group program. It resulted in a sharp decline in the use of informal loans by 14.5 percent and a slight decrease in the interest rates on informal loans” (World Bank 2017).

¹¹ p2p (peer-to-peer or person-to-person) lending is issuance and receipt of loans between the individuals without involvement of an intermediary (bank, microfinance organization, etc.). An individual can be as a lender and a borrower.

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