Economic Research Center

POPULATION NEEDS FOR DEPOSIT PRODUCTS OF MICROFINANCIAL ORGANIZATIONS AND DIFFICULTIES IN THEIR DEVELOPMENT

RESEARCH WORK

The National Bank of the Kyrgyz Republic
2015

CONTENTS

SUMMARY

The present study was conducted by the "M-Vector" company as per the order of the National Bank of the Kyrgyz Republic[1]. Study is aimed at identifying the current needs of the population and MFIs for deposit products as well as for other services and products of MFI; identifying the difficulties in development of MFI deposit products, including obstacles in the field of regulatory legal acts and preparation of recommendations on advisability of amending regulatory legal acts of the Kyrgyz Republic on their basis.

Representatives of the population segmented to clients and non-clients of MFI as well as heads of the largest MFIs of the country took part in this study.

In addition to identifying the needs for demand deposits, conducted study raised a number of questions that reveal existing problems of the population when they cooperate with MFIs and other financial institutions, experience of using MFI products, relation of clients to MFI and how MFIs understand the needs of the population.

In general, the study showed that the population has needs for savings, but these are often replaced by more familiar and understandable ways to save money such as purchasing of cattle, investment in business (trade and commerce), and increase in personal assets or by other non-monetary forms of funds saving. The population most often spends available funds on current needs and makes large spending by taking loans from MFIs.

The study identified that the population suffers from absence of money saving culture, which is also influenced by the availability of credits. Availability of credits for population is indirectly stimulated by MFI, and it is the main source of income for the latter.

Specificity of the MFI market reflects underdevelopment of the financial sector. In many cases, key employees of MFI do not have adequate knowledge in the field of finance. The MFI market mainly provides retail-lending services for a certain circle of people and enjoys small number of clients. In the context of MFI, introduction of such additional financial instruments as deposits requires large financial costs, which shall cause reduction of income of MFI.

The present scientific work resulted in provision of conclusions and recommendations on RLA and other activities, which may positively influence the gradual growth of both MFI and financial literacy of the population.

[1] NBKR. All abbreviations are interpreted in the Glossary

CONCLUSIONS AND RECOMMENDATIONS

Major opportunities and obstacles for development of MFI deposit products

PROBABLE POSITIVE ASPECTS (OPPORTUNITIES)	PROBABLE NEGATIVE ASPECTS (BARRIERS)
Economic/market indicators 1. Appearance of considerable number of MFI attracting deposits shall primarily improve the level of competition with commercial banks as well as the quality of services to be provided by MFI. 2. The largest MFIs have an extensive branch network, which allows increasing the population coverage, especially in remote and hard-to-reach regions, as compared with less developed network of commercial banks. 3. Attraction of deposits from the population enables MFIs to increase their lending due to borrowed funds. 4. If the population had deposits with MFIs, it would facilitate citizens' access to loans of MFIs, since the deposit can be used as collateral.	***Economic/market indicators*** 1. Low level of population confidence in financial institutions (particularly in MFI) in conjunction with changes may increase distrust of the population in the MFI institute. 2. In a greater or lesser degree, MFIs operate in rural areas, which population has significantly less money for saving than urban population. Thus, efforts to develop deposit products of MFI are unlikely to have the desired effect. 3 Rural residents have the developed express and firm culture of credit usage, but not money saving. 4 The largest and most stable MFIs enjoying significant client's base, loan portfolio and extensive experience in the microfinance market, show no interest in acquiring the status of deposits attracting MFI. It is related both to economic component of the transformation process and to a number of other additional factors. Larger MFIs tend to transform immediately into a banking institution, while smaller MFIs do not have such opportunity because of their economic potential (donor support). The present tendency may eventually lead to absence of deposits attracting MFIs at the market as deposit license obtaining process is economically money-losing and requires the ample quantity of resources.
	5 Many MFIs have not calculated charges and benefits of switching to deposit products.

Managerial aspects	***Managerial aspects*** 1. Management of MFIs has inadequate knowledge of current legislation of the country to switch to activities related to attraction of deposits. 2. Low level of cooperation (interaction) of MFI with the National Bank of the Kyrgyz Republic as the regulatory body on emerging issues. 3. Lack of initiative on the part of MFIs on the necessity to change existing laws that regulate activities of MFIs. 4. To obtain a deposit license, the MFI must have skilled personnel capable to get the deposits attraction work going. In most cases, MFI employees (including middle and senior managers) are not properly experienced in the deposit activity. In this regard, introduction of deposit products requires the MFI to hire qualified personnel and train the existing employees, which in turn requires additional costs.
Technical aspects	***Technical aspects*** 1. Reluctance of MFIs to transform into deposit-taking organizations is conditioned by the necessity to comply with requirements for technical strength of structural units of MFIs. These requirements are set forth in the "Instruction on single requirements for technical strengthening of financial and credit institutions and procedure for their protection in the Kyrgyz Republic", approved by the joint order No. 97/24–O dated February 11, 2010 of the KR Ministry of Internal Affairs and NBKR. Thus, according to norms of the specified document, all FCI committing transactions with cash assets should have their own storage and meet other special requirements for technical strengthening. MFIs cannot obtain a license for attraction of deposits until they comply with the specified requirements. Most MFIs cannot comply with such requirements, because: first, it requires for

	considerable financial investments, which is impossible for many MFIs; second, majority of premises that MFIs use for their activity are rented for a certain period and owners of those premises often prevent MFIs from taking measures on technical strengthening. 2. The need for introduction of special software (deposit module) for conducting and systematization of MFI transactions on deposits management: Introduction of the specified software requires much money. Cost of the relevant software in view of all follow-up revision, license and servicing may amount to about 500,000.00 USD.
Legal aspects (RLA) 1. In general, the current legislation of the Kyrgyz Republic in the field of microfinancing is liberal and balanced that allows carrying out microfinancial activities successfully and presents more accessible microfinancing products to the public. 2. In comparison with other members of the microfinance market, MFC can render a wider range of financial services. The legislation sets more severe requirements for them.	***Legal aspects (RLA)*** 1. One of the constraining factors in obtaining of the deposit license by MFI is the necessity to comply with prudential standards provided for deposits attracting MFI in contrast to microcredit companies and agencies. If MFI fails to comply with prudential regulations, the National Bank of the Kyrgyz Republic may apply appropriate sanctions against MFI. Comparative analysis of prudential regulations of deposits attracting MFI shows their identity with prudential regulations for commercial banks, and in some cases, prudential regulations for MFC are higher. In this regard, it is more profitable for the MFI to transform once into a commercial bank, bypassing the stage of transformation into deposits attracting MFC. 2. In accordance with Article 13 of the Law “On microfinance organizations in the Kyrgyz Republic”, founders and shareholders of MFC may be individuals and legal entities, residents or non-residents of the Kyrgyz Republic. In this case, the share of legal entity should not exceed 20% of voting shares of MFC in conjunction with the share of any other legal entity controlling it, controlled by it or bring under common control. Given that

3. Positive factor of recent changes in banking legislation is provisions that allow MFC and MCC transforming into a bank. The present matter was not settled earlier at the legislative level.	donor financing of MFI is decreasing and there are not so many large MFIs at the market, it is necessary to explore the issue of making appropriate amendments in current regulatory legal acts. The goal is to increase the maximum allowable equity share in MFI's capital and expand the circle of participants (shareholders) of MFI, which shall create more favorable investment climate and the additional financial investments into MFI. 3. The Law "On Microfinance Organizations in the Kyrgyz Republic" assumes that ICA may also transform into MFC. However, in practice this fact creates a number of difficulties upon transformation from one form of MFI into another. According to general rules of the civil legislation of the Kyrgyz Republic, ICA cannot be transformed from non-commercial organization into commercial. In this connection, they have to establish a new legal entity to transfer their assets to it. Such transfer of loan portfolio is time-consuming and money losing. To overcome these problems, it is necessary to develop and make appropriate amendments in the existing regulatory acts. 4. Currently the Law "On protection of bank deposits" does not cover microfinance organizations regarding protection of deposits. This situation negatively affects the position of microfinance organizations in relation to banks, which are part of the protection deposits system. 5. Resolution No.198 dated April 2, 2014 of the Kyrgyz Republic Government "On approval of the Program on provisional measures to introduce microfinance organizations' deposits protection system set forth list of measures, tasks and tools focused on introduction of the system for protection of microfinance organizations and credit unions' deposits. 6. In this connection, the work should be continued in the given area and the Law

	“On protection of bank deposits” should be amended accordingly by covering microfinance companies or there should be the developed separate regulatory acts for microfinance companies, which regulate deposits protection matters as defined in the Resolution No.198 dated April 2, 2014 of the Kyrgyz Republic Government. At the same time, MFIs are recommended that they should explore the issue on creation of separate Deposits Insurance Fund by themselves from their own funds or insure their liability in the relevant insurance companies.

Barriers and difficulties in introduction of deposit products for population

Major barriers and difficulties in introduction of deposit products for population consist of:

- misunderstanding of financial institutions operation specific character (lending practice in the population exceeds deposit understanding);
- tendency for non-monetary form of saving;
- lack of experience and knowledge of MFI and banks proposals (at the same time it is necessary to consider that none of operating MFC has proposed deposits saving services to the population as of today).

In general, conducted study identified direct correlation between the level of financial literacy and previous experience of population in cooperation with MFI. Unlike non-clients, clients of MFI are more aware of various products of financial institutions and have a higher level of income.

Today, main barriers against improvement of savings culture is misunderstanding and mistrust of the population to financial institutions as well as absence of proposals on saving of deposits on the part of MFC, which leads to ignorance of specifics of financial institutions' funds saving tools.

Most of respondents have long experience in cooperation with financial institutions with regard to crediting, but not to savings, which is reflected in shifted culture: "from savings - to living on credit". Therefore, the population rather prefers to use credit to cover current needs than to accumulate funds.

Upon questioning respondents noted that it was difficult to allocate funds for saving due to a small amount, but at the same time, they considered the option of making investments in livestock, vehicles or version of saving funds at home. In fact, even if people have funds for savings, they prefer non-deposit form of saving funds.

Most of respondents who have ever used an account or deposits enjoy experience in cooperation with banks in given areas, but often people, especially non-clients of MFIs, confuse money transfers without opening an account with transfers to current account. In other words, the source of problem for low usage of deposit products by the population is not so much the absence of products related proposals by nearest financial institutions as the lack of experience and knowledge of MFIs and banks proposals.

Thus, we can conclude that the population actually has both the opportunity and need for savings, but to stimulate people, work is required not as much in expanding the range of MFI services as in effective measures to improve the financial literacy.

Barriers and difficulties in introduction of deposit products for MFI

Major barriers and difficulties in introduction of deposit products for MFI consist of:
transaction risks

- considerable operational costs of creation relevant infrastructure, which MFI must produce to attract deposits;
- circulating capital of MFI is mainly formed of deposits of owners and borrowed funds, where attracted funds are under stable period enabling to set relevant maturity easily. Switching to alternative sources of capital like demand deposits or fixed-term deposits raises liquidity risk of MFI and require certain investments in construction of liquidity management system, accordingly;
- inexperience of MFI and lack of successful deposits handling examples results in receiving less profits than they are due or loss occurrence upon carrying out of the activity;
- critical relation of MFI representatives to population readiness to use deposit services;

capital risks

- measures on attraction of demand deposits must meet established regulations. However, attraction of specified deposits results in making more expenses by MFI, for instance, for technical equipping of branch offices. In its turn it makes introduction of the given product money-losing and unprofitable provided prudential regulations are complied with;
- absence of required equipment and availability of adequately qualified staff for handling of deposit products.

In most cases, respondents show interest in receiving of sources of cheap crediting resources, but they do not foresee follow-up investments related to new products due to lack of experience in deposits handling. The present factor may negatively affect development of deposit products; therefore, MFI must obtain maximum information on emerging opportunities on the part of a regulator. In some cases, research participants expressed incomprehension concerning regulator's requirements adopted by the Resolution No.16/2 dated March 11, 2015 of the NBKR Management Board for maximum total amount of assets borrowed from MFI founders, which cannot exceed authorized capital of MFC.

Existing practice shows that MCC is not ready to transform into MFC, which can be explained by insufficient experience and absence of successful examples. According to participants of focus-group discussion, it is much more economically sound for MCC to transform into a bank with a wider range of services under the same requirements. Answers of MFI representatives also state that the professional level of the staff should be improved, including knowledge of the legislative framework.

There is currently a potential for savings conditioned by the population investments in alternative savings. On the other hand, there is a clearly identified barrier associated with misunderstanding and lack of experience in banking products usage. This circumstance requires the financial sector to make large investments in changing the population consciousness, in shifting from the culture of "living on credit" to the culture of savings. According to statistics, a bulk of the deposit base of commercial banks is concentrated in Bishkek, Chui oblast, and in other large cities (more than 90 % of total deposits)[2].

It is exactly economic benefit of attracting deposits in large cities, which influences the banks' strategies on finding of cheap resources. By operating in a more economically active regions and cities, banks take into account such factors as the high average amount of the deposit and low attracting costs.

[2] NBKR, Section "Statistics"/"Banking statistics"/"Deposits in commercial banks by regions of the Kyrgyz Republic at the end of the period". October, 2015. Electronic resource: http://www.nbkr.kg/DOC/07082015/000000000036939.xls

Attraction of each individual deposit costs critically high when deposit’s average amount is little in rural areas (operation area of MFI), as it includes not only payment of interests to deposit clients, but also making investments in educational, promotional, attraction, image promotion and other activities. Such situation motivates MFI to use borrowed funds to maintain liquidity, because even in view of foreign currency hedging costs, total cost of attracting resources from creditors is less than the cost of attracting large mass of small deposits. According to the expert opinion, every deposit in regions of the country, regardless of the amount for MFI, will include the following costs:

- marketing measures;
- population training and teaching costs;
- employees training costs;
- administrative costs;
- cost of salaries of employees engaged in teaching, attraction, development of products;
- establishment of specialized subdivisions for development of deposits;
- creation of effective risk management system (operational, liquidity);
- connection to the clearing/gross systems;
- preparation of sales outlets for deposits servicing (technical and IT software);
- other costs.

Thus, introduction of deposit products, including demand accounts, shall result in considerable operating and capital costs for any MFI, which effectiveness is reduced in proportion to decrease in the average amount of deposit.

Recommendations

Despite the fact that the MFI sector in Kyrgyzstan has grown significantly over the last decade, we cannot still state that savings have mobilized countrywide. MFIs usually blame “restrictive” laws and regulations for that, which stand in the way of MFIs wishing to transform into deposit-taking MFIs.

Indeed, the NBKR requirements appear similar to some extent to those that are lodged to commercial banks.

Thus, the “Bai-Tushum” Bank CJSC (license dated November 13, 2012), being “Bai Tushum and Partners” MFC started to receive fixed-term deposits in September 2011 and attracted 86,134,752 KGS per year (about 1.8 million USD). Those figures demonstrate that MFC can attract deposits even under current requirements of the NBKR. However, this example is another confirmation of the fact that it is advantageous for MFC to transform into a bank with a full range of banking services, including opening of current accounts. In its turn, there are few domestic and foreign barriers for MCC and MCA to introduce deposit product.

Considering all arguments mentioned above, amending of RLA is unlikely to play significant role in effective stimulation of MFIs upon attraction of deposits. These study show that the problem probably lays in unsettled operational issues as well as mobilization of small deposits usually entails high costs and deposits taking process is actually the most expensive form of financing for small MFIs. At the same time, focus on large depositors requires compliance with certain requests of infrastructure and accounting, which is highly expensive activity for MFIs.

First of all, systematic implementation of measures focused on improving population confidence in the financial sector will be required for solution of the given issue, including comprehensive measures on raising financial literacy of the population, for which FCI do not want to spend money. The situation might be improved at this stage if: 1) the population learns to manage their own finances, 2) if the cost of activities related to attraction of deposits by MFIs is reduced.

For efficient development of the MFI sector in attraction of deposits, the following seems to be reasonable:

1. Most of the MFIs have simplest accounting system, which are primarily focused on loans, and poor knowledge of financial institution liabilities management. Minimum requirements for information systems, accounting, management experience and other aspects of MFIs activities should be tightened.
2. Taking into account the experience of the developed banking system, which also faces troubles with loss of clients’ funds, we see that the activities of small MFIs are still under a greater risk. Possible problems with clients’ deposits may result in the entire financial system to be more negatively perceived.
3. Measures focused on improving the population’s financial literacy and making savings more important should be executed. The present problem is the main limiting factor in deposits development and requires great attention.
4. It is necessary to widely inform the public about deposit protection system (DPS), about methods and conditions of operation of the system. The study showed that the main factor of distrust in the financial system is fear of losing deposits. Interviewed representatives of MFIs identified raising awareness of the DPS to be one of the conditions for attraction of deposits.

We recommend that massive savings development program should be created for the population by involving all interested financial institutions instead of amending RLA. Financial institutions might be encouraged to take part through creation of specific working conditions, access to capital, taxation, etc. It is necessary to consider direct interest of financial institutions in development of their deposit bases as the cheapest resources.

Please, see the Table of the section “Analysis of influence of changes in legislation on the Kyrgyzstan financial market” to find details of positive and negative aspects of changes in the legislation (including analyzed Resolution of the Kyrgyz Republic Government No.198 dated April 2, 2014 “On approval of the Program of provisional measures for introduction of the system for protection of deposits of microfinance companies and credit unions”).

Summarizing this study, it is worth noting once again that there is a deposit base growth potential as well as the opportunities and needs of the population, but amending of the current legislation is not the most effective way for the population to shift from the culture of “living on credit” to the money saving culture.