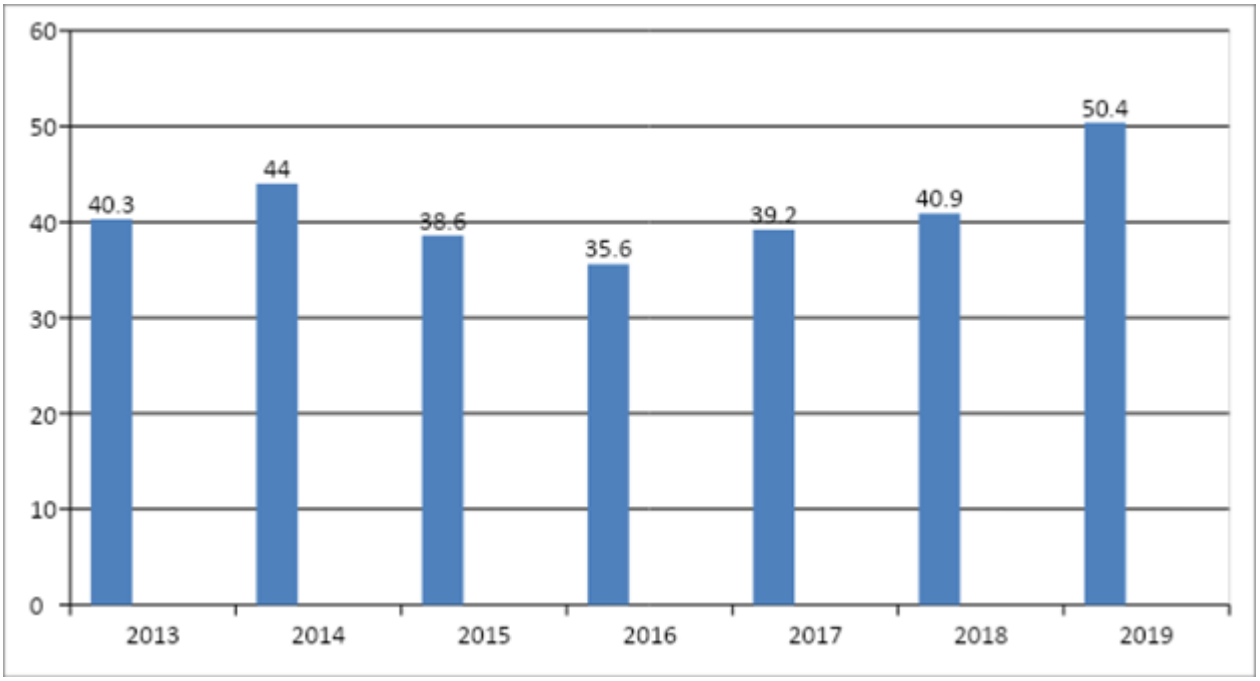
Why Are Consumer Loans on the Rise?

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Recently, in economic discussions, one of the topics that government officials have been most concerned about is the increase in the share of consumer loans in the total loan portfolio. The Central Bank's statement on the main directions of monetary and financial stability policies for 2020 and the medium term states that in 2019 credit investment increased by 16.1%, mainly due to the increase in household loans. In 2019, the share of household loans in the loan portfolio reached 50.4%.

There is also an increase in the amount of funds allocated by banks for lending. While in 2013, prior to the devaluation, banks allocated 73.5% of their assets to lending, after the devaluation, in 2017, this figure dropped to 41.5%. In 2019, however, this figure rose to 44.2%. Since the devaluation of 2015, approximately one in three banks and one in five non-bank credit institutions operating in Azerbaijan have shut down and more than 3.5 million citizens (70% of the population over 18) are indebted or liable to banks as loan guarantors, and the government's concern is understandable.

Chart: Share of household loans in total loan portfolio:



Source: Central Bank of Azerbaijan

Although banks often play the role of scapegoat in such cases, it is important to keep in mind that banks are also engaged in commercial activity, and if there is a demand for consumer credit, it is normal for banks to meet that demand. From this point of view, it is important to pay closer attention to the factors that shape the demand for credit products. On the other hand, banks' interest in consumer credit is stimulated by the higher interest rates of consumer loans compared to business loans, and the opportunity to make a profit in a shorter period of time. Taking this into consideration, it is clear that there are two main reasons for the growth of consumer credit. First of all, the incomes of the population do not meet their consumption expenditures; Secondly, due to problems in the real sector, banks are oriented toward the consumer sector, which is less risky than business loans because of the problems in the real sector.

Various factors affect the growth of demand for consumer credit. While the most important of these is the fact that income levels cannot fully meet expenses, on the other hand, a certain role is played by the expansion of the sales base due to job and official registration of the salaries of some

people who previously did not meet loan eligibility requirements, and the environment of relative competitiveness in the banking sector compared to other areas.

The head of the Azerbaijan Banks Association, Zakir Nuriyev, said in an interview that the increase in consumer demand is mainly due to the increase in the income level of the population. “It begs the question, if a person’s income rises, why would they take out a loan? Rather than saving money to buy a home, people prefer to take out a mortgage because it’s quicker, or they want to quickly renovate their home or to quickly get new furniture, they prefer longer vacations, and so on. This is the reason for the emergence of a consumer loan product: the desire to realize future consumption at the present moment.”

But on the other hand, it should be noted that the inability of people to pay for their expenses with their income is the most important factor in the demand for credit products. The most important indicator supporting this argument is the increase in household loans against the backdrop of declining household capital investment. Last year, there was a 35% decrease in the volume of household capital investments, or a decrease of about 500 million AZN. Household capital investment includes funds for the purchase of personal property and real estate, as well as renovation, the purchase of domesticated animals, and the development of private entrepreneurship.

In Azerbaijan, people do not have many options for financing. For example, the stock market has not developed to the extent that entrepreneurs can finance their businesses through the issuance of stocks, and the social security system is not so comprehensive that people can meet their needs through those social funds. Bank loans have a significant impact on the economy of Azerbaijan and on people’s well-being. Therefore, bank loans are among the first things to come to mind when people’s earnings cannot cover their current expenses. For

this reason, some banks also offer loan products to cover the cost of expenses that are usually covered with savings, such as tuition, travel, and the like. In regard to the population's savings, however, it should be noted that, as the Statistical Committee's statistical bulletin National Accounts of Azerbaijan, the population's income in the years following the devaluation has been insufficient to meet their final consumption expenditures. While the figures for the last two years are not available, the final consumption expenditures of the population in 2015-2017 exceeded incomes by about 1 billion AZN on average. From this point of view, one of the most important factors affecting the growth of consumer loans is the deterioration of the financial capacity of households.

Another statistic related to this issue is the growth rate of deposits and loans. In 2019, household deposits increased by 3.1%. During that time, the volume of household loans increased by more than 20%. Therefore, the growth rate of household loans during the year exceeded the growth rate of their deposits by up to 7 times. The slowdown in the growth of household deposits is an indication that their savings, i. e. the amount of money they have left over after paying for their consumption needs, have decreased. A factor that has a significant impact on the growth of the amount of credit is the increase in minimum and average wages. The raising of the minimum wage from 130 to 250 AZN over the course of one year, as well as the increase in the average monthly salary along with the minimum wage, will enable banks to sell larger loans on the condition that they meet the DTI requirement. The DTI ratio is one of the backup instruments that have emerged in the banking sector since the devaluation. DTI is the ratio of a borrower's debt burden to their income (Debt-To-Income), and in order to meet the DTI requirement, the amount that a client pays monthly on a loan should not exceed 45% of their monthly income. For example, if the minimum wage is 130 AZN per month, they can make a maximum monthly loan payment of 58.5 AZN, but if income rises to 250 AZN, this figure in turn increases to

112.5 AZN, which allows the client to borrow a larger amount. It should also be noted that the banks have the right to violate the DTI ratio on the condition that the bank must have in reserve 25% of the amount it provides to the client in the event of a breach.

Another factor that has an impact on the growth of consumer credit is the increased use of credit cards in the country. Developments such as the stimulation of non-cash payments, the increase in the number of bank partners, allowing customers to pay in installments (equal parts) for a few months without additional interest, and the implementation of a grace period during which interest is not charged on the amount used, have all increased the use of credit cards. According to Central Bank statistics, credit card transactions in Azerbaijan rose from 13.7 million in 2018 to 18.8 million in 2019. Another notable indicator is the increase in payroll cards in the country during the year. Over the past year, the number of payroll cards across the country has increased by 276,000. In other words, in the course of one year tens of thousands of people who previously did not meet the official income requirement were able to meet the requirement and entered the banks' sales base. One of the main factors influencing this increase in the number of cards is the official registration of pre-existing jobs.

Although the amount of funds raised by banks from the Central Bank through refinancing in Azerbaijan is not as high as in previous periods (falling from 20% in 2013 to 4.7% in 2019), factors such as the decrease in the the Central Bank's discount rate over the last 2 years from 15% to 7.75% and the lowering of the interest rate from 15% to 10% on the protected deposits that make up the bulk of the funds raised by banks have improved banks' access to relatively cheap financial resources, and can be added to the list of factors which impact customer demand. The offering of consumer loans at a rate of 15-16% per annum, which has been available not regularly but within the framework of certain campaigns at

several banks in recent months and is considered cheap for the Azerbaijani market, is another factor impacting client demand. Another notable statistic related to interest rates is the World Bank's interest rate spread (the difference between the deposit rate and the interest rate). While this figure was 8.6% in 2016 and 8.1% in 2017, in 2018 it was 7.2%. This indicator was 2.3% in Georgia, 4.1% in Armenia, and 3.5% in Russia.

While we tried to address the factors that influence consumer credit growth, for a more objective approach, it would be useful for those who express concern about the growth of consumer credit, along with asking the question "why is consumer credit growing," to think about the question "why isn't business credit growing?" Given the fact that capital markets in Azerbaijan are underdeveloped and that, apart from agriculture, the credit funds allocated by state institutions meet only a negligible portion of credit needs in other areas, the importance of bank loans in meeting the private sector's financial needs is even greater. In 2015-2019, there were decreases in lending of 21% in the trade and services sector in Azerbaijan, 84% in construction and property, 55% in industry and manufacturing, and 17% in transport and communications. Of these sectors, there was only an increase in the amount of agricultural loans due to the use of concessional financing through the state funds.

The factors impacting business loans include institutional factors such as the distortion of companies' credit histories, the allocation of banks' funds to less risky areas, the protection of property rights, the fairness of the justice system, and the freedom of the business environment. Due to the same institutional problems in the real sector, the consumer segment is more attractive to banks. In this regard, the creation of a more favorable business and investment climate, and the elimination of problems in the real sector will lead to revitalization, which could also help prevent the risks that would result in excessive consumer lending. On the

other hand, the growth of business loans also has a certain impact on job creation and the reduction of foreign currency. As most consumer products are secured through imports, most of the funds raised through consumer loans go abroad. But business loans have the potential to have a more positive impact on the country's economy in terms of increasing domestic production.

A report by World Bank analysts, *Global Economic Prospects*, states that "in Azerbaijan, activity is expected to be dampened by the effects of subdued oil prices and lingering structural rigidities in the non-oil sector. Longer-term growth depends on continuation of domestic reforms to enhance private sector development and address fragilities emanating from the financial sector, as well as investment in human capital to boost the quality of education and reduce skills mismatches." Non-diversification of exports, weak international competitiveness, and the major role played by the state in the economy are also factors that the World Bank considers risky for Azerbaijan's economy. In this regard, institutional risk reduction and access to financing can also play important roles for the business sector in terms of the reduction of public debt and risky loans.