Why Are Interest Rates High?

written by Samir Aliyev

The issue of high annual interest rates is currently a hot topic. When this problem is raised, mutual accusations begin, but after a while it is forgotten without being solved. For example, consumers, including entrepreneurs, always complain about high interest rates. While lending organizations may not share this concern, they occasionally say that they have small earnings despite high interest rates, and they suggest that people should look elsewhere for the origin of the problem.

In any case, interest rates are undeniably high. Although everyone admits it, there is no unanimous opinion concerning its causes. While consumers blame banks, the latter blame the state of the economy. It seems that both sides are right. The profitability of business has diminished, and compared to previous years, the current rates are not favorable for entrepreneurs. The economy requires cheap resources, which almost do not exist. Without the state's limited discounted credit mechanisms, banks are unable to offer a cheap credit product. Why are interest rates high? Should we really blame banks? There are many reasons behind these high interest rates and each of them has its own impact. Although eliminating all of the causes is impossible, determining and then reducing the impact of the decisive factor can help us to decrease the current interest rates.

As we have noted, interest rates are influenced by many factors, and one group of them are *macroeconomic factors*. It is no coincidence that officials continuously emphasize that the current macroeconomic stability in Azerbaijan is the key to lowering interest rates. For instance, the exchange rate of the national currency has been stable for a long time, and it seems that the government will try to maintain its stability in the near future. The official inflation rate is low, only 2%. Without taking into consideration the years between 2015 and 2017, the level of inflation has not been high in the past 10 years. However, despite the soft monetary policy (reduction of accounting rates, minimum reserve standards, etc.) of the Central Bank, there is no decline in the interest rates. It is important to pay attention to the real inflation level, which has always been viewed with suspicion by the public, including experts who have claimed that it is higher in reality. The fact that the Central Bank keeps its 8.5% discount rate at 2% inflation level further strengthens this claim. As a rule, the difference between the inflation rate and the discount rate is negligible. At the current level of inflation, the discount rate should be around 3-4%.

By looking at the financial indicators of the banks, it is possible to determine the main factors behind the high interest rates. **The main reason is the high cost of the resources needed to lend.** The selling price of any product in business is based on its cost price. A fall in the cost price, for example would allow entrepreneurs to reduce the selling price of their products. When the cost price is expensive, however, the price of the product offered to customers also rises. The same situation can be applied to credit products.

The reason behind the high cost of the banks' capital is the high cost of deposits. The banks' dependence on deposits is high and growing. According to official data, as of May 1, 2019, about 78.3 AZN of every 100 AZN brought in by the banks come from deposits. n 2016, however, this figure was 70.8 AZN per 100 AZN. As you can see, the share of deposits among the banks' resources increased by 7.5% over the past three years **(Chart 1).**

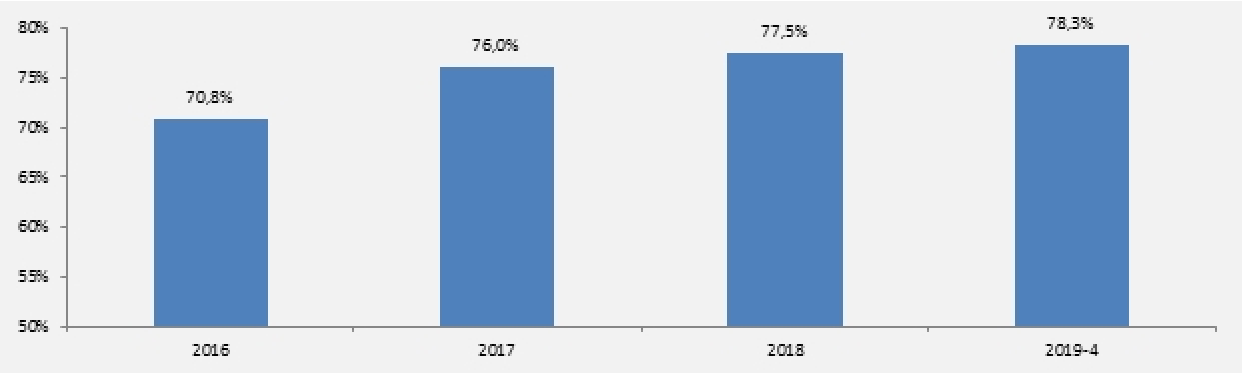

Chart 1: Fluctuations of deposits as a share of the banks' aggregate resources
Source: Financial Market Supervisory Authority of the Republic of Azerbaijan

This indicates a high dependence of the banks on a single source – deposits – and a decrease in the share of alternative sources. This trend of decreasing can be observed among at least two sources. For example, while in 2013 and 2014, the banks' *external liabilities* as a share of total credit was 27-28%, in the first four months of 2019, this figure fell to 12% due to a 63% decrease in the banks' external liabilities. A decrease was also observed in another source, the *centralized loans*. The share of loans allocated by the Central Bank to the other banks through its re-financing policy decreased from 20% to 4.5% between 2013 and 2019. During this period, the share of financing decreased by 81%. As a result, deposits become the main donor of credits.

Thus, the annual interest rate of deposits directly affects the annual interest rate of loans. According to the Central Bank, as of May 1, 2019, the average annual interest rate of all deposits in the national currency, including savings, was 9.5%. Taken separately, the interest rates on the deposits of legal entities and the savings of the population were 4.7% and 10.05%, respectively. The annual interest rate of AZN savings at some banks are as high as 15%. If we add *operational expenses* to the funds attracted by banks, we will see that the cost price of credit increases to double digits. Regarding operational expenses, Zakir Nuriyev, head of the Azerbaijan

Banks Association, and bank specialist Elman Sadigov pointed out that they account for around 4-5% of the banks' resources, which is not an insignificant indicator.

In the aftermath of the 2015 devaluation, banks pursued a policy of reducing the number of workers and their salaries, and consolidating branches for the sake of cost optimization, but in the last few months this process has begun to reverse. Between 2016 and 2019 (January-May) the average number of employees per bank increased by 14% from 530 to 606. In addition, the newly implemented service fee of the Financial Market Supervisory Authority (FMSA) is one of the reasons behind the recent increase of the banks' operational costs. For example, in 2018, the banks' annual payments to the FMSA amounted to 12.6 million AZN, and this figure becomes higher when we take into account the other payments to the FMSA. Of course, employee retention costs, fees to the FMSA and other expenses, increase operational costs, all of which are added on credit interest rates. Furthermore, banks also add *their additions* to credit interest rates. Thus, if we add the operational expenses and the additions of the banks to the funds brought in by high interest rates, we can see that the credit interest rates are at least 18-20%.

According to the World Bank, despite the high credit rates, the spread indicator (difference between credit interest rate and deposit interest rate) in Azerbaijan was 8.1% in 2017. However, in 2016, this figure was relatively high – 8.6%. For example, in 2017, this figure was 1.8% in Georgia, 4.6% in Moldova, 5.4% in Armenia, 7.3% in Ukraine, and 17% in Kyrgyzstan.

The second major reason is the high risk in the economy of Azerbaijan. High risks in the country's economy, including institutional risks (non-protection of ownership, an ineffective judicial system, the collateral mechanism, etc.), reduce the likelihood of repayment of loans, which in turn reduce the banks' interest in lending and forces them to increase their credit interest rates to insure their funds. If, before the devaluation, banks directed 73.5% of their funds (2013) to credit, in the first four months of 2019 this figure dropped to 43.3% (Chart 2). Given the reserve of 1.4 billion AZN to compensate for possible losses, it is clear that 38 AZN out of each 100 AZN of the banks' funds are directed to loans in the economy. Banks tend to invest in the less risky securities market rather than in risky credits. It is no coincidence that at present 13-14% of banks' assets are directed toward the securities market. In 2016, this figure was 1%.

Chart 2: Fluctuations in the share of credit in the asset structure of the banking sector
Source: Financial Market Supervisory Authority of the Republic of Azerbaijan

Although the increase in the share of problematic credits in our banks was caused by the devaluation of the national currency, this problem also existed before. While the official data indicate that the share of overdue loans at that time was 5-6%, indeed it was more than that. After the devaluation of the manat, the share of problematic credits rose to 15.5% according to the official data. According to the Fitch International Ratings Agency, however, the share of problematic loans was more than 20%. It is enough to remember the share of toxic assets of the International Bank of Azerbaijan to see that the scale of the loss was higher. Despite the fact that the presidential decree providing compensation for problematic credits caused by devaluation provided support for the solution of the problem, the complete recovery of credit has yet to be achieved.

Due to the risk in the economy, the banks mostly prefer to give consumer loans. According to the Central Bank, currently more than 42% of total credit investments in the country are directed toward consumer loans. Among the business loans, only the trade and service sectors (17-18%) as well as the transport and communications sectors (10%) remain attractive for the banks. The share of other sectors is not more than 6% for each.

Due to the high risk, the banks take the *risk margin* higher and add it to credit interests. One of the reasons behind the high level of the risk margin is the ineffective functioning of the judicial system. Not only do the clients suffer from unfair decisions of the courts; the banks are also victims of such decisions. Even the failure to implement fair court decisions (on time) costs the banks additional time and expenses, which in turn creates problems for the obligations of the banks to other creditors. Allegations and counter-allegations by banks and their clients can cause delays in a trial for months or even years. This situation reduces the collateral role of credit and the ability of collateral mechanisms to function effectively. In practice, loans are granted at 50% of the value of the collaterals provided by customers at best. Only real estate in Baku and the surrounding areas is accepted as collateral. The banks are not interested in accepting real estate in the regions as collateral. The reason for this is very simple – it is difficult, and sometimes impossible, to sell them.

Recently, two important internationally widely-used mechanisms have been put into practice in Azerbaijan to reduce credit interest rates. Based on the newly created state real estate system, now individuals seeking credit can register their properties as collateral against loans from banks. In addition, the creation of a credit collateral mechanism also reduces risks and is a well-tested mechanism around the world. These mechanisms are not yet functional, and they cannot affect the credit market. Moreover, the merging of the Credit Guarantee Fund with the Mortgage Fund does not allow this mechanism to function efficiently.

Currently, 55% of the deposits in the country are available on demand (*that is, the customers may withdraw their deposit at any time* – **S.A.**) and 66% are in foreign currency. Deposits of this category are brought in at a maximum of 3% per year. Indeed, although most of the resources are inexpensive, credit interest rates remain high. Of course, we should not forget the high level of concentration in the banking sector. The market shares of the top five and the top ten banks in the deposit market are 71% and 85%, respectively. Cheap deposit resources are deposited in these banks, and the remaining banks attract deposit resources by high interest rates. Therefore, banks are constantly complaining about the high deposit interest rates. At first glance, it can be said that lowering the cost price of loans is possible as a result of cheapening the cost of deposits. This, however, is not the way out. To implement this, the institutional risk level in the national economy should be minimized. It is possible to ensure competitiveness in the credit market through genuine judicial reforms, simplification of collateral mechanisms, as well as the development of the securities market, and the complete openness of the national economy to international resources. Banks can also reduce credit interest rates by developing internet and mobile banking, and increasing the range of banking products.