AZERBAIJAN: Borrowing by Individuals

A Review of the Attitudes and Capacity for Indebtedness

Summary Issues and Observations

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Note from the Writer:

The data and observations in this note are based solely upon the responses to the survey of 'Indebtedness of Individual Borrowers'. The reader will identify some strongly contrasting responses from different segments of borrowers. These reflect the responses which have been received. This version of the review of survey data has been undertaken without any input from market participants in Azerbaijan. It is anticipated that the discussion of the survey findings with stakeholders will provide additional and deeper interpretation of the responses to the survey.

INTRODUCTION

A survey, "Indebtedness of Individuals", has been undertaken in Azerbaijan. The research interviews commenced in late-July and were completed by mid-September.

The purpose of this note is to provide a review of the responses, involving 3,000 borrowers and 1,000 non-borrowers. These extend across borrowers from micro-credit, non-bank organisations and bank institutions, together with some non-borrowers. The methodology of the survey is outlined in Attachment 1, and the survey questionnaire is shown in Attachment 2.

Objective of Survey

The primary focus of the survey is to better identify the experience of borrowing upon individuals. The principal dimensions involve:

- The broad demographic profile of borrowers;
- The major characteristics of their financial and budgetary position;
- Their attitudes towards debt and lending institutions

A core objective of the survey is to gain greater insights into the extent, and impact, of over-indebtedness amongst borrowers. The structure of the survey is designed towards this goal. The objective of the survey is not, therefore, primarily to review the commercial and social performances of the lending industry, but only to the extent that such issues impact upon the budget and lifestyle of the individual borrower – and how these may vary in different locations.

An important dimension of the survey is to relate 'over-indebtedness' to the affordability of debt and the adequacy of income to meet expenditure needs. On this basis, lending should be undertaken against the capacity of the borrower to meet loan repayments in a timely manner – and not against any 'forced sale' realisation of assets or payments by a guarantor. A further key dimension is to gain better insights of the interaction between the quantitative dimensions of the borrowers' financial position and qualitative dimensions of the feelings of the borrower in relation to financial confidence, risk vulnerability and the impact of debt on their lifestyles.

Similar surveys have been undertaken in other countries[1]. During the last year, there have been significant global and national economic and market events which have impacted directly upon the borrowing clients. The structure of the surveys enables some comparative assessments of the 2016 situations of Azerbaijan and Tajikistan in relation to the quantitative and qualitative dimensions of the financial and social impact of debt upon the lifestyle of borrowers.

It is intended that this demand-side research will contribute an important benchmark for the assessment of the impact of the extension of financial services within society. The survey is directed towards borrowers. It does not seek to provide a representation of the total population of Azerbaijan, but rather identify the principal segments of borrowers and their profiles / characteristics. As this is the first such 'borrower focused' review (rather than industry-led initiatives), the range of interviews in the survey sample is substantial and is intended to provide a robust confidence level in the available insights.

[1] 'Indebtedness of Individuals' surveys have been undertaken in [i] Bosnia I Herzegovina in the 4 years 2011-2014, [ii] Kyrgyzstan in the 2 years 2013-2014, and [iii] Tajikistan in 2014 and 2016. Each survey involved a similar level of respondents of about 4,000.

Structure of the Report

The survey and this report is designed to consider the identification, performance and characteristics of different segments of borrowers. Some show significant and substantial differences, most notably between Baku region and other regions outside Baku.

External national data (see Attachment 3.) identifies that over 80% of lending balances (to both corporate and individual) is undertaken with the Baku region. This contrasts with the population of Baku accounting for about 28% of the national population.

The value of outstanding loans and the number of individual borrowers is not available on a regional basis. The national banking statistics clearly show a dominating concentration of lending activity in Baku. However, this relates to total lending which will include lending to corporate entities, large businesses, high-worth individuals, in addition to 'individual borrowers'. The scale of lending to such individual borrowers (the target respondents of this survey) is not known.

This report seeks to identify the different characteristics of the markets of Baku and the other regions for individual lending. The report describes the various major segments of borrowers. The scale and impact of these will vary in relation to the distribution of loan portfolios within individual lending institutions.

This report is focused towards the segmentation of borrowers based solely upon the responses to the survey. It does not seek to provide a weighted description of national borrowings by individuals.

Report Framework

This paper comprises four major sections:

SURVEY HEADLINES

Significant differences are shown in the risk exposure and attitudes of clients in major segments.

- The profile of Baku regions differs substantially from that of the other regions in relation to both credit risk performance and the attitudes of borrowers towards the lending institutions and the affordability and impact of debt;
- 36% of 'own business' clients show loan arrears, in contrast to 8% of ‘employed’ clients;
- About 50% of borrowers in Baku and 75% of borrowers in other regions show pressures on their domestic budget;
- The loan portfolios of ‘own business’ and ‘foreign currency loans’ show a high risk vulnerability. This is particularly acute in regions outside Baku;
- The reputation of the lending institutions in relation to the value of trustworthiness and integrity is extremely low (particularly outside Baku region);
- Minimal differentiation in the demographic and income profiles of MFI and bank clients, but significant differences between the loan performance and client attitudes of each institution;
- Lower impact and dependency of debt in the Baku market.

This presents a very segmented and differentiated profile of the delivery, performance and impact of financial services in different parts of the country. The challenges of loan performance and financial inclusion vary considerably between Baku and the other regions.

Note: The following ‘headlines’ are not weighted to reflect any national distribution of individual borrowing.

The following highlights show consistent differences between Baku and the other regions. This pervades the responses to the surveys. It suggests that there are either fundamental differences in market conditions and the service proposition / delivery of financial products and services – or that the cultures and behaviour of borrowers vary substantially.

Credit Quality is poor – and the differences between Baku and elsewhere are substantial

- Loan arrears: overall response at 17% … based on number of borrowers, within which:
  - MFI 14% Banks 19%
  - Baku 11% Other regions 19%
  - US Dollar 59% AZN Manat 8%
  - Own Business 36% Employed 8%
- Utility arrears: overall response at 9% (MFI 7%; bank 11%) … based on number of borrowers.
- Loan repayments more than can afford: overall response 43%, within which:
  - MFI 42% Banks 43%
  - Baku 18% Other regions 54%
- Reduced food to make loan repayments: 59%, within which:
  - MFI 56% Banks 62%
  - Baku 17% Other regions 78%

- Basic expenditures (food, household, utilities, and loan) more than 75% of income: overall 44%:
  - MFI 45% Banks 43%
  - Baku 25% Other regions 53%

Reputation of the values of lending institutions is extremely low – particularly for MFIs and outside Baku

A low level of positive reputation in relation to standards which should underpin the financial industry (based upon the percentage of respondents who agree, or strongly agree).

- Trustworthy: overall 13% of borrowers, within which
  - MFI 8% Banks 19%
  - Baku 20% Other regions 10%
- Integrity: overall 9% of borrowers, within which
  - MFI 3% Banks 15%
  - Baku 19% Other regions 4%
- Improve clients' lives: overall 7% of borrowers , within which:
  - MFI 3% Banks 12%
  - Baku 15% Other regions 3%
- Understand clients' needs: overall 40% of borrowers, within which:
  - MFI 47% Banks 33%
  - Baku 72% Other regions 25%

This seems to be particularly surprising for the MFI sector which is, reportedly, still at a relatively early developmental stage in the market and also challenging for 'financial inclusion'.

Lending institutions appear to have differentiated operational credit practices

- Only 18% of loans taken in last 6 months – this suggests a substantial reduction in lending, or demand:
  - MFI 17% Banks 20%
  - Baku 20% Other regions 18%
- Frequency of loan approvals varies substantially between the 'employed' segment and 'own business':
  - Employed 60% current loan approved within the last 12 months;
  - Own Business 26% current loan approved within the last 12 months.
- Only 27% of borrowers agree that 'loans were easy to obtain':
  - MFI 22% Banks 33%
  - Baku 19% Other regions 31%
- Respond well to lending problems: 59% of borrowers - still low, but higher than reputation:
  - MFI 56% Banks 54%
  - Baku 74% Other regions 46%

- Formal refinance (in last 12 months) is low - 10%:
    - MFI 8% Banks 13%
    - Baku 13% Other regions 9%

Similar client income profiles, but different credit quality and client attitudes between MFIs and banks

- Strong overlap of household incomes
    - with similar levels of average incomes (MFI AZN 1,008, bank AZN 1,016, former bank AZN 941) – which indicates that the lending banks have been focusing client 'rejection' on lower incomes;
    - similar proportion of borrowers with household incomes less than AZN 750 per month (about 25% of borrowers).
- Higher average loan balance with bank borrowers (MFI 1,850; bank 2,650) … but …
    - bank loans have a slightly longer residual repayment term (14 months compared with 11 for MFI), which results in.
    - average monthly repayment is broadly similar for each at about 35-40% of net disposable income (household income, less, food, essentials, utilities and telephone/internet).
- MFIs have a higher level of collateralisation (MFI 42% of borrowers against banks 30% of borrowers).
    - Principal items of collateral are business equipment 40%, domestic assets (MFI 19% and banks 15%), and gold / jewellery (MFI 19%, banks 15%) - % as a share of collateral assets;
    - Property as collateral was low at MFI 8% and banks 15% - % as a share of collateral assets.
- Banks have 41% of borrowers being paid income by bank transfer, whilst MFIs are still close at 28%.

Borrowers' attitudes show the financial pressures which they are experiencing:

- Financial position improved in last 6 months: only 17% agree, within which:
    - MFI 11% Banks 23%
    - Baku 16% Other regions 17%
- Feel in control of financial position: only 42% agree, within which:
    - MFI 42% Banks 42%
    - Baku 86% Other regions 23%
- Household expenses risen faster than income: 75% agree, within which:
    - MFI 81% Banks 72%
    - Baku 82% Other regions 74%
- Food expenditure reduced to make loan repayments: 59% agree, within which:
    - MFI 56% Banks 62%
    - Baku 17% Other regions 78%

- Basic expenditures (food, household, utilities, and loan) more than 75% of income: overall 44%:
  - MFI 45% Banks 43%
  - Baku 25% Other regions 53%
- Want help to resolve debt problems with lender: 69% agree, within which:
  - MFI 65% Banks 73%
  - Baku 37% Other regions 83%

Borrowers show some conflicting attitudes towards loans

- Loans improve life quality: 45% agree, within which:
  - MFI 41% Banks 49%
  - Baku 19% Other regions 56%
- Need to continue to borrow to maintain family lifestyle: 44% agree, within which
  - MFI 42% Banks 45%
  - Baku 13% Other regions 57%
- I can afford to buy 'treats' for family: 65% agree
  - MFI 59% Banks 69%
  - Baku 36% Other regions 76%

Social situation surrounding borrowers appears pressured

- Major illness of self or family: 25% borrowers - *(29% of those with repayment difficulties):*
  - MFI 28% Banks 21%
  - Baku 18% Other regions 28%
- Friends have difficulty meeting domestic budget: 94% agree
  - MFI 95% Banks 89%
  - Baku 74% Other regions 97%
- Debt causes family problems: [only] 39% borrowers agree
  - MFI 37% Banks 41%
  - Baku 21% Other regions 47%
- Children will have a better life than me only 35% of borrowers and non-borrowers agree:
  - MFI 31% Banks 38%
  - Baku 48% Other regions 31%

SUMMARY REVIEW OF A STUDY OF THE INDEBTEDNESS AND ATTITUDES OF INDIVIDUALS

SUMMARY OBSERVATIONS

The Contrasting Profiles of Baku and Other Regions

Baku region displays significant differences from other regions in relation to the profile and performance of borrowings by individuals, and also in relation to the attitudes of those clients' towards debt, their financial situation and the reputation of the lending institutions.

There are some strongly contrasting profiles across different borrower segments. This suggests that the different lending markets in Azerbaijan are subject to a range of dynamics which impact substantially upon the profile and performance of lending.

Baku and the other regions present substantial differences in many dimensions of the profile of lending and also the attitudes of borrowers. The profile of loans in Baku shows a consistently stronger and positive situation than is reflected across the other regions. This applies to lower levels of loan arrears (14% in comparison with 19%), a substantially lower incidence of reduced food expenditure to enable loan repayments (17% in contrast to 78%), the perception that loan repayments are more than can be afforded (17% in comparison with 54%) and that borrowers feel in control of their financial situation (86% in contrast to 23%). This more favourable position in Baku occurs despite similar levels of recognition of adverse economic pressures over the last 6 months involving costs rising faster than incomes, the recognition of domestic budget pressures amongst friends, and low improvement in the domestic financial position.

The profile of lending is also shown to differ substantially between Baku and elsewhere. Although only a small proportion of borrowers in Baku (19%) considered that it was 'easy' to obtain a loan (in comparison with 31% elsewhere), Baku showed a much stronger recognition (74% in comparison with 46%) that lending institutions respond well to problem lending situations. This is further reflected in the perception in Baku (72% of borrowers) that lending institutions understood clients' needs, which is in sharp contrast to only 25% in other regions.

Although the survey responses indicate a low overall reputation of the lending institutions, the contrasting profiles of Baku and the other regions continue – with the other regions showing extremely low perceptions of lending institutions in relation to trustworthiness (10% of borrowers), integrity (4%) and seeking to improve clients' lives (3%).

The above observations reflect some of the 'dimensions of contrast' between Baku and other regions. The national banking statistics indicate that about 80% of total bank lending (both corporate and individual)[2] is based in Baku region. This indicates that there will probably be an inevitable focus of the lending institutions towards this market. Conversely, Baku accounts for only 28% of the national population – and there is, therefore, a substantial market of individuals in the other regions. There is no available data to quantify the extent of lending across the different regions to individual borrowers by MFIs and banks. However, the often stark differences in the loan performance and attitudes of clients in Baku and the other regions suggest that the lending institutions may operate different lending policies and practices across the regions.

On this basis, the survey responses suggest that consideration of its findings need to be considered on a segmented basis reflecting not only the characteristics of individual borrower segments, but also with the overlay of different regional dynamics and structure.

[2] Care: Lending statistics are based on total bank lending for both corporate and individual clients. Separate regional analysis of individual borrowings has not been identified. The distribution of individual borrowing is not, therefore, available to the writer on an individual regional basis.

Financial Inclusion

There is a broad feeling of 'inclusion' amongst both male and female borrowers, and across the range of borrower incomes. Loan amounts and loan payment leverage are higher amongst male borrowers in both the 'employed' and 'own business' segments.

National statistics for bank lending indicate that about 80% of total lending (including both corporate and individual) is undertaken in the Baku region. However, national demographic statistics indicate that 28% of the population live in the Baku area, whilst 72% live in other regions. It is not known if this contrast between an apparent concentration of lending and the distribution of population reflects a lack of demand in the other regions, a lack of supply capacity by the lending institutions, or the existence of higher volume / lower value of lending to individuals in the regions. The borrowers in the regions outside Baku indicate strongly (about 75% of borrowers) that they feel to be part of the 'target market' for lending institutions. This feeling of 'inclusion' is also shown by former bank borrowers (80%) and those who have never borrowed (71%).

The profile of borrowers shows that 18% of borrowers in Baku and 31% of borrowers in other regions outside Baku have a household income less than AZN 750. This is suggested by the Wage Indicator Foundation to be about the minimal living income (AZN 720) for a family in Azerbaijan. This indicates that the borrower profile of incomes reflects an inclusive approach by lending institutions towards lower income households.

Household income levels of female borrowers are consistently about 10% lower than those of male borrowers across city, urban and rural locations. However, the proportion of females undertaking 'own business' activity is lower (42%) than males (58%). The average loan amounts and leverage ratios against income are higher amongst male borrowers. The average outstanding loan for male employed workers is 50% higher than for female employees; whilst the average outstanding loan amongst male 'own business' borrowers is 40% higher than their female counterparts. Such higher borrowings by males is also accompanied by higher levels of loans from friends. Both male and female borrowers demonstrate similar perceptions of being part of the target market / client of the lending institutions.

68% of borrowers stated that they were the 'only' borrower in the household, of which 64% were male. However, 22% identified independent borrowings by both the borrower and his/her spouse – 84% of such independent borrowers were female. This suggests that such 'independent female borrowers' were undertaking such loans without the knowledge of their spouse, or that (for some reason) such male spouses did not wish to acknowledge such actions. Such independent borrowers showed a higher level of loan usage for domestic consumption expenditures (non-asset acquisition) which may suggest that the female borrower may have been supplementing the family budget with loan funds.

The attitudes and profiles of respondents suggest, therefore, that there appears to be a broad feeling of inclusion and this applied across all the income segments of borrowers. The uncertainty of inclusion remains in relation to the apparent concentration of lending in the Baku region (*an assumption based solely upon the national total lending* statistics) and the consequent extent to which the low level of outstanding lending in other regions reflects predominately a 'demand-side' or 'supply-side' focus.

Microfinance and Non-Bank Organisations and Commercial Banks

Similar demographic profiles show a strong overlap for MFIs and banks – attitudinal and budget pressures are similar for MFI and bank borrowers in regions outside Baku – bank borrowers show higher outstanding loan amounts and repayment leverage than MFI clients with similar income characteristics – in Baku, MFI clients show a much lower level of loan arrears and budget pressures than bank borrowers but bank clients have a much more positive / favourable opinion of their lending institutions – no strategic differentiation of MFIs (if any were intended) is shown by client responses.

The current scale of lending to individual borrowers by microfinance institutions and non-bank organisations, and by commercial banks cannot be determined from available 'public domain' data. However, it is understood that the commercial banks have an established and dominant market share and that the activities of MFIs and NBOs are at a more developmental stage. Furthermore, available data indicates that total commercial lending (both corporate and individual) is predominately (c.80%) based in Baku – the comparative regional distribution of lending by MFIs and NBOs is also not known.

Whilst the survey responses indicate that the household income profiles of the individual borrowers of banks and MFIs show a high level of overlap, there are differences in the demographic, behavioural and attitudinal profiles of the two groups of clients – and also in the loan service propositions of the respective lending institutions.

Banks showed a slightly higher proportion of individual borrowers in regular employment (67% in comparison with 62%), whilst MFIs showed a slightly higher proportion of 'own business' clients (33% in comparison with 25%). MFIs have a higher proportion of clients who have pledged collateral assets (42% of borrowers compared with 30% in banks). The proportion of individual borrowers with foreign currency loans was similar (17%) for each type of institution, whilst the average outstanding bank foreign currency loan was 40% higher for bank borrowers in comparison with MFIs. The levels of collateral assets in property and business equipment were similar for each type of institution. MFIs hold slightly higher levels of domestic assets and jewellery, whilst the banks held slightly a higher level of motor vehicles.

Average household incomes in Baku are similar for MFI (AZN 1,250) and bank (AZN 1,225), and also in other regions (MFI AZN 900 and banks AZN 925). However, whilst average outstanding loans in other regions are only 20% higher for bank borrowers, average bank loans in Baku are 85% higher for bank clients. Such differences may be reflected in the level of loan arrears in Baku in which MFIs show 3% and bank borrowers show 20%. In the other regions, loan arrears are similar at 19% for both MFIs and banks.

The low reputations of the MFIs and banks are reviewed in a following section of this overview. However, the MFI clients demonstrate a consistently low opinion of the corporate values displayed by the lending institutions – only bank clients in Baku show a more favourable regard for the trustworthiness and integrity of lending institutions (albeit still at a low level). This extremely low regard for the lending institutions is also reflected in their seeking to improve the lives of clients being less than 5% in MFIs (throughout the country) and bank clients in regions outside Baku – about 30% of bank clients in Baku had a positive view.

Whilst the attitudes of both MFI and bank clients in regions outside Baku were broadly similar in relation to the impact[3] and affordability[4] of loans, there were substantial differences between individual borrowers of MFIs and banks in Baku.

Despite the MFIs / NBOs being in a relatively developmental stage, the MFIs do not appear to be generating a strong and favourable reputation. The levels of client overlap between the MFI and bank borrowers appear to be high and show little substantive differentiation of target markets (albeit with modest variations).

Over-Indebtedness

Problem debt pressures extend substantially beyond loan arrears – these varied substantially between Baku and the other regions (which displayed an extremely strong and adverse impact upon domestic lifestyle).

Whilst there is a continuing, and at times divergent, debate upon the definition of 'over-indebtedness', this review assesses over-indebtedness as:

> "The extent to which a borrower is adversely affected by the interaction of the quantitative dimensions of loan repayment(s) upon his/her financial position, and the qualitative dimensions of the impact of debt upon the financial confidence, risk vulnerability and the lifestyle of the borrower and dependents".

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[3] Impact of loan relates to questions involving: quality of life, cause of family problems, reduction in food expenditure to enable loan repayments

[4] Loan affordability relates to questions involving: loan arrears, utility arrears, loan repayments more than can be afforded, informal loans

On the basis of this definition, the impact of over-indebtedness must be considered more widely than the 'visible' popular measure of loan arrears – which was 8% amongst employed borrowers and 36% amongst the 'own business' segment – and – 11% in Baku and 19% in the other regions.

The wider impact of debt repayment pressures differed sharply between borrowers in Baku and those in other regions. Within Baku, only 18% of borrowers considered that loan repayments were more than they could afford in contrast to 54% in other regions. This attitude was widened further by the behavioural dynamic of the reduction in food expenditure to enable loan repayments – this was undertaken by only 17% of borrowers in Baku in sharp contrast to 78% in other regions. (Within Baku region, bank borrowers showed a much higher level of debt pressure than was reflected by MFI clients). Such debt repayment pressures are further reflected by a high recognition of borrowers (about 80%) outside Baku of the need for assistance to resolve problem debt situations with their lending institution (in comparison with 37% in Baku).

These different levels of problem debt recognition are reflected in the attitudes towards future borrowing needs. Although borrowers outside Baku show much higher levels of debt pressure, there is also a much stronger recognition (by 57% of borrowers) that they need to continue to borrow to maintain the lifestyle of their family, despite the austerity and constraint in their current financial behaviour. This contrasts with only 13% of Baku borrowers who need to borrow to support their lifestyle. However, in both Baku and the other regions, about 40% of borrowers used their last loan primarily for domestic consumption purposes.

In addition to the recognition of debt pressures by 50% of borrowers (29% of borrowers in Baku and 58% elsewhere), a further 19% of borrowers had basic committed expenditures[5] greater than 75% of income (16% of borrowers in Baku and 20% elsewhere). This represents a substantial majority of borrowers whose financial position is vulnerable to any disproportionate increase in the cost-of-living in relation to income growth. Borrowers in regions outside Baku are particularly sensitive to increases in the costs of basic household expenditure – a 10% increase in such costs would increase the proportion of clients with committed expenditures over 75% of income from 53% to 70% of borrowers – by comparison, the increase in Baku would be from 25% to 32%.

Lender / Borrower Relationship

The reputation of the lending industry is extremely low in relation to the core value of trustworthiness and integrity – an overwhelming majority of borrowers also consider that lending institutions do not seek to improve the lives of clients.

The reputation of the lending institutions was held in low regard by borrowers. In the core values of the lending institutions, the perception of 'trustworthiness' was only 13% and of 'integrity', only 9%. The MFIs / non-bank institutions were held in particularly low regard, only 8% and 3% respectively – in comparison with the attitudes of bank clients being 19% and 15%. These perceptions of the core values of the financial institutions contrast sharply with the much stronger and more favourable attitudes of borrowers in other countries[6]. This appears to present a fundamental market and strategic challenge to the financial sector. Such adverse attitude by only 1% of borrowers and 3% non-borrowers held savings with a financial institution, in contrast to some other forms of savings (by 28% of borrowers and 47% of non-borrowers).

This reputational challenge is further reflected by the perception amongst borrowers that the lending institutions do not seek to improve the lives of clients (only 3% of MFI/non-bank clients and 12% of bank clients). This appears to present an even greater challenge to the non-bank sector in relation to their mission focus towards the betterment of the lives of clients. Such attitudes are particularly low amongst the 'own business' client segment.

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[5] Basic committed expenditures: essential food and domestic expenditure, telephone and internet, utility payments and loan repayments – but excluding expenditures such as health, education, clothes, transportation and so on)

[6] Similar surveys have been undertaken in Tajikistan (2014 and 2016), Kyrgyzstan (2013 and 2014) and Bosnia i Herzegovina (2011-2014)

However, despite this low perception of the reputation of the lending institutions, a majority of borrowers outside Baku recognise a need for continuing borrowing to maintain the lifestyle of their family. This appears to suggest that the borrower / lender relationship is based essentially upon a 'transactional need' for loan funds (debt dependency), rather than any enduring client relationship strategy.

Impact of Lending on Borrowers

The positive impact of loans on the quality of life is perceived more strongly in the regions outside Baku, despite the apparent stronger affordability of debt and more discretionary attitude towards borrowing in Baku – the flow of loan approvals in the last 12 months has been much stronger to the 'employed' client segments than to 'own business' clients

Almost half (45%) of borrowers consider that loans improve the quality of their lives (slightly higher amongst bank clients than MFI/non-bank) and a similar proportion recognise that continuing loans are necessary to maintain their lifestyle. This favourable impact of loans on the quality of life was much stronger in regions outside Baku (56%) than in Baku (19%). Within Baku, only 2% of the MFI/non-bank clients agreed that loans improved the quality of life (even though credit risk performance was strong and did not show any significant level of pressure).

The impact upon lifestyles is reflected by the extent to which debt causes problems in the family (52% of 'own business' clients compared with 32% with 'employed).

Despite the adverse economic trends, borrowers have displayed a strong commitment to their loan repayment obligations. Even amongst those clients with arrears (17% of the total respondents of individual borrowers), 75% had reduced food expenditure to enable loan repayments (although Baku at 38% contrasted with 85% in other regions).

Borrowers show that a large majority of the friends of borrowers is having difficulties to meet their domestic budgets (75% in Baku and 97% in regions outside Baku). This suggests a wide recognition of the financial pressures. This broader recognition of financial challenges in Baku may seem to be somewhat incompatible with the response that only 18% of Baku borrowers were having difficulties to meet their loan repayments. This may suggest that in Baku, borrowers may be more ready to recognise the financial problems of other than to acknowledge it in their own position. If this observation reflects a cultural, or behavioural, characteristics of Baku, then it may further suggest that some of the more 'confident' responses to the recognition of financial problems may be somewhat 'optimistic' on the part of the borrower.

The availability of loan funds may also be impacting upon the attitudes of borrowers. Amongst 'employed' borrowers, 60% obtained their current loan within the last 12 months[7] whilst only 25% of loans with the 'own business' segment was provided in that period. Within this overall level, the major client segment of 'public sector' employees show 65% with loans obtained in the last year (a similar level in both Baku and other regions), whilst the 'own business' segment in retail activities contrasted with 50% in Baku in the last 12 months but only 18% in the other regions. Against the economic, exchange rate and inflationary pressures which have occurred in the last 12 months, it may have been anticipated that there would have been much higher demand from the 'own business' segment for revisions to their loans.

The responses display again the highly-segmented characteristics of borrowers and how these are reflected in the different aspects of the impact of loans.

Social Impact of Borrowing

There is a significant level of informal financial support within society, particularly in the regions outside Baku, in relation to financial guarantees, informal loans and credit from retailers – debt pressures are causing problems within families, not least as a result of the extensive reliance of reduced food expenditure as the budget mechanism to enable loan repayments (this is extremely high amongst borrowers outside Baku and Abershon).

[7] Date of last loan: survey interviews were undertaken primarily in July and August 2016

The structure of lending and the behaviour of borrowers has wider implications than is reflected through the direct credit quality performance of the loan account.

There appears to be a high level of social interaction and support in relation to borrowers. A large majority (85%) of borrowers have given at least one guarantee to support the loan indebtedness of another borrower. (The incidence of such guarantee support by non-borrowers is much lower at 60%). This occurs more extensively in the regions outside Baku.

Such interaction to support the financial commitment of 'friends' is further reflected in the availability and use of informal loans from friends by borrowers. This is greater (18%) in regions outside Baku, than in Baku (5%) – and somewhat higher (17%) amongst 'own business' than 'employed' (12%). However, such informal support within society is used more extensively by borrowers with loan arrears (Baku 14% and other regions 23%). Such defensive behaviour by 'arrears' borrowers is shown further by the higher usage of credit from retailers in relation to domestic consumption purchases (involving 12% of arrears clients in Baku and 19% elsewhere). This suggests that there would have been greater pressure upon the level of loan arrears if such informal loan support had not been available.

Additionally, it may be noted that the use of informal credit by borrowers from retailers has an adverse impact upon the cash flow of those retailers, who must continue to meet the cash flow obligations of payments to wholesalers and loan repayments. The 'ripple effect' of financial pressure upon the borrowers pervades more widely across the local economies.

The social impact of borrowing is also reflected in the level of reduced food expenditure to enable loan repayments. This is extensive and involved 60% of individual borrowers responding to the survey. This is a high overall level in comparison with 40% shown in Tajikistan in June 2016. Whilst only 17% of borrowers in Baku and Abershon had reduced food expenditures, this action had been taken by about 80% of borrowers in other regions. About 40% of respondents considered that debt repayments caused problems in their family, again this was lower in Baku (21%) than in the other regions (47%).

Loans Collateralised by Pledged Assets

Collateralised lending shows a substantially higher risk profile – the underlying realisable value of collateral assets appears to be much stronger in Baku than in the other regions – collateralised lending accounts for 35% of clients and almost 60% of loan balances with loan arrears of 30%.

The proportion of loans supported by collateralised assets is greater for MFIs than banks.

- Collateralised loans represented 42% of MFI clients and 62% of outstanding loans;
- Collateralised loans represented 30% of MFI clients and 53% of outstanding loans;
- The use of collateral was much higher in regions outside Baku – MFIs 47% in comparison with 30% in Baku, and with bank clients, 36% compared with 18%.

The scale of outstanding loan balances was much higher in relation to collateralised loans. This is now accompanied by substantially higher levels of problem lending situations.

- MFI collateralised loans were 125% higher than non-collateralised, whilst the related household income is only 13% higher. The level of loan arrears in such collateralised loans is 26% in contrast to 6% in non-collateralised debt;
- Bank collateralised loans were 162% higher than non-collateralised, whilst the related household income is only 20% higher. The level of loan arrears in such collateralised loans is 37% in contrast to 11% in non-collateralised debt.

This suggests that such collateralised lending may have been driven by a perceived asset value, rather than the strength of the underlying cash flow of the borrower.

Collateralisation of assets to support a loan presents a fundamental dilemma to the lending institution. In the short term, it demonstrates an underlying value of the borrower – it provides a motivation as a result of the borrower not wishing to lose the assets or be forced to sell it – but, in the event of an incapacity to repay (due to an inadequate cash flow), the fundamental issue relates to the 'forced sale' value of the asset.

The overwhelming majority of borrowers have lived in the same neighbourhood for many years. Any attempt to re-possess, or realise, assets would, therefore be a high profile action and may be anticipated to have an impact upon the reputation of the lending institution (not least when most members of the community "have difficulties meeting the domestic budget"). Furthermore, the 'forced sale' value of such assets would probably result in one member of the well-established community befitting from the failure of another.

The types of collateralised asset varied also between Baku and the other regions. In Baku, the principal types of collateral were vehicles (44%), residential property (24%), and gold / jewellery (17%); whilst in the other regions, the principal collateral assets were business equipment (45%), domestic assets (21%) and gold / jewellery (17%). The structure of collateral in Baku appears, therefore, to be stronger than in the other regions.

This is a challenging social situation – particularly in the urban and rural areas. The strategy of the lending institutions towards the future actions in relation to collateralised assets may have significant implications not only for the amount-at-risk, but also in relation to the already-pressured reputation.

Risk Concentration: Client Segmentation

Significant segmentation of borrowers in relation to regional location, 'own business', collateralisation, foreign currency and public sector employees – major concentration of immediate risk exposure in relation to 'own business' clients with foreign currency loans.

The individual borrower clients are not a homogenous group. There are significant differences in the financial capacities and behavioural characteristics of different segments.

The level of loan arrears varies significantly between Baku (11% of clients) in contrast with the other regions (19%). The level of arrears (as a % of total borrowers) comprised 8% of clients who are 'employed' and 36% of 'own business' borrowers.

The distribution of these loan arrears situations across the major client segments shows wide variations in the levels of risk concentrations.

- Individual borrowers who are 'employed' accounted for 35% of arrears clients, whilst 'own business' clients accounted for 64%. Based on the survey responses, the 'employed arrears' represented only 25% of the loan balances which are in arrears, whilst 'own business' arrears balances accounted for 74% of total arrears balances. Such 'own business' arrears were concentrated in the regions outside Baku, accounting for 50% of total arrears shown in the survey.

- This demonstrates a significant risk concentration towards the 'own business' segment and, particularly, in regions outside Baku. The 'retail trade sector' is the major source of business activity and, within such clients, the scale of arrears varies substantially between those in Baku (12% of clients with loan arrears) and 43% of retail own business clients in other regions.

- The impact of foreign currency loans also had a significant impact upon loan arrears. 60% of borrowers with loan arrears had foreign currency loans, representing almost 70% of loan arrears outstanding balances.

- Within the lower arrears of the employed segment, public sector employees showed a [perhaps surprising] difference between Baku, with 13% of such clients being in arrears, and in other regions, where only 6% of such employees were in arrears.

Foreign currency borrowers have faced significant disruption and pressure in the last 12 months as a consequence of the devaluation of the Manat AZN.

- The impact has fallen primarily upon the 'own business' segment, and within that, largely upon borrowers in the retail segment. A majority of such borrowers indicate that it is more than 12 months since their last loan was approved (50% in Baku and 80% in other regions). This suggests that the foreign currency loan was outstanding prior to the currency devaluation crisis. However, the scale of such businesses does not suggest that there is likely to be a matched currency revenue stream.

- There was, therefore, a fundamental structural risk exposure for such borrowers – and this is now reflected in the extremely high level and concentration of arrears.

- Furthermore, foreign currency borrowers do not consider that the lending institutions adequately explained the risks of foreign exchange. Whilst only 35% of foreign currency borrowers in Baku considered that the risks had been explained, this was dramatically still lower in the other regions with only 5% of borrowers indicating that the risks had been explained.

Public Sector employees represent a significant proportion (43%) of employed borrowers but also a majority (65%) of outstanding loan balances of the 'employed borrower' segment. This is a strategically significant exposure. Whilst the average household income and average outstanding loan is similar for public sector employees and other employees in Baku and in other regions (albeit at lower levels), the risk profile is probably influenced favourably by the greater employment stability [*writer's assumption*].

The survey responses indicate, therefore, that there are significant portfolio segmentations of loan performance and behaviour / attitudes amongst individual borrowers in relation to [i] Baku and the other regions, [ii] 'own business, [iii] employed public sector, and [iv] foreign currency loans. These segments interact and appear to be of significant strategic development and operational performance.

Outlook for Lending to Current Borrowers

The economic outlook appears sombre – the lending portfolios present substantially different risk characteristics and development opportunities – the current profile of the market in Baku presents a less severe risk profile than is presented by the other regions – domestic budgets are keenly sensitive to any net inflationary increase (particularly in regions outside Baku) – this will require a focused approach to the varying needs of different client segments.

The current situation appears to be sombre. The borrowers have faced continuing and increasing austerity during the current year, being impacted by the pressure upon economic growth (particularly in the regions outside Baku), and the inflationary pressures (particularly on imported goods) resulting from the dramatic exchange rate devaluation. There is a widespread recognition of the increased pressures on the financial domestic budgets.

Borrowers have responded by a 'tightening of the domestic belt' by reductions in domestic expenditure. This has been seen more strongly in the regions outside Baku.

However, borrowers may be broadly categorised as [i] those who recognise that they have financial difficulties and debt repayment problems, [ii] those have minimal disposable income after meeting basic lifestyle and loan expenditures, but do not acknowledge their delicate financial position, and [iii] the remaining borrowers whose financial position is somewhat stronger. The markets of Baku and the other regions display different profiles across these three categories of 'loan affordability' and financial pressure.

- Baku has 45% of its clients displaying financial pressure (58% of balances);

- Other regions show 77% of clients displaying financial pressure (85% of balances);

The earlier comments identified the differences between varying major client segments.

The outlook for future lending will reflect, therefore, the significant portfolio and segment situations which exist. These have been outlined in earlier sections, together with the substantive differences between Baku and the other regions. However, if the scale of individual lending in Baku, in comparison with other regions, is reflected by the national banking statistics (about 80% of bank lending), the structural and portfolio risk exposures appear to be less severe.

Development of the loan portfolio in regions outside Baku would appear to present particular challenges in relation to the risk profile.

ISSUES FOR CONSIDERATION

The survey responses indicate a range of issues which have significant strategic or operational implications for the lending institutions and other institutional stakeholders.

The following comments provide some observations based only on the findings of the survey. Whilst such issues may have been addressed by lending institutions and other stakeholders, it is hoped that these observations, based upon the responses of clients, will provide a useful additional perspective.

'Own Business'

The significance of the 'own business' segment has been indicated in the previous section. Such clients are the entrepreneurs who seek to generate economic value from the loans and contribute to the development of local economies. This segment accounts for a substantial proportion of outstanding loan value and is, therefore, an important dimension of the stability of the loan exposure of lending institutions.

The survey responses indicate the high level of loan arrears, high incidence of business failures, and strong recognition of the difficulty in making loan repayments. The 'own business' segment is strongly concentrated in the retail and service sectors, which have generally low-entry, low-exit barriers.

These trading activities are also directly sensitive to the level of consumer demand and the cash liquidity in the local communities / economies. This has been adversely affected, in real terms, by the strong increase in price inflation, the reductions in domestic expenditure (such as foodstuffs) and, to a lesser extent, the slow-down in lending to individuals. The low level of loan approvals in 2016 is also likely to have adversely impacted the cash flow and liquidity of the 'own business' borrower.

The constraints upon the liquidity of household budgets, and thereby purchasing capacity, is reflected in the level of informal credit being provided by retailers, particularly for domestic consumption expenditures in Baku. Whilst such 'retailer credit' supports the community and households and sustains nominal 'sales turnover', it does not provide sales cash flow. Such informal credit is, therefore, effectively funded by the 'own business' loan funds. This is a substantial cost overhead and the extent to which this is incorporated in the sales price structure is not known. Lending to such 'own business' clients is, therefore, effectively lending (in part) to the end-consumer, rather than the trading activity itself. However, the level of such informal credit is much lower in the regions outside Baku. This may suggest that those retailers did not have an adequate cash flow / liquidity to provide such support to their clients.

This is a complex situation. The dynamics of the 'own business' client performance reflect an interaction of the individual's business ability (operational credit), the quality of the business cash-flow from both trading and retailer credit (operational credit), the local market conditions with the in/outflow of competitors and trading terms of wholesalers and distributors (portfolio risk), and the external pressures of economic and inflationary changes (structural risk). The 'own business' segment of borrowers does not show any significant level of available cash savings by which to fund any adjustment in trading conditions.

The 'own business' segment appears to be, therefore, strategically important to the stability of the lending institutions but, in the current environment, extremely vulnerable and sensitive to a wide range of both controllable and external risk factors.

Issue: The 'own business' segment is both strategically and operationally important to the performance of the lending institution and the systemic risk performance of the industry. Whilst it is outside the scope of the 2016 Indebtedness Survey to determine the governance structure of lending portfolios, the management of this client segment represents an important dimension of the stability of the industry. The factors affecting the performance of the 'own business' segment are complex.

Consideration may be given to the management structure and processes which are available to support the stability and performance of the 'own business' segment.

‘Client Relationship’

The low reputation of the lending institutions is a clear insight from this survey, particularly in relation to the core values of ‘trustworthiness’, ‘integrity’, and ‘understanding of client needs’. Whilst the opinions of respondents in Baku are more favourable than those in the other regions, the overall reputation of lending institutions is low in comparison with that seen in other countries in which similar surveys have been conducted.

Such cultural values may be suggested to be an essential foundation of the stable provision of financial services and certainly in relation to deposit-taking and other ‘trust-based’ services. The medium and long term development strategies of the financial institutions may be largely driven by the extent to which such adverse reputational positions can be reversed.

In the short-term, however, a significant proportion of the borrowing clients recognise the pressure and vulnerability of their financial position. There are significant concentrations of risk exposure and pressures on clients in some core strategic client segments, most notably ‘own business’ in both Baku and other regions (albeit at different levels of risk intensity), and also the risk exposure of foreign currency debt positions. The profile of loan approvals suggests that the lending institutions may have ‘closed the window’ towards the ‘own business’ segment by appearing to undertaken a much lower level of loan agreements / renewals. The development of resolution mechanisms for these problem situations will require a significant level of mutual trust and co-operation, particularly if the economic outlook remains sombre – and the borrower must have a confidence with which to approach the lending institution. There is, however, a gap between the borrower and the lending institution which needs to be bridged to enable a constructive dialogue to be established and sustainable work-out proposals agreed.

Whilst financial pressures on domestic budgets are high, the level of arrears (albeit high) may be contained by the austerity and constraints which borrowers have exercised upon the lifestyle of their family. This may reflect a perception by many borrowers of their debt dependency and need for future loans. With the low reputation of the lending industry, the balance of between client expectancy (for the renewal of loans) and the actions of lending institutions (the continuing availability of loan approvals) may be delicate – there is minimal indication that the client feels any fundamental relationship with the lender. This may represent a structural risk to the industry,

In the medium to long term, the role of the financial service institutions may seek to consider if the client relationship is essentially ‘transaction-focused’ or ‘relationship-focused’. The survey responses suggest that the current relationship is primarily transactional, based upon the provision of the loan product rather than the establishment of a continuing, longer-term development relationship.

This is a fundamental dimension of the strategic positioning of the industry. The survey responses highlight the scale of the immediate challenge which faces the industry, its stakeholders and the regulatory environment.

Issue: ***The current low reputation of the lending institutions may be constraining the development of constructive proposals for the resolution of problem debt situations in the immediate future, particularly in relation to the ‘own business’ segment. Such low reputation also presents a core strategic and structural risk to lending institutions.***

‘Financial Inclusion’

The survey presents two different markets – Baku and the other regions. The challenge of financial inclusion may be reflected through the different perspectives of the borrower and the lending institution.

The impact of ‘Responsible Finance’ may be considered in relation to [i] Responsible Finance’, [ii] Responsible Lending’, and [iii] Responsible Borrowing’. (In the following sections, a suggested definition is set out in italics in view of the range of interpretations – this represents a ‘base-point’ by the writer for consideration – each institution will establish its own interpretation).

Responsible Finance: *“From the financial institution: The provision of financial services (both product and service) which are appropriate to provide a balance between the commercial performance of the institution and the needs of the recipient client and which provide a positive contribution to the client’s financial well-being.*

From the client: The realistic understanding of the likely income and expenditure cash flows in the near and medium term and to seek financial services which are commensurate with such anticipated cash flows and the usage of loan funds.”

The different profiles of Baku and the other regions suggest that there are two quite different markets – in Baku, a developed and largely-saturated market; whilst in the other regions, the market appears to be at a much earlier developmental stage. The needs of the client and the dimensions of ‘responsible finance’ are, therefore, different in each situation. If the provision of loan finance is perceived as simply a mechanism of providing a commodity, cash, then it may be difficult to determine the benefits of the loan as being attributable to the services of the lending institution.

Issue: Lending institutions need to consider the alignment of their mission and strategy in relation to the differentiated client service and product propositions in Baku and the other regions. This will enable clarification of the different drivers of the business strategy, together with the balance between a ‘product / transaction’-led market approach and a client relationship.

Responsible Lending: *“The provision of loan finance, by appropriate product structures and on clearly understandable terms, for the betterment of the client for which repayment can be undertaken from identified and adequate cash flow sources, and which will not cause inappropriate financial pressure or budgetary strictures upon the borrower or his/her dependents”*

The balance of ‘responsible lending’ and ‘prudent and commercial management’ presents a challenging dichotomy for the governance and management of the lending institution. The survey responses demonstrate a range of situations in which a ‘client-driven’ definition of ‘responsible lending’ is challenged by ‘commercial drivers’ for the credit strength of the loan portfolio and the financial performance and stability of the institution.

The competition between such driving factors is exampled below, based upon the survey responses of borrowers.

- For those institutions with US Dollar-based funding, foreign currency lending improved the balance sheet currency match … but the exchange rate risk exposure was transferred to the borrower with largely un-matched AZN income streams. (The response of clients to the absence of adequate explanation / identification of the exchange rate risks highlights this further);

- Collateralised assets supported the credit approval of higher-value loan exposure at higher leverage ratios … but the debt exposure resulted in a more vulnerable financial position for the borrower;

- Fixed-term, fixed repayment loans provide a cost efficient mechanism for loan delivery and operational control … but such loan structure is often inconsistent with the usage of the loan funds and, for ‘own business borrowers, the cash flow of the trading activity;

- Reduction to the flow of loan approvals and renewals may meet the liquidity demands of the institution and enable tighter operational credit management … but such reduction in the flow of loans impacts directly and immediately upon the cash flow and sustainability of ‘own business’ activities;

- The level of loan arrears may present a favourable position of credit performance in comparison to the underlying (and 'unseen') level of 'over-indebtedness … but many borrowers experienced significant reductions to their lifestyle to enable repayments to be made and maintain a 'credit record' to support loan renewal;

- The operational credit management of higher risk portfolios (such as 'retail own business' and 'foreign currency') may have short-term benefits upon performance ratios … but this may have longer-term structural implications for the local economies and communities in which such 'own business' clients operate.

This is a delicately-poised situation – the stability and performance of the institution needs to be maintained, together with the expectations of external stakeholders – a large majority of borrowers have a minimal 'trust' in the lending institutions – yet each is mutually-dependent on the other to enable a sustainable work-out resolution to be achieved. There are significant strategic and operational implications for the governance and management of individual institutions and the industry.

Issue: ***The balance of 'responsible lending' between a commercial-driven approach by the institution to maintain its obligations to external stakeholders and a client-driven approach to protect the client from inappropriate actions by either the institution or him/herself is a significant governance and management issue for the institution, the industry and external stakeholders. The wider economic and cultural implications of the current highly-strained reputation of the lending industry may need to be assessed.***

Responsible Borrowing: *"The acceptance of debt and repayment obligations which are consistent with the reasonably-anticipated income flows and expenditure commitments of the borrower, with the reasonable anticipation of the financial capacity to make timely loan repayments without an unduly adverse impact upon the lifestyle of the borrower or his/her dependents, and responding with accuracy and probity to information requested by the lending institution"*

The responses suggest that many borrowers perceive the loan primarily as a source of funds, rather than future stream of cash repayments. This is particularly illustrated by the increased recognition of difficulty in making loan payments whilst, at the same time, recognizing a dependency on continued borrowings.

This appears to be a much greater challenge in the more developmental markets of the regions outside Baku, than in in the mature market of Baku itself. The lending institutions appear to present a range of products which can be reasonably aligned to the usage of the loan funds, together with the application of operational credit standards in relation to repayment leverage for the 'employed' segment of borrowers

Issue: ***The challenge of financial education appears to be greater in the regions outside Baku. However, the scale of lending in these regions may be much less than that in Baku and the focus of financial education may need to be closely aligned to the strategies for business development in such regions.***

Strategic Implications

The survey on 'Borrowing by Individuals' identifies a range of issues which may have significant implications for individual lending institutions and the wider lending industry in Azerbaijan. Whilst it is not within the scope of this survey to quantify the potential implications resulting from the changes in the structure of the loan portfolios, the diverse attitudes and financial pressures amongst borrowers in different regions, the low reputational standing of the lending industry and the on-going impact of economic constraints, have a range of risk management implications which are broader than operational credit risk. Such dimensions may be anticipated to impact upon the financial structure, trading performances and strategic risk outlook of institutions.

The lending institutions appear to face some significant strategic challenges in relation to:

- The reputation of the industry and the absence of 'trust' by the client;
- The significant risk exposure of the 'own business' segment and the apparent reduction of loan approvals to these clients;

- The substantially adverse profile of borrowers in regions outside Baku;
- The period of time which will be required for the work-out of many foreign-currency debt situations.

This may be further influenced by actions in relation to the determination / realisation of collateral on defaulting loans. If the repossession / realisation of the collateral support is pursued, it may impact still further the reputation of the financial industry (and thereby future development of financial inclusion), but if such action is not pursued, then the ‘motivational value’ of such collateral may be eroded.

In the absence of a significant improvement in the financial position and outlook of individual borrowers, the strategic outlook of an institution must consider not only the dimensions of its own business / lending activities, but also the systemic implications for the behaviour and actions of the industry in relation to both the financial pressures upon borrowers and the financial stability / adequacy of individual lending institutions.

Issue: The structural risk pressures on the loan portfolio appear significant and the stability of credit performance are highly sensitive and vulnerable to both economic and social pressures. This presents potential systemic exposures to lending (institution and industry) beyond the operational credit management of individual borrowers.

SOME QUESTIONS AND ANSWERS …

Some Questions

A range of substantive issues have been raised by the responses of borrowers in the survey.

The following questions reflect these issues and the related dimensions are set out in the following 'Question and Answer' section. It is not intended that the following comments provide an exhaustive review of the particular issue, but rather enable brief 'cameo' insights. A more detailed review can be undertaken with the relevant data analysis spreadsheets.

It is hoped that the reader will find this list of questions / issues a useful basis by which to select those dimensions which are of particular interest.

The observations in the 'Questions and Answers' section are based entirely upon the responses to the survey. These have not been discussed with lending institutions, and no management information has been obtained from such lenders to provide a comparison with the survey responses. It would be ideal if the survey findings could be reviewed with the lending institutions and other institutional stakeholders in order to identify those areas of consistency and conversely those issues on which there are the greatest 'gaps' between the perceptions and data of borrowers and lenders.

Some survey respondents identified their respective lending institutions. The sample sizes varied and few were sufficiently large to provide a strong basis for detailed comment. However, from the available data, it can be seen that the distribution of borrower segments within the loan portfolio structures varies between lending institutions. As such, individual lending institutions will need to assess the implications of the different segments in relation to the respective compositions of their loan portfolios.

SYNOPSIS OF QUESTIONS AND ANSWERS

1 Survey Respondent Demographics

1.1. What is the domestic profile of borrowers?

Baku has a different demographic profile than other regions – high concentration of borrowers in the retail, service, and public sectors.

1.2. What are the income profiles of borrowers?

Almost identical income profiles for MFI and bank borrowers – incomes in Baku significantly higher than in other regions – incomes paid by bank transfer higher than those paid by cash / cheque.

1.3. What is the dependency upon multiple incomes to a household budget?

Over 80% of borrowers have multiple earners in the household – average incomes are significantly higher in single income households.

1.4. What is the level of expenditure on household essentials and utility costs?

Large majority of borrowers identify that household expenses are rising faster than incomes – basic expenditures (as % of income) are consistent across most regions, but lower in Baku and Abershon – majority of borrowers reduce food expenditure to meet loan repayments.

1.5. What impact does basic household expenditures (including food) have on attitudes and lifestyle?

Borrowers outside Baku show strong signs of financial pressure, together with a need for assistance to resolve debt problems – Bank borrowers in Baku show greater concern than MFI clients.

1.6. What are the principal differences between city, urban and rural borrower profiles?

Higher levels of loan arrears outside Baku – concentration of employment in the retail, service and public sectors – higher levels of foreign currency debt in the regions outside Baku – informal debt usage higher outside Baku – lending practices / structure appear different between Baku and the rest of the regions.

1.7. Is the loan structure consistent with the income cash flow of the borrower and the usage of the loan funds?

Loan products appear to be reasonably aligned to the purpose / usage of loan funds – collateral is used to support lending – the type of collateral is differentiated in relation to the purpose of loan funds – the maturity periods of loans appear to reflect the different usage of loan funds.

2 Financial Profile of Borrowers

2.1. What is the impact of loan repayments on net disposable income?

Repayment ratios are extremely similar for both MFI and bank lending – net disposable income is very similar in all regions outside Baku and Abershon – all income segments experience pressures in their capacity to make loan repayments impacts –net disposable incomes could be increased by 50-100% without loan repayments which creates a focus upon the perceived value of the loan.

2.2 . How does the frequency and regularity of income impact upon borrower performance and attitude?

Majority of borrowers are in regular employment or have their own business – 'own business' clients have a much higher incidence of loan arrears – income profiles of 'regular employment' clients are similar for MFIs and banks – loan amounts and loan arrears are higher amongst bank borrowers.

2.3. What proportion of borrowers reflect some recognition of debt repayment pressures?

Loan arrears are higher amongst bank borrowers (19%) than MFI borrowers (14%) – loan arrears are concentrated in the foreign currency loans and 'own business' segments – 50% of borrowers recognise that they have debt repayment problems – 70% would like assistance to resolve debt problems with their lending institution.

2.4. To what extent do borrowers use more than one lender, and do these clients show different characteristics?

Bank clients have more multiple loans than MFI clients – female borrowers have more independent loans in addition to their spouse.

2.5. How often are debt repayment problems caused by exceptional adverse events?

Higher 'own business' failures and loss of spousal income impact adversely upon loan arrears – family illness is higher amongst those borrowers experiencing loan arrears – the retail sector shows high exposure to these adverse events.

2.6. How does the profile of 'employed' borrowers compare with that of 'own business' borrowers?

'Own Business' borrowers show a substantially higher risk profile – regular employment borrowers, with income paid by bank transfer, show a stronger credit profile – banks have higher market share of 'regular employment / bank transfer' borrowers – MFIs have a slightly higher share of 'own business' clients – loan approvals to 'employed' borrowers have been significantly higher in the last 12 months than to 'own business' (particularly to the retail sector).

2.7. To what extent are loans used to support basic domestic expenditure needs?

About 56% of loans to employed persons are used primarily for domestic consumption purposes – 'own business' loan funds are used for business purposes, but responses indicate that budget pressures are likely to result in greater 'leakage' of funds for domestic needs.

2.8. What do former borrowers do after they leave an institution?

Lower average income amongst former bank borrowers – no indication that the former clients feel to have been excluded by the lending institutions – former borrowers show a slightly more positive attitude towards the quality of their live.

3 Lending Institutions and Lending Portfolios

3.1. What are the principal financial characteristics of borrowers?

Significant differences in the credit / risk profiles for borrowers in Baku and other regions – portfolio concentrations in 'own business' (primarily retail and service) and public sector employees – new loan approvals are particularly low for 'own business' during the last 12 months – foreign currency loans have a substantially higher level of loan arrears than loans in national currency – loan approvals in the last 12 months have been lower for 'own business' clients (particularly in the retail sector) and have been highest for public sector employees.

3.2. What are the principal similarities and differences between the loan portfolios of the MFIs and banks?

Strong portfolio concentration of loan exposure to higher income clients (> AZN 1,000 per month) – higher loan amounts and leverage in lending by banks – differentiation of loan product structure in relation to usage of funds.

3.3. Do the survey responses indicate credit standards or criteria?

Overall, banks provide higher loans and higher leverage ratios than those taken by MFI borrowers – possible indications that MFIs undertaken a more stringent credit quality assessment of potential borrowers than banks.

3.4. How does lending to 'own business' clients compare between MFIs and banks?

'Own Business' present a high risk client segment, which is more adverse in the other regions outside Baku – MFIs and banks show different credit strategies and practices – the profile of Baku 'own business' loans differs substantially from those in other regions – the 'own business' segment presents a structural risk to the lending institutions.

3.5. Collateral Security – does it affect lending?

Borrowers with collateral present a much high risk profile, with higher loan amounts and higher loan arrears – the use of collateral varies considerably between regions and MFIs / banks – collateral is focused primarily towards the foreign currency loan and 'own business' segments –property collateral is relatively low being primarily related to bank borrowers in Baku.

3.6. What is the scope of lending in foreign currency?

31% of loan balances are attributable to foreign currency loans (but only 17% of borrowers) – loan arrears are about 60% - foreign currency borrowers show generally higher risk characteristics and anxieties – foreign currency loan exposures present a fundamental strategic risk to lending institutions.

4. Risk Profile and Performance

4.1. What proportion of borrowers are over-indebted?

A large majority of borrowers appear to be over-indebted with minimal capacity to meet non-essential or unexpected expenditure needs – regions outside Baku and Abershon show a greater debt dependency, despite the budget and family pressures which it arise – 'own business' segment show the highest debt dependency despite the particular pressures faced currently by this segment.

4.2. What is the profile of loan arrears?

Retail and service trade sectors have a high loan arrears rate – substantial differences in refinance levels across the regions – 'own business' show high loan arrears (linked with higher levels of foreign currency loans and older, male borrowers) particularly in regions outside Baku – arrears in Baku are well-spread across client segments.

4.3. Do borrowers who move between lenders have a different risk profile?

Bank borrowers who use multiple institutions show a substantially higher level of loan arrears – however, such borrowers do not display any significantly higher levels of concern for their financial position.

4.4. Do borrowers with problem lending show different characteristics?

About 50% of borrowers recognise that they have debt repayment problems – significant differences between Baku and other regions in relation to the scale and recognition of problem debt – substantive difference in the risk profiles of Baku and the other regions.

4.5. Do borrowers who undertake loan refinance have particular characteristics?

Refinance has occurred primarily in relation to foreign currency loans and 'own business' clients (these reflect some overlap) – Baku and Abershon are the primarily locations for refinance.

4.6. What is the extent of informal lending?

Informal lending is primarily from friends and retailer credit – retailer credit is more prevalent in Baku – loans from friends are more frequent in other regions – borrowers who recognise their financial pressures are more likely to use informal sources of credit.

4.7. Are there differences in the credit profiles of those borrowers who have savings balances and those who do not?

Almost no usage of financial institutions for savings – about 28% of borrowers have 'other savings' (non-bank) – no direct linkage between savings and problem debt.

5 Impact of Borrowing

5.1. What proportion of borrowers appear to have benefitted, or been adversely affected, by the loan experience?

Strongly contrasting attitudes between MFI and bank borrowers in Baku – strongly contrasting attitudes between borrowers in Baku and those in other regions – such differences are so marked that there may have been some over-arching economic or strategic difference in the provision and delivery of financial services in these different locations.

5.2. Do microfinance institutions stimulate greater 'financial inclusion'?

MFIs appear to have a greater exposure to the 'own business' segment than the banks – MFIs demonstrate more cautious standards of operational credit and loan approval.

6 Lender / Borrower Relationship

6.1. What is the reputation of the lending institutions?

The reputation of lending institutions is extremely low in the core dimensions of trustworthiness and integrity - the scale of this is intensified by comparison with other countries – the reputational profile of Baku differs substantially from that in other regions – conversely, borrowers show a much more favourable attitude to the manner in which lending institutions respond to problem lending situations – there is a strong feeling by borrowers of inclusion in the target client base of lending institutions.

6.2. Do borrowers feel that the lender is providing clear information about the loan?

Major contrast between the high transparency of loan terms in national currency and the very low explanation of foreign currency risks – even in Baku, 65% of foreign currency borrowers considered that exchange rate risks were not explained.

6.3. Do lenders understand the borrower's financial position?

In regions outside Baku, a majority of borrowers do not feel that their needs are understood – borrowers consider that full information was provided at the time of the loan application.

7 Outlook for Borrowing

7.1. What is the outlook for borrowing demand?

Strongly different borrower profiles in Baku and the other regions – particular pressure upon the 'own business' segment which is more vulnerable in the 'other regions' than in Baku – 'employed' segment in Baku shows a relatively greater discretionary borrowing capacity than in the other regions.

7.2. What is the Sensitivity of Affordability?

The loan portfolios show significant sensitivity to relatively modest increases in the costs of basic foodstuffs and household essentials – this presents a significant structural and strategic risk to the lending institutions – there should be close and continuing review of the dynamics of this sensitivity.

QUESTIONS AND ANSWERS

1 Survey Respondent Demographics

1.1 What is the domestic profile of borrowers?

Baku has a different demographic profile than other regions – high concentration of borrowers in the retail, service, and public sector

- The profile of clients contrasted between those of Baku and the other regions. Although the age profile was broadly similar, Baku showed a lower number of dependents in the household.

	Average Age	Number in Household	Number of Dependents	Number of Wage Earners	Married
Baku: MFI	37.71	3.86	1.74	1.88	70%
Baku: Bank	37.03	3.97	1.87	1.94	74%
City: Other	37.50	4.69	2.06	2.40	75%
Urban: Other	37.75	4.39	1.93	2.17	81%
Rural: Other	41.64	5.13	2.41	2.50	88%

  - The survey review shows (below) that the budgetary position, loan performance and attitudes of Baku people were significantly different from those of the other regions.

- These demographic characteristics of households may be summarised across the regions.

	Average Age	Number in Household	Number of Dependents	Number of Wage Earners	Married
Baku	37.4	3.9	1.8	1.9	72%
Abershon	36.8	3.9	1.6	2.0	71%
Guba-Khachmaz	37.6	4.8	2.1	2.4	77%
Aran	38.2	4.9	2.1	2.5	78%
Ganja-Gazakh	38.7	4.8	2.2	2.4	81%
Shaki-Zagatala	37.8	4.8	2.2	2.5	78%
Dagligh Shirvan	37.9	4.9	2.2	2.6	75%
Lankaran	38.4	4.7	2.3	2.3	76%
Yukhari Garabagh	39.3	4.8	2.3	2.4	80%

- This profile varied in relation to the location of the borrower, and the following factors may be noted:

  - The principal trade sectors of employment are shown below:

	Agriculture	Retail	Service	Public Sector	Other
Baku: MFI	0%	23%	31%	25%	21%
Baku: Bank	2%	18%	14%	37%	29%
City: Other	1%	27%	22%	29%	21%
Urban: Other	2%	18%	20%	35%	24%
Rural: Other	35%	17%	9%	25%	14%

    - These emphasise the concentration of income sources for individual borrowers upon three major sectors – retail, service and public service.

- This profile was reflected across all regions, although there was a larger segment of public sector employees in Abershon region.

	Agriculture	Retail	Service	Public Sector	Other
Baku	1%	21%	22%	31%	25%
Abershon	2%	9%	19%	47%	24%
Guba-Khachmaz	6%	26%	19%	28%	21%
Aran	8%	27%	19%	27%	19%
Ganja-Gazakh	7%	25%	21%	26%	21%
Shaki-Zagatala	8%	26%	20%	27%	19%
Dagligh Shirvan	3%	26%	18%	35%	18%
Lankaran	6%	30%	21%	26%	17%
Yukhari Garabagh	9%	27%	19%	23%	22%

1.2 What are the income profiles of borrowers?

Almost identical income profiles for MFI and bank borrowers – incomes in Baku significantly higher than in other regions – incomes paid by bank transfer higher than those paid by cash / cheque

- The overall average household of all respondent borrowers was substantially higher in Baku than in the other regions.

	Household Income	Average Income per Earner	Average Income per Household Member	Average Number of Wage-Earners
Baku: MFI	1,266	675	328	1.9
Baku: Bank	1,224	630	308	1.9
City: Other	910	379	194	2.4
Urban: Other	883	408	201	2.2
Rural: Other	903	361	176	2.5

  - The distribution of household income was broadly similar for MFIs and banks across the country;
  - However, in Baku, the MFIs held a slightly higher proportion of higher income borrowers (see later comparative assessment of MFIs and banks).

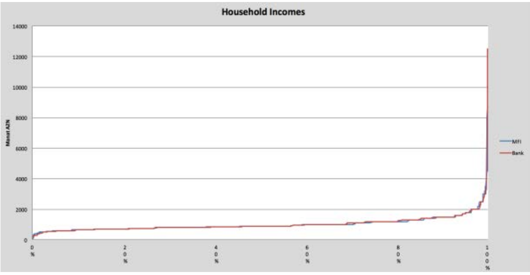
- Across the other regions (non-Baku), the household income levels were broadly similar.

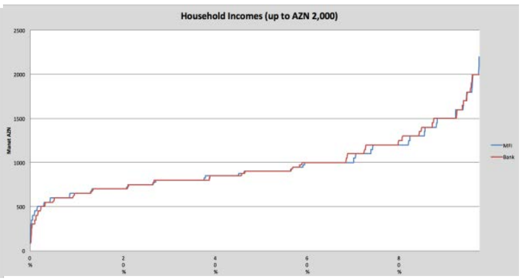
	Household Income	Average Income per Earner	Average Income per Household Member	Average Number of Wage-Earners
Baku	1,245	652	318	1.9
Abershon	979	495	250	2.0
Guba-Khachmaz	877	360	183	2.4
Aran	901	358	183	2.5
Ganja-Gazakh	911	379	190	2.4
Shaki-Zagatala	922	373	191	2.5
Dagligh Shirvan	897	352	184	2.6
Lankaran	869	375	185	2.3
Yukhari Garabagh	880	374	184	2.4

  - This suggests two distinct income profiles within the portfolio of individual borrowers;
  - The similarity of the overall distribution of incomes for MFI and bank borrowers is shown in the following table:
    - The former bank borrowers show a lower level of incomes than current borrowers. (The sample size of 'former MFI borrowers' is too small to provide an adequate profile);
    - Those persons who have never borrowed demonstrate an overall still lower income profile.

Distribution of borrowers across the income ranges: AZN	< 600	601-750	751-850	851-1,000	>1,000
MFI	9%	18%	19%	25%	30%
Bank	9%	17%	19%	23%	31%
Former Bank Clients	12%	20%	21%	25%	22%
Never Borrowed	20%	22%	14%	24%	21%

- There is, therefore, a significant level of overlap across the client portfolios. This is shown in the following graphs.





  - The left-hand graph shows household incomes of all 3,000 respondents, whilst the right-hand chart is limited to those borrowers with incomes up to AZN 2,000;
  - The almost-total overlap of the comparative MFI and bank income profiles is clearly demonstrated (in relation to the respondent individual borrowers).

- A comparison of household income across the different sources of income is shown below:

	Household Income	Average Income per Earner	Average Income per Household Member	Proportion of Total Respondents
MFI: Bank Transfer	933	412	220	14%
MFI: Cash / Cheque	878	386	197	19%
MFI: Own Business	1,216	570	256	17%
Bank: Bank Transfer	948	422	221	21%
Bank: Cash / Cheque	872	361	195	15%
Bank: Own Business	1,312	618	277	13%

  - The similarity of the MFI and bank borrower profiles is again demonstrated;
  - The income differentials indicate these three client segments to have different characteristics.

- A comparison of household incomes in relation to loan products is shown below:

	Household Income	Average Income per Earner	Average Income per Household Member	Proportion of Total Respondents
Business	1,179	565	253	23%
Consumer: Expenditure	863	382	195	37%
Consumer: Appliance	1,080	507	270	11%

  - This comparison of income levels shows an interesting comparison between business and consumer-based loans;
  - The use of loan funds for domestic consumption purposes (rather than asset acquisition) is based upon lower income levels;
  - The following table provides a comparison between AZN and foreign currency.

	Household Income	Average Income per Earner	Average Income per Household Member	Proportion of Total Respondents
MFI: AZN: Total	970	443	221	41%
MFI: Fgn Ccy: Total	1,188	505	241	9%
Bank: AZN: Total	957	422	219	41%
Bank: Fgn Ccy: Total	1,302	578	270	9%

The appropriateness of the use of foreign currency loans for certain purposes is reviewed in a later section. However, whilst the average income of currency borrowers is about 30% higher than that of AZN borrowers, the debt commitments are substantially higher.

1.3 What is the dependency upon multiple incomes to a household budget?

Over 80% of borrowers have multiple earners in the household – average incomes are significantly higher in single income households.

- The scale and impact of multiple income sources to households is shown in the following table:

	Household Income	Average Income per Household Member	Proportion of Total Respondents	Proportion of Total Loan Balances
One Income	1,003	281	16%	21%
Two Incomes	955	226	49%	48%
Over Two Incomes	1,094	210	35%	31%
Non Borrowers	942	212	0%	0%

  - The average earnings are much lower for the multiple earning clients;
  - The resultant income per household member is, however, similar for the large majority of borrowing households.

- The following table shows that single income households are more prevalent amongst 'own business' clients, whilst multiple income households are primarily based in the employee segment.

	Source of Income			Trade Sector of Activity		
	Regular work	Irregular work	Own business	Retail	Service	Public Sector
One Income	48%	7%	42%	29%	22%	23%
Two Incomes	65%	6%	28%	23%	19%	31%
Over Two Incomes	70%	3%	25%	21%	22%	31%

  - This level of multiple income earners is similar to that in Tajikistan, but higher than has been seen in Kyrgyzstan and Bosnia and Herzegovina (BiH).

1.4 What is the level of expenditure on household essentials and utility costs?

Large majority of borrowers identify that household expenses are rising faster than incomes – basic expenditures (as % of income) are consistent across most regions, but lower in Baku and Abershon – majority of borrowers reduce food expenditure to meet loan repayments.

- The overall monthly expenditure by borrowing households on basic domestic needs (food, family and domestic essentials, but excluding utilities) was AZN 455, equivalent to an average of AZN 102 per household person. Average utility costs amounted to AZN 68.
  - Borrower responses also identify that 59% had reduced food expenditures in order to afford loan repayments. This is significantly higher than the 41% identified in the comparable 2016 Tajikistan survey.

- 77% of borrowers identified that their household expenses had increased faster than incomes over the last 6 months. This clearly suggests increasing pressure upon the household budget.

- The impact of expenditure costs in relation to income is shown in the following table:

Income Range	Average Income	Household costs	Utility costs	Net Disposable Income (pre loan)	Net disposable income as % of Income
<600	526	269	45	213	40%
601-750	703	347	55	301	43%
751-850	818	408	63	347	42%
851-1,000	947	470	70	407	43%
>1,000	1,508	550	83	875	58%

  - This shows a strong consistency in the proportion of income being spent on basic essentials by clients with incomes up to AZN 1,000 (70% of respondent borrowers);
  - This contrasts somewhat with the survey findings in other countries (most recently Tajikistan) in which the level of such expenditures were higher for lower income segments in relation to income.

- The cost-of-living was similar across most regions, with the exceptions of Baku and Abershon.

	Income	Household costs	Utility costs	Net Disposable Income (pre loan)	Net Disposable Income as % Income
Baku	1,245	448	66	731	59%
Abershon	979	341	47	590	60%
Guba-Khachmaz	877	435	72	370	42%
Aran	901	459	75	367	41%
Ganja-Gazakh	911	464	67	379	42%
Shaki-Zagatala	922	464	74	384	42%
Dagligh Shirvan	897	454	80	363	40%
Lankaran	869	434	66	369	42%

  - This shows a very consistent net income profile across most regions;
  - The higher incomes in Baku are not reflected in higher expenditures upon the 'basics' of food, household essentials and utilities.

- However, the profile of MFI and bank borrowers in Baku is quite different, and may be compared with city, urban and rural locations.

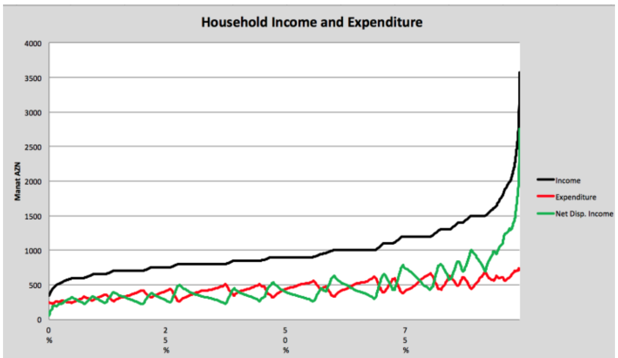
	Income	Household costs	Utility costs	Net Disposable Income (pre loan)	Net Disposable Income as % Income
Baku: MFI	1,266	471	60	735	58%
Baku: Bank	1,224	425	71	728	59%
City: Other	910	449	70	391	43%
Urban: Other	883	381	59	443	50%
Rural: Other	903	438	68	397	44%

  - The level of consumption expenditure amongst MFI clients in Baku is significantly higher than across the country;
  - This suggests that there may be opportunities for tighter budget management and thereby an increase in net disposable income;
  - Additionally, 42% of MFI clients (in Baku) indicated that loan funds were used for domestic consumption, in comparison with 32% of bank clients.

- The levels of household domestic expenditure increased as household incomes increased. However, the proportion of expenditure in relation to income remained broadly similar across the income ranges (with the exception of those incomes over AZN 1,000).

All Borrowers	Income Segments: AZN				
	<600	601-750	751-850	851-1,000	>1,000
Household Expenditure	269	347	474	470	550
Per capita	78	82	106	100	116
Household Expenditure as % of income	51%	49%	58%	50%	36%

The changing impact of food and household costs in relation to income levels is shown in the following graph.



This shows that:

- o the impact of food and essential household costs are relatively stable across the income range;
- o the net disposable income (after food, basic household and utility costs) fluctuates at different income within different income levels, reflecting the different spending behaviour of households;
- o the above chart is based upon a moving-50 average.

- The levels of household expenditure (including utilities) were:

Income Segments	Average Monthly Household Expenditure		Average Monthly Household Expenditure: Per Capita: AZN		Average Monthly Household Expenditure as % of Income	
	MFI	Bank	MFI	Bank	MFI	Bank
<600	318	309	92	89	59%	40%
601-750	409	395	95	95	58%	44%
751-850	513	465	114	105	63%	43%
851-1,000	543	526	115	112	58%	44%
>1,000	633	632	134	133	42%	58%

- A majority of borrowers indicates that food expenditure is reduced in order to make loan repayments. The following table shows that this was higher amongst bank borrowers than MFI.

Reduction in food expenditure to meet loan repayments	Income Segments				
	< 600	601-750	751-850	851-1,000	> 1,000
MFI	52%	75%	72%	63%	30%
Bank	59%	65%	67%	73%	49%

- o The middle income segments are clearly experiencing significant pressures;
- o Such expenditure reductions represent a significant social cost in relation to the real overall impact of loan repayments upon the family.

- The impact of reduced food expenditure was not shown consistently across the regions. In Baku and Abershon, the overall incidence of 'food reduction' was 17% of borrowers, whilst in the other regions, the level was between 73% and 91%.

1.5 What impact does basic household expenditures (including food) have on attitudes and lifestyle?

Borrowers outside Baku show strong signs of financial pressure, together with a need for assistance to resolve debt problems – Bank borrowers in Baku show greater concern than MFI clients.

- The expenditures upon basic household essentials are outlined in the above section.
- The impact of essential household expenditure impacts more strongly in the regions than in Baku.

	Income	Household costs	Utility costs	Net Disposable Income (pre loan)	Net Disposable Income as % Income
Baku: MFI	1,266	471	60	735	58%
Baku: Bank	1,224	425	71	728	59%
City: Other	910	449	70	391	43%
Urban: Other	883	381	59	443	50%
Rural: Other	903	438	68	397	44%

  - The higher level of disposable income in Baku is primarily driven by higher income, with expenditure levels being broadly similar.

- However, borrowers have been experiencing increasing budgetary pressures.

All Borrowers	Indicators of Expenditure Trends			Impact of Expenditure Pressures		
	My financial situation has improved in the last 6 months	My household expenses have risen faster than income in the last 6 months	Food expenditure has been reduced to make loan repayments	Debt repayments cause problems within my family	I can afford to buy 'treats' for myself or my family	I would like help to resolve debt problems with my lending institution
Baku: MFI	3%	94%	2%	9%	23%	16%
Baku: Bank	29%	69%	32%	33%	50%	58%
City: Other	17%	75%	80%	47%	76%	83%
Urban: Other	24%	71%	55%	37%	74%	80%
Rural: Other	15%	72%	86%	54%	76%	83%

  - These responses reflect the financial and emotional pressures upon borrowers.
  - The responses by Baku show a contrasting position than the other regions:
    - Although the increasing prices are strongly recognised, this has not yet been ‘translated’ into changes in their financial actions – reduced food expenditure is not as widespread, debt appears to be a much lower impact on the family, and a much lower perception of a need for assistance with debt issues - but, a lower level of spending on ‘treats’;
    - The rural areas appear to be experiencing particular pressure.
  - These attitudes may be compared with those seen in Tajikistan on the basis of similar surveys – the 2016 responses were obtained after a period of severe economic pressure and substantial devaluation of the currency against the US$.

	Indicators of Expenditure Trends			Impact of Expenditure Pressures		
	My financial situation has improved in the last 6 months	My household expenses have risen faster than income in the last 6 months	Food expenditure has been reduced to make loan repayments	Debt repayments cause problems within my family	I can afford to buy 'treats' for myself or my family	I would like help to resolve debt problems with my lending institution
Azerbaijan	17%	77%	59%	39%	64%	69%
Tajikistan 2016	67%	68%	41%	47%	69%	52%
Tajikistan 2014	85%	69%	41%	22%	86%	29%

- This comparison suggests that:
    - The impact of the adverse economic situation with high inflation in early-2016 has impacted the large majority of Azerbaijan borrowers;
    - Outside Baku, borrowers have adjusted their domestic budgets to a much greater extent than n either Baku or Tajikistan;
    - The need for assistance with problem debt situation is highly acute in regions outside Baku – and this is greater than in Tajikistan.

- These overall indicators are shown below in relation to different income ranges.

	Indicators of Expenditure Trends			Impact of Expenditure Pressures		
	My financial situation has improved in the last 6 months	My household expenses have risen faster than income in the last 6 months	Food expenditure has been reduced to make loan repayments	Debt repayments cause problems within my family	I can afford to buy 'treats' for myself or my family	I would like help to resolve debt problems with my lending institution
<600	9%	79%	55%	37%	55%	76%
601-750	12%	77%	70%	39%	68%	74%
751-850	12%	72%	69%	35%	65%	67%
851-1,000	16%	80%	68%	47%	65%	74%
>1,000	26%	76%	40%	37%	62%	61%

- These tables indicate the following:
    - Borrowers (outside Baku) have used food expenditure as a primary means to manage their budget capacity;
    - The adverse cost-of-living pressures are being felt across all individual borrowers;
    - Borrowers in Baku appear to be in a situation of either [i] there is still a feeling of some financial capacity to absorb the price changes, or [ii] there is a reluctance to accept (or acknowledge) the financial vulnerability which they face. (This will be explored in relation to other responses in later sections).

1.6 What are the principal differences between city, urban and rural borrower profiles?

Higher levels of loan arrears outside Baku – concentration of employment in the retail, service and public sectors – higher levels of foreign currency debt in the regions outside Baku – informal debt usage higher outside Baku – lending practices / structure appear different between Baku and the rest of the regions.

- The demographic profile of borrowers varies across the country:

	Number in Household	Number of Dependents	Less than 10 Years in Neighbourhood	Household Net Disposable Income (pre loan)	Average Household Expenditure per person
Baku: MFI	3.9	1.7	3%	735	122
Baku: Bank	4.0	1.9	9%	728	107
City: Other	4.7	2.1	4%	391	96
Urban: Other	4.4	1.9	19%	443	87
Rural: Other	5.1	2.4	2%	397	85

- This table highlights:
    - The higher household size in rural arears;
    - The greater mobility towards urban areas;
    - The higher expenditures in Baku.

- The similarity of average income in regions outside Baku was shown in an earlier section. The following table shows the varying levels of borrowing and arrears.

	Household Income	Net Disposable Income (after Loan)	Average Loan	Loan Arrears	Leverage: Loan payments as % of Net Disposable Income (pre loan)
Baku: MFI	1,266	532	2,081	3%	28%
Baku: Bank	1,224	487	3,883	20%	33%
City: Other	910	227	1,898	20%	42%
Urban: Other	883	270	1,922	17%	39%
Rural: Other	903	228	2,038	16%	43%

- This table indicates further that the borrowing market in Baku appears to be different from that in other parts of the country;
- The comparative performance of MFI and bank loan portfolios will be assessed later.

- The sources of income varied across the regions:

	Type of Employment			Trade Sector of Employment			
	Regular work	Irregular work	Own business	Retail	Service	Agriculture	Public Sector
Baku: MFI	58%	10%	31%	23%	31%	0%	25%
Baku: Bank	62%	13%	20%	18%	14%	2%	37%
City: Other	67%	2%	31%	27%	22%	1%	29%
Urban: Other	65%	7%	27%	18%	20%	2%	35%
Rural: Other	63%	2%	35%	17%	9%	35%	25%

- This shows the significant concentrations of activity amongst individual borrowers. (These segments will be examined further in later sections of this report);
- The profiles of the MFI and bank client bases in Baku show some differing dimensions, with the banks having a more diversified portfolio across the trade sectors;
- The public sector employees represent a significant segment of the client base.

- The profile of loan balances across the regions reflects the greater pressures which are being experienced by borrowers in the regions outside Baku.

	Average Loan	Loan Arrears	% of loans in foreign currency	% of borrowers with collateral assets	I would like help to resolve debt problems with my lending institution
Baku	2,981	11%	13%	24%	37%
Abershon	2,481	17%	5%	27%	82%
Guba-Khachmaz	1,974	23%	23%	50%	77%
Aran	1,962	21%	25%	45%	83%
Ganja-Gazakh	2,005	22%	20%	41%	84%
Shaki-Zagatala	1,784	18%	18%	41%	85%
Dagligh Shirvan	1,707	11%	20%	41%	83%
Lankaran	1,524	16%	17%	43%	83%
Yukhari Garabagh	1,585	14%	14%	44%	86%

- Baku shows again a more resilient, or stronger, financial performance – the average loan levels are comparatively lower in relation to incomes (lower leverage);
- The financial pressures and need for assistance with debt problems are extremely high outside Baku;
- The scale responses (outside Baku) in relation to repayment difficulties and need for assistance are substantially higher than have been seen in other countries (notably recently in Tajikistan despite the currency devaluations and increasing inflation).

- The profile of the loan amounts showed some differences.

Distribution of Borrowers	Outstanding Loan Balance (Average)					
	< 600	601-1,200	1,201-1,800	1,801-2,400	> 2,400	Average
Baku: MFI	12%	28%	18%	12%	31%	2,081
Baku: Bank	8%	28%	15%	8%	41%	3,883
City: Other	20%	34%	12%	6%	27%	1,898
Urban: Other	17%	28%	18%	8%	28%	1,922
Rural: Other	20%	32%	13%	4%	30%	2,038

- In addition to loan borrowings from the lending institutions, some borrowers used other 'informal' sources of credit.

	Utility Arrears	Informal Loans			Food expenditure has been reduced to make loan repayments
		Friends	Retail: Assets	Retail: Domestic	
Baku	8%	5%	15%	11%	17%
Abershon	2%	10%	6%	3%	17%
Guba-Khachmaz	16%	23%	12%	5%	88%
Aran	16%	21%	12%	5%	91%
Ganja-Gazakh	4%	20%	7%	5%	85%
Shaki-Zagatala	6%	16%	10%	3%	86%
Dagligh Shirvan	11%	17%	9%	4%	73%
Lankaran	6%	12%	4%	3%	83%
Yukhari Garabagh	6%	17%	7%	3%	82%

- This table demonstrates the wide range of additional debt liability being undertaken by borrowers.

1.7 Is the loan structure consistent with the income cash flow of the borrower and the usage of the loan funds?

Loan products appear to be reasonably aligned to the purpose / usage of loan funds – collateral is used to support lending – the type of collateral is differentiated in relation to the purpose of loan funds – the maturity periods of loans appear to reflect the different usage of loan funds.

- The distribution of the principal loan products is shown in the following tables:

AZN currency loans	Business	Consumer: Expenditure	Consumer: Appliance	Credit Card	Other
MFI	28%	44%	8%	0%	20%
Bank	19%	31%	15%	11%	25%
Baku: MFI	28%	41%	18%	0%	13%
Baku: Bank	9%	26%	22%	19%	24%
City: Other	27%	39%	7%	4%	23%
Urban: Other	31%	38%	13%	1%	19%
Rural: Other	20%	41%	1%	1%	37% [8]

  - The dominant majority of lending was undertaken by fixed-term, fixed repayment loans;
  - Credit card usage appears to be limited to Baku.

- The usage of the loan funds (based upon the number of loans, not value) may be summarised as:

AZN currency loans	Business: Working Capital	Individual: Domestic	Individual: Appliances	Holiday / Travel / Family Event	Other
MFI	30%	44%	7%	11%	9%
Bank	19%	36%	16%	10%	20% [9]
Baku: MFI	29%	42%	16%	3%	11%
Baku: Bank	9%	32%	28%	1%	30% [10]
City: Other	27%	42%	6%	14%	11%
Urban: Other	23%	40%	12%	9%	17%
Rural: Other	29%	41%	2%	19%	10%

  - The level of domestic consumption spending is consistent across the regions;
  - Bank lending in Baku shows a much stronger emphasis towards asset acquisition loans (appliances and auto credit);
  - MFI lending in Baku shows a stronger focus towards the small business-person.

- However, the pattern of loan usage may be compared with loan product being delivered to the borrower. This is shown for the major loan products. (The sample size for other products was small).

Loan Product	Usage of Loan Funds					
	Business: Investment	Business: Working Capital	Individual: Domestic	Individual: Appliances	Holiday / Travel / Family Event	Other
Business	12%	84%	2%	0%	0%	1%
Consumer: Expenditure	1%	1%	93%	3%	0%	2%
Consumer: Appliance	1%	0%	10%	84%	1%	4%
Other	0%	1%	5%	1%	84%	9%

  - There appears to be a strong alignment between the loan product description and the usage purpose of the loan funds.

[8] Rural: Other Regions: Other Loans includes 14% of clients with an Agricultural loan
[9] Bank: Other includes 9% in relation to autocredit loans
[10] Baku: Bank: Other includes 13% in relation to autocredit loans

- The scale and distribution of usage is shown in the following table:

Purpose / Usage of Loan Funds	Average Loan AZN	Average Residual Repayment Period (months)	Collateral Held	% of Loans in Foreign Currency	Loan Arrears
Business: Investment	5,448	16	57%	37%	36%
Business: Working Capital	3,402	13	78%	48%	38%
Individual: Domestic	1,164	9	19%	5%	6%
Individual: Appliances	1,319	10	6%	4%	9%
Individual: Autocredit	5,481	16	52%	20%	22%
Mortgage: property	5,572	21	35%	10%	23%
Holiday / Travel / Family Event	1,044	8	24%	1%	5%

  - This table identifies some significantly different loan structures;
  - The residual repayment period varies substantially and appears to correspond, on an intuitive basis, to the purpose of the loan;
  - The levels of collateral are higher for the non-domestic usages (see following analysis of collateral);
  - Higher loan arrears correspond with higher levels of foreign currency lending.

- The underlying types of collateral are shown in the following table in relation to the above usages of loan funds.

Purpose / Usage of Loan Funds	Type of Collateral Held						
	Business Property	Residential Property	Business Equipment	Domestic Asset(s)	Vehicle	Guarantee	Gold / Jewellery
Business: Investment	34%	6%	35%	4%	11%	0%	10%
Business: Working Capital	4%	5%	65%	9%	10%	0%	7%
Individual: Domestic	0%	5%	3%	40%	9%	1%	41%
Individual: Appliances	0%	10%	5%	20%	25%	15%	25%
Individual: Autocredit	0%	10%	0%	0%	84%	4%	2%
Mortgage: property	0%	49%	0%	5%	19%	0%	27%
Holiday / Travel / Family Event	0%	1%	1%	52%	3%	0%	43%

  - The types of collateral appear to be broadly aligned to the usage of loan funds;
  - The level of domestic residential property is low, which suggests that this is being used to directly support mortgage lending (which was not the primary focus of this survey);
  - The collateralisation of 'domestic assets' appears to suggest some form of lien over these assets during the period of the loan (possibly under some form of hire purchase / fixed asset finance arrangement;
  - Such alignment of the loan with the asset is particularly shown in relation to autocredit loans. (Note: this clear linkage provides good evidence that the respondents were treating the survey responses with respect and accuracy);
  - Similarly, the more extensive use of gold / jewellery as collateral for domestic-consumption loans appears to correspond with an intuitive expectation;
  - However, many of the types of collateral may be difficult to realise and have a significant market value. The collateral appears, therefore, to be in large part a motivational dynamic for repayment;

- It may be noted also that the levels of indebtedness for collateralised loans is significantly higher than those of non-collateralised borrowings. (See later section on collateralised loans).

2 FINANCIAL PROFILE OF BORROWERS

2.1 What is the impact of loan repayments on net disposable income?

Repayment ratios are extremely similar for both MFI and bank lending – net disposable income is very similar in all regions outside Baku and Abershon – all income segments experience pressures in their capacity to make loan repayments impacts – disposable incomes could be increased by 50-100% without loan repayments which creates a focus upon the perceived value of the loan.

- The overall average household income for individual borrowers was AZN 1,012, being a similar average for MFI clients (AZN 1,008) and bank clients (AZN 1,016). The net disposable incomes are shown in the following table in relation to current and former borrowers, and also persons who have never borrowed.

Net Disposable Income AZN	Income	Household costs	Utility costs	Net Disposable Income (pre-Loan)	Loan Repayments	Net Disposable Income (after Loan)
MFI	1,008	447	66	494	173	321
Bank	1,016	435	69	512	193	319
Former Borrowers MFI[11]	925	423	73	429		429
Former Borrowers Bank	941	449	73	419		419
Non-Borrowers	950	437	74	439		439

  - The net disposable income for borrowers was similar for both MFI and bank clients, but was 25% less than that of non-borrowers. In view of the budget pressures being recognised by borrowers, the benefits (if perceived by borrowers) of the use of loan funds may be set against the 'comfort' of additional disposable income (which arises from non-borrowing);

  - The former borrowers of banks had a lower average income than those who continue to borrow from the banks. This suggests that the banks have reduced their exposure to lower income clients.

- The profile of net disposable income, after loan payments, was extremely consistent across the regions (outside Baku and Abershon).

Net Disposable Income AZN	Income	Household costs	Utility costs	Net Disposable Income (pre-Loan)	Loan Repayments	Net Disposable Income (after Loan)
Baku	1,245	448	66	731	222	509
Abershon	979	341	47	590	191	400
Guba-Khachmaz	877	435	72	370	159	212
Aran	901	459	75	367	168	198
Ganja-Gazakh	911	464	67	379	167	213
Shaki-Zagatala	922	464	74	384	161	223
Dagligh Shirvan	897	454	80	363	161	201
Lankaran	869	434	66	369	153	216
Yukhari Garabagh	880	436	67	376	147	229

  - This suggests that there is a consistent basis of assessment of loan affordability by the lending institutions;

  - However, as essential domestic expenditure costs are reasonably similar across the country, it may suggest that the 'balance' of 'perceived loan benefit' versus increased disposable income' (from non-borrowing) may be a more acute decision in the other regions.

[11] MFI: Former Borrowers: small sample size

- However, among the lower income segments, the impact of committed expenditures was necessarily strong. The table below highlights the greater vulnerability of the financial position of a significant proportion of borrowers.

Household Income AZN	Income	Net Disposable Income (pre-Loan)	Loan Repayments	Net Disposable Income (after Loan)	Distribution of Borrowers	Distribution of Loan Value
<600	526	213	104	109	9%	4%
601-750	703	301	116	185	18%	8%
751-850	818	347	137	210	19%	11%
851-1,000	947	407	185	222	24%	22%
>1,000	1,508	875	273	602	30%	54%

  - For 70% of borrowers, net disposable income would be increased by 50-100% if loan repayments were not made;
  - This emphasises the balance between loan benefit and greater spending power – or – a recognition of being ‘locked into’ a debt situation;
  - This table highlights the particular vulnerability of about 70% of borrowers to only modest increases in the real cost-of-living. The costs in this table reflect only the committed essential expenditures – other costs such a clothing, medical, transport, education are not included;
  - The impact of earlier financial inclusion of lower income borrowers is now reflected in a much reduced capacity to respond to external inflationary pressures.

- The MFIs and banks appear to adopt similar ‘affordability ratios’ in relation to level of loan repayments.

Household Income AZN	MFI			Bank		
	Loan Repayment as % of Income	Loan Repayment as % of NDI (pre-loan)	Net Disposable Income (after loan payment)	Loan Repayment as % of Income	Loan Repayment as % of NDI (pre-loan)	Net Disposable Income (after loan payment)
<600	20%	49%	113	20%	49%	105
601-750	16%	39%	179	17%	38%	191
751-850	17%	45%	169	17%	39%	216
851-1,000	19%	45%	223	20%	45%	232
>1,000	16%	28%	625	20%	34%	581

  - These operational credit ratios are extremely similar;
  - However, the financial vulnerability of the lower income clients is more delicately balanced.

- The impact of credit risk across these segments is briefly demonstrated in the following table:

Household Income AZN	MFI			Bank		
	Loan Arrears	Difficulty to make loan repayments	Food expenditure reduced to make loan repayments	Loan Arrears	Difficulty to make loan repayments	Food expenditure reduced to make loan repayments
<600	13%	44%	52%	13%	47%	59%
601-750	7%	45%	75%	6%	44%	65%
751-850	6%	42%	72%	11%	32%	67%
851-1,000	22%	49%	63%	24%	49%	73%
>1,000	18%	33%	30%	29%	46%	49%

  - The pressure to make loan repayments (excluding loan arrears) is shown systemically across all income segments;
  - The longer residual repayment periods applicable to the higher loan levels amongst bank clients result in similar payment and affordability levels across MFIs and

banks – and this is reflected in similar levels of financial pressure being reported by each segment of borrowers.

- The consistency of the similar pressures being experienced by both MFI and bank clients is further reflected in the recourse to informal loan sources.

Household Income AZN	MFI			Bank		
	Loan from Friends	Retailer Loan for Asset Acquisition	Arrears on Utility Payments	Loan from Friends	Retailer Loan for Asset Acquisition	Arrears on Utility Payments
<600	12%	5%	8%	17%	6%	16%
601-750	17%	9%	10%	12%	11%	13%
751-850	14%	8%	9%	11%	10%	7%
851-1,000	18%	12%	9%	16%	12%	8%
>1,000	9%	7%	3%	14%	17%	12%

- o This table indicates that the social dependency upon friends for financial support is strong. (This is at a similar level to that demonstrated in Tajikistan in June 2016);
- o Bank borrowers, however, show a greater use of retailer credit to enable asset acquisition;
- o The incidence of arrears with utility payments is [surprisingly] erratic.

The comparative ratios with other countries are shown in the following table:

Loan Repayment as % of Income	<10%	11-20%	21-30%	31-40%	>40%	Average Repayment Period mths
Baku: MFI	24%	43%	21%	9%	4%	10
Baku: Bank	26%	36%	21%	9%	8%	16
City: Other	12%	55%	29%	3%	1%	12
Urban: Other	14%	50%	22%	7%	6%	11
Rural: Other	8%	59%	29%	4%	0%	12
Tajikistan: 2016	23%	26%	20%	14%	18%	10
Tajikistan: 2014	14%	26%	19%	15%	26%	9
Kyrgyzstan: 2014	13%	24%	21%	16%	26%	11
Kyrgyzstan: 2013	12%	28%	21%	14%	24%	10
Bosnia: 2014	29%	48%	16%	4%	2%	22
Bosnia: 2013	39%	39%	13%	5%	4%	22

- o This suggests that Azerbaijan has adopted a more conservative level of leverage of loan repayments in relation to income;
- o Such leverage in Azerbaijan has not been achieved by any excessive extension of the residual repayment period.

2.2 How does the frequency and regularity of income impact upon borrower performance and attitude?

Majority of borrowers are in regular employment or have their own business – 'own business' clients have a much higher incidence of loan arrears – income profiles of 'regular employment' clients are similar for MFIs and banks – loan amounts and loan arrears are higher amongst bank borrowers.

- The overwhelming majority of individual borrowers (responding to the survey) were in either regular employment (64%) and self-employed (29%). This was similar for MFIs and banks
  - o MFI Regular employment 62% Own Business 33%
  - o Bank Regular employment 67% Own Business 25%
- The level of borrowers with 'irregular' employment is low at about 5% for both MFIs and banks. This suggests (and this is only an inference) that the lending institutions have focused their credit standards towards the greater security of those with regular incomes.

- Those clients with regular employment were paid by either bank transfer or cash/cheque. Their income profiles, together with those of the 'own business' segment are shown in the following table:

	Income	Household costs	Utility costs	Net Disposable Income (pre-Loan)	Loan Repayment	Net Disposable Income (after Loan)
MFI: Bank Transfer	933	407	61	465	135	330
MFI: Cash / Cheque	878	419	62	398	135	263
MFI: Own Business	1,216	515	76	625	249	376
Bank: Bank Transfer	948	401	64	484	170	314
Bank: Cash / Cheque	872	422	67	383	137	246
Bank: Own Business	1,312	514	83	715	301	414

- The characteristics of these different employment segments are illustrated below:

	Distrib'n of Borrowers	Average Loan	Loan Arrears	Loan Repayment as % of Net Disposable Income	Utility Arrears	Food expend. reduced to make loan repayment
MFI: Bank Transfer	28%	1,234	6%	29%	7%	47%
MFI: Cash / Cheque	38%	1,137	6%	34%	8%	60%
MFI: Own Business	34%	3,170	31%	40%	7%	61%
Bank: Bank Transfer	42%	2,250	11%	35%	11%	56%
Bank: Cash / Cheque	31%	1,590	11%	36%	11%	69%
Bank: Own Business	26%	4,650	43%	42%	9%	65%

  - This comparative table provides some indication of a different market position of MFIs and banks.

    - The banks have a higher share of the 'bank transfer' client segment. This should provide greater security in obtaining loan repayments from those in receipt of income payments;

    - Nevertheless, with 28% of MFI clients using bank transfer for employment income, this represents a significant proportion of borrowers who must use some services from the banks;

    - The levels of lending are much higher by the banks across all these borrower segments, even though the average incomes are similar for both MFIs and banks. The interest income revenues to the banks will, therefore, be correspondingly higher;

    - The variations in loan arrears are stark. The situations of 'arrears' and 'own business' performance will be reviewed separately, later in this report. However, in relation to the 'employed' segment, although income levels are similar for both MFI and bank clients, the incidence of arrears for bank clients is almost twice that for MFI clients. This is also reflected in slightly higher indicators of financial pressure among bank clients.

- Borrowers recognise the pressures on their financial position in qualitative terms in addition to the quantitative financial dimensions.

	Loans improve the quality of life	I need to continue to borrow to maintain how my family lives	My loan repayment is more than I can afford	Debt repayment causes problems within my family	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution
MFI: Bank Transfer	37%	31%	31%	27%	50%	58%
MFI: Cash / Cheque	44%	40%	39%	34%	45%	62%
MFI: Own Business	42%	53%	53%	50%	62%	73%
Bank: Bank Transfer	49%	38%	35%	33%	40%	65%
Bank: Cash / Cheque	55%	46%	43%	38%	39%	71%
Bank: Own Business	45%	58%	59%	56%	68%	90%

- These responses show a much stronger recognition of the financial pressures than is demonstrated solely by loan arrears. However, the responses appear to indicate different positions between MFI and bank client interaction.
  - Although MFI arrears are lower, it appears that it is more difficult to deal with problem debt with MFIs than banks;
  - Despite a greater assistance from banks, those clients appear to suggest that they 'know' that their problems may be more deep-rooted.

2.3 What proportion of borrowers reflect some recognition of debt repayment pressures?

Loan arrears are higher amongst bank borrowers (19%) than MFI borrowers (14%) – loan arrears are concentrated in the foreign currency loans and 'own business' segments – 50% of borrowers recognise that they have debt repayment problems – 70% would like assistance to resolve debt problems with their lending institution.

- The overall level of loan arrears amongst individual borrowers (within the survey) is 17% - within which MFI arrears are 14% and bank arrears are 19%.
- The incidence of loan arrears across the principal locations and different income segments is shown in the following table.

Location	
Baku: MFI	3%
Baku: Bank	20%
City: Other	20%
Urban: Other	17%
Rural: Other	16%

Income	MFI	Bank
<600	13%	13%
601-750	7%	6%
751-850	6%	11%
851-1,000	22%	24%
>1,000	18%	29%

  - These tables reflect some significant influence in the levels of arrears in different borrower segments. These are illustrated below.

- The demonstration of debt pressures is not limited to loan arrears but is reflected in other behaviour and attitudes of borrowers (as is shown throughout this review). However, there are some seemingly-substantial differences between the situations in Baku and the other regions.

Location	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	Food expenditure has been reduced to make loan repayments	My loan repayment is more than I can afford
Baku: MFI	1,266	532	2,081	3%	2%	8%
Baku: Bank	1,224	487	3,883	20%	32%	29%
City: Other	910	227	1,898	20%	80%	53%
Urban: Other	883	270	1,922	17%	55%	45%
Rural: Other	903	228	2,038	16%	86%	60%

  - The performance of the MFI and bank borrowers in Baku differs sharply;

- o Although the loan arrears levels of Baku (bank) and the other regions are similar, the initial indications of impact and concern are substantially different. This may reflect the higher level of net disposable income (after loan payments) in Baku – but, nonetheless, the difference is substantial;
- o The attitudes of borrowers in these regions are further identified in the following table:

Location	Loans improve the quality of life	I need to continue to borrow to maintain how my family lives	I can afford to buy 'treats' for my family	Debt repayment causes problems within my family	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution
Baku: MFI	2%	4%	23%	9%	57%	16%
Baku: Bank	37%	22%	50%	33%	46%	58%
City: Other	57%	59%	76%	47%	49%	83%
Urban: Other	43%	38%	74%	37%	59%	80%
Rural: Other	62%	65%	76%	54%	46%	83%

- o The Baku MFI clients show again an independent position (except for the resolution of debt issues with their lender);
- o Although the attitudes of Baku clients demonstrate concern, they are less extreme than those in other regions.

- The borrower segments of ‘foreign currency’ and ‘own business’ show high levels of loan arrears and related pressures upon loan affordability.

Currency of Loan	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	My loan repayment is more than I can afford
MFI: AZN: Total	970	317	1,545	5%	34%	37%
MFI: Fgn Ccy: Total	1,188	329	3,300	58%	80%	65%
Bank: AZN: Total	957	308	2,199	11%	21%	39%
Bank: Fgn Ccy: Total	1,302	372	4,864	60%	73%	67%

- o The level of loan arrears for foreign currency loans is dramatically higher than that of national currency debt;
- o However, the levels of net disposable income (after loan payments) are broadly similar. The wide difference in arrears suggests that there are likely to be other factors, including the lifestyle of the borrower, which affect the payment performance. It may be noted that the average residual repayment period on the currency loans is slightly longer than those in Manat AZN;
- o The impact of these higher debt and arrears levels is reflected in the attitudes and lifestyle of the different borrower segments.

Currency of Loan	Loans improve the quality of life	I need to continue to borrow to maintain how my family lives	Food expend. has been reduced to make loan repayment	Debt repayment causes problems within my family	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution
MFI: AZN: Total	39%	36%	53%	32%	51%	62%
MFI: Fgn Ccy: Total	49%	67%	71%	61%	61%	76%
Bank: AZN: Total	48%	41%	58%	36%	43%	70%
Bank: Fgn Ccy: Total	54%	67%	78%	64%	67%	90%

- Despite the extremely high loan arrears, the foreign currency borrowers are [perhaps surprisingly] more positive about the role of debt in their lifestyle (but nevertheless only about 50% of borrowers). This is further reflected in an apparent higher debt dependency, or risk acceptance, by the currency borrowers. (It may also be noted that the previous table identified much higher levels of collateralisation of foreign currency loans);
- Foreign currency borrowers do, however, indicate the greater financial pressures which they are experiencing and their inability to resolve them.

- The 'own business' segment is shown in the tables below. This data relates only to those clients whose income is sourced from 'own business'.

'Own Business' Borrowers	Income	Net Disp. Income (after Loan	Loan Amount	Loan Arrears	% of Loans in Foreign Currency	% of Loans with Collateral	My loan payment is more than I can afford
MFI: Baku	1,569	700	3,014	4%	26%	54%	12%
MFI: Other Regions	1,066	239	3,236	42%	51%	84%	70%
Bank: Baku	1,814	786	7,001	29%	33%	41%	35%
Bank: Other Regions	1,137	285	3,830	47%	54%	85%	67%

- This table identifies some starkly contrasting situations:
  - The different levels of loan value in Baku between MFI and bank borrowers;
  - The sharply different levels of loan arrears between MFI and bank clients in Baku, and between the arrears performance between Baku and the other regions;
  - The sharply different levels of the problems with meeting loan repayments between Baku and other regions.
- This is a further example of the apparently substantial difference in the loan markets of Baku and other regions. (This is considered further in another section of this review);
- These differences are continued into the attitudes and concerns of borrowers, as shown in the following table:

'Own Business' Borrowers	Loans improve the quality of life	I need to continue to borrow to maintain how my family lives	Food expend. has been reduced to make loan repayment	Debt repayment causes problems within my family	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution
MFI: Baku	1%	3%	3%	13%	64%	22%
MFI: Other Regions	58%	74%	85%	66%	61%	95%
Bank: Baku	30%	24%	30%	38%	65%	76%
Bank: Other Regions	50%	70%	78%	62%	69%	94%

- The MFI clients in Baku present a completely different attitude profile from other MFI clients, and from bank clients. In view of the consistency of many other survey responses, this suggests that there may be a fundamental difference in the client relationship structure of MFI clients in Baku;
- The difference in attitudes continues with differences between the client attitudes of Baku and the other regions. This is a significant dimension of the survey responses and is examined further in this review.

- However, whilst arrears in loan repayments are a 'headline public measure' of credit risk quality, they do not fully reflect there is a significant range of risk appetite and recognition of risk problems by borrowers. Other surrogate measures may be used to provide some indication of such recognition of repayment pressures which borrowers may be experiencing. These are summarised in the following tables in which each segment is exclusive (no borrower is included in more than one segment).

Repayment Characteristic [12] (Al Borrowers)	Household Income	Net Disposable Income (after Loan)	Average Loan	Distribution of Borrowers	Distribution of loans
Arrears	1,064	243	3,918	17%	29%
Lender Refusal	1,107	402	3,350	3%	4%
Repayment Difficulty[13]	920	258	1,999	29%	26%
Expenditure >75% Income	871	134	1,785	19%	15%
Remainder	1,137	508	1,797	33%	26%

- This table indicates that:
  - 49% of clients recognise that they have a debt problem, representing 59% of loan balances;
  - a further 19% of clients have a very high level of committed basic expenditures in relation to income, with minimal capacity to meet the other costs of living;
  - only 25% of loan balances to individual borrowers relate to borrowers who demonstrate some budget capacity (although are not necessarily financially strong).

- These characteristics of repayment pressure are further demonstrated in the following additional dimensions of borrower profile.

Repayment Characteristic	Food expenditure has been reduced to make loan repayments	I (or my spouse) have taken additional work to make loan repayments	Arrears: Utility Payments	Informal Loan: Friends	Informal Loan: Retail: Domestic Assets	Informal Loan: Retail: Domestic Consumption
Arrears	75%	26%	13%	21%	16%	10%
Lender Refusal	40%	24%	12%	9%	19%	10%
Repayment Difficulty	74%	22%	9%	16%	9%	5%
Expenditure >75% Income	63%	14%	13%	15%	13%	6%
Remainder	37%	11%	5%	8%	8%	6%

  - The above characteristics demonstrate the range of actions which have been taken not only by those borrowers who have recognised the financial pressures which they must address, but also those under particular financial constraint;
  - The level of reduction of monthly food expenditure may be particularly significant. Current average monthly expenditures on food across all these segment is only about AZN 100 per person. If these borrowers are experiencing repayment problems, and many have already taken the actions indicated above, there may be minimal scope for further domestic budget economies or external borrowing;
  - It may be suggested that the amount, or continuation, of support from family is likely to be limited for many of these problem debt situations. As 'problem debt' is such a sizeable segment, it is appropriate to seek to identify and address such problems, either by a review of budget expenditures, or possible refinance / restructure of the debt.

- The impact of problem lending extends across all income segments. However, the following table highlights that the greatest impact of loan arrears occurs within the highest income segments.

[12] This reflects a progressive segmentation of clients – those in 'arrears' are excluded from subsequent segments and then 'lender refusal' are similarly excluded from the following segments, and so on.

[13] 'Repayment Difficulty': Based upon those borrowers who agreed that "my loan repayments are more than I can afford", and excluding those who have loan arrears or had been refused a loan by a lender in the last 12 months.

Household Income	<600	601-750	751-850	851-1,000	>1,000	Average Income	Average per earner
Arrears	7%	7%	10%	33%	43%	1,064	482
Lender Refusal	7%	9%	17%	24%	42%	1,107	504
Repayment Difficulty	11%	24%	20%	24%	22%	920	396
Expenditure >75% Income	10%	22%	26%	28%	14%	871	395
Remainder	8%	17%	19%	17%	40%	1,137	515

- *These figures show the total share of clients in each income segment for each 'problem' category – for example, in income segment AZN 851-1,000, 24% of borrowers had 'repayment difficulty', 28% of all borrowers in this income range had committed expenditures above 75% of income, and 33% had loan arrears.*

- Such widespread recognition of problem lending amongst clients (although the lending institutions will not be able to directly measure it) requires the lending institutions to differentiate the types / segments of debt problem which they face – to reflect the concerns and underlying attitudes of different borrowers;

- Such widespread financial problems amongst borrowers, most of whom are striving to maintain loan payments and meet their financial obligations, requires lending institutions, together with other stakeholders, to recognise the strategic and structural risk drivers – and not to focus primarily on the visible levels of arrears.

2.4 To what extent do borrowers use more than one lender, and do these clients show different characteristics?

Bank clients have more multiple loans than MFI clients – female borrowers have more independent loans in addition to their spouse.

- This issue can be considered in three principal dimensions.
  - The extent to which borrowers leave an MFI institution and move to a bank (or vice versa);
  - The extent to which borrowers hold more than one loan at any single time;
  - The extent to which borrowers move between lending institutions when they renew their loan.
- The survey did not indicate any substantive level of movement between lenders by borrowers.
- Borrowers indicated a high level of stability with the lending institution during the last two years.

	During the last 2 years, how many loans have you taken from microfinance institutions and commercial banks			How many lenders have you used for these loans		
	1	2	> 2	1	2	> 2
MFI	87%	13%	0%	99%	1%	0%
Bank	74%	21%	5%	85%	13%	2%

  - This suggests that the average loan period is either
    - significantly longer than 12-18 months, or
    - there is a high level of non-renewal client attrition (which may be a less likely scenario).
- There was no indication of any movement of borrowers between MFIs and banks, although there was a high level of overlap in the demographic profiles of MFI and bank individual borrowers.
- The level of borrowers with multiple concurrent loans is limited:
  - 12% of MFI clients have two loans;

- o 20% of bank clients have two loans and a further 4% have three loans.

- In response to a separate, direct question, whilst a majority of both MFI (84%) and bank (79%) clients agreed that "It is better to borrow from only one institution, rather than to change lenders".

  - o This is lower than Tajikistan (89% in 2016) but higher than 66% in BiH (2014).

- The borrowing behaviour of men and women appears to be substantially different. The following table indicates a recurrent pattern across different locations of the domestic borrowing patterns of households.

	Who undertakes the loans in your family			
	Only you	Only your spouse/partner	Jointly	Both of you independently
City - Male	88%	0%	5%	7%
City - Female	50%	3%	12%	35%
Urban - Male	83%	1%	6%	10%
Urban - Female	51%	4%	15%	30%
Rural - Male	92%	2%	2%	5%
Rural - Female	40%	6%	1%	53%

  - o This table shows a pattern of responses in which male borrowers predominately assert that they are the only borrowers; whilst,
  - o Female borrowers show a consistently higher level of separate (and joint) borrowings by themselves and their spouses;
  - o The differences in these responses are incompatible – if the male responses are primarily correct, then the female response cannot be applicable – and vice versa;
  - o This may suggest a significant behavioural or social dynamic. Whilst the writer is unaware of the social or cultural implications of this situation in Azerbaijan, the following may be options which impact the lending situation.
    - ▪ The male borrowers wish to be seen as the primary financial decision-makers; or,
    - ▪ Some of the male borrowers are unaware of the financial behaviour of their spouses; or,
    - ▪ Some female borrowers obtain loan funds on behalf of their spouses (possibly the spouse cannot access additional loan funds); or,
    - ▪ Some female borrowers need additional funds for [household] needs and cannot obtain such monies from their spouses;
    - ▪ The extent to which such multiple debts are acknowledged between spouses is not known.
  - o The financial characteristics of the 'sole' and 'both independently' borrower segments differ:

	Income	Net Disp. Income (after Loan	Loan Amount	Loan Arrears	Have you pledged any assets as collateral to secure your loan	Loan from Friends	% who are female borrowers
Sole Borrower	1,021	309	2,489	19%	40%	17%	36%
Both Independently	896	259	1,511	11%	30%	7%	84%

  - o 35% of 'independent' borrowers have a household income less than AZN 750, compared with 26% of the 'sole' borrowers – whilst the average monthly income per earner was significantly lower at AZN 366 for 'independent' borrowers than AZN 468 for 'sole' borrowers;

- The average monthly expenditure on food and household essentials (per person) was also much lower for 'independent' borrowers at AZN 91, compared with AZN 101 for 'sole' borrowers;
- 52% of 'sole' borrowers used loan funds for domestic consumption purposes (compared with 36%);
- These differences suggest that the additional 'independent' loans may be used to supplement domestic income:

	Loans improve the quality of life	I need to continue to borrow to maintain how my family lives	I feel in control of my financial situation	Debt repayment causes problems within my family	Food expend. Has been reduced to make loan payments	My loan payments are more than I can afford
Sole Borrower	44%	44%	42%	42%	60%	45%
Both Independently	56%	52%	29%	36%	73%	43%

- The above responses suggest further that the 'independent' borrower may, on average, be in a more constrained financial position and loan funds are being used to meet essential domestic needs.

- The development of credit bureau data on households will further identify / clarify this situation.

2.5 How often are debt repayment problems caused by exceptional adverse events?

Higher 'own business' failures and loss of spousal income impact adversely upon loan arrears – family illness is higher amongst those borrowers experiencing loan arrears – the retail sector shows high exposure to these adverse events.

- The incidence of adverse events in the last 6 months can be seen to impact particularly upon the 'own business' and higher income segments.

Adverse Events during the previous 6 months	I lost my job	My business was not successful	My spouse / partner lost his/her job	I had to sell a major asset to repay a loan	Major illness of self or family	Remittance income stopped, or reduced
Regular Employment	1%	1%	8%	1%	23%	2%
Own Business	0%	62%	20%	1%	30%	12%

- There is, therefore, a clear emphasis the particularly adverse events which appear to have faced the 'own business' segment during, at least, the last 6 months. This is further reflected in the incidence of such events in relation to loan arrears by borrowers.

Adverse Events during the previous 6 months	I lost my job	My business was not successful	My spouse / partner lost his/her job	I had to sell a major asset to repay a loan	Major illness of self or family	Remittance income stopped, or reduced
Arrears	2%	53%	22%	3%	31%	12%
Lender Refusal	2%	13%	13%	3%	20%	7%
Repayment Difficulty	1%	19%	13%	1%	28%	6%
Expenditure > 75%	1%	10%	10%	0%	25%	1%
Remainder	1%	7%	5%	1%	19%	2%

- The incidence of arrears appears to be related, to some extent, with the higher levels of the loss of a spousal [second] income to the household and reduced remittance income. Whilst a direct causal relationship cannot be asserted, the higher financial problems appear to be also linked to higher health problems;

- Such adverse events, and their potential impact, can also be related to the principal trade sectors;

Adverse Events during the previous 6 months	My business was not successful	My spouse / partner lost his/her job	Major illness of self or family	Remittance income stopped, or reduced	Loan Arrears	% of borrowers in 'Own Business'
Retail	53%	17%	31%	10%	35%	74%
Service	20%	9%	22%	4%	15%	33%
Agriculture	32%	19%	38%	10%	14%	52%

- These three trade sectors represent 90% of 'own business' borrowers (based upon survey respondents);
- The particular pressures on the retail 'own business' segment are starkly shown;
- The characteristics of the 'own business' segment and the higher risk profile which it displays are reviewed later in this report.

2.6 How does the profile of 'employed' borrowers compare with that of 'own business' borrowers?

'Own Business' borrowers show a substantially higher risk profile – regular employment borrowers, with income paid by bank transfer, show a stronger credit profile – banks have higher market share of 'regular employment / bank transfer' borrowers – MFIs have a slightly higher share of 'own business' clients – loan approvals to 'employed' borrowers has been significantly higher in the last 12 months than to 'own business' (particularly to the retail sector.

- The overall distribution of borrowers is shown in the following table in relation to the major sources[14] of income, together with some dimensions of their loan performance.

Source of Income	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans in Foreign Currency
MFI: Bank Transfer	933	330	1,234	6%	18%	5%
MFI: Cash / Cheque	878	263	1,137	6%	30%	4%
MFI: Own Business	1,216	376	3,170	31%	75%	43%
Bank: Bank Transfer	948	314	2,250	11%	10%	6%
Bank: Cash / Cheque	872	246	1,590	11%	23%	6%
Bank: Own Business	1,312	414	4,650	43%	73%	48%

- This table highlights:
  - The sharp difference in loan performance between borrowers with regular incomes and those in 'own business';
  - The strong concentration of problem lending in the 'own business' segment;
  - The higher incomes of 'employed' persons with regular incomes. This is reflected significantly higher loan amounts for bank clients – although this differential is not reflected in the MFI client portfolio;
  - The survey responses identified a structural difference between the 'mix' of the client portfolios of the MFIs and banks, in which the banks had less exposure to the higher risk segments.

[14] Sources of Employment: the table relates only those in paid employment – the receipt of remittances and/or social benefits causes overlap and are considered elsewhere in this review.

	Distribution of Clients	Distribution of Loan Value
MFI: Bank Transfer	28%	19%
MFI: Cash / Cheque	38%	23%
MFI: Own Business	34%	58%
Bank: Bank Transfer	42%	35%
Bank: Cash / Cheque	31%	19%
Bank: Own Business	26%	46%

- Such differences are further reflected in the attitudes of these three borrower segments.

	Loans improve the quality of life	I need to continue to borrow to maintain how my family lives	I feel in control of my financial situation	Debt repayment causes problems within my family	Food expend. Has been reduced to make loan payments	My loan payments are more than I can afford
MFI: Bank Transfer	37%	31%	49%	27%	47%	31%
MFI: Cash / Cheque	44%	40%	36%	34%	60%	39%
MFI: Own Business	42%	53%	43%	50%	61%	53%
Bank: Bank Transfer	49%	38%	52%	33%	56%	35%
Bank: Cash / Cheque	55%	46%	32%	38%	69%	43%
Bank: Own Business	45%	58%	40%	56%	65%	59%

- The 'employed' borrowers with a regular income paid by bank transfer demonstrate consistently more positive attitudes than the other borrowers;

- Bank borrowers show slightly greater levels of pressure as a result of their borrowings.

- The level of loan approvals for 'employed' borrowers has been higher than for 'own business' clients. This is shown in the following table, which identifies different client segments.

Time since last loan was approved	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
Baku					
Employed: Public Sector	0%	4%	22%	36%	35%
Employed: Non Public Sector	1%	4%	18%	42%	33%
Own Business: Retail	0%	1%	8%	40%	51%
Own Business: Non Retail	1%	6%	12%	44%	36%
Other Regions					
Employed: Public Sector	0%	7%	22%	34%	36%
Employed Non Public Sector	0%	3%	13%	37%	46%
Own Business: Retail	0%	1%	4%	13%	82%
Own Business Non Retail	1%	2%	7%	15%	75%

- The Public Sector is the largest segment of employed borrowers, and retail is the largest trade sector of borrowers;

- There are significant differences in the frequency of provision of new or renewal loans;

- The retail segment in Baku appears to have accessed loans more frequently in the period 7-12 months than their counterparts in other regions;

- Against the difficult economic background of the last 6-12 months, it may have been anticipated that there would have been a higher level of loan activity, or restructure amongst lending to the retail sector in the other regions[15];

[15] Loans to retail in 'other regions' was a significant sample size of 509 respondents

- Loan to the retail sector in other regions show a high level of arrears (43%). It is not known if this is the cause of the low level of loan approvals, or if it is caused, or exacerbated, by the low level of loan approvals.

- The major trade sector exposures of the 'income source' borrower segments are shown in the following table:

	Retail	Service	Public Sector	Manufacture	Agriculture
MFI					
MFI: Bank Transfer	0%	5%	88%	1%	0%
MFI: Cash / Cheque	15%	35%	1%	12%	7%
MFI: Own Business	59%	23%	0%	2%	9%
Bank					
Bank: Bank Transfer	0%	4%	83%	4%	1%
Bank: Cash / Cheque	19%	32%	2%	9%	4%
Bank: Own Business	58%	23%	1%	2%	8%

  - The distribution of borrowers is again very similar for both MFIs and banks;
  - The strong concentrations in the retail, service and public sectors are major determinants of the loan profile and performance, and the consequent strategic options.

- Informal borrowings and budget adjustment initiatives suggest additional actions being undertaken by individuals to maintain up-to-date loan repayments.

	Informal Loans				Arrears: Utilities
	Friends	Retail: Assets	Retail: Domestic	Employer	
MFI: Bank Transfer	5%	6%	3%	1%	7%
MFI: Cash / Cheque	19%	7%	4%	12%	8%
MFI: Own Business	16%	13%	6%	2%	7%
Bank: Bank Transfer	9%	14%	9%	4%	11%
Bank: Cash / Cheque	15%	10%	7%	9%	11%
Bank: Own Business	19%	13%	9%	2%	9%

  - These responses show a lower level of usage amongst those receiving income payments by bank transfer;
  - The higher pressures upon the 'own business' segment are again evident.

2.7 To what extent are loans used to support basic domestic expenditure needs?

About 56% of loans to employed persons are used primarily for domestic consumption purposes – 'own business' loan funds are used for business purposes, but responses indicate that budget pressures are likely to result in greater 'leakage' of funds for domestic needs.

- The profile of the use of loan funds is shown in the following table:

	Business: Investment	Business: Working Capital	Individual: Domestic	Individual: Appliances	Individual: Autocredit	Holiday / Travel / Family Event	Other
MFI	3%	30%	44%	7%	1%	11%	4%
Bank	4%	19%	36%	16%	9%	10%	6%
Former Bank	5%	15%	31%	22%	13%	9%	5%

- The larger market share of 'own business' clients by MFIs is reflected in the above table in relation to the use of funds for working capital purposes;

- Within the above figures, the primary use of loan funds by 'regular work' / employed and 'own business' clients was:

	Business: Investment	Business: Working Capital	Individual: Domestic	Individual: Appliances	Individual: Autocredit	Holiday / Travel / Family Event	Other
Employed	0%	1%	56%	15%	6%	15%	7%
Own Business	12%	78%	4%	2%	3%	0%	1%

- The tables indicate:

  - 'Own Business' display a strong focus for business usage of loan funds. This must be considered also in the context of the loan performance pressures which this borrower segment is experiencing. It does not reflect the extent which the 'own business' client withdraws funds from the business to meet on-going domestic expenditures. In view of other responses, it may be assumed that such indirect usage of funds is occurring to meet domestic consumption needs;

  - The use of funds for domestic consumption (c.55%) is high amongst the 'employed' segment. This reflects short-term usage being undertaken against medium-term (12-18 months) loan periods. Interest is currently charged at about 20-25% nominal and this represents a substantial increase in the real 'total cost' of the domestic consumption.

- The usage of loan funds changes in relation to the level of household income.

	Business: Investment	Business: Working Capital	Individual: Domestic	Individual: Appliances	Individual: Autocredit	Holiday / Travel / Family Event	Other
<600	2%	5%	59%	20%	2%	8%	5%
601-750	1%	6%	63%	11%	1%	14%	4%
751-850	2%	12%	51%	13%	2%	17%	3%
851-1,000	3%	33%	35%	7%	4%	13%	5%
>1,000	8%	41%	19%	12%	12%	2%	7%

- This table shows the strong and greater usage of loan funds for domestic consumption by lower income households – with a majority (55%) of such borrowers being female.

- The different impacts of the usage of loan funds on credit performance is shown below:

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans in Foreign Currency
Business: Investment	1,193	350	3,759	35%	57%	35%
Business: Working Capital	1,201	350	3,549	39%	78%	51%
Individual: Domestic	847	249	1,124	7%	20%	5%
Individual: Appliances	956	348	1,729	14%	14%	6%
Individual: Autocredit	1,115	395	3,461	15%	29%	11%
Holiday / Travel / Family Event	958	304	1,472	4%	24%	2%

- This indicates that, perhaps somewhat surprisingly, the lowest incidence of loan arrears occurs in conjunction with the usage of loan funds for domestic consumption (although the average loan amount is much lower).

- The perceptions by the borrower of the need to continue to borrow are reflected in the following table:

% of Borrowers in each Segment	Total expenditures (inc. loan repayment) greater than 75 % of Income	Loans improve the quality of life	I need to continue to borrow to maintain how my family and I live	Debt repayments cause problems within my family	My loan repayments are more than I can afford
Business: Investment	54%	46%	42%	44%	46%
Business: Working Capital	57%	44%	63%	59%	62%
Individual: Domestic	44%	52%	47%	35%	41%
Individual: Appliances	29%	36%	28%	30%	33%
Individual: Autocredit	32%	27%	22%	24%	31%
Mortgage: property	30%	25%	17%	30%	27%
Holiday / Travel / Family Event	45%	58%	41%	39%	33%

  - This shows again the particular current pressures of the 'own business' segment;
  - The use of loan funds for domestic consumption is reflected in a higher perception of the 'value' of the loan and the higher recognition of the continuing need to borrow.

2.8 What do former borrowers do after they leave an institution?

Lower average income amongst former bank borrowers – no indication that the former clients feel to have been excluded by the lending institutions – former borrowers show a slightly more positive attitude towards the quality of their lives.

- The survey obtained the responses of former borrowers of both MFIs and banks, and were selected based on those who had ceased to borrow from that type of lending institution within the last 2 years. The sample size of 'former bank clients' is adequate to provide comparison with current bank borrowers. However, the sample size of former MFI clients is too small to provide a reliable assessment.
- The principal characteristics of the former bank borrower segments are:
  - The average age and family size was similar for both current and former bank borrowers;
  - The type of employment for current and former borrowers was similar.
- However, the financial budget profiles display some significant differences and are shown in the following table, together with a further comparative of persons who have never borrowed:

	Income	Household costs	Utility costs	Loan Repayments	Net Disposable Income (after Loan)
Commercial Bank	1,016	435	69	193	319
Former Borrowers Bank	941	449	73		419
Never Borrowed	950	437	74		439

  - The significant dimensions of this table are:
    - The former and non-borrowers have, on average, lower and similar income levels;
    - Despite the higher income levels of those clients who continued to borrow, the 'non-borrowers' have a significantly higher level of net disposable income (after loan costs). The former bank borrowers show a stronger indication that the quality of their lives has improved in the last 12 months, but this cannot be directly aligned to the higher level of net disposable income;
    - Non-borrowers maintained similar levels of essential household expenditures as the 'borrowers'.

- The attitudes of these segments of respondents present somewhat different profiles.

% of respondents who 'Agree'	My financial situation has improved in the last 6 months	The quality of my life has improved in the last 12 months	Loans improve the quality of life	Loans were easy to obtain
Commercial Bank	23%	13%	49%	33%
Former Borrowers Bank	30%	23%	56%	32%
Never Borrowed	27%	22%	na	na

% of respondents who 'Agree'	My loan repayments are / were more than I can afford	It is / was difficult to resolve debt problems with my lender	I need / needed to continue to borrow to maintain how my family and I live	Lending institutions want to lend to people like me
Commercial Bank	44%	47%	45%	78%
Former Borrowers Bank	45%	43%	43%	83%

  - These responses may suggest:
    - The 'former borrowers' show more positive attitude in relation to the quality of their lives;
    - The 'former borrowers' do not indicate that they feel to have been excluded by their lending institution.
  - This may suggest that the 'former borrowers' are more 'discretionary' borrowers who have chosen not to take another loan at the current time.

3 LENDING INSTITUTIONS AND LENDING PORTFOLIOS

3.1 What are the principal financial characteristics of borrowers?

Significant differences in the credit / risk profiles for borrowers in Baku and other regions – portfolio concentrations in 'own business' (primarily retail and service) and public sector employees – new loan approvals are particularly low for 'own business' during the last 12 months – foreign currency loans have a substantially higher level of loan arrears than loans in national currency – 'loan approvals in the last 12 months have been lower for 'own business' clients (particularly in the retail sector) and have been highest for public sector employees.

- The following comments relate to the major generic client segments across the borrowing population and thereby span both MFIs and banks. The tables in this section show the quantitative financial profile and also indications of risk which have been recognised by the borrower.
  - In relation to a more detailed review of income and expenditure, it may be noted that:
    - There is a significant level of overlap between MFI and bank client bases, and this applies strongly across the range of income;
    - Bank borrowers have higher loan balances / loan leverage.

- **Regional Activity**: There are significant differences in the financial profiles of individual borrowers in the Baku region in comparison with those of other regions.

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans in Foreign Currency
Baku: MFI	1,266	532	2,081	3%	30%	12%
Baku: Bank	1,224	487	3,883	20%	18%	15%
City: Other	910	227	1,898	20%	41%	20%
Urban: Other	883	270	1,922	17%	38%	14%
Rural: Other	903	228	2,038	16%	48%	17%

  - There is, therefore, a significant regional overlay in relation to the assessment of the portfolio segments of individual borrowers;
  - However, there appears to be a generally strong level of overlap between the demographic and budget profiles of MFI and bank borrowers – with the principal differences relating to the employment types of client and the loan amounts.

- **Regional: Problem Lending**

	Loan Arrears Overall average = 17%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
Baku	11%	8%	18%	21%	17%	37%
Abershon	17%	2%	40%	33%	17%	82%
Guba-Khachmaz	23%	16%	43%	46%	88%	77%
Aran	21%	16%	48%	46%	91%	83%
Ganja-Gazakh	22%	4%	58%	51%	85%	84%
Shaki-Zagatala	18%	6%	60%	48%	86%	85%
Dagligh Shirvan	11%	11%	55%	43%	73%	83%
Lankaran	16%	6%	64%	58%	83%	83%
Yukhari Garabagh	14%	6%	71%	52%	82%	86%

  - These responses indicate some substantial differences in pressures being experienced by borrowers across the regions;
  - The Baku market shows some fundamental differences in borrower attitude.

- **Trade Activity in relation to Region**: The three major concentrations of employment in trade sectors (together with agriculture in rural arears) is shown in the following table:

	Retail	Service	Public Sector	Agriculture	Other
Baku: MFI	23%	31%	25%	0%	21%
Baku: Bank	18%	14%	37%	2%	29%
City: Other	27%	22%	29%	1%	21%
Urban: Other	18%	20%	35%	2%	24%
Rural: Other	17%	9%	25%	35%	14%

- **Trade Activity**: Financial: the principal trading activities which underpin the income of borrowers are agriculture, retail, service, and public sector.

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans in Foreign Currency
Retail	1,148	321	3,276	35%	65%	46%
Service	1,003	330	1,903	15%	38%	14%
Public Sector	919	314	1,549	8%	11%	5%
Agriculture	1,155	356	3,236	14%	61%	11%

  - These show quite different financial and loan profiles – which may suggest:
    - The lending institutions do establish different lending strategies and structures for different trade sectors;
    - The 'own business' segment is particularly concentrated in the retail sector and this increases the average loan;
    - The use of collateral differs substantially;
    - The focus of foreign currency loans in the retail sector implies that there was a [fundamental] mis-match between the currency of trading revenues and the loan currency.

- **Trade Activity: the scale of 'problem repayment'** amongst borrowers varies between these major sectors and is reflected in the following indicators:

	Loan Arrears Overall average = 17%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
Retail	35%	9%	56%	52%	68%	78%
Service	15%	9%	40%	37%	55%	64%
Public Sector	8%	7%	33%	30%	53%	61%
Agriculture	14%	6%	64%	58%	83%	85%

  - Financial pressures are being experienced and recognised by borrowers across the major sectors, although these are somewhat lower in the Public Sector (with the benefit of regular employment).

- **Age: Financial**

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans in Foreign Currency
16-25	889	336	1,363	10%	11%	5%
26-35	936	301	1,888	12%	26%	10%
36-45	1,021	308	2,316	18%	42%	21%
46-55	1,168	365	3,040	27%	50%	29%
> 55	1,282	416	3,603	19%	46%	16%

  - A clear progressive change through the age segments;
  - The higher debt levels of 46 years and older reflect;

- A much higher proportion (c.50%) of 'own business' clients;
- A related greater exposure to the retail sector;
- A slightly higher level of multiple incomes in the household.

- **Age: Problem Lending**
  - The following table shows, again, that the financial pressures are most impacting the older borrowers:

	Loan Arrears Overall average = 17%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
16-25	10%	9%	28%	26%	36%	55%
26-35	12%	10%	36%	34%	56%	66%
36-45	18%	9%	45%	41%	62%	70%
46-55	27%	9%	55%	51%	65%	75%
> 55	19%	4%	60%	44%	66%	74%

- **Loan Amount:**
  - Distribution of outstanding loan balances:
    - The distribution of outstanding loan balances (expressed in AZN Manat) is somewhat lower for MFIs than banks. The average outstanding bank balance for individual borrowers is 43% higher than that of MFI individual borrowers. The monthly loan payment for such higher loans is somewhat off-set by a longer residual repayment period. If the repayment period were the same for bank loans as that of MFI loans, the average repayment would be increased by AZN 55 per month (+29%).

Outstanding Loan Balance	< 600	601-1,200	1,201-1,800	1,801-2,400	> 2,400	Average	Average remaining repayment period mths
MFI	17%	32%	16%	8%	27%	1,849	11
Commercial Bank	16%	31%	13%	6%	34%	2,654	14

  - However, the structure of outstanding loans has been significantly impacted by the currency devaluation against the US Dollar during the last 12 months. It is appropriate, therefore, to review the separate distributions of Manat AZN and foreign currency loans:

Outstanding Loan Balance	< 600	601-1,200	1,201-1,800	1,801-2,400	> 2,400	Average	Average remaining repayment period mths
MFI: AZN: Total	21%	38%	17%	7%	18%	1,545	10
Bank: AZN: Total	19%	37%	14%	6%	24%	2,199	13
MFI: Fgn Ccy: Total	0%	7%	10%	14%	70%	3,300	14
Bank: Fgn Ccy: Total	1%	3%	7%	7%	82%	4,864	16

  - The higher level of outstanding loan balance and longer loan repayment period by banks is demonstrated in both AZN and foreign currency loans;

- The performance of these loan portfolios is summarised in the following table:

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans with expenditure > 75% of income
MFI: AZN: Total	970	317	1,545	5%	34%	41%
Bank: AZN: Total	957	308	2,199	11%	21%	38%
MFI: Fgn Ccy: Total	1,188	329	3,300	58%	80%	63%
Bank: Fgn Ccy: Total	1,302	372	4,864	60%	73%	68%

- The concentration of loan arrears in the foreign currency loan portfolios is stark;
- In Baku, foreign currency loans account for 13% of clients and 22% of balances, whilst in the other regions, the levels are 19% of clients and 27% of balances;
- The AZN-based loans demonstrate a relatively low loan arrears rate in relation to the economic pressures which have occurred during the last year;
- These foreign currency debt problems are reflected in the attitudes of the borrowers:

	Loan from Friends Overall average = 14%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
MFI: AZN: Total	13%	7%	37%	32%	53%	62%
Bank: AZN: Total	12%	10%	39%	36%	58%	70%
MFI: Fgn Ccy: Total	21%	10%	65%	61%	71%	76%
Bank: Fgn Ccy: Total	21%	16%	67%	64%	78%	90%

- The foreign currency borrowers have clearly made additional efforts to maintain their loan repayment and lifestyle obligations;
- The impact of the indebtedness extends substantially beyond the loan arrears and is having a significant impact upon the lifestyle of borrowers.

- **Loan Approvals**
  - The pattern of loan approvals appears to indicate that there has been a slow-down in loan approvals during the first 6 months of 2016:

Period since last loan was taken	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
MFI: AZN: Total	0%	4%	15%	37%	44%
Bank: AZN: Total	0%	5%	18%	33%	42%
MFI: Fgn Ccy: Total	1%	1%	5%	10%	83%
Bank: Fgn Ccy: Total	0%	1%	3%	13%	81%

  - The profile of new foreign currency loan sanctions is, unsurprisingly, much lower than that of AZN-based loans;
  - 19% of MFI loans were approved in the 6 months to June 2016, compared with 23% for the banks. This suggests that:
    - There are either different lending strategies, or different funding capacities, between the MFIs and the banks;

- If the average loan period for bank AZN-based loans is 24 months, then the survey responses would be consistent with such a loan structure. However, such a loan period would not be appropriate for the levels of loan usage for domestic consumption purposes;

- However, national statistics (see Attachment 3) indicate that there has been a substantial slow-down in the level of lending to households.

o The profile of loan approvals is substantially different between Baku and the other regions:

Period since last loan was taken	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
Baku: MFI	0%	3%	13%	41%	42%
Baku: Bank	1%	4%	19%	37%	35%
City: Other	0%	4%	13%	27%	56%
Urban: Other	2%	9%	19%	33%	37%
Rural: Other	0%	3%	12%	24%	61%
MFI: Fgn Ccy: Non-Baku	1%	0%	3%	2%	92%
Bank: Fgn Ccy: Non-Baku	0%	1%	2%	4%	92%

- This table suggests that there has been a lower level of loan approvals during the last year in regions outside Baku;

- There has been an almost cessation of foreign currency lending in regions outside Baku in the last 12 months;

- The financial profiles of these different segments of loan approval identify the significant differences in the budgetary and borrowing positions of these clients.

o The low level of loan approvals during the last 12 months is shown in the ‘own business’ segment, particularly in the other regions throughout the country:

Period since last loan was taken: Own Business	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
MFI: Baku	1%	3%	10%	42%	45%
Bank: Baku	0%	2%	5%	36%	54%
MFI: Other Regions	1%	1%	3%	10%	84%
Bank: Other Regions	0%	1%	5%	9%	84%

- The rate of loan approvals in other regions appears to have been particularly subdued in the period 7-12 months prior to the survey – but has returned to similar levels as banks in Baku in the 6 months prior to the survey;

o The income profiles of the different periods since the last loan approval are shown in the following table:

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of Loans with Foreign Currency	% of loans with expend. > 75% of income
Baku < 6 mths	1,184	510	2,367	12%	17%	6%	17%
Baku 7-12 mths	1,241	532	2,465	13%	18%	12%	27%
Baku > 12 mths	1,293	499	3,664	10%	34%	17%	25%
Regions < 6 mths	829	264	1,370	7%	26%	4%	34%
Regions 7-12 mths	823	231	1,162	6%	25%	2%	46%
Regions > 12 mths	972	222	2,468	29%	55%	32%	62%

- This table indicates that:
  - There is a clear concentration of problem lending in regions outside Baku amongst borrowers in which the loan was approved more than 12 months ago (representing 55% of non-Baku borrowers);
  - The credit 'affordability' of non-Baku borrowers is more delicately balanced. This may be reflected in operational credit standards having a lower rate of loan acceptance.
- Such differences in the profile of loan approvals are highlighted in a comparison of 'employed' borrowers and 'own business' borrowers:

Period since last loan was taken: Own Business	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
Employed	0%	5%	18%	37%	39%
Own Business	1%	2%	5%	18%	74%

- This represents a substantive difference in the timing of loan approvals between these client segments;
- Such differences are further extended by comparison between Baku and other regions:

Time since last loan was approved	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
Baku					
Employed: Public Sector	0%	4%	22%	36%	35%
Employed: Non Public Sector	1%	4%	18%	42%	33%
Own Business: Retail	0%	1%	8%	40%	51%
Own Business: Non Retail	1%	6%	12%	44%	36%
Other Regions					
Employed: Public Sector	0%	7%	22%	34%	36%
Employed Non Public Sector	0%	3%	13%	37%	46%
Own Business: Retail	0%	1%	4%	13%	82%
Own Business Non Retail	1%	2%	7%	15%	75%

- There appears to be a stronger emphasis towards loans to public sector employees across the regions;
- The retail sector has shown a low level of recent loan approvals, and this has applied particularly in regions outside Baku.

• Structure of Outstanding Loans

Outstanding Loan Amount	Distribution of Borrowers	Distribution of loans	Foreign Currency	Residual repayment period (months)	Refinance / consolidation of loans in last 12 months	Collateral pledge of assets
< 600	17%	3%	0%	5	5%	13%
601-1,200	31%	12%	3%	7	7%	18%
1,201-1,800	14%	9%	10%	9	7%	27%
1,801-2,400	7%	7%	25%	10	16%	48%
> 2,400	30%	68%	43%	16	17%	68%

- The impact of foreign currency lending in the larger loan balances contrasts sharply with the other segments;
- The higher level of loan reschedule amongst the largest loans is reflected in higher loan arrears (see next comments);

- The higher value loans represent a significant entrenched higher-risk portfolio – the overall quality of the loan portfolios is highly dependent, therefore, upon the credit quality of on-going new and renewal loan approvals;
- Higher levels of collateral are held for the higher value loans.

- **Loan Amount: Problem Lending**

Outstanding Loan Amount	Loan Arrears Overall average = 17%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
< 600	4%	7%	37%	31%	64%	63%
601-1,200	5%	9%	38%	33%	62%	68%
1,201-1,800	13%	12%	42%	38%	57%	68%
1,801-2,400	20%	11%	37%	40%	49%	63%
> 2,400	37%	8%	53%	50%	57%	75%

- Taken together, these reflect the substantive financial pressures being experienced by borrowers with higher value outstanding loan amounts;
- The impact of loan arrears increases directly with the amount of outstanding loan balance;
- There is clearly a widespread feeling of an inability to identify how to resolve current financial / debt problems.

3.2 What are the principal similarities and differences between the loan portfolios of the MFIs and banks?

This section takes the previous dimensions of borrowers and provides a comparison between MFI and bank clients in relation to location, income, loan type, and savings.

Strong portfolio concentration of loan exposure to higher income clients – higher loan amounts and leverage in lending by banks – differentiation of loan product structure in relation to usage of funds.

- There is a broad overlap in the comparative distributions of client numbers in relation to the range of household incomes.

Household Income	Distribution of Borrowers		Distribution of Loan Value		Outstanding Loan	Distribution of Borrowers		Distribution of Loan Value	
	MFI	Bank	MFI	Bank		MFI	Bank	MFI	Bank
<600	9%	9%	4%	4%	< 600	17%	16%	4%	3%
601-750	18%	17%	9%	8%	601-1,200	32%	31%	15%	10%
751-850	19%	19%	13%	10%	1,201-1,800	16%	13%	12%	7%
851-1,000	25%	23%	27%	19%	1,801-2,400	8%	6%	9%	5%
>1,000	30%	31%	48%	59%	> 2,400	27%	34%	59%	75%

- Although the income distribution of borrowers is similar for both MFIs and banks, the higher lending and leverage of bank clients is shown by the greater distribution of bank lending towards higher income clients;
- This suggests that MFIs and banks have similar target markets – but the development strategies differ in relation to available loan amounts.

- Amongst individual borrowers, MFIs show a slightly greater proportion of 'own business' and 'cash paid' employees, whilst banks have a greater share of employees being paid by bank transfer.

Income Payment	Distribution of Borrowers		Distribution of Loan Value		Loan Arrears		% of Loans with Collateral		% of Loans in Foreign Currency	
	MFI	Bank	MFI	Bank	MFI	Bank	MFI	Bank	MFI	Bank
Bank Transfer	28%	42%	19%	35%	7%	11%	18%	10%	5%	6%
Cash / Cheque	38%	31%	23%	19%	8%	11%	30%	23%	4%	6%
Own Business	34%	26%	58%	46%	7%	9%	75%	73%	43%	48%

- Despite a greater share of 'bank transfer' employed borrowers, bank clients show a higher level of arrears, which may be a further indication of the underlying financial pressures;
- Similar strategies appear to have been used by both MFIs and banks in relation to foreign currency lending;
- However, MFIs appear to have placed a greater focus upon some form of collateral to support loans. (See later comments in relation to the structure and potential value of collateral and guarantees).

- **Problem Lending**

Household Income	Loan Arrears		Loan Refinance		My loan repayments are more than I can afford		Food expenditure has been reduced to make loan repayments	
	MFI	Bank	MFI	Bank	MFI	Bank	MFI	Bank
<600	13%	13%	12%	14%	44%	47%	52%	59%
601-750	7%	6%	4%	8%	45%	44%	75%	65%
751-850	6%	11%	4%	8%	42%	32%	72%	67%
851-1,000	22%	24%	8%	10%	49%	49%	63%	73%
>1,000	18%	29%	12%	20%	33%	46%	30%	49%

- Problem debt appears to be somewhat more severe amongst bank borrowers. This appears to be experienced particularly by high income borrowers, who show higher loan arrears despite higher levels of loan refinance and longer loan repayment periods;
- Whilst the overall levels of reduction of food expenditure are high, the MFI clients appear to have shown greater constraint amongst lower income borrowers;

- **Income**: Range: Financial

This segmentation is based upon clients in the various income segments.

Household Income	Net Disposable Income NDI (pre Loan)		Average Outstanding Loan Balance		Net Disposable Income NDI (after Loan)	
	MFI	Bank	MFI	Bank	MFI	Bank
<600	219	207	888	1,191	113	105
601-750	294	308	902	1,169	179	191
751-850	341	353	1,249	1,409	204	216
851-1,000	404	421	1,959	2,229	223	232
>1,000	869	881	2,997	4,997	625	581

- Against broadly similar demographic profiles, the MFIs and banks are presenting similar loan product and service propositions – with the banks differentiating by slightly higher loan amounts;
- The lowest income segment (up to AZN 600) shows a highly marginal financial situation. However, this segment accounts for only 9% of clients and 4% of loan balances.

- **Income:** Range: Leverage of Loan Repayments
  - Lending by banks continues to be undertaken at significantly higher leverage ratios than those undertaken by the MFIs.

Household Income	Loan repayment as % of household income		Loan repayment as % of net disposable income		% of Borrowers with expenditures (inc loan payment) over 75% of income	
	MFI	Bank	MFI	Bank	MFI	Bank
<600	20%	20%	49%	49%	50%	45%
601-750	16%	17%	39%	38%	45%	42%
751-850	17%	17%	40%	39%	54%	43%
851-1,000	19%	20%	45%	45%	58%	58%
>1,000	16%	20%	28%	34%	26%	33%

- This suggests:
  - A general industry standard of loan repayments across most income ranges of a maximum of about 20% of household income. This appears to be applied by both banks and MFIs;
  - However, the impact of essential food and household expenditures highlights the relative higher commitment of loan repayments by the lower income segments.

- **Loan Product / Type**: Financial
  - The survey responses identified that the principal loan products were:
    - National Currency
      - 72% of loans were based upon business loans, consumer expenditure loans, and consumer appliance loans;
      - The other types of loan had relatively small sample sizes and are not included in the following table.
    - Foreign Currency
      - 73% of loans were business loans;
      - The consumer loans were spread across expenditure, appliance, and autocredit loans. These have been consolidated in the following tables:

National Currency Loans (Manat AZN)	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans with expenditure > 75% of income
Business	1,179	336	3,538	36%	74%	57%
Consumer: Expenditure	863	253	1,267	7%	20%	44%
Consumer: Appliance	1,080	487	1,436	10%	6%	24%

  - These major types of loan product show clearly differentiated characteristics in relation to credit performance and structure;
  - This suggests that the product / credit delivery process is, to a significant extent, differentiating the loan product with the end usage. (Note: earlier comments identified that female borrowers show a higher incidence of loan usage for doimestic consumption needs);
  - The higher risk profile of the 'own business' loan segment is shown starkly in relation to AZN-based loans – even without the impact of foreign currency-based loans:

Foreign Currency Loans (US Dollar)	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans with expenditure > 75% of income
Business	1,215	307	4,002	67%	85%	70%
Consumer	1,193	422	3,260	22%	37%	44%

  - The income profiles of these foreign currency loan products is broadly similar to those of the national currency loans;

- Despite the net disposable income (after loan payments) being only slightly lower than for AZN-based borrowers (10% for business loans and 25% for consumer loans), the loan arrears levels for foreign currency loans are significantly and disproportionately higher;
- Such higher risk profile is further reflected by the greater proportion of foreign currency borrowers having committed expenditures (food, household, utility and loan payments) over 75% of income.

- **Loan Product** / Type: Debt Pressure on Borrowers
  - In addition to the levels of loan arrears shown above, the following table provides some wider indications of the extent of debt pressures being experienced by different borrower segments:

	Loan from Friends Overall average = 14%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
National Currency: AZN						
Business	19%	8%	53%	51%	62%	80%
Consumer: Expenditure	13%	11%	40%	34%	64%	65%
Consumer: Appliance	7%	9%	23%	24%	32%	51%
Foreign Currency: US$						
Business	26%	11%	73%	70%	81%	89%
Consumer	7%	12%	34%	35%	52%	56%

  - The greater concentration of risk pressures is consistently shown amongst the 'own business' segment of borrowers in both national and foreign currency loans;
  - Consumer loans for appliances show consistently lower risk indicators.

- **Savings**: **Financial**

The level of savings with a financial institution is almost non-existent (only 1% of all borrowers), although the incidence of savings through other mechanisms is higher.

- The level of savings is low with financial institutions, although a minority of borrowers do undertake savings through other mechanisms.

	Do you make savings with a financial institution	Do you make other savings	Have you bought an insurance product(s) from your financial institution
MFI	1%	23%	19%
Bank	2%	33%	7%

- The budget profiles of 'savers' and 'non-savers' are shown in the following table – the level of responses by savers with a financial institution is so small that these are not shown. However, the responses of borrowers show that the reputation of financial institutions is extremely low, particularly in relation to trustworthiness and integrity (see later comments). This may be a significant dimension in the apparent negligible use of financial institutions for savings.

	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	% of Loans with Collateral	% of loans with expenditure > 75% of income
Other Savings: MFI	931	263	1,845	20%	51%	47%
Other Savings: Bank	1,069	355	2,967	25%	42%	43%
No Savings: MFI	1,032	336	1,856	13%	39%	44%
No Savings: Bank	990	300	2,498	16%	24%	43%

- This table shows the apparently perverse situation in which borrowers with some form of savings have higher loan arrears than the non-savers. This suggests that the savings are illiquid/non-realisable in the short term, or the problems of debt repayment are not sufficiently acute as to motivate the borrower to realise such assets;
- There is minimal difference in the incomes of savers and non-savers – and the levels of net disposable income show contrasting levels between MFI and bank clients.

3.3 Do the survey responses indicate credit standards or criteria?

Overall, banks provide higher loans and higher leverage ratios than those taken by MFI borrowers – possible indications that MFIs undertaken a more stringent credit quality assessment of potential borrowers than banks.

The survey responses show the differences in the loan leverage between MFI (lower leverage) and bank clients (higher leverage). Whilst other responses show an increasing recognition by many borrowers of the difficulties to manage their debt levels and loan repayments, the following tables demonstrate some characteristics of the relationship of debt to income, which reveal the dimensions of pressures being faced.

- The level of debt repayments may be considered in relation to household income. These aggregate figures reflect a range of committed expenditures across the income ranges:

Household Income	Household and Utility costs as % of Household Income		Loan Repayment as % of Total Household Income		Loan Repayment as % of Net Disposable Income (pre loan repayments)	
	MFI	Bank	MFI	Bank	MFI	Bank
<600	59%	60%	20%	20%	49%	49%
601-750	58%	56%	16%	17%	39%	38%
751-850	58%	57%	17%	17%	40%	39%
851-1,000	57%	56%	19%	20%	45%	45%
>1,000	42%	42%	16%	20%	28%	34%

- This table presents some critical perspectives of the credit risk process, based on the quantitative financial positions reported by borrowers[16];
- The cost of basic household essentials is much greater, in real terms, for the lower income households, and such households are more vulnerable to price changes in basic domestic essentials (including food);
- However, loan amounts are higher and the repayment periods in bank lending are longer than for MFI loans. This ‘improves’ the repayment: income ratio for bank borrowers;
- 27% of clients (MFI: 27% and Bank: 26%) are in the lowest two income segments.

[16] Data quality was reviewed and validated by the independent research agency which undertook the survey interviews. Additionally, the similarity of responses from different client segments (MFI and bank) and the relationship between responses at different income levels provides support for the appropriateness of these quantitative evaluations.

- The following table provides some indications of the interaction of the lending institution and the borrower at the time of the loan.

Household Income	Loans were easy to obtain		When I drew my last loan, the lender knew what I could afford		Lending institutions understand customers' needs	
	MFI	Bank	MFI	Bank	MFI	Bank
< 600	20%	31%	92%	89%	35%	29%
601-750	27%	28%	93%	87%	33%	26%
751-850	27%	33%	91%	86%	43%	32%
851-1,000	22%	37%	92%	88%	43%	30%
>1,000	15%	34%	96%	93%	64%	41%

  - This table suggests:
    - The MFIs had adopted a more stringent loan review / acceptance process, although this is not reflected in the profile and level of the loan approvals during the preceding 12 months;
    - The responses to the other two questions suggest that the MFIs may be more demanding in the information required prior to loan approval;
    - It may also be noted that loan arrears are lower with the MFIs than with the bank.

3.4 How does lending to 'own business' clients compare between MFIs and banks?

'Own Business' present a high risk client segment, which is more adverse in the other regions outside Baku – MFIs and banks show different credit strategies and practices – the profile of Baku 'own business' loans differs substantially from those in other regions – the 'own business' segment presents a structural risk to the lending institutions.

- Within the individual borrowers responding to the survey, the MFIs had a higher proportion of 'own business' clients than the banks.

- The credit performance and financial characteristics of the 'own business' segment were adverse to those of the other borrower segments.

Source of Income	Are any of your loans in arrears	Have you refinanced, or consolidated your debts during the last 12 months	Have you applied for a loan in the last 12 months	My loan repayments are / were more than I can afford	Have you pledged any assets as collateral to secure your loan	Is any of your loan indebtedness (Q.43) outstanding in a currency which is not Azerbaijan AZN
MFI: Bank Transfer	6%	8%	53%	31%	18%	5%
MFI: Cash / Cheque	6%	2%	48%	39%	30%	4%
MFI: Own Business	31%	14%	22%	53%	75%	43%
Bank: Bank Transfer	11%	14%	54%	35%	10%	6%
Bank: Cash / Cheque	11%	4%	46%	43%	23%	6%
Bank: Own Business	43%	22%	25%	59%	73%	48%

  - The 'own business' segment is showing the following characteristics which are slightly more adverse in bank clients than MFI:
    - Much higher loan arrears;
    - Higher levels of loan refinance;
    - Lower level of loan application in the last 12 months.

- The demographic structure of the 'own business' clients is similar for both MFIs and banks.

- There is also a broad similarity in the trade sectors which are supported, with some variation in the service and agricultural sectors:

	Manufacture	Food Production	Retail	Engineering	Building - Property	Service	Agriculture
MFI: Baku	3%	3%	62%	1%	2%	22%	0%
Bank: Baku	3%	1%	63%	0%	6%	8%	10%
MFI: Other Regions	1%	0%	58%	0%	0%	23%	13%
Bank: Other Regions	1%	0%	56%	0%	0%	29%	7%

  - *Care*: The above table reflects the survey responses and thereby provides a comparative profile of MFIs and banks – it does not purport to reflect a nationally-weighted sample – each lending institution will have its own mix of 'own business' activity;

  - This table shows a major change in concentration towards the retail segment. This is a 'low entry – low exit', low technology, [potentially] lower experience segment which offers relatively short-term opportunities for start-up situations. Such characteristics are likely to sustain short-term price competition, which will necessarily constrain the rate at which problem debt can resolved;

  - This 'vulnerability' of the retail sector is reflected in the highest level of business failures (53%) and arrears (35%) amongst borrowers in the retail sector – resulting in this sector being the highest credit risk segment;

  - The risk exposure of the 'own business' segment appears to be much higher in the regions outside Baku, than in Baku itself.

'Own Business' Borrowers	Loan Arrears	My business was not successful	My spouse lost his/her job	Major illness of self or family	Remittance income stopped, or reduced
MFI: Baku	4%	36%	1%	20%	0%
Bank: Baku	29%	38%	5%	14%	7%
MFI: Other Regions	42%	74%	26%	38%	15%
Bank: Other Regions	47%	70%	26%	32%	15%

  - The contrasting performance of borrowers in these different locations is stark;

  - It may also be noted that the loan arrears of MFI borrowers in Baku is substantially lower than that of the bank clients.

- The structure of the loans to 'own business' also differs significantly between Baku and other regions:

Own Business' Borrowers	% of Loans with Collateral	% of Loans in Foreign Currency	Have you applied for a loan in the last 12 months	I understand which type(s) of loan should be used for different needs	Loans refinance in the last 12 months
MFI: Baku	54%	26%	36%	88%	8%
Bank: Baku	41%	33%	45%	90%	27%
MFI: Other Regions	84%	51%	17%	59%	17%
Bank: Other Regions	85%	54%	18%	63%	20%

  - This table suggests that there are different lending strategies and practices in Baku in contrast to other regions;

  - The differences in loan refinance are substantial – in Baku, between MFIs and banks – for MFIs, between Baku and other regions. This suggests, again, that different lending strategies and standards are being applied;

  - The Baku market appears to be continuing to support loans to 'own business', whilst there have been relatively few loan applications in the last 12 months in the regions outside Baku.

- The comparative levels of income and loan exposure are shown in the following table:

Own Business' Borrowers	Income	Net Disposable Income (after Loan)	Average Loan	Loan Repayment as % of Income	Loan Repayment as % of Net Disposable Income (pre loan)
MFI: Baku	1,569	700	3,014	17%	28%
Bank: Baku	1,814	786	7,001	22%	33%
MFI: Other Regions	1,066	239	3,236	22%	50%
Bank: Other Regions	1,137	285	3,830	24%	49%

  - The contrasting lending strategies and standards appear to be significant:
    - MFIs apply much lower loan amounts and leverage than the banks – and this may be causal to the lower levels of loan arrears and the perception (by borrowers) of the greater difficulty to obtain a loan;
    - However, there is minimal differential between MFIs and banks in the other regions.

- The approval of loans for 'own business' has been much less than that for 'employed' borrowers – although the overall rate of new loans appears to have slowed generally.

How loan ago did you take your last loan?	Within 1 month	1-3 months	4-6 months	7-12 months	Over 12 months
Own Business: MFI	1%	2%	5%	19%	72%
Own Business:	0%	1%	5%	16%	76%
Employed: MFI	0%	4%	16%	40%	40%
Employed: Bank	1%	5%	20%	34%	39%

  - The impact of this low level of lending upon the cash flow management of these business is not known.

- The product structure and loan usage for the 'own business' segment is shown in the following table:

Own Business' Borrowers	Loan Product (AZN Loans)			Usage of Loan Funds		
	Business	Agricultural	Consumer and Other	Business: Investment	Business: Working Capital	Consumer and Other
MFI: Baku	87%	0%	13%	2%	88%	10%
Bank: Baku	46%	6%	48%	24%	39%	37%
MFI: Other Regions	83%	12%	5%	12%	85%	3%
Bank: Other Regions	87%	3%	10%	13%	78%	9%

  - This suggests that the MFIs apply a particular focus to the type of loan and its usage;
  - In Baku, the linkage of loan product to usage is much less defined by the banks – however, this contrasts with the much greater linkage of product and usage by banks in the other regions.

- The distribution of incomes is shown in the following table and is broadly similar for MFIs and banks in the respective regions.

Own Business' Borrowers	<600	601-750	751-850	851-1,000	>1,000	Average	Number of Earners in Household
MFI: Baku	1%	1%	3%	15%	79%	1,569	1.81
Bank: Baku	3%	5%	5%	9%	78%	1,814	1.75
MFI: Other Regions	1%	7%	13%	38%	41%	1,066	2.27
Bank: Other Regions	1%	4%	10%	35%	49%	1,137	2.25

- o Again, there are broadly similar income profiles by MFIs and banks in the respective regions;
- o This emphasises further the apparently different lending strategies and practices of MFIs and banks in Baku to the 'own business' segment'.

- The differences of MFIs and banks in Baku, and the similarities of MFIs and banks in other regions is further demonstrated in the distribution of outstanding loan balances.

Own Business' Borrowers	< 600	601-1,200	1,201-1,800	1,801-2,400	> 2,400	Average	Average Repayment Period mths
MFI: Baku	2%	13%	17%	13%	54%	3,014	11
Bank: Baku	0%	9%	10%	9%	72%	7,001	18
MFI: Other Regions	1%	7%	13%	11%	68%	3,236	14
Bank: Other Regions	0%	3%	8%	10%	78%	3,830	14

- o The difference in the residual loan repayment period in Baku is substantial. It may be noted that the banks had higher loan arrears and, without the higher levels of loan refinance, such arrears may have been even higher.

3.5 Collateral Security – does it affect lending?

Borrowers with collateral present a much high risk profile – the use of collateral varies considerably between regions and MFIs / banks – collateral is focused primarily towards the foreign currency loan and 'own business' segments –property collateral is relatively low being primarily related to bank borrowers in Baku.

- The extent of assets pledged as security is:
  - o MFI: 42% of borrowers Bank: 30% of borrowers
  - o Within these levels, the incidence of asset collateralisation is higher amongst borrowers in the following segments
    - ▪ MFI: Foreign Currency Total - 80%
    - ▪ Outside Baku 86%
    - ▪ Bank: Foreign Currency Total - 73%
    - ▪ Outside Baku 80%
    - ▪ 'Own Business': MFI 75%
    - ▪ 'Own Business": Bank 73%
    - ▪ Regions outside Baku: City 41%

      Urban 38%

      Rural 48%

- The distribution of the collateral loan portfolios of the lending institutions is shown below:

	Distribution of Borrowers	Distribution of loans	Income	Net Disposable Income (after loan)	Outstanding Loan	Loan Arrears
MFI Collateral	42%	62%	1,078	298	2,732	26%
MFI Non-Collateral	58%	38%	957	337	1,212	6%
Bank Collateral	30%	53%	1,151	305	4,669	37%
Bank Non-Collateral	70%	47%	960	327	1,782	11%

  - The relationship between collateral and higher outstanding loan / higher loan arrears is clearly demonstrated;
  - The net disposable incomes of collateralised borrowers are slightly lower, despite the higher average household incomes. This reflects the higher loan commitments;
  - It is not known if the collateral was obtained as a component of a higher initial loan, or as a consequence of a problem debt situation.

- A comparison of Baku with other regions is shown below:

Loans with Collateral	Income	Net Disposable Income (after loan)	Outstanding Loan	Loan Arrears	% of Loans in Foreign Currency	% of Loans Refinanced
Baku						
MFI: Collateral	1,417	554	3,457	5%	21%	6%
Bank: Collateral	1,627	570	9,717	25%	42%	29%
Other City						
MFI: Collateral	965	213	2,363	35%	40%	12%
Bank: Collateral	1,066	248	3,652	43%	44%	14%
Other Locations (outside Baku and other cities)						
MFI: Collateral	1,013	251	2,885	26%	28%	8%
Bank: Collateral	961	234	3,048	26%	31%	22%

  - This table shows different lending strategies, standards and performance across these locations by both MFIs and banks;
  - There does not appear to be a consistent profile.

- The types of collateralised asset are shown in the following table:
-

Loans with Collateral Distribution of loans by type of collateral	Business Property	Residential Property	Business Equipment	Domestic Asset(s)	Vehicle	Gold / Jewellery
Baku						
MFI: Collateral	1%	18%	6%	1%	57%	16%
Bank: Collateral	10%	35%	6%	5%	23%	20%
Other City						
MFI: Collateral	3%	2%	49%	25%	2%	19%
Bank: Collateral	5%	1%	46%	16%	18%	13%
Other Locations (outside Baku and other cities)						
MFI: Collateral	3%	2%	45%	21%	4%	24%
Bank: Collateral	12%	6%	39%	21%	4%	18%

  - The structure of collateral differs substantially in Baku between MFIs and banks;
  - There is a minimal level of property held outside Baku. The survey responses do not identify the reasons for such a significant absence. However, in view of the scale of the outstanding loan exposure and the high usage of foreign currency loans, it may have anticipated that property collateral would have been widely used.

- The wider pressures upon borrowers with collateral (in addition to the incidence of loan arrears) are shown in the following table:

	Loan from Friends Overall average = 14%	Utility Arrears Overall average = 9%	My loan repayments are more than I can afford Overall average = 43%	Debt repayments cause problems within my family Overall average = 39%	Food expenditure reduced for loan repay Overall average = 59%	I would like help to resolve debt problems with my lending institution Overall average = 69%
MFI						
Collateral	20%	7%	54%	50%	67%	73%
Non-Collateral	10%	8%	33%	28%	49%	58%
Bank						
Collateral	20%	12%	61%	55%	70%	88%
Non-Collateral	11%	10%	36%	35%	58%	67%

  - Collateralised borrowers are showing consistently higher levels of pressure;
  - Bank clients reflect a slightly worse position;
  - Whilst the collateralised borrowers show a need and readiness for assistance to resolve their debt problems, the following table highlights the financial pressures which they face – and thereby reduces the options for a ready resolution of the budgetary challenge.

- The leverage ratios reflect the greater financial and budget pressures being experienced by borrowers with collateral.

Loans with Collateral Distribution of loans by type of collateral	Household & Utility Expenditure as % of Income	Loan Repayment as % of Income	Loan Repayment as % of Net Disposable Income (after loan)	% of Borrowers with expenditure > 75% of Income
MFI: Collateral: Baku	39%	21%	35%	29%
Bank: Collateral: Baku	36%	29%	45%	39%
MFI: Collateral: Other City	58%	20%	48%	66%
Bank: Collateral: Other City	54%	23%	49%	62%
MFI: Collateral: Other Locations	54%	21%	46%	56%
Bank: Collateral:Other Locations	52%	23%	49%	57%
MFI: Non-Collateral: Total	51%	14%	29%	37%
Bank: Non-Collateral: Total	50%	16%	32%	38%

  - This table suggests that the debt positions of borrowers with collateral are substantially entrenched – and possibly unlikely to be available for resolution in the short-term;
  - Again, there are substantive differences between the situation in Baku and in other regions.

- The incidence and types of collateral may be compared with Tajikistan to provide some perspective to the profile in Azerbaijan.
  - The overall levels of collateral were similar in Azerbaijan (MFI 42% and bank 30% of clients) with those seen in Tajikistan (MFI 30% and bank 43%);
  - However, the types of collateral were different.

Loans with Collateral Distribution of loans by type of collateral	Business Property	Residential Property	Business Equipment	Domestic Asset(s)	Vehicle	Gold / Jewellery
Azerbaijan						
MFI	3%	5%	39%	19%	14%	19%
Bank	7%	8%	38%	15%	17%	15%
Tajikistan						
MFI	16%	27%	6%	18%	11%	15%
Bank	15%	32%	6%	15%	14%	12%

- The low proportion of property in collateral in Azerbaijan contrasts with the situation in Tajikistan. (It is not known if such assets have been used to enable separate mortgage borrowings);
- The realisable value of business equipment and domestic assets in Azerbaijan may be highly uncertain;
- It appears, therefore, that the structure of collateral in Tajikistan is stronger, although current market conditions may cause the realisation of most assets (including property) to be problematic.

- The number of borrowers who provide guarantees for borrowings by other individuals is shown in the following table:

Number of guarantees for outstanding debts	0	1	2	>2
MFI	11%	87%	1%	0%
Commercial Bank	20%	71%	9%	0%

  - There is, therefore, no indication of widespread guarantee exposure.

- However, the underlying value of many of such guarantees does not appear to be strong.

Risk Dimensions	Number of guarantees for outstanding debts (2014 levels in parentheses)			
	0	1	2	>2
Arrears	13%	72%	14%	1%
Lender Refusal	26%	58%	14%	2%
Repayment Difficulty	9%	88%	2%	0%
Expenditure > 75%	11%	85%	4%	0%
Remainder	24%	72%	3%	0%

  - Risk Dimensions[17] show the extent to which guarantees have been taken from borrowers who are, themselves, under significant financial pressures;
  - The underlying value of guarantee obligations appears to be more nominal than real, in relation to most guarantors, except possibly those in ‘remainder’ segment (33% of borrowers). The operational processes to implement and realise such guarantee commitments would be significant and the cost efficiency of the enforcement of the liability would probably be challenging;
  - The role of guarantees appears to be ‘motivational’ – however, the risk of such an extensive use of guarantees (with minimal apparent likelihood of enforcement) could be to further exacerbate the reputation of the financial institutions, and to unite borrowers to resist such obligations.

[17] Risk Dimensions are based upon: [1] Arrears: arrears with current loan; [2] Lender refusal: a lender has refused a loan application by the borrower in the last 12 months, although a loan was subsequently obtained from another lender; [3] Repayment difficulty: the borrower acknowledges to have difficulty in making the loan repayments; [4] Expenditure > 75% Income: the aggregate of essential household, utility and loan repayment expenditures exceed 75% of household income; [5] Remainder: all borrowers not included in segments 1 – 4. No borrower is included in more than one segment

- The diversity of factors suggests that the collateralisation of assets may be primarily a motivational factor to support loan repayment, rather than a source of potential realisable value for any shortfall in loan repayment:
    - With the possible exception of property (which is limited primarily to bank borrowers in Baku and, for which, current market conditions may be difficult for even these assets), then the intrinsic realisable value of each item of collateral may be limited;
    - Conversely, the asset may have considerable 'lifestyle' importance to the lender, and any loss of this would represent a significant deprivation to the quality of life;
    - The existence, and occasional enforcement, of such collateral assets may also be perceived by lending institutions as a wider market motivation to maintain repayment – particularly against the financial profile of constrained net disposable income and the extensive usage of informal loan sources;
    - It may be noted that experience in other countries has shown the extreme difficulty of realising domestic assets held as security. It was found that people were reluctant to buy the collateralised assets of other community members / neighbours.
- The interaction of factors shown within this review suggests that the 'collateralised borrower' segment presents a higher-risk profile within the lending portfolio.

3.6 What is the scope of lending in foreign currency?

31% of loan balances are attributable to foreign currency loans (but only 17% of borrowers) – loan arrears are about 60% - foreign currency borrowers show generally higher risk characteristics and anxieties – foreign currency loan exposures present a fundamental strategic risk to lending institutions

- During the last years the AZN Manat has experienced a severe devaluation against the US$ (which was the currency of all foreign currency loans in the survey). The trends in the AZN exchange rate are reviewed in Attachment 3. These show that following a long period of stability, with the AZN Manat effectively on a 'peg' against the US Dollar, there have been two significant devaluations since end-2014 – which resulted in about a 100% devaluation of the AZN Manat (from an exchange rate AZN: US$ of 0.80 to 1.60). This represented the crystallisation of a structural, or 'event', risk – rather than an operational credit risk.
- The extent of lending in foreign currency is shown in the following table:

	Distribution of Borrowers	Distribution of loans	Income	Net Disposable Income (after loan)	Outstanding Loan	Loan Arrears
MFI: AZN: Total	83%	69%	970	317	1,545	5%
MFI: Fgn Ccy: Total	17%	31%	1,188	329	3,300	58%
Bank: AZN: Total	83%	69%	957	308	2,199	11%
Bank: Fgn Ccy: Total	17%	31%	1,302	372	4,864	60%

    - The concentration of high risk exposure in foreign currency loans is shown starkly in this table;
    - This table highlights the immediate vulnerability of the credit quality of the 'foreign currency' segment – which is significant because it represents 31% of loan value (in relation to the respondent individual borrowers);
    - Such higher risk characteristics of the operational credit position must be considered also in conjunction with the structural risk exposures shown in the following paragraphs;
    - However, the level of loan arrears appears to be disproportionately high amongst foreign currency borrowers in relation to the comparable levels of net disposable income amongst AZN-based loan borrowers.
- Additional risk dimensions are shown in the following table which reflect the stronger pressures being experienced by foreign currency borrowers.

	Have you refinanced, or consolidated your debts during the last 12 months	Have you applied for a loan in the last 12 months	If 'yes', has any lender refused to lend to you	Have you pledged any assets as collateral to secure your loan	Food expenditure has been reduced to make loan repayments	My loan repayments are / were more than I can afford
MFI: AZN: Total	6%	45%	2%	34%	53%	37%
MFI: Fgn Ccy: Total	17%	20%	11%	80%	71%	65%
Bank: AZN: Total	11%	49%	5%	21%	58%	39%
Bank: Fgn Ccy: Total	20%	19%	11%	73%	78%	67%

- There is a consistent profile of higher pressure upon the foreign currency borrower.

- The external economic and political factors affecting the exchange rate continue as a strategic risk, but future repayment is also dependent upon other external factors, in addition to the continuing operational credit performance of individual borrowers.

	% Borrowers 'Own Business'	% Borrowers with lower / stopped remittances	Household		Trade Sector		
			Number of Income Earners	Number in Household	Retail	Service	Public Sector
MFI: AZN: Total	23%	3%	2.2	4.4	16%	24%	29%
MFI: Fgn Ccy: Total	83%	14%	2.4	4.9	70%	15%	6%
Bank: AZN: Total	16%	3%	2.3	4.4	14%	18%	40%
Bank: Fgn Ccy: Total	73%	13%	2.3	4.8	56%	19%	11%

- This table identifies that the operational credit quality of the 'foreign currency loan' segment is dependent upon a range of other external factors – which are outside the control of the borrower irrespective of how hard he/she works or commitment to loan obligations.
  - The higher level of 'own business' reflects the dependency upon the wider levels of national, and probably more particularly, local economic activity;
  - This trading dependency is emphasised by the concentration upon the retail and service sectors – which may be highly sensitive to local economic liquidity and also to variable levels of competitive market action (these are characteristically low-entry-barrier sectors);
  - 'Own Business' borrowers appear to have been particularly adversely affected by the economic environment.
    - The earlier section on 'Own Business' highlighted the pressures of this segment, the high failure rate of businesses, and the high level of loan arrears;
    - The scale of the 'own business' activity would suggest that the business revenue streams are likely to be in AZN national currency and there is, therefore, a basic currency mis-match with the loan indebtedness.
  - 'Own Business' borrowers have other incomes into the household. The wider level of wages and job security will impact, therefore, upon the performance of the foreign currency segment.

- The following table provides a summary of the comparative credit performance of AZN Manat and foreign currency lending.

Currency of Loan	Household & Utility Expenditure as % of Income	Loan Repayment as % of Income	Loan Repayment as % of Net Disposable Income (after loan)	Residual Repayment period of Loan (months)	% of Borrowers with expenditure > 75% of Income
MFI: AZN: Total	45%	16%	67%	10	41%
MFI: Fgn Ccy: Total	45%	20%	57%	14	63%
Bank: AZN: Total	43%	18%	65%	13	38%
Bank: Fgn Ccy: Total	41%	24%	55%	16	68%

- Whilst the leverage of the foreign currency borrowers is higher than that of those for national currency loans, the differences in leverage (re NDI) or the residual repayment period do not appear to reflect the full impact of a 100% devaluation;

- The 'foreign currency' borrower segment presents the significant operational and strategic risks which apply to the remaining 'foreign currency' borrowers.

- The impact of foreign currency upon the level of loan arrears is shown in the following table. This shows the distribution of arrears (both clients and the related loan balances).

Arrears Loans only	Distribution of Borrowers		Distribution of Loan Balances	
	Manat AZN	US$	Manat AZN	US$
Employee: Baku	59%	7%	31%	12%
Own Business: Baku	16%	18%	32%	25%
Employee: Other Rgns	20%	7%	11%	7%
Own Business: Other Rgns	9%	64%	9%	73%

- It must be noted that this is not a nationally weighted profile – but reflects the responses of the survey. The distributions are shown separately for Baku and the other regions because of the substantial differences which are shown in these locations;

- The adverse impact of foreign currency lending in Baku is minimal. This contrasts sharply with the position in the other regions;

- The position in the 'other regions' is starkly different – with an extremely strong concentration of arrears attributable to foreign currency loans with the 'own business' segment;

- The survey could not, of course, anticipate this finding and its causes – however, the following hypotheses may be suggested (Note: *this is purely conjecture by the writer*):

  - The level of foreign currency lending was always lower in Baku than elsewhere; and/or;

  - Foreign currency borrowers in Baku were able to transfer their loans to national currency loans more readily than in other regions; and/or

  - Some foreign currency borrowers in Baku were able to repay their currency debt from available sources of liquidity – or used the growth in mortgage lending (see Attachment 3.) as a means to refinance currency debt into longer-term national currency debt.

4. RISK PROFILE AND PERFORMANCE

4.1 What proportion of borrowers are over-indebted?

A large majority of borrowers appear to be over-indebted with minimal capacity to meet non-essential or unexpected expenditure needs – regions outside Baku and Abershon show a greater debt dependency, despite the budget and family pressures which it arise – 'own business' segment show the highest debt dependency despite the particular pressures faced currently by this segment

The definition of 'over-indebted' is widely interpreted. It may be appropriate, therefore, to describe the basis upon which the respondent borrowers are being reviewed.

> Over-indebtedness: "The extent to which a borrower is adversely affected by the interaction of the quantitative dimensions of loan repayment(s) upon his/her financial position and the qualitative dimensions of the impact of debt upon the financial confidence, risk vulnerability and the lifestyle of the borrower and dependents".

- A range of factors demonstrate that the financial pressures upon borrowers:
  - Loan arrears at 17%: AZN loans 8% and foreign currency loans 59%;
  - Arrears with Utility payments at 9% of all borrowers;
  - Reduction in food expenditure to make loan repayments at 59% of all borrowers;
  - Recognition of loan repayments more than can be afforded at 43% of all borrowers.
- These dimensions are also shown in relation to the range of income segments.

Income Range All Borrowers	Net Disposable Income (pre loan payment)	Net Disposable Income (after loan) as % of Income	Average Loan	Loan Repayment as % of Net Income (pre loan repayment)	Arrears: Loan	Arears: Utilities	Reduced food spending to make loan repayments
<600	213	21%	1,046	49%	13%	12%	55%
601-750	301	26%	1,032	39%	7%	12%	70%
751-850	347	26%	1,331	40%	9%	8%	69%
851-1,000	407	23%	2,087	45%	23%	9%	68%
>1,000	875	40%	4,025	31%	24%	8%	40%

  - These quantitative responses indicate the systemic pressures impacting across most income segments (70% of individual borrowers have household incomes less than AZN 1,000);
  - The brief review of external economic influences (Attachment 3) highlights the impact of adverse exchange rate movements, the disproportionate inflationary impact upon non-foodstuff expenditures of households, the lower level of domestic economic activity (with particular impact upon the 'own business' sector, and the constrained growth of incomes.

- Despite the positive actions by both lending institutions and borrowers (as indicated above), the external factors create financial pressure upon borrowers. The qualitative attitudes of borrowers show their perception of the adequacy of their financial position. Such pressures, together with continuing outstanding loans, provide a demonstration of 'over-indebtedness' – in that the quality of lifestyle is being increasingly impaired.

	The quality of my life has improved in the last 12 months	My financial situation has improved in the last 6 months	I can afford to buy 'treats' for myself or my family	I need to continue to borrow to maintain how my family and I live	Loans improve the quality of life	Debt repayments cause problems within my family	My loan repayments are / were more than I can afford
All Borrowers	9%	17%	64%	44%	45%	39%	43%
Non-Borrowers[18]	22%	29%	68%	43%	55%	46%	44%
Regional Borrowers							
Baku	12%	16%	36%	13%	19%	21%	18%
Abershon	21%	26%	79%	11%	15%	33%	40%
Guba-Khachmaz	7%	16%	62%	52%	54%	46%	43%
Aran	5%	15%	68%	56%	62%	46%	48%
Ganja-Gazakh	6%	19%	81%	66%	62%	51%	58%
Shaki-Zagatala	4%	21%	82%	71%	61%	48%	60%
Dagligh Shirvan	9%	16%	76%	69%	77%	43%	55%
Lankaran	8%	12%	83%	70%	57%	58%	64%
Yukhari Garabagh	13%	19%	87%	78%	63%	52%	71%

- The overall position does not reflect the considerable diversity of attitude across the regions:
  - The apparent greater financial capacity of borrowers and the somewhat more positive profile of lending activities in Baku, the above table shows that Baku presents a more ambivalent attitude towards borrowing than the other regions;
  - Although the budgetary constraints are greater in the other regions (pressures which are reflected in the above table), those borrowers feel nonetheless a greater debt dependency and a need for a continuing access to loans (despite the pressures and limited financial capacities which have been shown above);
  - The perception of loans ‘improving the quality of life’ is likely to reflect a perception that the inflow of loan funds meets an immediate need – and is not directly associated with the pressure of repayment. This may be reflected in:
    - About 40-50% citing domestic expenditure (consumption) as the main reason for the next loan;
    - Only about 60% of borrowers (outside Baku) feel they understand which type iof loan product is appropriate for their needs.

[18] Non-Borrowers: includes responses from former borrowers (predominately former bank). Observations in relation to loans are based upon the responses of such former borrowers

- The extent to which financial pressures impact upon the household and domestic lifestyle are indicated in the following table:

	The quality of my life has improved in the last 12 months	My financial situation has improved in the last 6 months	I can afford to buy 'treats' for myself or my family	I need to continue to borrow to maintain how my family and I live	Loans improve the quality of life	Debt repayments cause problems within my family	My loan repayments are more than I can afford
MFI							
Bank Transfer	6%	10%	55%	31%	37%	27%	31%
Cash / Cheque	4%	10%	57%	40%	44%	34%	39%
Own Business	6%	14%	65%	53%	42%	50%	53%
Bank							
Bank Transfer	16%	26%	67%	38%	49%	33%	35%
Cash / Cheque	9%	19%	66%	46%	55%	38%	43%
Own Business	14%	24%	78%	58%	45%	56%	59%

  - This table suggests:
    - A slightly more cautious attitude amongst MFI clients;
    - A slightly more optimistic / less cautious attitude amongst the 'own business' segment.
  - The table also appears to suggest the strongest demand for future borrowing lies with the 'own business' segment – and the delicate financial position of this segment, together with the lower level of loan approvals, has been highlighted above;
  - The 'employed' segment of borrowers show some level of adverse impact of borrowing on their lifestyles, but this does not appear to be at an unduly high level – not least in relation to the underlying economic pressures.

- Attachment 4 outlines a process of risk categorisation which identifies the integration of the quantitative dimensions of expenditure as a % of income with the qualitative attitudes of individual borrowers to a range of factors of the impact of debt. This suggests that, after loan repayments, only 6% of all borrowers (accounting for 6% of outstanding loan value) demonstrate a basis for confidence of their financial situation.

Risk Segments	Distribution		Household Income	Net Disposable Income (after loan)	Outstanding Loan
	Clients	Value			
Affordable	6%	6%	1,909	1,205	2,281
Concerned	4%	5%	1,444	860	2,924
Vulnerable	38%	32%	966	344	1,896
Exposed	53%	57%	916	167	2,459

  - The concentration of over 50% of borrowers and loan value in the high risk 'Exposed' segment reflects the pressures on the lending portfolio of individual borrowers;
  - The pressure upon the 'exposed' borrower category is emphasised by the low level of net disposable income (after loan repayments);
  - The 'Vulnerable' segment reflect largely those borrowers with over 75% of income committed to essential domestic and loan payments. This does not include the necessary lifestyle and domestic payments to purchase clothes, health, education and so on. This shows again the delicate financial position of this substantial segment of borrowers;
  - Overall, this shows a high risk profile for about 90% of borrowers and loan value – in comparison with 17% of individual borrowers being in loan arrears.

- The comparison of distribution of clients between Baku and other regions again shows substantive differences.

Risk Category (after loan repayment)	Affordable	Cautious	Vulnerable	Exposed
Baku	16%	9%	47%	29%
Other Regions	1%	1%	34%	63%

  - These different profiles are starkly illustrated in Attachment 4.

- The attitudes of this different risk segments are reflected in the following table:

Risk Category	The quality of my life has improved in the last 12 months	My financial situation has improved in the last 6 months	I can afford to buy 'treats' for myself or my family	I need to continue to borrow to maintain how my family and I live	Loans improve the quality of life	Debt repayments cause problems within my family	My loan repayments are more than I can afford
Affordable	24%	30%	51%	8%	15%	10%	7%
Cautious	22%	34%	57%	24%	48%	50%	35%
Vulnerable	11%	18%	61%	29%	39%	23%	28%
Exposed	6%	14%	67%	59%	53%	53%	58%

  - This table reflects the contrasting attitudes and risk appetites of different segments of borrowers:
    - At the extremes, the ‘affordable’ segment show much lower financial concerns, but also a substantially lower dependency on loans; whilst conversely, the ‘exposed’ segment show a strong debt dependency despite the adverse financial and domestic consequences;
    - The ‘Cautious’ segment reflect a more risk averse position and show higher level of anxiety about their financial position than the ‘Vulnerable’ – despite their financial position being stronger;
    - The “vulnerable’ segment do not either recognise, or accept, the fragility of their financial position.

- The profile if risk categories in Azerbaijan may be compared with that shown in Tajikistan (June 2016).

Risk Category	Azerbaijan		Tajikistan	
	Distribution of Borrowers	Distribution of Loan Balances	Distribution of Borrowers	Distribution of Loan Balances
Affordable	6%	6%	7%	3%
Cautious	4%	5%	7%	9%
Vulnerable	38%	32%	28%	16%
Exposed	53%	57%	58%	72%

  - Azerbaijan shows a similar level of financial pressure amongst borrowers as Tajikistan – with 91% of borrowers (89% of loan value) in the ‘vulnerable’ and ‘exposed’ categories, compared with 86% and 88% respectively in Tajikistan;
  - This is not intended to imply that the dynamics and outlook of the two cultures and economies are comparable – however, the scale of the immediate challenge of financial pressures amongst the borrowers is similar.

- In Azerbaijan, such distribution of the risk profile of the loan portfolio, the concentration in the high risk segments, and the underlying economic trends, suggest that the particular concern relates to the systemic risk exposure of borrowers to external events which have wide-ranging impacts – and thereby affect the performance of the lending industry.

4.2 What is the profile of loan arrears?

Retail and service trade sectors have a high loan arrears rate – substantial differences in refinance levels across the regions – 'own business' show high loan arrears (linked with higher levels of foreign currency loans and older, male borrowers) particularly in regions outside Baku – arrears in Baku are well-spread across client segments

The levels of arrears of individual borrowers / survey respondents is 17%, representing 29% of loan balances.

- The following tables demonstrate the impact of arrears across different borrower segments.

Arrears:	% of Borrowers with loan arrears	Outstanding loan balances of 'arrears' borrowers as % of total balances	Reduced Food Expenditure to make Loan Payments amongst borrowers with loan arrears	Refinance / Reschedule in last 12 months borrowers with loan arrears	Difficulty to make loan repayments borrowers with loan arrears
MFI	14%	23%	80%	21%	80%
Bank	19%	33%	71%	26%	66%

  - The performance of the two types of lending institution is broadly similar, with bank borrowers showing slightly higher adverse debt profiles.

- The following table provides a landscape of loan arrears and loan refinance across the country and trade sectors.

Region	% of Borrowers with loan arrears	Refinance / Reschedule in last 12 months	Industry Sectors with more than 20% of borrowers shown with **	% of Borrowers with loan arrears	Refinance / Reschedule in last 12 months
Baku	11%	13%	Manufacture	11%	12%
Abershon	17%	40%	Food Production	4%	1%
Guba-Khachmaz	23%	5%	Retail **	35%	12%
Aran	21%	5%	Engineering (Small Sample)	11%	11%
Ganja-Gazakh	22%	5%	Building - Property	9%	4%
Shaki-Zagatala	18%	7%	Service **	15%	9%
Dagligh Shirvan	11%	3%	Agriculture	14%	3%
Lankaran	16%	5%	Public Sector **	8%	12%
Yukhari Garabagh	14%	4%	Other	18%	24%

  - The regions appear to have differing strategies in relation to refinance;
  - Despite the high level of refinance in Abershon, the loan arrears have also remained at a relatively high level;
  - Despite the particular pressures on the retail sector (adverse economic environment, foreign currency loans and devaluation, and constrained consumer demand), there does not seem to have been widespread formal loan refinance;
  - The extent to which refinance may have been achieved by some form of loan restructure (without formal renegotiation of a 'refinance' package) is uncertain.

- The impact of foreign currency upon the level of loan arrears is shown in the following table. This shows the distribution of arrears (both clients and the related loan balances) – see also section re foreign currency lending).

Arrears Loans only	Distribution of Borrowers		Distribution of Loan Balances	
	Manat AZN	US$	Manat AZN	US$
Employee: Baku	59%	7%	31%	12%
Own Business: Baku	16%	18%	32%	25%
Employee: Other Rgns	20%	7%	11%	7%
Own Business: Other Rgns	9%	64%	9%	73%

- It must be noted that this is not a nationally weighted profile – but reflects the responses of the survey. The distributions are shown separately for Baku and the other regions because of the substantial differences which are shown in these locations;
- The adverse impact of foreign currency lending in Baku is minimal. This contrasts sharply with the position in the other regions;
- The position in the 'other regions' is starkly different – with an extremely strong concentration of arrears attributable to foreign currency loans with the 'own business' segment;
- The survey could not, of course, anticipate this finding and its causes – however, the following hypotheses may be suggested (Note: *this is purely conjecture by the writer*):
  - The level of foreign currency lending was always lower in Baku than elsewhere; and/or
  - Foreign currency borrowers in Baku were able to transfer their loans to national currency loans more readily than in other regions; and/or
  - Some foreign currency borrowers in Baku were able to repay their currency debt from available sources of liquidity – or used the growth in mortgage lending (see Attachment 3.) as a means to refinance currency debt into longer-term national currency debt.

- The strong incidence of loan arrears in the 'own business' segment is shown clearly in the following table:

Income Sources	% of Borrowers with loan arrears	Refinance / Reschedule in last 12 months	Product AZN Currency only	% of Borrowers with loan arrears	Refinance / Reschedule in last 12 months
MFI: Bank Transfer	6%	8%	Business	36%	19%
MFI: Cash / Cheque	6%	2%	Consumer: Expenditure	7%	4%
MFI: Own Business	31%	14%	Consumer: Appliance	10%	14%
Bank: Bank Transfer	11%	14%	Consumer: Autocredit (Small Sample)	20%	18%
Bank: Cash / Cheque	11%	4%	Mortgage Loan (Small Sample)	24%	23%
Bank: Own Business	43%	22%	Agriculture Loan (Small Sample)	18%	5%
			Credit Card (Small Sample)	19%	18%

- The higher levels of loan refinance are shown for the 'own business' segment;
- These are applied more frequently by the bank lending institutions;
- The following table identifies that loan arrears are more prevalent amongst older, male borrowers.

Age	% of Borrowers with loan arrears	Refinance / Reschedule in last 12 months	Gender	% of Borrowers with loan arrears	Refinance / Reschedule in last 12 months
16-25	10%	12%	City - Male	20%	10%
26-35	12%	10%	City - Female	13%	8%
36-45	18%	10%	Urban - Male	23%	19%
46-55	27%	13%	Urban - Female	17%	26%
> 55	19%	4%	Rural - Male	19%	6%
Note: about 50% of borrowers over 45 were employed in 'own business'			Rural - Female	14%	5%

- The following table indicates that such pressures are reflected across the major individual lending institutions (which together account for 86% of respondents to the survey – however, it must be recognised that the following statistics are merely indicators, based on limited samples – each institution would need to assess its own loan portfolios independently from their client data-bases.

Lending Institution	Net Disposable Income (after loan payment)	Outstanding Loan	% of Borrowers with loan arrears	% of Loan Refinanced in last 12 months	Difficulty to make loan repayments	Food expenditure has been reduced to make loan repayments
MFI: A	368	1,944	14%	7%	34%	48%
MFI: B	211	1,615	20%	9%	49%	75%
MFI: C	251	1,482	12%	7%	49%	65%
MFI: D	336	1,552	16%	13%	47%	60%
Bank: A	391	3,036	16%	11%	34%	53%
Bank: B	373	2,810	23%	16%	45%	55%
Bank: C	282	2,001	15%	14%	38%	65%
Bank: D	290	3,228	27%	20%	45%	65%
Bank: E	240	2,670	28%	9%	56%	76%

  - This table is based solely upon those respondents who identified their lending institution. This data does **not** represent a detailed (or statistically robust) assessment of an institution. This should be provided by the respective lending institution. It does, however, indicate that the management and governance of those institutions need to understand the institutional performance in relation to its competitors and the market and identify the need for a close understanding of the profile, characteristics and attitudes of the respective client bases;

  - Certain institutions appear to demonstrate higher risk characteristics (particularly certain of the banks);

  - Subject to the lower sample sizes and thereby lower statistical confidence, these high-level results indicate that:

    - there may be different lending policies and practices being applied across these institutions;

    - the client profiles vary substantially across institutions.

  - Lending institutions should consider the further indicators of risk exposure in relation to not only to client credit management, but also for structural risk concentrations and appropriate levels of loan loss reserve.

4.3 Do borrowers who move between lenders have a different risk profile?

Bank borrowers who use multiple institutions show a substantially higher level of loan arrears – however, such borrowers do not display any significantly higher levels of concern for their financial position.

- The level of survey responses provide adequate data only in relation to bank borrowers (the sample of MFI borrowers was too small to use);
- The following table provides a comparison of current and former bank borrowers:

Number of Lending Institutions in last 2 years: Bank Borrowers	Income	Net Disposable Income (after loan payment)	Loan Amount	Loan Arrears	Loan payment as % of NDI (after loan payment)	Arrears with Utilities
Current: One	976	308	2,294	15%	36%	9%
Current: More than one	1,263	395	4,757	43%	44%	24%
Former: One	911	395	na	na	na	11%
Former: More than one	1,158	591	na	na	na	10%

  - This indicates that higher income clients may be more disposed to move between lenders, perhaps reflecting a greater financial confidence and experience;
  - However, the multiple institution borrowers demonstrate a significantly higher level of financial pressure and loan arrears;
  - However, this is not substantially reflected in the following table. This suggests that the movement between institutions may create s greater feeling of optimism about the future.

Number of Lending Institutions in last 2 years: Bank Borrowers	Food expenditure has been reduced to make loan repayments	My loan repayments are / were more than I can afford	Loan from Friends	Loan from Retail: Domestic	I would like help to resolve debt problems with my lending institution	Debt repayments cause problems within my family
Current: One	61%	43%	13%	7%	72%	38%
Current: More than one	68%	47%	16%	17%	79%	56%
Former: One	65%	46%	8%	3%	74%	47%
Former: More than one	52%	33%	13%	8%	69%	44%

4.4 Do borrowers with problem lending show different characteristics?

About 50% of borrowers recognise that they have debt repayment problems – significant differences between Baku and other regions in relation to the scale and recognition of problem debt – substantive difference in the risk profiles of Baku and the other regions.

The above sections of this review have identified the level of loan arrears within a range of different loan segments and portfolios. The following comments segment the loan portfolios in relation to different dimensions of recognition of problem debt by the borrower. These segments involve:

i. Arrears

ii. Lender Refusal

iii. Repayment Difficulty

iv. Total Expenditures greater than 75% of Income

v. Remainder

A description of this segmentation is shown below. The characteristics are hierarchical – no borrower is included in more than one segments, starting with [i] Arrears:

- *'Arrears'* this segment clearly has severe repayment problems, together with relatively high levels of informal debt;
- *'Lender Refusal'* the incidence of 'lender refusal' suggests that this segment is likely to be of marginal credit quality. The borrower will have realised the problem lending situation;
- *'Repayment Difficulty'* this segment recognises the pressure / constraint upon its financial / budgetary position. This will reflect not only the borrowings from the lending institution, but also informal loans;
- *'Total expenditures greater than 75% of income'* this segment has a high commitment of current income to basic expenditures. This segment may have a more 'laissez-faire' approach towards their financial position;
- *'Remainder'* This segment does not demonstrate any of the financial pressure characteristics in the preceding segments.
- The distribution of the loan portfolios into these characteristics is shown below:

	MFI				Bank			
	Distribution		Net Disposable Income (post loan)	Loan Balance	Distribution		Net Disposable Income (post loan)	Loan Balance
	Clients	Loan Value			Clients	Loan Value		
Arrears	14%	23%	214	3,009	19%	33%	265	4,609
Lender Refusal	2%	2%	299	2,276	4%	6%	452	3,869
Repayment Difficulty	29%	25%	234	1,623	29%	26%	281	2,370
Expenditure > 75%	20%	18%	127	1,704	17%	12%	143	1,880
Remainder	35%	31%	543	1,618	31%	23%	468	2,001

  - This table identifies:
    - the contrasting levels of disposable income and outstanding indebtedness across these borrower segments;
    - the scale of loan balances in relation to borrowers who recognise that they have debt repayment problems (MFI: 50% and Bank: 65%).

- The following table highlights the contrasting profiles of Baku (all borrowers) and other regions (all borrowers).

	Baku (all borrowers)				Other Regions (all borrowers)			
	Distribution		Net Disposable Income (post loan)	Loan Balance	Distribution		Net Disposable Income (post loan)	Loan Balance
	Clients	Loan Value			Clients	Loan Value		
Arrears	11%	21%	346	5,429	19%	35%	215	3,506
Lender Refusal	6%	7%	473	3,987	2%	2%	293	2,377
Repayment Difficulty	12%	16%	489	3,945	37%	33%	224	1,717
Expenditure > 75%	16%	14%	102	2,652	20%	15%	146	1,468
Remainder	55%	42%	670	2,263	23%	15%	330	1,287

  - This highlights some substantial differences between Baku and other regions:
    - Higher average loan balances in Baku in each of the client segments;
    - A significantly lower proportion of balances (44%) in Baku of clients recognising debt problems in contrast to 70% in the other regions;

- The ‘mirror’ position of the financially stronger ‘remainder’ segment with a majority of clients in Baku (42% of loan value) in contrast to only 23% of clients in other regions (only 15% of loan value).

- The scale of additional financial commitments and pressures are reflected in the following tables:

	Arrears with Utility Providers		Have you refinanced, or consolidated your debts during the last 12 months		Informal Loans with Retailers		Informal Loans from Friends	
	Baku	Other	Baku	Other	Baku	Other	Baku	Other
Arrears	24%	10%	34%	21%	19%	7%	14%	23%
Lender Refusal	12%	12%	29%	35%	15%	3%	2%	21%
Repayment Difficulty	13%	8%	14%	4%	20%	3%	11%	17%
Expenditure > 75%	8%	15%	3%	4%	7%	5%	5%	19%
Remainder	4%	6%	10%	11%	9%	3%	3%	13%

  - The behaviour of borrowers differs greatly between Baku and the other regions across all these client segments;

  - The contrasting positions of informal loans from retailers (for domestic consumption) and friends suggests

    - Retailers in Baku have greater business liquidity than in the other regions and are thereby able to grant informal credit to customers. Conversely, retailers in other regions have greater and immediate debt pressures (higher foreign currency loans, higher loan arrears, and [possibly] less economically-buoyant local markets);

    - Loans from friends displays a reversed position between Baku and the other regions. This may suggest a stronger community spirit and ‘self-help’ in an environment in which the lending institutions have a lower appetite to provide loan finance.

	The quality of my life has improved in the last 12 months		Debt repayments cause problems within my family		I need to continue to borrow to maintain how my family and I live		Food expenditure has been reduced to make loan repayments	
	Baku	Other	Baku	Other	Baku	Other	Baku	Other
Arrears	17%	5%	45%	73%	30%	77%	38%	85%
Lender Refusal	18%	12%	25%	48%	23%	38%	33%	50%
Repayment Difficulty	17%	7%	70%	64%	37%	80%	29%	81%
Expenditure > 75%	9%	6%	10%	22%	6%	34%	14%	81%
Remainder	10%	14%	8%	18%	4%	25%	10%	67%

  - This chart starkly demonstrates the widespread and substantive differences in attitudes towards the domestic financial situation between Baku and the other regions;

  - This presents a fundamental strategic issue / challenge in relation to the provision of financial services in such different market environments.

- A comparison of this framework of ‘loan affordability’ in Azerbaijan may be shown with the recent position in Tajikistan.

Distribution: All Borrowers	Azerbaijan: Baku		Azerbaijan: Other Regions		Tajikistan: MFI		Tajikistan: Bank	
	Client	Loan Value	Client	Loan Value	Client	Loan Value	Client	Loan Value
Arrears	11%	21%	19%	35%	14%	26%	17%	26%
Lender Refusal	6%	7%	2%	2%	12%	14%	9%	16%
Repayment Difficulty	12%	16%	37%	33%	32%	26%	35%	32%
Expenditure > 75%	16%	14%	20%	15%	22%	25%	19%	18%
Remainder	55%	42%	23%	15%	21%	9%	20%	9%

- o The profile of the 'other regions' in Azerbaijan outside Baku appear to be more similar to the situation in Tajikistan, than is shown in Baku;
- o However, the profile of Baku appears to present a much stronger credit quality profile.

4.5 Do borrowers who undertake loan refinance have particular characteristics?

Refinance has occurred primarily in relation to foreign currency loans and 'own business' clients (these reflect some overlap) – Baku and Abershon are the primarily locations for refinance.

- The average level of refinance / reschedule of loans was 10%. This level appears to be somewhat low in relation to the debt repayment pressures which have demonstrated. There may be some definitional issues in relation to refinance / reschedule which affect a recognition of such a restructure by the borrower;
- The following table identifies refinance in relation to the different segments of problem debt.

Refinance / consolidation of debt within the last 12 months	MFI	Bank	Baku	Other Regions
Arrears	21%	26%	34%	21%
Lender Refusal	32%	31%	29%	35%
Repayment Difficulty	4%	5%	14%	4%
Expenditure > 75%	3%	4%	3%	4%
Remainder	7%	15%	10%	11%

  - o The levels of refinance are similar for MFIs and banks in relation to loan arrears situations and also borrowers who have been refused loans;
  - o This concentration of refinance towards the more immediate problem situations highlights the higher risk profile of such borrowers.
- The preceding sections have demonstrated a higher incidence of loan refinance / reschedule in various loan segments, compared with an overall average of 10%. These have include:
  - o Own Business MFI 14%
  - o Own Business Bank 22%
  - o Foreign Currency MFI 17%
  - o Foreign Currency Bank 20%
  - o Industry Retail 12%
  - o Region Abershon 40%
  - o Region Baku 13%

- It may be anticipated (in the absence of any significant economic upturn) that further and more extensive loan restructures will continue for the short and medium term futures. In this regard, the following comments may be noted:
    - Many of the existing refinance situations may be anticipated to require future restructure as borrowers continue to face the financial challenges;
    - The process of refinance / rescheduling will need to be increasingly 'productised' to reflect the on-going use of funds and the related underlying cash-flow.

4.7 What is the extent of informal lending ?

Informal lending is primarily from friends and retailer credit – retailer credit is more prevalent in Baku – loans from friends are more frequent in other regions – borrowers who recognise their financial pressures are more likely to use informal sources of credit.

- Informal Lending is based upon the use of non-financial institution sources for funding. These are primarily from family, friends, retailers, employers, money-lenders.
- The incidence of such informal loan sources amongst borrowers is shown in the following table.

Number of Informal Loan Sources	Distribution: Clients	Distribution: Loan Value	Household Income	Net Disposable Income (after loan payments)	Outstanding Loan
None	68%	65%	1,026	336	2,175
One	27%	27%	975	285	2,216
Two or more[19]	5%	8%	1,031	301	3,401

- The incidence of informal borrowings is shown to be significant, involving about 30% of borrowers;
- At this scale, it is a significant component of the credit assessment process and over-indebtedness.

- The financial performance of these 'informal loan' client segments may be summarised in the following table:

Number of Informal Loan Sources	Characteristic of Borrower				
	Arrears: Loan	Arrears: Utilities	Loan from Retail: Domestic Consumption	Loan from Friends	Food expenditure has been reduced to make loan repayments
None	13%	6%	0%	0%	55%
One	25%	14%	42%	14%	69%
Two or more	20%	26%	46%	49%	55%

- *This table shows the characteristics in relation to the number of informal loans – for example, 20% of those borrowers with 2 or more informal loans have loan arrears;*
- The use of loans from retailers (temporary credit to obtain, for example, foodstuffs) and friends is substantial;
- This table shows the higher levels of financial pressure being reflected amongst borrowers with informal loan sources. This has significant implications in relation to:
    - Capacity for repayment and the extent to which informal sources are 'preferred' in the hierarchy of cash payments;

[19] Informal Loans: The sample size for '2 or more' is relatively small (160 respondents). This results in a lower statistical confidence level for this segment.

- The high 'visibility' of the financial pressures of the borrower. The communities are highly stable and, therefore, the financial situation of the borrower will be well-known. However, other responses indicate that such financial pressures are widespread and there may not be a social stigma to the situation of extreme financial pressure;

- However, non-repayment of such indebtedness may be a cause of social pressure – money is often the cause of much social 'ill-ease' – this may suggest that the lending institution will be repaid after funds are disbursed informally;

- The high level of retailer credit is a significant dimension of the assessment of the credit quality of an 'own business' borrower. The business turnover and cash-flow depends, at some level, on the liquidity of the customers of the 'own business' borrower;

- The 'own business' trader (most of the 'own business' borrowers are in retail or service) is dependent upon the level of local demand. If loan funds decline, and/or the savings of family/ friends become used, and/or market conditions continue to be constrained by the impact of rising inflation – then the 'own business' sector will experience lower demand and lower liquidity within the community. This will, of course, vary in different locations – but if current trends continue, or are even held level, then the 'own business' borrowers will come under increasing pressure – and this is already one of the most vulnerable segments.

- The incidence of 'informal lending' varies in different segments and are exampled below.

	Family	Friends	Retail: Assets	Retail: Domestic	Construction Company	Employer	Other
Baku: MFI	1%	3%	5%	4%	1%	0%	0%
Baku: Bank	8%	8%	25%	19%	7%	1%	0%
City: Other	0%	19%	9%	4%	0%	6%	2%
Urban: Other	4%	15%	9%	5%	3%	8%	2%
Rural: Other	0%	15%	9%	4%	0%	3%	1%
Arrears	2%	21%	16%	10%	2%	3%	2%
Lender Refusal	0%	9%	19%	10%	3%	3%	1%
Repayment Difficulty	1%	16%	9%	5%	1%	7%	2%
Expenditure > 75%	2%	15%	13%	6%	1%	3%	1%
Remainder	2%	8%	8%	6%	1%	2%	1%

  - The lending institutions should incorporate informal lending as a possible strong indicator of financial pressure;

  - Financial education must reflect such lending into its programmes of communication.

4.8 Are there differences in the credit profiles of those borrowers who have savings balances and those who do not?

Almost no usage of financial institutions for savings – about 28% of borrowers have 'other savings' (non-bank) – no direct linkage between savings and problem debt.

  - The levels of 'savers' amongst borrowers is show in the following table:

	Savings with a Financial Institution	Other savings	Insurance products from Lending Institution
MFI	1%	23%	19%
Bank	2%	33%	7%

  - The absence of savings with financial institutions contrasts with the wider use of other forms of savings

- This profile is demonstrated across the regions:

	Savings with a Financial Institution	Other savings	Insurance products from Lending Institution
Baku: MFI	1%	4%	60%
Baku: Bank	3%	23%	18%
City: Other	1%	35%	2%
Urban: Other	3%	38%	2%
Rural: Other	1%	30%	1%

    - The behaviour of MFI clients in Baku is clearly different from other regions;
    - MFI insurance product activities in Baku appear to reflect an independent product strategy. The purpose of the insurance in Baku is not known – there should be, of course, a related product commission revenue stream.

- The financial profile of 'savers' is shown in the following table:

	Income	Net Disposable Income (after loan)	Outstanding Loan	Loan Arrears	% of Loans in Foreign Currency	Food expenditure has been reduced to make loan repayments
Savings: FI: Borrowers (Small Sample)	1,107	385	2,618	9%	16%	32%
Other Savings: MFI	931	263	1,845	20%	20%	72%
Other Savings: Bank	1,069	355	2,967	25%	17%	60%
No Savings: MFI	1,032	336	1,856	13%	17%	52%
No Savings: Bank	990	300	2,498	16%	17%	63%

    - There is little substantive difference in the net disposable income of the 'savers' compared with the 'non-savers';
    - The type of 'other savings' is not known (not part of the survey questions). However, the higher risk categories ('concerned', 'vulnerable' and 'exposed') show greater usage of such 'other savings' than by the 'affordable' risk segment. This suggests that such savings are unlikely to be readily realisable into cash, or that the borrower seeks to keep such assets distinct from the loan liabilities.

- The savers and non-savers present slightly different emphases in relation to their perception of the impact of borrowing on their lives.

	The quality of my life has improved in the last 12 months	My financial situation has improved in the last 6 months	I can afford to buy 'treats' for myself or my family	I need to continue to borrow to maintain how my family and I live	Food expend. has been reduced to make loan repayments	Debt repayments cause problems within my family	My loan repayments are more than I can afford
Savings: FI: Borrowers (Small Sample)	31%	48%	73%	21%	32%	21%	24%
Other Savings: MFI	9%	18%	85%	55%	72%	47%	54%
Other Savings: Bank	16%	28%	84%	52%	60%	42%	49%
No Savings: MFI	5%	9%	51%	38%	52%	35%	38%
No Savings: Bank	12%	21%	61%	43%	63%	40%	41%

- Those borrowers with 'other savings' appear to show slightly higher levels of financial pressure;
- The reactions of MFI and bank borrowers differ in relation to their perception of the change in their lifestyles – with bank borrowers reflecting a more positive attitude;
- Paradoxically, the responses of those savers with financial institutions show more strongly positive characteristics than the other segments. However, this is an extremely small sample

and cannot be interpreted with any statistical confidence. However, it may suggest that the banks may use such funds as hypothecated balances as part of a collateral structure for the refinance / reschedule of a loan – and the responses reflect the sense of relief in the borrower.

5 IMPACT OF BORROWING

5.1 What proportion of borrowers appear to have benefitted, or been adversely affected, by the loan experience?

Strongly contrasting attitudes between MFI and bank borrowers in Baku – strongly contrasting attitudes between borrowers in Baku and those in other regions – such differences are so marked that there may have been some over-arching economic or strategic difference in the provision and delivery of financial services in these different locations.

- The borrowers' perceptions of the benefits of loan indebtedness and the impact upon lifestyle are reflected in the following tables:

Location	Demand for Loan			Impact of Loan		
	Loans improve the quality of life	I need to continue to borrow to maintain how my family and I live	I borrowed too much	Debt repayments cause problems within my family	My loan repayments are more than I can afford	I would like help to resolve debt problems with my lending institution
Baku: MFI	2%	4%	4%	9%	4%	16%
Baku: Bank	37%	22%	24%	33%	22%	58%
City: Other	57%	59%	20%	47%	59%	83%
Urban: Other	43%	38%	14%	37%	38%	80%
Rural: Other	62%	65%	20%	54%	65%	83%

- o The attitudes of MFI Baku clients present a singular position. However, it was shown earlier that loan arrears for these clients is only 3% (compared with an overall average of 17%). This suggests that this segment may, therefore, be 'discretionary' borrowers (although the level of usage of loan funds to support domestic consumption needs was comparable with other locations);
- o The perceptions of the benefits of loans appear stronger in city and rural areas, whilst (somewhat paradoxically) this attitude is matched by a higher recognition of the financial pressures arising from debt.

The attitudes of borrowers do not vary substantially across the range of incomes.

Income Range	Demand for Loan			Impact of Loan		
	Loans improve the quality of life	I need to continue to borrow to maintain how my family and I live	I borrowed too much	Debt repayments cause problems within my family	My loan repayments are more than I can afford	I would like help to resolve debt problems with my lending institution
<600	37%	40%	19%	37%	46%	76%
601-750	51%	48%	16%	39%	44%	74%
751-850	52%	42%	16%	35%	37%	67%
851-1,000	51%	53%	20%	47%	49%	74%
>1,000	35%	35%	18%	37%	40%	61%

- o These responses appear to indicate that only about 50% of clients perceive a necessity for continued borrowing – within which for many, no loan debt, or a reduced loan amount, would create a greater net disposable income cash flow and thereby greater capacity for food expenditures;
- o This may suggest that such borrowers become inured to financial pressure and deprivation of food. Again, this is a fundamental challenge for 'responsible finance' and the responsibility (if at all) upon the lending institution;

- The amount of the loan reflects what was needed; however, the impact of repayments is somewhat dis-connected from the cause of the problem.

- The following tables consider such attitudes towards the role and impact of debt across the various levels of recognition of debt problems in Baku and the other regions.

Baku Region	Demand for Loan			Impact of Loan		
	Loans improve the quality of life	I need to continue to borrow to maintain how my family and I live	I borrowed too much	Debt repayments cause problems within my family	Food expenditure has been reduced to make loan repayments	I would like help to resolve debt problems with my lending institution
Arrears	39%	30%	33%	45%	38%	72%
Lender Refusal	33%	23%	12%	25%	33%	46%
Repayment Difficulty	34%	37%	42%	70%	29%	81%
Expenditure > 75%	13%	6%	7%	10%	14%	26%
Remainder	13%	4%	6%	8%	10%	21%

Other Regions	Demand for Loan			Impact of Loan		
	Loans improve the quality of life	I need to continue to borrow to maintain how my family and I live	I borrowed too much	Debt repayments cause problems within my family	Food expenditure has been reduced to make loan repayments	I would like help to resolve debt problems with my lending institution
Arrears	51%	77%	26%	73%	85%	97%
Lender Refusal	37%	38%	9%	48%	50%	78%
Repayment Difficulty	57%	80%	24%	64%	81%	92%
Expenditure > 75%	65%	34%	15%	22%	81%	73%
Remainder	54%	25%	13%	18%	67%	65%

- The contrasting responses in these different regions suggests that there are effectively two fundamentally different dimensions of client attitude – unless;

- There have been particular developments in the Baku market (*which are not known to the writer and are therefore purely speculative conjecture*) which have created a different [perhaps temporary] mindset within the Baku market.

5.2 Do microfinance institutions stimulate greater ‘financial inclusion’?

MFIs appear to have a greater exposure to the ‘own business’ segment than the banks – MFIs demonstrate more cautious standards of operational credit and loan approval

- Whilst the dimensions of ‘financial inclusion’ can be widely defined, the core aspects involve;
  - [i] the provision of financial services (including loans) to lower income groups;
  - [ii] wider inclusion, equal treatment and empowerment of female clients;, and
  - [iii] respect for the individual by the lending institution.

- The borrower profiles of MFI and bank clients are shown in the following tables:

% of borrowers	Own Business	Household Income less than AZN 750	Number of Dependents	Number of wage-earners	% lived in neighbourhood more than 10 years
			Total		
MFI	33%	27%	2.0	2.2	95%
Bank	26%	26%	2.0	2.3	93%
			Baku		
MFI	31%	14%	1.7	1.9	97%
Bank	20%	20%	1.9	1.9	91%

  - MFIs supported a greater proportion of 'own income' in both Baku and the other regions;
  - This higher share of 'own business' is reflected in the higher household incomes amongst MFI clients.

- The distribution of household incomes is shown in more detail in the following table:

Household Income	<600	601-750	751-850	851-1,000	>1,000	Average	Average per earner
				Total			
MFI	9%	18%	19%	25%	30%	1,008	454
Bank	9%	17%	19%	23%	31%	1,016	449
				Baku			
MFI	7%	7%	10%	21%	55%	1,266	675
Bank	10%	10%	14%	15%	50%	1,224	630

  - The impact of 'own business' upon the income distribution and average of MFI clients should be noted;
  - Both MFIs and banks have about 26% of clients with household incomes less than AZN 750 per month. The minimum 'living income' for a household has been indicated at about AZN 720 per month (see Attachment 3). This suggests that both MFIs and banks have demonstrated some financial inclusion of lower income households.

- 'Own business' appears to be the primary difference in the profile of individual borrowers between MFIs and banks.

- The structure of MFI lending appears to suggest a more cautious approach to operational credit standards.

	% of clients with foreign currency loans	% of clients with collateral	Average Loan	Loan repayment as % of Income	Loans were easy to obtain
			Total		
MFI	17%	42%	1,850	17%	22%
Bank	17%	30%	2,650	19%	33%
			Baku		
MFI	12%	30%	2,100	16%	2%
Bank	15%	18%	3,900	20%	36%

  - MFIs show a higher requirement for collateral, which is accompanied by lower loan amounts and shorter repayment periods;
  - Both MFIs and banks appear to have different lending practices in Baku than in other regions, although the underlying greater caution of the MFIs continues.

6 LENDER / BORROWER RELATIONSHIP

6.1 What is the reputation of the lending institutions?

The reputation of lending institutions is extremely low in the core dimensions of trustworthiness and integrity by comparison with other countries – the reputational profile of Baku differs substantially from that in other regions – conversely, borrowers show a much more favourable attitude to the manner in which lending institutions respond to problem lending situations – there is a strong feeling by borrowers of inclusion in the target client base of lending institutions.

- The reputation of the lending institutions was considered in relation to the perceptions of respondents of both cultural values and also operational performance;
- The survey responses show some dramatic levels of adverse client opinion about the financial institutions. Against a background of difficult economic and market conditions, it may not be surprising that public opinion is cautious – however, the reputation of both MFIs and banks is starkly low in some fundamental dimensions of financial industry;
- The following table shows the overall responses with some comparators from other countries.

All Borrowers - % of respondents who Agree	Clients are treated with respect	Lending institutions are trustworthy	Lending institutions act with integrity	Lending institutions seek to improve the lives of their clients	Lending institutions understand customers' needs
Azerbaijan	87%	13%	9%	7%	40%
Tajikistan:2016	96%	89%	86%	86%	83%
Tajikistan: 2014	98%	97%	96%	94%	95%
Kyrgyzstan: 2014	98%	92%	87%	81%	87%
Bosnia i Herzegovina: 2014	95%	86%	82%	77%	80%
Bosnia i Herzegovina: 2013	91%	76%	82%	71%	77%

  - These comparisons emphasise starkly the fundamental differences in the attitudes being expressed in Azerbaijan. (The questions were posed in the same manner in each of the other surveys);
  - The variations in the responses in Azerbaijan indicate that the respondents did differentiate their opinions in relation to the various questions:
    - 'Respect' suggests that the discussions with the financial institution are undertaken in a basically polite and courteous manner;
    - 'Trustworthy' and 'Integrity' suggest that there have been some fundamental structural issues / problems / actions by the financial industry which have aroused a broad systemic criticism by the borrowers. This may be contrasted with the responses in BiH which reflect a period in which the institutions were working their way out of the crisis which had occurred a few years earlier;
    - 'Improve lives' and 'Understand Needs' appear to indicate a widespread feeling of 'dis-connect' in the client-institution relationship.

- These responses appear to present a fundamental strategic challenge for the industry.
  - The dimensions within the aggregate survey responses for Azerbaijan are shown in the following table:

% of respondents who Agree	Clients are treated with respect	Lending institutions are trustworthy	Lending institutions act with integrity	Lending institutions seek to improve the lives of their clients	Lending institutions understand customers' needs
MFI	89%	8%	3%	3%	47%
Bank	86%	19%	15%	12%	33%
Former Borrowers Bank	84%	29%	17%	15%	30%
Never Borrowed	90%	22%	14%	11%	33%

	Respect	Trustworthy	Integrity	Improve lives	Understand needs
Baku: MFI	96%	2%	2%	1%	85%
Baku: Bank	90%	39%	38%	32%	59%
City: Other	85%	9%	3%	3%	25%
Urban: Other	85%	20%	15%	8%	20%
Rural: Other	83%	7%	2%	3%	28%

- o The reputation of the MFIs appears to be even more challenged than that of the banks. However, the attitudes of MFI clients in Baku appear to differ from other regions in relation to the understanding of needs – although the responses suggest that despite such understanding, this is not matched by delivery;

- o The responses of bank clients in Baku show, again, a different profile from those of clients in other regions;

- o Whilst these reputational responses are low, there is again a significant difference in the markets of Baku and those of other regions.

- These reputational dimensions may be further reflected in relation to different segments of loan affordability.

% of respondents who Agree - Baku	Clients are treated with respect	Lending institutions are trustworthy	Lending institutions act with integrity	Lending institutions seek to improve the lives of their clients	Lending institutions understand customers' needs
Arrears	89%	39%	26%	31%	41%
Lender Refusal	90%	21%	35%	26%	62%
Repayment Difficulty	95%	39%	31%	29%	47%
Expenditure > 75% Income	92%	13%	19%	9%	81%
Remainder	95%	14%	14%	10%	83%

% of respondents who Agree - Other Regions	Clients are treated with respect	Lending institutions are trustworthy	Lending institutions act with integrity	Lending institutions seek to improve the lives of their clients	Lending institutions understand customers' needs
Arrears	82%	7%	4%	3%	23%
Lender Refusal	97%	24%	17%	9%	39%
Repayment Difficulty	81%	5%	1%	2%	20%
Expenditure > 75%	85%	18%	4%	3%	31%
Remainder	90%	13%	6%	6%	27%

- o The reputation responses are particularly low amongst those borrowers who do not have, or have not recognised, any loan repayment difficulties;

- o For those clients who recognise repayment difficulties, the responses differ sharply between Baku and the other regions. This suggests that the strategy, and/or practices, and/or service propositions are quite different in Baku and elsewhere;

- o However, these adverse reputational opinions are less stridently reflected in the manner in which borrowers reflect their interactions with the lending institutions. The following responses indicate a much more favourable attitude by borrowers towards their lending institutions than is displayed by the attitudes towards the culture and values displayed by financial institutions.

% of respondents who Agree	The institutions respond well to people with lending problems	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution	Lending institutions want to lend to people like me	It is better to borrow from only one institution, rather than to change lenders
Baku: MFI	75%	57%	16%	53%	87%
Baku: Bank	72%	46%	58%	78%	74%
City: Other	44%	49%	83%	78%	82%
Urban: Other	50%	59%	80%	83%	79%
Rural: Other	48%	46%	83%	79%	85%

- This table indicates that, even in the other regions outside Baku, about 50% of borrowers do consider that they are able to deal with their lending institutions;
- The higher levels of clients wanting assistance in those discussions with their lender reflects [possibly] the difficult financial position and the limited options available to them to find a short-term, acceptable solution;
- The majority of clients do not feel excluded by the lending institutions and recognise the potential benefits of an on-going client-lender relationship;
- These attitudes are further shown across the different profile of 'loan affordability' amongst borrowers.

% of respondents who Agree - Baku	The institutions respond well to people with lending problems	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution	Lending institutions want to lend to people like me	It is better to borrow from only one institution, rather than to change lenders
Arrears	70%	65%	72%	65%	67%
Lender Refusal	78%	27%	46%	72%	84%
Repayment Difficulty	59%	68%	81%	83%	63%
Expenditure > 75%	71%	46%	26%	71%	78%
Remainder	78%	46%	21%	66%	88%

% of respondents who Agree - Other Regions	The institutions respond well to people with lending problems	It is difficult to resolve debt problems with my lender	I would like help to resolve debt problems with my lending institution	Lending institutions want to lend to people like me	It is better to borrow from only one institution, rather than to change lenders
Arrears	31%	67%	97%	73%	87%
Lender Refusal	50%	64%	78%	85%	70%
Repayment Difficulty	40%	52%	92%	81%	88%
Expenditure > 75%	54%	39%	73%	80%	75%
Remainder	59%	37%	65%	80%	73%

- It may be anticipated that those borrowers who recognise their loan repayment difficulties will have a somewhat less favourable opinion. However, the above tables do not reflect substantive differences.

6.2 Do borrowers feel that the lender is providing clear information about the loan?

Major contrast between the high transparency of loan terms in national currency and the very low recognition of foreign currency risks – even in Baku, 65% of foreign currency borrowers considered that exchange rate risks were not explained

- There is a strong recognition that the terms of the loan (in national AZN Manat currency) are being explained;

- The communication of loan terms in relation to foreign currency lending presents a starkly contrasting situation:

	When I took my last loan, the charges (interest and fees) were explained to me and I know how much I am paying: Response = Agree	Did the lending institution explain the risks of foreign exchange rate changes to you (Responses only from borrowers with foreign currency loans): Response = Yes
MFI	84%	10%
Bank	81%	13%

  - This suggests that there were fundamental challenges in relation to the delivery of foreign currency loans;
  - However, the lending process in relation to national currency loans appears to be clear and accepted by the borrowers;
  - The regional profile of these responses is shown in the following table:

	When I took my last loan, the charges (interest and fees) were explained to me and I know how much I am paying: Response = Agree	Did the lending institution explain the risks of foreign exchange rate changes to you (Responses only from borrowers with foreign currency loans): Response = Yes	% of borrowers with Foreign Currency loans
Baku	94%	35%	13%
Abershon	84%	36%	5%
Guba-Khachmaz	89%	9%	23%
Aran	81%	4%	25%
Ganja-Gazakh	69%	4%	20%
Shaki-Zagatala	74%	0%	18%
Dagligh Shirvan	89%	0%	20%
Lankaran	68%	0%	17%
Yukhari Garabagh	72%	0%	14%

Note: Sample size of responses was small in the regions, except Baku and Aran.

  - Whilst sample sizes may be small, it may be suggested that the impact of the exchange rate devaluation upon debt liability would have far-reaching reputational implications in the regions – particularly as most of the lending appears to have minimal opportunity for matched-currency revenues.

6.3 Do lenders understand the borrower's financial position?

In regions outside Baku, a majority of borrowers do not feel that their needs are understood – borrowers consider that full information was provided at the time of the loan application.

- The responses suggest that a majority of borrowers perceive that the lenders do not understand their borrowing needs. However, the responses further indicate that the lending institutions obtained sufficient information by which to assess the loan application.

% of borrowers who Agree	When I drew my last loan, the lender knew what I could afford	Lending institutions understand customers' needs	Loans were easy to obtain	I borrowed too much	My loan repayments are more than I can afford	It is difficult to resolve debt problems with my lender
Total						
MFI	93%	47%	22%	15%	42%	53%
Bank	89%	33%	33%	20%	44%	47%
Regions						
Baku: MFI	97%	85%	2%	4%	8%	57%
Baku: Bank	87%	59%	36%	24%	29%	46%
City: Other	91%	25%	33%	20%	53%	49%
Urban: Other	88%	20%	22%	14%	45%	59%
Rural: Other	92%	28%	32%	20%	60%	46%

- This series of questions reflect a continuum in the borrowing process which appears to show an uncertainty in the lender / borrower relationship. It may be anticipated that there will always be some tensions between borrower and lender – however, the above table does perhaps provide some insights into the adverse reputational responses which were shown in the preceding sections of this review.

  i. The 'assessment of affordability' suggests that respondents are indicating that they provided 'reliable' information to the lending institution and, therefore, any repayment difficulties should have been identified at the time of loan application / approval. *(This is simply a possible interpretation by the writer);*

  ii. The 'understanding of customer needs' shows a particularly low opinion in the regions outside Baku. This suggests that the lending institutions do not have a close relationship with their clients – and that, possibly, the loans are regarded as simply 'transactions, without any substantive assessment of the underlying proposition;

  iii. 'Loan access' is low and suggests that credit availability has been constrained;

  iv. 'Borrowed too much' may reflect two principal dimensions:

     - the borrower requested more than was needed; or

     - the lending institution encouraged the borrower to take an excessive loan amount.

     The responses do not suggest that this was a major cause of problem lending.

  v. 'Loan repayments' show strong financial pressures outside Baku. This should be contrasted with the respondents' views that adequate information was provided to the lender at the time of the last loan;

  vi. 'Resolve with lender' shows a strong level in all regions (including Baku) of the difficulty to resolve debt problems. Again, this may be considered in conjunction with [i] the provision of information, [ii] the lack of ease to obtain the loan, and [iii] for foreign currency borrowers, the lack of explanation of risks.

7 OUTLOOK FOR BORROWING

7.1 What is the outlook for borrowing demand?

Strongly different borrower profiles in Baku and the other regions – particular pressure upon the 'own business' segment which is more vulnerable in the 'other regions' than in Baku – 'employed' segment in Baku shows a relatively greater discretionary borrowing capacity than in the other regions.

- The short-term and strategic outlooks for lending in Azerbaijan are a complex interaction of a range of factors. The individual lending institutions will have a keen understanding of the strength and sensitivity of the range of dynamics. The following comments on the outlook for lending are based, however, solely upon the interpretation (by the writer) of the responses to the survey of individual borrowers, together with the public domain data of recent economic trends.
- The outlook for lending reflects the inter-action of four principal dimensions:
    - Current loan portfolio structure and the attitude of borrowers towards financial institutions;
    - External economic, financial and social factors which impact the market;
    - Borrower demand and requirements;
    - Risk framework (operational, portfolio, and structural) to be addressed by lending institution.
- The following comments briefly summarise issues which have been raised in the earlier review of the findings of the indebtedness of individual borrower survey.
    - Current loan portfolio structure;
        - Significant differences in loan portfolio performance:
            - In Baku, between MFIs and banks;
            - In other regions, in comparison with Baku region.
        - Strong adverse pressures on loan payments in relation to:
            - Foreign currency loans;
            - 'Own Business' segment.
        - Adverse relationship dynamics between borrowers and lending institutions;
        - Loan product structure (by the description of the product) appears to be broadly aligned to usage of funds.
    - External economic, financial and social factors which impact market conditions. (These factors are reviewed in Attachment 3, based upon public domain data):
        - Significant devaluation of the national currency against the US dollar;
        - Strong inflationary pressures upon imported goods;
        - Constrained levels of domestic economic activity.
    - Borrower demand and requirements:
        - Demand for future borrowing varies in relation to region and type of lending institutions, although such demand is, for a majority, despite a recognition of the difficulty to make existing loan repayments;

    - Significant usage of loan funds for purposes which reflect consumption, rather than generation of economic value.

  - Risk framework to be addressed by the lending institutions:

    - Operational credit risk – the capacity of existing (or potential) borrowers to maintain current, or increased, borrowings;

    - Portfolio credit risk – the structural risks which apply particularly to certain substantial segments of the loan portfolio and the performance of which has a significant impact on the total lending portfolio. (The 'own business' segment is such a major segment);

    - Systemic risk – the vulnerability and sensitivity of the total lending to external trends and pressures – together with the implications of the adverse reputation of the lending institutions.

- The outlook and strategy for the management of current loan exposures and development of future lending needs to reflect the inter-action of these various issues. The following comments do not seek to undertake a detailed review against each of the above issues – but rather to highlight the findings of the survey within the context of such strategic dynamics. The comments seek to provide some examples of these inter-related factors which are likely to impact on future borrowing levels and credit performance;

- The profile of the usage of loan funds by individuals shows a strong focus for domestic needs:

Usage of Loan Funds	Business	Domestic				Property / Mortgage
		Asset (inc Auto)	Expenses	Holiday, Travel and Family Events	Health / Education	
Employed	1%	21%	56%	15%	1%	5%
Own Business	90%	5%	4%	0%	0%	1%

    - This table provides an overall summary of usage of funds of the last loan;

    - This shows that a high level of funds was used by employed persons for domestic consumption needs;

    - The focus of loan funds for business purposes (predominately trading) by the 'own business' segment probably masks the 'leakage' of such monies for domestic purposes by means of higher drawings.

- The 'own business' segment has shown a high credit risk profile and, within this segment, the retail and service sectors account for the large proportion of clients and outstanding loan balances. The surveys and external data indicate that:

  - Stronger inflation and rising prices have increased at a greater rate than incomes – and this implies, therefore, that trading performance has been adversely affected;

  - Recent economic conditions will have further constrained liquidity in local markets;

  - Informal retailer credit to customers has continued and this will impact upon the cash flow of the respective businesses;

  - Such trading pressures have resulted in

    - higher levels of loan arrears,

    - higher levels of business failure, and

    - stronger recognition of difficulties in making loan repayments.

  - Nevertheless, whilst this 'own business' segment was only 30% of borrowers (based on survey responses only), it represented about 50% of outstanding loan value. This is, therefore, a critically important dimension of the lending business of the lending institutions – in relation to both income and risk.

- Lending to this type of borrower requires particular skills:
    - The relationship and credit management demands in depressed market conditions require different skills and responses from those in a more buoyant, growth environment;
    - The sensitivity of different business to varying external trends (economic, market demand) needs to be continuously monitored;
    - The level of market liquidity and demand will vary in relation to wage levels, loan levels and distribution to individuals, the level of retailer credit (to maintain turnover but at the expense of liquidity), and inward remittance. These factors may be at a quite local, community level – and there is, therefore, a great challenge to the lending institutions to identify these different trading environments;
    - Each lending institution will have a somewhat different profile of its 'own business' clients – however, in view of the strategic importance of this segment, it is necessary to gain a strong understanding of the dynamics and sensitivities of the clients.
- The regional differences in the usage of loan funds are highlighted in the following table:

Usage of Loan Funds	Business	Domestic				Property / Mortgage
		Asset (inc Auto)	Expenses	Holiday, Travel and Family Events	Health / Education	
Baku: MFI	30%	20%	42%	3%	1%	4%
Baku: Bank	15%	41%	32%	1%	1%	9%
City: Other	30%	11%	42%	14%	1%	2%
Urban: Other	30%	15%	40%	9%	1%	5%
Rural: Other	35%	3%	41%	19%	1%	1%

    - This table shows the different emphases in the usage of loan finance;
    - Such characteristics across the different client segments impact the outlook and strategy for future loan demand and structure.
- The following table seeks to relate these different dynamics to the distribution of borrowers, based upon their perceived profile of risk and loan affordability. It provides a framework to dis-aggregate the potential borrowing needs and capacities of client segments with different risk characteristics. This is not, of course, a forecast of lending volumes, and relates only to the current financial position of existing clients. There is no reflection of any events which may impact upon their future actions for borrowing, nor of any changes in their economic situation.
    - The basic financial profile of these segments is shown the following tables:

Risk Dimensions[20]	Income	Household and Utility Costs	Loan Repayment	Net Disposable Income	Outstanding Loan
Arrears	1,064	565	257	243	3,918
Lender Refusal	1,107	497	208	402	3,350
Repayment Difficulty	920	499	164	258	1,999
Expenditure >75% Income	871	542	195	134	1,785
Remainder	1,137	476	153	508	1,797

[20] Risk Dimensions are based upon: [1] Arrears: payment arrears with current loan; [2] Lender refusal: a lender has refused a loan application by the borrower in the last 12 months, although a loan was subsequently obtained from another lender; [3] Repayment difficulty: the borrower acknowledges to have difficulty in making the loan repayments; [4] Expenditure > 75% Income: the aggregate of essential household, utility and loan repayment expenditures exceed 75% of household income; [5] Remainder: all borrowers not included in segments 1 – 4. No borrower is included in more than one segment.

- This table shows the low level of net disposable income for those four segments which demonstrate pressures on the domestic financial budget. The net disposable income is based only on expenditures of food, essential household, utilities and loan repayments. Other domestic costs (such as travel, clothing, education, health and …) need to be met from the NDI amount shown above – and it is primarily such costs which have been impacted by the higher inflationary trends.

- The following table shows starkly the scale of borrowers and loan balances which are under pressure.

	MFI				Bank			
	Distribution		Net Disposable Income (post loan)	Loan Balance	Distribution		Net Disposable Income (post loan)	Loan Balance
	Clients	Loan Value			Clients	Loan Value		
Arrears	14%	23%	214	3,009	19%	33%	265	4,609
Lender Refusal	2%	2%	299	2,276	4%	6%	452	3,869
Repayment Difficulty	29%	25%	234	1,623	29%	26%	281	2,370
Expenditure > 75%	20%	18%	127	1,704	17%	12%	143	1,880
Remainder	35%	31%	543	1,618	31%	23%	468	2,001

- This table highlights:

    - The recognition of financial difficulty amongst almost 50% of borrowers and over 50% of outstanding loan value;

    - The significant level of borrowers (c.20%) with a high commitment of basic expenditures in relation to income, but who do not acknowledge the pressures which they face;

    - The very low level of borrowing being undertaken by clients who demonstrate a reasonably sound financial position;

    - The capacity for any increased debt commitment is limited, therefore, to about 33% of existing borrowers together with any additional new borrowers;

- The earlier sections in this review highlight the different market conditions in Baku and the other regions. These are reflected in the following table:

	Baku				Other Regions			
	Distribution		Net Disposable Income (post loan)	Loan Balance	Distribution		Net Disposable Income (post loan)	Loan Balance
	Clients	Loan Value			Clients	Loan Value		
Arrears	11%	21%	346	5,429	19%	35%	215	3,506
Lender Refusal	6%	7%	473	3,987	2%	2%	293	2,377
Repayment Difficulty	12%	16%	489	3,945	37%	33%	224	1,717
Expenditure > 75%	16%	14%	102	2,652	20%	15%	146	1,468
Remainder	55%	42%	670	2,263	23%	15%	330	1,287

    - This table highlights:

        - The significant differences in market conditions between these two regions;

        - The different business development and risk management strategies which will be required.

    - These regions show different attitudes in relation to the affordability and impact of debt on their lives:

Baku Region	I need to continue to borrow to maintain how my family and I live	Loans improve the quality of life	Debt repayments cause problems within my family	I would like help to resolve debt problems with my lending institution	Food expenditure has been reduced to make loan repayments
Arrears	30%	39%	45%	72%	38%
Lender Refusal	23%	33%	25%	46%	33%
Repayment Difficulty	37%	34%	70%	81%	29%
Expenditure > 75%	6%	13%	10%	26%	14%
Remainder	4%	13%	8%	21%	10%

- A comparison of the other regions is shown in the following table:

Other Regions	I need to continue to borrow to maintain how my family and I live	Loans improve the quality of life	Debt repayments cause problems within my family	I would like help to resolve debt problems with my lending institution	Food expenditure has been reduced to make loan repayments
Arrears	77%	51%	73%	97%	85%
Lender Refusal	38%	37%	48%	78%	50%
Repayment Difficulty	80%	57%	64%	92%	81%
Expenditure > 75%	34%	65%	22%	73%	81%
Remainder	25%	54%	18%	65%	67%

- These tables identify the strongly different characteristics of these two markets:
  - The responses in Baku for those borrowers who recognise their problem debt situation appear to be unduly optimistic – particularly in relation to the recognition of continuing borrowing needs and the extent to which problem debt has impacted their lifestyles;
  - This may be a reflection of a greater resilience / optimism in this region, or that there are some other factors (cultural or economic) which are impacting these responses. However, the consistency of the responses (from randomly-selected borrowers) suggests that there is some fundamental, underlying characteristic affecting such borrowers – or that the respective levels of economic activity are quite different;
  - The remaining borrowers in Baku region show, again, a much more positive view towards their financial position, in which the use of loans is suggested to be much more a discretionary decision;
  - The ‘other regions’, however, display a much more cautionary attitude towards their financial position.
- The following table provides a brief comparison between these two regions and the attitudes which were seen in Tajikistan.

	I need to continue to borrow to maintain how my family and I live			Debt repayments cause problems within my family			Food expenditure has been reduced to make loan repayments		
	Baku	Other Regions	Tajikistan	Baku	Other Regions	Tajikistan	Baku	Other Regions	Tajikistan
Arrears	30%	77%	85%	45%	73%	49%	38%	85%	41%
Lender Refusal[21]	23%	38%	80%	25%	48%	43%	33%	50%	36%
Repayment Difficulty	37%	80%	81%	70%	64%	43%	29%	81%	49%
Expenditure > 75%	6%	34%	75%	10%	22%	43%	14%	81%	30%
Remainder	4%	25%	78%	8%	18%	42%	10%	67%	39%

- These comparison suggest that:
  - Azerbaijan regions display significant ‘extremes’ of borrower attitude;
  - The perception of future borrowing needs by borrowers in Baku may be unduly low.

- The different regional profiles are demonstrated in the following table:

	‘Employed’ Borrowers				‘Own Business’			
	Distribution of Clients		Distribution of Loan Value		Distribution of Clients		Distribution of Loan Value	
	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions
Arrears	10%	8%	15%	15%	14%	44%	28%	50%
Lender Refusal	7%	1%	10%	1%	3%	2%	4%	2%
Repayment Difficulty	11%	40%	20%	39%	14%	31%	10%	28%
Expenditure > 75%	16%	23%	15%	21%	14%	13%	12%	11%
Remainder	56%	28%	40%	23%	55%	10%	46%	9%

- This table highlights:
  - The strongly-differing structures in the two regions in relation to both the ‘employed’ and ‘own business’ segments;
  - The business outlook for the lending institutions is starkly different for each of these borrower segments in relation to both risk management and business development.

- These different regional and employment profiles are further reflected in the attitudes towards the lending institutions:

‘Employed’ Borrowers	Lending institutions are trustworthy		Lending institutions act with integrity		Lending institutions seek to improve the lives of their clients		Lending institutions understand customers' needs	
	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions
Arrears	52%	7%	36%	8%	43%	3%	35%	20%
Lender Refusal	22%	23%	34%	11%	29%	13%	58%	21%
Repayment Difficulty	51%	5%	47%	2%	39%	2%	49%	20%
Expenditure > 75%	17%	16%	21%	4%	12%	3%	80%	31%
Remainder	13%	13%	15%	5%	12%	5%	84%	29%

[21] Lender Refusal: Care: small sample. The results shown do not have a strong statistical confidence

'Own Business'	Lending institutions are trustworthy		Lending institutions act with integrity		Lending institutions seek to improve the lives of their clients		Lending institutions understand customers' needs	
	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions
Arrears	19%	6%	10%	2%	13%	2%	53%	24%
Lender Refusal	17%	17%	38%	27%	0%	0%	100%	47%
Repayment Difficulty	21%	4%	3%	1%	10%	2%	38%	21%
Expenditure > 75%	3%	24%	13%	6%	0%	6%	81%	33%
Remainder	14%	8%	12%	15%	8%	7%	81%	18%

- These tables demonstrate starkly the different attitudes of borrowers in Baku and the other regions:
  - Whilst relatively low (in comparison with Tajikistan and other countries), Baku presents a more positive reputation of the lending institutions than applies in the other regions;
  - Such attitudes in Baku and, to an even greater extent in other regions, may be anticipated to present a significant dimension to the development of financial services;
  - The earlier section of this report on Savings identified that there were minimal savings undertaken with financial institutions. This may reflect the attitudes being displayed in the above tables.
- This may [probably] suggest that the client / lender relationship is predominately 'transactional', rather than 'relationship';
- The usage of the last loan is shown in the following tables in relation to the different segments of loan affordability.

Baku	Business	Individual: Domestic	Individual Appliance	Individual: Auto	Mortgage: property	Health / Education	Holiday / Travel / Family Event
Arrears	26%	28%	19%	11%	10%	1%	2%
Lender Refusal	12%	23%	33%	13%	15%	0%	2%
Repayment Difficulty[22]	26%	30%	20%	13%	7%	0%	3%
Expenditure > 75%	24%	39%	16%	11%	4%	3%	1%
Remainder	21%	41%	24%	5%	5%	1%	2%

Other Regions	Business	Individual: Domestic	Individual Appliance	Individual: Auto	Mortgage: property	Health / Education	Holiday / Travel / Family Event
Arrears	73%	11%	3%	6%	3%	0%	4%
Lender Refusal	47%	21%	15%	3%	9%	3%	3%
Repayment Difficulty	25%	47%	4%	4%	2%	1%	16%
Expenditure > 75%	19%	55%	4%	2%	1%	1%	18%
Remainder	14%	49%	15%	4%	2%	0%	17%

  - This table reflects again the very different profiles of Baku and the other regions – in the above tables, this is reflected in the usage of funds;

[22] Repayment Difficulty: an additional 2% of borrowers cited 'repayment of existing loan' as a reason for the last loan

- A particular contrast is the use of loan funds in Baku for asset acquisition purposes (domestic and auto), whilst there is somewhat greater emphasis in the other regions to use funds for domestic consumption needs;
- The diversity of the risk categories and the usage of the last loan demonstrates clearly that there is a need for a differentiation in the recognition, readiness and capacity of these segments to address future lending needs;
- The lending institutions should, ideally, establish differentiated service and product propositions to address the principal characteristics which are reflected in this table.

- The following comments provide observations on these different risk category segments;
- *'Arrears'* this segment clearly has severe repayment problems, particularly in relation to the 'own business' segment. It may be anticipated that this borrowing will remaining outstanding, at reducing levels, for longer than the next 12 months and may involve further rescheduling;
- *'Lender Refusal'* the incidence of 'lender refusal' is low, being only 3% of all borrowers. This suggests that, despite the adverse reputational comments, the lending institutions have sought to address problem debt situations;
- *'Repayment Difficulty'* this segment recognises the pressure / constraint upon its financial / budgetary position. This will reflect not only the borrowings from the lending institution, but also informal loans (16% of such borrowers take loans from friends);

  This borrower presents a paradox – the problem of debt is recognised, but yet debt is perceived as the solution amongst borrowers in 'other regions. The self-recognition of the debt problem may be considered to be a most important 'first step' in a process towards the establishment of a greater understanding of financial management – it appears that the essential challenge for this segment is a mixture of financial / budgetary education.

  There appears to be little capacity to increase lending to this segment. A cautious strategic approach to the overall risk exposure of the loan portfolio may cause these borrowings to be reduced whenever possible.
- *'Total expenditures greater than 75% of income'* this segment has a high commitment of current income to basic expenditures and there is minimal residual net income. This segment has not adjusted their lifestyles to reflect their financial situation to the same extent as the other borrower segments. This suggests that this segment may have a more 'laissez-faire' approach towards their financial position. However, in the current market and economic conditions, this segment is extremely vulnerable – not least because they have not acknowledged that they have a problem;
- *'Remainder'* this segment is much larger in Baku (55% of borrowers) than in the other regions);
- This segment clearly has the greatest discretion for a more independent determination of future borrowing. This segment represents the strongest group of clients for development of the loan portfolio – but possibly such borrowers have a relatively cautious approach to their debt commitments. The proportion of such clients who consider that they need to borrow to maintain family lifestyle is low – only 4% in Baku and 25% in the other regions. If such views are sustainable, this suggests that this segment have a relatively high discretion in their decision for loan renewal;
- These are clearly 'premium, lower risk' clients for whom the lending institutions should establish a service proposition which seeks to optimise the retention of the relationship. However, their perception of the 'trustworthiness' and 'integrity' of the lending

institutions is low. There appears, therefore, to be a fundamental challenge for the lending industry to establish an appropriate relationship with such clients.

- This segmentation framework, as an outlook for lending, suggests:
  - A highly differentiated regional strategy for both risk management and business development;
  - A highly differentiated strategy in relation to the ‘own business’ segment in Baku and the other regions;
  - The role and usage of loans appears to be quite different for the ‘employed’ segment between Baku and the other regions. This suggests that the loan product proposition will need to be focused towards these segmented needs.

7.2 What is the Sensitivity of Affordability?

The loan portfolios show significant sensitivity to relatively modest increases in the costs of basic foodstuffs and household essentials – this presents a significant structural and strategic risk to the lending institutions – there should be close and continuing review of the dynamics of this sensitivity.

- During end-2015-2016, the inflationary cost pressures (including foodstuffs) have increased substantially (see Attachment 3 for review of external economic data sourced from Azerbaijan Central Bank). This is reflected in the strong recognition from respondents that their budget capacity has been adversely impacted.

% of Borrowers who Agree	My financial situation has improved in the last 6 months		My household expenses have risen faster than income in the last 6 months		The quality of my life has improved in the last 12 months		Most of my friends have difficulties meeting their domestic budget needs	
	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions	Baku	Other Regions
Arrears	24%	16%	72%	80%	17%	5%	75%	98%
Lender Refusal	27%	18%	62%	71%	18%	12%	53%	86%
Repayment Difficulty	24%	16%	76%	76%	17%	7%	78%	98%
Expenditure > 75%	12%	16%	85%	69%	9%	6%	69%	95%
Remainder	13%	24%	86%	72%	10%	14%	76%	96%

  - The pressures are clear across all borrowers – but again, greater pressure is reflected amongst borrowers in other regions outside Baku;
  - The following table shows the current distribution of food and household expenditure, together with the impacts of increases of 5% and 10% in such costs. This shows the basic profile of such expenditures.

Monthly Food and Household Expenditure: Baku	< 350	351-450	451-550	551-650	>650	Average	Ave Exp per h'hld person
Survey Responses	34%	30%	18%	7%	11%	444	113
Increase + 5%	28%	18%	27%	12%	15%	466	119
Increase + 10%	19%	24%	28%	12%	16%	489	125

Monthly Food and Household Expenditure: Other Regions	< 350	351-450	451-550	551-650	>650	Average	Ave Exp per h'hld person
Survey Responses	25%	32%	27%	12%	4%	440	93
Increase + 5%	23%	27%	27%	13%	10%	462	98
Increase + 10%	16%	21%	32%	18%	12%	484	102

- The following tables show the sensitivity of only cost increases to food and essentials being applied to the wider ratio of household income and total committed expenditures (including loan repayments) in relation to income (*note: all other costs (utilities and loan repayments) remain unchanged).*

Household expenditure as % of Income: Baku	<25%	26-50%	51-75%	76-100%	>100%
Survey Responses	10%	76%	13%	1%	0%
Increase + 5%	7%	73%	19%	1%	0%
Increase + 10%	5%	70%	22%	1%	1%

Total expenditures as % of Income: Baku	<25%	26-50%	51-75%	76-100%	>100%
Survey Responses	1%	24%	51%	21%	4%
Increase + 5%	1%	20%	50%	23%	5%
Increase + 10%	1%	17%	50%	25%	7%

Household expenditure as % of Income: Other Regions	<25%	26-50%	51-75%	76-100%	>100%
Survey Responses	1%	48%	51%	0%	0%
Increase + 5%	1%	37%	62%	0%	0%
Increase + 10%	1%	29%	69%	1%	0%

Total expenditures as % of Income: Other Regions	<25%	26-50%	51-75%	76-100%	>100%
Survey Responses	0%	3%	44%	52%	1%
Increase + 5%	0%	2%	35%	61%	2%
Increase + 10%	0%	2%	28%	68%	2%

  - These tables show the sensitivity of 'affordability levels' in response to relatively modest increase in one dimension of domestic costs – a dimension may have had a progressive effect upon borrowers during 2016. They provide some indication of the extent of additional strains which would have been present in the loan portfolios if such cost increases had occurred.

- Such sensitivity presents an additional component to the structural risk exposure to the credit performance, particularly in relation to the other regions. This is further emphasised by the reductions to food expenditures which have been made to enable loan repayments. The lending institutions should monitor such costs trends closely, together with wage trends – if may be anticipated that these provide a strong indicator of future credit performance and are likely to have different regional dynamics.

Attachment 1.

"Indebtedness of Individuals"

Outline of Survey Methodology

A survey is being undertaken during July-September 2016 in which individuals are invited to respond to questions relating to their financial position, the extent of any indebtedness and their attitudes towards indebtedness. The objective of the survey was to examine the characteristics and debt capacity of individuals. It was designed to enable the characteristics of different segments of borrowers to be identified and reviewed. Each independent lending institution will have its individual mix of these segments within its loan portfolio.

The survey is being undertaken by an Azerbaijan research agency, ABTC (http://www.abtc.az/). This agency has experience of conducting large scale surveys in relation to financial services.

The survey is undertaken by face-to-face interviews with individuals selected on a random basis within the parameters described below. The interviews may be undertaken in public areas (market, street, or near to workplaces) or locations which do not compromise the responses of individuals. There is to be a good spread of locations of survey interviews which reflect a balanced spread of the borrower population.

The survey is being conducted at such times and locations which would not be affected by any exceptional events which may disrupt the normal profile of respondents. Such 'events' may include (but not be restricted to):

- Public holiday or festive occasions;
- Weekends, or such times at which the 'normal' profile of respondents may change;
- Occasions which cause an exceptional migration / movement of people (such as visiting relatives);
- Areas, or occasions, of any public unrest, disturbance, or demonstration.

The survey respondents are advised of the topic of the survey and the time which will be needed to complete the survey. It must be stressed to the respondents that the survey is completely anonymous and that there is no mechanism by which to identify the respondent with the lending institution.

The regional scope of the survey respondents is shown below.

Region	Number of Respondents				
	Microcredit and Non-Bank Institutions	Bank	Former Clients: Loans in last 2 years	No Previous Loans	Survey Total
Baku	468	468	250	62	1,248
Absheron	117	117	63	16	313
Guba-Khachmaz	71	71	38	10	190
Aran	328	328	175	44	875
Ganja-Gazakh	169	169	90	23	451
Shaki-Zagatala	86	86	46	12	231
Daghligh Shirvan	55	55	30	7	148
Lankaran	115	115	61	15	306
Yukhari Garabagh	89	89	48	12	238
Total	1,500	1,500	800	200	4,000

Attachment 2.

"Indebtedness of Individuals" Survey Format

CLIENT SURVEY - INDIVIDUAL

We would like to better understand about how you undertake loan repayments.
All responses will remain confidential - No Personal Identification or Contact Details are requested

1-2 Loan Identification *(All Respondents)*

Do you have loans with :

		Yes, loan for personal needs	Yes, loan for business	Not now, but in last 2 years	Never		If Yes, how many
Q.1	Micro-finance institution					Q.1.a	
Q.2	Commercial bank					Q.2.a	

3-9 Please tell us about yourself : *(All Respondents)*

Q.3 Gender : Male ☐ Female ☐ Q.4 Age : ☐

Q.5 Number of people in household (inc. respondent) ☐ Q.6 Number of dependents ☐

Q.7 Marital Status Married ☐ Single ☐ Widow/Widower ☐

Q.8 Where do you live : City / Town ☐ Urban ☐ Rural ☐

Q. 9 How long have you lived in this neighbourhood *years* ☐

10-13 Income *(All Respondents)*

Q.10 What is the source of your income : *(Tick any which apply)*
Regular work ☐ Irregular work ☐ Own Business ☐ Remittance ☐ Other inc. occasional sales and social subsidies ☐ None ☐

Q.11 In which trade sector(s) do you earn your income *(Tick any which apply)*
Manufacture ☐ Food Production ☐ Retail ☐ Engineering ☐ Building - Property ☐
Service ☐ Agriculture ☐ Public Sector ☐ Other ☐

Q.12 How would you describe the receipt of your income payments *(Tick any which apply)*
From employer by bank transfer ☐ From employer by cash / cheque ☐ Income from social subsidies ☐ Occasional or irregular payments ☐ Income from own business ☐

Q.13 How many people earn income in your household *(Please enter number)* ☐

14-24 Household Budget *(All Respondents)*

Q.14 How much is the average **total monthly** income into your household budget *(Please enter amount)* AZN ☐

Q.15 How much do you spend **each month** (on average) on food and household expenditure AZN ☐

Q.16a How much do you spend **each month** (on average) on gas, electricity, water, rent, garbage collection AZN ☐

Q.16b How much do you spend **each month** (on average) on telephone and internet services AZN ☐

Q.17 Do you have any payment arrears with any of electricity, gas, water, or housing costs Yes ☐ No ☐

Do you have loans from non-financial institutions :

		Yes, loan outstanding	Not now, but in last 2 years	Never
Q.18	Family			
Q.19	Friends			
Q.20	Retail shop : to purchase higher-value assets (such as car, washer, refrigerator)			
Q.21	Retail shop : to obtain normal domestic items (such as food, personal items, household needs)			
Q.22	Construction Company : purchase of apartment or land			
Q.23	Employer			
Q.24	Other (including Moneylender and Pawnshop)			

25-37 Lifestyle ***(All Respondents)***

Did any of the the following situations happen to you in the last six months *(Please tick all which apply)*

		Yes	No			Yes	No
Q.25	I lost my job			**Q.26**	My business was not successful		
Q.27	My spouse lost his/her job			**Q.28**	I had to sell a major asset to repay a loan		
Q.29	Major illness of self or family			**Q.30**	Remittance income stopped, or reduced		

We would like to know how much you agree with the following statements

		Strongly Agree	Agree	Disagree	Strongly Disagree	Do Not Know / No Opinion
Q.31	My financial situation has improved in the last 6 months					
Q.32	I feel in control of my financial situation					
Q.33	My children will have a better life than me.					
Q.34	My household expenses have risen faster than income in the last 6 months					
Q.35	The quality of my life has improved in the last 12 months					
Q.36	I can afford to buy 'treats' for myself or my family					
Q.37	Most of my friends have difficulties meeting their domestic budget needs					

38-42 Loan Dimensions ***(Current and Former Borrowers)*** Please tell us about your loan(s)

Q.38 What type(s) of loan do you use now and in which currency *(Please tick all which apply)*

	AZN	Fgn Ccy
Group Loan		
Business loan		
Consumer loan : Daily expenditures		
Consumer loan : Household appliances (such as TV, refrigerator, car)		
Consumer : avtocredit		
Mortgage loan : house, apartment, land for house construction		
Agricultural loan		
Credit card		
Other		

Q.39 What was the main reason(s) for your last loan and your next loan *(Mark up to two reasons)*

	Last loan	Next loan
Business : Investment		
Business : Working capital		
Individual : Domestic daily expenditures		
Individual : Household appliances (such as TV, refrigerator, car)		
Individual : avtocredit		
Mortgage loan : house, apartment, land for house construction		
Domestic : Health or education		
Domestic : Holiday or travel or family event		
Repay / increase existing loan		

Q.40	During the last 2 years, how many loans have you taken	*Enter number*	
Q.41	How many lenders have you used for these loans	*Enter number*	
Q.42	How many guarantees have you given for debts which are still outstanding	*Enter number*	

43-58 Loan Dimensions ***(Current Borrowers)*** Please tell us about your loan(s)

Q.43 Total amount outstanding of all loans

Q.44 How much is total **monthly** repayments for all loans (include MFIs, banks, house mortgage)

(Please enter AZN amounts for Q. 43 and Q.44)

		Yes	No
Q.45	Have you pledged any assets as collateral to secure your loan		

Q.46 If 'yes', which collateral was provided *(please tick all which apply)*

Business Property | Residential Property | Business Equipment | Domestic Asset(s) | Vehicle | Guarantee | Gold / Jewellry

		Yes	No
Q.47	Is any of your loan indebtedness (Q.43) outstanding in a currency which is not Azerbaijan AZN		

Q.48 If 'Yes' (Q.47), what is the foreign currency loan balance US$ Euro Other Amount

Q.49	If 'Yes' (Q.47), did the lending institution explain the risks of exchange rate changes to you		
Q.50	Are any of your loan payments in arrears or not fully up-to-date		
Q.51	Have you refinanced, or consolidated your debts during the last 12 months		
Q.52	Have you applied for a loan in the last 12 months		
Q.53	Has any lender refused to lend to you in the last 12 months		
Q.54	When you took your loan, did you obtain your credit rating		

Q.55	How long ago did you take out your last loan	Within 1 month	1 - 3 months	4 - 6 months	7 - 12 months	Over 12 months	Cannot remember
Q.56	Compared with 12 months ago your present total loans are	Much Higher	Higher	The Same	Less	Much Less	
Q.57	After the next 12 months, do you expect your debt level to be	Much Higher	Higher	The Same	Less	Much Less	
Q.58	Who undertakes the loans in your family	Only you	Only your spouse	Jointly	Both of you independently		

59-66 Lending Institution ***(All Respondents)***

When you think about lending institutions, how much do you agree with the following statements

		Strongly Agree	Agree	Disagree	Strongly Disagree	Do Not Know / No Opinion
Q.59	Clients are treated with respect					
Q.60	The institutions respond well to people with repayment problems					
Q.61	Lending institutions are trustworthy					
Q.62	Lending institutions seek to improve the lives of its clients					
Q.63	Lending institutions act with integrity					
Q.64	Lending institutions understand customers' needs					
Q.65	Lending institutions explain the terms and obligations of the loan					
Q.66	Lending institutions want to lend to people like me					

67-80 We would like to know your opinion, and how much you agree with the following statements ***(Current and Former Borrowers)***

		Strongly Agree	Agree	Disagree	Strongly Disagree	Do Not Know / No Opinion
Q.67	Loans improve the quality of life					
Q.68	When I took my last loan, the charges (interest and fees) were explained to me and I know how much I am paying					
Q.69	I understand which type(s) of loan should be used for different needs					
Q.70	Loans are easy to obtain					
Q.71	I borrowed too much					
Q.72	It is / was difficult to resolve debt problems with lending institutions					
Q.73	Debt repayments cause problems within my family					
Q.74	My loan repayments are / were more than I can afford					
Q.75	I need / needed to continue to borrow to maintain how my family and I live					
Q.76	I would like help to resolve debt problems with my lending institution					
Q.77	It is better to borrow from only one institution, rather than to change lenders					
Q.78	When I drew my last loan, the lender knew what I could afford					

Q.79	Food expenditure has been reduced to make loan repayments	Yes	No
Q.80	I (or my spouse) have taken additional work to make loan repayments	Yes	No

81-83 We would like to know your attitudes towards saving. ***(All Respondents)***

Q.81	Do you make savings with a financial institution	Yes	No
Q.82	Do you make other regular cash savings	Yes	No
Q.83	Have you bought an insurance product(s) from your financial institution	Yes	No

84-85 From which institution(s) have you borrowed in the last 2 years ***(Current and Former Borrowers)***

(Please tick all which apply)

Q.84 **Microfinance Institution**
- FINCA
- Inkishaf uchun maliyye
- Azerkredit
- Aqrarkredit
- Molbulak

Other' : Please name institution :

Q. 85 **Commercial Bank**
- Bank of Baku
- Unibank
- Nikoilbank
- Kapitalbank
- Rabitabank
- Demirbank

Other' : Please name institution :

Thank you for participating in this survey - All answers will remain confidential

Attachment 3.

Review of External Data

Introduction

The following notes provide a brief overview of some external 'desk-top' research which has been undertaken in anticipation of the survey 'Indebtedness of Individuals' being conducted on behalf of World Bank Group / IFC.

The objective is to demonstrate a broad framework of external trends and activities which impact upon the activities of individual borrowers and may, therefore, be reflected in the survey responses. The writer has not had access to information from any lending institution and the review is limited to documentation available in English.

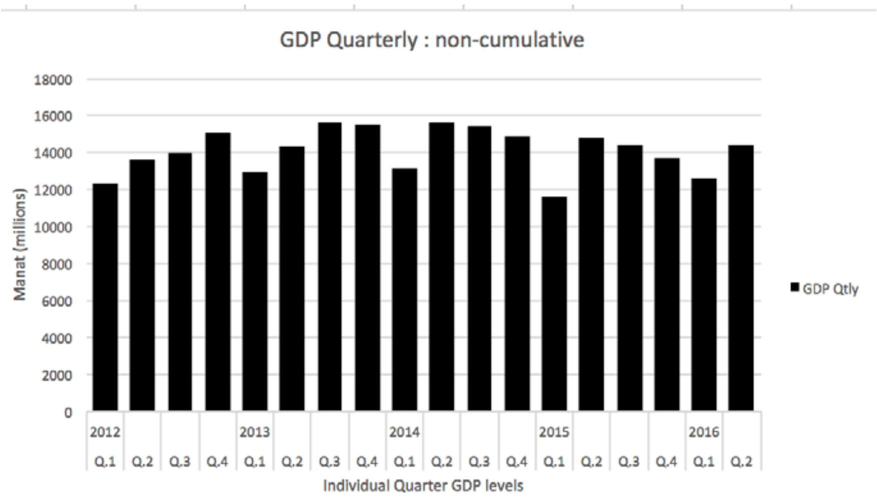
The external data in these notes has been sourced primarily from Azerbaijan Central Bank and Azerbaijan State Statistical Committee, together with supplementary data from institutional websites[23].

Economic Framework

The lending environment over the last few years has been dominated by:

- A relatively stable (unchanging) level of economic activity (GDP);
- Substantial devaluation of the national currency against the US Dollar in 2015 – 2016;
- Substantial increase in inflation in 2015 – 2016.

The annual growth in GDP (annual to June) has been +5% (2012-2013), +6% (2013-2014), -9% (2014-2015), and +3% (2015-2016). The quarterly levels of GDP are shown in the following chart. This shows a regular seasonal dip in Q.1. The Indebtedness Survey is being undertaken in August/September, which is a strong economic quarter and should not, therefore, have an adverse impact upon responses.

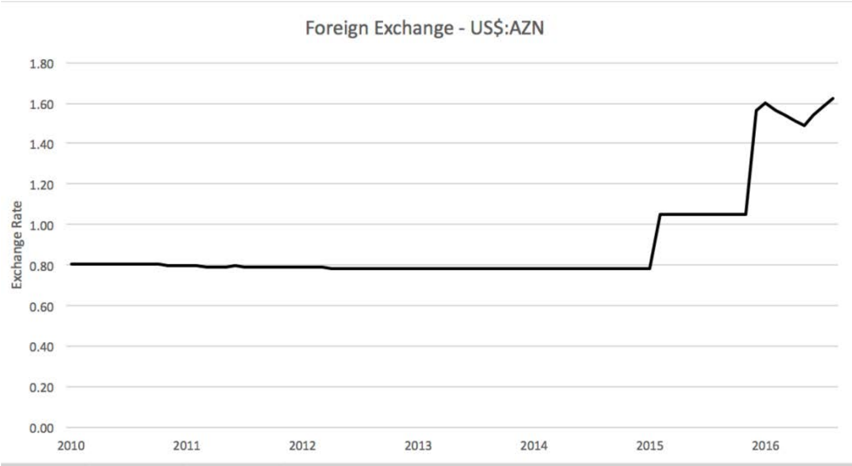


There have been substantial re-alignments of the national currency (AZN - Manat) against the US Dollar. Following a period of exchange rate stability at about US$: AZN 0.80, there were two significant devaluations – 34% in February 2015 and a further 48% in December 2015. This resulted in an overall devaluation of about 104% in the year between January 2015 and 2016. At January 2015, total foreign currency lending was about US$ 6.4 bn. (AZN 5.0 bn); by January 2016, whilst the US Dollar amount had

[23] The extensive data of the commercial banking sector (source: Azerbaijan Central Bank) is reflected in the graphs and commentary of this note. However, the detailed sub-analysis is restricted by the limited availability of data to separately identify household mortgage and non-mortgage loan exposure and performance. MixMarket data on the microfinance data is very limited and not up-to-date

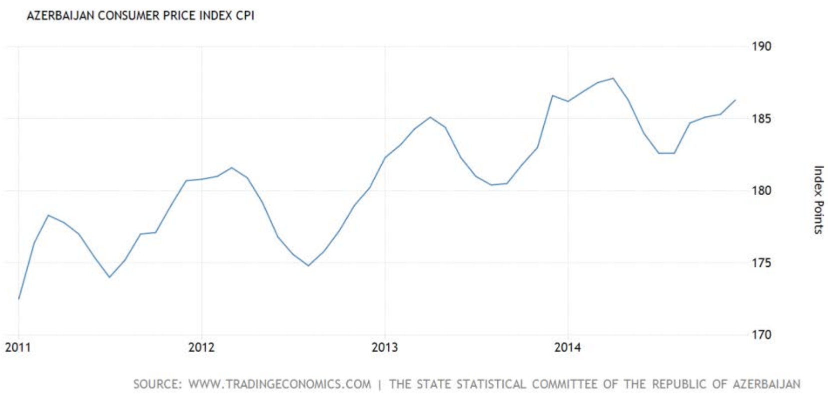
increased slightly to US$ 6.9 bn., the Manat equivalent had escalated dramatically to AZN 11 bn[24]. (Note: these outstanding loan balances relate to all foreign currency lending by Azerbaijan banks and include both corporate and individual private sector clients. The writer has been unable to identify lending statistics to show the separate levels of foreign currency lending for corporate and individual clients).

These substantial changes in the exchange rate are shown in the following graph.



The impact of the devaluation of the Manat is reflected in the sharp changes in the inflation rate, with a particularly adverse impact resulting from the second devaluation step. This is shown in the following graph.

The underlying trend in the Consumer Price Index (CPI) has been increasing over recent years (see following graph), with seemingly regular, seasonal fluctuations



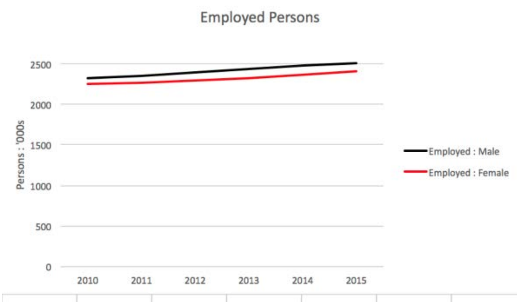
[24] Exchange Rate: US$: AZN 0.78 January 2015 … US$: AZN 1.60 January 2016

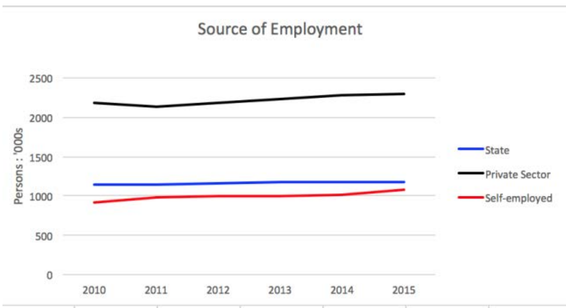
Within the CPI, the impact of the devaluation of the Manat has had a significant and adverse impact upon the immediate cost-of-living of essentials. A significant proportion of foodstuffs (about 35%) are imported into Azerbaijan. The following chart shows the dramatic impact of food inflation upon individuals in 2016.

This indicates that the survey should show particular pressures upon the domestic budget. It may also be anticipated to have a significant impact upon the 'affordability' of loans which were taken prior to January 2016. The 'affordability' ratios would have been based upon assumptions derived from a more stable economic environment. For those individual borrowers who have undertaken loan repayment commitments up to, or about, 'marginal affordability', the impact of this 'event risk', with a substantive change of underlying assumptions about their domestic budget situation, may be anticipated to be severe.

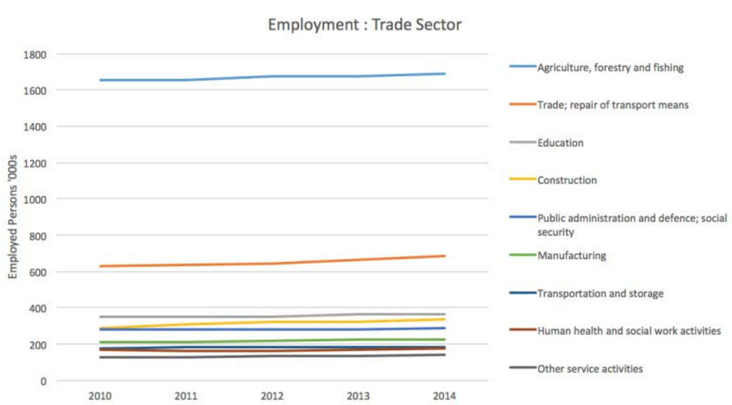
Employment

Employment levels have remained highly stable during the last 6 years, in which 51% of employed are male and 49% female (ratios unchanged from 2010). About 26% are employed by the State, 50% by the private sector, and 24% of self-employed (a slight increase from 22% in 2010). (2016 Data is not yet available).





The principal sectors of employment are shown in the following graph.



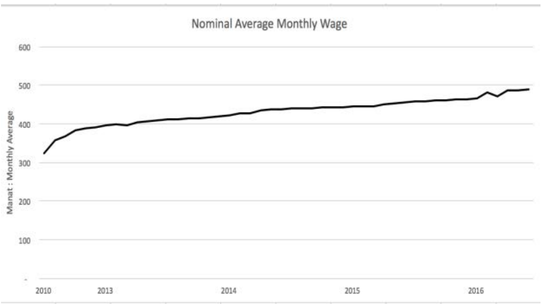
This shows that the main trade sectors of employment have been highly stable during the last 5 years.

Survey Observation:

- *Only 1% of borrowers report that they lost their job in the last 6 months;*
- *However, 11% of borrowers report that their spouse lost their job in the last 6 months;*
- *As employment data is only available to 2015, does this suggest that there has been some increase in employment pressure during 2016.*

Wages

The trend in overall nominal average monthly wages is shown on the following graph, together with an indexed comparison of wage trends with CPI.

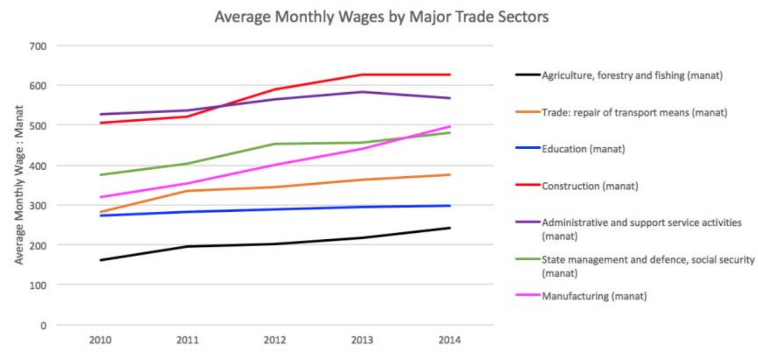


This comparison suggests that, during the period, 2010 – mid-2015, individuals may have been feeling more prosperous. Whilst increases in average incomes were not great (averaging 7% in 2014, 4% in 2015, - and now 7% in the first half, 2016), they were ahead of CPI increases. This suggests that, on balance, borrowers may have been disposed to take a somewhat optimistic view of their budgetary and financial outlook.

Survey Observation:

- *The average individual wage of borrowers was AZN 452 (non-borrowers AZN 407);*
- *The average household income was AZN 1,012 (non-borrowers AZN 942);*
- *Average number of wage-earners in the household was 2.2 with an average 4.5 persons in the household (national average in 2014: 4.7 persons).*

However, wage increases were not spread equally across the trade sectors and this is shown in the following graph. These follow the nominal monthly wages for the major trade sectors of employment which were shown above.



Survey Observation:

- *Principal trade sectors of employment of borrowers, in the survey sample, are Retail (23%), Service (21%) and Public Sector (30%)[25];*
- *These are generally amongst the lower paid employment sectors.*

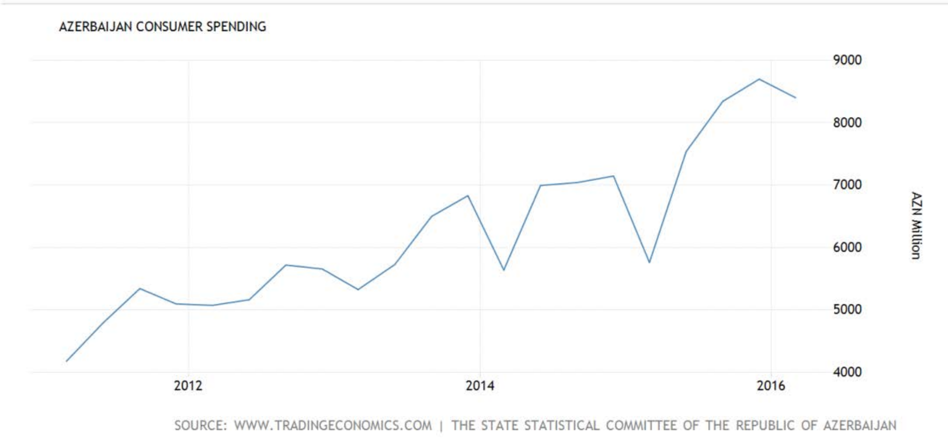
Other external research has indicated that the "living wage"[26] of an Azerbaijan family increased to AZN 720 in June 2016.

This suggests that in relation to the average nominal monthly wage of AZN 490, there would need to be 1.5 incomes into the household, although for low paid trade sectors, agriculture would require about 2.75 and trade / retail would require about 2.

Survey Observation:

- *The average household income amongst borrowers was AZN 1,012;*
- *27% of borrowers had a household income less than AZN 750.*

Such underlying optimism from wage increases above CPI is reflected in the trends of consumer spending, which dipped after the initial Manat / $ devaluation but then rebounded strongly until the second devaluation.



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[25] Excluding Agriculture which accounts for 37% of the employed population, national statistics for employment (2014) show retail trade at 23%, education, health and public administration at 29% of employed

[26] Source: www.tradingeconomic.com: Wage Indicator Foundation: "Living wage computations are based on the cost of living for a predefined food basket derived from the FAO database (UN Food and Agriculture Organisation) distinguishing 50 food groups with national food consumption patterns in per capita units, for housing and for transportation, with a margin for unexpected expenses."

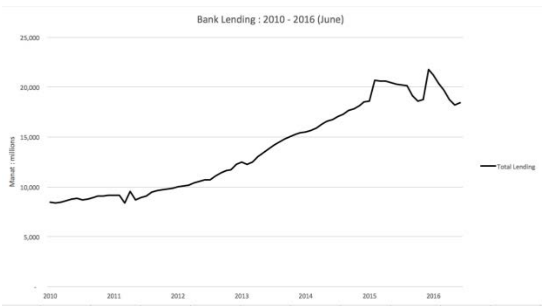
However, the growth in consumer spending (over 100%) between 2011 and 2016 is much greater than the c.40% growth in average wages in the similar period. This suggests that consumers:

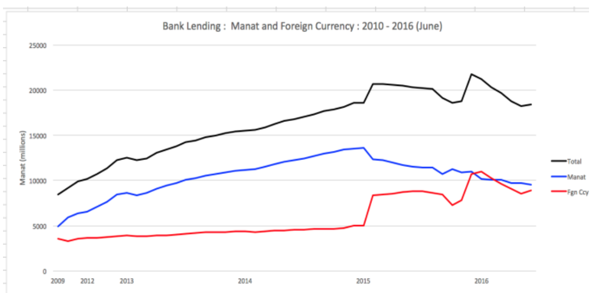
- were confident / optimistic of their future financial prospects;
- became accustomed to improving their lifestyles;
- were able to fund such expenditures by means other than savings from wages. (See later assessment of the growth in lending to households during this period).

Lending

Lending showed continuing strong growth between 2010 and 2015, particularly in national currency.

The following graphs show the overall level of loan outstandings (to both the business and individual client segments), together with a comparison of the AZN equivalents of both national and foreign currency loans.

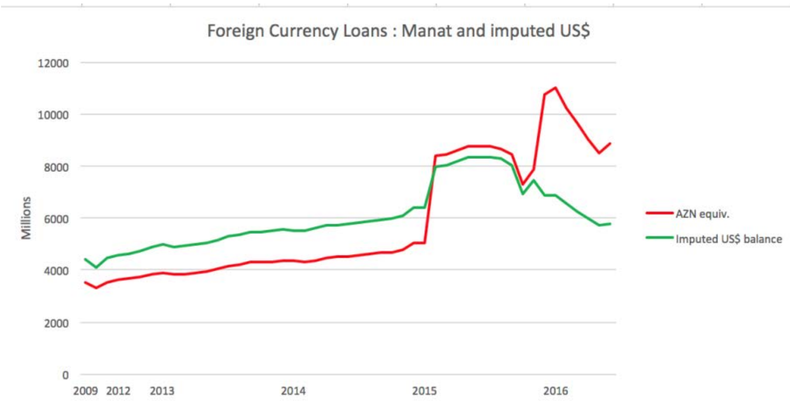




This shows that there had been minimal growth in foreign currency outstandings (expressed in Manat equivalent) between 2010 and 2015 (at the time of the first devaluation), whilst the strong growth had been in national currency. (Note: these figures relate to total lending to the private sector by commercial banks, and not only to individuals). The immediate impact of the two currency devaluations upon the Manat equivalent of foreign currency loans is clearly shown.

The following graph shows only the foreign currency lending (again, this relates to total bank lending, both corporate and individual). This shows that that had been only modest growth in foreign currency loan balances between 2010 and 2015. The red line shows the AZN / Manat equivalent balance, and the green line shows the related US$ equivalent (at the corresponding exchange rate).[27] The data indicates that additional lending was undertaken in foreign currency at the time of the first devaluation. This may have reflected some form of refinance, or capitalisation of interest, or additional currency lending. However, such mechanisms were not repeated at the time of the second devaluation. Such an increase in foreign currency loans would enable the lending institutions to improve the ‘currency matching’ in their balance sheet structure, and thereby favourable implications for capital ratios. (Note: it is not possible for the writer to determine the detailed reasons from the available data for the immediate increase in the imputed US$ equivalent).

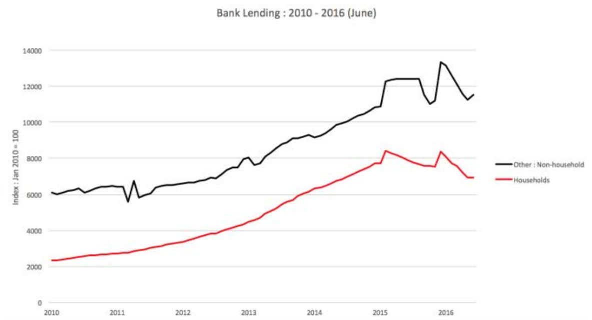
[27] For reference: the US$ balance is determined by dividing the AZN balance by the exchange rate. Data source for loans and exchange rate: Azerbaijan Central Bank

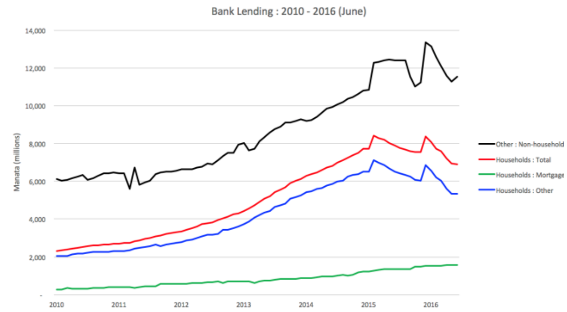


Survey Observation:

- *17% of borrowers had a loan in foreign currency (100% in US$);*
- *Loan amount: 30% < US$1,000; 41% US$1-2,000; 29% > US$2,000;*
- *Anecdotal comments obtained during the survey process suggest that [some] lending institutions caused some local currency loans to be converted into foreign currency without full consultation with the borrowers;*
- *88% of survey respondents identified that lending institutions did not explain the risks of foreign exchange; this contrasts with 83% of survey respondents who agreed that the normal terms and obligations of the loan were explained.*

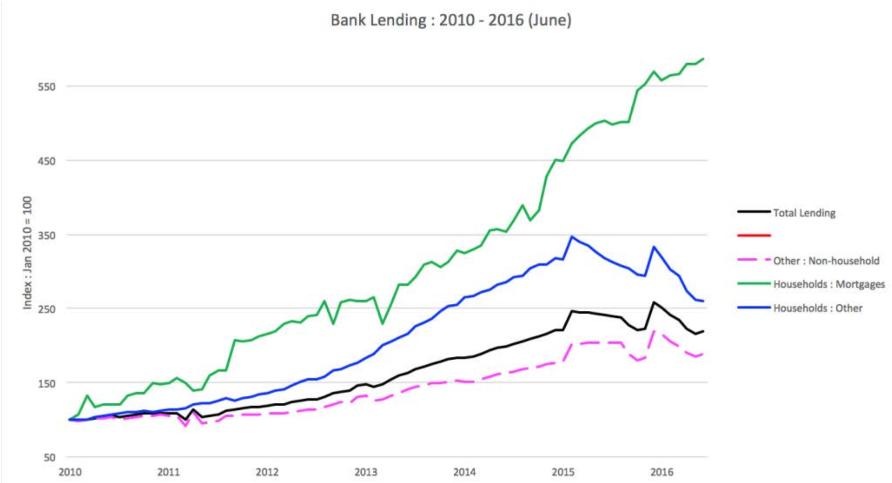
The comparative increase of lending to households by banks since 2010 has been particularly strong. The graphs (below) show that lending to households was a significant component of the growth in bank lending during that six-year period – increasing from 27% of total bank lending in January 2010 to a maximum of 42% in January 2015. This is now reduced to 37% (June 2016).





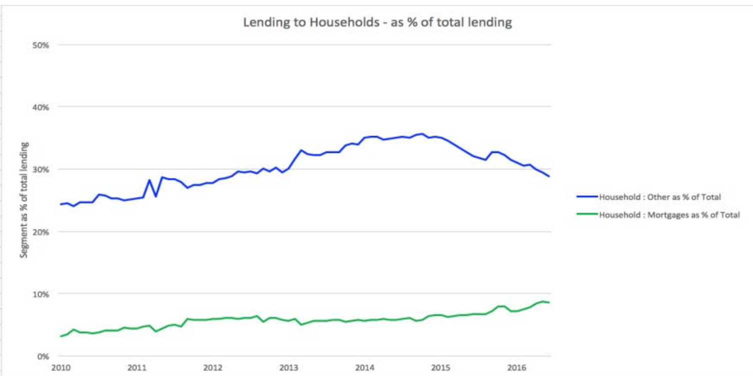
These graphs show a significant reversal of trends in non-mortgage lending to households. There has been a substantive reduction in the level of non-mortgage borrowings since February 2015. This coincided with the initial AZN / US$ devaluation and a substantial monthly increase (+4%) in CPI. This seems to be a remarkably immediate response, which suggests *(as an inference by the writer)* that it was driven by the industry or national authorities. Following this reversal, there has been a sustained reduction in outstanding borrowings (with the exception of the exchange rate impact of the second devaluation in December 2015).

The stronger growth rates of lending to households (shown in the above graphs) are shown clearly in the following graph (on an Index based on 2010) and are compared with other 'non-household' lending.



This graph (showing indexed growth) depicts a significant release of loan funding to individual borrowers during that period. It demonstrates how the increases in consumer spending (shown in an earlier graph above) were supported by increased debt by individuals. This will also have contributed a stimulus to the national economy and the GDP figures which were shown earlier. (The GDP had, however, remained broadly stable despite this increased consumer spending).

The more recent decline in the share of lending to households as a percentage of total bank lending is shown in the following graph.



The reversal of the strong growth of lending to household represents a substantial change in the strategy of the lending institutions. The reasons for this change are not known to the writer but the following factors may be considered:

- An immediate reduction in demand by households in the demand for loans. However, the prospect of higher inflation, and no immediate increase in interest rates, would have made the ‘real cost’ of borrowing lower and consumers may have been inclined to borrow in order to acquire assets before inflation took asset-prices higher. Individuals may also have thought that “the worst was over”.;

- The lending institutions may have been funded (at least in part) in US Dollars. As their balance sheets would be expressed in Manat, the first and second devaluations would have placed increasing pressure upon their capital ratios and probably the eligibility of loan capital under either [i] regulatory requirements for Tier 2 capital, and/or [ii] capital covenants established by international investment funding agencies. This may have caused the banks to reduce their lending – and the immediate priority may have been to provide continuing support to industrial and commercial clients. Lending to households would, therefore, have been the easiest means by which to reduce their balance sheet exposure to loan assets;

- If ‘reduced household lending’ was the response strategy to capital constraints, then it may be considered that the household borrower would feel this to be an unexpected ‘change of direction’ by lending institutions (on which there had been an increasing reliance by households), that domestic financial plans would need substantial revision, and that such households are likely to have felt to be ‘let down’ / failed by the lending institutions;

- Lending institutions considered that lending to households had become an ‘over-heated’ segment, that the sustained growth of previous years had been excessive, and that there was a need to reduce the structural risk exposure to this segment. If this were to be the reason – and it seems highly unlikely that it would be the reason – then the co-ordinated action of lending institutions in a competitive market arena to achieve this scale of reaction was extremely rapid.

Survey Observation:

- *Only 18% of loans drawn within the last 6 months (15% of outstanding loan value);*
- *50% of loans taken over 12 months ago (62% of outstanding loan value) and a residual repayment period for the outstanding balance of about 14 months;*
- *Anecdotal comments obtained during the survey process suggest that [some] lending institutions caused some local currency loans to be converted into foreign currency without full consultation with the borrowers;*
- *88% of survey respondents identified that lending institutions did not explain the risks of foreign exchange; this contrasts with 83% of survey respondents who agreed that the normal terms and obligations of the loan were explained.*

The continuing growth in mortgage lending presents a challenging paradox. ***The following comments are simply possible conjecture by the writer and there is no data evidence to validate the suppositions.*** The continuing strong rise in mortgage lending in 2015 – 2016 occurs whilst there is a corresponding sharp reduction in non-mortgage household borrowing. The economic and financial environments remain under pressure and the immediate outlook is one of increasing austerity and pressure for households.

The mortgage loan provides a potential opportunity for both the borrower and the lending institution.

1. For the borrower
    a. The mortgage loan provides an extension in the loan repayment period and, thereby, lower monthly repayments;
    b. The (re)mortgage of the property provides an opportunity for some level of ‘equity release’ which would enable planned expenditures to be undertaken. This would support the levels of consumer expenditure which were undertaken in 2016 (except for a temporary dip – see earlier graph);
    c. The borrower may have considered that the first phase devaluation and inflation hike would not happen again;
    d. The extent to which the borrower was / is aware that the ‘real risk’ is the potential loss of the property / home is uncertain.
2. For the lending institution
    a. The credit quality of the loan asset had a strengthened balance sheet value, because of the collateral attached to the mortgage loan;
    b. Lending levels were able to be somewhat sustained and thereby interest revenue could be considered to be stronger, again because of the underlying collateral and traditional credit performance of mortgage lending (*an inference by the writer*);
    c. Capital was strengthened as a result of the property-backed collateralised loan attracting a lower ‘capital risk weighting’ than non-collateralised household loans;
    d. The lending was not ‘refinance’ (thereby attracting a higher loan loss reserve allocation);

e. The ‘operational credit management’ was strengthened, but the structural risk exposure remained to the portfolio segment and to the ‘event risk’ of the second phase devaluation and stronger inflationary impact upon the domestic household budget.

Survey Observation:

- *Mortgage loan: AZN 4% of borrowers average loan balance AZN 5,074 (small sample)*
- *Mortgage loan: US$ 1% of borrowers sample too small*
- *36% of borrowers have provided collateral (MFIs 42%, banks 30%). However, the type of collateral is dominated by business equipment and domestic assets, with property being only 10% (either residential or commercial) .*

Regional Distribution of Lending

The regional distribution of lending is overwhelmingly concentrated in the Baku region. The scale and distribution of lending is shown in the following table.

	Lending (millions): July 2016			Distribution: July 2016			Change in Lending: 2014-2016		
	Total	Manat	Foreign Currency	Total	Manat	Foreign Currency	Total	Manat	Foreign Currency
Baku	15,697	7,707	7,990	85%	81%	90%	6%	-28%	98%
Abershon	581	364	217	3%	4%	2%	2%	-11%	32%
Aran	719	497	222	4%	5%	3%	-28%	-38%	11%
Daghlig-Shirvan	95	57	38	1%	1%	0%	-16%	-36%	51%
Ganja-Qazakh	585	394	191	3%	4%	2%	51%	28%	137%
Guba-Khachmaz	186	129	57	1%	1%	1%	44%	22%	144%
Lankaran	232	143	89	1%	1%	1%	-23%	-38%	26%
Sheki-Zagatala	180	128	52	1%	1%	1%	11%	1%	47%
Yikhari-Karabakh	48	44	4	0%	0%	0%	-35%	-33%	-50%
Kalbajar-Lachin	1	1	0	0%	0%	0%	-96%	-97%	-94%
Nakhchivan	110	107	3	1%	1%	0%	2%	2%	21%
Total	8,434	9,570	8,864				5%	-26%	91%

The following issues may be noted:

- The lending data continues to relate to all bank lending (both corporate and individual). (The writer has been unable to source data to identify the respective levels of lending to individuals);
- The significant reductions in national currency lending, particularly in Baku. This reduction in lending must have a significant impact upon the scale, cash flow and liquidity of local regional economies;
- The significant restructure of the debt profile in the regions between national and foreign currency. This will adversely impact the economic productivity of such debt and also the attitude / motivation of the borrower.

The profile of average interest rates also varies significantly over the regions – which suggests that there is probably a substantial variation in the ratio of corporate: individual borrowers.

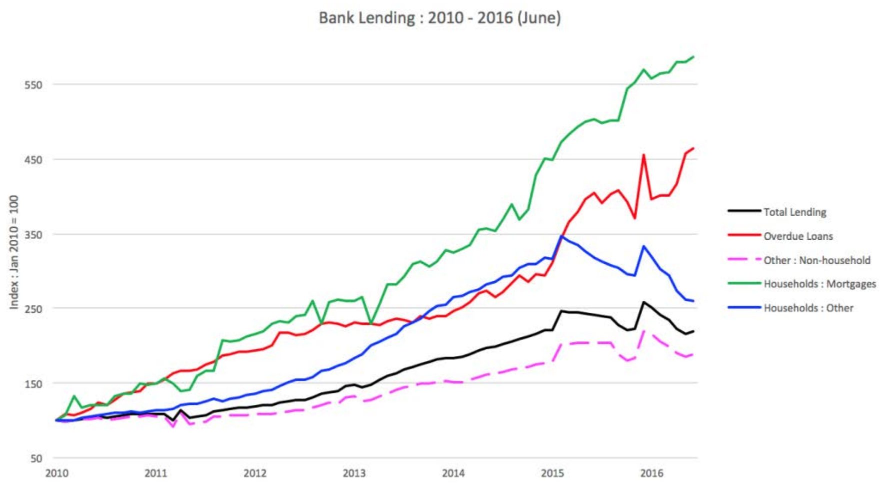
	Interest Rates (1 July 2016)			Change in Rates: July 2016 - Oct 2014		
	Total	Manat	Foreign Currency	Total	Manat	Foreign Currency
Baku	9.8%	11.1%	8.5%	-3.2%	-1.9%	-4.5%
Abershon	16.2%	14.7%	18.6%	-2.9%	-3.8%	-2.0%
Aran	21.2%	20.3%	23.1%	-0.3%	-1.1%	1.0%
Daghlig-Shirvan	20.9%	20.6%	21.4%	-2.8%	-3.0%	-2.7%
Ganja-Qazakh	18.9%	18.3%	20.1%	-3.0%	-3.5%	-2.5%
Guba-Khachmaz	20.3%	19.3%	22.4%	-1.0%	-1.2%	-2.8%
Lankaran	21.8%	21.8%	21.7%	-1.7%	-1.8%	-1.4%
Sheki-Zagatala	20.9%	19.7%	24.0%	0.4%	0.3%	-0.5%
Yikhari-Karabakh	17.9%	17.7%	20.6%	-2.5%	-2.1%	-4.6%
Kalbajar-Lachin	15.8%	14.0%	19.6%	-9.7%	-11.4%	-6.0%
Nakhchivan	12.6%	12.3%	22.3%	-0.8%	-0.9%	1.2%
Total	11.2%	12.5%	9.8%	-3.1%	-1.8%	-4.5%

The following issues may be noted:

- The change in rates – if negative (red) the current rate is lower than the average rate in October 2014;
- The wide variation in average rates suggests a range in the mix of business: household lending. This would suggest differing lending strategies and focus across the regions.

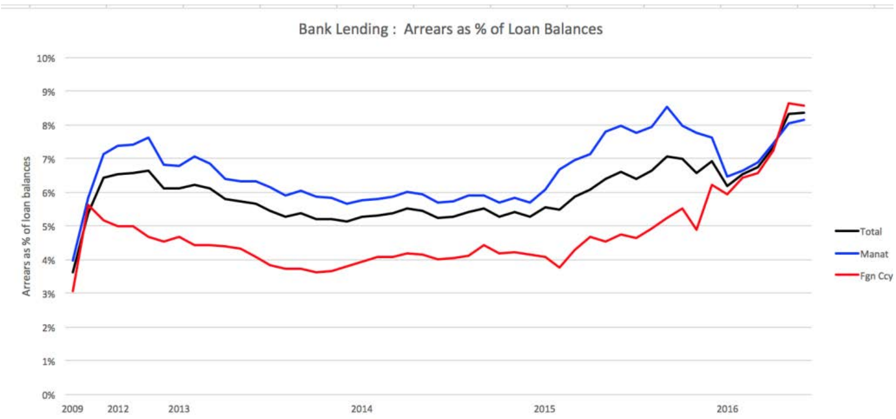
Arrears in Lending

The overall increase in 'overdue lending' / arrears is shown in the following graph – indexed against the growth in lending since 2010. (Note: the arrears data relates to all bank lending, not only individual / household and is based on balances, not number of borrowers).



This demonstrates that the lending institutions are facing significant levels of loan arrears and 'problem lending'. This suggests that the reversal in household lending in early-2015 may have resulted from some interaction of [i] capital pressures (reflecting the impact of the devaluation) and/or [ii] possible pressure on funding covenants in relation to arrears levels and/or [iii] profitability (as a result of the increased loan loss reserve requirements against arrears, rescheduled foreign currency loans, and 'impaired assets').

The trends in loan arrears in domestic and foreign currency loans are shown in the following graphs.



The following issues may be noted in relation to the above graph:

1. The above data is based upon total lending – including both corporate and household lending. The writer has been unable to obtain separate arrears data for these two segments.

2. However, as a broad indication and as a comparison with the overall average arrears of about 8%: if household arrears were currently at 15% (based on loan value), the level of corporate arrears would be about 4% (6% if household mortgages were excluded).

3. There was a gradual reduction in Manat loan arrears between 2012 and 2015. During this period, loan outstandings were increasing strongly (see above graph) and, therefore, the underlying trend is masked (by the strong growth in loan balances) whilst the incidence of loan arrears lags several months after the origination of the loan. The 'catch-up' of loan arrears in 2015 reflects, therefore, the colliding impacts of the 'lagged effect' of the recognition of loan arrears against the slow-down / reduction in lending and the financial impact of higher inflation on domestic household budgets and the impact of devaluation on foreign currency borrowers.

4. The sharp increase of arrears in 2016 probably reflects not only the 'colliding effects' (shown in 2 above) but also, the impact of the sharp increase in inflation (CPI and foodstuffs) will have impacted strongly upon households.

5. Household borrowers may, therefore, be considered to be impacted by a series of 'unexpected' adverse influences ("event risks") on their financial planning and budget management – leaving possibly many borrowers wondering 'what has happened', because most of the factors are outside their direct control, and possibly experience and/or understanding. *(The following is a series of inferences and interpretations by the writer)*:

    a. Reversal of lending strategy and availability of loans from lending institutions following several years of continuing availability and market expansion;

    b. Initial inflation impact of the first devaluation upon the domestic budget;

    c. Such 'first-phase' inflation being compounded, for some households, by the loan being denominated in a foreign currency and possibly a lack of awareness of the exchange rate risks which they faced;

    d. Against a continuing tightening of the availability of loans to households and inflationary pressures, domestic budgets come under increasing pressure;

    e. The second devaluation and strong inflationary hike impact upon an already pressured household segment.

Survey Observation:

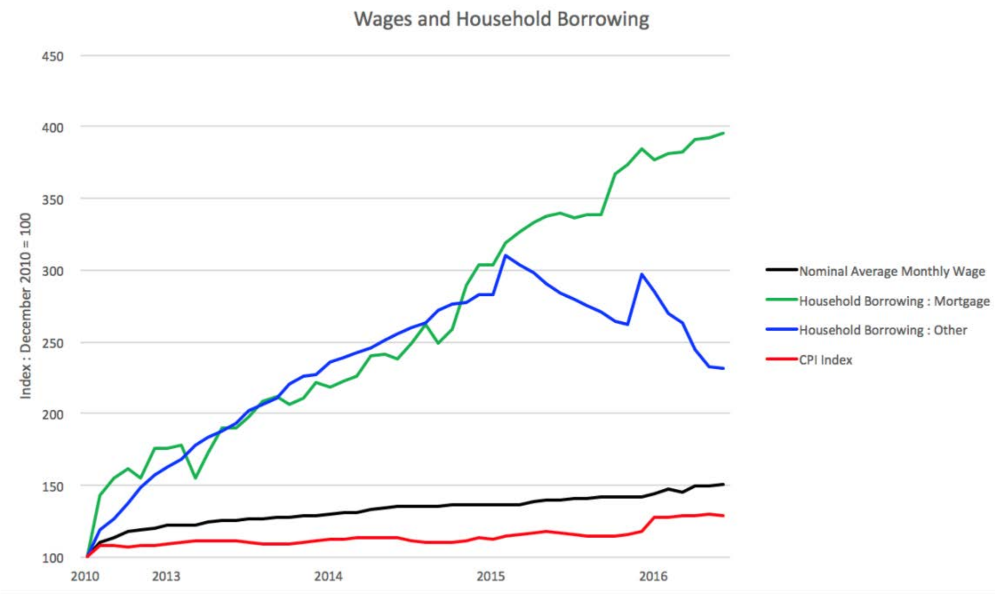
- *Loan arrears (based on number of borrowers, not loan value): 17% within which MFI 14% and bank 19%;*
- *Loan arrears balances represent 29% of total balances (based on individual borrowers in the survey);*
- *9% of borrowers have arrears with utility payments (MFI 7% and bank 11%);*
- *Arrears in foreign currency lending 59% in contrast to national currency loans of 8% (based on number of borrowers, not loan value).*

Borrowing in the Domestic Budget

There was an increasing level of debt within 'borrowing household' in the period 2010 - 2014. This identifies that those households with loans were accepting progressively higher levels of leverage. The earlier comments on inflation had suggested that, possibly, borrowers were becoming increasing sanguine / optimistic of the future and that this was based upon:

- An exchange rate value of the Manat which had been stable for several years;
- Relatively stable CPI price inflation and average wage increases which were slightly ahead of inflation;
- Access to an expanding lending market for both consumer expenditure and mortgage finance.

However, the growth in lending to households was considerably greater than the growth in wages or inflation. This is shown in the following graph.



This sustained increase in debt and leverage against wage levels represents the development of the structural risk exposure of the individual borrower segment. The expansion of the market by wider 'financial inclusion' would inevitably result in an increasing proportion of marginal credit quality borrowers. The survey will provide a basis to identify if the lending institutions now have a primary focus upon reducing exposure to those more 'credit marginal' individuals.

Survey Observation:

- *The average household income of never-borrowed and former borrowers is less than the incomes of current borrowers – (MFI current borrowers AZN 1,008 against 'never borrowed' AZN 950; Bank current borrowers AZN 1,016 against former borrowers AZN 941) .*

The ‘mirror-impact’ of the contrasting trends in household mortgage and ‘non-mortgage’ lending is clearly shown.

Data is not available to show the number of household borrowers for either mortgage or non-mortgage debt. It is not possible, therefore, to identify the extent to which the average debt per borrower changed during this period. However, the following issues may be noted:

1. The trends imply that there was a significant expansion of the availability of debt finance.

2. Such expansion will have led to increasing ‘financial inclusion’ of the more marginal risk clients.

3. The current contraction in the market is likely to focus more strongly upon the more marginal credit clients.

Attachment 4.

Risk Categorisation

An Outline of the Objective and Methodology.

An assessment of the financial capacities of microfinance clients should not be seen solely in relation to quantitative measures (such as arrears, or income ratios, or material assets) but may also be considered in conjunction with other more qualitative dimensions – because the client's propensity to repay is a combination of factors, both financial and attitudinal.

A basic segmentation may be undertaken, therefore, upon the quantitative assessment of debt affordability and the qualitative assessment of clients' sense of financial concern or vulnerability. This provides also some dimensions for the impact of 'financial inclusion'.

An evaluation of the financial concern / vulnerability can be established for each borrower from the responses to the various attitudinal questions, which can be compared with the level of expenditure (as a percentage of income) for that borrower.

In this assessment, the 'Vulnerability Score' is determined by the qualitative responses to the various questions in relation to the concern of the respondent about the debt, its impact and the intensity of the response. These are reflected as:

1. Low 'concern' score No responses which show difficulty;
2. Mid 'concern' score Limited range of responses which show difficulty;
3. High 'concern' score More frequent responses which show difficulty.

The range of questions / factors comprising the qualitative 'vulnerability / concern assessment comprise:

- Loan arrears;
- Utility arrears;
- Refinance of loan or refusal of a lender to approve a loan;
- Other 'informal' loans from family, retailer, employer or moneylender;
- Reduction in food expenditure or additional work to make loan repayments;
- Recognition that loan repayments are more than can be afforded;
- Adverse events in last six months affecting household earning capacity;
- Recognition that the borrower does not feel in control of financial situation;
- Recognition by the borrower that debt causes problems in the family;
- Recognition by the borrower that the financial position has not improved in the last six months.

The expenditure: income ratio is based upon the quantitative responses provided by the respective clients.

This enables the spread / scatter of individual client responses and positions to be plotted in the following matrix. The contrasting profiles of the client profiles in Baku and other regions is sharply displayed.

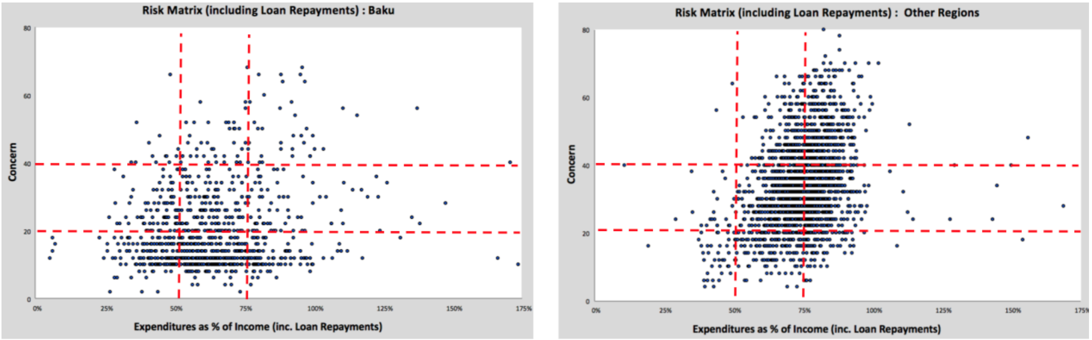


Chart: Expenditures include household and utilities, including loan repayments

This comparison shows a much stronger concentration of clients in regions outside Baku in relation to the higher levels of expenditure in relation to income – furthermore, the spread of the qualitative assessment of ‘concern’ is much widely spread amongst borrowers outside Baku.

This enables the creation of a matrix to provide some segmentation of the severity of risk amongst this group.

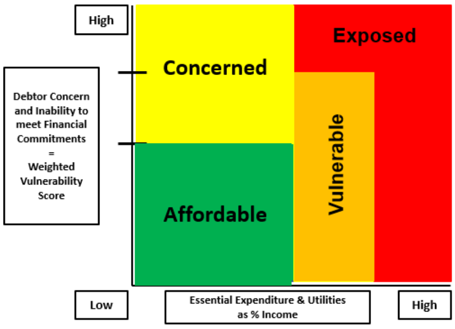


Chart 3. Client risk matrix

Such a matrix enables a broad differentiation between those clients who have possibly an unnecessarily high concerns for their repayment capacity / financial position but low expenditure commitments (these may be described as the “concerned” segments) in contrast to those with low levels of concern but whose financial position appears to be highly strained. The principle is to establish the interaction of both budget and attitude in the clients’ behaviour and for this to be reflected in the management of client portfolios.

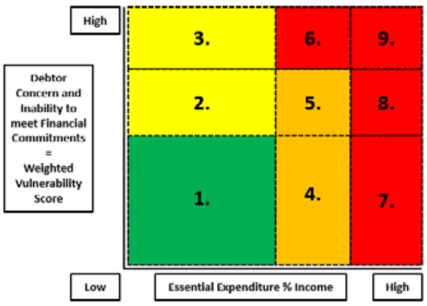


Chart 4. Segmentation of client risk and vulnerability

Such a distribution demonstrates that the management of the lending portfolios requires an understanding of the different client segments and that appropriate measures are available to address the differentiated needs and motivations of clients who are, or feel to be, experiencing financial and repayment pressures.

It is appropriate, therefore, to disaggregate the risk matrix (see charts 1 and 2 above) into different segments (charts 3 and 4 above) and identify the potential characteristics and risk management needs related to each.

The above analysis focuses upon the clients’ perception of concern / vulnerability in relation to their immediate budgetary cash flow pressures. Such segmentation of the varying attitudes towards risk and budgetary capacity will enable the establishment of a differentiated approach towards risk management and client development, and thereby more effective levels of client service and support – rather than the overly blunt mechanisms of an undifferentiated approach by the lending institution towards those clients with repayment difficulties or financial concerns.

The risk matrix provides, therefore, a broad segmentation of clients into a differentiated risk framework. This combines a range of factors and enables the traditional credit risk assessment of independent criteria to be complemented by a portfolio approach combining both quantitative and qualitative dimensions of the client.

Attachment 5.

Lending Institutions

The following comments are based upon desk-based internet searches of some lending institutions in Azerbaijan. Such comments are based upon a random selection of available web-pages in English. As such, these comments are simply indicative of institutional market positions. The extent to which these are widely-published to clients or adopted / implemented as the standards or policies of other / all institutions in the market is not known. For this reason, the respective institutions are not named.

Mission and Market Strategy

Institution A

- Mission
    - To build successful and long-term business relations with those in need through the provision of flexible and fast solutions;
    - Values
        - Ethics and honesty;
        - Professionalism and willingness to self-improve;
        - Politeness and tolerance;
        - Efficiency and smile.

Institution B

- Responsible Lending for Retail area of activity
    - To take into consideration existing opportunities and conditions in consumer lending;
    - Develop a sound loan portfolio through analysing indebtedness, financial personal liabilities and other parameters of borrowers;
    - Maintain Bank's financial sustainability;
    - Increase public trust in the Bank;
    - Prevent excessive indebtedness of Bank's clientele;
    - Develop responsibility and borrowing habits in the borrowers;
    - Increase financial education of the borrowers, and
    - Prevent factors causing deterioration of customer satisfaction in the future.
- In the event of negative decision [for loan applicants]
    - Reasons for rejection are explained to the borrower and, when possible, advice is provided to the customer on ways of eliminating such causes;
    - The Bank shall provide a clear and comprehensive written response to the applicant indicating reasons for rejection.

Institution C Loans for Entrepreneurs

- Loan decision and funds within 3 days of the application;
- No business plan is required. Simple procedures and minimal paperwork requirements;
- Application process;

- Work with a Credit Officer to prepare a simple two-page application;
- Credit Officer will visit business and home to collect data;
- Loan Officer will train on credit and managing cash flows;
- Credit Committee will evaluate loan application documents.

Pricing

Institution A

- Loan 1 Household needs;
  - Amount AZN 300 – 1,500;
  - Period 36 months;
  - Interest rate 27-28%;
  - Commission 1%;
  - Age range 21-70 years.

Institution D

- Loan 1 Group Villlage Loan;
  - Amount AZN 100-2,000 (can be taken in US$);
  - Period 3-18 months;
  - Interest 12.5-22.1%;
  - Commission 2%.
- Loan 2 Individual Business;
  - Amount AZN 100-3,000 (can be taken in US$);
  - Period 3-24 months;
  - Interest 12.5-22.7%;
  - Commission 2%.

Institution E

- Loan 1-3 Products for individual private customers

	New Customer, with no credit history	Holders of salary cards	Repeated customers
Amount	AZN 300 – 5,000	AZN 300 – 5,000	AZN 300 – 5,000
Term	Up to 24 months	Up to 24 months	Up to 12 months
Interest	30%	25 – 28.2%	30%
Fees	1%	1% (min AZN 20)	1% (min AZN 20)
Minimum income	No rule	No rule	No rule
Age	20-60 years	20-71 years	25-65 years
Registration	Baku: not a 'must'	Baku: not a 'must'	Baku: not a 'must'

- Loan 4 Mortgage
  - Amount Up to AZN 50,000 subject to 80% of market value and AZN only;
  - Period 3 – 25 years;

- Interest "Cannot exceed 8%";
- Collateral Acquired home or apartment;
- Market value Independent appraisal;
- Repayment Equal monthly – payment cannot exceed 70% of total monthly
- income of borrower(s);
- Insurance life and ability to work of borrower – and – property to be insured to an amount equalling amount of the loan;
- Age mortgage must be repaid by the time of the legal pension age of borrower.

Institution F

- Loan 1 Urgent credit line (to obtain cash at ATM);
  - Amount AZN 50-500;
  - Period credit line for 24 months;
  - Interest 29% pa applied on a daily basis to drawings of the credit line;
  - Commission 1% for a cash withdrawal;
  - Eligibility Salary or pension credited to account;
  - Employed in current job for at least 3 months – or – pensioner.
  - Age 18-70 years.

Survey Observation: Interim

- *Direct institution / client relationship is respectful – 91% agree;*
- *Industry ethics under extreme pressure:*
  - *Trustworthy 16% of borrowers agree;*
  - *Integrity 5% of borrowers agree.*

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