

MICROLOANS IN RUSSIA: HOW MUCH IS TOO MUCH?

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Today various financial pitfalls are inseparable part of our lives and there will always be a need for many of us to request a loan from someone. But as it's well-known, banks are tightening their credit policy, thus the number of people who can't get a bank loan is constantly growing. That's when one of the newest trends within financial institutions - so-called "microloans" appear.

1. What are microloans?

The financial innovation of microlending is generally considered to have originated with the Grameen Bank in Bangladesh. This bank was established by professor Muhammad Yunus who won the 2006 Nobel Peace Prize and gained worldwide recognition for his work in microfinance sphere. His first and now legendary microloan was given in 1976 for only \$27 of his own money. Later on he gave loans to poor people who had no collateral and he did it with trust and simple handshakes. By now Grameen Bank has disbursed more than \$8 billion in unsecured loans to people traditional banks ignore. But what is more important that Grameen Bank demonstrated that loans made to the working poor, if properly structured, had very high repayment rates and that the poor have the ability to pull themselves out of poverty.

Today the term "microloan" is a part of a wide financial products range called "microfinance". Nowadays total absorption of the world microfinance market is estimated at billions of dollars and demonstrates a steady tendency to grow. Microlending mechanism is extensively used now in the United States, Western Europe, Africa and Asia. The most prominent are Grameen Bank and Brac Bank in Bangladesh, Prodem in Bolivia, FINCA International and Provident Financial Group. But the fact is that the microloans specificity in African and Asian countries is basically different from the economic functions they perform in Europe and especially in our country. Let us make a distinction.

Historically, the goal of microfinance was the alleviation of poverty and we can clearly see that from the Grameen Bank experience. And so for developing countries microlending is a proven social tool letting poor people start or expand very small, self-sufficient businesses and as a result fighting poverty on a large scale. For example, a woman could borrow \$50 to start up embroidery or pottery business, or a snack cart or a stand selling cell phone cards, and through such petty entrepreneurship lift herself out of poverty.

But what role do microloans play in Russia?

2. The purpose of Russian microlending

Getting a microloan quickly and easily has become increasingly popular among Russians. According to the Russian legislation "microloan" is defined as a short-term loan aimed on thorough satisfaction of borrower's current needs. So the very matter of these "needs" represents a world of difference. There are two types of microloans: loans to businesses and loans to individuals.

1) Loans to businesses

This is an especially good source of finance for businesses that have never borrowed from a bank or simply do not comply with bank's strong requirements. Even though potential borrowers must have the same complete understanding of their market, capacity and competition, still the terms of getting a loan are much easier compared to the bank's requirements. For example business plans are not required here at all levels.

So this makes microloans a good financial arm for businesses.

2) Loans to individuals

But in the first place it's a natural person who resorts to the help of microloans. A determinative factor defining microloan borrowers is a middle or low level of income. Typically these people simply lack collateral, steady employment or have a bad credit history and take so-called "payday" loans to cover their urgent expenses.

A client only needs to produce a passport to obtain a loan in approximately 30 minutes, while traditional banks require a pile of documents confirming solvency and a waiting period of up to two days. You don't even have to give them a personal income statement; in rare instances a manager can make a call to your office, but often it's just a mere formality. So in fact the whole procedure of registration comes to signing a treaty, and now you can get your money.

In such a way easy access to much needed money is one of the key reasons for the growing popularity and relevance of microloans in Russia. The scheme is really simple: the company lends the borrower money for whatever their immediate need is, charges a fee, and then, by a specified date, the borrower pays the loan back in full plus interest. But if that were all that happened, it would be hard to see the whole ambiguity of this mechanism. So let us have a good look at this market.

3. Russian market of microlending

Microlending has existed in Russia for almost 15 years but it was not until 2011 that special legislation came into force. Federal Law No. 151-FZ on Microfinance and Microfinance Organizations introduces a legal framework for microfinance organizations giving microloans in Russia, and determines their rights and duties.

According to this law, microfinance organization (MFO) is a legal entity registered at the State Micro Finance Organizations List and qualified to: 1) give microloans up to 1 million rubles; 2) attract capital in the form of credits, loans, investments, membership fees and donations. Thus there are two main subjects in any microlending process and those are "micro-lenders" and "micro-borrowers".

Changes in legislation have increased the level of regulation of the microfinance market and as a result it provoked many of MFOs to come out of the shadows. MFOs reportedly disbursed loans of approximately 32 billion rubles to borrowers in 2011, representing a 34 percent increase from 2010. The 2011 increase also is attributed to the fact that not only public confidence in MFOs raised, but also investors confidence did, which manifested itself in accelerating the growth of raised investments.

And this market continues to demonstrate a striking growing tendency. At the beginning of the 2013 the total portfolio of microloans given was about 50 billion rubles. And the number of active MFOs is growing by leaps and bounds – according to the State Micro Finance Organizations List on March 19, 2013 there were 2882 such organizations. Why is it happening? Do they offer favorable conditions of finance lending? The thing is that the border between "justifiable" and "exploitative" conditions is really transparent here. And that is why.

MFOs offer microloans at very high interest rates. In 2011 an average annual interest rate for business loans was 31.4%. Now it is slowly coming down owing to increasing market competition and stands at 27%. But still it stays high since there are a lot of Business Financing Programs provided by banks offering an interest rate of 20% or even less.

But it's an individual loan that really is of a great interest to us.

An average microloan size for individuals is about 10000 – 15000 rubles with an average loan maturity of 15 days. And an average interest rate is 2% a day. Seems quite acceptable within the limits of 1-2 weeks, isn't it?

But what is the long-term outlook? It takes the form of outrageous 730% a year.

In case of delinquency the borrower would never be able to service such debt, whatever the original sum borrowed is. Of course the impact of market competition takes it's

time and now we can watch interest rates decreasing to 2.5-4% a week, but on the whole these numbers stay high. And is there any convincing reason for such an exorbitant interest rate? Actually, there is more than one.

In fact it is obvious that microloan lenders will charge higher interest rate than banks. That's because such exceptionally high interest rates charged from borrowers need to cover costs comprising four basic components:

- Cost of funds;
- Operating or processing costs;
- Cost of risk or loan losses;
- Net income, surplus or profit.

These loans are being disbursed without any credit enhancement and therefore the lender is automatically facing much higher total risks.

Among other things, every microfinance organization faces high rates of payment delays and non repayments. Banks' non repayments come to 5-10%, while at MFOs this figure wobbles within a range from 16% to 25% or even more. Since MFOs incur huge losses because of non repayments, their high interest rates are quite extenuated. Besides, there always is one conscientious client who pays the risks for a dozen of unfair.

But still, why would anyone resort to these MFOs when there are a lot of advantageous Consumer Credit offers proposed by banks?

In spite of everything there hardly is a competition between microfinance organizations and banks. They represent different business models and they attract different categories of lenders. It's remarkable to see that Russian microlending market continues to grow. But what is more noteworthy that this growth is provided merely with new clients attraction; MFOs do not entice away banks' client base.

Besides, according to statistics more than 80% of adult population in Russia have low income, so all these people are potential clients of MFOs. And they go to microfinance organizations and get a loan quite quickly and without much "runaround". That's when another question comes – maybe they shouldn't?

4. When is a microloan righteous?

So after all, when you want to get a loan, which option is the best: banks or microfinance organizations? It's important to realize that there's an appreciable difference between these two financial institutions, and microloans have got certain advantages that mark them out as worthy of consideration:

1. You need a little of time to get a loan. You don't have to wait for confirmation of your solvency and a treaty is being concluded within 30 minutes.

2. There are fewer constraints; you can get a loan if you're a student or a pensioner, if you've got a bad credit history or have no collateral.

3. Easy process of getting a loan: you just come and get your money. Moreover, now this service is widely spreading on the Internet which makes it more handy.

So in conclusion, getting a microloan may be considered as a solution of your urgent financial problems due to its availability and simplicity. But owing to the fact that this market is not mature enough and is still being shaped, there are a lot of unconscionable microlenders of the so-called "grey area" who only focus on profit making and completely disregard social impact of microfinance. In fact, many still operate outside of the legal framework. In the near future a tightened control over microfinance organizations is expected with the new law enacted by The Federal Treasury. These measures are going to help inform and protect Russian borrowers, as well as foster a more responsible and transparent microfinance sector in Russia. And till then one should keep his purse close to himself.