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GEORGIA: FINANCIAL SYSTEM STABILITY ASSESSMENT

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FINANCIAL SYSTEM STABILITY ASSESSMENT

December 2014

The **Financial System Stability Assessment** for Georgia, prepared by a staff team of the IMF for the Executive Board's consideration on October 31, 2014. This report is based on the work of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission to Georgia during May 20-June 3, 2014. The FSSA was completed in October 2014.

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GEORGIA

FINANCIAL SYSTEM STABILITY ASSESSMENT

October 31, 2014

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An IMF and World Bank team visited Georgia during May 20-June 3, 2014 to conduct an assessment under the Financial Sector Assessment Program (FSAP). The mission assessed banking sector stability, the regulatory and supervisory framework, crisis management and safety nets, corporate governance arrangements, and financial sector development, including capital market, insurance sector and access to finance.

The mission met with Georgi Kvirikashvili, Vice Prime Minister and Minister of Economy; Nodar Khaduri, Minister of Finance; Giorgi Kadagidze, Governor of the National Bank of Georgia (NBG); and Lasha Nikoladze, Head of the Insurance State Supervision Service of Georgia. The team also met with executives of local and foreign banks, as well as corporate and other private sector representatives.

The FSAP team comprised Elias Kazarian (Head, IMF), Aurora Ferrari (Head, World Bank), Hunter Monroe (Deputy, IMF), Fernando Montes-Negret (Deputy, World Bank), Ivan Guerra, Alessandro Gullo, Gösta Ljungman, and Azim Sadikov (all IMF); Laura Ard, Leyla Castillo, Luis Enriquez, Eugene Gurenko, Fredesvinda Montes, Marc Schrijver, and Lois Quinn (all World Bank); and Jaime Bowman, Michael Deasy, Maximilian Fandl, and Mindaugas Leika (experts).

FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

CONTENTS

BOXES

FIGURES

TABLES

ANNEX

APPENDIX

GLOSSARY

AML	Anti-Money Laundering
CAR	Capital Adequacy Ratio
CRS	Credit Reporting Systems
CSD	Central Securities Depository
DIS	Deposit Insurance Scheme
D-SIB	Domestic Systemically Important Bank
DSTI	Debt Service to Income
ELA	Emergency Liquidity Assistance
EU	European Union
FATF	Financial Action Task Force
FMS	Financial Monitoring Service of Georgia
FRMP	Financial Risks and Macro-Prudential Policy division
GCSD	Georgian Central Securities Depository
GFPAA	Georgian Federation of Professional Accountants and Auditors
GPSS	Georgian Payment and Settlement System
GRAPE	General Risk Assessment Program
GSE	Georgia Stock Exchange
GWP	Gross Written Premium
IFIs	International Financial Institutions
ILF	Intraday Liquidity Facility
LACB	Law of Georgia on Activities of Commercial Banks
LCR	Liquid Coverage Ratio
LEPL	Legal Entity of Public Law
LTD	Loan-to-Deposit Ratio
LTV	Loan-to-Value Ratio
ISSSG	Insurance State Supervision Service of Georgia
MFI	Microfinance Institution
MOE	Ministry of Economy
MOF	Ministry of Finance
NBFI	Nonbank Financial Institution
NBG	National Bank of Georgia
NPS	National Payments System
NPL	Nonperforming Loan
NSCG	National Securities Commission of Georgia
OCP	Open Currency Position
PSPS	Law on Payment Systems and Payment Services
RIP	Risk Identification Program
ROA (ROAA)	Return on (Average) Assets
ROE (ROAE)	Return on (Average) Equity
RRP	Recovery and Resolution Plan
SREP	Supervisory Review Evaluation Process
SSS	Securities Settlement System

EXECUTIVE SUMMARY

Georgia has weathered several shocks, but still faces a number of important risks. The economy has withstood well the conflict with Russia, the global financial crisis, and domestic political uncertainty. More recently, prospects appear to be improving in light of the peaceful democratic transition, the signature of the European Union (EU)-Georgia Association Agreement, falling sovereign rates, a falling domestic government yield curve, and the recent listing of the second largest commercial bank on the London Stock Exchange. Although the economy has recovered in 2014, the recent Russia-Ukraine conflict could weigh on the economy, credit growth has been rapid, and there remain structural vulnerabilities within the banking sector, including high levels of dollarization, short term liquidity, and highly concentrated banking sector.

Stress tests suggest that the banking system is resilient but still point to the need to strengthen capital and liquidity buffers. Banks could remain adequately capitalized even in the face of severe shocks, given high levels of profitability and conservative provisioning standards. Nonetheless, pockets of weakness were identified, and a further strengthening of capital buffers is warranted especially since foreign currency loans dominate the loan portfolios. Moreover, banks' reliance on short-term funding, including nonresident deposits, is another important source of vulnerability, and argues for steps to encourage a shift toward longer-term and domestic currency dominated funding.

Significant steps have been taken to strengthen banking regulation and supervision, which exhibit a very high degree of compliance with international standards. The NBG has introduced an advanced risk-based supervisory regime while maintaining a conservative approach aimed at detecting vulnerabilities at an early stage, and allocating supervisory resources in the most efficient and effective manner. Despite this noticeable progress across the supervisory spectrum, strengthening of the legal and regulatory framework is warranted, for instance, to introduce more explicit regulatory provisions rather than rely on the NBG's implicit broad powers.

The NBG should take measures to enhance banks' corporate governance. The NBG should, through the supervisory process, encourage banks' Boards to further discharge their oversight responsibilities by requiring them to play more of a lead role in developing the institution's risk appetite and conveying desired risk-taking parameters to management. The NBG should require that the Audit Committee be a subcommittee of the bank's Board of Directors.

The authorities have taken steps to improve the anti-money laundering (AML) law and to address weaknesses related to the Financial Monitoring Service (FMS). It will be important to ensure the operational independence and effectiveness of the FMS to address risks related to nonresident deposits and to strengthen compliance with the 2012 Financial Action Task Force (FATF) standard.

A number of macroprudential measures have been identified to further strengthen financial stability. The NBG's planned adoption of the Liquidity Coverage Ratio (LCR), the countercyclical capital buffer regime, and the capital surcharge for systemically important banks is welcome. Deploying further macroprudential instruments could address indirect FX risks, liquidity risk, and support dedollarization. The NBG should ensure that its systemic risk assessment and policy response are effectively communicated to relevant stakeholders and the general public, including by the publication of financial stability reports.

Significant enhancements are needed to strengthen the financial safety net and crisis preparedness and management framework. The authorities should revise the framework for emergency liquidity assistance (ELA) to mitigate the NBG's exposure to financial risks, introduce an effective bank resolution regime, and establish a deposit insurance scheme (DIS). Crisis management arrangements would benefit from the creation of a Financial Stability Council, the removal of impediments to possible government interventions in a crisis, and by facilitating cross-border cooperation between the NBG and foreign resolution agencies. Requirements for adequate recovery and resolution plans regarding systemically important banks should be enhanced.

Georgia's growth outlook depends on increasing investment and enhancing competitiveness and the financial sector needs to play a proactive role. Currently, the economy lacks sufficient stable and long-term private financing for investments required to enhance productivity, as the financial system is dominated by banks, the nonbank financial sector is underdeveloped, and capital markets are virtually nonexistent. A comprehensive financial sector development strategy to address constraints on SME financing, by encouraging private investment, strengthening the regulatory framework of the nonbank sector, reviving capital markets, and enhancing financial infrastructure. The insurance sector should be supported by introducing several compulsory classes of insurance (such as automotive insurance) and addressing deficiencies in the regulatory framework, including by the reintroduction of capital adequacy requirements.

Table 1. Georgia: Key Recommendations

Recommendations and Authority Responsible for Implementation	Priority	Timeframe[1]
Financial Sector Oversight		
Introduce more explicit regulatory provisions in areas highlighted in the BCP Assessment rather than rely on the NBG's broad powers (NBG).	High	Near term
Implement the definition of large exposures consistent with Basel standards (NBG).	High	Near term
Require Boards to take the lead in developing the banks' risk appetite and conveying desired risk-taking parameters to management (NBG).	High	Near term
Enhance the capacity of the Banking Supervision Department, including through recruitment, higher salaries, and specialized training (NBG).	Medium	Near term
Financial Stability		
Amend the NBG law to strengthen its macroprudential mandate (NBG).	High	Medium term
Implement the countercyclical capital buffer regime and the LCR of Basel III (NBG).	High	Near term
Implement the capital surcharge for systemically important banks (NBG).	High	Medium term
Employ macroprudential instruments to address indirect FX risks and support larization: (i) limit FX lending to unhedged borrowers; (ii) adjust liquidity regulations to provide stronger incentives for attracting local currency deposits; and (iii) promote stable long-term funding instruments, through more favorable treatment of FX CDs in reserve requirements (NBG).	High	Near term
Ensure that banks continue to build adequate capital buffers as long as foreign currency loans dominate the loan portfolios (NBG).	High	Near term
Develop a comprehensive framework for bottom-up stress testing by banks (NBG).	Medium	Medium term
Ensure systemic risk assessments and policy responses are effectively communicated, including by the regular publication of financial stability reports (NBG).	Medium	Near term
Crisis Management and Safety Nets		
Revise emergency liquidity assistance policy to mitigate the NBG's exposure to financial risk (NBG, (MOF).	High	Near term
Overhaul the bank resolution regime, by implementing effective resolution tools and reinforcing safeguards in the resolution process (NBG, MOF).	High	Near term
Introduce a deposit insurance scheme underpinned by features in line with international best practices (MOF, NBG).	High	Near term
Set up a Financial Stability Council, comprising the NBG, MOF, securities and insurance regulatory agencies, and relevant stakeholders (authorities).	Medium	Medium term
Enhance requirements for adequate recovery and resolution plans for systemically important banks (NBG).	Medium	Medium term
Financial Sector Development		
Develop a comprehensive financial sector development strategy, including revisiting existing government interventions to eliminate inefficiencies (MOF, MOE, and NBG).	High	Near term
Prepare a time-bound strategy for capital market development, including regulatory reform, institutional strengthening, and, possibly, establishing a market maker (MOF, MOE).	High	Near term
Designate and empower a capital market regulator for capital markets (MOF, MOE).	High	Medium term
Complete institutional reform of the insurance sector and strengthen the regulatory framework (MOF, MOE).	High	Medium term
Establish a regulatory framework for credit reporting to enhance the safety, efficiency, and protection of data privacy (MOF, MOE, and NBG).	Medium	Near term
Improve implementation of the secured transaction regime (MOE, MOJ).	Medium	Near term

[1] Near term: < 12 months; Medium term: 12 to 24 months.

MACROECONOMIC ENVIRONMENT AND FINANCIAL SECTOR STRUCTURE

A. Macroeconomic Setting and Outlook

1. **Georgia has passed through a stressful period**. The economy and the financial system, in particular, have experienced a number of shocks, including the conflict with Russia in 2008, the global financial crisis, political uncertainty during 2012–13, and regional tensions. However, the outlook has improved, and confidence has been bolstered by peaceful change in government, the Association Agreement with the European Union, and an improving sovereign yield curve.

2. **Following a slowdown in 2013, the growth outlook is positive, contingent upon a successful fiscal consolidation and structural reforms**. The economy is expected to grow strongly in 2014 at 5 percent, and maintain trend growth of 5 percent per year thereafter, on the assumption of strong investment and improving productivity. The latter will rely on the implementation of a number of structural reforms to improve human capital, promote competitiveness and exports, and facilitate labor moving from low-productivity subsistence farming to higher-productivity service and manufacturing sectors.

3. **Following a two-year period of exchange rate stability, the lari depreciated in late 2013**. Depreciation pressures had started to build up as the government drew down deposits to finance the resumption of capital spending. The NBG responded by selling about 15 percent of total reserves while also allowing the dollar exchange rate to depreciate by about 7 percent, although the lari has strengthened in 2014.

4. **Despite an overall positive outlook, there are several key macroeconomic vulnerabilities that would impact the financial sector:**

- **Current account deficits and low savings**. Persistent and relatively high current account deficits combined with low private savings force banks to continue relying on external funding.

- **Financial spillovers from geopolitical uncertainty**. Increased regional tension could increase investor uncertainty, choke off wholesale funding, and reduce nonresident deposits, leading to liquidity problems for Georgian banks.

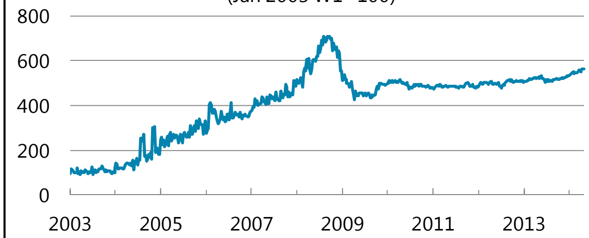
- **External spillovers on growth**. The sharp slowdown in growth in Russia and the recession in Ukraine could spill over into lower domestic growth through the trade and remittances channels, resulting in higher corporate NPLs.

- **Protracted domestic slow-down**. The restoration of sustainable growth in Georgia relies on maintaining macroeconomic stability, reducing fiscal and current account deficits, and successfully implementing a number of structural reform. Should these reforms be delayed, the economy could slow down, with the same effects as through an externally induced growth shock.

- **Sudden decline in asset prices**. As more than half of domestic private credit is backed by real estate, continued increases in real estate prices toward the pre-collapse level in 2008 could become a source of vulnerability.

Real Estate Prices (Offered)

(Jan 2003 W1=100)



Source: NBG

B. Financial Sector Structure

Commercial banks

5. **Although the banking system is small relative to the size of the economy, the two largest banks have an outsized role in the economy**. The system consists of 21 banks, including two branches of foreign banks with aggregate assets equivalent to 64 percent of GDP. The sector is highly concentrated with the two largest banks accounting for 58 percent of assets. In addition, these two banks own an insurance company, nonbank financial institutions, and a number of nonfinancial companies (some as a result of foreclosure). The banking sector consists primarily of foreign-owned banks,[2] and only three banks, representing 6 percent of banking sector assets, are domestically owned (Table 2). There are no state-owned banks. Banks dominate the financial system, given the underdeveloped nonbank financial sector and almost nonexistent capital markets.

6. **The banking system's assets are growing strongly**. Bank assets grew at a rate of 20 percent in 2013. Retail loans are now the largest and fastest growing segment, accounting for 42 percent of the portfolio, while corporate and SME loans account for 38 percent and 20 percent respectively.

Nonbank financial sector

7. **The size of the capital market is negligible.** In part, it was the result of legal amendments in 2007, which weakened securities market transparency, price discovery, and reporting requirements. Most corporate issuers increasingly have placed their debt internationally. Stock market capitalization amounted to 7 percent of GDP at end-2013, down from 13 percent at end-2007. There are 10 brokerage firms, one corporate securities depository, three registries, and one stock exchange.

[2] The three largest banks are foreign owned, but not by foreign banking institutions but rather institutional and individual investors and IFIs. Foreign banking institutions own only 11 smaller banks.

8. The insurance sector is small and characterized by weak financial performance, reflecting the lack of compulsory classes of insurance and government-mandated investments in hospitals. Despite an already very low market penetration rate in terms of premia per capita of €35, the market contracted in real terms by 10 percent in 2013. The market is characterized by high concentration, with the five largest companies controlling over 80 percent of the market. The financial fundamentals of the industry are very weak in spite of the presence of large foreign groups.

9. The other nonbank financial institution (NBFI) sector is underdeveloped. The sector includes 69 microfinance (MFI) institutions, 17 credit unions, and five leasing companies. The sector's assets are equivalent to 3¼ percent of GDP, up from ½ percent in 2008, with MFIs playing the dominant role. The NBG has acted to limit the operation of unregulated financial service providers who borrow from individuals and issue fast loans by introducing a new category of financial institutions.

Table 2. Georgia: Structure of the Financial System, 2010–13

(Assets in billions of GEL)

	2010		2011		2012		2013	
	Assets	Number	Assets	Number	Assets	Number	Assets	Number
Total Banking System	**10.6**	**19**	**12.7**	**19**	**14.4**	**19**	**17.3**	**21**
Foreign Controlled	10.2	15	12.2	16	13.8	16	16.3	18
o.w. Branches	0.0	2	0.0	2	0.1	3	0.1	2
Local Banks	0.3	4	0.4	3	0.6	3	0.9	3
Branches		119		144		142		164
Service Centers		522		564		691		739
Total Non-Bank Financial	**0.3**	**1694**	**0.5**	**1605**	**0.7**	**1114**	**0.9**	**1181**
Credit Unions	0.0	18	0.0	18	0.0	18	0.0	17
Microfinance Organizations	0.3	49	0.4	62	0.7	62	0.8	69
Exchange Bureaus	0.0	1626	0.0	1521	0.0	1030	0.0	1089
Stock Exchanges	0.0	1	0.0	1	0.0	1	0.0	1
Active leasing companies	0.0	0	0.0	3	0.1	3	0.1	5
Insurance Companies		**16**	**0.5**	**15**	**0.6**	**15**	**0.5**	**14**
Pension Funds		**6**		**7**		**6**		**5**
Total Financial System	**10.9**	**1,735**	**13.7**	**1,646**	**15.7**	**1,154**	**18.7**	**1,221**

Source: National Bank of Georgia

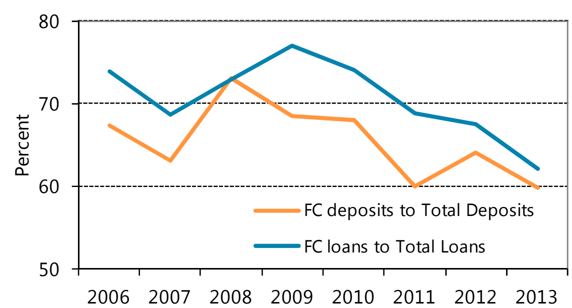
FINANCIAL STABILITY

A. Risks and Vulnerabilities

10. The banking sector is well capitalized, although there are pockets of weakness. In particular, banks report a capital adequacy ratio (CAR) of 17 percent (13 percent for Tier 1 capital) at end-2013 (Table 3). However, there is substantial variation across banks, with several near the 12 percent minimum.

11. Dollarization of the banking system is a challenge. Roughly 60 percent of deposits and loans are in foreign currency, down from around 75 percent in 2008–09. Over 90 percent of foreign currency borrowers rely on income in local currency and are unhedged against lari depreciation. This is a concern, given past episodes of significant depreciation, and Georgia is vulnerable to external shocks as described above. Dollarization also complicates crisis management, as banks will not have access to central bank liquidity in foreign currency (see the discussion below).

Loan and Deposit Dollarization



Source: NBG

12. It would be prudent for banks to reduce their reliance on short-term funding. While the share of wholesale funding has been declining since 2008, when IFIs stepped in to provide equity and financing, this decline has been offset by steady growth in nonresident deposits, which introduce new risks that could be exacerbated by external factors. About 15 percent and 25 percent of bank funding came from nonresident deposits and wholesale funding, respectively, as of end-2013 (see Box 1 and associated charts). Maturity mismatches in banks' balance sheets add another element of uncertainty. Nearly 60 percent of bank deposits have residual maturities of one month or less. The risk of deposit runoff in the event of a financial distress is exacerbated by the lack of adequate safety nets, including a deposit guarantee scheme.

Table 3. Georgia: Financial Soundness Indicators, 2010–13

	2010 Dec.	2011 Dec.	2012 Dec.	2013 Dec.
Asset Quality				
Nonperforming loans (in percent of total loans) 1/	12.5	8.6	9.3	7.5
Nonperforming loans (in percent of total loans) 2/	5.4	4.6	3.7	3.1
Loans collateralized by real estate (in percent of total loans)	47.5	53.4	50.6	52.5
Loans in foreign exchange (in percent of total loans)	74.0	68.8	67.5	62.1
Specific provisions (in percent of total loans)	6.5	4.6	4.6	3.8
Net foreign assets (in percent of total assets)	-8.2	-13.7	-19.7	-17.4
Credit-to-GDP ratio (in percent)	29.9	31.7	33.2	38.0
Profitability				
Net Interest Margin	6.3	6.3	5.9	6.3
Efficiency	45.0	47.8	41.3	42.1
Return on average assets (ROAA)	1.7	2.8	1.0	2.5
Return on average equity (ROAE) 3/	9.6	17.3	5.8	14.6
Liquidity and Funding				
Liquidity ratio (in percent) 4/	38.7	37.3	39.8	41.8
Deposit dollarization (residents and non-residents, in percent)	68.6	63.3	66.0	63.6
Deposit dollarization (residents, in percent)	65.0	58.6	60.4	57.8
Loan-to-deposit ratio (in percent)	107.6	105.3	106.7	102.9
Loans to resident deposits	126.4	129.9	134.7	129.0
Net open foreign exchange position (in percent of regulatory capital)	8.1	5.9	3.3	2.1
Borrowed funds from abroad-to-GDP ratio 5/	12.2	9.4	11.4	11.1
Capital				
Capital adequacy ratio (in percent) 6/	17.4	17.1	17.0	17.2
Capital adequacy ratio (in percent) 7/	23.6	25.6	25.3	25.2
Tier 1 Capital Ratio	13.7	11.3	13.4	13.0
Financial Leverage (times)	5.9	6.0	6.0	6.0

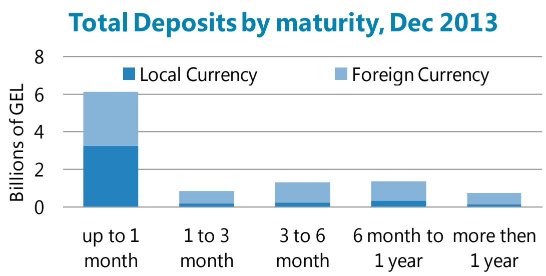
Sources: National Bank of Georgia; and IMF staff estimates.

1/ National definition: NPLs are defined as loans in substandard, doubtful, and loss loan categories.
2/ Standard 90-day overdue definition.
3/ After tax
4/ Ratio of liquid assets to all deposits plus other liabilities with 6-month and shorter maturity.
5/ Borrowed funds include subordinated debt.
6/ National definition. Risk weight to forex loans was reduced from 200 to 175 percent in September 2008, and to 150 percent in August 2009, and raised to 175 percent in January 2011.
7/ Basel I definition.

13. High concentration in the banking sector creates challenges, including for financial stability. The two largest banks account for 60 percent of banking assets. Their size brings scale benefits, greater risk diversification that helps sustain profitability, and access to international financing at an advantageous funding cost; but, if one of these banks were to fail, the impact on the financial system would be potentially substantial. While the shallow interbank market limits possible spillovers among Georgian banks, the two banks are those most widely connected with smaller banks. These banks' nonfinancial investments and large accumulation of foreclosed assets give them an outsized role in the economy. The banks are too big to fail and would be difficult to resolve in case of crisis. A third bank can be considered systemically important as well, due to its central role in government payments via an extensive branch network. To this end, special risk-mitigation arrangements, including more intensive supervision, higher loss absorbency, and robust recovery and resolution plans.

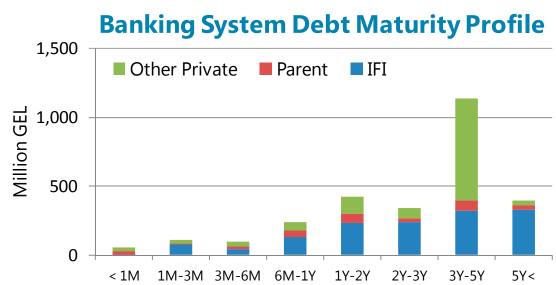
Figure 1. Georgia: Commercial Bank Liquidity and Funding

Deposits are mostly of maturity of one month or less.



Source: NBG

There is a significant bunching of maturities in the 3–5 year range.



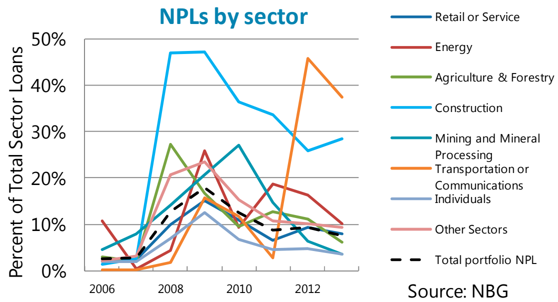
Source: NBG

14. Profitability has been strong, but volatile. Profits have recovered from a sharp fall in 2012, which was due largely to higher loan-impairment charges driven, in part, by problems at specific banks. Bank returns on equity reached close to 15 percent in 2013, a high level compared to regional peers, and benefited from high net interest margins, strong loan growth, and increased efficiencies.

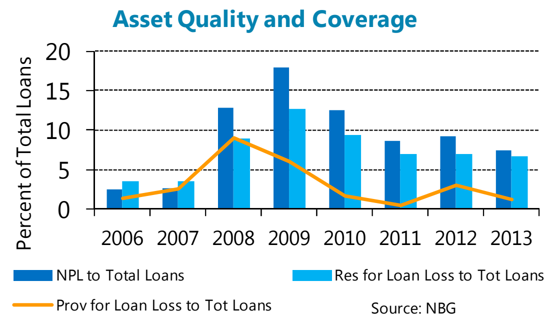
15. NPLs, which are defined conservatively by the NBG, have been decreasing, but are still elevated for local banks. They fell from about 18 percent following the crisis in 2009 to 8 percent in 2013 (or slightly above 3 percent according to the standard 90-day definition), although three banks exhibited NPLs of 20 percent or higher (Figure 2). The decline in NPLs was a result of strong credit growth, write-offs, and loan restructuring. Loan-loss reserves now cover about 90 percent of NPLs, but yearly provisions are diminishing. Collateral is readily executed, but restructured loans and foreclosed assets remain quite significant at some banks. Within the banking system, NPLs are highest in the local banks and in foreign currency loans.

Figure 2. Georgia: Commercial Bank Asset Quality

NPLs are disproportionately high in the transport and communications and construction sectors.

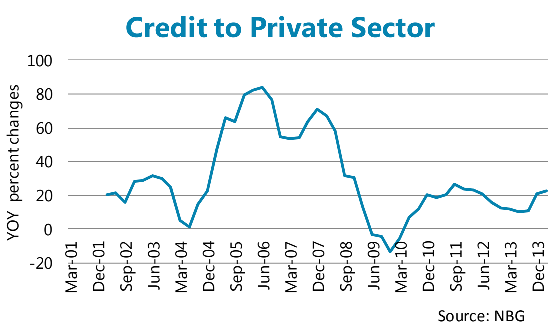


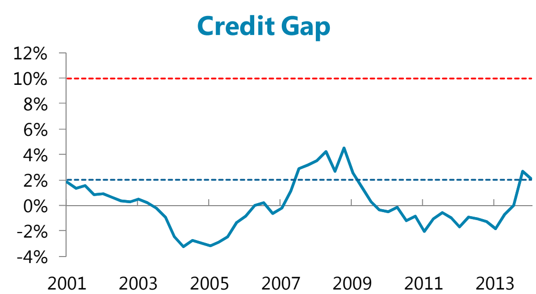
Overall, NPLs have dropped and are well covered.



16. **Rapid credit growth represents a further vulnerability**. The credit-to-GDP gap, which compares credit growth to its trend, suggests a risk of overheating—but not to the extent seen before the 2008 conflict with Russia, when real estate prices were increasing rapidly (Figure 3). Roughly, 50 percent of all loans are secured by real estate, while a similar share of retail lending is secured. The rapid growth in consumer credit has been focused in more risky products (consumer loans, credit cards, and fast installments). Lending to corporate customers has also grown rapidly but far from alarming. Nevertheless, credit growth should closely be monitored, both in terms of supervisory oversight of bank lending standards and with a view to a possible macroprudential response.[3]

Figure 3. Georgia: Credit to the private sector and Credit-to-GDP Gap





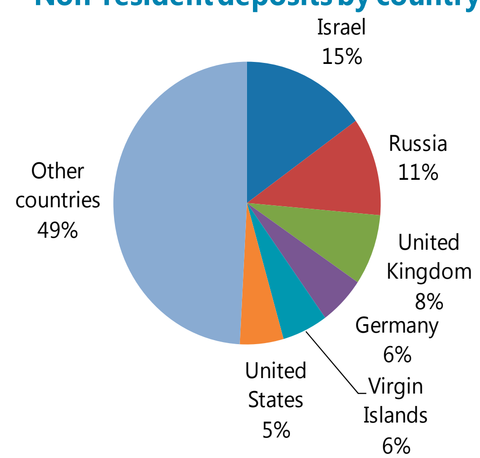
[3] The Basel Committee on Banking Supervision recommends that countercyclical capital buffers kick in at a credit gap threshold of 2 percent and reach their maximum at a threshold of 10 percent, parameters that are based on historical banking crises.

Box 1. Nonresident Deposits in Georgian Banks

The surge in nonresident deposits creates funding risks and does not support the authorities' "larization" strategy. Nonresident deposits grew rapidly after the 2008/09 crisis and accounted for GEL 1.5 billion or 15 percent of customer deposits as of April 2014, concentrated mainly in large banks. The depositors are located mostly in Israel, Russia, and the United Kingdom, of which about two-thirds are individuals (many of Georgian origin), with an average deposit of more than US$500,000. The collection of nonresident deposits is carried out by foreign representative offices of the two largest banks. Overall, the associated funding risks are high, given that those deposits are largely short-term (59 percent of them have residual maturities of less than three months) and denominated in foreign currency (92 percent). While recognizing that some longer-term nonresident deposits may reduce banks' duration gaps, the overall business strategy of attracting foreign currency deposits abroad also raises doubts on the country's larization efforts.

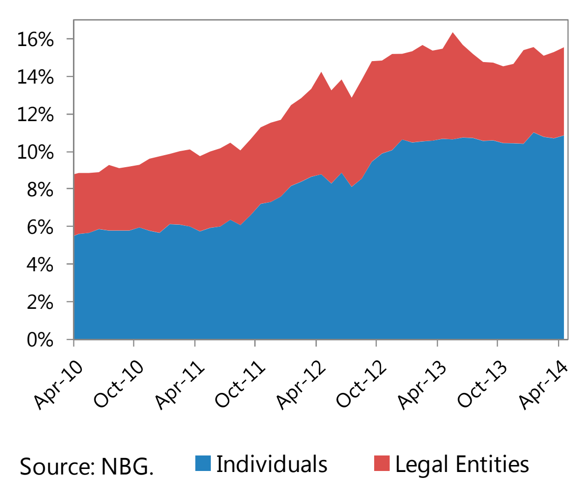
Since early 2013, the growth of nonresident deposits has slowed, due partly to the NBG's policy response. Since 2013, banks have had to hold more liquidity for nonresident deposits if they exceed 10 percent of total deposits. In addition, higher run-off rates for short-term deposits are applied in the LCR calculation, which is expected to become binding in September 2014, and will provide additional incentive for banks to move into higher maturities in their deposit-gathering activities, including by the issuance of FX certificates of deposit (CDs) with longer maturity, which now account for 20 percent of nonresident deposits. Despite these developments, the sustained reliance on nonresident deposits creates the potential for capital flow reversals in crisis situations.

Non-resident deposits by country



Source: NBG.

Non-resident share in total deposits



Source: NBG.

Box 2. How Did the Banking Sector Cope with the 2008 Dual Shocks?

The dual shocks—first, the August 2008 conflict with Russia and, subsequently, the global financial crisis—exposed vulnerabilities that had built up in the banking sector (Figure 4). In the years preceding the crisis, banks expanded loans aggressively, especially in construction, mortgages, and consumer loans; and about half were collateralized by real estate, the price of which rose quickly. Banks also exposed themselves to indirect FX risk by lending in foreign currency to unhedged borrowers. To finance this excessive credit growth, banks relied increasingly on external wholesale funding.

The immediate impact of the shock was liquidity pressure on the banking system. The loss of confidence triggered sizeable deposit outflows (about 13 percent in August 2008), which were largely converted to FX cash holdings, putting pressure on central bank reserves. Interbank lending virtually dried up. Banks also faced large external liabilities and risks so that early repayments clauses, which were attached to some outstanding external loans, may be activated.

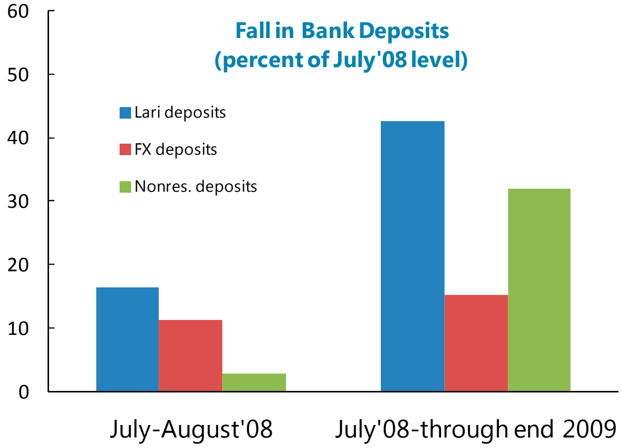
The shock tested the authorities' preparedness to handle a systemic liquidity crisis. In the early days of the crisis, the NBG declared a one-day bank holiday, and the market experienced a temporary shortage of dollar banknotes. It provided liquidity to banks by waiving reserve requirements and granting uncollateralized loans, though this exacerbated pressures in the foreign exchange market, as banks built precautionary balances to cover external repayment obligations, which, in 2009, amounted to US$700 million (14 percent of liabilities). Large lending and equity injections by IFIs and credits from parents of foreign-owned banks helped banks meet their external obligations.

Subsequent depreciation of the lari, contraction in the economy, and the bursting of the real estate bubble led to a sharp deterioration of the loan portfolio. At first, the NBG pegged the exchange rate, accommodating the sudden reversal in capital flows and large currency conversions through interventions. Eventually, it was forced to let the lari depreciate in November 2008 (by 16 percent), while the economy contracted by 4 percent and real estate prices fell by about 25 percent in 2009. As a result, NPLs jumped to 19 percent of total loans by mid-2009 (from 3 percent in early 2008) and bank profitability fell, weighed down by the need for greater loan-loss provisioning, higher funding costs, and lost interest income.

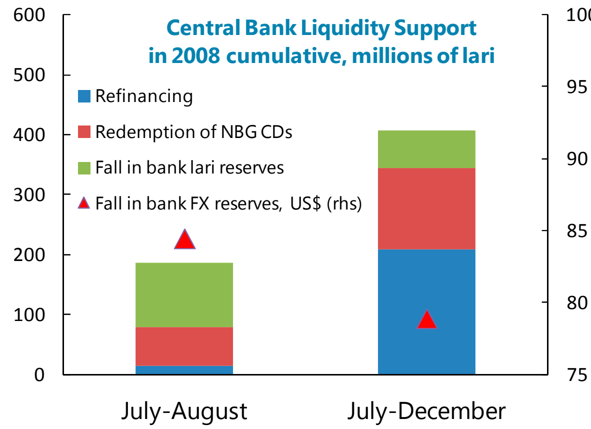
The banking sector weathered the crisis relatively well, helped by the authorities' skillful management and support from IFIs and parents. The cyclical recovery in 2010–11 led to a drop in NPLs and recovery in banks' profitability. Still, the underlying vulnerabilities—large FX lending and dependence on external financing—including nonresident deposits—remain. Some banks still hold assets, mostly real estate, repossessed during the crisis.

Figure 4. Georgia: The 2008 Dual Shocks and the Banking Sector

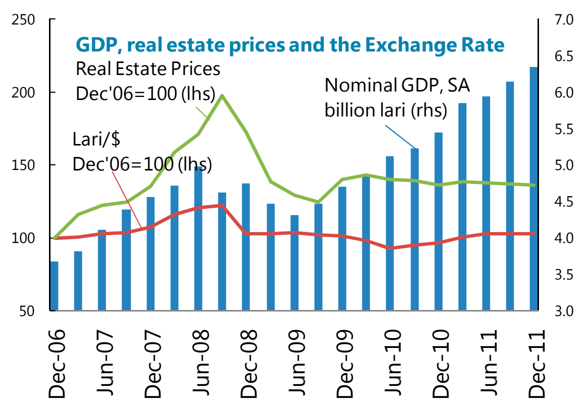
Loss of confidence from the external shocks in 2008 and domestic tensions in early 2009 triggered large deposit outflows...



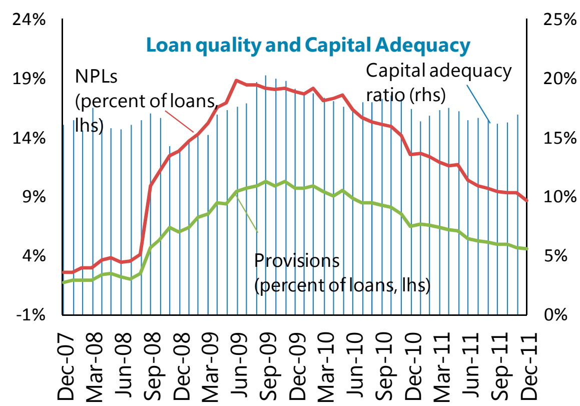
...but the NBG stepped in, providing liquidity support to banks through refinancing, redemption of CDs, and lower reserves requirements



The shock also led to output decline, bursting of the real estate bubble, and lari depreciation...



...eroding loan quality and bank profits, but bank performance started to turn around in 2010 with the cyclical recovery.



B. Banking Sector Resilience[4]

Overview and scenarios

17. **Stress tests (STs) covered all banks, while the nonbank sector was excluded due to its small size**. Banks' resilience was assessed against adverse scenarios, taking into account credit, market, and concentration risks, as well as liquidity risks. Contagion risks were estimated

[4] For more details, see the Technical Note on Stress Testing.

by using a simplified network-contagion approach. For solvency STs, three approaches were used: bottom-up by banks, top-down by the NBG, and top-down by the FSAP team. Baseline, mild, and extreme scenarios were considered (see Appendix I for ST methodologies), and while scenarios were the same for top-down approaches,[5] different modeling techniques and models were applied.

18. Banks as a whole appear able to withstand even severe shocks, but pockets of weakness are evident (Figure 5). Capital adequacy was assessed against the current regulatory thresholds, namely 12 percent of minimum total CAR and 8 percent of Tier I capital. It was also assumed that, following transition to Basel II Tier I, the CAR minimum will increase in 2015 to 8.5 percent.

- In the baseline scenario, the system's Tier I capital would increase by 3 percentage points to 11 percentage points, up to a range of 16–24 percent. This reflects the high level of profitability, capital buffers, moderate credit growth, and declining levels of NPLs.

- In the two adverse scenarios, banking system resilience is very unevenly distributed: aggregated, system-wide results mask vulnerabilities of some banks. Even in a mild shock scenario, four banks would need additional capital close to GEL 120 million (0.4 percent of GDP) to meet their minimum CAR.

- The extreme shock scenario reveals vulnerabilities related to indirect foreign exchange shock-related credit risks,[6] as well as a decline in profitability. Several banks would not meet the minimum Tier I CAR and total recapitalization needs would be about GEL 600 million (1.7 percent of GDP). Against this background, it should be noted that lowering risk weights for all loans from the current level, after the introduction of Basel II (or as a countercyclical measure during the crisis period), will effectively relax capital requirements and the recapitalization needs would be reduced to about GEL 400 million under the extreme scenario.

- Credit portfolio concentration risks are limited: default by the largest three borrowers would require additional capital of GEL 50 million for five banks.

- Results of single factor sensitivity tests for direct interest and exchange rate risks do not reveal significant losses to the banking system. Banks' exposure to market risks is limited as their net open position in foreign currencies is small, and almost all debt securities are held to maturity.

[5] Bottom-up stress tests were conducted using a two-year scenario.

[6] Indirect FX risk was captured via decline in GDP. It was assumed, that decline in GDP leads to GEL depreciation and increase in NPLs.

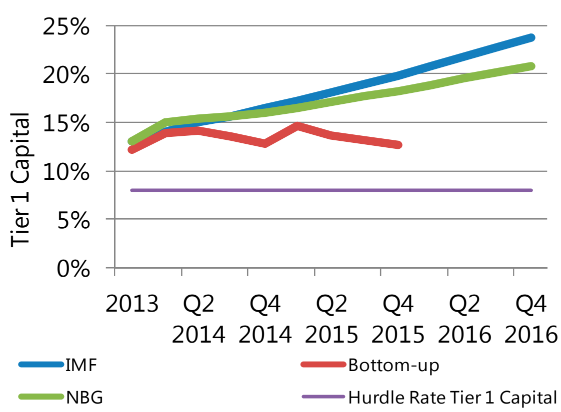
19. Differences in profitability assumptions among ST approaches are reflected in CAR evolution (Figure 5). The IMF top-down ST incorporates more severe assumptions about the decline in banks' profitability after a shock. These assumptions are based on the downward trend in lending margins and the assumed rigidity of operational expenses during one- and two-year horizons. Based on limited ST experience of banks and the inability to fully trace losses and income assumptions, bottom-up results are of limited use even were the scenarios for bottom-up ST the same as for top-down ST. While the FSAP team asked for a detailed breakdown of results, they do not fully reveal why banks are very optimistic about their income before loan-loss provisions.

Liquidity risk

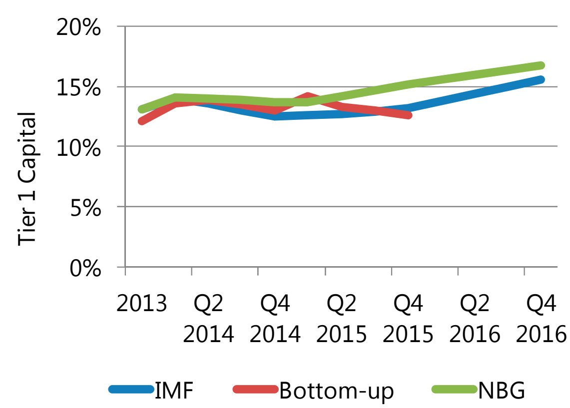
20. While banks can withstand relatively high liquidity shocks, some of them would have difficulty in maintaining positive cash flows in foreign currencies. The most severe impact comes from the withdrawal of wholesale and retail funding in foreign currency; one systemically important bank and several small banks need additional liquidity support. The exercise suggests that foreign currency funding risks need to be monitored closely.

Figure 5. Georgia: Comparing Stress Test Results

Baseline scenario

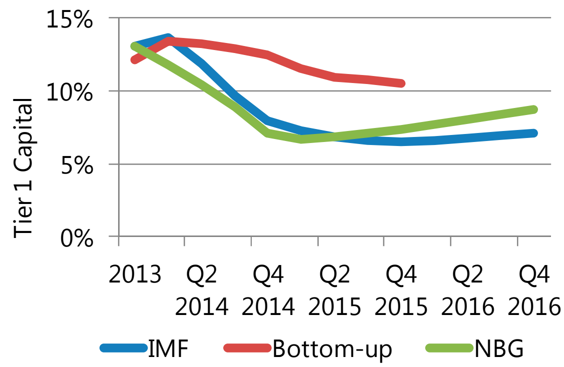


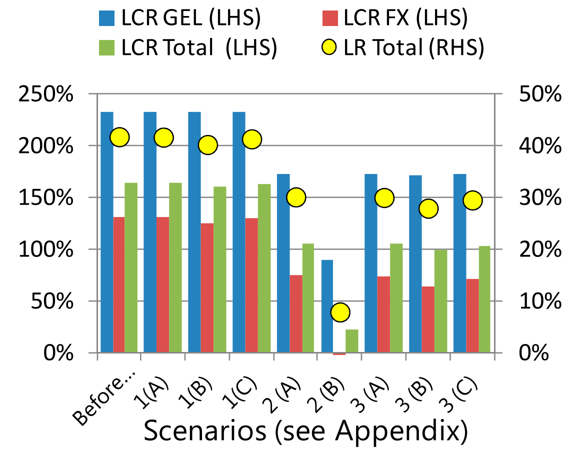
Mild shock scenario



Extreme shock scenario

Liquidity Stress Test Results: LCR and LR





Contagion risk

21. The direct contagion risk is relatively low, due to the shallow interbank market. Since the exposures to other countries and foreign financial institutions are relatively limited, the impact of a hypothetical shock from foreign financial markets on Georgian banks is low. Interbank market ST revealed that (a) four small banks might not be able to meet their minimum CAR if one of the systemically important banks were to fail; and (b) there is little balance sheet contagion effect between systemically important banks. In one case, single counterparty risk for a small bank exceeds 100 percent of its regulatory capital. While the probability of default for systemically important banks is low, some of the smaller banks need to improve their risk management practices and limit their exposure to a single counterparty (as a percentage of their own capital). There remains a risk for contagion through the behavior of depositors: in 2008, a loss of confidence in the banking system led to almost 13 percent deposit withdrawal.

C. Mitigation of Key Risks

22. The stress tests reveal several weaknesses in the banking system. While most of the banks maintain healthy capital buffers above regulatory minimum, some banks have capital of only a few percentage points above the minimum regulatory level, which limits their loss-absorption capacity. These banks especially are vulnerable to credit risk stemming from a decline in economic activity, depreciation of the lari, and wholesale funding risk in foreign currency. The high level of profitability and solid net interest margins would go down during crisis periods, driving down net interest and other income, similar to what was assumed in stress-testing scenarios.

23. The NBG should continue to reduce dollarization through a range of measures. In 2013, the NBG encouraged lari lending by accepting, for a period, floating rate mortgages as collateral, which increased lari-based lending. Furthermore, the NBG imposes higher risk weights on foreign currency loans and maintains higher reserve requirements on banks' foreign currency deposits. Nevertheless, it is important that NBG should continue to rely on macroprudential measures as discussed below and to build up capital buffers (for example, by limiting banks' ability to pay out dividends to shareholders) as long as foreign exchange loans are dominating their loan portfolios.

24. To address liquidity risks, the NBG introduced new prudential requirements, although additional measures should be considered. Recognizing the risks associated with nonresident deposits and to stem their growth, the NBG introduced a new liquidity requirement whereby banks were required to hold more than the standard level of liquidity (30 percent), if their nonresident deposits exceeded 10 percent of their total deposits. The mission encourages the NBG to address funding concentration through the LCR and other types of measures such currency-by-currency limits, by assuming different runoff rates on deposits depending on withdrawability, owner, maturity, and currency. These issues are discussed further in the macroprudential section below.

FINANCIAL SECTOR OVERSIGHT AND GOVERNANCE

A. Commercial Banking

Regulation and supervision

25. The NBG is responsible for the regulation and supervision of banks, the securities market, MFIs, and credit unions, while responsibility for insurance was transferred to a separate agency in April 2013. The Organic Law of Georgia on the National Bank of Georgia and the Law of Georgia on Activities of Commercial Banks provide legal framework for the supervisory regime.

26. There have been significant improvements in both the quality of regulation and the supervisory approach since the 2007 FSAP (Table 6). The NBG has strengthened effective supervision, including by strengthening banking supervisors' capacity, powers, and legal protections, and provided for the sharing of information across financial sectors. Many amendments to existing laws, new laws, and regulations have been introduced, to address shortfalls. These defined a "beneficial owner" and "significant share" in commercial banks, increased details required by applicants for bank licenses, strengthened the sanctioning and enforcement regime, enhanced consolidated supervision and AML requirements, and enhanced bank governance and the governance structure of the NBG.

27. Nevertheless, there are a number of instances where detailed rules are lacking. The BCP assessment suggests areas where a more precise set of powers would be beneficial to provide clearer expectations to supervised institutions while avoiding the potential for excessive discretion and regulatory uncertainty.[7]

28. The NBG maintains a conservative interpretation of international principles and standards. The minimum capital adequacy requirement of 12 percent is relatively high, and the NBG tightly restricts investments by banks. The NBG's current regulatory work focuses on the ongoing implementation of Basel II and III. Banks are required to undertake the International Capital Adequacy Assessment Process (ICAAP) by September 30, 2014.

29. The NBG employs an advanced, risk-based approach to supervision. This balances the use of bank supervisors responsible for a given bank's risks and specialist risk supervisors responsible for a given risk across banks, including systemic risk. The NBG's powerful supervisory information system enables supervisors to conduct "online" supervision and rigorous data analysis off-site.

The assessments have identified a number of areas for improvement which merit attention, especially in light of the vulnerabilities identified above:

- *Operational risk within the NBG's Supervision Department*. In order to retain and recruit appropriate staff, the NBG should review its salary levels and increase its training budget, including for specialist training. There has been a very high level of staff turnover during the past three years, particularly among specialists, and there also is an over-reliance on key personnel.

- *Licensing*. When licensing banks, the NBG relies on its broad powers to achieve its objectives, but there are a number of significant gaps in licensing criteria. For example, the NBG approval for appointments to the Supervisory Board, Directors, and top management, as well as for their replacements, is not required directly by legislation. There is no legal requirement for the NBG to assess whether the home supervisor practices global consolidated supervision and/or whether its supervision is equivalent to that of the NBG. Several explicit provisions have been introduced in this area subsequent to the mission.

- *Acquisitions*. The definition of "significant," as in shareholders, does not refer to shareholders acting in concert and there is no requirement to notify the NBG when an existing shareholder proposes to dispose of his/her significant shareholdings.

- *Risk management*. The NBG puts significant effort into understanding the risk profile of each individual bank and the banking system as a whole. However, more attention is

[7] For more detailed, see Annex I, Report on the Observance of Standards and Codes—Summary Assessments, and the Detailed Assessment Report of the Observance of Basel Core Principles for Effective Banking Supervision.

needed to improve the quality of risk management of the banks, which starts with banks articulating their risk appetite.

- *Home/host relationships*. While no Georgian bank has a material cross-border operation, the NBG's policy is to seek to establish MOUs with the relevant jurisdictions, and it has done so with most of them.

- *Regulatory supervisory fees.* The authorities should consider charging for regulation and supervision, as in many other jurisdictions.

Commercial bank corporate governance

30. Corporate governance in the banking system has progressed well, particularly in the largest banks, but more could be done. Strong NBG leadership, the migration to Basel II/III, and the requirement for banks to adopt an ICAAP process have provided impetus to upgrade banks' governance. Also, the listings on the London Stock Exchange of the two largest banks have contributed to a higher level of governance practices. The Boards of the largest banks have well-defined roles and responsibilities, but need to provide strategic guidance on the bank's aggregate risk profile. The function of Audit Committees should be enhanced by making them direct subcommittees of the Supervisory Boards. The NBG should, through the supervisory process, encourage Boards to further discharge their oversight responsibilities by elevating the focus on defining their bank's risk appetite and further formalizing the role of the Credit Risk Officer.

B. Capital Markets

31. Regulation of the securities market needs to strengthen transparency, price discovery mechanisms, and reporting requirements. The NBG is currently the regulator and supervisor of the securities market. In the absence of a vibrant capital market with investable corporate securities and institutions, current supervisory practices focus mainly on the licensing of participants and monitoring compliance with reporting requirements. Challenges going forward include enhancing and aligning regulation and supervision to meet commitments under the EU Association Agreement.

C. Insurance

32. The insurance sector oversight has been weak and requires a major overhaul. In May 2013, the responsibility for insurance supervision was moved out of the NBG to a newly formed independent agency, the Insurance State Supervision Service of Georgia (ISSSG). The regulatory framework is incomplete and severely deficient. Since it was repealed in 2010, no general solvency margin regulation has been in force. Although insurers and reinsurers are required to establish main classes of reserves, there is no regulatory requirement for an actuarial review of reserves adequacy. There is no regulatory stipulation of maximum or minimum risk retention in any class of business except surety, which has resulted in very limited reinsurance coverage of the local market.

D. Anti-Money Laundering and Combating the Financing of Terrorism

33. The 2012 AML/CFT detailed assessment report identified a number of weaknesses, including the lack of transparency of legal persons and deficiencies in the customer due diligence requirements, which needed to be addressed in light of the existing risks. In particular, the financial system was deemed vulnerable to (i) customers who are, or are owned by, offshore companies whose beneficial ownership is unknown or has not been verified; (ii) rapid and ongoing increase of nonresident deposits; (iii) the development of private banking activities, including a clientele of foreign, politically exposed persons (PEPs); and (iv) the existence of large Georgian-led criminal organizations abroad, raising the risk of proceeds of crime being transferred back to Georgia.

34. The authorities have since taken some remedial actions that should be strengthened further, as risks remain, particularly with regard to nonresident deposits. According to the authorities, amendments to the AML law adopted in November 2013 have improved compliance with the international standard, particularly with regard to the coverage of lawyers. The authorities also indicate that they have taken steps to address weaknesses related to the FMS, which has been institutionally moved from the NBG to the office of the prime minister. Going forward, the authorities are particularly encouraged to further ensure (i) the operational independence and effectiveness of the FMS; (ii) AML supervision properly addressing risks related to nonresident deposits; (iii) requiring financial institutions to adopt reasonable measures as regards domestic PEPs and persons entrusted with a prominent function by an international organization; and (iv) compliance with the 2012 FATF standard and effective implementation of the national AML/CFT strategy.

MACROPRUDENTIAL POLICIES

35. The institutional setting for macroprudential should be strengthened.[8] The NBG is legally responsible for ensuring financial stability and should establish a full-fledged macroprudential policy framework in line with international best practices, which is more formalized and transparent. The NBG should also set up a Financial Stability Unit that would be responsible mainly for systemic risk analysis and macroprudential policy. In addition, the revised framework should emphasize accountability and communication practices, including through the publication of regular reports on financial stability.

36. The planned introduction of buffer requirements to mitigate cyclical and structural risks is a welcome step. The authorities plan to introduce the countercyclical capital buffer and

[8] For more details, see the Technical Note on Macroprudential Policy Framework.

the capital surcharge for systemically important banks.[9] The capital surcharge is particularly important in the Georgian context due to the high market concentration in the banking sector.

37. Macroprudential measures for FX-induced credit and liquidity risks also have led to a strengthening of banks' buffers. As discussed previously, additional risk weights are applied to foreign currency loans to unhedged borrowers and reserve requirements are higher for foreign currency deposits and other borrowings. Furthermore, banks have to hold more liquidity for nonresident deposits, if those deposits exceed 10 percent of total deposits.

38. Further macroprudential instruments should be employed to address indirect FX risks and support "larization":

- *Asset side:* The NBG should limit FX lending to unhedged borrowers—at the minimum—for the riskiest forms of lending in line with the ESRB recommendation on FX lending[10] as well as for short-term loans for which local-currency alternatives are available and used by parts of the banking sector. These instruments would also reduce the NBG's need to support larization by accepting nonmarketable collateral in local currency for refinancing operations in normal times.

- *Liability side*: The vulnerabilities of the banking system that stem from the reliance on short-term funding, in particular in foreign currency, may be reduced by targeted measures to (i) increase the maturities of deposits, taking into account the possibility of withdrawals at penalty rates; (ii) increase the local-currency proportion of short-term deposits; and (iii) promote lari-denominated certificates of deposit (CDs). These policy priorities may be supported by various macroprudential instruments, such as more differentiated FX reserve requirements with respect to CDs with longer maturities or a more favorable treatment of local-currency liabilities in liquidity regulations.

39. Additional tools may need to be applied to address the potential build-up of concentration and credit risks. The introduction of concentration limits for the largest borrowers (for example, limits on Top-5 or Top-10 loan exposures) should prevent excessive concentrations in banks' loan portfolios; these should apply to both on- and off-balance sheet exposures. Moreover, the NBG should apply loan to value (LTV) or debt service to income (DSTI) caps, possibly differentiated by currency or sectoral risk weights as targeted measures in case of a strong growth in banks' risk exposures to high-risk market segments.

[9] In recent years, the NBG adjusted risk weights for foreign currency loans to unhedged borrowers in a countercyclical manner as an instrument to mitigate cyclical risks.

[10] Recommendation of the ESRB of September 21, 2011 on lending in foreign currency (ESRB/2011/1).

SAFETY NETS AND CRISIS MANAGEMENT

A. Emergency Liquidity Assistance[11]

40. The emergency liquidity assistance (ELA) regime and practices warrant further strengthening. Under special circumstances threatening the financial system, the ELA duration can be extended through a discretionary decision by the NBG Board for a term longer than three months, the interest rate can be flexibly determined by the NBG, and the ELA can be given without collateral. However, this would run the risk that the ELA would be used for open bank support and long-term funding. Therefore, the legal and regulatory framework should be revised to minimize the NBG's exposure to financial risk and to improve accountability. ELA should be provided only to solvent institutions. The government should indemnify the NBG through guarantees or government securities before providing ELA when there is uncertainty about a bank's solvency or the adequacy of collateral. Revised procedures for the approval of ELA should clearly allocate roles and responsibilities of the various functions within the NBG, and the NBG could make public—once confidentiality concerns subside—information of ELA operations to account for the use of public funds.

B. Bank Resolution

41. Although certain elements are sketched out in legislation, the bank resolution framework lacks a number of important features. The main areas for improvement are:

- *Grounds.* The NBG should be empowered to resolve a bank under a broader, well-defined range of circumstances and at an early stage. The triggers should be based on the nonviability (or likelihood thereof) of a bank.
- *Tools.* A stronger framework would provide greater legal certainty on the conduct of resolution and remove the need to obtain creditors' consent when banks' claims are transferred.
- *Safeguards.* A number of elements aimed at ensuring a fair and impartial resolution process could be enshrined in the law, such as the need for an independent evaluation of a failed bank's assets and liabilities, and the "no creditor worse off" principle.

42. Governance arrangements for resolution should be revamped by considering a variety of possible approaches. Under international best practices, it is recognized that conflicts of interest may arise between the supervisory and resolution functions. One measure that would mitigate the risk of regulatory forbearance would be to create a separate function responsible for

[11] For more details, see the Technical Note on Safety Nets, Bank Resolution, and Crisis Preparedness and Management Arrangements.

problem banks, with different reporting lines to a deputy governor or directly to the NBG governor.

C. Deposit Insurance

43. The authorities must introduce a deposit insurance scheme (DIS) within seven years under the EU Association Agreement, but a shorter timetable is warranted. A DIS can mitigate the risk of deposit outflows while increasing competition by fostering deposits in small- and medium-size banks which lack the implicit state guarantee of banks that "too-big-to-fail." The absence of a DIS may encourage the misuse of the ELA for resolution purposes. Lastly, introduction of a DIS now while profits are high would be timely.

44. The DIS should be underpinned by certain key design features in line with international best practices. The DIS should have a public interest objective of protecting insured deposits and contributing to financial stability. Close cooperation with the NBG is needed to share information on problem banks and to make quick payouts. An *ex ante* funded scheme would minimize systemic risk and avoid procyclicality while allowing for *ex post* extraordinary premiums and borrowing authority. Lastly, the coverage of depositors should be reasonably limited to mitigate moral hazard concerns.

D. Crisis Preparedness and Management

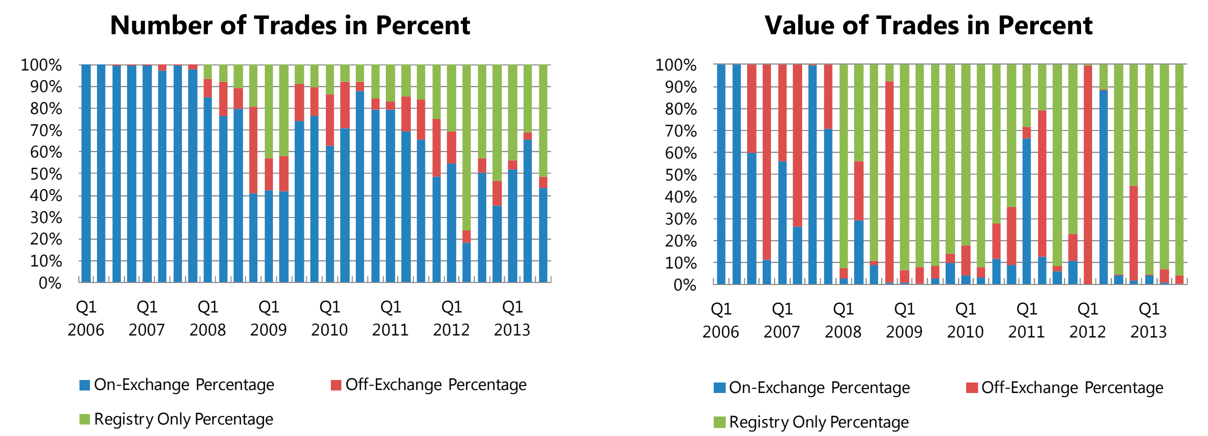
45. The legal and regulatory framework should be strengthened to remedy certain impediments to the NBG and government intervention. The NBG cooperates with foreign supervisors, but does not have legal authority to cooperate with resolution authorities. The government may provide financial assistance in the form of loans. Nonetheless, a specific legal provision prohibits the government from owning equity stakes in banks and other financial institutions, and state guarantees need to be ratified by the parliament.

46. Crisis tools and institutional arrangements for cooperation should be strengthened. A Financial Stability Council should be created and then develop guidelines and checklists clarifying roles and responsibilities of relevant stakeholders; draw crisis communication plans and conduct simulation exercises; verify the adequacy of operational procedures; and elaborate possible policy responses and related legal powers. Furthermore, the work conducted by the NBG on recovery and resolution plans (RRPs) should advance further, including by integrating stress tests exercises and enhancing the legal basis.

FINANCIAL SECTOR DEVELOPMENT

47. Capital markets are almost nonexistent. The corporate debt market is dormant and the government debt market is still relatively small—despite rapid growth of the government's local currency T-bills issues in 2013. Corporate issuance has mainly taken place overseas, with no domestic corporate bonds issued since 2009 (Figure 6). The development of the capital market has been dampened by the unwillingness of high-quality issuers to participate locally, which in turn reflects concern about the lack of market transparency and its impact on borrowing costs. Trade execution is carried out directly by the three share registries or via off-exchange fixings, which undermines confidence in the price discovery mechanism.

Figure 6. Georgia: Stock Exchange: Number and Value of Trades



48. The NBG and MOE should prepare a time-bound strategy for the development of the capital market as a source of stable and long-term private financing. This strategy should result from a comprehensive review of the institutional setting and the regulatory framework. In particular, the government should identify the lead capital market regulator (NBG or a new Securities Commission), with adequate power and the necessary independence. The MOE should bring the Securities Market Law into line with international best practices and EU requirements. Furthermore, the MOE should introduce legal provisions and Georgia's Stock Exchange (GSE) should revise its charter to create a more transparent and unified market, by prohibiting off-exchange trading of listed securities, thereby facilitating the achievement of economies of scale. The authorities have already taken welcome steps to develop the debt securities market, by arranging the sale of marketable, two- and five-year government bonds to banks, re-depositing the proceeds at banks in the form of term deposits with similar maturities. This mechanism has helped banks in lengthening the maturity of their funds in local currency and in promoting the de-dollarization of their credit portfolio.

49. The lack of compulsory classes of insurance business such as automotive insurance in Georgia severely hampers the development of the insurance market. Divestiture of government-mandated investments in hospitals would be a prerequisite for rejuvenating the sector. There is a lack of consumer protection and limited public awareness of the benefits of insurance.

50. Another important impediment to the development of the capital market is the virtually absence of actuarial expertise. This has meant that market participants cannot price risk and set reserves. Hence, the team recommends that the ISSSG jointly with the

Georgian Association of Actuaries develops an approach to training and licensing of local actuaries that would ensure adequate supply of qualified actuaries for the Georgian insurance market.

51. To promote the development of the insurance sector, the authorities should prepare a comprehensive policy and regulatory reforms. In particular, the policy should aim at (i) the financial stabilization of the industry; (ii) the development and growth of the insurance sector as by devising and introducing several compulsory classes of insurance; (iii) the adequate protection of policyholders' rights and consumer education; and (iv) institutional strengthening and attainment of true independence for the insurance regulatory agency.

52. Financial depth and access to finance for SMEs is limited. SME development is an essential pillar of Georgia's development strategy. However, survey data indicate that access to finance is among the main constraints for business growth. The banking sector is the main source of formal finance for the SME sector, and the total volume of intermediation in SME lending is considered to be low by international benchmarks.

53. Weak SME access to credit reflects several factors. First, banks are unable to supply credit in local currency and at longer terms because of their own limited access to long-term, local currency funding (only the two larger banks and some foreign banks access to wholesale funding). Second, according to a recent survey, SME assets are largely in the form of movable property, while banks typically prefer immovable property as collateral. As a result, SMEs are only able to borrow using real estate as collateral.

54. NBFIs lack the scale and financial capacity to bridge the SME gap and the capital market is nonexistent. The NBFI sector is fragmented into a relatively large number of small institutions that lack the capital or access to sources of funding to meet SME financing needs. Altogether, NBFIs account for about 3.3 percent of GDP and for less than 7 percent of banking sector assets. Factoring is almost nonexistent, while leasing has not taken off.

55. A comprehensive NBFI sector development strategy is warranted. It should include a revision of the Central Bank Law and the Law on Microfinance in order to expand its mandate to cover also the sound development of the financial sector, including a clear definition of microfinance institutions. Furthermore, it will be important to revise the leasing legislation and introduce amendments to create a level playing field with the tax treatment of banks. Moreover, the authorities should revise the legal framework governing secured transactions, which would enable creditors to accept movable property as collateral for loans and other obligations, in light of international best practice; establish a modern electronic "notice" registry of a security interest to achieve protection against third party claims; and evaluate the enforcement process in light of the principles of consumer protection.

56. The National Payment System is sound and effective, but its oversight framework should be strengthened. The core infrastructure for large-value payments is highly sophisticated, with appropriate risk mitigation, but the retail payments infrastructure is fragmented and costly. Oversight and risk mitigation are uneven, due in part to the lack of a systematic oversight framework.

57. Facilitating the use of movable property as secured collateral would increase the availability of credit for businesses, particularly for SMEs. The Ministry of Justice should revise the legal framework governing secured transactions in light of international best practices, evaluate the enforcement process to ensure consumer protection and debtor safeguards, and implement a dedicated, fully electronic registry.

58. There is no formal oversight framework for the Credit Reporting Systems (CRS) and the existing legal framework is incomplete. It is recommended that the authorities establish a legal framework and formal supervisory and oversight function for credit reporting; the sole existing credit bureau should improve current services by eliminating thresholds for loan reporting, and the government should facilitate the credit registry's access to other collateral, companies, and other registries.

Table 4. Georgia: Selected Macroeconomic Indicators 2008-15

	Actual						Projections	
	2008	2009	2010	2011	2012	2013	2014	2015
National accounts	(annual percentage change, unless otherwise indicated)							
Real GDP	2.3	-3.8	6.3	7.2	6.2	3.2	5.0	5.0
Nominal GDP (in billions of laris)	19.1	18.0	20.7	24.3	26.2	26.8	29.2	32.2
Nominal GDP (in billions of U.S. dollars)	12.8	10.8	11.6	14.4	15.8	16.1	16.1	17.5
GDP per capita (in thousands of U.S. dollars)	2.9	2.5	2.6	3.2	3.5	3.6	3.6	3.9
GDP deflator, period average	9.7	-2.0	8.5	9.5	1.2	-0.7	3.5	5.0
Investment and saving	(in percent of GDP)							
Gross national saving	4.0	2.5	11.3	13.4	17.3	18.9	17.2	18.5
Investment	26.0	13.0	21.6	26.2	28.9	24.8	25.5	26.4
Public	8.0	8.0	8.2	7.7	7.5	5.1	5.7	6.5
Private	18.0	5.0	13.4	18.5	21.4	19.7	19.8	19.8
Inflation	(in percent)							
Period average	10.0	1.7	7.1	8.5	-0.9	-0.5	4.6	4.9
End of period	5.5	3.0	11.2	2.0	-1.4	2.4	5.0	5.0
Consolidated government operations	(in percent of GDP)							
Revenue	30.7	29.3	28.3	28.2	28.8	27.5	27.1	27.3
o.w. Tax revenue		24.4	23.5	25.2	25.4	24.8	24.7	25.0
Expenditures	37.0	38.4	34.9	31.8	31.8	30.1	30.8	30.3
Current expenditures	28.5	30.1	26.0	23.1	23.1	24.3	24.8	23.3
Capital spending and net lending	8.6	8.4	8.8	8.8	8.7	5.9	6.0	6.9
Overall balance	-6.3	-9.2	-6.6	-3.6	-3.0	-2.6	-3.7	-3.0
Public debt	27.6	37.4	39.3	33.8	32.3	32.2	34.1	34.2
Of which: foreign-currency denominated	23.5	31.7	33.6	28.8	27.6	27.2	27.6	27.5
Money and credit	(annual percentage change, unless otherwise indicated)							
Credit to the private sector	32.6	-13.5	18.8	24.3	12.8	19.5	21.6	17.7
Broad money, including fx deposits	7.9	7.8	23.9	20.3	11.4	24.4	21.5	18.5
Deposit dollarization	74.8	71.8	68.6	63.3	66.0	62.1	63.6	61.2
External sector	(in percent of GDP, unless otherwise indicated)							
Gross international reserves (in billions of U.S. dollars)	1.5	2.1	2.3	2.8	2.9	2.8	2.7	3.0
In months of next year's imports of goods & services	3.4	4.1	3.4	3.7	3.7	3.3	3.0	3.1
In percent of broad money and nonresident deposits	0.1	0.1	62.0	59.3	51.9	42.5	35.5	33.9
Current account balance (in billions of U.S. dollars)	-2.8	-1.1	-1.2	-1.8	-1.9	-1.0	-1.3	-1.4
In percent of GDP	-22.0	-10.5	-10.2	-12.8	-11.7	-5.9	-8.4	-7.9
Trade balance	-30.0	-22.3	-22.3	-24.4	-26.6	-21.7	-25.1	-24.7
Foreign direct investment (inflows)	12.2	6.1	7.0	7.3	5.8	6.3	6.4	6.5
Gross external debt	44.6	58.8	84.4	78.0	82.2	81.5	84.2	83.1

Sources: Georgia authorities and IMF staff estimates.

Table 5. Georgia: Risk Assessment Matrix

	Overall Level of Concern	
Nature/Source of Main Threats	**Likelihood of Severe Realization of Threat Sometime in the Next Three Years**	**Expected Impact on Financial Stability, if Threat Is Realized**
Global financial conditions	***Assessment: Medium*** Abrupt Surge in global financial market volatility as investors reassess underlying risk	***Assessment: Medium*** The banking system is dominated by foreign banks, both from advanced and emerging economies, providing significant cross-border lending to local markets. Thus, higher international market volatility would affect the funding situation for the Georgian banks, both from parent banks and nonresident deposits. In addition, tight funding conditions could affect some foreign banks in Georgia if parent banks accelerate deleveraging, hoard liquidity, and cut intergroup lending.
Slower growth in advanced and emerging economies	***Assessment: Medium*** *Advanced economies*: Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation. *Emerging markets*: Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.	***Assessment: Medium*** A long period of slow growth in the world economy (and, particularly, in Georgia's main trading partners) would hurt export volumes and GDP growth, resulting in higher NPLs, lower profitability, and potential solvency pressures in some institutions. Currency depreciation in emerging countries could directly impact Georgia's exports, boost unemployment, and widen the current account deficit, leading to higher debt burdens of borrowers and higher NPL levels.
Increasing geopolitical tensions	***Assessment: High*** *Russia/Ukraine:* Sustained tensions depress business confidence and heighten risk aversion, amid disturbances in trade, remittances, and commodity markets.	***Assessment: High*** Economic uncertainty would reduce investment and GDP growth, undermining credit quality by constraining the ability of the corporate and household sectors to service their debt. It may also lead to reversal of capital inflows, including nonresident deposits, leading to funding and liquidity difficulties for banks.
Capital outflow shock	***Assessment: Medium*** Large nonresident deposits and external funding that make the financial sector vulnerable to shifts confidence. Reliance on nonresident deposits continues to be a source of concern.	***Assessment: High*** A sharp drawdown of nonresident deposits, triggered by a change in risk sentiment could create a funding and liquidity problem.

Table 5. Georgia: Risk Assessment Matrix (concluded)

	Overall Level of Concern	
Nature/Source of Main Threats	**Likelihood of Severe Realization of Threat Sometime in the Next Three Years**	**Expected Impact on Financial Stability, if Threat Is Realized**
Commodity price shock	***Assessment: Medium*** The relatively high share of oil imports makes Georgia vulnerable to oil price increases.	***Assessment: High*** A large oil price increase could affect the profitability of corporate, leading to problem in serving their debt resulting in higher NPLs.
Foreign exchange shock	***Assessment: Medium*** A large share of dollarized liabilities creates a risk given that income streams are mostly denominated in lari.	***Assessment: High*** Unhedged borrowers may not be able to service their loans leading to an increase of NPLs and lower bank capital due to higher level of provisioning. It would also reduce profitability and could encourage an outflow of nonresident deposits.
Asset quality shock	***Assessment: Medium*** The uptick in household credit could be more than a temporary phenomenon.	***Assessment: Medium*** Higher household credit would adversely affect banks' balance sheets through higher NPLs.
Bank concentration risk	***Assessment: Medium*** Dominated by three major banks, the banking system is very concentrated. They have very similar business models, and such similarities may be a source of risk causing stress to spread quickly.	***Assessment: Medium*** The similarities in their lending structures and funding profiles mean that stress in one bank could quickly be transmitted to others through lending. Georgia does not have any deposit guarantee scheme to address such a contagion risk, and fiscal resources would be needed to compensate potential failed bank's depositors.

Table 6. Georgia: Status of 2007 FSAP Recommendations

Recommendations	Actions taken
Bank Supervision and Resolution	
Implement the recommendations in the BCP assessment.	The authorities have made a number of legal and regulatory changes as described in the text
Implement consolidated supervision increase coordination with other financial sector supervisors.	The NBG now supervises both bank and nonbank financial institutions, although insurance supervision was made separate again in 2013. New regulation is still needed.
Start inspections and take actions on weak banks.	The NBG has performed inspections and taken a number of actions on weak banks.
NBG should draft a decree or internal guideline on principles and rules for use of its LOLR facility.	Done; however, the NBG Law and NBG Decree #6 of 2012 still expose the NBG to financial risk
Insurance Law and Regulations	
The law should make it clear that SISSG rulings stand until overruled by a court.	Not done.
Any foreign insurer should satisfy minimum financial strength ratings and time in active business criteria. The SISSG should be allowed to confirm with the home supervisor that there are no interventions under way with the parent company.	Not done.
Licensing criteria should require minimal fit and proper credentials of the management and supervisory Boards and evidence that solvency can be maintained during the initial establishment period.	Not done.
A simple regulatory ladder should be introduced.	Not done.
SISSG should have the power to request modification of a reinsurance program or the law should specify minimum acceptable security.	Not done.
Insurers (and pension schemes) should be allowed to invest foreign securities that are highly rated, subject to prudential limits.	Partially done. Insurers and pension funds are allowed by law to invest in securities of OECD countries. The law, however, does not specify the minimum credit quality of such securities.
Insurance Supervision	
Transfer the Pensions Team from National Securities Commission of Georgia (NSCG) into SISSG as a separate unit.	Partially done.
SISSG should define minimum skills criteria for future recruits and require that existing staff upgrade their skills to be able to implement risk-based supervision.	Done.
Non-State Pensions	
Allow the central depository to handle pension scheme assets.	Done. Assets of pension savings accounts are kept in the Central Depository.

Table 6. Georgia: Status of 2007 FSAP Recommendations (concluded)

Recommendations	Actions taken
Capital Markets	
Amend the legislation to allow the supervisory authority to enforce the rules.	Not done. The 1998 Securities Market Law was severely weakened with the amendments introduced in 2007.
Reduce the number of reporting companies based on reasonable criteria. Reviews should be meaningful, including reprimand.	The number of reporting companies has been reduced. This change has been detrimental to transparency and a well functioning securities market.
Oblige companies to report off-market trading to the GSE.	Most transactions moved away from the GSE and in 2013 94 percent of their value took place in a very nontransparent way in the securities depositories.
Reorganize NSCG. Improve financial independence of securities supervisor.	The NBG continues to be the independent supervisor.
Improve coordination with banking and insurance sector supervisors.	Proper coordination with banking supervisors is in place due to NBG's multiple mandate. An MoU with the new insurance supervisor agency is required.
Legal	
The ability of the courts to review the substantive technical aspects—as opposed to the procedural aspects—of NBG decisions should be limited by legislation.	No legislative changes have been implemented, but there have been no further cases where insolvent banks were allowed to operate.
Adopt amendments to the Banking Law to strengthen the fit and proper criteria for bank administrators and significant shareholders.	Done.
Consider introducing a Law on Credit Information Bureaus.	Not done.
Adopt a comprehensive Law on Microfinance Institutions and consequential amendments to the Civil Code and Tax Code to facilitate the operation of MFIs.	Done, but the definition of microfinance institution needs to be refined in the Law.
Consider revising the Law on Entrepreneurs to bring it more into line with the provisions of a modern company law.	Done. However, there is no responsible agency for the enforcement of the provisions of this Law.
Consider introducing a Law on Leasing based on the recommendations of the recent IFC study.	Leasing provisions in Civil Code were amended in 2011, but amendments to VAT treatment of leasing are pending.
Clarify the scope of the new Law on Licenses and Permits.	Done.
Consider enacting a new modern Law on Bankruptcy Proceedings.	Done.
Commission a study to examine options for improving the scope and operation of the Law on Execution of Judgments.	Major changes have been introduced in various laws to enhance enforcement of judgments.
Enact a new Law on Public Arbitration based on the UNCITRAL Model Law on Arbitration.	Done.
Financial Integrity	
Supervisory Boards should take greater responsibility for the financial statements of firms and should have an Audit Committee that deals with internal and external auditors.	Done.
Improve transparency of who are the beneficial owners of financial institutions.	Done.

Appendix I. Stress-Testing Scenarios and Methodologies

Solvency stress tests scenarios

59. It is important to note limitations of quantitative models used for stress testing, which, in Georgia's case, are based on relatively short time series, as models might not capture the full effects of extreme shocks. To account for this, stress tests results are based on three different models and approaches: bottom-up by banks, top-down by the NBG, and top-down by the FSAP team. All tests were based on solo data as of December 2013, and simulated shocks for three years ahead. Hurdle rates are in line with current regulatory framework (Basel I); however, the FSAP mission team made additional calculations to compare results with the upcoming Basel II Standardized as well as quasi-IRB frameworks.[12]

60. Stress tests considered three scenarios: one baseline and two adverse (mild and extreme). The baseline scenario is based on the forecast of most likely developments in the Georgian economy for two years ahead. The IMF's World Economic Outlook (WEO) assumptions and projections are used. Both adverse scenarios are calibrated using historical episodes. The mild recession scenario resembles the economic situation in 2008–09, when Georgia was affected by regional geopolitical turmoil. In this scenario, protracted regional political instability would affect Georgia's economy through a number of channels. Reduced trade with major partners in the region, lower remittances, and the impact of uncertainty on investment would lead to a decline in GDP, depreciation of the exchange rate, increase in lending interest rates, and fall in real estate prices. In an extreme recession scenario, the above factors would have more protracted effects on the Georgian economy: extreme decline in GDP, higher depreciation, higher shock in interest rates, and decline in real estate prices.[13] The scenario is compounded by liquidity shock based upon a run on nonresident deposits, which spilled over to resident deposits by sharply increased dollarization and by direct financial spillovers to banks (higher funding costs). Banks in both the mild and extreme recession scenarios are affected by an increase in credit risk, higher NPLs, and higher provisioning ratios due to a fall in property prices. Increases in interest rates also affect banks' funding costs and lower their profitability.

Liquidity stress tests scenarios

61. **The liquidity stress tests examine banks' resilience to liquidity shocks, including foreign currency and external funding**. This test is based on both gross and net liquidity mismatch positions.

[12] The NBG plans to introduce Basel II/III standardized approach by the end of 2014.

[13] This scenario was calibrated using expert judgment, taking into account episodes in Eastern European countries which experienced rapid credit growth before the recent Global Financial Crisis. The scenario thus is hypothetical.

Scenarios:

- Withdrawal of wholesale funding and closure of foreign funding markets. Wholesale funding based on loans and deposits are not rolled over according to the shock parameters in the table below.

- Bank run: deposit withdrawals of up to 30 percent (80 percent for nonresident deposits); wholesale funding withdrawal of up to 30 percent (100 percent for the interbank market); and fire sales of liquid assets with haircuts of up to 40 percent. The initial nominal stock of credit grows according to the baseline scenario. Fifty percent of committed credit lines are drawn down. No net additional intragroup funding is available. Interbank market is closed.

- Combined shocks. This scenario combines withdrawal of nonresident funding and bank run shocks.

Summary of Macroeconomic Assumptions for Scenario-Based Solvency Stress Tests

Scenario	Baseline	Mild recession	Extreme recession
GDP growth	2014 – 5% 2015 – 5% 2016 – 5%	2014 – -5% 2015 – 0% 2016 – +3%	2014 – -10% 2015 – -3% 2016 – +1%
Interest rates	Unchanged (10%)	2014 – +5 p.p. (15 percent) 2015 – unchanged compared to 2014 2016 – unchanged compared to 2015	2014 – +8 p.p. (18 percent) 2015 – unchanged compared to 2014 2016 – unchanged compared to 2015
Exchange rate	Unchanged (10%)	Depreciation by 10%	Depreciation by 30%
Change in property prices	Unchanged	2014 – -10% 2015 – unchanged compared to 2014 2016 – unchanged compared to 2015	2014 – -35% 2015 – unchanged compared to 2014 2016 – unchanged compared to 2015
Credit growth	2014 – 14% 2015 – 9% 2016 – 9%	2014 – 0% 2015 – 0% 2016 – 0%	2014 – -5% 2015 – -5% 2016 - -5%
Liquidity shock	Not included	Not included. Increase in average funding costs by 1 p.p.	Run on deposits and increase in average funding costs by 2 p.p.

Summary of Assumptions for Liquidity Stress Tests

Assumptions on Asset Liquidation for all Scenarios	
Liquidation value (in percent) of cash and funds held at the central bank, interbank deposits, deposits held at foreign banks, foreign government securities, and foreign bonds.	100 percent
Liquidation value (in percent) of deposits held at domestic banks, domestic government securities, domestic bonds, and other liquid assets.	60 percent
Other assumptions for all Scenarios	
Interbank market is closed.	
Percent of committed credit lines that are drawn down.	50 percent

Assumptions on Liabilities Withdrawals	
Scenario 1 *Withdrawal of nonresident funding and closure of foreign funding markets*	
Overnight withdrawal of wholesale funding.	(A) 10 percent of liabilities coming due within three months. (B) 10 percent of all liabilities. (C) 50 percent of liabilities coming due within three months. In all cases, we assume no withdrawals of customer deposits.
Scenario 2 *Bank Run*	
Withdrawal of resident and nonresident deposits over 5 and 30 days horizon.	(A) A withdrawal of 10 percent of residents deposits (irrespective of the currency of denomination and maturity of these deposits); 40 percent of nonresidents deposits (irrespective of the currency of denomination and maturity of these deposits), including foreign bank deposits; and 100 percent of domestic interbank deposits (irrespective of the currency of denomination and maturity of these deposits). (B) A withdrawal of 30 percent of residents deposits (irrespective of the currency of denomination and maturity of these deposits); 80 percent of nonresidents deposits (irrespective of the currency of denomination and maturity of these deposits), including foreign bank deposits; and 100 percent of domestic interbank deposits (irrespective of the currency of denomination and maturity of these deposits).
Scenario 3 *A combination of scenarios 1A and 2 (A), 1B and 2 (A), and 1C and 2 (A)*	
Overnight withdrawal of liabilities to parent banks and overnight withdrawal of resident and nonresident deposits	(A) Combination of scenarios 1A and 2 (A) (B) Combination of scenarios 1B and 2 (A) (C) Combination of scenarios 1C and 2 (A)

Stress tests methodologies

Solvency Risk Stress Tests

Scope	Assumptions		
	Bottom-Up by Banks	**Top-Down by the NBG**	**Top-Down by FSAP Team**
Institutions included	4 largest banks: Bank of Georgia, TBC Bank, ProCredit Bank, and Liberty Bank.	All banks.	All banks.
Market share	73 percent.	100 percent.	100 percent.
Data	Banks' own data.	Supervisory data.	Supervisory and public data.
Stress test horizon	2 years: 2014–2015.	3 years: 2014–2016.	3 years: 2014–2016.
Methodology	Bank own methodology for single-factor sensitivity analysis. Each bank used its own methodology, and in most of the cases this was simple sensitivity analysis.	NBGs own balance sheet model. Satellite model was used for credit losses and sensitivity model for net income.	Modified Next Generation Balance Sheet Model for balance sheet calculations. Satellite models for credit risk and sensitivity model for net income.
Shock scenarios	Scenarios defined by the IMF team. Different from final ones used in the FSAP as bottom up scenarios were circulated to banks before final scenarios were amended based on NBG request.	Scenarios are the same as defined by the IMF team.	Slowdown in global economic growth against a baseline from April 2014 WEO projections. Sizes of GDP shocks are estimated from various macro shocks, including export revenue decline and slowdown in public and consumer spending. Regional shift in risk appetite leads to withdrawal of nonresident deposits and increase in funding costs for banks. Higher interest rates pass through to higher loan interest rates and credit losses. ***Single-factor shocks:*** Asset quality deterioration default of up to the three largest borrowers).
Tail shocks	Global and regional slowdown: Extreme Recession scenario developed by IMF.	Global and regional slowdown: Extreme Recession scenario developed by IMF.	Global and regional slowdown: Extreme Recession scenario developed by IMF.
Market risks	An upward and downward shift in interest and exchange rates, direct impact on capital adequacy through profitability. Bank's own methodology for single-factor sensitivity	An upward and downward shift in interest and exchange rates, direct impact on capital adequacy through profitability. Bank's own methodology for single-factor sensitivity analysis on both banking and trading books.	An upward and downward shift in interest and exchange rates, direct impact on capital adequacy through profitability. Bank's own methodology for single-factor sensitivity analysis on both banking and trading books.

Scope	Assumptions		
	Bottom-Up by Banks	Top-Down by the NBG	Top-Down by FSAP Team
	analysis on both banking and trading books.		
Market risk scenarios	Impact of interest and exchange rate movements on profitability. Impact of 15 percent, 20 percent, and 25 percent sudden devaluation of the Lari against the USD on bank profitability.	Impact of interest and exchange rate movements on profitability. Impact of 15 percent, 20 percent, and 25 percent sudden devaluation of the Lari against the USD on bank profitability.	Impact of interest and exchange rate movements on profitability. Impact of 15 percent, 20 percent, and 25 percent sudden devaluation of the Lari against the USD on bank profitability.
Risks/factors assessed	Credit quality deterioration. FX shock.	Credit quality deterioration. FX shock.	Credit quality deterioration. FX shock. Funding risk.
Satellite models/risk transmission channels	Banks' own models.	Macro shocks are translated into NPLs/PDs via a satellite model. NBG's own satellite model for credit risk-based on NPLs ratios (dynamic panel OLS regression) and sensitivity model for income. Risks transmitted via shocked NPLs ratios and provisioning.	Macro shocks are translated into NPLs/PDs via a satellite model. Satellite model for Credit risk-based on NPLs ratios (dynamic panel GMM estimation); simplified income model based on sensitivity analysis. Risks transmitted via shocked NPLS ratios and provisioning. Solvency and funding risks incorporated via drop in interest spreads.
Calibration of risk parameters	Actual point-in-time risk parameters for credit risk (NPLs and provisioning ratios).	Actual point-in-time risk parameters for credit risk (NPLS and provisioning ratios); historical developments in FX market.	Actual point-in-time risk parameters for credit risk (NPLS and provisioning ratios). Expert judgment for shock to interest spreads, operational expenditures and other income; historical developments in FX market.
Hurdle rates & Basel III	Basel I/NBG minimum CAR rates: 12 percent for total CAR and 8 percent for Tier I CAR.	For 2014: Basel I/NBG minimum CAR rates: 12 percent for total CAR and 8 percent for Tier I CAR. For 2015 and 2016: 8.5 percent for Tier I CAR.	Basel I/NBG minimum CAR rates: 12 percent for total CAR and 8 percent for Tier I CAR. For 2015 and 2016: 8.5 percent for Tier I CAR.
Behavioral adjustments	Bank own strategy based on credit growth and dividend payout.	Credit growth estimated by a macrofinancial model and expert judgment. No dividend payout policy.	Credit growth estimated by a macro-financial model and expert judgment. No dividend payout policy.
Regulatory standards	Basel I /Basel II Standardized approach.	Basel I/ Basel II Standardized approach.	Basel I/ Basel II Standardized approach/Quasi IRB (based on PDs derived from quarterly write-off ratios).
Presentation of results	Output presentation.	Absolute and in terms of capital. Number of banks that fail; recapitalization needs.	Absolute and in terms of capital; distribution of capital ratios; number of banks that fail; recapitalization needs.

Liquidity Risk Stress Tests

Scope	Assumptions	
	Bottom-Up by banks	Top-Down by NBG (in cooperation with FSAP team and commercial banks)
Institutions included	N/A	All 21 banks.
Market share	N/A	100 percent.
Data	N/A	Supervisory and public data.
Stress test horizon	N/A	5-day and 30-day outflow.
Methodology	N/A	Implied cash flow based Bank-run type tests; stress tests separately for GEL and USD.
Risks	N/A	Bank runs: deposit withdrawals of up to 30 percent; wholesale funding withdrawal of up to 30 percent; fire sales with haircuts of up to 40 percent. Withdrawal of nonresident funding and closure of foreign funding markets.
Regulatory standards	N/A	Liquidity mismatches; maturity mismatches/rollover risks; concentration of funding (LCR). LCR analysis was based on GEL and USD.
Presentation of results	N/A	Number of banks that fail. Liquidity shortage in each currency (GEL and USD).

Contagion Risk Stress Tests

Scope	Assumptions		
	Bottom-Up by banks	Top-Down by NBG	Top-Down by FSAP team
Institutions included	N/A	All banks	N/A (robustness checks only)
Market share	N/A	100%	N/A
Data	N/A	NBG data on interbank market exposures among banks.	N/A
Stress test horizon	N/A	Immediate	N/A
Shocks/ Methodology	N/A	Simple sensitivity type of stress test based on netting of interbank market exposures. Addresses direct risks only.	N/A
Risks	N/A	Direct contagion risk (via balance sheet effects) due to a failure of a bank.	N/A

Annex I. Report on the Observance of Standards and Codes—Summary Assessments

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Introduction

1. **There have been significant improvements in both the quality of regulation and the supervisory approach since the 2007 FSAP**. Many amendments to existing laws, new laws, and regulations have been introduced to address shortfalls that were highlighted. These improvements will be evident throughout this assessment. At the same time, a number of weaknesses have been identified. Among these, there has been a very high level of staff turnover in recent years, and there appears to be over-reliance on key personnel. While the NBG puts significant effort into understanding the risk profile of each individual bank and the banking system as a whole, more attention is needed to improve the quality of banks' risk management. In a number of areas, notably in bank licensing, the NBG relies on its broad supervisory powers to carry out its functions in the absence of detailed explicit powers. While this regime generally seems to work well in practice, it could leave the NBG open to challenge where these broad powers are not supported by more granular and explicitly defined powers. Several amendments to the legislation have been introduced recently to address these shortcomings.

2. **Currently, there are 21 banks operating in Georgia**. Aggregate banking assets (per balance sheet) of the 21 banks amount to GEL 17.9 billion. Two banks account for over 57 percent of banking activity—Bank of Georgia (BOG) (34 percent) and TBC Bank (23 percent). The next largest bank—Liberty Bank—represents less than 8 percent of total bank assets. The 10 smallest banks each have a market share of less than 1 percent, and, in aggregate, represent about 5.3 percent of the total market share. BOG and TBC have diffuse ownership and are listed on the London Stock Exchange. Most of the remaining banks are subsidiaries or affiliates of foreign banks, and a few, mainly smaller banks, are owned by individuals, both Georgian and foreign.

B. Information on the Methodology Used for Assessment

3. **The methodology is based on the Basel Core Principles document as agreed in 2012**. The grading for each principle is based on the essential criteria (EC). Additional criteria are commented upon, but are not reflected in the grading. The assessment of capital adequacy has been undertaken against the Basel I standards, although assessors have reviewed Basel II/III.

4. **The assessment involved discussions with the NBG's Specialized Groups and Supervisory Policy Department and Banking Supervision Department**. It also involved discussions with the Financial Monitoring Service of Georgia (FMS), which is responsible for general anti-money laundering policy in the country. Meetings were held with the Ministry of Finance (MOF),

a number of commercial banks, the Banking Association, the Georgia Federation for Professional Accountants and Auditors (GFPAA), and an external auditing firm.

C. Main Findings

Responsibilities, Powers, Independence, Cooperation, etc. (CPs 1–4)

5. In legislation, the wording of the NBG's functions/tasks appears to give secondary status to its supervisory role as compared to its main function, that is, price stability. However, there are no practical examples that show it has compromised the objectives of supervision. For these principles, as well as for other principles, the NBG relies on its broad powers to achieve its supervisory aims in the absence of explicit legal provisions. Due to lack of salary competitiveness, there is a high level of staff turnover within the supervisory area, with over-reliance on key personnel. External training and education is under-resourced. Despite this, it should be noted that the quality of the supervisory staff is impressive.

Licensing Criteria, Transfer of Significant Ownership, Major Ownership (CPs 5–7)

6. There are a number of significant gaps in legislation under these headings. The NBG uses its broad powers to address these gaps, but explicit provisions should be provided in the legislation. For example, there are no explicit provisions specifying that: (a) the appointments to the Supervisory Board, Directors, and top management as well as for their replacements, requires NBG approval; and (b) the NBG should assess whether the home supervisor practices global supervision and/or whether its supervision standards are equivalent to those of the NBG. Further, there is no requirement for an existing bank shareholder, who is proposing to dispose of his/her significant shareholdings, to notify the NBG of his/her intention. Recently, several of these shortcomings were addressed by strengthening the regulations.

Supervisory Approach, Tools, Techniques and Corrective Measures (CPs 8, 9, and 11)

7. The NBG developed a comprehensive, forward-looking, and risk-based supervisory approach proportionate to the systemic relevance of supervised banks. It addresses all risks emanating from banks. It also includes elements such as stress tests, business models, corporate governance, and capital and contingency planning. Furthermore, the NBG has developed an approach that comprises a well-balanced use of bank supervisors and specialist risk supervisors (for example, credit risk, operational risk, financial risk, macroeconomic risk, group structure risk, and corporate governance). Bank supervisors are responsible for all the risks of one bank, and risk supervisors are responsible for one risk across all banks, including systemic risk.

8. Although the NBG developed an advanced supervisory approach, further enhancement is needed. The assessment of bank's resolvability should be further strengthened, in particular, for systemic relevant banks, and there is no comprehensive framework for handling banks in distress.

9. The supervisory approach is supported by a comprehensive supervisory information system. This enables the supervisor to conduct "online" supervision and rigorous data analysis off-site. There is only one important remark to be made: the NBG runs the risk of not spending enough time on-site because of excellent online possibilities; supervisors should consider spending more time on-site.

Supervisory Reporting, Consolidated Supervision (CPs 10 and 12)

10. There has been significant improvement in this area since the 2007 FSAP. The risks posed by group exposures are now assessed as part of the group structure risk assessment. Notwithstanding the miniscule banking group structure framework in Georgia, large exposures are now calculated on a consolidated basis and the NBG has begun to assess capital on the same basis. One weakness that still remains is that there is not as yet a formal prudential reporting structure in place. However, this is expected to be introduced in November 2014.

Home-Host Supervision (CP13)

11. The level of cross-border banking is very insignificant in Georgia. The legislation providing for cross-border cooperation is adequate and the actions undertaken by the NBG are commensurate with the level of activity.

Prudential Standards (CPs 14–25)

12. Additional efforts should be made to improve banks' risk management, ensuring adequate implementation of regulation and guideline. The NBG has been rightly focusing on the largest banks first and is generally more demanding toward more complex and large institutions in light of the risk-based supervision principles.

13. Though the intrusive supervisory approach is highly appreciated, the NBG should avoid being involved in banks' operational credit risk management. The NBG provided some examples where banks requested the NBG's views on the approval of specific credits. There is a fine balance between being truly intrusive, and focused on improving the quality of risk management of banks, and keeping banks fully responsible for their credit decisions and risk management.

Internal Control and Transparency (CP 26)

14. The legislation and practice in these areas appear adequate.

Financial reporting, audit, disclosure and transparency (CPs 27–28)

15. The requirements in these areas were met, although some minor weaknesses were identified.

Abuse of Financial Services (CP 29)

16. The legislation and practice in this area appear adequate. One weakness identified is that there is no legal obligation for banks to report to the NBG suspicious activities and incidents of fraud where such activities/incidents are material to the bank's safety, soundness, or reputation.

Table 7. Georgia: Summary Compliance with the Basel Core Principles

Core Principle	Comments
1. Responsibilities, objectives and powers	The supervisory function of the NBG should be given equal status to that of its so-called main task of price stability. Any doubt about the NBG's ability to set and enforce minimum prudential standards for all banking activities should be removed by amending Article 21 of the LACB Law, so that all areas are covered and not just those listed in the article. While public consultation on new laws and regulations takes place in practice, there is no legal obligation on the NBG to do so. While none of these issues seems to impede the NBG in carrying out its supervisory function, given that it relies on its broad powers to achieve its aims, it would be more desirable in the interests of certainty that explicit powers were given in the law.
2. Independence, accountability, resourcing and legal protection for supervisors	The quality of the supervisory staff is impressive. However, there is a very high level of staff turnover and there appears to be an over-reliance on key personnel, together with the reliance on short-term staff. Insufficient resources are put into external training and education. The NBG relies largely on internal training. The Georgian authorities do not charge for supervision. (This is an observation and is not taken into account for rating purposes.) There is no provision for the public disclosure of reasons for the removal of NBG Board members. The NBG does not publish a focused account of its strategic plans and targets or the extent to which these are met. There is no explicit legal provision that the supervisor will be adequately protected against the cost of defending their actions and/or omissions while discharging their duties in good faith. The protection afforded to staff taken or not taken, as long as such action was taken or refrained from in good faith, is not explicitly extended to the supervisor itself. Temporary administrators and liquidators are protected only if they are NBG Staff.

Core Principle	Comments
3. Cooperation and collaboration	A collaborative arrangement (MOU) between the NBG and the recently established insurance regulator has been signed and it should be fully implemented. A formal arrangement with the MOF to undertake recovery and resolution planning and actions was recently concluded, but it should be fully implemented.
4. Permissible activities	The NBG's policies and procedures are comprehensive and there is an increasing focus on looking through the shareholding and ownership structure above the institution.
5. Licensing criteria	The licensing process (that is, the acceptance or rejection of license applications) appears to work well in practice, notwithstanding some explicit gaps in legislation. The NBG relies on broad legal principles to achieve its aims in this regard. Amendments have recently been introduced to address some of these issues. There is no legal requirement for the NBG to assess whether the home supervisor practices global consolidated supervision and/or whether its supervision standards are equivalent to that of the NBG.
6. Transfer of significant ownership	The NBG relies on broad supervisory powers to achieve its aims under this Principle. At the same time, it has made notable progress in identifying beneficial owners of commercial banks, which was one of the major shortcomings during the last assessment. Nonetheless, there are some important shortcomings in legislation. The definition of "significant," as in shareholders, should be amended to include reference to persons acting in concert. There is no requirement to notify the NBG when an existing shareholder proposes to dispose of his/her significant shareholding. This could result in the NBG being unaware of significant changes of the shareholding structure. There is no reference to those that exert controlling influence in the context of transfers of significant ownership. There is no legal provision that requires banks to notify the supervisor as soon as they become aware of any material information which might negatively affect the suitability of a major shareholder or a party with a controlling interest.
7. Major acquisitions	The criteria used by the NBG to judge individual investment proposals are not statutorily based, although the criteria, which have been established as an internal guideline, are in line with the requirements of the principle and effectively applied in practice. Such criteria have been published by the NBG under its periodic journal. There is no explicit legal provision for the NBG to: – determine whether new acquisitions/investments will hinder effective implementation of corrective actions; prohibit banks from making acquisitions/investments in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision; or – take into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.

Core Principle	Comments
8. Supervisory approach	The NBG developed an advanced supervisory approach that is comprehensive, forward-looking, and risk-based, proportionate to the systemic relevance of supervised banks. It is comprehensive because it addresses all risks emanating from banks and the banking system. It is forward-looking because it includes elements such as stress tests, business model, corporate governance, and capital and contingency planning. It is risk-based because it focuses on the most important risks. However, the new approach is not yet fully implemented (just for 80 percent) and formalized. The NBG does not have an explicit operational framework or process for handling banks in times of stress that could support orderly recovery or resolution. Although the NBG has (basic) powers and tools that it can use for recovery and resolution of distressed banks. Nevertheless, during the last period of stress in 2008, the NBG applied a mix of recovery instruments. The NBG required four banks to set up resolution plans, but the process of implementation has only started recently. An insurance supervisory agency was recently set up and an MOU was signed between the NBG and the new agency. However, the insurance sector seems to be relatively small and the largest insurance company is a subsidiary of a bank through which the NBG monitors trends in the insurance sector and the implications for the bank.
9. Supervisory techniques and tools	The NBG has made enormous progress in the supervisory tools and techniques it is using. Three elements are worth mentioning: First, the NBG uses a supervisory cycle (risk identification, assessment and mitigation) at the level of each individual risk. This makes the NBG very flexible and this flexibility is balanced by periodical stock takings. Second, it seems the NBG has achieved a carefully balanced integration and equal usage of bank supervisors and risk supervisor. Bank supervisors are responsible for banks across risks, and risk supervisors are responsible for risks across banks, including systemic risk. Both supervisors do on-site and off-site activities, and it is very clear who is responsible for which task. Third, the NBG has a very powerful supervisory information system that enables the supervisor to do “online” supervision and rigorous data analysis. For example, the NBG does not have to go on-site to do a loan review because it receives all files online, which are connected to the bank’s information system. All this together enables supervisors to communicate on a daily basis with each other and with the banks on different levels (from technical staff to senior management).

Core Principle	Comments
	There is only one important remark to be made. The NBG runs the risk of not spending enough time on-site because of excellent online possibilities. An important element in a bank is its risk culture. The NBG supervisors should consider whether they spend enough time on-site to sense the risk culture.
10. Supervisory reporting	The NBG has a comprehensive supervisory reporting system; however, there is no formal consolidated prudential reporting framework in place—to be introduced in November 2014. Notwithstanding the absence of such a framework, there are sufficient alternatives and mitigants to otherwise address the issue.
11. Corrective and sanctioning powers of supervisors	Since adopting the risk-based approach, the NBG has been more focused on the analysis of underlying factors and more forward-looking for the risks such factors lead to. It prefers dialogue through letters, emails, and meetings, and seems to be reasonably effective. However, consideration should be given to imposing formal actions with clear escalation against banks in cases of safety and soundness issues, especially in cases where these issues linger in banks for a protracted period of time. Although there are examples of successful interventions by the NBG in the areas of safety and soundness, there are also examples where the NBG could have done better. This will become even more important as the focus on risk management increases with the implementation of Basel II, because implementation of Basel II will require banks to upgrade their risk management.
12. Consolidated supervision	There has been significant improvement in consolidated supervision since the last FSAP. It now features as part of the risk assessment program, and important ratios are now calculated on a consolidated basis. The main weakness is the absence of a formal consolidated prudential reporting framework, which is dealt with in Principle 10.
13. Home-host relationships	The level of cross-border banking is insignificant in Georgia. The legislation providing for cross-border cooperation is adequate and the actions undertaken by the NBG are commensurate with the level of activity.
14. Corporate governance	Since the NBG announced its intention to implement Basel II and III, it has put significant effort into determining that banks have robust corporate governance and that the policies and processes are commensurate with the risk profile and systemic importance of the bank. There are a few areas of improvement: Boards seem to be less involved in setting and overseeing the risk appetite. It seems that there is a conflict between the law and the regulation on whether a Director can or cannot be a member of the Supervisory Board. According to the NBG, such practice is very rare and Directors are restricted to participating in decision making where such participation creates conflicts of interest.

Core Principle	Comments
	The Audit Committee exists in all banks as required by law, but the function could be enhanced if made a direct subcommittee of the Supervisory Board. Although the committees are composed of independent members and have a reporting line to a bank's Supervisory Board, legally members are not held to the same accountability standards as Supervisory Board members. Still, the NBG has facilitated the banks to establish such committees as subcommittees of the Supervisory Board. The NBG does not have the explicit power to change Board composition. However, such power is implicitly in place. The NBG has the power to require dismissal of a Board member (LACB article 30.3e) who lacks experience or education (LACB article 41).
15. Risk management process	The NBG has a very good supervisory approach, which can be characterized as intrusive, forward-looking, and risk-based. Although the NBG has made significant progress, there are several essential criteria that are not yet fully met for large, medium, and small banks. The NBG rightly focused first on the largest banks (with highest risk profile), but should also bring the small and medium banks (proportional though) up to standard. The implementation of Basel II is an important step forward in this regard. However, one cautionary remark is to be made. Though the intrusive approach is highly appreciated, the NBG runs the risk of being too involved and taking over the bank's risk management, in particular, its credit risk management. First, the NBG is required to determine that banks have a suitable risk appetite. For instance, many banks do not have detailed lending standards or their interest rate risk appetite. It is expected that the implementation of Basel II will provide the right incentive in this regard. Second, the NBG is required to determine that banks have adequate internal processes for assessing capital and liquidity adequacy in relation to risk appetite and risk profile, and that this is also reflected in banks' internal reporting. However, these requirements are not (yet) met because banks are in the process of implementing Basel II, under which they are setting up an internal process for assessing the capital and liquidity adequacy in relation to the risk profile (ICAAP, ILAAP). A few banks have already submitted the first draft of their ICAAP. In addition, the NBG has not yet developed guidelines for how to determine the adequacy of the ICAAP in the so-called Supervisory Review Evaluation Process (SREP). Third, the NBG is required to request banks to have appropriate contingency arrangements and forward-looking stress tests. However, these requirements have not yet been fully implemented by all banks. The NBG expects all banks to have adequate stress tests in place at the end of this year as part of the implementation of Basel II.

Core Principle	Comments
	Finally, the NBG is required to determine that the risk management function is clearly segregated by the risk-taking function. However, it is observed in the assessment of bank governance conducted during the FSAP that the credit risk management function/Chief Risk Officer (CRO) is involved in the credit-approval process. In addition, it is important to note that several banks have remuneration policies for their credit risk management that combine elements of growth, volume of analysis, and quality of the loan portfolio.
16. Capital adequacy	The NBG is in the process of implementing Basel II and elements of Basel III. The NBG used a conservative application of Basel rules such as double capital requirements on loans denominated in foreign currencies. Banks are required to comply with the minimum capital requirements under Pillar 1 as of June 30, 2014. Regarding credit risk, banks can only apply the standardized approach. Regarding operational risk, banks can only apply the basic indicator or standardized approach. Regarding market risk, banks are required to use a simple approach to determine a capital requirement for FX risk. Pillar 2 will be in force as of September 30, 2014, when banks are required to report the outcome of their Internal Capital Adequacy Process (ICAAP). The NBG will decide before end-2014 when banks need to comply with the Pillar 3 requirements. During the transition period (2014-2017) banks need to comply with both the minimum capital requirements based on adjusted Basel I capital requirements and the minimum capital requirements based on Basel II/III. As of January 2014, banks have been required to file a parallel run.
17. Credit risk	The NBG has developed a very advanced, risk-based approach to determine whether banks have an adequate credit risk management system. This includes the assessment of credit risk policy and procedures, management information, and loan reviews. Together with the detailed monthly return, the NBG has the opportunity to do cross-checks and rigorous credit risk analysis. This analysis is (for the corporate and SME portfolios) based mostly on key ratio analysis (derived from Moody's and S&P) and valuation of collateral. However, in practice, not all banks have (yet) fully implemented the specific requirements of the credit risk management framework such as adequate lending standards. Second, there are no specific requirements that require banks to prescribe in their credit policy that major risks exceeding a certain amount or percentage of the bank's capital, as well as risky exposures that are otherwise not in line with the mainstream of banks' activities, are to be decided by the Board or senior management. Third, not all banks include their credit risk exposures into stress testing programs for risk management purposes. The NBG is currently facilitating implementation of a sound stress-testing framework in commercial banks, which would form an essential

Core Principle	Comments
	part of Pillar 2 processes by the end of the year.
18. Problem assets, provisions, and reserves	The NBG has put significant effort into identifying problem loans and maintaining adequate levels of provisioning, mostly for the large borrowers (40 percent of total loan portfolio). For SME and retail borrowers, it uses for instance sample techniques to ensure adequate provisioning. All of this is the result of comprehensive reporting, enhanced risk assessment skills, an intrusive supervisory approach, and active dialogue with the commercial banks. The NBG intends to facilitate transition toward the IFRS. When the IFRS framework is adopted, the NBG intends to update its guidelines on loan-loss provisioning.
19. Concentration risk and large exposure limits	The NBG has made major improvements in identifying connected borrowers. It receives on a monthly basis a database from every bank of the top 100 borrowers, the large exposures, and the participations, which has given the NBG the possibility to compare how banks treat groups of borrowers. Although banks are required by regulation to identify economic interdependence, there is limited practice at the banks to do this. This means that, for part of the portfolio, it is not fully clear what the large exposures are from the perspective of economic interdependence. However, to mitigate this uncertainty, the NBG decreased its total large exposure limit from 600 percent to 200 percent. Nevertheless, banks should put more effort into identifying economic interdependence. For this purpose, the NBG is planning to develop guidelines on economic interdependence. The regulation on concentration and large exposures does not prescribe requirements for concentrations other than single counterparties or groups connected counterparties. Although the NBG adopted a general regulation on risk management that includes some provisions on concentration risk, it did not fully implement this regulation. This will be repaired, according to the NBG, with the introduction of Pillar 2 of Basel II, which explicitly requires banks to assess all significant sources of concentration risk. The NBG recently prepared to change the definition of large exposures according to the new Basel standard on large exposures and concentration risk (June 2014). So, it includes all claims, including equity (although the position does not seem to be material). This amendment is not fully implemented yet.
20. Transactions with related parties	The NBG has put significant effort into identifying related parties and related transactions and making sure that transactions take place at an arm's-length basis. In addition, the supervisor reviews the pricing of both the loan and deposit sides in order to look for irregularities. The latter also gives the NBG the possibility to cross-check how different banks deal with related parties. Finally, it also determines, during credit risk assessments, whether it is a case of related parties and/or related transactions.

Core Principle	Comments
21. Country and transfer risks	The NBG very actively monitors the country and transfer risk (direct and indirect) themselves based on prudential reports and recently (May 2014) started to stimulate banks to manage their country and transfer risk through issuing a guideline on country and transfer risk. Further, the NBG does not determine systematically whether the bank's strategies, policies, and processes have been approved by the bank's Board and whether the Board oversees implementation by management. In addition, only the largest banks conduct stress tests and incorporate adverse scenarios of country and transfer risk. In the second half of 2014, the NBG will review the ICAAP set up by the banks (SREP) in order to stimulate an alignment between the risk profile, capital position, and the quality of risk management. This will give the right incentives to the banks to manage their country risk explicitly. The NBG does not have a formal provisioning model for country risk and transfer risk. Banks have the discretion to consider themselves whether provisioning for country risk is deemed necessary. It is part of standard analysis of a borrower. At the same time, if the NBG is not satisfied with the level of provisioning and the way it has taken country risk or transfer risk into consideration, it has the power to require extra provisioning. The NBG has used this power in the case of bank exposures to one country.
22. Market risk	The market risk in the trading book is not material (including consolidated supervision). The main market risk is foreign exchange risk. The NBG determines sufficiently whether banks have an adequate market risk management process, taking into account the market and macro-economic conditions. Since June 2014, currency risk is charged under Pillar 1. In September 2014, Pillar 2 will become effective.
23. Interest rate risk in the banking book	Banks could receive more guidance from the NBG on improving the quality of interest rate risk management. Despite the presence of guidelines on risk management introduced in 2008, it seems there is further room for improving the quality of interest rate risk management of banks. However, based on the new reporting standard, introduced in 2012, most of the banks don't have a material interest rate risk position because of the basic short-term nature of their balance sheets, although one systemic bank does have a material interest rate position without internal limits. This bank holds earmarked capital as a buffer for interest rate risk. All banks should take their interest rate risk into account in relation to their capital position, including defining trigger ratios. This will be part of the implementation of Basel II, Pillar 2.
24. Liquidity risk	Liquidity risk assessment by the NBG covers all aspects of liquidity. The NBG analyzes banks' inherent liquidity risks as well as their mitigants. Systemic and complex banks are required to have a more developed liquidity risk management framework. The NBG imposes a conservative liquidity requirement and is also in the process of moving toward the Basel III framework (Liquidity Coverage Ratio (LCR))

Core Principle	Comments
	The new regulation on liquidity risk will enter into force in September 2014. However, the NBG focuses its efforts on improving the quality of liquidity risk management of banks, mainly for the three largest banks. This is understandable from a risk-based supervision point of view, but there is a risk that the quality of liquidity risk management of the other banks lags behind. The assessors believe that these shortcomings will be resolved in the near future since the NBG is in the process of implementing the new regulation on liquidity (including elements of Basel II and III). Banks' have access to the NBG's emergency liquidity facility (ELA), pledging as collateral government or NBG debt instruments, and loans, including mortgages, with a 20 percent haircut.
25. Operational risk	The NBG made good progress in the area of operational risk. The recent enacted regulation and the establishment of a specialized operational risk unit significantly broadened the scope of operational risk supervision and expanded supervision into key areas that were not covered directly before (that is, business continuity management and outsourcing). There are some areas of improvement that are also recognized by the NBG. First, only 7 out of 21 banks have comprehensive business continuity plans (though these include the largest banks). The other banks have only disaster-recovery plans and should broaden their perspective toward comprehensive continuity plans. Second, most of the banks lack adequate outsourcing policies. Third, banks have insufficient internal reports that should, according to the NBG, be more analytical in nature. Fourth, most of the banks do not perform IT audits. This will probably change, since the new regulation requires incorporation of IT audits in the overall audit plan of banks.
26. Internal control and audit	As mentioned in CP 14, the law provides that an Executive Director can be appointed to the Supervisory Board, the body charged with the oversight of the executive, although Directors are prohibited by law from participating in decision making on issues related to supervision of executive functions activities, approval, and evaluation of its reports.
27. Financial reporting and external audit	The auditor has up to five business days in which to notify the NBG of any matters of serious significance that come to his/her attention, but that period is too long. However, the regulation was recently amended, requiring the auditors to report immediately material changes to NBG supervisors.
28. Disclosure and transparency	The NBG's current requirements for banks to disclose quantitative and qualitative information are limited on the qualitative side. The NBG plans to enhance its regulation on transparency with the introduction of IFRS 7 and Pillar 3 disclosures on the qualitative side. It will also require banks to publish information on their lending standards.

Core Principle	Comments
29. Abuse of financial services	There is no explicit obligation on banks to report to the NBG suspicious activities and incidents of fraud where such activities/incidents are material to the safely, soundness, or reputation of the banks. The definition of Politically Exposed Person (PEP) refers solely to a foreign citizen and does not address domestic PEPs nor persons entrusted with a prominent function by an international organization as is now required by the standard. The FMS (FIU) is moving from under the auspices of the NBG to the Office of the Prime Minister. There is some concern about its continued independence, including staffing and funding.

Table 8. Georgia: Recommendations to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Actions
Principle 1. Responsibilities, objectives and powers.	Seek review of the NBG Law, so that banking supervision will be given equal status to price stability as the main task of the National Bank. Amend Article 21 of the ACB Law so that in setting and enforcing minimum prudential standards all areas are covered and not just those listed in the Article. Amend the law to make public consultation on new laws and regulations statutorily binding.
Principle 2. Independence, accountability, resourcing and legal protection for supervisors.	Review NBG salary levels in light of NBG's legal obligation to maintain effective supervision by maintaining high qualified and experienced staff. The NBG should increase its training and education budget. Consider charging for supervision. (This recommendation is solely advisory —it is not taken into account in determining the rating.) The NBG should publish a more comprehensive and detailed strategic plan and targets in its annual accounts. Make specific legal provisions that the supervisor and its staff will be adequately protected against the cost of defending their actions and/or omissions made while discharging their duties in good faith. The protection afforded to staff on a personal level for any action done or not done, as long as such action was done or refrained from in good faith, should be extended to the supervisor itself.

Reference Principle	Recommended Actions
Principle 5. Licensing criteria	Introduce explicit and specific legal provisions relating to the NBG powers rather than relying on its broad powers to achieve its goals. This seems to work adequately in practice, but, in the interest of certainty and clarity, specific provisions should be introduced. Provide explicit powers that foreign banks proposing to establish a locally incorporated bank in Georgia must obtain the prior consent of its home supervisor to do so (as is currently the case for foreign banks proposing to establish a branch bank in Georgia). In determining the suitability of banks' shareholders, the NBG should, in addition to approving significant shareholders (owners of 10 percent or more of the share capital of the bank), have regard for others who may exert significant influence on the bank.
Principle 6. Transfer of significant ownership.	Expand the definition of "significant shareholder" to include persons acting in concert. Make it legally binding that existing significant shareholders proposing to dispose of their shareholding must notify the NBG in advance. Make it legally binding for banks to have to notify the NBG as soon as they become aware of any material information that might negatively affect the suitability of a major shareholder or a party with a controlling interest in the bank.
Principle 7. Major acquisitions	Provide direct statutory backing to the criteria used by the NBG to judge investment proposals by banks.
Principle 8. Supervisory approach	Complete the implementation of the new supervisory approach and formalize it. Set up a clear framework for distressed banks and require banks to set up resolution plans in order to identify and mitigate possible barriers for resolution. Undertake a crisis-simulation exercise.
Principle 9. Supervisory technique and tools	Consider how to balance the attention for inherent risk and quality of risk management. Integrate identification of risk culture in the supervisory approach and spending more time on-site to sense the risk culture.

Reference Principle	Recommended Actions
Principle 11. Corrective and sanctioning powers of supervisors	Employ an escalation framework for safety and soundness issues. Reflect to what extent NBG could have been more effective with regard to deficiencies that linger for a protracted period of time. Initiate law or regulation that gives the NBG the power to set individual risk governance requirements, intervene in the organizational structure or business model of a bank.
Principle 12. Consolidated supervision.	Ensure that a formal consolidated prudential reporting framework is in place by November 2014, as targeted.
Principle 14. Corporate governance	Increase involvement of Boards in setting and overseeing risk appetite. Align the legislation and regulation with regard to the role of Directors in a Supervisory Board. Make the Overseeing Risk Committee and Remuneration Committee a requirement by law or regulation. Encourage banks to make the Supervisory Committee directly responsible for the Audit Committee. Initiate a law that gives the NBG power to change the composition of a Board.
Principle 15. Risk management	Make sure that banks express their risk appetite for the different risk categories. Continue implementing Basel II, including ICAAP, contingency planning, stress testing, and SREP. Determine the internal pricing mechanism of all banks. Evaluate the role and independence of CRO and (credit) risk management, including the incentive structure.
Principle 16. Capital adequacy	Introduce a framework on how to deal with domestic systemically important banks, including the introduction of a capital buffer. Consider introducing a countercyclical buffer. Set up an implementation plan for Pillars 2 and 3 for banks and supervisors, including deciding who will do the assessment. Develop guidance for supervisors on SREP. Develop Pillar 3 requirements for banks.

Reference Principle	Recommended Actions
Principle 17. Credit risk	Stay focused on ensuring that all banks implement the credit risk management requirements under which the requirements for lending standards. Require banks to have certain exposures exceeding a certain amount to be decided by the banks' Board and senior management. Make sure that all, and not only large banks, include credit risk exposures in their stress tests.
Principle 19. Concentration risk and large exposure limits	Develop regulation or guidelines for concentration risk beyond large exposures. Make banks improve their identification of the economic interdependence of borrowers. Consider developing a limit for the 10 largest exposures.
Principle 20. Transactions with related parties	Add legal provisions that explicitly require write-off of related party exposures to be subject to prior approval by the bank's Board.
Principle 21. Country and transfer risk	Continue implementing the guideline on managing country and transfer risk, including stimulating the Board to explicate their risk appetite, set county and transfer risk limits, and take responsibility in overseeing the management. Develop an explicit provisioning system for country risk and transfer risk. Require prudential return on country risk on consolidated level on a semi-annual base.
Principle 22. Market risk	Continue implementing the new capital regime, since this will enhance risk management. Incentivize all banks to conduct stress tests. Allocate capital for unexpected market risk losses.
Principle 23. Interest rate risk in the banking book	Require banks (through regulation) to have internal limits for interest rate risk. Provide more guidance to banks on how to deal with interest rate risk in relation to ICAAP. Increase the frequency of reporting to a quarterly basis in order to keep abreast of developments.

Reference Principle	Recommended Actions
Principle 24. Liquidity risk	Continue with the finalization and implementation of draft regulation of LCR. Ensure that all banks have adequate contingency funding planning, taking into account limited opportunities.
Principle 25. Operational risk	Make sure that all banks set up business continuity plans and outsourcing agreements (including taking the local environment into account) and conduct (mandatory) IT audits.
Principle 26. Internal control and audit.	Seek the removal of the legal provision that allows Executive Directors to sit on Supervisory Boards.
Principle 28. Disclosure and transparency.	Enhance the level of qualitative information that banks are required to disclose in their annual accounts.
Principle 29. Abuse of financial services.	Legally require banks to report to the NBG any suspicious activities and incidents of fraud where such activities/incidents are material to the soundness or reputation of the banks. Require financial institutions to take the measures required by FATF Recommendation 12 with respect to domestic PEPs and persons entrusted with a prominent function by an international organization.

Authorities' Response to the Assessment

The National Bank of Georgia (NBG) would like to express its appreciation towards the FSAP mission team and its assessment of Georgian banking sector and the supervisory quality. We strongly respect the integrity of the mission members and the quality of the reports produced. We appreciate the efforts of the team to analyze the major developments in the banking sector and its supervision and observe major improvements which, according to the assessment, have resulted in an advanced, forward-looking, intrusive, risk-based, efficient, comprehensive and, in several instances, even leading supervisory approach. The discussions with the team members constituted a very interesting process for us. The recent assessment further increased our confidence that we are on the right path, pursuing well-established international standards. Such a positive assessment and acknowledgement of progress made gives forward momentum to remain committed to the continuous enhancement of our supervisory framework based on BCP principles and other international best practice guidelines.

We hope that FSAP project will be granted adequate importance and credit from IMF and WB in future as well, as it represents a very valuable instrument for the assessment of country practices. We believe in enhanced role of FSAP assessments, especially considering that self-identified shortfalls by IMF and WB (August 28, 2009) are gradually being eliminated through the improvement of analytical content, quality, and comparability of assessments and strengthening of "off-site" work. In our view, further efforts are required to ensure that all stakeholders interpret the BCPs in an adequate and uniform manner and apply all aspects of grading methodology to arrive at fair, competent and proportionate grading. In addition, increased emphasis on qualitative content and observance of particularly good practice would result in more stakeholders utilizing assessment reports as an input into their analysis for policy design. Such enhancements should promote better cross-country comparability of assessment results as well. In addition, we would like to highlight (not only in reference to Georgian assessment) that more emphasis should be made on testing the quality of supervisory judgment in practice, taking into account the role of FSAPs in enhancing financial stability.

Hereby we provide individual comments on several principles:

CP2 (Independence, accountability, resourcing and legal protection for supervisors)

The major driver of "MNC" score is the lack of salary competitiveness of the supervisor as compared to the banking industry and junior staff turnover rate. We would like to note that budget limitations have not compromised professionalism and effectiveness of NBG staff. As assessors also confirm that the quality of supervision staff is impressive, we consider the assigned grade to the principle rather incompatible.

CP5 (Licensing criteria)

We believe that we are fully compliant with all the requirements of the given principle. Legal requirement for the NBG to assess whether the home supervisor practices global consolidated supervision, and/or whether its supervision standards are equivalent to those of the NBG is not required by the BCPs. The principle refers solely to the practice that we effectively have in place. We would like to highlight that we have inquired if the assessment was in line with Basel FSI interpretation of the terms "supervisor determines," "supervisor assesses," "the supervisor requires" and "has the power to require." According to the feedback from assessors, presence of legal provisions was important despite the fact that it is not required by formal BCP guidelines. We strongly believe that such a deviation from assessment methodology had a significant negative impact on the grading of 1st, 5th, 7th and 15th principles.

CP6 (Transfer of significant ownership)

There are no sufficient qualitative observations presented in the assessment of the given principle that would reflect how we meet the objectives of the principle. We believe that all essential criteria are being satisfied in practice. We would additionally like to note that there is no risk that we are unaware of any changes in relation to shareholders, as banks have a clear notification requirement. Despite the fact that there are no practical concerns in place, we commit to eliminating legal gaps, such as prescribing in legislation "shareholders acting in concert," and introducing the obligation to receive supervisory approval for the disposal of qualifying holding.

CP 7 (Major acquisitions)

The assessment would have benefited from more qualitative content. We have a fairly comprehensive approach towards the analysis of major acquisitions and in practical terms we meet all aspects of the 7th principle. Besides, identified legal gaps, listed in the comments section, and are not stipulated by BCPs, for instance, legal obligation on supervisor to assess the effectiveness of the host supervisor.

CP 8 (Supervisory approach)

We were not convinced that there are any inconsistencies with Basel core principles. Given the absence of cross-border activities in Georgia and the prevalence of non-complex banking system and their balance sheets, the resolvability assessment under Georgian context is fairly straightforward and does not pose any material concerns. Moreover, even in advanced financial centers, resolvability framework is at an early stage of implementation; however, such observations have not impeded full compliance with the given principle. It should as well be noted that in practice, NBG has taken all relevant measures in cases where resolvability posed excessive risks to local banks. Among them are the requirements of operational independence, ring-fencing, simplification of group structure, etc. Going further, we plan to update the regulation on dealing with problem banks in line with the FSB's key attributes and Basel guidelines. As regards to supervisory approach, its enhancement is a continuous process in line with updating international standards.

CP 11 (Corrective and sanctioning powers of supervisors)

We agree that some deficiencies could exist for a prolonged period of time in commercial banks; however, consideration should be given to their materiality and the assessment benchmark as well. We did not receive concrete feedback to clarify the instances where there is a room for improvement and the relevant means despite the fact that we have been fully transparent to the assessors which is an important precondition for fruitful dialogue. In addition, we believe that we do have the powers to set individual risk governance requirements, intervene in the organizational structure or business model of a bank evidenced by practical examples. Relevant escalation matrix is also in place. We will conduct additional review to clarify the substance of the comments under the given principle; however, as of now we consider the recommended action plan to have been implemented already.

CPs 15–25

We confirm that we are committed towards further improvement of banks' risk management. However, we believe the assessment was conducted against benchmarks that are too high contradicting the proportionality principle which constitutes one of the cornerstones of BCP assessment methodology. The assessment of the 15th principle stands out as principally unclarified to us.

We do not agree that we focus on largest banks only in our supervisory assessments. We focus on every bank in line with the risk based supervision principles, and we are indeed oriented towards continuously bringing banks closer to their specific relevant standard. The fact that the sophistication of risk management varies across banks is in line with BCPs. Assessors highlight the need for more attention to the quality of the liquidity risk management and its supervision in small banks. We would like to affirm that NBG monitors liquidity risk management of each and every bank and that there are diverse examples of actions taken by NBG for both large and small banks.

We would like to comment on the assessment of ICAAPs as well. The transition to pillar 2 of Basel II/III has started in recent past; however, that does not imply that we are not complying with the core principles that refer to the assessment and planning of capital adequacy both by banks and supervisor. In 2009, NBG introduced legal provisions in LACB that empowered it to impose individual requirements on commercial banks in line with risk based supervision principles. Recent formal launching of pillar 2 of the Basel II/III does not imply that NBG has not already been assessing the ability of banks to quantify risks, price risks and govern risks which incorporate the calculation of both expected and unexpected losses. Instead, our approach has already been risk-based and the capital requirements across different banks have been in line with their individual risk profiles, what is also confirmed by the mission. As a result, the transition to Basel II/III is not a reversal of our current practice, but it should supplement the existing one. It should also be noted that Georgia is not the only country that is in the implementation process and there are many advanced economies that have not yet implemented the framework, or do not generally request ICAAP from small banks.

In certain instances the assessors advise NBG to introduce excessive pieces of legislation and/or impose requirements on banks to advance their internal models and risk management systems to address absent or very immaterial risks. For instance, we do not agree that there is a need to introduce formal provisioning model for country risk when there are no such direct exposures. Neither is there a need to require from bank boards to monitor such an absent risk. Nevertheless, when such even indirect risks have emerged, NBG has always determined and required from banks to address them. We believe that our practice in quantifying indirect country risk is effective through the estimation of exposures to companies which export/import from relevant countries (taking into account relevant shares of exports/imports in their returns).

Further, we cannot agree that there is any risk of us effectively becoming bank risk managers as intrusive supervision is what is urged and favored internationally. We strongly believe that the unfortunate lack of familiarity of supervisors with inherent risk of banks was one of the severe weaknesses which, at least to some extent, contributed to the global financial crisis and, in this regard, our detailed knowledge of risks in individual banks, as well as results of innovative horizontal reviews, should be seen as a particularly good practice. We also could not fully comprehend what is meant by the statement that banks do not have detailed lending standards. In addition, the fact that NBG commenced the implementation of regulatory stress-tests last year, which are transaction level and enterprise-wide, should not have interpreted as if banks had not already performed their own ones. In relation to credit and concentration risks, we have not observed any material concerns from the side of the assessors that could have compromised the efficiency of our framework. Furthermore, we believe we share a common view with the mission that all individual findings are not seen as "severe shortcomings," which is required to be evidenced if a principle is assessed as MNC. We agree that CP 15 is an overarching principle and incorporates findings from other principles, but it remains ambiguous to us how the combination of those findings was interpreted jointly. Moreover, based on the aforementioned findings relevant principles were already excessively downgraded to "LC." Consequently, the assessment methodology of fifteenth principle remains unclear and involves double counting, which is against relevant BCP methodology.