

**EXECUTIVE
BOARD
MEETING**

SM/21/159

Correction 1

September 14, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Georgia—Financial System Stability Assessment**

Board Action: The attached corrections to SM/21/159 (8/30/21) have been provided by the staff:

Evident Ambiguity

Page 27

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 9, 18, 45, 57

Questions:

Mr. Saiyid, MCM (ext. 35477)

Table 1. Georgia: Key Recommendations

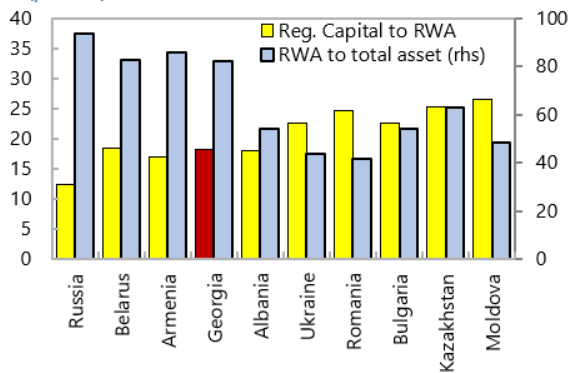
Recommendations and Authority Responsible for Implementation ^{1/}	Timing ^{2/}
Financial Stability Analysis	
Encourage banks to retain earnings until pandemic-related uncertainties subside and pre-pandemic capital buffers are restored.	ST
Implement Basel regulation on banks' large exposures as planned.	ST
Macroprudential Policy and Dollarization	
Review calibration of macroprudential tools aimed at reducing dollarization, including via impact assessments.	ST
Strengthen communication of the impact and rationale of macroprudential policy decisions to stakeholders.	ST
Enhance public communication to clarify the objectives of foreign exchange interventions.	I
Banking Supervisory Oversight	
Formalize and enhance the governance of key internal processes for supervisory operations and decisions.	I
Review the internal GRAPE scoring and weighting methodology.	ST
Carry out regular in-depth assessments of banks' governance and risk management practices.	ST
Require systemic banks and encourage others to incorporate internal stress testing in capital and liquidity planning.	ST
Anti-Money Laundering / Countering Financing of Terrorism (AML / CFT) Supervision	
Strengthen regulation / supervision for gaming sector, virtual asset service providers, and real estate agents. (MoF)	MT
Consider setting maximum thresholds for use of cash in certain transactions.	ST
Capital Markets Oversight	
Continue to develop and implement risk-based supervision for all market participants.	ST
Ensure that sanctions for market abuse are sufficiently punitive.	I
Financial Safety Nets	
Implement a prompt corrective action framework for banks.	I
Take steps to be able to implement a bridge bank swiftly when needed. (MoF, NBG)	I
Prepare crisis contingency plans for banks and adopt regular testing programs. (IFSC, NBG)	ST
Financial Sector Development	
Financial Market Infrastructure	
Develop detailed procedures for oversight of payment systems	I
Complete self-assessments of the two Central Securities Depositories. (NBG, GCSD)	I
Financial Sector Competition	
Develop institutional capacity for competition enforcement and advocacy as a separate function within NBG.	I
Carry out impact assessments of laws and regulations in the financial sector from a competition perspective.	ST
Capital Markets Development	
Commit to a predictable schedule of issuance for benchmark government bonds in sizable amounts. (MoF)	I
Enact relevant legislation for covered bonds as planned. (MoF, NBG)	I
Access to Finance	
Define a roadmap for the development of fintech and a National Financial Inclusion Strategy.	ST
Establish an online collateral registry and strengthen the legal framework for secured transactions. (NBG, MoJ)	ST
^{1/} Authority responsible for implementation is NBG unless indicated otherwise.	
^{2/} I Immediate (within 1 year); ST Short term (1-3 years); MT Medium Term (3-5 years)	

Figure 6. Georgia: Comparison of Selected Financial Soundness Indicators

2021 Q1 or Latest Available (percent)

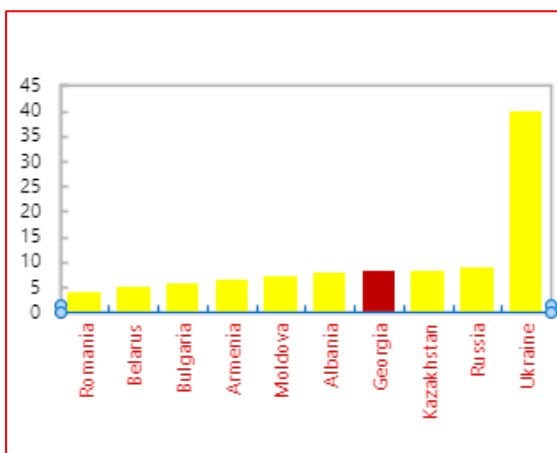
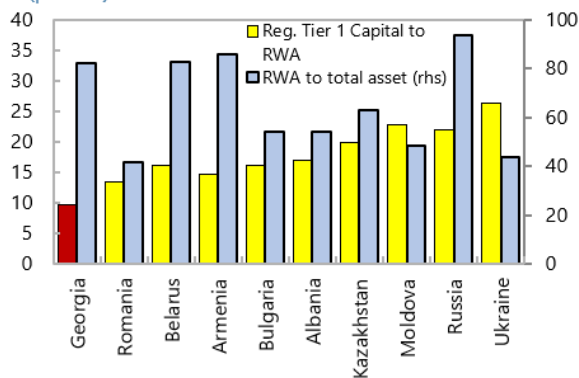
Regulatory Capital to Risk-weighted Assets

(percent)



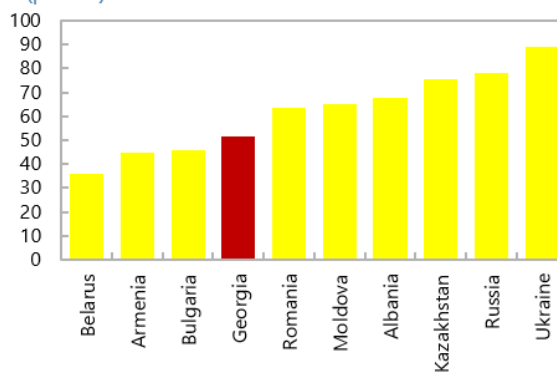
Regulatory Tier 1 Capital to Risk-weighted Assets

(percent)



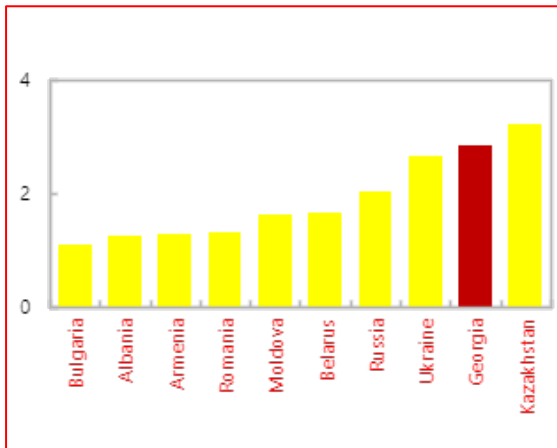
Provisions to NPL

(percent)



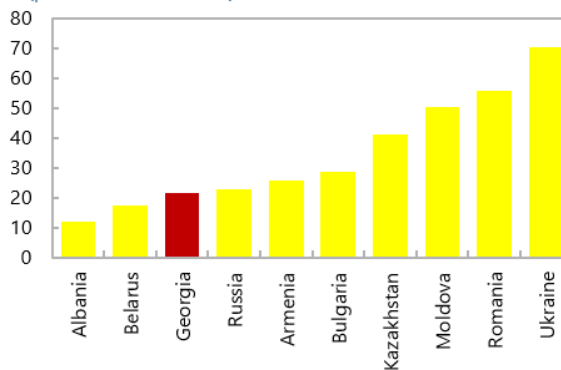
Note: NBG definition of NPLs for Georgia, IMF for all others.

Note: Specific provisions based on IMF FSI methodology.



Liquid Assets Ratio

(percent of total assets)



Source: IMF FSI

in place during the COVID-19 crisis, apart from a temporary, partial release of the CICR buffer, avoiding a setback of the de-dollarization agenda.

27. Further asset de-dollarization will depend on banks' ability to raise local currency funding. Households still prefer to save in foreign currency, which banks then channel to foreign currency loans. Sources of stable lari funding are scarce. **Introducing** excessive restrictions on foreign exchange lending risk financial disintermediation as banks may need to adjust lari deposit rates significantly, which would make lari credit more expensive. As the recovery takes hold, the NBG will need to continue to build a track record of low and stable inflation, which will have to be supported by the government via sound fiscal policies. The development of covered bonds could provide households with an alternative local currency savings instrument, while also providing banks with a means to raise local currency funding.

28. The NBG should review calibration of the macroprudential toolkit periodically and carry out impact assessments of any planned measures. For example, the NBG could leverage the large amount of income data accumulated including during the COVID-19 crisis to reassess PTI thresholds as appropriate. Over the medium term, the authorities should consider tightening dollarization measures gradually, with the choice of measures and calibration informed by impact assessments. Market-based measures are generally better suited to avoid inefficiencies in the allocation of credit while borrower-based measures can better target vulnerabilities but rely on additional data, which may be difficult to obtain. Outright restrictions, such as an increase in the 200,000 GEL limit, have higher efficiency costs but are easier to communicate and implement.

29. Although data supporting the implementation of tools is generally of good quality, there may be some areas for improvement. The NBG's planned credit registry, which will collect additional information on the income of borrowers and interest rates paid on their loans, is a welcome step. As in other countries, income verification using tax returns is challenging for borrowers in the informal sector, complicating implementation of borrower-based measures.

30. There is scope for the authorities to strengthen communication with the public. The following areas should be prioritized:

- **Foreign exchange intervention policy.** A series of external shocks in recent years and the pandemic have led to a depreciating trend in the GEL/USD exchange rate from 2019 to mid-2021. The NBG's objectives of reserve accumulation and volatility reduction in the FX market have at times been misperceived as conflicting. This could be addressed by a carefully timed publication of the FX intervention strategy and further public outreach. Together with sound macroeconomic policies, a well-designed and communicated FX intervention framework could help to establish more balanced exchange rate expectations and moderate demand for one-way hedging instruments like FX deposits.
- **The rationale for macroprudential policy decisions and their impact.** Adopting new tools for communicating risk assessments (e.g. heatmaps), publishing policy papers and increasing public outreach to banks and the non-financial sector would help to facilitate acceptance by stakeholders.

Table 5. Georgia: Financial Soundness Indicators for the Banking Sector

(in percent)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 Q2
Capital Adequacy											
Regulatory capital to risk-weighted assets	17.1	17.0	17.2	16.5	16.7	15.1	19.1	18.4	19.5	17.6	19.2
Regulatory tier 1 capital to risk-weighted assets	11.3	13.4	13.0	13.1	12.0	10.5	14.0	13.5	14.6	12.8	14.8
Asset quality											
Non-performing loans to total gross loans (IMF FSI data)	4.5	3.7	3.0	3.0	2.7	3.4	2.8	2.7	1.9	2.3	2.2
Non-performing loans to total gross loans (NBG)	8.6	9.3	7.5	7.6	7.5	7.3	5.9	5.5	4.4	8.2	6.7
Provisions to non performing loans (IMF FSI data)	70.9	59.1	59.0	57.6	55.8	56.1	54.8	54.2	51.9	50.8	50.2
Sectoral Composition of loans											
Loans to residents	98.8	98.4	97.9	97.4	96.4	97.8	97.6	97.4	97.4	96.4	96.3
Inter-bank loans	0.2	0.2	0.9	0.8	0.4	0.2	0.1	0.0	0.1	0.2	0.0
Other financial corporations	1.1	1.2	0.8	1.2	1.6	1.4	0.9	0.7	0.7	0.0	0.0
General government	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non financial corporates	59.9	58.4	54.9	51.4	51.9	50.1	48.3	46.3	49.1	47.1	46.4
Other domestic sector	37.4	38.6	41.4	44.0	42.5	46.1	49.2	50.5	47.5	49.1	49.9
Loans to non-residents	1.2	1.6	2.1	2.6	3.6	2.2	2.4	2.6	2.6	3.6	3.7
Profitability											
Net income (yoy percent change)	93.0	-50.4	144.1	28.4	10.5	32.1	18.8	13.3	-1.1	n.a.	n.a.
Return on assets (ROA)	3.2	1.3	2.9	3.1	2.7	3.2	3.1	3.1	2.5	0.2	4.0
Return on equity (ROE)	19.3	7.8	16.5	17.6	17.7	22.1	23.3	23.5	20.4	1.4	37.3
Interest margin to gross income	61.1	59.8	60.0	60.0	60.8	58.0	58.9	61.0	58.1	58.1	57.1
Non interest expenses to gross income	62.3	59.8	55.7	53.4	51.0	49.8	51.8	49.6	52.9	56.5	46.8
Liquidity											
Liquid assets to total assets	28.7	27.3	27.5	22.2	23.4	22.8	21.3	21.6	19.6	21.4	20.9
Liquid assets to short term liabilities	44.4	44.8	43.1	34.8	35.6	34.0	32.1	27.1	24.2	25.6	26.8
Total LCR				130.2	120.8	119.2	129.6	123.7	133.3	138.7	144.2
LCR in GEL				143.5	117.3	108.4	120.3	126.0	101.5	114.9	116.3
Other											
Household Debt to GDP	13.1	14.7	20.0	24.4	27.2	32.1	33.7	36.7	33.7	41.9	43.3
Residential real estate loans to total loans	18.0	18.1	19.4	21.3	26.4	28.2	28.9	32.4	31.6	32.8	33.0
Commercial real estate loans to total loans	33.5	30.8	29.7	29.0	26.2	27.6	25.5	24.4	26.3	31.8	31.3
Foreign Currency denominated loans to total loans	68.7	67.4	62.1	60.3	64.2	65.4	56.9	56.9	55.1	55.3	52.4
Foreign Currency denominated liabilities to total liabilities	68.7	69.3	65.9	63.6	70.7	70.7	63.5	61.4	61.6	61.4	58.7

Sources: National Bank of Georgia, FSI database

Domain		Assumptions
		Top-down by FSAP Team
		<ul style="list-style-type: none"> Impact of shocks on NPLs. Impact of shocks on key P&L components.
Banking Sector: Liquidity Stress Test		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> All fifteen banks.
	Market share	<ul style="list-style-type: none"> About 95 percent of total financial system assets.
	Data and Starting position	<ul style="list-style-type: none"> Baseline date: December 31, 2020 (possibly updated at a later date). Data Source: Daily supervisory returns on bank liquid assets and liabilities, and projected cash flows at various horizons. Liabilities classified by liquidity, currency, size, and residency of the counterparts.
2. Methodology	Overall framework	<ul style="list-style-type: none"> Cash-flow cum counterbalancing capacity-based liquidity stress test Basel III-LCR ratio. Separate results by local and foreign currency.
3. Type of analyses	Scenario analysis	<ul style="list-style-type: none"> Four scenarios combining two shocks to liabilities and two assumptions on asset haircuts. Shock calibration based on historic data.
4. Risks and Buffers	Risks	<ul style="list-style-type: none"> Cash-flow based LST. Adverse shock to deposits and other liquid liabilities combined with reduction of asset liquidity
	Buffers	<ul style="list-style-type: none"> Cash-flow based LST: Capacity of banks to generate liquidity from assets under stress (counterbalancing capacity) and central bank facilities LCR regulatory buffers
5. Regulatory Standards	Regulatory Standards	<ul style="list-style-type: none"> National regulatory framework: The LCR and NFSR. Hurdle rates of 100-75 percent for LCR in local currency and 75 100 percent for LCR in FX.
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> Distribution of banks and total assets by intervals of LCR after shock.
Corporate Stress Test		
1. Institutional Perimeter	Entities included	<ul style="list-style-type: none"> About 100 large corporations on a solo basis, representing about 49 corporations at the consolidated level. The sampled firms have total assets equivalent to about 25 percent of GDP on a solo basis, and 28 percent of GDP on a consolidated basis. The sample targets the ten largest borrowers of each bank.
	Data	<ul style="list-style-type: none"> Publicly available financial data on corporations is limited due to the shallow capital market. The corporate stress test uses data from bank files, comprising the latest available balance sheet and income statement accounts of the sampled corporations on a solo and a consolidated basis.
	Time Horizon	<ul style="list-style-type: none"> Data are unbalanced, during 2018–20.