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AGENDA**

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INFORMATION**

October 10, 2001

To: Members of the Executive Board

From: The Secretary

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

This paper provides background information to the staff report on the 2001 Article IV consultation discussions with Georgia (to be issued), which is now tentatively scheduled for discussion on Friday, October 26, 2001. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Georgia indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Ms. Brenner (ext. 38500) and Mr. Cortés (ext. 34172).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, October 18, 2001; and to the European Bank for Reconstruction and Development, the European Commission, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

GEORGIA

**Financial System Stability Assessment**

Prepared by the Monetary and Exchange Affairs and European II Departments

Approved by Stefan Ingves and John Odling-Smee

October 9, 2001

This Financial System Stability Assessment (FSSA) was prepared on the basis of two Financial Sector Assessment Program (FSAP) missions to Georgia from May 1–15 and from July 24–August 6, 2001 that overlapped with the 2001 Article IV consultation. The team met with Mr. Managadze (Governor of the National Bank of Georgia (NBG)), the three Vice-Presidents of the NBG and the staff of NBG departments; Mr. Nogaideli (Minister of Finance); Mr. Singletary (Chairman of the National Securities Commission); and Mr. Tsertsvadze (Head of the Insurance Supervision Service). The team also met with the association of commercial banks and representatives of commercial banks, with the staff of USAID and the EBRD who are providing technical assistance to Georgia on financial sector issues, and with other government officials, parliamentarians, and NGOs.

The missions were led by Ms. Patricia Brenner (IMF, Chief) and comprised Mr. Martin Slough (World Bank, Deputy Chief); Messrs. Ian S. McCarthy, Mariano Cortés, Steven Seelig, and Wim Fonteyne, Ms. Vanya Etropolska (Research Assistant), and Misses Renée Cardenas and Margarita Aguilar (Staff Assistants) (all IMF); Mr. Stephane Fumeaux (Swiss National Bank), Mr. George Treacy (Central Bank of Ireland); and Ms. Tatyana Kandelaki, Mr. Noritaka Akamatsu, Mr. Gregorio Impavido, Mr. Peter Kyle, Ms. Susan Rutledge, and Mr. Rodrigo Chaves (all World Bank). Mr. Robert Fish (MAE Resident Advisor on Banking Supervision) worked with the mission. The mission also liaised with EU2 missions, headed by Mr. David Owen, that overlapped with the FSAP missions, with Mr. Christopher Lane (IMF Resident Representative), and with Mr. Tevfik Yaprak (Manager, WBO Tbilisi).

Financial intermediation in Georgia is underdeveloped, dominated by banks, and faces significant vulnerabilities to exchange rate and credit risks. While considerable progress has been made to strengthen bank supervision, important weaknesses remain to be addressed. However, it should be noted that many of these weaknesses would be remedied by legal reforms presently under consideration. The main risks to the financial system come from the relatively high fiscal deficit and external debt which could lead to pressures on the exchange rate, prices and output, with repercussions on the banking system. At the same time, weaknesses in the banking system and the quasi-fiscal costs of dealing with insolvent banks could lead to a deterioration in the macroeconomic environment.

This report has two parts. The first part presents the main findings and overall assessment, while the second part presents a summary assessment of observance of standards and codes regarding banking supervision, transparency in monetary and financial policies, the payment system, corporate governance and insurance supervision, as inputs into the overall assessment.

The main authors of this FSSA are Patricia Brenner, Mariano Cortés, Steven Seelig, and Wim Fonteyne (all MAE).

Contents	Page
SECTION I—STAFF REPORT ON FINANCIAL SYSTEM STABILITY .....	5
I. Overall Stability Assessment.....	5
II. Overview of the Financial System and Financial Intermediation.....	8
A. Dollarization.....	9
B. Macroeconomic Environment, Risks, and Exposures.....	9
C. Transparency of Monetary and Financial Policies .....	12
III. The Banking System .....	12
A. Structure, Ownership, and Performance .....	12
B. Soundness of the Banking System .....	16
C. Adjusted Baseline.....	16
D. Banking System Vulnerabilities and Stress Testing .....	18
E. External Credit Lines.....	20
F. Regulatory and Supervisory Framework .....	21
G. Compliance with Basel Core Principles.....	22
H. Systemic Liquidity .....	24
I. Financial Safety Nets, and Tools for Managing Banking Crises.....	24
IV. Legal Framework .....	27
A. Financial Sector Legislation.....	27
B. Bankruptcy .....	27
C. Collateral and Security Enforcement.....	27
D. The Judicial Sector.....	28
V. Payment and Settlement Systems.....	28
VI. Capital Markets.....	29
A. Background .....	29
B. Regulation .....	30
C. Government Securities Market.....	30
VII. Corporate Governance Issues .....	31
VIII. Summary of Policy Recommendations .....	32
A. Banking Supervision .....	32
B. Payment Systems.....	33
C. Government Securities Markets and Strengthening Systemic Liquidity Arrangements .....	33
D. Legal Framework .....	33

SECTION II—REPORT ON FINANCIAL SYSTEM STANDARDS .....	34
I. Observance of Basel Core Principles for Effective Banking Supervision.....	35
II. Observance of Monetary and Financial Policies Transparency Code .....	41
A. Monetary Policy .....	41
B. Banking Supervision .....	43
C. Insurance Regulation and Supervision .....	45
III. Observance of CPSS Core Principles for Payment Systems.....	48
A. Overview .....	48
B. Main Findings—Summary .....	50
C. Recommended Plan of Action and Response to Assessment .....	52
IV. IAIS Insurance Supervisory Principles .....	54
V. Observance of OECD Corporate Governance Principles Summary Assessment .....	57
A. Summary of Findings and Recommendations .....	57
B. Summary of Recommended Action Plan .....	59
Text Tables	
Table 1. Georgia: Macroeconomic Indicators, 1996-2000 .....	10
Table 2. Georgia: Licensed Banks, March 31, 2001 .....	13
Table 3. Georgia: Banking System Balance Sheet, March 31, 2001 .....	13
Table 4. Georgia: Bank Ownership by Type and Number of Institutions.....	14
Table 5. Georgia: Aggregate Indicators of Financial Soundness for Deposit Money Banks .....	15
Table 6. Georgia: Outcome of baseline adjustment for the 10 largest banks (Aggregated) ....	17
Table 7. Georgia: Results of Stress Tests .....	19
Table 8. Georgia: Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision .....	38
Table 9. Georgia: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Monetary Policy .....	42
Table 10. Georgia: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Banking Supervision .....	45
Table 11. Georgia: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Insurance Regulation and Supervision.....	46
Table 12. Georgia: Recommended Actions to Improve Observance of MFP Transparency Code—Insurance Regulation and Supervision .....	47
Table 13. Georgia: Summary of Main Findings of Assessment of Observance of CPSS Core Principles for Payment Systems .....	51
Table 14. Georgia: Summary of Main Findings of Assessment of Observance of the IAIS Insurance Supervisory Principles .....	55
Figures	
Figure 1: Banking Sector Development: Cross-Country Comparison, 1999.....	5

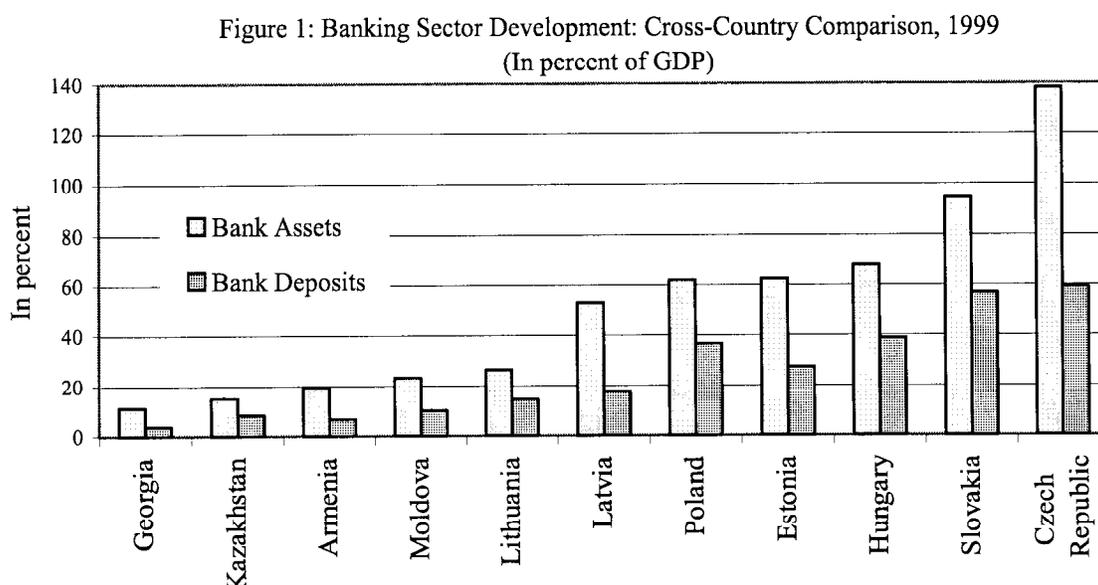
## GLOSSARY

BSD	Bank Supervision Department
CAR	Capital Adequacy Ratio
CPSS	Core Principles for Systemically Important Payment Systems of the Committee on Payment and Settlement Systems
GCSD	Georgian Central Securities Depository
GSE	Georgian Stock Exchange
ISSSG	Insurance State Supervision Service of Georgia
IAS	International Accounting Standards
IAIS	International Association of Insurance Supervisors
ISA	International Standards of Auditing
JSCs	Joint Stock Companies
LACB	The Law of Georgia on Activities of Commercial Banks
LNBG	The Law of Georgia on the National Bank
MFEPCC	Monetary and Foreign Exchange Policy Committee
MFP Transparency Code	Code of Good Practices on Transparency in Monetary and Financial Policies
NBG	National Bank of Georgia
NSCG	National Securities Commission of Georgia
RTS	Russian Trading System
TICEX	Tbilisi Interbank Currency Exchange
RTGS	Real Time Gross Settlements

## SECTION I—STAFF REPORT ON FINANCIAL SYSTEM STABILITY

### I. OVERALL STABILITY ASSESSMENT

1. **The Georgian financial system is small by international standards and by comparison with countries in the region.** The banking system is by far the largest component of the financial system but only accounts for assets equivalent to 12 percent of GDP (Figure 1). The financial system is vulnerable to several potential internal and external macroeconomic shocks. Moreover, strengthening financial infrastructure should be accorded high priority to stimulate financial intermediation and the savings and investment so critical to raising sustainable growth in Georgia. Weaknesses in the banking system and the likely need to deal with insolvent banks, beyond those already closed, could lead to a deterioration in the macroeconomic environment.



Source: National Bank of Georgia, IFS, and staff estimates.

2. **The vulnerabilities and policy challenges in the Georgian financial system are closely linked to the transitional stage of the economy.** There has been good progress in reducing the number of banks and the country has entirely privatized the banking system, but the banking sector has not yet reached the level of efficiency of the more advanced transition economies. Confidence in the banking system is low, the credit culture is generally weak, and intermediation costs are high. Almost all transactions take place in cash, reflecting the informal economy, and the lack of clearing facilities for checks. Moreover, the fiscal authorities can block deposit accounts. Enhanced resource mobilization and increased efficiency of banks are required to allow successful banks to exploit economies of scale. This will need to be supported by a coherent exit strategy for failed banks.

3. **The low level of financial intermediation stems at the macroeconomic level from a lack of bankable projects able to service the high lending costs, a typical development trap in transition economies.** The development of the banking sector in the medium term will depend on macroeconomic and structural policies that are conducive to investment and growth, and further development of an active private sector, as strong banks depend on strong clients and vice versa. On the supply side, increased deposits in the banking system will depend on raising the low level of savings and strengthening confidence in the banking system and banking services.

4. **While reported data for the Georgian banking system for end-2000 suggested a stable financial system, the underlying situation contains weaknesses and vulnerabilities that are especially important in light of the macroeconomic environment.** They include credit and foreign exchange risks because of inadequate risk identification and insufficiently rigorous monitoring and management practices. In addition, the banking system, mirroring the rest of the economy, is characterized by a high degree of dollarization of deposits and loans. Banks are exposed to considerable credit risk because of dollar-denominated lending to borrowers with no regular source of foreign exchange earnings even though banks generally do not have large open foreign exchange positions (in accordance with the regulation that open currency positions be limited to 20 percent of a bank's capital).

5. **A significant exchange rate shock, including secondary effects on banks' loan portfolios, could cause several banks to become insolvent.** Stress tests indicate that a macroeconomic shock causing a strong depreciation of the lari and a concomitant deterioration of the banks' loan portfolios could render banks representing 1/3 to 1/2 of the banking system assets insolvent, depending on the magnitude of the impact on the loan portfolios. On the other hand, the tests indicate that the banking system is relatively resilient to shocks or fluctuations in interest rates and/or a sudden withdrawal of lari deposits. In all scenarios tested, there is considerable variance among banks in the degree of sensitivity to shocks.

6. **The underlying risks in banks' balance sheets have been masked, in part, by deficiencies in reporting and supervisory practices.** The NBG has already put in place new asset classification and provisioning regulations that will go a long way toward improving the reliability of bank soundness indicators. These new standards have been applied in inspections of about one-third (10) of the commercial banks accounting for one-third of banking sector assets. The results show a need for a substantial increase in provisioning and a resulting decline in banks' capital. However, none of the 10 banks inspected (only one was a large bank) fell below the minimum Capital Adequacy Ratio (CAR) as a result of the inspection.

7. **The banking system has little access to market sources of systemic liquidity that can be mobilized at times of distress, such as the run on deposits and exchange rate**

**pressure following the Russian crisis.** There are no institutional investors, the secondary market for government securities does not function and the interbank market is shallow. Further, banks do not have any significant access to foreign financing (other than from multilateral organizations). In these circumstances the NBG relies on relatively high reserve and liquidity requirements, to provide a buffer in the face of pressure. The NBG also performs the lender of last resort (LOLR) function for banks experiencing difficulty. In June 2001, NBG issued revised procedures and policies governing its LOLR function that give more flexibility to provide liquidity support to solvent but illiquid banks, while taking care to consider the monetary impact of such support. There is a need to strengthen public debt management and develop the embryonic government securities market to allow better liquidity management by the NBG.

8. **The legal framework governing the financial sector needs improvement.** A major shortcoming is that technical decisions by the NBG to withdraw banking licenses have been successfully suspended by the courts. Revisions to the Organic Law of the NBG that would, inter alia, strengthen the NBG's ability to take remedial action to handle troubled banks without undue interference from the courts are now being considered by the parliament. At the same time, parliament will consider revisions to the Law on Commercial Banks that will strengthen the organization and governance of banks. In addition, the legal and administrative procedures for enforcement of collateral need to be strengthened.

9. **The assessment of compliance with the Basel Core Principles for Effective Banking Supervision found that while substantial advances in bank supervision have occurred during the past two to three years, there are several areas in need of improvement.** There is a need to provide legal protection to the supervisory staff of the NBG to protect them from being sued personally in respect of actions carried out while executing their official duties. Significant weaknesses were identified in the legal and regulatory structure regarding the "fit and proper" criteria for who should be allowed to own and manage a bank. There is a need to improve regulations regarding foreign exchange, country, and market risks. Finally, there is a need to improve the ability of the NBG to administer banks in distress and to close failed banks. These shortcomings have been addressed in the draft amendments to banking legislation being considered by parliament. There is also a need for the authorities to adopt anti-money laundering measures.

10. **The payment and settlement system is at an early stage of development.** It consists mainly of an interbank funds transfer system, which functions reasonably well. A major weakness, however, is that the NBG lacks a strategic vision regarding payment and settlement issues and has left the development of intrabank payments, the use of checks and credit cards, and the settlement systems of the securities market to the individual participants. To assure its safe and effective development, strengthening the payment system expertise of the NBG is recommended. The Core Principles for Systemically Important Payment Systems were applied to assess the interbank funds transfer system owned and operated by the NBG. The overall assessment is satisfactory from a purely operational point of view, but the oversight responsibilities of the NBG as defined in the Core Principles are not fulfilled.

11. **Assessment under the IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code) found that, in general, the transparency of the NBG's monetary and financial policies is very good.** The process for resolving problem banks needs to be made more transparent. Other areas for improvement are the introduction of a presumption in favor of prior public consultations for substantive technical changes in regulations, and the need for increased openness with respect to the role and functioning of the Monetary and Foreign Exchange Policy Committee (MFEPC).

12. **Other parts of the financial sector are relatively undeveloped.** The securities market is small and illiquid, with the securities of two banks representing 90 percent of trading on the Stock Exchange. The only government securities are Treasury bills, whose outstanding stock amounted to just US \$5.5 million (less than 0.2 percent of GDP) as of August 1, 2001. The systemic risks emanating from the insurance sector are negligible, given the small size of the market (gross premium payments were the equivalent of just US \$7 million in 1999). The supervisory practices of the Insurance State Supervision Service of Georgia (ISSSG) need to be strengthened to bring them into line with international standards.

13. **Corporate governance in Georgia remains weak, although there has been some improvement in recent years.** In particular, shareholders' rights are not adequately protected and the financial statements of enterprises remain largely opaque to third parties. Legislative changes and better enforcement of existing laws and regulations are required to ensure greater transparency and fairness in commercial dealings.

## II. OVERVIEW OF THE FINANCIAL SYSTEM AND FINANCIAL INTERMEDIATION

14. **Confidence in the banking system is low, contributing to the low degree of financial intermediation.** The limited scope of financial intermediation can be ascribed to a number of additional factors. On the supply side, a key factor is the adverse experience of hyperinflation in the years immediately following independence, which eroded the public's stock of savings. The bank failures of recent years have also led to a loss of confidence in the willingness and/or ability of the authorities to protect depositors. In addition, the fact that the tax authorities can freeze and seize bank accounts has also contributed to encourage a cash culture.<sup>1</sup> Finally, low per capita income severely constrains savings.

15. **At the same time, the banks are faced with limited effective demand for loans because of the scarcity of bankable projects that can pay the high real rates of interest required by banks to cover the high risks of loan default.** Moreover, the difficulty of

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<sup>1</sup>A study undertaken by the NBG found that only 3 percent of those surveyed held an account with a commercial bank. National Bank of Georgia (2000), "Banking System of Georgia: Public Opinion and Reality," *Banki*, 4: 65-67.

collecting on collateral and the high coverage of collateral typically demanded by the banks result in a shortage of effective collateral. The lack of a credit culture, weak governance, and the absence of reliable company financial statements further inhibit bank lending. These factors constitute a major disincentive to financial sector broadening and deepening.

**16. Reflecting the above, Georgia has one of the lowest degrees of monetization—as measured by the ratio of M3 to GDP—in the world and the lowest among all of the transition economies (including the CIS, the Baltics, and Central Europe).** At the same time, banking credit to the private sector is quite low and the majority of transactions take place in cash.

#### **A. Dollarization**

**17. After a decline of broad money in the wake of the Russian crisis, remonetization resumed, largely in the form of deposits denominated in foreign currency.** Low confidence in the domestic financial system and in the ability of the government to limit inflation and/or defend the external value of the lari has contributed to increasing dollarization. As of end-March 2001, 83 percent of deposits and 81 percent of loans were denominated in foreign currency (almost all in U.S. dollars). In addition, the NBG has estimated that the volume of foreign currency physically circulating in Georgia could, under not unreasonable assumptions, be as high as US \$120–150 million (50 to 60 percent of broad money).<sup>2</sup> Circulation of foreign currency results in loss of seignorage to Georgia while the prevalence of foreign currency denominated lending and deposits introduces additional risks and constraints for the financial system.

#### **B. Macroeconomic Environment, Risks, and Exposures**

**18. During the first half of the 1990s, Georgia experienced severe macroeconomic instability culminating in a precipitous decline in output and hyperinflation.** From the middle of the 1990s, reflecting a cessation of conflict and strenuous transformation efforts, the economy stabilized and then expanded, achieving an average annual growth rate of 6 percent a year between 1995 and 1999. Inflation was brought back to below 10 percent per annum at the same time that inflation volatility was declining and, since mid-1999, the exchange rate has stabilized at around 2 lari per U.S. dollar (Table 1). During 2000, there were encouraging developments, including improvements in the fiscal position and the external current account, and a further decline in inflation (12 months) to around 6 percent in June 2001. However, growth stalled in 2000, falling to about 2 percent as a result of a drought. While growth is expected to rebound somewhat in 2001, GDP per capita remains at about half what it was prior to independence.

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<sup>2</sup>“Dollarization in Georgia: Size of the Problem, Factors, and the Ways of Solution,” Merab Kakulia and Nina Aslamazishvili. NBG Website.

Table 1. Georgia: Macroeconomic Indicators, 1996–2000

(Annual percentage change, unless otherwise indicated)

	1996	1997	1998	1999	2000
National income, prices and exchange rates					
GDP at constant prices	10.5	10.6	2.9	3.0	1.9
Nominal GDP	57.4	20.6	8.7	12.4	5.1
Consumer price index, period average	39.3	7.0	3.6	19.1	4.0
Consumer price index, end-of-period	13.7	7.2	10.7	10.9	4.6
Exchange rate, period average (in lari / U.S. dollar)	1.26	1.30	1.39	2.02	1.98
Exchange rate, end-of-period (in lari / U.S. dollar)	1.27	1.30	1.79	1.96	1.98
Financial Aggregates					
Base money	35.9	32.6	-6.3	18.8	26.8
Broad money (M3)	41.9	45.6	-1.2	20.7	39.0
Credit by DMBs	-14.8	38.0	38.0	33.5	17.5
Foreign liabilities of DMBs	n.a.	154.8	347.4	43.5	17.6
Balance of payments					
Current account balance, including transfers (in percent of GDP) 1/	-10.8	-10.5	-10.7	-8.5	-5.4
Current account balance, excluding transfers (in percent of GDP) 1/	-13.7	-16.0	-16.6	-14.8	-8.7
External debt position (percent of GDP) 1/	44.9	43.6	45.0	60.7	53.4
Capital account (in millions of US\$) 1/	90.7	267.8	249.9	79.2	90.0
Inward FDI (in millions of US\$) 1/	n.a.	n.a.	221.0	61.7	152.6
Reserves assets, (-, increase; in millions of US\$)	79.2	61.0	54.9	-14.0	23.3
Gross international reserves (in months of imports) 1/	2.2	1.5	1.0	1.2	0.9
Interest rates					
3-month T-bill rate (in percent)	n.a.	34.0	33.6	13.3	14.9
Lending rates of DMBs					
Nnonindexed secured loans in lari (in percent ; annual avg.)	n.a.	n.a.	n.a.	29.3	24.3
Nnonindexed secured loans in forex (in percent ; annual avg.)	n.a.	n.a.	n.a.	31.4	27.8
Deposit rates of DMBs					
Lari deposits (in percent ; annual avg.)	n.a.	n.a.	n.a.	5.4	4.0
Foreign currency deposits (in percent ; annual avg.)	n.a.	n.a.	n.a.	13.6	11.2
Financial volatility indicators					
Inflation					
Stdev of 12 monthly percentage changes (level)	74.00	2.07	3.27	3.64	2.72
Stdev of CPI Index (level)	2.96	1.85	3.92	2.53	1.93
Stdev of monthly percentage changes in CPI Index (level)	1.38	1.16	3.75	2.03	0.71
Interest rates					
Stdev 3-month T-bill rates (level) 2/	n.a.	n.a.	n.a.	0.92	6.18
Exchange rates					
Stdev real effective exch. rate index (level)	1.70	1.05	5.29	5.28	1.37
Stdev nominal effective exch. rate index (level)	0.28	0.34	5.06	7.79	1.54
Other factors					
Government recourse to the banking system (in millions of lari)	n.a.	162.1	138.8	189.7	74.5
Domestic arrears accumulation (in millions of lari ; -, reduction)	n.a.	43.5	64.0	95.9	84.0

Source: National Bank of Georgia and staff estimates.

1/ Figure for 2000 is estimated.

2/ The treasury bill market opened in August 1999.

19. **The government's fiscal problem remains the most pressing macroeconomic policy challenge.** Tax collection as a share of GDP is among the lowest in the CIS, hampered by problems with poverty, governance, tax avoidance and evasion, and corruption. Fundamental reforms are needed to increase tax revenue and control expenditure on a permanent basis. To finance the deficits resulting from low fiscal revenues, the government resorted to the accumulation of domestic expenditure arrears (equivalent to 5.3 percent of GDP at end-2000) as well as arrears to external creditors. To some extent these domestic arrears substituted for domestic financial intermediation.

20. **Along with fiscal deficits, Georgia has experienced large external current account deficits during the past five years, partly reflecting heavy reliance on imported energy.** As a result, government and government-guaranteed external debt has risen dramatically since independence, from essentially nil to about 54 percent of GDP at end-2000, about half of which is owed to international financial institutions.

21. **Georgia maintains an independently floating exchange rate regime.** Inward and outward capital transactions are not restricted, although they are subject to registration requirements for monitoring purposes, and the reported capital transactions are relatively small. The lari depreciated substantially against the U.S. dollar in the aftermath of the Russian crisis in 1998, while appreciating with respect to the Russian ruble. The bilateral exchange rate has remained at about 2 lari per U.S. dollar since mid-1999.

22. **For the financial system, the main macroeconomic risk arises from the possibility of strong movements in exchange rates, prices, and output.** Such movements could be triggered by the government's fiscal problems, the external current account position, or developments in Georgia's main trading partners, or in the world economy. The large current account deficit and limited foreign exchange reserves make Georgia vulnerable to external developments. Finally, continued sluggish economic growth could pose a further macroeconomic risk for the financial system because it limits the profitability of existing investment projects, as well as opportunities for profitable new investment. Thus, it would increase credit risk and limit the potential for healthy growth and development of the financial sector.

23. **Although financial intermediation relative to GDP is small, the financial sector entails risks for the overall macroeconomic situation and growth potential.** While many weak banks have already been merged or liquidated, there remain a number of banks, accounting for a significant proportion of assets and liabilities of the system that may not fully meet regulatory standards. If a large bank were to fail, the NBS would likely be forced to provide support on a scale that would cause some combination of considerably higher interest rates, declining availability of credit to the private sector, a weaker currency, and an increase in inflation. This, in turn, would exacerbate the problem of nonperforming loans for the rest of the banking system, erode profitability and bank capital, and further delay the active participation of banks in the mobilization of savings. Furthermore, the payment system would suffer.

### C. Transparency of Monetary and Financial Policies

24. **An assessment of the observance of the MFP Transparency Code found that overall the transparency of the NBG's monetary and financial policies is very good.**<sup>3</sup> The NBG conducts its operations in an open and transparent manner, and it makes a concerted and largely successful effort to inform the public about the goals and objectives of monetary and supervisory policies. This is evidenced by its extensive publications, high-quality annual report, and excellent website. The NBG is also to be commended for issuing detailed financial statements that meet international accounting standards.

25. **The practices not being observed are those suggesting a presumption in favor of public consultations, within an appropriate period, for substantive technical changes to the structure of monetary and supervisory regulations.** In addition, transparency in the procedures for dealing with problem banks (ex post) should be improved. Other areas for improvement for the NBG are: to better disclose the functioning, composition and roles of the MFEPC, and to publicly disclose its meeting schedule in advance; to make greater efforts to inform the public about its procurement policies and procedures; to prepare and publish precise procedures for its participation in the secondary market for government securities; and to better disclose its data collection practices. Finally, it would also be useful for the NBG to implement the IMF's General Data Dissemination Standard.

## III. THE BANKING SYSTEM<sup>4</sup>

### A. Structure, Ownership, and Performance

#### Structure

26. **Following independence the authorities adopted a policy of freely licensing banks while imposing minimal capital requirements.** By the end of 1994 this had resulted in the establishment of 228 banks. Most of these banks, apart from former state-owned banks,

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<sup>3</sup> The Code identifies the broad principles for good transparency practices. In making public the objectives of policies, the considerations guiding policy decisions, and information on the conduct of policies, the central bank and other financial agencies enhance the public's understanding of what they are seeking to achieve. Such information also provides a context for articulating the supervisors' policy choices, gives an opportunity to obtain feedback from the market and strengthens general credibility, thus, contributing to the effectiveness of such policies.

<sup>4</sup> Unless otherwise indicated, all data in this section are as of March 31, 2001, before the impact of new asset classification and provisioning rules showed their effects.

were small-scale operations, often established to serve the interests of their founders with little emphasis on deposit mobilization.

27. **Since 1994, market pressures and an active regulatory approach by the NBG led to the liquidation of many banks.** By the end of 2000, the number of banks in Georgia declined to 33, including two branches of foreign banks. During the first six months of 2001, the licenses of six additional institutions were revoked, three because of their inability to meet new year-end 2000 capital requirements and three due to insolvency. The three revocations related to capital requirements have been blocked by the courts.<sup>5</sup>

28. **As of March 31, 2000, there were 31 licensed banks in Georgia, including one institution under temporary administration (since put into liquidation) (Table 2).** All but one of the banks are headquartered in Tbilisi where the majority of the population and most of the monetized activity takes place. Total assets of the banking system on March 31, 2001 were lari 775 million (13 percent of estimated 2000 GDP) while total liabilities were lari 517 million. The system had loans (net of provisions) of lari 425 million and total deposits of lari 337 million (Table 3).

Table 2. Georgia: Licensed Banks, March 31, 2001

	Number	Total Assets (Lari—millions)
Active banks—domestic	24	717
Temporary administration	1	25
Branches of foreign banks	2	12
Licenses revoked but still operating	4	21
<b>Total</b>	<b>31</b>	<b>775</b>

Sources: National Bank of Georgia and staff estimates.

Table 3. Georgia: Banking System Balance Sheet, March 31, 2001  
(In millions)

Assets	Lari	Percent	Liabilities & Capital	Lari	Percent
Cash & due from banks	199	26	Deposits	337	44
Loans (net)	425	55	Borrowing	139	18
Other assets	151	19	Other liabilities	41	5
			Subtotal	517	67
			Capital	258	33
<b>Total</b>	<b>775</b>	<b>100</b>		<b>775</b>	<b>100</b>

Sources: National Bank of Georgia and staff estimates.

<sup>5</sup>In addition, during 2001 a local court reinstated the license of a bank that had been revoked in August 2000, over the objections of the NBG, but the decision of the local court was subsequently overruled by the Supreme Court.

29. **The country's ten largest banks control 77 percent of total assets, 81 percent of total (gross) loans and 60 percent of total capital in the system.** They also control 83 percent of the system's deposits. The single largest bank controls 15 percent of total assets, 10 percent of total capital, and 13 percent of total deposits.

### Ownership

30. **There are no state-owned banks in Georgia.** Thirteen banks controlling 35 percent of the system's assets are entirely owned by Georgian citizens or legal entities, including four of the country's 10 largest banks. Foreign owners control seven of the country's banks and 11 percent of the banking system's assets, including 2 of the ten largest banks.<sup>6</sup> Foreign branches control less than 2 percent of system assets (Table 4).

Table 4. Georgia: Bank Ownership by Type and Number of Institutions  
March 31, 2001

	Ten Largest	All Other	Total
Domestic Owned (100%)	4	9	13
Foreign Owned - Majority Interests (> 50%)	2	5	7
- Minority Interests ( 50%)	4	5	9
Foreign Branches	-	2	2
<b>Total</b>	<b>10</b>	<b>21</b>	<b>31</b>

Sources: National Bank of Georgia and staff estimates.

### Performance

31. **Despite wide interest rate spreads (around 10 percentage points between deposit and lending rates), the basic business of lending is not highly profitable when full account is taken of loan-loss provisioning.**<sup>7</sup> Earnings of the banking system have stagnated. Ten banks reported net losses during 2000 and for the banking system as a whole, net income (return on assets) declined sharply (Table 5). During the first five months of 2001, the banking system experienced losses of lari 9.5 million; 11 of the 27 banks and both foreign

<sup>6</sup> Foreign investors in Georgian banks include the EBRD, IFC, a German commercial bank, offshore firms, and a number of private investors.

<sup>7</sup> Interest rates on foreign currency denominated loans and deposits are generally higher than those on lari-denominated loans and deposits. This can be explained by banks' desire to dollarize their balance sheet, by their less comfortable liquidity position in foreign exchange than in lari, and by the fact that, as three quarters of all lending is foreign-currency denominated, lari lending rates are not representative of rates available to all clients.

Table 5. Georgia: Aggregate Indicators of Financial Soundness for Deposit Money Banks, 1997–2000  
(In percent, unless otherwise indicated)

	1997	1998	1999	2000
<b>Capital adequacy:</b>				
Risk-based capital adequacy ratio (CAR)	n.a.	36.9	38.5	36.7
Tier 1 capital ratio	n.a.	33.6	36.6	34.1
Equity as percent of regulatory capital	n.a.	114.0	117.7	112.9
Leverage ratio (equity/total assets)	28.6	26.3	26.1	26.7
<b>Asset quality:</b>				
Nonperforming loans (NPL) / total loans	n.a.	5.4	6.6	7.1
Provisions / NPL	n.a.	34.1	28.0	26.3
<b>Management soundness:</b>				
Expense ratios				
Operating expenses / gross income	n.a.	42.3	45.5	48.9
Operating expenses / total assets	n.a.	8.7	9.2	8.5
Staff costs / gross income	n.a.	18.5	20.7	21.7
Staff costs / operating expenses	n.a.	43.7	45.4	44.4
<b>Earnings and profitability:</b>				
Return on assets (net income/avg. total assets)	n.a.	5.4	4.2	0.5
Return on equity (net income/shareholders' equity)	n.a.	14.9	11.8	1.4
Net interest income / gross income	n.a.	47.9	44.4	43.9
Net noninterest income / gross income	n.a.	-8.7	-9.4	-15.0
<b>Liquidity:</b>				
Central bank credit to banks / GDP	0.1	0.1	0.0	0.1
Deposits to M3 ratio	35.7	42.4	45.1	49.1
Loan-to-deposit ratio	121.0	136.9	150.5	140.8
Liquid Assets to Total Assets	25.1	29.8	26.8	24.3
Measures of secondary market liquidity:				
Interbank FX market turnover (US\$ thousands)	118.0	128.9	76.1	149.3
Interbank domestic market turnover (Lari millions) 1/	60.4	48.8	81.9	100.6
<b>Sensitivity:</b>				
Loans in foreign currency / total loans	n.a.	76.6	81.3	81.3
Deposits in foreign currency / total deposits	58.4	68.7	79.0	77.9
<b>Concentration ratios in the banking sector:</b>				
Number of banks accounting for 25 percent of total assets	n.a.	2	2	2
Number of banks accounting for 75 percent of total assets	n.a.	10	11	10
Number of banks 2/	54	44	37	33
Number of branches	215	212	219	220
Number of affiliates of foreign banks	n.a.	2	2	2

Source: National Bank of Georgia and staff estimates.

1/ Figures refer to activity on the interbank credit auction market only up to 1998. From 1999 onwards, they also include interbank lending outside the credit auctions.

2/ Figures include branches of foreign banks.

branches had losses. This reflects, in particular, the impact of the new asset classification and provisioning requirements.

32. **Shortcomings in regulations and in bank lending policies have led to significant underreporting of and underprovisioning for problem assets.** Prior to January 15, 2001, banks were required to classify and provision only against loans, and the Bank Supervision Department (BSD) procedure was to classify loans solely on the basis of performance (i.e., past due status). Thus, a sizable proportion of loan assets were improperly classified, and a further 50 percent of banking assets (non-loans) were not reviewed or classified by inspectors as to asset quality. The level of problem assets was understated as a result of loan extension (“prolongation”) and restructuring policies followed by Georgian banks. At the end of 2000, more than 20 percent of loans were reported as prolonged for 12 months or more. The recognition of the problems in asset quality has resulted in NBG reducing its CAMEL and CAEL (off-site) ratings, with the effect that 13 banks had four or five ratings as of March 31, 2001. These include two medium-size banks, with total assets equivalent to 6.3 percent of banking system assets.

### **B. Soundness of the Banking System**

33. **Based on their reported balance sheet and income statements as of March 31, 2001, before adjustments for additional provisioning to reflect the new regulations, the capital adequacy and liquidity ratios of the banking system were high by international standards.** Nevertheless, the ratio of nonperforming to total loans has been rising steadily, while the coverage of loss reserves have declined. Return on assets has been volatile, with a sharp drop in 2000, in response to an increase in loan provisioning. Banks are highly liquid in line with the 30 percent liquid assets requirement and the 14 percent reserve requirement (see Table 5).

34. **There are at present no indications of any asset price bubbles or over-investment in selected sectors, as financial markets are underdeveloped and inactive, growth in banks’ loan portfolios has been modest compared to the size of the economy, and banks report a reasonable diversification of their loan portfolios over different economic activities.**

### **C. Adjusted Baseline**

35. **To correct for known accounting problems and reporting weaknesses, and to establish a better data basis for conducting stress tests and analyzing the vulnerability of the banking system to shocks, the mission constructed an “adjusted baseline” for banks’ balance sheets (Table 6).** This adjusted baseline is derived from on-site inspections carried out during the first six months of 2001, the first to be conducted under International Accounting Standards (IAS) and the new asset classification and provisioning rules, and, therefore, the first to reflect the full extent of the problems with bank reporting of nonperforming and overvalued assets. It was found that banks had not reported accurately,

even when they indicated that they had fully implemented the new rules. The on-site inspections typically revealed that a very large part of the loan portfolio, and a substantial part of the non-loan assets were problem assets and needed to be classified. Most of the problem loans were reclassified as “Watch” or “Substandard” by the inspectors, while reclassified non-loan assets were mostly put into “Substandard” and “Loss.”

Table 6. Georgia: Outcome of Baseline Adjustment for the 10 Largest Banks (Aggregated)  
(In percent)

	Reported Data	Adjusted Baseline
Risk-weighted capital-assets ratio	30.0	17.0
Classified loans/Total loans	5.9	52.0
Classified non-loan assets / Total non-loan assets	0.1	8.9
Provisions/Total assets	2.1	13.3 1/

Sources: National Bank of Georgia and staff estimates.

1/ The adjusted ratio of provisions to total assets is the ratio that would be required to meet regulations.

**36. The baseline adjustment resulted in a significant downward revision of capital adequacy for the ten largest banks.**<sup>8</sup> For the 10 largest banks, the adjustment resulted in a decline in the risk-weighted CAR from 30 percent to 17 percent, an increase in the ratio of classified to total loans from 5.9 percent to 52 percent, and an increase in the ratio of classified non-loan assets to total non-loan assets from 0.1 percent to 8.9 percent. For one of the 10 largest banks, accounting for almost 16 percent of banking system assets, the adjustment results in a CAR below the regulatory threshold of 6 percent, below which a bank is subject to liquidation. For six additional banks among the 10 largest, accounting for 40 percent of banking system assets, the adjustment resulted in a CAR between 6 percent and 15 percent.<sup>9</sup>

<sup>8</sup> The adjusted baseline is based on the inspections of nine banks, one of which is among the ten largest banks. An “average inspection result,” in terms of asset quality, was constructed and applied to all banks, except one, which did not fit the pattern described above and was not representative of the system. The inspection results for this bank were excluded from the sample used to construct the adjusted baseline. The mission’s work on the adjusted baseline was discussed with the NBG for use in their work and to improve the analysis as more banks are inspected. Given that the adjustment is based on inspection results from only one of the ten largest banks, it is subject to considerable uncertainty.

<sup>9</sup> A further adjustment in the baseline implies the reversal of a long foreign exchange position to a short position. See paragraph 40.

#### **D. Banking System Vulnerabilities and Stress Testing**

37. **The stress tests performed by the mission indicate that, after adjusting for reporting problems, banks are vulnerable to macroeconomic shocks.** In particular, they are vulnerable to a depreciation of the lari, both through balance sheet exposure and the likely adverse impact on their loan portfolios. The tests indicate that a severe macroeconomic shock, including a strong depreciation of the lari, could potentially push much of the banking system into insolvency.

38. **The mission conducted stress tests for the 10 largest banks individually and as a group, on the basis of the banks' March 2001 financial data, after the baseline adjustment.** Three types of shocks were tested: exchange rate shocks, interest rate shocks, and shocks to the loan portfolio. Exceptional but plausible shocks were tested in univariate scenarios, in which only one parameter was changed and only first-order effects were considered, and in multivariate analyses corresponding to scenarios of macroeconomic deterioration.

39. **The results of the tests indicate that after the baseline adjustment, banks' balance sheets are vulnerable to credit risk.** The simulations indicated that a relatively modest further deterioration in the quality of banks' loan portfolios, in which 10 percent of standard loans are classified and 20 percent of existing classified loans are downgraded to the next lower classification category, would result in three additional banks—accounting for 16 percent of banking system assets—seeing their risk-weighted CARs drop below 6 percent. A more severe shock to the loan portfolio in which 20 percent of standard loans are classified and 40 percent of existing classified loans are downgraded, would bring a further two banks' CARs below 6 percent and push one of the biggest banks into insolvency.

40. **Although most banks hold long foreign currency positions, in the adjusted baseline a substantial part of foreign exchange denominated assets are classified and provisioned for, thus, reducing net foreign exchange assets while foreign exchange denominated liabilities are unaffected.** This reduces the net position in foreign currency for all banks, and for several of them it implies the reversal of a long position into a short position. In addition, banks are required to constitute provisions on foreign currency assets in domestic currency. As a result, a depreciation of the lari requires them to constitute additional provisions for their classified foreign-currency denominated assets. In a univariate test, under which the lari is assumed to depreciate from 2 lari/US \$1 to 3 lari/US \$1, two banks (representing 19 percent of banking system assets) become insolvent. Moreover, four additional banks (representing 32 percent of banking system assets) see their CARs drop below 6 percent.

41. **The stress tests indicate that bank exposure to interest rate risk is relatively low.** This reflects large interest rate spreads, the high ratio of equity to liabilities, and the short maturities of assets and liabilities.

42. **Multivariate tests showed that banks' vulnerability to foreign exchange risk is further exacerbated by the likely impact of a depreciation of the lari on the banks' loan portfolios.** About 75 percent of foreign-currency denominated assets consists of loans to domestic borrowers. Most of these borrowers (about 60 percent, according to some bankers) do not have reliable foreign currency income. Hence, severe exchange rate movements could render those borrowers unable to service their loans.

43. **For purposes of a worst-case scenario, the mission tested a combination of a currency depreciation of one-third (as occurred during the Russian crisis) and a concomitant increase in interest rates of 5 percentage points.** In addition, a range of shocks was assumed to the loan portfolio, in each of which foreign-currency denominated loans are affected more than domestic-currency denominated loans. The shocks to the loan portfolio were as follows (with the first figure indicating the percentage of domestic-currency loans being classified or downgraded if classified before, and the second figure indicating the same for foreign-currency denominated loans): 0/10 percent, 10/20 percent, and 20/40 percent.<sup>10</sup>

44. **The tests indicated that the impact on the banking system of any of these three scenarios would be severe, with four banks accounting for 32 percent of the banking system assets becoming insolvent in the first scenario, and the bulk of the banking system becoming insolvent under the third scenario.** The results of the middle of these three scenarios (10/20 percent) are given in Table 7.

Table 7. Georgia: Results of Stress Test <sup>1/</sup>

Ten Largest Banks	Baseline	Adj. Baseline	After Shock
Number of banks with:			
CAR < 0%	0	0	5
0% < CAR < 6%	0	1	2
6% < CAR < 15%	0	6	1
CAR > 15%	10	3	2
Share (in percent) in total banking system assets in Georgia, of top-10 banks with:			
CAR < 0%	0.0	0.0	45.3
0% < CAR < 6%	0.0	15.7	10.6
6% < CAR < 15%	0.0	40.2	15.5
CAR > 15%	79.6	23.6	8.2

Sources: National Bank of Georgia and staff estimates.

1/ Assumes a shock of a currency depreciation of one-third and an increase in interest rates of 5 percentage points.

<sup>10</sup> Historical data for Georgia do not allow an analysis of the relationship between exchange rate movements and banks' loan portfolios, because until mid-2001, the authorities were unable to measure nonperforming loans and capital properly.

45. **Stress tests for liquidity risk were carried out, simulating a sudden withdrawal of deposits.** The tests indicated that banks' balance sheets are sufficiently liquid in lari to cope with a withdrawal of lari deposits, but that they may be vulnerable to a sudden withdrawal of foreign currency deposits.

#### **E. External Credit Lines**

46. **External credit lines from official organizations are an important source of funding for the banking system, particularly long-term funding.** As of June 2001, amounts outstanding in operating banks amounted to about US \$46 million or 20 percent of banking system liabilities. Funding is concentrated among a few mainly large banks, with the five largest recipients accounting for about 90 percent of total disbursements. Maturities usually range between 2–10 years, in sharp contrast with the average maturity of time deposits of around 6 months. Thus, credit lines improve the maturity profile of banks' liabilities. External credits typically fund loans to small and medium enterprises (SMEs), agriculture projects, and tied imports.

47. **In the past, the government provided guarantees on some of the external credit lines (government-guaranteed credits now amount to about one third of the total outstanding credit) thereby assuming contingent liabilities that could add to the already difficult external public debt position.** Some of the guaranteed loans have accelerated repayment clauses that could be triggered in the event of liquidation of the local recipient bank (which has already happened in one case<sup>11</sup>). Aware of the risks that had been assumed, the ministry of finance discontinued the provision of public guarantees for new credit lines.

48. **Problems developed with loan recovery in two recipient banks that are currently in liquidation.** As a result, the multilateral creditors have introduced changes in their lending procedures, which call for more thorough due diligence reviews. They are also assisting banks to improve their internal governance, credit approval, and risk management processes.

49. **Banks and their borrowers are assuming the foreign exchange rate risk created by the requirement that credit lines be taken on as dollar-denominated liabilities by both the banks and their borrowers.** Since these lines provide credit to SMEs, many of which do not have foreign exchange income, the structure increases the foreign exchange/credit risk of the banking system.

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<sup>11</sup> Under the covenants of the loan contract, the creditor has the right to accelerate repayment when a recipient bank is liquidated. However, in this case the creditor has indicated its willingness not to demand accelerated repayment. Provided that certain conditions are met, it will acquiesce to the government's continued debt servicing on the original schedule.

## F. Regulatory and Supervisory Framework

50. **The regulatory and supervisory framework for banks is a combination of laws, regulations, supervisory practices, and accounting standards almost all of which are administered by NBG.** The two primary laws are the Law of Georgia on the National Bank (LNBG) and the Law of Georgia on the Activities of Commercial Banks (LACB), the banking law. The assessment of compliance with the Basel Core Principles for Effective Banking Supervision (see below) noted significant deficiencies in the regulatory framework for banks and the correction of many of these will require amendments to the law. Specifically, major deficiencies were noted in the lack of legal protection for supervisors, the “fit and proper” criteria for management and owners, the absence of any regulations or policies relating to money laundering, the inability of the NBG to revoke licenses of insolvent banks without judicial interference, the inability of NBG to assure the quality of independent audits or obtain information from auditors, and the lack of policies for controlling foreign exchange risks. Improvements in these areas are critical to enhancing the stability of the banking sector.

51. **The NBG has made substantial advances in recent years in improving the quality of bank supervision through the adoption of new regulations and the training of staff.** These efforts have been carried out with assistance from USAID, the IMF, and the EBRD. The BSD has been strengthened by the addition of 18 staff in the past two years to a level of 50 employees. BSD is carrying out both on-site and off-site bank supervision and has been systematically applying the new loan classification and provisioning requirements. In May 2001, the NBG issued a regulation to strengthen penalties related to findings of conflicts of interest and connected transactions by individuals engaged in banking activities.

52. **Despite the progress made by NBG, the legal framework governing their supervisory and regulatory activities and the financial transactions of the banking sector needs improvement.** With assistance from external advisors, the NBG has recently submitted to parliament amendments to the NBG Law and separate amendments to the LACB, the banking law. These amendments, if enacted, would represent a major advance in improving the independence of the NBG in regulating, licensing, and delicensing banks. The key amendments involve: (i) strengthening the powers of the NBG to license, regulate, supervise, administer, and liquidate banks; (ii) ensuring the primacy of the NBG in its regulation of the financial sector; (iii) strengthening the governance of banks particularly in establishing “fit and proper” criteria for owners and managers and requiring disclosure to the NBG of both direct and indirect ownership and control relationships; and (iv) protecting NBG employees from civil and criminal liability.

53. **IAS were required to be adopted by banks effective January 1, 2001.** There have been mixed results in adapting to the changes, but some banks are finding the transition difficult. Presently the responsibility for accounting policy has been vested in the Accounting Department of the NBG. However, in recognition that central bank accountants may not be the appropriate group to set accounting policy for the banking industry, the decision has been

made to create a separate accounting policy group within the BSD. A related accounting issue is the poor quality of financial statements offered to banks by borrowers and the need for higher quality audit practices and increased liability for firms auditing the financial statements of Georgian companies. Both bankers and examiners recognize the risks associated with accepting audited statements at face value.

### **G. Compliance with Basel Core Principles**

54. **Many of the measures taken to improve the quality of bank supervision and regulation have been guided by the Basel Core Principles (BCP), notably the new regulations and examination procedures relating to asset classification and loan loss provisioning.** Implementation of these procedures appears to be in line with international standards. As the NBG continues to apply the new provisioning and loan classifications to all banks, the weaknesses in the banking system will become readily apparent. However, several of the BCP are not being observed, and there is a need to strengthen certain areas of bank supervision and regulation to bring them in line with international standards.

55. **At present, there is no legal protection for the staff of the NBG from lawsuits brought against them personally as a consequence of the performance of their official duties in good faith.** The lack of protection exposes the supervisory staff to potential damages if the actions taken are found to be unwarranted and, at any rate, to possible legal expenses and discourages them from taking actions against a bank. Immunity from personal liability in respect of corrective actions or supervisory decisions taken by the NBG staff in good faith and in the ordinary course of their duties should be introduced.<sup>12</sup>

56. **Another area of weakness in the bank supervisory regime relates to principles surrounding the “fit and proper” criteria for bank management and controlling owners.** Neither the NBG Law nor the Banking Law provide the NBG with the specific authority to reject a proposal for a change in ownership. While there are requirements when a bank is licensed, requirements regarding levels of ownership, and requirements for notification to the NBG of changes in ownership, there is nothing in the laws or regulations that gives the NBG the power to block a disreputable individual from owning 25 percent of a bank. With regard to management, “fit and proper criteria” are applied to the managing director of the bank, branch managers, and chief accountants at the time the bank is licensed. There is a need to apply these standards to a broader range of senior management, controlling owners at the time a bank is licensed, and on an ongoing basis any time there are significant changes in ownership or top management.<sup>13</sup>

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<sup>12</sup> Weaknesses in the areas discussed in paragraphs 55, 56, and 57 are addressed in pending banking legislation.

57. **The ability of bank supervisors to take appropriate supervisory actions, especially when depositors are threatened with loss, is hampered by the legal system.** While the relevant statutes and regulations give the NBG a range of progressively stronger supervisory remedies to deal with banks in deteriorating condition, the banks' right to apply to a court and secure the suspension of the actions of the supervisor results in the NBG being unable to assure that remedial action will be taken in a timely manner. The powers of the courts to undermine or frustrate the supervisory acts and decisions of the NBG need to be limited. While judges need to be vigilant in protecting parties against unlawful or improper acts or procedures, on substantive issues they should not be able to substitute their opinions for the judgments of the NBG officials. It would also be desirable for litigation involving the NBG to be accorded priority status and for the decisions of the NBG to be presumed to be lawful and valid until proven otherwise.<sup>13</sup>

58. **Georgia does not have any specific legislation on money laundering, nor are there any regulations in place requiring banks to implement "know-your-customer" (KYC) policies.**<sup>13</sup> At present, there are no plans to introduce such legislation. The authorities are of the view that the domestic banking system, with its current low level of penetration and volume of transactions, does not lend itself to being a vehicle for international money laundering. Further, Georgian banks do not appear to have KYC rules in place, as part of their own internal control and risk management procedures. Indeed, discussions on this matter with leading banks revealed an almost dismissive attitude toward such rules.<sup>14</sup> Although money laundering may not be an immediate problem, as efforts to enforce the Financial Action Task Force (FATF) recommendations on anti-money laundering measures take hold in previous money-laundering havens, illegal activities may migrate to Georgia. The committee on anti-money laundering measures of the Council of Europe, an observer to the FATF, carried out an evaluation on anti-money laundering measures in Georgia, and a public report may be available at end-October after the committee meeting.

59. **The NBG does not have the authority to reject the work of a bank's external auditor or to require a second audit and there is no formal direct contact with the external auditor.** The NBG requires the bank's board of supervisors and management to consider the external auditor's opinion and recommendations and formulate a corrective plan. NBG should seek to put in place a statutory basis for direct contact with the external auditor.

60. **Another area of weakness relates to the policies and procedures for identifying, monitoring, and controlling country and foreign exchange risks.** Banks in Georgia are

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<sup>13</sup> The need for anti-money laundering measures is contained in Basel Core Principle 15.

<sup>14</sup> For example, one large bank referred to a rule whereby cash deposits in excess of US \$200,000 required authorization from a special committee, with smaller deposits automatically accepted.

not active international lenders and, thus, country risk is not presently a significant risk element. Nevertheless, the NBG should incorporate country risk into future changes to the regulatory regime so as to be prepared if banks change their lending strategies. More importantly, the NBG has not implemented the amendments to the Basel Capital Accord to include market risks. Of particular concern is credit risk associated with borrowers' foreign exchange exposure, as noted above.

#### **H. Systemic Liquidity**

61. **The banking system operates in a difficult context regarding the availability of market sources of liquidity that can be mobilized at times of distress.** The financial system is dominated by banks with no significant presence of institutional investors, nonexistent secondary markets for government securities, and somewhat shallow interbank markets. Further, banks do not have any significant access to foreign financing (other than from multilateral organizations). However, banks may be able to mobilize liquidity from the domestic foreign exchange markets, which are somewhat deeper, and involve the participation of numerous exchange bureaus.

62. **There are two main interbank markets—the credit auctions market conducted by the NBG and the U.S. dollar-denominated loans market.** In the former, with a critical presence of NBG on the bid side of the credit auctions, monthly turnover in 2000 averaged about lari 6 million (equivalent to about 12 percent of lari-denominated deposits), while in the latter with only banks participating, monthly turnover averaged about US \$1.3 million (about 1 percent of dollar-denominated deposits). These markets came under stress in the aftermath of the Russian crisis, when banks experienced a significant loss of both lari- and U.S. dollar-denominated deposits. Liquidity in the interbank auction market dried up (indeed, in December 1998 there were no transactions). In the US\$-loan interbank market turnover rose in September-October 1998 to about US \$4 million, possibly reflecting the re-circulation among banks of the heavy NBG sales of foreign exchange in the spot Tbilisi Interbank Currency Exchange (TICEX) market in support of the currency. Turnover fell sharply in the exchange market following NBG's decision to let the lari float.

63. **The NBG is constrained in its monetary policy implementation by the need to provide financing to the government.** Monetary tightening is generally achieved through the interbank markets. There is a need for improving public debt management and developing the government securities market to improve the instruments available for liquidity management (see Section VI.C below on the government securities market).

#### **I. Financial Safety Nets, and Tools for Managing Banking Crises**

64. **The NBG performs the lender of last resort function for large banks experiencing difficulty.** Under Article 62 of the NBG Law, the NBG is limited to granting credit or discounting notes, for a period not to exceed three months. While the NBG has the power to extend credit directly through a discount facility it appears that this tool has not

been used. In the last five years there have been only five instances of liquidity support. In addition to direct lending, the NBG has granted credit in the form of regulatory forbearance on reserve requirements. The NBG Law permits the NBG to lend only to “leading banks,” which the NBG interprets to cover the top 10 banks. Small banks needing liquidity are expected to go to the credit auction where they can borrow from other banks. There is also an unsecured inter-bank market but it is, in practice, limited to the five largest banks.

65. **In June 2001, NBG issued rules governing the procedures and policies it will follow in acting as a lender of last resort for commercial banks (Order 148).** This Order corrects many of the weaknesses that existed in prior procedures, while taking care to consider the monetary impact of LOLR operations. It makes clear that loans will only be extended to banks faced with liquidity problems. It allows NBG greater flexibility in determining which banks may borrow from it. The Order further clarifies that loans will be issued with a maturity of three months but that the NBG may extend the maturity or restructure the loan. Loans are to be collateralized by assets that have been valued by an independent auditor and the value of the collateral must be at least equal to 120 percent of the amount of the loan. Given the low level of government and private securities, NBG accepts other types of collateral, and is permitted to issue uncollateralized loans in certain circumstances, essentially to rescue banks from systemic crisis.

66. **While it is important that the NBG have the ability to provide liquidity as part of an overall resolution strategy for an insolvent bank, providing such credit should not be used to allow insolvent banks to continue to operate.** This practice undermines market discipline, imposes greater costs on depositors, and forces healthy banks to incur higher costs from having to compete with insolvent institutions. It is important, however, that the lender of last resort have plans to deal with bank runs should they occur.

67. **In 1998, in anticipation of a banking crisis, the ministry of finance included funds in the budget that were used to provide liquidity support to the banking system.** The ministry of finance has confirmed that it would collaborate with NBG to provide such emergency funds in the event of external or internal shocks to the banking system. However, such funds will not be allocated in the annual budget. The ministry pointed out that there are no fiscal resources available, and that an a priori provision could cause moral hazard in banking activities.

68. **In the absence of the necessary preconditions, there is no deposit insurance arrangement.** Government-backed deposit insurance would not be advisable or credible as long as the fiscal and public debt situations remain under severe pressure. Moreover, while the introduction of deposit insurance could contribute to an increase in the public’s confidence in the banking system, a number of insolvent banks would first need to be resolved. A precondition for deposit insurance is the establishment of a healthy banking sector and a strong supervisory regime. While a deposit insurance arrangement funded by the banking industry should be a viable medium-term alternative, the buildup of assets to fund

such a system will take time, and strong banks will understandably not be willing to assume the costs of protecting depositors at weak banks.

69. **A number of deficiencies in the problem bank resolution process also undermine confidence in the banking system and increase the incidence of losses to depositors and creditors of banks.** Weaknesses in the legal environment have hindered the NBS from revoking the licenses of insolvent banks. Specifically, bank owners have been able to persuade the courts to suspend the NBS's action to revoke licenses. Experience has shown that insolvent banks that continue to operate are at increased risk of asset stripping and excessive risk taking by management, both of which increase the ultimate loss in the bank.

70. **Insolvent banks that continue to operate should be subject to special supervision.** Presently the NBS is only applying regular supervision to these banks. In situations where the supervisors are aware that a bank is likely to be placed under administration or liquidation but there is a delay, international best practice calls for special supervisory actions, such as placing an examiner on site at the bank to guard against the owners or managers taking illegal actions.

71. **The process of resolving banks is not sufficiently transparent.** While the law lays out certain general principles for the priority of claims and the appointment of a temporary administrator and liquidator, the practices and policies of the NBS are not consistently implemented. Information is difficult to obtain on the economic justifications for the decisions and these are not well documented or communicated to the public. It also does not appear that a consistent analytical framework has been applied in choosing resolution approaches for insolvent banks.

72. **The bank resolution process has at times involved a freeze on deposits for specified or unspecified periods of time.** Deposits are typically frozen when a bank is placed under temporary administration. The freezing of deposits imposes present value losses on depositors in terms of lost liquidity and lost interest even if they eventually recover all of their principal. The practice of freezing deposits in insolvent banks and the uncertainty as to the practices followed undermines public confidence in the banking system.

73. **Since there are at least four insolvent banks operating (despite attempts by the NBS to revoke their licenses), and it is likely that additional banks will be found to be insolvent, there is a need for the NBS to prepare for the orderly resolution of insolvent banks.** It is recommended that a group be formed within the NBS to conduct this effort. This group should develop a set of options for bank resolution based on a least cost methodology and assess their feasibility for the troubled banks. At the time of the resolution, the results of the analysis and the least cost recommendation should be presented to the President of the NBS and should form the basis for the decision that is made.

#### IV. LEGAL FRAMEWORK

74. **Over the last decade the legal framework governing the regulation and supervision of the Georgian financial sector has undergone significant reform.** The result has been the adoption of laws and regulations that are reasonably sound and comprehensive and broadly consistent with international best practices. Indeed, compared to other countries of the former Soviet Union, Georgia is fairly advanced in the reform of its market-related legal infrastructure. However, the implementation of the applicable laws is generally poor, largely as a result of excessive bureaucracy, corruption, and weak contract enforcement.

##### A. Financial Sector Legislation

75. **The key components of this legal framework—the NBG Law and the Banking Law—appear to work satisfactorily, but improvements are needed as discussed in Chapter III above.** In addition, a framework for the regulation, as needed, of various types of nonbank financial institutions such as credit unions, leasing companies, foreign exchange bureaus, micro finance institutions and credit information bureaus needs to be introduced. At present such institutions are not subject to any form of regulation.

##### B. Bankruptcy

76. **Bankruptcy cases in Georgia are very rare.** The procedures set forth in the Law on Bankruptcy Proceedings (1996) are regarded as complicated and cumbersome and the process is time consuming and expensive. Judges are generally not familiar with the issues involved. As a result, although many enterprises are believed to be technically insolvent, few cases are ever taken to court. The nonenforcement of the bankruptcy law prevents nonviable enterprises from being closed and prevents resources from being freed for more productive uses. The law does not accord with modern day bankruptcy practice and should be replaced with a new statute that is supported by appropriate education and training programs and other measures necessary to provide a normal market-oriented exit mechanism for insolvent enterprises.

##### C. Collateral and Security Enforcement

77. **Georgia's experience with collateral and security enforcement is limited and not very satisfactory.** As these areas are not specifically regulated, the Civil Code of 1997 applies, supplemented by the Law on Civil Procedure of 1999. There appears to be general satisfaction with the content of these laws and the procedures but much dissatisfaction with the performance of the courts in the handling and resolution of claims and difficulties with the subsequent enforcement of judgments. Banks reported some success in repossessing apartments and houses through moral suasion. Out of court settlement mechanisms are unknown. The Public Register that provides for the registration of both movable and immovable property seems to operate satisfactorily, although it is not centralized and, in

some areas, is not computerized. A particular problem that results from the weak enforcement mechanisms is that banks frequently demand high multiples (typically around 1½ times but sometimes higher) of collateral relative to the value of loans, thereby further reducing the amount of credit that banks can provide. The country would benefit from the adoption of a modern specialized secured transactions law dealing respectively with both movable and immovable property.

#### D. The Judicial Sector

78. **The Georgian authorities have carried out a comprehensive reform of the court system and there have been some significant improvements but the courts continue to attract criticism.** Excessive delays, pervasive corruption, and unpredictability are the main complaints. In the financial sector, judges have been too willing to reverse decisions of the NBG, too focused on procedural irregularities rather than substantive issues and too prone to disregard inconvenient provisions or interpretations of the laws. Judicial reform is a long-term objective but some measures can and should be introduced to improve the efficiency of the security enforcement procedures and facilitate the operations of the NBG and of the banking sector.

#### V. PAYMENT AND SETTLEMENT SYSTEMS

79. **The payment and settlement systems in Georgia consists mainly of an interbank clearing arrangement, which functions reasonably well.** A relatively comprehensive legal framework underlying payment and settlement activities has been established and the NBG has designed and is operating a robust and safe but manually intensive interbank funds transfer system. Since the electronic interbank system was implemented in 1994, no operation has failed. Indeed, the system was designed to maximize security and minimize risks.<sup>15</sup>

80. **A major weakness, however, is that the NBG lacks a strategic vision regarding payment and settlement issues.** The NBG should assume a major role in overseeing and designing the future development of payment and settlement systems. At present, the NBG appears to have adopted a relatively passive role and has left the development of other systems, such as intrabank payments, the use of checks and credit cards, and the settlement systems of the securities market to the individual participants. The CPSS Core Principles for Systemically Important Payment Systems remain *terra incognita*. To assure safe and effective development of the financial sector, strengthening the payment system expertise of the NBG

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<sup>15</sup> The interbank funds transfer system has been developed over several years in line with international best practices. NBG personnel have participated in international seminars and workshops, and have acquired practical experience working with payment system experts in the United States, Europe, and countries of the former Soviet Union.

is required and a self-assessment of compliance with the CPSS Core Principles is encouraged.

81. **The main retail payments circuits comprise: cash—both domestic and foreign currency circulate freely and are probably more important both individually and together than banking transactions; payment orders, the main banking instrument; electronic payments, including a nascent credit card industry and a very limited number of ATMs; and checks, which are relatively unimportant.** At present there is no compilation of data regarding the payment system. The NBG should, as part of its oversight function, adopt such a role.

82. **On the wholesale payments side, the NBG focuses on the speed and the reliability of the interbank funds transfer system, avoiding any risk exposure.** The system the NBG owns and runs is simple and robust, but requires manual intervention. Notably, the NBG does not provide intraday credit, nor allow end-of-day overdrafts. Furthermore, reserve requirement deposits held at the NBG cannot be used to meet settlement requirements. Settlement of government securities is achieved on a book-entry basis, both the cash and the securities leg being settled on accounts at the NBG. Foreign exchange operations resulting from the TICEX, an electronic trading platform for foreign exchange interbank operations, are also settled on the books of the NBG.

83. **The NBG—with the help of USAID—is presently in the process of introducing a Real Time Gross Settlements (RTGS) system.** MONTRAN, a U.S.-based company, was chosen in 1997 to introduce such a system. The new system is being run in parallel with the old system, in a three-stage testing process, after which the new system is expected to be fully operational.

## VI. CAPITAL MARKETS

### A. Background

84. **Over the last three years, Georgia has made substantial progress in developing its capital markets infrastructure, although the market is still very small.** The core legal infrastructure for the capital markets comprises the Law on the Securities Market of 1998, under which the National Securities Commission of Georgia (NSCG) was created, and the Law on Entrepreneurs of 1996. The first five Commissioners of the NSCG were appointed in March 2000. The Chairman of the Commission is an experienced expatriate regulator.

85. **As in many other transition economies, the development of the nascent Georgian capital markets has been linked to the country's privatization program.** The small- and medium-scale privatization program produced about 16,500 private businesses. A program to privatize large state-owned enterprises is presently underway and is expected to result in the creation of a number of Joint Stock Companies (JSCs), many of which may eventually be

traded in the market. At the end of 2000, there were 1,334 enterprises approved for transformation, of which 1,312 had actually been transformed into JSCs.

86. **The Georgian Stock Exchange (GSE) was established in 1999 as a nonprofit JSC.** The GSE is owned by 38 member brokers of which 21 have been admitted to participate in the electronic trading system. The trading system is based on the Russian Trading System (RTS), which was itself modeled on the US Nasdaq. The GSE owns the Georgian Central Securities Depository (GCSD) as a wholly owned subsidiary. GCSD adopts a very risk-conservative settlement arrangement requiring the member brokers to deposit both money and securities before trading actually takes place at the GSE.<sup>16</sup> Money settlement is handled by four designated settlement banks. The present settlement arrangement is costly, inflexible, and complex. Recognition of ownership at the level of nominee holder(s) and registrar(s) also needs some clarification.

## B. Regulation

87. **The NSCG operates as an independent regulatory authority with clear and transparent operating procedures.** The NSCG has both administrative and civil enforcement powers but no criminal prosecutorial authority. It has used these powers as much as feasible given the embryonic state of the securities industry. The staff is being trained to enhance their enforcement expertise. The NBG and the NSCG are cooperating in the supervision of banks that have securities brokers as subsidiaries. Cooperation at the international level is not urgent as there are practically no foreign portfolio investments nor issuance of securities by Georgian companies in overseas markets. As the securities markets develop, it is important that the NSCG have sufficient budgetary resources to meet its obligations. There is also a need to strengthen the inspection powers of the NSCG, in particular relating to suspected criminal violations.

88. **The GSE and the GCSD are authorized and supervised by the NSCG.** By virtue of the requirement to trade all GSE-admitted securities only on the GSE, the NSCG is effectively centralizing all trading activities in an effort to enhance the transparency of the market. Manipulation, insider trading and other forms of malpractice are defined as illegal in the Law of the Securities Market. However, in a market where it is difficult to establish market-clearing prices, detecting malpractices is not easy. The GCSD's settlement arrangement emphasizes safety, sometimes at the expense of efficiency.

## C. Government Securities Market

89. **The market for government securities remains thin and limited.** Effectively, the only securities are Treasury bills, which are issued in small amounts in 28 and 91-day

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<sup>16</sup> Currently, trading sessions are held on Tuesday and Thursday afternoons for one hour each.

maturities,<sup>17</sup> reflecting the general preference for highly liquid instruments. At present the only purchasers are the banks and in practice the secondary market does not function, partly because of the differential tax treatment afforded to the interest yield on traded securities (20 percent profits tax) compared with those held until final maturity (10 percent withholding tax). On average about four banks participate in each auction although 11 banks presently licensed have participated at one time or another during 2001.

90. **Following the re-launch of the Treasury bill market in late 1999, the outstanding stock has risen to lari 6.3 million as of January 1, 2001 and lari 11.1 million as of August 1, 2001.** A major constraint on the development of the T-bill market appears to have been the reluctance of the ministry of finance to accept high rates. Instead it has preferred to rely upon low or noninterest advances from the NBG. Interest rates on treasury bills have been highly variable, falling to as low as 7.7 percent (in November 2000) but peaking at around 41 percent in June 2001. During the first seven months of 2001 the unweighted average interest yield was 26.5 percent. The variability in Treasury bill yields reflects not only the limited credibility of the government, but also the thinness of the market. Coverage ratios have varied widely during 2001 from 0.54 (under-subscribed) to 3.50 (over-subscribed), but there does not appear to have been any collusion in the auction process.

91. **T-bills are auctioned in a dematerialized (book entry) form by the NBG and settlement is also handled by the NBG.** The system functions well and could readily be used to collateralize NBG discounting and advances. Settlement risk is essentially zero as the banks are required to transfer funds from their reserve accounts with NBG to a blocked trading account in amounts sufficient to cover the full amount of their bids before the auction takes place. The NBG, although it has established the legal and regulatory framework for discounts and advances, as well as for repos, has made only limited use of these. The government is now considering launching a small retail program.

## VII. CORPORATE GOVERNANCE ISSUES

92. **Over the last two years, Georgia has made progress in improving the corporate governance framework for traded securities.** The Law on Securities Markets provides substantial authority to regulate all traded securities and financial market participants, including brokers, share registrars and the GCSD. In following best international practice, the securities law requires disclosure of all ownership interests (both direct and beneficial) in excess of 5 percent of a company, although the implementing regulation has only recently been approved and it will take some time to see how well the disclosure requirements can be

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<sup>17</sup>The government is presently considering adding two new maturities (56 days and 140 days) to improve the spectrum of maturities available for issue.

enforced. In addition, the 1999 amendments to the Law on Entrepreneurs substantially strengthened the corporate governance of all joint stock companies.

93. **However, the corporate governance framework still suffers from a number of significant weaknesses.** The Securities Industry Association estimates that as many as 80 percent of all joint stock companies fail to hold their required shareholders' meetings, suggesting that as many as one-third of traded companies are in violation of the basic corporate governance provisions of the company law. In addition, despite the introduction of IAS, financial reports are generally considered unreliable as weak audit practices (and the limitation of an auditor's liability to the amount of the annual audit fee) have allowed "clean audits" to be delivered for several companies that were later seen to have been on the verge of bankruptcy.

## VIII. SUMMARY OF POLICY RECOMMENDATIONS

94. **The following measures are proposed for improving financial stability through improvements in banking supervision, the legal framework governing the financial system, and the payment system.** Recommendations related to the assessment of standards and codes are contained in Section II.

### A. Banking Supervision

- Parliamentary approval of the proposed amendments to the NBG Law and to the Banking Law should be secured by October 2001.
- A consistent analytical framework for resolving insolvent banks should be developed and implemented.
- A strategy and program should be developed to put in place rules, policies, and/or statutes that protect against money laundering.
- The NBG's ability to obtain information from external auditors (including management letters), reject audits that are unsatisfactory, specify minimum requirements for the scope of the audit, and sanction auditors who do not perform to accepted professional standards should be established.
- The BSD should develop procedures for special supervision for banks identified as likely to have their licenses revoked to protect against asset stripping.
- NBG should establish a crisis management group, including the ministry of finance, to deal with issues surrounding bank restructuring and to do contingency planning in the event of a systemic crisis.

## **B. Payment Systems**

- NBG should establish a strategy for developing and overseeing a modern payment and settlement system, including by creating a sound infrastructure for clearing and settlement of retail payment instruments.
- NBG should develop and promote procedures to facilitate the introduction of alternative mediums of exchange (such as checks and debit and credit cards) to facilitate noncash transactions.

## **C. Government Securities Markets and Strengthening Systemic Liquidity Arrangements**

- NBG and the ministry of finance should establish a strategy of strengthening public debt management and developing the government securities market.
- The role of the NBG in monetary management should be strengthened with a view to reducing the high liquidity and reserve requirement ratios to help support lower interest rate spreads and greater financial intermediation.

## **D. Legal Framework**

- A comprehensive review of Georgia's law and practice relating to bankruptcy should be carried out.
- The entire regime for the taking and perfecting of security needs to be reviewed and a law on collateral needs to be adopted.
- NBG should prepare a review of court procedures that affect the enforcement of contracts and the recovery of debts with a view to simplifying the process and reducing the excessive direct and indirect costs associated with using the courts to resolve claims.

## SECTION II—REPORT ON FINANCIAL SYSTEM STANDARDS

This part reviews the extent to which Georgia observes several internationally recognized standards relevant for the financial sector. It contains summaries of the detailed assessments carried out as part of the FSAP work.

Detailed assessments were prepared based on information provided by the Georgian authorities and fieldwork during the May and July-August, 2001 FSAP missions. The assessor teams were Steven Seelig (IMF) and George Treacy (Central Bank of Ireland) for the Basel Core Principles for Effective Banking Supervision; Steven Seelig and Wim Fonteyne (both IMF) and Gregorio Impavido (World Bank) for the IMF Code of Good Practices on Transparency in Monetary and Financial Policies; Stephane Fumeaux (Swiss National Bank), Ian McCarthy and Mariano Cortés (both IMF) for the Core Principles for Systemically Important Payment Systems of the Committee on Payment and Settlement Systems (CPSS); Gregorio Impavido (World Bank) for the IAIS Insurance Supervisory Principles; and Susan Rutledge (World Bank) for the OECD Principles of Corporate Governance.

Georgia has made substantial advances in financial sector supervision, particularly in the banking area. However, even in banking supervision there is a substantial unfinished agenda for becoming compliant with the Basel Core Principles. There is a need to improve the legal and regulatory structure concerning: the ability of the NBG to administer banks in distress and to close failed banks; “fit and proper” criteria for bank owners and managers; and the protection of supervisory staff of the NBG in carrying out their duties. There is also a need to improve regulations regarding the ability of banks to take foreign exchange, country, and market risks. The payment system is underdeveloped and consists essentially of an interbank funds transfer system. The NBG needs to establish a strategy for developing a modern payment and settlement system. The securities and insurance sectors are also at an early stage of development. Improvements in oversight and regulation and supervision in these areas as well as in corporate governance in the securities market will need to be developed *pari passu* with the expansion of their importance in financial intermediation. The findings concerning transparency practices in banking supervision, monetary policy, and insurance supervision were quite favorable.

The Georgian authorities indicated agreement with these assessments and their intention to pursue the recommendations in all areas. They have requested technical assistance from international and bilateral sources to help them carry out the reform agenda.

## **I. OBSERVANCE OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

95. **This is an assessment of the NBG's compliance with the Basel Core Principles for Effective Banking Supervision.** It was conducted by Steven Seelig, IMF, and George Treacy, Central Bank of Ireland, as part of the joint IMF/World Bank FSAP mission to Georgia in May 2001.

96. **The principal laws relating to the licensing and supervision of the banking industry are LN BG and the LACB.** Under the LN BG, the NBG has issued a number of regulations, referred to as Decrees or Orders. The main regulations referred to in the assessment are Decree 118 (capital adequacy requirements), Decrees 61 and 62 (minimum authorized paid-up share capital of lari 5 million), and Decree 84 (licensing). Two important regulations, Decree 350 (asset classification and loan loss reserves) and Decree 116 (conflicts of interest and related parties), were recently introduced.

97. **It should also be noted that the NBG, with the assistance of advisors provided by the U.S. Agency for International Development (USAID), hopes to implement a range of further legislative improvements to strengthen the process of banking supervision.** With regards to new regulations, the NBG indicated that the main proposals under development relate to imposing financial penalties on bank management for failure to comply with banking laws and regulations and imposing specific standard internal audit requirements.

### **A. Institutional and Macprudential Setting and Market structure—Overview**

98. **Penetration of the banking system in Georgia is among the lowest levels in the world.** Total banking sector assets and deposits are 13.0 percent and 5.7 percent of 2000 GDP respectively. At end-March 2001, there were 31 licensed banks in Georgia (total assets of lari 775 million and deposits of lari 337 million), including five against which the NBG has intervened. The 10 largest banks control 77 percent of assets and 83 percent of deposits. The banks have country risk from trade relationships with Georgia's largest trading partners and are also reliant upon loans from international lenders as a funding source. Banks are subject to a high degree of credit risk because of lending in dollars to borrowers who do not have earnings in dollars (even though currency risk is minimal because most banks have a long position in dollars). All state-owned banks have been closed or privatized. Seven of the country's banks, including two of its largest, have foreign ownership.

### **B. General Preconditions for Effective Banking Supervision**

99. **In order for banking supervision to be effective certain preconditions need to be in place.** While these preconditions are largely beyond the control of the supervisory authority, weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement effectively the Core Principles. These are summarized below.

100. **For the financial system, the main macroeconomic risk is that of instability resulting from the government’s fiscal problems, in combination with the external current account position.** The large current account deficit and limited foreign exchange reserves make Georgia vulnerable to external developments. Finally, continued sluggish economic growth could pose a further macroeconomic risk for the financial system.

101. **The credit culture is generally weak, and intermediation costs are high.** The legal and administrative procedures for enforcement of collateral need to be strengthened.

102. **Corporate governance in Georgia remains weak, although there has been some improvement in recent years.** In particular the financial statements of enterprises remain largely opaque to potential lenders.

103. **The NBG has faced significant difficulties in the efficient resolution of problem banks.** This is a serious weakness in the system and has a strong detrimental effect on confidence in the banking system.

### C. Main findings—Summary

104. **During the past two years, with assistance from USAID and the IMF, the NBG has taken measures to significantly improve the quality of bank supervision and regulation.** Many of the measures taken have been guided by the Core Principles. These have included new regulations and examination procedures relating to asset classification and loan loss provisioning. These improvements have come against a backdrop of a banking system that has experienced significant difficulties. Both the size and the skill level of the supervision staff have been enhanced. However, in spite of the great strides that have been made there is a need to strengthen certain areas of bank supervision and regulation to bring them in line with international standards. Several of the Basel Core Principles are not being observed.

105. **International experience has shown that a critical precondition for effective banking supervision is the legal protection of the supervisory staff, which is lacking in Georgia.** There is no specific legal protection for the staff of NBG from lawsuits against them personally as a consequence of their performing their official duties in good faith. The lack of protection exposes the supervisory staff to potential damages if the actions taken are found to be unwarranted and, at any rate, to possible legal expenses. The absence of such protection exposes supervisors to the threat of litigation in an attempt to discourage them from taking actions against a bank. The absence of legal certainty for the supervisory staff of NBG is of serious concern. The NBG law should be amended to provide protection from litigation for the staff of the NBG’s BSD.

106. **Another particular area of weakness in the bank supervisory regime relates to those principles surrounding the “fit and proper” criteria for bank management and controlling owners.** This principle is important to assure the integrity of the operations of the

banking system. Neither the LNBS nor the LACB provide NBS with the specific authority to reject a proposal for a change in ownership. There are prudential requirements effective when a license is originally issued, requirements regarding levels of ownership, and requirements for notification to the NBS of changes in ownership. For example, if an individual acquires 5 percent of the shares of a bank, the bank must notify the NBS. However, there is nothing in the law or regulations that gives NBS the power to block a disreputable individual from owning a controlling interest (i.e., up to 25 percent) of a bank. With regard to management, "fit and proper criteria" are applied to the managing director of the bank, branch managers, and chief accountants at the time the bank is licensed. There is a need to apply these standards to a broader range of senior management, controlling owners at the time a bank is licensed, and on an ongoing basis any time there are significant changes in ownership or top management.

**107. The ability of bank supervisors to take appropriate supervisory actions, especially when depositors are threatened with loss, is hampered by the legal system.** While the relevant statutes and regulations give the NBS a range of progressively stronger supervisory remedies to deal with banks in deteriorating condition, the ability of a bank to go to court and obtain the suspension of the actions of the supervisor means that the NBS cannot assure that remedial action will be taken in a timely manner. The staff of the NBS is acutely aware of this problem and is seeking redress in proposed amendments to the LNBS. Unless this problem is addressed, the integrity of the supervisory process, and the ability of the bank supervisor to protect the interests of the public, is seriously compromised.

**108. Another area of weakness relates to the policies and procedures for identifying, monitoring, and controlling country and foreign exchange risks.** Banks in Georgia are not currently active international lenders and, thus, country risk is not a significant risk element at this time. Nevertheless, the NBS should incorporate country risk into future changes to the regulatory regime so as to be prepared if banks change their lending strategies. More importantly, NBS has not implemented the amendments to the Basel Capital Accord to include market risks. Of particular concern is the foreign exchange exposure (credit risk) of Georgian banks that extends beyond the open position, as discussed above. For this reason the NBS may need to introduce capital charges in relation to foreign exchange risk.

**109. Georgia has not implemented any anti-money laundering regulations or legislation that promote high ethical standards in banking and prevent the banking sector from being used by criminal elements.** While the banking sector is relatively small, the absence of appropriate safeguards accompanied by the inability of NBS to approve bank owners makes the system vulnerable to criminal activity.

Table 8. Georgia: Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	The NBG is the sole licensing and supervisory authority for the banking sector and is operationally independent. Over the past three years, the BSD has been given the resources, training, and assistance needed to achieve a high quality of supervision. The main concerns relate to the legal background, which prevent the NBG from properly carrying out its mandate. These are (a) the ability of courts to set aside the NBG's revocation of a banking license pending the decision of the court which can take in excess of one year, and (b) the lack of legal protection for staff acting in good faith.
Licensing and Structure (CPs 2–5)	The use of the term "Bank" and its derivatives is adequately addressed. A major concern is the lack of a fit and proper test for all senior management, directors and significant owners. The inability to identify the source of capital is also a problem. The NBG should have the ability to block undesirable owners - including where the necessary information is not available or the source of the capital is not established. It should also be possible for the NBG to block acquisitions, which would pose an undue risk to the bank.
Prudential Regulations and Requirements (CPs 6–15)	The NBG has implemented most of the requirements of the Basel Capital Accord. The mission noted that, while country risk is not addressed, at this time no Georgian bank is significantly engaged in international lending. However, there are significant weaknesses in the area of foreign exchange risk linked to lending in dollars to borrowers who may not have earnings in dollars, which should be studied and addressed. The NBG should consider the application of capital charges for both market and foreign exchange risk. Also, there is no provision for market risk. As a general point referred to in many CPs, the NBG should seek to have certain concepts clearly defined in law, specifically "significant influence," "controlling interest," and "closely related group" (in the general lending context). The internal audit process needs to be improved in some banks. Money laundering legislation should be introduced as soon as possible.
Methods of Ongoing Supervision (CPs16-20)	The mission noted the great strides the NBG and its staff have made, particularly in the areas of on and off-site supervision. There are significant concerns in relation to the quality of both external and internal audit functions. The mission noted that the NBG intends to address deficiencies in the internal audit functions by regulation later this year. Consolidated supervision and reporting should be introduced. The law should provide that the NBG has the power to discuss matters directly with the external auditor. The NBG should seek to have certain concepts clearly defined in law, specifically "significant influence," "controlling interest," and "closely related group" (in the general lending context).

Table 8. Georgia: Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

Information Requirements (CP 21)	The introduction of IAS for banks from January 2001 was an important development but full compliance will take some time. The role of the external auditor should be addressed, e.g., NBG should have authority to reject auditor appointments, auditors should have the legal duty to report breaches of law/regulations, and auditors should be protected from liability when they report such breaches. At the same time, the liability thresholds for auditor negligence should be raised.
Formal Powers of Supervisors (CP 22)	The NBG has made determined efforts to address weaknesses in the banking system. However, the inability of the NBG to effectively enforce its decisions due to the intervention of the courts is a serious problem. There is a need for a specific legal provision for criminal charges for negligent and culpable managers and directors.
Cross-border Banking (CPs 23–25)	The NBG should introduce formal procedures and requirements for foreign branches of Georgian banks in due course. It should open formal communication lines with foreign regulators before granting a license to the branch of a foreign bank.

#### D. Authorities' Response and Next Steps

110. **The “NBG thoroughly reviewed the FSAP Assessment of Implementation of Basel Core Principles for Effective Banking Supervision recommendations provided by IMF-World Bank mission and is prepared to comply with them and actively cooperate with IMF/World Bank.”**

111. **In order to improve the bank supervisory process and bring the program at NBG into greater compliance with the Basel Core Principles, it is recommended that the following steps be taken over the next six months by the NBG:**

- Secure parliamentary approval of the proposed amendments to the LNBG and LACB so as to correct some of the most significant weaknesses.
- Develop appropriate regulations for the determination of “fit and proper.”
- Develop a strategy and program to put in place rules, policies, and/or statutes that protect against money laundering.
- Either by statute or regulation, establish the ability to obtain information from external auditors, reject audits that are unsatisfactory, specify minimum requirements for the scope of the audit, and sanction auditors who do not perform to accepted professional standards.
- Develop more sophisticated techniques to measure foreign exchange risk, and consider the introduction of capital charges for this risk.

- Establish a program for regular meetings with senior management and boards of directors of individual banks.
- Seek necessary legislative changes and adopt appropriate regulations to allow supervision of a banking group on a consolidated basis.
- Adopt procedures requiring the establishment of direct regulator-to-regulator communications, on an ongoing basis, before a license is granted for a branch of a foreign bank.

## II. OBSERVANCE OF MONETARY AND FINANCIAL POLICIES TRANSPARENCY CODE

### A. Monetary Policy

112. **This is an assessment of the NBG's observance of the MFP Transparency Code with regard to its responsibilities as agency responsible for monetary policy in Georgia.** It was prepared as part of the joint IMF/World Bank FSAP missions to Georgia that took place in May and July–August 2001. The assessment has been prepared by Messrs. Wim Fonteyne and Steven Seelig (both from the IMF).

113. **Monetary policy in Georgia is the responsibility of the central bank, the NBG, and is governed by the Law on the NBG, as well as the “Main Directions of Monetary and Exchange Rate Policies,” a policy document that sets the objectives and main parameters for monetary policy in the year ahead and is subject to parliamentary approval before the start of each year.** The NBG undertakes great efforts to inform the public about its primary objective, maintaining price stability and the purchasing power of the national currency, its other goals and objectives, and its basic monetary policy framework; including broad money as an intermediate target, and reserve money as the operational target. It also conducts its operations in an open and transparent manner.

#### Main Findings—Summary

114. **The mission found that overall and in many aspects, the transparency of the NBG's monetary policy is very good.** The NBG undertakes great efforts to inform the public about the goals and objectives of monetary policy and, by and large, conducts its operations in an open and transparent manner. It makes a concerted and largely successful effort to communicate with the public, as evidenced by its extensive publications, high-quality annual report, and excellent website. The NBG issues detailed financial statements that meet international accounting standards and are audited by one of the major international audit firms' London office. Furthermore, the “Freedom of Information” chapter of the General Administrative Code gives Georgian citizens the right to demand and obtain access to any official document that does not contain a personal, commercial, or state secret. Refusal to grant access to an official document needs to be justified in writing by the government agency concerned.

115. **However, further improvements are possible.** The main potential improvements identified by the mission are the introduction of a presumption in favor of public consultations for substantive technical changes to the structure of monetary regulations, increased transparency on the role and functioning of the MFEPC, and increased disclosure on money market operations and lender of last resort support.

Table 9. Georgia: Summary of Main Findings of Assessment of Observance of MFP  
Transparency Code—Monetary Policy

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy	The roles, responsibilities and objectives of the NBG in matters of monetary policy are clearly specified in the Law on the NBG, other laws, and the annual “Main Directions of Monetary and Exchange Rate Policies,” as approved by parliament.
II. Open process for formulating and reporting monetary policy decisions	The process for formulating and reporting monetary policy decisions is open and transparent. However, further improvements are possible, especially in the openness of the process of formulating monetary policy decisions. In particular, it is recommended that the NBG introduce a presumption in favor of public consultations for substantive technical changes to the structure of monetary regulations, and that it increase transparency on the role and functioning of the MFEPC.
III. Public availability of information on monetary policy	Both in quantitative and qualitative terms, the level of information on monetary policy made available to the public is very good. However, the NBG could improve the provision of information on its money market operations and on the lender of last resort support it gives to commercial banks.
IV. Accountability and assurance of integrity by the central bank	Accountability and integrity of the central bank are assured by appropriate provisions in the Law on the NBG, and through a policy of open and frequent communication with the media.

### Authorities' Response and Recommended Next Steps

116. **The authorities confirmed that the assessment accurately reflected current conditions.** They remarked that the NBG’s staff, in cooperation with foreign experts, had been working on amendments to the banking legislation in Georgia. According to the authorities, the draft amendments incorporated most of the FSAP recommendations and they had already been submitted to the Georgian parliament for approval.

117. **The following are the main further steps recommended by the mission:**

- a public commitment by the NBG to a presumption in favor of holding public consultations, within an appropriate period, for proposed substantive technical changes to the structure of monetary policy regulations;
- better disclosure of the role and composition of the MFEPC;
- the inclusion of detailed information on the NBG’s operations in the money market auctions in the Monthly Bulletin;
- publication of more detailed information on lender of last resort support to commercial banks;

- publication, on a regular basis, of the NBG's foreign currency commitments; and
- periodic consultations with the commercial banks to review the adequacy of the NBG's publications program.

## **B. Banking Supervision**

118. **This is an assessment of the NBG's observance of the MFP Transparency Code in regards to its responsibilities as the bank supervisory agency for Georgia.** The assessment has been prepared by Steven Seelig and Wim Fonteyne (both from the IMF).

119. **The team received excellent cooperation from the authorities and also drew from the information gathered during the assessment of the Basel Core Principles.** The assessment has been made based on MFP Transparency Code and has also relied on information gathered in connection with the assessment of the portion of the code that relates to monetary policy since NBG is responsible for both functions.

### **Institutional and Market Structure—Overview**

120. **The NBG is responsible for the regulation and supervision of the banking sector.** The supervisory function of NBG is vested in the BSD and encompasses the following functional areas: licensing, on-site inspection, policy, supervisory information technology, off-site monitoring, and bank liquidation.

121. **The banking sector consists of 31 licensed banks, including two branches of foreign banks.** One of these banks is under temporary administration and four have been allowed to continue operating by the courts despite NBG's attempt to revoke their licenses. Total assets of the banking system on March 31, 2001 were lari 775 million (approximately US \$337.5) and total liabilities of lari 517 million, of which deposits were lari 337 million.

122. **Since year-end 1996 the number of banks has decreased by 50 percent from 61 banks.** During the same period total assets have grown 230 percent and deposits have grown similarly. With the consolidation of the banking industry, and prior license revocations, NBG is responsible for the liquidation of 24 banks.

### **Main Findings—Summary**

123. **Overall, Georgia is to be commended for conducting most of its bank regulatory activities in a transparent manner.** Laws and regulations are published and the NBG communicates its goals, objectives, and the rationale for most of its actions to the public through a variety of publications, its annual report, and reports to parliament. The only area of noncompliance with the MFP Transparency Code is the absence of any presumption that the public should be consulted in the deliberative process.

124. **Clarity of roles, responsibilities and objectives.** The roles and responsibilities, as well as broad objectives for NBG are spelled out in legislation and in decrees issued by NBG. There is no ambiguity as to NBG's responsibilities in the area of bank supervision. Annually, NBG reports to parliament on its objectives for the coming year and obtains parliament's agreement. Georgia fully observes all of the aspects of the MFP Transparency Code in this area.

125. **Open process for formulating and reporting policies.** NBG has an open process for reporting on its policies. The process in Georgia for obtaining parliament's approval of policy direction assures that the public is informed and that the process is open. Overall, Georgia generally observes an open process though there is one critical area where it does not observe the code. The process of formulating regulations makes *no* presumption that the public should be consulted during the process. NBG should consider developing a public comment period during its approval process for regulations. Only after policies are formulated is the public informed. Another area where improvements can be made is to more clearly define the broad policies relating to bank resolution and communicate these to the public.

126. **Public availability of information on policies.** NBG has performed exceedingly well in providing information about a broad range of its policies to the public. It has several publications that are available to the public and it uses a variety of media to communicate its policies. NBG clearly observes the MFP Transparency Code in this regard. The only item the mission determined was not fully transparent to the public was the detailed requirement for bank financial reporting to NBG.

127. **Accountability and assurance of integrity.** NBG is fully accountable in its supervisory activities. Parliament requires full reporting of the activities of NBG and these are shared with the public in its Annual Report. NBG publishes audited financial statements and disseminates to the public these results of its financial performance as well as a very detailed description of its goals, objectives, and performance. NBG Law, as well as other legislation relating to the conduct of NBG staff as government employees, provides the public with assurance as to the integrity of NBG staff. In addition, the ability of the public to have access on demand to most policy documents assures integrity and accountability. NBG fully observes the principles of the MFP Transparency Code relating to accountability and assurance of integrity.

Table 10. Georgia: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Banking Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of banking supervisory agencies	Consideration should be given to informing the public as to the relationships between financial regulatory agencies.
VI. Open process for formulating and reporting of banking supervisory policies	Steps should be taken to give the public a consultative role in the formulation of policies, by allowing a period for public comment prior to the adoption of regulations. The process for decision-making regarding bank resolution strategies should be clarified.
VII. Public availability of information on banking supervisory policies	<i>No action required.</i>
VIII. Accountability and assurance of integrity by banking supervisory agencies	<i>No action required.</i>

### Authorities' Response and Recommended Next Steps

128. **The NGB reviewed the assessment and had no comments.** It declared itself ready to implement the recommendations proposed by the staff.

129. **To further improve transparency of banking supervision, it is recommended that the NGB take the following steps:**

- introduce and publicly declare a presumption in favor of public consultations in the process of changing financial regulations;
- publish a description of NGB’s relationship with other financial agencies and its role relative to financial markets supervised by other regulators;
- develop broad policies relating to bank resolution and communicate these policies to the public;
- improve the availability to the public of the rules for financial reporting by banks;
- consider reporting to the public on supervisory actions more frequently than the current annual reporting, perhaps quarterly or semi-annually; and
- when NGB decides to relax minimum reserve requirements for an individual bank, this needs to be reflected in aggregate data, possibly with a lag.

### C. Insurance Regulation and Supervision

130. **This is an assessment of the observance of the MFP Transparency Code for insurance in the Republic of Georgia.** Insurance is regulated and supervised in Georgia by

the ISSSG. This assessment was undertaken by Mr. Gregorio Impavido (World Bank) as part of the FSAP mission, which took place in May and July–August 2001.

131. The disclosure of policy in the insurance sector is transparent. Objectives and responsibilities of the supervisory authority are clearly defined in the Law. **However, the legislative framework governing the activity of supervision is vague, it lacks detailed implementing regulation on important supervisory principles and therefore, it allows for considerable discretion on the part of the supervisory authority on many issues.** This is particularly true for the principles on licensing, internal controls, sanctioning, on-site inspections, reinsurance, and financial disclosure. Hence, the activity of supervision is considered less transparent than the policy formulation for the industry.

Table 11. Georgia: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Insurance Regulation and Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities, and objectives of insurance regulatory and supervisory agencies	The roles, responsibilities, and objectives of the ISSSG are clearly defined in the Law on Insurance. The President of the Republic appoints the head of the supervisory authority for an indefinite term. Accountability is achieved through parliamentary reporting. Criteria for removal from office are not formally defined but relate to unsatisfactory performance with respect to objective and responsibilities. Ultimate decision on removal lies with the President of the Republic.
VI. Open process for formulating and reporting of insurance regulatory and supervisory policies	All changes in policy or legislation are publicly debated in parliament. Changes in regulation are made by the supervisory authority with the involvement of market players. Development of new products and licenses takes place with the collaboration of all parties involved in the industry.
VII. Public availability of information on insurance regulatory and supervisory policies	All legislation and regulation is publicly available. However, the supervisory process is less transparent as the legislative framework is weak and allows for a wide degree of discretion on the part of the supervisory authority. Also, although the activity of the supervisory authority is debated in parliament on an annual basis, little information on on-site inspections and sanctioning is available on the annual report of the supervisory authority.
VIII. Accountability and assurance of integrity by insurance regulatory and supervisory agencies	The head of the supervisory authority is accountable to the President of the Republic. The integrity by the supervisory authority is achieved through public dissemination of its activity in parliament on an annual basis and by the implementation of the Law on Insurance, the Law on Public Officers, the Law on Conflict of Interests, the Law on Executive Powers, and their implementing regulation.

### Authorities' Response and Recommended Plan of Action

132. The ISSSG did not provide any written comments on this assessment, but indicated their broad agreement with its conclusions and recommendations.

Table 12. Georgia: Recommended Actions to Improve Observance of MFP Transparency Code—Insurance Regulation and Supervision

Subject	Recommended Action and Timeframe
V. Clarity of roles, responsibilities and objectives of insurance regulatory and supervisory agencies	No action required.
VI. Open process for formulating and reporting of insurance regulatory and supervisory policies	The legislative framework should be re-designed to increase transparency of the supervisory process.
VII. Public availability of information on insurance regulatory and supervisory policies	No action required.
VIII. Accountability and assurance of integrity by insurance regulatory and supervisory agencies	Establish an office to deal with dispute settlement processes.

### III. OBSERVANCE OF CPSS CORE PRINCIPLES FOR PAYMENT SYSTEMS

133. **This is an assessment of the NBG's observance of the Core Principles for Systemically Important Payment Systems in regards to its responsibilities as owner, operator, and overseer of the interbank funds transfer system in Georgia.** The assessment was based on discussions with representatives of the NBG, USAID, the GSE, the GCSD, and the commercial banks. The principal authors were Messrs. Ian McCarthy and Mariano Cortés (both IMF) and Mr. Stephane Fumeaux (Swiss National Bank).

#### A. Overview

134. **Payment and settlement systems in Georgia are functioning reasonably well in difficult circumstances (the difficulties of the economy, the poor performance of the banking sector, the lack of financial depth, and the limited telecommunications infrastructure).** A relatively comprehensive legal framework underlying payment and settlement activities has been established and the NBG has designed and is operating a robust and safe interbank funds transfer system.

135. **A major lacuna, however, is that the NBG has lacked a strategic vision regarding payment and settlement issues.** In most countries the central bank assumes a major role in overseeing and designing the payment and settlement systems. At present the NBG appears to have adopted a relatively passive role and has left the development of other systems, such as intrabank payments, the use of checks and credit cards and the settlement systems of the securities market to the individual participants. The Core Principles for Systemically Important Payment Systems remain *terra incognita*. To assure safe and effective development of the financial sector, strengthening the payment system expertise of the NBG is required.

136. **The main payments circuits within Georgia comprise: cash, both domestic and foreign currency circulate freely and are probably more important both individually and together than banking transactions; payments orders, the main banking instrument; electronic payments, including a nascent credit card industry and a very limited number of ATMs; and checks are not used at present.**

137. **Low confidence in the domestic financial system and in the ability of the government to limit inflation and/or defend the external value of the lari has contributed to increasing dollarization.** The NBG has estimated the volume of foreign currency physically circulating in Georgia as being as high as US \$120–150 million (50–60 percent of broad money). Another indicator of dollarization is the ubiquitous presence of almost 300 *bureaux de change* in Tbilisi.

138. **Where retail payments are concerned, despite a high reliance on cash, some encouraging signs can be observed.** Cashless payment instruments are gaining ground. For example, debit and credit cards have been introduced with relative success. In addition,

leading commercial banks are developing on-line banking applications for large corporate customers. Further improvements in the retail area will depend on increased public confidence in the banking sector. The creation of a sound infrastructure for clearing and settling retail payments instruments will also be essential and will have to be addressed in the near future.

139. **Where wholesale payments are concerned, the NBG focuses on the speed and the reliability of the interbank funds transfer system, avoiding any risk exposure.** The system the NBG owns and runs is simple and robust. Settlement of (dematerialised) government securities is achieved on a book-entry basis, both the cash and the securities leg being settled on accounts at the NBG. The NBG does not charge for its payments services. Foreign exchange operations resulting from the TICEX, an electronic trading platform for foreign exchange operations, are also settled on the books of the NBG. From a risk perspective, the settlement procedures are secure, safe, and reliable.

140. **The settlement of financial transactions on the embryonic stock exchange is settled through settlement banks.** The cash leg can and does pass through the four correspondent banks and therefore does not necessarily pass through the NBG's interbank funds transfer system. The securities leg of these transactions is settled on the books of the GCSD, a self-regulated organization approved by the NSCG. To the extent that transactions pass through the banks there is risk exposure. As the volume and value of transactions in this market increases major systemic risk concerns could arise. Further, there is a need to clarify the relationship between NBG and NSCG, with a view to ensure the effective regulation and supervision of the securities settlement system.

141. **The NBG—with USAID technical assistance and funding—is presently in the process of introducing an RTGS system. MONTRAN, a US based company, was chosen in 1997 to introduce such a system.** The system is now scheduled to be fully operational by the end of August 2001, three years later than originally scheduled.

142. **The legal basis for payment systems comprises:**

- The Law on the NBG;
- The Law on Commercial Banks;
- The Rules of Cashless Settlement in Georgia;
- Order N220 on Approval of Clearing Regulations in Georgia (September 1999);
- The Provisional Regulations on Protection of Information in Automated Systems (April 2000);
- Order N123 on Provisional Regulations on Electronic Settlement in the Banking System in Georgia (April 2000); and

- Instruction on Licensing and Regulating the Activity of Exchange offices of Physical and Nonbank Entities (January 1999); and Regulations on Cash Operations (December 1999).

## **B. Main Findings—Summary**

143. **The current interbank funds transfer system works well from a technical viewpoint.** Since its inception in 1994, there has never been a systemic failure and the existing system does not create any systemic risk. The overall assessment of the CPSS Core Principles for Systemically Important Payment Systems is, thus, satisfactory from a purely technical viewpoint. The strengths of the payment system can be illustrated by the full compliance with the principles dealing with the understanding of financial risks and procedures for managing those risks. The system is also fully compliant with Core Principles 4 and 6 on prompt final settlement and on the use of central bank balances as the settlement asset. However, where broader issues are concerned—for example, issues related to efficiency, governance, or oversight—the system is less satisfactory. In particular, the NBG’s responsibilities for systemic oversight as defined in the Core Principles for Systemically Important Payment Systems have not always been fully accepted. Indeed, the NBG has taken a narrow oversight view, focusing mainly on its role as the technical operator of the payment system it owns.

144. **There are several medium-term challenges for payment and settlement systems in Georgia.** The first one consists in reducing the reliance on cash in the economy. The second one consists in achieving further developments in the process toward the adoption of electronic payment and settlement infrastructure. This also implies evaluating the impact of such a process in terms of internal business organization at both the commercial banks and the central bank, and also in terms of staffing and retention policies of qualified personnel.

Table 13. Georgia: Summary of Main Findings of Assessment of Observance of CPSS Core Principles for Payment Systems

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions (CP 1)	The legal basis exists, but its effectiveness remains unclear. Neither a law nor regulation on electronic signature are in place.
Understanding of the system's impact on risks and procedures for the management of risks (CPs 2-3)	Risks are generally well understood. Rules and procedures aiming at mitigating risks are in place.
Final settlement, inability to settle by the participant with the largest single settlement obligations (CPs 4-5)	Settlement occurs promptly and intraday finality is given. The system works on a gross basis.
Assets for settlement (CP 6)	Central bank money is used as settlement asset.
Security and operational reliability and contingency arrangements (CP 7)	The system is robust and failures have seldom occurred. Operational risk has been a concern, given the aging of the software and hardware. However, no formal contingency arrangements, including crisis management, are in place. Back up tests exist but, apparently, are not tested on a regular basis.
Practical for the markets and efficient for the economy (CP 8)	The account structure (e.g., separation of accounts) and the strict nonoverdraft policy impair liquidity management at the level of system participants. The NBG does not provide any liquidity support to banks, neither on an intraday nor on an overnight basis. Furthermore, the NBG has not charged for its services, which tends to inhibit the evolution of competing systems.
Objective and publicly disclosed criteria for participation (CP 9)	All banks have access to the system, as long as they meet technical requirements. Disclosure has not been an issue.
Governance of the system should be effective, transparent and accountable (CP 10)	Governance over the system could be strengthened. The NBG has tended to focus on technical issues regarding the execution of interbank payments and has not paid a great deal of attention to broader issues, such as pricing or the operation of securities settlements. The only forum for discussion is the NBG's internal IT Governance Committee, which brings together representatives of the banks and the NBG but which does not normally include representatives of the private sector or the government.
Responsibilities of the central bank in applying the Core Principles (CP 11)	The NBG limits its responsibilities to the technical operations of the systems. Oversight responsibilities are not effective and a self-assessment of compliance with the Core Principles has not been undertaken. The NBG cooperates with foreign central banks and domestic/foreign authorities, but is limited.

### C. Recommended Plan of Action and Response to Assessment

#### Authorities' Response

145. **The authorities noted that, reflecting legal deficiencies dealing with the development of information technologies, electronic settlement is governed by banking law and prudential regulations issued by the NBG and instructions issued by its Information Technology Department, and endorsed by the ministry of justice.** These regulations lay out the roles and responsibilities of participants and the NBG. The authorities agreed with the recommendation to strengthen the legal mandate of the NBG as overseer of payment systems.

146. **The NBG has set up a secondary back-up location storing sensitive information to expeditiously handle eventual failures in the main interbank payment system processing facility with minimum disruption of activities.** The information stored in this facility replicates that in the main facility, thus, safeguarding critical data from damage and losses. Furthermore, multiple alternative communications channels with the regions have enhanced the operational reliability of the main processing system.

147. **The NBG is currently drafting an updated agreement between the central bank and the participants in the payment system to be applied when the new RTGS becomes fully operational.** This document will lay out access criteria, while the NBG is considering the introduction of a user's fee based on the amount of transactions generated by the participants. Once the agreement is finalized, it will be posted on the NBG's internet web site.

148. **From 1995 until 2001, payment and settlement systems have been continuously improved guided by the resolutions of National Payments Council (NPC), in which banking institutions representatives—management, accounting, and information technologies officials—participated.** From 2001 onwards, payment and settlements system issues, among other information technology matters, are governed by the Information Technology Steering Committee of the NBG. Objectives and responsibilities of this Committee are laid out in NBG regulations. Payment policy and key decisions are consulted with representatives of the financial system and government institutions—State Revenue, Customs, Treasury, and other public offices. The NBG noted that before introducing major policy changes, it consults with participants.

149. **The authorities noted that the NBG, in accordance with its organic law, organizes the countrywide payment system, oversees participants' compliance with standards, manages communications infrastructure, and implements a common security policy.**

150. **The authorities acknowledged the importance of NBG taking a broader oversight perspective on payment and settlement issues.** Further, they noted shortcomings

in the current system including the lack of a large-value payment infrastructure, clearing operations, and securities and plastic card settlement systems. These infrastructures will be introduced gradually in light of the overall economic conditions of Georgia. The ongoing implementation of an RTGS systems provides NBG an opportunity to improve its oversight of payment systems.

### **Recommended Actions**

**151. The NBG should prepare a policy paper laying out its strategic view on payment systems in Georgia, including its role as regulator and supervisor, and identifying near- and medium-term development needs and strategy.** Particular attention should be given to the oversight responsibilities, which should be conducted independently from the operations and IT departments. The NBG should actively involved interested parties in the formulation of the policy paper. Once the paper is finalized, the NBG should continue with its successful public disclosure policy by posting it on its internet web site.

**152. The NBG can assist in the development of the banking intermediation by creating a sound infrastructure for clearing and settlement retail payments instruments, including checks.**

**153. Existing legislation should be strengthened to unequivocally grant the NBG primary authority to regulate and supervise payment systems.** Further, legislation should be introduced to foster the development of electronic payment systems, including provisions concerning electronic signature. In this context, the NBG should step-up its activities as overseer of payment systems.

**154. In the context of the introduction of Montran RTGS system, the NBG should carefully assess the operational demands that the new system will impose both on the NBG and participants as the volume of transactions grows.** As experience is gained in the operation of the system, and with a view to enhance the efficiency of liquidity management by participants and the central bank, the NBG should review its intraday and overnight liquidity provision policies, introducing changes if deemed necessary. In the near term, the NBG should develop and implement a pricing policy for its settlement and payment systems services.

**155. The NBG should make public relevant data on payment systems activity.** A possible vehicle might be publication in its economic bulletin.

#### IV. IAIS INSURANCE SUPERVISORY PRINCIPLES

156. **This is an assessment of the observance of the core principles of the International Association of Insurance Supervisors (IAIS) in the Republic of Georgia. Insurance is regulated and supervised in Georgia by the ISSSG.** This assessment was undertaken as part of the FSAP mission. The principal author was Gregorio Impavido, World Bank.

##### A. Main findings—Summary

157. **The style of supervision in Georgia is based on a traditional “a priori” control on operations and activities of the insurers.** Thus, an “audit approach” seems to dominate the supervisory process with the objective of controlling compliance with existing regulation. At the same time the legislative framework is weak: it is often ambiguous, at times it does not address important internationally accepted principles, it often lacks detailed implementing regulations, in general it does not give sufficient powers to the supervisory authority to fully discharge its responsibilities, and often allows for subjective discretion. As a consequence, the supervisory process lacks transparency and objectivity, and is exposed to serious risk of being ineffective.

158. **In more developed environments, supervision has often developed from an auditing/policing style into a style of partnership/consulting.** In this second style of supervision the supervisor should be able to rely to some extent on the internal controls and self governance rules of the insurers, and to focus mainly on guaranteeing fairness of the services offered in the market and adequate solvency levels of the players. The supervisor has the authority to request the effective implementation of such rules and of the corresponding controls by insurers. Although the supervisory authority should aim at developing the way it supervises the market in such a fashion, it is doubtful that in a foreseeable near future these modification can take place in Georgia. The market has limited potential for growth because of very low levels of per-capita income in Georgia. Furthermore, governance is weak at all levels of the society and the economy so that self-regulation cannot be safely implemented. Finally, highly sought skilled individuals like actuaries and accountants are in practice either not available or unaffordable for the supervisory authority. However, the supervisory authority, the representatives of the insurance association, and many insurers have already identified the key weaknesses of the market. Further steps are being taken to create a sound, effective regulatory and supervisory system and to develop the technical expertise that a more sophisticated industry will require.

159. **Authorities’ Response.** The findings were discussed and agreed with the ISSSG. The authorities are in the process of preparing extensive amendments to the Law on Insurance as well as amendments to regulations that would address many of the legal weaknesses identified in the assessment, and that undermine the observance of the IAIS core supervisory principles. The following table summarizes the main findings of this evaluation.

Table 14. Georgia: Summary of Main Findings of Assessment of Observance of the IAIS Insurance Supervisory Principles

Subject	Main Findings
<p>Organization of the Insurance Supervisor (CP 1)</p>	<ul style="list-style-type: none"> <li>- The overall budget of the ISSSG is low and it can only be used in a rigid fashion. In particular, external expertise cannot be hired, and budget limits cannot be exceeded.</li> <li>- With such budgetary constraints, the introduction of changes in the structure of the ISSSG, needed to improve its performance in a growing market (in volume and breadth of new coverage), cannot be readily implemented.</li> <li>- Staff salaries are lower than in the private sector and this negatively affects the ability to retain highly qualified staff. This also negatively affects the training possibilities granted to staff.</li> <li>- There is no formal scheme of legal protection of staff whilst exercising their capacity.</li> </ul>
<p>Licensing and Changes in Control (CPs 2-3)</p>	<ul style="list-style-type: none"> <li>- The design of the law is vague, to say the least, in the area of licensing. This allows for the use of ample discretion about the licensing standards used.</li> <li>- The legislation does not explicitly require the ISSSG to carry out fit and proper tests for owners, directors, and senior management or to control the source of funds.</li> <li>- Controls on criminal records are not conducted by the ISSSG and take place only indirectly when companies are registered.</li> <li>- Separate licenses for life and nonlife businesses are not provided.</li> <li>- A requirement of maximum one month to process the license exists and applicants can start activity when this period lapses and no reply is received.</li> <li>- The legislation does not explicitly require the ISSSG to consider the suitability of owners, directors and senior management, or financial and economic reasons when refusing the license.</li> <li>- A controlling share is defined as 51 percent without consideration of minority shareholding(s) “de facto” controlling companies’ activity.</li> </ul>
<p>Corporate Governance (CP 4)</p>	<ul style="list-style-type: none"> <li>- The insurance legislation does not require the supervision of the implementation of the corporate governance rules contained in the Law on Entrepreneurial Activity.</li> </ul>
<p>Internal Controls (CP 5)</p>	<ul style="list-style-type: none"> <li>- The insurance legislation gives limited authority to the ISSSG in the area of internal controls.</li> <li>- Partial supervision of risk management is indirectly achieved for compulsory insurance by the fact that the supervisor sets tariffs for compulsory insurance.</li> <li>- Monitoring of risk management is conducted during on-site inspections.</li> </ul>
<p>Prudential Rules (CPs 6-10)</p>	<ul style="list-style-type: none"> <li>- The regulation on reserve allocation does not consider the risk of maturity and currency mismatch between assets and liabilities.</li> <li>- The investment floor on Georgian assets exposes companies to high asset risk.</li> <li>- Companies cannot sell insurance policies in foreign currency.</li> <li>- The solvency margin adopted resembles a retention limit and it underestimates the credit risk associated with excessive reinsurance.</li> </ul>

Table 14. Georgia: Summary of Main Findings of Assessment of Observance of the IAIS Insurance Supervisory Principles

Subject	Main Findings
Market Conduct (CPs 11)	<ul style="list-style-type: none"><li>- The insurance legislation does not give the authority to the ISSSG to set standards for market conduct.</li><li>- The insurance legislation does not give the authority to the ISSSG to supervise standards for market conduct used by companies.</li></ul>
Monitoring, Inspection, and Sanctions (CPs 12-14)	<ul style="list-style-type: none"><li>- A file and use approach for new products is used in Georgia. However, the ISSSG does not conduct an ex-post monitoring of policy terms.</li><li>- Not all companies are required to publish their annual reports.</li><li>- A full internal manual for inspections has not been developed. However, a list of items to be inspected and data to be collected exists. The ISSSG intends to transform this into regulation.</li><li>- A transparent and objective regulatory process has not been developed by the ISSSG.</li><li>- The ISSSG has important limitations in the sanctions that it can administer so that no gradualism is allowed.</li><li>- No automatic triggers are defined for the sanctioning activity.</li><li>- The ISSSG cannot revoke insurance licenses and put a company into liquidation.</li></ul>
Cross-border Business Operations (CP 15)	Not applicable.
Supervisory Coordination and Cooperation and Confidentiality (CPs 16-17)	No action required.

## V. OBSERVANCE OF OECD CORPORATE GOVERNANCE PRINCIPLES SUMMARY ASSESSMENT

160. **The assessment of the quality of corporate governance in Georgia was conducted by determining the levels of observance of the Principles of Effective Corporate Governance of the Organization of Economic Cooperation and Development (OECD).** The review was conducted by Ms. Susan Rutledge (World Bank). It was based on discussions with the NSCG, Georgian Stock Exchange (GSE), Parliamentary Committee on Economic Policy, Parliamentary Auditing Council, Supreme Court, Federation of Professional Accountants and Auditors, Central Securities Depository, Securities Industry Association, and members of professional service organizations. Detailed comments on the draft assessment were received from the NSCG and the GSE.

### A. Summary of Findings and Recommendations

161. **Over the last two years, Georgia has made major progress in improving the corporate governance framework for traded securities.** The 1998 Law on Securities Market established the NSCG as an independent regulatory agency with substantial authority to regulate all securities of “reporting companies” (i.e., joint stock companies with more than 100 shareholders or with shares admitted for trading on the stock exchange) and financial market participants, including brokers, share registrars and the Central Securities Depository. In following best practice internationally, the securities law requires disclosure of all ownership interests (both direct and beneficial) in excess of 5 percent of a company. At the same time, the 1999 amendments to the Law on Entrepreneurs substantially strengthened the corporate governance of all joint stock companies.

162. **The results are seen in the reduction of the “gray market” of securities trading outside of the stock exchange.** As of May 2000 (about a month after inception of trading on the Georgian Stock Exchange) an estimated 93 percent of all share trades was conducted on the gray market, that is, the informal Over-the-Counter market of companies that are not “reporting companies” or companies whose securities have not been admitted for trading on the Exchange. By October of the same year, the gray market had fallen to just 65 percent of all securities trades. While still very high, the reduction in the size of the gray market supports moves toward increased transparency in the corporate sector as the prices of share trades become publicly recorded.

163. **However, there remains substantial weakness in corporate governance.** The Securities Industry Association estimates that as many as one-third of reporting companies fail to hold their required shareholders’ meetings, suggesting that as many as half of traded companies are in violation of the basic corporate governance provisions of the company law. At the same, despite the introduction of IAS, financial reports are generally considered unreliable as weak audit practices have allowed “clean audits” to be delivered for companies that were later seen to have been on the verge of bankruptcy.

164. **At the crux of corporate governance in Georgia is the substantial liability assumed by managing directors and supervisory board members for damages due to their actions.** However, the test of the liability will be in litigation, for which none has been completed in Georgia and it is difficult to determine how the overburdened court system in Georgia will decide.

165. **An alternative but complementary approach is to strengthen the institutional infrastructure of corporate governance.** This would include NSCG regulations on issues such as requirements for notification of shareholders' meetings, voting procedures at shareholders' meetings, the authorized use of proxies in voting, disclosure of conflicts of interest (particularly by managing directors who may have control of the companies to which assets are sold or transferred), and provisions related to takeovers of joint stock companies. Emphasis should also be placed on making information publicly available and easily accessible, including that in the enterprise registers held by the district courts and company disclosure filings with the NSCG. It is important also to establish guidelines on the operation and structure of supervisory boards and provide training of judges and supervisory board members on the details of the company and securities legislation. In addition, many of the corporate governance abuses seen in Georgia relate to state-owned enterprises, which are in the legal form of limited liability companies, which have few corporate governance provisions. Transforming large state companies into joint stock companies would at a minimum establish supervisory boards for the large state companies, and thus, increasing the level of supervision of company managers.

166. **Other major concerns will require legislative amendments.** The current accounting legislation follows international best practice in adopting IAS, but the audit law has not yet been amended to follow suit. The law should formally adopt International Standards of Auditing (ISA) and should set a minimum liability for auditing companies to a multiple of the company's capital. Additional reforms will be needed to make financial statements reliable for investors but the revisions to the audit legislation will substantially strengthen the sector. At the same time, the securities law should be amended to allow the NSCG to supervise joint stock companies with 50 to 100 shareholders (now exempt from NSCG review) as well as the private placements of companies with publicly traded securities. In addition, the Law on Entrepreneurs could provide strengthened corporate governance by requiring mandatory cumulative voting (to allow small shareholders a voice in selection of members of the supervisory board), requiring that all shareholders' meetings have a minimum level of authorized capital participating in the meeting (rather than the zero percent permitted for the third time the shareholders' meeting is called), and authorizing the shareholders' meeting to approve both the independent auditor and his/her scope of work and annual fees (allowing shareholders to have a voice in the quality of the annual audit).

167. **It is suggested that the work that can be done without legislative change be first undertaken, while awaiting the results of the proposed surveys on impediments to foreign investment, lack of transparency in financial reporting, and other measures that reduce investor confidence in the corporate sector.** With additional information and

insight into the nature of corporate governance weaknesses, precise reform measures can be put in place.

## **B. Summary of Recommended Action Plan**

### **Phase I (Immediate Actions)**

- Mandatory notification procedures for shareholders' meetings (including the list of newspapers where notification is to be made).
- NSCG website to disseminate information.
- NSCG regulations related to voting procedures at shareholders' meetings (including the use of proxies), disclosure of conflicts of interest, and takeover provisions.
- Online access to the enterprise registers held by the district courts.
- Detailed guidelines for supervisory boards.
- Training of judges and supervisory boards.

### **Phase II (Studies and Discussion)**

- Proposed study by the Foreign Investment Advisory Services.
- Euro-Asian regional OECD corporate governance conferences.
- Other workshops.

### **Phase III (Legislative Amendments)**

#### ***Law on audit activity (currently under preparation)***

- Adoption of ISA.
- Setting of minimum liability for auditing companies at a multiple of the authorized capital of the auditing company.

#### ***Law on securities market***

- Extend the jurisdiction of the NSCG to include monitoring of the corporate governance provisions of the Law on Entrepreneurs.

- Increase the authority of the NSCG to supervise: (1) private placements of publicly traded companies and (2) all joint stock companies with 50–100 shareholders.

*Law on entrepreneurs*

- Mandatory cumulative voting for members of supervisory boards.
- Requirement that the shareholders' meeting approve the auditing company's scope of work and annual auditing fees.
- Establishment of a minimum quorum below which no shareholders' meeting may be considered valid.
- Consideration of provisions allowing class action lawsuits.
- Amend restricted transfer provision (Article 52.3) to state that it does not apply to reporting companies.