FINANCIAL SECTOR ASSESSMENT
GEORGIA
MARCH 2002

EUROPE AND CENTRAL ASIA REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

Based on the Joint IMF-World Bank Financial Sector Assessment Program

BACKGROUND

1. As part of the Bank-Fund Financial Sector Assessment Program (FSAP), two missions visited Georgia, one in May, 2001 and the second from July 24 to August 7, 2001. The missions focused on three broad areas: (i) the Georgian financial system’s short-term stability and its resilience to shocks; (ii) progress in meeting international standards and good practices in regulation, supervision, and transparency of the financial system; and (iii) key medium-term and developmental issues in the financial system. The mission produced a number of reports that were reviewed by and delivered to the authorities.

2. During the second FSAP mission discussions were held with the Georgian authorities about the main conclusions of the assessment, which will form the basis for ongoing technical assistance from the Bank and the Fund. Between the two missions, considerable progress was made by the NBG in implementing banking regulations. Furthermore, the NBG presented to parliament important amendments to banking legislation that were approved on October 23, 2001 and became effective in November 2001. These amendments to the laws contain provisions that establish the basis for improved banking supervision and help establish the primacy of banking law in bank-related matters.

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

2 The team left a detailed Aide Memoire in May and prepared a report comprising three volumes: the Main Report, Selected Financial Sector Issues, and the Detailed Assessment of Observance of Standards and Codes.
3. Although financial intermediation is small by international standards, with the assets of the Georgian banking system corresponding to only 12 percent of GDP, nevertheless the financial sector entails risks for the overall macroeconomic situation and growth potential. Conversely, the financial system is vulnerable to several potential internal and external macroeconomic shocks. Strengthening financial infrastructure should be accorded high priority to stimulate financial intermediation and to promote the savings and investment so critical to raising sustainable growth in Georgia. Failure to address weaknesses in the banking system, especially implementing coherent exit strategies for failing banks, could lead to a deterioration in the macroeconomic environment. If a large bank were to fail, the NBG would likely be forced to provide support on a scale that would cause some combination of higher interest rates, declining availability of credit to the private sector, a weaker currency, and higher inflation.

4. The Georgian banking system presents a moderate level of concentration. As of December 31, 2001, there were 29 licensed banks in Georgia, with total assets of GEL 879 million, while total liabilities were GEL 611 million (Table 1). The system had net loans of GEL 446 million and total deposits of GEL 430 million. The country’s ten largest banks account for 83 per cent of total assets and 60 per cent of total capital in the system, while the three largest banks account for about 42% of total assets. All but three of the country’s banks are headquartered in Tbilisi.

Table 1. Georgia: Banking System Balance Sheet, December 31, 2001 (millions)

<table>
<thead>
<tr>
<th>Assets</th>
<th>GEL</th>
<th>USD equiv</th>
<th>%</th>
<th>Liabilities &amp; Capital</th>
<th>GEL</th>
<th>USD equiv</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; correspondent banks</td>
<td>240</td>
<td>116.6</td>
<td>27%</td>
<td>Deposits</td>
<td>430</td>
<td>208.9</td>
<td>49%</td>
</tr>
<tr>
<td>Loans (net of provisions)</td>
<td>446</td>
<td>216.4</td>
<td>51%</td>
<td>Borrowing</td>
<td>163</td>
<td>79.2</td>
<td>19%</td>
</tr>
<tr>
<td>Other assets</td>
<td>193</td>
<td>93.6</td>
<td>22%</td>
<td>Other liabilities</td>
<td>17</td>
<td>8.2</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Subtotal</td>
<td>611</td>
<td>296.4</td>
<td>69%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Capital</td>
<td>268</td>
<td>130.2</td>
<td>31%</td>
</tr>
<tr>
<td>Total</td>
<td>879</td>
<td>426.6</td>
<td>100%</td>
<td></td>
<td>879</td>
<td>426.6</td>
<td>100%</td>
</tr>
</tbody>
</table>

Sources: National Bank of Georgia and staff estimates. (USD 1 = GEL 2.06)

5. Despite good progress in reducing the number of banks (from over 200 in 1994 to 29 licensed banks as of 12/31/2001), and privatization of the entire banking system, further consolidation of the banking system appears necessary to achieve economies of scale, to enhance resource mobilization and to eliminate weak and insolvent banks. The low level of financial intermediation stems on the demand side from a lack of bankable projects able to service the high lending costs, a typical development trap in transition economies. On the supply side, the banks face obstacles both in mobilizing deposits and in ensuring the enforceability of loan contracts. These factors, in combination with the banks’ small scale, result in high intermediation

---

3 The figure of 29 included one institution under temporary administration and one that has (thus far successfully) challenged the NBG’s license revocation action. Two other banks, closed in February 2001, successfully defeated NBG’s license revocation action through the courts and had their licenses restored.
costs. Public confidence in the banking system is low. Almost all transactions in Georgia take place in cash, reflecting the informal economy, and the lack of clearing facilities for checks. Moreover, the fiscal authorities can block deposit accounts, thus increasing uncertainty among the citizens as to the reliability of the banking system. The credit culture is generally weak, and collateral cannot easily be realized.

6. While reported data for the Georgian banking system for end-2000 suggested a stable financial system, the underlying situation contains severe weaknesses and vulnerabilities. These weaknesses include credit and foreign exchange risks and a high (about 80 percent) degree of dollarization of deposits and loans. Banks are exposed to considerable credit risk owing to their lending to borrowers with no regular source of foreign exchange earnings, even though their open exchange positions are usually kept within the strict limits imposed by the regulations. A severe exchange rate shock, including secondary effects on banks’ non-performing loans, could cause several banks to become insolvent. At the same time, the system appears relatively resilient to shocks or fluctuations in interest rates.

7. Underlying risks in banks’ balance sheets have been partially masked by deficiencies in reporting and supervisory practices that are now being addressed by the NBG’s new asset classification and provisioning regulations that became effective as from January 15, 2001. As of August 2001, these new standards had been applied in the NBG 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 up to that time (of which only one was among the ten largest banks), fell below the minimum Capital Adequacy Ratio as a result of the inspection.

8. 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 the exchange rate pressure that took place after the Russian crisis in 1998. There are no institutional investors, the secondary market for government securities does not function and the interbank market is shallow. Furthermore, banks do not have 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. NBG also performs the lender of last resort function in accordance with revised procedures and policies issued in June 2001.

9. Recently enacted amendments to the legislation have improved the legal framework governing the financial sector, but the legal and administrative procedures for enforcement of collateral still need to be strengthened. A major weakness, now corrected, was that technical decisions by the NBG to withdraw banking licenses were frequently suspended by the courts in response to legal actions by the banks. Revisions to the Organic Law of the NBG have, inter alia, strengthened the NBG’s ability to take remedial action to handle troubled banks without undue interference from the courts. Meanwhile, revisions to the Law on Commercial Banks have strengthened the organization and governance of banks.

---

4 The amendments to the NBG Law and the Commercial Banking Law were approved by the Parliament on 10/23/2001, signed into law by the President the same day and gazetted in November 2001.
10. The assessment of compliance with the Basel Core Principles revealed substantial advances in banking supervision, but also identified several areas in urgent need of improvement. Although most of the shortcomings identified by the mission were addressed in the amendments to banking legislation approved by parliament, significant weaknesses still remain in the “fit and proper” criteria to be applied to those who should be allowed to own a bank. A particular weakness is the inability of the NBG to bar someone from acquiring a controlling interest in a bank, regardless of past criminal activity.5

11. The interbank funds transfer system functions reasonably well, but the NBG lacks a strategic vision regarding payment and settlement issues. This vision should be developed in close collaboration with the market participants.

12. The assessment of the observance of the IMF Code on Transparency in Monetary and Financial Policies found that the transparency of the NBG’s monetary and banking supervision policies is generally good, but the process for resolving problem banks needs to be made more transparent. The insurance supervisor and securities commission are both largely transparent in their procedures.

13. Other parts of the financial sector are relatively undeveloped. The Stock Exchange is small and illiquid, with the shares of two banks representing 90 percent of trading volume. Supervisory authority was granted to an independent securities commission under the Securities Market Law adopted in 1999. The systemic risks emanating from the insurance sector are negligible, given the small size of the market (gross premium income of US$ 7 million in 1999). The supervisory practices of the Insurance State Supervision Service of Georgia (ISSSG) need to be improved to bring them into line with international standards. There is a need to improve the legal framework for the creation, regulation and supervision of credit cooperatives and similar non-bank deposit-taking institutions. In this regard, the NBG is now creating the necessary supervisory capability within the revised banking laws approved in October 2001. Leasing companies and finance companies have not yet been established in Georgia.

14. Corporate governance of enterprises and banks 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.

THE MACROECONOMIC CONTEXT

15. After hyperinflation and a sharp decline in output during the first half of the 1990s, the economy stabilized and then expanded during the second half, 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. During 2000, there were improvements in the fiscal position and the external current account, but economic growth stalled, falling to 2 percent as a result of a drought.

5 Regrettably the proposed clauses covering “fit and proper” criteria for owners were removed during the parliamentary debates on the laws, although those relating to managers were approved.
Economic growth rebounded somewhat in 2001, and inflation remains low (around 5%). Nevertheless, even allowing for problems of statistical comparability, real GDP per capita in 2001 was still less than half of what it was in 1989, prior to independence.6

16. The government’s fiscal problem remains the most pressing macroeconomic policy challenge. Tax revenue 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 will be needed to increase tax revenue and control expenditure on a permanent basis. Fiscal problems have led the Government to make extensive use of its credit facilities with the NBG, limiting the NBG’s scope for monetary policy and complicating its implementation.

17. 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, of which around half is owed to international financial institutions.

18. 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.

Near-term and Medium-term Vulnerabilities in the Financial System

Monetary Policy

19. The conduct of monetary policy is complicated by the variability of disbursements of loans and grants from international financial institutions and the attendant fluctuations in government spending. At the same time, the scope for an active monetary policy is limited by the high level of dollarization and the low level of monetization in Georgia. Furthermore, the Ministry of Finance has, from time to time, borrowed from the NBG, to supplement its financing of Government expenditure by issuing Treasury bills. Nevertheless the NBG has succeeded in maintaining reasonable price stability, and a reasonably stable exchange rate from mid-1999 onwards. after a sizeable depreciation associated with the effects of the Russia crisis that occurred in 1998. The NBG maintains a floating exchange rate policy, but the parity remained in the narrow range USD 2.00 to 2.10 between June 1999 and October 2001.7 Inward and outward capital transactions are not restricted, although subject to registration for monitoring purposes, and the reported capital transactions are relatively small.

Performance of the Banking System

20. Despite wide interest rate spreads, the basic business of lending is not very profitable when full account is taken of loan-loss provisioning. Ten banks reported net losses in 2000, and

---

6 Source: World Economic Outlook

7 During the period November 2001 to January 2002, the GEL has weakened somewhat to 2.18 (end-January, 2002) owing to seasonal factors and political uncertainty.
for the banking system in aggregate, profits declined sharply. A similar pattern emerged in 2001. This outcome reflects, in particular, the impact of the new asset classification and provisioning requirements effective as from January 15, 2001, that forced banks to recognize more accurately the inherent losses in their existing portfolios. The new regulations require banks to make a subjective judgment on the likelihood of repayment of a loan, based on the repayment capacity of the borrower (i.e., solvency and cash flow analysis), and also to take into account the liquidity and market value of the collateral when establishing the appropriate level of provisioning. Banks are now also required to take into account the deficiencies in their documentation, and to consider the overall quality of their lending to each borrower, rather than simply classifying loans individually, and to classify previously restructured loans, regardless of their current performance. The banks must also classify the quality of their non-loan assets and make appropriate provisions.

21. In contrast with the practice in well-developed financial sectors, where reliance on a borrower’s cash flow as the source of repayment is an integral part of bank lending, Georgian banks rely predominantly on collateral, owing to difficulties in assessing creditworthiness, compounded by a lack of reliable credit information. Indeed cash flow-based lending accounts for only a quarter of banking credit to the private sector. A significant contributory factor is the absence or unreliability of company financial reports and statements of net worth from individuals. In essence, there is no easy way for banks to determine a prospective borrower’s ability or willingness to repay, especially as neither credit bureaus nor reporting agencies exist.

22. The reported balance sheet and income statements of the banking system as of March 31, 2001 showed deceptively high capital adequacy and liquidity ratios compared with international standards, because the figures had not been adjusted for additional provisioning to reflect the new regulations effective January 15, 2001. Consequently the FSAP team constructed an “adjusted baseline” for banks’ balance sheets derived from on-site inspections carried out by NBG during the first half of 2001, the first conducted under IAS and the new rules for asset classification and provisioning. The adjusted baseline typically revealed that a large part of banks’ loan portfolios, and a substantial part of their non-loan assets, were problem assets that 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.” For the 10 largest banks, the baseline adjustment resulted in a downward adjustment in the risk-weighted Capital Adequacy Ratio from 30 percent to 17 percent, an increase in the ratio of classified to total loans from 6 percent to 52 percent, and an increase in the ratio of classified to total non-loan assets from 0.1 percent to 8.9 percent.

23. The mission also conducted stress tests for the 10 largest banks on the basis of their 03/31/2001 financial data, after the baseline adjustment, to measure the likely vulnerability of the banks to macroeconomic shocks and credit risk. Multivariate tests showed that banks’ vulnerability to foreign exchange risk would be exacerbated by the impact of a depreciation of the GEL on the banks’ loan portfolios, since about 75 percent of foreign-currency denominated assets comprise loans to domestic borrowers, most of whom do not have reliable foreign currency income to hedge their risk. That effect would likely exceed the gains and losses arising from currency mismatches in banks’ balance sheets. On the other hand, the stress tests indicated that banks’ exposure to interest rate risk is relatively low. The mission tested several combinations of a currency depreciation of 35 percent, a concomitant increase in interest rates of 5 percentage points, and different degrees of degradation in the quality of the loan portfolios. These tests
indicated that the impact on the banking system of any of these combinations would be severe, with four banks accounting for 32 percent of the banking system assets becoming insolvent in a relatively optimistic scenario, and the bulk of the banking system becoming insolvent in an unlikely, but not impossible, worst-case scenario.

24. External credit lines from official organizations provide an important source of funding for the banking system, particularly long-term funding, and in the past the government issued sovereign guarantees on about one third of the external credit lines disbursed to commercial banks, thereby assuming contingent liabilities that could add to an already difficult external public debt position. As of June 2001, external borrowing by operating banks amounted to about US$46 million or 20 percent of banking system claims. Problems have developed with loan recovery in two recipient banks that are currently in liquidation, and in a third that is now under Temporary Administration. Some of the guaranteed loans have accelerated repayment clauses that could be triggered in the event of liquidation of the local recipient bank, although to date the guaranteed creditors have refrained from taking such action. Aware of the risks that have been assumed, the Ministry of Finance has discontinued the provision of public guarantees for new credit lines to commercial banks from external creditors.  

Transparency in Monetary and Financial Policies

25. In general, financial agencies in Georgia are transparent in their conduct of financial policies. The NBG observes virtually all the transparency policies in monetary policy, banking supervision and banking system oversight, although those for problem bank resolution need to be made more transparent. While the law lays out general principles for the priority of claims, and for the appointment of a temporary administrator or liquidator, the practices and policies of the NBG are not consistently implemented. Other areas for potential improvement by NBG are the introduction of prior public consultations for substantive technical changes in regulations, and increased openness regarding the role and functioning of the Monetary and Foreign Exchange Policy Committee. The insurance supervisor and the National Securities Commission of Georgia are largely transparent in most important areas of the Code. However, coordination and information sharing among the various regulatory agencies could be improved.

Market Discipline, Exit Strategy and LOLR risks

26. The NBG performs the lender of last resort function for “leading” banks (defined by NBG to cover the top ten banks only) that are experiencing difficulty. In June 2001, NBG issued Order 148 setting out the procedures and policies it will follow in acting as a lender of last resort for commercial banks. This Order states that loans will only be extended to banks facing liquidity problems, but allows NBG greater flexibility in determining which banks may borrow from it. While the NBG should 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. In 1998, in anticipation of a banking crisis, the MOF included funds in the budget that were used to provide liquidity support to the banking system. The MOF has confirmed that it would collaborate with NBG to provide such emergency funds in the event of external or

---

8 Multilateral creditors have introduced changes in their lending procedures, which now call for more thorough due diligence reviews and tighter collateral requirements.
internal shocks to the banking system. However, such emergency funds will not be allocated in the annual budget, as fiscal resources are limited, and the MOF feels that inclusion of such contingency funds as a budget line item could cause moral hazard.

27. In the absence of the necessary preconditions, the Government has wisely not introduced state-backed deposit insurance, which would be neither advisable nor credible while 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 introducing deposit insurance is a healthy banking sector and a stronger supervisory regime.

28. Insolvent banks that continue to operate should be subject to special supervision by NBG under clearly defined rules, instead of the regular supervision regime presently being applied. When supervisors are aware that a bank is likely to be placed under administration or liquidation but a delay occurs, international sound practice calls for special supervisory actions. Presently, although 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 NBG are not consistently implemented. Furthermore, the bank resolution process has sometimes involved a deposit freeze for specified or unspecified periods of time that imposes present value losses on depositors in terms of lost liquidity and forgone interest, even if their principal is eventually recovered. Freezing deposits in insolvent banks and uncertainty as to the practices followed by NBG also undermines public confidence in the banking system, so streamlined resolution practices should be developed that reduce the delay in depositor access to their funds.

Regulatory and Supervisory Framework and Compliance with Basel Core Principles

29. The NBG has made substantial advances in recent years to improve the quality of bank supervision by adopting new regulations and increasing the staff complement of the Supervision Department to around 30 employees. In this task the NBG is being aided by a Resident IMF Technical Advisor and by Advisors funded by USAID and EBRD. A concern is whether the effort can be sustained, if the substantial flow of external technical assistance tails off.

30. At the time of the FSAP missions, the legal framework governing the NBG’s supervisory and regulatory activities and the financial transactions of the banking sector still needed improvement. With assistance from external advisors, the NBG subsequently submitted to parliament amendments to both the NBG Law and the Banking Law. These amendments, approved by Parliament on October 23, 2001, represented a major advance in improving the independence of the NBG in regulating, licensing, and de-licensing banks. The key amendments involved: (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 managers; (iv) disclosure to the NBG of direct and indirect ownership and control relationships; and (v) protecting NBG employees from civil and criminal liability. However, during the debate, the Parliament regrettably removed two key clauses: (a) requiring “fit and proper” criteria for owners; and (b) giving the NBG authority to approve or disapprove of changes in control.

31. Many of the measures taken to improve the quality of bank supervision and regulation have been guided by the Basel Core Principles (BCP). However, several of the BCP are not
being observed, and there is still a need to strengthen certain areas of bank supervision and regulation to bring them in line with international standards.

32. Banks were required to adopt International Accounting Standards (IAS) effective January 1, 2001. There have been mixed results in adapting to the changes, but some banks are finding the transition difficult. NBG should provide accounting guidance to banks and establish policies that are consistent with IAS but address issues unique to the Georgian banking system.

33. At the time of the FSAP missions in mid-2001, Georgia did not have any specific legislation on money laundering, as required by Basel Core Principle 15, nor were there any regulations in place requiring banks to implement “know-your-customer” policies. However, in November 2001 the Ministry of Finance drafted an anti-money laundering law entitled “Law for the Eradication of the Legalization of Black Money”, based on similar laws elsewhere and the recommendations of the Financial Action Task Force (FATF) on Money Laundering. The draft was sent to the NBG and the Ministries of Internal Affairs and State Security and a second improved draft was prepared and distributed more widely within Government circles in February 2002. A final version is expected to be presented by the Government to Parliament in the second calendar quarter of 2002.  

34. 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 active international lenders and, thus, country risk is not presently a significant risk element, but NBG should be prepared if and when banks change their lending strategies.

LONGER-TERM VULNERABILITIES AND DEVELOPMENTAL ISSUES

Regulatory framework for the payments system, capital markets and insurance

35. The payment and settlement systems in Georgia consist mainly of an interbank clearing arrangement, which functions reasonably well, but major weaknesses are that the NBG lacks a strategic vision regarding payment and settlement issues, and the NBG is not in compliance with many of the CPSS Core Principles for Systematically Important Payment Systems. 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.

36. Georgia has made substantial progress in developing its capital markets infrastructure, with the creation of the National Securities Commission of Georgia (NSCG), although the market itself is still very small. The first five Commissioners of the NSCG were appointed in March 2000, including the Chairman of the Commission who is an experienced expatriate regulator. The Georgian Stock Exchange (GSE), established in 1999 as a nonprofit Joint Stock Company (JSC), is owned by 38 member brokers of which 21 have been admitted to participate in

---

9 The World Bank FSAP team intends to review the draft anti-money laundering legislation and provide recommendations as part of its post-FSAP technical assistance program.
an electronic trading system based on the Russian trading system (RTS). A program to privatize large state-owned enterprises that is presently underway is expected to result in the creation of a number of JSCs many of which may eventually be traded in the market. The GSE owns the Georgian Central Securities Depository (GCSD) which 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. The present money settlement arrangement handled by four designated settlement banks is costly, inflexible, and complex. Recognition of ownership at the level of nominee holder(s) and registrar(s) also needs some clarification.

37. The market for government securities remains thin and limited, although following the re-launch of the treasury bill market in late 1999, the outstanding stock had risen to GEL 11 million as of August 1, 2001. Effectively, the only securities are Treasury bills, which are issued in small amounts in 28 and 91-day maturities, 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). A major constraint on the development of the Treasury bill market has been the reluctance of the Ministry of Finance to accept high rates. Instead it has preferred to rely upon advances from the NBG, a practice which should cease. Treasury bills are auctioned in book entry form by the NBG that also handles settlement. The system could readily be used to collateralize NBG discounting and advances. Settlement risk is essentially zero as the banks are required to transfer sufficient funds from their reserve accounts with NBG to a blocked trading account to cover the full amount of their bids before the auction takes place.

38. The systemic risk of the Georgian insurance sector in Georgia is negligible, given its small size (GEL 14 million gross premium income in 1999). The market is characterized by a high concentration and a significant foreign presence. There are many small companies, whose activities are inadequately supervised, and because of the lack of liquid and profitable investment opportunities, insurance companies may only invest in real estate and bank accounts. Insurance supervision is carried out by the Insurance State Supervision Service of Georgia (ISSSG), whose style of supervision is limited to controlling compliance with existing regulations. The legislative, regulatory and supervisory framework is weak and often ambiguous, at times failing to address important internationally accepted principles. In general, it does not give sufficient powers to the ISSSG to fully discharge its responsibilities, and it often allows for subjective discretion. As a consequence, the supervisory process lacks transparency and objectivity.

39. Despite the progress of recent years, the Georgian financial sector remains at an early stage of development. This is exemplified by (i) the lack of depth in the financial sector, as measured by the very low ratio of bank deposits to GDP, the high ratio of cash in circulation to bank deposits, and the low level of average bank deposits to population: (ii) a lack of diversification in financial instruments and products: and (iii) the relatively slow pace of banking sector consolidation. Much financial activity takes place in the cash economy, outside the formal banking system, owing to the prevalence of non-payment mechanisms that undermine the

---

10 At the end of 2000, there were 1,334 enterprises approved for transformation, of which 1,312 had actually been transformed into JSC's.
development of the financial sector, and limitations on access to formal financing by SMEs and poorer households.

40. **To better support SMEs and micro-enterprises, the impediments to the development of new financial institutions and instruments should be removed.** Leasing, for example, as yet unknown in Georgia, could stimulate the development of the SME sector, because it can often be arranged more quickly and easily than loan financing. The lessor focuses on the lessee’s ability to generate sufficient cash flow to service the lease payments and on the security provided by its ownership of the leased equipment, rather than relying on the lessee’s credit history, assets, or capital base.

41. **The authorities also need to develop further the legal and supervisory framework governing credit cooperatives (CCs)** and the other non-bank financial institutions that may emerge. There are around two hundred credit cooperatives (CCs), mostly created in rural areas under the umbrella of the World Bank’s Agricultural Development Project. The aggregate deposits of these credit cooperatives amounted to only about US$1 million as of end-2000. These do not presently constitute a threat to financial stability, but there is a concern that CCs could be used to carry out quasi-banking activities circumventing the regulations of the banking sector. To address this issue the NBG has assumed responsibility for regulating and supervising the credit cooperatives under the amendments to the banking laws approved in October 2001. These initial steps by the NBG will be supplemented by a new Credit Cooperative Law that is currently under consideration by the Government.

42. **Over the last two years, Georgia has made major progress in improving the institutional framework for the corporate governance of joint stock companies, but a number of significant weaknesses remain that need to be addressed.** 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 such 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. Notably weak audit practices and the presently low limits for an auditor’s liability have allowed “clean audits” to be delivered for several companies that were later seen to have been on the verge of bankruptcy. Other improvements would include the drafting of NSCG regulations on issues such as the requirements for notification of shareholders’ meetings, voting procedures at those meetings, the authorized use of proxies in voting, disclosure of conflicts of interest by management and owners, and provisions related to takeovers of joint stock companies. Emphasis should also be placed on making information publicly available and easily accessible.

11 Also known as “credit unions”
43. The FSAP mission presented the following key recommendations for the Georgian financial sector, which relate mostly to the banking system:

- NBG should use effectively the enhanced enforcement powers conferred upon it by the amendments to the NBG Law and to the Banking Law that were approved by Parliament in October 2001.

- The law and practice relating to bankruptcy and liquidation should be comprehensively reviewed and amended to provide a normal market-oriented mechanism to deal with insolvent enterprises.

- The entire legislative framework for the perfection and enforcement of secured transactions should be overhauled and a comprehensive Law on Collateral adopted.

- NBG should develop and implement a consistent analytical framework for handling expeditiously the closure and orderly liquidation of insolvent banks.

- NBG Banking Supervision Department should develop special supervision procedures for dealing with banks that have been identified as likely candidates for license revocation, in order to protect against asset stripping before their closure.

- NBG should establish a crisis management group, including the MOF, to deal with bank restructuring issues and to undertake contingency planning in the event of a systemic crisis.

- A strategy and program should be developed to put in place rules, policies, and/or statutes that protect against money laundering.

- The recently approved package of legislative amendments should be complemented by new laws to govern the creation and the activities of credit cooperatives, leasing companies, and credit reference bureaus.

- A comprehensive regulatory and supervisory framework should be developed by NBG for credit cooperatives and other deposit-taking non-bank financial institutions. In this regard, the recent amendment to the Banking Laws empowering NBG to supervise non-bank deposit-taking institutions is an important first step.

- NBG should establish a strategy for developing a modern payment and settlement system, including a sound infrastructure for the clearing and settlement of retail payments. In this regard, NBG should develop and promote procedures to facilitate the introduction of non-cash instruments such as checks, debit cards and credit cards.

- NBG and the MOF should establish a strategy to strengthen public debt management and to develop the market for government securities.
• The role of the NBG in monetary management should be strengthened with a view to reducing its high liquidity and reserve requirement ratios, thereby lowering interest rate spreads and encouraging greater financial intermediation.

44. In addition to the key recommendations listed above, the FSAP mission made the following further recommendations relating to insurance, the securities market, auditing and corporate governance:

• The legislation for insurance should be amended to introduce an explicit fit and proper test for the owners, directors, and senior management of insurance companies.

• The ISSSG should be given formal authority to refuse the issuance of new licenses for defensible reasons, and empowered to revoke the licenses of companies deemed unfit to continue operating.

• The solvency margin for insurers should be redefined to account for credit risk and claims history.

• The ISSSG should improve standards for re-insurers, establish a register of approved re-insurers, require companies to select re-insurers from that registry, and set standards for market conduct.

• The Law on the Securities Market should be amended to extend the authority of the NSCG to provide for private placements and to expand its jurisdiction to include the monitoring of the corporate governance compliance provisions of the Law on Entrepreneurs.

• The Law on Audit Activity should be revised to include the adoption of International Standards of Auditing (ISA) and to set the liability of auditing companies at a multiple of the audit company’s equity capital.

• All commercial banks should be required to publish, at least annually, the names and shareholding of all shareholders holding 5 percent or more of the share capital of a commercial bank.

• NBG should establish procedures 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.