

Website, 21/12/2017
Registration Code
220010010.18.011.016265

Order N176/04
Of the President of the National Bank of Georgia
18 December 2017, Tbilisi

**Rule on Additional Capital Buffer Requirements for Commercial Banks
within Pillar 2**

Pursuant to the subparagraph “g” of Paragraph 1 Article 15, Article 47 and Paragraph 3 of Article 48 of the Organic law of Georgia on the National bank of Georgia, Article 21 of the Law of Georgia on Commercial Bank Activities, Article 25 of the Regulation on Capital Adequacy Requirements for Commercial Banks approved by Order N100/04 dated 28 October 2013 of the President of the National Bank of Georgia and subparagraph “b” of Paragraph 1 of Article 25 of the Law of Georgia on Normative Acts, **I hereby order:**

Article 1.

Rule on Additional Capital Buffer Requirements for Commercial Banks within Pillar 2, along with its annexes, shall be approved.

Article 2.

The Order N125/04 dated 30 December 2015 of the President of the National Bank of Georgia on Approving the Instruction for Determining Capital Buffer for Credit Portfolio Concentration Risk of Commercial Banks shall be declared invalid.

Article 3.

This Order shall become effective upon publication.

President of the National Bank of Georgia

Koba Gvenetadze

Rule on Additional Capital Buffer Requirements for Commercial Banks within Pillar 2

Article 1. General Provisions

1. The purpose of the Rule on Additional Capital Buffer Requirements for Commercial Banks within Pillar 2 (hereinafter – the Rule) is to establish additional capital requirements for commercial banks in order to address the risks that are not covered under Pillar 1 requirements set out in the Regulation on Capital Adequacy Requirements for Commercial Banks approved by Order #100/04 dated 28 October 2013 of the President of the National Bank of Georgia.

2. Commercial banks shall take into account the capital buffer requirements within Pillar 2 in their business activities and planning of capital according to the periodicity they become effective and take every measure to ensure that such requirements are met.

3. Compliance with the requirements set out in the Rule shall be obligatory for all commercial banks and branches of foreign banks operating in Georgia (hereinafter – a bank).

Article 2. Definitions

1. The terms used in the present Rule shall have the following meanings for the purposes of this guideline:

(a) Group of interconnected borrowers – a relationship between two or more borrowers of a bank where the borrowers represent a single risk for the bank as they are so interconnected or interdependent, that financial difficulties of one may result financial difficulties for the other or all of the rest;

(b) Supervisory stress test – assumption and analysis of a stressful scenario defined by the National Bank for the purpose of identifying and assessing risk factors for a particular bank and defining adequate capital requirements;

(c) Borrower – a natural person, a legal entity or an organization unit without the status of a legal entity towards which a bank has an exposure;

(d) Basel III Regulation - the Regulation on Capital Adequacy Requirements for Commercial Banks approved by Order #100/04 dated 28 October 2013 of the President of the National Bank of Georgia;

(e) General Risk Assessment Program (GRAPE) - a continuous cycle of risk-based supervision, elaborated in accordance with the Rule on General Risk Assessment Program for Commercial Banks approved by Order 32/04 dated 27 March 2014 of the President of the National bank of Georgia, aimed at assessing the risk levels of commercial banks and elaborating relevant supervisory actions;

(f) Total risk exposures portfolio – total value of exposures subject to credit risk weighting, taking into account the mitigation effect of the credit risk;

(g) Regulatory default – violation of minimum capital requirements of Common Equity Tier 1 capital, Tier 1 capital and/or Total Regulatory capital (4.5%, 6% or 8% respectively) determined under

Article 8 of the Basel III Regulation. With respect to systemically important banks, regulatory default additionally implies violation of the systemic buffer requirement, along with the requirements listed above.

Article 3. Capital Buffers within Pillar 2

1. Buffers determined within Pillar 2 comprise the following:

(a) Unhedged currency-induced credit risk buffer as per Article 4 of this Rule;

(b) Credit portfolio concentration risk buffer which comprises the following:

(b.a) Name concentration buffer as per Article 5 of the Rule;

(b.b) Sectoral concentration buffer as per Article 6 of the Rule;

(c) Net stress test buffer – buffer determined through supervisory stress tests as per Article 7 of the Rule;

(d) Net GRAPE buffer – buffer determined by the National Bank of Georgia (NBG) through analysis of the results of assessment of the risk categories under the GRAPE and internal capital adequacy assessment process of the bank as per Article 8 of this Rule.

2. At establishing and calculating capital buffer requirements under Pillar 2, requiring capital for the same risk twice/several times shall be excluded to the extent possible. If a particular risk is adequately reflected in buffer determined through supervisory stress tests or other abovementioned buffers, additional capital buffer for such risk shall not be required. In order to avoid requiring capital for the same risk twice/several times, NBG shall determine deductible portions of the capital buffers.

Article 4. Unhedged Currency-Induced Credit Risk Buffer

1. The purpose of introduction of the unhedged currency-induced credit risk buffer is to determine the adequate capital buffer for credit risk derived from currency rate fluctuation.

2. In order to calculate the unhedged currency-induced credit risk buffer, 75% of the currency induced credit risk exposures as per paragraph 3 of this Article shall be multiplied by the minimum regulatory capital requirement determined in Article 8 of the Basel III Regulation.

3. Currency induced credit risk exposures comprise the on balance sheet exposures, after considering the mitigation effect, defined in subparagraphs “g”-“n” of Paragraph 1 of Article 11 of the Basel III Regulation, that are denominated in a currency different from that of the source of covering the exposure, except for the following:

(a) exposures and/or their portion secured by deposits in the same commercial bank in the currency of the exposure;

(b) exposures and/or their portion where the source of repayment is borrower’s income, identified in the contract and confirmed by appropriate documentation, in a currency different from that of the

exposure, where such income is duly hedged and effectively ensures denomination of the income in the currency of exposure;

(c) exposures and/or their portion covered from the borrower's income, identified in the credit facility and confirmed by appropriate documentation, in a currency different from that of the exposure, where the real volume of such income does not change according to the fluctuation of the exposure currency rate because the borrower's incomes are received from the sale of inelastic goods (e.g. sale of imported goods if such goods are price inelastic, which, in case of depreciation of a local currency exchange rate and subsequent increase in GEL-denominated price level, does not cause reduction in the sales volume of the goods and the income received from the same). In order to avoid counting the exposures under this subparagraph in the calculations of unhedged currency-induced credit risk buffers, a bank shall obtain an approval from NBG for regarding a particular entrepreneurial activity (activities) as a suitable one. Upon request, a bank shall be able to immediately submit to NBG detailed information about all the exposures that do not fall under the capital requirement for unhedged currency-induced credit risk according to this subparagraph.

Article 5. Name Concentration Buffer

1. The purpose of introduction of the name concentration buffer is to determine adequate capital buffer for a concentration risk of a single borrower or a group of interconnected borrowers of a credit portfolio.

2. A Herfindahl-Hirschman Index (HHI) is used to calculate the name concentration buffer according to the formula set out in Annex №1 of this Rule, considering the share of the exposure of 100 largest groups of interconnected borrowers in the total risk exposures portfolio of a bank (hereinafter – top 100 interconnected borrowers).

3. A name concentration buffer is determined through multiplying the minimum 8% regulatory capital requirement amount determined by Basel III Regulation by the appropriate capital multiplier of the concentration indicated in Table 1 of Annex №2 to this Rule. In the intervals between the HHI indexes of the table banks shall apply a linear interpolation method.

4. In the determination of a the exposure value given in Paragraph 2 of this Article, a bank shall follow the definition of an exposure provided in Paragraph 1 of Article 10 of the Basel III Regulation,

where 10%, instead of 0%, is used as the minimum credit conversion factor of off-balance-sheet elements.

5. In the determination of the exposure value given in Paragraph 2 of this Article, credit risk mitigation instruments can be used if the bank has obtained NBG's approval for using such instruments for the purposes of capital adequacy as per the Basel III Regulation.

6. In the determination of the exposure value set out in Paragraph 2 of this Article, the exposures described in the subparagraphs "a"- "f" of Paragraph 1 of Article 11 of the Basel III Regulation are not taken into account.

7. The group of interconnected borrowers referred to Paragraph 2 of this Article may be represented by two or more natural or legal persons or organizational units without the status of a legal entity, if at least either of the following conditions are present:

- (a) Control – one of the borrowers exercises direct or indirect control over another or the other members of the group;
- (b) Economic interdependence – if one of the borrowers encounters financial problems (e.g. difficulties with financing and/or covering financial liabilities), another or all the remaining members of the group may find themselves in financial difficulties as well.

8. In determining the control relationship referred to in subparagraph "a" of paragraph 7 of this Article, a bank shall take into account the following circumstances and criteria:

- (a) Voting arrangements. This may cover the analysis of the majority as per the charter/agreement between shareholders/partners at the time of voting for a decision making or other occasions;
- (b) Substantial influence on the executive bodies of an organization and appointment and removal of supervisory board members;
- (c) Substantial influence (through agreement or otherwise) on the decisions of management bodies of an organizations or on the general policy of the organization (the right to make decisions about the major activity of the organization);
- (d) In addition to the above criteria, a bank shall also follow the definitions of "control" and "substantial influence" of the International Financial Reporting Standards (IFRS).

9. A bank shall take all measures to identify the economic interdependence referred to in subparagraph "b" of Paragraph 7 of this Article. For this purpose, a bank shall take into account at least the following qualitative criteria:

- (a) A borrower determines 30% or more of the total annual income or total annual expenses of another borrower (e.g. an owner of a commercial property and a tenant who pays an important portion of the rent);
- (b) A borrower buys/sells a material portion of the production of another borrower and which cannot be fully replaced easily by other client;

- (c) A borrower fully or partially secures the exposure of another borrower, or otherwise bears the responsibility of their liabilities, and this is so material that arising of a claim may result in their insolvency and/or cause them material financial difficulties;
- (d) It is likely that the financial problems of a borrower and/or their insolvency will cause financial difficulties to other borrowers in terms of fully covering liabilities or covering them in a timely manner (e.g. when a large portion of financing two or more borrowers depends on the same source and, if the common source becomes insolvent, it is impossible to find an alternative source);
- (e) Legal entities are subject to control or significant influence of different natural persons who carry out a joint venture.

10. A bank shall elaborate and agree with NBG internal methodology for identifying economic interdependence referred to in Paragraphs 7-9 of this Article which, along with other matters, shall cover the issue of interconnectedness in a group of retail borrowers.

11. Probability of losses deriving from the credit portfolio concentration risk increases when the quality of largest exposures in the portfolio of total exposures of top 100 interconnected borrowers of a bank is worse than the quality of the remaining exposures in the same portfolio. Accordingly, at determining a concentration buffer, a bank shall take into account, along with the quantitative indicators, such qualitative indicators—as the quality of large exposures, riskiness of the sector of a large borrower/group of interconnected borrowers and other qualitative indicators.

12. The purpose of the quality assessment of the name concentration risk is to determine additional name concentration buffer due to high risks. However, in rare cases, it is possible to consider the possibility of reduction of the buffer, provided that there are sufficient facts and arguments present.

13. The quality assessment of a concentration risk shall count the size of the borrower. Considering that it is impossible in a stressful situation to determine a general approach regarding the connection between the size and the risk profile of a borrower, a bank shall elaborate on their own an internal model to determine the borrower's risk profile according to the increase in its size. For this purpose, a bank may take into consideration the type of a company (small or large) it would grant a loan to in a critical situation.

14. A bank shall submit to NBG reports about the internal methodology and the model of calculating the necessary buffer for the quality concentration risk and substantiate the justification of its approaches.

15. During its analysis and substantiation, a bank shall take into consideration the historical dynamics as well as the forecasts, namely, whether the same statistics maintains. For this purpose, a bank may as

well use the experience of previous years that demonstrates that the losses derived from large loans exceeded those derived from the granular portfolio.

16. If the capital requirement for particular exposures calculated within a name concentration buffer exceed 100%, a bank shall maintain the 100% capital requirement for the relevant exposure.

Article 6. Sectoral Concentration Buffer

1. The purpose of introducing a sectoral concentration buffer is to determine adequate capital buffer for a sectoral concentration risk of a credit portfolio.

2. A sectoral concentration buffer is calculated the same way as a name concentration buffer, according to Article 5 of this Rule. In order to calculate sectoral concentration buffer, the Table 2 of Annex N2 to this Rule contains capital multipliers for various HHI indexes of sector concentration.

3. Exposures should be broken down according to the NBG classification. However, it shall be taken into account that in some cases the sectors contained in it do not in fact reflect sectors that are vulnerable to unified risks or those of the same behavior (e.g. trade).

4. If a bank is widely present in a sector and it justifies that it is the bank's main activity, it has the specialization and assesses risks effectively, it is possible to impose a lower capital buffer requirement for the bank upon the decision of NBG.

5. If the capital requirement for particular exposures calculated within a sectoral concentration buffer exceed 100%, a bank shall maintain the 100% capital requirement for the relevant exposure.

Article 7. Net Stress-Test Buffer

1. The purpose of introduction of a net stress-test buffer is to determine the amount of the additional capital that will ensure, despite incurred losses, protection of a bank from regulatory default in case the scenarios and risk factors applied in supervisory stress-tests are realized.

2. For the purposes of Paragraph 1 of this Article, a bank shall carry out, according to the rule established by NBG, supervisory stress tests comprising shocks and idiosyncratic events of systemic and

sectoral importance and of economic nature that have a material impact on the bank. For this purpose, shocks with positive correlations as well as the simultaneous ones may be taken into account.

3. NBG determines the parameters of supervisory stress tests. At the same time, a bank shall be obliged to identify factors that are specific to that bank and the change of which may have a material impact on the financial standing of the bank.

4. The components and parameters of stress-test scenarios determined by NBG are subject to revision in accordance with the existing tendencies in the economy in general and a specific sector, as well as markets of goods.

5. A bank shall submit to NBG, following the manner and the regularity established by NBG, results of the supervisory stress-tests determined by this Article.

6. In order to determine net stress-test buffer, Pillar 1 conservation and countercyclical buffers shall be deducted from the capital buffer determined through supervisory stress tests. Deductible portions of Pillar 2 buffers, including unhedged currency-induced credit risk buffer and concentration buffer of a credit portfolio shall also be deducted.

7. If a systemic stress is realized, NBG may alleviate stress test assumptions, which will cause reduction of net stress-test buffers. The reduction of net stress-test buffers can also be applied in case of an idiosyncratic shock.

Article 8. Net GRAPE Buffer

1. The purpose of introducing net GRAPE buffer is to determine adequate capital buffers for the risks identified within GRAPE and not covered or inappropriately covered by the Pillar 2 capital buffers under this Rule.

2. In determining a net GRAPE buffer, inherent risks and relevant mitigants, assessed according to risk categories, shall be taken into consideration. The results of the assessment of internal capital

adequacy assessment process elaborated by the bank, as well as its quality and plan of development, may as well be taken into account.

3. In determining capital requirements for a bank within net GRAPE, NBG considers the plans of a bank in terms of reducing the risk profile, the ability to attract additional capital in a stressful situation and recovery plans.

4. Net GRAPE buffer may be determined in any phase of the continuous supervisory cycle, be it general risks assessment of a bank or assessment of a particular risk category, or as a result of receipt of any other information that NBG may regard as ground for timely reaction.

Article 9. Requirements for the Internal Capital Adequacy Assessment Process

1. Every bank shall have a process for assessing internal capital adequacy which shall adequately reflect all risks relevant to it. At the same time, banks shall establish a sound and functional process of capital planning which shall ensure more trust towards the calculations of capital requirements within Pillar 2 of the bank by NBG, while low quality processes usually lead to a more conservative assessment and increase in capital requirements. Besides, capital planning processes shall adequately respond to the business model, the risk appetite, as well as the size and the complexity of the bank.

2. The instruction of calculating buffers determined according to this Rule, including name and sectoral concentration buffers, do not limit the bank in developing its internal capital adequacy assessment process and submitting to NBG its own approaches and models of assessing concentration risk that are different from those described in this Rule. At the same time, in addition to the risks covered in this Rule, a bank shall also take into account other risks and the factors that cause such risks. For example, along with name and sectoral concentration, a bank shall assess geographic or other types of concentration risks of a credit portfolio.

Article 10. Determining Pillar 2 Capital Buffers

1. Capital buffers defined within Pillar 2 are imposed together with the minimum requirements established under the Basel III Regulation in accordance with the illustration provided in Annex N3 to the Rule.

2. Minimum 56% of any capital buffer determined within Pillar 2 shall be satisfied through elements of common equity Tier 1 capital, minimum 75% shall be satisfied through elements of Tier 1 capital, and the remaining portion (maximum 25%) may be satisfied with elements of Tier 2 capital.

3. From time to time and within its discretion, NBG may change the buffers determined for a bank according to the risk profile of the bank and the probability and/or realization of various stressful situations.

4. Total requirement of capital within Pillar 2 may be reduced as a result of annual depreciation of an exchange rate (YoY change in the exchange rate), with the amount of capital requirement derived from the increase in the risk weighted assets (growth of RWA denominated in Lari due to exchange rate depreciation).

5. The capital referred to in Paragraph 4 of this Article, i.e. the amount of reduction of the capital requirement within Pillar 2, shall be calculated according to the methodology elaborated by a bank and approved by NBG. A commercial bank shall ensure that the capital referred to in Paragraph 4 of this Article is calculated in compliance with such methodology.

6. If a bank reduces a capital requirement with an amount exceeding that calculated according to the methodology referred to in Paragraph 5 of this Article, the bank will be in violation of the combined buffer requirement with the volume of the reduced capital that exceeds the amount calculated through the methodology referred to Paragraph 5 of this Article. The restrictions envisaged under Article 8⁴ of the Basel III Regulation will apply to the bank.

Article 11. Frequency of Determining Pillar 2 Capital Buffers

1. The buffers of unhedged currency-induced credit risk and name and sectoral concentration risks of a credit portfolio referred to in Articles 4-6 of this Rule shall be calculated on a monthly basis.

2. Net GRAPE buffer is subject to annual review. In case of material changes in the banking sector or a bank, which NBG regards as ground for a timely reaction, the buffer may be changed at a higher intensity.

Article 12. Sanctions

NBG shall apply the penalties envisaged under the Georgian legislation in the cases of violation of the requirements determined in this Rule.

Article 13. Transitional Provisions

1. Buffer requirements for the name and sectoral concentration of a credit portfolio determined by Articles 5-6 of this Rule shall be effective from 1 April 2018.
2. The buffers for name and sectoral concentration of a credit portfolio, as well as the net GRAPE buffer, determined by articles 5-6 and 8 of the Rule, may be observed until 1 January 2022 according to the periods with appropriate proportions indicated in the table under Annex 4.
3. Net stress-test buffer determined by this Rule shall be effective from 1 January 2020.

Annex N1

HHI Calculation Formula

$$HHI = \sum_{i=1}^{100} s_i^2$$

where s_i is the relevant share of exposure of the i sector/group of interconnected borrowers in the total exposure portfolio of a bank.

Annex N2

Table 1	
Name Concentration (HHI)	Capital Multiplier
0.10%	0.00%
0.15%	1.70%
0.30%	7.40%
0.60%	15.40%
1.20%	26.60%
2.40%	60.20%
4.80%	129.00%
9.60%	247.90%
≥42.80%	1071.20%

Table 2	
Sectoral Concentration (HHI)	Capital Multiplier
$0\% < HHI \leq 12\%$	0.00%
$12\% < HHI \leq 15\%$	2.00%

$15\% < \text{HHI} \leq 20\%$	4.00%
$20\% < \text{HHI} \leq 25\%$	60.00%
$25\% < \text{HHI} \leq 100\%$	80.00%

Annex N3

Illustration of Pillar 1 and Pillar 2 Capital Requirements

		Common Equity Tier 1 Capital	Tier 1 Capital	Total Regulatory Capital
Pillar 1	Minimum Requirements as per Article 8 of the Basel III Regulation	4.5%	6.0%	8.0%
Combined Buffer	Conservation buffer (a)	2.5%	2.5%	2.5%
	Countercyclical buffer (b)	[0%-2.5%]	[0%-2.5%]	[0%-2.5%]
	Systemicity buffer	n%	n%	n%
Pillar 2	Unhedged currency-induced credit risk buffer (consisting of fixed (c_f) and deductible (c_v) portions)	n x (min)56%	n x (min)75%	n%
	Name concentration buffer (consisting of fixed (d_f) and deductible (d_v) portions)	n x (min)56%	n x (min)75%	n%
	Sectoral concentration buffer (consisting of fixed (e_f) and deductible portions (e_v))	n x (min)56%	n x (min)75%	n%
	Net stress-test buffer (stress-test result (ST) is added to minimum requirements after the systemicity buffer. Net stress test buffer is determined as follows: $\max\{ST - (a) - (b) - (c_v) - (d_v) - (e_v); 0\}$.)	n x (min)56%	n x (min)75%	n%
	Net GRAPE buffer	n x (min)56%	n x (min)75%	n%

Note: n% denotes a conditional capital requirement.

Annex N4

Concentration (Name and Sectoral) buffer and net GRAPE buffer rates	From effective date - 30/12/2018	31/12/2018	31/12/2019	31/12/2020	31/12/2021 and after
Common equity Tier 1 capital	0%	15%	30%	45%	56%
Tier 1 capital	0%	20%	40%	60%	75%
Total regulatory capital	100%	100%	100%	100%	100%