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INTRODUCTION

The 2015 annual report of National Bank of Georgia (NBG) is prepared in accordance with Articles 60 and 61 of the Organic Law on the National Bank of Georgia. It comprises an overview of the bank's monetary, exchange rate and supervisory policies, and audited financial statements. This report presents the priorities of the country's central bank during the 2015 accounting period. It also contains the NBG's assessments with regard to those ongoing processes in both Georgia and abroad that had a significant impact on Georgia's economic position and the fulfilment of the NBG's objectives during the year.

During 2015, the NBG conducted its monetary policy in accordance with the objectives and functions stipulated by Article 3 of the Organic Law on the National Bank of Georgia, which states that the primary goal of the NBG is to maintain price stability. The NBG should also ensure the stability and transparency of the financial system and promote sustainable economic growth, without jeopardizing its primary objective.

The NBG relies on an inflation targeting regime when conducting monetary policy. The inflation target for 2015-2016 is set at 5% and will decrease to 4% in 2017, and to 3% in 2018.

Inflation remained at a low level at the beginning of 2015, but increased in the remaining period with a growing dynamic. By the end of the reporting period, the annual rate of inflation amounted to 4.9%, which is consistent with the target rate of the National Bank (5% in 2015). Alongside the rise of overall inflation, core inflation¹ also increased. The inflation rate was less than core inflation, which was related to the decline of fuel prices. Low oil prices in international markets resulted in the decreased prices of energy products placing downward pressure on overall inflation. Accordingly, core inflation remained above the headline inflation rate. During 2015, consumer prices changes were strongly affected by the depreciation of the nominal effective exchange rate, which had an influence on the supply side. The prices of various imported products increased, including the prices of medicaments,

which, in turn, resulted in increased prices in other components of the health care category. Similarly, the depreciation of the exchange rate had an important impact on durable goods in the consumer basket. It should also be noted that, against the backdrop of the exchange rate depreciation, the rise in prices affected a large number of goods and services in the consumption basket, which, in turn, increased the perception of inflation.

From the supply side, the gradual increase of electricity tariffs and the growth of excise taxes on alcoholic beverages and tobacco put upward pressure on the overall inflation rate. The growth of intermediate costs also put upward supply side pressure on inflation. Higher intermediate costs of firms, which was a result of the increased debt service burden on foreign currency loans due to the depreciation of the lari against the US dollar, was the main factor contributing to higher inflation in 2015.

Demand factors in the economy put downward pressure on the inflation rate. The realization of various geopolitical risks and the subsequent economic downturn in Georgia's main trading partners was reflected on the Georgian economy. Such negative developments had an impact on aggregate demand, exports and remittances fell, and the growth of tourism revenues weakened. The tightening of monetary policy in the second half of 2015 also pushed domestic demand downwards. The various factors weakening both external and domestic demand thus caused a widening of the negative output gap, which put downward pressure on consumer prices.

During 2015, the monetary policy of the NBG was conducted on the basis of a complex analysis of the macroeconomic environment as well as of global and domestic political and economic processes. Consideration was given to price dynamics in Georgia's major trading partner countries, the government's fiscal policy, financial and foreign exchange market trends, trends in international commodity markets, the specifics of the consumer basket, and the monetary transmission channel.

It should be noted that 2015 was characterized by a number of external shocks that had a sig-

1. Inflation excluding prices of food and energy products.

nificant influence on the economic situation in Georgia. The realization of geopolitical risks had a negative impact on the Russian and Ukrainian economies. The imposed sanctions from the West, the massive outflow of capital and the falling oil price from the end of 2014, first caused Russia's economy to slow down, and then decline from 2015. The drop of oil prices also had a sharply negative impact on two other important trading partners of Georgia – Azerbaijan and Kazakhstan. The majority of both countries' income comes from the sale of oil and gas. Russia's economic problems quickly transferred to Armenia, primarily being reflected on a reduction of remittances. Meanwhile, at the end of 2014 and beginning of 2015 a new stage of the debt crisis started in Greece, which was followed by restrictions in the banking sector. The conflict in Syria negatively affected the Turkish economy. While throughout 2014, expectations of an end to the U.S. Federal Reserve's quantitative easing program, which was ultimately realized in October, led to the global strengthening of the US dollar. As a consequence of the above mentioned events, the economic conditions in the region significantly deteriorated, negatively impacting Georgia. Foreign exchange inflows from exports and remittances had been falling rapidly since the end of 2014, thus triggering the lari devaluation process against the US dollar.

In general, the optimal monetary policy response to external shock is policy loosening in order to balance weakened foreign demand by encouraging domestic demand. However, due to the high level of dollarization in Georgia, there is limited room for loosening monetary policy as lari depreciation against the US dollar causes the terms of foreign currency loan services to deteriorate, which increases companies' interim costs and price increase risks. One of the particular features of Georgia's economy is that inflation expectations largely depend on the trajectory of the lari/US dollar exchange rate. With this in mind, the depreciation of the lari against the US dollar was reflected on inflation expectations and created additional pressure on prices. Given these points, the central bank's response to the external shock of the first half of the year was a moderate increase of the policy rate. During the second part of 2015, inflation expectations

increased and, even though the GDP growth level was below its potential, it quickly became necessary to sharply tighten monetary policy, to a greater extent than had been considered in the previous forecast. According to the forecasts made in August 2015, a policy rate of 6.5% was predicted by the end of the year, but in the second half of the year the central bank had to increase the monetary policy rate by 3 percentage points to 8%.

The first results of the tightening of monetary policy came in the fourth quarter of the year. Interest rates were increased on mortgage loans issued in lari and on loans for legal entities. As a result, demand for bank loans reduced, which slowed the growth of the banking system credit portfolio. This fact is evidence of the improvement of the monetary policy transmission mechanism. The tightening of monetary policy had a positive impact on the interest rates of lari time deposits. However, despite increased interest rates, the volume of time deposits in lari did not increase, which can be explained by the decline of confidence in the national currency and negative expectations.

The year 2015 was important in terms of monetary policy instruments. At the beginning of the year, demand for refinancing loans in the banking system significantly increased. This was caused by the squeeze of liquidity from alternative sources of liquidity delivery (currency auctions, the government and other operations).

Despite the significant external shock that heralded the devaluation of the lari, the adequate and timely response of monetary policy made it possible to keep inflation at the target level. Inflation at the end of 2015 amounted to 4.9%.

In line with the trend of decreasing external revenues, a deterioration of the current account balance was expected. However, the depreciation of the exchange rate slowed the worsening of the current account balance. In 2015, the current account deficit reached 11.8% of GDP, which was 1.1 percentage points higher than the same indicator from the previous year. In absolute terms, the current account deficit improved by 112 million USD. The reduction of the current account deficit in 2015 was caused by an improvement of

the services balance – mostly a result of the high increase of tourism revenues. Tourism receipts, which are the biggest component of the services sector, posted 1.94 billion USD in 2015, which was 8.3% higher than in the previous year.

The trade balance remained the most negative component of the current account. The deficit of trade in goods reached 30.8% of GDP in 2015. Exports of goods started an annual decline in third quarter of 2014, which was a consequence of the deterioration of economic conditions in Georgia's major trading partner countries and a worsened geopolitical situation. Goods exports decreased significantly in 2015 and the rate of decline was more or less equally distributed among the quarters. Imports of goods started to decline from the second quarter of 2015, as demand for imported goods fell under the influence of the depreciated GEL. It should be noted that main burden for the decline in imports came from falls in consumer goods. The share of investment and mixed goods in this decline were much smaller, which indicates healthy misbalance reduction in the current account.

The economic growth of Georgia in 2015 slowed to 2.8%. Because of weak foreign demand, manufacturing decreased by 4.9%. Trade, the largest branch of the economy, also declined. In 2013-2014, trade grew by 5-6%, but decreased by 0.3% in 2015. Growth was low in agriculture at 2.9%, with the sector making a 0.2 percentage point contribution to GDP growth. The construction sector was the main driver of economic growth. During the year, it increased by 15.2% and made the biggest, 0.9 percentage points, contribution to economic growth. The most significant contribution to the growth of construction came from the construction of a new gas pipeline, but activity was also high in both government-funded infrastructural projects and private constructions. Throughout the year, the monetary policy tightening was not fully reflected on the interest rates of loans. Therefore, the volume of real estate loans continued to grow until the fourth quarter, thus promoting market activity. Alongside the construction of private housing, real estate, rental and business activities also grew, with the largest part of the turnover coming from real estate agencies.

Net exports were significantly reduced and had a negative impact on economic growth. Influenced by the depreciation of the lari, demand on imports fell and, consequently, from the second quarter, the negative impact of net exports on the economy started fading away.

Earlier in the year, the consumption growth rate was also high. However, after the lari depreciated against the US dollar, the service burden on dollar loans increased, which reduced the population's disposable income and hence lowered consumption. In addition, the monetary policy tightening had a restrictive effect on consumption, as interest rates on loans increased by the end of the year. At the same time, throughout the year consumption was fueled by the widened budget deficit. Compared to the previous year, in 2015 the consolidated budget deficit grew and reached 3.7% of GDP. Under the influence of these factors, consumption growth gradually diminished throughout the year and finally contributed 0.8% to GDP growth.

Although the growth rate of investments in 2015 decreased by 17% compared to 2014, investments remained the main drivers of economic growth. This decline was expected as the investment to GDP ratio is about 30%, which is consistent with the sustainable level of Georgia's current account and savings rate. It is expected that the increase in investments in following years will not considerably exceed nominal GDP growth. In 2015, the government's infrastructural and new gas pipeline projects made the largest contribution to the growth of investments.

In addition, the expansionary monetary policy of previous years was partially spread in 2015 and had an impact on the real estate market and private housing construction, giving positive impetus for the growth of investments. Ultimately, the most important contribution (3.1%) to GDP growth in 2015 was made by investments.

As of 31 December 2015, total international reserves of the National Bank of Georgia amounted to 2.521 billion USD. Several factors affected the volume of the NBG's international reserves during 2015: FX auctions, government expenditures, and grants and credits received from international organizations.

The year 2015 was a significant challenge for the process of de-dollarization. The depreciation of the lari against the US dollar significantly slowed the growth of larization that had been observed in previous years, especially in the case of deposits. During first three quarters of 2015 the larization of loans grew; however, the trend changed from October when larization began to decline. This fact, in parallel with the tightening of monetary policy, was related to the increase of interest on lari loans, with the difference in interest compared to foreign currency loans increasing. Finally, in 2015 fixed exchange rate loan larization increased by 2.1 percentage points to 35.6%. As already mentioned, despite the depreciation, the larization of deposits in the first half of the year was stable, but decreased to 31% in the second half of the year.

Reforms undertaken by the NBG over recent years have played an important role in the process of promoting larization. These reforms were directed towards developing financial and exchange markets. The expansion of the collateral base used for refinancing operations and the inclusion of debt securities in the national currency issued by international financial institutions with a minimum rating of BBB, encouraged the issuance of financial instruments in local markets by international financial institutions. In 2015, the Asian Development Bank (ADB), the International Finance Corporation (IFC) and the Black Sea Trade and Development Bank (BSTDB) started to issue lari-denominated debt securities. Over the year, these international financial institutions and the European Bank for Reconstruction and Development Bank (EBRD) issued bonds worth a total of 203 million GEL. This process will help enhance capital and secondary markets and will promote development of the local corporate bond market.

Important attention is being paid to the development of communication for increasing monetary policy efficiency. Communication gains particular importance within the framework of the inflation targeting regime, because it is essential to correctly formulate and manage public expectations. Timely and effective communication of the NBG's goals, strategies and economic analysis increases the predictability of monetary policy decision making. Therefore, improving and in-

creasing communication channels are some of the NBG's main priorities.

In 2015, the National Bank continued to hold regular meetings with analysts regarding Monetary Policy Committee decisions and provided them with detailed information about projections.

Throughout 2015, banking supervision operated in the face of various challenges. Particularly, against the backdrop of increased risks in the financial system, as a result of possible organizational changes, significant human resources were lost. However, due to the presence of a modern organizational structure and measures previously taken (see the 2009 annual report) the efficiency of banking supervision was maintained. Despite various challenges, the supervisory function of the NBG proactively implemented risk-oriented supervision.

The reorientation of the decreased resources on the main supervisory processes somewhat slowed down the implementation of new methodologies. However, in 2015, significant efforts were made by the NBG for enhancing and developing its regulatory framework. This included, but was not limited, to the implementation of Pillar II of the capital adequacy framework based on Basel II/III, a framework for concentration risk buffer, a framework for stress-tests, as well as the amendment of existing normative-legal acts and the development of new legislative initiatives for fostering effective supervision.

Throughout 2015, in the background of reduced economic activity, the main challenge for the financial sector was to soften the results of the lari depreciation. Moreover, it was necessary to take into account acute competition and the increasing amounts of unregulated non-bank financial intermediation.

As a response to recent events, loan portfolio monitoring became the main priority within the frames of the supervisory process. Critically important figures of the portfolio were updated promptly and continuously in order to ensure the quality of the credit risk portfolio as much as possible.

Under the high level of dollarization, the debt burden for borrowers increased and, consequently, credit risk increased as well. However, by the end of 2015 the quality of the loan port-

folio was satisfactory, which was primarily the result of existing buffers for credit standards, drop of borrowers' investment and consumption expenditures, positive economic growth, and a high level of liquidity in foreign currency in the banking sector. The impact of the time lag of maximum depreciation on asset quality, and certain drawbacks in the direction of refinancing/restructuring in line with international practice, do not change this assessment.

In addition, it must be pointed out that the growth of the debt burden, as a result of the Georgian lari exchange rate depreciation, will negatively affect the rate of loan portfolio growth in the following periods. Taking active steps in terms of decreasing the debt burden (deleveraging) can create balance sheet recession risks.

Throughout 2015, active work on refinancing/restructuring issues was carried out, the updated terms of which were introduced in 2014. This process has not yet been finished and requires further intensive work in order to differentiate refinancing and restructuring activities as objectively as possible. In terms of refinancing/restructuring activities, throughout 2015 the National Bank was actively involved in the Supervision and Implementation Group (SIG) of the Basel Committee on Banking Supervision (BCBS), which works on harmonizing different definitions, including solving problems related to refinancing/restructuring on the international level.

In parallel with the slowdown of the growth of the loan portfolio in 2015, competition further increased, which enhanced the risk of loosening credit standards. These conditions create inappropriate motivations for borrowers and weaken the debt servicing culture. Acute competition in the banking system may weaken individual banks' market positions in the future, or encourage these banks to take excessive risks. Therefore, considering the risk-oriented supervisory principles, throughout 2015 significant resources were allocated to the discussion of banks' profitability forecasts and the analysis of individual institutions' business models and strategies; particular attention was paid to scale effects, the existence of market niche and/or other competitive advantages; and the approximate evaluation of predicted loan losses. Supervisors further focused on risk mitigants, including the development of detailed pricing models for banking products.

Throughout 2015, within the frames of the supervisory process and in parallel with the assessment of inherent risks, significant supervisory resources were directed towards the evaluation of risk management functions at commercial banks and the enhancement of their efficiency. The evaluation entailed analysis of the adequacy of supervisory boards, management functions and internal control systems to determine how well the practice established at a bank corresponds to its respective risk profile, size, and best international practice. Within the frames of this evaluation, particular attention was paid to the assessment of the soundness of risk management functions, including capacity to properly assess credit risks and balance sales.

Considerable emphasis was put on the improvement and testing process of commercial banks' business continuity plans. At the same time, the National Bank of Georgia continued studying the quality and accuracy of commercial banks' data and associated information systems. Several commercial banks were assessed in terms of accuracy risk and particular attention was paid to both the adequacy of banks' business reporting processes and the possibility of optimizing existing processes. A particular achievement of the reporting period was the implementation of information systems (IS) audits by commercial banks. During last year, the largest share of losses was attributed to internal fraud, with external fraud being the second largest category.

Banking sector capital and liquidity indicators are at a conservative level. Therefore, in terms of financial stability, the ability of the financial system to absorb additional shocks is high.

Analytical activities were also enhanced in the direction of the non-banking financial sector. Studies undertaken on private lenders and pawnshops indicated that although this segment has a material impact on the total debt burden of banking system borrowers, the information on the liabilities of such clients are seldom provided to the credit reference bureau. As a result, banks cannot properly assess the creditworthiness of such clients. In order to overcome this problem, legislative amendments are planned to increase the credit bureau's coverage of the non-banking sector as far as possible.

Protection of consumer rights is one of the priorities for the National Bank of Georgia. The NBG continued actively monitoring the market,

including, through the implementation of “Mystery Shopper” study. The National Bank further maintained active communication with commercial banks to resolve existing shortcomings. In addition, the NBG was actively working in the direction of extending consumer protection framework to the non-bank financial sector, which will require relevant legislative changes.

In 2015, for the purpose of enhancing the levels of financial literacy in the country, the National Bank of Georgia carried out different activities and published various educational materials. However, meaningfully impacting large segments of the society is rather resource-intensive and time-consuming task. Therefore, the NBG continues to actively work on developing the strategy for financial education with the involvement of different stakeholders.

Throughout 2015, the National Bank of Georgia maintained its active international cooperation framework in the direction of banking supervision. Namely, the NBG participated in leading international initiatives and increased the export of its reforms implemented in the sphere of banking supervision.

By the end of 2015, two stock exchanges, a Central Securities Depository, eight brokerage companies and three independent securities registrars were operating on the Georgian securities market. Of the eight brokerage companies, two were not members of the stock exchange. Registrars maintained the registry of shares of 828 joint-stock companies (JSCs), which is an increase of 10 over the previous year.

The reporting year is noteworthy for the development of the debt securities market, and for the growth of investor interest in this field. It should be mentioned that the investor-oriented reforms and regulations that were conducted in recent years to encourage the development of the market proved productive and ultimately yielded the results that were projected during the implementation of the reforms. In 2015, four different companies emitted obligations in the form of public offerings. In addition, one company emitted stocks in the form of public offerings with a total value of 20 million GEL.

As of 31 December 2015, other financial institutions in Georgia comprised 15 credit unions, 70 mi-

crofinance organizations, 1,115 currency exchange bureaus and 45 monetary remittance units.

The microfinance sector continued to grow and develop in 2015. In comparison with 2014, total assets increased by 46%, and amounted to 1.6 billion GEL. A light supervision regime is still maintained on microfinance organizations.

Payment systems in Georgia are dynamically developing and are becoming more secure and efficient. In 2015, as in the previous year, the most significant payment system in Georgia (the Real Time Gross Settlement – RTGS System) operated by the National Bank of Georgia kept its continuity ratio at 99.9%, which indicates the success of the major infrastructural reforms of recent years and the sustainability of the systems introduced. In the past year, the payment service area has also dynamically developed. The number of payment service providers has increased and the services provided by them have become more diverse.

In 2015, the National Bank continued to improve its information technology infrastructure. The National Bank became the first organization in Georgia to successfully pass the certification audit and become certified in compliance of the information security management system ISO/IEC 27001: 2013 standard.

It is also noteworthy that in 2015 there was a modification of the 20, 50 and 100 lari denomination banknotes in terms of production and issuing in circulation. This is the first major upgrade of the banknotes' design in the 20-year history of the Georgian lari. Work on this project has lasted several years. In spite of some slight modifications, since 1995 there had been no significant changes to the initial design of the lari banknotes, their color or style. In terms of international standards and quality, the Georgian banknotes were quite old in terms of both aesthetics and technical parameters. According to specified requirements, work was thus started to improve the 5, 10, 20, 50 and 100 lari denomination banknotes in terms of aesthetics, durability and improving security features. Details of the design of new banknotes were maximally integrated with protective signs and creates concept of a whole family. Execution style, parameters and security features are modern, tested and consistent for each denomination.



I

MACROECONOMIC ENVIRONMENT



1.1 WORLD ECONOMY

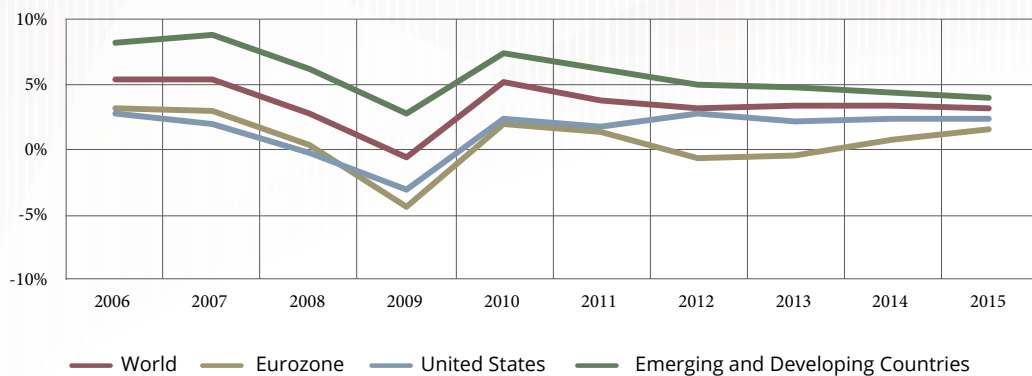
In 2015, global economic growth faced significant impediments. Weak aggregate demand, declining commodity prices and increased volatility in financial markets for products hindered economic activity, and, as a result, global growth totaled only 3.1%.² Especially notable was the slowdown in activity in emerging and developing economies. Developed economies, in contrast, continued to recover. A decreasing trend was observed in global inflation, which was mainly due to the fall in prices of oil and other commodities on international markets. The world's leading central banks, in response to weak inflation, were pursuing expansionary monetary policies; however, at the end of 2015, the US Federal Reserve Committee began the process of tightening and increased the interest rate by 0.25 percentage points. In addition, strict policies continued in developing countries, where the depreciation of local currencies against the US dollar created inflationary pressures.

Weak global demand and investments are partly the result of the lasting legacy of the global financial crisis and are driven by a deterioration of consumer and business sentiment. Structural and geopolitical challenges in 2015 further weakened economic agents' expectations and created additional uncertainty. This situation particularly affected emerging and developing parts of the world, reflecting reduced revenues from trade, declining investment and a rise in the cost of credit. The downward trend in commodity prices further amplified the difficulties. Oil prices continued to decrease during the year and reached a 10-year record low. The decline was caused by abundant stockpiles accumulated in developed countries, the intensive production-supply of oil and deteriorating expectations of global demand.³ However, it should be noted that reduced oil prices had a mixed effect on economies: while exporters were negatively affected, the current accounts of importers improved and real incomes increased.

2. World Economic Outlook (WEO), IMF, April 2016.

3. This was coupled with expectations of lifting economic sanctions on Iran, which would bring the resource-rich player back to the international market. In January 2016, the sanctions were removed.

Diagram N 1.1 Global Real GDP Growth



Source: IMF

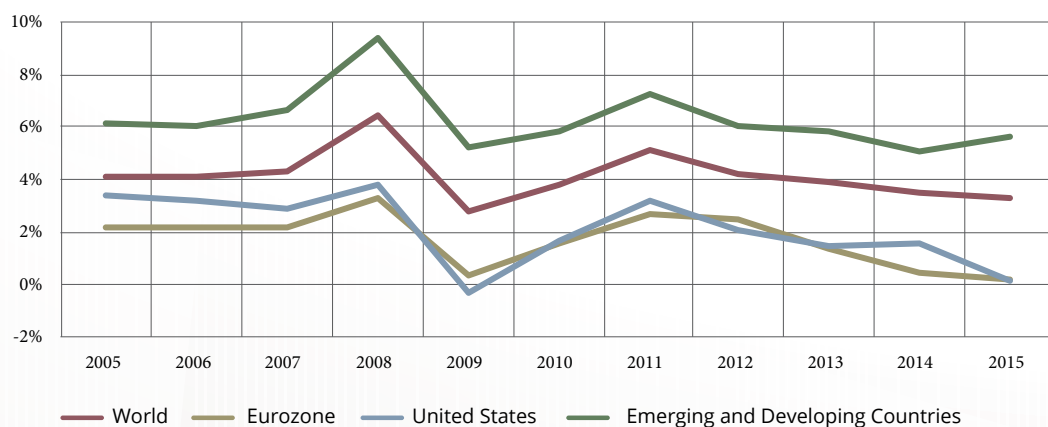
The year 2015 was characterized by weak capital flows, mainly reflected in reduced short-term debt and portfolio investments. The reason for this is attributed to slower economic activity, policy divergence and falling commodity prices. Decline in net capital inflows in many countries (especially in commodity-exporting countries) created depreciation pressures and led to significant fluctuations on equity markets. This was accompanied by a rising cost of credit amid increasing sovereign risks.

Like the capital flows, global trade also significantly reduced in 2015, which was mainly caused

by sluggish demand from emerging and developing markets. In particular, the rebalancing of the Chinese economy and the deteriorating macro-economic situations in Russia and Brazil played an important role in fueling tensions.

Despite the fact that in 2015 the local currency depreciation fueled price increases in some countries, the global inflation trend was lowering. The reason for this was falling commodity prices on the international markets and the decline in aggregate demand. The risks of deflation in the eurozone is still significant, and partly also in the US and Japan.

Diagram N 1.2 Global Inflation



Source: IMF

Along with other circumstances, the geopolitical tensions in the south-east of Europe, where the major trading partners of Georgia are located, had a significant influence on the region's economic situation. The Russia-Ukraine conflict badly damaged the Ukrainian economy. The gross domestic product fell by 9.9%, which was followed by high inflation averaging 40-50%. The rise in utility prices and the depreciation of the national currency caused the sharp increase in inflation. Furthermore, a significant decline was observed in exports, which was principally a consequence of the ongoing conflict in the industrialized eastern part of the country, the termination of trade relations with Russia and the global reduction in prices of metal and agricultural products.

The year was also hard for the Russian economy. Sharply reduced revenues from oil exports, the international sanctions and the massive outflow of capital were on the short list of problems facing the country. GDP declined by 3.7% during the year, while the depreciation of the ruble boosted inflation to 15% year on year. Against this background, investment and consumer sentiment deteriorated significantly, which, together with lower oil prices and international sanctions, exerted a negative impact on the forecast.⁴

In Azerbaijan, depreciation of the manat by 50% at the end of the year undermined consumer sentiment. The World Bank estimates that the economy of Azerbaijan increased by 1.1% in 2015.⁵ The crisis in Russia had a negative impact on economic activity in Armenia, which was reflected in weakened demand for exports and declined remittances and foreign direct invest-

ment. The World Bank estimates that Armenia's economy grew by 3% in 2015.⁶

Turkey's economic growth rate of 3.8% in 2015 was higher than that of Georgia's other main trading partners.⁷ However, there remained many factors that negatively contributed to that growth, including the migrant problem caused by the military conflict in Syria, political tensions in the June parliamentary elections (which was followed by a snap election in November that was won by the ruling party), and the weakening of exports (resulting from the interruption of trade with Russia and reduced demand for tourism services). Meanwhile, the low price of imported crude oil contributed to improved economic activity and the current account; however, amid uncertainties and the local currency depreciation, inflation increased to 8%.

In 2015, the eurozone recovery was slow, with the economy moderately increasing by 1.6%.⁸ Positive factors for the region included lower oil prices, favorable credit conditions and the depreciation of the euro in the first half of 2015. However, it should be noted that financial stability risks were still evident in some peripheral member countries, where credit conditions remained tough. In addition, in the second half of the year, the trade-weighted nominal and real effective exchange rate of the euro strengthened (due to the depreciation of local currencies of trading partners), leading to weaker exports and deflationary pressures.

In 2015, the main driving force of the US economy was solid consumer demand and growing investments in non-oil sectors. The economy grew by about 2.4%⁹, which was the highest annual figure

4. World Economic Outlook, IMF, April 2016.

5. World Economic Outlook, IMF, April 2016.

6. World Economic Outlook, IMF, April 2016.

7. World Economic Outlook, IMF, April 2016.

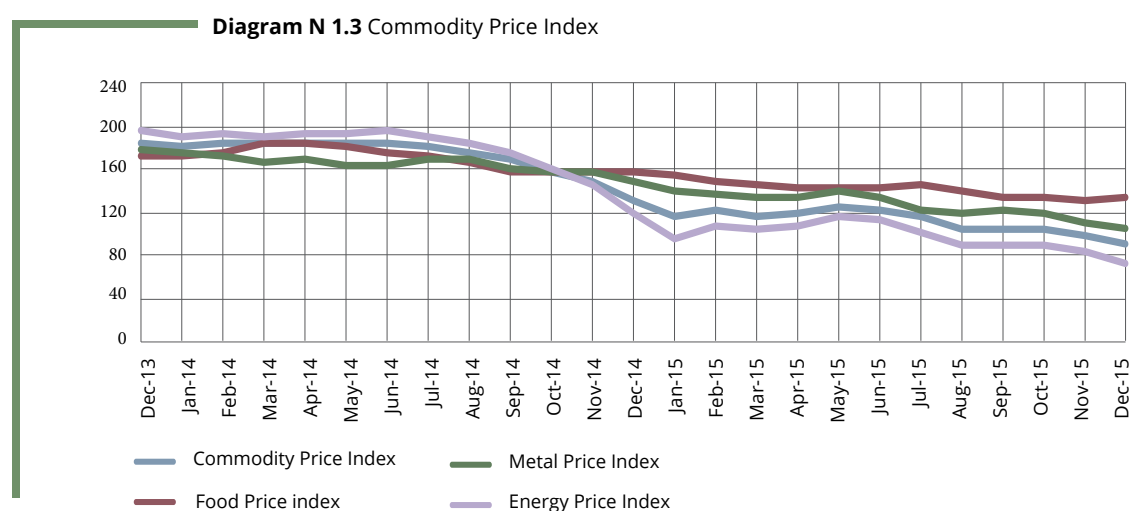
8. World Economic Outlook, IMF, April 2016.

9. World Economic Outlook, IMF, April 2016.

recorded since the global financial crisis. Unemployment gradually reduced to 5%, which had a positive impact on disposable income. However, the appreciation of the US dollar and weak global demand worsened net exports and, at the same time, reduced inflationary pressures. These factors, alongside falling oil prices, kept inflation near 0% in 2015.

In 2015, countries facing weak economic growth and low consumer price inflation maintained expansionary monetary policies. The European Central Bank further eased its policy late last

year on the grounds of low inflation. As for the US, the significantly reduced level of unemployment and inflation expectations forced the Committee of the Federal Reserve to increase the interest rate by 0.25 percentage points at the end of 2015. In addition, it is expected that the policy tightening will be gradual. This move immediately affected market rates: the 3-month USD LIBOR rate reached 0.6%. A partly different situation was observed in some developing countries, where strict monetary policies were maintained to combat inflation fueled by national currency depreciations.



Source: IMF

Despite the difficult geopolitical situation in East Asia, in late 2015 the price of oil fell to a recent record low of 30 USD per barrel. In addition, the lifting of international sanctions on Iran, which is one of the most oil-rich countries, had a negative impact on the price. Last year was marked

by the decline of other commodity prices as well: in particular, the price index of agricultural products, as calculated by the IMF, decreased by approximately 15%, while the metal price index fell by 20%.¹⁰

10. Commodity Price Outlook & Risks, IMF, January 2016.

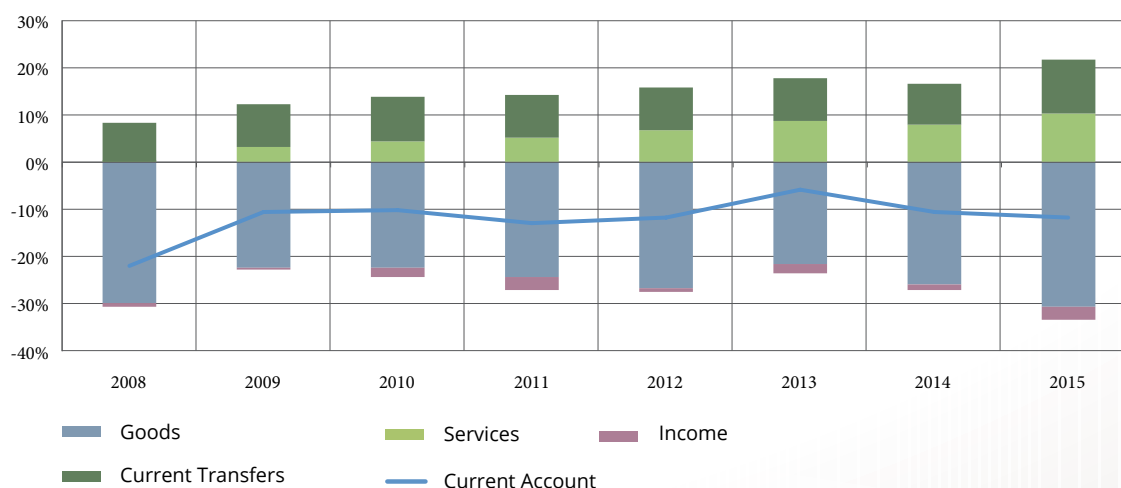
1.2 EXTERNAL SECTOR AND BALANCE OF PAYMENTS

The Georgian economy had to face strong economic shocks in 2015. Several factors reduced foreign demand for the Georgian economy. Throughout 2015, international markets were expecting the Federal Reserve System to increase the policy rate (which ultimately happened in December 2015). According to these expectations, the US dollar appreciated over most currencies. In addition, the national currencies of Georgia's main trading partner countries depreciated as a result of the global economic slowdown and tense geopolitical conditions. Meanwhile, the euro depreciated even further as a result of the loosening of monetary policy by the European Central Bank. As a result, the Georgian economy was losing competitiveness: there was increased demand on imports and decreased demand on

Georgian exports. Reduced oil prices weakened the economies of oil exporter countries and resulted in further reduced demand on Georgian exports from countries like Russia, Azerbaijan and Kazakhstan. In addition, money transfers significantly decreased from Russia and Greece, which also negatively affected foreign currency inflow in Georgia. These circumstances made the GEL depreciation inevitable. Later in the year, the GEL depreciation had an offsetting (corrective) effect on the current account balance through decreased imports, increased tourism revenues and a smaller negative growth of exports of goods.

In 2015, the current account deficit reached 11.8% of GDP, which was 1.1 percentage point higher than the same indicator from the previous year. In absolute terms, the current account deficit improved by 112 million USD and amounted to 1.64 billion USD.

Diagram N 1.4 Ratio of current account components to GDP

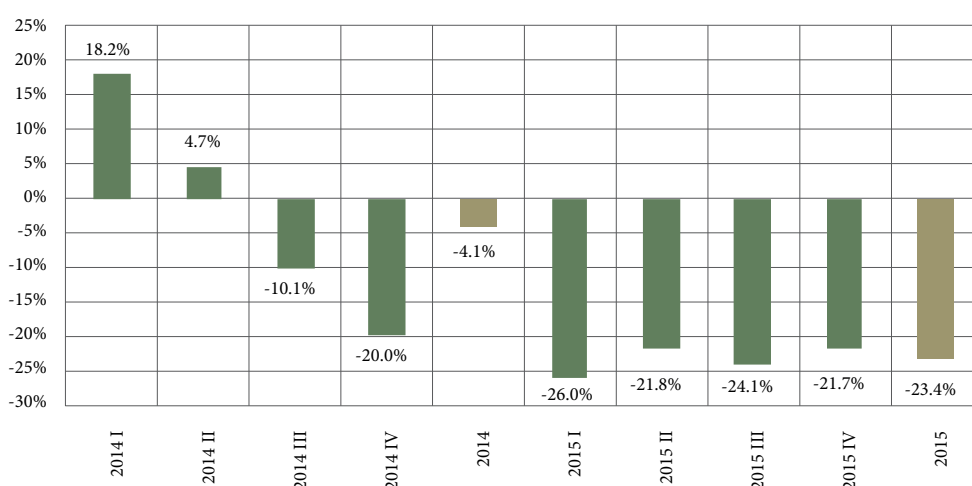


Source: National Bank of Georgia

The trade balance remains the most negative component of the current account. The deficit of trade in goods reached 30.8% of GDP in 2015. Exports of goods started an annual decline in the third quarter of 2014 as a consequence of the deterioration of the economic situation in major trading partner countries and the worsened geopolitical situation. Goods exports decreased significantly in 2015 and the rate of decline was more or less equally distributed among quarters.

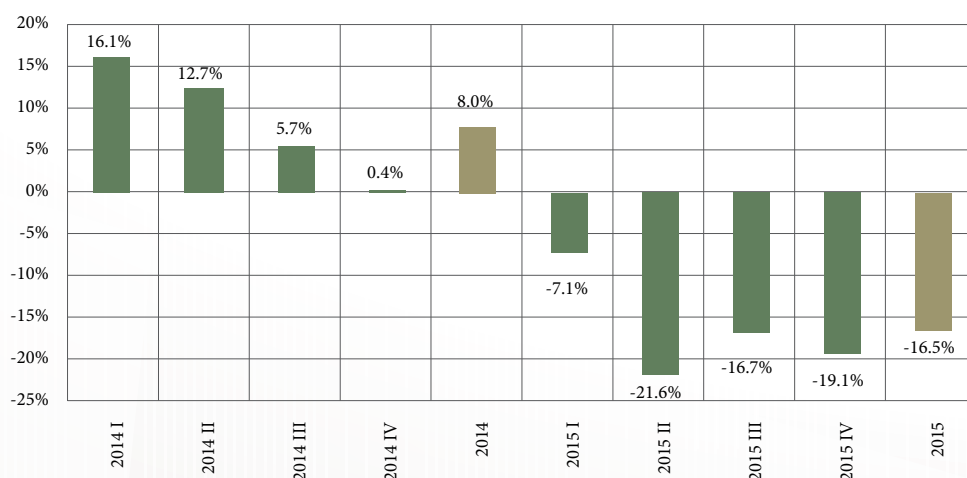
Imports of goods started to decline from the second quarter of 2015 as demand for imported goods fell under influence of the depreciated GEL. It should be noted that main burden for the decline in imports came from reductions in consumer goods imports. The shares of investment and mixed goods were much smaller (see Diagram N 1.13), which indicates a healthy form of misbalance reduction in the current account.

Diagram N 1.5 Annual growth rates of exports of goods (2014-2015)¹¹



Source: National Bank of Georgia

Diagram N 1.6 Annual growth rates of imports of goods (2014-2015)¹²



Source: National Bank of Georgia

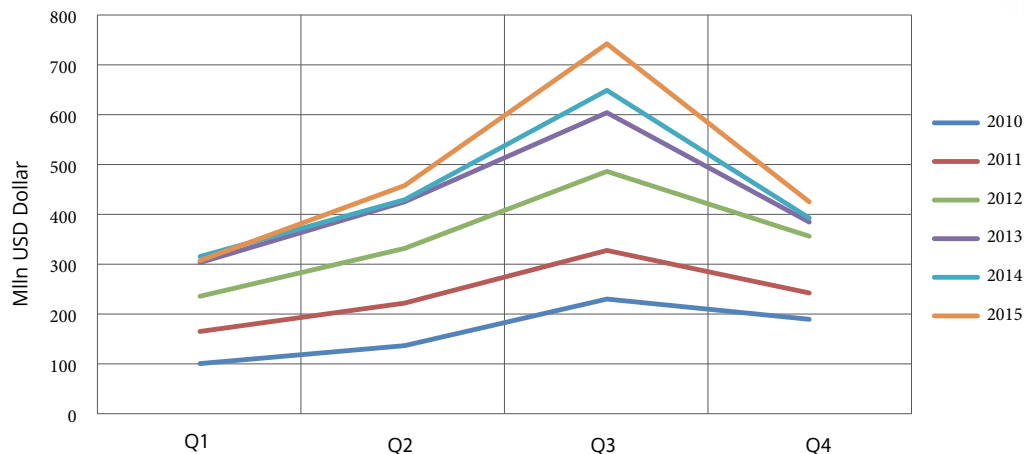
11. Exports of goods from BOP.

12. Imports of goods from BOP (imports of hepatitis C medicines are excluded).

The reduction of the current account deficit in 2015 was caused by an improvement of the services balance. The services surplus amounted 10.4% of GDP, which is 2.6 percentage points higher on an annual basis. In absolute terms, the services surplus was 158 million USD (12.2%)

higher than the previous year and posted 1.46 billion USD. The growth was mostly due the high increase of tourism revenues. Tourism receipts, which are the biggest item of the services sector, posted 1.94 billion USD in 2015, which is 8.3% higher than the previous year.

Diagram N 1.7 Tourism export receipts



Source: National Bank of Georgia

The high growth rate of tourism receipts was due a 7% growth in the number of visitors to Georgia. The greatest contribution was made by visitors from Armenia (10.7%), Russia (14%) and Azerbaijan (8.6%). Furthermore, for several years in a row there was an increased trend in visitors from Israel, Germany, Kazakhstan, the USA, Belarus and the UK. In contrast, the number of visitors fell from Turkey (-3.6%), Iran (-47.3%) and Iraq (-55%). It should be noted that the number of visitors started to accelerate after the second quarter of 2015 and the depreciation of the GEL played an important role in this.

The income account deteriorated significantly in 2015 and made a negative contribution to the change in the current account deficit. The investment income deficit remained a negative com-

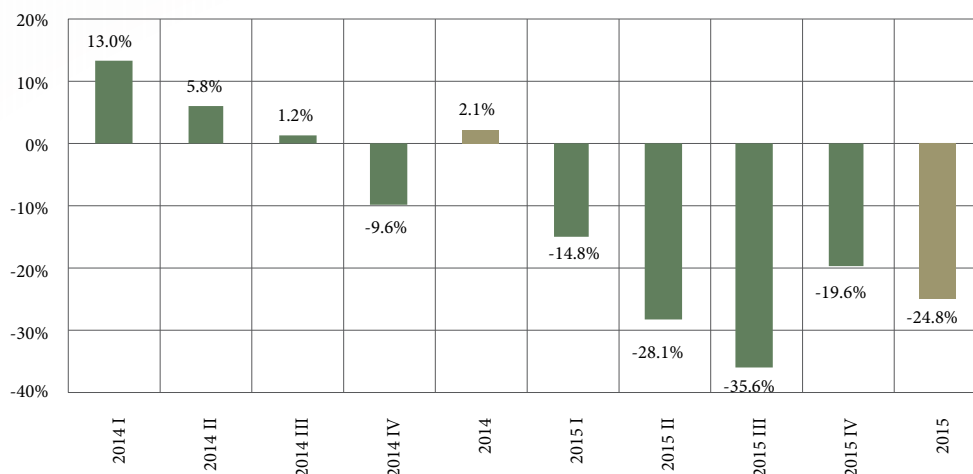
ponent of the income account, which worsened by 2.8% annually in 2015 and reached 891 million USD. The positive balance of worker salaries decreased by 26.2% and amounted to 489 million USD. The reasons behind the latter decrease were the worsening of economic conditions in neighboring countries and the depreciation of the national currencies of those countries, which resulted in a decrease of receivable income. The overall income account deficit increased by 197 million USD (96.6%) compared to the previous year and posted 402 million USD in 2015.

Private sector current transfers (personal remittances), which represent the most significant item of current transfers, decreased by 26.6% year on year in 2015. The reduction in remittances was evident throughout the whole year. The

largest contributions in the decline of remittances came from Russia and Greece – the countries with the most significant share in the amount of remittances Georgia receives. The worsened economic situation in these countries was the

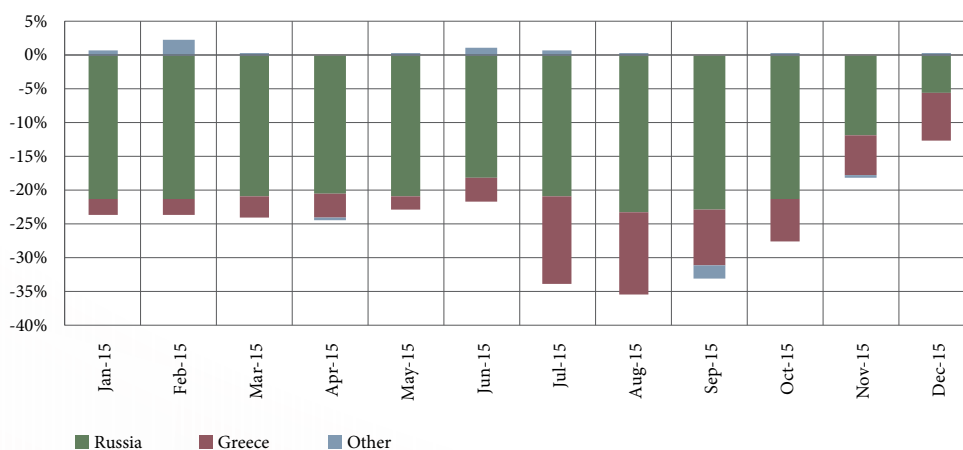
cause of the significant drop. It should be noted that the significant increase in government transfers compared to the previous year was due to a grant received (in the form of medicines) for the state hepatitis C elimination program.

Diagram N 1.8 Annual growth rate of money remittances (2014-2015)



Source: National Bank of Georgia

Diagram N 1.9 Contributions to change in money remittances (2015)

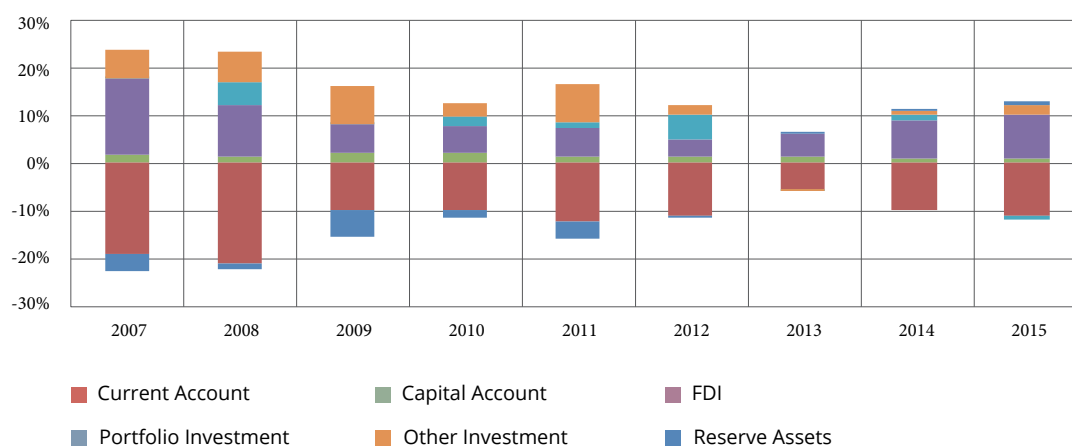


Source: National Bank of Georgia

As was the case in previous years, the current account deficit was mainly financed by foreign direct investments. Foreign direct investments in Georgia amounted to 1.21 billion USD in 2015, which was 10% less compared to the same figure a year earlier. The decline of FDI was chiefly driven by decreased investments in the construction, manufacturing and energy sectors. Compared to 2014, investments in these sectors

decreased by 59%, 56% and 53% respectively. Growth of investment was notable in the transport and communication sector (37%), which was related to the construction of a new pipeline by BP. As this project is being performed by the Azerbaijani office of BP, investments from Azerbaijan significantly increased and accounted for 40% of total investments in Georgia.

Diagram N 1.10 Financing of the current account deficit



Source: National Bank of Georgia

In 2014, the portfolio investment balance was negative and totaled -156 million USD. The majority of the change in the portfolio investment account came from the banking sector. In 2015, the banking sector had to pay off a significant amount of investment liabilities, which caused the negative balance on this component of the financial account.

The share of other investments in financing the current account deficit increased compared to the previous year. Net inflow of other investments in 2015 reached 512.2 million USD, mainly due to the increased borrowing of both the government and private (non-bank) sectors. In 2015, the budget deficit was mainly financed by foreign loans. Meanwhile, these loans represented

sources to finance the current account deficit. In 2015, budget support credits were received from both the World Bank and the Asian Development Bank, totaling 120 million and 75 million USD respectively.

The increase of assets in other investments stems from the banking sector. The banking sector accumulated excess liquidity in foreign currency, which was allocated to corresponding accounts abroad. Excess liquidity was caused by reduced demand on USD denominated bank loans. After the depreciation of the GEL, consumers became more cautious about taking loans in foreign currency, and this might enhance the trend of decreased dollarization in future.

Official reserve assets decreased by 178.6 million USD to 2.52 billion USD, mainly due to interventions on the FX market. During 2015, the NBG sold 287 million USD through FX auctions. By

the end of the year, the ratio of total reserves to months of imports (forecasted imports of 2016) is around 3.5.

Table N 1.1 Balance of Payments (2011-2015) (million USD)

Name	2011	2012	2013	2014	2015
Current Account	-1,843	-1,857	-938	-1,753	-1,641
Goods	-3,494	-4,216	-3,493	-4,280	-4,303
Export	3,254	3,502	4,246	4,073	3,121
Import	-6,748	-7,718	-7,738	-8,354	-7,424
Service	747	1,101	1,405	1,298	1,456
Credit	2,008	2,544	2,964	3,018	3,133
o/w: Tourism Revenues	955	1,411	1,720	1,787	1,936
Debit	-1,261	-1,443	-1,559	-1,721	-1,678
Income (Net)	-425	-149	-316	-204	-402
o/w: Investment Income	-313	-397	-385	-406	-451
Current Transfers (Net)	1,329	1,408	1,466	1,434	1,608
o/w: General Government	144	118	91	56	553
o/w: Workers' Remittances, Credit	617	712	786	761	587
o/w: Other Transfers, Credit	583	587	600	636	484
Capital Account	153	134	134	110	63
Financial Account	1,674	1,777	845	1,717	1,663
FDI (Net)	902	614	829	1,343	1,209
o/w: Direct investment in Georgia	1,048	911	949	1,750	1,350
Portfolio Investments (Net)	133	848	-37	207	-156
Financial Derivatives (Net)	5	5	-2	8	-2
Other Investments (Net)	1,207	347	10	125	512
o/w: General Government	274	396	280	353	347
Reserve Assets	-572	-38	45	33	99
Net Errors and Omissions	15	-53	-42	-74	-86
Important Coefficients					
Reserve Assets in Months of Imports of the Next Year (Months)	3.7	3.7	3.4	3.6	3.5
Export/Import (G&S)	-66%	-66%	-78%	-70%	-69%
CAB / GDP	-12.8%	-11.7%	-5.8%	-10.6%	-11.8%
FDI / GDP	6.2%	3.9%	5.1%	8.1%	8.7%
Tourism Revenues / GDP	6.6%	8.9%	10.7%	10.8%	13.9%
Personal Transfers / GDP	9.7%	10.1%	10.8%	10.8%	9.4%

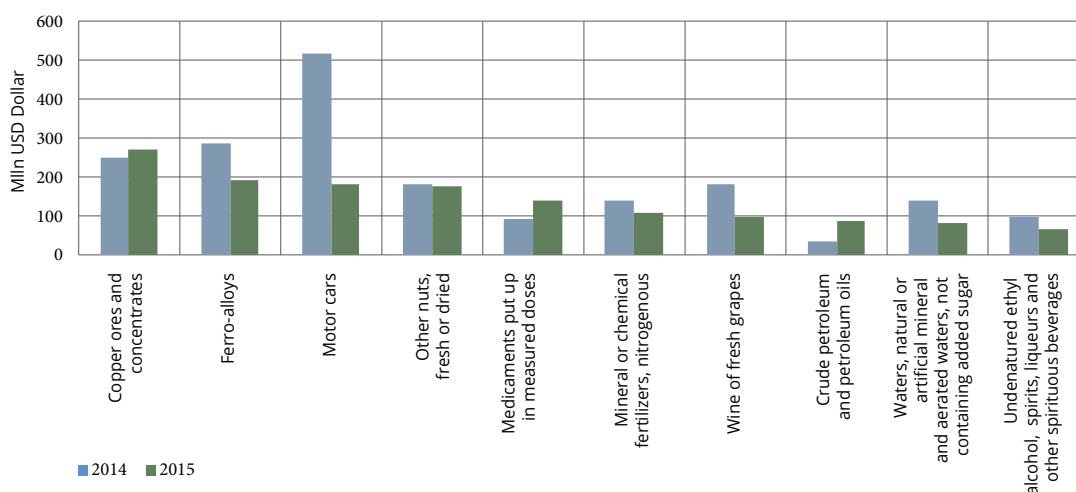
Source: National Bank of Georgia

Registered exports of goods declined by 23% and were down to 2.2 billion USD in 2015. On the other hand, registered imports of goods decreased by 10.1% and reached 7.72 billion USD (excluding hepatitis C medicines, the decline was 15.3%). In 2015, total trade decreased by 13.3% and amounted to 67.9% of GDP.

Among the different groups of goods, it is worth

mentioning that exports of cars (the biggest item in the export list) declined by 63.5%. At the same time, there was a reduction in exports of wines (-46.9%), mineral waters (-40%), steel bars (-67.6%), spirits (-31.8%) and fertilizers (-20.2%). The reduction of exports of these goods was partly offset by increasing exports of medications (+52.8%), crude petroleum (+134.1%), gold (+57.9%) and copper concentrates (+9.1%).

Diagram N 1.11 Largest groups of registered exports of goods (2014-2015)

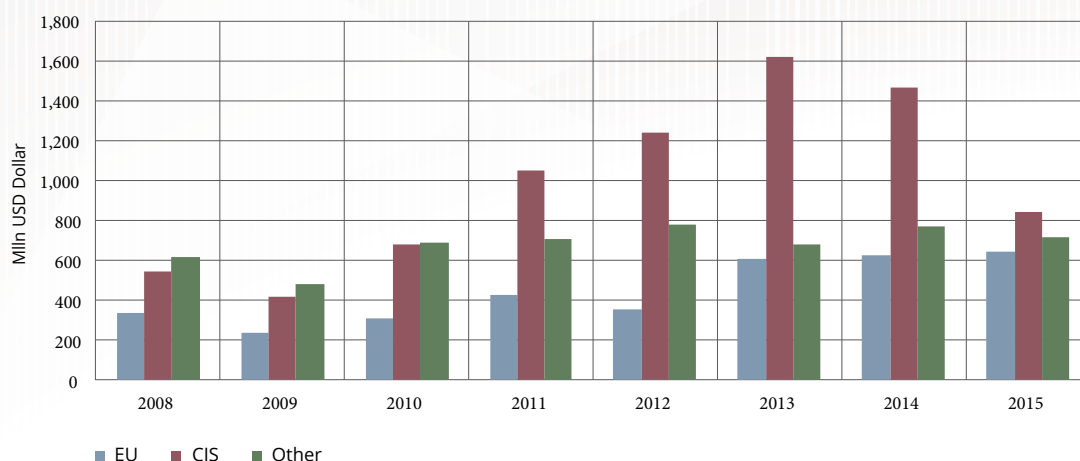


Source: National Statistics Office of Georgia

As for the geographic decomposition of exports, exports to the EU increased by 3.6% to 646.4 million USD. On the other hand, exports to CIS countries declined by 42.7%. The sharpest declines were observed in those to Azerbaijan (-55.8%), Ukraine (-57.2%), Armenia (-37.5%), and Russia (-40.7%). At the same time, exports to Uzbekistan

increased by 77.1% year on year (mainly medications). Exports to other countries declined by 7%, mainly due to reduced exports to Turkey (-22.3%) and the USA (-49.8%). These reductions were partially offset by increased exports to China (+39.2%).

Diagram N 1.12 Volume of registered exports by region



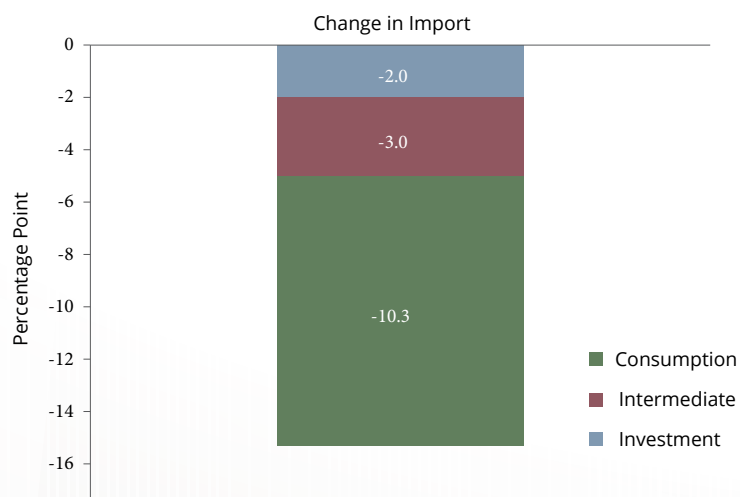
Source: National Statistics Office of Georgia

Despite declining exports to Azerbaijan, the country remained the top export destination for Georgian exports. Bulgaria and Turkey replaced Armenia and Russia as the second and third biggest export partners for Georgia in 2015.

In 2015, registered imports of goods (excluding hepatitis C medicines received from a grant) de-

creased by 15.3% and reached 7.28 billion USD in absolute terms. The decline in imports was mainly driven by decreasing imports of consumer goods (-22.1%), which contributed -10.3 percentage points to the change. Intermediate and investment goods declined by 7.5% and 15.3% respectively, contributing -3 and -2 percentage points to the overall import change.

Diagram N 1.13 Contributions of commodity groups to change in imports of goods

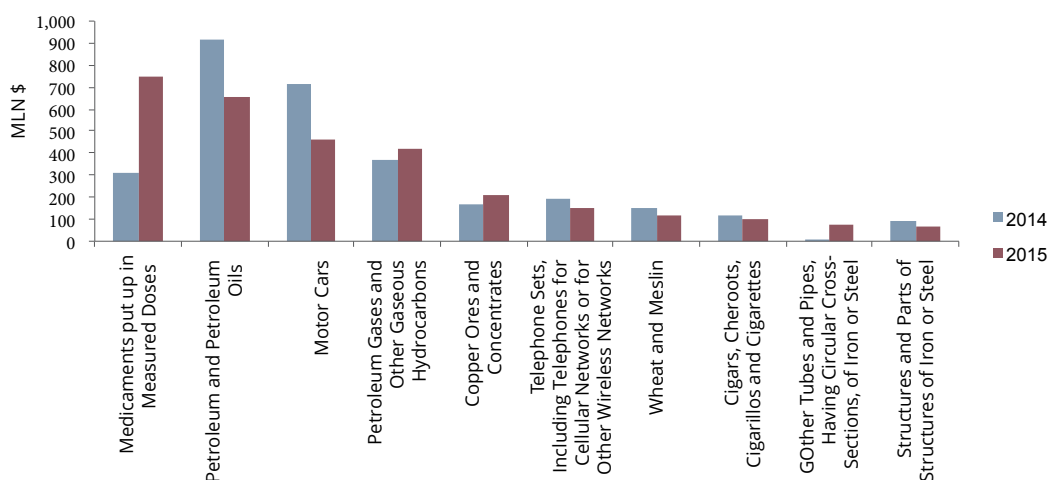


Source: National Statistics Office of Georgia

In 2015, the largest import commodity was medicaments, which amounted to 745.4 million USD (+136.9%), of which hepatitis C medicines accounted for a large share. Petroleum imports declined by 28.4% on an annual basis, falling to 657.4 million USD. This reduction was the result of declining prices on global markets. Imports of cars decreased by 35% compared to the previous year. Amongst other key import products

there was a significant decline in telephones (and electric gadgets in general), cigarettes and food products. Imports of black metal constructions increased by almost 10 times in annual terms in 2015 – which was related to the new BP pipeline project. Of the other key import products, there were significantly increased imports of petroleum gases (13.8%) and copper concentrates (25.8%).

Diagram N 1.14 Volume of biggest import products (2013-2014)

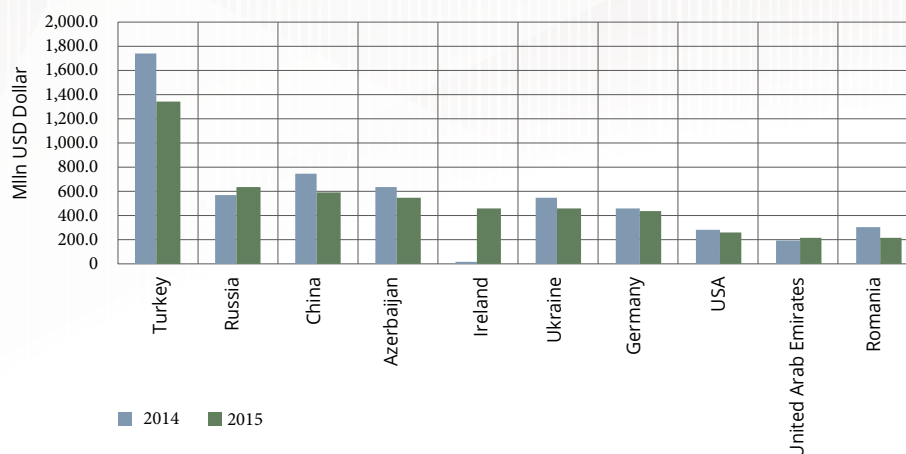


Source: National Statistics Office of Georgia

Turkey still led the list of largest importer countries for Georgia, despite the fact that the country also made the biggest negative contribution to the annual change in imports. In 2015, imports from Turkey totaled 1.33 billion USD, which is 22% less than the same indicator from the previous year. Russia followed, outpacing both Azerbaijan and China in the list of top import

partners. As the second biggest import partner after Turkey, Russia accounted for 8.1% of total imports in 2015; imports from China were the third largest. Imports from Ireland were in fifth place, which was due to the hepatitis C medicine imports (these accounted for 98.2% of the total imports from Ireland).

Diagram N 1.15 Largest import partners of Georgia (2014-2015)



Source: National Statistics Office of Georgia

A regional breakdown of import growth shows that imports from EU countries increased by 6.3% and reached 2.52 billion USD, representing 32.6%¹³ of total imports. Imports from CIS countries declined by 7.3% to 1.97 billion USD in nominal terms. Overall, CIS countries accounted for 25.5% of total imports in the country. Im-

ports significantly decreased from other countries (-21%), which was mainly due to decreasing imports from Turkey, Japan and China. In spite of this huge decline, the share of imports from the "other countries" group still amounted to 41.9% in 2015.

13. Excluding hepatitis C medicines, imports from the EU decreased by 12.6% and represented 28.5% of total imports.

1.3 ECONOMIC GROWTH

In 2015, economic growth was hindered by weakened foreign demand, which mainly stemmed from the complicated geopolitical situation in the region. In particular, the war in Ukraine negatively affected the country's economy. Sanctions imposed by the West, capital flight and the drastic fall in oil prices led to a decline of the Russian economy, with attendant difficulties for closely-dependent Armenia. The war in Syria affected the Turkish economy, especially its tourism sector. A new wave of debt crisis further deteriorated the economic situation in Greece. And falling oil prices were detrimental for Russia, Azerbaijan and Kazakhstan. It is evident that economic problems beset almost all of Georgia's main trading partners, which reflected on Georgia's own economic growth.

Economic growth in 2015 slowed to 2.8%. Due to weak foreign demand, manufacturing decreased by 4.9%. Trade, the largest branch of economy, also declined. In 2013-2014, trade grew by 5-6%, whereas in 2015 it decreased by 0.3%. At 2.9% growth was low in agriculture, which made a 0.2 percentage point contribution to GDP growth.

In the background of reduced foreign demand, the construction sector was the main driver of economic growth. During 2015 it increased by

15.2% and made the biggest, 0.9 percentage point, contribution to economic growth. The most significant contribution to the growth of construction came from the construction of the new gas pipeline, but activity was also high in both government-funded infrastructural projects and private constructions. Throughout the year, the monetary policy tightening process was not fully reflected on the interest rates of loans. Therefore, until the fourth quarter, the volume of real estate loans continued to grow, thus promoting market activity. Alongside the construction of private housing, real estate, rental and business activities also grew, with the largest part of turnover coming from real estate agencies.

High growth was recorded in the financial intermediation sector (9.4%), which made a 0.3 percentage point contribution to GDP growth. There was also a significant increase in the transport sector. Transportation via pipelines rose significantly and growth was also observed in rail transport, cargo handling and storage, and other supporting transport activities. This outweighed the reduction seen in other land and sea transport, resulting from the decline in goods imports. Ultimately, the transport sector grew by 2.9% in 2015. Meanwhile, the annual increase in the number of visitors entering the country contributed to the turnover of travel companies and travel agents, as well as hotels and restaurants.

Table N 1.2 Real GDP growth and sector breakdown

	2013		2014		2015	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
Agriculture, hunting and forestry; fishing	11.3%	0.8%	1.6%	0.1%	2.9%	0.2%
Mining and quarrying	2.8%	0.0%	0.2%	0.0%	21.0%	0.1%
Manufacturing	8.6%	0.8%	3.3%	0.3%	-4.9%	-0.5%
Electricity, gas and water supply	5.1%	0.1%	-2.4%	-0.1%	3.0%	0.1%
Processing of products by households	6.8%	0.2%	1.3%	0.0%	3.7%	0.1%
Construction	-10.5%	-0.7%	13.1%	0.8%	15.2%	0.9%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	5.4%	0.8%	5.8%	0.9%	-0.3%	-0.0%
Hotels and restaurants	4.6%	0.1%	7.3%	0.1%	7.4%	0.2%
Transport	3.2%	0.2%	5.8%	0.4%	2.9%	0.2%
Communication	0.9%	0.0%	6.3%	0.2%	5.0%	0.1%
Financial intermediation	7.0%	0.2%	9.9%	0.3%	9.4%	0.3%
Real estate, renting and business activities	9.6%	0.5%	8.1%	0.4%	6.9%	0.4%
Imputed rent of own occupied dwellings	3.1%	0.1%	2.6%	0.1%	1.3%	0.0%
Public administration	2.2%	0.2%	2.5%	0.2%	2.0%	0.2%
Education	2.4%	0.1%	3.1%	0.1%	2.2%	0.1%
Health and social work	-0.0%	0.0%	1.5%	0.1%	2.4%	0.1%
Other community, social and personal service activities	1.6%	0.1%	0.8%	0.0%	7.1%	0.3%
Private households employing domestic staff and undifferentiated production activities of households for own use	-0.6%	-0.0%	-5.4%	-0.0%	-4.9%	-0.0%
Financial Intermediation Services Indirectly Measured	11.6%	-0.1%	11.0%	-0.1%	7.6%	-0.1%
(+) Taxes on products	1.1%	0.2%	5.7%	0.8%	1.1%	0.2%
(-) Subsidies on products	14.2%	-0.1%	-0.0%	-0.0%	4.5%	-0.0%
(=) GDP at market prices		3.4%		4.6%		2.8%

Source: Geostat

DEMAND

As already mentioned, economic growth in 2015 slowed because of the reduction of foreign demand proceeding from regional developments. The reduction of foreign demand was primarily reflected on the decrease of exports. Over the course of the year, exports of goods fell by 23%, but the rate of decline rate was uneven throughout the year. At the beginning of the year, exports decreased at a rapid pace; however, after the exchange rate correction in the second quarter the decline slowed. In this regard, exports of services were especially important, particularly tourism revenue growth, which partly balanced the loss from exports of goods.

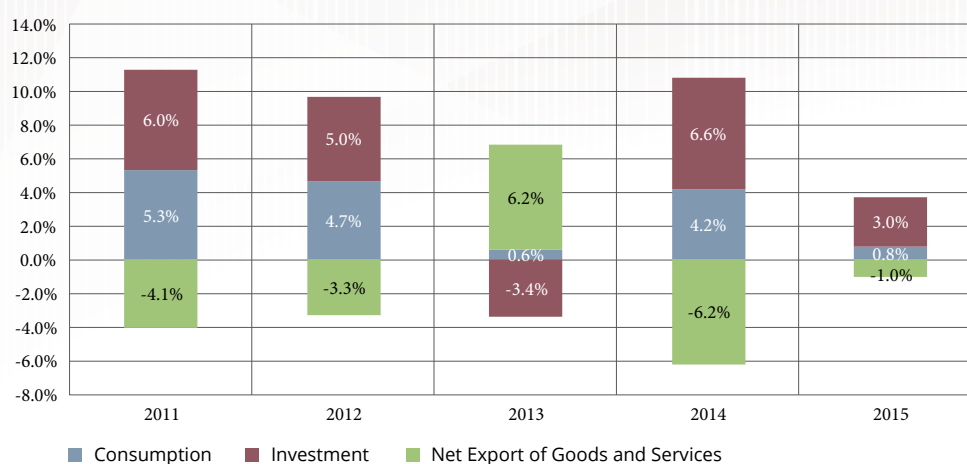
An opposite trend was observed in the case of imports. Earlier in the year, demand for imports was high. As a result, in the background of reduced exports, net exports had a negative impact on economic growth. Yet, influenced by the depreciation of the lari, demand on imports subsequently fell and, consequently, from the second quarter of the year the negative impact of net exports on the economy started fading away. However, the impact of net exports on economic growth remained negative overall at -1%.

Earlier in the year, the consumption growth rate was also high. However, after the lari depreciated against the US dollar, the service burden on dollar loans increased, which reduced the population's disposable income and hence con-

sumption. In addition, the tightening of monetary policy had a restrictive effect on consumption, as interest rates on loans increased by the end of the year. At the same time, throughout the year consumption was fueled by a widened budget deficit. Compared to the previous year, in 2015 the consolidated budget deficit grew and reached 3.7% of GDP. Under the influence of the above cited factors, consumption growth from the beginning to the end of the year gradually diminished and finally contributed 0.8% to GDP growth.

Although the growth rate of investments fell to 17% compared to 2014, these remained the main drivers of economic growth. This decline was expected because the investment to GDP ratio is about 30%, which is consistent with the sustainable level of Georgia's current account and savings rate. It is expected that in following years the increase in investments will not considerably exceed nominal GDP growth. In 2015, the government's infrastructural and new gas pipeline projects made the most significant contribution to the growth of investments. In addition, the expansionary monetary policy of previous years was partially spread in the year and had an impact on the real estate market and private housing construction, giving positive impetus for the growth of investments. Ultimately, investments made the most important contribution (3.1%) to GDP growth in 2015.

Diagram N 1.16 GDP growth by expenditures¹⁴



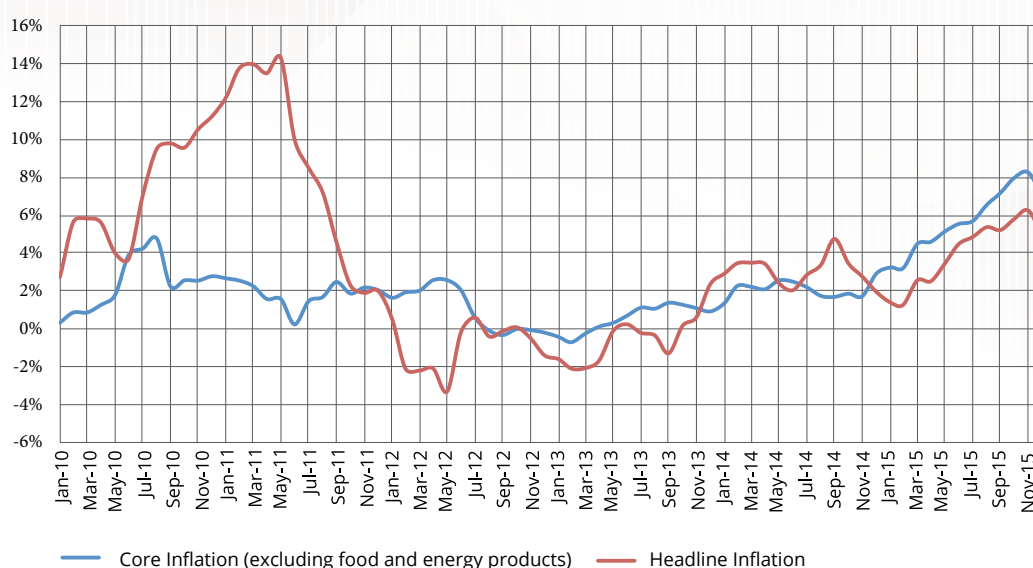
Source: Geostat, NBG assumptions

1.4 CHANGE IN CONSUMER PRICES

The National Bank's main objective is to ensure price stability in the country. During 2014 and the first quarter of 2015, inflation remained at a low level. It subsequently increased and was characterized by growth dynamics. By the end of accounting period, the annual rate of inflation amounted to 4.9%, which is consistent with the 5% target rate of the National Bank for 2015.

Core inflation also increased with the rise of overall inflation and somewhat exceeded the inflation rate. This was related to the decline of fuel prices. Low oil prices on international markets resulted in decreased prices of energy products having downward pressure on overall inflation. Accordingly, core inflation remained above the headline inflation rate. By the end of December, the change of price level, excluding food and energy prices, amounted to 9% (see Diagram N 1.17).

14. Consumption and imports in 2015 do not include imports of hepatitis C treatments implemented within the state program.

Diagram N 1.17 Headline and Core Inflation (2010-2015)

Source: GeoStat

The dynamics of the consumer price index was influenced by both supply and demand factors in the economy. The change in consumer prices was strongly affected by the depreciation of the nominal effective exchange rate in 2015. The share of imported consumer goods in the consumption basket in Georgia is high (41.2% of the basket consists of imported and mixed¹⁵ goods). Accordingly, depreciation was reflected in the overall price level. The price increase was recorded for goods that are not substituted. Prices of medicaments went up, which in turn resulted in increased prices in the remaining components of the health care category, in particular, insurance and other services. Similarly, depreciation of the exchange rate had an important impact on durable goods in the consumer basket, such as household appliances and furniture. It should also be noted that, against the backdrop of exchange rate depreciation, the rise in prices affected a large number of goods and services in the consumption basket, which further increased perceptions of inflation.

In Georgia, as in other low-income countries, the share of food products in the consumption

basket is relatively high. The inflation indicator is thus highly sensitive towards changes in food product prices. By the end of 2014 and beginning of 2015, a significant decrease was observed in international commodity markets. Against the background of Russia's economic decline and the sharp depreciation of the ruble, the price of foodstuffs imported from Russia declined. At the same time, exports to the Russian market were restricted. This was all reflected on domestic prices of food, and therefore on annual food inflation, and its impact on the overall inflation rate was minimal. However, after the exchange rate depreciation against the dollar, prices of some food products started to increase. This put upward pressure on headline inflation. The influence of depreciation continued into summer and by the end of this period the food prices inflation rate increased to 7.4%. The above mentioned pressure slowed by the end of 2015. Despite the exchange rate depreciation against the dollar, the increase in prices of certain food products was lower than expected due to the sharp depreciation occurring in partner countries exporting food to Georgia. As a result, the overall level of the y-o-y increase in food prices declined to

15. Items of consumer basket that include both imported and domestically produced goods.

3.6% in December, and its impact on the overall inflation rate was reduced to 1 percentage point. Against the background of a sharp drop in oil prices on international markets, fuel prices fell in Georgia. This had a significant impact on the overall index because of the high weight that such prices have in the consumer basket. By the end of the first quarter of 2015, petrol and diesel prices decreased by 17-18%, contributing -1.1 percentage points to headline inflation. In April 2015, the international fuel price increased temporarily. As a result, the rate of decline rate slowed down relatively; however, the impact was still significant. For the remainder of 2015, the annual decline in prices of petrol and diesel continued, albeit at a slower pace as a result of the nominal exchange rate depreciation. By the end of December, the annual reduction of petrol and diesel amounted to 14.4% and 13.8%. The impact this reduction had on the change in the general price level was -0.8 percentage points (see Diagram N 1.18).

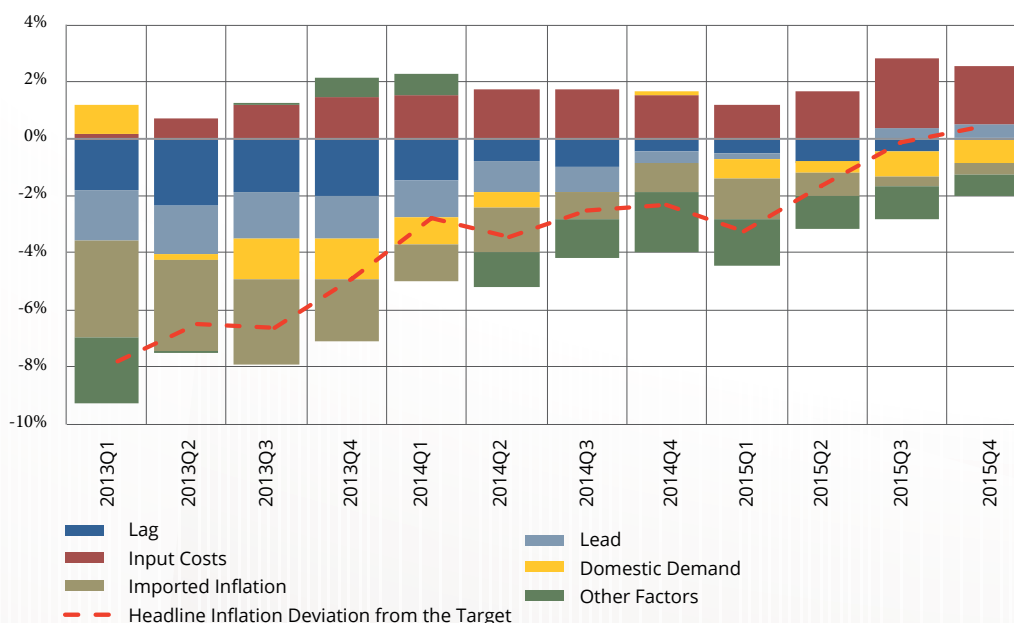
The growth of administrated utility prices – in particular, the gradual increase of electricity tariffs that took place in August and September 2015

– put upward pressure on the overall inflation rate. Some of the electricity consumed in Georgia is produced by thermal power plants, which use natural gas. The exchange rate depreciation caused a rise in prices of natural gas, which thus increased the price of electricity production. As a result, electricity tariffs increased, first in the regions and then in Tbilisi. Electricity tariffs rose by 27.5% y-o-y, contributing 0.5 percentage points to the overall price changes.

Prices of alcoholic beverages and tobacco increased due to the increase in excise taxes on those products that was implemented at the beginning of 2015. The impact of the price hike on the alcoholic beverages and tobacco group of goods on the annual inflation rate amounted to 0.6 percentage points.

The growth of intermediate costs, another supply side factor that puts upward pressure on inflation, is also worth noting. The higher intermediate costs of firms, which was a result of the increased debt service burden on foreign currency loans, was the main factor contributing to higher inflation in 2015.

Diagram N 1.18 Decomposition of deviations from the inflation target

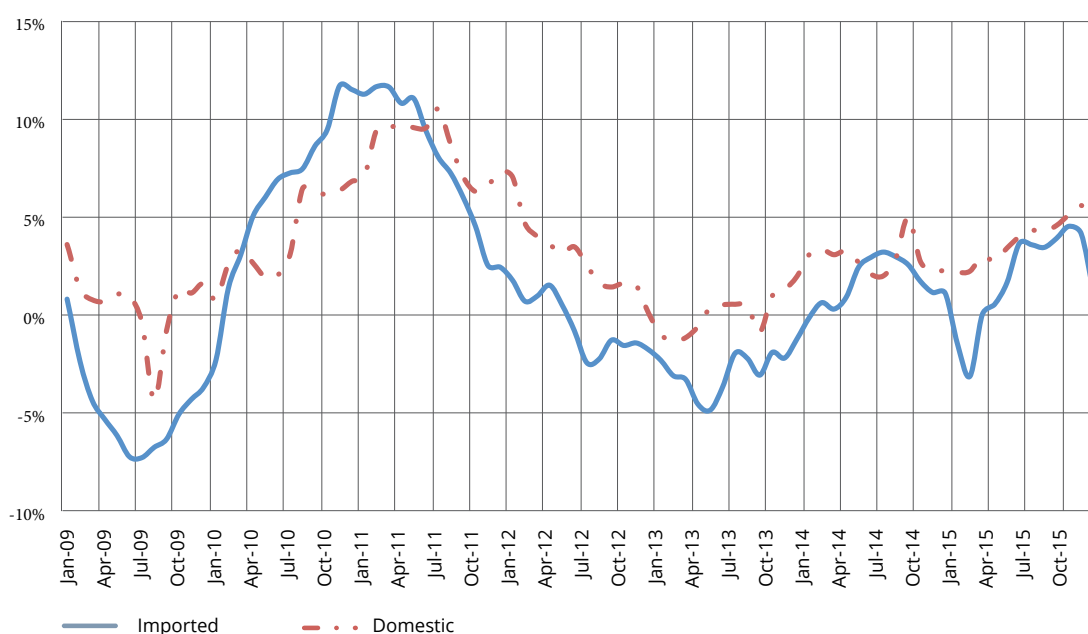


Source: GeoStat and NBG calculations

In terms of supply factors, it is worth stressing the influence imported inflation had on the overall price level. As imported products constitute quite a significant part of the consumer basket, imported inflation is one factor determining the low level of inflation in the country. From the second part of 2015, the nominal effective exchange rate started to depreciate. Against this, the change of imported prices and its impact on the overall price level became positive and

started growing. Nominal effective exchange rate depreciation peaked at 8.5% y-o-y in October. Consequently, imported inflation recorded a high indicator. However, in line with the sharp fall of fuel prices, pressure on imported inflation slowed. The imported inflation rate declined to 1.2% by the end of year (see Diagram N 1.19), contributing only 0.2 percentage points to headline inflation.

Diagram N 1.19 Imported¹⁶ and domestic inflation



Source: GeoStat and NBG calculations

As noted above, inflation is determined by both supply and demand factors in the economy. The realization of various geopolitical risks and the subsequent economic downturn in Georgia's main trading partners was reflected on the Georgian economy: such negative developments had an impact on aggregate demand; exports and remittances fell; and the tightening of monetary policy in the second half of 2015 pushed domestic demand downwards. The factors weakening both external and domestic demand thus caused a widening of the negative output gap. Weak aggregate demand put downward pres-

sure on consumer prices (see Diagram N 1.18).

It is important to observe the price dynamics of tradable¹⁷ and non-tradable goods in order to evaluate the impact of aggregate demand on overall price levels in the economy. As a response to the general macroeconomic environment, prices in the non-tradable sector have been increasing at a slower pace during recent years (even when deflationary processes occurred). Weak aggregate demand was pushing the inflation rate of non-tradable goods downwards. However, from the supply side inflation-

16. Imported and domestic inflation are calculated by the NBG based on indices of different items of the consumer basket provided by Geostat.
17. A class of goods and services that can be sold in a location distant from the place of production.

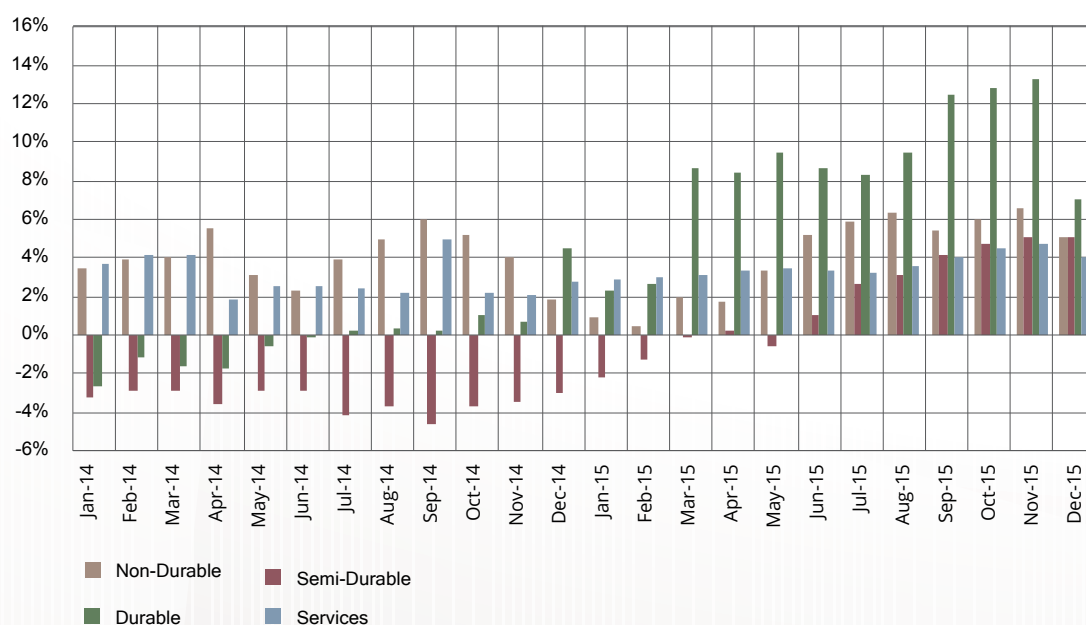
any pressure coming from growing intermediate costs was observable. As a result, the inflation rate of non-tradable goods increased slightly, fluctuating in the range of 2-4%.

An analysis of the change in prices of individual goods shows that the annual change in prices for products falling into the “food and nonalcoholic beverages” category amounted to 3.87%. The “alcoholic beverages and tobacco” group had a higher price increase (11.0%) as a result of the abovementioned growth of excise taxes on these products. The impact of the price rise due to the exchange rate depreciation was quite significant for other categories of the consumption basket too. The highest inflation rates were recorded for goods and services in the “health-care” and “furnishings, household equipment, routine house maintenance” categories, where a considerable share of goods are imported (medicaments, furniture and household appliances). The rise in the electricity tariff and apartment rental prices resulted in an 8.3% y-o-y inflation rate in the category of “housing, water, electricity, gas and other fuels”. Relatively high inflation indicators were also observed in the groups “rec-

reation and culture” and “hotels, cafes and restaurants” (of 6.5% and 5.5%, respectively). Given the general increase of aggregate price levels, it should be noted that only one category observed a decrease of prices: transportation, which had an annual deflation rate of 4.2% as a result of the sharp decline in fuel prices (see Table N 1.3).

An analysis of price changes in terms of consumption durability demonstrates that the level of consumer prices increased at a high rate throughout 2015 for products of long-term use. As was mentioned above, the category of durable consumption goods mainly consists of imported products (e.g. motor cars, household appliances, etc.). Exchange rate depreciation thus put upward pressure on such durable goods. By the end of the year, the relative appreciation of the nominal effective exchange rate somewhat eased inflationary pressure. As a result, the annual inflation rate on durables declined to 7% in December compared to the 12-13% rates recorded in previous months. For goods of medium- and short-term use, y-o-y inflation amounted to 5.1%. At the same time, prices of services included in the consumer basket increased by 4.1% (see Diagram N 1.20).

Diagram N 1.20 Change of annual inflation for goods of different durability and services



Source: GeoStat

Table N 1.3 Inflation indicators according to individual components (percentage), their share in the consumer basket (percentage) and contribution to CPI (percentage points)

	2014 December weights	Dec15/Dec14		Jan15Dec15/ Jan14Dec14	
		Inflation	Contribution	Inflation	Contribution
Total	100.0%	4.9%	4.9%	4.0%	4.0%
Food and Non-Alcoholic Beverages	30.7%	3.8%	1.2%	4.2%	1.3%
Food	28.0%	3.6%	1.0%	4.2%	1.2%
Bread and Bakery	7.3%	3.2%	0.2%	3.1%	0.2%
Meat and Meat Products	5.5%	1.6%	0.1%	3.1%	0.2%
Fish Products	0.1%	6.0%	0.0%	4.4%	0.0%
Milk, Cheese, and Egg	5.4%	0.0%	0.0%	0.3%	0.0%
Oil and Fats	1.7%	12.3%	0.2%	9.2%	0.2%
Fruits, Grapes	1.2%	17.3%	0.2%	27.5%	0.3%
Vegetables, Melons, Potatoes and other Tubers	3.0%	1.2%	0.0%	0.8%	0.0%
Sugar, Jams, Honey, Syrups, Chocolate, Pastry	3.2%	5.1%	0.2%	4.9%	0.2%
Other Food Products	0.7%	8.7%	0.1%	11.0%	0.1%
Non-alcoholic beverages	2.8%	5.5%	0.2%	3.7%	0.1%
Alcoholic Beverages, Tobacco	5.2%	11.0%	0.6%	11.2%	0.6%
Clothing and Footwear	2.9%	1.6%	0.0%	-2.4%	-0.1%
Housing, Water, Electricity, Gas and other Fuels	8.5%	8.3%	0.7%	3.9%	0.3%
"Furnishings, Household Equipment, Routine House Maintenance"	6.4%	9.2%	0.6%	8.0%	0.5%
Healthcare	9.5%	10.5%	1.0%	8.3%	0.8%
Transport	11.8%	-4.2%	-0.5%	-3.4%	-0.4%
Communication	3.6%	0.1%	0.0%	0.3%	0.0%
Recreation and Culture	7.1%	6.5%	0.5%	4.1%	0.3%
Education	5.0%	3.8%	0.2%	3.2%	0.2%
Hotels, Cafes and Restaurants	4.8%	5.5%	0.3%	4.5%	0.2%
Miscellaneous Goods and Services	4.5%	8.9%	0.4%	6.5%	0.3%

Source: GeoStat



II

MONETARY AND EXCHANGE RATE POLICY



2.1 MONETARY POLICY

In accordance with the Organic Law of Georgia on the National Bank of Georgia, the primary purpose of the National Bank is to ensure the maintenance of price stability. In addition, the law obliges the National Bank to “ensure stability and transparency of the financial system and to promote sustainable economic growth in the country, without jeopardizing its primary objective”.

The monetary policy conducted by the NBG in 2015 was in accordance with the Decree of the Parliament of Georgia on “the main directions of monetary and exchange rate policies of the years 2015-2017”. This document outlines the inflation target set by the National Bank, which is 5% for 2015-2016. If the inflation forecast exceeds the target rate, the NBG will tighten monetary policy, and if the inflation forecast is below the inflation target, the NBG will resort to loosening monetary policy. The inflation target of the National Bank of Georgia will be reduced to 4% in 2017 and to 3% from 2018 – these targets are declared in the

main directions of the monetary and exchange rate policies.

During 2015, the monetary policy of the NBG was conducted on the basis of a complex analysis of the macroeconomic environment and global and domestic political and economic processes. Consideration was given to price dynamics in Georgia’s major trading partner countries, the government’s fiscal policy, financial and foreign exchange market trends, trends in international commodity markets, the specifics of the consumer basket, and the monetary transmission channel. It must be noted that 2015 was characterized by external shocks that had a significant influence on the economic situation in the country.

Monetary policy in 2015 was influenced by the events that took place in Georgia and abroad. In 2014, a war started in Ukraine that severely damaged the country’s economy. The Russian economy was also damaged: the imposed sanctions, capital flight, and falling oil prices from the end of 2014 first made the Russian economy

slow and subsequently decline from 2015. The oil prices drop had a sharply negative impact on two other important trading partners of Georgia – Azerbaijan and Kazakhstan – as the majority of their income comes from the sale of oil and gas. Russia's economic problems quickly transferred to Armenia, and were primarily reflected in a reduction of remittances. At the end of 2014 and beginning of 2015, a new stage of the debt crisis started in Greece, which was followed by restrictions in the banking sector. The Turkish economy was negatively affected by the ongoing conflict in Syria. Throughout 2014, expectations of an end to the U.S. Federal Reserve's quantitative easing program, which ultimately occurred in October, led to the global strengthening of the US dollar. Due to the above mentioned events, the economic conditions in the region significantly deteriorated, negatively impacting Georgia. Foreign exchange inflows from exports and remittances fell rapidly since the end of 2014, heralding the start of the lari devaluation process against US dollar.

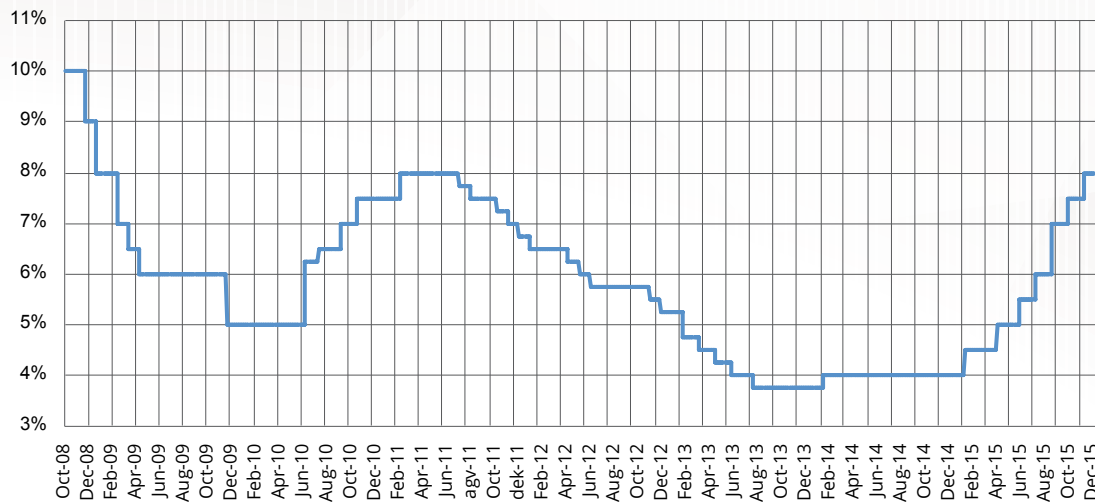
In February 2015, the National Bank's Monetary Policy Committee increased the key rate by 50 basis points to 4.5%. The National Bank started the interest rate normalization process because at that time the forecast suggested there was no longer a need for an overly accommodative monetary policy. Although inflation was at a low level at the beginning of the year, core inflation was slowly growing. In spite of the policy rate increase, the level remained below neutral. According to the forecast made at the time, it was thought that the normalization of the policy rate would see the rate increase to 5% by the end of the year.

In general, the optimal response of monetary policy to external shock is policy loosening, in

order to balance weakened foreign demand by encouraging domestic demand. However, in Georgia, due to the high level of dollarization in the economy, loosening monetary policy has limited room. Lari depreciation against the US dollar deteriorates the terms of foreign currency loans services, which increases companies' interim costs and therefore price risks increase. In addition, one of the particular features of Georgia's economy is that inflation expectations largely depend on the lari/US dollar exchange rate trajectory. With this in mind, the depreciation of the lari against the US dollar was reflected on inflation expectations and created additional pressure on prices. Based on the above factors, the central bank's response to the external shock during the first half of the year was a moderate increase of the policy rate.

The decline of imports, caused by exchange rate changes, began from May. This eased pressure on a further devaluation of the lari and therefore on inflation expectations. Although the lari depreciated against the US dollar by more than 20% between November 2014 and July 2015, the deposit dollarization rate remained stable; however, in the second half of the year the rate started to grow due to the negative expectations. This led to a further weakening of the lari against the US dollar.

Under such circumstances, even though the GDP growth level was below potential, in order to curb rising inflation expectations it became necessary to sharply tighten monetary policy to a level greater than had been considered in the previous forecast. According to forecasts made in August of 2015, the policy rate was predicted to be 6.5% by the end of the year; however, the central bank had to subsequently increase the monetary policy rate by 3 percentage points to 8%.

Diagram N 2.1 Monetary policy rate

Source: National Bank of Georgia

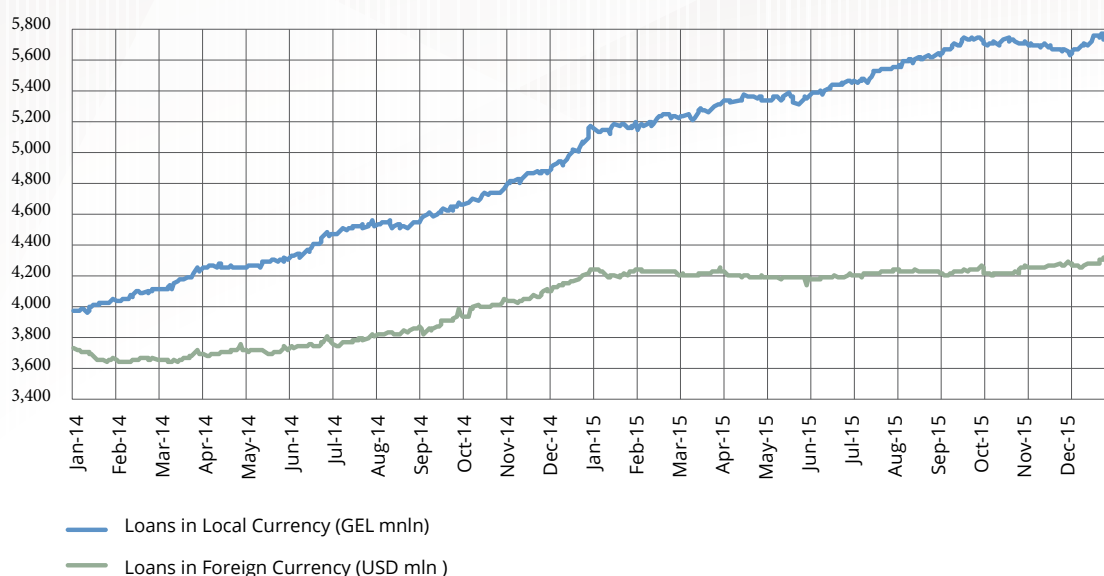
The first results of the tightening of the monetary policy were seen in the fourth quarter. Interest rates increased on mortgage loans issued in lari and on loans to legal entities. As a result, demand for bank loans was reduced, which slowed the growth of the banking system credit portfolio. This fact is evidence of an improvement of the monetary policy transmission mechanism.

The tightening of monetary policy had a positive impact on interest rates of lari time deposits. However, despite the increased interest rates, the volume of time deposits in lari did not increase. This can be explained by the decline of confidence in the national currency and negative expectations.

Diagram N 2.2 Policy rate and interest rates on loans

Source: National Bank of Georgia

Diagram N 2.3 Credit portfolio of commercial banks

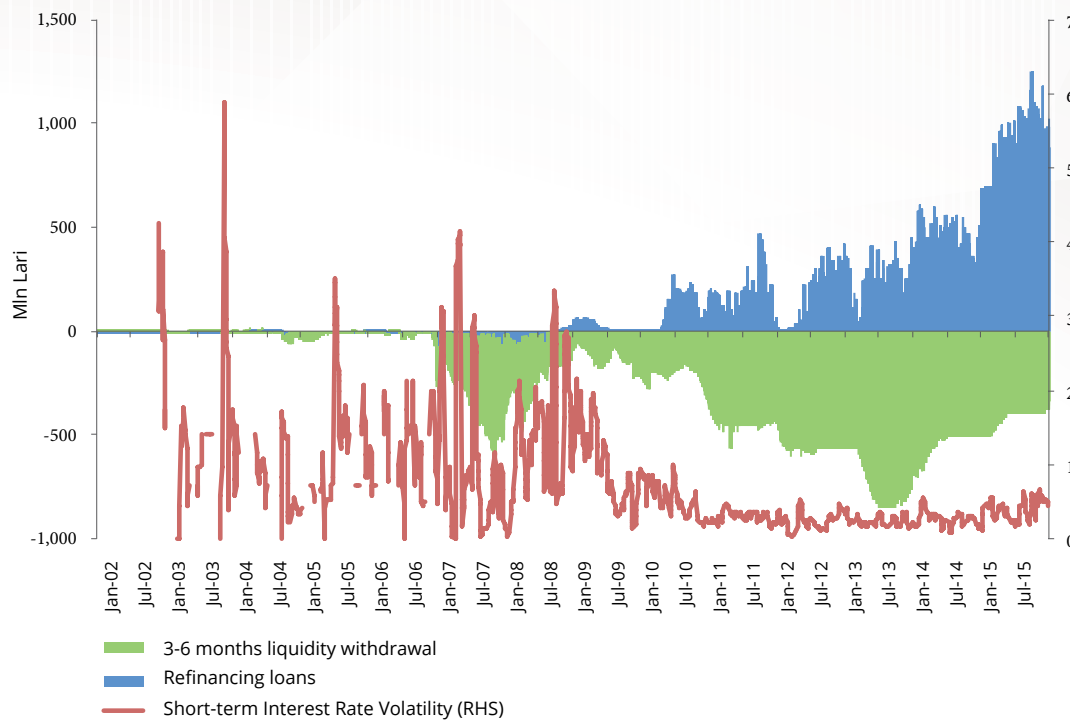


Source: National Bank of Georgia

The year 2015 was important in terms of monetary policy instruments. At the beginning of the year, demand for refinancing loans in the banking system significantly increased – a result of the reduction of liquidity from alternative sources of liquidity delivery (currency auctions, the government and other operations).

For the effective control of short-term interest rates, the National Bank uses liquidity supply and liquidity removal tools. In particular, by releasing 3 and 6 month certificates of deposit, the National Bank removes mid-term liquidity from the system, while providing short-term liquidity with one-week refinancing loans. The removal of medium-term liquidity happens to the extent that the system moves into deficit and this deficit is covered by the refinancing instrument. Bad liquidity management costs are significantly high-

er for the banks with a liquidity deficit (the penalty for a failure to reserve requirement) than for banks with excessive liquidity (not receiving the benefits for excess liquidity). This mechanism encourages commercial banks to more actively manage short-term liquidity and therefore allows the National Bank to more effectively implement short-term market interest rate management. As can be seen from Diagram N 2.4, the liquidity supply mechanism described above has significantly increased the effectiveness of monetary operations. In particular, the volatility of market interest rates has declined, which is a precondition for the deepening of the money market and improvement of the monetary transmission mechanism. A certain fluctuation of the market interest rate still exists, which is characteristic of an active money market.

Diagram N 2.4 Effectiveness of monetary operations¹⁸

Source: National Bank of Georgia

From 2015, there was no longer a need for the removal of medium-term liquidity in the market, as the excess liquidity, which had been accumulated in previous periods, expired and the system moved into deficit. This is proved by the fact that the volume of refinancing loans exceeded the volume of certificates of deposits (CDs). In response, the central bank lowered the volume of liquidity in the system with CDs from 505 million GEL at the beginning of the year to 360 million GEL by the end. Despite the fact that issuing CDs for the removal of the liquidity was subsequently no longer necessary, the National Bank continued to issue 3- and 6-month CDs in minimum amounts to ensure the presence of long maturity interest rates in the market that are necessary for the development of the money market.

As in previous years, one of the main objectives of the NBG's activities in 2015 was to increase the efficiency of monetary policy. The main obstacle to this was the low level of larization in the economy. Under high levels of dollarization, the interest rate transmission mechanism is weakened as most of the money supply is denominated in foreign currencies – the interest rates of which are determined by the central banks of other countries in accordance with the economic cycles of those countries, and are thus obviously beyond the control of the NBG. Foreign exchange risk is present for those economic agents that are unsafe from currency fluctuations; this is especially true for those bank clients (borrowers) whose income is denominated in the domestic currency, while their debt is in a foreign currency.

18. Volatility of short term interest rate is measured by 1 month standard deviation

The year 2015 was a significant challenge for the process of de-dollarization. The depreciation of the lari against the US dollar significantly slowed the growth of larization observed in previous years, especially in the case of deposits. During the first three quarters of 2015, the larization of loans grew; however, this trend changed from October and larization began to decline. This fact, in parallel with the tightening of monetary policy, is related to the increase in interest on lari loans, with the interest difference in comparison with foreign currency loans increasing. Ultimately, larization of loans with a fixed exchange rate increased by 2.1 percentage points to 35.6% in 2015. As already mentioned, despite the depreciation, larization of deposits in the first half of the year was stable, but fell by 3.4 percentage points to 30.6% (with fixed exchange rate) in the second half of the year.

Reforms undertaken by the NBG over recent years have played an important role in the process of promoting larization. These reforms were directed towards developing financial and exchange markets. The expansion of the collateral base used for refinancing operations and the inclusion of debt securities in the national currency issued by international financial institutions with minimum rating of BBB, encouraged the issuance of financial instruments in local markets by international financial institutions. In 2015, the Asian Development Bank (ADB), the International Finance Corporation (IFC) and the Black Sea Trade and Development Bank (BSTDB) started to issue lari-denominated debt securities. In 2015, these international financial institutions together with the European Bank for Reconstruction and Development Bank (EBRD) issued bonds worth a total of 203 million GEL. This process will help enhance capital and secondary markets and promote the development of the local corporate bond market.

The NBG pays important attention to the development of communication mechanisms for increasing monetary policy efficiency. Communication gains particular importance within the framework of the inflation targeting regime, because it is essential to correctly formulate and manage public expectations. Timely and effective communication of the NBG's goals, strate-

gies and economic analyses increases the predictability of monetary policy decision making. Therefore, improving and increasing communication channels are some of the NBG's main priorities.

In 2015, the National Bank continued to hold regular meetings with analysts regarding Monetary Policy Committee decisions and provided detailed information about the projections.

In terms of financial literacy, is important to mention the publication of the NBG's scientific-analytical journal *Economics and Banking*. The journal offers high-quality articles on the Georgian economy and popular global issues. In addition, the journal provides a forum for young researchers and scientists working on specific economic or financial topics to express their views and opinions.

For the monetary policy mechanism to function it is necessary that changes in short-term interest rates also be applied to longer-term interest rates and, ultimately, to lending rates. As mentioned earlier, during 2015 the central bank's monetary policy rate was increased by 4.0 percentage points, resulting in an increase in the yields on government securities of various maturities (see Diagram N 2.6).

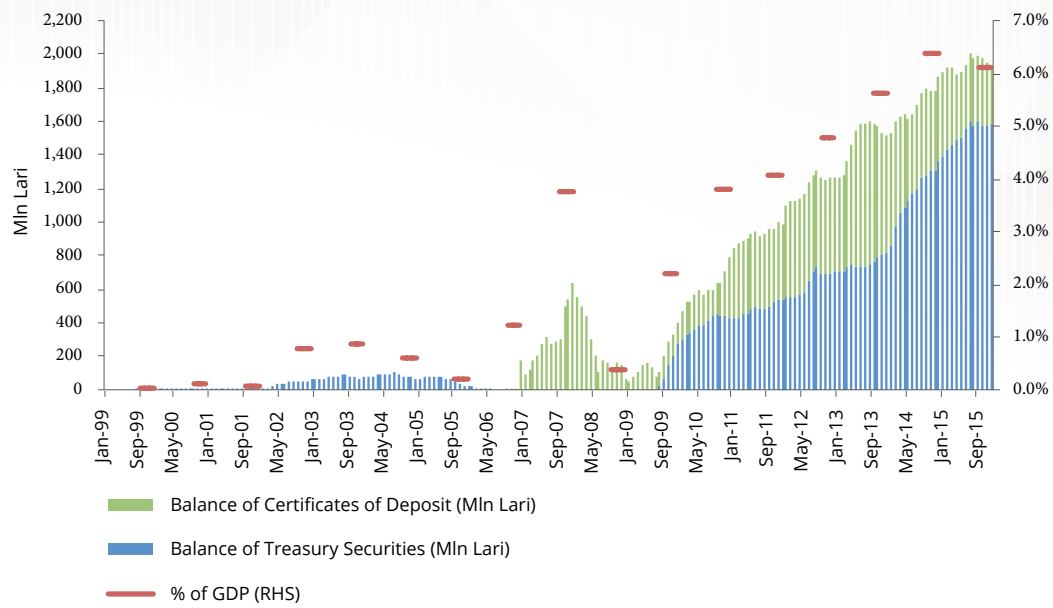
Diagram N 2.6 Money market interest rates



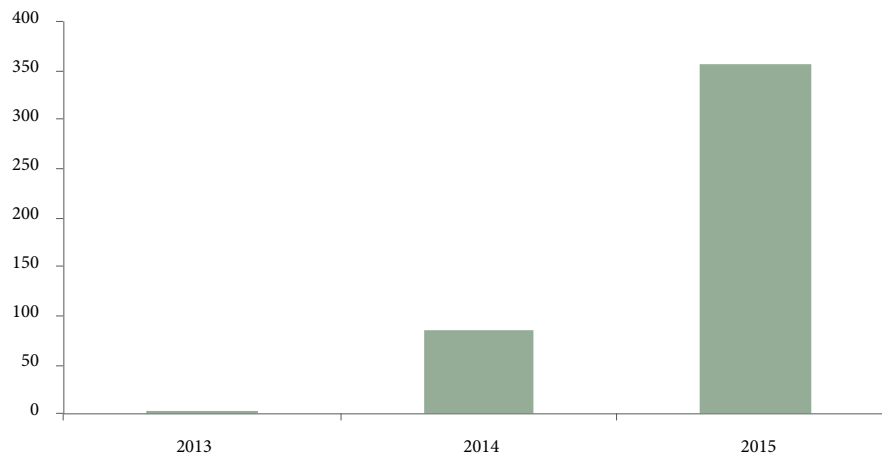
Source: National Bank of Georgia

The activities carried out by the NBG in previous years (such as the launch of new instruments and the simplification of conducting financial transactions) had a significant influence on the revitalization and development of the money and capital markets of Georgia. Over the past few years, considerable growth was recorded in the trade volumes of Treasury securities. During 2015, the balance of Treasury securities in circulation increased 3.6 times compared to 2010, and the growth amounted to 17% in comparison with the end of 2014. Along with the expansion of primary markets, for the development of the

financial market it is also important to revitalize secondary markets, as doing so will further promote market liquidity. A significant enhancement was recorded in repo transactions during 2015. The expansion of the volume of financial papers made a considerable contribution to the development of this segment, since the available resources for collateralized transactions increased and the market became more attractive for banks. In 2013, only four repo transactions were reported. In 2014, this figure rose to 86, and in 2015 this number reached 357.

Diagram N 2.7 The dynamics of the balance of treasury securities and certificates of deposit

Source: National Bank of Georgia

Diagram N 2.8 Number of repo deals

Source: National Bank of Georgia

Despite significant external shocks, after which the lari saw a significant devaluation, the timely monetary policy response made it possible to

keep inflation at the target level. Inflation at the end of 2015 amounted to 4.9%.

BOX N 1 MONETARY POLICY REACTION TO THE EXTERNAL SHOCK

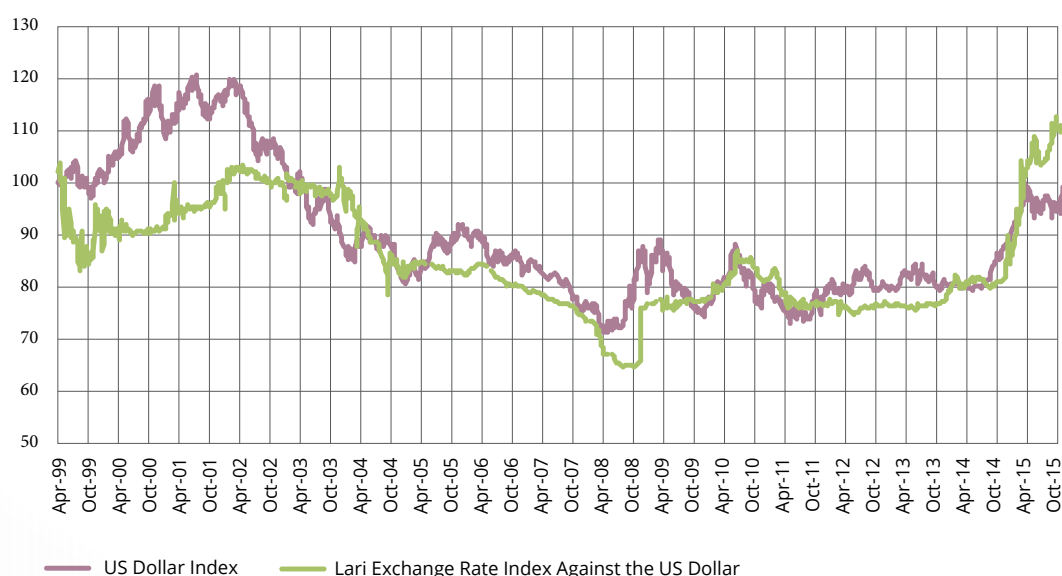
The main objective of the monetary policy of the National Bank of Georgia is to maintain price stability, which implies the existence of a moderate and predictable rate of inflation. Low and stable inflation is a necessary precondition for long-run economic growth, which will be accompanied by a stable exchange rate in the long run. The National Bank conducts monetary policy with an inflation targeting regime, which implies the announcement of an inflation target in advance and conducting monetary policy so that inflation is in line with the target in the medium term.

In 2014, developments at both the global and regional level were challenging for Georgia, which,

as a small open economy, is quite vulnerable to external shocks. These events created an unfavorable background that adversely affected the economy in terms of a sharp reduction in external revenues.

In 2014 and the beginning of 2015, the US dollar began to appreciate in line with positive economic trends and expectations in the United States. In addition, the announcement made by the Federal Reserve about the decision to complete the tapering that was started in 2013, further strengthened the position of the dollar. As a result, most of the world's currencies faced significant depreciation.

Diagram N 2.9 US dollar index²⁰ and the US dollar exchange rate index



Source: Bloomberg, NBG

In January 2015, the European Central Bank (ECB) announced the beginning of a quantitative easing program. The ECB will use this program to buy up private and sovereign bonds each

month until at least September 2016. This step put additional pressure on the already depreciated euro. Meanwhile, the depreciation of the currencies of the main trading partners weak-

20. The US dollar weighted average rate against major currencies (the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc).

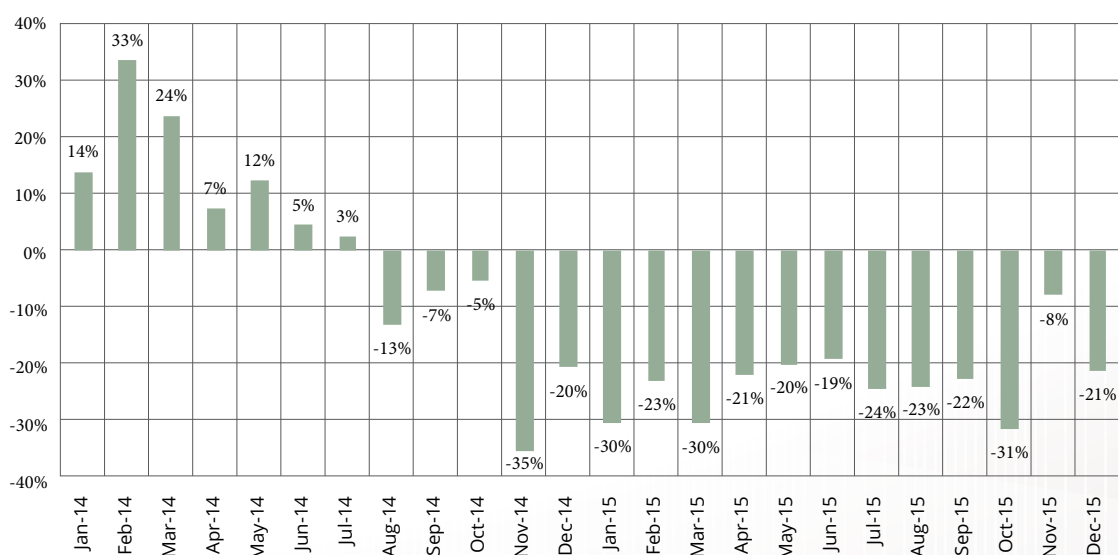
ened competitiveness. As a result, demand for imports increased, while demand for Georgian exports declined.

At the regional level, geopolitical risks were identified in the first half of 2014. The subsequent realization of those risks put negative pressure on the economic trends in Georgia's main trading partner countries. The conflict between Russia and Ukraine and the economic sanctions imposed on the former had a drastic effect on the economies of the two countries. It is worth noting that the ongoing crisis in Russia has had a contagious effect on other countries in the region, including Armenia and Azerbaijan – both major trading partners of Georgia. It is also worth noting that the sharp decline in oil prices on international markets in 2014 negatively affected the economic prospects of Russia and Azerbaijan. In addition, from the beginning of 2015, Azerbaijan imposed regulations restricting imports of vehicles produced earlier than 2005. Accordingly, demand

for re-exports from Georgia declined considerably. At the regional level, Turkey also faced problems as significant capital outflows occurred as a result of political tensions and the expectations of monetary policy tightening from the U.S. Federal Reserve System. This led to a depreciation of the Turkish lira and resulted in a significant decrease in export of goods and a slowdown in exports of services, in particular of tourism revenues. Remittances from abroad, which are an important source of revenue for Georgian citizens, also declined significantly.

The decline of export revenues started in August 2014 and reached a maximum level of 35% in November. Exports continued to fall over the following months, but did so at a relatively slower pace in the range of 20-30%. In total, export²¹ revenues declined by 23% during 2015. The biggest contributors to this decline were the sharp drops of exports to Azerbaijan, Armenia, Ukraine and Russia (see Diagram N 2.10).

Diagram N 2.10 Annual changes in exports



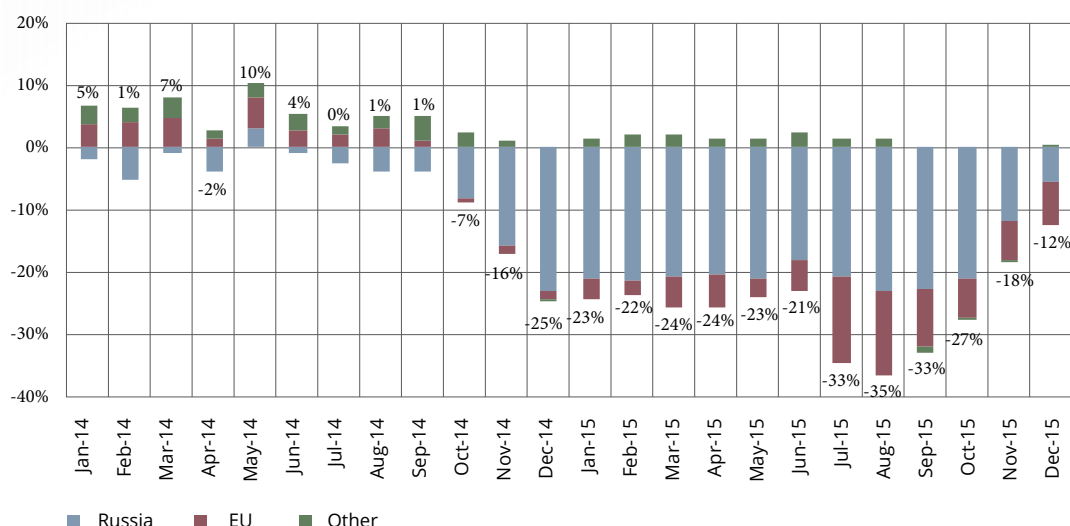
Source: GeoStat

21. Registered exports with goods.

The reduction of money transfers started in October 2014, but the growth rate had already slowed to 0.5% during the summer of that year. In November-December, a significant contraction took place and this continued over 2015, when money transfers decreased by 25%. The main reason for this downturn was a sharp de-

cline of remittances from Russia, the largest source country. Money transfers from Europe did not decline until late autumn. However, after that point remittances from countries such as Greece, Italy and Spain, which have the largest share in this segment, started to fall. This pattern continued in 2015 (see Diagram N 2.11).

Diagram N 2.11 Annual changes in remittances

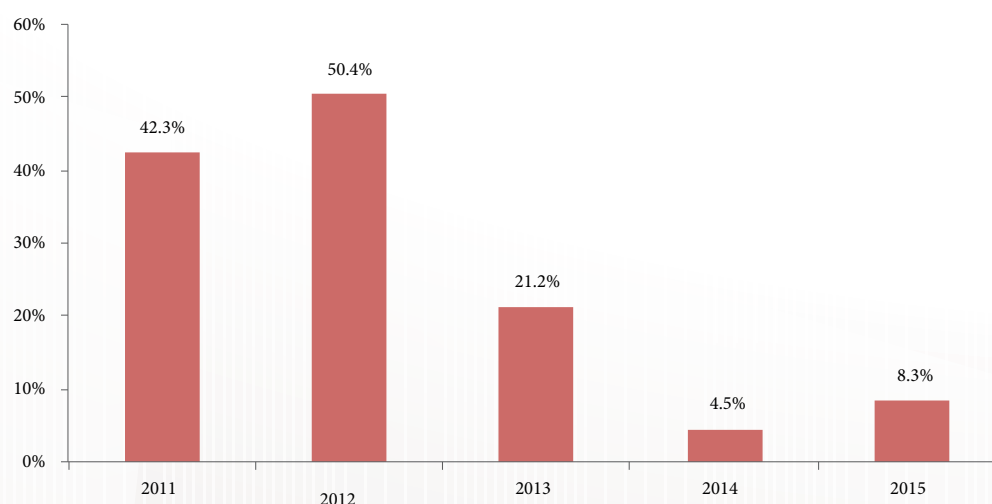


Source: NBG

Trends in the region negatively affected tourism revenues as well, which had been developing dynamically during recent years. Starting from the second half of 2013, the growth rate of income from tourism started to decline significantly. In 2014, revenues from tourism exports increased

by only 4.5% y-o-y, which is a much lower figure than the trend of the previous year. As for 2015, according to preliminary assessments, the statistics of annual tourism income change improved in relative terms by approximately 8.3% (see Diagram N 2.12).

Diagram N 2.12 Annual changes of inflow from tourism



Source: NBG

Despite such a significant reduction in inflows of foreign funds, imports were growing until the end of 2014. The nominal effective appreciation of the lari against the main trading partner country currencies contributed to these dynamics. As a result, the trade deficit deepened significantly, leading to exchange rate depreciation pressure. When an external shock comes from the decline of current account receipts the only way to restore balance is to diminish current expenses (i.e. costs on imports). In this situation, in order to correct the imbalance, the government has two strategic choices: it can allow the exchange rate to depreciate or directly reduce imports through aggregate demand tightening.

The first alternative considers the scenario in which the government maintains a floating exchange rate and allows the exchange rate to fall. Export competitiveness increases as local goods and services become cheaper for foreigners as a result of the depreciated domestic currency. At the same time, depreciation has the opposite effect on imports. Since prices of foreign goods and services rise, imports contract. Accordingly, increased exports and reduced imports help restore the misbalance. The domestic demand that can no longer be satisfied by imports is partly diverted to the local segment. The growth of foreign demand and the possibility of import substitution has a positive impact on local production and encourages it.

In the case of the second strategy, the government tries to adjust the misbalance by directly lowering aggregate demand. This type of policy means undertaking actions that reduce domestic demand instead of domestic currency depreciation. By adopting restrictive macroeconomic policies, aggregate demand, and therefore the economy, declines significantly. People's incomes reduce, unemployment surges and, as a

result, imports start to diminish. So, the misbalance arising from the external shock is corrected through the limitation of imports by means of reduced demand.

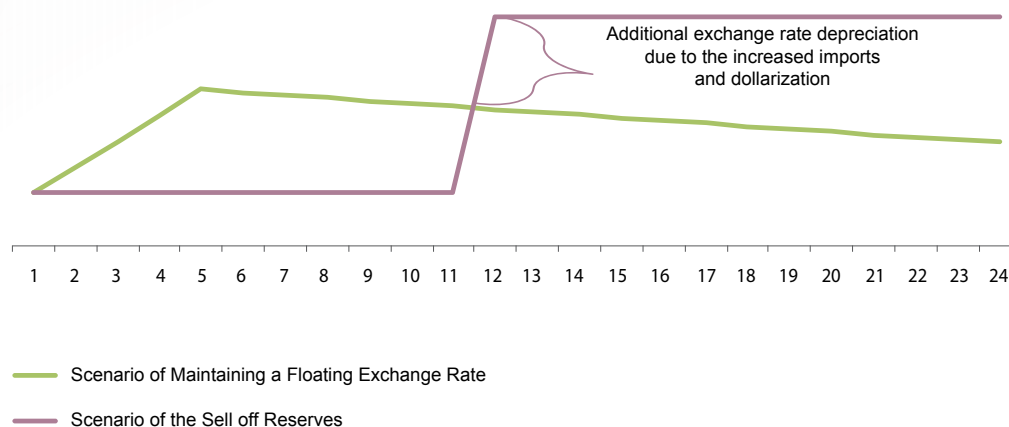
It is true that depreciation negatively affects dollarized economies. In cases where the liabilities of part of the population are denominated in foreign currency, exchange rate depreciation increases the debt service burden. However, in terms of restrained aggregate demand, the social costs are even higher. Adjustment of a misbalance by the limitation of domestic demand is a long process. The attendant reduction of employment and income negatively affects the whole population and the social situation worsens.

Therefore, when external shocks hit the economy stemming from the current account, the depreciation of the exchange rate is the preferred option, because in this case there is no need to limit imports in order to reduce demand. The exchange rate serves as a buffer, reducing imports to some extent and helping the economy overcome the shock with a minimum of social costs. During 2014-2015, in light of the developments in the region, a number of central banks' reactions were to sell foreign currency reserves in order to avoid depreciation. The National Bank of Georgia was also encouraged to follow such a policy by a number of experts. However, as experience has shown, intervention in exchange rate dynamics is the wrong decision, and is usually counterproductive. When selling reserves, the exchange rate is stabilized and the current account adjustment process is postponed. Exports remain subdued because of low foreign demand due to expensive local goods and services. At the same time, an over-valuated currency results in growing imports, which in turn increases the current account imbalance. Exchange rate de-

preciation pressure increases further and, most importantly, devaluation expectations surge. That, in turn, leads to increased dollarization in the economy, which escalates speculative pressure on the exchange rate. Foreign exchange reserves are limited, and therefore there comes

a point when the central bank is no longer able to maintain exchange rate stability and is forced to release it in a free float. When following this scenario, in many cases increased dollarization causes even higher depreciation in the end (see Diagram N 2.13).

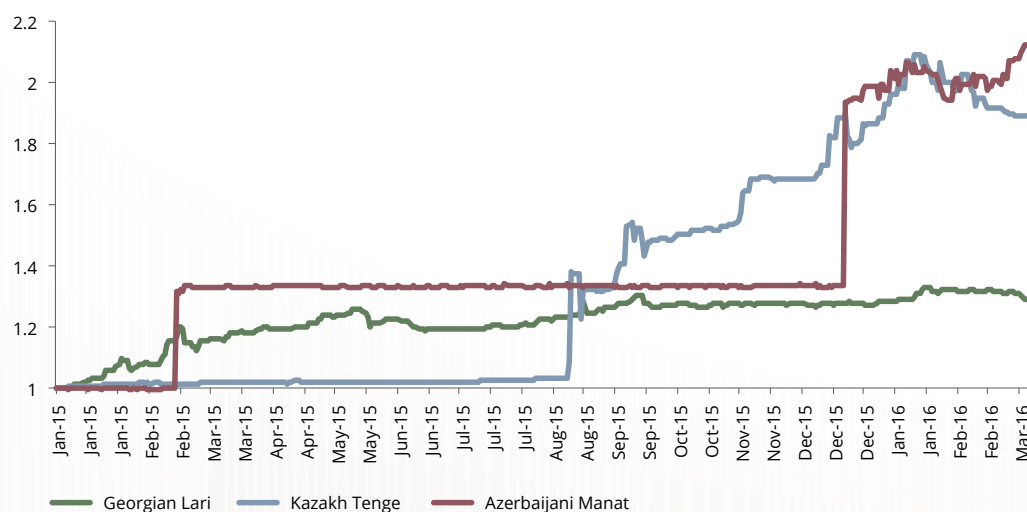
Diagram N 2.13 Exchange rate changes according to various scenarios



Clear examples of the failure of policies to try maintaining exchange rate stability by means of a reserve sell off were seen during the current crisis. Central banks in the region have followed the practice of maintaining the exchange rate at a certain level. Besides solid interventions, in

all cases, the exchange rate depreciation could not have been avoided. Moreover, in these instances, depreciation was subsequently much higher than it was in those economies where the exchange rate was floating in response to the external shock (see Diagram N 2.14).

Diagram N 2.14 Exchange rate dynamics in different countries



Source: NBG

In countries with developed financial markets in our region, such as Russia and Turkey, the depreciation of the exchange rate hits the economy from the side of the financial markets. In those countries, outflows of portfolio investments occur during the exchange rate depreciation. Investors react quickly and try to get rid of financial instruments. As a result, exchange rate depreciation pressure increases. In such circumstances, central banks usually follow the practice of a sharp hike of monetary policy interest rates, which, as a rule, has a quick effect. In light of increased interest rates, domestic financial instruments become attractive. Because of this, depreciation pressure on the domestic currency declines. However, in economies with underdeveloped capital markets, like Georgia, the achievement of the above explained effect is limited. Instead, the influence of the dramatically increased interest rates directly transfers to the economy. In light of significantly reduced investment and consumption, demand rapidly falls and the economy is severely downsized. As a result, unemployment rises and the income of the population declines. Borrowers are no longer able to serve their obligations due to their smaller or even non-existent incomes. This, in turn, threatens the financial stability of the banking system.

In all three cases discussed above, when the central bank uses a variety of tools for maintaining the exchange rate at a certain level, the social costs are much larger. Rising unemployment, a shrinking economy and the loss of income – all of these consequences are significantly higher than in the case when the exchange rate depreciation significantly increases the debt service burden in terms of high dollarization.

During 2014-2015, the National Bank of Georgia made monetary policy decisions within its mandate in accordance with best practices. The National Bank maintained a floating exchange rate, letting it serve as a buffer to some extent and mitigate external shocks. During this period, the National Bank carried out point interventions on the foreign exchange market. The purpose of these interventions was not to change the direction of exchange rate movement, but to give a signal to the market and to prevent the formation of panic expectations. When depreciation is too high, inflation expectations surge, creating future inflation risks. In response to increased inflation expectations, the National Bank gradually increased its key rate by 4 percentage points to 8% during the period. Thus, in 2014-2015, against the background of external shock, the monetary policy of the National Bank was in line with best practices and was directed at sustaining medium-term price stability.

2.2 MONETARY POLICY INSTRUMENTS

In 2015, the monetary policy of the NBG was conducted in accordance with the decisions of its Monetary Policy Committee (MPC). The objective of monetary operations is to keep interbank interest rates stable and close to the policy rate determined by the Monetary Policy Committee of the NBG. To meet this objective, the NBG's operational framework, which is the set of monetary policy instruments and the methods of their implementation, was used. The operational framework consists of the following monetary instruments: refinancing loans, overnight loans, overnight deposits, certificates of deposit and minimum reserve requirements.

The volume of transactions carried out in the national currency remained similar as in the previous year and equaled 17.7 billion GEL. The NBG monetary policy rate in 2015 rose from 4% to 8%. As a result, interbank rates also increased. The fluctuations of interbank rates were relatively mild and did not deviate from the NBG's rate too much. The NBG's monetary committee determined the weekly volumes of the refinance facility based on short-term liquidity forecasts.

2.2.1 Refinancing Loans

For the purpose of ensuring short-term liquidity in the banking system, throughout 2015 the National Bank of Georgia used the refinancing loan instrument on a weekly basis. This instrument first came into effect in 2008. Through refinancing loans, a reliable and low-risk source of short-term liquidity was made available to the banking sector. This positively affected the development of the money market and improved overall financial stability. The refinancing loan instrument is designed to manage short-term interbank interest rates. The National Bank is the sole pro-

vider of short-term liquidity in the market. The NBG thus has the capacity for achieving its desired interest rate on the interbank market. The interest rate of refinancing loans provided via auctions was based on the NBG monetary policy rate.

For the purpose of meeting mandatory liquidity requirements in the banking system and for enhancing the confidence of financial market participants towards the refinancing loan mechanism, the National Bank also utilizes a guaranteed refinance loan instrument that is issued without auction. The guaranteed refinance loan instrument provides commercial banks with a guaranteed source of liquidity when needed. Banks were able to use refinancing loans even in those cases when their bids were not satisfied in regular refinancing loan auctions. The interest rate for guaranteed refinancing loans is set in advance by the Monetary Policy Committee of the NBG and is determined as the monetary policy rate plus 1.5%. The maturities of the guaranteed refinancing loans and the dates for obtaining and repaying such loans are identical to those of regular refinancing loans.

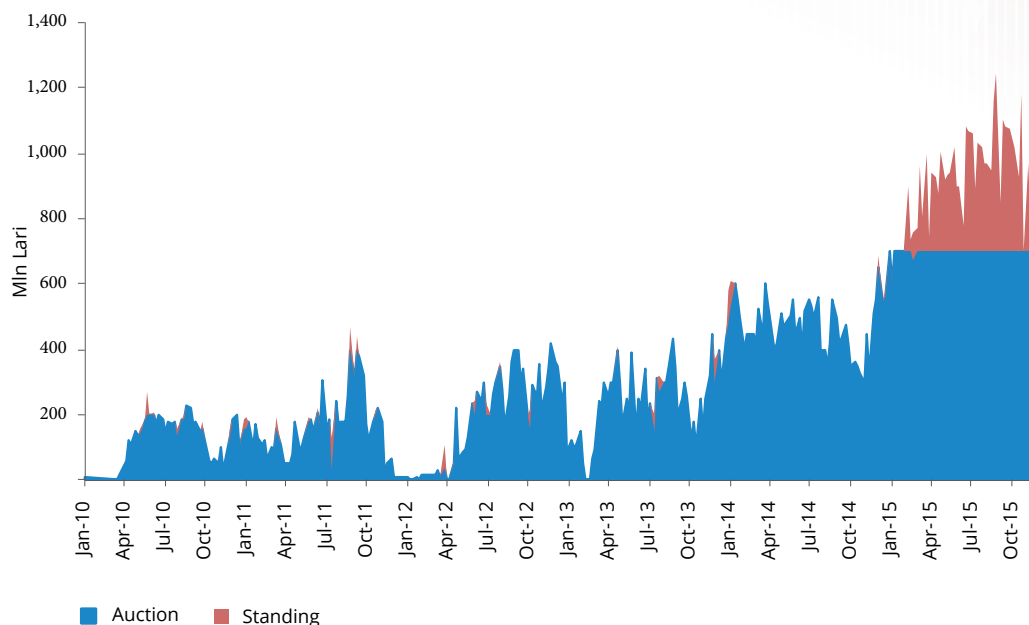
In 2015, as usual, banks mostly obtained short-term liquidity on the interbank financial markets and in refinancing loan auctions. However, absorbing short-term liquidity from the market via other liquidity providing sources caused an increase in demand for refinancing loans, which were limited in supply to some extent. As a result, unlike in previous years, in 2015 banks actively utilized the guaranteed refinancing loans with 1.5% higher interest than the policy rate. The banking system thus had no liquidity problems.

In 2015, the collateral base of monetary operations comprised certificates of deposits of the

National Bank of Georgia, Georgian government securities, loan assets of commercial banks, and lari denominated securities issued by international financial intuitions. In their operations with

the National Bank of Georgia commercial banks actively used all types of collateral in 2015. For each type of collateral, satisfactory criteria were defined by the National Bank.

Diagram N 2.15 Volume of refinancing loans (2011-2015)



Source: National Bank of Georgia

2.2.2 Overnight Loans and Deposits

In line with international best practice, the NBG continued to use the interest rate corridor for the purposes of financial market development, to reduce interbank interest rate fluctuations and to boost the activities of the financial market. This allowed interbank market interest rates to be maintained within stable limits. The interest rate corridor is defined by equal deviations from the monetary policy rate in both directions, thus forming the upper and lower interest rate limits. The upper limit was used for the NBG's overnight loans, while the lower limit was used for the NBG's overnight deposits. In 2015, the interest rate corridor was equal to 3% – the monetary policy rate plus and minus 1.5 percentage points. The use of the interest rate corridor reduces the sharp fluctuation of interest rates on

the interbank market and promotes the convergence of interbank interest rates with the monetary policy rate.

Overnight loans from the National Bank represented the fastest source of instant liquidity for the banking sector, albeit with a higher price in comparison with the market rate – which pushed banks to the interbank market in order to find a better price for needed funds. Thus, demand on this instrument was not high. Commercial banks mostly used refinancing loans, which the banking sector considered a significantly more flexible and comprehensive mechanism for the management of short-term liquidity. The collateral base accepted for overnight loans is the same as that for refinancing loans.

The instrument of overnight deposits, which has been in place since April 2010, was also used in 2015. By using the overnight deposit instrument commercial banks have an opportunity to transfer excess lari from correspondent accounts for overnight deposit with the NBG at the end of each day. The deposited amount will be returned to the correspondent account at the beginning of the next workday. The existence of overnight instruments played an essential role in the stabilization of interest rates on the interbank market in 2015.

2.2.3 Securities

Certificates of Deposit

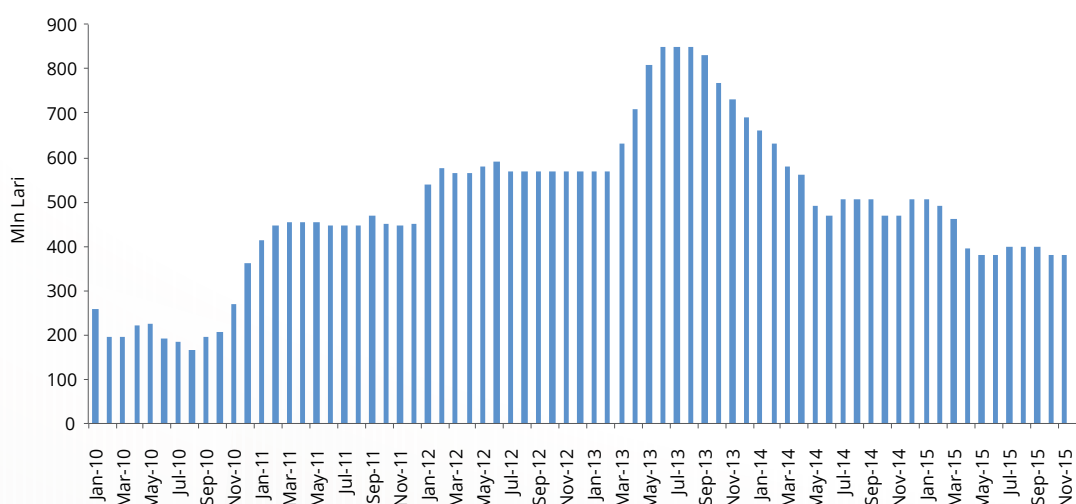
In 2015, the NBG continued to issue its own certificates of deposit (CD) securities. Together with Treasury Bills and Treasury Notes issued by the Ministry of Finance, certificates of deposit had a high level of demand from commercial banks. CDs are on the short side of the term structure, trading for 3- and 6-month maturities, while government securities trade for 1-, 2-, 5- and 10-year

maturities. These securities have contributed to the formation of a stable yield curve. The yield curve provides important information regarding the term structure of interest rates, and is indicative of the expectations of financial market participants. According to the yield curve, the spread between long- and short-term interest rates decreased during the year, indicating progress in terms of market efficiency.

In 2015, the NBG issued 3- and 6-month CDs, which the banking sector used as the most attractive and effective short-term liquidity management instrument. Therefore, the CD allocation ratio, which reflects the actual level of allocation compared to planned issue, equaled 1.0; the demand ratio, which reflects the relationship between the level of demand and allocated issue, amounted to 2.63.

In 2015, the interest rate on CD auctions fluctuated from 4.40-10.75%. The weighted average rate on NBG CDs was 7.21% (in 2014 it was 4.30%).

Diagram N 2.16 Volume of CD portfolio (2010-2015)



Source: National Bank of Georgia

In 2015, commercial banks purchased NBG CDs in all 50 auctions conducted by the NBG. The nominal amount allocated was equal to 1.05 billion GEL and a total of 1.19 billion GEL was redeemed in 2015. The stock of NBG CDs decreased from 505 million GEL at the start of the year to 360 million GEL at the end of the year. On average, five commercial banks participated in the CD auctions. As of 31 December 2015, 10 commercial banks held 360 million GEL worth of CDs. Over the year, four deals were conducted on the CD secondary market for a total amount of 33.86 million GEL (in 2014, five transactions were settled on the secondary market for a total of 66.5 million GEL).

Government Bonds

As of 31 December 2015, the NBG held government bonds with a par value of 112 million GEL, which were not used for open market operations during the year. In terms of government bonds in circulation in the banking sector, as of 31 December 2015, two commercial banks were owners of government bonds with a par value of 25 million GEL. In 2015, no transactions were settled on the secondary market.

Treasury Bills and Treasury Notes

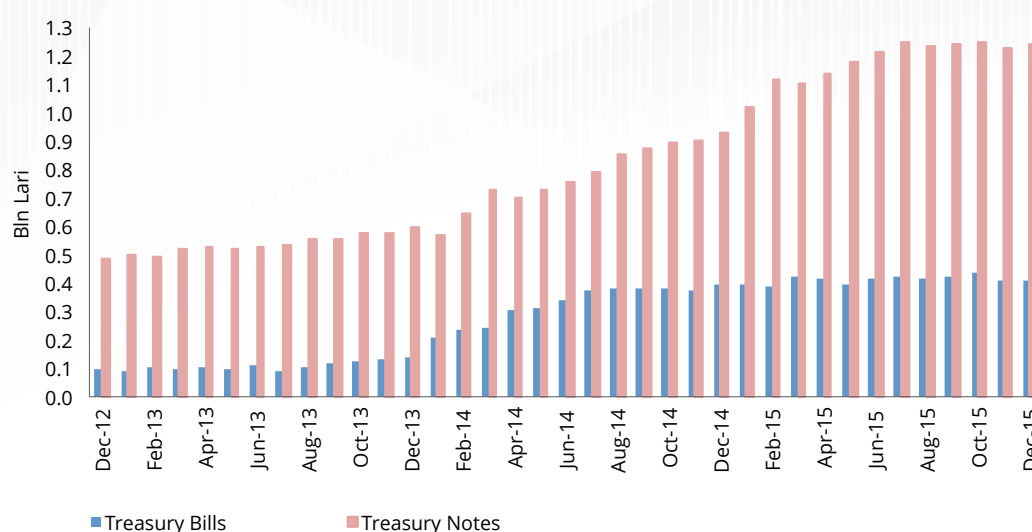
The Ministry of Finance of Georgia continued to issue Treasury Bills and Treasury Notes for the purpose of developing the Iari financial market. In 2015, the Ministry of Finance issued 1-year discount securities and 2-, 5-, and 10-year coupon notes. These securities are denominated in the national currency in non-materialized form. The nominal value of a security is 1,000 GEL. The placement of Treasury Bills and Treasury Notes are executed through a multiple price auction conducted by the NBG via the Bloomberg trad-

ing platform. All commercial banks licensed by the NBG have the right to participate in the auctions and any individual or legal entity can use a bank as its representative. A security may have a nominal owner – a market intermediary, to whom the owner grants authority, through written contract, to register Treasury securities in the registry under his/her name and to manage, buy, sell, and collateralize them.

In 2015, fourteen auctions of Treasury Bills were conducted and 409.0 million GEL of Treasury Bills were issued and fully allotted on those auctions. The weighted average yield equaled to 8.28% (in 2014, the weighted average yield was 6.19%). As of 31 December 2015, there were nine commercial banks and non-banking investors that held 409 million GEL of Treasury Bills. Non-banking investors held 23.3 million GEL of Treasury Bills. In 2015, 22 auctions of 2-, 5- and 10-year Treasury Notes were conducted and 434 million GEL of Treasury Notes were issued and fully allotted on those auctions. The weighted average yield equaled 8.75%, 10.86% and 12.12% respectively. As of 31 December 2015, there were 12 commercial banks and non-banking investors that held 1.24 billion GEL of Treasury Notes. Non-banking investors held 18.6 million GEL of Treasury Notes.

By the end of 2015, the total portfolio of Treasury Bills and Treasury Notes in circulation amounted to 1,649 million GEL, or 5.5% of GDP. It is worth mentioning that the size of Treasury securities in circulation remains small relative to the size of the economy. In order to increase market liquidity, it is essential to increase the volume of stock of Treasury securities, which will decrease risks associated with external loan acquisition.

Diagram N 2.17 Treasury bills and Treasury notes portfolio (2013-2015)



Source: National Bank of Georgia

The existence of a liquid secondary market has an important role in the efficiency of the monetary policy transmission mechanism. In 2015, interbank repo operations significantly intensified causing a substantial reduction of operational dealing. Basically, the main factor preventing further growth of secondary market activity is the insufficient amount of securities in circulation and the small amount of portfolio investors.

In order to facilitate the activation of the securities secondary market, the National Bank of Georgia continued to support the perfect functioning of the securities settlement system (the Central Securities Depository or CSD), which was constructed following modern international standards using the material and intellectual investment of the NBG. As a result, in 2015 the interbank repo market significantly intensified. This was based on an internationally adopted repo master agreement created on the initiative of the NBG and with the consent of commercial banks. Commercial banks used the Bloomberg trading system and the Central Securities Depository to conduct repo deals. Using these systems, in 2015 357 repo transactions were conducted between

commercial banks involving government securities with a total nominal value of 4,537 million GEL; while in 2014 there were only 86 transactions made with a nominal value of 1,184 million GEL.

The existing securities market practice and infrastructure provides a strong basis for the further development of secondary securities market activities, which, in turn, will increase market liquidity.

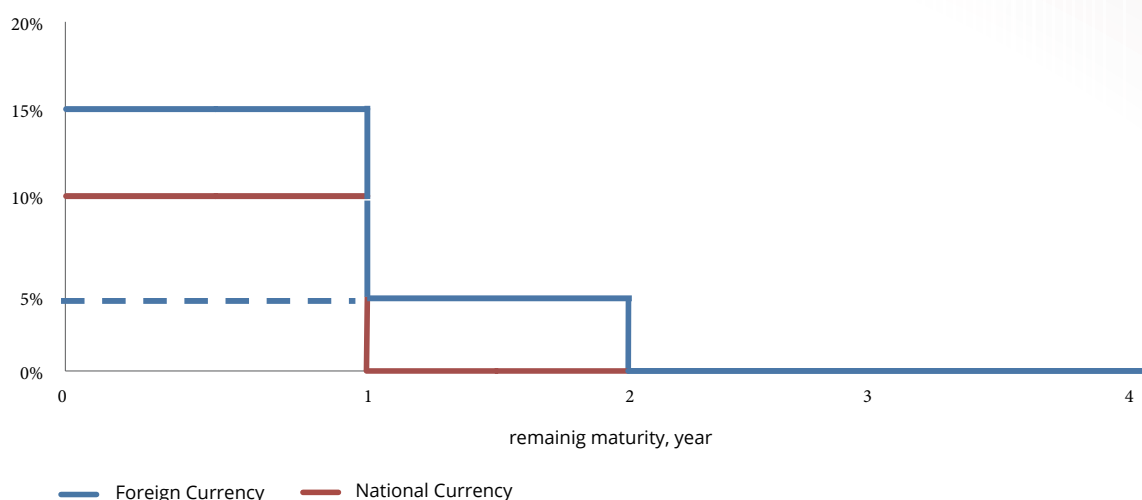
2.2.4 Minimum reserve requirements

The minimum reserve requirements instrument gives the NBG the opportunity to influence the money multiplier and to create preconditions for the efficient use of other monetary instruments. For the purposes of supporting the monetary policy transmission channel, promoting the development of the lari money market, and encouraging larization, the minimum reserve requirement rate for funds denominated in the national currency was set at 10% in 2015 (the reserve requirement for borrowings with a residual maturity of more than 1 year equals 0%); for foreign currency denominated funds, the rate was set at 15% (the minimum reserve rate for FX borrowings with a residual maturity of 1 to 2

years was 5%, while for FX borrowings with a residual maturity of more than 2 years it was 0%). In 2015, commercial banks earned interest equal to the NBG's monetary policy rate on minimum reserve balances placed in lari correspondent

accounts, while USD and euro cash balances accrued interest equal to the policy rates of the U.S. Federal Reserve and the European Central Bank respectively, minus 0.5 percentage points, but not less than zero.

Diagram N 2.18 Minimum reserve requirement rate



Source: National Bank of Georgia

BOX N 2 INTERNATIONAL SECURITIES CENTRAL DEPOSITORY – CLEARSTREAM

In 2015, the National Bank of Georgia laid the foundations for the beginning of a working process to open a securities settlement and storage (Custody) account of the International Central Securities Depository – Clearstream – in Georgia.

Clearstream is one of the biggest players in the securities service industry. It is an International Securities Central Depository (ICSD) with 2,500 customers in 110 countries in the post trade infrastructure and securities services industry.

Georgia is Clearstream's 55th domestic link. This strategic decision was in clear support of Georgia's aspiration to develop its capital markets and to move its infrastructure and legal framework closer

to international standards and best practices.

Opening settlement and custody accounts with Clearstream means that the Georgian national currency will be included in Clearstream's currency list available for settlement. This will facilitate non-resident investors executing operations with lari on the international securities market. The latter is an important precondition for the increase international investors' demand on lari denominated securities.

In 2016, Clearstream finalized the process of adding Georgian government securities to its clients via a Georgian commercial bank, which will act as the local custodian and cash correspondent bank.

2.3 EXCHANGE RATE POLICY AND INTERNATIONAL RESERVES MANAGEMENT

As in previous years, the main priorities for the foreign exchange policy of the National Bank of Georgia in 2015 were supporting exchange rate formation on market principles, the development of the foreign exchange market, and maintaining an adequate level of international reserves.

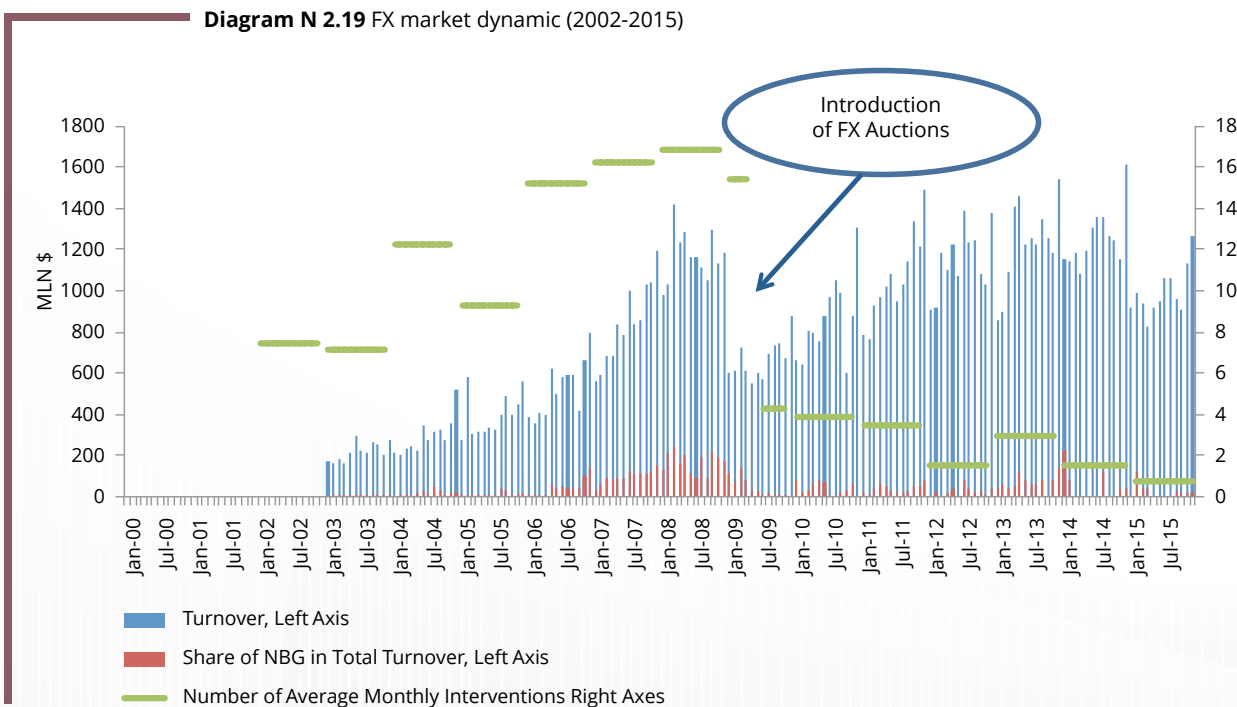
A floating exchange rate regime operates in Georgia. Such a regime represents the optimal instrument for countries with small-scale open economies, like Georgia, and it fulfills the function of shock absorption. In the event of foreign shocks, exchange rate fluctuations reduce the impact of shocks on the real economy – on economic growth and inflation.

During the floating regime, the exchange rate is defined according to supply-demand in the foreign exchange market, which is affected by both

fundamental economic factors and temporary events. In this regime, the foreign exchange market is characterized by short-term fluctuations. Such fluctuations are frequent in small open economies with high levels of dollarization, such as Georgia, and are related to small volumes in the foreign exchange market and uneven capital flows. The NBG's foreign exchange policy only considers interventions in the foreign exchange market through foreign exchange auctions in certain particular cases: when temporary capital flows trigger sharp currency fluctuation in the short term; in order to increase international reserves; and in order to balance public external operations.

The National Bank of Georgia only intervenes in the foreign exchange market through foreign exchange auctions. In comparison with previous years and in line with the development of the foreign exchange market, the frequency of interventions was reduced in 2015.

Diagram N 2.19 FX market dynamic (2002-2015)



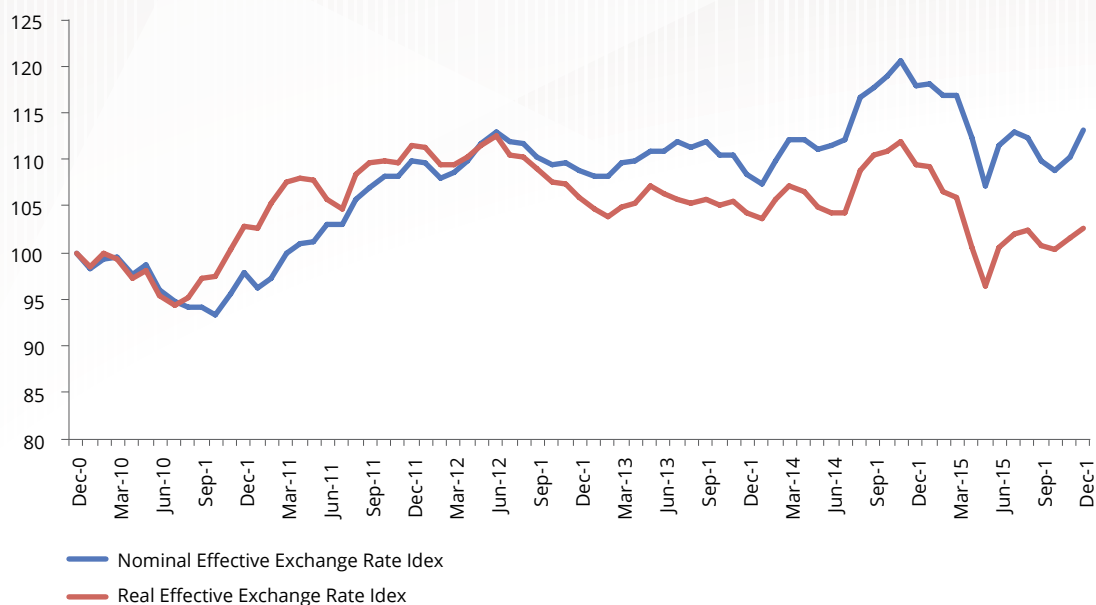
Source: National Bank of Georgia

In the second half of 2014, Georgia faced a strong external shock that continued into 2015. The strengthening USD, unstable economic conditions in Georgia's main trading partner countries and the depreciation of regional currencies all had a negative effect on the Georgian economy. In such cases, it is impossible to finance a currency misbalance from reserves. The National Bank thus aimed at making minimal interventions in the market in order to let the exchange rate adjust as quickly as possible. In these kinds of scenarios intervention from the central bank is counterproductive: it hinders adjustment of the external misbalance and promotes speculative expectations. During external shocks exchange rate corrections act as an automatic stabilizer of the economy. Currency depreciation adversely affects demand on imports, thus reducing the country's adequate currency outflow for the reduced inflows.

The pressure from the current account on the lari exchange rate was particularly strong at the

beginning of the year before imports started to decline. The foreign exchange policy of the National Bank was thus aimed at making minimal interventions. However, during this period the National Bank had to intervene in the foreign exchange market to signal to market participants that the fluctuation was not a result of an uncontrolled process. It was important to do so as a high level of exchange rate fluctuation could cause a shock in confidence in the monetary policy. During the majority of these interventions, the president of the National Bank gave briefings to help reduce speculative expectations from public with proper communication. As a result, during the first four months of the year, the National Bank of Georgia sold 200 million USD in auctions.

The depreciation of the lari occurred in both the real effective exchange rate (REER) and nominal effective exchange rate (NEER). In 2015, the REER and NEER depreciated by 6.2% and 4% respectively in comparison with 2014.

Diagram N 2.20 Real and nominal effective exchange rate indices (Dec. 2009=100)

Source: National Bank of Georgia

Table N 2.1 Annual change of effective exchange rate indices in 2015

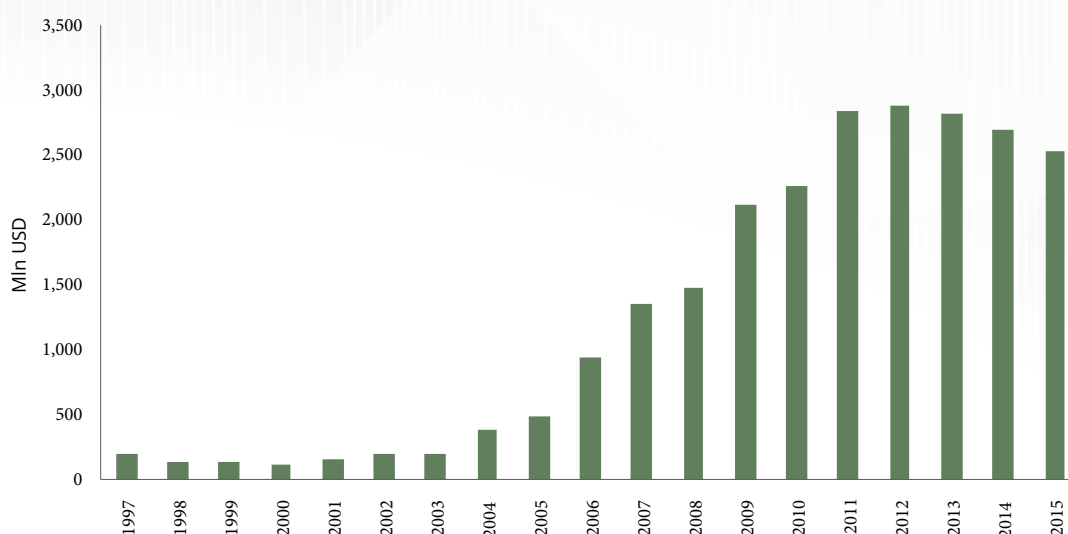
	Change in nominal effective exchange rate, %	Change in real effective exchange rate, %	Contribution to real effective exchange rate
Effective exchange rate	-4.0	-6.2	-6.2
Eurozone	-10.9	-6.8	-1.4
Turkey	0.2	-3.4	-0.7
Ukraine	18.4	-13.4	-1.1
Armenia	-17.9	-13.8	-0.8
USA	-21.4	-18.2	-0.9
Russia	-0.2	-7.4	-0.7
Azerbaijan	16.8	13.8	2.0
Other	-16.7	-13.3	-2.6

Source: National Bank of Georgia

International Reserve Management

In 2015, the main priority of the National Bank of Georgia was to maintain international reserves at the desired level. As a result, the total international reserves of the National Bank of Georgia amounted to 2.521 billion USD as of 31

December 2015 (including the funds externally managed by the World Bank and the Bank for International Settlements). Compared to the same figure from 2014 (USD 2.699 billion USD), the international reserves declined by USD 179 million USD in 2015, a 6.62 percentage point decrease.

Diagram N 2.21 Official international reserves (1997-2015)

Source: National Bank of Georgia

Several factors affected the volume of the NBG's international reserves during 2015: FX auctions, government expenditures, and grants and credits received from international organizations. During the year, the NBG's net sales of foreign currency via FX auctions amounted to 287 million USD. During 2015, 258 million USD was received in the form of loans and grants from different international financial organizations and donor countries (10 million USD from the European Union, 120 million USD from the World Bank, 74 million USD from the Asian Development Bank, and 54 million USD from other sources). Another 186 million USD was received for project financing: 64 million USD from the World Bank, 32 million USD from the Asian Development Bank, 22 million USD from the European Investment Bank, 36 million USD from Japan, and 32 million USD from other sources. Other than the above mentioned grants and loans for programs and projects, in 2015 the international reserves had inflows from the transit fees of the Baku-Tbilisi-

Ceyhan pipeline totaling 53 million USD. The year was particularly notable for the large-scale repayments of the NBG's and the government's debts, which negatively affected the volume of international reserves. In 2015, the NBG repaid a total of 266 million USD.

International financial markets saw a gradual improvement of the post 2008 crisis situation in 2015. Noticeable improvements were observed in the US, but the country was unable to fully recover to pre-crisis conditions. Given the relatively positive macroeconomic data throughout the year, market participants were eagerly waiting for the FED to increase the refinancing rate, but the FED ultimately only moved at the end of the year in the December FOMC meeting. This was the first rate hike in 7 years and the FED set a new range of 0.25-0.50% for the refinancing rate. The US Treasury 1-year note yield was slowly rising and was maintained between 20 to 45 basis points.

Economic conditions in the eurozone remained harsh. The European Central Bank (ECB) monetary policy was the opposite of what the FED was doing. The ECB started a new asset purchase program (regional government obligations, asset-backed securities). The program is set to be in place until March 2017 and aims to fight against deflation in the eurozone and the depreciation of the euro. It also encourages the growth of economic activities. The refinancing rate of the ECB remained at 0.05 throughout the year, while the ECB Deposit Facility rate decreased by 10 basis points in November to a negative 0.30%. The ECB tried to encourage investments and economic growth using negative interest rates. Eurozone government securities' yields remained in negative territory in 2015, which made investments of the EUR portion of the NBG's international reserves in securities practically impossible.

International equity market indices reached historic highs during 2015, but later dropped to end the year at the same levels as they were at the start of the year. Last year turned out to be very challenging for developing economies, especially for the Chinese economy, which has recently declined year after year – something that has negatively affected the growth of the world economy. This process may delay interest rate increases in developed countries, including the USA.

Throughout 2015, the NBG's investment policy remained conservative and was oriented toward the reduction of credit risk. The NBG's international reserves were allocated in highly liquid government, agency and supranational securities of the United States, eurozone countries, Australia and Canada, and in international bank-

ing institutions with high credit ratings. During 2014, the income generated from the management of international reserves amounted to 23.8 million GEL, which was 20.4% more than the result in 2014.

In 2015, the NBG continued its cooperation with the World Bank within the framework of the Sovereign Investments Partnership Program, which it became a member of in 2009. The program aims to provide technical assistance for the further development of international reserve management, the creation of proper infrastructure and the accumulation of knowledge. The program entails sharing the World Bank's experience in the fields of portfolio and risk management, international settlements, accounting, law and information technology. Within the framework of this program, and with assistance from the World Bank, the NBG implemented Repo/Reverse Repo instruments for its international reserves portfolio, which aim to reduce the share of money market deposits and relevant credit risk in the reserves portfolio. The World Bank shared its experience in international reserves management with employees of the NBG. As a part of this cooperation, parties have been working on mastering new financial instruments.

In 2015, the financial markets department of the NBG, as part of the risks management program, created and implemented a strategic asset allocation application (Strategic Asset Allocation Tool). This application models the expected returns of different types of bonds with different maturities and suggests optimal allocation based on their risks. Implementation of this application allows the performance of a strategic asset allocation

exercise without any external tools. The models used in the Strategic Asset Allocation Tool were created with the involvement of experts from the World Bank, the Bank for International Settlements and the Central Bank of Brazil.

An internal credit scoring model was also created in 2015, which reduces the NBG's dependence on the credit ratings assigned by international credit rating agencies and allows timely identification of increased credit risks. This model uses various economic and financial data to assess credit risk. When used in conjunction with the credit ratings assigned by the rating agencies, this allows for a more in-depth analysis of credit risks of the

NBG's counterparties and permits assigning relevant credit scores to them. The credit scoring model and permanent detailed monitoring of counterparties allows timely identification and effective management of credit risks involved in the international reserves management process. In 2015, the NBG continued to cooperate with the Bank for International Settlements (BIS) within the BIS Investment Pool (BISIP) program, which the NBG joined at the end of 2014. The BISIP program implies the management of funds from different central banks and international financial institutions in a single portfolio. It also involves assistance and experience sharing in other aspects of reserves management.



III

BANKING SUPERVISION



3.1 DEVELOPMENT OF THE REGULATORY FRAMEWORK

Throughout 2015, the NBG continued working on enhancing and developing its regulatory framework. This included, but was not limited to, the implementation of Pillar II of the capital adequacy framework based on Basel II/III, as well as the enhancement of normative-legal acts and developing new legislative initiatives for fostering effective supervision.

For the purpose of enhancing and developing the elements of Pillar II of the capital adequacy framework based on Basel II/III, the "Instruction on Determining a Capital Buffer for Credit Concentration Risk for Commercial Banks" was approved in December 2015. The updated regulation on the "Management of Conflicts of Interests" was also developed and approved in 2015, which ensures the implementation of adequate supervision and control mechanisms for commercial banks' transactions with related parties to avoid conflicts of interests as much as possible. The regulation is based on International

Accounting Standard IAS 24 and the "Core Principles for Effective Banking Supervision" of the Basel Committee on Banking Supervision (BCBS). The regulation on the "Internal Audit Requirements for Commercial Banks" was updated, which supports cooperation between supervisors and internal auditors in line with best international practice.

In line with the recommendations of the IMF and the World Bank, the National Bank has been working on legislative initiatives that support the strengthening of effective banking supervision.

3.2 GROUP STRUCTURE RISK

Assessment of risks related to the group structure of commercial banks is part of the NBG's General Risk Assessment Program (GRAPE). Group structure risk assessment entails the evaluation of risks related to bank ownership structure and transactions carried out with banking group members, as well as those related to banks' investments and banks' investment activities. Within the frames of the group structure risk assessment, the National Bank is actively in-

involved in monitoring processes that develop in the home countries of the international banking groups represented in Georgia, and in the assessment of significant shareholders.

As of 31 December 2015, 19 commercial banks operated on the Georgian banking sector. The sector was still represented by large international and regional investors. The share of non-resident beneficiaries in banks' assets, according to final ownership, stood at 85%, while in equity capital it stood at 82%.

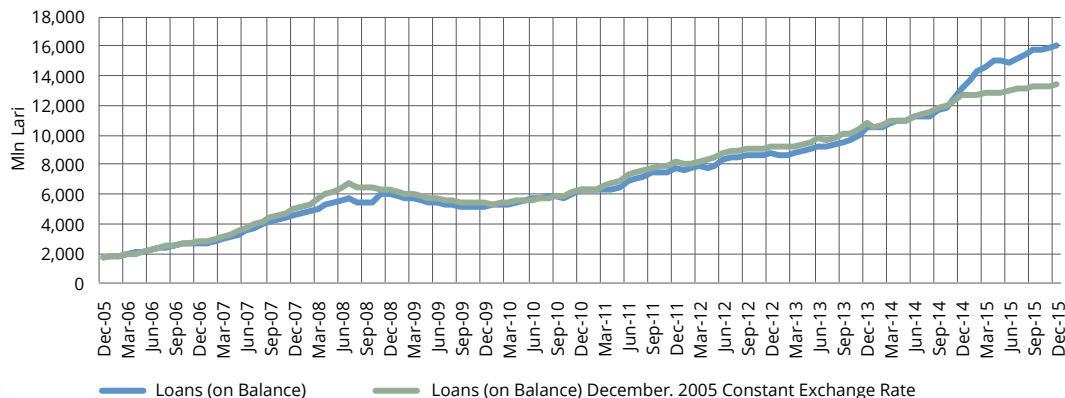
Throughout 2015, in accordance with the NBG's decision made in 2014, commercial banks involved in non-financial sector activities, including via subsidiaries, gradually exited these sectors through, amongst other things, the introduction

of changes in the group structure and through reorganization. The NBG continues monitoring commercial banks and other group member companies for the purpose of assessing risks related to conflicts of interests, as well as the impact of group risks on banks.

3.3 CREDIT RISK

As of 31 December 2015, the size of the total loan portfolio in the banking system exceeded 16 billion GEL. Not adjusted for exchange rate effects, growth during the year amounted to 5.5%. The year 2015 was characterized by the slowdown of lending activities, with expectations created by exchange rate changes significantly contributing to this.

Diagram N 3.1 Dynamics of gross loan portfolio



Source: National Bank of Georgia

Excluding interbank loans, the composition of the loan portfolio in terms of segments did not change significantly during 2015. Not adjusted for exchange rate effects, the SME loan segment grew the most over the year, followed by the cor-

porate and retail loan segments. However, it is noteworthy that $\frac{1}{4}$ of the growth of the SME loan segment was due to reclassification of the retail loan segment.

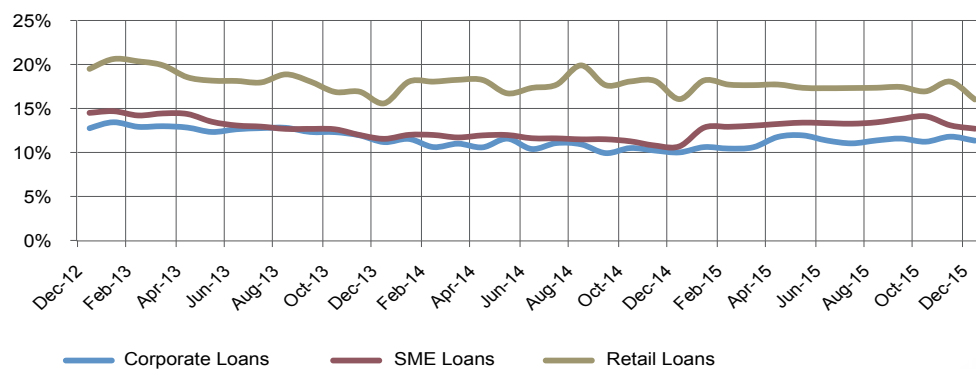
Table N 3.1 Composition of loan portfolio (excluding interbank loans) without the exchange rate effect (exchange rate as of the end of 2014)

	Dec-14		Dec-15		Growth -Percent- age
	Mln GEL	%	Mln GEL	%	
Corporate	4,846	37%	4,924	36%	2%
SME	2,422	19%	3,056	22%	26%
Retail	5,698	44%	5,739	42%	1%
Total	12,966	100%	13,719	100%	6%

Source: National Bank of Georgia

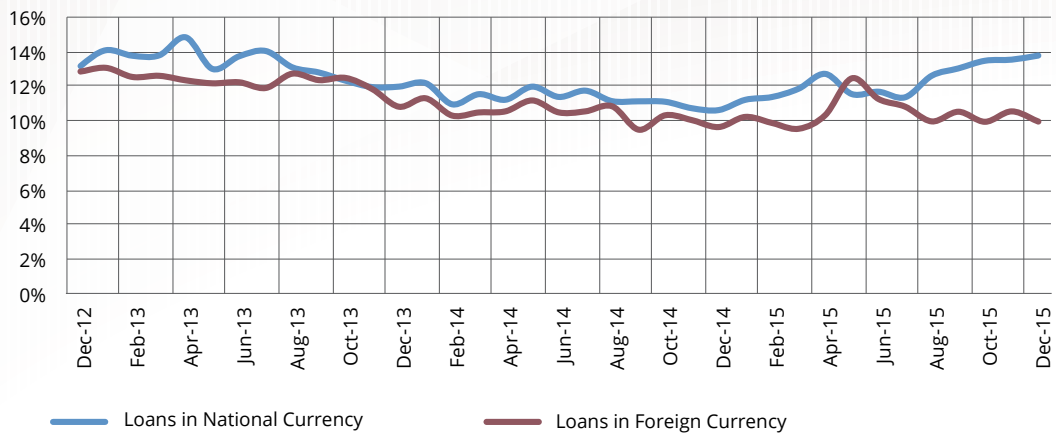
Throughout 2015, in comparison with 2014, interest rates on loans in GEL increased for all segments. For loans in USD there was a minor decrease in interest rates in the retail and SME loan segments, while interest rates in the corporate loan segment saw virtually no change. Despite the growth of the debt burden and the attendant

credit risks as a result of the Georgian lari depreciation, the increase of interest rates for FX loans was hindered by the accumulation of excessive liquidity of foreign currency in the banking system (see the Liquidity Risk section for more information).

Diagram N 3.2 Weighted average interest rates on loans per segment during a month

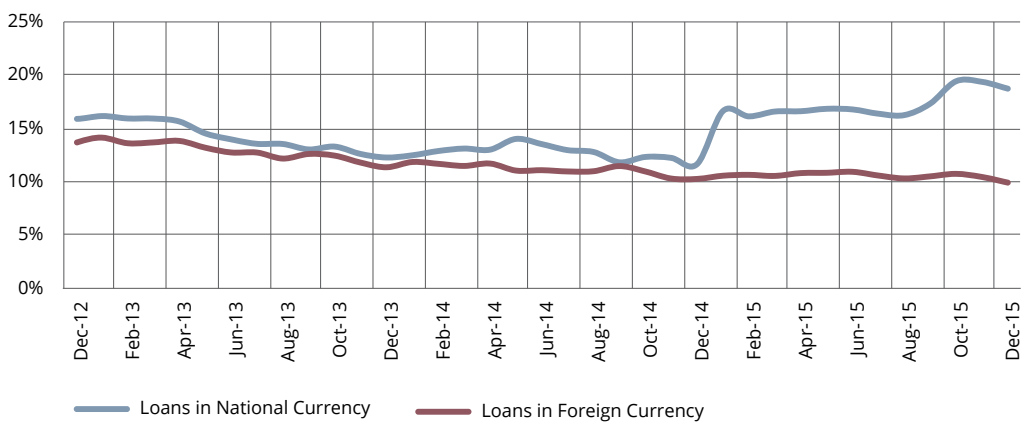
Source: National Bank of Georgia

Diagram N 3.3 Weighted average interest rates on loans per corporate segment during a month



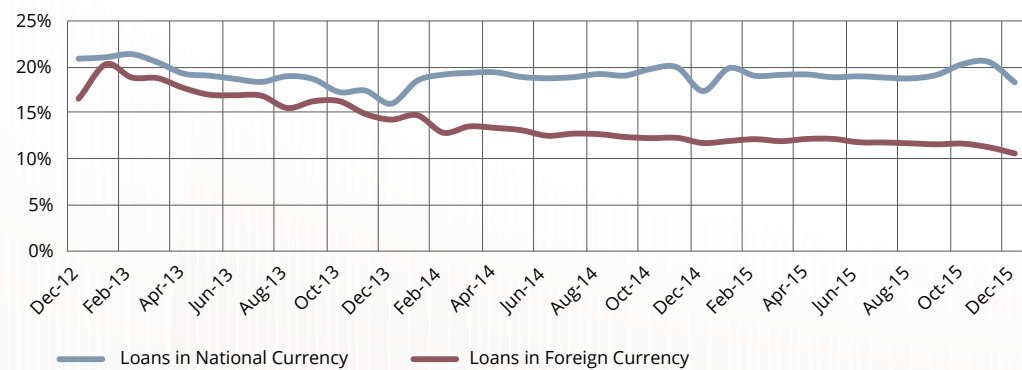
Source: National Bank of Georgia

Diagram N 3.4 Weighted average interest rates on loans per SME segment during a month



Source: National Bank of Georgia

Diagram N 3.5 Weighted average interest rates on loans per retail segment during a month



Source: National Bank of Georgia

The sectorial distribution of the loan portfolio is diversified. Throughout 2015, the share of procyclical sectors (real estate development, real estate management, production and trade of construction materials, production and trade of durable goods, and automobile dealers) in the

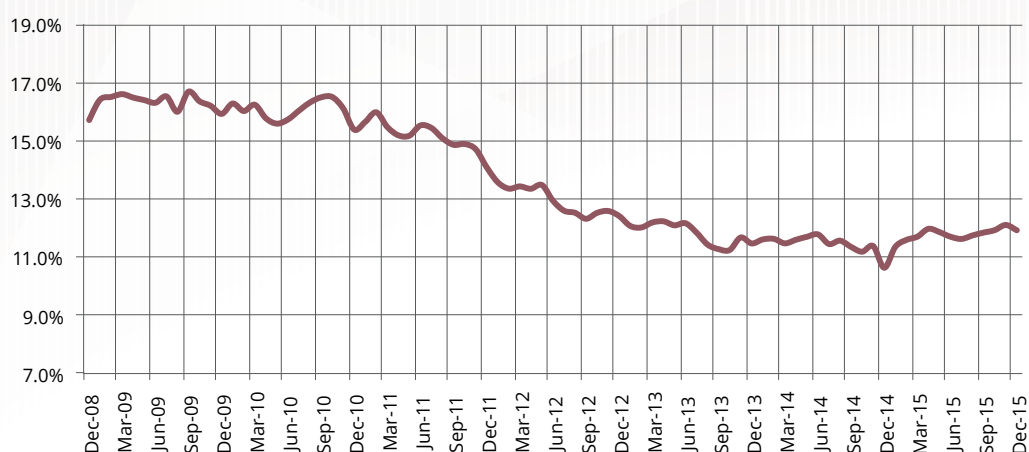
banking sector's loan portfolio remained moderate and stable (see Diagram N 3.6). The high volume of possible loss reserves in some sectors was mainly caused by idiosyncratic²² events (see Table N 3.2).

Table N 3.2 Gross loan portfolio according to risk sectors

Sector excluding interbank loans (Mln GEL)	Share in Portfolio	Loan	Loan Reserve	Loan reserve to Portfolio
State	0.3%	53	1	2.5%
Financial Institutions	1.9%	306	8	2.6%
Pawn-shop Loans	3.5%	567	19	3.4%
Real Estate Development	2.4%	388	54	13.9%
Real Estate Management	4.9%	778	45	5.7%
Construction Companies (non-developers)	1.8%	281	44	15.7%
Production and Trade of Construction Materials	2.0%	318	18	5.8%
Trade of Consumer Foods and Goods	4.7%	754	50	6.6%
Production of Consumer Foods and Goods	4.5%	714	42	5.9%
Production of Durable Goods	1.5%	247	17	7.1%
Production and Trade of Clothes, Shoes and Textiles	0.9%	139	8	5.4%
Trade (other)	4.6%	732	32	4.3%
Other Production	1.8%	287	16	5.6%
Hotels and Tourism	3.3%	528	24	4.6%
Restaurants	1.3%	210	14	6.7%
Industry	3.1%	501	40	7.9%
Oil Importers and Retailers	1.4%	219	12	5.4%
Energy	2.8%	446	14	3.1%
Auto	1.1%	178	57	32.0%
Healthcare	2.5%	399	13	3.4%
Pharmacy	0.7%	107	12	11.2%
Telecommunication	1.4%	217	36	16.5%
Service	4.3%	684	56	8.1%
Agriculture sector	4.6%	734	36	5.0%
Other including scrap metals	1.9%	304	12	3.8%
Retail products	37.0%	5,922	326	5.5%
Car Loans	0.5%	74	4	6.0%
Consumer Loans	15.7%	2,507	145	5.8%
Instant Installments	2.2%	350	25	7.0%
Payrolls (overdrafts)	0.4%	67	6	9.0%
Credit Cards	3.1%	492	33	6.8%
Loans for Housing Renovations	1.7%	277	11	3.8%
Mortgage Loans	13.5%	2,156	102	4.7%
Total	100.0%	16,013	1,014	6.3%

Source: National Bank of Georgia

22. Idiosyncratic means individual, and does not represent factors of a systemic nature.

Diagram N 3.6 The share of pro-cyclical sectors in the gross loan portfolio

Source: National Bank of Georgia

During 2015, the main drivers of retail portfolio growth were consumer loans and mortgages; car loans grew insignificantly, while for other products the portfolio size decreased. The annual growth rate of consumer loans and mortgages reached 10% in 2015; however, in 2014, consumer loans increased by 23% and mortgages increased by 30%.

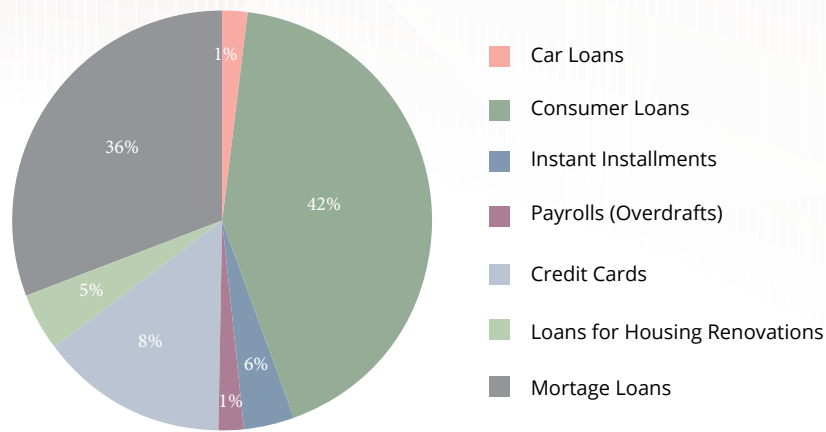
Despite the fact that banks had different credit standards with regard to the debt service ratio in terms of currencies before 2015, throughout 2015 banks rendered their PTI (the ratio of monthly loan payment to monthly income) requirements for retail loans pro-cyclically stricter, mostly, in relation to unhedged borrowers. The existing requirements with regard to the LTV (the ratio of loan amount and the value of collateral), remained virtually unchanged.

Table N 3.3 Growth of retail products without the exchange rate effect (exchange rate as of the end of 2014)

	Dec-2014		Dec-2015		Change - percent	Change - Mln GEL
	Mln GEL	Share %	Mln GEL	Share %		
Retail products	4,999	100%	5,282	100%	6%	284
Car Loans	51	1%	58	1%	13%	7
Consumer Loans	2,135	43%	2,355	45%	10%	220
Instant Installment	369	7%	350	7%	-5%	-19
Payroll (overdrafts)	71	1%	65	1%	-8%	-5
Credit Card	564	11%	488	9%	-14%	-76
Loans for Housing Renovations	232	5%	228	4%	-2%	-4
Mortgage Loans	1,577	32%	1,738	33%	10%	161

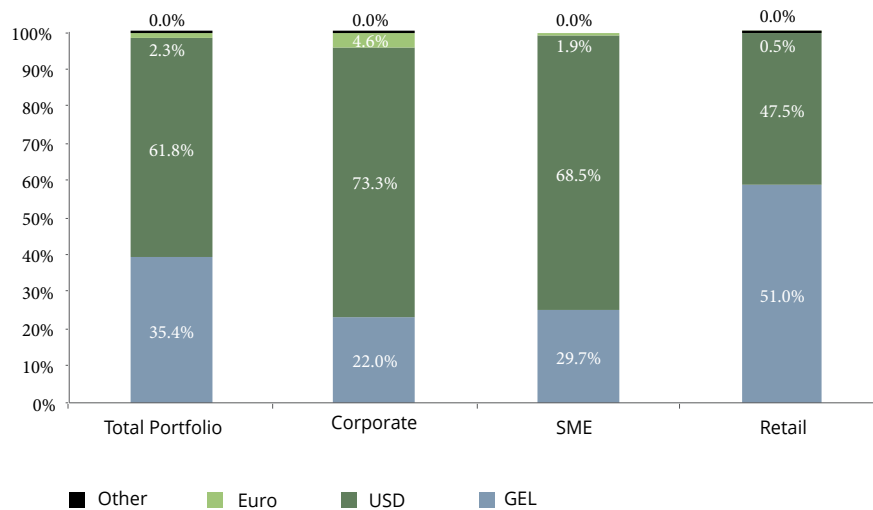
Source: National Bank of Georgia

Diagram N 3.7 Retail products distribution



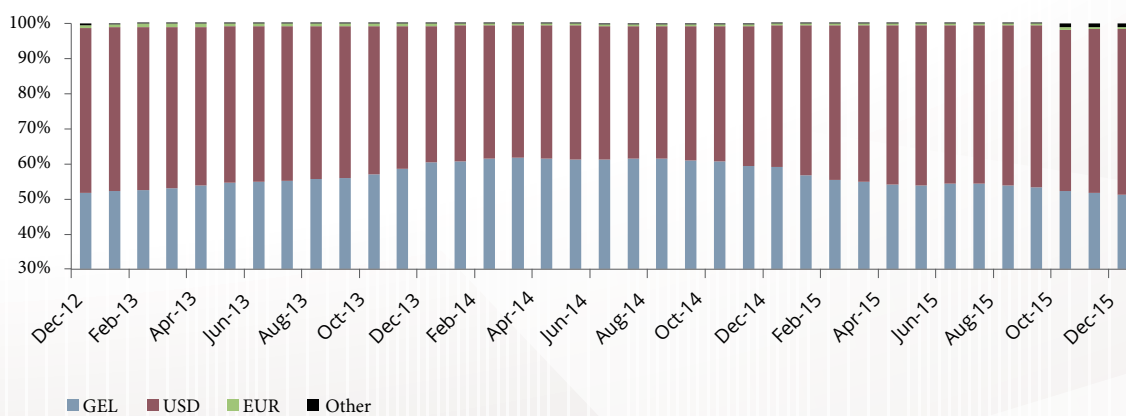
Source: National Bank of Georgia

Diagram N 3.8 Portfolio composition by currency (excluding interbank loans)



Source: National Bank of Georgia

Diagram N 3.9 Retail portfolio composition by currency (excluding interbank loans)



Source: National Bank of Georgia

By the end of 2015, the quality of the loan portfolio was satisfactory. The share of negative loans increased insignificantly during the 1-year inter-

val, while the share of non-performing loans decreased, which was mainly the result of several idiosyncratic events.²³

Table N 3.4 Gross loan portfolio risk categories and loan loss reserves

Risk category (excluding interbank loans)	Amount (Mln GEL)	Share	Reserve
Standard	13,840	86.4%	2%
Negative Loans	2,173	13.6%	32%
Watch	973	6.1%	10%
Non - performing	1,200	7.5%	49%
Substandard	504	3.1%	30%
Doubtful	380	2.4%	51%
Loss	316	2.0%	79%
Total	16,013	100%	6%

Source: National Bank of Georgia

The quality of the portfolio varied significantly based on its segments. Historically, corporate segment losses have been significantly higher

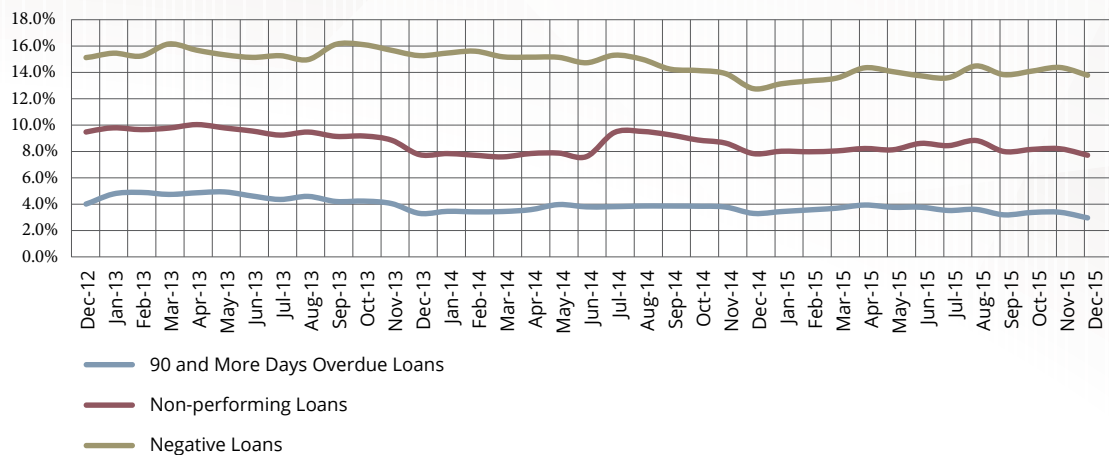
than SME and retail loan portfolio losses. This is clearly evident when comparing qualitative parameters in terms of segments.

Table N 3.5 Quality of portfolio by segment

Segment	Negative Loans	Non-performing	Average reserve
Corporate	21.40%	13.04%	8.34%
SME	10.62%	4.45%	4.56%
Retail	7.98%	4.11%	5.47%

Source: National Bank of Georgia

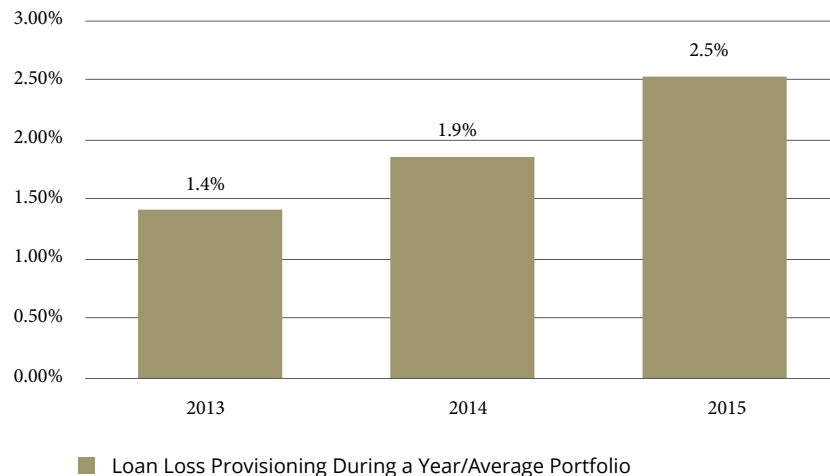
23. Idiosyncratic means individual, and does not represent factors of a systemic nature.

Diagram N 3.10 Loan Portfolio composition by quality (excluding interbank loans)

Source: National Bank of Georgia

The volume of the cost of the loan portfolio mainly increased as a result of the exchange rate depreciation. However, the growth was not sub-

stantial enough to have a significant impact on the portfolio quality.

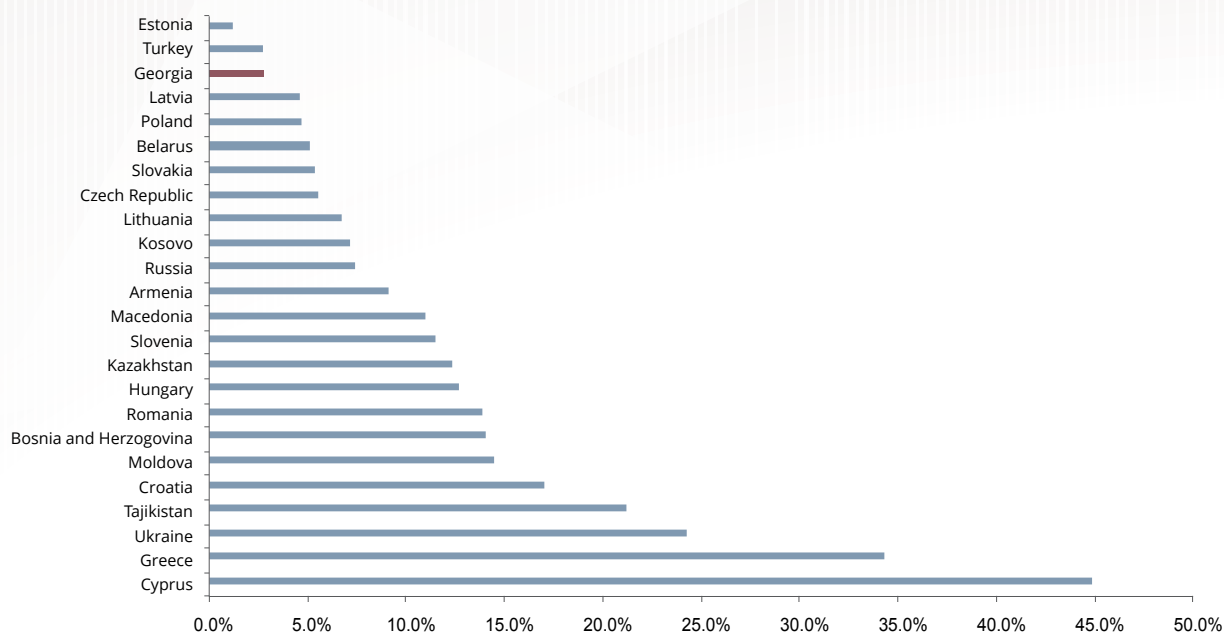
Diagram N 3.11 Ratio of annual provision for loan impairment to average loan portfolio

Source: National Bank of Georgia

The share of 90-day overdue loans in the total loan portfolio (excluding interbank loans) amounted to 2.8%, which represents one of the best results among comparable countries.

It must be mentioned that this result does not account for different approaches with regard to restructuring/refinancing across different supervisory jurisdictions.

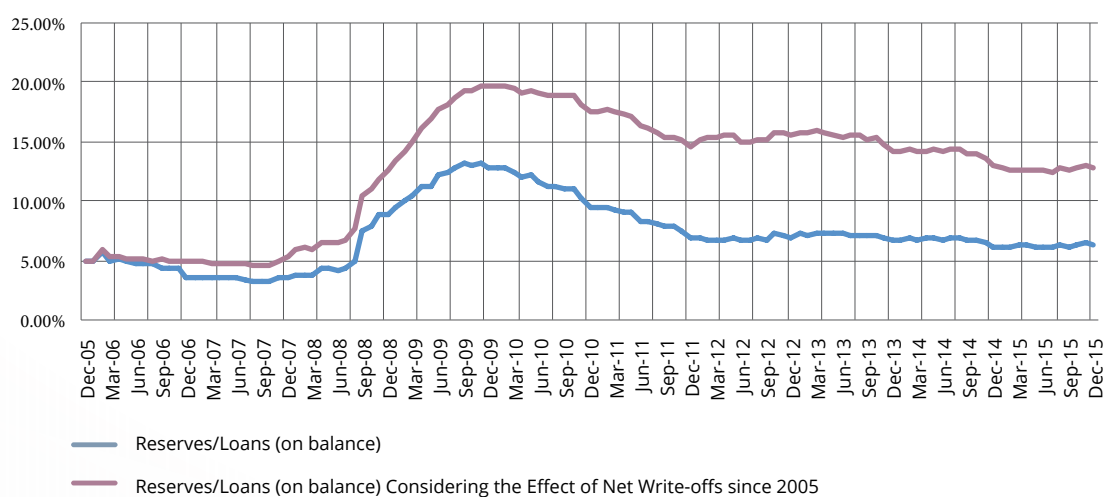
Diagram N 3.12 Overdue loans of 90 days and more



There may be several months' difference between the data. The latest available dates are used.

Sources: IMF, National Bank of Georgia

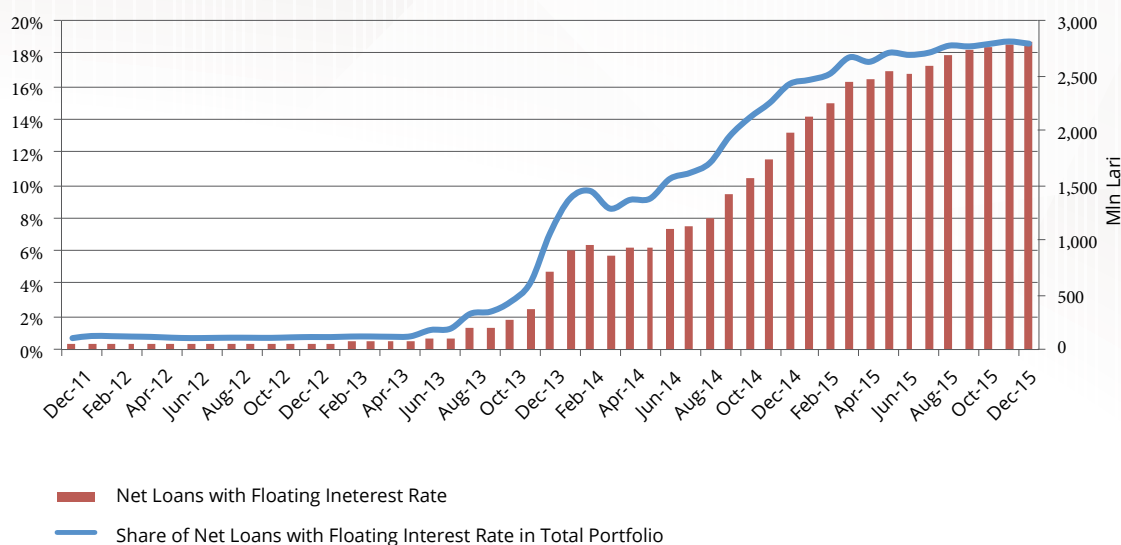
Diagram N 3.13 Loan loss reserve to gross portfolio



Source: National Bank of Georgia

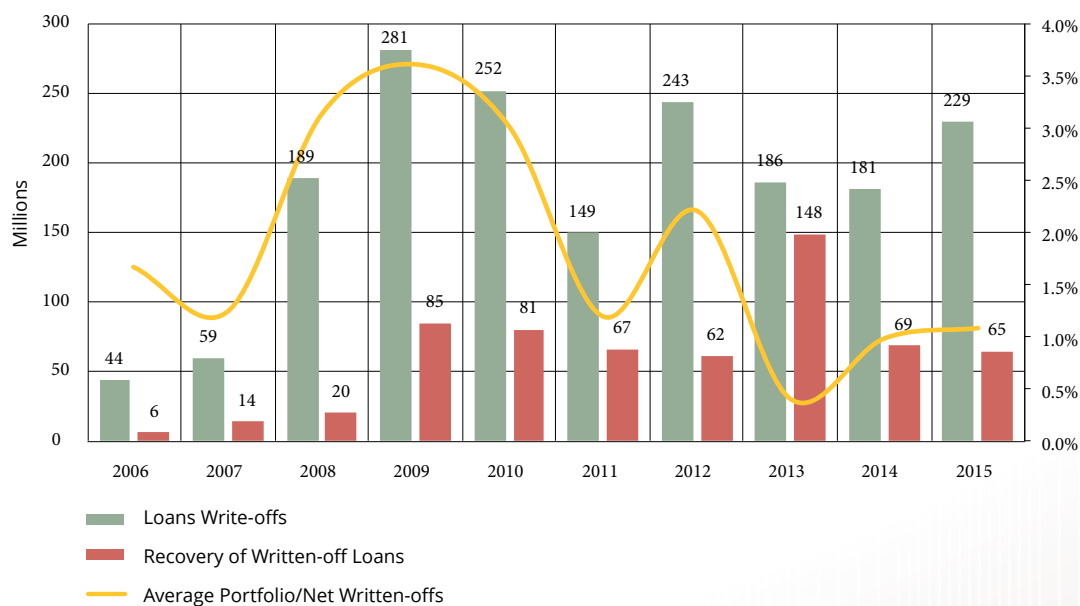
Starting from 2013, the banking sector began active disbursement of variable interest rate loans; and the latter amounted to 19% of the entire loan portfolio by the end of 2015. The fact that global interest rates are at historically low levels, which is mostly related to LIBOR (London Interbank Of-

fered Rate), may create additional risks in terms of loan servicing by borrowers. It must also be pointed out that the management of variable rate loans by commercial banks requires further improvement and the use of more sophisticated approaches.

Diagram N 3.14 Volume of net loans²⁴ with floating interest rates and the share in total portfolio

Source: National Bank of Georgia

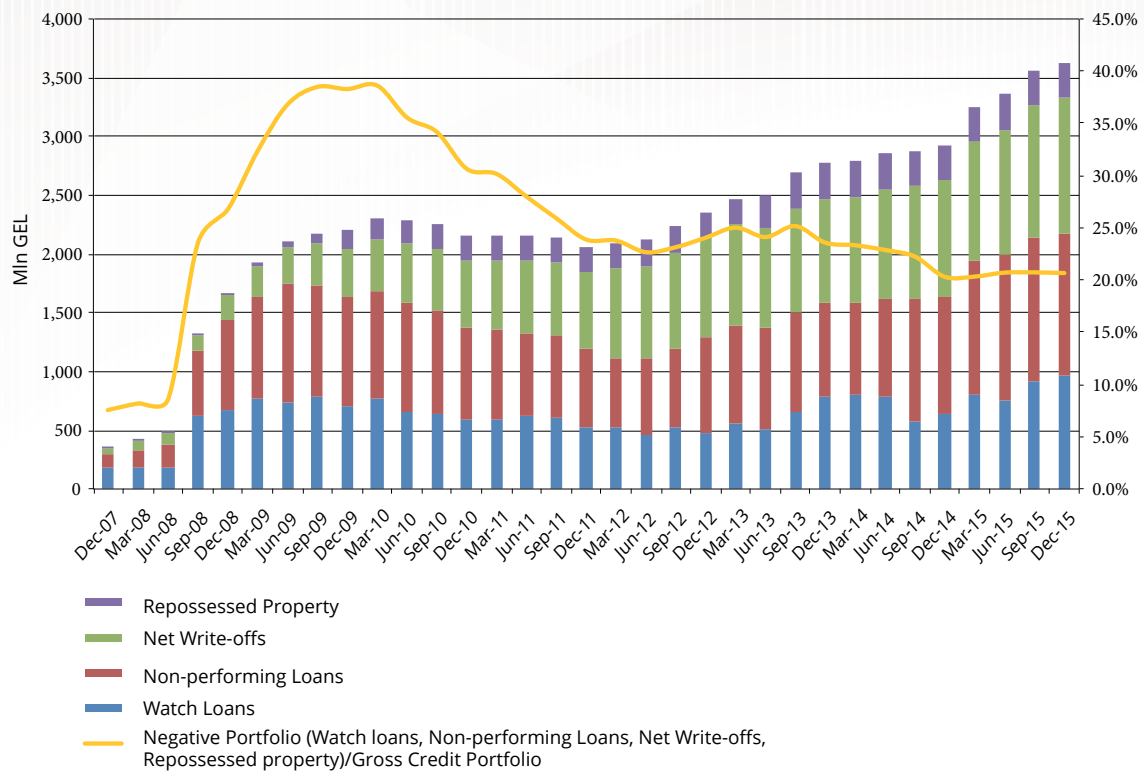
The net value of written-off loans increased insignificantly throughout 2015 when compared to the analogous figure from 2014.

Diagram N 3.15 Write-off and recovery of loans

Source: National Bank of Georgia

24. The volume of loans after deducting the loan loss reserve.

Diagram N 3.16 Problem assets

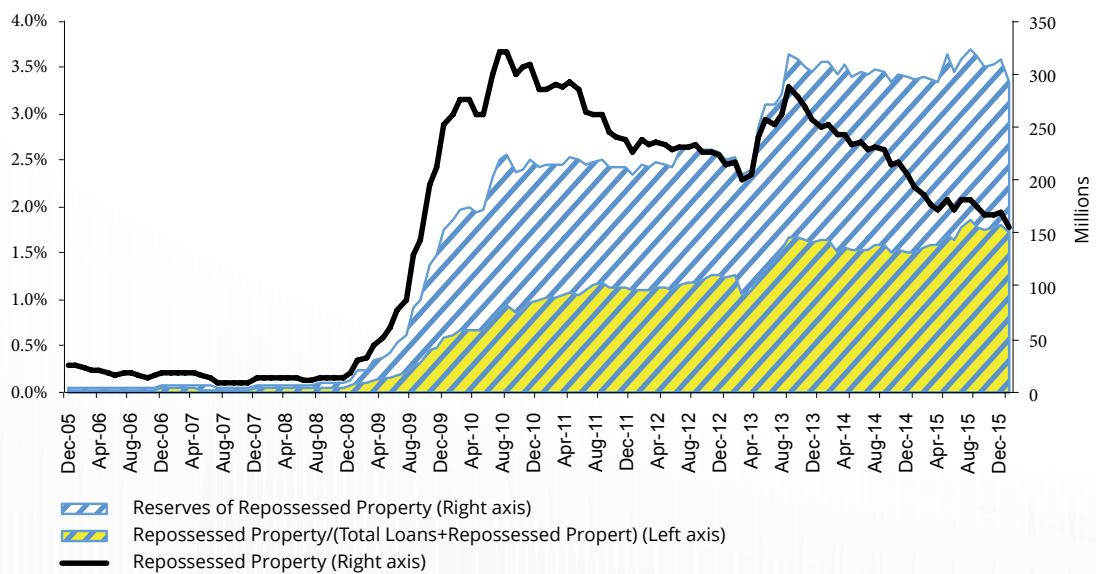


Source: National Bank of Georgia

As in 2014, the ratio of repossessed assets to the sum of loans and repossessed assets decreased

in 2015 and amounted to 2%. The main reason for this was the growth of the loan portfolio.

Diagram N 3.17 Repossessed property



Source: National Bank of Georgia

In parallel with the satisfactory qualitative parameters of the portfolio, in all three segments of the system (corporate, SME and retail), the debt burden of FX borrowers increased significantly due to the Georgian lari exchange rate depreciation. However, the qualitative parameters of the portfolio did not significantly deteriorate. The following factors played an important role in maintaining the satisfactory quality of the loan portfolio:

- Nominal growth of GDP;
- Established practice, according to which a borrower must have healthy financial performance and the ability to absorb shocks in order for the loan to be classified as “Standard”;
- Existence of relatively strict requirements with regard to unhedged borrowers. This entails somewhat different approaches to credit standards, as well as the practice of more actively taking foreign currency risk into consideration when disbursing loans, in parallel with the development of supervisory stress-tests;
- A high level of liquidity in the system throughout the year, which did not hinder refinancing/restructuring activities, and which supported the softening of the balance sheet effect of the Georgian lari exchange rate for economic agents;
- Relatively low maturity of the loan portfolio, which was an additional means for easing the debt burden;
- Time interval after 30% and higher depreciation;
- Usage of existing savings for debt servicing;
- In parallel with the increased debt, the drop of other consumer or capital expenditures;
- The drop of oil prices, which positively affected both businesses’ and retail borrowers’ cost structure;
- Interest rates decreased significantly over recent years, which improved borrowers’ capacity for servicing financial liabilities;
- A drop of dollarization levels in comparison with previous years;
- Prior to the Georgian lari exchange rate depreciation, the growth of the loan portfolio was not significant; after the exchange rate changed, the portfolio growth remained positive;
- The share of pro-cyclical sectors with regard to the loan portfolio and supervisory capital dropped (the volume of losses on pro-cyclical sectors is historically high in comparison with other sectors).

In addition, it must be pointed out that the growth of the debt burden, as a result of the Georgian lari depreciation, will negatively affect the rate of loan portfolio growth in following periods. Taking active steps in terms of decreasing the debt burden (deleveraging) can create balance sheet recession risks.

Taking into account the events that unfolded in the region, the exchange rate depreciation, and current conditions on the global commodities market, the following sectors are actively monitored by the National Bank: real estate development, real estate management, construction companies, heavy industry (companies export-

ing commodities), the hotels and tourism sector, and wine export industry; the NBG also closely monitors the growth rate of the retail debt burden and real estate prices in terms of the value of underlying collateral. In contrast to previous years, as a response to recent events, loan portfolio monitoring became a continuous process within the frames of the supervisory process. Critically important figures of the portfolio were continuously updated in order to control credit risk portfolio quality as fully as possible. Significant attention was paid to identifying potentially weak borrowers. Borrowers whose financial position had deteriorated significantly as a result of the Georgian lari exchange rate depreciation, but whose ability to repay had not been jeopardized, fell into this category of borrowers.

Alongside the lari depreciation, a reduction of USD denominated leases was observed in the real estate management sector. In parallel with the growth of the debt burden as a result of the exchange rate depreciation, USD-denominated lease obligations also became a significant burden. Adjusting lease contracts thus became important for some borrowers. The drop of prices was also influenced by a significant growth in the supply of commercial real estate.

The drop of sales caused problems in the real estate development sector. The growth of supply in the short-term period remains an important issue and will place additional pressure on real estate prices in the medium term.

The significant growth of supply in the hotels and tourism sector in the medium term remains a pressing issue; its effect will likely overshadow the positive trend of the growth in the number of foreign visitors, and may materialize in the form of a significant credit risk for borrowers in this sector.

In parallel with the slowdown of the growth of the loan portfolio in 2015, competition increased even more, which enhances the risk of loosening credit standards. These conditions create inappropriate motivations for borrowers and weaken the debt servicing culture.

Throughout 2015, within the frames of the supervisory process and in parallel with the assessment of inherent risks, significant supervisory resources were directed towards the evaluation of risk management functions at commercial banks and the enhancement of the latter's efficiency. These evaluations entailed the analysis of the adequacy of supervisory boards, management functions and internal control systems to determine how well the practice established at a bank corresponds to its respective risk profile, size, and best international practice. Within the evaluation, particular attention was paid to the assessment of the soundness of risk management functions, including capacity to properly assess credit risks and balance sales.

Throughout 2015, active work on refinancing/restructuring issues was also carried out, the updated terms of which were introduced in 2014. This process is not yet finished and requires further intensive work in order to differentiate refinancing and restructuring activities as objectively as possible. In terms of refinancing/restructuring activities, throughout 2015 the National Bank was actively involved in the Supervision and Implementation Group (SIG) of the Basel Committee on Banking Supervision (BCBS), which works on harmonizing different definitions, including solving problems related to refinancing/restructuring on the international level.

Within the frames of the supervisory assessment process of Pillar II of Basel II/III, the "Instruction on Determining Capital Buffer for Concentration

Risk” came into force in 2015. This regulation is an important step in terms of concentration risk management. This document outlines guiding instructions for banks to start the timely calibration of requirements related to concentration risk,²⁵ the development of internal approaches and providing the reasoning behind them to the National Bank. This document particularly emphasizes single name and sectoral concentrations; however, banks should also assess geographic and other types of credit concentration. In addition, the regulation specifically addresses questions related to the formation of interrelated borrowing groups, including the question of their economic interdependence. The regulation specifically provides a rule for calculating the necessary capital for single name and sectoral concentration risks, which is based on the Herfindahl-Hirschman Index.

The regulation highlights the necessity for establishing principles for the qualitative assessment of single name concentration risk. According to the regulation, the purpose of the qualitative concentration is to require additional capital due to high levels of risk; however, in rare cases, if facts and satisfactory arguments exist, the possibility of its reduction may be discussed. For the purposes of qualitative concentration, it is important to take into account the borrower size, as far as that determines the probability of borrower default. There is no common approach regarding how a client risk profile changes in line with the growth of its size. More specifically, when sales drop during stress, small companies may prove more flexible in introducing changes in their activities, due to the small size of their inventory. While this may not be possible for large businesses, the latter have access to more resources and can therefore more easily overcome temporary difficulties. For the purpose of calculating

the necessary buffer for qualitative concentration risk, banks must establish their own internal models, in line with their own approaches. In particular, banks should take into account to what type of company (large or small) it would disburse loans to in a crisis situation. In the process of analysis and argumentation, banks must take into consideration historical dynamics, as well as future forecasts, in particular whether or not the same links will be maintained in the future. For this purpose, a bank should use its experience of previous years, when losses from large loans exceeded losses from the granular portfolio.²⁶ The qualitative assessment of the loan portfolio can also be performed through stress tests. In order to avoid potential overlaps, it is important that the buffer for qualitative concentration does not cover losses already included in stress tests.

In parallel with the abovementioned requirements, the National Bank welcomes proactive efforts of commercial banks to develop internal models, and will take these into account within the framework of the supervisory assessment program.

In 2015, the NBG continued actively working on the asset classification amendments initiated in 2014. These entail the implementation of quantitative indices (financial ratios) for identifying “standard” loans. The implementation of these changes will considerably support the more appropriate management of the system’s loan portfolio and improvement of its quality, including in terms of unhedged borrowers. The National Bank is working on different methods of implementing these updates, including their integration in the stress test framework.

As a response to the gradual growth of the debt burden, it is important to introduce legislative

25. Preliminary measurement of results.

26. The portfolio consisting of small loans.

changes that will enable credit information bureaus to better cover the non-bank sector. This is important for accurately assessing borrower creditworthiness, as well as for managing credit risks and objectively allocating credit resources.

3.4 MARKET RISK

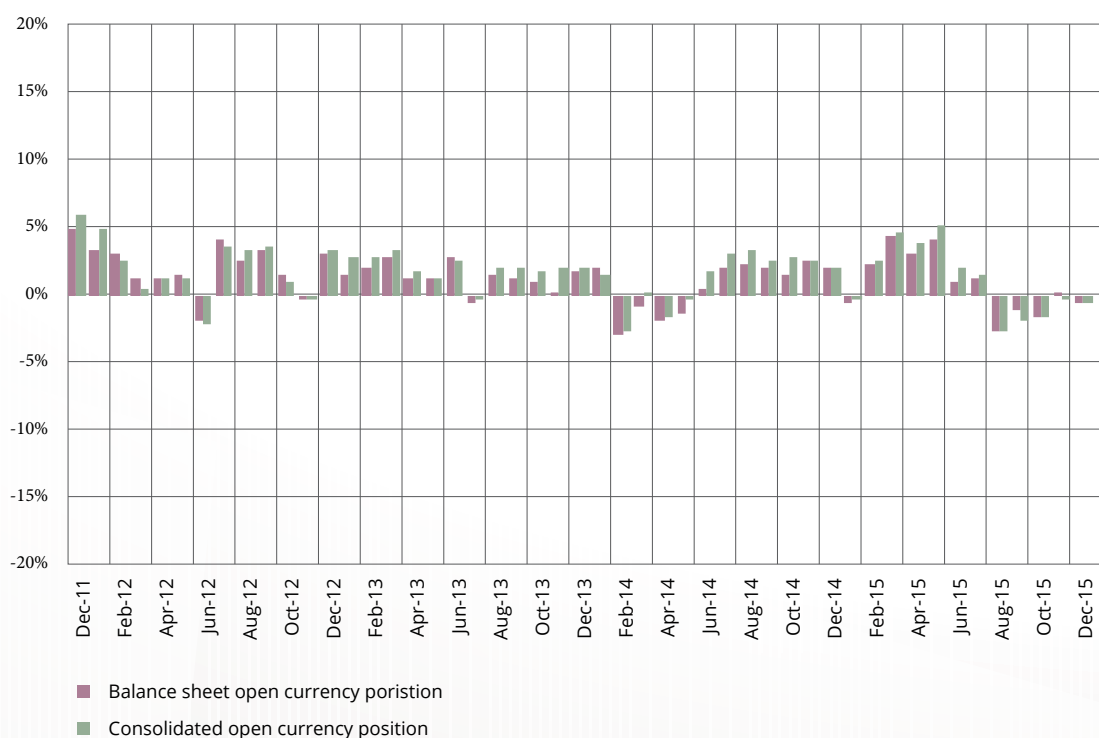
3.4.1 Foreign Currency Risk

The sensitivity of the Georgian banking system to FX risk is rather high. Considering the structure of financial market liabilities, the larization of loans remains at a low level (over 50% of loans to individuals and 35% of total loans). The NBG continues to direct its supervisory efforts towards improving its existing approaches to foreign exchange risk management. Particular attention is paid to the revaluation of foreign exchange reserves, the assessment of risks relating to structural position, and the improvement of banks' internal models. Throughout 2015, this

process became even more important due to the increased currency volatility in countries of the region.

The currency position calculated with the existing methodology is quite balanced on the systemic level. However, because gross loans (not net loans) are factored as assets when calculating the abovementioned position, and since loan loss reserves are formed in lari, banks' actual positions are short.²⁷ As a result, considering the revaluation of reserves, commercial banks are at a loss during currency depreciation. Furthermore, because the share capital is denominated in lari, the revaluation of risk-weighted assets due to currency depreciation significantly reduces banks' capital adequacy ratios. Credit risk caused by exchange rate fluctuations is a separate matter and is discussed in detail in the Credit Risk section of this report.

Diagram N 3.18 Balance sheet and consolidated open currency positions to regulatory capital



Source: National Bank of Georgia

27. In case of a short currency position, foreign currency liabilities exceed foreign currency assets.

3.4.2 Interest Rate Risk

Similar to previous years, in 2015 Georgian banks owned almost no trading securities. Because of this the banking book approach is used for banking supervision. Nevertheless, the NBG requires that banks with trading books develop relevant procedures and report to the National Bank. When significant growth opportunities are identified as a result of monitoring, regulations for the management of trading book risk will be enforced.

All other things being equal, if interest rates go up by 300 basis points, incremental losses will amount to an annual 58.2 million GEL, while the regulatory capital adequacy coefficient will decrease from 17.5% to 17.3%.

The aforementioned result accounts for the balance effect during the reporting period. The influence of interest rate shock on economic value – which is not directly reflected in profits and losses, but has an impact on a bank's market value – is also noteworthy. In this regard, based on existing assessments, a 400 basis point interest rate growth in lari, and a 200 basis point interest rate growth in foreign currency, have manageable results and fall significantly behind the 20% threshold of regulatory capital established by in-

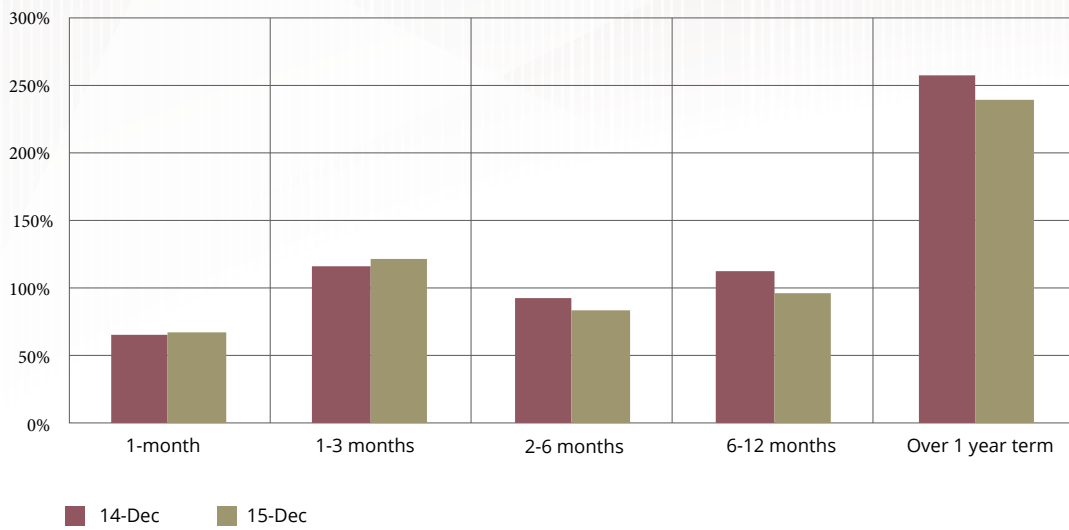
ternational standards. Therefore, the latter does not pose a threat to the stability of the system. Supervisory mitigation measures²⁸ are applied to those banks that have relatively high interest rate risks. When analyzing the interest rate risk stress scenario, attention is currently focused on the risk of a hike in interest rates, which is especially significant considering that monetary policy is tightening, risks are increasing due to regional fluctuations, and the United States Federal Reserve System started the process of increasing interest rates on the US Dollar.

Further, through the new Basel II/III capital framework, and as part of the capital adequacy internal management process, banks submitted their own calculations of interest rate risks for the purpose of supervisory review. In this regard, the evaluation process and the communication of the NBG's position with the banks continues. This process aims at supporting the establishment of foreign exchange risk management as an important and efficient way of mitigating risk at commercial banks.

Questions related to the difficulties of assessing and mitigating foreign currency risk are discussed in detail in the NBG's 2014 Annual Report.

28. Risk alleviation.

Diagram N 3.19 Interest bearing assets coverage of liabilities



Source: National Bank of Georgia

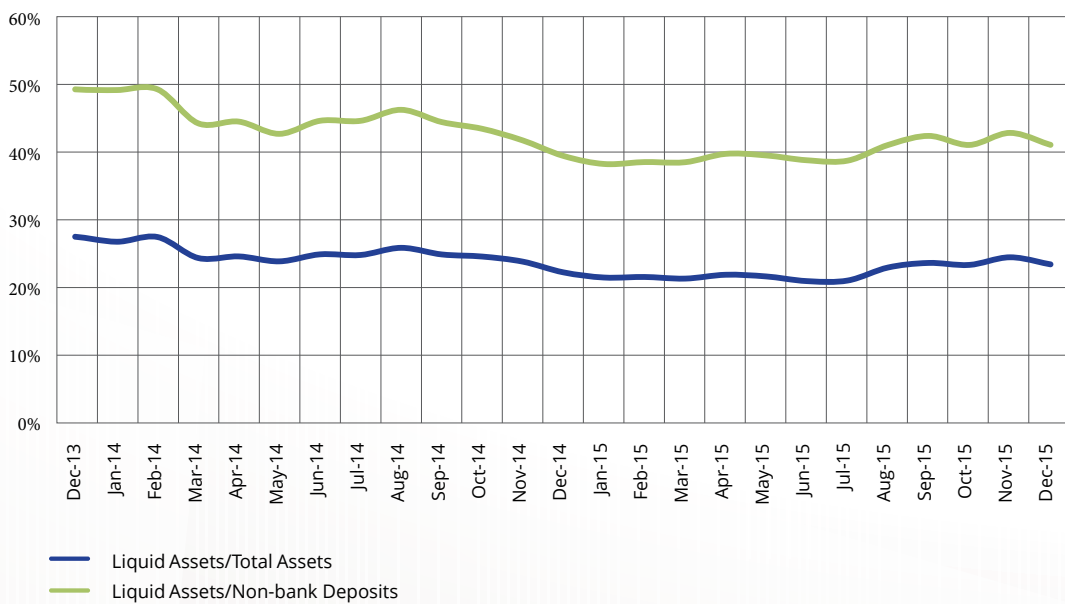
3.5 LIQUIDITY RISK

3.5.1 Structure of Liquid Assets

Throughout 2015, the volume of liquid assets was high and was characterized by minor fluctuations.

Liquid assets constitute 23% of total assets, which is sufficient to cover 41% of non-bank deposits.

Diagram N 3.20 Level of liquid assets

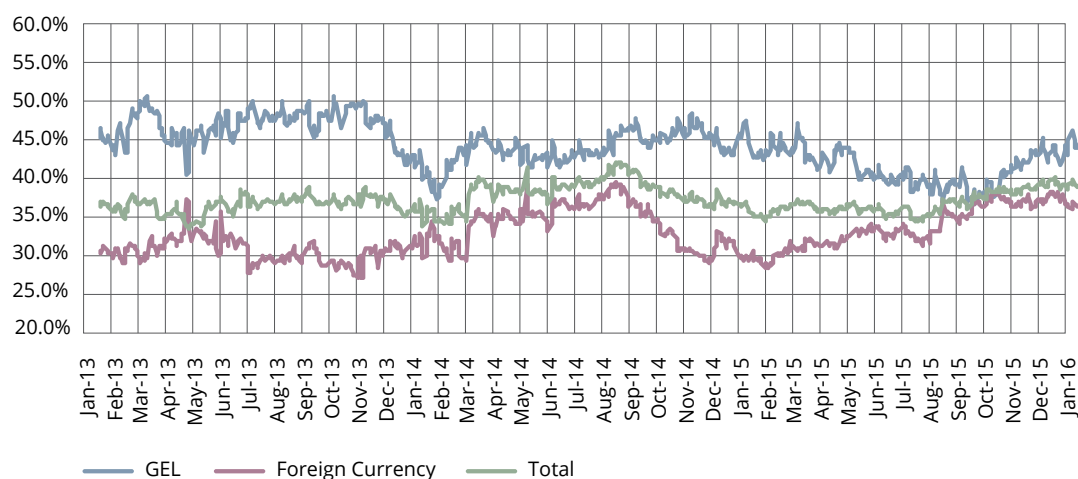


Source: National Bank of Georgia

Despite the stability of the total liquidity ratio, it is noteworthy that liquidity by currency was characterized by significant fluctuations. In general, the liquidity ratio in the national currency exceeded that of foreign currency, which was mostly a result of the short-term nature of lari-denominated liabilities with a high yield on lari-denominated liquid assets.

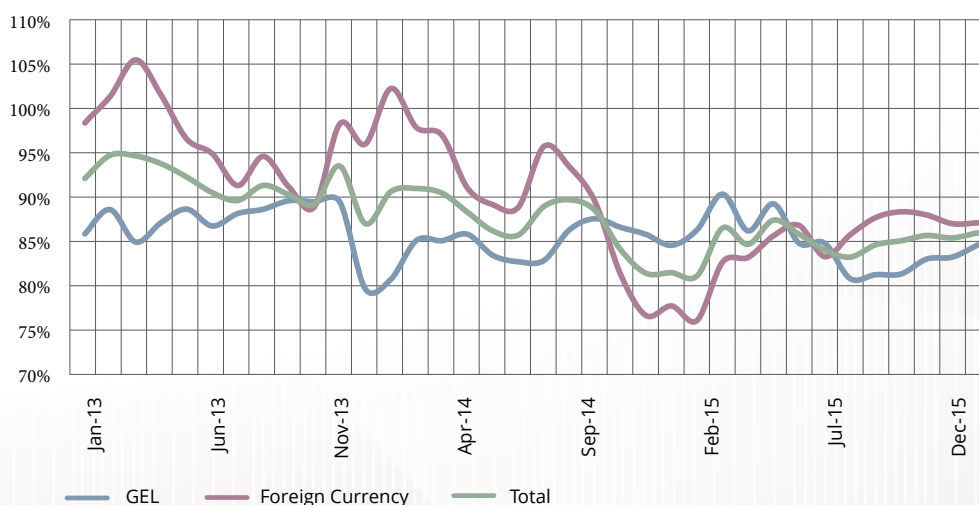
Demand for foreign currency loans dropped as the result of the Georgian lari exchange rate fluctuations and the slowdown of economic activities. This caused the growth of foreign currency liquidity throughout the year. The dynamics were also reflected on the maturity gap of less than one month and the structure of liquid assets has not changed significantly. Throughout the year, the National Bank continued to monitor liquidity by currency.

Diagram N 3.21 Liquidity coefficients by currency



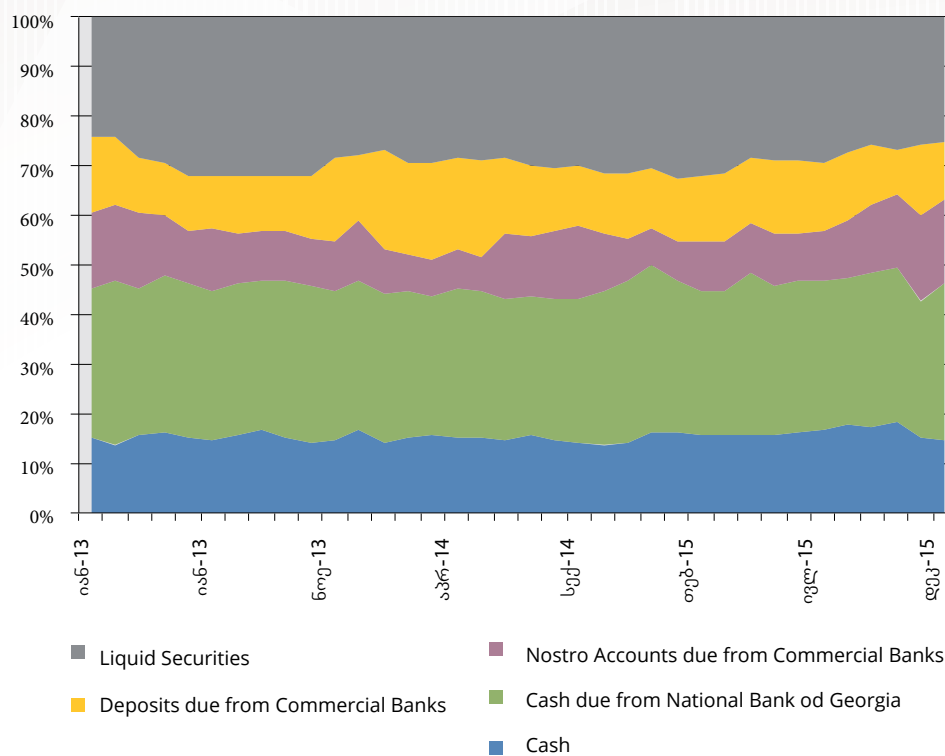
Source: National Bank of Georgia

Diagram N 3.22 Liquidity gap: assets with a maturity of less than one month to liabilities with a maturity of less than one month



Source: National Bank of Georgia

Diagram N 3.23 Structure of liquid assets

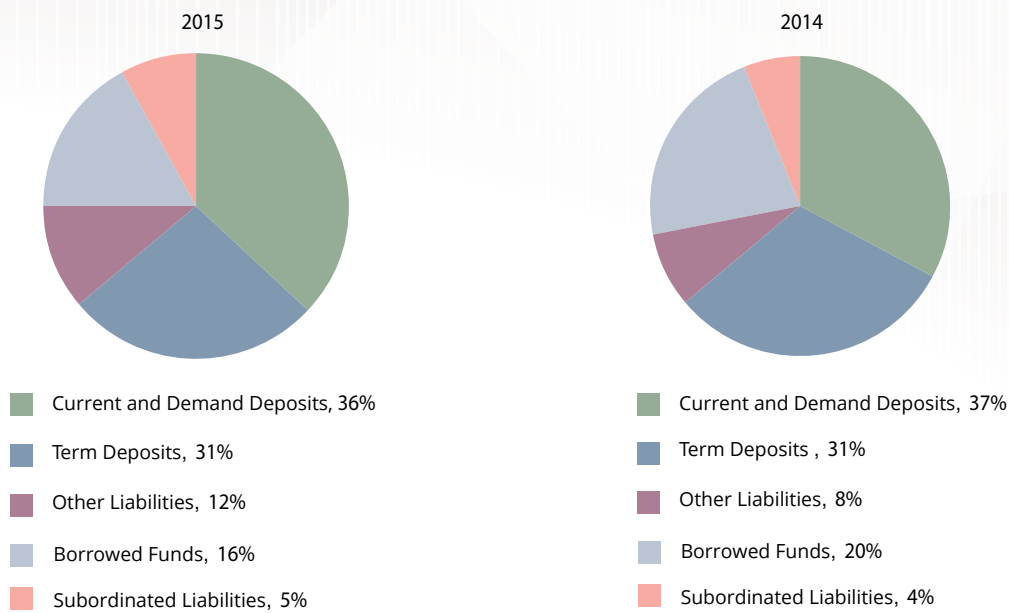


Source: National Bank of Georgia

3.5.2 Structure of Liabilities

There were no significant qualitative changes in the structure of liabilities in 2015 if we exclude the growth of the share of other liabilities (own debt securities) and the drop of the borrowed

funds (this is related to the reclassification of the specific instrument and does not change the total structure). In addition, banks maintained a comfortable level of liquid assets, which appropriately corresponded to the liability structure risks.

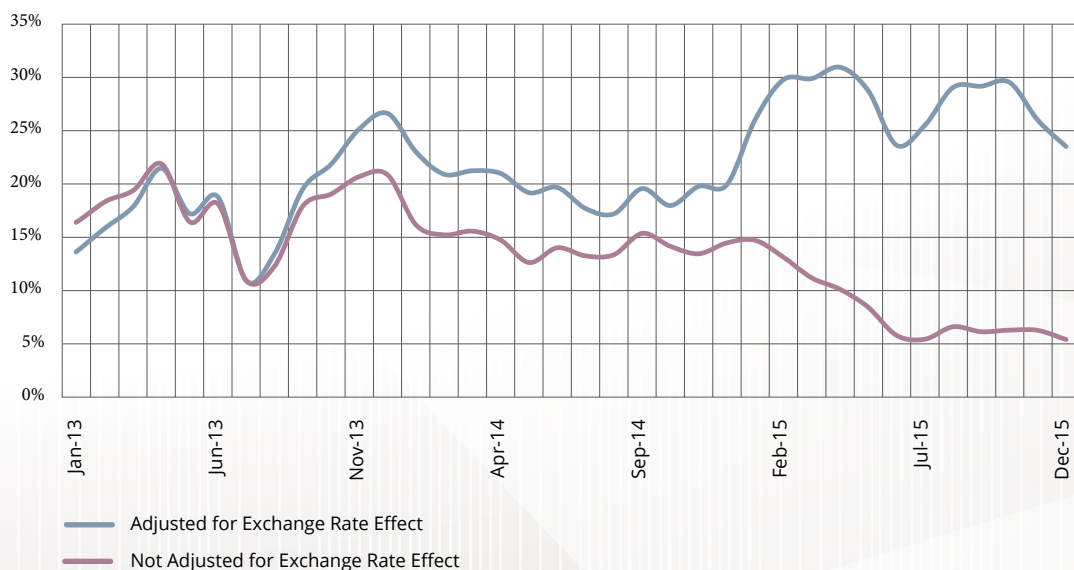
Diagram N 3.24 Liability Structure

Source: National Bank of Georgia

3.5.3 Retail Funding

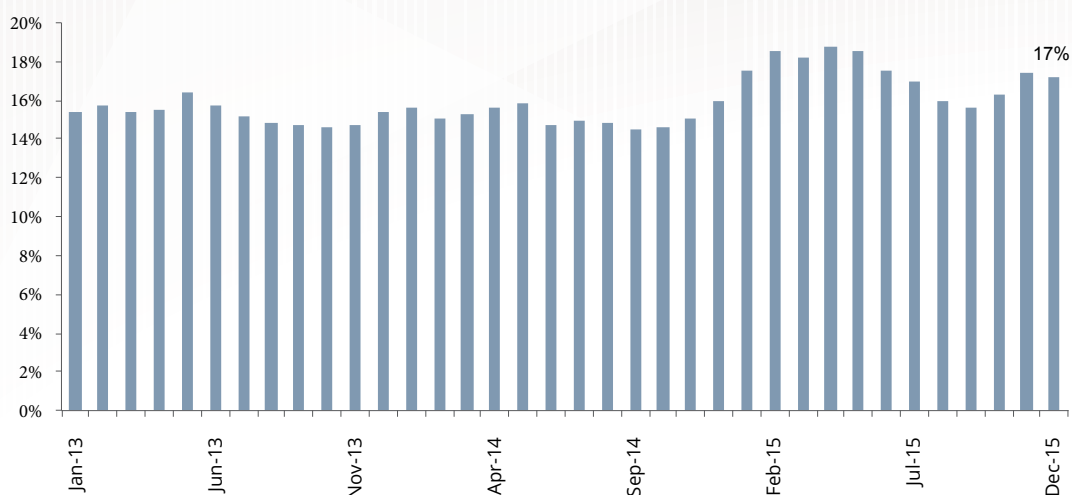
During 2015, the volume of deposits increased by 2.72 billion GEL (by 23%, or by 5.4% adjusted for exchange rate effects) and stood at 14.63 billion GEL by December. In terms of depositors' structure, the growth of deposits by individuals and legal entities amounted to 26.2% and 20.7% respectively (4% and 7% respectively when ad-

justed for exchange rate effects). The drop of the growth rate in comparison with previous years was primarily caused by the slowdown of economic activities. Due to exchange rate depreciation expectations, the dollarization of deposits increased in the second half of 2015 and reached 70% by December.

Diagram N 3.25 Annual growth of non-bank deposits

Source: National Bank of Georgia

Diagram N 3.26 Share of non-resident deposits



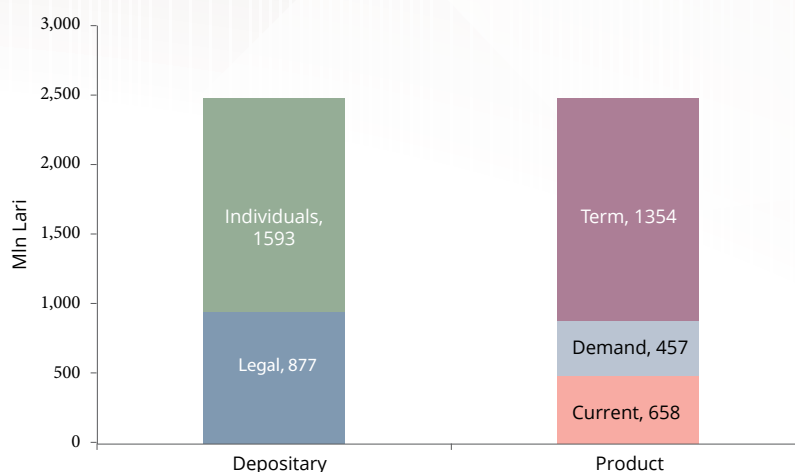
Source: National Bank of Georgia

The share of non-resident deposits in total non-bank deposits did not significantly increase in 2015, standing at 17.2% by December. These deposits were rather diversified in terms of country of origin, which is a positive factor in terms of risks. In addition, the share of term deposits remains high, which significantly reduces the risk of outflows.

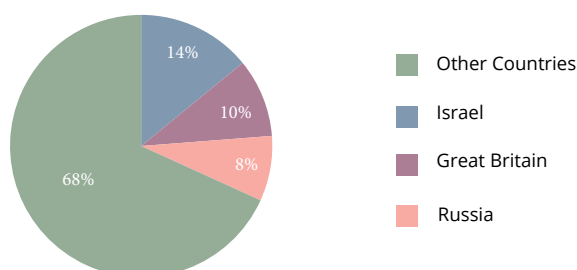
In order to prevent excessive dependence on this type of funding, the NBG maintains a requirement for additional liquidity for banks whose

share of non-resident deposits exceeds 10% of total non-bank deposits.²⁹ When calibrating this requirement, the fact that some non-resident customers are Georgians with foreign passports or Georgians registered abroad was taken into consideration. The necessity for additional liquidity in banks with a high share of non-residents reduces motivation to attract this type of deposit portfolio. Consequently, this was reflected in the stabilization of the share of non-resident deposits in recent years.

29. The liquidity requirement for non-resident deposits increases by as many percentage points as the share of non-resident deposits in total non-bank deposits exceeds 10%.

Diagram N 3.27 Structure of non-resident deposits (December 2015)

Source: National Bank of Georgia

Diagram N 3.28 Non-resident deposits by country (December 2015)

Source: National Bank of Georgia

3.5.4 Wholesale Funding

Throughout 2015, the ratio of loans to deposits remained stable.

Wholesale funding is diversified in terms of both lender type and residual maturity. Principal payment of Eurobond debt is concentrated in the 12-24-month period. It is expected that these funds will be refinanced before the maturity

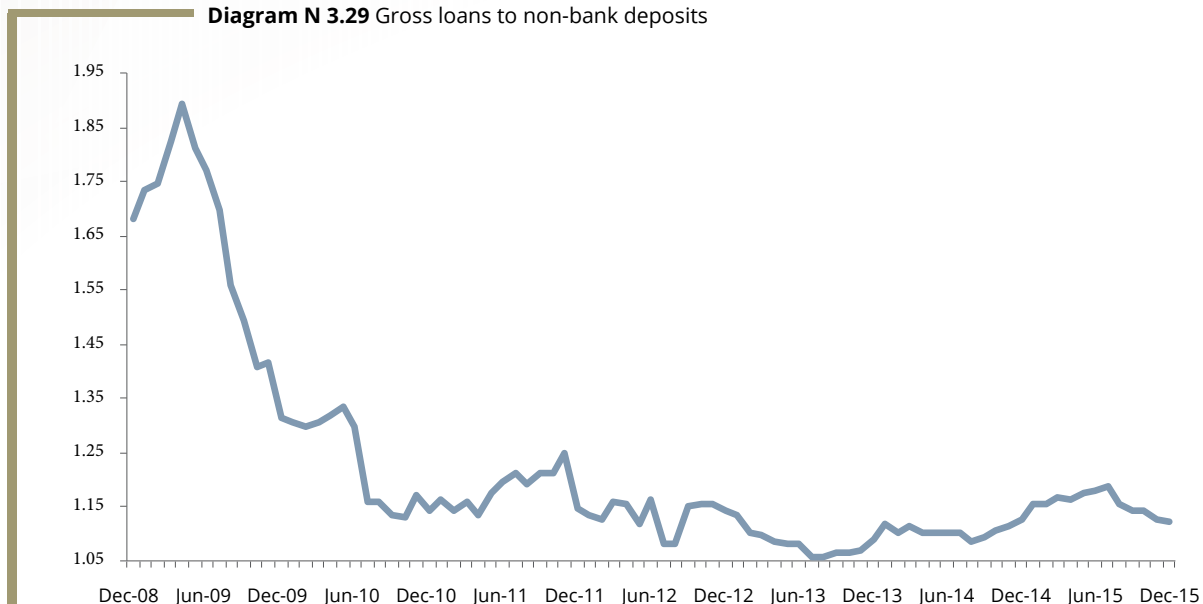
date. However, considering that the Eurobond issued by one of the largest Georgian companies matures at around the same time, the NBG will carefully analyze all possible scenarios and review their potential impact on the system's funding.

A total of 47% of wholesale funding is attributed to international financial institutions, 14% to par-

ent/related companies and 39% to other private institutions. The high share of international financial institutions and the long-term repayment schedule can be assessed as low-risk. Monitoring

of covenants³⁰ was regularly conducted and their effects were naturally included in the new framework of stress tests.

Diagram N 3.29 Gross loans to non-bank deposits



Source: National Bank of Georgia

Table N 3.6 External sources of wholesale funding and the repayment schedule as of December 31, 2015

Month	<1	1-3	3-6	6-12	12-24	24-36	36-60	>60	jami
Total	7.92%	2.89%	5.36%	13.86%	30.72%	12.90%	9.96%	16.39%	100.00%
International Financial Institutions	0.58%	1.17%	2.61%	4.90%	8.08%	10.56%	7.51%	11.93%	47.34%
Related/Parent Financial Institutions	3.42%	0.41%	0.34%	3.25%	1.43%	1.25%	1.04%	2.41%	13.55%
Other Private Financing	3.92%	1.31%	2.41%	5.71%	21.22%	1.08%	1.41%	2.05%	39.10%

Source: National Bank of Georgia

30. Restrictions established through loan agreements.

3.5.5 Regulation of Liquidity Risk

Throughout 2015, several amendments were introduced regarding liquidity supervisory requirements and a detailed analytical reporting form for separate categories of liquid assets and short-term liabilities was implemented.

Throughout 2015, the process of calibration and implementation of the Basel III's liquidity coverage ratio (LCR) in the banking system continued. This represents a modern and effective approach to short-term liquidity management (up to 30 days), and provides an opportunity for improved identification, assessment, monitoring and control of risks.

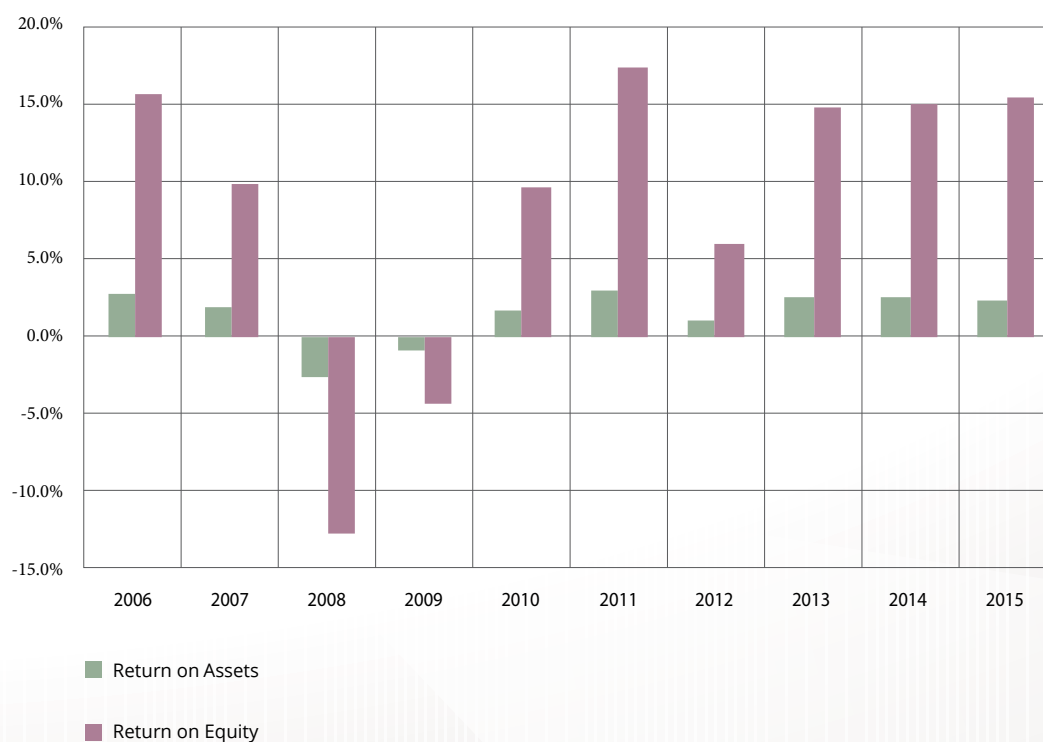
The implementation of the Liquidity Coverage Ratio (LCR) will significantly improve prudential supervision, but it must be taken into consid-

eration that this does not cover some integral aspects of liquidity risk regulation that receive attention during risk assessments, such as the concentration of payments for liabilities and actual contingency funding plans. In addition, after the LCR requirements are enforced, implementation of Net Stable Funding Ratio (NSFR) benchmarks is planned for the improvement of long-term liquidity regulations.

3.6 PROFITABILITY RISK

In 2015, the return on average assets and equity amounted to 2.3% and 15.4% respectively, which did not differ significantly from the figures of the previous year. The rate of banking system profitability has been stable in recent years and, in total, has approached the required return on equity for shareholders.

Diagram N 3.30 Return on assets and equity

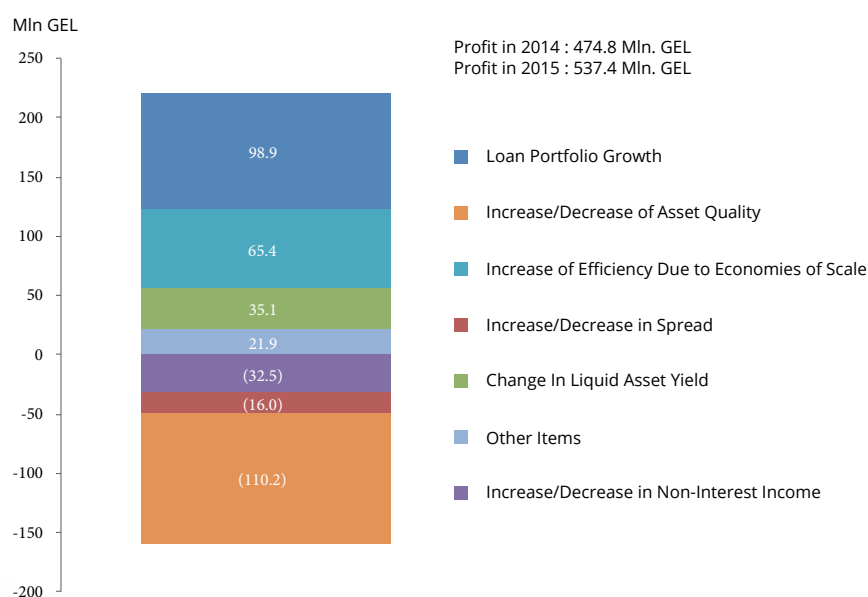


Source: National Bank of Georgia

The profitability of the banking system was positively affected by the growth of assets and the subsequent increase in effectiveness due to economies of scale. Alongside the growth of total assets by 22.1% and total loans by 23.1%³¹, non-interest expenses increased by only 12.6%. The increase of efficiency was reflected in the ratio of cost to income, which dropped from 49.6% to 46.6%. In addition, the liquid assets yield increased as a result of the higher interest income on interbank accounts and deposits, as well as the return on certificates of deposit and Treasury bonds. On the other hand, the improvement of

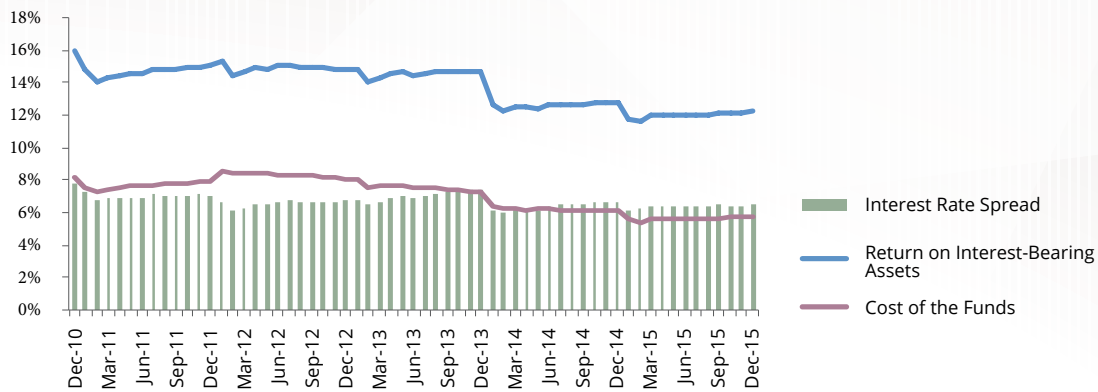
profitability in 2015 was negatively affected by a decrease of the interest rate spread, which was due to the relatively large drop in interest rates on loans compared to those on deposits. In addition, there was insufficient growth of non-interest income, compared to assets. However, the latter had little impact on profitability. Credit losses were mainly caused by the revaluation of possible loan loss reserves. Due to the deterioration of asset quality, significant negative effects are expected on profitability; however, the latter will not have a material negative effect on the stability of the system.

Diagram N 3.31 Decomposition of profitability growth

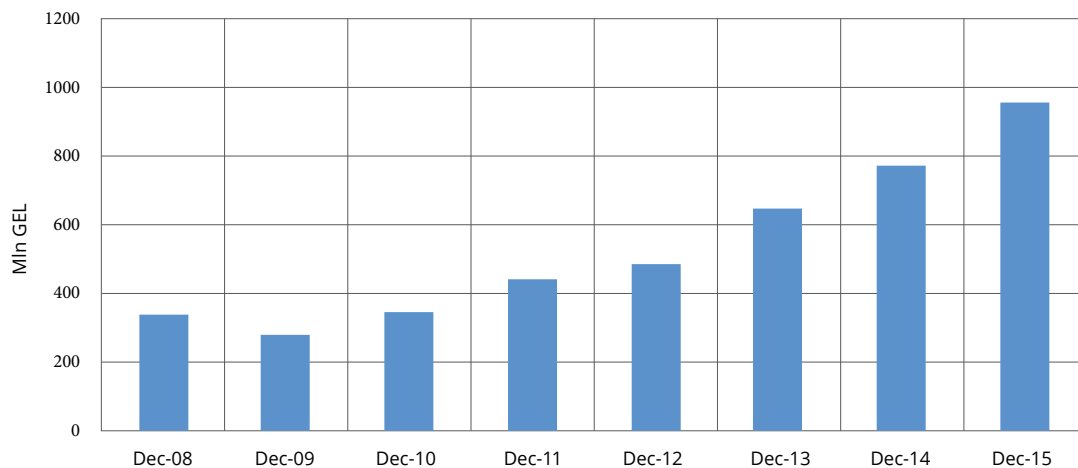


Source: National Bank of Georgia

31. Including the exchange rate effect.

Diagram N 3.32 Interest spread and factors affecting it

Source: National Bank of Georgia

Diagram N 3.33 Banking system net profit from operations³²

Source: National Bank of Georgia

In general terms, we can assess the impact of the depreciation of the Georgian lari on individual elements of the banking system. In particular, as far as reporting is made in the national currency, the interest margin of foreign currency loans and fee-based income on foreign currency operations, expressed in Georgian lari, increased. The income from currency revaluation and trading

operations also increased, which was partly due to the high spread³³ on currency conversions. However, both of these effects were exceeded by the revaluation of possible loan loss reserves on the foreign currency loan portfolio. As a result, total depreciation was negatively reflected on banks' profitability and reduced the ROE (return on equity) by 0.6% annually (see Diagram N 3.34).

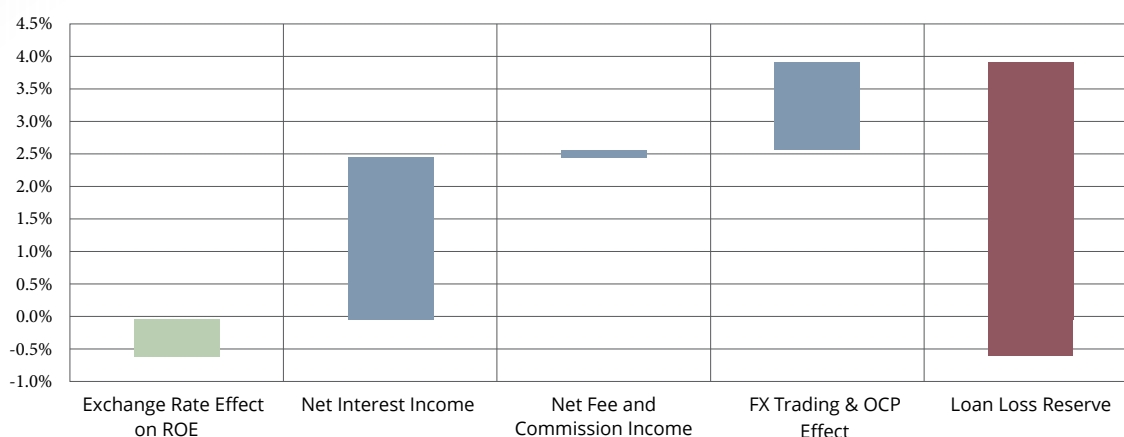
32. Profit before provisioning and one-time income/expenses.

33. Considering the exchange rate fluctuations throughout the year, the growth of spreads is natural; the latter, in turn, served as a hindrance to speculative conversions and the conversion of Georgian lari deposits to foreign currency deposits.

In addition, the debt burden of borrowers increased, which increased banks' credit risks in the following period. Furthermore, considering the existing ownership structure of the banking system, despite the positive ROE, non-resident shareholders faced material losses due to the revaluation of investments made in Georgian

lari, as far as it is impossible to insure these assets against exchange rate fluctuations due to the fact that a Georgian lari hedging market is virtually nonexistent. This was also reflected on the dynamics of Georgian banks' share prices on international markets.

Diagram N 3.34 Breakdown of FX Effect on ROE



Source: National Bank of Georgia

It must be pointed out that despite historically high losses from the business portfolio, and a high level of credit risk as a result of possible currency depreciation, interest rates on corporate loans remained at historically low levels. The main reason for this is acute competition in the banking system, which may weaken individual banks' market positions in the future, or encourage these banks to take excessive risks. Therefore, considering the risk-oriented supervisory principles, throughout 2015, significant resources were allocated to the discussion of banks' profitability forecasts and the analysis of individual institutions' business models and strategies; particular attention was paid to the following issues: the scale effect, existence of

market niche and/or other competitive advantages, and approximate evaluation of predicted loan losses. Supervisors also focused on risk mitigants³⁴, including the development of detailed pricing models for banking products.

3.7 OPERATIONAL RISK

Supervisory activities associated with operational risk management were ongoing during 2015. The implementation of an information systems (IS) audit of commercial banks can be highlighted as one of the most significant achievements during the reporting period. This type of audit has never been conducted in the Georgian banking sector before. In addition, considerable empha-

34. Actions that alleviate risks.

sis was placed on the improvement and testing process of commercial banks' business continuity plans. At the same time, the National Bank of Georgia continued studying the quality and accuracy of commercial banks' data and associated information systems; several commercial banks were assessed in terms of accuracy risk. Further, particular attention was paid to both the adequacy of the banks' reporting business processes and the possibility of optimizing existing processes.

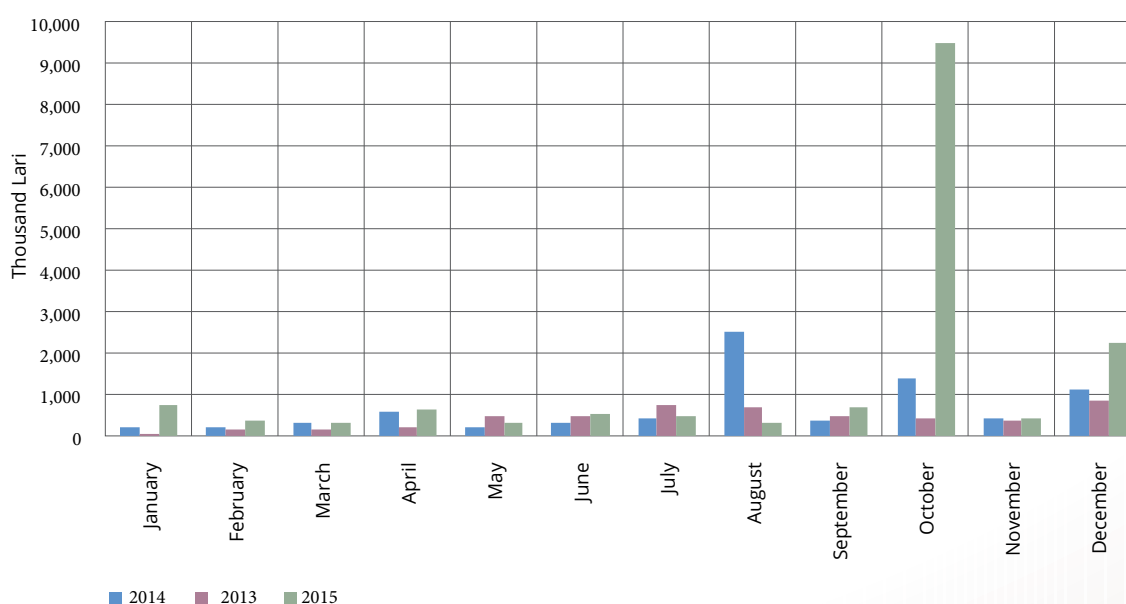
Overview of operational risk events

During 2015, the total gross loss from operational risk events in the banking system amounted to 16.5 million GEL. The ratio of annual total gross

losses to total gross revenues, calculated according to Basel II, amounted to 0.9%. Gross loss represents the initial amount lost related to an operational loss event, prior to any compensation/recoveries.

A total of 11,347 operational losses were reported in 2015. It should be noted that, according to the National Bank's operational risk reporting standards, commercial banks are obliged to keep a record of all operational loss events with a total loss equal to or greater than 10 GEL. The volume of the average loss amounted to 1,462 GEL during the reporting period (see Diagram N 3.35 below).

Diagram N 3.35 Dynamics of operational losses (2013-2015) (in GEL)



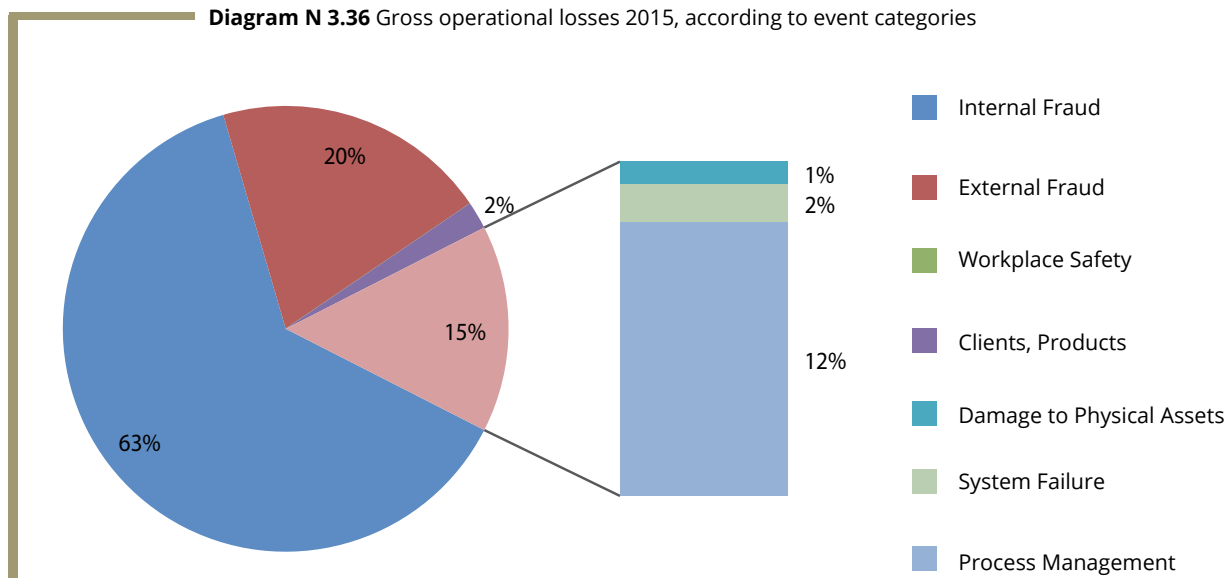
Source: National Bank of Georgia

Operational losses were predominantly observed in the retail banking business line, but were also present to some extent in the commercial banking business line. In addition to retail banking services, the retail banking business line includes operational risk-related losses associated with payment cards. The fact that the operating losses of the banking sector are predominantly found in the retail and commercial banking business lines, should come as no surprise. These two lines represent the main activities for Georgian commercial banks and the

other six business lines defined by Basel are not well-developed in Georgia.³⁵

If operational losses are divided in terms of loss event categories, the largest share of losses during the reporting year (63% of total losses) were attributed to internal fraud. The second largest category (27%) constituted external fraud, while the third most significant loss event category was execution, delivery and process management (12% of total losses). The breakdown of operational losses for 2015 are provided in Diagram N 3.36.

Diagram N 3.36 Gross operational losses 2015, according to event categories



Source: National Bank of Georgia

Business continuity management

Business continuity management is an integral part of the operational risk management framework at each commercial bank. The year 2015 was marked by the strengthening and improvement of business continuity management principles. Despite the fact that the active phase of the development process of banks' business

continuity plans was completed in earlier reporting periods, the quality of business continuity testing still remains relevant. In addition, the business impact analysis and risk assessments constitute a cyclical process, requiring active monitoring and supervision. Based on the information provided above and considering the existing environment, the National Bank continues

35. BIS Basel document 8 appendix 8 gives detailed description of Basel Business lines (<http://www.bis.org/publ/bcbs128.pdf>)

to proactively supervise the business continuity management process.

Outsourcing

The National Bank of Georgia assesses the outsourcing risk of commercial banks on a regular basis. Several commercial banks' outsourcing contracts and related business processes were assessed during the reporting period. In this respect, the existence of adequate risk assessment processes is crucially important. It should be noted that commercial banks should carry out a risk assessment before signing outsourcing contracts.

Accuracy risk

One of the priorities of the National Bank of Georgia is to study the quality and accuracy of banking sector data. Along with other risks, accuracy risk is of particular importance in terms of integrity risk, since financial data must be protected and free from unauthorized modification. The National Bank actively assesses the quality of the data of different financial institutions; at present, the accuracy risk of reporting was assessed in terms of supervisory capital adequacy. Within the assessment process, the NBG pays considerable attention to the viability and efficiency of the business process in terms of reporting. At the same time, the NBG monitors the level of automation and complexity of commercial banks' electronic information systems.

Information systems audit

Information systems audits play an extremely important role in modern risk management processes within commercial banks. The information systems audit covers, among other topics, the issue of cyber-security in commercial banks. According to the NBG's regulation on opera-

tional risk management, commercial banks are required to perform regular audits of their information systems. Commercial banks have started implementing these audits, which include topics such as business continuity management, information security and data quality.

Dependence on other critical sectors

Various sectors of the economy are inextricably linked with each other. As the banking system is highly dependent on other sectors of the economy, it remains important to assess risks directly linked to this dependence on the energy, information technology (IT), transport and communication sectors. It is advisable to establish close relations with representatives of these critical sectors, including the sectors' relevant regulatory authorities, in order to improve coordination and supervision-related activities.

International cooperation

The National Bank of Georgia's Operational Risk and Information Processing Division maintains permanent contact with various European central banks and other banking supervision authorities. The division regularly conducts international seminars on various topics associated with operational risk management. At the same time, international supervisory authorities and international financial institutions organize operational risk management seminars at the NBG. In 2016, the division plans on taking part in a number of international seminars in order to share its own experiences and supervisory approaches.

External loss database

It is essential to develop an external operational loss database as no such database is currently available in Georgia. An external loss database

will allow banks to use the information included to improve their operational risk management practices and this will aid the development of operational risk capital models. Moreover, such a database will allow all banks to compare their operational loss data with the aggregated banking system data.

Awareness-raising initiatives

The National Bank is actively working on raising levels of awareness associated with operational risk. Several key aspects of operational risk – including business continuity management, the role of cyber-security, and the complexity of information systems – were included in awareness-raising initiatives during 2015. Additionally, the NBG deems it necessary to raise levels of awareness associated with information systems audits. The NBG will continue to work closely with commercial banks in the foreseeable future to raise the level of awareness regarding information systems audits in both the banking sector and beyond.

3.8 MACRO PRUDENTIAL RISKS

The NBG continues the close monitoring of systemic risk indicators that may have a material impact on the banking system. The identification and monitoring of particular systemic risks is generally carried out by specialized groups. These groups, together with the supervisors, then monitor the banks in which systemic risks have been identified.

Information on these risks is provided in different sections of this report. Currently, the main challenges for the banking system are as follows: borrowers' increased debt burdens due to the Georgian lari exchange rate depreciation against the US dollar; further exchange rate fluctuation

for unhedged loans; a slowdown of economic growth and the negative impact of balance sheet effects on business activities; acute competition in business lending against deficiencies in pricing models for banking products; a spike of interest rates on global markets; large-scale fraud on a system-wide level; an increase in unregulated non-bank financial intermediation; and current risks in the region.

During the risk assessment process, in addition to general macroeconomic parameters, trends in individual sectors are taken into consideration. In this regard, real estate market dynamics – where demand fell against the background of exchange rate fluctuations and economic slowdown – requires particular attention. Residential apartment prices and rental prices, expressed in the main transactional currency, US dollars, dropped significantly; however, when expressed in Georgian lari the figure still exceeds last year's analogous figure. Against the backdrop of the slowdown of mortgage loan activities and the increased number of permits given for the construction of residential apartments, the risk of a further reduction of prices is quite high, which is risky for loan portfolios collateralized by real estate. In addition, the NBG closely monitors growth dynamics in the construction of high-end hotels, which, in the event of a reduction of tourist inflows (due to the situation in the region), may lead to an excess of supply due to the low occupancy rate of the hotels. Although the financing of this sector by commercial banks is limited, should a negative scenario materialize it will have a significant negative effect on the profitability of commercial banks.

Within the framework of the forward-looking supervisory approach, periodic reviews of the main parameters of stress tests and their discussion with commercial banks are conducted.

Activities oriented towards the enhancement of micro stress tests are carried out in coordination with commercial banks. The NBG maintains a conservative approach regarding the elasticity of the exchange rate on non-performing loans.³⁶ Despite the fact that during the reporting period the share of non-performing loans in the total portfolio did not increase, the time lag factor must be taken into account (which is discussed in the credit section of this chapter). It is expected that the increased debt burden of borrowers will negatively affect the quality of the loan portfolio and bank profitability in 2016.

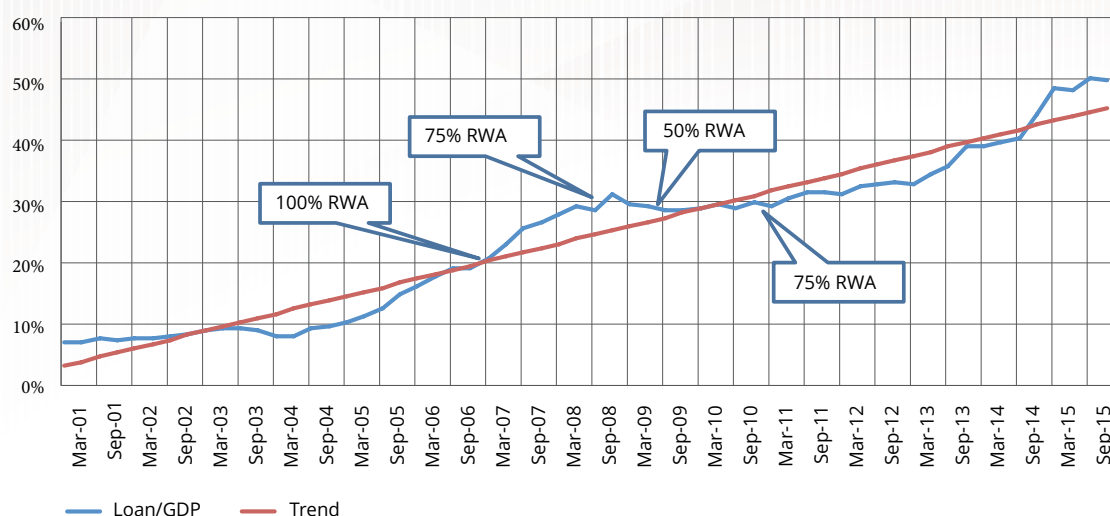
According to an analysis of various plausible stress scenarios, the banking system as a whole remains adequately capitalized, with the capital adequacy level close to the regulatory minimum. In addition, based on the existing ownership structure and expected support from international financial development institutions, and given the operational profitability and restructuring potential, the capacity for banks to grow their capital is substantial. In light of this, stress realization will materially affect the profitability of the sector; however, the stability of neither the system nor any individual bank is endangered. Furthermore, the scenario analysis included, amongst other things, spillover risks from other countries in the region. In this regard, banks do not have direct loans or exposure to other risks from these countries. As for indirect exposure to risks, the loans disbursed by banks to companies exporting to these countries account for a very small portion of their total loan portfolio.

Considering credit risk induced by currency mismatch, the National Bank maintains a conservative approach in form of additional capital requirements for foreign currency loans disbursed to unhedged borrowers. Within the frames of counter-cyclical supervisory approaches, the National Bank can, where necessary, temporarily soften additional market risk-weighting on foreign currency loans, in order to not reduce credit supply to the real sector. In parallel, it is naturally important to monitor loss realization and credit growth, which is the reason why these instruments are not immediately activated. Further, it must be taken into consideration that banks maintain buffers above minimum requirements. Banks' ability to increase capital when necessary can also be positively assessed.

For the purpose of monitoring credit cycles, the study of the loan/GDP gap, as calculated with the Basel methodology, continues. Statistically, this indicator well describes bank activities and also provides correct warning signals; however, it becomes less useful during exchange rate fluctuations in dollarized economies. Here too, the growth of the gap was mainly caused by the exchange rate effect. It is noteworthy that the NBG, in cooperation with commercial banks, is currently working on macro prudential instruments, including several coefficients that need to be observed during loan disbursement, as well as on limiting the growth rate of total retail lending (excluding mortgages). However, due to low levels of total lending activity throughout the year, no specific actions were taken. The NBG will observe the subsequent dynamics at the beginning of 2016, and will decide on the appropriateness of using this instrument.

36. During the stress-tests, elasticity within the range of 2.0-3.2 is used. According to economic literature, when considering the dollarization of the financial sector and the average debt burden, the experience of other countries is comparable. On the other hand, banks' internal assessments are less strict. In addition, a lower total impact is projected by the model that the IMF developed for the Georgian financial sector within its "Financial Stability Assessment Program." Nevertheless, the NBG maintains a conservative approach and relies more on its own assessments.

Diagram N 3.37 Loans to GDP gap



Source: National Bank of Georgia

Analytical activities were also enhanced within the non-banking financial sector. Studies undertaken on private lenders and pawnshops indicated that this segment has a material impact on the total debt burden of banking system borrowers, but the information on the liabilities of such clients are seldom provided to the credit reference bureau. As a result, banks cannot properly assess the creditworthiness of such clients. In order to overcome this problem, legislative amendments are planned in order to increase credit bureau coverage of the non-banking sector as far as possible.

3.9 CAPITAL ADEQUACY

Throughout 2015, the Georgian banking system maintained adequate capitalization in terms of the capital adequacy framework based on both Basel I and Basel II/III. The Tier I capital ratio, calculated with Basel I, exceeded 11% and the regulatory capital ratio reached 17.5%, which exceeded the NBG's minimum capital adequacy requirements by 3.4% and 6.1%, respectively. The Tier I capital ratio, within the frames of Basel II/III, amounts to 12%, while the regulatory capital

ratio amounts to 16.7%, which exceeds the NBG's minimum capital adequacy requirements by 3.5% and 6.2%, respectively (see Diagram N 3.38). The simple leverage indicator (capital/assets) was also high, reaching 14%; while due to high liquidity, the ratio of net loans to equity equaled 3.51. Capital growth resources are positively assessed in terms of both shareholder strength and profitability.

It must be pointed out that in 2015 commercial banks were required to meet 95% of the Tier I capital adequacy requirements within the frames of Basel I. Starting from 2016, the minimum requirements for Tier I capital and total regulatory capital based on Basel I, equal 7.2% and 10.2%. These requirements will be gradually phased out during the next two years, and, starting from 2018, will be fully replaced with the Basel II/III framework.

Throughout 2015, activities were carried out towards enhancing and developing the Pillar 2 elements of the capital adequacy framework based on Basel II/III. Within the frames of the aforementioned activities, the results of Internal

Capital Adequacy Assessment Process (ICAAP) presented by commercial banks were assessed. In particular, within the frames of the Pillar 2 Supervisory Review and Evaluation (SREP), relatively large commercial banks in the banking system were given comments on the ICAAP results they had presented, and were requested to update their ICAAP documents based on these comments. It is important to note that the development and enhancement of the ICAAP for commercial banks is a priority for the National Bank. This document, in addition to capital calculations made in consideration of a bank's risk profile, should support the improvement of risk management and corporate governance at commercial banks, as well as the involvement of the supervisory board in these activities. The risk appetite document approved by the supervisory board within the frames of ICAAP should represent the main risk management document for the bank. In order to support these objectives, the National Bank is planning to develop corporate governance and risk management framework guidelines.

For the purpose of developing and enhancing Pillar 2 elements within the frames of Basel II/III, the "Instruction on Determining Capital Buffer for Credit Concentration Risk for Commercial Banks" was signed into force in December 2015. This document includes instructions enabling banks to start calibrating requirements on con-

centration risk, developing internal approaches and providing the reasoning behind these to the National Bank in a timely manner.

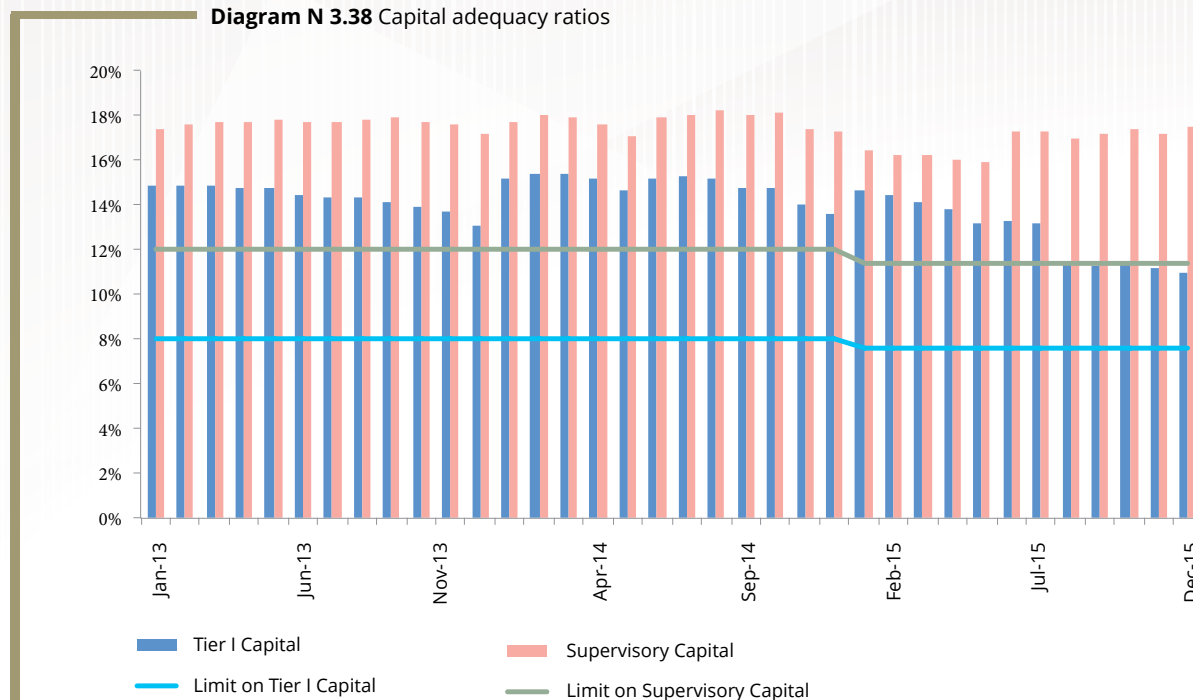
Development of guiding instructions is highly important for the reason that, within the frames of Pillar 2, banks are required to calculate capital even for those risks that are not covered by Pillar 1.

The capital within the frames of Pillar 2 of Basel II/III must reflect a sufficient amount necessary to cover all material risks of a bank. Despite this, the National Bank is gradually developing an approach that ensures the integration of supervisory stress tests³⁷ into Pillar 2 of the capital adequacy framework.³⁸ Enterprise-level stress tests allow for assessment of the effects of economic shocks of systemic and sectoral importance, as well as the effect of idiosyncratic events on a bank, and help determine the amount of capital needed in these scenarios. In addition to integrating supervisory stress tests in Pillar 2, it is necessary to avoid double capital requirements for similar risks. Therefore, the capital requirement calculated within the frames of supervisory stress tests will be established at such a figure that exceeds the total requirement of conservation and counter-cyclical buffers. The National Bank plans to continue working on fully implementing Pillar 2 of the capital adequacy framework.

37. Please see the supervisory stress test methodology in Box N3 of the 2013 Annual Report of the NBG.

38. For more details, please see the presentation titled "Building Supervisory Pillar 2 under GRAPE using Simplicity, Comparability and Risk Sensitivity Principles" on the following link: <https://www.nbg.gov.ge/uploads/publications/on/f/Building%20Supervisory%20Pillar%202%20under%20GRAPE.pdf>

Diagram N 3.38 Capital adequacy ratios



Source: National Bank of Georgia

3.10 FINANCIAL REPORTING AND TRANSPARENCY

Enhancing the transparency of the financial sector remains one of the top priorities of the National Bank of Georgia. To that end, relevant important reforms continue to be implemented. Throughout 2015, the NBG continued working on the transition of commercial banks' regulatory reporting requirements to International Financial Reporting Standards (IFRS). This initiative will ensure that the continuous regulatory reporting by commercial banks is based on the European Union reporting form (FINREP) that is prepared in accordance with IFRS. This will contribute to enhancing transparency and efficiency, and any double reporting burden will be avoided. At the same time, the NBG will maintain all existing prudential filters at its disposal in order to ensure that the risk-based supervision process continues uninterrupted.

In 2015, within the scope of the aforementioned project, the NBG developed a pilot version of the FINREP form. This is a modified version of the European Union's form that considers the specifics of the Georgian banking sector. The NBG conducted meetings with commercial banks in order to obtain their views on the FINREP form developed. Within the scope of the consultation process, a comparatively large number of representatives from the banking sector were tasked with filling out the pilot reporting form. Their doing so gives an opportunity to identify technical difficulties that will follow the transition of the reporting system to the IFRS. Once the filled-out forms are received and additional meetings are organized, the NBG plans to refine the forms based on comments received from commercial banks.

A high quality auditing process is an important prerequisite for the reliability of financial statements. With the growth of the banking sector's

assets and their complexity, supervisors and auditors face common challenges. Cooperation and information sharing is thus important for efficient and high quality supervision and auditing, especially in an environment where the professional services industry is self-regulated. Accordingly, in 2015 the National Bank continued its cooperation with external auditors of commercial banks in order to improve the quality and transparency of the annual financial statements.

In 2015, the NBG became a member of a temporary inter-agency group working on accounting and auditing reform issues. The working group's activities include ensuring the enactment of relevant reforms in Georgian legislation related to accounting, financial reporting and auditing, in order to gradually approximate these to EU legislation. In addition to participating in consultations held with accounting and auditing professional organizations, within the scope of its membership of the working group the NBG was also engaged in the process of developing new legislation related to reporting and auditing. The development of this legislation is an important step for enhancing transparency and improving corporate governance in real sector. This, in turn, supports various different directions in the country, such as loans, foreign direct investment, private capital and capital markets.

In 2015-2016, the Basel Committee on Banking Supervision (BCBS) concluded working on Pillar III of Basel II/III, which aims at improving transparency. Within the scope of the given pillar, commercial banks are obliged to publish quantitative and qualitative information on capital elements, risk-weighted assets, management remuneration and other material issues. In 2016, the NBG plans to develop a regulation on transparency requirements for commercial banks in accordance with Pillar III of the capital adequacy framework.

3.11 CONSUMER PROTECTION

Protection of consumers' rights is a priority area for the National Bank of Georgia. The year of 2015 was quite challenging in terms of consumer rights protection. In October, the results of the "Mystery Shopper" study, conducted by the National Bank and the Savings Banks Foundation for International Cooperation (SBFIC), were published. The study aimed at assessing the compliance of commercial banks' consumer protection practices with existing regulations. The study revealed that when providing banking services, commercial banks often violate the requirements of the rule on "Disclosing Essential Information to Consumers when Providing Services by Commercial Banks".

In response to these findings, the NBG reviewed and tightened existing consumer protection approaches. At the same time, the NBG carried out a number of activities in order to help eliminate the shortcomings revealed by the study.

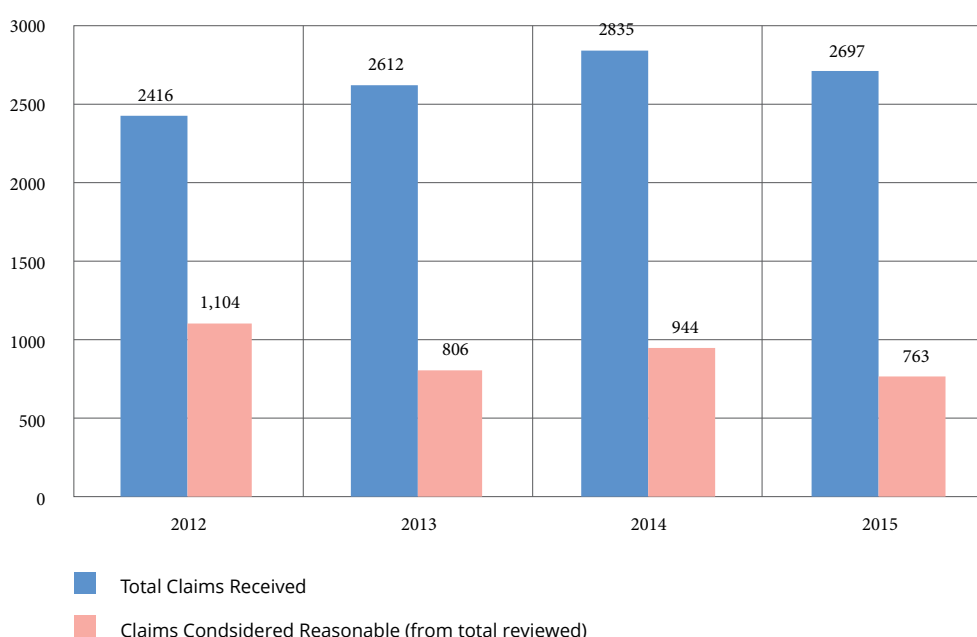
In 2015, companies offering small, short-term loans (so-called payday or "online" loans) remained active on the retail financial market. The National Bank actively studied these companies and, together with stakeholders, discussed the development of a relevant regulatory framework. At the same time, a number of legislative amendments concerning different credit institutions were developed with the aim of enhancing the regulatory framework for consumer rights protection.

During 2015, commercial banks received 2,697 complaints from consumers, which was 5% lower than the previous year's figure. Only 28% of the complaints received and reviewed were considered reasonable by the banks and were

resolved in favor of consumers – this figure is 5% lower than the analogous data from the previous year. If we look at the dynamics of all complaints (including reasonable complaints) received since 2012, It can be seen that up until 2015, there was a growing trend in the number of complaints received, while in 2015 this figure dropped for the first time; the number of reasonable complaints also declined. Although the 5% drop may point to

the possibility that commercial banks improved their capacity for resolving shortcomings in consumer service, based on the National Bank's observations, the drop is more likely caused by existing gaps in commercial banks regarding the consumer claims submission process – something that is confirmed by the results of the abovementioned "Mystery Shopper" study.

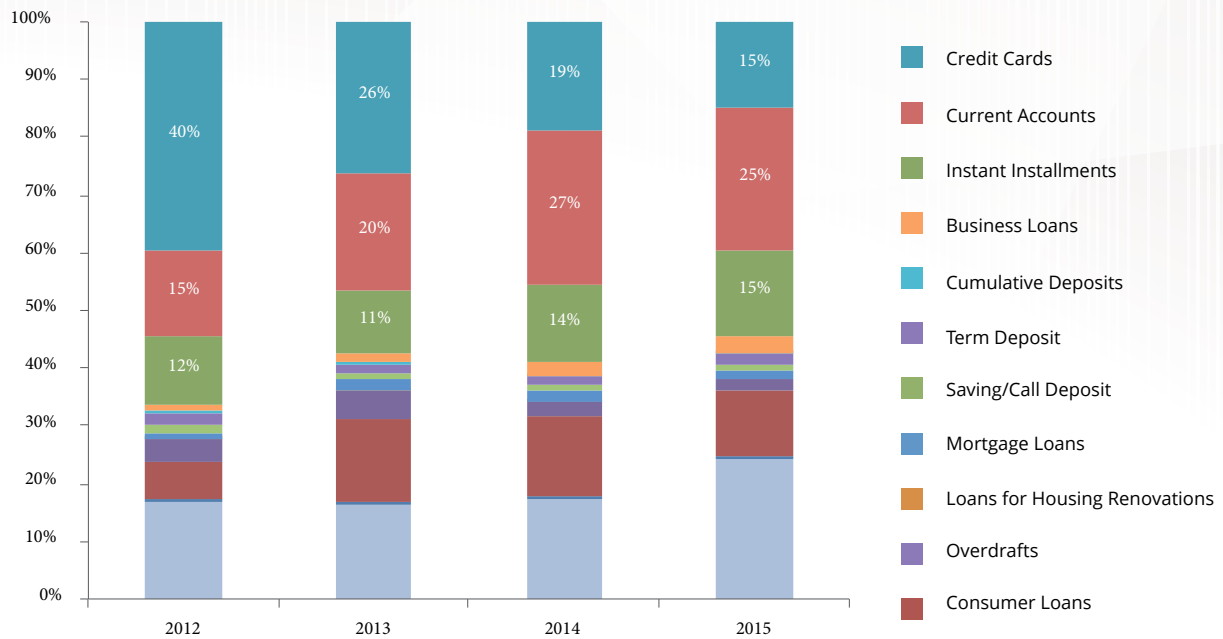
Diagram N 3.39 Total claims received and considered reasonable by commercial banks (2012-2015)



Source: National Bank of Georgia

It is also interesting to analyze the distribution of consumer claims according to banking products. The top three banking products in terms of the number of claims received remain practically unchanged over the years: 1) credit cards; 2) current accounts, and 3) instant installments. Between

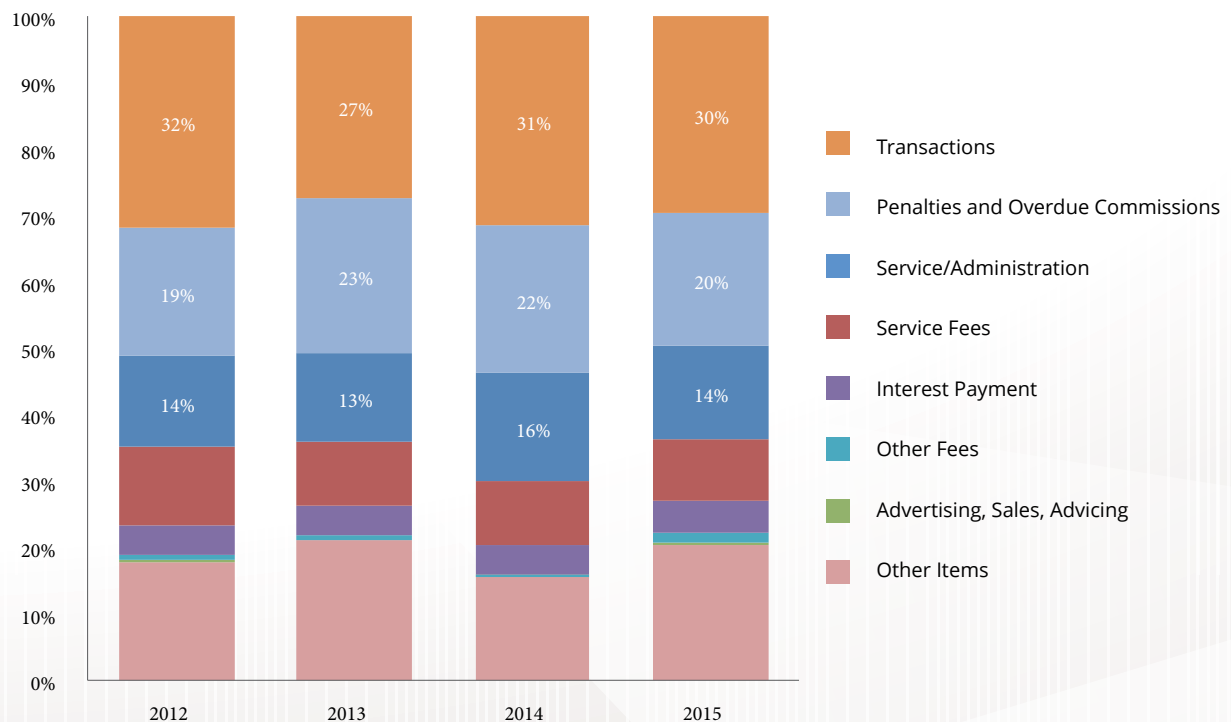
June 2011 and 2015, the share of claims regarding credit cards dropped from 42% to 15%, while the share of claims regarding current accounts increased from 19% to 25%, and the share of claims regarding instant installments increased from 10% to 15%.

Diagram N 3.40 Distribution of claims received by commercial banks by product type (2012-2015)

Source: National Bank of Georgia

Distribution of claims by content reveals that approximately half of the total claims received by commercial banks related to transactions, pen-

alties and commission fees. The share of claims regarding service quality is also noteworthy, and amounted to 14% on average.

Diagram N 3.41 Distribution of claims received by commercial banks by content (2012-2015)

Source: National Bank of Georgia

These statistics allow us to conclude that consumer complaints are often due to difficulties consumers have in understanding banking products (for example, credit cards) and related commissions. However, over time, consumers, as well as bank employees, become adapted to the banking products and, therefore, the number of claims drop. On the other hand, with increased consumption of banking products, the number of claims grows as well. It is thus important for the National Bank to monitor whether commercial banks provide consumers with accurate and easily understandable information regarding their banking products. At the same time, financial education and raising the awareness of the benefits of financial education in the population and among representatives of the financial sector remain priorities for the NBG.

The majority of claims, 719 (82%), were expressed over the phone; 90 claims were made in writing (10%); 41 consumers visited the NBG personally (5%); and 28 consumers addressed the NBG by email (3%).

In 2015, the Consumer Protection division of the NBG received 1,026 claims from consumers, which was approximately 17% more than the previous year's figure. The majority of claims, 798 (78%), were expressed over the phone, but the number of claims received via social networks increased. In 2015, for the purpose of providing consumers with qualified consultations, the NBG continued the practice of discussing claims in detail with the relevant financial institutions and other structural units of the NBG.

"Mystery Shopper" study

In 2015, the results of the "Mystery Shopper" study conducted by the NBG, in cooperation with the Savings Banks Foundation for International Cooperation (SBFIC), were published. The aim of the study was to identify gaps in commercial banks' compliance with the National Bank's rule on "Disclosing Essential Information to Consumers when Providing Services by Commercial Banks" when delivering banking services and to

respond to identified problems with appropriate measures.

The study was conducted in Tbilisi and other regions of Georgia, and covered six active commercial banks. According to the study's results, commercial banks formally take into account the requirements of the rule on "Disclosing Essential Information to Consumers when Providing Services by Commercial Banks"; however, the information disclosure process is repeatedly carried out with violations. Consumers are often not fully provided with important information on matters such as effective interest rates, foreign exchange risk, and financial costs. Moreover, when providing their services, commercial banks are not sufficiently proactive in offering their customers the option of making a claim/complaint.

In 2012, the NBG conducted a similar study also in cooperation with the SBFIC. The results of the 2015 study revealed that the deficiencies identified in the earlier study are still applicable and the compliance of commercial banks with the NBG's rule on "Disclosing Essential Information to Consumers when Providing Services by Commercial Banks" remains low. The NBG continues active monitoring and analysis of consumer protection practices and policies at commercial banks in order to help eliminate the identified problems.

Consumer protection workshop for commercial banks

For the purpose of discussing the results of the 2015 "Mystery Shopper" study in detail, the National Bank, with support from the SBFIC, conducted a two-day workshop for commercial bank representatives responsible for consumer protection. The following topics were analyzed during the meeting: the results of the study, the main shortcomings revealed, possible causes of the deficiencies and solutions to the identified problems. In addition, the attendees discussed how commercial banks train their staff in customer service and consumer rights protection. The National Bank assessed existing practices

of commercial banks and provided them with the main directions in which existing practices should be improved.

In addition, commercial banks were presented with the NBG's approaches to financial education, relevant projects that had been implemented, and existing initiatives.

3.11.1 Financial Education

Financial education constitutes one of the most important challenges for the country, which to some extent was confirmed by the results of the aforementioned "Mystery Shopper" study.

A financially literate person is a well-informed consumer. Financial education is thus in the common interest for the finance and education sectors, as well as for the economy and the country as a whole. Based on these considerations, since 2014 the National Bank has been actively working on developing a National Strategy for Financial Education with the involvement of different stakeholders from government, the private financial sector and civil society.

For the purpose of enhancing the levels of financial education in the country, in 2015 the National Bank of Georgia carried out a number of different activities and published various educational materials.

National Strategy for Financial Education

Throughout 2015, National Bank was actively working on the National Strategy for Financial Education, which defines the main principles and objectives of financial education, and establishes a list of potential stakeholders. The strategy also entails the development of specific action plans and programs.

The aim of the strategy is to enhance financial education levels in the country and thus help consumers make optimal financial decisions. The document is being developed by the NBG, with both local and international experts being involved in the process. The list of local stakehold-

ers includes both private and public sector representatives, and their active commitment to the project will be critical for its full implementation.

The strategy covers a range of target groups: the rural population, preschool and school age students and young people, people facing specific life decisions, etc.

Educational materials

Consumer protection education program

In 2015, with funding from the SBFIC and with support from the NBG and the Association of Banks of Georgia (ABG), a manual and a practical workbook on consumer protection, titled "Consumer Rights Protection in Banks", were finalized. The consumer protection education program includes both theoretical and practical exercises, and commercial banks actively use these when training their staff.

Brochures

In 2015, with support from the European Fund for Southeast Europe Development Facility (EFSE DF), the National Bank completed its work on educational materials for individuals and SMEs. A brochure for individuals will help them make informed decisions regarding mortgage loans, while a brochure for SMEs provides important advice regarding foreign currency financing of businesses. The brochures will be published in 2016.

Savings Calendar

The savings calendar is yet another interesting project aimed at the improvement of financial literacy. The calendar, developed with support from the SBFIC, teaches consumers 12 different practical methods for saving money.

Educational videos

In 2015, the National Bank started developing Georgian versions of Khan Academy educational videos on various topics from economics and finance. The process of developing Georgian versions of Khan Academy videos entails translating the original, English-language texts; adapting the content, so that it is better tailored to the inter-

ests and needs of local consumers (and the local market in general); and developing relevant visuals.

Khan Academy's target audience includes viewers with all levels of proficiency in given subjects. The video-lessons on economics and finance will not only improve consumers' general knowledge in these fields, but will also help them to make more informed financial decisions.

In December 2015, the National Bank developed five Georgian Khan Academy video-lessons; however, with assistance from the European Fund for Southeast Europe Development Facility (EFSE DF), it is planned to develop up to 40 more videos during 2016. The first five videos include the following topics: gross domestic product (GDP) and its components; simple and compound interest rates; the so-called "Rule of 72"; and the law of demand. The videos can be accessed on a YouTube channel created specifically for this purpose and on the National Bank's Consumer Protection webpage.

Global Money Week

In 2015, the National Bank of Georgia, in coordination with Child and Youth Finance International (CYFI), and in cooperation with the Children and Youth National Palace of Georgia, celebrated Global Money Week (GMW) for the second time. GMW is celebrated in many countries in the first half of March. The main objective of this event is to encourage the younger generation's participation in discussions on savings, changes in the economic system, and their financial future. The theme of GMW 2015 was: "Save Today. Safe tomorrow!"

Within Global Money Week, drawing, photography and essay competitions, public lectures, etc. were organized for the youth. The winners of these competitions were invited by the NBG on a field trip to the Cash Center of the National Bank of Georgia. Attendees were also given a lecture on the history of the NBG, its functions and savings culture.

World Savings Day

World Savings Day was celebrated for the fourth time in Georgia in October 2015. Celebrating this day is a good mechanism for overcoming the barriers between the population and commercial banks.

In 2015, the National Bank of Georgia, in cooperation with the SBFIC and five Georgian commercial banks (Bank of Georgia, TBC Bank, Liberty Bank, VTB Bank and FINCA Bank), conducted a range of events for World Savings Day. A national drawing competition was announced via social media; children submitted paintings on the topic of a "Dream piggy bank" and were encouraged to name their saving goals. The children with the best works were invited by National Bank to the Cash Center of the NBG, while commercial banks opened deposits for them and the SBFIC awarded them with gifts, including piggy banks created based on their drawings.

Instant "online" (payday) loans and other credit institutions

In 2015, companies that offer small, short-term (so-called payday) loans online remained active on the retail financial market. These organizations are widespread internationally, and the loans that they disburse are short-term with the goal of easing liquidity problems before payday. In some countries, the activities of such companies are not regulated, while in others they are partially regulated, or completely banned (for example, in some states of the US). Payday or "online" loans are associated with unreasonably high interest rates and fees. However, it should also be noted that these companies play a certain role in improving access to finance.

According to Georgian legislation, payday or "online" lenders are not regulated by the National Bank of Georgia. However, because of the risks associated with such companies' activities, and due to an increased number of complaints regarding them, the National Bank started studying the scale of the loan portfolios of payday

lenders in Georgia, and began developing a regulatory framework to protect consumer rights. Legislative changes are necessary for the implementation of the regulatory framework. In coordination with international organizations, experts and other stakeholders, it is planned to introduce legislative amendments that will cover all market participants, including microfinance organizations, and which will aim to disclose all necessary information (e.g., information on the effective annual interest rate) to consumers. It is important that legislative and regulatory changes enhance the transparency of the segment, and encourage consumers to make financially optimal decisions.

Credit bureau

Credit information bureaus constitute an important part of financial systems and more detailed information on them is provided in the sections on credit and macro prudential risks in this report. Healthy functioning of credit bureaus is highly important for the National Bank in terms of consumer protection and controlling over-indebtedness levels in the country.

All commercial banks and many other credit institutions cooperate with the credit bureau operating in Georgia. In addition to financial institutions, a number of insurance and leasing companies, public organizations and other institutions are involved in the data sharing system. Based on the National Bank's observations, complaints regarding the credit bureau have been quite common in the recent period. The credit information bureau does not have sufficient authority to collect full and comprehensive information from all relevant sources, with many credit organizations remaining beyond the credit bureau coverage, which jeopardizes the possibility of thoroughly assessing consumer creditworthiness. It is thus important to improve the regulatory framework for credit information bureaus in order to fix the

shortcomings regarding credit information sharing schemes.

3.12 INTERNATIONAL COOPERATION

Throughout 2015, the National Bank of Georgia was actively engaged in the main activities of the Basel Consultative Group (BCG)⁴⁰ of the Basel Committee on Banking Supervision (BCBS). The NBG first became a member of the BCG in 2014. Within the frames of this working group, NBG representatives actively participated in group meetings, where, in addition to developing modern approaches of banking supervision, experience and knowledge was shared.

The National Bank further enhanced its cooperation with the BCBS within the framework of the Regulatory Consistency Assessment Program (RCAP). The BCBS invited NBG representatives to serve as experts in the RCAP team that monitors and evaluates the consistency of the Basel III implementation process in Basel Committee member countries.

During 2015, the National Bank was also actively involved in the Supervision and Implementation Group (SIG) of the Basel Committee. In particular, the NBG was engaged in developing international standards of prudential approaches to asset classification.

In 2015, the export of the reforms implemented by the National Bank of Georgia in the direction of banking supervision increased. The NBG hosted representatives of central banks from different countries in order to present its reforms and share its experiences of banking supervision. In addition, NBG representatives conducted international seminars in different countries on the topic of banking supervision.

40. For additional information on the BCG, please see the following link: http://www.bis.org/bcbs/membership_bcg.htm. The BCG encompasses the following countries: Austria, UAE, New Zealand, Bulgaria, Germany, Colombia, Malaysia, Mexico, Norway, Peru, Poland, France, Georgia, Thailand, Tunisia, Hungary, the Philippines, Qatar, Chile, China, and the Czech Republic.



IV

NON BANK SUPERVISION



4.1 SECURITIES SECTOR

By the end of 2015, two stock exchanges, a Central Securities Depository, eight brokerage companies and three independent securities registrars were operating on the Georgian securities market. Of the eight brokerage companies, two were not members of the stock exchange. Registrars maintained the registry of shares of 828 joint-stock companies (JSCs), which are more by 10 than in the previous year.

The reporting year was noteworthy for the development of the debt securities market, and for the growth of investor interest in this field.

It must be mentioned that the investor-oriented reforms and regulations conducted during recent years to encourage the development of the market proved productive and ultimately yielded the results that were projected during the implementation of reforms.

In 2015, four different companies emitted obligations in form of public offerings. Four international financial institutions emitted obligations in form of private offerings that amounted to 203 million GEL. In addition, one company emitted stocks in the form of a public offering, with a total value of 20 million GEL.

Table N 4.1 Public emissions of bond

#	Issuer	Currency/Volume	Maturity	Nominal Value	Interest Rate(%)
1	JSC M2	USD/20,000,000	2	USD/1,000	9.50
2	EVEX Medical Corporation	USD/15,000,000	2	USD/1,000	9.50
3	FINCA Bank	GEL/20,000,000	3	GEL/100,000	10.10
4	GWP	GEL/5,000,000	2	GEL/1,000	14.00
5	GWP	GEL/6,000,000	2	GEL/1,000	NBG refinance rate +7.5%

Source: National Bank of Georgia

For the development of the corporate bond market it is important that there is consolidation of the actions of the state and market participants in forming the right establishment. In particular, it is necessary to determine the market values of securities and ensure transparency of prices, the education of market participants, access to information, transparency of issuers, etc. It should be noted that the development of a plan for the corporate bond market is an important part of the securities market development strategy. A group of specialists from various organizations continue to work on this strategy.

Given the tendencies of 2015, the corporate bond market is expected to grow rapidly in the coming years, which will contribute to the development of the stock market. The deepening of money markets, government securities, corporate bond and stock markets will promote the development of a financial derivatives market. In the initial phase of development, comparably simple instruments like FX forwards⁴¹ and swaps⁴² will be

desirable. In the later stages, more complex instruments like interest rate swaps and options⁴³ will be developed. Although this order may not be strictly observed, this path of development is expected given the pattern in other countries.

The development of both regulated exchange and non-regulated market (OTC) segments will be proportionately developed and neither will be artificially or administratively placed in a privileged position at the expense of other instruments. While financial instruments will be allowed to trade in both segments, some instruments will naturally be established on the regulated exchange segment and others on the OTC market. By adopting such an approach, all instruments will be given maximum opportunity for development.

One of the main purposes of the capital market development strategy is to establish Georgia as a regional financial powerhouse; offering investors a fair and sound legal framework, and an invest-

41. Currency forward transaction – a transaction for the purchase or sale of foreign currency that is settled within more than two banking days after the transaction is made.

42. Currency swap transaction – a transaction for the purchase or sale of foreign currency under preliminarily agreed terms for its further sale or repurchase.

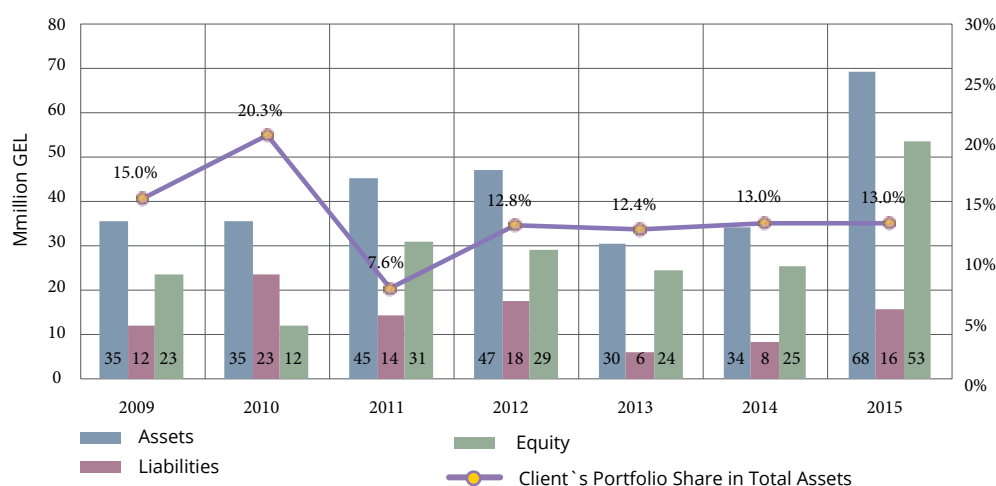
43. Option – a right, under a present contract, to enjoy an agreed future benefit under terms and conditions presently agreed or to choose not to enjoy such an agreed future benefit.

ment environment based on contemporary institutional governance, innovative and competitive service, and world-class financial infrastructure. The reinvigoration of the debt securities market influenced growth in the activities of market intermediaries. By 31 December 2015, the total volume of the assets of active brokerage companies amounted to 68.4 million GEL, which was 103% more than in the previous year. Total volume of liabilities increased by 86% and amounted to

15.6 million GEL. While total volume of capital amounted to 52.9 million GEL, which was 109% more than in 2014.

According to 2015 data, the consumer portfolio (cash and securities) comprised 13% of brokerage companies' total assets and amounted to 8.9 million GEL. It must be mentioned that the consumer portfolio to total assets ratio has not changed in recent years.

Diagram N 4.1 Information on brokers' total assets, liabilities and equity, and share of consumer portfolio in total assets (2009-2015)



Source: National Bank of Georgia

Table N 4.2 Brokerage company activities (2015)

Brokerage Company	Volume (number of securities)	Value(Gel)
JSC Galt and Taggart	70,037,813	444,688,820
LLC TBC Capital	837,257	119,249,840
LLS Liberty Securities	665,519,509	12,989,709
JSC Caucasus Capital Group	746,561	66,850
LLS Cartu Broker	62,637	44,096
LLS Abbey Asset Management	-	-
LLS Stocks	-	-
LLS Tbilisi Traders Club	-	-
Total	737,203,777	577,039,315⁴⁴

Source: National Bank of Georgia

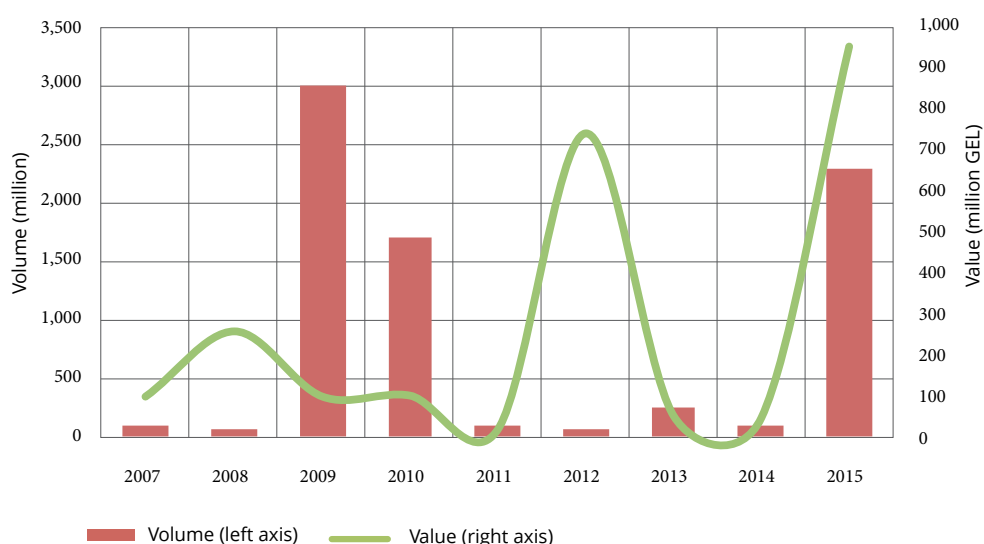
44. A significant portion of this value is related to operations carried out on the international market.

The value of securities (both over-the-counter and through the stock exchange) executed via brokerage companies amounted to 588 million GEL (737.2 million pieces). During stock exchange trading sessions, a total of 1.7 million GEL of deals (7.6 million pieces) were executed, while the remaining 575.3 million GEL of deals (729.6 million pieces) were made over-the-counter (OTC).

As of December 2015, the securities of 128 issuers were admitted for trade through the Georgian Stock Exchange (GSE). During the reporting

period, the total value of securities transactions amounted to 945.6 million GEL (2.285 million pieces). In comparison with the comparable data from 2014, the value of transactions increased 20 times and the volume increased 27 times. A total of 1.6 million GEL worth of deals were executed in stock exchange sessions and remaining 944 million GEL were transactions made OTC. In addition, registrars executed 105 OTC transactions on 5.3 million securities, which include the transfer of securities via inheritance, gifts and other transactions that are not executed on the stock exchange.

Diagram N 4.2 Main trade indicators (deals executed during trading sessions and outside the stock exchange) (2007-2015)

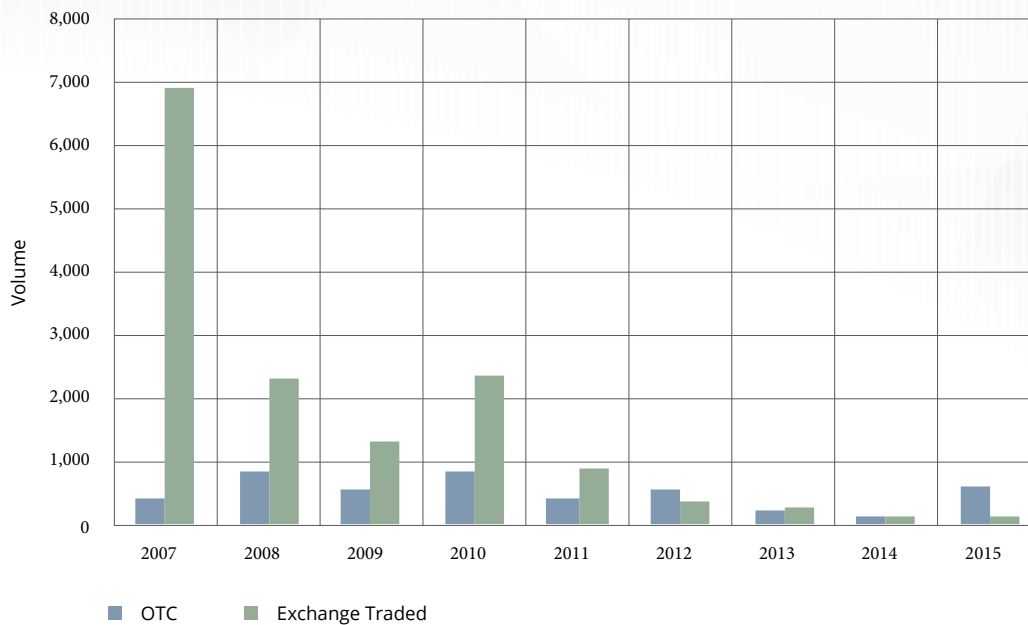


Source: National Bank of Georgia

Table N 4.3 Aggregate information on main indicators of trade concluded during trading sessions and outside the stock exchange (2012-2015)

Year	Number of Deals		Volume of securities (Number)		Value of securities (GEL)	
	2015	2014	2015	2014	2015	2014
At Stock Exchange	120	131	6,157,585	12,122,547	1,635,820	46,549,015
Outside Stock Exchange	579	115	2,278,584,220	73,306,185	943,987,562	942,647,422
Sum	699	513	2,284,741,805	252,679,511	945,623,382	52,485,730

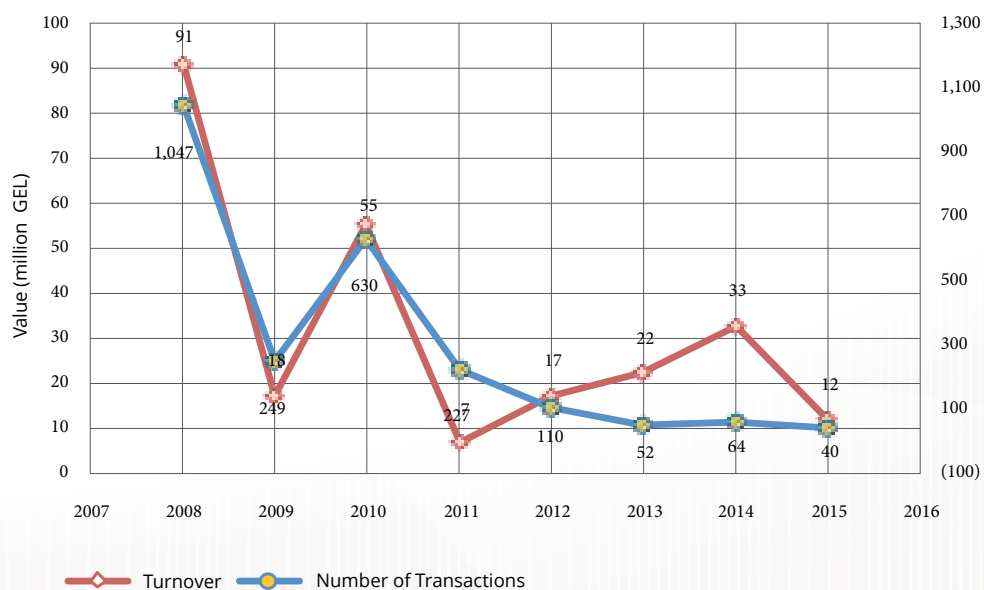
Source: National Bank of Georgia

Diagram N 4.3 Number of deals executed on and off the stock exchange (2007–2015)

Source: National Bank of Georgia

In 2015, 12.2 million securities (pieces) and 12 million GEL in cash were deposited in the Central Securities Depository. In comparison to 2014, the

number of securities transactions in the depository decreased by 23% and the turnover of deposited securities decreased by 63%.

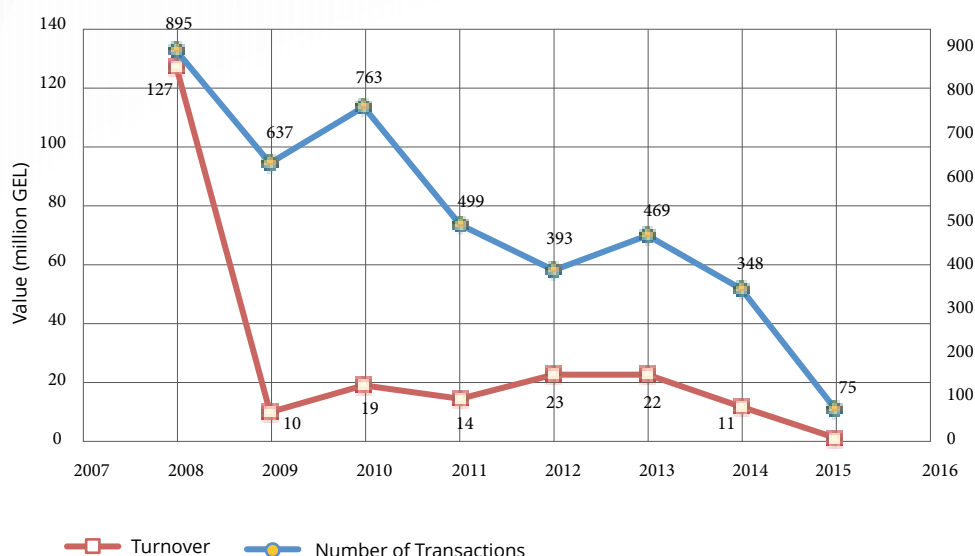
Diagram N 4.4 Turnover of securities deposited with the Central Depository (2008–2015)

Source: National Bank of Georgia

Turnover of funds in the Central Securities Depository in 2015 decreased by 10.2 million GEL

and the number of transactions fell by 26% in comparison with 2014.

Diagram N 4.5 Turnover of funds deposited with the Central Depository (2008-2015)



Source: National Bank of Georgia

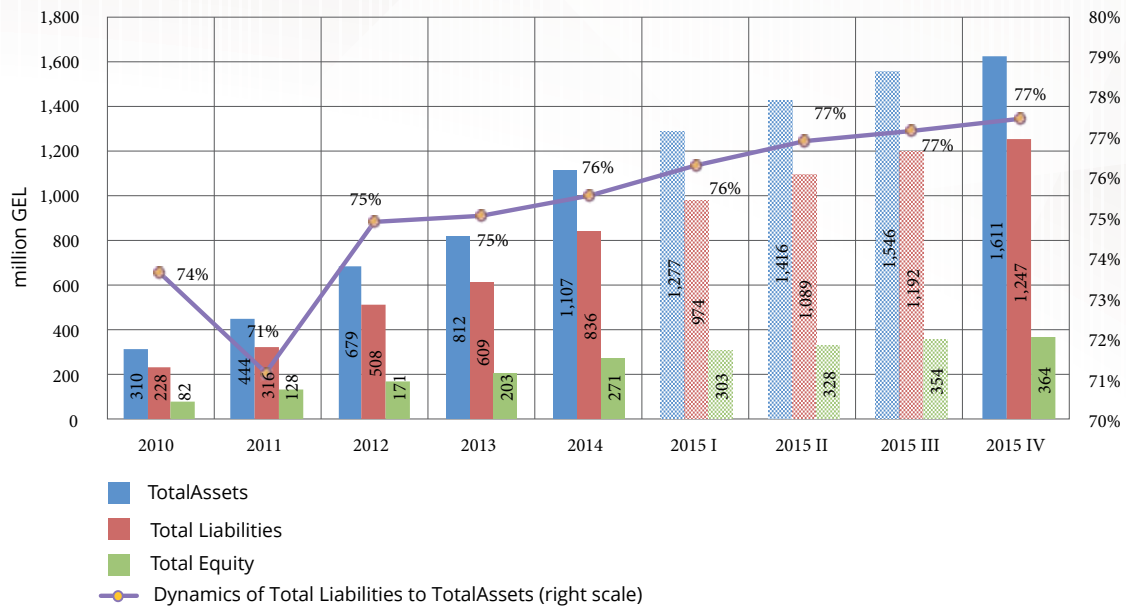
4.2 OTHER FINANCIAL INSTITUTIONS

Other Financial Institutions include credit unions, microfinance organizations, qualified credit institutions, currency exchange bureaus and monetary remittance units.

As of 31 December 2015, other financial institutions in Georgia comprised 15 credit unions, 70 microfinance organizations, 1,115 currency exchange bureaus and 45 monetary remittance units.

Microfinance Organizations

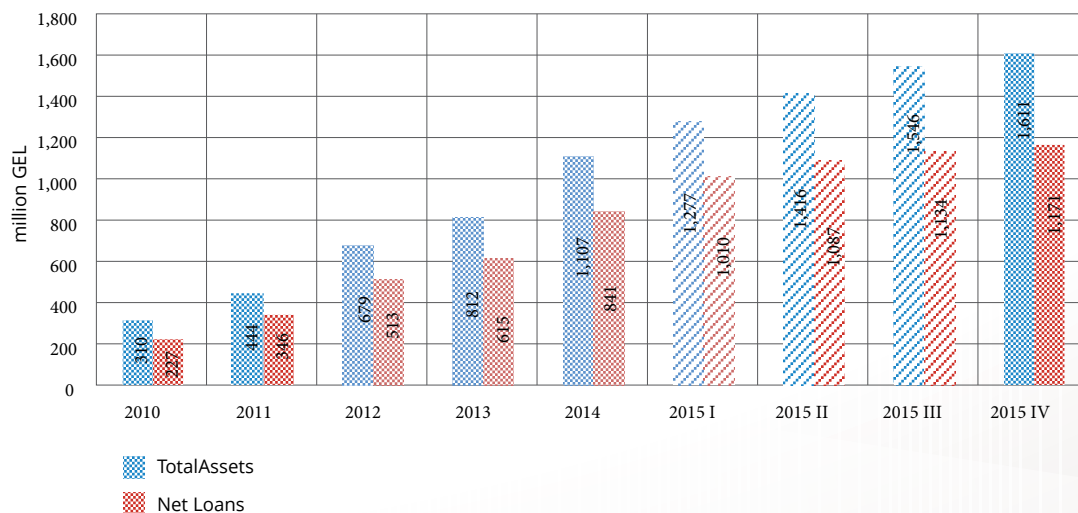
The microfinance sector continued to grow and develop in 2015. In comparison with 2014, total assets increased by 46%, and amounted to 1.6 billion GEL. The growth was proportionate to the expense of liabilities and capital, which amounted to 1.2 billion GEL and 364 million GEL respectively. The 46% asset growth rate in 2015 was slightly above the average of recent years, which was approximately 42%. A light supervision regime is still maintained on microfinance organizations.

Diagram N 4.6 Total assets, liabilities, equity and liabilities-to-assets dynamics of microfinance organizations

Source: National Bank of Georgia

According to 2015 data, the net loan portfolio comprised 73% of total assets and was equal to 1.17 billion GEL. It must be mentioned that the

ratio of net loans to total assets has not changed over recent years. The growth rate of net loans was equal to 39%.

Diagram N 4.7 Net loan portfolio growth relative to assets

Source: National Bank of Georgia

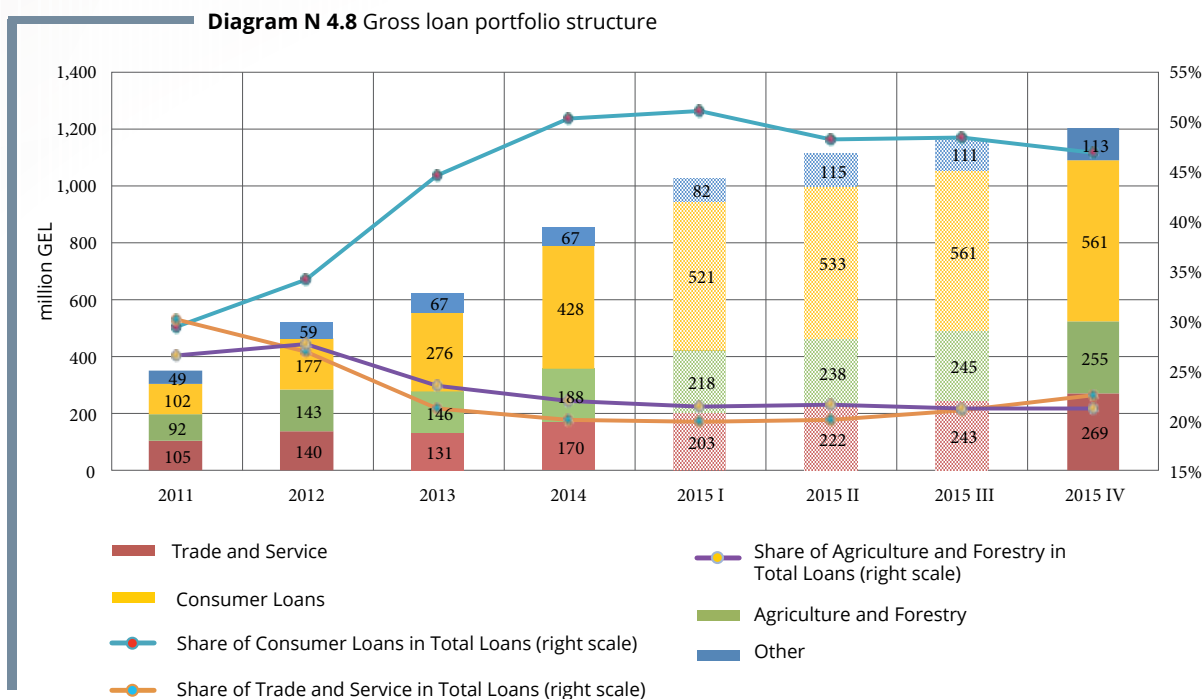
According to 2015 data, the gross loan portfolio of the microfinance sector amounted to 1.2 billion GEL. The portfolio is represented by three main sectors:

1. Trade and services: 269 million GEL (22% of

the portfolio);

2. Agriculture and forestry: 255 million GEL (21% of the portfolio);

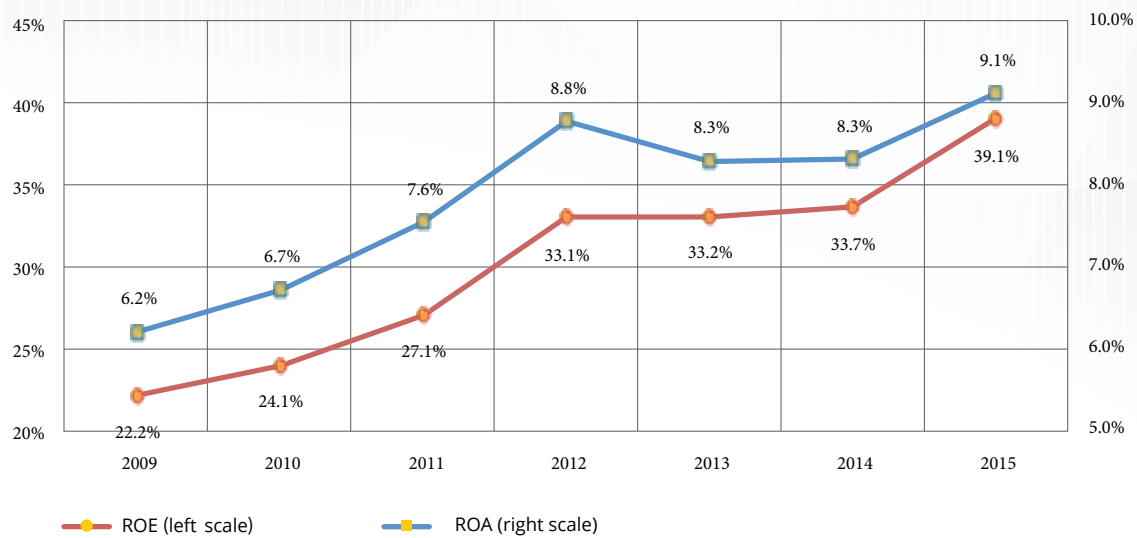
3. Consumer loans: 561 million GEL (47% of the portfolio).



Source: National Bank of Georgia

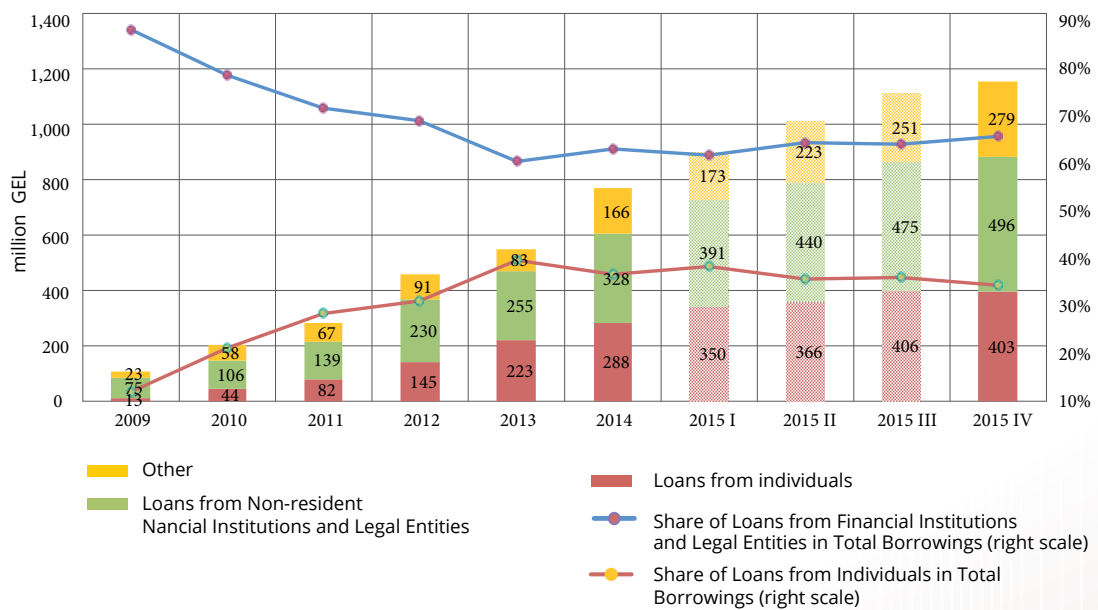
Diagram N 4.8 shows that, in light of the growth in the share of trade/service loans and loans granted to other sectors, the share of loans granted to the agriculture sector decreased. However, the tendency of microfinance sector lending to agriculture was maintained.

Because of the high margins on the products offered to the market, the microfinance sector is characterized by high profitability (see Diagram N 4.9). It should be noted that because of the existing “light” supervision regime, the NBG does not inspect the adequacy of loan loss reserves.

Diagram N 4.9 Profitability indicators (ROE, ROA) of microfinance organizations

Source: National Bank of Georgia

As in previous years, borrowed funds were the main source of asset financing (69% on average).

Diagram N 4.10 Borrowed funds structure, raised from non-resident organizations and private individuals

Source: National Bank of Georgia

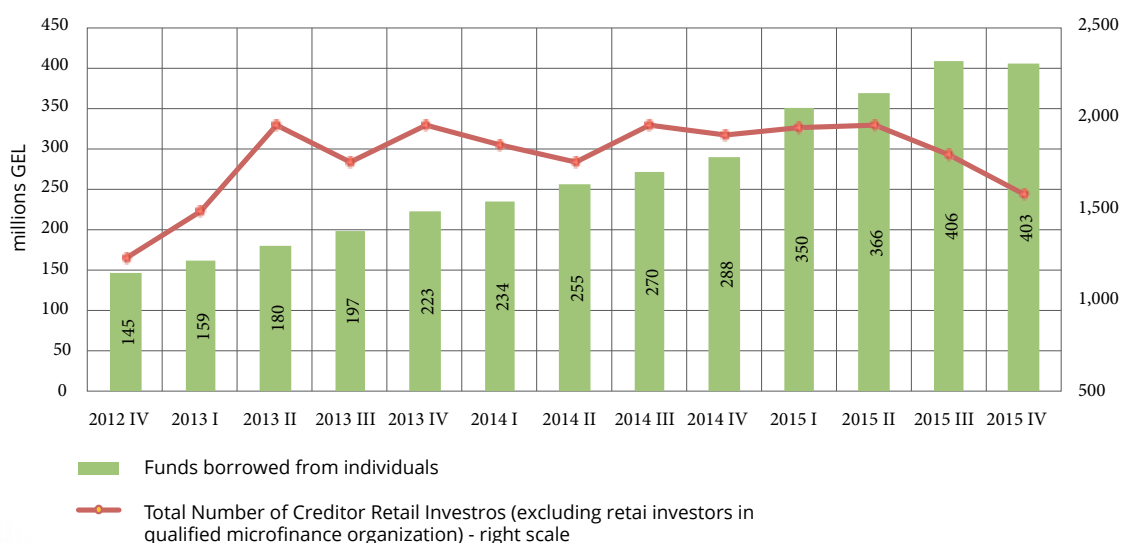
A total of 34% of borrowed funds were attracted from the retail sector. Due to the growth in foreign and resident institutional financing and the NBG's activities targeting retail investors, the share of funds attracted from individuals in the liability structure of microfinance organizations declined in 2014-2015.

According to the collected information, funds attracted from retail investors increased by 40% during 2015. Because of high levels of dollarization (around 95%), this 40% increase was mainly attributable to the depreciation of the GEL against the US dollar. In constant GEL, funds attracted

from retail investors increased by 10%. A total of 64% of the given increase was attributable to a microfinance organization that is recognized by the NBG as a "Qualified Credit Institution". The remaining portion of the growth mainly came from large individual investors.

It is significant that because of the material decline in retail investors, the total number microfinance organizations' individual creditors have declined over recent periods. However, this decline has been partially offset by the increase in the total number of large individual investors (see Diagram N 4.11).

Diagram N 4.11 Funds borrowed from individuals and total number of creditor retail investors



Source: National Bank of Georgia

In 2015, the NBG continued its efforts to work with microfinance organizations that attract funds from less informed retail investors and that have expressed readiness to change their business models. These organizations presented an action plan that entails a decrease of the number of relatively small loans issued to physical persons, and a gradual exit from the retail segment. The importance of this issue is exacerbated by the fact that interest rates on bank deposits denominated in foreign currency declined radically.

According to the action plan, microfinance organizations have stopped using advertisement campaigns used to attract funds from retail investors and have started to replace retail investors with more qualified investors. This replacement process was partially executed during 2014-2015 and will be continued.

Significant attention was also paid to those non-banking financial intermediaries operating on the Georgian market that were not registered with the NBG and that use various advertisement

campaigns to attract funds from retail investors. It should be noted that, as a result of NBG's intensive communication initiatives, the majority of these organizations stopped attracting funds from retail investors and ceased such advertisement campaigns. The NBG continues to work in the framework of existing legislation, which is based on the authority granted by Article 48¹ of the "Organic Law of Georgia on the National Bank of Georgia".

It is important that retail investors make intelligible and informed decisions. Before investing, they should understand that, all else being equal, higher interest rates are associated with higher degrees of risk.

Throughout 2015, the NBG continued working on legislative initiatives aimed at developing the sector, enhancing its regulatory framework, and protecting the interests of consumers of microfinance organizations. Specific initiatives were discussed, such as providing consumers with necessary information and placing some limits on funds attracted from individual investors.



V

ANTI-MONEY
LAUNDERING INSPECTION
AND SUPERVISION



In 2015, the National Bank of Georgia continued its anti-money laundering and countering financing of terrorism activities. During the reporting year, a number of structural changes occurred enabling implementation of a risk-based approach according to FAFT 2012 standards.

In 2015, a risk based approach towards commercial banks was implemented. This includes remotely receiving data (a report and internal control system description) from commercial banks, processing them, dynamically monitoring information, the early identification of risks concerning problematic institutions, and taking supervisory measures in accordance with any identified risks.

The off-site supervision reporting form includes components characteristic of all commercial banks and allows definition of the weaknesses and negative tendencies in terms of fighting against money laundering and the financing of terrorism. Following analysis of the report, each commercial bank is assigned a risk level based on the compound risk of the following components: "database of clients", "bank products/

operations", "information about operations according to geographic area" and "internal control system assessment".

The assessment of the components is based on both quantitative, or volumetric, and qualitative analysis of the factors, and in some cases of the sub-factors, of the components. During the assessment, the capacity and diversity of activities of the commercial bank are also considered.

At present, a project for a risk based approach to non-banking financial institutions is being developed. There are on-going discussions regarding this project in relation to the above-mentioned subjects. It is planned to finish the project in the first half of 2017.

While implementing off-site supervision, new guidelines for the on-site supervision of commercial banks were also adopted. Amongst other important issues, these guidelines cover the planning process, aims, types (complex, thematic, additional) and topics of inspection, the rights and duties of inspectors, and methodology.



VI

PAYMENT SYSTEMS



Payment systems in Georgia are dynamically developing and becoming more secure and efficient. In 2015, the most significant Payment System in Georgia (the Real Time Gross Settlement (RTGS) System) as operated by the National Bank of Georgia kept its continuity ratio at 99.9%, the same as in the previous year. This is an indicator of the success of the major infrastructural reforms undertaken in recent years and of the sustainability of the systems introduced.

In the past year, besides infrastructural improvements, the payment service area was dynamically developed. The number of payment service providers increased and the services provided by them became more diverse. Based on present development trends, it is crucial for payment services to meet high standards and rules. Furthermore, it is essential that payment service terms and conditions are transparent and accessible. Customers need to be able to make informed choices, their rights need to be well protected and the quality of payment services need to be improved as well. To this end, the National Bank of Georgia adopted rules on “providing payment

service users with essential information”, which will enter into force from 1 May 2016. The rules have been prepared on the basis of the Directive on Payment Services of the European Parliament and the European Council.

In 2015, the integration of the National Bank’s Core Banking System to the SWIFT System was accomplished in order to improve settlements in foreign currency inside the country. The implemented module facilitates automated receipt/execution of electronic payment orders in foreign currency, including currency exchange orders, from customers of the National Bank of Georgia. This increases the efficiency and security of foreign currency payment transactions.

Throughout the reporting year, activities for regulating payment systems continued. Within the framework of the Georgian law on “Payment Systems and Payment Services” the drafting of legal acts and reporting forms were improved. In September 2015, updated reporting forms for transactions inside the country were introduced, which make it possible to receive more com-

plete statistical information for payment market oversight. Additionally, the National Bank began working on the relevant recognition criteria for systemically important payment systems and important payment providers, and on establishing additional requirements for such entities.

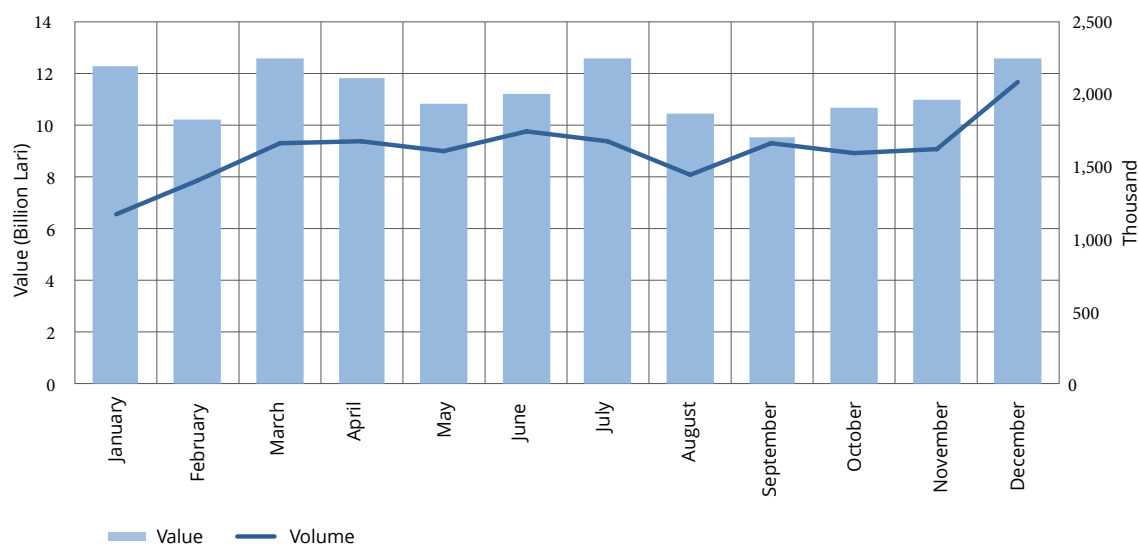
RTGS Statistics

Throughout 2015, a total of 19.2 million payment operations (the average daily number of trans-

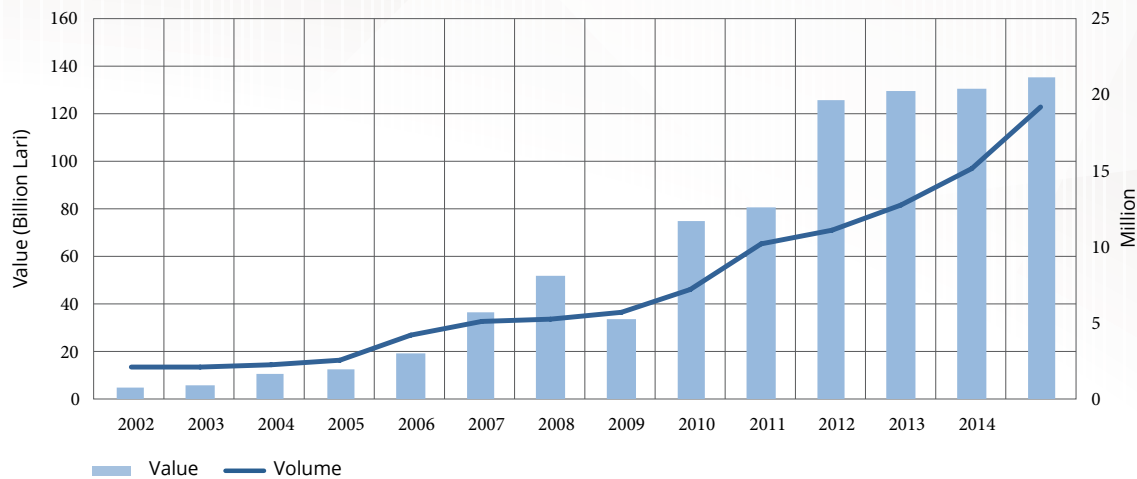
actions was 77,500) were processed through the Real Time Gross Settlement (RTGS) system, amounting to 134.9 billion GEL (the average daily number was 525.5 million GEL). Compared to 2014, the number of transfers through the RTGS system increased by 4 million (26.5%), while the value increased by 4.1 billion GEL (3%).

The statistical data of the RTGS system can be found on Diagrams N 6.1 and N 6.2 below.

Diagram N 6.1 Transfers processed through the RTGS system (2015)



Source: National Bank of Georgia

Diagram N 6.2 Transfers processed through the RTGS system (2002-2015)

Source: National Bank of Georgia

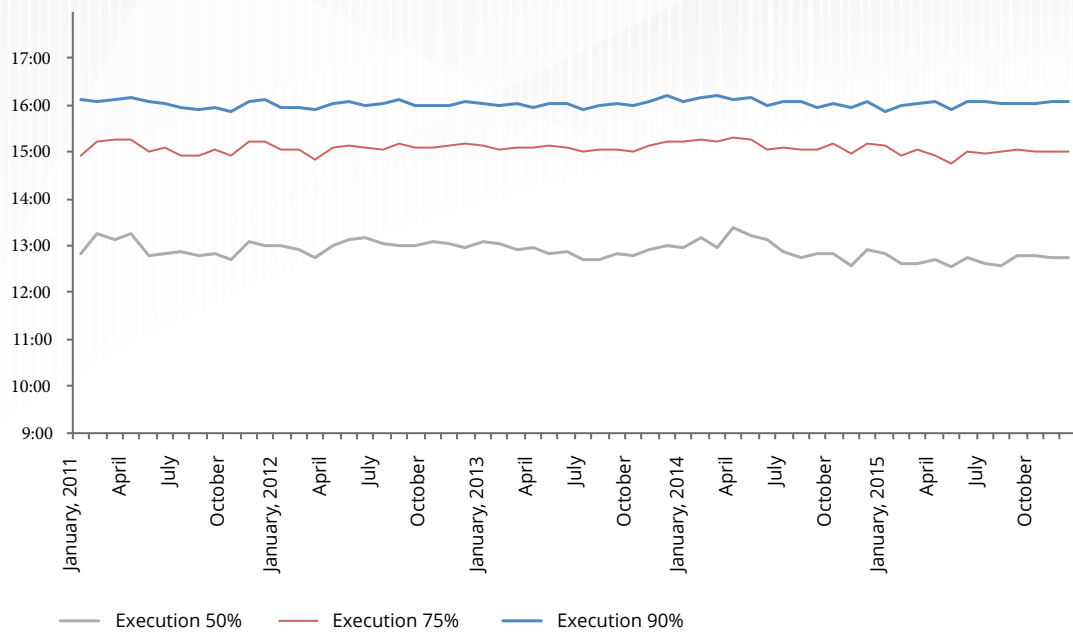
Throughout 2015, as in previous years, the RTGS system continued to play a key role in both large- and low-value (retail) payment transactions. The share of transactions processed through the NBG's RTGS system in the total turnover of transactions carried out in Georgia (by value) in 2015 was similar to 2014 levels and equaled 73% (in 2014, this figure amounted to 75.7%). This rate is at least four times greater than that of any other non-cash payment system/means⁴⁵ in Georgia and it thus acts as the most important element

for the smooth flow of financial resources. It should be noted that the current RTGS system has been functioning for five years and, despite the significant growth of RTGS transactions over this period (87% in terms of volume and 67% in terms of value), it did not have any impact on the intraday settlement process. More than 50% of daily transactions are performed by 13:00, while 90% are done by 16:00, much earlier than the end of the day⁴⁶ (Diagram N 6.3).

45. Aside from the payment systems existing inside the country, banks also use the direct correspondent relations for cashless payments/settlements when necessary, especially for the execution of foreign currency transactions.

46. According to RTGS rules, a second cut-off is carried out by 18:00, after which participants are no longer able to make payments from their settlement account, only then is the close of the day performed.

Diagram N 6.3 Intraday interbank settlement in RTGS (2011-2015)

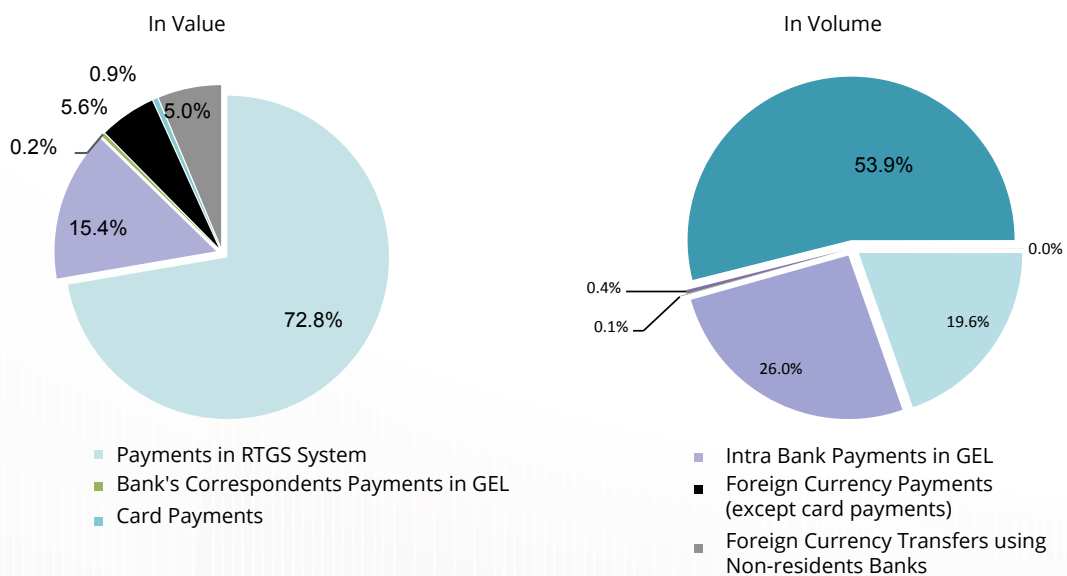


Source: National Bank of Georgia

In 2015, the share of card payments in the total number of non-cash payments increased significantly and amounted to 53.9% (44.6% in 2014). In terms of the volume of processed payments, intra-bank (26%) and RTGS transactions (19.6%)

also played a significant role. It should be noted that non-cash payments executed in foreign currencies have traditionally played a minor role in Georgia.

Diagram N 6.4 Payment transactions by payment systems and other means of execution (2015)



Note: Foreign currency transfers using non-residents banks include transfers between resident bank's clients where the final settlement between banks is held on their corresponding accounts at non-resident banks.

Source: National Bank of Georgia

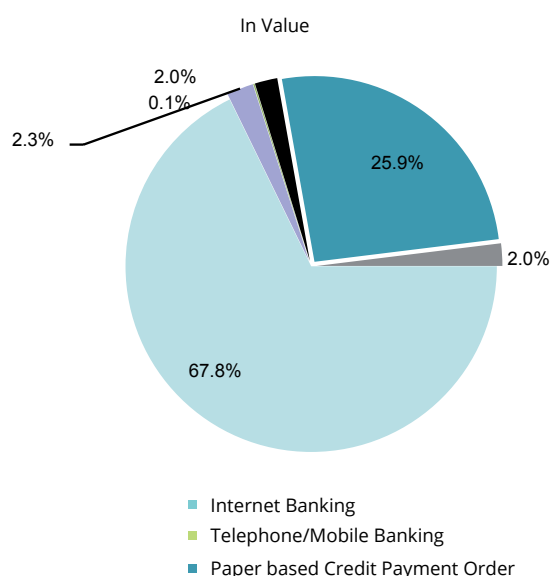
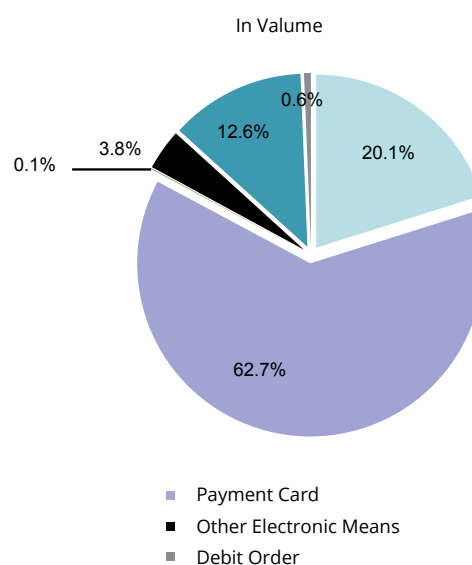
Electronic Payment Instruments

During 2015, consumers' attitudes towards electronic means of payment (payment cards, online banking, etc.) maintained a positive trend. Payment cards still play the leading role in the payment instruments used by consumers. In 2015, the share of card payments in total non-cash payments further increased and amounted to 62.7% (57.5% in 2014). The share of transactions performed by internet-banking in total non-cash transactions was also significant and amounted to 20.1% (21.3% in 2014). It should also be noted that the share of paper-based credit orders submitted by customers directly to banks has steadily been decreasing over the last five years,

and in 2015 these amounted to 12.6% of the total number of non-cash payments. In terms of value, payments initiated via internet banking still led in non-cash payment transactions (in 2015 the share amounted to 67.8%, which is 3.2 percentage points greater than the corresponding indicator of 2014).

In 2015, a simplified and innovative method of electronic payments – via mobile phone – was introduced in Georgia. Owners of mobile phones supporting NFC technology can link a payment card to their mobile phone using a special application and then make contactless payments anywhere in the world.

Diagram N 6.5 Non-cash payments by means of initiation (2015)



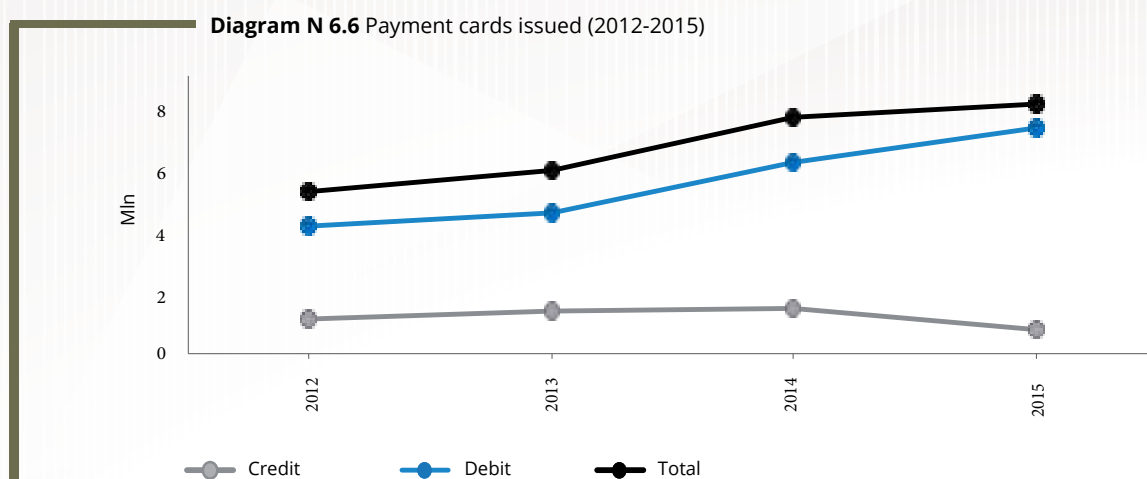
Source: National Bank of Georgia

Payment cards

At the end of 2015, the number of payment cards issued by Georgian commercial banks amounted to 8.1 million, which is 5% higher than the data from December 2014. Approximately 22 cards were issued per 10 inhabitants in Georgia.

The number of credit cards issued in Georgia

almost halved (decreased by 49%) by the end of 2015 compared to the end of the previous year, while the number of debit cards issued increased by 18% and amounted to 7.4 million. By the end of 2015, the share of credit cards in the total number of issued cards amounted to 9%. The dynamics of payment cards issued for 2012-2015 is shown in Diagram N 6.6.



Source: National Bank of Georgia

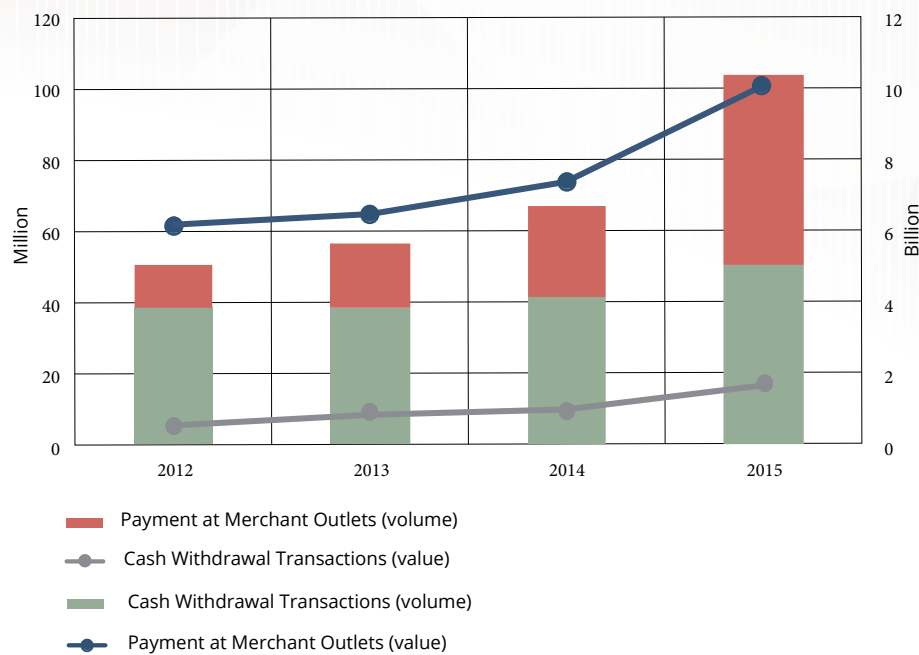
By the end of 2015, the share of international cards in the total number of issued cards slightly increased (by 0.2 percentage points) compared to the same period of the previous year and amounted to 79%. The number of Visa cards issued decreased by 17% compared to the previous year, while the number of MasterCard and local cards increased by 41% and 4% respectively. These changes certainly had a significant impact on the distribution of the card market. In particular, the share of Visa cards decreased by 10 percentage points and amounted to 40% of the total issued cards. The share of American Express cards slightly decreased (by 1 percentage point) and amounted to 1% of the total number of issued cards, whereas the share of MasterCard cards increased by 9 percentage points and amounted to 34%. Compared to the previous year, the share of Union Pay International cards also increased by 2 percentage points and reached 4% of the total issued cards. The share of local cards remained unchanged and amounted to 21% out of the total issued cards.

The total number of transactions (inside the country and abroad) performed by cards issued in Georgia in 2015 amounted to 107 million, with a total value of 12.5 billion GEL. A total of 96% in

terms of volume, and 93% in terms of value, of total card transactions were performed inside the country, while the remainder occurred abroad. The above data of total card transactions is an increase of 18% in terms of volume and 16% in terms of value compared to the corresponding data of 2014.

The share of POS payments in total card transactions was 53% in terms of volume and 18% in terms of value. The above indicators are an increase of more than 5 percentage points in terms of volume and 1 percentage point in terms of value over the previous year. Compared to 2014, POS-transactions increased by 31% in terms of volume and by 24% in terms of value, while cash withdrawal operations increased by 6% in terms of volume and by 14% in terms of value.

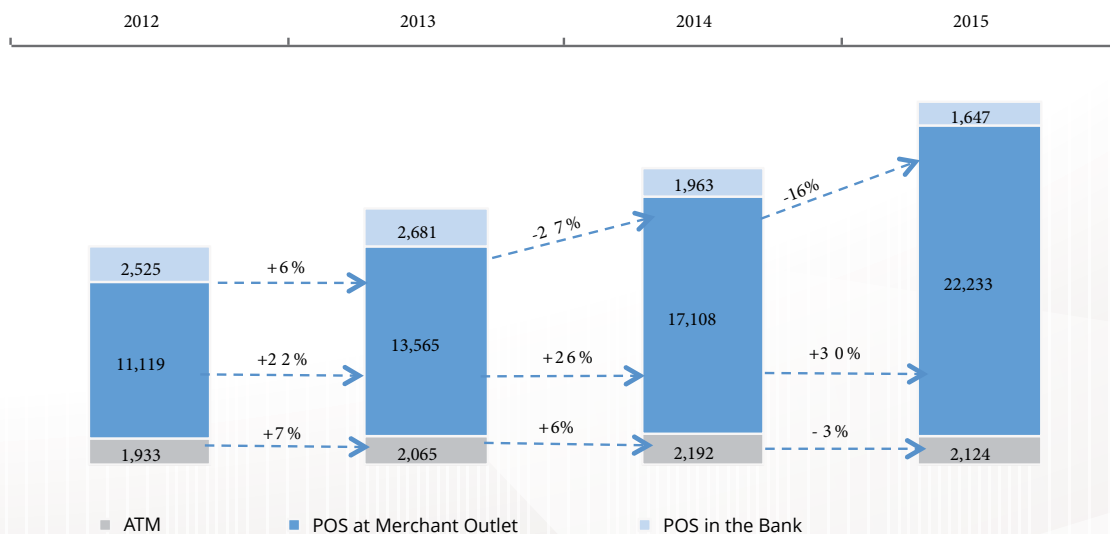
The total number of e-commerce payments by cards issued in Georgia in 2015 amounted to 12.6 million, with a total value of 567 million GEL. The share of these payments in the total number of POS-transactions amounted to 22% in terms of volume and 25% in terms of value. The trend of transactions performed inside the country by payment cards issued in Georgia during 2012-2015 is shown in Diagram N 6.7.

Diagram N 6.7 Local transactions executed by payment cards issued in Georgia (2012–2015)

Source: National Bank of Georgia

The infrastructure of payment card-accepting devices has also been developing. By the end of 2015, there were 2,124 ATMs operating in Georgia. The number of POS terminals at bank branches and service centers amounted to 1,647 and the number at merchant outlets was 22,233. It should be noted that in 2015 mobile POS ter-

minals technology was introduced in Georgia, which contributed to the penetration of electronic payments in areas where major payments are generally provided in cash. It is significant that the number of POS terminals at merchant outlets increased by 30% compared to the previous year.

Diagram N 6.8 Payment card accepting devices (2012–2015)

Source: National Bank of Georgia

In 2015, the average monthly number of cash withdrawal transactions performed at a single ATM located in Georgia was 2,052, amounting to 409,000 GEL in terms of value. The average monthly transactions performed by one POS terminal were 199 in terms of volume and 8,000 GEL in terms of value.

Payment Service Providers

By 31 December 2015, 24 payment service providers were registered in the National Bank of Georgia, seven of which were registered during 2015. Payment service providers offer a variety of payment services to consumers, such as the acceptance of payments through self-service kiosks, the issuance of payment cards and electronic money, and the execution of payments through these instruments.

In 2015, the total value of payment transactions executed by payment service providers amounted to 4.3 billion GEL (an increase of more than 48% compared to the previous year), which was a fairly minor amount compared to the total payments executed by commercial banks (representing only 2.3% of the total). Nevertheless, the number of the payments provided by payment service providers plays an important role in low value (retail) payments. According to the cumulative data of 2015, the number of payments executed by registered providers was equal to 500 million transactions (5% growth over 2014) – this figure exceeds the total number of customer payments executed through the RTGS system in 2014 by 28 times.

The number of electronic money payments continued to significantly increase in 2015 (a 17% increase compared to the previous year). The share of e-money payments out of the total payments performed by registered payment service providers increased by 3 percentage points. Elec-

tronic money used for transportation had the largest share in this growth. It should be noted that the value of transactions executed through electronic money accounted for only 4% of total payments performed by payment service providers.

The number of non e-money payments accounted for 55% of the total number of payments executed by registered payment service providers. Self-service kiosks played a leading role among this type of providers (87% in terms of volume and 80% in terms of value). The share of payments executed by self-service kiosks out of the total number of payments of registered providers amounted to 48% in terms of volume and 77% in terms of value; but these decreased by 6 percentage points in terms of volume and by 5 percentage points in terms of value compared to the previous year.

Protection of Payment Service Consumers' rights

Consumer rights protection is one of the top priorities of the National Bank of Georgia. With this in mind, the National Bank of Georgia developed "rules on providing payment service users with essential information", which will enter into force on 1 May 2016. These rules apply to three main areas:

1. Payment services provided under the framework agreement between the provider and the consumer;
2. Payment services without conclusion of the framework agreement (single payment transactions, such as money transfers, etc.);
3. Low value payment instruments and payment operations made by these means.

The rules apply to Payment Service Providers (in-

cluding commercial banks, money transfer entities, and microfinance organizations) that provide payment services according to the current legislation in Georgia.

The above mentioned rules determine, on the one hand, the mandatory information payment service providers must supply the payer before providing and after receiving the payment service and, on the other hand, the information to supply the payee. In addition, the rules determine the format, means and frequency of information provision, and outline the rights and responsibilities of the provider and consumer. Representatives from this market took part in discussions regarding the development of these rules.

Improving payment service reporting

Updated instructions about statistics of the commercial banks' payments entered into force in September 2015. These allow the National Bank of Georgia to collect more complete data on commercial banks' payment services.

In order to improve the systems of the National Bank of Georgia, the RTGS statistical portal was developed. This facilitates the automatic generation of different types of statistical information (reports) from the RTGS system and grants authorized users access to this portal. This increases the availability of a variety of statistical information that will help the effective use of human resources and improve operational risk assessment.



VII

DEVELOPMENT OF INFORMATION TECHNOLOGIES



In 2015, the National Bank continued to improve its information technology. It became the first organization in Georgia to successfully pass a certification audit and become certified in compliance of information security management system standard ISO/IEC 27001: 2013.

Certification was undertaken for international payments and reserve management, as well as payment and settlement services related to securities. This has proven that the National Bank's information security management system is in full compliance with international standards. The certification gives clear recognition that availability, confidentiality and integrity measures are being implemented in compliance with the ISO / IEC 27001: 2013 standard in order to protect the information assets held by National Bank.

At the 8th Regional Conference of Cyber Security and Development of Information Technologies

(GITI 2015), which occurred on 19-20 November 2015, the National Bank of Georgia once more won the award for "the most successful infrastructure solution". The conference discussed recent information security technology solutions in the National Bank that were deployed during the ISO 27001 standard implementation.

Last year, in order to improve network security, network access controls were implemented in the National Bank based on the IEEE 802.1X international standard. This protects the corporate network from unauthorized personal computers. The system components associated with this protocol were also updated and the network was segmented to virtual networks to separate different unit networks from each other, which has led to increased levels of security and availability. Major updates were made to network security and the firmware of external network devices were updated to support SHA2 hashing algorithms.

With regard to web security, a new generation of internal and external network (internet) connection control and protection software was deployed for internet users. This allowed web filtering, network traffic control and restrictions for internet applications. For increased availability of critical services, internet access to local and global sites was divided. Based on the results of penetration testing conducted in 2015 that simulated a cyber-attack on network and server infrastructure. Subsequently, a series of initiatives were planned and executed to eliminate the vulnerabilities and threats revealed by the penetration testing that could have been exploited by cyber criminals.

In 2015, the National Bank improved its server infrastructure resources, which significantly improved the physical server virtualization environment, productivity and availability. The virtualization system software was also updated to a newer version.

A remote access solution was implemented for access to critical components of infrastructure. This provides system and network administrators with remote access even if the equipment in the datacenter is out of order.

An analytics tool was introduced for network and server infrastructure, databases and datacenter physical infrastructure. This tool collects information through a centralized logging system and, as a result, valuable trends and shortcomings can be easily identified and addressed.

Last year, the certificates of the Georgian payment and securities settlement systems were mi-

grated from a SHA1 to a SHA2 hashing algorithm. The migration to modern and more secure certificates for the systems happened gradually and without disruption of service operations.

During the reporting period, the database management system was upgraded and a modern and secure environment was created for database infrastructure.

In 2015, the National Bank's core banking system and the SWIFT system were integrated with each other in the context of Georgian licensed commercial banks and the State Treasury. This led to the elimination of paper-based payment orders and records. Commercial bank and State Treasury transactions to the National Bank (contractual operations) are now only made through electronic orders.

Last year, an online search portal was setup to support the systematization and development of a search engine for legislation related to the activities of the National Bank and legal documents issued by the National Bank. The electronic portal legal.nbg.ge is tied to the official website of the National Bank of Georgia and allows any interested person to easily find current and past legal documents related to the financial sector.

Last year, work was completed on the "GPSSStat"-RTGS statistical portal system. This will provide different types of statistical information from the interbank settlement system.

During 2015, the National Bank's financial, macroeconomic and statistical information system SebStat was improved and the next phase was completed. Commercial banks no longer provide

information in Excel-format; all information is supplied using the SebStat system.

In 2015, an updated version of the core banking and cash management system was launched. The main goal of the new version is to provide accounting of numismatic and other values and

to ensure operations related to these values (internal and external movement, sale, assigning categories). Also, Modification/improvements were done on cash related transactions in order to reduce human resources and improve operations time.



VIII

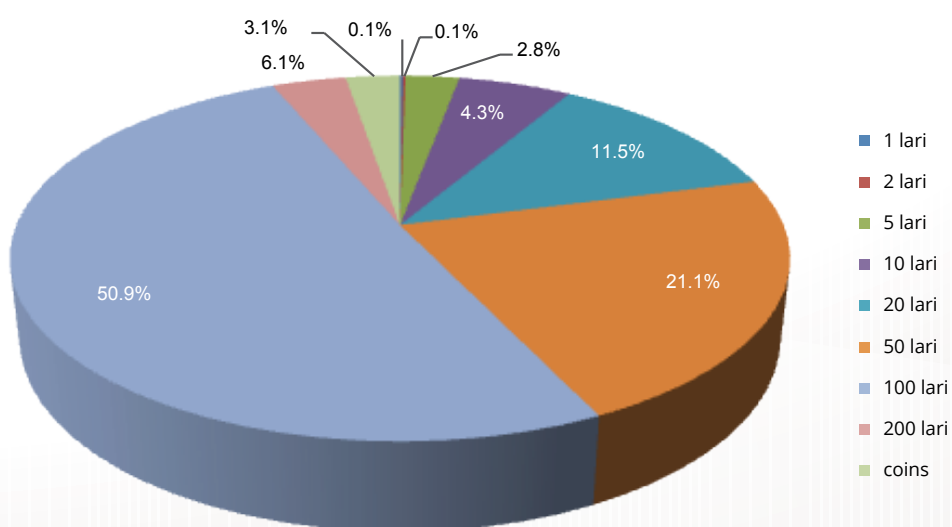
ORGANIZATION OF CASH EMISSION ACTIVITIES



In order to fully meet the economy's demand for cash in 2015, the NBG continued its activities related to regulating the production, import, storage and issue of notes and coins in circulation; improving the quality of banknotes and coins in circulation; sorting new notes and coins and those received from circulation in accordance with established rules; the detection of counter-

feit money; the destruction of unfit banknotes and the improvement of relevant normative acts. As of 31 December 2015, the value of cash in circulation amounted to 2.5 billion GEL, of which banknotes accounted for 2.43 billion GEL and coins 77.2 million GEL (the percentage share of all banknotes and coins in circulation by value is shown in Diagram N 8.1).

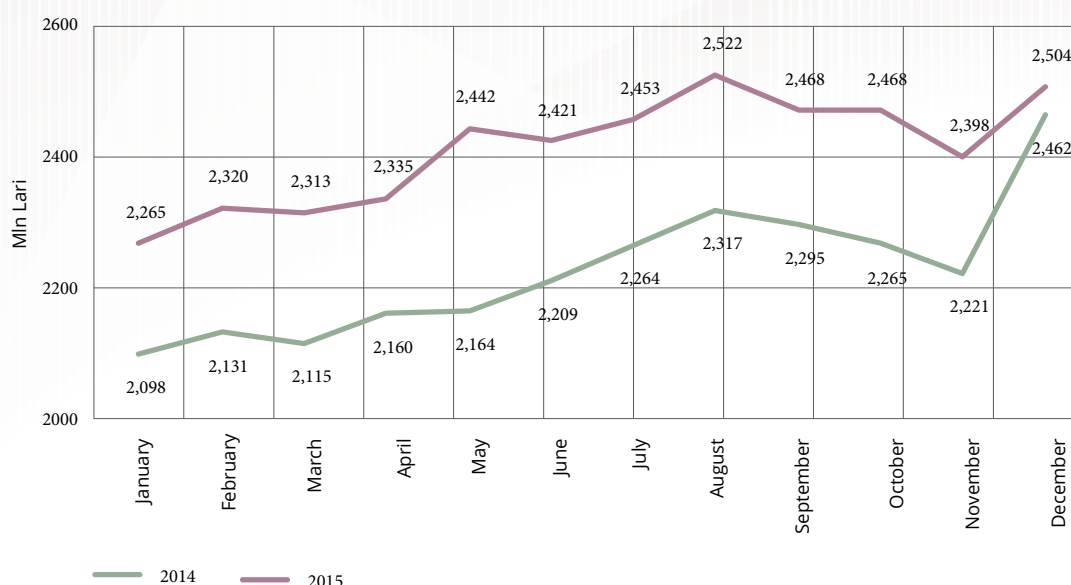
Diagram N 8.1 Cash in circulation (31 December 2015)



Source: National Bank of Georgia

The volume of cash in circulation increased by 1.7%, or 41.6 million GEL, during the course of the year (Diagram N 8.2).

Diagram N 8.2 Cash in circulation (2014-2015)



Source: National Bank of Georgia

In 2015, the volume of banknotes in circulation increased by 34.3 million GEL and accounted for 96.9% of the total volume of money in circulation. Demand for high denomination 50 lari banknotes increased by 2.6% and doubled for 200 lari banknotes. Compared to the beginning of the year, demand for 100 lari banknotes decreased by 53 million GEL (4%); with these notes accounting for 50.9% of the value of all circulation. The volume of 1 and 2 lari banknotes fell by 0.7% (44.7 million GEL). The volume of 1 and 2 lari coins in circulation increased by 10.9% and accounted for 49 million GEL in circulation by the end of the year.

It should also be noted that the value of “tetri” coins in circulation grew by 10.1% compared to the same rate in 2014.

In order to provide an uninterrupted supply of cash to the economy, the NBG continued to replenish its reserve stock of lari banknotes and coins. In 2015, the NBG issued new collector coins dedicated to the XIII European Youth Olympic festival “Tbilisi 2015” and the 20th anniversary of the lari being in circulation.



Cash turnover at the NBG increased in 2015. The NBG cash offices received 4.4 billion GEL of banknotes and coins, which was 4.8% higher than the previous year's figure. Outgoings amounted to 4.5 billion GEL, which was 4.7% higher than in the previous year. Foreign currency issued by the NBG amounted to 100,000 USD in banknotes. Cash handling offices serving individuals exchanged cash in the amounts of 424,100 GEL and 23,700 USD.

In 2015, NBG experts examined a total of 25,258 suspicious banknotes that were submitted by the NBG cash desk, commercial banks, cash exchange offices, the Ministry of Internal Affairs of Georgia, the investigation service of the Ministry of Finance of Georgia, and private individuals. Table N 8.1 shows the results of the examinations.

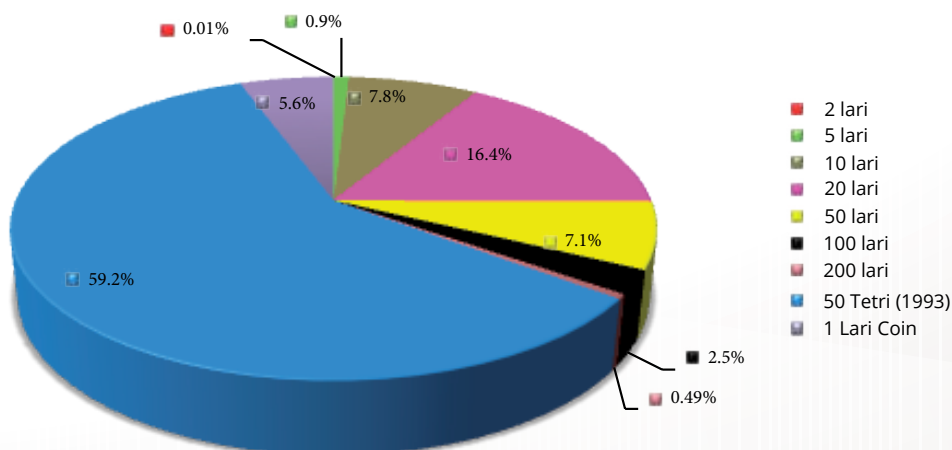
Table N 8.1 Examination results of suspicious banknotes and coins received by the NBG in 2015

	Suspicious	Counterfeit	Genuine	Non-redeemable
Lari notes	3 725	3 036	482	207
Lari coins	20 346	5 582	14 764	-
USD	943	774	169	-
EURO	94	75	19	-
Other Foreign Currency	150	97	53	-
Total	25 258	9 564	15 487	207

Source: National Bank of Georgia

The percentage share of counterfeit banknotes and coins removed from circulation in 2015 are shown in Diagram N 8.3.

Diagram N 8.3 Counterfeit lari banknotes and coins detected in 2015, by percent

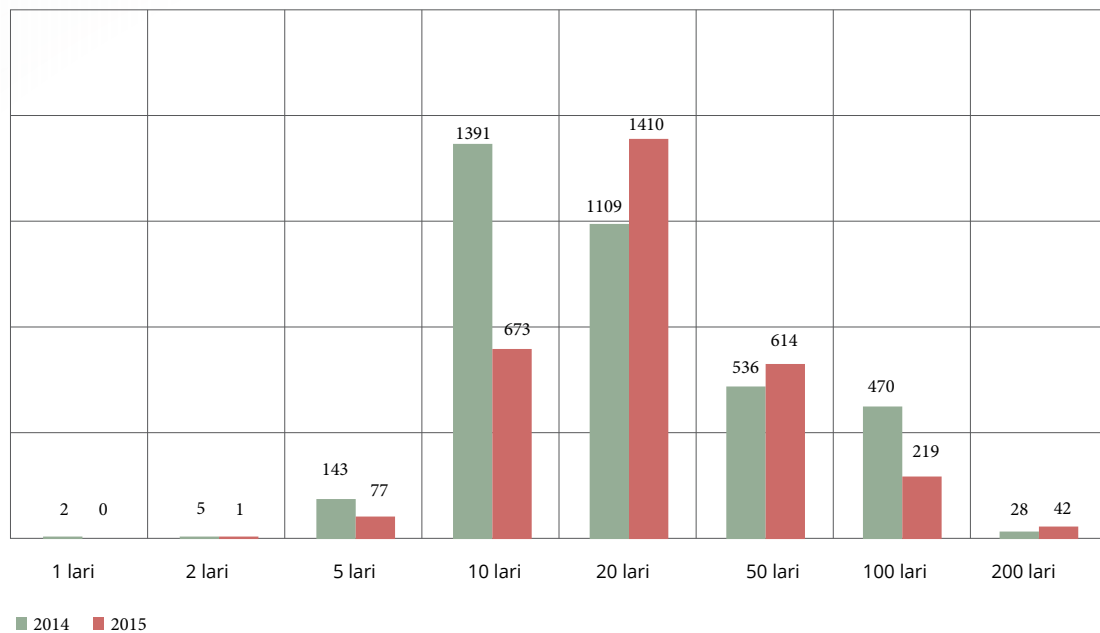


Source: National Bank of Georgia

The number of counterfeit lari banknotes in 2015 decreased by 17.6% compared to the previous period. The share of counterfeit US dollars increased by 13.2% and that of euro banknotes by 31.6%. The number of other counterfeit foreign banknotes increased 1.5 times during the same

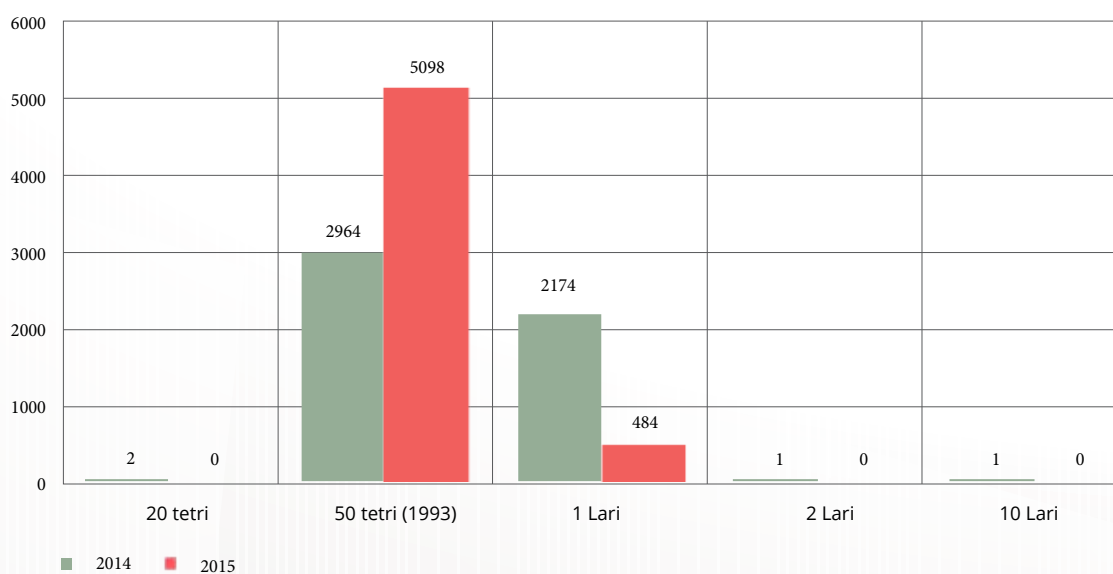
period. The number of counterfeit 50 tetri coins increased 1.7 times, while the number of counterfeit 1 lari coins decreased 4.5 times (Diagram N 8.4 and Diagram N 8.5 illustrate the quantity of counterfeit lari banknotes and coins detected in 2014-2015 by denomination).

Diagram N 8.4 Number of counterfeit lari banknotes



Source: National Bank of Georgia

Diagram N 8.5 Number of counterfeit coins



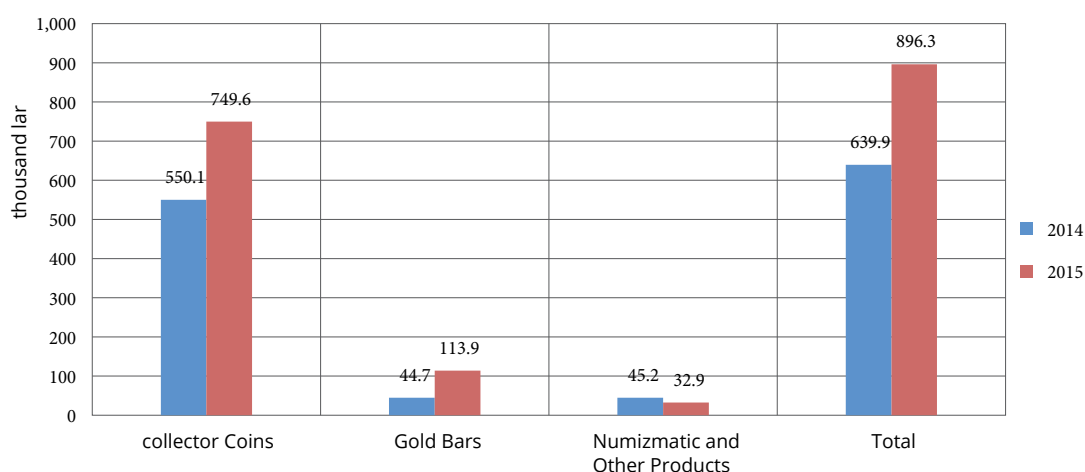
Source: National Bank of Georgia

During 2015, the NBG provided methodological support to commercial banks and currency exchange bureaus, as well as to other legal entities and persons in matters related to staff development. In particular, training was given to 644 persons seeking to raise their competence in currency authenticity and fitness checks, knowledge of security features and the general handling of cash.

The NBG continued to successfully sell its investment, collector and numismatic coins. Total sales

amounted to 18,176 pieces worth 896,400 GEL in value, which was 40.1% higher than in 2014. A total of 6,179 units of collectors' banknotes/coins were sold, worth 749,600 GEL (including 368 Golden Fleece coins worth 545,700 GEL), which was 36.3% more than in 2014. A total of 148 gold bars (excluding gold certificate bars) were sold worth 113,900 GEL, which is 2.5 times more than the previous year. And 11,849 units of numismatic and other products, worth 32,900 GEL, were sold, which is 27.2% less than in 2014 (see Diagram N 8.6).

Diagram N 8.6 Investment, collector and numismatic products sold (2014-2015)



Source: National Bank of Georgia

In order to promote the history of Georgian money and raise the public's awareness of the main activities of the National Bank of Georgia, the NBG's Museum of Money continued offering educational lectures to the public. During the course of 2015, the museum received 4,395 visitors (617 more than in 2014).

During 2015, 94 educational field trips were carried out in the Museum of Money, which included an overview of Georgian numismatics and the viewing of artifacts. A total of 1,390 students and 127 teachers participated in lectures. In addition, six thematic lectures on the "history of Georgian money and the functions and responsibilities of

the central bank of Georgia" were given for 97 students.

In May 2015, on International Museums Day, the museum organized an art exhibition of young painters that earned acclaim from visitors.

In 2015, the NBG's Museum of Money and the State Council of Heraldry made an exhibition of "Modern Georgian Symbols", which was of great interest for visitors of all ages. To promote the museum, booklets providing information about the museum in Georgian and English languages were produced and given to tourist information centers.



IX

UPGRADED LARI BANKNOTES



Since 1995, in spite of slight modifications, there has been no significant changes to the initial design, color or style of lari banknotes. Following the new technological developments in international practice, in terms of both visuals and technical parameters, the design of the lari banknotes has become quite outdated and does not correspond to recent trends of the printing industry. In light of this, in 2015 activities related to the production of the new 20, 50 and 100 lari denomination banknotes as well as preparatory works for their issuance have been performed.

This was the first major upgrade of the banknotes' design in the 20-year history of the Georgian lari. Work on this project has been ongoing for several years.

Before the decision was made to upgrade the banknotes, surveys had been carried out on matters including recent trends and the positive and negative aspects of various countries' banknotes, the substrates used, their parameters, designs, and security features. Special attention was paid to the study of those countries that had upgraded banknotes in the last 10 years.

Based on the study and analysis of international practice and recent trends, it was clear that in visual terms the lari banknotes did not form a whole family.

High protection was also a concern. It should be mentioned that following rapid developments of security printing technologies, the methods of counterfeiting are also improved. To help prevent this, we should remain vigilant and stay one step ahead of the counterfeiters before the potential for counterfeiting becomes visible in circulation.

The National Bank of Georgia also carried out a survey of banknote authentication automatic machines used by commercial banks and pay machines, their parameters, their work processes, and the devices used for banknote checking. This led to an analysis of possibility of their adaptations to process with the new banknotes.

It should be noted that during the banknote renewal project, the specialists of the National Bank of Georgia took advice and recommendations from companies involved in the printing industry, such as "De La Rue" (England), "Giesecke & Devrient" (Germany), "Oberthur Fiduciaire" (France), "Orell Fussli" (Switzerland), "Enschede" (Netherlands), "Sicpa" (Switzerland), and Swedish company "Crane" – a subsidiary paper manufacturer for US dollar banknotes, which often supported the National Bank of Georgia with various technical details.

By taking into consideration all of the above, the production of a new series of banknotes was conducted with the following factors in mind: creating a modern, approved and consistent design and other features common to the one family of banknotes; protection from counterfeiting and, at the same time, having easily identifiable security features; the steadiness of banknotes for automatic sorting and processing machines; durability to protect the notes from wearing out; consideration of public attitudes; minimizing risks associated with the process; and cost-effective distribution.

According to these specifics, work commenced on improving the 5, 10, 20, 50 and 100 lari denomination banknotes in terms of aesthetics, durability and improving the security features (there will be no upgrade for the 200 lari banknote yet as it was introduced in 2007 and its supply, design, and other features do not need work).

According to the decision of the NBG's Board and recommendations made from foreign experts, at the initial stage the design sketches for the new lari banknotes were created by the NBG's designers. To ensure printability according to the common industry standard, these design sketches were further developed by German printing company "Giesecke & Devrient", which performed engraving of portraits for all five denominations. It should also be noted that before tendering the production of the new modification of lari banknotes, the developed drafts of the design were further verified by the companies "De La Rue", "Oberthur Fiduciaire" and "Sicpa" to establish universal printing terms). The themes outlined on the original banknotes are still relevant. The population is accustomed to the famous figures represented on the banknotes and have positive attitudes toward them. Work thus continued to make modifications based on the same historical, cultural, traditional values that were thematically presented on the original banknotes. Each of the new modifications of the lari banknotes presents the same historical figures as on the older notes, but uses different portraits and other additional details (it should be noted that the main motives of designs of 1

and 2 Lari denominations banknotes was also preserved and reflected on the new Lari series).

Furthermore, the upgraded designs include other changes and individual elements that accurately highlight the diversity of Georgia's cultural and historical heritage.

For each of the new lari banknotes, the dominant colors of the previous banknotes were chosen for the same denomination of note. These were then harmoniously combined with contrasting colors. However, to minimize the possible risk of confusion among denominations and to protect banknotes from contamination, the range and intensity of the spectrum of dominant colors were changed. For instance, in this respect the 100 lari denomination note has quite different colors from those of the 50 lari banknote.

The new modification of the banknotes retained a horizontal orientation and denominations were scaled according to the size of the diagonal principle. However, the size between the banknotes were proportionally increased between denominations (the difference between denominations is 5mm in length and 2mm in width), which was not foreseen in the previous banknotes.

According to the "one family" principle, mandatory elements on the new banknotes, such as the denomination numeral, currency name, issuing authority, coat of arms, serial numbering, signature, date of issue, inscriptions and security features, are located in the same places on all denominations of banknote and the style of their presentation is similarly preserved.

The new banknote security features were selected with consideration of the fact that they should be easy to understand by the population, but at the same time technologically difficult to reproduce. When selecting the security features, the advantages and disadvantages of those from the previous series of lari banknotes were considered, particularly the ability to identifying them by using cash machines. The new modification of the lari banknotes have modern, easily understandable and improved, internationally proven



security features. These can be identified by looking, tilting and touching, but also by using special tools and sorting equipment.

The security concept of the banknotes was divided into two groups, with slightly different levels of quality and security features. The first group contains the 5, 10 and 20 lari denominations, for which security features were selected according to consumption specifications, in particular the considerations of resilience to wearing out and their production costs. The second group contains the 50 and 100 lari denominations. For this group, higher level security features were used to protect against counterfeiting.

And, the main achievement is that the upgrading layouts of the banknotes represent maximal harmonious combination of the design plots, details and features for all denominations providing their integrity as one family.

It is aware that the banknotes and coins are delivered according to the actual demand for each denomination. The National Bank of Georgia is obligated to continuously have reserves of each denomination of banknote and can issue them in the event of need. As the macroeconomic fore-

cast estimated that the reserves of 20, 50 and 100 lari banknotes needed supplies and it was necessary to work on their production, the first phase of the work on new banknotes thus began on those denominations. The initial phase of examining the received banknotes was carried out by visual and laboratory examination; cash sorting BPS machines, control counting and sorting processes for the new banknotes followed.

An information about the new 20, 50 and 100 lari banknotes was unveiled on 3 November 2015. Appropriate information was spread through the media; flyers, posters and booklets giving information about the features of the upgraded banknotes were printed and distributed through commercial banks and other appropriate channels; special training sessions about the upgraded banknote features were held for commercial banks, microfinance and non-bank organizations, and authorized persons from the Ministry of Internal Affairs and the Ministry of Finance. Before the new modification banknotes of 20, 50 and 100 lari go into circulation in order to ensure adaptation of the cash receipt-issuing and / or counting-sorting technical means the necessary amount of banknotes have been given to commercial banks and the holders of such technical means of other relevant organizations.



X

INTERNAL AUDIT, RISK MANAGEMENT AND ACCOUNTING



Based on accumulated experience and according to the requirements of International Standards for the Professional Practice of Internal Auditing, the Internal Audit Service of National Bank of Georgia has updated its Business Audit Universe and defined 33 auditees. The Information Technology Audit Universe was also updated, based on the Global Technology Audit Guide manual "Developing the IT Audit Plan", and 31 auditees were included. The Audit Universe provides full coverage of critical business areas, processes and systems of the IT environment.

In accordance with the three-year audit cycle and the long-term activity plan, annual action plans were developed for both the Business and IT Audit Universes. In line with these plans, which were agreed with the Audit Committee and approved by the NBG board, a total of 31 audits and reviews were conducted during 2015. Within the framework of these activities, individual audit reports on each business processes were pre-

pared, including assessments and recommendations concerning risk management, internal controls and compliance with the requirements of relevant regulations.

At the same time, in accordance with existing practice, the Internal Audit Service continued consulting the structural units of the National Bank of Georgia regarding various operational management projects. Through this consultative mandate, a substantial part of internal audit resources were used to support the development of a Centralized Risk Management function, via active cooperation, analysis of elaborated manuals and providing advice.

In line with the audit manual, during the reporting period the Internal Audit Service continued to follow up the process of implementing the recommendations given during its assurance services and provided quarterly reports on them. The Internal Audit Service also carried out periodic

monitoring of the accomplishment of recommendations issued by various external parties (the external auditing company and the International Monetary Fund) and prepared consolidated reports based on information provided by the relevant structural units of the National Bank of Georgia.

One of the most significant achievements of reporting year was the conduct of the first full external quality assessment of the Internal Audit Service, which was considered by the Quality Assurance and Improvement Program. The assessment team comprised De Nederlandsche Bank experts, who are certified by the Institute of Internal Auditors. The results of the assessment were meaningful since the main quality criteria – “General Conformity”⁴⁷ with International Standards for the Professional Practice of Internal Auditing and Code of Ethics – was achieved.

Because of a desire for permanent improvement and continuous development, an Internal Audit Strategy based on international standards and best practices was developed for 2015-2018. The results of the expectation survey of Audit Committee members and the outcome of a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis were taken into consideration while preparing the strategy. This research was aimed at the identification of all internal and external factors that may affect the achievement of the strategic objectives of the Internal Audit Service.

It should be noted that considering the accumulated experience and best practices, four volumes of the manual were created. These consist of an updated set of regulations, guidance, as

well as methodologies and additional reference materials. The audit manual is aimed at facilitating the effectiveness of internal auditors’ activities. Along with various regulatory and methodological documents, the “Internal Audit Manual” includes new procedures and guidance on matters such as Reporting Policy and Procedures, Audit Sampling, Consulting Service Procedures, the Internal Audit Service Staff’s Professional Development Program, and Internal Auditors’ Individual Performance Assessment Procedures. In addition, the following updated documents were enclosed: Engagement Planning and Auditing Procedures, the Quality Assurance and Improvement Program, Policy and Procedures on the follow-up of External Audit Recommendations, and the Information Security Management System Internal Audit Manual (ISMS).

Risk management

Based on international standards and practice in developed countries, in 2015 the NBG established a centralized risk management system framework for the implementation and development of an effective risk management system. In order to maintain the efficiency and effectiveness of the centralized risk management system, a model employing three lines of defense is used that clearly specifies the roles and responsibilities within the bank.

1. The first level of risk defense is the risk owners’ structural entity that is responsible for the direct risk management process inside the structural entity.
2. The second level is the centralized risk management system department. This is responsible for the implementation, permanent improvement and monitoring of the centralized

47. The IIA Quality Assessment Manual Scale includes the following levels of conformance: Does Not Conform, Partially Conforms, and Generally Conforms.

risk management system within the national bank. The centralized risk management process includes assessment of risk (identification, analysis, measurement), planning/developing responsive activities, and monitoring and reporting. Furthermore, the department coordinates the development of effective rules to respond to risks for first level risk owners.

3. The third level is an internal audit that ensures the adequacy, efficiency and effectiveness of the central risk management system.

During the period, a consolidated risk map of the NBG was created. This map describes core business processes, associated risks, existent risks and residual risks. Assessment and analysis of the map shows that operational risk management practices at NBG is falls into affordable boundaries and existent controls ensure minimization of operational risks.

Taking all this into account, and in order to improve operational risk management, various activities are under way to implement relevant internal procedures. In addition, based on best international practices, an incident management system is being implemented to identify hazards at an early stage and to search for the necessary actions for their prevention.

In line with international practice, business discontinuity management has recently been integrated with the centralized risk management system. For business discontinuity management, in 2015 the NBG regularly planned and implemented tests, renovated the relevant procedures and made improvements.

During the period, the NBG has been activity cooperating with the central banks of the Netherlands and Germany and the World Bank. Moreover, the centralized risk management department of the NBG is involved in the International Risk Management Working Group (IORWG).

Accounting

Throughout 2015, Bank continued working to further develop Accounting and Financial Reporting, as well as achieve full automation of accounting operations.

In respect of Financial Reporting, NBG mainly focused on the issues related with the implementation of new standard - IFRS 9 Financial Instruments (IASB's replacement of IAS 39 Financial Instruments: Recognition and Measurement). Compliance with the International Financial Reporting Standards has always been one of the key priorities for the bank, since nowadays it is crucial for integrated system of doing business. With this regard, relevance of IFRS 9 is huge, as is its role for the financial institutions. In this area, National Bank of Georgia has been actively communicating and consulting with the World Bank.

Throughout the reporting period, significant work has also been performed to further develop and completely automate accounting operations. National Bank of Georgia has successfully completed second stage of implementation of the "Cash Management Module" software, which completely automated accounting for operations related to cash and other valuables.



XI

PUBLIC RELATIONS
AND INTERNATIONAL
COOPERATION



Public Relations

Active communication with the public took high priority for the NBG in 2015. Given the challenges the NBG faced in the year, and taking into account the projects it implemented, particular attention was given to ensuring that the public understands current economic processes and their expected results, as well as the policies implemented by the NBG and their impact on the economy.

In order to ensure maximum transparency and to inform society of current processes in the banking sector in a timely manner, the NBG promptly disseminated press releases and statistical data, conducted press conferences, briefings, conferences and seminars, presentations and meetings on relevant subjects. Public relations were carried out through the mass media and other means of communications, and regular meetings took place with representatives of printed and electronic media.

In this regard, in line with the conventional practice of central banks of developed countries, the

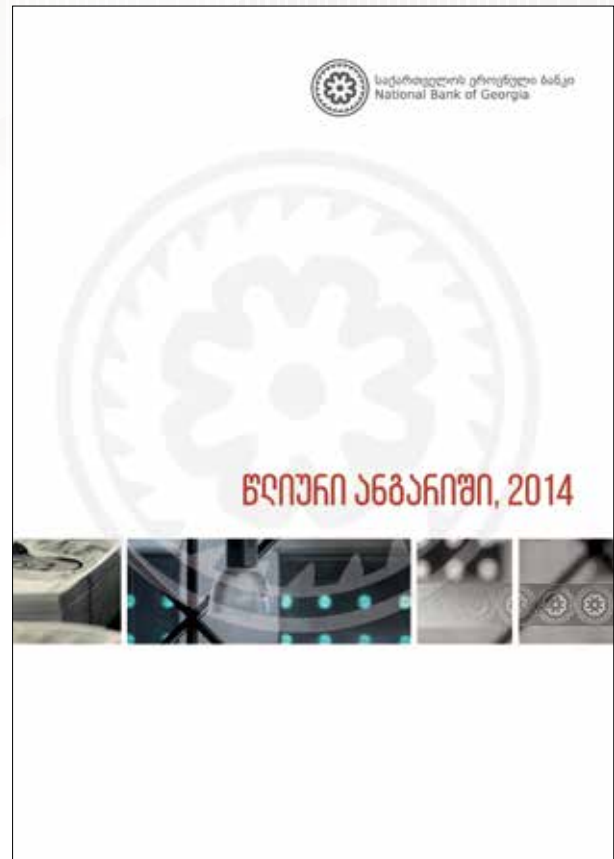
NBG made efforts to ensure the accessibility of information on current trends in the money and FX markets, to express its opinion regarding these issues, and to explain the motives behind particular decisions. This was done through both electronic and print publications as well as other forms of mass media.

The NBG publishes a "Monthly Review", a quarterly "Inflation Report", as well as various statistical data and Monetary Policy Committee press-releases. In addition, the NBG prepared and printed the "Annual Report of the National Bank of Georgia, 2014". The NBG also published four issues of the scientific-analytical magazine "Economics and Banking", offering readers papers and articles on various topical issues. The NBG also produced a new publication "Legal Regulations" – which is a collection of normative acts on the activities of the NBG and the financial sector. Electronic versions of the NBG's publications are available on the bank's official website: www.nbg.ge.

International Cooperation

The year 2015 was important from the standpoint of international cooperation and the NBG hosted several high-level international meetings. On 14-16 May, the EBRD Annual Meeting and Business Forum was held. The event was attended by government delegations of more than 60 countries, over 1,500 businessmen and representatives of international organizations.

Within the framework of the EBRD Annual Meeting and Business Forum, the President of the EBRD, Sir Suma Chakrabarti, visited the National Bank of Georgia. In a meeting with the Governor of the NBG, Giorgi Kadagidze, Sir Chakrabarti discussed the current conditions of the Georgian banking sector and the reforms implemented by the NBG. The stability of the Georgian banking sector was again praised and it was reaffirmed that the EBRD fully supports the monetary policy of the NBG.



"According to our assessment, the banking sector of Georgia is strong and well capitalized. Two large [Georgian] banks are listed on the London Stock Exchange. This is a very important achievement for Georgia, proving that there is a strong banking sector; the NBG regulates it in a highly profes-

sional manner based on the best and exemplary model. The monetary policy pursued by the NBG is commendable as well, we consider that NBG has chosen correct and sound policy to safeguard foreign exchange reserves during GEL exchange rate fluctuations, since foreign exchange reserves are important assets for the country. EBRD thinks that the governor of NBG acted appropriately. NBG fulfills its basic functions and tasks in a professional manner and its independence is crucial and fundamental, being a fundamental factor both for investors' confidence and for short and long-term economic development".

Sir Suma Chakrabarti
President of the EBRD

Within the framework of the EBRD Annual Meeting and Business Forum, the Deputy Director of the Middle East and Central Asia department of the IMF, Juha Kahkonen also visited the National

Bank of Georgia. The main topics of discussion during this visit were macroeconomic conditions and the current challenges facing Georgia.

In order to become familiarized with the Bloomberg securities auction implementation and settlement process, a delegation from the Ministry of Finance of Mongolia, led by Secretary of State Gantsogt Khurelbaatar, also visited the National Bank of Georgia.

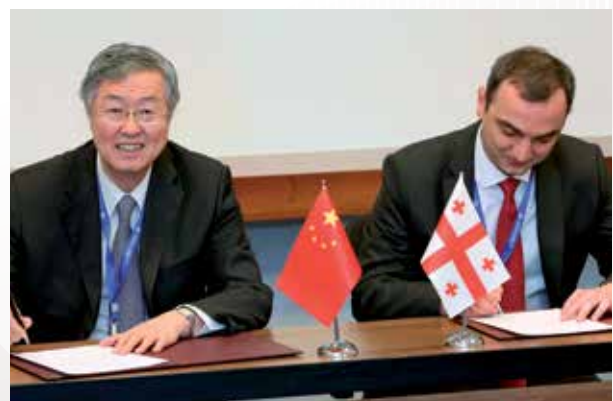
Within the framework of the EBRD Annual Meeting, former Prime Minister of the Czech Republic Jiří Rusnok was another visitor to the NBG. In a meeting with the governor of the National Bank of Georgia, he became acquainted with the macroeconomic tendencies of Georgia and the reforms implemented by the NBG.



On 21 June, the 17th Annual Meeting of the Board of Governors of the Black Sea Trade and Development (BSTDB) Bank was held in Tbilisi. The meeting was chaired by Giorgi Kadagidze, Governor of the National Bank of Georgia and the BSTDB Governor for Georgia. The Black Sea Trade and Development Bank (BSTDB) is an international financial institution established by Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Turkey, and Ukraine. The BSTDB headquarters are located in Thessaloniki, Greece. The BSTDB supports economic development and regional cooperation by providing loans, credit lines, equity and guarantees for projects and trade financing in the public and

private sectors of its member countries. Prior to the annual meeting, the bank organized a business forum on 19 June. Under the auspices of the government of Georgia and the NBG, the forum discussed the development of entrepreneurship and access to capital, in particular for SMEs.

On 25-27 September, Tbilisi hosted the XXXIV Meeting of the Central Bank Governors' Club of the Central Asia, the Black Sea Region and Balkan Countries, organized by the National Bank of Georgia (NBG). The meeting was led by Giorgi Kadagidze, Governor of the National Bank of Georgia. Governors from the Central Banks of the 23 member countries of the club – Israel, the



Czech Republic, Poland, Bulgaria, Turkey, China, Ukraine, Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Croatia, Kazakhstan, Kyrgyzstan, Macedonia, Moldova, Montenegro, Russia, Serbia, Slovenia and Tajikistan – participated in the event. The governors of the financial institutions discussed some of the most challenging questions facing the region: foreign exchange rates and high levels of dollarization. Within the scope of the meeting, for the purpose of promoting Georgian-Chinese economic relations, a Memorandum of Understanding was signed between the National Bank of Georgia and the People's Bank of China. "After this memorandum, we will begin working on the currency swap between the lari and the yuan. If the swap is successful, our businessmen and small entrepreneurs who have trade relations with China will have the opportunity to get access to very interesting credit products", said Giorgi Kadagidze.

The Banker

The world's leading financial magazine The Banker, named Giorgi Kadagidze, Governor of the National Bank of Georgia as Europe's Central Banker of the Year 2014. Every year this publication nominates the best financial institutions and central bankers in 149 countries. The Central Bank Governor of the Year award celebrates the officials who have best managed to stimulate growth and stabilize their economies. On 13



May, within the framework of the EBRD Annual Meeting, Stefanie Linhardt, the Europe Editor of The Banker handed the Governor of the National Bank of Georgia the award. The Banker is the world's premier banking and finance resource and is read in over 180 countries.

Export of Reforms

In 2015, the NBG continued exporting its reforms. Numerous countries have expressed desire to familiarize themselves with the reforms implemented by the National Bank of Georgia in recent years and to share its experience. It should be mentioned that most of the delegations from different central banks that visited the NBG did so on the World Bank's recommendation. On 23-24 April, a delegation of the National Bank of Moldova, headed by the Deputy Governor Aureliu Cincilei visited the National Bank of Georgia.



The main purpose of the trip was to visit the Cash Center of National Bank of Georgia and to share the successful experience related to the cash operations and security measures. Representatives of the NBG Cash Center shared their experience in cash operations and security measures with their Moldovan counterparts as well as other important aspects that will be useful for the successful implementation of a similar system.

The Central Bank of Austria (CBA) also expressed interest in the successful projects of the NBG. On 6 May, CBA representatives Robert Rupsch and Anton Schautzer visited the NBG with the purpose of touring the Cash Center and sharing ex-

perience. Georgian specialists provided them with detailed information on this successful project.

In July 2015, the National Bank of Georgia hosted a European Central Bank forum. The European Central Bank held its user group meeting for the Portfolio Management System in Georgia. This was the first time that such a forum was held outside the eurozone. The objective was to promote cooperation and partnership among central banks using the same reserve management system. The forum is held biannually and its primary members are the central banks of the euro system. Georgia, along with a few other countries, was invited as an observer.

International Experience

The international experience that central banks of different countries share with the NBG is quite significant. In 2015, Marek Petrus, the director of communications for the Czech National Bank visited the NBG. He held meetings with the management of the bank, met representatives of the governor's apparatus, the public relations office and other departments. During his visit, Marek Petrus held training sessions for Georgian business media representatives. The main topics of these were the communication strategies of central banks, media relations and communication instruments. He also introduced the Czech National Bank's communication strategy and shared experience of the Czech PR office's relations with the media.

Special media training on the Bloomberg International System was organized by the National



Bank of Georgia on 11 June. The manager of Bloomberg's Caucasus and Central Asia department, Alexander Artyomov, led the training. He discussed Bloomberg and its main products in detail. He showed the media how foreign exchange, money and securities markets work in different countries of the world, including Georgia. Artyomov reviewed Bloomberg's capabilities, discussed what it can be used for and outlined who can work on the platform. At the same time, he shared Bloomberg's experience in Georgia and answered questions from media representatives.

Celebrating World's Savings Day has already become a tradition. Started in 1925, it soon became an annual tradition in several countries and involves celebrations and campaigns to encourage savings. The main event dedicated to Savings Day was held in the Cash Center of the NBG on 30 October 2015. A country-wide moneybox competition was announced through social media. Children under 14 were encouraged to send a painting of a "moneybox of my dreams" and state their savings goal. Out of the 139 participants, 11 winners were selected, who were each invited to an excursion at the NBG's Cash Center. Commercial banks also opened children deposit accounts for the winners so that they can continue saving for their goals. The winners were also awarded various prizes and were given copies of the money boxes of their dreams created from their own designs. World Savings Day is a good way to overcome the barriers between the population and commercial banks. This day helps contribute to restoration of public confidence in the financial sector and promotes saving money in banks.





XII

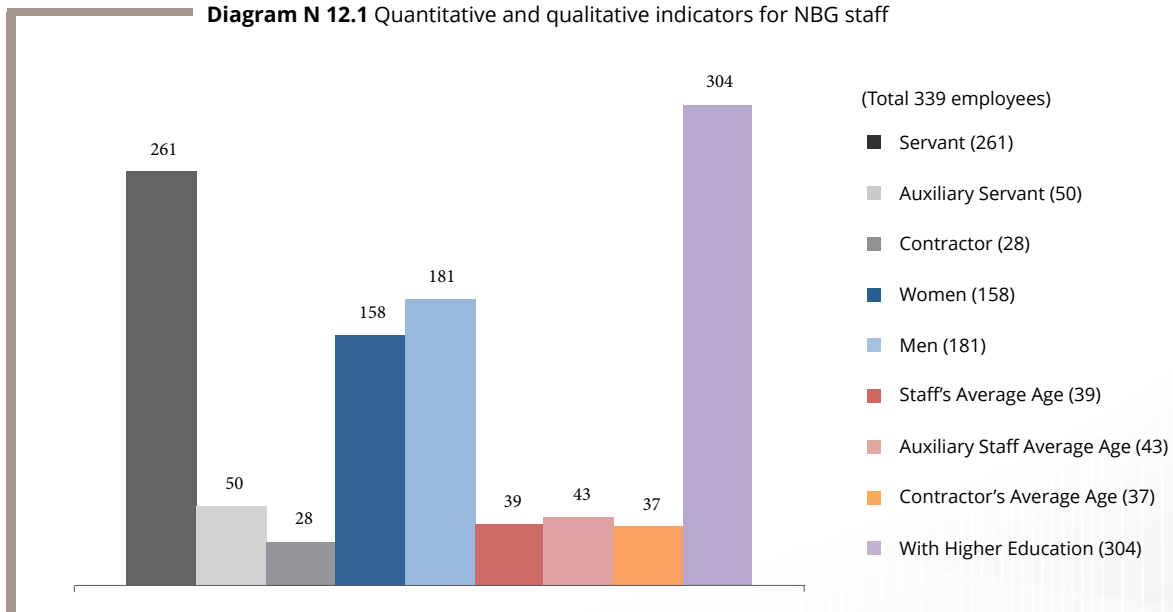
HUMAN RESOURCES MANAGEMENT AND DEVELOPMENT



Statistical information on the number of employees
By the end of 2015, the NBG employed 339 per-

sons, with an average age of 40. Of the total number of employees, 47% were women.

Diagram N 12.1 Quantitative and qualitative indicators for NBG staff



Source: National Bank of Georgia

Structural optimization

In order to fulfill the requirements of the 26th recommendation of the Financial Action Task Force on Money Laundering (FATF), made in the conclusion of the fourth evaluation round of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) of the European Council and its intermediate report on Georgia, as well as the requirements of the "2014-2017 Strategy of Combating Money Laundering and Terrorism Financing" approved by the Government of Georgia, certain structural optimizations were carried out at the National Bank of Georgia in March 2015.

Namely, the money laundering and special inspection department was closed, along with its money laundering inspection and special inspections divisions. Subsequently, a money laundering inspection and supervision department was created with attendant inspection, methodology and off-site supervision divisions.

Cooperation with higher education institutions

Every year the NBG gives students the opportunity to become familiar with the National Bank, to become interns and develop practical skills that will help them in their future careers. For this purpose, and in line with a memorandum of cooperation, the NBG hired 37 interns, of whom five subsequently became NBG employees. At the same time, the NBG provides summer internship opportunities for Georgian students who study abroad, in order to increase their interest toward the NBG, so that after finishing their studies they might decide to return and use their knowledge in Georgia. During 2015, five such interns were hired.

Employees' professional development

During 2015, the NBG continued to take care of its employees' professional development. A total

of 80 NBG employees visited the following institutions for training purposes: the IMF, the Joint Vienna Institute, Deutsche Bundesbank, the Bank of France, the Bank of the Netherlands, the National Bank of Poland, the Swiss National Bank, the Czech National Bank, the National Bank of Austria, the Central Bank of Armenia, the Central Bank of the Republic of Turkey, the Asian Development Bank, the World Bank, and the central banks of various other countries. In addition, 12 NBG employees were trained in Georgian educational institutions.

An English language course was held at the National Bank of Georgia in 2015 and was attended by 26 NBG employees. Furthermore, internal training sessions were carried out at the National Bank throughout the year to share any accumulated knowledge and experience with interested employees.

A business continuity seminar was carried out for all NBG employees. Naturally, managing business continuity is a priority issue in any organization with the critical systems and operations, like the National Bank of Georgia. At the seminar, employees learned how the organization should work in an uninterrupted way during unexpected, non-standard or critical situations. At the same time, the practical testing of pre-developed scenarios was carried out. Such testing is an important prerequisite for detecting shortfalls.

Professional development of financial sector employees

The NBG also supports the professional development of banking sector employees. To that end, in May, April and November 2015 experts from the Luxembourg Financial Technology Transfer Agency conducted three seminars at the NBG for NBG and commercial bank employees. A total of 75 people attended these.



The background of the top section is a collage. On the left, there is a sketch of a building with arched windows and a group of people. On the right, there is a large, stylized number '10' with a textured, woven pattern inside the digits. The entire collage is rendered in a light blue tone.

XIII

DEVELOPMENT OF THE
NORMATIVE BASE



In 2015, the normative acts of the National Bank of Georgia were further refined.

During the reporting period, several important normative acts were drafted and enacted. These include “The rule on performance of payment operations”, the “Decree on the capital adequacy requirements for commercial banks”, “The rule on liquidation procedure of commercial banks”, the “Decree on the requirements for internal auditing activities of commercial banks”, the “Decree on the management of conflicts of interest”, “The rule on electronic currency trading for legal entities through the Bloomberg trading platform (system)”, “Instruction for delivery of information by commercial banks on executed (performed) payment operations”, and “The rule on the use of the single financial and statistical database system of the National Bank of Georgia – SebStat”.

The National Bank of Georgia prepared 43 draft normative acts and brought these in compliance with existing legislation. These normative acts were officially published in electronic form on

the website of the Legislative Herald of Georgia. Issues related to state secrecy were also regulated in 2015. Specifically, the Parliament of Georgia enacted a new “Law on State Secrecy.” Pursuant to this legislation, draft normative acts were prepared by the NBG. These will come into the force at a determined time in the future. The new regulations entirely change the principles for the treatment of state secrecy within the NBG. Among other changes, state secrecy related to the manufacture transportation and registration of Georgian lari banknotes and coins will be available in electronic form. The normative act outlines the protective measures and instructions according to which electronic information related to state secrecy will be stored, exchanged and protected. This normative act is currently being negotiated with the State Security Service.

In 2015, two important contracts were concluded by the National Bank of Georgia. One was related to repo transactions (the Global Master Repurchase Agreement), and the other was the

Securities Lending Agreement concluded with Clearstream Luxemburg Banking, which involves securities lending transactions.

In 2015, the National Bank of Georgia, working in cooperation with the European Bank of Reconstruction and Development, launched a new project for the development of the derivatives market in Georgia. The project's objective is to create a proper legal and business environment for the development of money markets. One of the outcomes of this project is to bring Georgian legislation into compliance with recognized best international practice.

During the reporting period, the NBG initiated a new project aimed at upgrading the legal and infrastructural aspects of the financial collateral instruments related to refinancing loans. The objective of the project is to offer commercial banks an easier and faster procedure that will be

in compliance with existing legislation.

Based on recommendations made by the IMF and the World Bank, the NBG worked on legislative initiatives that will reinforce effective banking supervision in Georgia. The issues addressed in the legislative initiative include, but are not limited to, the protection of the interests of the NBG's employees, licensing of commercial banks, purchase of significant shares and consolidated supervision.

During the reporting period, the NBG ensured the availability of public information. In 2015, a total of 189 applications for public information were submitted to the NBG, of which 185 were satisfied with information being released to the interested parties. In the remaining four cases, the applications were forwarded to the relevant administrative bodies in a timely manner, and the applicants were informed of this.





XIV

STATISTICAL ACTIVITY



Following the President of the NBG's decree of November 2015 a new statistical information system for the National Bank of Georgia – known as SebStat – was launched. This is a completely innovative statistical business process that has fundamentally changed the statistical environment in the banking sector. In order to ensure the high quality of data, SebStat has been operating in tandem with Excel-based reporting since 2014. The main advantage of SebStat is that commercial banks are now able to submit their data to NBG through web-based technologies, instead of Excel-based questionnaires.

SebStat is an information system that guarantees the standardization and optimization of the NBG's statistical business process through the harmonization of statistical terms, categories and concepts. Commercial banks' data intended for reporting are strictly structured in a standard format, which ensures high data quality, automation of validation and processing procedures and a reduction of the reporting burden.

SebStat is a transparent system, which means that its methodology, guide, practical handbooks, consistency schemes, procedures to ensure high data quality, and reporting rules are all published on the NBG website and are available to any interested user (<https://www.nbg.gov.ge/index.php?m=634>; in Georgian only).

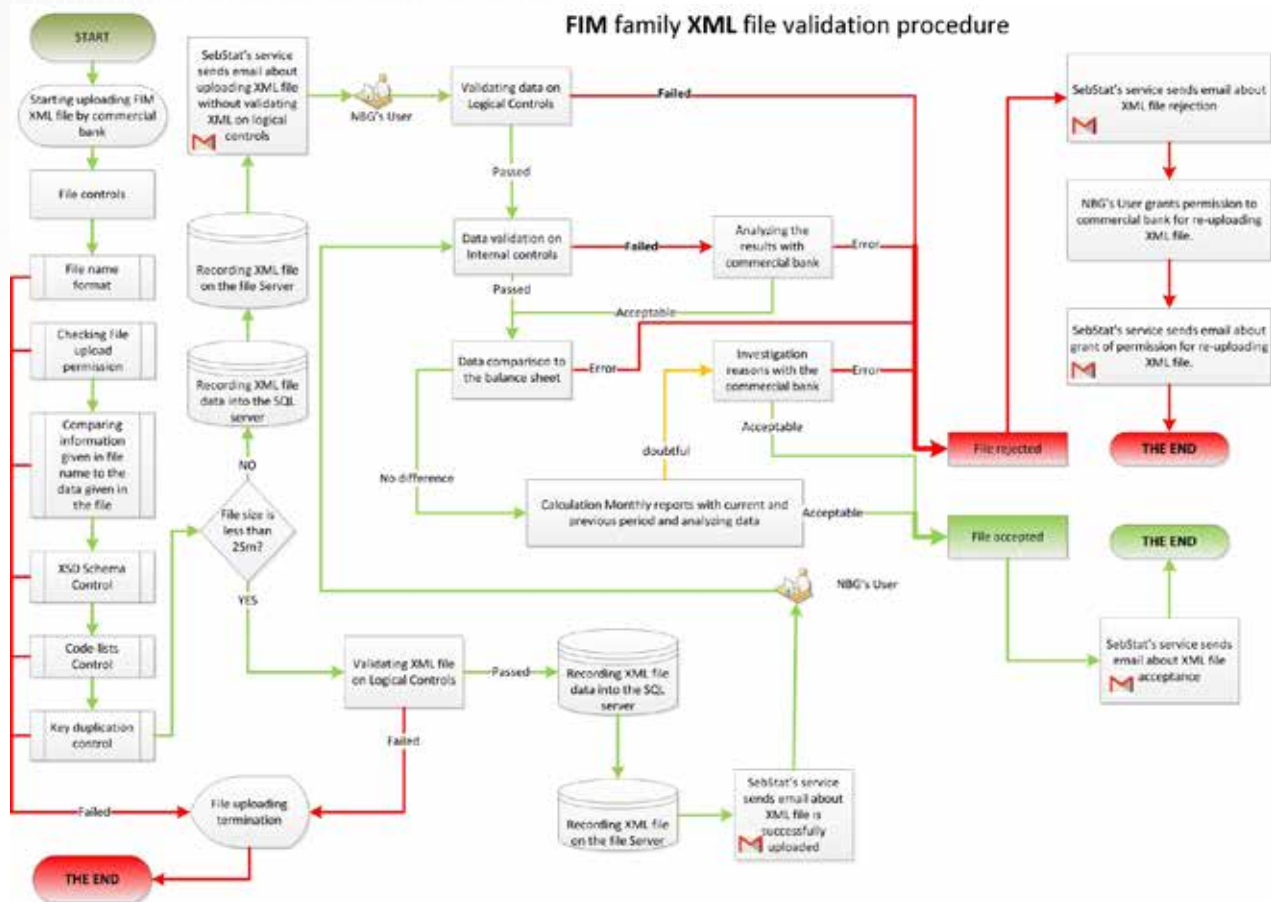
SebStat is a harmonized system, which ensures consistency with modern international standards established by macroeconomic statistical systems (the System of National Account, the Balance of Payments, Monetary and Financial Statistics, and Government Financial Statistics).

SebStat is a flexible system: any institutional or structural changes in the banking system can be reflected immediately in SebStat without extra time or cost, and it can be extended by adding new data family groups at minimal cost.

The main advantage of SebStat – as a new statistical concept – is that it not only allows an ex-

tension of the required data coverage, but also increases the quality of the data reported by commercial banks. High data quality is ensured both by the clear step-by-step data preparation procedures followed in commercial banks and

by the comprehensive validation schemes employed at the National Bank of Georgia. One of the validation procedures (FIM family XML file validation) is illustrated below.



The National Bank of Georgia is going to provide step-by-step updated statistical information to users.

New data collection technologies serve the development of new analytical products. In this regard, intensive statistical work was started to develop financial account statistics and provide information for flow of funds analysis. The financial account is a very important statistical instrument for macroeconomic analysis as it describes financial linkages between different economic sectors. That is why the following experimental accounts were compiled:

- ✓ The basic flow of funds;
- ✓ The flow of funds of the National Bank, other depository corporations and other financial corporations according to the System of National Accounts (SNA);
- ✓ Flow of funds of the government, non-financial corporations, households and Non-profit institutions serving households (NPISHs).

In order to get additional information for the financial account, the NBG is in continuous co-operation with Geostat. On the initiative of the NBG, a new annual survey of nonfinancial corporations' financial performance was introduced.

Agreement was reached on sharing experimental versions of sectoral balances, which is something that is very important for estimating net borrowing/lending (an item of the capital account).

Starting from 2015, the NBG introduced additional statistical tables on the external debt statistics of Georgia. This was in line with the new methodology on external debt statistics (2013 EDS Guide), which is updated according to changes in the Balance of Payments Statistics Manual, sixth edition (BPM6). The major methodological changes in compilation of external debt are as follows:

- ✓ The item “Accumulated arrears” is no longer recorded. According to BPM6, when arrears occur, no transactions should be imputed and the arrears should continue to be shown in the same instrument until the liability is ex-

tinguished, rather than recording arrears as a repayment of the original liability and the creation of a new short-term debt liability.

- ✓ Accrued interest is recorded under the same item on which it was accrued (i.e. interest accrued on a long-term loan is included in long term-loans and interest accrued on a short-term loan is included in short-term loans). In BPM5, both long- and short-term loan interests were recorded as separate short-term debt instruments.
- ✓ The change in the methodology of trade credit calculation in BPM6 resulted in a difference between the trade credits data calculated according to the old and new editions. Therefore, the external debt calculated according to BPM6 is somewhat reduced compared to the old edition.



XV

NATIONAL BANK OF GEORGIA

FINANCIAL STATEMENTS FOR THE
YEAR ENDED 31 DECEMBER 2015



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NATIONAL BANK OF GEORGIA

STATEMENT OF MANAGEMENT'S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2015

Management is responsible for the preparation of the financial statements that present fairly the financial position of the National Bank of Georgia (the "Bank") at 31 December 2015, the results of its operations, cash flows and changes in equity for the year then ended, in accordance with International Financial Reporting Standards ("IFRS").

In preparing the financial statements, management is responsible for:

- Properly selecting and applying accounting policies;
- Presenting information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- Providing additional disclosures when compliance with the specific requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Bank's financial position and financial performance; and
- Making an assessment of the Bank's ability to continue as a going concern.

Management is also responsible for:

- Designing, implementing and maintaining an effective and sound system of internal controls, throughout the Bank;
- Maintaining adequate accounting records that are sufficient to show and explain the Bank's transactions and disclose with reasonable accuracy at any time the financial position of the Bank, and which enable them to ensure that the financial statements of the Bank comply with IFRS;
- Maintaining statutory accounting records in compliance with legislation and accounting standards of Georgia;
- Taking such steps that are reasonably available to them to safeguard the assets of the Bank; and
- Preventing and detecting fraud and other irregularities.

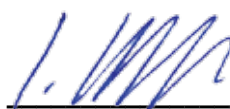
The financial statements for the year ended 31 December 2015 were authorized for issue on 8 April 2016 by the Council of the Bank.

On behalf of the Council of the Bank:



**Chairman of the Council
Koba Gvenetadze**

8 April 2016
Tbilisi, Georgia



**Head of Finance and Accounting Department
Salome Skhirtladze**

8 April 2016
Tbilisi, Georgia



KPMG Georgia LLC
4, Besiki Street,
Tbilisi, 0108,
Georgia

Telephone +995 (32) 2935695
Fax +995 (32) 2935713
Internet www.kpmg.ge

Independent Auditors' Report

To the Council of the National Bank of Georgia

We have audited the accompanying financial statements of the National Bank of Georgia (the "Bank"), which comprise the statement of financial position as at 31 December 2015, and the statements of profit or loss and other comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2015, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

KPMG Georgia LLC

8 April 2016

KPMG Georgia LLC

KPMG Georgia LLC, a company incorporated under the Laws of Georgia,
a member firm of the KPMG network of independent member firms
affiliated with KPMG International Cooperative ("KPMG International"), a
Swiss entity.



NATIONAL BANK OF GEORGIA

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2015

(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-15	Year ended 31-Dec-14
Interest income			
International reserves management			
Due from international financial institutions		1,934	1,781
Trading securities		1,174	1,186
Investments available-for-sale		20,513	14,489
Other		232	339
		23,853	17,795
Monetary policy operations			
Due from resident financial institutions		59,552	18,398
Investments available-for-sale		8,989	5,712
		68,541	24,110
Other interest income			
Investments held-to-maturity		24,227	26,938
Other		49	70
		24,276	27,008
Total interest income		116,670	68,913
Interest expense			
Monetary policy operations			
Debt securities issued		(24,846)	(22,032)
Due to resident financial institutions		(12,127)	(9,505)
		(36,973)	(31,537)
Other interest expenses			
Due to international monetary fund		(517)	(2,698)
Total interest expense		(37,490)	(34,235)
NET INTEREST INCOME		79,180	34,678
Recovery/(loss) of impairment on other assets	18	92	(74)
NET INTEREST INCOME AFTER IMPAIRMENT PROVISION		79,272	34,604
Net gains/(losses) from foreign currencies:			
-translation differences		700,237	103,894
-dealing		(258)	832
Fee and commission income	4	1,577	1,409
Fee and commission expense	4	(1,585)	(1,281)
Net gain on realised available-for-sale financial assets		2,321	3,667
Net loss on financial instruments at fair value through profit or loss		(553)	(2,073)
Net unrealized (loss)/gain on financial instruments at fair value through profit or loss		(1,817)	379
Other income	5	1,620	1,266
NON-INTEREST INCOME		701,542	108,093

The statement of profit or loss and other comprehensive income is to be read in conjunction with the notes to, and forming part of, the financial statements.

NATIONAL BANK OF GEORGIA

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2015 (CONTINUED)

(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-15	Year ended 31-Dec-14
Personnel expenses	6	(13,453)	(13,141)
General and administrative expenses	6	(9,336)	(6,168)
Money printing expenses		(11,134)	(2,467)
Depreciation and amortization	6	(5,426)	(6,204)
Loss on disposal of property and equipment		(5)	(44)
Other expenses		(33)	(27)
NON-INTEREST EXPENSES		(39,387)	(28,051)
PROFIT FOR THE YEAR		741,427	114,646
Other comprehensive income			
<i>Items that are or may be reclassified subsequently to profit or loss:</i>			
Net unrealized (loss)/gain on revaluation of available-for-sale investments during the year		(15,705)	1,034
Net realized losses on available-for-sale investments reclassified to profit or loss		(1,124)	(93)
Total other comprehensive (loss)/income		(16,829)	941
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		724,598	115,587

The financial statements as set out on pages 3 to 52 were approved by management on 8 of April 2016 and were signed on behalf of the Council of the Bank by:


Chairman of the Council
Koba Gvenetadze


Head of Finance and Accounting Department
Salome Skhirtladze

The statement of profit or loss and other comprehensive income is to be read in conjunction with the notes to, and forming part of, the financial statements.

NATIONAL BANK OF GEORGIA

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2015

(in thousands of Georgian Lari)

	Notes	31-Dec-15	31-Dec-14
ASSETS:			
Foreign currency assets			
International reserves			
Cash and cash equivalents	7	1,541,161	1,725,028
Special Drawing Rights holdings with the International Monetary Fund	9	478,230	388,675
Assets related to derivative instruments	10	3,204	2,835
Trading securities	11	577,474	494,071
Investments available-for-sale	12	3,440,021	2,422,291
Other foreign currency assets			
Other assets	18	65	4
		6,040,155	5,032,904
National currency assets			
Monetary policy instruments			
Due from resident financial institutions	8	1,067,000	712,500
Investments available-for-sale	12	101,617	80,776
Other national currency assets			
Investments held-to-maturity	13	401,914	442,094
Investment property	14	2,544	2,173
Assets held for sale	15	-	415
Property and equipment	16	54,828	58,547
Intangible assets	17	1,248	2,514
Other assets	18	6,086	4,102
		1,635,237	1,303,121
TOTAL ASSETS		7,675,392	6,336,025

The statement of financial position is to be read in conjunction with the notes to, and forming part of, the financial statements.

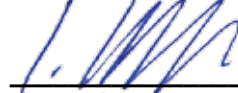
NATIONAL BANK OF GEORGIA

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2015 (CONTINUED) (in thousands of Georgian Lari)

	Notes	31-Dec-15	31-Dec-14
LIABILITIES AND EQUITY:			
LIABILITIES:			
Foreign currency liabilities			
Monetary policy instruments			
Due to resident financial institutions	19	1,717,245	1,154,372
Other foreign currency liabilities			
Due to resident financial institutions	19	273,349	172,276
Due to the Ministry of Finance	20	261,914	187,948
Due to the International Monetary Fund	9	524,010	467,431
Other liabilities	18	2,472	617
		2,778,990	1,982,644
National currency liabilities			
Money issued in circulation	21	2,503,735	2,462,111
Monetary policy instruments			
Debt securities issued	23	353,397	500,688
Due to resident financial institutions	19	453,832	712,257
Other national currency liabilities			
Due to the Ministry of Finance	20	591,464	407,787
Due to customers	22	777	1,046
Due to the International Monetary Fund	9	1,252	1,058
Other liabilities	18	8,475	9,562
		3,912,932	4,094,509
TOTAL LIABILITIES		6,691,922	6,077,153
EQUITY:			
Capital	24	15,000	15,000
Reserve fund	24	51,942	10,373
Foreign currency revaluation reserve	24	929,839	229,602
Revaluation reserve of investments available-for-sale	24	(13,311)	3,518
Other revaluation reserve	24	-	379
TOTAL EQUITY		983,470	258,872
TOTAL LIABILITIES AND EQUITY		7,675,392	6,336,025

The financial statements as set out on pages 3 to 52 were approved by management on 8 of April 2016 and were signed on behalf of the Council of the Bank by:


Chairman of the Council
Koba Gvenetadze


Head of Finance and Accounting Department
Salome Skhirtladze

The statement of financial position is to be read in conjunction with the notes to, and forming part of, the financial statements.

NATIONAL BANK OF GEORGIA

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2015

(in thousands of Georgian Lari)

	Capital	Reserve fund	Foreign currency revaluation reserve	Other revaluation reserve	Revaluation reserve of investments available-for-sale	Retained earnings	Total equity
1-Jan-14	15,000	-	125,708	-	2,577	-	143,285
Total comprehensive income							
Profit for the year	-	-	-	-	-	114,646	114,646
Other comprehensive income							
<i>Items that are or may be reclassified subsequently to profit or loss:</i>							
Net unrealized (loss)/gain on revaluation of available-for-sale investments during the year	-	-	-	-	1,034	-	1,034
Net realized losses on available-for-sale investments reclassified to profit or loss	-	-	-	-	(93)	-	(93)
Total other comprehensive income	-	-	-	-	941	-	941
Total comprehensive income for the year	-	-	-	-	941	114,646	115,587
Transactions recorded directly in equity							
Transfer to reserve fund (Note 24)	-	10,373	-	-	-	(10,373)	-
Transfer to foreign currency revaluation reserve (Note 24)	-	-	103,894	-	-	(103,894)	-
Transfer to/(from) other revaluation reserve (Note 24)	-	-	-	379	-	(379)	-
Total transactions recorded directly in equity	-	10,373	103,894	379	-	(114,646)	-
31-Dec-14	15,000	10,373	229,602	379	3,518	-	258,872
Total comprehensive income							
Profit for the year	-	-	-	-	-	741,427	741,427
Other comprehensive income							
<i>Items that are or may be reclassified subsequently to profit or loss:</i>							
Net unrealized (loss)/gain on revaluation of available-for-sale investments during the year	-	-	-	-	(15,705)	-	(15,705)
Net realized losses on available-for-sale investments reclassified to profit or loss	-	-	-	-	(1,124)	-	(1,124)
Total other comprehensive income	-	-	-	-	(16,829)	-	(16,829)
Total comprehensive income for the year	-	-	-	-	(16,829)	741,427	724,598
Transactions recorded directly in equity							
Transfer to reserve fund (Note 24)	-	41,569	-	-	-	(41,569)	-
Transfer to foreign currency revaluation reserve (Note 24)	-	-	700,237	-	-	(700,237)	-
Transfer to/(from) other revaluation reserve (Note 24)	-	-	-	(379)	-	379	-
Total transactions recorded directly in equity	-	41,569	700,237	(379)	-	(741,427)	-
31-Dec-15	15,000	51,942	929,839	-	(13,311)	-	983,470

The financial statements as set out on pages 3 to 52 were approved by management on 8 of April 2016 and were signed on behalf of the Council of the Bank by:


Chairman of the Council Department
Koba Gvenetadze


Head of Finance and Accounting
Salome Skhirtladze

The statement of changes in equity is to be read in conjunction with the notes to, and forming part of, the financial statements.

NATIONAL BANK OF GEORGIA

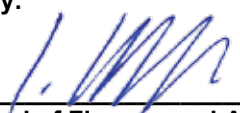
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2015

(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-2015	Year ended 31-Dec-2014
CASH FLOWS FROM OPERATING ACTIVITIES:			
Interest received		139,328	96,888
Interest paid		(30,535)	(28,539)
Fees and commissions received		1,577	1,409
Fees and commissions paid		(1,585)	(1,281)
Net gain from investment securities		553	2,073
Net realized (loss)/gain from dealing in foreign currencies		(258)	832
Other income received		1,248	752
Personnel expenses paid		(13,453)	(13,141)
Cash paid for printing money		(11,134)	(2,467)
Other general and administrative expenses paid		(9,323)	(4,294)
Cash flow from operating activities before changes in operating assets and liabilities		76,418	52,232
<i>Net (increase)/decrease in operating assets:</i>			
Due from financial institutions resident.		(353,364)	(312,440)
Special Drawing Rights holdings with the International Monetary Fund		2,001	1,210
Assets related to derivative instruments		(369)	(2,166)
Trading securities		26,773	(79,958)
Other assets		(1,761)	332
<i>Net increase/(decrease) in operating liabilities:</i>			
Money issued in circulation		41,624	110,559
Due to resident financial institutions		63,708	334,143
Due to the Ministry of Finance		211,126	102,318
Due to customers		(269)	(89)
Other liabilities		(212)	-
Net cash inflow from operating activities		65,675	206,141
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment		(246)	(2,036)
Purchase of intangible assets		(156)	(269)
Purchase of investments available-for-sale		(5,492,000)	(5,207,306)
Proceeds from redemption of investments available-for-sale		5,090,795	5,420,105
Net cash (used in)/from investing activities		(401,607)	210,494
CASH FLOWS FROM FINANCING ACTIVITIES:			
Debt securities issued		1,017,863	1,449,021
Debt securities redeemed		(1,172,143)	(1,636,777)
Repayment of amounts due to the International Monetary Fund		(48,141)	(122,758)
Net cash used in financing activities		(202,421)	(310,514)
Effect of exchange rates changes on cash and cash equivalents		354,486	104,726
Net (decrease)/increase in cash and cash equivalents		(183,867)	210,847
CASH AND CASH EQUIVALENTS, at the beginning of the year	7	1,725,028	1,514,181
CASH AND CASH EQUIVALENTS, at the end of the year	7	1,541,161	1,725,028

The financial statements as set out on pages 3 to 52 were approved by management on 8 of April 2016 and were signed on behalf of the Council of the Bank by:


Chairman of the Council
Koba Gvenetadze


Head of Finance and Accounting Department
Salome Skhirtladze

The statement of cash flows is to be read in conjunction with the notes to, and forming part of, the financial statements.

NATIONAL BANK OF GEORGIA

NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

1. ORGANIZATION

The National Bank of Georgia (the “Bank”) is the central bank of Georgia and the banker and fiscal agent of the Government of Georgia. It acts in accordance with the Organic Law of Georgia “On the National Bank of Georgia” enacted effective from 1 December 2009 (the “Law”), which fully replaced the previous law dated 24 October 1995.

The responsibilities of the Bank focus on the goals of price stability, financial system stability and efficiency, national currency emission, and the efficient management of international reserves. These functions are carried out as part of the broad functions described below.

Monetary policy

The main objective of the monetary policy of the National Bank of Georgia is to maintain price stability. Price stability implies the existence of a moderate and predictable rate of inflation, which is a necessary precondition for long run economic growth. Furthermore, the Bank supports financial system stability and promotes the country's economic growth as long as the latter objectives do not contradict with its main goal – maintaining price stability. Monetary and exchange rate policies serve the objective of preserving the purchasing power of the national currency, raising the growth potential of gross domestic product, and improving the investment climate.

Supervision and financial stability

The main objective is ensuring the stability and efficiency of Georgia's financial system. In achieving those objectives, the Bank is responsible for the supervision and regulation of separate participants on the financial market – commercial banks, credit unions, micro financial organizations, money remittance units and currency exchange bureaus – and the securities market.

Currency

The Bank is the only body in the country authorized to issue Georgian Lari banknotes and coins on the territory of Georgia. The Bank determines the design, composition and other features of the Georgian Lari banknotes and coins, printed and minted in leading European mints.

International reserve management

The Bank maintains a portfolio of foreign currency reserves for policy and operational purposes, for instance to protect the country from external vulnerability by maintaining sufficient liquidity to absorb shocks during a financial crisis, to support day to day foreign currency payment requirements of the Georgian Government and those of the Bank.

Payment systems

The Bank operates the largest payment system in the country – the Real Time Gross Settlement (RTGS), which processes and settles interbank and the Government payments in national currency.

Governance

As at 31 December 2015 and 2014, the members of the Council of the Bank are:

Position	Name (2015)	Name (2014)
Chairman	Mr. Giorgi Kadagidze (Governor)	Mr. Giorgi Kadagidze (Governor)
Member	Mr. Archil Mestvirishvili	Mr. Archil Mestvirishvili
Member	Mr. Otara Nadaraia	Mr. Otara Nadaraia
Member	Mr. Lasha Jugeli	Mr. Lasha Jugeli
Member	Mr. Nikoloz Gongliashvili	Mr. Nikoloz Gongliashvili
Member	Mr. Vazha Jankarashvili	Mr. Vazha Jankarashvili
Member	Mr. Nikoloz Kavelashvili	Mr. Archil Mamatelashvili

NATIONAL BANK OF GEORGIA

NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

The Bank's main office is located at 2 Sanapiro, Tbilisi, 0114, Georgia. As at 31 December 2015 and 2014 the Bank has one cash service center. The Bank has 339 and 351 personnel as at 31 December 2015 and 2014, respectively.

2. BASIS OF PREPARATION OF FINANCIAL STATEMENTS

Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

The presentation of these financial statements is framed within an economic and accounting framework that fairly reflects the financial position of the Bank, and at the same time, contributes to the economic analysis of the Bank's operations. For this reason, the economic concepts of international reserves and monetary policy are shown under the captions international reserve and monetary policy instruments, respectively. The presentation principle according to the latter concept has been first applied in 2014. As at 31 December 2015 liabilities are presented between Foreign currency and National currency. Comparative information is represented to conform to changes in the current year presentation.

Basis of measurement

These financial statements are prepared on the historical cost basis except that financial instruments at fair value through profit or loss and available-for-sale financial assets are stated at fair value.

Functional and presentation currency

The Bank's main objective is to maintain price stability, which implies that open-market operations play a significant role in the development of the monetary policy, accordingly, its main activity is the issuance of banknotes and coins, in Georgian Lari, which has been defined as the functional and presentation currency for the financial statements. Consequently, all balances and transactions denominated in currencies other than the Georgian Lari are considered as denominated in "foreign currency".

These financial statements are presented in thousands of Georgian Lari ("GEL"), unless otherwise indicated. Financial information presented in GEL is rounded to the nearest thousand.

3. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below are applied consistently to all periods presented in these financial statements, and are applied consistently by the Bank.

Financial Instruments

A financial instrument is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

The Bank's financial instruments are its Georgian Lari securities, foreign government, supranational or agency securities, interest rate futures, holdings in the International Monetary Fund (IMF), cash and cash equivalents, due from financial institutions, due to commercial banks and Ministry of Finance of Georgia and other financial assets and liabilities. The Bank accounts for its financial instruments in accordance with IAS 39–*Financial Instruments: Recognition and Measurement* and reports these instruments under IFRS 7–*Financial Instruments: Disclosures* and IFRS 13–*Fair Value Measurement*.

The Bank classifies its financial assets in the following categories: at fair value through profit or loss (FVTPL), held-to-maturity (HTM), loans and receivables and available-for-sale (AFS). The classification

NATIONAL BANK OF GEORGIA

NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

depends on the purpose for which the financial assets were acquired. Management determines the classification of financial assets at initial recognition.

Initial recognition of financial assets and liabilities.

The Bank recognises financial assets and liabilities in its statement of financial position when it becomes a party to the contractual obligations of the instrument. Regular way purchases and sales of financial assets and liabilities are recognised using settlement date accounting.

Financial assets and liabilities are initially recognised at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs directly attributable to the acquisition of financial assets or financial liabilities at fair value through profit or loss are recognised immediately in profit or loss. The accounting policies for subsequent re-measurement of these items are disclosed in the respective accounting policies set out below.

Derecognition of financial assets and liabilities

Financial assets

The Bank derecognizes a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred to another party or in which the Bank neither transfers nor retains substantially all the risks and rewards of ownership and it does not retain control of the financial asset. If the Bank neither transfers nor retains substantially all the risks and rewards of ownership and continues to control the transferred asset, the Bank recognizes its retained interest in the asset and an associated liability for amounts it may have to pay. If the Bank retains substantially all the risks and rewards of ownership of a transferred financial asset, the Bank continues to recognise the financial asset and also recognises a collateralised borrowing for the proceeds received.

On derecognition of a financial asset in its entirety, the difference between the asset's carrying amount and the sum of the consideration received and receivable and the cumulative gain or loss that had been recognized in other comprehensive income and accumulated in equity is recognized in profit or loss.

On derecognition of a financial asset other than in its entirety (e.g. when the Bank retains an option to repurchase part of a transferred asset), the Bank allocates the previous carrying amount of the financial asset between the part it continues to recognize under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. The difference between the carrying amount allocated to the part that is no longer recognised and the sum of the consideration received for the part no longer recognised and any cumulative gain or loss allocated to it that had been recognised in other comprehensive income is recognized in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.

Financial liabilities

The Bank derecognises financial liabilities when, and only when, the Bank's obligations are discharged, cancelled or they expire. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification, is treated as a derecognition of the original liability and the recognition of a new liability. The difference between the carrying amount of the financial liability derecognized and the consideration paid and payable is recognized in profit and loss.

Fair value measurement principles

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal, or in its absence, the

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most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

When available, the Bank measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active, if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

When there is no quoted price in an active market, the Bank uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all the factors that market participants would take into account in these circumstances.

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price, i.e., the fair value of the consideration given or received. If the Bank determines that the fair value at initial recognition differs from the transaction price and the fair value is evidenced neither by a quoted price in an active market for an identical asset or liability nor based on a valuation technique that uses only data from observable markets, the financial instrument is initially measured at fair value, adjusted to defer the difference between the fair value at initial recognition and the transaction price. Subsequently, that difference is recognised in profit or loss on an appropriate basis over the life of the instrument, but no later than when the valuation is supported wholly by observable market data or the transaction is closed out.

Amortised cost

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment. Premiums and discounts, including initial transaction costs, are included in the carrying amount of the related instrument and amortised based on the effective interest rate of the instrument.

Financial assets

Cash and cash equivalents

Cash and cash equivalents consist of cash on hand in foreign currency, unrestricted balances on correspondent and time deposit accounts including overnight deposits and amounts due from financial institutions that mature within ninety days from the date of origination and are free from contractual encumbrances. Cash and cash equivalents are subsequently measured at amortized cost.

Membership in the International Monetary Fund (the “IMF”) and other international financial institutions

Based on the provision of Article 5 of the Law, the Bank acts as an intermediary of the Government of Georgia on transactions related to the membership of Georgia in international financial organizations (i.e. the IMF, World Bank), including payment of membership fees to such organizations.

Loans and receivables

In the normal course of business, the Bank maintains loans and deposits for various periods of time with financial institutions. Due from financial institutions and other financial assets are considered in this category. Loans and receivables are non-derivative financial instruments that are not quoted in an active market. They are not entered into with the intention of immediate or short-term resale and are not classified as trading securities or designated as available-for-sale investments. Loans and receivables are initially recognised at fair value and subsequently measured at amortised cost using the effective interest method. Amounts of loans and receivables are carried net of any allowance for impairment losses. Gains and losses are recognised in the statement of profit or loss and other comprehensive income when the loans and receivables are derecognised or impaired, as well as through the amortization process.

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Trading securities

Financial assets at fair value through profit and loss (FVTPL) are financial assets held for trading. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term. Derivatives are also categorised as held for trading unless they are designated as hedges. The trading portfolio includes part of international reserves managed by external managers - World Bank and Bank for International Settlements ("BIS").

Financial assets at FVTPL are stated at fair value, with any gains or losses arising on re-measurement recognised in profit or loss presented in net unrealized gain/loss on financial instruments at fair value through profit or loss line item in the statement of profit or loss and other comprehensive income. Fair value is determined in the manner described in Note 27.

Derivative financial instruments

The Bank uses interest rate futures contracts on overseas exchanges to manage interest rate risk on its portfolio of foreign securities. An interest rate futures contract is a contract to buy or sell a specific amount of securities for a specific price on a specific future date.

Interest rate futures positions are classified under IAS 39 as 'at fair value through profit or loss'. Derivatives are initially recognised at fair value at the date a derivative contract is entered into and are subsequently re-measured to their fair value at each reporting date. The positions are marked to market on balance date at the relevant bid price provided by Bloomberg and valuation gains and losses taken to net unrealized gain/loss from securities and derivatives in the statement of profit or loss and other comprehensive income. Derivatives are carried as assets when their fair value is positive and as liabilities when it is negative.

Investments available-for-sale

Investments available for sale financial assets are non-derivatives that are either designated in this category or not classified in any of the other categories. The Bank's available-for-sale financial assets comprised of Georgian and foreign government, international financial institutions and agency debt securities.

Investments available-for-sale are initially recorded at fair value and subsequently measured at fair value, with such re-measurement recognised in other comprehensive income, except for impairment losses, foreign exchange gains or losses on debt financial instruments available-for-sale and interest income accrued using the effective interest method, which are recognised in the profit or loss.

When the instrument is sold, gains or losses previously recognized as part of the equity are realized, and are transferred to the profit and loss, excluding the effects of the exchange rate difference, which is recorded as stated in paragraph above.

The Bank uses quoted market prices to determine fair value of the Bank's investments available-for-sale. The quoted market prices for international securities are provided daily by Bloomberg and are based on current bid prices. In Management's opinion, such prices reflect reasonably the value of investments in international securities, considering the current market information and the accounting policies established by the Bank's Management.

If the market for investments is not active, the Bank establishes fair value by using discounted cash flow analysis and other relevant valuation techniques. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, reference to the current fair value of another instrument that is substantially the same and discounted cash flow analysis, making maximum use of market inputs and relying as little as possible on entity-specific inputs.

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Investments held-to-maturity

Investments held-to-maturity (HTM) are debt securities with determinable or fixed payments and fixed maturity, and that the Bank has a positive intent and ability to hold them to maturity. Such securities are carried at amortised cost using the effective interest method, less any allowance for impairment

Any premium or discount of the instruments representative of debt classified as held-to-maturity investments is recognized with the calculation of the amortized cost by applying the effective interest rate method, recognizing the accrued interest in the "Investment held-to-maturity" caption of the statement of profit or loss and other comprehensive income. The effective interest method uses the rate inherent in a financial instrument that discounts the estimated future cash flows over the expected life of the financial instrument so as to recognize interest on a constant-yield basis. The Georgian Government bond is classified as HTM.

Allowance for impairment losses on financial assets

An asset is impaired if its carrying amount is greater than its estimated recoverable amount.

(a) Financial assets carried at amortised cost

The Bank assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. A financial asset is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (a loss event) and that loss event has an impact on the estimated future cash flows of the financial asset, that can be estimated reliably. The factors the Bank evaluates in determining the presence of objective evidence of occurrence of an impairment loss include:

- information on credit rating of the debtor or issuer;
- liquidity of the debtor or issuer;
- solvency of the debtor or issuer;
- business risks and financial risks;
- levels and tendencies of default on obligations on similar financial assets;
- national and local economic tendencies and conditions; and
- fair value of the security and guarantees.

These and other factors individually or in the aggregate represent, to a great extent, objective evidence of recognition of the impairment loss on the financial asset or group of financial assets. If there is objective evidence that an impairment loss has been incurred on financial assets measured at amortized cost, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the original effective interest rate of the financial asset.

The carrying amount of the asset is reduced and the amount of the loss is recognised in profit or loss. If a loan or receivable has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as improved credit rating, the previously recognised impairment loss is reversed and is recognized in profit or loss.

(b) Financial assets carried at fair value

The Bank assesses whether there is objective evidence that available for sale financial asset carried at fair value is impaired at each reporting date. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired. If any objective evidence of impairment exists for available-for-sale financial assets, the cumulative loss, measured as the difference between the acquisition cost and current fair value, less any impairment loss on the financial asset previously recognised in profit or

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loss, is removed from other comprehensive income and recognised in profit or loss. If, in a subsequent periods, the fair value of a debt instrument classified as available-for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through profit or loss. However, any subsequent recovery in the fair value of an impaired available-for-sale equity security is recognised in other comprehensive income.

Financial liabilities

Financial Liabilities measured at amortized costs

Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Bank having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity instruments. Such instruments include amounts due to the Government, amounts due to resident financial institutions, amounts due to customers, debt securities issued, liabilities to the International Monetary Fund and other financial liabilities. These are initially recognised at fair value of the consideration received less directly attributable transaction costs. After initial recognition, these financial instruments are subsequently measured at amortised cost using the effective interest method.

Money issued in circulation

Money issued in circulation represents banknotes and coins issued by the Bank in accordance with the Law and its function as the central bank. Banknotes and coins in circulation are recorded in the statement of financial position at their nominal value net of cash in the Bank's cash offices.

The expenses for the production of notes and coins are expensed as incurred.

When notes are returned to the Bank by the commercial banks they are removed from money in circulation and depending on their condition or legal tender status, are either sent for destruction or held by the Bank as cash in vaults outside of the statement of financial position.

Provisions (included in other liabilities)

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the obligation can be made.

Retirement and other employee benefit obligations (included in other liabilities)

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Bank has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee, and the obligation can be estimated reliably.

Pension scheme liabilities on the statement of financial position (note 18) represent the payables under pension arrangement cancelled on 29 May 2009, according to which the Bank had been collecting contributions from its employees and paying aggregated contributions to the employees after they reached the pension age according to the pre-agreed schedule.

Precious metals (included in other assets)

Gold commemorative coins and gold bars are recognized and subsequently measured according to IAS 2-Inventories requirements. Gold commemorative coins and gold bars initially are measured at cost, including expenses on minting, transportation and other direct costs, subsequently measured at the lower of costs and net realizable value. When commemorative coins and bars are sold, gain or loss is recorded in the statement of profit or loss and other comprehensive income. Expenses on other commemorative

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coins and bars are recognised as current expenses when produced and reflected in the statement of profit or loss and other comprehensive income.

Investment property

Investment properties (including property under construction for such purposes) are properties held to earn rental income and/or for capital appreciation but not for sale in normal course of business, or for the use in production or supply of goods or services or for administrative purposes. Investment properties are measured initially at cost, including transaction costs. Subsequent to initial recognition, investment property is carried at historical cost net of accumulated depreciation and recognized impairment loss. Depreciation is calculated on a straight line basis over the useful life of the assets.

Assets held for sale

A non-current asset is classified as held for sale if it is highly probable that the asset's carrying amount will be recovered through a sale transaction rather than through continuing use and the asset (or disposal group) is available for immediate sale in its present condition. Management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification of an asset as held for sale.

Non-current assets held for sale are measured at the lower of its carrying amount and fair value less costs to sell. If the fair value less costs to sell of an asset held for sale is lower than its carrying amount, an impairment loss is recognised in the statement of profit or loss and other comprehensive income as loss from non-current assets held for sale. Any subsequent increase in an asset's fair value less costs to sell is recognized in total comprehensive income to the extent of the cumulative impairment loss that was previously recognised in relation to that specific asset.

Property and equipment

Property and equipment are carried at historical cost less accumulated depreciation and any recognised impairment loss, if any. Land is not depreciated.

Where an item of property and equipment comprises major components having different useful lives, they are accounted for as separate items of property and equipment.

Depreciation is charged on the historical cost of property and equipment and is designed to write off assets over their useful economic lives. Depreciation commences on the date of acquisition or, in respect of internally constructed assets, from the time an asset is completed and ready for use. Depreciation is charged to profit or loss on a straight line basis at the following annual prescribed rates:

	%
Buildings	2
Computers, office equipment and fixtures	10-20
Vehicles and other	20

Expenses related to repairs and renewals are charged when incurred and included in operating expenses unless they qualify for capitalization.

The carrying amounts of property and equipment are reviewed at each reporting date to assess whether they are recorded in excess of their recoverable amounts. The recoverable amount is the higher of fair value less costs to sell and value in use. Where carrying values exceed the estimated recoverable amount, assets are written down to their recoverable amount; impairment is recognised in the respective period in the statement of profit or loss and other comprehensive income. After the recognition of an impairment loss the depreciation charge for property and equipment is adjusted in future periods to allocate the assets' revised carrying value, less its residual value (if any), on a systematic basis over its remaining useful life.

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Intangible assets

Intangible assets include computer software and licenses.

Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and any accumulated impairment losses. The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortised over the useful economic lives of five years and assessed for impairment whenever there is an indication that the intangible asset may be impaired. Amortization periods and methods for intangible assets with finite useful lives are reviewed at least at each financial year-end.

Taxation

According to the Law assets, property and income of the Bank, as well as its activities and operations are exempted from all taxes and other levies.

Contingencies

Contingent liabilities are not recognised in the statement of financial position but are disclosed unless the possibility of any outflow in settlement is remote. A contingent asset is not recognised in the statement of financial position but disclosed when an inflow of economic benefits is probable.

Recognition of income and expense

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured.

Interest and similar income and expense

For all financial instruments measured at amortised cost and interest bearing securities classified as trading and available for sale, interest income or expense is recorded at the effective interest rate, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. The calculation takes into account all contractual terms of the financial instrument (for example, prepayment options) and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective interest rate, but not future credit losses. The carrying amount of the financial asset or financial liability is adjusted if the Bank revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate and the change in carrying amount is recorded as interest income or expense.

Once the recorded value of a financial asset or a group of similar financial assets has been reduced due to an impairment loss, interest income continues to be recognised using the original effective interest rate applied to the new carrying amount.

Fee and commission income and expense

The Bank earns fee and commission income from a diverse range of services it provides to its counterparties. Fee and commission income includes cash operations fees and fund transfer fees, which are recognised as revenue as the services are provided. Fee and commission expense consists of cash operation, settlement fees and fees paid to the external manager, which are recognized as expense as the services are rendered.

Foreign currency translation

The financial statements are presented in Georgian Lari, which is the Bank's functional and presentation currency. Transactions in foreign currencies are initially recorded in the nominal currency converted into the functional currency rate of exchange ruling at the date of the transaction. Monetary assets and

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liabilities denominated in foreign currencies are translated at the functional currency rate of exchange ruling at the end of reporting date. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Gains and losses resulting from the translation of foreign currency transactions are recognised in the statement of profit or loss and other comprehensive income as net gains (losses) from foreign currencies - translation differences.

Differences between the contractual exchange rate of a transaction in a foreign currency and the Bank's exchange rate on the date of the transaction are included in net gains (losses) from dealing in foreign currencies.

Rates of exchange

The exchange rates used by the Bank in the preparation of the financial statements as at year-end are as follows:

	31 December 2015	31 December 2014
GEL/1 US Dollar	2.3949	1.8636
GEL/1 Euro	2.6169	2.2656
GEL/1 Australian Dollar	1.7478	1.5218
GEL/1 Canadian Dollar	1.7263	1.6021
GEL/1 Special Drawing Right	3.3187	2.6992

Offset of financial assets and liabilities

Financial assets and liabilities are offset and reported net in the statement of financial position when the Bank has a legally enforceable right to set off the recognised amounts and the Bank intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. In accounting for a transfer of a financial asset that does not qualify for de-recognition, the Bank does not offset the transferred asset and the associated liability. No offset of financial assets and liabilities have been made as of reporting period.

Reclassification of financial assets

If a non-derivative financial asset classified as held for trading is no longer held for the purpose of selling in the near term, it may be reclassified out of the fair value through profit or loss category in one of the following cases:

- a financial asset that would have met the definition of loans and receivables above may be reclassified to loans and receivables category if the Bank has the intention and ability to hold it for the foreseeable future or until maturity;
- other financial assets may be reclassified to available-for-sale or held-to-maturity categories only in rare circumstances.

A financial asset classified as available-for-sale that would have met the definition of loans and receivables may be reclassified to loans and receivables category if the Bank has the intention and ability to hold it for the foreseeable future or until maturity.

Financial assets are reclassified at their fair value on the date of reclassification. Any gain or loss already recognised in profit or loss is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable. No reclassification of financial assets has been made as of reporting period.

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Areas of significant management judgment and sources of estimation uncertainty

The preparation of the Bank's financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities at the reporting date and the reported amount of income and expenses during the period ended. Management evaluates its estimates and judgments on an ongoing basis. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Information about significant areas of estimation uncertainty and critical judgments in applying accounting policies is described in the Note 27 Fair values of financial instruments.

Application of new and revised International Financial Reporting Standards (IFRSs)

Summary of new and revised IFRSs in issue but not yet effective are provided in the below table. The Bank intends to adopt these standards, if applicable, when they become effective.

New Standards and amendments to existing standards	Effective for annual periods beginning on
IFRS 9 Financial Instruments	
IFRS 9 <i>Financial Instruments</i> was issued in phases and is intended ultimately to replace International Financial Reporting Standard IAS 39 <i>Financial Instruments: Recognition and Measurement</i> . The first phase of IFRS 9 was issued in November 2009 and relates to the classification and measurement of financial assets. The second phase regarding the classification and measurement of financial liabilities was published in October 2010. The third phase of IFRS 9 was issued in November 2013 and relates to general hedge accounting. The standard was finalized and published in July 2014. The final phase relates to a new expected credit loss model for calculating impairment. The Bank recognises that the new standard introduces many changes to accounting for financial instruments and is likely to have a significant impact on the financial statements. The Bank has not analysed the impact of these changes yet. The Bank does not intend to adopt this standard early. The standard will be effective for annual periods beginning on or after 1 January 2018 and will be applied retrospectively with some exemptions.	1 January 2018, with early application permitted. The management is assessing the potential impact on its financial statements resulting from the application of IFRS 9.
Clarification of Acceptable Methods of Depreciation and Amortisation	
The amendments clarify the principle in IAS 16 and IAS 38 that revenue reflects a pattern of economic benefits that are generated from operating a business (of which the asset is part) rather than the economic benefits that are consumed through use of the asset. As a result, a revenue-based method cannot be used to depreciate property, plant and equipment and may only be used in very limited circumstances to amortise intangible assets.	1 January 2016, with early adoption permitted

Various *Improvements to IFRS* are dealt with on a standard-by-standard basis. All amendments, which result in accounting changes for presentation, recognition or measurement purposes, will come into effect not earlier than 1 January 2016. The Bank has not yet analysed the likely impact of the improvements on its financial position or performance.

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4. FEE AND COMMISSION INCOME AND EXPENSE

Fee and commission income and expense comprise:

	Year ended 31-Dec-15	Year ended 31-Dec-14
Fee and commission income:		
Funds transfer	1,568	1,399
Other	9	10
Total fee and commission income	1,577	1,409
Fee and commission expense:		
Fees paid to external manager	(949)	(786)
Settlement operations	(509)	(420)
Cash operations	(127)	(75)
Total fee and commission expense	(1,585)	(1,281)

The Bank owns and manages a real-time gross settlement system, which is an interbank payment system for national currency settlement operations. Funds transfer represents the billing fees paid by the participants (except for the Ministry of Finance of Georgia) for settlement transactions.

5. OTHER INCOME

Other income comprises:

	Year ended 31-Dec-15	Year ended 31-Dec-14
Revenue from grant received	1,084	1,122
Other	536	144
Other income	1,620	1,266

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6. OPERATING EXPENSES

Operating expenses comprise:

	Year ended 31-Dec-15	Year ended 31-Dec-14
Salaries and bonuses	12,515	12,319
Paid vacation and sick leave	938	822
Total personnel expenses	13,453	13,141
Subscription to information services	1,278	1,036
Utilities	781	794
Software maintenance fees	729	642
Social benefit expensesw	520	434
Legal and consultancy	452	432
Advertisement expenses	382	32
Repairs and maintenance	377	147
Business travel and related expenses	357	222
Security	305	315
Fuel expenses	197	224
Personnel training	138	233
Communications	55	73
Office supplies	19	22
Expenses related to financing of legal public entities	-	1,071
Expenses related to EBRD event in Tbilisi.	3,000	-
Other	746	491
Total general and administrative expenses	9,336	6,168
Depreciation charge (Notes 14, 16)	4,004	4,809
Amortization charge (Note 17)	1,422	1,395
Total depreciation and amortization	5,426	6,204

Expenses related to financing of legal public entities represent expenses related to the Georgian Financial Monitoring Service. However, based on amendments in the *Law on Prevention of Illicit Income legalization*, effective from 1 January 2015, the Georgian Financial Monitoring Service became a legal entity that is controlled and financed by the Government of Georgia.

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7. CASH AND CASH EQUIVALENTS

	31-Dec-15	31-Dec-14
Cash on hand in foreign currencies	331,819	262,700
Current accounts	180,105	162,174
Time deposits with credit institutions up to 90 days	1,029,237	1,300,154
Total cash and cash equivalents	1,541,161	1,725,028

No cash and cash equivalents are impaired or past due.

As at 31 December 2015 and 2014, GEL 1,170,939 and GEL 1,094,505 thousand, respectively, was placed in current accounts and time deposits up to ninety days with eight (six in 2014) internationally recognised banks and central banks from Organization of Economic Co-operation and Development member countries (OECD).

As at 31 December 2015 and 2014, annual interest rate range of time deposits with financial institutions up to 90 days was 0.24%-2.23% and 0.06%-2.6%, respectively.

8. DUE FROM RESIDENT FINANCIAL INSTITUTIONS

Due from financial institutions as at 31 December 2015 and 2014 comprise:

	31-Dec-15	31-Dec-14
Due from resident financial institutions		
Refinancing loans	1,020,000	690,000
Overnight loans	47,000	22,500
Total due from financial institutions in national currency	1,067,000	712,500

Refinancing loans are the Bank's Monetary Policy instruments that are issued to Georgian commercial banks for liquidity purposes and have 7 days maturity. As at 31 December 2015 and 2014, the Bank had a concentration of refinancing loans in the amount of GEL 862,200 thousand due from four resident commercial banks at annual interest rates of 9.07%-9.50%, and GEL 618,271 thousand due from three resident commercial banks at annual interest rate of 4.05%-5.50%, respectively.

Collateral and other credit enhancements

The eligible type of collateral and criteria for each type of collateral is defined by the Council of the Bank. The accepted types of collateral are a) debt securities issued by the Bank and by the Government of Georgia, denominated in Lari; b) debt securities issued by the international financial institutions, denominated in Lari; c) debt securities issued by the resident or non-resident legal entities in accordance with the "Law of Georgia on Securities Market", denominated in Lari; d) claims to eligible loan assets of commercial banks; haircuts to each type of collateral are periodically defined by the Monetary Policy Committee (MPC) of the Bank. In special cases defined by the Law, the Council of the Bank can grant the last resort loan without collateral. The Bank has the first lien on borrowers' assets according to the Law.

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As at 31 December 2015 and 2014 types and fair values of financial assets collateralizing due from resident financial institutions are:

	31-Dec-15	31-Dec-14
Government securities (treasury bills/notes)	721,976	508,697
Debt securities issued by the Bank (certificates of deposits)	91,467	144,520
Loan portfolio of commercial banks	97,333	101,372
Bonds issued by International Financial Institutions, denominated in GEL:		
Asian Development Bank (ADB)	100,000	-
European Bank for Reconstruction and Development (EBRD)	75,000	25,000
Black Sea Trade and Development Bank (BSTDB)	48,000	-
International Finance Corporation (IFC)	27,700	-
	1,161,476	779,589

The Bank monitors the value of collateral, requests additional collateral in accordance with the underlying agreement, and monitors the value of collateral obtained during its review of the adequacy of the allowance for loan impairment.

9. SPECIAL DRAWING RIGHTS HOLDINGS WITH THE INTERNATIONAL MONETARY FUND

Balances with the International Monetary Fund ("IMF") comprise:

	31-Dec-15	31-Dec-14
Assets:		
Special Drawing Rights (SDR) holdings	478,230	388,675
Liabilities:		
IMF current accounts		
Current account # 1	1,220	1,031
Current account # 2	32	27
	1,252	1,058
Borrowings from the IMF		
Poverty Reduction and Growth Facility (PRGF)	46,210	78,822
General SDR allocation	369,888	300,841
Special SDR allocation	107,912	87,768
	524,010	467,431
Total due to the IMF	525,262	468,489
Off-balance sheet balances:		
IMF Quota	488,150	412,463
Security held in custody in respect of IMF quota and as collateral of IMF granted facilities	(746,725)	(732,026)

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SDR Holdings

SDR holdings represent the current account of the Bank with the IMF used for borrowings and settlements with the IMF. SDR holdings are primarily obtained from the general and special SDR allocations provided by the IMF under its Articles of Agreement. Interest accrued in respect of SDR holdings is calculated using the rate set by the IMF weekly on the basis of short-term market rates in major money markets. The annual nominal interest rate range on the SDR allocation in 2015 and 2014 is 0.050%-0.055% and 0.03%-0.13%, respectively.

IMF current accounts

The Bank is required to maintain two separate accounts: IMF current account number 1 and IMF current account number 2. IMF current account number 1 is for settlement of the IMF's operational transactions, whereas IMF current account number 2 is used for operational expenses incurred by the IMF in Georgian Lari.

IMF granted facilities

Facilities received from the IMF include the PRGF loan with a carrying amount of GEL 46,210 thousand with original maturity of 10 years bearing an initial interest rate of 0.5% per annum issued for the purpose of poverty reduction and macroeconomic stability. The PRGF-ECF (Extended Credit Facility) Trust borrows resources from central banks, governments, and official institutions generally at market-related interest rates, and lends them on a pass-through basis to PRGF-eligible countries. There is no such trust for other IMF granted facilities. On 10 December 2014 the IMF Executive Board extended through to 31 December 2016, the interest waiver for PRGF-ECF facilities that was introduced on 7 January 2010. Projected interest charges for 2017 and 2018 was defined at 0%. The IMF Executive Board will review the interest rates for all PRGF ECF facilities by the end of 2016 and every two years thereafter. The PRGF-ECF borrowing is expected to be fully repaid by 2017.

All facilities received from the IMF are denominated in SDR.

SDR allocations

The SDR allocation is an unsecured, interest bearing distribution of SDRs by the IMF through general and special allocations. The general allocation is made by the IMF according to the Articles of Agreement to all participants in its SDR Department in proportion to countries' quotas in the IMF. On 10 August 2009, the Fourth Amendment to the IMF Articles of Agreement providing for a special one-time allocation of SDRs entered into force to boost global liquidity. According to the amendment dated 9 September 2009, the special allocation was made to the IMF members, which includes Georgia. Members and prescribed holders may use their SDR holdings to conduct transactions with the IMF. The Bank treats the allocation as a foreign currency liability to the IMF.

Georgia, as a member country of the IMF and recipient of the allocations, is obliged to pay to the IMF an amount equal to its net cumulative allocation and any other amounts that may be due and payable because of the membership termination or liquidation of the IMF's SDR Department.

The annual interest rate range on the SDR allocation in 2015 and 2014 is 0.050%-0.055% and 0.03%-0.13%, respectively.

IMF Quota

The IMF Quota of Special Drawing Rights of 150,300 thousand, represents the membership subscription of Georgia with the IMF, and is non-interest bearing. The IMF receives its resources from its member countries. Each member country of the IMF is assigned a quota, based broadly on its relative position in the world economy. A member's quota delineates basic aspects of its financial and organizational relationship with the IMF. As National Bank of Georgia is a fiscal agent between republic of Georgia and IMF, this instrument is not presented on the statement of financial position.

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Security held in custody in respect of the IMF Quota and as collateral of the IMF granted facilities

Security held in custody comprises GEL 488,150 thousand, in respect of the IMF Quota and GEL 746,725 thousand held in custody as collateral for the IMF granted facilities. The security was issued by the Government of Georgia in 1992 in settlement of the IMF Quota. The security used as collateral includes the total nominal value of the IMF granted facilities to Georgia: to the Bank and to the Government. Nominal value of the security is changed annually according to the revaluation and at the time of facility receipt from the IMF General Resources Account by the facility amount. As this security is held by the Bank in custody, it is accounted for as an off-balance sheet item and presented at nominal value.

10. ASSETS RELATED TO DERIVATIVE INSTRUMENTS

		Notional principal		Notional principal
	31-Dec-15	31-Dec-15	31-Dec-14	31-Dec-14
Interest rate futures				
Futures margin	4,523		2,960	
Interest futures assets	-	52,338	9	348,365
Interest futures liabilities	(1,319)	(1,804,797)	(134)	(1,531,879)
Net interest futures position	(1,319)	(1,752,459)	(125)	(1,183,514)
Total derivative financial assets	3,204	(1,752,459)	2,835	(1,183,514)

At their inception, derivatives often involve only a mutual exchange of promises with little or no transfer of consideration. However, these instruments frequently involve a high degree of leverage and are very volatile. A relatively small movement in the value of the asset, rate or index underlying a derivative contract may have a significant impact on the profit or loss of the Bank.

The futures contracts are contractual agreements to buy or sell a specified financial instrument at a specific price and date in the future. The futures contracts are transacted in standardised amounts on regulated exchanges and are subject to daily cash margin requirements. The credit risk related to future contracts is considered minimal because the cash margin requirements of the exchange help ensure that these contracts are always honored and are settled on a net basis.

The Bank has been trading Eurodollar Futures since March 2012, as a part of Active Portfolio management. This financial instrument is listed on CME (Chicago Mercantile Exchange & Chicago Board of Trade), hence it is exchange traded and standardized. Eurodollar Futures remain the most liquid and actively traded money market derivatives contracts. Each Eurodollar contract's underlying is 3 month Eurodollar time deposit with notional amount of USD 1 million. When trading Eurodollar futures, the Bank is facing the credit risk only of the clearing house, where purchases and sales of Eurodollar futures offset one another.

The Bank is taking positions in Eurodollars for hedging purposes, by means of buying/selling US Treasuries or Spread Products (Agency and Supranational Securities) and entering opposite positions of corresponding amounts of Eurodollar Futures, matching the risk (duration and curve). The main purpose of such strategies is to reduce the portfolio's exposure to interest rate risks and express a view on credit spreads.

Eurodollar futures held in the Bank's portfolio are not held for trading purposes, i.e. the Bank is not going to make profits from favorable movements in their prices.

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

11. TRADING SECURITIES

Trading securities comprise:

	31-Dec-15	31-Dec-14
Funds managed under the World Bank RAMP* program		
Government securities		
US Treasury Notes	306,786	119,478
Kingdom of Belgium	2,401	2,277
French treasury bills	-	91,329
Bundesrepublik Deutschland	-	31,917
Government of Netherlands	-	27,284
Kingdom of Belgium	-	2,304
	309,187	274,589
Supranational securities		
European Investment Bank, Luxembourg	5,979	1,105
Council of Europe Development Bank, Paris	4,848	-
Asian Development Bank, Manila	4,785	-
European Financial Stability Facility, Luxembourg	-	4,563
	15,612	5,668
Agency securities		
Kreditanstalt fuer Wiederaufbau	20,674	39,767
Caisse Des Depots et Consignations	16,813	5,611
Bank Nederlandse Gemeenten	15,443	8,317
Svensk Exportkredit AB	11,972	15,475
Kommunalbanken AS, OSLO	10,532	8,503
Landeskreditbank Baden-Wuerttemberg Foerderbank	10,229	-
Caisse D'Amortissement de la Dette Sociale, Paris	8,170	-
Erste Abwicklungsanstalt	8,152	6,352
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden NV, Hague	6,467	4,483
Kommunekredit	4,792	1,864
NRW Bank, Duesseldorf	4,790	1,871
Province of Ontario Canada, Toronto	3,609	-
FMS Wertmanagement	3,595	5,592
British Columbia	2,653	-
Neder Waterschapsbank, Hague	2,640	8,153
State of North Rhine-Westphalia, Duesseldorf	2,147	-
Province of Quebec Canada, Quebec	-	5,397
Municipality Finance PLC	-	3,729
Kommuninvest I Sverige AB, Orebro	-	3,727
Federal National Mortgage Association, Washington	-	1,868
	132,678	120,709
Total funds managed under the World Bank RAMP program	457,477	400,966
Funds managed by BIS**		
BISIP_K	119,997	93,105
Total trading securities	577,474	494,071

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* Funds managed under the RAMP program corresponds to the outsourcing of the management of a portion of the reserves to the World Bank treasury specialized in portfolio management (external manager), with the main objective of transferring know-how and providing consulting services to the Bank. The manager receives a management fee, established in the contract, and is evaluated based on the net asset value of the transferred funds. The assets within the external manager portfolio are held on behalf of the Bank, under the responsibility of a global custodian selected for the purpose of investing in and reinvesting the trading securities. The Bank may, from time to time, by notice to the external manager, make additions to or reductions of the investment amount.

** The fund managed by the Bank for International Settlements (BIS) refers to the investment placed in the Bank for International Settlements Investment Pool (BISIP K), a fund (comprising US treasury and European Agency bonds) managed for the investment of international reserves of central banks, with the main objective of transferring know-how and providing consulting services to the Bank. The quota holders of the fund may request the partial or complete withdrawal of their investments at any time.

Analysis of interest rates (coupon) and maturities on trading securities:

	31-Dec-15		31-Dec-14	
	Interest rate p.a.	Maturity	Interest rate p.a.	Maturity
Government securities	0.25%-1.125%	2016- 2018	0.125%-4%	2015 - 2019
Supranational securities	1.625%-2.625%	2016- 2020	0.25%-1.625%	2015 - 2017
Agency securities	0.5%-2.625%	2016 - 2020	0.05%-3.625%	2015 - 2019

No financial assets at fair value through profit or loss are past due or impaired.

12. INVESTMENTS AVAILABLE-FOR-SALE

	31-Dec-15	31-Dec-14
Investments available-for-sale in foreign currency:		
Government securities		
US Treasury Notes	1,929,279	1,345,437
Australia Government bond	376,691	283,341
Canada Government Bond	162,421	110,131
France Treasury Note	57,084	83,299
German Government Bond	36,771	86,380
Netherlands Government Bond	18,344	15,866
Finland Government Bond	10,225	2,394
Austria Government Bond	4,282	3,837
Sweden Government Bond	-	37,315
	2,595,097	1,968,000
Supranational securities		
IBRD World Bank	106,548	18,834
European Investment Bank	73,358	18,180
International Finance Corporation	26,116	-
Inter-American Development Bank	21,881	32,760
Asian Development Bank	13,587	26,694
EUROFIMA, Basel	11,977	-
European Stability Mechanism	-	11,327
Nordic Investment Bank	-	6,261
Council of Europe Development Bank	-	3,920
	253,467	117,976

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	31-Dec-15	31-Dec-14
Agency securities		
Neder Waterschapsbank, Hague	131,101	35,156
NRW Bank, Duesseldorf	114,779	39,954
Landeskreditbank Baden-Wuerttemberg Foerderbank	95,851	18,651
Kreditanstalt fuer Wiederaufbau, Frankfurt	76,926	67,633
Bank Nederlandse Gemeenten, Den Haag -Netherlands	58,971	33,275
Kommuninvest I Sverige AB, Orebro	38,161	57,241
Province of Ontario Canada, Toronto	26,957	24,560
Kommunalbanken AS, Oslo	24,704	18,807
Landwirtschaftliche Rentenbank, Frankfurt	12,034	10,819
Svensk Exportkredit AB, Stocholm	11,973	3,741
Oesterreichische Kontrollbank AG, Vienna	-	17,078
Kommunekredit, Copenhagen	-	9,400
	591,457	336,315
Total investments available-for-sale in foreign currency	3,440,021	2,422,291
Marketable government securities in national currency		
Georgian Government Bonds	101,617	80,776
Total investments available-for-sale in national currency	101,617	80,776

Analysis of interest rates (coupon) and maturities on investment available-for-sale:

	31-Dec-15		31-Dec-14	
In foreign currency:	Interest rate p.a.	Maturity	Interest rate p.a.	Maturity
Government Bonds	0.25%-6.0%	2016-2020	0.25%-6.25%	2015-2019
Supranational Bonds	0.5%-6.0%	2016-2020	0.5%-6.0%	2015-2018
Agency Bonds	0.44%-6.0%	2016-2020	0.375%-6.0%	2015-2016
In national currency:				
Government Bonds	7.3%-9.125%	2016-2020	7.3%-8.5%	2015-2019

No financial assets available for sale are past due or impaired.

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

13. INVESTMENTS HELD-TO-MATURITY

	31-Dec-15		31-Dec-14	
	Carrying value	Nominal value	Carrying value	Nominal value
Georgian Government securities				
Georgia Government Bonds	401,914	400,846	442,094	440,846
Total investments held-to-maturity in national currency	401,914	400,846	442,094	440,846

Analysis of interest rate (coupon) and maturity of the held to maturity investment:

	31-Dec-15		31-Dec-14	
	Interest rate p.a.	Maturity	Interest rate p.a.	Maturity
Georgia Government Bonds	5.92%	2016-2025	6.0%	2015-2025

Georgian Government Bonds in national currency represent interest bearing securities issued by the Ministry of Finance of Georgia according to the agreement formed between the Government of Georgia and the Bank in March 2006 to convert borrowings of the Government of Georgia into debt securities. The Government Bonds are repaid by issuance of new bond instrument in the amount of GEL 40,000 thousand annually, that are classified as available-for-sale financial instruments (note 12). Interest rate of the bond is subject to annual repricing considering market rates.

No financial assets at held-to-maturity are past due or impaired.

14. INVESTMENT PROPERTY

	2015	2014
Cost		
As at 1 January	2,217	2,618
Transferred from assets held for sale	415	-
Transferred to assets held for sale	-	(401)
As at 31 December	2,632	2,217
Accumulated depreciation		
As at 1 January	(44)	-
Depreciation charge	(44)	(44)
As at 31 December	(88)	(44)
Net book value as at 31 December	2,544	2,173

Investment property includes a building used by a government agency under the usufruct agreement and with currently undetermined use. The building is held for capital appreciation purposes. During 2014, land of GEL 401 thousand was transferred from investment property to assets held for sale (note 15). During 2015, property classified as assets held for sale of GEL 415 thousand was reclassified to Investment Property (note 15) as it was not expected to be realized within twelve months after the year then ended.

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15. ASSETS HELD FOR SALE

	2015	2014
Beginning balance at 1 January	415	-
Transfer from/to property and equipment	-	14
Transfer from/to investment property	(415)	401
Ending balance at 31 December	-	415

16. PROPERTY AND EQUIPMENT

	Land and buildings	Computers, office equipment and fixtures	Vehicles and other	Total
At initial cost:				
1-Jan-2014	51,753	5,485	15,503	72,741
Additions	2	2,021	13	2,036
Disposals	-	(283)	(318)	(601)
Transfers to assets held for sale (Note 15)	-	-	(14)	(14)
31-Dec-14	51,755	7,223	15,184	74,162
Additions	36	130	80	246
Disposals	-	(191)	(1)	(192)
31-Dec-15	51,791	7,162	15,263	74,216
Accumulated depreciation:				
1-Jan-14	(1,086)	(2,649)	(7,672)	(11,407)
Depreciation charge	(1,032)	(1,123)	(2,610)	(4,765)
Disposals	-	273	284	557
31-Dec-14	(2,118)	(3,499)	(9,998)	(15,615)
Depreciation charge	(1,031)	(1,041)	(1,888)	(3,960)
Disposals	-	186	1	187
31-Dec-15	(3,149)	(4,354)	(11,885)	(19,388)
Net book value:				
As at 31 December 2015	48,642	2,808	3,378	54,828
As at 31 December 2014	49,637	3,724	5,186	58,547

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17. INTANGIBLE ASSETS

	Software	Licenses	Total
At cost:			
1-Jan-14	6,848	65	6,913
Additions	74	195	269
31-Dec-14	6,922	260	7,182
Additions	113	43	156
31-Dec-15	7,035	303	7,338
Accumulated amortization:			
1-Jan-14	(3,253)	(20)	(3,273)
Charge for the year	(1,359)	(36)	(1,395)
31-Dec-14	(4,612)	(56)	(4,668)
Charge for the year	(1,369)	(53)	(1,422)
31-Dec-15	(5,981)	(109)	(6,090)
Net book value			
31-Dec-15	1,054	194	1,248
31-Dec-14	2,310	204	2,514

18. OTHER ASSETS AND LIABILITIES

	31-Dec-15	31-Dec-14
Other assets in foreign currency:		
Prepayments	60	-
Other debtors	5	4
Total other assets in foreign currency	65	4
Other assets in national currency:		
Commemorative gold coins and gold bars	4,804	3,117
Loans to employees	755	1,009
Inventory	508	422
Prepayments	446	92
Other debtors	107	125
	6,620	4,765
Allowance for impairment of other assets	(534)	(663)
Total other assets in national currency	6,086	4,102

As at 31 December 2015 and 2014, other financial assets amount to GEL 328 thousand and GEL 471 thousand, respectively.

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The movements in allowance for impairment losses on other assets were as follows:

	Allowance for impairment of other assets
1-Jan-14	(637)
Net impairment charge	(74)
Write-offs	48
31-Dec-14	(663)
Net impairment recovery	92
Write-offs	37
31-Dec-15	(534)

Allowance for impairment losses on other assets represents allowance for impairment of loans to employees. Employees of the Bank have the right to take a loan from the Bank during the time period of his/her employment with the Bank. When an employee leaves the Bank, a 100% allowance is made for the outstanding loan. Write-off is conducted according to the decision made by the management of the Bank.

Other liabilities comprise:

	31-Dec-15	31-Dec-14
Other liabilities in foreign currency:		
Amounts due to suppliers	2,472	617
Total other liabilities in foreign currency	2,472	617
Other liabilities in national currency:		
Amount due to suppliers	5,724	5,779
Deferred revenue	636	1,719
Liability for realized banknotes and coins	1,488	1,439
Pension scheme liabilities	203	304
Other liabilities	424	321
Total other liabilities in national currency	8,475	9,562
Total other liabilities	10,947	10,179

As at 31 December 2015 and 2014, other financial liabilities amount to GEL 10,260 thousand and GEL 8,402 thousand, respectively.

As at 31 December 2015 and 2014 the Bank does not have any active pension arrangements and no significant post-retirement benefits. As at 31 December 2015 and 2014 the Bank has pension scheme liabilities of GEL 204 thousand and GEL 304 thousand, respectively, that represent the payables under pension arrangement cancelled on 29 May 2009, according to which the Bank had been collecting contributions from its employees and paying aggregated contributions to the employees after they reached the pension age according to the pre-agreed schedule.

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19. DUE TO RESIDENT FINANCIAL INSTITUTIONS

Due to resident financial institutions comprise:

	<u>31-Dec-15</u>	<u>31-Dec-14</u>
Due to resident financial institutions under monetary policy instruments		
Correspondent accounts in national currency	453,832	480,334
Overnight deposits in national currency	-	231,923
Obligatory reserves of banks in foreign currency	<u>1,717,245</u>	<u>1,154,372</u>
Total due to resident financial institutions under monetary policy instruments	<u><u>2,171,077</u></u>	<u><u>1,866,629</u></u>
Due to resident financial institutions, other		
Correspondent accounts in foreign currency	<u>273,349</u>	<u>172,276</u>
Total due to resident financial institutions, other	<u><u>273,349</u></u>	<u><u>172,276</u></u>
Total due to resident financial institutions	<u><u>2,444,426</u></u>	<u><u>2,038,905</u></u>

As at 31 December 2015 and 2014 included in due to resident financial institutions is a balance with the three largest local commercial banks of GEL 1,718,216 thousand and GEL 1,275,989 thousand, respectively, that exceed 70.29% of the total balance due to resident financial institutions.

Resident commercial banks are required to maintain obligatory reserves with the Bank. As at 31 December 2015 the obligatory reserves are calculated as 10% of their eligible liabilities denominated in national currencies, and 15% of their eligible liabilities denominated in foreign currencies. For foreign currency liabilities with a remaining maturity of 1-2 years the reserve requirement amounts to 5%. As at 31 December 2015 and 2014 annual interest rate on GEL denominated obligatory reserves is 8.00% and 4.00%, respectively, and USD and EUR denominated obligatory reserves is nil. Borrowings with a remaining maturity of over one year in national currency, and over two years in a foreign currency, are exempt from reserve requirements.

20. DUE TO THE MINISTRY OF FINANCE

	<u>31-Dec-15</u>	<u>31-Dec-14</u>
Due to the Ministry of Finance		
Current accounts in foreign currency	261,914	187,948
Current account in national currency	<u>591,464</u>	<u>407,787</u>
Total due to the Ministry of Finance of Georgia	<u><u>853,378</u></u>	<u><u>595,735</u></u>

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

21. MONEY ISSUED IN CIRCULATION

Money issued in circulation represents the amount of national currency of Georgia issued by the Bank. Movements during the year ended 31 December 2015 and 2014 are as follows:

	2015	2014
Balance as at 1 January	2,462,111	2,351,552
Banknotes issued into circulation	4,479,460	4,325,732
Coins issued into circulation	64,876	72,855
Less: Cash on hand in national currency	-	(1,480)
Banknotes withdrawn from circulation	(4,445,195)	(4,220,498)
Coins withdrawn from circulation	(57,517)	(66,050)
Balance as at 31 December	2,503,735	2,462,111

22. DUE TO CUSTOMERS

Due to customers comprise:

	31-Dec-15	31-Dec-14
International financial institutions	777	1,046

23. DEBT SECURITIES ISSUED

	Interest rate p.a.	Maturity	Nominal value	Carrying value
Certificates of deposit as at 31-Dec-15	8.16%-10.36%	8 Jan-16 June 2016	360,000	353,397
Certificates of deposit as at 31-Dec-14	4.12%-4.94%	8 Jan-25 June 2015	505,000	500,688

24. EQUITY

As stated in the Law, the Bank's capital is comprised of its subscribed and fully paid-up capital and reserve fund.

Authorised capital

The authorised and fully paid-up capital of the Bank is GEL 15,000 thousand as at 31 December 2015 and 2014.

Capital management

The Bank defines capital as its total equity measured in accordance with IFRS. According to Article 24 of the Law dated 1 December 2009 (N2186) the net profit of the Bank for each financial year is calculated as the sum of unrealised net gains or losses resulting from net operational profit or loss and revaluation. Net operational profit or loss shall be received after deducting from revenues of the reporting year all operating expenditures intended for the main activity. Retained earnings are transferred to different

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 *(in thousands of Georgian Lari)*

reserves based on the requirements of the Law and after approval of the Council. After approval of the annual report of the Bank by the Council the remaining part of the retained earnings is transferred to the State budget within six months.

Reserve fund

According to the amended Article 25 of the Law the reserve fund should make up 15% of the reserve money, which comprises the national currency in cash put into circulation by the Bank together with the correspondent accounts of commercial banks in national currency, and are established by allocations from the realised profit for the year, which comprises net profit for the year excluding net foreign currency translation gain. The Council is entitled to determine the establishment of the reserve fund of less than 15% of the reserve money.

The reserve fund may only be used to offset losses of the Bank. With the specific objective of maintaining stability of the financial system, as well as fostering sustainable economic growth in the country, the Council is entitled to take a decision on the distribution of the reserve fund. Upon establishment of the reserve fund, the residual balance of realised profit of the Bank shall be transferred to the State Budget of Georgia.

In 2015 and 2014 Bank transferred GEL 41,569 thousand and GEL 10,373 thousand, respectively, to the reserve fund.

Foreign currency and other revaluation reserves

According to the Article 25(a) of the Law, the Bank transfers net unrealized gains from foreign currency revaluation to the foreign currency revaluation reserve and net unrealized losses arising from changes of the FVTPL financial assets' market prices are compensated from the revaluation reserve created for this purpose in prior years.

During 2015 the entire amount of unrealized gain on foreign currencies translation of GEL 700,237 thousand was transferred to the foreign currency revaluation reserve (2014: GEL 103,894 thousand). In addition, during 2015 the Bank transferred GEL 379 thousand from other revaluation reserve back to retained earnings.

Revaluation reserve for investments available-for-sale

This reserve records fair value changes of investments available-for-sale.

25. COMMITMENTS AND CONTINGENCIES

In the normal course of operations, the Bank is a party to financial instruments with off-balance sheet commitments. The Bank uses the same risk management policies in undertaking off-balance sheet commitments as it does for on-balance operations.

Capital commitments

As at 31 December 2015 and 2014 the Bank has no material capital commitments.

Operating environment

As an emerging market, Georgia does not possess a well-developed infrastructure that would generally exist in a more mature market economy. Therefore, especially sharp changes of operating environment (including global environment) could affect the Bank's results and financial position in a manner not currently determinable.

Over the last few years the Government of Georgia and the Bank have made a number of developments that positively affect the overall investment climate in Georgia, specifically implementing the reforms

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necessary for creating efficient banking, judicial, taxation and regulatory systems, as well as, using various measures to fulfill the liquidity needs of the economy and to stabilize the exchange rate of the national currency. This has resulted in a stable macroeconomic environment with higher real growth rates and inflow of foreign investments. The existing tendency aimed at the overall improvement of the economy is expected to persist.

However, future development of economy of Georgia is largely dependent upon these reforms and developments, and the effectiveness of economic, financial and monetary measures undertaken by the Government and the Bank.

Management believes that all the necessary measures are implemented to support the Bank's role in maintaining macroeconomic and financial stability.

Operating lease commitments

No material lease commitments were outstanding as at 31 December 2015 and 2014.

Legal proceedings

The Bank is subject to legal actions and complaints. Management believes that the ultimate liability, if any, arising from such actions or complaints will not have a material effect on the financial position or the results of operations of the Bank. Management is of the opinion that no material unaccrued losses will be incurred and accordingly no provision has been made in these financial statements.

Credit commitments and contingent liabilities

As at 31 December 2015 and 2014, the Bank has no material credit commitments and contingent liabilities.

Insurance

The insurance industry in Georgia is in a developing state and many forms of insurance protection common in other parts of the world are not yet generally available. The Bank does not have full coverage for its operations interruption or third-party liability in respect of environmental damage arising from accidents on its operations or arising from errors or omissions. Until the Bank obtains adequate insurance coverage, there is a risk that the loss or destruction of certain assets could have adverse effect on operations and financial position.

26. RELATED PARTY TRANSACTIONS

The Bank, as a state entity, is related to the Government of Georgia entities. To achieve its policy objectives, the Bank maintains a position of structural and functional independence from the Government of Georgia through its ability to fund its own operations without external assistance and through its management and governance.

Under key management personnel are regarded those persons having authority and responsibility for planning, directing and controlling the activities of the Bank, directly or indirectly. Key management personnel comprise the Board members, Chief Executive Officer and head of departments.

In the normal course of its operations, the Bank enters into transactions with related parties, and material transactions and balances are presented in these financial statements, based on substance of the relationship, and not merely the legal form.

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The Bank had the following transactions outstanding with related parties:

	31-Dec-15		31-Dec-14		
	Note	Related party balances Total category as per the financial statements caption	Related party balances Total category as per the financial statements caption		
Assets:					
Investments available-for-sale in national currency		101,617	101,617	80,776	80,776
- <i>Government of Georgia</i>	12	101,617		80,776	
Investments held-to-maturity in national currency		401,914	401,914	442,094	442,094
- <i>Government of Georgia</i>	13	401,914		442,094	
Loans to employees		124	755	214	1,009
- <i>Key management personnel</i>	18	124		214	
Liabilities:					
Due to the Ministry of Finance		853,378	853,378	595,735	595,735
- <i>Government of Georgia</i>	20	853,378		595,735	
		Year ended 31 December 2015		Year ended 31 December 2014	
		Related party transactions	Total category as per the financial statements caption	Related party transactions	Total category as per the financial statements caption
Key management personnel compensation:					
- <i>short-term employee benefits</i>		(2,644)	(13,453)	(2,508)	(13,141)
		Year ended 31-Dec-15		Year ended 31-Dec-14	
		Related party transactions	Total category as per the financial statements caption	Related party transactions	Total category as per the financial statements caption
Interest income		33,230	116,670	32,672	68,913
- <i>Government of Georgia</i>		33,216		32,650	
- <i>Key management personnel</i>		14		22	
Loss on disposal of property and equipment		-	(3)	-	(44)
- <i>Government of Georgia</i>		-		-	
General and administrative expenses		-	(9,336)	(1,071)	(6,168)
- <i>Other related parties</i>		-		(1,071)	

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27. FAIR VALUE OF FINANCIAL INSTRUMENTS

IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in orderly transactions between market participants at the measurement date.

Fair value of the Bank's financial instruments measured at fair value on a recurring basis

Some of the Bank's financial instruments are measured at fair value at the end of each reporting period. The following table gives information about how the fair values of these financial assets are determined (in particular, the valuation techniques and inputs used).

Financial instruments measured at fair value are broken down for disclosure purposes into a three level fair value hierarchy based on the observability of inputs:

- Quoted prices in an active market (**Level 1**) – Valuations based on quoted prices in active markets that the Bank has the ability to access for identical assets or liabilities. Valuation adjustments and block discounts are not applied to these financial instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuations of these products do not require a significant amount of judgment. This level entails financial instruments under international reserve portfolio and classified as derivative financial instruments, trading securities and investments available-for-sale. The instruments are valued on daily bases, based on the bid prices obtained from the Bloomberg at the closing of the markets of the current day.
- Valuation techniques using observable inputs (**Level 2**) – Valuations based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include the following:
 - a) quoted prices for similar assets or liabilities in active markets;
 - b) quoted prices for identical or similar assets or liabilities in markets that are not active;
 - c) inputs other than quoted prices that are observable for the asset or liability, for example:
 - interest rates and yield curves observable at commonly quoted intervals;
 - implied volatilities; and
 - credit spreads;
 - d) market-corroborated inputs

Georgian Government securities, classified as investments available-for-sale, are measured using observable inputs under Level 2, in particular market yields on similar securities issued by Georgian Government. For fair value assessment, a discount cash flow model is used based on a current interest rate yield curve appropriate for the remaining term to maturity.

- Valuation techniques incorporating information other than observable market data (**Level 3**) – Valuations based on inputs that are unobservable and significant to the overall fair value measurement. The Bank does not have any financial instruments valued based on unobservable inputs.

The Bank considers that the accounting estimate related to valuation of financial instruments where quoted markets prices or other observable inputs are not available is a key source of estimation uncertainty because: (i) it is highly susceptible to change from period to period because it requires management to make assumptions about interest rates, volatility, exchange rates, the credit rating of the counterparty, valuation adjustments and specific feature of the transactions and (ii) the impact that recognizing a change in the valuations would have on the assets reported in the statement of financial position as well as its profit or loss could be material.

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The table below analyses financial instruments measured at fair value at 31 December 2015 and 2014, by the level in the fair value hierarchy into which the fair value measurement is categorised. The amounts are based on the values recognised in the statement of financial position:

		Fair value as at		Fair value hierarchy	Valuation techniques and key inputs	Significant unobservable inputs
Financial Assets	Notes	31-Dec-15	31-Dec-14			
International reserves						
Derivative financial assets	10	3,204	2,835	Level 1	Quoted bid prices in an active market	N/A
Trading securities	11	577,474	494,071	Level 1	Quoted bid prices in an active market	N/A
Investments available-for-sale	12	3,440,021	2,422,291	Level 1	Quoted bid prices in an active market	N/A
Monetary policy instruments						
Investments available-for-sale	12	101,617	80,776	Level 2	Market interest rate for similar instruments	N/A

There were no transfers between Level 1, 2 and 3 during the year ended 31 December 2015 and 2014.

Gains and losses included in other comprehensive income relate to investments available-for-sale and are reported as changes in revaluation reserve of investments available-for-sale.

Net unrealized gain/(loss) from securities and derivatives included in profit or loss relates to derivative financial assets and trading securities as changes in fair value during the year ended 31 December 2015.

Fair value of financial assets and financial liabilities that are not measured at fair value on a recurring bases (but fair value disclosures are required)

For fixed interest bearing financial assets and liabilities that have a short term maturity, it is assumed that the carrying amounts approximate to their fair value. This assumption is also applied to demand deposits and savings accounts without a maturity.

For variable interest bearing financial assets (Georgian Government bond classified as held-to-maturity) and liabilities (borrowings from the IMF), it is assumed that the carrying amounts approximate to their fair value. Moreover, management of the Bank believes that due to their specific nature, borrowings from the IMF represent a separate segment of borrowings from international financial organisations to support developing countries. As a result, these borrowings were considered received in an "arm's length" transaction.

28. RISK MANAGEMENT

Introduction

The activities of the Bank are exposed to various risks. These include financial risks in the form of market, credit, and liquidity risks. It is also exposed to operational risks. Due to its unique role and functions, the Bank's risk management and control are not based simply on institutional risk and return considerations, but also take into account national interest, in line with its statutory responsibilities prescribed in relevant legislation. The Bank views risk management and control as an integral part and an essential element of good corporate governance.

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The Council of the Bank is ultimately responsible for the oversight of the risk management framework, overseeing the management of key risks and reviewing its risk management policies and procedures; however, there are separate business units responsible for managing and monitoring the various risks.

First line of defense: Departmental management

Risk management and internal control are an integral part of the Bank's management and accountability function. Depending on the structure of operations, the risk management in the Bank is conducted by a centralised and non-centralised method. Financial risk management is conducted centrally whereas operational risk management is managed on a departmental level. Departmental management carries the primary responsibility for the ongoing identification, assessment and management of risks in their respective departments, including designing, implementing and maintaining an adequate and effective system of control.

Second line of defense: Integrated risk management functions

The National Bank of Georgia identified risk management activities as a strategic priority and the Centralized risk management department was established in November 2014. The department is accountable to the Governor. However, the day-to-day risk management (financial, non-financial) still resides at department level, but overall responsibility for coordinated, comprehensive and systematic management is provided by the Centralized Risk management department. The department ensures that risks are identified, assessed and mitigated within the framework that is consistent to standards and approaches of best international risk management activities.

Third line of defense: Internal Audit

Risk management processes throughout the Bank are audited regularly by Internal Audit that examines both the adequacy of the procedures and the Bank's compliance with the procedures. Internal Audit discusses the results of all assessments with management, and reports its findings and recommendations to the Chairman of the Council.

Organization of risk management department

Nature of risk	Management	Guidelines policies issued by	Supervision
Financial risks	At department level	Monetary policy committee International reserve management committee	Centralized risk management department
Non-financial risk	At department level	Responsible Committees	Centralized risk management department

Centralized Risk Management at the NBG

Risk management is a fully integrated process in activities and responsibilities of the National Bank of Georgia and is provided by the Centralized Risk management department. The department ensures the effective and efficient risk management implementation across the bank and is accountable directly to the Governor.

The three lines of defense model supports the clear allocation of roles and responsibilities for business departments, risk management and internal audit. According to this model, the first line of defense (NBG departments) have a responsibility to assess the risks related to their processes, put in place appropriate controls and implement additional internal controls if required. The second line of defense (Centralized Risk management department) assists individual departments to manage their risk environment effectively within the approved framework, facilitates and coordinates all risk processes and provides business continuity support. Internal Audit represents the third line of defense and ensures the effectiveness and adequacy of CRM system. The abovementioned roles and

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responsibilities are formalized in Centralized risk management policy and framework. The process itself is comprehended all over the bank.

The identification of key risk areas has been achieved by control self-assessment sessions resulting in creation of risk map. The map describes business processes, existing control systems and assessed the inherent and residual risks. The assessment is based on a qualitative approach considering the probabilities and impacts of risk events. To ensure an that effective assessment system is in place and risk appetite is defined adequately, the Centralized Risk management department is currently in the process of implementation of an incident management system.

The NBG's objective is to build an ERM (Enterprise risk management) framework starting with operational risk and subsequently intergrading other risk categories. For that reason, the risk universe has been restricted by operational (Human, IT, 3d party, Security, Process, Project, Legal) and reputational risks. Business continuity management has also been incorporated in the Centralized Risk management framework, although the oversight of Business Continuity ("BC") management is undertaken by a committee chaired by the Chief Executive Officer. Regular BC testing and continuous improvement of procedures ensures the resilience of the Bank's processes.

Financial risks

The Bank uses financial instruments as a means of achieving its monetary policy objectives and also for managing international reserves. These two portfolios have different risk policies and characteristics, both of them are managed by the financial market department. The description of financial risks below presents the main risks to which these two portfolios of financial instruments are exposed, as well as the management policy of these risks.

The table below shows the maximum exposure to credit risk for the components of the statement of financial position.

		Maximum exposure 31-Dec-15	Maximum exposure 31-Dec-14
Foreign currency assets	Notes		
International Reserves			
Cash and cash equivalents (excluding cash on hand)	7	1,209,342	1,462,328
Special Drawing Rights holdings with the International Monetary Fund	9	478,230	388,675
Assets related to derivative instruments	10	3,204	2,835
Trading securities	11	577,474	494,071
Investments available-for-sale	12	3,440,021	2,422,291
Other foreign currency assets			
Other financial assets	18	5	4
National currency assets			
Monetary policy instruments			
Due from financial institutions	8	1,067,000	712,500
Investments available-for-sale	12	101,617	80,776
Other national currency assets			
Investments held-to-maturity	13	401,914	442,094
Other financial assets	18	328	471
Total credit risk exposure		7,279,135	6,006,045

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International reserve portfolio

According to the Law the Bank is eligible to hold and manage an international reserve portfolio. The Bank maintains a portfolio to support its monetary and exchange policies and normal functioning of domestic and foreign payments. Reserves are also employed to protect the country from external vulnerability by maintaining sufficient liquidity to absorb shocks during a financial crisis. Therefore, the multiple objectives of holding international reserves feature safety, liquidity, and profitability. Hence, assets under the international reserve portfolio are invested on conservative bases to facilitate these objectives, with an emphasis on liquidity and capital preservation. For instance the Bank's Investment Guidelines prioritizes the preservation of capital and a high level of liquidity of reserves. Once these conditions are met, return is to be maximized.

The portfolio is managed in line with investment guidelines ("SAA" strategic asset allocation) approved by the Council. The Reserve Management Committee (the "Committee") of the Bank is responsible for monitoring and implementation of risk mitigation measures prescribed in the SAA and making sure that the Bank operates within the established risk parameters. Typical activities of the Committee are reviewing the monthly reports, approving the list of eligible counterparties, approving changes to the strategy before submitting them to the Council and occasionally making important tactical decisions on asset allocation. The Risk Management and Control Division (the "Division") of the Bank is responsible for the overall day to day risk management and compliance functions, ensuring the implementation of common principles and methods for identifying, measuring, managing and reporting risks.

international Reserve Portfolio is divided into three major tranches based on their objectives:

- **Working Capital Tranche** - to meet short term cash needs for payments, short-term obligations and possible foreign exchange interventions;
- **Liquidity Tranche** - to provide a buffer in case of a significant increase of liquidity needs due to external shocks or depletion of the working capital tranche;
- **Investment Tranche** - to maximize return over a longer investment horizon while limiting the level of market risk;

Monetary policy portfolio

The monetary policy is executed mainly through financial instruments such as Georgian government securities, loans to commercial banks, deposit of certificates and minimum reserve requirements for commercial banks. The monetary policy committee is responsible for monitoring and implementation of risk mitigation tools, such as collateral requirements for refinancing loans.

Credit risk

Credit risk is the risk that one party will incur a loss because the other party failed to comply with its financial obligations.

a) Financial instruments under international reserves portfolio

In order to control the credit risk of the financial instruments used in the international reserves operations, the SAA limits the exposures to credit risk of countries, counterparties and issuers, by setting concentration limits and minimum long-term credit rating, established by the international rating agencies (Standard & Poor's, Moody's and Fitch). For instance, investment guidelines clearly define the minimum level of the credit rating for investing in any Debt Instruments (Bonds, Bills) as AA- rating. While for bank deposits and other financial instruments the minimum acceptable level of credit rating is A-. However, minimum credit rating of BBB is acceptable for counterparties used only for Nostro accounts, securities trading, repo/reverse repo operations and derivatives trading.

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Additionally, SAA limits the duration and instrument composition, mostly limited to various money market instruments, as well as fixed income and floating rate securities (Government Bonds, Agency including Regional Governments and Supranational Securities) and other highly liquid, highly secure instrument types.

While selecting the Bank's counterparties, the counterparty's credit rating, the country of its residence, the volume of its assets and capital, the experience of working in international markets and with corporate clients and the spectrum of the services and instruments offered to its clients are taken into consideration. In case of downgrade of the long-term credit rating of the Bank's counterparty by the above-mentioned rating agencies, the counterparty will be withdrawn from the list of eligible counterparties.

When different credit ratings are designated by the rating agencies (Standard & Poor's, Moody's and Fitch) for the assets, the second best credit rating is used for credit risk assessment. If the lowest of the credit rating is below the acceptable level determined under strategic assets allocation policy, then bank does not invest in financial instruments.

The table below provides information on credit ratings of financial instruments within the international reserve portfolio:

As at 31 December 2015	Notes	AAA	AA+	AA	AA-	A+	A	A-	BBB+	Total
Foreign currency assets										
International reserves										
Cash and cash equivalents (excluding cash on hand)	7	449,892	117,484	-	-	441,759	199,737	199	271	1,209,342
Special Drawing Rights holdings with the International Monetary Fund	9	478,230	-	-	-	-	-	-	-	478,230
Assets related to derivative instruments	10	-	-	-	-	-	3,204	-	-	3,204
Trading securities	11	189,687	341,705	24,983	17,490	3,609	-	-	-	577,474
Investments available-for-sale	12	1,214,501	2,026,700	57,084	114,779	26,957	-	-	-	3,440,021
Total international reserves		2,332,310	2,485,889	82,067	132,269	472,325	202,941	199	271	5,708,271

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As at 31 December 2014	Notes	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	Total
Foreign currency assets											
International reserves											
Cash and cash equivalents (excluding cash on hand)	7	202,539	172,720	106,809	532,196	236,919	208,741	1,079	-	1,325	1,462,328
Special Drawing Rights holdings with the International Monetary Fund	9	388,675	-	-	-	-	-	-	-	-	388,675
Assets related to derivative instruments	10	-	-	-	-	-	2,835	-	-	-	2,835
Trading securities	11	189,759	186,912	101,503	10,500	5,397	-	-	-	-	494,071
Investments available-for-sale	12	802,452	1,472,026	83,299	64,514	-	-	-	-	-	2,422,291
Total international reserves		1,583,425	1,831,658	291,611	607,210	242,316	211,576	1,079	-	1,325	4,770,200

b) Financial instruments under monetary policy portfolio

Credit risk is associated to open-market operations and facilities that inject liquidity to the financial system. The Banks's securities portfolio is comprised exclusively of securities issued by the Government of Georgia, considered as assets with low credit risk. To mitigate the risk associated to loans to banking institutions, the Bank requires collaterals eligible according to their credit quality, which are valued at market prices at the time of their receipt and subject to the application of discounts or haircuts according to the instrument specific characteristics.

The table below shows the credit quality by class of assets under the monetary policy portfolio and other financial assets, based on the banks internal credit rating system:

As at 31 December 2015				
		Neither past due nor impaired		
	Notes	AAA grade	B grade	Total
Foreign currency assets				
Other financial assets	18	-	4	4
National currency assets				
Monetary policy instruments				
Due from financial institutions	8	1,067,000	-	1,067,000
Investments available-for-sale	12	101,617	-	101,617
Other national currency assets				
Investments held-to-maturity	13	401,914	-	401,914
Other financial assets	18	-	324	324
Total		1,570,531	328	1,570,859

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As at 31 December 2014				
	Notes	Neither past due nor impaired AAA grade	B grade	Total
Foreign currency assets				
Other financial assets	18	-	4	4
National currency assets				
Monetary policy instruments				
Due from financial institutions	8	712,500	-	712,500
Investments available-for-sale	12	80,776	-	80,776
Other national currency assets				
Investments held-to-maturity	13	442,094	-	442,094
Other financial assets	18	-	467	467
Total		1,235,370	471	1,235,841

The Bank classifies its financial assets other than international reserves as follows:

AAA grade – borrowers with excellent financial performance, having no changes in the terms and conditions of loan agreements and no overdue in principal and interest.

AA grade – borrowers with stable financial performance, having no changes in the terms and conditions of loan agreements and no overdue in principal and interest.

A grade – borrowers with satisfactory financial performance, having changes in the terms and conditions of loan agreements and no overdue in principal and interest.

B grade – loans issued to borrowers with satisfactory financial performance, having changes in the terms and conditions of loan agreements and overdue in principal and interest.

It is the Bank's policy to maintain accurate and consistent risk ratings across the credit portfolio. The attributed risk ratings are assessed and updated regularly.

Excessive risk concentration

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risks, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. The concentration risks by counterparties and asset quality are disclosed in relevant notes to the financial statements.

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Geographical concentration

The Bank's financial assets and liabilities are concentrated in Georgia except for the international reserve portfolio and borrowings from the IMF. The below table provides information on geographical concentration for these financial assets and liabilities outside of Georgia:

As at 31 December 2015	Notes	US	EU*	Australia	Canada	International	Other	Total
Assets:								
International reserves								
Cash and cash equivalents (excluding cash on hand)	7	143,533	663,891	17	192,096	198,795	11,010	1,209,342
Special Drawing Rights holdings with the IMF	9	-	-	-	-	478,230	-	478,230
Assets related to derivative instruments	10	3,204	-	-	-	-	-	3,204
Trading securities	11	306,786	128,817	-	6,262	135,609	-	577,474
Investments available-for-sale	12	1,929,279	691,206	376,691	189,378	253,467	-	3,440,021
		2,382,802	1,483,914	376,708	387,736	1,066,101	11,010	5,708,271
Liabilities:								
Due to the International Monetary Fund	9	-	-	-	-	525,262	-	525,262
		2,382,802	1,483,914	376,708	387,736	540,839	11,010	5,183,009
Net position								
As at 31 December 2014								
Assets:								
International reserves								
Cash and cash equivalents (excluding cash on hand)	7	190,799	722,447	212,349	321,171	601	14,961	1,462,328
Special Drawing Rights holdings with the IMF	9	-	-	-	-	388,675	-	388,675
Assets related to derivative instruments	10	2,835	-	-	-	-	-	2,835
Trading securities	11	121,346	273,118	-	5,397	94,210	-	494,071
Investments available-for-sale	12	1,397,031	547,107	283,341	134,691	60,121	-	2,422,291
		1,712,011	1,542,672	495,690	461,259	543,607	14,961	4,770,200
Liabilities:								
Due to the International Monetary Fund	9	-	-	-	-	468,489	-	468,489
		1,712,011	1,542,672	495,690	461,259	75,118	14,961	4,301,711
Net position								

*EU-including Norwegian agency securities.

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Liquidity risk

Liquidity risk is the risk that arises from a possible difficulty in trading securities in a secondary market, due to the fact that it cannot absorb the volume that is desired to be traded without there being a significant change in price.

a) *Financial instruments under the international reserve portfolio*

The purpose of the management of the liquidity risk is to ensure that the Bank fulfills all the financial commitments that it has assumed. Accordingly, there is a policy for diversification of maturities and also the establishment of limits aiming at ensuring that the securities purchased may be traded in the secondary market without causing abrupt changes in the prices of the assets. Due to these guidelines, even securities with longer maturities have immediate liquidity.

The Bank's Monetary Policy and International Reserves Management Committees set limits on the minimum proportion of maturing funds available to cover cash outflows. The liquidity management policy of the Bank requires:

- Projecting cash flows by major currencies and considering the level of liquid assets necessary in relation thereto;
- Maintaining a diverse range of funding sources;
- Managing the concentration and profile of debts;
- Maintaining a portfolio of highly marketable assets that can easily be liquidated as protection against any interruption to cash flow; and
- Maintaining liquidity and funding contingency plans.

The Financial Markets Department receives information from business units regarding the liquidity profile of their financial assets and liabilities and details of other projected cash flows arising from projected future operations. The Bank's liquidity risk relates to foreign currency cash flows.

The table below summarizes the maturity profile of the Bank's financial liabilities in foreign currency as at 31 December 2015 and 2014 based on contractual undiscounted repayment obligations. The financial assets in foreign currencies are presented in "less than 3 months" category on the basis that the Bank can realize them within the period not exceeding 3 months to meet the liquidity requirements:

As at 31 December 2015	Notes	Less than 3 months	3 to 12 months	1 to 5 years	Total
Foreign currency assets					
International Reserves					
Cash and cash equivalents (excluding cash on hand)	7	1,209,342	-	-	1,209,342
Special Drawing Rights holdings with the International Monetary Fund	9	478,230	-	-	478,230
Assets related to derivative instruments	10	3,204	-	-	3,204
Trading securities	11	577,474	-	-	577,474
Investments available-for-sale	12	3,440,021	-	-	3,440,021
Other foreign currency assets					
Other financial assets	18	5	-	-	5
Total foreign currency assets		5,708,276	-	-	5,708,276
Foreign currency liabilities					
Due to resident financial institutions	19	1,990,594	-	-	1,990,594
Due to the Ministry of Finance	20	261,914	-	-	261,914
Due to the International Monetary Fund	9	487,092	23,231	13,939	524,262
Other liabilities	18	2,472	-	-	2,472
Total foreign currency liabilities		2,742,072	23,231	13,939	2,779,242
Net Position		2,966,204	(23,231)	(13,939)	2,929,034

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

As at 31 December 2014	Notes	Less than 3 months	3 to 12 months	1 to 5 years	Total
Foreign currency assets					
International Reserves					
Cash and cash equivalents (excluding cash on hand)	7	1,462,328	-	-	1,462,328
Special Drawing Rights holdings with the International Monetary Fund	9	388,675	-	-	388,675
Assets related to derivative instruments	10	2,835	-	-	2,835
Trading securities	11	494,071	-	-	494,071
Investments available-for-sale	12	2,422,291	-	-	2,422,291
Other foreign currency assets					
Other financial assets	18	4	-	-	4
Total foreign currency assets		4,770,204	-	-	4,770,204
Foreign currency liabilities					
Due to resident financial institutions	19	1,326,648	-	-	1,326,648
Due to the Ministry of Finance	20	187,948	-	-	187,948
Due to the International Monetary Fund	9	404,784	26,452	37,789	469,025
Other liabilities	18	617	-	-	617
Total foreign currency liabilities		1,919,997	26,452	37,789	1,984,238
Net position		2,850,207	(26,452)	(37,789)	2,785,966

b) Financial instruments under the monetary policy portfolio

Considering the characteristics of a monetary authority, which include controlling the liquidity of the financial system, the Bank is not subject to the limitations resulting from a mismatch between assets and liabilities in local currency.

Market risk

Market risk is the risk that the value of financial instruments will fluctuate due to changes in market variables such as interest rates and foreign exchanges rates. Market risks comprise currency risk, interest rate risk and other price risk. Market risk arises from open positions in interest rate, currency and equity financial instruments, which are exposed to general and specific market movements and changes in the level of volatility of market prices.

a) Financial instruments under the international reserve portfolio

Market risk implies possible losses due to variations in the price of investments.

The SAA process limits the market risk based on the risk tolerance of the Bank. Strategic benchmarks are defined for individual portfolios to maximize returns, after assessing various interest rate scenarios, while staying within the market risk limit. Currency exposures are defined based on the analysis of the foreign debt and diversification effects are also considered to decrease overall currency risk (refer to note about currency risk below).

All portfolios except the Working Capital and EUR Investment portfolio (since 15th December, 2015) are actively managed versus strategic benchmarks. Active market risk versus benchmarks is defined during the risk budgeting process and active market risk limits are established for each portfolio through limiting ex-ante tracking error and duration deviation. Regular stress-testing is conducted to assess resilience of active portfolios to market shocks.

Strategic Benchmark Durations and Active Market Risk Limits for the international reserve portfolio are as follows:

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Tranches	Benchmark Duration (Duration Deviation Limits)	Ex-Ante Tracking Error Limits
Liquidity Portfolio in USD	3 Months (+/- 1 Month)	10 Basis Point
Investment Portfolio in USD	6 Months (+/- 3 Months)	15 Basis Point
Investment Portfolio in EUR*	1 year (+/- 3 Months)*	15 Basis Point*
Investment Portfolio in AUD	1,5 year (+/- 3 Months)	15 Basis Point
Investment Portfolio in CAD	1,5 year (+/- 3 Months)	15 Basis Point

* The EUR Investment Portfolio was stopped to be managed versus Benchmark since 15th December, 2015

Market risk is monitored through the daily measurement of the maturity and composition of currencies, and by the follow-up of tracking error. The international reserve management daily report, prepared by the Financial Market Department, includes the measurements of performance and risk in an absolute manner and as compared to a benchmark, and presents an evaluation of the implemented investment strategy.

b) Financial instruments under monetary policy portfolio

For open-market operations, this risk is mainly associated with changes in the market value of Georgian government bonds, and the change in value of collaterals received in liquidity injection transactions. For collaterals the risk of value loss is mitigated by using margins and haircuts that write-down their value and allow the effective amount lent to be lower than the collateral received.

The interest rate sensitivity of the Bank's financial assets and liabilities

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The following table demonstrates the net effect of 1% change in interest rates, with all other variables held constant, of the Bank's statement of profit or loss taking into account the effect of derivatives.

Currency	2015		2014	
	Increase in interest rate	Sensitivity of net interest income	Increase in interest rate	Sensitivity of net interest income
USD	1%	27,864	1%	22,472
SDR	1%	(460)	1%	(793)
EUR	1%	329	1%	4,084
AUD	1%	4,569	1%	3,589
CAD	1%	1,904	1%	1,604
GEL	1%	12,188	1%	4,959
Other	1%	112	1%	161

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

Currency	2015		2014	
	Decrease in interest rate	Sensitivity of net interest income	Decrease in interest rate	Sensitivity of net interest income
USD	1%	(27,864)	1%	(22,472)
SDR	1%	460	1%	793
EUR	1%	(329)	1%	(4,084)
AUD	1%	(4,569)	1%	(3,589)
CAD	1%	(1,904)	1%	(1,604)
GEL	1%	(12,188)	1%	(4,959)
Other	1%	(112)	1%	(161)

The sensitivity of equity is calculated by revaluing fixed rate available-for-sale financial assets at 31 December 2015 and 2014 for 1% change in interest rates.

Currency	2015		2014	
	Increase in interest rate	Sensitivity of equity	Increase in interest rate	Sensitivity of equity
USD	1%	26,541	1%	16,824
EUR	1%	1,177	1%	2,237
AUD	1%	4,471	1%	3,456
CAD	1%	1,876	1%	1,386
GEL	1%	1,120	1%	800

Currency	2015		2014	
	Decrease in interest rate	Sensitivity of equity	Increase in interest rate	Sensitivity of equity
USD	1%	(26,541)	1%	(16,824)
EUR	1%	(1,177)	1%	(2,237)
AUD	1%	(4,471)	1%	(3,456)
CAD	1%	(1,876)	1%	(1,386)
GEL	1%	(1,120)	1%	(800)

Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. Subject to the currency structure of assets, the value of assets of the Bank is exposed to the risk of changes in exchange rates of main foreign currencies. Within the overall exposure and to a limited extent, foreign currency risk can be mitigated by holding assets across a diversified portfolio of currencies. Throughout the year, prior to 14th December 2015 the Bank held foreign reserves in the following currencies: U.S. dollars (70%), Euros (20%), Canadian dollars, Australian dollars and other currencies up to 10%. Since December 14, 2015, the target currency composition has changed to 80% USD, 10% EUR, 10% Other (Canadian dollars, Australian dollars and other currencies up to 10%). Under SAA, a deviation from target currency composition for the Canadian dollar and the Australian dollar +/- 5% is allowed, and a deviation +/-10% is allowed for the U.S. dollar and the Euro's target currency composition.

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 (in thousands of Georgian Lari)

Sensitivity to foreign currency

The table below provides the concentration of the Bank's financial assets and liabilities by major currencies and analyses of the effect of a 1%, 5% and 10% movement of the currency rate against Georgian Lari, with all other variables held constant on the statement of comprehensive income. A negative amount in the table reflects a potential net reduction in the statement of comprehensive income, while a positive amount reflects a net potential increase.

As at 31 December 2015	USD	EUR	SDR	AUD	CAD	Other	Total
Foreign currency assets	4,544,286	333,535	478,230	477,977	194,836	11,226	6,040,090
Foreign currency liabilities	(1,908,067)	(346,674)	(524,010)	-	-	(185)	(2,778,936)
Net position	2,636,219	(13,139)	(45,780)	477,977	194,836	11,041	3,261,154
As at 31 December 2014	USD	EUR	SDR	AUD	CAD	Other	Total
Foreign currency assets	3,456,607	632,269	388,675	376,913	162,372	16,067	5,032,903
Foreign currency liabilities	(1,221,634)	(293,402)	(467,965)	-	-	(280)	(1,983,281)
Net position	2,234,973	338,867	(79,290)	376,913	162,372	15,787	3,049,622
Effect on statement of total comprehensive income							
31-Dec-15							
	USD	EUR	SDR	AUD	CAD	Other	Total
Increase in currency rate of 1%	26,362	(131)	(458)	4,780	1,948	110	32,611
Increase in currency rate of 5%	131,811	(657)	(2,289)	23,899	9,742	552	163,058
Increase in currency rate of 10%	263,622	(1,314)	(4,578)	47,798	19,484	1,104	326,116
Decrease in currency rate of 1%	(26,362)	131	458	(4,780)	(1,948)	(110)	(32,611)
Decrease in currency rate of 5%	(131,811)	657	2,289	(23,899)	(9,742)	(552)	(163,058)
Decrease in currency rate of 10%	(263,622)	1,314	4,578	(47,798)	(19,484)	(1,104)	(326,116)
Effect on statement of total comprehensive income							
31-Dec-14							
	USD	EUR	SDR	AUD	CAD	Other	Total
Increase in currency rate of 1%	22,350	3,389	(793)	3,769	1,624	158	30,497
Increase in currency rate of 5%	111,749	16,943	(3,965)	18,846	8,119	789	152,481
Increase in currency rate of 10%	223,497	33,887	(7,929)	37,691	16,237	1,579	304,962
Decrease in currency rate of 1%	(22,350)	(3,389)	793	(3,769)	(1,624)	(158)	(30,497)
Decrease in currency rate of 5%	(111,749)	(16,943)	3,965	(18,846)	(8,119)	(789)	(152,481)
Decrease in currency rate of 10%	(223,497)	(33,887)	7,929	(37,691)	(16,237)	(1,579)	(304,962)

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NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2015 *(in thousands of Georgian Lari)*

Other Risks

Settlement risk

Settlement risk (i.e., the risk that the counterparty may not be able to complete a transaction) is mitigated in a number of ways. The Bank will only transfer funds after sufficient collateral has been secured. For outright transactions in securities, settlement risk is eliminated through the use of systems that are based on delivery versus payment, that is, the simultaneous exchange of securities and cash. Additionally, the settlement of the cash component is performed through the payment system referred to as Real Time Gross Settlement, which is owned and managed by the Bank, which determines the position of each participant in real time on an individual payment-to-payment basis. This automatically avoids overdrafts and as it simultaneously uses accounts in the Bank as settlement asset, it mitigates credit risk.

Non-financial risk

Non-financial risk, which includes, among others, the strategic, legal and operational risks, may generate financial loss, damage to reputation or inability to achieve the objectives of the business, resulting from one or more causes of risk, originating from human factors, or defective or inadequate processes or systems, or external events.

Among non-financial risks management, Business Continuity planning became a critical component for the Bank. In this regard the Bank improved the resilience of the Bank's critical processes providing the management of business continuity risks. The Business Continuity system was implemented during 2014. The Bank introduced two key units: Business Continuity Committee and Business Continuity team. The Business Continuity Committee is led by the Chief Executive Officer of the Bank and is responsible for the policy and related strategic decisions. The Business Continuity team is responsible for the execution of tasks. The Committee monitors and verifies all actions taken to manage those risks.

For preventing and controlling the non-financial risks, the Bank has internal control systems in accordance with the characteristics of its activities, as well as, procedures and policies within the competencies of each department and the attributions of their managers. Compliance with these regulations and the existing practice of risk management are monitored/observed by the Bank's Internal Audit, for ensuring the adequacy of internal control systems.

29 EVENTS AFTER THE REPORTING PERIOD

In February 2016 the term of the Governor of the Bank, Giorgi Kadagidze expired. By the proposal of the President of Georgia, the Parliament of Georgia has approved new member of NBG board Koba Gvenetadze, who took office as a new governor in March 2016, as a result of NBG board decision



2, Sanapiro Str., Tbilisi 0114, Georgia
Tel.: (995 32) 6488; Fax: (995 32) 240 6577
Hot line: (995 32) 240 6406
E-mail: Info@nbg.ge; www.nbg.ge