



საქართველოს ეროვნული ბანკი  
National Bank of Georgia

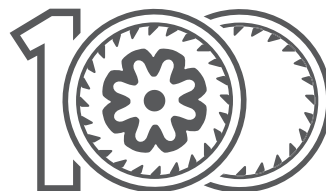


# 2018

ANNUAL REPORT

National Bank of Georgia

# ANNUAL REPORT 2018



FIRST GEORGIAN  
**CENTRAL  
BANK**

The annual publication

ISSN 1512-1739

**BEST CENTRAL BANKER AWARD 2018**



**GLOBAL  
FINANCE**

**GEORGIA**

**KOBA GVENETADZE**

*The Governor of the National Bank of Georgia Koba Gvenetadze was awarded with the Best Central Banker of 2018 Award by Global Finance*

# CONTENTS

---

<b>Abbreviations</b> .....	<b>8</b>
<b>Introduction</b> .....	<b>9</b>
<b>1. Macroeconomic Environment</b> .....	<b>19</b>
1.1 World Economy .....	20
1.2 The External Sector and Balance of Payments .....	23
1.3 Economic Growth .....	35
1.4 Inflation .....	38
<b>2 Monetary and foreign exchange policy</b> .....	<b>45</b>
2.1 Monetary policy .....	46
2.2 Monetary Policy Instruments .....	54
2.2.1 Refinancing loans .....	55
2.2.2 One-month open market instrument .....	55
2.2.3 Overnight loans and deposits .....	55
2.2.4 Securities .....	56
2.2.5 Minimum reserve requirements .....	58
2.3 Exchange Rate Policy and International Reserves Management .....	60
<b>3 Financial Stability</b> .....	<b>65</b>
3.1 Financial Stability Policy .....	66
3.2 Development of the Financial Stability Framework .....	67
<b>4 Banking Supervision</b> .....	<b>71</b>
4.1 Development of the Supervisory Framework .....	72
4.2 Group Structure Risk .....	78
4.3 Credit Risk .....	80
4.4 Market Risk .....	94
4.4.1 Foreign Currency Risk .....	94
4.4.2 Interest Rate Risk .....	95
4.5 Profitability Risk .....	96
4.6 Liquidity Risk .....	99
4.6.1 Structure of Liquid Assets .....	99
4.6.2 Structure of Liabilities .....	101
4.6.3 Retail Funding .....	102
4.6.4 Wholesale Funding .....	104
4.6.5 Regulation of Liquidity Risk .....	105
4.7 Operational Risk .....	107
4.7.1 Operational risk reporting .....	107
4.7.2 Business continuity management .....	108
4.7.3 Outsourcing .....	108
4.7.4 Dependence of the banking system on other sectors .....	108
4.7.5 Accuracy risk .....	108
4.8 Capital Adequacy .....	109
4.9 Macroprudential Risks .....	113
4.10 Financial Reporting and Transparency .....	114
4.11 Credit Information Bureau Supervision .....	115
4.12 International Cooperation .....	116
<b>5. Consumer Protection and Financial Education</b> .....	<b>119</b>
5.1 Consumer Rights Protection .....	120
5.2 Financial Education .....	124

<b>6. Supervision of Non-bank Depository Institutions</b> .....	<b>133</b>
6.1 Non-Banking Financial Institutions.....	134
6.1.1 Microfinance Organizations.....	134
6.1.2 Credit Unions.....	137
6.2 The Regulation and Supervision of the Non-Banking Sector .....	138
<b>7. Securities Market</b> .....	<b>135</b>
7.1 Securities Market Development.....	142
7.2 Securities Market Indicators and Core Participants .....	142
<b>8. Money Laundering Inspection and Supervision</b> .....	<b>149</b>
<b>9. Payment Systems</b> .....	<b>153</b>
<b>10. IT Development</b> .....	<b>165</b>
<b>11. Organization of Cash and Emission Activities</b> .....	<b>169</b>
<b>12. Internal Audit and Centralized Risk Management</b> .....	<b>181</b>
<b>13. Public Relations and International Cooperation</b> .....	<b>185</b>
<b>14. Human Resources Management and Development</b> .....	<b>191</b>
<b>15. Development of the Normative Legal Base</b> .....	<b>195</b>
<b>16. Statistical Activities</b> .....	<b>201</b>
<b>17. Financial Reports</b> .....	<b>205</b>

## DIAGRAMS

Diagram 1.1 Global real GDP growth.....	21
Diagram 1.2 Global CPI inflation.....	22
Diagram 1.3 Real GDP growth in Georgia and its trade partners.....	23
Diagram 1.4 Ratio of current account components to GDP.....	24
Diagram 1.5 Annual growth rates of exports of goods (2011-2018).....	25
Diagram 1.6 Annual growth rates of imports of goods (2011-2018).....	25
Diagram 1.7 Export structure by country in 2018.....	26
Diagram 1.8 Top 10 export commodities in 2018.....	27
Diagram 1.9 Import structure by country in 2018.....	28
Diagram 1.10 Revenues from exports of tourism (2011-2018).....	28
Diagram 1.11 Number of international visitors by country.....	29
Diagram 1.12 The ratio of revenues from goods and services exports to GDP.....	29
Diagram 1.13 Annual growth rate of personal remittances (2014-2018) .....	30
Diagram 1.14 Money transfers by country.....	31
Diagram 1.15 Financing of current account deficit (in % of GDP).....	31
Diagram 1.16 Assessment of international reserves adequacy, according to I MF methodology (ARA metrics).....	32
Diagram 1.17 Indices of the Real Effective Exchange Rate and Nominal Effective Exchange Rate (Dec. 2012=100).....	34
Diagram 1.18 Real growth of exports and imports of goods and services.....	37
Diagram 1.19 Investments to GDP.....	37
Diagram 1.20 GDP growth by categories of use.....	38
Diagram 1.21 Headline and core inflation (excluding food, energy and tobacco products) Source: Geostat.....	39
Diagram 1.22 Contribution of fuel, food, alcohol drinks, tobacco and utilities to headline inflation.....	40
Diagram 1.23 Imported and domestic inflation .....	41
Diagram 1.24 Inflation of tradable and non-tradable goods.....	43
Diagram 1.25 Change of annual inflation for services and goods of different durability.....	43
Diagram 2.1 Monetary policy rate.....	47
Diagram 2.2 Annual inflation and inflation excluding the effect of food, energy and tobacco prices.....	48
Diagram 2.3 Monetary policy rate and interest rates on loans .....	49
Diagram 2.4 The factors affecting the change in refinancing.....	50
Diagram 2.5 Interbank money market.....	51
Diagram 2.6 Dollarisation level in the banking sector (excluding the exchange rate effect).....	53

Diagram 2.7 Dynamics of Treasury Securities, Certificates of Deposit and Securities of International Financial Institutions.....	54
Diagram 2.8 Portfolio of certificates of deposit (2013-2018).....	57
Diagram 2.9 Treasury securities by holder.....	58
Diagram 2.10 Minimum reserve requirements.....	59
Diagram 2.11 FX market during 2003-2018.....	61
Diagram 2.12 Official FX Reserve Assets 1997-2018 (million USD, end of year).....	62
Diagram 3.1. Credit to GDP Ratio (percent of GDP).....	67
Diagram 4.1 YoY percentage change in gross loans.....	81
Diagram 4.2 Monthly weighted average interest rates on loans per segment.....	82
Diagram 4.3 Monthly weighted average interest rates on loans for the corporate segment.....	82
Diagram 4.4 Monthly weighted average interest rates on loans for the SME segment.....	82
Diagram 4.5 Monthly weighted average interest rates on loans for the retail segment.....	83
Diagram 4.6 Share of pro-cyclical sectors in the gross loan portfolio.....	83
Diagram 4.7 Retail products distribution, December 2017-2018.....	86
Diagram 4.8 Segments by currency (excluding interbank loans), December 2018.....	88
Diagram 4.9 Retail portfolio composition by currency (excluding interbank loans).....	88
Diagram 4.10 Loan portfolio composition by qualitative indicators (excluding interbank loans).....	90
Diagram 4.11 Overdue loans of 90 days and more*.....	90
Diagram 4.12 The share of restructured loans in the gross loan portfolio.....	91
Diagram 4.13 the ratio of loan loss reserves to gross portfolio.....	91
Diagram 4.14 Volume and share of net floating interest rate loans in the net loan portfolio.....	92
Diagram 4.15 Write-offs and the recovery of loans.....	92
Diagram 4.16 Problem assets.....	93
Diagram 4.17 Repossessed property.....	93
Diagram 4.18 Balance sheet and consolidated open currency positions to regulatory capital.....	94
Diagram 4.19 Interest bearing assets' coverage of liabilities.....	95
Diagram 4.20 Return on assets and equity.....	96
Diagram 4.21 Decomposition of profitability growth.....	97
Diagram 4.22 Interest spread and factors affecting it.....	97
Diagram 4.23 Banking system net operating profit and annual growth.....	98
Diagram 4.24 Level of liquid assets.....	99
Diagram 4.25 Liquidity ratio by currency.....	100
Diagram 4.26 Liquidity gap: assets with maturity of less than one month to liabilities with a maturity of less than one month.....	100
Diagram 4.27 Structure of liquid assets.....	101
Diagram 4.28 liability structure.....	101
Diagram 4.29 Annual growth of non-bank deposits.....	102
Diagram 4.30 Share of non-resident deposits.....	102
Diagram 4.31 Structure of non-resident deposits (December 2018).....	103
Diagram 4.32 Non-resident deposits by country (December 2018).....	104
Diagram 4.33 Gross loans to non-bank deposits.....	105
Diagram 4.34 Certificates of Deposit and their share in non-bank deposits.....	106
Diagram 4.35 Dynamics of Liquidity Coverage Ratio (LCR).....	106
Diagram 4.36 The dynamics of total operational losses in 2013-2018.....	107
Diagram 4.37 The distribution of gross operational losses in 2018.....	108
Diagram 4.38 Basel III Tier 1 Capital ratios.....	110
Diagram 4.39 Basel III Tier 1 Capital ratios.....	110
Diagram 4.40 Basel III regulatory capital ratios.....	111
Diagram 4.41 Pillar 2 requirements for commercial banks as 31 December of 2018.....	112
Diagram 5.1 Claims drawn at commercial banks.....	123
Diagram 5.2 Distribution of claims by product type.....	123
Diagram 6.1 The dynamics of assets, liabilities and capital.....	134
Diagram 6.2 The dynamics of net portfolio to total assets.....	135
Diagram 6.3 The structure of total portfolio.....	135

Diagram 6.4 The dollarization of credit portfolio.....	136
Diagram 6.5 The structure of attracted funds.....	136
Diagram 6.6 The total funds attracted from private individuals and the quantity of creditor private individuals.....	137
Diagram 7.1 The Volume of Bonds Placed through Public and Private Offerings throughout the years 2014-2018.....	143
Diagram 7.2 Dynamics of Bonds Issued by Currency throughout the years 2014-2018.....	143
Diagram 7.3 Bonds Outstanding by the Issuer Sector (As at the year-end of 2018).....	144
Diagram 7.4 Dynamics of Outstanding Corporate Bonds by Credit Ratings throughout the years 2014-2018.....	144
Diagram 7.5 Dynamics of Total Brokerage Assets, Clients' Cash Accounts and Client Cash Accounts as a Percentage of Total Assets throughout the years 2010-2018.....	145
Diagram 7.6 Major Trade Indicators for the Transactions Carried out on the Georgian Stock Exchange throughout the years 2010 -2018.....	146
Diagram 7.7 Number of transactions made on the trading sessions Georgian Stock Exchange throughout the years 2010-2018.....	146
Diagram 7.8 Securities deposited in the Central Securities Depository throughout the years 2010-2018.....	147
Diagram 7.9 Funds deposited in the Central Depository throughout the years 2010-2018.....	147
Diagram 9.1 RTGS operations (2002-2018).....	155
Diagram 9.2 RTGS operations (2018).....	156
Diagram 9.3 The value of the transfers processed through RTGS system according to participants (2011-2018).....	156
Diagram 9.4 The Volume of RTGS operations by participants (2011-2018).....	157
Diagram 9.5 Cashless payments by means of initiation in 2012-2018.....	158
Diagram 9.6 Distribution of non-cash payments by means of payment order initiation (2018).....	159
Diagram 9.7 Issued cards by payment card schemes.....	160
Diagram 9.8 The dynamics of transactions performed with payment cards.....	161
Diagram 9.9 E-money Payments.....	162
Diagram 9.10 the existing funds in electronic wallets according to currencies by December 31, 2018.....	163
Diagram 11.1 The share of banknotes in circulation per denomination and modification.....	170
Diagram 11.2 – Shares of denominations of banknotes and coins in circulation (2015-2018 years).....	171
Diagram 11.3 – Cash in circulation (2015-2018 years).....	171
Diagram 11.4 – 5, 20, 50 and 100 lari banknotes in circulation per modification for each denomination (%).....	172
Diagram 11.5 – counterfeit notes and coins detected in 2018 (%).....	174
Diagram 11.6 Number of counterfeit lari banknotes detected in 2015-2018.....	175
Diagram 11.7 – Number of counterfeit lari coins detected in 2015-2018.....	175
Diagram 11.8 Products sold in 2015-2018.....	176

## TABLES

Table 1.1 Balance of payments (2014-2018) (million USD).....	33
Table 1.2 Annual changes in effective exchange rates in 2018.....	34
Table 1.3 Real GDP growth and sector breakdown.....	36
Table 1.4 Inflation indicators according to individual components (percentage), their share in the consumer basket (percentage) and contribution to CPI (percentage points).....	42
Table 4.1 Composition of the loan portfolio (excluding interbank loans) by segment (adjusted for exchange rate effect, the exchange rate as of the end of 2017).....	81
Table 4.2 Gross loan portfolio according to risk sector.....	84
Table 4.3 Growth of retail products adjusted for the exchange rate effect (exchange rate as of the end of 2017).....	86
Table 4.4 Limits of payment-to-income ratios according to the "Retail Lending Guideline".....	87
Table 4.5 Limits of loan-to-value ratios according to the "Retail Lending Guideline".....	87
Table 4.6 Gross loan portfolio by risk classification.....	89
Table 4.7 Portfolio quality by segment.....	89
Table 4.8 External sources of wholesale funding and their schedules as of 31 December 2018.....	105
Table 4.9 Systemic buffer phase-in dates.....	109
Table 4.10 Concentration and net GRAFE buffer phases in periods.....	111
Table 7.1 Aggregate information on transactions carried out on the Georgian Stock Exchange, 2017-2019.....	146
Table 11.1 Results of the examination of suspicious banknotes and coins received in 2018.....	173



# ABBREVIATIONS

---

**AFI** - Alliance for Financial Inclusion

**API** - Application Programming Interface

**ARA** - Assessing Reserve Adequacy

**BI** - Business Intelligence

**BSCEE** - Banking Supervisors from Central and Eastern Europe

**CEMEA** - Central Europe Middle East and Africa

**CET1** - Common Equity Tier 1

**CPSS** - Committee on Payment and Settlement Systems

**CRD IV Package** – Regulation (EU) No. 575/2013 and Directive (EU) 2013/36/EU of the European Parliament and of the Council on Capital Requirements

**CYFI** - Child and Youth Finance International

**EBRD** - European Bank for Reconstruction and Development

**EFSE DF** - Development Facility of the European Fund for Southeast Europe

**ESG** - Environmental, Social, and Governance

**FIFA** - International Federation of Association Football

**FINREP** - Financial Reporting, a European regulation regarding financial reporting that applies to credit institutions

**FSAP** - Financial Sector Assessment Program

**GPFI** - Global Partnership for Financial Inclusion

**GRAPE** - General Risk Assessment Program

**G-SIB** - Global Systemically Important Banks

**GSSS** - Georgian Securities Settlement System

**HHI** - Herfindahl-Hirschman Index

**ICAAP** - Internal Capital Adequacy Assessment Process

**ICMA** - International Capital Market Association

**IFC** - International Finance Corporation

**IFRS** - International Financial Reporting Standards

**IORWG** - International Operational Risk Working Group

**IOSCO** - Technical Committee of the International Organization of Securities Commissions

**LCR** - Liquidity Coverage Ratio

**LTV** - Loan-to-Value Ratio

**NFC** - Near Field Communication

**NSFR** - Net Stable Funding Ratio

**OECD** - Organization for Economic Co-operation and Development

**PFMI** - Principles for Financial Market Infrastructures

**PTI** - Payment-to-Income Ratio

**RCAP** - Regulatory Consistency Assessment Program

**RTGS** - Real Time Gross Settlement

**SBN** - Sustainable Banking Network

**TIBR** - Tbilisi Interbank Rate

**USAID** - United States Agency for International Development

**WEO** - World Economic Outlook

**XBRL** - Extensible Business Reporting Language

# INTRODUCTION

---

The 2018 Annual Report of the National Bank of Georgia (NBG) has been prepared in accordance with Articles 60 and 61 of the Organic Law on the National Bank of Georgia. It comprises an overview of the NBG's monetary, exchange rate and supervisory policies, and audited financial statements.

The primary goal of the NBG is to maintain price stability. The NBG also aims to ensure the stability and transparency of the financial system to promote sustainable economic growth – so long as this does not compromise its primary objective.

Price stability implies maintaining inflation around the target level in the medium term. Focusing on the medium term is key; in the short term, inflation can deviate from the target (in both directions), but in the medium term, the NBG's monetary policy actions will guide inflation to the target level. Through the adoption of this approach, the long-term interest rate is maintained at the lowest level, price stability is ensured, and economic growth is higher and more stable than it would be under alternative approaches.

The conduct of monetary policy based on the approach mentioned above is possible under the inflation-targeting framework, which is widely regarded as the most efficient monetary policy approach. Moreover, with the development of monetary policy instruments and their transmission mechanisms, the inflation targeting framework allows price stability to be reached at the lowest possible social cost. The National Bank of Georgia thus continually strives to increase the efficiency of monetary policy instruments and their transmission mechanisms.

The NBG adopted its inflation-targeting framework in 2009. Since then (over 2009-2018), the average annual inflation rate has stood at 3.5%. The initial

inflation target was set at 4%, but has gradually declined over time – moving to 3% from 2018, which corresponds to the long-term target level.

In Georgia, as in other small open economies, exogenous shocks (independent from monetary policy) are imminent. Exogenous factors can cause actual inflation to deviate from the target level. As monetary policy is a tool to affect aggregate demand, it is the central bank's response to demand shocks. However, central banks do not usually react to exogenous cost-push shocks, since doing so would lead to high economic costs and facilitate economic fluctuations that would increase unemployment in the long run. Moreover, research has demonstrated that monetary policy is transmitted to the real economy with a certain time lag. Hence, in the short run, actual inflation can temporarily deviate from the target level. However, if a deviation is so significant that it affects inflation expectations and the inflation forecast, the NBG will adjust its policy response accordingly.

In early 2018, temporary factors, most notably the effect of increased excise tax on tobacco and fuel, petered out, and the inflation level declined significantly. Although prices on tobacco and fuel were increasing throughout the year, and from early 2018 tariffs on electricity were raised, inflation in 2018 remained below the target level of 3%. Moreover, despite bread prices rising in December, inflation fell to 1.5% during that period. Over the year, inflation averaged 2.6%.

Over 2018, as in previous periods, domestic demand still lagged behind the potential level, exerting downwards pressure on inflation. In the first half of the year, the growth of economic activity accelerated. At the same time, from early 2018, due to the volatility on international financial markets and the developing macroeconomic environment in Turkey,

the risk of higher imported inflation increased significantly. Moreover, in the beginning of the year, the depreciation of the nominal exchange rate also put upwards pressure on inflation. Although there was a need for a gradual easing of monetary policy in the medium term, considering these risks, the NBG decided to maintain a relatively tight monetary policy stance at the beginning of the year, keeping the monetary policy rate at 7.25%. In the second half of the year, the higher-than-expected appreciation of the nominal exchange rate reduced inflationary pressure. Moreover, the upward risks to the inflation forecast weakened. Hence, in June, the Monetary Policy Committee deemed it appropriate to start a gradual exit from the moderately tight monetary policy and to cut the policy rate by 0.25 basis points to 7%. According to the NBG's press releases, there is still a need for a further easing of monetary policy to the neutral rate. However, the speed of policy normalization will depend on both how fast the output gap closes and how strongly increased regional macroeconomic risks are transmitted to the Georgian economy.

One of the main policy priorities for the National Bank of Georgia is supporting larization (de-dollarization), as doing so would decrease macro financial risks and reduce external vulnerabilities. Moreover, larization will increase the efficiency of monetary policy. The NBG has thus gradually implemented reforms supporting the larization process and has made significant steps in this direction over the course of 2018. In particular, to further support lending in the national currency and to increase the attractiveness of GEL resources, in June 2018 GEL reserve requirements fell from 7% to 5%, while reserve requirements for foreign currency resources increased from 20% to 25%. It is worth noting that the reserve requirement for foreign currency resources with a maturity from one to two years equals 10%, while attracted foreign currency funds with a remaining maturity of more than two years are free from reserve requirements.

The Monetary Policy Committee also made the de-

cision to reduce the accrued interest on required reserves, thereby supporting the attractiveness of GEL deposits. By changing reserve requirements, the National Bank of Georgia is able to influence commercial banks' credit activities and interest rates. For instance, increasing the reserve requirement imposes extra costs on local banks when borrowing foreign currency resources and, as a result, they have to increase interest rates on credits denominated in foreign currency, thereby affecting lending in foreign currency. Moreover, reserve requirements act as a buffer and are used for prudential purposes. For example, in the case of capital flight, these resources guarantee the availability of foreign currency resources, reducing the risk of a crisis.

Moreover, since 2017, lending to individuals up to a value 100,000 GEL has only been possible in GEL. In 2018, the decision was made to increase this limit to 200,000 GEL and extend this restriction to legal entities. This amendment entered into force on 23 January 2019.

As a result of these changes, the de-dollarization trend that started in 2017 persisted in the first half of 2018, affecting loans to both individuals and legal entities. However, in the second half of the year, the larization of total loans slowed down and the larization trend for physical persons reversed. This was related to a surplus of foreign currency resources in the banking sector, which allowed banks to offer low-interest foreign currency loans to the market. In addition, the impending implementation of regulations concerning the extension of the limit for loans in foreign currency and the introduction of macroprudential instruments gave banks additional motivation to issue loans in foreign currency at that time.

The rise in lending in foreign currency in the second half of the year indicates that the market does not adequately assess currency risk. Over 2018, the dollarization of loans (excluding the exchange rate effect) decreased by 0.8 percentage points (pp) and

equaled 56.8%, while the dollarization of deposits fell by 3.2 pp to 63.1%. At the same time, the dollarization level of loans to physical persons increased from 46.3% at the end of 2017 to 47.7% by the end of 2018. Following the introduction of responsible lending standards for physical persons, we expect the de-dollarization trend to be strong over 2019. Active communication with society remains one of the main priorities and the NBG is always trying to improve its communication channels. In 2018, particular attention was paid to ensuring that society understood current macroeconomic trends and their expected outcomes as well as the policies implemented by the National Bank of Georgia and their impact on the economy. Over the year, the National Bank of Georgia introduced a variety of new monetary policy communications formats.

In 2018, to further enhance its credibility, the NBG continued holding press conferences in different regions of Georgia. Over the year, Monetary Policy Committee (MPC) meetings were organized in the Kvemo Kartli and Samegrelo regions, which were followed by meetings of the Governor and other NBG representatives with the media, where policy decisions were discussed in detail. These press conferences were broadcast live on social networks. In addition, Koba Gvenetadze, the Governor of the NBG, held meetings with regional representatives of business and financial institutions, where he presented the decisions of the MPC and provided information on current macroeconomic trends. It should be noted that the National Bank of Georgia is among the small number of central banks that regularly publish the expected trajectory of the monetary policy rate. Like last year, the National Bank continued to produce short videos to accompany the publication of its quarterly monetary policy reports. In these videos the Governor of the National Bank emphasized noteworthy aspects of the analysis behind the reports. In addition, video recordings were made of the monetary policy report presentations that were attended by analysts, field specialists and media representatives, and these are posted on the National Bank's official website

and its social media. To ensure maximum transparency and the timely delivery of information about the banking system to society, the National Bank distributed press releases and statistical data and regularly organized briefings, seminars, presentations and meetings. Public relations were conducted through mass media and other means of communication. Periodic meetings with print and electronic media representatives were also held regularly.

In this regard, based on the practice of other central banks, the National Bank of Georgia tried to make information about the trends in the money and foreign exchange markets available through the media, outlining the vision and motives behind the decisions made. Electronic versions of NBG publications are available on the bank's official website.

The year 2018 was notable in terms of the growth of revenues from exports of commodities and tourism, as well as for the growth of money transfers. The current account deficit in the balance of payments reached 7.7% of GDP, which was the lowest level over the last five years. Moreover, in the third quarter of 2018, for the first time in Georgian history since independence, the current account balance was positive. The current account was positively affected by the improvement of the trade balance in services, which increased by 220 million USD in 2018. Of this growth, it is worth mentioning that tourism export inflows increased by 518 million USD (by 19%). The trade balance remains the most negative component of the current account. In 2018, the ratio of the trade deficit in goods to GDP worsened by 0.2 percentage points and reached 25.4% of GDP. Exports of goods from Georgia increased substantially, mainly due to the improved economic environments in major trading partner countries. However, further growth in exports of goods was somewhat suspended by the difficulties facing the Turkish economy in the second half of 2018. In sum, the overall annual increase in exports of goods was 23.4%. Imports of goods grew unevenly throughout the year. In the first half of 2018,

imports increased at a high rate, before slowing near the end of the year. Overall imports of goods increased by 15.5% and continued to outweigh the growth level of exports of goods.

In 2018, similar to previous years, the current account deficit was mainly financed by foreign direct investments (FDI) (see Diagram 1.15). In total, these reached 1.2 billion USD, which was 35% less than in the previous year. This decline in FDI was mainly driven by the completion of the final phase of the BP pipeline project in Georgia. The majority of investments were directed at the finance, transport and energy sectors. Compared to the previous year, foreign direct investments increased in the manufacturing and mining sectors.

Given the significant improvements in the external sector, the main driver of economic growth in 2018 was net exports – the contribution of investment and domestic demand was weak in comparison.

In 2018, Georgia's economy grew by 4.7%, with a huge contribution of 4.5 percentage points from service sector, while industrial sector contributed 0.2 percentage points.

Over 2018, the National Bank of Georgia continued to fill its international reserves. It should be emphasized that the level of international reserves is a significant indicator of the resilience of a country's economy against foreign shocks, and maintaining an adequate level is particularly important for countries with high dollarization. Reserve adequacy is a precondition for the macroeconomic stability of the country.

For making FX interventions, the National Bank of Georgia relies on FX auctions. In 2018, the only purpose of NBG interventions on the FX market was the accumulation of international reserves. Total purchases on the FX market over 2018 equaled 197.5 million USD.

The National Bank of Georgia continues to develop a financial stability policy framework in accordance with best international practice. The first step in this direction was developing complex, Georgia-specific financial stability indicators. These indicators, which were adopted by the NBG in 2018, can be used to make cyclical macroprudential policy decisions.

During the last year, the credit portfolio continued to grow at a fast pace. Given the high growth of credit, the credit-to-GDP ratio exceeded the long-run trend, which was mainly driven by household loans. Although overall credit growth would ordinarily indicate a need to activate the countercyclical capital buffer, the Financial Stability Committee decided that the enactment of a responsible lending framework for individuals and the limits placed on the payment-to-income (PTI) and loan-to-value (LTV) coefficients, which are to be introduced on 1 January 2019, would reduce the growth of lending to a sustainable level. As a result, the decision was made not to activate the countercyclical capital buffer.

Decisions to tighten macroprudential policy are often unpopular. In the short run these carry social or economic costs, while the benefits (high and stable growth, high employment and low fiscal expenditure), despite potentially exceeding the costs, often materialize only in the long run. As a result, the need for tightening can often be quite hard to understand.

During 2018, given the locally reduced interest rates on foreign currency loans, FX loans issued to individuals have increased. This might be an indication of the underestimation of foreign currency risks from both borrowers as well as banks, which could be significant for financial stability. Foreign currency denominated loans are exposed to exchange rate risk, but are also accompanied by interest rate risk – the latter being especially note-

worthy given the anticipated increase in interest rates on the US dollar and euro on global markets. In addition, the country risk premium should also be taken into account – this has been significantly depressed given the historically low interest rates in the aftermath of the global financial crisis. The possible impact of a tightening of global financial conditions on the risk premiums of developing countries (in particular, of Georgia) should thus also be considered when assessing foreign currency funding risks. In order to address these issues, the Financial Stability Committee has been issuing press releases to encourage financial institutions to adequately evaluate and consider foreign currency interest rate risk when pricing loans.

In 2018, the NBG started publishing macroeconomic forecast scenarios for International Financial Reporting Standards (IFRS 9) for financial institutions. These scenarios are countercyclical by nature, which helps mitigate the impact of financial cycles. A sustainable financial system and the development of a sustainable finance framework is important for financial stability. In September 2017, the NBG became a member of the Sustainable Banking Network. With the purpose of increasing awareness about sustainable finance, the NBG, in cooperation with the private sector, translated the International Capital Market Association's (ICMA) Green, Social and Sustainable Bond Principles into Georgian. The translated documents have been available on the ICMA's website since last year. An important part of sustainable financing is integrating environmental, social and governance (ESG) considerations in the Corporate Governance Code. These ESG considerations are already reflected in the Corporate Governance Code for commercial banks and integrating these into the Corporate Governance Code for capital markets is underway. The NBG, in cooperation with the OECD, is working on ESG disclosure and reporting principles, which will help financial institutions and companies comply with the requirements of the code.

As of 31 December 2018, 15 commercial banks were operating on the Georgian banking sector. At that time, 87% of bank assets and 84% of stockholder equity were beneficially owned by foreign/non-resident investors.

In recent years, the National Bank of Georgia has taken measures in response to the increased number of loans issued in the financial sector without proper analysis. As a result of amendments to the "Regulation on Assets Classification and the Creation and Use of Reserves for Losses by Commercial Banks", limits on the PTI and LTV ratios for "standard" category loans were determined. In the event of non-compliance with these ratios, banks have to increase the required capital. According to these changes, the risk weight was doubled for non-collateralized retail loans that do not comply with these ratios. These amendments ensure the accumulation of capital buffers on behalf of increased retail lending in banks and increase the ability to absorb shocks caused by credit risk in the banking sector. However, despite the decreased risk as a result of increased capital buffers, those changes did not stop a large increase in retail lending. Overindebtedness remained an unsolved problem because the NBG's mandate was only applicable to the banking sector.

During 2018, the National Bank of Georgia, in cooperation with the financial sector, actively worked on a responsible lending framework that aims to strengthen the stable functioning of the financial sector and encourage sound lending standards. The "Regulation on Lending Standards for Natural Persons" was introduced, which was fully established on the principles of responsible lending. The regulation requires using standards in the process of drafting loans that encourage borrowers to repay their loans without financial distress. The requirements of the regulation cover loans withdrawn without business purposes to natural persons (including individual entrepreneurs) when

the total liability of the borrower does not exceed 2 million GEL. Analyzing the creditworthiness of the borrower in the process of the drafting a loan has become mandatory, which involves examining the borrower's income, expenses and liabilities. In addition, maximum limits for the payment-to-income and loan-to-value ratios were defined. All loan-granting institutions must comply with these limits. In 2018, the return on average assets and equity amounted to 2.5% and 19.5% respectively, which was lower than the same indicators from the previous year (2.8% and 20.8% respectively). The rate of banking system profitability has remained stable in recent years and, in total, has approached the required return on equity for shareholders.

Total liquidity remained stable at a high level in 2018. The foreign currency liquidity ratio remains high as a result of lower demand for foreign currency loans and increased minimum reserve requirements on FX liabilities. Wholesale funding is diversified in terms of both lender type and residual maturity. The residual maturity of 60% of the wholesale funding exceeds two years, which reduces funding risk for the system. The share of non-resident deposits in total non-bank deposits decreased in 2018 and amounted to 16% by December. These deposits were well 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 improve long-term liquidity regulations, work on the implementation of the Net Stable Funding Ratio (NSFR) has started. After the introduction of this coefficient, the existing liquidity requirement (30% for short-term liabilities) will be abolished and will only be used for monitoring purposes. As a result, the liquidity risk supervisory framework will be in full compliance with Basel Standards. As of 31 December 2018, within the revised Basel III framework, the Tier 1 and total regulatory capital adequacy ratios amounted to 13.51% and 18.39% respectively. The leverage ratio was also high, amounting to 11.83%

as of 31 December 2018 and exceeding its minimum requirement by 6.8 percentage points.

From January 2018, Basel I Tier 1 and total regulatory capital adequacy ratios were phased out and have fully been replaced by the Basel III capital adequacy requirements. On 31 December 2018, a systemic buffer was set up on total regulatory, Tier 1 and CET 1 capital.

Enhancing the transparency of the financial sector is one of the main objectives of the National Bank of Georgia. An important component in doing so is the preparation of annual financial statements of commercial banks and other representatives of the financial sector. These statements are prepared in accordance with International Financial Reporting Standards (IFRS). Banks are also required to publish their quarterly and annual Pillar 3 reports in accordance with the "Regulation on Disclosure Requirements for Commercial Banks within Pillar 3". These reports offer market participants key insights into the main risks that banks face, alongside information about supervisory capital components, corporate governance and risk management practices.

An amendment to the Organic Law on the National Bank of Georgia was approved at the end of 2017, which entered into force on 11 January 2018. According to this regulation, the National Bank of Georgia was authorized to regulate and supervise the activities of the Credit Information Bureau, and was obliged to issue legal acts regulating that supervision until 1 September 2018. Data accuracy is very important for the National Bank of Georgia and it is worth mentioning that as a result of this supervision technical corrections were made to 20% of the total data. Additional data from regulated entities, which had not been available to the bureau before, helped solve the fragmentation problem.

In 2018, the National Bank of Georgia was the chair of the BSCEE (Banking Supervisors from Central and Eastern Europe) Group. The National Bank of

Georgia first became a member of the BSCEE in 2013 and has since been actively involved in the group's activities. The BSCEE comprises representatives of 24 countries of Eastern and Central Europe. According to the group's rules, the chair of the group is annually elected from its member states. The National Bank of Georgia also hosted the BSCEE annual conference in 2018.

Throughout 2018, the efforts of maintaining and supporting a stable macroeconomic and financial environment were reflected in improvements to Georgia's credit ratings from international rating agencies. "Fitch Ratings" last changed its rating for Georgia in 2011, but at the beginning of 2019 the agency raised the sovereign credit rating for Georgia from "BB-" to "BB", which was the highest rating for Georgia to date.

The rise in Georgia's credit rating is a result of a number of clear achievements attained during recent periods. Despite a rise in external risks, economic growth in Georgia has remained strong. There was continued support from the floating exchange rate, which helped narrow the current account deficit during recent years. There has also been an increased diversification of financing sources. Moreover, it is significant that, despite the existing challenges, the National Bank of Georgia has continued the accumulation of international reserves. The higher credit ratings further solidify the credibility of Georgia for international institutions and investors and positively affect the business environment of Georgia.

Significant changes have been made to the normative base in regard to the regulation and supervision of the non-banking sector. For the purpose of increasing transparency and access to information related to the microfinance sector, a new rule on the "Manner and Term of Filing Financial Statements and Regulation of Submitting Accounts by Microfinance Organizations to the National Bank of Georgia" was approved. This rule has consider-

ably changed the format of financial reporting. Active microfinance organizations (MFOs) are now required to publish quarterly information on their websites. Furthermore, MFOs are now obliged to conduct annual external audits and to publish reports on those audits on their websites by 15 June of the following year. Regulations regarding the registration of microfinance organizations have also undergone significant changes. Registration requirements have been made stricter and it has become mandatory for MFOs to provide information about their sources of capital and correspondence criteria were set for administrators and beneficiary owners. In 2018, the dollarization rate for the credit portfolio of microfinance organizations decreased from 27% to 16%. The implementation of these changes have made the microfinance sector more liquid, capitalized and stable.

During 2018, significant steps were undertaken towards the development of the capital market and its supervisory policy. In 2018, the National Bank of Georgia became an associate member of the International Organization of Securities Commissions (IOSCO), which was the result of a lengthy and thorough process that started in 2017. Throughout this process, the NBG actively cooperated with the World Bank to finalize the self-assessment of the regulatory, legal and supervisory framework of the Georgian securities market with the IOSCO objectives and principles. According to its action plan, the National Bank of Georgia plans to sign a memorandum of understanding to become an ordinary member of the IOSCO. The NBG has already started working on making adjustments to the different legal and regulatory securities market frameworks in order to meet all requirements in an efficient and timely manner.

A sound legal framework is one of the key components for a well-functioning securities market. In 2018, the NBG worked with the Ministry of Economy and Sustainable Development of Georgia, different market participants, foreign supervisory



entities, and a diverse range of international organizations to elaborate an updated legal framework for investment funds. The renewed legal working document is based on the European regulations and principles that are applicable to different types of investment funds. In 2018, the NBG also signed a three-year agreement with the Financial Services and Markets Authority (FSMA) to establish a proper legal framework for the Georgian securities market. Focusing on a regulatory framework for market intermediaries and issuers, the updated legislation will be formed in accordance with EU standards, which will considerably improve the current supervisory framework.

As for market activity, throughout the year the bond market became significantly more active. In 2018, 10 companies issued 15 bonds totaling 714 million GEL, of which 12 were issued through public offerings and the remaining three through private offerings. The National Bank of Georgia continues to investigate and conduct rigorous market research for equity securities in order to identify major breaches in supply and demand factors. In this regard, improving the supervisory environment, increasing issuer transparency and ensuring the proper implementation of high corporate standards should attract more investors and increase their interest.

By the end of 2018, the Georgian securities market comprised of two stock exchanges, a central securities depository, four independent registrars of securities and 10 brokerage companies, of which four were not members of the Stock Exchange.

In the reporting period, the NBG issued three kinds of collector coins. These were all sold out, reflecting great appreciation by the public.

The NBG issued 5-lari collector coins dedicated to the 100th Anniversary of Ivane Javakhishvili Tbilisi State University. Their sale started from 1 February 2018. Subsequently, 10-lari collector coins were issued dedicated to the celebration of the

100th Anniversary of the establishment of the First Democratic Republic of Georgia and their sale commenced on 15 May 2018. Competitions were carried out for the design of both coins, and winners were chosen. A partner selection process was subsequently implemented, and a relevant contract was concluded with the Spanish mint that was selected for their production.

Further 5-lari collector coins were designed on the theme of Georgian books and were dedicated to Georgia's status as a guest of honor at the Frankfurt Book Fair. The Frankfurt Book Fair is one of the biggest book fairs in the world that attracts thousands of international visitors every year. Within the framework of the event, every year one country is eligible to present its intellectual resources (literature, theater, music, painting, cinema, cuisine, etc.) in different cities of Germany throughout the year. In 2018, that opportunity was given to Georgia as the guest of honor. On 18 December 2017, a relevant contract was concluded with the Lithuanian Mint on the production of these coins, which were made available for sale from 10 September 2018.

Protecting consumer rights in the financial sector and encouraging financial education among the population are some of the priorities of the National Bank of Georgia. With this in mind, the NBG continued its efforts of the previous year and took significant steps towards improving consumer protection and encouraging financial literacy to efficiently respond to challenges on the financial market.

The Governor of the National Bank declared 2018 as the "Year of Financial Literacy", and the year saw a flurry of financial literacy activities with numerous projects implemented for different target groups. A financial education program for micro and small entrepreneurs was developed and piloted; a local version of a FIFA World Cup™ Financial Football video game was created and launched; financial literacy brochures for schoolchildren were developed and distributed; financial literacy was

integrated as part of the School Mathematics Olympiad organized by KINGS Georgia; teachers from public and private schools, as well as representatives from commercial banks were trained as part of the SchoolBank project; and, as per tradition, Global Money Week and World Saving Day were celebrated on a larger scale.

Close cooperation continued with the Ministry of Education, Science, Culture and Sport of Georgia with the purpose of integrating financial literacy into the national school curriculum. As a result, in 2018 a new national curriculum for grades VII-IX was developed, under which financial literacy became a part of the civics education subject "Citizenship".

On the basis of the steps taken and projects accomplished for improving the financial literacy of the Georgian population, including children and youth,

the National Bank received a regional "Country Award" during the 2018 Global Inclusion Awards, which have been organized by Child and Youth Finance International (CYFI) since 2012.

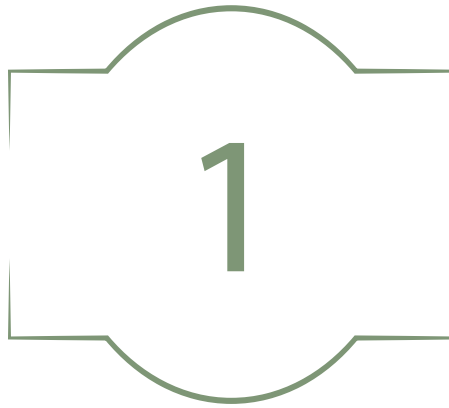
The world's leading financial editorial magazine *Global Finance* named Koba Gvenetadze, Governor of the National Bank of Georgia, among its Best Central Bankers of 2018. The international magazine annually publishes "Central Banker Report Cards", which grade the performance of central bank governors. The *Global Finance* awards are acknowledged worldwide and individuals and banks receiving awards are recognized in the global financial community for their high reputation and successful work. A total of 90 central bankers were graded in the 2018 Central Banker Report Cards (85 national and five regional central bank governors) and the final results were published in October.



*Building of the State bank of Georgia (1920-1921)*



FIRST GEORGIAN  
**CENTRAL  
BANK**



# MACROECONOMIC ENVIRONMENT

## 1.1 World Economy

Global economic growth slowed somewhat in 2018. According to the International Monetary Fund's (IMF) preliminary estimates,<sup>1</sup> annual growth stood at 3.7%, which is a lower indicator than in the previous forecast.<sup>2</sup> Weak growth was mostly evident in the eurozone and Great Britain and was driven by a reduction in external demand stemming from lower export volumes on the back of an appreciated euro, as well as deteriorated domestic economic indicators – alongside a reduction in private consumption and fixed investments. The “trade-war” between the US and China is still a challenge, but the possibility of an agreement and a calmer phase is expected ahead. Even though last year was distinctively good for emerging and developing countries, their growth recently lost momentum – mostly a consequence of the appreciation of the US dollar and a reduction in capital flows. In the second half of 2018, economic activity was high and robust in the United States, which can be explained by the strong fiscal stimulus and increased consumer spending. According to the IMF's forecast, annual GDP growth in the US in 2018 stood at 2.9%, while inflation is expected to be 2.4%.<sup>3</sup>

A slowdown of economic growth was also observed in the main trading partner countries of Georgia, which was partly a result of the undesirable global environment, local currency depreciations (in Turkey, Russia and Ukraine) and a deterioration of consumer and business sentiment. It should be noted that trade barriers remain a significant challenge. Last year, the growth rate of eurozone countries slowed substantially – including in Germany where real GDP growth was 1.5% – alongside a reduction in private consumption. Weak economic growth of only 1% was seen in Italy, where a high debt burden, high taxes and a fragile banking sector prevented effective economic development. In the background of frequent protests, the French economy weakened significantly, with real GDP growth standing at 1.5%. Meanwhile, Spain saw growth of 2.5%, representing a small reduction in economic growth. Overall, in 2018 the eurozone's economic growth slowed and, according to the IMF's estimates, it grew by 1.8%, with there being an expectation of a further weakening in 2019.<sup>4</sup> Uncertainty regarding Brexit has created negative expectations in financial markets, which in turn negatively impacts ongoing processes in the eurozone. Inflation, alongside the strengthening of euro, remained somewhat close to the target level and stood at 1.6%.

---

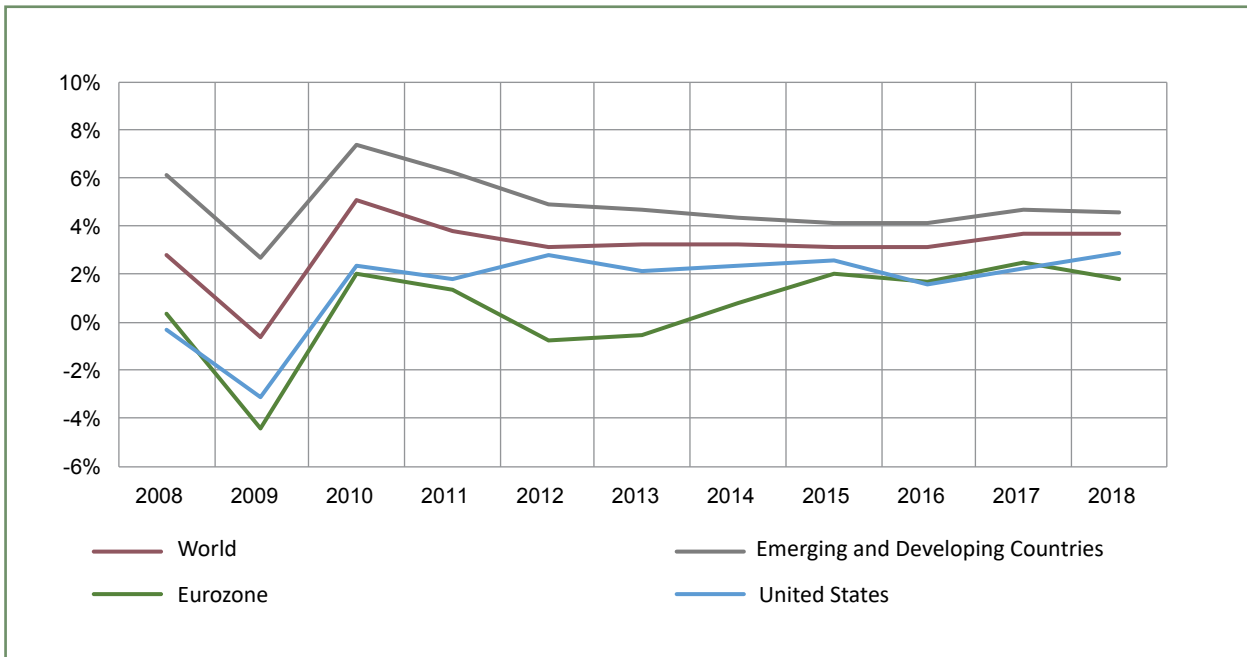
1. International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, D.C., January.

2. International Monetary Fund. 2018. World Economic Outlook: Challenges to Steady Growth. Washington, D.C., October

3. International Monetary Fund. 2019. World Economic Outlook Update: A Weakening Global Expansion. Washington, D.C., January.

4. Ibid.

**Diagram 1.1 Global real GDP growth**



Source: International Monetary Fund

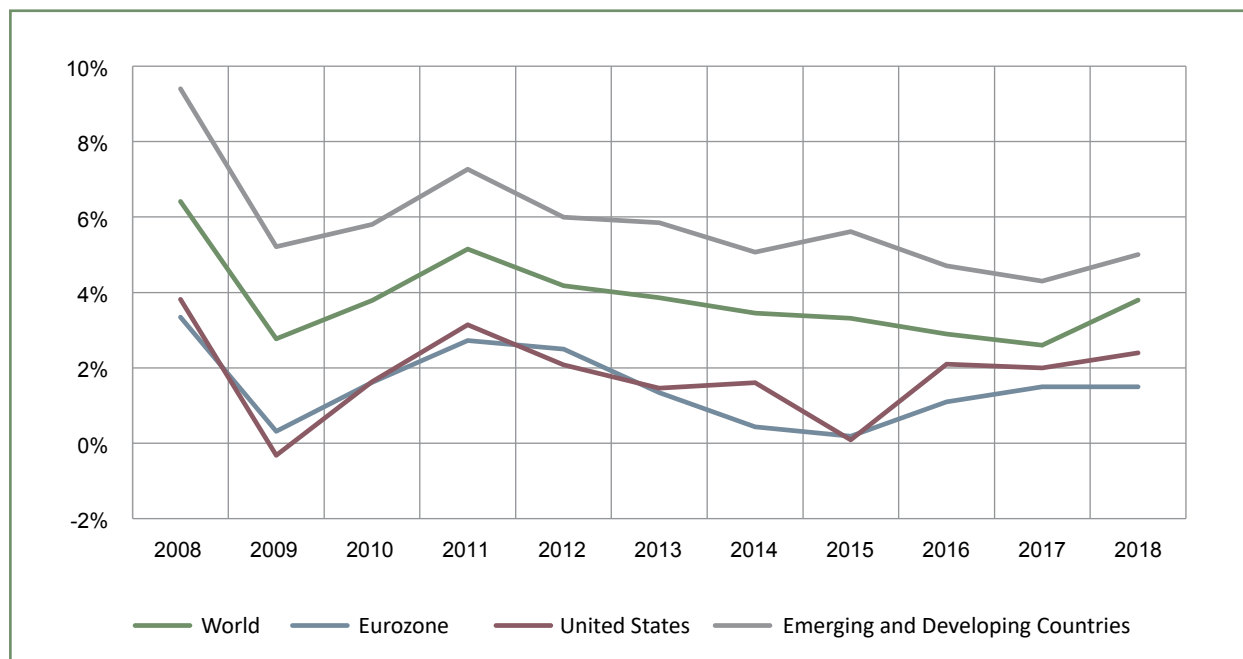
According to the IMF's estimates, the economic growth of Russia in 2018 stood at 1.7%, which was higher than expected.<sup>5</sup> Despite this upward revision, the recovery process still lost steam as the depreciation of the local currency, deteriorating consumption dynamics on the back of an increased VAT rate, and poor performance of the agricultural sector all weighed on activity. Falling oil prices were also an issue, but these were partly balanced by an agreement reached between OPEC and Russia about further limiting oil production. Annual inflation in Russia stood at 2.9% in 2018.

Turkey faced a particularly tough environment, which resulted in a decline in trade and other financial inflows to Georgia. The impact of the August 2018 currency crisis has continued to reverberate, with Turkey's economy shrinking significantly. According to the World Bank's estimates, real GDP growth in 2018 stood at 3.5%, with the expectation of it further weakening to 1.6% in 2019.<sup>6</sup> This was followed by a deterioration of consumer and business sentiment, accompanied by U.S. tariffs on Turkish steel, which has significantly hindered real economic growth. Last year, annual inflation in Turkey stood at 20.3%.

5. Ibid.

6. World Bank. 2019. Global Economic Prospects: Darkening Skies. Washington, D.C., January.

**Diagram 1.2 Global CPI inflation**



Source: International Monetary Fund

Last year can be positively assessed for Ukraine, where the active recovery of the economy continued. Improved conditions on the labor market and increased consumer spending caused a boost in domestic demand, while money transfers also increased. According to the World Bank's estimates, real GDP growth in 2018 was 3.5%.<sup>7</sup> However, the challenging external environment has negatively impacted the volume of exports and the economy as a whole. Despite a tightening of monetary policy, inflation at the end of the year was projected at 9.8%, which is significantly above the target level of 5%.

Regardless of the setback experienced in the second half of 2018, Armenia's economic growth remained solid during the year and, according to

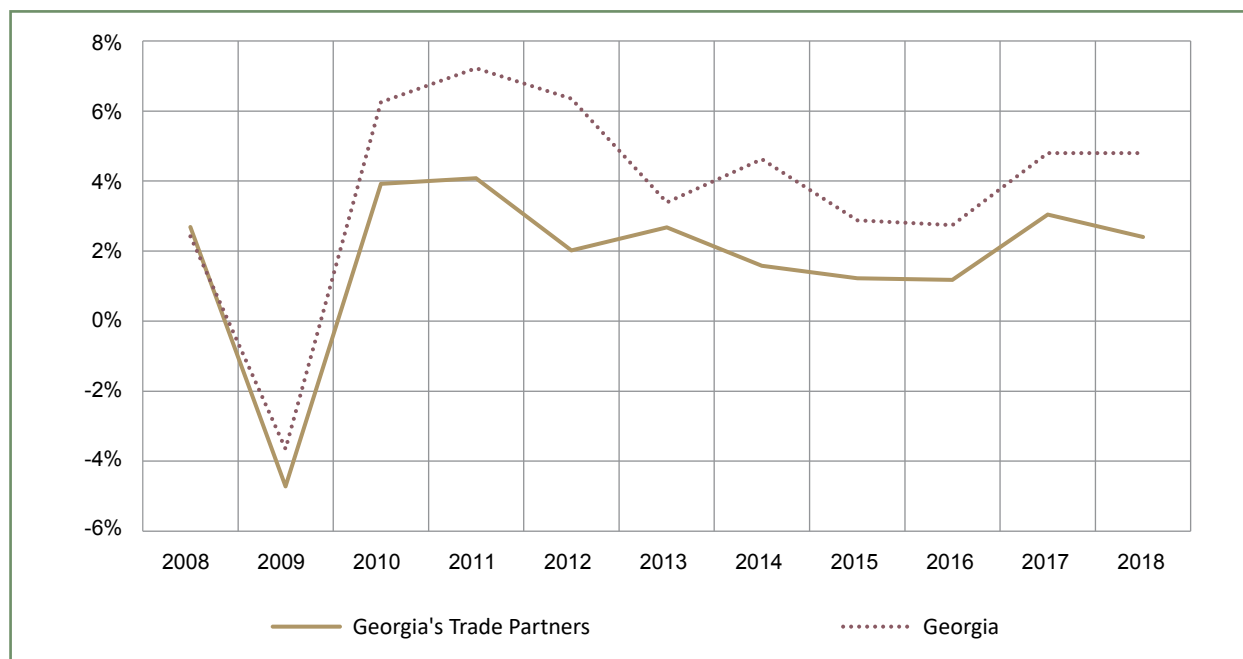
the World Bank's forecast, stood at 5.3%.<sup>8</sup> Political stabilization, loose monetary policy and stable money transfers all contributed positively. Annual inflation in December was 1.8%.

Last year was also positive for Azerbaijan, where solid government spending and accelerated growth in the non-oil sector made a significant contribution. With stabilizing prices on the commodity market, the country's external imbalance has slightly improved. Although a fall in international oil prices negatively impacted growth, this effect was partly balanced by the agreement reached between OPEC and Russia about further limiting oil production. Azerbaijan's annual GDP growth in 2018 was 1.1%, while inflation stood at 2.3%.

7. Ibid.

8. Ibid.

**Diagram 1.3 Real GDP growth in Georgia and its trade partners**



Source: International Monetary Fund

In 2018, in response to rising inflation expectations and depreciations of local currencies, the central banks of some trading partners started to tighten their monetary policy, which was somewhat unexpected for the financial markets. Moreover, the U.S. Federal Reserve increased interest rates once more in 2018, a move justified by inflation expectations and the situation on the labor market. In addition, the European Central Bank (ECB) ended its monthly asset purchases in December 2018, which were part of the quantitative easing program, and has kept the policy rate unchanged. Taken together, this means a tightening of monetary policy to some degree relative to previous periods.

## 1.2 The External Sector and Balance of Payments

The year 2018 was notable in terms of the growth in revenues from exports of commodities and tourism, as well as the growth in money transfers.

In light of this, the current account deficit in the balance of payments reached 7.7% of GDP, which was the lowest level over the last five years (see Diagram 1.4). This positive trend was mainly due to an increase of surplus in trade in services and in secondary income surplus.

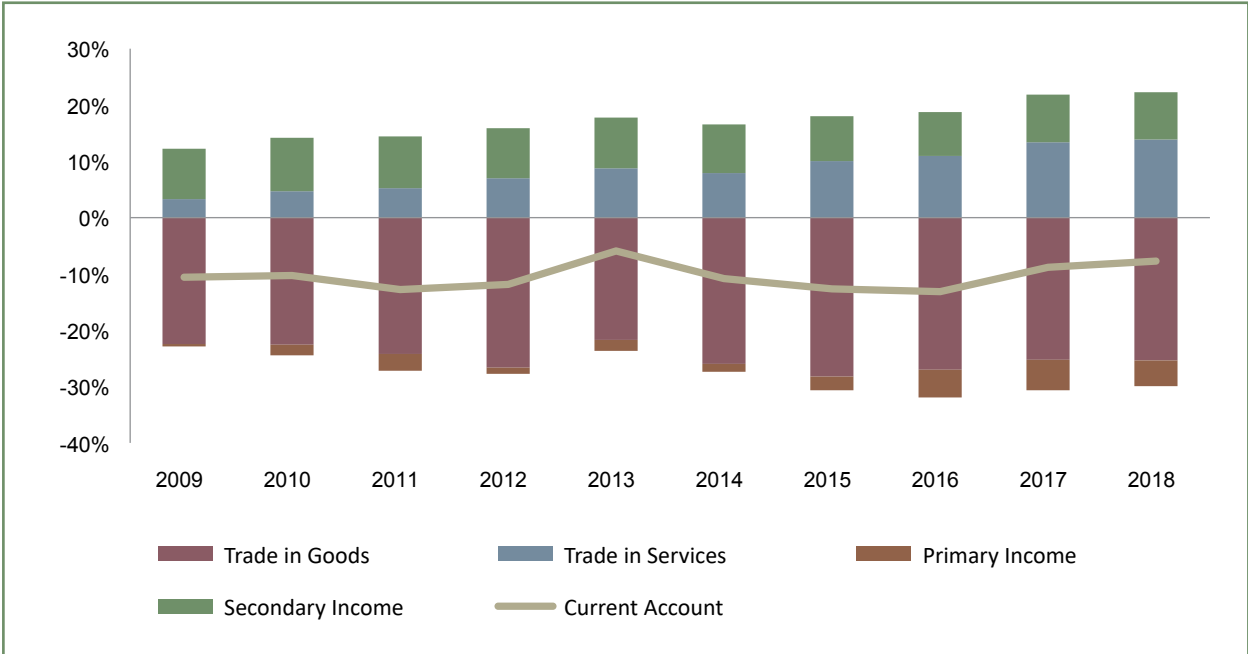
Throughout 2018, the USD appreciated against all major currencies. In light of the improved geopolitical environment in the region, the depreciation of national currencies in Georgia's trade partner countries, with the exception of Turkey, slowed down. It is worth mentioning that the depreciation of the euro was a result of expectations about the UK's exit from the EU, despite the fact that the ECB moved away from its monetary policy easing stance. Changes in the exchange rates and inflation levels of trade partner countries are important for Georgia's competitiveness. The appreciation of trade partner currencies in real terms induces a growth of external demand in Georgia and thus helps narrow the current account deficit.



It is worth mentioning that in the first half of 2018 oil price developments signaled a substantial rise in prices, which triggered economic activity in major trade partner and oil-exporting countries. As a result, demand on Georgian exports increased in such countries. However, this trend was also reflected in the rise of expenses in oil imports. Moreover, the difficulties in the Turkish economy had a negative impact on revenues from exports in Georgia. In sum, in light of the higher growth in exports of goods, imports of goods grew moderately and ultimately the deficit in trade in goods worsened. It is worth noting that exports of services, especially tourism, grew substantially, which significantly helped narrow the current account deficit. At the same time, in light of general improvements to the economic environment, money transfers from Russia and the EU both increased, which positively affected the reduction of the current account deficit in Georgia.

In 2018, the current account deficit reached 7.7% of GDP, which was 1.1 percentage point lower than the same indicator from the previous year. In absolute terms, the current account deficit narrowed by 81.5 million USD and amounted to 1.25 billion USD. The trade balance in goods worsened by 8.1 percentage points or by 307 million USD. In contrast, the current account deficit was positively affected by the improvement in the trade balance in services, which increased by 220 million USD in 2018. It is worth mentioning that tourism export inflows increased by 518 million USD (by 19%). Moreover, the narrowing of the current account deficit was supported by a decrease in the primary income deficit (by 81 million USD), which was mostly affected by the slower rate of investment income outflows. It is also worth noting that the volume of distributed dividends, as well as of reinvested earnings is still high, which by itself ensures an increase in the current account deficit.

**Diagram 1.4 Ratio of current account components to GDP**

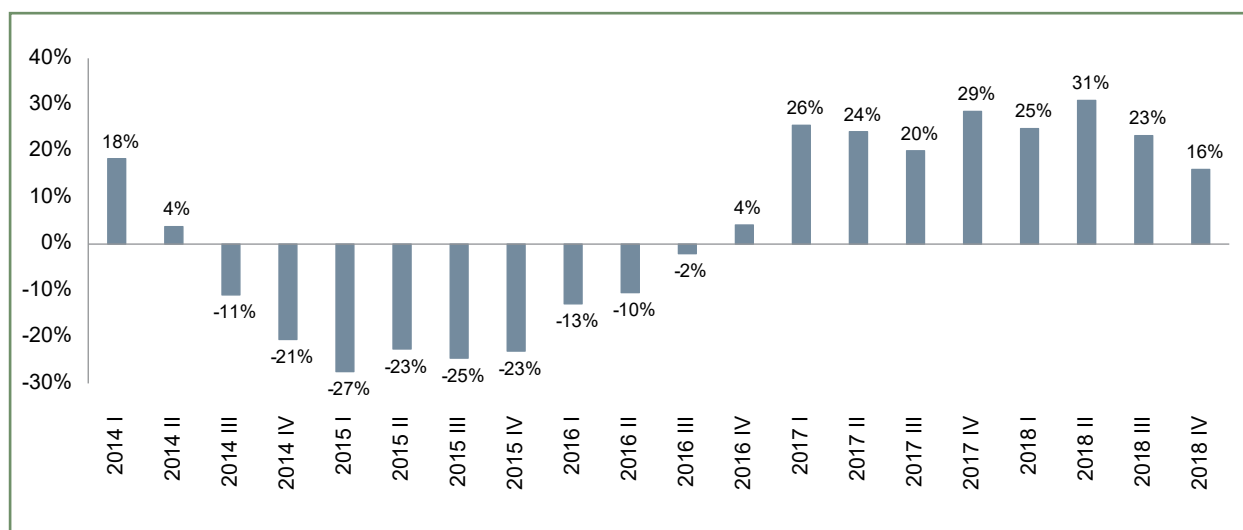


Source: National Bank of Georgia

The trade balance remains the most negative component of the current account. In 2018, the ratio of trade deficit in goods to GDP worsened by 0.2 percentage points and reached 25.4% of GDP. As was noted above, exports of goods from Georgia increased substantially, mainly due to the improved economic environment in major trading partner countries. However, a further growth in exports of goods was somewhat suspended as a

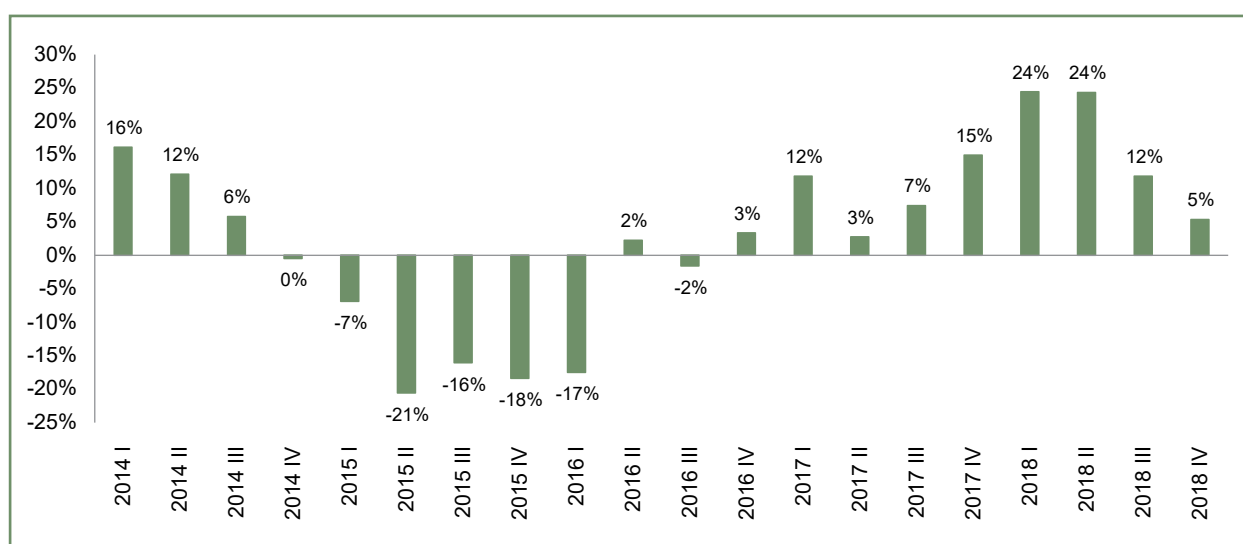
consequence of the difficulties facing the Turkish economy in the second half of 2018. In sum, the overall annual increase in exports of goods was 23.4% (see Diagram 1.5). Imports of goods grew unevenly throughout the year. In the first half of 2018, imports increased at a high rate before slowing near the end of the year (see Diagram 1.6). Overall imports of goods increased by 15.5% and continued to outweigh the exports of goods.

**Diagram 1.5 Annual growth rates of exports of goods (2011-2018)<sup>9</sup>**



Source: National Bank of Georgia

**Diagram 1.6 Annual growth rates of imports of goods (2011-2018)<sup>10</sup>**



Source: National Bank of Georgia

9. Exports of goods in BOP. The external trade data by GeoStat and the data on exports/imports by the BOP are different concepts that rely on different methodological frameworks. Foreign trade statistics are based on the principle of crossing a border, whereas the main principle of trade of goods in the BOP is a change of ownership between residents and nonresidents. Moreover, in external trade statistics exports are presented in FOB price, while imports are presented in CIF price. In contrast, in the BOP, export/import of goods are presented in FOB prices.

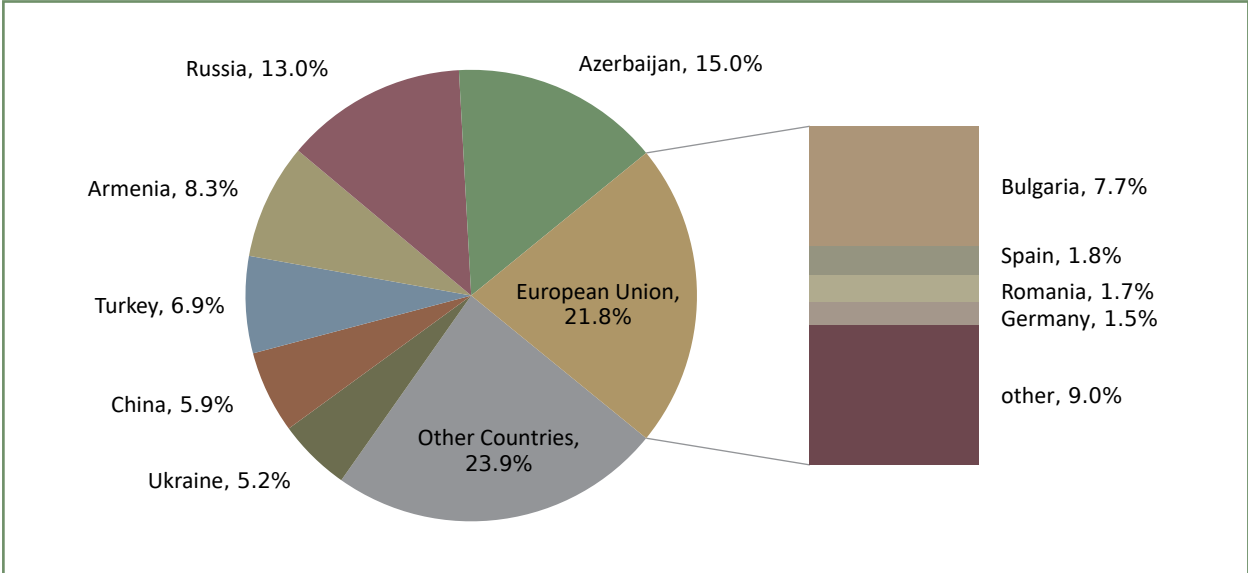
10. Exports of goods in BOP. The external trade data by GeoStat and the data on exports/imports by the BOP are different concepts that rely on different methodological frameworks. Foreign trade statistics are based on the principle of crossing a border, whereas the main principle of trade of goods in the BOP is a change of ownership between residents and nonresidents. Moreover, in external trade statistics exports are presented in FOB price, while imports are presented in CIF price. In contrast, in the BOP, export/import of goods are presented in FOB prices.

In light of the increase in exports, it is interesting to look at the destination countries. Exports to EU and CIS countries increased by 11.5% and 40.9% respectively. The increase to EU countries was mainly driven by increased exports to Bulgaria (38.5%) and France (66.0%); however, exports declined to Italy (-37.6%) and Romania (-23.2%). Moreover, a high growth of exports was observed to regional countries: Azerbaijan (84.7%), Armenia (32.1%) and Ukraine (40.6%). Exports to Russia were substantial once more (increasing by 10.2%). The level of exports to Turkey and China were at a similar level compared to 2017. From other countries, a greater amount of exports were directed

to the USA (an increase by 31.1%) and to other CIS countries like Kazakhstan, Kyrgyzstan and Uzbekistan.

In terms of exports, the EU was the largest trade partner of Georgia in 2018, accounting for 21.8% of total exports. Aside from the EU, exports were directed towards the following countries: Azerbaijan (15.0%), Russia (13.0%), Armenia (8.3%) and Turkey (6.9%) (see Diagram 1.7). With a 5.9% share of total exports, China was among top export destination countries – with 78% of exports to China being copper ores and concentrates that are related to re-exports.

**Diagram 1.7 Export structure by country in 2018**

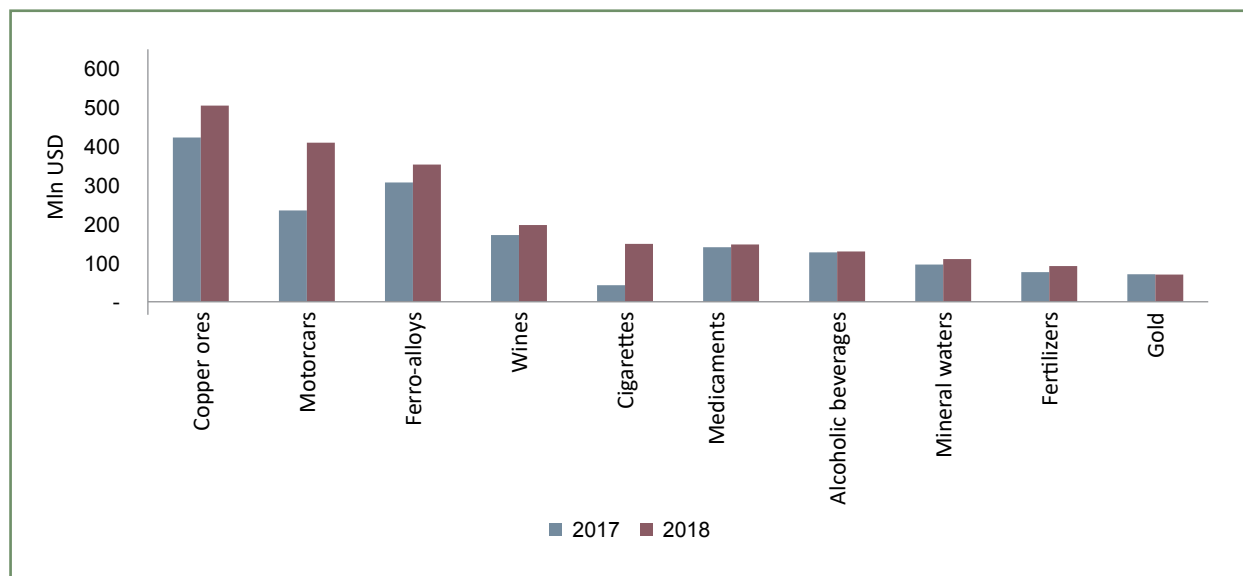


Source: National Statistics Office of Georgia

In 2018, exports of copper ores and concentrates significantly contributed to the overall increase of exports, comprising 15.0% of overall exports in goods and showing 19.3% annual growth. Exports of motor cars increased as well, rising by 74.1% compared to the previous year and having a 12.2% share in overall exports. It is worth noting that in 2018 exports of cigarettes and cigarillos increased

by 251.4% and medicaments increased by 4.7%, both of which were mostly directed to re-export. Due to a poor harvest, exports of hazelnuts and other nuts fell significantly during the year. In contrast, alcoholic beverages and mineral fertilizers were among the top export commodities. In sum, total exports of commodities increased by 23%, while exports excluding re-exports increased by 11%.

**Diagram 1.8 Top 10 export commodities in 2017-2018**



Source: National Statistics Office of Georgia

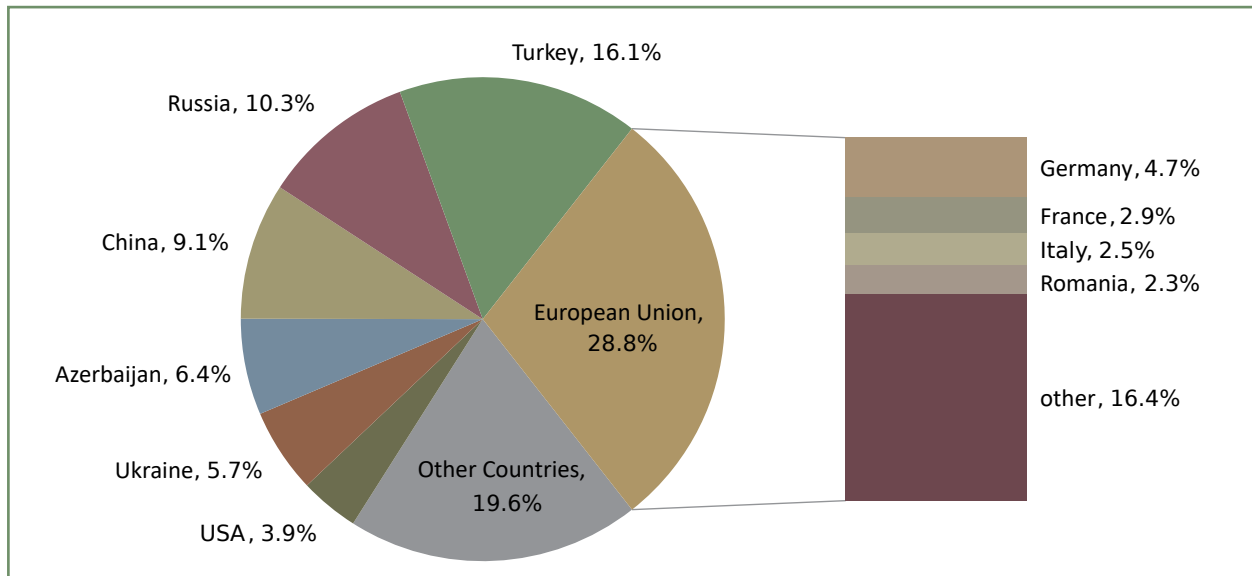
In 2018, in light of relatively active domestic demand, the growth of imports was mostly a result of increased imports of consumer goods (16.2%). Imports of intermediate goods have increased over the last two years and this trend has continued, growing by 14.2% in 2018. In addition, imports of investment goods increased by 12.4%, although this contributed little to the overall growth of total imports. As previously, the largest import commodity was petroleum and petroleum oils, which had a 9.5% share in total imports. The impact of oil price changes during the year was significant. In the first half of 2018, the price increase in oil markets induced a rise in imports in Georgia, but this growth decelerated in the second half of the year, partially as a result of reduced oil prices on global markets. Compared to the previous year, imports of motor cars and tobacco products increased substantially and made a significant contribution (of 2.6 percentage points) to the overall growth in imports. Moreover, it is worth mentioning that imports of copper ores and concentrates showed growth of 17% in 2018 (a 4.4% share in total imports), which was mainly driven by the recovery of copper re-exports in recent years. For illustration, 37% of the increase in total imports was driven by

imports of motorcars, cigarettes, petroleum gases and copper ores – all of which were the result of re-exports of those commodities.

A regional analysis of imports shows that imports increased substantially from the EU (increasing by 19.6%) as well as from other countries (increasing by 13.1%). The annual growth of registered imports was 15%. Imports from Russia, Armenia and Ukraine were characterized by high growth rates. The increase in imports from the EU was mainly due to a rise of imports from France (1.6 percentage points in overall growth) and Belgium (1.7 percentage points in overall growth). Moreover, external trade with other CIS countries such as Turkmenistan and Kazakhstan intensified.

Similar to previous years, aside from the EU, Turkey was the largest source of imports to Georgia. In 2018, imports from Turkey grew by 7.1%. Imports from Russia increased by 17.5% and comprised 9.0% of total imports. Imports from China also increased substantially (by 13.8%), which was mainly a result of the import of turbo-jets and turbo-propellers (see Diagram 1.9).

**Diagram 1.9 Import structure by country in 2018**

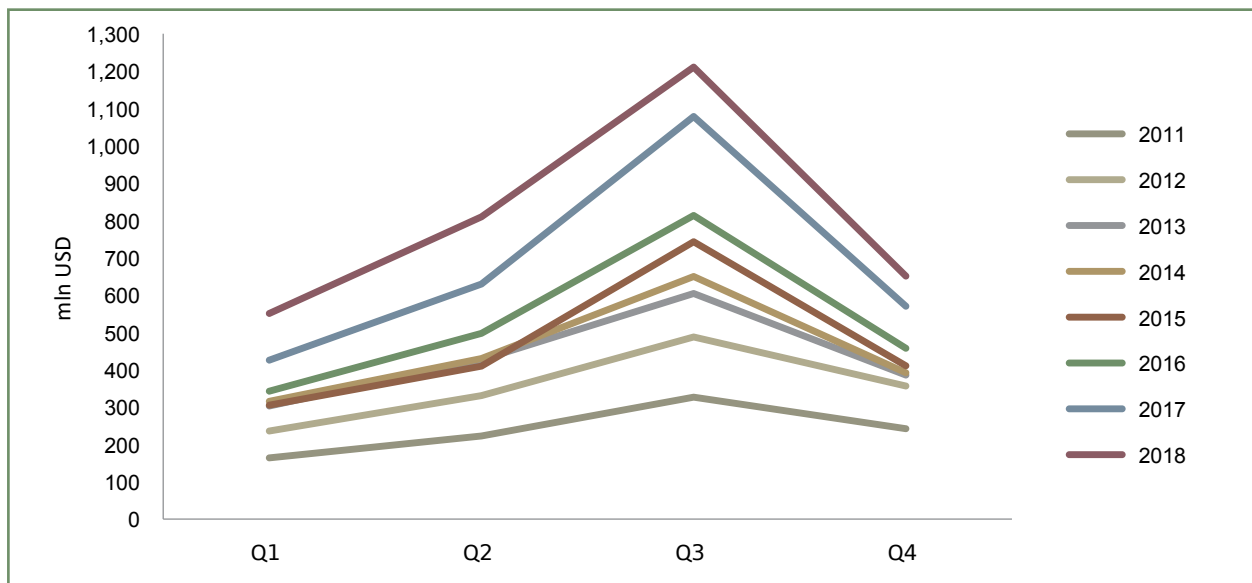


Source: National Statistics Office of Georgia

As has already been mentioned, improvements in the balance of trade in services positively impacted the narrowing of the current account deficit. The ratio of trade in services to GDP amounted to 13.8%, which was 0.4 percentage points higher than the same indicator from the previous year. In absolute terms, the balance of trade in services improved by 220 million USD and reached 2.24 bil-

lion USD. The rise in the surplus was mainly due to increased inflows from the tourism sector. Revenues from tourism, which comprise the majority of exports in services, amounted to 3.22 billion USD – an increase of 19.1% compared to the previous year (see Diagram 1.10). During recent years, revenues from tourism have become a major source of financing the goods trade deficit.

**Diagram 1.10 Revenues from exports of tourism (2011-2018)**



Source: National Bank of Georgia

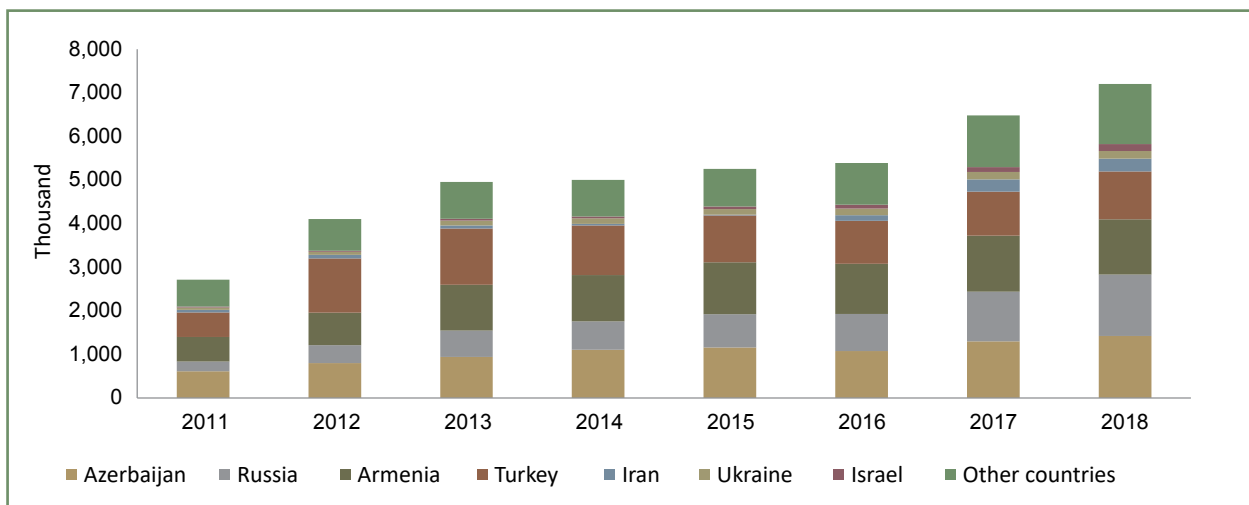
The number of international visitors to Georgia increased by 11.1% in 2018, which was mainly due to increased inflows of tourists from Russia (23.8%),

Azerbaijan (9.5%) and Turkey (9.1%). Moreover, increased numbers of visitors arrived from Israel, Germany, Belarus, Kazakhstan, the USA and Po-

land. In addition, international visitors from Saudi Arabia and India grew substantially, by 14% and 19% respectively. Following high inflows during recent years, visitors from Iran grew more modestly (3%). Along with the rise in the number of visitors, increased numbers of tourists also arrived from new countries. Although the number of visitors from Armenia decreased modestly (by -0.3%), visitors from that country still accounted for a

sizeable proportion of the overall number of international visitors. Moreover, the number of visitors from Georgia travelling abroad increased as well. The latter is a consequence of both the visa liberalization arrangements for Georgian citizens traveling to Schengen countries and the availability of low-cost airlines connecting Georgia to EU countries.

**Diagram 1.11 Number of international visitors to Georgia by country**



Source: National Bank of Georgia

It is worth mentioning that the high growth of tourism revenues during the last few years has seen tourism approach the level of revenues received from exports of goods (see Diagram 1.12).

Considering the size of the trade deficit, the high revenues from tourism significantly contribute to narrowing the current account deficit.

**Diagram 1.12 The ratio of revenues from goods and services exports to GDP**



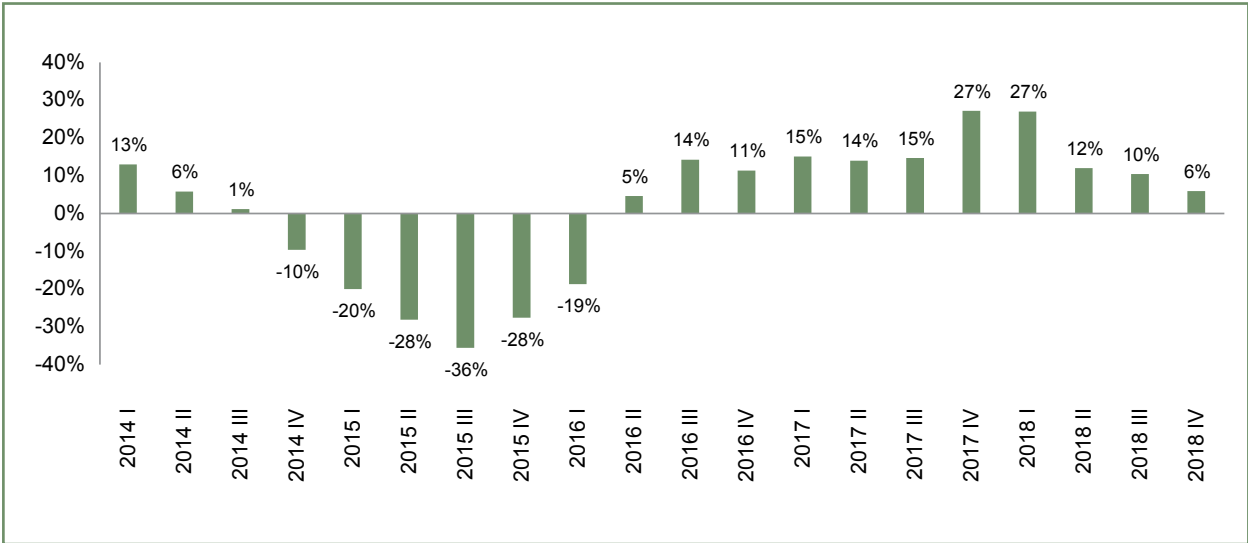
Source: National Bank of Georgia

In overall terms, the income account deficit decreased by 81 million USD compared to the previous year and amounted to 744 million USD. The high level of the income account deficit was once more mainly driven by the large deficit in investment income, which decreased marginally by 7 million USD and totaled 1.4 billion USD. This was induced by a worsening of the income account in terms of direct and other investments – specifically the increase of distributed dividends and re-

invested earnings. Although the latter has a negative impact on the current account balance, it is shown in foreign direct investments and thus did not induce capital outflows.

Moreover, the balance of compensation of employees increased by 75 million USD and amounted to 697 million USD. This increase was mainly due to the revival of economic activities in neighboring countries.

**Diagram 1.13 Annual growth rate of personal remittances (2014-2018)**

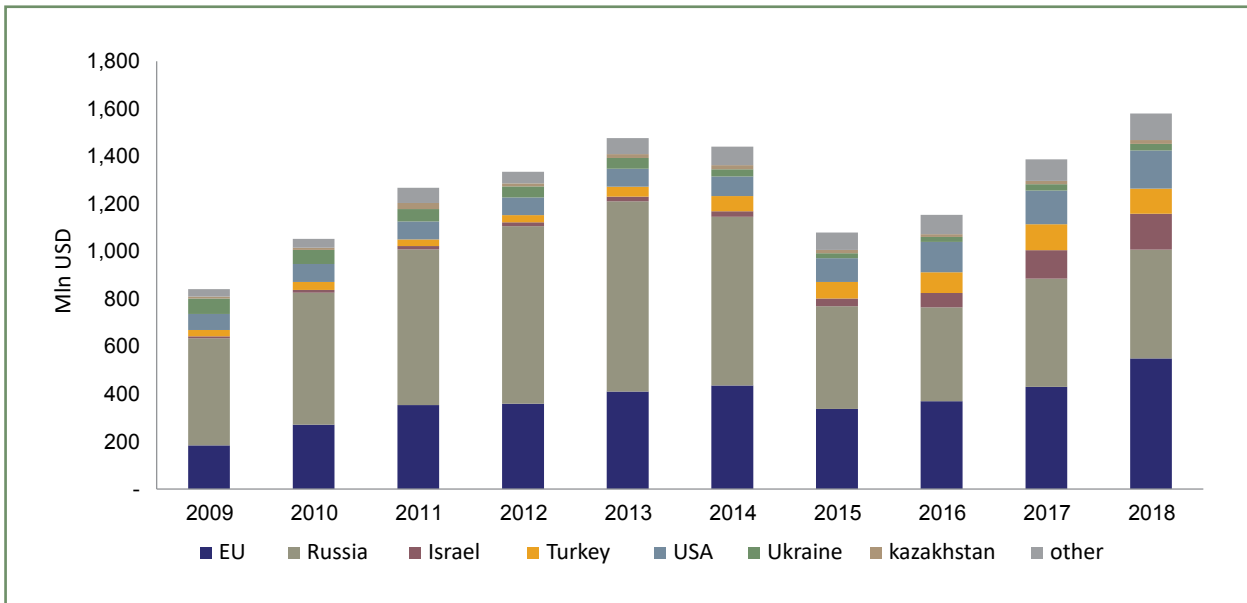


Source: National Bank of Georgia

In 2018, secondary income increased by a modest 6.9%, which was mostly due to increased remittances from abroad. Personal remittances, which is the largest component of secondary income, grew by 13% annually. Personal remittances were increasing throughout the year, mostly being sent from Italy, Israel, Greece and the USA. Personal remittances from Russia remained at almost the

same level as last year; however, remittances from Turkey decreased substantially from the second half of 2018 and eventually made a negative contribution to the overall growth of personal remittances. Secondary income declined in the government sector (-26.6%), which was related to a decline in aid received in the framework of international cooperation.

**Diagram 1.14 Money transfers by country**

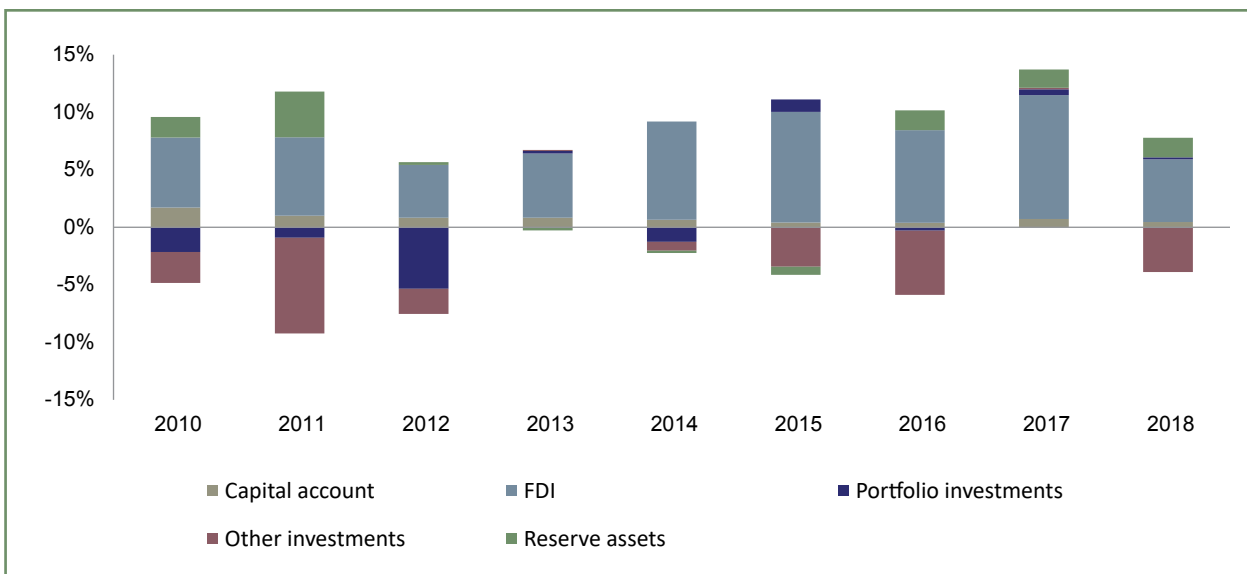


Source: National Bank of Georgia

In 2018, similar to previous years, the current account deficit was mainly financed by foreign direct investments (FDI), which reached 1.2 billion USD, representing a 35% drop from the previous year (see Diagram 1.15). The decline in FDI was mainly driven by the completion of the final phase of the

BP pipeline project in Georgia. The majority of investments were directed to the finance, transport and energy sectors. Compared to the previous year, foreign direct investments increased in the manufacturing and mining sectors.

**Diagram 1.15 Financing of the current account deficit (in % of GDP)**



Source: National Bank of Georgia



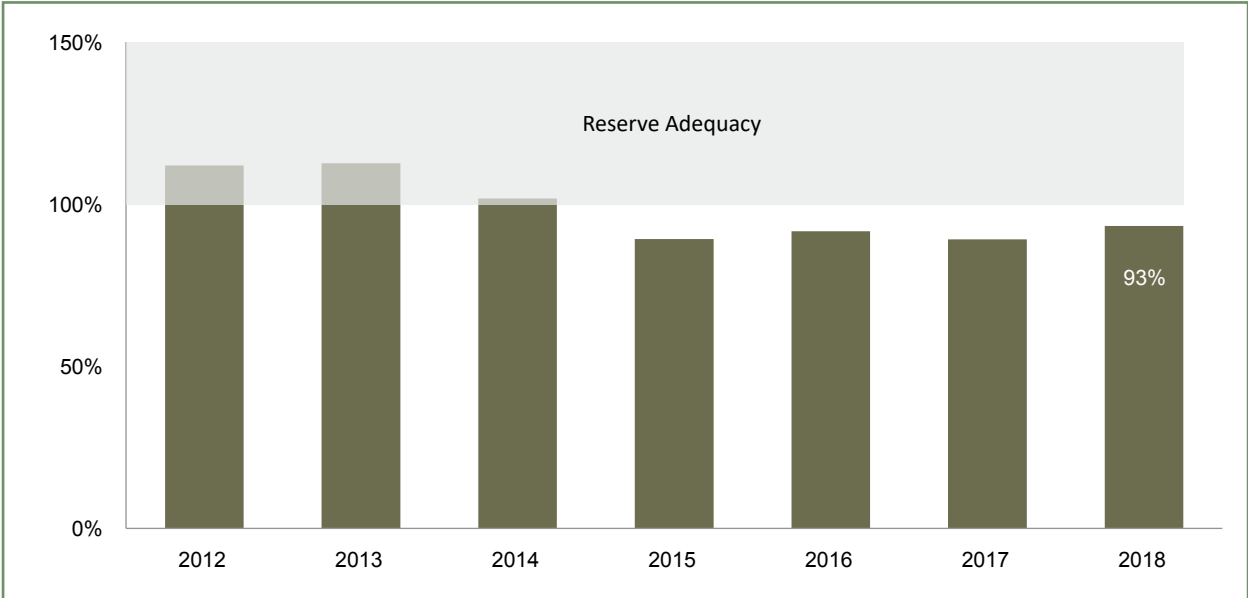
Unlike the previous year, other investments played an important role in financing the current account deficit. In terms of inflows, an essential part of the increase of liabilities came from the loans for government and the private (non-bank) sectors. The public sector received 260 million USD of concessional loans, including budget support loans of 100 million USD from the French Development Agency. In addition, in the framework of the extended fund facility, the National Bank of Georgia received 84 million USD from the IMF.

In 2018, international reserve assets increased by 250.6 million USD to amount to 3.29 billion USD. The increase of reserves was supported by the NBG’s interventions in the foreign exchange market, with net purchases from the NBG amounting to 197.5 million USD. It is worth mentioning that the increase in international reserve assets was also backed up by the changes in the foreign liabilities reserve requirements for commercial banks. The latter led to international reserves increasing by nearly 270 million USD. However, foreign cur-

rency changes directed to the government had a negative impact on reserve accumulation. The service of foreign liabilities by the government totaled 390 million USD and government currency expenses on services and goods amounted to 333 million USD.

According to the reserve adequacy assessment (based on the IMF’s ARA methodology<sup>11</sup>), by the end of 2018 the international reserves of Georgia were around 93%. According to this methodology, in order to reduce the negative impacts from external and liquidity shocks, it is advised that IMF member countries like Georgia have reserves that comprise 100-150% of the ARA metric. Over the next years, the National Bank of Georgia intends to introduce additional instruments for interventions. It is expected that in the nearest period, the international reserves of Georgia will be brought into the adequacy range. By the end of 2018, the ratio of total reserves to months of imports (forecasted imports of 2019) was around 3.5.

**Diagram 1.16 Assessment of international reserves adequacy according to IMF methodology (ARA metrics)**



Source: National Bank of Georgia

11. For more details on the IMF ARA methodology, see: <https://www.imf.org/external/np/spr/ara/>

**Table 1.1 Balance of payments (2014-2018) (million USD)<sup>12</sup>**

	2014	2015	2016	2017	2018
<b>Current Account</b>	<b>-1,784</b>	<b>-1,767</b>	<b>-1,890</b>	<b>-1,331</b>	<b>-1,249</b>
Goods	-4,286	-3,952	-3,883	-3,804	-4,112
Export	3,995	3,021	2,865	3,570	4,407
Import	8,281	6,973	6,747	7,374	8,518
Services	1,306	1,404	1,577	2,024	2,244
Credit	3,044	3,087	3,313	3,990	4,490
o/w: Revenues from Tourism	1,787	1,868	2,111	2,704	3,222
Debit	1,738	1,683	1,736	1,966	2,246
Primary income (Net)	-230	-338	-706	-825	-744
o/w: Investment Income	-893	-827	-1,263	-1,447	-1,441
o/w: Compensation of Employees	663	488	558	623	697
Secondary income (Net)	1,425	1,120	1,121	1,274	1,361
o/w: General Government	159	193	232	233	171
o/w: Financial corporations, nonfinancial corporations, households, and NPISHs	1,266	927	889	1,040	1,190
<b>Capital Account</b>	<b>106</b>	<b>58</b>	<b>56</b>	<b>108</b>	<b>76</b>
<b>Financial Account</b>	<b>-1,790</b>	<b>-1,766</b>	<b>-1,754</b>	<b>-1,288</b>	<b>-1,222</b>
Direct Investment (Net)	-1,411	-1,343	-1,159	-1,625	-892
o/w: Direct Investments in Georgia	1,818	1,659	1,571	1,830	1,184
Portfolio Investments (Net)	-209	154	-41	77	28
Financial derivatives (other than reserves) and employee stock options (Net)	-8	2	2	0	1
Other Investments (Net)	-128	-479	-803	17	-639
o/w: General Government	-221	-276	-276	-432	-351
o/w: Others	93	-202	-527	449	-288
Reserve Assets	-33	-99	245	242	279
<b>Net Errors and Omissions</b>	<b>-112</b>	<b>-58</b>	<b>80</b>	<b>-65</b>	<b>-49</b>
<b>Important Coefficients</b>					
Reserve Assets in Months of Imports of the Next Year (Months)	3.7	3.6	3.5	3.6	3.5
Export/Import (G&S)	-70%	-71%	-73%	-81%	-83%
CAB/GDP	-10.8%	-12.6%	-13.1%	-8.8%	-7.7%
FDI/GDP	11.0%	11.9%	10.9%	12.1%	7.3%
Revenues from Tourism/GDP	10.8%	13.4%	14.7%	17.9%	19.9%
Personal Transfers/GDP	10.8%	9.2%	8.9%	10.2%	10.8%

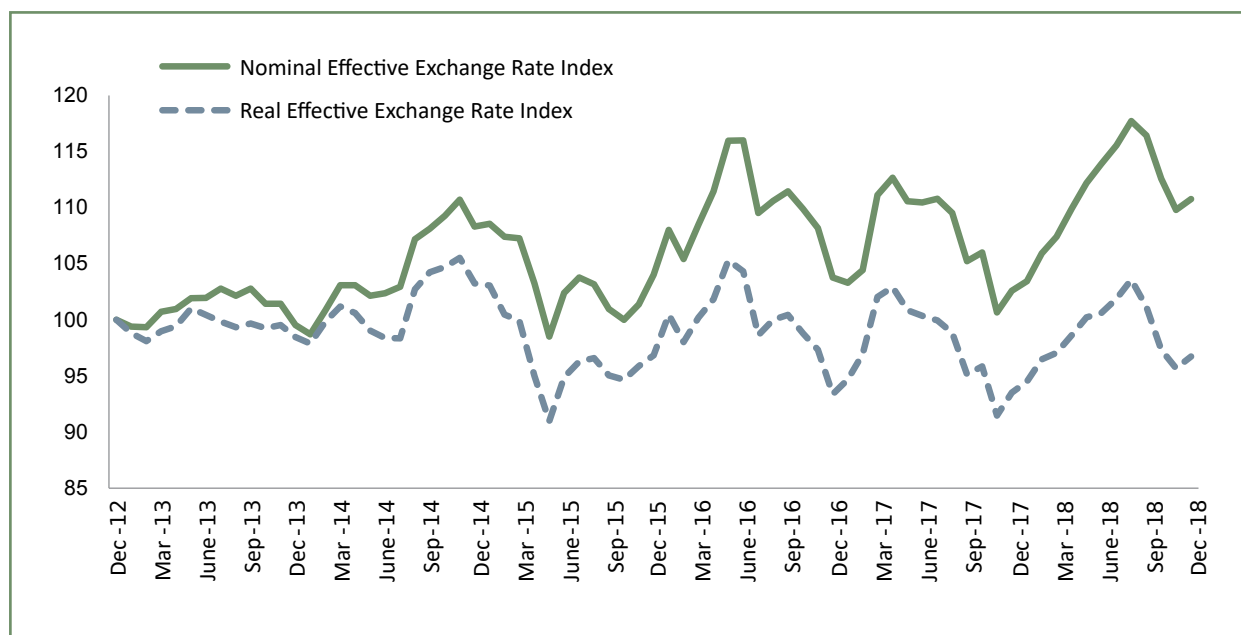
Source: National Bank of Georgia

The real effective exchange rate (REER) is a crucial indicator for assessing a country's external competitiveness (see Diagram 1.17). In 2018, the REER

appreciated by 3.4%, while the nominal effective exchange rate appreciated by 8.0%.

12. According to the IMF's Balance of Payments (sixth edition).

**Diagram 1.17 Indices of the Real Effective Exchange Rate and the Nominal Effective Exchange Rate (Dec. 2012=100)**



Source: National Bank of Georgia

**Table 1.2 Annual changes in effective exchange rates in 2018**

	Change in nominal effective exchange rate, %	Change in real effective exchange rate, %	Share in real effective exchange rate
<b>Effective Exchange Rate</b>	<b>8.0</b>	<b>3.4</b>	<b>3.4</b>
Eurozone	1.8	1.8	0.4
Turkey	35.1	14.0	2.7
Ukraine	-1.2	-8.7	-0.6
Armenia	-1.8	-2.1	-0.1
USA	-2.1	-2.5	-0.1
Russia	12.6	9.6	1.4
Azerbaijan	-2.2	-2.4	-0.2
Other	2.4	1.9	0.1

Source: National Bank of Georgia

Throughout 2018, the efforts to maintain and support stable macroeconomic and financial environments were reflected in improvements in the international credit ratings of Georgia. It was in 2011 when “Fitch Ratings” last changed its ratings for Georgia, but at the beginning of 2019 the agency raised the sovereign credit rating for Georgia from “BB-” to “BB”. This is the highest credit rating Georgia has received thus far. It is also worth noting that in 2017 another international rating

agency, “Moody’s”, raised its sovereign credit rating for Georgia to Ba2. These higher credit ratings further solidify the credibility of Georgia for international institutions and investors, and positively affect the business environment of Georgia.

The rise in Georgia’s rating was a result of the various achievements attained in recent periods. Despite the rise in external risks, economic growth in Georgia has remained strong. There was con-

tinued support from the floating exchange rate, which helped narrow the current account deficit during recent years. There was also a diversification of financing sources. Moreover, it is important that, despite the existing challenges, the National Bank of Georgia continued the accumulation of international reserves.

### 1.3 Economic Growth

In 2018, according to preliminary estimates, the Georgian economy grew by 4.7%. The largest share of that growth, 4.5 percentage points, came from services, 0.2 pp came from industry and 0.0 pp from agriculture.

Last year's economic growth was mostly determined by strong external demand. The increased number of foreign visitors had a particularly positive effect on real estate operations, hotels and restaurants, and transport. In real estate operations, where the participation of foreigners is high, growth surged to 12.1% and made a 0.7 pp contribution to overall growth. Transport also made a large 0.6 pp contribution, leaping by 9.4%. Foreigners' participation was also important for the output of hotels and restaurants, which grew by 9.7% and contributed 0.2 pp to total growth. That a substantial share of the growth came from travel agencies, tour operators and air transport all further underlines the significance of the en-

largement of the tourism industry for the Georgian economy.

Trade, which is the largest branch of the economy, grew by 5.9% in 2018. Trade grew rapidly in the first half of the year (growing by 5.9% in the first quarter and by 9.8% in the second), which was an indication of a certain revival of demand. However, that growth slowed in the second half of the year following a real reduction of retail trade, which was a sign of a slackening of internal demand.

Manufacturing increased by 3.2% following a rise in external demand. Manufacturing of alcoholic and non-alcoholic beverages, basic metals and fabricated metal products saw the largest increase, which was also reflected in the rise of exports of those products. Meanwhile, high growth of 13.5% continues in the financial sector.

From other branches of the economy, the output decrease in construction is noteworthy. During the last several years, activity in construction remained high and was one of the drivers of the economy. However, from the second half of 2018, construction began to decline and ultimately led to a 3.1% annual decrease in comparison with the previous year. Both infrastructural construction, which can be linked to a slowdown of projects financed by the government, and private sector construction has declined. Agriculture saw a slight increase (see Table 1.3).

**Table 1.3 Real GDP growth and sector breakdown**

	2016		2017		2018	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
Agriculture, hunting and forestry; fishing	0.3%	0.0%	-3.8%	-0.3%	0.7%	0.0%
Mining and quarrying	9.5%	0.1%	6.5%	0.1%	7.6%	0.1%
Manufacturing	4.3%	0.4%	5.1%	0.4%	3.2%	0.3%
Electricity, gas and water supply	4.9%	0.1%	4.2%	0.1%	0.1%	0.0%
Processing of products by households	4.0%	0.1%	-4.5%	-0.1%	2.8%	0.0%
Construction	10.0%	0.7%	13.5%	1.0%	-3.1%	-0.3%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	2.4%	0.4%	4.6%	0.7%	5.9%	0.9%
Hotels and restaurants	12.9%	0.3%	10.7%	0.3%	9.7%	0.2%
Transport	-3.0%	-0.2%	6.5%	0.4%	9.4%	0.6%
Communication	-3.1%	-0.1%	5.4%	0.1%	5.8%	0.1%
Financial intermediation	9.7%	0.3%	9.2%	0.3%	13.5%	0.5%
Real estate, renting and business activities	5.9%	0.3%	8.4%	0.5%	12.1%	0.7%
Imputed rent of own occupied dwellings	2.2%	0.1%	3.2%	0.1%	1.2%	0.0%
Public administration	1.7%	0.1%	3.4%	0.3%	0.9%	0.1%
Education	3.1%	0.1%	2.6%	0.1%	3.4%	0.1%
Health and social work	1.4%	0.1%	1.7%	0.1%	6.2%	0.3%
Other community, social and personal service activities	1.0%	0.0%	4.1%	0.1%	13.2%	0.4%
Private households employing domestic staff and undifferentiated production activities of households for own use	-1.0%	0.0%	-1.8%	0.0%	2.6%	0.0%
Financial Intermediation Services Indirectly Measured	9.1%	-0.1%	6.7%	-0.1%	12.2%	-0.2%
(+) Taxes on products	1.3%	0.2%	5.6%	0.8%	4.9%	0.7%
(-) Subsidies on products	3.4%	0.0%	4.8%	0.0%	7.9%	0.0%
<b>GDP at market prices</b>		<b>2.8%</b>		<b>4.8%</b>		<b>4.7%</b>

Source: GeoStat

## Demand

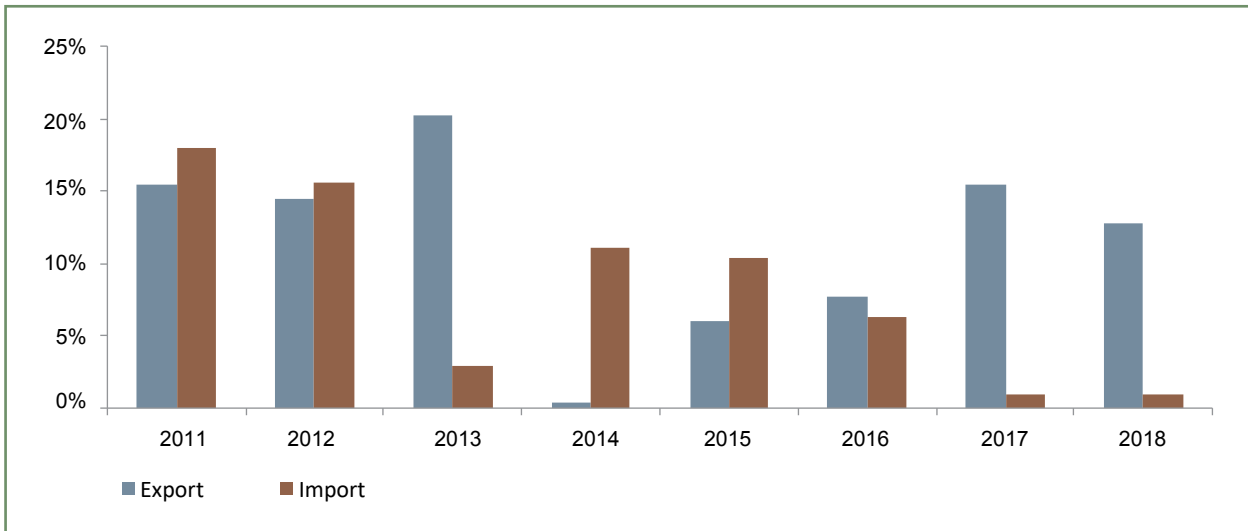
The main driver of economic growth in 2018 was net exports. From the total 4.7 percentage points

growth, 3.3 pp came from net exports and 1.4 pp from internal demand. The contribution of investments was close to zero.

In 2018, external demand was strong. According to the NBG's assessment, exports of goods significantly grew in both nominal and real terms (see Diagram 1.18). In the meantime, the growth

of imports stood behind that of exports. During the year, the number of foreign visitors grew significantly, causing a rise of tourism revenues that were reflected in the rise of exports of services.

**Diagram 1.18 Real growth of exports and imports of goods and services**

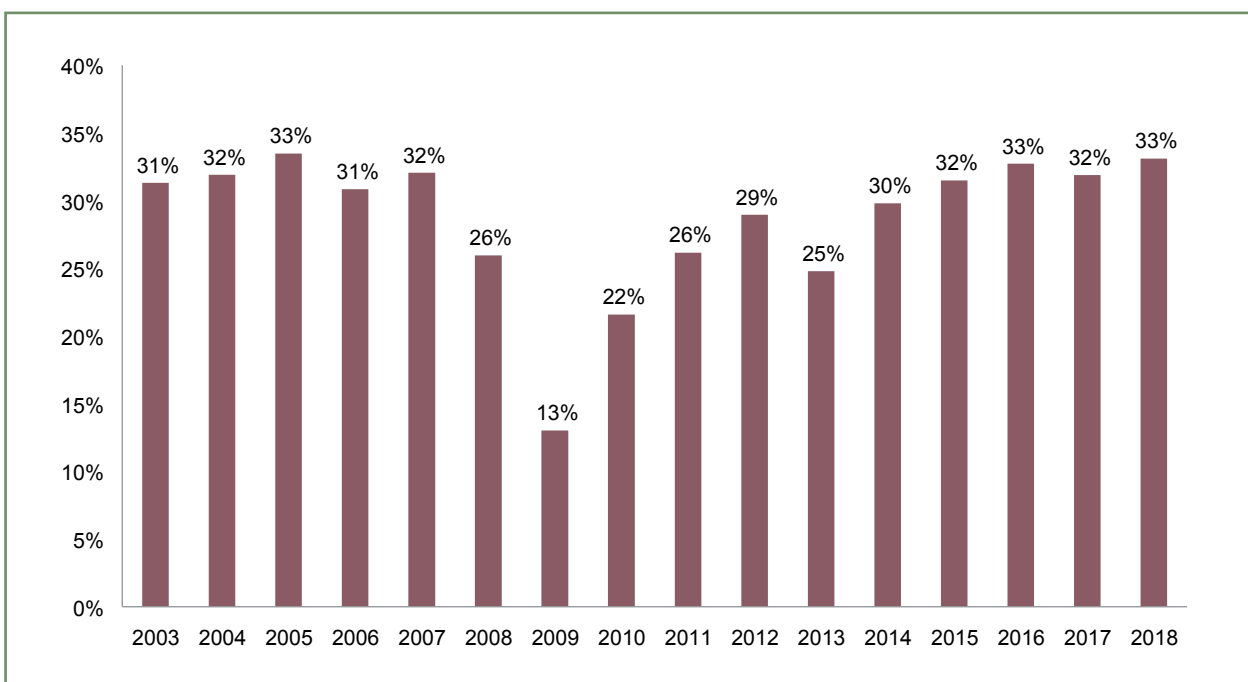


Source: GeoStat; NBG calculations

In 2018, the investments-to-GDP ratio stood at 33%. During recent years this figure has remained stable and can be considered an adequate level for Georgia's economic development. Maintaining this level by capital accumulation will support

long-term economic growth (see Diagram 1.19). The reduction of the output of construction can be one explanation for the humble contribution that investments made to last year's economic growth.

**Diagram 1.19 Investments to GDP**

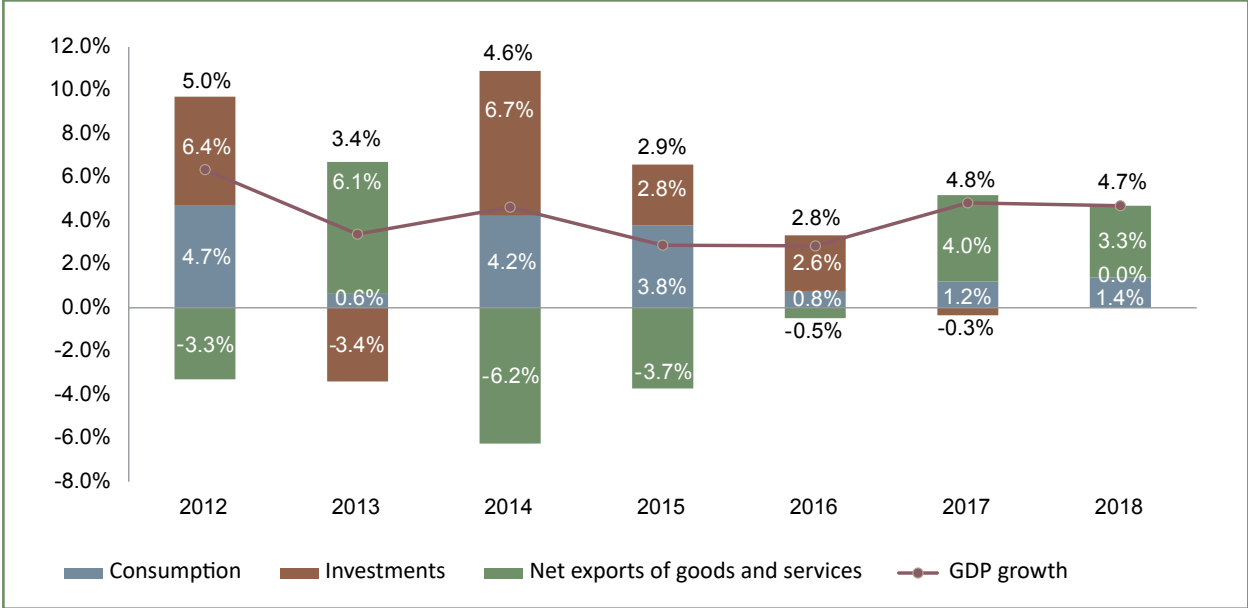


Source: GeoStat; NBG calculations

In the first half of 2018, there were some signs of a revival of both private and public consumption. However, consumption slowed in the second half of the year. The slowdown of private consumption was partly related to the slowing of retail lending, which is linked to the regulations on responsible

lending coming into force. It is important to stress that the reduction in private consumption was mostly related to imported goods, which thus promoted a rise in net exports. The public sector saw moderate annual growth in spite of a reduction in the third quarter.

**Diagram 1.20 GDP growth by categories of use**



Source: GeoStat; NBG calculations

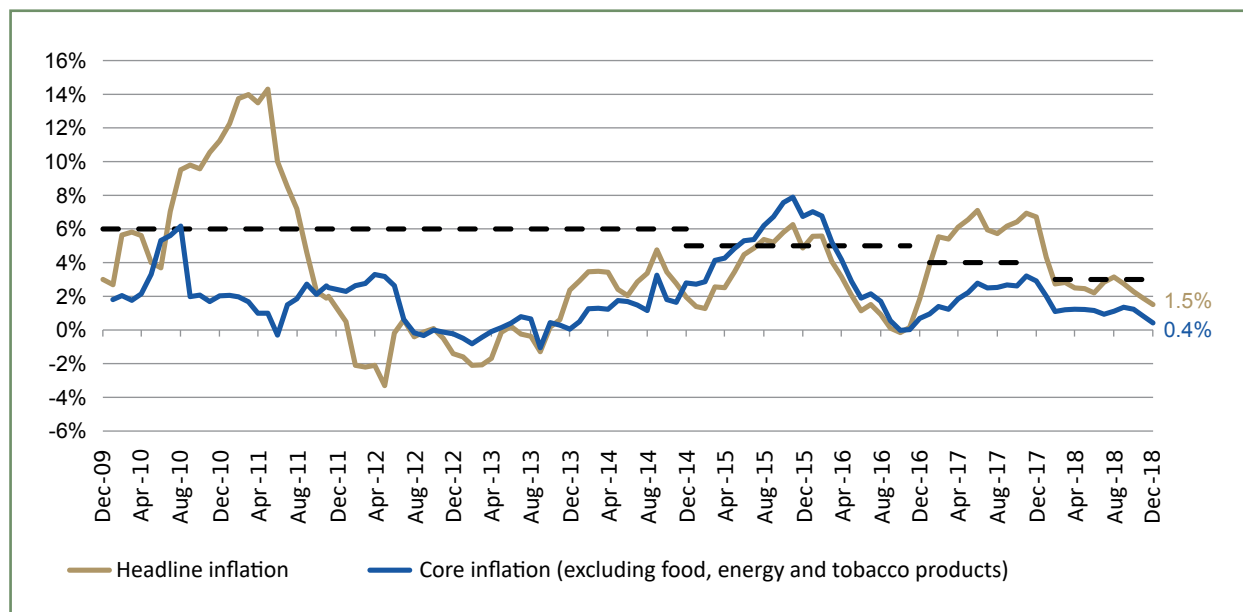
### 1.4 Inflation

Inflation significantly declined in the beginning of 2018. This was expected as the influence of the rise on excise taxes on tobacco and fuel were exhausted. During the course of the year, inflation stood slightly under the target level of 3%. This occurred in spite of the substantial increase in tobacco and fuel prices, and the growth of water and electricity fees from the beginning of the year. In December, there was also a hike in bread prices, but inflation nevertheless declined to its lowest

point of 1.5%. Throughout the year average inflation equaled 2.6%.

Meanwhile, core inflation, which excludes volatile food, energy and tobacco prices, stood much lower than headline inflation (as a result of the relatively high prices on fuel and tobacco), averaging 1.2% during the year (see Diagram 1.21). The analysis of core inflation is significant as it reflects the long-term trend. Lower core inflation signals a reduction of headline inflation in the future.

**Diagram 1.21 Headline and core inflation (excluding food, energy and tobacco products)**



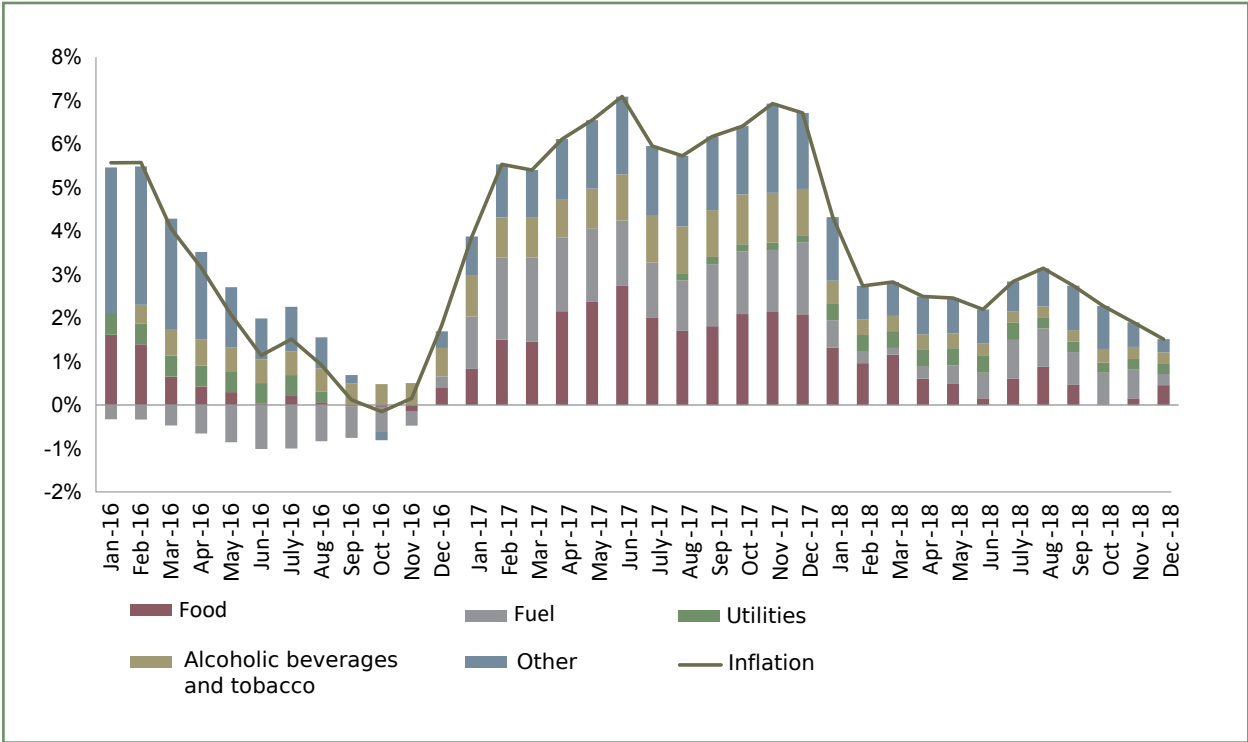
Source: GeoStat

As mentioned above, the influence of fuel and tobacco product prices on inflation was significant (see Diagram 1.22), with their average influence on inflation standing at 0.5 and 0.3 percentage points respectively throughout the year. The rise in fuel prices was linked to the increase in global oil prices during the first three quarters of 2018. However, by the end of the year, the oil price declined, leading to lower fuel prices, which made a reduced 0.3 pp contribution to inflation. Since January 2018, the increase of water and electricity fees had a 0.2 pp influence on inflation.

Food inflation was low. The relative increase of prices on meat products were balanced by low inflation on fruit, vegetables and products containing sugar. The bread price, which has the largest weight (3.6%) in the consumer basket, surged in December by 13.3% annually, which added 0.5 pp to inflation. In spite of this, the broad picture did not change. Average food inflation during the year equaled 2.3% and its contribution to overall inflation was 0.6 pp.



**Diagram 1.22 Contribution of fuel, food, alcohol drinks, tobacco and utilities to headline Inflation**



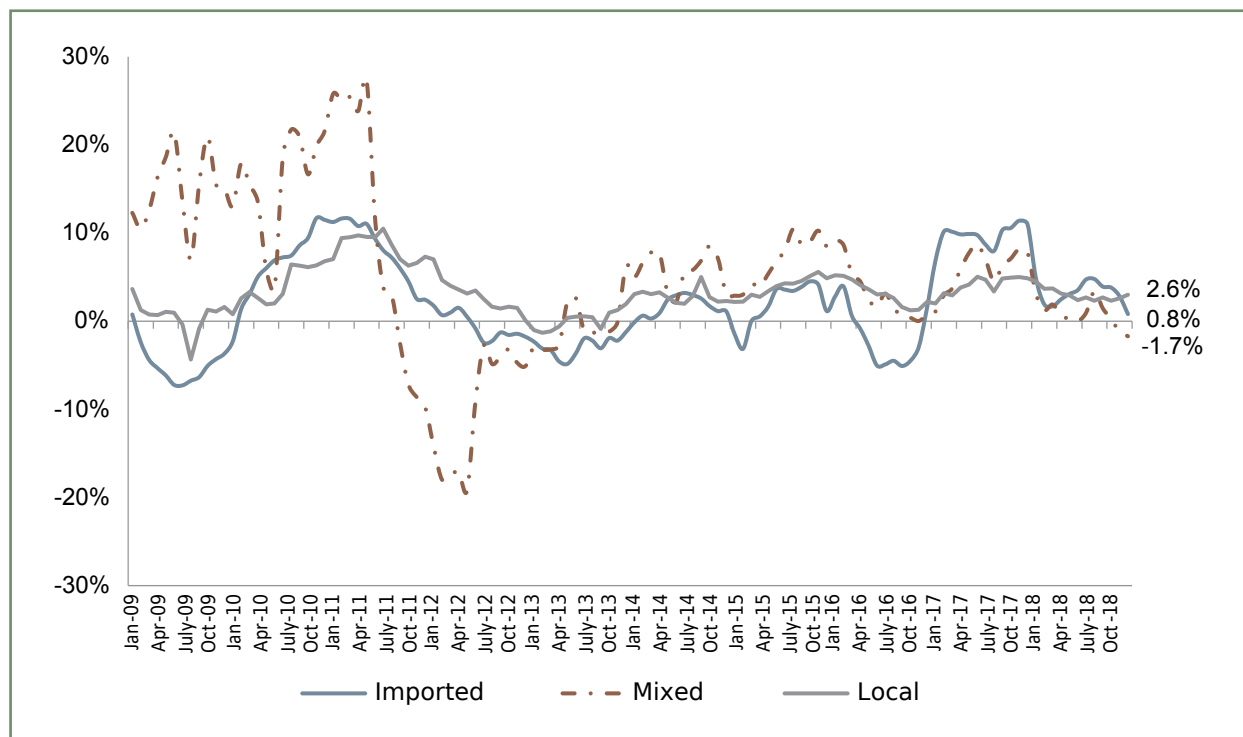
Source: GeoStat; NBG calculations

Throughout the year, inflation on imported and locally produced goods were nearly equal, at 3.2% and 3.0% respectively. Imported inflation is more volatile than local inflation. The share of fuel and tobacco products in imported goods were significant. The average contribution of imported inflation to overall inflation was 0.7 pp; however, if we deduct inflation on fuel and tobacco products, which totaled 0.8 pp, we receive a negative (-0.1 pp) contribution of imported inflation. The aver-

age inflation of mixed products, which are those partially produced from imported products, stood at 0.9% and their contribution to inflation was thus negligible (see Diagram 1.23).

One of the factors that explains the slight change of prices on imported products (excluding fuel and tobacco) is the appreciation of the nominal and real effective exchange rates during the year, which rose by 8.2% and 3.4% respectively.

**Diagram 1.23 Imported and domestic inflation<sup>13</sup>**



Source: GeoStat; NBG calculations

Besides the abovementioned product groups, the trend of decreasing prices on shoes and clothes, which has been evident in recent years, has continued. During 2010-2017, shoes and clothes saw average annual deflation of 3-4%. In 2018, this deflation accelerated to 6%, being influenced by the appreciation of the lari against the Turkish lira and the subsequent increase of imports from Turkey.

The trend of increasing healthcare prices continued to average 4.8%, with the price increase on medicines being more notable (8.5%) than those on medical services (3.2%). Meanwhile, the surge of prices in the transport group was related to the rise in fuel prices (see Table 1.4).

13. Imported and domestic inflation are calculated by the NBG based on the indices of different items in the consumer basket provided by GeoStat

**Table 1.4 Inflation indicators according to individual components (percentage), their share in the consumer basket (percentage) and contribution to CPI (percentage points)**

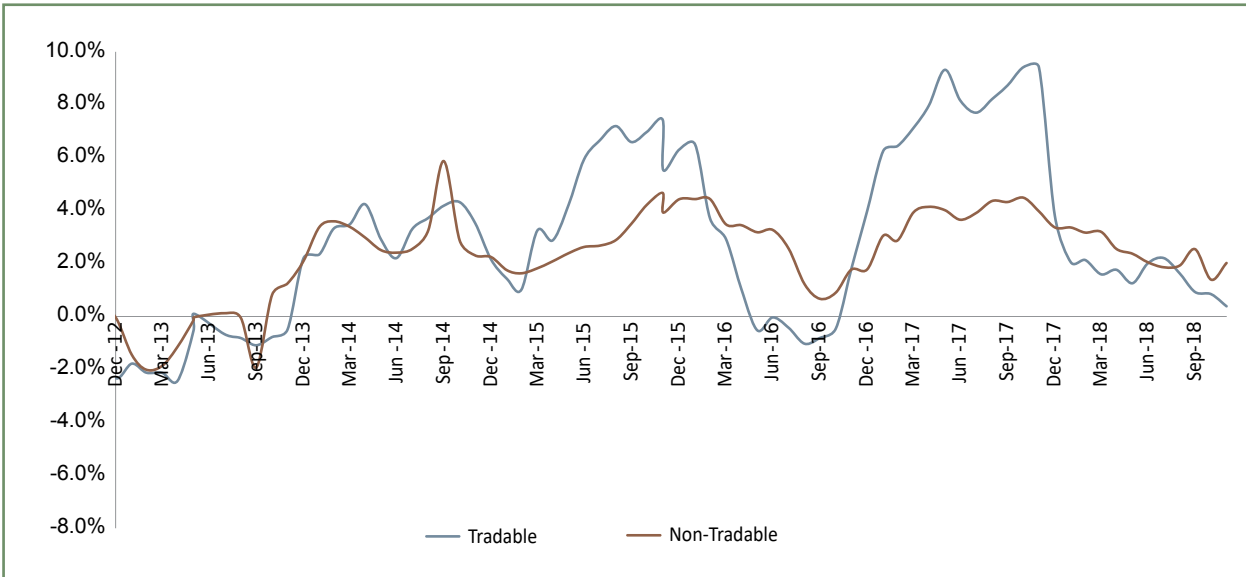
	December 2018 weights	Dec. '18/Dec. '17		Jan. '18 - Dec. '18/ Jan. '17 - Dec. '17	
		Inflation Contribution	Inflation Contribution	Inflation Contribution	Inflation Contribution
<b>Total</b>	100.0%	1.5%	1.5%	2.6%	2.6%
<b>Food and Non-Alcoholic Beverages</b>	30.3%	1.7%	0.5%	2.2%	0.7%
Food	26.9%	1.7%	0.5%	2.3%	0.6%
Bread and Bakery	5.6%	8.8%	0.5%	1.8%	0.1%
Meat and Meat Products	6.1%	4.5%	0.3%	4.0%	0.2%
Fish Products	0.5%	11.1%	0.1%	4.9%	0.0%
Milk, Cheese, and Eggs	5.2%	0.4%	0.0%	1.7%	0.1%
Oil and Fats	1.7%	1.0%	0.0%	3.6%	0.1%
Fruits, grapes	1.3%	-17.5%	-0.2%	2.8%	0.0%
Vegetables, Melons, Potatoes and other Tubers	3.1%	-3.2%	-0.1%	2.4%	0.1%
Sugar, Jams, Honey, Syrups, Chocolate, and Pastry	2.6%	-4.3%	-0.1%	-2.7%	-0.1%
Other Food Products	0.7%	2.7%	0.0%	3.8%	0.0%
Non-alcoholic beverages	3.4%	1.2%	0.0%	1.6%	0.1%
<b>Alcoholic Beverages, Tobacco</b>	6.7%	4.9%	0.3%	5.9%	0.4%
<b>Clothing and Footwear</b>	3.6%	-6.6%	-0.2%	-6.0%	-0.2%
<b>Housing, Water, Electricity, Gas and other Fuels</b>	8.5%	3.1%	0.3%	4.3%	0.4%
<b>Furnishings, household equipment and maintenance</b>	6.4%	0.5%	0.0%	1.4%	0.1%
<b>Healthcare</b>	8.6%	2.9%	0.2%	4.8%	0.4%
<b>Transport</b>	12.6%	1.7%	0.2%	4.6%	0.6%
<b>Communication</b>	3.9%	-2.6%	-0.1%	-1.6%	-0.1%
<b>Recreation and Culture</b>	5.8%	1.1%	0.1%	1.5%	0.1%
<b>Education</b>	4.6%	1.9%	0.1%	1.6%	0.1%
<b>Hotels, Cafes and Restaurants</b>	4.0%	1.8%	0.1%	3.6%	0.1%
<b>Miscellaneous Goods and Services</b>	5.1%	0.6%	0.0%	1.0%	0.1%

Source: GeoStat

The price trend in tradable and non-tradable goods is important for observing the impact of the demand on inflation (see Diagram 1.24). A

slight increase in the prices of non-tradable goods reflects weak pressure on inflation coming from the demand side.

**Diagram 1.24 Inflation of tradable and non-tradable goods**

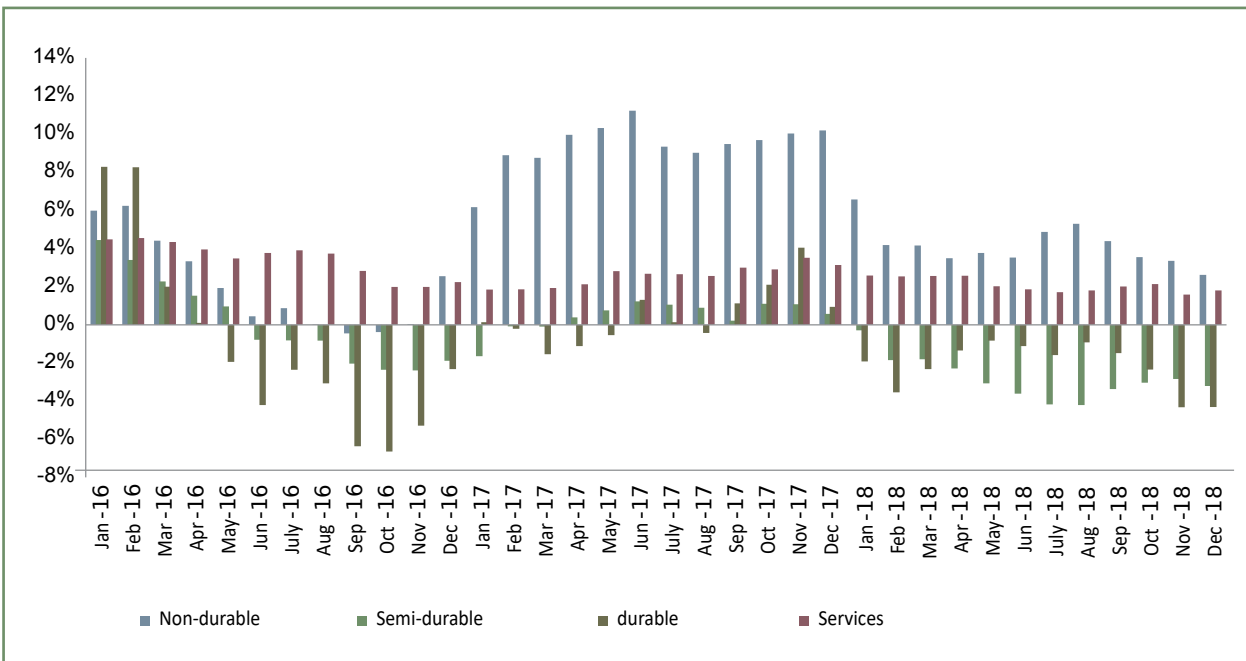


Source: GeoStat; NBG calculations

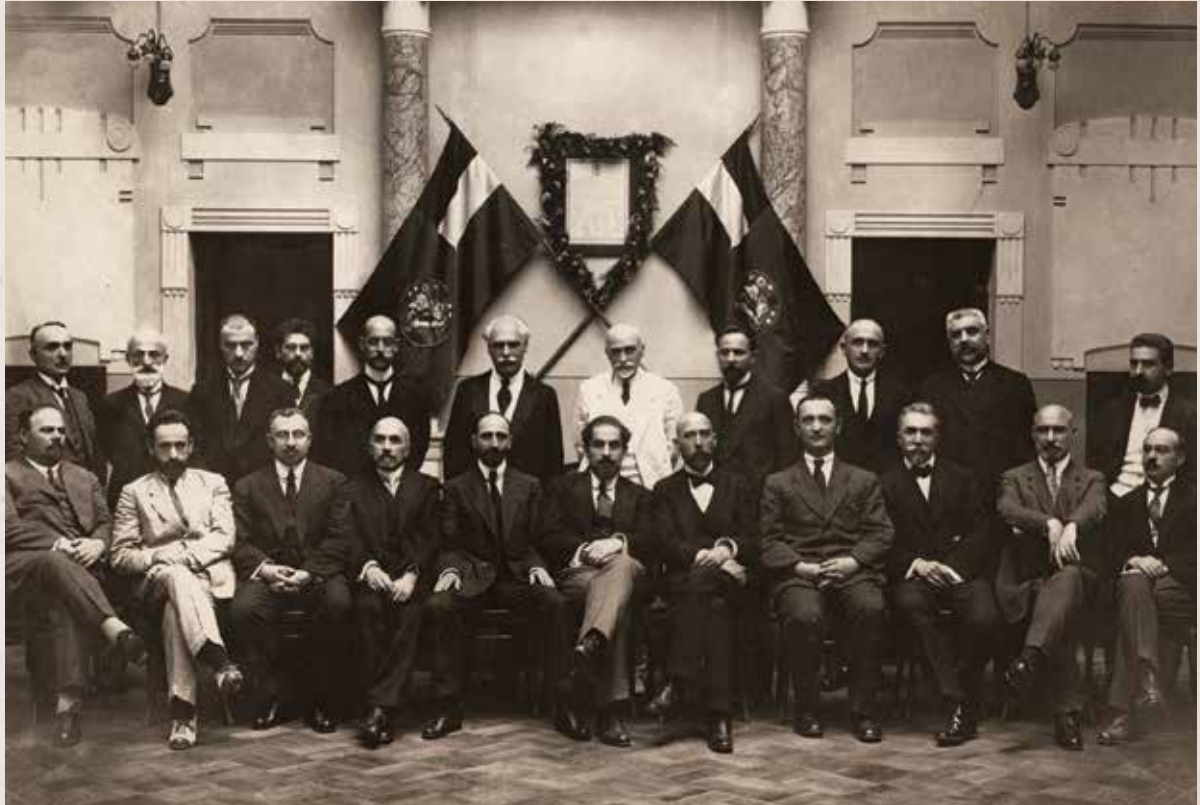
Throughout 2018, consumer prices for non-durable goods saw the largest increase of 4.2%. The main reason for this rise was the price increase on fuel and tobacco products. Prices for semi-durable and durable goods both decreased. Inflation of

services averaged 2.1%, which is also a measurement of the pressure on inflation from the demand side. In this case, the low inflation in services indicates weak pressure on inflation from the demand side.

**Diagram 0.25 Change of annual inflation for services and goods of different durability**



Source: GeoStat



*Opening Ceremony of State Bank of Georgia (July 24th, 1920)*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## MONETARY AND FOREIGN EXCHANGE POLICY

## 2.1 Monetary policy

According to the Organic Law on the National Bank of Georgia, the primary purpose of the National Bank is to ensure price stability.<sup>14</sup> Price stability implies a level of inflation over the medium term that is optimal for high and sustainable economic growth in the long term.

The monetary policy of the NBG follows an inflation-targeting framework. This regime, which is seen as the most efficient contemporary approach to maintaining price stability, relies on the announcement of an inflation target that is used to guide policy for maintaining inflation at the target level in the medium term.

The main instrument of the monetary policy of the National Bank of Georgia is the monetary policy rate, which changes according to inflation forecasts. If an inflation forecast exceeds the target rate, the NBG will tighten monetary policy; whereas if the inflation forecast is lower than the target level, the NBG will resort to loosening monetary policy. The inflation-targeting framework guarantees price stability and, compared to other policy frameworks, results in relatively lower long-term interest rates. In line with the development of monetary policy instruments and monetary policy transmission mechanisms, the social costs of achieving price stability will decline. The NBG is thus continuously working on increasing the efficiency of monetary policy instruments and monetary policy transmission mechanisms.

Monetary policy is guided by the Decree of the Parliament of Georgia on the “Main Directions of Monetary and Exchange Rate Policy”.<sup>15</sup> Given

Georgia’s current stage of economic development, the inflation target for 2017 was set at 4% and declined to 3% for the period 2018-2020. It should be noted that developing countries tend to have higher inflation compared to advanced countries, resulting from the faster growth of productivity (Balassa, 1964; Samuelson, 1964).<sup>16</sup>

In Georgia, as in other small open economies, exogenous shocks (independent from monetary policy) are always looming. Exogenous factors can cause actual inflation to deviate from the target level. Monetary policy is a tool to impact aggregate demand and is thus the central bank’s response to demand shocks. The central banks do not usually react to supply side exogenous shocks, since doing so would lead to high economic costs and increase unemployment in the long run. Moreover, Bernanke & Blinder (1992) and Bernanke & Gertler (1995) demonstrated that monetary policy is transmitted to the real economy with a certain time lag.<sup>17</sup> Hence, in the short run, actual inflation can temporarily deviate from the target level. However, if a deviation is so significant that it affects inflation expectations and the inflation forecast, the NBG will adjust its policy response accordingly.

As previously discussed, in 2017 inflation remained above the target level as a result of one-off factors (the rise excise tax on oil and tobacco). These negatively affected inflation expectations, albeit only temporarily. Hence, although output was below the potential level, in order to curb inflation expectations the NBG retained a moderately tight monetary policy stance. At the same time, the NBG was actively communicating the message that inflation would only temporarily overshoot the target and would, with the exhaus-

14. Article 1 of the Organic Law on the National Bank of Georgia.

15. Decree of the Parliament of Georgia, “On the Main Directions of the Monetary Policy of Georgia, 2018-2020”, para. 1.

16. See: Balassa, B. (1964), “The Purchasing Power Parity Doctrine: A Reappraisal”, *Journal of Political Economy*, 72, 584-96; and Samuelson, P. (1964), “Theoretical Notes on Trade Problems”, *Review of Economics and Statistics*, 23, 1-60.

17. See: Bernanke, B. S. & Blinder, B. A. (1992) “The Federal Funds Rate and the Channels of Monetary Transmission”, *American Economic Review*; Vol. 82 (4), 901-21; and Bernanke, B. S. & Gertler, M. (1995) “Inside the Black Box: The Credit Channel of Monetary Policy Transmission”, *Journal of Economic Perspectives*, Vol. 9 (4) (Autumn, 1995), 27-48.

tion of one-off factors from early 2018, gradually return to the target. This projection proved accurate and from early 2018 inflation returned to the target level and mainly remained below the 3% target over the rest of the year.

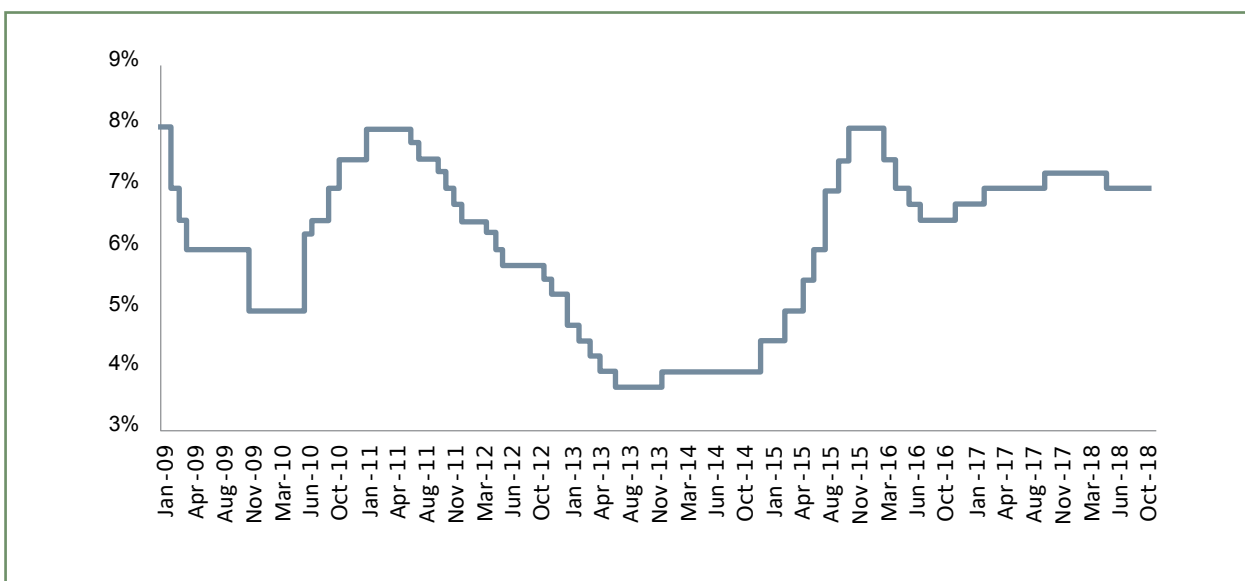
Over 2018, as in previous periods, domestic demand still lagged behind the potential level, exerting downwards pressure on inflation. However, in the first half of the year, the growth of economic activity accelerated. At the same time, from early 2018, due to the volatility on international financial markets together with the developing macroeconomic environment in Turkey, the risk of higher imported inflation increased significantly. Moreover, the depreciation of the nominal exchange rate also put upwards pressure on inflation. Thus, despite the a need for a gradual easing of monetary policy in the medium term, considering these risks, the NBG maintained a relatively tight monetary policy stance at the beginning of the year, keeping the monetary policy rate at 7.25%.

In the second half of the year, the higher-than-expected appreciation of the nominal exchange

rate reduced inflationary pressure. Moreover, the upward risks to inflation forecast also weakened. In June, the Monetary Policy Committee therefore deemed it appropriate to start a gradual exit from the moderately tight monetary policy and to cut the policy rate by 0.25 basis points to 7%. According the NBG’s press release, there will be a need for a further easing of monetary policy to the neutral rate, but the speed of that policy normalization will depend on how fast the output gap closes and how strongly increased regional macroeconomic risks are transmitted to the Georgian economy.

In the second half of the year, economic growth slowed down, thereby weakening the demand-side pressure on inflation. Moreover, external sector trends exerted a negative impact on Georgia’s economic outlook, leading to increased negative expectations and exchange rate fluctuations. As a result, the upwards risks to the inflation forecast increased and the Monetary Policy Committee deemed it appropriate to keep the monetary policy unchanged for the rest of the year (see Diagram 2.1).

**Diagram 2.1 Monetary policy rate**



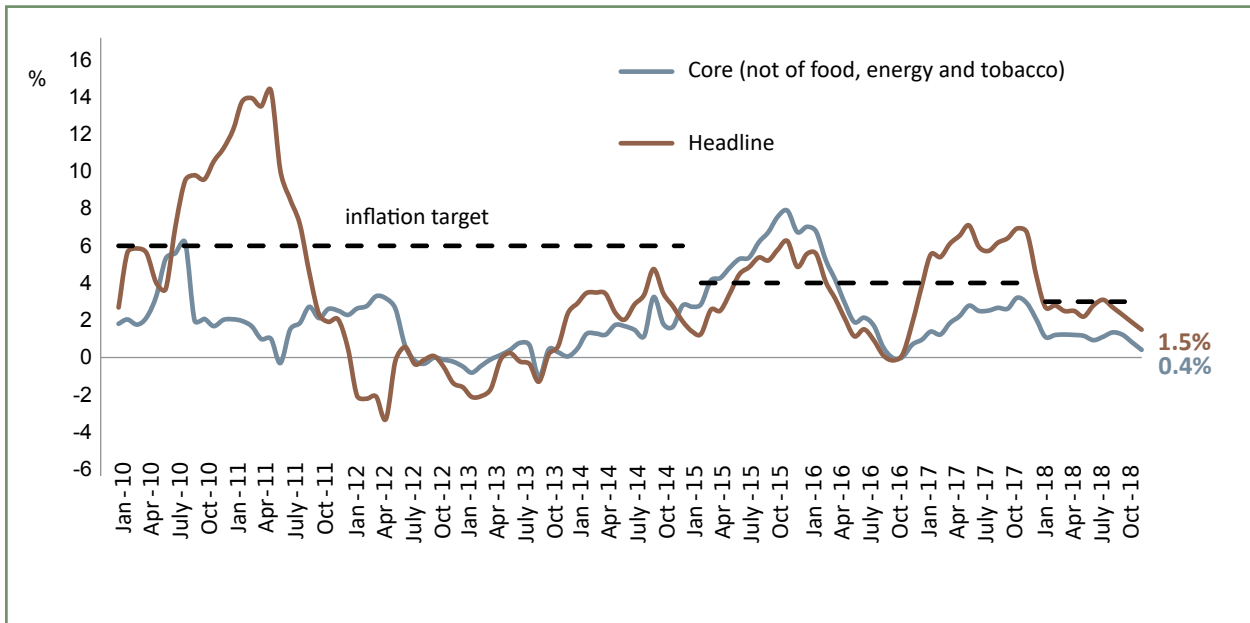
Source: National Bank of Georgia



Considering the above-mentioned factors, and despite the risks, inflation remained close to the target level over 2018. In December 2018, inflation equaled 1.5%, while over the year as a whole

annual inflation averaged 2.6%. It is important to note that if the effect of food, energy and tobacco prices are excluded, inflation totaled 1.2%.

**Diagram 2.2 Annual inflation and inflation excluding the effect of food, energy and tobacco prices**

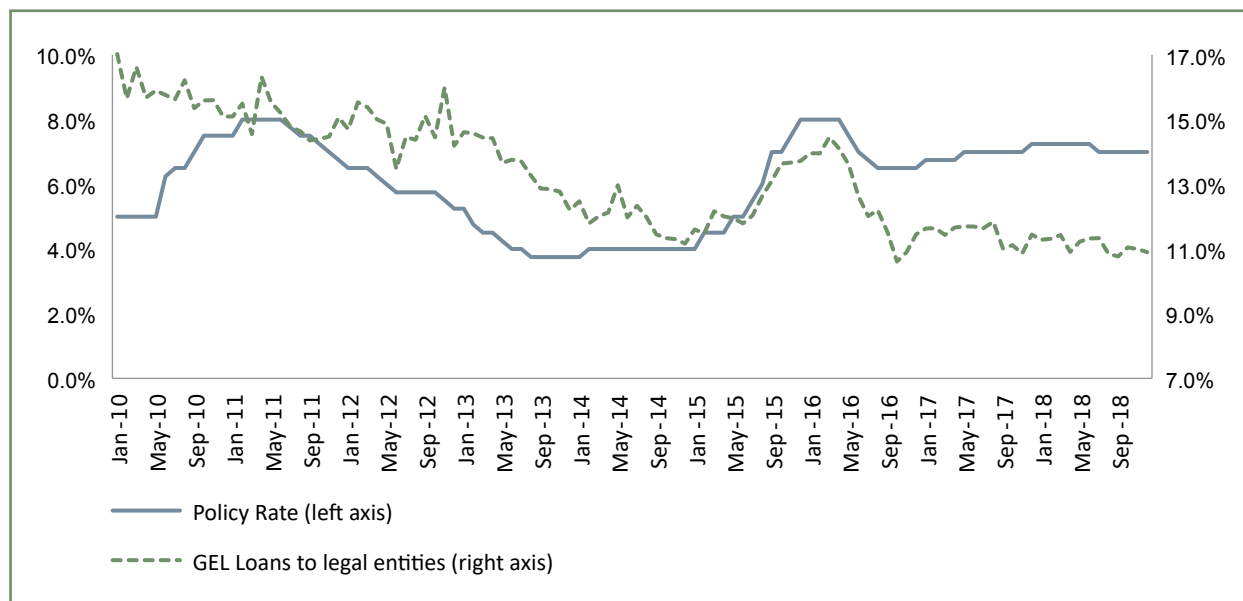


Source: National Bank of Georgia; GeoStat

In the first half of 2018, considering the improved economic activity and higher-than-expected economic growth, the NBG revised its economic growth forecast from 4.8% to 5.5%. However, in the event, economic growth for 2018 was lower than expected at 4.7%. The lower level of growth was a consequence of the lower-than-planned fiscal stimulus and reduced external demand. In the first half of the year, high external demand supported the growth of tourism revenues and exports of both goods and services. Moreover, money transfers and foreign investments also increased, which supported the growth of domestic demand. At the same time, the growth rate of consumption and imports was modest. These dynam-

ics were reflected in the improvement of current account in 2018, which declined by 1.1 percentage point and stood at 7.7% of GDP. However, despite high levels of economic activity, domestic demand was still lagging behind its potential level – as a result, demand-side pressure on inflation was weak. Meanwhile, interest on loans for both households and legal entities revealed a decreasing trend following the start of the NBG’s monetary easing process (see Diagram 2.3). In particular, interest rates for households declined on both mortgages and consumer loans. By the end of 2018, interest rates on mortgages fell by 1.5 percentage points annually. At the same time, interest rates on loans for legal entities declined by 0.4 percentage points.

**Diagram 2.3 Monetary policy rate and interest rates on loans**



Source: National Bank of Georgia

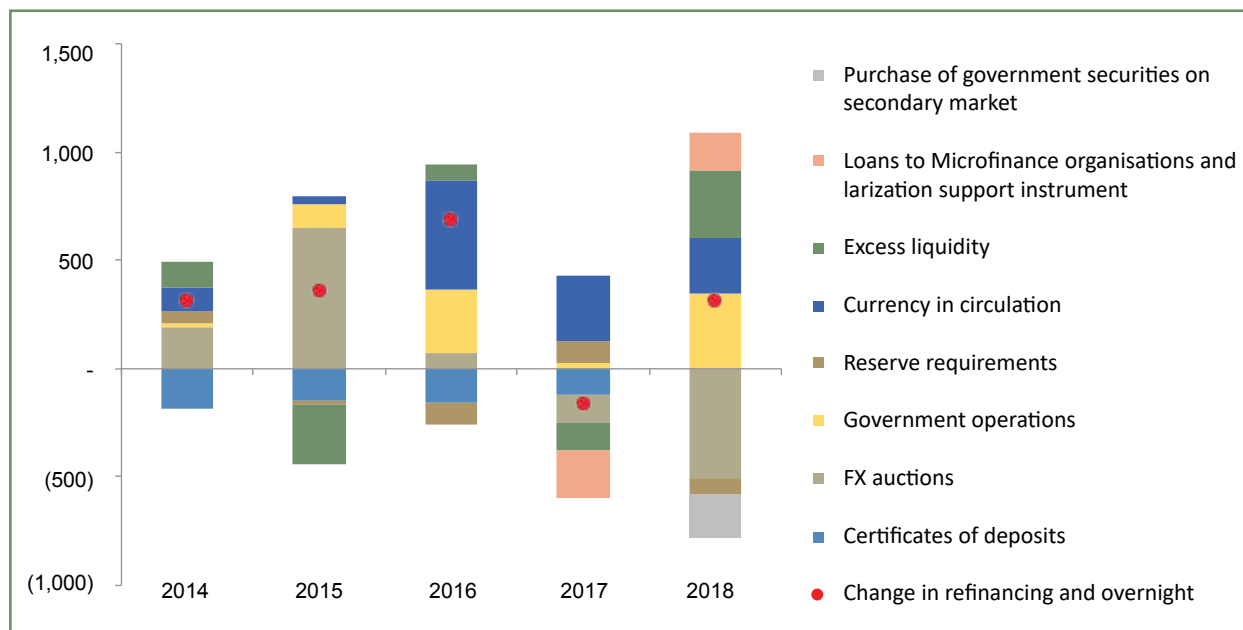
As discussed above, under the inflation-targeting regime, price stability is guaranteed using the NBG’s main policy tool – the short-term interest rate. The management of the short-term interest rate relies on the NBG’s liquidity management framework. This framework includes both liquidity provision and liquidity absorption instruments, the latter include open market operations (refinancing loans and certificates of deposit), minimal reserve requirements and standing facilities. The availability of GEL resources and efficient liquidity management are preconditions for the increase in lari lending and the promotion of larization.

Over the last few years, with the market operating under a liquidity deficit, the need for liquidity absorption lessened. However, the NBG continues to issue certificates of deposit with maturities of three months, supporting the short-term yield curve. Through these operations, the NBG maintained the balance of certificates of deposit at a minimum level. Over 2018, commercial banks relied on refinancing loans for liquidity management. It is important to note that over the year government operations had an uneven impact on the liquidity of the banking system. For the first three quarters, budget revenues exceeded

expenses, reducing banking sector liquidity and increasing the demand for refinancing loans. However, at the end of year, with a significant increase in government expenses, the liquidity of the banking sector grew, thereby reducing demand for refinancing. Commercial banks used refinancing loans to balance the uneven spending of the government over the course of the year, which otherwise would have led to volatility in interest rates and reduced economic activity. It is important to note that the aim of refinancing operations is balancing liquidity supply when there is an uneven liquidity provision from other sources.

Over the year, the refinancing volume was affected by a combination of several factors (see Diagram 2.4). In particular, the demand for cash increased, increasing the demand for liquidity in banks. At the same time, government operations reduced the liquidity on the market. Over the year, the decline in refinancing followed the FX purchases of the NBG and the purchase of government securities on the secondary market by the National Bank of Georgia. Moreover, the Government of Georgia started to place free balances on commercial bank accounts, which also helped lead to the decline in demand for refinancing on the market.

**Diagram 2.4 Factors affecting the change in refinancing**

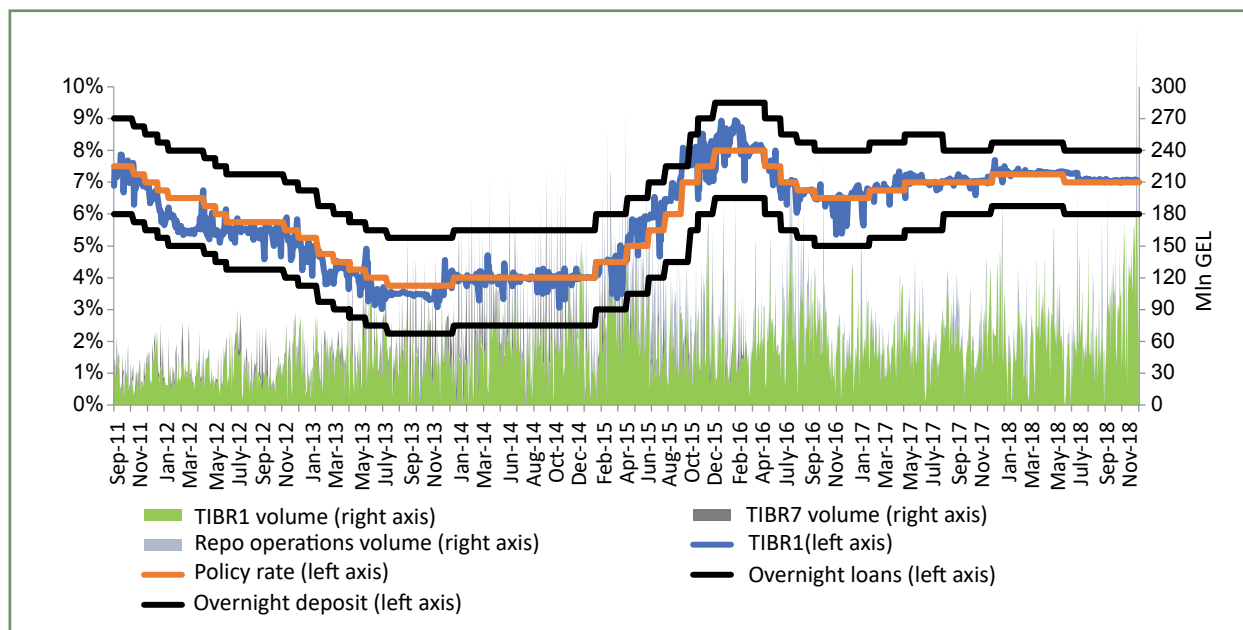


Source: National Bank of Georgia

As noted above, the NBG uses both liquidity provision and absorption instruments for efficient liquidity management. For the efficiency of monetary policy, it is essential that changes in short-term interest rates are transmitted to short- and long-term money market rates so that they can ultimately affect the economy as a whole. The National Bank of Georgia provides short-demand liquidity to the banking sector through refinancing and open market operations depending on need. Hence, interest rates on the interbank money market move around the monetary policy rate. As a result of the efficient liquidity management resulting from the use of these instruments, the volatility of interest rates on the market is low (see Diagram 2.5).

As discussed above, the banking system currently operates under a liquidity deficit and commercial banks obtain additional liquidity through refinancing loans. It is noteworthy that the volume of one-week refinancing loans recently exceeded the amount required to balance short-term liquidity fluctuations. This indicated a need for longer-term liquidity in the banking system. In response, in 2018, the National Bank started providing liquidity to the banking system through purchasing government securities on the secondary market. The purchase of government securities is common practice among central banks. Central banks in developed countries effectively manage liquidity and thereby control interest rates through open market operations on both primary and secondary markets. Open market operations on the secondary market are generally conducted using government securities since they are characterized by high liquidity and lower risk.

**Diagram 2.5 Interbank money market**



Source: National Bank of Georgia

In 2018, the International Monetary Fund (IMF) concluded its second and third reviews of the NBG under the extended fund facility program and positively evaluated the NBG’s ability to fulfill all criteria envisaged by the program: inflation remained within the established limits and the NBG accumulated net international reserves at a faster pace than set out in the program. However, the IMF once again emphasized that in order to increase resistance towards foreign shocks, it is necessary for the NBG to continue its efforts to accumulate international reserves.

### Measures supporting larization

One of the main policy priorities for the National Bank of Georgia is the support for larization, as this would decrease macro-financial risks and reduce external vulnerabilities. Hence, the NBG has implemented a range of reforms supporting the larization process and made significant steps in this direction over 2018. In particular, to further support lending in the national currency and increase the attractiveness of GEL resources, in June 2018 the reserve requirements for lari fell from 7% to 5%, while the reserve requirements

for foreign currency resources were increased from 20% to 25%. It is worth noting that the reserve requirement for foreign currency resources with a maturity from one to two years equals 10%, while attracted foreign currency funds with a remaining maturity of more than two years are free from reserve requirements. The Monetary Policy Committee also made the decision to reduce the interest accrued on required reserves, thereby increasing the attractiveness of GEL deposits. In particular, the amount on correspondent accounts, the amount on deposit accounts and the required reserves denominated in USD are remunerated at a rate equal to the U.S. Federal Reserve System’s policy rate minus 2 percentage points (but not less than 0%), instead of the earlier U.S. Federal Reserve System’s policy rate minus 0.5 pp. Meanwhile interest rates on euro reserves are 2 pp lower (but not less than -0.6%) compared to the deposit facility of the European Central Bank, instead of the earlier 0.2 pp lower than the deposit facility on ECB deposits. By changing reserve requirements, the National Bank of Georgia is able to influence commercial banks’ credit activities and interest rates. For instance, increasing the re-

serve requirements imposes extra costs on local banks when borrowing foreign currency resources and, as a result, those banks have to increase interest rates on the credits denominated in a foreign currency, thereby affecting lending in foreign currency. Moreover, reserve requirement act as a buffer and are used for prudential purposes. For example, in the case of capital flight, these resources guarantee the availability of foreign currency resources, reducing the risk of a crisis.

In addition, through the macroprudential instruments introduced in 2018, the National Bank ensures the formation of adequate foreign currency buffers for unhedged borrowers. Amendments made to the assets classification rules for commercial banks defined the minimum coefficients for loan services (PTI) and loan assurance (LTV). In the event of exceeding the established norms, a commercial bank will require additional capital, and, under the responsible lending framework coming into force in 2019, lending to physical persons without assessing the ability of their clients to repay the debt is prohibited. It is also important to note that the coefficient for foreign currency loans are stricter and these macro-prudential measures thus promote larizaiton.

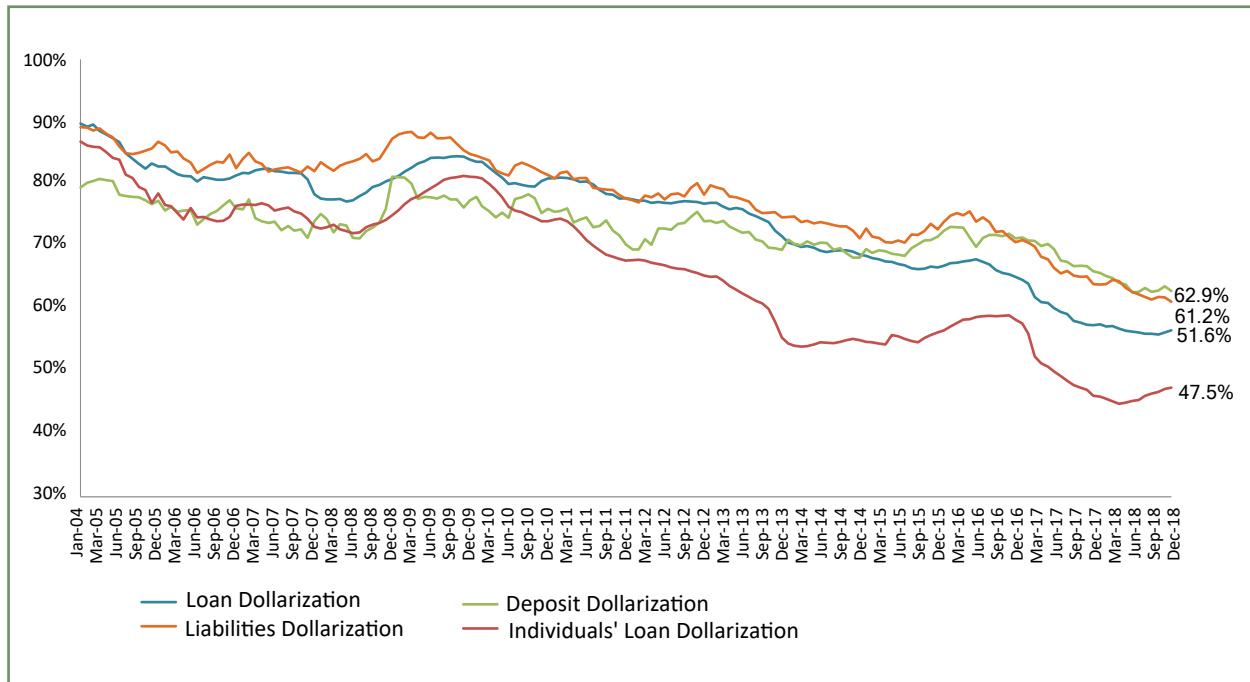
Moreover, since 2017 lending to individuals up to a value of 100,000 GEL has only been possible in GEL. In 2018, the decision was made to increase

that limit to 200,000 GEL and to extend this restriction to legal entities. The ban on issuing loans valued up to 200,000 GEL in foreign currency entered into force on 23 January 2019.

As a result of these initiatives, the de-dollarization trend that started in 2017 persisted in the first half of 2018, affecting loans to both individuals and legal entities. However, in the second half of the year, the larization of total loans slowed, while the larization trend for physical persons actually reversed. These developments were related to the surplus foreign currency resources in the banking sector, which allowed the banks to offer the market low-interest loans in foreign currency. In addition, the imminent enforcement of regulations regarding the minimum limit for loans in foreign currency and the introduction of macroprudential instruments gave banks additional motivation for issuing foreign currency loans at that time.

The increased lending in foreign currency in the second half of the year indicates that the market does not adequately assess currency risk. Over 2018, the dollarization of loans (excluding the exchange rate effect) decreased by 0.8 pp to equal 56.8%, while the dollarization of deposits fell by 3.2 pp to 63.1%. At the same time, the dollarization level for loans to physical persons increased from 46.3% at the end of 2017 to 47.7% by the end of 2018.

**Diagram 2.6 Dollarization level in the banking sector (excluding the exchange rate effect)**

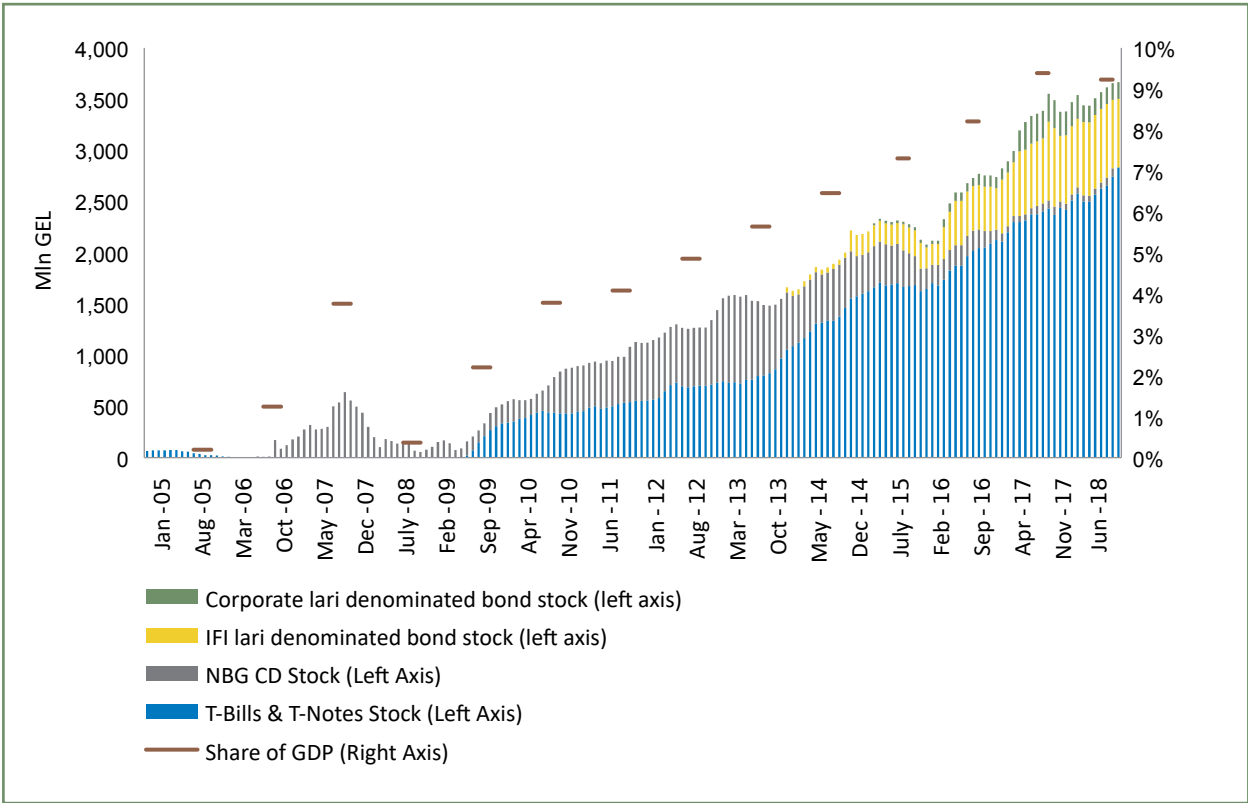


Source: National Bank of Georgia

The promotion of the capital market remains one of the key priorities for the NBG. The development of the capital market will increase long-term lari resources and, at the same time, will facilitate dollarization. In 2016, the National Bank of Georgia and the Government of Georgia developed a joint strategy for the development of the capital market, part of which was enacted in 2018. In 2018, corporate securities denominated in lari first appeared on the market, which is a signal of the gradual activation of the market. Moreover, according to changes made in 2016, corporate securities can be used as collateral in monetary operations with the National Bank and this has created an additional incentive for holding securities for liquidity management.

As noted above, in 2018 the National Bank started purchasing state securities on the secondary money market. Considering the current level of activity on the secondary market in Georgia, the NBG's involvement will contribute to its development, which is also important for the efficiency of monetary policy. Increased activity on the secondary market, where previously issued bonds and stocks are traded, also makes these financial instruments more attractive in the light of increased liquidity. Furthermore, with increased liquidity and an active secondary market, liquidity management is becoming more efficient in the business sector. This will subsequently be reflected in a reduction of interest rates and lower risk premiums on the market.

**Diagram 2.7 Dynamics of Treasury securities, certificates of deposit and securities of international financial institutions**



Source: National Bank of Georgia

## 2.2 Monetary Policy Instruments

The implementation of Monetary Policy Committee (MPC) decisions (be they tightening, easing, or keeping monetary policy unchanged) is done through monetary operations. The objective of monetary operations is to keep interbank interest rates stable and close to the policy rate determined by the Monetary Policy Committee. The NBG operational framework consists of the following monetary instruments: refinancing loans, the one-month open market instrument, open market operations with government securities, overnight loans, overnight deposits, certificates of deposit, and minimum reserve requirements.

The interbank deposit/loan market is the money market where banks trade short-term excess liquidity. The NBG has a vital interest in the market as it plays an important role in the efficiency of

the monetary transmission mechanism. The NBG influences interest rates by declaring monetary policy decisions and by using monetary policy instruments. To monitor the interbank money market, up until 1 August 2018, the NBG calculated and published, on a daily basis, the previous day's interest rate statistics in the form of TIBR-1 and TIBR-7.

Starting from August 2018, a reformed TIBR index was established by the NBG as a risk-free overnight rate benchmark. The methodology was introduced with the assistance of European Bank for Reconstruction and Development (EBRD) in close partnership with market participants. The reform of the TIBR follows the global trend observed in recent years whereby domestic interest rate benchmarks have undergone fundamental reviews and reforms to improve their robustness, transparency and governance, whilst having an increased focus on the wider use of reformed overnight interest rate benchmarks.

The TIBR index is based on actual deals, which is something that will eventually increase its credibility. An additional benefit of the index is the fact that the relevant information gathering and calculation will be done by the NBG. The methodology for its calculation will regularly be reviewed to ensure its continued adequacy.

Starting from 1 August 2018, the National Bank of Georgia started publishing the money market TIBR index on its website.

The volume of transactions carried out in the national currency in 2018 rose modestly compared to 2017 and equaled 18.8 billion GEL. The NBG monetary policy rate decreased gradually in 2018 from 7.25% to 7.00%, and, as a result, interbank rates also decreased. The fluctuations of interbank rates were relatively mild and did not deviate significantly from the NBG's rate. In order to keep the weighted average interest rate close to the policy rate at auction, the NBG determined weekly volumes for the refinancing facility and the one-month open market instrument.

### 2.2.1 Refinancing loans

To ensure short-term liquidity in the banking system, the National Bank of Georgia used the refinancing loan instrument on a weekly basis throughout 2018. This instrument was first introduced in 2008. Refinancing loans represent a reliable and low-risk source of short-term liquidity that has positively affected the development of the money market and overall financial stability. The refinancing loan instrument is designed to manage short-term interbank interest rates. As the National Bank of Georgia is the sole provider of short-term liquidity in GEL on the market, the NBG has the capacity to achieve its desired interest rate on the interbank market with the help of the refinancing loan instrument. The interest rate for refinancing loans on auctions is based on the NBG's monetary policy rate.

In 2018, the collateral base of monetary operations encompassed the certificates of deposits of

the National Bank of Georgia, Georgian government securities, loan assets of commercial banks, GEL-denominated securities issued by international financial intuitions, and GEL-denominated securities issued by resident and non-resident legal entities. In order to qualify for certain operations, the NBG has defined the relevant criteria for each type of collateral. Commercial banks actively used all types of collateral in their operations with the National Bank of Georgia in 2018.

### 2.2.2 One-month open market instrument

Following the recommendations of the IMF's technical assistance mission to Georgia, in December 2016 the National Bank of Georgia introduced a new monetary policy instrument: the one-month open market instrument. Using this policy instrument, the National Bank of Georgia supplies short-term liquidity to the country's banking system every month via auctions. Similar to other open market operations, the goal of the one-month open market instrument is to manage short-term interest rates on the interbank money market, which is in line with international best practice. On a monthly basis, the liquidity forecast group estimates the short-term liquidity deficit in the banking system. Based on those forecasts, the NBG announces an auction for a specific amount of one-month open market instruments. The minimum interest rate at auction is equal to the policy rate and only local commercial banks are permitted to participate in the auctions. NBG certificates of deposit, government securities, local currency denominated bonds issued by international financial institutions, local currency denominated securities issued by resident and non-resident legal entities, commercial banks' own loan assets in the national currency, can all be used as collateral.

### 2.2.3 Overnight loans and deposits

Similar to previous years, in 2018 the NBG continued to use standing facilities like overnight deposits and overnight loans in monetary policy operations. In 2018, in accordance with best practice, the NBG used an interest rate corridor to maintain



interbank interest rates within stable boundaries. At the beginning of 2018, the interest rate corridor was equal to the monetary policy rate plus or minus 1.0 percentage point. The upper interest rate was used for overnight loans and the lower rate for overnight deposits in the NBG. The use of an interest rate corridor reduces sharp interest rate fluctuations on the interbank market and promotes a convergence of interbank interest rates with the monetary policy rate.

Overnight loans from the National Bank represent the fastest source of obtaining liquidity for the banking sector, albeit being offered at a higher price in comparison with the market rate. The collateral base accepted for overnight loans is the same as that for refinancing loans.

The overnight deposit instrument, which has been in place since April 2010, continued to be used in 2018. By using overnight deposits, commercial banks have an opportunity to transfer excess GEL from correspondent accounts for overnight deposit with the NBG at the end of each day. The amount deposited will be returned to the correspondent account at the beginning of the next working day.

## 2.2.4 Securities

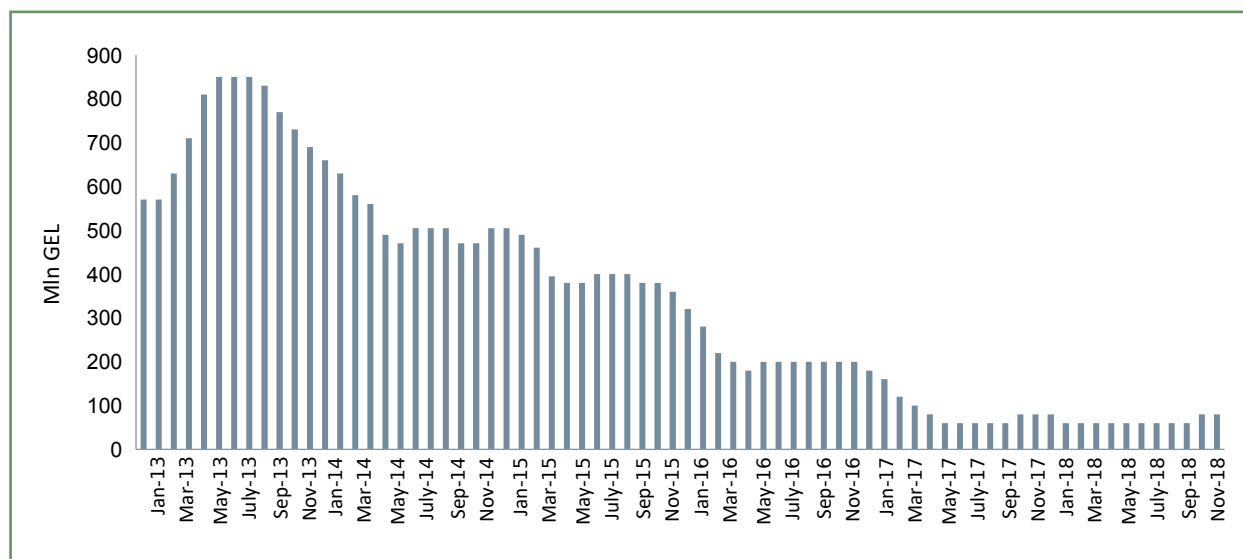
### Certificates of deposit

In 2018, the NBG continued to issue its own securities in the form of certificates of deposit (CD). Together with Treasury bills and bonds issued by the Ministry of Finance, certificates of deposit enjoyed a high level of demand from commercial banks. CDs are on the short side of the term structure, trading for 3-month maturities, while government securities trade for 6-month and 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 an increase in market efficiency and a decrease of expectations regarding long-term interest rates.

In 2018, the NBG only issued 3-month CDs, which the banking sector used as the most attractive and effective short-term liquidity management instrument.

Over the course of the year, commercial banks purchased CDs in all 13 auctions conducted by the NBG. The nominal amount of allotment was equal to 260 million GEL, and 260 million GEL was redeemed in 2018. The stock of the NBG's CD equaled 80 million GEL at the end of the year. As of 31 December 2018, seven commercial banks held CDs worth 80 million GEL.

**Diagram 2.8 Portfolio of certificates of deposit (2013-2018)**



Source: National Bank of Georgia

### Government bonds

As of 31 December 2018, the NBG held government bonds with a par value of 152 million GEL. These were not used for open market operations during the year.

### Treasury bills and bonds

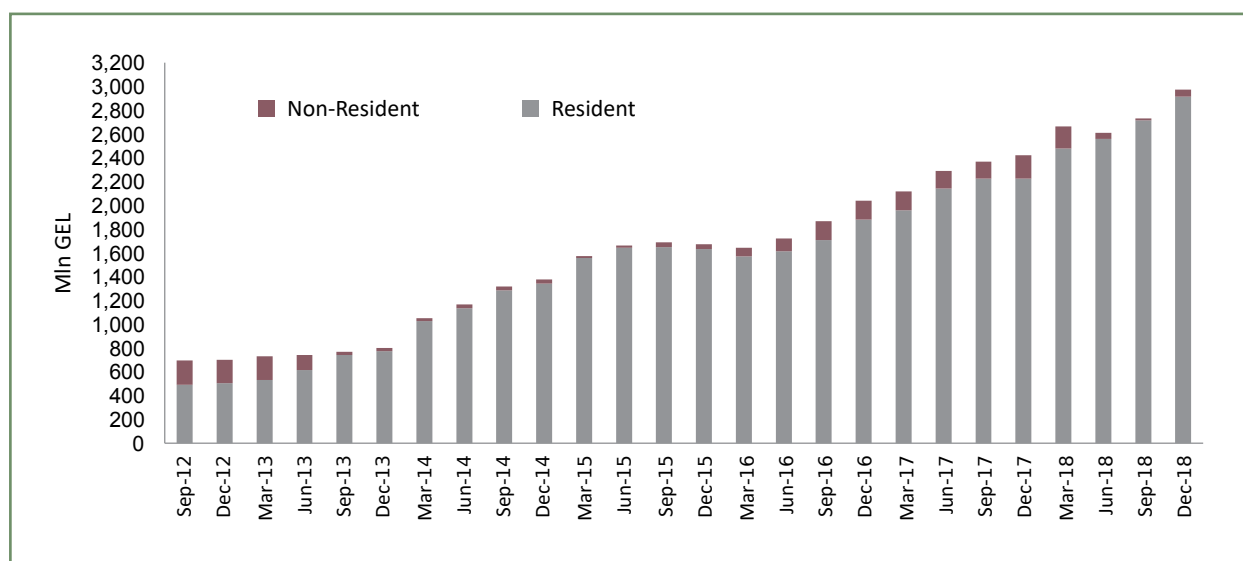
To further develop the GEL money market, it was vital that the Ministry of Finance of Georgia increased the issuance of government securities. In 2017, the Ministry of Finance issued 6-month and 1-year discount securities and 2-, 5-, and 10-year coupon bonds. These securities are denominated in the national currency in non-materialized form. The nominal value of a security is 1,000 GEL. The placement of Treasury bills and bonds is executed through a multiple price auction conducted by the NBG via the Bloomberg trading platform. All commercial banks licensed by the NBG have the right to participate in an auction 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 2018, 52 auctions of Treasury bills and notes were conducted, and 1.7 billion GEL worth of securities were issued and fully allotted in those auctions. As of 31 December 2018, there were 12 commercial banks and non-banking investors that held 2.99 billion GEL of securities in circulation. Non-banking investors held Treasury securities worth 82.9 million GEL.

It is worth noting that the value of Treasury securities in circulation remains small relative to the size of the economy (7% of GDP). To increase market liquidity, the government has issued 2-, 5- and 10-year benchmark bonds (each denominated at 240 million GEL). This action reduced FX risks associated with external financing in foreign currency.

**Diagram 2.9 Treasury securities by holder**



Source: National Bank of Georgia

The existence of a liquid secondary market for securities plays an important role in the efficiency of the monetary policy transmission mechanism. To increase operations on the secondary market, the NBG continued to support the effective functioning of the Georgian Securities Settlement System (GSSS). Starting from 2014, the development of the interbank repo market was actively intensified. The market is based on the internationally adopted repo master agreement and was created on the initiative of the NBG with the consent of commercial banks. Commercial banks use the Bloomberg trading system and the GSSS to conduct repo deals. Using these systems, in 2018 a total of 120 repo transactions were conducted between commercial banks involving government securities with a total nominal value of 1.5 billion GEL.

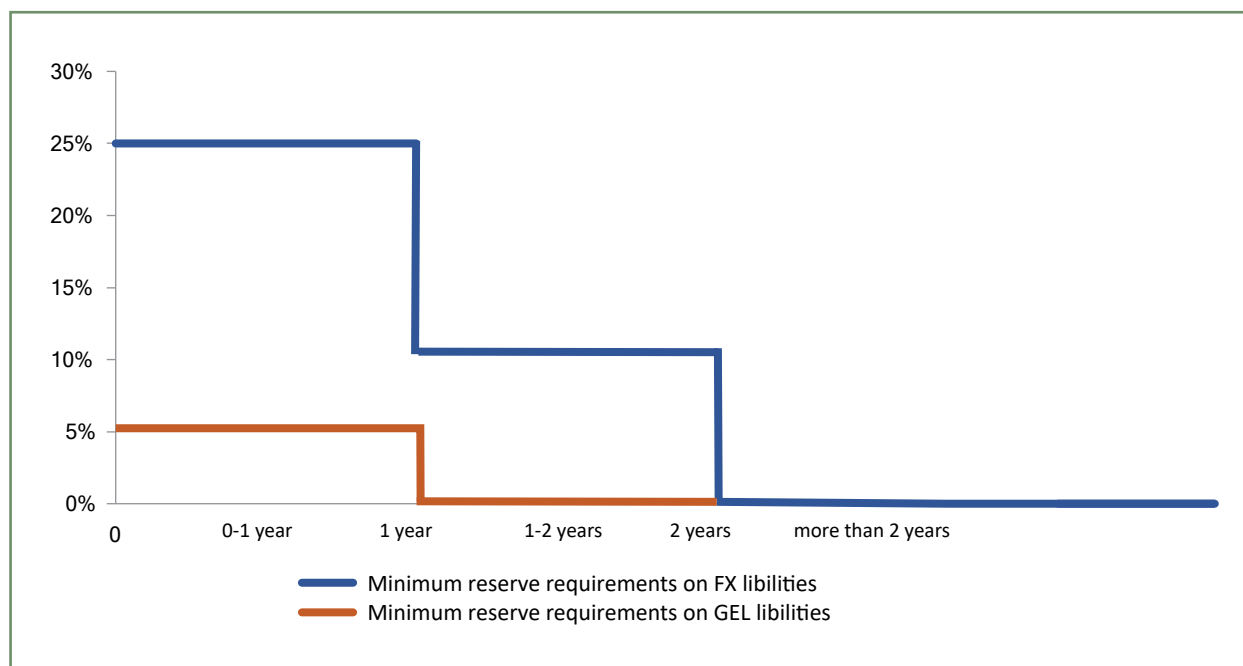
The current practice and market infrastructure on the securities market provide a good basis for intensifying activities on the secondary market for securities. This will induce an increase of liquidity on the secondary market.

### 2.2.5 Minimum reserve requirements

Through use of the minimum reserve requirements instrument, the NBG has the opportunity to influence the money multiplier and create pre-conditions for the efficient use of other monetary instruments. To increase the trend of larization, from the second half of 2018 the NBG decreased the minimum reserve requirement rate for funds denominated in the national currency from 7% to 5%, while for foreign currency denominated funds the rate rose from 20% to 25%. Moreover, the reserve requirement for funds in the national currency with a residual maturity of more than one year equals 0%, and for FX funds with a residual maturity of between one and two years the requirement is 10%. In 2018, commercial banks could earn interest equal to the NBG’s monetary policy rate on minimum reserve balances placed in GEL correspondent accounts.

The required reserves denominated in USD are remunerated at a rate equal to the upper bound of the U.S. Federal Reserve System’s policy rate minus 200 basis points. Interest rates on euro reserves are equal to the European Central Bank’s deposit rate minus 200 basis points, but not less than 0.6%.

**Diagram 2.10 Minimum reserve requirements**



Source: National Bank of Georgia

### Development of the Securities Settlement System in Georgia

In December 2018, Georgia launched a centralized system for securities settlement – the Georgian Securities Settlement System (GSSS). The new system offers a comprehensive set of the highest quality services to both domestic and international participants. By use of the system, securities transactions with Georgian securities have become faster, cheaper, more convenient and highly secure.

The NBG has been operating an automated securities settlement system for government securities since 2010. On 3 December 2018, the system received a major upgrade that allows for operations with both government and corporate securities and equities. In the new system, all Georgian securities can be settled in a centralized manner.

Work on the new system started in 2016 as a large-scale joint project of the NBG and the Georgian Central Securities Depository (GCSD), a private depository owned by the Tbilisi Stock Exchange, that sought important reforms to reshape the Georgian capital market landscape. This initiative proved to

be a prominent example of a successful partnership between the public and private sector.

The new system allows for riskless, fast and safe settlements of securities transactions. It offers automated solutions for nearly all operations, including issue of securities, secondary market transactions, pledges and repos, corporate actions and redemptions. The automation of the process requires less time and manual intervention, thus reducing costs, which are duly reflected in lower service fees.

The new system is operated by the NBG and is hosted on its IT infrastructure. The NBG ensures its uninterrupted operation and security. Cash leg settlement is done in another system operated by NBG – the Real Time Gross Settlement (RTGS) system. This allows, under an integrated model, delivery versus payment (DvP) settlement for all securities transactions in central bank money, using commercial banks' RTGS accounts at the NBG. The GSSS includes a range of innovative features, including efficient tools for liquidity management, partial settlements, net settlement using optimization algorithms, auto-collateralization and intra-day loan mechanisms.

The new system will be used by brokerage companies, alongside commercial banks. For the former, it opens up a whole new range of opportunities. The GSSS will be interfaced with trading platforms, both exchange and OTC (Bloomberg). This ensures full straight-through processing (STP) automation for the entire lifecycle of the trade. With same day settlements, the time from trade until settlement completion will take only a few minutes.

With the launch of the new system, existing rules and procedures will undergo significant changes. Securities held by investors will be kept in a more secure environment than before. Selling, pledging or reopening securities, in cases of a need for liquidity, will become even simpler and more convenient. This should increase the attractiveness of Georgian financial markets for domestic and foreign investors alike.

## 2.3 Exchange Rate Policy and International Reserves Management

As in previous years, the monetary policy of Georgia was based on a floating exchange rate regime. Consequently, the national currency rate is determined by market conjuncture. A floating exchange rate mechanism is recognized as the optimal currency regime for countries with small open economies, like Georgia, as it absorbs foreign shocks and promotes the sustainable development of the economy. The advantage of such an approach was

confirmed during the period of foreign shocks experienced in 2014-2015, when the exchange rate mitigated the effect of foreign shocks and helped maintain the competitiveness of Georgia.<sup>18</sup>

Under this policy, the National Bank aims to maintain its international reserves at an adequate level, such that currency interventions would neither result in excess fluctuations on the market nor re-route the existing trajectory of the exchange rate. Aside for the filling of reserves, as a rule, under the floating exchange rate regime the National Bank only intervenes on the interbank currency market in cases where there is a temporary inflow of excess capital that would result in sharp short-term fluctuations of the currency or to balance the state's external transactions.

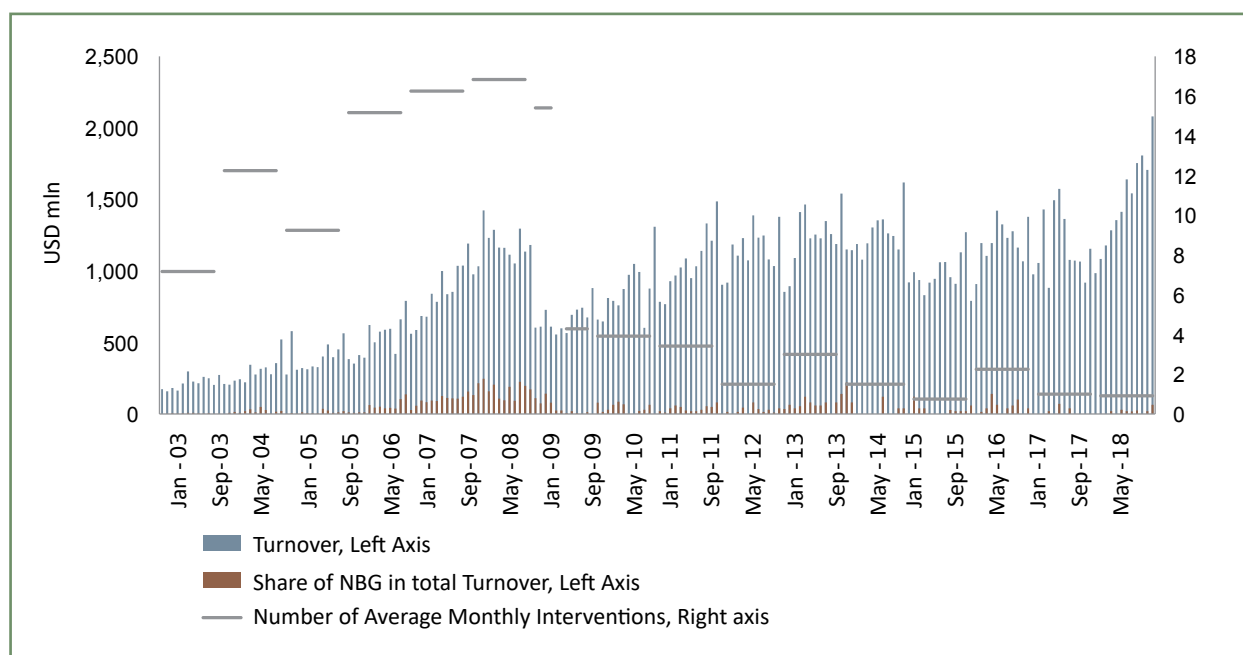
During 2018, the interventions of the National Bank were only directed towards the purchase of foreign currency – the goal of these interventions being to fill the NBG's international reserves. It should be emphasized that having an adequate level of international reserves, especially for countries that are highly dollarized, is a significant indicator of the sustainability of the economy towards foreign shocks and is an important component of macroeconomic stability.

The National Bank of Georgia uses an auction mechanism to perform foreign currency interventions. Throughout 2018, the net purchases of interventions made by the NBG to fill the international reserves amounted to 197.5 million USD (see Diagram 2.11).

---

18. Annual report of the National Bank of Georgia, 2015, <https://www.nbg.gov.ge/index.php?m=348>

**Diagram 2.11 FX market (2003-2018)**



Source: National Bank of Georgia

During the accounting period the National Bank actively worked on the development of additional mechanisms that would further increase the transparency of currency interventions and better fit the needs of the market. With this in mind, a new financial instrument – currency options – was developed, which will be traded from 2019. Currency options give the holder the right (though not the obligation) to exchange currency in a prescribed timeframe. The option allows the owner to buy lari (in exchange for USD or EUR) from the NBG before the expiration of the deadline and obliges the National Bank to sell lari to the owner of the option. The National Bank will publish the benchmarks of currency options in advance, but it will be possible to change the volumes by considering market conditions. The currency exchange rate will be the official exchange rate (strike price) of the same day, which is practically the market exchange rate of the previous day. As a result, international reserves will be automatically accumulated only on those days when the lari has a strong tendency to appreciate. Additionally, in contrast to traditional options, the owner can only use the currency option if the exchange rate is more appreciated than the average exchange rate of the past 20 working

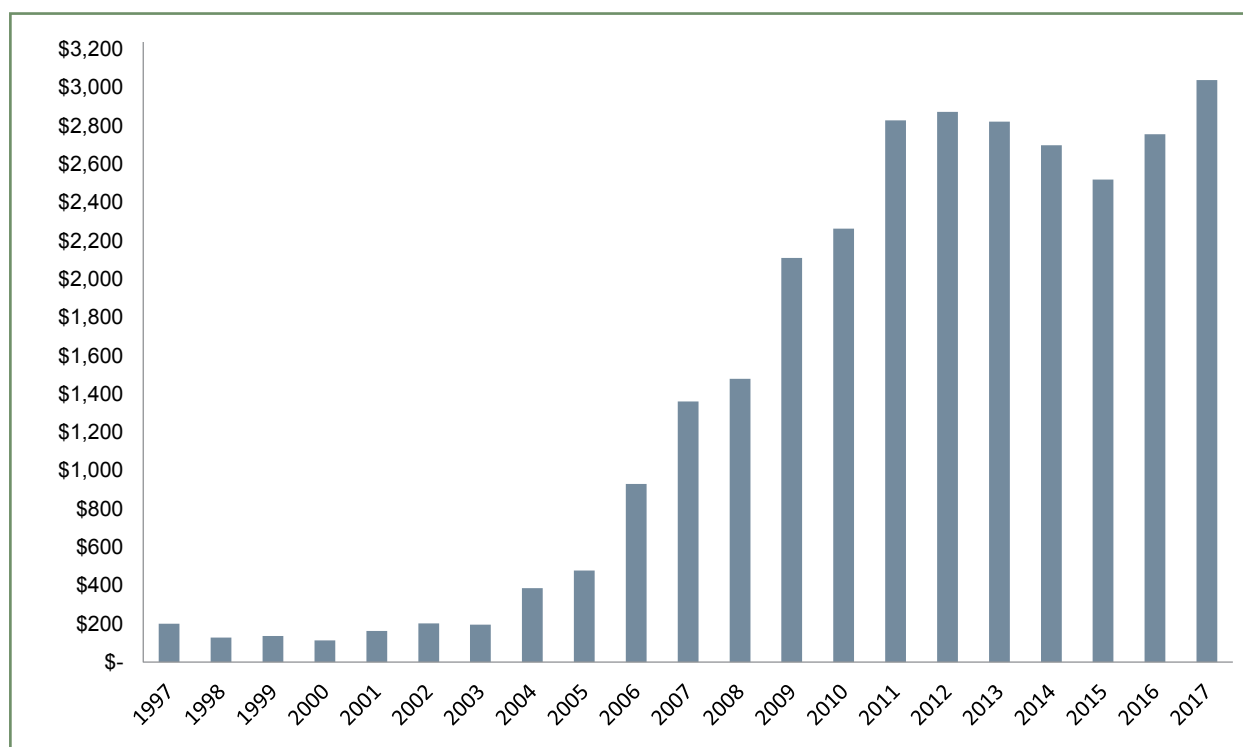
(business) days. This restriction ensures that the filling of reserves does not occur during short-term fluctuations in the exchange rate.

In 2018, the economic environments of trading partner countries improved, which substantially increased demand on Georgian exports. As a result, exports of goods and services increased significantly. Moreover, the substantial increase in exports of goods, alongside revenues from tourism and money transfers, collectively influenced the appreciation trend of the lari nominal exchange rate. Ultimately, the lari real effective exchange rate appreciated by an annual 3.5% and the nominal effective exchange rate by 7.9%. Meanwhile, the official exchange rate of the GEL against the USD changed from 2.5922 to 2.6766, reflecting depreciation of 3.3%.

### International reserves management

In 2018, the volume of the National Bank of Georgia's international reserves increased by 251 million USD, to total 3.29 billion USD as of 31 December 2018 (which includes funds managed by the World Bank and the Bank of International Settlements) (see Diagram 2.12).

**Diagram 2.12 Official FX reserve assets 1997-2018 (million USD, end of year)**



Source: National Bank of Georgia

Traditional factors affected the volume of the NBG’s international reserves during 2018: the foreign exchange auctions of the NBG, government expenditures and credits, and grants received from international organizations. In 2018, the NBG’s net purchase of foreign currency via FX auctions amounted to 197.5 million USD. During the year, loans and grants received by the Georgian government to finance various programs and projects from international financial organizations and donor countries amounted to 456 million USD, while funds received from the IMF in the framework of the extended fund facility amounted to 84 million USD. On the other hand, the Georgian government debt service amounted to 390 million USD and currency conversions equaled 319 million USD. It should be noted, that the volume of the NBG’s international reserves were affected by the increase of the minimum reserve requirement rate for funds raised by commercial banks in foreign currency. The latter caused the NBG’s reserves to increase by approximately 270 million USD.

The 2008 global financial crisis continued to be normalized during 2018. This was especially visible in the U.S., where the economic growth trend was positive and stable. According to preliminary data, GDP growth in the USA was around 2.9% in 2018, which exceeded the previous year’s figure by 0.3 pp. During 2018, positive trends were also observed on the labor force market. The unemployment rate decreased to 3.9%, which was the lowest level since 1969. According to the data from December 2018, the non-farm payroll sector flourished and an additional 2.64 million jobs were created – a significantly higher figure than the same time in the previous year (when 2.2 million jobs had been created).

Against the background of improved economic activities in the U.S., the Federal Open Market Committee increased the target interest rate four times during the year, and at the end of 2018 it was fixed in the range between 2.25-2.50%. In line with the increase of the refinancing rate, the

yields on Treasury securities also increased – the yield on 2-year U.S. Treasury notes moved by at least 60 basis points – from 1.48% to 1.9%. Moreover, without the pressure of inflation, the yield on 10-year U.S. Treasury notes moved only by 18 basis points. However, 2018 did not pass without problems. During the year, the “Trade War” between the U.S. and China intensified and both countries increased tariffs and quotas on imports and exports of specific raw materials, goods and services. At the end of the year, in December, the U.S. government was temporarily “shut down” – a result of the President being unable to reach an agreement with the Democrats over financing a border wall with Mexico for 5.7 billion USD.

In 2018, the ECB (European Central Bank), unlike the U.S. Federal Reserve System, retained its loose monetary policy. During the period 2014-2018, monetary policy easing was conducted through the purchase of large portions of government, asset-backed and corporate bonds. By the end of 2018, total purchases amounted to 2.65 trillion euros, of which the greatest part – 2.2 trillion euros – consisted of purchases of obligations from Eurozone member countries (270 billion euros were

in asset-backed bonds and 180 billion euros were in corporate bonds). After 2018, the ECB will no longer continue to increase its bond portfolio, and a reinvestment program is planned for 2019-2021 (the preliminary volume of that reinvestment program is 1.4 billion EUR).

In 2018, the Eurozone economy still maintained a low-inflation environment and the average annual increase of the consumer price index hit 1.6% (this stood at 1.4% in 2017), which is moderately less than the ECB target level of 1.75-2.25%. In 2018, as in the previous year, improvements to the business environment and expectations in the real sector of the Eurozone economy (the average annual real GDP growth rate in 2018 was 2.07%, lower than the rate of 2.53% in 2017), were provided by both monetary stimulus and higher fiscal discipline among the majority of EU member countries, especially in Greece as well as in Portugal, Spain, Italy, and France. The labor market also improved, with the unemployment rate returning to single digits – 8% – which is the lowest figure for the last 10 years.





*Iason Lortkipanidze  
First Chairman of the Georgian State Bank*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## FINANCIAL STABILITY

### 3.1 Financial Stability Policy

Under the Organic Law on the National Bank of Georgia, one of the main tasks of the NBG is maintaining financial stability without compromising price stability – the main mandate of the National Bank. Financial stability is a condition where the financial system ensures long-run, sustainable economic development. For this purpose, financial intermediation and market infrastructure (payment systems) need to be efficient, the financial system needs to be resilient to shocks, and systematic risks need to be mitigated. A stable financial system also assumes the development and deepening of financial markets.

Implementing macroprudential policy is important for maintaining financial stability. Financial stability issues are discussed by the NBG's Financial Stability Committee (FSC), which also determines macroprudential policy. The latter implies the identification, evaluation and constant monitoring of systemic risks and the implementation of response measures to reduce those risks. To increase the transparency and effectiveness of macroprudential policy, starting from 2018 the Financial Stability Committee moved onto a new framework. Furthermore, special attention was devoted to the implementation of countercyclical macroprudential policy. The main instrument of macroprudential policy is a countercyclical capital buffer. Its goal is to limit excessive credit growth, which could lead to a buildup of systemic risks. The countercyclicality of the buffer serves the main purpose of macroprudential policy, which is to reduce systemic risks to financial stability. In the event of negative shocks, the countercyclical buffer should help the financial system to avoid a significant deterioration of lending to the economy and thus help prevent a further worsening of conditions in the financial sector and the economy as a whole. In determining the countercyclical cap-

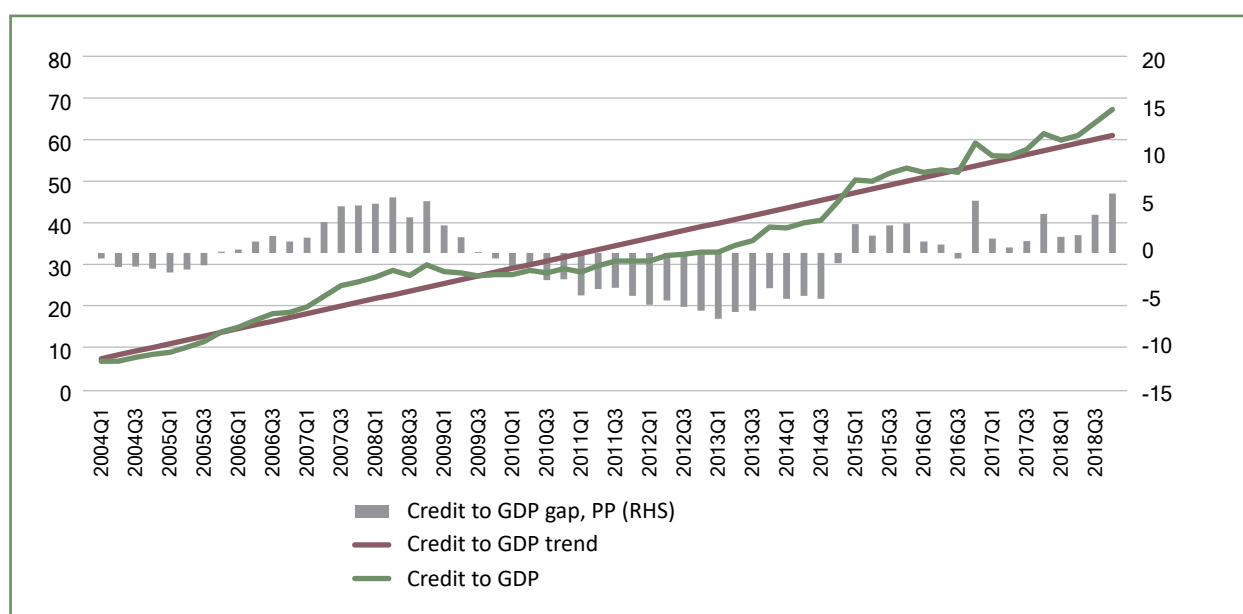
ital buffer, the analysis of a number of factors is taken into account, including the credit-to-GDP ratio and indicators describing its deviation from the long-run trend; trends in lending; other indicators of the financial sector's cyclical position; and characteristics of the country's domestic and external macro-financial environment.

To conduct macroprudential policy, in addition to countercyclical buffer, the NBG uses other buffers that have been implemented in accordance with the Basel III framework. These macroprudential policy instruments include the payment-to-income ratio (PTI), loan-to-value ratio (LTV), and sectoral risk weights.

During 2018, the credit portfolio continued to grow at a fast pace. Given the high rate of credit growth, the credit-to-GDP ratio exceeded the long-run trend, which was mainly driven by household loans. Overall credit growth indicated the need to activate the countercyclical capital buffer. However, the Financial Stability Committee decided that the enactment of the responsible lending framework for individuals and the enforcement of limits on the PTI and LTV coefficients on 1 January 2019 would reduce lending growth to a sustainable level.<sup>19</sup> As a result, the decision was made not to activate the countercyclical capital buffer. Implementation of the responsible lending framework will ensure the reduction of financial stability risks and will have a positive impact on the economy. This regulation will reduce the excess credit burden and lower long-run interest rates, which will contribute to sustainable economic growth. It should be noted that these responsible lending regulations are being introduced in line with the EU directives. In recent years, similar regulations have been implemented in countries such as Estonia, Hungary, Sweden, Denmark, Lithuania, and the Czech Republic.

19. For more information, see: [https://www.nbg.gov.ge/uploads/fsc/desicions/eng\\_fin\\_stab\\_november.pdf](https://www.nbg.gov.ge/uploads/fsc/desicions/eng_fin_stab_november.pdf)

**Diagram 3.1. Credit-to-GDP ratio (percent of GDP)**



Source: National Bank of Georgia

Decisions to tighten macroprudential policy are often unpopular, as in the short run doing so would carry social or economic costs, while the benefits (of high and stable growth, high employment and low fiscal expenditure), despite potentially exceeding the costs, only materialize in the long run, thus often making the need for tightening policy hard to understand.

Risks related to dollarization remain a major challenge for the financial system.

### 3.2 Development of the Financial Stability Framework

The development of the financial stability framework is part of the NBG’s mandate to provide financial stability, which is one of the key factors determining a country’s economic development. It is noteworthy that in recent years the importance of financial stability and macroprudential policy has grown all over the world. According to best international practice, regular comprehensive and in-depth analyses of financial stability are required. Financial stability analysis does not only encom-

pass an evaluation of risks in the banking system, but also focuses on external factors that have been a source of significant risks in recent years. Financial stability also assesses the domestic macro-financial environment, households, companies, and non-banking institutions.

The NBG is continuing to develop a financial stability policy framework in accordance with best international practice. As this requires developing adequate analytical opportunities, the first step in this direction was focused on developing complex, Georgia-specific financial stability indicators. These indicators are used to make cyclical macroprudential policy decisions.

Macro-financial modeling is another important part of the financial stability analysis framework. With the support of the IMF’s technical mission, the Financial Stability Department is actively working on the development of a macro-financial model that aims to assess the risks to financial and macroeconomic stability; on constructing and analyzing macro-financial scenarios; and on conducting macroeconomic stress tests, which are the

main cornerstones of appropriate macroprudential policy design. In 2018, in the scope of the IMF's technical mission, this model was extended to better describe the financial sector. An additional IMF technical mission is planned for 2019 to further develop the model and improve reporting.

One of the most important aspects of the financial stability framework is increasing transparency and improving communications. In order to increase public awareness about financial stability policy, the NBG is constantly updating the financial stability section of its website to provide detailed information regarding this subject. More precisely, it outlines the main tasks of the Financial Stability Committee (FSC) and describes the available macroprudential policy tools; it also provides a calendar of committee meetings, and reports on committee statements, decisions, and issues related to IFRS 9.<sup>20</sup>

In order to increase the transparency and effectiveness of financial stability policy, starting from 2018 the FSC moved onto a new framework. The committee evaluates and analyzes financial stability risks, designs macroprudential policy and makes decisions regarding corresponding policy actions. This involves the identification, assessment, and continuous monitoring of systematic risks and the implementation of corresponding policies to mitigate those risks. The FSC meets once a quarter according to a preannounced calendar. After each meeting, a press release is published that describes current trends and challenges in the financial system and reports the decisions of the committee. Moreover, twice a year the committee's meetings are followed by a press conference.

It should also be noted that the NBG supports the efficient implementation of new financial accounting standards (IFRS 9) by financial institutions. To aid the transparent, consistent and efficient implementation of IFRS 9, and also ensure comparability among the reports, the NBG regularly publishes macroeconomic and financial forecasts and risk scenarios. The estimates provided within these scenarios can be used for calculating expected credit losses. The macroeconomic forecasting scenarios of IFRS 9 are based on the macro-financial model and incorporate additional analysis and expert judgment. It is important to note that the provided scenarios are countercyclical by nature, which helps mitigate the potential impact of financial cycles.

A sustainable financial system is essential for financial stability. This revolves around the management of social and environmental risks and is one of the main factors contributing to sustainable development. In September 2017, the NBG became a member of the Sustainable Banking Network and is actively working on developing a framework for sustainable finance. With the purpose of increasing awareness about sustainable finance, the NBG in cooperation with the private sector translated the International Capital Market Association's (ICMA) Green, Social and Sustainable Bond Principles into Georgian. These translated documents have been available on the ICMA's website since last year. An important part of sustainable financing is integrating environmental, social and governance (ESG) considerations into the Corporate Governance Code. These ESG considerations are already reflected in the Corporate Governance Code for commercial banks and their integration in the relevant code for capital markets is under-

---

20. International Financial Reporting Standard (IFRS).

way. The NBG, in cooperation with OECD, is also working on ESG disclosure and reporting principles that will help financial institutions and companies to comply with the requirements of the Corporate Governance Code.

On 26 September 2018, the NBG, in cooperation with the IFC and the SBN, hosted the Sustainable Finance workshop that brought together IFC experts, representatives from SBN member countries and regional central banks, senior representatives from the Ministry of Economy and Sustainable Development of Georgia, the Ministry of Finance of Georgia, the Ministry of Environment Protection and Agriculture of Georgia, the Presidents/CEOs and senior leadership of financial institutions, and other stakeholders. As a result of the workshop and consultations, a decision

was made about developing a sustainable finance roadmap for the upcoming 3-4 years. In 2018, the NBG started working on this document in cooperation with SBN/IFC and a final version is scheduled for publication in 2019. The goal of this document is to introduce the local market and international investors to the NBG's plans regarding sustainable financing in Georgia.

One of the main priorities of the NBG is to prepare and publish financial stability reports, which are an important component of the financial stability framework. The development of such reports started in 2018 with technical assistance from the IMF. These will be based on forward-looking macro-financial analysis and will be prepared in accordance with best international practice. The first Financial Stability Report is planned for publication in 2019.

# წესდება საქართველოს სახელმწიფო ბანკისა

ზოგადი დადგინდობანი

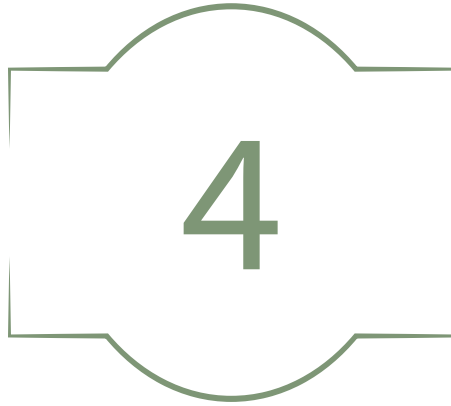
სახელწოდება, მოწყობა და დანიშნულება ბანკისა, მისი თანხები, უფლებანი და მოვალეობანი.

1. ამ წესდების საფუძველზედ არსდება საქართველოს დემოკრატიულ რესპუბლიკის სახელმწიფო ბანკი, სახელწოდებით „საქართველოს სახელმწიფო ბანკი“, რომლის დანიშნულებას შეადგენს გადავიღება ფულის ტრიალისა, ხელის შეწყობა მოკლევადიან სესხის საშუალებით. ვაჭრობისა. პრინციპობისა და სოფლის მეურნეობისათვის, აგრეთვე განუტკიცება ფულის საქმისა.
2. ბანკის ძირითადი თანხა, რომლის სულ უდიდესი რაოდენობა განისაზღვრება **ოც მილიონ** მანეთად, გადაიღება სახელმწიფო ხაზინიდან.
3. ბანკის სათადარიგო თანხა, რომლის განსაკუთრებული დანიშნულებაც ანაზღაურებს ზარალი, თუ ვინიკობა ასეთი ბანკის ოპერაციებს მოყვა, უნდა შეადგენს ბანკის წმინდა მოგების ნაწილის ყოველწლიურ გადაღებით. მატება ამ თანხისა უნდა განჭობილ იქნას იმ დრომდე, ვიდრე შესდგება **ათი მილიონი მანეთი**.
4. ვიდრე **ძირითადი** თანხა ოთხ მილიონამდე ავიდოდეს, ყოველწლივ უნდა გადაიღოს წმინდა მოგებიდან არა ნაკლებ ოცის პროცენტისა, ხოლო შემდეგ, ვიდრე ეც თანხა სრულ ნორმამდე მიადწევდეს (შეს. 3), არა ნაკლებ ათის პროცენტისა.
5. თუ ვინიკობა სათადარიგო თანხა შემცირდა ზარალის გასტუმრების მიზეზითა, იგი შევსებულ უნდა იქნას იმ წესით, რომელიც მის შედგენისათვის არის დაწესებული.
6. თუ ბანკის ზარალი სათადარიგო თანხით ვერ დაიფარა, დანარჩენი უნდა გასტუმრებულ იქნას ძირითადის თანხიდან. შემდეგ ეს თანხა უნდა შევსოს სახელმწიფო ხაზინამ.
7. თანხები ბანკისა და ის ფული, რომელიც მიუბარებია მისთვის ყერო კაცთ, დაწესებულდება და საზოგადოებათ, აგრეთვე დემოკრატები ხაზინისა არ შეიძლება დაბარჯულ იქნას სახელმწიფოს საჭიროებისათვის.
8. ბანკის ოპერაციებისგან შემოსული წმინდა მოგება, გარდა იმისა, რაც გაღორცება სათადარიგო თანხის საშუალებით ანა წესდებისამებრ, ხაზინის შემოსავალს უნდა მიემატოს.
9. ფული, ბანკში დაბინავებული, არ შეიძლება ან დაკავებულ იქნას, ან სექესტრ-დადებული, თუ არ იმ წესით, რომელიც განსაზღვრული იქნება რესპუბლიკის კანონებით და სათანადო შეთანხმებაში ბანკს უნდა წარედგინოს მის მიერ გაცემული ბილეთები ანუ საანგარიშო წიგნაკები.
10. ბანკის უზრუნველ-საყოფელად წარდგენილი ლიზონი და სხვა საქონელი, კონსიგნატები და ვიტანციები სატრანსპორტო კანტარებისა, რეინს-გუბისა და სანავოსნო საზოგადოებათა და სხვა გირაონი არ შეიძლება არც დაკავებულ იქნას, არც სექესტრ-დადებული ვინც ყერო ან სახაზინო მოშვიან-შევაღეს მიერ; აგრეთვე არც შეიძლება ბანკის მოვალეთა სხვა ქონებაში იტროს, რომლისათვისაც კონკურსია დანიშნული, იმ დრომდე ვიდრე იგი მოვალე სულ არ გადაუღოს ბანკს, რაც ვალად აუღია, აგრეთვე ხვედრ სარგებლითა ჯარბითა, ხარჯითურთ და საჯარესოთი თუ ვალის გადახდა ვადა გადაკლებულია, ამიტომ გირაოს ვაუიღვას, რომლითაც უნდა იქნას ანაზღაურებული ბანკის მიერ გაცემული ვალი, ვერავითარი მოქმედება სისამართლოსი ვერ შეაყენებს.
11. ბანკს ნება აქვს შესხებულსაც დაუტოვოს სასარგებლოდ ან შესანახად მისგან მიღებული თვის ვალდებულების უზრუნველ-საყოფელად მომზადი ქონება, შილოდ იმ პირობით-ით, რომ ამისთანა ქონების ნუხა იყოს შედგენილი თანადსწრებით არა ნაკლებ სამის მოწმის და აღმინისტრაციის მოხელეთა და რომ ქონებას ზედ ეღოს რაიმე გარჯანი ნიშანი, შესვენებული იმისი, რომ ქონება დაგირავებულია (ლუქის ბეჭედი, დამა, ნიშნისანი ტყვიის ნაჭერი და სხვ.), თუ ქონება ისეთია, რომ ასეთის ნიშნის დადება შეიძლება. გირაოს დამაღვისა და ან გაუიღვისათვის, ვიდრე სესხი გადახდილი არ არის, შესხებელი ქსისის გებაში მიეცება, როგორც გამოსაწვავი შესანახად მიმარბულ ქონებისა.
12. წესნი ბანკის ოპერაციების განსამარტებლად და დამატებათ ამა წესდების სათანადო მუხლთა, აგრეთვე წესრიგი საქმეთ-წარმოებისა და ანგარიშისა ასევე ბანკის სხვა და სხვა დაწესებულებაში უნდა დატკიცებულ იქნას სამწის მიერ, შილოდ იგი წინდაწინვე უნდა შეუთანხმდეს სახელმწიფო კონტრალიორს ანგარიშების წარმოების წესრიგის თაობაზედ.
13. ბანკს აქვს ბეჭედი, რომელზედაც ამოჭრილია სახელმწიფოს გერბი რესპუბლიკისა და წარწერილია „საქართველოს სახელმწიფო ბანკი“.

Statute of the State Bank of Georgia



# FIRST GEORGIAN CENTRAL BANK



## BANKING SUPERVISION



## 4.1 Development of the Supervisory Framework

Throughout 2018, the NBG continued the development of the supervisory regulatory framework and the approximation of current standards with international practices and principles.

In 2018, the NBG approved the “Code of Ethics and Professional Conduct Standards for Commercial Banks” that aims to establish internationally recognized ethical and professional standards for the banking profession in Georgia. These will facilitate an enhancement of public trust, including amongst investors, towards the banking sector. It will also significantly support the banking sector in operating in a stable and efficient manner. The principles and standards established by the latter document are based on the framework of ethical principles and standards of professional conduct developed by the Certified Financial Analysts (CFA) Institute – one of the most respected manuals in the financial market. The document defines ethical principles in detail and regulates the standards of professional conduct, including professionalism, the integrity of financial markets and the banking sector, duties to clients and employers, principles of professional behavior, conflicts of interests, and the responsibilities of subjects in the scope of the code. In addition, the code establishes the obligations of commercial banks for the purpose of complying with the standards and requirements of the code as well for issues concerning identification of violations of the code, and decision making and appeal procedures. Commercial banks are currently elaborating on the requirements and standards defined within the code.

The Code of Ethics is a component of the corporate governance framework. In 2018, the National Bank of Georgia made significant changes in this direction. In particular, in order to approximate with the principles of best corporate governance practice, the National Bank of Georgia elaborated

and approved the “Corporate Governance Code for Commercial Banks”. This code follows internationally accepted requirements and standards, including regarding the composition of a bank’s supervisory board, ensuring the inclusion of independent members and maintaining gender balance. The regulation concerns the following issues regarding a bank’s supervisory board and its committee(s): the number of members, their independence, qualifications and responsibilities, and the delegation of authority. In addition, the regulation defines issues related to the composition and qualifications of the management board, risk management and internal control functions, and remuneration principles for senior management and material risk takers. The code aims to introduce international best practice on the corporate governance of commercial banks, which supports the banking sector in operating in a stable and efficient manner.

The National Bank of Georgia implemented the Basel III leverage ratio during the year. The leverage ratio is a simple and transparent figure that acts as a supplementary measure of risk-based capital adequacy requirements. The ratio is defined as Tier 1 capital divided by a bank’s total risk exposures. The regulation on the “Leverage Ratio Requirements for Commercial Banks” came into force in September 2018 and established the requirement of a minimum leverage ratio of 5%. The ratios calculated under this regulation are published by commercial banks in their quarterly Pillar 3 reports.

In order to fully comply with the Basel III Tier 2 capital quality standards, the NBG plans to work on defining the requirements for additional Tier 1 and Tier 2 capital instruments. This implies creating write-off or conversion requirements for additional Tier 1 and Tier 2 capital instruments into common Tier 1 equity, either upon the occurrence of predetermined trigger events or at the NBG’s request.

On 14 May 2018, the Governor of the National Bank of Georgia approved the “Instructions on Real Estate Appraisal for Commercial Banks”, which was subsequently enacted on 1 June 2018. The main purpose of this instruction is to improve the quality of real estate valuation in the banking sector and to ensure greater transparency of valuation principles and processes. This will contribute to the stable and efficient functioning of the banking sector. The instructions determined and regulated ethical standards, the qualification requirements for the appraiser, commercial banks’ liabilities regarding the real estate valuation process conducted by professional internal/external appraisers, and the rights of the National Bank of Georgia relating to the above-mentioned liabilities.

According to the amendments to the Organic Law on the National Bank of Georgia made by the Parliament of Georgia at the end of 2017, the NBG was authorized to regulate and supervise the activities of the Credit Information Bureau from 1 September 2018. Accordingly, two orders of the Governor of the National Bank of Georgia entered into force in 2018: “On Approving the Rule of Registering, Cancelling Registration and Regulation of the Credit Information Bureau in the National Bank of Georgia” and “On Submitting Information to the Credit Information Bureau on the Territory of Georgia, Recording Information in the Database of the Credit Information Bureau and its Accessibility”. NBG supervision of the Credit Information Bureau aims to ensure financial stability and to protect the rights of customers within the mandate of the NBG. These regulations encourage the provision, reporting and accessibility of reliable, accurate, objective and comprehensive information to the Credit Information Bureau. Within the framework of its supervision of the Credit Information Bureau, the National Bank of Georgia actively works on the elimination of errors in the

data preserved in the Credit Information Bureau. This will improve the quality of data and, ultimately, encourage analysis of the creditworthiness of potential borrowers/customers. The aforementioned regulations define the list of permitted activities and establish fit and proper criteria for administrators, the minimal amount of capital, operational and other risk management requirements, and the norms for receiving, reporting/analyzing and distributing information.

During 2018, the National Bank of Georgia, in cooperation with the financial sector, actively worked on a framework for responsible lending. Accordingly, on 24 December 2018, the Governor of the National Bank of Georgia approved the “Regulation on Lending Standards for Natural Persons” (Decree N281/04). This regulation aims to strengthen the stable functioning of the financial sector and encourage sound lending standards, which will favor the sustainable development of the country’s economy. According to the regulation, a financial institution shall not grant a loan or other liability (e.g. guarantee) without prior analysis of a client’s solvency. The regulation covers all lending institutions under the supervision of the National Bank of Georgia and was enacted on 1 January 2019. Lenders will be obliged to analyze the income of the client, the value of the collateral and draft the loan so long as the payment-to-income (PTI) and loan-to-value (LTV) ratios do not exceed the limits defined by the regulation. The abovementioned ratios differ for local and foreign currency loans, this is protect borrowers and the financial system from foreign exchange volatility induced risk.

It is significant that the National Bank of Georgia is working on a bank recovery and resolution framework that will be based on respective international best practice and the relevant EU directives (see Box 1).

### **Box 1 An overview of international practice on recovery and resolution frameworks**

*The global financial crisis of 2007-2009 revealed serious shortcomings in the effective management of pre-crisis and crisis processes. Specifically, the crisis proved that there was a lack of effective early intervention, recovery and resolution regimes, which would effectively be able to ensure the continuity of critical functions of systemic banks (that were “too big to fail”) and, more generally, the safety of the financial sector by imposing adequate resolution tools and using less state funding in crisis situations.*

*For the purposes of discussing crisis prevention, management and resolution issues, in 2008, the Group of Twenty (G20) conducted a summit in Washington, D.C., composed of governments, central bank governors and European Union representatives.<sup>21</sup> In 2011, the Financial Stability Board (FSB), published “The Key Attributes of Effective Resolution Regimes for Financial Institutions”<sup>22</sup> that laid the key groundwork for Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 for the Bank Recovery and Resolution framework (the Bank Recovery and Resolution Directive (hereinafter “the Directive”)).<sup>23</sup> The latter became the foundation for the internal legal regimes for the recovery and resolution frameworks of EU member states. It is also noteworthy that following the challenges of the global financial crisis the United States appropriately responded, including enacting the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act.<sup>24</sup> For the purposes of improving financial stability, this act tightened the reporting and transparency requirements for members of the financial market and limited the legal opportunity for using state funds (“bail-outs”) in resolution.*

*The National Bank of Georgia analyses and learns from international practice and the resolution regimes of different countries. In so doing, the NBG works on developing recovery and resolution standards that will properly fit Georgia’s national and sectoral context.*

#### **The key principles of the legal frameworks of the recovery and resolution regimes of EU countries**

*As mentioned above, the resolution regimes of EU member states were substantially based on the principles and standards of Directive 2014/59/EU on the Bank Recovery and Resolution framework. The Directive creates a unified resolution regime across the European Union (the so-called “Single Resolution Mechanism”)<sup>25</sup> and establishes the following fundamental objectives:*

- *ensuring the continuity of critical functions;*
- *avoiding a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures;*
- *protecting public funds by minimizing reliance on extraordinary public financial support;*
- *protecting insured depositors;*
- *protecting client funds and assets.*

*The key requirements of the Directive are related to the following:*

- *recovery and resolution planning;*
- *early intervention tools;*

21. See: <http://www.g20.utoronto.ca/2008/2008declaration1115.html>

22. See: [http://www.fsb.org/wp-content/uploads/r\\_111104cc.pdf?utm\\_content=VKD](http://www.fsb.org/wp-content/uploads/r_111104cc.pdf?utm_content=VKD)

23. See: <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:02014L0059-20171228>

24. See: <https://www.govtrack.us/congress/bills/111/hr4173/text>

25. See: [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-resolutionmechanism\\_en#single-resolution-board](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-resolutionmechanism_en#single-resolution-board)

- a unified platform for resolution powers and tools;
- resolution financing;
- cooperation and coordination issues between relevant bodies.

### **Recovery and resolution planning, early intervention**

*It is noteworthy that, according to the Directive, the resolution process should be managed by a resolution authority that is to some extent separated from the supervisory authority in order to avoid risks of conflicts of interest and to not hinder the effectiveness of the process (the sole resolution board in the European Union is the Single Resolution Board).<sup>26</sup>*

*Recovery and resolution plans are key elements for the prevention of crisis situations. Through recovery planning banks draw up recovery plans that are composed of relevant conditions and procedures that provide a bank's proper response to different forms of financial difficulties. Recovery plans are assessed by the supervisory authority and provide grounds for the resolution plans developed by the resolution authority. Resolution plans include a resolution strategy for the eventuality that the resolution regime is commenced by the relevant body towards a bank that has financial difficulties when the recovery plan is no longer effective. Recovery and resolution planning is particularly important for systemically important banks – those that it would not be either feasible or credible to liquidate when taking into account their systemic importance for financial stability.*

*Through resolution planning, the resolution authority assesses and analyzes the potential implications and opportunities for implementing the resolution and liquidation of each bank. As a result, the authority develops individual assumptions for imposing resolution or liquidation during a crisis/stress situation for each bank.*

*On the basis of the Directive, the supervisory authorities of EU member states are empowered with early intervention tools and powers that can be imposed to react adequately and in a timely fashion to financial difficulties. These tools include the power to require the implementation of the recovery plan, the dismissal of management members, and updating a bank's business strategy or operational structure.*

### **Resolution tools and powers, resolution financing, coordination and cooperation issues**

*Despite the early intervention measures, in the event that the financial difficulties are not eliminated and, taking into account the public interest, bank resolution is critical, then the resolution authority may decide to commence the resolution regime towards a bank. The Directive sets out the resolution tools and powers. These include the following:*

- *the power to take control of an institution under resolution and exercise all the rights and powers conferred upon the shareholders, other owners and the management body of the institution under resolution;*
- *the power to remove or replace the management body and senior management of an institution under resolution;*
- *the power to suspend any operation or transaction of a bank;*
- *the power to suspend any payment or delivery obligations and/or the power to temporarily suspend termination rights ("moratorium regime");*

---

26. See: <https://srb.europa.eu/>

- *the power to stay legal proceedings;*
- *the power to merge a bank with another commercial bank or sell the bank's shares to another commercial bank;*
- *the power to transfer wholly or partly a bank's rights, liabilities, assets and claims to a third party;*
- *the power to reduce to zero or cancel a bank's common shares and/or other ownership instruments;*
- *the power to require a bank to issue new shares and/or other ownership instruments;*
- *except in exceptional cases, the power to reduce to zero the value of existing liabilities or convert these liabilities to bank's common shares or to other ownership instruments ("bail-in", which is the most innovative resolution tool);*
- *the power to terminate any contract of a bank. In addition, the power to cancel debt instruments issued by the bank except in some exceptional cases or to modify the maturity or interest rates or the frequency of the payment of interest;*
- *the power to initiate civil and criminal actions to seek damages and restitution from shareholders, directors, or other officers whose actions caused damage to a bank;*
- *the power to engage with, at the expense of the bank under resolution, independent attorneys, accountants, auditors, valuation experts and/or consultants;*
- *the power to control a bridge bank and give instructions, including on the preparation of an exit plan, and exercise other necessary powers for the effective management of a bridge bank.*

*Regarding the resolution financing, according to one of the fundamental principles of the Directive, shareholders and regulatory capital instrument holders bear losses first. Only after the latter losses are taken may financial funds from the resolution fund be used.*

*The resolution fund is a pre-established fund (account) that is used by banks to make payments that should be proportionate to a bank's liabilities and risk profile. The resolution fund might be used for the purposes of the effective resolution process, but not for the direct recapitalization of the bank. In addition, the Directive sets the principle that state funds may only be used after an 8% bail-in is applied. Besides, state funds can only be used for resolution in cases of a systemic crisis and may be applied directly, through a state entity in the capital of a bridge bank or in the acquisition of equity of the bank under resolution. To some extent the Directive sets the standard of resolution financing by the Deposit Insurance Fund.*

*According to the Directive, coordination and cooperation between the relevant bodies (e.g. the supervisory authority, resolution authority, the Deposit Insurance Fund, and the Ministry of Finance) is important for the purposes of developing effective mechanisms for financial crisis preparation and crisis management. This includes confidentiality issues regarding information exchange and public relations issues.*

It should be noted that technological developments have an influence on traditional financial services. Technologies used in the financial sector, or 'FinTech', are used by financial institutions the world over to improve their financial services and take competitive advantages. However, this trend enhances risks related to such technologies, which should fall under the scope of financial sector supervisors. In order to ensure that technological

innovations in the financial sector do not need to be restricted and at the same time ensure that technological risks are not amplified, supervisors in various central banks have started implementing so-called regulatory sandboxes. The National Bank of Georgia is studying these approaches with the idea of subsequently implementing a similar approach (see Box 2).

## **Box 2 An overview of a regulatory sandboxes**

*A regulatory sandbox is a regulatory framework implemented by a financial sector supervisor under which a producer of an innovative financial product, service or model is allowed to test their innovation in a controlled environment. A controlled environment implies one where, under the regulator's supervision, the provider of the innovative product or service is considered exempt from financial regulations in order to test their innovation. The concept of a regulatory sandbox is related to the very rapid development of technological innovations in financial markets. The idea is an attempt from regulators to encourage financial innovations and at the same time strengthen financial regulations after the 2007-08 global financial crisis. Currently, several countries are actively trying to develop a regulatory sandbox in order to encourage financial innovations.*

*The National Bank of Georgia is studying the experiences of different countries in terms of implementing regulatory sandboxes. This could become the basis for developing a regulatory sandbox relevant for the Georgian financial sector.*

### **Singapore**

*The Monetary Authority of Singapore actively encourages experiments with financial technologies in order to test innovative products and services in a real market environment and, after successful tests, gives them an opportunity to enter larger markets, not only in Singapore but also abroad. Under the regulatory sandbox, financial institutions and other providers of financial technologies are able to examine their products and services in a real environment with the conditions and duration of the trial determined in advance. The regulatory sandbox includes a safety mechanism that is responsible for financial sector stability in the event of the failure of the innovative financial product or service. Based on the characteristics of the innovation being trialed, the Monetary Authority of Singapore determines which regulatory requirements can be eliminated for the provider of the product or service. After the regulatory sandbox is completed, the participant needs to be fully compliant with all regulatory requirements without any exemptions.*

### **Australia**

*The regulatory sandbox framework implemented by the Australian Securities and Investments Commission allows financial institutions to provide some financial services without an Australian financial service or credit license for up to 12 months. Exemption from these license requirements is only available for special financial products and services that meet certain criteria (for example, up to 100 retail clients, a risk exposure of up to 5 million dollars, and a resolution plan). Within the regulatory sandbox framework, it is possible to be exempt from some other regulatory requirements in the scope of Australian Securities and Investments Commission.*

### **Switzerland**

*The Swiss Financial Market Supervisory Authority actively encourages financial innovation and recognizes the high importance of technological processes. It has actively worked on the licensing and regulation challenges regarding financial product and service providers. In this regard, in March 2016 a regulatory sandbox framework was initiated to simplify the licensing process for financial innovation providers. This framework is for banking activities, but it places limits on lending. The aim of the regulatory sandbox is to stimulate the development of financial innovations while still maintaining consumer protection and financial stability.*

## **Netherlands**

*De Nederlandsche Bank and the Netherlands Authority for Financial Markets are actively working on the encouragement of financial innovation. The Dutch Ministry of Finance and Economic Affairs is also involved in this initiative. In this regard, in January 2017 a regulatory sandbox was implemented that allows financial product providers to enter the market and provide their innovative financial product, service or business model. The sandbox is available not only for those who are already regulated market participants, but also for those who are trying to enter the market. The sandbox can provide innovative financial products that may have a positive effect on financial sector stability, the effective functioning of financial markets and the financial wellbeing of consumers and investors.*

## **4.2 Group Structure Risk**

Assessment of risks related to the group structures and corporate governance of commercial banks is part of the National Bank of Georgia's General Risk Assessment Program (GRAPE). Assessment of group structure risk entails the evaluation of risks related to banks' ownership structures, transactions carried out with banking group members, and banks' investments and investment activities. Within the framework of group structure risk assessments, the National Bank is actively involved in monitoring ongoing developments in the home countries of the international banking groups represented in Georgia, and in the assessment of significant shareholders.

In 2018, the "International Bank of Azerbaijan-Georgia" JSC left the market, following the decision of its shareholders regarding the annulment of its banking license and its transformation into a non-banking financial institution. The banking license of that bank was revoked and the liquidation process began according an order of the Vice President of the National Bank of Georgia. The bank was a subsidiary of the Azerbaijan-based "International Bank of Azerbaijan" JSC, which decided to leave the Georgian market due to economic processes developing in Azerbaijan.

As a result of these changes, by 31 December 2018, 15 commercial banks were operating on the Georgian banking sector. At that time, 87% of bank assets and 84% of stockholder equity was beneficially owned by foreign/non-resident investors.

The National Bank, in cooperation with the State Insurance Supervision Service, continues to work on the development and implementation of a supplementary supervision framework for financial conglomerates. This is in accordance with the EU-Georgia Association Agreement and aims to approximate Georgia's legislation with the EU acquis within a stipulated timeframe. The supplementary supervision framework implies prudential supervision with respect to capital adequacy, risk concentration, intra-group transactions and the internal control mechanisms of entities within a financial conglomerate.

According to amendments made to the Organic Law on the National Bank of Georgia, since the end 2017 the NBG has been authorized to regulate banking groups (via so-called consolidated supervision). The NBG has thus started working on a framework for consolidated supervision, which will be completed by the end of 2019 (see Box 3).

### **Box 3 Review of the consolidated supervision framework**

*According to the Core Principles of Banking Supervision<sup>27</sup> adopted by the Basel Committee on Banking Supervision (hereafter – the Basel Committee), an essential element of banking supervision is that the supervisor supervises a banking group on a consolidated basis as well as on a stand-alone basis. This includes adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group.*

*The Basel Committee published a report regarding the importance of consolidated supervision in 1979.<sup>28</sup> The committee determined that, due to the rapid increase in the internationalization of many banks' operations and their growing complexity, the authorities responsible for carrying out supervisory functions should analyze banks' activities on a consolidated basis in order to completely assess their soundness.*

#### **Criteria for supervision on a consolidated basis**

- 1. The supervisor understands the overall structure of the banking group and is familiar with all material activities (including non-banking/non-financial activities) conducted by entities of the wider group (including the parent entity and subsidiaries of the parent entity), both domestic and cross-border. The supervisor understands and assesses how group-wide risks are managed and takes action when risks arising from the banking group and other entities in the wider group, in particular contagion and reputation risks, may jeopardize the safety and soundness of the bank and the banking system.*
- 2. The supervisor imposes prudential standards and collects and analyses financial and other information for the banking group on a consolidated basis, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits and group structure.*
- 3. The supervisor reviews whether the oversight of a bank's foreign operations by the group's management is adequate in regard to their risk profile and systemic importance and ensures there is no hindrance in host countries for the parent bank having access to all the material information from their foreign branches and subsidiaries. The supervisor also determines whether banks' policies and processes require the local management of any cross-border operations to have the necessary expertise to manage those operations in a safe and sound manner, and in compliance with supervisory and regulatory requirements.*
- 4. The home supervisor visits the foreign offices periodically, the frequency of these visits being determined by the risk profile and systemic importance of the foreign operation. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations or if additional reporting is required, and has the power and resources to take those steps as and when appropriate.*
- 5. The supervisor reviews the main activities of parent companies, and of the companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and takes appropriate supervisory action.*
- 6. The supervisor can limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted (including the closing of foreign offices) if it determines that:*
  - a) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed;*
  - b) the supervision by other supervisors is not adequate relative to the risks the activities present;*
  - c) the exercise of effective supervision on a consolidated basis is hindered.*
- 7. In addition to supervision on a consolidated basis, the responsible supervisor supervises individual banks within the group. The responsible supervisor supervises each bank on a stand-alone basis and understands its relationship with other members of the group.*

27. See: <https://www.bis.org/publ/bcbs230.pdf>

28. See: <https://www.bis.org/publ/bcbsc112.pdf>



### **Prudential requirements on a consolidated basis**

According to Basel Committee, the following prudential requirements need to be set on a consolidated basis:

- Capital adequacy requirements;
- Liquidity requirements;
- Requirements regarding large exposures and concentration;
- Leverage ratio requirements;
- Fit and proper criteria for administrators and corporate governance-related requirements;
- Requirements regarding transparency and audits.

In order to introduce consolidated requirements, it is important for the respective level of consolidation to be defined and for the consolidated requirements to be calculated accordingly. According to the Basel Committee, a consolidated basis is defined as an entity where 50% or more of total consolidated assets are comprised of banking assets or 50% or more of total revenues are generated from banking activities.

### **Current situation and action plan**

Despite supervising and imposing prudential requirements on a stand-alone basis, the National Bank of Georgia has good knowledge of the group structures of commercial banks and monitors intra-group transactions.

In addition, according to the December 2017 amendments to the Organic Law on the National Bank of Georgia, the NBG has authority to supervise and regulate banking groups.

The NBG is currently drafting a regulation on consolidated supervision, which will define prudential requirements – including on capital adequacy, large exposures and the leverage ratio – on a consolidated basis, alongside the existing requirements on a stand-alone basis.

The process of imposing prudential requirements on a consolidated basis requires all entities under the scope of consolidation to use the same accounting standards. Consequently, prudential requirements will be set on the coefficients calculated based on the International Financial Reporting Standards (IFRS) and respective regulatory/prudential filters<sup>29</sup> will be included. This process requires quantitative analysis and the use of prudential filters in the process of calculating ratios on a consolidated basis.

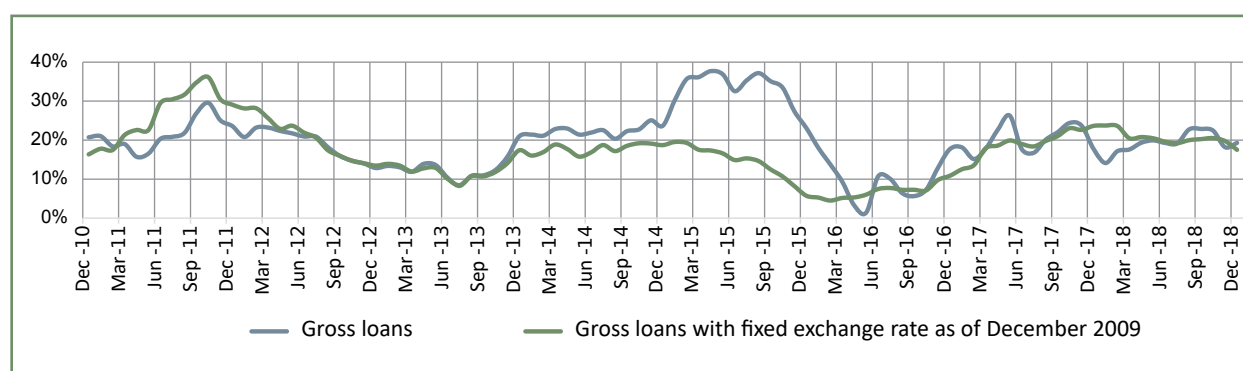
In addition, the consolidated requirements will include disclosure of information, corporate governance, fit and proper criteria for administrators and reporting, and audit-related issues.

## **4.3 Credit Risk**

The total loan portfolio of the banking system reached 26.6 billion GEL at the end of 2018 – an increase of 17.7%, excluding the foreign exchange rate effect.

29. Differences are due to generally accepted local accounting principles and international financial accounting standards.

**Diagram 4.1 YoY percentage change in gross loans**



Source: National Bank of Georgia

During 2018, due to the increase in the share of the SME segment, the consistency of the credit portfolio in the banking system (excluding interbank loans) changed slightly.

**Table 4.1 Composition of the loan portfolio (excluding interbank loans) by segment (adjusted for exchange rate effect, the exchange rate as of the end of 2017)**

	Dec. '17		Dec. '18		YoY change %
	LP	%	LP	%	
Corporate	6,824	31%	7,927	30%	16.2%
SME	5,176	23%	6,525	25%	26.1%
Retail	10,282	46%	11,793	45%	14.7%
Total:	22,282	100%	26,245	100%	17.8%

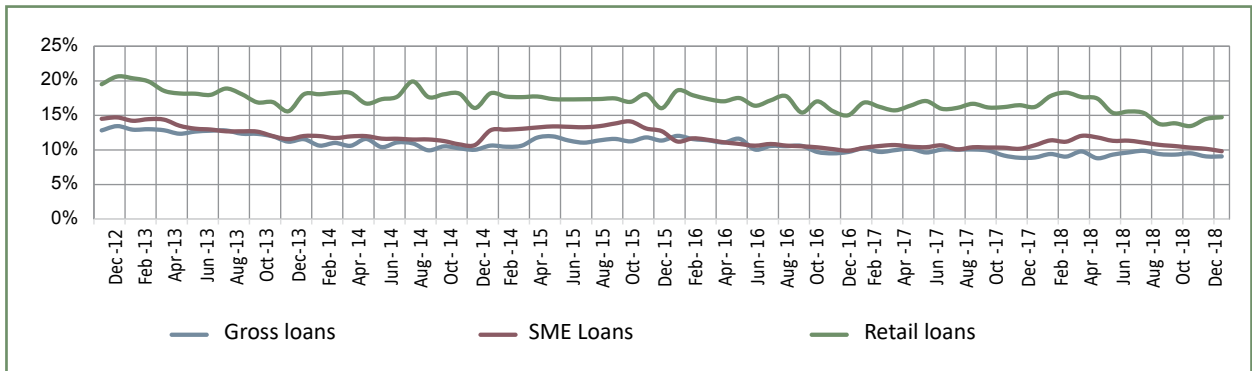
Source: National Bank of Georgia

A few different types of reclassifications occurred during the year, including technical reclassifications, which had an effect on the nominal growth rate by segment. According to the NBG's estimations, during 2018 the retail, SME and corporate portfolios increased by 18.6%, 18.8% and 17.4% respectively (with the assumption of a fixed currency rate and without the above-mentioned corrections). There was also an increase in the portfolio of corporate bonds bought by commercial

banks and, according to the NBG's estimations, the increase in the corporate loan portfolio was 17.9%.

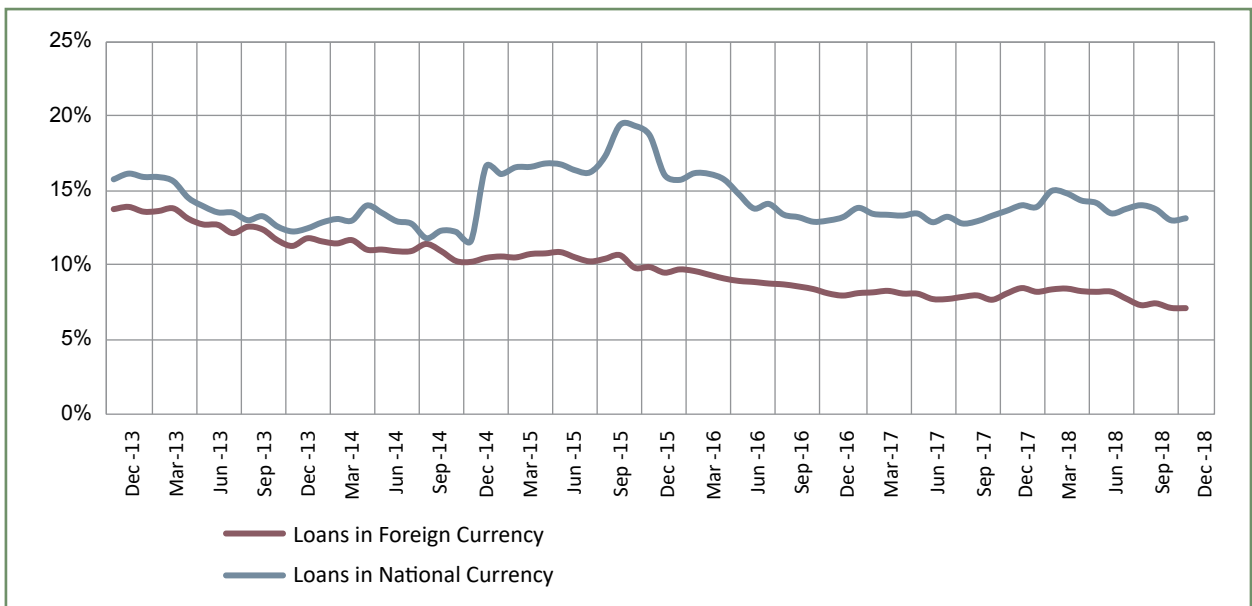
Interest rates in the corporate segment were stable, while interest rates in the SME and retail segments slightly decreased in 2018 compared to the previous year. Interest rates decreased for both foreign currency and lari loans, but the key driver for the retail segment was the decrease in interest rates on euro-denominated loans.

**Diagram 4.2 Monthly weighted average interest rates on loans per segment**



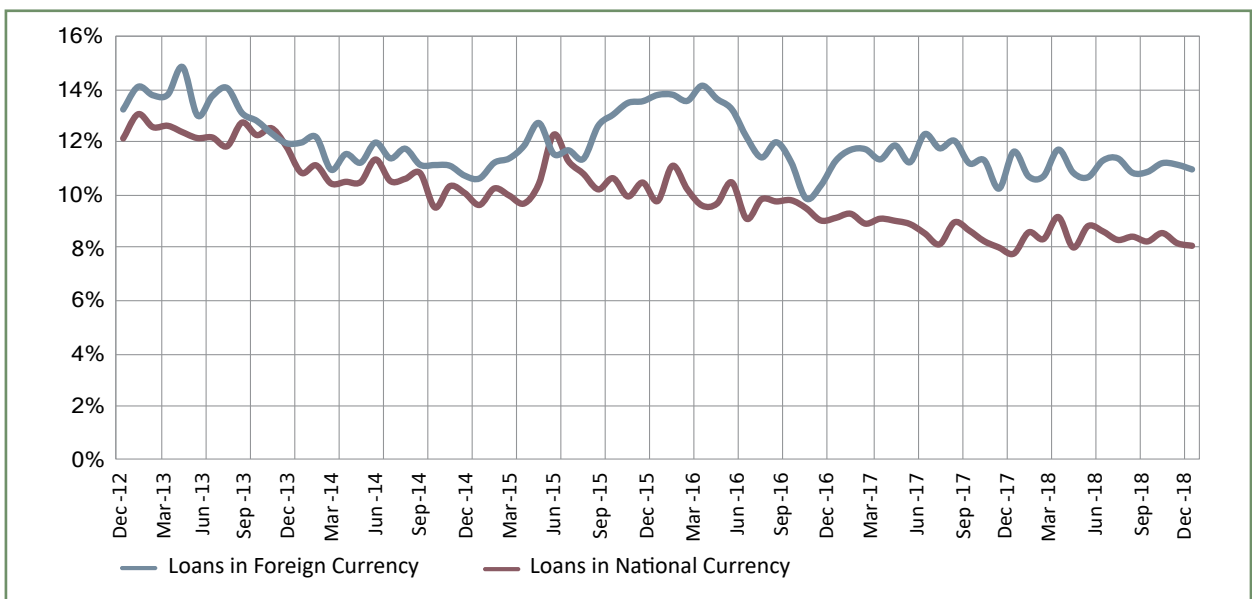
Source: National Bank of Georgia

**Diagram 4.3 Monthly weighted average interest rates on loans for the corporate segment**



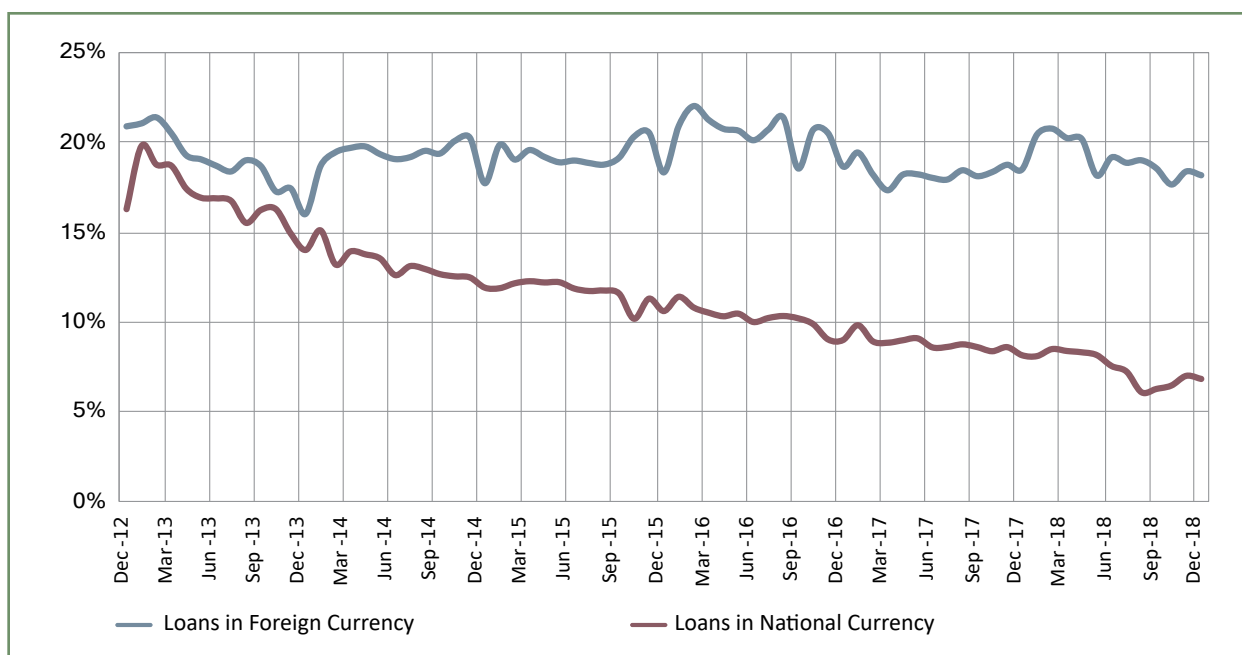
Source: National Bank of Georgia

**Diagram 4.4 Monthly weighted average interest rates on loans for the SME segment**



Source: National Bank of Georgia

**Diagram 4.5 Monthly weighted average interest rates on loans for the retail segment**

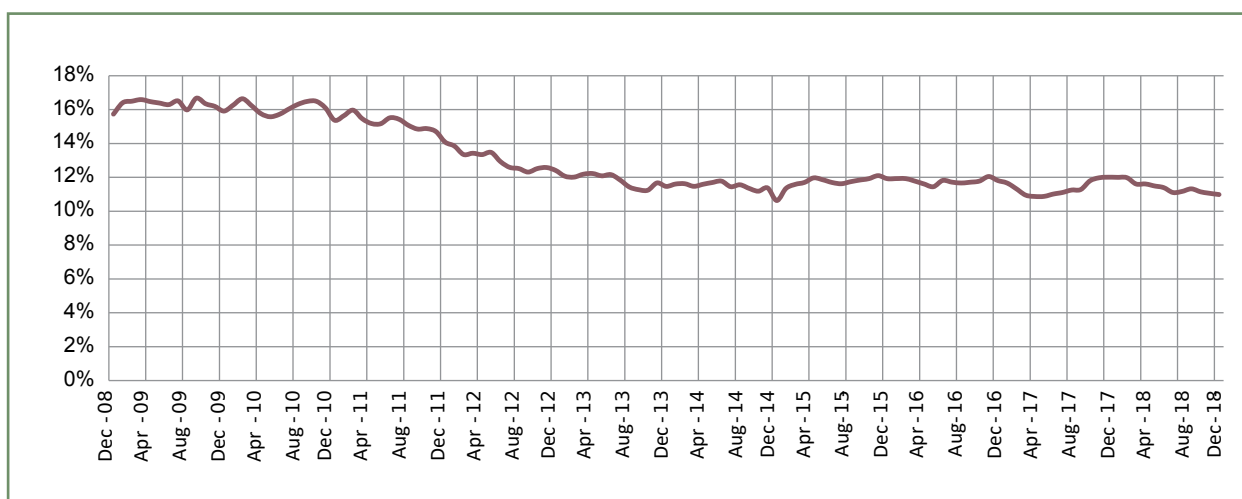


Source: National Bank of Georgia

The sectoral distribution of the loan portfolio is diversified. Throughout 2018, the share of pro-cyclical sectors<sup>30</sup> (real estate development, real estate management, production and trade of construction materials, production and trade of dura-

ble goods, and automobile dealers) in the banking sector’s loan portfolio remained moderate and stable (see Diagram 4.6). The high volume of loan loss reserves in some sectors was largely caused by idiosyncratic events<sup>31</sup> (see Table 4.2).

**Diagram 4.6 Share of pro-cyclical sectors in the gross loan portfolio**



Source: National Bank of Georgia

30. Sectors that are characterized by a high positive correlation with economic growth.

31. Individual events characteristic of the sector that are not of a systemic nature.

**Table 4.2 Gross loan portfolio according to risk sector**

<b>Sector, Excluding Interbank Loans (Million Gel)</b>	<b>Share in Gross Portfolio</b>	<b>Loan Balance</b>	<b>Loan Reserve</b>	<b>Reserve to Portfolio</b>
State Organizations	0.0%	3	0.1	2.1%
Financial Institutions	1.6%	422	9	2.2%
Pawn-shop Loans	2.0%	531	26	4.9%
Real Estate Development	2.2%	597	50	8.4%
Real Estate Management	4.6%	1,235	50	4.0%
Construction Companies (non-developers)	1.9%	507	48	9.4%
Production and Trade of Construction Materials	2.7%	712	26	3.7%
Trade of Consumer Goods	3.7%	990	44	4.4%
Production of Consumer Goods	3.9%	1,031	59	5.7%
Production and Trade of Durable Goods	0.8%	225	9	4.2%
Production and Trade of Clothes, Shoes and Textiles	0.6%	150	6	3.9%
Trade (Other)	3.9%	1,036	53	5.1%
Production (Other)	3.0%	793	34	4.3%
Hotels and Tourism	4.2%	1,117	43	3.8%
Restaurants, Bars, Cafes and Fast Food Outlets	1.2%	331	18	5.3%
Heavy Industry	1.7%	450	18	4.1%
Oil Importers and Retailers	1.1%	284	14	4.9%
Energy	3.7%	982	31	3.1%
Automobile Dealers	0.6%	153	27	17.6%
Healthcare	1.9%	505	13	2.7%
Pharmacy	0.4%	115	9	7.8%
Telecommunication	1.6%	415	12	2.9%
Service	4.4%	1,166	57	4.9%
Agriculture	4.9%	1,307	68	5.2%
Other (Including scrap-metal)	2.0%	531	55	10.3%
<b>Retail</b>	<b>41.4%</b>	<b>11,010</b>	<b>521</b>	<b>4.7%</b>
Car Loans	0.3%	76	3	4.4%
Consumer Loans	15.3%	4,062	238	5.9%
Instant Installments	1.2%	329	32	9.7%
Payrolls (Overdrafts)	0.3%	74	6	8.2%
Credit Cards	2.1%	554	32	5.8%
Loans for House Renovations	1.8%	470	15	3.2%
Mortgage Loans	20.5%	5,444	194	3.6%
<b>Total Credit Portfolio (Deducted Interbank Loans)</b>	<b>100.0%</b>	<b>26,597</b>	<b>1,300</b>	<b>4.9%</b>

Source: National Bank of Georgia

In recent years, the National Bank of Georgia has taken measures in response to the increased number of financial sector loans that had been issued without financial analysis. As a result of amendments made to the "Regulation on Assets Classification and the Creation and Use of Reserves for Losses by Commercial Banks", limits on the PTI and LTV ratios for "standard" category loans were determined. In the event of non-compliance with these ratios, banks have to increase the required capital. According to these changes, the risk weight was doubled for non-collateralized retail loans that do not comply with these ratios. Those amendments ensured the accumulation of capital buffers on behalf of increased retail lending in banks and increased the ability to absorb shocks caused by credit risk in the banking sector. Despite the decreased risk as a result of increased capital buffers, those changes did not stop a large increase in retail lending. Over-indebtedness has remained an unsolved problem because the NBG's mandate was only applicable to the banking sector.

Expanding the supervisory authority of the NBG over both banking and non-banking financial sectors was critically important in order to effectively manage supervisory activities. In response to this challenge, in 2018 the NBG actively worked on retail lending guidelines, under which all loan issuers would be overseen by the National Bank of Georgia and equal requirements would be set for all major financial sector players to ensure healthy credit standards. As work on the guidelines required in-depth analysis and consensus from all stakeholders, the NBG implemented a number of interim measures in order to establish healthy lending

practices before the completion of the guidelines.

On 17 April 2018, Order N49/04 was issued by the Governor of the National Bank of Georgia amending the June 2014 "Regulation on Credit Concentration and Large Risks in Commercial Banks". According to the changes,

- the total amount of loans issued without financial analysis (aside from loans collateralized with precious stones, metals or immovable property) must not exceed 25% of the bank's supervisory capital;
- the total amount of all loans secured by immovable property, which are issued by banks without a full-fledged analysis of the solvency of the borrower/co-owner, shall not exceed 15% of the bank's supervisory capital. At the same time, during the disbursement of loans without financial analysis, the LTV ratios must not exceed 50% (except in the case of restructuring when the borrower does not increase the loan amount. An increase of the loan amount does not include capitalization of the accrued interest, penalty/fines or other amounts).

As a result of the amendments, the growth rate of retail products decreased. In terms of instant installments, credit cards and auto loans, the annual change was negative, and consumer credit growth was substantially reduced. The main driver of the growth of retail products was mortgage loans. A reduction of interest rates (especially for euro loans), loosened lending standards and grace periods offered as a result of aggressive marketing campaigns all led to the high growth rate.

**Table 4.3 Growth of retail products adjusted for the exchange rate effect (exchange rate as of the end of 2017)**

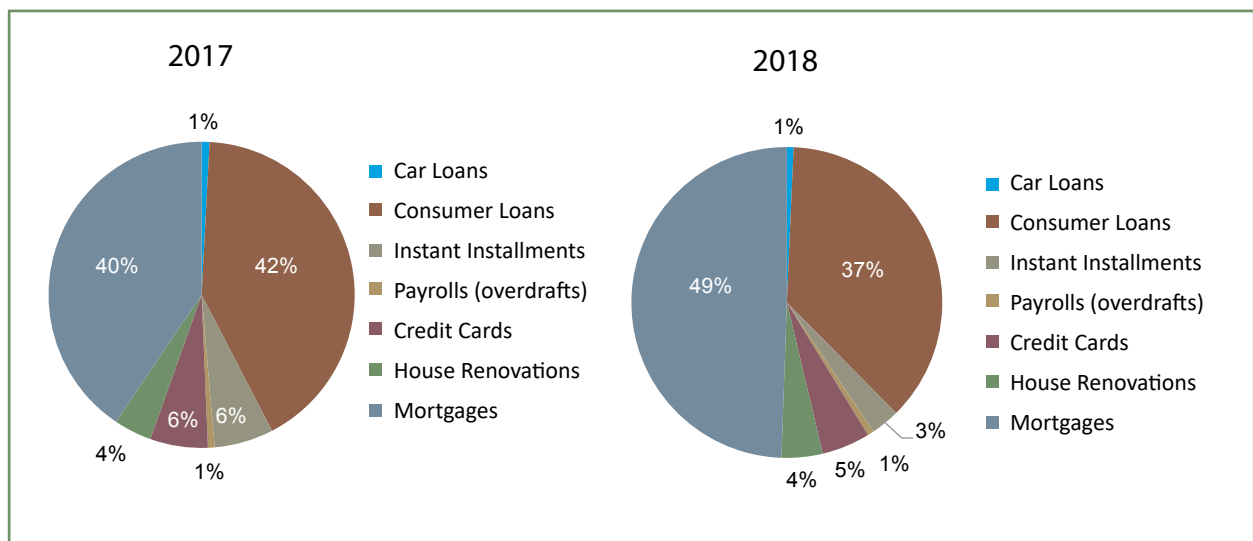
Product	Dec. '17		Dec. '18		Change %	Change mln GEL	GEL Change % (Adjusted for exchange rate and reclassification effects)
	mln GEL	Share, %	mln GEL	Share, %			
Retail products	9,464	100%	10,894	100%	15%	1,430	19.4%
Car Loans	79	1%	76	1%	-4%	-3	-3.7%
Consumer Loans	3,934	42%	4,042	37%	3%	108	12.3%
Instant installments	591	6%	329	3%	-44%	-261	-44.2%
Payrolls (overdrafts)	67	1%	74	1%	10%	7	10.2%
Credit Cards	578	6%	554	5%	-4%	-24	-4.1%
Loans for House Renovations	379	4%	464	4%	22%	85	22.5%
Mortgage Loans	3,838	41%	5,355	49%	40%	1,517	39.6%

Source: National Bank of Georgia

The structure of the retail products portfolio has also changed in comparison with the previous year. The share of mortgage loans in the portfolio increased

significantly and the share of consumer loans was reduced.

**Diagram 4.7 Retail products distribution, December 2017-2018**



Source: National Bank of Georgia

On 24 December 2018, according Order N281/04 of the Governor of the National Bank of Georgia the “Retail Lending Guideline” was approved and entered into force on 1 January 2019. With this occurring, the above mentioned interim amendments to the “Regulation on Credit Concentration and Large Risks in Commercial Banks” were abolished. The “Retail Lending Guideline” is based on the principles of responsible lending, which imply the use of standards in the lending process that enable borrowers to

pay loans without financial difficulties. The regulation is applied to individuals (including to sole proprietors) if the borrowers’ total exposure does not exceed 2 million GEL. The analysis of borrowers’ creditworthiness has become mandatory with the enactment of the guideline, which entails the in-depth evaluation of income, expenses and liabilities. At the same time, maximum limits on the payment-to-income and loan-to-value ratios were established for all loan-issuing organizations.

**Table 4.4 Limits of payment-to-income ratios according to the “Retail Lending Guideline”**

Monthly net income, GEL	Maximum/contractual maturity for a non-hedged borrower	Maximum/contractual maturity for a hedged borrower
<1,000	20% / 25%	25% / 35%
>=1,000-2,000<		35% / 45%
>=2,000-4,000<	25% / 30%	45% / 55%
>=4,000	30% / 35%	50% / 60%

**Table 4.5 Limits of loan-to-value ratios according to the “Retail Lending Guideline”**

Lari loans	85%
Foreign currency loans	70%

The payment-to-income ratio is calculated based on the contractual and maximum maturities, which vary according to the retail products: standing at 15 years for mortgage loans, 10 years for consumer loans collateralized with real estate, 6 years for car loans and 4 years for uncollateralized consumer loans (except for revolving loans). Aside from the ratios, the loan-issuing entities must ensure a loan underwriting process so that the difference between the borrower’s monthly income and loan payments must be higher than the subsistence minimum as defined by the National Statistics Office of Georgia.

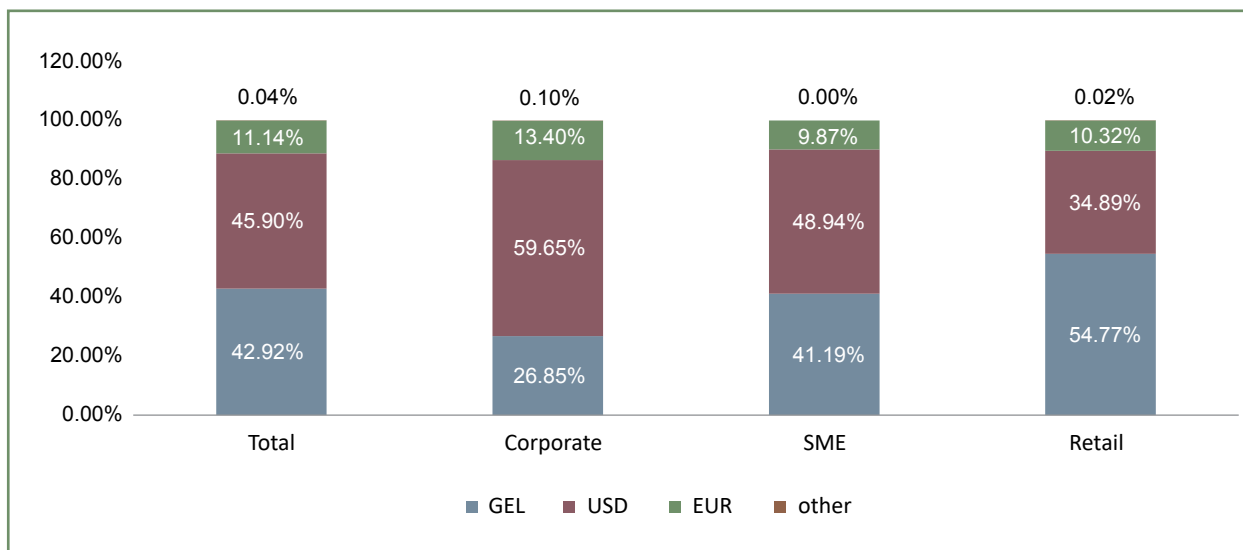
Issuing collateralized loans without solvency analysis has become prohibited. In exceptional cases, it is

permissible to underwrite a loan without solvency analysis if, due to objective reasons, it is difficult to analyze a borrower’s creditworthiness and if loans are collateralized with movable property or real estate and the borrower makes at least a 40% down payment of the collateral value.

However, it should be mentioned that all loans issued without solvency analysis are subject to the so-called “non-recourse” principle. According to this principle, in the event of default, a creditor’s claim shall be considered satisfactory only by the actions (including property realization and/or reciprocity) undertaken by the legislation of Georgia with respect to collateral.

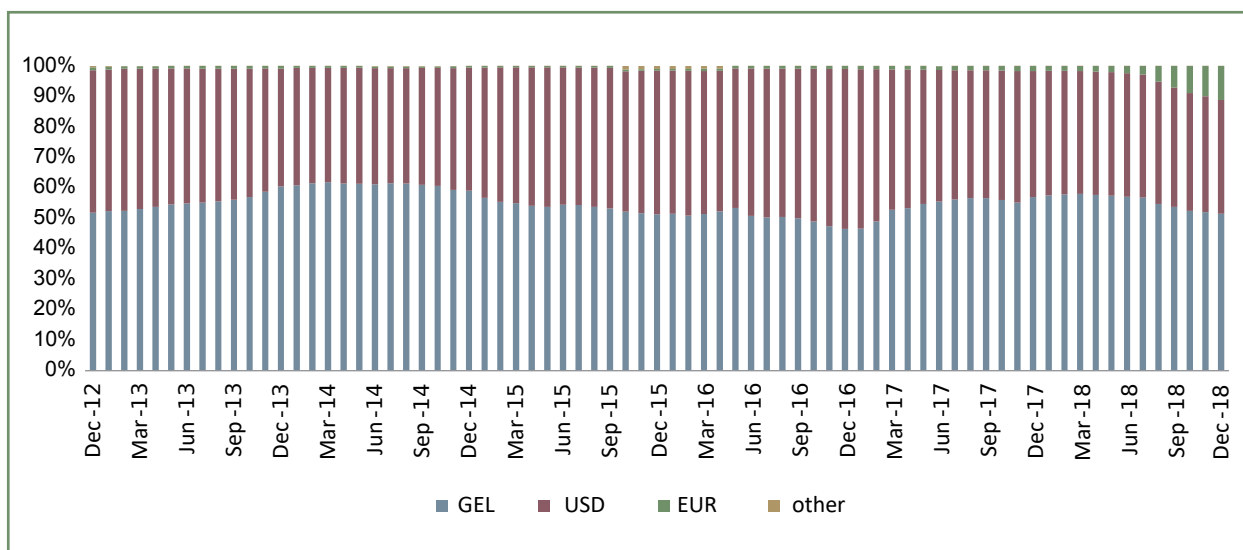


**Diagram 4.8 Loan segments by currency (excluding interbank loans), December 2018**



Source: National Bank of Georgia

**Diagram 4.9 Retail portfolio composition by currency (excluding interbank loans)**



Source: National Bank of Georgia

By the end of 2018, the quality of the loan portfolio was satisfactory.

**Table 4.6 Gross loan portfolio by risk classification**

Risk category (excluding interbank loans)	Amount (mln GEL)	Share %	Reserve
Standard	24,005	90.3%	2%
Negative Loans	2,592	9.7%	30%
Watch	1,112	4.2%	10%
Non-performing	1,480	5.6%	46%
Substandard	769	2.9%	30%
Doubtful	290	1.1%	47%
Loss	421	1.6%	74%
<b>Total:</b>	<b>26,597</b>	<b>100%</b>	<b>5%</b>

Source: National Bank of Georgia

The quality of the portfolio varies significantly by segment. Historically, losses of the corporate loans segment have been noticeably higher than SME and retail loan portfolio losses. Comparing the qualitative parameters according to segment shows this clearly (see Table 4.7). The main reasons behind the improvements to portfolio quality were the increased total loan portfolio and the improved situ-

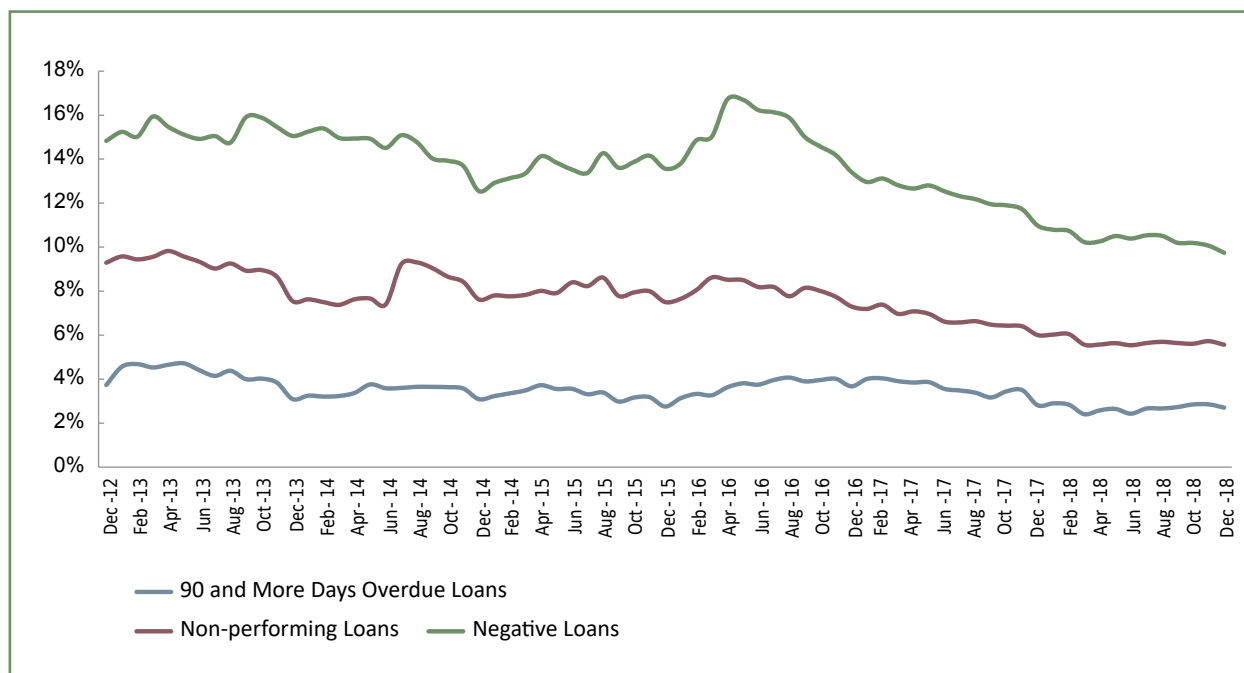
ation in neighboring countries. In the case of the corporate loan portfolio, improvements related to idiosyncratic cases were also observed. More specifically, the financial situation of several important corporate clients improved. This was followed by a decrease in the provision of their loans, which led to a one-time increase in banks' incomes.

**Table 4.7 Portfolio quality by segment**

Segment	Negative Loans	Non-performing Loans	Average reserve
Corporate	14.00%	6.97%	5.46%
SME	9.29%	6.15%	4.68%
Retail	7.12%	4.29%	4.62%

Source: National Bank of Georgia

**Diagram 4.10 Loan portfolio composition by qualitative indicators (excluding interbank loans)**

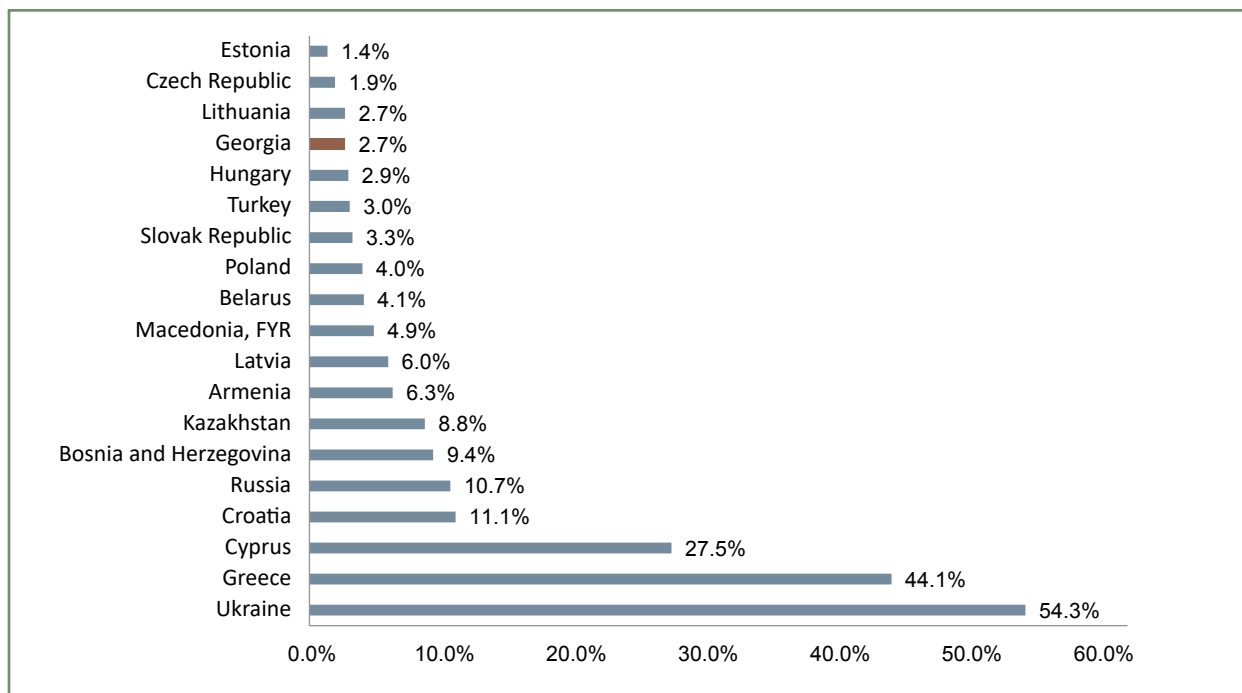


Source: National Bank of Georgia

The share of loans past due for 90 or more days in the gross loan portfolio (excluding interbank loans) amounted to 2.71%, which is one of the best results among comparable countries. However, it should be

noted that these numbers do not take into consideration the different standards for registering restructuring/refinancing that different countries may use.

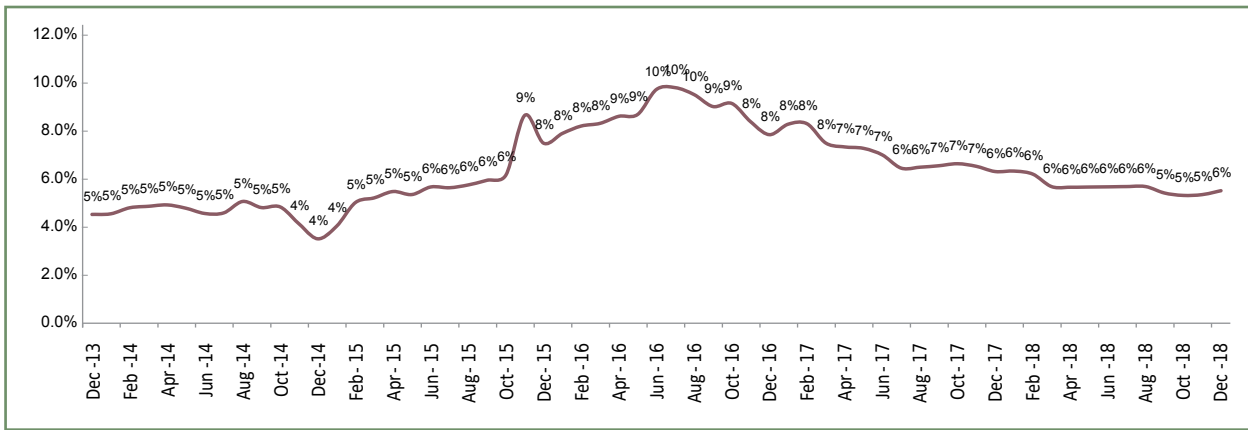
**Diagram 4.11 Overdue loans of 90 days or more<sup>32</sup>**



Source: National Bank of Georgia; International Monetary Fund

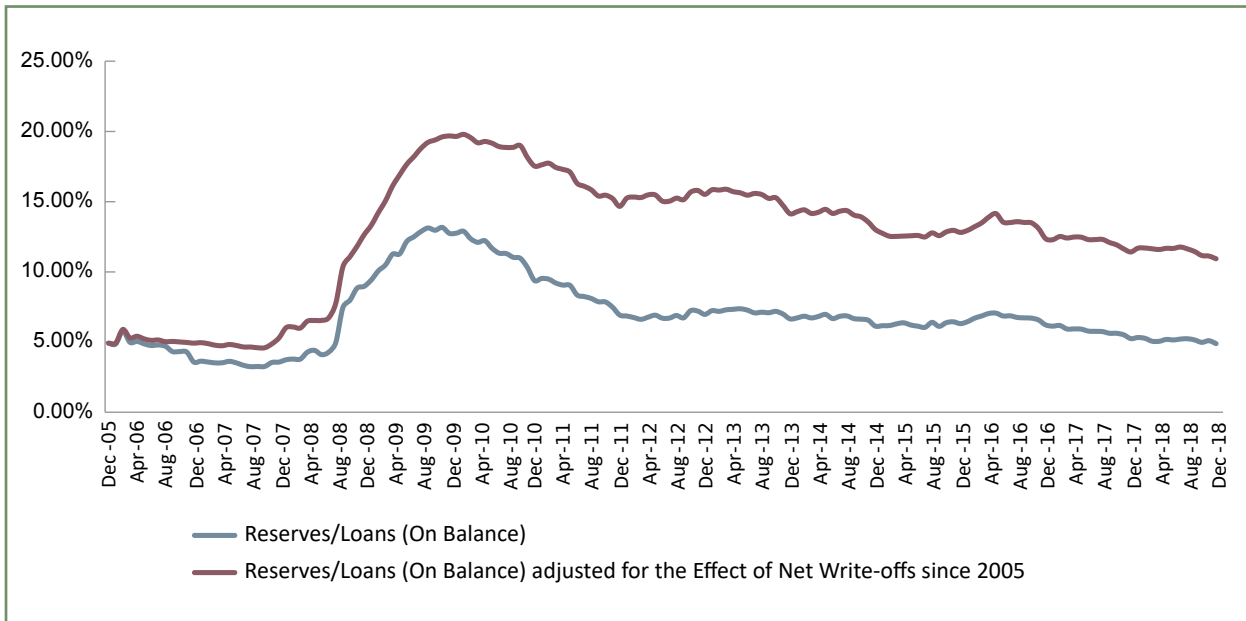
32. Data from the end of 2018. Although the latest available data are used, several months' difference may be observed.

**Diagram 4.12 The share of restructured loans in the gross loan portfolio**



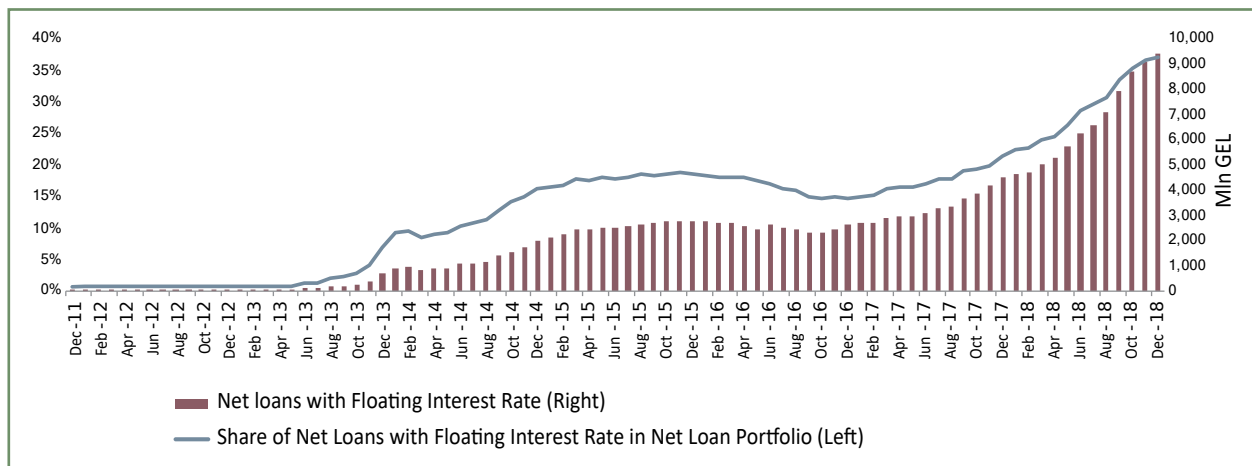
Source: National Bank of Georgia

**Diagram 4.13 The ratio of loan loss reserves to gross portfolio**



Source: National Bank of Georgia

**Diagram 4.14 Volume and share of net floating interest rate loans in the net loan portfolio<sup>33</sup>**

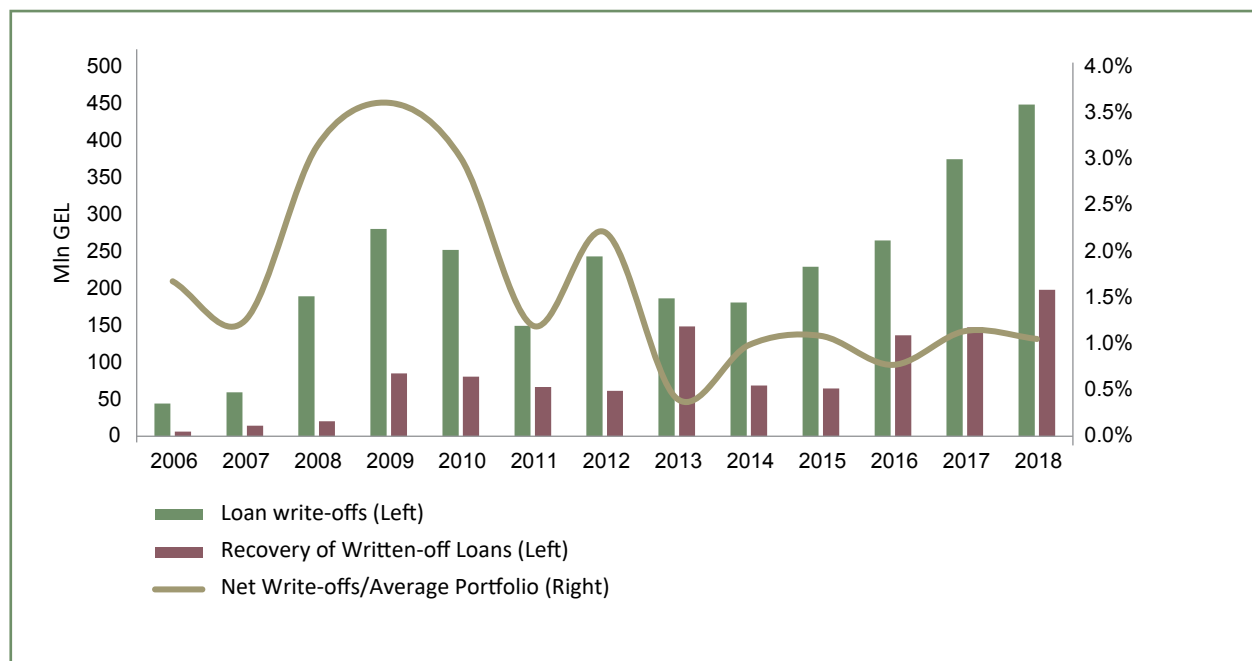


Source: National Bank of Georgia

In 2018, the net value of written-off loans increased by 10.5% compared to the corresponding figure from 2017. An increase was observed in both write-

offs and the recovery of written-off assets, but the latter was considerably greater than the increase in write-offs.

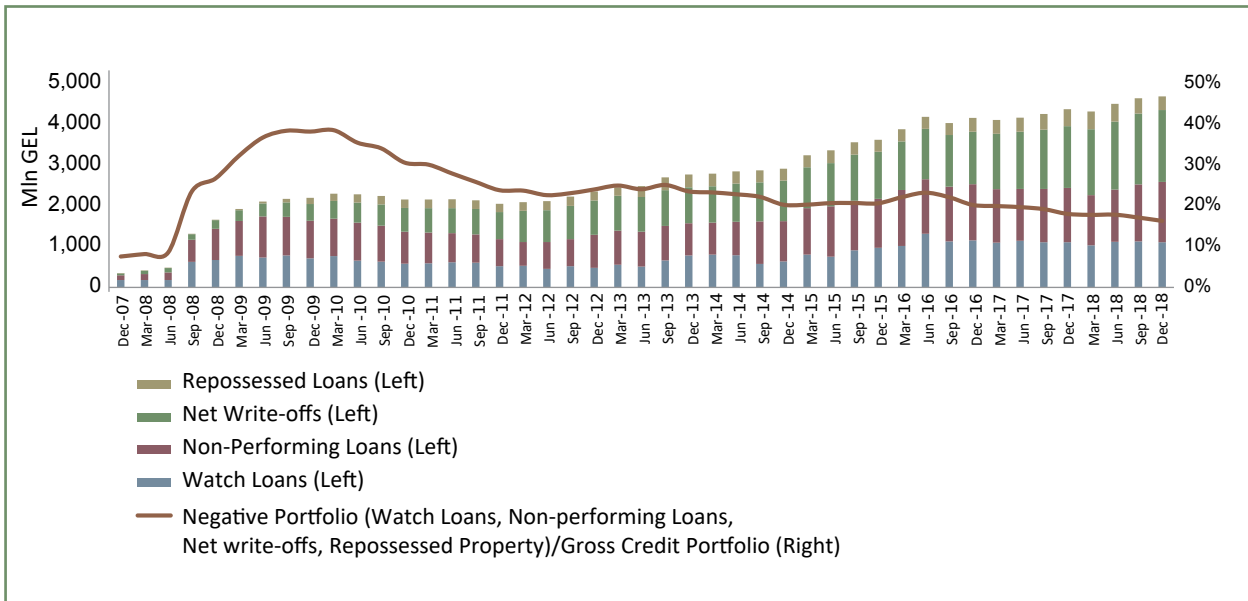
**Diagram 4.15 Write-offs and the recovery of loans**



Source: National Bank of Georgia

33. Net Loans – the volume of loans net of the loan loss reserve.

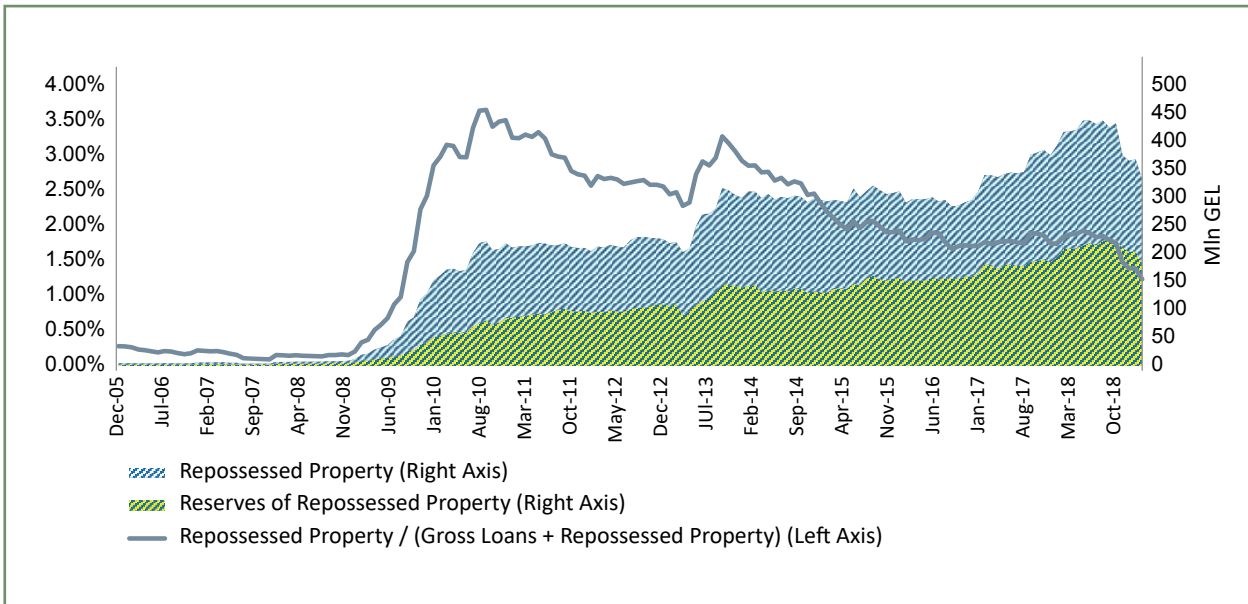
**Diagram 4.16 Problem assets**



Source: National Bank of Georgia

In 2018, the ratio of repossessed assets to the sum of loans and repossessed assets slightly decreased compared to 2017.

**Diagram 4.17 Repossessed property**



Source: National Bank of Georgia

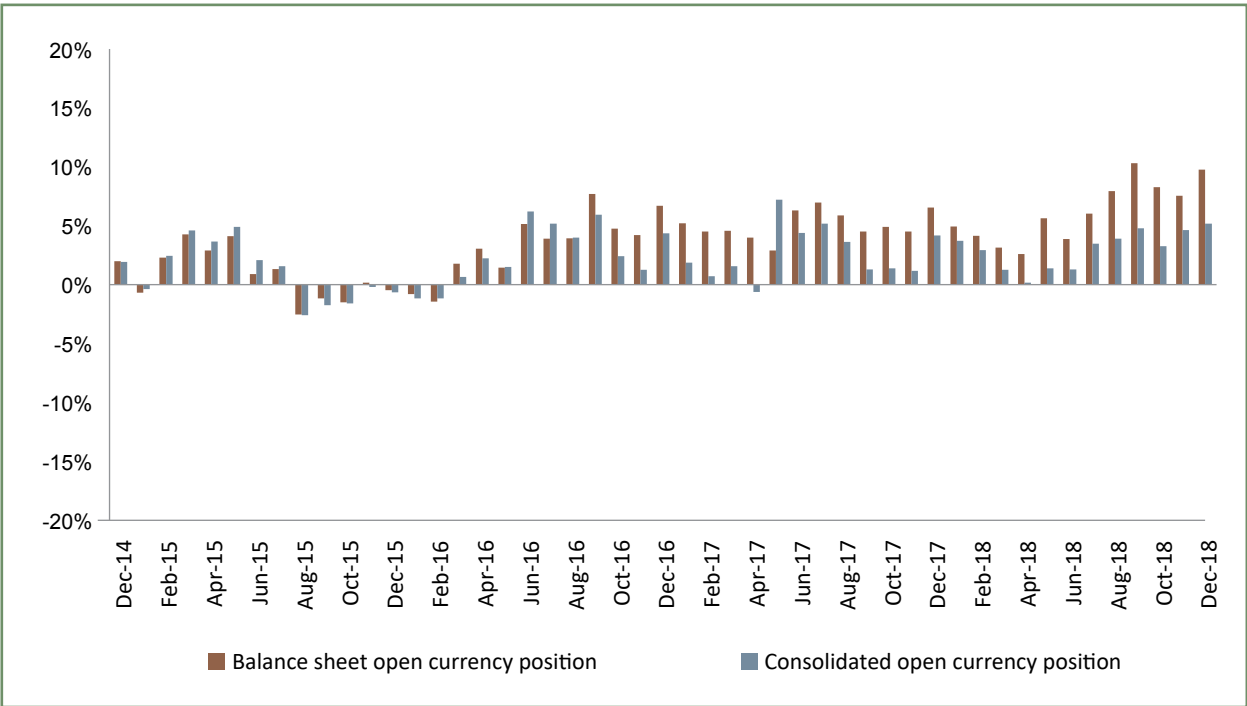
## 4.4 Market Risk

### 4.4.1 Foreign Currency Risk

The sensitivity of the Georgian banking system to FX risk is still high. Larization has been increasing in the medium term, however the share of foreign currency denominated assets and liabilities remains high. The NBG continues to direct its supervisory efforts towards improving existing approaches to foreign exchange risk management. Last year, the approach for the revaluation of foreign exchange asset loss reserves in an open currency position was reviewed and this will become fully compliant with international practice over the next two years. This process has gained even more importance due to the increased currency volatility in the countries of the region.

If we look at the open currency position calculated with the existing methodology, it is quite balanced on the systemic level. However, because gross loans (and not net loans) are factored in as assets when calculating the abovementioned position, and since loan loss reserves are formed in lari, banks' actual positions are short.<sup>34</sup> As a result, considering the revaluation of reserves, commercial banks are at a loss during periods of currency depreciation. Furthermore, because the share capital is denominated in lari, the revaluation of risk-weighted assets due to lari depreciation significantly reduces commercial banks' capital adequacy ratios, which further increases their vulnerability towards the risk. Currency-induced credit risk is a separate matter that remains a major challenge for the financial sector (this is discussed in detail in the Credit Risk section of this report).

**Diagram 4.18 Balance sheet and consolidated open currency positions to regulatory capital**



Source: National Bank of Georgia

34. In the event of a short currency position, foreign liabilities exceed foreign currency assets.

#### 4.4.2 Interest Rate Risk

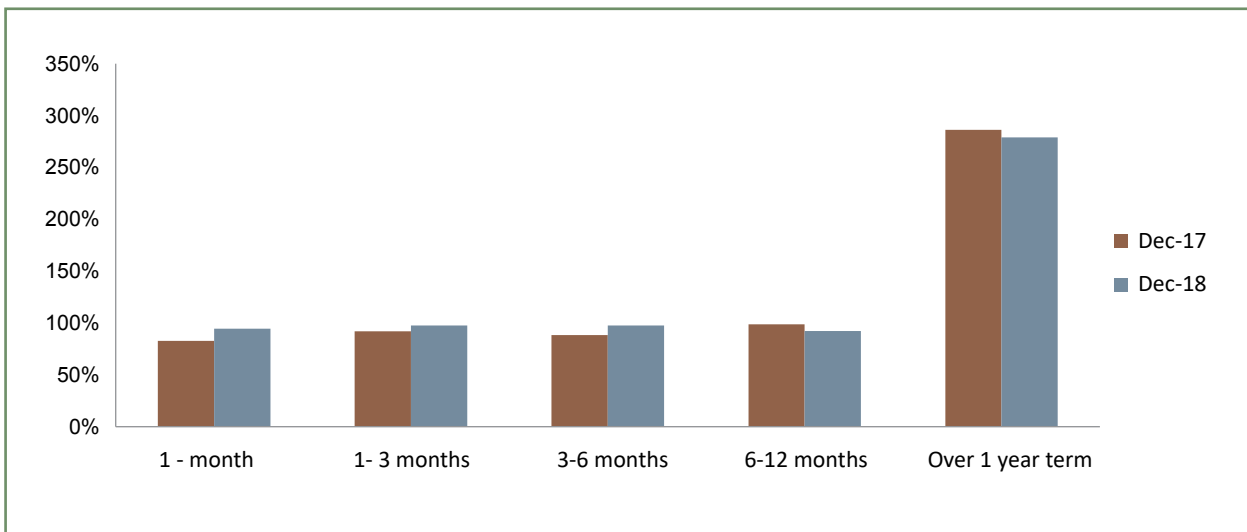
Similar to previous years, Georgian banks held almost no trading securities in 2018. In light of this, the banking book approach was used for the entire balance sheet for supervisory purposes. Nevertheless, the NBG requires that banks with trading books develop relevant procedures and report to the National Bank. When significant growth opportunities are identified as a result of monitoring, regulations for the management of trading books will be enforced.

All things being held constant, if interest rates on banks' interest-bearing assets and liabilities increase by 300 basis points, system-wide annual incremental losses will amount to 23 million GEL, while the regulatory capital adequacy ratio will decrease from 18.39% to 18.33%. This accounts for the balance sheet effect in the reporting period.

The influence of interest rate shocks on economic value is also noteworthy – although not directly reflected in profit and loss, this has an impact on a bank's market value. In this regard, based on existing assessments, the effect of a 400-basis-point interest rate growth in lari and a 200-basis-point interest rate growth in foreign currency on this measure is manageable and falls significantly behind the 20% threshold of regulatory capital established by international standards. Therefore, the latter does not pose a threat to the stability of the system.

Supervisory mitigation measures are applied to those banks that have high interest rate risks. When analyzing the interest rate risk stress scenario, attention is currently focused on risks of a hike in interest rates, especially considering increasing risk levels due to regional instability. It should also be noted that a rise of interest rates by the U.S. Federal Reserve System will have the effect of raising interest rates globally.

**Diagram 4.19 Interest bearing assets' coverage of liabilities**



Source: National Bank of Georgia

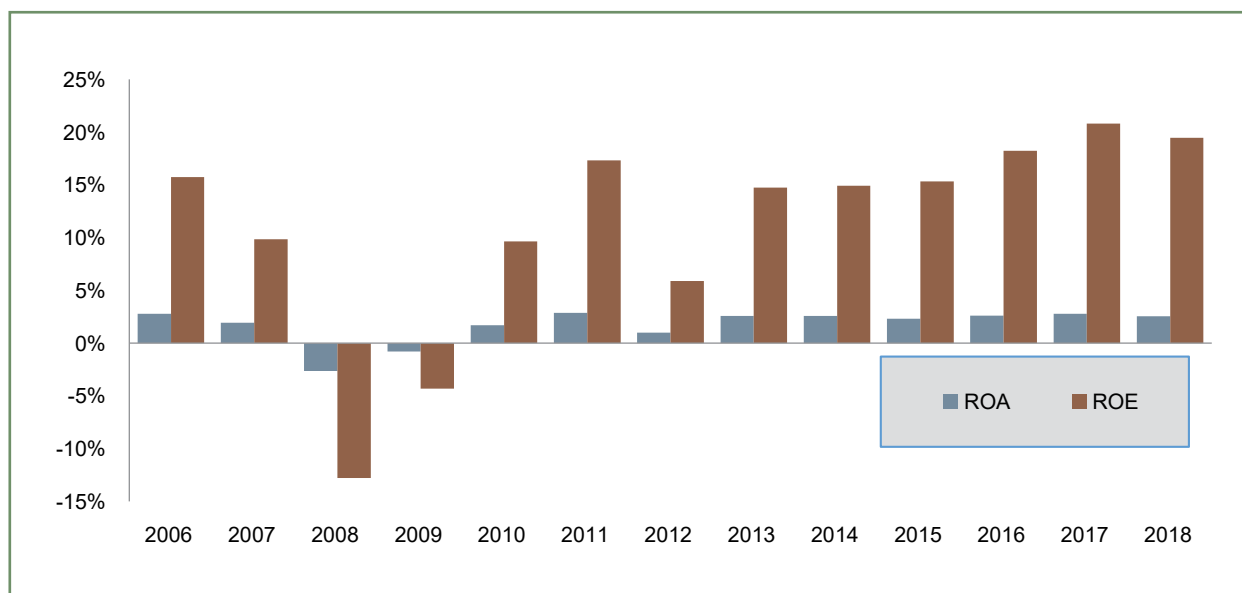


## 4.5 Profitability Risk

In 2018, the return on average assets and equity amounted to 2.5% and 19.5% respectively, which were similar to the same indicators from the previ-

ous year (2.8% and 20.8% respectively).<sup>35</sup> However, the rate of banking system profitability has remained stable in recent years and, in total, has approached the required return on equity for shareholders.

**Diagram 4.20 Return on assets and equity**



Source: National Bank of Georgia

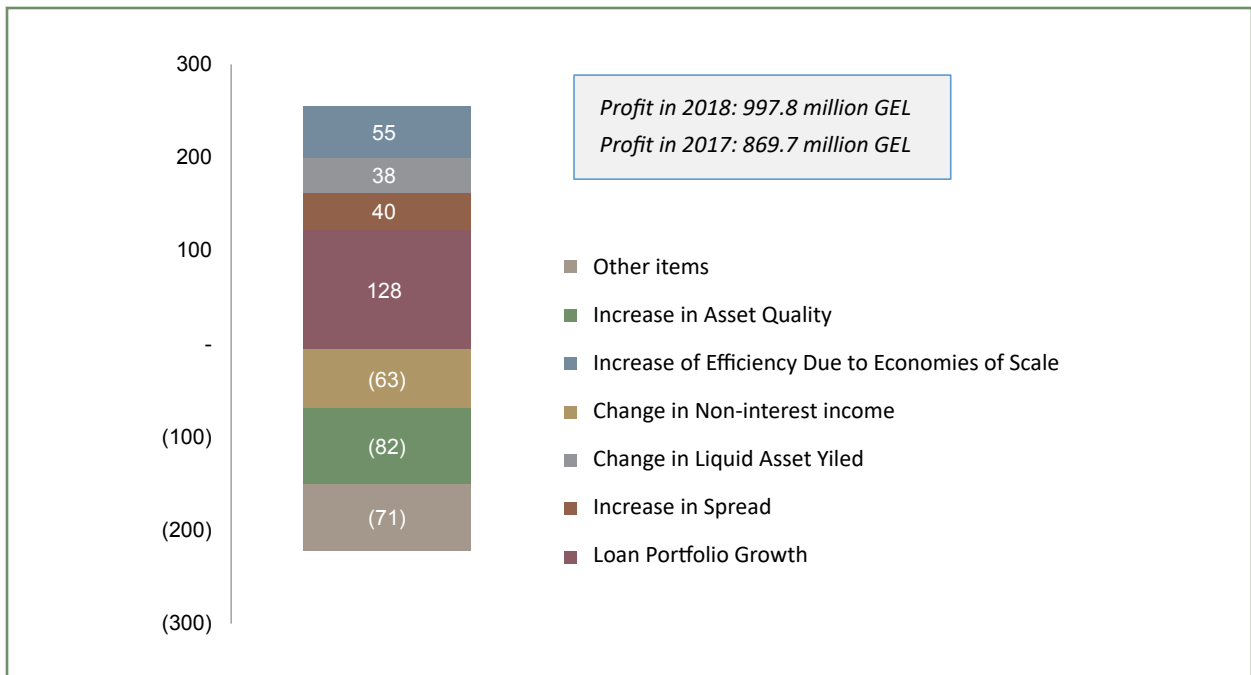
The profitability of the banking system was positively affected by the growth of assets and the subsequent increase in effectiveness due to economies of scale and the improved quality of assets. Considering the 14.7% growth of total assets and the 19.3% growth of total loans<sup>36</sup>, non-interest expenses increased by only 9.8%. The increase of efficiency was reflected in the cost-to-income ratio, which amount-

ed to 44.8%. On the other hand, the interest rate spread decreased in 2018 as a result of an increase in interest rates on funding. Non-interest income did not grow as much as the balance sheet expanded. In addition, the liquid asset yield increased as a result of the increase in interest income from interbank accounts and deposits, certificates of deposit and the higher profitability of Treasury bills.

35. Return on equity (ROE) is net income divided by the average yearly shareholder's equity. Return on assets (ROA) is net income divided by average yearly total assets. Net income is calculated by taking revenues and subtracting non-interest expenses, loans and other financial assets' loss provisions, after extraordinary revenues and taxes.

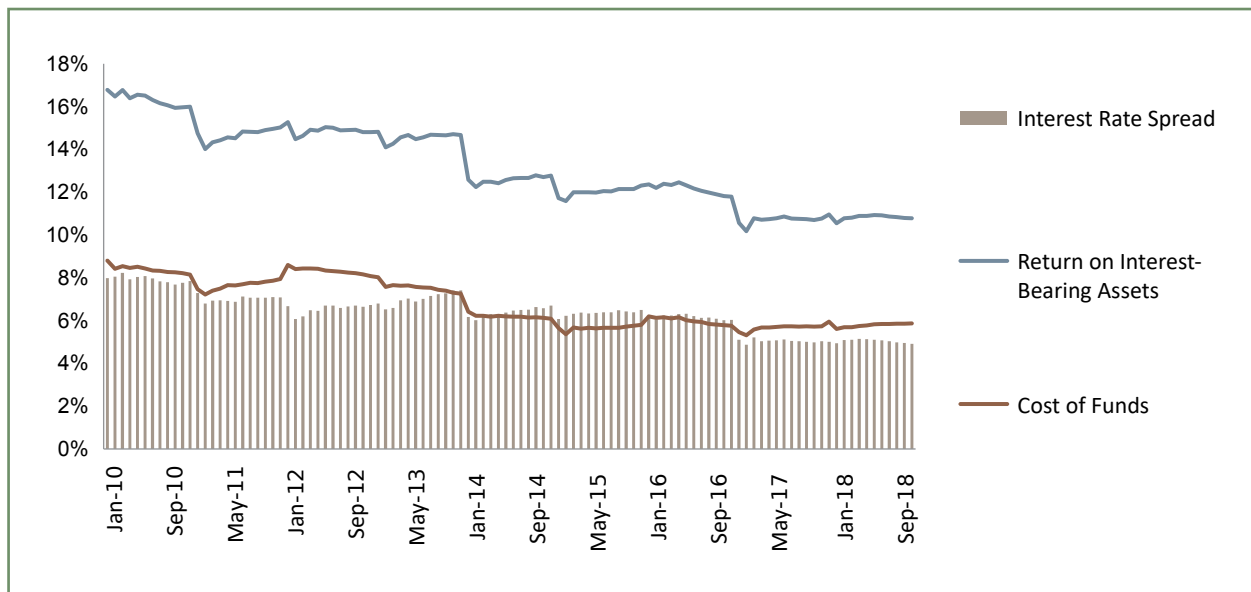
36. Including the exchange rate effect.

**Diagram 4.21 Decomposition of profitability growth**



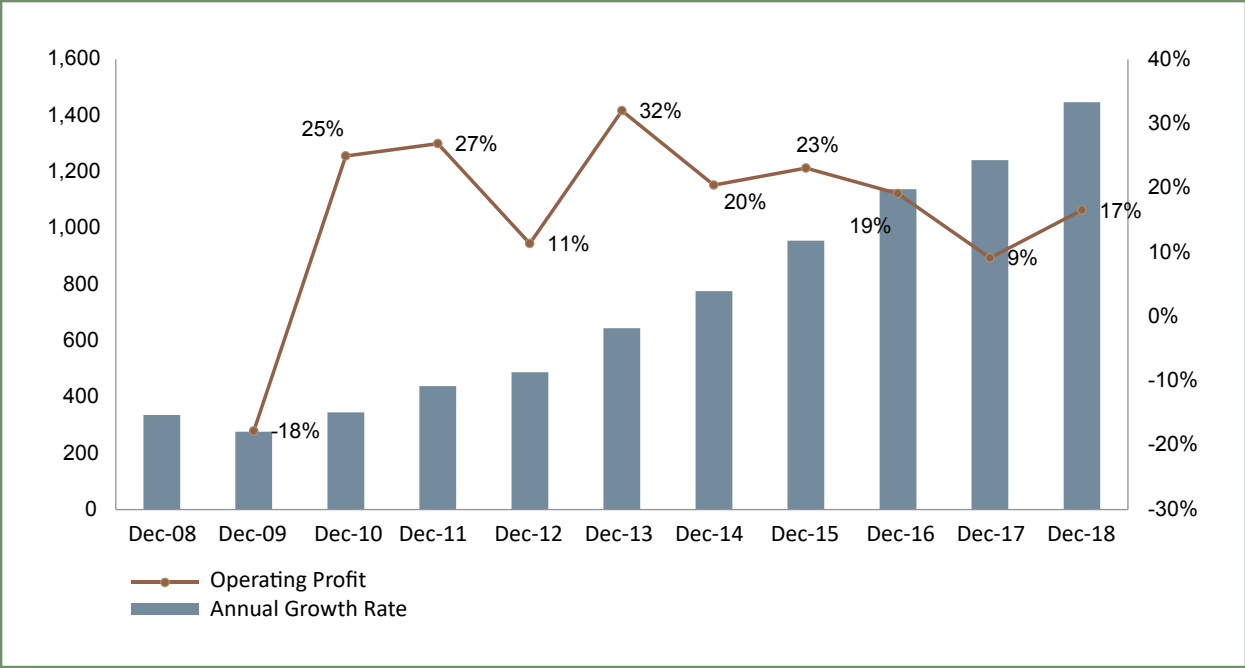
Source: National Bank of Georgia

**Diagram 4.22 Interest spread and factors affecting it**



Source: National Bank of Georgia

**Diagram 4.23 Banking system net operating profit and annual growth<sup>37</sup>**



Source: National Bank of Georgia

It must be pointed out that, despite historically high losses from the business portfolio and the high level of credit risk stemming from a possible currency depreciation, interest rates on corporate loans have remained at historically low levels. The second half of 2018 was distinguished by massive offers of euro-denominated mortgage loans and, during the peak period, interest rates even fell to 4%, which, considering the risks, is inadequately low for the region. The main reason for this trend is the acute competition in the banking system, which may encourage individual banks to take excessive risks and may weaken their market posi-

tions in the future. Therefore, considering the risk-based supervisory principles, throughout 2018 significant resources were allocated to discussion of commercial banks' profitability forecasts and the analysis of individual institutions' business models and strategies; particular attention was paid to the scale effect, the existence of market niche and/or other competitive advantages, and the approximate evaluation of predicted loan losses. Supervisors also focused on risk mitigants, including the development of detailed pricing models for banking products.

37. Earnings before provision and non-recurring income/expense.

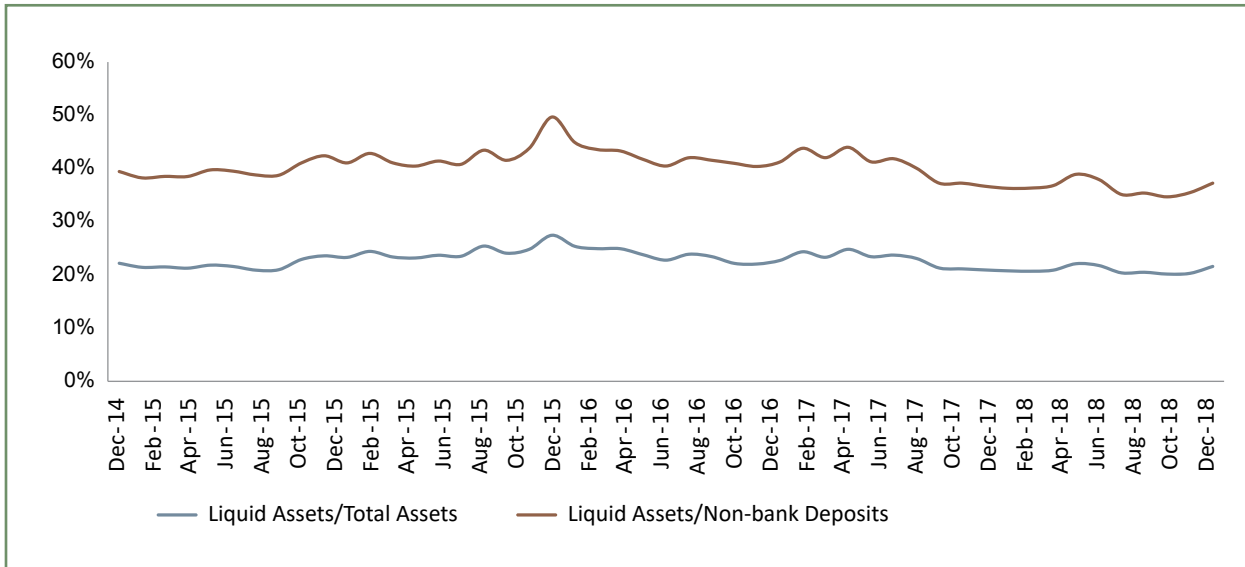
## 4.6 Liquidity Risk

### 4.6.1 Structure of Liquid Assets

Throughout 2018, the volume of liquid assets was high and was characterized by minor fluctuations.

Liquid assets constitute over 21% of total assets, which is sufficient to cover 37% of customer deposits.

**Diagram 4.24 Level of liquid assets**

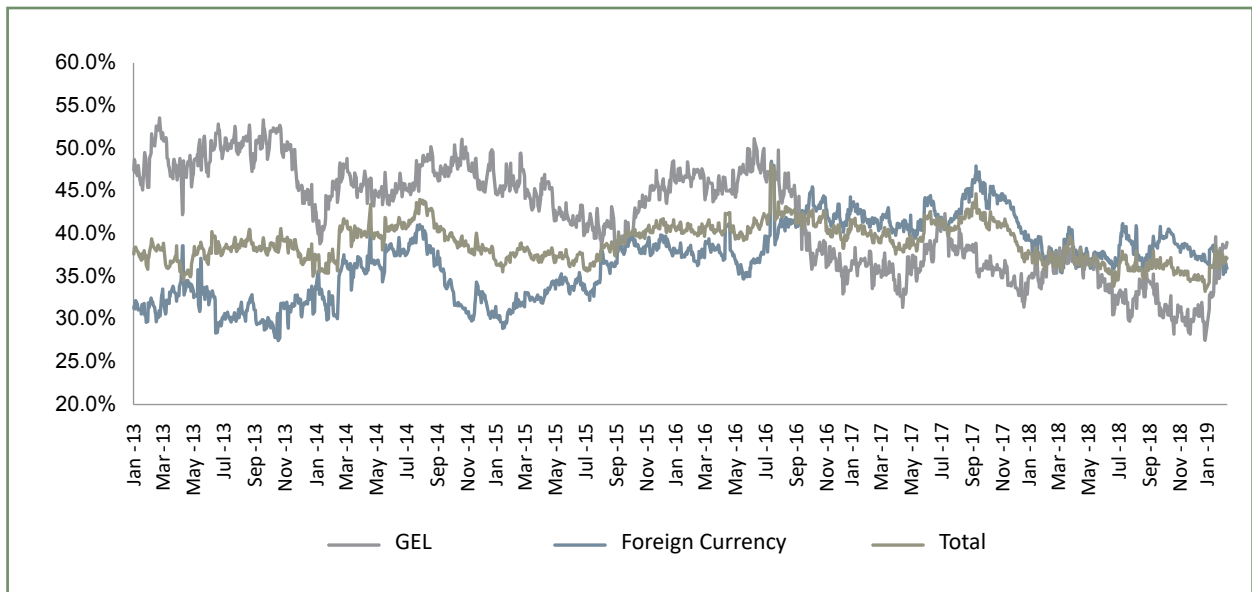


Source: National Bank of Georgia

Total liquidity remained stable at a high level in 2018. The foreign currency liquidity ratio remains high as a result of lower demand for foreign currency loans and increased minimum reserve requirements on FX liabilities. In addition, at the end of the year, banks attracted lari funding from a number of large legal entities, which has been re-

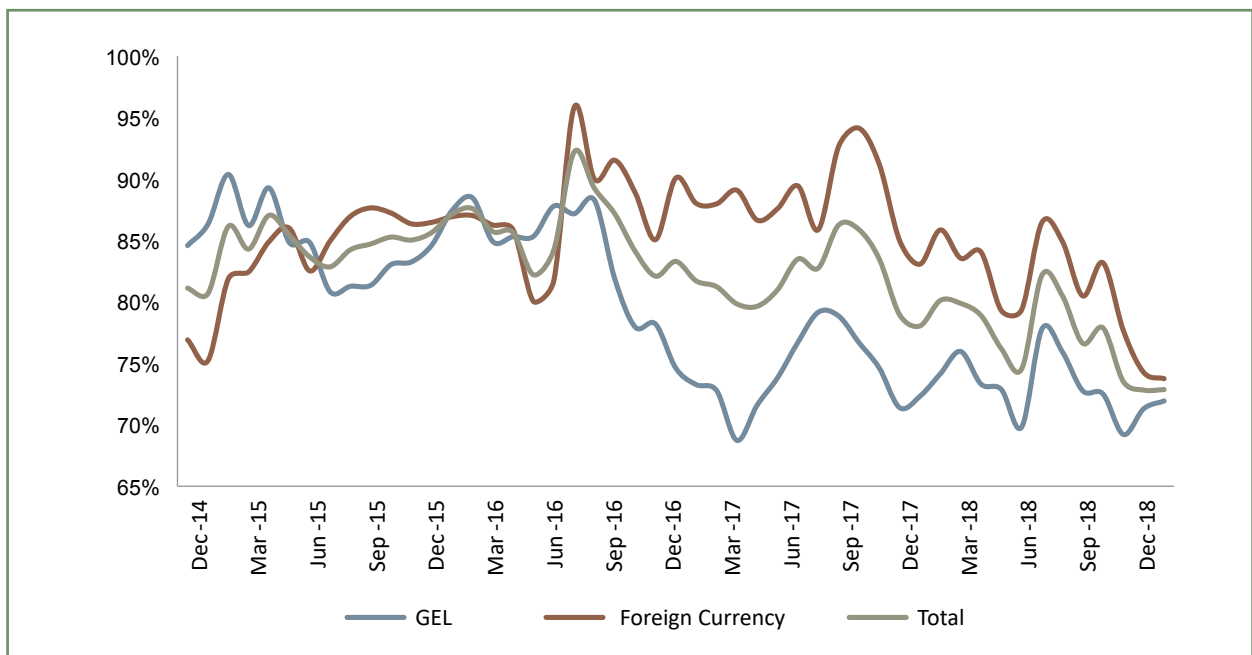
flected on lari and total liquidity levels. These dynamics were also reflected on the maturity gap of less than one month. The structure of liquid assets remains stable. Throughout 2018, like in previous years, the National Bank continued to monitor liquidity risk by currency.

**Diagram 4.25 Liquidity ratio by currency**



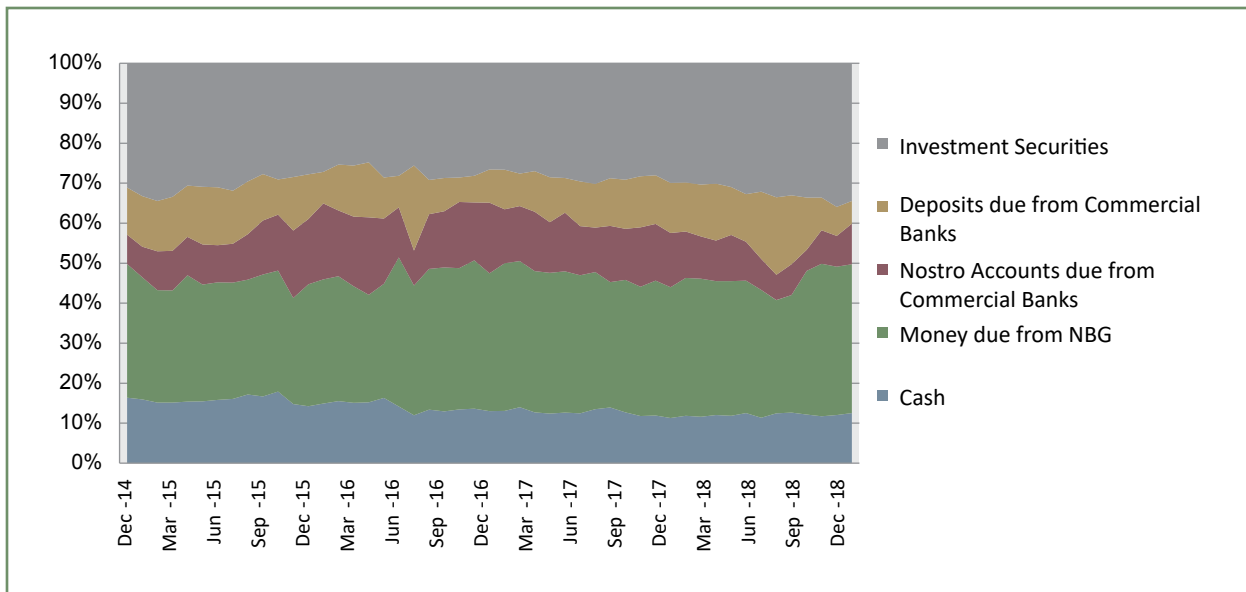
Source: National Bank of Georgia

**Diagram 4.26 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 4.27 Structure of liquid assets**



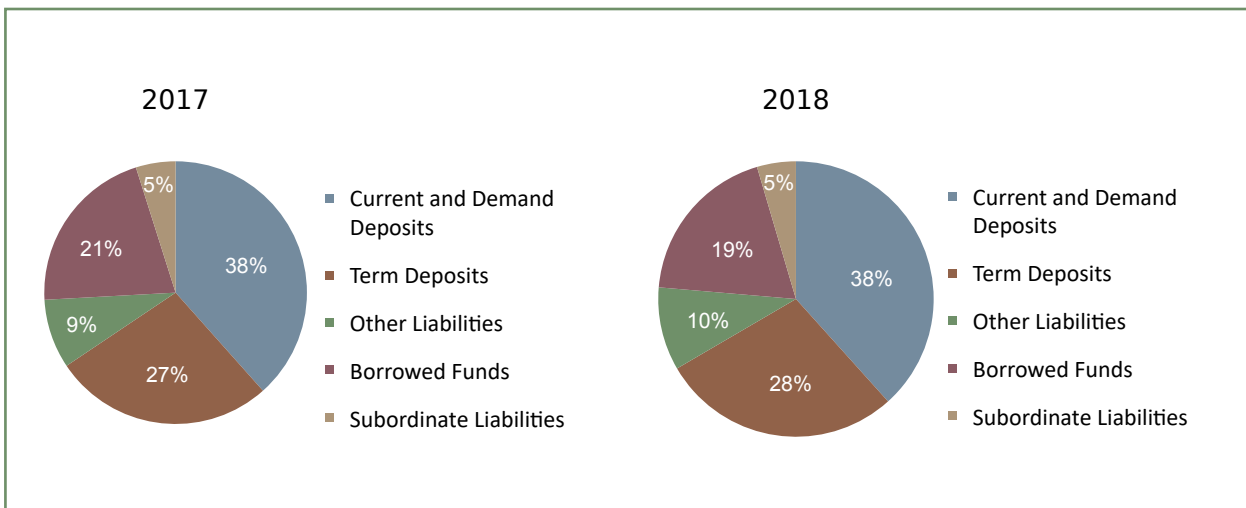
Source: National Bank of Georgia

### 4.6.2 Structure of Liabilities

The share of term deposits in the structure of liabilities increased slightly, while the share of

borrowed funds decreased. In addition, banks maintained a comfortable level of liquid assets corresponding to liability structure risks.

**Diagram 4.28 Liability structure**



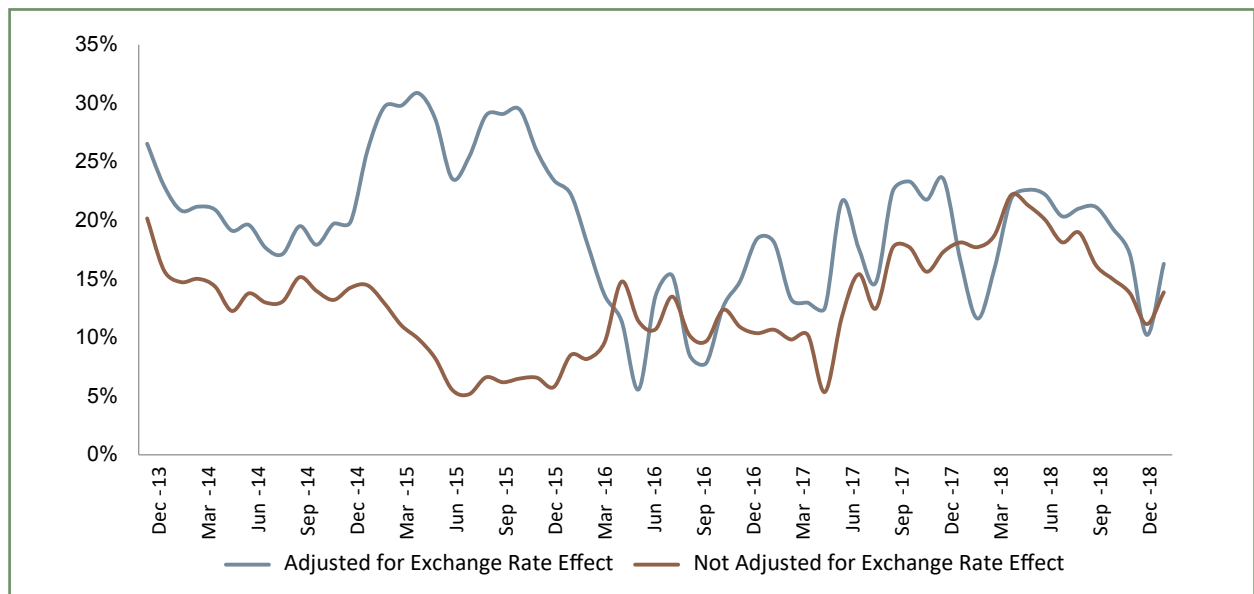
Source: National Bank of Georgia

### 4.6.3 Retail Funding

During 2018, the volume of deposits increased by 3.2 billion GEL (by 16.3%, or by 13.9% if adjusted for exchange rate effects) and totaled 23.0 billion GEL by December. In terms of depositors' structure, the growth of deposits by individuals

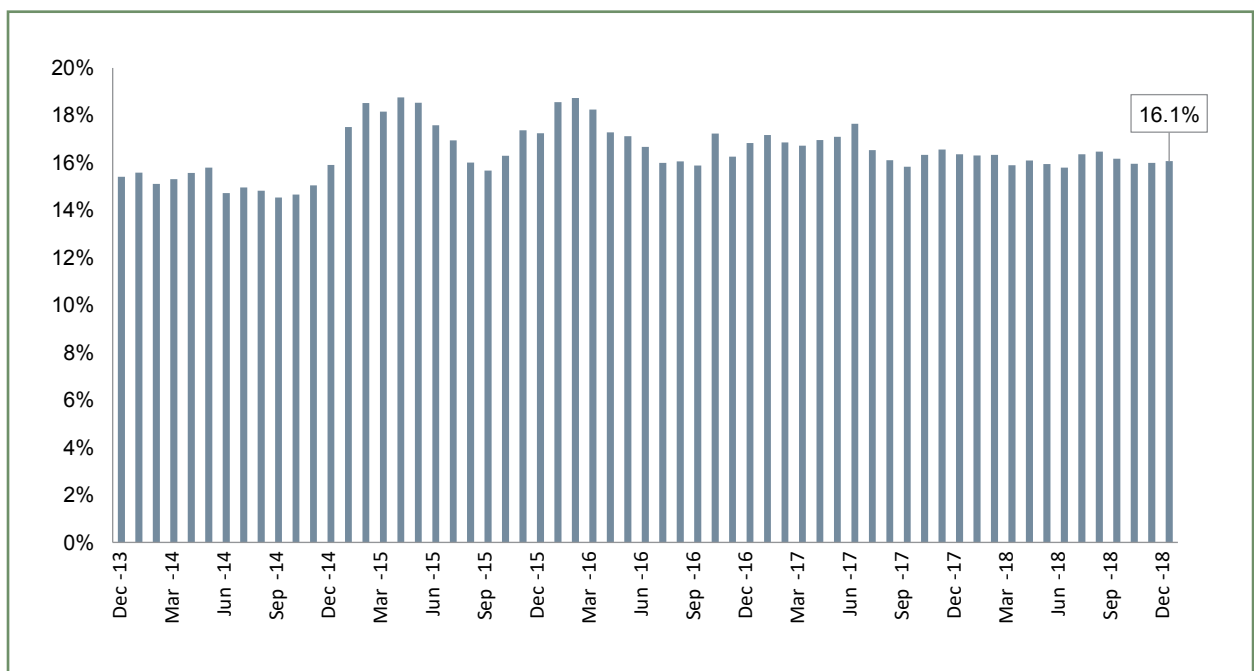
and legal entities amounted to 17.1% and 15.3% respectively (or by 14.3% and 13.4% respectively when adjusted for exchange rate effects). In 2018, the larization of deposits increased and reached 36.9% by December.

**Diagram 4.29 Annual growth of non-bank deposits**



Source: National Bank of Georgia

**Diagram 4.30 Share of non-resident deposits**



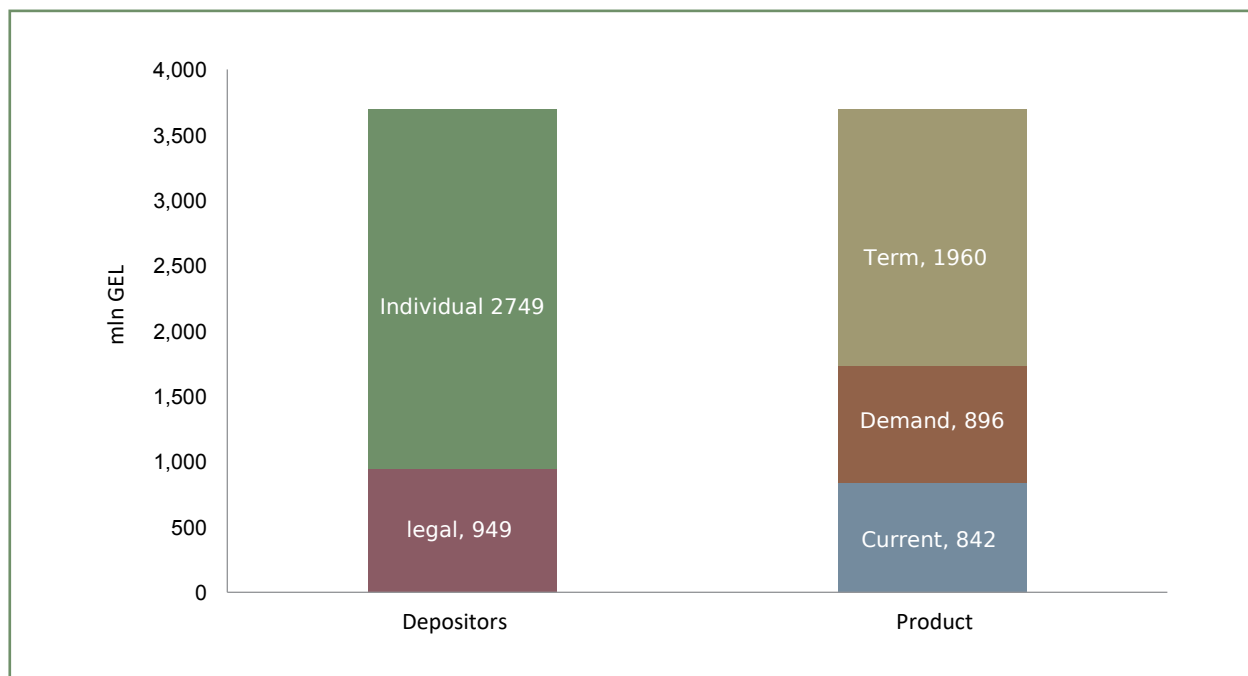
Source: National Bank of Georgia

The share of non-resident deposits in total non-bank deposits decreased in 2018 and amounted to 16% by December. These deposits were well 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 non-resident funding, the NBG maintains an additional liquidity requirement for banks whose share of non-resident deposits in total

non-bank deposits exceeds 10%.<sup>38</sup> When calibrating this requirement, the fact that some non-resident customers are Georgians with foreign passports, or are Georgia-based companies registered abroad, was taken into consideration. The necessity for additional liquidity in banks with a high share of non-resident customers reduces the incentives for banks to attract this type of deposit portfolio. The latter fact has been reflected in the stabilization of the share of non-resident deposits in recent years.

**Diagram 4.31 Structure of non-resident deposits (December 2018)**

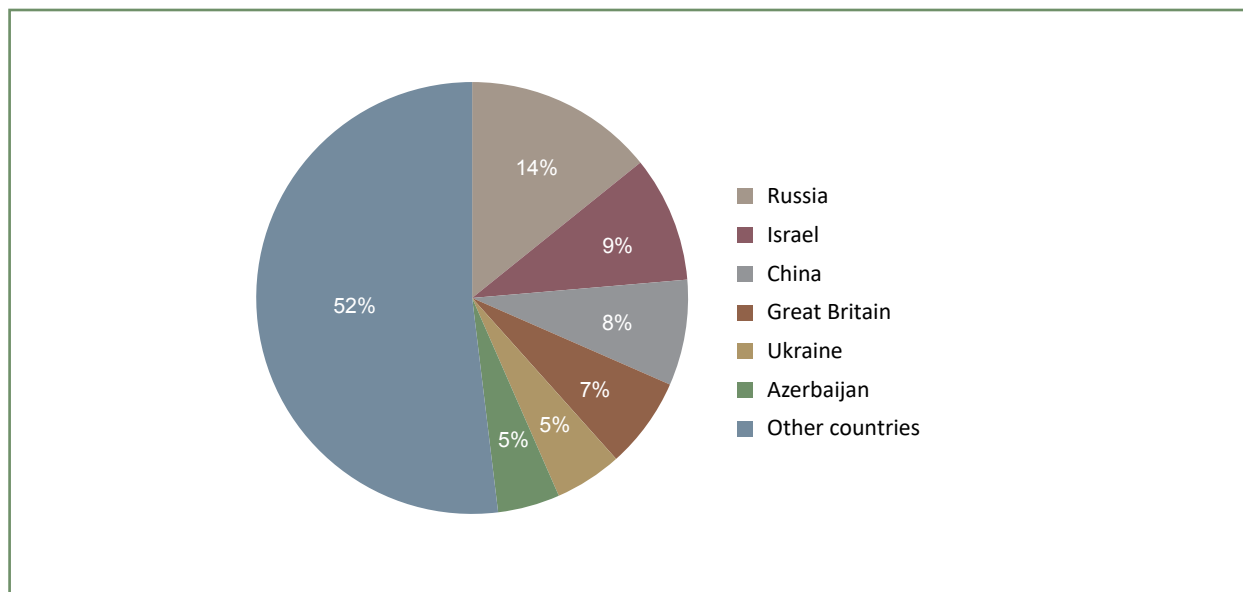


Source: National Bank of Georgia

38. 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 4.32 Non-resident deposits by country (December 2018)**



Source: National Bank of Georgia

#### 4.6.4 Wholesale Funding

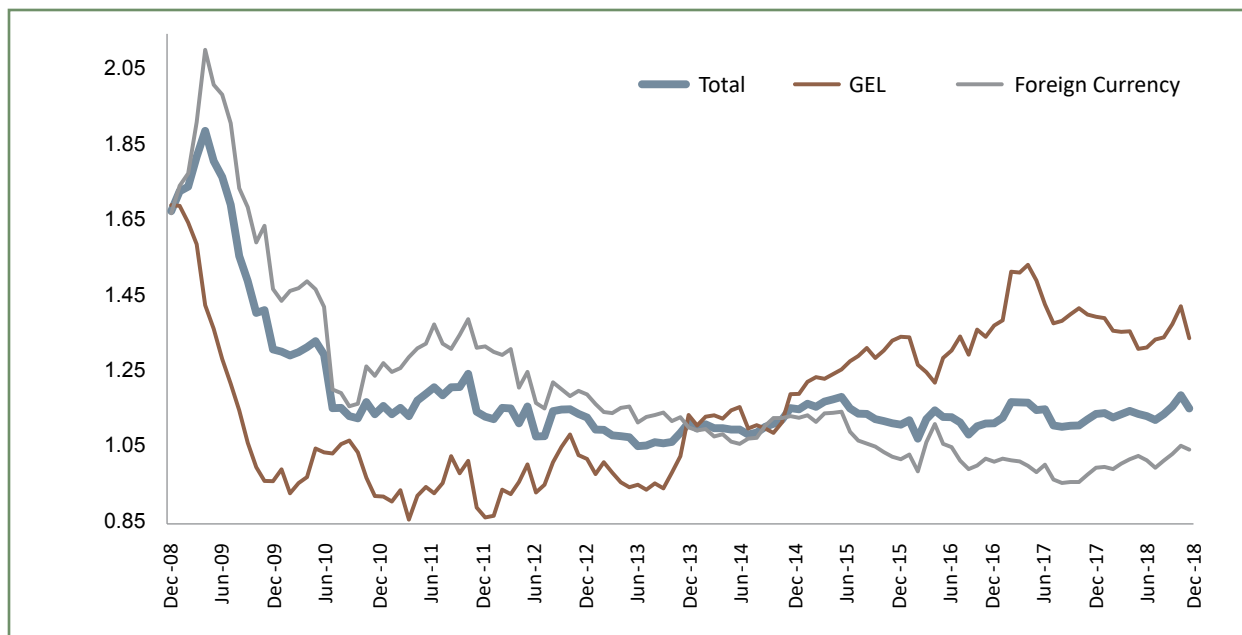
Throughout 2018, the ratio of loans to deposits remained stable. It is noteworthy that the same coefficient calculated for lari loans and deposits has exceeded the ratio of loans and deposits calculated in foreign currency since 2015 and remains high. This was partially caused by the high growth of lari loans due to foreign exchange risks and the larization measures undertaken. All else being equal, this makes funding risk more manageable.

Wholesale funding is diversified in terms of both

lender type and residual maturity. The residual maturity of 60% of wholesale funding exceeds two years, which reduces the funding risk for the system. A total of 52% of wholesale funding was attributed to international financial institutions, 15% to parent/related companies and 33% to other private institutions. The high share held by international financial institutions and the long-term repayment schedules can be assessed as being low risk. Lender covenants<sup>39</sup> were regularly monitored and their effects were reflected in the new framework of stress tests.

39. Restrictions imposed by a loan agreement.

**Diagram 4.33 Gross loans to non-bank deposits**



Source: National Bank of Georgia

**Table 4.8 External sources of wholesale funding and their schedules as of 31 December 2018**

Month	<1	1-3	3-6	6-12	12-24	24-36	36-60	>60	Total
<b>Total</b>	<b>3.47%</b>	<b>2.32%</b>	<b>4.68%</b>	<b>13.02%</b>	<b>16.28%</b>	<b>22.34%</b>	<b>20.57%</b>	<b>17.31%</b>	<b>100.00%</b>
International Institutions	0.62%	0.96%	2.87%	5.86%	8.14%	9.52%	15.42%	8.25%	51.65%
Related/Parent Institutions	0.42%	0.63%	0.59%	3.37%	1.79%	4.46%	1.27%	2.67%	15.20%
Other Private Financing	2.44%	0.73%	1.23%	3.78%	6.36%	8.35%	3.87%	6.39%	33.15%

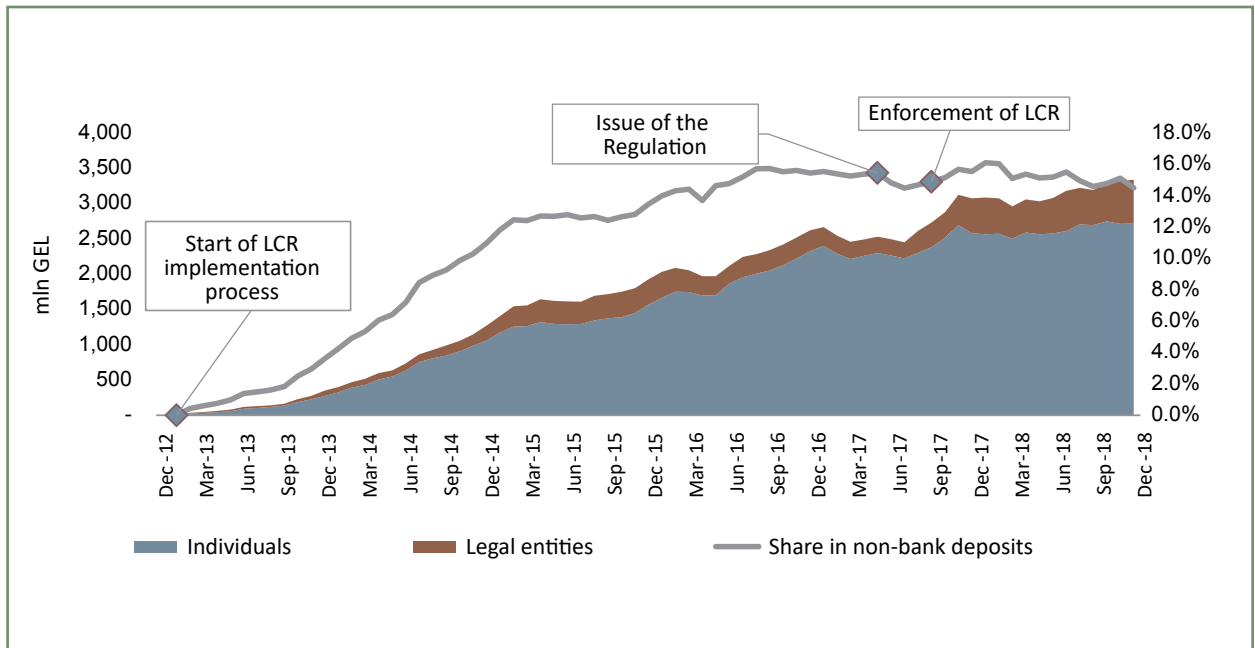
Source: National Bank of Georgia

#### 4.6.5 Regulation of Liquidity Risk

Throughout 2018, several amendments were introduced regarding liquidity supervisory requirements and a detailed analytical form for the separate categories of liquid assets and liabilities was implemented.

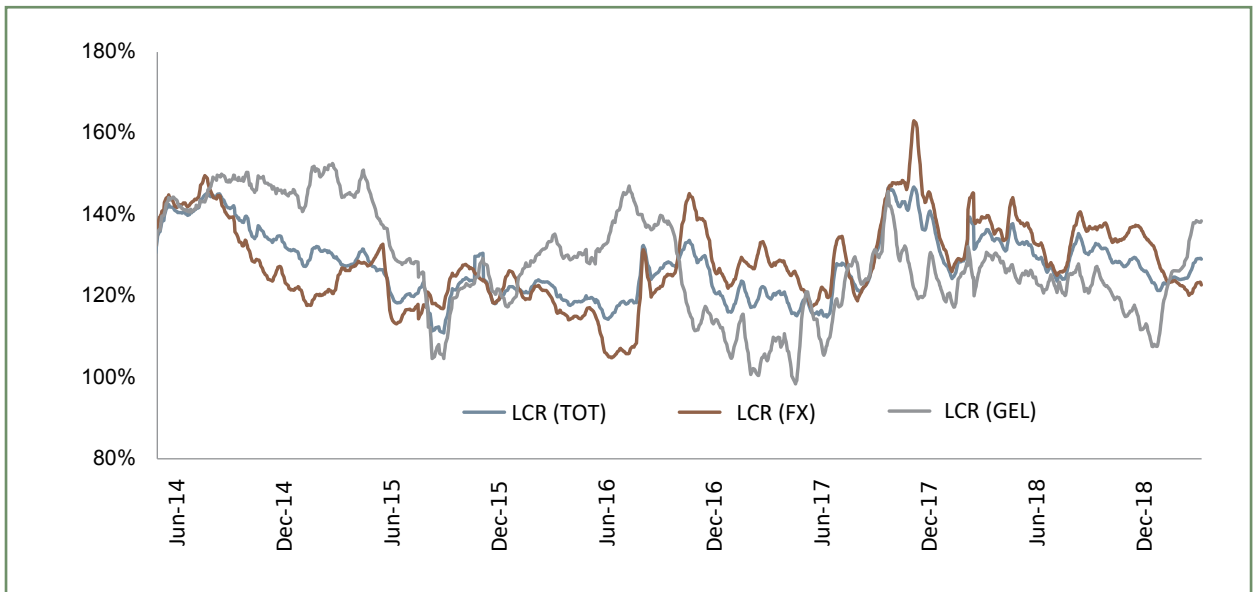
The liquidity coverage ratio (LCR) remains stable at a high level. The LCR represents a modern and effective approach to short-term liquidity management (of up to 30 days), and provides a means to improve the identification, assessment, monitoring and control of risks. Implementation of the LCR has significantly improved prudential supervision and has contributed to making liabilities long term, including the development of certificates of deposit.

**Diagram 4.34 Certificates of deposit and their share in non-bank deposits**



Source: National Bank of Georgia

**Diagram 4.35 Dynamics of the Liquidity Coverage Ratio (LCR)**



Source: National Bank of Georgia

However, it should be taken into consideration that the LCR does not include the indivisible parts of liquidity risk regulation, such as concentration of residual maturity of liabilities, funding contingency plans and other related issues – these aspects are considered during subsequent liquidity risk assessments. In addition, in order to improve long-term liquidity regulation, the implementation process for the Net Stable Funding Ratio (NSFR) has started. After the introduction of this coefficient, the existing liquidity requirement (30% for short-term liabilities) will be abolished and will only be used for monitoring purposes. As a result, the liquidity risk supervisory framework will be in full compliance with Basel Standards.

In addition, in order to reduce foreign currency liquidity risk and encourage a lengthening of the terms of liabilities, the minimum reserve requirements give preferential treatment to long-term certificates of deposit. Such certificates of deposit are non-callable, and the development of this instrument will significantly reduce the immediate flow of liabilities during periods of financial stress.

## 4.7 Operational Risk

Cybersecurity management was one of the main topics of focus for the National Bank of Georgia in 2018. In this direction, the NBG developed a draft cybersecurity regulatory framework for commercial banks that, after approval, will be fully integrated into the operational risk management process for Georgian commercial banks.

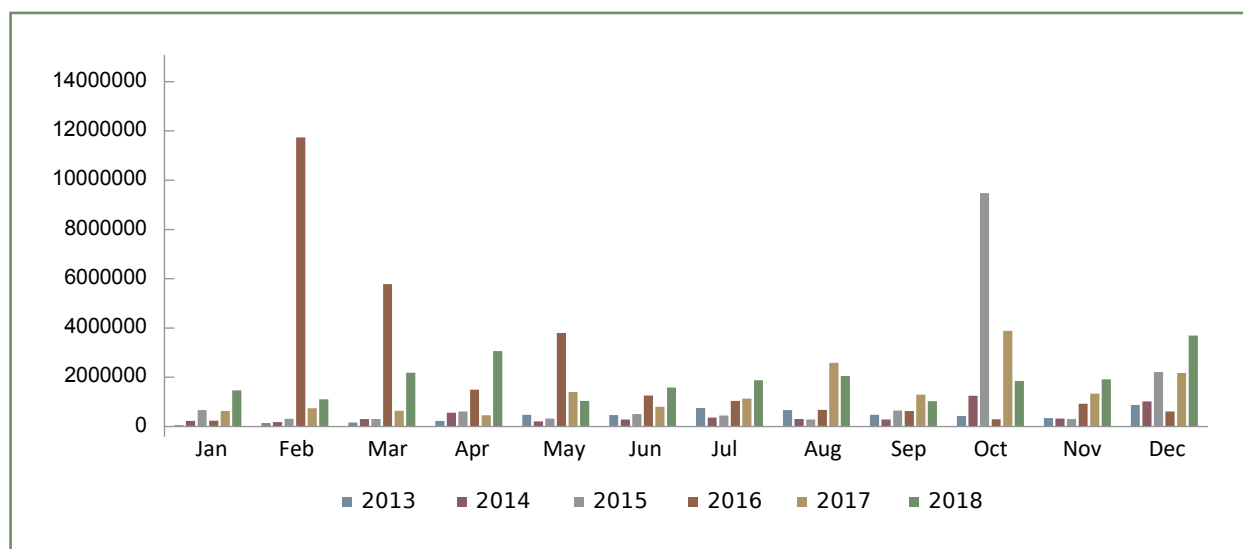
### 4.7.1 Operational risk reporting

Total operational risk-related gross losses of the banking system amounted to 22.9 million GEL in 2018, representing an increase of 34% compared to the previous year.

The annual operational gross loss indicator (gross losses divided by gross income) stood at 0.73%. A gross operational loss represents a loss amount associated with a specific operational event, prior to any recoveries or reimbursements.

A total of 23,466 operational loss events were recorded in 2018. It is worth noting that commercial banks have to report all operational loss events with a gross value that equals or exceeds 10 GEL to the National Bank of Georgia. The average operational loss in 2018 was 975 GEL (see Diagram 4.36).

**Diagram 4.36 The dynamics of total operational losses, 2013-2018**

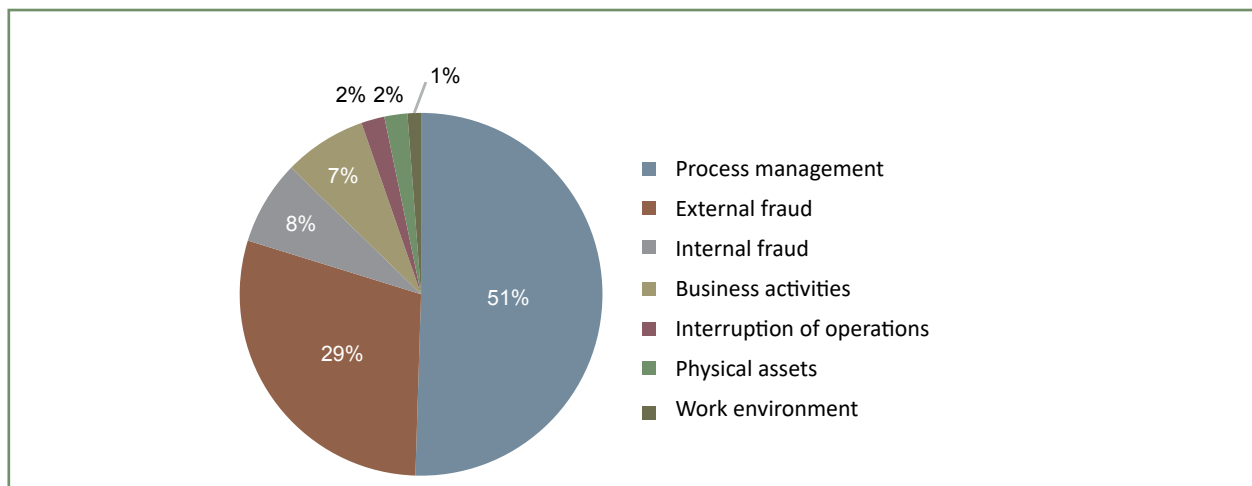


Source: National Bank of Georgia

Operational loss events were mostly observed in the retail banking business line (which includes payment card-related operational losses, along with traditional retail banking), and to a lesser extent in the commercial banking business line. That most operational loss events were observed in these two banking business lines is due to the fact that they are the primary sources of banking activity in the Georgian banking system. When breaking down

operational risk events based on loss event categories, the greatest share of operational losses (51% of total gross losses) were related to execution, delivery and process management. The second largest loss category was external fraud, which had a 29% share of total losses. The third largest loss category was internal fraud, which accounted for 8% of total losses (see Diagram 4.37).

**Diagram 4.37 Distribution of gross operational losses in 2018**



Source: National Bank of Georgia

#### 4.7.2 Business continuity management

Business continuity risk belongs to the categories of risks that cannot be mitigated by high levels of capital. The NBG continues to work closely with commercial banks in order to make sure that sound business continuity management principles are being followed by commercial banks. The NBG also pays attention to various key components, including the existence of sufficient infrastructure and the implementation of business continuity tests.

#### 4.7.3 Outsourcing

Outsourcing, although carrying numerous benefits, is also characterized by various significant risks. As a consequence, the supervision of outsourcing risk remains a top priority for the NBG. In order to maintain offshoring/outsourcing risks within acceptable limits, the NBG continues to study the nature and types of risk that the Georgian banking system is exposed to in this regard

#### 4.7.4 Dependence of the banking system on other sectors

The Georgian banking system, similar to banking systems around the world, is critically dependent on other sectors of the economy, including the telecommunications, information technology, energy and transportation sectors. The NBG is willing to establish close relations with representatives of these sectors in order to properly manage the risks stemming from such complex interdependence.

#### 4.7.5 Accuracy risk

A significant aspect of the NBG's operational risk supervision concerns data quality management, with one of the main objectives being to study and assess the quality and accuracy of commercial banks' data. In this regard, integrity risk is especially important, since financial data must be secure and free from unauthorized modifications.

The National Bank of Georgia continued its data quality inspections of financial institutions in 2018. These examinations included a detailed analysis of the reporting process used by commercial banks, and of the adequacy and correctness of data in their information systems. The NBG also examined the liquidity coverage ratio (LCR) reports of several banks.

In addition, based on the cooperation framework that exists between the NBG and the Deposit Insurance Agency, supervisors from the National Bank of Georgia participated in inspections of the deposit insurance reporting process of commercial banks as initiated by the Deposit Insurance Agency.

The NBG places special emphasis on the adequacy of the reporting process and its effectiveness. It is important for commercial banks to implement and

maintain a sufficient level of information systems automation and to reduce the complexity of the information systems utilized.

## 4.8 Capital Adequacy

At the end of 2018, the Georgian banking system continued to maintain an adequate level of capital under the Basel III capital adequacy framework. From January 2018, the Basel I Tier 1 and total regulatory capital adequacy ratios were phased out and fully replaced by Basel III capital adequacy requirements.

On 31 December 2018, the systemic buffer was set up on total regulatory, Tier 1 and CET 1 capital (see Table 4.9)

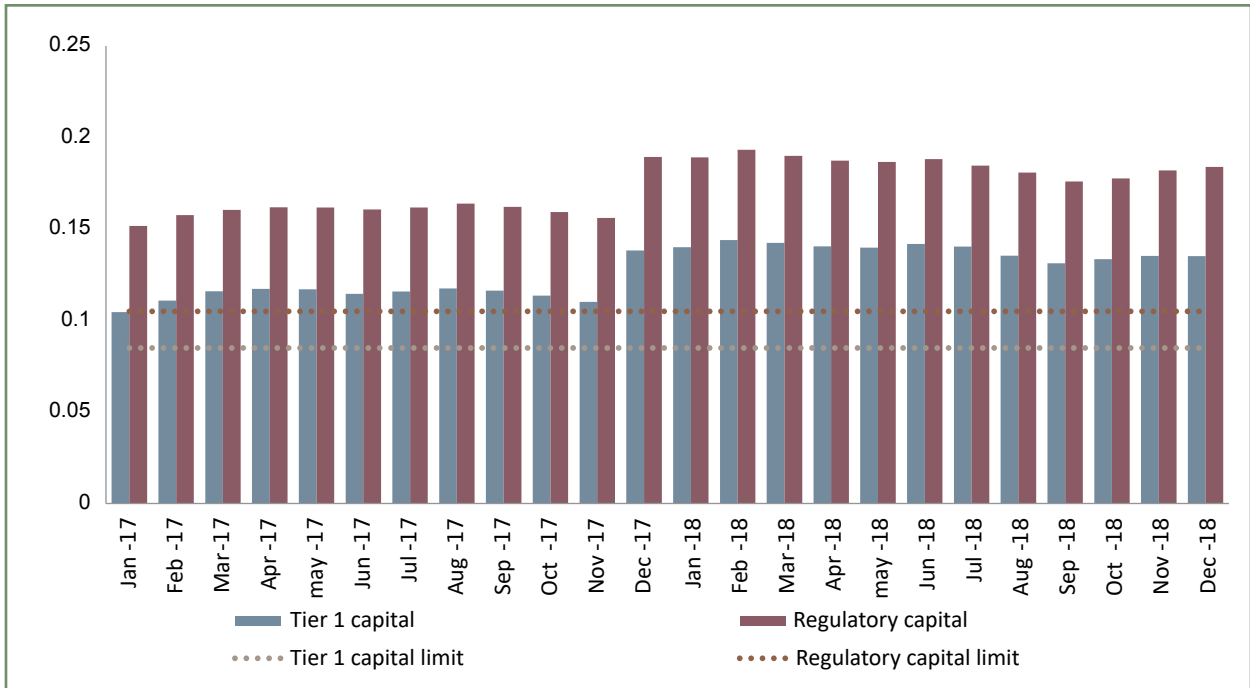
**Table 4.9 Systemic buffer phase-in dates**

Bank	2017	2018	2019	2020	2021
JSC "TBC Bank"	0.0%	1.0%	1.5%	2.0%	2.5%
JSC "Bank of Georgia"	0.0%	1.0%	1.5%	2.0%	2.5%
JSC "Liberty Bank"	0.0%	0.6%	0.9%	1.2%	1.5%

As of 31 December 2018, within the revised framework and after the abovementioned changes, the Tier 1 and total regulatory capital adequacy ratios

amounted 13.51% and 18.39%, respectively – this exceeded their minimum requirements by 9.0 p.p and 10.39 pp respectively (see Diagram 4.38).

**Diagram 4.38 Basel III Tier 1 capital ratios<sup>40</sup>**



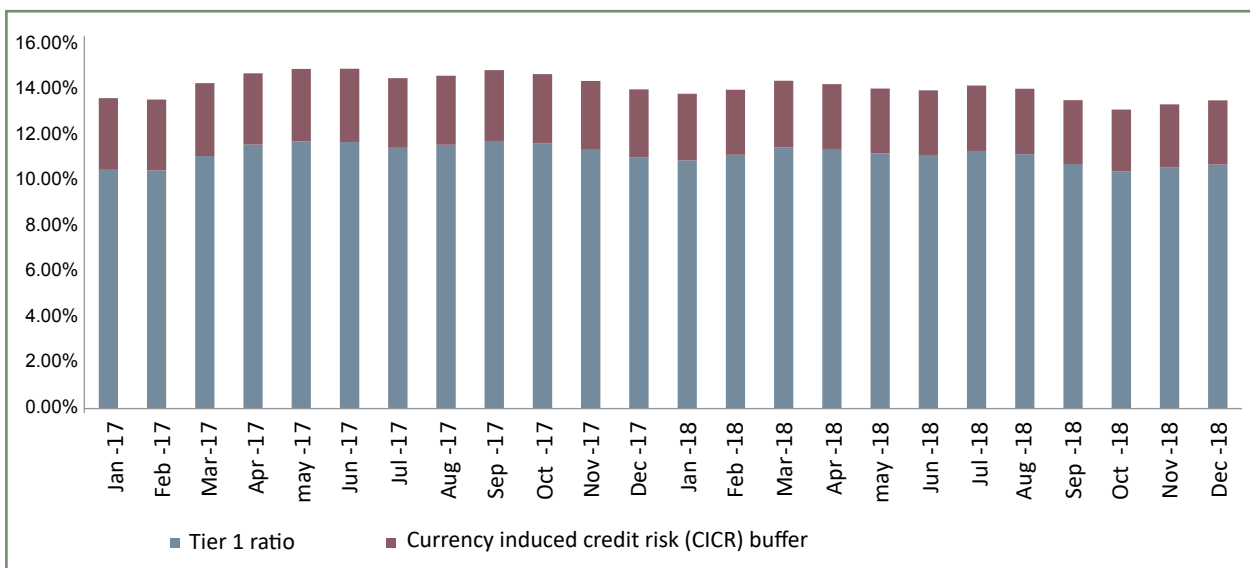
Source: National Bank of Georgia

The leverage ratio was also high. As of 31 December 2018, this amounted to 11.83%, exceeding the minimum requirement by 6.83 percentage points.

Given shareholders' strength and profitability, capital growth resources are rated positively.

The transfer of currency-induced credit risk from the Pillar 1 to the Pillar 2 buffer has reduced risk weighted assets. All Tier 1 and total regulatory capital ratios seen on Diagrams 4.39 and 4.40 are calculated in the same manner as for December 2017 and 2018.

**Diagram 4.39 Basel III Tier 1 capital ratios<sup>41</sup>**



Source: National Bank of Georgia

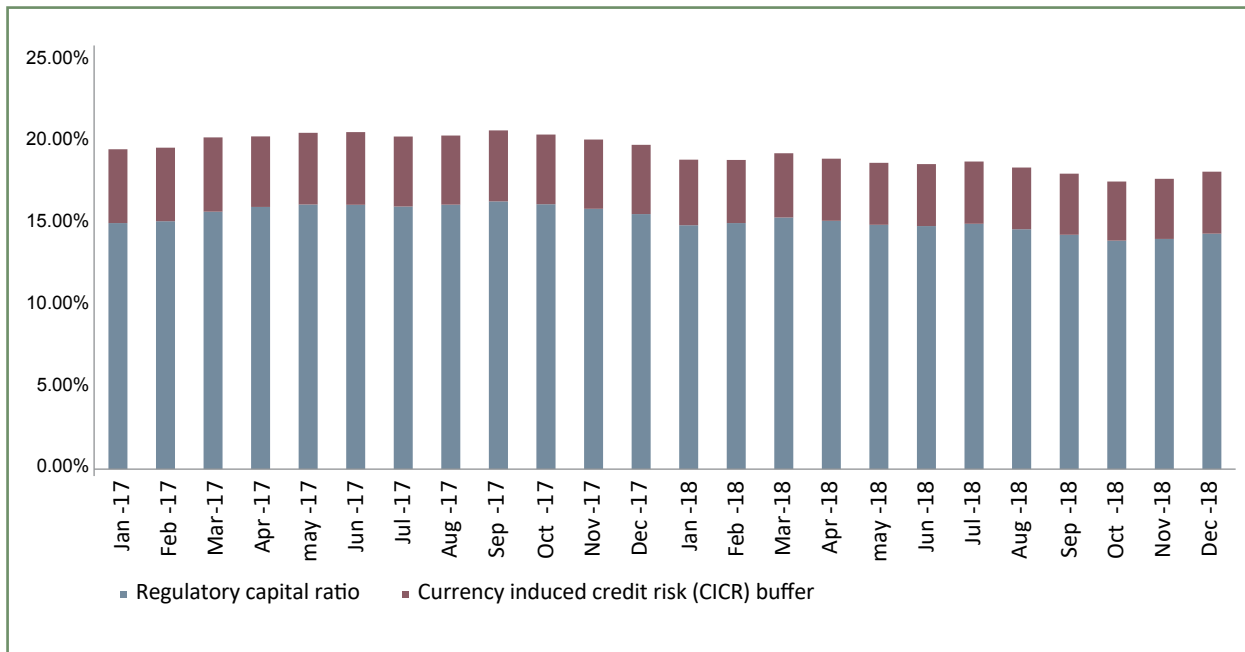
40. Each indicator is calculated according to the capital adequacy framework in December 2018.

41. Each indicator is calculated according to the capital adequacy framework in December 2018.

As of December 2018, capital requirements were increased. The Pillar 2 framework determines capital buffer requirements on credit portfolio concentration risk (for both name concentration and sec-

toral concentration risks), a net stress buffer based on regulatory stress tests, and estimates the buffer established within the NBS's General Risk Assessment Program (GRAPE) framework.

**Diagram 4.40 Basel III regulatory capital ratios<sup>42</sup>**



Source: National Bank of Georgia

The capital buffers imposed under Pillar 2 requirements should be met with the same proportion of regulatory capital as in the minimum requirements (Common Equity Tier (CET) 1 capital of 4.5%, Tier 1 capital of 6%, and total regulatory capital of 8%). Accordingly, the required capital under Pillar 2 should be met with CET 1 capital of 56% and Tier

1 capital of 75%. In order to comply with these requirements, commercial banks have been given a relevant timeframe (see Table 4.10). As of 31 December 2018, concentration and net GRAPE buffers are imposed at 100% on regulatory capital, 20% on Tier 1 capital and 15% on CET 1 capital.

**Table 4.10 Concentration and net GRAPE buffer phases in periods**

Concentration (sectoral and name) buffer and net GRAPE buffer proportion	Until 30/12/2018	31/12/2018	31/12/2019	31/12/2020	After 31/12/2021
CET 1 capital	0%	15%	30%	45%	56%
Tier 1 capital	0%	20%	40%	60%	75%
Total regulatory capital	100%	100%	100%	100%	100%

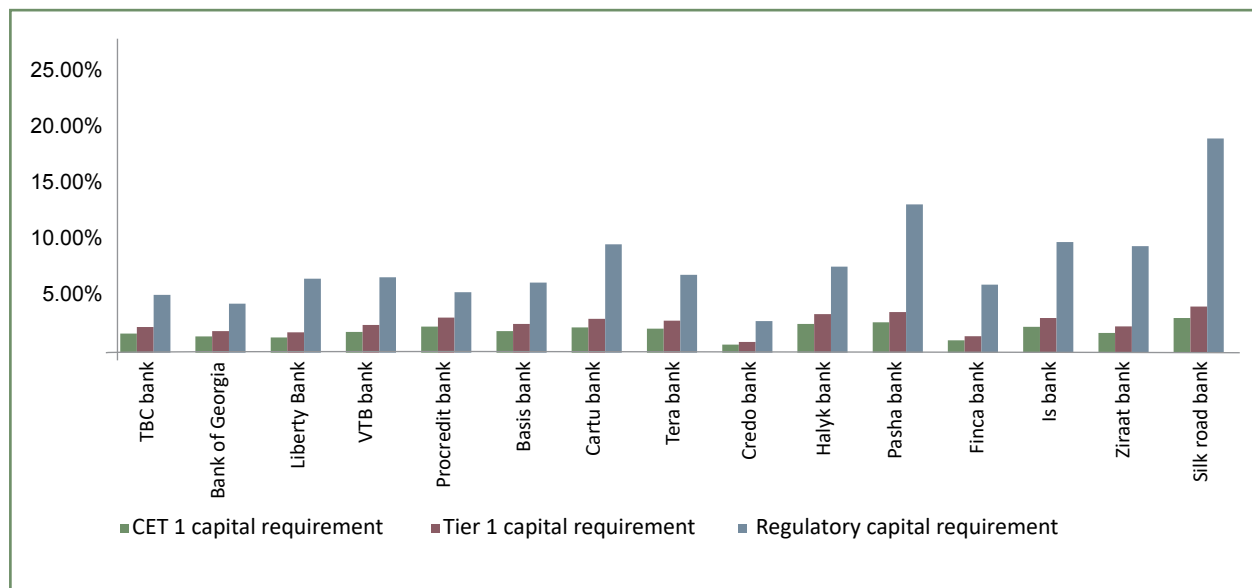
42. Each indicator is calculated according to the capital adequacy framework in December 2018.



In accordance with the changes in capital adequacy, when a commercial bank cannot meet the total regulatory requirements, it is assumed at first that the combined capital buffer has been breached. According to the changes in the “Regulation on Capital Adequacy Requirements”, when the combined buffer is breached, a bank is restricted in the distribution of capital, including the distribution of dividends.

From the Pillar 2 buffers, the currency-induced credit risk (CICR) buffer became effective immediately after the order was approved and was thus included in the capital requirements from December 2017. In addition, from April 2018 banks were required to meet the capital requirements for credit risk concentration (see Diagram 4.41).

**Diagram 4.41 Pillar 2 requirements for commercial banks as of 31 December 2018**



Source: National Bank of Georgia

From January 2020, a net stress test buffer will be implemented based on supervisory stress testing. During 2018, the National Bank of Georgia actively worked on the calibration of this buffer. During the following year, the NBG plans to formalize and standardize the stress testing framework in cooperation with commercial banks in order to fully integrate the stress test buffer in the Pillar 2 requirements. Enterprise-level stress tests help assess the effect of systemic and sectoral economic shocks and idiosyncratic events on banks and help determine the relevant capital requirements. With the integration of the net stress test buffer in the Pillar 2 requirements, it is important to avoid double capital requirements. Accordingly, the stress test buffer requires capital in an amount that exceeds

the sum of the conservation and countercyclical buffers.

During 2018, the net GRAPE buffer became effective. This is determined within the risk-based supervision framework that aims to assess and evaluate the risk profile of each commercial bank. In 2018, the individual GRAPE buffer became effective, which ranges between 1.4% and 14.4%.

In addition, the National Bank of Georgia continues to develop its stress testing framework and it is expected that the scenarios employed will include all the risks and relevant capital requirements of Pillar 2. As a result, the net GRAPE buffer can be equal to zero after implementing the net stress test buffer.

However, it should be noted that some banks may be characterized by increased risks (for example, risks related to corporate governance), that are not covered by the stress testing framework. Those kinds of risks should be mitigated by the net GRAPE buffer.

## 4.9 Macprudential Risks

The NBG continues the close monitoring of systemic risk indicators that may have a material impact on the banking system. Information on these risks is provided in the different sections of this report. An incomplete list of the main challenges currently facing the banking system includes the following: increased debt burdens of unhedged borrowers due to the depreciation of the Georgian lari against the US dollar; 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 threats in the region.

During the risk assessment process, trends in individual sectors are taken into consideration in addition to general macroeconomic parameters. In this regard, the NBG closely monitors growth dynamics in the purchase of real estate for rental purposes and in the construction of hotels. In the event of a reduction in tourist inflows, this may lead to excess supply and low occupancy rates, which, as a result, may have a negative effect on the real estate market. Although the financing of this sector by commercial banks is limited, if a negative scenario were to materialize it would 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 discussions of these with commercial banks are conducted. Supervisory stress tests were carried out in 2018 and, according to the results, the banking sector has a sufficient

capital buffer to absorb economic shocks and continue credit activities in the contraction phase of the business cycle. In addition, there is no danger to the sustainability of the system or to any bank's solvency. Such a result also comes from the fact that the increased credit losses sustained during periods of stress are substantially compensated by the operational income in the same period.

The scenario analysis included, amongst other things, spillover risks from other countries in the region. In this regard, banks are not directly exposed to these risks and indirect exposure, in the form of loans disbursed by banks to companies exporting to these countries, account for a very small portion of their total loan portfolio.

For credit risk induced by currency mismatches, the National Bank maintains a conservative approach in the form of imposing additional capital requirements for foreign currency loans disbursed to unhedged borrowers. Moreover, in order to mitigate risks associated with high dollarization, only 75% of minimum reserves are counted as liquid assets for the purpose of the liquidity coverage ratio. Banks will have to maintain additional foreign currency liquidity and, as a result, will be less dependent on the reserves held at the National Bank. In the event of deposit outflows during periods of financial stress, this will mitigate liquidity risk to some extent. It is noteworthy that banks' liquidity contingency funding plans, other mitigation measures and the NBG's support instruments are all restricted in foreign currency.

In order to monitor credit cycles, the NBG continues to monitor the loan-to-GDP gap, which is calculated with the Basel methodology. Statistically, this indicator well describes bank activities and provides correct warning signals. Based on this and other indicators of the financial sector, there have been no significant changes in the credit cycle and, as a result, at this point a countercyclical buffer is not determined for the banking sector. Along with global trends and risks in the region, this also con-

firms the need for minimum foreign reserves and high liquidity requirements.

## 4.10 Financial Reporting and Transparency

Enhancing the transparency of the financial sector is one of the main objectives of the National Bank of Georgia. Enhancing transparency aids the reduction of information asymmetry, increases trust in the financial sector and protects the rights of investors and users. The NBG is continuing to implement relevant reforms towards that end.

An important component in ensuring the transparency of the financial sector is the preparation of annual financial statements of commercial banks and other representatives of the financial sector. These statements are prepared in accordance with International Financial Reporting Standards (IFRS), which are periodically updated.

In addition to the financial statements prepared under the IFRS, banks are required to publish quarterly and annual Pillar 3 reports in accordance with “Regulation on Disclosure Requirements for Commercial Banks within Pillar 3”. These reports provide key information to market participants about the main risks banks face and regarding their supervisory capital components, corporate governance and risk management practices.

Fostering the implementation of periodic updates to the IFRS, which mainly aim at enhancing transparency and increasing comparison in global terms, is one of the main components for ensuring the transparency of the financial sector. At the current stage, IFRS 9, which became effective from 1 January 2018, is of special importance. A main component of this standard is the expected credit loss (ECL) model, which implies recognition of credit losses expected to be incurred in the future. According to this standard, the loss model should

take into account forward-looking information that includes, but is not limited to, expectations related to macroeconomic factors.

Given that the NBG has extensive experience in undertaking macroeconomic research and preparing forecasts, as well as having access to the necessary statistical information for doing so, and recognizing that it may be too costly for market participants to produce such information on their own, the NBG periodically publishes macroeconomic and financial forecasts and risk scenarios to help facilitate the implementation of IFRS 9. The objective of doing so is to ensure consistency, transparency and efficiency when different financial institutions are preparing their financial statements.

The NBG continues to work on transitioning supervision from the national GAAP to the IFRS. This entails the implementation of the European unified reporting format (FINREP) for the periodical reporting of commercial banks’ financial information. This will help increase transparency and effectiveness by implementing internationally recognized standards and eliminating the burden of dual reporting. However, the NBG plans to retain certain supervisory filters that are currently in place in order to continue exercising risk-based supervision without interruption. It should be noted that the FINREP format is based on consolidated supervision, while the current supervisory reporting takes place on individual entities. Applying the current prudential filters to the consolidated figures is thus an important task for ensuring the efficiency of the whole process. This is an area that the NBG is actively working on in conjunction with some international experts and consultants.

Commercial banks were required to submit their first draft FINREP forms to the NBG during 2018. The NBG is currently engaged in the analysis of those submissions. For 2019, it plans to continue to require banks to submit FINREP forms in parallel with the existing supervisory forms.

The NBG is actively engaged in cooperation with the Service of Accounting, Financial Reporting and Audit Supervision (hereinafter “The Service”) on issues related to the quality of financial statements and audits. The activities of the Service in this sphere include implementing reforms related to financial accounting, reporting and audit supervision for the purpose of gradual approximation of the current legislation with the appropriate EU legislation. The NBG is cooperating with the Service in the implementation of these reforms and is also engaged in consultations with other professional accountancy and auditing organizations. For example, the NBG has cooperated with the Service since 2016 on the implementation of a new Law of Georgia on “Accounting, Reporting and Audit”. The subsequent implementation of this law was important as it promotes transparency and enhances corporate governance practices – outcomes that help promote the flow of international investments and the development of the country’s capital market.

During 2018, based on the Law of Georgia on “Accounting, Reporting and Audit”, accountable entities were required by the Service to submit the following within specified timeframes for the 2017 reporting year: separate financial statements, consolidated financial statements, a separate management report, a consolidated management report, a report on payments to government, and, in certain cases, independent auditors’ reports. It is noteworthy that some entities under the supervision of the NBG are also in the list of accountable entities noted above. During 2018, the NBG cooperated with the Service regarding the submission of the required reports. This process enhances the availability of information on financial and non-financial sector representatives to existing or potential investors as well as to other stakeholders, which ultimately increases transparency.

On 26 December 2018, the NBG published the regulation on “Statutory Audits of Financial Statements and Disclosure Requirements of Commer-

cial Banks”, and in so doing made changes to the NBG’s earlier regulation on the audit of commercial banks’ financial statements. The purpose of the change was to increase the quality of banks’ financial statements by imposing additional rules on audit processes and disclosure requirements. Changes were made in accordance with the EU directives and regulations regarding statutory audits and disclosure requirements for the financial statements of public interest entities. This law came into effect on 1 January 2019 and has become mandatory for all commercial banks operating in Georgia.

It is noteworthy that cooperation with local or international organizations in this field is critical for achieving the common goal of increased financial transparency. For this purpose, the National Bank continues to cooperate with various organizations, including audit companies, audit supervision services and the World Bank.

## 4.11 Credit Information Bureau Supervision

An amendment to the Organic Law on the National Bank of Georgia was approved at the end of 2017 and entered into force on 11 January 2018. According to this regulation, the National Bank of Georgia was authorized to regulate and supervise the activities of the Credit Information Bureau. The National Bank of Georgia was obliged to issue legal acts regulating the supervision of the activities of the Credit Information Bureau up until 1 September 2018.

Since September 2018, according to changes in the legislation, two orders of the Governor of the National Bank of Georgia entered into force: “On Approving the Rule of Registering, Cancelling Registration and Regulation of the Credit Information Bureau in the National Bank of Georgia” (N193/04) and “On Submitting Information to the Credit Information Bureau on the Territory of Georgia, Recording Information in the Database of the Credit Infor-

mation Bureau and its Accessibility” (N195/04).

According to the regulation “On Approving the Rule of Registering, Cancelling Registration and Regulation of the Credit Information Bureau in the National Bank of Georgia”, organizations willing to register need to fulfill NBG requirements, including minimum equity and managements professional experience requirements. Other requirements relate to their staff qualifications, policy procedures and organizational structure.

The main activities of the Credit Information Bureau are collecting, storing, processing, and sharing credit, non-credit and other relevant information. According to this rule, the bureau can also work on related fields, such as selling software, creating and using statistical and behavioral models, and analytical and educational activities. Any other activities require special consent from the National Bank of Georgia. The National Bank of Georgia makes decisions about registration and its cancellation. Reasons for the cancellation of registration can include announcements from the bureau, as well as a violation of the requirements of this decree.

To avoid data fragmentation, according to the decree “On Submitting Information to the Credit Information Bureau on the Territory of Georgia, Recording Information in the Database of the Credit Information Bureau and its Accessibility”, it became mandatory for loan-issuing entities to share credit data to the Credit Information Bureau on a daily basis. In turn, loan-issuing entities have a right to request corresponding information from the bureau. The Credit Information Bureau does not include exposures secured by the deposit and client’s exposures whose initial amount of current liabilities exceeds 3 million GEL within the organization issuing the loan. Moreover, loan-issuing entities do not have an obligation to provide information on loans secured by up to 3,000 GEL in cases where the requirement for a loan is limited (Order N273/04 of the Governor of the National Bank of Georgia).

The Credit Information Bureau is responsible for data accuracy and, in the event of penalties, the bureau has the right to ask the creditor to fully compensate the penalty amount. Information about closed liabilities are available for five years after the termination date, and for statistical purposes data are available for 35 years.

Loan-issuing organizations are obliged to create a secured technical tool to share information with the bureau, to review consumer claims within five working days and inform the data subject about the information shared with the bureau. Loan-issuing organizations have a right to check credit reports without consent when a liability is active.

Data accuracy is very important for the National Bank of Georgia. It is worth mentioning that technical corrections have been made to 20% of the total data. Obtaining additional data from regulated entities, which had not been in the bureau before, has helped solve the fragmentation problem.

Issues related to the consumer protection side of the Credit Information Bureau are presented in the consumer protection section of this report.

## 4.12 International Cooperation

In 2018, the National Bank of Georgia was the chair of the BSCEE (Banking Supervisors from Central and Eastern Europe) Group. The National Bank of Georgia became a member of BSCEE in 2013 and has since been actively involved in the group’s activities. The BSCEE combines 24 countries of Eastern and Central Europe. According to the group’s rules, the chairperson of the group is elected annually from its member states.

The National Bank of Georgia hosted the BSCEE Group annual conference in 2018. This event, which held in Tbilisi, was dedicated to the Basel III reform, the stress test methodology and to solvency analy-

sis issues with respect to reducing excess debt risks. Participants were able to share their thoughts and experiences on the topics presented in the conference and had an opportunity to listen to the experience of the member states. It is noteworthy that Toshio Tsuik, a representative of the General Secretary of the Basel Committee of Bank Supervision, attended the conference. He delivered a speech in which he introduced the final Basel III framework and future priorities to participants.

In 2018, the National Bank of Georgia continued its cooperation with supervisory bodies of different countries. The NBG signed memorandums of understanding with the Astana Financial Services Authority and the China Banking and Insurance Regulatory Commission. According to these memorandums, the parties agreed to a mutual exchange of information and close cooperation in banking and security market supervision in order to improve the functioning of financial institutions, commercial banks and capital markets.

In October 2018, representatives of the Azerbaijan Financial Market Supervision Agency (FIMSA) visited the National Bank of Georgia on a study mission. Within the scope of the visit, meetings were held on the following issues: the NBG's risk-based Basel III supervision framework, stress tests, liquidity and market risks, corporate and retail credit risks, corporate governance and group structure risks, and financial stability analysis.

The National Bank of Georgia has also deepened cooperation with the Basel Committee on Banking Supervision within the framework of the Regulatory Consistency Assessment Program. Employees of the National Bank of Georgia were invited to join the team of this program as experts. Within the program, employees of the National Bank of Georgia conduct monitoring and assessment of the implementation process of Basel III's large exposures and the Net Stable Funding Ratio (NSFR).



*Ilya Chavchavadze, First Georgian Banker*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## CONSUMER PROTECTION AND FINANCIAL EDUCATION



## 5.1 Consumer Rights Protection

Consumer protection is a priority area for the National Bank of Georgia. For this purpose, and to ensure an appropriate response to the challenges facing the financial market, the existing legislative framework needs continuous improvement. In this regard, as in previous years, significant changes were made in 2018.

### Renewed normative base

#### **The Rule on the Protection of Consumer Rights**

Within the scope of the NBG's mandate, with the purpose of improving the financial sector's consumer protection framework and approximating regulations to the relevant EU directives within the frames of the EU/Georgia Association Agreement, amendments were made to the rule on the "Protection of Consumer Rights while Rendering Services by Financial Institutions". The aim of the amendments, which were enacted on 1 June 2017, was to increase public confidence in the financial sector, maximize consumer interest protection and ensure transparency of information regarding the financial products on the market. The renewed document establishes standards for commencing distant contracts and an obligation for accruing interest on credit products on a daily basis. In addition, rules on personal offerings of loan/deposit products were tightened and the financial expenses that should be considered in the calculation of the effective interest rate were clarified.

Within the frames of the EU/Georgia Association Agreement, the NBG continues to work on approximating its regulations with the relevant EU directives.

#### **Credit Information Bureau**

On 11 January 2018, within the scope of the amendment to the Organic Law on the National Bank of Georgia, the NBG was authorized to regulate and supervise the activities of the Credit Information Bureau. One of the objectives of this amendment was to ensure consumer rights pro-

tection within the mandate of the National Bank of Georgia. In addition to other factors, various consumer protection issues were determined by this rule. In particular, a consumer now has the right to access to their data kept at the Credit Information Bureau. The Credit Information Bureau is obliged to provide this information free of charge upon a consumer's request at least three times per year.

In addition, customers will be able to make claims related to the activities of the Credit Information Bureau directly to the bureau, to the National Bank of Georgia and to the Office of the Personal Data Protection Inspector. The respective body will then review the received complaint according to the procedures determined by the legislation. In addition, a memorandum was signed between the National Bank of Georgia and the Office of Personal Data Protection Inspector for the purpose of formalizing cooperation in terms of the protection of consumer rights. The Credit Information Bureau is obliged to review consumer complaints, inform consumers about the results of their investigations and offer ways to solve problems where possible.

To ensure maximum consumer awareness, the Credit Information Bureau is obliged to operate a website that contains important information for consumers, including regarding the legal acts that regulate the activities of the bureau; to provide information about the services offered to third parties by the bureau and their respective fees; and to list the requisites for information users/providers.

In addition, for the purpose of checking consumer information, credit-issuing organizations are obliged to take single consent from the consumer that is valid for 30 working days. Those organizations that are not required to be enrolled in the system are obliged to take consent from consumers for both information verification as well as for information provision. The purpose of verification should be limited to only assessment of the solvency of the consumer. Loan issuing entities

have access to full information (Order of the Governor of the National Bank of Georgia N195/04, Appendix 1), while other organizations only have access to a summary of the information (Order of the Governor of the National Bank of Georgia N195/04, Appendix 2).

Additional information is available in the section of this report concerning the regulation of the activities of the Credit Information Bureau.

### **Code of Ethics**

Within the rule on the “Protection of Consumer Rights while Rendering Services by Financial Institutions”, financial organizations are obliged to develop a code of ethics for loan collections. During the year, it became obvious that the code of ethics needs greater detail and elaboration. Such improvements are planned for 2019.

### **Civil Code**

In addition to the legal acts developed by the National Bank of Georgia, changes in the direction of consumer rights protection were made at the legislative level. Specifically, according to these changes, upper limits for annual effective interest rates and penalties were reduced, which now stand at a maximum annual effective interest rate of 50% and a daily penalty of 0.27% respectively. In addition, the maximum amount for interest and any kind of penalty for an overdue loan was established at an annual 150% of the overdue amount of the loan.

In addition, restrictions were established on mortgage and car-backed loans for private individuals. In particular, only those loan-issuing entities under the NBG’s supervision are authorized to issue such loans. The only exception for this rule is such a case where an individual/legal entity wants to rent property with the aim of living/operating in it. At the same time, a natural person is allowed to reg-

ister no more than two such mortgage contracts.

Moreover, following changes made to the Civil Code, if a loan-issuing entity is not subject to the NBG’s supervision, any loan issued to a natural person is considered a non-recourse loan, even if the amount earned from the realization of the pledged real estate is not sufficient to fully cover the debt amount. The National Bank of Georgia has been granted the authority to establish different or additional rules for entities subject to its supervision.

Following high public interest and given the complexity of the topic, the National Bank of Georgia has prepared and published relevant FAQs and explanations regarding these changes on its website.<sup>43</sup>

### **Onsite and offsite inspections of financial sector representatives with regard to consumer protection issues**

During 2018, in order to check compliance with the requirements of the financial consumer protection legislation framework, the NBG conducted onsite inspections of the organizations under its supervision. In response to violations revealed by onsite and offsite inspections, the NBG took relevant supervisory actions. As a consequence, ten microfinance organizations and three commercial banks were fined hundreds of thousands of lari by the NBG.

### **Consultations regarding amendments to consumer protection legislation**

As in previous years, the provision of consultations and recommendations to financial sector representatives and other stakeholders comprised a significant part of the work of the NBG in 2018. Consultations were provided on various legislative requirements regarding consumer pro-

43. See: [https://www.nbg.gov.ge/cp/uploads/2018\\_for\\_WEB\\_Final1.pdf](https://www.nbg.gov.ge/cp/uploads/2018_for_WEB_Final1.pdf)

tection, including on the “Protection of Consumer Rights while Rendering Services by Financial Institutions”. These included provision of recommendations about ensuring the compliance of the format and content of loan agreements with the legislative requirements.

According to the January 2018 changes made to the Organic Law on the National Bank of Georgia, any entrepreneur, to which, at any one time, more than 20 private individuals have loan/credit liabilities, is obliged to register at the National Bank of Georgia. An extension of consumer protection requirements to cover such entities is also planned. In December 2018, for the purpose of facilitating this and to raise awareness in the market about these requirements, the National Bank of Georgia held meetings with representatives interested in registering at the NBG as loan-issuing entities. The requirements to be established in upcoming amendments, as well as other issues related to consumer protection, were clarified and discussed in detail during those meetings.

## Consumer Claims

### **Consumer claims made to the National Bank of Georgia**

During 2018, the Consumer Protection Division of the NBG received 4,434 claims from consumers, which was an increase of approximately 35.6% over the previous year. The majority of those claims (2,954 or 66.7%) were made over the

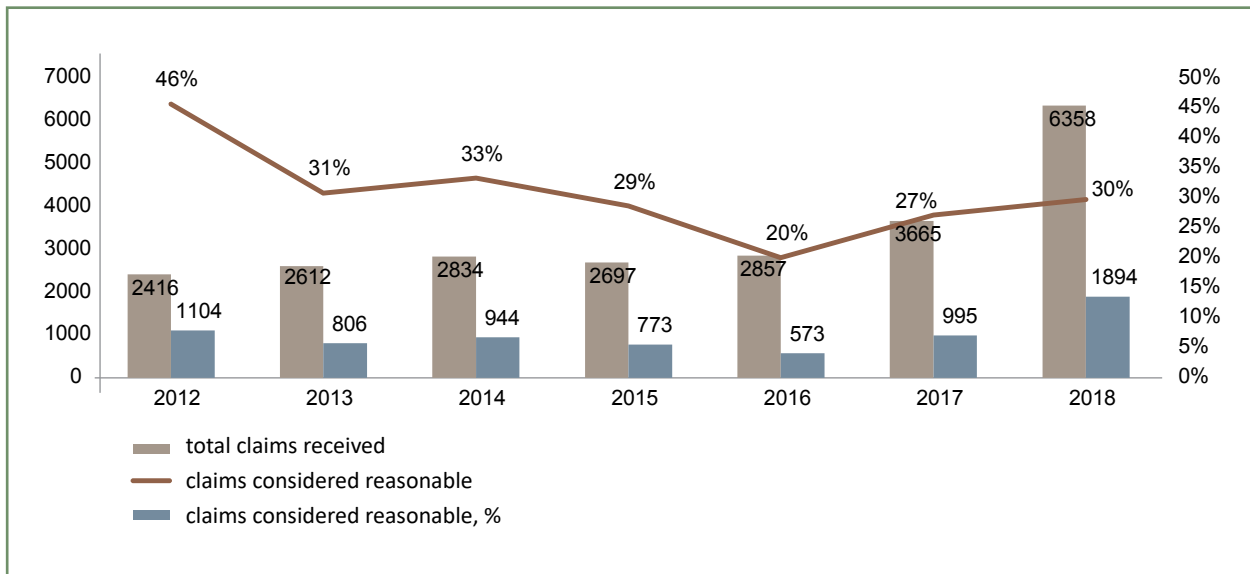
phone. The number of claims received via other means also increased: 297 complaints were made in writing (6.7%); 284 were expressed over social media (6.4%); 588 consumers (13.3%) addressed the NBG over email, and 311 (7.0%) visited the NBG personally.

In terms of content, the majority of complaints were related to credit restructuring requests and the prepayment process; administrative/services issues; the terms and conditions of contracts; and requests for general information. In terms of products, the majority of complaints were related to consumer and mortgage loans. Claims related to current accounts were also frequent.

### **Consumer claims made to financial organizations (banks and microfinance organizations)**

During 2018, commercial banks received 6,358 complaints from consumers – an increase of 73.5% over the previous year. If we look at the dynamics of all complaints made at commercial banks since 2012, there has been a growing trend in the number of complaints received. This should be considered as a positive trend caused by the increased awareness of consumers about the mechanisms of consumer rights protection. The increased number of claims in 2018 primarily stemmed from the legislative amendments made to the Civil Code and the extension of consumer protection regulation requirements. The methodology for handling complaints has also been improved.

**Diagram 5.1 Claims made at commercial banks**

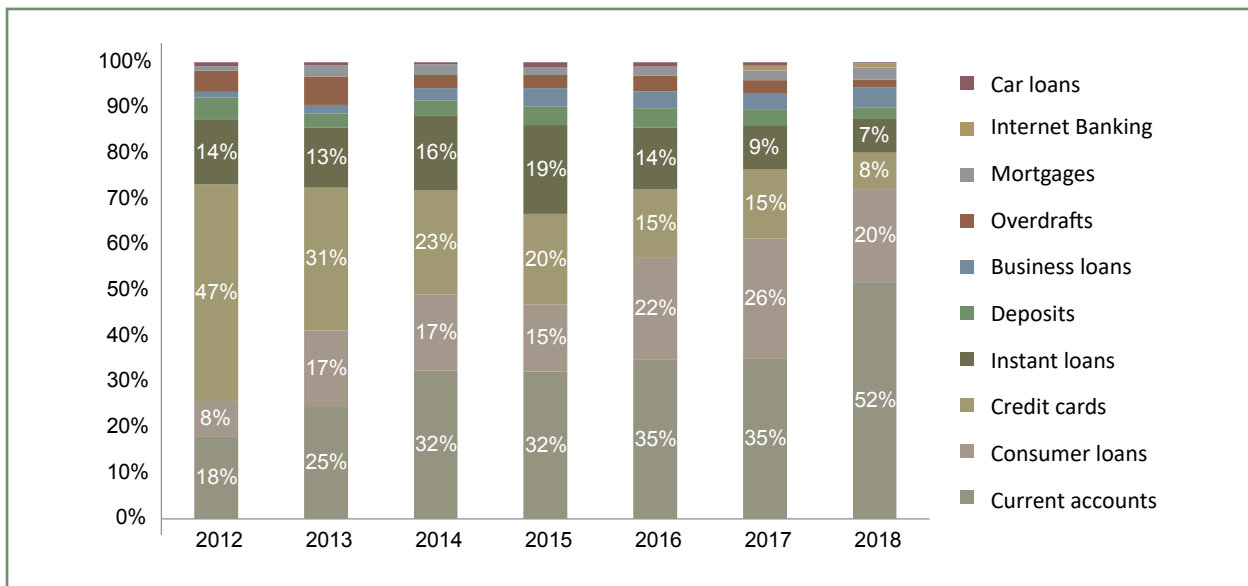


Source: National Bank of Georgia

The majority of complaints were related, to the following banking products: 1) current accounts; 2) consumer loans; 3) credit cards; and 4) instant loans. This distribution shows little change from

year to year – as should be expected, given that the majority of claims relate to the most frequently used products.

**Diagram 5.2 Distribution of claims by product type**



Source: National Bank of Georgia

Microfinance organizations have been obliged to register complaints received from consumers since 2017. However, the implementation of the legislative amendments on microfinance organizations revealed certain errors in this regard. In 2018, following the elimination of those deficiencies and the standardization of the process to receive reliable statistical data on consumer complaints, the NBG started the publication of data. During 2018, microfinance organizations received 1,459 complaints from consumers. The majority of which (84%) were related to consumer loans – which should be expected as consumer loans are the main product of microfinance organizations. In terms of the content of the complaints, the majority were related to administrative/service issues, fines, penalties for overdue payment, and transactions.

## 5.2 Financial Education

To raise awareness of the objectives and benefits of financial education amongst the population, the Governor of the National Bank of Georgia declared 2018 as the “Year of Financial Literacy.” Numerous projects, including training sessions, workshops, competitions and games, were implemented for different target groups during the year. In addition, new partnerships were formed and existing partnerships were strengthened during the year, with various local and international organizations working together on encouraging financial education.

As a result of these steps and the significant progress achieved in the direction of child and youth financial education and inclusion, the National Bank of Georgia received a “Country Award” during the Global Inclusion Awards of 2018. Together with NBG, the Ministry of Finance of the Russian Federation was also nominated in the category. The award was presented on 3 July in Riyadh, Saudi Arabia, as part of the Global Partnership for Financial Inclusion (GPI) forum organized on the initiative of the G20 countries.

In order to share the NBG’s experience in the directions of financial consumer protection and financial education, representatives of the NBG visited the National Bank of Ukraine (NBU) in August 2018. As part of a 4-day visit, NBG representatives discussed the financial consumer protection framework and practice, the National Strategy for Financial Education and the research methodology for studying financial literacy levels. In addition, NBG representatives took part in a workshop dedicated to developing a national strategy for financial education in Ukraine, which was also attended by representatives from the NBU, EBRD, USAID, and academic and civil society organizations.

The NBG also joined the Alliance for Financial Inclusion (AFI) as an associate member. The AFI is a global network of central banks and other financial regulatory institutions from developing countries that aims at promoting financial inclusion worldwide by helping member countries develop policies supporting access to safe and formal finance for all. The AFI is a platform that allows policymakers from over 90 countries to share knowledge and experience, and develop and implement effective policies.

### Financial Education Projects

#### **Financial Education Program for Micro and Small Enterprises**

To support the financial education of entrepreneurs, the National Bank, with support from the Development Facility of the European Fund for Southeast Europe (EFSE DF) and with the involvement of the Export Development Association (EDA), developed a financial education program for micro and small entrepreneurs. As part of the program, “A Guidebook for Micro and Small Enterprises: Interacting with Financial Organizations and Financial Decision-Making” and a relevant training module were developed. As a pilot for this program, some 80 entrepreneurs from the Samtskhe Javakheti and Kvemo Kartli regions received training. In addition, 15 trainers underwent

a training-of-trainers course. The results of the subsequent evaluation of the pilot program, as performed by the NBG and EDA, suggested that the knowledge of the participating entrepreneurs improved as a result. Furthermore, the beneficiaries positively assessed the program and highlighted its usefulness and benefits.

The program aims to equip current and future micro and small business owners with the essential knowledge and skills necessary for making sound financial decisions based on their own business needs and capacities. As part of the program, beneficiaries will learn about the sources of business finance, relevant financial services, and the approaches and indicators used for business assessment. The program will also help beneficiaries understand their own rights and responsibilities, enabling them to independently evaluate their short- and long-term business needs and credit-worthiness. In addition, they will learn about financial reporting and how to effectively plan their future actions to avoid financial pitfalls. The program was developed in simple and user-friendly language and includes case studies, tips and examples to help beneficiaries apply theoretical knowledge in practice.

Throughout 2019, the National Bank is planning to scale up the project with further training of trainers and entrepreneurs, as well as by involving different public, private and civil sector stakeholders, including commercial banks and government agencies working on supporting entrepreneurship.

The guidebook for micro and small entrepreneurs, accompanying financial statement templates and a loan calculator are available to all interested parties for free on the NBG's website: <https://www.nbg.gov.ge/index.php?m=706>

### **Financial Literacy Video Game**

In 2018, the National Bank and VISA launched a localized version of the Financial Football online

game. Financial Football is a dynamic and interactive FIFA World Cup™ video game. The game has three difficulty levels – geared at children, teens and adults – and can be played both single player and head-to-head. In the game, players learn key concepts about saving, budgeting, financial safety, the wise use of credit, and other principles of financial literacy.

The Financial Football game was presented to the public in May 2018 at the Biltmore Hotel in Tbilisi and stakeholders from the public, private and civil sectors were in attendance. As part of the event, the Deputy Governor of the National Bank, the Chair of the Education, Science and Culture Committee of the Parliament of Georgia, and the Vice President of Government Relations in CEMEA (Central Europe, Middle East and Africa) from VISA discussed financial literacy challenges and strategies, the role of games and technology in financial education, and best international practices in the field. Attendees had a chance to play the Financial Football game and test their financial knowledge. The Financial Football game is accompanied by educational modules and tutorials that will allow teachers to use the game in the classroom.

To raise awareness about the Financial Football game, several educational and entertainment events were held during 2018. On 10 June, a football tournament was organized in Mukhrani with the involvement of the Arveladze Foundation and commercial banks. Up to 600 children and teens from all over Georgia participated in the tournament. On 22 September, a back-to-school event was held at Tbilisi Mall, where schoolchildren and their parents had a chance to play Financial Football and receive symbolic gifts from VISA and the NBG.

### **School Olympics in Financial Literacy**

To foster interest towards financial literacy among schoolchildren, the National Bank, the Savings Banks Foundation for International Cooperation (SBFIC) and KINGS Georgia developed an innova-

tive project that involved integrating a financial literacy component into the KINGS School Olympics.

The project was presented to the public at Tech Park Georgia in October 2018. As part of the event, representatives from the National Bank, SBFIC and KINGS Georgia discussed the importance of financial literacy and the objectives of the project with schoolchildren and their parents. In addition, a lecture on key financial decisions – such as saving, budgeting, financial goal setting and financial responsibilities – was held for the youth.

The KINGS School Olympics is an educational program for schoolchildren in grades II to XII. More than 250,000 children and youth across Georgia are involved in the program. The Olympics covers three subjects: Georgian, English and Mathematics. The financial literacy component was integrated in the mathematics olympics. Special educational resources were developed within the frames of the project, which were uploaded on a dedicated online platform: [www.Lupi.ge](http://www.Lupi.ge). These resources cover important financial topics such as personal money management, saving, spending, financial goal setting and decision-making, financial products, consumer rights and responsibilities, and financial safety. These educational resources were developed in a child-friendly format and language.

The final round of the KINGS School Olympics in Mathematics was held in December 2018. In addition to questions on mathematics, schoolchildren had to answer financial literacy questions. The awards ceremony for the winners took place on 30 December at Tbilisi Open University. During this event, representatives from the National Bank and SBFIC awarded symbolic gifts to the winners. The educational resources uploaded to the dedicated educational portal remain accessible for all interested schoolchildren nationwide.

### **Children's Brochures on the History of Money and Budgeting**

The National Bank, with support from EFSE DF, developed two educational brochures for schoolchildren – “Traveling through the World of Money” and the “Financial Education Manual”. These brochures mainly target pupils in grades V-VII, but should be interesting and informative for youth of all ages.

“Traveling through the World of Money” introduces readers to the history, forms, significance and functions of money. Children will learn about contemporary Georgian money, the security features of the Georgian lari banknotes, foreign currencies and unique banknotes. Meanwhile, the “Financial Education Manual” will teach young readers about money management, responsible spending, saving and borrowing. The simplified dictionary of financial terms provided in the brochure, as well as interactive exercises and a personal budget template, will all help readers manage their own finances and develop useful skills. The two brochures are accompanied by a paper piggy bank template, which can be used to start saving. These resources are available for all interested parties for free on the NBG’s website: <https://www.nbg.gov.ge/index.php?m=705>.

To raise awareness about these two brochures among schoolchildren and their parents, NBG representatives visited a number of schools and held interactive lectures throughout 2018. As part of this campaign, on 6 June 2018, Koba Gvenetadze, Governor of the National Bank, visited public school No.23, his alma mater, where he discussed money matters, savings and personal money management with schoolchildren.

### **The SchoolBank project**

Throughout 2018, the NBG continued working on developing and scaling up the SchoolBank project. SchoolBank is a joint project of CYFI and the Na-

tional Bank, which aims at improving the financial literacy levels of youth between the ages of 12 and 15. This includes a 15-lesson educational module that covers saving, responsible spending, budgeting, consumer rights and responsibilities, financial products, and risks and opportunities. This project was piloted in 2017 in partnership with the Ministry of Education, Science, Culture and Sport in 11 public schools in Tbilisi, Rustavi and Mtskheta, as well as in the National Youth and Children's Palace (NYCP).

To scale up the project and involve more schools, in October 2018 the National Bank held an informational meeting with principals and teachers from private schools in Tbilisi. During these meetings, NBG specialists discussed the importance of financial literacy, the content of the SchoolBank project and the opportunities for teacher training. On 13-14 October, the NBG organized yet another teacher training event with support from the Ministry of Education of Georgia. This was attended by teachers from both private and public schools, as well as from the Tbilisi Youth House.

In addition SchoolBank project includes educational and banking component as well: commercial banks can get involved in developing and offering youth-friendly financial products. To facilitate the involvement of more banks in the project, trainers from commercial banks were also invited to the teacher training event held in October. Currently, just one commercial bank is involved in the SchoolBank project, but the NBG is holding consultations with other banks regarding greater involvement.

Five additional public and private schools from the Tbilisi, Zugdidi and Tsalka municipalities, and the Tbilisi Youth House joined the SchoolBank project in 2018. Furthermore, within the frames of a memorandum of understanding, SchoolBank lessons have continued at the National Youth and Children's Palace as well.

In October 2018, the ISET Policy Institute and the National Bank, with support from the Administration of the President of Georgia, hosted a presentation about the effectiveness of the SchoolBank pilot project. The presentation was followed by a roundtable discussion about the effectiveness of financial literacy programs in schools. Representatives from the Ministry of Education and other relevant state organizations, commercial banks, microfinance institutions, international organizations, universities and public schools participating in the SchoolBank project took part in the event.

Research into the SchoolBank pilot was performed by ISET Policy Institute on the basis of pre- and post-test questionnaires that were filled out by the participating schoolchildren. The results of this show that the average financial literacy level among those schoolchildren was improved after participation, specifically in the direction of their financial knowledge and attitudes. The study showed that no gender gap in financial literacy is observable; and that the pilot SchoolBank project was more successful in Tbilisi schools than in those outside of the capital. The empirical results also showed a positive correlation between financial literacy and holding formal saving accounts, which further emphasizes the importance of the financial inclusion of the youth.

Throughout 2019, the NBG and the Ministry of Education are planning to strengthen their cooperation and involve more regional schools in the SchoolBank project.

### Awareness-raising Events

Throughout 2018, the NBG has continued its tradition of being actively involved in annual events dedicated to raising awareness about financial literacy.



### **Global Money Week**

Global Money Week (GMW), which is a CYFI initiative, was celebrated for the fifth time in Georgia in 2018. With coordination from the NBG, the event saw the involvement of the Ministry of Education, the NYCP, Junior Achievement Georgia (JAG), commercial banks, microfinance organizations, schools and universities. GMW is celebrated annually across the globe every March, and its main goal is to help spread financial, economic and entrepreneurial literacy among children and youth. The GMW slogan for 2018 was “Money Matters Matter.”

As part of the GMW celebrations, the NBG and Ministry of Education organized a country-wide drawing competition for schoolchildren between grades II and XII on the topic of Georgian money. The competition was titled the “Future Governor of the National Bank of Georgia.” During this event, individual schools undertook an initial review of the submitted pieces of work and then forwarded over 300 selected art pieces to the National Bank. Some of the artwork depicted existing banknotes and coins in a creative manner, while others portrayed completely new nominal values and designs. The NBG organized an educational field trip to the Money Museum in Kvareli for the 20 winners of the competition. As part of that field trip, the winners talked about their artwork, listened to a lecture about the history of Georgian money and discussed the importance of money with representatives of the National Bank. On 18 March, JAG, in cooperation with the National Bank, hosted an Innovations Camp on the topic of financial literacy at International Black Sea University. During this intensive, idea-generating event, 35 children between the ages of 9 and 12 worked in groups to plan the budget of an average Georgian family – requiring them to manage income and expenses and make savings. Throughout the day, children had access to guidance from mentors and experts.

During GMW, specialists from the National Bank’s Cash Circulation and Currency Production and Financial Education Divisions visited the NYCP and held an interactive lecture on the history of contemporary Georgian money for children between the ages of 11 and 14. The NBG specialists and participating children discussed the history and significance of Georgian money, the transformation of the Georgian lari since its first emission, the process of issuing Georgian banknotes and removing them from circulation, collectible coins and banknotes, and the importance of money in young people’s lives.

### **World Savings Day**

On the joint initiative of the SBFIC and NBG, and with the involvement of commercial banks, World Savings Day (WSD) was celebrated again on 31 October 2018. The goal of WSD is to raise awareness about the benefits of saving and to promote saving among children as well as adults. In 2018, seven commercial banks – the Bank of Georgia, Basisbank, Credo Bank, FINCA Bank Georgia, Liberty Bank, TBC Bank, and Terabank – participated in activities dedicated to WSD.

As part of the WSD celebrations, commercial banks displayed a video dedicated to Grovia, the Georgian mascot of WSD, in their branches. Moreover, as is now an annual tradition, commercial banks provided information about WSD and the importance of saving on their ATMs, websites and social media. In addition, commercial banks visited schools and disseminated print materials dedicated to financial literacy among schoolchildren.

The National Bank and SBFIC also organized a social media competition for the youth – titled “Play against the Chief Banker” – on Grovia’s Facebook page. As part of the competition, the Governor of the NBG asked video-questions to children between the ages of 9 and 13. As a result of this competition, 25 winners were chosen and were

invited by the NBG and SBFIC to an entertaining educational event at the International Scout Center Rustavi on 3 November. As part of the event, participating children were formed into teams and had to compete against each other in a game about saving. The organizers of the event awarded symbolic gifts to each participant, while commercial banks opened child deposit with 500 GEL for all members of the winning team so that they and their parents can continue saving in the future.

### **Innovations Camp in cooperation with Junior Achievement Georgia**

On 7 October 2018, the NBG and Junior Achievement Georgia hosted an Innovations Camp on financial literacy at the State Teaching University of Zugdidi. This was the second time the camp was held during the year.

The Innovations Camp was implemented within the framework of the USAID project “Supporting Entrepreneurship Education in Georgia”. Six commercial banks – the Bank of Georgia, Credo Bank, FINCA Bank Georgia, Liberty Bank, TBC Bank, and Terabank – as well as the Crystal microfinance organization participated in the camp. It involved 120 schoolchildren between the ages of 15 and 18 from the Adjara, Guria, Imereti and Samegrelo-Zemo Svaneti regions.

The camp was opened by NBG specialists who held an interactive lecture on financial literacy in which the young attendees discussed the importance of financial education. After this, a challenge was presented and the youth had to work in teams throughout the day to find effective solutions to the problem. During the event, students had access to range of tools, information and resources, while representatives from commercial banks and the microfinance organization assumed the role of “Volunteer Experts” who held consultations with the children, provided advice, helped them develop innovative ideas and offered information about financial topics. By the end of the event, each team presented a business plan and dis-

cussed their innovative solutions and methods for solving the challenge. A jury subsequently chose the winning team and awarded symbolic gifts to each participant.

## **Local and International Cooperation**

### **Cooperation with the Ministry of Education, Science, Culture and Sport of Georgia**

Throughout 2018, the NBG continued its cooperation with the Ministry of Education, Science, Culture and Sport of Georgia (Ministry of Education) for integrating financial literacy into the national school curriculum for grades VII-IX.

In May 2018, a new national curriculum was approved, according to which a financial education module was integrated into the civics education subject “Citizenship”. The financial education module covers the following key topics: saving, spending and personal money management, financial organizations and services, consumer rights and responsibilities, charity, budgets and taxes, insurance, investment, financial risks, fraud and safety. Teaching of the new national curriculum in grade VII will begin across the country in September 2019, while it will gradually be implemented for grades VIII to IX in upcoming years.

Under the initiative of the Ministry of Education, and with the involvement of the NBG, a workshop was organized for the publishers and authors of the “Citizenship” and mathematics textbooks in December 2018. During the workshop, NBG specialists discussed the importance of financial literacy with the participants, as well as the key financial education topics to be taught as part of the national curriculum. The authors and the publishers also received educational resources developed by the NBG and other stakeholders.

In order to build the capacity of “Citizenship” teachers in the direction of financial education, the NBG is currently developing a special guidebook that will discuss the main financial-economic

topics covered by the national curriculum and offer useful advice and possible activities that can be used in the classroom. Throughout 2019, the NBG is planning to cooperate with the Ministry of Education in teacher training and to integrate financial literacy in the national curriculum for later grades.

### **The activities of the Steering Committee of the National Strategy for Financial Education and the World Bank's Technical Assistance (TA) project**

In February 2018, the NBG hosted the third meeting of the Steering Committee of the National Strategy for Financial Education. The goal of the meeting was to discuss joint projects for the “Year of Financial Literacy”, as well as the main challenges and difficulties related to implementing the National Strategy for Financial Education. The meeting was chaired by the Governor of the National Bank.

The NBG hosted the World Bank's Technical Assistance (TA) mission in May 2018 in order to facilitate the successful implementation of the National Strategy for Financial Education and to improve the effectiveness of the work of the Steering Committee.

The priority for the TA project was to develop an action plan for the implementation of the National Strategy for Financial Education. As part of the mission's visit, individual meetings were held with Steering Committee members and other stakeholders. These meetings were dedicated to discussing the main challenges in the direction of financial literacy, as well as the interests, capacities and plans of the stakeholders, and possible synergies between these and the NBG's objectives.

During the mission, the expert from the World Bank shared best international practice and made recommendations for implementing financial literacy programs directed at different target groups.

The expert also shared resources for use on the financial literacy website, and, in partnership with the National Bank, developed a draft action plan. The action plan is currently being discussed in consultation with the Steering Committee's members. Approval of the action plan is planned for the beginning of 2019.

### **Cooperation with OECD/INFE and the Ministry of Finance of the Netherlands**

In 2018, the NBG became involved in the OECD/INFE 5-year Technical Assistance (TA) Project for Financial Education, which was conducted with the financial support of the Ministry of Finance of the Netherlands. In addition to Georgia, six other countries from Southeast Europe are involved in this project – Bulgaria, Croatia, North Macedonia, Moldova, Montenegro, and Romania. The project aims at supporting central banks and other relevant stakeholders in participating countries to improve the financial literacy levels of their populations. The project has three priority directions: planning and implementing research in the direction of financial literacy; designing and evaluating a National Strategy for Financial Education; and assisting stakeholders in implementing the national strategy and in designing effective interventions to promote financial literacy.

As part of the program, the NBG and OECD/INFE hosted public and private sector roundtables in July 2018. These were attended by representatives from the Ministry Education, Ministry of Economy and Sustainable Development, Ministry of Labor, Health and Social Affairs, the Entrepreneurship Development Agency, commercial banks, microfinance organizations, universities and non-governmental organizations. During the roundtables, participants singled out Georgia's main needs and key priorities. They also discussed the existing situation and challenges to financial literacy, the planned projects from each participating organization, monitoring and evaluation tools for financial literacy interventions, and the

development of the National Strategy for Financial Education.

In October 2018, the Governor of the National Bank took part in the project's official launch event in the Hague, which was attended by high-level officials from the participating countries. The Governor of the National Bank talked about

the projects undertaken and the results achieved in Georgia in the direction of financial education, and highlighted the importance of international cooperation for improving financial literacy levels. As part of the launch event, the needs of each participating country, as well as plans for future cooperation were discussed.



*Building of the National Bank of Georgia (1910-1915)*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## SUPERVISION OF NON-BANK DEPOSITORY INSTITUTIONS

# 6.1 Non-Banking Financial Institutions

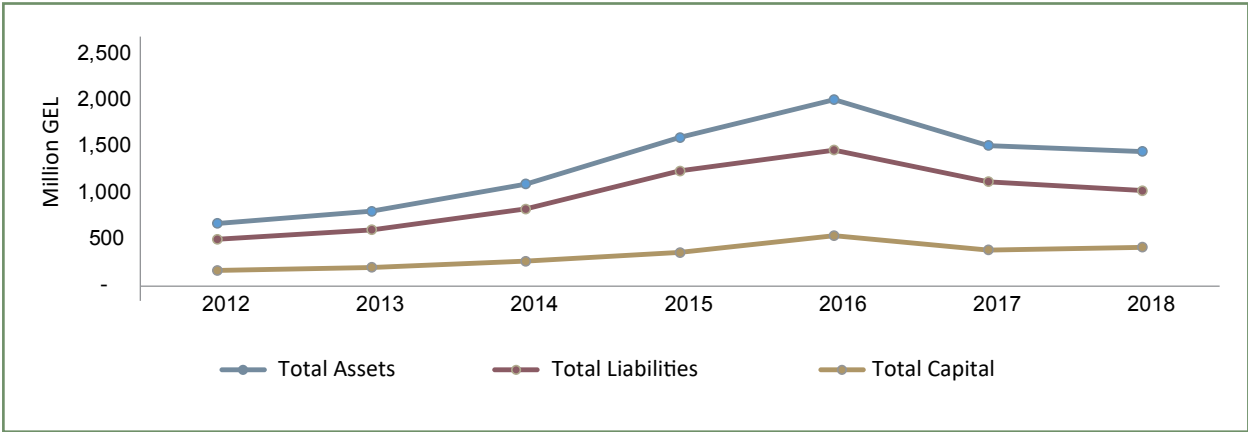
As of 31 December 2018, the non-banking sector in Georgia was represented by 67 microfinance organizations, 1,018 currency exchange bureaus and two credit unions.

## 6.1.1 Microfinance Organizations

During 2018, the total assets of microfinance organizations gradually increased until the last

quarter of the year when the indicator started to decline. By the end of the year, total assets amounted to 1.45 billion GEL, which falls 66 million GEL short of the corresponding figure in 2017. This trend was triggered by several factors, including the initiation of liquidation processes in eight microfinance organizations, the trading of the credit portfolios of a number of microfinance organizations, and the formation of possible asset loss reserves – the latter of which have been required for microfinance organizations since 1 September 2018.

**Diagram 6.1 The dynamics of assets, liabilities and capital**

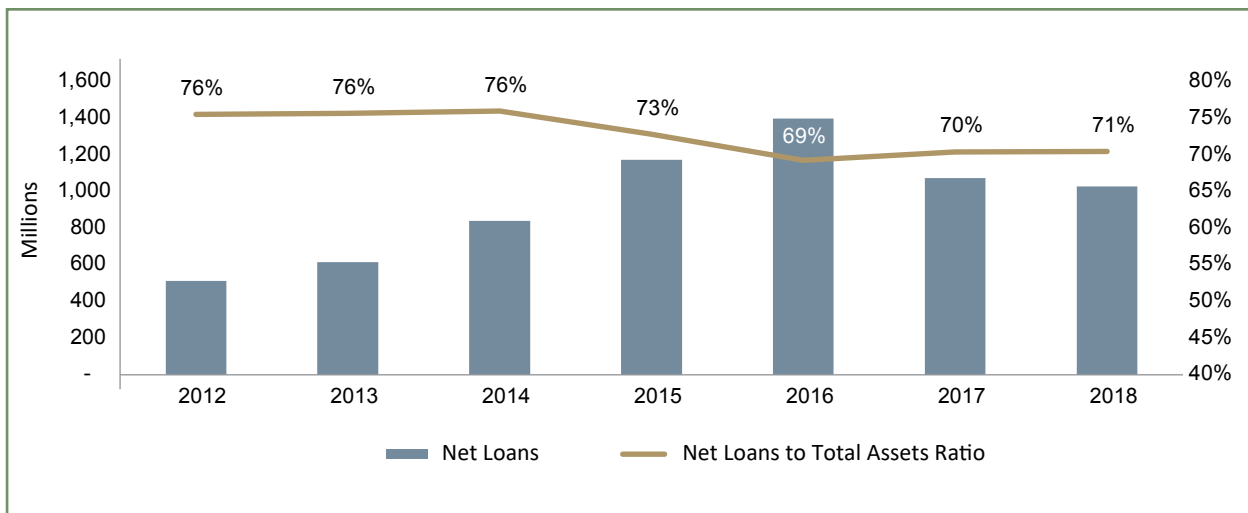


Source: National Bank of Georgia

As of 31 December 2018, the total net portfolio amounted 1.03 billion GEL. The share of the net

portfolio to total assets has not changed considerably in recent years and has remained around 71%.

**Diagram 6.2 The dynamics of net portfolio to total assets**

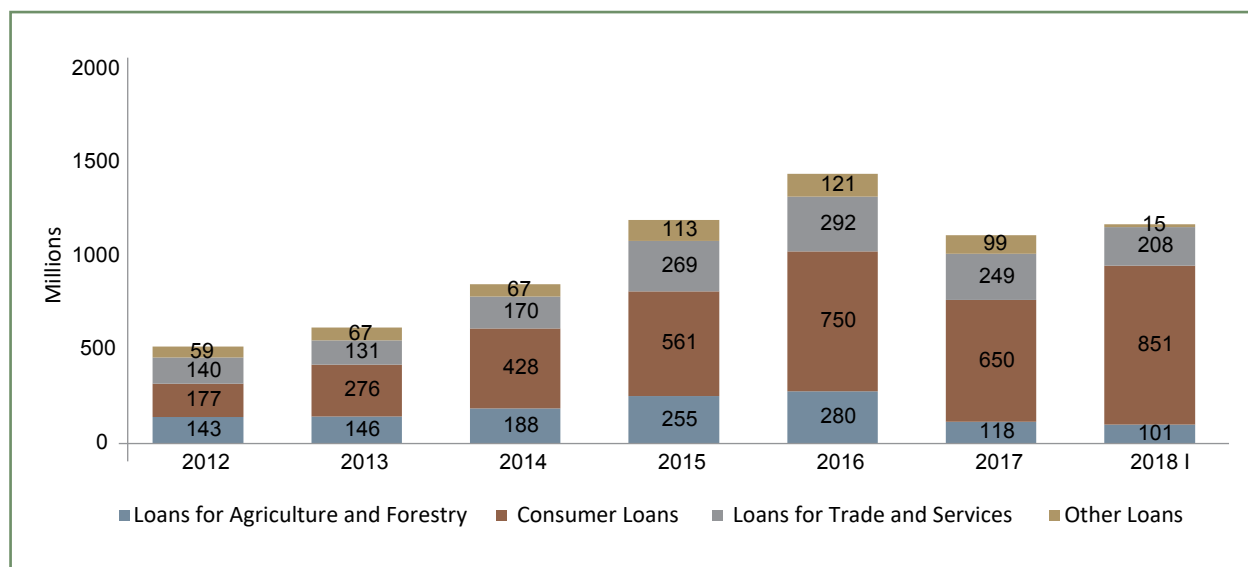


Source: National Bank of Georgia

The credit portfolio of the microfinance sector mainly covers three areas: 1) Consumer loans, amounting to 798 million GEL (72% of the total portfolio); 2) Trade & Services, amounting to 187

million GEL (17% of the total); and 3) Agriculture & Forestry, amounting to 95 million GEL (9% of the total).

**Diagram 6.3 The structure of the total portfolio**



Source: National Bank of Georgia

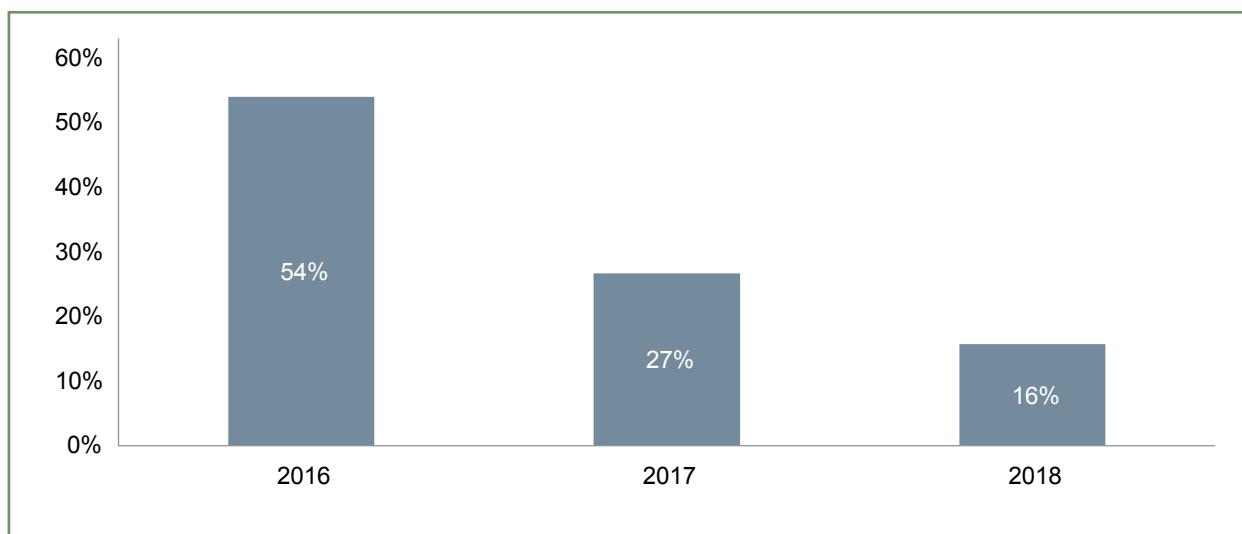
The upsurge in the share of consumer loans in the total portfolio was caused by the technical reclassification of the credit portfolio.

than 100,000 GEL granted to private individuals could no longer be issued in a foreign currency. As a consequence, in 2018, the dollarization rate of the credit portfolio of microfinance organizations decreased from 27% to 16%.

As a result of legal changes to Article 625 of the Civil Law, starting from January 2017 loans of less



**Diagram 6.4 The dollarization of the credit portfolio**

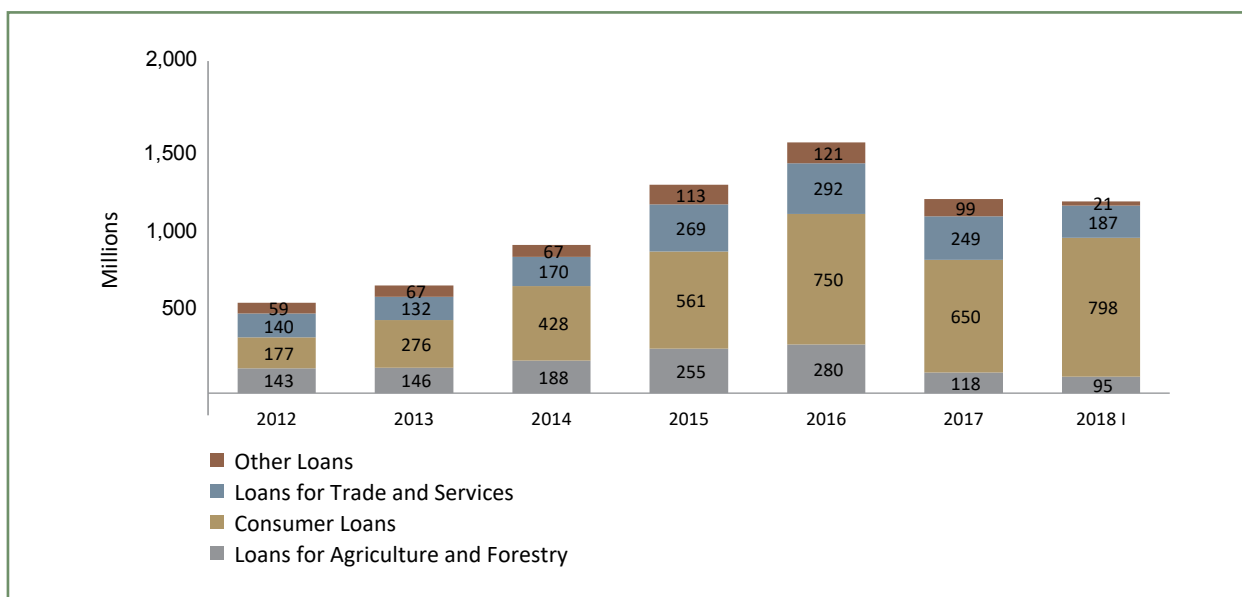


Source: National Bank of Georgia

Similar to previous years, the main source of asset funding (66% on average) remained attracted

funds, and the share of non-resident lenders was 44%.

**Diagram 6.5 The structure of attracted funds**



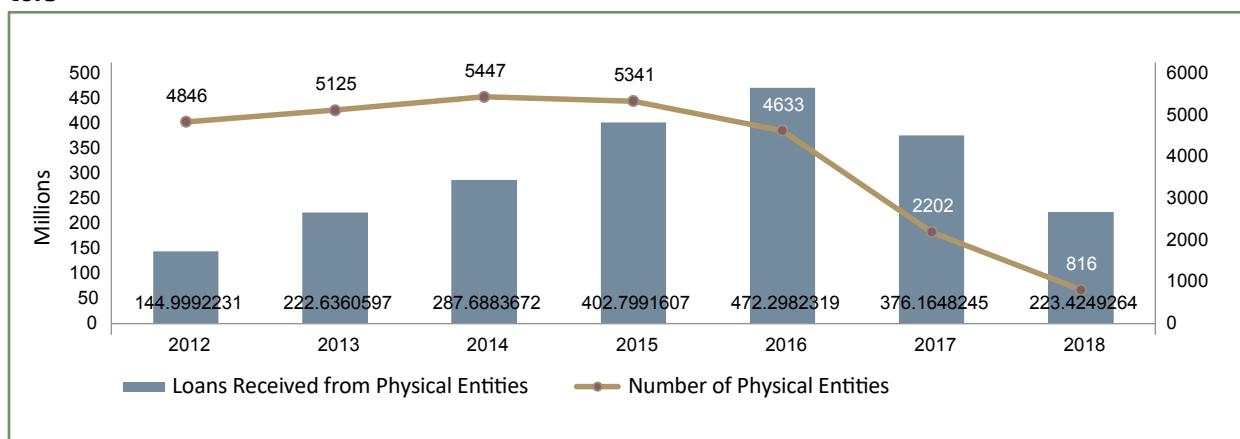
Source: National Bank of Georgia

In 2018, the structure of the liabilities of micro-finance organizations was modified. This has been reflected in the replacement of funds from private individuals with liabilities towards financial institutions. In particular, compared to 2017, the share of funds from private individuals has declined from 36% to 23% (by 153 million GEL) in 2018, whereas the share of credit from banks and

financial institutions has increased from 41% to 58% (by 132 million GEL).

Within the structure of funding from private individuals, there has been a decline in both the volume of funds and the quantity of creditors (in 2017 there were 2,202 creditors; in 2018 there were 816).

**Diagram 6.6 Total funds attracted from private individuals and the quantity of private individual creditors**



Source: National Bank of Georgia

During 2018, the share of subordinated loans in total liabilities drastically increased (by 28 million GEL). This was due to the new regulations that require microfinance organizations to have a minimum amount of supervisory capital. This, alongside the growth of share capital by 56 million GEL, has contributed to increased sustainability, growing resistance towards sectoral risks and an improvement of the liquidity position. As of 31 December 2018, the coefficients of capital adequacy and liquidity were 30% and 34% respectively.

In 2018, the operational profit of the microfinance sector amounted to 150 million GEL; however, the net profit was 31 million GEL, which was caused by the one-time effect of possible asset loss reserve costs (106 million GEL). This, along with the increase of capital, has considerably reduced the return on equity, which amounted to 7.6%.

### 6.1.2 Credit Unions

As of 31 December 2018, two credit unions were operating in the non-banking sector with total assets of 2.4 million GEL.

According to the amendments made on 23 December 2017 to the “Law of Non-Bank Depository Institutions – Credit Unions”, one of the main

principles of Credit Union activity were defined as the unification of individuals living in the same administrative unit of the same self-governing community. Furthermore, the maximum number of union members was set at 200. The main purpose of these changes was to encourage the creation of such entities based on shared goals and necessity, rather than for the purpose of attracting deposits from members.

These changes influenced events in this sector during 2018. In particular, five out of the eight previously licensed credit unions had their registration terminated and liquidation processes have begun upon their written request. In one case, a credit union was liquidated as a result of the NBG’s supervisory engagements.

As a result of the amendments made on 23 December 2017 to the Organic Law on the National Bank of Georgia, the NBG is authorized to supervise loan-issuing entities, including powers of registration, termination of registration, regulation, and the issuance of written directives, requests, restrictions and sanctions. On 27 September 2018, according to Order N217/04 of the President of the National Bank of Georgia, the “Rule of Registration, Termination of Registration and Regula-

tion of Loan Issuing Entities” was approved. The registration of such organizations started on 20 December 2018 and a deadline for entities that are subject to registration was set for 30 April 2019.

## 6.2 The Regulation and Supervision of the Non-Banking Sector

Significant changes have been implemented in the normative base in regard to the regulation and supervision of the non-banking sector. In particular, new normative acts have been passed and existing legislation has undergone important alterations.

For the purpose of increasing transparency and access to information related to the microfinance sector, a new rule of the “Manner and Term of Filing Financial Statements and Regulation of Submitting Accounts by Microfinance Organizations to the National Bank of Georgia” was approved. This rule has considerably changed the format of financial reporting. Active microfinance organizations (MFOs) are now required to publish information on their websites on a quarterly basis. Furthermore, MFOs have to conduct annual external audits and publish audit reports on their websites by 15 June of the following year.

The rule on the registration of microfinance organizations has also undergone significant changes, with registration requirements having been made stricter. It has become mandatory for MFOs to provide information about their sources of capital and correspondence criteria were set for administrators and beneficiary owners.

The National Bank approved the rule on “Assets Classification and the Creation of Reserves for Possible Losses by Microfinance Organizations” with the purpose of classifying assets according to risks and forming adequate reserves to compen-

sate possible losses. To mitigate credit risks, microfinance organizations are supposed to establish and follow the written policy and procedures approved by a supervisory board and to present the National Bank with information about the reserves they have formed in accordance with the rule. This will allow creditors, management, shareholders, potential investors, the National Bank and other stakeholders to be informed about the organization’s real financial situation.

The rule on the “Regulation and Supervision of Microfinance Organizations” defines relevant norms and limits, including capital liquidity, investments and other coefficients, as well as the minimum amount of supervisory capital and its methods of calculation. Moreover, a differentiated and more conservative approach has been taken towards those microfinance organizations whose funds from private individuals exceed 50% of their supervisory capital. As a result of these changes, the system has become more liquid and capitalized. Once the legal changes are completely enforced (by 30 June 2019), these indicators will most likely increase even further and thereby facilitate the improvement of solvency and encourage the stable functioning of system participants.

According to Order N59/04 of the Governor of the National Bank of Georgia of 5 April 2018, the “Rule of Liquidation of Microfinance Organizations” was approved. This defined the main stages of the liquidation process, the duties and responsibilities of the liquidator and the sequence for pay-offs. After the enactment of this rule, liquidation processes began in eight microfinance organizations, five of which were initiated by the organizations themselves.

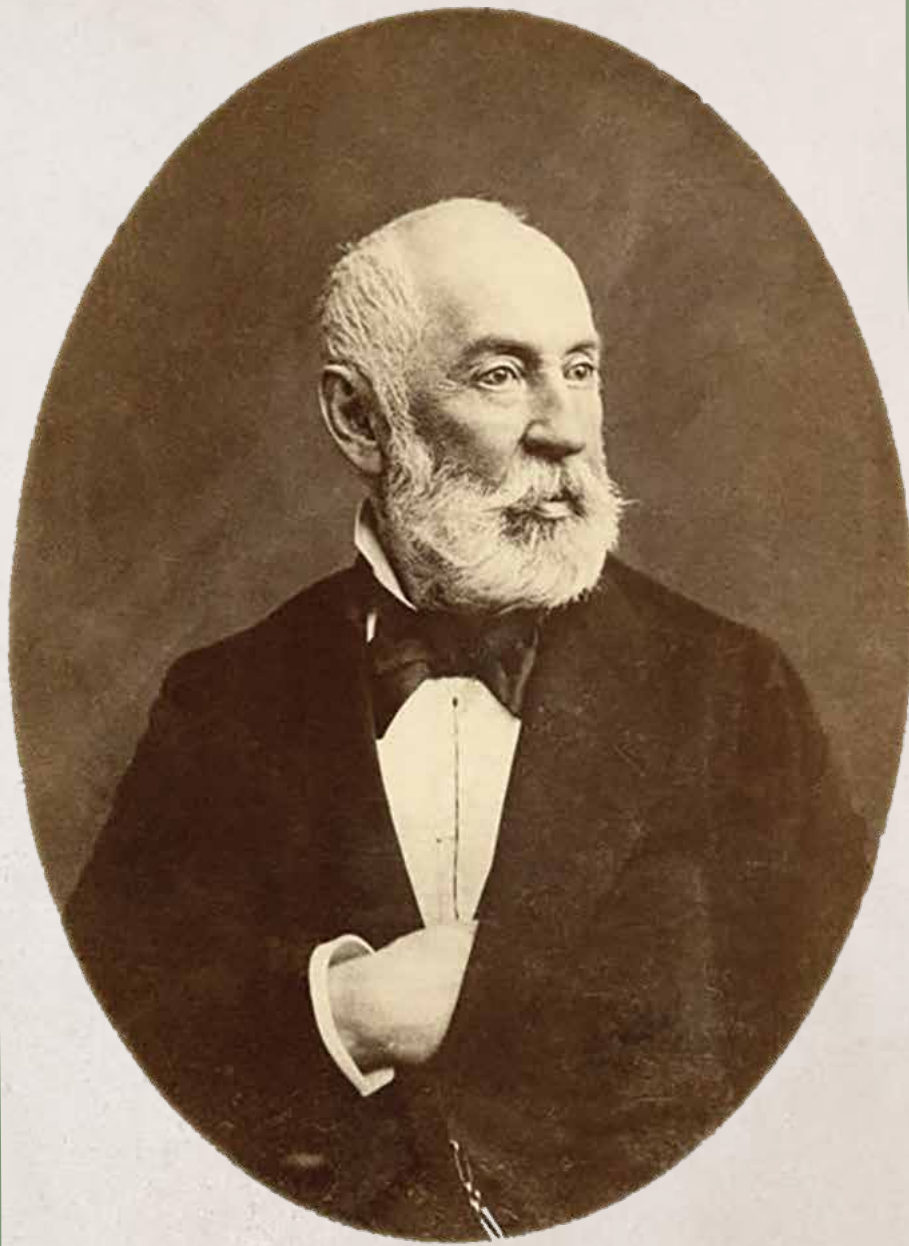
On 28 February 2018, by Order N37/04 of the Governor of the National Bank of Georgia, the “Rule of Registration and Regulation of Currency Exchange Bureaus” was approved. This rule aims at protecting consumer rights and sets certain requirements

for currency exchange bureaus. For instance, if a transaction amount does not exceed 5,000 GEL or its equivalent in foreign currency, a customer is free to cancel the transaction and receive their money back within 30 minutes after the completion of an exchange operation upon providing a receipt. Furthermore, this rule has made registration requirements stricter regarding correspondence criteria and the arrangement of operational spaces.

For the purpose of increased transparency and the maximum involvement of sector participants in the process of legal changes, the National Bank continued to regularly publish drafts of new normative acts. Moreover, numerous working group

meetings were organized with the microfinance organizations and loan-issuing entities that became subject to registration. As a result of such coordination, the views of sector representatives were taken into consideration. In addition, since the enforcement of these rules and regulations, the National Bank has regularly been communicating with supervised entities so as to ensure smooth implementation of the changes.

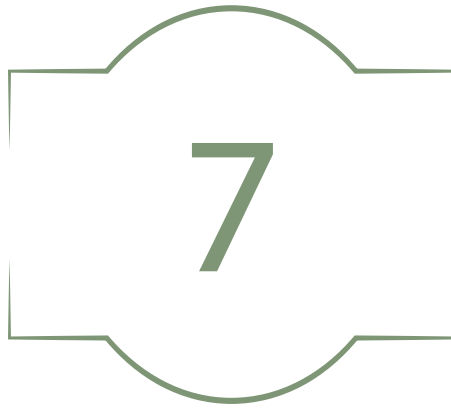
The National Bank of Georgia will continue active communication with sector representatives within the framework of its supervision strategy to ensure the stable functioning of the sector and the maximum protection of consumer rights.



*Dimitri Kipiani,  
Founder of the Nobilities Land Bank*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## SECURITIES MARKET

In 2018, substantial steps were taken for the further development of the securities market and its supervisory policy.

## 7.1 Securities Market Development

### **IOSCO Self-Assessment**

As a result of a thorough working process that commenced in 2017, the National Bank of Georgia became an associate member of the International Organization of Securities Commissions (IOSCO). Since then, the NBG has been actively cooperating with the World Bank to finalize the self-assessment of the regulatory/legal and supervisory framework of the Georgian securities market in line with the IOSCO objectives and principles.

For future endeavors, the NBG plans to improve its ties with IOSCO by signing a multilateral memorandum of understanding and becoming an ordinary member. The NBG has already started working on adjustments to the different legal and regulatory securities market frameworks in order to meet all of the requirements in an efficient and timely manner.

### **Investment Funds**

In 2018, the NBG worked with Ministry of Economy and Sustainable Development of Georgia, different market participants, foreign supervisory entities, and a diverse range of international organizations on establishing a common framework for investment funds. The renewed legal document that has been developed is based on the European regulations and principles that are applicable to different types of investment funds.

The NBG plans to share its legal project with broader audiences to consider their opinions about making further changes in a sequential ar-

angement. In addition, the NBG is working with the Ministry of Finance of Georgia on a tax framework for investment funds that will be specifically customized for the domestic market and its needs.

### **Approximation of the Georgian Securities Market Legislation with European Laws and Regulations**

A sound legal framework is one of the key components for a well-functioning securities market. The NBG signed a three-year agreement with the Financial Services and Markets Authority (FSMA) to establish a proper legal framework for the Georgian securities market. Focusing on the regulatory framework for market intermediaries and issuers, the updated legislation will be formed in accordance with EU standards. It will drastically ameliorate the current supervisory framework through advancing intermediary services, protecting the rights and interests of investors, and increasing market transparency.

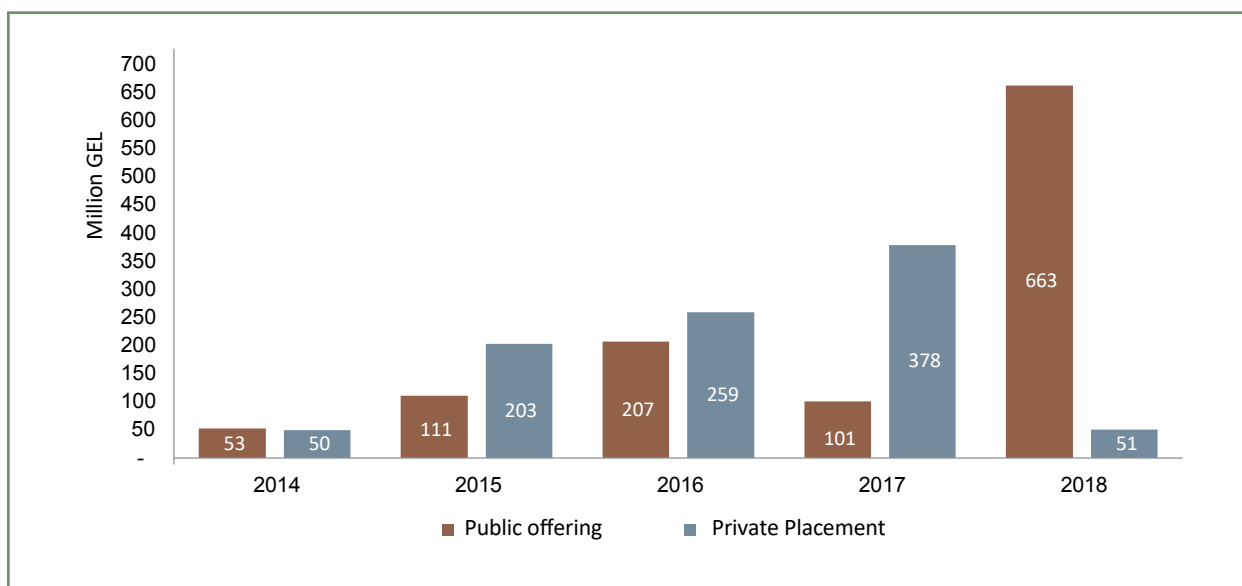
## 7.2 Securities Market Indicators and Core Participants

### **The bonds market**

In 2018, activity on the bonds market improved significantly. A total of ten companies issued 15 bonds totaling 714 million GEL, of which 12 were issued through public offerings and the remaining three through private offerings (see Diagram 7.1).

Compared to the previous year, the number of bonds issued through public offerings increased by 6.6 times and amounted to 663 million GEL, of which a 458 million GEL contribution was made by international financial institutions. The bonds issued through private offerings include those that have been assigned an International Identification Number (ISIN) by the NBG.

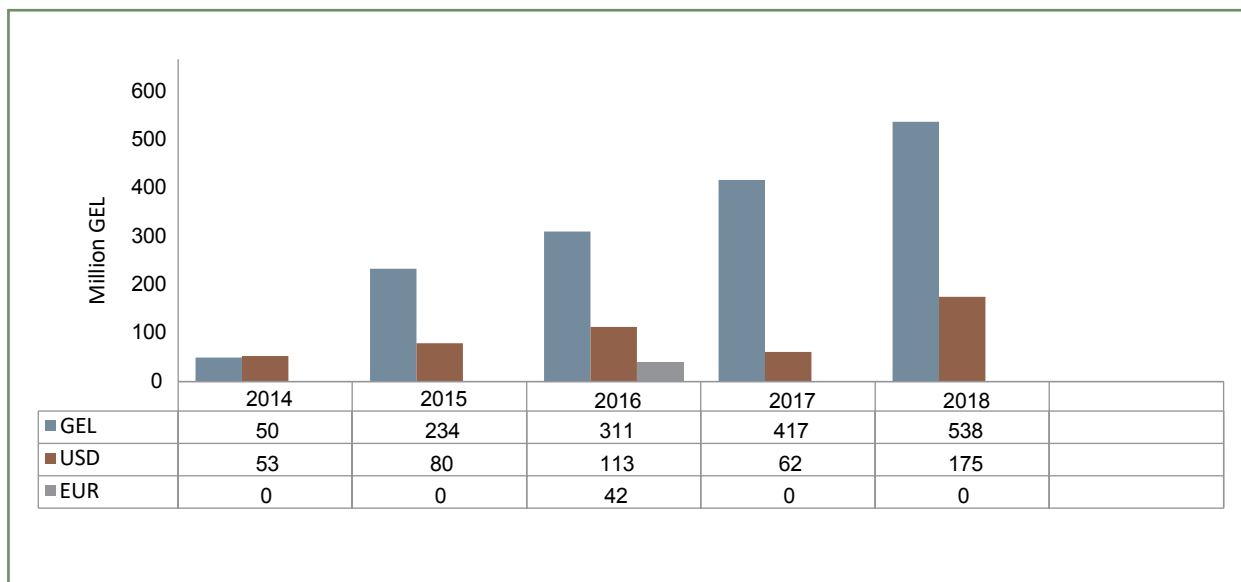
**Diagram 7.1 The volume of bonds placed through public and private offerings, 2014-2018**



Source: National Bank of Georgia

Furthermore, the volume of debt securities denominated in GEL increased throughout 2018, reaching approximately 75% of the bonds issued.

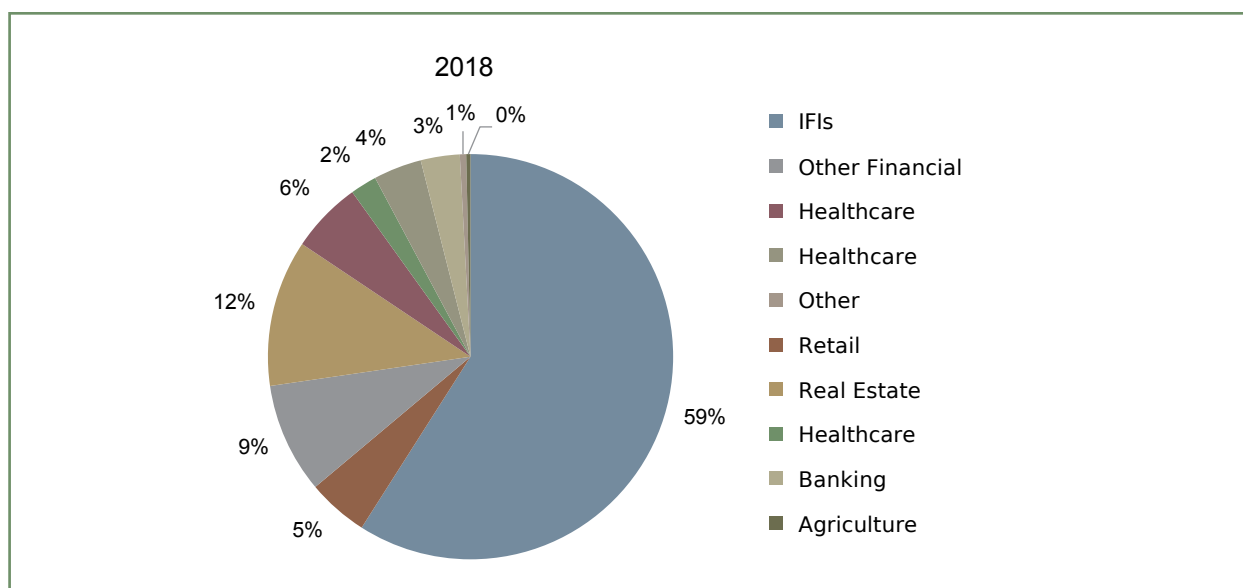
**Diagram 7.2 Dynamics of bonds issued by currency, 2014-2018**



Source: National Bank of Georgia

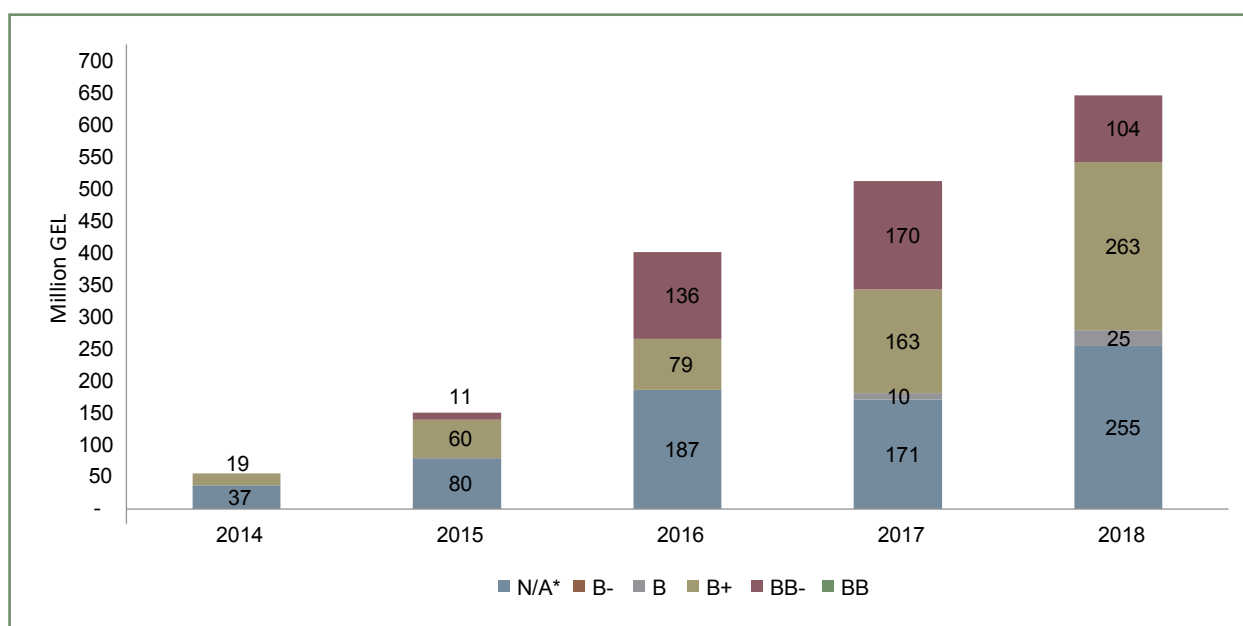


**Diagram 7.3 Bonds outstanding by issuer sector (as of the end of 2018)**



Source: National Bank of Georgia

**Diagram 7.4 Dynamics of outstanding corporate bonds by credit rating, 2014-2018<sup>44</sup>**



Source: National Bank of Georgia

44. In the chart, N/A refers to corporate bonds without a credit rating.

The volume of outstanding-rated issuances increased by 50 million GEL compared to 2017, and totaled 392 million GEL in 2018. Meanwhile, B+ rated issuances grew by 100 million GEL. Furthermore, throughout 2018 several existing issuers obtained credit ratings.

### The shares market

In comparison with the bond market, there was no public issuance of shares in 2018. The National Bank of Georgia is thus continuing to investigate this issue and is conducting rigorous market research to identify major breaches in supply and demand factors. The improved supervisory environment, increased issuer transparency and proper implementation of high corporate standards should attract more investors and increase their interest in the market.

### Overview of market participants

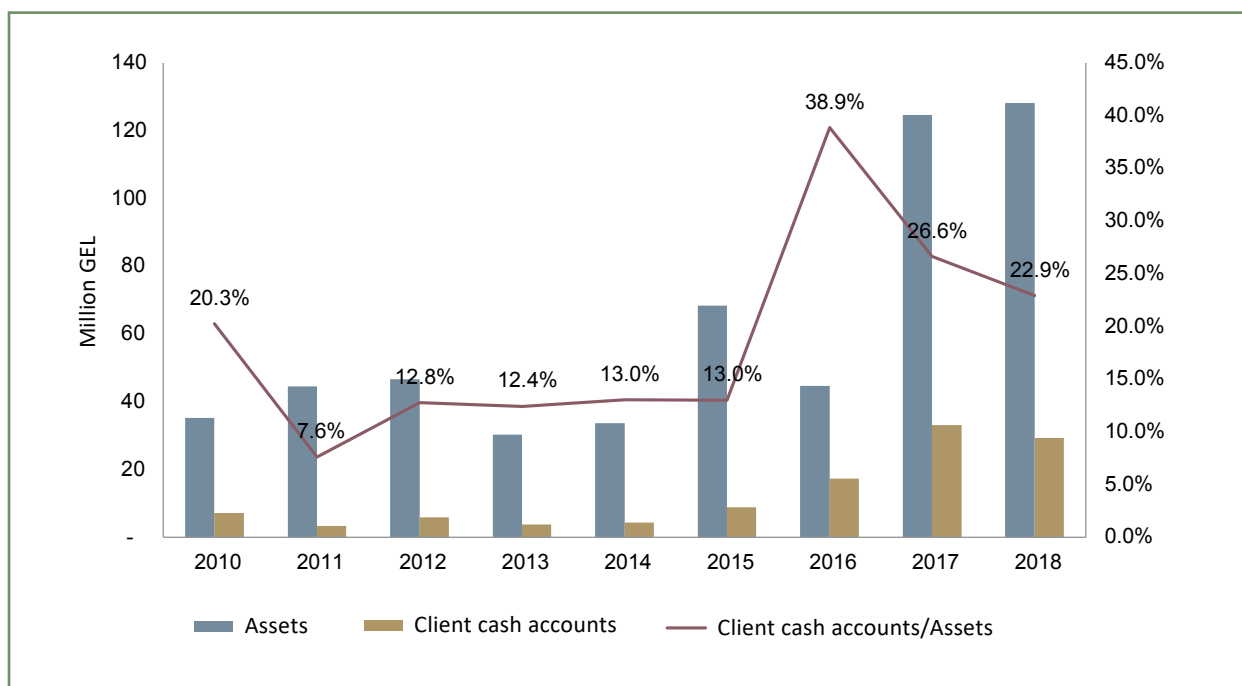
By the end of 2018, the Georgian securities market comprised two stock exchanges, a central securities depository, four independent securities registrars and 10 brokerage companies, of which four were not members of the Stock Exchange.

### Brokerage companies

The increased activity of the debt securities market affected the growth rate of market intermediaries. By 31 December 2018, total assets of active brokerage companies amounted to 128.2 million GEL.

According to 2018 data, client cash accounts amounted to 29.4 million GEL, which accounted for 22.9% of brokerage companies' total assets.

**Diagram 7.5 Dynamics of total brokerage assets and client cash accounts as a percentage of total assets, 2010-2018**



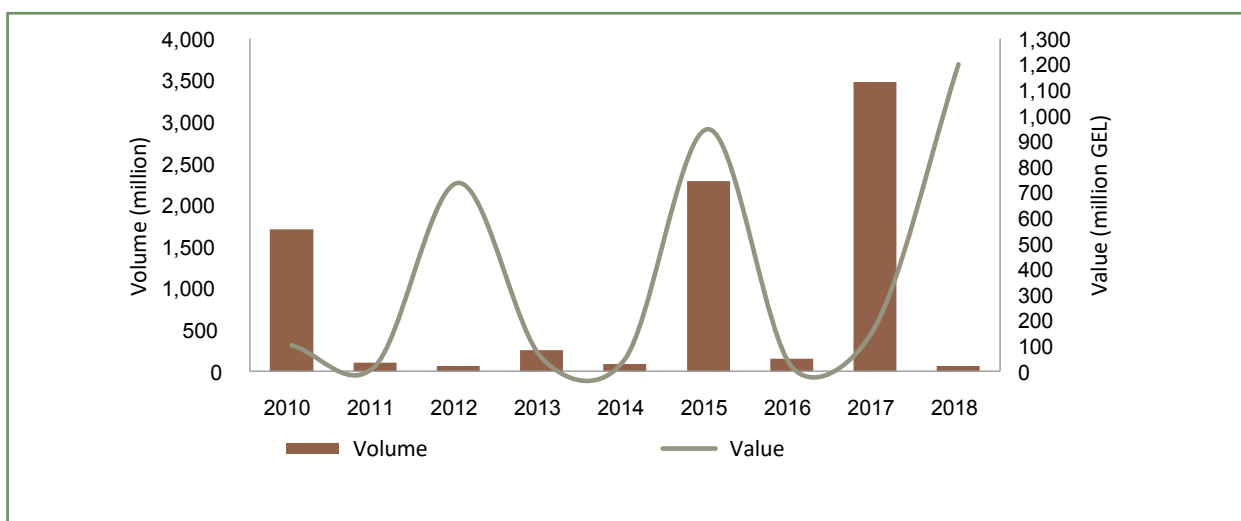
Source: National Bank of Georgia

**Table 7.1 Aggregate information on transactions carried out on the Georgian Stock Exchange, 2017-2018**

Year	Number of trades		Quantity of securities traded		Value of securities traded (GEL)	
	2018	2017	2018	2017	2018	2017
Trading sessions	133	277	2,851,935	7,312,239	1,425,925	26,558,750
Fixing	215	438	60,375,060	3,470,735,399	1,197,286,628	146,161,813
<b>Total</b>	<b>348</b>	<b>715</b>	<b>63,226,995</b>	<b>3,478,047,638</b>	<b>1,198,712,553</b>	<b>945,623,382</b>

Source: National Bank of Georgia; Georgian Stock Exchange

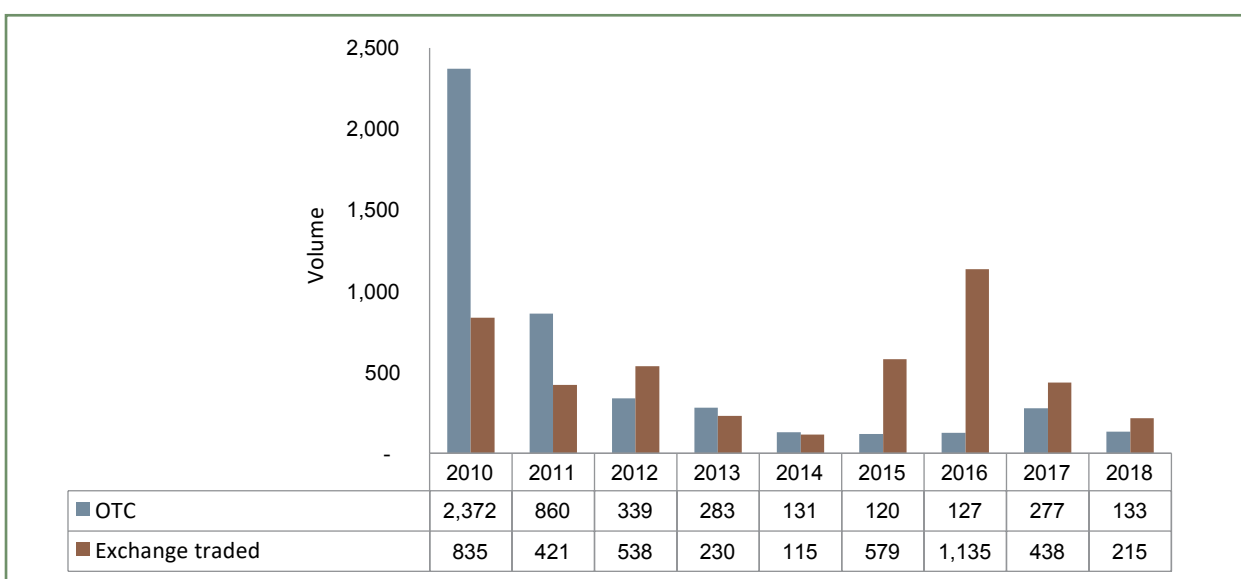
**Diagram 7.6 Major trade indicators for transactions carried out on the Georgian Stock Exchange, 2010 -2018**



Source: National Bank of Georgia; Georgian Stock Exchange

Compared to previous periods, the value of transactions has increased significantly. This was a result of JSC Bank of Georgia's OTC transaction of 1058.5 million GEL (with a volume of 5.5 million units).

**Diagram 7.7 Number of transactions made on trading sessions on the Georgian Stock Exchange, 2010-2018**



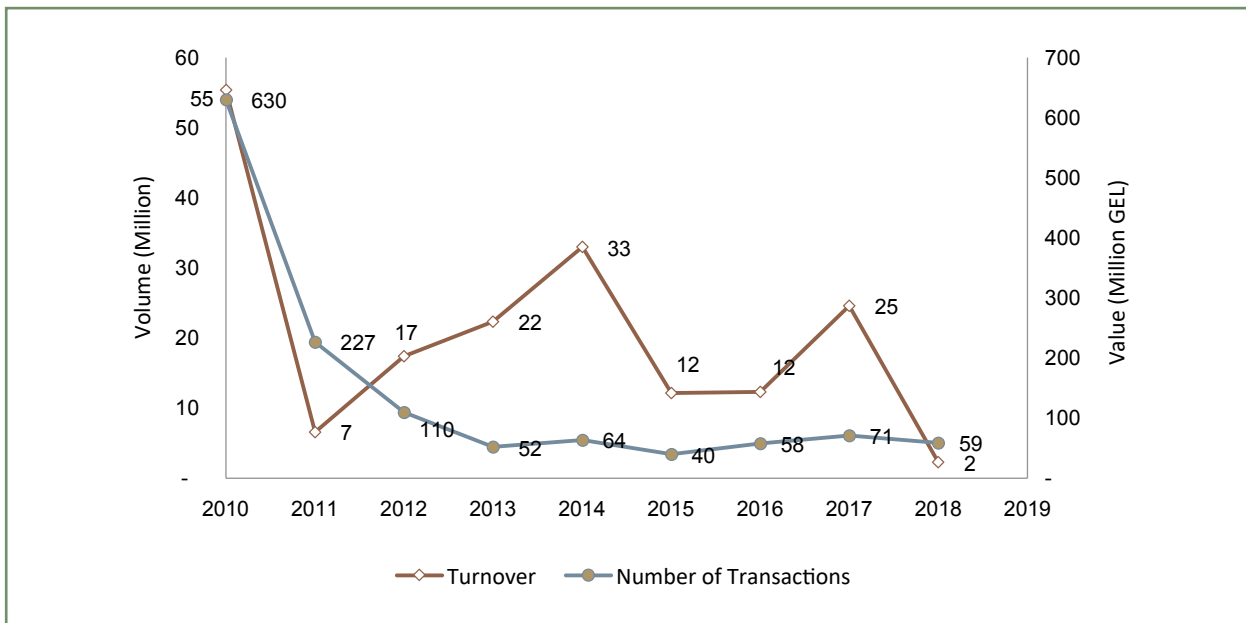
Source: National Bank of Georgia

### Central Securities Depository

In 2018, 2.3 million securities and funds amounting to 0.9 million GEL were deposited on the Georgian Central Securities Depository (GCSD). In terms of the funds deposited, 70.0% of transactions and 95.4% of the total amount were execut-

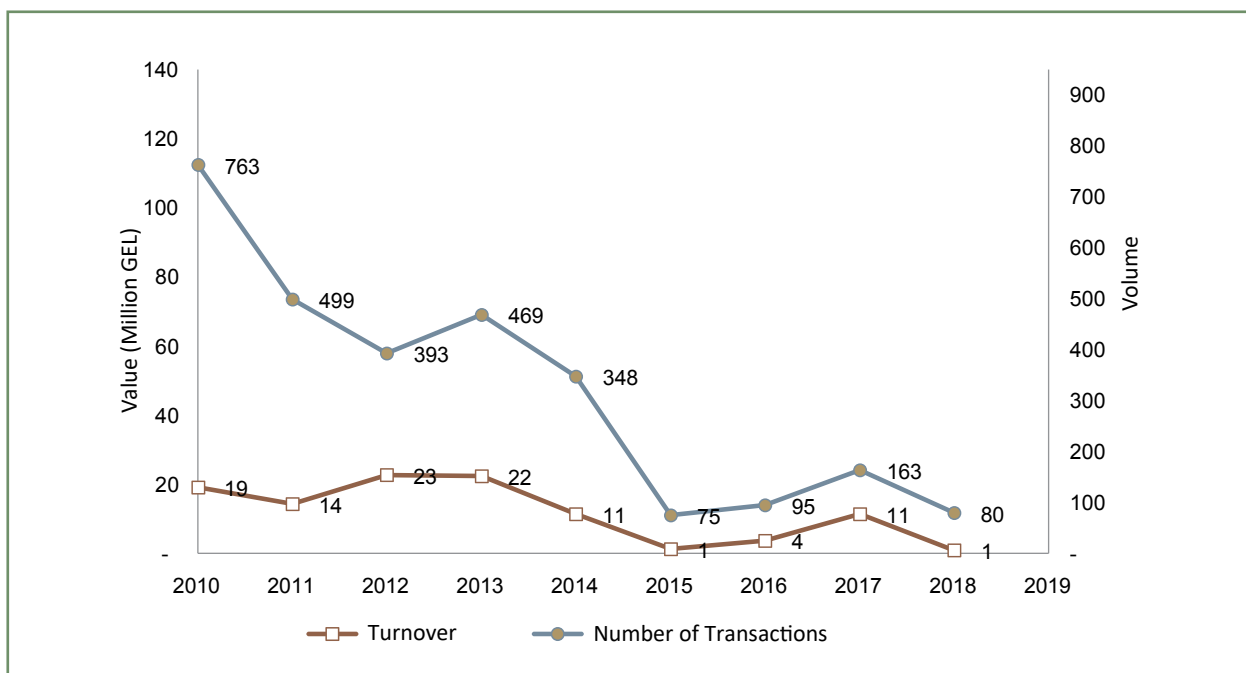
ed through the participation of JSC Bank of Georgia. Compared to the previous year, the number of securities transactions deposited in the Central Securities Depository decreased by 90.8% (22.3 million GEL), while the volume of funds deposited declined by 92.5% (10.6 million GEL).

**Diagram 7.8 Securities deposited in the Central Securities Depository, 2010-2018**



Source: National Bank of Georgia

**Diagram 7.9 Funds deposited in the Central Depository, 2010-2018**



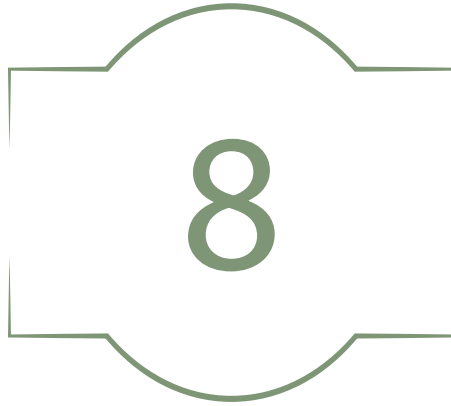
Source: National Bank of Georgia



*Operational Hall of the State Bank of Georgia*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## MONEY LAUNDERING INSPECTION AND SUPERVISION

In 2018, the NBG elaborated the Supervisory Framework of the National Bank of Georgia on Combating Money Laundering and Terrorism Financing. This document determines the basic principles for effectively managing the risk-oriented Anti-Money Laundering and Combating the Financing of Terrorism AML/CFT supervisory process, which forms the basis for executing the supervisory functions of the NBG.

During the year, on-site inspections focused on the following issues:

- The adequacy of the classification process of clients according to the money laundering and terrorism financing risk level and the appropriateness of the commensurate due diligence measures employed.
- The process for determining the beneficial owner in companies with complex ownership structures.
- The effectiveness of the fulfillment of obligations under the legislation with respect to politically exposed persons
- Knowledge of the transactions of financial institutions (including the effectiveness of the risk management process for transactions through money remittance systems).
- The effectiveness of risk management processes related to correspondent relationships.
- The adequacy of anti-money laundering software, the effectiveness of the study process, etc.

In accordance with the risk-based approach, six commercial banks were selected and inspected and the total value of penalties subsequently imposed on them amounted to 596,000 GEL.

In 2018, the Money Laundering Inspection and Supervision Department also established off-site supervision of currency exchange bureaus with the

aim of ensuring the effective supervisory process of subordinated financial institutions. Off-site supervision is targeted at the identification of problematic financial institutions, the identification of risks in financial institutions and the determination of supervisory measures to be taken towards existing risks.

During the year, 38 currency exchange bureaus and two microfinance organizations were inspected. Total penalties subsequently imposed amounted to 748,300 GEL and the registration of one currency exchange bureau was terminated. In addition, within the year, four brokerage companies and four registrars were inspected and penalties of 107,500 GEL were imposed.

The on-site inspection of nine payment service providers began at the end of the year. These are complex inspections that take into account the existing risks in the sector and involve the assessment of internal control systems as well as all monitoring processes.

Several meetings were held with financial institutions with the aim of informing them about existing threats and weaknesses identified at the sectoral level, as well as to inform them about supervisory expectations. Training sessions were also held with representatives of currency exchange bureaus.

At the end of 2018, in accordance with the "Supervisory Framework on Combating Money Laundering and Financing of Terrorism", the NBG adopted an annual supervisory plan for 2019 under the order of the Governor of the National Bank of Georgia. Supervisory actions within the year will be initiated according to that plan. It should be noted that the theme of inspections and the categorization of financial institutions are based on the sector risk analyses as prepared by the NBG from 2014 to the first half of 2018.

In 2018, with the aim of identifying and supervising the risk of money laundering and terrorism financing, the NBG elaborated and launched the AML/CFT off-site supervisory software/portal. Through this, the money laundering inspection and supervision department obtains, keeps and

updates all AML/CFT-related supervisory statistics/trends, identifies problematic institutions and problems in financial institutions at an early stage, and defines risks from subordinated entities at a sectoral level. As a result, the effectiveness of the supervisory process has increased.





Bond of the Republic of Georgia



FIRST GEORGIAN  
CENTRAL  
BANK



## PAYMENT SYSTEMS

The reliable and efficient functioning of payment systems is one of the key factors for the smooth flow of financial resources in the economy and for the sustainable development of the country. According to the Organic Law on the National Bank of Georgia, one of the functions of the NBG is to facilitate the safe, sustainable and efficient functioning of payment systems. In order to accomplish this in an effective way, significant work was carried out in a range of directions:

- Ensuring the sustainable and efficient functioning of the Real Time Gross Settlement system of the NBG.
- Establishing CPSS-IOSCO principles for financial market infrastructure.
- Registration of payment service providers and the off- and on-site inspection of active payment service providers.
- Supporting the development of existing payment instruments and tools, and the promotion of innovative instruments.
- Working on drafts of legal acts within the framework of payment systems oversight and refining the existing legal base.

The Real Time Gross Settlement system (RTGS) of the NBG is a key mechanism for interbank final settlements in the national currency. The system's proper operation is thus an important prerequisite for the uninterrupted functioning of the economy and the country's financial sector. In 2018, as in previous years, the system's continuity was ensured at a high level, with the availability ratio for RTGS participants standing at 99.97%. The system also has a business continuity plan that has been designed in accordance with best international practice. This plan is regularly tested according to pre-designed scenarios.

In 2018, with the support of the World Bank, the first self-assessment of the RTGS system was con-

ducted against the Principles for Financial Market Infrastructure (PFMI)<sup>45</sup>, which were developed by the Committee on Payment and Settlement Systems (CPSS) of the Bank of International Settlement (BIS) and the technical committee of the International Organization of Securities Commissions (IOSCO). Based on the recommendations of the World Bank, the evaluation of the following aspects of the RTGS system were carried out: the legal basis, governance, management of credit and liquidity risks, mechanisms of final settlement, operational and business risks, participation requirements, the efficiency and effectiveness of the system, and the assessment of the transparency of main standards and procedures. In addition, the responsibility of the National Bank of Georgia, as the central bank of Georgia, was assessed against the financial market infrastructure in Georgia. The goal of this self-assessment was the timely detection of potential risks related to the interbank settlement system (RTGS), the prevention of financial shocks and the improvement of system operations in general. Compliance with the Principles for Financial Market Infrastructures (PFMI) will be regularly evaluated in accordance with best international practice.

In order to improve the regulation of payment service providers, "The Rule on Payment Service Provider's liquidation" was adopted in 2018. In the event of a cancellation of a provider's registration, this rule regulates the process for the realization of the provider's assets and the fulfillment of claims of its customers and other creditors. This will increase the trust of market stakeholders and customers towards the payment service sector.

Additionally, in order to further facilitate the use of payment cards, the National Bank of Georgia has been working on a renewal of the existing Payment Card Regulations. This focuses on the responsibilities of both the issuer and acquirer in

---

45. See: <https://www.bis.org/cpmi/publ/d101a.pdf>

terms of making safe and secure payments, it also pays attention to the responsibilities of card issuers and users during unauthorized transactions, as well as to the ways and means of dispute resolution. The new project will also facilitate the development of innovations in the payment card market. It is planned to adopt this rule in 2019.

## RTGS Statistics

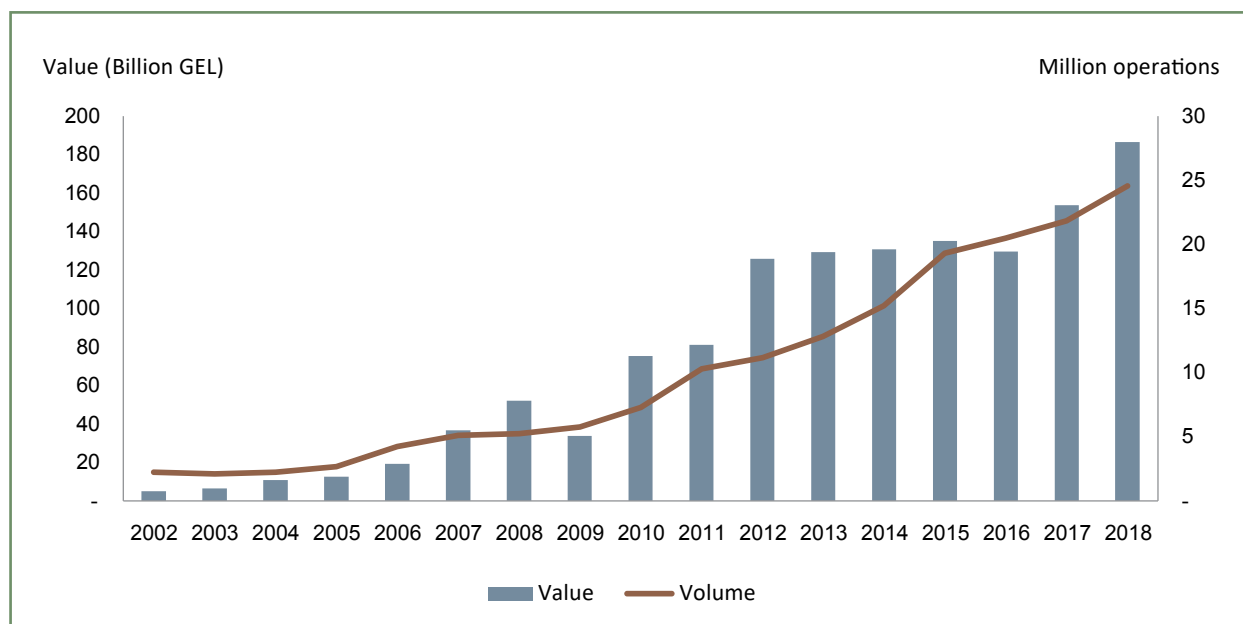
The Real Time Gross Settlement System (RTGS) operated by the National Bank of Georgia was introduced in December 2010. In 2018, users of the RTGS comprised 16 commercial banks, the NBG and the Treasury Service of the Ministry of Finance.

Throughout 2018, 24.6 million payment operations were processed through the Real Time Gross

Settlement (RTGS) system, amounting to 186.4 billion GEL – exceeding the corresponding figures of 2017 by 12.4% and 21.3% respectively. It should be noted that a similarly high growth of value was observed in 2017, which was a result of the increased value of transfers between commercial banks and the NBG.<sup>46</sup> In contrast, in 2018 the main reason for the growth of RTGS transfers in terms of value was the rise of both interbank transfers (17% growth compared to the previous year) and those between commercial banks and the Treasury Service (43% growth compared to 2017). The growth of the value of interbank transactions through the RTGS system was mainly caused by the growth of clients' transfers (20% growth compared to 2017).

The dynamics of the volume and the value of RTGS transactions can be found on Diagrams 9.1 and 9.2 below.

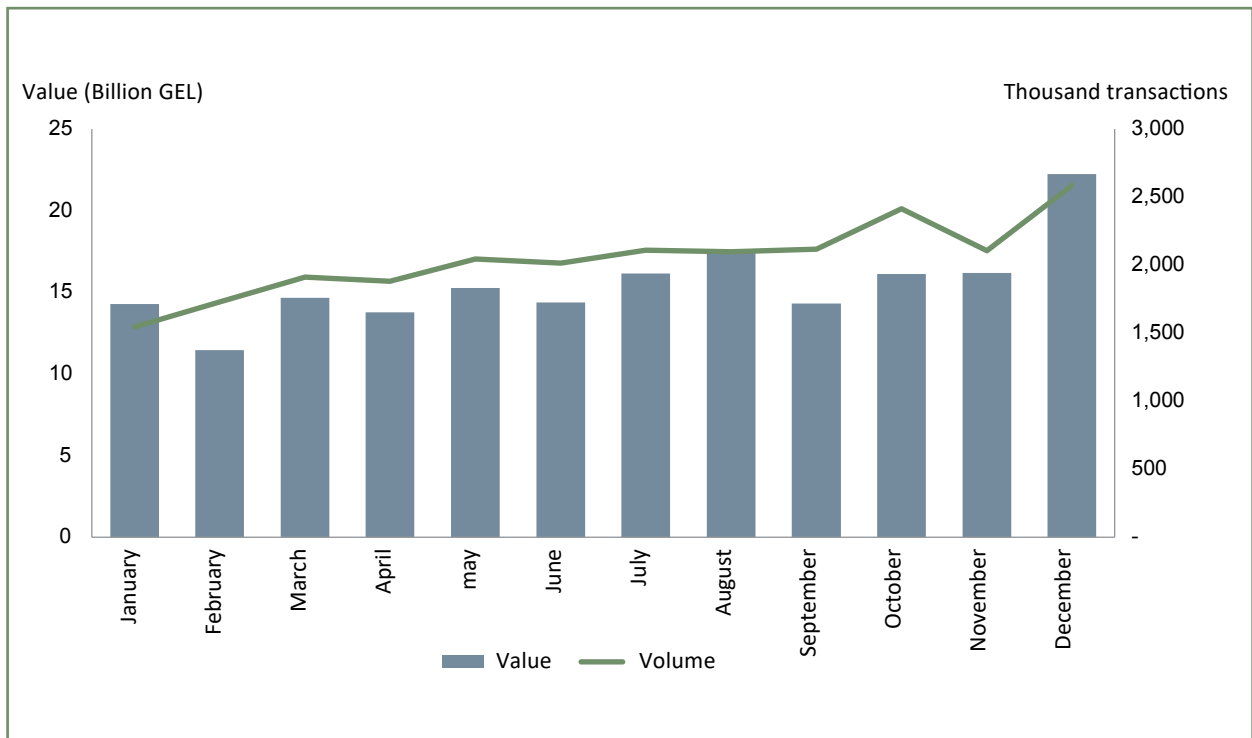
**Diagram 9.1 RTGS operations (2002-2018)**



Source: National Bank of Georgia

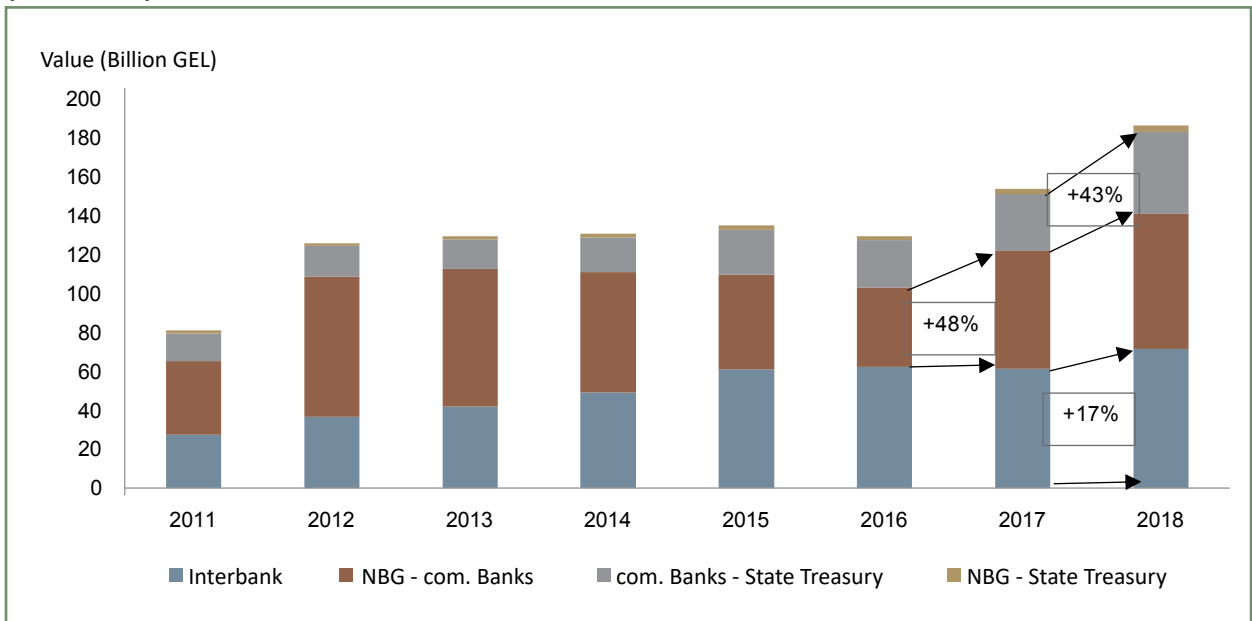
46. In 2017, compared to the 2016, the value of transfers through the RTGS system increased by 18.7%

**Diagram 9.2 RTGS operations (2018)**



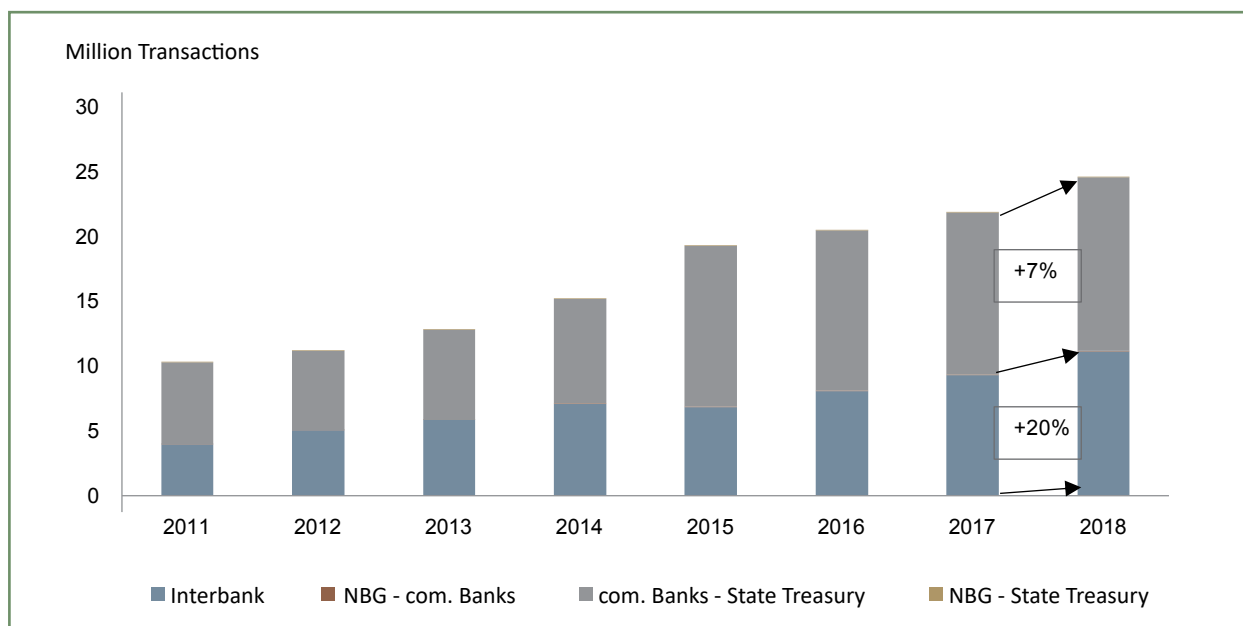
Source: National Bank of Georgia

**Diagram 9.3 Value of the transfers processed through the RTGS system according to participants (2011-2018)**



Source: National Bank of Georgia

**Diagram 9.4 Volume of RTGS operations by participants (2011-2018)**



Source: National Bank of Georgia

The RTGS system processes payments (transfer orders) with a high level of efficiency. In 2018, the average time for processing a single transfer order increased by 83% compared to 2011, reaching an average speed of 0.064 seconds per transaction, which amounts to 15.6 transactions per second. It is noteworthy that the total number of transfers processed through the system grew by 139% over the same period. In addition, in 2018 the maximum number of transfer orders processed within one hour reached 69,000 transactions with a processing speed of 27.8 transactions per second – that is 40% higher compared to 2011 and slightly higher compared to 2017.<sup>47</sup>

According to the data from 2018, the share of the turnover of the three largest banks in the total interbank turnover (excluding NBG transfers) amounted to 66.9%, which exceeded the corresponding indicator for 2017 by 6 percentage points. The concentration of interbank transfers changed slightly during 2012-2016, but has increased significantly during the past two years. This is possibly due to the fact that one of the

largest commercial banks participating in RTGS system acquired another large shareholder on the market.

In order to make the processing of transfers made by clients of commercial banks more flexible, the System's operating time was extended by an hour. Commercial banks are now able to process their clients' orders received up until 18:00 on the same day.

### Electronic means of payment

In 2018, similar to the previous year, the share of card payments in the total volume of cashless payments has steadily been growing and amounted to 79.4%, which exceeded the corresponding indicator from 2017 by 5.5 percentage points. It should be noted that in recent years, payment cards have become the most commonly used retail payment instrument.

Payments made by internet banking and mobile banking are also very important. It is noteworthy that in the last two years, the usage of mobile

47. In 2017, the maximum number of transfer orders processed within an hour was 71,000 and the average processing speed was 25.9 transactions per second.

banking has increased significantly. In particular, the number of payments made through mobile banking increased by 125% in 2017 and by 149% in 2018, while the number of payments made through internet banking for the same period changed insignificantly.<sup>48</sup>

In 2018, the share of internet banking payments in the total volume of cashless payments decreased by 4.6 percentage points compared to the previous year and amounted to 11.5%, whereas the share of mobile banking payments in the total volume increased by 1.6 percentage points and amounted to 3.5%. Despite this trend, internet banking remains the most frequently used means of payment after payment cards.

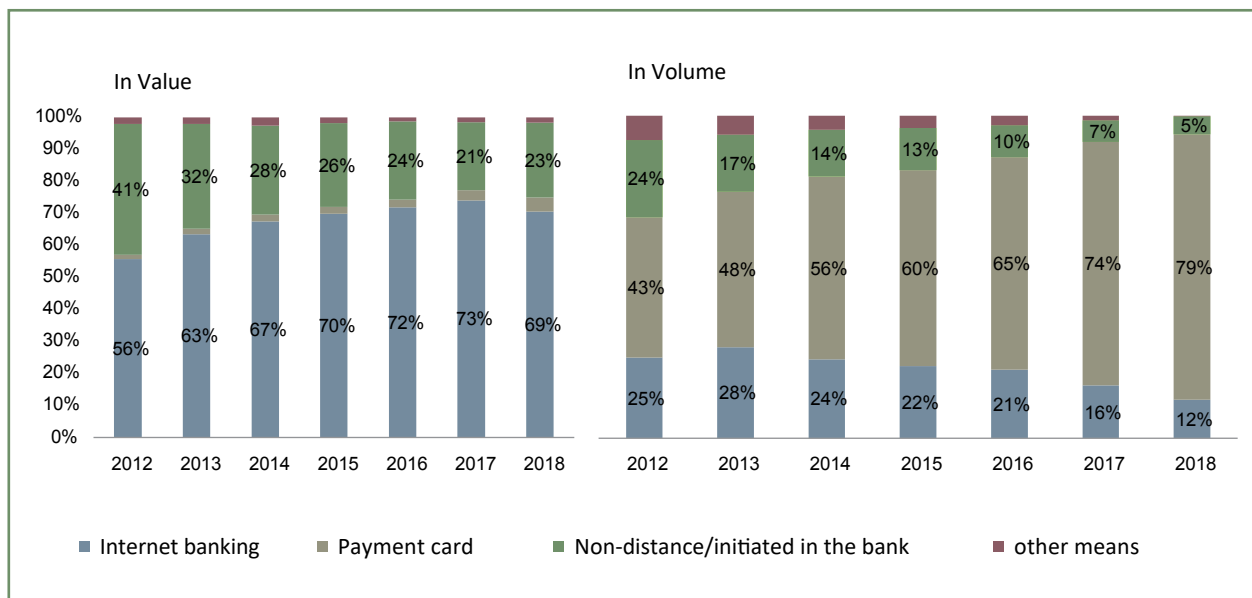
Payment cards are the unqualified leader in the non-cash payments market in terms of volume; whereas in terms of value, card payments play a

relatively minor role – accounting for only 4.4% of total non-cash payments in terms of value in 2018. Meanwhile, the share of internet banking transactions and credit transfers initiated by customers directly through commercial banks’ service centers in the total value of non-cash payments amounted to 69.2% and 23% respectively. Mobile banking payments accounted for 1.8% of the total value of non-cash payments.

The average value of a single payment operation executed with a payment card was 30-35 GEL in 2018, while the average value of internet banking and credit payment orders initiated by a customer through commercial banks’ service centers amounted to 3,600 and 2,600 GEL respectively.

The statistical data for non-cash payments by means of initiation are shown in Diagrams 9.5 and 9.6.

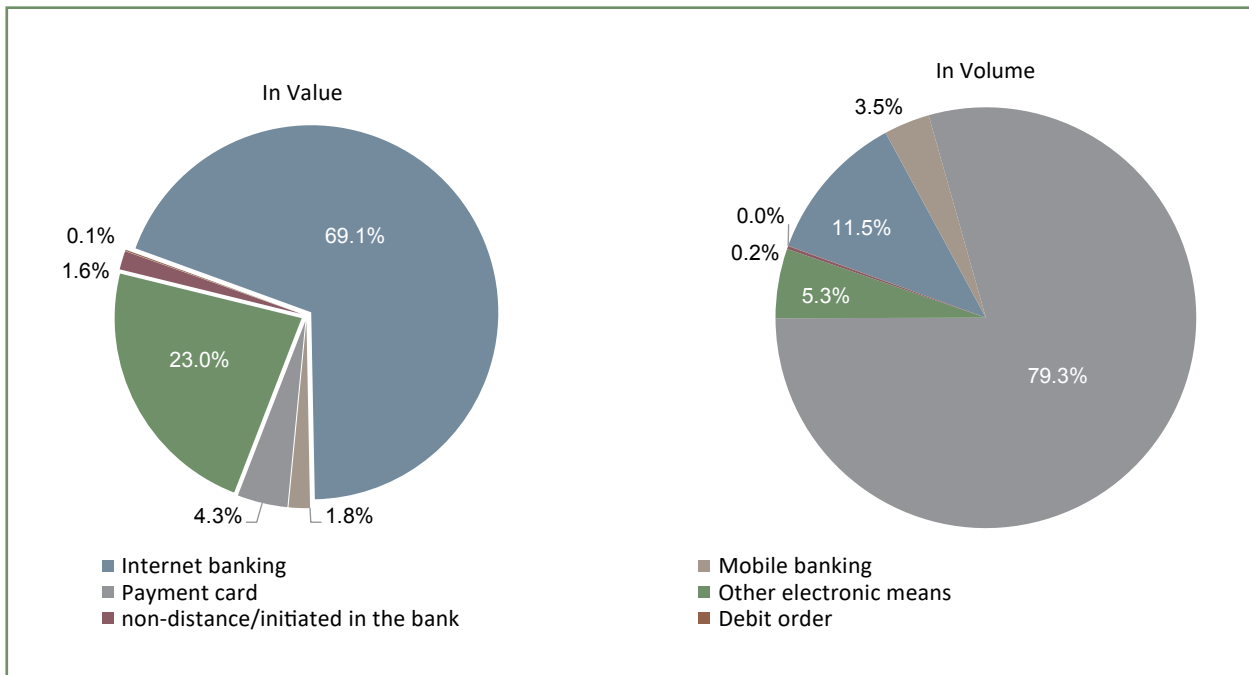
**Diagram 9.5 Cashless payments by means of initiation, 2012-2018**



Source: National Bank of Georgia

48. In 2017, the number of payments made through internet banking increased by 0.4% compared to 2016, and decreased by 3% in 2018.

**Diagram 9.6 Distribution of non-cash payments by method of payment order initiation (2018)**



Source: National Bank of Georgia

## Payment Cards

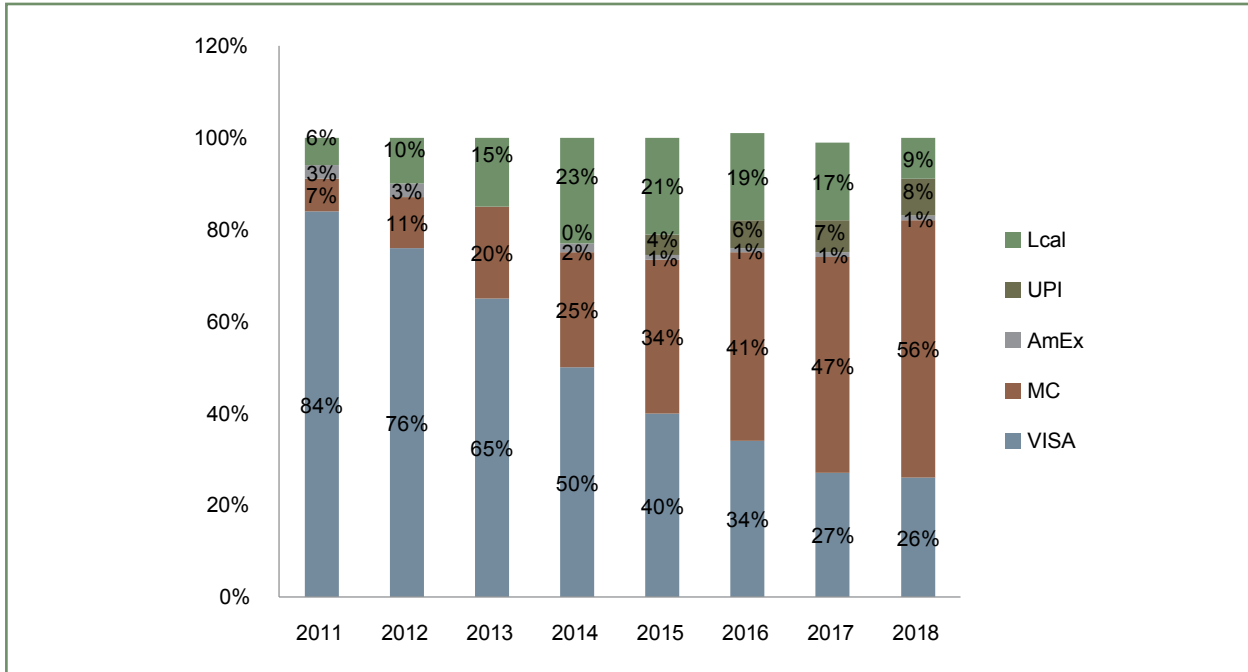
The main factor behind the increased volume of payments with payment cards during recent years is the improvement and development of the payment cards infrastructure in Georgia. Besides commercial banks, payment service providers have also started to issue local electronic money (pre-paid) cards. One microfinance organization also issues credit cards.

The number of payment cards issued by commercial banks by the end of 2018 reached 7.4 million. However, the number of issued cards per capita decreased compared to the previous year, which was a result of the cancellation of inactive cards by banks.

In 2018, as in previous years, international payment cards (Visa, MasterCard, Union Pay and American Express) issued by commercial banks accounted for 91% of the total number of cards issued. The share of MasterCard cards issued in the total has been continuously increasing over the last three years and accounted for 56% of the total by the end of 2018. The share of Visa cards amounted to 26%. The share of Union Pay cards has increased gradually (by 8%), while the share of local cards decreased by 8 percentage points compared to the previous year and amounted to 9% of the total.



**Diagram 9.7 Cards issued by payment scheme**



Source: National Bank of Georgia

It should be noted that the growth of the number of payment cards is mainly due to the increase of debit cards. In 2018, the share of credit cards remained unchanged at 10-11%.

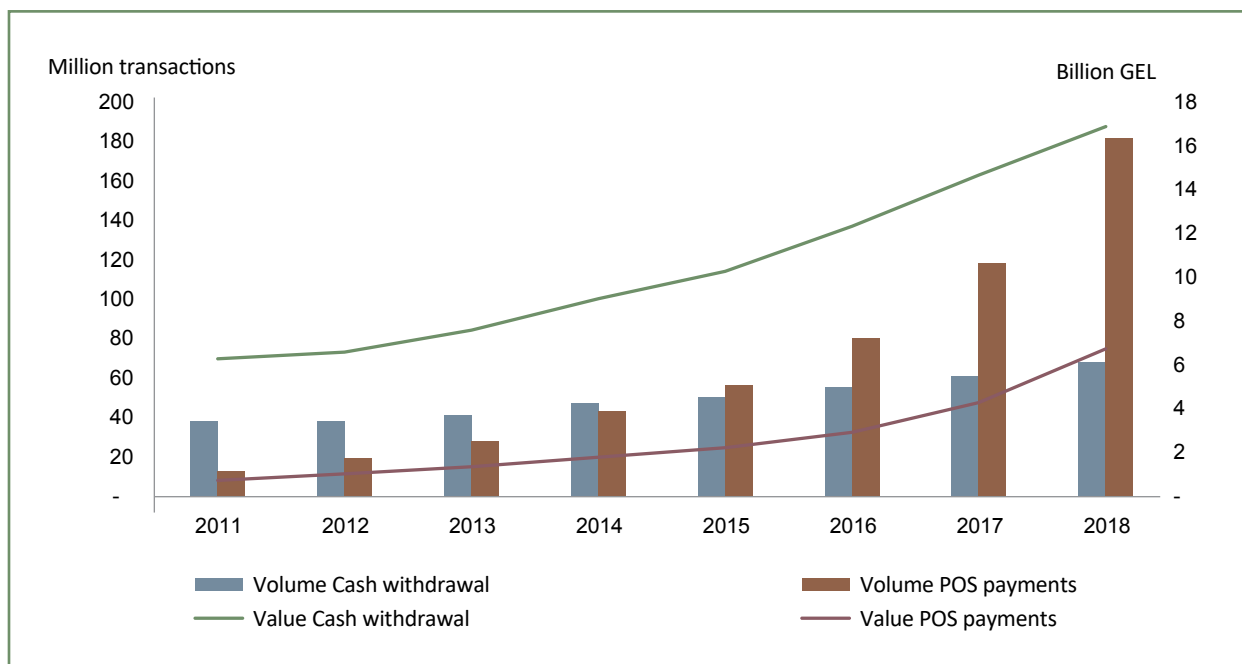
Significant progress is noticeable regarding the issuance of payment cards with enhanced security features. Commercial banks are gradually replacing magnetic stripe payment cards with chip cards that provide higher security. By the end of 2018, 65% of issued cards were chip cards, while the share of contactless cards out of the total number of chip cards issued amounted to 96%. The usage of contactless cards reduces the time for card operations and makes payment more comfortable for the card user. The commercial banks offer their customers bank cards integrated within the mobile application through which the payment at merchant outlets is performed easily using NFC<sup>49</sup> technology. Use of "stickers", which have the same card functions, are also very popular and enable contactless payments. It is worth mentioning that Georgia is one of the global leaders in terms of contactless payments. In 2018, the share

of contactless payments performed by Visa and MasterCard cards issued in Georgia in total card payments at merchant outlets using those cards ranged from 80% to 90%.

The year 2018 was also very important in terms of the growth of card payments. Compared to 2017, the number of card payments made at merchant outlets increased by 54% in terms of volume and by 57% in terms of value. Meanwhile, cash withdrawal transactions for the same period increased by only 12% in terms of volume and by 15% in terms of value. However, the share of the value of payment cards out of the total value of card transactions was still low and amounted to 29%. This figure is 6 percentage points more than the previous year. The dynamics of transactions performed by payment cards issued in Georgia are shown on Diagram 9.8. One of the reasons for the increased number of payment cards in use since 2011 could be rising number of contactless cards and "stickers", which customers are increasingly using for payments at merchant outlets because of their simplicity and reliability.

49. NFC (Near-Field Communication) is the wireless technology that allows communication between two closely positioned electronic devices. This technology is used for contactless payments.

**Diagram 9.8 The dynamics of transactions performed with payment cards**



Source: National Bank of Georgia

The infrastructure of card-accepting devices has also steadily been developing. Besides ATMs and POS terminals, card payments are also possible through self-service kiosks. By the end of 2018, there were 2,323 ATMs located in Georgia, 38,444 POS terminals at merchant outlets and 2,565 self-service kiosks with card payment functions.

## Payment service providers

### Regulation

At the beginning of 2018, 38 payment service providers were registered with the National Bank of Georgia. During the course of the year, 11 new payment service providers were registered; however, registration was cancelled for 21 providers, nine of those as a result of on-site inspections conducted by the NBG. By 31 December 2018, 28 payment service providers were registered in the National Bank of Georgia.

The practice of on-site inspection, which was first implemented in 2017, saw 10 payment service providers inspected during 2018. As a result of

problems and violations identified during these inspections, the registration of nine providers was revoked. The remaining provider that was inspected was given recommendations and a reasonable period of time to eliminate the shortcomings identified. During the on-site inspections several legislative violations were identified, including operating significantly different schemes than had been submitted for registration at the NBG, violations of legal requirements regarding customers' funds, and having a head office not based in Georgia. For ensuring the stability of the payments market and the implementation of best international practices, comprehensive as well as thematic inspections are planned for the future.

### Payments with non-electronic money

In 2018, total transactions performed by payment service providers numbered 248.9 million, amounting to 5.4 billion GEL in terms of value. Self-service kiosks, through which it is possible to initiate electronic payments with cash, were the most commonly used method of making payments. The share of self-service payments through these kiosks out of the total payments (excluding

e-money) amounted to 73.5% in terms of volume and 59.6% in terms of value. The absolute majority of payments received through kiosks were performed with cash, while the share of payment card payments amounted to only 0.7% in terms of volume and 0.1% in terms of value. The share of payments at providers' service centers out of total provider payments (except e-money) amounted to 13.2% in terms of volume and 12.6% in terms of value. Usage of providers' websites was one of the most common means of initiating payments. A total of 4.5 million payments, amounting to 169.5 million GEL in terms of value, were initiated through providers' websites. It is noteworthy that out of the total website-initiated payments, 95% in terms of volume and 94% in terms of value were performed through payment cards. The share of payments through agents in total payment service provider payments amounted to 34% in terms of volume and 31% in terms of value.

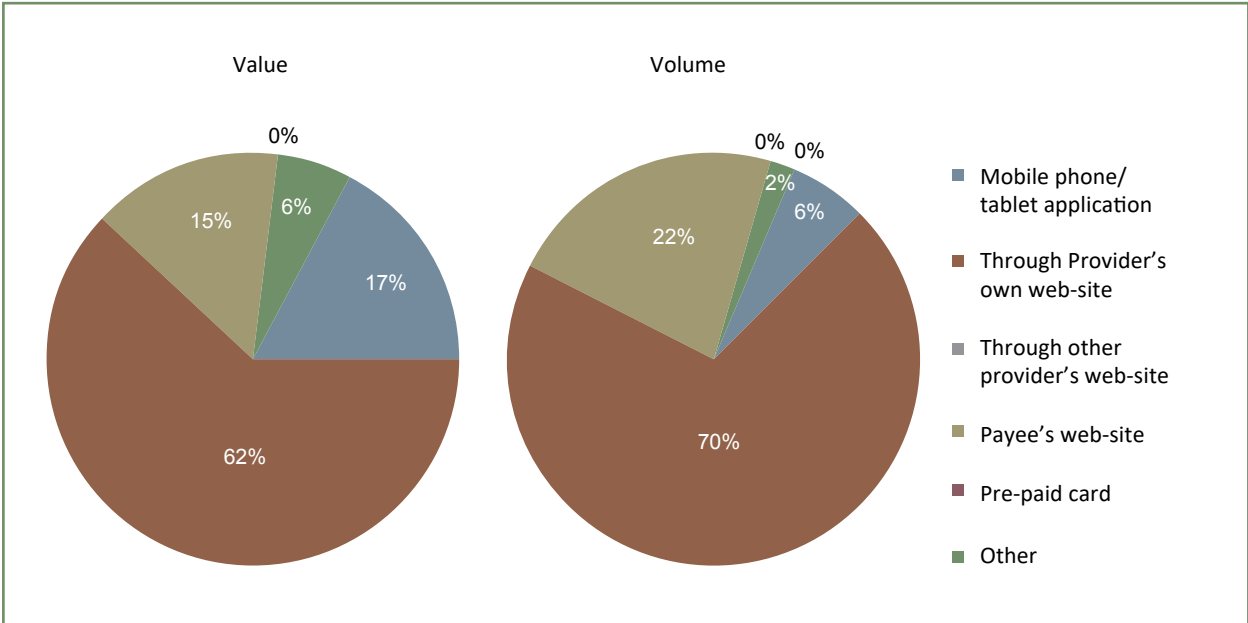
**Payments with electronic money**

In 2018, as in the previous year, the share of public transport prepaid card payments in total e-money payments was significant. Transport cards are

actively used in order to pay city public transport fees. The number of payments through these cards is thus significantly higher than payments through other forms of electronic money. The share of such payments amounted to 99.4% in terms of volume and 33.4% in terms of value out of total e-money payments. The average amount of a single payment through these prepaid cards amounted to 0.37 GEL, which is drastically different from the total payments made through other electronic money instruments. Considering this clear distinction, the figures for the electronic payments market excludes the data from the transport cards.

In 2018, excluding transport cards, providers performed 834,000 payments amounting to 116 million GEL, out of which 70% in terms of volume and 62% in terms of value were initiated through the websites of e-money issuers. A significant share of e-money payments (22% in terms of volume and 17% in terms of value) was initiated through mobile phone/tablet applications. The share of e-money payments by means of initiation can be seen on Diagram 9.9

**Diagram 9.9 E-money payments by means of initiation**

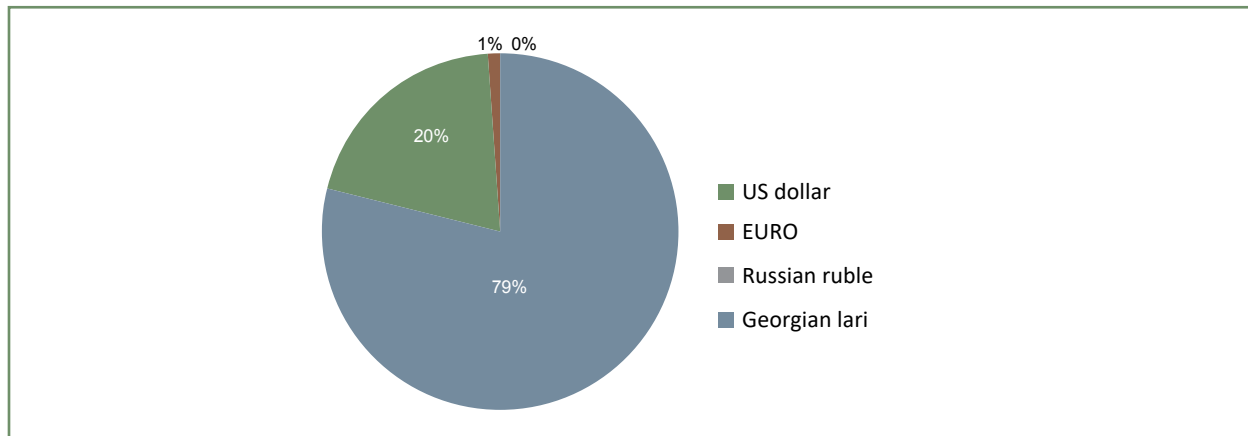


Source: National Bank of Georgia

As of December 2018, 5.3 million e-wallets were issued, within which funds with a nominal value of 2.1 million GEL were placed. A total of 128,900 of these electronic wallets were active at that time.

For the distribution of the nominal value of electronic money stored in wallets at payment service providers by currency, see Diagram 9.10.

**Diagram 9.10 Funds existing in electronic wallets according to currency as of 31 December 2018**



Source: National Bank of Georgia

### Ongoing work

In order to improve the legal base for payment services, work on approximation with EU directives and regulations continued in 2018. This will also contribute to the development of the payment service market, will increase customer trust towards payment service providers and encourage the development of new types of providers, including financial technology companies. In addition, work on establishing open banking principles is underway. This will enable customers to get a more flexible payment service through the application programming interface (API), to obtain aggregated financial information from his/her ac-

counts in various commercial banks, and to initiate payment orders through financial technology companies etc.

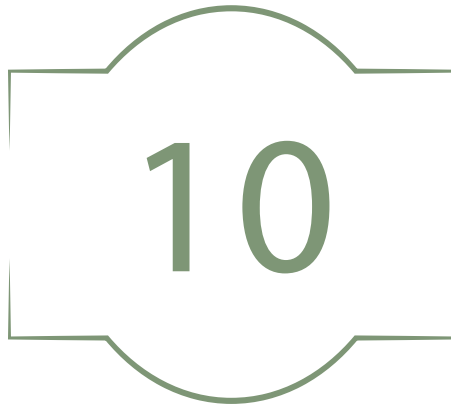
In order to develop the retail payments market, work on the implementation of a faster payment system has started. This will make it possible to transfer funds on a 24/7 basis from a payer's account to a payee's account within a few seconds from the initiation of the payment transaction. With the implementation of this system, a more reliable financial market infrastructure will be created and all participants of the payment service field will benefit.



*Meeting of the Founders of Democratic Republic of Georgia*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## IT DEVELOPMENT

The National Bank of Georgia is distinguished for its analytical and research activities. The information and technologies that provide the backbone for such activities are thus among the NBG's most valuable assets. The NBG acknowledges the increasing dependency of banking activities on informational technologies, is aware of related risks and properly manages them. The existing IT technologies of the National Bank enhance productivity and improve the efficiency of the working process. The National Bank of Georgia strives to be in the front line for implementing and developing innovative IT solutions in order to retain its high reputation among its employees, clients and partners, both within the country and internationally.

In order to be equipped with all necessary assets for achieving its goals, the NBG should make investments and manage and control informational technologies via structured processes. Driven by several major IT initiatives that are currently being planned within the National Bank, in 2018 the NBG drafted its "Informational Technologies Development Strategy for 2019-2023".

The IT strategy, which has been approved by the Governor, is in full compliance with the overall business strategy of the National Bank and has been shaped to support the NBG in properly delivering its functions, purposes and objectives. The strategy embodies the National Bank's key vision, mission and values, permitting organizational self-assessment and stakeholder analysis from an IT standpoint. The document will help the NBG to see the big picture over a medium-term horizon and will facilitate analysis and decision making that considers all relevant factors.

In 2018, the IT Department underwent a structural reorganization, and several new units were formed to focus on data management, cyber security and application administration. Recruiting qualified personnel for these units is an ongoing process and is an integral prerequisite for the successful implementation of future projects.

Last year, the infrastructure implementation processes for a third reserve server center was completed. This is one of the first hyper-convergent infrastructure systems in the country, it consists of several server points, software data storage as

well as network support infrastructure. The system will enable the NBG to fulfill its business process continuity scenario in such cases where IT services need to be delivered through the third reserve data center located outside Tbilisi. In addition, in order to improve the connection quality and reliability of the data centers, the communication channel was transferred to L2 connections, which simplify management and reduce the data replication time from the main data center.

Several NBG sites require physical security and are therefore subject to video monitoring. The latter requires adequate server infrastructure. Throughout 2018, the architecture of the video monitoring infrastructure was improved considerably, with it now employing modern server equipment and data storage. The outcome is the easier management of servers, technologically superior and reliable infrastructure, decreased potential damage to equipment and increased operational efficiency.

Foreign partners of the NBG tend to prefer so-called "online collaboration" over traditional telephone communication. This includes use of internet applications that facilitate and simplify the setting up of virtual meetings, and web and video conferences for remote stakeholders. In addition to audio signals, these applications enable the presentation and sharing of various documents and presentations. In 2018, the NBG thus implemented one of the best online collaboration and video conferencing systems for the conduct of remote online meetings, thereby substantially advancing cooperation between the NBG employees and third parties.

Corporate network security systems are vital assets for the IT infrastructure security of the NBG. During 2018, the security infrastructure was considerably upgraded via the implementation of advanced security systems. The launch of a network access management system has resulted in higher network security and allows control, authentication and authorization of all computer equipment in the corporate network. These kinds of security controls are extremely important given the recent intensification of global cyber incidents.

In order improve web security, web application delivery and security systems were launched and all external services were migrated to the new system.

This provides a safe and protected means of publishing and providing the external services of the NBG over the internet. The system will profoundly enhance the security and reliability of the NBG's websites and other external services.

In 2018, the National Bank also successfully completed another notable IT project by increasing the connection rate between its two server centers in Tbilisi up to 10 GB/sec. This has brought several benefits, including improved management of the increased load on server infrastructure in terms of multiple ongoing and upcoming projects, risk mitigation for capacity overload during peak loads, a decrease of backup/restoration times and an increase of server capacity.

It is widely accepted that any developed institution must use backup systems for business continuity and data protection. All business applications and systems are categorized according to their level of criticality and are backed up and stored for a certain period of time according to a formalized backup policy. Backup data is stored on specific backup appliances within all the three server centers of the National Bank. These appliances were upgraded during 2018 in order to cope with the increased loads of the backup system. The system compresses (for minimum space usage), deduplicates (storing only replaced blocks and replicates (data transfer) data to other the backup appliances, thus significantly increasing backup capacity and decreasing the time of the backup process. In addition, the automatic backup of critical data from NBG's employees' personal computers was piloted in 2018.

Throughout 2018, the server infrastructure of the NBG has been significantly modernized. Specifically, an advanced hyper-convergent solution has been implemented that enables the NBG to effectively deliver IT services of higher quality with greater safety. The system represents a unified platform for server, network and data storage systems that is managed by centralized software defined storage. Within the scope of this project, the enhancement of computing resources will meaningfully improve the capacity and reliability of the virtualized server infrastructure. In order to successfully finalize this project, various important steps were taken in 2018. Several solutions were tested and analyzed, which served as the basis for the preparation of detailed technical and functional requirements,

with the procurement of these being announced at the end of the year. Additionally, the operational environment of critical systems and virtualization systems, were upgraded, deoptimized, and the testing environment was restored during the year. In addition, the operating systems for the database management servers and database management system underwent upgrades.

At the end of 2018, the two-factor authentication system of the NBG, which is used for critical system access control, was updated and enhanced. The upgraded system has considerably advanced and eased the system management process. These technical changes were aimed at providing higher levels of security and minimizing the risk of unauthorized access.

Moreover, in 2018 the document management system was upgraded to improve system capacity, functionality and the interface. The result is a more user-friendly program.

In response to the recent cyber incidents in the SWIFT network, within the scope of the SWIFT users' security program, a security control framework document was developed by SWIFT that describes all technical, procedural and organizational control mechanisms to be met by all financial institutions within the SWIFT network. For full compliance with these requirements, the NBG carried out various required actions within its infrastructure and successfully underwent re-assessment of its compliance with the SWIFT security control requirements. The NBG also upgraded its version of SWIFT's main system, which resulted in changing the format of payment orders and new notification standards for 2018. The format changes included the addition of two fields for the easier tracking of an order and the identification of its location and status at any time. These changes subsequently gave rise to changes in the main and backup management systems.

In 2018, improvements in the incident management process were started. The incident registration portal was upgraded, incident and request samples were prepared in accordance with the staff guidebook and system level agreement (SLA) requirements, and changes were applied in categorization. The registration process for users' applications (helpdesk registration) was also modified.





*May 26, 1919 Commemorative Event, Representatives of Government of the Democratic Republic of Georgia on Rustaveli Avenue*



FIRST GEORGIAN  
**CENTRAL  
BANK**

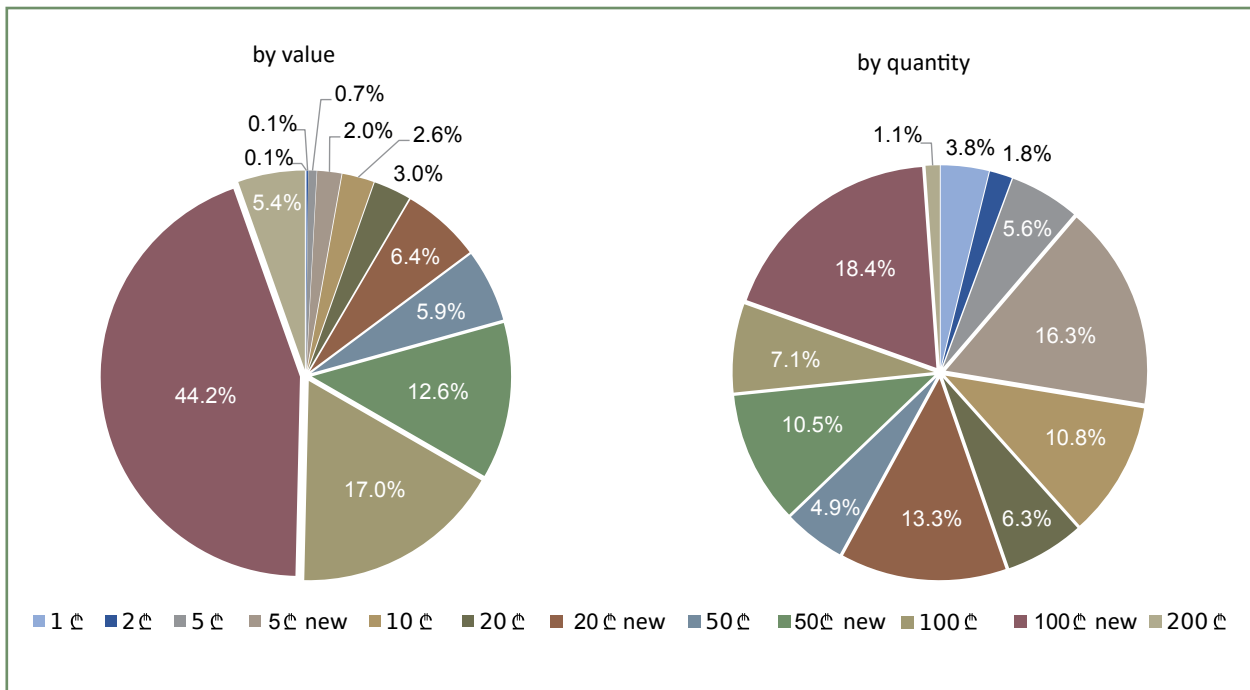


## ORGANIZATION OF CASH AND EMISSION ACTIVITIES

During the reporting period, the NBG carried out work to meet the economy's demand for cash. This included organizing activities related to currency production, delivery, storage and emission; the enhancement of the quality of banknotes and coins in circulation; sorting newly produced banknotes/coins and those received from circulation in accordance with established rules; the destruction of unfit banknotes; and the improvement of currency expert procedures and legal acts.

As of 31 December 2018, the volume of cash in circulation amounted to 3,565.5 million GEL, of which banknotes accounted for 3,455.1 million GEL and coins for 110.4 million GEL. The share of each denomination of banknote in circulation in terms of value and quantity, as of 31 December 2018, is given in.

**Diagram 11.1 Shares of banknotes in circulation according to denomination and modification**

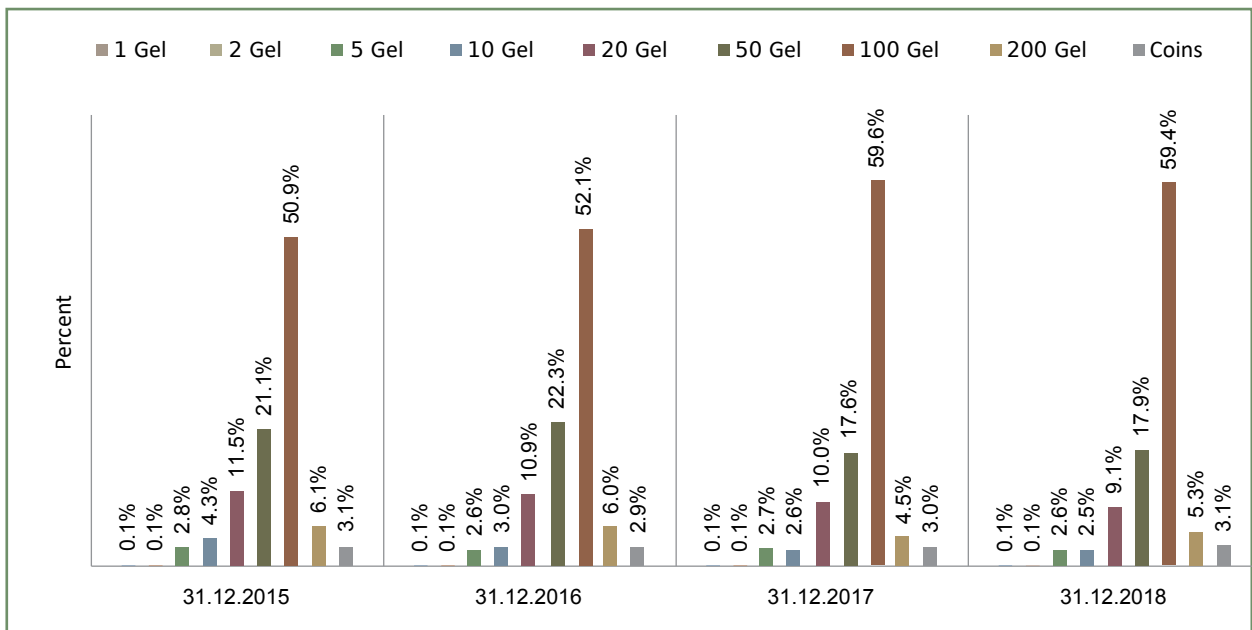


Source: National Bank of Georgia

The share of denominations of banknotes and coins by value as of 31 December in the period

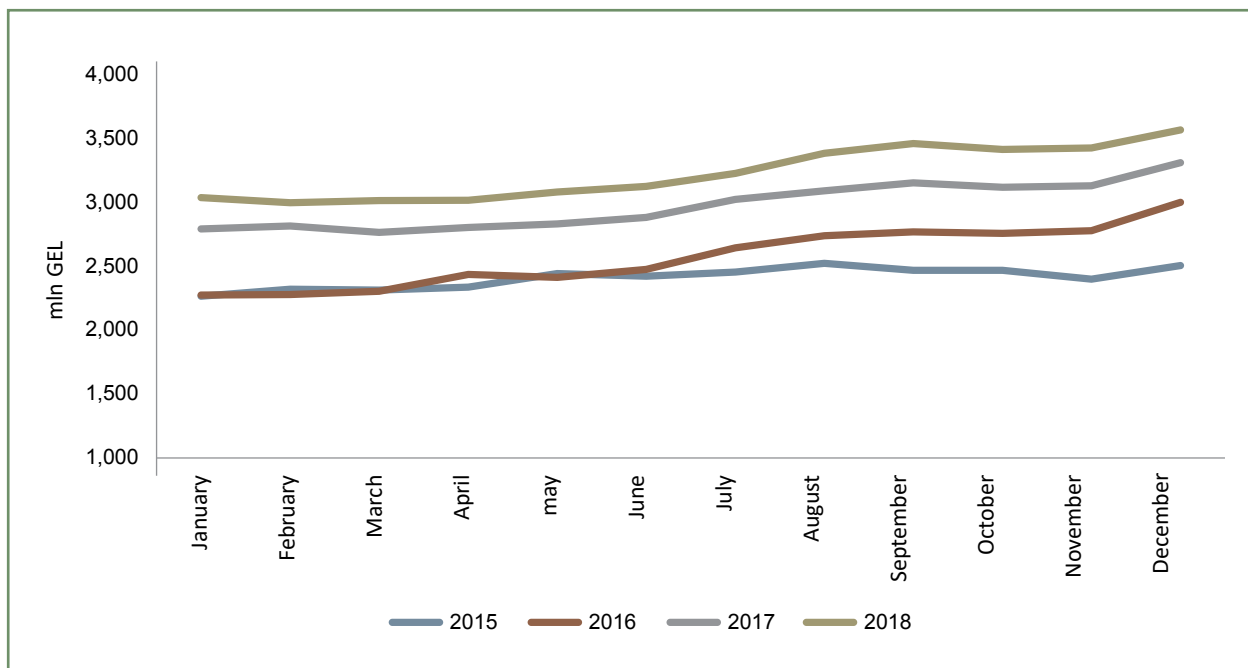
2015-2018 are given in Diagram 11.2.

**Diagram 11.2 Shares of denominations of banknotes and coins in circulation (2015-2018)**



Source: National Bank of Georgia

**Diagram 11.3 Cash in circulation (2015-2018)**

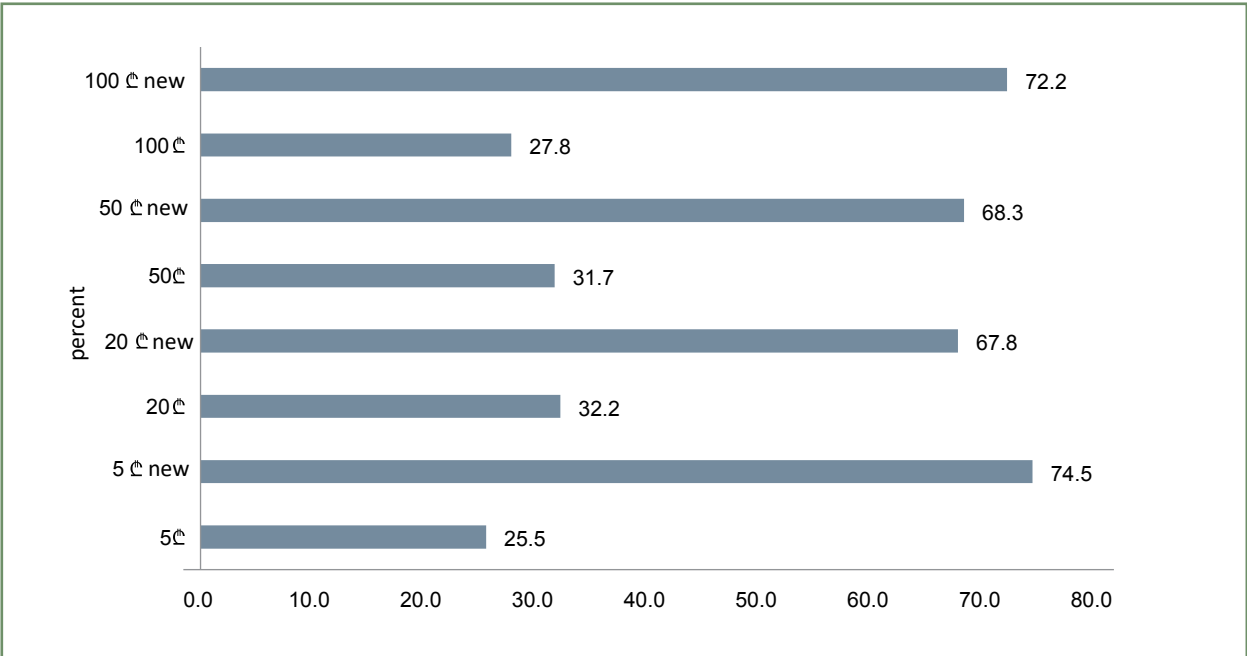


Source: National Bank of Georgia

In 2018, the volume of banknotes in circulation increased by 245.5 million GEL and amounted to 96.9% of the total volume of cash in circulation. Demand increased for banknotes of low denominations – 5 and 10 lari (rising by 3.8% and 3.2% respectively) – as well as high denominations – 50, 100 and 200 lari (respectively growing by 10.1%, 7.4% and 27%). Conversely, the amount 20-lari banknotes in circulation fell by 1.5% compared to the previous year. The upgraded versions of 5-,

20-, 50- and 100-lari banknotes have been successfully spread. At the end of the reporting period, the upgraded 5-lari banknote had a 74.5% share of the total volume of all 5-lari banknotes in circulation; the upgraded 20-lari banknote had a 67.8% share of all 20-lari banknotes in circulation; the upgraded 50-lari banknote had a 68.3% share of all 50-lari banknotes in circulation; and the upgraded 100-lari banknote had a 72.2% share of all 100-lari banknotes in circulation

**Diagram 11.4 Percentage of 5-, 20-, 50- and 100-lari banknotes in circulation per modification of each denomination**



Source: National Bank of Georgia

During the reporting period, the volume of 1- and 2-lari coins in circulation increased by 11.2% and amounted to 72.5 million GEL at the end of the year. Compared to 2017, the volume of tetri coins in circulation increased by 11.4%.

In respect to the circulation of coins, it is worth mentioning the ongoing work related to the implementation of a cash rounding rule in cash payment systems. Due to the low purchasing power of 1- and 2-tetri coins, these are commonly unused for payment operations and are not circulated. Consequently, the majority of these coins disap-

pear after being put into circulation. The damping rate of these coins has been around 94.7% for 1-tetri and 91.2% for 2-tetri coins for many years. Moreover, practical research showed that consumers often refuse to accept 1- and 2-tetri coins as change in the cash settlement process from markets and service agencies.

Apart from the low purchasing power of these denominations, their circulation is related to extra needless expenses. Specifically, the production cost for a single 1-tetri coin is around 0.021 GEL, while that for a 2-tetri coin it is around 0.033 GEL,

which significantly exceeds their nominal value. Moreover, the high cost and technical processing difficulties related to their circulation (including sorting, storage, transportation, etc.) should also be considered.

Due to these factors, appropriate amendments have been made to the Organic Law on the National Bank of Georgia and to the Code of Administrative Offenses, according to which from 1 January 2019, cash payment operations will be provided using the rounding rule on the territory of Georgia. In accordance with the rounding principle, under the new law prices on individual products and services will remain unchanged and rounding will apply in the event of a cash purchase of one or more products or services if the total sum of the price does not end in a “0” or “5”. In this case, the payable sum will be rounded in surplus or shortage to the nearest multiple of 5. Meanwhile, cashless payments will continue to be provided without any changes to the 1-tetri accuracy and will exclude changes of prices for individual products or services.

These legislative changes also refer to the timing of the circulation of 1- and 2-tetri coins. Based on the decision of the NBG Board, the validity of these coins in circulation will cease at the end of 2020.

From 1 January 2021, these denomination coins will be replaced by commercial banks and the National Bank of Georgia within that year, while from 1 January 2022 only the National Bank of Georgia will replace them without any time limitation.

During the year, in order to ensure an uninterrupted supply of cash to the economy and to replenish relevant reserve stocks, the NBG continued working on the production of lari banknotes and coins, on putting them into circulation, and on the performance of obligations envisaged under contracts concluded in previous years.

Cash inflows in the Georgian currency at the NBG increased during 2018 and amounted to 5.0 billion GEL, which was 8.7% higher than the relevant figure of the previous year. Cash outflows in the Georgian currency from the NBG amounted to 5.2 billion GEL, which was 6.1% higher than the relevant figure of the previous year.

Currency-expertizing activities were also carried out. During the reporting period, NBG experts examined a total of 9,030 suspicious banknotes and coins submitted by commercial banks, cash exchange and microfinance offices, as well as by law-enforcement authorities and individuals. Table 11.1 shows the results of those examinations.

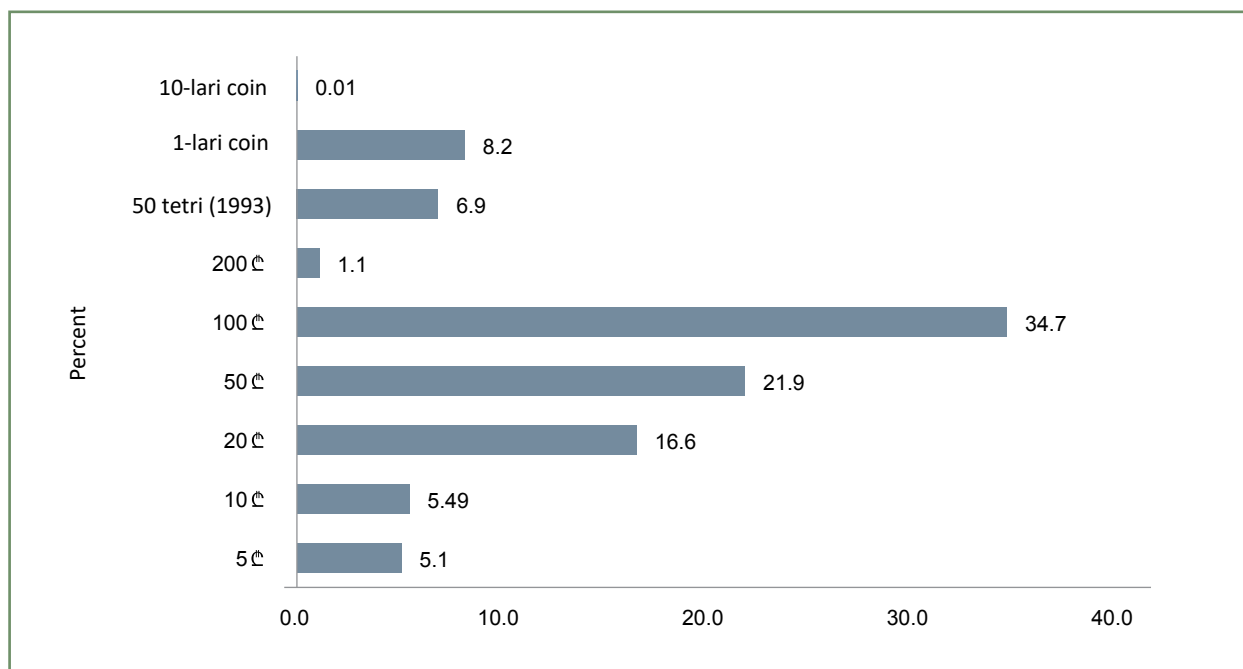
**Table 11.1 Results of the examination of suspicious banknotes and coins received in 2018**

	Suspicious	Counterfeit	Genuine	Faulty
Lari banknotes	5,930	4,865	808	257
Lari coins	1,347	870	477	–
USD notes	1,291	608	683	–
Euro notes	244	198	46	–
Other foreign currency notes	218	196	22	–
In total	9,030	6,737	2,036	257

Source: National Bank of Georgia

The ratio of counterfeit lari banknotes and coins detected in 2018 are shown in

**Diagram 11.5 Counterfeit notes and coins detected in 2018 (%)**

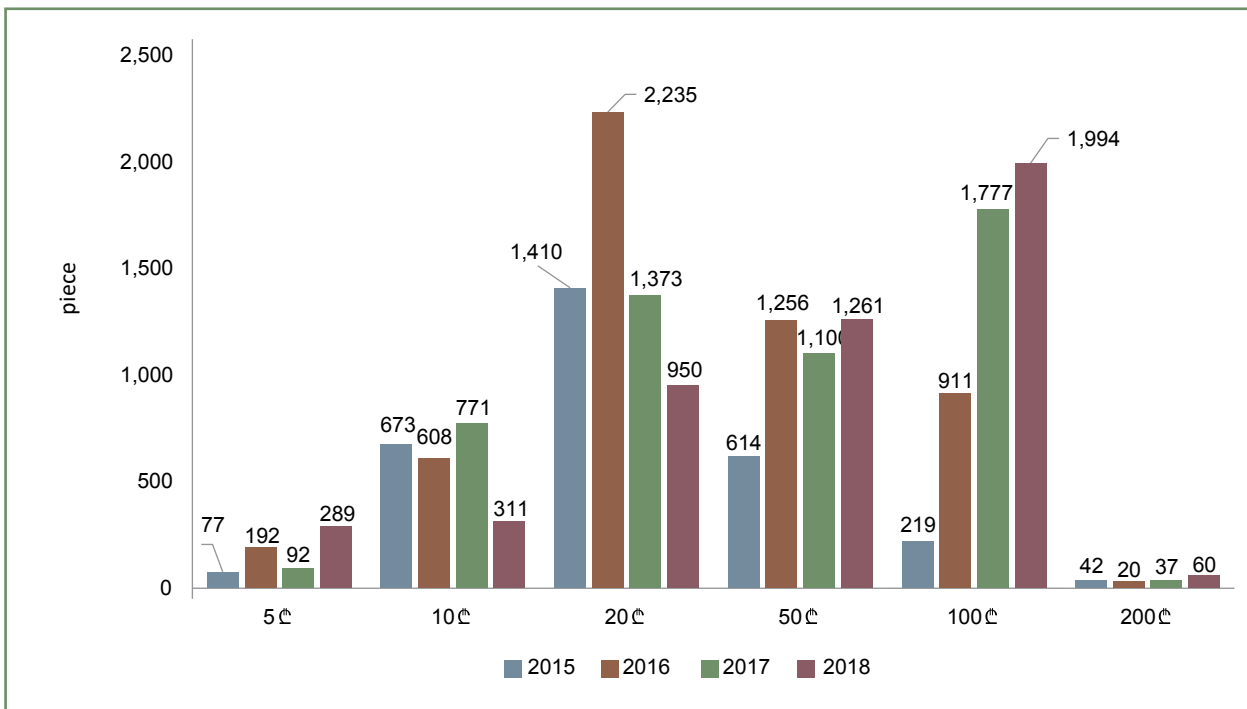


Source: National Bank of Georgia

The number of counterfeit banknotes detected in 2018 decreased by 5.5% for lari banknotes and by 3.3% for USD notes, whilst the number of counterfeit euro banknotes and other foreign currency notes increased by 5.3% and 5.9% respectively compared to the previous year. As regards coins, the number of counterfeit 50-tetri coins detected

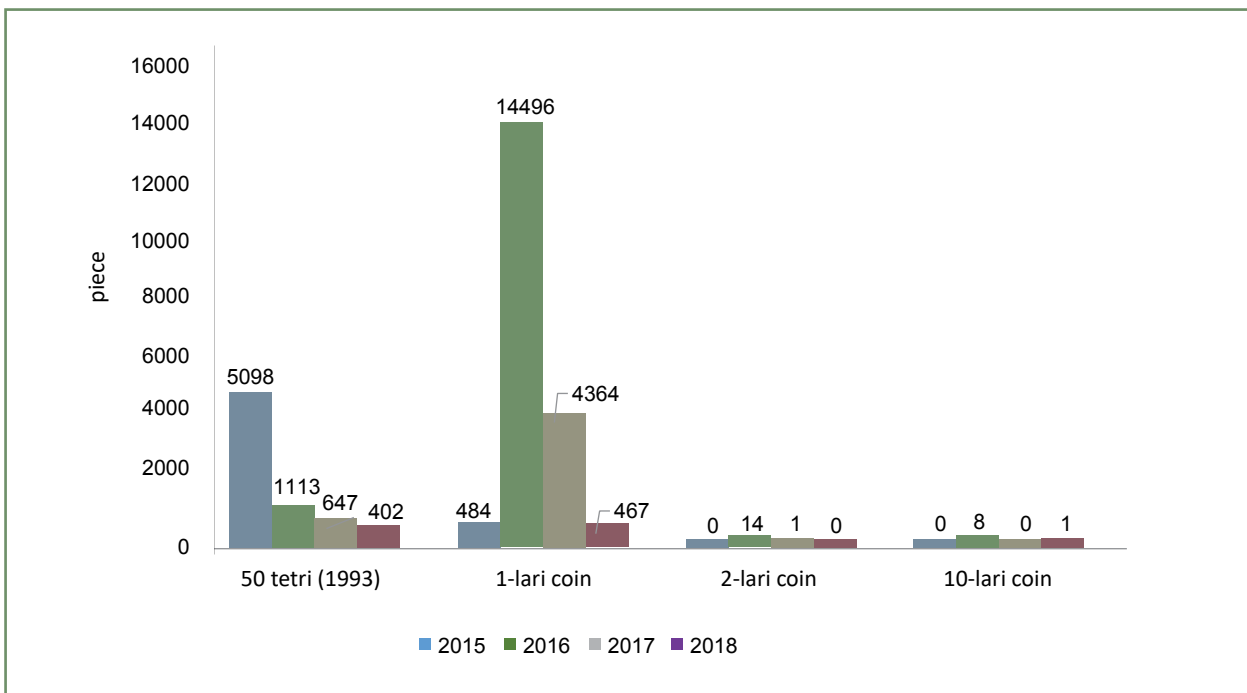
decreased by 37.9%, while the number of 1-lari coins decreased 9.3 times compared to the previous year. (Diagram N 11.6 and Diagram N 11.7 illustrate the number of counterfeit lari banknotes and coins per denomination detected in 2015-2018).

**Diagram 11.6 Number of counterfeit lari banknotes detected in 2015-2018**



Source: National Bank of Georgia

**Diagram 11.7 Number of counterfeit lari coins detected in 2015-2018**



Source: National Bank of Georgia



The NBG also provided methodological support and, over the course of the year, 133 concerned people were trained in determining the fitness of currency units and in general cash handling procedures.

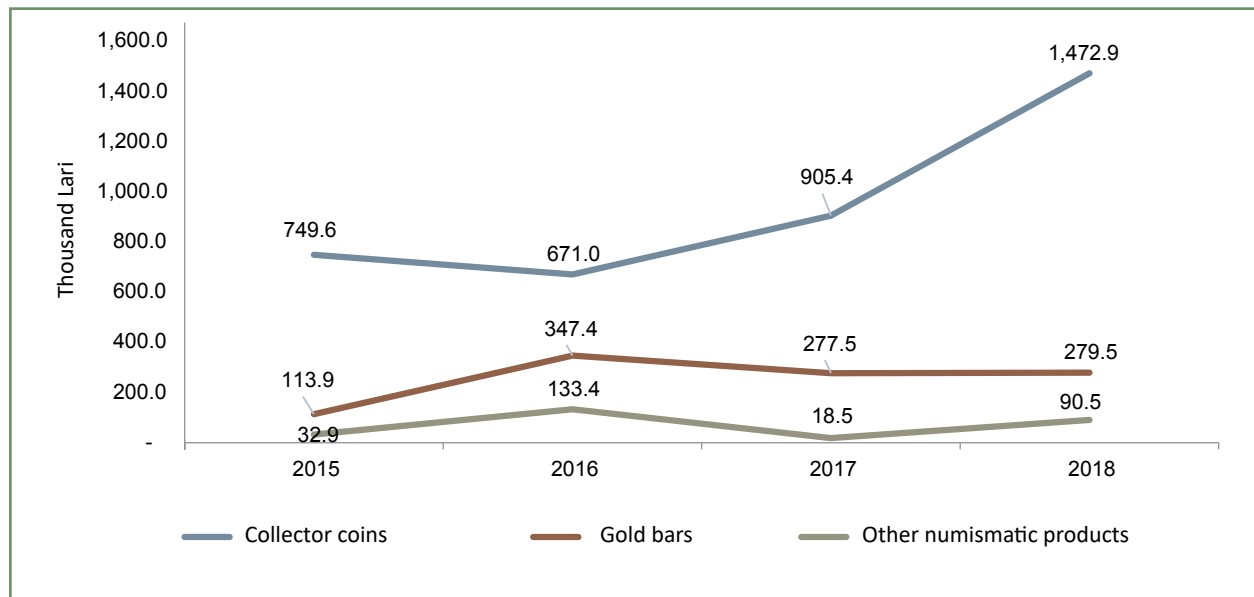
The NBG continued to sell collector coins and gold bars as well as other numismatic products during the reporting period. The sales of various kinds of products amounted to 212,500 pieces, worth a total of 1.8 million GEL. The number of the collector coins, gold bars and other numismatic products sold in 2018 increased 5.3 times compared to

2017, and the revenue received over this period increased by 53.4%. The following quantities of products were sold in 2018:

- 550 pieces, worth 49,000 GEL in total, from the Kvareli museum;
- 210,000 pieces, worth 1.6 million GEL in total, from the cash service desk of the Cash Center;
- 1,900 pieces, worth 174,700 GEL in total, through the online shop.

The dynamics of the products sold in 2015-2018 per types are illustrated in Diagram N 11.8.

**Diagram 11.8 Products sold in 2015-2018**



Source: National Bank of Georgia

The NBG Money Museum continued to offer educational activities to the public during the year. Within the reporting period, the museum received a total of 3,334 visitors. During 2018, 63 educational tours (excursions) were arranged to the museum. These included an overview of Georgian numismatics and the viewing of exhibits. In total, 834 schoolchildren and 71 teachers attended lectures at the museum. In addition, a series of three lectures were held on the theme “the history of Georgian currency, the NBG tasks and obligations”, in which 63 students participated.

In March 2018, the Money Museum also hosted the winners of the “We draw the Money” competition.

In June 2018, within the framework of the “School-Bank” project, a group of children and adolescents from the National Youth Palace visited the Money Museum, where a lecture was held on the theme of the history of Georgian money. The museum was also involved in the preparation of a brochure entitled “Money History”.

Additional educational activities included hosting participants of the Choreographic Festival, as well as providing lectures for students of the Business School of Gori State University.

### Collector and investment coins

For the popularization of Georgian currency and of the country as a whole, the NBG continued working on the issuance of collector coins. In 2018, the NBG issued three kinds of collector coins, all of which quickly sold out – reflecting great demand and appreciation from the public.

First, the NBG issued a 5-lari collector coin dedicated to the 100th anniversary of Ivane Javakhishvili Tbilisi State University. Their sale started from 1 February 2018. The emblem of Ivane Javakhishvili Tbilisi State University is the main composition on the obverse of the coin. The emblem is surrounded by seven luminaries, as were found on the national coat of arms at the beginning of the 20th century. The inscription “ხუთი ლარი” is also applied on the coin. On the reverse, the building of Ivane Javakhishvili Tbilisi State University is the main composition. It also bears the following inscriptions: “საქართველო”, “Georgia”, “1918”, “2018” and “5 ლ”.



Next, a 10-lari collector coin dedicated to the celebration of the 100th anniversary of the establishment of the First Democratic Republic of Georgia was issued. The sale of these coins commenced on 15 May 2018. A fluttering national flag and an emblem, the heraldic symbols of the Democratic Republic of Georgia in the years of 1918-1921, are the main composition on the obverse of the coin. The following inscriptions are also present: “26

მაისი”, “1918”, “საქართველოს დემოკრატიული რესპუბლიკა” and “10 ლ”.

The reverse features the more recent state symbols of Georgia. The flying national flag and the Coat of Arms of Georgia are the main composition. The following inscriptions are also placed: “საქართველო”, “10 ლარი”, “2018” and “Georgia”.



A competition was carried out for the design of both of these coins. Once winners were chosen, a partner selection process was implemented and a relevant contract was concluded with the Spanish mint selected for their production. Both of these collector coins are sold out.

The third collector coin issued during the year was a 5-lari coin on the theme of Georgian books. These were dedicated to Georgia's status of a guest of honor at the Frankfurt Book Fair. It is worth mentioning that the Frankfurt Book Fair is one of the biggest book fairs in the world, which receives

thousands of international visitors every year and is the focus of numerous international journalists and critics. Within the framework of this event, every year one country is chosen to represent its intellectual resources (literature, theater, music, paintings, cinema, folk, cuisine, etc.) throughout different cities of Germany. In 2018, this opportunity was given to Georgia as the guest of honor. On 18 December 2017, a relevant contract was concluded with the Lithuanian Mint on the production of these coins. Their sale commenced on 10 September 2018 and they are also sold out.



The production of the following collector coins was also started in 2018:

- A 5-lari collector coin dedicated to the 100th anniversary of the Georgian Constituent Assembly (Parliament).
- A 5-lari collector coin dedicated to the 100th anniversary of issuance of the first Georgian National postage stamp.

During the reporting period, two competitions were carried out to obtain designs for these coins. After winners were chosen, the partner selection processes was implemented and two separate contracts were concluded with the mint selected for their production.

- A 5-lari collector coin dedicated to the 100th anniversary of the establishment of the State Bank of Georgia.
- A 5-lari collector coin dedicated to the 2019 Rugby World Cup.

Competitions were carried out for obtaining designs for both of these coins, and winners were chosen.

- 10-lari (1/10 oz), 25-lari (1/4 oz), 100-lari (1 oz) and 1,000-lari (10 oz) gold bullion investment coins.

In the reporting period, tender procedures were carried out for the production of these collection and investment coins. The conclusion of a contract for their production is in process with the winner of the tender.

In addition, a competition was announced for obtaining a design for a 1-lari coin dedicated to the Georgian alphabet. The deadline for the submission of designs for this was set for 31 January 2019.



*Tbilisi State University Opened On February 8, 1918*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## INTERNAL AUDIT AND CENTRALIZED RISK MANAGEMENT

## Internal Audit

In line with the Strategy of the Internal Audit Service, at the beginning of the reporting year, the third and final step of the complex implementation process of the Risk-Based Internal Audit Planning approach was completed. "The Risk-Based Internal Audit Engagement Methodology" was elaborated and the National Bank of Georgia completely switched to this new approach. This new approach considers greater concentration on areas containing significant risks from an organizational perspective and on the controls used by process owners. Accordingly, at the same time, "the Planning Methodology of the Internal Audit Service Activities" was also updated, which became the basis for using the above-mentioned principle in developing working plans.

A significant change was the complete transition to the principle of relying on the organizational risk map for the purposes of planning and developing short-term dynamic audit plans (with an interval of 6 months). Based on the new methodology, the annual action plan for 2018 was elaborated and approved by the Audit Committee and the practice of reviewing and updating the plan was established. At the same time, according to the three-year audit cycle model, a medium-term orientation plan was also elaborated.

In accordance with the action plan, within the framework of assurance services, 26 audits were conducted during the reporting year. Two follow-up audits were also carried out in 2018, during which the implementation of the recommendations provided by the Internal Audit Service to various structural units of the NBG were reviewed, the actions taken by process owners were analyzed and the status of the recommendations were updated.

In line with existing practice, the Internal Audit Service also provided consulting services to certain structural units of the NBG during the past year.

In order to formalize the automation of audit process that had been automated as a result a result of the implementation of Internal Audit and Risk Management software, several instructions and manuals were elaborated for internal auditors. These included documents on "Sending Notifications and Questionnaires from the System", "Creating an Audit Program", "Generating an Audit Report", "Recommendations Follow-up", and "Generating a Follow-up Report". The Internal Audit Service has also begun work on development of a new direction for audits and on elaborating a framework of Real-Time Audit.

The active cooperation of the Internal Audit Service with the Audit Committee of the NBG included discussions about and approval of orientation and annual plans, the communication of audit engagement results and recommendations, and providing advice in terms of new perspectives for the development of Audit Functions.

Within the framework of international cooperation between the National Bank of Georgia and De Nederlandsche Bank, in 2018 a seminar for internal auditors of various state institutions and the commercial banks of Georgia was organized. The event aimed at discussing the challenges and current issues facing the internal audit field, as well as promoting the internal audit profession and strengthening Internal Audit Function in the country.

## Non-financial risk management

The centralized risk management framework of the National Bank of Georgia consists of non-

financial risks, incident and business continuity management systems. The framework is also supported by the National Bank's internal procedures, representing a significant internal control instrument and promoting the improvement of institutional memory.

In accordance with the centralized risk management framework, within the reporting period, work was conducted to evaluate the non-financial risks related to business processes, to implement a risk response plan and monitor such risks. The risk assessment system, which is based on a qualitative method, clarifies that the level of residual risk was maintained at the NBG's acceptable level during the reporting period. This was achieved through preventive, detective and corrective control mechanisms.

In order to strengthen the centralized risk management system, the "Risk Appetite Statement of the National Bank of Georgia" was elaborated. The statement declared the acceptable and tolerable levels for non-financial risks, and improved the NBG Board's involvement in the risk management process.

In 2018, important steps were taken to enhance the operational risk management framework – an initiative supported by the International Monetary Fund. In particular, a quantitative method of operational risk assessment was selected and the data on existing operating losses were analyzed. Implementation of this model ensures the analysis of existing and potential operational losses in monetary terms. In addition, the NBG's risk framework model was initiated, which includes the steps of learning, assessing and documenting the existing

models of the bank. Work is continuing in both of these directions to ensure that the current results are improved and expanded.

To improve risk culture and minimize operational and reputation risks, the NBG introduced a Code of Ethics that stipulates general values and defines ethical, moral and behavioral norms for employees.

For the purpose of optimizing the NBG's business processes and improving the control environment, the development and renewal of internal procedures has been continuously supported within the centralized risk management framework.

In 2018, the NBG was actively involved in the research conducted by the International Operational Risks Working Group (IORWG) that sought to share results and experiences with other central banks.

### **Business Continuity Management**

The National Bank of Georgia, as the provider of critical services, recognizes the importance of ensuring the continuity of those services. The NBG thus continuously allocates resources to support and improve the business continuity system. During the reporting period, high importance was given to the SWIFT international settlement system in terms of minimizing information security risks and ensuring system continuity.

In addition to the initiatives mentioned above, the systematic approach of conducting training, testing and scenario development continued with the aim of raising staff awareness and improving coordination regarding crisis management.





*Tbilisi Nobilities Land Bank*



FIRST GEORGIAN  
**CENTRAL  
BANK**



13

**PUBLIC RELATIONS  
AND INTERNATIONAL COOPERATION**

## Public Relations

Dynamic communication with the public is one of the main priorities of the National Bank of Georgia. Consequently, the NBG has continued to focus on elaborating and implementing effective dialogue and communication techniques. When planning communication activities in 2018, particular attention was devoted to ensuring that the public understands current economic processes and their expected results, as well as the policies implemented by the National Bank of Georgia and their impact on the economy. To that end, the National Bank of Georgia's monetary policy communication activities became more dynamic throughout the year.



The tradition of having every other meeting of the Monetary Policy Committee continued in 2018. Within the reporting period, meetings of the Monetary Policy Committee were held in Kvemo Kartli and Samegrelo-Zemo Svaneti. The Governor of the National Bank of Georgia and other representatives from the NBG held briefings to clarify the decisions of the Monetary Policy Committee. At these, the Governor responded to all questions regarding monetary policy in general, its instruments and the committee's decisions. These briefings were broadcast live on social media. Moreover, Koba Gvenetadze met with representatives of the business sector and financial institutions, where he personally presented the committee's decision and provided information regarding macroeconomic trends.

Alongside the publication of the quarterly monetary policy reports, the National Bank of Georgia continued the tradition of releasing short videos of the Governor emphasizing important aspects of those reports. The reports were also presented to analysts, specialists and media representatives and these events were recorded and published on the official website and social networks of the National Bank of Georgia.

In order to guarantee maximum transparency and inform society about current processes in the banking sector in a timely manner, the National Bank of Georgia promptly disseminated press releases and statistical data, and conducted press conferences, presentations, briefings, conferences, seminars and meetings. Public relations were carried out through the mass media and other means of communication, and regular meetings took place with representatives of both print and electronic media. In this regard, in line with the conventional practice adopted by central banks of developed countries, the National Bank of Georgia made efforts to ensure the accessibility of information regarding current trends on the money and FX markets, to express its vision regarding these issues, and to explain its motives behind particular decisions. This was disseminated through both electronic and print publications as well as via other forms of mass media.

During the year, the National Bank of Georgia published its "Monthly Review", the quarterly "Monetary Policy Report", the quarterly analytical "Indicators of Financial Sector" and "Indicators of Current Macroeconomic Tendencies" as well as various statistical data and Monetary Policy Committee press releases. The NBG also prepared and printed the "Annual Report of the National Bank of Georgia, 2017". Electronic versions of the National Bank of Georgia's publications are available on the bank's official website: [www.nbg.gov.ge/index.php?m=308](http://www.nbg.gov.ge/index.php?m=308).

To enhance its communication with the public, the National Bank of Georgia embraced new and innovative opportunities offered by the increasing number of users on social media platforms.

### International Cooperation

The year 2018 was vital from the perspective of international cooperation, with the National Bank of Georgia hosting several high-level international meetings during the reporting period.

Within the framework of the Global Inclusion Awards, the National Bank of Georgia was nominated for the Child and Youth Finance International's Country Award for the second time. The Ministry of Finance of the Russian Federation was also nominated in that category, but the National Bank of Georgia won the prize. The National Bank of Georgia was nominated for its achievements in 2017 – in particular for the projects implemented



towards developing a national strategy of financial literacy and the efforts made for enhancing the younger generation's financial education. The Governor of the National Bank of Georgia, Koba Gvenetadze, attended the Global Inclusion Awards ceremony that was held in Riyadh, Saudi Arabia.

The world's leading financial editorial, Global Finance, named Koba Gvenetadze among the Best Central Bankers of 2018. The international magazine publishes annual "Central Banker Report Cards", which grade the different governors of central banks. The Global Finance Award is acknowledged worldwide, with those individuals and banks receiving an award being recognized in the global financial community for their high reputation and successful work. A total of 90 central bankers were graded in the 2018 Global Finance Central Banker Report Cards (those of 85 countries and five regional central bank governors). The final results were published in October.



In October 2018, the Governor of the National Bank of Georgia attended the official opening ceremony of the Frankfurt Book Fair, participating in the opening of the guest of honor pavilion. The Governor presented Federica Mogherini, the High Representative of the European Union, with a silver collector coin minted by the National Bank of Georgia to signify the importance of Georgia being the guest of honor at the Frankfurt Book Fair. In April 2018, Koba Gvenetadze participated in the World Bank's Executive Forum for Policy Makers and Senior Officials, which was held within the framework of the spring meeting of the Boards of Governors of the International Monetary Fund (IMF) and the World Bank Group in Washington, D.C. The Forum's participants represented the economic, financial and regulatory sectors of various countries. Koba Gvenetadze delivered a presentation titled "What are the implications of

unwinding major central banks' highly accommodative monetary policies for emerging markets?". In his speech, the Governor elaborated the importance of de-dollarization, maintaining a floating exchange rate and inflation targeting.

In June, the President of the Asian Development Bank, Takehiko Nakao, visited the National Bank of Georgia, his first visit in that position. There, he and the Governor of the National Bank of Georgia had a working meeting in which they discussed the current economic situation in the country, existing challenges in the banking sector, and dollarization indicators. Koba Gvenetadze and Takehiko Nakao also took the opportunity to define their future partnership, with the latter elaborating on the resilient and growing relationship and confirming the determination of the Asian Development Bank to support Georgia's economic development.



As the chair of the Banking Supervisors from Central and Eastern Europe (BSCEE), the National Bank of Georgia hosted the annual conference for BSCEE member countries. The National Bank of Georgia has been a member of this group since 2013 and has been actively involved in its activities. The group unites 24 Eastern and Central European countries and, according to its legislation, the chair is selected on an annual basis from its member countries. Georgia was elected as the chair country for 2018, with the Vice-Governor of the National Bank of Georgia, Murtaz Kikoria, holding the position. The conference, which was



held in Tbilisi, focused on the conclusion of the Basel III reforms, the stress test methodology, the risks towards the aim of decreasing excess-indebtedness, and issues regarding solvency analysis. Participants had the opportunity to share relevant practice and experience with other members. A total of 18 representatives from Eastern and Central European central banks and 32 financial supervisory structures participated in the conference.

In September 2018, the National Bank of Georgia, in cooperation with the International Financial Cooperation (IFC) and the Sustainable Banking Network (SBN), hosted a conference on sustainable finance. The workshop's main objective was the discussion of ongoing challenges regarding sustainable finance and the sharing of international practice among participants. The workshop brought together IFC experts, representatives from SBN member countries and regional central banks, senior representatives from the Ministry of Economy and Sustainable Development of Georgia, the Ministry of Finance of Georgia, the Ministry of Environment Protection and Agriculture of Georgia, Presidents/CEOs and senior leadership representatives of financial institutions, and other stakeholders.

A further conference was organized by the National Bank of Georgia, the World Bank and the International Finance Corporation on the subject

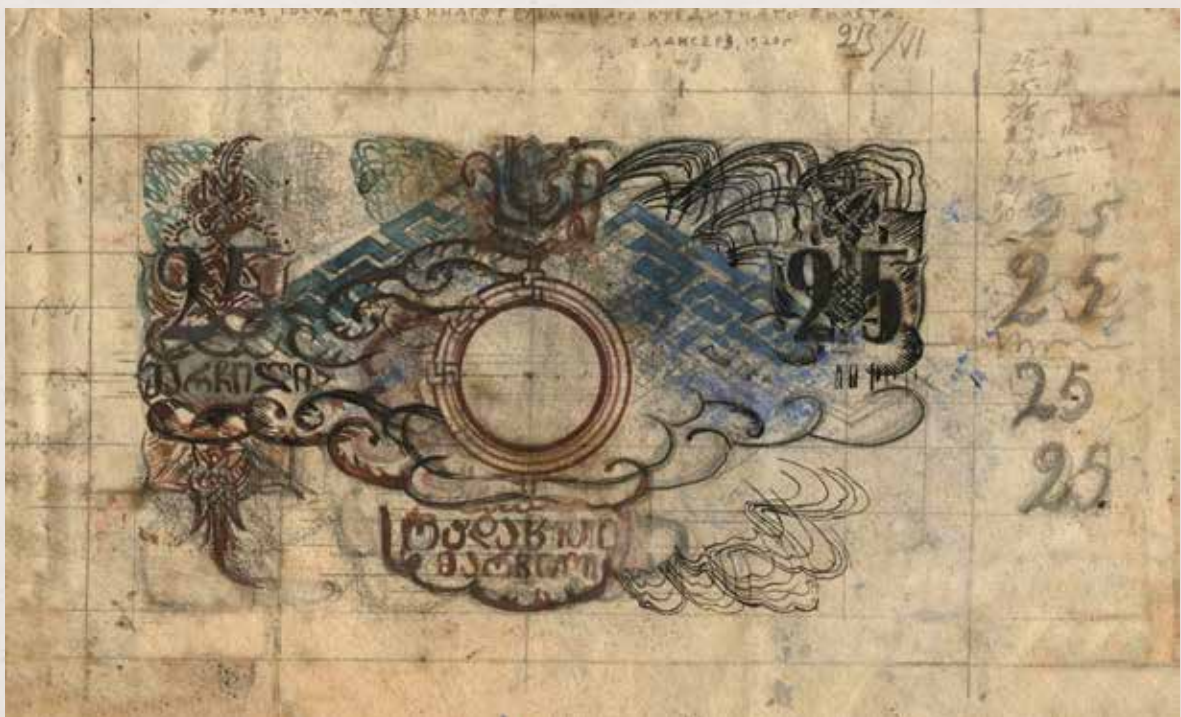


of corporate governance in October 2018. The aim was to raise awareness of corporate governance, to discuss existing challenges and the benefits of implementing the principles of corporate governance. Representatives from different international organizations and academia, including experts from the World Bank and the International Finance Corporation attended the conference. Attendees included professors from the Universities of Tilburg and Karlsruhe, and representatives



from credit rating organizations, the financial accounting office, the supervisory reporting and audit office, the National Bank of Georgia and the private sector.

The year 2019 marks 100 years since the establishment of Georgia's first Central Bank. To celebrate that anniversary, numerous events are planned for the year.



*Sketch of 25 Marchili Denomination State Credit Note*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## HUMAN RESOURCES MANAGEMENT AND DEVELOPMENT



## Statistical information on the number of employees

By the end of 2018, the National Bank of Georgia employed 467 individuals, of whom 338 are public servants. The average age of employees is 38. Of the total number of employees, 49.9% are female and 50.1% are male.

## Structural reorganization and optimization

In 2018, the National Bank of Georgia went through a structural reorganization in order to effectively fulfill its objectives as the central bank. Two new divisions were created under the Financial Stability Department: the Financial Stability Policy Analysis Division and the Macroeconomic Modelling and Analysis Division. The Non-Banking Organizations Inspection Division was added under the Money Laundering Inspection and Supervision Department. Two additional divisions were created under the Specialized Groups and Supervisory Policy Department: the Reporting System Monitoring and Developing Division and the Credit Information Bureaus Supervision Division. The Capital Markets Supervision Division was transformed into the Capital Markets Department and three additional divisions were created: the Capital Markets Supervision Division, the Capital Markets Regulatory Policy and Methodology Division, and the Capital Markets Strategic Development, External Communication and Research Division. Structural changes also took place in the Non-Banking Institutions Supervision Department with the following divisions created: the Non-Banking Institutions Registration and Licensing Division, the First Division of Non-Banking Institutions' Supervision, the Second Division of Non-Banking Institutions' Supervision, and the Non-Banking Institutions Inspection Division. Two divisions were also added to the Information Technology Department: the Data Management Division and the Cyber Security Division. In addition, a Project Management office was established within the National Bank of Georgia.

## Cooperation with higher education institutions

Every year, the National Bank of Georgia gives students an opportunity to become familiar with the National Bank by becoming interns and developing practical skills that will help them in their future careers. In line with a memorandum of cooperation, the National Bank of Georgia took on 42 interns in 2018, of whom ten subsequently became National Bank of Georgia employees. At the same time, the central bank provides summer internship opportunities for Georgian students studying abroad. The objective of the latter initiative was to increase the interest of such students towards the National Bank of Georgia, so that after graduating they might decide to return to Georgia and apply their knowledge. During 2018, six such students enrolled in the internship program.

## Implementing the Employees' Performance Evaluation System

In 2018, the Employees' Performance Evaluation System was implemented in the National Bank of Georgia, which aims to improve the efficiency of NBG employees. Before engaging in the project, numerous examples and experiences from different central banks were researched. To implement the system, several training stages were conducted with management representatives and employees of the National Bank of Georgia. These included training on planning objectives, change management, effective feedback and implementation of evaluation. Throughout the project, both high- and mid-level management and other employees were included in an intense series of discussions that led to the successful conclusion of the project. The conclusion of the evaluation cycle will lead to an improvement of the system and the development of future plans.

## Employees' professional development

Throughout 2018, the National Bank of Georgia continued to provide professional development

for its employees. A total of 203 employees visited the following institutions to increase their effectiveness: the Deutsche Bundesbank, the Central Bank of Italy, the Central Bank of France, the Central 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, the IMF, and the central banks of various other countries. In addition, 48 specialists from the National Bank of Georgia successfully underwent training in Georgian educational institutions.

An English language course was held at the National Bank of Georgia in 2018 that was attended by 51 employees. A certified course in “Project Management” was also held for 32 employees, each of whom passed tests to receive certificates. In 2018, 66 employees in managerial positions at

the National Bank of Georgia attended training on “Change Management” at the Management Academy.

In addition, employees from different departments of the National Bank of Georgia systematically conducted presentations with the aim of increasing and sharing knowledge within the organization.

### **Professional development of financial sector employees**

The National Bank of Georgia also supports the professional development of banking sector employees. To that end, in 2018, experts from the Luxembourg Financial Technology Transfer Agency conducted four seminars at the National Bank of Georgia that were attended by 68 individuals from the National Bank of Georgia and commercial banks.



*Ilia Chavchavadze and Ivane Machabeli*



FIRST GEORGIAN  
**CENTRAL  
BANK**



**DEVELOPMENT OF THE  
NORMATIVE LEGAL BASE**

The Legal Department of the National Bank of Georgia carried out its activities according to the functions and main directions of activities as determined by the Statute of the National Bank of Georgia. The development, improvement and renewal of the normative legal base was actively carried out during 2018.

In the reporting period significant legislative amendments were drafted with the participation of the Legal Department and subsequently entered into force. According to an amendment of the Organic Law on the National Bank of Georgia, coins with a face value of 1 and 2 tetri were withdrawn from circulation and the rounding off principle was implemented for use by business entities with customers using cash payments. The relevant amendment was also made to the Administrative Offences Code of Georgia, according to which the principle of carrying out the cash transactions with the precision of one tetri was canceled.

A further amendment to the Organic Law on the National Bank of Georgia was adopted during the year, according to which terms for loan issuing institutions were determined as well as their obligations to observe the requirements set out by the order of the Ministry of Internal Affairs of Georgia related to security and maintaining a special electronic program for recording movable items obtained as means of securing a claim.

It is also worth mentioning that the NBG actively participated in working meetings and parliamentary discussions regarding the amendment to the Organic Law on the National Bank of Georgia about the Human Resources Authority. According to the draft law, the legal base was established that will allow the National Bank of Georgia to regulate a number of issues regarding service activities that are divergent from the Law of Georgia on Public Service. The objective of this is to ensure that the

NBG can more effectively and independently carry out the authority granted to it by the Constitution of Georgia and the Organic Law.

It is also important to recognize the NBG's participation in the process of developing the Law of Georgia on Cumulative Pensions and attendant legal acts. According to this, and the amendment to the Organic Law on the National Bank of Georgia, the NBG is carrying out prudential supervision of the investment activities of the LEPL Pension Agency.

According to Article 35 of the draft changes to the Organic Law on the National Bank of Georgia, it was determined that the Board of the National Bank will elaborate and adopt, based on its normative acts, the decoration and design of lari banknotes and coins.

During 2018, 112 drafts of normative acts were prepared by the National Bank of Georgia, which were adjusted to the current legislation. These acts were subsequently published on the official webpage of the Legislative Herald of Georgia.

These acts included Order N193/04 of the Governor of the National Bank of Georgia of 27 August 2018 on "Approving the Rule of Registering, Cancelling Registration and Regulation of the Credit Information Bureau in the National Bank of Georgia". The purpose of this legislation is to ensure financial stability and consumer protection within the authority of the National Bank of Georgia; it also determines terms related to the security and protection of information, which will provide for the continuity of the activities of the Credit Information Bureau.

Order N195/04 of the Governor of the National Bank of Georgia of 27 August 2018 concerns "Submitting Information to the Credit Information Bu-

reau on the Territory of Georgia, Recording Information in the Database of the Credit Information Bureau and its Accessibility". This determines the supervision of the activities of the Credit Information Bureau on the territory of Georgia, including the provision, registration, processing, and accessibility of credit, non-credit and other relevant information by loan-issuing organizations and information receivers/providers to the Credit Information Bureau. It also addresses the procedure for reviewing claims and other issues related to the activities of the bureau.

Order N217/04 of the Governor of the National Bank of Georgia, dated 27 September 2018, was adopted concerning the "Rule of Registration, Termination of Registration and Regulation of Loan Issuing Entities". The requirements of this rule apply to persons who, according to the current legislation, are under an obligation to register at the National Bank and meet the requirements of this rule, or whom wish to perform loan-issuing entity activities in the future. The rights, obligations, and limitations of loan issuing entities are regulated in detail under this order.

Order N218/04 of the Governor of the National Bank of Georgia, dated 27 September 2018, is on the "Approval of Rules for Determining Fine Amounts, its Imposition and Enforcement against a Loan Issuing Entity". The adoption of this order defines the rules for determining the amount of fines and the mechanisms for their imposition and enforcement against loan-issuing entities by the National Bank of Georgia.

Order N281/04 of the Governor of the National Bank of Georgia, as dated 24 December 2018, concerns "Measures for Responsible Lending to Physical Persons". This was adopted to ensure the stable and sustainable functioning of the finan-

cial system of Georgia and to encourage healthy lending. This decree establishes rules for issuing any type of loan/credit/off-balance sheet liability (guarantee, letter of credit, etc.) to physical persons (including individual entrepreneurs).

Throughout the year, adopting measures aimed at the legal approximation of laws with the EU-Georgia Association Agreement, and drafting general principles and methods that are in alignment with EU laws governing fair financial system activities, were on-going processes.

Annex XV-A of the Association Agreement, established a 2018 deadline for the approximation of the requirements of various EU legislative acts. Based on the NBG's legislative analysis, a number of relevant legal acts were drafted and/or adopted:

- With the aim of approximation of Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions, Order N46/04 of the Governor of the National Bank of Georgia, dated 16 March 2018, was adopted on the "Approval of the Rule of Winding of Commercial Bank".
- The draft law on "Additional Supervision of Financial Conglomerates" was adopted in order to approximate legislation with Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 concerning the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.
- Following intensive consultations with stakeholders, Order N253/04 of the President of the National Bank of Georgia, dated 30 November 2018, concerning the "Approval of the Regulations on Transaction Information" was adopted for approximation with regulation

(EU) 2015/847 of the European Parliament and of the Council of 20 May 2015 on information accompanying transfers of funds and repealing regulation.

- Analysis was also carried out for the purpose of legal approximation with Directive 86/635/EEC, and a draft act was drafted. However, since the legislation for commercial banks sets out the obligation to use IFRS, no additional action has been taken towards adopting this act.

In 2018, the National Bank of Georgia actively cooperated with the European Commission on the approximation of its legislation in the field of financial services, including updating the Annex of the Association Agreement. Moreover, in 2018 an implementation of a “Twinning Project” was planned. Within the framework of the project, within the framework of the project Polish Financial Supervisory Authority was selected as a Twinning partner, which will assist the National Bank of Georgia with legal approximation in the fields of banking and payment services in 2019-2021.



*The National Bank of Georgia won Regional "Country Award" within the Frameworks of "Global Inclusion Award" 2018*





*Society for the Spreading of Literacy among Georgians*



FIRST GEORGIAN  
**CENTRAL  
BANK**



## STATISTICAL ACTIVITIES

During 2018, to improve communication with data users, the National Bank of Georgia successfully implemented the Business Intelligence Platform (BI). This is a flexible digital platform that is used for the visual representation and analysis of a large volume of data in various types and formats. By implementing the BI platform, the NBG took another important step forward on the path to improving communication with data users. The BI platform was preceded by the implementation of SebStat – an innovative statistical business process that corresponds to international standards. SebStat is an information system for collecting, ensuring quality control and processing statistical information from financial institutions. The data collected via SebStat became the basis for the BI platform’s interactive reports. This provides the possibility for a gradual replacement of static statistical Excel tables, as are currently published on the NBG website, with automatically updated, interactive and analytical information. This has partially been implemented during the reporting period.

The potential benefits of the BI platform, as a powerful tool, include the acceleration of decision making, an upgrade of quality, the optimization of internal working processes, an increase of operational effectiveness, and the identification of trends.

The BI platform covers a wide spectrum of tools, applications and methodologies, which provide the opportunity to collect data from internal systems as well as from external sources, prepare these for analysis, and to create reports and dashboards for data visualization. This ensures the availability of analytical results for decision makers and other employees, enabling their use in everyday activities.

During the reporting period, based on the detailed information provided by the banking sec-

tor, interactive reports were developed and the BI platform project was successfully implemented. It should also be noted that sharing interactive reports with the banking sector is an effective and useful form of providing feedback from the NBG. Reports on loans and deposits were published on the NBG’s website throughout 2018. New interactive reports will be periodically added, including those concerning money transfers and monetary surveys. As planned, during 2019 the static reports published on the NBG website in Excel format will be gradually replaced by interactive dashboards. This upgrade will grant users of the statistics on the NBG website an opportunity to receive much more information as a result of the detailed data included in the interactive reports.

In the framework of the SebStat statistical information system, the NBG receives monthly statistical information from active commercial banks registered in Georgia. After processing this information, various types of reports are prepared for dissemination as well as for internal use.

It is worth mentioning that, since the beginning of 2018, generalization of the standard reports produced by the NBG has been planned and preparatory work has been undertaken to elaborate the financial account of the financial sector. This was one of the tasks in the framework of the International Monetary Fund mission of September 2017, which placed clear emphasis on what kinds of information needed to be collected to achieve the goal. The mission suggested that statistical information should be collected from commercial banks, not only concerning stocks, but on flows as well. Intensive communication was subsequently carried out with commercial banks’ reporting units to achieve this goal. A list of required information was sent to them so that they could prepare monthly reports to be sent to SebStat according to the new format. NBG staff members were sent to commercial banks to observe the report

preparation process in detail and provide specific instructions according to the new requirements. The compliance study on commercial banks' reporting and the NBS's requirements is planned to continue through 2019.

The end of the year saw a flurry of activity, with many commercial banks taking the necessary measures to prepare the updated reports. It is important to mention that some commercial banks had also implemented a data warehouse, which

made a significant contribution to their rapid qualitative reporting.

Significant work has already been undertaken to elaborate the financial account of the financial sector, and an account for stocks has already been elaborated. The collection of all relevant statistical information is planned by the end of the third quarter of 2019, which will provide an opportunity to develop a complete financial account for both stocks and flows.



*First Georgian National Post Stamp*



FIRST GEORGIAN  
**CENTRAL  
BANK**



# FINANCIAL REPORTS

For the Year Ended 31 December 2018

# TABLE OF CONTENTS

**STATEMENT OF MANAGEMENT’S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018** **207**

**INDEPENDENT AUDITORS’ REPORT** **208-209**

**FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018:**

- Statement of profit or loss and other comprehensive income.....210-211
- Statement of financial position.....212-213
- Statement of changes in equity.....214
- Statement of cash flows.....215
- Notes to the financial statements.....216-261

## NATIONAL BANK OF GEORGIA

### STATEMENT OF MANAGEMENT'S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2018

---

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 2018, 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 adopted in Georgia which are IFRSs ;
- 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 2018 were authorized for issue on 24 April 2019 by the Council of the Bank.

**On behalf of the Council of the Bank**

**Chairman of the Council  
Koba Gvenetadze**

**Head of Finance and Accounting Department  
Andria Manelashvili**





KPMG Georgia LLC  
GMT Plaza  
5th Floor, 4, Liberty Square  
Tbilisi, Georgia 0105  
Telephone +995 322 93 5713  
Internet www.kpmg.ge

## **Independent Auditors' Report**

To the Council of the National Bank of Georgia

### ***Opinion***

We have audited the financial statements of the National Bank of Georgia (the "Bank"), which comprise the statement of financial position as at 31 December 2018, the statements of profit or loss and other comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising significant accounting policies and other explanatory information.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2018, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS).

### ***Basis for Opinion***

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditors' Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Georgia, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

### ***Responsibilities of Management and Those Charged with Governance for the Financial Statements***

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRS, 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.

In preparing the financial statements, management is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank's financial reporting process.

### ***Auditors' Responsibilities for the Audit of the Financial Statements***

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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.



As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

**The engagement partner on the audit resulting in this independent auditors' report is:**

**Karen Safaryan**

**KPMG Georgia LLC**  
**Tbilisi, Georgia**  
**24 April 2019**

## NATIONAL BANK OF GEORGIA

### STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-18	Year ended 31-Dec-17
<b>Interest income from international reserves</b>			
Cash and cash equivalents		13,077	12,944
Trading securities		-	5,708
Investments available-for-sale ("AFS")		-	49,067
Investments measured at fair value through other comprehensive income ("FVOCI")		127,870	-
Other		4,840	2,657
		<b>145,787</b>	<b>70,376</b>
<b>Interest income from monetary policy operations</b>			
Due from resident financial institutions		108,185	109,625
Investments available-for-sale		-	15,177
Investments measured at fair value through other comprehensive income		20,742	-
		<b>128,927</b>	<b>124,802</b>
<b>Other interest income</b>			
Investments held-to-maturity		-	27,116
Investments measured at amortised cost		21,006	-
Due from resident financial institutions		11,065	13,588
Other		6	16
		<b>32,077</b>	<b>40,720</b>
<b>Total interest income</b>		<b>306,791</b>	<b>235,898</b>
<b>Interest expense from monetary policy operations</b>			
Debt securities issued		(4,626)	(6,544)
Due to resident financial institutions		(40,865)	(32,488)
		<b>(45,491)</b>	<b>(39,032)</b>
<b>Other interest expenses</b>			
Due to resident financial institutions		(598)	(471)
Due to International Monetary Fund		(10,893)	(4,103)
<b>Total interest expense</b>		<b>(56,982)</b>	<b>(43,606)</b>
<b>NET INTEREST INCOME</b>		<b>249,809</b>	<b>192,292</b>
Impairment (charges)/recovery	27	(105)	104
<b>NET INTEREST INCOME AFTER IMPAIRMENT PROVISION</b>		<b>249,704</b>	<b>192,396</b>
Net gains/(losses) from foreign currencies:			
- translation differences		54,186	(30,653)
- dealing		543	643
Fee and commission income	4	2,125	1,839
Fee and commission expense	4	(1,800)	(1,816)
Net loss on realised available-for-sale financial assets		-	(1,456)
Net loss on realised instruments measured at fair value through other comprehensive income		(8,538)	-
Net gain on realised financial instruments measured at fair value through profit or loss		2,590	330
Net unrealised loss on financial instruments measured at fair value through profit or loss		(2,667)	(256)
Other income	5	5,852	1,918
<b>NON-INTEREST INCOME/(EXPENSE)</b>		<b>52,291</b>	<b>(29,451)</b>

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 2018 (CONTINUED)

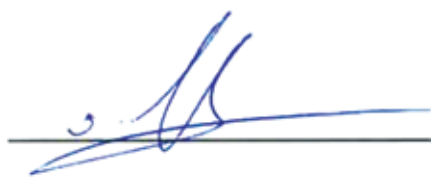
(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-18	Year ended 31-Dec-17
Personnel expenses	6	(21,286)	(18,004)
General and administrative expenses	6	(9,810)	(7,098)
Money printing expenses		(10,931)	(6,213)
Depreciation and amortization	6	(3,888)	(3,993)
Loss on disposal of property and equipment		(3)	-
Other expenses		(38)	(14)
<b>NON-INTEREST EXPENSES</b>		<b>(45,956)</b>	<b>(35,322)</b>
<b>PROFIT FOR THE YEAR</b>		<b>256,039</b>	<b>127,623</b>
<b>Other comprehensive income/(loss)</b>			
<i>Items that are or may be reclassified subsequently to profit or loss:</i>			
Net unrealized gain/(loss) on revaluation of investments measured at fair value through other comprehensive income (2017: Available-for-Sale) during the year		3,730	(6,302)
Net realized gain on investments measured at fair value through other comprehensive income (2017: Available-for-Sale) reclassified to profit or loss		4,962	1,094
<b>Total other comprehensive income/(loss)</b>		<b>8,692</b>	<b>(5,208)</b>
<b>TOTAL COMPREHENSIVE INCOME FOR THE YEAR</b>		<b>264,731</b>	<b>122,415</b>

The financial statements as set out on pages 4 to 55 were approved by management on 24 April 2019 and were signed on behalf of the Council of the Bank by:



Chairman of the Council  
Koba Gvenetadze



Head of Finance and Accounting Department  
Andria Manelashvili

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 2018 (in thousands of Georgian Lari)

	Notes	31-Dec-18	31-Dec-17
<b>ASSETS:</b>			
<b>Foreign currency assets</b>			
<b>International reserves</b>			
Cash and cash equivalents	7	1,278,475	1,589,656
Special Drawing Rights holdings with the International Monetary Fund	9	537,249	534,253
Assets related to derivative instruments	10	1,523	657
Trading securities	11	-	655,807
Investments measured at fair value through profit or loss	11	138,094	-
Investments available-for-sale	12	-	5,097,929
Investments measured at fair value through other comprehensive income	12	6,847,456	-
<b>Other foreign currency assets</b>			
Other assets	17	8	6
		<b>8,802,805</b>	<b>7,878,308</b>
<b>National currency assets</b>			
<b>Monetary policy instruments</b>			
Due from resident financial institutions	8	1,901,477	1,590,936
Investments available-for-sale	12	-	155,198
Investments measure at fair value through other comprehensive income	12	364,653	-
<b>Other national currency assets</b>			
Due from resident financial institutions	8	46,272	221,303
Investments held-to-maturity	13	-	321,952
Investments measured at amortised cost	13	281,808	-
Investment property	14	-	2,042
Property and equipment	15	54,518	53,291
Intangible assets	16	5,061	2,116
Other assets	17	8,521	6,521
		<b>2,662,310</b>	<b>2,353,359</b>
<b>TOTAL ASSETS</b>		<b>11,465,115</b>	<b>10,231,667</b>

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 2018 (CONTINUED) (in thousands of Georgian Lari)

	Notes	31-Dec-18	31-Dec-17
<b>LIABILITIES AND EQUITY:</b>			
<b>LIABILITIES:</b>			
<b>Foreign currency liabilities</b>			
<b>Monetary policy instruments</b>			
Due to resident financial institutions	18	3,642,799	2,818,536
<b>Other foreign currency liabilities</b>			
Due to resident financial institutions	18	8,122	312,177
Due to the Ministry of Finance of Georgia	19	414,917	434,263
Due to the International Monetary Fund	9	983,435	753,021
Other liabilities	17	2,776	2,744
		<b>5,052,049</b>	<b>4,320,741</b>
<b>National currency liabilities</b>			
Money issued in circulation	20	3,565,496	3,308,869
<b>Monetary policy instruments</b>			
Debt securities issued	21	79,310	79,284
Due to resident financial institutions	18	669,726	438,778
<b>Other national currency liabilities</b>			
Due to the Ministry of Finance of Georgia	19	362,445	541,489
Due to customers		666	1,371
Due to the International Monetary Fund	9	1,872	1,795
Other liabilities	17	7,711	8,231
		<b>4,687,226</b>	<b>4,379,817</b>
<b>TOTAL LIABILITIES</b>		<b>9,739,275</b>	<b>8,700,558</b>
<b>EQUITY:</b>			
Capital	22	15,000	15,000
Reserve fund	22	288,120	165,180
Retained earnings	22	80,000	70,000
Foreign currency revaluation reserve	22	1,334,309	1,280,123
Revaluation reserve of investments measured at fair value through other comprehensive income	22	8,411	(402)
Other revaluation reserve	22	-	1,208
<b>TOTAL EQUITY</b>		<b>1,725,840</b>	<b>1,531,109</b>
<b>TOTAL LIABILITIES AND EQUITY</b>		<b>11,465,115</b>	<b>10,231,667</b>

The financial statements as set out on pages 4 to 55 were approved by management on 24 April 2019 and were signed on behalf of the Council of the Bank by:



**Chairman of the Council**  
**Koba Gvenetadze**



**Head of Finance and Accounting Department**  
**Andria Manelashvili**

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 2018 (in thousands of Georgian Lari)

	Capital	Reserve fund	Foreign currency revaluation reserve	Other revaluation reserve	Revaluation reserve of investments measured at FVOCI (2017: AFS)	Retained earnings	Total equity
<b>1-Jan-17</b>	<b>15,000</b>	<b>141,648</b>	<b>1,310,776</b>	<b>1,464</b>	<b>4,806</b>	<b>-</b>	<b>1,473,694</b>
<b>Total comprehensive income</b>							
Profit for the year	-	-	-	-	-	127,623	127,623
<b>Other comprehensive income</b>							
<i>Items that are or may be reclassified subsequently to profit or loss:</i>							
Net unrealized loss on revaluation of available-for-sale investments during the year	-	-	-	-	(6,302)	-	(6,302)
Net realized gain on available-for-sale investments reclassified to profit or loss	-	-	-	-	1,094	-	1,094
Total other comprehensive loss	-	-	-	-	(5,208)	-	(5,208)
<b>Total comprehensive income/(loss) for the year</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(5,208)</b>	<b>127,623</b>	<b>122,415</b>
<b>Transactions recorded directly in equity</b>							
Transfer to the Ministry of Finance of Georgia (Note 22)	-	(65,000)	-	-	-	-	(65,000)
Transfer to reserve fund (Note 22)	-	88,532	-	-	-	(88,532)	-
Transfer to foreign currency revaluation reserve (Note 22)	-	-	(30,653)	-	-	30,653	-
Transfer to other revaluation reserve (Note 22)	-	-	-	(256)	-	256	-
<b>Total transactions recorded directly in equity</b>	<b>-</b>	<b>23,532</b>	<b>(30,653)</b>	<b>(256)</b>	<b>-</b>	<b>(57,623)</b>	<b>(65,000)</b>
<b>31-Dec-17</b>	<b>15,000</b>	<b>165,180</b>	<b>1,280,123</b>	<b>1,208</b>	<b>(402)</b>	<b>70,000</b>	<b>1,531,109</b>
Adjustment on initial application of IFRS 9, (see Note 3)	-	-	-	-	121	(121)	-
<b>1-Jan-18</b>	<b>15,000</b>	<b>165,180</b>	<b>1,280,123</b>	<b>1,208</b>	<b>(281)</b>	<b>69,879</b>	<b>1,531,109</b>
<b>Total comprehensive income</b>							
Profit for the year	-	-	-	-	-	256,039	256,039
<b>Other comprehensive income</b>							
<i>Items that are or may be reclassified subsequently to profit or loss:</i>							
Net unrealized gain on revaluation of investments measured at fair value through other comprehensive income available-for-sale investments during the year	-	-	-	-	3,730	-	3,730
Net realized gain on investments measured at fair value through other comprehensive income reclassified to profit or loss	-	-	-	-	4,962	-	4,962
Total other comprehensive income	-	-	-	-	8,692	-	8,692
<b>Total comprehensive income for the year</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>8,692</b>	<b>256,039</b>	<b>264,731</b>
<b>Transactions recorded directly in equity</b>							
Transfer to the Ministry of Finance of Georgia (Note 22)	-	-	-	-	-	(70,000)	(70,000)
Transfer to reserve fund (Note 22)	-	122,940	-	-	-	(122,940)	-
Transfer to foreign currency revaluation reserve (Note 22)	-	-	54,186	-	-	(54,186)	-
Transfer to other revaluation reserve (Note 22)	-	-	-	(1,208)	-	1,208	-
<b>Total transactions recorded directly in equity</b>	<b>-</b>	<b>122,940</b>	<b>54,186</b>	<b>(1,208)</b>	<b>-</b>	<b>(245,918)</b>	<b>(70,000)</b>
<b>31-Dec-18</b>	<b>15,000</b>	<b>288,120</b>	<b>1,334,309</b>	<b>-</b>	<b>8,411</b>	<b>80,000</b>	<b>1,725,840</b>

The financial statements as set out on pages 4 to 55 were approved by management on 24 April 2019 and were signed on behalf of the Council of the Bank by:

  
Chairman of the Council  
Koba Gvenetadze

  
Head of Finance and Accounting Department  
Andria Manelashvili

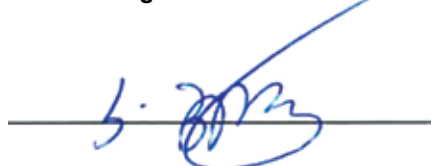
The statement of changes in equity is to be read in conjunction with the notes to, and forming part of, the financial statements.

# NATIONAL BANK OF GEORGIA

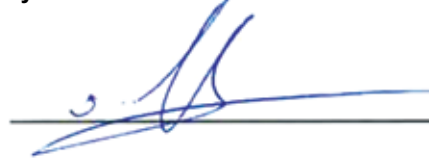
## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-2018	Year ended 31-Dec-2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Interest received		275,566	242,904
Interest paid		(51,464)	(40,655)
Fees and commissions received		2,125	1,839
Fees and commissions paid		(1,800)	(1,816)
Net gain/(loss) on financial instruments at fair value through profit or loss		2,590	(330)
Net realized gain from dealing in foreign currencies		543	643
Other income received		2,167	2,581
Personnel expenses paid		(21,286)	(18,004)
Cash paid for printing money		(10,931)	(6,213)
Other general and administrative expenses paid		(9,810)	(7,370)
<b>Net cash inflow from operating activities before changes in operating assets and liabilities</b>		<b>187,700</b>	<b>173,579</b>
<i>Net (increase)/decrease in operating assets:</i>			
Due from resident financial institutions		(135,963)	(56,215)
Special Drawing Rights holdings with the International Monetary Fund		4,148	(2,267)
Assets related to derivative instruments		(785)	(657)
Investments measured at fair value through profit or loss		(2,259)	2,402
Other assets		(278)	(382)
<i>Net increase/(decrease) in operating liabilities:</i>			
Money issued in circulation		256,627	312,811
Due to resident financial institutions		659,955	177,374
Due to the Ministry of Finance		(203,288)	(11,765)
Due to customers		(705)	(1,340)
Other liabilities		(295)	1,354
<b>Net cash inflow from operating activities</b>		<b>764,857</b>	<b>594,894</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from disposal of investment property		3,703	-
Purchase of property and equipment		(4,555)	(4,608)
Purchase of intangible assets		(3,502)	(1,675)
Purchase of investments available-for-sale		-	(8,450,337)
Purchase of investments measured at fair value through other comprehensive income		(9,378,175)	-
Proceeds from redemption of investments available-for-sale		-	7,878,920
Proceeds from redemption of investments measured at fair value through other comprehensive income		8,163,045	-
<b>Net cash used in investing activities</b>		<b>(1,219,484)</b>	<b>(577,700)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Transfer to the Ministry of Finance		(70,000)	(65,000)
Debt securities issued	7	255,400	255,499
Debt securities redeemed	7	(256,081)	(374,145)
Net proceeds from the International Monetary Fund	7	214,454	200,011
<b>Net cash from in financing activities</b>		<b>143,773</b>	<b>16,365</b>
Effect of exchange rates changes on cash and cash equivalents		(327)	12,713
Net (decrease)/increase in cash and cash equivalents		(311,181)	46,272
<b>CASH AND CASH EQUIVALENTS, at the beginning of the year</b>	7	<b>1,589,656</b>	<b>1,543,384</b>
<b>CASH AND CASH EQUIVALENTS, at the end of the year</b>	7	<b>1,278,475</b>	<b>1,589,656</b>

The financial statements as set out on pages 4 to 55 were approved by management on 24 April 2019 and were signed on behalf of the Council of the Bank by:



**Chairman of the Council**  
**Koba Gvenetadze**



**Head of Finance and Accounting Department**  
**Andria Manelashvili**

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 2018 *(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”).

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 responsibilities are carried out as part of the broad functions described below.

#### **Monetary policy**

The main objective of the monetary policy of the Bank 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 of the Bank is to ensure 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, banking groups, non-bank depository institutions, micro-finance organisations, independent securities registrars, brokerage companies (except for insurance brokerage companies), the stock exchange, central depository, specialised depository, asset management companies, publicly accountable enterprises, foreign currency exchange offices, investment funds, payment system operators, payment service providers, credit information bureaus, loan issuing institutions and the Pension Agency of Georgia (with respect to its investment activities).

The National Bank of Georgia within the relevant regulatory framework supports the protection of consumer and investor rights. Moreover, the Bank, with the involvement of different stakeholders from the Government structures, the private financial sector, and civil society has developed the National Strategy of Financial Education as a complement to financial consumer protection and inclusion efforts, with a view of supporting financial stability and individuals' financial well-being.

#### **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 and 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 Government payments in national currency.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018

(in thousands of Georgian Lari)

---

### Governance

As at 31 December 2018 and 2017, the members of the Council of the Bank are:

<b>Position</b>	<b>Name (2018)</b>	<b>Name (2017)</b>
Chairman	Mr. Koba Gvenetadze (Governor)	Mr. Koba Gvenetadze (Governor)
Member	Mr. Archil Mestvirishvili (Vice-governor)	Mr. Archil Mestvirishvili (Vice-governor)
Member	Mr. Papuna Lezhava	Mr. Murtaz Kikoria (Vice-governor)
Member	Mr. Robert H. Singletary	Mr. Robert H. Singletary
Member	Mr. Nikoloz Gongliashvili	Mr. Nikoloz Gongliashvili
Member	Mr. Vazha Jankarashvili	Mr. Vazha Jankarashvili
Member	Mr. Nikoloz Kavelashvili	Mr. Nikoloz Kavelashvili

The Bank's main office is located at 2 Sanapiro, Tbilisi, 0114, Georgia. As at 31 December 2018 and 2017 the Bank has one cash service center. The Bank has 467 and 398 personnel as at 31 December 2018 and 2017, 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").

This is the first set of the Bank's annual financial statements to which IFRS 9 Financial Instruments and IFRS 15 *Revenue from Contracts with Customers* have been applied. Changes to significant accounting policies are described in Note 3.

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.

### Basis of measurement

These financial statements are prepared on the historical cost basis except that financial instruments measured at fair value through profit or loss and investments measured at fair value through other comprehensive income (available-for-sale investments under IAS 39) 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 is the national currency of Georgia and which has been defined as the functional and presentation currency for the purpose of these 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.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

### 3. SIGNIFICANT ACCOUNTING POLICIES

Except for the changes disclosed in Note 3, the Bank has consistently applied the following accounting policies to all periods presented in these financial statements.

#### 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 and options, holdings in the International Monetary Fund (IMF), cash and cash equivalents, due from financial institutions, due to commercial banks, Ministry of Finance of Georgia, IMF and other financial assets and liabilities. Starting from 1 January 2018, the Bank accounts for its financial instruments in accordance with IFRS 9–*Financial Instruments*. Before 1 January 2018 the Bank accounted for its financial instruments in accordance with IAS 39 – *Financial Instruments: Recognition and measurement*. The Bank reports its instruments under IFRS 7–*Financial Instruments: Disclosures* and IFRS 13–*Fair Value Measurement*.

#### Classification (*Policy applicable from 1 January 2018*)

The Bank classifies its financial assets in the following categories: measured at amortised cost (AC), measured at fair value through other comprehensive income (FVOCI) and measured at fair value through profit or loss (FVTPL). The classification depends on business model under which the financial assets are managed and their cash flow characteristics. The Bank classifies its financial liabilities as subsequently measured at amortized cost except for derivatives liabilities, which are measured at fair value through profit or loss. Classification of the financial assets and the financial liabilities are determined at initial recognition. A financial asset is measured at amortised cost if it meets both of the following conditions and is not designated as at FVTPL:

- the asset is held within a business model whose objective is to hold assets to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVTPL:

- the asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

For debt financial assets measured at FVOCI, gains and losses are recognised in other comprehensive income, except for the following, which are recognised in profit or loss in the same manner as for financial assets measured at amortised cost:

- interest income using the effective interest method;
- Expected credit losses (further referred as "ECL") and reversals; and
- foreign exchange gains and losses.

When a debt financial asset measured at FVOCI is derecognised, the cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss.

All other financial assets are classified as measured at FVTPL.

On initial recognition, the Bank may irrevocably designate a financial asset that otherwise meets the requirements to be measured at amortised cost or at FVOCI at FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

#### *Business model assessment*

The Bank makes an assessment of the objective of a business model in which an asset is held at a portfolio level because this best reflects the way the business is managed and information is provided to management. The information considered includes:

- Objectives of holding the portfolio;
- Frequency, value and timing of sales (both past and future);
- How the performance of the business model and financial assets are evaluated and reported to the Bank's key management personnel ;
- The risks that affect the performance of the business model, in particular, the way in which those risks are managed (to meet the objectives);
- How managers of the business are compensated; e.g. whether compensation is based on the fair value of the assets managed or the contractual cash flows collected; and
- Whether collection of contractual cash flows (e.g. interest income received) represents significant part of the portfolios returns.

#### *Assessment whether contractual cash flows are solely payments of principal and interest*

For the purposes of assessment whether the contractual cash flows are solely payments of principal and interest, the 'principal' is defined as the fair value of the financial asset on initial recognition. 'Interest' is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs (e.g. liquidity risk and administrative costs), as well as profit margin.

In assessing whether the contractual cash flows are solely payments of principal and interest, the Bank considers the contractual terms of the instrument. This includes assessing whether the financial asset contains a contractual term that could change the timing or amount of contractual cash flows such that it would not meet this condition. In making the assessment, the Bank considers:

- contingent events that would change the amount and timing of cash flows;
- leverage features;
- prepayment and extension terms;
- terms that limit the Bank's claim to cash flows from specified assets (e.g. non-recourse asset arrangements); and
- features that modify consideration of the time value of money – e.g. periodical reset of interest rates.

#### **Classification (Policy applicable before 1 January 2018)**

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 depends on the purpose for which the financial assets were acquired. Management determines the classification of financial assets at initial recognition.

#### *Loan and receivables*

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.

#### *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 FVTPL unless they are designated as hedges. The trading portfolio

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

includes part of international reserves managed by external managers – the World Bank and the 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 the 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.

#### *Investments available for sale*

Investments available for sale are non-derivative financial assets that are either designated in this category or not classified in any of the other categories. 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. Impairment losses, foreign exchange gains or losses on debt financial instruments available-for-sale and interest income accrued using the effective interest method 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 the paragraph above.

#### *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.

#### **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 recognise under continuing involvement, and the part it no longer

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

---

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.

#### **Measurement principles**

##### *Fair value*

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 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.

The Bank uses quoted market prices to determine fair value of the Bank's investment securities. 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.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

---

#### *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 accounts and amounts due from financial institutions, including time deposit accounts and overnight deposits, that mature within ninety days from the date of origination and are free from contractual encumbrances. Cash and cash equivalents are subsequently measured at amortised 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.

#### **Financial assets measured at amortised cost (applicable from 1 January 2018)**

In the normal course of business, the Bank maintains loans, deposit, current accounts, and other receivables for various periods with financial institutions. Objective of the business model under which these assets are managed is achieved by collecting contractual cash flows. Contractual terms of these assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Amounts due from financial institutions and other financial assets are considered in this category. The Bank's investments measured at amortised cost also include Georgian Government bonds.

Any premium or discount of the instruments representative of debt measured at amortised cost is recognized with the calculation of the amortised cost by applying the effective interest rate method, recognizing the accrued interest in respective 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 recognise interest on a constant-yield basis.

#### **Investments measured at fair value through profit or loss (applicable from 1 January 2018)**

The Bank's investments measured at FVTPL comprise part of international reserves managed by the Bank for International Settlements ("BIS") which represent investments placed in the Bank for International Settlements Investment Pool (BISIP K). The objective of the business model under which the investment is managed is achieved by collecting contractual cash flows. However, contractual terms do not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

##### *Derivative financial instruments*

The Bank uses interest rate futures and options contracts on overseas exchanges to manage interest rate risk on its portfolio of foreign securities. Exchange traded interest rate futures are futures contracts with an underlying instrument that pays interest, which allows investor to lock in the price of an interest-bearing asset for a future date. An interest rate option on exchange traded interest rate futures is a financial derivative that allows the holder to benefit from the changes in interest rates.

Interest rate futures and options positions are classified as at fair value through profit or loss (FVTPL). Derivatives are initially recognised at fair value at the date a derivative contract is entered into and are

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

subsequently re-measured to their fair value at each reporting date. The positions are marked to market on the reporting 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 measured at fair value through other comprehensive income (*applicable from 1 January 2018*)**

The Bank's investments measured at FVOCI comprise Georgian and foreign government's, international financial institutions and agency debt securities. The securities are either part of the Bank's international reserve portfolio or represent monetary policy instruments. The objective of the business model under which the debt securities are managed is achieved by both collecting contractual cash flows and selling financial assets. The debt securities are classified as investments measured at FVOCI given that their contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

#### **Expected credit losses (*applicable from 1 January 2018*)**

The Bank recognises loss allowances for expected credit losses (ECL) on the debt financial instruments that are measured at amortised cost or FVOCI.

The Bank measures loss allowances at an amount equal to lifetime ECL, except for the following, for which they are measured as 12-month ECL:

- debt investment securities that are determined to have low credit risk at the reporting date; and
- other financial instruments on which credit risk has not increased significantly since their initial recognition

The Bank considers debt investment securities to have low credit risk when their credit risk rating is equivalent to the globally understood definition of 'investment grade'. Considering the Bank's strict investment guidelines, which propose holding of extremely high credit-rated investments, financial instruments held as international reserves are considered to have low credit risk. In addition, the Bank considers exposure to the Georgian Government, which is denominated in Georgian Lari, to have low credit risk. Such an approach reflects the general assumption that sovereign debt denominated in local currency is considered to have an extremely low risk of default (usually referred to as "risk-free" from market participant perspective) as well as the fact that due to the unique link between the Bank and the Government of Georgia, the Bank maintains the main current account of the Ministry of Finance of Georgia. The Bank does not apply the low credit risk exemption to any other financial instruments.

#### *ECL calculation*

Lifetime ECLs are the ECLs that result from all possible default events over the expected life of the financial instrument. 12-month ECL are the portion of ECL that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

ECL are a probability-weighted estimate of credit losses. They are measured as follows:

- financial assets that are not credit-impaired at the reporting date: as the present value of all cash shortfalls (i.e. the difference between the cash flows due to the entity in accordance with the contract and the cash flows that the Bank expects to receive);
- financial assets that are credit-impaired at the reporting date: as the difference between the gross carrying amount and the present value of estimated future cash flows;

#### *Credit-impaired financial assets*

At each reporting date, the Bank assesses whether financial assets carried at amortised cost and debt financial assets carried at FVOCI are credit impaired. A financial asset is 'credit-impaired' when one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred.



## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

Evidence that a financial asset is credit-impaired includes the following observable data:

- significant financial difficulty of the borrower or issuer;
- a breach of contract such as a default or past due event;
- the restructuring of a loan or advance by the Bank on terms that the Bank would not consider otherwise;
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation; or
- the disappearance of an active market for a security because of financial difficulties.

All financial assets measured at amortised cost or FVOCI, which are overdue for 90 days or more, are considered to be in default except for exposure to the Government of Georgia which would be considered to be in default if overdue for more than 180 days. This represents a rebuttal of the presumption of IFRS 9 that the default does not occur later than when the financial asset is 90 days past due. However, it reflects the circumstances of the Government's budgetary approval processes and the Bank's unique relationship with the Government as it acts as banker and fiscal agent of the Government.

#### *Presentation of allowance for ECL in the statement of financial position*

Loss allowances for ECL are presented in the statement of financial position as follows:

- financial assets measured at amortised cost: as a deduction from the gross carrying amount of the assets;
- debt instruments measured at FVOCI: no loss allowance is recognised in the respective caption of the statement of financial position because the carrying amount of these assets is their fair value. However, the loss allowance is disclosed and is recognised in the revaluation reserve of investments measured at fair value through other comprehensive income.

#### *Write-offs*

Financial assets measured at amortised cost or FVOCI are written off (either partially or in full) when there is no reasonable expectation of recovering a financial asset in its entirety or a portion thereof. This is generally the case when the Bank determines that the borrower does not have assets or sources of income that could generate sufficient cash flows to repay the amounts subject to the write-off. This assessment is carried out at the individual asset level.

Recoveries of amounts previously written off are included in caption for impairment losses on financial instruments in the statement of profit or loss and other comprehensive income.

#### **Allowance for impairment losses on financial assets (*applicable before 1 January 2018*)**

At the end of each reporting date, the Bank assesses whether any objective evidence of impairment for its financial assets exists and estimates the impact on related future cash flows, in order to determine whether the financial assets are impaired.

#### *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.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

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.

#### *Financial assets carried at fair value*

For available-for-sale financial assets, 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, 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 loss, is removed from other comprehensive income and recognised in profit or loss. If, in 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 security is recognised in other comprehensive income.

#### **Financial liabilities measured at amortised cost**

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.

#### **Securities lending agreements**

Securities lent under automatic securities lending agreements continue to be recognized in the Bank's statement of financial position with other securities that are not involved in these transactions and are valued in accordance with the accounting policies applicable to assets available-for-sale.

Securities lending transactions are collateralized with securities that should not be reported as assets and liabilities in the statement of financial position, since the Bank does not have the ability to pledge or sell these securities unless the borrower defaults. Only cash collateral placed on the account of the Bank is recognized in the statement of financial position.

Income originated from these operations is recognized in the statement of profit or loss as interest income.

#### **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.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

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.

#### **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 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.

#### **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.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

### 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 Organic Law of Georgia "On the National Bank of Georgia", assets, property and income of the Bank, as well as its activities and operations are exempt 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 recognized when the Bank satisfies a performance obligation by transferring a promised good or service (ie an asset) to counterparties. An asset is transferred when (or as) the counterparties obtain control of that asset.

#### *Interest and similar income and expense*

For all financial instruments that are measured at amortised cost, fair value through other comprehensive income interest income or expense is recorded at the effective interest rate, which is the rate that exactly discounts estimated future cash receipts or payments 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.

#### *Interest income recognition base (applicable from 1 January 2018)*

The original effective interest rate is applied to the gross carrying amount (carrying amount without reduction by expected credit loss allowance) of a financial assets for which:

- credit risk has not increased significantly since initial recognition;
- credit risk has increased significantly since initial recognition, but which are not credit-impaired

For financial assets which are credit-impaired, the original effective interest rate is applied to the net carrying amount (carrying amount after reduction by expected credit loss allowance)

#### *Interest income recognition base (applicable before 1 January 2018)*

If 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 the services are provided. Fee and commission expense consists of cash operation,

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

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 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:

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
GEL/1 US Dollar (USD)	2.6766	2.5922
GEL/1 Euro (EUR)	3.0701	3.1044
GEL/1 Australian Dollar (AUD)	1.8894	2.0266
GEL/1 Canadian Dollar (CAD)	1.9674	2.0683
GEL/1 Special Drawing Right (SDR)	3.7226	3.6916

### 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 (applicable from 1 January 2018)

Financial assets are not reclassified subsequent to their initial recognition, except in the period after the Bank changes its business model for managing financial assets.

### Reclassification of financial assets (applicable before 1 January 2018)

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

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

---

becomes its new cost or amortised cost, as applicable. No reclassification of financial assets has been made as of reporting period.

### **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.

Significant areas of critical judgments applicable from 1 January 2018 are described in the following notes:

- Classification of financial assets: assessment of the business model within which the assets are held and assessment of whether the contractual terms of the financial asset are solely payments of principal and interest on the principal amount outstanding – Note 3
- Application of low credit risk exemption – Note 3

Significant areas of estimation uncertainty and critical judgments applicable from and before 1 January 2018 are described in following note:

- Fair valuation of financial instruments - Note 26

### **Changes in accounting policies and presentation**

The Bank has adopted IFRS 9 and IFRS 15 from 1 January 2018.

A number of other new standards are also effective from 1 January 2018 but they do not have a material effect on the Bank's financial statements.

Due to the transition methods chosen by the Bank in applying IFRS 9, comparative information throughout these financial statements has not generally been restated to reflect its requirements.

The effect of initially applying these standards is mainly attributed to the following:

- an increase in impairment losses recognised on financial assets (see Note 3);
- additional disclosures related to IFRS 9 (see Notes 3 and 27).

### **Application of new and revised International Financial Reporting Standards (IFRSs)**

#### **Transition to IFRS 9 Financial instruments**

IFRS 9 *Financial instruments*, published in July 2014, replaced the existing guidance in IAS 39 *Financial Instruments: Recognition and Measurement*, and includes requirements for classification and measurement of financial instruments, impairment of financial assets and hedge accounting. IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early adoption permitted.

#### **(i) Classification and measurement**

##### *International reserves:*

International reserves of the Bank consist of funds managed internally by the Bank and funds managed by external managers (World Bank and BIS). As at 31 December 2017 funds managed by the Bank's internal managers are classified as available-for-sale and funds managed by the external managers are classified as FVTPL (trading securities). As a result of the business model assessment at the date of initial application (1 January 2018) of IFRS 9, international reserves of the Bank are classified as measured at AC, measured at FVOCI and measured at FVTPL as indicated in the tables A and B below.

##### *Monetary policy instruments:*

Lending to commercial banks are classified as loans and receivables as at 31 December 2017. Marketable government securities are classified as investments available-for-sale as at 31 December 2017. As a result

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018

(in thousands of Georgian Lari)

of the business model assessment at the date of initial application (1 January 2018) of IFRS 9, monetary policy instruments of the Bank are classified as measured at AC and measured at FVOCI as indicated in the tables A and B below.

### Other financial assets:

Non-marketable government bonds are classified as investments held-to-maturity as at 31 December 2017. Other financial assets are measured at amortized cost as at 31 December 2017. These financial assets include trade receivables and loans to employees. As a result of the business model assessment at the date of initial application (1 January 2018) of IFRS 9, the assets of the Bank are classified as measured at AC as indicated in the tables A and B below.

The following Table A shows the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Bank's financial assets and financial liabilities as at 1 January 2018:

Line-item on Statement of Financial Position	Notes	Original classification under IAS 39	New classification under IFRS 9	Original Carrying Amount under IAS 39	New Carrying Amount under IFRS 9
<b>ASSETS:</b>					
<b><u>Foreign currency assets</u></b>					
<b><u>International Reserves</u></b>					
Cash and cash equivalents	7	Loans and Receivables	Amortised Cost	1,589,656	1,589,656
Special Drawing Rights holdings with the International Monetary Fund	9	Loans and Receivables	Amortised Cost	534,253	534,253
Assets related to derivative instruments	10	FVTPL	FVTPL (mandatory)	657	657
Trading Securities (Excl. BISIP_K)	11	FVTPL	FVOCI	524,334	524,334
Trading Securities (BISIP_K)	11	FVTPL	FVTPL (mandatory)	131,473	131,473
Investments available for sale	12	Available for Sale	FVOCI	5,097,929	5,097,929
<b><u>Other foreign currency assets</u></b>					
Other assets	17	Loans and Receivables	Amortised Cost	6	6
<b><u>National currency assets</u></b>					
<b><u>Monetary policy instruments</u></b>					
Due from financial institutions	8	Loans and Receivables	Amortised Cost	1,590,936	1,590,936
Investments available for sale	12	Available for Sale	FVOCI	155,198	155,198
<b><u>Other national currency assets</u></b>					
Due from financial institutions	8	Loans and Receivables	Amortised Cost	221,303	221,303
Investments held to maturity	13	Held to Maturity	Amortised Cost	321,952	321,952
Other assets	17	Loans and Receivables	Amortised Cost	645	645
<b>Total Financial Assets</b>				<b>10,168,342</b>	<b>10,168,342</b>
<b>LIABILITIES:</b>					
<b><u>Foreign Currency Liabilities</u></b>					
<b><u>Monetary policy instruments</u></b>					
Due to resident financial institutions	18	Amortised Cost	Amortised Cost	2,818,536	2,818,536
<b><u>Other foreign currency liabilities</u></b>					
Due to resident financial institutions	18	Amortised Cost	Amortised Cost	312,177	312,177
Due to the Ministry of Finance	19	Amortised Cost	Amortised Cost	434,263	434,263
Due to the International Monetary Fund	9	Amortised Cost	Amortised Cost	753,021	753,021
Other liabilities	17	Amortised Cost	Amortised Cost	2,744	2,744
<b><u>National Currency Liabilities</u></b>					
<b><u>Monetary policy instruments</u></b>					
Debt securities issued	21	Amortised Cost	Amortised Cost	79,284	79,284
Due to resident financial institutions	18	Amortised Cost	Amortised Cost	438,778	438,778
<b><u>Other national currency liabilities</u></b>					
Due to the Ministry of Finance	19	Amortised Cost	Amortised Cost	541,489	541,489
Due to customers		Amortised Cost	Amortised Cost	1,371	1,371
Due to the International Monetary Fund	9	Amortised Cost	Amortised Cost	1,795	1,795
Other liabilities	17	Amortised Cost	Amortised Cost	8,231	8,231
<b>Total Financial Liabilities</b>				<b>5,391,689</b>	<b>5,391,689</b>

The Bank's accounting policies on the classification of financial instruments under IFRS 9 are set out in Note 3. The application of these policies resulted in the reclassifications set out in the table above and explained below.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

The following table B reconciles the carrying amounts under IAS 39 to the carrying amounts under IFRS 9 on transition to IFRS 9 on 1 January 2018.

Table B	IAS 39 carrying amount			IFRS 9 carrying amount
Line-Item	31 December 2017	Reclassification	Remeasurement	1 January 2018
<b><u>Foreign currency assets</u></b>				
Cash and cash equivalents	1,589,656	-	-	1,589,656
Special Drawing Rights holdings with the International Monetary Fund	534,253	-	-	534,253
Assets related to derivative instruments	657	-	-	657
<b>Trading Securities</b>				
Opening Balance	655,807	-	-	-
- To FVOCI	-	(524,334)	-	-
- To FVTPL	-	(131,473)	-	-
Ending Balance	-	-	-	-
<b>Investments available for sale</b>				
Opening Balance	5,097,929	-	-	-
- To FVOCI	-	(5,097,929)	-	-
Ending Balance	-	-	-	-
Other assets	6	-	-	6
<b>Investments measured at fair value through profit or loss</b>				
Opening Balance	-	-	-	-
- from Trading Securities	-	131,473	-	-
Ending Balance	-	-	-	131,473
<b>Investments measured at fair value through other comprehensive income</b>				
Opening Balance	-	-	-	-
- from Trading Securities	-	524,334	-	-
- from Investments available for sale	-	5,097,929	-	-
Ending Balance	-	-	-	5,622,263
<b><u>National currency assets</u></b>				
<b>Due from financial institutions - Monetary Policy instruments</b>				
Investments available for sale	1,590,936	-	-	1,590,936
Opening Balance	155,194	-	-	-
- To FVOCI	-	(155,194)	-	-
Ending Balance	-	-	-	-
Due from financial institutions – other	221,303	-	-	221,303
<b>Investments held to maturity</b>				
Opening Balance	321,952	-	-	-
- to Investments measured at mortised cost	-	(321,952)	-	-
Ending Balance	-	-	-	-
Other assets	645	-	-	645
<b>Investments measured at fair value through other comprehensive income</b>				
Opening Balance	-	-	-	-
- from Investments available for sale	-	155,194	-	-
Ending Balance	-	-	-	155,194
<b>Investments measured at amortised cost</b>				
Opening Balance	-	-	-	-
- from Investments held to maturity	-	321,952	-	-
Ending Balance	-	-	-	321,952
<b>Total Financial Assets</b>	<b>10,168,338</b>			<b>10,168,338</b>

Assets managed under the World Bank RAMP were classified as held for trading since initiation of the program in 2009. The initial classification depicted expectations and the actual pattern of trading with assets managed under the program: assets managed under World Bank RAMP were characterized with frequent trading compared to assets managed internally by the Bank. In the absence of any specific guidance with respect to classification of assets as available-for-sale, the classification of assets managed under World Bank RAMP was based on the interpretation of the definition of “held for trading” provided in IAS 39. During the existence of the program (2009-2017) there was no significant change in trading frequency over the assets managed under the World Bank RAMP or incentives of the program.

At the date of initial application of IFRS 9 (1 January 2018), the business model of total international reserves held by the Bank was assessed. The assessment took into account the definition of assets held for trading



## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

provided in IFRS 9 in conjunction with specified criteria and extensive guidance introduced by IFRS 9 regarding business models supporting FVTPL, FVOCI and AC classification. The result of the assessment indicated that the business model of assets managed internally by the Bank and assets managed under World Bank RAMP is similar (the assets can be considered together for business model assessment purposes) and its objective is achieved by both collecting contractual cash flows and selling the financial assets. Considering the abovementioned, starting from 1 January 2018, securities managed under the World Bank RAMP are measured at FVOCI together with internally managed assets, given that the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

The following table shows the effects of reclassification of the assets managed under World Bank RAMP from fair value through profit or loss category under IAS 39 into fair value through other comprehensive income category under IFRS 9:

<i>In thousands of GEL</i>	<u>Impact</u>
Fair value at 31 December 2018	69,248
Fair value gain/(loss) that would have been recognised during 2018 in profit or loss if the financial assets had not been reclassified	19
The effective interest rate determined on the date of initial application	1.12%
The interest income recognised during 2018	2,964

#### (ii) Impact on equity

The following table summarizes the impact of transition to IFRS 9 on the opening balance of the fair value revaluation reserve and retained earnings. There is no impact on other components of equity.

	<u>Impact of IFRS 9 adoption at 1 January 2018</u>
<b>Fair Value Revaluation Reserve</b>	
Closing balance under IAS 39 (31 December 2017)	(403)
Recognition of expected credit losses under IFRS 9 for debt financial assets at FVOCI	121
Opening balance under IFRS 9 (1 January 2018)	<u>(282)</u>
<b>Retained Earnings</b>	
Closing balance under IAS 39 (31 December 2017)	-
Recognition of expected credit losses under IFRS 9	(121)
Opening balance under IFRS 9 (1 January 2018)	<u>(121)</u>

#### (iii) Impairment

The following table reconciles the closing impairment allowance for financial assets under IAS 39 to the opening ECL allowance determined under IFRS 9 as at 1 January 2018.

	<u>31 December 2017 (IAS 39)</u>	<u>Reclassification</u>	<u>Remeasurement</u>	<u>1 January 2018 (IFRS 9)</u>
Trading Securities under IAS 39 reclassified to FVOCI category under IFRS 9 (in foreign currency)	-	-	13	13
Investments available for sale under IAS 39 / Investments measure at fair value through other comprehensive income under IFRS 9 (in foreign currency)	-	-	108	108
Other assets (in national currency)	282	-	-	282
<b>Total ECL allowance</b>	<u>282</u>	<u>-</u>	<u>121</u>	<u>403</u>

#### Standards issued but not yet effective

##### IFRS 16

The Bank is required to adopt IFRS 16 Leases from 1 January 2019. IFRS 16 introduces a single, on-balance sheet lease accounting model for lessees. A lessee recognises a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. There are recognition exemptions for short-term leases and leases of low-value items. Lessor accounting

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

remains similar to the current standard – i.e. lessors continue to classify leases as finance or operating leases. In addition, the nature of expenses related to leases changes because IFRS 16 replaces the straight-line operating lease expense with a depreciation charge for right-of-use assets and interest expense on lease liabilities.

IFRS 16 replaces existing leases guidance, including IAS 17 Leases, IFRIC 4 Determining whether an Arrangement contains a Lease, SIC-15 Operating Leases – Incentives and SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

#### **Impact assessment**

The Bank has assessed the estimated impact that the initial application of IFRS 16 will have on its financial statements, as described below.

The Bank plans to apply IFRS 16 initially on 1 January 2019, using a modified retrospective approach. Therefore, the cumulative effect of adopting IFRS 16 will be recognized as an adjustment to the opening balance of retained earnings at 1 January 2019, with no restatement of comparative information.

The Bank estimates that as at 1 January 2019 the total amount of right-of-use assets and lease liabilities recognized in the statement of financial position will be GEL 2,922 thousand and GEL 2,553 thousand respectively.

#### **Other standards**

The following amended standards are not expected to have a significant impact on the Bank's financial statements:

- Definition of Material (Amendments to IAS 1 and IAS 8)
- Definition of a Business (Amendments to IFRS 3)
- Conceptual Framework for Financial Reporting
- Amendments to References to Conceptual Framework in IFRS Standards
- Annual Improvements to IFRS Standards 2015–2017 Cycle – various standards
- Long-term Interests in Associates and Joint Ventures (Amendments to IAS 28)
- Plan Amendment, Curtailment or Settlement (Amendments to IAS 19)
- IFRIC 23 Uncertainty over Income Tax Treatments
- IFRS 17 Insurance Contracts.

## 4. FEE AND COMMISSION INCOME AND EXPENSE

Fee and commission income and expense comprise:

	Year ended 31-Dec-18	Year ended 31-Dec-17
<b>Fee and commission income:</b>		
Funds transfer	2,107	1,826
Other	18	13
<b>Total fee and commission income</b>	<b>2,125</b>	<b>1,839</b>
<b>Fee and commission expense:</b>		
Fees paid to external manager	(1,032)	(1,018)
Custodian and settlement fees	(649)	(467)
Cash operations	(119)	(331)
<b>Total fee and commission expense</b>	<b>(1,800)</b>	<b>(1,816)</b>

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 for settlement transactions.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### 5. OTHER INCOME

Other income comprises:

	Year ended 31-Dec-18	Year ended 31-Dec-17
Gain from the sale of investment property	4,243	1,016
Other	1,609	902
<b>Other income</b>	<b>5,852</b>	<b>1,918</b>

#### 6. OPERATING EXPENSES

Operating expenses comprise:

	Year ended 31-Dec-18	Year ended 31-Dec-17
Salaries and bonuses	19,793	16,803
Paid vacation and sick leave	1,493	1,201
<b>Total personnel expenses</b>	<b>21,286</b>	<b>18,004</b>
Subscription to information services	1,877	1,634
Social benefit expenses	1,063	844
Utilities	991	766
Software maintenance fees	976	906
Repairs and maintenance	663	368
Personnel training	491	319
Business travel and related expenses	475	298
Security	371	293
Fuel expenses	279	227
Legal and consultancy	197	225
Other	2,427	1,218
<b>Total general and administrative expenses</b>	<b>9,810</b>	<b>7,098</b>
Depreciation charge (Notes 14, 15)	3,331	3,703
Amortization charge (Note 16)	557	290
<b>Total depreciation and amortization</b>	<b>3,888</b>	<b>3,993</b>

#### 7. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as at 31 December 2018 and 2017 comprise:

	31-Dec-18	31-Dec-17
Cash on hand in foreign currencies	76,209	76,270
Current accounts	623,925	231,498
Time deposits with credit institutions up to 90 days	578,341	1,281,888
<b>Total cash and cash equivalents</b>	<b>1,278,475</b>	<b>1,589,656</b>

As at 31 December 2018 and 2017, GEL 1,157,893 thousand and GEL 1,490,893 thousand, respectively, were placed in current accounts and time deposits up to ninety days with four (eleven in 2017) internationally recognised banks and central banks from the Organization of Economic Co-operation and Development member countries (OECD).

As at 31 December 2018 and 2017, annual interest rate range of time deposits with financial institutions up to 90 days was 2.52%-3.04% and 0.09%-2.10%, respectively.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

Reconciliation of movements of liabilities to cash flows arising from financing activities:

	Note	Cash			Non-Cash			31-Dec-2018
		1-Jan-2018	Interest Paid	Net Proceeds from financing activities	Accrued Interest	Translation Differences	Other	
<b>Liabilities arising from financing activities:</b>								
Debt securities issued	21	79,284	(3,919)	(681)	4,626	-	-	79,310
Due to the International Monetary Fund	9	754,816	(9,648)	214,454	10,771	15,334	(420)	985,307
<b>Liabilities arising from financing activities:</b>								
	Note	1-Jan-2017	Interest Paid	Net Proceeds from financing activities	Accrued Interest	Translation Differences	Other	31-Dec-2017
Debt securities issued	21	197,240	(5,854)	(118,646)	6,544	-	-	79,284
Due to the International Monetary Fund	9	528,994	(4,012)	200,011	4,103	25,814	(94)	754,816

## 8. DUE FROM RESIDENT FINANCIAL INSTITUTIONS

Due from resident financial institutions as at 31 December 2018 and 2017 comprise:

	31-Dec-18	31-Dec-17
<b>Due from resident financial institutions under monetary policy instruments</b>		
Refinancing loans	1,501,166	1,000,608
One-month open market instruments	400,311	400,242
Overnight loans	-	190,086
<b>Total due from resident financial institutions under monetary policy instruments</b>	<b>1,901,477</b>	<b>1,590,936</b>
<b>Due from resident financial institutions, other</b>		
Loans issued under the Larisation program	46,272	221,303
<b>Total due from resident financial institutions, other</b>	<b>46,272</b>	<b>221,303</b>

Refinancing loans are the Bank's Monetary Policy instruments that are issued to Georgian commercial banks for liquidity purposes and have 7 days maturity. Similar to refinancing loans, through one-month open market instruments the Bank supplies short-term liquidity to Georgia's banking system when needed.

Loans issued under the Larisation program represent funds provided by the National Bank of Georgia to resident commercial banks in order to provide support to them for an increased demand for national currency loans from the public caused by the Larisation program approved by the Government of Georgia in January 2017.

As at 31 December 2018 and 2017, the Bank had a concentration of refinancing loans of GEL 1,478,148 thousand due from three resident commercial banks at annual interest rates of 7.06%-7.13%, and GEL 963,585 thousand due from three resident commercial banks at annual interest rates of 7.38%-7.43%, respectively.

As at 31 December 2018 and 2017 the concentration of one-month open market operations was GEL 350,272 thousand due from one resident commercial bank at an annual interest rate of 7.09%, and GEL 367,222 thousand due from three resident commercial banks at annual interest rates of 7.34%-7.37%, respectively.

As at 31 December 2018 and 2017 the concentration of loans issued under the Larisation program was GEL 42,152 thousand due from two resident commercial banks at an annual interest rate of 7%, and GEL 220,513 thousand due from three resident commercial banks at an annual interest rate of 7.25%, respectively.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### 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 in accordance with the "Law of Georgia on Securities Market" by the resident and non-resident legal entities and securities issued as a private placement till 1 January 2018, denominated in Lari, but excluding debt securities issued by the commercial banks operating in Georgia and debt securities issued by the legal entities related to those commercial banks and held by the latter; d) claims to eligible loan assets of commercial banks; e) foreign currency deposits in the Bank; In special cases, the Council of the Bank may determine other type of assets for loan collateral; haircuts to each type of collateral are periodically defined by the Monetary Policy Committee (MPC) of the Bank to the nominal amount of eligible assets. 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.

As at 31 December 2018 and 2017 types and fair values of financial assets pledged for amounts due from resident financial institutions are:

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
Government securities (treasury bills/notes)	418,479	526,432
Loan portfolio of commercial banks	588,598	514,883
Corporate bonds	-	3,800
<b>Bonds issued by International Financial Institutions and development banks, denominated in GEL:</b>		
European Bank for Reconstruction and Development (EBRD)	477,100	385,000
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden NV	259,467	-
Black Sea Trade and Development Bank (BSTDB)	229,572	108,000
International Finance Corporation (IFC)	90,274	108,340
Asian Development Bank (ADB)	65,198	135,500
	<u>2,128,688</u>	<u>1,781,955</u>
Deposits and loan portfolio of commercial banks pledged for loans issued under the Larisation program	57,843	275,058
	<u>2,186,531</u>	<u>2,057,013</u>

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.

As described in the table above the Bank receives collateral in the form of financial instruments in respect to the instruments due from resident financial institutions. Similar arrangements, if considered as master netting arrangements, do not meet the criteria for offsetting in the statement of financial position. This is because the Bank obtains a right of set-off of recognised amounts that is enforceable only following an event of default, insolvency or bankruptcy of the counterparties. The Bank and its counterparties do not intend to settle on a net basis or to realise the assets and settle the liabilities simultaneously.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

## 9. SPECIAL DRAWING RIGHTS HOLDINGS WITH THE INTERNATIONAL MONETARY FUND

Balances with the International Monetary Fund (“IMF”) comprise:

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
<b>Assets:</b>		
Special Drawing Rights (SDR) holdings	<u>537,249</u>	<u>534,253</u>
<b>Liabilities:</b>		
IMF current accounts		
Current account # 1	1,862	1,785
Current account # 2	10	10
	<u>1,872</u>	<u>1,795</u>
<b>Borrowings from the IMF</b>		
Extended Fund Facility (EFF)	446,560	220,951
General SDR allocation	415,621	411,901
Special SDR allocation	121,254	120,169
	<u>983,435</u>	<u>753,021</u>
<b>Total due to the IMF</b>	<u>985,307</u>	<u>754,816</u>
<b>Off-balance sheet balances:</b>		
IMF Quota	744,831	713,975
Security held in custody in respect of IMF quota and as collateral of IMF granted facilities	(1,291,603)	(1,170,228)

### 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 2018 and 2017 is 0.764%-1.121% and 0.244%-0.747%, 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 Extended Fund Facility (EFF) loan with a carrying amount of GEL 446,560 thousand as at 31 December 2018 (2017: GEL 220,951 thousand). The EFF provides assistance to Georgian authorities in support of their comprehensive program to preserve macro and financial stability and advance structural reforms to bolster growth. The 36-month Extended Fund Facility (EFF) approved on 12th of April 2017 with access of SDR 210.4 million (100 percent of quota) and during 2018 SDR 60 million was used out of it by the Bank (2017: SDR 60 million). Repayments are projected to start in 2021 and the loan is projected to be fully covered by 2028. The lending rate is tied to the IMF's market-related interest rate, known as the basic rate of charge linked to the Special Drawing Rights (SDR) interest rate, which amounted to 1.103% at 31 December 2018 (2017: 0.743%).

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

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

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 2018 and 2017 is 0.764%-1.121% and 0.244%-0.747%, respectively.

#### IMF Quota

The IMF Quota of Special Drawing Rights (SDR) of 210,400 thousand, represents the membership subscription of Georgia with the IMF which is non-interest bearing and is effective from 26 January 2016 as a result of the 14<sup>th</sup> General Review of Quotas by the Board of Governors of the IMF, the Fund's highest decision-making body. 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 the Bank is a fiscal agent between the Government of Georgia and the IMF, this instrument is not presented on the statement of financial position.

#### Security held in custody in respect of the IMF Quota and as collateral of the IMF granted facilities

Security held in custody comprises GEL 744,831 thousand in respect of the IMF Quota and GEL 546,772 thousand held as collateral for the IMF granted facilities (totally GEL 1,291,603 thousand). 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

	<b>Book value</b>	<b>Notional principal</b>	<b>Book value</b>	<b>Notional principal</b>
	<b>31-Dec-18</b>	<b>31-Dec-18</b>	<b>31-Dec-17</b>	<b>31-Dec-17</b>
<b>Interest rate futures</b>				
Futures margin	4,187	-	646	-
Interest futures assets	64	219,481	-	23,848
Interest futures liabilities	(2,689)	(2,339,348)	(2)	(178,862)
<b>Net interest futures position</b>	<b>(2,625)</b>	<b>(2,119,867)</b>	<b>(2)</b>	<b>(155,014)</b>
<b>Options on futures</b>				
Put option assets	-	401,490	13	259,220
Put option liabilities	-	(802,980)	-	(259,220)
Call option assets	-	267,660	-	-
Call option liabilities	(39)	(535,320)	-	-
<b>Net options on futures</b>	<b>(39)</b>	<b>(669,150)</b>	<b>13</b>	<b>-</b>
<b>Net assets related to derivative instruments</b>	<b>1,523</b>	<b>(2,789,017)</b>	<b>657</b>	<b>(155,014)</b>

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.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

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 a 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. In 2017, the Bank began to purchase put options for futures contracts in order to hedge against adverse movements of futures contracts.

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 does not aim to make profits from favorable movements in their prices.

## 11. INVESTMENTS MEASURED AT FAIR VALUE THROUGH PROFIT OR LOSS

Investments measured at fair value through profit or loss comprise:

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
<b>Funds managed under the World Bank RAMP*</b>		
Government securities	-	308,395
Supranational securities	-	20,004
Agency securities	-	195,935
<b>Total funds managed under the World Bank RAMP</b>	<u>-</u>	<u>524,334</u>
<b>Funds managed by BIS**</b>		
BISIP_K	138,094	131,473
<b>Total amount of instruments at fair value through profit or loss under IFRS 9 /trading securities under IAS 39.</b>	<u><b>138,094</b></u>	<u><b>655,807</b></u>

\* Funds managed under the RAMP program corresponds to the outsourcing of the management of a portion of the international 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. Starting from 1 January 2018 funds managed under the World Bank RAMP are classified as investments measured at FVOCI (refer to Note 3).

\*\* The funds 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.



## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

Analysis of interest rates (coupon) and maturities on investments measured at fair value through profit or loss:

	31-Dec-18		31-Dec-17	
	Interest rate p.a.	Maturity	Interest rate p.a.	Maturity
Government securities	-	-	0.125%-1.77%	2018-2020
Supranational securities	-	-	1.41%-1.54%	2018-2019
Agency securities	-	-	0.875%-4.63%	2018-2020

## 12. INVESTMENTS MEASURED AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME

As at 31 December 2018 investment securities measured at fair value through other comprehensive income comprise:

	<u>31-Dec-18</u>
<b>Government securities</b>	
US Department of the Treasury, Washington	4,152,313
Australian Government, Canberra	489,679
Canada, Ottawa	204,765
Republic of Finland, Helsinki	26,671
	<u>4,873,428</u>
<b>Supranational securities</b>	
EUROFIMA, Basel	99,980
Inter-American Development Bank	81,149
European Investment Bank	76,309
Bank for International Settlements	53,312
African Development Bank	41,018
International Finance Corporation	29,489
Asian Development Bank, Manila	6,205
European Stability Mechanism, Luxembourg	5,413
	<u>392,875</u>
<b>Agency securities</b>	
NRW Bank, Duesseldorf, Germany	206,407
Kommunalbanken AS, Oslo, Norway	192,997
Svensk Exportkredit AB, Stockholm, Sweden	176,926
Bank Nederlandse Gemeenten, The Hague, The Netherlands	169,267
Kommuninvest I Sverige AB, Orebro, Sweden	158,408
Landeskreditbank Baden-Wuerttemberg Foerderbank, Germany	97,129
Toronto, Province of Ontario, Canada	84,640
Neder Waterschapsbank, The Hague, The Netherlands	68,591
Province of Quebec Canada	53,663
Erste Abwicklungsanstalt, Dusseldorf, Germany	53,059
Municipality Finance PLC, Helsinki, Finland	50,741
Province of Alberta Canada	49,372
FMS Wertmanagement, Munich, Germany	43,256
Oesterreichische Kontrollbank AG, Vienna, Austria	40,196
Caisse D'Amortissement de la Dette Sociale, Paris, France	26,671
Kreditanstalt fuer Wiederaufbau, Frankfurt, Germany	22,563
Agence Francaise de Developpement, Paris, France	17,131
State of North Rhine-Westphalia, Duesseldorf, Germany	16,126
CPPIB Capital Inc, Toronto, Canada	10,736
SNCF Reseau EPIC, France	7,683
Export Development Canada, Ottawa	7,598
Queensland Treasury Corp, Australia	5,670
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden NV, Hague, The Netherlands	5,395
Caisse Des Depots et Consignations, Paris, France	5,367
Canada Housing Trust No.1, Toronto, Canada	5,129
New South Wales Treasury Corp, Australia	3,769
Treasury Corporation Victoria, Australia	2,663
	<u>1,581,153</u>
<b>Total investments measured at fair value through other comprehensive income in foreign currency</b>	<u><b>6,847,456</b></u>
<b>Marketable government securities in national currency</b>	
Georgian Government Bonds	364,653
<b>Total investments measured at fair value through other comprehensive income in national currency</b>	<u><b>364,653</b></u>

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

Analysis of interest rates (coupon) and maturities on investment measured at fair value through other comprehensive income comprise:

	31-Dec-18	
	Interest rate p.a.	Maturity
<b>In foreign currency:</b>		
Government Bonds	0.125%-5.75%	2019-2022
Supranational Bonds	2.375%-6.25%	2019-2023
Agency Bonds	1%-6.25%	2019-2023
<b>In national currency:</b>		
Government Bonds	7.3%-14.375%	2019-2022

As at 31 December 2017 investments available-for-sale comprise:

	31-Dec-17
<b>Investments available-for-sale in foreign currency:</b>	
<b>Government securities</b>	
US Treasury Notes	3,379,696
Australian Treasury Bills	525,543
Canada Government Bond	208,371
Province of Quebec, Canada	57,949
French Treasury Note	20,347
	<b>4,191,906</b>
<b>Supranational securities</b>	
European Investment Bank	76,130
EUROFIMA, Basel, Switzerland	44,213
IBRD World Bank, Washington, US	31,172
International Finance Corporation	28,516
	<b>180,031</b>
<b>Agency securities</b>	
NRW Bank, Dusseldorf, Germany	178,010
Bank Nederland's Gemeenten, The Hague, The Netherlands	163,781
Neder Waterschapsbank, The Hague, The Netherlands	80,790
Erste Abwicklungsanstalt, Dusseldorf, Germany	80,393
Landeskreditbank Baden-Wuerttemberg Foerderbank, Germany	75,080
Kommunalbanken AS, Oslo, Norway	59,474
Kreditanstalt fuer Wiederaufbau, Frankfurt, Germany	56,932
Kommuninvest I Sverige AB, Orebro, Sweden	15,612
Municipality Finance PLC, Helsinki, Finland	10,375
Toronto, Province of Ontario, Canada	2,999
Landwirtschaftliche Rentenbank, Frankfurt, Germany	2,546
Kommunekredit, Copenhagen, Denmark	-
New South Wales Treasury Corporation, Australia	-
	<b>725,992</b>
<b>Total investments available-for-sale in foreign currency</b>	<b>5,097,929</b>
<b>Marketable government securities in national currency</b>	
Georgian Government Bonds	155,198
<b>Total investments available-for-sale in national currency</b>	<b>155,198</b>

Analysis of interest rates (coupon) and maturities on investments available-for-sale:

	31-Dec-17	
	Interest rate p.a.	Maturity
<b>In foreign currency:</b>		
Government Bonds	0.625%-5.5%	2018-2020
Supranational Bonds	1.0%-6.5%	2018-2020
Agency Bonds	0.875%-6.25%	2018-2021
<b>In national currency:</b>		
Government Bonds	7.3%-14.375%	2018-2022

For none of the financial assets measured at fair value through other comprehensive income has credit risk increased significantly since initial recognition.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### 13. INVESTMENTS MEASURED AT AMORTISED COST

	31-Dec-18		31-Dec-17	
	Carrying value	Nominal value	Carrying value	Nominal value
<b>Georgian Government securities</b>				
Georgia Government Bonds	281,808	280,846	321,952	320,846
<b>Total investments measured at amortised cost in national currency</b>	<b>281,808</b>	<b>280,846</b>	<b>321,952</b>	<b>320,846</b>

Analysis of interest rate (coupon) and maturity of investments measured at amortised cost:

	31-Dec-18		31-Dec-17	
	Interest rate p.a.	Maturity	Interest rate p.a.	Maturity
Georgian Government Bonds	7.259%	2019-2025	7.31%	2018-2025

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 investments measured at fair value through other comprehensive income starting from 1 January 2018 and as available-for-sale financial instruments before 1 January 2018 (Note 12). Interest rate of the bond is subject to annual repricing considering market rates.

For none of the financial assets measured at amortised cost has credit risk increased significantly since initial recognition.

#### 14. INVESTMENT PROPERTY

	2018	2017
<b>Cost</b>		
As at 1 January	2,218	2,632
Disposals	(2,218)	(414)
<b>As at 31 December</b>	<b>-</b>	<b>2,218</b>
<b>Accumulated depreciation</b>		
As at 1 January	(176)	(132)
Depreciation charge	(7)	(44)
Disposals	183	-
<b>As at 31 December</b>	<b>-</b>	<b>(176)</b>
<b>Net book value as at 31 December</b>	<b>-</b>	<b>2,042</b>

#### 15. PROPERTY AND EQUIPMENT

	Land and buildings	Computers, office equipment and fixtures	Vehicles and other	Assets under construction	Total
<b>At initial cost:</b>					
<b>1-Jan-17</b>	<b>51,755</b>	<b>8,214</b>	<b>15,271</b>	-	<b>75,240</b>
Additions	152	1,467	3,011	-	4,630
Disposals	-	(234)	(4)	-	(238)
<b>31-Dec-17</b>	<b>51,907</b>	<b>9,447</b>	<b>18,278</b>	-	<b>79,632</b>
Additions	81	2,934	1,297	245	4,557
Disposals	-	(1,578)	(34)	-	(1,612)
<b>31-Dec-18</b>	<b>51,988</b>	<b>10,803</b>	<b>19,541</b>	<b>245</b>	<b>82,577</b>
<b>Accumulated depreciation:</b>					
<b>1-Jan-17</b>	<b>(4,181)</b>	<b>(5,271)</b>	<b>(13,468)</b>	-	<b>(22,920)</b>
Depreciation charge	(1,031)	(1,081)	(1,547)	-	(3,659)
Disposals	-	234	4	-	238
<b>31-Dec-17</b>	<b>(5,212)</b>	<b>(6,118)</b>	<b>(15,011)</b>	-	<b>(26,341)</b>
Depreciation charge	(1,036)	(1,291)	(997)	-	(3,324)
Disposals	-	1,573	33	-	1,606
<b>31-Dec-18</b>	<b>(6,248)</b>	<b>(5,836)</b>	<b>(15,975)</b>	-	<b>(28,059)</b>
<b>Net book value:</b>					
<b>As at 31 December 2017</b>	<b>46,695</b>	<b>3,329</b>	<b>3,267</b>	-	<b>53,291</b>
<b>As at 31 December 2018</b>	<b>45,740</b>	<b>4,967</b>	<b>3,566</b>	<b>245</b>	<b>54,518</b>

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### 16. INTANGIBLE ASSETS

	Software	Licenses	Total
<b>At cost:</b>			
1-Jan-17	7,114	303	7,417
Additions	927	1,042	1,969
<b>31-Dec-17</b>	<b>8,041</b>	<b>1,345</b>	<b>9,386</b>
Additions	1,531	1,971	3,502
Disposals	(45)	-	(45)
<b>31-Dec-18</b>	<b>9,527</b>	<b>3,316</b>	<b>12,843</b>
<b>Accumulated amortization:</b>			
1-Jan-17	(6,872)	(108)	(6,980)
Charge for the year	(119)	(171)	(290)
<b>31-Dec-17</b>	<b>(6,991)</b>	<b>(279)</b>	<b>(7,270)</b>
Charge for the year	(284)	(273)	(557)
Disposals	45	-	45
<b>31-Dec-18</b>	<b>(7,230)</b>	<b>(552)</b>	<b>(7,782)</b>
<b>Net book value:</b>			
<b>31-Dec-17</b>	<b>1,050</b>	<b>1,066</b>	<b>2,116</b>
<b>31-Dec-18</b>	<b>2,297</b>	<b>2,764</b>	<b>5,061</b>

#### 17. OTHER ASSETS AND LIABILITIES

	31-Dec-18	31-Dec-17
<b>Other assets in foreign currency:</b>		
Other debtors	8	6
<b>Total other assets in foreign currency</b>	<b>8</b>	<b>6</b>
<b>Other assets in national currency:</b>		
Commemorative gold coins and gold bars	2,961	3,728
Loans to employees	206	348
Inventory	429	483
Prepayments	2,481	1,665
Other debtors	2,676	579
	<b>8,753</b>	<b>6,803</b>
Allowance for impairment of other assets	(232)	(282)
<b>Total other assets in national currency</b>	<b>8,521</b>	<b>6,521</b>

As at 31 December 2018 and 2017, other financial assets, net of allowance, amount to GEL 2,658 thousand and GEL 651 thousand, respectively.

Allowance for expected credit losses on other assets represents allowance for expected credit losses on loans to employees and other debtors. The movements in allowance for expected credit losses are presented in Note 27.

Other liabilities comprise:

	31-Dec-18	31-Dec-17
<b>Other liabilities in foreign currency:</b>		
Amounts due to suppliers	2,776	2,744
<b>Total other liabilities in foreign currency</b>	<b>2,776</b>	<b>2,744</b>
<b>Other liabilities in national currency:</b>		
Amount due to suppliers	5,749	5,872
Liability for realized banknotes and coins	1,669	1,589
Deferred revenue	-	2
Other liabilities	293	768
<b>Total other liabilities in national currency</b>	<b>7,711</b>	<b>8,231</b>
<b>Total other liabilities</b>	<b>10,487</b>	<b>10,975</b>

As at 31 December 2018 and 2017, other financial liabilities amount to GEL 10,485 thousand and GEL 10,901 thousand, respectively.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### 18. DUE TO RESIDENT FINANCIAL INSTITUTIONS

Due to resident financial institutions comprise:

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
<b>Due to resident financial institutions under monetary policy instruments</b>		
Correspondent accounts in national currency	395,565	426,778
Overnight deposits in national currency	274,161	12,000
<b>Total due to resident financial institutions under monetary policy instruments in national currency</b>	<u>669,726</u>	<u>438,778</u>
Obligatory reserves of banks in foreign currency	3,642,799	2,818,536
<b>Total due to resident financial institutions under monetary policy instruments</b>	<u>4,312,525</u>	<u>3,257,314</u>
<b>Due to resident financial institutions, other</b>		
Correspondent accounts in foreign currency	7,135	130,723
Special Deposits pledged as collateral under the Larisation program	987	181,454
<b>Total due to resident financial institutions, other</b>	<u>8,122</u>	<u>312,177</u>
<b>Total due to resident financial institutions</b>	<u>4,320,647</u>	<u>3,569,491</u>

As at 31 December 2018 and 2017 included in due to resident financial institutions are balances with the three largest local commercial banks of GEL 3,209,325 thousand and GEL 2,646,651 thousand, respectively, that represent 74.28% and 74.15% 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 2018 the obligatory reserves are calculated as 5% of their eligible liabilities denominated in national currencies (2017: 7%), and 25% of their eligible liabilities denominated in foreign currencies (2017: 20%). For foreign currency liabilities with a remaining maturity of 1-2 years the reserve requirement amounts to 10% (2017: 10%). As at 31 December 2018 and 2017 the annual interest rate on GEL denominated obligatory reserves is 7% and 5%, respectively. As at 31 December 2018 and 2017 the annual interest rate on USD/EUR denominated obligatory reserves are 0.5%/0.6% and 1%/0.25% respectively. 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.

#### 19. DUE TO THE MINISTRY OF FINANCE

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
<b>Due to the Ministry of Finance</b>		
Current accounts in foreign currency	414,917	434,263
Current account in national currency	362,445	541,489
<b>Total due to the Ministry of Finance of Georgia</b>	<u>777,362</u>	<u>975,752</u>

#### 20. 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 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
<b>Balance as at 1 January</b>	3,308,869	2,999,323
Banknotes issued into circulation	5,134,500	4,915,164
Coins issued into circulation	82,113	59,401
Banknotes withdrawn from circulation	(4,889,018)	(4,617,167)
Coins withdrawn from circulation	(70,968)	(47,852)
<b>Balance as at 31 December</b>	<u>3,565,496</u>	<u>3,308,869</u>

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

## 21. DEBT SECURITIES ISSUED

	<u>Interest rate p.a.</u>	<u>Maturity</u>	<u>Nominal value</u>	<u>Carrying value</u>
Certificates of deposit as at 31-Dec-18	7.10%-7.15%	3 Jan-28 March 2019	80,000	79,310
Certificates of deposit as at 31-Dec-17	7.09%-7.33%	4 Jan-29 March 2018	80,000	79,284

## 22. 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 2018 and 2017.

### 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 income of the Bank for each financial year is calculated as the sum of net operational profit or loss and unrealised gain or loss from revaluation. Net operational profit or loss shall be calculated after deducting from revenues of the reporting year all operating expenditures intended for the main activity. Retained earnings are transferred to different reserves based on the requirements of the Law and after approval of the Council. Following 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 after the end of financial year.

### 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 is established by allocations from the realised profit for the year, which comprises net profit for the year excluding net foreign currency translation and other revaluation 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. Following the transfers to the Reserve Fund, the residual balance of realised profit of the Bank shall be transferred to the State Budget of Georgia.

In 2018 and 2017 the Bank transferred GEL 122,940 thousand and GEL 88,532 thousand, respectively, to the Reserve Fund.

In accordance with Article 25(c) of the Law, in 2018, following the transfers to the Reserve Fund, the Bank transferred GEL 70,000 thousand to the Ministry of Finance from retained earnings (2017: GEL 65,000 thousand from the Reserve Fund). As at 31 December 2018 the remaining balance of the retained earnings of GEL 80,000 thousand can be transferred to the Ministry of Finance within six months after the reporting date subject to the approval of the Council.

### Foreign currency and other revaluation reserves

According to the Article 25(a) of the Law, the Bank transfers the net unrealized gains from foreign currency revaluation to the foreign currency revaluation reserve and net unrealized gains arising from changes of the FVTPL financial assets' market prices are transferred to the revaluation reserve created for this purpose.

During 2018 the entire amount of unrealized gain on foreign currencies translation of GEL 54,186 thousand was transferred to the foreign currency revaluation reserve (2017: loss of GEL 30,653 thousand). During

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 *(in thousands of Georgian Lari)*

---

2018 the full amount of other revaluation reserve comprising GEL 1,208 thousand at 31 December 2017 was transferred to retained earnings.

#### Revaluation reserve for investments measured at FVOCI

This reserve records fair value changes of investments measured at FVOCI (2017: investments available-for-sale).

## 23. 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 2018 and 2017 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 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 the 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

The future minimum lease payments under non-cancellable operating leases were payable as follows:

	<b>31 December 2018</b>	<b>31 December 2017</b>
Not later than 1 year	882	25
Later than 1 year but not later than 5 years	2,055	-

#### 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 2018 and 2017, the Bank has no material credit commitments and contingent liabilities.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

### 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.

## 24. SECURITIES LENDING PROGRAMME

The Bank participates in the automatic securities lending programme, where securities held by the Bank are lent against other securities' collateral. This programme is managed on behalf of the Bank by a specialized agent (Depository Clearstream, Luxembourg). The Bank's agent administers the securities lending programme and monitors the eligibility of the securities lending and related collateral against requirements agreed with the Bank.

Securities lending transactions provide additional income without any material impact on investment liquidity as the securities lent are readily available to the Bank.

As at 31 December 2018, the fair value of the securities lent was GEL 1,207,490 thousand (2017: GEL 1,126,346 thousand).

As at 31 December 2018 and 2017, the fair value of collateral provided in securities lending transactions was as follows:

	<u>31-Dec-18</u>	<u>31-Dec-17</u>
Debt securities of foreign governments	1,111,884	1,041,108
Debt securities of foreign financial institutions	157,506	126,973
Debt securities of foreign non-financial corporations	-	10,671
	<u>1,269,390</u>	<u>1,178,752</u>

## 25. 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 members of the Council, Chief Executive Officer and heads 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.



## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

The Bank had the following transactions outstanding with related parties:

	Year ended 31 December 2018		Year ended 31 December 2017	
	Related party transactions	Total category as per statement of profit or loss and other comprehensive income	Related party transactions	Total category as per statement of profit or loss and other comprehensive income
<b>Key management personnel compensation:</b>				
- short-term employee benefits	(3,361)	(21,286)	(3,091)	(18,004)

	Notes	31-Dec-18		31-Dec-17	
		Related party balances	Total category as per statement of financial position	Related party balances	Total category as per statement of financial position
<b>Statement of financial position</b>					
<b>Assets:</b>					
Investments measured at fair value through other comprehensive income (2017: available-for-sale) in national currency- <i>Government of Georgia</i>	12	364,653	364,653	155,198	155,198
Investments measured at amortised cost (2017: held-to-maturity) in national currency- <i>Government of Georgia</i>	13	281,808	281,808	321,952	321,952
Loans to employees-Key management personnel	17	13	206	38	348
<b>Liabilities:</b>					
Due to the Ministry of Finance	19	777,362	777,362	975,752	975,752
<b>Statement of profit or loss and other comprehensive income</b>					
Interest income		41,749	306,791	42,297	235,898
- <i>Government of Georgia</i>		41,748	-	42,293	-

## 26. 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, investments measured at fair value through profit or loss and investments measured at fair value through other comprehensive income (2017: available-for-sale). The instruments are valued on a daily basis, based on the bid prices obtained from 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:

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

- 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 the Georgian Government. For fair value assessment, a discounted 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.

The table below analyses financial instruments measured at fair value at 31 December 2018 and 2017, 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:

Financial Assets	Note	Fair value as at		Fair value hierarchy	Valuation techniques and key inputs	Significant unobservable inputs
		31-Dec-18	31-Dec-17			
<b>International reserves</b>						
Derivative financial assets	10	1,523	657	Level 1	Quoted bid prices in an active market	N/A
Trading securities	11	-	655,807	Level 1	Quoted bid prices in an active market	N/A
Investments measured at fair value through profit or loss	11	138,094	-	Level 1	Quoted bid prices in an active market	N/A
Investments available-for-sale	12	-	5,097,929	Level 1	Quoted bid prices in an active market	N/A
Investments measure at fair value through other comprehensive income	12	6,847,456	-	Level 1	Quoted bid prices in an active market	N/A
<b>Monetary policy instruments</b>						
Investments available-for-sale	12	-	155,198	Level 2	Market interest rate for similar instruments	N/A
Investments measure at fair value through other comprehensive income	12	364,653	-	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 2018 and 2017.

Gains and losses included in other comprehensive income relate to investments measured at fair value through other comprehensive income (2017: investments available-for-sale) and are reported as changes in revaluation reserve of investments measured at FVOCI (2017: investments available-for-sale).

Net unrealized gain/(loss) from securities and derivatives included in profit or loss relates to derivative financial assets and investments measured at fair value through profit or loss as changes in fair value during the year ended 31 December 2018.

#### **Fair value of financial assets and financial liabilities that are not measured at fair value on a recurring basis (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 approximates to their fair value. This assumption is also applied to demand deposits and savings accounts without a maturity.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

For variable interest bearing financial assets (Georgian Government bond classified as investments measured at amortized costs) 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.

## 27. RISK MANAGEMENT

### Introduction

The activities of the Bank are exposed to various types of risks. These include financial risks in the form of market, credit, and liquidity risks. The Bank’s activities are also exposed to a diverse range of non-financial risks. Due to its unique role and functions, the Bank’s risk management and control is not only based on the institutional risk and return considerations, but also takes into account the national interest, in line with its statutory responsibilities prescribed in relevant legislation. The Bank views risk management as an integral part of overall management process and an essential element of good corporate governance. The Council of the Bank is ultimately responsible for the oversight of the risk management framework, overseeing the management of the key risks and reviewing its risk management policies and procedures.

To support the effective and efficient risk management system the bank established a three lines of defense model. The model allocates clear roles and responsibilities for business departments, risk management, and internal audit.

### First line of defense: Departmental management

The first line of defense (NBG departments) is responsible to identify, assess, and manage the risks in their respective departments by designing, implementing and maintaining an adequate and effective systems of control.

### Second line of defense: Centralized risk management function

The second line of defense (Centralized Risk Management Department) is responsible to define and implement an effective non-financial risk management framework that is consistent to standards and approaches of best international practices. The Centralized Risk Management Department provides independent forward-looking assessment of the risks, facilitates, risk management processes and provides business continuity support. The department is accountable to the Governor of the Bank.

### Third line of defense: Internal audit

Internal Audit represents the third line of defense, which ensures the effectiveness, and appropriateness of the risk management and internal control systems. Internal audit examines both the adequacy of internal controls and the Bank’s compliance with the procedures on a regular basis and reports its findings and recommendations to the Chairman of the Council.

### Organization of risk management department

Nature of risk	Management	Guidelines	Supervision
		policies issued by	
Financial risks	At department level	Monetary policy committee	Board
		International reserve management committee	
Non-financial risk	At department level	Centralized risk management department	Internal Audit, Audit Committee

### 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.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

The table below shows the maximum exposure to credit risk for financial instruments of the Bank for which impairment requirements are not applied:

Foreign currency assets	Notes	Maximum exposure 31-Dec-18	Maximum exposure 31-Dec-17
<b>International Reserves</b>			
Assets related to derivative instruments	10	1,523	657
Trading securities	11	-	655,807
Investments measured at fair value through profit or loss		138,094	-
<b>Total credit risk exposure</b>		<b>139,617</b>	<b>656,464</b>

#### 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 a conservative basis 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 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 investment guidelines 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.

The 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.

#### a) *Financial instruments under the international reserves portfolio*

In order to control the credit risk of the financial instruments used in the international reserves operations, the strategic asset allocation 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

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

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.

Additionally, the investment guidelines limit the concentration into non-benchmark financial instruments and the portfolio is diversified into various money market instruments, as well as fixed income and floating rate securities (Government Bonds, Agency including Regional Governments and Supranational Securities) and other 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.

#### Credit quality analysis

The table below shows, by class of financial instruments, gross carrying amount of assets within the international reserve portfolio for which impairment requirements are applied:

	As at 31 December 2018			As at 31 December 2017
	12-month ECL	Lifetime ECL not credit- impaired	Lifetime ECL credit-impaired	Total
<u>Cash and cash equivalents (excluding cash on hand)</u>				<u>Total</u>
AAA	548,411	-	-	834,627
AA	112,757	-	-	374
AA-	538,821	-	-	399,789
A+	939	-	-	34,440
A	1,294	-	-	243,064
A-	-	-	-	467
BBB+	44	-	-	579
BBB	-	-	-	46
BBB-	0	-	-	-
<b>Gross carrying amount</b>	<b>1,202,266</b>	-	-	<b>1,513,386</b>
<i>Loss Allowance</i>	-	-	-	-
<b>Net carrying amount</b>	<b>1,202,266</b>	-	-	<b>1,513,386</b>
<u>Special Drawing Rights holdings with the International Monetary Fund</u>				
AAA	537,249	-	-	534,253
<b>Gross carrying amount</b>	<b>537,249</b>	-	-	<b>534,253</b>
<i>Loss Allowance</i>	-	-	-	-
<b>Net carrying amount</b>	<b>537,249</b>	-	-	<b>534,253</b>
<u>Investments measured at fair value through other comprehensive income (2017: available-for-sale)</u>				
AAA	5,911,004	-	-	4,703,641
AA+	581,212	-	-	60,947
AA	206,203	-	-	20,346
AA-	149,037	-	-	312,991
<b>Net Carrying amount - Fair Value</b>	<b>6,847,456</b>	-	-	<b>5,097,925</b>
<i>Loss Allowance (recognized in other comprehensive income)</i>	(261)	-	-	-

#### b) Financial instruments under the monetary policy portfolio

Credit risk is associated to open-market operations and facilities that inject liquidity to the financial system. The Bank'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.

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

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.

The table below shows, by class of financial instruments, gross carrying amount of monetary policy and other financial assets for which impairment requirements are applied, based on the banks internal credit rating system:

	2018				2017
	12-month ECL	Lifetime ECL not credit-impaired	Lifetime ECL credit-impaired	Total	Total
<b>Foreign currency assets</b>					
<u>Other financial assets</u>					
B grade	7	-	-	7	6
<b>Gross carrying amount</b>	<b>7</b>	<b>-</b>	<b>-</b>	<b>7</b>	<b>6</b>
<i>Loss Allowance</i>	-	-	-	-	-
<b>Net carrying amount</b>	<b>7</b>	<b>-</b>	<b>-</b>	<b>7</b>	<b>6</b>
<b>National currency assets</b>					
<b>Monetary policy instruments</b>					
<u>Due from financial institutions</u>					
AAA grade	1,901,477	-	-	1,901,477	1,590,936
<b>Gross carrying amount</b>	<b>1,901,477</b>	<b>-</b>	<b>-</b>	<b>1,901,477</b>	<b>1,590,936</b>
<i>Loss Allowance</i>	-	-	-	-	-
<b>Net carrying amount</b>	<b>1,901,477</b>	<b>-</b>	<b>-</b>	<b>1,901,477</b>	<b>1,590,936</b>
<u>Investments measured at fair value through other comprehensive income (2017: available-for-sale)</u>					
AAA grade	364,653	-	-	364,653	155,194
<b>Carrying Amount - Fair Value</b>	<b>364,653</b>	<b>-</b>	<b>-</b>	<b>364,653</b>	<b>155,194</b>
<b>Other national currency assets</b>					
<u>Due from financial institutions</u>					
AAA Grade	46,272	-	-	46,272	221,303
<b>Gross carrying amount</b>	<b>46,272</b>	<b>-</b>	<b>-</b>	<b>46,272</b>	<b>221,303</b>
<i>Loss Allowance</i>	-	-	-	-	-
<b>Net carrying amount</b>	<b>46,272</b>	<b>-</b>	<b>-</b>	<b>46,272</b>	<b>221,303</b>
<u>Investments measured at amortized cost (2017: Investments held to maturity)</u>					
AAA Grade	281,808	-	-	281,808	321,952
<b>Gross carrying amount</b>	<b>281,808</b>	<b>-</b>	<b>-</b>	<b>281,808</b>	<b>321,952</b>
<i>Loss Allowance</i>	-	-	-	-	-
<b>Net carrying amount</b>	<b>281,808</b>	<b>-</b>	<b>-</b>	<b>281,808</b>	<b>321,952</b>
<u>Other financial assets</u>					
A Grade	2,688	-	-	2,688	-
B Grade	-	-	191	191	927
<b>Gross Carrying Amount</b>	<b>2,688</b>	<b>-</b>	<b>191</b>	<b>2,879</b>	<b>927</b>
<i>Loss Allowance</i>	(41)	-	(191)	(232)	(282)
<b>Net carrying amount</b>	<b>2,647</b>	<b>-</b>	<b>-</b>	<b>2,647</b>	<b>645</b>

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

The following table shows reconciliation of opening and closing balances of the loss allowance by class of those financial instruments for which expected credit losses are recognized. Comparative amounts for 2017 represent the allowance for credit losses calculated under IAS 39 basis.

	2018			2017
	12-month ECL	Lifetime ECL not credit-impaired	Lifetime ECL credit-impaired	Total
<b>Foreign currency assets</b>				
<b>International reserves</b>				
<b>Investments measured at FVOCI</b>				
<b>Balance at 1 January</b>	<b>121</b>	-	-	<b>121</b>
New financial assets recognized	230	-	-	230
Remeasurement of loss allowance	(44)	-	-	(44)
Foreign exchange and other movements	1	-	-	1
Financial assets that have been derecognized	(47)	-	-	(47)
<b>Balance at 31 December</b>	<b>261</b>	-	-	<b>261</b>
<b>National currency assets</b>				
<b>Other national currency assets</b>				
<b>Other Assets</b>				
<b>Balance at 1 January</b>	-	-	<b>282</b>	<b>282</b>
New financial assets recognised	41	-	-	41
Remeasurement of loss allowance	-	-	(75)	(105)
Financial assets that have been derecognized	-	-	(16)	(2)
<b>Balance at 31 December</b>	<b>41</b>	-	<b>191</b>	<b>282</b>
<b>Total balance at 1 January</b>	<b>121</b>	-	<b>282</b>	<b>389</b>
<b>Total balance at 31 December</b>	<b>302</b>	-	<b>191</b>	<b>282</b>

### 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 minimize excessive concentrations of risks, the Bank's policies and procedures include specific guidelines to focus on maintaining a low credit risk profile. The concentration risks by counterparties and asset quality are disclosed in relevant notes to the financial statements.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### 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 by issuer for these financial assets and liabilities outside of Georgia:

As at 31 December 2018	Notes	US	EU	Australia	Canada	International	Other	Total
<b>Assets:</b>								
<b>International reserves</b>								
Cash and cash equivalents (excluding cash on hand)	7	41,561	620,757	216	384,395	-	155,337	1,202,266
Special Drawing Rights holdings with the IMF	9	-	-	-	-	537,249	-	537,249
Assets related to derivative instruments	10	-	-	-	-	-	1,523	1,523
Investments measured at fair value through profit or loss	11	-	-	-	-	138,094	-	138,094
Investments measured at fair value through other comprehensive income	12	4,152,313	1,384,584	501,783	415,903	392,873	-	6,847,456
		<b>4,193,874</b>	<b>2,005,341</b>	<b>501,999</b>	<b>800,298</b>	<b>1,068,216</b>	<b>156,860</b>	<b>8,726,588</b>
<b>Liabilities:</b>								
Due to the International Monetary Fund	9	-	-	-	-	985,307	-	985,307
<b>Net position</b>		<b>4,193,874</b>	<b>2,005,341</b>	<b>501,999</b>	<b>800,298</b>	<b>82,909</b>	<b>156,860</b>	<b>7,741,281</b>
<b>As at 31 December 2017</b>								
	Notes	US	EU	Australia	Canada	International	Other	Total
<b>Assets:</b>								
<b>International reserves</b>								
Cash and cash equivalents (excluding cash on hand)	7	102,271	953,190	94	9,241	185,342	263,248	1,513,386
Special Drawing Rights holdings with the IMF	9	-	-	-	-	534,253	-	534,253
Assets related to derivative instruments	10	13	-	-	-	-	644	657
Trading securities	11	282,389	211,783	-	14,581	147,054	-	655,807
Investments available-for-sale	12	3,379,696	787,556	525,543	269,319	135,815	-	5,097,929
		<b>3,764,369</b>	<b>1,952,529</b>	<b>525,637</b>	<b>293,141</b>	<b>1,002,464</b>	<b>263,892</b>	<b>7,802,032</b>
<b>Liabilities:</b>								
Due to the International Monetary Fund	9	-	-	-	-	754,816	-	754,816
<b>Net position</b>		<b>3,764,369</b>	<b>1,952,529</b>	<b>525,637</b>	<b>293,141</b>	<b>247,648</b>	<b>263,892</b>	<b>7,047,216</b>

\*EU-including Norwegian agency securities.



## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

#### Liquidity risk

Liquidity risk considers the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

#### 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, bank diversifies maturities and also establishes limits aiming to ensure 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 2018 and 2017 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 2018	Notes	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
<b>Foreign currency assets</b>						
<b>International Reserves</b>						
Cash and cash equivalents (excluding cash on hand)	7	1,202,266	-	-	-	1,202,266
Special Drawing Rights holdings with the International Monetary Fund	9	537,249	-	-	-	537,249
Assets related to derivative instruments	10	1,523	-	-	-	1,523
Investments measured at fair value through profit or loss	11	138,094	-	-	-	138,094
Investments measure at fair value through other comprehensive income	12	6,847,456	-	-	-	6,847,456
<b>Other foreign currency assets</b>						
Other financial assets	17	7	-	-	-	7
<b>Total foreign currency assets</b>		<b>8,726,595</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>8,726,595</b>
<b>Foreign currency liabilities</b>						
Due to resident financial institutions	18	3,650,921	-	-	-	3,650,921
Due to the Ministry of Finance	19	414,917	-	-	-	414,917
Due to the International Monetary Fund	9	538,907	7,043	166,180	333,356	1,045,486
Other liabilities	17	2,776	-	-	-	2,776
<b>Total foreign currency liabilities</b>		<b>4,607,521</b>	<b>7,043</b>	<b>166,180</b>	<b>333,356</b>	<b>5,114,100</b>
<b>Net Position</b>		<b>4,119,074</b>	<b>(7,043)</b>	<b>(166,180)</b>	<b>(333,356)</b>	<b>3,612,495</b>

# NATIONAL BANK OF GEORGIA

## NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

As at 31 December 2017	Notes	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
<b>Foreign currency assets</b>						
<b>International Reserves</b>						
Cash and cash equivalents (excluding cash on hand)	7	1,513,386	-	-	-	1,513,386
Special Drawing Rights holdings with the International Monetary Fund	9	534,253	-	-	-	534,253
Assets related to derivative instruments	10	657	-	-	-	657
Trading securities	11	655,807	-	-	-	655,807
Investments available-for-sale	12	5,097,929	-	-	-	5,097,929
<b>Other foreign currency assets</b>						
Other financial assets	17	6	-	-	-	6
<b>Total foreign currency assets</b>		<b>7,802,038</b>	-	-	-	<b>7,802,038</b>
<b>Foreign currency liabilities</b>						
Due to resident financial institutions	18	3,130,713	-	-	-	3,130,713
Due to the Ministry of Finance	19	434,263	-	-	-	434,263
Due to the International Monetary Fund	9	531,525	-	46,145	175,351	753,021
Other liabilities	17	2,673	-	-	-	2,673
<b>Total foreign currency liabilities</b>		<b>4,099,174</b>	-	<b>46,145</b>	<b>175,351</b>	<b>4,320,670</b>
<b>Net Position</b>		<b>3,702,864</b>	-	<b>(46,145)</b>	<b>(175,351)</b>	<b>3,481,368</b>

### 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 Strategic Asset Allocation (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 15 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:

Tranches	2018*		2017	
	Benchmark Duration (Duration Deviation Limits)	Ex-Ante Tracking Error Limits	Benchmark Duration (Duration Deviation Limits)	Ex-Ante Tracking Error Limits
Liquidity Portfolio in USD	6 Months (+/-3 Month)	10 Basis Point	3 Months (+/-1 Month)	10 Basis Point
Investment Portfolio in USD	1 year (+/-3 Months)	15 Basis Point	6 Months (+/-3 Months)	15 Basis Point
Investment Portfolio in EUR*	1 year (+/-3 Months)*	15 Basis Point*	1 year (+/-3 Months)*	15 Basis Point*
Investment Portfolio in AUD	1,5 year (+/-3 Months)	15 Basis Point	1,5 year (+/-3 Months)	15 Basis Point
Investment Portfolio in CAD	1,5 year (+/-3 Months)	15 Basis Point	1,5 year (+/-3 Months)	15 Basis Point

\* The EUR Investment Portfolio ceased to be managed versus Benchmark since 15 December 2015

\* Due to the annual SAA decision, the Benchmark Durations for the Liquidity Portfolio in USD and Investment Portfolio in USD was increased from February 2018.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

Market risk is monitored through the daily measurement of the duration and composition of currencies, and by the follow-up of ex-ante 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.

The Bank's exposure to fair-value interest rate risk arises principally through its investment in International reserves portfolio, which are exposed to fluctuations because of changes in market interest rates.

Interest rate risk for Foreign Currency Reserves is the risk of changes in fair value of financial instruments due to changes in market interest rates.

The Bank's internally managed Foreign Currency Reserve's portfolio is divided into tranches and the Bank measures interest rate risk for its tranches, in all currencies, based on a 1% change in interest rates that indicates a change in the fair market value of financial instruments per 1% change in market yields. The fair market values of tranches held by the Bank are exposed to fluctuations, however these variations would not affect the ability of the Bank to fulfil its obligations.

#### The market yield sensitivity of the Bank's International Reserve tranches

The table shows the sensitivity of reserve tranches to a 1% increase or decrease in market yields to the asset values (the figures are provided in thousands of USD):

Currency	2018		2017	
	Increase in Market Yield	Sensitivity of asset value	Increase in Market Yield	Sensitivity of asset value
Investment Tranche in USD*	1%	(21,098)	1%	(9,495)
Investment Tranche in EUR	1%	-	1%	(150)
Investment Tranche in AUD	1%	(3,630)	1%	(3,671)
Investment Tranche in CAD	1%	(1,275)	1%	(1,241)
Liquidity Tranche in USD	1%	(3,097)	1%	(2,149)
Working Capital Tranche in USD	1%	(6)	1%	(326)

Currency	2018		2017	
	Decrease in Market Yield	Sensitivity of asset value	Decrease in Market Yield	Sensitivity of asset value
Investment Tranche in USD*	1%	21,667	1%	9,732
Investment Tranche in EUR	1%	-	1%	155
Investment Tranche in AUD	1%	3,748	1%	3,787
Investment Tranche in CAD	1%	1,314	1%	1,276
Liquidity Tranche	1%	3,156	1%	2,196
Working Capital Tranche	1%	6	1%	331

\* Investment Tranche in USD\* does not include interest rate exposure of assets managed by Bank for International Settlement (BISIP\_K);

#### b) Financial instruments under the 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.

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

Currency	2018		2017	
	Increase in interest rate	Sensitivity of net interest income	Increase in interest rate	Sensitivity of net interest income
USD	1%	37,776	1%	34,772
SDR	1%	(4,462)	1%	(2,188)
EUR	1%	(171)	1%	(1,320)
AUD	1%	5,487	1%	5,750
CAD	1%	2,271	1%	2,344
GEL	1%	18,433	1%	14,699
Other	1%	21	1%	39

Currency	2018		2017	
	Decrease in interest rate	Sensitivity of net interest income	Decrease in interest rate	Sensitivity of net interest income
USD	1%	(37,776)	1%	(34,772)
SDR	1%	4,462	1%	2,188
EUR	1%	171	1%	1,320
AUD	1%	(5,487)	1%	(5,750)
CAD	1%	(2,271)	1%	(2,344)
GEL	1%	(18,433)	1%	(14,699)
Other	1%	(21)	1%	(39)

The sensitivity of equity is calculated by revaluing fixed rate investments measured at fair value through other comprehensive income (2017: available-for-sale) at 31 December 2018 and 2017 for 1% change in interest rates.

Currency	2018		2017	
	Increase in interest rate	Sensitivity of equity	Increase in interest rate	Sensitivity of equity
USD	1%	60,719	1%	42,774
EUR	1%	-	1%	204
AUD	1%	5,485	1%	5,749
CAD	1%	2,270	1%	2,252
GEL	1%	3,647	1%	1,552

Currency	2018		2017	
	Decrease in interest rate	Sensitivity of equity	Increase in interest rate	Sensitivity of equity
USD	1%	(60,719)	1%	(42,774)
EUR	1%	-	1%	(204)
AUD	1%	(5,485)	1%	(5,749)
CAD	1%	(2,270)	1%	(2,252)
GEL	1%	(3,647)	1%	(1,552)

### Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign currency 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 partially mitigated by holding assets across a diversified portfolio of currencies. Since 14 December 2015, the target currency composition is 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.

### 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

## NATIONAL BANK OF GEORGIA

### NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018 (in thousands of Georgian Lari)

reflects a potential net reduction in the statement of comprehensive income, while a positive amount reflects a net potential increase.

As at 31 December 2018	USD	EUR	SDR	AUD	CAD	Other	Total
Foreign currency assets	6,923,121	564,498	537,249	548,725	227,110	2,101	8,802,804
Foreign currency liabilities	(3,299,000)	(768,948)	(983,435)	-	-	(669)	(5,052,052)
<b>Net position</b>	<b>3,624,121</b>	<b>(204,450)</b>	<b>(446,186)</b>	<b>548,725</b>	<b>227,110</b>	<b>1,432</b>	<b>3,750,752</b>
As at 31 December 2017	USD	EUR	SDR	AUD	CAD	Other	Total
Foreign currency assets	6,235,371	295,398	534,253	575,028	234,413	3,845	7,878,308
Foreign currency liabilities	(2,946,513)	(621,169)	(753,021)	-	-	(38)	(4,320,741)
<b>Net position</b>	<b>3,288,858</b>	<b>(325,771)</b>	<b>(218,768)</b>	<b>575,028</b>	<b>234,413</b>	<b>3,807</b>	<b>3,557,567</b>
Effect on statement of total comprehensive income							
31-Dec-18							
	USD	EUR	SDR	AUD	CAD	Other	Total
Increase in currency rate of 1%	36,241	(2,044)	(4,462)	5,487	2,271	14	37,508
Increase in currency rate of 5%	181,206	(10,223)	(22,309)	27,436	11,356	72	187,538
Increase in currency rate of 10%	362,412	(20,445)	(44,619)	54,873	22,711	143	375,075
Decrease in currency rate of 1%	(36,241)	2,044	4,462	(5,487)	(2,271)	(14)	(37,508)
Decrease in currency rate of 5%	(181,206)	10,223	22,309	(27,436)	(11,356)	(72)	(187,538)
Decrease in currency rate of 10%	(362,412)	20,445	44,619	(54,873)	(22,711)	(143)	(375,075)
Effect on statement of total comprehensive income							
31-Dec-17							
	USD	EUR	SDR	AUD	CAD	Other	Total
Increase in currency rate of 1%	32,889	(3,258)	(2,188)	5,750	2,344	39	35,576
Increase in currency rate of 5%	164,443	(16,288)	(10,938)	28,751	11,721	190	177,879
Increase in currency rate of 10%	328,886	(32,577)	(21,877)	57,503	23,441	381	355,757
Decrease in currency rate of 1%	(32,889)	3,258	2,188	(5,750)	(2,344)	(39)	(35,576)
Decrease in currency rate of 5%	(164,443)	16,288	10,938	(28,751)	(11,721)	(190)	(177,879)
Decrease in currency rate of 10%	(328,886)	32,577	21,877	(57,503)	(23,441)	(381)	(355,757)

### 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 Risks

Non-financial risks to which bank is exposed are: Reputational and Operational risks. Operational Risks itself are originated from inadequate or failed internal processes, people and systems or external events. The Bank is exposed to the following sub-categories of operational risks: Legal, Information Technology, Human resources, Security (Physical and Information), Project, Third-party, Business continuity and Settlement risks. Realizing the Non-Financial risks may generate financial loss, damage to reputation or failure in achieving the bank's business objectives. Hence, the bank developed Centralized Risk management system in order to minimize the impact of non-financial risks and ensure solid internal control system.

## **NATIONAL BANK OF GEORGIA**

### **NOTES TO THE FINANCIAL STATEMENTS AS AT AND FOR THE YEAR ENDED 31 DECEMBER 2018**

*(in thousands of Georgian Lari)*

---

Centralized risk management (CRM) framework is comprised of non-financial risks management, incident management and business continuity systems and is supported by internal control system of procedures. Non-financial Risk assessment is based on qualitative method (5 scale) method and includes all bank-wide processes where risks could jeopardize the achievement of the objectives. Incident Management system captures and analysis the incidents in order to avoid the repetitive occurrence of incidents. Business Continuity management system continuously improves the resilience of the Bank's critical processes and provides adequate procedures, regular testing and expansion of scenarios.

The Bank defined the aggregate level (Risk Appetite) of risks the Bank is willing to assume within its risk capacity to achieve its strategic objectives and goals. Overall, the Bank operates within a low risk range and is conservative in its approach to Reputational and Operational risks. Hence, the bank makes resources available and sets the effective governance process to control and maintain non-financial risks to low risk level.



FIRST GEORGIAN  
**CENTRAL  
BANK**

2, Sanapiro Str., Tbilisi 0114, Georgia

Tel.: (995 32) 2 406 488; Fax: (995 32) 2 406 577

Hot line: (995 32) 2 406 406

E-mail: [Info@nbg.ge](mailto:Info@nbg.ge); [www.nbg.ge](http://www.nbg.ge)