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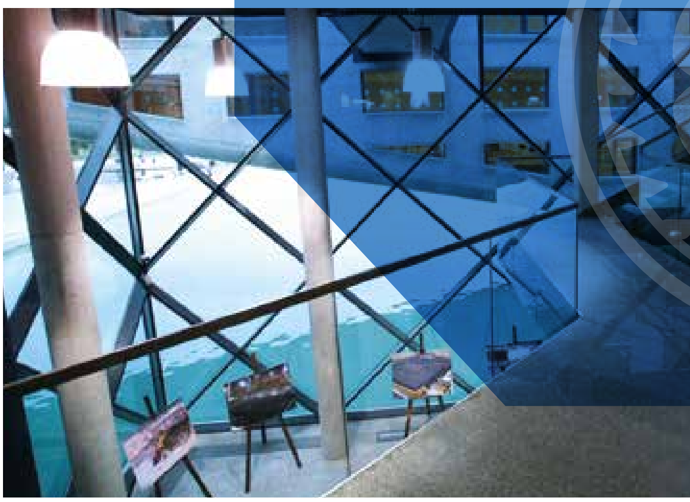
National Bank of Georgia



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2020

National Bank of Georgia

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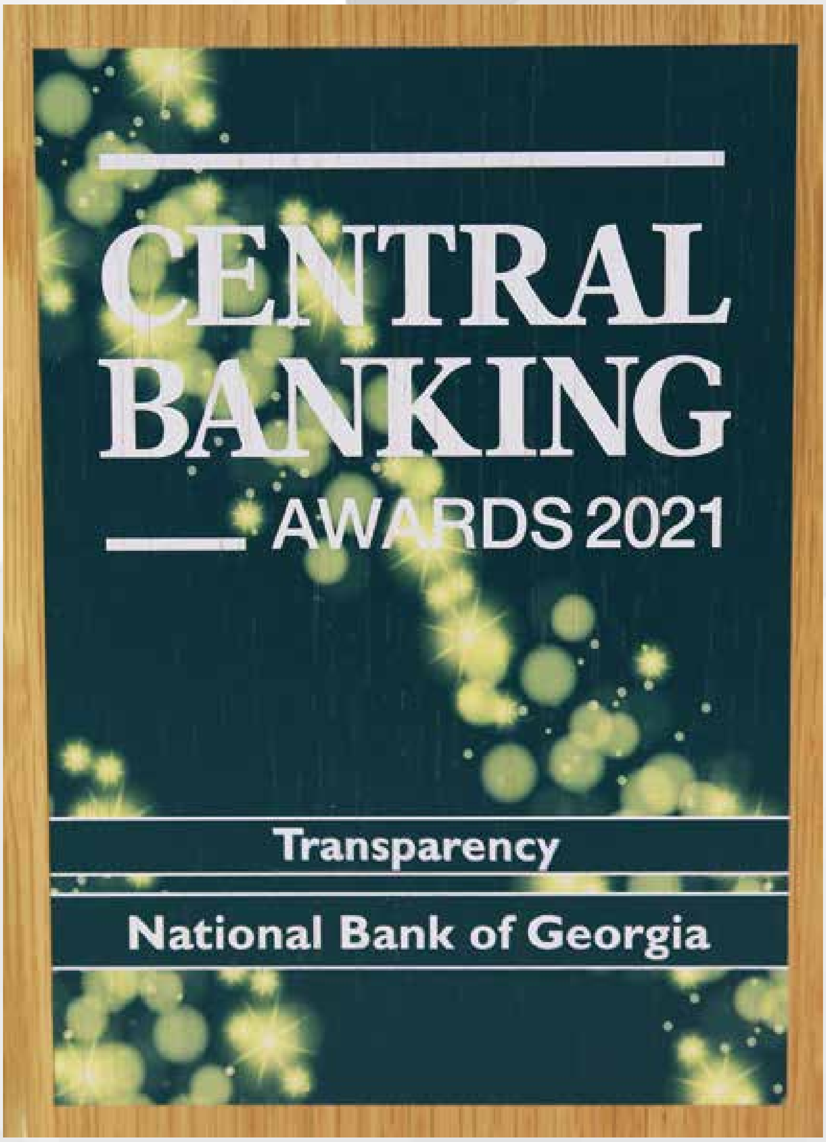

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Note: From July 28, 2021 the renewed website of the National Bank of Georgia www.nbg.gov.ge will be working in testing regime. Please, take into consideration, that some of the links in the Annual Report might not be available.

ABBREVIATIONS

AIFMD – Alternative Investment Fund Managers Directive
AML/CFT – Anti–Money Laundering/Combating the Financing of Terrorism
API – Application Programming Interface
ARA – Assessing Reserve Adequacy
BI – Business Intelligence
BIS – Bank for International Settlements
BISIP – BIS Investment Pool
BMatch – Bloomberg Foreign Exchange trading platform
BRRD – Bank Recovery and Resolution Directive
CIF – Cost, Insurance and Freight
CPMI – Committee on Payments and Market Infrastructures
CRD IV – Directive on Activities of, and Regulation for, Credit Institutions operating in the European Union
CSR – Corporate Social Responsibility
EBA – European Banking Authority
EBRD – European Bank for Reconstruction and Development
ECB – European Central Bank
EFF – Extended Fund Facility
EFSE DF – Development Facility of the European Fund for Southeast Europe
ESG – Environmental, Social, and Governance
EVE – Economic Value of Equity
FATF – Financial Action Task Force
FID – Financial Indicator–Daily
FinEdu – First Georgian financial education webportal (www.finedu.gov.ge)
FINREP – Financial Reporting (a European regulation which applies to credit institutions)
FOB – Free on Board
FSAP – Financial Sector Assessment Program
FSB – Financial Stability Board
FSI – Financial Stability Indicators
GET – German Economic Team
GFIN – Global Financial Innovation Network
GITA – Georgia's Innovation and Technology Agency
GRAPE – General Risk Assessment Program
GSSS – Georgian Securities Settlement System
HHI – Herfindahl–Hirschman Index
HRMS – Human Resource Management System
ICAAP – Internal Capital Adequacy Assessment Process
IFC – International Finance Corporation
IFRS – International Financial Reporting Standards
IMF – International Monetary Fund
IOSCO – Technical Committee of the International Organization of Securities Commissions
IRRBB – Interest Rate Risk in the Banking Book
LCR – Liquidity Coverage Ratio
LGD – Loss Given Default
LIBOR – London Inter–Bank Offered Rate
NGFS – Network for Greening the Financial System
NII – Net Interest Income
NSFR – Net Stable Funding Ratio
OECD – Organization for Economic Cooperation and Development
OECD/INFE – OECD International Network for Financial Education
ROA – Return on Assets
ROE – Return on Equity
RTGS – Real Time Gross Settlement
SBFIC – Savings Banks Foundation for International Cooperation
SBN – Sustainable Banking Network
SDMX – Statistical Data and Metadata Exchange
SRB – Single Resolution Board
TIBR – Tbilisi Interbank Rate
UCITS – Undertakings for Collective Investment in Transferable Securities
USAID – United States Agency for International Development
WB – World Bank
WSS – Wallstreet Suite
XBRL – Extensible Business Reporting Language

INTRODUCTION

The 2020 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 NBG and includes a review of monetary, foreign exchange and supervisory policies and audited financial statements.

The ultimate task of the NBG is to ensure price stability. In addition, the NBG should ensure the stability and transparency of the financial system and promote sustainable growth of the national economy so as not to jeopardize its core objectives. Price stability implies the availability of a level of inflation in the medium term that is optimal for high and sustainable economic growth in the long run. Focusing on the medium term is particularly important as current inflation and that over the short term may deviate from the target (either upward or downward).

The conduct of monetary policy based on the aforementioned focus is possible under an inflation-targeting framework, which is widely regarded as the most efficient monetary policy approach. This approach ensures price stability and the lowest long-term interest rates compared to other alternatives. 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 NBG is thus constantly improving its monetary policy instruments and increasing the efficiency of the monetary policy transmission mechanism.
The NBG adopted the inflation-targeting regime in 2009. Since then (2009-2020), the average annual inflation rate in Georgia has been 3.7%. Prior to the enactment of this regime, inflation averaged 10.2% over the period 1996-2008. Initially, when shifting to inflation targeting, the inflation target was 6%, but this figure gradually declined and fell to 3% from 2018, representing the current long-term target for annual inflation.

In Georgia, as in other open economies, exogenous (those independent of monetary policy) shocks are inevitable. Under the influence of such shocks, it is possible for inflation to deviate from the target. Monetary policy is a tool to influence demand. Central banks mainly respond to demand shocks, as responding to supply shocks is associated with high costs for the economy and will lead to fluctuations in economic growth and reduced employment in the long run. However, a similar deviation can raise inflation expectations, which may be reflected in rising inflation in the future. As studies show, the transfer of monetary policy changes to the economy is time-consuming.[1] Short-term deviations from the inflation target are thus advisable if, in the medium term, inflation is expected to return to its target. If a shock raises medium-term inflation expectations and the forecast, the NBG will adjust its policy accordingly.

The year 2020 started with inflation above the target. This was largely due to the depreciation of lari effective exchange rate stemming from the ban on flights from Russia in the summer of 2019. As a result of the tightening of monetary policy in 2019,

1. Bernanke & Blinder (1992) The Federal Funds Rate and the Channels of Monetary Transmission, *American Economic Review*, Vol. 82, Issue 4, 901-21; Bernanke & Gertler (1995) Inside the Black Box: The Credit Channel of Monetary Policy Transmission, *The Journal of Economic Perspectives*, Vol. 9, No. 4 (Autumn, 1995), 27-48.

as was expected, annual inflation began to decline from the beginning of 2020. Inflation fell to 6.4% in January and February 2020 (down 0.6 percentage points from the 7.0% observed in December 2019). However, the subsequent shock caused by the start of the coronavirus pandemic altered the inflation path. Inflation-related changes resulted from the temporary disruption of supply chains stemming from restrictions imposed to curb the pandemic, the reflection of costs associated with the pandemic on final prices, and the depreciation of the lari nominal effective exchange rate. International tourism practically stopped across the world as a result of the pandemic, leaving tourism-dependent countries, including Georgia, particularly impacted.[2] Restricting the entry of foreign tourists caused a sharp devaluation of the lari effective exchange rate, which was also reflected in prices. As a result, the inflation rate reached a peak of 6.9% in April. It was expected that the significantly reduced aggregate demand over the year would affect inflation in a downward direction; therefore, there was no longer a need to maintain a tightened policy at the existing level. The Monetary Policy Committee thus began a gradual exit from the tightened policy stance and reduced the policy rate by 0.5 percentage points (pp) at its April 2020 meeting, and by a further 0.25-0.25 pp in June and August to 8.0%.

Risks related to inflation expectations emerged again in autumn, accompanied by increased volatility in foreign exchange markets and the ongoing long-term maintenance of inflation above the target. However, the depreciation of the nominal effective exchange rate put pressure on the prices of imported goods, which, in turn, had a significant impact on inflation. In addition, due to the high level of dollarization, the exchange rate depreciation increased the cost of servicing loans to non-hedged producers. The dramatically increased rate of COVID-19 infections at this time also led to additional constraints and the continuation of supply-side factors influencing growth. Accordingly, the policy rate was maintained at 8.0% for the remainder of the year. Inflation fell sharply to 2.4% in December 2020 due to government subsidies on utility fees. Over the year as a whole, inflation averaged 5.2%.

In 2020, according to preliminary data, the Georgian economy shrank by 6.2%. This economic downturn hit the service sector the hardest, with its contributions estimated at -5.8 pp. The industrial sector decreased relatively less (-0.6 pp), while agriculture increased slightly and made a positive contribution of 0.2 pp.

The impact of the 2020 pandemic on the Georgian economy was reflected in a sharp decline in revenues from international tourism. In addition, the slowdown in economic activity in Georgia's trade partner countries had a negative impact on exports of goods. Amid declining external and domestic demand, imports of goods also fell and the trade deficit improved. However, the decline in revenues from international travelers in 2020 fully offset the improvement in the goods trade deficit and led to a significant worsening of the current account deficit.

The current account deficit in 2020 was 12.4% of GDP. This is a significant increase compared to the 5.5% figure of 2019, which was the lowest figure since 2000. In absolute terms, the current account deficit deteriorated by USD 1,005 million to USD

2. For more information, see https://www.imf.org/external/pubs/ft/fandd/2020/12/impact-of-the-pandemic-on-tourism-behsudi.htm

1,965 million. Exports of goods decreased by 12.0% annually during the year. Meanwhile, imports of goods decreased substantially after the second quarter and fell by 13.7% annually. As a result, the trade balance of goods in 2020 improved by 1.6 pp of GDP (USD 597 million) to 19.8% of GDP. Amid a sharp decline in revenues from international travelers (gross inflows of USD -2.7 billion and net inflows of USD -2.3 billion), the service balance surplus saw a substantially reduction (USD -2.0 billion) and the current account deficit worsened. Despite the overall decline, net foreign direct investment was one of the major sources of financing the current account deficit in 2020. Foreign direct investment in Georgia amounted to USD 616 million, which was 57% less than the previous year. Most of the foreign direct investment was directed to the finance, mining, manufacturing and real estate sectors; while, compared to the previous year, investments were mostly reduced in the energy, hotels, restaurants and transport sectors.

In 2020, against the backdrop of the crisis, a negative external balance was formed in the private sector and, simultaneously, a positive external balance emerged in the government sector as a result of foreign inflows and assistance received by the government. With the NBG being the government's banker, the government has foreign currency accounts with the NBG. Thus, most of the foreign exchange inflows received by the government are directly reflected in government's accounts in the National Bank of Georgia and do not appear in the foreign exchange market. This is why the NBG resorted to a policy of making active foreign exchange interventions in terms of providing foreign exchange (FX) liquidity to the market. In 2020, the NBG sold USD 873.2 million via FX auctions. In addition to standard FX auctions, the NBG provided around USD 42.9 million of liquidity to the market through the BMatch platform, which was launched in 2020. The volume of foreign currency supplied by the NBG to the foreign exchange market totaled USD 916.1 million in 2020.

In 2020, the NBG published its Supervision Strategy Document for 2020-2022.[3] This outlines the NBG's vision, objectives, supervisory principles and values, as well defining its strategic supervisory priorities and providing a detailed roadmap with relevant timelines. The goal of the strategy is to provide the financial sector, investors, international financial institutions, credit rating agencies, the general public and other stakeholders with information on the NBG's supervisory priorities, plans and future activities. The strategy document will be updated annually as needed and published on the NBG's website.

Promoting financial stability is one of the most important tasks of the NBG. For this purpose, it pursues macroprudential policy. By identifying, assessing and monitoring systemic risks, the NBG pursues a policy to mitigate these risks, thereby facilitating resilience of the financial system. The capital requirements imposed by the NBG in the past and the profits generated by commercial banks have allowed banks to accumulate sufficient capital buffers to cope with the stressful situation posed by the COVID-19 pandemic. In 2020, the banking system faced the crisis caused by the pandemic with

3. Read more at https://www.nbg.gov.ge/index.php?m=756

sustainable asset quality that was backed up by the regulation on responsible lending and a number of macroprudential measures to reduce the dollarization of loans. In recent years, the introduction of the Liquidity Coverage Ratio (LCR) and Net Stable Financing Ratio (NSFR) enabled commercial banks to have stable funding sources and solid liquidity buffers. In addition, in 2020, the NBG significantly expanded its lari liquidity provision instruments to ensure uninterrupted credit supply to the economy. As part of the supervision plan, portions of the banks' capital buffers were released, and they were thus given more flexibility in managing liquidity. Even though the share of non-performing loans increased as a consequence of the pandemic, the commercial banks had set up reserves for potential losses in advance. As a result of the financial stability policy pursued by the NBG, the financial system faced the pandemic in good shape and has sufficient resources to continue lending to the economy smoothly.

A sustainable financial system is crucial for financial stability. This involves the management of social and environmental risks and is an important contributing factor for sustainable development. The NBG continues to implement the measures listed in the Sustainable Finance Roadmap. In particular, environmental, social and governance (ESG) considerations have been integrated in the Corporate Governance Code for Commercial Banks. Furthermore, in cooperation with the OECD, the NBG developed ESG reporting and disclosure principles and a corresponding template. Another step towards developing a Sustainable Finance Framework was joining the Network for Greening the Financial System (NGFS) in February 2020. The NBG continues to implement its action plan given in the Sustainable Finance Roadmap and is working with the IFC to develop a Sustainable Finance Taxonomy.

Throughout 2020, despite the challenges caused by the COVID-19 pandemic, the NBG continued its efforts to upgrade its supervisory framework, bringing it closer to advanced international best practice. In response to the COVID-19 pandemic and to ease the operational burden of financial institutions, the NBG announced a temporary moratorium on the elaboration and imposition of new supervisory requirements. However, given its importance and role in the recovery of the economy, this moratorium did not apply to the ongoing reforms concerning resolution. In 2020, the National Bank enacted regulations that would serve to fully implement the Commercial Banks Recovery and Resolution Framework in accordance with the legislative changes implemented at the end of 2019.

As of 31 December 2020, there were 15 commercial banks operating in the banking sector. The share of non-resident owners in the assets of banks, by ultimate ownership, as of that date was 88.3% and 86.6% in the share of equity.

At the end of 2020, the total loan portfolio of the banking system amounted to GEL 38 billion and, excluding the exchange rate effect, its annual growth was 9%.

Deposits increased by GEL 8.3 billion, or by 31.8%, during the year (or by 20.8% without the exchange rate effect) to GEL 34.6 billion as of December 2020.

The lower growth rate of the loan portfolio compared to previous years was a result of the slowdown in lending activity due to the

COVID-19 pandemic. The composition of the loan portfolio, in terms of segments, has not changed significantly and the portfolio is diversified from a sectoral viewpoint.

The restricted mobility caused by the COVID-19 pandemic has significantly increased risks in the loan portfolio. As a result, by the end of 2020, the quality of the loan portfolio of the banking system significantly deteriorated compared to the previous year, which was reflected in a greater share of negative and restructured loans. Moreover, the reserve for possible loan losses has increased significantly. In March 2020, the NBG instructed commercial banks to evaluate their portfolios and the banks created an additional general loan loss reserve of GEL 1.1 billion. From September 2020, according to the methodology developed by the NBG, the general loan reserve that had already been created was transferred to a specific loan reserve. The deterioration of portfolio quality and the growth of loan reserves were due to the negative economic consequences stemming from economic mobility constraints in vulnerable sectors and the increase in the debt burden for foreign currency borrowers due to the exchange rate depreciation.

In 2020, the banking sector was actively offering loan deferrals to borrowers. The share of overdue loans did not increase significantly compared to the period before the pandemic due to high levels of loan deferrals and/or restructuring. However, the share of restructured and negative loans in the portfolio increased.

Considering the supervisory measures related to COVID-19, according to the Basel III capital adequacy framework, the Georgian banking system continued to maintain an adequate level of capital by the end of 2020. In order to mitigate the negative impact of the COVID-19 pandemic on the financial sector and to stimulate the country's economy, the NBG took significant supervisory measures.[4] Under the supervision plan, commercial banks eased their capital requirements by reducing the capital conservation buffer (by 2.5% of risk-weighted assets) and the Pillar 2 buffer (by two-thirds of the hedged foreign currency credit buffer).

Despite the risks and negative expectations associated with the pandemic, foreign exchange risks were reduced through timely interventions by the NBG, while banks continued to operate in stable currency positions. The growing trend of larization in the banking system continued throughout the year at a relatively slow pace. However, the share of foreign currency assets and liabilities is still high, keeping the currency risk factor important for Georgian banks.

Reducing dollarization is a necessary precondition for reducing macro-financial risks and improving resilience to external vulnerabilities. Increasing larization is therefore one of the priorities of the NBG and various reforms are being implemented to facilitate this. During the year, the dollarization of total deposits, excluding the exchange rate effect, decreased by 5.7 pp to 61.6%. Loan dollarization, excluding the exchange rate effect, fell by 3.1 pp to 55.3% in December. The dollarization rate of retail loans fell from 46.1% to 41.5% in 2020, excluding the exchange rate effect.

In the first half of the year, amid the declining

4. For detailed information, see the press release “NBG emergency measures to COVID-19”.

GEL liquidity caused by the COVID-19 pandemic, interest rate risks increased – a result of a major upsurge in interest rates on local currency deposits. However, a result of the NBG's GEL liquidity support measures, interest rates were stabilized and returned to pre-stress levels. The Interest Rate Risk in the Banking Book (IRRBB) entered into force, the purpose of which was the identification, evaluation and management of interest rate risk arising in banking books and, by imposing related requirements, the promotion of stability and the sound functioning of commercial banks and the financial sector.

Compared to the previous year, profitability was significantly reduced due to the adverse results of the pandemic. This led to the creation of an additional general loan loss reserve in March. However, net interest margins and non-interest income decreased during the year. Meanwhile, the improvement in efficiency due to reduced operating costs had a positive effect on profitability amid growing assets. The NBG continues efforts to review the profitability projections of banks, to analyze the business models and strategies of individual institutions, and to evaluate relevant profitability risk mitigators.

During 2020, despite the negative expectations and fluctuations fueled by the pandemic, the volume of liquid assets remained high. Following the emergence of risks related to COVID-19, the NBG immediately implemented significant measures to support lari liquidity, which allowed it to attract additional liquidity and significantly reduce ongoing risks. After these measures, at the end of the first half of the year, sufficient lari resources had been accumulated and the liquidity ratio (LCR) significantly exceeded the pre-pandemic level. The Net Stable Financing Ratio (NSFR) was also maintained at a high level.

Macroprudential supervision continues in key areas. The NBG maintains a prudent approach to credit risk caused by currency mismatches. Concessional liquidity and minimum reserve requirements for the national currency have been used to support the larization of liabilities. In 2020, the supervisory stress test methodology was upgraded, a stress test methodology manual was published[5], and the updated results were analyzed based on 2019 data.

The financial system had to quickly respond and adapt to the new reality created by the pandemic. One such area concerned the continuous provision of financial services to businesses and the public. The pandemic gave rise to key operational risks related to fraud, data protection and cyber resistance. The proper functioning of information systems and reliance on key sectors of the financial system, such as telecommunications and information technology, acquired increased significance.

In 2020, significant work was done to move the financial statements of the banking sector to International Financial Reporting Standards (IFRS). Working groups were set up with the participation of the NBG, representatives of the banking sector, and the Georgian Bankers' Association. The project is supported by the World Bank and experienced local and international experts are involved in discussing best practices as implemented by advanced economies. As a result, from 2021, commercial banks can voluntarily start

5. For more information, see https://www.nbg.gov.ge/index.php?m=769

preparing their financial statements according to IFRS, and doing so will become mandatory from the following year. By 2022, banks will be required to submit their statements under both the current standards and IFRS.

One of the most important parts of the IFRS transition project is the introduction of an updated provisioning methodology. This process is underway in close cooperation between the banking sector, auditors and World Bank consultants. To harmonize with IFRS 9, the NBG developed a draft Regulation on Determining the Risk Categories of Financial Instruments and the Expected Credit Loss. This regulation conforms with the IFRS 9 standard and specifies approaches to be used by banks when calculating reserves. The regulation uses a "comply or explain" principle. The draft version of the document was published on the NBG's website for review and consultation at the end of 2020 and its approval is scheduled for 2021.

In 2020, the NBG completed formation of the Recovery and Resolution Framework, and the implementation of this reform is ongoing. This framework envisages the introduction of recovery plans by all commercial banks operating in Georgia and the promotion of risk management culture. In addition, the resolution mechanism set up by the NBG is intended to improve crisis preparedness, thereby ensuring greater financial stability in the banking sector and securing critical economic functions. In 2021, the NBG will develop initial resolution plans for domestic systematically important banks and will facilitate compliance with the framework's requirements through intensive communication with commercial banks.

The NBG is committed to the development of the financial market. The pace of innovation in the financial sector is growing, bringing both new opportunities and new risks, and ensuring that the sector remains the most regulated economic sector in the world – a trend that seems to be increasing. The existing supervisory framework is technical, complex and quite intense, especially for new financial startups and for the implementation of new technologies. With that in mind, it is a significant challenge for financial sector regulators to encourage fintech companies with innovative ideas and to help them transform these ideas into sustainable financial models. In response to this challenge, the NBG is developing a variety of supervisory approaches aimed at facilitating the availability of basic infrastructure for fintech operations. To achieve this goal, the NBG is prepared to assist both non-regulated companies and regulated entities who generate innovative ideas. The NBG Innovations Office assists those outside of regulation in navigating the supervisory framework and learning about the different approaches. Whenever regulated entities have innovative products for which the supervisor has no defined approach, the NBG offers a regulatory laboratory. One example of an innovative approach is the use of different statistical models to guide the decision-making process in the financial sector. Such models are widely used in lending, financial accounting and risk management, especially in retail lending. Extensive work on the Open Banking project took place during 2020, and open banking services will gradually be made available from March 2021. The information exchange service will initially only be operational for individuals, but full coverage of open banking is planned by the end of 2021. It is also expected that the project will be made available to non-banking institutions in the same period.

In 2020, a credit registry was established in consultation with the World Bank working group. This is a large database containing the data provided by lending organizations about their loan portfolios and is intended to be used to improve the effectiveness of credit risk supervision and to reduce the burden of various supervisory reports.

As a result of the non-banking sector regulation and supervision reforms implemented by the NBG over the past three years, the microfinance sector faced the COVID-19 pandemic armed with adequate levels of capital and liquidity, improved risk management and a better corporate culture. The results of these reforms paved the way for the NBG to launch a liquidity support program for the microfinance sector during the pandemic. In particular, a USD 200 million swap tool was launched for microfinance institutions to increase their access to GEL resources. With the introduction of the SME Liquidity Support Facility by the NBG, microfinance institutions could attract loans from commercial banks with the support of the NBG, within a set criteria for the loan portfolio. Most microfinance institutions have demonstrated social responsibility, announcing a 3-month moratorium/grace period on loan repayments, and in some cases even doing so repeatedly.

On 3 September 2020, the International Monetary Fund released an evaluation document prepared by the Technical Assistance Mission.[6] This recognized that, through the joint efforts of the Government of Georgia and the NBG, the prudential regulation and supervision of non-bank credit institutions and their activities had been significantly strengthened. According to the mission, the NBG has significantly improved data collection and on- and off-site inspection processes, resulting in a strengthened supervisory framework for the non-banking sector, the setting of minimum capital and liquidity requirements for microfinance institutions, and raising the transparency standard. According to representatives of the non-banking sector, the NBG's regulations and the supervisory framework have helped to improve the reputation of the sector.

The NBG also developed and launched an off-site supervision portal for non-banking institutions, thus replacing the conventional method for supervised non-banking entities to submit information to the NBG. The portal allows them to upload their reports online and establishes opportunities for remote communication with the NBG.

As of 31 December 2020, the non-bank financial sector was represented by 40 microfinance institutions, 791 currency exchange bureaus (616 head offices and 175 branches), 368 lending entities (198 head offices and 169 branches) and one credit union. The total assets of the non-bank financial sector amount to GEL 2 billion (of which the microfinance sector takes the largest share of GEL 1.5 billion).

Despite the reduction in the number of microfinance institutions in 2020 and the increased demand for pawn loans, the loan portfolio maintained its growth trend, irrespective of the pandemic: 5% annual growth led to a total portfolio of GEL 1.18 billion.

6. See https://www.imf.org/en/Publications/CR/Issues/2020/09/03/Georgia-Technical-Assistance-Report-Strengthening-Regulation-Supervision-and-Oversight-of-49728

Consumer protection and financial education are important focuses for the NBG. The year saw a number of important projects and activities implemented: the legislative framework was upgraded in line with international best practice and communication with the market continued.

The fight against money laundering and terrorism financing are important for the NBG. Following the supervision levels envisaged under the Supervisory Framework for Combating Money Laundering and Terrorism Financing, the NBG established effective, risk-based supervisory measures for supervised entities in 2020. It takes an ongoing and uninterrupted effort to ensure adequate levels of supervisory attention, alongside the remote identification and assessment of risks. The NBG received and processed money laundering and terrorism financing risk supervision reports from each of its supervised entities on more than one occasion during 2020. To this end, a regulation on the Completion and Submission of Money Laundering and Terrorism Financing Risk Supervision Reports and Submission of Information by Lending Entities was developed and approved. The supervision measures implemented during 2020 included both complex and thematic special on-site inspections.

In 2020, the European Council Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) approved Georgia's Fifth Round Assessment Report. The report assesses measures to prevent money laundering and terrorism financing in Georgia, evaluates the technical compliance of the country's legal and institutional framework with the 40 Financial Action Task Force's (FATF) recommendations, and reviews the effectiveness of the country's AML/CFT system. Georgia's Fifth Round Assessment Report highlighted the progress made since MONEYVAL's previous visit, in 2011, in terms of both the effectiveness of the NBG's supervisory tactics and the level of compliance of the financial institutions under its supervision.

The smooth and effective functioning of payment systems is an essential factor for the stability of the financial sector and the development of the national economy. Electronic payments are playing an increasingly important role in the daily lives of each customer. The development of digitalization has a particular impact on the diversity of payment methods. The rate of smartphone use in payments for goods and services is considerably increasing, while payment service providers are trying to make the payment process simpler and more convenient. Planned legislative changes, which are in line with the EU Payment Services Directive (PSD2), encourage the emergence of new players in the payment market, especially from the non-banking sector. New payment services, along with the instant payment system, boost the development of innovative business models, stimulating competition in the payments market. Along with presenting a variety of opportunities, digitalization also carries risks, making the development of an appropriate regulatory framework and supervision function increasingly important. The NBG has developed several legislative documents in this area.

The NBG's statistical activity was further improved during 2020. Interest in the interactive visual reports on the bank's website is growing day by day across a wide circle of users. In order to continuously improve the quality of statistical data, the NBG regularly introduces various methods of data analysis and validation, which

are subsequently shared with the analytical units of commercial banks through the interactive statistics portal. Applicable individualized interactive reports were developed for each commercial bank, as in previous years, the use of which significantly speeds up and simplifies the business process.

In order to ensure an uninterrupted supply of cash to the country's economy and to replenish the NBG's stock of reserves, work continued during the reporting period to ensure the production, issuance and functionality of lari banknotes and coins.

The National Bank of Georgia continued to work on the issuance of collector coins in order to promote the national currency and the country as a whole. In 2020, the NBG issued a 5-lari collector coin that honored King Erekle II (a part of the "Kings of Georgia" series) – 1,500 were produced in silver and 300 pieces in gold. The coins were met with great public approval, as confirmed by their sale.

In 2020, the legislative framework of the National Bank of Georgia continued its pace of development and improvement, with several important draft laws developed and enacted. The Law of Georgia on the Securities Market and the Organic Law of Georgia on the National Bank of Georgia were each amended in relation to harmonization with the EU Transparency Directive and Market Abuse Regulation, as well as membership of the International Organization of Securities Commissions (IOSCO). In 2020, a new Law on Investment Funds came into force. With that, Georgia met its commitment under the EU Association Agreement, with the legislation bringing Georgia closer to the Directive on Undertakings Collective Investment in Transferable Securities (UCITS). Regulations of the National Bank of Georgia were subsequently published based on these legislative acts, thereby completing the legal framework on the issue. Important legal acts were also published on the basis of the Law of Georgia on Payment System and Payment Services, including the “Rule on Strong Customer Authentication” approved by Decree №156/04 of the Governor of the National Bank of Georgia and the “Rule on Card Instrument” approved by Decree №155/04 of the Governor of the National Bank of Georgia, both on 2 September 2020. In order to fully implement the Recovery and Resolution Framework for Commercial Banks, approved as a result of legislative changes enacted at the end of 2019, the National Bank of Georgia developed various applicable regulations. The legislative framework was complemented by legal acts regarding banking supervision, non-banking supervision and other important functions of the National Bank of Georgia.

In 2020, during the ongoing pandemic, the NBG's efforts to maintain a stable macroeconomic and financial environment were reflected in Georgia maintaining its credit ratings of international rating agencies. Since 2017, Georgia's sovereign rating has gradually increased. In 2017, Moody’s increased Georgia's sovereign credit rating to Ba2. In 2019, Standard & Poor's (S&P) raised Georgia's sovereign rating to "BB" with a stable outlook. In the same year, Fitch Ratings, the second-largest international rating company, upgraded Georgia's sovereign credit rating from "BB-" to "BB". In 2020, due to the negative impact of the COVID-19 pandemic on tourism and tourism-related business activities, as well as the increasing fiscal pressures and external risks due to healthcare and social needs, Fitch Ratings

downgraded the country's outlook from stable to negative, however, it reaffirmed the rating at "BB". The reaffirmation of the rating was conditioned on the successes that Georgia achieved, reflective of the high degree governance and consistent macroeconomic policy in spite of the pandemic, global uncertainties and rising external risks. Such assessments of the investment environment in Georgia further strengthen the confidence of international institutions and investors towards Georgia and have a positive impact on the business environment in the country.

Both before and during the pandemic, the NBG’s activities were timely and appropriate. This is has been affirmed by numerous trustworthy international organizations, including the IMF, the World Bank, ADB, EBRD, and the international ratings companies.

It is also worth noting that the world's leading financial editorial, Global Finance, named Koba Gvenetadze, Governor of the NBG, among the Best Central Bankers of the year for the third consecutive time.

MACROECONOMIC ENVIRONMENT

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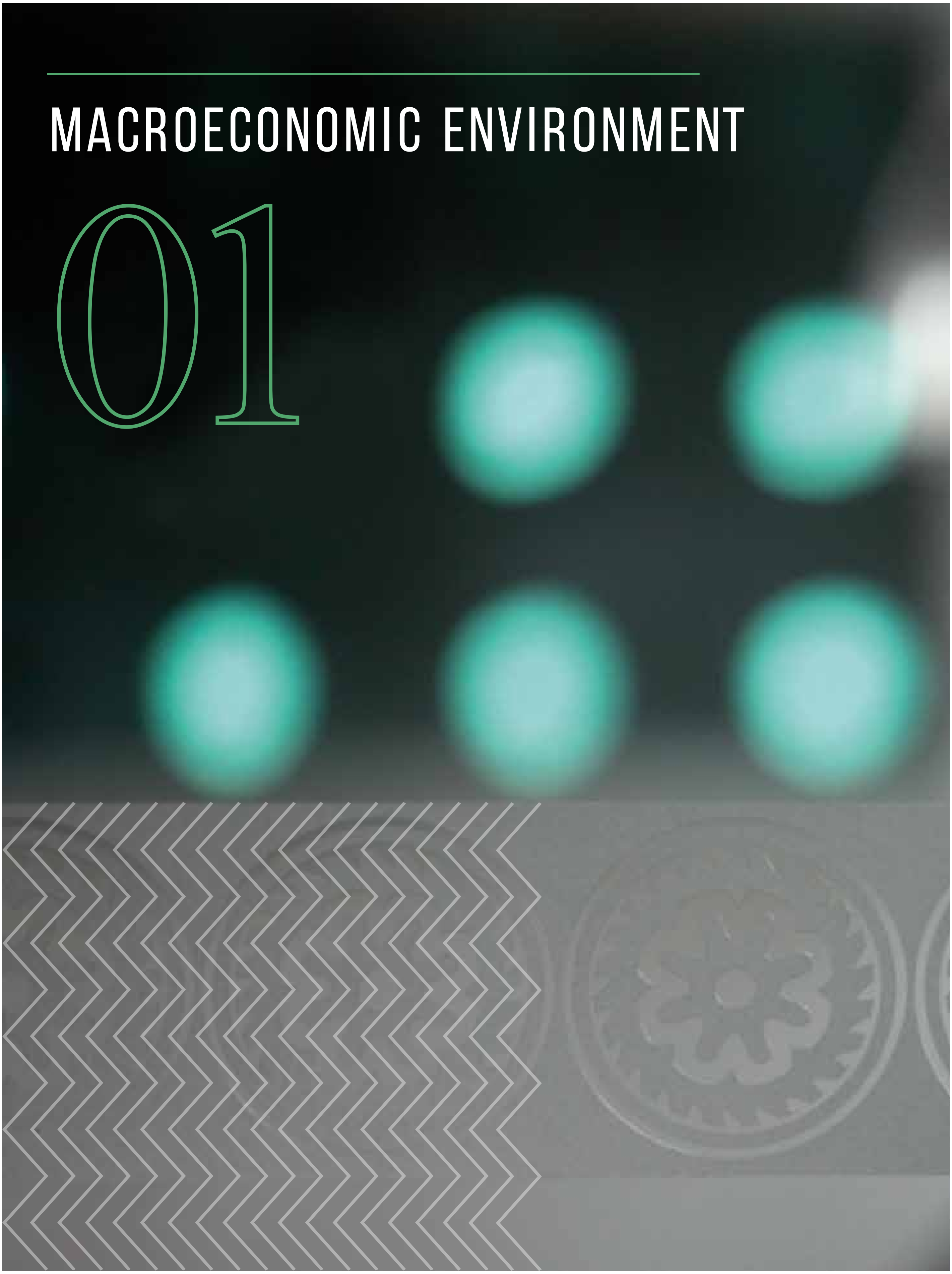


1.1 WORLD ECONOMY

The year 2020 has been challenging for the global economy. Amid restrictions imposed due to the COVID-19 pandemic, economic and business activities have been hampered. Following the declaration of a state of emergency and the subsequent national lockdowns, aggregate demand deteriorated, with supply chains and production processes disrupted. This led to a deep recession in developed as well as in emerging and developing countries. Most employed people transferred to remote (distance) working arrangements. However, in the second half of the year, with a gradual easing of restrictions, economic activity slightly recovered. Overall, according to the International Monetary Fund's (IMF) April 2021 forecast, the global economy declined by 3.3% in 2020.[7] After the spread of the virus slows, economic activity should stabilize, and growth in 2021 is projected at 6%. In the eurozone and the UK, along with the rapid spread of COVID-19, the manufacturing and tourism sectors deteriorated, and retail sales fell. Due to reduced demand from trading partners, exports and investments decreased. Amid the pandemic, the European Central Bank (ECB) resumed quantitative easing.

Economic activity also fell sharply in emerging and developing countries. The tourism sector deteriorated and production processes and sales declined with the closure of firms. This was supplemented by a sharp drop in oil prices, resulting in a decrease in the volume of exports and investments. In a deep recession, central banks started easing monetary policy to encourage domestic demand. According to the IMF, the real GDP of emerging and developing countries declined by 2.2% in 2020.[8]

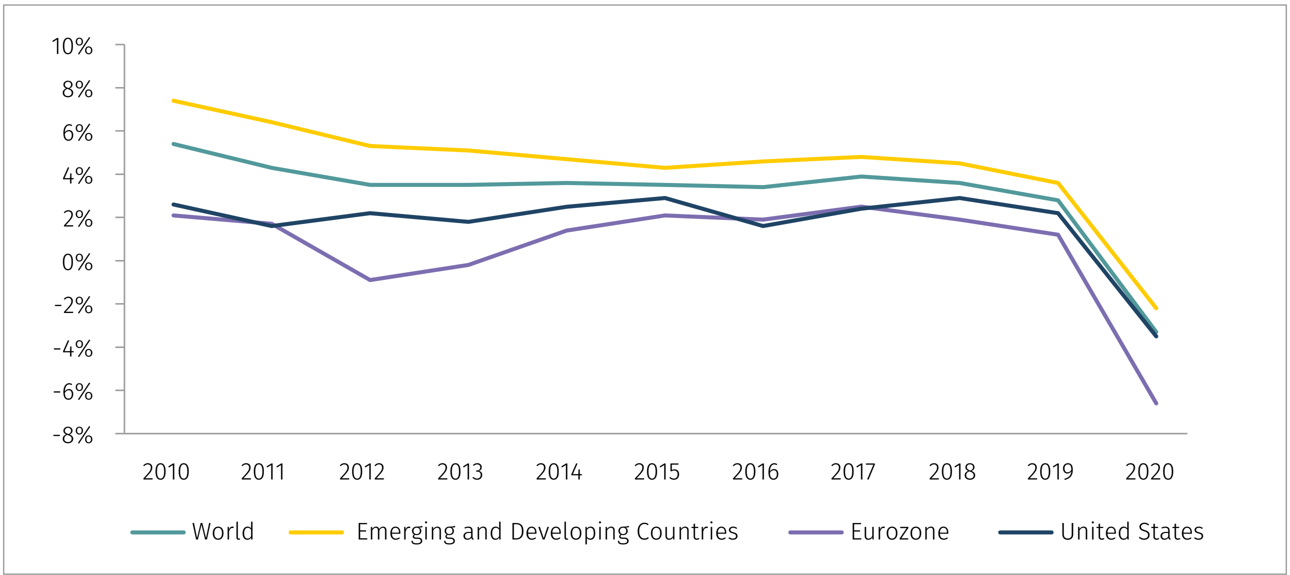
In the first half of 2020, amid pandemic-related constraints, economic activity fell to a record low in the United States. The level of unemployment increased significantly. Private consumption and retail sales declined, and, with the closure of firms, industrial production deteriorated. Consumer and business sentiment fell as a result of lockdowns in individual states. In addition, the sharp drop in oil prices had a negative impact on the investment environment. However, in the second half of 2020, growth rates slightly stabilized, mainly due to an easing of pandemic-related restrictions. Amid a decline in imports, the external sector recovered slightly. The unemployment rate also declined. Overall, according to the IMF, the real economy in the US declined by 3.5% in 2020.[9] Annual inflation stood at 1.2%. To encourage domestic demand, fiscal spending increased through the year, while the US Federal Reserve eased its monetary policy in early 2020 and cut the federal funds rate sharply (from 1.5-1.75% to the 0-0.25% range).

7. International Monetary Fund. 2021. World Economic Outlook: Managing Divergent Recoveries. Washington, D.C., April.

8. Ibid.

9. Ibid.

DIAGRAM N 1.1 GLOBAL REAL GDP GROWTH



Source: International Monetary Fund

Along with the rapid spread of COVID-19, the mass closure of countries and disruptions to the global economy had dire consequences for Georgia's trading partners, which experienced deteriorating consumer and business sentiment amid a global recession. The manufacturing and tourism sectors worsened due to the closure of borders and firms. The volume of exports and investments also decreased significantly. The year was particularly difficult for developed economies, including those in the eurozone. The production process in Germany worsened and retail sales declined. Consumer and business sentiment deteriorated, while the volume of exports and investments decreased significantly. According to the IMF, the real economy in Germany declined by 4.9% in 2020.[10] Italy, one of the first countries in Europe to experience a rapid COVID-19 outbreak, also found itself in a difficult situation. As a result, Italy's real economy declined by 8.9% in 2020. The pandemic also hit France hard, with the various lockdowns in the country having dire consequences for the economy. According to the IMF, France's real economy declined by 8.2% in 2020.[11] Spain also had a difficult year, with fairly high rates of infection during the year being accompanied by severe restrictions from the state. As a result, Spain's real economy declined by 11% in 2020. Annual inflation in the eurozone in 2020 was 0.3%.

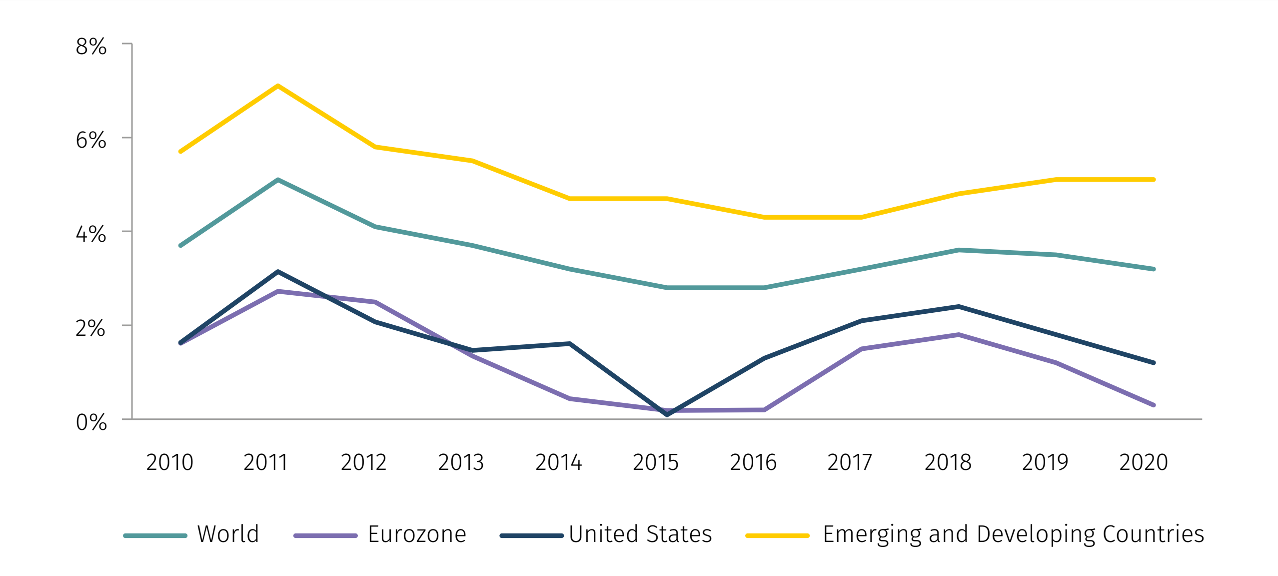
In early 2020, Turkey saw some economic recovery, although the onset of the COVID-19 pandemic changed the situation radically. Both domestic and external demand deteriorated. Restrictions imposed due to the pandemic significantly reduced economic activity. The manufacturing and tourism sectors deteriorated, as did consumer spending and consumer sentiment. Business sentiment fell to its lowest level since 2009. The volume of exports and investments also decreased. Inflationary pressures remained high throughout the year. According to the IMF, Turkey's real economic growth was 1.8% in 2020.[12] Inflation stood at 12.3% in 2020.

10. International Monetary Fund. 2021. World Economic Outlook: Managing Divergent Recoveries. Washington, D.C., April.

11. Ibid.

12. Ibid.

DIAGRAM N 1.2 GLOBAL CPI INFLATION



Source: International Monetary Fund

The year turned out to be particularly tough for Russia. Against the backdrop of the pandemic, the manufacturing sector deteriorated and, with falling oil prices, export volumes fell further. The volume of investments decreased significantly, while the unemployment rate increased. The depreciation of the ruble and disruptions to supply chains led to a significant slowdown of the economy. According to the IMF, Russia's real economy reduced by 3.1% in 2020, while inflation stood at 3.4%.[13]

Low economic activity was observed in Ukraine, where industrial production and consumer spending saw a significant reduction. Exports and investment deteriorated as a result of restrictions imposed to prevent the spread of COVID-19. Although consumer spending picked up slightly after July, due to prolonged restrictions within the country, the situation worsened again towards the end of the year. The annual inflation rate was low as a result of reforms implemented by the government and the central bank. According to the IMF, Ukraine's real economy fell by 4.2% in 2020, while inflation was 2.7%.[14]

Amid the difficult epidemiological situation, economic activity fell sharply in Armenia in 2020. The closure of firms caused a reduction in industrial production and trade. Consumer and business sentiment deteriorated and remittances from Russia decreased. On top of this, there was the military conflict with Azerbaijan. As a result, Armenia's external sector worsened alongside a weakening of the export growth rate and increased imports. Along with high foreign debt, Fitch downgraded the country's credit ranking from BB- to B+. According to the IMF, Armenia's real GDP reduced by 7.6% in 2020 and inflation stood at 1.2%.[15]

13. International Monetary Fund. 2021. World Economic Outlook: Managing Divergent Recoveries. Washington, D.C., April.

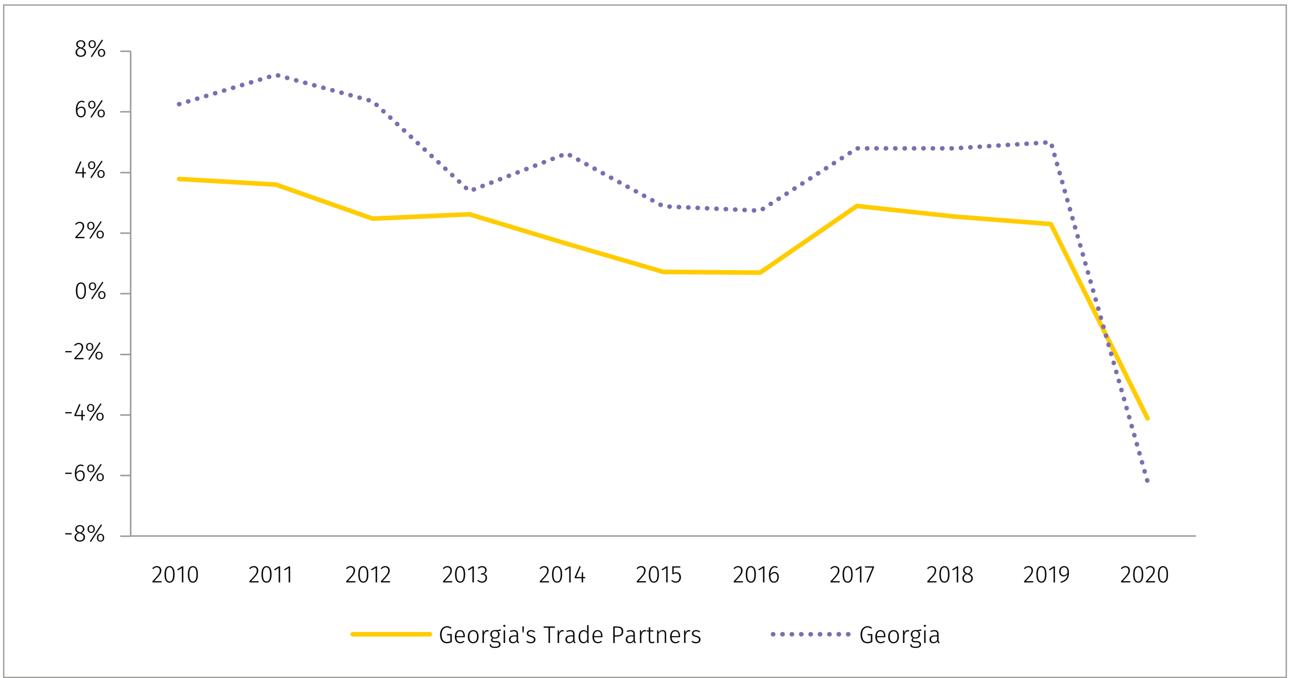
14. Ibid.

15. Ibid.

In Azerbaijan, economic activity slowed in both the oil and the non-oil sectors. Amid a collapse in oil prices, oil extraction and production decreased, which led to a deterioration in exports and external demand. The military conflict with Armenia also affected the economy. According to the IMF, the real economy in Azerbaijan reduced by 4.3% in 2020, and inflation was 2.8%.[16]

In total, the economies of the Georgia's trading partner countries declined by 4.1% on average in 2020, while the weighted average growth in 2019 was 2.3%.[17] Meanwhile, according to preliminary estimates, Georgia's economy declined by 6.2% in 2020, while real GDP growth was 5% in 2019 (see Diagram N 1.3).

DIAGRAM N 1.3 REAL GDP GROWTH IN GEORGIA AND WEIGHTED AVERAGE GROWTH OF ITS TRADING PARTNERS



Source: International Monetary Fund

The central banks of Georgia's main trading partners reduced their monetary policy rates several times in 2020 in an effort to encourage domestic demand amid the COVID-19 pandemic. The only exception to this is Turkey, where the main policy rate was increased to 17% in December 2020 (up from 10.25% in September). The US Federal Reserve has also eased its monetary policy and cut the federal funds rate from 1.5-1.75% to 0-0.25% at the beginning of the year. Meanwhile, the European Central Bank kept its interest rates unchanged at 0%, however, to mitigate the negative effects of the pandemic, the ECB implemented a broad quantitative easing program that can be considered equivalent to monetary policy easing.

16. Ibid.

17. The weighted average growth of Georgia's trading partners is calculated according to the trade shares of the partner countries.

1.2 EXTERNAL SECTOR AND BALANCE OF PAYMENTS

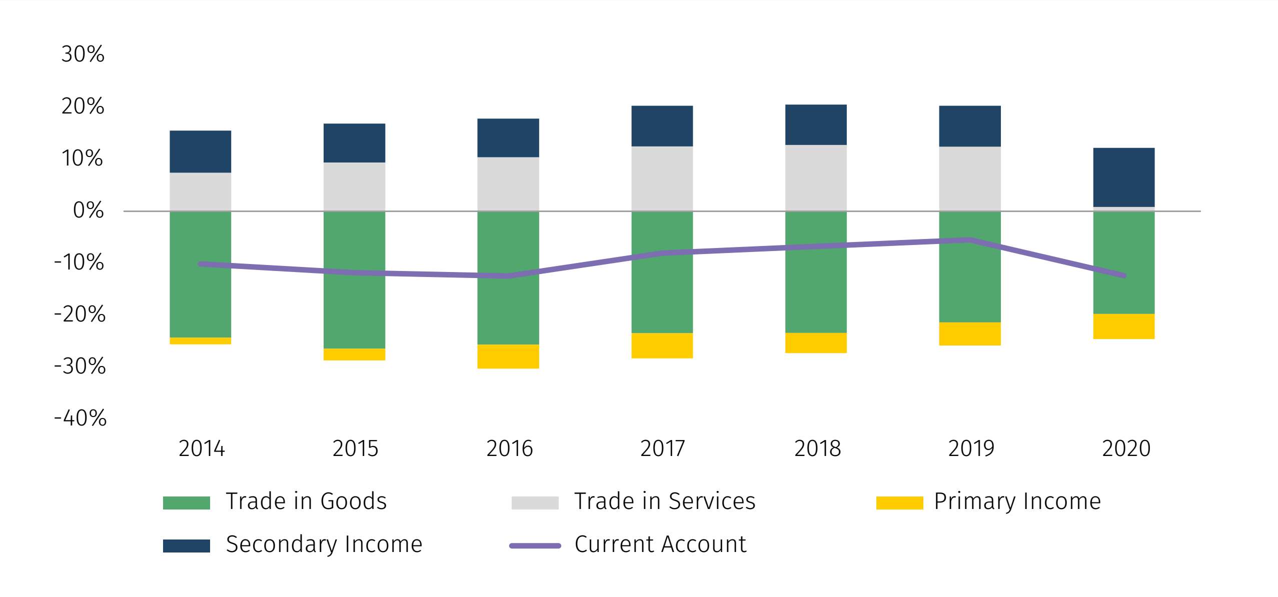
In 2020, external demand declined substantially, adversely affecting economic growth. This was due to the unprecedented COVID-19 pandemic and the attendant growth of economic uncertainty in the world. The restrictions imposed to tackle the pandemic had a negative impact on international tourism, including in Georgia. Since March, the number of international travelers to Georgia fell to a minimum level, which adversely impacted revenues from tourism and tourism-related businesses. Despite the fact that the government and the National Bank of Georgia pursued timely and consistent economic policies amid the instant financial assistance received from international institutions, the adverse external shock hit several areas of the national economy. Aggregate demand fell sharply, and business expectations deteriorated. The decline in external demand was also reflected in the balance of payments, especially in terms of a worsening service sector balance. As a result, the current account deficit in 2020 amounted to 12.4% of GDP – a significant deterioration compared to the 5.5% observed in 2019, which was the lowest level for Georgia since the 2000s (see Diagram N 1.4).

International travel restrictions and a slowdown in the economic activity of trading partner countries had a negative impact on Georgia's export revenues. In light of reduced external and domestic demand, imports of goods also declined. In overall terms the trade deficit improved, as exports of goods declined more moderately compared to the fall in imports of goods. However, in contrast to the growth of previous years, exports of services, in particular revenues from international travelers, decreased significantly and remained low throughout the year. This, in turn, completely outweighed the improvement in the trade deficit and induced a worsening of the current account deficit. Following the end of the first wave of the pandemic, the relative recovery of the economic situation in the EU and some regional countries had a positive impact on the dynamics of the inflow of instant money transfers into the country.

The current account deficit for 2020, 12.4% of GDP, is 6.9 percentage points higher than the previous year. In absolute terms, the current account deficit deteriorated by USD 1,005 million to USD 1,965 million (see Table N 1.1). The commodity trade deficit improved by 1.6 percentage points of GDP (by USD 597 million) in 2020 to 19.8% of GDP. Amid a sharp drop in revenues from international travelers (-83.4%), the trade surplus in services substantially reduced, leading to a worsening of the current account deficit. The current account balance in 2020 was negatively affected by the primary income[18] deficit, fueled by the outflow of investment income. 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.

18. Primary income is part of the current account balance of payments that includes the incomes of a country's residents and nonresidents associated with the production process and property (compensation of employees, investment income, etc.).

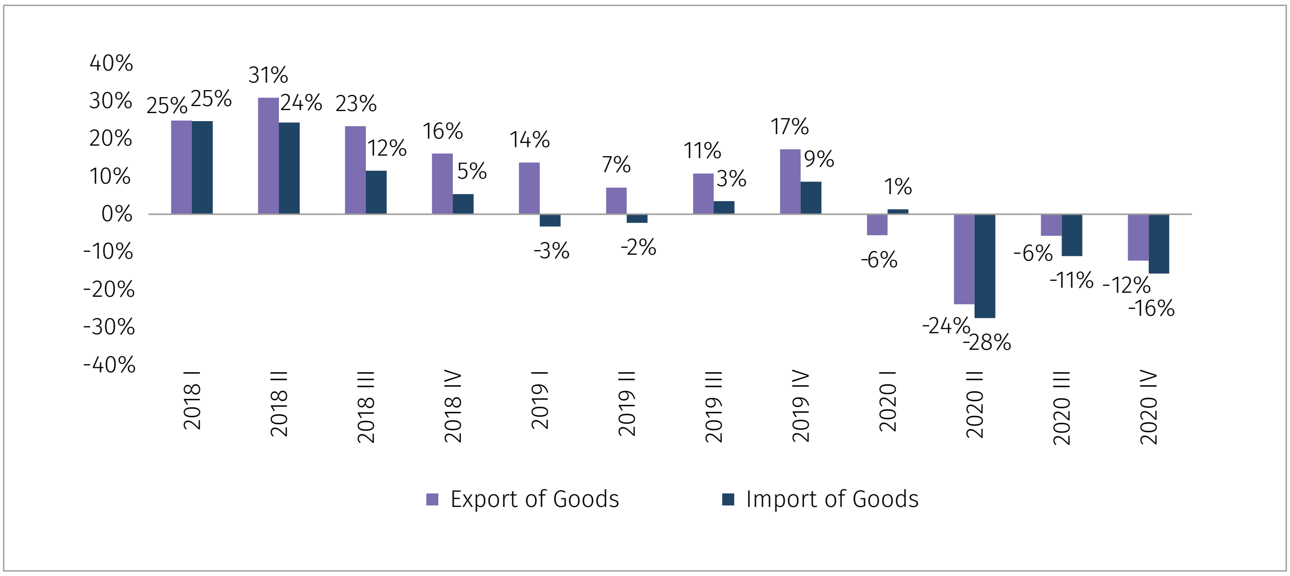
DIAGRAM N 1.4 RATIO OF CURRENT ACCOUNT COMPONENTS TO GDP



Source: National Bank of Georgia

The trade balance remains the most negative component of the current account. However, in 2020, the trade deficit in goods improved by 1.6 percentage points of GDP compared to the previous year and amounted to 19.8% of GDP, as imports showed a greater decline than exports. As already mentioned, during 2020, exports of goods decreased significantly. In the first half of the year, the decline in exports of goods, both in the region and globally, was due to the slowdown in production processes and restrictions placed on economic activities in an effort to curb the COVID-19 pandemic. In the second half of the year, exports declined less, largely owing to the easing of restrictions and the relative revival of economic activity. Overall exports of goods fell by 12.0% annually. Meanwhile, due to the decline in domestic demand, imports of goods fell substantially from the second quarter of 2020. Overall imports of goods fell by 13.7% annually. As a result, the trade deficit narrowed and had a less negative contribution to the current account deficit than in the previous year (see Diagram N 1.5).

DIAGRAM N 1.5 ANNUAL GROWTH RATES OF EXPORTS AND IMPORTS OF GOODS (2018-2020)[19]



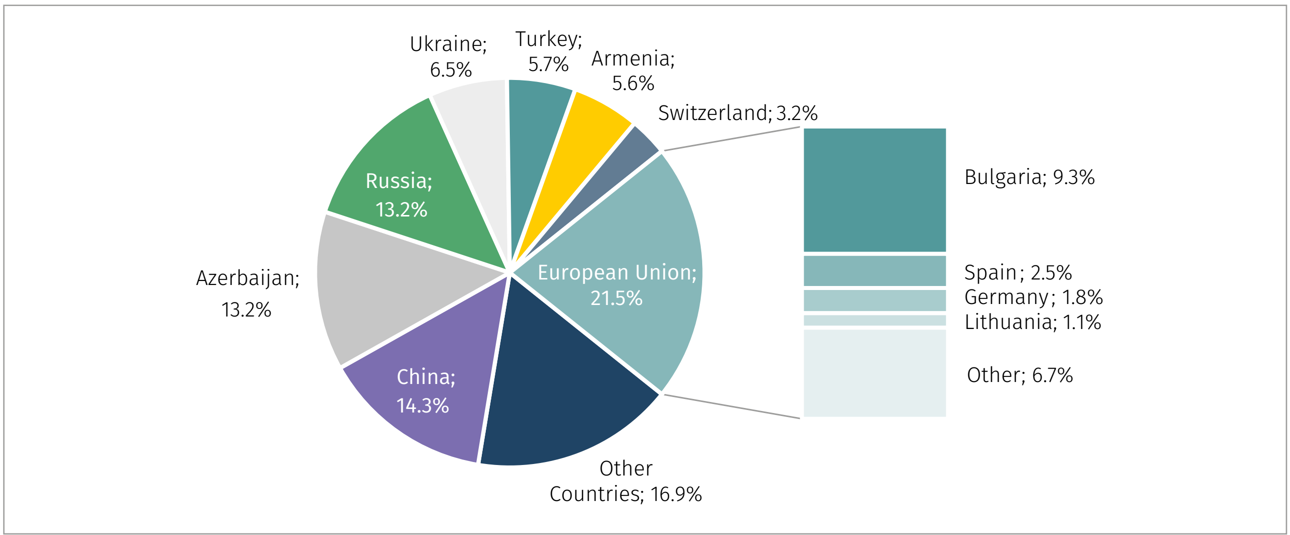
Source: National Bank of Georgia

Exports of goods from Georgia decreased in almost all trade partner countries. In 2020, exports declined to both the EU (-12.5%) and other countries in the region. Romania (-88.5%) and Lithuania (-20.7%), saw the largest declines in exports, while Spain (81.9%) and Bulgaria (10.0%) picked up. The decrease in exports to regional countries was mainly due to the decrease in exports to Armenia (-56.6%), Azerbaijan (-13.2%) and Russia (-153.3%). Exports to the US (-39.5%) and Iran (-59.1%) also shrank.

In terms of exports, the EU was the largest trade partner of Georgia in 2020, accounting for 21.5% of total exports, the other main partners in terms of exports were Azerbaijan (13.2%), Russia (13.2%), Ukraine (6.5%) and Turkey (5.7%). Exports to China accounted for 14.3% of total exports, representing growth of 113% annually. The largest share of these exports (91%) continued to be related to the re-export of precious metals, as well as copper ores and concentrates.

19. Exports of goods in the balance of payments (BOP). The external trade data provided 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 the external trade statistics, exports are presented in FOB price, while imports are presented in CIF price. In contrast, export/import of goods are presented in FOB prices in the BOP.

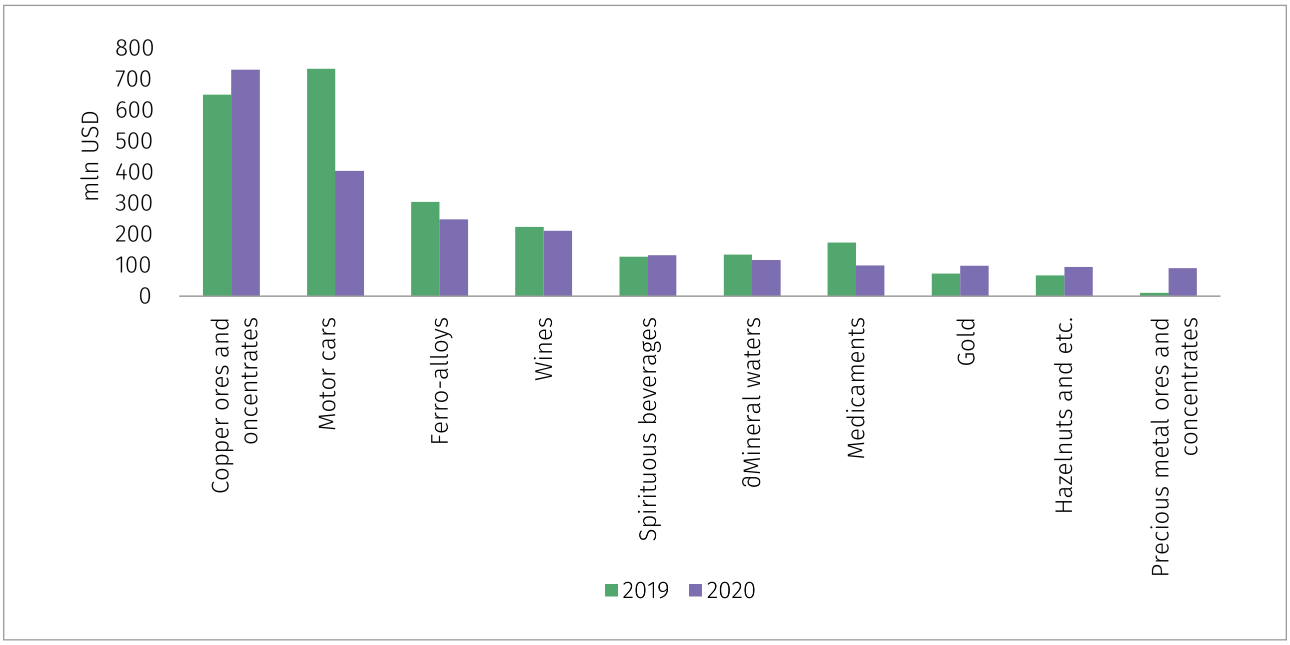
DIAGRAM N 1.6 EXPORTS STRUCTURE BY COUNTRY (2020)



Source: GeoStat

In 2020, re-exports of copper ores and concentrates accounted for a significant share of commodity exports, which increased by 12.3% compared to the previous year and accounted for 21.8% of total exports. In addition, despite a significant decrease (-44.9%) compared to the previous year, exports of motor cars continued to have a high share. Exports of ferro-alloys, natural grape wines, and mineral waters retained the top positions in the categories of locally produced goods, showing a reduction of 18.5%, 5.6% and 12.7% respectively. Exports of cigarettes, most of which were re-exports, also substantially reduced. In contrast, exports of alcoholic beverages, unprocessed gold, hazelnuts and walnuts all increased. Overall, in 2020, exports of goods decreased by 12.0%, while exports (excluding re-exports) increased by 3.5%.

DIAGRAM N 1.7 TOP 10 EXPORT COMMODITIES (2019-2020)



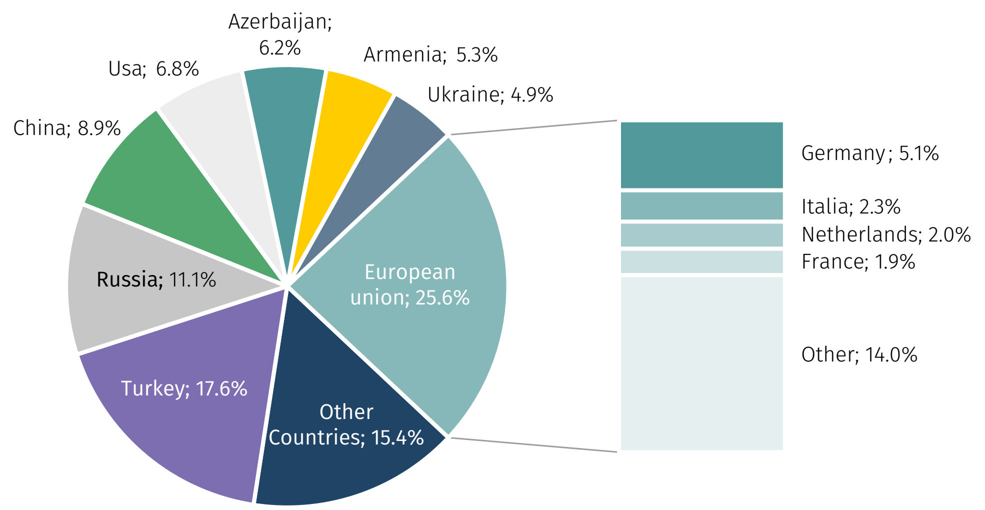
Source: GeoStat

In 2020, the largest decline was observed in imports of consumer goods. This was a result of both falling domestic demand and a decrease in re-exports, particularly of motor cars. Petroleum and petroleum products, one of the largest imported consumer goods, also decreased (with a 6.2% share of total imports). The latter was significantly affected by the decline in international petroleum prices during the year. In 2020, spending on imports of petroleum and petroleum products fell by 34.2%, of which the price effect was responsible for -31.5 percentage points, while real consumption fell by 2.7%. The decline in imports of intermediate goods stemmed from lower imports of copper ores and concentrates, as well as of petroleum gas. Motor cars, copper ores and concentrates, medicaments, and cigarettes and cigarillos, which are leading re-export categories, also contributed significantly to the decline of total imports of goods (by 7.3 pp). Construction equipment and special purpose vehicles also showed a high rate of decline in imports of investment goods.

A regional analysis of imports shows that imports decreased from both the EU (-20.2%) and other countries (-14.4%) in 2020. The decline in imports of registered goods amounted to 15.9% annually. Turkey (-2.2 pp), China (-1.6 pp) and Iran (-1.5 pp) each made high contributions to this decline. The decline in imports from Germany (-1.0 pp) and Romania (-1.0 pp) contributed significantly to the decline in total imports from EU countries. Imports also dropped due to lower purchases of petroleum and petroleum products from Turkmenistan and Azerbaijan.

Similar to previous years, in 2020, after the European Union, Turkey topped the list of importer countries, from where imports decreased by 13.0% annually. Imports from Russia fell by 9.2% and comprised 11.1% of total imports. Those from the US and Japan also declined, mainly as a result of lower purchases of motor cars (see Diagram N 1.8).

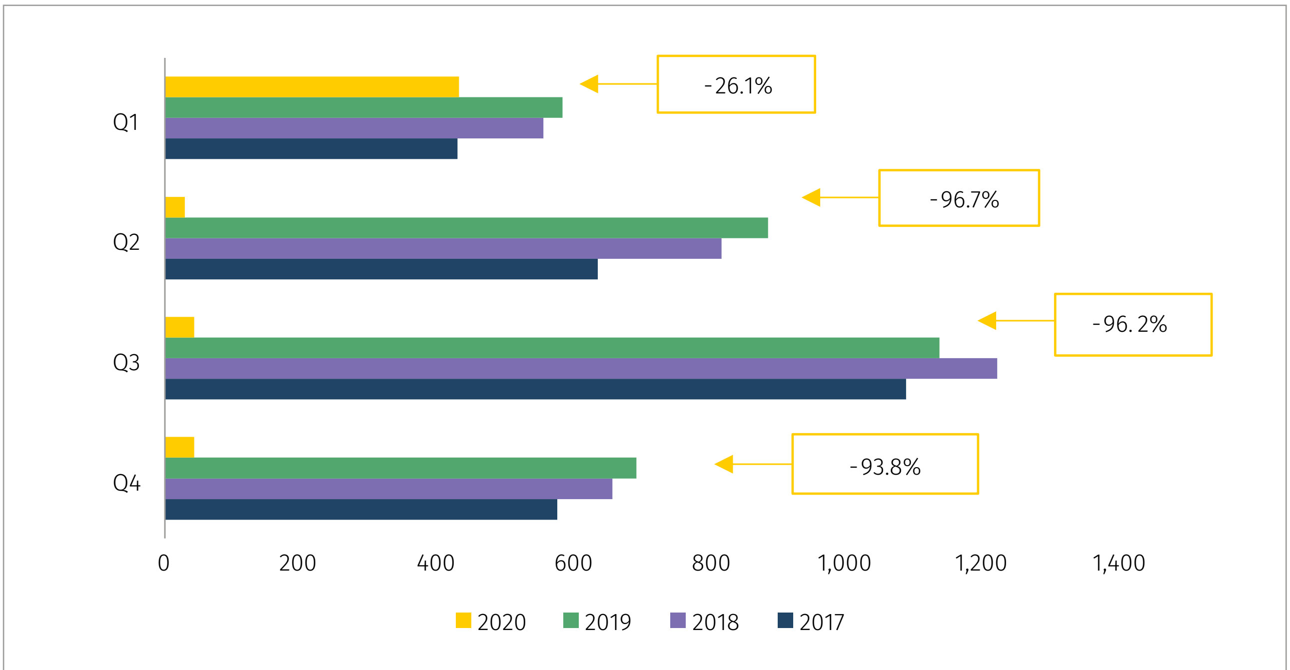
DIAGRAM N 1.8 IMPORT STRUCTURE BY COUNTRY (2020)



Source: GeoStat

In 2020, the balance of trade in services had a positive impact on the current account, albeit only slightly. The ratio of service surplus to GDP was 0.8%, which is 11.6 percentage points lower than the previous year. In absolute terms, the positive balance of trade in services in 2020 was USD 2,046 million less than in the previous year and only stood at USD 130 million. Global restrictions (stopping international air and land mobility) aimed at curbing the spread of the coronavirus had an adverse effect on the export of services, especially on tourism and tourism-related business activities. As a result, revenues from international travelers, which account for the bulk of services exports, stood at USD 542 million in 2020, down 83.4% from the previous year (see Diagram N 1.9). In previous years, revenues from international travelers was one of the most important sources of financing the trade deficit.

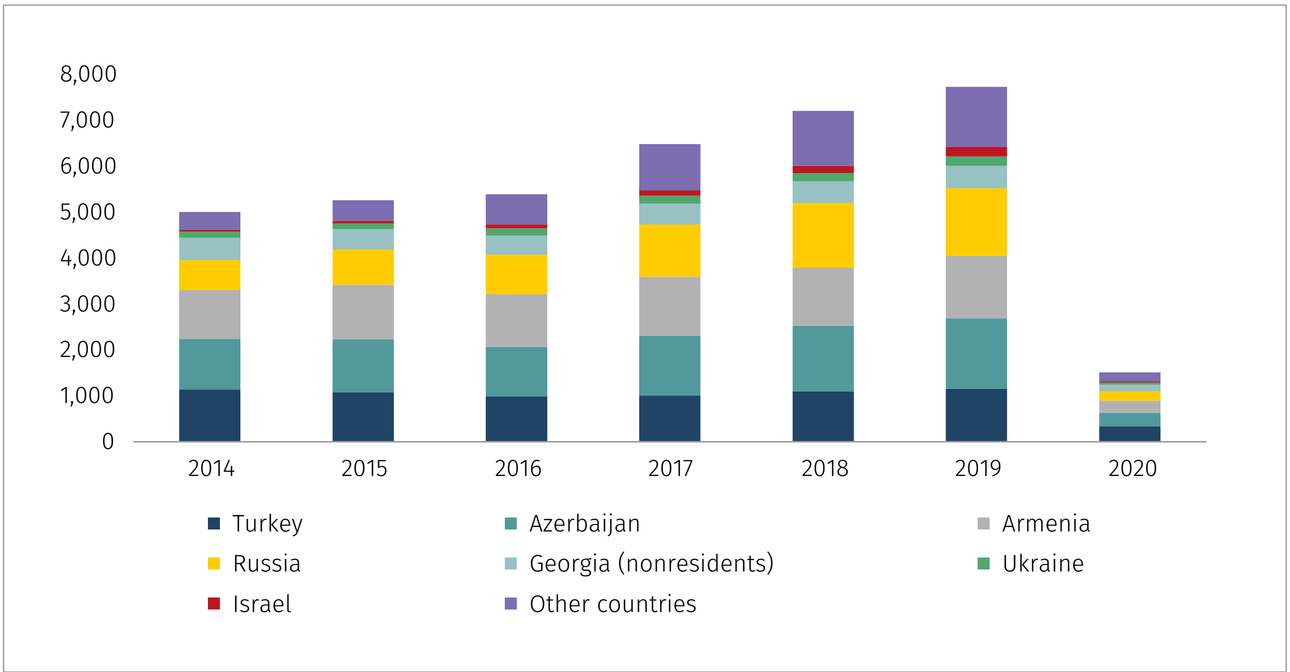
DIAGRAM N 1.9 REVENUES FROM EXPORTS OF TOURISM (2017-2020)



Source: National Bank of Georgia

In 2020, in the aftermath of restrictions imposed on international mobility and the semi-closure of the economy, the number of international visitors decreased by 84.3% annually. This decrease was most acute from a lower number of visitors from Russia (-85.8%), Azerbaijan (-80.7%), Armenia (-80.9%) and Turkey (-71.0%). The number of visits made by Georgian residents abroad also decreased significantly (-74.1%).

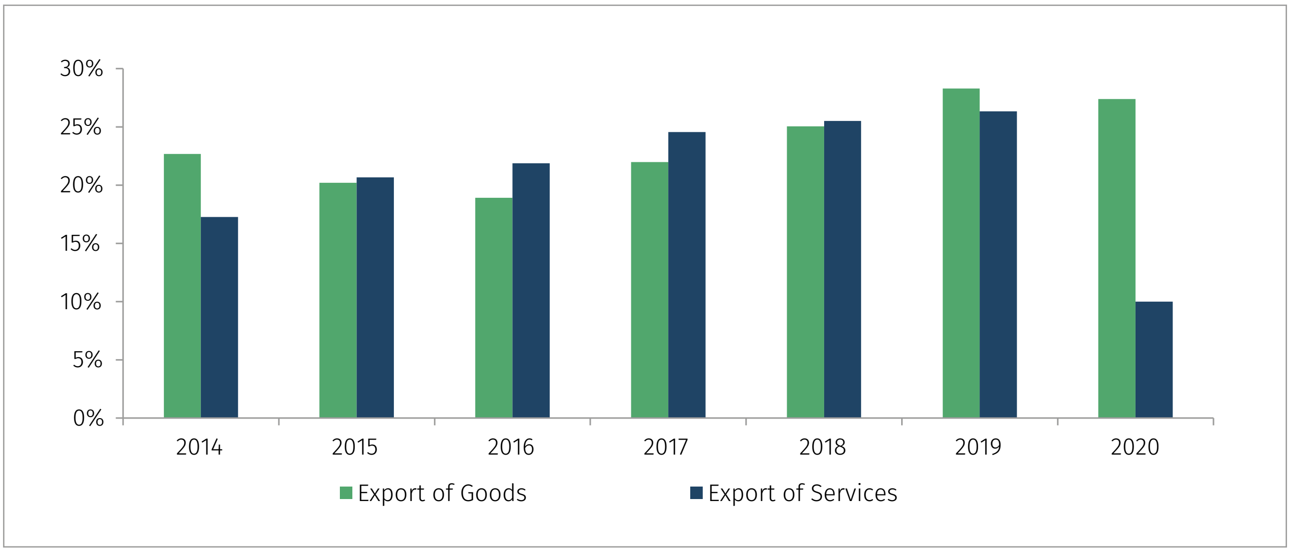
DIAGRAM N 1.10 NUMBER OF INTERNATIONAL VISITORS TO GEORGIA BY COUNTRY



Source: Georgian National Tourism Administration

In contrast to previous years, revenues from tourism were significantly lower than those from exports of goods (see Diagram N 1.11). That, in turn, played a role in worsening the current account deficit.

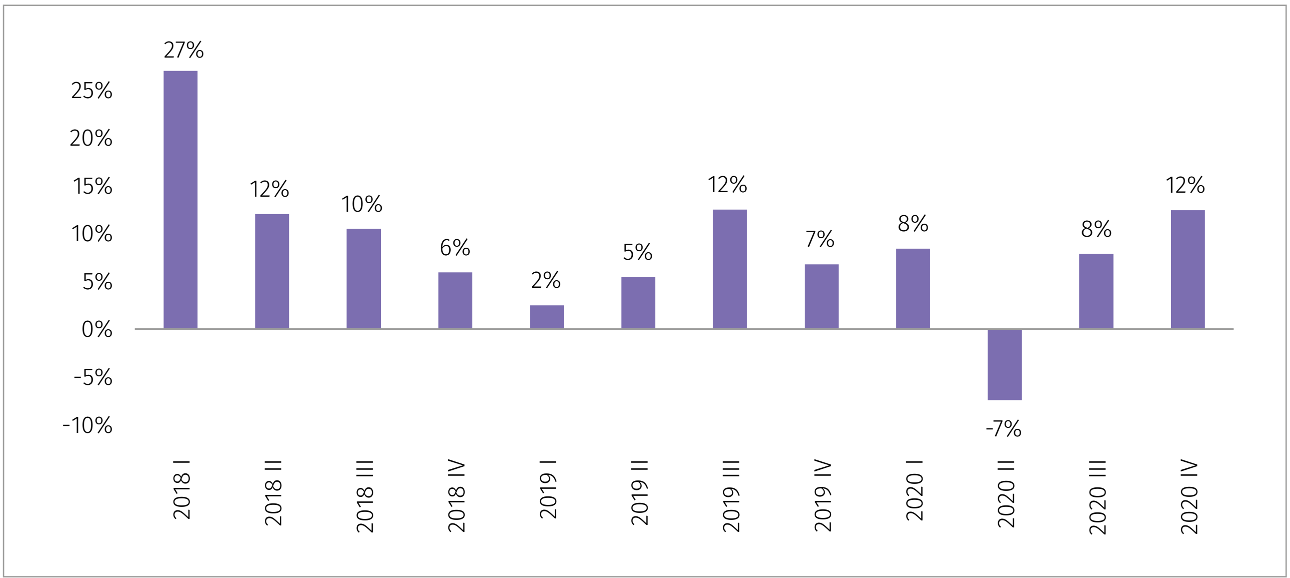
DIAGRAM N 1.11 THE RATIO OF REVENUES FROM EXPORT OF GOODS AND SERVICES TO GDP



Source: National Bank of Georgia

The primary income account deficit in 2020, compared to the previous year, decreased by USD 10 million to USD 765 million. The main reason for the high deficit of the primary income account remains the negative balance of investment income, which decreased by USD 329 million in 2020 and amounted to USD 1.3 billion. This was induced by a worsening of the investment income account in terms of direct and other investments – specifically the increase of distributed dividends and reinvested earnings. Although the latter has a negative impact on the current account balance, it is shown in the financial account under foreign direct investments and thus did not induce capital outflows. Moreover, the balance of compensation of employees decreased by USD 318 million in 2020, amounting to USD 488 million. This decline is partly due to the slowdown in economic activity in regional countries and other negative consequences of the pandemic.

DIAGRAM N 1.12 ANNUAL GROWTH RATE OF PERSONAL REMITTANCES

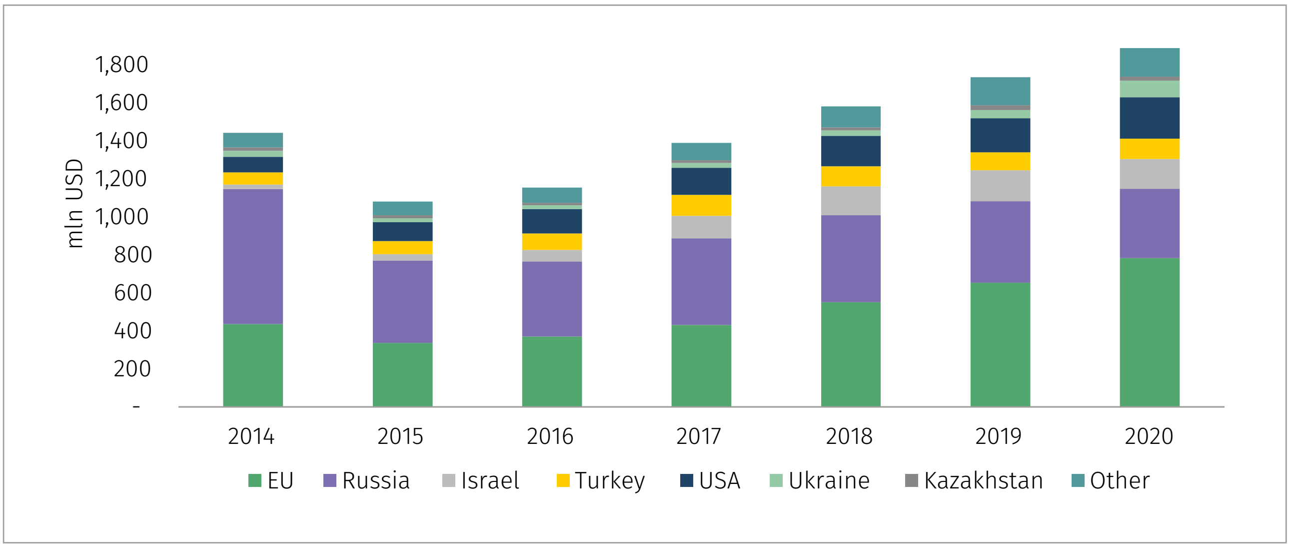


Source: National Bank of Georgia

In 2020, secondary revenues increased significantly (by 31.6%) at the expense of increased remittances from abroad.[20] Personal remittances, which are usually the largest part of secondary income, increased by 5.5% per year (see Diagram N1.12). After a decline in April and May, the volume of remittances picked up again from mid-summer. Larger remittances from Italy, Ukraine, Azerbaijan and Greece made a significant contribution to the increase in remittances during 2020 (see Diagram N 1.13). The volume of remittances from Russia, Kazakhstan and Kyrgyzstan has gradually been declining and contributed negatively to the annual growth of remittances.

20. Secondary income is part of the current account balance of payments that shows current transfers (excluding capital transfers) between residents and non-residents (personal transfers, budgetary transfers and grants in the framework of international cooperation, social contributions and benefits, etc.).

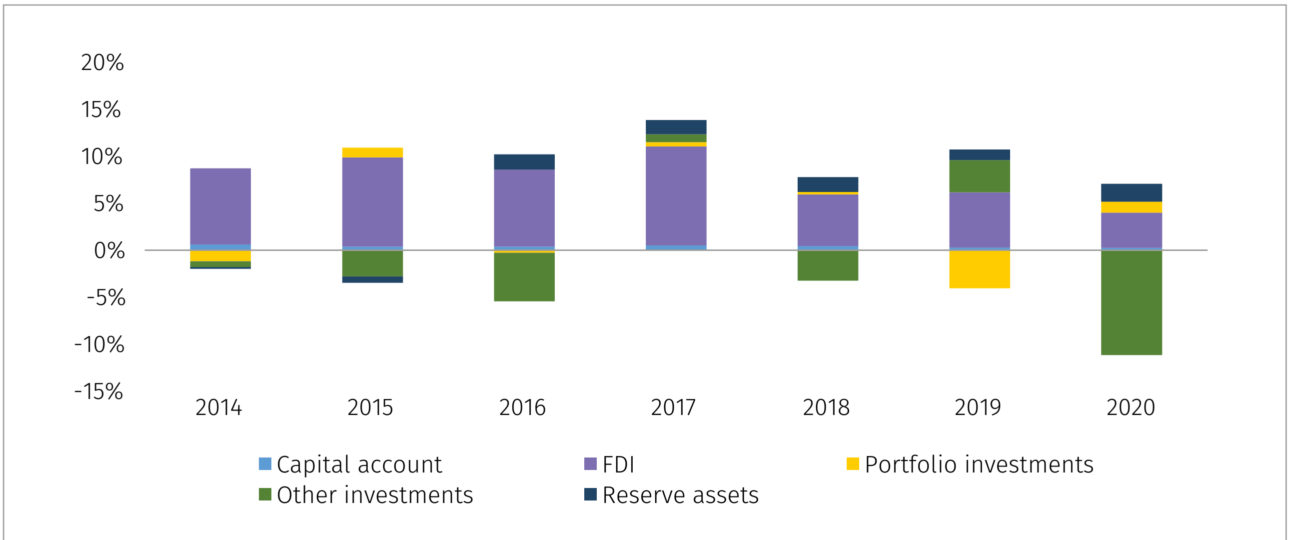
DIAGRAM N 1.13 MONEY TRANSFERS BY COUNTRY



Source: National Bank of Georgia

In 2020, despite a decline, net foreign direct investment remained a significant source of financing the current account deficit (see Diagram N 1.14). Foreign direct investment in Georgia amounted to USD 617 million, which was 52.9% less than the previous year. The majority of foreign direct investments were directed towards the finance, mining, manufacturing and real estate sectors. Compared to the previous year, investments were mostly reduced in the energy, hotels, restaurants and transport sectors.

DIAGRAM N 1.14 FINANCING THE CURRENT ACCOUNT DEFICIT (IN % OF GDP)



Source: National Bank of Georgia

In the light of the increased current account deficit and reduced inflows from the private sector in the financial account, it was important to attract increased government funding from international institutions to make up for the shortfall. Public sector net inflows in 2020 amounted to USD 1.45 billion, which was USD 1.10 billion more than in 2019. Of note are the significant financial resources that were made available by the World Bank, the French Development Agency, the Asian Development Bank, the German Bank for Reconstruction and Development, and EU institutions that were directed to fund anti-pandemic measures and increased healthcare costs. In addition, within the framework of the Extended Fund Facility of the International Monetary Fund, the National Bank of Georgia and the government received 226 million SDR[21] (USD 315 million) as a loan to address the immediate needs of the balance of payments posed by the pandemic. In terms of portfolio investments in the financial account, the main part of the decrease in liabilities was due to reduced investments in the banking sector.

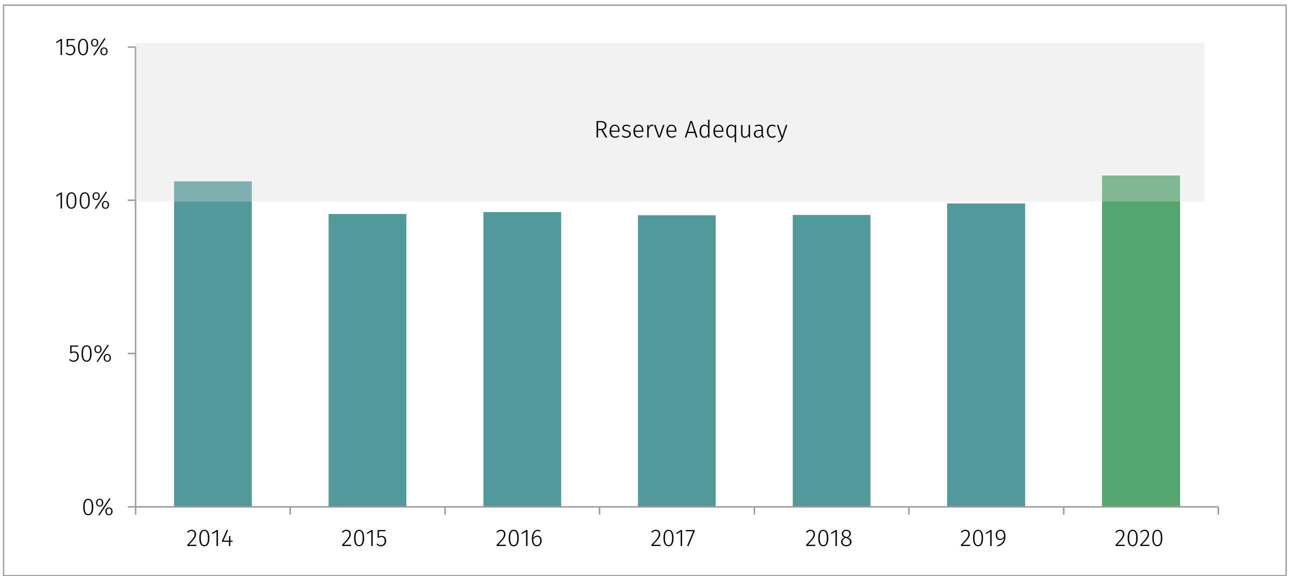
In 2020, official reserve assets increased by USD 404.8 million to USD 3.91 billion. In 2020, official reserve assets increased by USD 404.8 million to USD 3.91 billion. Funds raised from international organizations, which were accumulated on the government's account in the National Bank of Georgia, as well as operations with commercial banks concerning increased stock of reserves requirements, worked well in direction of increasing reserve assets. Foreign exchange interventions, foreign debt service and government foreign exchange expenditures are all noteworthy in terms of the reduction of assets. In 2020, the National Bank of Georgia provided USD 916 million to the foreign exchange market through foreign exchange interventions. The government's debt service in foreign currency and the government's foreign exchange expenditures on goods and services totaled about USD 750 million. In addition to these foreign exchange expenditures, foreign exchange interventions were largely financed by the loans and grants obtained by the government.

According to the reserve adequacy assessment (based on the IMF's ARA methodology[22]), Georgia's level of international reserves by the end of 2020 was around 108%. As defined by the same methodology, this is within the level (100-150%) necessary to ensure protection against external and liquidity shocks. By the end of 2020, the ratio of reserves to months of imports (forecasted imports of 2021) was around 5.1 months.

21. Special Drawing Right – an international reserve asset created by the IMF.

22. For more details on the IMF's ARA methodology, see https://www.imf.org/external/np/spr/ara/

DIAGRAM N 1.15 ASSESSMENT OF INTERNATIONAL RESERVE ADEQUACY ACCORDING TO THE IMF'S METHODOLOGY (ARA METRICS)



Source: National Bank of Georgia

TABLE N 1.1 BALANCE OF PAYMENTS, 2016-2020 (MILLION USD)[23]

	2016	2017	2018	2019	2020
Current account	**-1,886**	**-1,306**	**-1,192**	**-960**	**-1,965**
Goods	-3,883	-3,809	-4,116	-3,736	-3,139
Export	2,865	3,570	4,407	4,944	4,349
Import	6,747	7,379	8,522	8,681	7,489
Services	1,577	2,024	2,244	2,176	130
Credit	3,313	3,990	4,490	4,600	1,586
Of this: Revenues from international travelers	2,111	2,704	3,222	3,269	542
Debit	1,736	1,966	2,246	2,425	1,456
Primary revenue (net)	-701	-794	-683	-775	-765
Of this: Investment income	-1,259	-1,417	-1,381	-1,581	-1,253
Of this: Remuneration	558	623	697	807	488
Secondary revenue (net)	1,121	1,273	1,364	1,375	1,809
Of this: Public sector	232	233	173	133	256
Of this: Other sectors	889	1,040	1,190	1,242	1,553
Capital account	**56**	**83**	**76**	**47**	**41**
Financial account	**-1,822**	**-1,252**	**-1,208**	**-942**	**-1,907**
Direct investment (net)	1,245	1,709	966	1,029	594
Of this: Direct investments in Georgia	1,658	1,918	1,260	1,341	578
Portfolio Investment (net)	-41	76	48	-707	183
Financial derivatives (excluding reserves) and employee options on shares	4	0	1	-4	-27

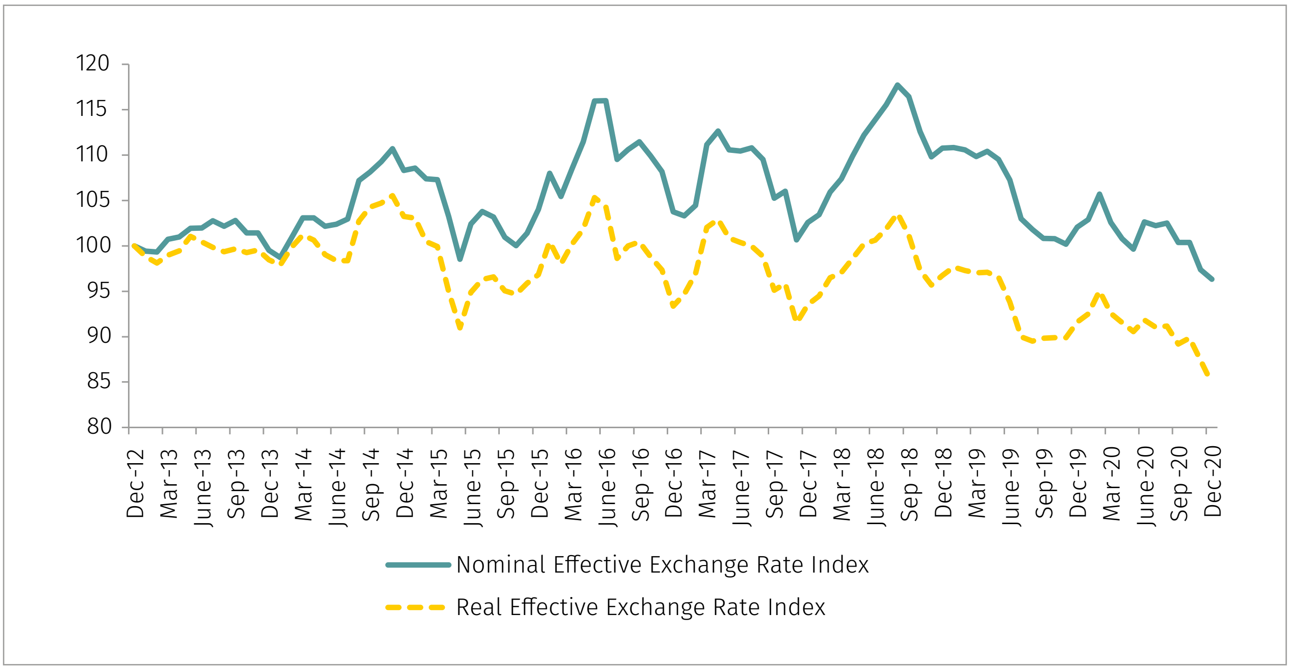
23. According to the IMF's Balance of Payments and International Investment Position Manual (sixth edition).

(continue)

	2016	2017	2018	2019	2020
Other investments (net)	784	-138	569	-596	1,775
Of this: Government sector	276	432	351	346	1,445
Of this: Private sector	508	-570	218	-942	330
Reserve assets	-245	-242	-278	-202	-305
Net errors and omissions	**8**	**-29**	**-92**	**-29**	**17**
Important ratios					
Reserve assets in next year's imports (months)	3.5	3.6	3.5	3.5	5.1
Export/import (goods and services)	-73%	-81%	-83%	-86%	-66%
Current account / GDP	-12.5%	-8.0%	-6.8%	-5.5%	-12.4%
FDI/GDP	11.0%	11.8%	7.2%	7.7%	3.6%
Travel revenue/GDP	13.9%	16.6%	18.3%	18.7%	3.4%
Personal remittances/GDP	8.7%	9.5%	9.9%	10.7%	12.4%

The real effective exchange rate (REER) is a crucial indicator for assessing a country's external competitiveness (see Diagram N 1.16). In 2020, the REER fell by 7.4%, while the nominal effective exchange rate depreciated by 5.6%. Most of Georgia's trading partner currencies contributed to the depreciation of the real effective exchange rate in 2020, besides Turkey, Ukraine and Russia, whose currencies all strengthened the REER (see Table N 1.2).

DIAGRAM N 1.16 INDICES OF REAL AND NOMINAL EFFECTIVE EXCHANGE RATES (DEC. 2012=100)



Source: National Bank of Georgia

TABLE N 1.2 ANNUAL CHANGES OF EFFECTIVE EXCHANGE RATES IN 2020

	Nominal effective exchange rate change, %	Real effective exchange rate change, %	Share in real effective exchange rate
Effective Exchange Rate	**-5.6**	**-7.4**	**-7.4**
Euro area	-19.3	-17.1	-3.2
Turkey	16.9	4.4	0.8
Ukraine	5.5	2.9	0.2
Armenia	-4.2	-5.3	-0.4
USA	-11.6	-10.7	-0.6
Russia	4.2	1.7	0.3
Azerbaijan	-11.5	-11.7	-1.3
Remainder	-17.7	-16.1	-3.2

Source: National Bank of Georgia

In 2020, during the COVID-19 pandemic, the National Bank of Georgia's efforts to ensure a stable macroeconomic and financial environment were adequately reflected in Georgia's credit ratings with international rating agencies. Since 2017, Georgia's sovereign rating has gradually increased. In 2017, Moody's increased Georgia's sovereign credit rating to Ba2. In 2019, the Standard & Poor's (S&P) raised Georgia's sovereign rating to "BB" with a stable outlook. In the same year, Fitch Ratings, the second-largest international rating agency, upgraded Georgia's sovereign credit rating from "BB-" to "BB". In 2020, due to the negative impact of the pandemic on tourism and tourism-related business activities, as well as increasing fiscal pressures and external risks due to healthcare and social needs, Fitch Ratings downgraded the country's outlook from stable to negative, but kept the rating at "BB". Maintaining this rating in the context of the current pandemic, global uncertainty and external risks is testimony to the progress that Georgia has achieved through its consistent macroeconomic policies. Such assessments of Georgia's investment environment by international ratings agencies further reinforces the confidence of international institutions and investors about Georgia.

BOX 1 THE IMPORTANCE OF THE TOURISM SECTOR FOR GEORGIA'S ECONOMY

The COVID-19 pandemic has triggered an unprecedented global economic crisis, which has primarily been manifested in declining international mobility and attendant economic activities. Expenditures (both internal and external) of the tourism sector before the pandemic reached 10% of global GDP.[24] This indicator was even higher in tourism-dependent economies. As a result, the pandemic proved particularly severe for countries with small economies that are dependent on tourism. Countries for which international tourism was an important source of foreign exchange inflows, and for revenues in general, found themselves facing both increased external imbalances as well as fiscal pressures. Georgia is one such country, with the growing revenues from tourism observed up until 2020 representing an important factor in financing the current account deficit and supporting economic activity.

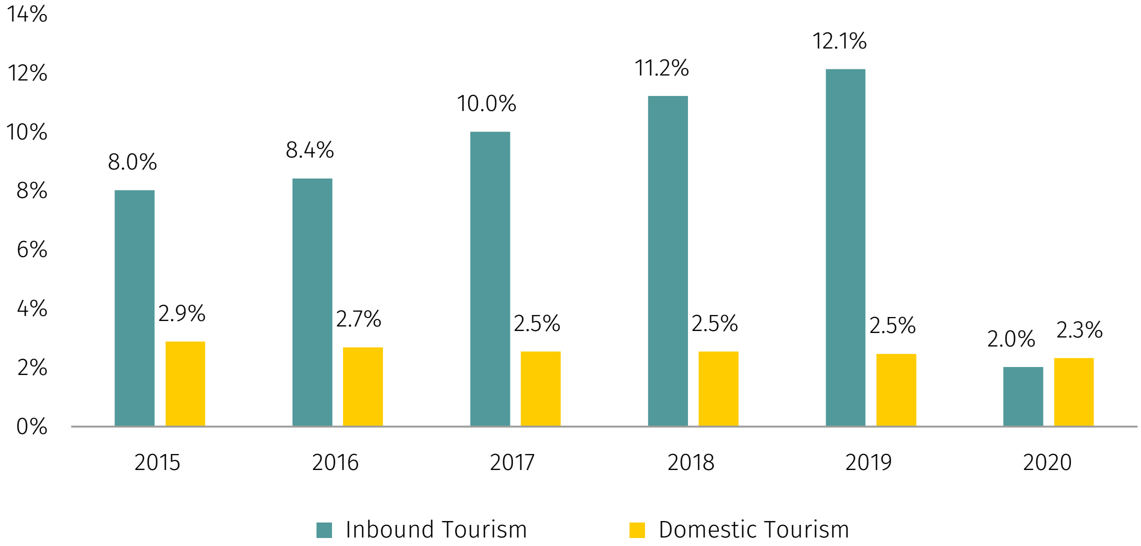
In recent years, the number of international travelers to Georgia and, consequently, the amount of money spent by them in the country, saw a major increase. Georgia, a country with a population of only 3.7 million, saw the number of international visitors reach 7.7 million in 2019. In the same period, revenues from international travel totaled USD 3.3 billion (see Diagram N 1.17) or 18.7% of GDP. The share of value added created by inbound tourism activity in GDP, according to the NBG, reached 12.1%; while the share of domestic tourism has fluctuated within 2.5% in recent years (see Diagram N 1.18). However, these positive dynamics totally changed as a result of the pandemic.

DIAGRAM N 1.17 INTERNATIONAL VISITOR TRIPS AND REVENUES FROM INTERNATIONAL TRAVELERS

Source: National Bank of Georgia and National Tourism Administration

24. See https://www.imf.org/en/News/Articles/2021/02/24/na022521-how-to-save-travel-and-tourism-in-a-post-pandemic-world

DIAGRAM N 1.18 SHARE OF INBOUND AND DOMESTIC TOURISM IN GDP[25]



Source: GeoStat and NBG calculations

The tourism sector includes many other interrelated sectors (air travel, accommodation and catering, retail, hotels and restaurants, entertainment, transport, etc.) and the growth rate of these sectors was also quite high before the pandemic. For comparison, in 2019, sectors such as accommodation and catering (real growth 18.5%), real estate (real growth 4.1%) and transport (real growth 8.4%), where the share of foreign visitors is quite high, contributed 1.6 percentage points to the 5% increase of real GDP. However, in 2020 the growth rate of these sectors and, consequently, their contributions to growth, became negative.

The pandemic began to negatively impact the country's economy in February 2020. Following the declaration of a state of emergency in March and the closure of national borders, the entry of foreign visitors to Georgia and the associated tourism revenues received from them entirely stopped (see Diagram N 1.17). If the share of inbound tourism in GDP was 12% in 2019, in 2020 this indicator fell to only 2% (see Diagram N 1.18). This, in turn, had a negative impact on real GDP growth. Overall, real GDP fell by 6.2% in 2020, with net exports contributing -9.8 percentage points to that decrease. This decline is mostly due to the drastic drop in exports of services, which was induced by the termination of revenues from international travelers. The economic sectors in which the role of foreign visitors is usually quite high saw severe falls in 2020. For example, the real growth of the accommodation and food supply sector was -37.9%, that of real estate activities was -0.1%, and transport -22.2%. These sectors contributed -3.0 percentage points to the 6.2% decline in real GDP.

The sharp decline in tourism exports has also significantly worsened the recent positive dynamics of the current account balance. The current account deficit reached 12.4% of GDP whereas in 2019 the same indicator was 5.5% of GDP, which had represented a record low since 2000.

25. Share of tourism in value added.

The negative impact of the pandemic on the growth of unemployment in various tourism-related services was also evident. Overall, the unemployment rate rose by 3.8 percentage points to reach 20.4% in 2020.

In the future, it is believed that new technologies will play an important role in the recovery and development of tourism and services in general.[26] However, as social isolation and the observance of health and hygiene protocols will likely remain on the agenda in the near future, contactless supply and increased investment in digital technologies will likely play a crucial role in the economic recovery. Such practices will vary in different countries, which will each have to gradually develop a qualitatively different 'new normal' for the tourism sector. It is believed that diversification, the transition to more sustainable tourism models and investment in new technologies will provide a good basis for the overall recovery of the economy.

1.3 ECONOMIC GROWTH

Preliminary data suggest that the Georgian economy decreased by 6.2% in 2020. The economic downturn hit the service sector the hardest, with its overall contribution estimated at being -5.8 percentage points. The industry sector decreased relatively less (-0.6 pp), while agriculture increased slightly and made a 0.2 pp positive contribution.

The COVID-19 pandemic delivered a hard blow to the world economy. Due to restrictions on mobility and various activities, the tourism industry in Georgia, as elsewhere, suffered the most. In recent years, the tourism industry has been one of the main drivers of economic growth in Georgia; it combines various sectors and covers a large part of the economy. The adverse effects of the pandemic on the Georgian economy became evident in the first quarter of 2020. A minor decrease in the number of foreign visitors was observed in February. In March, after the state of emergency was declared and the national borders were shut, the entry of foreign visitors to the country effectively stopped.

Severe pandemic restrictions were eased in summer, at which point domestic mobility and domestic tourism activity somewhat increased. The economy revived in the third quarter and the annual decline slowed compared to the second quarter. However, towards the year end, a new wave of infections and subsequent restrictions posed additional hardship. Ultimately, in 2020, accommodation and catering activities, where the output of hotels and restaurants has the largest share, fell by 37.9% compared to 2019, making a 1.7 pp negative contribution to economic growth. The transport sector, where the contribution of travel agencies is significant, decreased by 22.3% (a negative contribution to GDP growth of 1.3 pp). Industry and agriculture suffered a little less. Despite the pandemic, infrastructure projects continued, as did the manufacturing industry, where the share of export enterprises is high. A minor increase was observed in agriculture (see Table N 1.3).

26. See https://www.imf.org/en/News/Articles/2021/02/24/na022521-how-to-save-travel-and-tourism-in-a-post-pandemic-world

TABLE N 1.3 GDP BY SECTOR

	2020Q1		2020Q2		2020Q3		2020Q4		2020	
	Real growth	Share in growth	Real growth	Share in growth	Real growth	Share in growth	Real growth	Share in growth	Real growth	Share in growth
Agriculture, forestry and fishing	3.4%	0.2%	4.7%	0.4%	1.5%	0.1%	5.2%	0.3%	3.6%	0.2%
Mining and quarrying	6.2%	0.1%	8.8%	0.1%	14.7%	0.2%	-19.5%	-0.2%	1.5%	0.0%
Manufacturing	13.2%	1.1%	-7.8%	-0.7%	0.6%	0.1%	-3.0%	-0.3%	0.0%	0.0%
Electricity, gas, steam and air conditioning supply	-8.1%	-0.2%	-4.6%	-0.1%	-11.5%	-0.2%	-5.4%	-0.1%	-7.4%	-0.2%
Water supply; sewerage, waste management and remediation activities	-2.1%	0.0%	-20.2%	-0.2%	-11.4%	-0.1%	-9.7%	-0.1%	-11.1%	-0.1%
Construction	7.5%	0.4%	-26.7%	-1.8%	2.0%	0.2%	-1.2%	-0.1%	-4.7%	-0.3%
Wholesale and retail trade; repair of motor vehicles and motorcycles	0.3%	0.0%	-18.8%	-2.3%	-0.3%	0.0%	-3.9%	-0.5%	-5.6%	-0.7%
Transportation and storage	-3.7%	-0.2%	-30.2%	-1.7%	-25.0%	-1.4%	-26.7%	-1.6%	-22.3%	-1.3%
Accommodation and food service activities	5.4%	0.2%	-35.7%	-1.6%	-53.1%	-2.8%	-53.8%	-2.2%	-37.9%	-1.7%
Information and communication	5.4%	0.2%	-14.1%	-0.4%	1.9%	0.0%	3.7%	0.1%	-0.7%	0.0%
Financial and insurance activities	-8.3%	-0.4%	-14.9%	-0.7%	-4.4%	-0.2%	7.2%	0.3%	-5.0%	-0.2%
Real estate activities	3.0%	0.3%	-2.8%	-0.3%	-0.8%	-0.1%	0.5%	0.0%	-0.1%	0.0%
Professional, scientific and technical activities	-17.5%	-0.4%	-26.3%	-0.6%	-12.5%	-0.3%	-17.5%	-0.4%	-18.4%	-0.4%
Administrative and support service activities	-3.1%	0.0%	-49.3%	-0.6%	-49.0%	-0.7%	-41.6%	-0.5%	-37.9%	-0.5%
Public administration and defense; compulsory social security	5.3%	0.4%	-0.2%	0.0%	4.3%	0.2%	-1.6%	-0.1%	1.8%	0.1%
Education	3.1%	0.1%	3.8%	0.2%	5.6%	0.2%	0.3%	0.0%	3.1%	0.1%
Human health and social work activities	9.7%	0.4%	9.2%	0.3%	6.6%	0.2%	6.3%	0.2%	7.9%	0.3%
Arts, entertainment and recreation	16.0%	0.5%	-23.4%	-0.7%	-32.4%	-1.0%	-27.9%	-0.9%	-18.9%	-0.6%
Other service activities	18.0%	0.1%	-4.8%	0.0%	8.4%	0.1%	7.0%	0.0%	7.1%	0.0%
Activities of households as employers; undifferentiated goods and services producing activities of household for own use	-34.1%	-0.1%	-18.1%	0.0%	31.2%	0.0%	111.1%	0.1%	11.6%	0.0%
(+) Taxes on products	-2.7%	-0.3%	-19.3%	-2.4%	-0.9%	-0.1%	-7.2%	-1.0%	-7.5%	-1.0%
(-) Subsidies on products	0.3%	0.0%	8.0%	0.0%	7.7%	0.0%	4.5%	0.0%	5.5%	0.0%
GDP		**2.3%**		**-13.2%**		**-5.6%**		**-6.8%**		**-6.2%**

Source: GeoStat

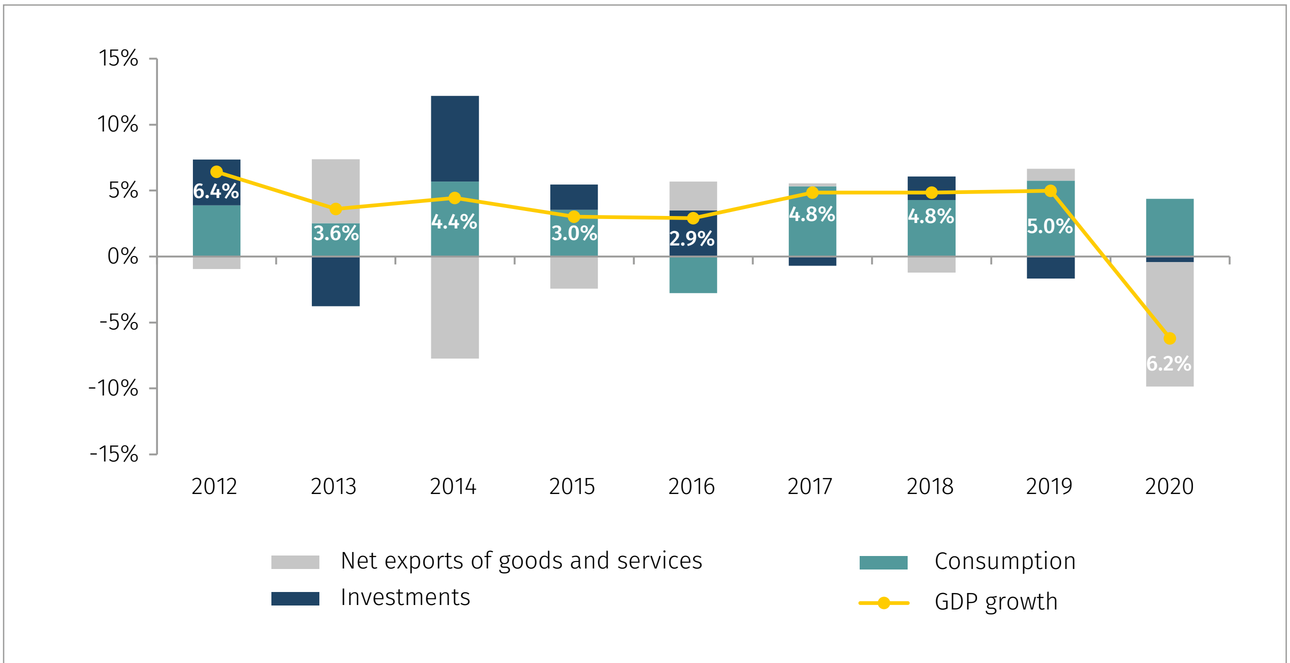
DEMAND

In 2020, exports of goods and services decreased by 38.2% in real terms, while imports of goods and services decreased by 17.4%. However, the pandemic hit the tourism industry hardest. This fact was reflected in the export of services. Last year, exports of services in real terms decreased by 64.5% compared to the previous year. The contribution of net exports to economic growth was sharply negative due to plummeting tourism revenues (i.e., exports of services).

The severely negative contribution of net exports (-9.8 pp) was partially offset by consumption (4.5 pp), that picked up a little. The increase in the latter can be linked to increased fiscal stimulus and continued lending to the economy aimed at mitigating the effects of the pandemic.

Despite the crisis, infrastructure projects continued. This can be considered as the main reason why the negative contribution of investments (-0.9 pp) in the economic downturn was less than that of other components (see Diagram N 1.19).

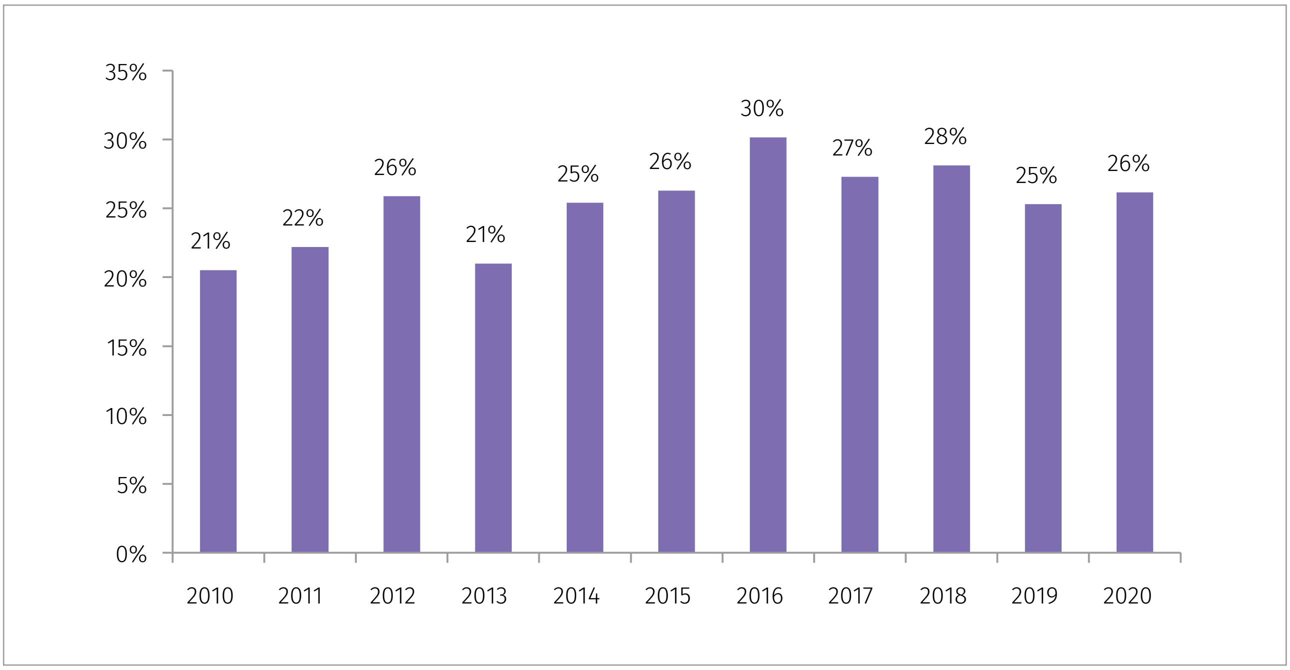
DIAGRAM N 1.19 GDP GROWTH BY EXPENDITURES



Source: GeoStat

In 2020, in spite of the pandemic, the ratio of investment to GDP did not decrease and amounted to 26%. Stable in recent years, this indicator can be considered at an adequate level for the development of the Georgian economy (see Diagram N 1.20).

DIAGRAM N 1.20 INVESTMENTS TO GDP



Source: GeoStat

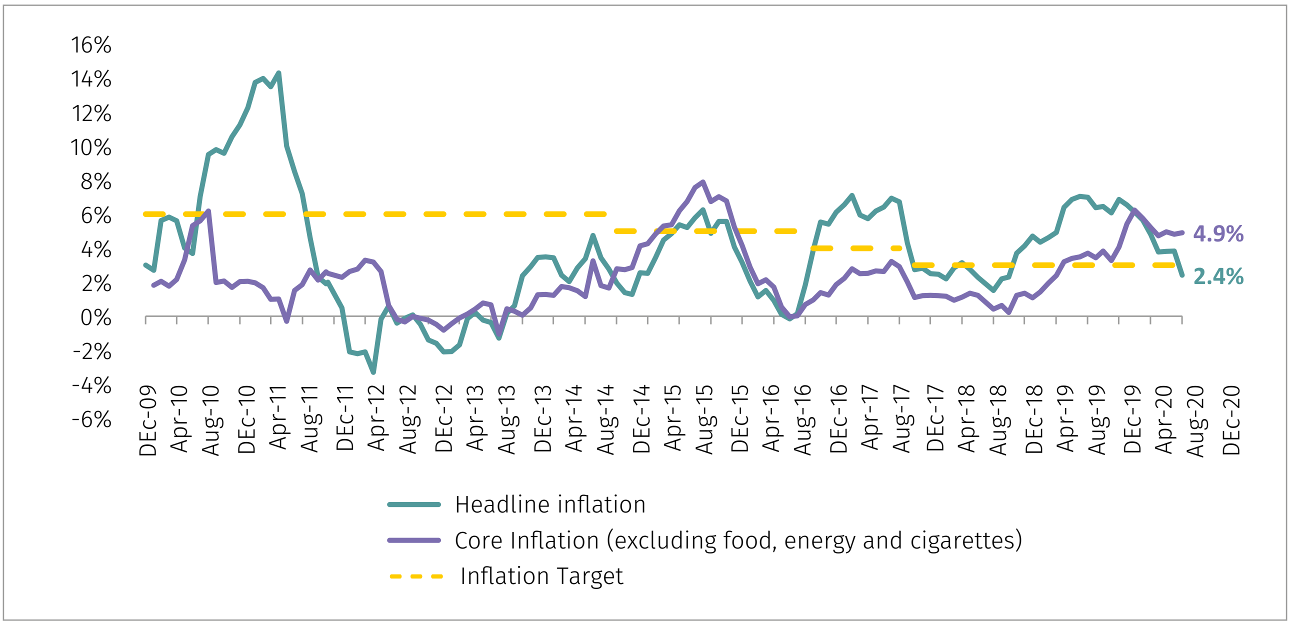
1.4 INFLATION

Georgia started 2020 with inflation above the target. This was largely due to the depreciation of the lari effective exchange rate that stemmed from the ban on flights from Russia in the summer of 2019. In 2020, inflation was significantly impacted by both demand and supply. Consumer prices were pushed downwards by weakened aggregate demand; however, this pressure was offset by the effects of increased production costs resulting from pandemic supply disruptions and the depreciation of the lari exchange rate. In addition, rising inflation was driven by an increase in unit labor cost, which was a result of a smaller decrease in salaries than in output. As a result, inflation remained above the target.

Inflation began to decline from the beginning of 2020, as had been expected. Annual inflation was 6.4% in January and February (down 0.6 percentage points from 7.0% in December 2019). However, the shock caused by the subsequent onset of the COVID-19 pandemic slowed down the decline in inflation. Annual inflation fell less than expected to 6.1% in March, reaching 6.9%, its highest level of the year, in April. Inflation gradually declined in the following months, falling to 2.4% in December. The sharp decline in inflation in December was triggered by the government subsidizing utility fees for the population, providing a negative 1.9 pp contribution to inflation.

Core inflation, which excludes highly volatile food, energy and cigarette prices, exceeded headline inflation from June to the end of the year. The increase in core inflation is due to the depreciation of the lari nominal effective exchange rate and the COVID-related restrictions that increased operating costs of companies and, which, to some extent, were reflected in final prices. The most significant difference between headline and core inflation was observed in December, which was related to the aforementioned government subsidy of utility bills (see Diagram N 1.21).

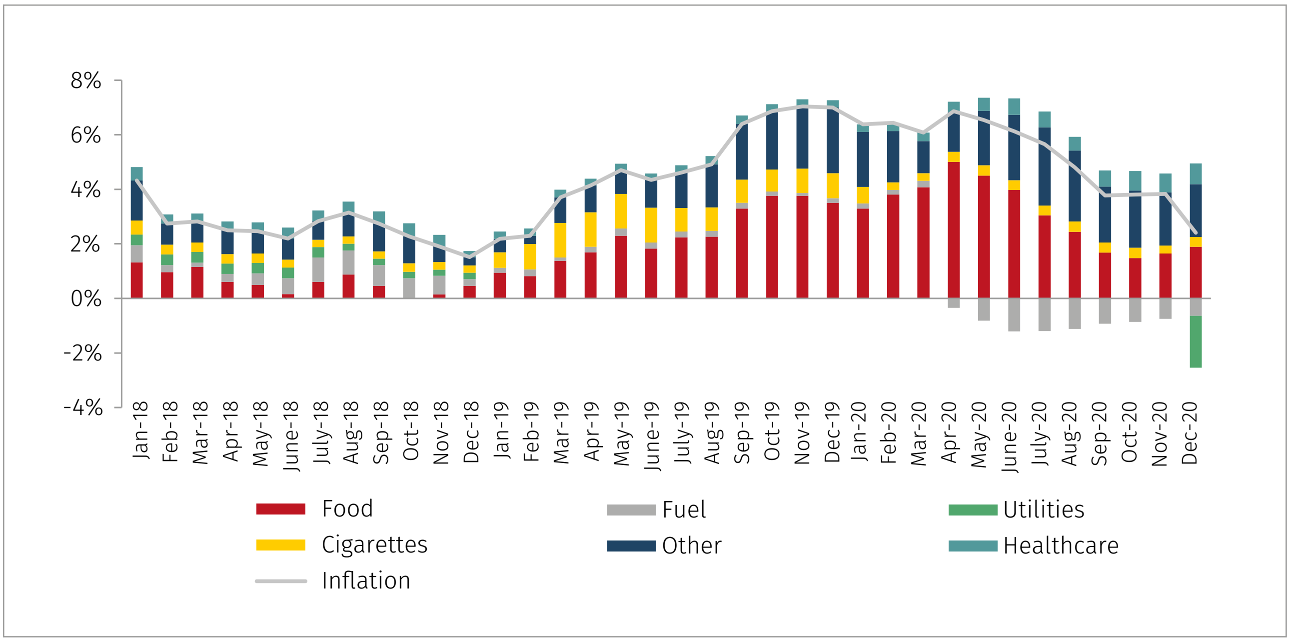
DIAGRAM N 1.21 HEADLINE AND CORE (EXCLUDING FOOD, ENERGY AND TOBACCO) INFLATION



Source: GeoStat

Rising inflation was affected by food prices during the year. The latter are characterized by high volatility under the influence of seasonality, yields and other factors. Due to the high weight of food in the consumer basket (28.0%), this volatility of prices significantly affected the overall inflation rate. In 2020, 3.1% of the average inflation rate of 5.2% was for food. Headline inflation was also gradually declining towards the end of the year, in parallel with the drop in food inflation. Food inflation in December was 6.7%, and its contribution to headline inflation was 1.9 pp. Inflation was also significantly affected by rising prices for healthcare (average contribution 0.5 pp) and cigarettes (average contribution 0.4 pp). Low oil prices in the world market caused a reduction of fuel prices, which pushed inflation down (average -0.6 pp). Oil prices began to recover as the pandemic eased, which also affected fuel prices and, consequently, its negative impact on inflation gradually diminished towards the end of the year (see Diagram N 1.22).

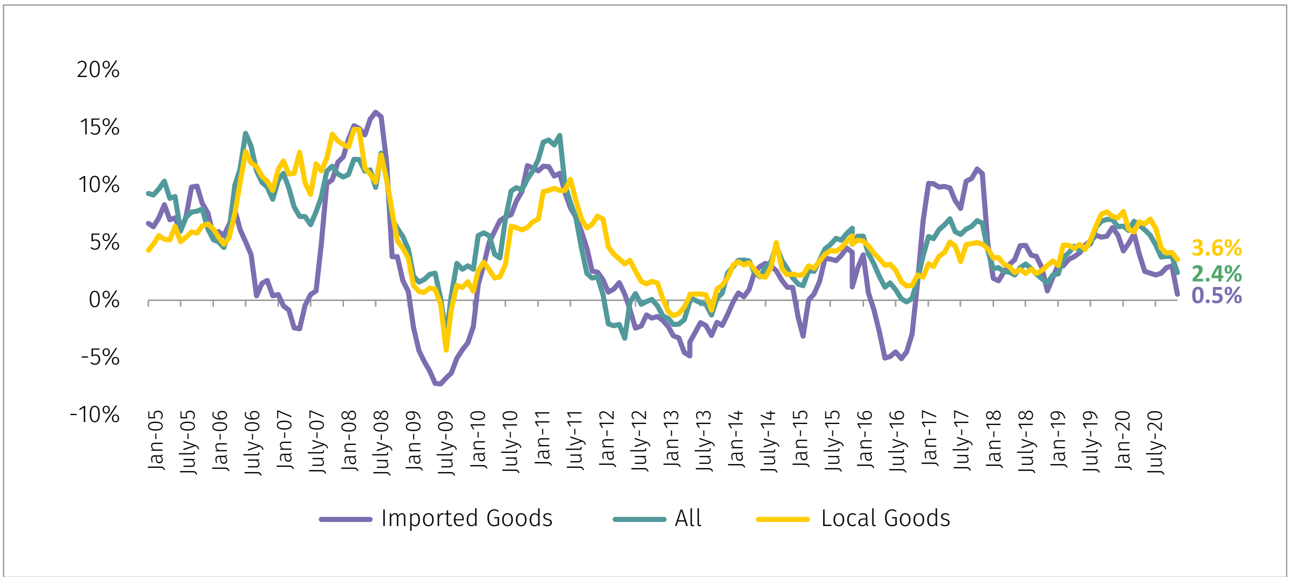
DIAGRAM N 1.22 CONTRIBUTIONS TO HEADLINE INFLATION BY CORE COMPONENTS



Source: GeoStat and NBG Calculations

Average inflation rates of imported and domestically produced goods during the year were 3.4% and 5.8% respectively. Mixed goods rose by an average of 5.8%. The relatively high inflation of domestically produced goods is largely related to the high inflation of food, while the relatively low inflation of imported goods was due to the annual decrease in fuel prices.

DIAGRAM N 1.23 INFLATION OF IMPORTED AND LOCAL GOODS[27]



Source: GeoStat

27. The headline inflation rate includes mixed-type goods, in addition to domestic and imported goods, so it may be outside the range of domestic and imported goods inflation.

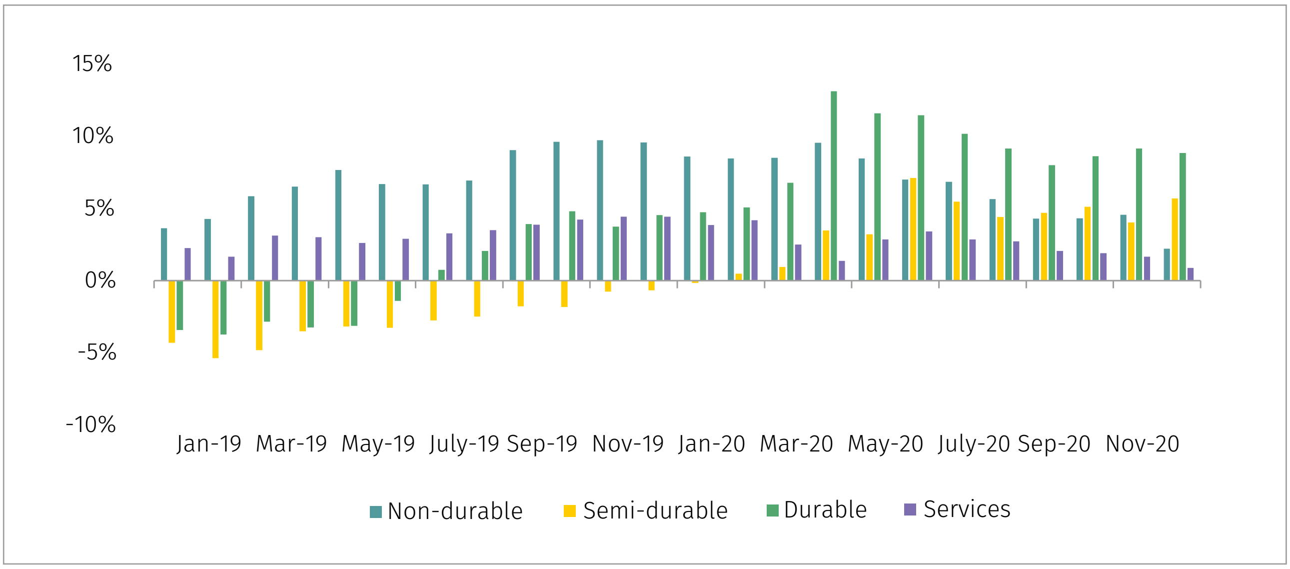
TABLE N 1.4 INFLATION INDICATORS ACCORDING TO INDIVIDUAL COMPONENTS (PERCENTAGE), THEIR SHARE IN THE CONSUMER BASKET (PERCENTAGE) AND CONTRIBUTION TO THE CPI (PERCENTAGE POINTS)

	2019 December weights	Dec20/Dec19		Jan20-Dec20/Jan19-Dec19	
		Inflation	Weight	Inflation	Contribution
Total	100.0%	2.4%	2.4%	5.2%	5.2%
Food and Non-Alcoholic Beverages	32.2%	6.8%	2.1%	10.5%	3.2%
Food	28.9%	6.7%	1.9%	10.7%	2.9%
Bread and Bakery	5.6%	7.0%	0.4%	7.8%	0.4%
Meat and Meat Products	6.8%	1.7%	0.1%	9.8%	0.6%
Fish Products	0.5%	8.8%	0.0%	12.1%	0.1%
Milk, Cheese, and Eggs	6.3%	11.3%	0.7%	14.3%	0.8%
Oil and Fats	1.9%	27.2%	0.5%	13.8%	0.3%
Fruits, Grapes	1.6%	-4.5%	-0.1%	21.8%	0.3%
Vegetables, Melons, Potatoes and other Tubers	3.3%	3.3%	0.1%	5.1%	0.2%
Sugar, Jams, Honey, Syrups, Chocolate, Pastry	2.3%	8.0%	0.2%	9.3%	0.2%
Other Food Products	0.6%	5.1%	0.0%	14.2%	0.1%
Non-alcoholic Beverages	3.3%	6.8%	0.2%	8.8%	0.3%
Alcoholic Beverages, Tobacco	6.4%	8.6%	0.6%	6.3%	0.4%
Clothing and Footwear	3.8%	-0.9%	0.0%	0.4%	0.0%
Housing, Water, Electricity, Gas and other Fuels	9.0%	-21.7%	-2.0%	0.8%	0.1%
Furnishings, Household Equipment and Maintenance	5.3%	9.5%	0.6%	8.0%	0.5%
Healthcare	7.8%	9.6%	0.8%	6.5%	0.5%
Transport	13.0%	-2.3%	-0.3%	-3.7%	-0.5%
Communication	3.6%	0.0%	0.0%	-0.1%	0.0%
Recreation and Culture	3.7%	-2.8%	-0.1%	-2.0%	-0.1%
Education	4.6%	0.6%	0.0%	2.2%	0.1%
Hotels, Cafes and Restaurants	5.4%	3.5%	0.2%	6.4%	0.3%
Miscellaneous Goods and Services	5.3%	8.4%	0.5%	8.7%	0.5%

Source: GeoStat

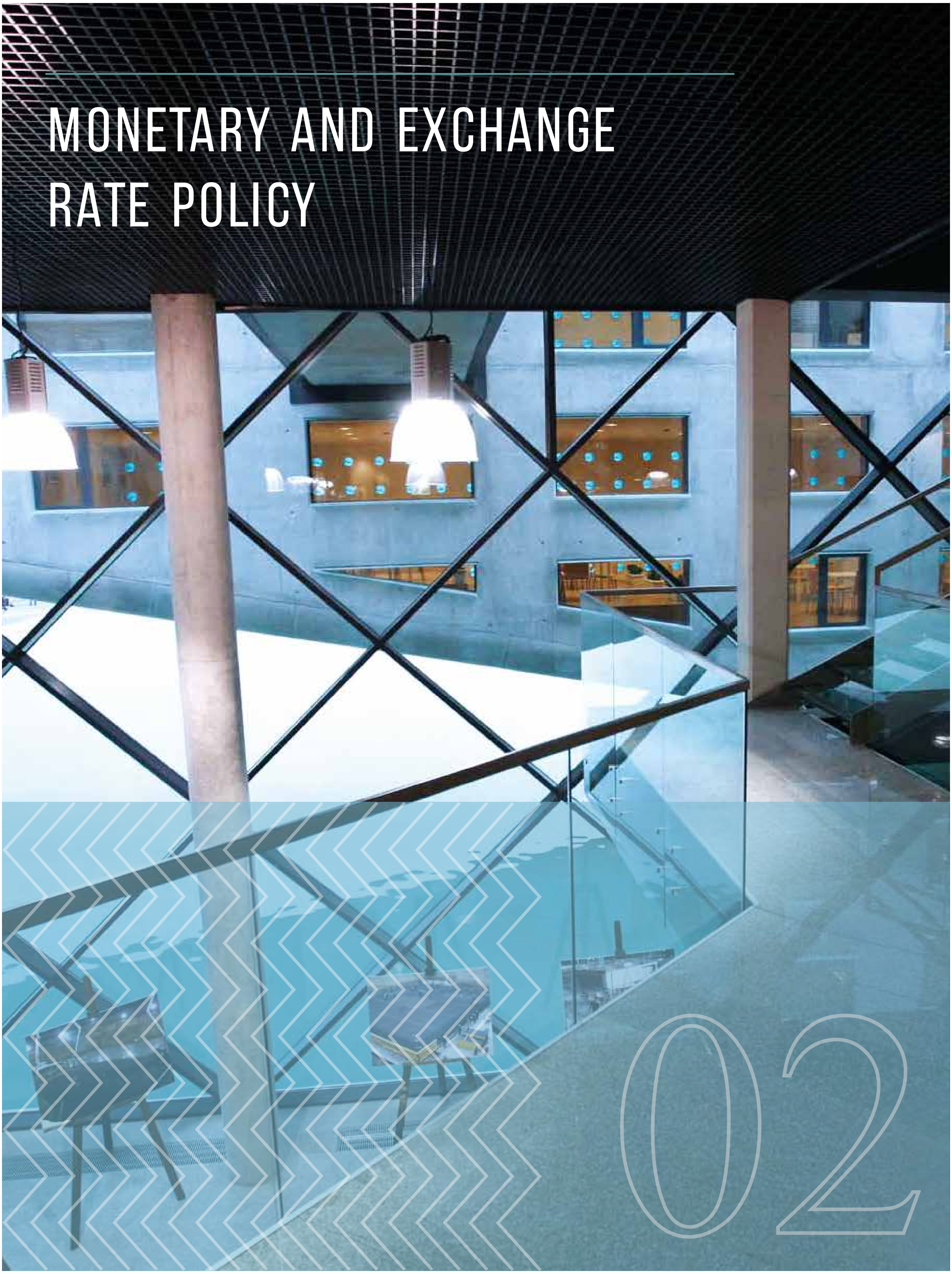
During 2020, as compared to the previous year, prices increased the most (by 8.9% on average) for durable goods. Those for non-durable goods rose by an average of 6.5%, semi-durable goods rose by 3.7%, and services by 2.5%. The high inflation on durable goods can be attributed to the depreciation of the lari effective exchange rate. A large share of non-durable goods comes from food, while the relatively low inflation in services indicates weak demand.

DIAGRAM N 1.24 CHANGE OF ANNUAL INFLATION FOR SERVICES AND GOODS OF DIFFERENT DURABILITY



Source: GeoStat

MONETARY AND EXCHANGE RATE POLICY



2.1 MONETARY POLICY

According to the Organic Law on the National Bank of Georgia, the primary purpose of the NBG is to ensure price stability.[28] 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 for maintaining price stability, relies on the announcement of an inflation target that is used to guide policy for maintaining inflation at the target level over the medium term.

The main monetary policy instrument of the NBG 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".[29] According to the current policy, the target inflation rate has remained at 3% since 2018. It should be noted that developing countries tend to have higher inflation than advanced countries, resulting from a faster growth of productivity.[30]

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. 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. Bernanke & Blinder (1992) and Bernanke & Gertler (1995) demonstrate 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.[31] However, if a deviation is so significant that it affects inflation expectations and the inflation forecast, the NBG will adjust its policy response accordingly.

The year 2020 started with inflation above the target, which was largely due to the pass through of the depreciation of the nominal effective exchange rate to inflation amid the ban on flights by Russia in the summer of 2019. As a result of

28. Paragraph 1 Article of the Organic Law on the National Bank of Georgia

29. Decree of the Parliament of Georgia, "On the Main Directions of the Monetary Policy of Georgia, 2018-2020", para. 1

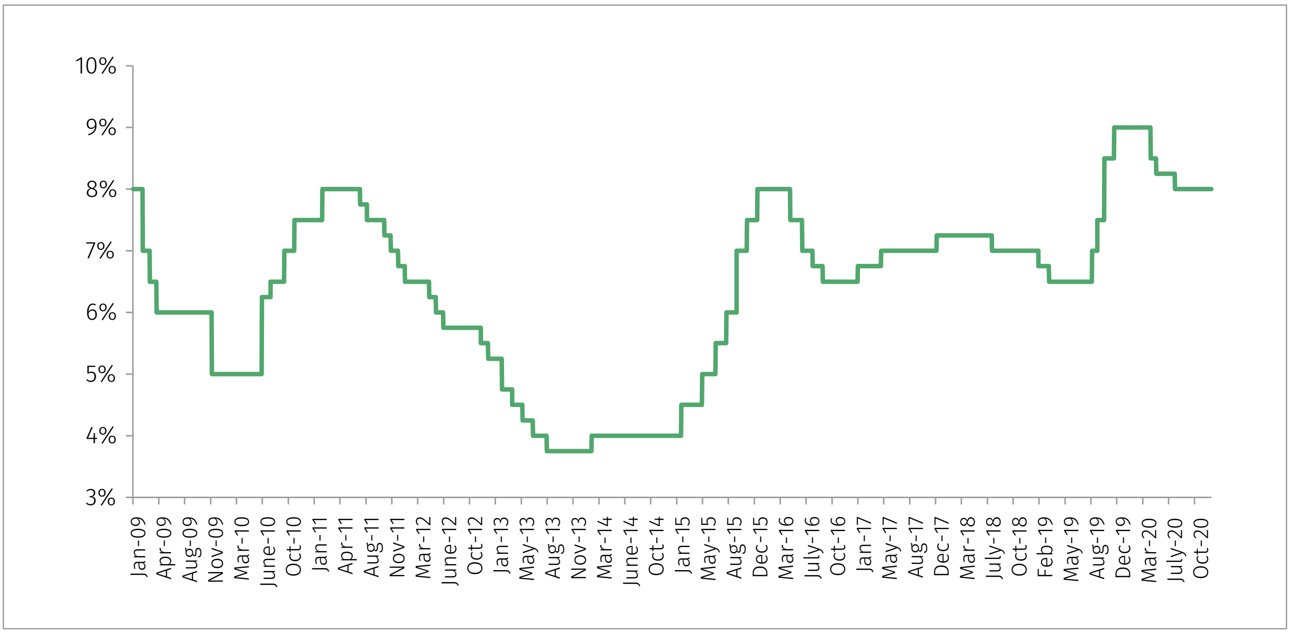
30. Balassa, B. (1964), The Purchasing Power Parity Doctrine: A Reappraisal, Journal of Political Economy, 72, 584-96; Samuelson, P. (1964), Theoretical Notes on Trade Problems, Review of Economics and Statistics, 23, 1-60.

31. Bernanke & Blinder (1992) The Federal Funds Rate and the Channels of Monetary Transmission, American Economic Review; Vol. 82, Issue 4, 901-21; Bernanke & Gertler (1995) Inside the Black Box: The Credit Channel of Monetary Policy Transmission, The Journal of Economic Perspectives, Vol. 9, No. 4 (Autumn, 1995), 27-48.

the tightened monetary policy in 2019, annual inflation began to decline, as expected, from the beginning of 2020. Annual inflation fell to 6.4% in January and February 2020 (down 0.6 pp from 7.0% in December 2019). The subsequent shock caused by the coronavirus pandemic altered the inflation path. Inflation-related changes were due to the temporary disruption of supply chains as a result of restrictions imposed to curb the pandemic, the reflection of the costs associated with the pandemic in final prices, and the depreciation of the lari nominal effective exchange rate. International tourism practically stopped in the wake of the pandemic, particularly affecting tourism-dependent countries, including Georgia. Restricting the entry of foreign tourists into the country caused a sharp depreciation of the lari effective exchange rate, which was also reflected in prices. As a result, the inflation rate reached a peak of 6.9% in April. As it was expected that significantly reduced aggregate demand during the year would affect inflation in a downward direction, there was no longer a need to maintain a tightened policy. Accordingly, the Monetary Policy Committee began a gradual exit from the tightened policy stance and reduced the policy rate by 0.5 pp at the April meeting, and by a further 0.25-0.25 pp in June and August to 8.0% (see Diagram N 2.1).

Risks related to inflation expectations emerged once more in autumn, which were accompanied by increased volatility in foreign exchange markets and the long-term maintenance of inflation above the target. However, the depreciation of the nominal effective exchange rate put pressure on the prices of imported goods, which, in turn, had a significant impact on inflation. In addition, due to the high level of dollarization, the exchange rate depreciation increased the cost of servicing loans to non-hedged producers. Moreover, at this stage the rate of new infections started to increase dramatically, leading to additional constraints and a maintenance of the supply-side factors pressuring inflation. There was also a significant increase in geopolitical risks that stemmed from the military conflict between Armenia and Azerbaijan. In view of all the above factors, the Monetary Policy Committee decided to leave the refinancing rate unchanged at 8.0% for the rest of the year. It should also be noted that aggregate demand was positively impacted by significant fiscal stimulus, including a partial subsidy on interest expenses on mortgages, which in fact had a similar effect to the easing of monetary policy.

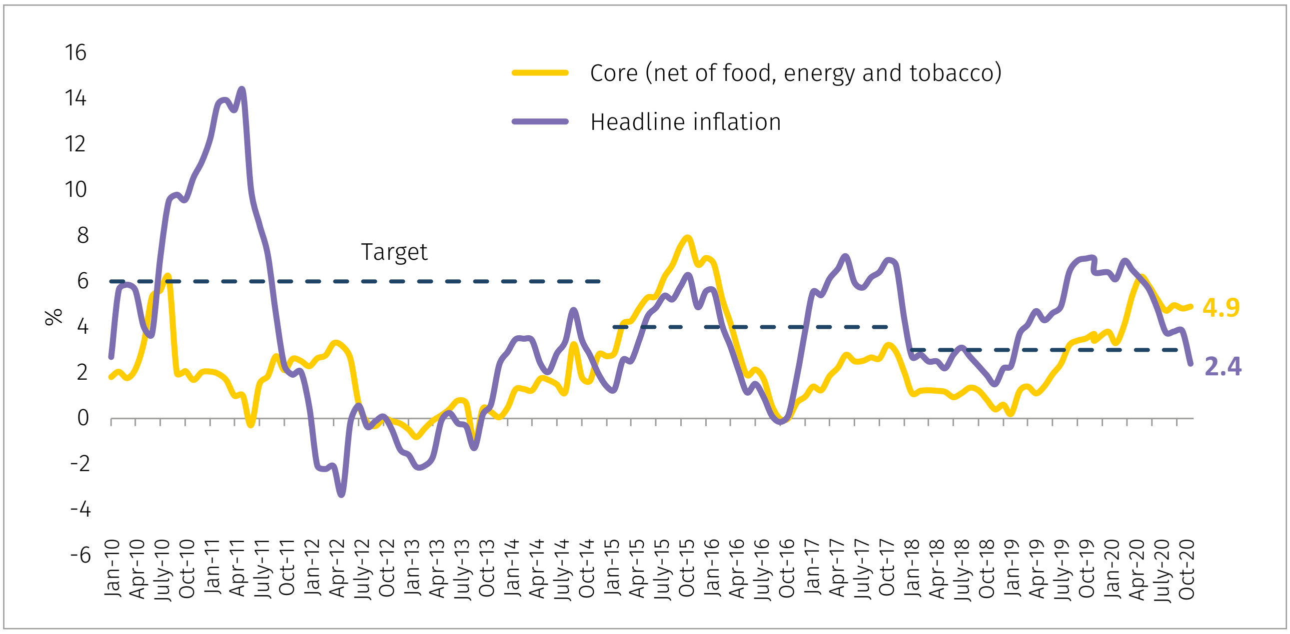
DIAGRAM N 2.1 MONETARY POLICY RATE



Source: National Bank of Georgia

Overall, inflation has been declining since April. Inflation fell sharply to 2.4% in December 2020, mainly due to the government subsidies on utility fees[32] being reflected in the calculation of the Consumer Price Index. Average annual inflation stood at 5.2% (see Diagram N 2.2).

DIAGRAM N 2.2 HEADLINE INFLATION AND INFLATION EXCLUDING FOOD, ENERGY AND TOBACCO



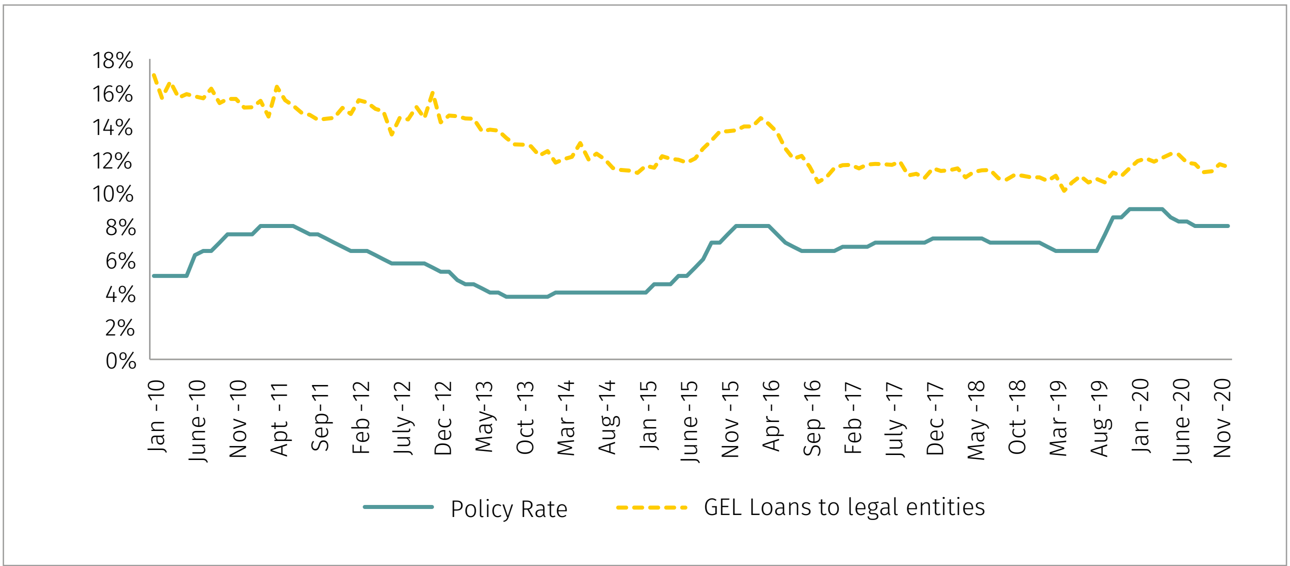
Source: GeoStat and NBG calculations

32. This subsidy was enacted in November 2020 and was reflected on the CPI from December.

Economic activity in Georgia declined significantly against the backdrop of the coronavirus pandemic, with real GDP decreasing by 6.2% in 2020 according to preliminary estimates. The negative effects of the pandemic on the Georgian economy first began to appear in February. The significant decline in foreign demand had a negative impact on Georgia's economic activity. Global travel restrictions dramatically reduced service exports, affecting tourism and related industries. Meanwhile, economic activity slowed in Georgia's trade partner countries, leading to a decline in exports of goods. However, in light of weak aggregate demand and reduced external inflows, imports of goods also declined significantly. Remittances decreased sharply in the second quarter, although picked up again in the third quarter. Amid these changes, the current account deficit increased significantly and amounted to 12.4% of GDP.

In the wake of the pandemic and subsequent logistical constraints, liquidity risks became evident in spring. Demand for cash from individuals and companies increased significantly. To fund pandemic-related costs, the state budget collected funds from commercial bank accounts into government accounts with the NBG. The NBG's FX interventions reduced the amount of GEL in circulation. In addition, commercial banks and most microfinance institutions offered borrowers a three-month grace period, which further increased demand for liquid funds. These liquidity risks were also reflected in an increase in GEL market interest rates. However, the NBG responded quickly by launching additional liquidity provision tools to reduce liquidity risks. Interest rates fell again in the second half of 2020. Overall, interest rates on mortgage loans decreased by 0.5 pp per year, while those on GEL loans to legal entities increased by 0.1 pp (see Diagram N 2.3).

DIAGRAM N 2.3 MONETARY POLICY RATE AND INTEREST RATES ON GEL LOANS

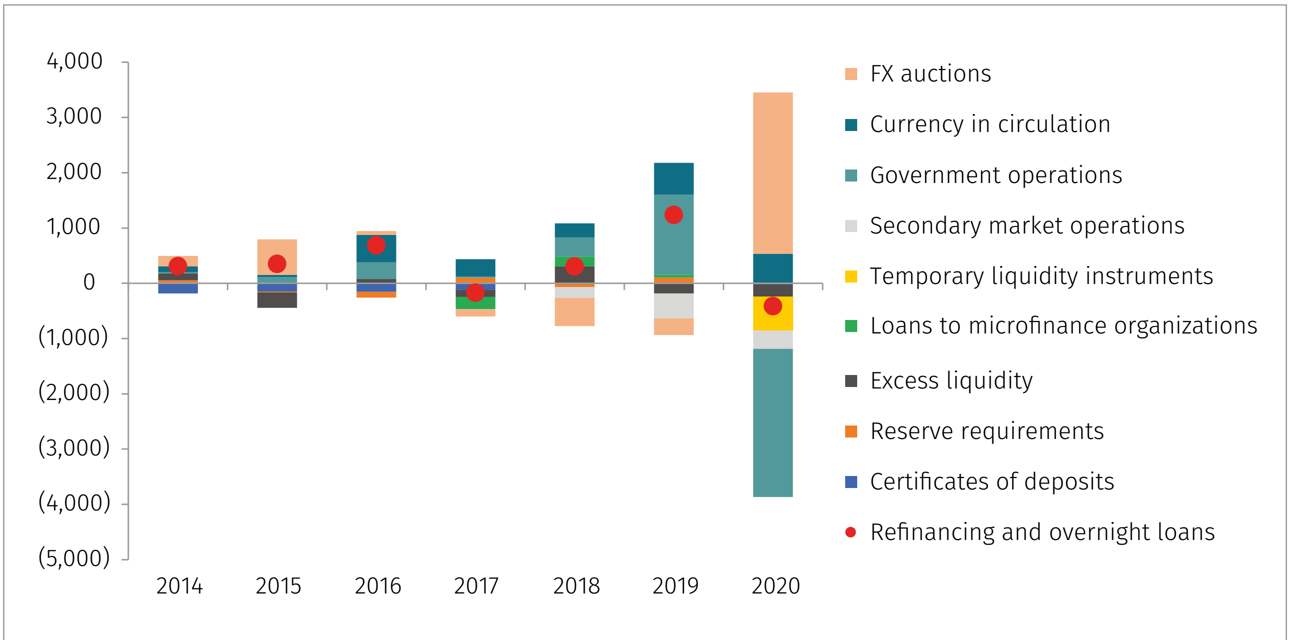


Source: National Bank of Georgia

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. After the onset of the pandemic, the NBG, as already mentioned, launched additional temporary liquidity provision instruments: a FX swap, a stand-by FX swap and a liquidity support instrument for small- and medium-sized businesses. In addition, a FX swap agreement was signed with the European Bank for Reconstruction and Development (EBRD) (see Box 2). For monetary policy to be effective, it is important that interbank interest rates reflect policy rate changes and ultimately affect the real economy. In recent years, the banking system has been operating in circumstances of a liquidity shortage, which is why there is no need to absorb medium-term liquidity from the market. Nevertheless, the NBG continued to issue 3-month certificates of deposit throughout the year, to make sure that the short-term portion of the yield curve was formed. The NBG kept the balance of certificates of deposit at a minimum level through these operations, in the range of GEL 60-80 million.

In 2020, banks were actively using refinancing loans to manage liquidity and offset fluctuations from other sources of liquidity provision. The volume of refinancing loans during the year was influenced by several factors (see Diagram N 2.4). As demand for cash increased, it gave rise to the need for liquid funds. Government sector operations had a downward effect on refinancing loans. The increased demand for refinancing loans during the year was due to the NBG's foreign exchange operations, while the decrease was triggered by the NBG's purchase of government securities in the secondary market and the launch of temporary liquidity provision instruments.

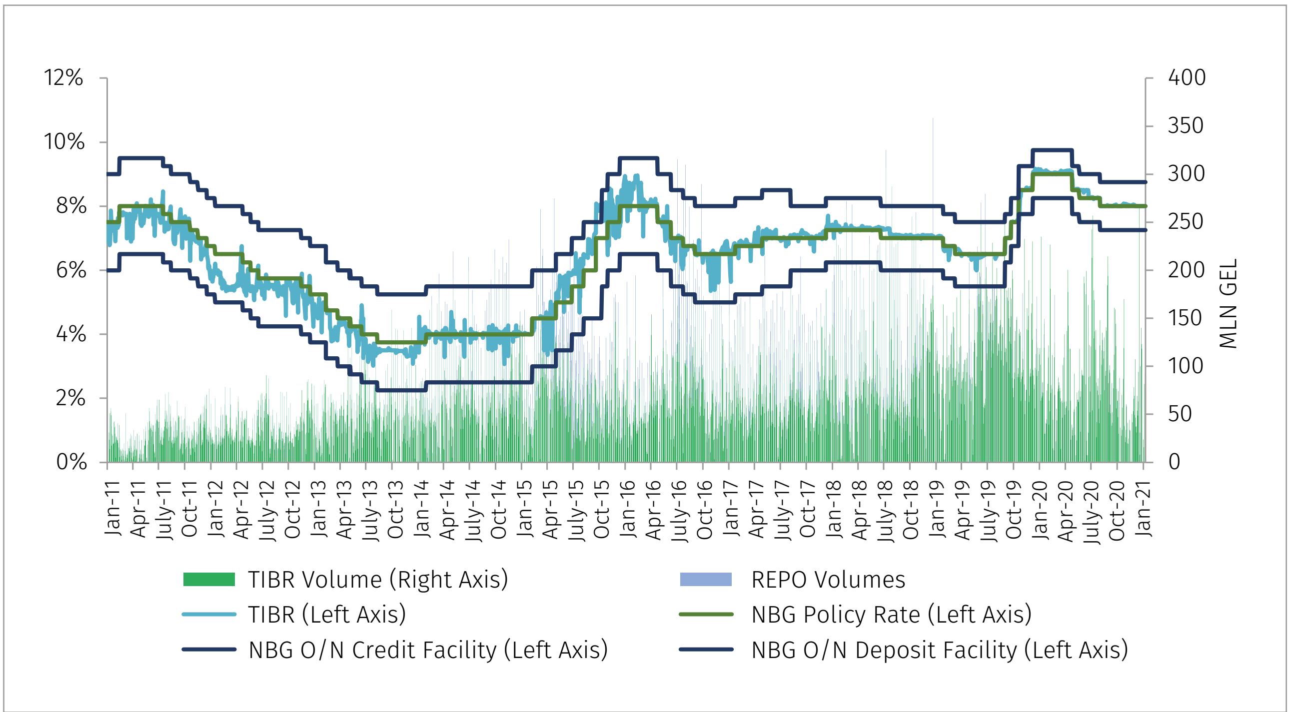
DIAGRAM N 2.4 FACTORS AFFECTING THE ANNUAL CHANGE IN REFINANCING LOANS



Source: National Bank of Georgia

The NBG provided the financial sector with the required amount of short-term liquidity by applying the abovementioned instruments, and, in so doing, ensured that interest rates in the interbank money market remained close to the policy rate (see Diagram N 2.5). Making sure that the banking system has access to sufficient lari resources and ensuring its effective management is important to encourage lending in lari and facilitate de-dollarization.

DIAGRAM N 2.5 INTERBANK MONEY MARKET



Source: National Bank of Georgia

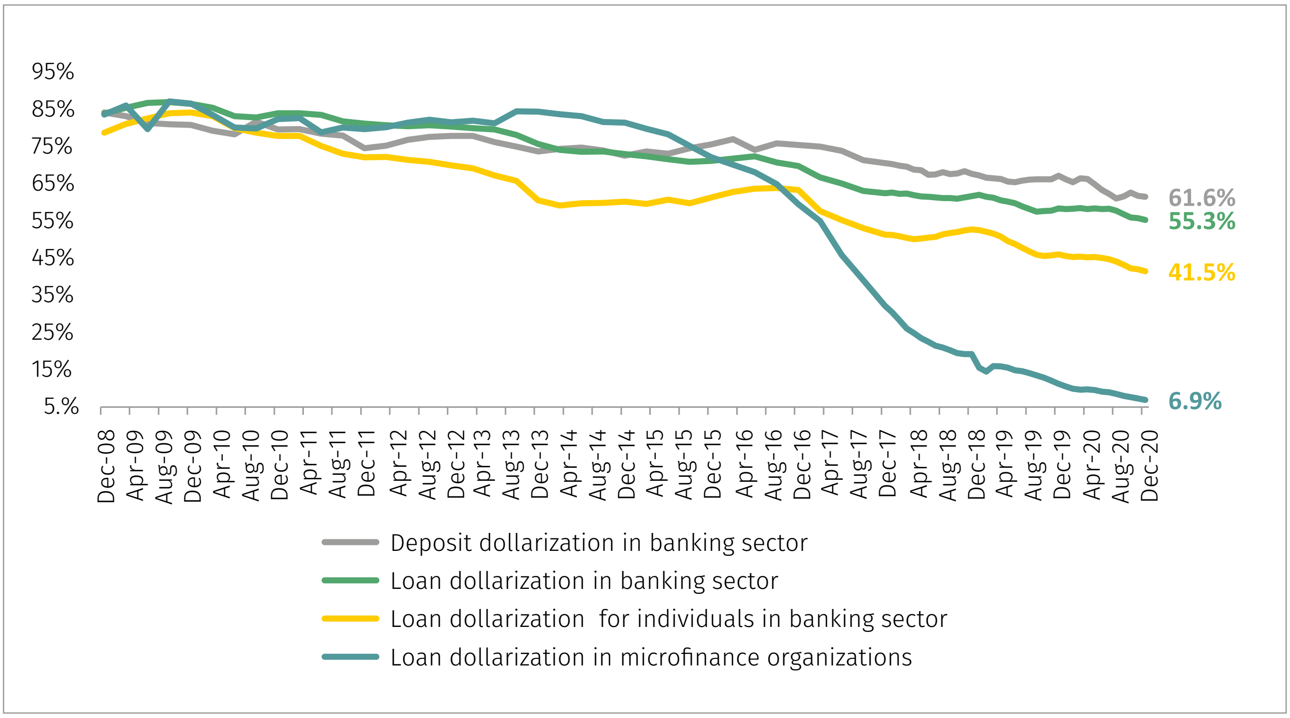
In 2020, the International Monetary Fund (IMF) successfully completed its review of the program supported by the Extended Fund Facility (EFF). In April, the IMF mission and the Georgian government reached an agreement to successfully complete the sixth review of the ongoing program in Georgia and to increase the total amount of the program by 130% (approximately USD 375 million). Following approval from the IMF's Board of Directors, USD 200 million was immediately made available to the Georgian budget. The IMF completed its seventh review in December, approving the next tranche of USD 113.9 million. These facilities significantly helped alleviate the negative impact caused by the COVID-19 pandemic in Georgia, helping to address the immediate needs of the balance of payments, and to finance the increased costs of healthcare and social assistance. The agreement accelerated the attraction of additional resources from other international financial institutions. Importantly, the IMF mission gave a positive evaluation of the NBG's fulfillment of all of the criteria provided by the program.

Promoting the efficient functioning of the foreign exchange market by taking timely and necessary measures is one of the tasks of the NBG. In 2020, in addition to operating FX auctions, the NBG launched a rule-based intervention facility. These new types of interventions were conducted on the Bloomberg BMatch platform with the purpose of reducing excess volatility in the foreign exchange market and ensuring its provision in cases of liquidity shortages. When exchange rate fluctuations exceeded the set range, the NBG engaged in trading on the platform within pre-defined limits.

Promoting larization (de-dollarization) is a long-term goal of the NBG. Encouraging larization is a prerequisite for reducing macro-financial risks in the country and increasing resilience to external vulnerabilities. Accordingly, increasing larization is one of the priorities of the NBG and reforms to facilitate this process continue to be implemented.

The trend of de-dollarization continued in 2020, as visible in the statistics of both the loan portfolio and total deposits. Overall, the dollarization of total deposits, excluding the exchange rate effect, decreased by 5.7 pp during the year and reached 61.6% (including the exchange rate effect, it increased by 0.2 pp). Loan dollarization, excluding the exchange rate effect, decreased by 3.1 pp and stood at 55.3% in December (including the exchange rate effect, it decreased by 2.7 pp). The dollarization rate of retail loans decreased from 46.1% to 41.5% in 2020 excluding the exchange rate effect (decreasing by 1.3 pp including the exchange rate effect).

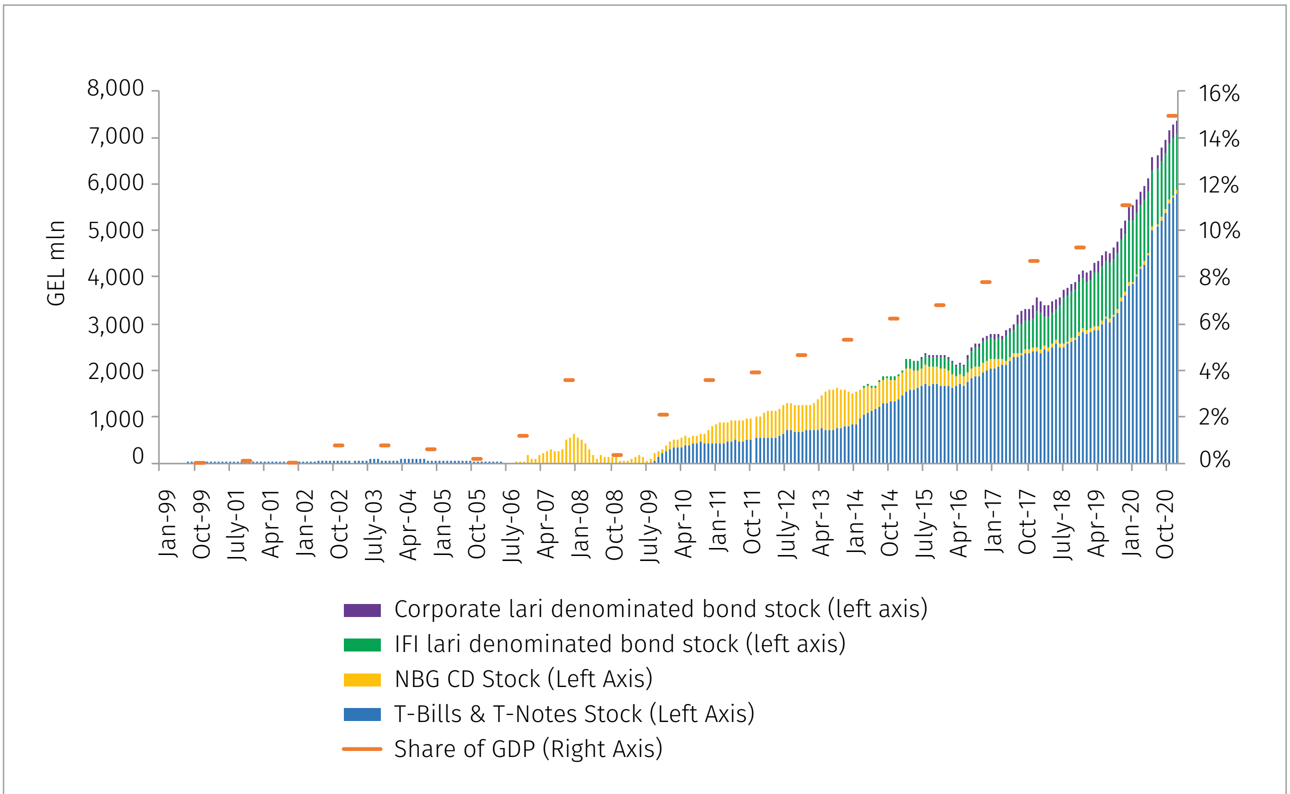
DIAGRAM N 2.6 DOLLARIZATION LEVEL IN THE BANKING SECTOR (EXCLUDING THE EXCHANGE RATE EFFECT)



Source: National Bank of Georgia

Promoting capital market development remains one of the NBG's top priorities. In 2016, the NBG and the Government of Georgia developed a joint strategy for the development of the capital market, part of which was enacted in 2020. Its development will increase long-term lari resources and, at the same time, facilitate larization. The market welcomed new lari-denominated corporate securities in 2020, a signal of the gradual activation of the capital market (see Diagram N 2.8). Based on amendments made to the collateral base in 2016, these securities will be admitted in monetary transactions with the NBG, creating an additional incentive to manage liquidity on top of investment purposes. It is also important to note that demand from non-residents for government securities was growing during the year. This was largely due to the high interest rates, which contributed to the increase in foreign exchange inflows and served to appreciate the exchange rate. This factor, in turn, indicates the development of this channel of the monetary policy transmission mechanism and reflects an increase in process efficiency as a whole.

DIAGRAM N 2.7 DYNAMICS OF GEL-DENOMINATED SECURITIES



Source: National Bank of Georgia

BOX 2 ADDITIONAL LIQUIDITY PROVISION INSTRUMENTS

The NBG took significant steps to mitigate the negative impact of the COVID-19 pandemic on the financial sector and to stimulate the country's economy. One such action was to provide liquidity to the banking system so that liquidity risks would not become an impediment to lending in the economy. In order to reduce potential liquidity risks in the financial sector during the pandemic, the NBG launched a number of temporary liquidity instruments: FX swaps, stand-by FX swaps and a liquidity provision instrument for small- and medium-sized businesses.

FX swaps

In April 2020, the NBG launched FX swap operations to support additional liquidity for the banking sector. This tool is available not only for commercial banks but also for microfinance institutions. In the case of FX swaps, a limit of USD 200-200 million (totaling USD 400 million) is available to commercial banks and microfinance institutions. The total amount of the swap is distributed among the participants of the scheme in proportion to the market share of the financial institution. However, to avoid over-concentration, a limit of up to 25% of the total volume was imposed on a single institution, thereby ensuring that resources remained available for small financial institutions. Commercial banks and microfinance institutions were able to use different swap amounts within the monthly limit set for them.

The calculation of the forward rate of the FX swap relies on the interest rates of the one-month TIBR for GEL and the interest rate of the one-month LIBOR rate for USD. The calculation of the forward rate of the swap operation is based on the formula $F = S * (1 + (T1-L1) * D / 365)$, where F stands for the forward rate, S is the official GEL exchange rate against the USD, T1 is the one-month TIBR interest rate, L1 is the one-month LIBOR interest rate on USD published in the Bloomberg system, while D is the duration of the swap in days. The parameters S, T1 and L1 are determined on the basis of the data available on the date when commercial banks submit the swap transaction application to the NBG.

Commercial banks could originally use swaps from 15 April 2020 to 15 April 2021, and microfinance institutions from 15 April 2020 to 15 October 2021 (with a decreasing schedule from 15 April 2021). In the spring of 2021, this was extended to 15 April 2022.

Stand-by FX Swap Instrument

To reduce liquidity risk, the NBG introduced a stand-by FX swap instrument in the spring of 2020, through which additional liquidity could be obtained at a penalty interest rate. However, there was no need to use this tool during the year.

Similar to a FX swap, calculation of the forward exchange rate of a standby FX swap also relies on the interest rates of the one-month GEL TIBR and the one-month LIBOR of the USD, although added to that is the NBG's overnight loan spread with the monetary policy rate. The interest rate of the loan is determined by the following formula $R = T - L + O + D$, where T is the one-month TIBR interest rate, L is the one-month USD LIBOR interest rate published in the Bloomberg system, O is the NBG's overnight loan spread with the monetary policy rate, while D is the interest rate accrued on the USD deposit by the NBG.

The stand-by swap operations facility was launched on 1 May 2020. The duration of the stand-by swap operation is one month, with the possibility of a monthly renewal. The term of this instrument was originally set at one year, until 1 May 2021, but in the spring of 2021 it was extended until 1 May 2022.

Swap agreement with the European Bank for Reconstruction and Development

In April, the NBG signed a swap agreement with the European Bank for Reconstruction and Development (EBRD) with a USD 200 million limit. The EBRD finances many important projects in Georgia. Funding is provided in both foreign and, in some cases, national currencies. The swap operation with the NBG allowed the EBRD to continue providing national currency funding for major projects in the Georgian economy at the outset of the pandemic, thereby helping to avoid FX risks for beneficiaries.

Liquidity instrument to support small and medium businesses

A liquidity instrument to support small- and medium-sized businesses was launched on 1 June 2020 and consists of two components. The first is for commercial banks, who can receive lari liquidity from the NBG in exchange for mortgaging a small- and medium-sized business loan portfolio. The second component is intended for microfinance institutions, which can attract lari resources from the NBG through commercial banks. These loans use a small and medium business loan portfolio as collateral, which must meet the criteria set by the NBG.

The interest rate on this instrument is the one-month TIBR index active on the date of its use. The instrument is valid until 31 December 2023, with a gradual reduction from 2022.

2.2 MONETARY POLICY INSTRUMENTS

The implementation of Monetary Policy Committee (MPC) decisions (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 of the NBG. The NBG's 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 in which banks trade short-term excess liquidity. The NBG has 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.

The Tbilisi Interbank Interest Rate (TIBR) index of the money market is the overnight interest rate benchmark. It is based on actual transactions on the interbank money market, which increases the credibility of the index. The reliability of the index is further enhanced by the involvement of the National Bank of Georgia in the process of collecting information and calculating the index. For the use of medium- and long-term instruments in the market as a benchmark (especially in lari variable rate instruments) the National Bank of Georgia started publishing TIBR term indices on 14 March 2019. These are based on the overnight TIBR index and represent a more effective way to manage interest rate risks.

The methodology for calculating the TIBR index and TIBR term rates was developed in close cooperation with money market participants and with the help of the EBRD. The methodology also provides procedures for data control and methodology review. The TIBR indices are published daily (at 9 a.m.) on the official website of the National Bank of Georgia.

The volume of transactions in local currency on the interbank market in 2020 was 71.2% of those of the previous year and amounted to GEL 20.1 billion. In the context of the changes made to the NBG's monetary policy rate in 2020, the year also saw a change of interbank interest rates, which moved close to the monetary policy interest rate. The National Bank of Georgia determined weekly volumes for refinancing loans and monthly volumes for the one-month open market instrument within the framework of the decisions of the Monetary Policy Committee, and based on the short-term liquidity forecast of the banking system. The NBG managed these processes in such a way that the average interest rates observed at the auctions were maintained close to the monetary policy rate.

2.2.1 REFINANCING LOANS

The National Bank of Georgia used the refinancing loan instrument on a weekly basis throughout 2020 to ensure short-term liquidity in the banking system. Refinancing loans represent a reliable and low-risk source of short-term liquidity and have positively affected both 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 lari 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 offered on the auctions are based on the NBG's monetary policy rate.

In 2020, the collateral base of monetary operations encompassed certificates of deposits of the National Bank of Georgia, Georgian government securities, loan assets of commercial banks, lari-denominated securities issued by international financial intuitions and lari-denominated securities issued by resident and non-resident legal entities. To qualify for certain operations, the NBG defined appropriate criteria for each type of collateral (e.g., minimum level, residual maturity, currency, etc.). Commercial banks used all types of collateral in their operations with the National Bank of Georgia in 2020.

2.2.2 ONE-MONTH OPEN MARKET INSTRUMENT

Similar to other monetary instruments, the one-month instrument aims to manage short-term interest rates on the interbank market. Its use is in line with best international practice and the recommendations of the International Monetary Fund's Technical Assistance Mission. Every month, the liquidity forecasting group evaluates the short-term liquidity deficit in the banking system, on the basis of which an auction is announced for the specific volume of the one-month open market instrument to be offered. The minimum interest rate for this instrument at auction equals the monetary policy rate. NBG certificates of deposit, government securities, local currency bonds issued by IFI's, corporate bonds issued in local currency by resident corporations and the loan assets of commercial banks can all be used as collateral.

2.2.3 OVERNIGHT LOANS AND OVERNIGHT DEPOSITS

In 2020, the National Bank of Georgia continued to use the interest rate corridor on the interbank market to support the development of the money market, to reduce the volatility of interbank interest rates and increase activity on the money market. The interest rate corridor was defined as an equal deviation from the monetary policy rate to form the upper and lower bounds of interest rates. The upper bound of the interest rate was used for overnight (O/N) loans of the National Bank of Georgia, and the lower interest rate bound was used for O/N deposits of the National Bank of Georgia. In 2020, the interest rate corridor was 1.5pp – the monetary policy rate plus/minus 0.75%. The use of the interest rate corridor reduces excessive volatility of interest rates on the interbank market and, in turn, helps bring the interbank interest rate closer to the monetary policy rate.

Overnight loans from the National Bank represent the fastest source of 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.

Commercial banks can use the O/N deposit instrument at the end of the day to allocate excess liquidity on correspondent accounts at the National Bank of Georgia. Such deposits are returned to the relevant commercial bank's correspondent account at the beginning of the next business day. This tool plays an important role in stabilizing interest rates on the interbank market.

2.2.4 ADDITIONAL LIQUIDITY PROVISION INSTRUMENTS

In the context of the pandemic, the National Bank launched temporary liquidity instruments –currency swaps, standby swaps, and liquidity provision instruments for small and medium-sized businesses – to minimize possible liquidity risks in the financial sector (see Box 2).

Swap operations

From April 2020, the National Bank started using currency swap operations to support additional liquidity for the banking sector. This tool was available to microfinance institutions and commercial banks. In swap operations, the National Bank bought foreign currency in the national currency for one month at a spot rate on the condition of selling it back at its forward rate. Currency swap transactions were conducted once a month and were conducted a total of nine times in 2020. As many as nine commercial banks and eight microfinance institutions (through banks) participated in these operations at different frequencies. The amount of currency swap transactions varied each month and ranged from USD 38.5 million to USD 119.4 million, accounting for 10-30% of the allocated resources. As of 31 December 2020, USD 40.7 million was used in swap transactions, equivalent to GEL 133.7 million.

Standby swap instrument

The National Bank introduced and launched a standby swap instrument as an additional liquidity support instrument for the banking sector in May 2020. This allows commercial banks to receive additional lari liquidity on any day at a penalty interest rate. Although commercial banks did not use this instrument in 2020, it served as a form of assurance against liquidity risk.

Liquidity instrument to support SMEs

In June 2020, the National Bank launched an additional liquidity instrument to reduce the negative impact of the pandemic on the economy and to support small- and medium-sized businesses. The one-month liquidity instrument offered the possibility of monthly renewals and was used by eight commercial banks. Based on the need for liquidity, the volume of the instrument changed over the months. Its minimum rate was GEL 52.8 million, while its maximum rate was GEL 349.1 million at the end of the year.

2.2.5 SECURITIES

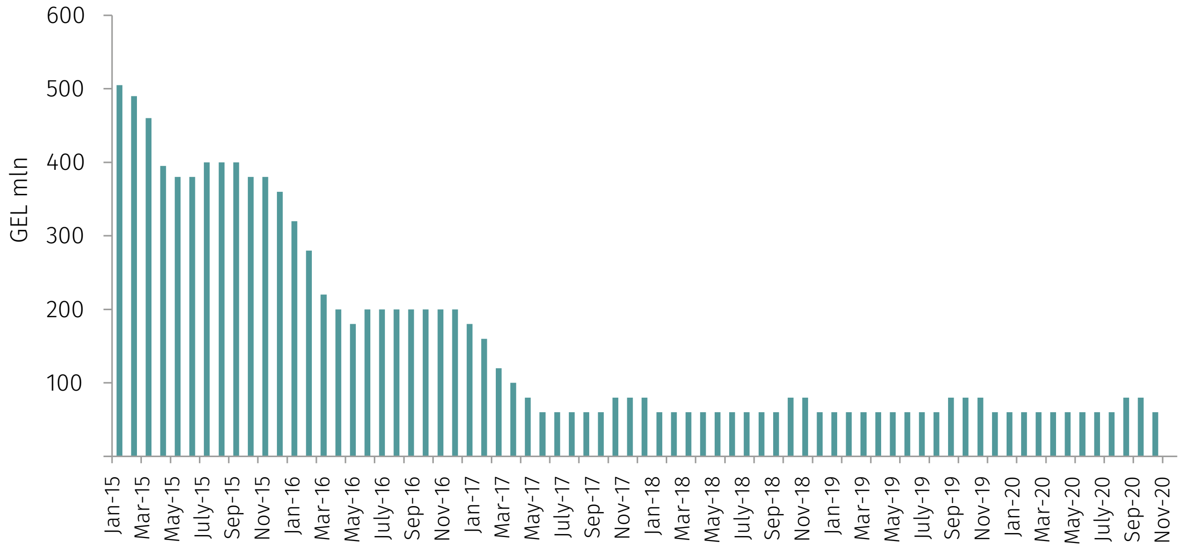
The National Bank of Georgia issued 3-month certificates of deposit, and the Government of Georgia issued 6-month, 1-, 2-, 5- and 10-year treasury securities in 2020. These securities were in high demand by commercial banks and helped establish a stable yield curve. This curve provides important information about interest rates of different maturities and the expectations of financial market participants.

Certificates of deposit

The National Bank of Georgia continued to issue 3-month certificates of deposit in 2020. These are used by the banking sector as an attractive and effective short-term liquidity management tool.

In the 13 auctions announced in 2020, commercial banks purchased the full amount of certificates of deposit offered. In total, certificates of deposit with a nominal value of GEL 260 million were placed and those with a face value of GEL 280 million were repaid. As of 31 December 2020, GEL 60 million worth certificates of deposit in circulation were held by four commercial banks.

DIAGRAM N 2.8 VOLUME OF THE CERTIFICATES OF DEPOSIT PORTFOLIO (2015-2020)



Source: National Bank of Georgia

Government bonds

As of 31 December 2020, the National Bank of Georgia held government bonds with a nominal value of GEL 152 million, which were not used for open market operations during the year.

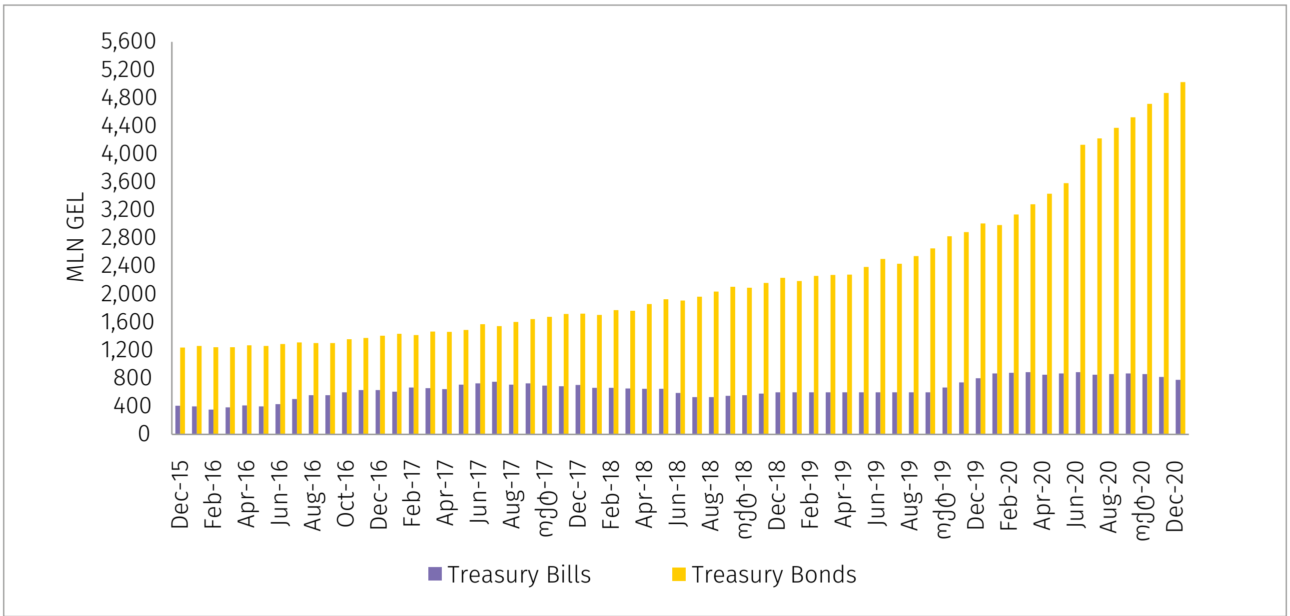
Treasury bills and treasury bonds

To further develop the GEL money market, it was vital that the Ministry of Finance of Georgia increase the emission of government securities. In 2019, 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 GEL 1,000. The placement of treasury bills and bonds are executed through a multiple price auction conducted by the NBG via the Bloomberg trading platform. All commercial banks licensed by the National Bank of Georgia can participate directly in these auctions and any legal or individual entities may also participate by using a commercial bank as an agent.

In 2020, 52 auctions of treasury bills and notes were conducted, and GEL 2.97 billion worth of securities were offered. As of 31 December 2020, 15 commercial banks, the National Bank and non-banking investors held GEL 5.81 billion worth of securities in circulation. Non-banking investors held treasury securities worth GEL 715.4 million.

The volume of government securities in circulation in the market is still small compared to the size of the economy. In order to increase market liquidity, the Georgian government has issued 2-, 5- and 10-year benchmark bonds since 2018. This has led to an increase in the issuance of treasury securities, which contributes to the reduction of foreign exchange risk.

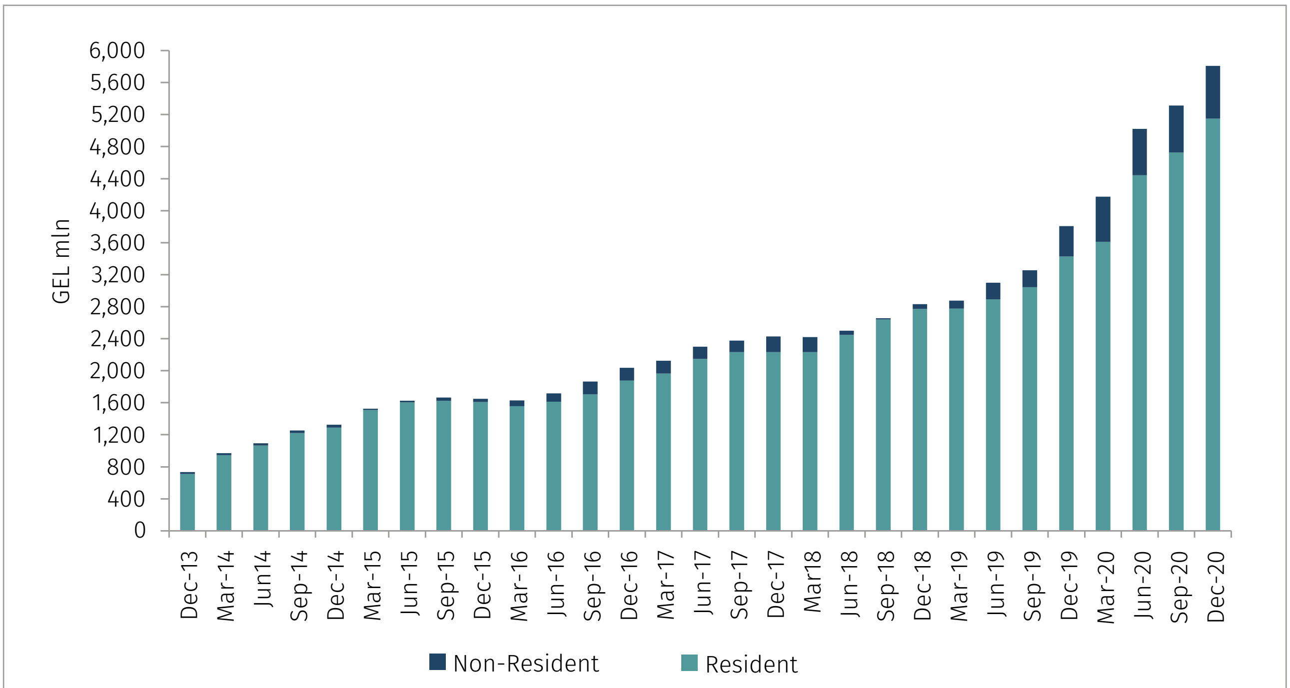
DIAGRAM N 2.9 DYNAMICS OF TREASURY BILLS AND TREASURY BONDS (2016-2020)



Source: National Bank of Georgia

The stable macroeconomic environment, attractive interest rates on GEL financial instruments, an acceptable level of financial market development and modern infrastructure has sparked the interest of non-resident investors in the treasury market. The increased activity of such investors is evident in their involvement in both primary and secondary markets, with the portfolio of treasury securities owned by them increasing by GEL 276.6 million (72.6%) during 2020 to total GEL 657.6 million.

DIAGRAM N 2.10 TREASURY BILLS AND TREASURY BONDS PORTFOLIO DYNAMICS (2016-2020)



Source: National Bank of Georgia

To promote the activation of the secondary securities market, the National Bank of Georgia continued to foster the full functioning of the Georgian Securities Settlement System (GSSS) and various integrated systems, in accordance with current requirements, through its own material and intellectual investments.

The interbank repo market, which is based on the repo master agreement, was established in line with best international practice by the National Bank of Georgia in close cooperation with the Georgian banking community. Banks used the Bloomberg trading platform and the Georgian Securities Settlement System (GSSS) to conduct repo transactions. Through these systems, a total of five repo transactions worth GEL 96.9 million were made between commercial banks in 2020.

The infrastructure and experience amassed in the securities market provide a good basis for the further activation of the secondary securities market, which should lead to an increase in the liquidity of the securities market.

Pilot program for a primary dealer system to develop the securities market

The development of the treasury securities market is a strategic focus for the development of the Georgian financial market and for the management of government debt. In recent years, the volume of the securities market has been steadily increasing. Benchmark bonds were first issued in 2018, with their volumes subsequently increasing gradually.

To take the securities market development to a new level, to expand the investor base and to activate the secondary market, the National Bank of Georgia and the Ministry of Finance of Georgia considered it expedient to establish a primary dealer institute, as adopted in international practice. The primary dealer can act as an important mediator in the securities market, operating between the Ministry of Finance of Georgia, as the issuer of treasury securities, and investors. A well-developed government securities market will, in turn, help the advancement of the capital market. Primary dealers will take care of the diversification of the investor base and the increase of liquidity in the secondary market by making regular price updates and providing appropriate trade and settlement infrastructure.
The National Bank of Georgia and the Ministry of Finance of Georgia, with technical assistance from the International Monetary Fund and the World Bank, have spent a great deal of time in recent years preparing a pilot program for primary dealers. A jointly prepared memorandum of understanding in this direction was discussed with market participants. Ultimately, six commercial banks operating in Georgia expressed their desire to participate in the pilot program and memoranda of understanding were signed with them. The pilot started in November 2020 and its validity period was set at 1-1.5 years. After this period, the results of the program will be summarized, and future development plans outlined.

National Bank operations in the secondary market

The National Bank of Georgia is constantly working on improvement and development of monetary instruments and the liquidity management framework. Buying and selling securities through open market operations is one of monetary policy instruments that central banks use to manage liquidity.

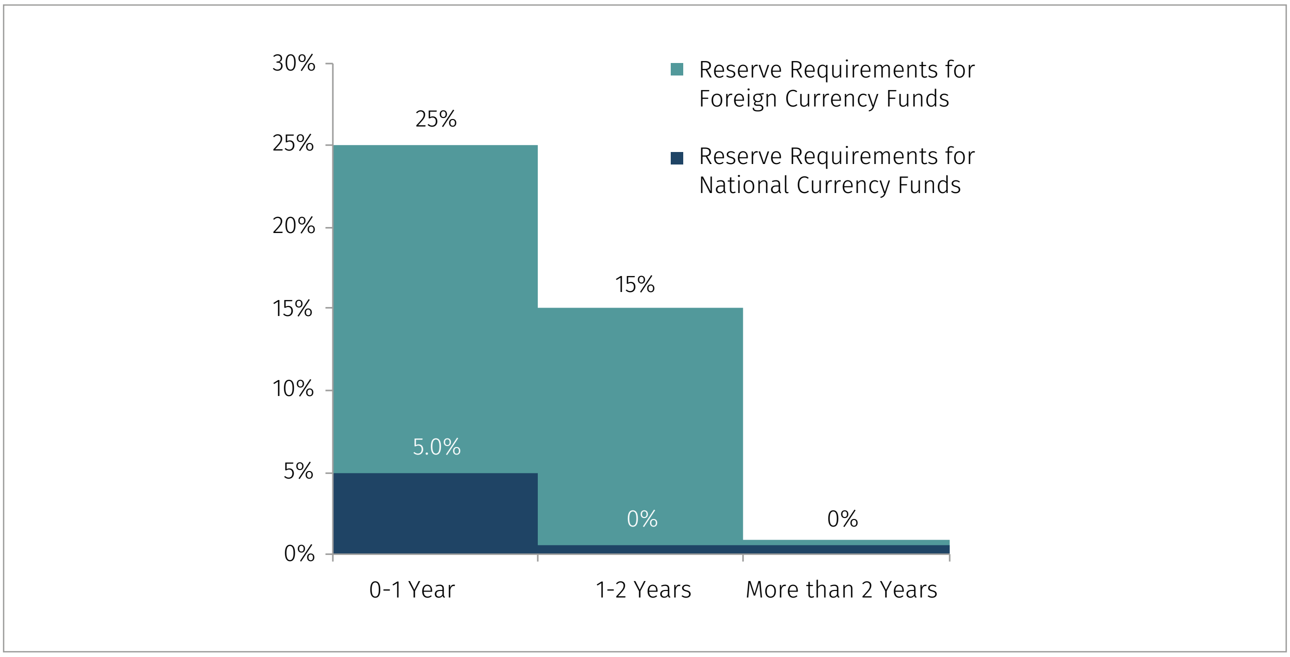
In 2020, the NBG continued purchasing securities under open market operations in the secondary market. The purpose of these operations was to effectively manage the liquidity of the national currency. It also promotes the development of the securities market.

The National Bank of Georgia held 17 auctions during 2020 in which it purchased treasury securities with a nominal value of GEL 603.9 million. Considering the securities balances repaid in 2020 and acquired in 2019, the securities portfolio held by the National Bank as of 31 December 2020 amounted to GEL 984.96 million. At the end of 2019, the volume of this portfolio was GEL 653.3 million.

2.2.6 MINIMUM RESERVE REQUIREMENTS

By employing the minimum reserve requirements instrument, the National Bank of Georgia creates a precondition for the effective use of other monetary instruments. As of 31 December 2019, the minimum reserve rate for funds attracted in the national currency was 5%, for foreign currency attracted funds it was 25%, for foreign currency borrowings with a residual maturity of 1 to 2 years it was 15%, and for borrowings with a residual maturity of more than 2 years, the interest rate was 0%.

DIAGRAM N 2.11 RESERVE REQUIREMENTS



Source: National Bank of Georgia

In 2020, the National Bank applied the monetary policy rate active in the relevant period to the minimum reserves that commercial banks had placed in the national currency in the National Bank of Georgia.[33] The rate applied to US dollar minimum reserves was 50 basis points lower than the upper limit of the US Federal Reserve policy, and the rate for euro minimum reserves was 20 basis points lower than the European Central Bank's deposit rate.

33. For further details, please visit the NBG's official webpage: https://www.nbg.gov.ge/index.php?m=558

Development of the Securities Settlement System in Georgia

A Securities Settlement System has been operating at the National Bank of Georgia since 2010. This modern, high-tech, fast and secure electronic system ensures safe and transparent securities transactions for government and NBG-issued securities.

Launched on 3 December 2018, and successfully operating throughout 2020, the updated Georgian Securities Settlement System (GSSS) provides high-quality services to both local and international financial market participants. The system can settle the whole spectrum of both public and private securities. With its use, transactions with securities have become faster, cheaper, more convenient and fully protected. This project is a clear example of successful cooperation between the National Bank of Georgia and the private financial sector. The innovative GSSS system includes modern approaches, such as effective liquidity management mechanisms, partial settlement capacity, netting of reverse transactions, automatized pledging and intraday liquidity provision mechanisms. All local commercial banks are connected to the GSSS as well as some brokerage companies. The system is integrated with the stock exchange and the Bloomberg trading platform and automates the entire trading and settlement cycle. Thus, it only takes a few minutes from the time of a transaction to its settlement. With the introduction of the new system, available procedures and payment procedures were renewed based on the principles recognized in international best practice. Investors' security holdings will now be more securely protected, making it easier and more convenient to convert them into cash if needed (through sales, pledge or repo operations). This will undoubtedly increase the attractiveness of the Georgian capital market for both Georgian and foreign investors.

The updated GSSS allows the integration of the Georgian Central Securities Depository in the system, enabling services to be provided to all participants in the Georgian securities market, and the registration and settlement of all types of securities in this system in Georgia (including bonds and shares issued by private companies). Private securities issuance, repayment, buying and selling, repo, coupon and dividend payment operations registered in this system are fully automated, as well as their pledging to the National Bank of Georgia or professional market participants.

The updated GSSS system is expected to make Georgian financial markets attractive for foreign financial institutions and investors, while helping the local securities markets' infrastructure become more reliable and up to date.

2.3 EXCHANGE RATE POLICY AND INTERNATIONAL RESERVES MANAGEMENT

Exchange rate policy

Similar to previous years, in 2020 the monetary policy of Georgia was based on a floating exchange rate regime, which involves maintaining market pricing principles for the national currency. A floating exchange rate mechanism is recognized as the optimal currency regime for countries with small open economies, like Georgia. These principles are reflected in the monetary policy strategy of the National Bank of Georgia. The key benefit of such an exchange rate formation mechanism is a weakening of the negative impact of external shocks on the country's economy and its ability to function as an automatic stabilizer for the economy. The latter played a particularly important role during the pandemic crisis.

Foreign exchange (FX) auctions were still used by the NBG as the main tool for interventions in the FX market during the reporting period. In the crisis environment of 2020, a negative external balance was formed in the private sector, whilst a positive external exposure simultaneously emerged in the government sector as a result of foreign government inflows and assistance. The NBG is the government banker, so the government's foreign currency accounts are opened with the NBG. Most of the government's foreign exchange inflows are thus directly reflected in government accounts in the NBG and do not reach the FX market. This is why the NBG resorted to a policy of active foreign exchange interventions in the area of FX sales.

In the reporting year, the volume of foreign currency sold by the NBG at foreign exchange auctions amounted to USD 873.2 million. In addition to standard foreign exchange auctions, the NBG provided an additional USD 42.9 million in liquidity to the FX market through the BMatch platform launched in 2020 (see Box 3). The volume of foreign currency supplied by the NBG to the FX market in the reporting year totaled USD 916.1 million.

The COVID-19 pandemic severely affected the country's tourism industry, which led to a sharp decline in foreign exchange inflows, putting strong pressure on the FX market. At the end of 2020, the lari nominal exchange rate depreciated by 14.3% against the US dollar and by 25.4% against the euro compared to the previous year. During the same period, the lari nominal effective exchange rate depreciated by 3.0% annually, while the real effective exchange rate depreciated by 3.4% year on year.

BOX 3 FX MARKET REFORMS

The BMatch platform

FX trades were launched on the BMatch platform in the Bloomberg system during the reporting period. BMatch is based on the principle of the automatic matching of transactions. Market participants place foreign currency buying and selling bids on the Bloomberg BMatch platform. If the exchange rates between the buyer and seller match, then foreign exchange transactions are concluded automatically between the parties. Along with commercial banks, companies can also participate in the BMatch platform. The launch of this new system helps to strengthen competition in the FX market and improves the transparency of the market operation process. An analysis of the past period shows that the competitive and more transparent environment offered by the BMatch platform has made it possible to significantly narrow spreads.

The launch of the BMatch platform has allowed the NBG to introduce an additional tool, rule-based interventions, which offers the benefits of actively intervening in the FX market without hindering the competitive pricing process in the market. The NBG's rule-based interventions on the BMatch platform are completed at a pre-defined amount. The NBG's small-scale interventions reduce excess volatility in the FX market, whereas exchange rate fluctuations are caused by low liquidity (low activity) in the foreign exchange market. Management of excess volatility was particularly relevant during the reporting period, when volatility increased significantly in the face of high market uncertainty. In addition to sales at standard foreign exchange auctions, the NBG provided an additional USD 42.9 million in foreign currency liquidity to the FX market through the BMatch platform.

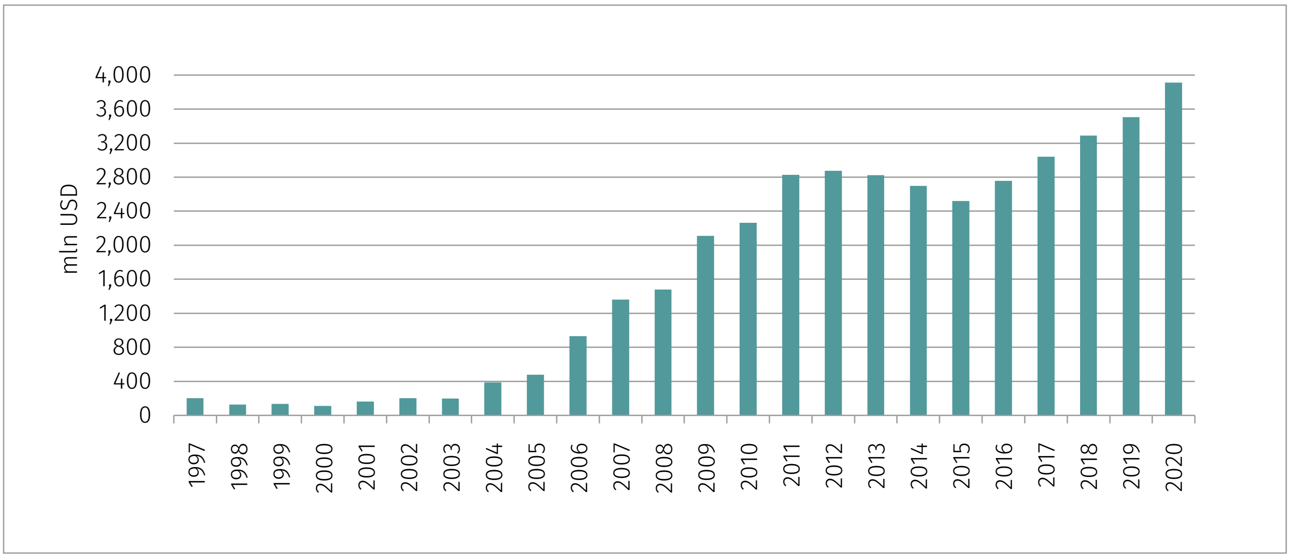
FX Global Code

To facilitate the efficient functioning of the FX market, the NBG initiated a harmonization process aligning regulations with the requirements of the FX Global Code. The FX Global Code was established in 2017 with the participation of the central banks of the world's leading countries. The Bank of International Settlements, the central banks of 47 countries, as well as more than 1,000 financial institutions and companies recognize the need to meet the terms set out in the code. These include the central banks and leading banking institutions of the USA, England, Europe, Japan, Canada and Australia. The NBG has initiated new regulations regarding the rules of conduct for FX market participants. These are based on the requirements of the FX Global Code, while still reflecting the idiosyncrasies of the local market. The FX Global Code and the rules of conduct for FX market participants aim to increase transparency and competition, establish fair and equitable conditions for market participants, and better protect the interests of their clients.

International reserve management

The volume of international reserves of the National Bank of Georgia increased by USD 405 million in 2020, compared to the previous year, and, as of 31 December 2020, amounted to USD 3.9 billion (see Diagram N 2.12). The funds raised by the government from international donors were provided by the National Bank to the foreign exchange market through interventions. In line with the growth of FX deposits, the reserves were positively affected by an increase in the volume of compulsory reserves, currency swap operations, and by the receipt of the next installment from the International Monetary Fund at the end of the year. Despite the increase in total reserves, a decrease in net international reserves was observed in 2020. The factors that affected the volume of the NBG’s international reserves during 2020 were the foreign exchange auctions of the NBG, government expenditures and credits, and grants received from international organizations. Foreign exchange sales of the NBG through foreign exchange auctions and the Bloomberg's BMatch platform amounted to USD 916.1 million in 2020. The amount of grants and loans received from international financial institutions and donor states in foreign currency to NBG accounts to finance various programs and projects was about USD 1.3 billion. The total amount of loans received from the International Monetary Fund by the National Bank and the Ministry of Finance amounted to about USD 315 million. Meanwhile, public debt service and foreign exchange costs were about USD 750 million.

DIAGRAM N 2.12 OFFICIAL RESERVE ASSETS 1997-2020 (MILLION USD, YE)



Source: National Bank of Georgia

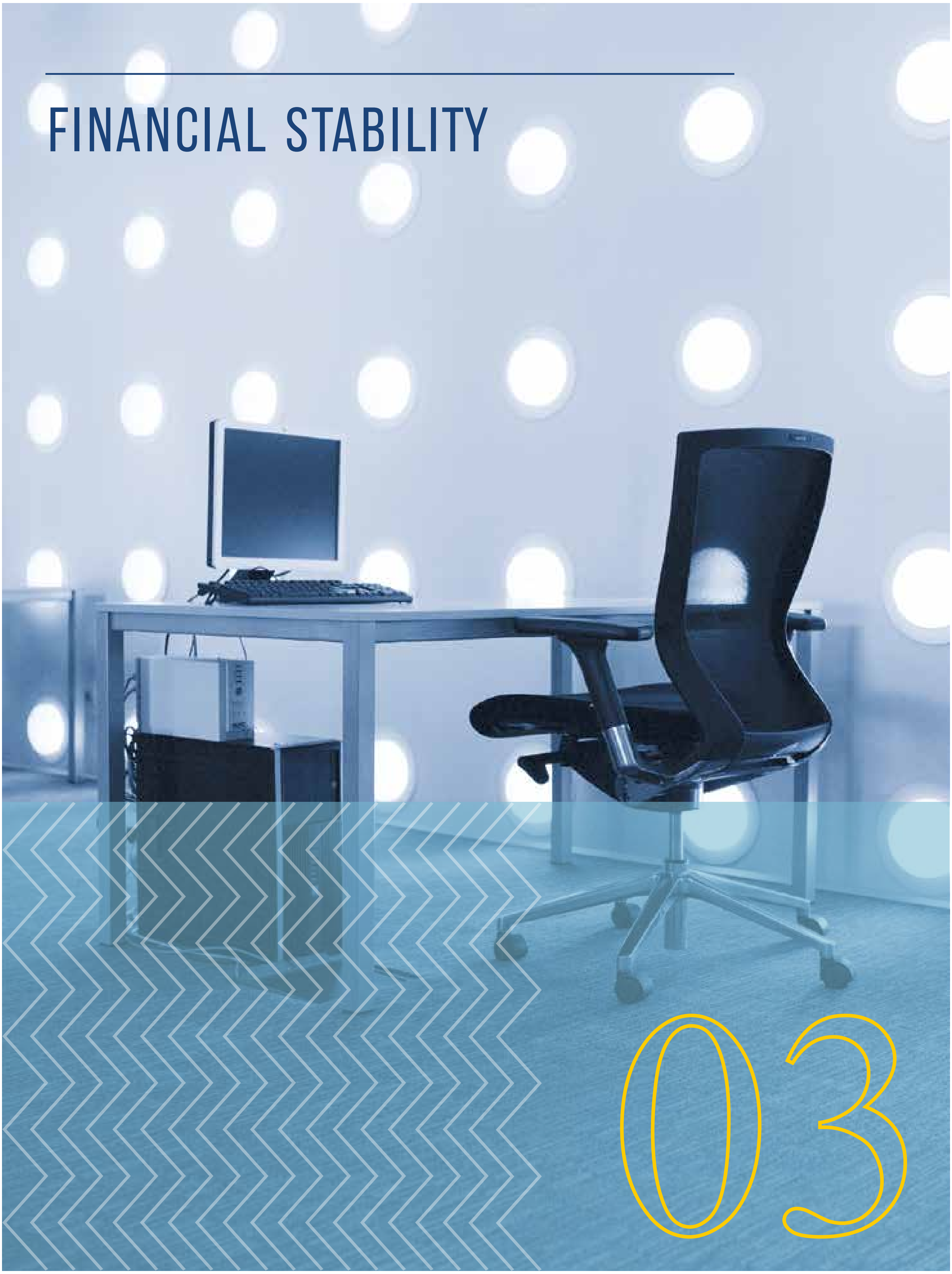
The investment policy of the National Bank of Georgia continued to be conservative and focused on reducing credit risks. The National Bank of Georgia's international reserves were located in high-liquidity securities of US, eurozone, Australian and Canadian government agencies and supranational financial institutions, and in international credit institutions with high credit ratings. Revenues from the International Reserve Management of the National Bank of Georgia during 2020 amounted to GEL 176 million. The sharp decline in rates in the first half of 2020 had a significant impact on the dynamics of reserve earnings.

To overcome the crisis caused by the COVID-19 pandemic, an agreement was signed between the European Central Bank and the National Bank of Georgia to launch a euro repo line to support liquidity in 2020. This line was launched for Georgia for the first time within the framework of the Eurosystem Repo Facility for central banks.

The National Bank of Georgia continued its cooperation with the World Bank within the framework of the Sovereign Investment Partnership Program in 2020. The National Bank became a member of this program in 2009. It provides technical support to the National Bank for further development of international reserves management, infrastructure development and knowledge accumulation, and includes the sharing of World Bank experience in portfolio and risk management, settlement, accounting, legal, and information technology issues.

Cooperation between the National Bank of Georgia and the Bank for International Settlements (BIS) also continued in 2020. The National Bank of Georgia joined the BIS Investment Pool (BISIP) program at the end of 2014. The program involves the management of joint funds from various central banks and international financial institutions in a single portfolio. The BISIP program also includes assistance in reserve management and facilitates the sharing of experience.

FINANCIAL STABILITY



03

3.1 FINANCIAL STABILITY POLICY

Promoting financial stability as a precondition for sustainable economic growth is one of the fundamental goals of the National Bank of Georgia. As defined by the Organic Law on the National Bank of Georgia, the NBG is mandated to maintain financial stability in the country as long as that objective does not come into conflict with its main mandate of maintaining price stability. Financial stability is the state under which the financial system can provide crucial services to market participants in both good times and periods of stress.

The NBG conducts macroprudential policy with the goal of maintaining financial stability. The NBG identifies, evaluates and monitors systemic risks and implements corresponding policies to prevent or mitigate those risks, thereby enhancing the resilience of the financial system. The Financial Stability Committee (FSC) of the NBG, which is chaired by the NBG's Governor, coordinates macroprudential policy within the NBG's mandate. The FSC identifies and analyses systemic risks and ways to mitigate them, makes recommendations on the use of macroprudential measures and coordinates actions that promote financial stability.

The countercyclical capital buffer is one of the main macroprudential policy instruments. Its goal is to limit excessive credit growth that leads to the build-up of systemic risks. The countercyclicality of the buffer serves the main purpose of macroprudential policy: reducing systemic risks. In the event of negative shocks, the countercyclical buffer should help the financial system 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. An analysis of a number of factors is used to determine the countercyclical capital buffer, 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 the characteristics of the country's domestic and external macro-financial environment.

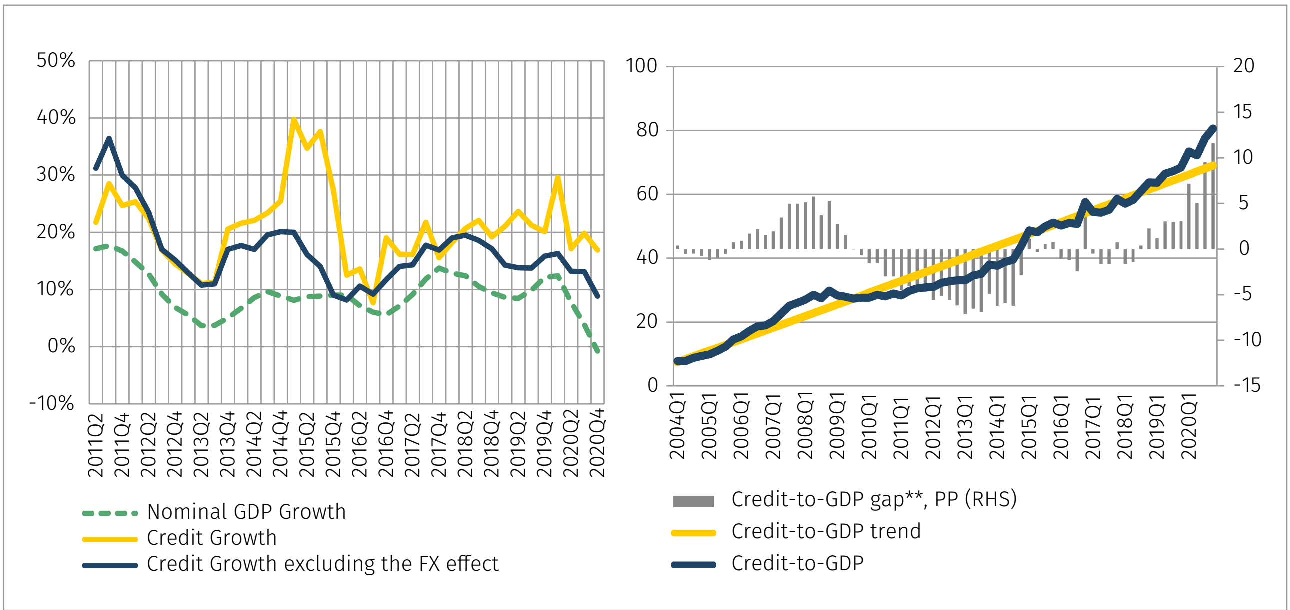
In addition to the countercyclical buffer, the National Bank of Georgia uses other capital buffers consistent with Basel III standards. These macroprudential instruments include the payment-to-income ratio and loan-to-value ratio, sectoral risk weights and other instruments.

The capital requirements imposed by the National Bank and the profits made by commercial banks in previous periods allowed banks to accumulate sufficient capital buffers to cope with the stressful situation posed by COVID-19. The banking system also faced the pandemic armed with sustainable asset quality, as facilitated by the introduction of responsible lending regulations and a number of macroprudential measures to reduce the dollarization of loans. The establishment of the Liquidity Coverage Ratio (LCR) and Net Stable Financing Ratio (NSFR) in recent years led to the stability of banks' funding sources and an improvement of the liquidity buffer.

The National Bank significantly expanded its lari liquidity provision instruments in 2020 to facilitate lending to the economy and released part of the commercial banks' capital buffers under the supervisory plan, giving them more flexibility in managing liquidity. The share of non-performing loans increased as a consequence of the pandemic, although commercial banks had created preliminarily loan loss reserves. The financial stability policy pursued by the National Bank of Georgia allowed the financial system to face the pandemic and offer much-needed benefits to the most vulnerable borrowers in the form of deferrals and restructuring, while continuing to lend to the economy smoothly.

The annual growth of loans in December 2020, excluding the exchange rate effect, was 9.1%. However, the ratio of loans to GDP still exceeded its long-term trend, reflecting the high credit growth and exchange rate effect in previous periods. Such a deviation from the trend (the gap) indicates a rising debt burden and vulnerability, especially in the corporate sector. The debt burden increased even more in 2020 as a result of reduced economic activity and exchange rate effects stemming from the pandemic; however, considering the weak demand for loans and the countercyclical macroprudential policy, the National Bank did not increase demand for the countercyclical buffer and kept it unchanged at 0%. If the baseline scenario is implemented, a recovery plan for the capital buffers released in 2020 will be announced in 2021, and the banking sector will be given sufficient time to gradually re-accumulate and restore the buffers without special hindrance.

DIAGRAM N 3.1 COMPARISON OF LOAN AND NOMINAL GDP GROWTH RATES



** Loans include loans issued by banks and microfinance institutions, as well as bonds issued locally by companies.*
*** The gap of the loans-to-GDP ratio is the difference between the ratio and its long-term trend. An HP filter is used to evaluate the trend according to the Basel recommendations.*
Source: National Bank of Georgia; GeoStat

Dollarization remains a major challenge for the financial sector, despite a considerable decline recently. Foreign currency loans are accompanied by both exchange rate and interest rate risks. The potential medium-term impact of the latter is particularly significant today as interest rates in US dollars and euros are historically low in world markets. In the pre-crisis period, the National Bank took a number of macroprudential measures to reduce the dollarization of loans, which contributed to a significant reduction in vulnerabilities. However, given the continued high share of foreign currency loans in lending and increased exchange rate fluctuations, dollarization remains a key risk for non-hedged borrowers and for the financial system as a whole.

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 the country's economic development. The importance of financial stability and macroprudential policy has increased all over the world in recent years. The pandemic that emerged in 2020, resulting in a global economic crisis, reaffirmed the importance of financial stability. A sound and efficient framework for financial stability will ensure a smooth supply of financial resources, even during economic downturns, and will make a significant contribution to the rapid recovery of the economy. Regular, comprehensive and in-depth analyses of financial stability are required according to best international practice. Financial stability analysis not only encompasses an evaluation of risks in the banking system, but also focuses on external factors that have been a source of significant risk in recent years. The financial stability framework also assesses the domestic macro-financial environment, including households, companies, and non-banking institutions.

The NBG continues to develop a financial stability policy framework in accordance with best international practice. As this requires developing adequate analytical capacity, the first step in this direction was focused on developing complex and Georgia-specific financial stability indicators. These indicators are used to make cyclical macroprudential policy decisions. As the next step, the NBG published its macroprudential strategy.[34] The strategy reflects the basic principles of the National Bank's macroprudential policy and aims to improve decision-making processes, communication and accountability to the public. In addition, the NBG is working on the development of an analytical toolkit, which is based on both international experience and country-specific characteristics. In this regard, a research paper prepared by the Financial Stability Department was published in 2020.[35] The paper proposes various analytical tools to ensure the timely detection of systemic risks and thus to establish a credible macroprudential policy guide.

Macro-financial modeling is another important part of the financial stability analysis framework. The National Bank of Georgia is actively working on the development of a macro-financial model with the support of the IMF's technical mission. The model is designed to assess the risks to financial and macroeconomic stability; to construct and analyze macro-financial scenarios; and to conduct macroeconomic stress tests, which are the cornerstones of an appropriate macroprudential policy framework. Developments in the financial system and accompanying challenges are creating growing demand for the macro-financial model and expanding the scope of its application. The further development and advancement of the model is thus an ongoing process in which cooperation with international partner organizations is crucial.

Increasing transparency and improving communications are among the most important aspects of the financial stability framework. The NBG is constantly updating the financial stability section of its website in order to increase public

34. See https://www.nbg.gov.ge/index.php?m=738&lng=eng

35. See Measuring Credit Gaps for Macroprudential Policy Guidance: An Application to Georgia, https://www.nbg.gov.ge/uploads/workingpaper/2020/wp.24.122020_nbg_credittogdp_eng_v1.pdf

awareness about the financial stability policy. The NBG's website outlines the main responsibilities of the Financial Stability Committee (FSC) and describes the available macroprudential policy tools; it also provides a calendar of committee meetings and offers reports on committee statements and decisions, issues related to IFRS 9 and information regarding the sustainable finance framework.

The NBG supports the efficient implementation of the new financial reporting standards (IFRS 9) by financial institutions. The NBG regularly publishes macroeconomic and financial forecasts and risk scenarios along with quantitative assessments of macroeconomic trends to aid the transparent, consistent and efficient implementation of IFRS 9, and to ensure comparability across reports.[36] It is recommended that the estimates provided within these scenarios be used for calculating expected credit losses. The macroeconomic forecast scenarios for IFRS 9 are based on the macro-financial model and incorporate additional analysis and expert judgment. The provided scenarios are countercyclical by nature, which helps mitigate the potential impact of financial cycles. Given the high uncertainty caused by the pandemic and the increased risks in its wake, the NBG released three updates to its forecast scenarios in 2020, thus allowing financial companies to incorporate forward-looking macroeconomic information in their loan loss reserve estimates in a timely manner.

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. The NBG became a member of the Sustainable Banking Network in September 2017. Since then, it has been actively working on developing a framework for sustainable finance.

The NBG is gradually implementing the action plan outlined in the Roadmap for Sustainable Finance. The roadmap summarizes all the actions that the NBG plans to accomplish before the end of 2022. The ultimate goal of the roadmap is to provide a credible, predictable and stable regulatory framework and to prepare the market for a transition to sustainable finance. The action plan outlined in the roadmap consists of the following main pillars: increasing awareness and building market capacity for sustainable finance; embedding environmental, social and governance (ESG) management into risk-assessment frameworks and decision-making processes; and ensuring greater transparency and market discipline, which will facilitate capital flow towards sustainable sectors.

Integrating ESG considerations into the corporate governance code is one of the major objectives of the sustainable finance framework. These aspects have already been covered in the corporate governance code for commercial banks and the incorporation of ESG considerations in the codes of other capital market participants is in progress. Such integration entails not only the disclosure of ESG considerations, but also concerns related risk management aspects. The NBG, in close collaboration with OECD, created ESG Reporting and Disclosure Principles and developed a corresponding template. These were also discussed with the Sustainable Finance Working Group, whose members are representatives of the financial sector. The final version of these documents ware published on the NBG's website in early 2020.

36. See https://www.nbg.gov.ge/index.php?m=694&lng=eng

These principles and the template are designed to support financial institutions in complying with the requirements outlined in the corporate governance code as well as assisting them with the disclosure of ESG-related information in a consistent and comparable manner. Disclosure of ESG issues in this format will also help the Georgian financial sector to better manage ESG risks and increase transparency. Starting from 2021, banks will disclose ESG information using the NBG's template in accordance with the requirements of the corporate governance code. The templates filled out by financial institutions are published on the NBG's website on an annual basis to facilitate access to information on ESG issues for investors and other stakeholders.

The development of a Sustainable Finance Taxonomy, which is an action set out in the Roadmap for Sustainable Finance, is another important step that the NBG has taken towards the development of the Sustainable Finance Framework.[37] The lack of common definitions and classification systems in this regard is recognized as one of the major challenges for the development of sustainable finance. To address this challenge, the National Bank, in collaboration with the IFC, began working on the development of the Sustainable Financing Taxonomy. A well-defined and precise taxonomy can help increase market transparency, help finance flow to sustainable investments, and meet the Paris Agreement and the UN Sustainable Development Goals. This initiative also includes a Sustainable Finance Working Group, which aims to involve stakeholders in the actions listed in the roadmap at an early stage and to ensure the successful implementation of the action plan.

The NBG took another step towards developing the Stable Finance Framework by joining the Network for Greening the Financial System (NGFS) in February 2020. The NGFS is a group of central banks and supervisors that are willing, on a voluntary basis, to share best practices, contribute to the development of environment and climate risk management in the financial sector, and mobilize mainstream finance to support the transition towards a sustainable economy. At present, the NBG has an appointee at the NGFS's macrofinancial workstream and a representative at the plenary. This will further support effective implementation of the action plan provided in the NBG's Roadmap for Sustainable Finance.

This, together with other important steps taken towards the development of the Sustainable Finance Framework, have met with international recognition. The NBG was invited to various sustainable finance conferences during 2020 to share its successful experience. RAEX-Europe organized an international webinar on Sustainable Finance in Georgia on 23 September 2020. Trends in the development of sustainable finance in Georgia, and the measures and initiatives taken by the NBG in the area of sustainable finance, were discussed at the meeting. Attention was also paid to sharing the experiences of the financial sector in this field. RAEX-Europe held a second international forum on responsible investments in the CIS and the Black Sea region on 9 December, where the NBG was again invited to share its experiences of sustainable finance development. The Central Bank of Hungary, the EBRD and the European Commission organized the Central European Green Financing Workshop on 20 October 2020, where the NBG was the keynote speaker. The National Bank briefed participants on the process of working on the Sustainable Finance Taxonomy, and its key approaches and results. In addition, the NBG, in cooperation with the IFC and SBN, hosted a knowledge-sharing

37. The Sustainable Finance Taxonomy is a document that identifies and classifies the actions and economic activities that have a positive environmental or social impact.

event with the National Bank of Ukraine at the end of the year. The event focused on discussing the role of central banks and sharing experiences in developing the Sustainable Finance Framework. The NBG continues its efforts to promote the development of the framework and is gradually implementing the action plan set out in the roadmap.

The NBG published its scheduled edition of the 2020 Financial Stability Report.[38] An updated version of the Financial Stability Report, developed in close collaboration with the International Monetary Fund (IMF), has been published since 2019. The report is based on forward-looking macro-financial analysis and incorporates international best practices. The report presents an assessment of the vulnerabilities and risks in the financial system, focusing on the medium and long term. It reviews the structural characteristics of the financial sector and the aspects of the Georgian economy that are important for financial stability. The report also includes an analysis of the resilience of the local financial system. In addition, the report reviews policies and measures implemented by the NBG to ensure financial stability, including macroprudential measures focusing on the entire banking system and microprudential measures aimed at increasing the resilience of individual financial institutions. The 2020 edition of the Financial Stability Report offers a detailed analysis of the financial stability risks caused by the COVID-19 pandemic and describes the countermeasures taken by the NBG to ensure the resilience of the financial system in Georgia.

Stress tests are another vital component of the financial stability framework. The NBG is vigorously developing a stress-testing model with support from the IMF technical mission. The main objective of stress tests is to assess the resilience of banks against sizable adverse shocks. This instrument allows central banks to identify shock mitigation measures and formulate policies that support the continuity of financial intermediation under periods of stress. These measures and policies help decrease the duration of a shock and foster rapid economic recovery. The stress-testing model was extended in 2020, alongside the IMF technical mission, to allow for more comprehensive risk analysis and the development of satellite models. The updated stress test framework uses 12 satellite models to analyze non-performing loans and interest rates. Part of the credit risk was allocated to satellite models for the corporate and household sectors, sorted by currency. This is important for better credit risk assessment, as macroeconomic variables have different effects according to sector and loan currency. The improved methodology for assessing interest rate risk allows for better assessment of the impact of shocks on local and foreign currency interest rates, considering the maturity of assets and liabilities. The changed structure of the framework allows for detailed monitoring of the on- and off-balance-sheet and components. As a result, dollarization channels are fully integrated into the model and the updated model can provide a more accurate assessment of the impact of shocks.

38. See https://www.nbg.gov.ge/uploads/publications/finstability/2020/finstability_2020_eng.pdf

BANKING SUPERVISION

4.1 DEVELOPMENT OF THE SUPERVISORY FRAMEWORK

The National Bank of Georgia continued efforts to improve its supervisory framework and to harmonize domestic rules with international best practices in 2020.

The NBG announced a temporary moratorium on the development and imposition of new regulatory requirements as a response to the challenges of the COVID-19 pandemic. The intention behind this move was to alleviate the operational burden of financial institutions. However, given its importance and role in the recovery of the economy, this moratorium did not extend to the ongoing reforms concerning resolution.

In 2020, the National Bank continued working on legal acts to fully enact the Commercial Banks Recovery and Resolution Framework, as approved by the legislative amendments concluded in late 2019. The legislative amendments adopted by the Parliament of Georgia in 2019 defined the basic principles and requirements of the Recovery and Resolution Framework (see the 2019 Annual Report of the National Bank of Georgia). The legal acts concerning the Recovery and Resolution Framework were developed and approved in two stages: the first regulations were approved by 1 July 2020, and the second by 1 January 2021. As a result, the National Bank of Georgia has a full-fledged framework for the recovery and resolution of commercial banks in place from 1 January 2021.

The process of drafting the regulations was arranged following consultations with banking sector representatives. The National Bank provided the banking sector with relevant information on the key principles and requirements of the developed legal acts. This occurred in the format of meetings and presentations that were delivered with the support of the Georgian Bankers' Association. Drafts of the acts were also submitted to the banking sector for comment and feedback, which were properly reflected in the final versions of the acts. For further details on the Recovery and Resolution Framework, the opinions of different international organizations, and details on the implementation of the framework, please refer to Box 4 below.

BOX 4 COMPLETION OF THE RECOVERY AND RESOLUTION FRAMEWORK AND ITS IMPLEMENTATION

At the end of 2019, the Parliament of Georgia adopted amendments to the Organic Law on the National Bank of Georgia (NBG) and the Law on the Activities of Commercial Banks. These changes equip the NBG with resolution powers and set out the primary basis for the Recovery and Resolution Framework. Moreover, based on the relevant EU law, the frameworks for early intervention and supervisory measures were improved. The Recovery and Resolution Framework was developed based on modern international practice, including the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions"[39], and Directive 2014/59/EU of the European Parliament and the Council of Europe of 15 May 2014 on Bank Recovery and Resolution.[40] The amendments authorize the NBG to exercise early intervention measures

39. FSB "Key Attributes of Effective Resolution Regimes for Financial Institutions".

40. Bank Recovery and Resolution Directive – BRRD.

when a commercial bank is faced with financial difficulties and to apply resolution tools if early intervention measures prove ineffective (e.g., grounds for revocation of a banking license are in place). The resolution implies that the NBG can restructure a problem bank in a manner that does not jeopardize financial stability.

Resolution is considered an alternative to the commercial bank liquidation procedure and is applied when the latter is believed to pose significantly adverse effects to financial stability. The resolution regime enables maintaining the critical functions of a problem bank and avoids wider contagion on the financial market. The foundational principle of the regime establishes that shareholders and creditors shall not incur greater losses by the final result of the resolution proceedings than they would have incurred if the bank had been liquidated. Furthermore, resolution incorporates more rigid protection mechanisms for depositors and creditors as compared to liquidation, since insured deposits are guaranteed while creditor losses are mitigated to a minimum extent. The resolution tools defined by the legislation are the following: merger with another commercial bank; sale or partial sale of the shares, assets and/or liabilities of a commercial bank; transfer or partial transfer of the shares, assets and/or liabilities of a commercial bank to a bridge bank; the recapitalization of a commercial bank by issuing new shares; and the recapitalization of a commercial bank by writing down its liabilities or converting the liabilities into shares (the so-called bail-in tool).

Regulatory acts developed within the framework of Recovery and Resolution

The regulations developed for the completion of the Recovery and Resolution Framework are based on the context of the country's financial sector and incorporate advanced international practices, including the technical standards, regulations and guidelines of the Financial Stability Board (FSB), the European Banking Authority (EBA), the European Union's Single Resolution Board (SRB), the Delegated Regulations of the European Commission and Directive 15/2014/EU of the European Parliament and Council of 15 May 2014.

In the first half of 2020, the National Bank drafted and approved the following regulations:

- **"Rule on Developing and Assessment of the Recovery Plan of a Commercial Bank"** – according to the requirements imposed by this rule, banks will develop recovery plans predetermining operational and efficient recovery measures to ensure their adequate readiness for financial stress.
- **"Rule on Identification and Assessment the Critical Functions of a Commercial Bank"** – this regulation states that the banks are expected to develop recovery plans that identify functions that are critical for financial stability, the real sector of the economy or bank service recipients.
- **"Rule on Valuation of Commercial Bank Assets and Liabilities for Resolution Purposes"** – this regulation sets out the rules, procedures and methodology for valuations of bank assets

and liabilities for the purposes of resolution, as well as the qualification requirements for an independent valuer. The National Bank developed a separate document, the “Guidelines for the Valuation of Commercial Bank Assets and Liabilities for Resolution Purposes”, which are intended for an independent valuer.

- **“Rule on Licensing, Management and Market Exit of a Bridge Bank" –** defines issues related to bridge bank licensing, management and exiting from the market as concerning the use of the bridge bank resolution instrument established by the Organic Law of Georgia on the National Bank of Georgia.
- **"Rule on Simplified Procedures for the Acquisition of a Significant Share of a Commercial Bank Under Resolution"** – sets out a simplified procedure for the acquisition of a significant share of a bank in resolution in order to conduct the resolution process smoothly.
- **"Rule on Establishment and Activities of the Resolution Committee of the National Bank of Georgia" –** defines the powers, obligations and decision-making procedures for the Resolution Committee established at the National Bank. The committee aims to facilitate the achievement of the goals of the resolution by exercising its resolution powers.
- **"Regulation on the Interagency Committee on Financial Stability"** – defines the activities of the Interagency Committee on Financial Stability. The committee was established on the basis of the Organic Law on the National Bank of Georgia and is composed of the Minister of Finance of Georgia, the Governor of the National Bank, the Head of the Deposit Insurance Agency and the Head of the State Insurance Supervision Office of Georgia. The main task of the committee is to develop mechanisms for managing crisis situations and financial crises and to promote the stable functioning of the financial system.

At the end of 2020, the National Bank completed work on the second stage of drafting the resolution framework project, and approved the following regulations:

- **"Rule on Recapitalization by Means of Issuing New Shares of a Bank in the Resolution Regime”** – defines the procedures, conditions and rules for issuance and sale of new shares for the purpose of recapitalization, as of one of the resolution tools of a commercial bank.
- **“Rule on Recapitalization of a Commercial Bank in Resolution by Means of Write-down or Conversion of a Bank's Liabilities”** – defines issues related to the write-down or conversion of a bank’s liabilities for the purpose of recapitalization as a resolution tool. The regulation also clarifies how to calculate funds necessary to comply with the requirements on eligible liabilities and capital instruments, how to evaluate these funds, set conversion rates, and how to develop, approve and implement an action plan.
- **"Rule on Developing a Resolution Plan for a Commercial Bank"** – this will be used by the National Bank to develop resolution plans for banks, including individually assessing resolvability and selecting the preferred resolution strategy for the bank.
- **“Rule on the Establishing, Administration of the Resolution Fund and Provision of Temporary State Financing by the Ministry of Finance of Georgia"** – defines the rules and procedures for

issuing temporary state funding to finance the resolution process of a commercial bank, as well as the creation, cancellation and administration of the resolution fund.

- **"Rule on Criteria for the Collection of Contributions and the Procedure for Making Contributions for the Purpose of Repayment of Funds Allocated under Temporary State Funding"** – sets out the criteria and procedures for calculating the funds allocated under temporary state funding, including the issues of payment implementation and deferral.
- **"Rule on Appointment and Activities of a Temporary Administrator of the Commercial Bank"** – sets out the procedures for the appointment and dismissal of a temporary administrator of a commercial bank, including outlining the administrator's powers and accountability as part of the early intervention temporary administration regime.
- **"Rule on Appointment and Activities of a Special Manager"** – establishes the procedure for the appointment and dismissal of a special manager of a commercial bank in resolution, as well as defining their powers and accountability.

In addition, a number of important changes were made to the "Regulation on the Approval of the Terms for Allotting a Lender of Last Resort Facility by the National Bank of Georgia". In December 2019, based on amendments to Article 33 of the Organic Law of Georgia on the National Bank of Georgia, the terms and conditions for issuing the lender-of-last-resort facility were clarified and harmonized with best international practices.

International assessment

The new framework for recovery and resolution was positively evaluated by a number of important international financial institutions and rating agencies. In May 2020, the International Monetary Fund (IMF) decided to increase the amount of funds available to Georgia as part of the Extended Fund Facility to finance the needs emerging from the COVID-19 pandemic. The IMF's November 2020 statement noted that the IMF welcomes the further progress made by the National Bank of Georgia in implementing the resolution framework.

The reform was also positively assessed by the rating company Moody's. In its 2019 assessment, the company noted that the resolution framework was important for strengthening financial stability, and that the framework would have a positive impact on Georgia's rating.[41] In April 2020, a Resolution Framework Assessment Report was published by Moody's that gave a positive evaluation of the enactment of the framework in the context of the government support rating for systemically important banks. The report states:

"Implementing the recovery and resolution framework is an important step in terms of crisis management and strengthening the stability of the financial sector.... Strengthening the

41. For further details, see https://www.moodys.com/research/Moodys-affirms-Georgias-Ba2-rating-maintains-stable-outlook--PR_404307

resolution authority of the National Bank as a result of legislative changes and upgrading the framework is in line with the requirements of the applicable EU Directive (BRRD), international best practice and potentially helps to reduce creditor losses."[42]

An important component of the rating agency's assessment is the availability of greater or lesser government support. With this in mind, Moody's regards the EU Resolution Framework, which provides an 8% prerequisite for writing-down creditors' liabilities for use of government funds or converting them into shares, as a form of weakened government support. According to the rating agency, the Recovery and Resolution Framework introduced by Georgia differs from the EU model in this respect, as such a prerequisite is not provided. The agency states that the new framework provides for institutionalized government support; whereas, before the changes, this possibility would have only been considered on an ad-hoc basis without a pre-defined framework. In addition, the Georgian framework provides an ex-post resolution fund, in which, unlike in the European model, funds are accumulated after the resolution process is completed, provided that a temporary state funding instrument is used to fund the resolution. Taking all of the above into consideration, Moody's assessed the Recovery and Resolution Framework as being well tailored to the context of the country's financial sector.

Framework implementation status

Following the completion of the resolution framework, the National Bank continues to work on its implementation. To this end, the Resolution and Liquidation Unit has been formed, which is tasked with the implementation of the framework. The functions of the unit include the assessment of recovery plans and critical functions identified by banks, the development of resolution plans for systemically important commercial banks, and the study and analysis of other preparatory issues related to resolution planning.

The National Bank started working on analyzing and developing competition policy and relevant competition standards as applicable for the financial sector in late 2020. The Law of Georgia on Competition defines the obligation for regulatory authorities, including the National Bank, to approve specialized legislation regulating competition issues by early 2021. The National Bank has therefore established an internal working group staffed with representatives from all relevant NBG departments. Keeping in mind the mandate of the NBG, the purpose of the working group is to develop competition-related policies and to facilitate their enforcement in practice, as well as to share any concerns and problems raised in practice and to come up with ways to solve them. The National Bank continues to work on applicable competition-related legal acts with technical assistance from the World Bank.

42. For further details, see Banking – Georgia: FAQ: Credit implications of Georgia's new bank recovery and resolution regime https://www.moodys.com/researchandratings/region/europe/georgia/042075/005001000?stop_mobi=yes

The National Bank actively worked on encouraging the emergence of sound entities in the market during 2020. Notable reforms in this regard were as follows:

- **The enactment of the Regulation on the Regulatory Laboratory in May 2020,** which enables financial sector representatives regulated by the National Bank to test innovative services and products in a supervised environment in real time. The regulation aims to facilitate testing and rapid development of innovative financial services and products, which is important in the context of rapidly evolving financial technologies. It also enables the timely detection of potential systemic risks, ensures compliance with the supervisory requirements of the National Bank, and enables identification of the need for possible changes in regulatory requirements.
- **Publication of digital bank licensing principles by the National Bank in July 2020.**[43] By developing a digital banking model, the National Bank aims to promote the development of innovative business models and a diversity of financial products, encouraging the entry of new technology players and enhancing competition in the financial sector. The principles define what kinds of business models are perceived by the National Bank as being digital banks and what additional requirements and incentive conditions need to be assessed in the licensing process.

In early 2020, the National Bank planned to approve the Regulation on Fit and Proper Criteria for Administrators and Shareholders and to improve the licensing framework in terms of its alignment with international best practices and the standards and requirements of the EU Directive. Drafts of these legal acts were developed during the year; specifically, a draft Regulation on Fit and Proper Criteria for Shareholders was developed, and relevant amendments were planned regarding the Fit and Proper Criteria for Administrators alongside relevant licensing requirements and standards. However, in response to the pandemic, the National Bank announced a temporary moratorium on the development and imposition of new supervisory requirements. This decision affected these regulations and postponed their approval until 2021.

In late 2020, the National Bank actively worked on preparatory arrangements for the Financial Sector Assessment Program (FSAP) implemented by the Joint Mission of the International Monetary Fund and the World Bank, which included the completion of questionnaires and self-assessment for all areas to be addressed by the mission. The FSAP mission, which is planned for 2021, will assess the stability and soundness of the financial sector, the National Bank's reforms, as well as growth and development prospects. As a result of the assessment, the mission will develop a number of recommendations for the advancement of the National Bank's supervisory framework (which, for the most part, defines the National Bank's current and future supervisory priorities and plans). The last FSAP evaluation was conducted in 2014 and resulted in a positive assessment of the performance of the National Bank.[44]

43. For further details, see https://www.nbg.gov.ge/index.php?m=340&newsid=4000

44. For further details, see https://www.nbg.gov.ge/index.php?m=339&n&newsid=2680

In 2020, the National Bank published its supervisory strategy document for 2020-2022.[45] This includes the National Bank's vision, objectives, supervisory principles and values, strategic supervisory priorities and plans for reforms and amendments, alongside offering relevant timelines. The aim of the strategy is to provide the financial sector, investors, international financial institutions, rating agencies, the public and other stakeholders with access to information on the National Bank's supervision priorities, plans and future activities. The strategy document will be updated on an annual basis as needed and is published on the National Bank's official website.

The year also saw intensified cooperation with various domestic public institutions, including the Competition Agency and the Communications Commission. The National Bank is cooperating with the latter in a number of supervisory areas in an effort to upgrade its supervisory framework.

4.2 CORPORATE GOVERNANCE AND GROUP STRUCTURE RISK

Decree N215/04 of the Governor of the National Bank of Georgia of 26 September 2018 approved the "Corporate Governance Code of Commercial Banks". Commercial banks used 2019 and 2020 to comply with the requirements of this code. The code regulates issues such as the composition of banks' supervisory boards and board of directors, the responsibilities of supervisory board committees, risk management, the effective operation of internal control functions and the principles of remuneration for senior management and material risk takers.

A draft amendment to the Corporate Governance Code of Commercial Banks was prepared in 2020 and submitted to representatives of the banking sector for consultation. The object of the amendment is to ensure improvement of corporate governance standards at commercial banks and to harmonize them with international best practices and the requirements of the Basel Committee on Banking Supervision's Guidelines on the Corporate Governance Principles for Banks, the requirements under the EU directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV - EU/36/2013), and the recommendations of the European Banking Authority (EBA). Based on these amendments, the code provided clarification of the criteria for defining a material risk-taker; to strengthen the supervisory board of a bank, a list of assigned functions and responsibilities was added; to ensure the independence of a supervisory board and its members, the maximum tenure of board members to be deemed independent was altered; the appointment of an independent chairperson for the board was required at systemically important banks; a requirement was introduced to set up a nomination committee for systemically important banks; requirements for the composition of supervisory board committees was specified; and, to ensure a sound remuneration system being in place, remuneration requirements were expanded and specified. The proposed draft also included changes to other principles of corporate governance, with the common goal being to safeguard the sound functioning of the supervisory boards, boards of

45. For further details, see https://www.nbg.gov.ge/index.php?m=756

directors and other structural units of the banks.

Recommendations to harmonize existing regulations with the EU legislation were developed as part of the project "Strengthening the Capacities of the National Bank of Georgia in banking and payment services" that was undertaken in cooperation with the Polish Financial Supervision Authority (UKNF). These recommendations aim to improve the requirements for information disclosure under Pillar 3. Significant changes are planned in this area in 2021.

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

As of 31 December 2020, 15 commercial banks were operating on the Georgian banking sector. In the same period, 88.3% of bank assets and 86.6% of stockholder equity was held by non-resident beneficial owners.

As part of the obligations stipulated by the EU-Georgia Association Agreement, the National Bank, in cooperation with the State Insurance Supervision Service, continues to work on elaboration and implementation of a supplementary supervision framework for financial conglomerates, with a focus on approximating the legislation to the agreed acts and international legal instruments within a specific timeframe. This supervisory framework implies supplementary prudential supervision with respect to capital adequacy, risk concentration, intra-group transactions, internal control mechanisms and risk management processes for entities within financial conglomerates.

The National Bank also continues to work on the consolidated supervision framework, which will be finalized by the end of 2021. As a result of amendments made to the Organic Law on the National Bank of Georgia at the end of 2017, the National Bank of Georgia was empowered with a mandate to execute supervision of banking groups (so-called consolidated supervision).

Following the global trend, banking groups in Georgia have been vigorously developing e-commerce platforms and related ecosystems. To manage ecosystem risks, the National Bank shared the basic principles of ecosystem operations with systemically important commercial banks, including topics related to platform openness, accessibility and arms-length operations, possession of adequate resources by the ecosystem so as to avoid the use of the bank's resources, and avoiding conflicts of interest in decision-making processes. The National Bank of Georgia cooperates with the Competition Agency on issues related to the functioning of ecosystems. It is also planned to upgrade the regulatory framework for ecosystems as needed.

4.3 CAPITAL ADEQUACY

At the end of 2020, in consideration of the supervisory measures related to the COVID-19 pandemic, the Georgian banking system continued to maintain an adequate level of capital under the Basel III capital adequacy framework.

The National Bank of Georgia took significant supervisory measures to mitigate the negative impact of the COVID-19 pandemic on the financial sector and to promote the national economy. Under the supervisory plan, capital requirements for commercial banks were eased by temporary reducing the capital conservation buffer (at 2.5% of risk-weighted assets) and a portion of the Pillar 2 buffer (two-thirds of the unhedged foreign currency credit risk buffer, which equaled 1.6% of risk-weighted assets). The systemic risk buffer, which was launched on 31 December 2018, was imposed on Regulatory, Tier 1 and CET1 capital. As no reliefs were introduced for the systemic risk buffer under the COVID-19 supervisory plan, the phasing in of buffer requirements for systemically important banks continued according to the predetermined schedule in December 2020 (see Table N 4.1).

TABLE N 4.1 SYSTEMIC BUFFER PHASING 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 2020, under the capital adequacy framework, the Tier 1 capital ratio was 12.81% and the total regulatory capital ratio was 17.59%, which are higher than the total capital adequacy requirements (considering the capital reliefs under the COVID-19 supervisory plan) by 3.95 pp and 3.86 pp respectively. Excluding the capital reliefs provided under the COVID-19 supervisory plan, the total requirement for Tier 1 capital and regulatory capital would be 12.51% and 17.78% respectively.

Under the current capital adequacy framework, when a bank cannot meet total regulatory capital requirements, it is first assumed that the combined capital buffer has been breached. According to 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.

As part of the COVID-19 regulatory actions, the National Bank of Georgia instructed commercial banks not to use the released buffers for paying dividends, share buybacks, equity investments, increasing variable remuneration management, or other payments that can reduce the bank’s capital.[46]

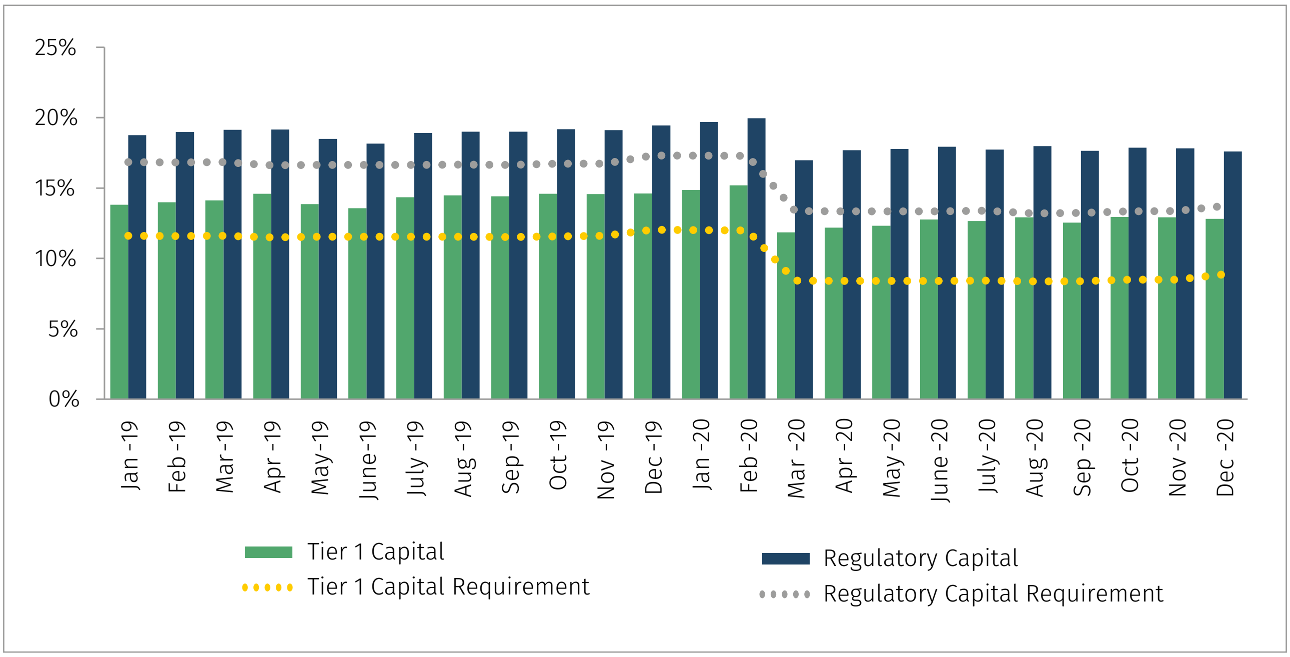
The leverage ratio (equity to assets) is also high, equaling 10.07% and exceeding the minimum leverage ratio requirement by 5.07 percentage points as of 31 December 2020.

The National Bank gives a positive evaluation to capital growth resources, both in terms of shareholder strength and profitability. In the context of maintaining the stability of the financial system and ensuring smooth lending to the economy, in 2021 the National Bank will announce a plan to restore capital buffers and

46. Refer to the press release for additional information “The NBG’s Covid-related supervision plan”.

provide dates for their gradual replenishment. The banking sector will be given sufficient time to re-accumulate the buffers. Banks will be given a year to restore the unhedged currency induced credit risk buffer and two years to restore the conservation buffer. Banks have the opportunity to opt out of the supervisory benefits offered by the National Bank and, at their own discretion, to re-establish those capital adequacy requirements eased under the COVID-19 regulatory actions. In such cases, the bank will no longer face restrictions on the distribution of capital.

DIAGRAM N 4.1 CAPITAL ADEQUACY RATIOS ACCORDING TO BASEL III



Source: National Bank of Georgia

In parallel with the supervisory actions related to COVID-19, banks continued to calculate the capital buffers included in Pillar 2. The Pillar 2 framework determines capital buffer requirements for credit portfolio concentration risk (including name concentration and sectoral concentration risks), the unhedged currency induced credit risk buffer, the net stress test buffer determined through supervisory stress tests, and the net GRAPE buffer determined by the National Bank of Georgia through an assessment of risk categories under the GRAPE (General Risk Assessment Process) framework.

It is important that the capital buffers imposed under Pillar 2 are met with the same proportion of regulatory capital elements as required by the minimum requirements (4.5% of CET1 capital, 6% of Tier 1 capital and 8% of total regulatory capital). Accordingly, 56% of the capital required under Pillar 2 should be met by CET1 capital elements and 75% by Tier 1 capital elements. Commercial banks were given an appropriate timeframe to comply with these requirements (see Table N 4.2)

TABLE N 4.2 CONCENTRATION AND NET GRAPE BUFFER PHASE-IN DATES BEFORE COVID-19 RELATED SUPERVISORY ACTIONS

Concentration (name and sectoral) and net GRAPE buffers	Since enactment to 30/12/2018	31/12/2018	31/03/2020	31/03/2021	31/03/2022 and further
CET1 capital	0%	15%	30%	45%	56%
Tier1 capital	0%	20%	40%	60%	75%
Total regulatory capital	100%	100%	100%	100%	100%

As part of its COVID-19 supervisory actions, the National Bank temporarily suspended the phasing in of its Pillar 2 CET1 and Tier 1 capital requirements. Accordingly, the concentration and net GRAPE buffers were set at 100% on regulatory capital, 20% on Tier 1 capital and 15% on CET1 capital as of 31 December 2020. As part of the COVID-19 supervisory actions, renewed timeframes for the phasing in of concentration (HHI) and net GRAPE buffers were determined in accordance with the schedule found in Table N 4.3, which extends the timeframe for the phasing in of these buffers by one year.

TABLE N 4.3 CONCENTRATION AND NET GRAPE BUFFER PHASING IN DATES WITHIN COVID-19 RELATED SUPERVISORY ACTIONS

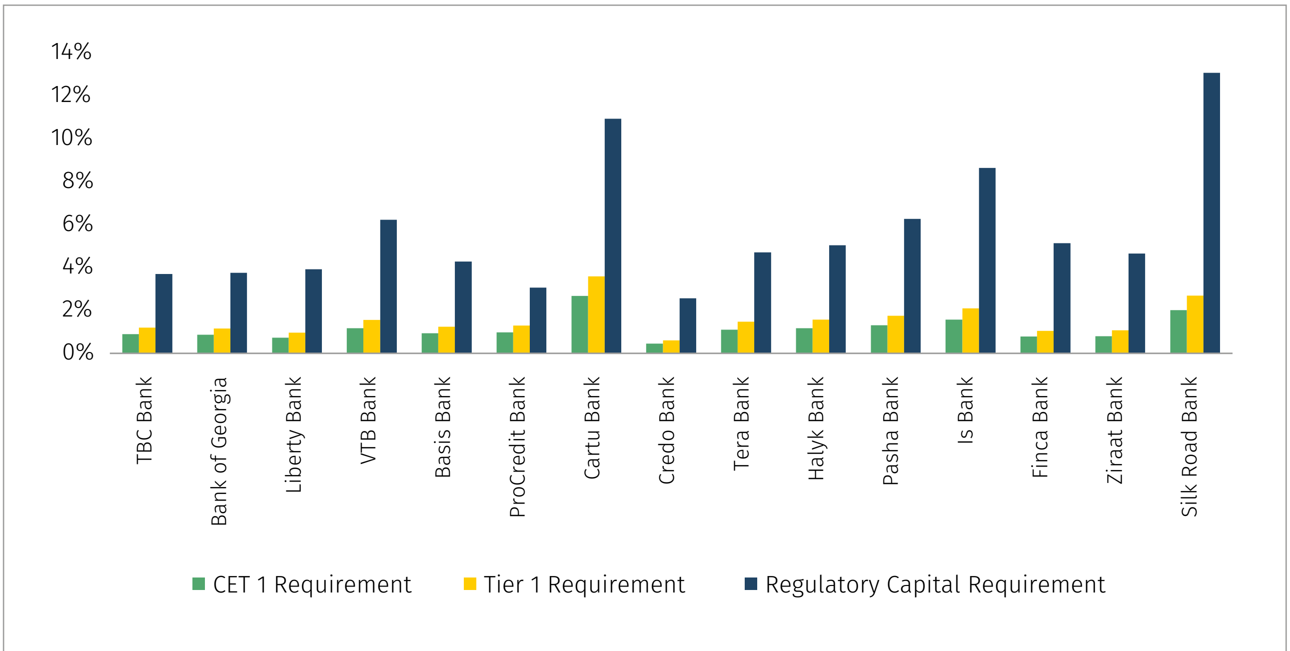
Concentration (name and sectoral) and net GRAPE buffers	31/03/2021	31/03/2022	31/03/2023 and further
CET1 capital	30%	45%	56%
Tier1 capital	40%	60%	75%
Total regulatory capital	100%	100%	100%

In 2020, the National Bank of Georgia worked on the calibration of the net stress test buffer. In addition, the NBG formalized the stress testing framework in cooperation with commercial banks. Enterprise-level stress tests help assess the effect of systemic and sectoral economic shocks and idiosyncratic events on banks and help determine related capital requirements. With the integration of the net stress test buffer in the Pillar 2 requirements, it is important to avoid a duplication of capital requirements. Accordingly, the stress test buffer requires capital in an amount that exceeds the sum of the conservation and countercyclical buffers. In addition, the National Bank may, as necessity prompts, issue additional instructions for capital buffers that may be added to deductible items from the stress test buffer to avoid a duplication of capital requirements for the same risk.

As a result of the stress tests conducted by banks in 2020, the National Bank did not impose a net stress-test buffer. The National Bank's approach to the capital adequacy framework involves the countercyclical application of requirements (i.e., the accumulation of capital buffers during economic growth and their release during times of stress), and, as a result of the COVID-19 pandemic, the year was stressful for the banking sector.

The net GRAPE buffer, which was launched in 2018, is defined as part of a continuous cycle of risk-based supervision and aims to assess the risks of commercial banks. The risk profile of each commercial bank is assessed based on GRAPE. During 2019, individual GRAPE buffers were updated, and their volume was set in the range of 1.4-9.7% of risk-weighted assets. The net GRAPE buffers were not revised in 2020 due to the change in supervisory priorities in the wake of the COVID-19 pandemic. The National Bank will review the net GRAPE buffers in the first quarter of 2021.

DIAGRAM N 4.2 PILLAR 2 REQUIREMENTS FOR COMMERCIAL BANKS AS OF 31 DECEMBER 2020[47]



Source: National Bank of Georgia

As part of its COVID-19 supervisory plan, the National Bank announced a temporary moratorium on the development and implementation of new regulatory requirements. However, in 2021, the National Bank will continue to bring its capital adequacy standards closer to the EU-regulated standards.

47. The requirements of Pillar 2 are given under the COVID-19 regulatory measures, taking into account the reduction of the unhedged currency credit risk (CICR) buffer requirement.

BOX 5 INTERNATIONAL PRACTICE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) STANDARDS

The NBG Supervisory Strategy for 2020-2022 plans to strengthen non-financial risk management standards, including environmental, social and governance (ESG) standards, climate change risk management and other corporate social responsibility (CSR) standards, and to consider them in supervisory processes. In accordance with the requirements of the Corporate Governance Code of Commercial Banks, banks must take into account ESG issues in their strategic development plans. However, international practice in this area is still under development and no unified approach concerning the requirement for additional capital for ESG risks has yet been established.

As part of the development of ESG risk management standards, the use of two different methods is being discussed.[48] The first method is the so-called green supporting factor, which means reducing capital requirements for banks with low climate-related risks. The second method is the so-called brown penalizing factor, which is a punitive instrument for environmental damage that implies increasing capital requirements for certain banks in violation of those standards. Recent discussions support the use of the second method (the brown penalizing factor); however, before agreeing on a final, unified approach, it is first necessary to define and classify the assets that would fall under the "green" and "brown" categories. Under the Basel III framework, the Internal Capital Adequacy Assessment Process (ICAAP) requires consideration of environmental risks, while financial institutions are required to produce reports on lending and investing in green economies.[49]

In Brazil, as part of its supervisory functions, the central bank imposed new requirements in 2014 that required banks to consider environmental and social risks in the risk management process.[50]

In Hungary, the MNB[51] required banks to reduce interest rates by a minimum of 0.3% on loans disbursed for purchasing or constructing energy-efficient houses. In return, banks will have a reduced requirement for regulatory capital, which will allow them to issue more or larger loans for energy-efficient construction. However, reducing the capital requirements for such incentives may increase financial stability risks and violate the principle of risk-based capital requirements.

In March 2020, the Bank of England announced a plan to use the brown penalizing factor, which was intended to tighten regulatory capital requirements for banks, although no further action has been taken.

48. For further details, see The green swan – Central banking and financial stability in the age of climate change

49. For details, see https://www.bis.org/bcbs/publ/d502.pdf

50. For details, see https://www.mondaq.com/brazil/financial-services/311440/the-social-and-environmental-responsibility-policy-of-the-brazilian-financial-institutions

51. The Magyar Nemzeti Bank – Central Bank of Hungary

According to the European Central Bank (ECB), it is still too early to impose climate risk related capital requirements on financial institutions.

Regarding ESG risk management, the EBA's assessment document, which is scheduled for publication in June 2021, will be important.[52] The document is expected to incorporate the following items:

- Developing a unified definition of ESG risks.
- Establishing appropriate qualitative and quantitative criteria in the short, medium and long term so that institutions can assess the impact of ESG risks on their financial stability. Such criteria should include stress-test processes and scenario analysis to assess the impact of ESG risks, and the occurrence of scenarios of varying severity.
- The definition of actions, processes, mechanisms, and strategies for institutions to identify, assess and manage ESG risks.
- The methods and tools used to assess the impact of ESG risks on institutions' credit and financial intermediary functions.

Based on the results of this document, the EBA may, as necessary, produce an instruction on considering ESG risks during the supervisory review and evaluation process. In the GRAPE assessment process, the National Bank will be guided by EBA guidelines on ESG risks, along with other international best practice.

The EBA published a Discussion Paper on ESG Risk Management and Supervision by Credit Institutions and Investment Companies on 30 October 2020.[53] According to the document, ESG risks may have an impact on the financial condition of institutions. For example, deteriorating physical conditions in areas where economic activities (e.g., agriculture or construction) occur to which a credit institution is connected (through loans or securities) may result in high credit losses. If such activities are related to financial instruments, it may result in a drop of market prices. Necessary and politically agreed actions towards a sustainable economy may also have a negative impact on current business models. Credit and market losses affect capital adequacy and, consequently, the prudential strength and soundness of a financial institution. Furthermore, when credit agencies consider ESG risks, the credit ratings of vulnerable corporations may be reduced, resulting in a higher risk weight for such corporations under a standardized approach. In addition, ESG risks reduce the value of collateral, which in the event of default may increase losses (LGDs). ESG risks can also lead to capital outflows, for example after a natural disaster. When it comes to capital and funding costs, investors and depositors are likely to prefer

52. For details, see Article 98 of CRD V

53. For details, see EBA Discussion paper, On management and supervision of ESG risks for credit institutions and investment firms

institutions that consider the negative impact their activities may have on ESG factors. The EBA Discussion Paper also states that ESG risks affect both an institution's profit and loss account and its balance sheet. ESG factors affect an institution's current capital adequacy and liquidity ratios, its risk weight of exposures, and the future accessibility of capital and liquidity.

ESG risks have a negative financial impact on credit institutions when they take the form of prudential risks. In such cases, the effect extends to the institution's total capital and liquidity (including over the long term). This may affect the resilience of its business model. A regulator's understanding of the impact of ESG risks is crucial for assessing the risks that a supervised entity may face.

Although regulators assess risks over different periods of time, ESG risks may not be fully incorporated in a given supervisory assessment because the consequences of these risks may materialize in the long run.

The Network for Greening the Financial System's handbook for regulators includes a detailed description of climate and environmental supervision approaches and indicates that the work is still in its early stages.

4.4 FINANCIAL REPORTING AND TRANSPARENCY

In accordance with the supervision strategy of the National Bank of Georgia for 2020-2022 the approximation of supervisory reports to International Financial Reporting Standards (IFRS) is one of the most important priorities.

Considerable effort was devoted to transitioning the financial statements of the banking sector to IFRS during 2020. Working groups were set up with participants from the National Bank, the banking sector and the Banking Association of Georgia. Supported by the World Bank, the project involves local and international experts with diverse experience, who consult with project working groups and discuss the best practices implemented by advanced economies.

The IFRS project entails full transition of the National Bank's regulatory reports to IFRS, the IFRS-based calculation of supervisory indicators with appropriate regulatory filters, and the development of an IFRS 9 provisioning methodology for supervisory purposes.

During 2020, the National Bank completed the main activities for the transition to IFRS. However, due to the complexity of the project, commercial banks will need some time to adapt to the updated requirements. Accordingly, the commencement of reporting according to IFRS will only occur on a voluntary basis for commercial banks from 2021, becoming mandatory from 2022. By 2022, banks will be required to submit reports in accordance with both the current standards and IFRS.

Introducing FINREP reporting forms is one of the most important aspects of the IFRS project. Commercial banks have been reporting these forms on a test basis since 2018; however, with the full transition to IFRS, the submission of FINREP reporting forms will be required on a monthly basis, in order to meet the need for regulatory information.

The introduction of an updated provisioning methodology is another key part of the IFRS transition project. Work on updating the provisioning methodology is underway in close cooperation with the banking sector, auditors and World Bank consultants. To transition to IFRS 9, the National Bank developed a draft Regulation on "Credit Loss Estimation and Credit Rating Determination of Financial Instruments". This regulation is based on IFRS 9, although it specifies certain approaches to be used by banks when calculating reserves. The regulation uses a "comply or explain" principle. A draft version of the document was published on the NBG website for review and consultation at the end of 2020 and its official adoption is scheduled for 2021.

A significant step was taken in 2020 to improve effective communication with auditors. The Guide on Effective Communication between the National Bank and Audit Firms is intended to facilitate cooperation between the National Bank and audit firms on supervised entities.[54] The introduction of these guidelines ensure that there is regular and standardized communication between audit firms and the National Bank. This communication framework is based on a publication of the European Banking Authority (EBA) and other leading international practices. Effective communication with auditors is of particular importance in light of the IFRS project, because, as a result of transitioning supervisory reporting to IFRS, the supervisor will rely on IFRS numbers, making it important to identify differences between the current approaches of commercial banks and to formulate consistent approaches.

In order to facilitate the conduct of independent audit processes in commercial banks, the National Bank of Georgia made a significant change in the regulation concerning the "Statutory Audit of Consolidated Financial Statements of Commercial Banks and the Disclosure of Information in the Notes to the Financial Statements". Commercial banks are now obligated to hold a tender for the selection of a new audit firm after receiving audit services from the same audit firm for five consecutive years, and it is only permissible to hire the same audit firm for a maximum of 10 consecutive years. After the expiration of this maximum period, the commercial bank must adhere to a four-year "cooling off" period. The amendment provides for transitional provisions for commercial banks that did not meet these requirements at the time of the enactment of the regulation or that would have to comply with the requirement in a short time frame. This transitional period is set for no later than 2023.

In light of the pandemic situation, particular financial reporting issues became relevant, including the issuance of state-initiated grants, the calculation of expected credit losses, and changes in provisioning models. The National Bank of Georgia analyzed the publications of international organizations and leading regulators related to calculating expected credit

54. For further details, see https://www.nbg.gov.ge/uploads/301220/communication_framework.pdf

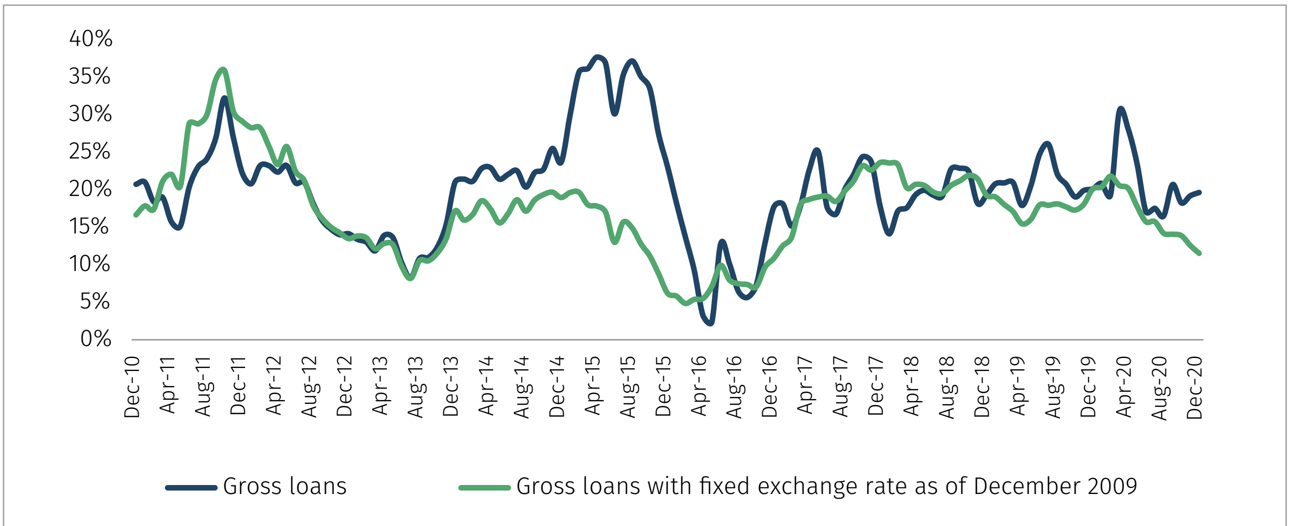
losses under IFRS 9 and published the "Guideline on Expected Credit Losses".[55] In addition, the National Bank closely monitored and analyzed the International Accounting Standards Board's and other publications on reporting issues.

The National Bank continues to publish macroeconomic scenarios to facilitate provisioning under IFRS 9. At the outset of the COVID-19 pandemic, these scenarios were published to allow banks to adequately assess macro scenarios while taking ongoing events into account.

4.5 CREDIT RISK

As of 31 December 2020, the total loan portfolio of the banking system reached GEL 38 billion, and its annual growth, excluding the exchange rate effect, was 9%. The composition of the loan portfolio (excluding interbank loans) did not change significantly in terms of segments. The reason for this was a slowdown in lending activity due to the COVID-19 pandemic.

DIAGRAM N 4.3 TOTAL LOAN PORTFOLIO CHANGE (YOY)



Source: National Bank of Georgia

TABLE N 4.4 COMPOSITION OF THE LOAN PORTFOLIO (EXCLUDING INTERBANK LOANS) BY SEGMENT (ADJUSTED FOR EXCHANGE RATE EFFECT, THE EXCHANGE RATE AS OF THE END OF 2019)

	Dec-19		Dec-20		YoY change %
	LP (million GEL)	%	LP (million GEL)	%	
Corporate	10,950	34%	11,728	34%	7.1%
SME	8,121	25%	9,012	26%	11.0%
Retail	12,844	40%	14,075	40%	9.6%
Total:	31,915	100%	34,815	100%	9.1%

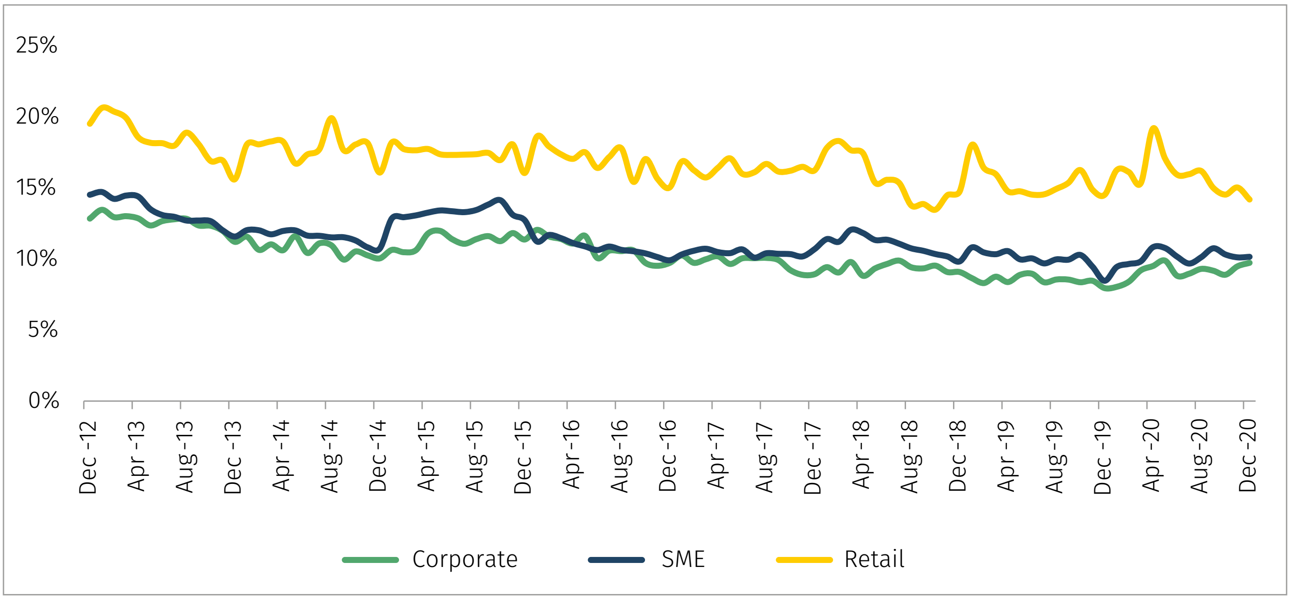
Source: National Bank of Georgia

55. See https://www.nbg.gov.ge/uploads/sakredito_sakheldzgvanelo/guideline.pdf

During 2020, the volume of securities acquired by commercial banks from various corporate clients increased. Given the effect of these acquisitions, the corporate segment's portfolio growth is 8.1%.

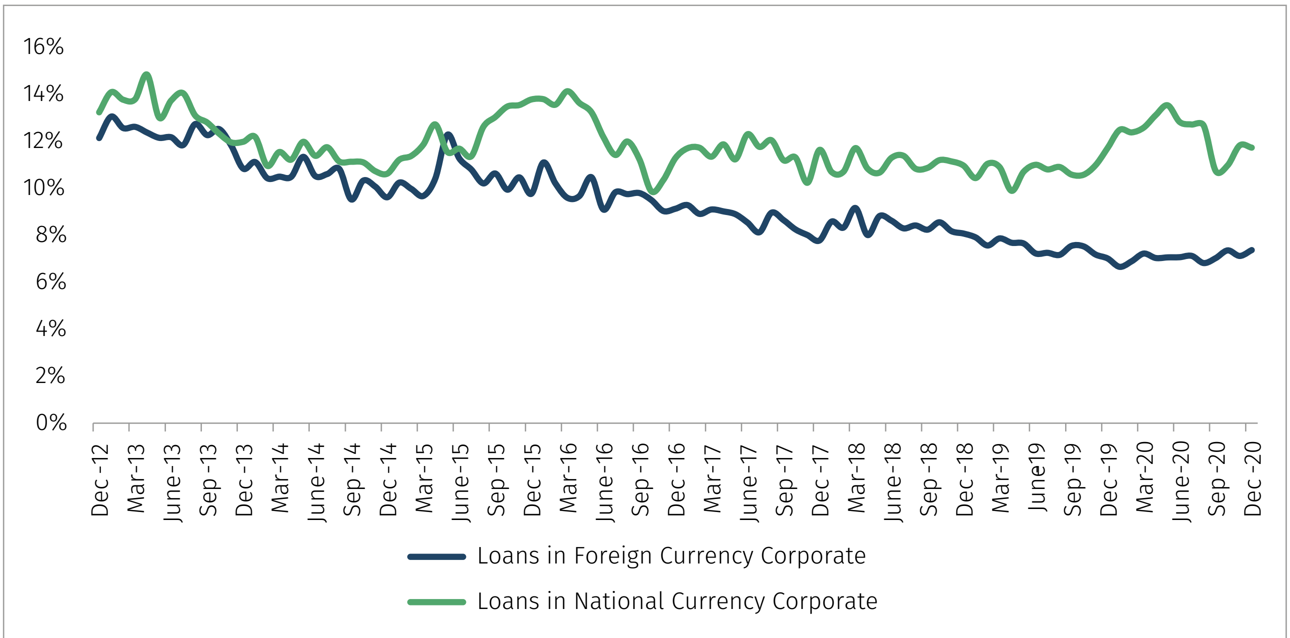
In 2020, there was a slight increase in interest rates on corporate and small- and medium-sized loans, compared to 2019, although the upward trend was mainly observed on foreign currency loans. Interest rates also increased for the retail segment, for both national and foreign currency loans, in the second quarter, which was due to a decrease in the share of mortgage lending in the relevant period; however, an intensification of lending in mortgages from the third quarter significantly reduced interest rates.

DIAGRAM N 4.4 MONTHLY WEIGHTED AVERAGE INTEREST RATES ON LOAN FLOWS BY SEGMENT



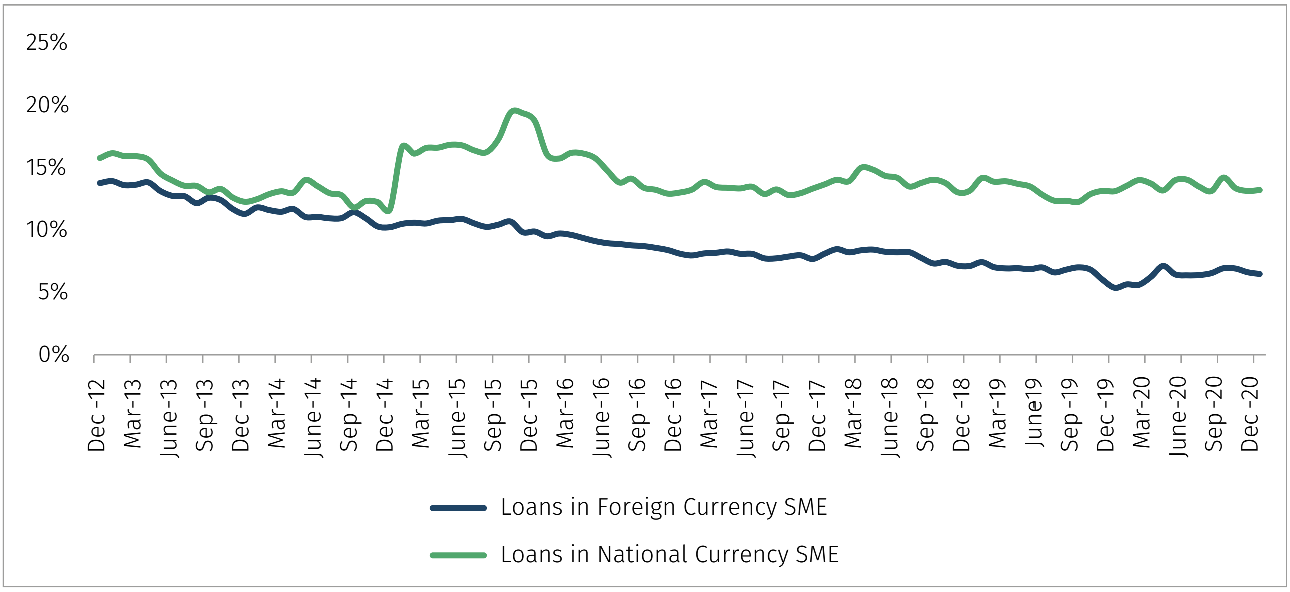
Source: National Bank of Georgia

DIAGRAM N 4.5 MONTHLY WEIGHTED AVERAGE INTEREST RATES ON LOAN FLOWS FOR THE CORPORATE SEGMENT



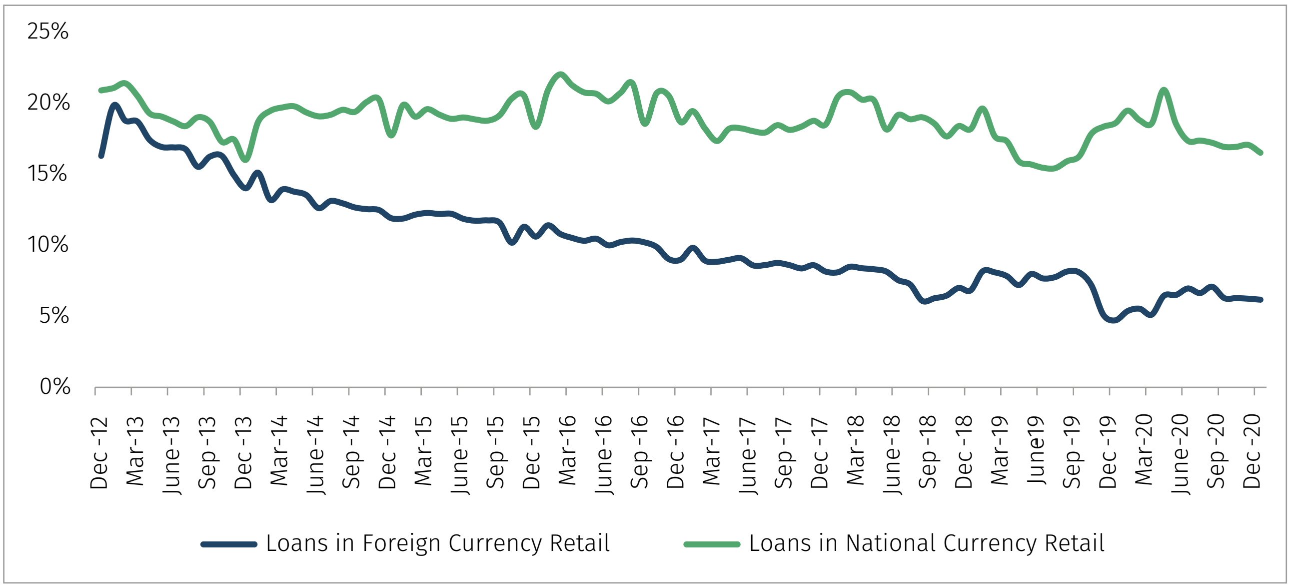
Source: National Bank of Georgia

DIAGRAM N 4.6 MONTHLY WEIGHTED AVERAGE INTEREST RATES ON LOAN FLOWS FOR THE SME SEGMENT



Source: National Bank of Georgia

DIAGRAM N 4.7 MONTHLY WEIGHTED AVERAGE INTEREST RATES ON LOAN FLOWS FOR THE RETAIL SEGMENT



Source: National Bank of Georgia

The loan portfolio is diversified in sectoral terms. However, due to the limited mobility caused by the COVID-19 pandemic, the share of economically vulnerable sectors (real estate development, real estate management, hotels and tourism, restaurants and catering, and auto dealers) in the portfolio was high at 19.2%. In previous years, tourism lending, in particular, had been growing and thus the high volume of expected loan loss reserves in some sectors was mainly due to the additional loan reserves created as a consequence of COVID-19.

During 2020, several technical reclassifications were also recorded, the largest of which was a portfolio of up to GEL 230 million being transferred from the agricultural sector to retail products.

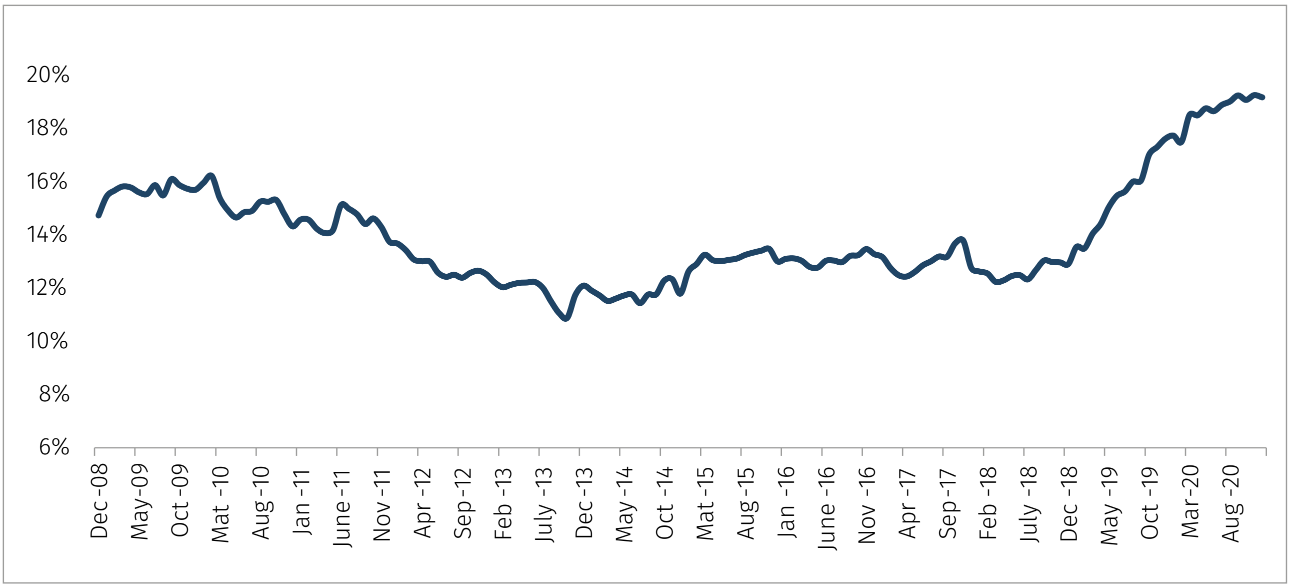
TABLE N 4.5 SECTORAL DISTRIBUTION OF THE LOAN PORTFOLIO

Sector, excluding interbank loans (million GEL)	Share in Gross Portfolio	Loan Balance	Loan Reserve	Reserve to Portfolio
State	0.4%	146	3	2.2%
Financial Institutions	1.3%	512	11	2.2%
Pawn-shop Loans	1.1%	420	11	2.6%
Construction Development, Land Development and other Land Loans	3.4%	1,281	99	7.7%
Real Estate Management	6.3%	2,416	144	6.0%
Construction Companies	1.7%	640	36	5.7%
Production and Trade of Construction Materials	2.8%	1,062	46	4.3%
Trade of Consumer Foods and Goods	3.2%	1,236	52	4.2%
Production of Consumer Foods and Goods	4.3%	1,656	100	6.1%
Production and Trade of Durable Goods	0.8%	303	16	5.3%
Production and Trade of Clothes, Shoes and Textiles	0.6%	210	13	6.4%
Trade (Other)	4.8%	1,834	112	6.1%
Other Production	1.6%	607	30	4.9%
Hotels, Tourism	7.5%	2,861	198	6.9%
Restaurants	1.5%	575	53	9.2%
Industry	1.8%	678	38	5.6%
Loans to Oil Importers and Retailers	0.9%	331	24	7.3%
Energy	3.6%	1,376	46	3.3%
Auto Dealers	0.5%	193	27	14.2%
Health Care	1.9%	736	28	3.7%
Pharmacy	0.4%	138	5	3.7%
Telecommunication	0.8%	315	9	3.0%
Service	4.8%	1,818	107	5.9%
Agro	4.8%	1,816	103	5.7%
Other (Including Scrap-metal)	1.5%	570	28	4.8%
Retail	**37.9%**	**14,486**	**844**	**5.8%**
Car Loans	0.4%	135	8	6.1%
Consumer Loans	12.8%	4,903	320	6.5%
Installments	0.8%	300	29	9.6%
Payrolls (Overdrafts)	0.1%	50	7	13.1%
Credit Cards	1.1%	412	32	7.8%
Housing Renovations	1.6%	612	23	3.8%
Mortgages	21.1%	8,075	424	5.3%
Total Credit Portfolio (Deducted Interbank Loans)	100.0%	38,219	2,435[56]	6.4%

Source: National Bank of Georgia

56. The loan portfolio reserve (excluding interbank loans) includes the general reserve.

DIAGRAM N 4.8 SHARE OF PRO-CYCLICAL SECTORS IN THE GROSS LOAN PORTFOLIO



Source: National Bank of Georgia

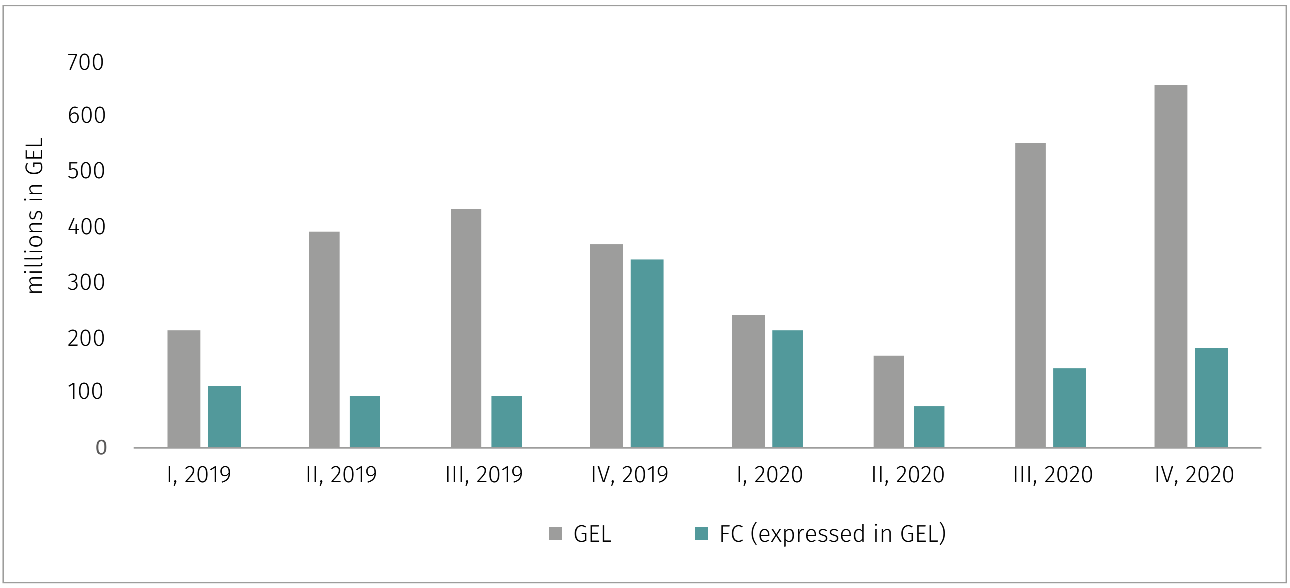
In 2020, the growth rate of retail products increased compared to the previous year. An increase was observed in all products except for overdrafts and credit cards. However, considering the fixed exchange rate and excluding the reclassification effect, the main determinant of the growth of retail products was the growth of consumer and mortgage lending, with the latter increasing more than the former. Mortgage lending gained a boost in the middle of 2020, when the government "Mortgage Support Facility" program was launched.

TABLE N 4.6 GROWTH OF RETAIL PRODUCTS ADJUSTED FOR THE EXCHANGE RATE EFFECT (EXCHANGE RATE AS OF THE END OF 2019)

Product	Dec-19		Dec-20		Change, %	Change, mln GEL	Change % (Adjusted for exchange rate and reclassification effects)
	mln GEL	Share, %	mln GEL	Share, %			
Retail Products	**11,976**	**100%**	**13,579**	**100%**	**13.4%**	**1,603**	**9.9%**
Car Loans	105	1%	126	1%	20.1%	21	8.2%
Consumer Loans	4,184	35%	4,805	35%	14.8%	621	8.9%
Installments	193	2%	300	2%	55.5%	107	9.0%
Payrolls (Overdrafts)	57	0%	49	0%	-13.9%	-8	-14.0%
Credit Cards	458	4%	411	3%	-10.3%	-47	-10.4%
Housing Renovations	513	4%	578	4%	12.7%	65	2.7%
Mortgages	6,466	54%	7,310	54%	13.1%	844	12.9%

Source: National Bank of Georgia

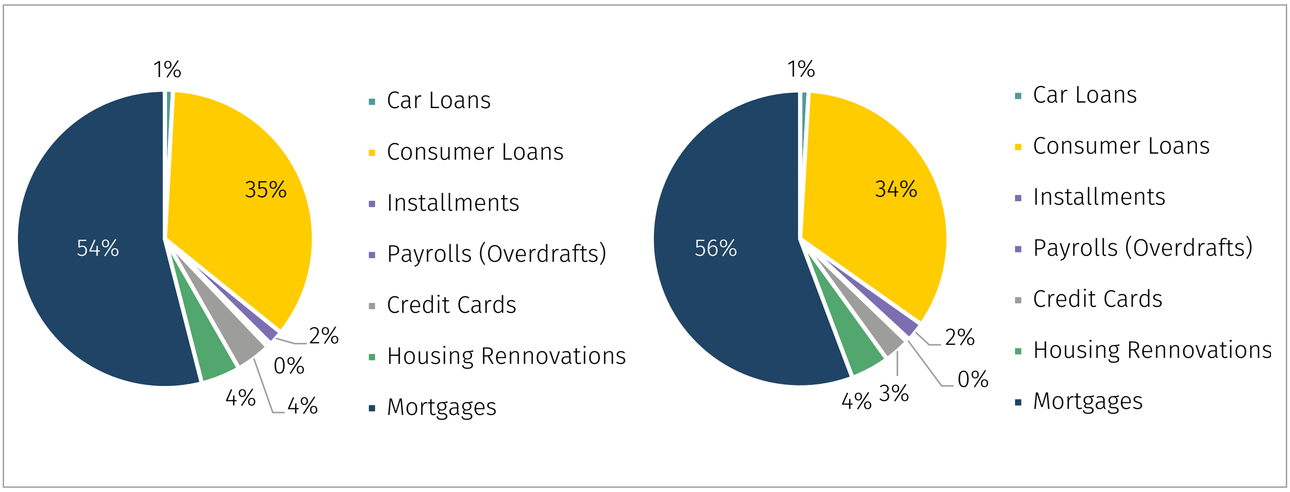
DIAGRAM N 4.9 APPROVED MORTGAGES BY CURRENCY, EXCLUDING REFINANCING/RESTRUCTURING



Source: National Bank of Georgia

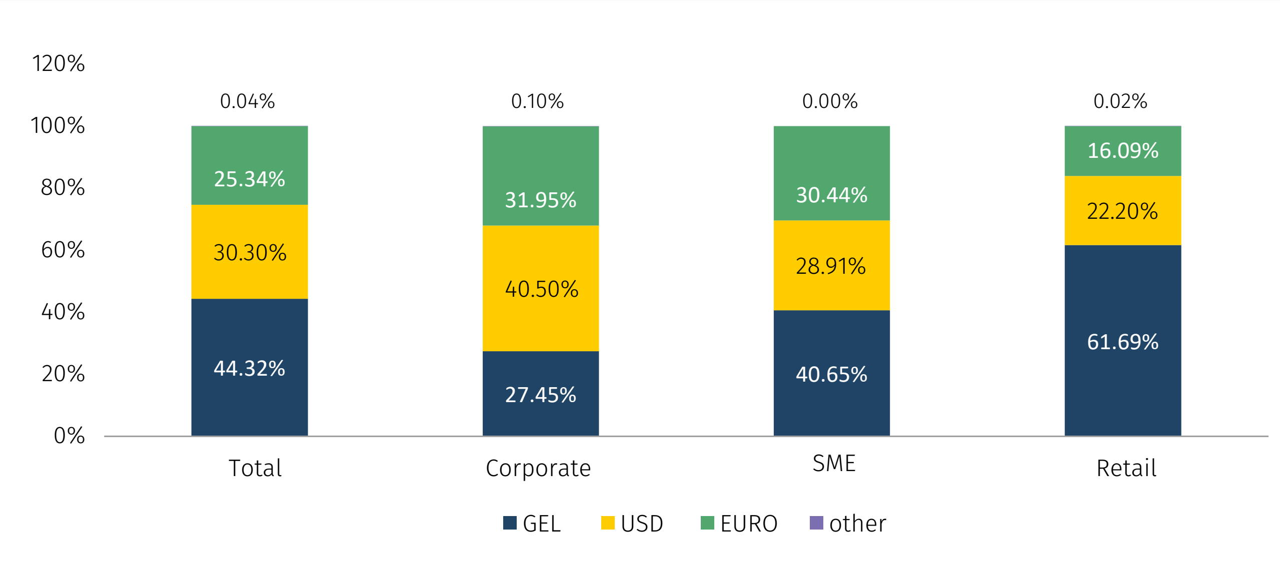
The structure of the retail product portfolio changed slightly compared to the previous year, which was reflected in an increase in the share of mortgage loans and a decrease in the share of consumer loans. In view of the higher dollarization of mortgages, this was mainly due to the depreciation of the exchange rate.

DIAGRAM N 4.10 DISTRIBUTION OF BALANCES OF RETAIL PRODUCTS AS OF YE 2019 AND 2020



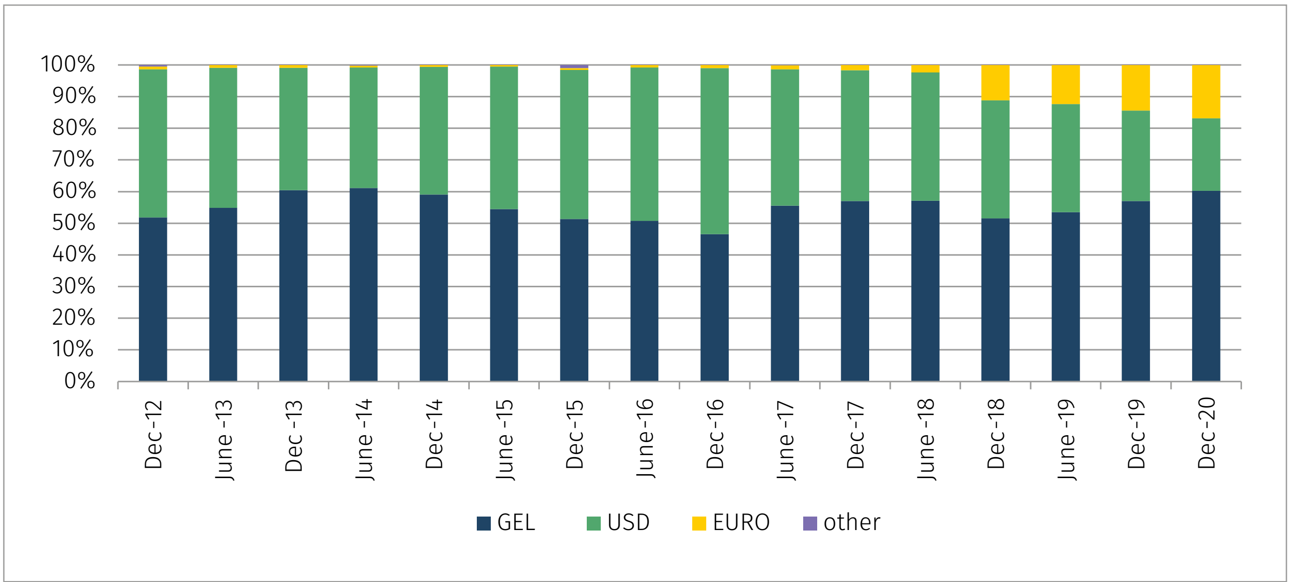
Source: National Bank of Georgia

DIAGRAM N 4.11 SEGMENT BALANCES BY CURRENCY AS OF YE 2020 (EXCEPT INTERBANK LOANS)



Source: National Bank of Georgia

DIAGRAM N 4.12 RETAIL PORTFOLIO COMPOSITION BY CURRENCY



Source: National Bank of Georgia

Compared to the previous year, the quality of the loan portfolio of the banking system significantly deteriorated by the end of 2020 – a consequence of the economic slowdown caused by the COVID-19 pandemic. In response to the pandemic, the NBG instructed commercial banks to evaluate their portfolios and the banks created an additional general loan loss reserve of GEL 1.1 billion in March 2020. From September, according to the methodology developed by the NBG, the general reserve that had already been created was transferred to a special reserve. This led to a significant increase in negative and non-performing loans in the fourth quarter of the year.

The banking sector actively offered loan deferrals to borrowers during 2020. At the outset of the pandemic, during the first loan deferral phase (from March to June), the existing uncertainty led commercial banks to offer massive 3-month deferrals to borrowers. However, during the second and third phases of deferrals, which took place from July onwards, commercial banks offered to defer loans to borrowers on a more individual basis: for those borrowers who had reduced or lost incomes and were unable to service their loans, commercial banks offered a grace period for both principal and interest payments. To encourage deferrals, the National Bank did not ask commercial banks to create an additional expected loss reserve for such borrowers.

During all three phases of deferrals, there were no significant increases in the share of overdue loans due to active deferrals or restructurings as compared to the period before the pandemic. However, the pandemic and resulting mobility constraints increased risks in the loan portfolio, which were reflected in an increase in the share of restructuring and non-performing loans.

TABLE N 4.7 LOAN PORTFOLIO CLASSIFICATION BY QUALITY

Risk category (excluding interbank loans)	Amount (million GEL)	Share %	Reserve
Standard	32,225	84.3%	2%
Negative Loans	5,994	15.7%	25%
Watch	2,791	7.3%	10%
Non-performing	3,203	8.4%	38%
Substandard	2,230	5.8%	30%
Doubtful	484	1.3%	46%
Loss	489	1.3%	68%
Total	**38,219**	**100%**	**6%**

Source: National Bank of Georgia

TABLE N 4.8 PORTFOLIO QUALITY BY SEGMENT

Segment	Negative Loans	Non-performing Loans	Average reserve
Corporate	16.54%	7.44%	5.18%
SME	19.06%	9.75%	6.33%
Retail	12.67%	8.30%	5.79%

Source: National Bank of Georgia

The negative effect of COVID-19 was reflected in the quality indicators of the retail loan portfolio. The percentage of both non-performing loans and reserves in the portfolio for all retail products (except for instant installments) increased considerably at the end of 2020 compared to the previous year. Instant installments improved in percentage terms due to the portfolio growth resulting from reclassification.

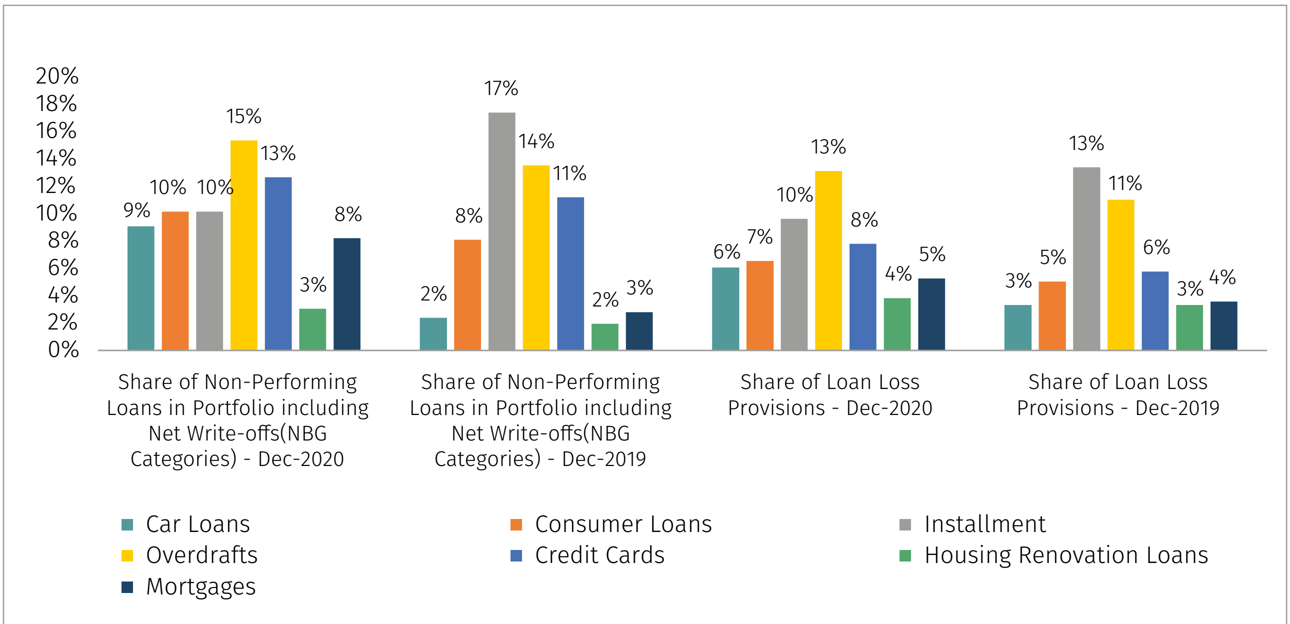
As evidenced by the diagrams below, the share of restructured and non-performing loans increased more in foreign currency loans than in lari loans at the end of 2020 in year-on-year terms. A further deterioration in the quality of foreign currency loans was caused by the 14% depreciation of the lari against the US dollar and the 25% depreciation against the euro, which in turn caused a much heavier debt burden for foreign currency borrowers.

The share of foreign currency loans was particularly high in the sectors that suffered most from the COVID-19 economic shock. The share of foreign currency loans in the total loans of these sectors is as follows:

1. Real estate development, 94%
2. Real estate management, 89%
3. Hotels and tourism, 88%
4. Restaurants, bars, cafes and fast-food outlets, 85%
5. Car dealers, 57%

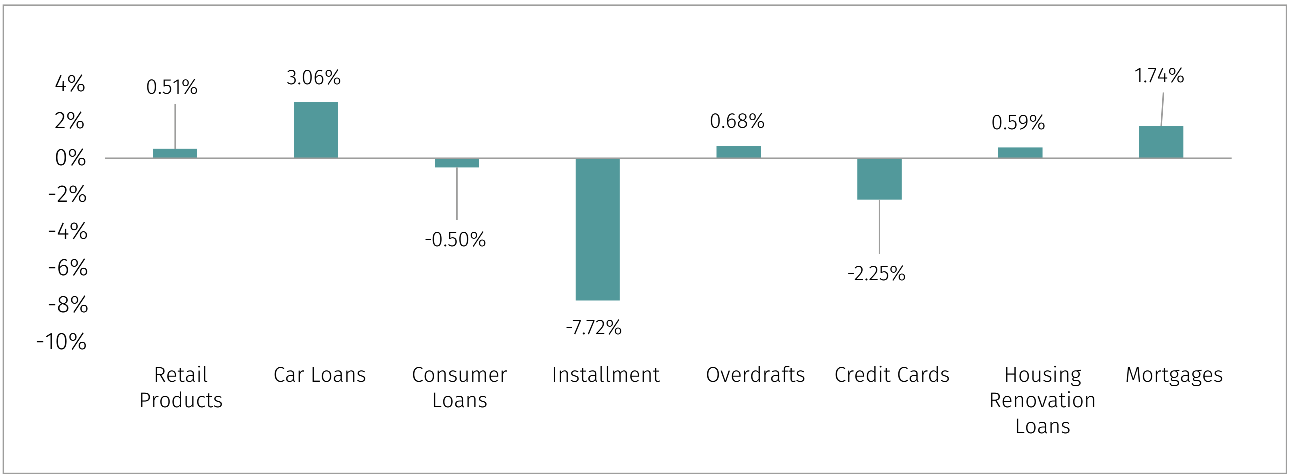
The cost of risk for the retail portfolio was also greater than before. The year-on-year reduction in the cost of risk for consumer loans, instant installments and credit cards was caused by reclassifications and a decrease in the share of net written-off loans during the year.

DIAGRAM N 4.13 RETAIL PORTFOLIO QUALITY AND COST OF RISK BY PRODUCT



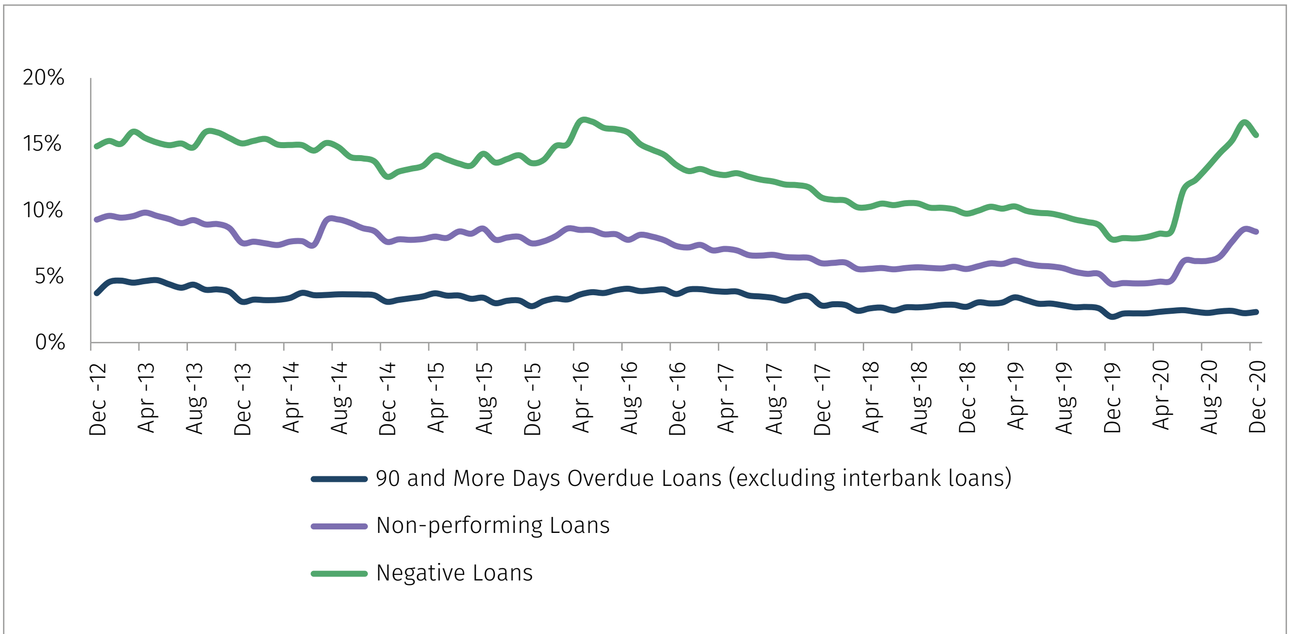
Source: National Bank of Georgia

DIAGRAM N 4.14 CHANGE IN COST OF RISK (DEC. 2020 - DEC. 2019)



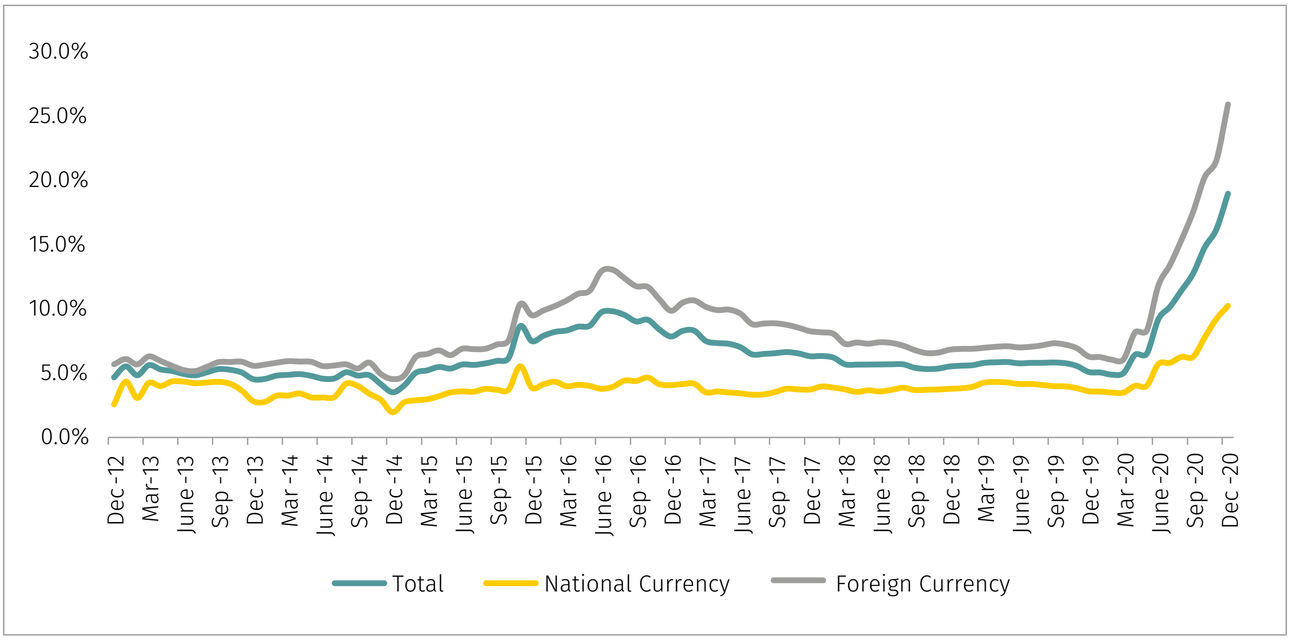
Source: National Bank of Georgia

DIAGRAM N 4.15 LOAN PORTFOLIO BY QUALITATIVE INDICATOR (EXCEPT INTERBANK LOANS)



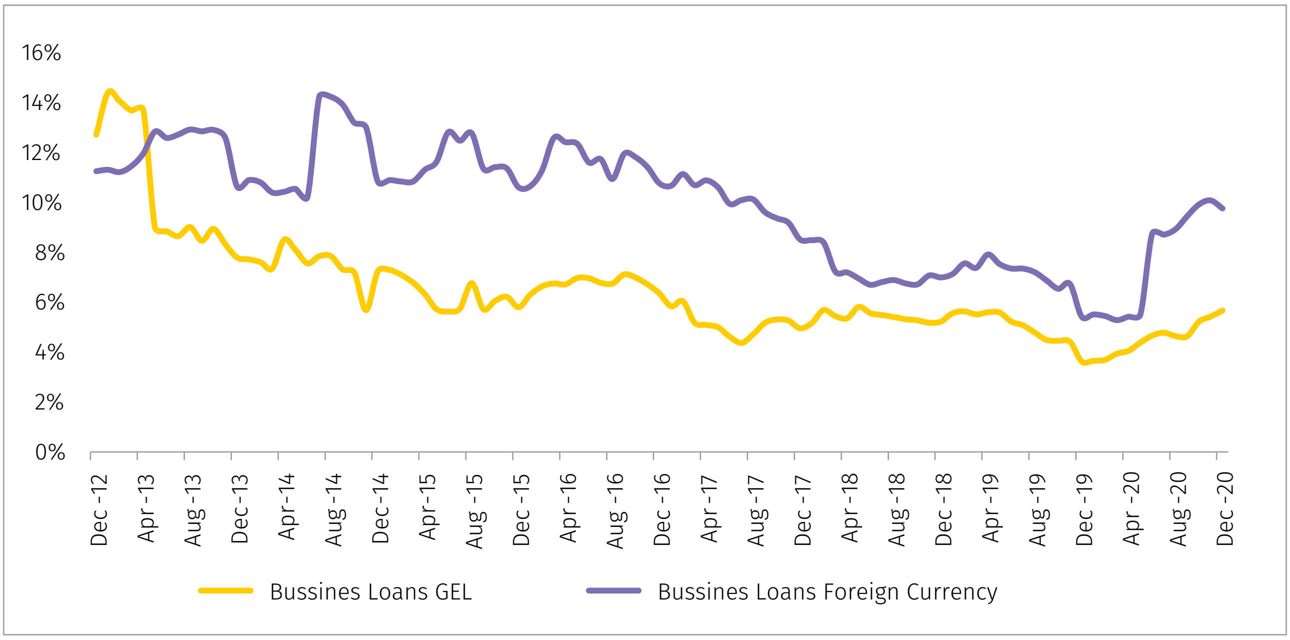
Source: International Monetary Fund; National Bank of Georgia

DIAGRAM N 4.16 PERCENTAGE OF RESTRUCTURED LOANS BY CURRENCY IN THE TOTAL LOAN PORTFOLIO



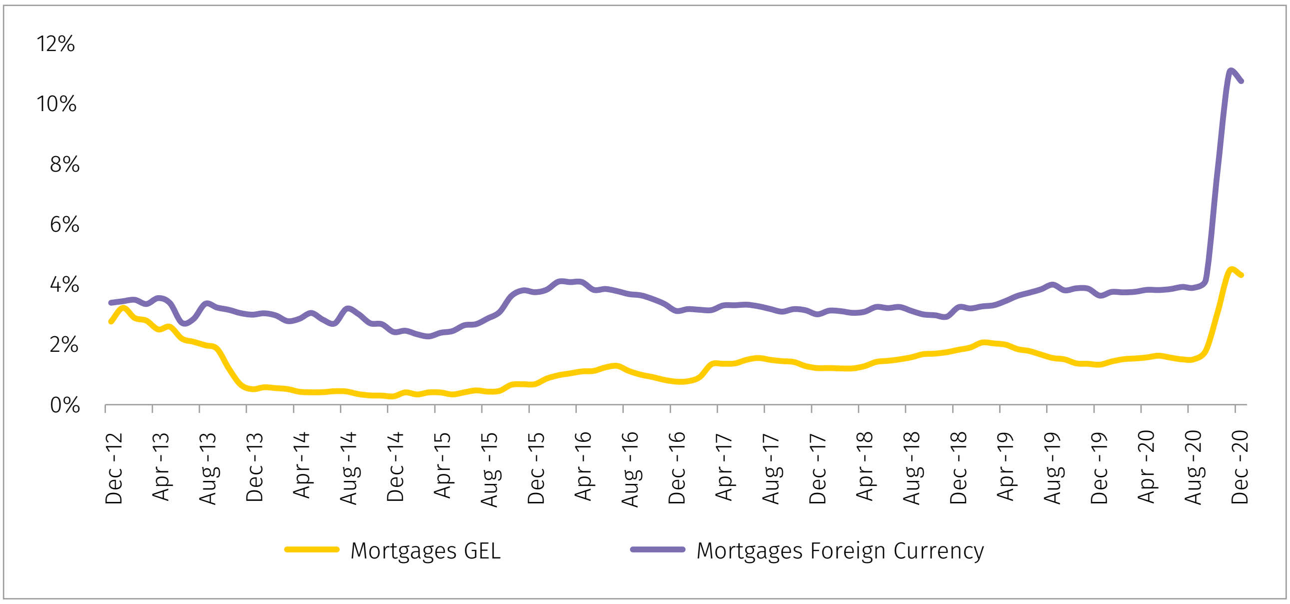
Source: National Bank of Georgia

DIAGRAM N 4.17 PERCENTAGE OF NON-PERFORMING BUSINESS LOANS BY CURRENCY



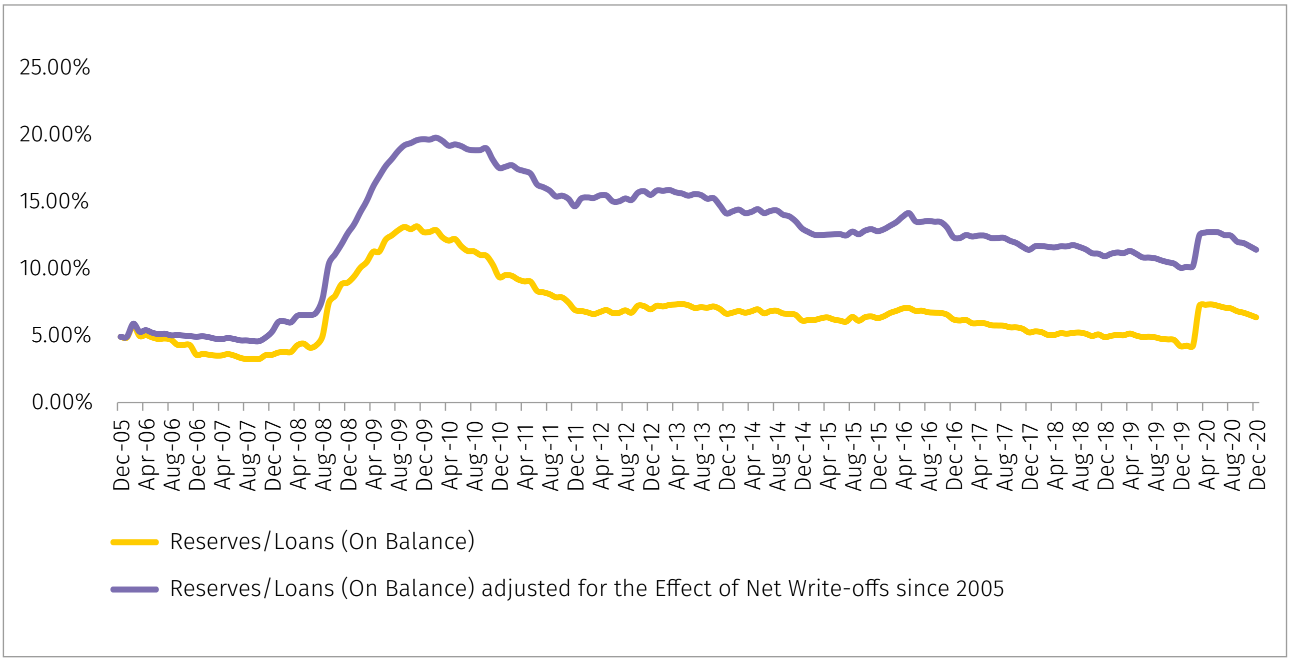
Source: National Bank of Georgia

DIAGRAM N 4.18 SHARE OF NON-PERFORMING MORTGAGE LOANS BY CURRENCY



Source: National Bank of Georgia

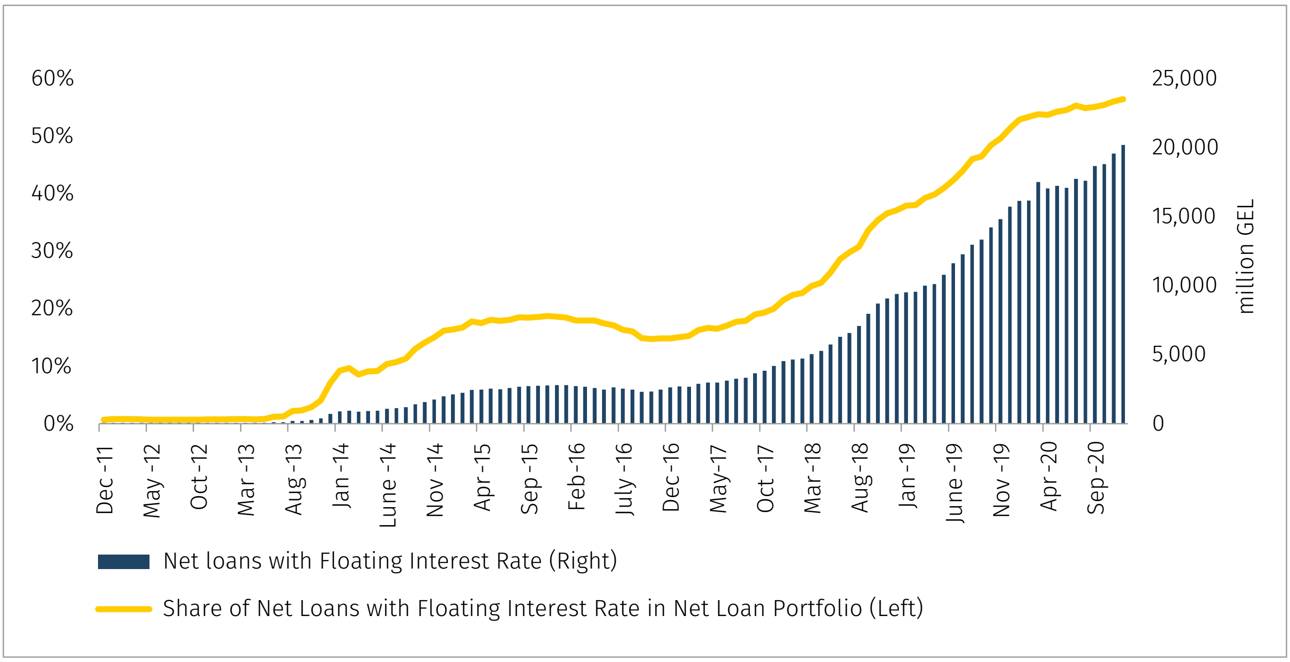
DIAGRAM N 4.19 LOAN LOSS RESERVE TO TOTAL RESERVE PORTFOLIO[57]



Source: National Bank of Georgia

57. This includes the general reserve.

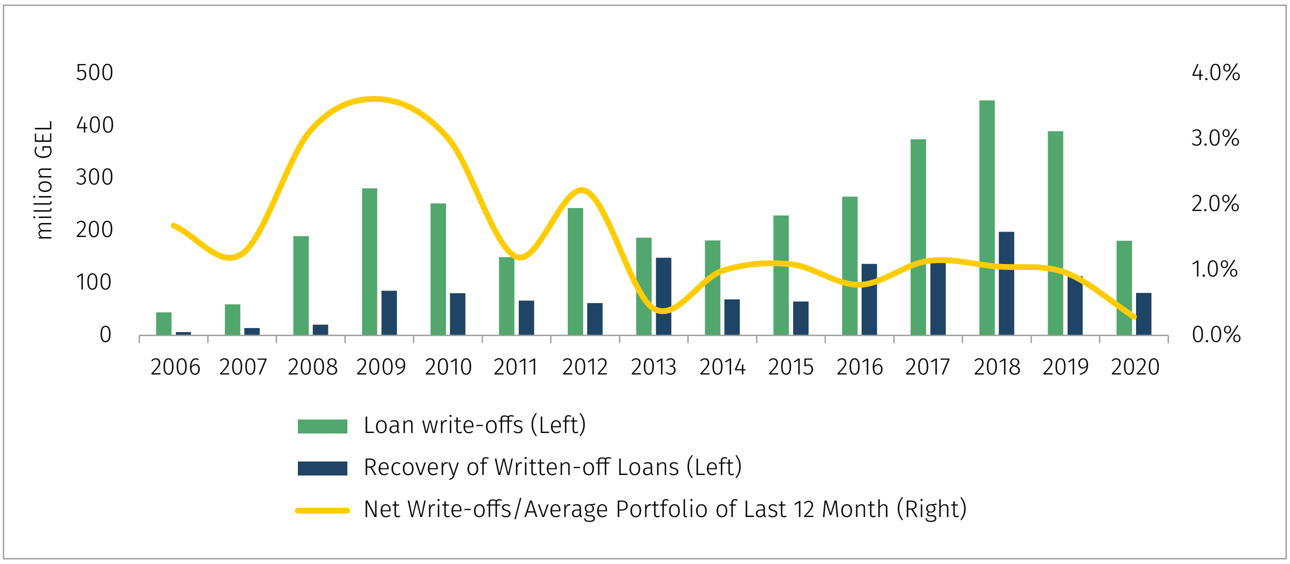
DIAGRAM N 4.20 VOLUME AND SHARE OF NET FLOATING INTEREST RATE LOANS IN THE NET LOAN PORTFOLIO[58]



Source: National Bank of Georgia

The volume of net written-off loans in 2020 decreased by 64.1% compared to the same period in 2019. Although a decrease was observed in both written-off assets and the recovery of written-off assets, the latter saw a smaller reduction.

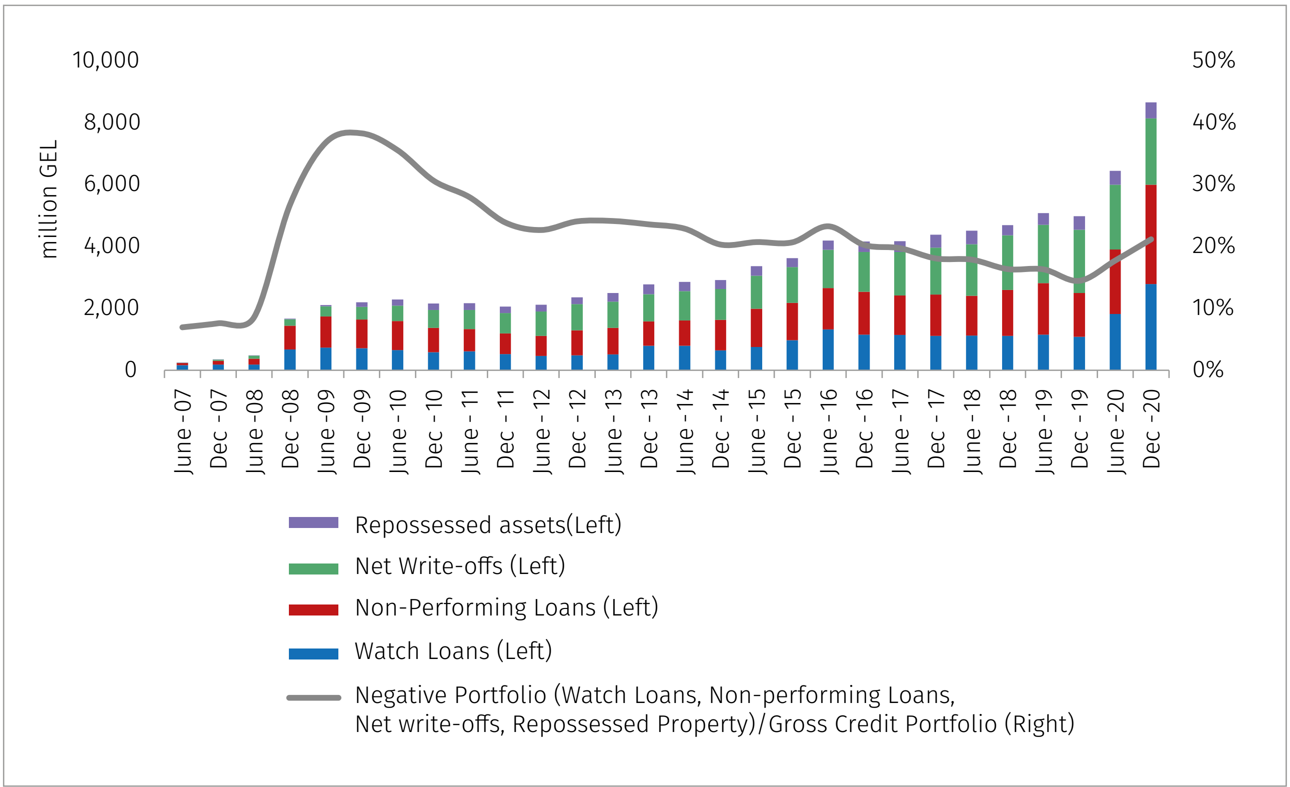
DIAGRAM N 4.21 LOAN WRITE-OFFS AND RECOVERIES



Source: National Bank of Georgia

58. Net loans refer to the volume of loans after subtracting loan loss reserves.

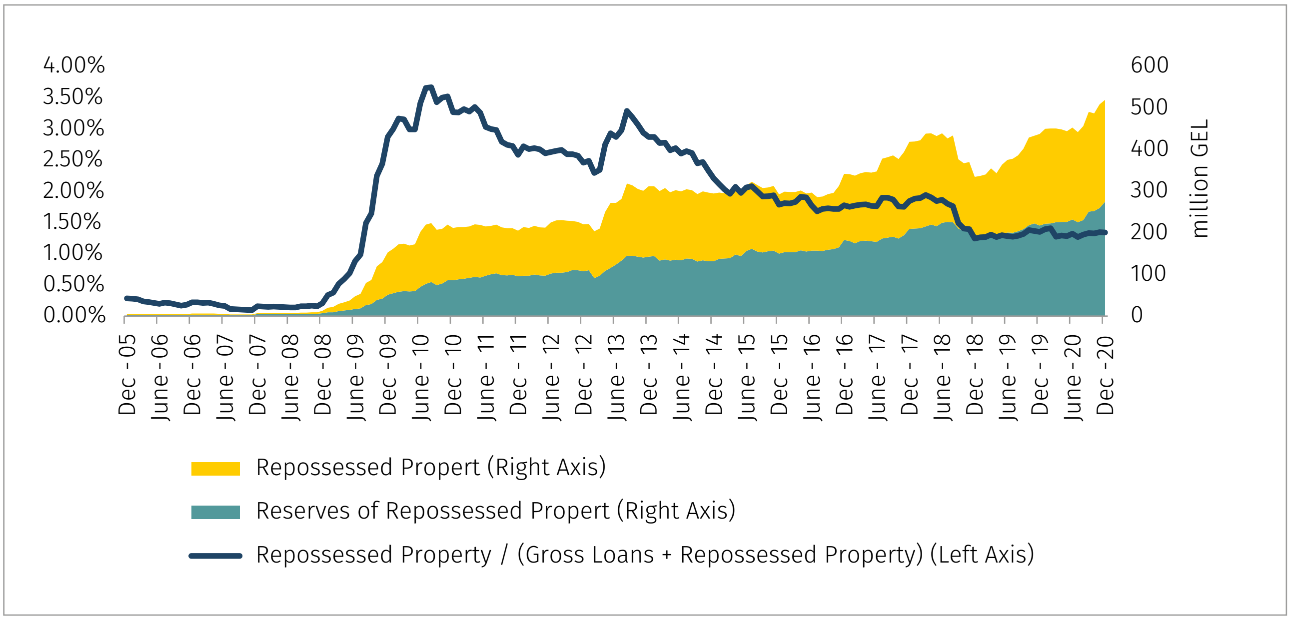
DIAGRAM N 4.22 PROBLEM ASSETS



Source: National Bank of Georgia

The share of repossessed property in total investments (loans plus repossessed property) remained unchanged in 2020 year on year.

DIAGRAM N 4.23 REPOSSESSED ASSETS



Source: National Bank of Georgia

BOX 6 THE IMPACT OF COVID-19 ON THE LOAN PORTFOLIO

In March 2020, at the request of the NBG, commercial banks assessed the impact of the COVID-19 pandemic on their loan portfolios and created general reserves to reflect expected loan losses. The total reserves created amounted to about GEL 1.1 billion, representing 3% of the total loan portfolio. General reserves were created for both business and retail loans.

In creating general reserves, the banks focused on sectors particularly vulnerable to the current economic shock, including the following:

1. Hotels and tourism
2. Restaurants, bars, cafes and fast-food outlets
3. Real estate management
4. Real estate development
5. Car dealers

Business borrowers were assessed with the assumption of a 3-year stress scenario for the economy and further recovery, with attention being paid to various relevant factors, including geographical distribution and exchange rate impacts. Meanwhile, the assessment of retail borrowers incorporated factors such as the depreciation of the GEL exchange, rising unemployment, including for those employed in vulnerable sectors, a reduced volume of remittances, and the loan servicing ratio. From June 2020, commercial banks were instructed to translate the general reserves created in March into individual, special reserves for borrowers and to assign an appropriate risk category for loans. The NBG was actively involved in this process, providing the banking sector with adequate limits on sectoral turn-over reductions and debt service coverage ratios (DSCR) to assess the creditworthiness of individual borrowers. This approach ensured comparability between commercial banks while giving parties an opportunity to share their expectations for economic recovery. The most notable development was the minimum DSCR set by the NBG, which incorporates the peculiarities of different sectors as well as considering bank lending/provisioning practices. These figures for the corporate and SME segments are as follows:

All Sectors

Debt Service Coverage Ratio (DSCR) for 10 Years	Loan Provision rate	Debt/earnings before interest, taxes, depreciation, and amortization, (EBITDA)	Loan Provision rate
≥1.2	2%	≤4.50	2%
1.0-1.19	10%	4.50-6.00	10%
0.7-0.99	30%	6.00-8.50	30%
0.5-0.69	50%	8.50-11.50	50%
<0.5	100%	>11.50	100%

Hotels, real estate management, and energy (HPP) sectors

Debt Service Coverage Ratio (DSCR) for 10 Years	Loan Provision rate	Debt/earnings before interest, taxes, depreciation, and amortization, (EBITDA)	Loan Provision rate
≥1.2	2%	≤6.00	2%
1.0-1.19	10%	6.00-7.50	10%
0.7-0.99	30%	7.50-10.00	30%
0.5-0.69	50%	10.00-13.00	50%
<0.5	100%	>13.00	100%

For individual assessments of the solvency of retail segment borrowers, the maximum limits of the loan servicing ratio and the corresponding risk categories were defined as follows:

Risk Category	Standard Loans	Watch Loans	Non-Performing Loans
PTI	≤60%	60%-70%	>70%

The NBG developed a methodology to define the risk category for borrowers for whom a solvency assessment was not performed individually, with consideration being given to restructuring, grace periods, loan maturity and overdue days.

As of the end of December 2020, banks transferred approximately GEL 770 million from the general to the special reserve, of which the internal use of the reserve segments amounted to the following:

1. Corporate segment - 58%
2. SME segment - 86%
3. Retail segment - 73%

The process of allocating reserves to individual borrowers is accompanied by ongoing monitoring from the NBG. The assessment of the adequacy of the special reserves created for corporate segment borrowers was completed by the end of 2020. No material deficiency was identified, and the process was assessed positively. After careful planning, the examination of SME and retail portfolio borrowers is underway, and is expected to be completed in May 2021.

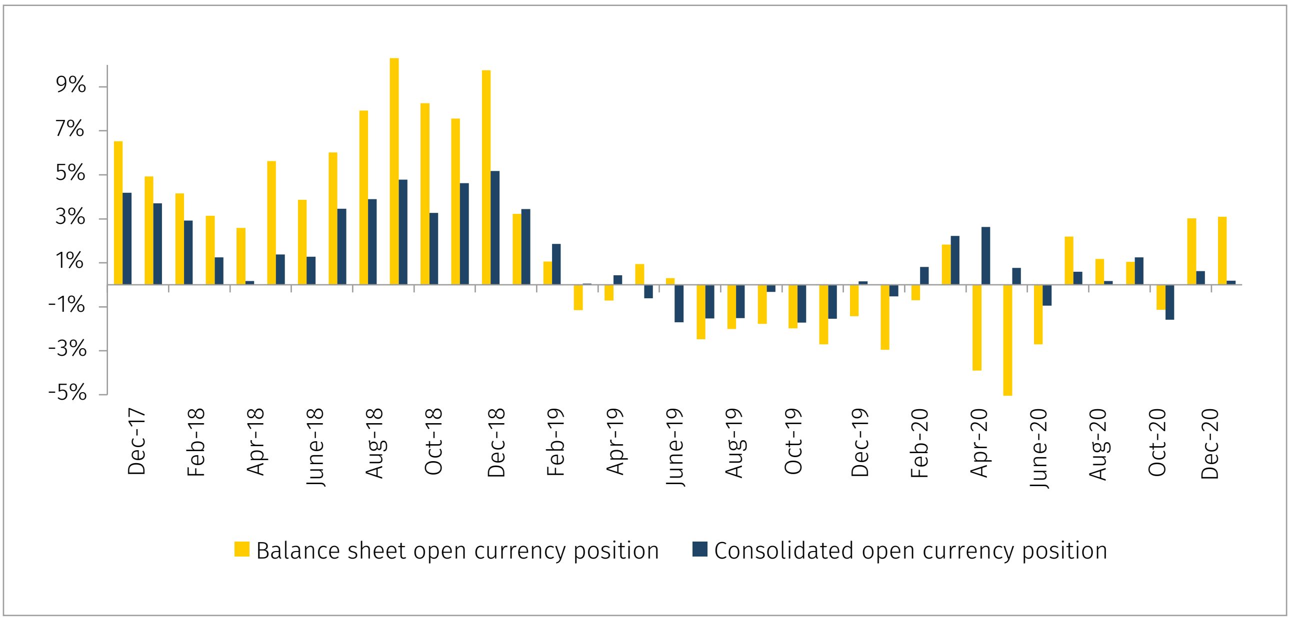
4.6 MARKET RISK

4.6.1 FOREIGN CURRENCY RISK

In the context of the COVID-19 pandemic, negative expectations prompted by uncertainty, and subsequent exchange rate fluctuations, the NBG intervened to reduce foreign currency risk, and banks continued to operate with stable open currency positions. Towards the end of the year, the total open currency position of the system was balanced at around 0%. However, since total (but not fully net) loans are still partially integrated in the current period, the real FX position of banks is short.[59] As a result, considering the revaluation of reserves, the depreciation of the lari causes a loss. In addition, because share capital is denominated in lari, the revaluation of risk-weighted assets during lari depreciation significantly reduces banks' capital adequacy ratios, making them even more vulnerable to this risk.

The growing trend of larization in the Georgian banking system continued, though it did so at a relatively slow pace. Despite this, the share of foreign currency assets and liabilities continues to be high, and the currency risk factor thus remains important for Georgian banks. The National Bank of Georgia continues to direct its supervisory effort at improving existing approaches towards foreign exchange risk management, including upgrading the accounting treatment for the revaluation of foreign currency asset loss reserves in the open currency position. A schedule for these actions had been made ready, but this had to be temporarily suspended as part of the NBG's COVID-19 pandemic response. Considerable effort is also devoted to the assessment of structural position risks and the development of internal currency risk models in banks. This process has become even more important in the context of the global and regional challenges associated with COVID-19.

DIAGRAM N 4.24 BALANCE SHEET AND CONSOLIDATED OPEN CURRENCY POSITIONS TO REGULATORY CAPITAL



Source: National Bank of Georgia

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

4.6.2 INTEREST RATE RISK

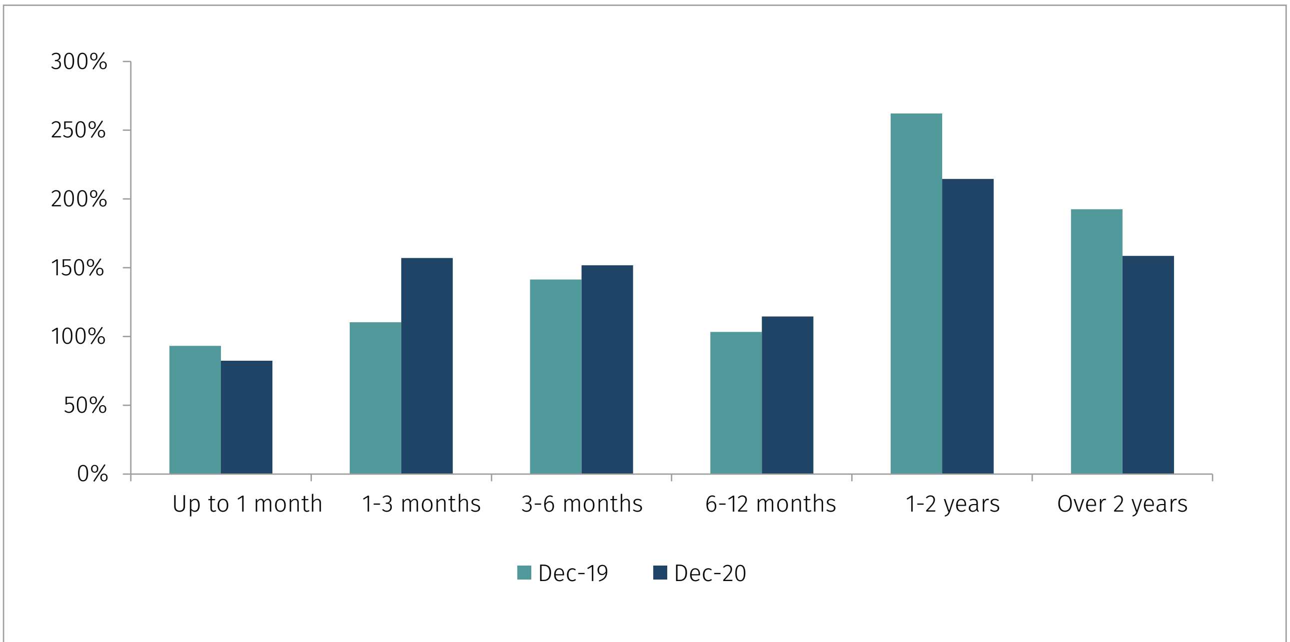
In early 2020, amid the declining GEL liquidity caused by the COVID-19 pandemic, interest rate risks increased due to a significant increase in interest rates on local currency deposits. Following the measures taken by the National Bank of Georgia to support lari liquidity, interest rates stabilized and returned to pre-stress levels. Such fluctuations reaffirm the importance of regularly monitoring and adequately assessing interest rate risk in commercial banks.

Banks operating in Georgia hold almost no trading securities. However, banks with a trading book are required to develop appropriate procedures and report to the National Bank. If subsequent monitoring reveals the possibility of significant portfolio growth, trade book risk management regulations will be applied.

At present, regulations and approaches concerning interest rate risk in the banking book are applied for the entire balance sheet. The "Regulation on the Management of Interest Rate Risk in the Banking Book (IRRBB)" came into force in 2020. The purpose of this is to identify, assess, and manage interest rate risk arising from the banking book, and, by imposing relevant requirements, to support the stability and sound functioning of commercial banks and the financial sector (see Box 7).

Positive dynamics were observed in the coverage of liabilities with interest-bearing assets in both the medium and long term (see Diagram N 4.22). This is related to the emergence of additional long-term sources of funding in the system, the longer maturity of liabilities, as well as the increase in loans with floating interest rates.

DIAGRAM N 4.25 COVERAGE OF LIABILITIES WITH INTEREST-BEARING ASSETS



Source: National Bank of Georgia

BOX 7 MANAGEMENT OF INTEREST RATE RISK IN THE BANKING BOOK (IRRBB)

Interest rate risk reflects a bank's sensitivity to changes in interest rates. It refers to current or future risks to a bank's capital and earnings, as arising from adverse movements in interest rates, and affects the position of the banking book. Changes in interest rates change the net present value and residual maturities of future cash flows – also altering respective assets, liabilities, off-balance sheet items and their economic value (EVE). Changes in interest rates also affect a bank's net interest income (NII), by altering interest rate-sensitive income and expenses. Management of this risk can have a significant impact on a bank's profitability and equity.

EVE interest rate risk is measured under six scenarios, while the impact on net interest income is based on two scenarios (parallel up and down movements in interest rates).

The National Bank monitors both of these measurements and supervisory actions are taken when the interest rate risk is high and the economic value of a loss due to various interest rate risk shocks exceeds 15% of a bank's Tier 1 capital. Aside from this traditional approach, in certain cases, judging from expected trends and risks, when a supervisor considers that a bank does not have appropriate capital for interest rate risk, they may decide to take supervisory measures to increase the bank's equity or to decrease interest rate risk positions.

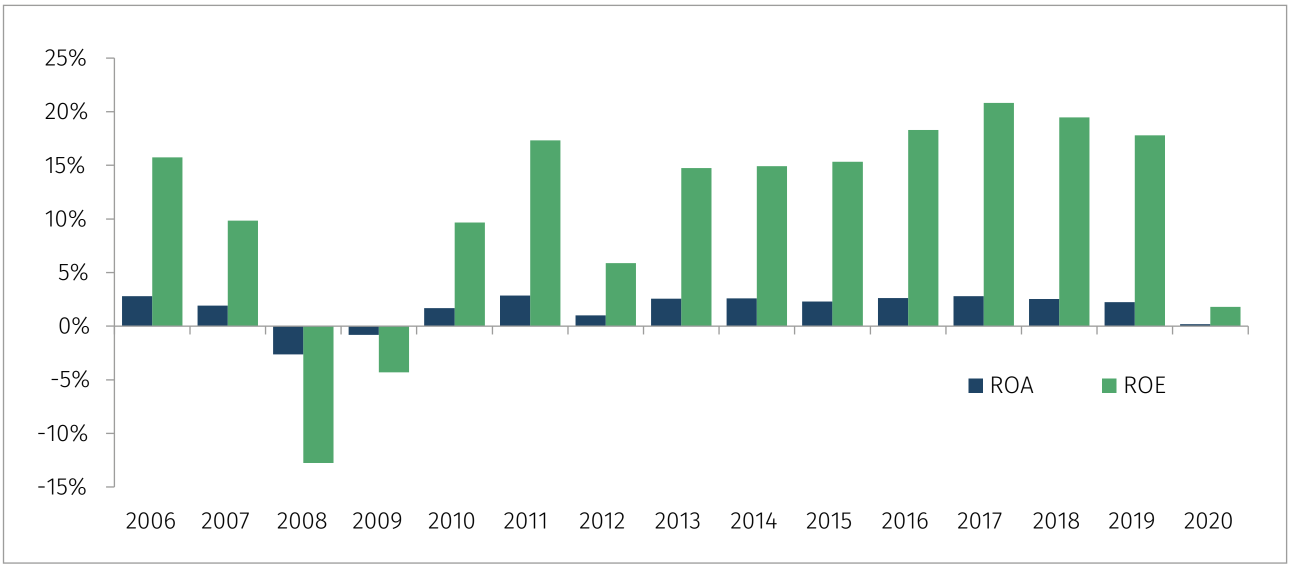
Prior to the enactment of this regulation, the parameters were calibrated, upgraded and adjusted to the Georgian banking sector. In parallel with this interest rate assessment framework, the National Bank continues to monitor other forms and indicators of interest rate risk. At the end of the year, based on the current interest rate risk approach, the ratio of changes in EVE and NII to Tier 1 capital were 7.4% and 1.2%, respectively, and significantly below the maximum supervisory limit.

4.7 PROFITABILITY RISK

In 2020, the return on average assets and equity amounted to 0.2% and 1.8%, respectively, falling far below the previous year's figures of 2.2% and 17.8%.[60] The main driver of this change was the general reserves of GEL 1.1 billion, which were provisioned in advance in March as an counter-pandemic action.

60. ROE is the net profit to the average annual share capital and ROA is the net profit to the average annual assets. In these calculations, net profit is calculated as the sum of the net interest income and net non-interest income less provisions for potential losses on loans and other financial assets, after unforeseen income and taxes.

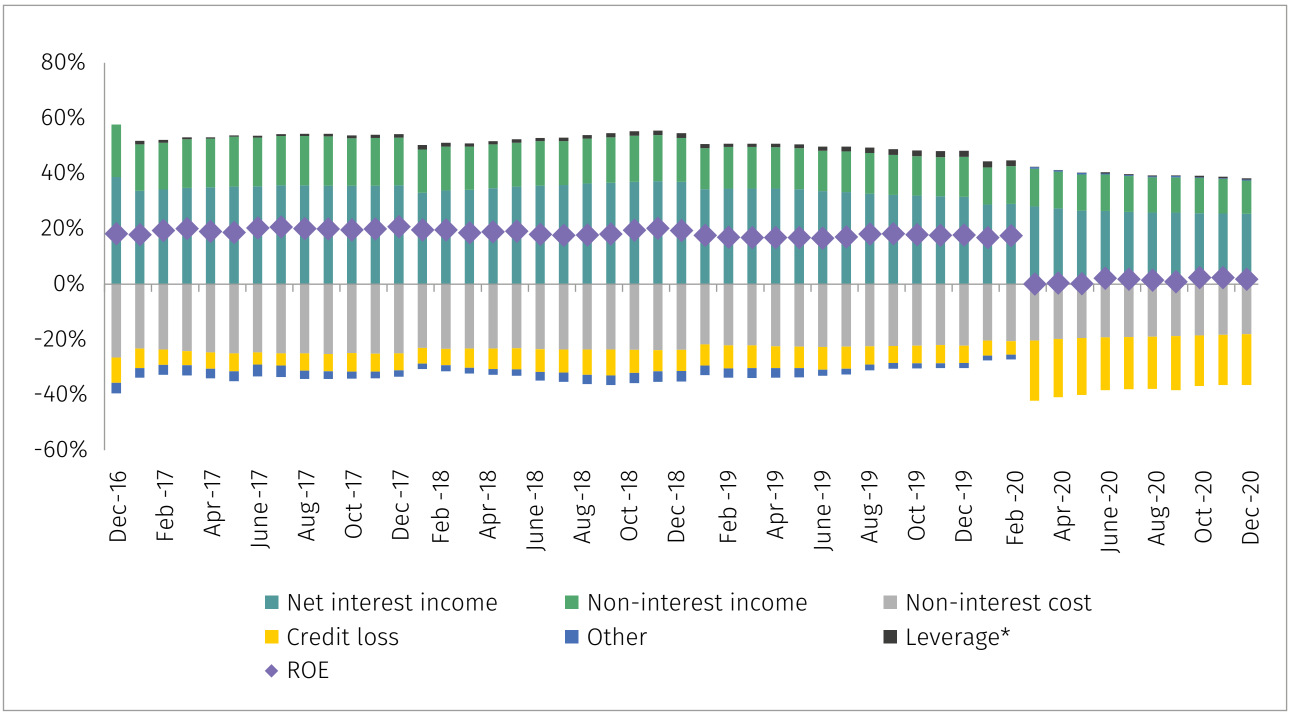
DIAGRAM N 4.26 RETURN ON ASSETS AND EQUITY



Source: National Bank of Georgia

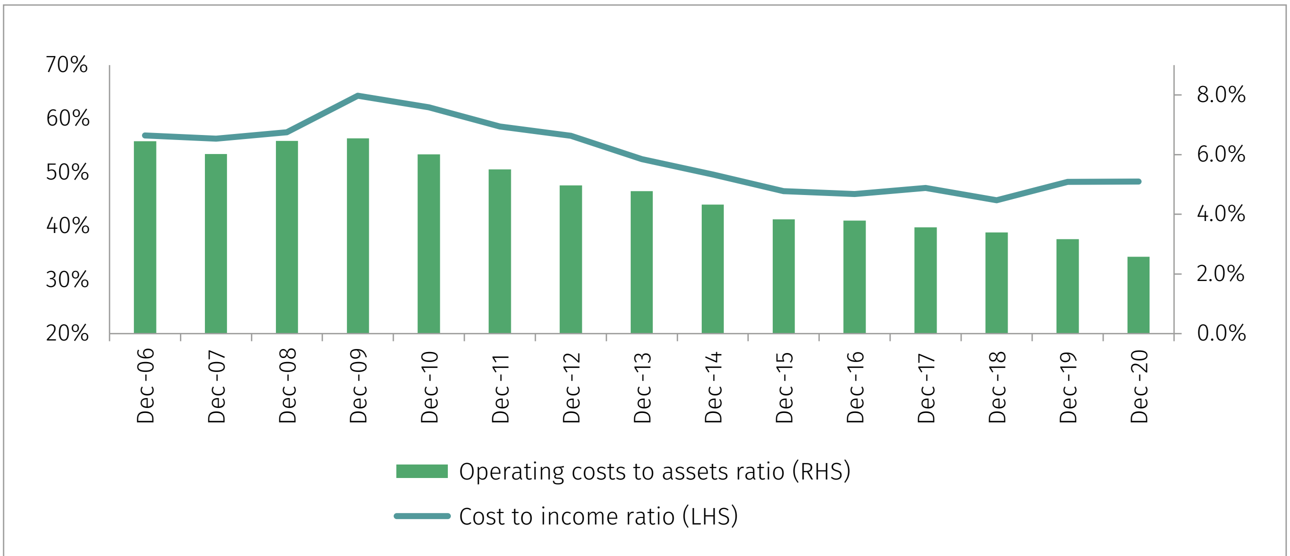
In terms of the profit decomposition for 2020, several important factors affecting the profitability of the banking system are noteworthy. Net interest margins and non-interest income decreased during the year, mainly due to the slowdown in lending activity and the moratorium on loans offered by banks due to the pandemic. However, profitability was positively affected by growth, scale and increased efficiency due to reduced operating costs. Total assets and total loans grew by 20.5% and 19.6% respectively, excluding the exchange rate effect, while non-interest costs decreased by 2.9%. The costs-to-asset ratio, another illustration of higher efficiency, fell from 3.2% to 2.6%. The decline in profitability due to the deterioration in asset quality followed the creation of a loan loss reserve of nearly GEL 1.1 billion in March 2020.

DIAGRAM N 4.27 PROFIT DECOMPOSITION



Source: National Bank of Georgia
**Leverage is an indicator that has been indexed since December 2016.*

DIAGRAM N 4.28 COST-TO-INCOME AND COST-TO-ASSETS RATIOS



Source: National Bank of Georgia

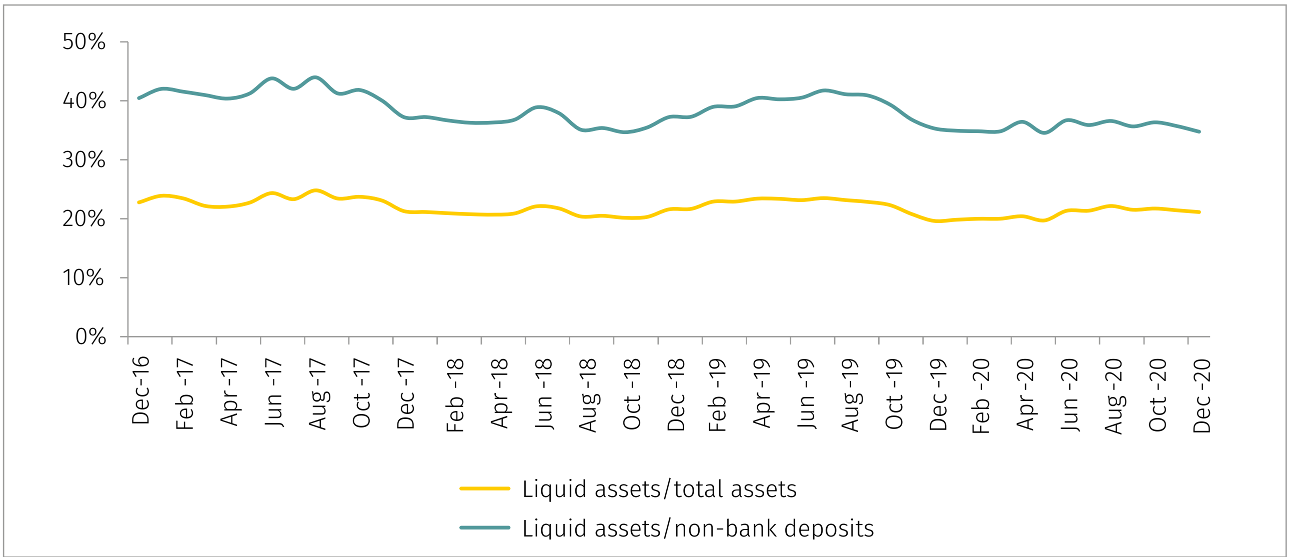
The National Bank of Georgia continues to review the profitability forecasts of banks, to analyze the business models and strategies of individual institutions, and to assess relevant mitigating factors for risks. Considerable attention is paid to scale effects, market niche or other competitive advantage, and projected credit loss factors. Development and improvement of pricing models for bank products is closely monitored.

4.8 LIQUIDITY RISK

4.8.1 LIQUID ASSET STRUCTURE

The volume of liquid assets remained high in 2020, despite pandemic-related negative expectations and fluctuations. As a result, liquid assets accounted for more than 21% of total assets, sufficient to cover up to 35% of non-bank deposits.

DIAGRAM N 4.29 LEVEL OF LIQUID ASSETS



Source: National Bank of Georgia

The liquidity coverage ratio (LCR) for 2020 was subject to certain fluctuations. With the onset of the pandemic, the NBG intensified daily monitoring of deposit changes. Despite the increased uncertainty, the maximum monthly outflow of deposits was only 4.4%.

Following the rise of risks stemming from COVID-19, the National Bank of Georgia immediately took significant actions to support lari liquidity, allowing banks to attract additional liquidity and significantly reduce underlying risks (see Box 2). These actions included the following:

- The financial sector was offered low-interest and affordable GEL/USD swap operations with the National Bank of Georgia, within a total limit of USD 400 million.
- A standby swap operations tool became available, which allows banks to receive additional unlimited lari liquidity, if necessary, at a penalty rate.
- A USD 200 million GEL/USD swap agreement was signed with the European Bank for Reconstruction and Development (EBRD), allowing the EBRD to increase funding of the private sector in local currency and giving banks an opportunity to accumulate additional lari liquidity.
- From 1 May 2020, banks were given the opportunity to use foreign currency buffers to manage lari liquidity and meet the total liquidity requirement. In force for a year, this tool gives them additional flexibility in liquidity management.
- The lari collateral base expanded, allowing banks to attract additional lari resources

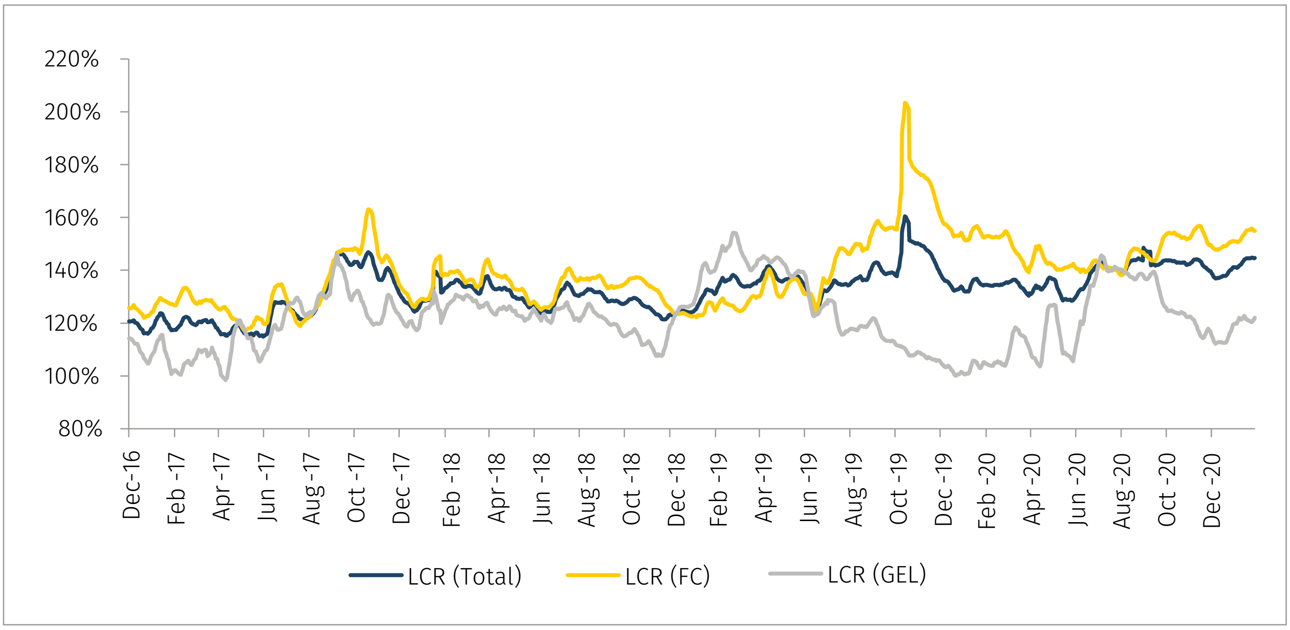
from the National Bank by securing them with loans extended to the SME segment.

- With the support of the National Bank, microfinance institutions were given the opportunity to attract additional resources from commercial banks, depending on the size of the loan portfolio, which also had a positive impact on liquidity risks in the financial sector.
- In parallel with the NBG's actions, the government issued securities worth GEL 600 million and the proceeds were placed in commercial banks as a source of stable long-term financing.

Through use of the additional liquidity instruments of the National Bank of Georgia, the financial sector attracted over GEL 550 million. However, as the total limit is GEL 2 billion, additional liquidity may be used as necessary. The total amount of lari attracted as part of the actions of the National Bank of Georgia and the government exceeded GEL 1.1 billion.

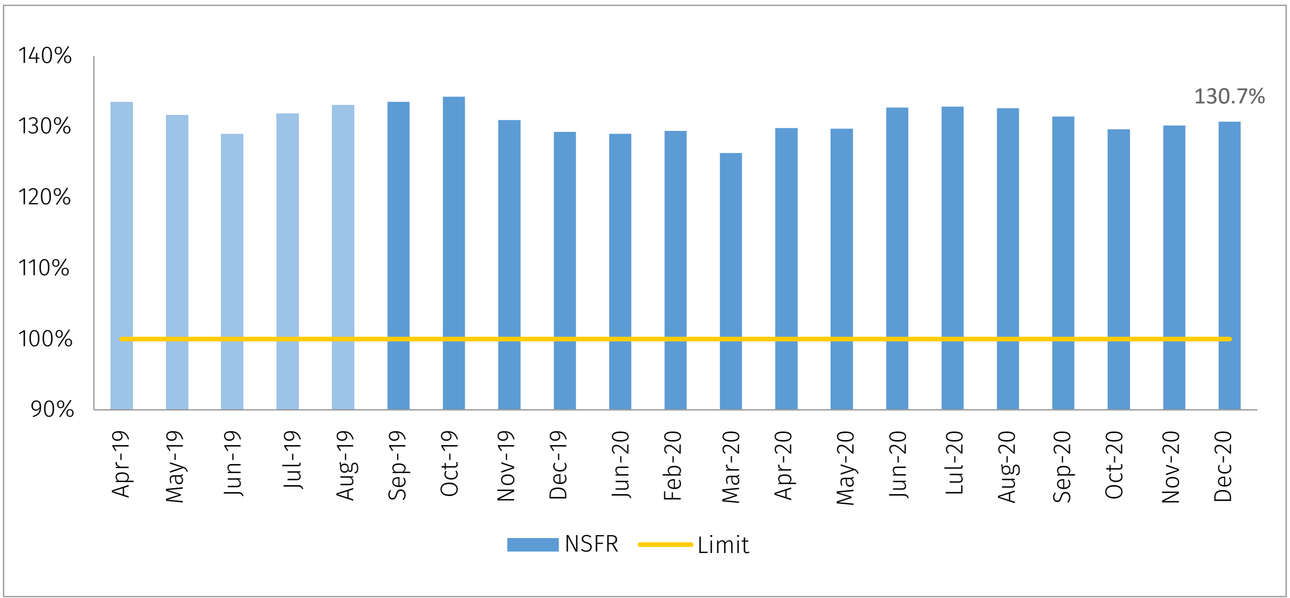
Following these actions, sufficient lari resources were accumulated at the end of the first half of 2020, and the liquidity coverage ratio significantly exceeded the pre-pandemic level. The decrease in the lari liquidity coverage ratio by the end of the third quarter was mainly due to the increased demand for lari loans, which resulted in the absorption of accumulated liquidity. The Net Stable Funding Ratio (NSFR) also remained high at 130% during the year.

DIAGRAM N 4.30 LIQUIDITY COVERAGE RATIO (LCR) DYNAMICS



Source: National Bank of Georgia

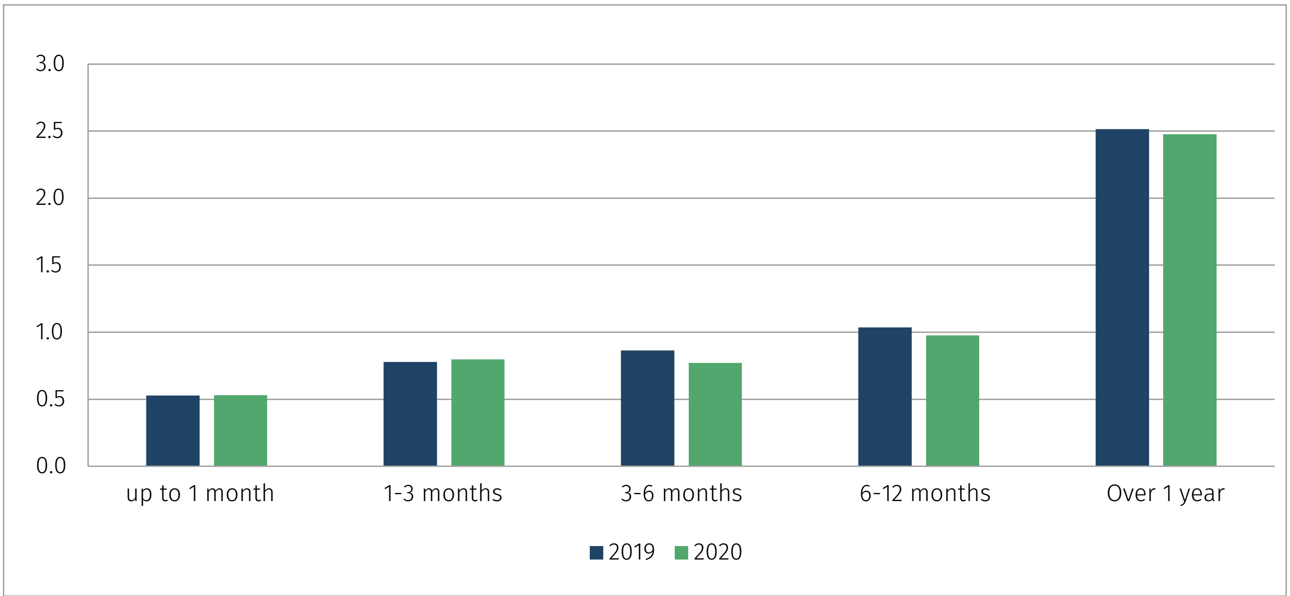
DIAGRAM N 4.31 NET STABLE FUNDING RATIO



Source: National Bank of Georgia

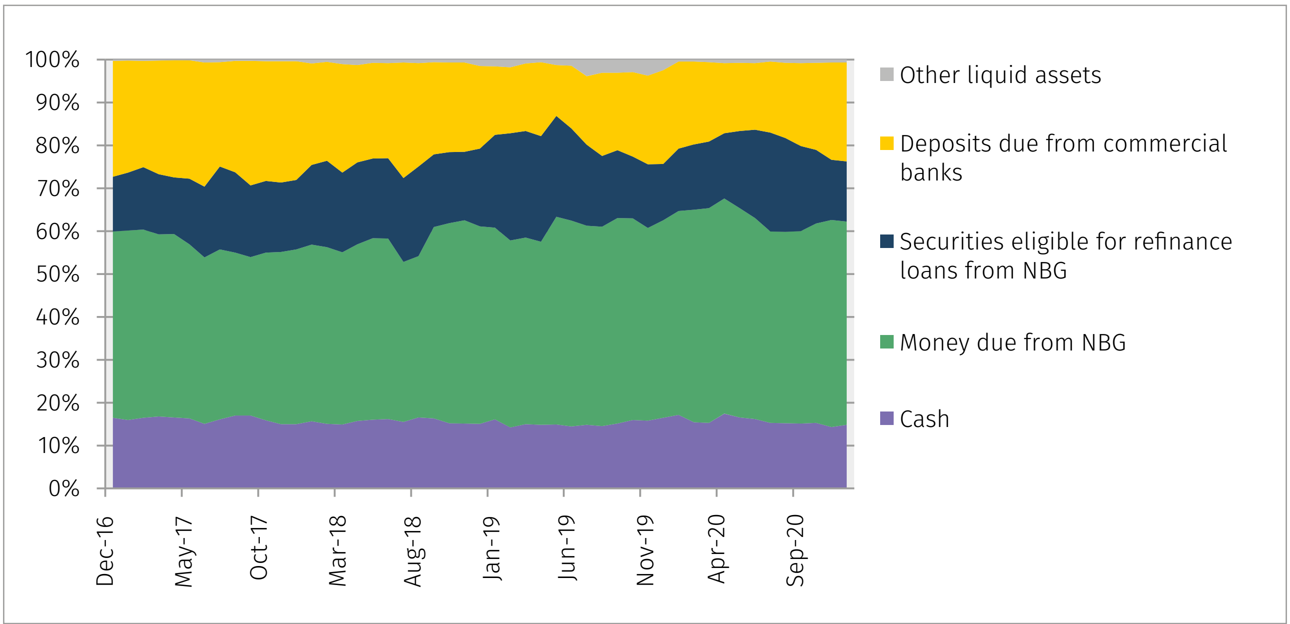
In 2020, the liquid asset gap structure remained stable in both the up-to-1-year and more-than-1-year time baskets.

DIAGRAM N 4.32 LIQUIDITY GAP – ASSETS TO LIABILITIES



Source: National Bank of Georgia

DIAGRAM N 4.33 VOLUME AND STRUCTURE OF LIQUID ASSETS

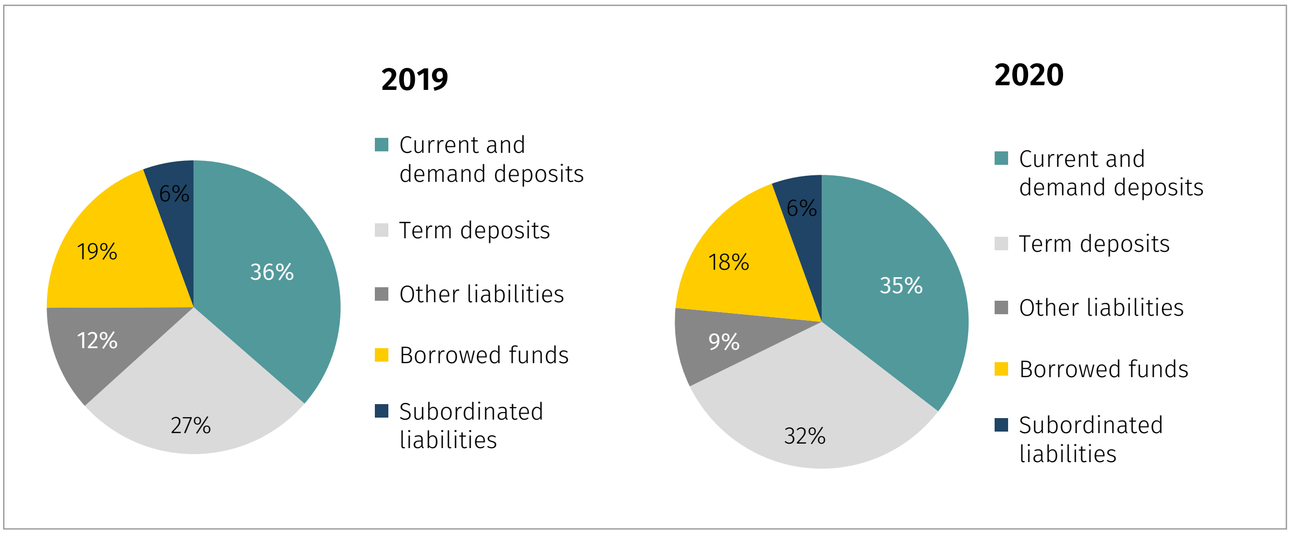


Source: National Bank of Georgia

4.8.2 LIABILITY STRUCTURE

The share of term deposits increased with the growth of certificates of deposit in the structure of liabilities. In addition, banks maintained a fairly comfortable level of liquid assets relevant to the risks of the liability structure.

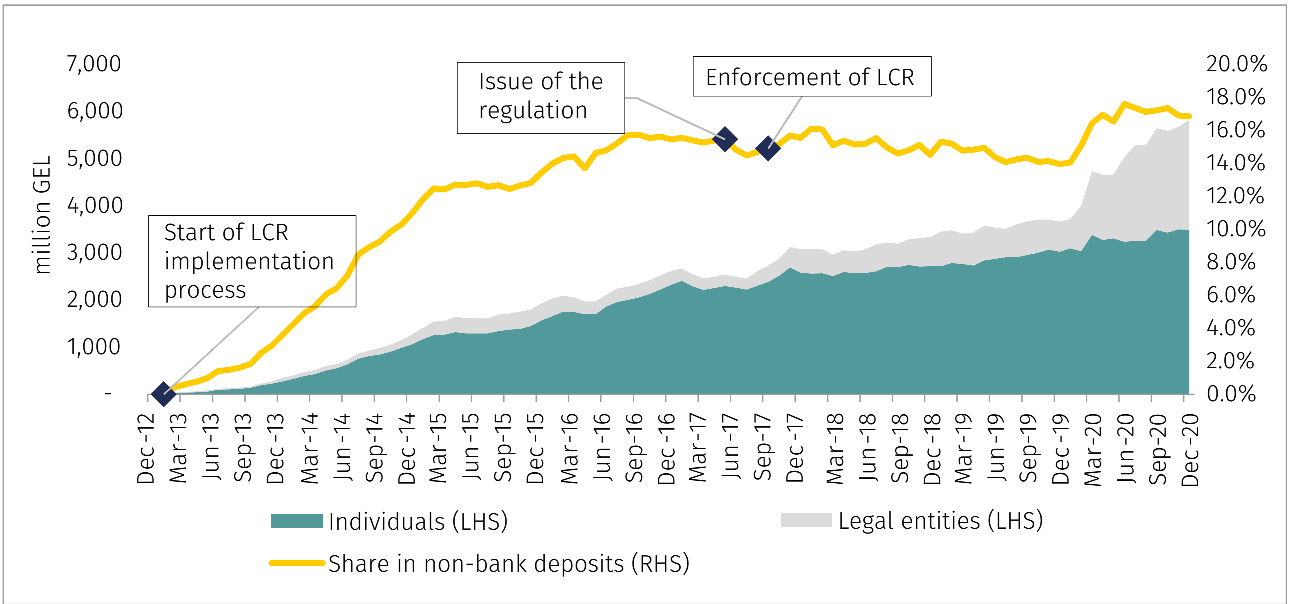
DIAGRAM N 4.34 LIABILITY STRUCTURE



Source: National Bank of Georgia

The development and growth of non-redeemable certificates of deposit have had a significant impact on the funding structure of the banking system. This stable funding product provides the bank with a low-risk liquidity resource and allows depositors to receive higher interest rates. The growth of certificates of deposit continued in 2020 and exceeded GEL 5.8 billion at the end of the year, which is GEL 2.1 billion more than the same figure at the end of 2019, accounting for 16.8% of total non-bank deposits.

DIAGRAM N 4.35 CERTIFICATES OF DEPOSIT AND THEIR SHARE IN NON-BANK DEPOSITS

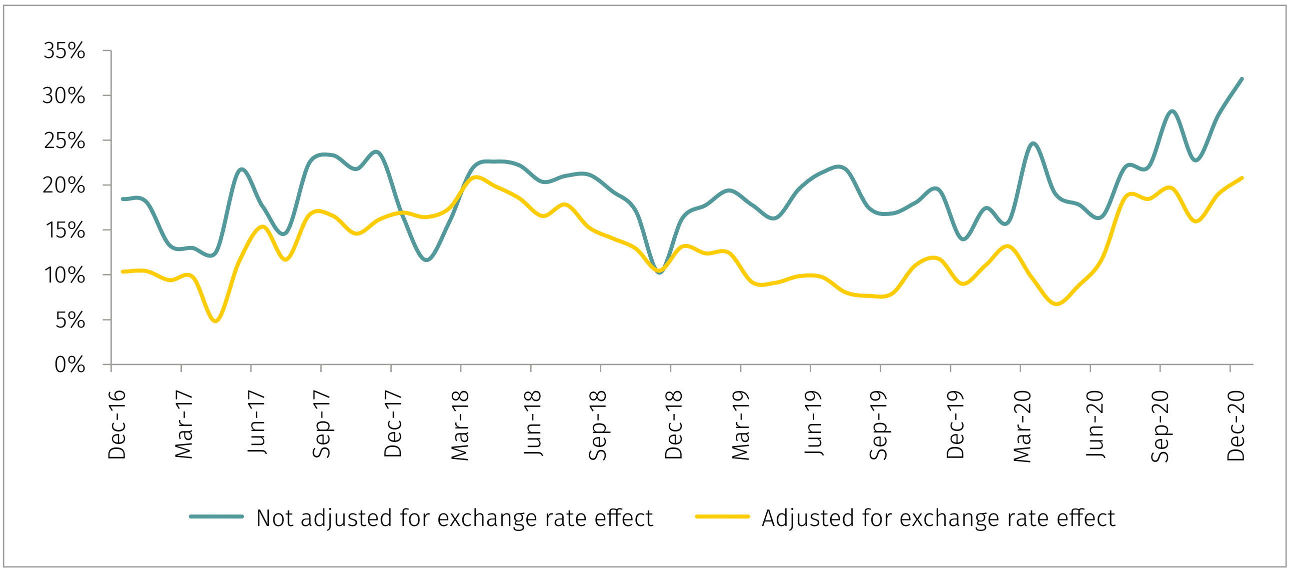


Source: National Bank of Georgia

4.8.3 RETAIL FUNDING

Deposits increased by GEL 8.3 billion (by 31.8%, or by 20.8% if excluding the exchange rate effect) in 2020 to total GEL 34.6 billion as of December. According to the structure of depositors, the growth of deposits of individuals and legal entities was 22.8% and 43.9% respectively (excluding the exchange rate effect, the growth was 11.0% and 34.4% respectively). The larization of deposits also increased during the year and stood at 38.5% by the end of December.

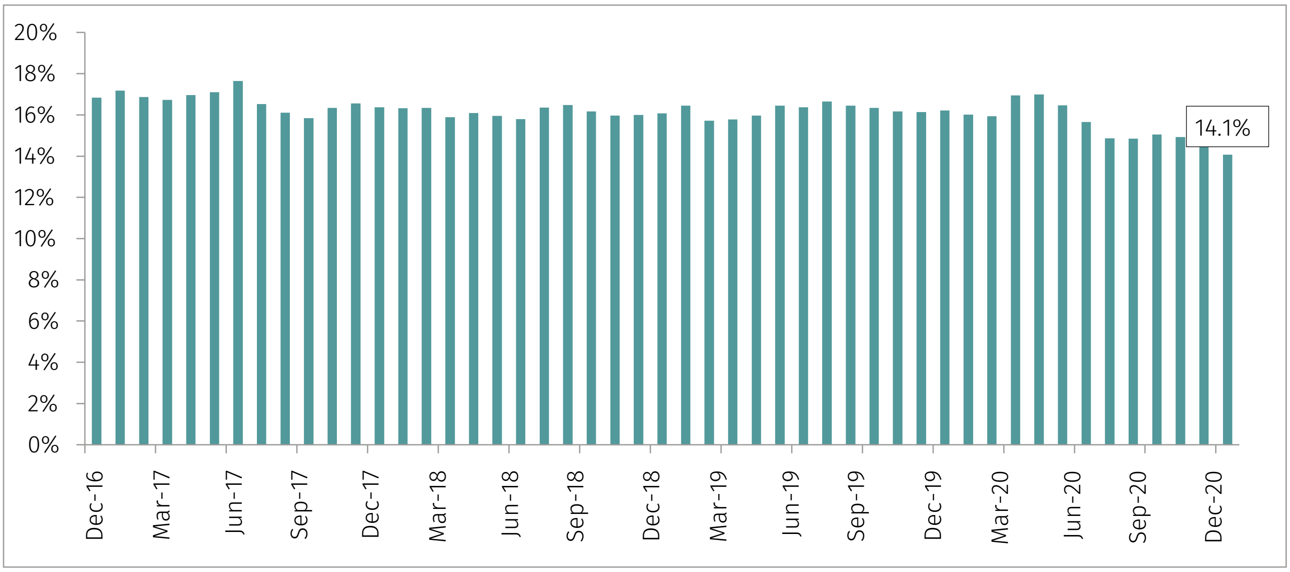
DIAGRAM N 4.36 ANNUAL GROWTH OF NON-BANKING DEPOSITS



Source: National Bank of Georgia

The share of non-resident customer deposits in total non-bank deposits decreased by 2.1 percentage points during 2020 and stood at 14.1% by the end of December. These deposits are still diversified by country of origin, which is a positive factor in terms of risk. However, the share of term deposits is high, which significantly reduces the risk of outflow. To prevent overdependence on this type of funding, the National Bank of Georgia maintains an additional liquidity requirement for deposits of non-residents.[61] This additional requirement discourages banks with a high share of non-resident deposits from attracting this type of deposit portfolio. This was consequently reflected in the stabilized share of non-resident deposits in recent years.

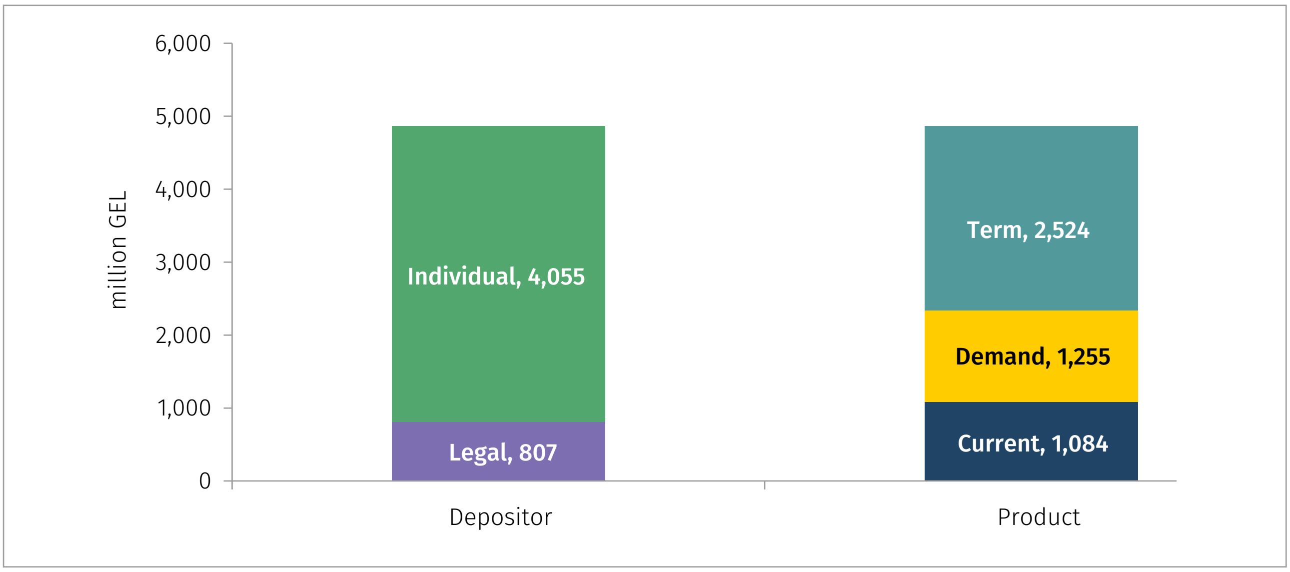
DIAGRAM N 4.37 SHARE OF NON-RESIDENT CLIENT DEPOSITS



Source: National Bank of Georgia

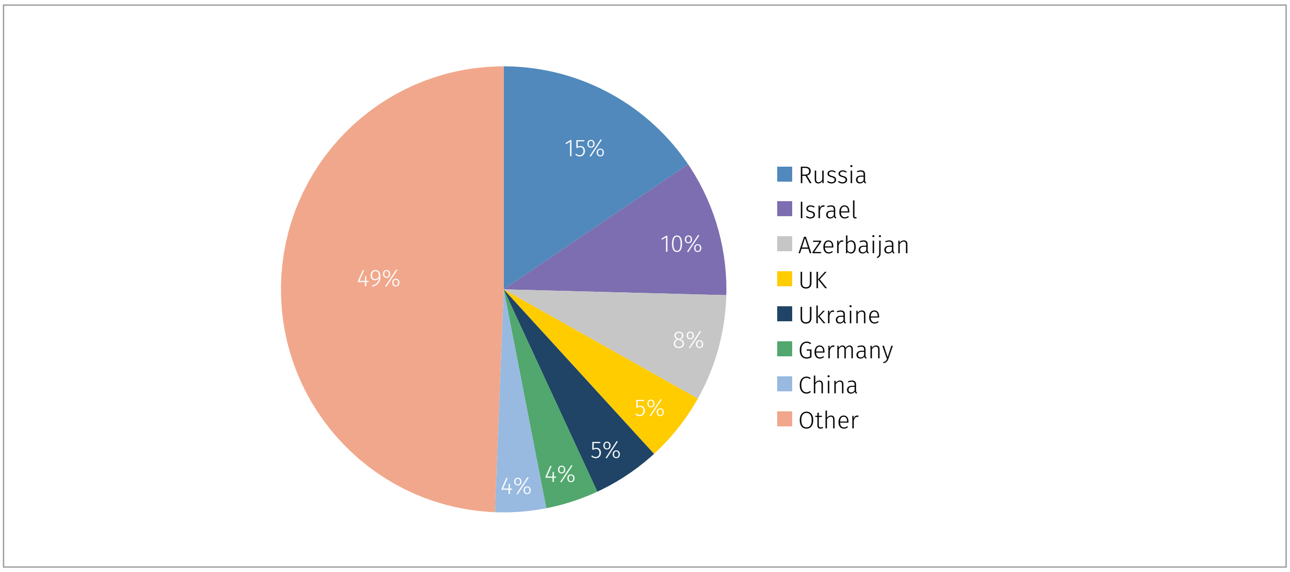
61. For LCR calculation purposes, high outflow rates are applied to non-resident deposits.

DIAGRAM N 4.38 STRUCTURE OF NON-RESIDENT DEPOSITS (DEC. 2020)



Source: National Bank of Georgia

DIAGRAM N 4.39 NON-RESIDENT DEPOSITS BY COUNTRY (DECEMBER 2020)

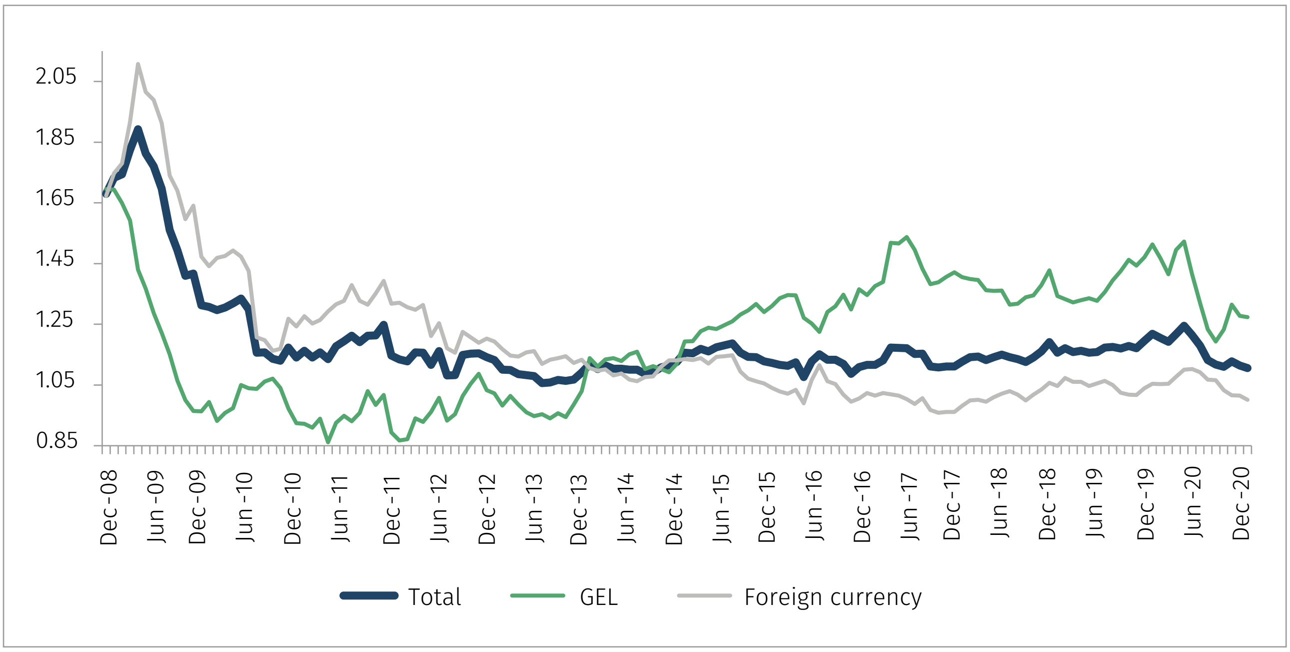


Source: National Bank of Georgia

4.8.4 WHOLESALE FUNDING

Although remaining high, the loans-to-deposits ratio decreased during 2020, which was mainly due to the high growth of deposits. The same ratio calculated for lari loans and deposits still exceeds that for foreign currency loans and deposits. To some extent, this was due to the high growth rate of lari loans driven by currency risks and larization measures.

DIAGRAM N 4.40 TOTAL LOANS TO NON-BANK DEPOSITS BY CURRENCY



Source: National Bank of Georgia

The funds received from external sources of wholesale funding are quite diversified in terms of both type of creditors and by residual maturity. The residual maturity of up to 60% of wholesale funding exceeds two years, which reduces funding risk for the system.

A total of 58% of wholesale funding comes from international financial institutions, 10% from parent/affiliate companies, and 32% from other private institutions. The high share of international financial institutions and long-term repayment schedules can be assessed as being low risk. Monitoring of covenants acquired greater importance in the pandemic, and this was performed regularly by commercial banks and the National Bank.

TABLE N 4.9 EXTERNAL SOURCES OF WHOLESALE FUNDING AND THEIR SCHEDULES (AS OF 31 DECEMBER 2020)

Month	<1	1–3	3–6	6–12	12–24	24–36	36–60	>60	Total
Total	**3.65%**	**3.32%**	**10.16%**	**12.51%**	**12.88%**	**12.93%**	**31.88%**	**12.68%**	**100.00%**
International financial institutions	1.92%	2.24%	4.80%	7.52%	9.43%	8.80%	13.70%	9.55%	57.95%
Affiliated/parent institutions	1.03%	0.25%	0.87%	1.20%	0.69%	1.84%	2.46%	2.16%	10.49%
Other private funding	0.71%	0.83%	4.49%	3.78%	2.77%	2.29%	15.72%	0.97%	31.56%

Source: National Bank of Georgia

4.9 OPERATIONAL RISK

Operational risk is the risk of losses arising from failed/inefficient internal processes, people, systems or external events. The latter includes the COVID-19 pandemic, which has had a large-scale impact on the world. This impact became manifested on the financial sector early in the year, posing new challenges in terms of operational risk.

Operational risk is growing for various sectors of the economy, even disregarding the effects of the pandemic. Operational risk is a crucial consideration for modern-day organizations, where reliance on electronic information systems is progressively increasing. Digitally transformed financial institutions tend to have high dependence on electronic information systems, since they employ new technologies and engage in more complex operations and financial services. The global pandemic has accelerated the digital transformation of financial institutions. As a consequence of these developments, cyber risk and challenges related to cyber security management are currently some of the main issues in terms of operational risk management.

To better prepare for the anticipated effects of the global pandemic, the National Bank of Georgia started working with commercial banks to manage business continuity from the beginning of 2020. The NBG instructed commercial banks to upgrade and expand their existing business continuity plans according to the scenario of a rapid spread of the virus. In parallel, the NBG developed recommendations and guidelines for operational risks related to the pandemic for commercial banks. The purpose of this process was to reduce the risk of business disruption in the financial sector. NBG supervisory guidelines covered the following areas:

- The implementation of appropriate measures and control mechanisms related to the spread of infections in the workplace, based on the recommendations of various accredited organizations and entities.
- The establishment of procedures for remote work.
- Timely and prompt testing of key employees' remote work processes to ensure business continuity.
- Pandemic scenario testing from the perspective of the capacity and workload of the available critical information technology systems environment.
- Full assessment of increased cyber risk resulting from the increased workload of remote channels.
- Cyber-risk fraud assessments, which includes the bank, the bank's clients and its employees.
- Ensuring and strengthening the physical security of financial institutions' operating branches and service centers in light of the pandemic situation.

Commercial banks updated their business continuity plans for the first quarter of 2020 in line with the above guidelines and recommendations. The NBG had ongoing communication with commercial banks as soon as the pandemic broke out, which was part of the business continuity management supervision process. On the positive side, commercial banks managed to develop procedures for the remote work of employees and transferred back-office employees to remote work in a short period of time. This switch to remote work involved a considerable transformation of existing business processes, including of banks' information systems. The capacity and workload of the banks' networks were also constantly monitored.

In late 2020, the NBG transitioned to a remote assessment of the operational and cyber risk management framework for commercial banks. As a result, the bank examination process was redesigned to take into account the ongoing effects of the pandemic.

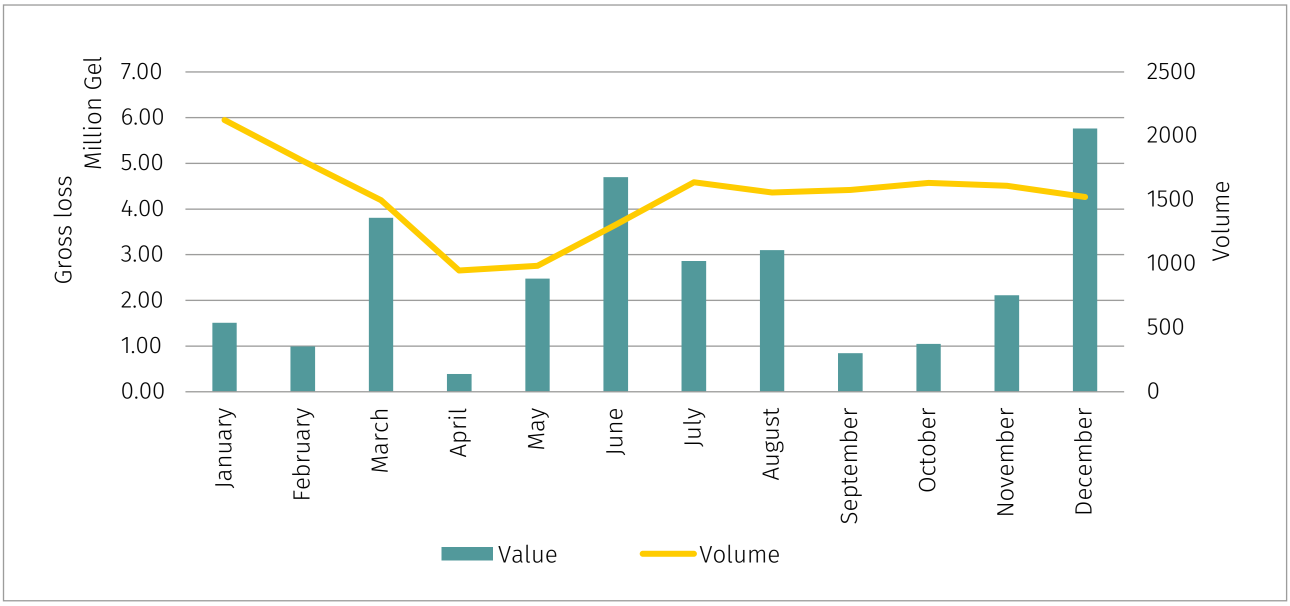
4.9.1 OPERATIONAL RISK IN THE GEORGIAN BANKING SECTOR

The banking system of Georgia is characterized by a relatively low complexity of banking products and financial services. Despite this, there is constant development and transformation in the sector: new banking products and services are being introduced at a fast pace and these are increasingly based on information systems. The pandemic has accelerated the development and introduction of remote banking products. The number of digital services also increased. These developments all increase the inherent operational risk to the financial sector to some extent.

In 2020, total gross losses of Georgian commercial banks amounted to GEL 29.6 million, which was a 32% increase over 2019. Gross losses relate to the initial amount of the operational event prior to any reimbursement of operating losses.

During 2020, 18,202 operational loss events were recorded, which was a 19% reduction over 2019. As part of the operational risk reporting of the National Bank of Georgia, commercial banks are obliged to record all operating losses that total or exceed GEL 10. The average loss for 2020 was GEL 1,626. Diagram N 4.41 shows the dynamics of total operating losses in 2020.

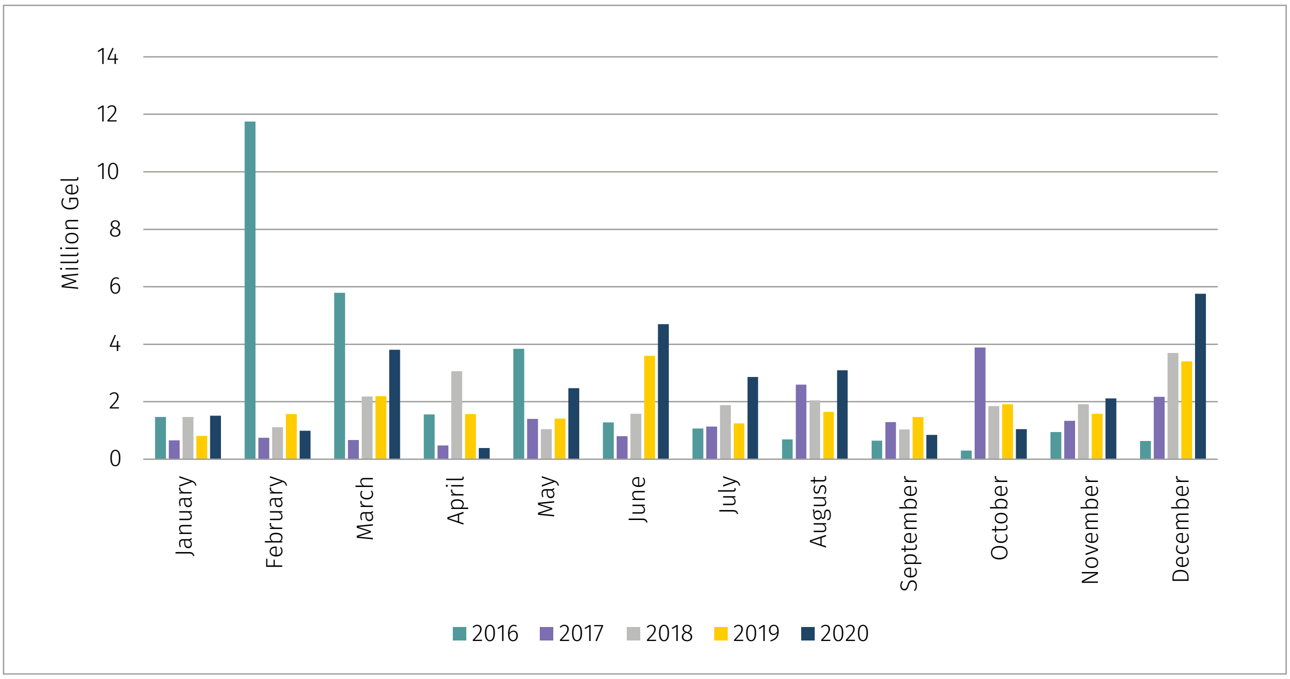
DIAGRAM N 4.41 TOTAL LOSSES FOR THE BANKING SECTOR IN 2020



Source: National Bank of Georgia

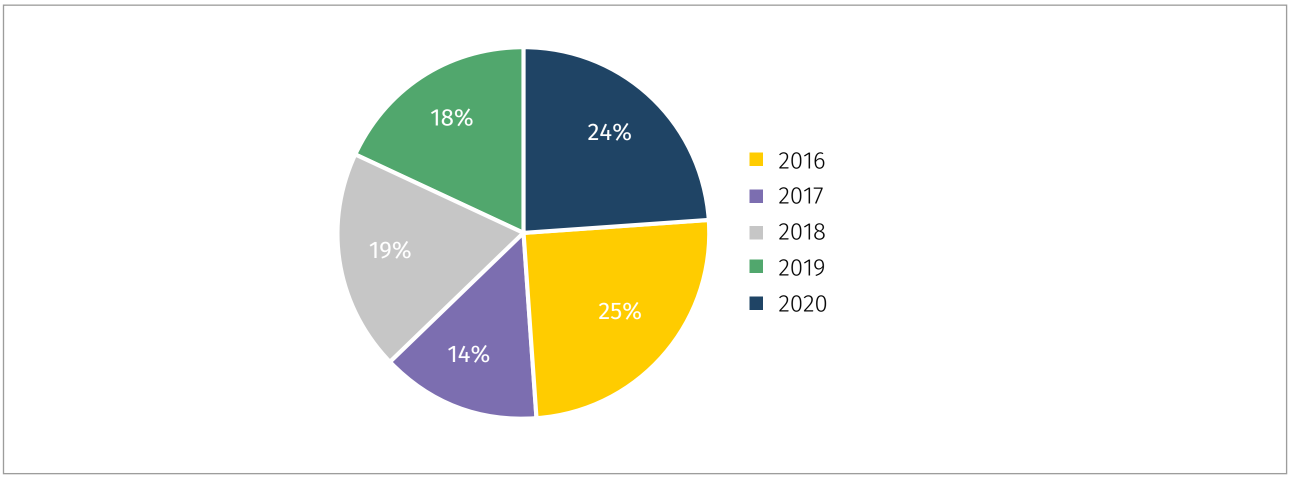
Diagram N 4.42 depicts the time series of total operational losses over the last five years (2016-2020). Similarly, Diagram N 4.43 presents the proportional distribution of the total amount of operational losses over the same period.

DIAGRAM N 4.42 TOTAL LOSSES FOR THE LAST FIVE YEARS (2016-2020)



Source: National Bank of Georgia

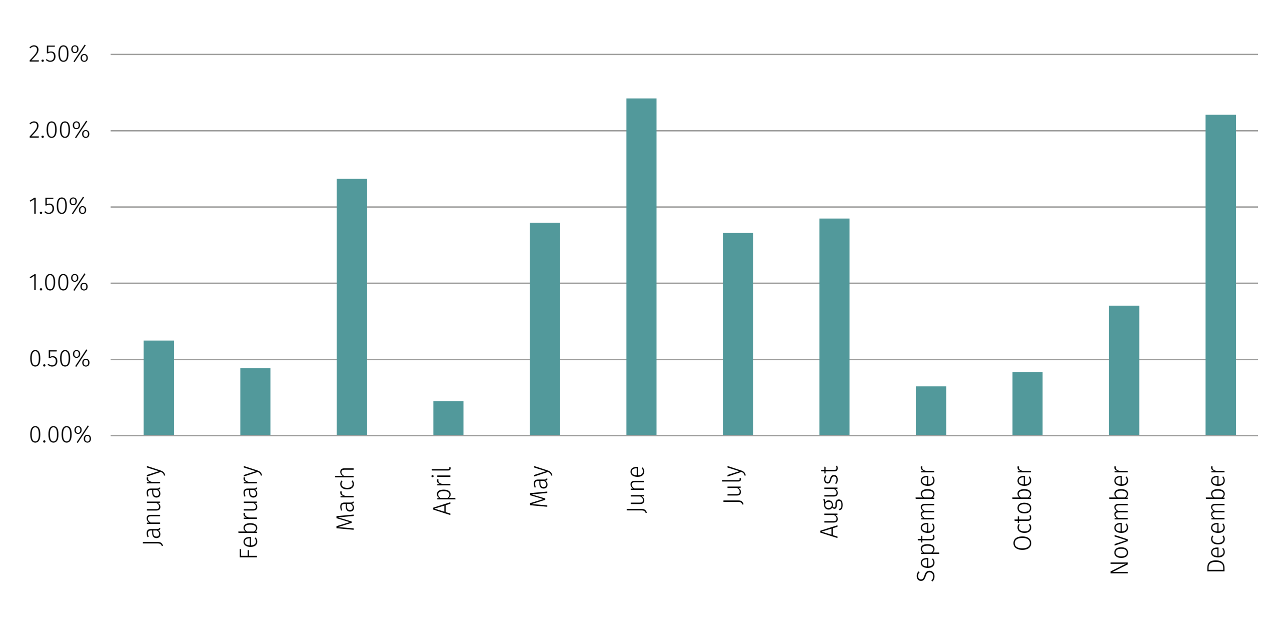
DIAGRAM N 4.43 PROPORTIONAL DISTRIBUTION OF TOTAL OPERATIONAL LOSSES FOR THE LAST FIVE YEARS (2016-2020)



Source: National Bank of Georgia

The operational loss indicator is one of the best measures to determine the operational risk of the financial system. This figure is calculated based on the ratio of the total operational losses of the financial system to total revenues. In 2020, the ratio of total annual losses to total revenues, as calculated under Basel 2 guidelines, was 1.1%. Diagram N 4.44 presents the monthly dynamics of the operational loss indicator of the Georgian banking sector for 2020.

DIAGRAM N 4.44 OPERATIONAL LOSS INDICATOR DYNAMICS FOR 2020 (TOTAL LOSS TO TOTAL REVENUE)

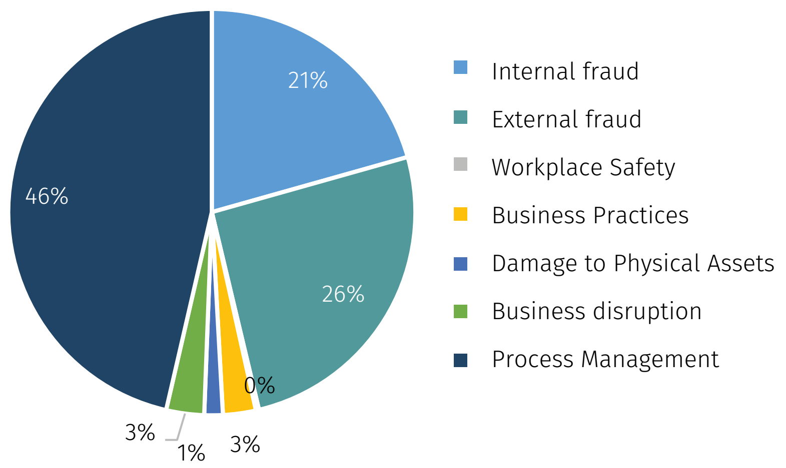


Source: National Bank of Georgia

In 2020, operational losses were mainly recorded in the business lines of retail banking and, to some extent, in commercial banking services. The retail banking business line, in addition to retail banking services, also includes operational losses related to payment cards. The fact that operational losses in the Georgian banking sector are mostly found in the retail and commercial banking business lines is due to the fact that these are the two most prevalent business lines in the banking sector. The other six business lines defined under the Basel principles are not well developed in Georgia.

Looking at operational losses according to the group of event categories, one can observe that execution, delivery and process management accounts for the largest share of total losses (46%), while external fraud was the second largest category (26%). Internal fraud was the third largest loss event type, accounting for 21% of total losses. The structure of operational losses for 2020 is shown in Diagram N 4.45.

DIAGRAM N 4.45 DISTRIBUTION OF TOTAL LOSSES FOR 2020 BY CATEGORY OF EVENTS



Source: National Bank of Georgia

4.10 CYBER SECURITY

Cybersecurity is of particular importance for the financial sector. This is especially evident in the context of the pandemic, a time when remote service channels are undergoing considerable development and growth in popularity, amid increasing geopolitical risk.

The National Bank of Georgia provides ongoing monitoring of current developments in the banking sector in terms of cyber security. Cyber-security supervision requirements for the banking sector were first introduced in 2019 and include, among other things, requirements for cyber incident response, information asset accounting, incident response, penetration testing, and information systems audits. In addition to complying with these requirements, commercial banks are required to introduce cyber security controls and conduct regular assessments. Penetration tests of banks are considered in the context of cyber security, and the National Bank of Georgia deems it highly important to conduct these in order to have effective business continuity and readiness plans in place in the event of a potentially large-scale cyber incident. In 2014, operational risk capital requirements were imposed on commercial banks.

Payment cards represent an additional avenue for fraud and cyber-risk on a global scale. The National Bank of Georgia works closely with commercial banks to emphasize the importance of adequate control mechanisms and the implementation of information systems that will help banks prevent fraud associated with payment cards. In this respect, it is important to implement types of preventive and proactive controls that will deter unauthorized transactions stemming from both local and foreign payment cards.

Hacking and hacking attempts offer unauthorized parties the potential ability to penetrate the electronic information systems of organizations and individuals and to execute financial transactions. Phishing attacks often precede such unauthorized transfers in which a hacker attempts to take over a client's computer (or other device) and access their electronic banking account and other related data. Georgia, like many other nations, experiences events associated with unauthorized transactions stemming from hacking attacks. It is vital for financial institutions to create a type of environment that will deter such events by using comprehensive and adequate controls. It is therefore necessary to raise the level of awareness of consumers to reduce the risk of successful phishing attempts, to take related actions, and to better inform users to protect themselves from similar events.

Cyber risks increased considerably during the COVID-19 pandemic as financial institutions switched to full-time remote work. Georgia, like the rest of the world, has seen a larger number of cyber attacks, especially phishing attacks, targeted at employees working remotely. Due to this, the National Bank of Georgia, together with commercial banks, has been working on the introduction of appropriate security measures and control mechanisms in banks, raising the awareness of employees, and improving the security of internal corporate networks, personal computers and other areas to deter cyber attacks on remote banking. The National Bank of Georgia monitored cyber risks in the banking sector on a daily basis during the pandemic. It was able to identify, analyze and respond to attacks in a timely manner, while making sure to immediately inform the entire banking sector of any such events.

4.11 MACROPRUDENTIAL 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 different sections of this report. The main challenge in this regard in 2020 was to assess the risks to financial sector stability posed by the COVID-19 pandemic and to develop and implement appropriate macroprudential and supervisory policies. The following actions were taken by the National Bank of Georgia in response to the COVID-19 pandemic:

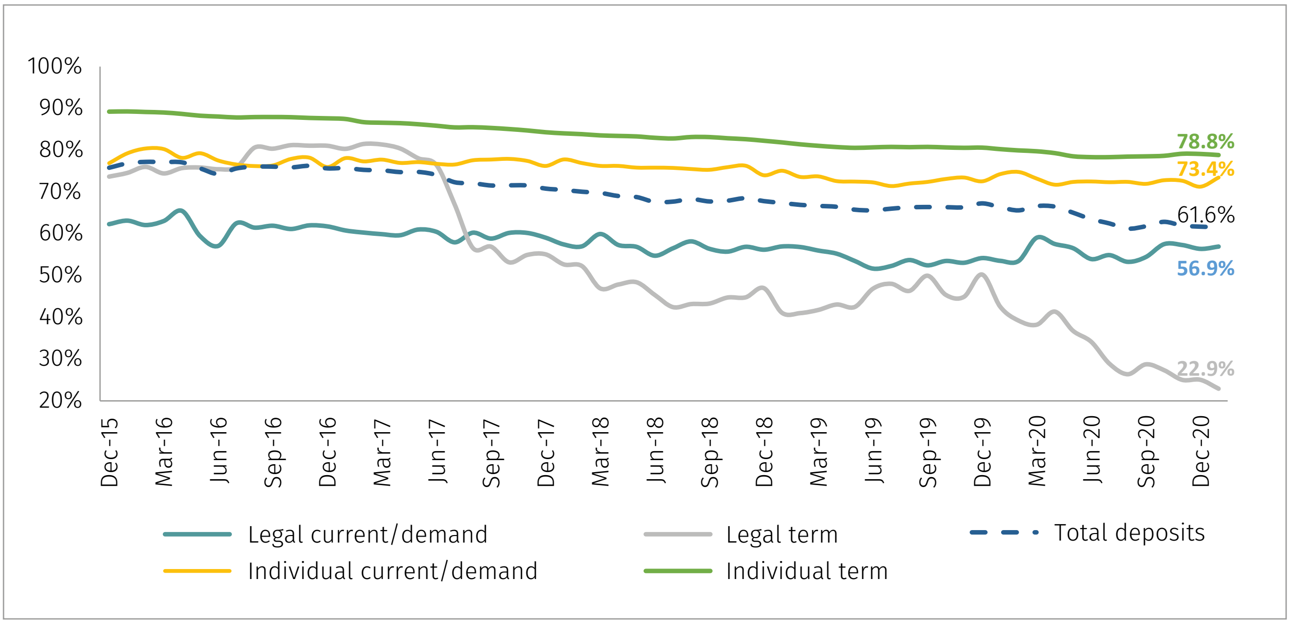
- After the shock of the pandemic, the imposition of a moratorium on loans was encouraged and the provisioning policy was temporarily altered.
- A moratorium was imposed on new supervisory reforms and sanctions.
- The planned March 2020 increase in scheduled Tier 1 capital requirements for loan portfolio concentration risk and the net GRAPE buffer was temporarily deferred.
- The conservation buffer (2.5% of risk-weighted assets) and part of the Pillar 2 buffer (two-thirds of the unhedged currency-induced credit risk buffer, 1.6% of risk-weighted assets) were cancelled.
- On-site inspections of supervised entities were suspended. Lending procedures were simplified so that, temporarily, it was no longer required to perform an on-site evaluation of real estate. The requirement related to updating financial statements was also eased.
- The enactment of the "Regulation on Concentration of Exposures and Large Exposures", which had been scheduled for June 2020, was deferred for a year.
- Restrictions were imposed on payments of dividends, repurchases of shares, investments and other forms of capital reduction.

Macroprudential supervision continues in the following key areas: the increased debt burden for non-hedged borrowers due to foreign currency loans; the over indebtedness of vulnerable portions of the population; strong competition in business and mortgage lending amid imperfect pricing models; system-wide cyber risks and fraud; the potential growth of non-regulated financial intermediation based on financial technologies; and regional geopolitical threats.

The National Bank of Georgia uses capital adequacy requirements among other instruments to safeguard the stability and sustainability of the financial sector. The net stress test buffer, which sets the capital requirements required for a stressful period, is one of the most important elements of this approach. The supervisory stress test methodology was upgraded in 2020, with the publication of the Stress Test Methodology Manual and updated results based on 2019 data (see Box 8).

Despite significant reductions in recent years, the dollarization of deposits remains a challenge. Varying in terms of the types of customers and deposits, dollarization is higher in retail deposits and relatively low on the accounts of legal entities – something that stems from the need for lari in the operations of companies. The 79% dollarization of term deposits of individuals requires attention. As the largest item of the total portfolio, it considerably affects the dollarization of total deposits and thus serves as a good means to measure the expectations of individuals regarding the exchange rate.

DIAGRAM N 4.46 DEPOSIT DOLLARIZATION (FIXED EXCHANGE RATE)

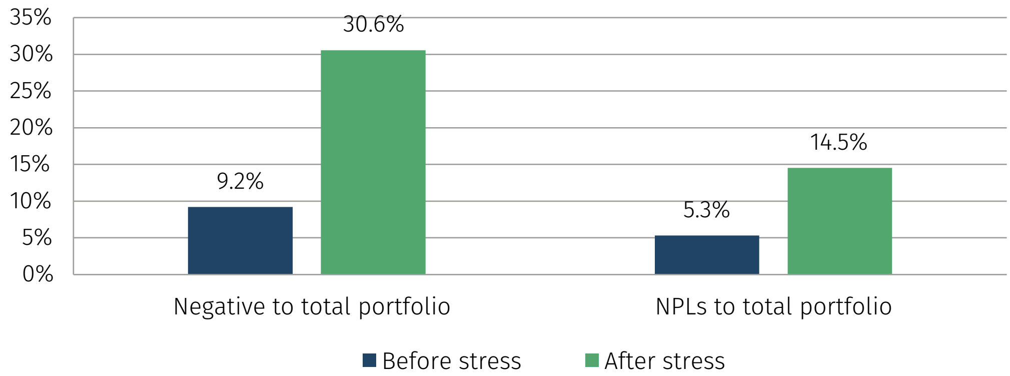


Source: National Bank of Georgia

BOX 8 STRESS TEST RESULTS

According to the "bottom up" supervisory stress test (a test run that was based on 2019 data and evaluated and analyzed in 2020), loan portfolio stress showed potential system losses of GEL 2.3 billion, with the share of negative loans in the total portfolio growing from 9.2% to 30.6% and that of non-performing loans from 5.3% to 14.5%.

DIAGRAM N 4.47 SHARE OF NEGATIVE AND NON-PERFORMING LOANS IN THE TOTAL PORTFOLIO



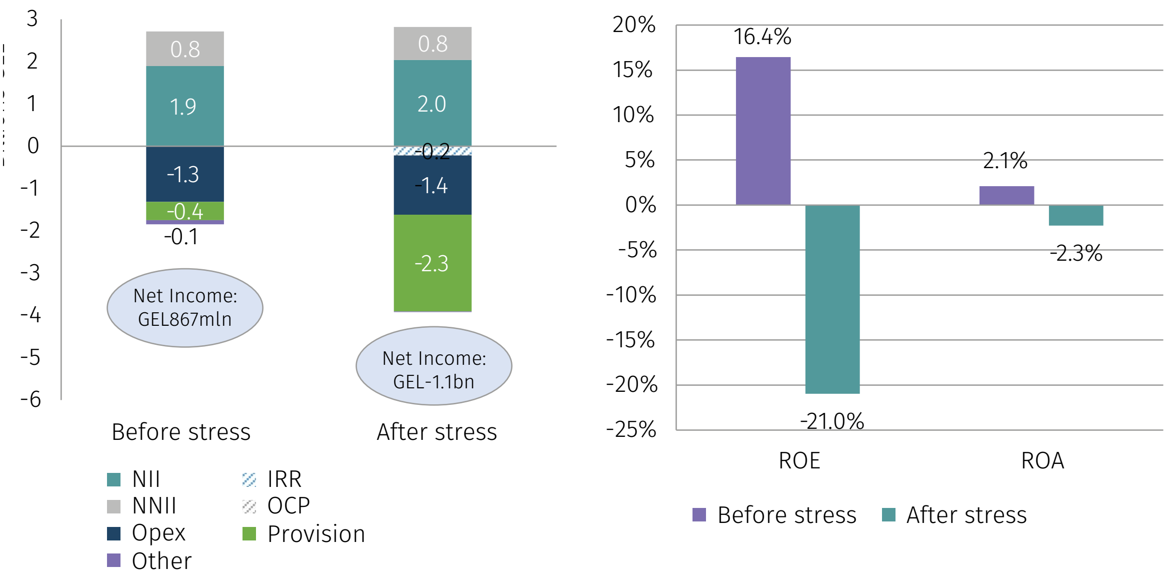
Source: National Bank of Georgia

Different types of effects originating from the scenario's assumptions are reflected in profits and losses:

- Based on the assumption of exchange rate depreciation, the currency positions of commercial banks are revalued. As of the stress test date, the banking system was operating at a short position, which, with a 20% depreciation of the exchange rate, would result in losses of GEL 5.6 million.
- Assuming a 1% decline in interest margins has a significant effect. The profit/loss calculation was made over a one-year horizon from the revaluation of the interest rate gap resulting from the increase in interest rates. Increased interest income and expenses are charged to both floating and fixed rate assets and liabilities that are replaced by the same type of assets and liabilities after maturity. Consideration is given to the effect of hedging on the part of the interest rate gap to which the stress relates. As a result, the losses of the banking sector totals GEL 213 million.
- Non-interest income and expenses change according to the assumption of a 5% reduction in the scenario; in addition, the stress caused by declining real estate prices is reflected in the decreased value of bank-owned real estate and repossessed property.

Summing up all the losses, the profitability of the banking system in the post-stress scenario deteriorates significantly. The system's post-stress losses reach GEL 1.1 billion, while the pre-stress profit of the system was GEL 867 million. System efficiency also deteriorates after the stress: the net interest margin decreases from 4.6% to 3.7%, and the cost-to-income ratio increases from 48.4% to 54%.

DIAGRAM N 4.48 DECOMPOSITION OF PROFIT AND PROFITABILITY INDICATORS*



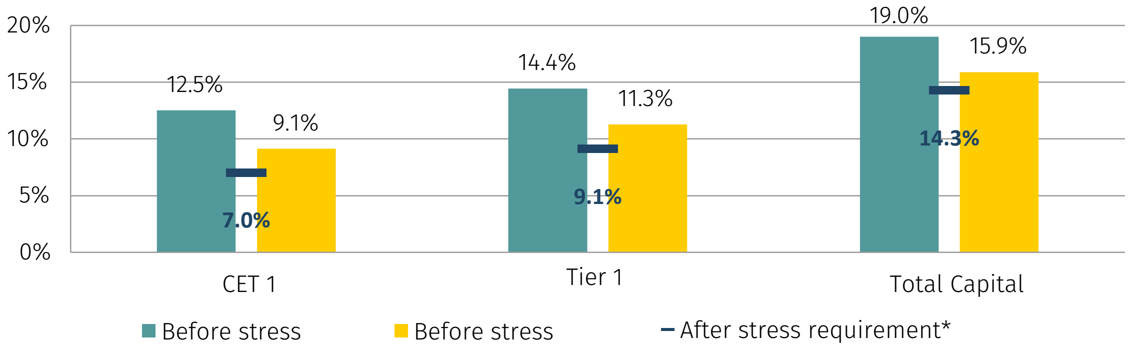
** NII – net interest income; IRR – interest rate risk; NNII – non-interest income; OCP – open currency position; Opex – non-interest expenses; ROE – net earnings to average annual share capital; ROA – net earnings to average annual assets*
Source: National Bank of Georgia

The purpose of the stress-test assessment of a bank's capital is to show whether the banking sector is fully prepared to face severe, yet plausible, stress without violating the existing capital adequacy requirements. The main purpose of the capital conservation and countercyclical buffers is ensure a sufficient amount of capital in the banking system to help banks absorb systemic losses caused by stress.

Consequently, the portion of capital that a bank needs to deal with stress is already provided by the capital countercyclical and conservation buffers. To avoid a double capital requirement, when calculating the net stress test buffer the amount of capital already required through the capital conservation and countercyclical buffers is subtracted from the capital needed under stress conditions. The net stress test buffer calculated as a result of the supervisory stress tests performed within the banking system was determined as 0.8% of total risk-weighted assets, which is a system-average figure. As a result of the stress applied in the test, nine banks have a total deficit of GEL 408 million in terms of capital requirements, while six banks continue to operate with a total of GEL 82 million in excess capital. At the date of the stress test, the system as a whole and individual banks operate with large capital buffers and the available buffers and the potentially releasable conservation buffer are sufficient to cover the stress losses (i.e., banks will not have to raise additional capital).[62]

62. These calculations are based on CET1 capital data.

DIAGRAM N 4.49 CAPITAL RATIOS



** Conservation buffer is subtracted.*

The values of net stress test buffers were calculated individually for banks and range from 0% to 6% of total risk-weighted assets, indicating significant differences between the banks and demonstrating the degree of their vulnerability to economic shocks.

TABLE N 4.10 LOAN PORTFOLIO STRESS RESULTS

Million lari	Total	Corporate and SME (assessed individually)	Corporate and SME (assessed selectively)	Retail	Micro
Portfolio	31,469	11,884	4,966	10,845	3,774
Reserves before stress	1,433	550	208	488	188
Additional reserves as a result of stress test	1,809	685	311	727	87
Reserves after stress	3,242	1,235	519	1,215	275
Reserves before stress in percent	4.6%	4.6%	4.2%	4.5%	5.0%
Additional reserves as a result of stress test in percent	5.7%	5.8%	6.3%	6.7%	2.3%
Reserves after stress in percent	10.3%	10.4%	10.4%	11.2%	7.3%

4.12 DEVELOPMENT OF FINANCIAL AND SUPERVISORY TECHNOLOGIES

4.12.1 SUPPORTING FINANCIAL INNOVATIONS

The National Bank of Georgia constantly strives to develop the financial market. The speed of innovation in the financial sector is increasing, which brings new opportunities as well as new risks. The financial sector remains the most regulated economic sector in the world, and its regulation continues to grow. As a result, the modern supervisory framework is quite technical and complex, especially for new financial startups. It is therefore an important challenge for financial sector regulators to encourage innovators with fintech ideas whilst at the same time supporting the transformation of these ideas into sustainable financial models. In response, the NBG is paving the way for the availability of basic fintech infrastructure by developing various supervisory approaches.

Financial Innovations Office[63]

Established in December 2019, the Financial Innovations Office is an effective platform for the NBG to communicate with financial innovators. The mission of the innovations office is to facilitate responsible innovation in the financial sector and to assist fintech organizations/startups in learning about the National Bank of Georgia's regulatory approach.

During 2020, the innovations office hosted a number of important meetings with innovative individuals. In December, the office initiated and organized a panel discussion on Open Banking. Throughout the year the office has also been working in close contact with USAID, the German Economic Group (GET), BaFin, GFin and other organizations to share innovations and supervisory approaches in the financial sector.

Regulatory Laboratory

As part of its technology support function, the National Bank of Georgia approved the Regulation on the Establishment of the Framework of the Regulatory Laboratory on 25 May 2020. The laboratory allows for real-time testing of innovative products or services.

Work on the regulatory laboratory at the National Bank began in 2019. In the same year, the National Bank became a member of the Global Financial Innovation Network (GFIN), which is a leading platform for supervisory collaboration, offering a new and effective opportunity to Georgian financial institutions and fintech companies to showcase their technology internationally.

A working group consisting of employees from six NBG departments participated in a discussion of projects submitted to the Regulatory Laboratory during 2020. A total of 42 projects from 26 organizations were submitted for consideration with the goal of identifying online remote service providers. The high interest of organizations in remote services and, consequently, the large number of applications was partly due to the global pandemic; however, the financial market had welcomed the development of online services in previous periods, owing to technological developments and customer demand.

63. See the Stability section of the NBG website for more information about the Financial Innovations Office https://www.nbg.gov.ge/index.php?m=742

Of the online identification projects submitted to the Regulatory Laboratory in 2020, 15 projects from 15 organizations were approved for transition to the “Real Environmental Testing” phase. A further 14 projects are still under consideration.

Credit Registry

Established in consultation with the World Bank’s Working Group, the Credit Registry is a database containing information on the loan portfolios of lending entities. These entities provide data to the National Bank on a monthly basis, including the following data sets:

- Client identification data
- Last updated financial client data
- Loan commitment details
- Loan commitment data
- Information on refinanced loans
- Information on investments
- Information on rejected loan applications
- Information on loan files closed during the reporting month

The Credit Registry facilitates the effective discharge of the National Bank's supervisory functions while also helping lending entities to submit their mandatory reports in a simple manner.

At the initial stage, only commercial banks are obliged to submit data under the Credit Registry. Data collection started in December 2020 and improvements in the quality of the data are planned for early 2021. This will enable the data to be used for supervisory measures in the shortest time practicable, while allowing the NBG to accomplish the rights and responsibilities defined by its mandate.

4.12.2 MODEL RISK

The use of various statistical models for business decision making in the financial sector has become widespread. Such models are widely used for lending, financial accounting, and risk management. There has been an especially large growth in the use of mathematical-statistical models in the arena of retail credit products. Recently, models based on machine learning and artificial intelligence algorithms have started to be used more frequently.

Although these developments can increase the efficiency of models, they can also complicate analysis and risk assessment processes. In response to this challenge, the National Bank of Georgia developed a draft of a regulation on the risk management of data-driven models. The purpose of the regulation is to promote the establishment of a model risk management framework and to ensure effective risk management of the models. This regulation defines the basic principles of model building, validation and application.[64] The principles and standards related to model risk management are based on current best practices, challenges, and the experiences of financial supervisors in advanced economies. This framework will help the wider and more efficient use of models in the financial sector.

Currently, all new models of financial institutions should be created in accordance with this regulation, while existing models must be brought into compliance with the regulation before September 2021.

64. Additional information is available at https://nbg.gov.ge/en/page/financial-and-supervisory-technologies

Models for accounting expected losses on loans in financial institutions, as required under IFRS 9, are being introduced in the National Bank. Based on their complexity and their potential impact on the financial stance of the bank, these models carry high risk. The National Bank is using its resources to develop a coordination model that will be used for the analysis of such models. The results generated by the coordination model will be used as a means of evaluating the models of financial institutions.

BOX 9 FINTECH COMPETITIONS

Promoting the education and interest of talented young people in financial sector research is one of the priorities of the National Bank of Georgia. With this objective in mind, a master's thesis competition was successfully held on the initiative of the National Bank to encourage research into financial technologies. The competition was open to graduate students whose master's theses were related to financial technology. The prize for the winning researchers was a 3-month paid internship at the National Bank, along with the opportunity to have consultations with NBG experts while working on their master's theses.

The competition proved an effective way to promote the interests of young people in financial technologies.

Similar competitions are planned for next year and will not be limited to graduate students. A TechSprint and a supervisory hackathon are also planned. Short, task-oriented competitions are an acceptable challenge for young people interested in technology. It is expected that these activities will prove popular and will increase recognition of the National Bank in the field of financial technologies.

4.12.3 CREDIT INFORMATION BUREAU

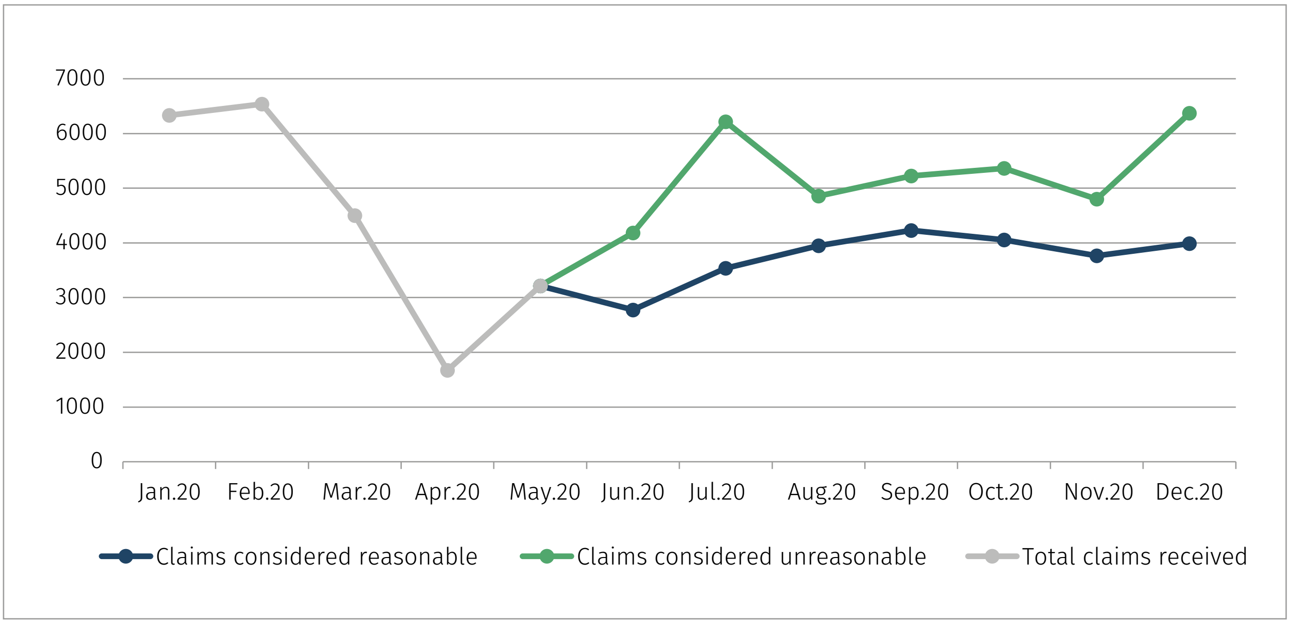
Based on the 2018 amendments to the Organic Law of Georgia on the National Bank of Georgia, the NBG was given the function of regulating and supervising the activities of the Credit Information Bureau.

In early 2020, amendments were made to the "Regulation on Providing Information to the Credit Information Bureau on the Territory of Georgia, Registration and Access to Information in the Database of the Credit Information Bureau". These amendments were intended to introduce voluntary consent for the verification of marketing offerings and specifying e-consent requirements.

As of December 2020, 245 lending entities and 13 organizations are enrolled on a non-mandatory basis for cooperation with the Credit Information Bureau. This is a slight reduction from the previous year, when 252 lending entities and 24 organizations were enrolled. The process of registration and liquidation of lending entities affects the number of organizations using the bureau.

Great attention is paid to the accuracy of the data registered in the Credit Information Bureau and the observance of processing rules. Claims made by users are thoroughly studied and responded to accordingly. Diagram N 4.50 shows the number of monthly customer claims in 2020.

DIAGRAM N 4.50 CUSTOMER CLAIMS (2020)



Source: National Bank of Georgia

TABLE N 4.11 RESULTS OF NBG INSPECTIONS AS PART OF ITS SUPERVISORY MANDATE (2020)

Organization type	Inspection	Written instruction	Amount of penalty (GEL)
Commercial bank	18	12	19,000
Microfinance institution	13	7	17,000
Lending entity	8	3	3,000
Other	7	6	17,000
Total	**46**	**28**	**56,000**

Importantly, the Credit Information Bureau paid significant attention to raising the awareness of consumers during the year. A public presentation was held on the topic of "Consent of a data subject on verifying their data with the credit bureau". In addition, commercial banks operating in Georgia presented their customers with an offer to register with the Credit Information Bureau.

4.12.4 OPEN BANKING

Initiated by the National Bank in 2019, the implementation of open banking continued throughout 2020. Open banking involves the immediate exchange of information between different financial institutions using electronic technologies, at a customer's desire and with their consent. Open banking technology is already used in countries such as the United Kingdom, Australia and EU member states. The sharing of user data through such channels is mandatory for EU member states under the updated PSD2 regulation of payment services.

An Open Banking Committee was established with the Georgian Bankers' Association at the beginning of 2020, with the task of developing necessary standards for the introduction of open banking in Georgia and to promote the further development of the project.

The Open Banking Committee developed the first version of the Open Banking Framework in September 2020 with the involvement of the Georgian Bankers' Association, commercial banks and the National Bank of Georgia. The framework document sets out the rules and standards that commercial banks must follow and use to share customer data with each other. The first step is to exchange data such as bank account balances and transaction information. The data must be exchanged using open application interfaces (APIs) online and, obviously, be subject to the user's willingness and consent.

The deadline for commercial banks to meet the requirements of the first stage of the introduction of open banking is 31 March 2021. Once the first phase is successfully completed, a gradual expansion of the use of open banking will follow. The plan includes both an increase in the amount of data to be shared and the possibility of initiating banking transactions. Involving licensed fintech companies, other representatives of the financial sector, and commercial banks is considered in the next stages of open banking. This, in turn, should help increase consumers' access to banking services and offer greater diversity in such services.

4.13 DATA PROCESSING AND SUPERVISORY TECHNOLOGIES

The National Bank of Georgia decided to implement an international standard for data exchange (the Extensible Business Reporting Language (XBRL)) to improve data quality (see the 2017 Annual Report of the NBG). During 2020, the National Bank of Georgia continued to work on transferring full reporting for the supervision of commercial banks to IFRS. In support of this project, in the first phase the NBG started receiving financial statements on the XBRL standard accepted in the European Union (FINREP).

The Central Bank of the Netherlands and the National Bank of Poland are cooperating productively with the National Bank to successfully implement the project within the framework of an EU Twinning Mission. With their help and recommendations, the National Bank has developed the functional requirements and parameters of the project.

In 2020, the National Bank of Georgia held an international tender for the introduction of the XBRL Standard Reporting Portal. CoreFilling, the tender winner, is headquartered in Oxford in the UK, and is one of the flagship companies licensed by XBRL International. The products generated by the company are recommended by BaFin, the Bank of England and Banco De Espana and the organization is world-renowned for creating XBRL taxonomies. Through the portal, banks will be able to submit the required supervisory reports and receive their validation results in real time. The information collected in a database will be available for the analytics required for banking supervision.

From March 2021 onward, commercial banks will submit regulatory financial statements (FINREP) based on the XBRL standard format to the National Bank.

The NBG plans the further advancement of supervisory analytical information software for the continued development of supervisory technologies. These tools will help banking sector supervisors better processes the information needed for the functions defined by their mandate. These changes are expected to increase the accuracy of supervisory information, simplify the reporting process, and facilitate effective supervisory analytics.

4.14 RESOLUTION AND LIQUIDATION

Recovery and Resolution Framework

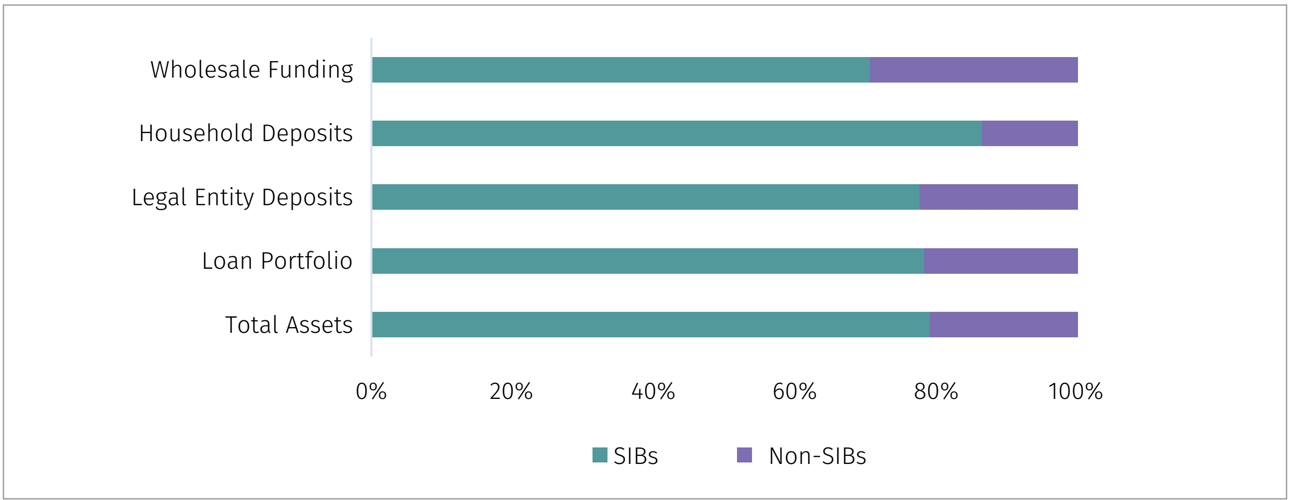
In 2020, the National Bank of Georgia completed work on the formation of the Recovery and Resolution Framework. From next year, the reform of the recovery and resolution mechanism in the banking sector will move into the implementation phase. This will strengthen the financial stability of the banking sector and enhance the risk management culture in commercial banks. The Resolution Framework was developed on the bases of the Financial Sector Assessment Program (FSAP), the recommendations of the International Monetary Fund and the World Bank's "Key Attributes of Effective Resolution Regimes for Financial Institutions", and the European Parliament and the Council of the European Union's Bank Recovery Directive 2014/59/EU of 15 May 2014. As a result of this reform, the National Bank acquired resolution powers towards commercial banks, and the Liquidation Structural Unit was established to be responsible for the further development and administration of this new function.

The resolution framework not only regulates the management of actions necessary to achieve the objectives of a resolution, if necessary, but also includes the important component of preliminary crisis preparation in the form of recovery and resolution plans. A recovery plan is a combination of remedial measures caused by financial losses in stress scenarios (the modeling of hypothetical events) relevant to a bank's business model; it aims to ensure the continuity of the bank's critical functions while retaining financial sustainability. The key attributes of recovery plans, as well as requirements related to development processes and actions, are regulated by the relevant legal acts of the National Bank. Commercial banks' development of recovery plans starts with the self-assessment of critical economic functions, which involves identifying key functions and support services. Should these be suspended, banks look at the possibility substitutions from other market players, considering the impact of this on counterparties and the real economy. As a result, virtually every commercial bank in Georgia should have an effective crisis recovery plan that integrates financial crisis vulnerability indicators and early warning measures into a comprehensive crisis preparedness system. Recovery plans should be updated on an annual basis and in response to significant structural changes. When it is necessary and possible to use the recovery mechanism, the National Bank monitors processes and, if necessary, uses the power of early intervention by appointing a temporary administration.

The resolution mechanism, which is a constituent part of the resolution framework, offers an alternative to the liquidation of a commercial bank in such cases where there are grounds for liquidation. However, to avoid the potential significant negative adverse effect that liquidation would have on the stability of the financial sector, it is advisable to attempt to recover the financial institution and maintain its functionality. Resolution provides an opportunity to maintain a commercial bank's critical functions and to prevent financial difficulties from reaching other participants in the industry. One of the principles of the resolution is that shareholders and creditors should not bear losses greater than they would have suffered in the event of liquidation. This means that exercising resolution powers provides for the equal protection of creditors. The guaranteed protection of insured deposits and minimization of creditor losses during the resolution regime will have a positive impact on the country's business and investment environment. The task of the National Bank in administering the resolution framework is thus to maintain the stability and critical functions of the financial system and to limit the use of taxpayer funds during recapitalization or restructuring.

The high concentration of systematically important domestic banks in the banking market is evident, with the dominance of certain banks encompassing assets, wholesale funding, and loan and deposit portfolios. The stability of these banks and the continuity of their critical financial services is thus particularly important for the functioning of the real sector, the overall sustainability of the financial sector, and the minimization of fiscal risks. To achieve stability, the National Bank will focus on drafting initial resolution plans for systematically important domestic banks next year, this will focus on the assessment of resolvability and outlining preferred resolution strategies. As seen from international practice, better opportunities for effective resolution are still on the agenda, and work will continue in this direction in the future.

DIAGRAM N 4.51 CONCENTRATION OF SYSTEMATICALLY IMPORTANT DOMESTIC BANKS IN THE BANKING MARKET (31 DECEMBER 2020)



Source: National Bank of Georgia

Prior to the initiation of the resolution regime, the National Bank assesses the prospect of resolving the resolution within a reasonable time, through either a private solution or by applying supervisory measures, and only then considers the need to enact a resolution. The resolution authority of the National Bank implies either individual or combined use of the following resolution tools without the consent of, or prior notice being given to, the shareholders or creditors:

- Merger of a commercial bank.
- Sale of shares, assets and/or liabilities of a commercial bank.
- Transfer of shares, assets and/or liabilities of a commercial bank to a bridge bank.
- Recapitalization of a commercial bank by issuing new shares.
- Recapitalization of a commercial bank by writing off or converting its liabilities (bail-in).

Committees

In line with the reform, a Resolution Committee was set up at the National Bank to review and approve resolution-related issues. The Governor and Vice-Governors of the National Bank and the heads of relevant structural units are involved in the committee's work. The Resolution Committee approves the resolution plans developed by the National Bank's Resolution Unit and makes decisions on the initiation of a resolution regime at a commercial bank, including the use of a special manager and tools. The Resolution Committee is accountable to the Board of the National Bank.

In addition, in order to promote the stable functioning of the financial system, within the framework of the powers vested by the legislation of Georgia and in observance of the principle of independence, a new platform of cooperation – the Interagency Committee for Financial Stability – was established to ensure regular exchange of information, elaborate financial crisis management mechanisms and maintain effective coordination. The committee is composed of the Minister of Finance, the Governor of the National Bank, the Head of the Deposit Insurance Agency, and the Head of the State Insurance Supervision Office. The committee is chaired by the Minister of Finance of Georgia, and the functions of the Secretariat are performed by the National

Bank. According to its charter, the interagency committee will meet at least once a year or at the request of the National Bank.

Liquidation of financial institutions

There are 15 commercial banks operating in Georgia. No liquidation processes were started in 2020, with the last liquidation in the banking sector being completed in 2019.

During and after the completion of a liquidation, the National Bank keeps and administers unclaimed funds from creditors in a special account (according to Decree N46/04 of the Governor of the National Bank of Georgia of 16 March 2018) and ensures their return to their owners as they are detected (according to Decree N45/04 of the Governor of the National Bank of 3 April 2012). This process continued in 2020: more than 30 requests for the transfer of funds from the unclaimed funds account were granted upon the submission of relevant documents from their owners.

In addition, the National Bank disposes of assets discovered after the liquidation of a commercial bank (there were such occurrences after the completion of the liquidation process in previous years), the proceeds of which are normally distributed among the remaining creditors of the liquidated bank in an appropriate order.[65]

In 2020, the National Bank disposed of three newly discovered assets of commercial banks in liquidation, in one case the partially recovered funds were distributed to creditors, while the other assets will be processed in 2021.

In discharging its liquidation functions, the National Bank is guided by the following laws and decrees:

1. The Organic Law of Georgia on the National Bank of Georgia[66]
2. The Law of Georgia on the Activities of Commercial Banks[67]
3. Decree N46/04 of the Governor of the National Bank of Georgia of 16 March 2018 on the Approval of the Commercial Bank Liquidation Procedure[68]

The National Bank issues available data on the basis of a request for public information in accordance with Chapter 3 (Freedom of Information) of the General Administrative Code of Georgia. It is also authorized to provide other types of information to law enforcement agencies (on the bases of their resolutions) within the scope of its competence. In 2021, it is planned to separate the management of the liquidation regime for microfinance institutions from the supervisory function and to integrate that into the newly created Resolution and Liquidation Unit.

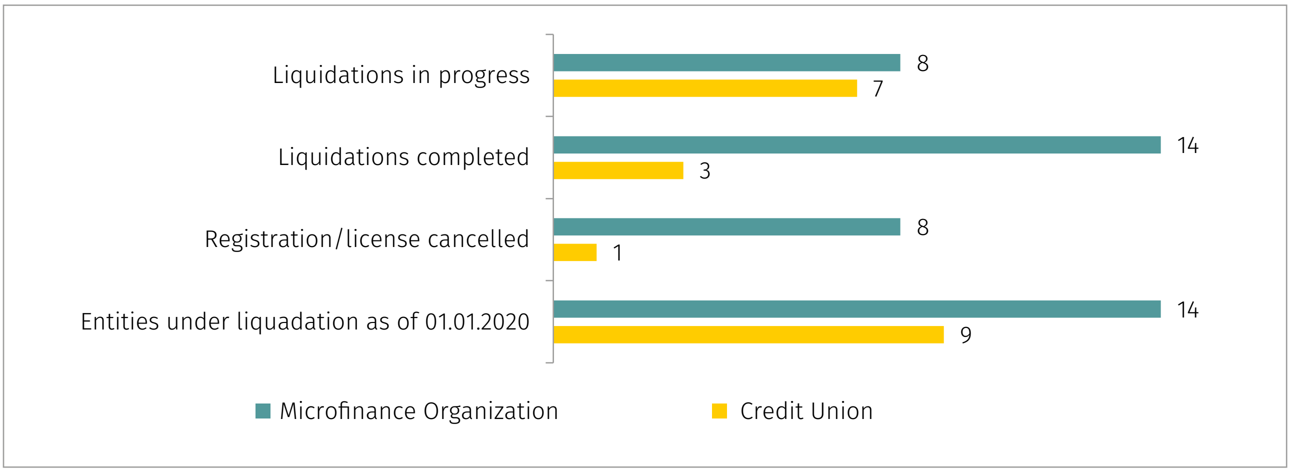
65. An asset, which previously, before the issuance of an individual administrative legal act on the completion of the liquidation process of a commercial bank, was an asset of that commercial bank, is automatically deemed an asset of a liquidated commercial bank and the National Bank acquires the right to dispose of it. See Article 3.712, para.15, the Law of Georgia on the Activities of Commercial Banks.

66. See Organic Law of Georgia on the National Bank of Georgia

67. See Law of Georgia on Commercial Bank Activities

68. See “Rule on Liquidation and Insolvency and/or Bankruptcy of Commercial Bank” Order N46/04 of the President of the National Bank of Georgia
- (available in Georgian)

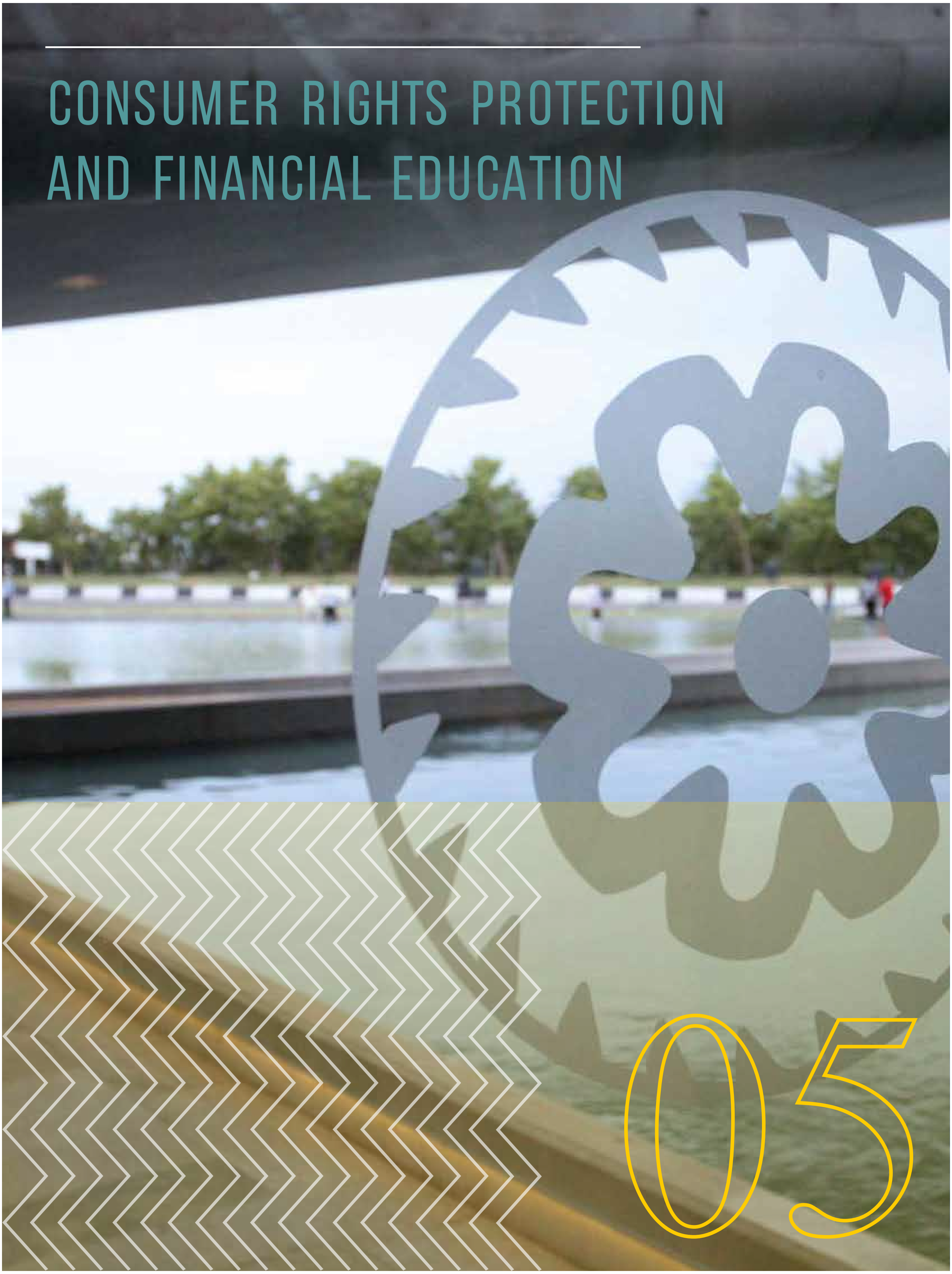
DIAGRAM N 4.52 MANAGEMENT OF THE LIQUIDITY REGIMES OF MICROFINANCE INSTITUTIONS (31 DECEMBER 2020)



Source: National Bank of Georgia

The National Bank initiated a package of legislative changes in 2020 for submission to Parliament for approval. The proposed legislative changes encompass the following laws: the Organic Law of Georgia on the National Bank of Georgia, Insolvency Proceedings, Microfinance Institutions, the Tax Code of Georgia, and the Law of Georgia on State Duty. The purpose of the legislative changes is for the National Bank to have a greater legal authority in terms of the liquidation, insolvency/bankruptcy of microfinance institutions, as well as their temporary administration. These amendments give the National Bank sole power to declare a microfinance institution insolvent and/or bankrupt. This, in turn, will make sure the claims of the creditors of the microfinance institutions are satisfied in a timely and effective manner. The National Bank will appoint a temporary administrator and liquidator for microfinance institutions and they will be accountable to the National Bank. The supervisory framework of the National Bank for the regulation and supervision of microfinance institutions will be strengthened as these legislative amendments are approved. This is also expected to fill a previously discovered legislative gap that concerned the lack of legal norms covering the insolvency/bankruptcy of microfinance institutions, which had been hindering the progress of such cases.

CONSUMER RIGHTS PROTECTION AND FINANCIAL EDUCATION



05

5.1 CONSUMER RIGHTS PROTECTION

Protecting the rights of consumers in the financial sector is an important task for the National Bank of Georgia. Similar to previous years, 2020 saw a number of important steps taken in this regard.

IMPROVEMENT OF THE LEGISLATIVE FRAMEWORK

The Rule on Consumer Protection for Financial Organizations

The National Bank of Georgia started working on amendments to the "The Rule on Consumer Protection for Financial Organizations", which initially came into force on 1 June 2017. The amendments are based on the obligation to reflect the requirements of legal acts under the EU Association Agreement, and to respond to both the existing situation in the financial sector and to new challenges stemming from the study and analysis of customer feedback.

The project increases the time frame for the prior notification of customers by financial institutions in the event that the institution implements significant unilateral changes in the terms of loan and deposit agreements, or other financial products, which would lead to a price increase. It also applies to instances where a unilateral change in the terms of a general contract occurs and additional loan within the mentioned agreement is disbursed, and the guarantor/joint guarantors and the owner of the collateral are notified about said changes. In order to promote competition and ensure that the consumer makes a choice, in case a financial institution requires a loan related insurance, abovementioned changes require that the customer be informed of the insurance criteria in advance and, in some cases, require that they be offered several alternatives.

These changes are expected to achieve greater public confidence in the financial sector, increasing the transparency of information about financial products on the market, and improving consumer protection practices. Industry players were involved in all stages of the work on this subject.

In order to improve the protection of consumer interests and rights, work continued on a draft Code of Ethics for loan recoveries by financial institutions. This is scheduled for approval in 2021.

Competition Working Group

In 2020, amendments were made to the Law of Georgia on Competition and to the Organic Law of Georgia on the National Bank of Georgia. The amendments referred to the authority of the National Bank of Georgia to regulate and monitor competition issues in the financial sector. As a follow up, a group working on competition issues was set up in the National Bank of Georgia. It studies international best practice and develops related legislative acts. As the presence of a competitive environment in the market is one of the most important factors in terms of consumer protection, the NBG Consumer Protection Unit is dynamically engaged in this working group.

Credit Information Bureau

In both 2019 and 2020, consumers continued to provide feedback regarding the Credit Information Bureau. This helped the identification and elimination of shortcomings with the bureau's activities and shows that the mechanism for recording and responding to consumer complaints is an effective tool for improving consumer protection practices in the activities of entities supervised the National Bank. In 2020, the National Bank made certain changes to Decree № 1955/04 of the Governor of the National Bank of Georgia of 27 August 2018 on "Providing Information to the Credit Information Bureau on the Territory of Georgia, Registration and Accessibility of Information in the Credit Information Bureau Database". The amendments referred to, among other things, updating the confirmation form for the verification of consumer information at the Credit Information Bureau.

Actions taken during the pandemic

The pandemic posed a number of challenges to the financial sector in 2020, and tackling them effectively required a rapid response. In response to these challenges, banks and microfinance institutions have been flexible in offering deferrals to their customers. The National Bank of Georgia vigorously monitored the loan deferral process. The Consumer Protection Division reviewed consumer complaints and, within its competence, mediated with financial institutions to facilitate agreement between consumers and the financial institutions.

Remote and on-site review of consumer rights protection standards in the financial sector

Due to the pandemic, no on-site consumer rights protection inspections were conducted in 2020 as part of the mitigation of supervisory requirements; however, in order to monitor the protection of the rights of financial service users, the National Bank continued to remotely inspect the entities under its supervision, which included the study of consumer feedback. The National Bank took a number of supervisory actions in response to various violations of legal requirements, and written instructions were sent to nine commercial banks, three microfinance institutions and three lending entities.

Consultations on changes in consumer protection legislation

In 2020, the National Bank of Georgia continued to remotely advise representatives of the financial sector and other stakeholders on issues related to the protection of the rights of consumers in the financial sector.

Similarly to previous years, the National Bank of Georgia continued to provide advice to loan lending entities on the proper registration of customer complaints, compliance of agreements with the requirements of the normative acts of the National Bank of Georgia, and other issues.

The National Bank of Georgia continued to cooperate with judges and representatives from the High School of Justice and provided training on consumer rights. As part of this, it was particularly important to identify the target segment and specific problems, as these will become subjects for the training module and sessions to be delivered in 2021. This project will help raise the awareness of judges about the consumer protection legal acts currently in force, and will help them better understand the specifics of consumer protection mechanisms in the financial sector.

A working group set up at the NBG's Regulatory Laboratory is charged with monitoring and evaluating innovative products for which no definite NBG treatment is yet available. As it is important to assess consumer protection issues that may exist with such products, the NBG Consumer Protection Unit is keenly involved in the working group and consults on the products and processes developed by various financial institutions.

Consumer applications

In 2020, the National Bank received a total of 9,737 referrals, which is 62% more than the previous year. Most of these, 6,567 (or 67%), were made over the phone, 1,159 (12%) in writing, 971 (10%) over social media, 956 (10%) by email, and 84 (1%) by personal visit.

In terms of content, most referrals concerned loan restructuring requests. There were also general information requests and those regarding administration/service issues. The most frequent consumer feedback regarding products related to consumer, mortgage and problem loans.

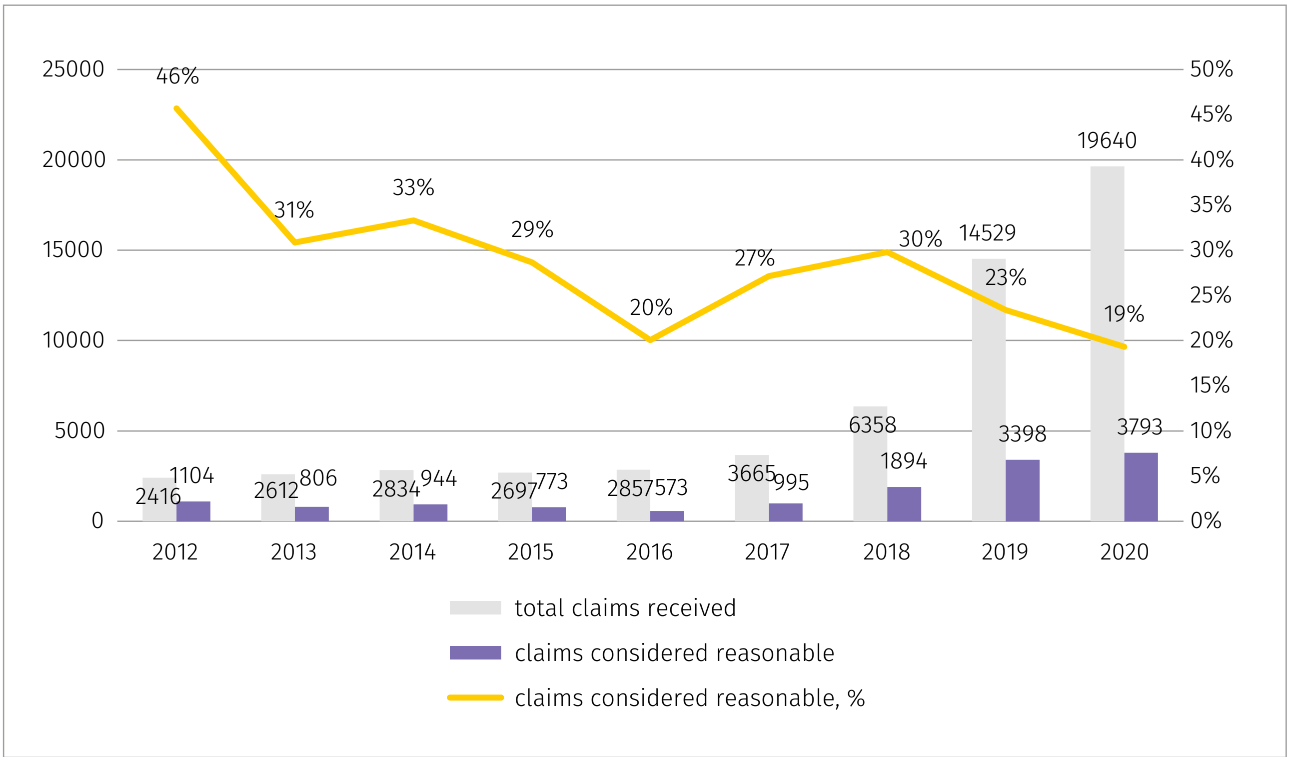
The increase in the number of referrals to the National Bank of Georgia in 2020 was mostly due to the problems caused by the pandemic. Consumers wanted to know about loan deferrals and requested mediation with financial institutions on loan restructuring matters.

Consumers also applied to financial institutions (banks, microfinance institutions and loan lending entities) and the Credit Information Bureau to file complaints. During 2020, 19,640 claims were registered in commercial banks, which was 35.2% higher year on year. Since 2012, there has been a constant growth in the number of appeals made in commercial banks, which indicates greater consumer awareness of consumer protection mechanisms. The increase in claims made in commercial banks in 2020 was largely a reaction to the grace period on loans that was announced as a response to the COVID-19, while the issue of transactions was also relevant. In order to prevent unauthorized transactions, the National Bank of Georgia issued a number of warnings and called on users to be more careful when sharing their personal and financial information.[69]

The most common complaints related to the following products: 1) current accounts; 2) consumer loans; 3) credit cards and 4) other types of claims. The latter includes transactions made through express payment machines and/or claims related to administration/services – including those related to the terms of the grace period. This distribution has not changed year on year, as the most significant proportion of claims relate to the most common/frequently used products.

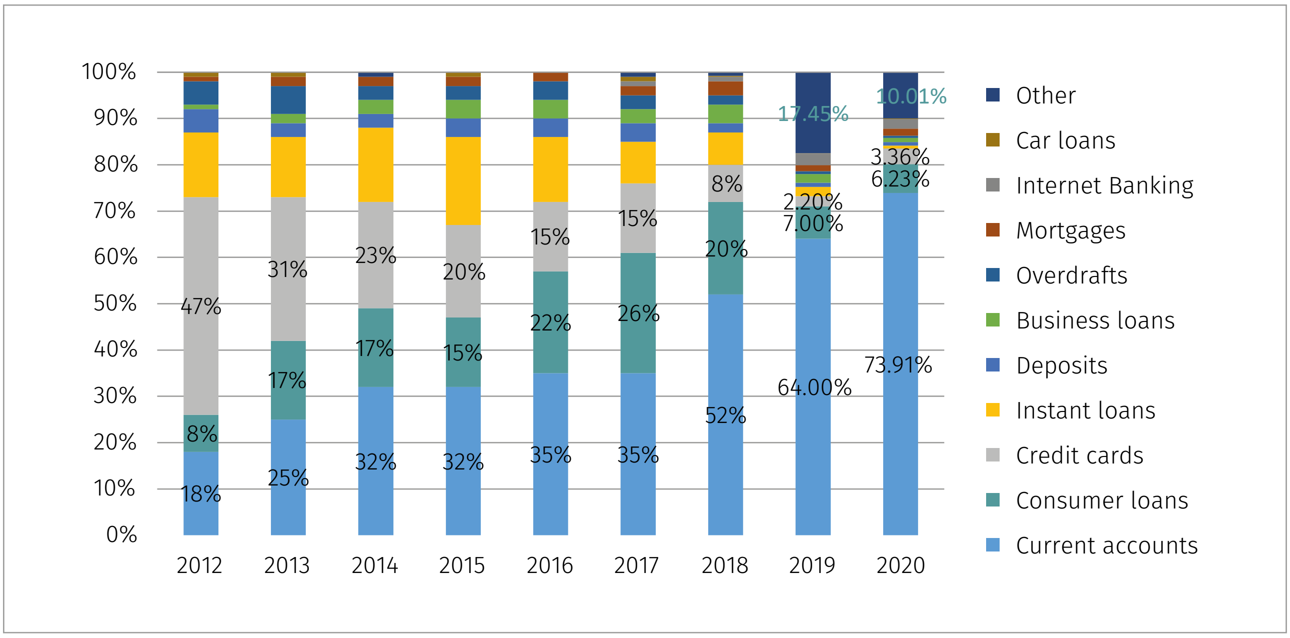
69. See https://www.nbg.gov.ge/index.php?m=340&newsid=3981

DIAGRAM N 5.1 DISTRIBUTION OF CLAIMS MADE AT COMMERCIAL BANKS BY STATUS



Source: National Bank of Georgia

DIAGRAM N 5.2 DISTRIBUTION OF CLAIMS MADE AT COMMERCIAL BANKS BY PRODUCT

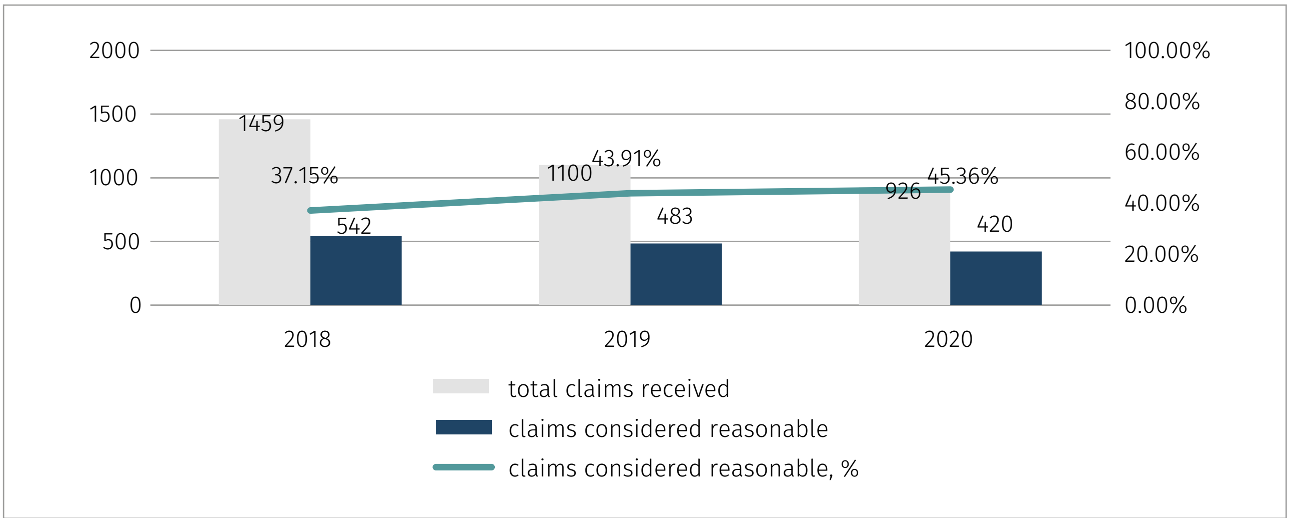


Source: National Bank of Georgia

Microfinance institutions started recording consumer claims in 2017, and the National Bank has been publishing this information since 2018. During 2020, a total of 926 claims were registered at microfinance institutions, which is 15.8% less than the previous year. The decrease in this figure is mainly a result of the diminished number of microfinance institutions.

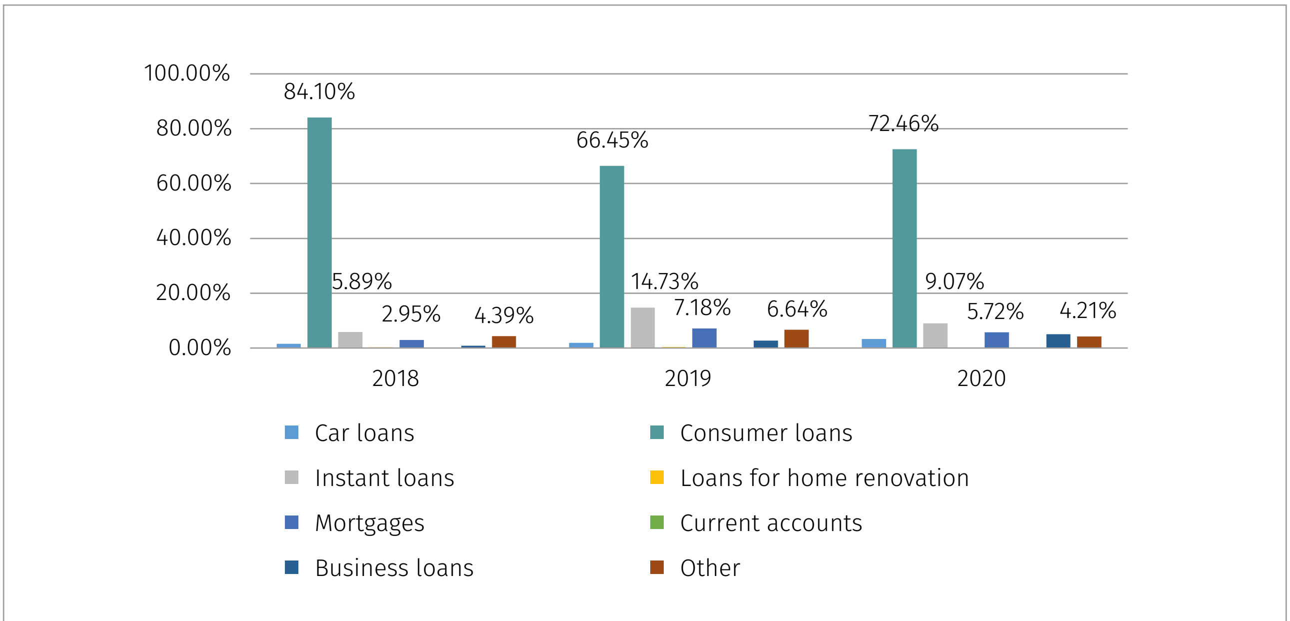
About 77.4% of claims in 2020 related to consumer loans, which is to be expected as this is the major product offered by these institutions. In terms of the nature of the claims, the largest share related to fines and overdue fees, administration/services and interest payments.

DIAGRAM N 5.3 DISTRIBUTION OF CLAIMS MADE AT MICROFINANCE INSTITUTIONS BY STATUS



Source: National Bank of Georgia

DIAGRAM N 5.4 DISTRIBUTION OF CLAIMS MADE AT MICROFINANCE INSTITUTIONS BY PRODUCT



Source: National Bank of Georgia

5.2 FINANCIAL EDUCATION

The NBG successfully ran its financial education projects and programs in 2020. While the COVID-19 pandemic turned out to be a challenge in terms of spreading financial education, greater emphasis was placed on using remote channels. During the year, the first Georgian educational web portal for financial education was launched – www.finedu.gov.ge ("FinEdu"). This is entirely devoted to financial education and presents a good opportunity to establish remote communication with the public, presenting them with various projects. The portal brings together a variety of educational resources, including publications and blogs, brochures, textbooks, and other similar support materials, along with various textual, video, and audio content. The FinEdu pages are also available on various social networks, helping promotion of the website and encouraging user interaction.

Different types of activities were offered to priority target groups identified under the Financial Education Strategy: these included training and webinars for young people, start-ups and micro-entrepreneurs. A new educational program was offered to agri-entrepreneurs. Competitions were held and print and online educational materials were generated. Educational videos on saving, phishing threats and other topics were also developed. Financial education issues were integrated into a TV series aired by the Public Broadcaster. As has become a tradition, World Savings Day was celebrated with the involvement of partner organizations. In connection with the integration of Financial Education into the national curriculum, civic education teachers were trained, and an introductory meeting was held with the authors of the 9th grade civic education textbook. The technical assistance project of the International Network on Financial Education of the Organization for Economic Co-operation and Development (OECD/INFE) and the Netherlands Ministry of Finance held several international online conferences and webinars to share the experiences of project participant countries and international financial education experts and to introduce best practices. Representatives of the National Bank of Georgia shared their experiences at one of these conferences dedicated to the financial education of children and youth in the new digital reality.

International survey of adult financial literacy

The International Survey of Adult Financial Literacy published in 2020 included Georgia.[70] Covering 26 countries, the study was conducted in 2019 as part of a five-year technical assistance project of OECD/INFE and the Netherlands Ministry of Finance, with the goal of promoting financial education in South-East Europe. The study was based on the methodology developed by OECD/INFE and looked at the overall level of financial education of the population based on three components – knowledge, behaviors and attitudes. The study also covered issues such as the financial inclusion of the population, financial stability, and financial well-being.

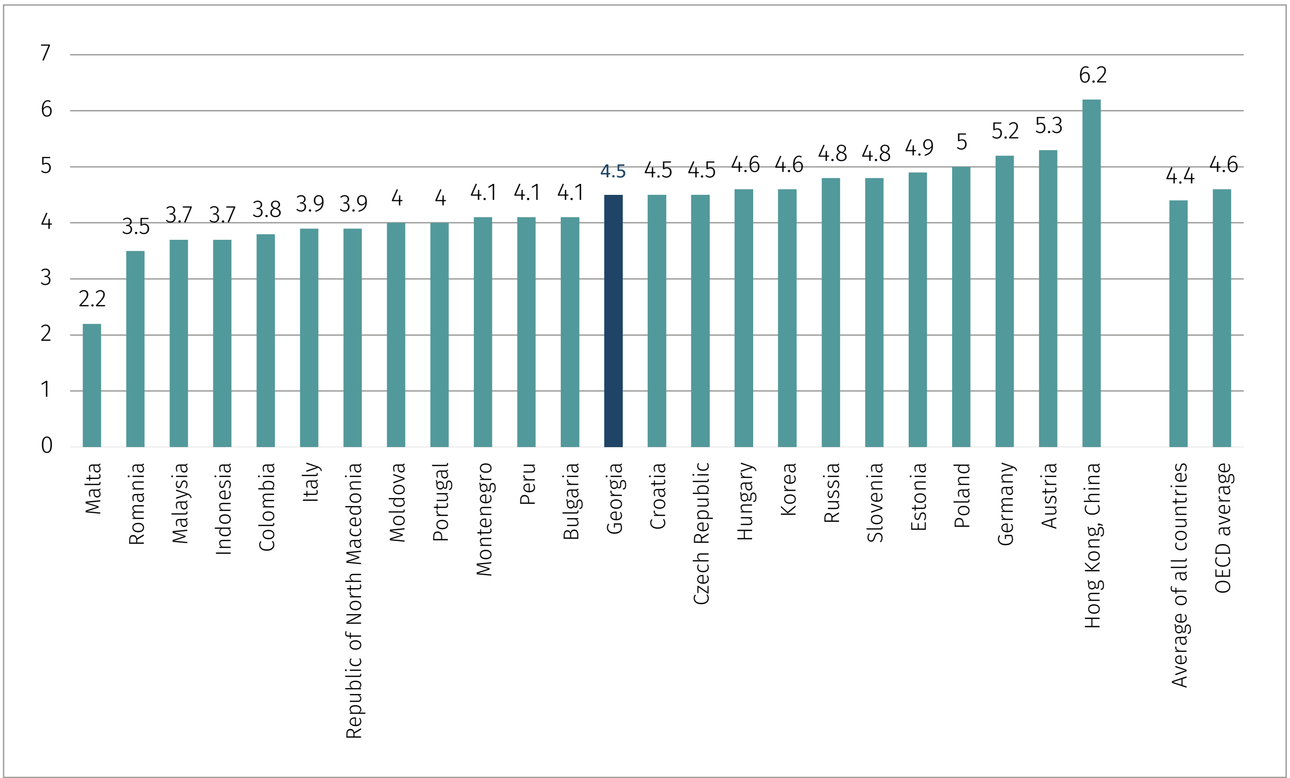
A presentation of the results of the study was held in June 2020 in an online webinar organized by OECD/INFE and was attended by representatives of the participating countries. The event was attended by Koba Gvenetadze, Governor of the National Bank of Georgia, who assessed the current situation in the country and spoke about the strides that the National Bank had made in recent years in terms of financial education.

70. See http://www.oecd.org/financial/education/oecd-infe-2020-international-survey-of-adult-financial-literacy.pdf

The international survey showed Georgia as having 12.1 points out of a maximum 21 points (57.6%) in financial education. According to the individual components of the survey, the population of Georgia had a score of 4.5 out of 7 points in terms of knowledge of financial education issues, 5.1 out of 9 points (56.3%) in behaviors, and 2.5 out of 5 points (50%) in attitudes.

In terms of knowledge, Georgia has a score higher than the average of all other countries and is ahead of 11 countries. The results of the knowledge component clearly show that the population of Georgia has a better understanding of issues such as the time value for money (76%), interest on loans (89%), risk and return (79%), and inflation (88%), while exhibiting an average level of knowledge of risk diversification matters (54%). However, for the majority it was difficult to calculate simple interest (44%), hard to explain the notion of compound interest (43%), and it turns out that only 24% of the population has a correct understanding of both types of interest.

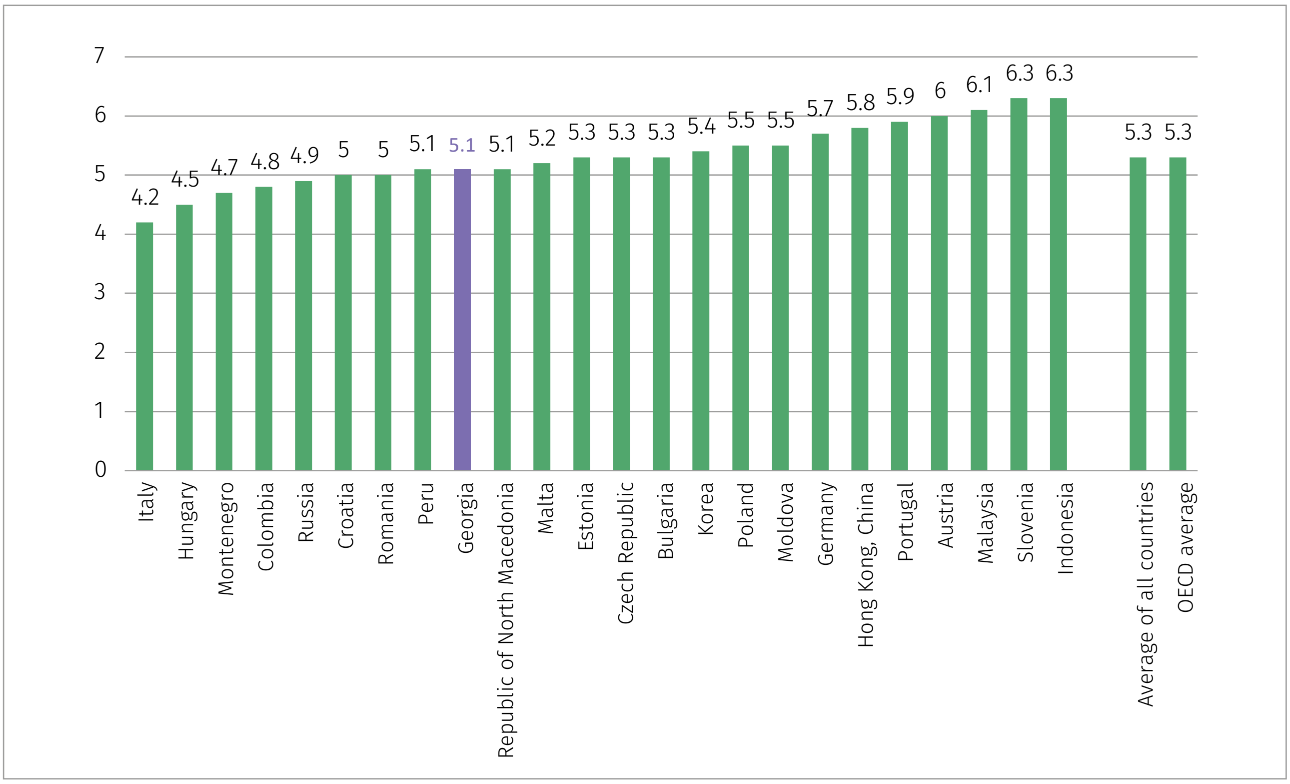
DIAGRAM N 5.5 COMPONENT: KNOWLEDGE



Source: OECD/INFE 2020 International Survey of Adult Financial Literacy
Note: Data for Malta are not included in the average figures (as only four questions were asked to assess knowledge).

In terms of behavior, Georgia's score is slightly behind the average of all other surveyed countries and is ahead of the data of eight countries. The results of the study show that a large part of the Georgian population controls their own money and expenditures (70.6%). It was reported that 90% pay their bills on time and 71.4% are careful of purchases and consider alternatives. The population of Georgia also showed high results in components of behavior, such as the existence of a family budget (88%) and having active savings (66.7%). However, only a relatively small proportion of the population (40.4%) has long-term plans, while only 12% are ready for retirement – the vast majority face this age in the hope of a state pension or support from their family and children. When it comes to products other than financial products, the population will look for alternatives; however, only 20% of the population will try to compare prices when buying financial products, and only 38% will seek unbiased advice.

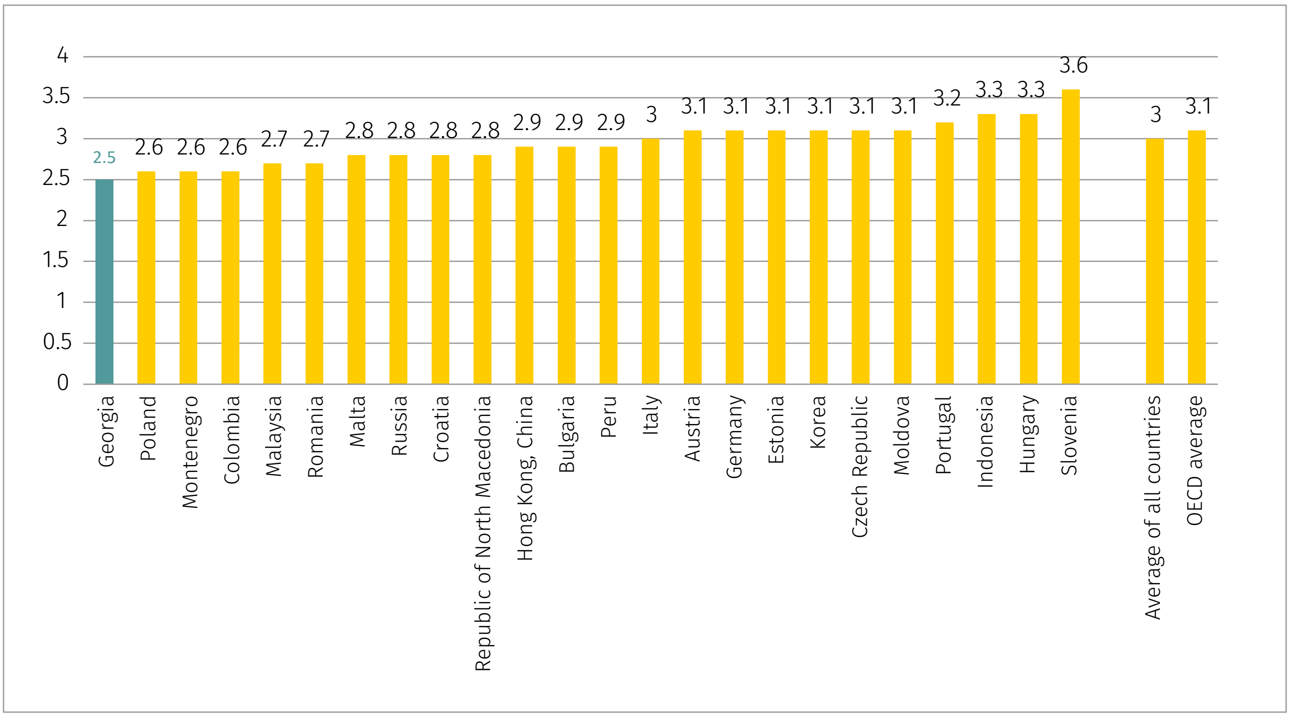
DIAGRAM N 5.6 COMPONENT: BEHAVIOR



Source: OECD/INFE 2020 International Survey of Adult Financial Literacy
Note: Only seven questions were asked to assess behavior in Malta. The diagram does not show data from Thailand, as the study used the OECD 2015 instruments that do not allow calculation of the behavioral score. The diagram does not show France either, as no information about behavior was collected. The average rate does not include Malta's data.

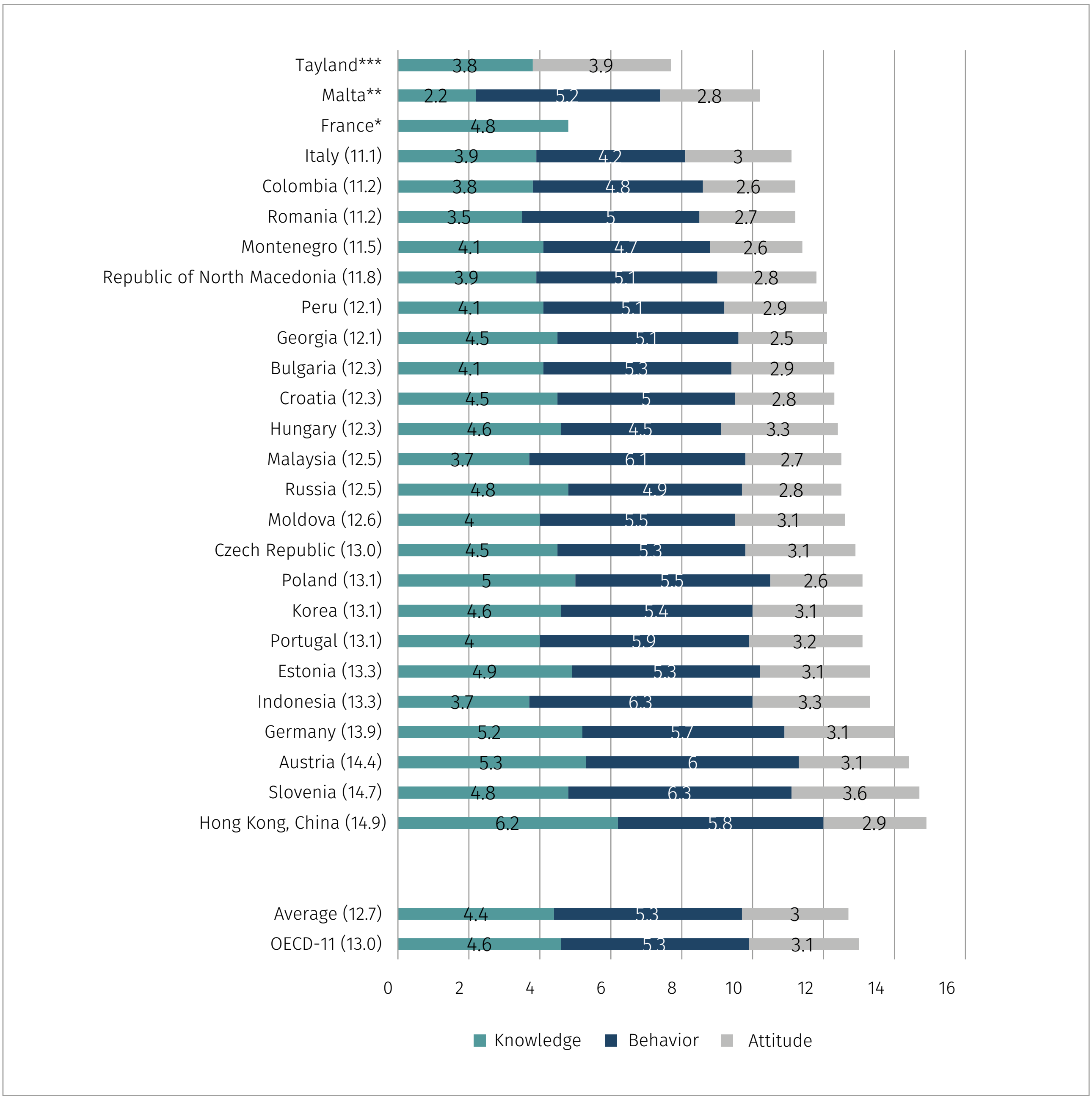
The survey of the Georgian population showed the lowest results in the attitudes component as compared to the indicators of all other countries. The vast majority of Georgians think that money is there to be spent (79%), and many of them fully or partially share the view that spending money is more satisfying than saving for the long term (56%); about 37% live only day by day, thinking less of tomorrow.

DIAGRAM N 5.7 COMPONENT: ATTITUDES



Source: OECD/INFE 2020 International Survey of Adult Financial Literacy
Note: France is not represented in the diagram, as information on attitudes was not collected.

DIAGRAM N 5.8 FINANCIAL LITERACY SCORES



Source: OECD/INFE 2020 International Survey of Adult Financial Literacy
Notes:
** Only financial knowledge data were collected for France.*
*** The case of Malta is not comparable, as the data were collected incompletely and using an earlier survey.*
**** The methodology for 2015 was used for Thailand and thus the behaviors score is not comparable.*
The average indicator does not include France, Malta and Thailand data.

FINANCIAL EDUCATION PROJECTS

FinEdu – Financial Education web portal

In 2020, the National Bank, within the framework of the National Strategy for Financial Education, introduced a new educational platform, finedu.gov.ge (FinEdu), to the public.

FinEdu brings together all financial education information, including helpful tips, calculators, tests, publications, brochures, thematic textbooks, videos, and blogs. By using simple language, FinEdu provides users with objective, impartial information based on current legislation and best practices. Any interested party is free to use the materials published on the website (except for copyrighted blogs) for non-business purposes.

The purpose of FinEdu is to address the challenges facing the market today, including the diversity and complexity of financial products and services, which is often accompanied by intense and potentially perplexing marketing from financial market players; the difficulty for users to obtain the unbiased information they need online; and the problem of distinguishing between credible and false information.

The FinEdu blog is open for any interested party, giving them the opportunity to share their views or experiences of financial education with other users. The information on the web portal is updated on a regular basis. In addition, the support pages of the web portal have been made available to the general public on social networks, including the FinEdu Facebook page, which informs users about developments in financial education including information about activities planned or already carried out, shares materials posted on the FinEdu web portal and offers financial advice.

The FinEdu web portal has been operative since September 2020. As of the end of 2020, it had 13,705 unique users who had visited a total of 46,351 pages during 19,705 sessions.

Financial education program for agri-entrepreneurs

The National Bank developed a new financial education program to support the development of agribusiness in 2020. The project was implemented in cooperation with the European Fund for South-East Europe’s Development Facility (EFSE/DF) and with the involvement of the Civil Development Agency (CIDA).

The goal of the program was to help entrepreneurs involved in the agricultural sector to select the right financial products suited for their business needs and capacities, and to make the right financial decisions. A manual and training module were developed within the program. Electronic versions of these materials are publicly available for free on the Financial Education Portal: www.finedu.gov.ge. A practical guide specifically for farmers, "Make Better Financial Decisions”, was also published as part of the program.

The financial education program for agricultural entrepreneurs uses simple language and includes practical examples and tips that allows the audience to easily apply theoretical skills in practice. The program allows entrepreneurs to independently identify the short- and long-term needs of their businesses, to educate themselves on their rights and responsibilities, to learn how to increase the competitiveness of their businesses with energy efficient investments, and to understand the importance of agricultural insurance.

The National Bank hosted financial awareness training sessions as part of the program on 21-

22 February 2020. The training was conducted by CIDA agribusiness expert consultants and trainers, with the goal of further improving the quality of consultations and training delivered to the farmers.

The program also involved an educational video produced in October in cooperation with the Georgia's Innovation and Technology Agency (GITA). The video, based on the aforementioned practical guide for farmers, provides examples and tips in simple language to help agri-entrepreneurs make reasoned financial decisions to grow their businesses.

The Innovation and Technology Laboratory and Geolab held an online Creathon for young people in November. It was organized to put forward important financial education issues for young entrepreneurs that will lead to them make sound financial decisions in business development. The participants analyzed the content of the guide for agricultural entrepreneurs – "Make Better Financial Decisions" – and the video based on the same brochure, and presented their visions and ideas on important financial issues for the development of agribusiness in their own work environments. The three best works developed during the Creathon, as nominated by a jury, were awarded with certificates and souvenirs. The first prize winner was also given the opportunity to take a 3-month UI/UX design training course organized by Geolab.

Financial education program for micro and small entrepreneurs

The National Bank continued its financial education program in support of micro and small entrepreneurs in 2020, with the program operating through remote channels.

A series of webinars was held in July and December for start-ups, micro and small businesses. Titled "Relations with Financial Institutions and Financial Decision Making", the webinars were meant to encourage micro and small business owners and financial managers, as well as future entrepreneurs, to acquire and enhance the knowledge and skills that will help them make the right financial decisions, including while interacting with financial institutions, bearing in mind their business needs and capabilities. The series of webinars covered the following important topics: business loans and related issues, assessment of the financial solvency of a business by a financial institution and key financial ratios, and the rights of financial institutions' consumers. A record of a webinar and presentations are available on the Financial Education Portal: www.finedu.gov.ge.

Financial education brochures for students

The National Bank, with the involvement of the Business and Technology University, published financial education brochures designed to promote financial education among the younger generation. The project was implemented with the support of the Administration of the President of Georgia. The brochures consist of ten key topics and their target audience is students.

The brochures are designed to provide readers with information about the financial system and its participants, money and currency, the state budget and taxes, and also cover basic financial management issues such as personal budgeting and saving, borrowing, insurance, financial safety, and consumer rights protection.

These brochures will help consumers acquire and develop the knowledge and skills that will help them make the right financial decisions and achieve financial well-being that matches their personal and their families' needs and capacity.
The brochures were published in July 2020 and electronic versions are available for any interested

person on the Financial Education Portal: www.finedu.gov.ge.

Educational videos

The National Bank produced several educational animated videos in 2020 to communicate financial education issues to the public in simple language. In an effort to help young children understand the importance of saving, the National Bank teamed up with the Crystal Foundation and Crystal, the Financial Inclusion Organization, to produce an animated video at the Velosipedi ("bicycle") animation studio. In the animation, Jose the Giraffe, a beloved cartoon character uses song to explain to children that saving has useful results and that it is not necessary to spend everything at once. Another animated video on the importance and need for savings was produced by the National Bank with support from the German Sparkassenstiftung for International Cooperation (SBFIC). The video provides information in simple language on how to wisely distribute income, how to develop the habit of saving and how and where to save.

The National Bank, in cooperation with the Banking Association of Georgia, also produced an educational video on phishing threats in an effort to protect consumers from internet fraud. The video introduces the eight signs of phishing attacks and provides tips in simple language on how to protect against phishing.

The National Bank, teaming up with the German Sparkassenstiftung for International Cooperation and the Public Broadcaster, also raised financial education issues in the "The Perfect Mother" television series, which saw renowned actors/characters skillfully discuss budgeting, savings and financial fraud.

A lesson on personal budgeting from TV School

Following the integration of financial literacy issues into the national curriculum, the National Bank, in cooperation with the German Sparkassenstiftung for International Cooperation and the Public Broadcaster, produced a lesson on personal budgeting in support of students' financial education.

The recording of the lesson has been made available online for interested parties on the financial education portal: www.finedu.gov.ge. It allows students to learn what a personal budget is, how to make one and what can help them in their budgeting efforts. They can learn how to distinguish between wants and needs, how to set financial goals and how to save money to achieve them.

AWARENESS-RAISING EVENTS

World Savings Day

The National Bank and the German Sparkassenstiftung for International Cooperation, with the involvement of commercial banks, organized the traditional World Savings Day on 31 October for the ninth time in a row. However, unlike in previous years, the events dedicated to the day were only covered on remote channels.

The campaign to mark the 2020 World Savings Day took place throughout all of November through the Financial Education platform: www.finedu.gov.ge.

As part of the campaign, 500 interested people were sent educational materials for children aged 7-12. To receive these items, which included brochures and comics about savings, budgeting and money, they only needed to fill out an online registration form published on FinEdu and its

Facebook page. In addition to the educational brochures, the children also received surprise souvenirs from Grovia the Ant, the Georgian mascot of World Savings Day. The campaign was meant to raise children's awareness of the importance of saving and to connect that with pleasant memories of the day.

As part of the same campaign, seven commercial banks of Georgia – the Bank of Georgia, TBC Bank, Basisbank, Credo Bank, Liberty Bank, FINCA Bank Georgia, and Terabank – worked together on a blogging competition on the topic of savings. The title of the competition – "Change a lot with a little saving!" – echoed the global message of 2020 World Savings Day. According to the terms of the competition, the 20 best blog posts would pass to the second stage of the competition and were published on the financial education portal www.finedu.gov.ge. The authors of the seven most successful posts were then awarded with GEL 500 savings plan deposits opened in the jury members' banks.

The same commercial banks also engaged in various independent activities: they showed an information video featuring of Grovia the Ant, the Georgian mascot of World Savings Day, on the screens of their branches, ATMs, websites and social networks. These events were also widely covered in the media.

DOMESTIC AND INTERNATIONAL COOPERATION

Cooperation with the Ministry of Education, Science, Culture and Sports

As a follow-up to the integration of Financial Education into the national curriculum, the National Bank continued to cooperate with the Ministry of Education, Science, Culture and Sports in 2020.

In December, the National Bank and the Ministry of Education conducted a webinar for those wishing to write a 9th grade textbook on Citizenship. According to the new national curriculum, the Citizenship syllabus brings together the concepts of financial and economic literacy, and schools have gradually included this discipline, at the basic level, in their curricula starting from the 2019-2020 academic year.

Tradition has it that meetings are held with authors before educational textbooks are written. A similar meeting was held with the authors of the 7th grade textbook in previous years. In 2020, a webinar was arranged to discuss financial and economic topics, which, according to the national curriculum, are a focus for the 9th grade.

During the webinar, representatives of the National Bank provided valuable insights into the choice of profession, state budget and taxes, financial institutions and financial products, the rights and responsibilities of consumers of financial institutions, and the importance of insurance. The webinar participants shared expedient information on the activities and exercises that could be used with pupils, along with other useful information concerning educational resources. A record of the webinar and the presentations are available on the Financial Education Portal: www.finedu.gov.ge.

Cooperation with the German Sparkassenstiftung for International Cooperation and Civic Education Teachers Forum

The National Bank launched a Civic Education Teacher Training Project in 2020. This occurred in connection with the integration of Financial and Economic Literacy into the national curriculum. The project was supported by the German Sparkassenstiftung for International Cooperation (SBFIC) and was held with the involvement of the Civic Education Teachers Forum.

The project aimed to promote the professional development of teachers in economic and financial education, and to encourage them to plan and conduct interactive lessons appropriate for students of certain age groups.

Within the frames of the project a training module and supporting training materials for teachers were developed that cover economic and financial issues suitable for the 7th grade Citizenship discipline. This included topics on money and barter; the market (supply-demand) and prices; private and public property; income, spending and budgeting (personal finance management); and savings and charity. The learning materials and additional class activities are available for free on the financial education portal: www.finedu.gov.ge.[71]

The project also focused on the training of trainers. Former trainees of the program went on to train up to 400 civic education teachers from different regions of Georgia during 2020. Registration for this teacher training was open to any interested teacher who is responsible for teaching Citizenship.

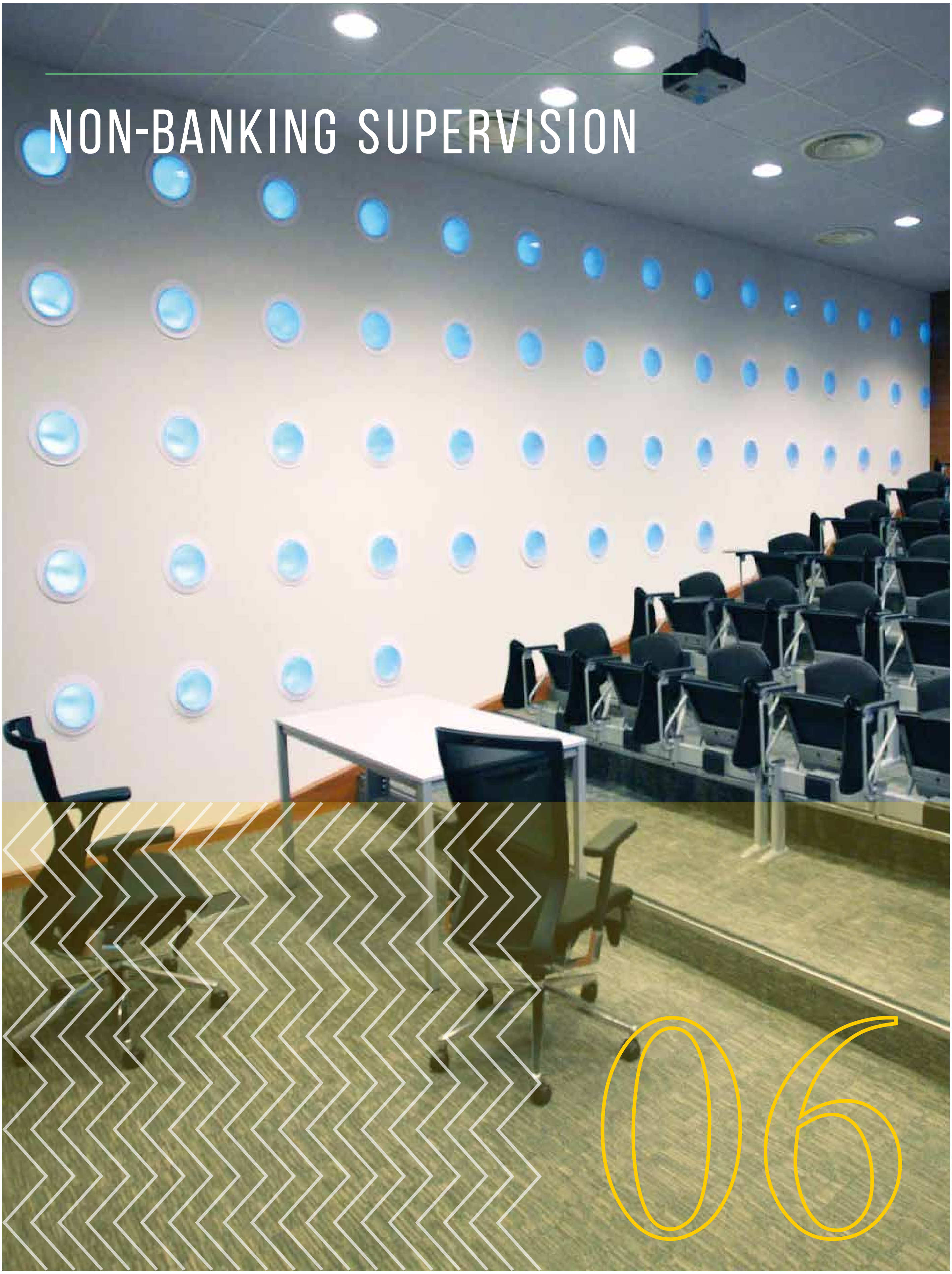
Cooperation with OECD/INFE and the Netherlands Ministry of Finance

In 2020, the National Bank of Georgia continued its cooperation with the International Network for Financial Education of the Organization for Economic Cooperation and Development (OECD/INFE) and the Netherlands Ministry of Finance. This is a 5-year technical assistance project, which, besides Georgia, engages six other countries of South-Eastern Europe: Bulgaria, Northern Macedonia, Moldova, Montenegro, Romania and Croatia.

On 18-19 November, the project held its second annual meeting dedicated to the financial education of children and young people in the digital era. The online conference focused on the process of developing financial education policies and programs for this segment, and on sharing information regarding international best practice and the challenges in South-East Europe. In addition to the high-level representatives from the project countries, the conference was attended by practicing specialists and experts whose direct responsibility is to develop and implement national initiatives for financial education in their respective countries. The conference discussed the level of financial education for children and young people in the region and the role of financial education in enhancing their financial well-being. The best examples of financial education initiatives were discussed, including the integration of financial literacy into school curricula, as well as the impact of the COVID-19 pandemic on the delivery of financial education, and the use of digital technologies and other innovative tools in delivering financial education. Representatives of the National Bank of Georgia were eager to share Georgia's experience in developing various financial education programs for children and young people, including the introduction of financial education in schools and the teacher training initiative.

71. See https://finedu.gov.ge/ge/ghonisdziebebi-2/vebinari-saskolo-sakhelmdzghvanelos-avtorobis-msurvelebisatvis-finansuri-da-ekonomikuri-tsignierebis-temaze-1

NON-BANKING SUPERVISION



6.1 REGULATION OF THE NON-BANKING SECTOR AND THE REGULATORY FRAMEWORK

Thanks to the regulatory reforms concerning the supervision of the non-banking sector over the past three years, the microfinance sector faced the negative consequences of the COVID-19 pandemic somewhat prepared. The sector maintained capital and liquidity at a level higher than set, while risk management and corporate culture in the sector improved significantly.

Triggered by the devaluation of the national currency, credit risk would have been much higher had it not been for the existing restriction of lending in foreign currency and the standard umbrella of responsible lending to microfinance institutions. Most microfinance institutions also demonstrated social responsibility by announcing a 3-month moratorium/grace period on loan repayments, and, in some cases even extended this repeatedly.

Funds raised from individuals in the liability structure were replaced by those received from institutional creditors and founders. At the same time, due to the short open currency position and the moratorium on loans, demand for GEL resources increased. To increase access to lari resources for the microfinance sector, a USD 200 million swap tool was offered to microfinance institutions. In addition, with the introduction of the SME Liquidity Support Facility by the National Bank, microfinance institutions were able to borrow from commercial banks, with the support of the National Bank, provided they had loan portfolios matching the set criteria.

The National Bank suspended on-site inspections of supervised entities during the COVID-19 pandemic. Lending procedures were therefore simplified, with the requirement of real estate appraisal temporarily being lifted through site visits. The requirement for a renewal of financial statements was also eased.

The National Bank of Georgia launched a Remote Supervision Portal for Non-Banking Institutions. This allowed supervised entities to upload reports online and to maintain ongoing remote communication with the National Bank (instead of the traditional way of report filing). This change proved to be much needed in the context of the pandemic as use of the portal increased flexibility for communicating with and obtaining information from non-banking entities. The capacity of the portal also allowed elimination of technical inaccuracies and thus increased the reliability of the submitted information.

In 2020, the “Regulation on Defining, Imposing and Enforcing Fines on Microfinance Institutions and their Administrators” was approved, replacing the “Regulation on Defining, Imposing and Enforcing Fines on Microfinance Institutions and Currency Exchange Bureaus”. According to this new regulation, the National Bank is authorized to impose various sanctions on a microfinance institution or its administrator, depending on the nature of the violation and the severity of the actual or potential risk. This can include the imposition of fines as established under the regulation.

A change in the “Regulation on Liquidation of a Microfinance Institution” was prompted by a need to ensure the protection and return of funds belonging to those creditors who could not be contacted and repaid during the liquidation process of a microfinance institution. To ensure such protection and refundability, it was considered expedient for a microfinance institution to transfer such creditor funds to an account opened with the National Bank of Georgia and, upon the creditor's request, to ensure the return of the funds by the National Bank.

On 3 September 2020, the International Monetary Fund published an assessment document prepared by its Technical Assistance Mission.[72] The report stated that, as a result of the joint efforts of the Government of Georgia and the National Bank of Georgia, the prudential regulation and supervision of non-banking credit institutions and their activities had been significantly strengthened. "The measures taken by the National Bank have contributed to the sustainability of the non-banking sector, strengthened the sector and improved the reputation of the microfinance brand", the IMF report stated. According to the same report, the National Bank of Georgia has significantly improved its data collection, remote monitoring and on-site inspection processes, thus strengthening the supervisory framework of the non-banking sector. Minimum capital and liquidity requirements have been set for microfinance institutions and the standard of transparency has been raised. According to representatives of the non-banking sector, the regulations of the National Bank's supervisory framework have helped improve the reputation of the sector. "Advancing oversight of the microfinance sector helps to enhance the reputation of these institutions and increase credibility for both domestic and international investors", the IMF assessment document stated.

It was the recovery of the sector that enabled the National Bank to create liquidity support products for microfinance institutions. These helped cushion the adverse impact of the pandemic, which would have been impossible 2-3 years ago when there was no regulation of the sector.

NON-BANK FINANCIAL INSTITUTIONS

As of 31 December 2020, the non-bank financial sector was represented by 40 microfinance institutions, 791 currency exchange bureaus (616 head offices and 175 branches), 367 lending entities (198 head offices and 169 branches) and one credit union.

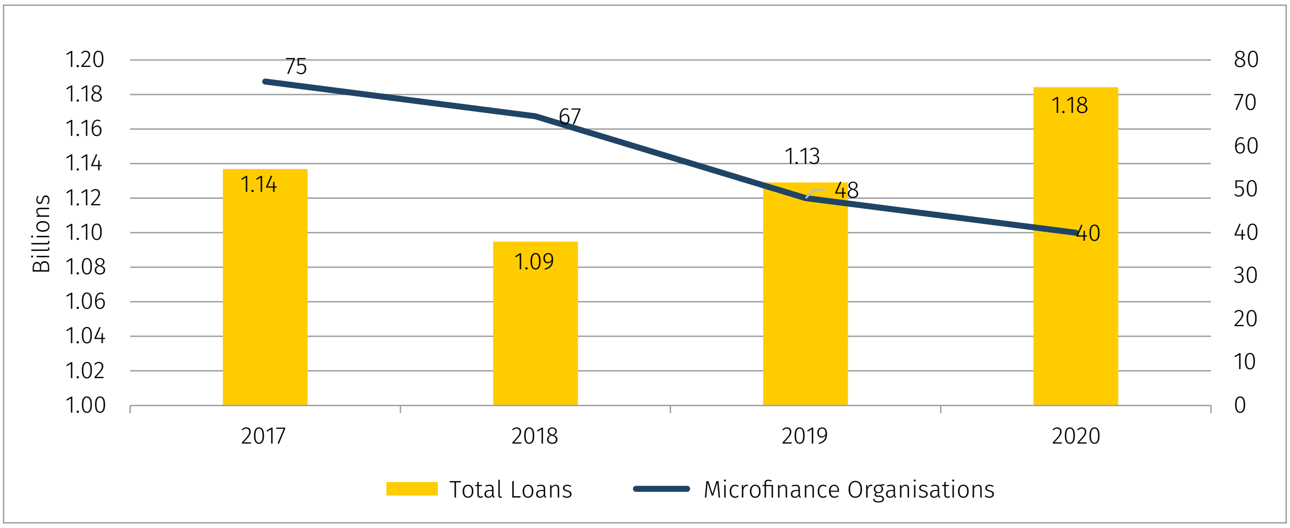
The total assets of the non-bank financial sector amount to GEL 2 billion (of which the largest share of GEL 1.5 billion belongs to the microfinance sector).

6.1.1 MICROFINANCE INSTITUTIONS

Despite the decline in the number of microfinance institutions, due to the pandemic and increased demand for pawn loans, the loan portfolio maintained an upward trend in 2020. Considering an annual growth rate of 5%, the total loan portfolio amounted to GEL 1.18 billion.

72. See https://www.imf.org/en/Publications/CR/Issues/2020/09/03/Georgia-Technical-Assistance-Report-Strengthening-Regulation-Supervision-and-Oversight-of-49728

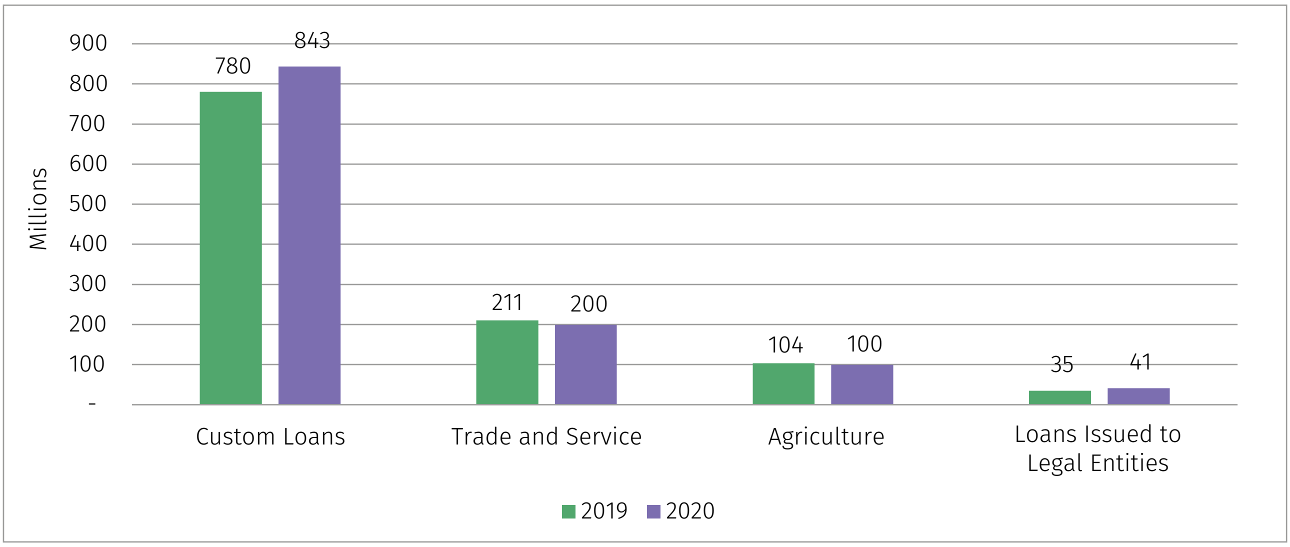
DIAGRAM N 6.1 TOTAL LOANS AND NUMBER OF MICROFINANCE INSTITUTIONS



Source: National Bank of Georgia

Consumer loans to individuals is the primary focus of the microfinance sector (consumer loans, online loans, pawnshops, installments, etc.), accounting for 71% of the sector's total loan portfolio valued at GEL 843 million. Loans to agriculture and trade services constituted only 25% of total loans, amounting to GEL 299 million. Significantly, material growth in the sector was only seen in the area of consumer loans. This was driven by a 20% increase in the pawnshop portfolio, amounting to GEL 87 million. This was a direct consequence of the increased demand stemming from the COVID-19 pandemic. The pandemic effect also explains the declining demand for business loans and, consequently, the downward trend in the sector's portfolio in that category.

DIAGRAM N 6.2 TOTAL LOAN PORTFOLIO STRUCTURE

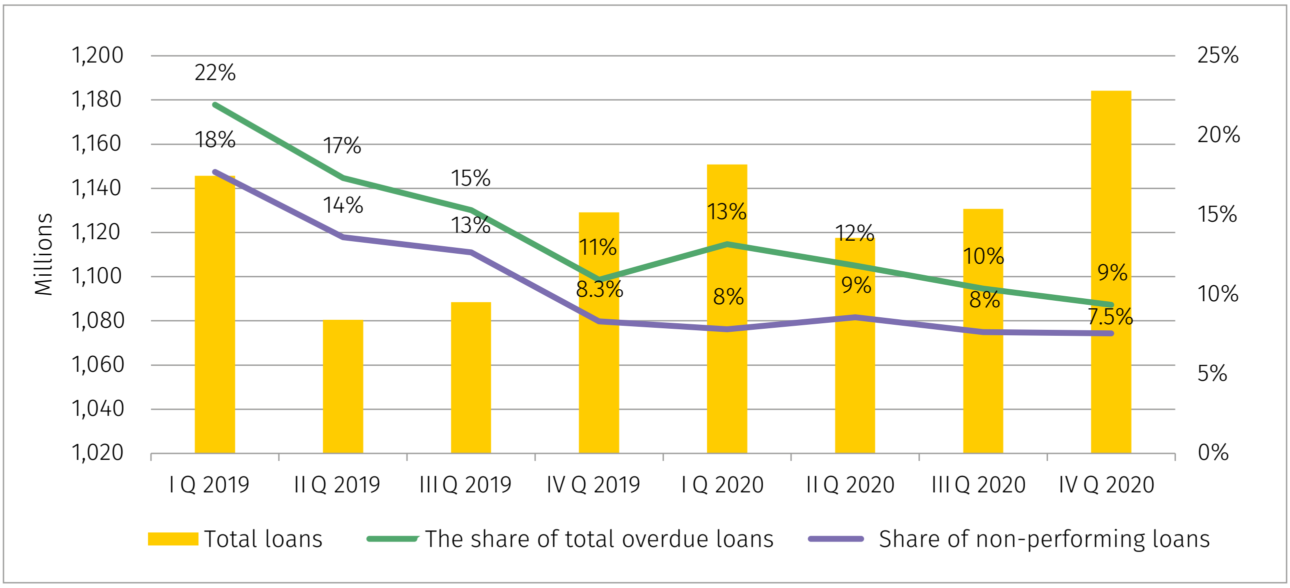


Source: National Bank of Georgia

Loans to the agricultural, and trade and services sectors were mainly disbursed by four microfinance institutions.

The quality of the loan portfolio improved year on year, despite the pandemic. The share of non-performing loans in the total portfolio decreased from 8.3% to 7.5%, while the share of overdue loans in decreased from 11% to 9%. This was consequence of both the liquidation of eight microfinance institutions during the year, which mainly had non-performing loans in their portfolios, and the growth of the total loan portfolio at the expense of pawn loans, most of which are in the standard category.

DIAGRAM N 6.3 LOAN PORTFOLIO QUALITY

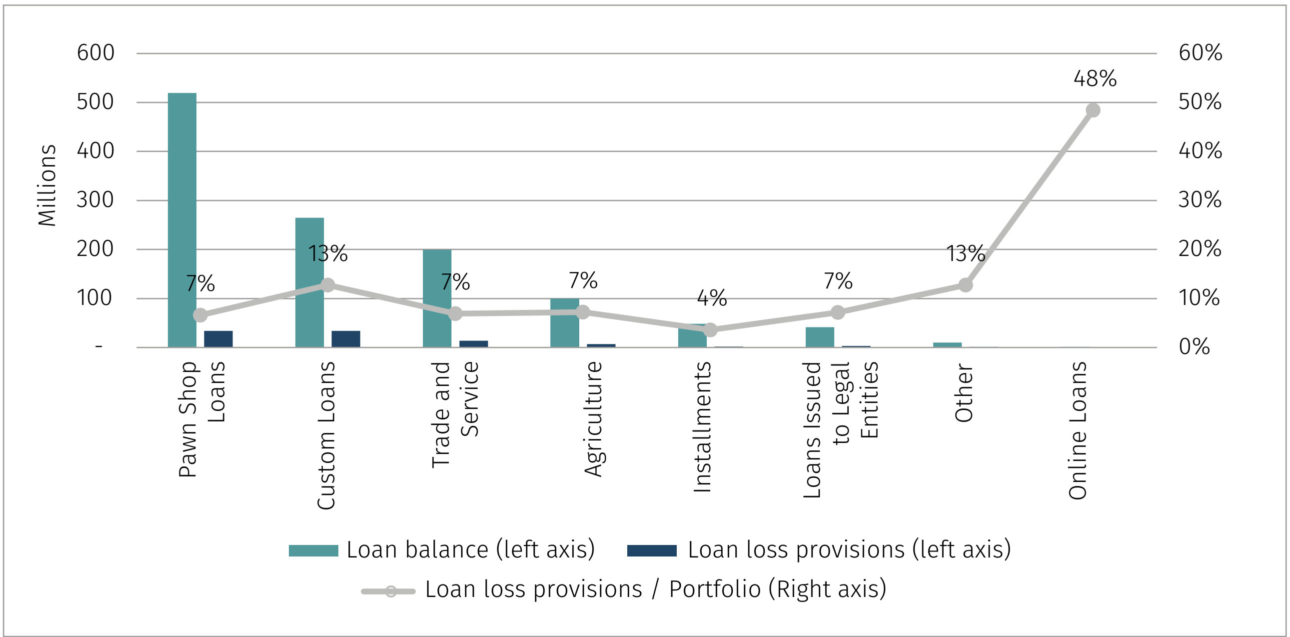


Source: National Bank of Georgia

The structure of the portfolio also improved in terms of collateral: the share of signature and guaranteed loans decreased from 28% to 25%, which is also linked to the growth of the pawn shop portfolio.

In terms of products, the online loan portfolio has the highest reserve ratio of 48%. However, due to the small balance of this portfolio, this figure does not have a significant impact on the quality of the overall loan portfolio.

DIAGRAM N 6.4 LOAN PORTFOLIO RESERVE BY PRODUCT

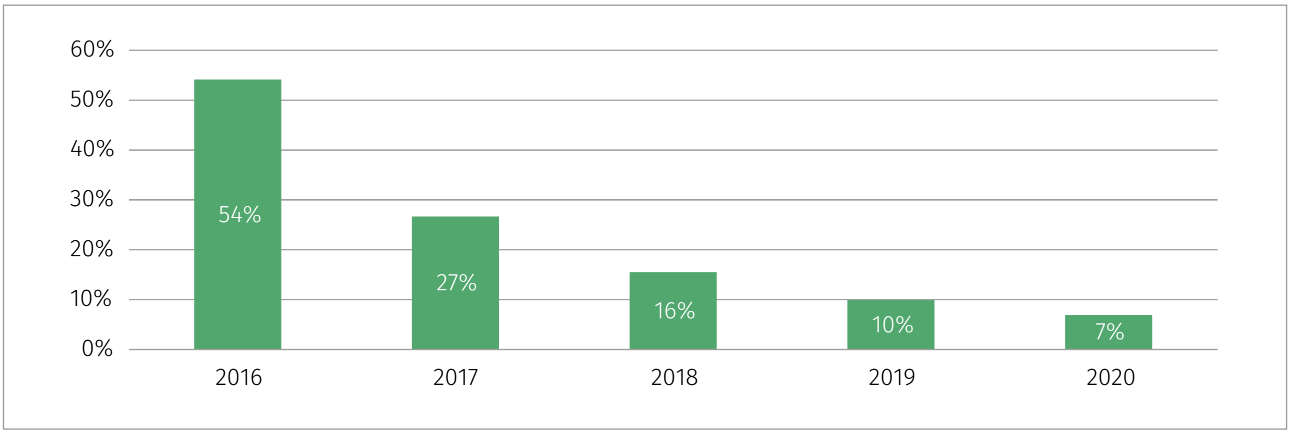


Source: National Bank of Georgia

To mitigate the potential adverse effects of the pandemic on the loan portfolio, in June 2020 the National Bank of Georgia decided to require microfinance institutions to set up a general reserve for possible loan losses to the amount of 5% of the total loan portfolio as of the end of the same month. The reserve, which was set up in accordance with the “Regulation on Classification of Assets of Microfinance Institutions and Formation of Reserves for Possible Loan Losses”, as approved under Decree №142/04 of the Governor of the National Bank of Georgia on 5 July 2018, was supposed to be formed gradually on a special reserve account. However, microfinance institutions were also allowed to present an internal methodology/model for loan loss reserves to the National Bank. As a result, a general reserve of GEL 53 million GEL was created in the system.

Since 2017, there has been a downward trend in the dollarization of the loan portfolio of microfinance institutions. This was partly due to the amendments made to Article 625 of the Civil Code of Georgia, which prohibited the disbursement of foreign currency loans valued up to GEL 200,000 to individuals.

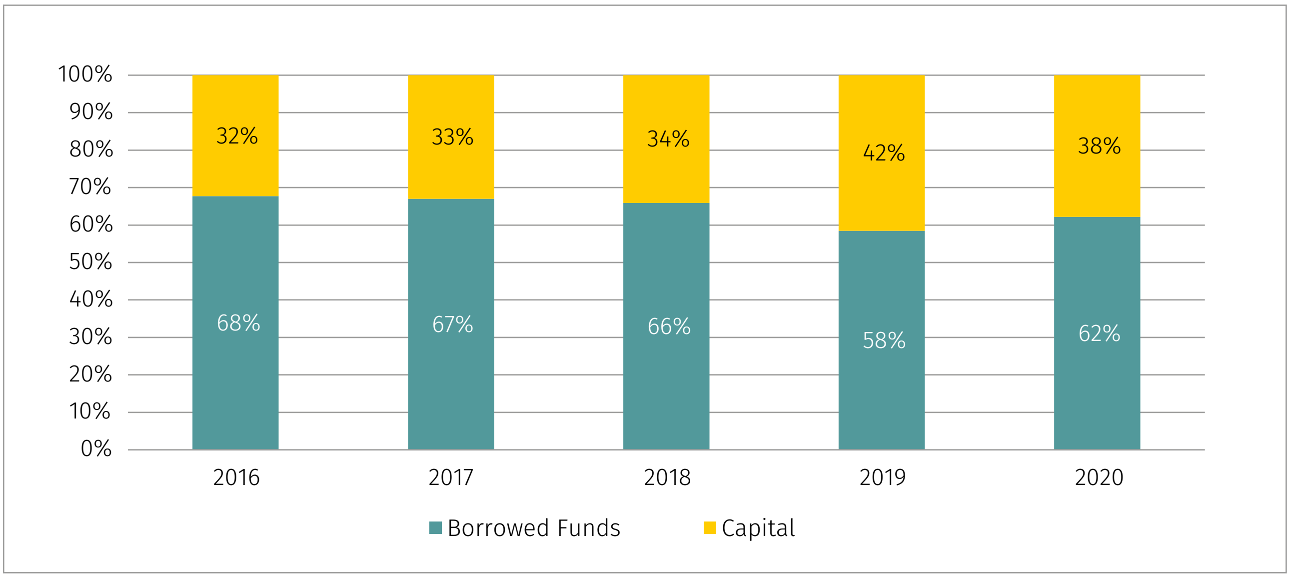
DIAGRAM N 6.5 DOLLARIZATION OF THE LOAN PORTFOLIO



Source: National Bank of Georgia

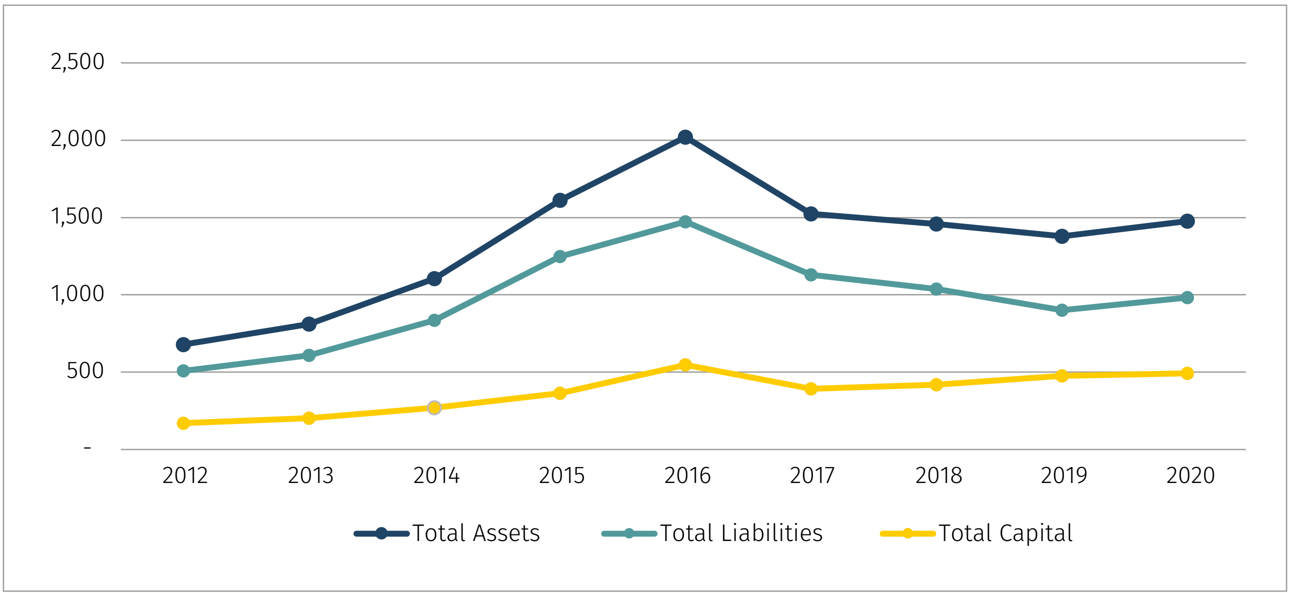
The share of borrowed funds in the asset funding structure increased from 58% to 62% year on year, amounting to GEL 112 million.

DIAGRAM N 6.6 SOURCE OF FUNDING



Source: National Bank of Georgia

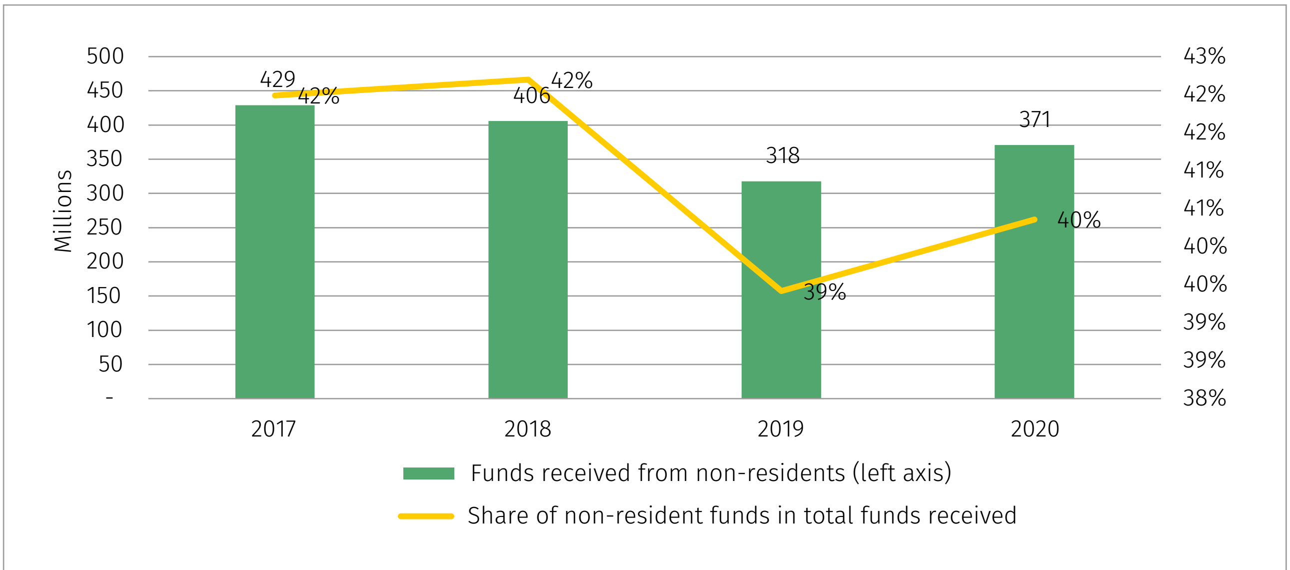
DIAGRAM N 6.7 DYNAMICS OF ASSETS, LIABILITIES AND EQUITY



Source: National Bank of Georgia

The share of borrowings from non-resident entities in the borrowings structure increased by GEL 53 million year on year, as an effect of large microfinance organizations of the system.

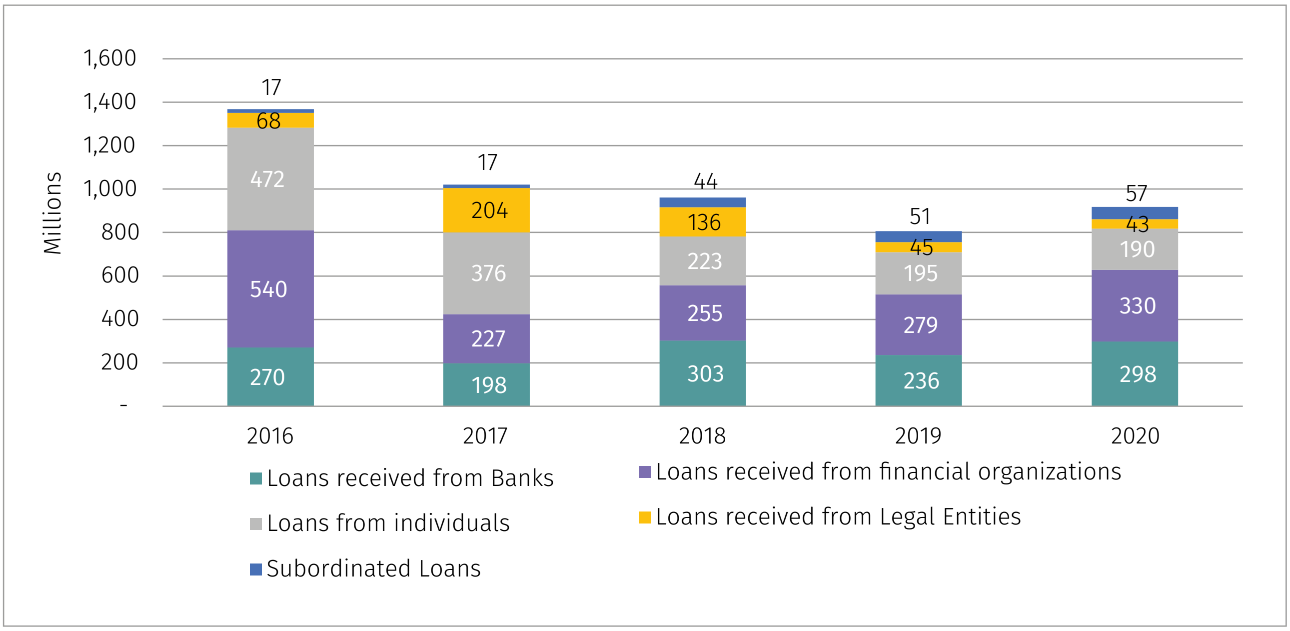
DIAGRAM N 6.8 FUNDS OF NON-RESIDENTS



Source: National Bank of Georgia

Although the share of non-resident shareholders in the authorized capital of the sector increased from 32% to 33%, it nevertheless decreased by a total of GEL 25 million, which was the effect of a single microfinance institution.

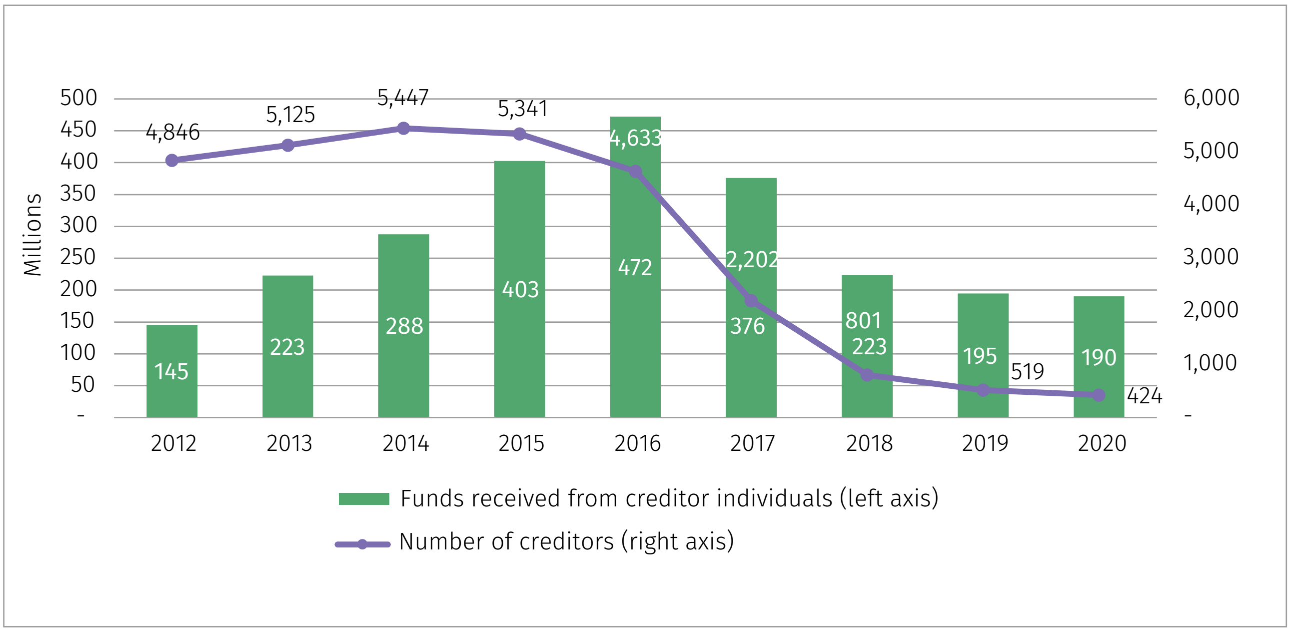
DIAGRAM N 6.9 STRUCTURE OF BORROWINGS



Source: National Bank of Georgia

Funds received from banks and financial institutions increased significantly year on year, while loans attracted from individuals and legal entities decreased by GEL 6.6 million. The increase in the share of funds received from financial institutions is partly due to the greater attractiveness and credibility of the microfinance sector, in which prudential supervision has played a major role.

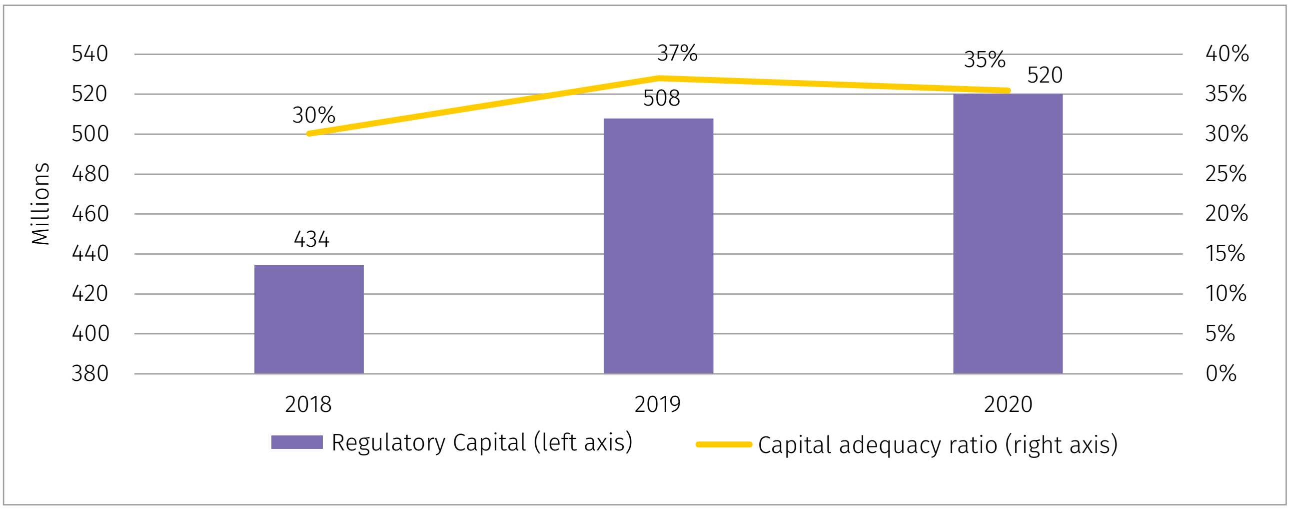
DIAGRAM N 6.10 BORROWINGS FROM INDIVIDUALS AND NUMBER OF CREDITOR INDIVIDUALS



Source: National Bank of Georgia

Adopted in December 2018, the "Regulation on Supervision and Regulation of Microfinance Institutions" sets out the requirements for the minimum amount of regulatory capital and capital adequacy ratios for the microfinance sector. There were to gradually be met by microfinance institutions by 31 December 2019. Regulatory capital also showed an upward trend in 2020, despite the decline in the number of microfinance institutions.

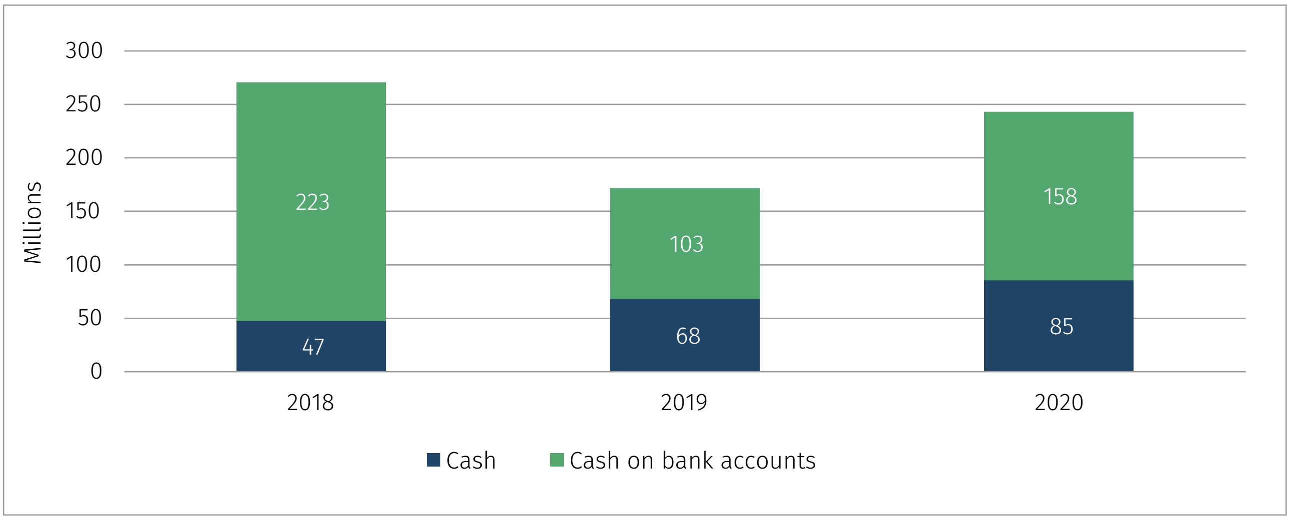
DIAGRAM N 6.11 REGULATORY CAPITAL



Source: National Bank of Georgia

With the number of microfinance institutions declining throughout the year, the system still managed to maintain liquidity – largely a result of the new liquidity regulations that have been phased in since 2018.

DIAGRAM N 6.12 LIQUID FUNDS



Source: National Bank of Georgia

Significantly, in the face of the pandemic, the National Bank developed additional liquidity support tools for microfinance institutions in the form of the currency swap and the SME liquidity provision tools (see Box 2).

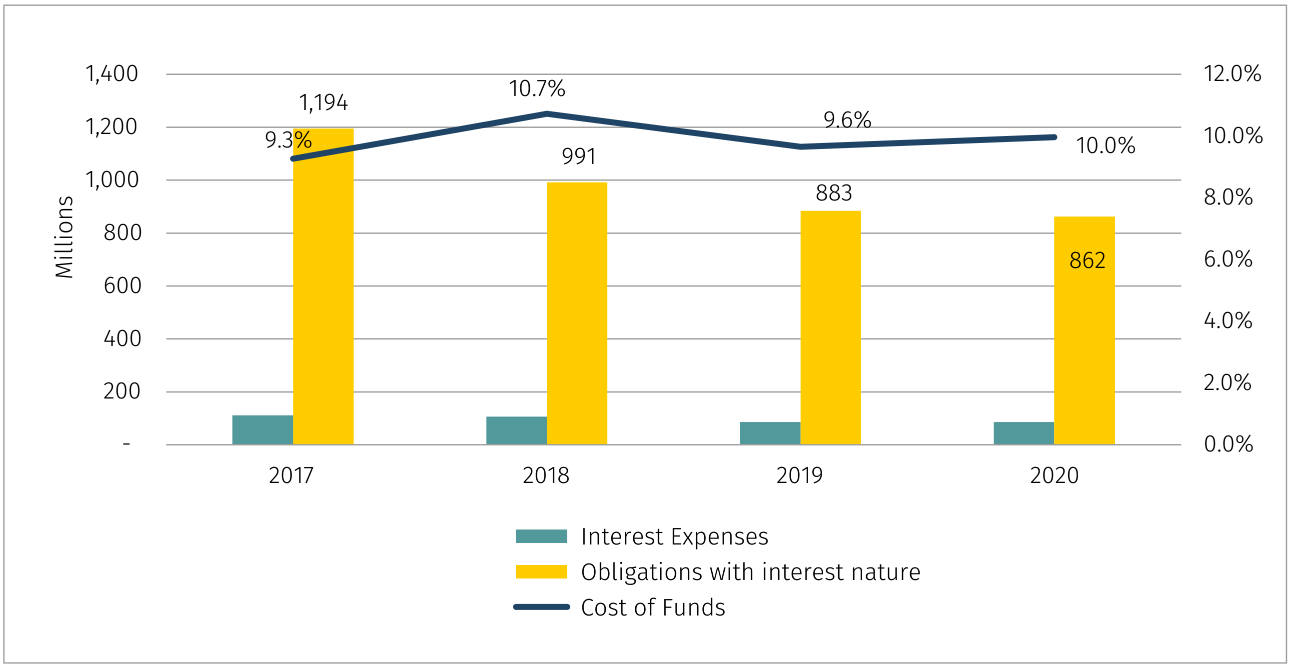
Regardless of the effects of the COVID-19 pandemic, with a net profit of GEL 45.1 million, the microfinance sector retained profitability, with almost half of its players ending the reporting year with a profit.

The total reserve for possible loan losses, which was formed in the sector in June 2020, did not have a large impact on net profits. As per the NBG's instructions, the reserve was gradually amortized into a special reserve account. By the end of 2020, about half of the total reserve had been realized. As a result, the reserve expenditure in 2020 was only 9% higher than it had been for 2019.

The operational profit of the system amounted to GEL 102 million, which was 65% higher year on year. This increase was partly due to the liquidation of one loss-making company, which did not affect 2020 profits.

The ROE of the system is within 10%, the ROA is 3%, and the margin and spread are 14%. Yields were down 2.9 pp from a year earlier, while funds were up 0.4 pp.

DIAGRAM N 6.13 COST OF FUNDS



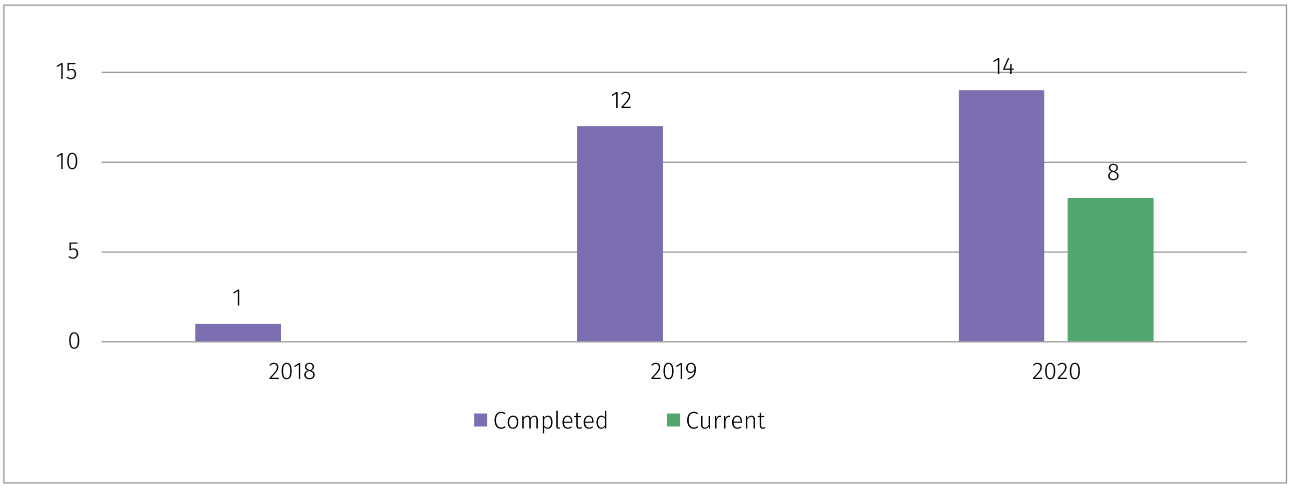
Source: National Bank of Georgia

6.1.2 LIQUIDATION

Since 2018, after the enactment of the regulation related to the liquidation of microfinance institutions, liquidation proceedings for 35 organizations commenced, of which 27 have already been completed. In ten cases, former microfinance institutions changed their form of activity and registered as lending entities. In 2020, the liquidation process was initiated for eight microfinance institutions and was completed for 14.

Following an assessment of the supervisory burden, some of the organizations exiting the microfinance sector decided to relocate to the lending entities sector, where lighter regulations apply. In contrast, lending entities have a more limited scope of activities, including lower access to the resources of individuals, thereby resulting in lesser financial stability risks.

DIAGRAM N 6.14 NUMBER OF MICROFINANCE INSTITUTIONS IN TERMS OF CURRENT AND COMPLETED LIQUIDATION PROCEDURES

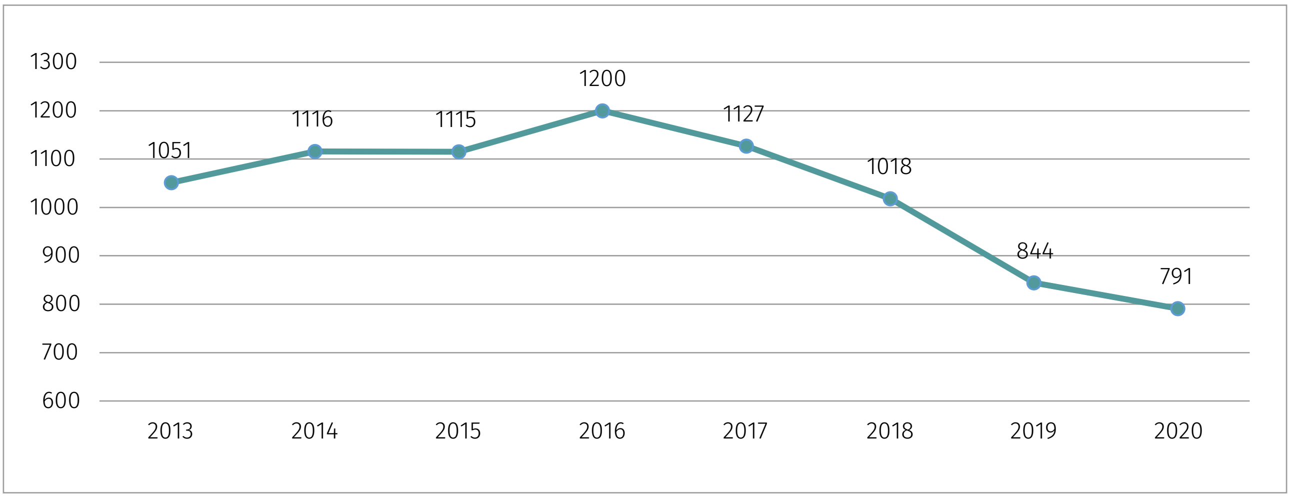


Source: National Bank of Georgia

6.1.3 CURRENCY EXCHANGE BUREAUS

The trend of a decreasing number of currency exchange bureaus continued in 2020. This was prompted by the tightening of registration and supervision requirements, which occurred with the purpose of protecting the rights of consumers and improving the quality of services in this sector. As of 31 December 2020, there were 616 registered currency exchange bureaus, which had branches at 791 locations.

DIAGRAM N 6.15 NUMBER OF CURRENCY EXCHANGE BUREAUS



Source: National Bank of Georgia

6.1.4 CREDIT UNIONS

As of 31 December 2020, one credit union with total assets of GEL 0.55 million continued to operate on the market.

The amendments to the "Law of Georgia on Non-Bank Depository Institutions - Credit Unions", which was made on 23 December 2017, defined the bringing together of individuals residing in the administrative unit of the same self-governing community as one of the principles of credit union activity. The amendments also set a limit of 200 for the maximum number of members of a credit union. The key purpose of the amendments was to unite the members of a credit union around real common goals and needs and not for such unions to merely serve as a mechanism to attract deposits from members.

The above amendments have had a certain impact on developments in the sector over the last three years, with six of the eight licensed credit unions filling written applications for license revocations. Their applications were granted: their licenses were revoked and they went into liquidation. In the case of the seventh union, the revocation of the license and the commencement of liquidation proceedings was linked to the NBG's supervisory actions.

The year 2020 saw some completions of these liquidations processes: of one that was started in 2020 and three that had commenced in previous years.

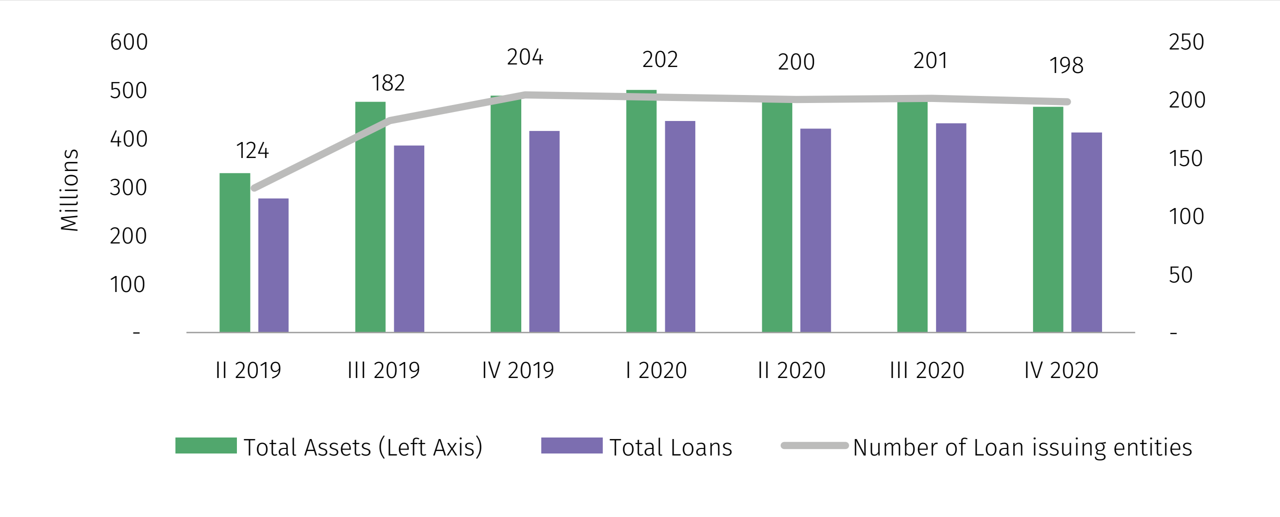
Lending entities

The amendment to the Organic Law of Georgia on the National Bank of Georgia made on 23 December 2017 authorized the NBG to supervise the activities of lending entities. This typically includes the registration and cancellation of registration, inspection and regulation, issuance of written instructions, and the imposition of requirements, restrictions and sanctions. Decree N217/04 of the Governor of the National Bank of Georgia of 27 September 2018 approved the "Regulation on Registration, Cancellation of

Registration, and Regulation of Lending Entities by the National Bank of Georgia". Entities wishing to register as lending entities could start filing applications from 20 December 2018, and the deadline for applicants to register with the National Bank was 30 April 2019.

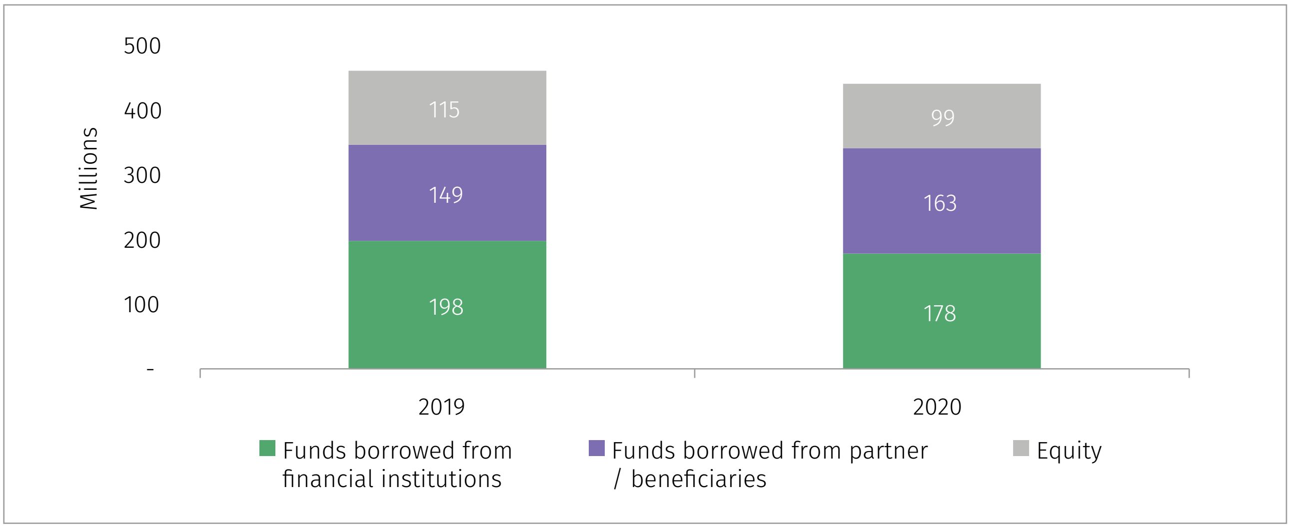
As of 31 December 2020, there were 198 registered lending entities on the market, which operated branches from 367 locations.

DIAGRAM N 6.16 NUMBER OF LENDING ENTITIES, THEIR TOTAL ASSETS AND LOAN PORTFOLIO



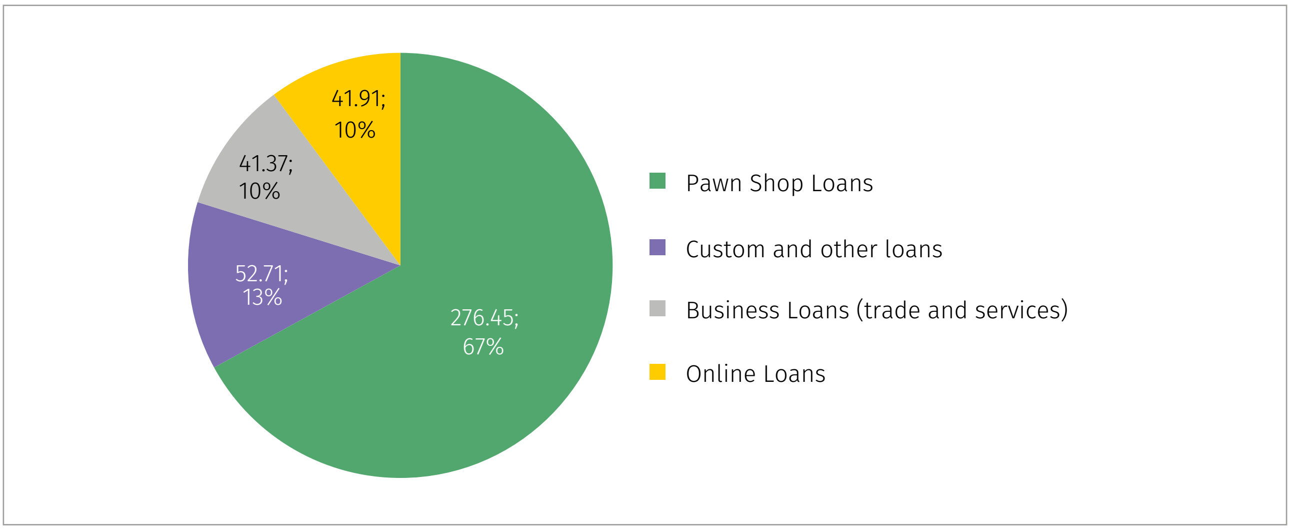
Source: National Bank of Georgia

DIAGRAM N 6.17 SOURCE OF FUNDING FOR LENDING ENTITIES



Source: National Bank of Georgia

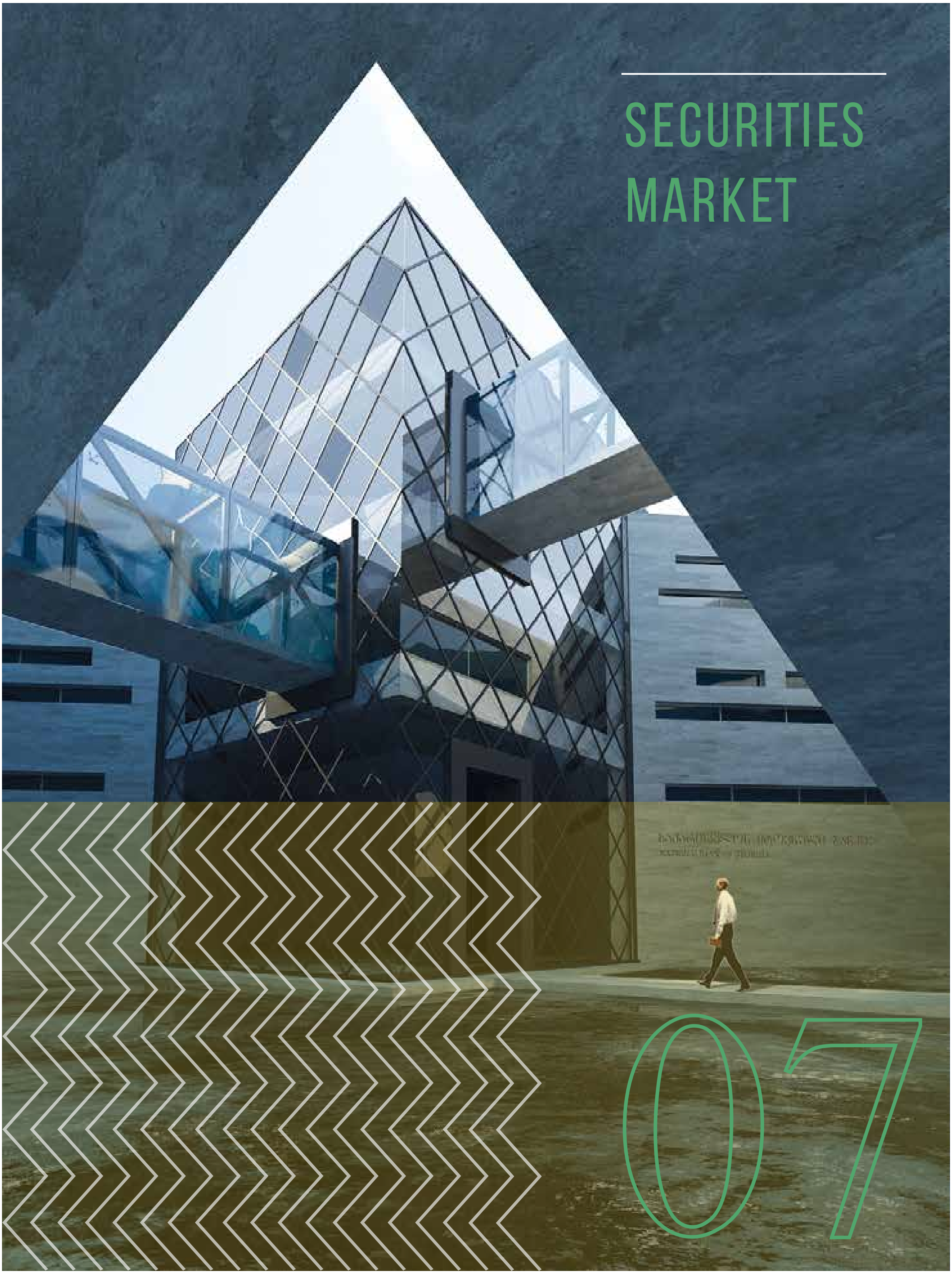
DIAGRAM N 6.18 LOAN PORTFOLIO STRUCTURE OF LENDING ENTITIES



Source: National Bank of Georgia

SECURITIES MARKET

07



7.1 LARGE-SCALE REFORM OF THE LEGISLATIVE AND REGULATORY FRAMEWORK FOR THE SECURITIES MARKET

In 2020, a large-scale reform of the legislative and regulatory framework of the securities market was successfully completed. This was the first large reform since the adoption of the Law of Georgia on Securities Market in 1999. The amendments to this law, adopted on 29 June 2020, and those to the Law of Georgia on Investment Funds, which were adopted on 14 July 2020, are crucial components of the securities market reform. Both draft laws were developed as a result of joint work between the National Bank of Georgia, the Ministries of Economy and Sustainable Development and Finance, the private sector and international financial institutions. These are fully in line with international securities regulations and the IOSCO's principles, while still fully reflecting the level of development of the Georgian capital market and the idiosyncrasies of the country. The amendments to the Law of Georgia on the Securities Market are meant to safeguard investors' interests (through the detection and prevention of untruthful actions and protecting investors from such actions) and raise market transparency standards, which is an important precondition for the development of the capital market. The updated legislation considerably improves the transparency framework for issuers and sets requirements for filing financial information, data on the acquisition of a significant share of issuers, and the publication of inside information. The law provides clarification of what constitutes inside information and defines/prohibits those actions that are considered an illegal disclosure of inside information, insider trading or market manipulation.

The law served as the basis for the NBG to draft legal acts, which explained in greater detail the issues covered by the law, specified the obligations of securities market players, and defined relevant exceptions. The same legislative change also relieved most of the enterprises that had been privatized in the 1990s of additional regulatory pressure.

In 2020, the legislative framework for investment funds was fundamentally upgraded. The Law of Georgia on Investment Funds defines the rules of operation for investment funds and asset management companies. Its scope also extends to entities involved in investing, managing, holding, administering and accounting for investment fund assets. This law is based on basic international principles and regulation models, reflecting certain requirements of both the UCITS (Directive 2009/65/EC of the European Parliament and Council of 13 July 2009) and the Alternative Investment Fund Asset Management (AIFMD) Directive. As part of this reform, the Tax Code also underwent significant changes, with the tax regime for investment funds defined to reflect the experience of the world's leading countries (Ireland and Luxembourg). Along with these legislative changes, the National Bank of Georgia also developed and approved related legal acts.

During 2020, the National Bank of Georgia remained committed to pursuing the actions required for ordinary membership of the International Organization of Securities Commissions (IOSCO), and worked with the organization's selection committee in this direction. The National Bank was granted associate member status of the IOSCO in 2018 and applied for ordinary membership in the fall of 2019. The IOSCO Selection Committee completed its evaluation of the NBG's application at the end of 2020. The National Bank expects to obtain the status of ordinary membership in the organization in the near term.

As international practice shows, the development of the securities market is a long-term process, especially for small countries. The aforementioned legislative changes are necessary, but are not in themselves sufficient for the development of the capital market. The desired result will be attained in the long run.

7.2 SECURITIES MARKET INDICATORS

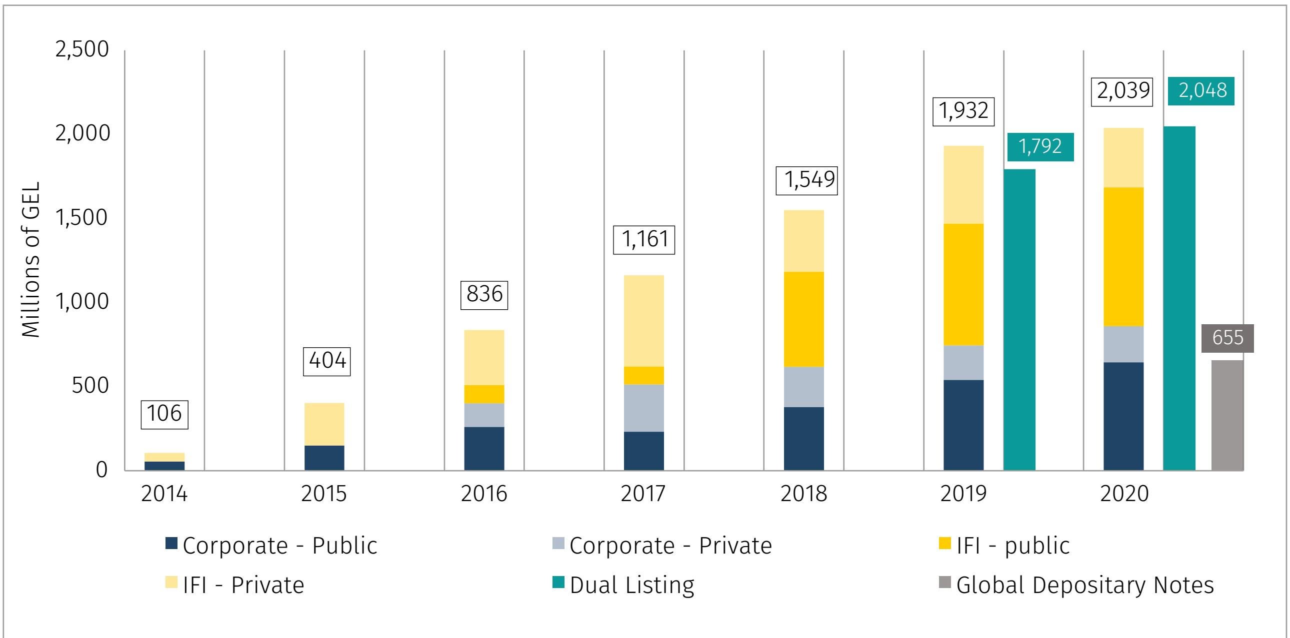
Although the local bonds market has been showing a trend of rapid growth in recent years, the pandemic and subsequent economic developments had a mixed impact on securities market dynamics in 2020.

Corporate bonds market

A downward growth trend of the commercial bond market was observed in 2020 in year-on-year terms. The market segment grew by 5.5%[73] and its size was 4.13% of GDP. Some 58% of commercial bonds issued are GEL denominated bonds of international financial institutions.

In recent years, Georgian local companies listed on foreign exchanges have shown interest in making domestic offerings of securities that have been admitted to trading on reputable international exchanges. In 2019, three corporate bonds admitted to trading on international stock exchanges were offered a dual listing on the stock exchange. Loan depository bonds were issued for one of these, with the involvement of the Central Depository of Georgia at the end of 2020 (see Diagram N 7.1).

DIAGRAM N 7.1 BALANCES OF COMMERCIAL BONDS AT THE END OF PERIOD (2014-2020)

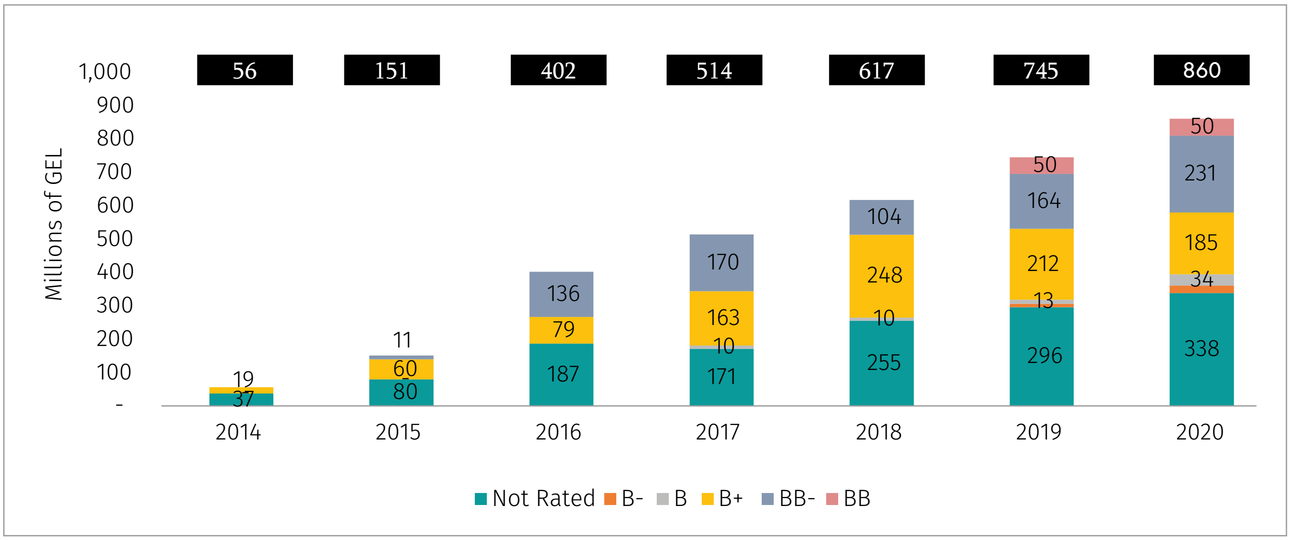


Source: National Bank of Georgia; Georgian Stock Exchange; Bloomberg; other public sources

73. The data includes bonds issued by corporate and international financial institutions by both public and private offerings, except for non-government loan securities/depository bonds offered for dual listing on the Georgian Stock Exchange.

At the end of 2020, 67% (71% in 2019) of corporate bond issuers had earned ratings from international credit rating agencies (Fitch, Scope). This represents 48% of the remaining public bond balance (52% in 2019). Some 50% of the issuers of public bonds with a credit rating had a BB/BB- rating in 2019-2020. In 2020, the credit ratings of two issuers were reduced by one step.

DIAGRAM N 7.2 BALANCE OF CORPORATE BONDS BY INTERNATIONAL CREDIT RATINGS (2014-2020)

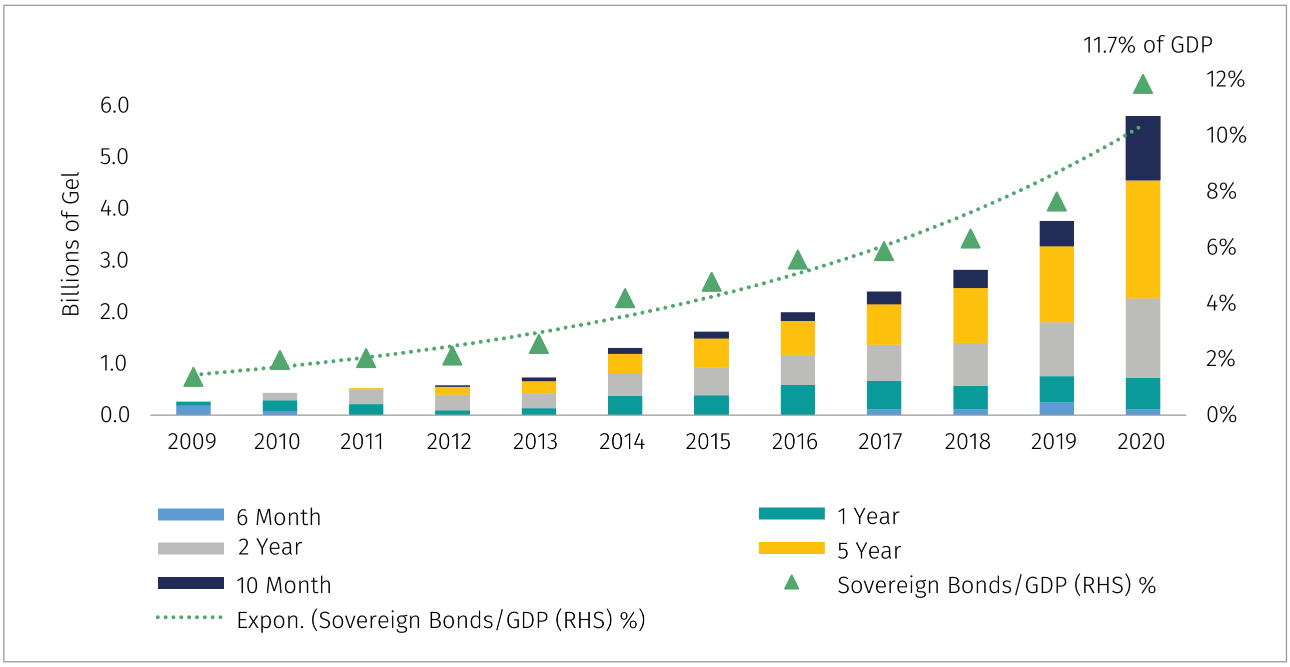


Source: National Bank of Georgia

In contrast to the corporate bond market, 2020 saw the treasury bond market grow considerably (a 54% increase compared to 2019), with its volume reaching 11.7% of GDP (see Diagram N 7.3).

DIAGRAM N 7.3 TREASURY SECURITIES BALANCES BY MATURITY

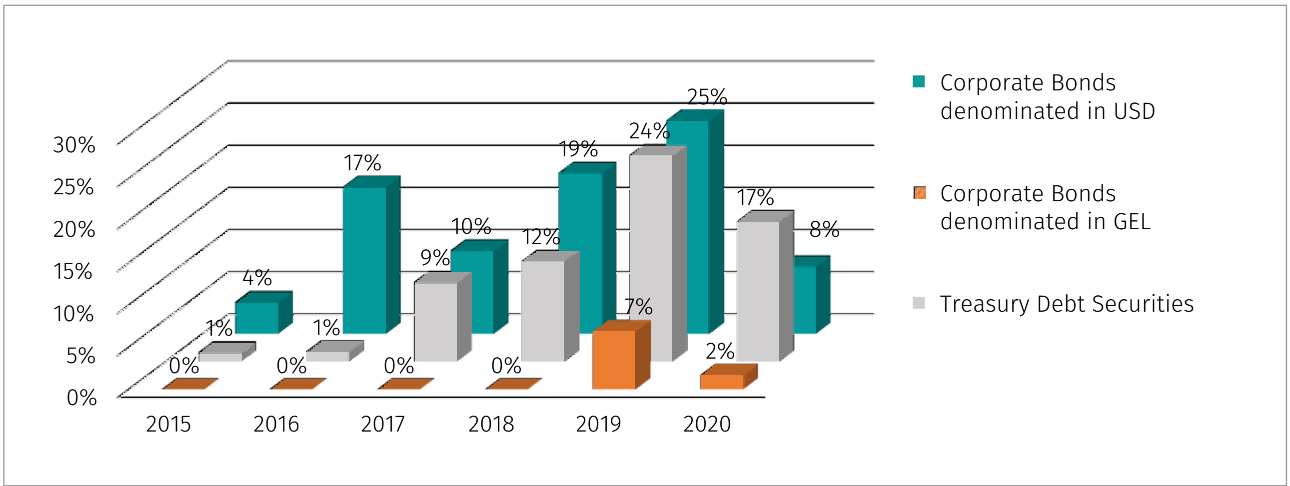
SOVEREIGN BONDS/GDP



Source: Ministry of Finance; GeoStat

Over the past few years, local market liquidity rates have been improving, although bond market liquidity declined significantly in 2020. A large share of treasury bond liquidity is generated by NBG operations; however, in spite of rising interest rates in recent years, and irrespective of a slightly downward trend in 2020, the share of non-resident investors increased significantly (see Diagrams N 7.4 and N 7.5).

DIAGRAM N 7.4 SECONDARY MARKET ACTIVITY FOR DEBT SECURITIES ISSUED IN GEORGIA[74]

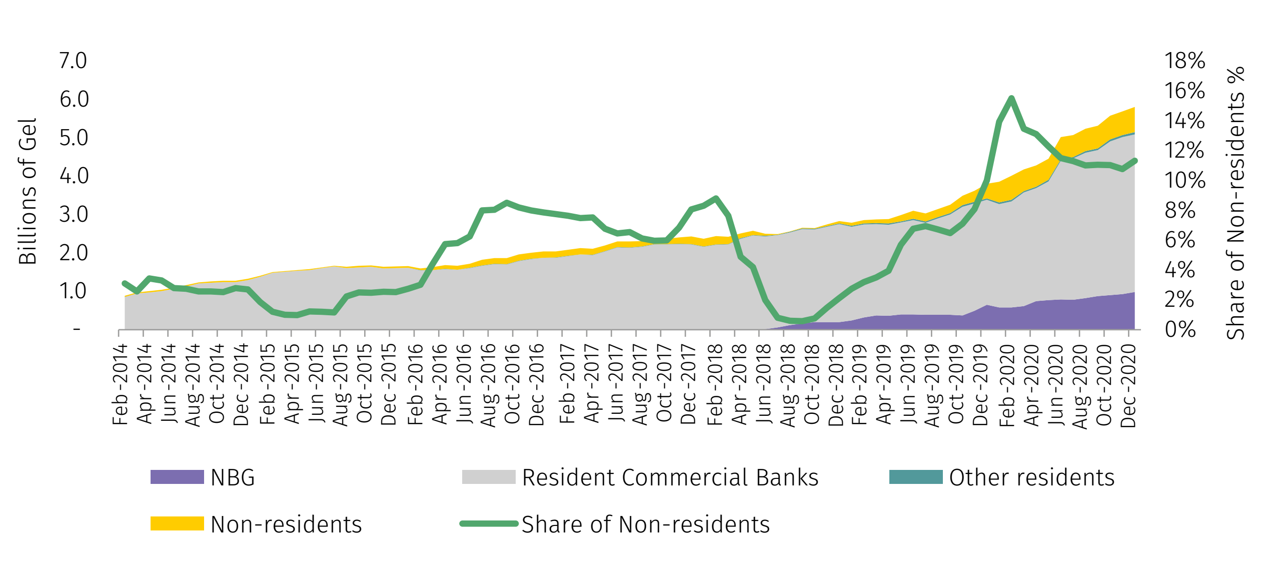


Source: National Bank of Georgia; Georgian Stock Exchange

In 2019, local market liquidity indicators improved, although this indicator differed by segment of the bond market. The liquidity rate of the foreign currency-denominated bond segment of the corporate securities market is much larger than the segment denominated in GEL. As for treasury bonds, in 2019 secondary market transactions skyrocketed in value, mainly as a reflection of the NBG's operations. In addition to higher interest rates, the share of non-resident investors also increased (see Diagram N 7.5).

74. The diagram shows secondary market activity as the ratio of secondary market transactions during the year to the average annual balances of securities.

DIAGRAM N 7.5 DISTRIBUTION OF TREASURY SECURITIES BY OWNERSHIP



Source: National Bank of Georgia; Georgian Stock Exchange

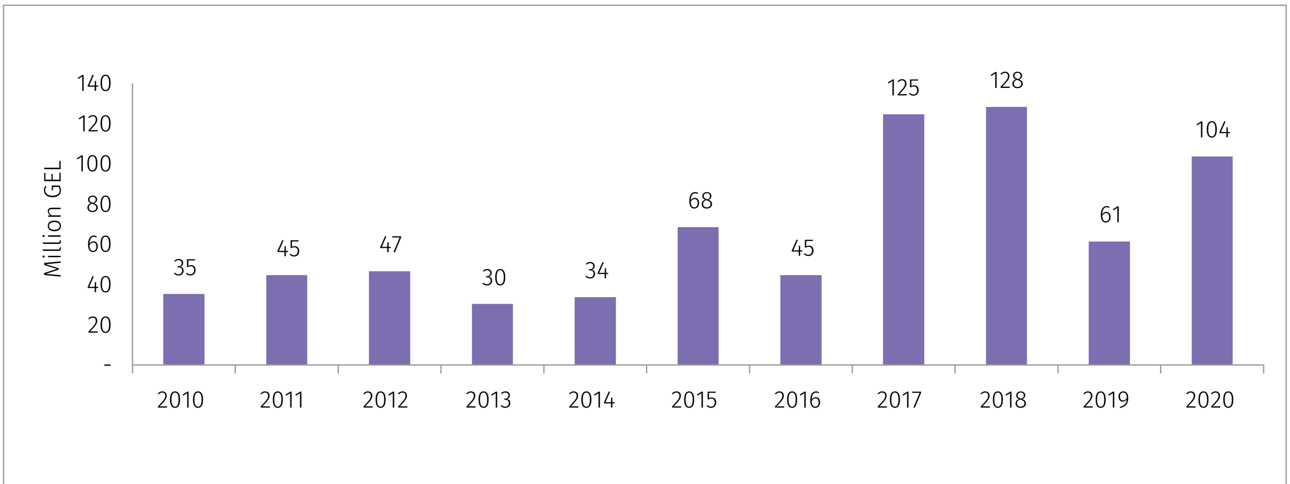
7.3 MARKET PLAYERS

By the end of 2020, there were two stock exchanges, one central securities depository, nine brokerage companies and four independent securities registrars operating in the Georgian securities market. Three of the nine brokerage companies were not members of the stock exchange.

Brokerage companies

As of 31 December 2020, the total assets of brokerage companies amounted to GEL 104 million.

DIAGRAM N 7.6 AGGREGATE ASSETS OF BROKERAGE COMPANIES BY YEAR (2010-2020)

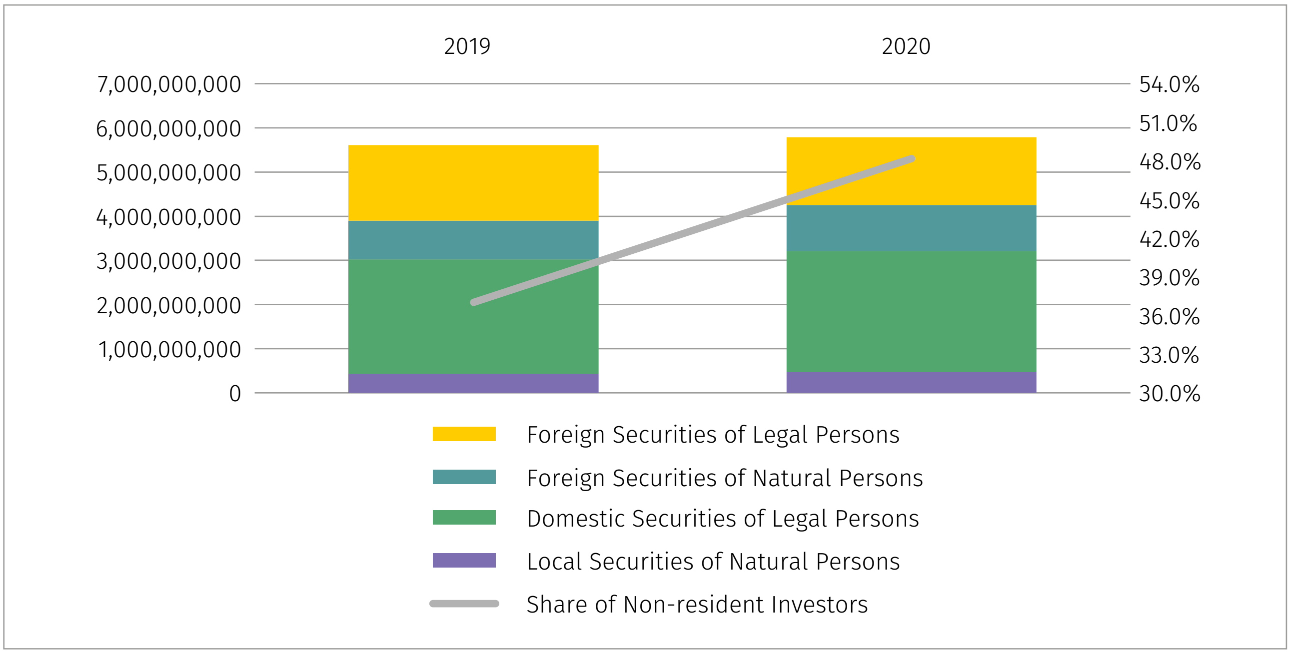


Source: National Bank of Georgia; quarterly and annual financial statements of brokerage companies

The total value of clients' securities on the securities accounts of brokerage companies and commercial banks amounted to GEL 5.8 million at the end of 2020 and increased by 3.2% compared to 2019 (excluding the exchange rate effect). This increase is related to foreign securities accounts, which was largely a reflection of the depreciation of the local currency. Importantly, 48% of client securities balances are non-resident investor accounts. As of the end of 2020, a total of 6,919 clients received brokerage services from brokerage companies and banks, of whom the majority (78%) were resident individuals. At the end of 2020, compared to the same period in 2019, the number of clients of brokerage companies increased by 13%.

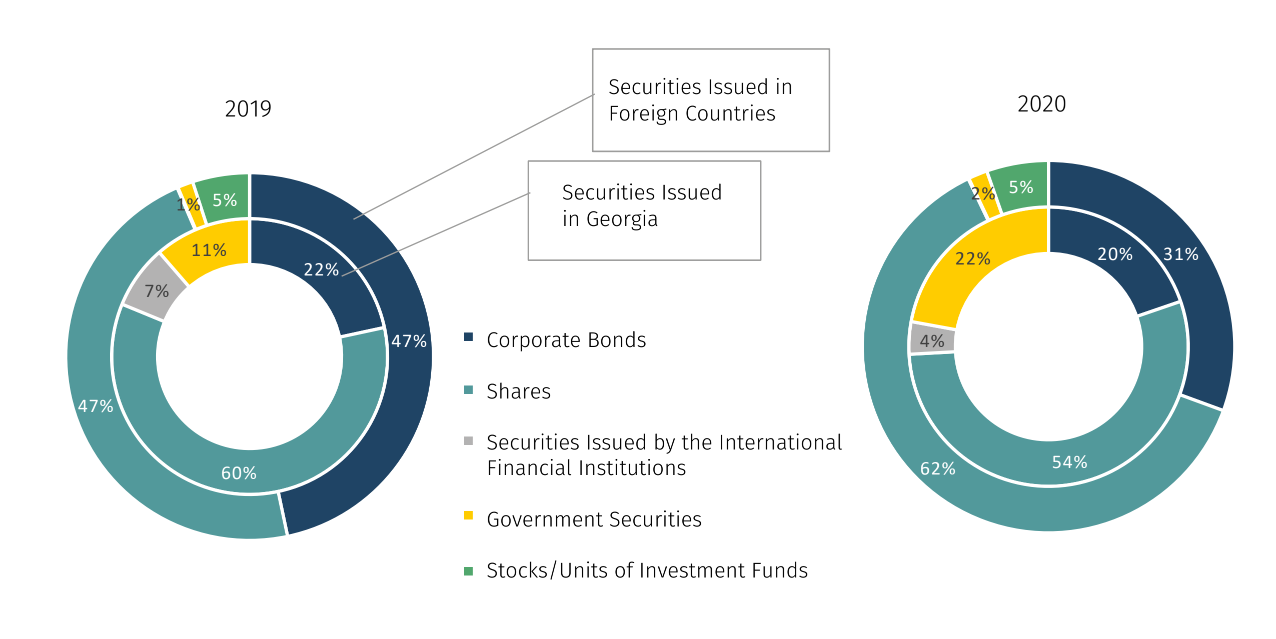
Some 73% of client securities balances and 65% of clients were concentrated in the two largest brokerage firms.

DIAGRAM N 7.7 TOTAL VALUE OF CLIENT SECURITIES ACCOUNTS OF BROKERAGE COMPANIES AND BANKS



Source: National Bank of Georgia; monthly reports of brokerage companies and commercial banks

DIAGRAM N 7.8 DISTRIBUTION OF THE CLIENT SECURITIES PORTFOLIO ON THE SECURITIES ACCOUNTS OF BROKERAGE COMPANIES AND BANKS (SECURITIES ISSUED IN FOREIGN COUNTRIES AND IN GEORGIA)



Source: National Bank of Georgia, monthly reports of brokerage companies and commercial banks

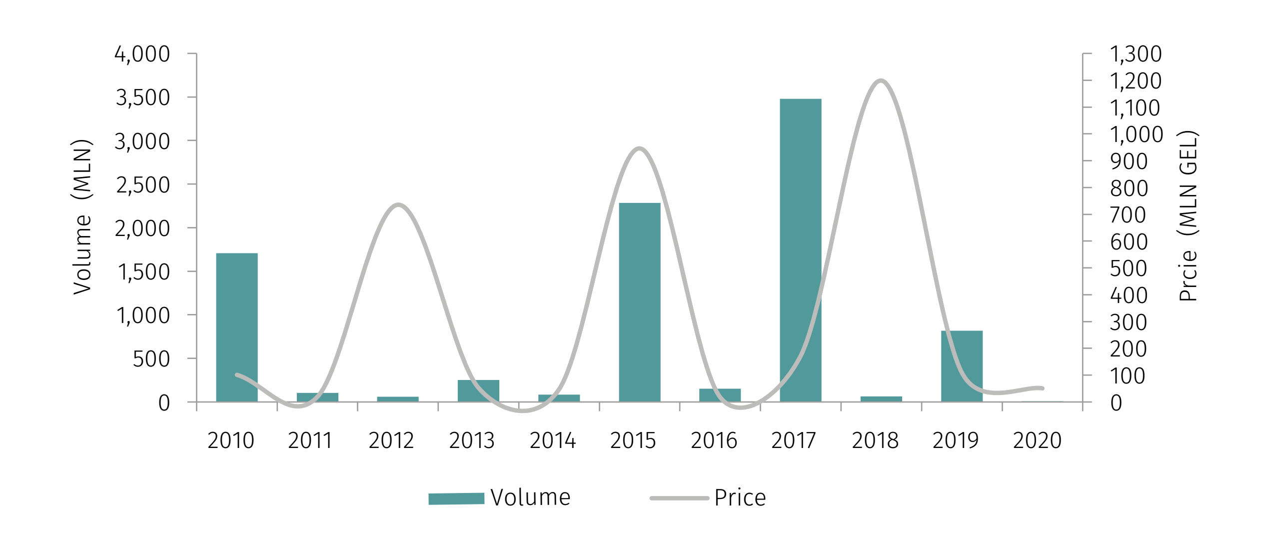
Stock Exchange

As of 31 December 2020, securities of 38 issuers were admitted to the trading system of the Georgian Stock Exchange. The total value of transactions recorded in trading sessions and the stock exchange during the reporting period amounted to GEL 50.8 million (5.9 million units of securities). Of this, a total value of trades executed on stock exchange trading sessions amounted approximately GEL 46 000 and OTC trades registered at the stock exchange amounted GEL 50.7 million. OTC transactions registered at the stock exchange, include 9 trades on 4 659 285 securities made by securities registrars. Total value of transactions amounted GEL 19.7 million.

TABLE N 7.1 AGGREGATE INFORMATION ON TRADES EXECUTED ON STOCK EXCHANGE TRADING SESSIONS AND OTC TRADES REGISTERED AT THE STOCK EXCHANGE (2019-2020)

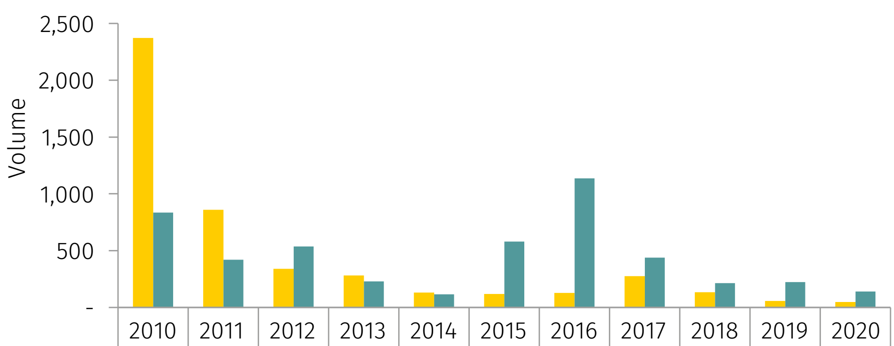
	Number of deals		Number of securities		Value of securities (GEL)	
Year	**2020**	**2019**	**2020**	**2019**	**2020**	**2019**
Stock exchange	48	56	921,086	1,185,044	46,135	45,717
OTC trades registered at the stock exchange	139	224	5,035,697	814,772,528	50,733,190	109,141,165
Total	**187**	**280**	**5,956,783**	**815,957,572**	**50,779,326**	**109,186,882**

DIAGRAM N 7.9 KEY TRADE INDICATORS (TRADES EXECUTED ON STOCK EXCHANGE TRADING SESSIONS AND OTC TRADES REGISTERED AT THE STOCK EXCHANGE) (2010-2020)



Source: Annual Report of the Georgian Stock Exchange

DIAGRAM N 7.10 NUMBER OF TRADES EXECUTED ON STOCK EXCHANGE TRADING SESSIONS AND OTC TRADES REGISTERED AT THE STOCK EXCHANGE BY YEAR (2010-2020)



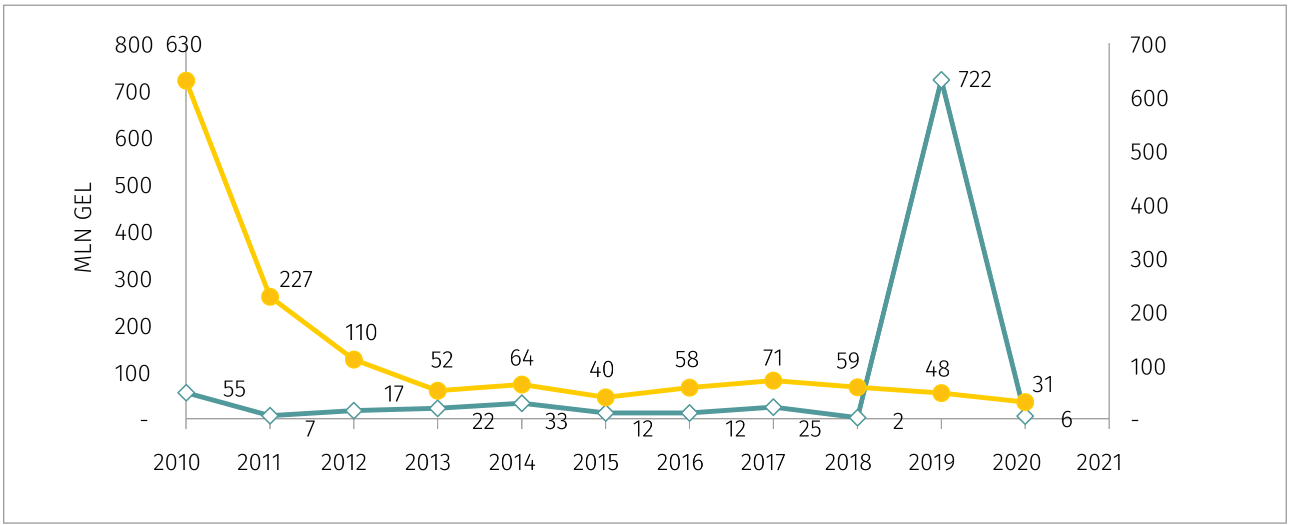
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Stock Exchange Trades	2,372	860	339	283	131	120	127	277	133	56	48
OTC trades registered at the stock exchange	835	421	538	230	115	579	1,135	438	215	224	139

Source: Annual Report of the Georgian Stock Exchange

Central Depository

In 2020, the Central Depository had 5.6 million securities and GEL 0.37 million deposited in it. of this, 83% of cash deposit transactions and 98% of the total amount were made with the participation of JSC Bank of Georgia. The number of transactions on securities deposited with the Central Depository decreased by 35.4% compared to the same period of last year, while the number of securities fell by 715 million units. A total of 33 new accounts were opened with the Central Depository throughout 2020.

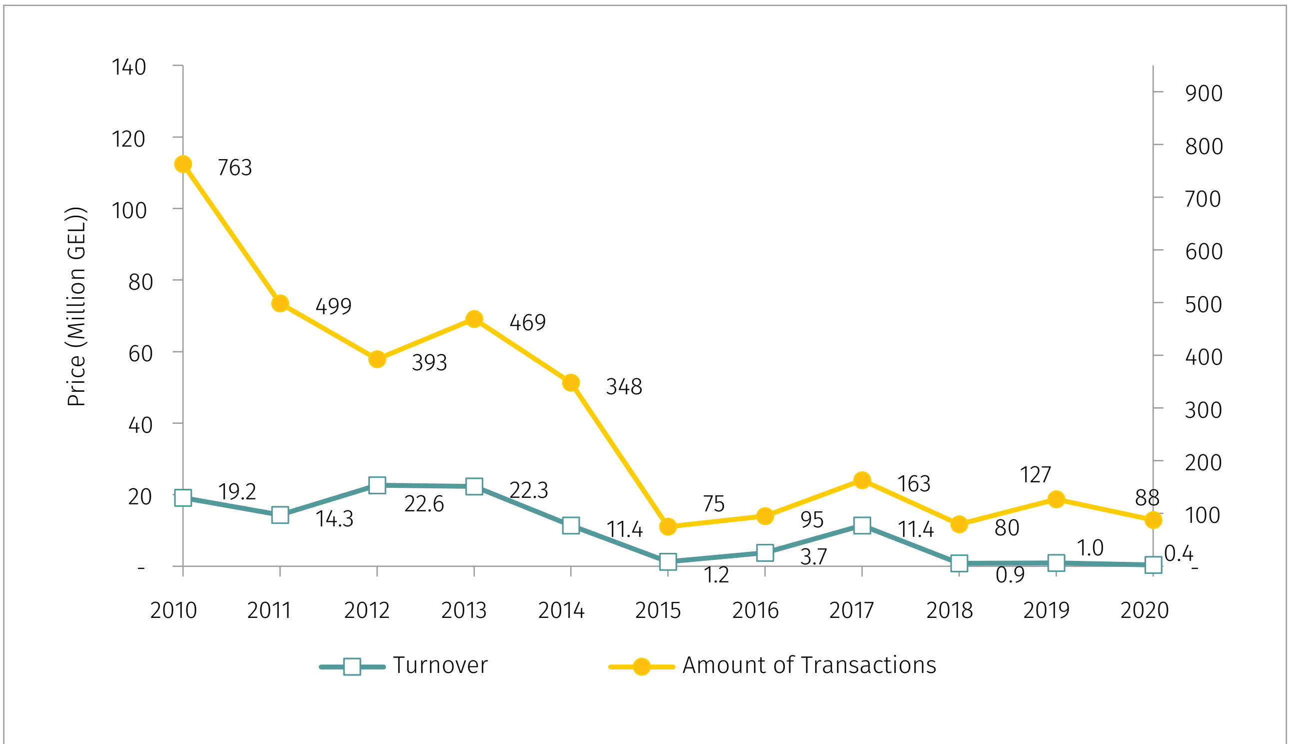
DIAGRAM N 7.11 SECURITIES DEPOSITED WITH THE CENTRAL DEPOSITORY BY YEAR (2010-2020)



Source: Annual Report of the Georgian Central Securities Depository

Cash flow in the Central Depository decreased by GEL 0.6 million in the reporting year, and the number of cash transactions was 31% lower than in 2019.

DIAGRAM N 7.12 FUNDS DEPOSITED AT THE CENTRAL DEPOSITORY BY YEAR (2010-2020)



Source: Annual Report of the Georgian Central Securities Depository

7.4 INVESTMENT ACTIVITIES OF THE PENSION SCHEME

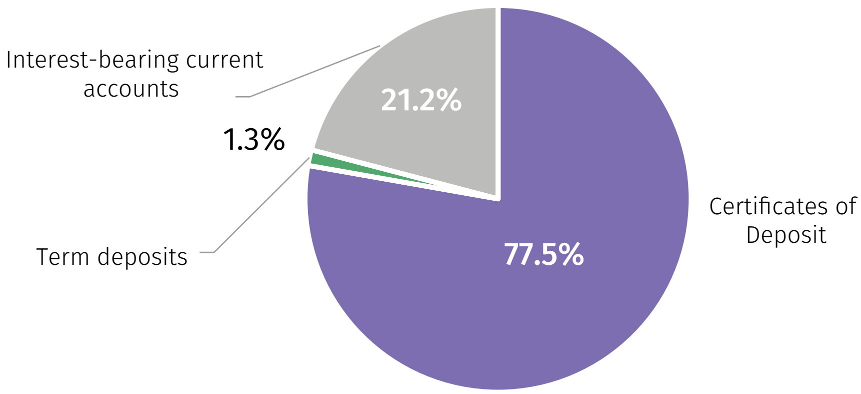
Initiation of the investment process by the Pension Agency

In March 2020, within its temporary investment policy, the Pension Agency started investing, placing funds on Certificates of Deposit and Term Deposits of Georgian commercial banks.

As of 31 December 2020, the pension fund was GEL 1.2 billion, fully denominated in GEL. Of pension assets, 78.8% were placed in Certificates of Deposit and Term Deposits, while 21.2% were used in interest-bearing current accounts.

The accrued interest for 2020 totaled GEL 87 million, which was equivalent to annual returns of about 10.8%.

DIAGRAM N 7.13 DISTRIBUTION OF THE PENSION ASSET PORTFOLIO (31 DECEMBER 2020)

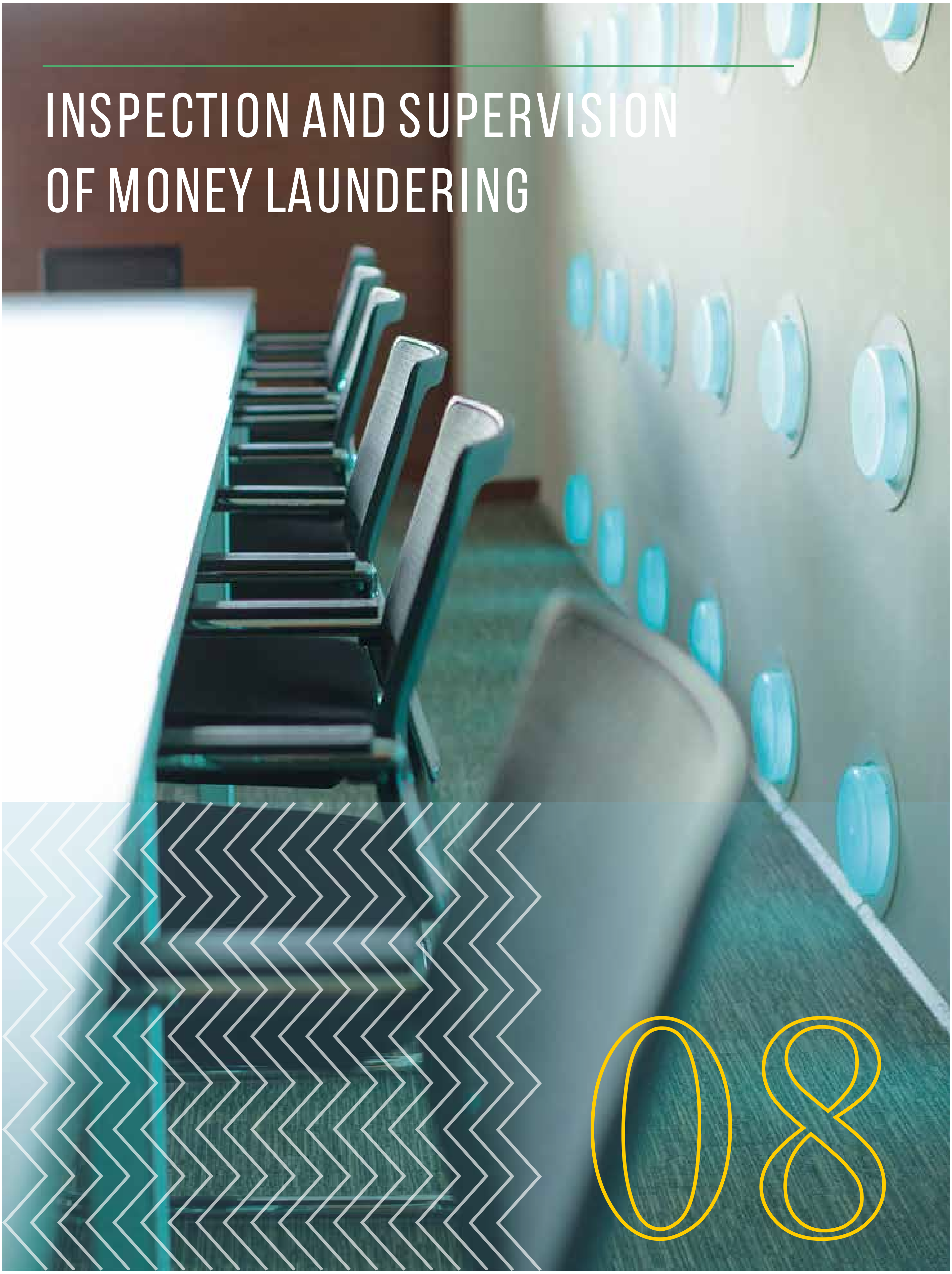


Source: Pension Agency

The Pension Agency devoted 2020 to staffing its Investment Office and organizing business processes related to investment. The Senior Investment Officer and Deputy Senior Investment Officer of the Pension Agency were selected by the Investment Board. The Pension Agency's Investment Board approved an Investment Policy Document that outlined the framework for managing and investing in pension assets, while defining a long-term strategy for asset placement. The Investment Policy Document also defined the benchmark portfolio used to assess returns on the less risky investment portfolio.

The benchmark portfolio consists of three classes of assets: Georgian treasury bonds (25%), lari deposits/Certificates of Deposit (60%) and foreign stocks (15%). The process of bringing the current investment portfolio closer in line with the benchmark portfolio will begin in 2021, after the pension agency is able to receive the services of a specialized depository. At the decision of the Investment Board of the Pension Agency, a competition for the selection of a specialized depository was re-announced in 2020 and the selection process will be completed in 2021.

INSPECTION AND SUPERVISION OF MONEY LAUNDERING



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In line with the levels of supervisory attention stipulated under the Supervisory Framework for Combating Money Laundering and Terrorism Financing, the National Bank of Georgia set out effective risk-based supervisory measures for supervised entities throughout 2020.

In order to determine the required levels of supervisory attention, the National Bank of Georgia applies a continuous process of identifying and assessing risks through off-site means. During 2020, for the purposes of combating money laundering and terrorism financing, the National Bank of Georgia received and processed relevant reports from each monitored entity twice. In the reporting year, off-site supervision of loan issuing entities was introduced. To this end, a "Rule on Completion of Money Laundering and Terrorism Financing Risk Supervision Report and Submission of Information by Loan Issuing Entities" was developed and approved.

Supervisory actions carried out during 2020 included both complex and thematic, as well as special and follow up type on-site inspections. It should be acknowledged that the use of off-site follow-up supervisory controls introduced by the National Bank of Georgia significantly reduced the negative impact of the pandemic on the supervision process.

During the reporting year, in light of the threats and weaknesses identified on a sectoral level, on-site inspections were focused on the following topics:

For commercial banks

- The process of risk classification and the implementation of appropriate preventive measures.
- The process of identifying and verifying beneficial owners of clients with complex ownership structures.
- Awareness of the commercial bank concerning clients related to free industrial zones, offshore and high-risk jurisdictions through their ownership (control) structures, as well as transactions related to such zones and the parties involved.
- The effectiveness of the risk management process associated with internet acquiring.
- The effectiveness of the process determining the source of cash.
- The effectiveness of the process of detecting suspicious/unusual transactions (including the process of detecting the use of fictitious companies/companies utilized for transit purposes, measures taken to implement UN resolutions (TF/proliferation), software adequacy, and bank awareness of transactions carried out by non-profit and charitable legal entities).

For payment service providers

- The process of risk classification and the implementation of appropriate preventive measures.
- Risks related to the products offered and the effectiveness of mitigation measures.
- The effectiveness of the process of detecting suspicious/unusual transactions (including measures taken to implement UN resolutions (TF/proliferation), and software adequacy).
- The effectiveness of the risk management process related to correspondent relations.
- Examination compliance with the instructions of the National Bank of Georgia (the risk management process associated with international P2P transactions and crypto-assets).
- Examination of the accuracy of completed reporting forms.

For brokerage companies

- The process of risk classification and the implementation of appropriate preventive measures.

- The process of identifying and verifying beneficial owners of clients with complex ownership structures.
- Knowledge of intermediaries and the adequacy of the process of monitoring transactions conducted through them.
- The effectiveness of the process of detecting suspicious/unusual transactions (including measures taken to implement UN resolutions (TF/proliferation), and software adequacy).
- The adequacy of the risk management process related to Forex activities.
- The effectiveness of the process determining the source of cash.
- Examination of the accuracy of completed reporting forms.

For microfinance organizations

- The process of classification and the implementation of appropriate preventive measures.
- Knowledge of cross-border transactions (including offshore and high-risk jurisdictions).
- The effectiveness of the process of detecting suspicious/unusual transactions (including measures taken to implement UN resolutions (TF/proliferation), and software adequacy).
- The effectiveness of the cash flow origination process.
- Examination of the accuracy of completed reporting forms.

Currency exchange bureaus

- The process of risk classification and the implementation of appropriate preventive measures.
- The process of identifying and verifying beneficial owners of clients with complex ownership structures.
- The effectiveness of the process of detecting suspicious/unusual transactions (including measures taken to implement UN resolutions (TF/proliferation), and software adequacy).
- Examination of the accuracy of completed reporting forms.

During 2020, 23 representatives of the financial sector were inspected, including 10 entities whose inspections began in 2019 and were finalized in 2020. The total amount of fines imposed for violations of the Georgian anti-money laundering and combating the financing of terrorism legislation amounted to GEL 584,000.

TABLE N 8.1 AMOUNT OF FINES (2020)

Financial Sector	Fine (GEL)
Commercial Bank	276,000
Microfinance Institution	271,000
Payment Service Provider	21,000
Currency Exchange Bureau	16,000

It is important to point out that, in order to ensure an improvement of the deficiencies identified during the inspections, the Money Laundering Inspection and Supervision Department of the National Bank of Georgia initiated off-site follow-up inspections of 43 entities in 2020.

The implementation of preventive supervisory measures is essential for the National Bank of Georgia. These measures ensure informing financial sector representatives about supervisory expectations on a regular basis and serve to increase their level of compliance.

In order to raise the culture of compliance in supervised sectors, the NBG developed the "Rule on Examination of Client's Ownership and Control Structure and the Identification and Verification of Beneficial Owner of Client". The rule determined the identification data, information and documents that should be obtained by the obliged entity under supervision of the National Bank for the purpose of understanding the client's ownership and control structure and identifying and verifying the beneficial owner. The rule also describes the procedure for recording, updating and certifying these data, information and documents. Representatives of the financial sector were actively involved in the process of drafting this regulation. Meetings were held with banking sector representatives to discuss issues related to practice and those concerning international requirements.

During 2020, the National Bank of Georgia organized training sessions on customer due diligence measures and ML/TF risk re-assessment for representatives of payment service providers, microfinance organizations, credit unions, securities registrars, brokerage companies and currency exchange bureaus.

In addition, meetings with representatives of the financial sector were held throughout the year in order to share information about threats and vulnerabilities identified in relevant sectors, as well as to introduce supervisory expectations. Co-operation with loan issuing entities also took place for the purpose of introducing current legislative requirements and supervisory expectations.

The financial sector has shown increased demand for online services. During 2020, 26 entities under the supervision of the National Bank submitted 42 electronic identification projects for consideration in order to enable them various services remotely. Each project submitted was individually reviewed by the Money Laundering Inspection and Supervision Department.

In 2020, the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) approved the Fifth Round Evaluation Report of Georgia. The report evaluates anti money laundering and counter terrorism financing (AML/CFT) measures in Georgia, the technical compliance of the country's legal and institutional framework with the 40 recommendations of Financial Action Task Force (FATF), and the level of effectiveness of the country's AML/CFT system.

Georgia's Fifth Round Assessment Report highlighted the progress that had been made since the previous MONEYVAL visit (in 2011) in terms of the effectiveness of the National Bank of Georgia's supervisory approach and the increased compliance of the financial institutions under its supervision. The report noted the following:

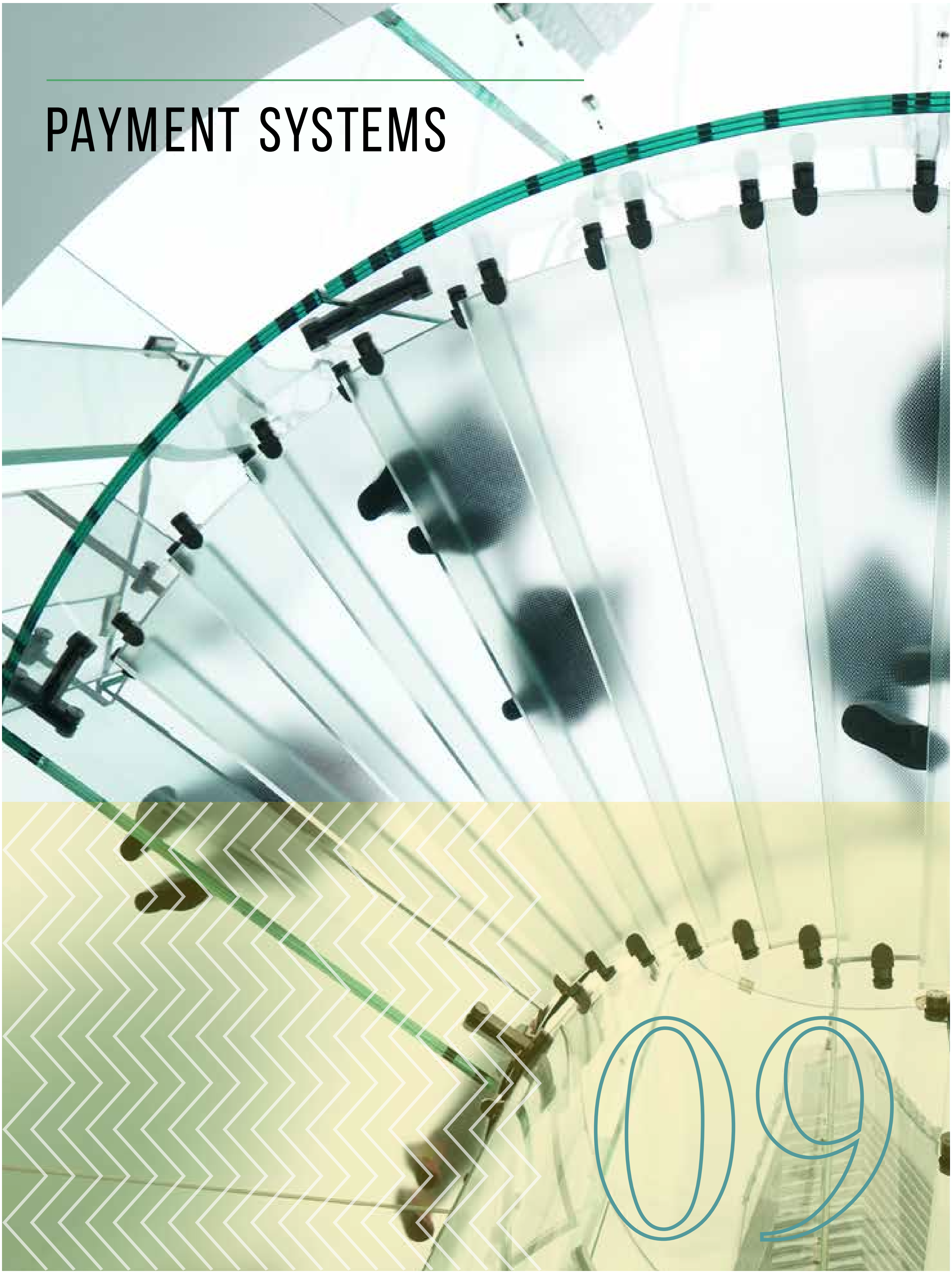
- The approach of the National Bank of Georgia towards AML/CFT supervision has significantly improved and is currently fully risk based. The National Bank has a comprehensive understanding and knowledge of the risks inherent to both individual financial institutions and the sector.
- The National Bank has established an effective supervisory cycle and conducts a proportionate number of inspections based on the size and importance of the sectors under supervision. The National Bank utilizes its supervisory instruments effectively.
- The National Bank has a broad range of supervisory measures. The sanctions regime is effective, proportionate and, at the same time, preventive.

- The Money Laundering Inspection and Supervision Department is adequately resourced and staffed with qualified personnel.
- At the licensing/registration stage of supervised financial institutions, the National Bank applies appropriate "fit and proper" checks, including an in-depth review of the reputaion of these institutions.
- The National Bank effectively combats systemic challenges (by closing the accounts of fictitious companies or refusing to establish business relationships). It also issues general recommendations (warnings) for certain sectors about the risks associated with virtual asset service providers, e-commerce and gambling businesses.
- Due to the efforts of the National Bank, the AML/CFT compliance function is considered a priority in banks and major non-bank financial institutions. These entities have sophisticated AML/CFT internal controls that include well-structured compliance and audit functions, as well as training programs.
- Financial institutions, for the most part, are aware of the risks, threats and vulnerabilities inherent to the sector. Their assessments essentially match those of the National Bank.
- Financial institutions, who are members of a large banking or other financial groups, have developed effective internal control systems and controls for risk management. In addition, they have implemented sophisticated electronic systems for sanctions screening and transaction monitoring.
- Representatives of commercial banks demonstrated an adequate understanding of the risks associated with correspondent relations, politically exposed persons and high-risk jurisdictions, and demonstrated a sound level of understanding of managing such risks through enhanced measures.

According to the report, the adequate understanding of risks by the supervised population and their level of compliance with the AML/CFT requirements, is dependent on the supervision process of these entities. According to the committee, the National Bank of Georgia demonstrated the proven impact of its supervisory policy on the compliance level of the entities under its supervision. This, consequently, significantly contributed to the positive evaluation of the recommendations and immediate outcomes, in which the effectiveness of the supervisory approach of the National Bank of Georgia was evaluated together with those of other sectors (IO.3. IO.4). In the course of the MONEYVAL Fifth Round Mutual Evaluation process, the supervisory measures undertaken by the National Bank of Georgia and the increased compliance level in the financial sector became decisive factors leading to a positive assessment of the country in terms of supervision effectiveness.

In terms of technical compliance, the legislative and supervisory framework of the National Bank of Georgia is in full compliance with the FATF's recommendations, which was a crucial factor in the assessment of Recommendation 26 (Regulation and Supervision of Financial Institutions). Given the effectiveness of its legal framework and considering the materiality of the sectors under its supervision, the assessment represents a significant achievement of the National Bank of Georgia.

The evaluation committee also emphasized the significant positive impact of the National Bank of Georgia made in the implementation of the United Nations' sanctions regime (UNSCR). According to the report, the National Bank demonstrated its capacity to examine issues related to compliance with terrorism financing-related targeted financial sanctions (TFS) requirements within the scope of on-site inspections and by applying appropriate sanctions in the event of violations. This, according to MONEYVAL, impacts the effective implementation of the UN TFS regime.



PAYMENT SYSTEMS

09

The efficient and smooth functioning of payment systems is a precondition for the stability of the financial sector and the development of the national economy. The development of digital technologies has a particular impact on the diversity of payment methods, which are playing an increasingly important role in the daily lives of each customer. Smartphones, in particular, play an increasing role in payment processes for purchases of goods and services, and providers of payment services thus strive to make the payment process simpler and more convenient. The planned legislative changes, which are in line with the EU Payment Services Directive (PSD2), will facilitate the emergence of new players on the payment market, especially from the non-banking sector. New payment services, along with the instant payment system, will encourage innovative business models and spark competition in the payment market. Although digital technologies have diverse capabilities, they also carry risks. Therefore, the development of an appropriate regulatory framework and supervision function is becoming increasingly important. The National Bank of Georgia has developed several legal acts in this regard:

1. In the course of 2020, the draft regulation on strong customer authentication was further improved. Following extensive and thorough consultations with relevant market players, the "Regulation on Strong Customer Authentication" was approved by decree №156/04 of the Governor of the National Bank of Georgia on 2 September 2020. The purpose of the regulation is to ensure secure user authentication for payment services, to protect the privacy and integrity of a user's customized security features, and to reduce the risks of fraud and other illegal activities. The regulation also includes transitional provisions to ensure smooth and effective implementation, and to help payment market players comply with the strong customer authentication measures step by step, in a timely and consistent manner. This is particularly important for the protection of users and their funds, including when obtaining services from third-party service providers (providers of account information services and payment initiation services).

2. A new regulation on card instruments, which has been in force since September 2020, established a unified approach to the payment market for all entities that issue card instruments or provide acquiring services (commercial banks, microfinance institutions and payment service providers registered with the NBG).

The definition of a card instrument encompasses all innovative card products on the market: virtual/digital cards, mobile apps, stickers, watches and more. The new regulation provides the legislative-level definition of the concept of multi-functional card co-badging, which allows the availability/functionality of diverse payment schemes on a single card (for instance, conventional card and innovative instant payment schemes). The regulation also covers the other side of the card business – acquisitions. It regulates relations between the trade/service points and acquirers. To further promote electronic payments at these points, it introduces the concept of new entities – sub-acquirers, which are known in the global market as payment facilitators.

Protection of consumer rights is an important part of the regulation, which covers issues such as the deadlines for reviewing consumer complaints; issues related to currency exchange; mandatory components of the service agreement, including the provider's obligation to inform the customer about the terms of use for the card instrument; and fraud protection mechanisms.

3. Pursuant to the Association Agreement between Georgia and the European Union, the

National Bank of Georgia continues to work on the implementation of the Payment Services Directive (PSD2 – EU Directive 2015/2366 on payment services). In 2020, a draft law on amendments to the Law of Georgia on Payment Systems and Payment Services was under discussion with representatives of the private sector. The amendments address the protection of consumers' rights in cases of unauthorized and/or improperly performed transactions and the issue of access to the payment system. It is expected that the amendments will put both banking and non-banking institutions (payment service providers) under the same conditions. In addition, the changes address the market entry and regulation of new market players (providers of account information and payment initiation services), allowing customers to receive more flexible payment services.

4. In 2020, in parallel with drafting of amendments to the Law of Georgia on Payment System and Payment Services, work was underway on the "Regulation on Uniform and Secure Open Standards of Communication". The draft regulation was discussed with market representatives, where views and opinions were exchanged. The regulation is meant to provide effective and secure communication when providing new types of payment services, account information services and payment initiation services, and to ensure the development and promotion of innovative products.

5. Work also continued on establishing a regulatory framework for the supervision of payment service providers. A regulation on calculating the initial and working capital of a payment service provider was drafted to ensure harmonization with the European directive. The goal of the regulation is to promote financial stability of payment service providers in Georgia. It determines startup capital requirements, working capital requirements, and working capital calculation procedures and methods. Compliance with these requirements will be mandatory for entities interested in registering as a payment service provider, as well as for all payment service providers already registered with the National Bank of Georgia, including electronic money providers.

6. In 2020, work began on the implementation of the provisions of the EU Payment Account Directive (Directive 2014/92/EU). The NBG's website will feature information on fees for payment account services (an initial list has already been prepared). This is meant to help customers compare fees offered by various providers and to make informed decisions. This will ultimately lead to enhanced competition between commercial banks and enable improved services for customers. It is further planned to introduce a standardized approach for the disclosure of information on customer service fees.

Experts from the Central Bank of Poland, the Polish Financial Supervisory Authority and the Central Bank of Lithuania all supported the National Bank of Georgia the development of the aforementioned legal acts. This international cooperation, which involved consultations and the sharing of practices and experience, was part of the ongoing twinning project.

The Real Time Gross Settlement (RTGS) system self-assessment process was updated on the basis of the CPMI-IOSCO principles for financial market infrastructure. Compared to the previous self-assessment, which was conducted in 2018-2019, the rating of certain principles improved, especially in terms of establishing a comprehensive risk management framework and improving information publicity. Currently, with the support of World Bank experts, the self-assessment process of the National Bank and private central depository systems is underway. In addition, the adoption of the legal act defining the categories of payment systems and oversight is planned.[75] The regulation will extend to systemically important and prominently important payment systems. The latter includes card payment systems, which play a major role in retail payments. The legal act is based on financial market infrastructure principles and the ECB's oversight standards for payment systems.

TRANSACTIONS IN THE RTGS SYSTEM

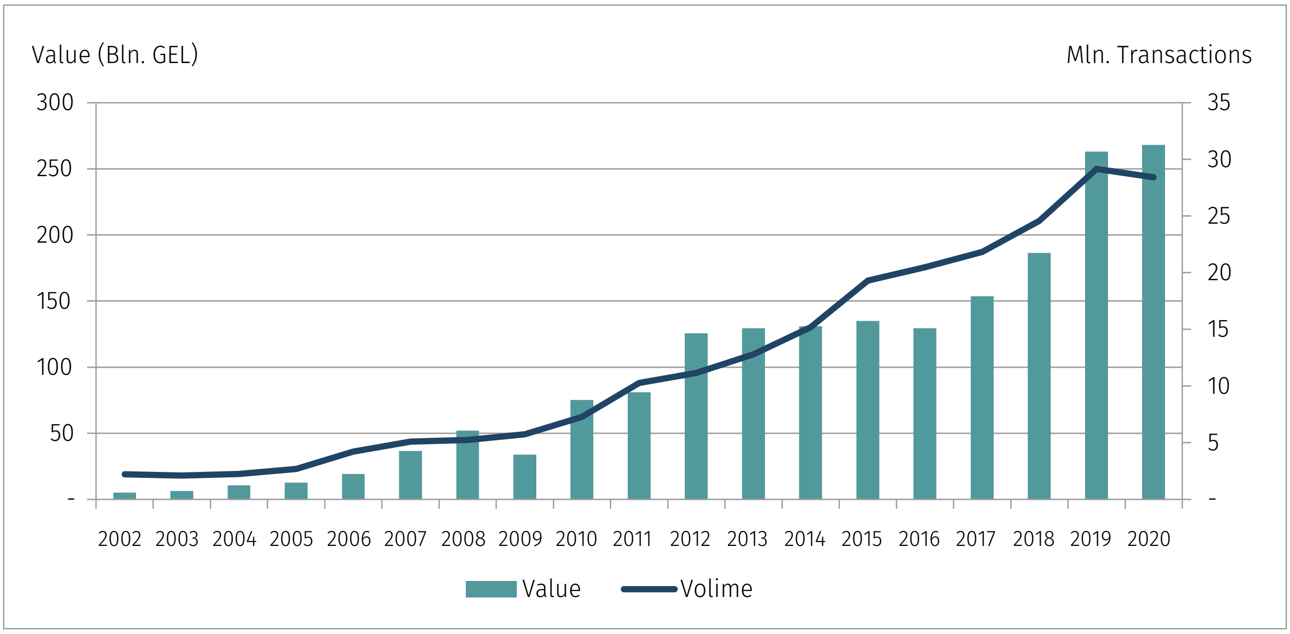
The Real Time Gross Settlement (RTGS) system operated by the National Bank of Georgia represents a key mechanism for interbank settlements in the national currency. The smooth operation of the RTGS system is thus a key precondition for the frictionless functioning of the financial sector and the whole economy. In 2020, as in previous years, the system's continuity was ensured at a high level, with the availability rate for RTGS participants standing at 99.9%. This is significant considering the role that the RTGS system plays as a settlement agent for other systems. 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. The participants of the RTGS system comprise 15 commercial banks licensed in Georgia, the National Bank of Georgia and the Treasury Service of the Ministry of Finance.

Throughout 2020, 28.4 million payment operations were processed through the RTGS system, amounting to GEL 268 billion. This exceeded the corresponding figure from 2019 by 2% in terms of value, but saw a reduction of 2.5% in terms of volume. The value of payments among commercial banks decreased by 14.8%. In terms of volume, the decline was mainly due to a decrease in the number of payment transactions between commercial banks and the treasury (which saw a 11% decrease compared to the corresponding figures for 2019).

The dynamics of the value and volume of RTGS payments are presented in Diagrams N 9.1 – N. 9.4 below.

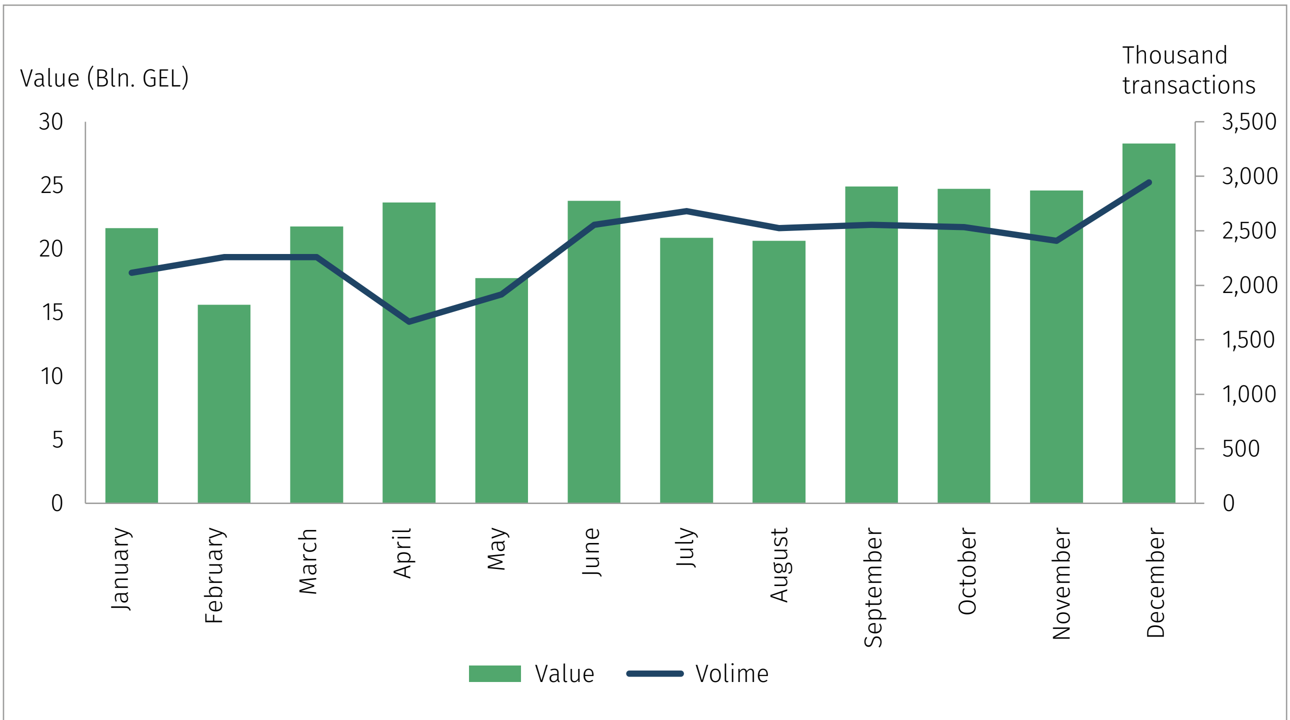
75. The oversight of payment and settlement systems is a function of a central bank through which security and efficiency objectives are achieved by monitoring current and upcoming systems, assessing the achievement of these objectives and, if necessary, initiating changes. See The Committee on Payment and Settlement Systems of G10 Central Banks, "Central bank oversight of payment and settlement systems", 2005, p. 1. para. 1.

DIAGRAM N 9.1 RTGS DYNAMICS OF OPERATIONS (2002-2020)



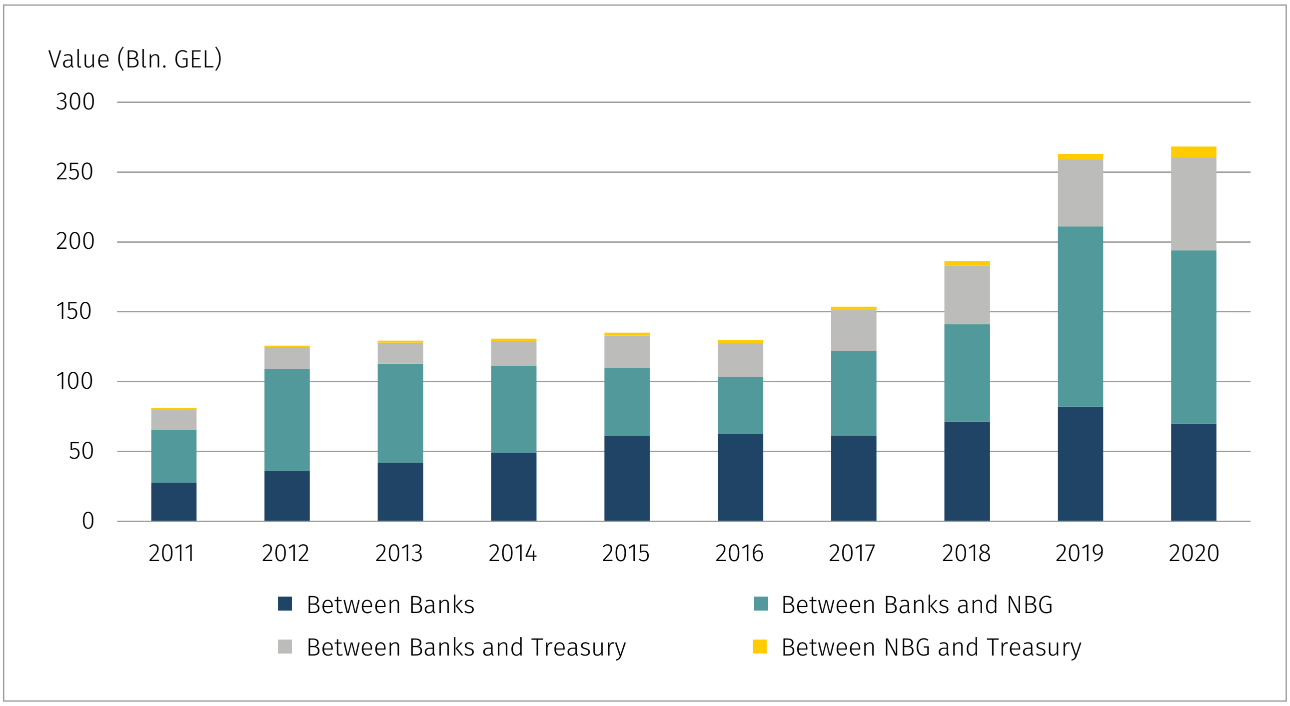
Source: National Bank of Georgia

DIAGRAM N 9.2 RTGS OPERATIONS (2020)



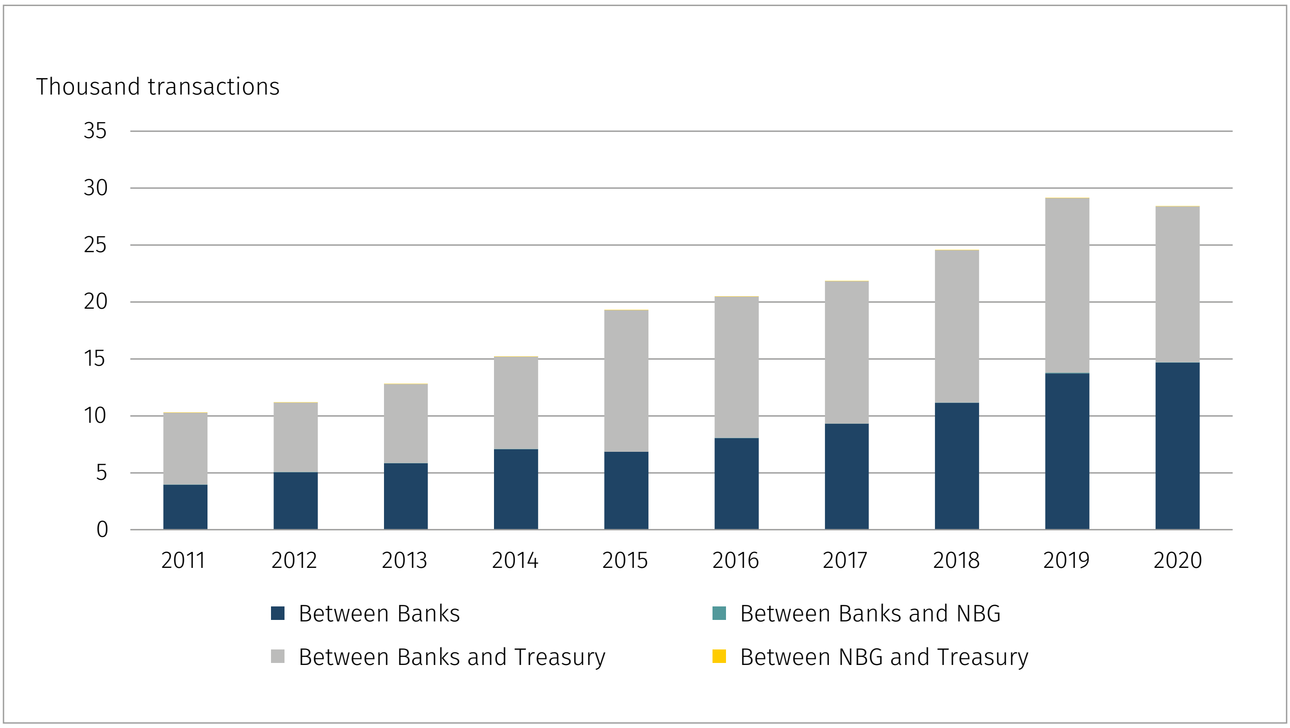
Source: National Bank of Georgia

DIAGRAM N 9.3 VALUE OF RTGS OPERATIONS BY PARTICIPANTS (2011-2020)



Source: National Bank of Georgia

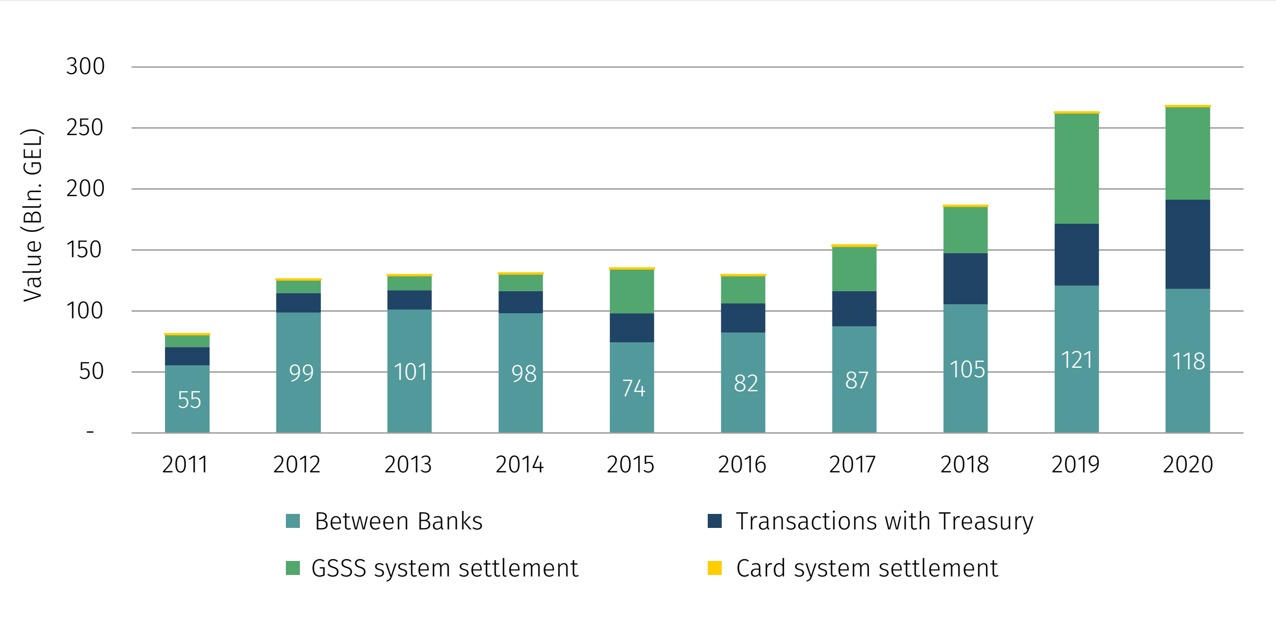
DIAGRAM N 9.4 VOLUME OF RTGS OPERATIONS BY PARTICIPANTS (2011-2020)



Source: National Bank of Georgia

As in previous years, the role of the RTGS system as a payment mechanism for other systems remained important. In 2020, the share of final settlement transactions for other systems in total RTGS transactions was 29% (see Diagram N 9.5), which is 6 percentage points lower than in 2019. Such a decrease was mainly due to a decline in overnight loans on demand in the National Bank GSSS system (a 25% decrease compared to 2019).

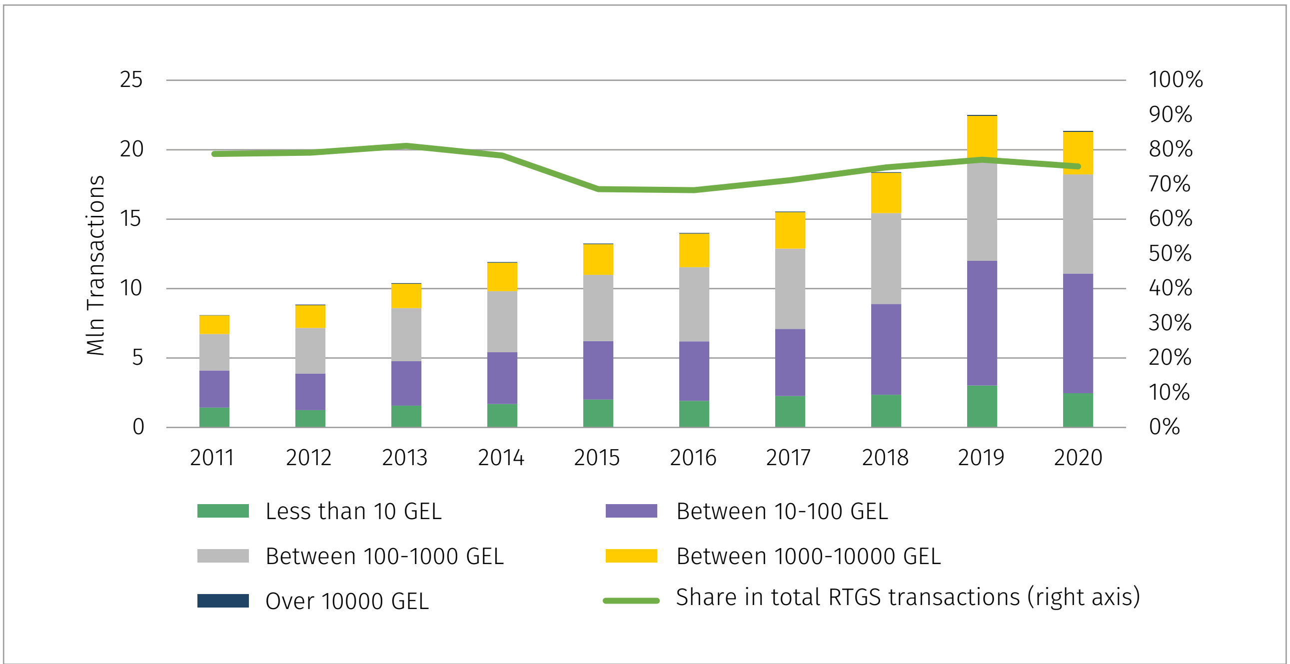
DIAGRAM N 9.5 VALUE OF RTGS OPERATIONS BY SETTLEMENTS (2011-2020)



Source: National Bank of Georgia

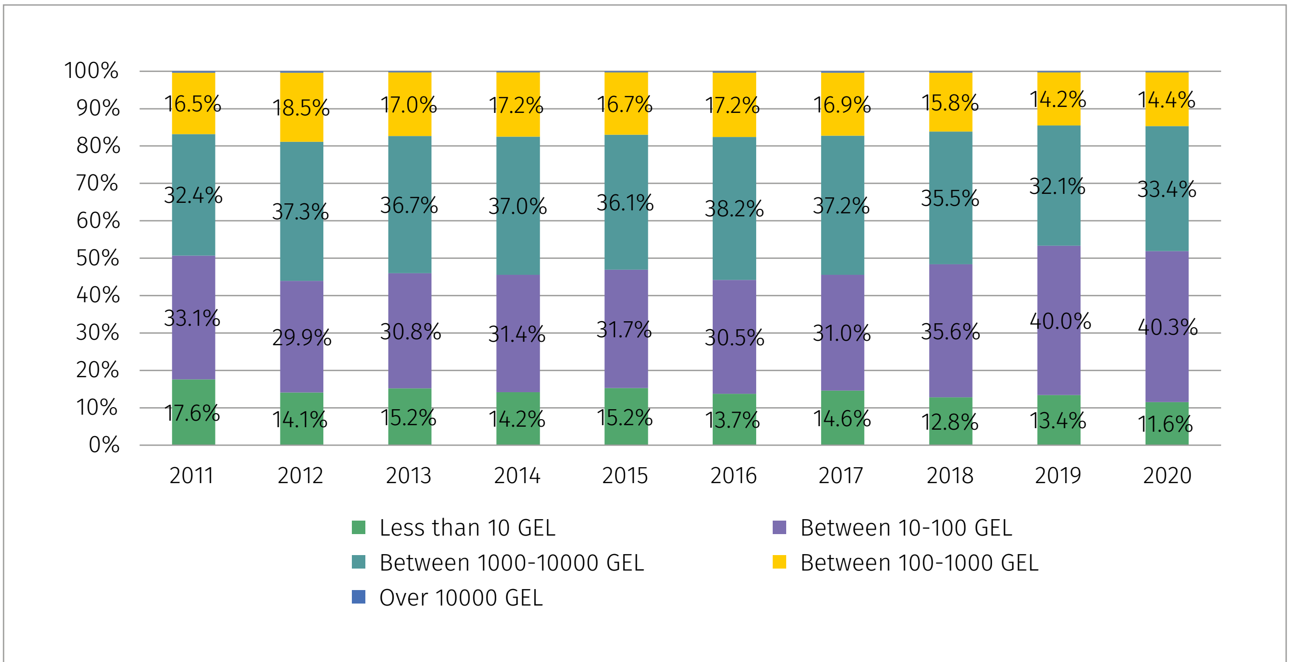
The RTGS system plays an important role in both wholesale and retail payments. In 2020, the share of commercial banks' customer payments in total RTGS payments was 27% in terms of amount and 75% in terms of volume. The distribution of the number of retail payments by value intervals has been relatively stable during 2011-2020. In recent years, there has been only a small increase in the share of payments in the GEL 10 to GEL 100 range (see Diagrams N 9.6 and N 9.7).

DIAGRAM N 9.6 NUMBER OF PAYMENTS BY BANK CLIENTS BY VALUE (2011-2020)



Source: National Bank of Georgia

DIAGRAM N 9.7 DISTRIBUTION OF PAYMENTS BY BANK CLIENTS BY VALUE (2011-2020)



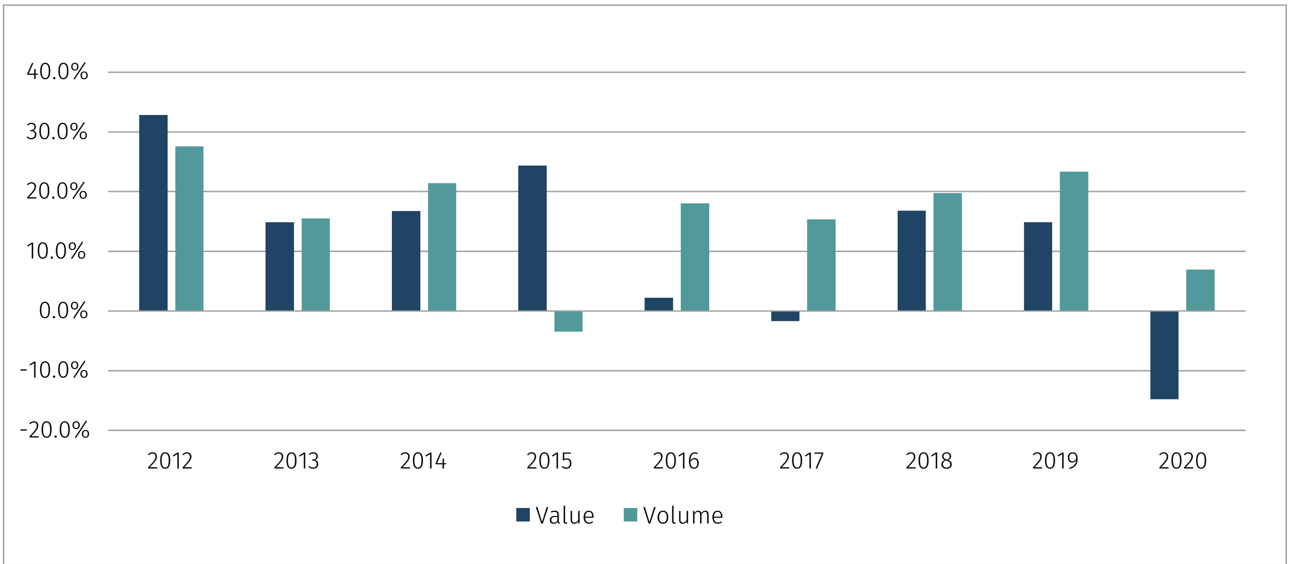
Source: National Bank of Georgia

The impact of the COVID-19 pandemic on RTGS system operations

The pandemic hit virtually all sectors of the economy hard in 2020, and RTGS operations were no exception. Over the year, the value of payments between commercial banks decreased by 14.8%, which was a record low for the last decade (13.1 percentage points lower than the previous low) (see Diagram N 9.8). The drastic drop in the annual growth rate of the value of transactions in the RTGS system (falling from 21.3% in 2018 and 41.1% in 2019 to only 2% in 2020) was mainly due to the reduction of payments between commercial banks. Meanwhile, the fall in the number of transactions with the RTGS system in 2020 was due to a significant decline (of up to 7%) in the growth rate of client payments between commercial banks (which saw growth of 19.7% in 2018 and 23.4% in 2019) and a 11% reduction in the number of payments between commercial banks and the treasury.

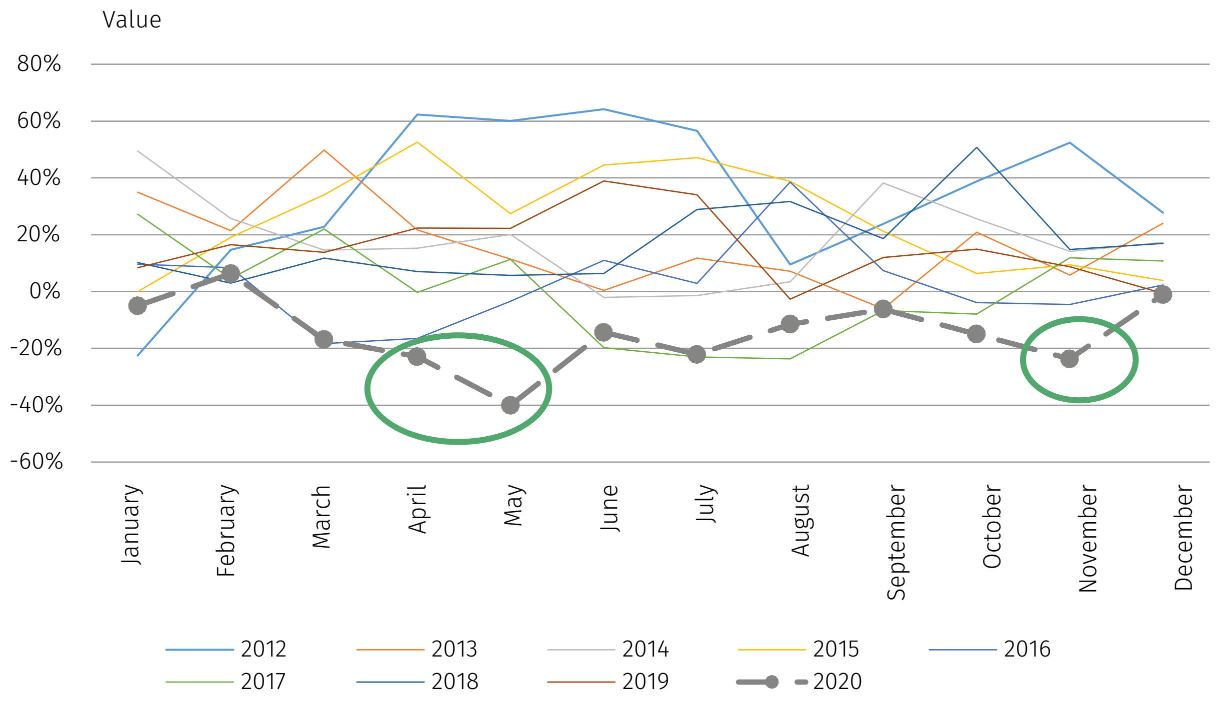
It is significant that a decrease in both the volume and value of interbank payments over the previous year were observed in the months when extreme restrictive measures were in place to prevent the spread of coronavirus. This is clearly shown in Diagram N 9.9.

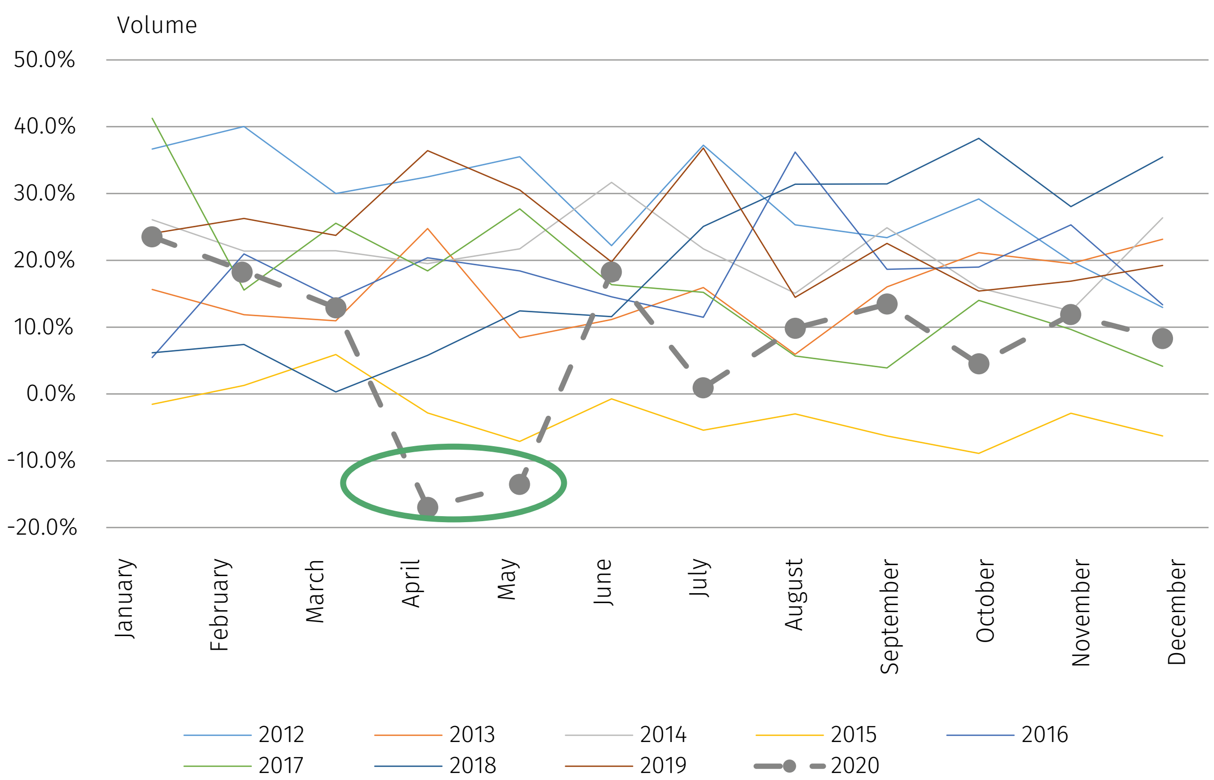
DIAGRAM N 9.8 ANNUAL CHANGE IN PAYMENTS BETWEEN COMMERCIAL BANKS THROUGH THE RTGS SYSTEM (2012-2020)



Source: National Bank of Georgia

DIAGRAM N 9.9 CHANGE IN PAYMENTS BETWEEN COMMERCIAL BANKS THROUGH THE RTGS SYSTEM COMPARED TO THE CORRESPONDING MONTH IN PREVIOUS YEARS (2012-2020)

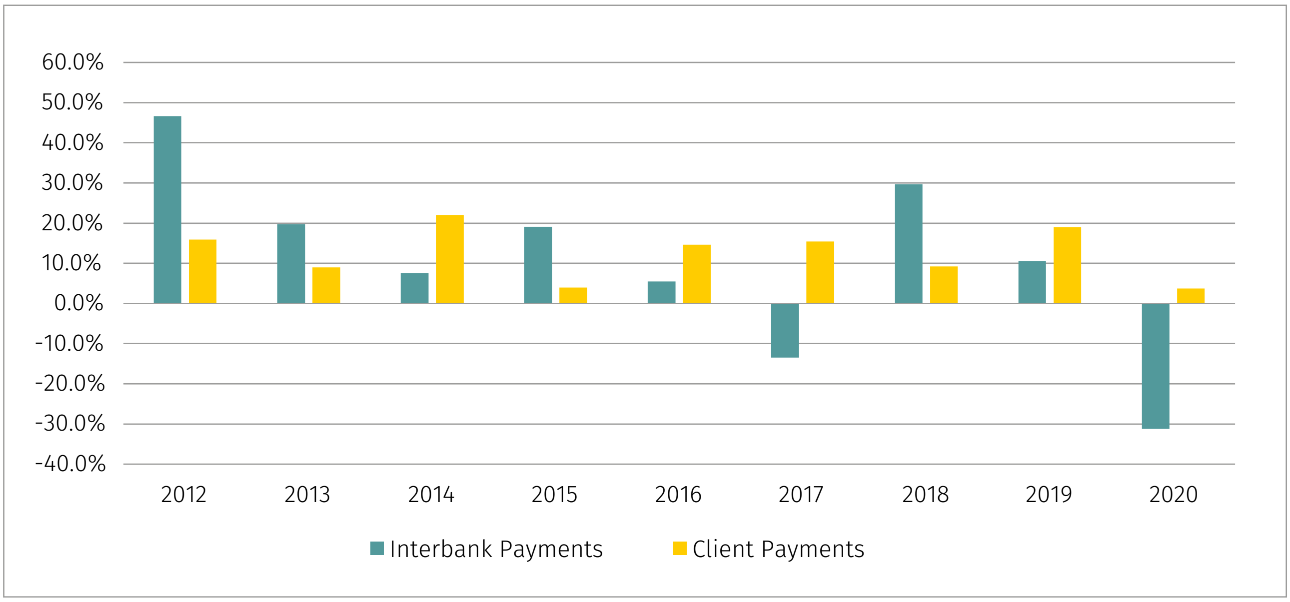




Source: National Bank of Georgia

Two factors affected the reduction in the value of payments between commercial banks in 2020. First, there was a relatively temperate reduction of the average daily value of interbank payments during the year, which was a trend observed since November 2019.[76] Secondly, there was significant reduction in payments made by commercial bank clients during the period of strict measures that were enacted in response to the pandemic (see Diagram N 9.9). Similarly, the decrease in the volume of RTGS transactions was due to the reduced volume of payments made by banks' customers during the period of restrictions. Unlike the period of April-July 2020, the restrictions that were reintroduced in November-December did not lead to a reduction in the value or volume of client payments to commercial banks – a development that may be explained by several factors. First, in the latter period commercial banks and consumers managed to adapt to the altered circumstances, and hence the measures taken to combat the pandemic had a more limited impact on the initiation of payment transactions. Second, at the outset of the restrictions, consumers were more restrained in incurring costs, something supplemented by the fact that during the period of restrictions imposed in the spring of 2020, a large part of bank clients had their loan repayments deferred (see Diagrams N 9.10 and N 9.11). Further evidence of this trend can be seen in the dynamics of electronic means of payment in 2020.

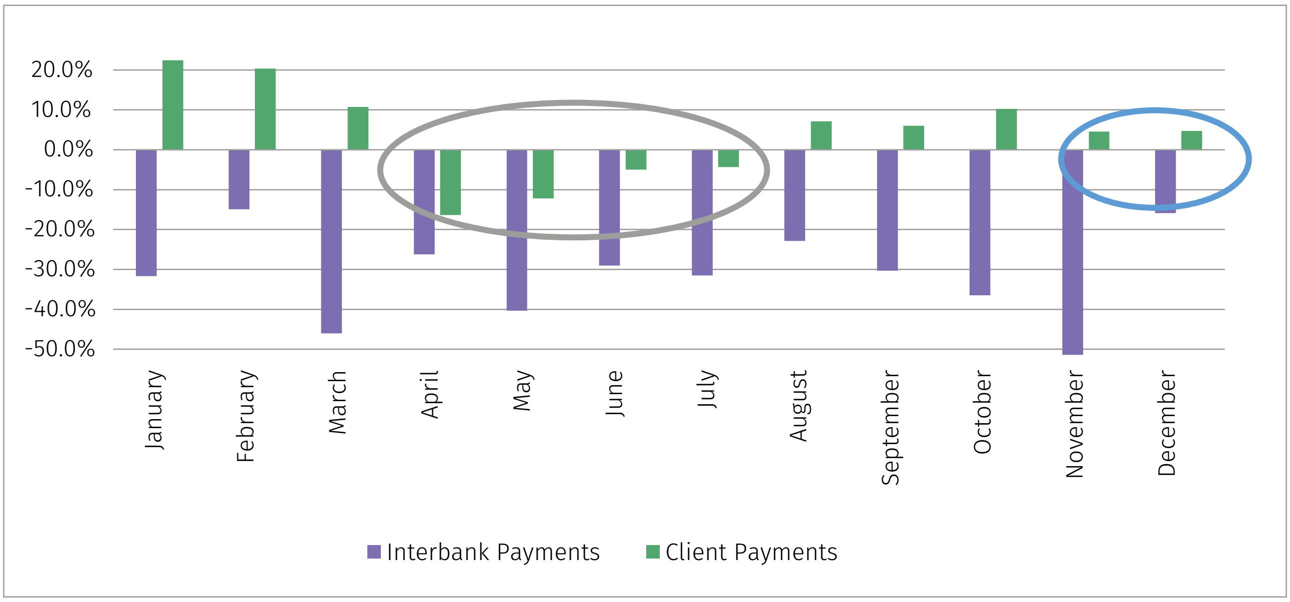
DIAGRAM N 9.10 ANNUAL CHANGE IN INTERBANK PAYMENTS BETWEEN COMMERCIAL BANKS AND VOLUME OF PAYMENTS MADE BY CLIENTS (2012-2020)



Source: National Bank of Georgia

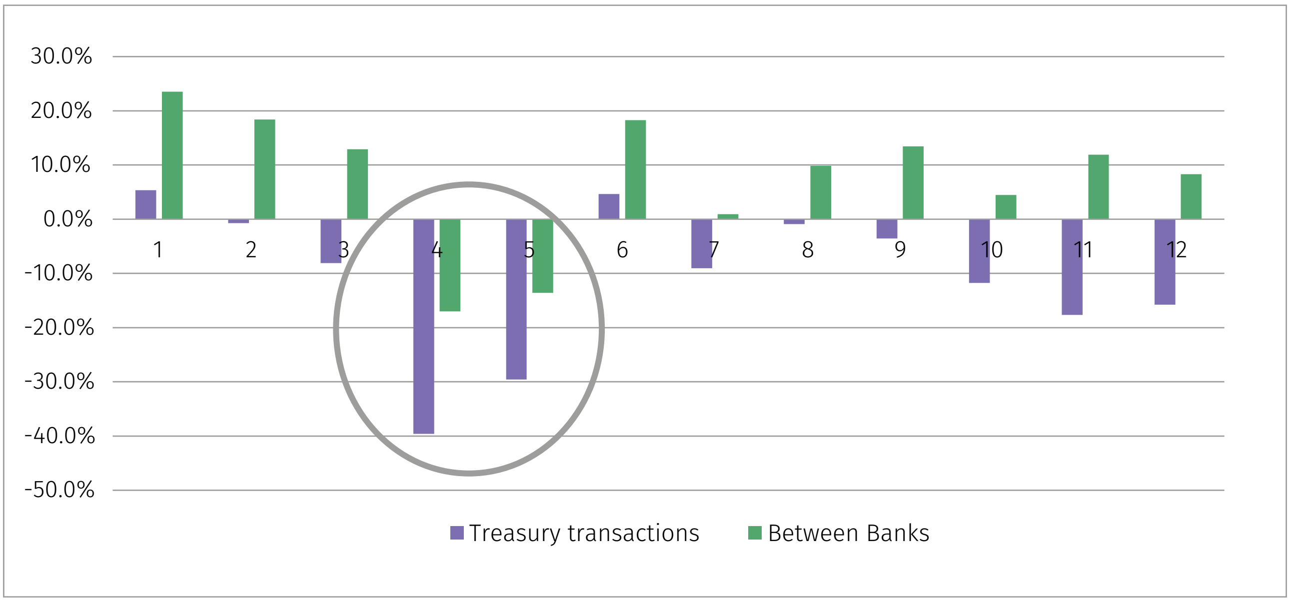
76. In November 2019, the amount of payments between commercial banks decreased by 15.2% compared to the corresponding month of the previous year, and by 28.4% in December 2019.

DIAGRAM N 9.11 ANNUAL CHANGE IN THE VALUE OF INTERBANK PAYMENTS BETWEEN COMMERCIAL BANKS AND PAYMENTS MADE BY CLIENTS (2020)



Source: National Bank of Georgia

DIAGRAM N 9.12 CHANGE IN THE VOLUME OF PAYMENTS MADE BY COMMERCIAL BANK CLIENTS BY MONTH (2020)



Source: National Bank of Georgia

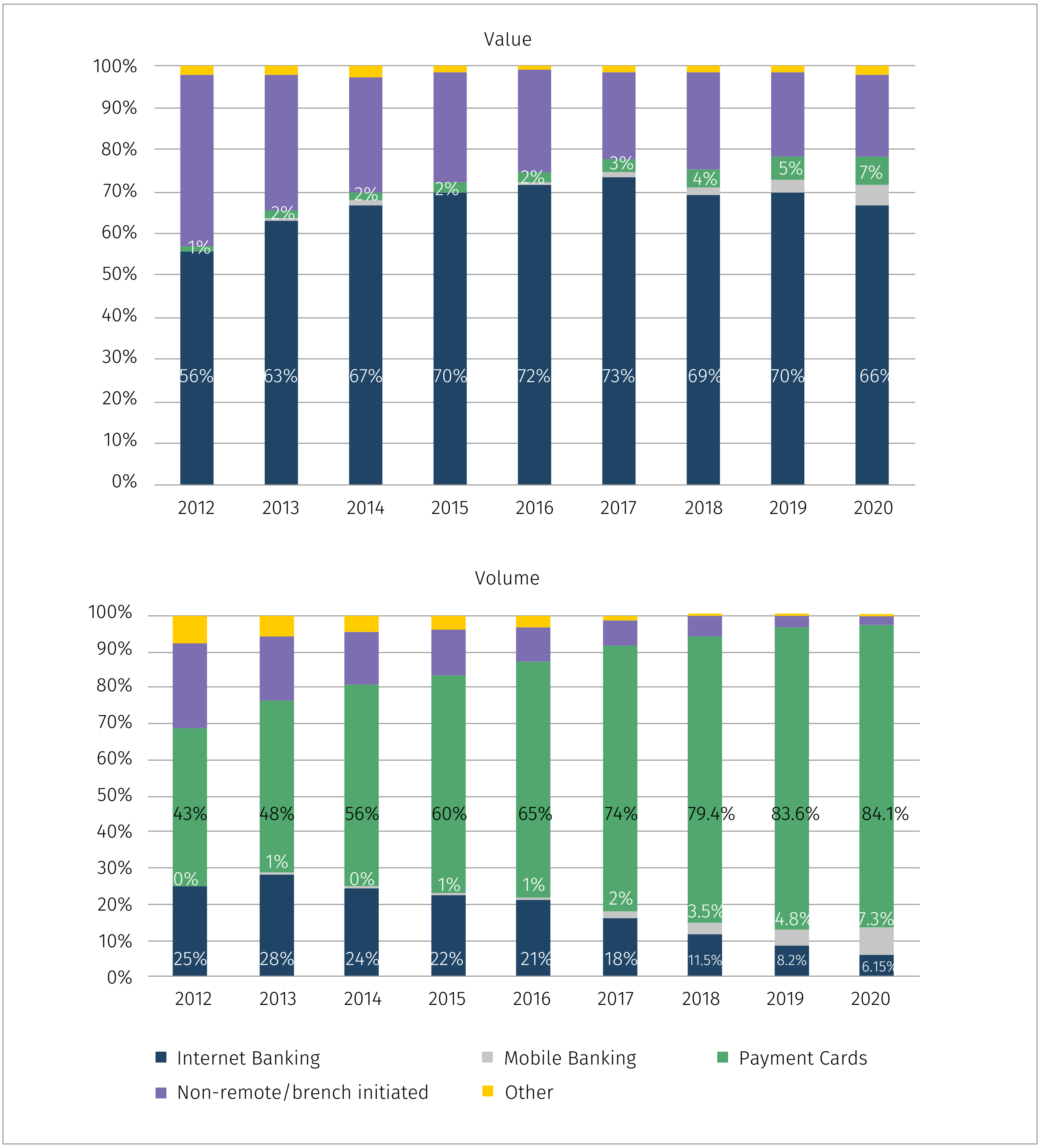
Electronic means of payment

Similar to the pattern of the last four years, the use of mobile banking for payments grew rapidly in 2020. The volume of mobile banking transactions has increased nine-fold since 2017, exceeding the volume of internet banking payments for the first time and accounting for 7% of total cashless payments – representing growth of 2.5 percentage points over the 2019 figure. In contrast, the volume of payments made through internet banking fell by 2 percentage points to 6.3% of total cashless payments. Meanwhile, payment cards remain the most commonly used electronic means of payment. The share of cashless payments (with cards) in total cashless payments in 2020 was 84.1%, 0.5 pp higher than the previous year.

In terms of value, internet banking is the most important electronic means of payment. In 2020, the share of credit payment orders initiated through internet banking in total cashless payments was 66%, which is 4 pp less year on year (YoY). In this regard, the share of payment cards and mobile banking is relatively insignificant, despite constantly growing over the last four years. Aggregate data for 2020 show that total payments made by credit cards accounted for 7% of the total amount of cashless payments, which is 2 pp higher YoY. The share of payments made through mobile banking also increased by 2 pp and amounted to 5% of total cashless payments. Meanwhile, the amount of credit payment orders initiated by clients on location at the service centers of commercial banks has steadily been decreasing and, in 2020, equaled 20% of total cashless payments, which is 1 pp less YoY.

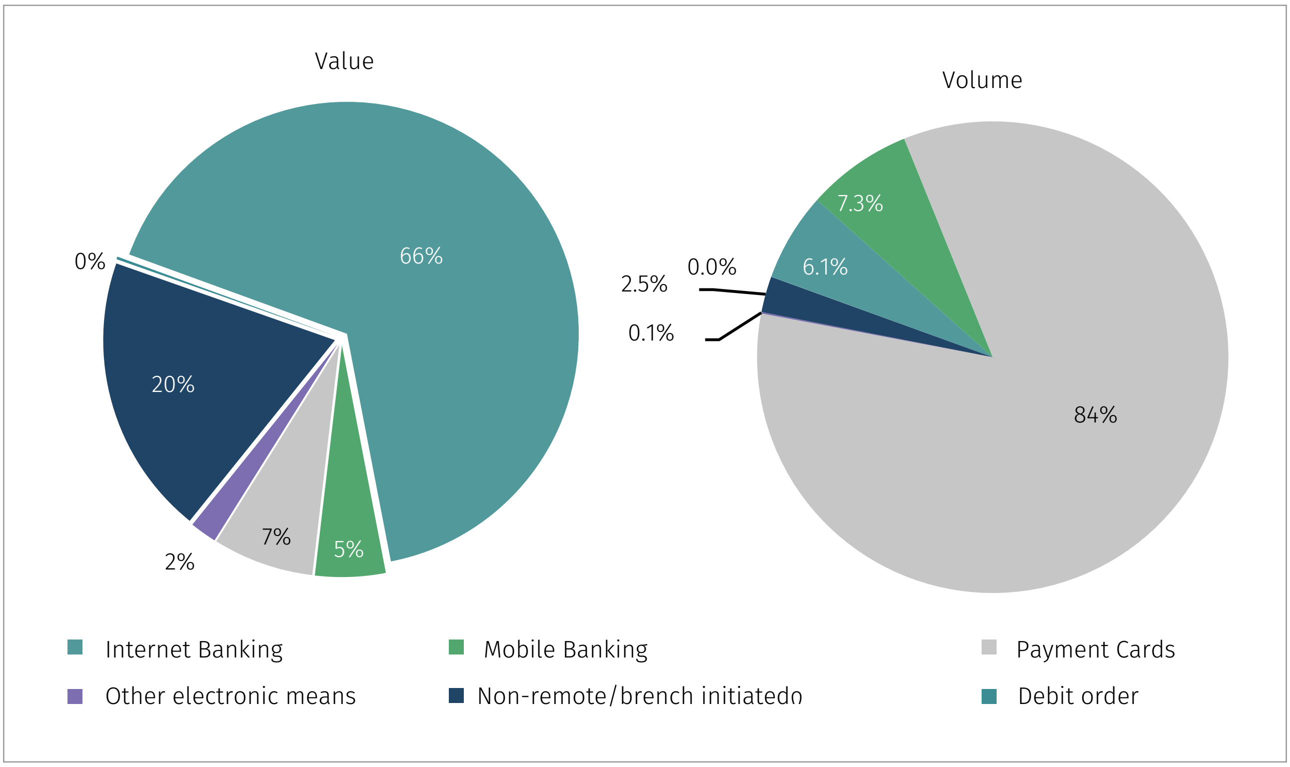
The statistics of cashless payments, in terms of their means of initiation, are shown in Diagrams N 9.13 and N 9.14.

DIAGRAM N 9.13 USE OF PAYMENT INITIATION MEANS IN 2012-2020



Source: National Bank of Georgia

DIAGRAM N 9.14 DISTRIBUTION OF CASHLESS PAYMENTS BY MEANS OF INITIATING PAYMENT ORDER (2020)

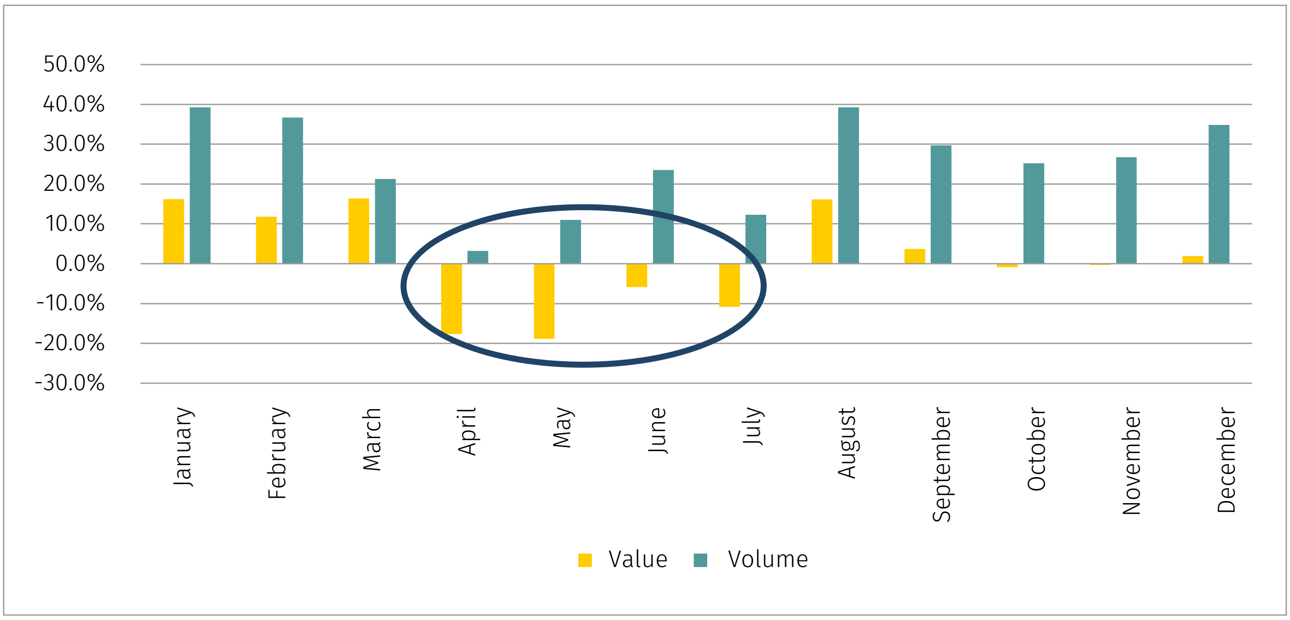


Source: National Bank of Georgia

The impact of the COVID-19 pandemic on electronic means of payment

In 2020, 49 million payments totaling GEL 109 billion were made through internet and mobile banking, which is 0.7% and 24.8% more, respectively, compared to the same period of the previous year. The amount of payments made through internet and mobile banking decreased considerably due to the restrictions introduced in April-July 2020, which was similar to the case of commercial bank transactions performed through the RTGS system. The subsequent November-December restrictions, however, had a lesser impact on the growth of internet and mobile banking transactions and, in terms of quantitative indicators, these managed to return to pre-pandemic growth rates (see Diagram N 9.15). A similar trend was evident in RTGS system operations, possibly prompted by the factors described above.

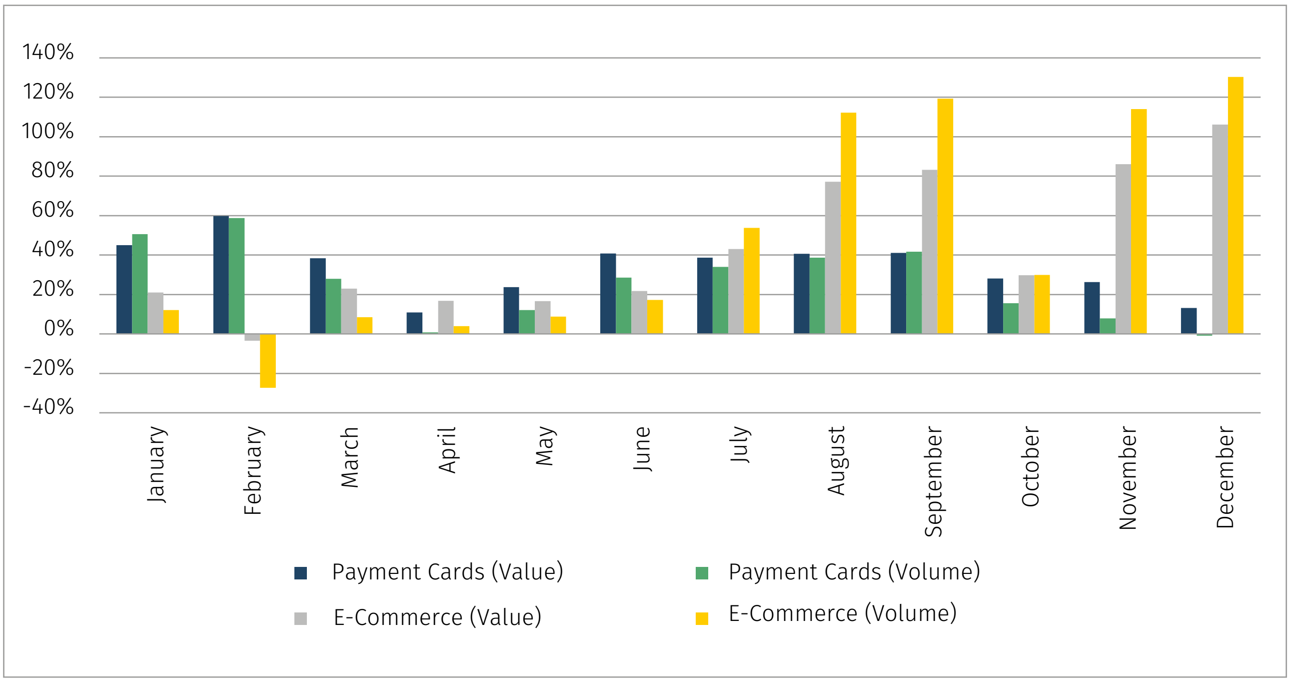
DIAGRAM N 9.15 INCREASE IN PAYMENTS THROUGH INTERNET BANKING AND MOBILE BANKING COMPARED TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR (2020)



Source: National Bank of Georgia

The pandemic-related restrictions had a relatively minor impact on total payment card transactions. However, unlike other electronic means of payment, the restrictions imposed in both April-May and November-December 2020 had an equally adverse impact on the rate of payment card use. This could be related to the fact that a major part of payment cards are used at trade/service points, whose work was limited to prevent the spread of coronavirus. This is further evidenced by the dynamics of payments in e-commerce facilities, where the impact of the pandemic was relatively minor. In November-December 2020, compared to the parallel period of the previous year, the growth rate of e-commerce increased significantly (see Diagram N 9.16). In response to the challenges posed by the pandemic, the limit on contactless payments was increased from GEL 50 to GEL 100, as per the NBG's instruction.

DIAGRAM N 9.16 INCREASE OF CARD PAYMENTS WITHIN THE COUNTRY COMPARED TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR (2020)

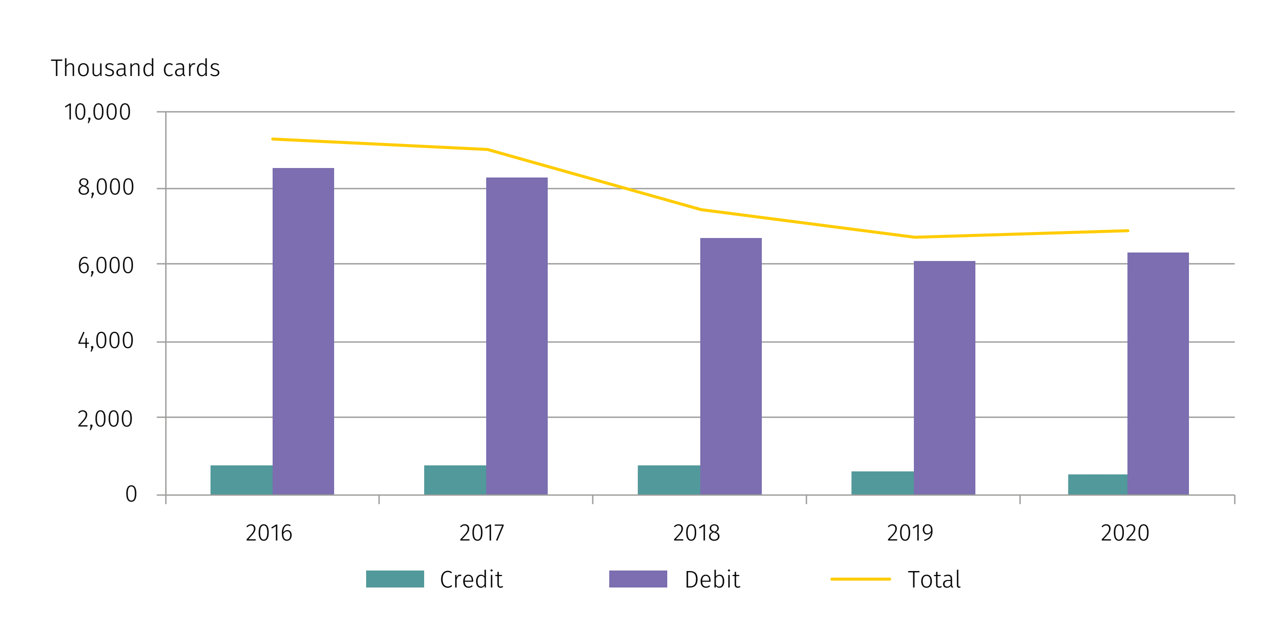


Source: National Bank of Georgia

Payment cards

As of December 2020, the volume of payment cards issued by commercial banks in Georgia amounted to 6.9 million, which is 2% more than in December 2019. A previous decrease in the number of cards over 2018-2019 was triggered by the annulment of a number of inactive cards. Most of the issued cards (93%) were those of international card systems. By the end of 2020, the volume of cards issued per capita in the country was about two, with debit cards constituting 92% of the cards issued. The distribution of credit and debit cards over time is given in Diagram N 9.17.

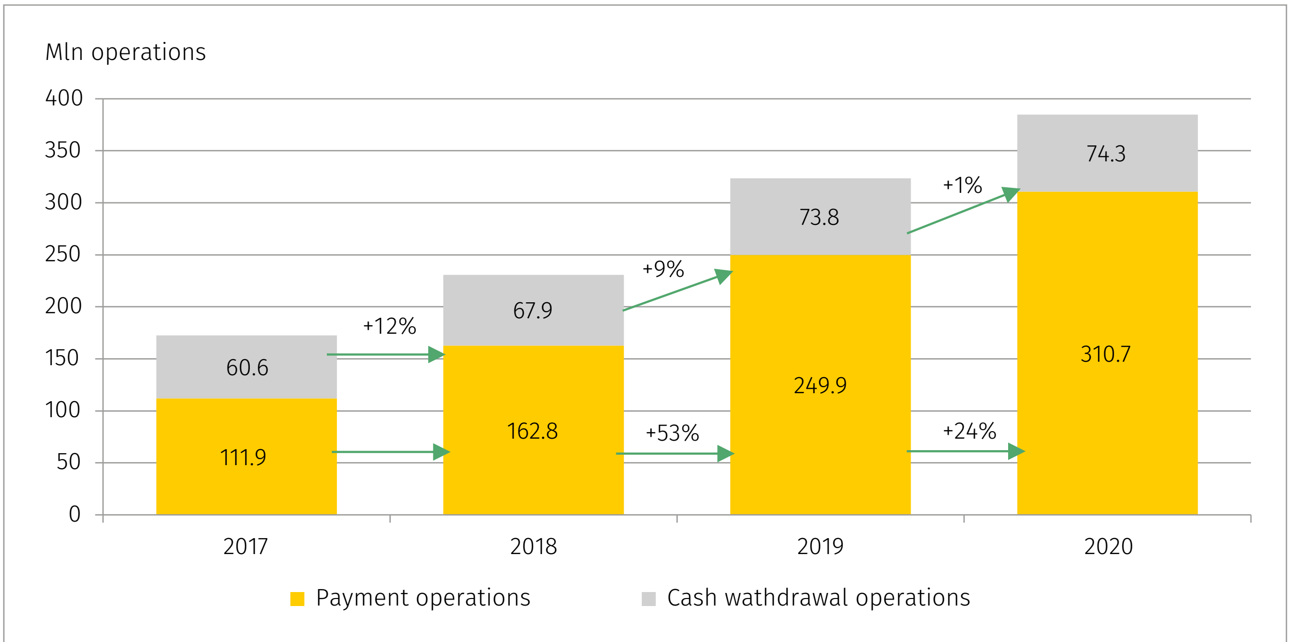
DIAGRAM N 9.17 VOLUME OF PAYMENT CARDS ISSUED (DECEMBER, 2016 - 2020)



Source: National Bank of Georgia

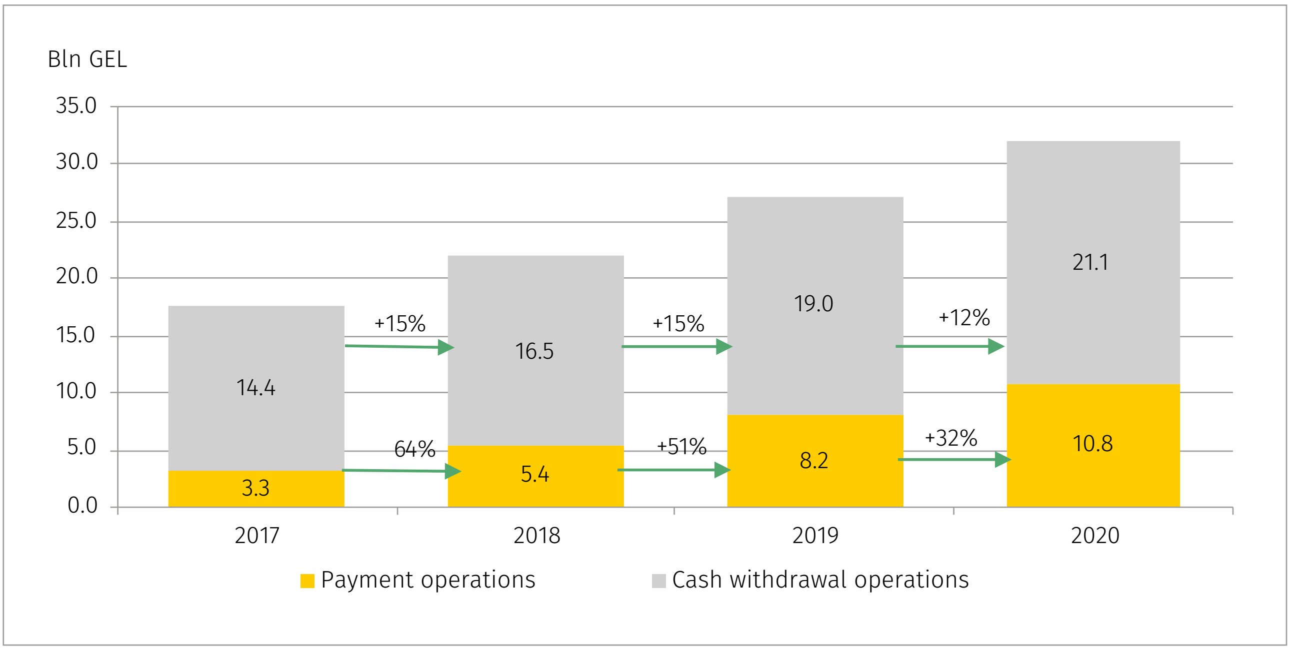
Some 410 million transactions using payment cards issued in Georgia were completed during the year, with a total amount of GEL 34 billion. Of this, 94% of transactions were completed in Georgia, in terms of both volume and value. Trends of transactions completed domestically are shown in Diagrams N 9.18 and N 9.19.

DIAGRAM N 9.18 VOLUME OF TRANSACTIONS COMPLETED DOMESTICALLY WITH GEORGIAN CARDS



Source: National Bank of Georgia

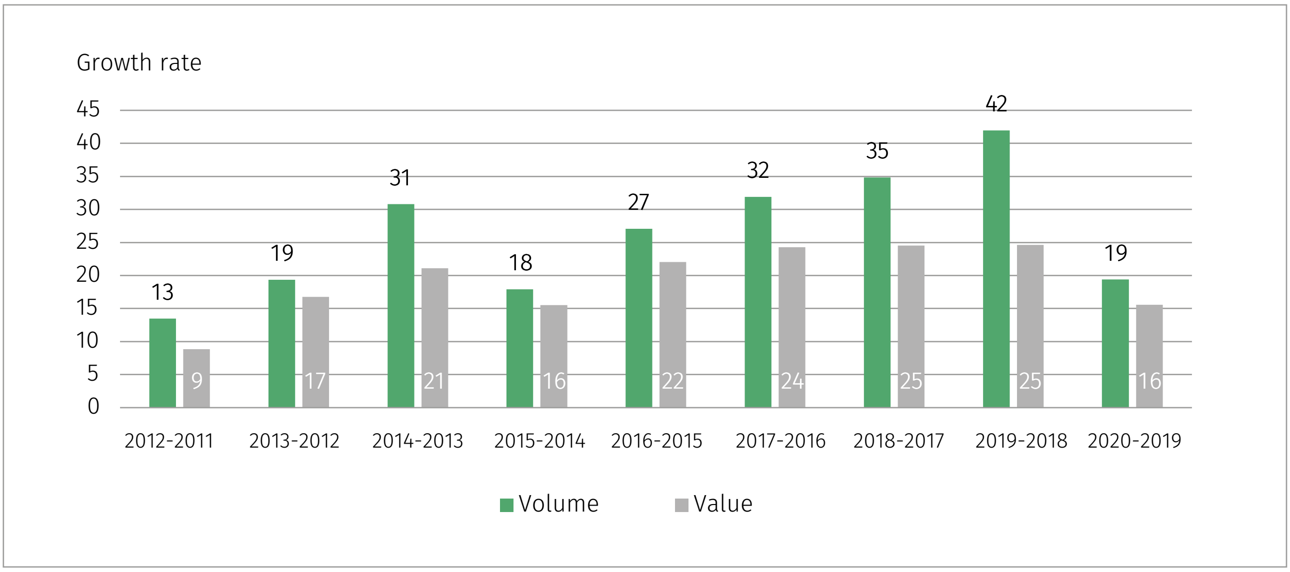
DIAGRAM N 9.19 VALUE OF TRANSACTIONS COMPLETED DOMESTICALLY WITH GEORGIAN CARDS



Source: National Bank of Georgia

Compared to the previous year, card transactions in 2020 saw an increase of 19% in terms of volume and 16% in terms of value; but these figures were 23 pp and 19 pp lower than the corresponding growth rates for 2019, respectively. The increase in card transactions over time is shown in Diagram N 9.20.

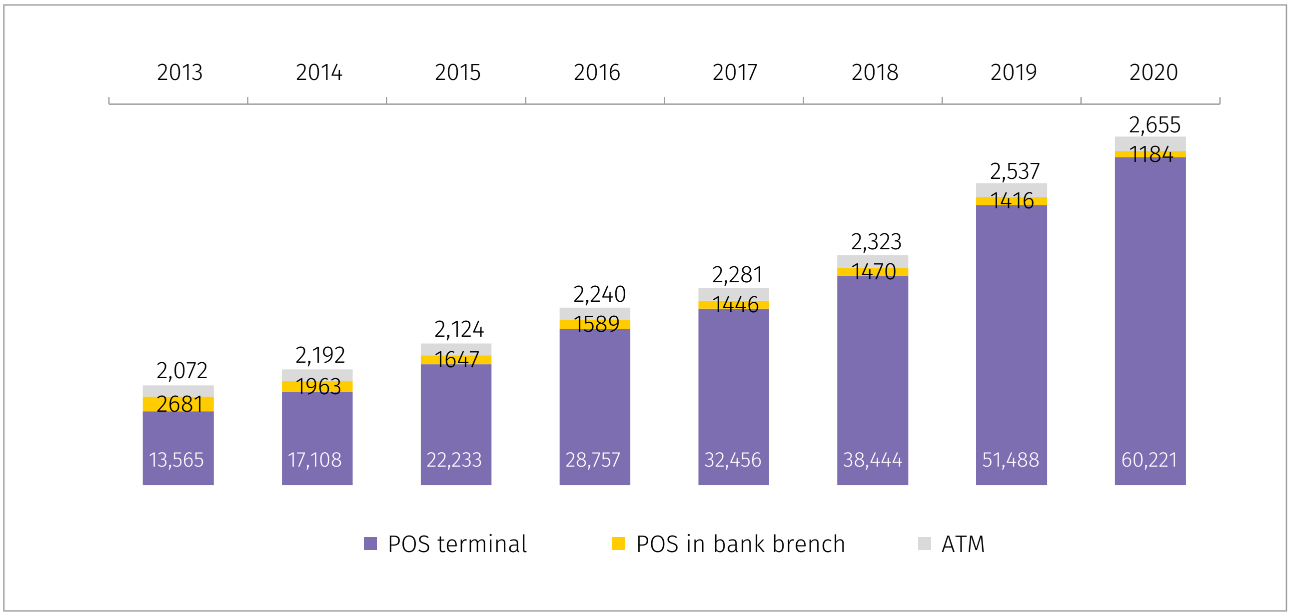
DIAGRAM N 9.20 ANNUAL GROWTH OF CARD TRANSACTIONS



Source: National Bank of Georgia

During 2020, an average of 12 operations per month were performed with a single card instrument, totaling an average of GEL 1,000. In 2020, 82% of the total volume of transactions and 37% of the total value of transactions were payments for goods and services. The volume of POS terminals on the market increased significantly in 2020, exceeding 60,000, representing 17% growth YoY. The number of virtual (e-commerce) terminals increased by 29%, and the number of ATMs by 5%. The volume of card devices over time is shown in Diagram N 9.21.

DIAGRAM N 9.21 VOLUME OF CARD DEVICES (2013-2020)



Source: National Bank of Georgia

Throughout 2020, the market welcomed the introduction of innovative products and services. Chip cards made up about 80% of total cards. Digital cards were also introduced for mobile applications. Issuers, along with their own mobile apps, also offered their customers the Apple Pay product.

PAYMENT SERVICE PROVIDERS

As of 31 December 2020, 31 payment service providers were registered with the National Bank of Georgia. However, two of these providers were in the process of liquidation. During the year, three entities were registered as payment service providers at the National Bank, despite the fact that the provider registration process was temporarily suspended because of the pandemic from 23 March to 23 July and again from 10 December 2020 to 31 January 2021. The remote supervision of these entities continued as usual, in spite of the pandemic. Ongoing communication with providers helped the identification of difficulties resulting from the imposed restrictions and their elimination in a timely manner.

Provider payments (excluding electronic money transactions)

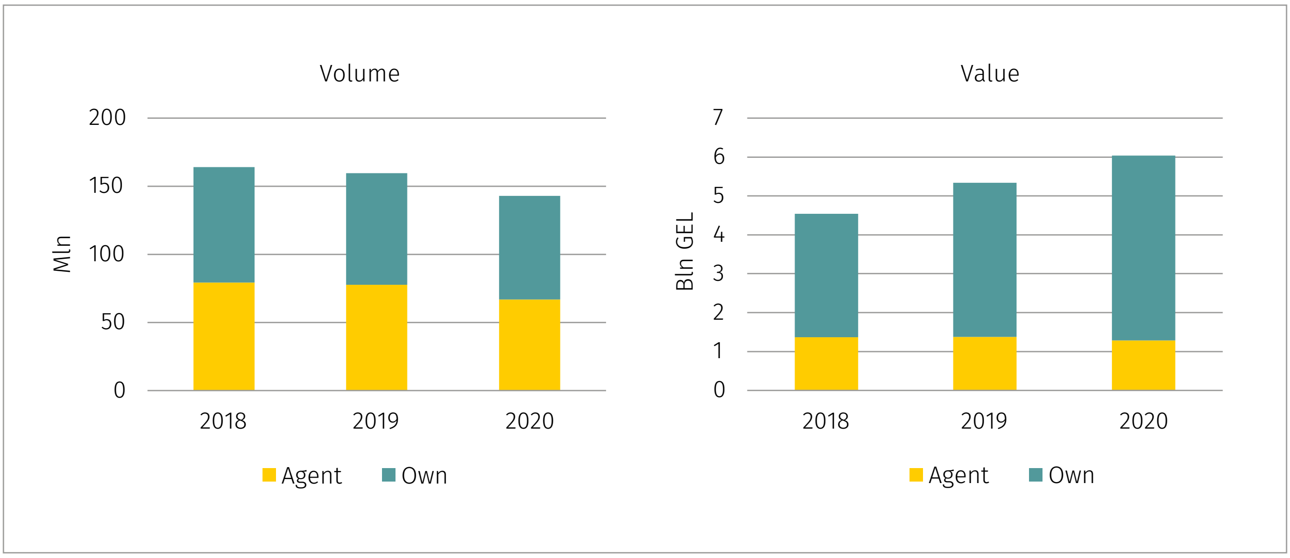
In 2020, 143 million transactions worth GEL 6 billion were completed by payment service providers. The volume of payments decreased by 10.5% compared to 2019, while the value increased by 13.2% (see Diagram N 9.22).

Self-service kiosks were most frequently used for payments, as they allow customers to initiate electronic payments in cash. Kiosks completed 95.7% of the total volume of such payments and were responsible for 95.4% of the value, which are 3.3 pp and 2 pp increases over 2019, respectively. The vast majority of kiosk-initiated payments were made using cash, while the share of card use in kiosks was negligible, not exceeding 0.1%. Compared to 2019, fewer payments were made at the service centers of providers. In 2020, such payments accounted for 3.1% of the total amount and 3.7% of the volume, reductions of 4 pp and 1 pp, respectively, from the previous year.

The websites of payment service providers were also used to initiate payments, these initiated 2.2 million payments worth GEL 78 million over the year, representing 1.3% and 1.6% of total payments, respectively.

In 2020, payments made through agents accounted for 46.8% of the total volume of payments made by providers and accounted for 21.3% of the value, which was 1.8 pp and 4.5 pp less than the same period in 2019, respectively.

DIAGRAM N 9.22 PAYMENTS BY PAYMENT SERVICE PROVIDERS (EXCLUDING E-MONEY)



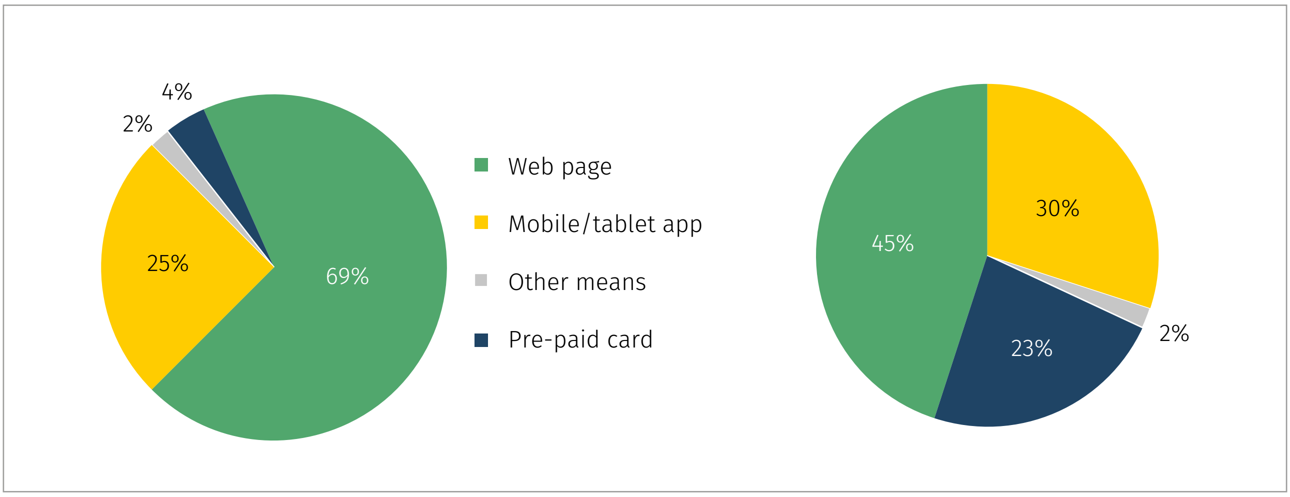
Source: National Bank of Georgia

Payments with e-money

Prepaid transport cards have a special place in the electronic money (e-money) market for payments. The average value of a single payment made through such cards is GEL 0.41, and is drastically different from other payments made with electronic money. Transport cards are widely used to pay for public transport, so the volume of payments made through them significantly exceeds the volume of payments with other forms of e-money. Transport cards accounted for 98.9% of the total volume of e-money payments and 25.6% of the total value. Given the peculiarity of transport cards, these are excluded from the following analysis of the e-money payment market.

In 2020, approximately 780,000 payments were made by e-money providers, which were worth GEL 85.7 million. A total of 45.5% of the volume of these payments and 69.2% of the amount were made through the websites of the companies' issuing and providing e-money. A significant portion of electronic money payments (25% of the value and 30% of the volume) were initiated using a mobile phone/tablet application.

DIAGRAM N 9.23 PAYMENTS WITH E-MONEY (EXCLUDING TRANSPORT CARDS) (2020)

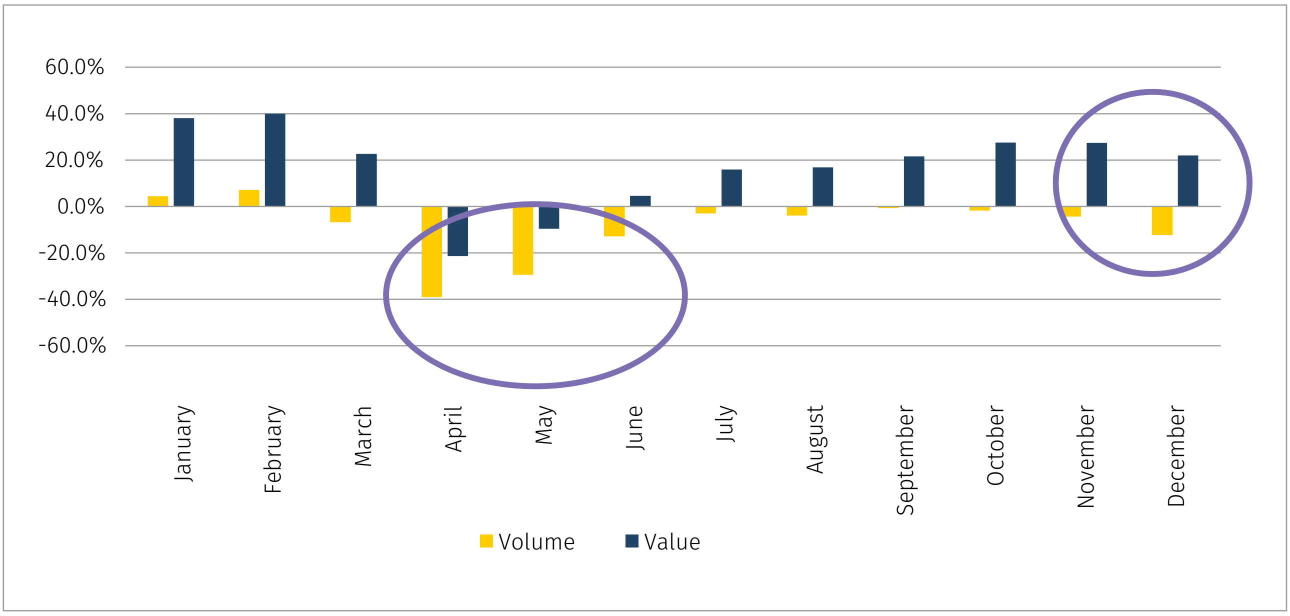


Source: National Bank of Georgia

The impact of the COVID-19 pandemic on the operations of payment service providers

The coronavirus pandemic had a major impact on the functioning of payment service providers. Self-service kiosks, the most commonly used means of payment, saw a significantly reduced number of payments in year-on-year terms due to measures taken to curb the spread of the virus. However, while the indicators for both the amount and number of transactions decreased in April-June, the subsequent reduction observed in the period of restrictions imposed in November-December 2020 only affected the number of payments (see Diagram N 9.24).

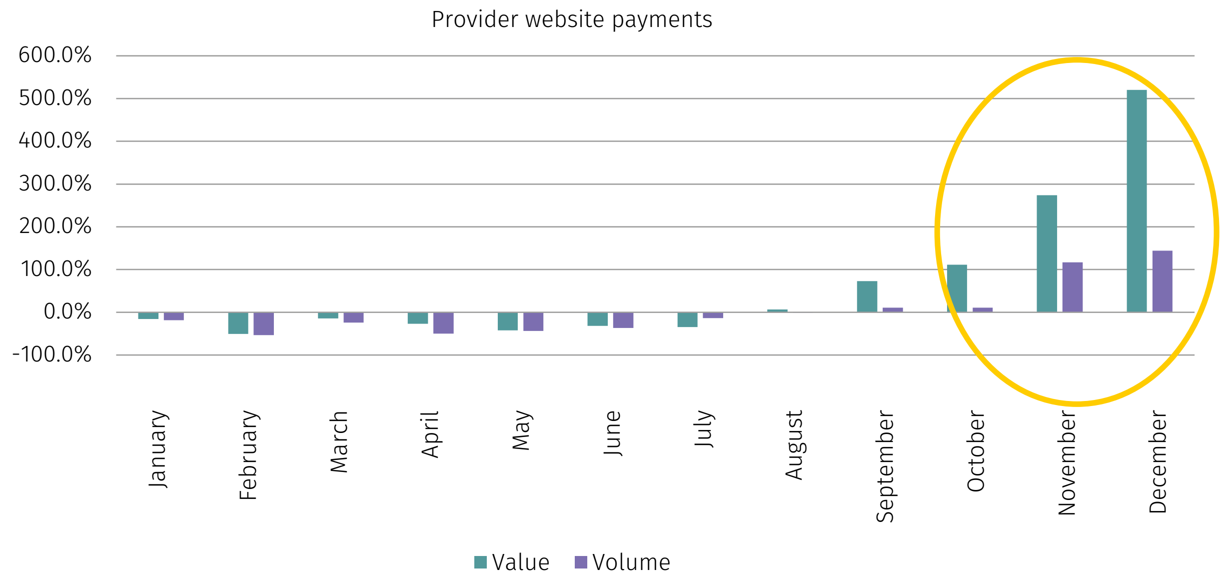
DIAGRAM N 9.24 CHANGE IN PAYMENTS MADE THROUGH SELF-SERVICE KIOSKS COMPARED TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR (2020)

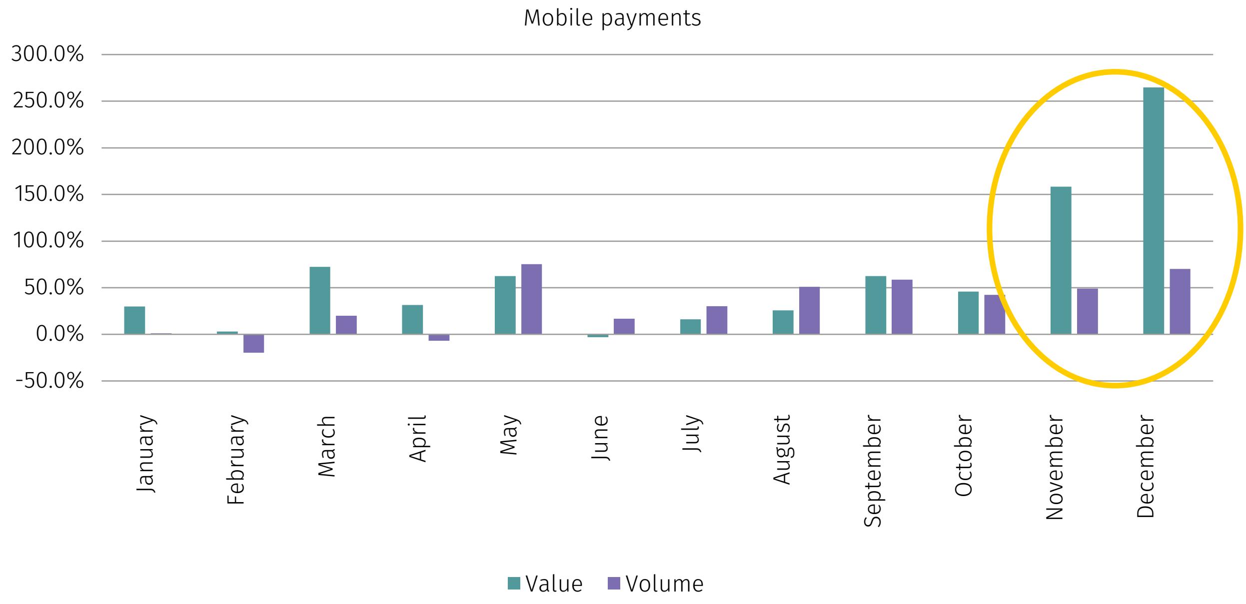


Source: National Bank of Georgia

Similar dynamics were observed in payments made with electronic money. Growth of both the volume and value of electronic money transactions on the e-money issuers' website, as well as on mobile phones, has accelerated significantly since the second half of 2020 (see Diagram N 9.25).

DIAGRAM N 9.25 CHANGE IN PAYMENTS WITH E-MONEY COMPARED TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR (2020)





Source: National Bank of Georgia

Payment service providers issue both domestic and international prepaid cards, which are widely utilized by users to access their e-wallets. Also, a mechanism for making withdrawals from an e-wallet using QR codes was made available. Most providers are widely using mobile apps, which has helped increase remote payments. The growing synergy with microfinance institutions is also promising, allowing customers to use both loan products and payment services simultaneously.

Payments between providers

When providing payment services, providers often use intermediary providers to run their operations more efficiently. According to 2020 data, 35.5% of the total amount of orders that providers received from payers were performed through intermediary providers, which is 1 pp less than the same figure for 2019. In terms of funds transferred to recipients, 99% of payments made by providers were completed at resident commercial banks of Georgia, which was similar to the previous year.

INFORMATION TECHNOLOGY DEVELOPMENT

In 2020, the upgrade and optimization of the National Bank's server infrastructure capacity and resources was completed. Within the framework of this project, use of one of the most advanced technologies – hyper-converged infrastructure – was doubled in the two main datacenters of the National Bank of Georgia, upgrading the capacity and sustainability of IT services. The hyper-converged system is the combination of server, network, and database systems on a single platform managed by centralized software.

Network switches in data centers were replaced by newer, more modern hardware. This update helped to increase the bandwidth of exchanged information flows.

In 2020, an email archiving solution was implemented, which helps optimize email services and reduce the potential overload of users' mailboxes. Attached files older than two months are uploaded on the server using the so-called 'stubbing' method, which involves replacing the attached files with a server-side link. A flexible search tool simplifies the search process with improved filters. Overall, the archiving system has improved employee e-mail productivity and has helped optimize the e-mail system infrastructure of the National Bank of Georgia.

In 2020, the National Bank continued to improve its cyber security posture with the introduction of new products. A vulnerability scanning system was introduced to detect vulnerabilities in the bank's infrastructure. Based on the results of the scan, various work was carried out and relevant activities were planned.

A system for monitoring and controlling the actions of privileged users (administrators) has also been implemented in the bank's infrastructure. This ensures the protection of highly critical IT infrastructure (servers, databases, active network hardware, software, etc.) and prevents the unauthorized access of users with administrator rights.

Another new product – a Network Security Monitoring System – has also been added to the National Bank's infrastructure. This enables threat detection, elimination and rapid response in the network.

The Cyber Security Division continued to vigorously engage employees on the subject of cyber awareness and to conduct various proactive activities. Throughout 2020, new employees received a cyber security awareness training, and current employees were regularly informed about prevailing cyber threats and the ways to avoid them.

The COVID-19 pandemic affected the standard working environment and, by the decision of the management of the National Bank of Georgia, the bank switched to a remote working format. The Information Technology Department took care of acquiring additional computer equipment to ensure the provision of critical business services to customers, and for providing NBG staff with portable devices. The service department managed to technically arrange the distribution of portable devices in a tight timeframe and continued to support the staff 24/7 in virtual force majeure circumstances.

The bank's video conferencing system has simplified the remote transfer of employees and facilitated the smooth running of online meetings as one of the most important components of the dynamic work process.

During 2020, the NBG has been actively working on important data optimization projects. Notably, for the Risk Management and Control Division of the Financial Markets Department, database architecture for information generated by Bloomberg since 2011 was created, data integrity issues were identified and existing process were automated to enable businesses to create reports using business intelligence (BI) in a common shared space.

A similar technical solution was developed for the Monetary Statistics Division of the Department of Macroeconomics and Statistics, granting the ability to import daily historical files received from commercial banks into a common data viewing system.

In 2020, business critical databases were migrated to a cluster-type technology, allowing use of the resources of both data centers via synchronous replication. This change reduced the business continuity recovery time from two hours to just three minutes and allowed switching without human intervention.

Commercial banks submit financial statements to the National Bank of Georgia at regular intervals, with information reflecting debit or credit turnover. Operations used to be recorded in an Excel file and submitted to the National Bank after formatting. A new method has been initiated that involves the introduction of a program where data are entered and profit-loss, percentages and other indicators are calculated automatically by uploading them to the National Bank's platform. Access to this application was granted in 2020, which ensures that the information is stored securely and is not accessible to third parties.

In 2020, the BI version was updated, and new functionality is scheduled to be added. So-called workbooks have been added on a Tableu server. This feature allows users to view the contents of a report without the desktop. The process of verifying published reports or those to be published on the NBG website was also simplified.

In 2020, the Omnify reporting and automated testing system was introduced. Based on WSS data, this significantly expanded reporting capabilities and made its functionality and visuals user-friendly. It is significant that the system contains automated testing functionality, so that, after creating certain test scenarios, the system performs testing automatically, without human intervention. This significantly reduces the need for human and time resources, as well as eliminating potential human error.

The Automated Human Resource Management System was replaced with an updated version. The speed of operations was significantly improved together with the portion of the basic report where all employees' data are gathered. The payroll module allows for automatic management of mandatory pension contributions, employee and company breakdowns, final settlement functionality and income declaration reporting. Various other types of reports were also updated. The functionality of the electronic system of the National Enforcement Bureau was added to the central banking software. Now cash collection orders are electronically received from the National Enforcement Bureau and all related processes (including accounting transactions) are automated. The addition of this function replaced the manual registration and execution of collection orders of the National Enforcement Bureau. Now less time is needed for data exchange and there are fewer operational risks to take care of.

A remote supervision portal for non-banking institutions replaced the conventional way for supervised non-banking entities to file information with the National Bank. They now upload reports online and have ongoing remote communication with the National Bank. The portal has made it more flexible to communicate with non-banking entities and obtain information from them.

Its capacity also allows for the elimination of technical inaccuracies as soon as the information is uploaded, while increasing the reliability of the submitted information. The remote supervision portal significantly reduces data processing times and frees up the time of the inspector for more analytical activities. Another benefit of the portal is that it allows working with large databases, which provide the NBG and other stakeholders with more comprehensive information about the sector and helps to identify and eliminate risks.
In 2020, more efforts were devoted to the upgrade, expansion and further development of the Unified Statistical Information System of the National Bank of Georgia. This system employs statistical software for obtaining and processing information from financial institutions and ensuring quality control.

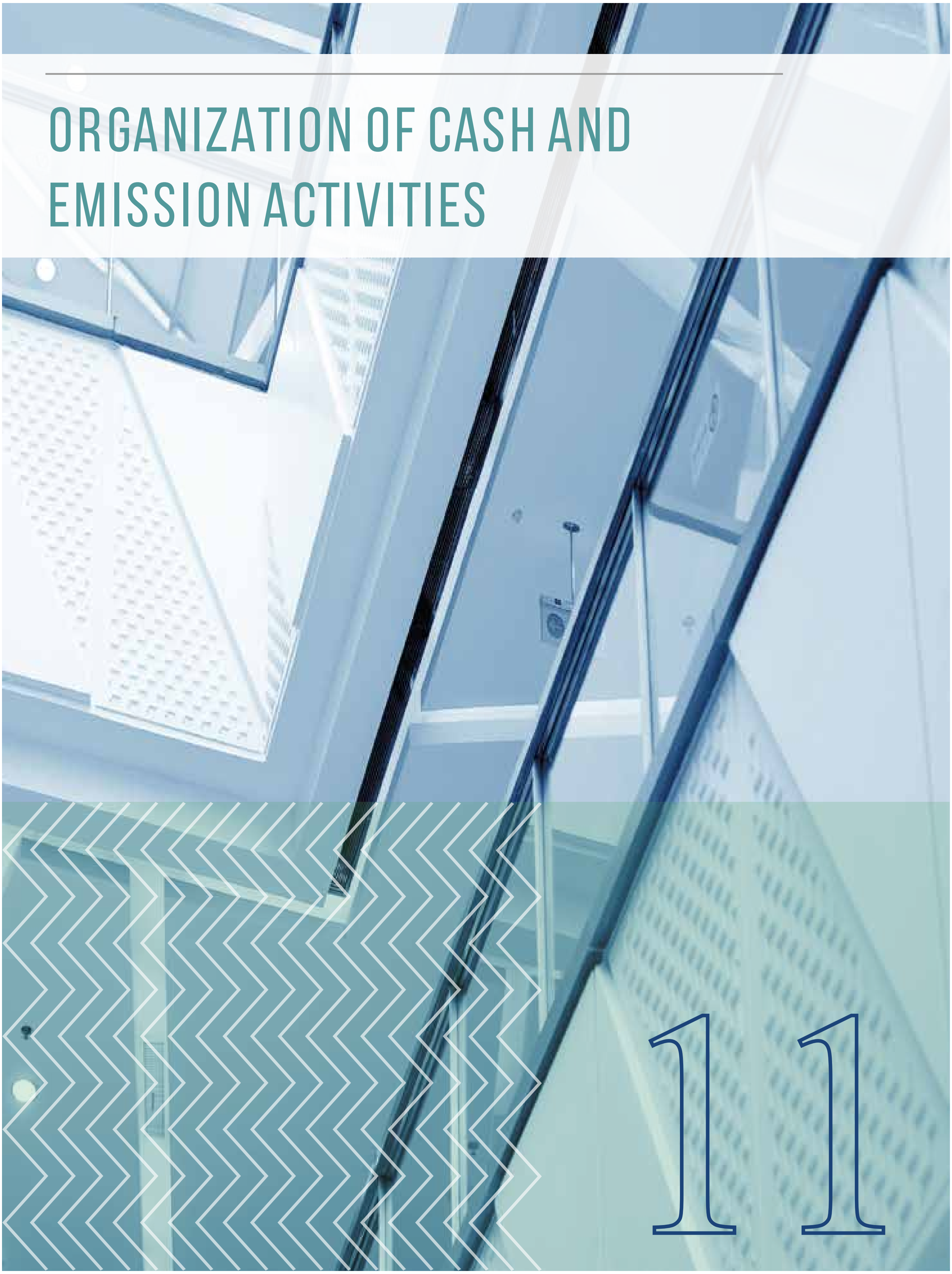
Due to the pandemic, employees of the National Bank of Georgia were unable to attend training events outside of Georgia during 2020; however, the use of new technologies, in particular online platforms, allowed IT staff to continue to participate in online conferences and seminars. The participation of the National Bank in these events proved to be beneficial to the development of the information technologies and services of the National Bank as a whole, while contributing to raising the qualifications and motivation of the employees concerned.

One of such event was conducted within the scope of the Georgia-Estonia Strategic Partnership. It focused on enhancing cyber security capabilities and included "Hunt the Hacker" and CRX [77] training exercises. The training event aimed to strengthen mechanisms for identifying cyber incidents and responding to them effectively. As a result of the training, relevant employees of the Information Technology Department deepened their technical knowledge and received certificates.

The National Bank introduces and develops up-to-date technologies on an ongoing basis, recognizing that doing so is an important factor for attaining the central goals and objectives of the bank.

77. Cyber Range Exercise

ORGANIZATION OF CASH AND EMISSION ACTIVITIES



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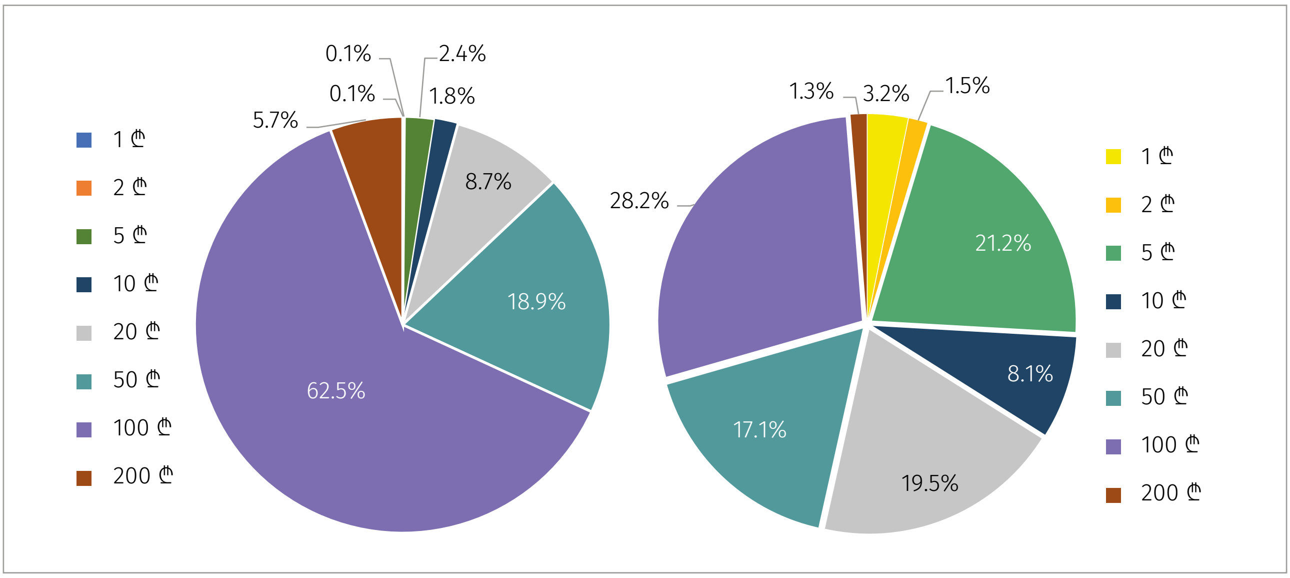
The impact of the COVID-19 pandemic turned out to be particularly severe for the staff of the National Bank. Nevertheless, the NBG managed to find ways to overcome the crisis and ensure the uninterrupted supply of cash to the country's economy. The Cash Operations and Currency Circulation Department worked enthusiastically with European banknote and coin producing companies to prevent the global pandemic from affecting production processes.

During the year, the department continued improving the quality of banknotes and coins in circulation, working with newly produced lari banknotes/coins and processing those received from circulation in the established manner, upgrading currency expertise procedures and improving the legal framework.

As of 31 December 2020, the amount of cash in circulation was GEL 4,661.4 million. Of this, banknotes accounted for GEL 4,526.6 million and coins for GEL 134.8 million. Diagram N 11.1 shows the share of banknotes in circulation by denomination in terms of value and quantity.

DIAGRAM N 11.1 SHARE OF BANKNOTES IN CIRCULATION BY DENOMINATION*

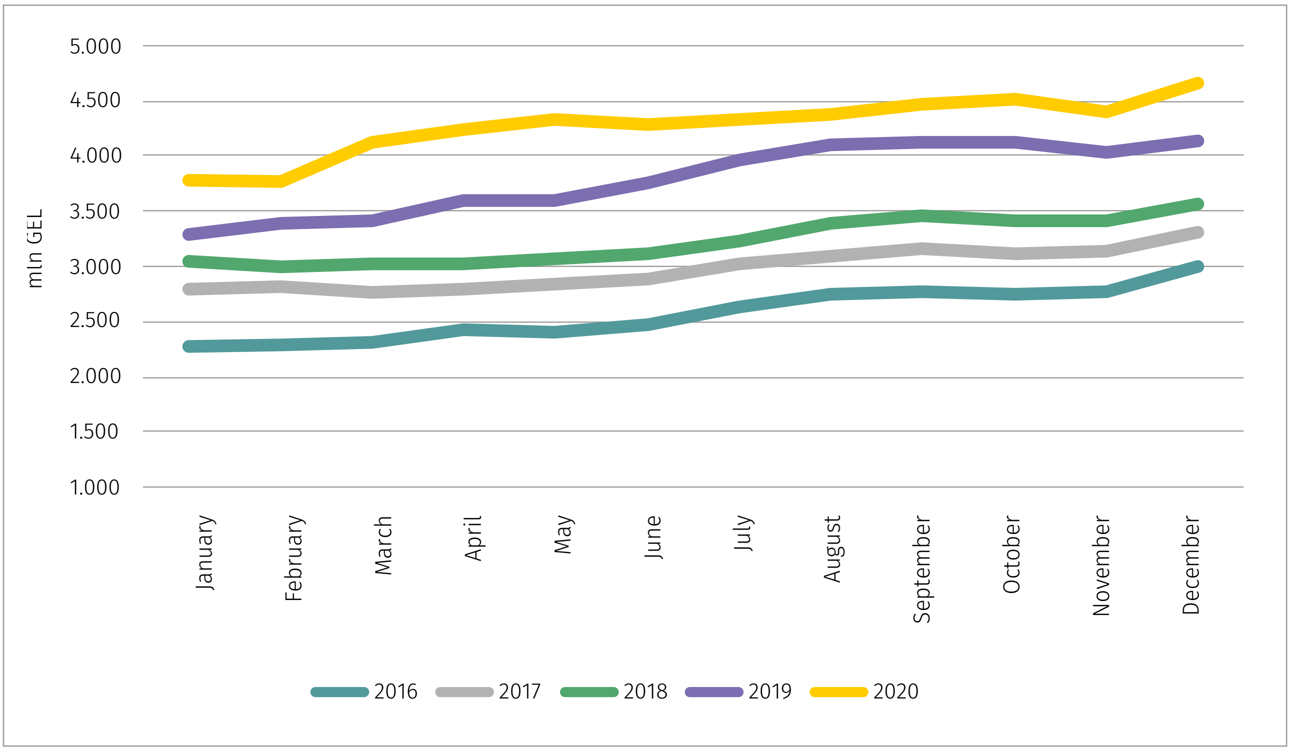


Source: National Bank of Georgia

During the reporting period, the amount of cash in circulation increased by GEL 524.4 million, or by 12.7%, compared to the beginning of the year.

Diagram N 11.2 shows the dynamics of Georgian currency in circulation in the period 2016-2020.

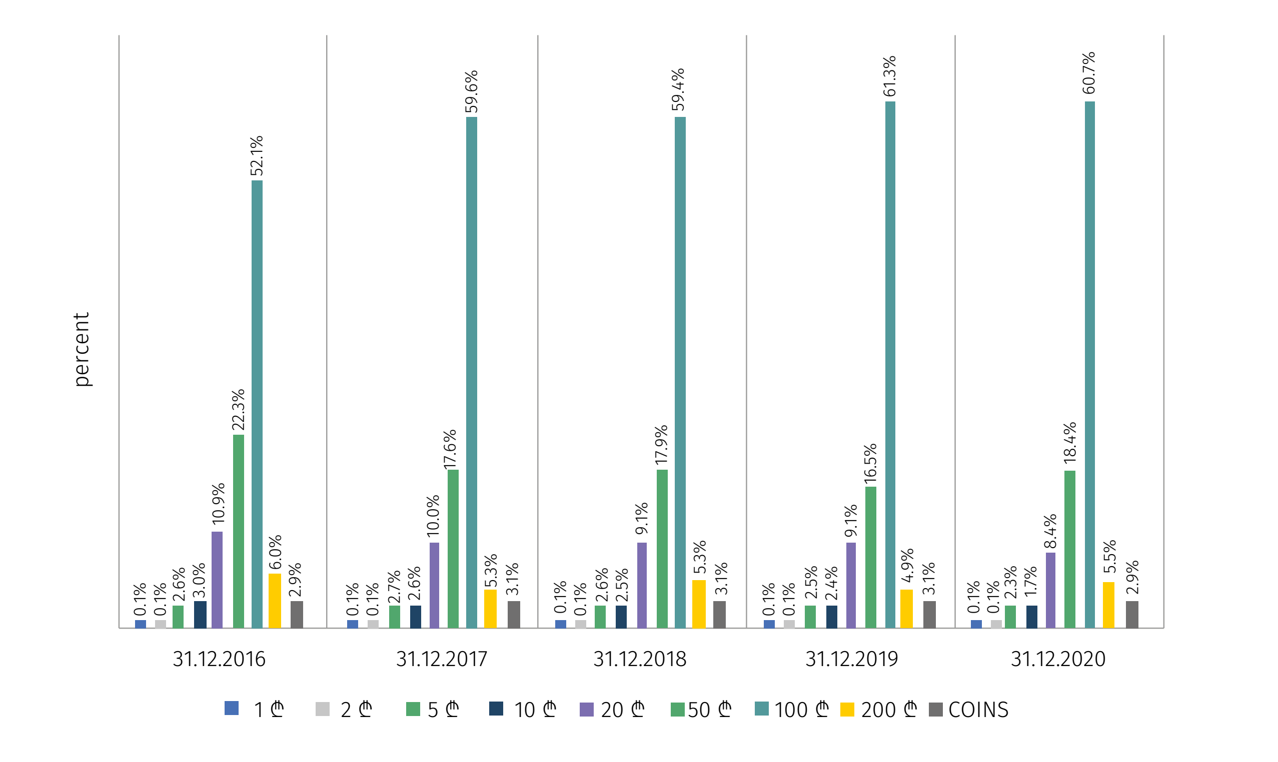
DIAGRAM N 11.2 CASH IN CIRCULATION (2016-2020)



Source: National Bank of Georgia

During 2020, the total value of banknotes in circulation increased by GEL 516.8 million, and its share in the total volume of money in circulation amounted to 97.1%. During this period, demand increased for banknotes of low denominations, specifically for 5- and 20-lari notes (rising by 3.3% and 4.1%, respectively), while demand for 10-lari banknotes decreased by 18.8%. Circulation demand also increased for all high denominations, with demand for 50-, 100- and 200-lari banknotes rising by 25.1%, 11.6% and 25.3%, respectively. However, in the context of such an increase in the total volume in circulation during the reporting period, with the exception of the shares of 50- and 200-lari banknotes, the shares of all other banknotes in circulation decreased slightly compared to the previous year. During this period, the total share of coins in circulation decreased slightly, falling by 0.18 percentage points to 2.89% (see Diagram N 11.3).

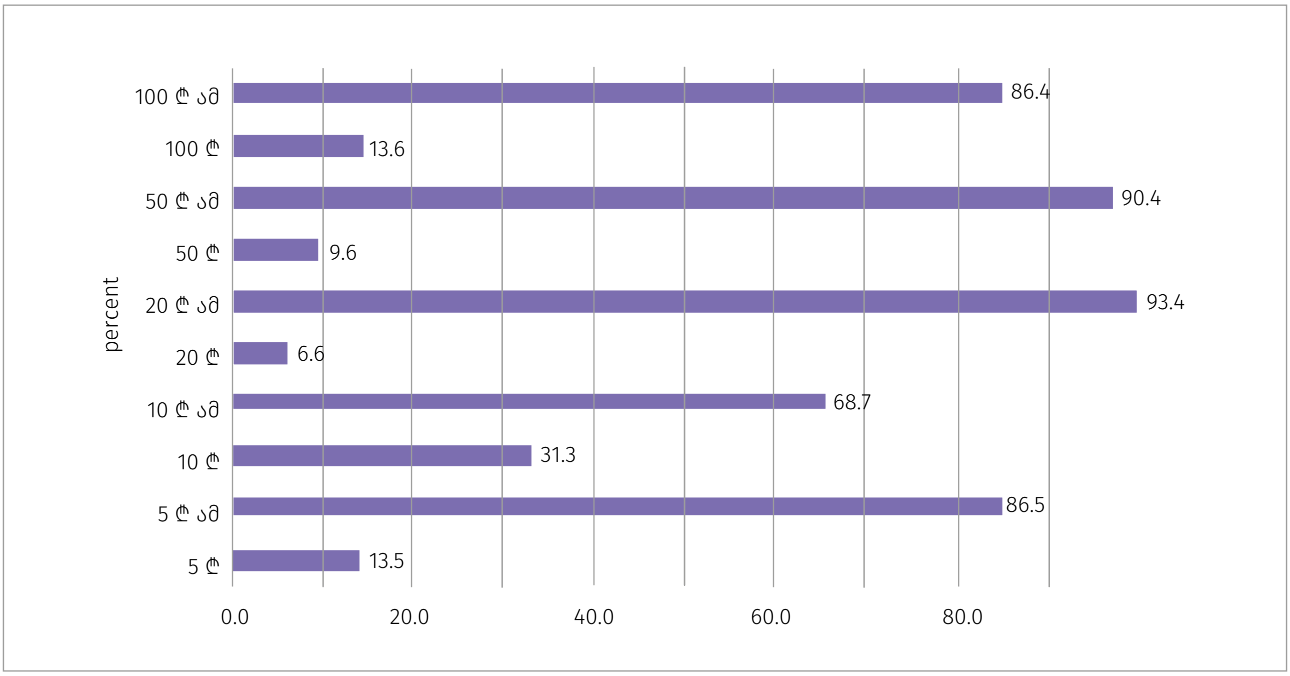
DIAGRAM N 11.3 SHARE OF BANKNOTES OF INDIVIDUAL DENOMINATIONS AND COINS IN CIRCULATION (2016-2020)*



Source: National Bank of Georgia

The process of upgrading the cash in circulation by withdrawing banknotes issued before 2016 and replacing them with the new modifications of 5-, 10-, 20-, 50-, and 100-lari banknotes has successfully been completed. By the end of the reporting period, the share of the upgraded 5-lari banknote accounted for 86.5% of the total banknotes of the same denomination in circulation, the upgraded 10-lari banknote accounted for 68.7%, the upgraded 20-lari banknote for 93.4%, the upgraded 50-lari banknote for 90.4% and the upgraded 100-lari banknote for 86.4% (see Diagram N 11.4).

DIAGRAM N 11.4 PERCENTAGES OF 5-, 10-, 20-, 50- AND 100-LARI BANKNOTES IN CIRCULATION, ACCORDING TO MODIFICATIONS



Source: National Bank of Georgia

The share of older banknotes in circulation by pieces in relation to the newer modifications of banknotes of the same denominations was only 12.9% at the end of the reporting period.

The total amount of 1- and 2-lari coins in circulation increased by 4.9% during the reporting period and amounted to GEL 88.9 million at the end of the year.

The total amount of tetri coins in circulation increased by 8.2% compared to 2019.

During the reporting period, we remained committed to our goal of sustaining the production of lari banknotes and coins and putting them into circulation, thus safeguarding an uninterrupted supply of cash to the country’s economy, while replenishing the National Bank's reserve.

The design and other characteristics of the 50- and 100-lari banknotes produced during the reporting period are identical to those of the same denominations of 2016 the modification, with the exception of featuring the year of issue as "2020" and incorporating a modified signature reflecting that of the current Governor of the National Bank of Georgia. Following the routine inspection of these banknotes, the 50-lari banknotes were put into circulation from 15 October, and the 100-lari banknotes from 14 December 2020.

During the reporting period, the production of 2-lari, 50-tetri and 10-tetri coins occurred, which included inspection of their compliance with proof samples and contractual specifications, and putting them into circulation.

In 2020, work commenced on the production of further banknotes and coins of two denominations in circulation. In this regard, selection procedures for a production partner were completed, an agreement was signed with the selected partner and the production process got underway. The process of producing banknotes of both denominations is nearing completion. The coin sample is expected to be received from the selected mint for the purpose assessing the design and its quality.

The National Bank of Georgia continued to work on the issuance of collector coins during the reporting period. These are used for promoting the national currency and the country as a whole. In 2020, a committee consisting of representatives of the National Bank of Georgia and other pertinent agencies determined the figures to be featured on the collector coins forming the "Kings of Georgia" series that had previously been confirmed by the Board of the National Bank of Georgia.

During the reporting period, work was conducted on the production of 5-lari collector coins dedicated to King Erekle II (from the "Kings of Georgia" series) and the Summer Olympic Games. However, due to the pandemic, only the former was received, with 1,500 silver and 300 gold 5-lari collector coins dedicated to King Erekle II being produced. The coins received great public approval, as was confirmed by the results of their sale.

Coin designed by Levan Kakiashvili

The central composition of the obverse of the coin is a portrait of King Erekle II. The coin also features Erekle's signature "ერეკლე", his sword and the years of the king's birth and death – "1720" and "1798". In the lower central part of the coin there is an image of a coin that had been minted in the name of Erekle II in the Tbilisi Mint, which portrays the ancestral coat of arms of the Bagrationians: a crown, scales, sphere, scepter and sword. In the case of the silver coin, these details are gilded.

The central composition of the reverse of the coin is the Iverian (Georgian) crown. The inscriptions on the coin are: "საქართველო", "5 ლარი", "GEORGIA" and "2020".

In 2020, preparations were also made for the production of 5-lari collector coins recognizing the 100th anniversary of the adoption of the first Constitution of Georgia, Earth Day, and on the themes of King David the Builder and Queen Tamar (as part of the "Kings of Georgia" series). These included the following steps:

- A competition was held for designs for collector silver coins dedicated to the 100th anniversary of the adoption of the first Constitution of Georgia and Earth Day, and a partner was selected.
- A competition was announced for the selection of appropriate design sketches for silver and gold collector coins on the themes of King David the Builder and Queen Tamar (for the "Kings of Georgia" series).

Work on these collector coins is still underway.
The National Bank of Georgia took preventive measures necessary to prevent the spread of the COVID-19 pandemic, to supply the national economy with cash and to minimize risks inherent to this function. These measures included the following:

- At the outset of the pandemic, the National Bank of Georgia immediately created virtual storage facilities for the cash center, which are equipped with security measures and applicable software at three different locations, developed pertinent regulations, and started servicing commercial banks.
- The NBG imposed a two-week quarantine on cash received from circulation, placing it separately and only recalculating it after the expiration of the set period.
- Cash center personnel interchanged their working hours at strictly defined intervals.

The inflow of national currency in cash increased and amounted to GEL 6,362 million in 2020, which is 14.3% more than in 2019; while the outflow of national currency in cash from the National Bank of Georgia amounted to GEL 6,886.7 million, which was 13.1% more than in the previous year. Foreign currency inflows during the reporting period amounted to USD 85.8 million and EUR 3.8 million, while foreign currency inflows amounted to USD 148.2 million and EUR 7.1 million.

In terms of temporary storage, 155 valuable items were received from the courts, investigative and other administrative bodies, and 92 units of valuables were issued to them. A single unit of domestic valuable was also received for temporary storage.

Banknotes of 50- and 100-lari denominations that were made in 2020, totaling GEL 150,000, were issued to commercial banks on the condition of their return for adaptation, and were duly returned.

The accomplishments of the Cash Center’s cash desk over the year include the following:

- 393 operations exchanged 54,590 units of money with an overall value of GEL 115,700.

- 8,789 operations were performed to issue products of numismatic value, including:

- Products worth GEL 352,500 were purchased with cash.
- Products worth GEL 360,200 were acquired with plastic payment cards.
- Products worth GEL 750,400 were purchased through the online store.
- Products worth GEL 2.3 million were purchased with advance payment.
- Products worth GEL 8,400 were donated on the basis of orders.

During the reporting period, the following work was performed to ensure the proper functioning of the technical facilities for counting and processing money:

- Following the procedure for lari banknote sorting, as well as the frequency of such sorting as set by the procedure, the proper functioning of money counting/sorting machines was verified.
- The technical support group of the cash center performed the scheduled annual inspection and capital repairs for two BPS-M7 and two BPS-1080 cash processing aggregates, as well as of four air compressors. With the involvement of a group of experts, the available money sorting machines were inspected for compliance with the third level of sorting suitable banknotes on a quarterly basis, and appropriate inspection acts were drawn up.
- Twelve new "MAGNER 35-2003" banknote counting machines were purchased, adapted and put into operation.

Newly produced units of money were thoroughly counted and sorted, to ensure that defective or substandard banknotes did not enter circulation. During the reporting period, the process of recalculating the 2-lari coins received from the German Bavarian State Mint, was completed and 6,487 defective coins were found. The process of counting and sorting 10- and 50-tetri coins has commenced and is still in progress.

During the year, Oberthur Fiduciaire, the French banknote manufacturer, was found to have complied with the specifications of their contract for the production of the 50- and 100-lari banknotes. Written conclusions on this matter were submitted to the Board of the National Bank of Georgia for an appropriate response.

The examination of existing banknotes and coins in circulation continued during the year. This covered 19,688 suspicious banknotes submitted by commercial banks, currency exchange bureaus, microfinance institutions, law enforcement agencies and those brought in by individuals. The results of the inspections are shown in Table N 11.1 below.

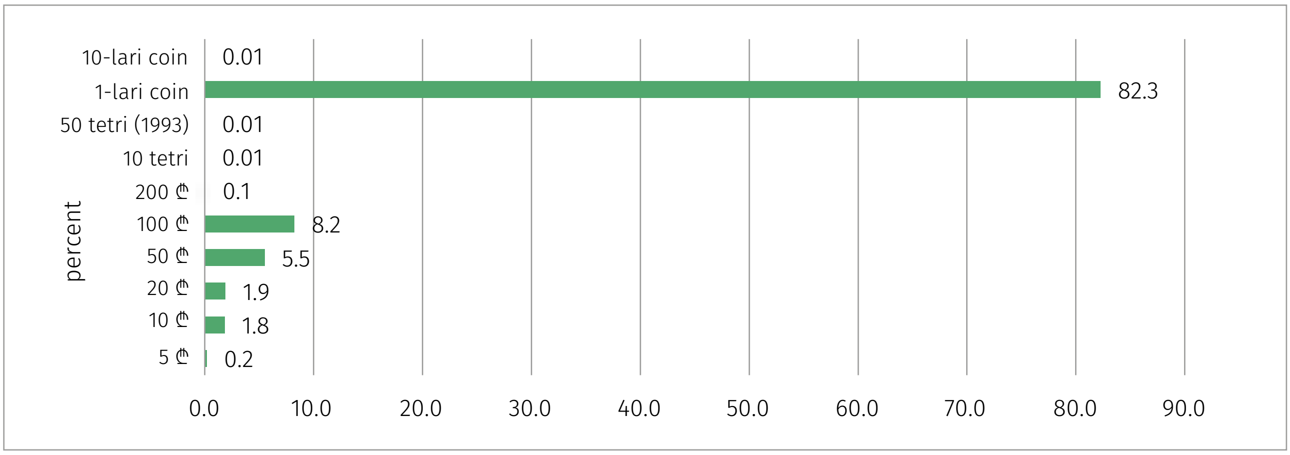
TABLE N 11.1 RESULTS OF THE EXAMINATION OF SUSPICIOUS BANKNOTES AND COINS RECEIVED IN 2020

	Suspicious	Counterfeit	Genuine	Faulty
Lari banknotes	4,556	3,035	1,016	505
Lari coins	14,282	14,101	180	
US dollar notes	576	399	177	
Euro notes	126	93	33	
Other foreign currency notes	126	93	33	
Total	**19,688**	**17,765**	**1,418**	**505**

Source: National Bank of Georgia

The ratio of counterfeit lari banknotes and coins detected in 2020 are shown in Diagram N 11.5.

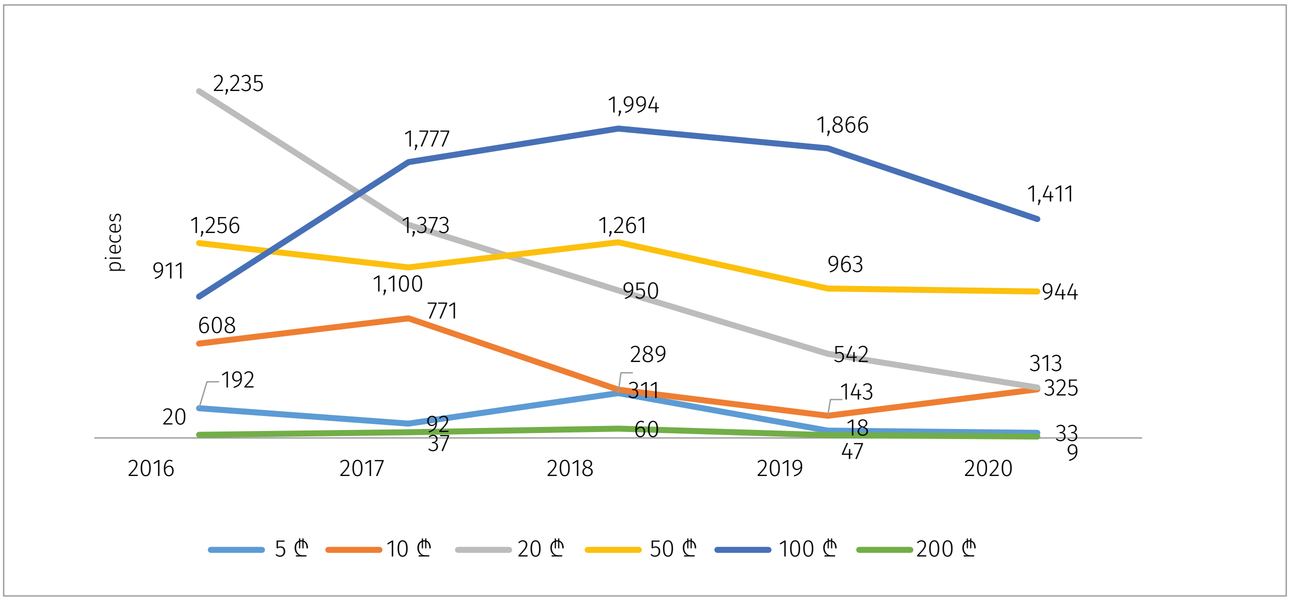
DIAGRAM N 11.5 COUNTERFEIT NOTES AND COINS DETECTED IN 2020 (PERCENTAGE)



Source: National Bank of Georgia

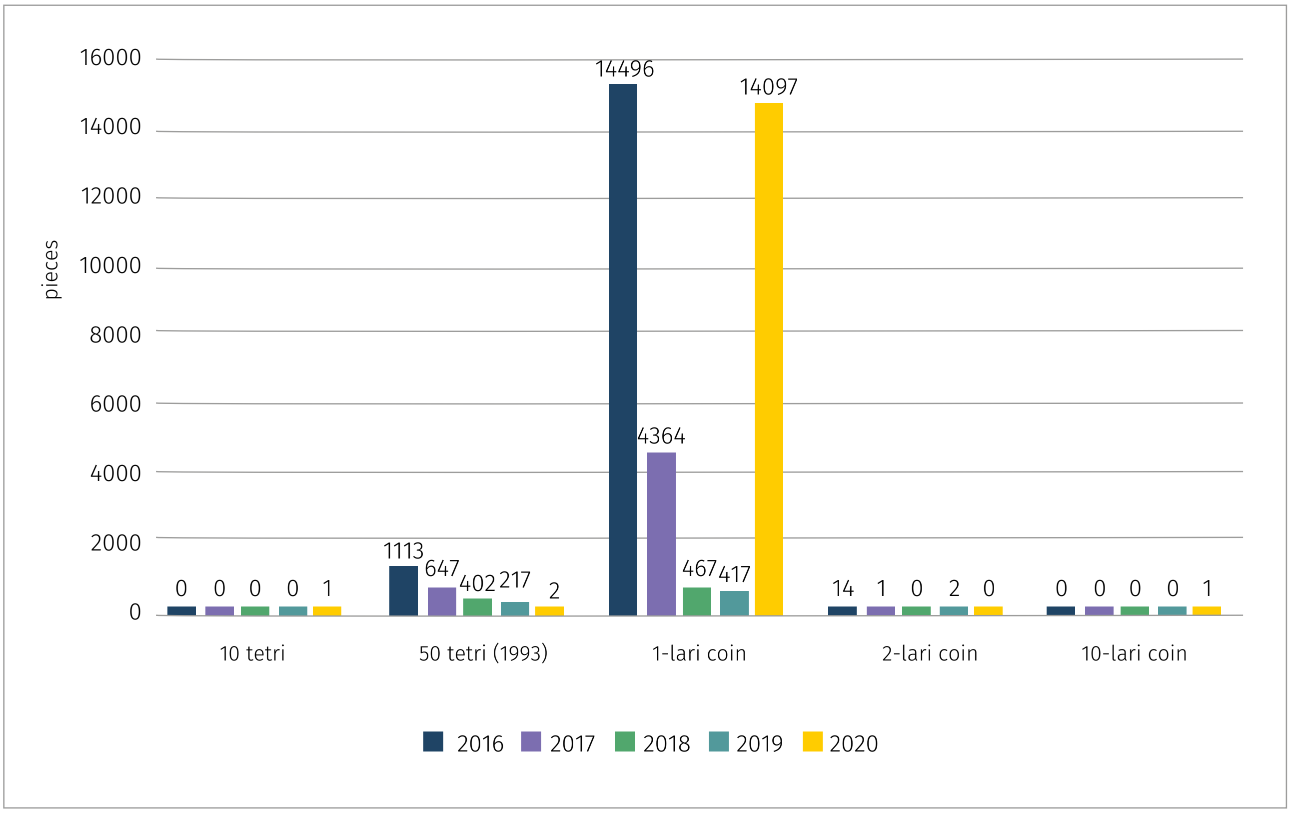
The number of counterfeit lari banknotes detected in 2020 decreased by 15.2% compared to the previous year, the number of counterfeit euro banknotes decreased by 41.1%, the number of counterfeit dollar banknotes decreased by 42.5%, and other counterfeit foreign currency detected fell by 34.7%. The number of counterfeit lari coins detected increased 22.2 times compared to 2019. The majority of these coins were handmade by fraudsters apparently targeting payment and automatic vending machines. The number of counterfeit lari banknotes and coins detected in 2016-2020 by denomination is shown in Diagrams N 11.6 and N 11.7.

DIAGRAM N 11.6 NUMBER OF COUNTERFEIT LARI BANKNOTES DETECTED IN 2016-2020



Source: National Bank of Georgia

DIAGRAM N 11.7 NUMBER OF COUNTERFEIT LARI COINS DETECTED IN 2016-2020



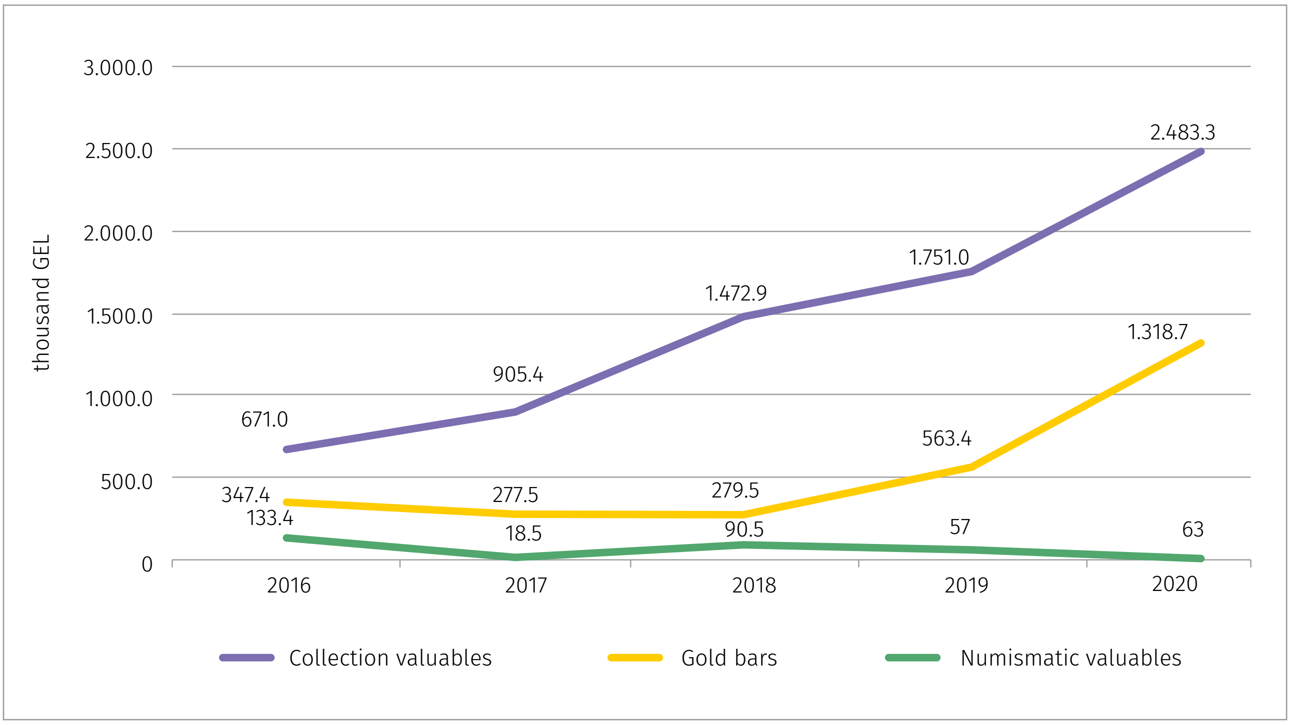
Source: National Bank of Georgia

The NBG continued to sell collector valuables and gold bars, as well as other numismatic products during the reporting period. During 2020, 22,100 units of various valuables were sold, with a total value of GEL 3.8 million. Proceeds from the sale of collector coins increased by 41.8% compared to the previous year and income from the sale of gold bars increased 2.3 times. Meanwhile, proceeds from the sale of numismatic products decreased to only 11.1% of last year's income. Total earnings from the sale of such valuables during this period increased by 60.6% (GEL 1.4 million). The items sold in 2020 were as follows:

- The Cash Center's cash desk serving individuals sold 19,700 units, with a total value of GEL 3 million.
- The online store sold 2,300 units, for the amount of GEL 752,000.
- Kvareli Museum sold 39 units, with a total value of GEL 427.

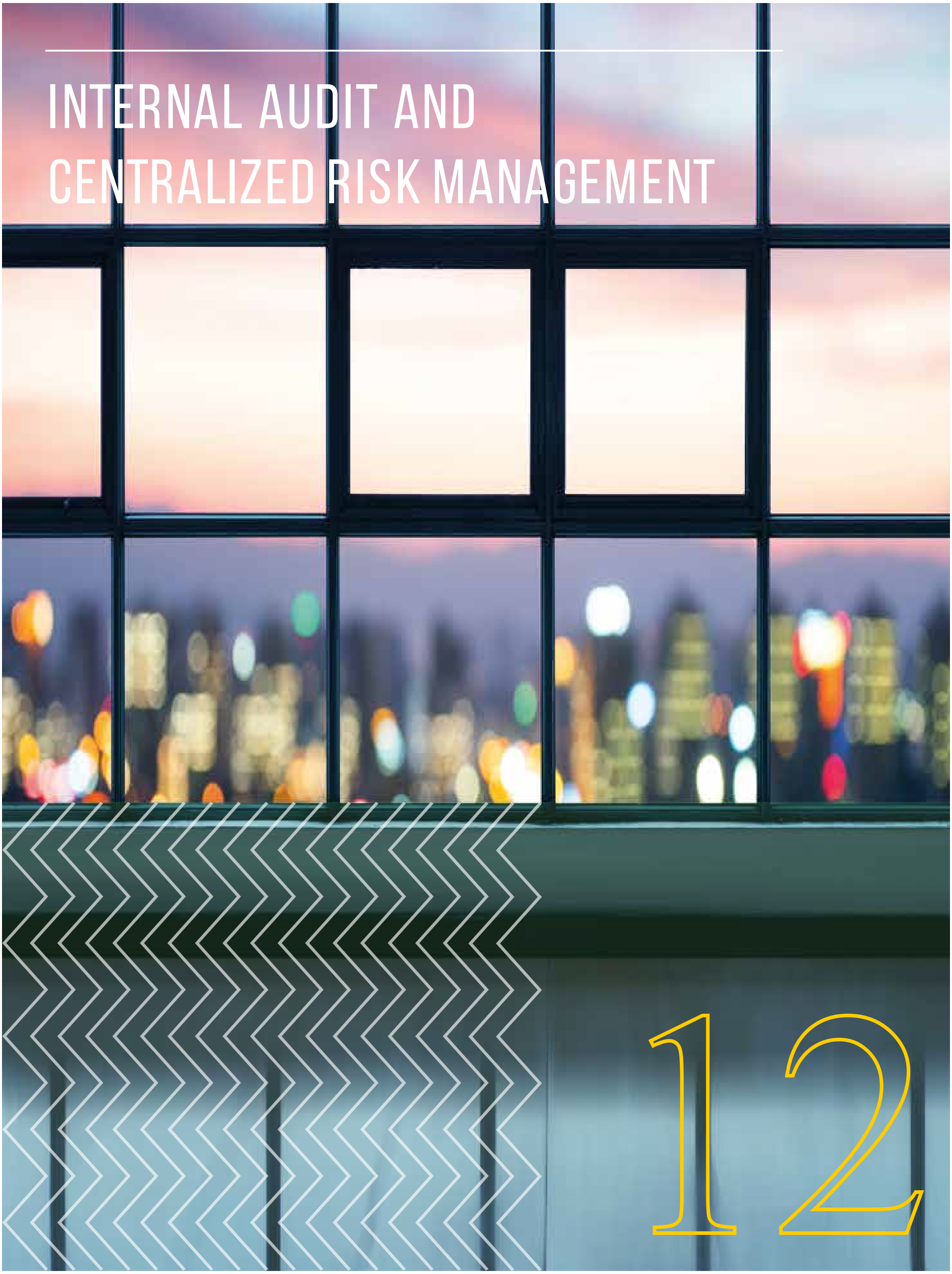
Diagram N 11.8 shows the dynamics of valuables sold in 2016-2020 by type.

DIAGRAM N 11.8 VALUABLES SOLD IN 2016-2020



Source: National Bank of Georgia

INTERNAL AUDIT AND CENTRALIZED RISK MANAGEMENT



12

INTERNAL AUDIT

The Internal Audit Service operates in accordance with the IIA's[78] International Standards for the Professional Practice of Internal Auditing. In line with the requirements of the Quality Assurance and Improvement Program, an internal assessment was completed at the beginning of the reporting year. Based on the results of the assessment, the main quality criteria was achieved, with there being "general conformity" with the aforementioned standards and the IIA's Code of Ethics.

In line with the modern approach of risk-based internal auditing, and taking into consideration the results of the organization's risk maturity assessment, the internal audit activity plan was based mainly on the organization's risk register. The prioritizing of auditees, as part of the planning process, incorporated factors such as the three-year audit cycle, the date of the last audit, audit assessments and the status of recommendations. Following changes in the organizational structure of the National Bank and the upgrading of the functions of relevant structural units in the Statute of the National Bank, Audit Universe was also updated.As a result, a dynamic plan of assurance services for 2020 was developed and approved by the Board. Considering the dynamic principle of planning, which implies a revision of the audit plan at six-month intervals, the assessments of the risks related to auditees were re-analyzed in the middle of the reporting year. This approach allows the concentration of audit resources on high-risk auditees.

Despite the transition to a remote mode of work during the pandemic, the Internal Audit Service carried out 24 internal audit engagements and reviews, as specified in the audit plan for the reporting year. However, the transition to remote work mode required the application of approaches that differed from the standard process of providing assurance services. In this regard, the Internal Audit Service developed a remote audit procedure for use when auditing in a variety of possible emergencies.

The process of monitoring recommendations provided by the Internal Audit Service on the basis of various audit engagements continued during the reporting period. The follow-up process was carried out through the Audit and Risk Management Software, which makes it possible to update information by audited entities, upload relevant evidence and consolidate the data placed in the system. During the follow-up audit, the internal auditors responsible for monitoring the recommendations issued to individual structural units, rechecked the active recommendations and updated their status.

Taking into account the state of emergency and the epidemiological situation in the country, consulting services included two additional topical areas: business continuity and ensuring a safe working environment within the organization during the pandemic. The Internal Audit Service, within the framework of its consulting mandate, participated in the work of the Business Continuity Committee and was involved in the meetings of a working group established to ensure compliance with the requirements of the Ministry of Labor, Health and Social Affairs of Georgia. Meanwhile, the Internal Audit Service provided consulting services to the structural units of the National Bank on various issues and procedural documents on a case-by-case basis, as a response to their requests.

78. Institute of Internal Auditors

Taking into consideration the organizational goals of the National Bank of Georgia and the current challenges facing the professional internal audit field, a new Strategy for the Internal Audit Service in 2020-2023 was developed during the reporting period. The strategy highlighted seven key strategic goals: software upgrades, implementation of real-time audit components, the development of the data analysis process, professional certification, optimization of remote internal audits, an analysis of stakeholder expectations, and modernization of the Internal Audit Service's organizational structure.

During the reporting period, important steps were taken to develop the methodology of the Internal Audit Service, in order to improve and clarify perception of the conclusions set out in the audit reports on assurance services provided. Following the complete transition to a risk-based internal audit approach, the key criteria for defining the categories of an audit's conclusion (regarding identification and management of risks; risk mitigation to an acceptable level; the effectiveness of correcting deficiencies; and the effectiveness of the monitoring system) were upgraded. These criteria are the basis for the assessment the effectiveness of the risk management and controls of each auditee. The new approach also gives a possibility to involve additional criteria in the assessment process and to evaluate the compliance of specific risks related to a particular auditee with the Risk Appetite of the organization. Thus, the new approach is an additional tool that enables internal auditors to use certain additional criteria for assessment (in addition to the audit judgement that remains the basis for assessment according to IIA standards). Each of the above developments will have a positive effect on the quality of assurance services provided.

Non-financial risk management

The Non-Financial Risk Management Framework is implemented and performed at the National Bank of Georgia to ensure a common, consistent approach towards the identification, assessment, treatment and monitoring of non-financial (operational and reputational) risk. It also identifies response measures that serve the purpose of reducing risk. The framework is forward-looking, comprising of three components: incident management, non-financial risk management and business continuity management systems. Furthermore, the framework is supported by the NBG's internal procedures system in order to achieve maximum transparency of the bank's processes. Risk management in the bank is arranged using a three-line of defense model, where the first line is the structural units (risk owners), the second line is the Centralized Risk Management Department, and the third line is the Internal Audit Office. The Centralized Risk Management Department is responsible for the effective functioning and continuous improvement of the centralized risk management system. The centralized risk management framework includes a definition of the acceptable level of non-financial risks (risk appetite). The Board of the National Bank sets the risk appetite on an annual basis. Overall, the National Bank uses a conservative approach to non-financial risks and makes sure that the acceptable level it sets is in the low-risk zone. The NBG allocates adequate resources and continuously improves its internal control environment in order to comply with and maintain the acceptable level.

The risk assessment process aims to identify the material risks to which the bank is vulnerable. The bank applies risk and control self-assessment to every function in order to guide the risk assessment process. During the reporting year, special attention was paid to COVID-19 and its risk assessment, as the pandemic put the bank in need of significant additional controls.

To support the Centralized Risk Management Framework, the NBG will develop internal procedures to formalize the bank's processes and achieve maximum transparency. During the year, the bank continued to update its internal procedures and to develop new ones. In the context of COVID-19, the bank developed internal procedures that covered issues such as the remote work of employees, the prevention of the spread of infection inside the bank and the creation of a safe work environment.

Business continuity management

As the National Bank of Georgia is among the critical institutions of the country, it recognizes the importance of the resilience and continuity of its services. In this regard, the bank constantly plans, implements and monitors various activities. During the reporting period, in order to test and assess the readiness of the NBG's resources (human, logistical and technical), a series of training, testing and practical exercises were conducted on a regular basis. The business continuity management process is constantly being upgraded and advanced through these activities, which will ultimately be reflected in both the overall resilience of the bank and the continuous delivery of the critical services.

The spread of the coronavirus throughout the country became a significant challenge for the National Bank during the reporting period, putting the bank in need of rapid and significant response measures. New emergency tasks were initiated to safeguard the health of employees, to guarantee the continuous and smooth delivery of critical services, and, ultimately, to ensure the fulfillment of the National Bank's mandate. This was made possible through adopting appropriate technological solutions, which allowed the National Bank to discharge its functions remotely, including critical tasks. All necessary actions were prescribed and taken to prevent the spread of the virus and to create a safe work environment. Training offered during the year helped employees to adapt to the new reality and reduced underlying risks. As staff worked remotely, due attention was devoted to raising their awareness of information security issues. Care was also taken to introduce staff to the implementation of new requirements established by the bank.

The Business Continuity Management System and the aforementioned steps undertaken in the reporting year allowed the NBG to conduct its operations without any disruption, despite the pandemic crisis.

PUBLIC RELATIONS AND INTERNATIONAL COOPERATION

13

PUBLIC RELATIONS

The year 2020 was far from typical. It posed challenges to the entire world, including the National Bank of Georgia. The coronavirus pandemic put its own twist on the central bank's communication chain, with conventional channels largely being replaced by electronic and social media. The bank has published a list of the emergency actions taken in connection with COVID-19 on its website.

The National Bank of Georgia shifted its planned media activities to electronic platforms during the year. Along with the publication of the quarterly monetary policy reports, the bank produced short videos featuring the Governor of the NBG summarizing key points of the reports. Recordings of the presentation of the reports were also posted on the NBG's official website and social networks.

The Public Relations Division was dynamically involved in projects implemented during the year to ensure public awareness. These included the projects such as the currency market reform, the Launch of BMatch – Bloomberg's new trading platform, the start of the FinEdu education platform and various financial technology projects. Videos of various formats were produced and posted on social media.

The NBG continued working with international media and Central Banking, the renowned international publication, covered the National Bank's news over the year. Committed to transparency as one of its guiding principles, the NBG continued publishing periodical and thematic publications, including the Monthly Review, the quarterly Monetary Policy Report, along with the Financial Sector Indicators and Current Macroeconomic Indicators analytical reports. Statistical data and Monetary Policy Committee press releases were made available in a timely manner. The annual report for 2019 was printed in paperback. In addition, an edition of Economics and Banking, a scientific/analytical journal, was released, offering readers important articles on up-to-date matters. These publications are all available in electronic format on the official website of the NBG: https://nbg.gov.ge/en/publications

Social media channels also featured stories on the National Bank's staff. Posts included information about their education and professional experience, as well as success stories and achievements.

INTERNATIONAL COOPERATION

The actions of the National Bank of Georgia during 2020 were timely and adequate, both before and during the pandemic. This was confirmed by the assessments of a number of reputable international organizations, including the International Monetary Fund, the World Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, and various international rating agencies.

In 2020, Global Finance, a renowned international publication, nominated the Governor of the NBG among the world's best governors of central banks for the third year in a row.

GLOBAL FINANCE

BEST CENTRAL BANKER AWARD 2020

KOBA GVENETADZE

Nominated among the
World's Best Central Bankers
for the third year in a row

Earlier in the year, Koba Gvenetadze, Governor of the National Bank of Georgia, participated in an event organized by the International Monetary Fund in Rabat, Morocco, titled “Promoting Better Economic Governance and Eradicating Corruption in the Middle East, North Africa and Central Asia”. In a speech at the event, he spoke in detail about the reforms of the National Bank of Georgia that are crucial for long-term sustainability.

National Bank professionals participated in various high-level meetings throughout the year, which, due to the global circumstances, were held online. Governor Gvenetadze took part in a discussion organized by the International Monetary Fund dedicated to monetary and financial policy responses to the pandemic in emerging markets and developing economies. The participants of the event discussed examples from various countries.

The Governor of the National Bank of Georgia was also invited to be the keynote speaker at the World Bank’s Reserve Advisory and Management Partnership (RAMP) meeting titled "Global Response to COVID-19: Open Talk on Challenges and Goals". In this event, Governor Gvenetadze spoke in detail about how the COVID-19 pandemic affected the process of managing the reserves of the National Bank, how the process is being performed remotely and how this may help to create a model for the future.

Governor Gvenetadze was also the keynote speaker at a webinar of the Astana International Finance Center and the Bretton Woods Committee. In this speech he spoke about the impact of COVID-19 on the financial sector and the role of central banks.

SUSTAINABLE DEVELOPMENT AND SOCIAL RESPONSIBILITY

Sustainable development is a global challenge that is firmly on the agenda of the Georgian state. The integration of Sustainable Development Goals into national strategy requires a revision of the roles and operational models of government agencies, including those of the central bank.

The National Bank intends to set high standards of social responsibility for the financial sector and the economy and to lead by example in achieving its goal of making a positive impact, while simultaneously putting forward issues relevant to the general public.

Social responsibility lies at the heart of the National Bank’s mission and functions. In 2020, the National Bank began working on a new strategic approach to social responsibility. This involved an analysis of the bank's multifunctional setting, the classification of involved parties/ stakeholders, and the development of a CSR model and long-term strategy. The UN Framework for Sustainable Development Goals was used as a framework for this (see Illustration 1).

UN 2030 AGENDA: GLOBAL SUSTAINABLE DEVELOPMENT GOALS

Eight of the UN's seventeen global goals were selected as those that best reflect the priorities of the National Bank of Georgia (see Illustration 2):

1. No poverty (#1)
2. Quality education (#4)
3. Gender equality (#5)
4. Decent work and economic growth (# 8)
5. Industry, innovation and infrastructure (#9)
6. Climate action (#13)
7. Peace and justice, strong institutions (#16)
8. Partnership to achieve the goals (#17)

THE NBG'S PRIORITIES

Categories of involved parties/stakeholders:

Government Sector
- Ministries
- LEPL's
- Parliament

Financial Sector
- Commercial banks
- Microfinance institutions
- Capital market representatives
- Insurance companies

INVOLVED PARTIES/STAKEHOLDERS

International Partners
- Central banks
- The World Bank
- International Monetary Fund
- European Bank for Reconstruction and Development
- Asian Development Bank
- Sustainable Banking Network (SBN)
- International Finance Corporation
- Rating agencies

Civil Sector
- Donors
- Non-government organizations
- Experts
- Educational institutions

The functions of the National Bank were grouped according to the CSR model. The initial version of which consists of five components: 1) employees; 2) management and communication; 3) the general public; 4) the market; and 5) the environment.

THE CSR MODEL

1. EMPLOYEES

Employees are at the heart of the CSR model as the central support workforce of the organization. The responsibilities of the National Bank towards its employees and any applicable measures are divided into two aspects:

- Well-being – a safe work environment, remote work opportunities, health insurance, stress management and personal development workshops, corporate discounts, and an employee fund.
- Professional development – local and international training, transparent schemes for career growth, evaluation and remuneration.

In 2020, in response to the pandemic, the National Bank immediately responded to the new reality by shifting most of its staff to remote work formats. A new security protocol was developed, the central office and the cash center were equipped with disinfectants and other protective materials. Appropriate equipment was distributed to those who had to continue work as usual. All employees were provided emergency information training.

2. MANAGEMENT AND COMMUNICATION

By discharging its functions, the National Bank impacts not only the financial sector, but also many state and private institutions and organizations, and ultimately every citizen. As the policy of the National Bank is complex, explicit, controversial and out of favor in some cases, it is necessary to maintain open and ongoing communication with the public to explain any decisions taken. To serve this purpose, the National Bank sustains regular, transparent reporting (live reporting, social media posts, publications, and research papers) alongside proactive and scheduled media activity. In addition, the bank manages to promptly respond to questions raised by the media or the public.

During 2020, the National Bank delivered eight presentations of monetary policy reports and hosted four press conferences online. All events were covered in social media and were thus readily made available to the general public. Policy decisions were followed by online press conferences during the year. The decisions of the Financial Stability Committee and the Financial Stability Report, which were also made available to the public, presented an assessment of the vulnerabilities and risks to the financial system.

3. THE SOCIETY

The responsibilities of the National Bank towards society at large and any applicable measures were divided into two areas: 1) responsibility towards the financial sector and its customers and 2) responsibility towards the general public.
Responsibility towards consumers means protecting their rights. The National Bank also cares about the financial education of consumers and informing them about the increasing number of cyber threats. To this end, in 2020, the National Bank launched the educational platform FinEdu,

which contains valuable information and provides advice on issues such as financial management, financial and cyber security, and saving. The information on FinEdu.ge is regularly updated, and competent and impartial individuals are invited to post articles on the platform.

The National Bank's internship programs encourage students of economics, young professionals, small entrepreneurs and judges to obtain unique knowledge and experience from top industry experts.

Engagement with the general public is further encouraged through various scientific and creative competitions. Designs for collector coins are invited through open competitions. Through the production of collector coins that celebrate events and personalities of national and historical importance, the National Bank seeks to make a contribution to the nation's cultural heritage.

4. THE MARKET

The task of the National Bank is to maintain price stability and ensure the sustainability of the financial sector. In the medium term, price stability, under floating exchange rate conditions, is achieved through inflation targeting. In its capacity as the supreme regulatory body, the National Bank oversees and regulates the financial sector (providing access to financial services, responsible financing, etc.). In addition, the National Bank is responsible for the issuance and circulation of national currency and the development of new financial technologies.

Each of these functions were put to a great test by the events of 2020. In the context of the pandemic, the National Bank had to rearrange its operational processes in the shortest possible time and run them in the safest mode possible. The management of reserves and systems was thus switched to a remote scheme to ensure the continuity of bank functions.

The National Bank developed a temporary supervision plan as part of its effort to cushion the adverse impact of the pandemic on the financial sector and to stimulate the national economy. The bank simultaneously continued to provide liquid cash resources to the market. The National Bank's foreign exchange interventions were meant to mitigate excessive fluctuations of the national currency.

BMatch of the Bloomberg trading platform was launched at the initiative of the National Bank. It served to increase access to foreign exchange resources and to make the market more diversified, competitive and liquid. In addition, an open banking framework was developed in partnership with the Bankers' Association.

5. THE ENVIRONMENT

In today's world, environmental and social responsibility issues are becoming increasingly important for the financial system. In 2020, the coronavirus pandemic gave even greater relevance to the issue of climate and ecosystem change.

The National Bank has been a member of the Sustainable Banking Network (SBN) since 2017, and in February 2020 it joined the Network of Greening the Financial System (NGFS), which is comprised of central banks and supervisors. In 2019, a Sustainable Financing Guide was released to promote green and social and sustainable financing.

During 2020, the National Bank participated in five international webinars and forums on sustainable financing. At the end of the year, the National Bank, as a member of the SBN, together with the International Finance Corporation, hosted the National Bank of Ukraine and was eager to share its experience on a sustainable financing framework.

FUTURE STEPS

An analysis of the situation in 2020 has uncovered opportunities and areas for development, including the need for more vigorous employee volunteering and pro bono projects, energy efficiency initiatives, and enhanced cooperation with experts.

The following steps were deemed reasonable for strengthening the CSR strategy over the next two years: an action plan for 2021-2023, an information campaign for greater employee awareness, inclusion of thematic reporting in relevant platforms and publications for the general public and media (via the Annual Report, social media, and the NBG's website).

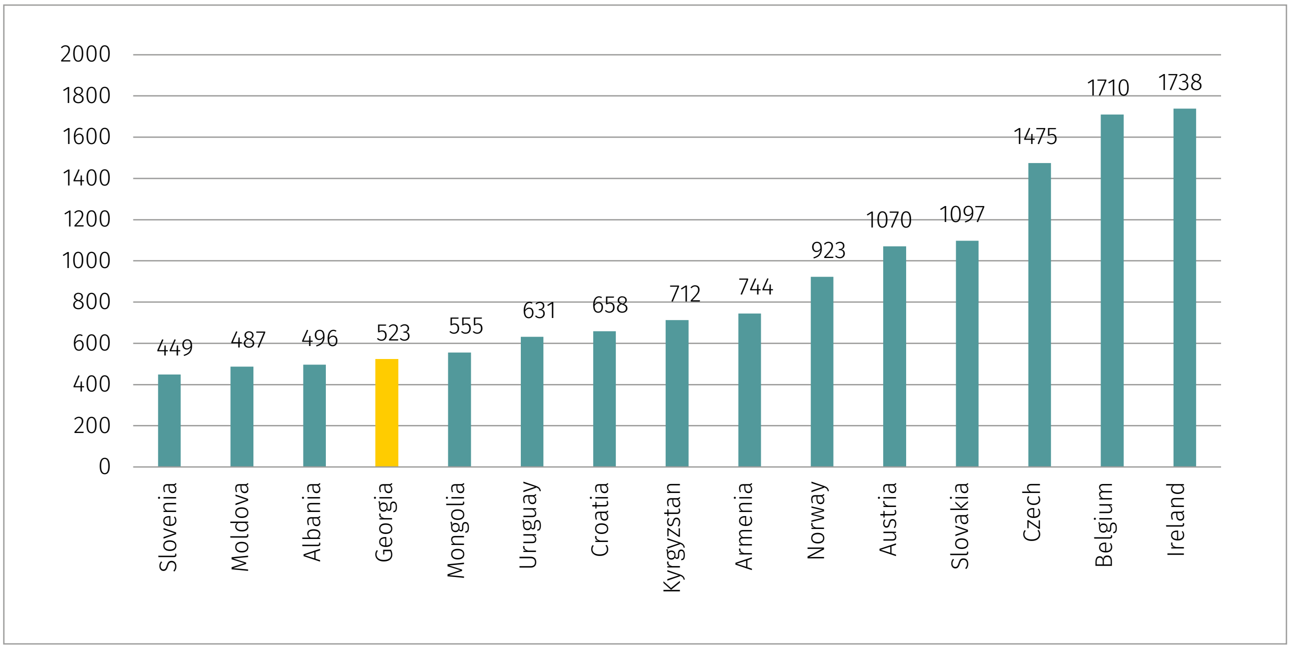
HUMAN RESOURCE MANAGEMENT AND DEVELOPMENT

14

STATISTICS ON THE NUMBER OF STAFF

By the end of 2020, the National Bank had 523 employees, of whom 411 were civil servants. The average age of employees is 38 years. Women made up 51.1% of the employees of the National Bank, and men 48.9%.

DIAGRAM N 14.1 NUMBER OF STAFF AT VARIOUS CENTRAL BANKS[79]



Source: Central banks and calculations of the National Bank of Georgia

The task of the National Bank of Georgia is to ensure the stability of prices and of the financial system. As a result of a number of legislative changes adopted by the Parliament of Georgia in the last few years, the mandate of the National Bank has been significantly expanded. Accordingly, structural changes were implemented in the organization and the number of employees increased. As shown in Table N 14.1, despite this increase, the National Bank still maintains an adequate size in relation to the country's population. The National Bank also oversees the securities market (in a similar manner to the central banks of Armenia, Norway, Ireland, Slovakia and Belgium).

79. The central banks included in the diagram implement monetary policy and oversee the banking sector.

TABLE N 14.1 NUMBER OF STAFF AT VARIOUS CENTRAL BANKS

Country	National population size	Number of central bank staff
Albania	2.88 million	1,070
Armenia	2.95 million	496
Austria	8.93 million	1,710
Belgium	11.49 million	1,738
Croatia	4.13 million	487
Czech	10.71 million	555
Georgia	3.99 million	923
Ireland	**4.88 million**	**523**
Kyrgyzstan	6.58 million	1,097
Moldova	4.04 million	449
Mongolia	3.22 million	744
Norway	5.37 million	631
Slovakia	5.45 million	712
Slovenia	2.07 million	1,475
Uruguay	3.51 million	658

Source: Central banks and calculations of the National Bank of Georgia

PROFESSIONAL DEVELOPMENT OF EMPLOYEES

The year 2020 was not a typical one for the National Bank of Georgia in terms of the professional development of its employees. All of the seminars that had been planned by European central banks and other financial institutions were canceled.

In 2020, 57 officials of the National Bank completed the certified Personal and Professional Competencies Development Course. In addition, 16 managers of the bank attended the Managerial Skills Course. Both trainings were organized remotely by the LEPL Ministry of Finance Academy, and, after testing, the participants were awarded with certificates.

In addition, as has become a tradition, the sharing of thematic presentations continued inside the National Bank. This is regarded as a good way to sustain institutional knowledge sharing.

PROFESSIONAL DEVELOPMENT OF FINANCIAL SECTOR STAFF

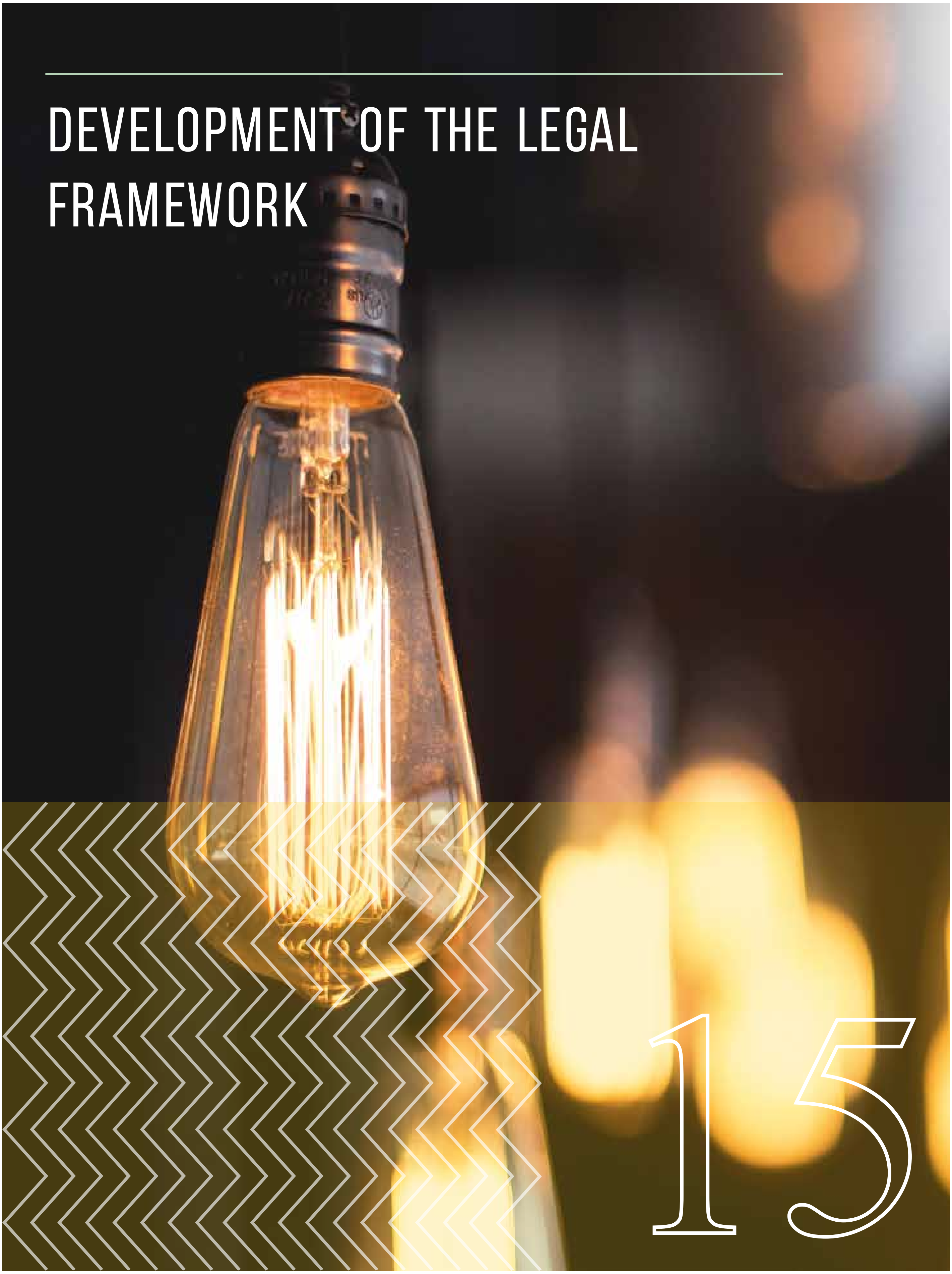
The National Bank of Georgia continuously promotes the professional development of employees of the banking sector. To this end, experts of the Luxembourg Financial Technology Transfer Research Agency conducted a series of three remote training sessions in 2020. Also, at the initiative of that agency, 91 representatives from the National Bank of Georgia and the financial sector attended e-learning courses. In addition, three seminars were held remotely, in which 25 participants from both the National Bank and commercial banks participated.

WORKING REMOTELY

The year 2020 turned out to be a significant challenge for the National Bank. Similar to other organizations, the bank was forced to switch almost completely to a remote mode of operating. The key challenge for the HR department while working remotely was to maintain team spirit and strengthen internal communications. To tackle this task, a number of undertakings were implemented, including online team building activities, and meetings with psychologists and field specialists to reduce work stress. Following the completion of a survey of employee satisfaction with remote work, a number of recommendations were developed to increase efficiency.

An online space for internal communication was also set up to give employees an opportunity to communicate and share news with each other.

DEVELOPMENT OF THE LEGAL FRAMEWORK



15

Throughout 2020, the Legal Department of the National Bank of Georgia continued to conduct its activities in accordance with the functions and main directions as defined by the Statute of the National Bank of Georgia. Considerable progress was made in the ongoing development and improvement of the legal framework.

The National Bank of Georgia was the author of numerous significant laws that entered into force in 2020. In particular, the Law of Georgia on the Securities Market and the Organic Law of Georgia on the National Bank of Georgia were amended in connection with the EU Transparency Directive and the harmonization of the legislation with Market Abuse Regulation, as well as membership of the International Organization of Securities Commissions (IOSCO). Adoption of the draft law enhanced and strengthened transparency requirements for issuers of public securities and holders of public equity securities; regulated a number of issues related to market manipulation and insider trading; and brought these in line with recognized international practice. These changes ensured the availability of necessary mechanisms for the effective functioning of the securities market, which, in turn, will help increase the level of transparency in the market, increase investor confidence and enhance their protection.

For these purposes, the following legal acts regulating the securities market were enacted within the timeframe provided by law: the "Rule on Issuer Transparency and Appointment of a Securities Registrar" approved by Decree №181/04 of the Governor of the National Bank of Georgia of 7 October 2020; the "Rule on Insider Trading, Illegal Disclosure of Insider Information and Market Manipulation" approved by Decree №180/04 of the Governor of the National Bank of Georgia of 7 October 2020; the "Rule on Submission of Reports on Public Offering and Placement of Securities" approved by Decree №179/04 of the Governor of the National Bank of Georgia of 7 October 2020; and the "Rule on Recognition of a Person as a Conscious Investor" approved by Decree №223/04 of the Governor of the National Bank of Georgia of 16 December 2020.

In 2020, a new Law on Investment Funds came into force with relevant amendments made to other laws. With the adoption of this law, Georgia has fulfilled its obligations under the EU Association Agreement, which implies the approximation of legislation to the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS).[80] In addition, the enactment of the law introduced principles for governing investment funds as developed by the International Organization of Securities Commissions (IOSCO). Legal acts regulating investment funds were also enacted within the timeframe provided by the law: the "Rule on Authorization, Registration, Recognition and Regulation of Investment Funds" approved by Decree №170/04 of the Governor of the National Bank of Georgia of 22 September 2020; the "Rule on Licensing, Registration, Recognition and Regulation of an Asset Management Company" approved by Decree №167/04 of the Governor of the National Bank of Georgia; the "Rule on Activities of Specialized Depository'' approved by Decree №168/04 of the Governor of the National Bank of Georgia of 22 September 2020; the "Rule on Maintaining the Register of Investment Fund

80. Directive 2009/65/EC of the European Parliament and the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) in a securities business. See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02009L0065-20200107

Unit Owners“ approved by Decree №169/04 of the Governor of the National Bank of Georgia of 22 September 2020; and the “Rule on Liquidation of the Investment Fund” approved by Decree №198/04 of the Governor of the National Bank of Georgia of 11 November 2020.

An amendment was also made to the Organic Law of Georgia on the National Bank of Georgia regarding the number of members of the Board of the National Bank. As a result of the changes, the number of board members was increased by two and, according to the law, the board now consists of nine members. In addition to the Chairperson, the board consists of three Vice-Presidents of the National Bank and other non-executive members. To fully enact the recovery and resolution framework as a follow-up to legislative changes made in 2019, the National Bank developed the following legal acts: the “Rule on Licensing, Management and Market Exit of the Bridge Bank” approved by Decree №132/04 of the Governor of the National Bank of Georgia of 29 June 2020; the “Rule on Simplified Procedures for Acquisition of a Significant Share of a Commercial Bank in Resolution” approved by Decree №130/04 of the Governor of the National Bank of Georgia of 29 June 2020; the “Rule on Valuation of Commercial Bank Assets and Liabilities for the Purposes of the Resolution” approved by Decree №128/04 of the Governor of the National Bank of Georgia of 29 June 2020; the “Rule on Defining and Assessing the Critical Functions of a Commercial Bank” approved by Decree №129/04 of the Governor of the National Bank of Georgia of 29 June 2020; the “Rule on Development and Evaluation of a Commercial Bank Recovery Plan” approved by Decree №131/04 of the Governor of the National Bank of Georgia of 29 June 2020; the “Rule on Write-down or Conversion of Commercial Bank Liabilities for Recapitalization” approved by Decree №241/04 of the Governor of the National Bank of Georgia of 29 December 2020; the “Rule on Issuance of New Shares for the Recapitalization of a Commercial Bank in Resolution” approved by Decree №239/04 of the Governor of the National Bank of Georgia of 29 December 2020; the “Resolution on Appointment and Functions of the Temporary Administrator” approved by Decree №240/04 of the Governor of the National Bank of Georgia of 29 December 2020; the “Rule on Appointment and Functions of a Special Manager” approved by Decree №243/04 of the Governor of the National Bank of Georgia of 29 December 2020; the “Rule on Elaboration of the Commercial Bank Resolution Plan” approved by Decree №242/04 of the Governor of the National Bank of Georgia of 29 December 2020; and the “Terms and Conditions for Issuing a Last Resort Loan by the National Bank of Georgia” approved by Resolution №5 of the Board of the National Bank of Georgia of 28 December 2020.

The Statute of the Interagency Committee on Financial Stability was signed and Decree №117/04 of the Governor of the National Bank of Georgia of 3 June 2020 approved the “Rule on Procedure of the Resolution Committee of the National Bank of Georgia”. Decree №118/04 of the Governor of the National Bank of Georgia of 3 June 2020 approved the “Composition of the Resolution Committee of the National Bank of Georgia”.

Joint Decrees of the Minister of Finance of Georgia and the Governor of the National Bank of Georgia were also issued: “Establishment and Administration of a Resolution Fund, Approval of the Procedure for Issuance of Temporary State Funding by the Ministry of Finance of Georgia” №329 – 247/04 of December 31, 2020 Joint Decree

of the Minister of Finance of Georgia and the Governor of the National Bank of Georgia, and another Joint Decree of the Minister of Finance of Georgia and the Governor of the National Bank of Georgia, №328 - 246/04 of 31 December 2020 on "Approval of the Criteria for Imposition of Contributions for the Reimbursement of Funds Allocated under Temporary State Funding".

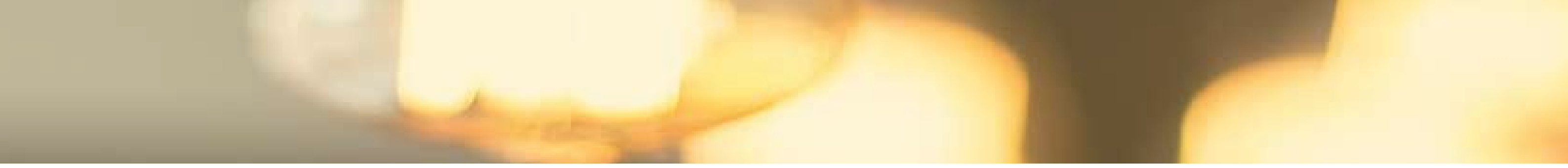
Significant changes were also made in the area of banking supervision. In 2020, important legal acts were issued in this direction, including the "Rule on Interest Risk Management of Bank Books" approved by Decree №42/04 of the Governor of the National Bank of Georgia of 12 March 2020, and the "Rule on Lending to Individuals" approved by Decree №44/04 of the Governor of the National Bank of Georgia of 13 March 2020. Several other decrees were amended, including Decree №26/04 of the Governor of the National Bank of Georgia of 10 March 2015 regarding the "Rule on the Approval of the Regulation on Managing Conflict of Interests".

In 2020, the legislative framework was improved in terms of non-banking supervision as well. Legal acts such as the "Rule on Determining, Imposing and Enforcing the Amount of Fines on Currency Exchange Bureaus" approved by Decree №17/04 of the Governor of the National Bank of Georgia of 5 February 2020; and the "Rule on Determining, Imposing and Enforcing Fines on a Microfinance Organization and Its Administrators" approved by Decree №16/04 of the Governor of the National Bank of Georgia of 5 February 2020.

On the basis of the Law of Georgia on Payment System and Payment Services, further important legal acts were issued, including the "Rule on Strong Costumer Authentication", approved by Decree №156/04 of the Governor of the National Bank of Georgia of 2 September 2020, which was aimed at ensuring secure authentication of payment service users. This regulation includes protection of the privacy and integrity of the customized security features of the payment service user; the reduction of the risk of fraud or other illegal activities that could positively affect the stability of the financial sector; a strengthening of consumer protection; the promotion of the effective and reliable functioning of financial and payment systems; and increasing consumer confidence in payment services and cashless payments. In 2020, the "Rule on the Card Instrument" approved by Decree №155/04 of the Governor of the National Bank of Georgia of 2 September 2020, was published. The purpose of this rule is to govern the issuance of card instruments in Georgia (including electronic money), to settle relations between the parties involved in the implementation of transactions using these instruments, ensure transparency of the payment service process, and protect clients' rights, while increasing client confidence in the payment instruments and cashless payments.

Other statutory documents of significance for financial market supervision were published and amended. These included the "Rule on Electronic Currency Trading Using the Bloomberg Trading System" approved by Decree №141/04 of the Governor of the National Bank of Georgia of 21 July 2020, and the "Rule on Activities of Foreign Exchange Market Participants" approved by Decree №142/04 of the Governor of the National Bank of Georgia of 21 July 2020.

In the area of financial technologies, the "Rule on the Establishment and Use of the Regulatory Laboratory Framework by the National Bank



of Georgia" approved by Decree №110/04 of Governor of the National Bank of Georgia of 25 May 2020, is expected to help test innovative financial products/services on the market, while promoting their development and market access at a lower cost. In an effort to develop financial technologies, the "Rule on Managing Risks Inherent to Statistical, Artificial Intelligence and Machine Learning Models" approved by Decree №151/04 of the Governor of the National Bank of Georgia of 17 August 2020, was published. This rule is intended to promote the establishment of a risk management framework for statistical, artificial intelligence and machine learning models and to effectively manage risks associated with these fields. In view of improving, developing and upgrading the legislative framework of the National Bank of Georgia on Facilitating the Prevention of Money Laundering and the Financing of Terrorism, the National Bank published an important legal act: the "Rule on the Study of the Client Ownership and Control Structure by the Accountable Entity and Approval of the Procedure for Identification and Verification of the Beneficial Owner" approved by Decree №189/04 of the Governor of the National Bank of Georgia of 21 October 2020. Amendments were also made to other regulations, including Decree №240/04 of the Governor of the National Bank of Georgia of 18 December 2019 on the "Approval of the List of High-risk Jurisdictions for Purposes of the Law of Georgia on Facilitating the Prevention of Money Laundering and Financing of Terrorism".

Electronic versions of the mentioned legal acts were officially published in the Legislative Herald of Georgia.


STATISTICAL
ACTIVITIES
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Despite the negative impact of the pandemic, the statistical activities of the National Bank of Georgia saw further improvement during 2020. The interactive visual reports published on the NBG's website are becoming increasingly popular. The generalized monthly financial data collected from commercial banks in previous years was successfully introduced and implemented during the year, allowing work with better quality data on transactions and a greater detail of aggregated data. This progress allowed the generation of financial account reports concerning financial assets and liabilities on stocks. As a result, at the beginning of the third quarter of 2020, such reports were published on a quarterly basis on the NBG's official website in the form of interactive visual reports. These reports provide detailed information on the financial position and financial flows of various institutional sectors of the economy, including those of the rest of the world. The reports detail financial indicators in different terms and can be presented in terms of both financial assets and liabilities on stocks, as well as flows. Further, the reports indicate which institutional sector distributed financial resources, to what extent these resources were distributed, for which sector and in what form, and which financial intermediaries were involved in the financial cycle.

The NBG plans to publish financial account statistics on flows. This work is underway, and its completion is expected in 2021. As such, the National Bank of Georgia is the first central bank in the region to have taken initial steps to prepare financial account reports in observance with the International Monetary Fund's recommendations. The validation methods of data on money transfers collected from commercial banks and microfinance institutions have now been improved, allowing users to be provided with high-quality reliable information about cash flows received and sent from different countries. The NBG website continued to publish interactive reports on a monthly basis and to provide remittance reports in a numerical format. These were reports were also featured in the media for the attention of the wider public.

Another accomplishment was the introduction of a modern format for statistical data and metadata exchange (SDMX). Benefiting from close cooperation with the Statistics Department of the International Monetary Fund and their consultations, reports of sectoral balance sheets compatible with the SDMX standard were generated. This format ensures the automatic filing of scheduled reports to the International Monetary Fund, thus replacing the previous format of data sharing. The basic metadata developed up until now only related to sectoral balance sheets. We went through the technical details related to the introduction of SDMX format, and plan to transform the data and metadata of the Statistical Information System of the National Bank of Georgia (SebStat) and to further migrate to the SDMX format.

The interactive report on official exchange rates to be posted on the NBG's website became generalized by adding nominal and real effective exchange rate indices. This report is currently undergoing testing and will be posted on the website in 2021. All reports related to exchange rates presented on the website in numerical format have already been transformed into interactive reports using the modern Business Intelligence platform of data visualization and analysis. Interactive exchange rate reports allow for much more varied and detailed analysis than the previous reports presented only in numerical format.

Considerable work was done to change the database required for the calculation of Financial Stability Indicators (FSI). The database used to produce this report is now based on the data of the Statistical Information System of the National Bank (SebStat). The applied changes allow generation of interactive reports based on the forms and appendices included in the FSI. Interactive reports on the FSI are nearing completion and will be published in an updated format on the NBG's website in 2021. This work will also facilitate the validation and correlation of the data to be uploaded to the IMF database.

The production of daily financial indicators data was also successfully updated. As a result of close communication and cooperation with commercial banks' reporting and analytics units during the year, daily financial data were collected and a number of interactive reports were prepared for internal consumption. The value of these reports lies in the ability to assess and analyze the daily dynamics of the banking system, which allows the National Bank, as a regulator, to instantly make decisions.

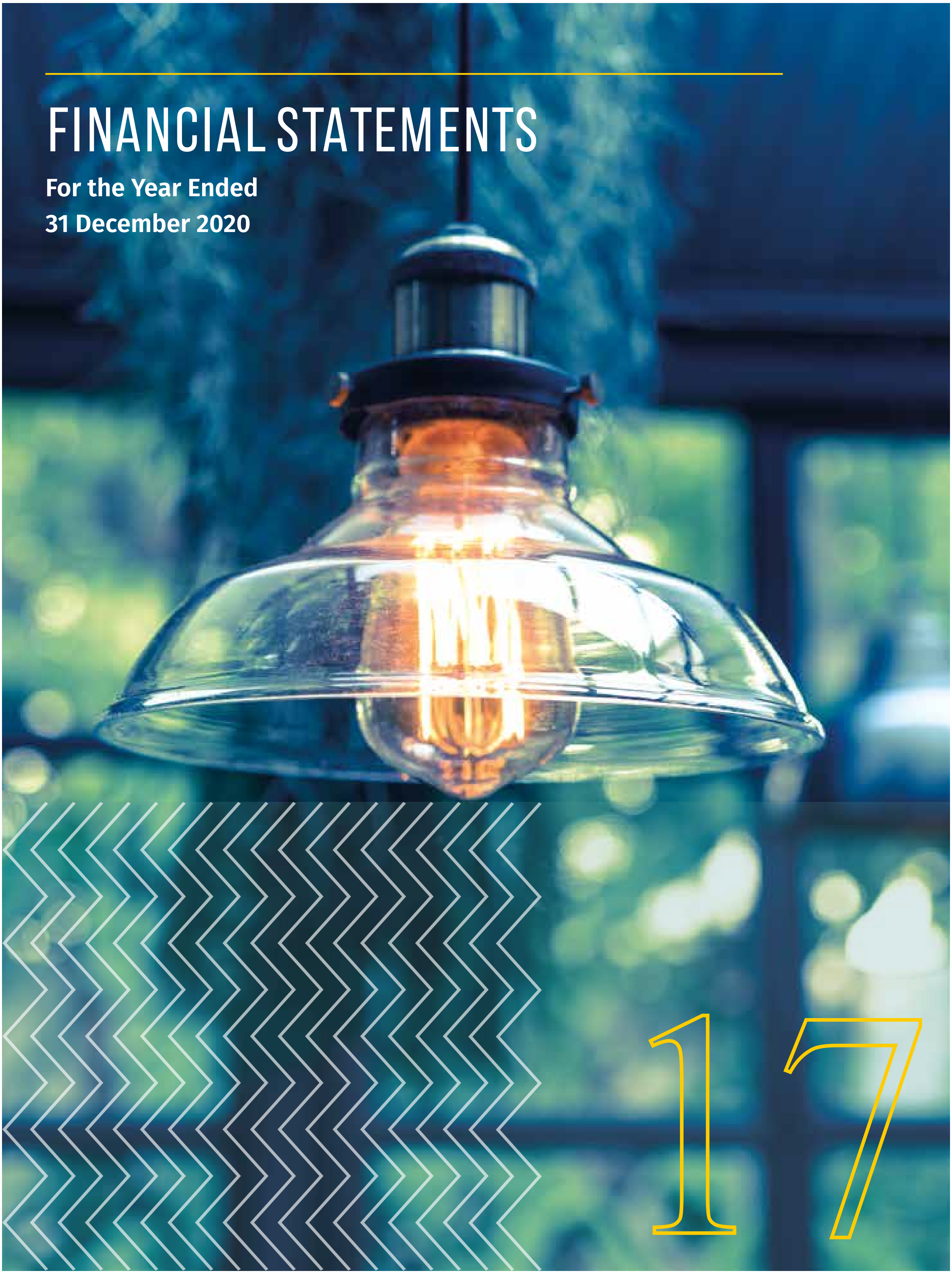
It is noteworthy that the 2020 Open Data Assessment of Open Data Watch ranked the statistical system of Georgia in 31st place in the world, placing it among the top 20 in Europe. Conducted in 187 countries, the assessment included 22 statistical categories and 65 indicators that incorporate the monetary and foreign sector statistics of the National Bank.

The National Bank of Georgia is committed to improving the quality of statistical data. The bank introduces various methods of data analysis and validation on a regular basis. These are then shared with the analytics units of commercial banks through the interactive statistics portal. As in previous years, individual interactive reports were prepared for each commercial bank, which significantly speeds up and simplifies the business process.

Actions are taken to improve the quality of data every year. In 2021, the NBG plans to improve data quality with regards to flows and other changes in the volume of assets for loans and securities instruments.

FINANCIAL STATEMENTS

For the Year Ended
31 December 2020



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NATIONAL BANK OF GEORGIA

STATEMENT OF MANAGEMENT RESPOSIBILITIES
FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2020

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 2020, 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 2020 were authorized for issue on 23 April 2021 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**

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Tbilisi, Georgia 0105
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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 2020, 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 2020, 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 International Code of Ethics for Professional Accountants (including International Independence Standards) (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.

Other Information

Management is responsible for the other information. The other information comprises the information included in the Annual report, but does not include the financial statements and our auditors' report thereon.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

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.

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
Georgia, Tbilisi
23 April 2021

NATIONAL BANK OF GEORGIA

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 2020
(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-20	Year ended 31-Dec-19
Interest income/(expense) from international reserves			
Cash and cash equivalents		(1,140)	13,333
Investments measured at fair value through other comprehensive income ("FVOCI")		123,329	190,775
Other		1,221	5,558
		123,410	**209,666**
Interest income from monetary policy operations			
Due from resident financial institutions		230,220	131,090
Investments measured at fair value through other comprehensive income		75,496	40,087
		305,716	**171,177**
Other interest income			
Investments measured at amortised cost		17,290	17,730
Due from resident financial institutions		-	498
Other		3	6
		17,293	**18,234**
Total interest income calculated using the effective interest rate method		**446,419**	**399,077**
Interest expense from monetary policy operations			
Debt securities issued		(5,495)	(4,440)
Due to resident financial institutions		(36,474)	(52,102)
		(41,969)	**(56,542)**
Other interest income/(expenses)			
Due to resident financial institutions		19	(320)
Due to International Monetary Fund		(12,602)	(14,440)
Due to customers		(5,212)	(9,181)
Interest expense on lease liabilities		(112)	(161)
		(17,907)	**(24,102)**
Total interest expense		**(59,876)**	**(80,644)**
NET INTEREST INCOME		**386,543**	**318,433**
Impairment (charges)/recovery	28	(32)	31
NET INTEREST INCOME AFTER IMPAIRMENT PROVISION		**386,511**	**318,464**
Net gains/(losses) from foreign currencies:			
- translation differences		680,748	339,677
- dealing		(22,978)	2,919
Fee and commission income	4	4,280	2,501
Fee and commission expense	4	(3,836)	(4,057)
Net gain on realised instruments measured at fair value through other comprehensive income		38,283	12,924
Net gain/(loss) on realised financial instruments measured at fair value through profit or loss		23,009	(4,220)
Net unrealised (loss)/gain on financial instruments measured at fair value through profit or loss		(7,571)	2,512
Other income	5	1,890	1,259
NON-INTEREST INCOME		**713,825**	**353,515**

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 2020 (CONTINUED)
(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-20	Year ended 31-Dec-19
Personnel expenses	6	(28,303)	(25,378)
General and administrative expenses	6	(10,640)	(10,550)
Money printing expenses		(16,848)	-
Depreciation and amortization	6	(6,240)	(5,582)
Other expenses		(930)	(1,060)
NON-INTEREST EXPENSES		**(62,961)**	**(42,570)**
PROFIT FOR THE YEAR		**1,037,375**	**629,409**
Other comprehensive income/(loss)			
Items that are or may be reclassified subsequently to profit or loss:			
Net unrealized gain on revaluation of investments measured at fair value through other comprehensive income during the year		69,591	34,958
Net realized gain on investments measured at fair value through other comprehensive income reclassified to profit or loss		(38,283)	(3,624)
Total other comprehensive income		**31,308**	**31,334**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		**1,068,683**	**660,743**

The financial statements as set out on pages 4 to 51 were approved by management on 23 April 2021 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 2020
(in thousands of Georgian Lari)

	Notes	31-Dec-20	31-Dec-19
ASSETS:			
Foreign currency assets			
International reserves			
Cash and cash equivalents	7	3,602,487	1,713,548
Special Drawing Rights holdings with the International Monetary Fund	9	697,227	572,233
Assets related to derivative instruments	10	13,989	5,362
Investments measured at fair value through profit or loss	11	177,163	152,395
Investments measured at fair value through other comprehensive income	12	8,323,015	7,610,388
Other foreign currency assets			
Other assets	17	986	253
		12,814,867	**10,054,179**
National currency assets			
Monetary policy instruments			
Due from resident financial institutions	8	3,214,170	3,142,134
Assets related to derivative instruments	10	1,318	-
Investments measured at fair value through other comprehensive income	12	1,168,338	809,443
Other national currency assets			
Due from resident financial institutions	8	-	-
Investments measured at amortised cost	13	201,661	241,616
Right-of-use assets under lease	14	1,232	2,077
Property and equipment	15	55,529	57,819
Intangible assets	16	4,856	4,980
Other assets	17	11,380	4,639
		4,658,484	**4,262,708**
TOTAL ASSETS		**17,473,351**	**14,316,887**

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 2020 (CONTINUED)
(in thousands of Georgian Lari)

	Notes	31-Dec-20	31-Dec-19
LIABILITIES AND EQUITY:			
LIABILITIES:			
Foreign currency liabilities			
Monetary policy instruments			
Due to resident financial institutions	18	5,480,533	4,231,029
Other foreign currency liabilities			
Due to resident financial institutions	18	103,071	73,437
Due to the Ministry of Finance of Georgia	19	788,928	616,518
Due to the International Monetary Fund	9	1,898,473	1,282,884
Other liabilities	17	6,203	1,247
		8,277,208	**6,205,115**
National currency liabilities			
Money issued in circulation	21	4,661,427	4,137,012
Monetary policy instruments			
Debt securities issued	22	59,273	79,149
Due to resident financial institutions	18	524,949	471,453
Other national currency liabilities			
Due to the Ministry of Finance of Georgia	19	661,984	838,104
Due to customers	20	1,394	267,604
Due to the International Monetary Fund	9	2,315	1,979
Other liabilities	17	9,579	9,932
		5,920,921	**5,805,233**
TOTAL LIABILITIES		**14,198,129**	**12,010,348**
EQUITY:			
Capital	23	15,000	15,000
Reserve fund	23	475,296	475,296
Foreign currency revaluation reserve	23	2,354,734	1,673,986
Other revaluation reserve	23	-	2,512
Revaluation reserve of investments measured at fair value through other comprehensive income	23	71,053	39,745
Retained earnings	23	359,139	100,000
TOTAL EQUITY		**3,275,222**	**2,306,539**
TOTAL LIABILITIES AND EQUITY		**17,473,351**	**14,316,887**

The financial statements as set out on pages 4 to 51 were approved by management on 23 April 2021 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 2020
(in thousands of Georgian Lari)

	Capital	Reserve fund	Foreign currency revaluation reserve	Other revaluation reserve	Revaluation reserve of investments measured at FVOCI	Retained earnings	Total equity
1-Jan-19	**15,000**	**288,120**	**1,334,309**	**-**	**8,411**	**79,956**	**1,725,796**
Total comprehensive income							
Profit for the year	-	-	-	-	-	629,409	629,409
Other comprehensive income							
Items that are or may be reclassified subsequently to profit or loss:							
Net unrealized gain on revaluation of investments measured at fair value through other comprehensive income during the year	-	-	-	-	34,958	-	34,958
Net realized loss on investments measured at fair value through other comprehensive income reclassified to profit or loss	-	-	-	-	(3,624)	-	(3,624)
Total other comprehensive income	-	-	-	-	31,334	-	31,334
Total comprehensive income for the year	**-**	**-**	**-**	**-**	**31,334**	**629,409**	**660,743**
Transactions recorded directly in equity							
Transfer to the Ministry of Finance of Georgia (Note 23)	-	-	-	-	-	(80,000)	(80,000)
Transfer to reserve fund (Note 23)	-	187,176	-	-	-	(187,176)	-
Transfer to foreign currency revaluation reserve (Note 23)	-	-	339,677	-	-	(339,677)	-
Transfer to other revaluation reserve (Note 23)	-	-	-	2,512	-	(2,512)	-
Total transactions recorded directly in equity	**-**	**187,176**	**339,677**	**2,512**	**-**	**(609,365)**	**(80,000)**
31-Dec-19	**15,000**	**475,296**	**1,673,986**	**2,512**	**39,745**	**100,000**	**2,306,539**
Total comprehensive income							
Profit for the year	-	-	-	-	-	1,037,375	1,037,375
Other comprehensive income							
Items that are or may be reclassified subsequently to profit or loss:							
Net unrealized gain on revaluation of investments measured at fair value through other comprehensive income during the year	-	-	-	-	69,591	-	69,591
Net realized loss on investments measured at fair value through other comprehensive income reclassified to profit or loss	-	-	-	-	(38,283)	-	(38,283)
Total other comprehensive income	-	-	-	-	31,308	-	31,308
Total comprehensive income for the year	**-**	**-**	**-**	**-**	**31,308**	**1,037,375**	**1,068,683**
Transactions recorded directly in equity							
Transfer to the Ministry of Finance of Georgia (Note 23)	-	-	-	-	-	(100,000)	(100,000)
Transfer to foreign currency revaluation reserve (Note 23)	-	-	680,748	-	-	(680,748)	-
Transfer to other revaluation reserve (Note 23)	-	-	-	(2,512)	-	2,512	-
Total transactions recorded directly in equity	**-**	**-**	**680,748**	**(2,512)**	**-**	**(778,236)**	**(100,000)**
31-Dec-20	**15,000**	**475,296**	**2,354,734**	**-**	**71,053**	**359,139**	**3,275,222**

The financial statements as set out on pages 4 to 51 were approved by management on 23 April 2021 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 2020
(in thousands of Georgian Lari)

	Notes	Year ended 31-Dec-2020	Year ended 31-Dec-2019
CASH FLOWS FROM OPERATING ACTIVITIES:			
Interest received		468,399	350,834
Interest paid		(57,969)	(75,869)
Fees and commissions received		4,280	2,501
Fees and commissions paid		(3,836)	(4,057)
Net (loss)/gain on financial instruments at fair value through profit or loss		23,009	(4,220)
Net realized (loss)/gain from dealing in foreign currencies		(22,978)	2,919
Other income received		3,669	1,487
Personnel expenses paid		(28,303)	(25,378)
Cash paid for printing money		(16,848)	-
Other general and administrative expenses paid		(11,569)	(11,607)
Net cash inflow from operating activities before changes in operating assets and liabilities		**357,854**	**236,610**
Net (increase)/decrease in operating assets:			
Due from resident financial institutions		(74,100)	(1,191,728)
Special Drawing Rights holdings with the International Monetary Fund		(18,656)	181
Assets related to derivative instruments		(15,379)	(855)
Investments measured at fair value through profit or loss		(2,805)	(4,363)
Other assets		(5,966)	(888)
Net increase/(decrease) in operating liabilities:			
Money issued in circulation		524,415	571,516
Due to resident financial institutions		600,558	137,728
Due to the Ministry of Finance		(108,601)	670,091
Due to customers		(266,210)	266,939
Other liabilities		5,225	(1,313)
Net cash inflow from operating activities		**996,335**	**683,918**
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from disposal of investment property		-	3,057
Purchase of property and equipment		(4,659)	(6,312)
Purchase of intangible assets		(1,472)	(1,193)
Purchase of investments measured at fair value through other comprehensive income		(9,292,369)	(10,040,444)
Proceeds from redemption and sale of investments measured at fair value through other comprehensive income		9,481,094	9,566,336
Net cash used in investing activities		**182,594**	**(478,556)**
CASH FLOWS FROM FINANCING ACTIVITIES:			
Transfer to the Ministry of Finance	23	(100,000)	(80,000)
Debt securities issued		254,628	255,400
Debt securities redeemed		(274,961)	(256,390)
Proceeds from the International Monetary Fund	27	374,823	234,773
Net cash from in financing activities		**254,490**	**153,783**
Effect of exchange rates changes on cash and cash equivalents		455,520	75,928
Net increase in cash and cash equivalents		1,888,939	435,073
CASH AND CASH EQUIVALENTS, at the beginning of the year	7	**1,713,548**	**1,278,475**
CASH AND CASH EQUIVALENTS, at the end of the year	7	**3,602,487**	**1,713,548**

The financial statements as set out on pages 4 to 51 were approved by management on 23 April 2021 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.

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.

Governance

As at 31 December 2020 and 2019, the members of the Council of the Bank were as follows:

Position	Name
Chairman	Mr. Koba Gvenetadze (Governor)
Member	Mr. Archil Mestvirishvili (Vice-governor)
Member	Mr. Papuna Lezhava (Vice-governor)
Member	Mr. Robert H.Singletary
Member	Mr. Nikoloz Kavelashvili

During 2020 according to amendment of Law on National Bank of Georgia ("The Law"), Council of the Bank was defined to consist of 9 members (7 members before the amendment). Therefore as at 31 December 2020 positions of 4 members of the Council were vacant (2019: 2 positions).

The Bank's main office is located at 2 Sanapiro, Tbilisi, 0114, Georgia. As at 31 December 2020 and 2019 the Bank has one cash service center. The Bank has 523 and 512 personnel as at 31 December 2020 and 2019, respectively.

2. BASIS OF PREPARATION OF FINANCIAL STATEMENTS

Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

The presentation of these financial statements is framed within an economic and accounting framework that fairly reflects the financial position of the Bank, and at the same time, contributes to the economic analysis of the Bank's operations. Assets and liabilities within the statement of financial position are segregated as captions of foreign and local currencies, which better reflects economics and risks behind the Bank's operations. The Bank's assets in foreign currency are mainly related to its international reserve management function. At the same time, the Bank's assets and liabilities in local currency are mainly recognised as a result to operations related to conduct of monetary policy, issue of money in circulation and other functions of the Bank as defined by the Law. For these reasons, the economic concepts of international reserves and monetary policy are additionally grouped under the sub-captions international reserve and monetary policy instruments, respectively. Statement of Profit or Loss and Other Comprehensive Income separately presents interest income/expenses and non-interest income/expenses by functional operations of the Bank. Statement of cash flows is presented using direct method.

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 that 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.

3. SIGNIFICANT ACCOUNTING POLICIES

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. The Bank accounts its financial instruments in accordance with IFRS 9–*Financial Instruments* and reports these instruments under IFRS 7–*Financial Instruments: Disclosures* and IFRS 13–*Fair Value Measurement*.

Classification

The Bank classifies its financial assets in the following categories: measured at amortised cost (AC), measured at fair value though 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 as FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

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.

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 derecognises 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 recognises 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 recognised in other comprehensive income and accumulated in equity is recognised 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 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 recognised 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 derecognised and the consideration paid and payable is recognised 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.

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, being the representative of Georgia, the Bank may undertake obligations and carry out operations related to participation of Georgia in the activities of international organizations (i.e. the IMF, World Bank), including payment of membership fees to such organizations.

Financial assets measured at amortised cost

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 recognised with the calculation of the amortised cost by applying the effective interest rate method, recognising 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

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. The Bank also uses foreign currency derivative instruments to manage currency risk for some of its foreign currency investments.

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 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

The Bank's investments measured at FVOCI comprise Georgian and foreign governments', 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

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 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 Bank 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.

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 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 180 days. This represents a rebuttal of the presumption of IFRS 9 that the default does not occur later that 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.

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.

Money issued in circulation

Money issued in circulation represents banknotes and coins issued by the Bank in accordance with the Law and its function as the central bank. Banknotes and coins in circulation are recorded in the statement of financial position at their nominal value net of cash in the Bank's cash offices.

The expenses for the production of notes and coins are expensed as incurred.

When notes and coins 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 investment coins and gold bars are recognised and subsequently measured according to IAS 2- *Inventories* requirements. Gold investment 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 investment coins and bars are sold, gain or loss is recorded in profit or loss. 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.

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 maintenance are charged when incurred and included in other 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.

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.

Right-of-use assets under lease

From time to time, the Bank may lease particular assets for its administrative purposes.

The Bank recognises a right-of-use asset and a lease liability at a lease commencement date. The right-of-use asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs incurred and an estimate of costs to dismantle and remove any improvements made.

The right-of-use asset is subsequently depreciated using the straight-line method from the commencement date to the end of the lease term. In addition, the right-of-use asset is periodically reduced by impairment losses, if any, and adjusted for certain remeasurements of the lease liability.

The lease liability is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted using the interest rate implicit in the lease or, if that rate cannot be readily determined, the Bank's incremental borrowing rate. Generally, incremental borrowing rate is used as the discount rate.

The lease liability is measured at amortised cost using the effective interest method. It is remeasured when there is a change in future lease payments or in assessment of whether the Bank will exercise extension or termination option. A corresponding adjustment is made to the carrying amount of the right-of-use asset, or the amount is recorded in profit or loss if the carrying amount of the right-of-use asset has been reduced to zero.

The Bank presents right-of-use assets as separate line-item and lease liabilities in 'other liabilities' in the statement of financial position.

The Bank has elected not to recognise right-of-use assets and lease liabilities for leases of low-value assets and short-term leases. The Bank recognises the lease payments associated with these leases as an expense on a straight-line basis over the lease term.

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 recognised 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 or 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.

(in thousands of Georgian Lari)

Interest income recognition base

The original effective interest rate is applied to the gross carrying amount (carrying amount without reduction by expected credit loss allowance) of 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)

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, settlement fees and fees paid to the external manager, which are recognised 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:

	31-Dec-20	**31-Dec-19**
GEL/1 US Dollar (USD)	3.2766	2.8677
GEL/1 Euro (EUR)	4.0233	3.2095
GEL/1 Australian Dollar (AUD)	2.5118	2.0057
GEL/1 Canadian Dollar (CAD)	2.5616	2.1939
GEL/1 Special Drawing Right (SDR)	4.7192	3.9655

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

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.

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 and estimates 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 and rebuttal of the presumption that the default does not occur later that when the financial asset is 90 days past due – Note 3
- Fair valuation of financial instruments - Note 27

Application of new and revised International Financial Reporting Standards (IFRSs)

New and revised standards:

The following are effective from 1 January 2020:

- Revised version of the Conceptual Framework for Financial Reporting (Conceptual Framework), issued in March 2018 (together with number of references in IFRS Standards to the revised Conceptual Framework);
- Definition of a Business—amendments to IFRS 3 Business Combinations;
- Definition of Material—amendments to IAS 1 Presentation of Financial Statements and IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors;
- Interest Rate Benchmark Reform—amendments to IFRS 9 Financial Instruments, IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures;

The amendments mentioned above did not have significant effect on the Bank's financial statements.

The following new and amended standards are not expected to have a significant impact on the Bank's financial statements. The pronouncements are effective for periods beginning after 1 January 2020:

- Onerous Contracts – Cost of Fulfilling a Contract (Amendments to IAS 37);
- COVID-19-Related Rent Concessions (Amendment to IFRS 16);
- Property, Plant and Equipment: Proceeds before Intended Use (Amendments to IAS 16);
- Reference to Conceptual Framework (Amendments to IFRS 3);
- Classification of Liabilities as Current or Non-current (Amendments to IAS 1);
- IFRS 17 Insurance Contracts and amendments to IFRS 17 Insurance Contracts;
- Interest Rate Benchmark Reform - Phase 2 (Amendments to IFRS 4, IFRS 7 Financial Instruments: Disclosures, IFRS 9, IFRS 16 and IAS 39 Financial Instruments: Recognition and Measurement);
- Annual Improvements to IFRS Standards 2018 – 2020 (Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards, IFRS 9 Financial Instruments, IFRS 16 Leases and IAS 41 Agriculture);

(in thousands of Georgian Lari)

4. FEE AND COMMISSION INCOME AND EXPENSE

Fee and commission income and expense comprise:

	Year ended 31-Dec-20	Year ended 31-Dec-19
Fee and commission income:		
Funds transfer	2,295	2,479
Cash operations	1,961	-
Other	24	22
Total fee and commission income	**4,280**	**2,501**
Fee and commission expense:		
Fees paid to external manager	(1,420)	(1,167)
Custodian and settlement fees	(1,379)	(1,942)
Cash operations	(1,037)	(948)
Total fee and commission expense	**(3,836)**	**(4,057)**

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.

5. OTHER INCOME

Other income comprises:

	Year ended 31-Dec-20	Year ended 31-Dec-19
Gain from sale of commemorative coins	1,198	621
Revenue from fines	656	55
Other	36	583
Other income	**1,890**	**1,259**

6. OPERATING EXPENSES

Operating expenses comprise:

	Year ended 31-Dec-20	Year ended 31-Dec-19
Salaries and bonuses	26,887	23,409
Paid vacation and sick leave	1,416	1,969
Total personnel expenses	**28,303**	**25,378**
Subscription to information services	2,668	2,325
Social benefit expenses	2,184	1,840
Software maintenance fees	1,803	1,368
Utilities	1,255	1,182
Security	522	460
Repairs and maintenance	414	321
Personnel training	185	595
Fuel expenses	149	286
Business travel and related expenses	139	504
Legal and consultancy	120	238
Other	1,201	1,431
Total general and administrative expenses	**10,640**	**10,550**
Depreciation charge (Note 15)	4,738	4,307
Amortization charge (Note 16)	1,502	1,275
Total depreciation and amortization	**6,240**	**5,582**

(in thousands of Georgian Lari)

7. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as at 31 December 2020 and 2019 comprise:

	31-Dec-20	31-Dec-19
Cash on hand in foreign currencies	1,604,147	882,526
Current accounts	1,349,538	608,795
Time deposits with credit institutions up to 90 days	648,802	222,227
Total cash and cash equivalents	**3,602,487**	**1,713,548**

As at 31 December 2020 and 2019, GEL 1,847,489 thousand and GEL 779,063 thousand, respectively, were placed in current accounts and time deposits up to ninety days with six (five in 2019) internationally recognised banks and central banks from the Organization of Economic Co-operation and Development member countries (OECD).

As at 31 December 2020 and 2019, annual interest rate range of time deposits with financial institutions up to 90 days was 0.19%-0.33% and 1.25%-2.07%, respectively.

8. DUE FROM RESIDENT FINANCIAL INSTITUTIONS

Due from resident financial institutions as at 31 December 2020 and 2019 comprise:

	31-Dec-20	31-Dec-19
Due from resident financial institutions under monetary policy instruments		
Refinancing loans	2,150,473	2,273,402
Fixed rate loans	482,949	-
One-month open market instruments	400,705	400,606
Overnight loans	180,043	468,126
Total due from resident financial institutions under monetary policy instruments	**3,214,170**	**3,142,134**

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, overnight loans and fixed rate loans the Bank supplies short-term liquidity to Georgia’s banking system.

As at 31 December 2020 and 2019, respectively, the Bank had a concentration of refinancing loans of GEL 1,954,929 thousand due from three resident commercial banks at annual interest rates of 8.001%-8.05%, and GEL 2,143,205 thousand due from three resident commercial banks at annual interest rates of 9%-9.2%, respectively.

As at 31 December 2020 and 2019 the Bank had a concentration of overnight loans of GEL 180,043 thousand due from one resident commercial bank at annual interest rate of 8.75% and GEL 440,118 thousand due from one resident commercial bank at annual interest rate of 9.75%, respectively.

As at 31 December 2020 and 2019 the concentration of one-month open market operations was GEL 320,563 thousand due from one resident commercial bank at an annual interest rate of 8.033%, and GEL 400,606 thousand due from one resident commercial bank at an annual interest rate of 9.22%, respectively.

As at 31 December 2020 the concentration of fixed rate loans was GEL 383,675 thousand due from two

(in thousands of Georgian Lari)

For none of the exposures due from resident financial institutions has credit risk increased significantly since initial recognition. For credit risk disclosure see note 28.

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 Georgian Lari; b) debt securities issued by the international financial institutions, denominated in Georgian 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 Georgian Lari, but excluding debt securities issued by the commercial banks operating in Georgia; 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. The Bank has the first lien on borrowers' assets according to the Law.

As at 31 December 2020 and 2019 types and fair values of financial assets pledged for amounts due from resident financial institutions are:

	31-Dec-20	**31-Dec-19**
Loan portfolio of commercial banks	1,863,617	1,172,794
Government securities (treasury bills/notes)	1,537,824	1,257,885
Debt securities issued by the Bank (Certificates of Deposit)	7,454	-
Bonds issued by International Financial Institutions and development banks, denominated in GEL:		
European Bank for Reconstruction and Development (EBRD)	212,739	516,804
Black Sea Trade and Development Bank (BSTDB)	-	254,093
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden NV	-	226,446
International Finance Corporation (IFC)	-	33,247
Asian Development Bank (ADB)	-	30,442
Bonds issued by private sector	23,651	-
	3,645,285	**3,491,711**

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.

(in thousands of Georgian Lari)

9. SPECIAL DRAWING RIGHTS HOLDINGS WITH THE INTERNATIONAL MONETARY FUND

Balances with the International Monetary Fund ("IMF") comprise:

	31-Dec-20	31-Dec-19
Assets:		
Special Drawing Rights (SDR) holdings	**697,227**	**572,233**
Liabilities:		
IMF current accounts		
Current account # 1	2,302	1,968
Current account # 2	13	11
	2,315	**1,979**
Borrowings from the IMF		
Extended Fund Facility (EFF)	1,218,979	711,254
General SDR allocation	526,029	442,527
Special SDR allocation	153,465	129,103
	1,898,473	**1,282,884**
Total due to the IMF	**1,900,788**	**1,284,863**
Off-balance sheet balances:		
IMF Quota	920,893	787,425
Security held in custody in respect of IMF quota and as collateral of IMF granted facilities	(2,695,502)	(1,459,028)

SDR Holdings

SDR holdings represent the 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 holding in 2020 and 2019 is 0.050%-0.750% and 0.740%-1.153%, 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 1,218,980 thousand as at 31 December 2020 (2019: GEL 711,254 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) was approved on 12th of April 2017 with access of SDR 210.4 million (100 percent of quota). On 14th of April 2020 an augmentation of access of 130 percent of quota was approved, bringing total access under the EFF to SDR 484 million (230 percent of quota) and during 2020 SDR 79 million was used out of it by the Bank (2019: SDR 60 million). Repayments are projected to start in 2021 and the loan is projected to be fully covered by 2030. 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 1.080% at 31 December 2020 (2019: 1.740%).

All facilities received from the IMF are denominated in SDR.

SDR allocations

The SDR allocation is an unsecured, interest bearing distribution of SDRs by the IMF through general and special allocations. The general allocation is made by the IMF according to the Articles of Agreement to all participants in its SDR Department in proportion to countries' quotas in the IMF. On 10 August 2009, the Fourth Amendment to the IMF Articles of Agreement providing for a special one-time allocation of SDRs entered into force to boost global liquidity. According to the amendment dated 9 September 2009, the special allocation was made to the IMF members, which includes Georgia. Members and prescribed holders may use their SDR holdings to conduct transactions with the IMF. The Bank treats the allocation as a foreign currency liability to the IMF.

Georgia, as a member country of the IMF and recipient of the allocations, is obliged to pay to the IMF an amount equal to its net cumulative allocation and any other amounts that may be due and payable because of the membership termination or liquidation of the IMF's SDR Department.

The annual interest rate range on the SDR allocation in 2020 and 2019 is 0.050%-0.750% and 0.740%-1.153%, 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 14th 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 920,893 thousand in respect of the IMF Quota and GEL 1,774,609 thousand held as collateral for the IMF granted facilities (totally GEL 2,695,502 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.

(in thousands of Georgian Lari)

10. ASSETS RELATED TO DERIVATIVE INSTRUMENTS

	Book value	Notional principal	Book value	Notional principal
	31-Dec-20	**31-Dec-20**	**31-Dec-19**	**31-Dec-19**
Assets related to derivative instruments under international reserve management				
Interest rate futures				
Futures margin	22,365		5,743	
FX-Forward				
FX-Forward assets	587	-	456	-
Amount receivable	-	581,432	-	321,242
Amount Payable	-	(590,442)	-	(320,950)
Net FX-Forward	**587**	**(9,010)**	**456**	**292**
Interest rate futures assets	249	-	-	-
Interest rate futures liabilities	(9,212)	(3,935,524)	(974)	(1,629,427)
Net interest futures position	**(8,963)**	**(3,935,524)**	**(974)**	**(1,629,427)**
Options on futures				
Put option assets	-	-	77	143,385
Put option liabilities	-	-	-	-
Call option assets	-	-	60	200,739
Call option liabilities	-	-	-	-
Net options on futures	**-**	**-**	**137**	**344,124**
Net assets related to derivative instruments under international reserve management	**13,989**	**(3,944,534)**	**5,362**	**(1,285,011)**
Assets related to derivative instruments under monetary policy operations				
FX SWAPs				
FX SWAP Assets	1,318		-	
Amount Receivable		134,610		-
Amount Payable		(133,292)		-
Net FX SWAPs	**1,318**	**1,318**	**-**	**-**
Net assets related to derivative instruments under monetary policy operations	**1,318**	**1,318**	**-**	**-**

At their inception, derivatives often involve only a mutual exchange of promises with little or no transfer of consideration. However, these instruments frequently involve a high degree of leverage and are very volatile. A relatively small movement in the value of the asset, rate, or index underlying a derivative contract may have a significant impact on the profit or loss of the Bank.

The futures contracts are contractual agreements to buy or sell a specified financial instrument at a specific price and date in the future. The futures contracts are transacted in standardised amounts on regulated exchanges and are subject to daily cash margin requirements. The credit risk related to future contracts is considered minimal because the cash margin requirements of the exchange help ensure that these contracts are always honored and are settled on a net basis.

The Bank has been trading Eurodollar Futures since March 2012, as a part of active portfolio management. This financial instrument is listed on CME (Chicago Mercantile Exchange & Chicago Board of Trade), hence it is exchange traded and standardized. Eurodollar Futures remain the most liquid and actively traded money market derivatives contracts. Each Eurodollar contract's underlying is 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 funds managed by the Bank for International Settlements (BIS). It 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. As at 31 December 2020 total amount of funds managed by BIS was GEL 177,163 thousand (2019: GEL 152,395 thousand).

(in thousands of Georgian Lari)

12. INVESTMENTS MEASURED AT FAIR VALUE THROUGH OTHER COMPREHENSIVE INCOME

As at 31 December 2020 investment securities measured at fair value through other comprehensive income comprise:

	31-Dec-20	31-Dec-19
Government securities		
US Department of the Treasury, Washington	5,074,444	4,648,290
Australian Government, Canberra	662,094	539,163
Canada, Ottawa	225,278	172,355
Government of Sweden	49,141	-
Government of Denmark	32,744	-
	6,043,701	**5,359,808**
Supranational securities		
European Investment Bank, Luxembourg	69,791	65,143
Bank for International Settlements, Basle	65,517	86,020
African Development Bank, Abidjan	59,847	74,171
Asian Development Bank, Manila	54,350	6,697
EUROFIMA, Basel	50,833	43,142
International Bank for Reconstruction & Development, Washington	15,721	2,027
International Finance Corporation, Washington D.C.	13,926	31,567
Inter-American Development Bank, Washington D.C.	13,366	44,854
New Development Bank, Shanghai	6,907	-
Inter-American Investment Corporation	5,950	-
	356,208	**353,621**
Agency and other securities		
Bank Nederlandse Gemeenten, Den Haag	163,709	242,556
CPPIB Capital Inc, Toronto	144,719	14,535
CDP Financial In, Montreal	131,326	55,250
Agence Francaise de Developpement, Paris	125,506	91,581
Kreditanstalt fuer Wiederaufbau, Frankfurt	124,165	84,072
Svensk Exportkredit AB, Stocholm	118,500	144,585
Royal Bank of Canada	93,413	64,777
Kommuninvest I Sverige AB, Orebro	92,104	83,147
Province of Alberta Canada	77,231	54,776
Korean Development Bank	75,489	-
Landeskreditbank Baden-Wuerttemberg Foerderbank	71,768	86,736
Province of Quebec Canada, Quebec	68,919	74,562
NRW Bank, Duesseldorf	65,551	100,635
Erste Abwicklungsanstalt, Dusseldorf	63,379	83,952
Kommunalbanken AS, Oslo	60,658	144,148
SNCF Reseau EPIC	57,781	59,937
Other	388,887	511,713
	1,923,105	**1,896,959**
Total investments measured at fair value through other comprehensive income in foreign currency	**8,323,015**	**7,610,388**
Marketable government securities in national currency		
Georgian Government Bonds	1,168,338	809,443
Total investments measured at fair value through other comprehensive income in national currency	**1,168,338**	**809,443**

(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-20		31-Dec-19	
In foreign currency:	**Interest rate p.a.**	**Maturity**	**Interest rate p.a.**	**Maturity**
Government securities	0.125%-5.75%	2021-2025	0.5%-5.75%	2020-2022
Supranational securities	0.25%-6%	2021-2025	1.375%-3%	2020-2024
Agency and other securities	0.25%-5.25%	2021-2025	1%-4.5%	2020-2024
In national currency:				
Government Bonds	6.75%-14.375%	2021-2028	7.25%-14.375%	2020-2024

Investments measured at fair value through other comprehensive income include funds managed under the RAMP program, which 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 securities. The Bank may, from time to time, by notice to the external manager, make additions to, or reductions of, the investment amount. As at 31 December 2020 total amount of funds managed under the RAMP was GEL 720,204 thousand (2019: GEL 613,698 thousand).

For none of the financial assets measured at fair value through other comprehensive income has credit risk increased significantly since initial recognition. Please see note 28

13. INVESTMENTS MEASURED AT AMORTISED COST

	31-Dec-20		31-Dec-19	
	Carrying value	**Nominal value**	**Carrying value**	**Nominal value**
Georgian Government securities				
Georgia Government Bonds	201,661	200,846	241,616	240,846
Total investments measured at amortised cost in national currency	**201,661**	**200,846**	**241,616**	**240,846**

Analysis of interest rate (coupon) and maturity of investments measured at amortised cost:

	31-Dec-20		31-Dec-19	
	Interest rate p.a.	**Maturity**	**Interest rate p.a.**	**Maturity**
Georgian Government Bonds	8.610%	2021-2025	7.100%	2020-2025

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. 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. Please see note 28.

(in thousands of Georgian Lari)

14. RIGHT-OF-USE ASSET UNDER LEASE

The Bank leases premise for administrative purposes for part of its personnel and recognises respective right-of-use asset and lease liability.

Change in the outstanding balance of the related right-of-use asset is provided below:

	2020	2019
Balance as at 1 January	**2,077**	**2,922**
Depreciation charge for the year	(845)	(845)
Balance as at 31 December	**1,232**	**2,077**

Change in outstanding balance of lease liability is provided below:

	2020	2019
Balance as at 1 January	**1,877**	**2,553**
Interest expense for the year	112	161
Repayments for the year	(837)	(837)
Balance as at 31 December	**1,152**	**1,877**

15. PROPERTY AND EQUIPMENT

	Land and buildings	Computers, office equipment and fixtures	Vehicles and other	Assets under construction	Total
At initial cost:					
1-Jan-19	**51,988**	**10,803**	**19,541**	**245**	**82,577**
Additions	668	6,138	991	494	8,291
Disposals	(4)	(403)	(162)	(676)	(1,245)
31-Dec-19	**52,652**	**16,538**	**20,370**	**63**	**89,623**
Additions	-	2,226	221	1	2,448
31-Dec-20	**52,652**	**18,764**	**20,591**	**64**	**92,071**
Accumulated depreciation:					
1-Jan-19	**(6,248)**	**(5,836)**	**(15,975)**	**-**	**(28,059)**
Depreciation charge	(1,039)	(2,264)	(1,004)	-	(4,307)
Disposals	-	400	162	-	562
31-Dec-19	**(7,287)**	**(7,700)**	**(16,817)**	**-**	**(31,804)**
Depreciation charge	(1,050)	(2,542)	(1,146)	-	(4,738)
31-Dec-20	**(8,337)**	**(10,242)**	**(17,963)**	**-**	**(36,542)**
Net book value:					
As at 31 December 2019	**45,365**	**8,838**	**3,553**	**63**	**57,819**
As at 31 December 2020	**44,315**	**8,522**	**2,628**	**64**	**55,529**

16. INTANGIBLE ASSETS

	Software	Licenses	Total
At cost:			
1-Jan-19	**9,527**	**3,316**	**12,843**
Additions	753	441	1,194
31-Dec-19	**10,280**	**3,757**	**14,037**
Additions	1,350	28	1,378
Disposals	(190)	(33)	(223)
31-Dec-20	**11,440**	**3,752**	**15,192**
Accumulated amortization:			
1-Jan-19	**(7,230)**	**(552)**	**(7,782)**
Charge for the year	(566)	(709)	(1,275)
31-Dec-19	**(7,796)**	**(1,261)**	**(9,057)**
Charge for the year	(794)	(708)	(1,502)
Disposals	190	33	223
31-Dec-20	**(8,400)**	**(1,936)**	**(10,336)**
Net book value:			
As at 31 December 2019	**2,484**	**2,496**	**4,980**
As at 31 December 2020	**3,039**	**1,817**	**4,856**

(in thousands of Georgian Lari)

17. OTHER ASSETS AND LIABILITIES

	31-Dec-20	31-Dec-19
Other assets in foreign currency:		
Prepayments	977	123
Other debtors	9	130
Total other assets in foreign currency	**986**	**253**
Other assets in national currency:		
Prepayments	8,133	186
Commemorative gold coins and gold bars	1,982	3,762
Inventory	617	579
Loans to employees	162	166
Other debtors	642	107
	11,536	**4,800**
Allowance for impairment of other assets	(156)	(161)
Total other assets in national currency	**11,380**	**4,639**

As at 31 December 2020 and 2019, other financial assets, net of allowance, amount to GEL 1,633 thousand and GEL 365 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 28.

Other liabilities comprise:

	31-Dec-20	31-Dec-19
Other liabilities in foreign currency:		
Amounts due to suppliers	6,203	1,247
Total other liabilities in foreign currency	**6,203**	**1,247**
Other liabilities in national currency:		
Amount due to suppliers	6,295	6,002
Liability for realized banknotes and coins	1,782	1,742
Lease liability	1,152	1,877
Other liabilities	350	311
Total other liabilities in national currency	**9,579**	**9,932**
Total other liabilities	**15,782**	**11,179**

18. DUE TO RESIDENT FINANCIAL INSTITUTIONS

Due to resident financial institutions comprise:

	31-Dec-20	31-Dec-19
Due to resident financial institutions under monetary policy instruments		
Correspondent accounts in national currency	446,249	463,053
Overnight deposits in national currency	78,700	8,400
Total due to resident financial institutions under monetary policy instruments in national currency	**524,949**	**471,453**
Obligatory reserves of banks in foreign currency	5,480,533	4,231,029
Total due to resident financial institutions under monetary policy instruments	**6,005,482**	**4,702,482**
Due to resident financial institutions, other		
Correspondent accounts in foreign currency	89,741	73,437
Special deposits of commercial banks in foreign currency	13,330	-
Total due to resident financial institutions, other	**103,071**	**73,437**
Total due to resident financial institutions	**6,108,553**	**4,775,919**

(in thousands of Georgian Lari)

As at 31 December 2020 and 2019 included in due to resident financial institutions are balances with the three largest local commercial banks of GEL 4,469,736 thousand and GEL 3,653,198 thousand, respectively, that represent 73.17% and 76.49% 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 2020 the obligatory reserves are calculated as 5% of their eligible liabilities denominated in national currencies (2019: 5%), and 25% of their eligible liabilities denominated in foreign currencies (2019: 25%). For foreign currency liabilities with a remaining maturity of 1-2 years the reserve requirement amounts to 15% (2019: 15%). As at 31 December 2020 and 2019 the annual interest rate on GEL denominated obligatory reserves is 8% and 9%, respectively. As at 31 December 2020 and 2019 the annual interest rate on USD/EUR denominated obligatory reserves are -0.25%/-0.7% and 1.25%/-0.7% 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

	31-Dec-20	31-Dec-19
Due to the Ministry of Finance		
Current accounts in foreign currency	788,928	616,518
Current account in national currency	661,984	838,104
Total due to the Ministry of Finance of Georgia	**1,450,912**	**1,454,622**

20. DUE TO CUSTOMERS

	31-Dec-20	31-Dec-19
Due to customers in national currency		
Due to the Pension Agency	-	266,644
Due to International organizations	1,394	960
Total due to customers in national currency	**1,394**	**267,604**

During 2020 the Pension Agency transferred funds from its accounts at the Bank.

21. MONEY ISSUED IN CIRCULATION

Money issued in circulation represents the amount of national currency of Georgia issued by the Bank. Movements during the year ended 31 December 2020 and 2019 are as follows:

	2020	2019
Balance as at 1 January	**4,137,012**	**3,565,495**
Banknotes issued into circulation	6,973,721	6,156,260
Coins issued into circulation	54,257	100,185
Banknotes withdrawn from circulation	(6,456,882)	(5,601,513)
Coins withdrawn from circulation	(46,681)	(83,415)
Balance as at 31 December	**4,661,427**	**4,137,012**

22. DEBT SECURITIES ISSUED

	Interest rate p.a.	Maturity	Nominal value	Carrying value
Certificates of deposit as at 31-Dec-20	8.01%-8.13%	28 Jan-25 March 2021	60,000	59,273
Certificates of deposit as at 31-Dec-19	7.60%-9.09%	3 Jan-26 March 2020	80,000	79,149

23. 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 2020 and 2019.

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.

Realised profit for financial year 2020 amounted to GEL 359,139 and will be distributed between the Reserve Fund and State Budget of Georgia after approval of financial statements by the Council.

In accordance with Article 25(c) of the Law, in 2020, following the transfers to the Reserve Fund, the Bank transferred GEL 100,000 thousand to the Ministry of Finance from retained earnings (2019: GEL 80,000 thousand).

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 2020 net unrealized gain on foreign currencies translation of GEL 680,748 thousand was transferred to the foreign currency revaluation reserve (2019: gain of GEL 339,677 thousand). During 2020 the full amount of other revaluation reserve comprising GEL 2,512 thousand at 31 December 2019 was transferred from other revaluation reserve to retained earnings (during 2019 GEL 2,512 thousand was transferred from retained earnings to other revaluation reserve).

Revaluation reserve for investments measured at FVOCI

This reserve records fair value changes of investments measured at FVOCI.

24. 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

No material capital commitments were outstanding as at 31 December 2020 and 2019.

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 Banks 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.

In response to Covid-19 pandemic, the Bank has set up temporary liquidity instruments to avoid or minimize the negative impact of potential future liquidity risks in the banking sector. From April 2020, in addition to standard refinancing loans, the Bank provides liquidity support to the market through FX SWAP operations. FX SWAP operations are monetary policy instruments aimed at delivering liquidity to the market. Through the FX SWAP transactions, the Bank buys foreign currency with the national currency for a period of one month at a spot rate, provided that it is sold back at the predetermined forward rate.

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 2020 and 2019, the Bank has no material credit commitments and contingent liabilities.

Insurance

The insurance industry in Georgia is in a developing state and many forms of insurance protection common in other parts of the world are not yet generally available. The Bank does not have full coverage for its operations interruption or third-party liability in respect of environmental damage arising from accidents on its operations or arising from errors or omissions. Until the Bank obtains adequate insurance coverage, there is a risk that the loss or destruction of certain assets could have adverse effect on operations and financial position.

(in thousands of Georgian Lari)

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.

The Bank had the following transactions outstanding with related parties:

	Year ended 31 December 2020		Year ended 31 December 2019	
	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**
Key management personnel compensation:				
- short-term employee benefits	(3,922)	(28,303)	(3,847)	(25,378)

		31-Dec-20		31-Dec-19	
	Notes	**Related party balances**	**Total category as per statement of financial position**	**Related party balances**	**Total category as per statement of financial position**
Statement of financial position					
Assets:					
Investments measured at fair value through other comprehensive income in national currency- *Government of Georgia*	12	1,168,338	1,168,338	809,443	809,443
Investments measured at amortised cost in national currency- *Government of Georgia*	13	201,661	201,661	241,616	241,616
Loans to employees-Key management personnel	17	-	-	-	-
Liabilities:					
Due to the Ministry of Finance	19	1,450,912	1,450,912	1,454,622	1,454,622
Statement of profit or loss and other comprehensive income					
Interest income		92,786	446,419	57,818	399,076
- Government of Georgia		*92,786*		*57,817*	
- Key management personnel		-		*1*	

Unrealized fair value gain on government securities measured at fair value through other comprehensive income is GEL 4,917 thousand for 2020 (2019: loss of GEL 10,023 thousand).

(in thousands of Georgian Lari)

26. LIABILITIES RELATED TO FINANCING ACTIVITIES

Table below shows reconciliation of movements of liabilities to cash flows arising from financing activities:

		Cash			Non-Cash			
	Note	1-Jan-2020	Interest Paid	Net Proceeds from financing activities	Accrued Interest	Translation Differences	Other	31-Dec-2020
Liabilities arising from financing activities:								
Debt securities issued	22	79,149	(5,039)	(20,332)	5,495	-	-	59,273
Due to the International Monetary Fund	9	1,284,863	(11,729)	374,823	12,602	240,228	-	1,900,788

		Cash			Non-Cash			
	Note	1-Jan-2019	Interest Paid	Net Proceeds from financing activities	Accrued Interest	Translation Differences	Other	31-Dec-2019
Liabilities arising from financing activities:								
Debt securities issued	22	79,310	(3,611)	(990)	4,440	-	-	79,149
Due to the International Monetary Fund	9	985,307	(15,783)	234,773	14,440	66,027	99	1,284,863

27. FAIR VALUE OF FINANCIAL INSTRUMENTS

IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in orderly transactions between market participants at the measurement date.

Fair value of the Bank's financial instruments measured at fair value on a recurring basis

Some of the Bank's financial instruments are measured at fair value at the end of each reporting period. The following table gives information about how the fair values of these financial assets are determined (in particular, the valuation techniques and inputs used).

Financial instruments measured at fair value are broken down for disclosure purposes into a three level fair value hierarchy based on the observability of inputs:

- Quoted prices in an active market (**Level 1**) – Valuations based on quoted prices in active markets that the Bank has the ability to access for identical assets or liabilities. Valuation adjustments and block discounts are not applied to these financial instruments. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuations of these products do not require a significant amount of judgment. This level entails financial instruments under international reserve portfolio which are classified as derivative financial instruments, investments measured at fair value through profit or loss and investments measured at fair value through other comprehensive income. 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:
     - interest rates and yield curves observable at commonly quoted intervals;
     - implied volatilities; and
     - credit spreads;
  d) market-corroborated inputs

(in thousands of Georgian Lari)

Georgian Government securities, measured at fair value through other comprehensive income, 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 recognising 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 2020 and 2019, by the level in the fair value hierarchy into which the fair value measurement is categorised. The amounts are based on the values recognised in the statement of financial position:

		Fair value as at				
Financial Assets	**Note**	**31-Dec-20**	**31-Dec-19**	**Fair value hierarchy**	**Valuation techniques and key inputs**	**Significant unobservable inputs**
International reserves						
Derivative financial assets	10	13,989	5,362	Level 1	Quoted bid prices in an active market	N/A
Investments measured at fair value through profit or loss	11	177,163	152,395	Level 1*	Quoted bid prices in an active market	N/A
Investments measure at fair value through other comprehensive income	12	8,323,015	7,610,388	Level 1	Quoted bid prices in an active market	N/A
Monetary policy instruments						
Investments measure at fair value through other comprehensive income	12	1,168,338	809,443	Level 2	Market interest rate for similar instruments	N/A
Derivative financial assets	10	1,318	-	Level 1	Quoted bid prices in an active market	N/A

** The Bank's investments measured at fair value through profit or loss 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). Vast majority of the pool's assets represent instruments which have quoted prices in active markets that the Bank has the ability to access for identical assets or liabilities. Therefore the investment's fair valuation is considered to be Level 1 within fair value hierarchy*

There were no transfers between Level 1, 2 and 3 during the year ended 31 December 2020 and 2019.

Gains and losses included in other comprehensive income relate to investments measured at fair value through other comprehensive income and are reported as changes in revaluation reserve of investments measured at FVOCI.

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 2020.

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.

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 organizations to support developing countries. As a result, these borrowings were considered received in an “arm’s length” transaction.

28. RISK MANAGEMENT

Introduction

The activities of the Bank are exposed to various 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 (the Bank’s 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.

(in thousands of Georgian Lari)

Organization of risk management department

Nature of risk	Management	Guidelines policies issued by	Supervision
Financial risks	At department level	Monetary policy committee International reserve management committee	Board
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.

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-20	Maximum exposure 31-Dec-19
International Reserves			
Assets related to derivative instruments	10	13,989	5,362
Investments measured at fair value through profit or loss	11	177,163	152,395
National currency assets			
Monetary policy instruments			
Assets related to derivative instruments		1,318	-
Total credit risk exposure		**192,470**	**157,757**

Exposure to credit risk for instruments where impairment requirements are applied are represented by carrying amounts of the respective assets in the statement of financial position.

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 well as for bank deposits and other financial instruments as A-. However, minimum credit rating of BBB is acceptable for counterparties used only for Nostro accounts.

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.

(in thousands of Georgian Lari)

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:

	31 December 2020				31 December 2019			
	12-month ECL	Lifetime ECL not credit-impaired	Lifetime ECL credit-impaired	Total	12-month ECL	Lifetime ECL not credit-impaired	Lifetime ECL credit-impaired	Total
Cash and cash equivalents (excluding cash on hand)								
AAA	1,034,722	-	-	1,034,722	535,971	-	-	535,971
AA	400,030	-	-	400,030	252,128	-	-	252,128
A	563,229	-	-	563,229	42,639	-	-	42,639
BBB	359	-	-	359	284	-	-	284
Gross carrying amount	**1,998,340**	**-**	**-**	**1,998,340**	**831,022**	**-**	**-**	**831,022**
Loss Allowance	-	-	-	-	-	-	-	
Net carrying amount	**1,998,340**	**-**	**-**	**1,998,340**	**831,022**	**-**	**-**	**831,022**
Special Drawing Rights holdings with the International Monetary Fund								
AAA	697,227	-	-	697,227	572,233	-	-	572,233
Gross carrying amount	**697,227**	**-**	**-**	**697,227**	**572,233**	**-**	**-**	**572,233**
Loss Allowance	-	-	-		-	-	-	
Net carrying amount	**697,227**	**-**	**-**	**697,227**	**572,233**	**-**	**-**	**572,233**
Investments measured at fair value through other comprehensive income								
AAA	7,363,058	-	-	7,363,058	6,573,776	-	-	6,573,776
AA+	-	-	-	-	-	-	-	-
AA	913,925	-	-	913,925	957,223	-	-	957,223
AA-	-	-	-	-	-	-	-	-
A	46,032	-	-	46,032	79,389	-	-	79,389
Net Carrying amount - Fair Value	**8,323,015**	**-**	**-**	**8,323,015**	**7,610,388**	**-**	**-**	**7,610,388**
Loss Allowance (recognised in other comprehensive income)	(337)	-	-	(337)	(301)	-	-	(301)

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.

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.

(in thousands of Georgian Lari)

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:

	31 December 2020			**31 December 2019**			
	12-month ECL	**Lifetime ECL credit-impaired**	**Total**	**12-month ECL**	**Lifetime ECL not credit-impaired**	**Lifetime ECL credit-impaired**	**Total**
Foreign currency assets							
Other financial assets							
AAA grade	977	-	977	-	-	-	-
B grade	9	-	9	7	-	-	7
Gross carrying amount	**986**	**-**	**986**	**7**	**-**	**-**	**7**
Loss Allowance	-	-	-	-	-	-	-
Net carrying amount	**986**	**-**	**986**	**7**	**-**	**-**	**7**
National currency assets							
Monetary policy instruments							
Due from financial institutions							
AAA grade	3,214,170	-	3,214,170	3,142,134	-	-	3,142,134
Gross carrying amount	**3,214,170**	**-**	**3,214,170**	**3,142,134**	**-**	**-**	**3,142,134**
Loss Allowance	-	-	-	-	-	-	-
Net carrying amount	**3,214,170**	**-**	**3,214,170**	**3,142,134**	**-**	**-**	**3,142,134**
Investments measured at fair value through other comprehensive income							
AAA grade	1,168,338	-	1,168,338	809,443	-	-	809,443
Carrying Amount - Fair Value	**1,168,338**	**-**	**1,168,338**	**809,443**	**-**	**-**	**809,443**
Other national currency assets							
Investments measured at amortized cost							
AAA Grade	201,661	-	201,661	241,616	-	-	241,616
Gross carrying amount	**201,661**	**-**	**201,661**	**241,616**	**-**	**-**	**241,616**
Loss Allowance	-	-	-	-	-	-	-
Net carrying amount	**201,661**	**-**	**201,661**	**241,616**	**-**	**-**	**241,616**
Other financial assets							
A Grade	648	-	648	109	-	-	109
B Grade	-	156	156	-	-	164	164
Gross Carrying Amount	**648**	**156**	**804**	**109**	**-**	**164**	**273**
Loss Allowance	-	(156)	(156)	-	-	(161)	(161)
Net carrying amount	**648**	**-**	**648**	**109**	**-**	**3**	**112**

(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 recognised:

	2020			2019		
	12-month ECL	**Lifetime ECL credit-impaired**	**Total**	**12-month ECL**	**Lifetime ECL credit-impaired**	**Total**
Foreign currency assets						
International reserves						
Investments measured at FVOCI						
Balance at 1 January	**301**	**-**	**301**	**261**	**-**	**261**
New financial assets recognised	190	-	190	199	-	199
Remeasurement of loss allowance	(51)	-	(51)	(80)	-	(80)
Foreign exchange and other movements	17	-	17	7	-	7
Financial assets that have been derecognised	(120)	-	(120)	(86)	-	(86)
Balance at 31 December	**337**	**-**	**337**	**301**	**-**	**301**
National currency assets						
Other national currency assets						
Other Assets						
Balance at 1 January	**-**	**161**	**161**	**41**	**191**	**232**
New financial assets recognised	-	-	-	-	-	-
Remeasurement of loss allowance	-	-	-	-	-	-
Financial assets that have been derecognised	-	(5)	(5)	(41)	(30)	(71)
Balance at 31 December	**-**	**156**	**156**	**-**	**161**	**161**
Total balance at 1 January	**301**	**161**	**462**	**302**	**191**	**493**
Total balance at 31 December	**337**	**156**	**493**	**301**	**161**	**462**

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.

(in thousands of Georgian Lari)

Geographical concentration

The Bank's financial assets and liabilities are generally concentrated in Georgia except for the international reserve portfolio and borrowings from the IMF. The below table provides information on geographical concentration for these financial assets and liabilities outside of Georgia:

As at 31 December 2020	Notes	US	EU*	Australia	Canada	International	Other	Total
Assets:								
International reserves								
Cash and cash equivalents (excluding cash on hand)	7	136,471	1,525,764	355	59	-	335,691	1,998,340
Special Drawing Rights holdings with the IMF	9	-	-	-	-	697,227	-	697,227
Assets related to derivative instruments	10	-	-	-	-	-	13,989	13,989
Investments measured at fair value through profit or loss	11	-	-	-	-	177,163	-	177,163
Investments measured at fair value through other comprehensive income	12	5,074,444	1,285,632	701,550	852,010	290,692	118,687	8,323,015
		5,210,915	**2,811,396**	**701,905**	**852,069**	**1,165,082**	**468,367**	**11,209,735**
Liabilities:								
Due to the International Monetary Fund	9	-	-	-	-	1,900,788	-	1,900,788
Net position		**5,210,915**	**2,811,396**	**701,905**	**852,069**	**(735,706)**	**468,367**	**9,308,947**

As at 31 December 2019	Notes	US	EU*	Australia	Canada	International	Other	Total
Assets:								
International reserves								
Cash and cash equivalents (excluding cash on hand)	7	97,089	618,299	105	57,463	-	58,066	831,022
Special Drawing Rights holdings with the IMF	9	-	-	-	-	572,233	-	572,233
Assets related to derivative instruments	10	-	-	-	-	-	5,362	5,362
Investments measured at fair value through profit or loss	11	-	-	-	-	152,395	-	152,395
Investments measured at fair value through other comprehensive income	12	4,648,290	1,448,222	585,569	581,317	267,600	79,390	7,610,388
		4,745,379	**2,066,521**	**585,674**	**638,780**	**992,228**	**142,818**	**9,171,400**
Liabilities:								
Due to the International Monetary Fund	9	-	-	-	-	1,284,863	-	1,284,863
Net position		**4,745,379**	**2,066,521**	**585,674**	**638,780**	**(292,635)**	**142,818**	**7,886,537**

******EU-including Norwegian* agency *securities.*

(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 2020 and 2019 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 2020	Notes	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
Foreign currency assets						
International Reserves						
Cash and cash equivalents (excluding cash on hand)	7	1,998,340	-	-	-	1,998,340
Special Drawing Rights holdings with the International Monetary Fund	9	697,227	-	-	-	697,227
Assets related to derivative instruments	10	13,989	-	-	-	13,989
Investments measured at fair value through profit or loss	11	177,163	-	-	-	177,163
Investments measure at fair value through other comprehensive income	12	8,323,015	-	-	-	8,323,015
Other foreign currency assets						
Other financial assets	17	8	-	978	-	986
Total foreign currency assets		**11,209,742**	**-**	**978**	**-**	**11,210,720**
Foreign currency liabilities						
Due to resident financial institutions	18	5,583,604	-	-	-	5,583,604
Due to the Ministry of Finance	19	788,928	-	-	-	788,928
Due to the International Monetary Fund	9	682,474	22,189	556,641	717,720	1,979,024
Other liabilities	17	1,688	4,398	117	-	6,203
Total foreign currency liabilities		**7,056,694**	**26,587**	**556,758**	**717,720**	**8,357,759**
Net Position		**4,153,048**	**(26,587)**	**(555,780)**	**(717,720)**	**2,852,961**

(in thousands of Georgian Lari)

As at 31 December 2019	Notes	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
Foreign currency assets						
International Reserves						
Cash and cash equivalents (excluding cash on hand)	7	831,022	-	-	-	831,022
Special Drawing Rights holdings with the International Monetary Fund	9	572,233	-	-	-	572,233
Assets related to derivative instruments	10	5,362	-	-	-	5,362
Investments measured at fair value through profit or loss	11	152,395	-	-	-	152,395
Investments measure at fair value through other comprehensive income	12	7,610,388	-	-	-	7,610,388
Other foreign currency assets						
Other financial assets	17	130	-	123	-	253
Total foreign currency assets		**9,171,530**	**-**	**123**	**-**	**9,171,653**
Foreign currency liabilities						
Due to resident financial institutions	18	4,304,466	-	-	-	4,304,466
Due to the Ministry of Finance	19	616,518	-	-	-	616,518
Due to the International Monetary Fund	9	574,579	9,314	312,980	464,469	1,361,342
Other liabilities	17	1,247	-	-	-	1,247
Total foreign currency liabilities		**5,496,810**	**9,314**	**312,980**	**464,469**	**6,283,573**
Net Position		**3,674,720**	**(9,314)**	**(312,857)**	**(464,469)**	**2,888,080**

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. All monetary policy instruments except for obligatory reserve are short term.

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:

	2020		2019	
Tranches	**Benchmark Duration (Duration Deviation Limits)**	**Ex-Ante Tracking Error Limits**	**Benchmark Duration (Duration Deviation Limits)**	**Ex-Ante Tracking Error Limits**
Liquidity Portfolio in USD*	1 year (+/-3 Months)	10 Basis Point	1 year (+/-3 Months)	10 Basis Point
Investment Portfolio in USD*	1,5 year (+/-3 Months)	15 Basis Point	1,5 year (+/-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 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

** Due to the annual SAA decision, the Benchmark Durations for the Liquidity Portfolio in USD and Investment Portfolio in USD was increased from February 2019.*
*** The EUR Investment Portfolio ceased to be managed versus Benchmark since 15 December 2015.*
**** Due to annual SAA decision, the Benchmark Duration for Investment Portfolio in AUD has been decreased in 2020.*

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):

	2020		2019	
Currency	**Increase in Market Yield**	**Sensitivity of asset value**	**Increase in Market Yield**	**Sensitivity of asset value**
Investment Tranche in USD*	1%	(30,005)	1%	(28,294)
Investment Tranche in EUR	1%	-	1%	-
Investment Tranche in AUD	1%	(3,302)	1%	(3,694)
Investment Tranche in CAD	1%	(1,496)	1%	(1,385)
Liquidity Tranche in USD	1%	(4,469)	1%	(5,102)
Working Capital Tranche in USD	1%	(35)	1%	(81)

(in thousands of Georgian Lari)

	2020		2019	
Currency	**Decrease in Market Yield**	**Sensitivity of asset value**	**Decrease in Market Yield**	**Sensitivity of asset value**
Investment Tranche in USD*	1%	30,945	1%	29,136
Investment Tranche in EUR	1%	-	1%	-
Investment Tranche in AUD	1%	3,398	1%	3,823
Investment Tranche in CAD	1%	1,540	1%	1,429
Liquidity Tranche in USD	1%	4,578	1%	5,223
Working Capital Tranche in USD	1%	36	1%	82

** 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.

	2020		2019	
Currency	**Increase in interest rate**	**Sensitivity of net interest income**	**Increase in interest rate**	**Sensitivity of net interest income**
USD	1%	33,583	1%	34,562
SDR	1%	(12,012)	1%	(7,107)
EUR	1%	3,053	1%	(191)
AUD	1%	7,610	1%	5,981
CAD	1%	3,096	1%	2,579
GEL	1%	39,978	1%	33,721
Other	1%	1,947	1%	16

	2020		2019	
Currency	**Decrease in interest rate**	**Sensitivity of net interest income**	**Decrease in interest rate**	**Sensitivity of net interest income**
USD	1%	(33,583)	1%	(34,562)
SDR	1%	12,012	1%	7,107
EUR	1%	(3,053)	1%	191
AUD	1%	(7,610)	1%	(5,981)
CAD	1%	(3,096)	1%	(2,579)
GEL	1%	(39,978)	1%	(33,721)
Other	1%	(1,947)	1%	(16)

The sensitivity of equity is calculated by revaluing fixed rate investments measured at fair value through other comprehensive income at 31 December 2020 and 2019 for 1% change in interest rates:

(in thousands of Georgian Lari)

Currency	*2020*		*2019*	
	Increase in interest rate	*Sensitivity of equity*	*Increase in interest rate*	*Sensitivity of equity*
USD	1%	72,529	1%	67,812
EUR	1%	-	1%	-
AUD	1%	7,606	1%	5,970
CAD	1%	3,095	1%	2,322
GEL	1%	11,683	1%	8,094

Currency	*2020*		*2019*	
	Decrease in interest rate	*Sensitivity of equity*	*Decrease in interest rate*	*Sensitivity of equity*
USD	1%	(72,529)	1%	(67,812)
EUR	1%	-	1%	-
AUD	1%	(7,606)	1%	(5,970)
CAD	1%	(3,095)	1%	(2,322)
GEL	1%	(11,683)	1%	(8,094)

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 profit or loss and other comprehensive income. A negative amount in the table reflects a potential net reduction in the statement of profit or loss and other comprehensive income, while a positive amount reflects a net potential increase.

As at 31 December 2020	**USD**	**EUR**	**SDR**	**AUD**	**CAD**	**Other**	**Total**
Foreign currency assets	8,633,286	2,218,135	698,205	760,984	309,577	194,680	**12,814,867**
Foreign currency liabilities	(4,822,737)	(1,542,680)	(1,898,473)	-	-	(13,318)	**(8,277,208)**
Net position	**3,810,549**	**675,455**	**(1,200,268)**	**760,984**	**309,577**	**181,362**	**4,537,659**

As at 31 December 2019	**USD**	**EUR**	**SDR**	**AUD**	**CAD**	**Other**	**Total**
Foreign currency assets	7,172,396	1,451,831	572,356	598,092	257,863	1,641	**10,054,179**
Foreign currency liabilities	(3,888,656)	(1,029,881)	(1,282,884)	-	-	(3,694)	**(6,205,115)**
Net position	**3,283,740**	**421,950**	**(710,528)**	**598,092**	**257,863**	**(2,053)**	**3,849,064**

	Effect on total comprehensive income and equity						
	31-Dec-20						
	USD	**EUR**	**SDR**	**AUD**	**CAD**	**Other**	**Total**
Increase in currency rate of 1%	38,105	6,755	(12,003)	7,610	3,096	1,814	**45,377**
Increase in currency rate of 5%	190,527	33,773	(60,013)	38,049	15,479	9,068	**226,883**
Increase in currency rate of 10%	381,055	67,546	(120,027)	76,098	30,958	18,136	**453,766**
Decrease in currency rate of 1%	(38,105)	(6,755)	12,003	(7,610)	(3,096)	(1,814)	**(45,377)**
Decrease in currency rate of 5%	(190,527)	(33,773)	60,013	(38,049)	(15,479)	(9,068)	**(226,883)**
Decrease in currency rate of 10%	(381,055)	(67,546)	120,027	(76,098)	(30,958)	(18,136)	**(453,766)**

(in thousands of Georgian Lari)

	Effect on total comprehensive income and equity						
	31-Dec-19						
	USD	**EUR**	**SDR**	**AUD**	**CAD**	**Other**	**Total**
Increase in currency rate of 1%	32,837	4,219	(7,105)	5,981	2,579	(21)	**38,490**
Increase in currency rate of 5%	164,187	21,097	(35,526)	29,905	12,893	(103)	**192,453**
Increase in currency rate of 10%	328,374	42,195	(71,053)	59,809	25,786	(205)	**384,906**
Decrease in currency rate of 1%	(32,837)	(4,219)	7,105	(5,981)	(2,579)	21	**(38,490)**
Decrease in currency rate of 5%	(164,187)	(21,097)	35,526	(29,905)	(12,893)	103	**(192,453)**
Decrease in currency rate of 10%	(328,374)	(42,195)	71,053	(59,809)	(25,786)	205	**(384,906)**

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, Fraud and Compliance 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.

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. To expend and improve operational risk assessment the Bank selected and accepted quantification method - Standardised Measurement Approach (SMA). In order to finalize the implementation, the Bank will continue working on financial loss data, consequent processes and procedure development. Business Continuity management system continuously improves the resilience of the Bank's critical processes and provides adequate procedures, regular testing and expansion of scenarios. Year 2020, due to the pandemic, challenged the Bank and its business continuity risk. The Bank exercised its activities, including critical services, through remote work. Additional technical resources, process and procedures were introduced, staff trainings were provided to support the continuity of the Bank services and functions.

The Bank defined the aggregate level (Risk Appetite) of non-financial risks the Bank is willing to assume within its risk capacity to achieve its strategic objectives and goals. Overall, the Bank has conservative approach to operational and reputational risks and operates within low risk appetite and tolerance levels. Hence, the bank makes resources available and sets the effective governance process to control and maintain non-financial risks at low risk level. Risk appetite statement is reviewed and approved annually by the Council of the Bank.

29. EVENTS AFTER THE REPORTING PERIOD

No subsequent events occurred in 2021, up to the date these financial statements are authorized for issue.

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