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GEORGIA

TECHNICAL ASSISTANCE REPORT—STRENGTHEN REGULATION, SUPERVISION, AND OVERSIGHT OF MICRO LENDING INSTITUTIONS

September 2020

This Technical Assistance report on Georgia was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in November 2019.

Disclaimer:
This document was prepared before COVID-19 became a global pandemic and resulted in unprecedented economic strains. It, therefore, does not reflect the implications of these developments and related policy priorities. We direct you to the **IMF Covid-19 page** that includes staff recommendations with regard to the COVID-19 global outbreak.

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Monetary and Capital Markets Department

GEORGIA

NATIONAL BANK OF GEORGIA: STRENGTHEN REGULATION, SUPERVISION, AND OVERSIGHT OF MICRO LENDING INSTITUTIONS

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Ross Henderson, and Andrew Poprawa (MCM Experts)

August 2020

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Glossary

BCP	Basel Committee's Core Principles
FX	Foreign Exchange
GEL	Georgian GEL (local currency)
GRAPE	General Risk Assessment Program
ICAAP	Internal Capital Adequacy Assessment Process
IT	Information Technology
LIE	Loan Issuing Entity
LTV	Loan-to-Value Ratio
MCM	IMF's Monetary and Capital Markets Department
MFI	Microfinance Institutions
NBG	National Bank of Georgia
PTI	Payment to Income
SME	Small and Medium Sized Enterprises
TA	Technical Assistance

PREFACE

At the request of the National Bank of Georgia (NBG), a technical assistance (TA) mission visited Tbilisi, Georgia, during November 4–13, 2019. The mission was led by Ms. Ellen Gaston, Monetary and Capital Markets Department (MCM), and included Messrs. Ross Henderson and Andrew Poprawa (MCM external experts specializing in bank and nonbank regulation and supervision).

This is a follow-up mission to the one conducted in May 2017. The mission met with the NBG Governor Mr. Koba Gvenetadze; Deputy Governor Mr. Papuna Lezhava; Ms. Irma Bokuchava, Head of Nonbanking Institutions Supervision Department; Ms. Natia Tsotsonava, Head of the First Division of Nonbanking Supervision Department; Ms. Natia Gvazava, Head of Legal Department; and Ms. Teona Kontridze, Head of Supervisory Policy Department, as well as other staff from the NBG. Meetings were also held with Board members of the Micro Financial Institutions (MFIs) Association, and representatives from MFIs.

The mission wishes to express its gratitude and appreciation to the NBG Governor, Deputy Governor, and staff of the NBG for their hospitality, excellent cooperation, and arrangements made to facilitate the work of the mission, as well as for the constructive and open discussions held during the visit. The mission would also like to thank industry participants who generously shared their time and insights.

EXECUTIVE SUMMARY

In the past two years, the NBG has adopted a series of measures to strengthen nonbank sector financial regulation, supervision, and oversight.[1] The MCM TA mission in 2017 provided recommendations along these lines, most of which have been implemented by the NBG. Currently, the nonbank sector consists of Micro Financial Institutions (MFIs) and Loan Issuing Entities (LIEs). In reforming the sector, the NBG has, among others: (i) amended laws and issued new and revised regulations on registration, capital, and liquidity requirements for MFIs; (ii) significantly expanded supervisory powers and authorities and increased supervisory resources for the nonbank sector; (iii) registered 200 LIEs; and (iv) put in place consumer protection and responsibility lending rules. These new measures have helped to enhance the resilience of the nonbank sector, weed out those that are non-viable, and improved the reputation of the MFI brand.

Nonetheless, there remain issues and challenges in the sector. Currently, MFIs have high funding cost. One main factor that explains the elevated funding cost for MFIs is no direct access to Georgian GEL (local currency) from the NBG, while at the same time, lending under a certain threshold is required by the NBG to be in Georgian GEL. MFIs are allowed to take repayable funds as a form of deposit, though individuals providing funding to MFIs are not covered by deposit insurance. In addition, contrary to the policy objectives of the NBG and the government of Georgia for this sector, only a few MFIs undertake small and medium sized enterprises (SME) and agricultural lending, which is essential to economic development in Georgia. The NBG is interested in further strengthening the oversight of the nonbank lending sector and further promoting financial inclusion on both the asset and liability sides. The NBG would also like to make this sector more attractive to foreign investors, who may find the environment in other parts of the world more conducive to micro lending entities and activities.

The mission supported the NBG's proposed new structure in the micro lending sector, which would help meet the NBG's policy objectives. Under the proposed new structure, the top tier would be micro-banks, which would gradually be allowed to take deposits, have deposit insurance, like banks, and have access to GEL from the NBG. Existing qualified MFIs would be allowed to apply to be licensed as micro-banks. The licensed micro-banks would have a clear mandate to function as a lender to underserved individuals, SMEs, and agri-businesses. In addition, they would be required to implement capital and liquidity requirements per the Basel framework with proportionality, be subject to enhanced supervision, and put in place risk management and corporate governance frameworks. These measures would help to promote SME lending and reduce funding cost for the micro-banks, as well as achieving better safety and soundness of the financial system. The current MFIs could: (i) choose to stay as MFIs and be

[1] The current nonbank sector also includes insurance and securities market segments. For convenience, in this report, the term "nonbank sector" refers to the current nonbank lending institutions, including MFIs and LIEs.

subject to the regulatory and supervisory measures recently put in place by the NBG; (ii) apply to be a micro-bank, or (iii) register as a LIE, which would not have to abide by prudential requirements but would also not be able to use the name “MFI”. There would be no substantial change for existing LIEs, for which registration should continue and registration and prudential and nonprudential requirements for new LIEs may be enhanced.

The mission recommended applying proportionality for the micro-banks in implementing Basel’s prudential requirements. Micro-banks would be subject to Basel requirements such as for capital, liquidity, and leverage ratio. The mission advised that these requirements be calibrated in commensuration with the size, complexity, and risk levels of the micro-banks. Proportionality would also be applied to supervision and risk management of the micro lending sector.

The mission recommended that the transition to the new structure be undertaken in a gradual manner over a period of two–three years. Along this line, the mission recommended steps and sequencing for the transition, as well as regulatory and supervisory measures to support the transition. The gradual approach would: (i) provide the NBG and the government sufficient time to weigh the benefits and risks of the proposed new structure, as well as devising prudential and other requirements needed for a successful and smooth transition; (ii) allow MFIs, which are qualified and interested in being licensed as micro-banks, to gradually ease into deposit taking with no limit, adopting the required business model, and meeting higher prudential and risk management requirements; (iii) ensure that the NBG nonbank supervision department is fully prepared to supervise the micro-banks by further enhancing the supervisory framework and guidance, and (iv) minimize any potential negative impact on the micro lending sector as well as on existing MFIs and LIEs (e.g., gradual unwinding of MFIs’ deposit taking in the form of repayable funds).

Table 1. Georgia: Main Recommendations

Para No.	Action Plan	Priority	Time-Frame[1]
22	1. Overarchingly, the NBG should consider several policy, regulatory, and supervisory strategies to further reduce the risks and vulnerabilities of the micro lending sector and enhance financial inclusion. This includes incorporating these strategies in the NBG's three-year strategic plan.	High	Short Term
23	2. To meet the NBG and Georgia government's objective of improving financial inclusion by providing credit to under-served individuals, and the SME and agricultural sectors, the mission supports the NBG's proposal to create a new structure in the micro lending sector and introduce a new class of bank (micro-bank).	High	Immediate to Long Term
24	3. If government approval is received, the NBG should draft amendments to the Banking Law and the Organic Law on National Bank of Georgia to add to the existing definition of bank a new class of bank called "micro-bank".	High	Medium Term
26 65	4. The NBG should design and implement a licensing regime for micro-banks. New applications to become a micro-bank should go through a licensing process, which would also require enhancements to Order No. 58/04 "Procedures and Terms of Registration of Microfinance Organizations".	Medium to high	Medium to Long Term
72	5. A clear "mandate" should be established for the proposed class of micro-banks so that they function as a lender to underserved individuals, SMEs, and agribusinesses and are not just another commercial bank.	Medium	Short to Medium Term
28 60	6. Deposit insurance should be extended to cover micro-bank deposits. For the first two to three years, deposits for micro-banks may be restricted.	High	Long Term
34 38	7. Micro-banks should have access to GEL by swapping foreign currency for GEL directly with the NBG, as commercial banks currently do, to reduce funding cost.	Medium	Long Term
61	8. As an interim measure the current definition of repayable funds should be redefined as a conditional deposit within the micro-bank regulations before MFIs migrate to micro-banks.	Medium	Long Term
75	9. The NBG should draft regulations to allow those MFIs that wish to convert to a LIEs to register as a LIE without going through a liquidation process. For those larger MFIs that choose to become LIEs, it may be appropriate to consider additional safeguards to ensure continued viability.	Medium	Medium to long Term

Para No.	Action Plan	Priority	Time-Frame[1]
29 62	10. Transition arrangements should be introduced for the category of repayable funds over 20 persons for continuing MFIs. No repayable funds should be allowed for MFIs or LIEs 24 months after the government approves appropriate changes to the Law.	Medium to high	Long Term
27	11. The NBG should apply Basel's framework for regulation and supervision on micro-banks and MFIs on a proportional basis.	Medium	Long Term
77	12. The NBG should complete the revisions to the NBG Supervisory Framework for the nonbank and micro-bank sectors, incorporating the various elements related to offsite and onsite supervisory processes.	Medium	Medium Term
57	13. The NBG should complete drafting regulations on prudential requirements on capital, liquidity, leverage ratio, and large exposure limits for micro-banks.	Medium	Medium Term
84	14. The NBG should plan to develop regulations for corporate governance, credit risk, market risk, and operational risk (including business continuity) management for micro-banks and MFIs.	Medium	Medium Term
52	15. The NBG should consider reviewing its current liquidity requirements for MFIs for possible simplification.	Medium	Long Term
86	16. The NBG should consider further measures to reduce the likelihood of fraud and speculation.	Medium	Medium Term
87	17. The regulations should be revised to provide explicit authority for the NBG to have the power of temporary administration over an MFI.	Medium	Long Term

[1]Legend of timelines: ***Immediate***- less than 3 months, ***short term***- 3 to 6 months, ***medium term***- 6 to 12 months, ***long term***- more than 1 year.

I. INTRODUCTION

1. **In May 2017 an MCM TA mission to Georgia provided recommendations related to the nonbank sector, which at that point was lightly regulated and virtually unsupervised.** The then existing Law of Georgia on Microfinance Organizations was a simple rules-based framework designed for small entities that did not take deposits and did not require prudential supervision. However, by 2017, even though MFIs were a relatively small part of the financial sector representing about 3 percent of aggregate loans in the system, they began posing risks to the financial sector at firm and systemic levels since they had begun to raise deposit-like funds without the benefit of having any supervisory oversight. In response, the 2017 mission developed a plan for the NBG to address these risks through proposed changes to the regulatory and supervisory framework for the nonbank sector. Over the past two years, the NBG has implemented most of these recommendations.

2. **The vulnerabilities and risks, which existed in the nonbank sector, have been partially mitigated by the recent enhancements to the regulatory and supervisory regime.** Prior to the financial crisis in 2008, there was a period of "deregulation" of the financial sector in Georgia during which the veracity of the regulation and supervision of the financial sector was significantly reduced. Since that time the NBG had devoted its main supervisory resources towards enhancing the regulation and supervision of the banking sector. Over the past two years the NBG has been turning its attention to addressing the nonbank lending sector.

3. **The government of Georgia and the NBG have made significant progress in strengthening prudential regulation, supervision, and the oversight of all nonbank lending institutions and activities over the past two years.** Amendments to the Law on Microfinance Organizations along with new and revised regulations have established prudential and consumer protection requirements to enhance the safety and soundness of MFIs and providing the NBG with expanded supervisory powers and authority to enforce compliance with the law. The NBG has been able to register the vast majority of entities as either MFIs or LIEs. In contrast to MFIs, under the legislation, LIEs are allowed to make small loans to consumers usually secured by collateral such as gold or jewelry. In addition, the amendments to the laws and regulations provided for the registration of LIEs to ensure that all organizations making loans to consumers were registered with the NBG and followed prescribed requirements for consumer protection. Additional supervisory staff have also been added to ensure that compliance with these strengthened supervisory processes are adequately resourced.

4. **Notwithstanding the above, there remain issues and challenges regarding the stability and viability of the sector as currently structured.** A careful examination of the operations of the sector indicates that most of the institutions currently classified as MFIs could more accurately be described as finance companies. These institutions provide credit facilities to

individuals for consumer purchases or mortgages and provide other services such as money transfers and currency exchange. Their operations are funded by bank loans, shareholders, or deposit like repayable funds. Recently, foreign investors have been turning their attention to other microlending prospects such as in southeast Asia, where microfinancing opportunities have been yielding higher returns and where the regulatory environment has been more receptive to foreign investment. Commercial banks are also creating competition in the microlending space. It is estimated that approximately 10 percent of the microlending market is currently being serviced by commercial banks.

5. **The rest of the report is divided into three sections**. Section II discusses the current structure, improvements made by the NBG, and remaining challenges faced by the nonbank sector. Section III talks about the proposed new structure for the micro lending sector and recommends transition steps and timelines. Section IV recommends regulatory and supervisory measures to be put in place to support the transition to the new structure.

II. Structure, Improvements, and Remaining Issues in the Current Nonbank Sector

A. Current Structure

6. **The NBG has currently registered 50 MFIs and 200 LIEs which serve a significant number of individuals.** Total loans outstanding for MFIs and LIEs as of September 30, 2019 amount to about GEL1.5 billion or slightly more than 3 percent of the financial sector's aggregate loans. It is estimated that the nonbank lending sector which includes MFIs and LIEs provides services to approximately 780,000 Georgians or 22 percent of the population, mostly individuals of modest means and those who are unbanked. At the end of the third quarter of 2019, there were 50 MFIs, holding GEL1.3 billion of assets or about 3 percent of the total financial sector assets of GEL43 billion. The two largest MFIs make up 50 percent of the total MFI assets. On a consolidated basis, MFIs are funded through loans from commercial banks (36 percent), repayable funds from individuals (10 percent), private foreign investment (10 percent), other debt instruments (9 percent), and shareholders (35 percent). Commercial banks represent 97 percent of the financial sector with a high concentration of assets in the top three systemically important banks. The smallest bank which transitioned from an MFI in 2018 is roughly the same size as the largest MFI.

7. **MFIs have evolved over the past two years reflecting changing market conditions as well as the legislative, regulatory, and supervisory initiatives undertaken by the NBG.** The number of MFIs has significantly decreased as a result of more stringent prudential requirements. Some MFIs have determined that registration as a LIE was preferable to being subject to the new prudential, regulatory, and supervisory requirements. At end-2016, there were 80 MFIs operating in Georgia and currently that number has declined to 50 with the likelihood that 5 others will fail to meet the new requirements by end-2019 and thus forfeit their registration as an MFI. Despite

the number of MFIs falling substantially, total assets have remained relatively stable over the period.

8. **There are several different business models being employed by MFIs to meet the demand for credit, fund their operations, and remain sustainable**. Each model is unique depending on the origins of the MFI, its geographic footprint, its ability to access capital, and the aspirations of its shareholders and funders. It appears that the demand for credit by consumers, small businesses, and farmers remains unfilled to a significant extent by commercial banks thus creating a market opportunity for MFIs. This is likely the result of commercial banks not wanting to address the smaller "bottom end" of the loan market, for reasons of cost (e.g., banks do not wish to open branches in rural areas with lower population density) and higher incidence of problem credits. Most MFIs are lending on the basis of collateral with little or no analysis of the ability to repay. Much of the consumer lending appears to be against the collateral of gold and precious stone jewelry (which is a traditional store of wealth in Georgia) and these types of lenders are classed as "pawn shop" type operations. Generally, these lenders do not undertake substantive analysis of the borrower's ability to repay, if the borrower defaults then the gold is melted down and sold to recover the debt. New consumer protection rules implemented in 2018 now include responsible lending provisions (including an assessment of ability to repay) and require disclosure of the cost of borrowing as well as the terms and conditions of the loan.

9. **Based on the data provided by the NBG and collected from MFIs, 12 of the current 50 registered MFIs are actually engaged in MFI activities related to small businesses and agricultural activities.** Using criteria established by the mission, and per discussion with the NBG, at least 50 percent of their loan portfolio are lent out for those purposes. These 12 MFIs account for most of the loans used to support SME business or agriculture. These 12 MFIs include 4 of the 5 largest MFIs in the sector, with the exception of the largest MFI (Table 2). The external funding for these MFIs has been generally obtained from local banks, foreign investors, including foundations, NGOs, or other microlending focused organizations, or from Georgian based shareholders interested in advancing the cause of financial inclusion. These mission driven MFIs expect a reasonable rate of return for the cost of funds as well as the risk levels inherent in lending to individuals undertaking business and agricultural activities.

Table 2. Georgia: Analysis of Loan Portfolio and Sources of Funding for SME and Agriculture Lending MFIs

Loan Portfolio			External Funding		
	Amount in GEL (millions)	In percent		Amount in GEL (millions)	In percent
Consumer Loans	153	35	Bank loans	327	83
Business Loans	195	44	Loans from 147 Individuals	27	7
Agricultural Loans	96	21	Loans from Legal Entities	25	7
Total Loans	444	100	Subordinated debt	14	3
Aggregate Assets	527		Total External Funding	393	100

Source: The National Bank of Georgia reports. The sample includes 12 traditional MFIs.

10. **The rest of the MFIs in the sector are largely consumer lenders by providing credit to individuals rather than small businesses or farmers.** Table 3 provides an overview of these MFI's loan portfolios as well as their funding sources. These MFIs represent about 60 percent of aggregate sector assets and are funded primarily by bank loans and repayable funds from individuals which are analogous to deposits. For regulatory and supervisory purposes, these repayable funds are not using the term "deposits" since only banks are allowed to accept deposits from the public. The NBG has implemented a rule that requires each of these repayable funds to be greater than GEL100,000 once the number of borrowers exceeds 20 individuals on the premise that those are more sophisticated investors. Even though these instruments are crafted in such a way so as to provide a disclaimer of any claim other than an ordinary creditor claim against the MFI, they do create an expectation from individuals that their funds will be redeemed in full. As explained later in this report there are issues with respect to realization of these amounts in the event of a liquidation of an MFI.

Table 3. Georgia: Analysis of Loan Portfolio and Sources of Funding for Consumer Lending MFIs

Loan Portfolio			External Funding		
	Amount in GEL (millions)	In Percent		Amount in GEL (millions)	In percent
Consumer Loans	627	96	Bank loans	146	38
Business Loans	23	4	Loans from 147 Individuals	179	46
Agricultural Loans	2	0	Loans from Legal Entities	30	8
Total Loans	652	100	Subordinated debt	32	8
Aggregate Assets	782		Total External Funding	393	100

Source: The National Bank of Georgia reports. The sample includes 38 consumer lending MFIs.

11. **The aggregate loan portfolio of the MFI sector is skewed towards consumer lending which represents about 60 percent of the portfolio.** In particular, most MFIs, including and especially the largest MFI, which represents about 26 percent of aggregate sector assets, are engaged in lending to individual consumers on a collateral basis. The NBG collects loan data from MFIs on a monthly basis and monitors the types of loans by individual MFIs in order to track the nature of lending activities. Table 4 provides a breakdown of the most recent information available. Collateral provided for loans includes gold, jewelry, and other valuables as well as liens against motor vehicles and real estate. A popular form of collateralized lending in Georgia is "pawn shop" lending where individuals provide gold and other types of jewelry to secure consumer loans. Lenders accept and hold these items as security. In the event of nonpayment, lenders will dispose of the security to realize on the loan. As described by the management of the largest MFI in the sector, this approach is efficient and provides instant credit to those who have this type of security.

Table 4. Georgia: Aggregate MFI Loan Portfolio by Type of Loan

Loan Type	Number of Loans	Total Amount GEL (millions)	Total Amount (In Percent)
Business Loans (Trade and Service)	34,498	193,212	18
Agriculture	19,438	99,661	9
Consumer Loans			
Custom Loans	59,632	292,270	26
Online Loans	115,898	53,531	5
"Pawn Shop" Loans	438,257	386,388	35
Installments	62,745	29,508	3
Other	1,323	13,611	1
Loans Issued to Individuals	**731,791**	**1,068,181**	**97**
Loans Issued to Legal Entities	**1,191**	**29,702**	**3**
Total Loans	**732,982**	**1,097,883**	**100**

Source: The National Bank of Georgia reports.

B. Improvements by the NBG

12. **Since 2017, the NBG has improved regulatory and supervisory oversight through amendments to laws and regulations for MFIs and LIEs.** These include:

(a) Requiring all lenders with more than 20 clients (other than MFIs) to register as LIEs and meet certain requirements for registration, reporting, and compliance with all applicable laws, including the Consumer Protection Act.

(b) Requiring certain detailed information about shareholders, governance, and business plans as a condition to filing an application for the registration of an MFI.

(c) Establishing the required information to be submitted by both MFIs and LIEs to the NBG on a regular basis as well as the requirement to obtain an external audit for MFIs.

(d) Establishing minimum initial capital requirements for MFIs of GEL1 million and ongoing minimum capital requirements of either 18 percent or 24 percent [2] (for deposit takers in the form of repayable funds).

(e) Establishing minimum ongoing liquidity requirements for MFIs of either 18 percent or 25 percent.[3]

(f) Enhancing supervisory framework and resources.

(g) Establishing prudential limits on investments in securities, properties, pawned assets, and loans to connected borrowers for MFIs.

(h) Establishing the rules for determining the required provisions for MFI delinquent loans based on arrears, loan-to-value ratios, security, and other relevant factors.

(i) Outlining the procedures and processes to be followed in liquidating an MFI.

13. **The NBG has enhanced its supervisory framework and resources for the nonbank sector through the implementation of improved data collection, offsite monitoring, and onsite inspection processes**. All MFIs and LIEs are required to submit reports on either a monthly or quarterly basis to the NBG for analysis. The NBG staff assess these reports to determine potential indicators of risk or noncompliance. In addition, the NBG has developed an onsite inspection process to examine the validity of information reported as well as assessing compliance with the law and regulations. The NBG has also significantly increased its supervisory resources from 5 officers in 2016 to a staff complement of 25 in 2019. There are now five divisions within the nonbank supervisory department, responsible for offsite monitoring, onsite inspections, as well as registration for MFIs and LIEs. During the discussions with the staff of the Nonbank Supervision Department, the mission was impressed with the level of knowledge and expertise of the individuals charged with these responsibilities.

14. **The NBG has also introduced consumer protection rules to require all lenders to improve lending practices to individual Georgians.** The measures contained in the rules, which became effective in 2019, have had a significant impact on the practices of all lenders

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[2]Capital adequacy requirements are based on a non-risk weighted ratio of regulatory capital to assets. For those MFIs which attract funds from individuals in excess of 50 percent of regulatory capital, requiring a ratio of 24 percent is required, and for those not meeting that threshold, 18 percent is required. Both capital and liquidity requirements are higher than those on the bank side, reflecting the higher risk in the nonbank sector.

[3]Similarly, liquidity requirements are based on a ratio of liquid assets to average current liabilities. For those MFIs which attract funds in excess of 50 percent of regulatory capital, a ratio of 25 percent is required, and for those not meeting that threshold, 18 percent is required.

including MFIs, LIEs, and non-regulated private lenders. These rules establish standards for debt service ratios (Payment to Income or PTI), loan to value ratios (LTV), and other measures to encourage healthy lending, financial inclusion, and reduce debtor over-indebtedness. All loans in excess of GEL3,000 must be reported to the credit bureau to ensure that lenders have access to information regarding the borrower's credit capacity. Borrowers provide authorization to lenders to access their information at the credit bureau so that lenders can assess their credit worthiness. The NBG oversees the credit bureau.

15. **The loan quality of MFIs appears to be improving as a result of the measures implemented by the NBG.** The regulations prescribing the classification of loans and loan loss provisions have now been implemented, and each MFI must report on a monthly basis on the various categories of assets and the appropriate provisions established. Interest accruals and other fees must be halted once a loan is determined to be 30 days past due. In addition, there are now restrictions on restructured loans to avoid the practice of restoring loans to active status without making required number of payments. A review of the aggregate loan loss provisions being recorded as well as the continuous monitoring by the NBG staff indicates that these new rules are being respected.

16. **The NBG has required LIEs to be registered by April 2019 pursuant to an order issued by the NBG.** The purpose of creating the concept of LIEs was to ensure that all lenders in the country, both individuals and entities, were identified and required to meet certain minimum standards of consumer protection and managing operational risk. While there likely remain a number of unregistered lenders, the NBG is actively pursuing these lending operations to ensure that they are properly registered and file the necessary information as required under the order. LIEs are almost all owned by resident shareholders and typically provide small loans to individuals using various types of collateral such as gold, jewelry or other valuables to ensure repayment. In aggregate, LIEs are funded by bank loans (80 percent) and shareholders (20 percent). LIEs must also meet certain security requirements as well as comply with branch size restrictions. There are prescribed penalties for non-compliance with these requirements. Since these entities are not permitted to accept deposit-like funds from the public, the NBG does not consider them to be of significant risk to the financial sector. The NBG's strategy is to continue to monitor LIEs to ensure compliance with legislation and consumer protection rules. Entities or individuals conducting lending activities with 20 or less clients remain unregistered and unregulated. The current registration process for LIEs is quite limited and does not provide the NBG with sufficient information to determine their viability or the ability of these entities to comply with the requirements of the legislation.

C. Remaining Issues and Challenges

17. **There is a mismatch between foreign exchange funding and local currency lending for MFIs.** MFIs are permitted to lend to individuals and connected parties to a

maximum of GEL100,000 and all loans at and below that level must be made in GEL. Since about 56 percent of funding from banks and others are denominated in foreign currencies (typically U.S. dollars or Euros because of the concern around the stability of GEL), this imbalance between foreign exchange funding and local currency lending creates additional complexity to the operations of MFIs. To exchange foreign currencies to GEL to allow MFI's to lend costs MFI's about 3 percent to 4 percent more (as an interest rate cost) through the commercial banks than it does for the banks to access GEL for foreign exchange (FX) through their accounts with the NBG. Hence, the MFI representatives expressed the view that access to GEL from the NBG would lower their costs of funds and thus potentially improve access by borrowers to microloans. In addition, to manage this currency imbalance on their balance sheet (future liability obligations in FX), MFIs currently enter into swap arrangements with commercial banks to obtain the foreign currency at a set rate when the deposits mature. The NBG allows some open positions to be maintained for this risk but monitors individual MFIs, discusses their exposure and management of the risk, and conducts stress testing. No currency speculation is allowed.

18. **While MFIs fund their operations largely through loans from commercial banks, individuals providing funding to MFIs have no deposit insurance.** Approximately 60 percent of aggregate funding of MFIs is from commercial banks with larger MFIs borrowing at even a higher level. MFIs provide collateral to banks to secure these loans by way of a pledge against fixed assets and their loan portfolio. The regulations limit the level of security pledged to commercial banks at 90 percent of equity to ensure that there is a margin of safety in the event of default. However, despite this limit, there remains a concern that secured creditors such as commercial banks would stand ahead of unsecured creditors as individuals with repayable funds (deposit-like instruments) in the event of a distressed scenario. There remain approximately 500 individuals who have advanced about GEL200 million in funds to MFIs. Unlike depositors of banks, which have explicit deposit insurance protection, individuals who have provided funding to MFIs through repayable funds have no such protection from loss in the event of a failure.

19. **The lack of risk management and restrictions on interest rates make it challenging for some MFIs to be profitable under the 50 percent interest rate cap.** The effective interest rates for MFIs are capped at 50 percent including any additional loan fees. This cap was recently reduced from 100 percent to ensure that borrowers were protected from predatory lending practices. Several MFI representatives indicated that this cap was too low and should be removed for their MFIs to remain sustainable. It appears that the business model followed by certain MFIs is predicated on providing credit to borrowers without a robust credit analysis thus increasing the likelihood of loan losses and requiring higher interest income to cover the cost of these losses as well as their funding costs. On the other hand, other MFIs indicated that a cap of 50 percent provides sufficient latitude to cover the cost of funds and operations and still remain viable.

20. **While representatives of MFIs are positive about the enhanced regulatory and supervisory measures, they also voiced concerns.** They noted that the enhanced regulatory and supervisory framework is appropriate and has helped to improve the reputation of the sector and weed out entities which should not be involved in the microlending sector. However, these representatives also indicated that while these initiatives are welcome, the additional regulatory and supervisory burden has not been sufficiently offset by improvements in their operating environment. In addition to lower interest rate caps, MFIs emphasized that they must hold more capital, more liquidity, comply with responsible lending rules, respect maximum loan sizes, file more frequent regulatory reports than before, and invest in technology and training for staff in order to remain compliant. Significant issues remain regarding access to GEL and other reasonably priced funding sources such as retail deposits.

III. Proposed New Structure and Transition Plan

A. Proposed New Structure

21. **The NBG should consider future steps to promote the long-term sustainability and efficacy of the nonbank lending in meeting its policy objectives of promoting access to credit and financial inclusion.** Primarily, to enhance Georgia's economic growth, more emphasis should be placed on providing sustainable and reasonably priced credit to small businesses and those engaged in agricultural activities. Currently, 27 percent of the existing MFI loan portfolio is focused on these two sectors of the economy. In order to promote this type of lending, more efficient lending processes are required along with access to GEL to increase the availability of funds and reduce funding cost, which in turn would over time reduce the effective interest rates of loans. Other sources of funding in GEL would be helpful including clarifying whether individuals should have the benefit of providing their savings to MFIs to enhance financial inclusion for savings as well as borrowing. Continued improvements in the regulation and supervision of MFIs would assist in rebuilding the reputation of these entities in the marketplace as well as enhancing confidence by those providing funding, both domestically and internationally.

22. **To further reduce the risks and vulnerabilities of the sector and enhance financial inclusion, the NBG may wish to consider several policy, regulatory, and supervisory strategies.** The mission understands that the NBG is preparing a three-year strategic plan to assist in guiding it in setting its priorities for regulation and supervision of the financial services sector including MFIs, LIEs, and other nonbank institutions. Given the number of initiatives already undertaken over the past two years in the nonbank sector, the mission would suggest that any further enhancements be introduced on a gradual basis with sufficient consultation and lead time to allow institutions to absorb them and ensure a smooth transition.

23. **The mission supports the NBG's proposal to introduce a new class of bank specifically designed to serve the micro-finance sector.** Under this three-tier structure, there would be micro-banks, MFIs, and LIEs (see below for further detail), with micro-banks being a new category. Other jurisdictions[4] have successfully established a separate class of banking institution for the express purpose of providing microloans to underserved individuals, small businesses, and agricultural enterprises in rural areas. These institutions would also become deposit taking entities which would be prudentially regulated and supervised to ensure the safety of savings.

24. **The NBG believes that the introduction of another class of bank to promote micro-lending and micro-saving would advance the evolution of the sector with minimal impact on the existing structure.** The introduction of a separate class of bank would allow those MFIs (and perhaps one former MFI which converted to a commercial bank) with the desire to expand their offerings to micro borrowers and savers to move upmarket and take advantage of the benefits of a banking license. MFIs, which would remain operating in the mid-market space offering collateralized loans to consumers, would gradually phase out the deposit-like funding model and remain supervised under the current regime. LIEs would remain in the lower end of the market offering small loans to consumers with limited supervisory oversight being required. The regulatory and supervisory model for each segment of the sector is described below.

25. **There would be several benefits of introducing a new class of bank specifically designed for the micro-finance and micro-savings sector.** These benefits include the ability to diversify sources of funds by ultimately allowing micro-banks to accept deposits from the public thus providing financial inclusion for savers as well as borrowers. As a bank, these savers would benefit from having access to the deposit insurance through the deposit guarantee scheme once the micro-bank has met the standards required to be insured. The desired outcome would be for licensed and prudentially regulated micro-banks to have a better reputation both in the local market and with foreign investors to better attract funds at a lower cost, which would then translate in lower interest rates for SME and agricultural borrowers.

26. **The NBG should design and implement a licensing regime for micro-banks.** To help to meet the NBG objectives mentioned above, as a pre-condition to licensing micro-banks, the NBG should consider measures to incentivize or require micro-banks to have a minimum portion of their loan portfolio (perhaps 50 percent initially and a higher level over time) allocated to serving underserved individuals, SME, and agricultural lending in line with a well thought out business plan. There are currently 12 MFIs which already exceed 50 percent of their loan portfolios lent out to SMEs and agricultural enterprises. While it is recognized that not all of

[4] These jurisdictions include Mongolia, Papua New Guinea, Serbia, and Uzbekistan

those will have the willingness or necessary resources to transition to a banking license, four of the largest five MFIs currently meet this basic requirement. As part of the consideration of this approach, the NBG should consider a consultation process to ensure that the current MFI sector is fully informed of the proposal and has the opportunity to provide its perspectives on them. In those cases where a new applicant, which is not an existing MFI, is interested in forming a micro-bank, the licensing process would necessarily be more vigorous.

27. **The NBG would need to ensure that appropriate regulatory and supervisory controls be put in place to minimize the risk of micro-banks to the financial system.** Similar to the current regulations and rules for banks and MFIs, the NBG would need to implement appropriate safeguards to ensure the safety and soundness of micro-banks consistent with the Basel framework applied on a proportional basis[5] and in a gradual manner. Other elements of the regulatory and supervisory framework should deal with appropriate types and levels of capital, liquidity, and risk management requirements, as well as enhanced governance approaches. It is contemplated that the current staff of the nonbank supervisory department would have the appropriate expertise and skill levels to assume the supervisory oversight of micro-banks should the NBG decide to pursue this concept. See further detail in the next section.

28. **The NBG may wish to consider providing additional benefits to MFIs transitioning to micro-bank status, subject to meeting the above requirements.** In particular, it would be useful to implement a transitional provision to allow MFIs which meet the minimum criteria for licensing, together with other prudential measures to continue as a micro-bank without the necessity to wind up and then apply for a banking license. Provided that these institutions would meet the necessary regulatory and supervisory requirements, they would be able to access the NBG's accounts for local currency thus eliminating the need to enter into swaps with commercial banks and thus incur higher costs of funding. In addition, micro-banks should also be protected by deposit insurance like other banks subject to meeting the above-mentioned requirements.

29. **The creation of micro-banks would have an impact on those institutions which choose to remain registered as MFIs**. As has been described above, the vast majority of the institutions currently registered as MFIs do not exhibit characteristics of finance entities providing loans on a collateralized basis to consumers. As has been noted, the funding of these institutions comes primarily from commercial banks, their shareholders, and deposit-like repayable funds. With no protection, these deposit-like repayable funds are at risk of loss in the event of a failure of an MFI. Thus, it is suggested that deposit-like repayable funds should be phased out over a period of time (perhaps 24 months). With the phasing out of these sources of

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[5]IMF Working Paper: From Basel I to Basel III: Sequencing Implementation in Developing Economies, June 2019. See link to working paper in reference section at the end of this report.

funding, it is possible that the consumer-focused lending entities would not want to continue as MFIs. It is likely that those MFIs that did not see the benefits of remaining regulated would re-register as LIEs. By doing so they would avoid the costs of holding higher levels of capital and liquidity than would otherwise be required. The NBG should draft regulations to allow those MFIs that wish to convert to LIEs to register as LIEs without going through a liquidation process. At the same time, additional prudential and nonprudential measures should be considered as a safeguard for these larger LIEs.

30. **The largest MFI in the sector may choose to remain an MFI under the proposed structure.** This MFI has a unique business model which is based primarily on acquiring deposit-like repayable funds (all in excess of GEL100,000) as opposed to bank loans to fund its operations. It currently does not lend to the SME or agricultural sectors and thus is strictly a consumer lender using various types of security as collateral for loans. Under its current business model, it would not meet the qualifications for a micro-bank.

31. **There would be no substantial change to the current entities registered as LIEs**. The NBG should continue to register "underground" LIEs and strengthen oversight of LIEs over time to ensure continued compliance with enhanced registration requirements, consumer protection and responsible lending act, and their ongoing viability.

32. **The creation of micro-banks should not require significant changes to the legislative and regulatory structure**. The mission met with the legal counsel at the NBG and confirmed that the creation of micro-banks would require some amendments to the Banking Law, the regulations for licensing, and potentially revisions to other regulations. The conclusion was that these amendments and revisions could be implemented within a 12–18 month period depending on the legislative priorities of the government and the NBG.

33. **Below summarizes the proposed new structure in the micro lending sector.**

Micro-banks:

- A new class of banks called "micro- banks" would be licensed to undertake micro lending.
- Micro-banks would be subject to licensing requirements with possible minimum lending to SMEs and agricultural operations.
- Micro-banks would be subject to enhanced supervision.
- Capital requirements including a risk weighted approach as well as a leverage ratio in addition to liquidity requirements would be imposed in line with the Basel framework applied on a proportional basis.
- Micro-banks would be expected to meet appropriate standards for enterprise risk management including credit, operational, liquidity, and market risk as well as sound corporate governance practices.

- Micro-banks would have access to a local currency account at the NBG.
- Micro- banks would have the ability to take deposits which would be covered by deposit insurance.

MFIs:

- MFIs would, over time, be required to cease taking repayable funds (deposits) from the public.
- MFIs would be permitted to continue to operate in the same market as currently.
- MFIs would be permitted to apply for a license as a micro-bank provided, they meet the requirements established for such a license.
- MFIs would be permitted to apply for a license as a LIE, and as a result, larger LIEs would be subject to enhanced prudential and nonprudential measures.

LIEs:

- The registration requirements for new entrants as a LIE would be strengthened.
- The NBG would continue to ensure those entities which remain unregistered become registered.

B. Transition Plan

34. **In the event that the NBG decides to pursue the development of micro-banks and the related changes to regulation and supervision, a reasonable timeline and proper sequencing of its actions should be established and included in its strategic plan.** To ensure a successful implementation of the recommendations which have been made, the NBG may wish to consider developing a transition plan for the short, medium, and long term. In the short term, the NBG would need to draft a policy proposal for new structure and undertake public consultations on the concept of micro-banks. Following the consultation process obtaining government support would be helpful. Once approval is received draft changes to the Law of Georgia on Commercial Banking to permit micro-banks would be the next priority. In the medium term it would be necessary to draft changes to the regulations and complete the necessary revisions to the NBG Supervisory Framework. Finally, in the longer term the process of licensing micro-banks would begin including providing these new institutions with access to GEL accounts at the NBG along with deposit insurance coverage.

IV. REGULATORY AND SUPERVISORY MEASURES TO SUPPORT THE TRANSITION TO A NEW STRUCTURE

35. **Regulatory and supervisory measures to support the proposed new structure should take a proportional approach based on the risk profile and size of the relevant institutions[6] and allow for a gradual transition.** The process should also take into account the level of change already experienced in the MFI sector over the past year. Having recently introduced a suite of prudential regulatory and supervisory changes, the NBG will need a period of time to understand and analyze the extent to which MFIs are complying before moving on with further necessary reforms. The MFIs themselves need a period to adjust and become fully familiar with the new requirements before facing further changes.

36. **A transition period is proposed, which covers the stage until all the initial intake of micro-banks have attained full compliance with interim requirements as micro-banks.** Before that, micro-banks will not be allowed to move to full deposit taking status, which is expected to occur within two (but possibly three) years from those initial entities becoming micro-banks. This might be further delayed if difficulties were experienced in bringing micro-banks to full compliance with the transitional arrangements.

A. Overall Aims

37. **The NBG and industry are of the view that one of the main problems holding back growth of lending to the SME and agricultural sectors is the high interest rates on loans.** High loan interest rates are driven by a high cost of funds for MFIs and from high loan losses. The cost of funds is impacted by the necessity for swapping foreign currency received from overseas investors through commercial banks and borrowing from commercial banks. Access to deposit taking will help to reduce the cost of funds over time. Prudential regulation and supervision will drive improvement in loan losses, which are high, over time.

38. **Allowing for a gradual transition for microbanks to move to full deposit taking status, will drive a reduction in the cost of funds for micro-banks.** The reasons for such an expected reduction include:

- Micro-banks will eventually be able to take deposits from the general public, without restrictions on size or number.
- Micro-banks will have access to GEL from the NBG (by swapping foreign currency for GEL directly with the central bank, as commercial banks currently do), which is expected to reduce cost of funds, probably by at least 3 to 4 percent.

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[6]Basel Committee on Banking Supervision "Range of practice in the regulation and supervision of institutions relevant to financial inclusion". January 2015.

- There will be a reduction in interest rate margins currently charged by commercial banks on loans to MFIs as these entities would be regulated as banks.
- A further impact on loan pricing for micro-banks, apart from the cost of funds, will arise from lower loan losses over time as weaker credits are weaned out of loan portfolios.

B. Applying Rules in a Proportional Manner for Micro-Banks

39. **The Basel Committee's Core Principles (BCP) of banking supervision allows supervisors to accommodate different types of banks, including those with a mandate to foster financial inclusion.** According to a guidance issued by the Basel Committee,[7] compliance with the Core Principles may be assessed on a proportional basis that is commensurate with the risk profile and systemic importance. This entails flexibility in the application of regulatory and supervisory requirements to microfinance organizations. In applying proportionality, a balance needs to be struck between the core safety and soundness objective of banking supervision and the objectives of financial inclusion, together with the focused approach and small size parameters of the micro-bank model.

40. **Micro-banks will be regulated under the existing Banking Law in Georgia, though this Law will need to be amended to incorporate specific provisions for micro-banks.** Only relatively minor adjustments are needed to incorporate these provisions into the Banking Law. Micro-banks can be regulated somewhat differently from commercial banks because they are highly focused on a primary market for lending; therefore, regulation and supervision can be more tailored as many of them are significantly smaller and have less impact.

41. **Once the transitional period is underway, further amendments in key areas, particularly capital, should be undertaken.** This would help to bring the micro-banks more into compliance with the Basel framework, as befits bank status. This could occur at about 18 months after the advanced group of MFIs become micro-banks. This will give them time to become more aligned with being regulated as a bank before moving to full deposit taking.

42. **In incorporating these final amendments into the Banking Law, associated regulations should be made on a proportional basis for micro-banks.** Requirements on capital adequacy and risk management framework including for credit risk, operational risk, liquidity risk, and market risk, are expected to be put in place.

43. **The BCP should be followed when setting up capital requirements for micro-banks.** In particular, Core Principle 16 allows proportionality when setting a capital adequacy ratio. It states that: "The supervisor sets prudent and appropriate capital adequacy requirements for banks

[7] Basel Committee on Banking Supervision "Guidance on the application of the Core Principles for Effective Banking Supervision to the regulation and supervision of institutions relevant to financial inclusion", September 2016.

that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates". This provides some scope for considering the risk presented by micro-banks when the final capital adequacy ratio is set.

44. **Compared to the capital structure in the Law on MFIs, the capital structure for micro-banks should be developed on a tiered basis (identifying Tier 1 and Tier 2 capital).** This would occur when the final amendments to the Banking Law are completed (i.e., six months before the end of the transition period). However, quantifying the components of the tiers can be simplified (treated on a proportional basis). This would allow for the interpretation and calculation of capital adequacy to be brought within the capabilities of micro-banks. Nonetheless, maintaining a basic linkage of the required capital structure with fundamental Basel capital requirements is important in maintaining the integrity of this 'cornerstone' of prudential regulation for banks.

45. **Other capital requirements in line with the Basel framework are considered as suitable to be treated on a proportional basis given the size and complexity of these institutions.** This includes a tailored approach to the possible risk weighting of assets, internal capital adequacy assessment process (ICAAP), buffers, and the leverage ratio. All of these capital requirements should be treated on a proportional basis, with expectations moving more towards full compliance on a proportional basis by six months before full deposit taking is allowed to commence for micro-banks.

46. **It is considered appropriate to introduce a simplified ICAAP in time.** Micro-bank management and supervisory boards should be responsible for managing their own business decisions rather than simply being reactive to the rules set by the regulator. The ICAAP was designed for this purpose, amongst others. At present, it is acknowledged that simple micro-banks, which were recently MFIs, will not be able to understand or calculate their risks and work out how much capital they should have. However, in time and with good supervision, it is expected they will develop and become more sophisticated and this will become achievable, perhaps in two to three years.

47. **The leverage ratio requires Tier 1 capital to be divided by on and off-balance sheet exposures.** Micro-banks may have some challenges in implementing the Basel framework for capital. Total assets might be substituted initially. However, amendments need to be considered on a proportional basis, so that micro-banks move to calculation of a proper leverage ratio by the time they start taking deposits on an unrestricted basis. In addition, the timing of introduction of the public disclosure requirements should be carefully considered. Only when micro-banks have moved to a proper leverage ratio calculation and have become reliable in reporting on it, should public disclosure commence. Micro-banks should never be allowed to commence using an internal ratings-based approach for credit risk.

48. **The minimum amount of initial capital needs to be higher for micro-banks than for MFIs to recognize their status as a bank.** The amount should be reasonably substantial. For

commercial banks it is GEL50 million, but that would appear well beyond the capacity of any current MFI. An amount in the range of GEL5 million to GEL10 million would be appropriate. While there are at present several MFIs that could achieve GEL10 million of capital, it is also appropriate to consider the future and whether any other current MFIs could in time reach that level of capital and step up and how long this might take them. Hence a level somewhat below GEL10 million would seem appropriate.

49. **As an interim measure, the adoption of the minimum capital requirements and capital adequacy ratio (coefficient) specified in the regulations, along with a leverage ratio, is suitable for micro-banks.** This would provide an appropriate alternative to the Basel requirements for capital until these institutions are considered ready to evolve to Basel requirements on a proportional basis. However, micro-banks are expected to be in compliance with these before the end of the transition period.

50. **A number of factors will need to be considered when determining a minimum capital adequacy ratio for micro-banks.** Setting this ratio at a higher level than the minimum requirements in the Basel II framework would be consistent with the higher risk faced by micro-banks. These small institutions are less complex yet suffer from a lack of diversification in their loan portfolios. Clearly, micro-banks will face the challenge of higher credit risk by virtue of lending to smaller borrowers with potentially higher default rates.

51. **The mission suggests a base capital adequacy ratio of 10.5 percent plus capital conservation buffer of 2.5 percent (i.e., 12 percent overall).** This would be an appropriate minimum capital ratio and could be set higher if the NBG considers that all the risk factors associated with micro-banks would warrant a higher capital ratio.

52. **The NBG should review its current liquidity requirement for MFIs with a view to reduce it over time.** Relative to the liquidity requirement for other types of smaller lending institutions, the current ratio could be considered high and might be reduced considering that: (i) the MFIs minimum proportion of funding from capital is set relatively high (although a few MFIs are yet to reach this level) at 18[8] percent and 24 percent (where deposited funds are over 50 percent of regulatory capital); and (ii) MFIs mostly raise term debt thus reducing liquidity risk. In time, when the regulatory and supervisory changes have improved the management and riskiness of many MFIs, consideration might be given to reducing this liquidity ratio. This would not necessarily apply to micro-banks.

53. **The current liquidity ratio for MFIs is considered to be overly complex.** It requires the deduction of longer-term liabilities, but apparently these funds can normally be redeemed early by request. For these small institutions a simple ratio setting liquid assets against total liabilities is likely to be more easily understood and avoid mistakes. The minimum ratio in the

[8]The NBG calculates the current liquidity ratio as liquid assets (cash and cash equivalents) less long-term liabilities and other adjustments as a percentage of total assets.

regulations for MFIs would need to be readjusted from its current base to one based on a portion of the liabilities.

54. **When these entities have transitioned to become micro-banks and certainly before full deposit taking by micro-banks is allowed, then they should also be required to take a forward-looking approach.** The approach could:

- use a simple gap analysis; and
- undertake some simple planning, especially a plan for what to do in a liquidity crisis, with a series of steps planned out as to what action they would take when liquidity falls.

55. **A simplified liquidity requirement should be developed for micro-banks.** Based on the revisions and simplifications to the liquidity requirements for MFIs noted above and those already in place for commercial banks in Georgia, a simplified liquidity requirement could also be developed for micro-banks. Again, the decision on this ratio and other liquidity requirements can be kept simple and straightforward in harmonization with proportionality.

56. **Micro-banks should be required to timely communicate to the NBG their liquidity pressures.** When developing a regulation on liquidity for micro-banks, it would be appropriate to include a requirement that any micro-bank that is experiencing or has determined it may experience liquidity pressure (as a result of taking a forward looking approach to its liquidity management), must contact the NBG within 24 hours. This is because early intervention by the central bank might help avoid a crisis.

57. **Issuance of regulations on capital, liquidity, and market (FX) risk should be properly sequenced.** It is suggested that the capital and liquidity risk regulations be issued by end-June 2020, along with the other regulations planned. This is because these are critical prudential regulatory requirements and must be in place when micro-banks begin operation. Market risk can begin development in July 2020 and be completed by end-December 2020. For example, restrictions on the type of loans to reflect SME and agricultural lending and a review and upgrade of the existing regulation covering asset classification and reserves should be strengthened over time. When developing new regulations, a good practice is to include the essential requirements into the regulations and then provide guidance containing further description and expectations.

58. **The NBG should ensure it is comfortable that micro-banks are safe and sound before allowing them to begin unrestricted deposit taking**. Discussions with the NBG staff revealed that many MFIs are not considered to be safe and sound at this time. Therefore, the mission suggests that all deposit taking by MFIs should cease on a transitional basis over a period of two years so as not to disrupt the market for credit. If a micro-bank, transitioned from an MFI, is determined to be safe and sound, after a suitable period of time (perhaps two to three years), full unrestricted deposit taking may be considered. Otherwise, a minimum deposit size will need to be imposed until the micro-banks reach this point. This is to continue to limit deposit

taking to larger and more sophisticated investors/depositors, who are likely to understand the risks better. The NBG may consider lowering the minimum deposit size from the current GEL100,000 applying to MFIs to a lower number, perhaps GEL50,000, to provide further incentive for MFIs to convert to a micro-bank.

59. **While maximum loan size should remain at GEL100,000, the NBG could consider applying a maximum deposit size to micro-banks.** The maximum deposit size would be a longer-term measure introduced after the transition period, otherwise it would likely conflict with the proposed deposit taking with a minimum deposit size during the transition period. The purpose of the maximum loan and deposit size proposals are to create a micro-banking model where there is no significant funding concentration. In the regulations to be drafted for micro-banks, the short-term imperatives of establishing a stable model will have to be balanced with a longer term need to allow growth and development within the micro-bank sector. The mission understands and supports the desire to introduce both a maximum loan and deposit size. However, this must be considered in conjunction with the expectation that a minimum deposit size may also apply in the short term so as to ensure that depositors are sophisticated enough to understand the risks associated with placing their funds with these institutions. While protecting depositors is paramount, a firm objective to balance this is to encourage a growing and healthy micro-bank sector.

60. **Deposit insurance should be extended to cover micro-bank deposits.** This will be an enhancement that will protect depositors and should be introduced at licensing. For the first two to three years the deposits for micro-banks may be restricted. As mentioned above, the NBG may wish to consider reducing the current GEL100,000 minimum deposit limit to GEL50,000. In this way, only a relatively small proportion of these large deposits would need to be covered by deposit insurance. This would give micro-bank depositors more comfort in depositing with them. To make such a determination, the NBG would likely consider the term of deposits as well as the potential concentration risk associated with the MFIs deposit base. At the end of the two to three-year transition period, the license would be changed to either remove all restrictions in relation to deposits or the restrictions altered but not removed completely, depending on how far advanced each microbank will be at the time.

61. **As an interim measure the current definition of repayable funds should be redefined as a conditional deposit within the micro-bank regulations before MFIs migrate to micro-banks.** Currently the NBG requires MFIs to maintain two categories in terms of number of individuals with repayable funds, one with a number of 20 or less and another with a number greater than 20. These categories of repayable funds can be dispensed with, but the requirement for deposit taking by micro-banks should remain at GEL100,000, with possible reduction to GEL50,000 within the regulations until the transition period has expired.

62. **The category of repayable funds of 1 to 20 persons should be eliminated at the point where an MFI is allowed to convert to become a micro-bank.** Generally, these deposits are from people associated with the business and preferably such deposits should be converted to

some form of capital which will qualify as regulatory capital, but otherwise repaid. This will involve a change to the regulations.

63. **The category of repayable funds of 1 to 20 persons for continuing MFIs should be eliminated as soon as possible after the proposed changes are implemented.** However, some transition period should be allowed for procedural fairness and so as not to disrupt the supply of credit. Again, a significant proportion of these repayable funds are from people associated with the business and preferably such repayable funds should be converted to some form of capital for the MFI which will qualify as regulatory capital, but otherwise repaid.

64. **Transition arrangements should be introduced for the category of repayable funds over 20 persons for continuing MFIs.** Minimum repayable funds allowed for this category is GEL100,000 each. Repayment of these repayable funds too quickly could introduce instability. Therefore, the mission recommends a gradual approach to allow time for those who will remain to be MFIs as well as those who will transition from MFIs to micro-banks. For example, the largest existing MFI may not seek to transition to a micro-bank due to its current business model, therefore, it may pose challenges to both its own business and the sector if it were to be forced to repay all of its repayable funds in a short period of time.

65. **Unrestricted deposit taking, or a maximum deposit size as preferred by the NBG, for micro-banks should be allowed up to two to three years after they are licensed.** When the NBG supervisors can establish confidence that a micro-bank is safe and sound then unrestricted deposit taking can commence. This decision process would best be driven by the General Risk Assessment Program (GRAPE)[9] supervision system used by the NBG so that when the supervisor is satisfied that the micro-bank has reached a prescribed overall GRAPE rating and is conducting itself in a manner that is likely to maintain that rating, then full deposit taking can commence.

66. **For micro-banks, initial limits should be placed on deposits to reduce concentration risk.** The NBG should consider putting a maximum deposit limit in place to control this risk, at least initially. That is, supervisory action should be taken when a single deposit or series of deposits from one source, one industry or one sector of the economy exceeds a certain percentage of regulatory capital.

67. **When MFIs convert to micro-banks, the NBG would prefer to retain the maximum loan limit of GEL100,000, which currently applies to MFIs**. This reflects a desire to limit excessive concentration risk. Again, consideration needs to be given to the need to allow growth of these institutions over time, in order to create a healthy sector. In achieving this it is not

[9]GRAPE assesses risk in the following categories: credit risk, liquidity risk, market risk, operational risk, business model, profitability, macroeconomic environment, group structure, and corporate governance. GRAPE also provides for potential bank access to resources in case of risk realization.

desirable to let micro-banks to immediately commence writing larger loans after licensing. Rather, they should gradually increase loan size in the medium to long term.

68. **The loan size limit set at the outset for micro-banks could be periodically increased over time to allow for growth in some of their exposures within their SME and agricultural customer base.** If growth in the loan limit size occurs over a period of years, limitations should be introduced which will control large loan or other exposures created by micro-banks. Even well capitalized micro-banks can fail if they experience significant losses on large exposures. While the primary function of micro-banks within Georgia will be to provide small loans to SME and agricultural/agribusiness customers, the NBG could consider gradually increasing the loan limit and exceed the current maximum loan size of GEL100,000.

69. **A large exposures framework should be introduced for micro-banks with an upper limit of 25 percent of regulatory capital, which cannot be exceeded.** Loan exposures which exceed 10 percent of regulatory capital should become classified as large exposures and reported to the NBG as such. This is required under the Basel treatment of large exposures even though it is unlikely that a micro-bank will reach the limit. However, this upper limit could be set at a much lower level considering the nature of micro-banks. At the conclusion of the transition period for the initial group of micro-banks, the same large exposure requirements should be based on Tier 1 capital, so a further amendment will then be necessary.

70. **A higher upper limit for micro-bank loans (currently GEL100,000 for MFIs) may therefore be considered in conjunction with the large exposure ratio to capital.** Some of the largest MFIs might be able to attract loans of well over GEL5 million under the above large exposure formula. The intention is not to allow micro-banks to immediately seek large loans, but to allow growth in the SME and agricultural lending market and to allow micro-banks to benefit over time from a customer relationship that they have fostered. Hence an upper limit of GEL500,000 or GEL1 million would allow some flexibility.

C. Licensing of Micro-Banks and Registration of MFIs and LIEs

71. **New applications to becoming a micro-bank should go through a licensing process.** This would require enhancements to Order No. 58/04 “Procedures and Terms of Registration of Microfinance Organizations”. Specifically, licensing should at least require:

- A strategic plan, showing in particular definite viability and how the proposed micro-bank will achieve the desired growth or maintenance of SME and agricultural lending.
- Meet prudential requirements.
- Financial projections (preferably three years) that are consistent with the strategic plan.
- Details of its risk management framework, including policies and procedures for all risk areas.
- Governance, including separation of management and supervisory board.

- Internal audit program.

72. **A clear "mandate" should be established for the proposed class of micro-banks so that they function as a lender to underserved individuals, SMEs, and agribusinesses and are not just another commercial bank.** The NBG should consider establishing licensing criteria to incentivize or even require micro-banks to conduct some minimum of their lending to individuals who are underserved or operating SMEs and agriculture businesses. This information should be published on the NBG's website so that new applicants are clear about what they are seeking licensing for and to provide the NBG with a strong position if the new entrant later does not achieve the required minimum. If this is to be required, then a clearer definition of SME and agricultural lending business would be helpful to ensure integrity.

73. **Existing MFIs that express an interest in converting to a micro-bank should enter consultation with the NBG for a period so that the NBG's expectations for a micro-bank will be met before a conversion occurs.** What is required leading up to the conversion of an MFI to micro-bank is regular supervision to ensure they have reached an adequately advanced stage. The more intensive supervision for a period could be included in the licensing process.

74. **It is expected that licenses issued for micro-banks will be conditioned.** The license will contain conditions for the transition period described above. Longer term conditions on a micro-bank license may include constraints on the type of business it can conduct (type of products and type of customer), possible conditions on source of deposits, particular issues identified from its business plan and limits on various aspects of its business.

75. **The NBG should draft regulations to allow those MFIs that wish to convert to a LIEs to register as a LIE without going through a liquidation process.** For registration of LIEs, the requirement to date has been very simple, which is appropriate when seeking to encourage existing non-registered lenders to register. However, in the medium term, when registration of the existing lenders is completed, it would be appropriate to strengthen the requirements for new applications, to include some basic information to verify that a viable business will result. Basic information about the skills and experience of senior management and a basic business plan, with some financial projections, plus identification of the amount of capital they will subscribe seems appropriate. For those larger MFIs that choose to become LIEs, it may be appropriate to consider additional safeguards to ensure continued viability. These safeguards could include requirements for enhanced risk management and governance as well as consideration of capital and liquidity thresholds for larger, more complex LIEs.

76. **It is understood that there are still some lending institutions operating within Georgia which have more than 20 loans and are not registered, despite the deadline for registration having expired**. Registration of these entities should continue as they have the capacity to damage the reputation of the registered MFIs and LIEs; the NBG should allow some of them fail. One suggestion the NBG had was to offer a further six-month extension to licensing, with a waiving of the license fee for this period. Although that may cause friction with

those that did register within the previous stipulated time period and paid their fee, this appears to be one way to create an incentive for registration.

D. Supervisory Framework for Micro Lending Entities

77. **The NBG should complete the revisions to the NBG Supervisory Framework for the nonbank and micro-bank sectors incorporating the various elements related to offsite and onsite supervisory processes.** The NBG is currently developing its supervision framework for MFIs and requested the mission to provide guidance in this area. The NBG already has an established supervision framework for banks (GRAPE), however it seeks to tailor a framework that will fit MFIs. The mission left some best practice commentary towards enhancing a supervision framework with the NBG.

78. **Once developed, this framework should become applicable to MFIs and micro-banks.** Supervisory responses undertaken within the framework will be driven by scale, complexity, and risk issues. However, changes to regulations to reflect the new supervisory framework would be necessary. Completion of the supervisory framework could be done by December 2020 and put into effect during the conversion process of MFIs to micro-banks.

79. **The NBG's approach to onsite supervision, which is being developed, encompasses a full suite of onsite supervision activities and tools.** The NBG has already started undertaking onsite inspections of MFIs on a comprehensive basis covering all key risk areas, though not risk focused on key risk areas, displaying heightened risk or targeted to specific issues within key risk areas. In time, the NBG should move to a more risk-based approach to onsites, commensurate with the size and risk of the institutions, so that supervisory resources can be applied more effectively.

80. **It is considered best practice to have a specialist enforcement department to carry out liquidations, with experts who are well practiced in this field.** A comprehensive supervisory attention framework structure will assist the "frontline" teams to coordinate transfer of problem institutions to the enforcement area requiring liquidation or other enforcement action, by having a designation in the framework that triggers the transfer. In time the remaining MFIs that do not take deposits can move to a supervision approach in tune with proportionality, but some supervision is essential if the remaining MFIs are to move towards becoming micro-banks in a later stage. The NBG should consider reviewing the enforcement powers it has for MFIs and ensure it has all the enforcement tools it needs to be effective when dealing with problem institutions. Once an MFI transitions to become a micro-bank it will come under the Banking Law (see paragraph 32) and the NBG will then be able to utilize all the enforcement tools currently available for commercial banks also on micro-banks.

81. **While the mission suggests prudential supervision of LIEs should cease, if the NBG decides LIEs are to continue to be supervised, then a separate minimalist supervision**

framework should be developed. This would reflect the 'light touch' supervision that this sector would warrant since no deposit like funds can be accepted by these entities.

E. Proportionality in Supervision and Risk Management

82. **An important component of a supervision framework in a risk-based system is the process for determining the level of supervisory attention and the application of the corresponding framework of supervisory action.** This should be proportional to the size and risk of the institution, which lends itself to a matrix approach. As an example, the NBG's supervision framework should determine frequency of onsite examinations for each institution based on size and the risk of supervised institutions. A basic supervision framework helps to mitigate the risk of missing emerging risks under a risk-based approach by setting the minimum core supervision needed, across all onsite and offsite activities, to gain a satisfactory understanding of an institution's complete risk profile. This would be achieved by determining, based on a set risk measure, what supervisory activities must at a minimum be undertaken over a set timeframe.

83. **In determining the risk categories to decide supervisory action, a matrix involving size bands on one axis and the level of risk on the other, again in bands, should be developed.** Certain areas of the matrix are delineated as categories of 'riskiness' for determining supervisory attention and action. This approach allows for consistency of supervisory approach to be maintained across different sized entities, with proportionality in supervision being preserved at the same time. For any institution, its position within the matrix can then be readily established from its size and risk rating as determined from the risk measurement calculation within GRAPE. Supervisory attention is driven by the category within which an entity falls, which in turn causes certain supervisory actions. For example, under the set risk measure approach, larger institutions, even those with relatively low risk characteristics, will tend to be grouped in the higher supervisory attention band and only very high-risk smaller institutions will be in this same group for supervisory stance.

84. **The NBG should plan to develop regulations for corporate governance, credit risk management, and operational risk (including business continuity) management for MFIs and micro-banks.** The mission believes that in conjunction with this it would be sensible to develop an overarching enterprise wide risk management regulation which includes various individual regulations on risk areas.

85. **While operational risk will be assessed on a proportional basis for MFIs, the requirements for micro-banks should step up over time.** At this stage it is considered that the MFIs are not equipped to comply with a full suite of operational risk requirements. The mission considers that the aim should be to introduce a final operational risk regulation in conjunction with the final amendments to the capital regulation, around six months before micro-banks are licensed. This final version of the operational risk regulation should cover such areas as

information technology (IT) risk, outsourcing (if any), disaster recovery planning, business continuity, and pandemic planning, all on a proportional basis.

F. Other Measures

86. **The NBG should consider further measures to reduce the likelihood of fraud and speculation.** At present MFIs do not, in general, have fraud insurance. While MFIs are very simple systems, the potential for fraud appears relatively high. Fraud insurance can usually be obtained at reasonable cost and a requirement should be considered, including for micro-banks. Some MFIs are currently experiencing pressure on their profitability. To reduce their cost of funds there is a real temptation not to hedge their FX positions. Regulations should require MFIs and micro-banks not to speculate and hedge all FX positions.

87. **The regulations should be revised to provide explicit authority for the NBG to have the power of temporary administration over an MFI.** A full suite of enforcement powers would include temporary administration. Temporary administration provides supervisors with an institution to appoint a manger/administrator (who would displace existing management and the supervisory board) where the supervisor(s) believe a viable entity has been poorly managed and the best outcome would be to employ a professional person to clean it up and turn the business around and then remove it from administration. The mission was advised the NBG does not have this power. It would be of significant benefit to the NBG in certain circumstances.

Appendix I
Reference Materials

Supervisory Guidance

Enterprise Risk Management Framework for Less Complex Institutions (Canada)
Link: https://www.dico.com/Design/Publications/En/ERM%202018/ERM_Framework_2018.pdf

IMF Working Paper: From Basel I to Basel III: Sequencing Implementation in Developing Economies, June 2019
Link: https://www.imf.org/en/Publications/WP/Issues/2019/06/14/From-Basel-I-to-Basel-III-Sequencing-Implementation-in-Developing-Economies-46895

IMF Working Paper: The Impact of the Global Financial Crisis on Microfinance and Policy Implications, 2011
Link: https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-Impact-of-the-Global-Financial-Crisison-Microfinance-and-Policy-Implications-25093

BIS Proportionality in bank regulation and supervision – a survey on current practices
Link: https://www.bis.org/bcbs/publ/d460.pdf

BIS: Proportionality in banking regulation: a cross-country comparison
Link: https://www.bis.org/fsi/publ/insights1.pdf

Examples of Micro-banks
Annual Report of Microbank (Spain)
Link: https://www.microbank.com/Informe_Anual_2018_en.pdf

Peoples Micro-bank Papua New Guinea
Link: http://peoplesmicrobank.com/about-us/

Xacbank Mongolia
Link: https://www.xacbank.mn/page/about

Opportunity Bank Serbia
Link: http://www.obs.rs/en/

Hamkorbank Uzbekistan
https://hamkorbank.uz/uz/

Mikrocreditbank Uzbekistan
https://mikrokreditbank.uz/en/

Other Resources
MicroFinance Center (Poland)
Link: http://mfc.org.pl/membership/list-of-mfc-members/

European MicroFinance Network
Link: https://www.european-microfinance.org/