



GEORGIA

FINANCIAL SYSTEM STABILITY ASSESSMENT

September 2021

This paper on Georgia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on September 14, 2021.

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International Monetary Fund
Washington, D.C.



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KEY ISSUES

Context: A recovery from the Covid-19 pandemic now underway in Georgia has benefited from a recent pickup in external demand and substantial fiscal support. Significant exchange rate depreciation, global commodity price increases and supply constraints have contributed to inflationary pressures and provided impetus for the authorities to start tightening monetary policy during 2021. Credit growth slowed during the pandemic but has since picked up again. Household and firm indebtedness is relatively high reflecting rapid credit growth in recent years. Banks face elevated credit risks as they carry high exposure to unhedged borrowers in foreign currency, some of whom are facing debt-servicing difficulties due to the pandemic.

Findings: The authorities' regulatory reforms in recent years and pro-active policy actions for the Covid-19 shock have supported financial sector resilience. With solid pre-crisis capital and liquidity buffers and strong profitability, banks should be able to absorb pandemic-related losses in a baseline scenario. The banking system also appears resilient under potential adverse scenarios, though a few banks could face manageable capital shortfalls relative to regulatory minima. The authorities' wide-ranging dollarization measures have helped to reduce banks' asset and deposit dollarization, though it remains high. They have also made commendable progress in deepening financial stability analyses, developing a framework for macroprudential policy and tools, strengthening the quality of supervisory oversight and upgrading the framework for bank resolution and crisis management since the last FSAP.

Policies: The authorities should encourage banks to retain earnings until pandemic-related uncertainties subside and pre-pandemic capital buffers are fully restored. Subsequently, further tightening and recalibration of de-dollarization measures and adoption of new tools should follow a gradual approach based on thorough impact assessments. Stable macroeconomic conditions and enhanced communication on foreign exchange intervention policy would help to support measures to reduce dollarization. The NBG should continue to strengthen its supervisory framework by formalizing and enhancing the governance of internal processes and carrying out more regular in-depth assessments of banks' governance and risk management practices. It should establish clear procedures, funding arrangements and contingency planning for bank resolution, deposit insurance and crisis management.

Approved By
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This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that carried out virtual missions to Georgia in May-June and January-February 2021. The FSAP findings were also discussed with the authorities during the Article IV consultation mission in July 2021.

- The FSAP team was led by Mustafa Saiyid, IMF, and Haocong Ren, World Bank, and included Rachid Awad (Deputy Mission Chief), Julia Faltermeier, Inutu Lukonga, Maksym Markevych, Rangachary Ravikumar, Sergejs Saksonovs, Francisco Vazquez (all IMF); Tim Clark and David Scott (IMF external experts); Heinz Rudolph (Deputy Mission Chief), Ahmed Faragallah, Jose Antonio Gagnani, Sonia Iacovella, Sheirin Iravantchi, Graciela Miralles Murciego, Oliver Masetti, Noelia Carreras Schabauer, Andrius Skarnulis (all World Bank), and Keith Ligon (World Bank external expert). The FSAP benefited from research support provided by Stephanie Ng and Hannah Sheldon, and administrative support provided by Vanessa Guerrero, Angelica Mendez, Kene Ndir (all IMF); and Nino Kurtanidze (World Bank).
- The mission met with Governor of the National Bank of Georgia Koba Gvenetadze, Mr. Ivane Matchavariani (then Finance Minister), Mr. Nikoloz Gagua (Deputy Finance Minister), Ms. Eka Mikabadze (First Deputy Minister of the Economy), as well as senior officials and staff at the National Bank of Georgia, Ministry of Finance, the Ministry of Economy, and key government agencies. Private sector counterparts included commercial banks, banking and industry associations, the stock exchange, brokerage firms, auditors, investment funds, law firms, real estate developers, mortgage companies, rating agencies, academics, and others.
- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- This report was prepared by Mustafa Saiyid with contributions from IMF and World Bank teams.

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Glossary

AML/CFT	Anti-Money Laundering / Combating the Financing of Terrorism
BCP	Basel Core Principles
BRRD	Banking Recovery and Resolution Directive
CAR	Capital Adequacy Ratio
CCA	Caucasus and Central Asia
CCB	Capital Conservation Buffer
CCyB	Counter Cyclical Buffer
CICR	Currency-Induced Credit Risk
CPMI	Committee on Payments and Market Infrastructures
CSD	Central Securities Depository
CET1	Common Equity Tier 1 Capital Ratio
CRE	Commercial Real Estate
D-SIB	Domestic Systemically Important Bank
DGS	Deposit Guarantee Scheme
DTI	Debt-to-Income Ratio
EFF	Extended Fund Facility
ELA	Emergency Liquidity Assistance
ESRB	European Systemic Risk Board
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Committee
FSSA	Financial System Stability Assessment
FX	Foreign Exchange
GFC	Global Financial Crisis
GRAPE	General Risk Assessment Program
HHI	Herfindahl-Hirschman Index
HQLA	High-Quality Liquid Assets
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IFSC	Interagency Financial Stability Committee
IRB	Internal Ratings-Based
IOSCO	International Organization of Securities Commissions
LCR	Liquidity Coverage Ratio
LTV	Loan-to-Value Ratio
M&A	Mergers and Acquisitions
MFI	Micro Finance Institution
MoESD	Ministry of Economy and Sustainable Development
MoF	Ministry of Finance
MoJ	Ministry of Justice
MoU	Memorandum of Understanding
MMoU	Multilateral Memorandum of Understanding
MSME	Micro, Small, and Medium Size Enterprises
NBG	National Bank of Georgia
NBG Law	Organic Law of Georgia on the National Bank of Georgia
NPL	Nonperforming Loan
NPS	National Payment System
NSFR	Net Stable Funding Ratio
P&A	Purchase and Assumption
PCGS	Partial Credit Guarantee Scheme
PSP	Payment System Provider

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PTI	Payment-to-Income Ratio
RLR	Responsible Lending Regulation
RTGS	Real Time Gross Settlement
RWA	Risk-Weighted Asset
SME	Small to Medium-Sized Enterprise
SRB	Systemic Risk Buffer
WEO	IMF World Economic Outlook

EXECUTIVE SUMMARY

The FSAP was conducted virtually during the Covid-19 pandemic, which hit the economy hard. Lockdowns and restrictions on movement led to a collapse in tourism revenues and a significant contraction in net exports and growth. The earnings of firms declined sharply while unemployment surged, weakening the debt-servicing ability of corporates, SMEs and households. Although non-performing loans have increased, banks have remained resilient in terms of capital and liquidity and credit growth has remained robust during the pandemic. A recovery supported by external demand and fiscal stimulus is now underway.

Financial sector resilience has been supported by the authorities' pro-active policy actions.

In recent years, the NBG has strengthened the legal and regulatory framework for the financial sector by implementing Basel III standards and prudential tools, including for responsible lending and dollarization-related risks. Early during 2020, the NBG required banks to take up-front general provisions against loan losses, restricted capital distributions, and released some of banks' capital buffers. It supported banks' liquidity in lari by lowering the policy rate, suspending the LCR requirement in lari temporarily, expanding the range of collateral for access to central bank liquidity, and allowing banks to swap foreign currency holdings. The government meanwhile provided sizeable fiscal support to the economy via unemployment compensation, direct transfers and mortgage subsidies for households; tax relief and credit guarantees for businesses; and placements of debt issuance proceeds with banks to support their liquidity.

FSAP solvency and liquidity analysis confirmed resilience of the banking system. All 15 banks were found to be adequately capitalized in a conservative baseline scenario for Georgia over a 3-year period. For an adverse scenario, in which an extended pandemic through end-2021 is coupled with an external disturbance, four banks were found to suffer capital shortfalls relative to minimum Tier 1 requirements, amounting to 1.5 percent of GDP in aggregate. All banks were found to be sufficiently liquid in various scenarios, including one that replicated deposit outflows during the Global Financial Crisis. The authorities should encourage banks to retain earnings until pandemic-related uncertainties dissipate and pre-pandemic capital buffers are fully restored and proceed with planned implementation of the Basel single party concentration standard for banks.

The authorities' macroprudential toolkit is comprehensive. For addressing the key systemic risk of dollarization, it includes an outright ban on FX lending for amounts below 200,000 GEL; higher capital charges on unhedged FX lending; borrower-based measures such as payment-to-income and loan-to-value requirements by currency; higher reserve requirements and penalty rates of remuneration on FX versus lari deposits, as well as differentiation of reserve requirements by individual banks' deposit dollarization; and differentiated liquidity coverage requirements for FX and lari deposits. While banks' dollarization has declined by about 10 percentage points since 2016, it remains above 60 percent for deposits and 55 percent for loans, the highest in the CCA region.

Further progress in reducing dollarization will benefit from stable macroeconomic conditions and a gradual approach. In the short term, the NBG is appropriately focused on

restoring the few de-dollarization related measures, which were released during the pandemic. Over the medium term, it should consider tightening de-dollarization measures gradually, with the choice of measures and calibration informed by impact assessments. The NBG should seek to enhance public communication on macroprudential decisions as well as on foreign exchange intervention policy to explain how it reconciles objectives of flexibility and reserve accumulation. It should expand impact assessments of macroprudential measures and carry them out regularly.

Supporting resilience of the banking system, the authorities have made progress in strengthening the quality of supervisory oversight in recent years. The regulatory regime is now generally consistent with Basel standards and tailored to a highly dollarized banking system. The NBG should formalize key supervisory processes, including for supervisory planning and decision making; expand communication with banks on supervisory assessments; and follow up on banks' actions to implement remedial measures. It should deepen its assessments of banks' governance and risk management and require systemic banks to incorporate internal stress tests in their management of capital and liquidity.

The regulatory and policy framework for capital markets oversight is already aligned with IOSCO standards. Further supervisory enhancements could focus on identification of emerging risks, assignments of risk scores to supervised entities, and conduct assessments. Monetary sanctions for market abuse should be made sufficiently punitive.

The authorities have taken welcome steps to strengthen financial safety net arrangements since the last FSAP though additional steps would ensure their effectiveness. In 2019, they amended NBG and Banking Laws relating to recovery planning, resolution and liquidation of banks; and formed a new Interagency Financial Stability Committee to handle banking resolution. They should establish clear procedures for bank resolution and crisis management; take steps to facilitate the swift establishment of a bridge bank when needed; prepare formal contingency plans for crisis situations; and clarify sources of official financing available during bank resolution.

The authorities have also made significant progress in several areas of financial sector development. For the National Payment system, further efforts should be aimed at improving access and efficiency. The NBG should continue to develop a comprehensive risk management framework for the RTGS and conduct assessments of the CSDs according to CPMI/IOSCO Principles. With regards to Financial Sector Competition, the new Competition Law assigns a competition mandate to the NBG, while new regulations provide guidance on anti-competitive practices. The NBG should expand its surveillance of financial sector participants for anticompetitive conduct; increase penalties for such conduct; carry out systematic reviews of merger and acquisition activity; and continue to develop institutional capacity for enforcement. To develop capital markets, the authorities should continue with ongoing efforts to develop legislation for covered bonds, which could provide investors with an additional savings instrument, help to lower interest rates on local currency mortgages, and serve as an additional liquidity management tool by banks and the NBG. Access to finance may be facilitated by further development of fintech. The authorities should seek to expand credit information on potential borrowers; develop an online collateral registry; and strengthen the legal framework for secured transactions.

Table 1. Georgia: Key Recommendations

Recommendations and Authority Responsible for Implementation ^{1/}	Timing ^{2/}
Financial Stability Analysis	
Encourage banks to retain earnings until pandemic-related uncertainties subside and pre-pandemic capital buffers are restored.	ST
Implement Basel regulation on banks' large exposures as planned.	ST
Macprudential Policy and Dollarization	
Review calibration of macroprudential tools aimed at reducing dollarization, including via impact assessments.	ST
Strengthen communication of the impact and rationale of macroprudential policy decisions to stakeholders.	ST
Enhance public communication to clarify the objectives of foreign exchange interventions.	I
Banking Supervisory Oversight	
Formalize and enhance the governance of key internal processes for supervisory operations and decisions.	I
Review the internal GRAPE scoring and weighting methodology.	ST
Carry out regular in-depth assessments of banks' governance and risk management practices.	ST
Require systemic banks and encourage others to incorporate internal stress testing in capital and liquidity planning.	ST
Anti-Money Laundering / Countering Financing of Terrorism (AML / CFT) Supervision	
Strengthen regulation/ supervision for gaming sector, virtual asset service providers, and real estate agents. (MoF)	MT
Consider setting maximum thresholds for use of cash in certain transactions.	ST
Capital Markets Oversight	
Continue to develop and implement risk-based supervision for all market participants.	ST
Ensure that sanctions for market abuse are sufficiently punitive.	I
Financial Safety Nets	
Implement a prompt corrective action framework for banks.	I
Take steps to be able to implement a bridge bank swiftly when needed. (MoF, NBG)	I
Prepare crisis contingency plans for banks and adopt regular testing programs. (IFSC, NBG)	ST
Financial Sector Development	
Financial Market Infrastructure	
Develop detailed procedures for oversight of payment systems	I
Complete self-assessments of the two Central Securities Depositories. (NBG, GCSD)	I
Financial Sector Competition	
Develop institutional capacity for competition enforcement and advocacy as a separate function within NBG.	I
Carry out impact assessments of laws and regulations in the financial sector from a competition perspective.	ST
Capital Markets Development	
Commit to a predictable schedule of issuance for benchmark government bonds in sizable amounts. (MoF)	I
Enact relevant legislation for covered bonds as planned. (MoF, NBG)	I
Access to Finance	
Define a roadmap for the development of fintech and a National Financial Inclusion Strategy.	ST
Establish an online collateral registry and strengthen the legal framework for secured transactions. (NBG, MoJ)	ST
^{1/} Authority responsible for implementation is NBG unless indicated otherwise.	
^{2/} I Immediate (within 1 year); ST Short term (1-3 years); MT Medium Term (3-5 years)	

BACKGROUND

A. Context

- 1. Georgia, a small, open economy, has faced several macrofinancial and geopolitical shocks since independence.** These include a civil war, bank failures and a period of hyperinflation during the 1990s, all of which undermined confidence in the domestic currency and led to a highly dollarized banking system. In recent years, rising consumption along with higher private and public investment has resulted in persistently high current account deficits, financed largely by foreign direct investment, and an accumulation of external liabilities (Figure 1). The Georgian economy remains exposed to external shocks owing to the importance of tourism, mining, agricultural exports, and remittances.
- 2. The COVID-19 pandemic was the latest shock to hit the economy.** During 2020, mobility restrictions together with falling tourism and export receipts contributed to the largest output decline since the nineties (of 6.2 percent). The pandemic lowered firms' earnings and household incomes and led to significant loss of jobs, with the unemployment rate rising from 16.6 percent at end-2019 to 21.9 percent in 2021Q1. The government provided substantial fiscal support for the economy, amounting to 3.8 percent of GDP in 2020, including subsidies for households and credit guarantees for corporates and SMEs, and a further 2.9 percent of GDP in 2021, mostly for healthcare. The NBG meanwhile provided monetary support via cumulative rate cuts of 100 bps. Between end-2019 and April 2021, the lari depreciated by about 20 percent against the dollar though its net effective exchange rate remained stable due to appreciation versus key trading partners, including Russia and Turkey.
- 3. A V-shaped recovery, supported by external demand and fiscal stimulus, is now underway.** CPI inflation, which had declined sharply during 2020, has now risen to about 11.9 percent at end-July 2021, well above the NBG's target of 3 percent.¹ On concerns about exchange-rate passthrough to inflation and rising inflation expectations, the NBG reversed its monetary policy stance for the pandemic and raised the policy rate by 200 bps cumulatively between March and August 2021.
- 4. Credit growth, which despite slowing significantly during the pandemic, remains robust.** At constant exchange rates, credit slowed to 7.7 percent (y-o-y) in March 2021 compared to about 16 percent before pandemic but has since picked up again (to 12.6 percent y-o-y in June) notwithstanding the tightening in rates. In recent years, the main drivers of credit growth have gradually shifted from consumer and mortgage lending to large corporates, facilitated by responsible lending regulation on household credit in 2019. NBG analysis suggests that the credit gap was close to zero before the pandemic and became positive subsequently.
- 5. Macrofinancial vulnerabilities are exacerbated by the pandemic.** Corporate, SME and household credit risks are elevated but real estate and sovereign-related risks are more muted:

¹ The authorities have operated an inflation targeting framework with a floating exchange rate regime since 2019.

- **Corporates and SMEs.** Corporate sector debt has doubled over the last decade to 69 percent of GDP (Figure 2), which is moderately high in cross-country comparison. There is significant variation in debt servicing ability among firms. With three-quarters of corporate loans in FX (Figure 1), of which only 20 percent are hedged, exchange rate depreciation and lower corporate earnings during the pandemic period weigh on asset quality. 60 percent of SME loans are in FX and almost none are hedged.
- **Households.** Household sector debt is 38 percent of GDP, significantly higher than in peer countries, and has tripled in proportion to disposable income over the past decade (Figure 2). Against their debt, households appear to carry significant cash assets at the aggregate level, but there is likely to be significant variation in vulnerabilities by income groups. Over 40 percent of household loans are in FX and almost none are hedged.
- **Real Estate.** The housing market is mostly priced in dollars. While residential real estate prices have increased about 60 percent in lari terms over the past decade, they have been largely stable in dollar terms and there appear to be no signs of overvaluation (Figure 2). Housing demand has been met by significant pickup in construction over the years. There is limited data available on commercial property prices.
- **Sovereign.** Government debt reached 60 percent of GDP, almost 20 percentage points higher than in 2019 reflecting pandemic-related deficits, depreciation, and GDP decline. Almost 80 percent of this debt is in foreign currency. However, government debt is mainly owed to IFIs at concessional rates and is assessed as sustainable (in the 2021 Article IV consultation). Banks' holdings of government debt, about 10 percent of banks' assets, are held to maturity (rather than being marked to market), and banks' net claims on the government have remained broadly unchanged since 2015.

B. Financial System Overview

6. The Georgian financial sector is moderately sized. The financial sector, which consists almost entirely of banks, has assets amounting to 108 percent of GDP (Figure 3; Table 4). It includes 15 commercial banks (94 percent of assets); microfinance organizations (2 percent), insurers (2 percent) and pension funds (2 percent). There are 9 domestic banks, of which 3 are D-SIBs, and 6 small banks that are subsidiaries of foreign banks. There are no state-owned banks. The banking system is quite concentrated with the two largest banks making up nearly three-quarters of lending (Figure 4).

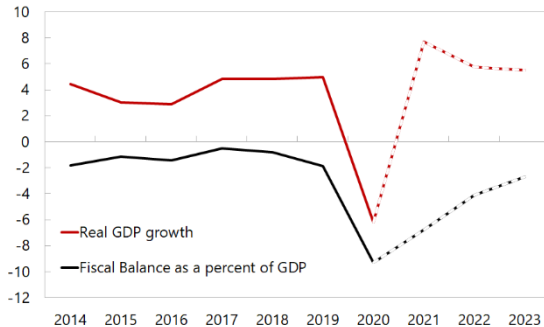
7. Banks' assets and liabilities are highly dollarized (Figure 4). Banks' assets are comprised largely of loan portfolios and carry exposure to securities markets, amounting to 11 percent of total assets respectively. Securities market exposure is mainly due to government bonds, as holdings of equities and corporate bonds are negligible, given undeveloped capital markets. Domestic interbank exposure is negligible though banks carry balances with correspondent banks abroad. Banks' loan portfolios are split almost evenly between corporates and households, with the latter being mainly for mortgages. On the liability side, banks' funding is deposit-based with debt issuance, including in foreign markets, comprising about 20 percent

of the total. About 55 percent of banks' lending portfolios are in foreign currency, mostly U.S. dollar and euro, against deposit funding of which 61 percent is in foreign currency.

Figure 1. Georgia: Indicators of Macroeconomic Conditions
2021 Q1 or Latest Available

GDP and Fiscal Balance

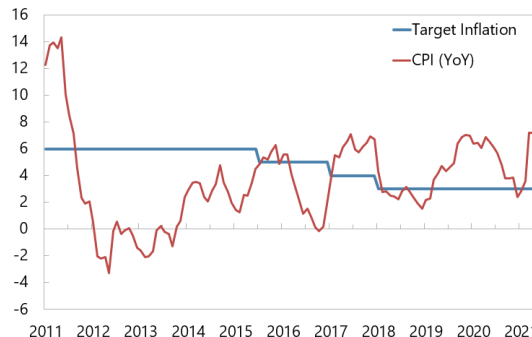
(percent, yoy)



Sources: Georgian authorities; IMF staff estimates.

Inflation

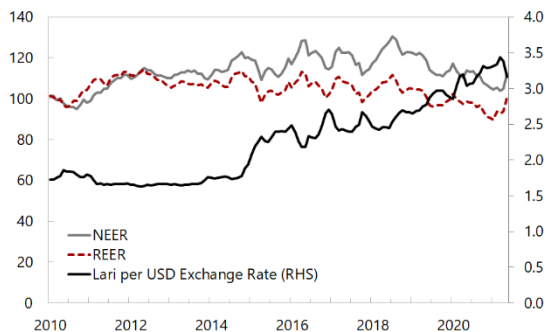
(percent, Jan 2011 - Jun 2021)



Sources: NBG; IMF staff calculations.

Exchange Rate

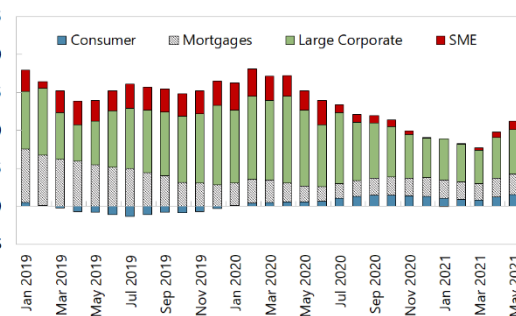
(Jan 2010 = 100, Jan 2010 - Jun 2021)



Sources: NBG; IMF staff calculations.

Decomposition of Credit Growth

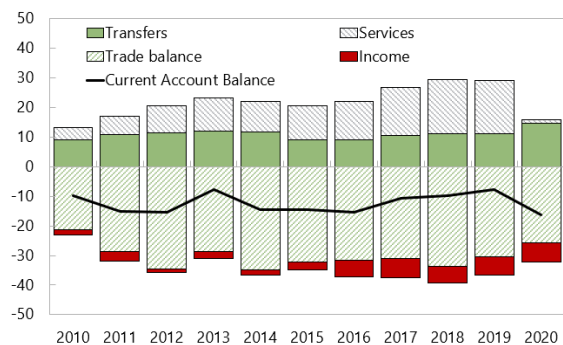
(In percent)



Sources: NBG; IMF staff calculations.

Current Account Balance

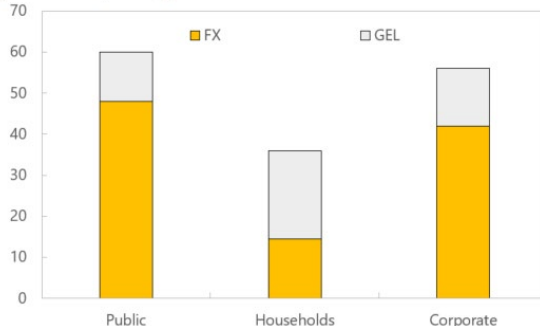
(percent of GDP)



Sources: NBG; Ministry of Finance; IMF staff estimates.

Sectoral Debt Composition

(percent of GDP, 2020 Q2)

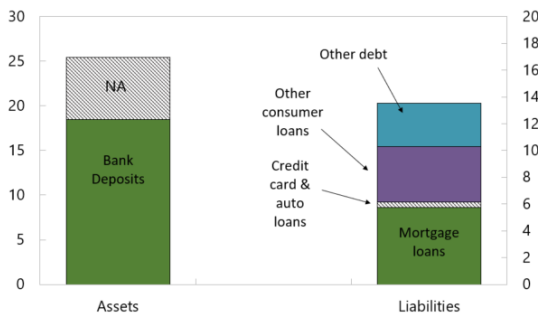


Source: NBG.

Figure 2. Georgia: Macrofinancial Vulnerabilities
2021 Q1 or Latest Available

Household Balance Sheets

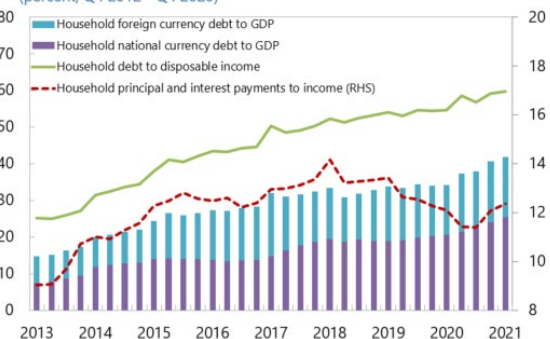
(In billions of GEL, Dec 2020)



Sources: NBG, IMF staff calculations.
Note: NA = financial and physical (real estate) assets data not available.

Household Debt Burden

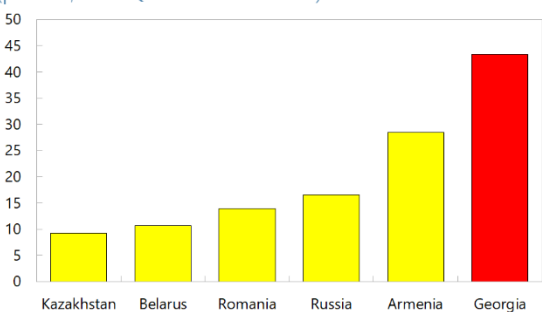
(percent, Q4 2012 - Q4 2020)



Source: NBG.

Household Debt-to-GDP

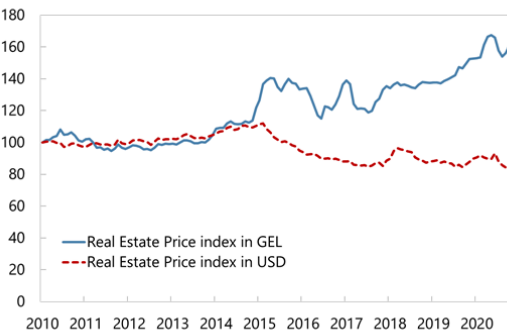
(percent, 2021 Q2 or latest available)



Source: IMF FSI database.
Note: Georgia data is from 2021 Q2.

Residential Real Estate Developments

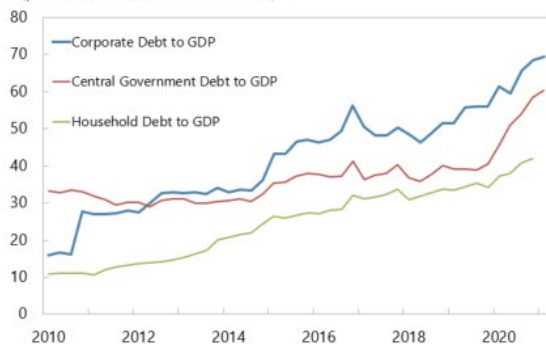
(index level 100 = Jan 2010, Jan 2010 - Dec 2020)



Sources: NBG; IMF staff calculations.

Debt by Sector

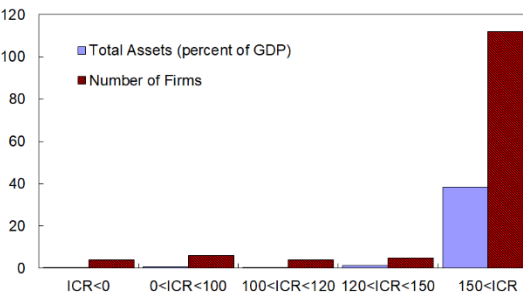
(percent of GDP, Q1 2010 - Q1 2021)



Source: NBG.

Interest Coverage Ratio of Large Corporations 1/

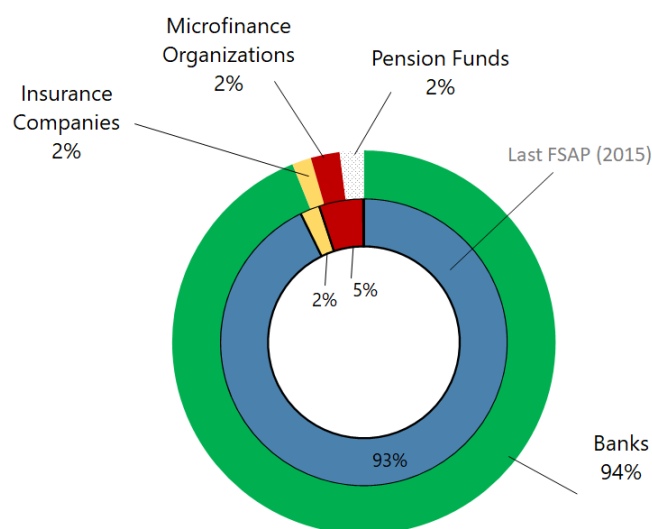
(Latest Available Unconsolidated Financial Data)



1/ Sample of 114 companies in 49 consolidated groups with total assets of about 28 percent of GDP.
The ICR ratio (in percent) is computed by dividing EBITDA by interest expenses.
Sources: NBG and IMF staff calculations.

Figure 3. Georgia: Evolution of Financial System Structure

(In percent of total assets; 2020 versus at last FSAP)^{1,2}



Source: National Bank of Georgia.

¹ Total assets of about 18 billion USD (108 percent of GDP).

² Inner ring is for 2015, outer for 2020.

8. Banks entered the ongoing Covid-19 crisis with strong capital and liquidity buffers, though profitability took a temporary hit from pandemic-related provisions required by the NBG (Figures 4, 5, 6; Table 5).

- Capital ratios strengthened in the years prior to the pandemic even as banks’ risk-weighted assets increased. Following the COVID-19 outbreak, banks’ CAR ratios fell by 1.9 ppt during 2020, but have since risen to 19.2 percent (Tier 1 ratio of 14.8 percent) by 2021Q2.
- Liquidity has remained in full compliance with the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements during the pandemic, due to pre-emptive policy actions taken by the authorities (see below).² Given high dollarization in the system, the authorities also enforce LCR by currency (100 percent in foreign currency, 75 percent in lari), though the latter was temporarily eased during the pandemic.
- Profitability, which was high before the COVID crisis, dropped sharply during 2020 due to increased provisions for expected credit losses and falling interest income, though it has recovered by early 2021.

² Overall system liquidity was also supported by the successful refinancing in April 2021 of a Eurobond, which at a yield of 2.75 percent was priced well above peers and earlier issuances and is expected to serve as a benchmark for possible future issuance by Georgian banks.

- Asset quality weakened, with NPLs reaching 6.7 percent by Q2-2021 compared with 4.4 percent at end-2019, under the NBG’s asset classification.³ NPLs were higher for firms operating in sectors heavily exposed to the pandemic and on FX versus lari loans (at about 12 percent and 8 percent on dollar and euro loans respectively versus 6 percent on lari loans as of February 2021).
- Banks’ deposits, including from non-residents, have remained stable through the crisis. Reflecting improvements in public confidence, deposits have grown in real terms over the past decade and the proportion of non-resident deposits has stabilized at 15 percent of the total (see Figure 5, lower left panel). However, the interest rate spread on local versus foreign currency deposits has widened during the pandemic (Figure 4).
- Banks’ external debt has increased to 27 percent of GDP in 2020 (about one fifth of Georgia’s external debt) from about 10 percent in 2010. About three quarters of the debt is long-term and nearly half of it is owed to IFIs.

C. Policy Actions

9. Despite challenges, the authorities have maintained a strong commitment to reform over the years. Since the 2015 FSAP, they have made significant progress with several FSAP recommendations (Table 9) supported, in part, by an extensive program of IMF technical assistance (Table 10). This notably includes implementation of the Basel III framework for capital and liquidity. The implementation of a limit on banks’ single party concentration has been delayed to mid-2022 owing to the pandemic.⁴ The authorities have also introduced responsible lending regulation (RLR) for household borrowers based on PTI, LTV (2019); implemented a new banking resolution regime (at end-2019) and deposit insurance scheme (2017); established a Corporate Governance Code (2018); strengthened the top-down stress testing framework; and started publication of an annual Financial Stability Report (since 2019).⁵ In 2020, the authorities announced plans to issue a Central Bank Digital Currency (CBDC) (Appendix I).

³ NBG’s definition of NPLs is based on the risk classification of loans, which contains a forward-looking assessment, which is different from the 90-days past due FSI methodology. FSI data (Table 5) report only a small pickup in NPLs to 2.2 percent at Q2 2021 compared with 1.9 percent at end-2019.

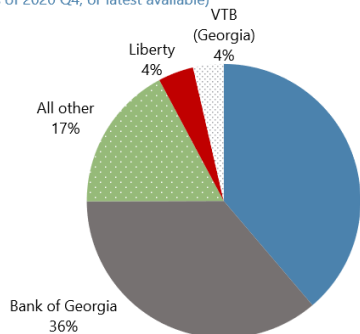
⁴ This limit, which applies to single party exposures that individually exceed 10 percent of a bank’s Tier 1 capital, is that each of them must not exceed 25 percent of a bank’s Tier 1 capital.

⁵ These measures have helped contain credit growth and with the credit gap close to zero, the countercyclical capital buffer has never been activated.

Figure 4. Georgia: Banking Sector Structure
2021 Q1 or Latest Available (percent)

Lending Shares in Banking System

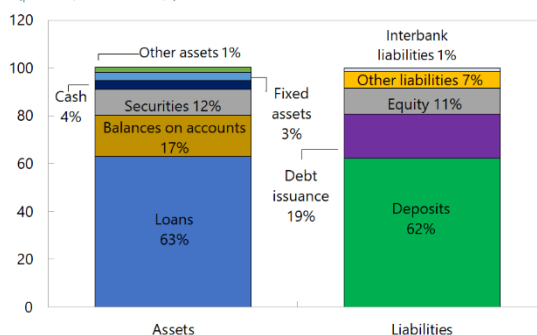
(as of 2020 Q4, or latest available)



Sources: Fitch, banks' annual reports.

Banks' Assets and Liabilities

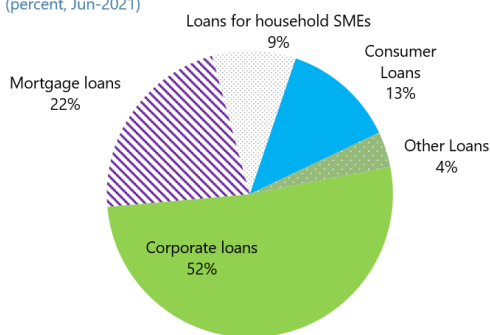
(percent, as of 2021 Q1)



Sources: NBG; IMF staff calculations.

Banks' Loan Portfolio

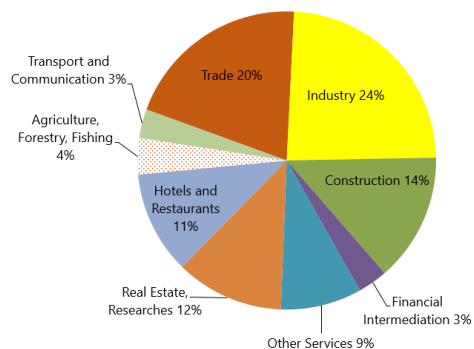
(percent, Jun-2021)



Sources: NBG; IMF staff calculations.

Banks' Corporate Lending

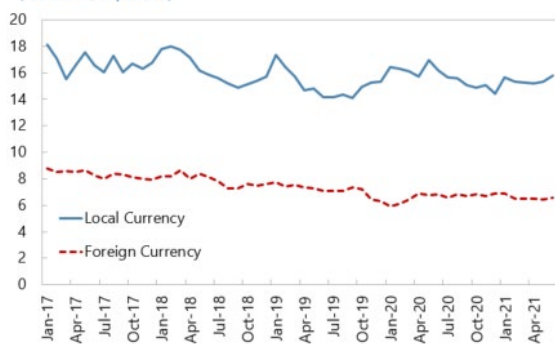
(as of Jun-2021)



Sources: NBG; IMF staff calculations.

Interest Rates on Loans

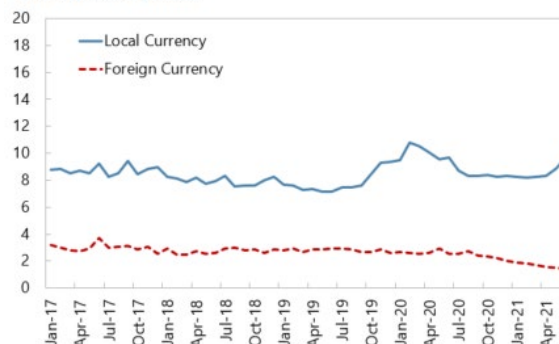
(new loans, in percent)



Source: NBG.

Interest Rates for Deposits

(new deposits, in percent)

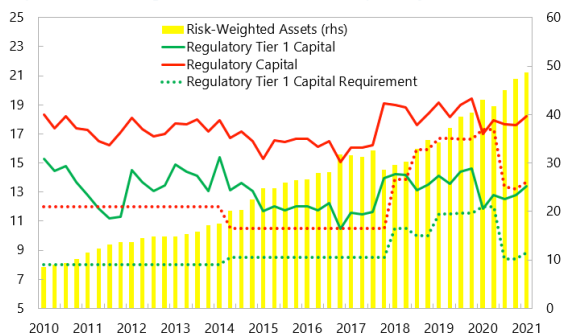


Source: NBG.

Figure 5. Georgia: Banking Sector Developments
2021 Q1, or Latest Available

Bank Capital and Risk-Weighted Assets

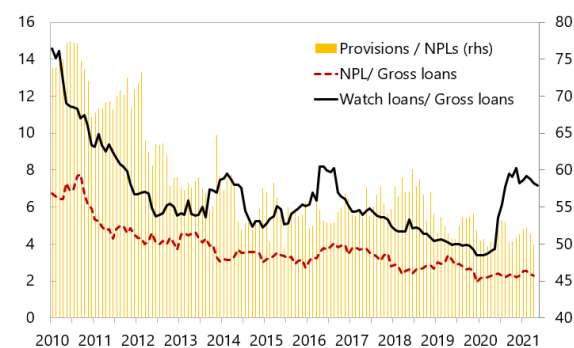
(percent of risk-weighted assets, billions of GEL respectively)



Source: IMF FSI Database; NBG.

Banks' Asset Quality

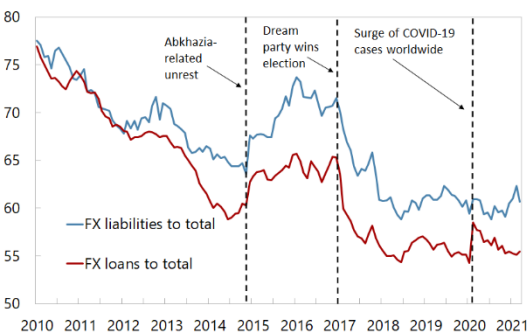
(percent, Jan 2010 - May 2021)



Sources: NBG; IMF FSI Database.

Share of Foreign Currency Loans and Liabilities

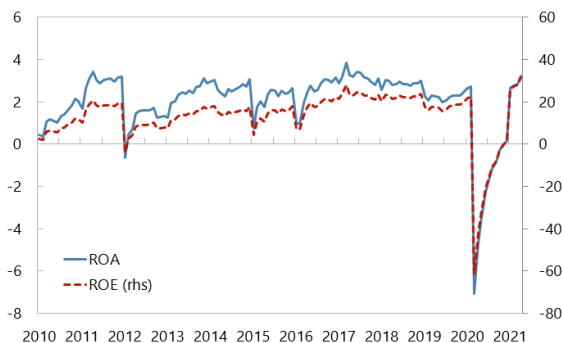
(percent, Jan 2010 - Apr 2021)



Source: NBG.

Banks' Profitability

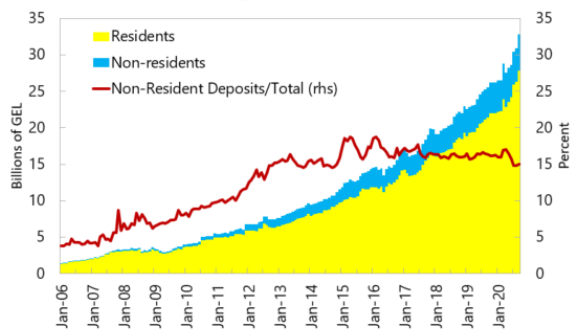
(percent, Jan 2010 - Apr 2021)



Source: IMF FSI Database.

Banks' Deposits and Non-Resident Proportion

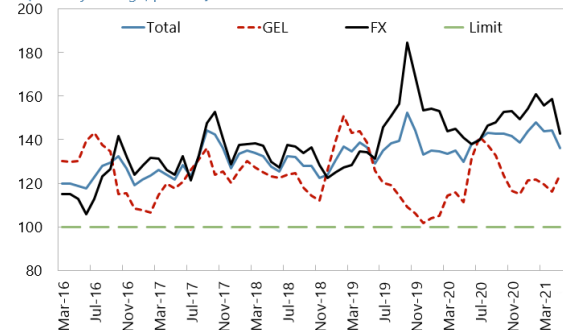
(billions of GEL, percent respectively, Jan 2006 - Sep 2020)



Source: NBG.

Liquidity Coverage Ratio

(monthly average, percent)



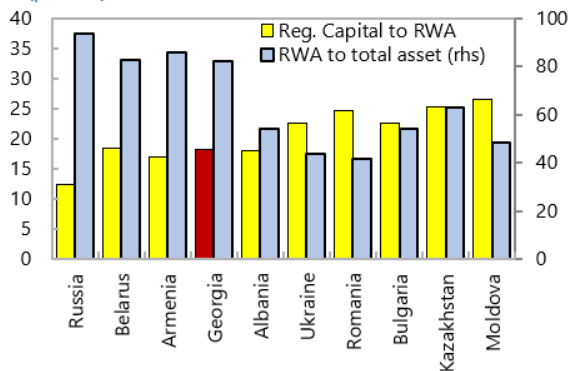
Source: NBG.

Figure 6. Georgia: Comparison of Selected Financial Soundness Indicators

2021 Q1 or Latest Available (percent)

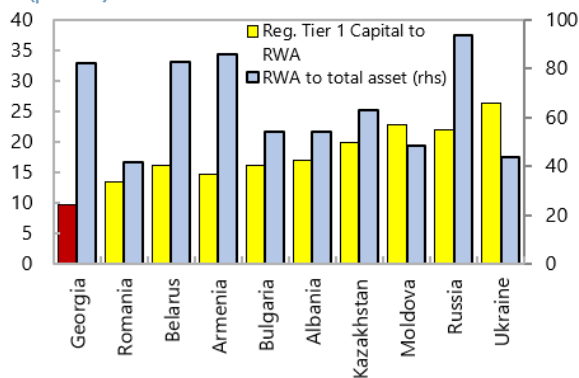
Regulatory Capital to Risk-weighted Assets

(percent)



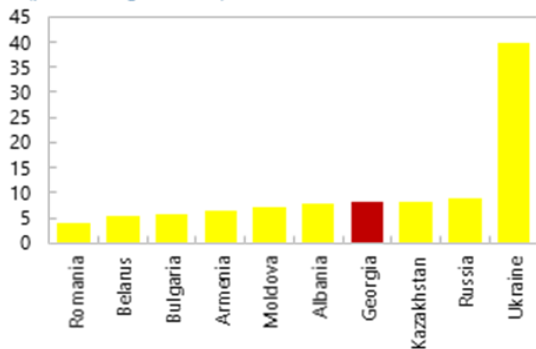
Regulatory Tier 1 Capital to Risk-weighted Assets

(percent)



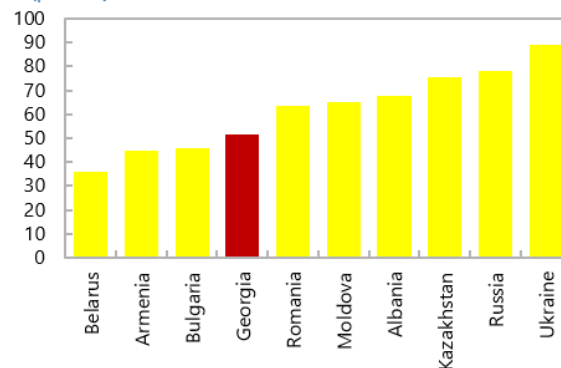
Asset quality (NPL ratio)

(percent of gross loans)



Provisions to NPL

(percent)

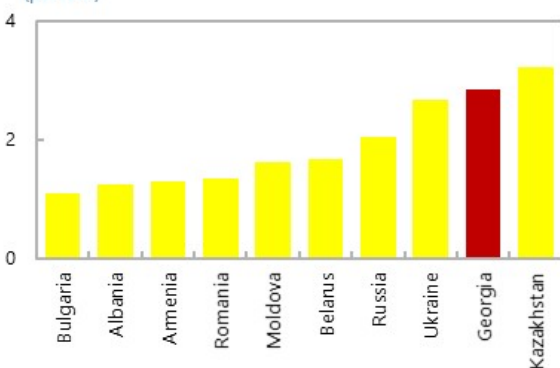


Note: NBG definition of NPLs for Georgia, IMF for all others.

Note: Specific provisions based on IMF FSI methodology.

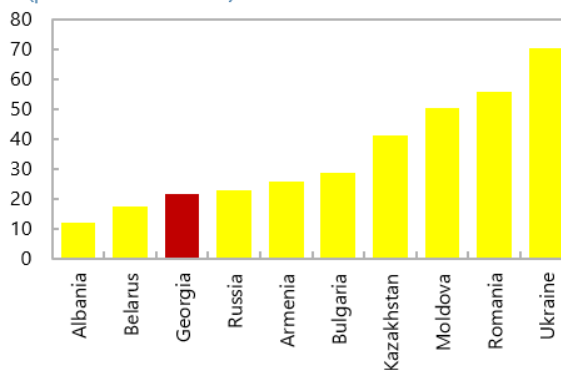
Return on Assets

(percent)



Liquid Assets Ratio

(percent of total assets)



Source: IMF FSI

10. Several reforms have been aimed at reducing the level of dollarization in the banking system (Tables 6, 7, Figure 5 middle left panel). These include more stringent LTV and PTI requirements for unhedged borrowers in FX, as part of the RLR; the introduction of a currency-induced credit risk (CICR) pillar 2 capital buffer, which carries higher capital charges on unhedged FX credit; an outright ban on FX loans below 200,000 GEL for households, corporates and SMEs; an LCR requirement for banks in FX; higher reserve requirements and penalty rates of remuneration for banks on their FX deposits; and most recently reserve requirements differentiated by bank based on their level of deposit dollarization.⁶

11. The authorities have also taken swift and decisive steps to alleviate the burden of the Covid-19 crisis on the financial sector (Table 6).

- The government provided interest subsidies to SMEs and households, the latter receiving a four-percentage point rate discount on new lari mortgage loans; and provided credit guarantees for corporates and SMEs.⁷
- With NBG support banks announced loan service moratoria (during Q1-Q3, 2020) and offered loan restructurings. During 2020, 63 percent of household loans, 46 percent of SME loans and 30 percent of corporate loans benefited from loan moratoria at least once.
- The NBG provided lari liquidity using swap lines with banks, expanded the collateral framework for NBG liquidity support to include SME loans of banks (in addition to mortgage loans), and partially released the LCR buffer in lari, which has been restored in May 2021. The government also issued an additional 600 million GEL in securities, whose lari proceeds were placed as long-term deposits in banks.
- The NBG required banks to take general provisions early, during Q1 2020—amounting to about 3.5 percentage points of banks' CET1 ratios, while also restricting shareholder payouts and bonuses.⁸ Simultaneously they lowered banks' capital requirements by about the same amount—reducing part of pillar 2 buffers (2/3rd of CICR buffer) and the capital conservation buffer (CCB). A timeline for restoration of these requirements has been announced.

VULNERABILITIES AND RISK ANALYSIS

A. Risks to Financial Stability

12. High dollarization of banks' assets and liabilities is the key financial sector vulnerability in Georgia. It threatens financial stability in two ways:

⁶ The average house price is below 200,000 lari so the outright ban is effective in limiting mortgage loans in FX.

⁷ Only loans for new construction issued between June 1 and January 1, 2021 were eligible for the subsidy, which will be provided for five years.

⁸ NBG is in the middle of transitioning supervisory reporting to IFRS standards. Full transition of prudential provisioning requirements to IFRS9 is expected by 2022.

- **Credit risk from unhedged borrowers:** Banks maintain net open foreign currency positions within a narrow band, limiting their exposure to exchange rate risk.⁹ Credit risk to banks from unhedged borrowers in FX is elevated because about 75 percent of corporates' liabilities and 40 percent of households' liabilities are in FX (Figure 1); and only about 20 percent of corporate borrowers in FX are estimated to be fully hedged, with natural sources of income in FX, while all other borrowers are either partially hedged or unhedged. The share of corporate borrowers able to fully hedge is estimated at only 20 percent and concentrated in a few sectors. A sufficiently large depreciation could quickly force unhedged borrowers into default.¹⁰
- **Liquidity risk:** The NBG has limited ability to backstop systemic liquidity shocks in foreign currency. Instead, banks depend on their own liquidity buffers to weather sudden outflows of FX deposits, their main source of funding. Although recent years have not seen a buildup of FX liquidity risk – non-resident deposits have stabilized and IFIs make up a large share of banks' external debtors - liquidity risks need to be carefully monitored.

13. Financial stability risks could follow from an extended pandemic or less benign external financing conditions (see Table 2 for a Risk Assessment Matrix). If new mutations were to result in additional lockdowns, this would lower profits of firms, increase unemployment, and weaken the debt-servicing ability of firms and households, which would, in turn, erode banks' asset quality, profitability, and capital buffers. Falling economic growth, exports, remittances, and financing flows from abroad could lead to further exchange rate depreciation, which would further increase indebtedness and deteriorate asset quality.¹¹ Residential real estate could face a price adjustment if unemployment were to rise; and commercial real estate could be hit by lockdown-related business failures. An external shock, arising from regional political turmoil or a global increase in risk aversion, could lead to capital outflows, including from banks' non-resident deposits, weaken the currency and raise sovereign borrowing costs.

B. Stress Testing—Approach

14. These risks were incorporated in the design of stress test scenarios for banks. A baseline scenario used the April 2021 WEO forecast, while two adverse scenarios over a three-year horizon implied negative GDP shocks of 1-1.5 standard-deviations relative to the baseline (Figures 7, 8). These shocks were smaller than usual, as the baseline is already below the long-term average growth path.¹² Scenario assumptions were as follows:

- **Baseline:** The economy starts to recover in mid-2021 with benign external financial conditions.

⁹ The tolerance band for banks' net open FX position is plus or minus 20 percent of regulatory capital.

¹⁰ During 2015–16, lari depreciation of 15 percent led to a 50 percent increase in NPLs.

¹¹ The most recent external sector assessment found that external position is broadly in line with fundamentals and desirable policies (see 2021 Article IV).

¹² Recent economic data suggest that the economic rebound in the first half of 2021 is stronger than the April 2021 WEO projections, which would make the baseline scenario more conservative.

- **Adverse Scenario 1, *Extended Pandemic*:** Additional pandemic-related lockdowns extend into late 2021. In the outer years, sluggish growth is predicated on the phased withdrawal of support measures and lower potential due to scarring.
- **Adverse Scenario 2, *Capital Outflows*:** The extended pandemic of the first adverse scenario is coupled with an external shock that leads to higher sovereign spreads, capital outflows and sharp exchange rate depreciation, with adverse feedback on economic activity.

15. Financial sector resilience was assessed by means of solvency, liquidity, and contagion stress tests of banks (see Stress Testing Matrix (STeM) in Appendix II). The assessment focused on the banking system, as other types of financial institutions are not large enough—individually or collectively—to be included. The analysis covered all 15 banks in the system as of end-December 2020. For the solvency analysis, hurdle rates for Basel CAR, T1 and CT1 were 8 percent, 6 percent, and 4.5 percent, respectively. For the liquidity analysis, hurdle rates were based on the LCR, with requirements of 100 percent coverage of short-term liabilities in aggregate, 100 percent in FX and 75 percent in lari.

16. Key macroeconomic variables projected in each of the scenarios were used to simulate the performance of banks' balance sheets and income statements for the stress tests. These included, *inter alia*, real GDP, exchange rate, CPI inflation, housing prices, unemployment, policy interest rate, country risk premium as measured by the EMBI sovereign spread, and 5-year government bond yields (see Figures 7, 8 for magnitudes of shocks arising from the historical linkages of key variables with GDP).

C. Financial Stability Assessment

17. Banks appear well prepared to absorb losses stemming from the pandemic under the baseline scenario, without threatening financial stability. Systemic resilience comes from solid pre-crisis capital buffers—both in terms of size and quality—and robust profitability. Under the baseline, credit losses can be absorbed with a combination of operational profits and capital cushions without threatening financial stability. Given the widespread impact of the pandemic, the absorption of losses and the replenishment of bank capital buffers is likely to take 2-3 years.

18. The banking system also appears resilient under the adverse scenarios, though a few banks face capital shortfalls relative to regulatory minima. Under the *Extended Pandemic*, three banks experienced capital shortfalls of 0.5 percent of GDP relative to minimum Tier 1 capital requirements (Figure 9); while in the *Capital Outflows* scenario four banks suffered capital shortfalls that add up to about 1.5 percent of GDP.¹³ A credit VaR model produced similar qualitative results over a one-year horizon. Overall, expected losses ranged between 3–6½ percent of the gross performing loan exposures, which appeared commensurate with current provisioning (Figures 11, 12).

¹³ In the extended pandemic scenario, the aggregate capital shortfall for banks is 12.7 million lari or 0.03 percent of their RWA; while in the capital outflows scenario, it is 149 million lari or 0.4 percent of RWA.

Figure 7. Georgia: Changes in Key Variables in Stress Test Scenarios

	Real GDP Growth (percent)			
	2020	2021	2022	2023
Baseline	-6.1	3.5	5.8	5.5
Scenario 1	-6.1	0.0	4.8	5.5
Scenario 2	-6.1	-2.9	1.8	4.5

	GEL / USD Change (percent) 1/			
	2020	2021	2022	2023
Baseline	10.3	5.0	-0.5	-0.4
Scenario 1	10.3	15.0	-0.4	-0.4
Scenario 2	10.3	25.0	-0.5	-0.4

	Average CPI Inflation (percent)			
	2020	2021	2022	2023
Baseline	5.2	3.8	2.7	2.7
Scenario 1	5.2	6.8	3.7	2.7
Scenario 2	5.2	9.8	4.7	2.8

	Change in USD House Prices (percent)			
	2020	2021	2022	2023
Baseline	-5.0	0.0	5.0	5.0
Scenario 1	-5.0	-7.0	0.0	5.0
Scenario 2	-5.0	-14.0	-5.0	0.0

	Change in Unemployment Rate (pp)			
	2020	2021	2022	2023
Baseline	3.5	-0.3	-2.0	-1.0
Scenario 1	3.5	1.2	-1.0	-2.0
Scenario 2	3.5	3.2	0.0	-2.0

	Change in Policy Interest Rate (pp)			
	2020	2021	2022	2023
Baseline	1.3	-0.3	-1.0	-0.5
Scenario 1	1.3	0.7	-1.5	-0.5
Scenario 2	1.3	2.7	-2.1	-1.5

	Change in Country Risk Premium (bps)			
	2020	2021	2022	2023
Baseline	300	-50	-50	-100
Scenario 1	300	200	-200	-100
Scenario 2	300	500	-100	-300

	Change in 5-year Sovereign Yield (pp)			
	2020	2021	2022	2023
Baseline	1.0	-0.5	-0.9	-0.4
Scenario 1	1.0	1.2	-2.0	-0.5
Scenario 2	1.0	4.2	-2.5	-2.2

1/ A positive number indicates GEL depreciation

Source: NBG and IMF staff projections

19. Banks have sufficient high-quality liquid assets to survive severe shocks to their deposit base (figures 14,15). In alternative exercises, all banks were able to endure extreme shocks to their liabilities, which emulated those at the peak of the 2008–09 Global Financial Crisis, while sustaining their regular operations, even after restricting the gross inflows from loans and securities to zero.

20. Other risks are not deemed significant:

- **Market risk** (Figure 15). A 30 percent lari depreciation would cause a drop in the CAR of about 0.6 percentage points. Interest rate risk is inconsequential as banks' assets and liabilities are not marked to market. Equity price risk is absent.
- **Interbank contagion.** Given the small size of interbank exposure, interbank contagion was not found to be material in terms of credit risk exposure of lender banks, or liquidity risk for borrower banks.
- **Bank-sovereign nexus.** While banks' portfolios of sovereign bonds are not marked-to-market, sensitivity analysis of sovereign spreads widening by 600 bps. produced a 1.5 percentage point drop in overall CAR, down to a minimum of 11.5 percent across individual banks. Since public bonds can be used as collateral for central bank liquidity, it is unlikely that banks would be forced to liquidate their bonds under distressed market conditions.

21. Stress tests of banks' large corporate exposures indicated a moderate shortage of provisions under the adverse scenarios. The FSAP carried out a detailed analysis of the ten largest credit exposures of each bank. Each credit exposure to a conglomerate group included all loans granted to companies within that group. Using the latest available financial statements for each company, the FSAP estimated the impact of the above scenarios on key corporate vulnerability indicators, which were then used to estimate loan loss provisions under the adverse scenarios. Companies with less than full coverage of their annual debt interest payments with latest available annual earnings accounted for about 12 percent of sampled firms' assets.¹⁴

22. FSAP risk analysis suggests the following recommendations for the authorities.

- **Encourage retention of banks' earnings until credit losses are absorbed and capital buffers fully restored.** The proposed timetable to replenish capital buffers (Table 7) appears reasonable, but the uncertain recovery calls for prudence and flexibility to accommodate unforeseen events. As such, the NBG should continue its close monitoring of banks' credit risk to evaluate the implications of the pandemic on banks' asset quality and to judge when credit losses are fully absorbed by individual banks.
- **Proceed with the implementation of the single-party concentration limit as planned.** Enforcement of the Basel concentration limit would have very limited impact on the availability of bank credit to large firms (Figure 16). From a long-term perspective, enforcing the concentration limit should not significantly constrain the capacity of banks to finance large corporations.
- **While the authorities collect an impressive amount of data, there is some scope for further refinement in a few areas.** Information on large borrowers reported by banks could benefit from further refinements to detail available in consolidated financials and some additional strengthening of data validation processes. There may be some scope to expand data on foreign currency risk exposures of large corporate borrowers. The sectoral classification of credit could benefit from additional granularity and mapping with standard economic classification. The implementation of the ongoing credit registry project would prove useful to complement the wealth of data already available.

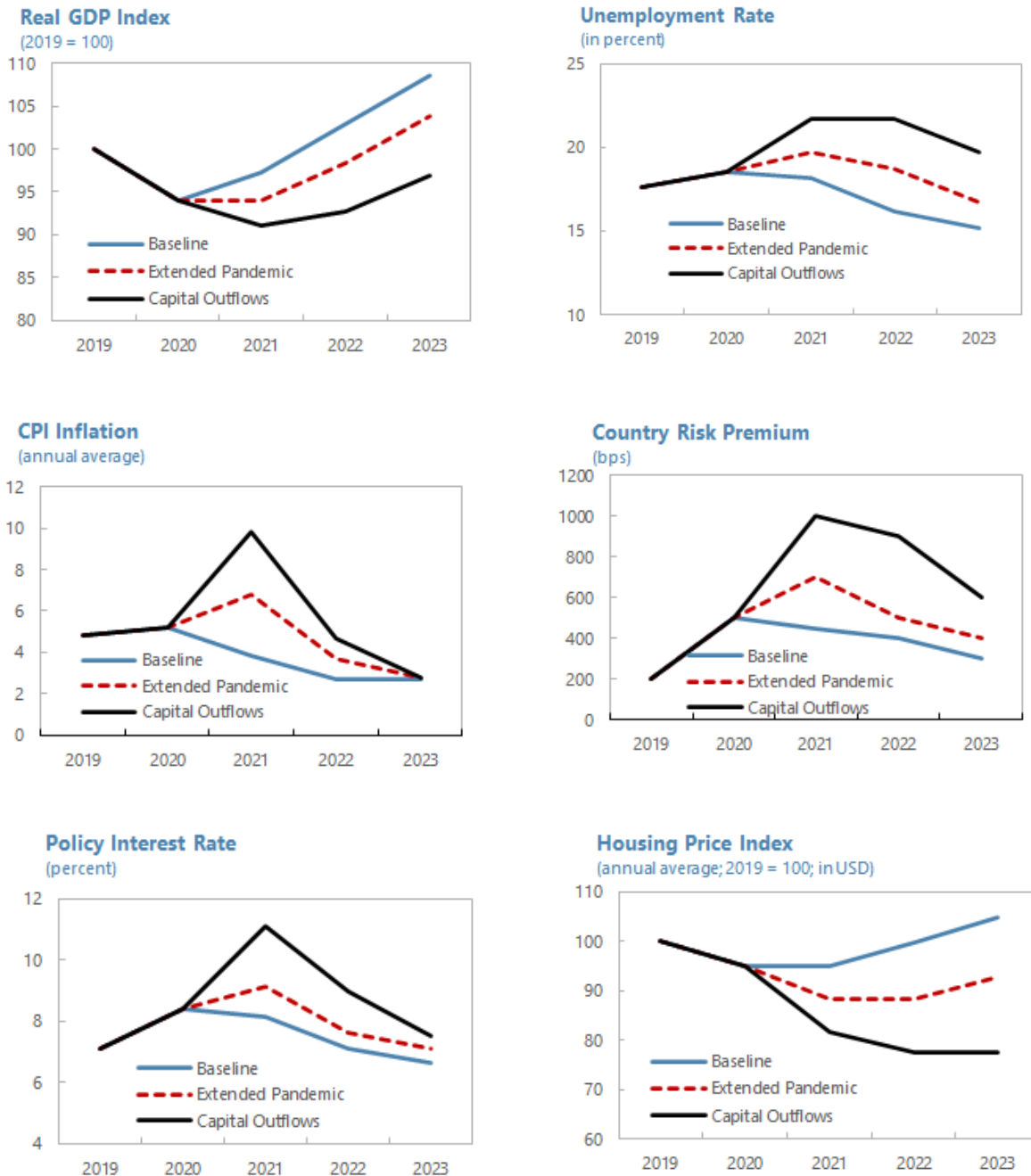
D. Authorities' Views

23. The authorities largely agreed with FSAP results for banks' solvency and liquidity in baseline and adverse scenarios. They highlighted that provisions taken by banks in 2020Q1 are still expected to fully cover losses stemming from the pandemic. Regarding the FSAP recommendation for continued retention of banks' earnings until the end of pandemic-related uncertainties, they felt that this should only be required for banks that fall below pre-pandemic capital buffer requirements. On the findings of the corporate stress test, they noted that analysis of banks' risks from large corporate borrowers should be based on their consolidated financials.

¹⁴ The organization of corporate financial statements did not allow analysis based purely on consolidated data.

They also emphasized the availability of up-to-date information on banks' exposures to large corporate borrowers including monthly processes for assessment and validation.

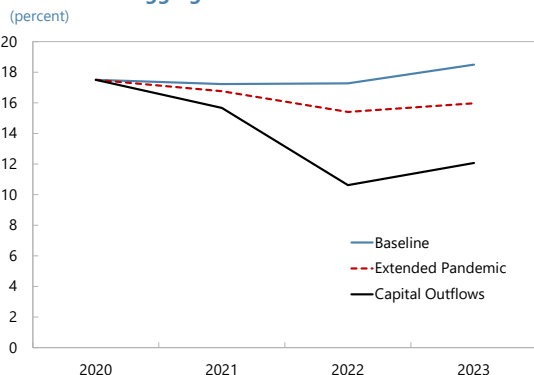
Figure 8. Georgia: Banks' Stress Test Scenarios
(percent)



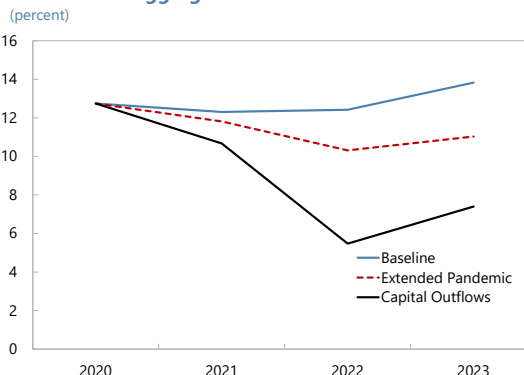
Source: NBG and IMF staff projections

Figure 9. Georgia: Results of the Solvency Stress Test

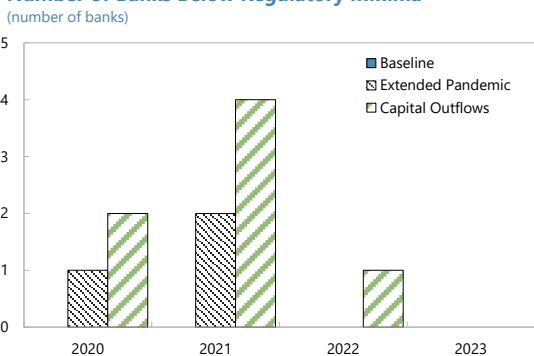
Evolution of Aggregate CAR



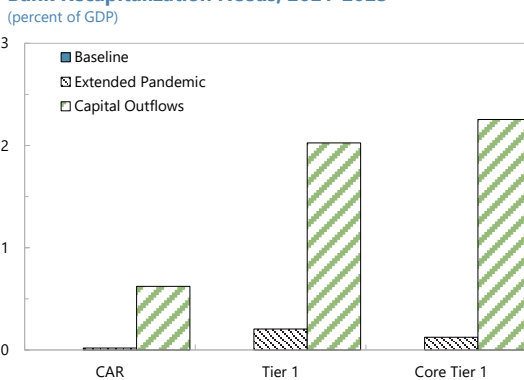
Evolution of Aggregate Tier 1



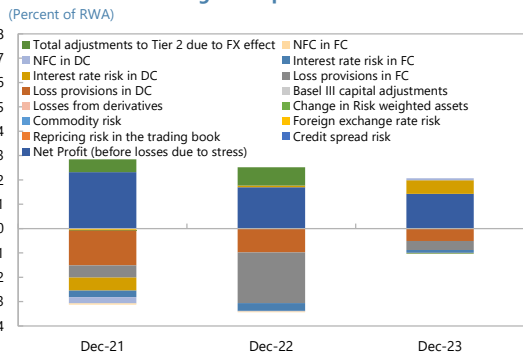
Number of Banks Below Regulatory Minima



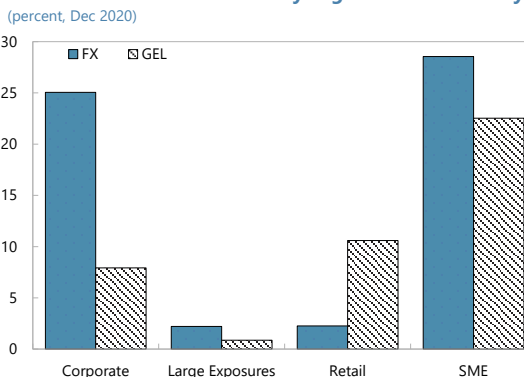
Bank Recapitalization Needs, 2021-2023



Contribution to Change of Capitalization Ratio



Contribution to Credit Losses by Segment and Currency



MACROPRUDENTIAL POLICY AND DOLLARIZATION

A. Institutional Framework and Governance

24. The institutional framework for macroprudential policy broadly meets the principles of good design. The Organic Law, which grants the NBG supervisory powers over the financial sector, confers it with sufficient “ability to act”; while a legal mandate to safeguard financial stability, a published macroprudential policy strategy, and specific allocation of institutional resources provide enough “willingness to act”.¹⁵ The NBG’s mandate for macroprudential policy is rooted in its legal mandate to safeguard financial stability. This mandate is fulfilled by a Financial Stability Committee (FSC), comprised of senior NBG staff, and supported by a dedicated financial stability department, which is responsible for formulating and analyzing macroprudential policy proposals.

B. Macroprudential Toolkit and Dollarization

25. The NBG now has a comprehensive macroprudential toolkit (see Table 7). Tools introduced in recent years, such as PTI/LTV ratios, have helped to slow the growth of credit in recent years and to shift its composition from households, for whom indebtedness is high, to corporates (Figure 2), and, as noted earlier, a number of tools have also been used to reduce dollarization, which is one of the key objectives of macroprudential policy strategy. The NBG is now appropriately focusing its attention on refining the implementation of existing tools rather than expanding the toolkit further. The NBG’s macroprudential policy strategy emphasizes monitoring the effects of tools and evaluating the achievement of intermediate objectives. One notable example has been the NBG’s ex post assessment of the impact of responsible lending regulations in the 2019 NBG Financial Stability Report.

26. In line with its key macroprudential policy objective, the NBG’s measures to reduce banks’ credit and liquidity risks from dollarization have been appropriate. While the overall level of dollarization in Georgia has declined in recent years, it remains well-above a cross-country benchmark.¹⁶ High financial dollarization makes Georgia’s financial system vulnerable to exchange rate shocks and constrains monetary policy effectiveness. While building trust to encourage savings in local currency through sound macro fundamentals takes time, macroprudential measures limit risks and dis-incentivize financial intermediation in FX. In line with best practice, the NBG’s toolkit limits credit risk from unhedged borrowers directly through stricter PTIs, LTVs and the 200,000 GEL limit on FX lending. As a second line of defense, the CICR capital buffer enables banks to absorb losses following sharp depreciations. Finally, higher LCR and reserve requirements in FX build additional liquidity buffers. With the introduction of borrower-based restrictions on FX lending, especially to households which are mostly unhedged, new issuance of FX loans has declined. Macroprudential tools targeting dollarization have stayed

¹⁵ See IMF (2014), “Staff Guidance Note on Macroprudential Policy.”

¹⁶ See Technical Note “Macroprudential Policies and De-Dollarization” for details.

in place during the COVID-19 crisis, apart from a temporary, partial release of the CICR buffer, avoiding a setback of the de-dollarization agenda.

27. Further asset de-dollarization will depend on banks' ability to raise local currency funding. Households still prefer to save in foreign currency, which banks then channel to foreign currency loans. Sources of stable lari funding are scarce. Introducing excessive restrictions on foreign exchange lending risk financial disintermediation as banks may need to adjust lari deposit rates significantly, which would make lari credit more expensive. As the recovery takes hold, the NBG will need to continue to build a track record of low and stable inflation, which will have to be supported by the government via sound fiscal policies. The development of covered bonds could provide households with an alternative local currency savings instrument, while also providing banks with a means to raise local currency funding.

28. The NBG should review calibration of the macroprudential toolkit periodically and carry out impact assessments of any planned measures. For example, the NBG could leverage the large amount of income data accumulated including during the COVID-19 crisis to reassess PTI thresholds as appropriate. Over the medium term, the authorities should consider tightening dollarization measures gradually, with the choice of measures and calibration informed by impact assessments. Market-based measures are generally better suited to avoid inefficiencies in the allocation of credit while borrower-based measures can better target vulnerabilities but rely on additional data, which may be difficult to obtain. Outright restrictions, such as an increase in the 200,000 GEL limit, have higher efficiency costs but are easier to communicate and implement.

29. Although data supporting the implementation of tools is generally of good quality, there may be some areas for improvement. The NBG's planned credit registry, which will collect additional information on the income of borrowers and interest rates paid on their loans, is a welcome step. As in other countries, income verification using tax returns is challenging for borrowers in the informal sector, complicating implementation of borrower-based measures.

30. There is scope for the authorities to strengthen communication with the public. The following areas should be prioritized:

- **Foreign exchange intervention policy.** A series of external shocks in recent years and the pandemic have led to a depreciating trend in the GEL/USD exchange rate from 2019 to mid-2021. The NBG's objectives of reserve accumulation and volatility reduction in the FX market have at times been misperceived as conflicting. This could be addressed by a carefully timed publication of the FX intervention strategy and further public outreach. Together with sound macroeconomic policies, a well-designed and communicated FX intervention framework could help to establish more balanced exchange rate expectations and moderate demand for one-way hedging instruments like FX deposits.
- **The rationale for macroprudential policy decisions and their impact.** Adopting new tools for communicating risk assessments (e.g. heatmaps), publishing policy papers and increasing public outreach to banks and the non-financial sector would help to facilitate acceptance by stakeholders.

C. Authorities' Views

31. The authorities agreed that dollarization is a key risk to financial system and are committed to reducing it. They agreed that further reductions, particularly on deposits, will need to be gradual. In the meantime, the reduction in the FX reserve requirement for banks based on a sliding scale of deposit dollarization continues to provide an incentive for banks to favor lari deposits without adding costs during the pandemic (Table 7).

FINANCIAL SECTOR OVERSIGHT

A. Banking Supervisory Oversight

32. The NBG has undertaken extensive efforts to upgrade its regulatory regime since the last FSAP. The regulatory capital and liquidity framework is now generally consistent with Basel III standards, with specific tailoring to the Georgian system, particularly due to high dollarization in the banking system. In addition, the NBG has introduced a capital surcharge for DSIBs (which is being phased-in) and amended the large exposure regulation in compliance with Basel standards.

33. The NBG has also made progress in strengthening its supervisory framework, which is evolving towards a risk-based approach. A large share of NBG's supervisory efforts has focused on reviewing, monitoring and analyzing information to check for compliance with laws, rules and limits and to assess the financial condition and risks of banks and the banking system. A new supervisory risk-based framework, as of 2017, is supported by the issuance of a Code of Corporate Governance and the introduction of a General Risk Assessment Program (GRAPE) assessment, which is applied to each bank based on the NBG's weighted scoring of its risks along various dimensions.¹⁷ The NBG's supervisory process revolves around assessment of these scores, which are not disclosed to banks except as a final pillar 2 capital charge.

34. Despite progress in building out the NBG's bank supervision framework, there is scope for formalizing and enhancing supervisory processes. The FSAP recommended the NBG to do the following:

- Develop and formalize internal supervisory processes related to supervisory planning and decision making; communications with banks on supervisory assessments; and follow up on actions taken by banks to address supervisory concerns in a timely and effective manner.
- Reconsider the specific weightings applied to GRAPE elements and develop internal guidelines to support the GRAPE scoring process, including by identifying the most important sub-categories across GRAPE elements and ensuring that they are appropriately weighted in the scoring process. This would also support planning and qualitative assessments by identifying key areas of regular review at banks.

¹⁷ These include risks related to corporate governance, group structure, business model, credit, liquidity, market exposure, and operations.

- Require banks to develop remediation plans to address identified supervisory concerns, and formally review the implementation of those plans. While the NBG communicates its supervisory findings and directives through a variety of channels; the annual GRAPE letter and Pillar 2 capital surcharge maintain preeminence in its communication with banks. More formal practices to enhance supervisory communication with bank management and supervisory boards would help to improve remediation.

35. There is scope to enhance existing practices for in-depth assessments of banks' risk management and governance. NBG supervisory risk assessment framework is generally very thorough across key risks, with credit and liquidity risks receiving substantial attention alongside operational and cyber-related risks. A significant share of supervisory staff resources is spent on monitoring of risks on an ongoing basis, including checking positions against regulatory requirements and limits. The NBG is recommended to undertake more in-depth assessments of banks' risk management and governance beyond compliance.

36. The NBG should require systemic banks to incorporate internal stress testing into capital and liquidity planning and management processes. The NBG's own periodic supervisory (bottom up) stress tests could be used to derive the Net Stress Buffer capital charge and to inform the risk assessment process. It should evaluate banks' capacity to carry out effective supervisory and internal stress testing for a more forward-looking assessment of banks' risk management, internal controls, and corporate governance.

B. Capital Markets Oversight

37. While the authorities have already aligned capital markets oversight with international standards, there is scope to enhance the supervisory approach. This could benefit from further development of methodologies for risk assessment and scoring for supervised entities; strengthening of conduct assessments; enhancement of the market surveillance framework, including a surveillance plan and direct access to an audit trail and order flows; and the application of sufficiently punitive sanctions for market abuse

C. Cyber Security Oversight

38. The NBG has taken several steps to strengthen regulation and supervision of cyber security for the financial sector in recent years. These include a cybersecurity framework for banks, a dedicated cyber risk supervision division, a data governance agency, and amendments to a 2012 information security law, which are ongoing. The NBG now includes cyber risk as part of the operational component of its GRAPE assessment for banks. Banks are required to carry out an annual audit of cybersecurity and must report any material operational incidents to the NBG. The authorities have coordinated two cyber exercises in the past few years.

39. Steps in a few other areas might help to further strengthen the cybersecurity oversight framework. The NBG's role in designating a bank or FMI as a critical information system should be clearly articulated in amendments to the information security law. There is scope to strengthen the framework for offsite supervision of cyber risk and automate the

compliance monitoring process.¹⁸ The NBG should also seek to enhance the frequency and sophistication of its testing exercises and develop a testing strategy.

D. AML/CFT

40. Georgia has made some progress in enhancing its legal AML/CFT framework since the last FSAP. A 2020 MONEYVAL assessment mentioned NBG's adoption of a risk-based approach to AML/CFT supervision; reform of legal and regulatory frameworks; and strengthening of "fit and proper" checks for financial institutions. Nevertheless, there is room for improvement, as Georgia only scores sufficient ratings for AML/CFT effectiveness on two out of eleven performance benchmarks.

41. The financial sector faces elevated AML / CFT risks in a number of areas, for which the authorities should take additional steps in risk mitigation.

- Money laundering risks stem from the high use of cash in transactions, including for real estate purchases; the activities of politically exposed persons; the absence of regulation for providers of virtual assets; and weak regulations for the gaming sector. These risks are compounded by various exemptions from FATF recommendations, including for real estate agents, accountants, and virtual asset service providers.
- The authorities should consider setting maximum cash thresholds for various transactions; make efforts to strengthen the analysis of suspicious transactions reported by banks; include virtual asset service providers in the AML framework by end-2021 as planned; and further strengthen licensing and supervision for the gaming sector.

E. Authorities' Views

42. The authorities agreed with the need to formalize supervisory oversight procedures. They highlighted that the supervisory GRAPE methodology should remain an internal procedure although some aspects of the approach could be shared with banks. The NBG indicated its dedication to further enhancement of the internal operational and decision-making process as also reflected in and communicated with stakeholders through its Supervisory Strategy document. In response to the FSAP recommendation for strengthening supervision of banks' corporate governance and risk management, the NBG plans to communicate material supervisory findings with banks' supervisory boards on a regular basis.

¹⁸ This would include collecting relevant cyber information like gap assessment, summary of incidents, level of concentration of service providers, technology landscape, key risk indicators, compliance status of action points arising on account of NBG supervisory visits, internal audit, external audit and various tests carried out, on a periodic basis.

FINANCIAL SAFETY NETS

A. Assessment

43. The authorities have recently taken steps to strengthen their crisis management, bank resolution and financial safety net arrangements. NBG and Banking Laws were amended in December 2019 to upgrade the legal regimes for bank liquidation and systemic bank resolution, to establish an *ex post* funded Resolution Fund, and to introduce a bank recovery planning regime. The NBG has issued a comprehensive series of regulations and rules to support implementation of the new legal regimes, which include:

- **Clarification of the roles and responsibilities of the NBG and MoF.** These cover coordination in systemic cases, including with respect to potential emergency liquidity assistance and temporary public financing.
- **Expansion of coverage by the new Deposit Insurance System.** During mid-2020, the authorities expanded deposit insurance coverage significantly to GEL 15,000 from 5,000 for natural persons on local and FX deposits, and now covers 97 percent of resident and non-resident deposits.¹⁹
- **A new Interagency Financial Stability Committee.** Established in mid-2020, the committee, which is comprised of the MoF, the NBG, the Deposit Insurance Agency and the Insurance State Supervision Service, is responsible for coordination of banking resolution issues.

44. Nevertheless, the FSAP recommends strengthening the procedural regime for bank resolution, deposit insurance and crisis management. With reference to the FSB's *Key Attributes*, the FSAP team conducted a review of the amended legislation, implementation regulations and operational preparedness of the authorities to deal with potential banking problems.

- It found that the authorities now have most of the mechanisms needed to resolve banks in the system, though there is still scope to simplify the creditor hierarchy to make it consistent with deposit insurance coverage, clarify recovery planning requirements and triggers, increase banks' loss absorbency capacity and resolvability, enhance the operational capacity of the financial safety net authorities, allow the deposit insurance fund to finance purchase and assumption transactions in liquidation (if lesser cost), and mitigate potential legal challenges to liquidators and the NBG.
- The NBG should implement policies encouraging competitive bidding for the sale of assets and liabilities of a bank in resolution. Such sales to private entities may not be feasible in a systemic situation, for example if multiple small banks were to fail simultaneously. In that case, the authorities might need to create a bridge bank, for which an operational framework does not yet exist. Against this background, the FSAP recommended that the authorities lay

¹⁹ Expansion of eligibility to legal entities is pending in the Parliament.

the operational groundwork for a bridge bank, such as setting up a license, establishing a supervisory board and arranging funding, so it is immediately available when needed.

45. Although the NBG has extensive early intervention powers it needs a formal corrective action framework to guide the use of those powers. Among these powers is the ability to require banks to take actions defined in their recovery plans. Adoption of a formal prompt corrective action policy framework would enable the authorities to intervene in a failing bank prior to balance sheet insolvency.

46. The NBG should proceed with preparing resolution plans for systemic banks and consider whether other banks should be prioritized for resolution planning in 2021. Resolution planning for the three SIBs is underway. Initial plans, setting out the preferred resolution strategy, variants on the strategy, and an analysis of impediments to resolution action, will be presented to the NBG Resolution Committee by year-end 2021. Given pandemic-related stresses, the Resolution Committee could assess whether banks other than the SIBs should be prioritized for resolution planning in 2021.

47. The authorities should also prepare formal contingency plans for crisis situations along with formal testing programs. These should eventually dovetail into a national-level plan and testing program. The authorities should clarify the modalities for resolution funding, including also with an MoF-NBG agreement for MoF funding in resolution. Further steps should be taken to strengthen DIA funding arrangements, include securing a backstop line of credit from the MoF to be able to replenish the insurance fund in time of need and agreeing on a framework with the NBG to borrow against its investment portfolio to be able to raise cash if required to make a payout.

B. Authorities' Views

48. The authorities largely agreed with FSAP recommendations in this area and were mainly focused on operational aspects of implementation. They indicated that they are: (i) investigating mechanisms for setting up a bridge bank; (ii) seeking to amend bank resolution and liquidation frameworks in various areas, including in relation to creditor hierarchy; (iii) broadening recovery planning of banks, in line with updated international guidelines, to cover both systemic and selected non-systemic banks; (iv) updating their internal operational processes for bank resolution; and (v) establishing stand-by cooperation agreements with external parties. They agreed that IFSC participants should collaborate more proactively on crisis preparedness.

FINANCIAL SECTOR DEVELOPMENT

49. The FSAP identified several priority areas related to financial sector development.

- **Financial Market Infrastructure.** While there has been significant development of the national payment system (NPS) and its oversight framework since the last FSAP, there is scope for further action in some areas. The FSAP recommended the NBG to complete and approve the framework for comprehensive risk management for the RTGS; assess the two

central securities depositories against CPMI/IOSCO PFMI standards; and establish detailed risk and crisis management procedures, including for defaults of RTGS participants.

- **Financial Sector Competition.** Alongside its role as regulator of the financial sector, the NBG now has competition enforcement powers under the new Competition Law. The FSAP suggested that the authorities provide a systematic assessment of prudential regulations from a competition perspective; enhance monitoring of financial sector participants for anticompetitive practices; conduct systematized competition review of M&A activity in the financial sector; and strengthen institutional capacity for enforcement.
- **Capital Markets Development.** The government should commit to a predictable schedule of issuance for a few benchmark bonds in sizable amounts for yield curve development. The authorities should enact planned legislation for covered bonds, which could provide investors with an additional savings instrument, help to lower interest rates on local currency mortgages, and serve as an additional tool for liquidity management by banks and the NBG.
- **Access to Finance.** Fintech could help to improve access to finance for SMEs and enhance financial inclusion broadly. In addition to steps already taken by the authorities to develop fintech, the FSAP recommended defining a Fintech roadmap to promote innovation, competition and financial inclusion. It also offered suggestions for: (i) an online collateral registry; (ii) enhancements to the legal framework for secured transactions; (iii) an improved retail payments infrastructure, with interoperability between bank and e-money accounts; and (iv) expansion of credit-related information on SMEs to cover alternative data, for example, on their payments for utilities or other operational liabilities.

Figure 10. Georgia: Summary Results of the Credit VaR

One-Year, 99 percent Credit VaRs, Summary Statistics				
		Credit VaR Results, 2021		
	2020	Baseline	Ext. Pandemic	Cap. Outflows
Summary Results, in percent				
Expected Loss to Gross Exposure	2.3	3.0	4.2	6.7
VaR to Gross Exposure	6.8	7.9	10.9	16.9
Tier 1 Ratio	17.9	12.1	9.9	5.4
CAR	22.6	16.8	14.6	10.1
Selected Parameters				
Performing Exposures (Mil. GEL)	35,016	35,012	35,012	35,012
Number of Loans (Million)	3.2	3.2	3.2	3.2
Number of Banks	15	15	15	15
Number of Credit Types	78	78	78	78
Number of Currencies	2	2	2	2
Probability of Default (percent)				
Median	4.7	4.7	7.0	15.0
Mean	5.5	9.7	14.1	22.8
Recovery Rates (percent)				
Median	51.9	51.9	51.9	51.9
Mean	60.3	60.3	60.3	60.3
Memo Items, in Mil. GEL				
VaR (Mil. GEL)		2,748.8	3,799.0	5,932.9
Expected Loss (Mil. GEL)		1,065.4	1,486.4	2,341.8
Total Gross Loans	38,234.0	38,234.0	38,234.0	38,234.0
Loan loss reserves	2,434.0	2,434.0	2,434.0	2,434.0
Total Assets	57,051.0	57,051.0	57,051.0	57,051.0
Tier I	6,059.0	6,059.0	6,059.0	6,059.0
Eligible Total Capital	8,320.0	8,320.0	8,320.0	8,320.0
Risk-Weighted Assets	47,539.7	47,539.7	47,539.7	47,539.7

This table presents summary results of a one-year credit VaR at the 99 percent level.

Sources: NBG and IMF staff calculations.

Figure 11. Georgia: Banks' Expected Loan Loss Provisions and Capital Versus Credit VaR Needs under FSAP Scenarios
(in percent)

	Loan Loss Provisions and EL				Capital and VaR			
	Actual	Baseline	Extended Pandemic	Capital Outflows	Actual	Baseline	Extended Pandemic	Capital Outflows
B1	100	279	187	110	100	446	306	184
B2	100	226	161	101	100	325	232	146
B3	100	343	301	241	100	257	233	196
B4	100	73	52	34	100	144	103	68
B5	100	65	45	30	100	110	75	53
B6	100	391	275	168	100	398	288	180
B7	100	280	223	150	100	462	409	317
B8	100	197	153	107	100	202	157	111
B9	100	262	174	101	100	474	340	209
B10	100	228	141	75	100	316	196	104
B11	100	634	605	563	100	6391	6297	6146
B12	100	232	164	103	100	313	221	139
B13	100	207	142	86	100	237	164	100
B14	100	332	269	193	100	289	247	186
B15	100	348	296	240	100	1523	1368	1173
Total	100	228	164	104	100	303	219	140

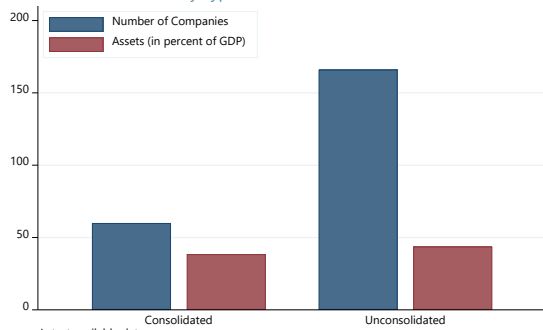
This table compares the existing loan loss provisions and capital to the expected losses and tail losses of a one-year credit VaR at the 99 percent level under the three scenarios. Values above 100 indicate that current levels are adequate to cover the corresponding losses.

Sources: NBS and IMF staff projections.

Figure 12. Georgia: Selected Statistics of the Sampled Corporations

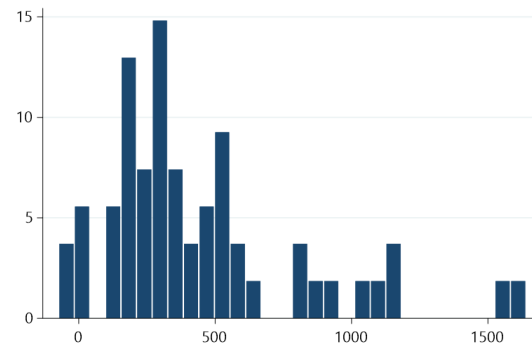
Sample of Large Corporations by Type of Financial Statements

(Latest available data)



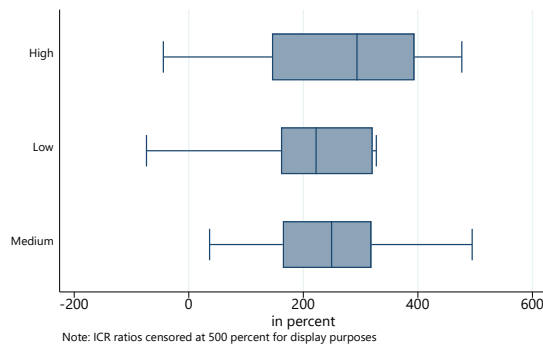
Distribution of Interest Coverage Ratios of Large Corporates

(number of firms in percent intervals)



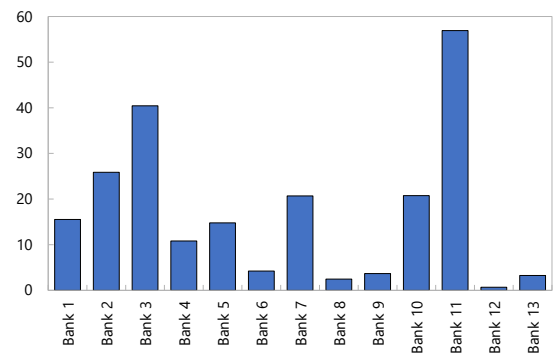
Interest Cover Ratios of Large Corporations

By Sensitivity of Firm Activity to COVID



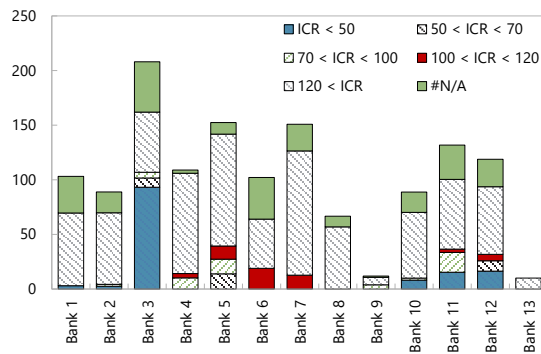
Share of Large Exposure not fully covered by Collateral

(percent)



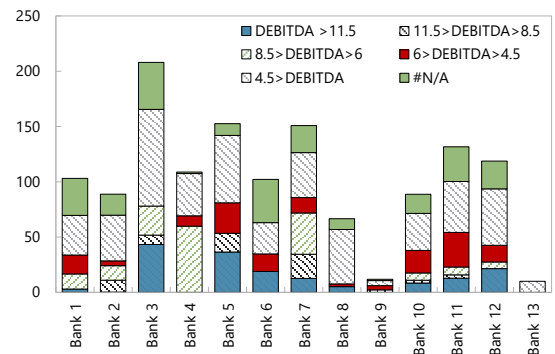
Distribution of large Exposures by ICR Ratio by Bank

(Intervals, in percent of Tier 1 Capital)



Distribution of Large Exposures by DEBITDA by Bank

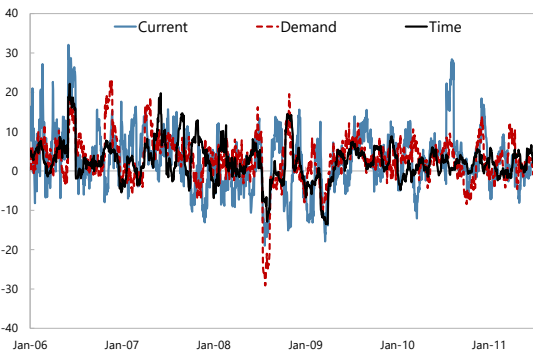
(Intervals, in percent of Tier 1 Capital)



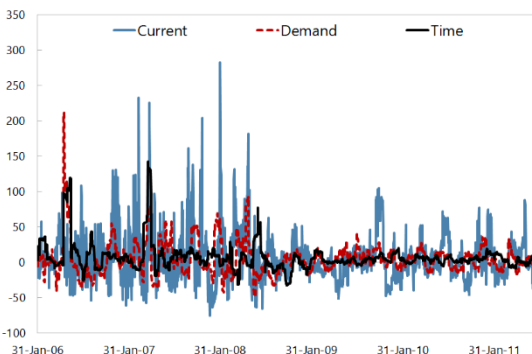
Sources: NBG and IMF staff projections.

Figure 13. Georgia: Reference Data for the Calibration of the Liquidity Shocks

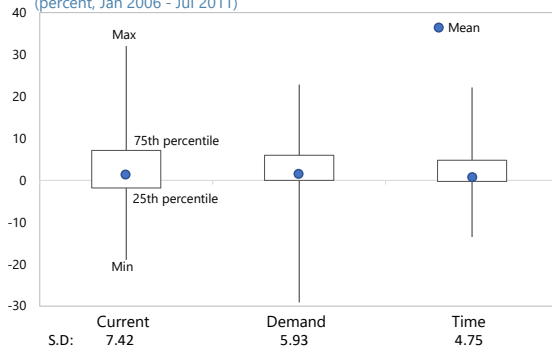
Total Residents
(percent, 30-days outflow)



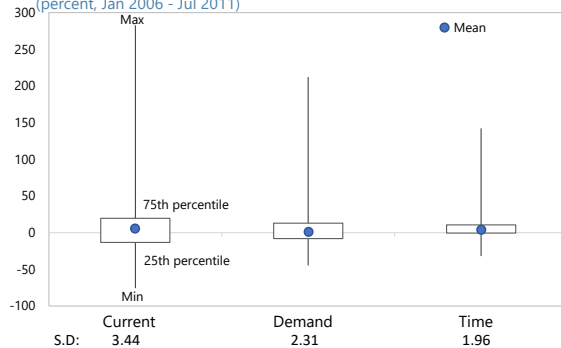
Total Non-residents
(percent, 30-days outflow)



Distribution of 30-days Deposit Outflow: Residents
(percent, Jan 2006 - Jul 2011)



Distribution of 30-days Deposit Outflow: Non-residents
(percent, Jan 2006 - Jul 2011)

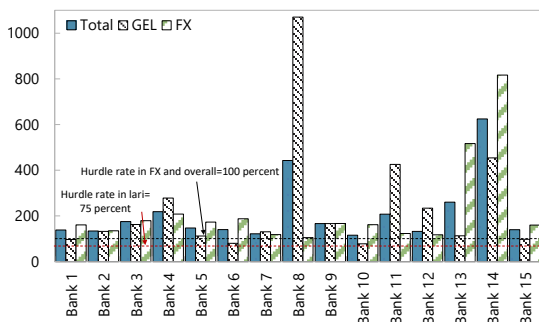


Source: NBG and IMF staff calculations.

Figure 14. Georgia: Summary Results of the Liquidity and Interbank Contagion Stress Tests

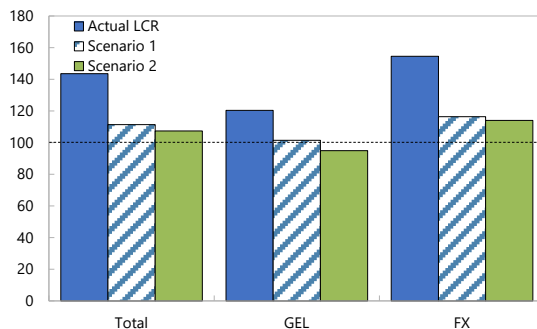
Pre-Stress LCR

(percent)



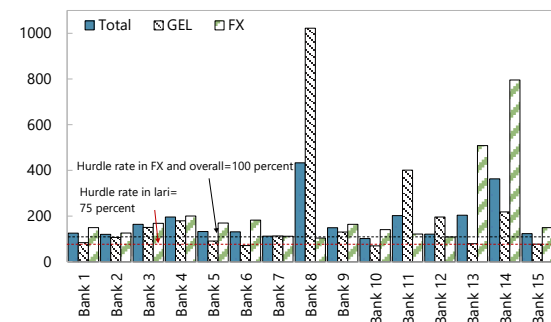
LCR After Stress

(percent)



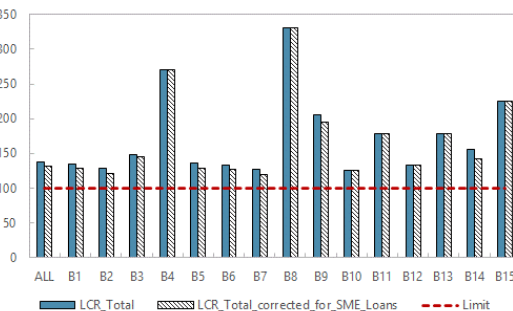
Post-Stress LCR: Scenario 2

(percent)



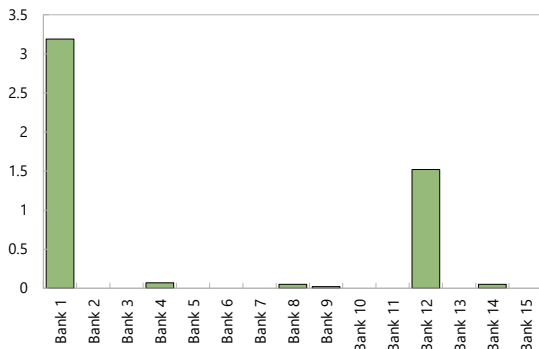
Total Liquidity Coverage Ratio

(in percent)



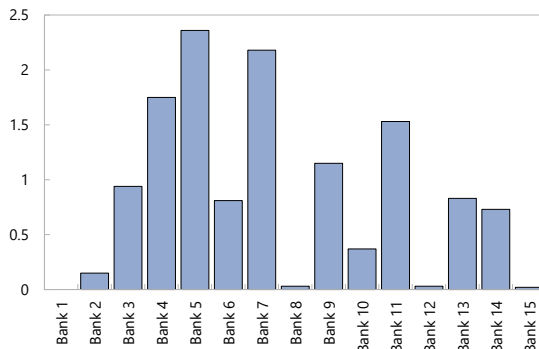
Network Analysis: Index of Contagion

(Index)



Network Analysis: Index of Vulnerability

(Index)



Note: The Vulnerability index measures the percent drop in regulatory capital of individual banks during the failure of all other banks in the system.

Sources: NBS and IMF staff calculations

Figure 15. Georgia: Summary Results of the Sensitivity Analysis to Market Risks



Sources: NBG and IMF staff calculations

Figure 16. Georgia: Expected Credit Impact from Implementation of Basel Limit on Large Exposures

	Number of Companies if Loan Demand Increases by:				Loan Shortage, in percent of GDP if Loan Demand Increases by:			
	Actual	20	40	60	Actual	20	40	60
Bank 1	0	0	1	2	0.0	0.0	0.2	0.4
Bank 2	1	1	1	1	0.1	0.3	0.5	0.7
Bank 3	0	0	2	2	0.0	0.0	0.0	0.0
Bank 4	0	1	2	4	0.0	0.0	0.0	0.1
Bank 5	0	0	0	0	0.0	0.0	0.0	0.0
Bank 6	0	0	0	0	0.0	0.0	0.0	0.0
Bank 7	4	5	5	8	0.1	0.2	0.3	0.5
Bank 8	1	1	2	4	0.0	0.0	0.0	0.1
Bank 9	0	1	1	1	0.0	0.0	0.0	0.0
Bank 10	2	3	6	8	0.0	0.0	0.1	0.1
Bank 11	0	1	1	3	0.0	0.0	0.0	0.0
Bank 12	0	0	0	0	0.0	0.0	0.0	0.0
Bank 13	0	0	0	0	0.0	0.0	0.0	0.0
Total	8	13	21	33	0.2	0.6	1.2	1.9

This table presents an estimation of the number of firms that would hit single exposure concentration limits with their lender banks, if their loan demand increases by 20-60 percent above their current loan volumes. It also presents the estimated loan shortage, measure by the difference between the requested loan amount and the regulatory limit, expressed in percent of GDP.

Source: NBG and IMF staff calculations.

Table 2. Georgia: Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years (high, medium, or low)	Expected Impact on Financial Stability if Threat is Realized (high, medium, or low)
1. Prolonged COVID-19 pandemic.	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Unexpected increase in rates of infection or deaths, possibly from additional waves of virus. • Renewed lockdowns affecting economic activity and employment. • Reduced space for monetary and fiscal policy response amid debt sustainability concerns. • Repricing of global risk assets, including debt securities. • Financing difficulties for the sovereign, capital outflows, exchange rate depreciation, and inflation. • Emergence of sovereign-bank feedback loop leading to weaker credit growth. 	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • Renewed lockdown measures in Georgia or its trading partners would reduce growth and government revenues further, which would lead to an increase in external imbalances and add to pressure on the lari. • A lack of recovery and/or an abrupt exchange rate depreciation would make it harder for borrowers to service their bank loans, particularly in foreign currency, if loan repayment moratoria are not extended. The resulting impact on banks' NPLs, profitability and capital could lower credit growth. • Stretched household and corporate balance sheets could have second round impacts on consumption, investment, and growth. • Higher unemployment (both formal and informal) could lead to a price adjustment for residential real estate, while lockdown-related business failures could hit commercial real estate. • The high level of financial dollarization could strengthen feedback loops between bank liquidity and solvency, leading to rapid currency depreciation.
2. Regional conflict	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • Widening of regional conflict in neighboring countries. • Disruption of trade with Turkey, Azerbaijan or Armenia; reduced remittances from Russia. 	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • Shock to confidence leading to deposit outflows, particularly from non-residents. • An increase in global risk premia following a weakening of confidence could threaten external financial flows on which Georgia relies to finance the current account deficit. • Lower financial flows and/or capital outflows would put pressure on the currency, lower banks' asset quality and increase banks' funding costs.

Table 2. Risk Assessment Matrix (concluded)

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years (high, medium, or low)	Expected Impact on Financial Stability if Threat is Realized (high, medium, or low)
3. Sharp rise in global risk premia exposes financial and fiscal vulnerabilities.	<p>Medium</p> <ul style="list-style-type: none"> A reassessment of market fundamentals (e.g., in response to adverse Covid-19 developments) triggers a widespread risk-off event. 	<p>High</p> <ul style="list-style-type: none"> Risk asset prices fall sharply and volatility spikes, leading to increases in sovereign spreads and FX rate depreciation. Higher risk premia generate financing difficulties for leveraged firms and households, and a wave of bankruptcies affects banks' capital buffers. Financing difficulties extend to the sovereign with FX rate depreciation generating a sharp increase in public debt to GDP.
4. Cyber-attacks	<p>Medium</p> <ul style="list-style-type: none"> Cyber-attacks on critical global infrastructure, institutions, and financial systems could trigger systemic financial instability or widespread disruptions in socio-economic activities and remote work arrangements. 	<p>High</p> <ul style="list-style-type: none"> Significant disruption to payment systems could threaten confidence in the banking system, cryptocurrencies, and bank supervision. This, in turn, would tend to increase deposit dollarization and could lead to deposit outflows, which would increase banks' vulnerability to exchange rate fluctuations and raise their funding costs.
5. Higher frequency and severity of natural disasters related to climate change	<p>Medium</p> <ul style="list-style-type: none"> Higher precipitation in Caucasus mountain areas could lead to events such as floods, landslides, mudslides, avalanches etc. Adverse impact on industries of wine and tourism (especially winter sports), which could have a broader impact on growth and external imbalances 	<p>Low / Medium</p> <ul style="list-style-type: none"> Weaker lari, higher dollarization Higher NPLs on banks' loans to borrowers in related industries

Table 3. Georgia: Selected Economic Indicators, 2015–23

(In percent year-on-year or as stated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
	Projected								
National accounts and prices 1/									
(annual percentage change; unless otherwise indicated)									
Real GDP	3.0	2.9	4.8	4.8	5.0	-6.2	7.7	5.8	5.5
Output Gap			-1.9	-1.5	-0.6	-3.9	-1.0	-0.4	0.0
Nominal GDP (in billion of laris)	33.9	35.8	40.8	44.6	49.3	49.4	57.5	64.5	70.2
Nominal GDP (in billion of U.S. dollars)	15.0	15.1	16.2	17.6	17.5	15.9	17.8	19.7	21.6
GDP per capita (in thousand of U.S. dollars)	4.0	4.1	4.4	4.7	4.7	4.3	4.8	5.3	5.8
GDP deflator, period average	5.7	2.6	8.4	4.3	4.9	6.9	8.3	6.1	3.0
CPI, Period average	4.0	2.1	6.0	2.6	4.9	5.2	9.3	5.4	3.0
CPI, End-of-period	4.9	1.8	6.7	1.5	7.0	2.4	13.1	3.2	3.0
Core CPI, End-of-period			3.1	0.5	3.8	3.7	...	...	...
Investment and saving									
(in percent of GDP)									
Gross national saving	14.5	17.7	19.2	21.4	19.8	13.7	15.6	17.0	17.2
Investment	26.3	30.2	27.3	28.1	25.3	26.2	25.6	24.6	23.4
Public	5.2	4.8	5.7	6.4	8.0	8.6	8.0	7.4	6.4
Private	21.1	25.4	21.6	21.7	17.3	17.6	17.5	17.2	17.0
Consolidated government operations									
(in percent of GDP)									
Revenue and grants	26.3	26.9	27.1	26.4	27.1	25.1	25.7	26.1	26.1
o.w. Tax revenue	23.5	24.4	24.3	23.4	23.7	22.2	22.9	23.6	23.7
Expenditures	28.6	29.5	28.2	27.7	28.9	34.4	32.2	29.7	28.7
Expense	23.4	24.7	22.6	21.3	21.4	26.2	25.0	22.7	22.6
Net acquisition of non-financial assets					7.6	8.1	7.2	7.0	6.1
Capital spending	5.2	4.8	5.7	6.4	8.0	8.6	8.0	7.4	6.4
Privatization Proceeds					-0.4	-0.4	-0.8	-0.4	-0.4
Net Lending/Borrowing (GFSM 2001)	-1.1	-1.4	-0.5	-0.8	-1.8	-9.2	-6.5	-3.6	-2.6
Budget Lending					0.2	0.1	0.2	0.3	0.3
Augmented Net lending / borrowing (EFF definition) 2/	-2.4	-2.8	-2.7	-2.3	-2.1	-9.3	-6.6	-3.9	-2.9
General government debt 3/			45.1	38.9	40.4	60.0	54.2	53.6	52.1
o.w. Foreign-currency denominated	30.3	33.3	32.4	31.6	32.0	47.5	43.9	42.1	39.3
General government debt net of government deposits 3/			42.6	36.4	37.5	53.6	50.7	50.9	49.4
Money and credit									
(annual percentage change; unless otherwise indicated)									
Credit to the private sector	N.A.	18.6	18.6	19.9	20.7	22.4	10.5	11.8	8.7
In constant exchange rate	3.9	11.8	18.3	17.7	16.1	9.0	14.0	8.5	8.8
Broad money	17.3	21.1	14.6	13.9	17.6	24.6	14.1	19.7	10.3
In constant exchange rate (estimate)	5.8	13.4	15.8	15.1	14.3	14.4	18.7	15.2	10.7
Broad money (excl. fx deposits)	-3.8	14.8	27.9	15.9	18.8	18.8	16.8	19.5	11.5
Deposit dollarization (percent of total) 4/	66.8	69.9	63.7	63.1	64.0	61.4	66.7	66.2	65.6
Credit dollarization (percent of total)	63.1	64.6	56.1	57.1	55.4	55.7	55.0	54.9	53.9
Credit to the private sector (percent of GDP)	44.8	50.3	52.4	57.4	62.8	76.6	72.6	72.4	72.4
External sector									
(in percent of GDP; unless otherwise indicated)									
Current account balance (in billions of US\$)	-1.8	-1.9	-1.3	-1.2	-1.0	-2.0	-1.8	-1.5	-1.3
Current account balance	-11.8	-12.5	-8.1	-6.8	-5.5	-12.5	-10.0	-7.6	-6.2
Trade balance	-26.3	-25.6	-23.4	-23.4	-21.3	-19.8	-19.1	-18.1	-17.6
Terms of trade, goods (percent change)	-3.3	-7.6	10.4	-0.5	-0.7	5.8	-2.1	0.5	2.2
Gross international reserves (in billions of US\$)	2.5	2.8	3.0	3.3	3.5	3.9	3.8	4.0	4.3
In percent of IMF Composite measure (floating)	94.7	95.7	95.1	95.4	98.3	107.6	98.5	98.5	100.3
Gross external debt	102.4	105.3	106.7	101.4	106.6	129.5	116.8	111.8	108.4
Gross external debt, excl. intercompany loans	77.9	84.4	85.6	83.1	87.7	109.0	95.9	91.7	87.6
Laris per U.S. dollar (period average)	2.27	2.37	2.51	2.53	2.82	3.11	...	...	...
Laris per euro (period average)	2.52	2.62	2.83	2.99	3.15	3.55	...	...	...
REER (period average; CPI based, Jan 2010=100)	104.0	107.5	105.2	106.2	100.5	97.5	...	...	...

Sources: Georgian authorities; and Fund staff estimates.

1/ National accounts numbers include the impact of GDP rebasing, which increased GDP levels while leaving growth rates unchanged.

2/ Augmented Net lending / borrowing (EFF definition) = Net lending / borrowing - Budget lending.

3/ Excludes domestic legacy debt amounting to 1.2 percent of GDP.

4/ Includes nonresident deposits.

Table 4. Georgia: Structure of the Financial System, 2020

	Number	Assets (millions of GEL)	Assets (millions of US dollars)	Percent of Assets	Percent of GDP
Banks	15	56,871	17,286	94	114
<i>Of which</i>					
domestic foreign controlled 1/	5	45,491	13,827	75	91
domestic private	4	5,874	1,785	10	12
foreign	6	5,505	1,673	9	11
Insurance Companies	18	977	297	2	2
Microfinance Organizations	42	1,477	449	2	3
Pension Funds	4	1,225	372	2	2
Total financial system	79	60,549	18,404	100	121
Memorandum items:					
GDP (millions of GEL, 2020)	49,888				
Exchange rate: GEL per US dollar (2020)	3.29				

1/ Based on domicile of investors owning more than 50 percent of outstanding shares

Sources: National Bank of Georgia, IMF World Economic Outlook, IMF staff estimates (December 2020 or latest available)

Table 5. Georgia: Financial Soundness Indicators for the Banking Sector

(in percent)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 Q2
Capital Adequacy											
Regulatory capital to risk-weighted assets	17.1	17.0	17.2	16.5	16.7	15.1	19.1	18.4	19.5	17.6	19.2
Regulatory tier 1 capital to risk-weighted assets	11.3	13.4	13.0	13.1	12.0	10.5	14.0	13.5	14.6	12.8	14.8
Asset quality											
Non-performing loans to total gross loans (IMF FSI data)	4.5	3.7	3.0	3.0	2.7	3.4	2.8	2.7	1.9	2.3	2.2
Non-performing loans to total gross loans (NBG)	8.6	9.3	7.5	7.6	7.5	7.3	5.9	5.5	4.4	8.2	6.7
Provisions to non performing loans (IMF FSI data)	70.9	59.1	59.0	57.6	55.8	56.1	54.8	54.2	51.9	50.8	50.2
Sectoral Composition of loans											
Loans to residents	98.8	98.4	97.9	97.4	96.4	97.8	97.6	97.4	97.4	96.4	96.3
Inter-bank loans	0.2	0.2	0.9	0.8	0.4	0.2	0.1	0.0	0.1	0.2	0.0
Other financial corporations	1.1	1.2	0.8	1.2	1.6	1.4	0.9	0.7	0.7	0.0	0.0
General government	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non financial corporates	59.9	58.4	54.9	51.4	51.9	50.1	48.3	46.3	49.1	47.1	46.4
Other domestic sector	37.4	38.6	41.4	44.0	42.5	46.1	49.2	50.5	47.5	49.1	49.9
Loans to non-residents	1.2	1.6	2.1	2.6	3.6	2.2	2.4	2.6	2.6	3.6	3.7
Profitability											
Net income (yoy percent change)	93.0	-50.4	144.1	28.4	10.5	32.1	18.8	13.3	-1.1	n.a.	n.a.
Return on assets (ROA)	3.2	1.3	2.9	3.1	2.7	3.2	3.1	3.1	2.5	0.2	4.0
Return on equity (ROE)	19.3	7.8	16.5	17.6	17.7	22.1	23.3	23.5	20.4	1.4	37.3
Interest margin to gross income	61.1	59.8	60.0	60.0	60.8	58.0	58.9	61.0	58.1	58.1	57.1
Non interest expenses to gross income	62.3	59.8	55.7	53.4	51.0	49.8	51.8	49.6	52.9	56.5	46.8
Liquidity											
Liquid assets to total assets	28.7	27.3	27.5	22.2	23.4	22.8	21.3	21.6	19.6	21.4	20.9
Liquid assets to short term liabilities	44.4	44.8	43.1	34.8	35.6	34.0	32.1	27.1	24.2	25.6	26.8
Total LCR				130.2	120.8	119.2	129.6	123.7	133.3	138.7	144.2
LCR in GEL				143.5	117.3	108.4	120.3	126.0	101.5	114.9	116.3
Other											
Household Debt to GDP	13.1	14.7	20.0	24.4	27.2	32.1	33.7	36.7	33.7	41.9	43.3
Residential real estate loans to total loans	18.0	18.1	19.4	21.3	26.4	28.2	28.9	32.4	31.6	32.8	33.0
Commerical real estate loans to total loans	33.5	30.8	29.7	29.0	26.2	27.6	25.5	24.4	26.3	31.8	31.3
Foreign Currency denominated loans to total loans	68.7	67.4	62.1	60.3	64.2	65.4	56.9	56.9	55.1	55.3	52.4
Foreign Currency denominated liabilities to total liabilities	68.7	69.3	65.9	63.6	70.7	70.7	63.5	61.4	61.6	61.4	58.7

Sources: National Bank of Georgia, FSI database

Table 6. Georgia: Financial and Prudential Measures in Response to Covid-19	
Government Support Measures	<ul style="list-style-type: none"> • A credit guarantee scheme amounting to GEL 330 million was introduced to help businesses cope with the pandemic. • An interest subsidy scheme amounting to GEL 70 million was provided to family-owned, small and medium-sized hotels to co-finance up to 80 percent of the annual interest rate on their loans. • Another subsidy scheme covered 4 percentage points of the interest rate for new mortgage loans for 5 years for physical persons. The scheme only applied to lari-denominated mortgages below GEL200,000 to purchase newly built residential apartments between June 1, 2020 and January 1, 2021. • 600 million GEL in debt issuance for support of banks' liquidity (see below).
Liquidity Measures	<ul style="list-style-type: none"> • In April 2020, the MoF issued an extra 600 million GEL of government securities and deposited the lari proceeds with commercial banks as long-term deposits. • In April 2020, the NBG introduced swap lines (for up to \$400 million) with banks and microfinance institutions in order to provide GEL liquidity to the system. The swaps, which have a one-month maturity, may be renewed on a monthly basis, until April 2022. • Moreover, the NBG activated the stand-by swap instrument, which enables banks to get GEL liquidity in exchange for foreign currency, at a penalty rate. • In June 2020, the NBG provided commercial banks with the opportunity to receive liquidity support from the NBG against a collateral of SME loans. Microfinance institutions may also seek financing from commercial banks against SME loans, if these meet certain criteria. This mechanism will phase out from 2022 and expire at end-2023. • In May 2020, for a period of one year, banks were allowed to use their foreign currency buffers for GEL liquidity management (LCR in lari relaxed from 75 percent to zero). • The NBG reduced its policy rate by 50 bps on April 29, 2020, by 25 bps on June 24, and again by 25 bps on August 5.
Capital and lending Measures	<ul style="list-style-type: none"> • In March 2020, the NBG reduced capital requirements for commercial banks by reducing their capital conservation buffer (2.5 percent of RWA) and a portion of their pillar 2 buffer (2/3 of their currency-induced credit risk buffer). • In April 2020, the NBG instructed that commercial banks shall not use the relief on capital requirements for dividends, share buybacks, equity investments or other types of distributions and payments that would cause a reduction of bank capital. • In March 2020, the NBG also postponed an increase in CET1 and Tier 1 capital requirements that would have come from an increase in banks' CICR and GRAPE buffers. • Commercial banks offered renewable three-month grace period on loans to customers. • In March 2020, the NBG issued a guideline on the computation of expected credit losses during the Covid-19 crisis. This guideline indicated that banks' loan exposures to borrowers facing temporary liquidity problems and enjoying payment holidays should not be regarded as exposures with a significant increase in credit risk and should not be provisioned solely for that reason. • The regulation on Credit Concentration and Large Risks in Commercial Banks which should have been enacted from June 2020, was postponed by a year and a half. • The NBG suspended on-site inspections of entities under its supervision, except for money laundering inspections which were performed remotely. • The NBG introduced a moratorium on fines on regulated entities arising from breaches due to the crisis.

Table 7. Georgia: Key Measures Relevant to Financial Stability (2017–2020)

Instruments	Details	Implementation Date
Capital Measures		
Regulatory Capital Thresholds	Increase in minimum regulatory capital for banks to GEL 50 million.	May 2017
Capital Ratios	Alignment of capital ratios with Basel III and introduction of Pillar 2 Capital Requirements	December 2017
Capital Conservation Buffer	<ul style="list-style-type: none"> • CCB (2.5 percent) introduced as part of the Basel III implementation • CCB released as part of COVID-19 response, to be restored by January 2024 	December 2017 April 2020
Unhedged Currency Induced Credit Risk Buffer	<ul style="list-style-type: none"> • Pillar 2 buffer equivalent to 75 percent additional risk weighting for credit exposure to unhedged borrowers • Two-thirds of this buffer was released as part of the NBG response to Covid-19, to be restored by January 2023 	December 2017 April 2020
Countercyclical Buffer	CCyB introduced but not activated	December 2017
Systemic Buffer	DSIB Buffers (between 1.5 and 2.5 percent) introduced for three identified DSIBs to be phased in gradually through December 2021.	December 2019
Leverage Ratio	Minimum requirement of 5 percent	September 2018
Capital Distributions	As part of response to Covid-19, the NBG prohibited use of relief on capital requirements for dividend payouts, share buybacks, equity investments, increases in variable remuneration for management, or other types of distributions and payments.	April 2020
Liquidity-related Measures		
Reserve Requirements	<p><u>FX Deposits</u></p> <ul style="list-style-type: none"> • Remunerated at Fed Funds rate minus 50 bp or ECB deposit facility minus 20 bp • Increase in reserve requirement from 20 to 25 percent. • Further increase from 25 to 30 percent. • Reduction from 30 to 25 percent. • Differentiation by bank: 1 ppt reduction for every 2 ppt below 70 percent of deposit dollarization till 40 percent. <p><u>Lari Deposits</u></p> <ul style="list-style-type: none"> • Remunerated at policy rate • Reduction of reserve requirements from 7 to 5 percent. 	July 2018 March 2019 October 2019 July 2021 July 2018

Table 7. Georgia: Key Measures Relevant to Financial Stability (2017–2020) (concluded)		
Instruments	Details	Implementation Date
LCR	<ul style="list-style-type: none"> • LCR of 100 percent (overall), 75 percent (domestic currency), and 100 percent (foreign currency) 	September 2017
	<ul style="list-style-type: none"> • LCR in domestic currency reduced to zero for one year 	May 2020
	<ul style="list-style-type: none"> • Removal of the 25 percent haircut previously applied to FX required reserves in the calculation of high-quality liquid assets as part of FX liquidity coverage ratio 	October 2019
NSFR	Net Stable Funding Ratio requirement of 100 percent	September 2019
Borrower-based Measures		
Payment-to-Income Limit	Unhedged Borrowers: 20 – 35 percent Hedged Borrowers: 25 – 60 percent	January 2019
	Unhedged Borrowers: 20 – 30 percent Hedged Borrowers: 25 – 50 percent	March 2020
Loan-to-Value Limit Restriction on FX lending	GEL Loans: 85 percent	January 2019
	Foreign Currency Loans: 70 percent	January 2017
	<ul style="list-style-type: none"> • Issuance of FX loans below 100,000 GEL prohibited • Limit tightened to 200,000 GEL 	January 2019
Currency-risk Measures		
Limit on net open FX position	20 percent of regulatory capital	July 2006

Table 8. Georgia: Financial Sector Policy Recommendations in Recent Article IV Consultations and Program Reviews

- Monetary policy should balance the impact of lari depreciation (which calls for keeping the rate high for longer) with a sharp weakening in demand (which would allow reducing rates) and be driven by inflation developments. Exchange rate flexibility should continue to act as a shock absorber, but excessive lari volatility should be avoided as it could prove disruptive to financial stability.
- Providing adequate liquidity and releasing some capital buffers in financial institutions would help sustain financial stability. The authorities should continue with the implementation of bank resolution and insolvency frameworks.
- The planned emergency liquidity assistance and bank resolution framework will strengthen financial stability. Adopting the insolvency framework, developing the local capital market, and judiciary reform will further improve the business environment and support private investment.
- The stance of monetary policy is adequate and the National Bank of Georgia (NBG) remains committed to the floating exchange rate regime while continuing efforts to build up reserves. Establishing a new insolvency framework for nonfinancial corporations will improve further the business environment. The funded pension pillar, coupled with capital market reforms, should help mobilize domestic savings for investment, which would also be supported by the new public private partnership (PPP) framework.
- Monetary policy remains adequately focused on price stability. The flexible exchange rate remains a key shock absorber, with interventions only limited to reduce excessive volatility and to build buffers.
- Monetary policy remains rightly focused on price stability, supported by the flexible exchange rate and efforts to strengthen the transmission mechanism. The NBG's monetary policy stance is appropriate, but the authorities need to remain vigilant on monetary and financial developments, including related to credit growth.
- The authorities' steps to increase the resilience of the financial sector are welcome. Proposed legal amendments would appropriately expand the role of the central bank in regulating and supervising non-banks and credit bureaus, enhance the bank resolution framework, and supervise banks on a consolidated basis. The authorities' efforts to identify legal amendments to adopt an effective ELA framework are also commendable.

Table 9. Georgia: Status of Key Recommendations of the Georgia 2015 FSAP

Recommendation	Progress
Financial Sector Oversight	
Introduce explicit regulatory provisions in areas highlighted in the BCP Assessment rather than rely on the NBG's broad powers (NBS).	Done. By the end of 2017 and 2019, the Parliament of Georgia approved legislative amendments to the Organic Law on NBS and the " Law on the Activities of Commercial Banks ". These amendments further strengthened the NBG's authority to regulate banking groups on a consolidated level, to enhance the requirements of licensing and transferring of significant shares of commercial banks, to have the explicit power to exercise risk-based supervision and to create enhanced framework for the resolution of commercial banks.
Implement the definition of large exposures consistent with Basel standards (NBS).	Done. The regulation on the concentration of the exposures and large exposures for commercial banks in accordance with Basel III was approved in November 2019. The definition is fully consistent with relevant Basel standard. Implementation of this regulation has been delayed through June, 2022 owing to the pandemic.
Require Boards to take the lead in developing the banks' risk appetite and conveying desired risk-taking parameters to management (NBS).	Done. The NBS has developed a Corporate Governance Code for commercial banks (approved in September 2018) that defines the responsibilities of supervisory boards of commercial banks. These include setting banks' risk parameters in consultation with senior management.
Enhance the capacity of the Banking Supervision Department, including through recruitment, higher salaries, and specialized training (NBS).	Pending. The NBS plans to modify its remuneration system with salaries based on the complexity of work. The NBS primarily recruits fresh university graduates as staff, and seek to retain employees by providing opportunities for training and secondment.
Financial Stability	
Amend the NBS law to strengthen its macroprudential mandate (NBS).	Done. The Financial Stability Committee (FSC) of the NBS now defines the NBG's macroprudential policy strategy .
Implement the countercyclical capital buffer regime and the LCR of Basel III (NBS).	Done. In addition to the CCyB and the LCR, the NBS has implemented the NSFR as of 2019. Activation of the CCyB is considered by the FSC on a quarterly basis.
Implement the capital surcharge for systemically important banks (NBS).	Done. The Regulation on Identification of Systemically Important Banks and Determination of the Systemic Buffer was implemented in December 2017. Relevant amendments to the Regulation on Capital Adequacy Requirements for Commercial Banks have also been issued. The D-SIB buffer will phase-in gradually for three systemically important banks and will be fully loaded by December 2021.
Employ macroprudential instruments to address FX risks and support larization: (i) limit FX lending to unhedged borrowers; (ii) adjust liquidity regulations to provide stronger incentives for attracting local currency deposits; and (iii) promote stable long-term funding instruments, through more favorable treatment of FX CDs in reserve requirements (NBS).	Done. In addition, Retail Credit Regulation has implemented more conservative requirements (PTI, LTV, Loan Maturity) for FX unhedged borrowers and the current Stress Test framework provides an FX exchange rate depreciation scenario, which has a corresponding impact on regulatory capital.

Table 9. Georgia: Status of Key Recommendations of the Georgia 2015 FSAP (continued)

Ensure that banks continue to build adequate capital buffers as long as foreign currency loans dominate the loan portfolios (NBG).	Done. In addition, the recent Stress Test framework will also account for this risk in the regulatory capital requirement.
Develop a comprehensive framework for bottom-up stress testing by banks (NBG).	Done. Pillar 2 regulation includes a stress test buffer for commercial banks. Guidance on the calculation of this buffer has been provided to banks. While a stress test buffer will not be applied during Q3 2020 due to the Covid-19 situation, results from banks in this period are expected to provide an indication of the buffer range for the banking sector.
Ensure systemic risk assessments and policy responses are effectively communicated, including by the regular publication of financial stability reports (NBG).	Done. The NBG has been publishing an annual Financial Stability Report since 2019. It is complemented by an Annual Report , which covers analysis of systemic risks. The Financial Stability Committee meets on a quarterly basis with a predefined calendar and publishes a summary statement and decisions . It also holds a press conference semiannually. A formal Macprudential Strategy document is available on the NBG website.
Crisis Management and Safety Nets	
Revise emergency liquidity assistance policy to mitigate the NBG's exposure to financial risk (NBG, MOF).	Done. The NBG Law was amended to require a MoF guarantee of any ELA to a bank whose solvency is in doubt, such as a bank undergoing resolution.
Overhaul the bank resolution regime, by implementing effective resolution tools and reinforcing safeguards in the resolution process (NBG, MOF).	Done. A new bank resolution and safeguards framework, which was designed with the help of IMF experts, was implemented at end-2019. All implementing regulations and rules were adopted by end-2020.
Introduce a deposit insurance scheme underpinned by features in line with international best practices (MOF, NBG).	Done. A deposit insurance scheme based on the IADI's Core Principles for Effective Deposit Insurance Systems was established in 2017.
Set up a Financial Stability Council, comprising the NBG, MOF, securities and insurance regulatory agencies, and relevant stakeholders (authorities).	Done. The 2019 NBG Law amendments established a new Interagency Financial Stability Committee comprised of the NBG, MoF, DIA and Insurance State Supervision Service.
Enhance requirements for adequate recovery and resolution plans for systemically important banks (NBG).	Done. The 2019 amendments to the Banking and NBG Laws included requirements for all banks to prepare recovery plans and update them annually, and for the NBG to prepare resolution plans for SIBs and other banks for which liquidation may give rise to systemic risks, and to update them annually.

Table 9. Georgia: Status of Key Recommendations of the Georgia 2015 FSAP (concluded)

Financial Sector Development	
Develop a comprehensive financial sector development strategy, including revisiting existing government interventions to eliminate inefficiencies (MOF, MOE, and NBG).	Partial and in progress. The authorities have made significant progress in strengthening the legal and regulatory framework and have taken various initiatives involving elements of financial development, while there is room for improvement in coherence and coordination. Government interventions entail a significant fiscal outlay and further scope for improving efficiency exists.
Prepare a time-bound strategy for capital market development, including regulatory reform, institutional strengthening, and, possibly, establishing a market maker (MOF, MOE).	In progress. The MoE and NBG, with the support of ADB and the involvement of other government entities and private sector representatives, are preparing a new capital market development strategy. Significant progress has been made in upgrading capital market legal/regulatory framework and increasing NBG's supervisory capacity. The NBG became an associate member of IOSCO in 2018 and is seeking to become a signatory to the IOSCO MMoU.
Designate and empower a capital market regulator for capital markets (MOF, MOE).	Done. In the process of seeking to become a signatory to the IOSCO MMoU, the NBG identified major gaps in supervisory powers for capital markets oversight, which have been addressed via recent amendments to the securities market law (approved by parliament of Georgia in July 2020).
Complete institutional reform of the insurance sector and strengthen the regulatory framework (MOF, MOE).	Done. The minimum capital requirement for insurance companies has been raised and essential regulations (on solvency requirements and risk retention) put in place. A supervisory levy was introduced in 2018, and ISSSG has become financially independent. Current effort is focused on transposing Solvency II into a new Insurance Law.
Establish a regulatory framework for credit reporting to enhance the safety, efficiency, and protection of data privacy (MOF, MOE, and NBG).	Done. New laws provide the NBG with the power to supervise credit information bureaus and relevant regulations have been issued.
Improve implementation of the secured transaction regime (MOE, MOJ).	In Progress. The MoESD is leading an ongoing effort, in collaboration with MOJ and NBG. A movable collateral registry has yet to be operationalized. Legal and regulatory framework for secured lending also requires strengthening.

Table 10. Georgia: Recent IMF TA Missions to Georgia on Financial Sector Issues

Number of Missions	Dates	Title
3	December 2019 - July 2020	Top-down Stress Testing Framework
2	June 2018 - July 2020	Central Bank Risk Management
5	June 2017 - June 2020	Development of Government Securities Market
1	February, 2020	FX Policy Framework and Communications
1	November, 2019	Nonbank Financial Institutions
3	October 2018 - October 2019	Financial Stability Report
3	October 2017 - April 2019	Implementing IFRS 9 and Accounting Modernization
1	September, 2018	Eurobond Refinancing
1	September, 2018	Pillar 2 - Determination of Supervisory Buffers
1	July, 2018	Resolution Framework
3	December 2017 - May 2018	Financial Stability Analysis
1	April, 2018	Consolidated Supervision
1	January, 2018	Centralized Risk Management
1	December, 2017	Monetary and Foreign Exchange Operations/ELA
1	June, 2017	Macroprudential Policy Framework

Appendix I. Central Bank Digital Currency

- 1. The National Bank of Georgia (NBG) is considering launching a retail Central Bank Digital Currency (CBDC) to enhance payment system efficiencies and financial inclusion.** At this early stage, the NBG has developed principles for its preferred technical design features and has invited technology firms, Fintech companies, and interested financial institutions to tender proposals on how to develop a CBDC that meets the stated principles.
- 2. As CBDCs can have important macro financial stability implications, the CBDC design should be aligned with policy objectives while allowing innovation by third parties.** The NBG should control the issuance and destruction of money, the register/account system, and the rules of operation while banks and other third parties provide end-user services.
- 3. To ensure a seamless process, consideration could be given to establishing a joint taskforce with the Ministry of Finance.** This would coordinate the exploration of the CBDC, experimental testing of technical solutions and further analysis of purposes and consequences of introducing a CBDC. The task force could be supported by sub-committees comprised of private sector individuals to focus on both technology and non-technology aspects, including implications for monetary policy, financial stability, integrity, inclusion etc.
- 4. The mission welcomes the NBG's plans to provide a controlled environment for testing technical solutions.** This could help identify the preferred characteristics of Digital Gel, uncover potential unintended consequences, and help reveal relevant economic and regulatory issues. The NBG may also want to ensure that non-bank payment service providers for CBDCs have strong cyber resilient frameworks; undertake financial and digital literacy programs to support financial inclusion objectives; and conduct an analysis of the public law aspects of CBDC under central bank and monetary law.

Appendix II. Stress Testing Matrix (STeM)

Domain		Assumptions
		Top-down by FSAP Team
Banking Sector: Solvency Stress Test		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> All banks (fifteen institutions with total assets equivalent to about 100 percent of GDP) including the three DSIBs.
	Market share	<ul style="list-style-type: none"> About 95 percent of total financial system assets.
	Data source and starting date	<ul style="list-style-type: none"> Data Sources: Supervisory returns, special requests to banks and publicly available data. Baseline date: Balance sheets as of December 2020. Credit and funding risk based on historical data back to 2010. Scope of Consolidation: Consolidated bank balance sheets.
2. Methodology	Overall framework	<ul style="list-style-type: none"> Credit risk assessed using two methodologies to compensate for model and parameter uncertainty as amplified by the idiosyncratic nature of the COVID pandemic. These two methods will comprise: an IMF Balance sheet-based model and a static credit VaR using Monte Carlo simulation to compute expected and tail losses. These will be complemented with sensitivity analysis (see below). Given the high dollarization of bank credit and the asymmetric impact of the pandemic across economic activities, the credit portfolio will be split by credit types (retail, mortgages, SMEs and commercial), currency, and main activity of the corporate borrowers. In addition, concentration risk will be assessed with a case-by-case analysis of the financial statements of the largest ten borrowers for each bank, using the results of a corporate stress test.
	Satellite models for macro-financial linkages	<ul style="list-style-type: none"> Satellite models based on previous IMF TA linking PDs, NPL ratios, and provisioning levels to a set of macroeconomic variables comprising GDP growth, FX rate depreciation, interest spreads, and other macro variables. Net interest income based on dynamic panel econometrics.
	Stress test horizon	<ul style="list-style-type: none"> 3-years (2020-2023).
	Assumptions	<ul style="list-style-type: none"> Static balance sheet assumption: (i) total assets and credit growth evolve in line with nominal GDP growth; (ii) the composition of the asset side of the balance sheet remains constant throughout the stress test horizon; (iii) banks build capital through retained earnings; and (iv) short-term liabilities adjust as needed to close the accounting identity Dividend distribution allowed if net income after taxes are positive and if banks are adequately capitalized. The dividend payout ratio is assumed to be 50 percent.
3. Type of analyses	Scenario analysis	<ul style="list-style-type: none"> Scenario-based stress tests focus on the impact of the macroeconomic environment on FX-induced credit risk, COVID-related credit losses, and concentration risk. Given the domestic orientation of banks, the scenarios focus on domestic macro-financial variables (e.g., GDP, inflation, interest rates, unemployment rate, exchange rate, and property prices).

Domain		Assumptions
		Top-down by FSAP Team
		<ul style="list-style-type: none"> • To account for the differential impact of COVID across businesses, the scenarios will simulate the evolution of value added by economic sectors. These sectors are grouped in three categories to differentiate their sensitivity to the pandemic. • Three scenarios are simulated at the yearly frequency, using NBG and RES models: <ul style="list-style-type: none"> • Baseline scenario using the April 2021 WEO projections. The economy starts to recover during mid-2021 from the April 2020 slump, and is supported by benign external and domestic financial conditions. However, growth momentum remains weak in the near term, as social distancing measures and the pandemic remain a drag on tourism and other contact-intensive services. The Baseline may be a conservative scenario, as the economic rebound in the first half of 2021 has been stronger than that projected in the April 2021 WEO. • Adverse Scenario 1: This assumes additional waves of COVID infections, which extend into late 2021 while conditions remain supportive in global financial markets. GDP growth remains sluggish in 2022, fueling unemployment and hitting household income. Firms operating in tourism-related services, particularly SMEs are severely hit, and many become insolvent. The effects of the pandemic on economic activity are long-lasting and hurt potential growth. • Adverse scenario 2: This scenario is assumed to be more severe and less likely than the first one, but assumes an adverse external shock. It is characterized by a widening of the sovereign spread, capital outflows including from banks' non-resident deposits and sharp currency depreciation, which lead to adverse feedback effects on economic activity.
	Sensitivity analysis	<ul style="list-style-type: none"> • Sensitivity analyses to complement the scenario-based analysis. The risks comprise: <ul style="list-style-type: none"> • Credit risk from reclassification of loans between risk categories • FX-induced credit risk • Credit risk from large exposures (10 largest for each bank) • Interest rate risk in the banking book • Sovereign debt holdings
4. Risks and Buffers	Risks assessed	<ul style="list-style-type: none"> • Credit loss from banks' loan portfolios and sovereign exposures, including off-balance sheet credit exposures. • Interest rate risk in the banking book, compression of interest margins.
	Buffers	<ul style="list-style-type: none"> • Existing loan loss provisions and capital buffers. • Internal capital generation from net income after taxes. • No new capital injections.
5. Regulatory Standards	Regulatory Standards	<ul style="list-style-type: none"> • National regulatory framework. • Basel III approach.
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • System-wide capital shortfalls from macroprudential perspective. • Number of banks and percentage of banking system assets by CAR intervals.

Domain		Assumptions
		Top-down by FSAP Team
		<ul style="list-style-type: none"> • Impact of shocks on NPLs. • Impact of shocks on key P&L components.
Banking Sector: Liquidity Stress Test		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • All fifteen banks.
	Market share	<ul style="list-style-type: none"> • About 95 percent of total financial system assets.
	Data and Starting position	<ul style="list-style-type: none"> • Baseline date: December 31, 2020 (possibly updated at a later date). • Data Source: Daily supervisory returns on bank liquid assets and liabilities, and projected cash flows at various horizons. Liabilities classified by liquidity, currency, size, and residency of the counterparts.
2. Methodology	Overall framework	<ul style="list-style-type: none"> • Cash-flow cum counterbalancing capacity-based liquidity stress test • Basel III-LCR ratio. • Separate results by local and foreign currency.
3. Type of analyses	Scenario analysis	<ul style="list-style-type: none"> • Four scenarios combining two shocks to liabilities and two assumptions on asset haircuts. Shock calibration based on historic data.
4. Risks and Buffers	Risks	<ul style="list-style-type: none"> • Cash-flow based LST. Adverse shock to deposits and other liquid liabilities combined with reduction of asset liquidity
	Buffers	<ul style="list-style-type: none"> • Cash-flow based LST: Capacity of banks to generate liquidity from assets under stress (counterbalancing capacity) and central bank facilities • LCR regulatory buffers
5. Regulatory Standards	Regulatory Standards	<ul style="list-style-type: none"> • National regulatory framework: The LCR and NFSR. Hurdle rates of 75 percent for LCR in local currency and 100 percent for LCR in FX.
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • Distribution of banks and total assets by intervals of LCR after shock.
Corporate Stress Test		
1. Institutional Perimeter	Entities included	<ul style="list-style-type: none"> • About 100 large corporations on a solo basis, representing about 49 corporations at the consolidated level. The sampled firms have total assets equivalent to about 25 percent of GDP on a solo basis, and 28 percent of GDP on a consolidated basis. • The sample targets the ten largest borrowers of each bank.
	Data	<ul style="list-style-type: none"> • Publicly available financial data on corporations is limited due to the shallow capital market. The corporate stress test uses data from bank files, comprising the latest available balance sheet and income statement accounts of the sampled corporations on a solo and a consolidated basis.
	Time Horizon	<ul style="list-style-type: none"> • Data are unbalanced, during 2018–20.

Domain		Assumptions
		Top-down by FSAP Team
2. Methodology	Overall framework	<ul style="list-style-type: none"> Stress test based on the Interest Coverage Ratio (ICR) and EBITD conditional on the distressed scenarios applied to the bank stress tests. Individual firms are classified by their economic activities and subject to the adverse scenarios used in the bank stress tests. The shocks include an increase in interests on short-term debt and maturing long-term debt, and a drop in EBITD proportional to the evolution of value added in the sector where the firm operates. Individual firms are mapped to their corporate groups and to their lender banks, and the results used to inform the bank stress tests of credit risk.
	Scenarios	<ul style="list-style-type: none"> The analysis applies the same baseline and distressed scenarios used in the bank stress tests. The corporate stress test applies the projections of sectoral value added and the shocks to sovereign spreads to come up with a set of firm-specific shocks consistent with the bank stress tests.
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> Insolvency risk.
	Buffers:	<ul style="list-style-type: none"> EBITD and share of long-term debt in total debt.
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> Total assets and number of firms with ICR below 100 percent by economic sectors, and lender banks, under baseline and distressed scenarios. Total bank debt owed by firms with ICR below 100 percent, by lender banks, under baseline and distressed scenarios. Total bank debt owed by firms with negative EBITD or negative equity, by lender banks, under baseline and distressed scenarios.
Financial System: Interconnectedness Analysis		
1. Institutional Perimeter	Institutions Included	<ul style="list-style-type: none"> Interbank network: Largest all fifteen 15 banks.
	Data	<ul style="list-style-type: none"> Data source: Supervisory data on interbank exposures. Interbank positions as of December 2020.
2. Methodology	Overall framework	<ul style="list-style-type: none"> Interbank: Balance sheet-based interbank model by Espinosa-Vega and Solé (2010). Common exposure: balance sheet approach.
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> Credit and funding losses related to interbank exposures. Default of large common borrowers in the banking system.
	Buffers	<ul style="list-style-type: none"> Interbank network: banks' own capital and liquidity buffers.
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> Interbank network: a network chart, index of vulnerabilities. Common exposure: system-wide capital shortfalls. Evolution and direction of spillovers.