Banking Sector Monitoring Georgia 2018

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in cooperation with ISET

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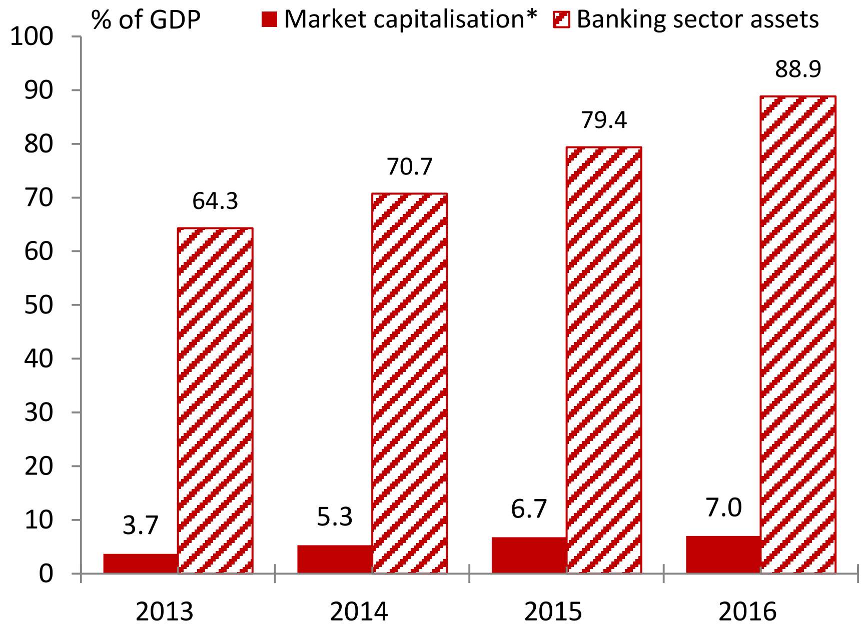
I. Banking sector and financial markets in Georgia

1. Banking sector vs capital markets in Georgia

2. Regional comparison

1. Banking sector vs capital markets in Georgia

Market capitalisation and banking sector assets



Source: National Bank of Georgia; eop
** Due to data limitations, market capitalisation before 2016 is calculated by assuming the same structure of the capital market as in 2016*

Banking sector

- Good progress in deepening intermediation
- 89% bank assets to GDP relatively high for an economy at this stage of development

Capital markets

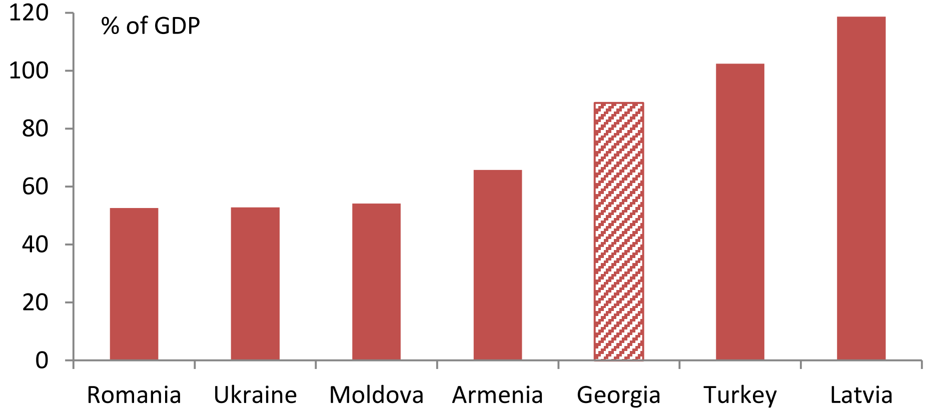
- Relative stagnation may be due to some structural obstacles

➢ **Uneven development of banking sector and capital markets**

➢ **Georgia's financial sector almost entirely dependent on banks**

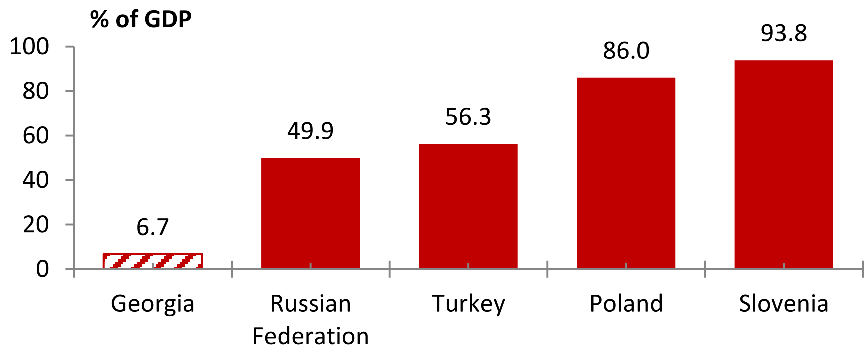
2. Regional comparison

Banking sector assets, 2016



Source: National Banks, eop

Market capitalisation, 2015



Source: Bank for International Settlements, World Bank, IMF and capital market development strategy from the Ministry of Economy of Georgia and National Bank of Georgia; eop

Banking sector

- Georgia ranks highly in terms of overall banking sector 'depth'
- There are still some problems with access to credit

Capital market remains underdeveloped

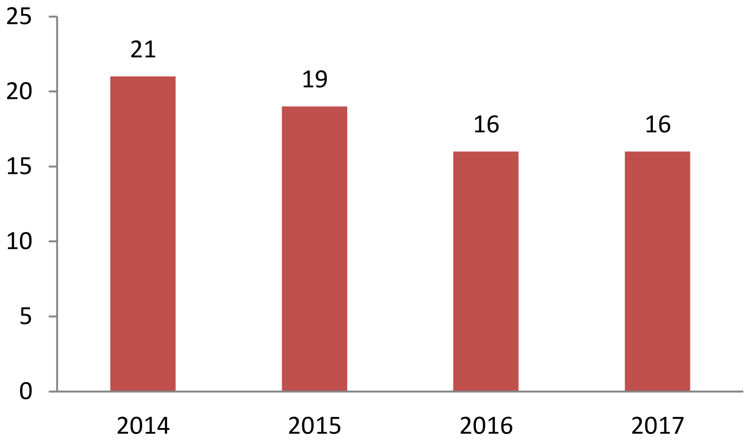
- Equity market highly illiquid
- Liquid sovereign bonds but private bond issuance limited

➢ **IMF index of financial development suggests considerable growth benefits from further financial deepening**

II. Market structure, profitability and governance

3. Number of banks
4. Market structure
5. Bank profits
6. Corporate governance and foreign listings

3. Number of banks



Source: NBG, eop

Jan2015: Merger of TBC and Bank Constanta

May2015: Merger of BOG and Privatbank

2016: Progress Bank cancelled its banking license to become a non-bank institution

Sep2016: NBG revoked license of Caucasus Dev Bank; bankruptcy of mother company in AZE

Nov2016: Closure of Capital Bank due to breach of NBG regulations (money laundering)

Mar2017: Banking license for Credo (microfinance)

May2017: Merger of TBC and Bank Republic

2014-2017

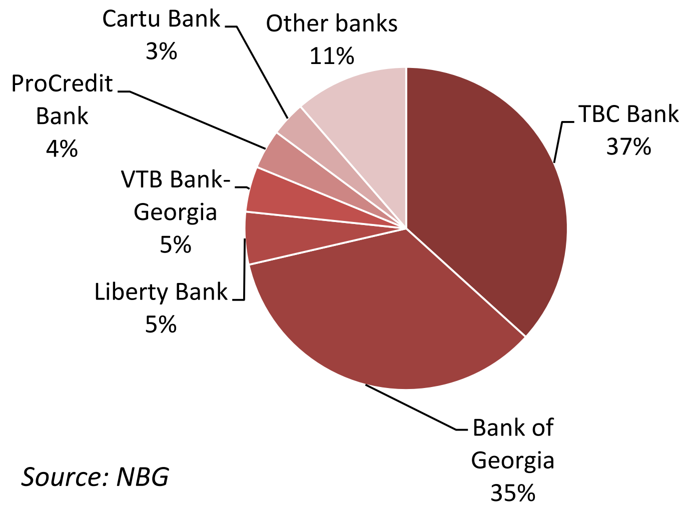
- Numbers of active banks went down from 21 to 16
- Six small banks no longer active, TBC and Bank of Georgia acquired smaller institutions
- But: One microfinance institution received a banking license
- A dynamic process of entry and exit

Drivers of the consolidation process

- NBG regulation and supervision, e.g. higher minimum capital requirements in effect from 2018
- But also market forces; search for economies of scale / efficiency

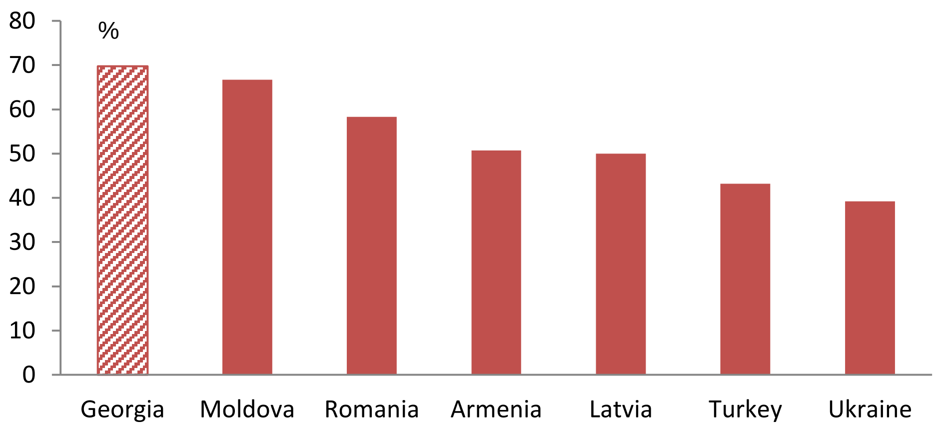
4. Market structure

Banking sector assets, Dec 2017



Source: NBG

Share of top 3 banks - regional comparison, 2015



Source: Global Financial Development Indicators (World Bank)

Top 3 banks currently account for 77% of assets; high concentration

- TBC Bank: 37% of assets
- Bank of Georgia: 35% of assets

Strong presence of foreign capital

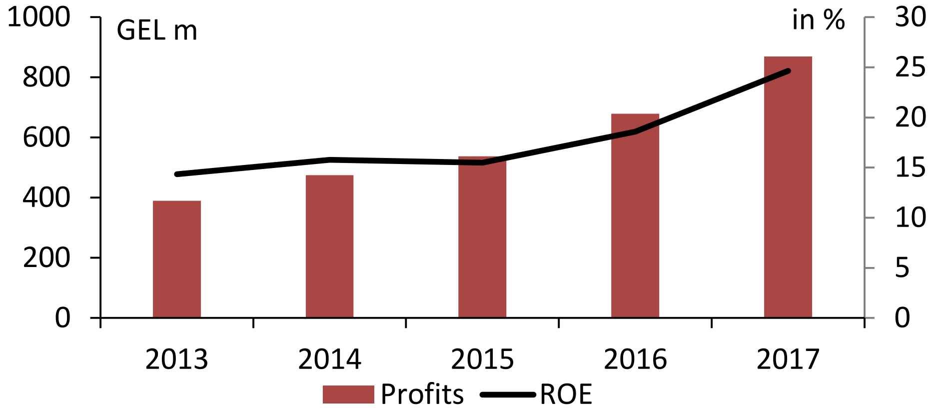
- 15 of the 16 banks with foreign-capital participation
- 80% of assets under foreign ownership (though by portfolio, not strategic, investors)

➢ **Unusual, no state-owned bank**

➢ **International experience suggests that even highly concentrated banking systems can be efficient and provide good access to credit for firms**

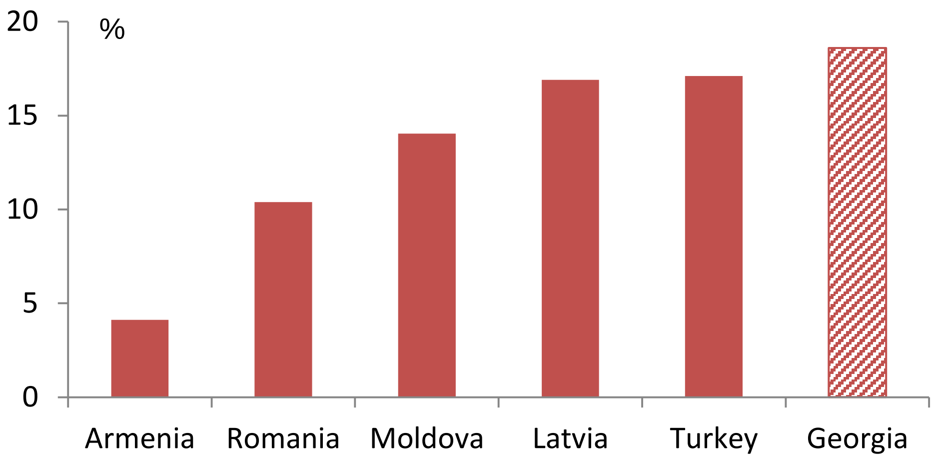
5. Bank profits

Banking sector profit



Source: NBG

Return on equity: regional comparison, 2016



Source: IMF Financial Soundness Indicators

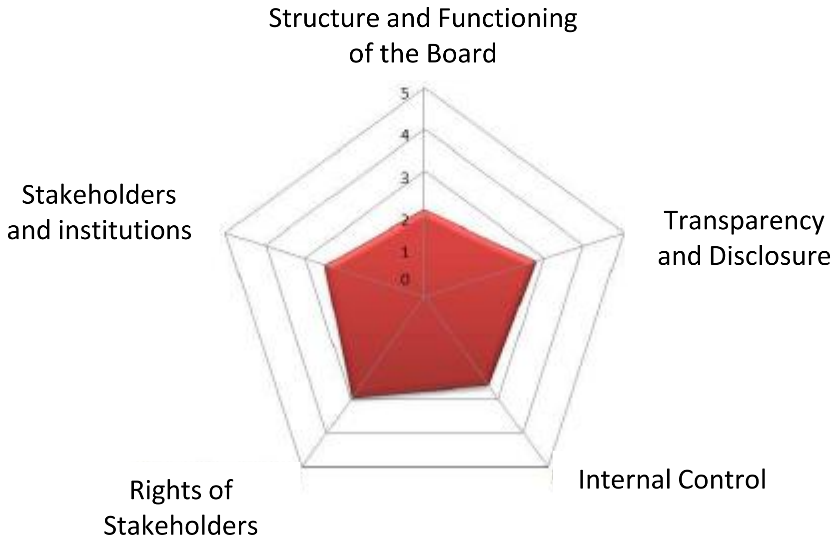
Return on equity (ROE)

- Increase to 24.6% in 2017 likely due to special factors
- Positive for financial stability
- Relatively high in regional context but partly explained by good operating efficiency and low impairment charges

➢ **Policy will need to**
  - **Ensure open entry into the sector**
  - **Safeguard against abuse of market dominance and facilitate information sharing**
  - **Tackle the ‘too-big-to-fail’ problem**

6. Corporate governance and foreign listings

EBRD assessment of the Georgian Corporate Governance Code



Source: EBRD

- Weak Georgian legislative framework for corporate governance
- TBC and BoG both listed on premium London Stock Exchange segment (BoG in the FTSE250)
- As such they comply with the UK corporate governance code and a high level of transparency
- This defines an expanded investor base, and likely reduces costs of funding within Georgia, however at the expense of liquidity in Georgian securities markets

➢ **Introduces high corporate governance standards within Georgia, which has a weak local framework**

III. Bank soundness

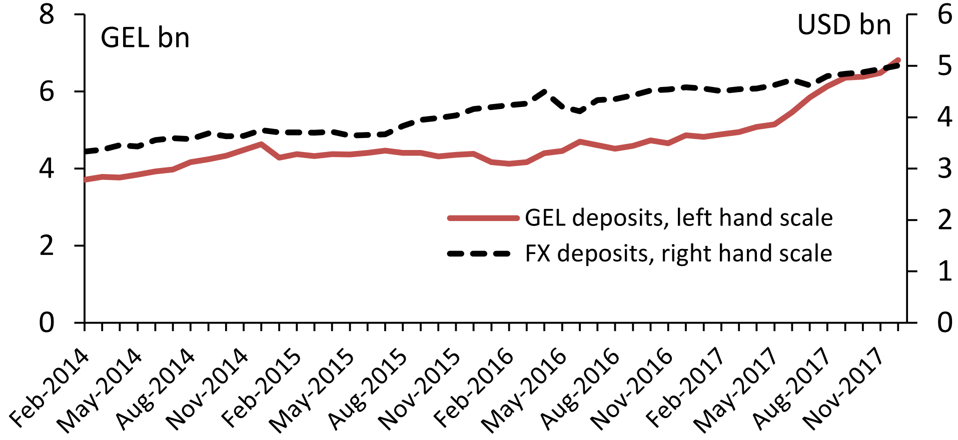
7. Liquidity

8. Capital

9. Asset quality and non-performing loans

7. Liquidity

Bank deposits



Source: NBG, own calculations, excl. interbank deposits

Structure of deposits

Current	Term
58.2%	41.8%
GEL	**FX**
33.8%	66.2%

Source: NBG, own calculations

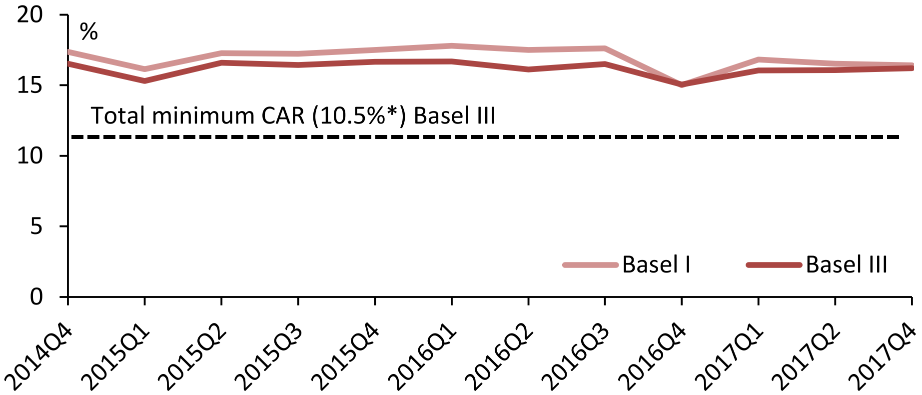
- Deposit funding stable, and steady growth since 2014, despite major regional turbulences and GEL depreciation
- Limited wholesale funding, in part from IFIs
- High share of liquid assets
- Loan to deposit ratios around 100% at all key banks

➢ **Depositors appear to trust the banks and the supervisor; absence until now of a deposit insurance scheme has not been a problem**

➢ **Banks adopt conservative funding models**

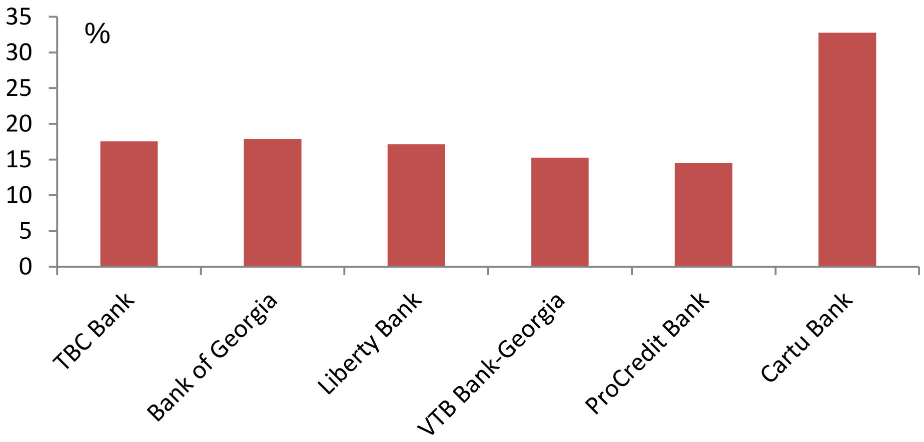
8. Capital

Capital adequacy ratio



*Source: NBG; *including minimum capital requirement of 8% and capital conservation buffer of 2.5%*

CAR as % of risk-weighted assets of individual banks



Source: NBG, Note: Data for 4Q2017 (after regulatory changes by NBG)

Capital adequacy ratio (CAR)

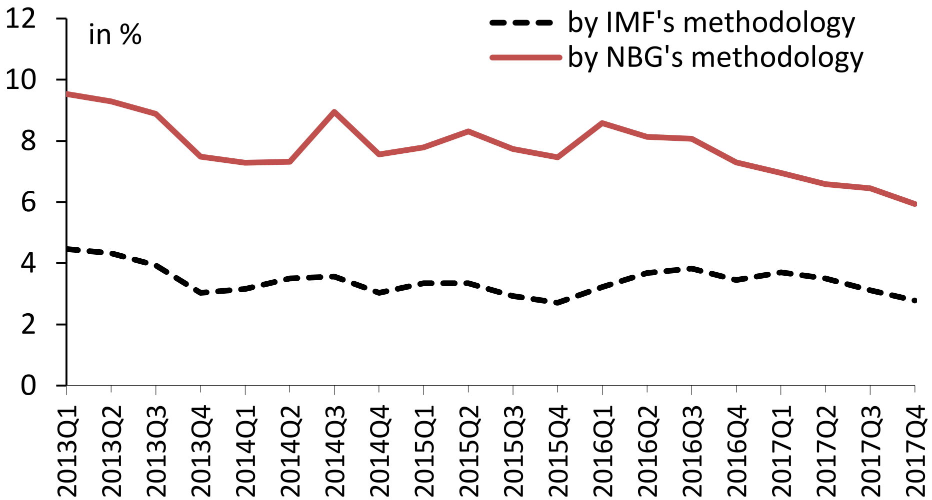
- Regulatory minimum for each bank: 10.5% total CAR (including minimum capital requirement and capital conservation buffer) comfortably met by all banks
- System-wide ratio about 16%
- Demanding risk weights for FX loans
- BoG and TBC as systemic banks also have substantial additional buffers

➢ **The system is well-capitalized**

➢ **Capital buffers should be maintained, given the external risks, and other vulnerabilities**

9. Asset quality and non-performing loans

NPLs as a share of total gross loans



Source: NBG

Non-performing loans (NPLs)

- Long-term decline of NPLs, according to the NBG‘s definition from 9.5% (Q1-2013) to 5.9% (Q4-2017)
- Good provisioning policies by the banks
- Active restructuring efforts of over-indebted companies and a new bankruptcy law should also help
- No major spike in NPLs following the depreciation of GEL in 2015

➢ **Potential risks from rapid growth in retail credit, and FX borrowing, but various NBG safeguards are in place**

IV. Access to credit

10. Credit to the real sector

11. Loan growth

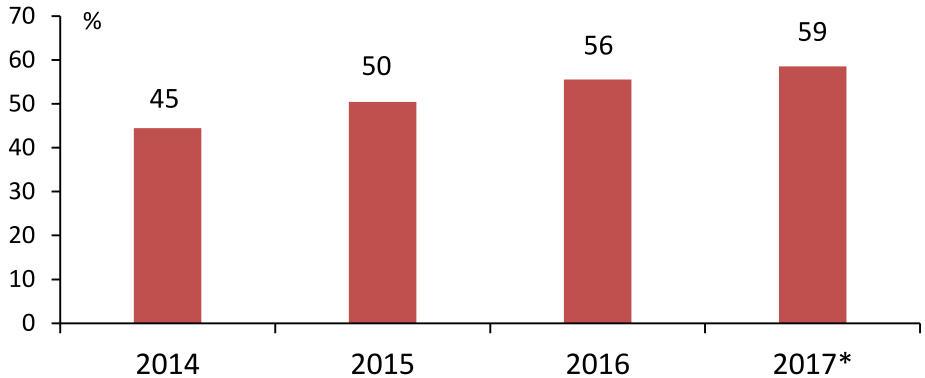
12. Growth dynamics: corporates vs retail

13. SME lending and credit access

14. Interest rates and spreads

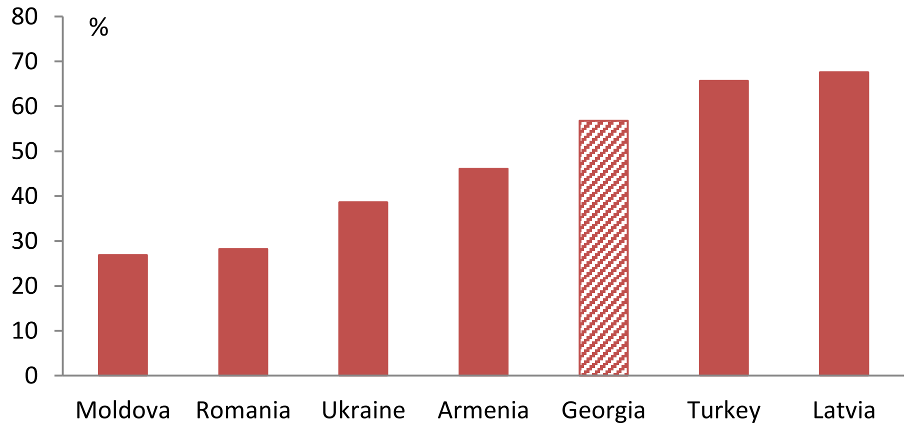
10. Credit to the real (non-financial) sector

Credit to real sector to GDP



*Source: NBG, own calculations; *own estimation, Note: absolute values in GEL bn*

Credit to real sector to GDP: Regional comparison



Source: World Bank, data for 2016

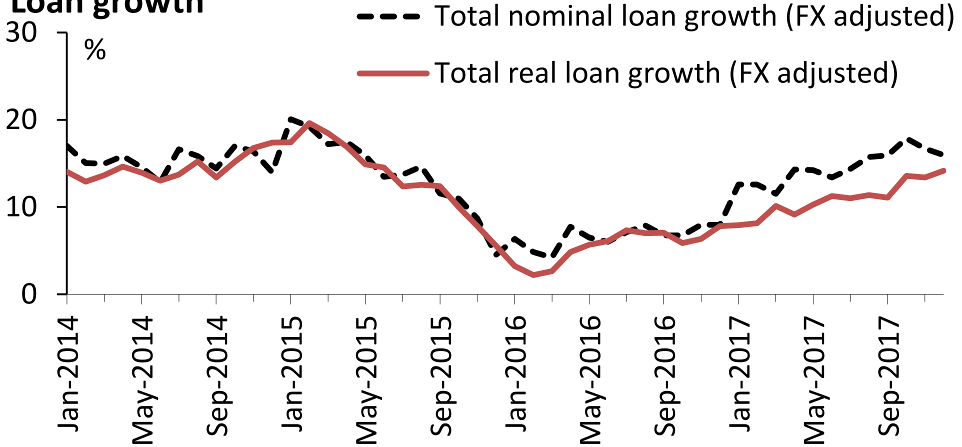
Credit to the real sector

- Credit ratio reasonably high in a regional comparison
- Growth in excess of GDP growth, and accelerated in recent years
- Retail lending is the main driver of loan growth
- Corporate lending constrained by high leverage, and access to external funding by some firms

➢ **Bank lending seems to work well, though cannot entirely make up for absence of capital market instruments**

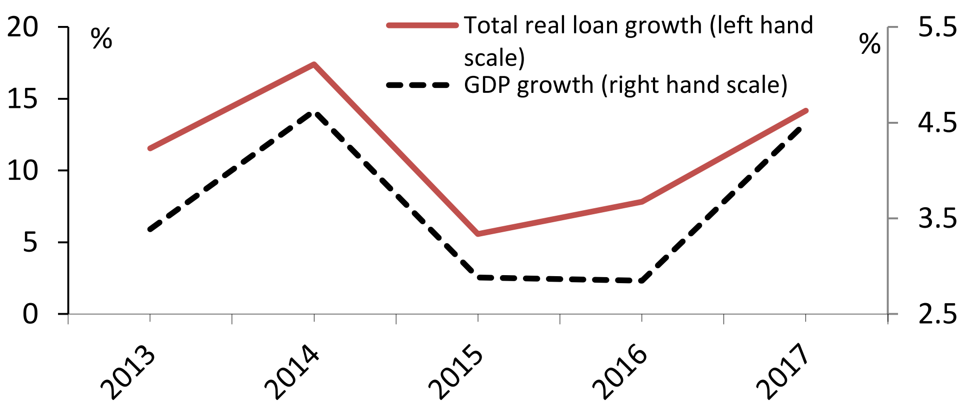
11. Loan growth

Loan growth



Source: NBG, own calculations

GDP growth and loan growth



Source: NBG, own calculations

Loan growth (real & FX adjusted)

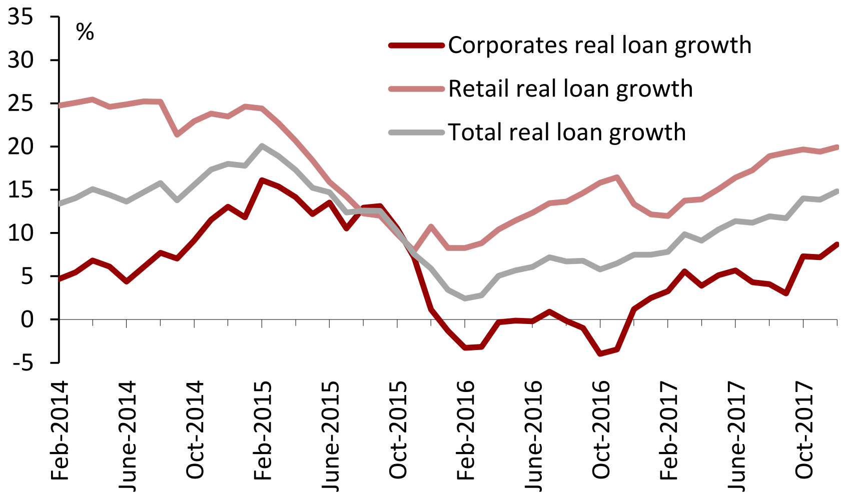
- Loan growth correlated with variation in economic activity, though consistently exceeds it
- Ongoing deepening of credit relative to GDP

➢ **Aggregate demand seems to be the driving force for credit expansion**

➢ **There is no evidence of a credit crunch**

12. Growth dynamics: corporates vs retail

Corporate vs retail loan growth



Source: NBG, own calculations

Structure of loans

% of total loans	2014	2017
Corporate	51.2	45.8
Retail	48.8	54.2

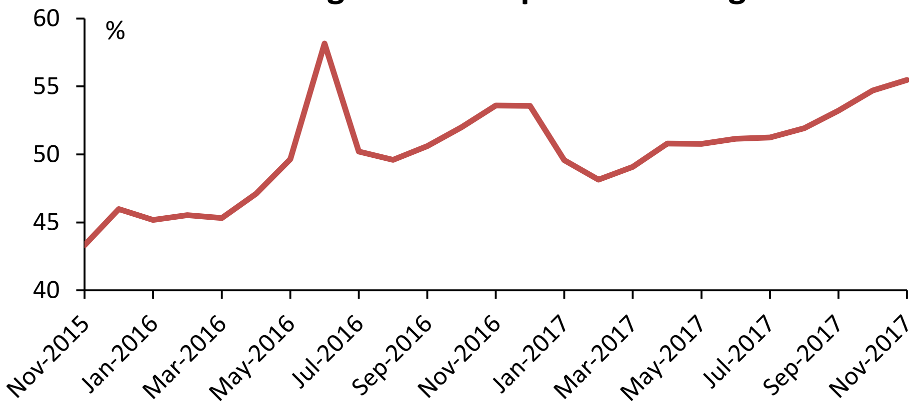
Source: NBG, own calculations, eop

- With 20% increase yoy, retail credit is the driving force of loan growth
- The NBG has addressed emerging risks through a number of measures which complement its de-dollarisation strategy (e.g. limits on loan-to-value ratios)
- Retail credit penetration (about 32% of GDP) relatively high in a regional comparison

➢ **Rapid loan growth is always a concern, though there seem to be various safeguards for sound lending standards**

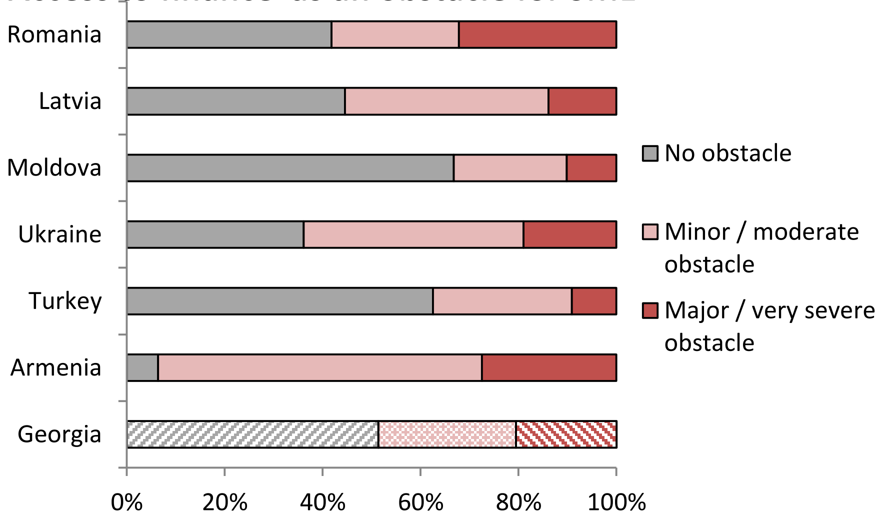
13. SME lending and credit access

Share of SME lending in total corporate lending



Source: NBG

Access to finance as an obstacle for SME



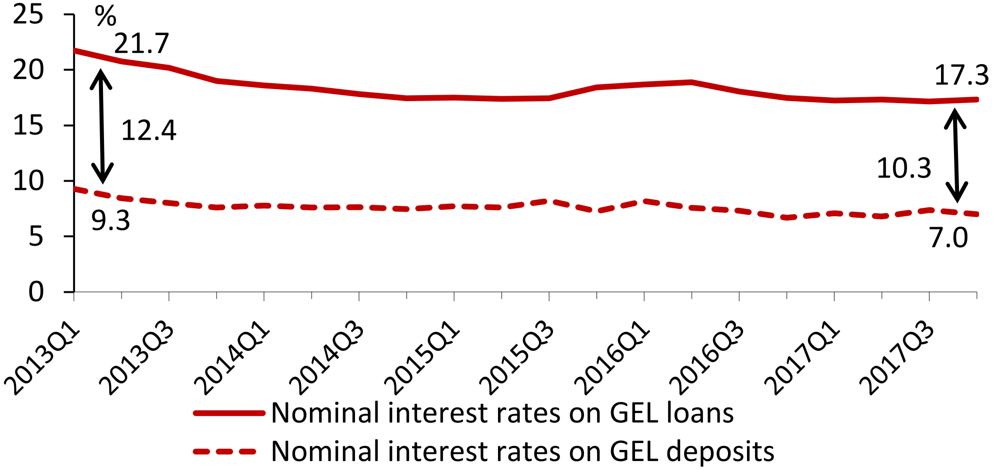
Source: BEEPS survey by EBRD; Question: To what degree is access to finance an obstacle to the current operations of this establishment?

- Access to credit flagged as the third most important obstacle to business in the World Bank/EBRD survey
- But the overall share of SMEs which flag such a constraint does not seem to be out of line compared to other countries
- Share of SME credit slightly increasing over the past 2 years
- Access to credit by individuals also seems to in line with peer group

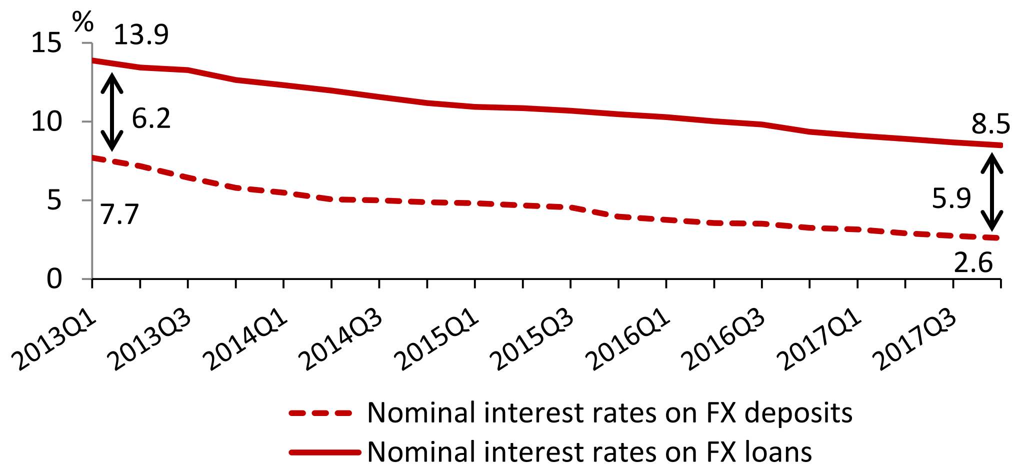
➢ **Low wealth and corporate debt rather than lending policies seem to be the key constraints**

14. Interest rates and spreads

Interest rates on GEL loans and deposits



Interest rates on FX loans and deposits



Source: NBG

- Significant decline in GEL and FX interest rates
- Also reduction in loan-deposit-spreads in both FX and local currency

➢ **Despite high profitability banks seem to pass on improved efficiency to loan pricing**

➢ **GEL rates should converge further with USD rates as GEL stability takes hold**

➢ **For now GEL-USD interest rate spreads are the principal explanation for dollarisation, the key vulnerability**

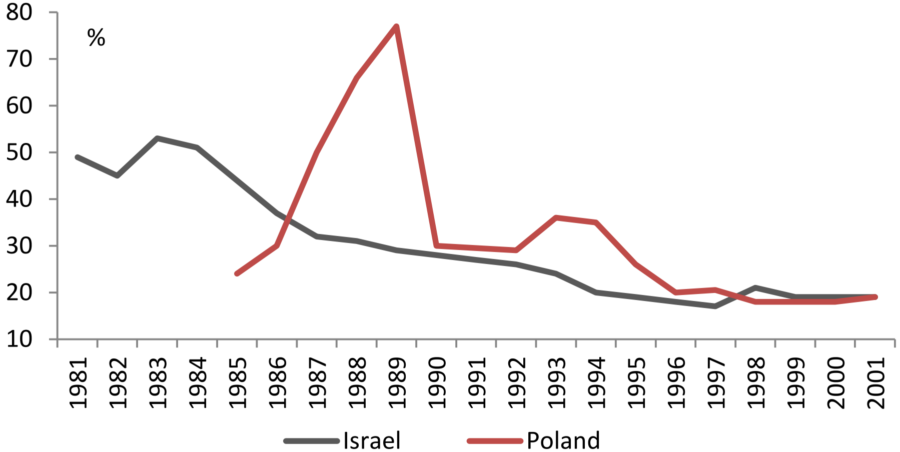
V. Dollarisation and NBG‘s de-dollarisation strategy

15. International experience with de-dollarisation

16. Dollarisation in Georgia: recent developments

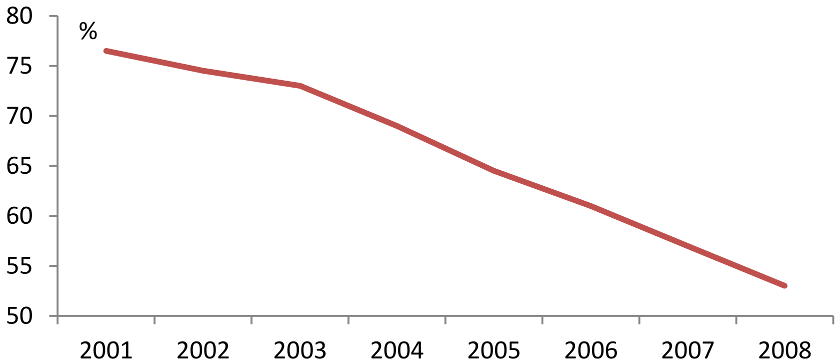
15. International experience with de-dollarisation

Deposit dollarisation ratio in Israel and Poland



Sources: Galindo and Leiderman (2005)

Deposit dollarisation ratio in Peru

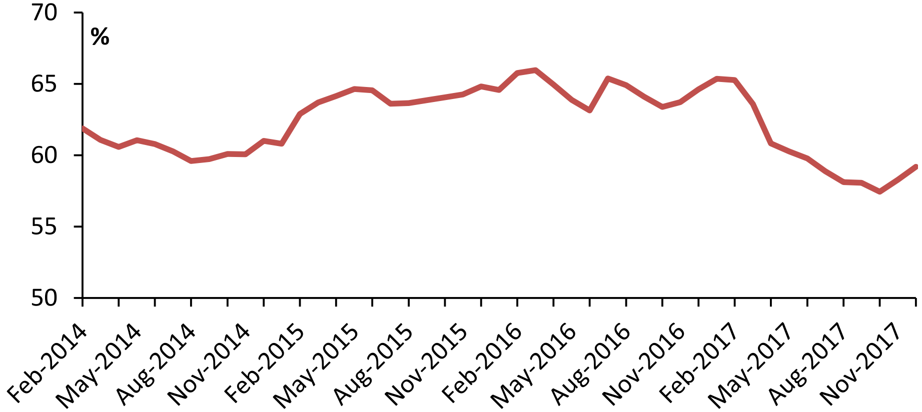


Source: IMF Working Paper 10/169

- High dollarisation ratios raise risks to banks' solvency and financial stability; it may also constrain macro policy (a 'fear of floating')
- Lack of a credible monetary regime and high FX and inflation variability are the root causes of dollarisation
- Experience from other emerging markets is encouraging: inflation targeting and stabilisation and the resulting macroeconomic credibility are the foundations of reducing dollarisation ratios
- Poland, Israel, Peru all managed this process successfully

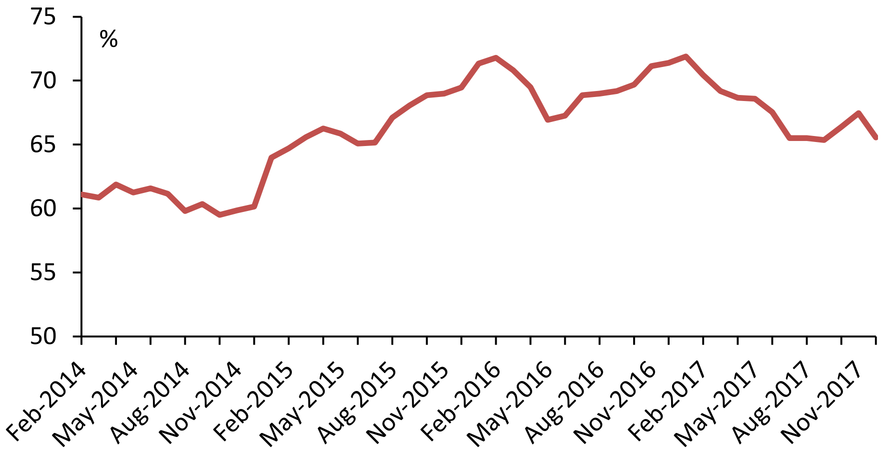
16. Dollarisation in Georgia: Recent developments

Loan dollarisation ratio



Source: NBG, own calculations, excl. interbank deposits

Deposit dollarisation ratio



Source: NBG, excl. interbank deposits

- Significant decline in loan dollarisation in 2017, likely helped by prohibition of FX loans under GEL 100,000
- Also reduction in deposit dollarisation
- However: deposit dollarisation cannot be addressed by administrative measures alone
- Additionally: FX still widely regarded as a sounder store of value

➢ **Some progress in fighting dollarisation in 2017**

VI. Outlook and policy challenges

17. Tackling high dollarisation
18. Capital market development
19. Convergence to the EU regulatory framework

17. Tackling high dollarisation

- Relatively high dollarisation remains the key vulnerability of Georgia‘s financial system
- The key macroeconomic pre-conditions for de-dollarisation are in place
- The recent prudential measures will further help to shift behaviour: higher capital requirements for FX-loans will act as a buffer and reduce risks in the banking sector
- The introduction of inflation-indexed bonds could also help
- As will the development of local currency long term debt instruments

18. Capital market development

- Georgia stands out regionally for underdeveloped bond and equity markets. Larger companies therefore lack long-dated local currency debt instruments, and risk-oriented capital
- Central Europe has demonstrated that both types of security markets can become liquid, even within a small economy
- The emergence of Georgia's pension funds and the growing interest of foreign institutional investors would be supportive
- Regulatory priorities will need to be the concentration of liquidity; enhancing transparency at issuance and once a company is listed; and containing 'self-dealing' or insider dealing

19. Convergence to the EU regulatory framework

- Under its ‘Deep and Comprehensive Free Trade Agreement’ (DCFTA) with the EU Georgia has committed to adopt the entire EU financial framework as it evolves
- This is in Georgia’s own interest, as it imports a credible legal regime that is well recognized internationally
- But EU rules need to be adapted to the local context
  - The deposit insurance fund is a good illustration of reflecting much smaller local thresholds
  - As in all emerging markets, a framework for orderly bank resolution is essential, though mobilizing a potential ‘bail-in’ will depend on credible domestic supervision having been established
  - Many capital market instruments are not yet developed. Present EU rules could overburden the supervisor unnecessarily, and discourage further market development

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