



# GEORGIA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

### TECHNICAL NOTE—SELECTED ISSUES IN BANKING SUPERVISION

September 2021

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## SELECTED ISSUES IN BANKING SUPERVISION

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This Technical Note was prepared by IMF and WB staff in the context of the Financial Sector Assessment Program in Georgia, led by Mustafa Saiyid, IMF and Haocong Ren, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance, Competitiveness, and Innovation Global Practice, World Bank Group. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>, and [www.worldbank.org/fsap](http://www.worldbank.org/fsap).



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## Glossary

BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
CCG	Code on Corporate Governance
CG	Corporate Governance
D-SIB	Domestic systemically important bank
CET1	Common Equity Tier 1
CCB	Capital Conservation Buffer
CICR	Currency Induced Credit Risk
GDP	Gross domestic product
GRAPE	General Risk Assessment Program
FSAP	Financial Sector Assessment Program
HHI	Herfindahl-Hirschman Index
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LACB/ACB Law	Law of Georgia on Activities of Commercial Banks
LCR	Liquidity-Coverage Ratio
MOF	Ministry of Finance
MCM	IMF's Monetary and Capital Markets Department
NBG	National Bank of Georgia
NBG Law	Organic Law of Georgia on the National Bank of Georgia
NSFR	Net Stable Funding Ratio
RRP	Recovery and Resolution Plan
RWA	Risk-weighted assets
SB	Supervisory Board

## EXECUTIVE SUMMARY

**This note was prepared for the 2021 FSAP mission to Georgia and provides recommendations on a select set of banking supervision topics against relevant elements of the Basel Core Principles for Effective Banking Supervision.** The current review focused on implementation and effectiveness of recent changes to the Georgian banking supervisory framework, and included actions being taken or planned to address current challenges facing Georgian authorities.

**The NBG continues to strengthen the effectiveness of its supervision of banks and enhance the breadth and sophistication of its regulatory and supervisory regimes.** It has rapidly implemented an enhanced set of rules and regulations and broadly strengthened the regulatory regime. Capital and liquidity standards are broadly in line with Basel 3 and the supervisory framework is generally consistent with international practices. Changes to rules and supervisory approaches since 2017 exhibit both a commitment to promoting a stable banking system and a good understanding of the key prudential measures that are needed to support this mission. NBG staff is knowledgeable and motivated and has made important strides in advancing the risk-based supervision approach.

**NBG has taken a number of timely actions in response to the COVID-19 pandemic.** It is closely monitoring banks' condition during the pandemic and has exercised discretion and flexibility where necessary. NBG has developed plans to reinstate those pre-COVID requirements that have been relaxed during the pandemic over time, with the starting date for reinstatement still under consideration given uncertainty about the timing and further severity of the pandemic.

**A strong tradition of a compliance-based emphasis in NBG's supervisory approach, combined with broad discretionary powers, provides a solid foundation on which to continue to build out the supervisory framework and 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 individual banks and the banking system more broadly. This is supported by extensive reporting requirements and authority to compel banks to provide any information relevant to the supervisory monitoring and analysis efforts.

**The NBG has made significant progress in building out its banking supervision framework, though further work needs to be done to promote more effective implementation.** NBG will benefit from ongoing efforts to develop and formalize effective supervisory processes, including both internal governance processes related to supervisory assessments, analyses and decision making, as well as further enhancements to its qualitative supervisory assessments of banks' risk management practices and corporate governance.

**NBG should enhance governance and internal procedures for supervisory activities.** The role of the FSSC should be clarified and appropriate delegation of decision-making on supervisory issues to management levels should be considered. To support this evolution, key supervisory processes should be formalized. This should include more formal procedures across the entire supervisory

cycle, from supervision planning to decision-making and communications with banks with respect to supervisory assessments, to follow up on banks' actions to address issues raised.

**NBG's adoption of a new risk-based supervisory framework needs to further evolve and complement its compliance-based approach with more comprehensive, periodic qualitative assessments of banks' internal risk management practices and governance.** Key elements of this evolving approach have been the issuance of the Code of Corporate Governance (2018) and increased supervisory emphasis on governance practices, and the implementation of the GRAPE framework. Processes for promoting timely and effective efforts by banks to address weaknesses in important functions and practices to complement the Pillar 2 add-on approach can be enhanced. A key step in this direction would be an internal assessment and documented determination of what aspects of banks' practices the NBG views as most important. These practices should be subject to periodic reviews with an internally mandated schedule to ensure effective supervisory coverage of practices identified as the most important.

**Qualitative reviews should increase emphasis on assessing the role of supervisory boards and senior management in ensuring appropriate risk and control frameworks, and greater focus on the independence, role and effectiveness of banks' internal audit functions.** A more formal process for communications with banks' boards should be established to ensure they are aware of specific supervisory concerns that must be addressed and understand their responsibility for ensuring that these concerns are addressed effectively and in a timely manner. To support this NBG should require banks to submit formal remediation plans for significant weaknesses identified in supervisory reviews and increase its emphasis on the role of internal audit and audit committees in assessing the adequacy of banks' responses to supervisory concerns and directives.

**The NBG should reassess the weightings in the GRAPE scoring process broadly, and should specifically consider more heavily weighting concentration risk management, liquidity risk management, and board and senior management effectiveness with respect to overall risk management and controls.** The reassessment of the board and senior management weighting should include looking at the relative importance of this factor in those GRAPE elements covering specific risks (e.g., credit, liquidity, etc.) and in the overall corporate governance element.

**For the supervision of DSIBs, greater emphasis should be placed on assessments of the banks' forward-looking processes.** In addition to the NBG's supervisory stress testing, NBG should require these banks to have robust processes that incorporate the potential impact of a stressed operating environment, including for ongoing capital and liquidity planning processes, and greater supervisory attention should be given to assessing the various practices banks have to support such efforts.

**The NBG recognizes challenges in its hiring and retention of qualified professional staff and should emphasize ongoing efforts to address them.** Plans to address human resource challenges are part of NBG's 2020-2022 strategic plan; while NBG's commitment is evident, ensuring continued support to strengthen human resources will be key to the success of this initiative.

**Table 1. Georgia: Summary of Key Recommendations**

<b>Recommendations and Authority Responsible for Implementation</b>		<b>Time<sup>1</sup></b>
1.	Improve and clarify NBG Board operations regarding supervisory activities by clarifying the roles and responsibilities of the board, its committees, and senior management. (NBG/Government; ¶13-18, 22-23)	ST
2.	Address staffing and human resource challenges; continue the compensation review and enhance policies and practices supporting effective hiring and retention. (NBG, ¶19-21)	I
3.	Review and enhance the GRAPE scoring and weighting methodology; (NBG; ¶36, 37, 38, 59, 69, 70, 78, and 92)	I
4.	Enhance the supervisory approach and decision-making--ensure that key supervisory processes (planning, analysis, internal review, supervisory determinations, enforcement, and directives for remediation activities) are well-supported by internal procedures and policies. (NBG; ¶39-41, 68).	I
5.	Establish a formal structure for communication with banks' supervisory boards and senior management, including annual meetings, and upgrade the quality and effectiveness of GRAPE letters in communicating supervisory findings and directives to banks' supervisory boards and senior management. (NBG; ¶42, 45, 46, 60).	ST
6.	Require banks to develop formal remediation plans to address important supervisory concerns. (NBG; ¶47-48, 50-51).	ST
7.	Enhance expectations from internal audit for assessment and validation of remediation actions taken by banks in response to significant supervisory concerns. (NBG; ¶49, 61).	ST
8.	Conduct internal review to determine the relative importance of specific practices and functions in banks' key risk management and control frameworks; and carry out in-depth qualitative assessments covering these functions and practices on a periodic basis. (NBG; ¶38, 63, 64)	ST
9.	Further clarify standards to require that material changes in the suitability of significant shareholders or controlling interests, including beneficial owners, are reported in a timely fashion. (NBG; ¶55).	MT
10.	Increase emphasis on D-SIBs' internal capital and liquidity planning and management; strengthen requirements for stress testing in such planning and consider making the Net Stress Buffer a hard Pillar 2 requirement for D-SIBs. (NBG; ¶65, 66, 87, 93)	ST
<sup>1</sup> Timing: I; immediate (< 1 year); ST; short term (1–3 years); MT: medium term (3–5 years)		

# INTRODUCTION

## A. Scope and Approach

**1. This Note was prepared in the context of the FSAP virtual mission to Georgia from January 25 to February 16, 2021.**<sup>1</sup> The Note provides findings and recommendations on a select set of banking supervision topics against certain elements of the Basel Core Principles for Effective Banking Supervision (BCP) as outlined below. The last FSAP for Georgia was conducted in 2014 and the detailed assessment published in January 2015<sup>2</sup>. Since 2015, the authorities have made significant progress in implementing recommendations pursuing legal and regulatory reforms in the banking sector.

**2. The scope of the 2021 review included an assessment of the authorities' response to the 2015 FSAP recommendations, and reviewed the status of key reforms, and the effectiveness of their implementation.** The review focused upon the implementation and effectiveness of recent changes to the Georgian supervisory framework, and included actions being taken or planned to address current challenges facing Georgian authorities given the stresses presented by the COVID-19 global pandemic. The review was not intended to result in an assessment of the BCPs.

**3. The review focused on a select set of banking supervision topics of current relevance to bank supervision in Georgia.** The issues reviewed focus on selected areas of key BCPs that are pertinent to current developments in the Georgian bank regulatory and supervisory framework. The areas reviewed pertain to:

- Operational independence, resourcing and legal protection;
- Licensing and transfer of significant ownership;
- Supervisory approach, techniques and tools, corrective actions, and supervisory reporting;
- Supervisory oversight of banks' corporate governance and risk management, in relation to credit and concentration risk (large exposures); and,
- Capital adequacy and liquidity framework.

**4. To support this note, the NBG updated and provided a partial self-assessment of the BCPs and provided answers to a detailed questionnaire on specific qualitative and quantitative topics.** The mission had access to supervisory documents and files and held extensive meetings with NBG staff and management. The mission also met an auditing firm and banking sector participants.

**5. The mission enjoyed full cooperation from the authorities.** The review took place during the global pandemic and resulting restrictions required the assessment to be conducted remotely.

<sup>1</sup> This note was prepared by Tim P. Clark, external expert at the IMF's Monetary and Capital Markets Department and Keith A. Ligon, external expert the World Bank Group's Finance, Competitiveness, and Innovation Global Practice.

<sup>2</sup> See, *The Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision* (January 2015) at <https://www.imf.org/external/pubs/ft/scr/2015/cr1510.pdf>



The reviewers wish to acknowledge the time and effort extended by NBG staff and thank them for their cooperation and assistance. We also thank other parties for their time and insights.

## B. Institutional Framework

**6. NBG is the main financial supervisor in Georgia, with broad authority over commercial banks, capital markets, and other financial services providers and intermediaries.** NBG has authority over a broad spectrum of participants in the Georgian financial system. The Law on the Activities of Commercial Banks (ACB Law) was adopted in 1996, but after fundamental changes in 2009 the supervision of the broader financial sector (not insurance) was entrusted to the NBG.<sup>3</sup> Of relevance to this Note, the NBG is the sole authority responsible for the supervision of commercial banks. (See, the Organic Law on the National Bank of Georgia which defines NBG's functions, tasks, responsibilities, and objectives (NBG Law)).

**7. NBG's operational independence as a supervisory authority over commercial banks is well established.** As prescribed by the Constitution of Georgia (Article 68), "...the National Bank of Georgia shall be independent in its activities. The Organic Law shall determine the rights and duties, the procedure of activities, and shall guarantee independence of the National Bank." NBG's operational independence is supported by structural features that provide NBG adequate budgetary resources, sets clear processes for appointment and removal of board members, and establishes full discretion to take supervisory actions on banks and banking groups under its supervision, among other factors. Georgian authorities have been updating the regulatory framework since the past FSAP that serve to strengthen NBG's supervisory powers. While the concentrated nature of the Georgian banking system and the related commercial, non-financial groups in which they operate result in concentrated economic power, this has not resulted in any apparent impairment of the operational independence of NBG.

## C. Banking Sector Structure

**8. The financial sector of Georgia is bank-centric and characterized by high concentration.** The banking sector accounts for over 90 percent of total financial institution assets in Georgia. There are 15 commercial banks; the majority of which are foreign-owned. There are no state-owned banks. The two largest banks account for 74 percent of total banking assets and several control non-bank financial institutions. Some banks are also affiliated with non-financial companies in a wide range of industries (e.g., real estate, healthcare, water utility, beverage, renewable energy, etc.) The three largest banks are identified as domestic systemically important banks (D-SIBs) by the NBG.<sup>4</sup>

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<sup>3</sup> The National Bank of Georgia has the authority to supervise following participants of capital markets: brokerage firms (except for the insurance brokerages), the Georgia Stock Exchange, central depository, specialized depository, asset management companies, accountable entities, and investment funds. NBG also supervises non-banking institutions including micro-finance organizations, loan issuing entities, credit unions, and currency exchange bureaus. The State Insurance Supervision Agency of Georgia supervises and oversees the insurance sector. It should be noted that there are no state-owned banks in Georgia; state ownership is prohibited. This Note focuses strictly upon the regulated commercial banking sector.

<sup>4</sup> Two Georgian D-SIBs banks are listed on the London Stock Exchange. The third D-SIB has a non-resident holding company with non-resident ultimate beneficial owners. Foreign subsidiaries of these D-SIBs are not material.

**9. Georgian banks present a traditional banking model, with lending activities supported by deposits and an absence of complex trading or derivatives activities.** Loan portfolios are roughly split between retail (22.8 percent mortgage, 12.9 percent consumer credit, and 14.7 percent other retail) and corporate portfolios. Of corporate loans, 25.7 percent are trade, with the balance across other corporate sectors. Non-bank deposits are the dominant source of funding (33.6 billion GEL of 50.2 billion GEL total liabilities) The ratio of loans to deposits is reported at 111 percent. (Data as of November 2020, See NBG Financial Sector Review, January 2021)

#### Box 1. NBG Response to the COVID Pandemic

In response to the COVID-19 pandemic, NBG took a variety of actions to respond to risks presented by Georgian banks and maintain the operational continuity of bank supervisory activities. With respect to bank supervision policy and oversight<sup>1</sup>, several key actions were taken, these included, inter alia:

- Release of certain capital and liquidity requirements (elimination of the capital conservation buffer and two-thirds of the Pillar 2 currency-induced credit risk buffer; temporary relief from local currency LCR). NBG prohibited the use of released capital for dividends, share buybacks, equity investments, increasing variable remuneration for management or other types of distributions and payments.
- At the onset of the pandemic, required that banks establish loan loss provisions adequate to address potential COVID-19-related losses based upon supervisory stress tests.
- Issued guidance on provisioning for loans subject to moratoria on payments. See discussion at TN para. 71.
- Established enhanced liquidity reporting and monitoring.
- Oversaw the conduct of asset quality reviews at banks.
- Postponed or re-scheduled the issuance or enforcement of certain new regulatory actions.
- Temporarily suspended the conduct of on-site examinations, and off-site and virtual examinations were emphasized.
- Developed a capital restoration plan that defines the strategy to restore released capital requirements. (For further discussion of current post-COVID-19 restoration planning, see discussion in the Capital and Liquidity Frameworks at Section I.)

<sup>1</sup>NBG, in coordination with the Ministry of Finance, took additional significant actions to support GEL liquidity, enable commercial banks to receive liquidity support from NBG, and address impacts to the broader economy, such as support facilities for SME and micro-financial entities, that are not described here.

**10. Despite significant efforts and some progress in reducing dollarization, it remains a key structural feature of the financial system.** The government and the NBG adopted a 10-point dollarization plan at the end of 2016 to limit the financial stability risks associated with high dollarization. Dollarization of liabilities and loans in the banking sector remain at high levels of 61.4 percent and 55.6 percent, respectively, as of end-2020, despite modest decline from 70.7 percent and 65.4 percent, respectively, at the end of 2016. Banks hedge their foreign currency exposure by managing balance sheet structure (rather than hedging instruments). Their credit exposure to unhedged borrowers is high, raising concerns over currency induced credit risks. NBG applies various

supervisory tools to address risks presented by banks due to foreign currency imbalances and volatility (e.g., a currency-induced credit risk buffer).

**11. Banks entered the ongoing Covid-19 crisis with comfortable capital and liquidity buffers, though profitability was severely reduced and asset quality weakened due to implications of the pandemic on banks' loan portfolios.** Banks' capital ratios strengthened in the years leading to the pandemic even as banks' risk-weighted assets increased considerably. Following COVID-related developments, banks' CAR ratios fell by 1.9 ppt during 2020 to 17.6 percent (Tier 1 ratio of 12.8 percent) against bank-specific capital requirements, amounting to 13.8 percent on total regulatory capital for the overall system (after the pandemic-related reduction in the capital conservation and pillar 2 buffers). Banks' liquidity has remained in compliance with standard Basel metrics including the total liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) during the pandemic, due to policy actions taken by the authorities. However, asset quality has weakened sharply, with the NPL ratio reaching 8.4 percent by end-2020 compared with 4.4 percent at end-2019.

**12. NBG has responded to the COVID-19 pandemic.** Starting in March 2020, NBG has taken multiple actions within its supervisory authority targeted to address financial and operational stresses faced by the banking sector due to COVID-19. It has taken a balanced approach consistent with maintaining the ongoing safety and soundness of its supervised institutions. In its response, NBG has demonstrated flexibility in the application of existing capital and prudential regulations and has pending the issuance of new regulations. An exit strategy for released capital and other requirements has been developed. See Box 1 for a compilation of key supervisory actions taken to address the pandemic crisis.

## MAIN FINDINGS AND RECOMMENDATIONS

### A. The Framework for Banking Supervision

**13. Overall, the mission has found that NBG is an effective supervisor with experienced and knowledgeable staff dedicated to the safe and sound operation of Georgian commercial banks.** NBG has made significant and material progress towards updating its supervisory framework, adopting multiple amendments to the ACB Law and the NBG Law in 2017 and 2019 in response to recommendations made in the prior FSAP. NBG is clearly dedicated to incorporating international standards and guidance into its supervisory framework. It has been successful in moving forward multiple key improvements to its governing laws and supervisory regulations. A key challenge being faced by the NBG and its supervised banks is the need to absorb and implement the many changes adopted. The scope and breadth of these recent, necessary, and valuable changes is impressive and meaningful. Overall, NBG is facing this challenge successfully. See Box 2, below and Appendix 1.

#### NBG Board Supervisory Functions and Operations

**14. NBG should continue to ensure that promoting the safety and soundness of banks and the banking system remains one of its primary objectives along with price stability.**

- NBG, as with many other central banks, possesses a dual mandate to ensure both price stability and financial stability. This dual mandate is stipulated in the constitution even though the NBG law puts price stability as the NBG’s main objective.<sup>5</sup> The latter has not actually constrained the NBG from thoroughly focusing on safeguarding financial system stability through its various actions, decisions, and activities. Nevertheless, conflicts between these objectives could conceivably arise in the future; a risk that is not inconsequential given the highly dollarized Georgian economy.
- The operational independence and autonomy of the bank supervisory function is essential and should be supported by the legal and operational framework. NBG presently assigns the financial stability mandate to a single Vice-Governor and has established a Financial Stability Committee and amended the ACB Law to reinforce its focus on bank supervisory issues.
- This note acknowledges these improvements and recommends that the internal governance and operations of NBG’s bank supervisory function could be improved in various respects. These structural improvements should incorporate protections that address the potential tension arising from NBG’s dual mandate. See paras. 16-19, below. In addition, the authorities should consider raising the importance of the NBG’s financial stability objective to equal that of price stability as part of any future planned amendments to the NBG Organic Law in the long-term.

**15. NBG Law clearly establishes the National Bank of Georgia as the sole authority responsible for the supervision of commercial banks.** Amendments were successfully adopted clarifying that the objectives and functions of the NBG include power to set and enforce minimum prudential standards for bank and banking groups (See, Articles 48, 49(1) of the NBG Law). Further, the ACB Law provides powers to impose supervisory measures and sanctions for a broad range of supervisory issues, including engaging in unsafe and unsound banking practices. NBG staff advises that it has not experienced any impediment to its oversight and enforcement of the safety and soundness of the financial sector on grounds of conflict with the objective of seeking price stability. The current assessment continues to find no evidence that NBG’s dual mandate has adversely impacted its ability to carry out its supervisory function.

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<sup>5</sup> Article 68(1) of the Constitution of Georgia, provides: “The National Bank of Georgia shall conduct monetary policy to ensure price stability and maintain the stable operation of the financial sector.” Article 3 of the NBG Law, in setting out the objectives of the National Bank, provides: “The main objective of the National Bank shall be to ensure price stability.” Article 3 also provides that the “National Bank shall ensure stability and transparency of the financial system...”

## Box 2. Overview of Recent Amendments and Changes to Banking Laws and Regulations

Major amendments have been made to Georgian banking laws and implementing regulations. The Law on Activities of Commercial Banks and Organic Law on the National Bank of Georgia was amended in 2017 and in 2019. Additional changes were adopted through 2020. Key changes to these laws and regulations effected material amendments and updates across a broad range of supervisory areas, including, inter alia:

- Regulation on the Management of Conflicts of Interest (2015)
- Banking Licensing and Transfer of Significant Ownership (2017).
- Investments and Group structure related requirements – (2017)
- NBG empowered to supervise banking groups (2017)
- Amendments to equip NBG with resolution powers and set out a preliminary basis for the recovery and resolution framework (2020)
- “Capital Adequacy Requirements for Commercial Banks” regulation (2017). Major additional changes in the regulation were made, include the establishment of a conservational capital buffer, countercyclical capital buffer and systemic buffer.
- “Identification of Systematically Important Banks and Determining Systemic Buffers” (2017)
- “Rule on Additional Capital Buffer Requirements for Commercial Banks within Pillar 2” (2017). This rule established various buffer requirements (including the CICR Buffer - an unhedged currency induced credit risk buffer, the Credit Portfolio Concentration Risk (Name and Sectoral concentration) Buffer and GRAPE (General Risk Assessment Program) Buffer). Further, a Net Stress Test Buffer, determined through supervisory stress tests, was implemented. [For the purpose of complying with these requirements commercial banks have been given appropriate timeframes (5 years phase-in period, which have been postponed by additional one year due to COVID-19)]
- “Regulation on Disclosure Requirements for Commercial Banks within Pillar 3” (2017)
- Liquidity Coverage Ratio (LCR) (2017)
- Net Stable Funding Ratio (NSFR) (2019)
- “Leverage Ratio Requirements for Commercial Banks” (2018)
- “Regulation on Large Exposure and Concentration Risks in Commercial Banks” (2020) (enforcement suspended until 2022 due to supervisory actions taken in response to COVID-19)
- “Corporate Governance Code for Commercial Banks” (2018)
- “Code of Ethics and Professional Standards” (2018)
- “Law Defining Minimum Capital Requirements for Commercial Banks” that first came into force on 23 May 2006 (Decree N144) (2017)
- “Regulation on Interest Rate Risk in the Banking Book (IRRBB)” (2020)
- “Instructions on Real Estate Appraisal for Commercial Banks” (2018)

**16. NBG should seek to promptly fill open vacancies on its board.** The NBG law (Article 7) was amended in June of 2020 expanding the Board to nine members (from seven). Under the law, should the number of its members be less than 5, the Board is not authorized to perform its duties. In such case, NBG Law provides that vacancies should be filled within two months. Under the

amendments, a transitional period was set until the end of 2020 permitting the Board to perform its duties with the composition of at least 4 members. At present, there are five board members leaving four vacancies. Also, under the recent changes, three Vice-Governor positions are established; and, at present, the third Vice-Governor position is not filled. Recognizing that NBG board members are subject to a nomination and confirmation process outside of NBG's control, NBG should seek to promptly fill all vacancies on its Board.

**17. NBG should develop and issue clear delegations of authority to department heads from the Vice-Governor.** A Vice-Governor is responsible for all the NBG's supervisory functions, across all sectors, and extends to resolution functions. This broad range of responsibilities calls for effective delegation to staff to enhance supervisory decision-making. The heads of the various supervisory departments report to the Vice-Governor (these departments are: Banking Supervision, Specialized Risks, Supervisory Policy, Non-banking Institutions Supervision, Financial and Supervisory Technologies Development, and Resolution and Liquidation Division). Supervisory decisions within NBG do not appear impaired by the current structure; however, clear, explicit, written delegations of authority that fully describe what supervisory actions and decisions are permitted to be taken by the department heads or other supervisory staff should be developed. Such delegations would support NBG taking supervisory decisions at the level appropriate to the significance of the issue and support more efficient and timely decisions.

**18. NBG should review the charter and operations of the Financial Sector Supervision Committee with a view toward clarifying its role in the supervisory process.** Under the authority provided in NBG Law, two committees have been established relating to the supervisory process; these are the Financial Stability Committee and the Financial Sector Supervision Committee (FSSC). The functioning of the committees is established by the decrees (or charters) set by the Governor of NBG. NBG staff advise that these committees are consultative or advising bodies only; that recommendations are made to the Governor who authorizes any legal acts. The Governor chairs both committees and their membership are essentially identical. The charter of the FSSC indicates that it is primarily a body intended to discuss policy development ("... support supervision of the activities of the financial sector and the development and implementation of the regulatory policy.") The charter does not plainly reflect that supervisory issues or enforcement issues fall within the powers assigned to the Committee (or which supervisory issues fall within its jurisdiction). However, minutes of the Committee reflect that significant enforcement actions (e.g., revocation of bank licenses) are brought to the Committee. A review of the charter and clarifying its role and authority related to the supervisory process could render its operations more transparent and efficient.

**19. NBG should continue to fulfill its 2020-2022 supervisory strategic plan to enhance internal governance and operations.** NBG Supervisory Strategy (2020-2022) indicates a commitment to "strengthening the leadership culture through the increase of duties and responsibilities of the employees", and "promotion of cooperation and information sharing culture," as well as the "promotion of working groups and joint decision-making in response to the challenges identified in the process of supervision." The strategic plan also seeks the "maximum increase of the role, responsibilities and accountability of the supervisor in the process of communication with the

regulated entity, including with the senior management.” These goals would be supported by a review of delegations of authority and the clarification of board-level committee authority and operations, among other actions.

### **Staff Compensation and Retention; Training Programs; Legal Protections for Staff**

**20. NBG should continue to address staffing and human resource challenges in the supervision departments that can negatively impact the effectiveness of bank supervision.** A critical finding issued during the 2014 FSAP assessment relates to the inadequacy of resources for the conduct of effective supervision and oversight (See, BCP 2, EC 5). These concerns were rooted in the recognized remuneration gap between NBG supervisory staff, specialists and managers and similar opportunities in the private sector which resulted in challenges to hire and retain qualified personnel. In 2017, NBG raised management salaries by 25 percent and non-managerial positions by 20 percent and it has raised salaries by 3% in order to align with inflation. A performance management system was implemented that addressed the bonus and promotion system. Remuneration to employees includes health insurance and other benefits. Still, retention and hiring to reduce vacancies in skilled positions remain an ongoing concern.

**21. NBG should continue to conduct regular reviews of its hiring, retention and compensation practices to ensure that policies and practices supporting effective hiring and retention continue to be pursued.** NBG staff reports that there remains a salary gap between the ‘average supervisor’ and the ‘average banker’ and the salary gap is ‘much higher’ for managerial positions<sup>6</sup>. To identify and respond to this gap, NBG commenced a Job Evaluation Project in 2019 that identified the discrepancy in compensation levels, but the project is presently halted due to the pandemic. NBG staff reports that vacant positions have been open for several years, due to an inability to attract needed talent, particularly in specialty areas. Turnover rates, felt to be related to the salary gap, remain a concern and the ability to recruit and hire new employees has not fully kept pace with departures (e.g., staff losses have resulted in a net decline of 3 positions out of 26 in the Banking Supervision Department over the past 3 years; turnover rates are 9% and 8% for 2019 and 2020, respectively.). These gaps are not extreme on their face, and overall staffing levels are adequate (NBG maintains 66 staff to address 15 supervised banks). Nevertheless, vacancies at key specialist positions and loss of senior supervisory staff members can impact the effectiveness of a small organization. NBG should regularly review hiring, retention and compensation practices. The NBG Supervisory Strategy (2020-2022) provides that acquiring and maintaining talent is a strategic priority and advances the development of a recruitment program, to ensure “professional satisfaction” and increasing opportunities for educational programs. Understanding that the pressures of the current pandemic present challenges, NBG should advance efforts as early as practicable.

**22. Training programs are not fully structured and could bear improvement but are broadly appropriate to NBG’s mission and supervisory staff levels.** A new system of staff evaluation was implemented in 2018 and periodic training programs are conducted. Training

<sup>6</sup> NBG analysis shows a –48% to –126% gap for middle management and a –75% to +13% gap for non-managerial positions, on average. This excludes any share-based compensation for private sector employees.

materials are somewhat cursory and lean heavily upon a compilation of international standards and Georgian banking legislation and regulations. Staff is given access to FSI Connect, an online training resource which provides a deep and broad-based training resource. Specialty training and career path or development training is not fully developed. Staff is provided tuition support to obtain relevant industry certifications; yet, there is no examiner training program across a determined set of knowledge, skills, and abilities and that leads towards an internal certification. The lack of an examination manual and formal examination procedures is noted, and the GRAPE guidelines do fill this gap to an extent. Improvements in training programs scope and quality would benefit NBG supervisory staff; high-quality training and a certification program could enhance employee retention.

## Public Consultation

**23. Legislative changes have been enacted and NBG has adopted practices that enhance the public consultation process; NBG is encouraged to continue efforts to improve transparency of the rulemaking process and the effectiveness of the consultation process.** In response to a prior FSAP recommendation, the NBG Law was amended to authorize NBG "...to publish drafts of normative acts related to financial sector for the purpose of obtaining comments from stakeholders prior to their approval." Normative acts that are considered "essential" for resolution or financial stability concerns and should come into force "immediately" were excluded from this authority. (NBG Law, Article 48, Section 13) However, the legislative change only authorizes NBG to consult publicly, and does not statutorily oblige NBG to do so, as was recommended in the 2014 FSAP. Nevertheless, the NBG has since the effective date of the law in 2018 consulted on most major normative acts and legal acts are generally accompanied by an explanatory note that provides information on the underlying rationale, expected outcomes and other aspects of the proposed amendment. As recommended in the prior FSAP, it would be preferable to adopt legal requirements that clearly establish the essential elements of due process in the establishment of normative acts. These elements would firmly establish due process elements such as notice and opportunity to be heard, and publication requirements. While discussions regarding proposed regulations are conducted with industry, including the Georgia Banker's Association, it would enhance transparency and ensure full consideration of comments by requiring that comments received and NBG's consideration thereof be published.

## B. Supervisory Approach, Techniques and Tools, Supervisory Reporting

**24. The NBG supervisory framework continues to evolve from a rules-based monitoring and analysis approach to more risk-based supervision, with an increasing emphasis on qualitative assessment of banks' practices.** The scope of the review extended to certain key aspects of NBG's supervisory approach, techniques and tools, and reporting. The primary focus of the review was on the implementation of the recently adopted supervisory framework, the General Risk Assessment Program. This new supervisory framework was adopted in 2017 and represents significant change from a rules-based approach to a risk-based supervisory approach.



## NBG's Risk-Based Supervisory Approach

**25. The General Risk Assessment Program (GRAPE) adopted in 2017 stands at the center of the NBG supervisory process; it supports issuance of a Pillar 2 capital charge – the net GRAPE buffer – based on qualitative assessments of banks' risk management, group structure and corporate governance.** In 2017, the NBG implemented the new supervision framework as published in the guideline on "Risk-Based Supervision Framework of the National Bank of Georgia – General Risk Assessment Program (GRAPE)". GRAPE guidelines set out NBG's supervisory approach to oversight of commercial banks. As provided in the GRAPE guidelines, NBG pursues a "continuous cycle of risk-based supervision" that develops a supervisory plan rooted in the GRAPE risk assessment. Supervisory activities are conducted throughout the year, and the cycle is finalized at the end of each year by grading GRAPE risk categories and translating those scores into the net GRAPE buffer, which is applied as part of a Pillar 2 capital surcharge.

**26. GRAPE establishes NBG's supervisory principles and approach and is the core of NBG's supervisory framework.** The assessment of banks' risk profile, the prioritization of higher risk banks, the level of supervisory attention, the supervisory actions determined, and their follow up are encompassed within GRAPE. GRAPE seeks to follow these set of principles:

- Concentration on material risks;
- Forward-looking approach and early interventions;
- Dialogue with regulated financial institutions;
- Taking account of systemic issues;
- Consistency, comparability and compliance;
- Efficient use of internal resources.

Under GRAPE, NBG seeks to assess the potential impact and risks presented by each commercial bank and establishes risk assessment criteria across the various risk areas. Several Georgian banks present complexities associated with their affiliations within group structures. Under GRAPE, these complexities are considered when assigning a systemic risk designation, and when assessing banks' operational risk and corporate governance.

**27. Factors to be considered in the conduct of supervisory reviews across risk areas are discussed in the published GRAPE guidelines; but the guidelines do not represent an examination manual or set of procedures.** NBG has determined to not establish an examination manual, instead relying on providing supervisory staff access to legislation and regulations, international standards and guidance, and examination modules from other jurisdictions to inform the examination process. Revisions and planned updates to GRAPE, discussed below, will support further delineation of examination processes.

**28. The setting and application of the net GRAPE buffer is a key supervisory tool.** Risk assessment under GRAPE applies a scoring system and involves evaluation and inherent risks and their mitigants (supervisory board, management board, risks management and internal control mechanisms) in each risk category, with mitigants being netted against the inherent risk for a net score. Each main GRAPE category is assigned a risk weight, and these sum up to 100 percent.

**29. NBG determines each bank's net GRAPE score and based on this score establishes a net GRAPE buffer as a part of Pillar 2.** The net GRAPE score is translated into the GRAPE buffer using a predetermined formula, which generally weights each net risk category the same for all banks. NBG has the authority to adjust these weights on a bank-by-bank basis but has not yet done so in practice. The score and relevant buffer requirement for each bank are reassessed annually. Under the current GRAPE methodology, risk weights for each of the major categories have been disclosed to banks. The weightings for the sub-factors within each major category are appropriately not provided to the banks, supporting the use of supervisory discretion in determining the specific importance of various factors in a bank-specific context.

**30. Annual GRAPE letters sent to each bank represent the culmination of the supervisory cycle.** At the conclusion of the GRAPE process, a formal letter is sent to the bank's executive management and copied to its supervisory board. The substance of the letters is discussed in greater detail with senior management. In the GRAPE letters, banks are provided a broad description of the key supervisory findings that determined the score. The process followed to issue, monitor, and resolve supervisory findings or directives is discussed in Section F below on Corrective Actions.

**31. Regulatory and supervisory reports required from banks are comprehensive and numerous; reporting forms and processes are being currently adapted to accommodate changes to IFRS reporting.** Supporting the GRAPE process is an extensive set of required supervisory reporting that informs the risk assessment process, and which can point to weak practices at banks when reports are inaccurate or show a failure to adhere to regulatory requirements. Supervisory reports are received across a wide range of risk and operational areas. NBG requires regular reports on organizational structure, financial condition, prudential ratios, LCR, funding, NSFR, loan rejections, top 100 loans, loan concentrations, sectoral risks, related party transactions, and other regular and ad hoc reports. NBG validates the information received by conducting reviews of bank reporting processes during operational risk examinations using automated and manual processes, including staff-level cross-checks of data validity through reconciliation to underlying files. As part of its rollout of consolidated supervision guidelines, NBG is transitioning supervisory reporting to coordinate with IFRS reporting.

**32. NBG's supervisory approach envisions frequent and often verbal or email communication with bank staff, business line and senior management in a process of "continuous supervision."** A key feature of the NBG supervisory approach is to communicate with supervised banks daily and engage in what NBG identifies as a practice of "continuous supervision." Regarding supervisory issues or concerns, communication with the bank can be initiated at the various levels of NBG management and at either the NBG supervisory staff or risk and policy specialist level, on an on-going basis. The main responsibility for communicating with the bank and

addressing supervisory recommendations is on the employee who carried out the review of the issue. Meetings with bank line managers, risk managers, or senior management (as needed) are held (currently meetings are held virtually, though face-to-face meetings were common pre-COVID-19). Communications are often made over-the-phone or through e-mail correspondence, less frequently by letter, and are performed “on a very frequent basis.”

**33. NBG conducts both on- and off-site examinations; though on-site examinations have largely been suspended during the COVID-19 pandemic.** As part of its continuous supervision approach, NBG conducts off-site analysis and frequent interaction with banks supplemented by on-site inspections. On-site inspections are more rigorous for D-SIBs, reflecting a risk-based approach towards defining the resources allocated and intensity of the review. Targeted and unscheduled examinations have been employed. Supervisors are not separated into on- or off-site examination units; all work is coordinated within a single organizational unit assigned the particular bank. NBG does allocate more of its resources to off-site supervision, generally (e.g., 9 on-site examinations were conducted in 2019 vs. 47 off-site examinations). Most recent on-site examinations conducted by NBG supervisors focused on a review of operational and credit risk (retail and MSME portfolios). As a response to COVID-19 on-site examinations (except those targeting anti-money laundering activities) were suspended.

**34. NBG is currently reviewing GRAPE and determining areas needed for improvement; and continues to conclude actions to address prior recommendations.** NBG intends to incorporate resolvability assessments into its supervisory process, an acknowledged gap in the GRAPE framework. Recovery planning is a current requirement for commercial banks that is in its early stages. And, recently in 2019 NBG updated and established a recovery and resolution framework. As the new framework advances, and recovery and resolution planning evolve, further changes to GRAPE are being considered.

### **Areas to Improve Risk-Based Supervision under GRAPE**

**35. The reviewers identified several substantive and procedural challenges in the current GRAPE process and found that further improvements are warranted.** NBG acknowledges that GRAPE needs enhancements in multiple respects and this Note encourages a continued focus on improving the supervisory framework and approach under GRAPE. These issues are discussed throughout multiple sections in this Note.

**36. The use of Pillar 2 add-ons to provide an incentive for banks to address qualitative risk management weaknesses can be an important supervisory tool and such an approach is used broadly across many jurisdictions.** It is important to note that such a process faces challenges and should be used only as a complement to other tools through which supervisors actively require banks to have strong and appropriate risk management and control practices. Some examples of these challenges are:

- In the case of a bank that may normally operate with capital well in excess of minimum regulatory requirements, an increase in the minimum requirement due to the pillar 2 charge may not serve as a meaningful incentive.
- A relatively small charge in a specific risk area may lead a bank to downplay the importance of addressing related weaknesses that may well prove to be quite critical.
- Assessing the amount of increased capital relative to risk-weighted assets that can compensate for poor risk management and other key practices at banks is difficult at best. In practice, a Pillar 2 add-on effectively represents a penalty function that does not serve as an adequate substitute for ensuring banks have strong internal practices that allow them to be safely managed and to effectively assess their capital needs relative to their risk profiles.

**37. While there are a very broad number of sub-factors that can feed into calculating the score of risk ‘mitigants’, there is no defined internal hierarchy of importance for these factors.**

This approach appropriately provides for supervisory discretion, while making it difficult to understand how qualitative assessments inform the GRAPE score. Though assessments of the effectiveness of banks’ SB and senior management and of specific risk management and control processes in each risk area are identified as contributing factors, their relative importance has not been formalized internally.

**38. NBG should consider possible adjustments to the GRAPE score weighting system and greater use of bank-by-bank adjustments in the weightings.** It is not clear that a weighting system that is the same for each bank and in every circumstance can appropriately reflect the importance of different risk attributes across different banks. Moreover, the specific weights currently used may not reflect evolving views of the importance of key elements covered in the GRAPE scoring process. (See recommendations in the Supervision of Corporate Governance and Risk Management at Section H below.)

**39. The NBG should analyze the relative importance of GRAPE element sub-factors for financial stability and supervisor’s qualitative assessment should focus directly on them.** This internal analysis should provide more clarity on the relative importance of qualitative assessments of various factors included in the “mitigants” used in determining GRAPE score, and should be documented for internal use in determining the GRAPE scores across banks. (See further discussion in the Supervision of Corporate Governance and Risk Management Section regarding designing “comprehensive” qualitative assessments of key bank functions and practices at Section H below.)

**40. NBG should establish formal internal procedures to better ensure that supervisory plans and their implementation are fully developed and executed as intended.** Supervisory analysis and findings should be fully informed by internal discussions and decisions, so that all supervisory staff can ensure their input, findings and observations are clearly recorded and considered by management. Assessors found the GRAPE process was not well-supported by formal procedures addressing the development of the annual supervisory plan and the culmination of supervisory findings in the GRAPE letters. Basic procedural elements and substantive requirements

were found lacking or unclear and not formalized. The review reflected a need for greater clarity regarding roles and responsibilities, timelines, review processes, and documentation requirements. The NBG should develop formal internal documentation that set forth the policies, procedures and approaches to its supervisory review and evaluation process and provides requirements for examination processes.

**41. NBG should establish venues and processes for coordinating and sharing supervisory findings across groups (beyond the “four eyes” principle).** NBG’s supervisory function is conducted across three departments (Banking Supervision, Specialized Risks, and Supervisory Policy). NBG staff communicate frequently across the various supervisory departments to plan and decide supervisory actions; though established procedures are lacking. It is essential that these three groups communicate and coordinate the development of supervisory risk assessments and findings, bringing the firm-specific analysis together with horizontal or peer analysis. NBG staff clearly communicate frequently across the departments. Yet, the process by which supervisory issues and findings are vetted and developed is not clearly established within the GRAPE framework. There is no clearly established venue or process that provides opportunities for challenge and dissent; nor is there a channel through which staff can report real or perceived distortions to the supervisory process (anonymously or otherwise).

**42. The FSSC is considered by NBG to be a sharing and coordination venue for supervisory issues, but a staff-level forum or process should be considered.** The FSSC properly is focused on high-level, sensitive, and significant supervisory actions that require or deserve the attention of the Governor and Vice-Governors. Open vetting of more routine supervisory analysis, the opportunity to discuss and challenge supervisory findings, would be enhanced should a staff-level forum be established. (See discussion above at para. 20)

**43. NBG should establish a more formal structure related to communication with banks’ supervisory boards, which should include an annual meeting to ensure board members have a clear understanding of the NBG’s views of practices at the bank.** Communication and contact with the supervisory boards are conducted from time to time and primarily are conducted by the Vice-Governor and Governor. There is no regular schedule or structure for such meetings. NBG staff, management and senior leadership can meet with banks’ supervisory boards and key risk and audit committees. Meetings with banks’ supervisory boards are understandably held less frequently than meetings with bank line or senior management. NBG staff does meet periodically with heads of internal audit and the supervisory board’s audit or risk committees. A more formal structure regarding the timing, purpose, and scope of regular meetings with banks’ supervisory boards could improve communication with supervisory boards regarding material supervisory findings. For example, an annual meeting to present the GRAPE letter could be held, supported by a discussion of key risks and issues together with the NBG’s remediation expectations. Such communication would reinforce the importance of SBs’ responsibilities for ensuring effective risk management and controls frameworks are in place and working as intended, while also highlighting its responsibilities for oversight of senior management. This can be a good practice and should be complemented by direct periodic discussions, which should include providing NBG supervisory staff views on how the

quality of risk management and control practices is taken into account when assessing the quality of SB oversight of the effectiveness of these practices relative to risk appetite and risk profile.

**44. External auditors are not presently, but should be, routinely contacted to identify weaknesses in banks’ risk management practices or reporting, or potential supervisory concerns.** External auditors are legally required to notify the NBG if they are made aware of a material issue. Under the regulation on External Audits of Commercial Banks, an auditor must notify the NBG “no later than 5 business days after identification” of material adverse changes regarding the banks business or risks, among other matters. NBG has recently issued an updated Framework for Communication with Auditors intended to establish principles regarding and facilitate communication between the NBG and external auditors. The Framework sets out principles that support more frequent communication between the NBG and external auditors and encourages sharing of material information relating to significant risks observed at the bank. Under the Framework, communication is encouraged when the need suddenly arises due to issues or trends that change the risk assessment of the bank. The Framework anticipates that detailed procedures will be established to support frequent flow of material information of importance to supervisors. NBG should fully implement changes in this area and take steps to seek deeper and more frequent, regular contact with external auditors to leverage their analysis and information to support supervisory oversight and enforcement.

### C. Corrective Actions, Enforcement of Supervisory Directives, and Early Remediation

**45. Recent legislative amendments provide NBG adequate authority to take and enforce supervisory actions.** In 2019, the NBG Law was amended to clarify NBG’s authority to impose supervisory measures, sanctions and other directives and actions. The amendments provide broad authority to impose “...one or several supervisory measures and/or sanctions...” in response to violations of law, standards or instructions, including engaging in “unsafe and unsound banking practices” and where “risks have been identified through the supervisor review and evaluation process (including the General Risk Assessment Program).” (Article 30, ACB Law) Further, 2017 amendments to the NBG Law extended NBG authority more explicitly to the “banking group.”<sup>7</sup>

**46. As noted above, NBG communicates its supervisory findings and directives through a variety of channels; however, the annual GRAPE letter maintains preeminence in communication with the banks and their supervisory boards.** In an environment of daily contact and interaction, NBG’s supervisory approach allows for the development and issuance of supervisory actions at any time during the “continuous” supervisory cycle. Supervisory directives can take the form of emails, letters, or formal directives. Issue-specific emails or supervisory letters are generated where considered necessary and appropriate. Even though supervisory directives can take many

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<sup>7</sup> Banking Group extends to the bank, its parent (holding company) and their (bank and bank holding company) subsidiaries, associated and joint companies that are at the same time financial institutions and/or legal entities engaged in banking related activities both within a country and abroad. Bank holding (parent) company is defined as an entity which owns more than 50 percent of a bank’s shares or controls a bank. (Article 49 NBG Law).

forms and channels, the annual GRAPE letter is the primary mode of supervisory communication regarding risk management issues and major supervisory concerns and seeks to reflect the culmination of supervisory findings over an annual period. GRAPE letters address material weaknesses that have been identified by supervisors during the examination cycle and reflect determinations ranging from reporting violations to issues that demonstrate the application of supervisory judgement and discretion (e.g., large exposure limit violations and issues arising from related party transactions). The GRAPE letter is sent to bank senior management and in certain cases to the supervisory board. The findings in the GRAPE letter are discussed with bank management before a final GRAPE score (and surcharge) is settled. The GRAPE letter and capital surcharge applied is the preeminent if not primary enforcement mechanism employed to incentivize banks' remediation of identified supervisory issues.

**47. GRAPE letters should be enhanced to provide more clarity regarding the prudential objectives and should specifically describe actions banks are required to take to remediate areas of weakness.** The GRAPE letters provide high-level discussions of key supervisory findings and operate primarily to communicate and support the NBG's determination of the bank's net GRAPE buffer. Details regarding the underlying assessment of specific practices warranting remediation, the prudential objectives and expected or required remediation actions to be taken by the bank (including the development of a remediation plan) are not clearly set forth. NBG discusses its findings set forth in the GRAPE letter to ensure bank management is aware of prudential considerations. In some cases, banks provide a written response and action plan detailing a remediation plan. As part of its continuous supervision approach, NBG staff monitors open issues and follows-up to seek that the remediation steps are completed.

**48. NBG should require banks to develop remediation plans to address identified supervisory concerns; such plans should be formally reviewed and approved by NBG and the closure of supervisory issues formally accepted by NBG.** Often, NBG supervisory directives will result in the banks' development of a remediation plan. These plans are not always fully documented, nor is there an explicit process by which NBG reviews and approves such plans. To ensure the completion of remediation actions, NBG staff monitors the banks progress towards remediation on a 'continuous' or daily basis and is aware of status. Once remediation is validated (see below), NBG should then 'sign off' or confirm the remediation of the supervisory issue. More formal practices would improve prompt remediation, utilize bank resources to conduct validation efforts, and enhance supervisory communication with bank management and supervisory boards. Banks' willingness or capacity to address supervisory concerns in a timely manner should be taken into consideration in evaluating effectiveness of SBs and senior management.

**49. NBG should develop more formalized internal procedures, internal governance and controls related to the issuance of and follow-up on supervisory directives.** NBG follows a 'continuous supervision' approach and allows flexibility in allowing supervisory actions to be issued at any time and at any level. Staff assigned to the individual bank maintain a listing of open supervisory issues and monitor remediation in their day-to-day contact with the bank. The review found no internal procedures surrounding the development, issuance, monitoring, tracking, and

closing out of supervisory issues or directives. There is no management report or database which tracks the number, type, status, opening or closing of supervisory issues, or serves to flag over-due, late, or overly extended remediation actions. It is, accordingly, difficult to assess whether the ongoing monitoring of the banks and the process to issue and monitor open supervisory issues and remediation actions has resulted in an effective and timely supervisory response. A formal management system (e.g., monitoring software) and related procedures would enhance the effectiveness of management oversight, internal controls and governance.

**50. NBG should consider keeping any related supervisory restrictions or actions in place until the remediation of a significant deficiency it has communicated to the bank has been evaluated and approved by banks' internal audit functions.** NBG should generally not accept as complete a banks' remediation actions for supervisory directives on significant matters until the internal audit function has assessed, validated and reported to the banks' SB (Audit Committee) that the remediation is complete and appropriate. NBG would thereafter review the bank's response and reach its own determination whether to consider the supervisory issue remediated. The SB should be held responsible and accountable for ensuring the effectiveness of the internal audit function, including its capacity to serve in this role. (See comments below in the Supervision of Governance and Risk Management at Section H for further discussions of supervisory assessments of internal audit.)

**51. The rules, guidelines and practice implementing the ACB Law's flexible framework do not guard against undue delay in taking appropriate corrective actions.** there are no rules-based or qualitative guidelines for issuing or taking corrective actions that ensure that supervisory responses are taken early on and that guard against undue delay in enforcement. There are no internal criteria for identifying or declaring an institution as a 'problem bank' subject to early remediation or corrective actions. The 2019 amendments to the NBG and ACB laws related to early intervention are effective to equip the NBG with resolution powers and establish requirements for recovery and resolution planning. These powers, along with NBG's broad set of enforcement powers and tools under the ACB Law, provide ample authority for the NBG to intervene early and seek prompt remediation of identified supervisory issues. However, the implementing rules, guidelines and practices should reflect a framework supporting the exercise of such broad powers at an early stage and that protect against undue delay.

**52. NBG should consider the development of an early remediation framework and pursue regulatory changes (or changes to GRAPE) that would set out prompt corrective action triggers.** GRAPE principles encourage the identification of problems "at an early stage and implementing appropriate corrective measures to eradicate them"; but it does not provide a framework or guidance for monitoring or analysis of early warning indicators that would drive early remediation. NBG supervisors are aware of factors that can provide an early warning of emerging or uncontrolled risk at its supervised institutions, however the overall approach to early remediation, the factors or indicators that are to be monitored, any trigger levels or measures to be employed is unspecified. As an element of the overall review of GRAPE and related procedures, NBG should



consider adoption of an early remediation framework; such an effort could coincide with the evolution of banks' recovery plans.<sup>8</sup>

## D. Licensing and Transfer of Significant Ownership

**53. NBG has addressed most identified gaps in legal and regulatory standards related to licensing and approvals and it continues to clarify its regulatory standards regarding transfers of significant ownership.** The 2014 FSAP made several recommendations for changes in legislation to ensure that NBG was provided explicit powers related to licensing review and approvals. Legislative and regulatory responses have been enacted, and additional amendments are in process. See BOX 3 and Appendix 1.

**54. NBG maintains a detailed understanding of the ownership structure of its banks.** The ownership of the two listed D-SIBs is more readily transparent, while information on the ownership structure of the remaining institutions not subject to securities disclosure rules are otherwise revealed in annual and periodic reporting. Under NBG requirements, all banks submit a "Pillar 3" report, which is published quarterly. These reports must describe the current ownership structure of the banks. Pillar 3 reports are required to include a list of shareholders owning 1 percent or more of issued capital, a list of bank beneficiaries showing indirect and direct holders of 5 percent or more of shares. The Pillar 3 reports vary in level of detail given the complexity and sophistication of the bank.

**55. Non-resident ownership presents challenges to monitoring suitability and changes to ownership structures, but NBG has been able to obtain necessary information to gauge suitability.** There are no restrictions on foreign ownership under NBG law and non-resident ownership of Georgian commercial banks is prevalent.<sup>9</sup> As a result, the assessment of ownership structures and monitoring changes in ownership and suitability criteria can be complicated. NBG possesses adequate authority to obtain needed information, staff appreciates the related complexities and act to fill any information gaps as best practicable.

**56. NBG should further clarify its standards to ensure that material changes in the suitability of significant shareholders or controlling interests, including beneficial owners are reported in a timely fashion.** The prior FSAP recommended that NBG make it legally binding for banks to notify the NBG as soon as they learn of material information that might negatively affect the suitability of a major shareholder or a party with a controlling interest in the bank. The amendments made to the ACB law (paragraph 6 of Article 8/1), do not appear to fully address this recommendation. Under the amended provisions, a "bank shall immediately notify the National Bank about any change in a fit and proper criteria related" to its shareholders. The language plainly requires banks to notify NBG of changes that the bank makes to its suitability criteria. NBG interprets

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<sup>8</sup> For additional information regarding early supervisory intervention frameworks and approaches refer to: FSI Insights on policy implementation No 6; *Early intervention regimes for weak banks* (Svoronos; April 2018); and *Frameworks for early supervisory intervention* (BCBS; March 2018)

<sup>9</sup> The vast majority of NBG supervised commercial banks are foreign owned. As of EOY 2019, just under 90 percent of bank assets and stockholder equity was held by non-resident beneficial owners.

the provision as also creating an obligation on banks to notify NBG of any actual changes in suitability. In practice, banks have failed to notify NBG of material events that have presented suitability issues. , Banks may not consider themselves obligated to bring forward material changes in suitability under the existing law. To clarify the amendment, NBG should issue guidance to banks that sets forth NBG's interpretation and its supervisory expectations.

### **Box 3. Improvements to Licensing and Transfer of Significant Ownership Laws and Regulations**

A regulation on "Licensing of Banking Institutions" was approved in 2014, and in addition, in 2017 legislative amendments to the ACB Law and NBG Law were adopted to address identified gaps.

These new requirements specify criteria applied to assess ownership/group structure and provide that group structures and ownership should be transparent and not pose a threat to effective supervision, safety and soundness of the bank, or the financial sector. Information on ownership structure is detailed and includes requirements for disclosure on all ownership levels including direct shareholders, interim owners and beneficial owners holding "significant share."<sup>1</sup> (Requirements are set forth in paragraph 3 of Article 3 of ACB law).

Additional amendments addressed NBG's review and assessment of the supervisory board, audit committee and directors, including information on their qualification, criminal records and on the solvency/insolvency and financial liabilities. (in paragraph 4 of Article 3 of ACB law). The assessment must extend to a review of the internal governance and risk management frameworks and policies and assessment of business plan (See detailed requirements on business plan in paragraph 6 of Article 3 of ACB law).

Similarly, NBG has enacted recommended changes to its laws governing transfers of significant ownership and major acquisitions. These amendments expand the definition of "significant shareholder" to include persons "acting in concert" and authorized NBG to require banks to change ownership or group structure if such structures hinder effective supervision, among other changes.

Amendments to the ACB Law ensure that ownership structures are fully elaborated in any licensing applications and must provide information regarding 'fit and proper' of bank administrators. (See, Regulation on Fit and Proper Criteria for Administrators of Commercial Bank). Further, suitability criteria for significant shareholders are defined by the ACB Law (Articles 5 and 8(1)).

NBG is working to implement further enhancements to its regulatory standards in terms of transfer of significant ownership. To be in full compliance with EU standards, NBG has developed the new draft rule "on the acquisition of qualifying holding in commercial bank." The approval of this rule is postponed due to the temporary moratorium on introducing new supervisory requirements during the Covid-19 pandemic. Important additional clarifications are being addressed in the draft rule. These include clarification to key terms such as "controlling share", "significant influence", "acting in concert", "indirect acquisition" and prescribes additional circumstances which should be considered when assessing each of them.

<sup>1</sup>Significant share was defined as "direct or indirect ownership of 10 percent or more of the bank's authorized or issued capital or/and voting shares by a person or partners (shareholders) acting in concert or an opportunity to have significant influence over commercial bank by a person or partners (shareholders) acting in concert regardless their share in capital or/and voting shares." "Significant influence" was defined as "as a right to take part in decision – making process with respect to financial and operational policy, which does not represent control or joint control over such policies. (Article 1 Par. z5, ACB Law)

**57. The lack of any supervisory authority to enforce a direct reporting requirement and penalize banks for not informing NBG regarding material changes or events could result in potentially unsuitable ownership.** This reporting gap is known and has been filled by NBG staff periodic monitoring of available public sources to track events related to identified shareholders and beneficial owners. Given the complex structure of certain large, commercial banks and the non-resident ownership structure, NBG staff is faced with the burden of constantly monitoring multiple parties and jurisdictions for events that may materially impact suitability of a wide range of significant shareholders and beneficial owners.

## E. Supervision of Corporate Governance and Risk Management<sup>10</sup>

### Supervision of Corporate Governance

**58. Since the prior FSAP, the NBG has implemented a comprehensive Code of Corporate Governance (CCG) and increased the supervisory emphasis on corporate governance.** However, NBG is still relatively early in the process of overseeing full implementation of those requirements by banks and incorporation into ongoing supervision processes. Hence, more work is needed to ensure effective implementation of these rules. The CCG is consistent with international standards. The CCG and other regulations and laws cover the broad spectrum of expectations for banks' supervisory boards and senior management such as board structure and composition, including required risk and audit committees, minimum number of independent directors, fit and proper criteria, etc. Additionally, the CCG articulates the responsibilities of supervisory boards and senior management with respect to risk management and internal control frameworks and practices. Consistent with international practices, supervisory boards are responsible for setting the risk appetite of the bank and ensuring the existence of effective and independent risk management and control functions that are commensurate with the risk appetite and associated risk profile of the bank. This includes responsibility for the oversight of senior management to ensure they are effectively carrying out their responsibilities with respect to risk management and controls practices.

**59. NBG has taken an important step towards improving banks' CG by strengthening requirements for independent directors and key board committees, including for audit and risk.** Recent changes (passed in February 2021) will require that the chair of the SB be an independent board member. Combined with enhancements to regulatory requirements for related party transactions, the evolution to greater independence of SB members should: 1) allow for clearer distinction between board and senior management-level responsibilities; 2) reduce the occurrence of executive board members' dominance of the SB and 3) enhance efforts to ensure related party transactions do not pose undue risks to the banks. (see more below on related party transactions).

**60. The NBG should consider more heavily weighting its assessment of the effectiveness of the SB and senior management in ensuring an effective risk management framework in its GRAPE process for determining the value of risk "mitigants" and should consider increasing**

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<sup>10</sup> The review of risk management focused both broadly on select BCP 15-related issues and specifically on Credit Risk, including concentrations and related party transactions, Liquidity Risk and Capital adequacy-related assessment practices (e.g., ICAAP).

**the weighting of the broader CG element in GRAPE.** The effectiveness of the SB with respect to the risk management framework should also serve as a key element in determining the overall CG GRAPE assessment. Currently, the GRAPE process addresses the effectiveness of the SB in this regard in two ways: 1) as a ‘mitigant’ that serves as an offset to inherent risk in each risk category and 2) as a component of the broader GRAPE assessment of CG. It is not clear the extent to which the assessment of a bank’s risk management and internal control practices impacts each of these GRAPE score components and what contribution that makes to the GRAPE buffer requirement. From the perspective of effective prudential supervision and the BCP, the role of the SB in this regard is among the key elements of its responsibilities.

**61. NBG communications with banks’ SB should indicate more clearly the NBG’s view of the effectiveness of SB and senior management in carrying out their respective roles (see also para. 42)** When there have been significant weaknesses noted in risk management independence, capability or practices, internal audit independence, capability, or practices, and/or in other important internal control processes, these should be significant negative factors in assessing SB effectiveness and CG. The weaknesses identified and their importance in the NBGs’ assessment should be communicated in writing directly to the SB to ensure it is aware of NBG supervisors’ concerns. This should also be used to reinforce the message that it is the SB that is ultimately accountable for ensuring an effective risk management framework and risk governance and overseeing management’s execution of its responsibilities.

**62. Greater supervisory emphasis should be placed on the role of internal audit and the audit committee in supporting the SB mandate of “ensuring compliance with all regulatory and supervisory requirements”, as required by Article 4 of the CCG.** In addition to current practices through which supervisors meet with internal audit and review internal audit reports and minutes of audit committee meetings, NBG should explicitly assess if internal audit functions effectively fulfill their role as the third line of defense. This should include assessing the extent to which internal audit is actively identifying risk management and control weaknesses, reporting those to the board and serving as the eyes and ears of the SB. Where significant internal audit weaknesses exist – which may be demonstrated by supervisors identifying weaknesses in bank practices that internal audit did not identify -- these should not only be communicated to the SB and audit committee, but they should also be clearly indicated as an important negative factor in assessing overall CG.

### **Supervision of Risk Management**

**63. As noted above, NBG supervision uses a risk-based approach, with more attention given to the largest banks and those where there are identified concerns.** A significant share of supervisory staff resources is spent on risk assessments and monitoring risks on an ongoing basis, including checking positions against regulatory requirements and limits. Given the size and complexity of the banks, the risk assessment framework is generally very thorough across key risks, with credit and liquidity risks apparently receiving substantial attention, though it is noted that the NBG is also quite focused on operational/cyber-related risks. NBG bank supervisors with responsibility for the understanding all aspects of the banks are clearly deeply knowledgeable about

the banks and aware of the key risks and can draw on the expertise of Risk Specialists and Policy Experts, who demonstrate a strong understanding of the banks and the risks to individual banks and across the banking system.

**64. As identified in its supervision strategy for 2020-2022, NBG supervision should increase its focus on, and continue to work to enhance its practices for, qualitative assessments of banks' important risk management and control practices.** NBG supervision processes emphasize monitoring and evaluating required regulatory reporting and other information to check banks' compliance with regulatory requirements and limits, as well as to assess banks' 'inherent' risks. These processes are well-developed and represent good practice. Extensive reporting requirements and legal authority to require banks to submit virtually all information needed for effective supervision has allowed NBG staff to develop and maintain a solid understanding of the risks within and across supervised banks and to track banks' compliance with regulations. Reviewers observed that NBG supervisors' knowledge of the activities and associated risks of the banks was quite strong and comprehensive. NBG is well prepared to evolve to an increased focus on qualitative assessments.

**65. For those functions and practices identified as the most important in the internal NBG review recommended above, supervisors should undertake in-depth qualitative assessments on a regular periodic basis.** These assessments should include a significant onsite element and encompass a holistic assessment of, for example, the entire credit risk management framework and function, including the effectiveness of the SB/Risk Committee, senior management, internal audit, and other important control elements. For example, such a review could include assessing the quality and effectiveness of the independent credit risk management functions, the effectiveness of the Chief Risk Officer ultimately in charge of managing them, independence and quality of the internal audit function, and the effectiveness of SB Risk and Audit Committees in ensuring these functions are effective. It could inform views of these parties more broadly rather than just the contribution to the credit risk GRAPE score. For example, it should also influence broader CG assessments. The review would not necessarily have to cover every element described in the NBG's GRAPE assessment guidelines, but rather focus on those determined to be the most critical.

**66. For D-SIBs, NBG should strengthen requirements for the use of stress testing in internal capital and liquidity management and planning processes to promote greater emphasis by systemically important banks capacity to withstand stressful operating environments.** In addition, NBG should increase its focus on the effectiveness of stress testing processes at D-SIBs. The NBG carries out a periodic supervisory (bottom up) stress testing program which can be used to derive the Net Stress Buffer (see Capital section below) and to inform the risk assessment process. To promote more effective "forward-looking" aspects of these bank's risk management and enhance NBG supervisory practices, supervisory assessments of the banks capacity to carry out effective supervisory and internal stress testing should contribute to assessments of banks' qualitative risk management, internal controls, and corporate governance. For the D-SIBs, emphasis on forward-looking risk management practices is particularly important given the potential negative impact on the economy and financial system should one of these banks become financially distressed or collapse. For systemically important banks, having a well-run internal stress testing

program to inform risk appetite setting frameworks and capital adequacy assessments in a ‘forward-looking’ manner should be a minimum expectation.

**67. At least for DSIBs, NBG should put more emphasis on ensuring the banks have an effective ICAAP, as required by NBG rules, and that supervisors are assessing banks’ ICAAP practices in the context of Pillar 2-related evaluations.** NBG regulations require an ICAAP to be submitted periodically by banks. However, discussions with NBG supervisors indicated this has not been an area of focus for NBG activities so far. Given the importance of ICAAP in assessing the adequacy of banks’ capital position and planning processes, oversight of the quality and reliability of banks’ ICAAP should be a key part of the NBG supervision process.

**68. For the D-SIBs, NBG should put more emphasis on ensuring the banks’ have robust internal capital planning processes and how effectively their risk management and internal controls frameworks and practices support capital decisions.** Decisions regarding appropriate capital levels and distributions (e.g., dividends) are key responsibilities of the SB. Practices necessary to support and inform these decisions include a broad range of risk management and internal control tasks, as discussed above. Consequently, an assessment of the bank’s risk appetite, and capital assessment and planning processes provides a good opportunity to gain an integrated view of the effectiveness of key bank practices and risk governance.

### **Credit Risk Management**

**69. NBG supervision of credit risk is well supported by comprehensive reporting requirements and offsite monitoring and analysis is a key component of NBG supervision of credit risk.** Banks provide extensive data that allow NBG supervisors to closely monitor compliance with regulatory requirements, credit underwriting standards and credit decisions, as well as developments in retail, SME and corporate loan portfolios, including related party transactions, large exposures, portfolio asset quality, and loan loss provisioning levels and decisions. The extensive data required of banks in regulatory reporting provides strong support for supervisory analytics and would be a leading practice even in some larger jurisdictions for the purposes of credit risk analysis and assessments as well as for monitoring compliance with credit-related regulations.

**70. NBG should focus more on the quality of banks’ internal loan loss classification and provisioning practices, in addition to the focus on the adequacy of banks’ actual provisions.** Where weak practices are identified it should be a clear and important factor in determining the GRAPE score for credit risk. NBG appropriately emphasizes the adequacy of loan loss provisions and has detailed processes for assessing this against regulatory standards, which are based on regulatory loan classification determinations (i.e., Standard, Watch, Substandard, Doubtful, and Bad.) Loan classification is based on days in arrears as well as financial performance of the borrower and collateral, with the capacity to repay and number of days in arrears being key drivers of classification and provisioning. NBG supervisors carry out detailed analyses of banks’ loan portfolios and generally play a significant role in driving banks’ provisioning decisions, implying weak bank practices relative to NBG expectations. As NBG supervision continues to evolve, the supervisory objective should be for banks to carry out these activities effectively on their own, with any supervisory requirements

serving as a backstop. This will become increasingly important as the transition to IFRS standards for regulatory reporting and accounting, which is currently under way, come into place over the next several years.

**71. Thorough credit risk-related monitoring and analyses is complemented by qualitative reviews of credit risk management to inform the GRAPE process, which incorporates assessments of risk management as a ‘mitigant’ applied in GRAPE and contributes to the Net Grape Buffer.** These reviews can cover a wide variety of the key elements in a credit risk management framework, including reviewing policies and procedures documentation, checking reported data against credit files or ledgers to assess data completeness and integrity, discussions with risk managers, reviews of reporting to senior management and the board and the other key factors one would expect to see in a well-developed risk governance framework.

**72. While the elements to be reviewed as part of assessing credit risk management are comprehensive, the process for incorporating qualitative assessments into the GRAPE score, including which elements are the most important considerations driving supervisory assessments, should be made clearer internally.** While each of the elements are important, the NBG would benefit from an internal analysis and determination of which of the elements it considers most important. This internal analysis and determination should take as a starting point that it is the responsibility of the SB and senior management to ensure the bank has strong practices and the role of bank supervisors is to assess the quality of the practices and the effectiveness of those responsible for approving and managing them at the banks are carrying out their duties. Currently, credit risk GRAPE scoring does not provide internal guidelines on the relative weighting of various aspects of credit risk management expectations, including the role of the SB and senior management, or internal audit. This makes it unclear what is driving the rating and which components supervisors should emphasize.

**73. NBG has sought to address increased credit risk resulting for COVID-19 largely through suspension or reduction of capital requirements – the CCB has been reset to zero and the CICR was reduced by two thirds – rather than forbearance in loan classifications and provisioning.** Banks have been encouraged to provide borrowers with repayment moratoriums on a voluntary basis. Loan classification standards have continued to require assessments of borrowers’ capacity to repay, though the focus on payment days in arrears is not applied during the pandemic. Pandemic-related loan-loss provisioning initially included banks carrying out portfolio level analysis and creating general provisions, which have been shifting into loan-specific provisions as the banks have had time to carry out loan/borrower level assessments. NBG provided banks with guidelines for provisioning during the pandemic that assume a three-year recovery period for corporate and SME sectors. NBG closely monitors restructured loans, requiring banks to submit internal risk reports and updated financial statements to assess the adequacy of provisions for restructured loans.

## **Large Exposures/Concentration Risk**

**74. In 2019 the NBG updated its regulation on the concentration of exposures and large exposures, with the new requirements scheduled to take effect starting January 1, 2022.** (See

Appendix 2 for details on the limits set through the new rule.) Once in place, the requirements – including the definition of connected parties and the use of supervisory discretion in making such determinations – will be consistent with international standards. The rule updates the definition of large exposures and recalibrates large exposure limits, including both gross limits and limits net of credit risk mitigation for individual borrowers and connected groups of borrowers. In addition, the measurement of required limits is scheduled to change from a percentage of Total Regulatory Capital to Tier 1 capital. There are no regulatory sectoral concentration limits in place though NBG does include a measure for sectoral concentrations in its Pillar 2 buffers. (See discussion below in Capital and Liquidity Regulatory Frameworks at Section I.)

**75. Qualitative assessments of large exposure risk management are incorporated as one part of the GRAPE credit risk management processes and inform the Net GRAPE score used to derive the Net GRAPE Buffer.** Assessments include reviewing the limit structure and credit decision making, quality of the data in the required regulatory reports, and checking reported positions against regulatory limits. Banks' SBs are required to set internal thresholds for when a large exposure must be approved by the board, though those thresholds are not required to be set at the same level as the regulatory limits.

**76. Given the importance of concentration risk in the context of the Georgian banking system, consideration should be given to increasing the importance of this risk and associated risk management practices in the calculation of the GRAPE score, the assessment of banks' inherent risks and the prioritization of supervisory plans.** Concentration risk is a particularly important risk management challenge in the Georgian banking system given the small number of large banks and limited capacity for corporate entities to access funds through capital markets. It is a key area of focus for NBG supervisors. While the NBG continues to assess the best way to address this challenge, it has expressed its commitment to promote the safety and soundness of the banking system by ensuring these risks are well identified, constrained by regulation, addressed in capital requirements (Pillar 2 buffer, see below at Section I), and effectively controlled by banks as part of credit risk management practices.

**77. Large exposures to firms, corporate groups and sectors are also addressed in Pillar 2 requirements that include a specific buffer for concentration risk.** (See discussion of the HHI buffer in Capital and Liquidity Frameworks at Section I below.) Pillar 2 buffer calculations for concentrations further address the definition of "control" in determining connected parties and groups and defines standards for assessing "economic interdependence" among a bank's borrowers.

**78. NBG supervisory stress testing can also provide a view of potential vulnerabilities related to various economic sectors to which banks may have large exposures via the stress testing parameters provided by the NBG for banks to run stress tests.** For example, scenario analysis-based stress testing can capture correlations among banks' exposures to certain events. However, the capacity for this to serve as an incentive for banks to actively manage or reduce such correlated exposures is not strong since, as noted elsewhere, there is at this time no hard requirement to hold capital against supervisory stress test results.



## Related Party Transactions

**79. NBG was assessed as ‘compliant’ with Basel Core Principles for related party transactions in the 2015 FSAP and continues to have well-developed processes for monitoring banks compliance with related party transaction regulations.** The NBG issued the “Regulation on the Management of the Conflict of Interests” in 2015, which has strengthened the requirements and NBG authority for related party transactions. The rule includes broad and comprehensive definitions of related parties and the transactions covered by related party restrictions, and NBG has the authority to define both on a case-by-case basis and to require banks to treat them as such. All transactions with related parties are required to be conducted at “arms-length”, must approved by the bank’s SB and, with some exceptions outlined in the regulation, must be collateralized at 110 percent of the value of the loan.

**80. Starting in 2022, the total value of exposures to one related party must not exceed 5 percent of Tier 1 capital and total value of exposures to all related parties must not exceed 25 percent of Tier 1 capital.** Under the current rule related party limits are based on exposures a percentage total regulatory capital. Related party transactions are monitored through regulatory reporting that requires banks to report all related party transactions. Supervisors analyze the monthly reports as well as assessing other information available on credit exposures to determine if reporting is appropriately including all related party transactions. In addition, NBG staff use a variety of sources including publicly available information to analyze and identify related parties.

**81. Given the importance of requiring banks to manage related party transactions, including with respect to complex group structures, consideration should be given to increasing the importance of this risk and associated risk management practices in the calculation of the GRAPE score, the assessment of inherent risk and the prioritization of supervisory plans.** While the NBG has generally strong practices and appropriate rules in this area, FSAP reviews noted that related party transactions have continued to be an area that warrants closer attention by banks and in some better practices to ensure a bank is in compliance with NBG requirements.

## F. Capital and Liquidity Regulatory Frameworks

### Capital Adequacy

**82. NBG’s capital adequacy requirements are largely line with Basel III and international practices, though the NBG should address several self-identified gaps in the definition of capital for certain AT1 and Tier 2 instruments.** NBG has expressed that it plans to close the following self-identified gaps over the “medium term”. These are: (1) NBG does not include provisions regarding regulatory event and tax events, which permit the banks to call AT1 or Tier 2 instruments within first five years of initiation; (2) general provisions regarding conversion and write-down requirement of AT1 instruments are required, but it does not include any specific threshold; (3) provisions regarding conversion or write down of Tier 2 instruments are not currently included in capital requirements. After adoption of resolution framework (from 2021), NBG will have the

authority to convert or write-off liabilities (bail-in) during resolution. (4) Requirements do not include provisions for threshold deductions (under 10 percent ownership) for investments in AT1 or Tier 2 instruments of banking, insurance or financial entities. They are directly deducted from capital. (See Appendix 3 for current and pre-COVID-19 regulatory requirements.)

**83. To address potential threats to banks capitalization, liquidity and solvency presented by the high level of foreign currency assets and liabilities at the banks, NBG regulation restricts the allowable net open currency positions at banks.** The “Regulation Setting, Calculating and Maintaining Overall Open Foreign Exchange Position Limit of Commercial Banks” limits open foreign exchange positions, in all currencies and consolidated foreign exchange positions, to a maximum of 20 percent of the total regulatory capital. The limit applies to all on balance sheet and off- balance-sheet positions and must be adhered to on a daily basis.

**84. As of October 31, 2020, all banks remained above the minimum capital requirements in place as a result of the COVID-19 response, and most banks remain above the pre-COVID requirements.** CET1 ratios range from a low of 9.3 percent to a high of 80 percent (at one small bank), with an aggregate system CET1 ratio of just over 11 percent. CET1 accounts for over 80 percent of the aggregate total Tier 1 capital 1 ratio of 13 percent. The aggregate Total Regulatory Capital ratio was approximately 18 percent. (see Appendix 3 on capital requirements pre-COVID-19 and current.) Pillar 1 capital charges are derived using the Basel 2 standardized approach to calculating risk weighted assets; there is no use of banks’ internal models for calculating Pillar 1 regulatory capital requirements.

**85. Pillar 2 capital buffers are currently required to be covered mostly by Tier 2 instruments, which is not in line with usual international practice.** The quality of regulatory capital will shift further towards CET1 and Tier 1 going forward as the Net Grape Buffer and Concentration Buffer (HHI) are scheduled to phase in an increasing share of CET1 and Tier 1 requirements each year to a final coverage mix that is in line with Pillar 1 requirements of 56 percent CET1, 80 percent Tier 1, 100 percent total capital by March 2023.

**86. Pillar 1 requirements include minimum capital ratios (4.5 percent CET1, 6 percent Tier 1 and 8 percent Total), the capital conservation buffer (2.5 percent), a countercyclical buffer (currently set to zero), and a systemic risk capital buffer for the 3 D-SIBs, which is scheduled to phase in up to as high as 2.5 percent requirement for the two largest banks by year-end 2021.** Currently, the capital conservation buffer has been set to zero as part of the COVID-19 pandemic response. Banks will be given two years to restore the CCB with the starting point still yet to be determined due to uncertainty about the length of the pandemic.

**87. As of 2018, NBG regulatory capital requirements also include a 5 percent Tier 1 leverage ratio.** As of October 31, 2020, all banks exceeded the leverage requirement comfortably. Leverage ratios across the banks ranged from 7.1 percent to over 40 percent.

**88. NBG has a variety of Pillar 2 buffers for risks not captured in Pillar 1 and the GRAPE buffer add-on charge derived using qualitative assessments of banks’ risk management,**

**controls, corporate governance, group structure and other elements.** (See above discussion for details of the Net GRAPE Buffer.) Specific Pillar 2 buffers are: The Unhedged Currency Induced Credit Risk buffer (CICR buffer); a Name and Sectoral Concentration Buffer (HHI buffer); the Net GRAPE Buffer; and a Net Stress Test Buffer, which has not been implemented as a requirement at this time.

**89. The CICR Buffer measures a capital charge for banks' exposures to borrowers taking loans in a foreign currency.** It is based on Foreign Currency exposures net of a variety of mitigating or 'hedging' factors. Under COVID-19 response measures, the CICR buffer has been temporarily reduced by 66 percent.

**90. HHI Buffer – HHI buffer requires capital to be held against name (including connected groups)** and sectoral concentrations through the use of a Herfindahl-Hirschman Index based calculation of concentration and a capital charge based on the HHI score.

**91. Net Grape Buffer – The Net GRAPE Buffer represents a significant capital charge for banks** and is derived using the GRAPE process discussed elsewhere in this technical Note.

**92. Net Stress Buffer – Stress test scenario parameters are provided to the banks by NBG and banks calculate the impact of the stress scenario on CET1 capital.** The Net Stress Buffer is not currently in place. The NBG is considering how this buffer interacts with other buffers and if it creates "double-counting" with other buffer requirements. Further, NBG has not yet decided on the consequences for banks that fail to meet the Net Stress Buffer (i.e., it has yet to be determined if it will become a required buffer under Pillar 2 rules.)

**93. The NBG should increase the emphasis placed on scenario-based stress testing for supervisory assessments of capital adequacy at D-SIBs and consideration should be given to making the Net Stress Buffer a hard Pillar 2 requirement for these banks.** Supervisors should assess D-SIBs' stress testing practices including those stress tests designed and run by D-SIBs for risk management and internal capital planning, as well as the NBG supervisory stress test. As the net stress buffer is not formally in place, NBG supervisors have not made regular assessments of the banks' practices in this area. (See additional comments above regarding stress testing in the Corporate Governance and Risk Management section at H.) Given the importance of systemic banks and the potential challenges associated with their resolution, ensuring these banks are well-capitalized against potentially severely stressful outcomes would help reduce the probability they could default/collapse and disrupt the financial system and economy.

## **Liquidity and Liquidity Risk Management**

**94. NBG has a strong liquidity risk regulatory framework with comprehensive monitoring that is well supported by required reporting.** LCR and NSFR rules have both been implemented and are consistent with Basel III standards. Given potential vulnerabilities associated with a high level of dollarization in the Georgian economy, the NBG has a higher requirement for liquidity coverage of foreign currency positions than for the local currency in the LCR. Local currency requirements for the LCR are at 75 percent coverage ratio. For foreign currencies, LCR coverage is required at 100 percent

across all foreign currencies. The total combined required LCR coverage is 100 percent. The NSFR requirement is 100 percent coverage in aggregate, though banks are required to monitor positions on a currency-by-currency basis. The LCR is required to be calculated and reported on a daily basis (with a maximum two-day lag) and the NSFR is required on a monthly basis (required 15 days from end of month). The local currency requirement for the LCR has been suspended during COVID-19 pandemic. Given current uncertainty about the future of the pandemic the timing for reimposition of this requirement has not been conclusively decided.

**95. NBG should consider if current inflow and outflow assumptions in regulatory requirements are appropriately calibrated to the Georgian banking environment.** NBG should look at two areas in this regard: 1) with respect to related party transactions, particularly for D-SIBs and banks that form part of complex group structures, inflows/outflows from affiliates and other related parties may be especially likely to differ from assumptions in a period of stress as contractual commitments could be subject to loosening or suspension to support these entities. 2) With respect to repayment risks of borrowers in foreign currencies, while the CICR buffer requires capital to be held for the greater potential deterioration of credit worthiness or default for unhedged foreign currency loans, LCR/NSFR assumptions make no distinction between estimated inflows from borrowers in local or foreign currencies.

**96. Supervisory monitoring of liquidity risk and positions is supported by extensive required reporting from the banks, with periodic detailed reviews expected to be carried out by supervisors periodically to ensure data accuracy.** Liquidity positions across the banks are monitored regularly to ensure compliance with the LCR and NSFR. In addition, liquidity risk is monitored through required reporting on a variety of positions and indicators, including reports covering a comprehensive set of metrics for maturities of assets and liabilities, sources of interbank and wholesale funding, largest depositors, and where banks stand relative to covenant agreements with major lenders and sources of funding, including international financial institutions.

**97. Supervision of liquidity risk management at banks is supported by a full set of appropriate elements to be reviewed and assessed in ensuring compliance with liquidity regulations.** As with other types of risks in the GRAPE process, and discussed elsewhere in this technical Note, the value given to “mitigation” of liquidity risk in the GRAPE score is meant to be substantially defined by qualitative assessments of many different practices at banks. These include a range of banks’ internal risk management practices and the effectiveness of the SB and senior management at ensuring those practices are strong and appropriate given the banks risk profile.

**98. NBG should consider increasing the weighting given to qualitative issues related to liquidity risk management in the overall GRAPE score.** Alternatively, it should emphasize the use of other processes through which it can create appropriate incentives. For example, requiring banks to have a robust ILAAP framework, and making supervisory assessments of ILAAP a key area of focus. Such assessment should be an important contributor to its views on the quality and effectiveness of the board and senior management and incorporated into NBG assessments of governance.

**99. For D-SIBs, NBG should emphasize periodic qualitative assessments of liquidity risk stress testing practices in their assessments of liquidity risk management.** While LCR and NSFR coverage provides a critical mitigant to potential liquidity stresses, each bank may have specific vulnerabilities that are not well captured by a standardized set of assumptions. Systemically important banks should conduct their own liquidity stress testing designed to ensure any potential idiosyncratic vulnerabilities not well measured in the LCR and NSFR are well captured and controlled.

## Appendix I. Responses to 2015 FSAP Recommendations

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
Principle 1. Responsibilities, objectives, and powers.	<ul style="list-style-type: none"> <li>Seek review of the NBG Law (Organic Law on NBG), so that banking supervision will be given equal status to price stability as the main task of the National Bank.</li> </ul>	N	<ul style="list-style-type: none"> <li>The issue was discussed; however, changes have not made to the NBG law mainly due to the fact that in practice NBG has not come across any impediments with regard to taking actions for the safety and soundness of financial sector, which was compromised by the price stability objective. From the operational perspective, NBG have two active vice-governors with equal powers one responsible for price stability and one for banking supervision. In addition, in recent years, Financial Stability Committee has become more active, its functionality has been increased.</li> </ul>
	<ul style="list-style-type: none"> <li>Amend Article 21 of the ACB Law (The Law on Activities of Commercial Banks) so that in setting and enforcing minimum prudential standards all areas are covered and not just those listed in the Article.</li> </ul>	Y	<ul style="list-style-type: none"> <li>The ACB Law was amended, according to the amendment the provision of setting prudential standards based on risk-based supervision principles has been expanded and covers all areas (paragraph 3, Article 21).</li> </ul>
	<ul style="list-style-type: none"> <li>Amend the law to make public consultation on new laws and regulations statutorily binding.</li> </ul>	N	<ul style="list-style-type: none"> <li>NBG law was amended and paragraph 13 added to Article 48: "the National Bank shall be authorized to publish drafts of normative acts related to financial sector for the purpose of obtaining comments from stakeholders prior to their approval. This shall not apply to the drafts of those normative acts, adoption of which is essential for the purposes of resolution and/or for maintaining the stability of financial sector or/ and which shall come into force immediately". The practice also changed; draft law could be seen on the following link:</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
			<a href="https://www.nbg.gov.ge/index.php?m=696&amp;lng=geo">https://www.nbg.gov.ge/index.php?m=696&amp;lng=geo</a>
<p>Principle 2. Independence, accountability, resourcing, and legal protection for supervisors.</p>	<ul style="list-style-type: none"> <li>Review NBG salary levels in light of NBG's legal obligation to maintain effective supervision by maintaining high qualified and experienced staff.</li> <li>The NBG should increase its training and education budget.</li> <li>Consider charging for supervision. (This recommendation is solely advisory – it is not taken into account in determining the rating.)</li> <li>The NBG should publish a more comprehensive and detailed strategic plan and targets in its annual accounts.</li> <li>Make specific legal provisions that the supervisor and its staff will be adequately protected against the cost of defending their actions and/or omissions made while</li> </ul>	<p>P</p> <p>P</p> <p>N/A</p> <p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>See NBG 2020-2022 Supervisory Strategy</li> <li>See NBG 2020-2022 Supervisory Strategy.</li> <li>Not discussed.</li> <li>The NBG started publishing 3 years supervisory strategy document starting from 2020. In addition, annual reports cover reviews of all upcoming and significant plans in terms of supervision. E.g., in last year's report, several Boxes were published describing the substance of upcoming reforms (please see: Box 6, 7, 8, 9, 10, 11)</li> <li>Amendments made to NBG Law include protection of NBG staff. Article 68 states that no employee of the National Bank shall be personally liable to any party for any action done or not done, as long as such action was done or such person refrained doing it in good faith by such person and in the ordinary course of his or her duties, in accordance with the Georgian legislation. In disputes emerged</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	<p>discharging their duties in good faith.</p> <ul style="list-style-type: none"> <li>The protection afforded to staff on a personal level for any action done or not done, as long as such action was done or refrained from in good faith, should be extended to the supervisor itself.</li> </ul>	<p>Y</p>	<p>with respect to fulfillment of work duties, NBG shall defend the interests of the current or former employee, if disputed action or omission was determined by fulfillment of those duties (except for the case when the dispute is raised by the NBG itself against such employee), which may be expressed in providing legal services to the employee, compensation of dispute related costs and the other measures, which the NBG may deem expedient for protection of an employee's interests. It is noteworthy that this provision also refers to temporary administrator, special manager and liquidator and administrators of bridge bank.</p>
<p>Principle 5. Licensing criteria</p>	<ul style="list-style-type: none"> <li>Introduce explicit and specific legal provisions relating to the NBG powers rather than relying on its broad powers to achieve its goals. This seems to work adequately in practice, but in the interest of certainty and clarity, specific provisions should be introduced.</li> <li>Provide explicit powers that foreign banks proposing to establish a locally incorporated bank in Georgia must obtain the prior consent of its home supervisor to do so (as is currently the case for foreign banks proposing to</li> </ul>	<p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>Amendments made to the ACB Law introduced explicit and legal provisions on the NBG's powers regarding the licensing process of commercial banks, harmonizing requirements with Basel Core Principles for Effective Banking Supervision. The enhanced requirements include detailed information on banks' supervisory boards, audit committees, governance documents, as well as detailed information on ownership structure.</li> <li>According to amendment to ACB law, in Article 3 "in case of branch and subsidiary of a foreign bank applicant additional information should be submitted in accordance with Paragraph 7 of this Article". Paragraph 7c by itself requires submitting "approval of supervisory body (home supervisor) of the parent bank on opening a subsidiary or a branch."</li> </ul>



Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	<p>establish a branch bank in Georgia).</p> <ul style="list-style-type: none"> <li>In determining the suitability of banks' shareholders, the NBG should, in addition to approving significant shareholders (owners of 10 percent or more of the share capital of the bank), have regard for others who may exert significant influence on the bank.</li> </ul>	<p>Y</p>	<ul style="list-style-type: none"> <li>According to new amendments to ACB law, the applicant must present the suitability of all holders of significant ownership. The definition of significant holding/share changed in a way that it also includes shareholders who may exert significant influence on the bank. In particular: "Significant share – direct or indirect ownership of 10 percent or more of the bank's authorized or issued capital or/ and voting shares by a person or partners (shareholders) acting in concert or an opportunity to have significant influence over commercial bank by a person or partners (shareholders) acting in concert regardless their share in capital or/ and voting stock."</li> </ul>
<p>Principle 6. Transfer of significant ownership.</p>	<ul style="list-style-type: none"> <li>Expand the definition of "significant shareholder" to include persons acting in concert.</li> <li>Make it legally binding that existing significant shareholders proposing to dispose of their shareholding must notify the NBG in advance.</li> <li>Make it legally binding for banks to have to notify the NBG as soon as they become aware of any material information that might</li> </ul>	<p>Y</p> <p>Y</p> <p>N</p>	<ul style="list-style-type: none"> <li>The definition of "significant shareholding" changed (see above) and now includes persons acting in concert.</li> <li>New paragraph 5 added to Article 8<sup>1</sup> of ACB Law, specifying that "direct or indirect owner of the Bank who intends to sell its share in a bank directly or indirectly, as a result of which its share as a beneficial owner becomes less than 10, 25 or 50 per cent, shall notify the NBG in advance on this fact. The notification shall include detailed information about the transaction.</li> <li>New paragraph 6 added to Article 8<sup>1</sup> of ACB Law, stating that "Commercial bank is obliged to immediately notify the National Bank about any change related to a fit and proper criteria of significant ownership."</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	negatively affect the suitability of a major shareholder or a party with a controlling interest in the bank.		
Principle 7. Major acquisitions	<ul style="list-style-type: none"> <li>• Provide direct statutory backing to the criteria used by the NBG to judge investment proposals by banks.</li> <li>• Effective implementation of corrective action<sup>1</sup>;</li> <li>• Prohibit banks from making acquisitions/investments in countries with laws or regulations prohibiting</li> </ul>	<p style="text-align: center;">N</p> <p style="text-align: center;">Y</p> <p style="text-align: center;">Y</p>	<ul style="list-style-type: none"> <li>• In practice, NBG effectively applies such criteria. In addition, based on the amendments made Law in December 2017, all permissible investments were defined under the law. Restrictions related to investments were also specified (please see below). Currently there is no need to develop separate regulation on investments. However, based on the amendments, NBG has the authority to define the criteria used in decision making process regarding investments by a normative act.</li> <li>• According to NBG law and the regulation on licensing of commercial banks, the group structure of the bank must not be so complicated that it hinders its supervision, and the licensed commercial bank must always comply with the aforementioned requirement. NBG effectively applies such criteria in practice as well. In addition, according to the amendments made in December 2017, NBG has the authority to require commercial bank to change ownership or group structure changes if such structures hinder effective supervision or endangers stable functioning of a bank or financial sector.</li> <li>• Based on the amendments made to the ACB Law, in case of making investment outside of Georgia, banks are required to prove that the laws or regulations of the country do not</li> </ul>

<sup>1</sup> FSAP BCP TC: "There is no explicit legal provision for the NBG to determine whether new acquisitions/investments will hinder effective implementation of corrective actions"

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	<p>information flows deemed necessary for adequate consolidated supervision;</p> <ul style="list-style-type: none"> <li>• Take into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.</li> </ul>	<p>Y</p>	<p>prohibit information flows deemed necessary for supervision. In addition, the requirement that group structure of the bank must not hinder its supervision applies all banks according to the legislation (see above). NBG effectively applies such criteria in practice as well.</p> <ul style="list-style-type: none"> <li>• NBG effectively applies such criteria. The amount of the investments outside of Georgia is insignificant. In addition, NBG has signed MOUs with the countries (Belarus, Azerbaijan), where such investments exist. It should be also noted, that as part of the sound supervision, NBG collects extensive information about the subsidiaries throughout the group structure analyses of the banks and monitors the value of the investment based on the consolidated financial statements. Besides, according to the newly added provisions (please see above), NBG has sufficient powers to require bank to changes its group structure.</li> </ul>
<p>Principle 8. Supervisory approach</p>	<ul style="list-style-type: none"> <li>• Complete the implementation of the new supervisory approach and formalize it.</li> <li>• Set up a clear framework for distressed banks and require banks to set up resolution plans in order to identify and mitigate possible barriers for resolution.</li> <li>• Undertake a crisis-simulation exercise.</li> </ul>	<p>P</p> <p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>• New approach is implemented. NBG has formalized GRAPE assessment and developed pillar 2 framework.</li> <li>• Changes have been made to ACB law and NBG law in order to develop resolution framework. According to the amendments, banks are required to set up recovery plans.</li> <li>• With the help of World Bank, NBG undertook a crisis-simulation exercise. Representatives of commercial banks and relevant government agencies were involved in the process.</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
Principle 9. Supervisory technique and tools	<ul style="list-style-type: none"> <li>Consider how to balance the attention for inherent risk and quality of risk management.</li> <li>Integrate identification of risk culture in the supervisory approach and spending more time on-site to sense the risk culture.</li> </ul>	<p>Y</p> <p>P</p>	<ul style="list-style-type: none"> <li>NBG implemented GRAPE which implies assessment of inherent risk as well as mitigants including quality of risk management.</li> <li>Supervisory staff does on-site from time to time in addition meetings with SB, management, staff from different divisions are held on a frequent basis at NBG building. Based on the report by Federal Reserve Bank of New York Staff (see the <a href="#">link</a>), NBG's approach is quite similar to the one used by FRBNY.</li> </ul>
Principle 10. Supervisory reporting.	<ul style="list-style-type: none"> <li>Ensure that a formal consolidated prudential reporting framework is in place by November 2014, as targeted.</li> </ul>	<p>P</p>	<ul style="list-style-type: none"> <li>Based on amendments to the NBG Law, NBG has the mandate to supervise banking groups, which among others includes consolidated prudential reporting framework. In addition, NBG is working on implementing IFRS which is an important milestone toward implementing consolidated requirements.</li> </ul>
Principle 11. Corrective and sanctioning powers of supervisors	<ul style="list-style-type: none"> <li>Employ an escalation framework for safety and soundness issues.</li> <li>Reflect to what extent NBG could have been more effective with regard to deficiencies that linger for a protracted period of time.</li> </ul>	<p>P</p> <p>P</p>	<ul style="list-style-type: none"> <li>The escalation matrix works in practice as NBG acts from a risk-based perspective. According to Article 30 of ACB law, NBG can use its supervisory measures on banks in line with the risk-based approach. Supervisory measures and fines should be imposed either according to prescribed order or without it, in accordance with the severity of the violations and the risks posed by them.</li> <li>As relevant changes are made to ACB law in December 2019, NBG has strengthen its early intervention measures and supervisory powers.</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	<ul style="list-style-type: none"> <li>Initiate law or regulation that gives the NBG the power to set individual risk governance requirements, intervene in the organizational structure or business model of a bank.</li> </ul>	Y	<ul style="list-style-type: none"> <li>Based on amendments to the ACB Law, NBG has an explicit power to set individual requirements on commercial banks based on the principles of risk-based supervision (Article 21, paragraph 3).</li> </ul>
Principle 12. Consolidated supervision.	<ul style="list-style-type: none"> <li>Ensure that a formal consolidated prudential reporting framework is in place by November 2014, as targeted.</li> </ul>	P	<ul style="list-style-type: none"> <li>Based on amendments to the NBG Law, NBG has the mandate to supervise banking groups, which among others includes consolidated prudential reporting framework. In addition, NBG is working on implementing IFRS which is an important milestone toward implementing consolidated requirements.</li> </ul>
Principle 14. Corporate governance	<ul style="list-style-type: none"> <li>Increase involvement of Boards in setting and overseeing risk appetite.</li> <li>Align the legislation and regulation with regard to the role of directors in a Supervisory Board.</li> <li>Make the overseeing risk committee and remuneration committee as a requirement by law or regulation.</li> <li>Encourage banks to make the Supervisory</li> </ul>	<p>Y</p> <p>Y</p> <p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>According to the code of corporate governance adopted in 2014, boards are required to develop and approve risk appetite statement.</li> <li>Based on the amendments to the ACB and CCG, independent board members are required on the board and as chairs on key committees.</li> <li>According to Code of Corporate Governance risk committees are required for each commercial bank. In addition, remuneration committees are mandatory for only for systematically importance banks as it is prescribed by Basel Committee of Banking Supervision. In case of banks which do not have a remuneration committee, risk committee and board should fulfill the responsibilities of rem committee.</li> <li>Based on the change to the ACB, audit committees are composed with independent</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	<p>Committee directly responsible for the Audit committee.<sup>2</sup></p> <ul style="list-style-type: none"> <li>Initiate a law that gives the power to change the composition of a Board.</li> </ul>	<p>Y</p>	<p>supervisory board members. In addition, the provision and practice changed in a way that audit committee is the sub-committee of the supervisory board and it is not composed with outsider members (members which were not in a board).</p> <ul style="list-style-type: none"> <li>The NBG has the power to change the composition of the Board. According to Article 30.3e of ACB Law NBG has the power to require dismissal of a Board member who lacks experience or education. In addition, NBG has such a power according to the regulation on Fit and Proper Criteria for Administrators of Commercial Banks, which was updated in 2014. According to the regulation the composition of the supervisory board should ensure a variety of experience and skill set, which corresponds to the scale and complexity of the bank's activities. This requirement is assessed under GRAPE.</li> </ul>
<p>Principle 15. Risk management</p>	<ul style="list-style-type: none"> <li>Make sure that banks express their risk appetite for the different risk categories.</li> <li>Continue implementing Basel II including ICAAP, contingency planning, stress testing and SREP.</li> <li>Determine the internal pricing mechanism of all banks.</li> <li>Evaluate the role and independence of CRO and (credit) risk</li> </ul>	<p>Y</p> <p>P</p> <p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>All banks are required to develop and approve risk appetite statement according to the code of corporate governance.</li> <li>NBG implemented Pillar 2 under Basel III. Stress testing methodology was published in 2020. Recovery plans are required starting from 2020.</li> <li>Banks have basic internal pricing mechanism. NBG has also published the guideline regarding sound pricing principles.</li> <li>The requirement to separate CRO and its compensation from business line activities is reflected into the code of corporate</li> </ul>

<sup>2</sup> FSAP BCP TC: "Audit committees should be direct sub-committees of the board."

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	management, including the incentive structure.		governance. In addition, risk management framework of commercial banks, including the role and independence of CRO and incentive structure are assessed under corporate governance assessment throughout the GRAPE.
Principle 16. Capital adequacy	<ul style="list-style-type: none"> <li>• Introduce a framework on how to deal with domestic systemically important banks, including the introduction of a capital buffer.</li> <li>• Consider introducing a countercyclical buffer.</li> <li>• Set up an implementation plan for Pillars 2 and 3 for banks and supervisors, including deciding who will do the assessment.</li> <li>• Develop guidance for supervisors on SREP.</li> <li>• Develop Pillar 3 requirements for banks.</li> </ul>	<p style="text-align: center;">Y</p> <p style="text-align: center;">Y</p> <p style="text-align: center;">P</p> <p style="text-align: center;">P</p> <p style="text-align: center;">Y</p>	<ul style="list-style-type: none"> <li>• Framework is developed in accordance with Basel principles. 3 banks were identified as D-SIBs and relevant capital requirements are imposed on them.</li> <li>• Basel III countercyclical buffer mechanism was introduced in December 2017. The Financial Stability Committee initiates imposing countercyclical buffer based on its evaluation of financial stability risks. The Financial Stability Committee meets once a quarter in accordance with a pre-announced schedule. Unplanned committee meetings may also be called in special cases.</li> <li>• Pillar 2 and Pillar 3 are successfully implemented in practice. Relevant regulations are also approved. Internal procedures are clear.</li> <li>• GRAPE guideline is developed. It will be updated periodically.</li> <li>• Regulation on Information Disclosure for Commercial Banks within Pillar 3 based on Basel latest documents was adopted in 2017. Banks published their first pillar 3 quarterly</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
			reports as of Q2 2017 based on new regulation.
Principle 17. Credit risk	<ul style="list-style-type: none"> <li>• Keep focused on ensuring that all banks implement the credit risk management requirements under which the requirements for lending standards.</li> <li>• Require banks to have certain exposures exceeding a certain amount to be decided by the banks' Board and senior management.</li> <li>• Make sure that all and not only large banks include credit risk exposures into their stress tests.</li> </ul>	<p>P</p> <p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>• Credit risk management including lending standards is assessed as part of mitigant under GRAPE. In addition, retail credit regulation and risk management standards of CG code are applicable for each commercial bank. Compliance of which is assessed within GRAPE framework.</li> <li>• New regulation on large exposures requires boards to receive information on largest exposures. In addition, NBG is authorized to require risk committees of supervisory board to approve largest exposures.</li> <li>• Detailed guideline for stress testing ensures this in practice.</li> </ul>
Principle 19. Concentration risk and large exposure limits	<ul style="list-style-type: none"> <li>• Develop regulation or guidelines for concentration risk beyond large exposures.</li> <li>• Make banks improve their identification of the economic interdependence of borrowers.</li> <li>• Consider developing a limit for the 10 largest exposures.</li> </ul>	<p>Y</p> <p>Y</p> <p>N</p>	<ul style="list-style-type: none"> <li>• Pillar 2 reflects that recommendation and separate buffer for credit risk concentration is developed in this regard.</li> <li>• The definition of connected parties has been updated and it requires commercial banks to identify groups of connected counterparties by the criteria of control relationship and economic interdependence.</li> <li>• This was considered but not decided to impose such limit. However, NBG developed separate credit risk concentration buffer (Name and sectoral concentration) within Pillar 2 framework.</li> </ul>



Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
Principle 20. Transactions with related parties	Add legal provisions that explicitly require write-off of related party exposures to be subject to prior approval by the bank's Board.	Y	Regulation on the management of conflict of interests has been updated in 2015. According to the regulation, commercial banks are required to have internal policies of conflict of interests which should include the procedure for writing off risk exposures to related parties. Based on the regulation, any amendments to the contracts with the related parties must be approved by the supervisory board,
Principle 21. Country and transfer risk	<ul style="list-style-type: none"> <li>• Continue implementing the guideline on managing country and transfer risk, including stimulating the Board to explicate their risk appetite, set county and transfer risk limits, take responsibility in overseeing the management.</li> <li>• Develop an explicit provisioning system for country risk and transfer risk.</li> <li>• Require prudential return on country risk on consolidated level on a semi-annual base.</li> </ul>	<p>Partial</p> <p>Partial</p> <p>P</p>	<ul style="list-style-type: none"> <li>• Country risk guidelines were sent to the banks. Transfer risk is immaterial as exposures are mainly denominated in EURO and US dollars.</li> <li>• According to the country risk guideline banks should develop provisioning system for country risk.</li> <li>• Monthly reporting form includes distribution of exposures by country.</li> </ul>
Principle 22. Market risk	<ul style="list-style-type: none"> <li>• Continue implementing the new capital regime since this will enhance the risk management.</li> <li>• Incentivize all banks to conduct stress tests.</li> </ul>	Not material	<ul style="list-style-type: none"> <li>• Georgian banks do not have trading books. Existing trading book guidelines require banks to notify NBG if their assets will qualify under trading book definition.</li> <li>• General stress test includes relevant market risk shocks.</li> </ul>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	<ul style="list-style-type: none"> <li>Allocate capital for unexpected market risk losses.</li> </ul>		<ul style="list-style-type: none"> <li>Capital adequacy framework (Basel II/III) includes capital charge for an open currency position risk defined by the Regulation on Setting, Calculating and Maintaining Overall Open Foreign Exchange Position Limit of Commercial Banks.</li> </ul>
Principle 23. Interest rate risk in the banking book	<ul style="list-style-type: none"> <li>Require banks (through regulation) to have internal limits for interest rate risk.</li> <li>Provide more guidance to banks on how to deal with interest rate risk in relation to ICAAP.</li> <li>Increase the frequency of reporting to a quarterly basis in order to keep abreast of developments.</li> </ul>	<p>Y</p> <p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>The regulation on interest rate risk in the banking book is approved and became effective since September 2020.</li> <li>According to the regulation, the limits on IRRBB are defined. In addition, banks are required to have risk appetite regarding IRRBB and it must be part of their capital planning process.</li> <li>According to the new regulation, banks are required to submit the reporting forms on a monthly basis as defined by NBG.</li> </ul>
Principle 24. Liquidity risk	<ul style="list-style-type: none"> <li>Continue with the finalization and implementation of draft regulation of LCR.</li> <li>Ensure that all banks have adequate contingency funding planning, taking into account limited opportunities.</li> </ul>	<p>Y</p> <p>P</p>	<ul style="list-style-type: none"> <li>The Regulation on calculation and preservation of Liquidity Coverage Ratio (LCR) was adopted.</li> <li>Such a requirement is applied under LCR regulation.</li> </ul>
Principle 25. Operational risk	<p>Make sure that all banks set up business continuity plans and outsourcing agreements (including taking the local</p>	<p>Y</p>	<p>Banks have created business continuity plans. The banks have also set up outsourcing agreements. The current status is that the smaller banks are drafting outsourcing policies. Mandatory IT (IS) audit requirements are already</p>

Reference Principle	Recommended Actions	Reviewers' Assessment Completed (Y/N) In Progress (P)	NBG Response/Actions
	environment into account) and conduct (mandatory) IT audits.		in place based on the new operational risk regulation that was enacted in 2014 and commercial banks have begun implementing the audits.
Principle 26. Internal control and Audit.	Seek the removal of the legal provision that allows Executive Directors to sit on Supervisory Boards.	Y	According to the amendments to ACB, supervisory members will no longer have the executive functions.
Principle 28. Disclosure and transparency.	Enhance the level of qualitative information, which banks are required to disclose in their annual accounts.	Y	New Regulation on Information Disclosure for Commercial Banks within Pillar 3 based on Basel latest documents has been adopted. Banks have published their first pillar 3 quarterly reports as of Q2 2017 based on new regulation.
Principle 29. Abuse of financial services.	<ul style="list-style-type: none"> <li>• Legally require banks to report to the NBG any suspicious activities and incidents of fraud where such activities/incidents are material to the soundness or reputation of the banks.</li> <li>• Extend the definition of PEP to include domestic and foreign persons.</li> </ul>	<p>Y</p> <p>Y</p>	<ul style="list-style-type: none"> <li>• Supervisory reporting form for operational risk includes the incidents of fraud and is monitored by the operational risk division at NBG. Additional reporting form for commercial banks is drafted by the Money Laundering and on-site Inspection Department. Based on this reporting form commercial banks will be required to report all transactions, which will be classified as suspicious.</li> <li>• The law has been updated and the definition of PEP includes foreign as well as domestic persons.</li> </ul>

## Appendix II. Large Exposure Regulations

Topic	Current Regulation (will be abolished in January 2022)	New Regulation (starts January 2022)
Bases for limits calculation	Regulatory capital	Tier 1 capital
Definition of large exposures	>= 5 percent of regulatory capital	>= 10 percent of Tier 1 capital
Exposure value to a single client	<= 15 percent of regulatory capital	<= net exposure of 25 percent of Tier 1 capital
Exposure value to a group of connected clients	<= 25 percent of regulatory capital	<= gross exposure of 50 percent of Tier 1 capital (excl. mitigation effect)
Exposure value to a bank or group of connected clients containing a bank	N/A	Highest of 25 percent of Tier 1 capital and GEL 200m for net exposures.  50 percent of Tier 1 capital for gross exposures (excl. mitigation effect)
Exposure value to a non-resident bank or group of connected clients containing a non-resident bank w/o an investment grade	N/A	<= net exposures of 25 percent of Tier 1 capital  <= gross exposure of 50 percent of Tier 1 capital (excl. mitigation effect)
Exposure value of resident systemically important bank to another resident systemically important bank	N/A	<= net exposure 15 percent of Tier 1 capital  <= gross exposure of 50 percent of Tier 1 capital (excl. mitigation effect)
Total amount of large exposures	<= 200 percent of regulatory capital	N/A

## Appendix III. Current Capital Requirements

	February 2020 (before Covid-19)			October 2020		
	CET1	Tier 1	Total	CET1	Tier 1	Total
<b>Min. Requirements</b>	<b>4.5%</b>	<b>6.0%</b>	<b>8.0%</b>	<b>4.5%</b>	<b>6.0%</b>	<b>8.0%</b>
<b>Combined Buffer</b>	<b>3.6%</b>	<b>3.6%</b>	<b>3.6%</b>	<b>1.1%</b>	<b>1.1%</b>	<b>1.1%</b>
<i>Conservation Buffer</i>	2.5%	2.5%	2.5%	0.0%	0.0%	0.0%
<i>Countercyclical Buffer</i>	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<i>D-SIB Buffer</i>	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
<b>Pillar 2 Buffers*</b>	<b>1.8%</b>	<b>2.4%</b>	<b>5.7%</b>	<b>1.0%</b>	<b>1.3%</b>	<b>4.1%</b>
<i>CICR Buffer</i>	1.3%	1.7%	2.2%	0.5%	0.6%	0.8%
<i>HHI Buffer</i>	0.1%	0.1%	0.7%	0.1%	0.1%	0.6%
<i>Net GRAPE buffer</i>	0.4%	0.5%	2.7%	0.4%	0.5%	2.7%
<b>Total Requirements</b>	<b>9.9%</b>	<b>12.0%</b>	<b>17.3%</b>	<b>6.7%</b>	<b>8.5%</b>	<b>13.3%</b>

\*Pillar 2 buffer requirements are on a bank-specific basis. This table shows aggregates across the system.