INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/10

GEORGIA

FINANCIAL SECTOR ASSESSMENT PROGRAM

January 2015

DETAILED ASSESSMENT OF OBSERVANCE OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

This Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision on Georgia was prepared by a staff team of the International Monetary Fund and the World Bank. It is based on the information available at the time it was completed in October 2014.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND
THE WORLD BANK

GEORGIA

October 2014

DETAILED ASSESSMENT OF OBSERVANCE

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Prepared By
Monetary and Capital Markets Department, IMF and Finance and Private Sector Development Vice Presidency, World Bank

This Detailed Assessment Report was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission in Georgia during May, 2014, led by Elias Kazarian, IMF and Aurora Ferrari, World Bank and overseen by the Monetary and Capital Markets Department, IMF, and the Finance and Private Sector Development Vice Presidency, World Bank. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

AML	Anti-Money Laundering
APRA	Australian Prudential Regulation Authority
BAFIN	German Financial Supervisory Authority
BCP	Basel Core Principles
CAMEL	Capital adequacy, assets, management capability, earnings, liquidity, and sensitivity (rating system) Customer Due Diligence
CDD	Customer Due Diligence
CP	Contingency Plan
CRO	Chief Risk Officer
EC	Essential Criteria
FMS	Financial Monitoring Service of Georgia
FRMP	Financial Risks and Macro-prudential Policy Division
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
GAAP	Generally Accepted Accounting Principles
GCSD	Georgian Central Securities Department
GFPAA	Georgian Federation of Professional Accountants and Auditors
GRAPE	General Risk Assessment Program
GSE	Georgian Stock Exchange
IASB	International Accounting Standards Board
ICAAP	International Capital Adequacy Assessment Process
IFI's	International Financial Institutions
IFRS	International Financial Reporting Standards
LACB/ACB Law	Law of Georgia on Activities of Commercial Banks
LCR	Liquidity Coverage Ratio
LEPL	Legal Entity of Public Law
AML/CFT	Anti Money Laundering/Countering the Terrorism Financing
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NBG	National Bank of Georgia
NBG Law/Organic Law	Organic Law of Georgia on the National Bank of Georgia
NSCG	National Security Commission of Georgia
OCP	Open Currency Position
P & L	Profit and Loss
PEP	Politically Exposed Person
RIP	Risk Identification Program
RMP	Risk Mitigation Program
SME	Small & Medium Enterprise
SREP	Supervisory Review Evaluation Process
STR	Suspicious Transactions Report

SUMMARY, KEY FINDINGS AND RECOMMENDATIONS

A. Introduction

1. **There have been significant improvements in both the quality of regulation and the supervisory approach since the 2007 FSAP**. Many amendments to existing laws, new laws, and regulations have been introduced, aimed at addressing shortfalls identified in the 2007 FSAP. These improvements will be evident throughout this assessment. At the same time, a number of weaknesses have been identified. Among these is an operational risk within the NBG's own Banking Supervisory Department. There has been a very high level of staff turnover in recent years due to a lack of salary competitiveness vis-à-vis the commercial banks, and there appears to be over-reliance on key personnel. Also, the level and type of staff training need to be expanded. While the NBG puts significant effort into understanding the risk profile of each individual bank and the banking system as a whole, more attention is needed to improve the quality of risk management of the banks. In a number of areas, notably bank licensing, the NBG relies on its broad supervisory powers to carry out its functions in the absence of detailed explicit powers. While this regime generally seems to work well in practice, it could leave the NBG open to challenge where these broad powers are not supported by more granular powers. Recently, several amendments to the legislation have been introduced in order to address these shortcomings.

2. **This assessment of Georgia's implementation of Basel Core Principles for Effective Banking Supervision (BCP) has been completed as part of the Financial Sector Assessment Program (FSAP) undertaken jointly by the International Monetary Fund (IMF) and the World Bank**. An assessment of the effectiveness of banking supervision requires a review of the legal framework, both generally and as specifically related to the financial sector, and a detailed examination of the policies and practices of the institutions responsible for banking supervision.

3. **It was undertaken between May 15 and June 3, 2014**. The assessors were Michael Deasy (IMF Consultant) and Marc Schrijver (World Bank). The previous assessment took place in 2007.

B. Information on the Methodology Used for Assessment

4. **The methodology is based on the Basel Core Principles document as agreed in 2012**. The grading for each principle is based on the essential criteria (EC). Additional criteria are commented upon, but are not reflected in the grading. The assessment of capital adequacy has been done against the Basel I standards, although assessors have reviewed Basel II/III.

5. **The assessment involved discussions with the NBG's Specialized Groups and Supervisory Policy Department and Banking Supervision Department**. It also involved discussions with the Financial Monitoring Service of Georgia (FMS), which is responsible for general anti-money laundering policy in the country, including the receipt and analysis of suspicious transactions reports. Meetings were held with the Ministry of Finance (MOF), a number of commercial banks, the Banking Association, the Georgia Federation for Professional Accountants and Auditors (GFPAA), and a bank external auditing firm. The assessors would like to put on record

their deep appreciation for the full cooperation and courtesy they received from all concerned, both in the public and private sectors. The NBG staff was fully transparent throughout the visit, which helped the assessment process.

INSTITUTIONAL AND MACROECONOMIC SETTING AND MARKET STRUCTURE

6. **Following the downturn of the economy in the first half of 2013, there are clear signs that growth is returning and inflation is picking up**. Buoyed by accommodative fiscal and monetary policies, credit expansion, and a gradual return of business confidence, growth has been steady since mid-2013, with GDP growth reaching 3.1 percent for the year as a whole. Preliminary figures for the first months of 2014 indicate that the recovery continues into this year, despite regional turbulence. Following deflationary pressures in early 2013, inflation is also picking up and will likely approach the NGB's target of 6 percent in the coming 12 months. Fiscal policy was procyclical in 2013, which aggravated both the downturn in the first half of the year and created pressures on the external current account at the end of the year. While the current account deficit has come down quickly in 2013—helped by tight fiscal policies—it is projected to widen again in 2014 as imports pick up. External vulnerabilities remain high.

7. **The lari depreciated at the end of 2013 after two years of relative stability**. While officially being committed to a floating exchange rate, the NBG has intervened, largely to prevent appreciation, thus maintaining the lari-U.S. dollar exchange rate within a 2 percent band since early 2011. Facing mounting exchange rate pressures in the third quarter of 2013—in response to the expansionary fiscal policy and a seasonal demand for imports—the dollar exchange rate depreciated by more than 6 percent, breaking through the NBG's de facto band. Exchange rate pressures have since subsided. The effective exchange rate has remained broadly stable throughout this episode, helped by the depreciation of the Turkish lira, Russian ruble, and Ukrainian hryvnia.

8. **Growth is expected to continue throughout 2014 and remain robust in the medium term**. Private consumption—supported by continued credit growth after a 10 percent decline in 2013—and a return of private sector investment on the back of improved business confidence is expected to raise 2014 GDP growth rate to 5 percent, in line with potential growth. Higher imports resulting from the increase in domestic demand will widen the current account deficit in 2014. Over the medium term, sustained growth will depend on maintaining macroeconomic stability, reducing vulnerabilities, and successfully implementing the ambitious reform agenda. The current account is expected to narrow toward 5 percent of GDP.

9. **Although the macro-outlook is relatively benign, there are several risks:**

- The worsening of the economic outlook in key trading partners (Russia, Turkey, and Ukraine) could reduce growth through the trade and remittances channel.

- A relatively high share of oil and gas imports in total imports makes Georgia vulnerable to fuel price shocks. Oil and gas make up more than 15 percent of total imports, implying that an oil price increase could have a large knock-on effect.

- The large dollarization—around 60 percent of lending is dollar denominated—creates balance sheet risks, as income streams are predominantly in lari. However, it should be noted that a significant part of the economy is also dollarized.

- Protracted regional political instability could undermine confidence of resident and nonresident depositors, as well as reduce FDI.

- Banks are reliant to some extent on short-term nonresident deposits, which make up over 15 percent of commercial banks' deposits.

While the recent increase in domestic credit is largely consistent with GDP growth, there are signs of the emergence of a credit gap.

10. The financial sector is dominated by a few large banks. There is a very small insurance sector and a very underdeveloped securities market. There also exists so-called microfinance institutions—essentially nonbank lending institutions, many of which are pawn brokers. There is a miniscule credit union sector. Leasing is also very underdeveloped.

11. Currently, there are 21 banks operating in Georgia. Aggregate banking assets (per balance sheet) of the 21 banks amount to GEL 17.9 billion. Two banks account for over 57 percent of banking activity—Bank of Georgia (BoG) (34 percent) and TBC Bank (23 percent). The next largest bank—Liberty Bank—represents less than 8 percent of total bank assets. The 10 smallest banks each have a market share of less than 1 percent, and, in aggregate, represent about 5.3 percent of the total market share. The BoG is widely owned and listed on the London Stock Exchange. TBC Bank is owned by a number of financial institutions and it, too, obtained a London listing recently. Most of the remaining banks are subsidiaries or affiliates of foreign banks and a few, mainly the smaller banks, are owned by individuals, both Georgian and foreign. There are two branches of foreign banks operating in Georgia. In terms of lending, the breakdown in aggregate terms is: corporate loans 37 percent; small and medium enterprise (SME) loans 20 percent, and retail loans 43 percent as of April 2014.

12. The number of banks has remained relatively constant over the last 10 years. The number has hovered around 20. At one point in the early 1990s, there were over 220 banks in existence, but the number has been whittled down through a rationalization scheme involving closures and mergers and by banks going out of business.

13. The insurance sector is at an early stage of development. The total size of the insurance sector remains below 1 to 2 percent of GDP. In 2011, the insurance market (life, non-life, personal accident, and health care) was ranked one hundred and nineteenth globally. Due to the recent privatization of health care in 2011, health insurance accounted for nearly 75 percent of the total market. There are no compulsory classes of insurance. The largest insurance company is owned by BoG, but this investment still represents less than 1 percent of that bank's total assets. Until April 2013, it was supervised by the NBG when that supervision was transferred to a separate agency.

14. **The securities market is underdeveloped**. It comprises a small stock exchange, a central securities depository, three independent registrars, and nine broker companies. The securities sector is supervised by the NBG.

15. **There are over 60 microfinance institutions in existence**. A number of them, fewer than 10, have issued promissory notes. The issuing of these notes was seen as a loophole regarding the collection of deposits from the public. Accordingly, legislation was introduced to create a new type of institution—qualified credit institution—to deal with those institutions that attract funds from retail customers. To date, one microfinance institution has been reclassified as a qualified finance institution. All microfinance institutions must register with the NBG. Qualified credit institutions must be authorized by the NBG and are subject to supervision, although to a lesser extent than banks. The microfinance institutions are required to register with the NBG, but are not subject to any meaningful supervisory regime. To date, no members of the public have lost money on the purchase of promissory notes.

16. **The total assets of the credit union sector amounted to GEL 7.6 million at end December 2013 with total current and term deposits amounting to GEL5.3 million**. They are supervised by the NBG.

PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

17. **The legislative system in Georgia provides a range of business laws**. These include corporate, bankruptcy, contract, consumer protection, and private property law. They appear to be upheld and enforced by courts and relevant public authorities in Georgia. On consumer protection, a special consumer protection unit was established in the NBG to deal with complaints from commercial bank customers.

18. **Frequent changes of the law may generate uncertainty over contractual arrangements**. Since its enactment in 1999, the Securities Law has been amended 19 times (roughly every nine months over the past 14 years). The Companies Law, enacted in 1996, has been amended 44 times (roughly every five months over the past 17 years). Recently, the Tax Code and the Law on Enforcement Proceedings were amended to give the Tax Authority priority of claim over validly registered pledges and mortgages. In response to demands by the banking industry, the law was amended to reinstate the original scheme of priorities, but only with respect to specific types of financial institutions. This flux in the legislation and its uneven implementation create major legal uncertainty and hamper the overall effectiveness of the legislative and regulatory framework.

19. Accounting standards in Georgia are based on International Financial Reporting Standards (IFRS). However, its application among smaller concerns might be uneven. All banks are required to prepare their annual accounts in IFRS. Audits must be carried out in accordance with best international practice. The "Big 4" audit firms are present in the country and almost all banks are audited by one of them. Accountants and auditors have a representative body in Georgia—Georgia Federation of Professional Accountants and Auditors (GFPAA), but it has a very limited oversight role.

20. In July 2012, a new Law on Payments Systems and Payment Services came into effect. It provides a legal framework for all participants in the payments market and establishes a legal basis in terms of systemic, liquidity and credit risk management.

21. A private credit bureau exists in Georgia. It allows for the exchange of information among banks relating to small- and medium-sized creditors. It appears to work well, although the limit on exchange of positive information is US$500,000, and there is no limit established on the exchange of negative information.

22. No deposit insurance scheme currently exists in Georgia. The Georgian authorities are committed to establishing a deposit insurance agency over the next seven years under the EU Association Agreement that is due to be signed in June.

23. The NBG has a broad financial stability mandate while the macroprudential framework is evolving. The NBG is legally responsible for ensuring financial stability and has the power to issue regulatory measures that could be considered macroprudential. This notwithstanding, the institutional setting for macroprudential policy should be strengthened. The NBG should consider setting up a financial stability unit, which would be responsible for systemic risk analysis and macroprudential policy. On the question of dollarization—one of the main risk areas in the financial system—the NBG has sought to reduce its impact through a number of measures, including by seeking to strengthen trust in the GEL.

24. On bank resolution, the NBG has certain basic powers to take control of a problem bank, to act as a resolution authority, and to lead the liquidation process. The NBG can appoint a temporary administrator and—if it decides to revoke banking license—a liquidator. Both the temporary administrator and the liquidator—accountable to the NBG—take over the shareholders' and managerial powers, and may arrange for certain resolution transactions, such as a sale of assets and liabilities or the recapitalization of the bank under temporary administration.

A. Main Findings

Principles 1 to 4. Responsibilities, Powers, Independence, Cooperation, etc.

25. In legislation, the wording of the NBG's functions/tasks appears to give secondary status to its supervisory role as compared to its main function, i.e., price stability. However, there are no practical examples that it has compromised the objectives of supervision. For these principles, as well as for other principles, the NBG relies on its broad powers to achieve its supervisory aims in the absence of explicit legal provisions. Due to lack of salary competitiveness, there is a high level of staff turnover within the supervisory area, with over-reliance on key personnel. External training and education is under-resourced. Despite this, it should be noted that the quality of the supervisory staff is impressive.

Principles 5 to 7. Licensing Criteria, Transfer of Significant Ownership, Major Ownership.

26. There are a number of significant gaps in legislation under these headings. The NBG uses its broad powers to address these gaps, but an explicit provision should be provided in the legislation. For example, there are no explicit provisions specifying that (a) the appointments to the Supervisory Board, Directors, and top management, as well as for their replacements, requires NBG approval; and (b) the NBG should assess whether the home supervisor practices global supervision and/or whether its supervision standards are equivalent to those of the NBG. Further, there is no requirement for an existing bank shareholder who is proposing to dispose of his/her significant shareholdings to notify the NBG of his/her intention. Recently, several of these shortcomings were addressed by strengthening the regulations.

Principle 8, 9, and 11. Supervisory Approach, Tools, Techniques and Corrective Measures

27. The NBG developed a comprehensive, forward-looking, and risk-based supervisory approach proportionate to the systemic relevance of supervised banks. It addresses all risks emanating from banks. It also includes elements such as stress tests, business models, corporate governance, and capital and contingency planning. Furthermore, the NBG has developed an approach that comprises a well balanced use of bank supervisors and specialist risk supervisors (e.g., credit risk, operational risk, financial risk, macroeconomic risk, group structure risk, and corporate governance). Bank supervisors are responsible for all the risks of one bank and risk supervisors are responsible for one risk across all banks, including systemic risk.

28. Although the NBG developed an advanced supervisory approach, further enhancement is needed. The assessment of bank's resolvability should be further strengthened; in particular, for systemic relevant banks, and there is no comprehensive framework for handling banks in distress.

29. The supervisory approach is supported by a comprehensive supervisory information system. This enables the supervisor to conduct "online" supervision and rigorous data analysis off- site. There is only one important remark to be made: the NBG runs the risk of not spending enough time on-site because of excellent online possibilities. The NBG supervisors should consider spending more time on-site.

Principles 10 and 12. Supervisory Reporting, Consolidated Supervision

30. There has been a significant improvement in this area since the 2007 FSAP. The risks posed by group exposures are now assessed as part of the group structure risk assessment. Notwithstanding the miniscule banking group structure framework in Georgia, large exposures are now calculated on a consolidated basis and the NBG has begun to assess capital on the same basis. One weakness that still remains is that there is not as yet a formal prudential reporting structure in place. However, this is expected to be introduced in November 2014.

Principle 13. Home-Host Supervision

31. The level of cross-border banking is very insignificant in Georgia. The legislation providing for cross-border cooperation is adequate, and the actions undertaken by the NBG are commensurate with the level of activity.

Principle 14–25. Prudential Standards

32. Additional efforts should be made to improve banks' risk management, ensuring adequate implementation of regulation and guideline. The NBG has been rightly focusing on the largest banks first and is generally more demanding toward more complex and large institutions in light of the risk-based supervision principles.

33. Though the intrusive supervisory approach is highly appreciated, the NBG should avoid being involved in bank's operational credit risk management. The NBG provided some examples where banks requested NBG views regarding the approval of specific credits. It is a fine balance of being truly intrusive, focused on improving the quality of risk management of banks, but keeping banks fully responsible for their credit decisions and risk management.

Principle 26. Internal Control and Transparency

34. The legislation and practice in these areas appear adequate.

Principles 27 and 28. Financial reporting, audit, disclosure and transparency.

35. The requirements in these areas were met, although some minor weaknesses were identified.

Principle 29. Abuse of Financial Services

36. The legislation and practice in this area appear adequate. One weakness identified is there that there is no legal obligation on banks to report to the NBG suspicious activities and incidents of fraud where such activities/incidents are material to the safety, soundness, or reputation of the bank.

Table 1. Georgia: Summary Compliance with the Basel Core Principles—Detailed Assessments

Core Principle	Grade	Comments
1. Responsibilities, objectives and powers	LC	The supervisory function of the NBG should be given equal status to that of its so-called main task of price stability. Any doubt about the ability of the NBG to set and enforce minimum prudential standards for all banking activities should be removed by amending Article 21 of the LACB Law, so that all areas are covered and not just those listed in the article. While public consultation on new laws and regulations takes place in practice, there is no legal obligation on the NBG to do so. While none of these issues seems to impede the NBG in carrying out its supervisory function, given that it relies on its broad powers to achieve its aims, it would be more desirable in the interests of certainty that explicit powers were given in the law.
2. Independence, accountability, resourcing and legal protection for supervisors	MNC	The quality of supervisory staff is impressive. However, there is a very high level of staff turnover and there appears to be an over-reliance on key personnel, together with the reliance on short-term staff. Insufficient resources are put into external training and education. The NBG relies largely on internal training. The Georgian authorities do not charge for supervision. (This is an observation and is not taken into account for rating purposes.) There is no provision for the public disclosure of reasons for the removal of NBG Board members. The NBG does not publish a focused account of its strategic plans and targets or the extent to which these are met. There is no explicit legal provision that the supervisor will be adequately protected against the cost of defending their actions and/or omissions while discharging their duties in good faith. The protection afforded to staff taken or not taken, as long as such action was taken or refrained from in good faith, is not explicitly extended to the supervisor itself. Temporary administrators and liquidators are protected only if they are NBG Staff.

Core Principle	Grade	Comments
3. Cooperation and collaboration	C	A collaborative arrangement (MOU) between the NBG and the recently established insurance regulator has been signed and it should be fully implemented. A formal arrangement with the MOF to undertake recovery and resolution planning and actions was recently concluded, but it should be fully implemented.
4. Permissible activities	C	The NBG's policies and procedures are comprehensive and there is an increasing focus on looking through the shareholding and ownership structure above the institution.
5. Licensing criteria	LC	The licensing process (i.e., the acceptance or rejection of license applications) appears to work well in practice, notwithstanding some explicit gaps in legislation. The NBG relies on broad legal principles to achieve its aims in this regard. Amendments have recently been introduced to address some of these issues. There is no legal requirement for the NBG to assess whether the home supervisor practices global consolidated supervision and/or whether its supervision standards are equivalent to that of the NBG.
6. Transfer of significant ownership	MNC	The NBG relies on broad supervisory powers to achieve its aims under this Principle. At the same time, it has made notable progress in identifying beneficial owners of commercial banks, which was one of the major shortcomings during the last assessment. Nonetheless, there are some important shortcomings in legislation. The definition of "significant," as in shareholders, should be amended to include reference to persons acting in concert. There is no requirement to notify the NBG when an existing shareholder proposes to dispose of his/her significant shareholding. This could result in the NBG being unaware of significant changes of the shareholding structure. There is no reference to those that exert controlling influence in the context of transfers of significant ownership. There is no legal provision that requires banks to notify the supervisor as soon as they become aware of any material information which might negatively affect the suitability of a major shareholder or a party with a controlling interest.

Core Principle	Grade	Comments
7. Major acquisitions	LC	The criteria used by the NBG to judge individual investment proposals are not statutorily based, although the criteria, which have been established as an internal guideline, are in line with the requirements of the principle and effectively applied in practice. Such criteria have been published by the NBG under its periodic journal. There is no explicit legal provision for the NBG to: - determine whether new acquisitions/investments will hinder effective implementation of corrective actions; prohibit banks from making acquisitions/investments in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision; and - take into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.
8. Supervisory approach	LC	The NBG developed an advanced supervisory approach that is comprehensive, forward looking, and risk-based, proportionate to the systemic relevance of supervised banks. It is comprehensive because it addresses all risks emanating from banks and the banking system. It is forward looking because it includes elements such as stress test, business model, corporate governance, and capital and contingency planning. It is risk-based because it focuses on the most important risks. However, the new approach is not yet fully implemented (just for 80 percent) and formalized. The NBG does not have an explicit operational framework or process for handling banks in times of stress that could support orderly recovery or resolution. Although the NBG has (basic) powers and tools that it can use for recovery and resolution of distressed banks. Nevertheless, during the last period of stress in 2008, the NBG applied a mix of recovery instruments. The NBG required four banks to set up resolution plans, but the process of implementation has only started recently. An insurance supervisory agency was recently set up and MOU was signed between the NBG and the new agency. However, the insurance sector seems to be relatively small and the largest insurance company is a subsidiary of a bank through which the NBG monitors trends in the insurance sector and the implications for the bank.

Core Principle	Grade	Comments
9. Supervisory techniques and tools	C	The NBG has made enormous progress in the supervisory tools and techniques it is using. Three elements are worth mentioning: First, the NBG uses a supervisory cycle (risk identification, assessment and mitigation) at the level of each individual risk. This makes the NBG very flexible. This flexibility is balanced by periodical stock takings. Second, it seems the NBG has achieved an carefully balanced integration and equal usage of bank supervisors and risk supervisor. Bank supervisors are responsible for banks across risks, and risk supervisors are responsible for risks across banks, including systemic risk. Both supervisors do on-site and off-site activities. It is very clear who is responsible for which task. Third, the NBG has a very powerful supervisory information system that enables the supervisor to do "online" supervision and rigorous data analysis. For example, the NBG does not have to go on-site to do a loan review because it receives all files online which are connected to the bank's information system. All this together enables supervisors to communicate on a daily basis with each other and with the banks on different levels (from technical staff to senior management). There is only one important remark to be made. The NBG runs the risk of not spending enough time on-site because of excellent online possibilities. An important element in a bank is its risk culture. The NBG supervisors should consider whether they spend enough time on-site to sense the risk culture.
10. Supervisory reporting	LC	The NBG has a comprehensive supervisory reporting system; however, there is no formal consolidated prudential reporting framework in place—to be introduced in November 2014. Notwithstanding the absence of such a framework, there are sufficient alternatives and mitigants to otherwise address the issue.
11. Corrective and sanctioning powers of supervisors	LC	Since adopting the risk-based approach, the NBG has been more focused on the analysis of underlying factors and more forward-looking for the risks such factors lead to. It prefers dialogue through letters, emails, and meetings, and seems to be reasonably effective. However, consideration should be given to imposing formal actions with clear escalation against banks in cases of resolution of safety and soundness issues, especially if these issues linger for a protracted period of time.

Core Principle	Grade	Comments
		Although there are examples of successful interventions by the NBG in the areas of safety and soundness, there are also examples where the NBG could have done better. This will become even more important as the focus on risk management increases with the implementation of Basel II, because implementation of Basel II will require banks to upgrade their risk management.
12. Consolidated supervision	C	There has been significant improvement in consolidated supervision since the last FSAP. It now features as part of the risk assessment program, and important ratios are now calculated on a consolidated basis. The main weakness is the absence of a formal consolidated prudential reporting framework, which is dealt with in Principle 10.
13. Home-host relationships	C	The level of cross-border banking is insignificant in Georgia. The legislation providing for cross-border cooperation is adequate and the actions undertaken by the NBG are commensurate with the level of activity.
14. Corporate governance	LC	Since the NBG announced its intention to implement Basel II and III, it has put significant effort into determining that banks have robust corporate governance and that the policies and processes are commensurate with the risk profile and systemic importance of the bank. There are a few areas of improvement: – Boards seem to be less involved in setting and overseeing the risk appetite. – It seems that there is a conflict between the law and the regulation on whether a Director can or can't be a member of the Supervisory Board. According to the NBG, such practice is very rare and Directors are restricted to participate in decision making where such participation creates conflicts of interest. – The Audit Committee exists in all banks as required by law, but the function could be enhanced if made a direct subcommittee of the Supervisory Board. Although the Committees are composed of independent members and have a reporting line to a bank's Supervisory Board, legally members are not held to the same accountability standards as Supervisory Board members. Still, the NBG has facilitated the banks to establish such committees as subcommittees of the Supervisory Board. The NBG does not have explicit power to change the composition of the Board. However, such power is implicitly in place. The NBG has the power to require dismissal of a Board member (LACB article 30.3e) who lacks experience or education (LACB article 41).

Core Principle	Grade	Comments
15. Risk management process	MNC	The NBG has a very good supervisory approach that can be characterized as intrusive, forward looking, and risk based. Although the NBG made significant progress, there are several essential criteria that are not yet fully met for large, medium, and small banks. The NBG rightly focused first on the largest banks (with highest risk profile), but should also bring the small and medium banks (proportional though) up to standard. The implementation of Basel II is an important step forward in this regard. However, one cautionary remark is to be made. Though the intrusive approach is highly appreciated, the NBG runs the risk of being too involved and taking over the risk management of the bank, in particular its credit risk management. First, the NBG is required to determine that banks have a suitable risk appetite. For instance, many banks do not have detailed lending standards or their interest rate risk appetite. It is expected that the implementation of Basel II will provide the right incentive in this regard. Second, the NBG is required to determine that banks have adequate internal processes for assessing capital and liquidity adequacy in relation to risk appetite and risk profile, and that this is also reflected in banks' internal reporting. However, these requirements are not (yet) met because banks are in the process of implementing Basel II, under which they are setting up an internal process for assessing the capital and liquidity adequacy in relation to the risk profile (ICAAP, ILAAP). A few banks have already submitted the first draft of their ICAAP. In addition, the NBG has not yet developed guidelines for how to determine the adequacy of the ICAAP in the so-called Supervisory Review Evaluation Process (SREP). Third, the NBG is required to request banks to have appropriate contingency arrangements and forward-looking stress tests. However, these requirements have not yet been fully implemented by all banks. The NBG expects all banks to have adequate stress tests in place at the end of this year as part of the implementation of Basel II. Finally, the NBG is required to determine that the risk management function is clearly segregated by the risk-taking function. However, it is observed in the assessment of bank governance conducted during the FSAP that the credit risk management function/Chief Risk Officer (CRO) is involved in the credit approval process. In addition, it is important to note that several banks have remuneration policies for their credit risk management that combine elements of growth, volume of analysis, and quality of the loan portfolio.

Core Principle	Grade	Comments
16. Capital adequacy	C	The NBG is in the process of implementing Basel II and elements of Basel III. The NBG used a conservative application of Basel rules such as an additional 75 percent risk weight on loans denominated in foreign currencies. Banks are required to comply with the minimum capital requirements under Pillar 1 as of June 30, 2014. Regarding credit risk, banks can only apply the standardized approach. Regarding operational risk, banks can only apply the basic indicator or standardized approach. Regarding market risk, banks are required to use a simple approach to determine a capital requirement for FX risk. Pillar 2 will be in force as of September 30, 2014, when banks are required to report the outcome of their Internal Capital Adequacy Process (ICAAP). The NBG will decide before end-2014 when banks need to comply with the Pillar 3 requirements. During the transition period (2014–2017) banks need to comply with both the minimum capital requirements based on adjusted Basel I capital requirements and the minimum capital requirements based on Basel II/III. As of January 2014, banks have been required to file a parallel run.
17. Credit risk	LC	The NBG has developed a very advanced risk-based approach to determine whether banks have an adequate credit risk management system. This includes assessment of credit risk policy and procedures, management information, and loan reviews. Together with the detailed monthly return, the NBG has the opportunity to do cross-checks and rigorous credit risk analysis. This analysis is (for the corporate and SME portfolio) based mostly on key ratio analysis (derived from Moody's and S&P) and valuation of collateral. However, in practice, not all banks have (yet) fully implemented the specific requirements of the credit risk management framework such as adequate lending standards. Second, there are no specific requirements that require banks to prescribe in their credit policy that major risks exceeding a certain amount or percentage of the bank's capital, as well as risky exposures that are otherwise not in line with the mainstream of banks' activities, are to be decided by the Board or senior management. Third, not all banks include their credit risk exposures into stress testing programs for risk management purposes. The NBG is currently facilitating implementation of a sound stress-testing framework in commercial banks, which would form an essential part of Pillar 2 processes by the end of the year.

Core Principle	Grade	Comments
18. Problem assets, provisions, and reserves	C	The NBG has put significant effort into identifying problem loans and maintaining adequate levels of provisioning, mostly for the large borrowers (40 percent of total loan portfolio). For SME and retail borrowers, it uses for instance sample techniques to ensure adequate provisioning. All of this is the result of comprehensive reporting, enhanced risk assessment skills, an intrusive supervisory approach, and active dialogue with the commercial banks. The NBG intends to facilitate transition toward the IFRS. When the IFRS framework is adopted, the NBG intends to update its guidelines on loan-loss provisioning.
19. Concentration risk and large exposure limits	LC	The NBG has made major improvements in identifying connected borrowers. It receives on a monthly basis a database from every bank of the top 100 borrowers, the large exposures and the participations. This has given the NBG the possibility to compare how banks treat groups of borrowers. Although banks are required by regulation to identify economic interdependence, there is limited practice at the banks to do this. This means that for part of the portfolio it is not fully clear what the large exposures are from the perspective of economic interdependence. However, to mitigate this uncertainty, the NBG decreased its total large exposure limit from 600 percent to 200 percent. Nevertheless banks should put more effort into identifying economic interdependence. For this purpose, the NBG is planning to develop guidelines on economic interdependence. The regulation on concentration and large exposures does not prescribe requirements for concentrations other than single counterparties or groups connected counterparties. Although the NBG adopted a general regulation on risk management that includes some provisions on concentration risk, it did not fully implement this regulation. This will be repaired, according to the NBG, with the introduction of Pillar 2 of Basel II, which explicitly requires banks to assess all significant sources of concentration risk. The NBG recently prepared to change the definition of large exposures according to the new Basel standard on large exposures and concentration risk (June 2014). So, it includes all claims, including equity (although the position does not seem to be material). This amendment is not fully implemented yet.

Core Principle	Grade	Comments
20. Transactions with related parties	C	The NBG has put significant effort into identifying related parties and related transactions and making sure that transactions take place at an arm's-length basis. In addition, the supervisor reviews the pricing of both the loan and deposit sides in order to look for irregularities. The latter also gives the NBG the possibility to cross-check how different banks deal with related parties. Finally, it also determines during credit risk assessments whether it is a case of related parties and/or related transactions.
21. Country and transfer risks	LC	The NBG very actively monitors the country and transfer risk (direct and indirect) themselves based on prudential reports and recently (May 2014) started to stimulate banks to manage their country and transfer risk through issuing a guideline on country and transfer risk. Further, the NBG does not determine systematically whether the bank's strategies, policies, and processes have been approved by the bank's Board and whether the Board oversees implementation by management. In addition, only the largest banks conduct stress tests and incorporate adverse scenarios of country and transfer risk. In the second half of 2014, the NBG will review the ICAAP set up by the banks (SREP) in order to stimulate an alignment between the risk profile, capital position, and the quality of risk management. This will give the right incentives to the banks to manage explicitly their country risk. The NBG does not have a formal provisioning model for country risk and transfer risk. Banks have the discretion to consider themselves whether provisioning for country risk is deemed necessary. It is part of standard analysis of a borrower. At the same time, if the NBG is not satisfied with the level of provisioning and the way it has taken country risk or transfer risk into consideration, it has the power to require extra provisioning. The NBG has used this power in the case of bank exposures to one country.
22. Market risk	C	The market risk in the trading book is not material (including consolidated supervision). The main market risk is foreign exchange risk. The NBG determines sufficiently whether banks have an adequate market risk management process, taking into account the market and macro-economic conditions. Since June 2014, currency risk is charged under Pillar 1. In September 2014, Pillar 2 will become effective.
23. Interest rate risk in the banking book	LC	Banks could receive more guidance from the NBG to improve the quality of interest rate risk management. Despite the presence of guidelines on risk management, introduced in 2008, it seems that there is further room for improving the quality of interest rate risk management of banks.

Core Principle	Grade	Comments
		However, based on the new reporting standard, introduced in 2012, most of the banks don't have a material interest rate risk position because of the basic short-term nature of their balance sheets, although one systemic bank does have a material interest rate position without internal limits. This bank holds earmarked capital as a buffer for interest rate risk. All banks should take their interest rate risk into account in relation to their capital position, including defining trigger ratios. This will be part of the implementation of Basel II, Pillar 2.
24. Liquidity risk	LC	Liquidity risk assessment by the NBG covers all aspects of liquidity. The NBG analyzes banks' inherent liquidity risks as well as their mitigants. Systemic and complex banks are required to have a more developed liquidity risk management framework. The NBG imposes a conservative liquidity requirement and is also in the process of moving toward the Basel III framework (Liquidity Coverage Ratio (LCR)) The new regulation on liquidity risk will enter into force in September 2014. However, the NBG focuses their efforts to improve the quality of liquidity risk management of banks mainly for the three largest banks. This is understandable from a risk based supervision point of view, but there is a risk that the quality of liquidity risk management of the other banks lags behind. The assessors believe that these shortcomings will be solved in the near future since the NBG is in the process of implementing the new regulation on liquidity (including elements of Basel II and III). Banks' have access to the NBG's emergency liquidity facility (ELA), pledging as collateral government or NBG debt instruments, and loans, including mortgages, with a 20 percent haircut.
25. Operational risk	LC	The NBG made good progress in the area of operational risk. The recent enacted regulation and the establishment of a specialized operational risk unit significantly broadened the scope of operational risk supervision and expanded supervision into key areas that were not covered directly before (i.e. business continuity management and outsourcing). There are some areas of improvement also recognized by the NBG. First, only 7 out of 21 banks have comprehensive business continuity plans (though these include the largest banks). The other banks have only disaster-recovery plans and should broaden their perspective toward comprehensive continuity plans. Second, most of the banks lack adequate outsourcing policies. Third, banks have insufficient internal reports that should, according to the NBG, be more analytical in nature. Fourth, most of the banks do not perform IT audits. This will probably change, since the

Core Principle	Grade	Comments
		new regulation requires incorporation of IT audits in the overall audit plan of banks.
26. Internal control and audit	C	As mentioned in CP 14, the law provides that an Executive Director can be appointed to the Supervisory Board, the body charged with the oversight of the executive, although Directors are prohibited by law from participating in decision making on issues related to supervision of executive functions activities, approval, and evaluation of its reports. As CP 14 has been rated LC on account of this, there is no downgrade in this Principle.
27. Financial reporting and external audit	C	The auditor has up to five business days in which to notify the NBG of any matters of serious significance that comes to his/her attention. That period is too long. However, the regulation was recently amended, requiring the auditors to report immediately material changes to NBG supervisors.
28. Disclosure and transparency	LC	The NBG's current requirements for banks to disclose quantitative and qualitative information are limited on the qualitative side. The NBG plans to enhance its regulation on transparency with the introduction of IFRS 7 and Pillar 3 disclosures on the qualitative side. It will also require banks to publish information on their lending standards.
29. Abuse of financial services	LC	There is no explicit obligation on banks to report to the NBG suspicious activities and incidents of fraud where such activities/incidents are material to the safely, soundness, or reputation of the banks. The definition of Politically Exposed Person (PEP) refers solely to a foreign citizen and not to both domestic and foreign persons, which is now regarded as best practice. The FMS (FIU) is moving from under the auspices of the NBG to the Office of the Prime Minister. There is some concern about its continued independence, including staffing and funding.

RECOMMENDED ACTIONS

Table 2. Georgia: Recommendations to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Actions
Principle 1. Responsibilities, objectives and powers.	Seek review of the NBG Law, so that banking supervision will be given equal status to price stability as the main task of the National Bank. Amend Article 21 of the ACB Law so that in setting and enforcing minimum prudential standards all areas are covered and not just those listed in the Article. Amend the law to make public consultation on new laws and regulations statutorily binding.
Principle 2. Independence, accountability, resourcing and legal protection for supervisors.	Review NBG salary levels in light of NBG's legal obligation to maintain effective supervision by maintaining high qualified and experienced staff. The NBG should increase its training and education budget. Consider charging for supervision. (This recommendation is solely advisory – it is not taken into account in determining the rating.) The NBG should publish a more comprehensive and detailed strategic plan and targets in its annual accounts. 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 discharging their duties in good faith. 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.
Principle 5. Licensing criteria	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. 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 establish a branch bank in Georgia). 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.

Reference Principle	Recommended Actions
Principle 6. Transfer of significant ownership.	Expand the definition of "significant shareholder" to include persons acting in concert. Make it legally binding that existing significant shareholders proposing to dispose of their shareholding must notify the NBG in advance. Make it legally binding for banks to have to notify the NBG as soon as they become aware of any material information that might negatively affect the suitability of a major shareholder or a party with a controlling interest in the bank.
Principle 7. Major acquisitions	Provide direct statutory backing to the criteria used by the NBG to judge investment proposals by banks. Effective implementation of corrective action; Prohibit banks from making acquisitions/investments in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision; and Take into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.
Principle 8. Supervisory approach	Complete the implementation of the new supervisory approach and formalize it. 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. Undertake a crisis-simulation exercise.
Principle 9. Supervisory technique and tools	Consider how to balance the attention for inherent risk and quality of risk management. Integrate identification of risk culture in the supervisory approach and spending more time on-site to sense the risk culture.
Principle 10. Supervisory reporting.	Ensure that a formal consolidated prudential reporting framework is in place by November 2014, as targeted.

Reference Principle	Recommended Actions
Principle 11. Corrective and sanctioning powers of supervisors	Employ an escalation framework for safety and soundness issues. Reflect to what extent NBG could have been more effective with regard to deficiencies that linger for a protracted period of time. 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.
Principle 12, Consolidated supervision.	Ensure that a formal consolidated prudential reporting framework is in place by November 2014, as targeted.
Principle 14. Corporate governance	Increase involvement of Boards in setting and overseeing risk appetite. Align the legislation and regulation with regard to the role of directors in a Supervisory Board. Make the overseeing risk committee and remuneration committee as a requirement by law or regulation. Encourage banks to make the Supervisory Committee directly responsible for the Audit committee. Initiate a law that gives the power to change the composition of a Board.
Principle 15. Risk management	Make sure that banks express their risk appetite for the different risk categories. Continue implementing Basel II including ICAAP, contingency planning, stress testing and SREP. Determine the internal pricing mechanism of all banks. Evaluate the role and independence of CRO and (credit) risk management, including the incentive structure.
Principle 16. Capital adequacy	Introduce a framework on how to deal with domestic systemically important banks, including the introduction of a capital buffer. Consider introducing a countercyclical buffer. Set up an implementation plan for Pillars 2 and 3 for banks and supervisors, including deciding who will do the assessment. Develop guidance for supervisors on SREP. Develop Pillar 3 requirements for banks.

Reference Principle	Recommended Actions
Principle17. Credit risk	Keep focused on ensuring that all banks implement the credit risk management requirements under which the requirements for lending standards. Require banks to have certain exposures exceeding a certain amount to be decided by the banks' Board and senior management. Make sure that all and not only large banks include credit risk exposures into their stress tests.
Principle 19. Concentration risk and large exposure limits	Develop regulation or guidelines for concentration risk beyond large exposures. Make banks improve their identification of the economic interdependence of borrowers. Consider developing a limit for the 10 largest exposures.
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.
Principle 21. Country and transfer risk	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. Develop an explicit provisioning system for country risk and transfer risk. Require prudential return on country risk on consolidated level on a semi-annual base.
Principle 22. Market risk	Continue implementing the new capital regime since this will enhance the risk management. Incentivize all banks to conduct stress tests Allocate capital for unexpected market risk losses.
Principle 23. Interest rate risk in the banking book	Require banks (through regulation) to have internal limits for interest rate risk. Provide more guidance to banks on how to deal with interest rate risk in relation to ICAAP. Increase the frequency of reporting to a quarterly basis in order to keep abreast of developments.
Principle 24. Liquidity risk	Continue with the finalization and implementation of draft regulation of LCR. Ensure that all banks have adequate contingency funding planning, taking into account limited opportunities.

Reference Principle	Recommended Actions
Principle 25. Operational risk	Make sure that all banks set up business continuity plans and outsourcing agreements (including taking the local environment into account) and conduct (mandatory) IT audits.
Principle 26. Internal control and Audit.	Seek the removal of the legal provision that allows Executive Directors to sit on Supervisory Boards.
Principle 28. Disclosure and transparency.	Enhance the level of qualitative information, which banks are required to disclose in their annual accounts.
Principle 29. Abuse of financial services.	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. Extend the definition of PEP to include domestic and foreign persons.

Authorities' Response to the Assessment

The National Bank of Georgia (NBG) would like to express its appreciation towards the FSAP mission team and its assessment of Georgian banking sector and the supervisory quality. We strongly respect the integrity of the mission members and the quality of the reports produced. We appreciate the efforts of the team to analyze the major developments in the banking sector and its supervision and observe major improvements which, according to the assessment, have resulted in an advanced, forward-looking, intrusive, risk-based, efficient, comprehensive and, in several instances, even leading supervisory approach. The discussions with the team members constituted a very interesting process for us. The recent assessment further increased our confidence that we are on the right path, pursuing well-established international standards. Such a positive assessment and acknowledgement of progress made gives forward momentum to remain committed to the continuous enhancement of our supervisory framework based on BCP principles and other international best practice guidelines.

We hope that FSAP project will be granted adequate importance and credit from IMF and WB in future as well, as it represents a very valuable instrument for the assessment of country practices. We believe in enhanced role of FSAP assessments, especially considering that self-identified shortfalls by IMF and WB (August 28, 2009) are gradually being eliminated through the improvement of analytical content, quality, and comparability of assessments and strengthening of "off-site" work. In our view, further efforts are required to ensure that all stakeholders interpret the BCPs in an adequate and uniform manner and apply all aspects of grading methodology to arrive at fair, competent and proportionate grading. In addition, increased emphasis on qualitative content and observance of particularly good practice would result in more stakeholders utilizing assessment reports as an input into their analysis for policy design. Such enhancements should promote better cross-country comparability of assessment results as well. In addition, we would like to highlight (not only in reference to Georgian assessment) that more emphasis should be made on testing the quality of supervisory judgment in practice, taking into account the role of FSAPs in enhancing financial stability.

Hereby we provide individual comments on several principles:

CP2 (Independence, accountability, resourcing and legal protection for supervisors)

The major driver of "MNC" score is the lack of salary competitiveness of the supervisor as compared to the banking industry and junior staff turnover rate. We would like to note that budget limitations have not compromised professionalism and effectiveness of NBG staff. As assessors also confirm that the quality of supervision staff is impressive, we consider the assigned grade to the principle rather incompatible.

CP5 (Licensing criteria)

We believe that we are fully compliant with all the requirements of the given principle. Legal requirement for the NBG to assess whether the home supervisor practices global consolidated supervision, and/or whether its supervision standards are equivalent to those of the NBG is not required by the BCPs. The principle refers solely to the practice that we effectively have in place. We would like to highlight that we have inquired if the assessment was in line with Basel FSI interpretation of the terms "supervisor determines", "supervisor assesses", "the supervisor requires" and "has the power to require." According to the feedback from assessors, presence of legal provisions was important despite the fact that it is not required by formal BCP guidelines. We strongly believe that such a deviation from assessment methodology had a significant negative impact on the grading of 1st, 5th, 7th and 15th principles.

CP6 (Transfer of significant ownership)

There are no sufficient qualitative observations presented in the assessment of the given principle that would reflect how we meet the objectives of the principle. We believe that all essential criteria are being satisfied in practice. We would additionally like to note that there is no risk that we are unaware of any changes in relation to shareholders, as banks have a clear notification requirement. Despite the fact that there are no practical concerns in place, we commit to eliminating legal gaps, such as prescribing in legislation "shareholders acting in concert," and introducing the obligation to receive supervisory approval for the disposal of qualifying holding.

CP 7 (Major acquisitions)

The assessment would have benefited from more qualitative content. We have a fairly comprehensive approach towards the analysis of major acquisitions and in practical terms we meet all aspects of the 7th principle. Besides, identified legal gaps, listed in the comments section, and are not stipulated by BCPs, for instance, legal obligation on supervisor to assess the effectiveness of the host supervisor.

CP 8 (Supervisory approach)

We were not convinced that there are any inconsistencies with Basel core principles. Given the absence of cross-border activities in Georgia and the prevalence of non-complex banking system and their balance sheets, the resolvability assessment under Georgian context is fairly straightforward and does not pose any material concerns. Moreover, even in advanced financial centers, resolvability framework is at an early stage of implementation; however, such observations have not impeded full compliance with the given principle. It should as well be noted that in practice, NBG has taken all relevant measures in cases where resolvability posed excessive risks to local banks. Among them are the requirements of operational independence, ring-fencing, simplification of group structure, etc. Going further, we plan to update the regulation on dealing with problem banks in line with the FSB's key attributes and Basel guidelines. As regards to supervisory approach, its enhancement is a continuous process in line with updating international standards.

CP 11 (Corrective and sanctioning powers of supervisors)

We agree that some deficiencies could exist for a prolonged period of time in commercial banks; however, consideration should be given to their materiality and the assessment benchmark as well. We did not receive concrete feedback to clarify the instances where there is a room for improvement and the relevant means despite the fact that we have been fully transparent to the assessors which is an important precondition for fruitful dialogue. In addition, we believe that we do have the powers to set individual risk governance requirements, intervene in the organizational structure or business model of a bank evidenced by practical examples. Relevant escalation matrix is also in place. We will conduct additional review to clarify the substance of the comments under the given principle; however, as of now we consider the recommended action plan to have been implemented already.

CPs 15 – 25

We confirm that we are committed towards further improvement of banks' risk management. However, we believe the assessment was conducted against benchmarks that are too high contradicting the proportionality principle which constitutes one of the cornerstones of BCP assessment methodology. The assessment of the 15th principle stands out as principally unclarified to us.

We do not agree that we focus on largest banks only in our supervisory assessments. We focus on every bank in line with the risk based supervision principles, and we are indeed oriented towards continuously bringing banks closer to their specific relevant standard. The fact that the sophistication of risk management varies across banks is in line with BCPs. Assessors highlight the need for more attention to the quality of the liquidity risk management and its supervision in small banks. We would like to affirm that NBG monitors liquidity risk management of each and every bank and that there are diverse examples of actions taken by NBG for both large and small banks.

We would like to comment on the assessment of ICAAPs as well. The transition to pillar 2 of Basel II/III has started in recent past; however, that does not imply that we are not complying with the core principles that refer to the assessment and planning of capital adequacy both by banks and supervisor. In 2009, NBG introduced legal provisions in LACB that empowered it to impose individual requirements on commercial banks in line with risk based supervision principles. Recent formal launching of pillar 2 of the Basel II/III does not imply that NBG has not already been assessing the ability of banks to quantify risks, price risks and govern risks which incorporate the calculation of both expected and unexpected losses. Instead, our approach has already been risk-based and the capital requirements across different banks have been in line with their individual risk profiles, what is also confirmed by the mission. As a result, the transition to Basel II/III is not a reversal of our current practice, but it should supplement the existing one. It should also be noted that Georgia is not the only country that is in the implementation process and there are many advanced economies that have not yet implemented the framework, or do not generally request ICAAP from small banks.

In certain instances the assessors advise NBG to introduce excessive pieces of legislation and/or impose requirements on banks to advance their internal models and risk management systems to address absent or very immaterial risks. For instance, we do not agree that there is a need to introduce formal provisioning model for country risk when there are no such direct exposures. Neither is there a need to require from bank boards to monitor such an absent risk. Nevertheless, when such even indirect risks have emerged, NBG has always determined and required from banks to address them. We believe that our practice in quantifying indirect country risk is effective through the estimation of exposures to companies which export/import from relevant countries (taking into account relevant shares of exports/imports in their returns).

Further, we cannot agree that there is any risk of us effectively becoming bank risk managers as intrusive supervision is what is urged and favored internationally. We strongly believe that the unfortunate lack of familiarity of supervisors with inherent risk of banks was one of the severe weaknesses which, at least to some extent, contributed to the global financial crisis and, in this regard, our detailed knowledge of risks in individual banks, as well as results of innovative horizontal reviews, should be seen as a particularly good practice. We also could not fully comprehend what is meant by the statement that banks do not have detailed lending standards. In addition, the fact that NBG commenced the implementation of regulatory stress-tests last year, which are transaction level and enterprise-wide, should not have interpreted as if banks had not already performed their own ones. In relation to credit and concentration risks, we have not observed any material concerns from the side of the assessors that could have compromised the efficiency of our framework. Furthermore, we believe we share a common view with the mission that all individual findings are not seen as "severe shortcomings," which is required to be evidenced if a principle is assessed as MNC. We agree that CP 15 is an overarching principle and incorporates findings from other principles, but it remains ambiguous to us how the combination of those findings was interpreted jointly. Moreover, based on the aforementioned findings relevant principles were already excessively downgraded to "LC". Consequently, the assessment methodology of 15^{th} principle remains unclear and involves double counting, which is against relevant BCP methodology.

DETAILED ASSESSMENT

The assessment of compliance with each principle will be made based on the following four-grade scale: **compliant, largely compliant, materially noncompliant,** and **noncompliant**. A "not applicable" grading can be used under certain circumstances. While grades in self-assessments may provide useful information to the authorities, these are not mandatory as the assessors will arrive at their own independent judgment.

Compliant: A country will be considered compliant with a Principle when all essential criteria applicable for this country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.

Largely compliant: A country will be considered largely compliant with a Principle whenever only minor shortcomings are observed that do not raise any concerns about the authority's ability and clear intent to achieve full compliance with the Principle within a prescribed period of time. The assessment "largely compliant" can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.

Materially noncompliant: A country will be considered materially noncompliant with a Principle whenever there are severe shortcomings, despite the existence of formal rules, regulations, and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. It is acknowledged that the "gap" between "largely compliant" and "materially noncompliant" is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement.

Noncompliant: A country will be considered noncompliant with a Principle whenever there has been no substantive implementation of the Principle, several essential criteria are not complied with, or supervision is manifestly ineffective.

In addition, a Principle will be considered not applicable when, in the view of the assessor, the Principle does not apply given the structural, legal, and institutional features of a country.

Unless the country explicitly opts for any other option, compliance with the Core Principles will be assessed and graded only with reference to the essential criteria. As a second option, a country may voluntarily choose to be assessed against the additional criteria, in order to identify areas in which it could enhance its regulation and supervision further and benefit from assessors' commentary on how it could be achieved. However, compliance with the Core Principles will still be graded only with reference to the essential criteria. Finally, to accommodate countries that further seek to attain best supervisory practices, a country may voluntarily choose to be assessed and graded against the additional criteria, in addition to the essential criteria.

Table 3. Georgia: Detailed Assessment of Compliance with the Basel Core Principles	
Supervisory Powers, Responsibilities and Functions	
Principle 1	**Responsibilities, objectives and powers**. An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups.[1] A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.[2]
Essential criteria	
EC1	The responsibilities and objectives of each of the authorities involved in banking supervision[3] are clearly defined in legislation and publicly disclosed. Where more than one authority is responsible for supervising the banking system, a credible and publicly available framework is in place to avoid regulatory and supervisory gaps.
Description and findings re EC1	The NBG is the sole supervisory authority for commercial banks in Georgia. Article 3 of the Organic Law of the National Bank of Georgia (NBG Law) sets out its tasks and duties. It specifies (Article 3 (1)) that its main task is to ensure price stability. Article 3 (3) lists the duties of the National Bank, which include the supervision of the financial sector and seeking the prevention of money laundering and the financing of terrorism. Articles 47, 48 and 49 of the NBG Law elaborate on its supervisory powers. Article 48 (1) states that the National Bank shall be granted full authority to supervise the operations of the commercial banks. Article 49 specifies that the National Bank shall be authorized to supervise the operation of the commercial banks (and nonbank depository institutions). This covers: issuance and revocation of licenses, audit and regulation, imposition of restrictions and sanctions. In support of the legislative framework, the NBG has issued regulations on specific prudential areas (e.g., capital, large exposures, related party lending, liquidity, etc.). Recommendations have full statutory backing.

[1] In this document, "banking group" includes the holding company, the bank and its offices, subsidiaries, affiliates, and joint ventures, both domestic and foreign. Risks from other entities in the wider group, for example nonbank (including nonfinancial) entities, may also be relevant. This group-wide approach to supervision goes beyond accounting consolidation.

[2] The activities of authorizing banks, ongoing supervision and corrective actions are elaborated in the subsequent Principles.

[3] Such authority is called "the supervisor" throughout this paper, except where the longer form "the banking supervisor" has been necessary for clarification.

	The legislation (Article 3 of the NBG Law) gives clear prominence to price stability as the NBG's main task. Its other duties (which include the supervision of the financial sector and seeking the prevention of money laundering) are carried out "provided this is possible in a manner to avoid threatening of its main task" (i.e., price stability). In theory, at least, this prominence could compromise NBG's supervisory function or at a minimum understate its importance.
EC 2	The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it.
Description and findings re EC2	Under the Constitution of Georgia, the NBG is charged with the implementation of monetary policy to ensure price stability, and the support of a stable functioning of the financial sector. As indicated in EC1, the NBG Law specifies that its main task is to ensure price stability (Article 3(1). Article 3 (2) states that the NBG shall ensure the stability and transparency of the financial system and shall facilitate stable economic growth in Georgia, provided this is possible without threatening its main task. Article 3(3) lists the duties of the NBG. These include the supervision of the financial system and supporting anti-money laundering and financing of terrorism legislation. (See EC1 above for further comment on this issue.)
EC3	Laws and regulations provide a framework for the supervisor to set and enforce minimum prudential standards for banks and banking groups. The supervisor has the power to increase the prudential requirements for individual banks and banking groups based on their risk profile and systemic importance.
Description and findings re EC3	The NBG Law and, in particular, the Law on Activities of Commercial Banks (ACB Law) provide the main framework for the supervisor to set and enforce minimum prudential standards for banks and banking groups. Article 21 of the ACB Law - Prudential Limits and Standards - specifies that commercial banks must observe prudential limits in a wide range of areas (e.g., capital, large exposures, related-party lending, liquidity, asset classification, foreign exchange and interest rate risk.) However, the list is exhaustive and there is no specific provision for the NBG to set minimum prudential standards for risks not included in such list, e.g., market risk, operational risk (although the NBG does set prudential standards for such risks). In the case of operations where the NBG has not issued prudential instructions, banks are required to conduct such operations in accordance with international norms and standards (Article 19 of the ACB Law). It is recommended that Article 21 of the ACB Law be amended to remove any doubt about NBG's ability to set prudential standards for all relevant areas of banking activity. This could be achieved by the inclusion of a 'catch all' provision allowing the NBG to set prudential standards for any area where it believed such standards were required. Based on the powers given to it in Article 21 of the NBG Law, the NBG has issued detailed regulations dealing with the various prudential issues. The NBG does not have the power to set prudential standards directly for banking groups, although group structure analysis is part of the NBG's risk assessment process. Currently, a

	regulation on consolidated supervision is being drafted. (In practice, no large or complex groups exist in Georgia.) (See Principle 12 – Consolidated Supervision – for greater details and comment.)
EC4	Banking laws, regulations and prudential standards are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices. These are subject to public consultation, as appropriate.
Description and findings re EC4	The ACB Law was adopted in 1996 and was substantially amended in 2009, when the NBG assumed responsibility for the supervision of the entire financial sector (integrated supervisor). The NBG Law was also significantly amended in 2009. Prudential regulations/standards are also regularly reviewed and updated. Recent amendments have included developing criteria for: the granting of bank licenses; independence criteria regarding the Audit Committee members; dealing with liquidated banks; significant shareholdings in banks, anti-money laundering; and Basel II/III. While, in practice, the NBG generally consults on draft regulations, there is no legal obligation on it to do so. It is recommended that the NBG be statutorily obliged to consult before the finalization of the regulations.
EC5	The supervisor has the power to: (a) have full access to banks' and banking groups' Boards, management, staff, and records in order to review compliance with internal rules and limits as well as external laws and regulations; (b) review the overall activities of a banking group, both domestic and cross-border; and (c) supervise the activities of foreign banks incorporated in its jurisdiction.
Description and findings re EC5	The ability of the NBG to have full access to these sources is governed by a number of Articles in both the NBG Law and the ACB Law. Article 45 of the NBG Law states that the NBG shall be authorized to require and receive from state institutions and any other person (including banks) all statistical, accounting, and other information (including confidential information) necessary for the discharge of its duties. Article 48(4) states that for the purpose of performing its supervisory functions, the NBG is authorized to request and receive within its field of competence from the commercial banks any information (including confidential information). Article 29 of the ACB Law states: 1. Each bank shall prepare and submit to the National Bank, both for the bank itself and separately for each of its subsidiaries, reports concerning organizational-administrative and operational activities and concerning liquidity, solvency, and profitability in order to enable the National Bank to assess their financial conditions both individually and on a consolidated basis. These reports shall be prepared in such form and detail and shall be submitted at such intervals as shall be prescribed by regulation of the National Bank.

	2. Each bank and each of its subsidiaries shall be subject to inspections by inspectors of the National Bank or by auditors appointed by it. Such auditors may include employees of the monetary or prudential supervision divisions of pertinent foreign regulators in cases where such inspections are to take place with respect to a branch office or subsidiary of a foreign bank. 3. In their inspections of banks and their subsidiaries, the NBG and its auditors may: a. examine all books, records, accounts, funds, and other documents of banks and their subsidiaries; b. require that administrators and employees of banks and their affiliates submit to review information on the bank's shareholders, controlling persons, and administrators and any information concerning the bank's operation and transactions.
EC6	When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaging in unsafe or unsound practices or actions that have the potential to jeopardize the bank or the banking system, the supervisor has the power to: (a) take (and/or require a bank to take) timely corrective action; (b) impose a range of sanctions; (c) revoke the bank's license; and (d) cooperate and collaborate with relevant authorities to achieve an orderly resolution of the bank, including triggering resolution where appropriate.
Description and findings re EC6	Article 30 of the ACB Law sets out a list of infractions whereby the National Bank can impose sanctions (Subsection 2). The list appears comprehensive. Subsection 3 sets out the range of sanctions available to the NBG. They range from issuing written warnings to the cancellation of the bank's license. Article 30 reads as follows: 1. The penalties provided for infractions described in this Article shall be determined in particular cases by the National Bank. Any aggrieved party may appeal such determination to the courts of law. 2. The National Bank shall be authorized to impose the following actions and sanctions with respect to banks, their administrators and controlling persons if a bank, any of its administrators or controlling persons is guilty of an infraction consisting of: a. a violation of a provision of this law or of any regulation, instruction, rule, decree, order or written guidelines of the National Bank; b. a violation of any condition or restriction attached to the banking license of a bank or to a regulation issued by the National Bank; and c. failure to meet a timeframe for the submission of reports or the submission of incorrect reports or of other inaccurate information.

	3. When the above-mentioned violations are revealed, the National Bank has the right, with increasing severity depending on the seriousness of such violation and any actual or potential risk it poses to the assets of the bank, to impose on banks the following sanctions: a. issue written warnings; b. carry out special actions or issue instructions requiring that a bank must cease certain current practices and desist from future ones and other violations and take measures to eliminate violations within a specified period; c. impose fines according to rules and amounts established by the National Bank, but not in excess of a bank's own funds; d. impose civil money penalties in such amounts and pursuant to such procedures as are established by the National Bank if action of the bank's administrators caused financial loss to the bank or permitted the violation of regulations and requirements of the National Bank; e. suspend the signing authority of the bank's administrators and to require the bank's Supervisory Council to dismiss him or her temporarily or permanently; f. require the Supervisory Council and Management Directorate to call a special meeting of the bank's shareholders to discuss the violations and to take necessary measures to eliminate them; g. suspend or terminate asset growth, distribution of profits, payment of dividends and bonuses, and salary increases and the reception of deposits; h. in special cases, when the interests of the bank's depositors and other creditors are jeopardized, to suspend active operations and to place the bank in Temporary Administration; i. request from the controlling persons of a bank to divest or reduce their control in case of failure to provide financial or other information to the National Bank or in cases where a violation has been discovered. Such divestiture or reduction shall be undertaken in accordance with such terms and conditions the National Bank shall deem necessary in the particular circumstances; and j. cancel the bank's license. On cooperation, etc., there are no provisions in the law for cooperation with other authorities; in practice, the NBG will cooperate where needed (for example, with the Ministry of Finance under a contingency working group framework to achieve an orderly resolution.) Recently, the NBG has signed an MOU with the MOF.

EC7	The supervisor has the power to review the activities of parent companies and of companies affiliated with parent companies to determine their impact on the safety and soundness of the bank and the banking group.
Description and findings re EC7	Article 29 of the ACB Law provides that the NBG can require from banks information for review on their shareholders and controlling for the purposes of carrying out its supervisory function.
Assessment of Principle 1	Largely compliant.
Comments	The reason for the 'largely compliant' rating relates to the fact that, whereas none of the shortcomings identified under this Principle appear to impact adversely on the ability of the NBG to carry out its supervisory function effectively, the absence of explicit powers generally in these areas could, at least in theory, leave the NBG open to challenge. Moreover, the clause in the legislation (Article19 (1) of the CBA Law), which states that where there is no specific banking rule established by the NBG, banks should act pursuant to international banking rules and customs is aspirational only and could not be enforced. Accordingly, it is recommended that the following areas be addressed: EC3: Remove any doubt about the NBG's ability to set and enforce minimum prudential standards for all banking activities by amending Article 21 of the ACB Law, so that all areas are covered and not just those listed in the Article, notwithstanding the fact that, in practice, these powers seem available under broad general provisions. ECI: Amend legislation to give equal prominence (along with price stability) to the NBG's supervisory function. This is a very theoretical point. The primacy of price stability in the objectives of any central bank is recognized, as is the fact that many central banks carry out the dual roles of price stability and financial markets regulation and that the fulfillment of these roles do not, as a rule, give rise to conflicts of interest. Nonetheless, any reference to "main tasks" should be deleted from legislation. EC4: Make consultation obligatory before the finalization of draft regulations, although it is recognized that such consultation takes time, as was confirmed by the banks visited. Regarding EC6 and specifically the supervisor's ability to revoke a bank's license, Article 6 of the ACB Law (introduced in 2009) provides that a banking license may only be revoked upon a decision of the National Bank. This was introduced to address one of the findings of the last assessment, namely, that in several instances, the NBG decision to revoke a license was overruled by the courts resulting in technically insolvent banks continuing to operate. The NBG would also argue that this finding was not wholly correct and that the real problem at the time was that the banks in question could continue in business while the case was been heard because of the absence of legislation to prevent them doing so. This loophole has also been addressed by the insertion of Article 68(5) in the NBG Law: "In the event that there is litigation brought to oppose an administrative act of the National Bank the bringing of such litigation shall not suspend the effect of such administrative act until the final decision is made, unless otherwise decided by the National Bank."

Principle 2	Independence, accountability, resourcing, and legal protection for supervisors. The supervisor possesses operational independence, transparent processes, sound governance, and budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.
Essential criteria	
EC1	The operational independence, accountability, and governance of the supervisor are prescribed in legislation and publicly disclosed. There is no government or industry interference that compromises the operational independence of the supervisor. The supervisor has full discretion to take any supervisory actions or decisions on banks and banking groups under its supervision.
Description and findings re EC1	The operational independence of the NBG is guaranteed by both the Constitution of Georgia and the NBG Law. Article 95 of the Constitution states that "The National Bank of Georgia shall be independent in its activities. The Organic Law [NBG Law] shall determine the rights and duties, the procedure of activities, and shall guarantee the independence of the National Bank." Article 4 of the NBG Law states: "1. The National Bank shall be independent in its activity. Legislative, executive and other authorities shall not be entitled to interfere in its activity or to monitor it except in cases as prescribed under the Georgian Constitution and this Organic Law. 2. The National Bank shall be economically independent and shall provide for all its expenses. The National Bank shall not be liable for liabilities of the State of Georgia. Georgia shall not be liable for the liabilities of the National Bank except in cases as envisaged under this Organic Law. (Amended on 23.03.2010 N2828). 3. The National Bank, its assets, property and income, as well as activities and operations carried out by it shall be exempt from all state taxes, duties fees and charges (10.04.2012 N6017)." Article 1 of the NBG Law further states that the NBG is authorized to sign contracts independently, independently purchase real and moveable property and own and dispose of them, act as a plaintiff and a defendant, independently execute the duties imposed on it. One area of possible constraint relates to the setting of salaries of NBG staff. Paragraph 2 of Article 9 of the Law of Georgia on Public Service states that the governor of the National Bank determines the remuneration for employees within the margins determined by the government. (See EC6 hereunder for further details.) Apart from the above-mentioned possible constraint, there appears to be no form of interference that would compromise the operational independence of the supervisor. On accountability, the NBG is accountable to the parliament of Georgia and presents reports to it annually. According to Article 61 of the NBG Law, "Annually, no later than 4 months after the completion of a financial year, the National Bank shall submit to the parliament of

	Georgia the report on the progress of monetary-credit, currency and supervision policies. The parliament of Georgia shall approve the submitted report." (If the parliament of Georgia does not approve the draft of basis directions of monetary-credit and currency policies for the NBG, the NBG shall act within the framework developed by itself).
	Chapter VIII of the NBG Law (Supervision of Financial Sector) supplemented by the provisions of the ACB Law gives the NBG full powers to take any supervisory actions or decisions on banks and banking groups under its supervision(although see Principle 1,EC3 re the constraints on consolidated supervision.) The Governance Framework of the NBG is provided for in Article 7 of the NBG Law. Subsection 1 states that the supreme governing body of NBG is the Board of NBG, which consists of seven members. According to Article 9 the Board of the National Bank shall be authorized to: a) review and approve the key principles of management and disposition of international reserves; b) stipulate the rule for determining the national currency's official exchange rate against other countries' currencies; c) approve the budget of the National Bank's administrative and capital costs; d) create special reserves; e) review, approve, and submit to the President of Georgia the annual report and financial statements of the National Bank; f) issue legal acts; g) define the basic trends of supervision and regulation of the activity of financial sector; h) approve the organizational structure and regulation of the National Bank; and i) perform other duties as prescribed under this Organic Law. The governance of the supervisory function is delegated to a responsible vice-governor by the NBG governor. The decision-making process takes a bottom-up form. In particular, individual tasks related to banking supervision are performed by divisions under two departments: the Specialized Groups and the Supervisory Policy Department and Banking Supervision Department. The decisions made by these divisions are afterwards approved by the heads of two departments and the vice-governor concerned. The vice-governor makes any significant decisions in agreement with the governor. The organizational structure is based on the four-eye principle, clear delegation of responsibilities, and the possibility of tracking and monitoring such decisions.
EC2	The process for the appointment and removal of the head(s) of the supervisory authority and members of its governing body is transparent. The head(s) of the supervisory authority is (are) appointed for a minimum term and is removed from office during his/her term only for reasons specified in law or if (s)he is not physically or mentally capable of carrying out the

	role or has been found guilty of misconduct. The reason(s) for removal is publicly disclosed.
Description and findings re EC2	The Board members of the NBG are appointed by a majority of the parliament on the president's nomination. According to Article 96 of the Constitution of Georgia, the members of the NBG Board may be dismissed only upon decision by the parliament, consistent with
	Article 64 of the Constitution. Article 64 of the Constitution prescribes the following: "1. In case of the violation of the Constitution and/or commission of criminal offence, at least one third of the total number of the members of the parliament shall have a right to raise the question of the dismissal of the Chairperson of the Supreme Court, members of the government, the Prosecutor General, the General Auditor of the State Audit Office of Georgia and members of the Board of the National Bank via impeachment procedure." Article 7 of the NBG Law states that members of the Board of the National Bank, as nominated by the President of Georgia, shall be elected by the parliament of Georgia for 7-year term of office with the majority of votes of total number of the parliament Members. A Member of the Board may be re-elected. A member of the Board of the National Bank may be dismissed only in accordance with aforementioned Article 64 of the Constitution of Georgia, upon the decision of the parliament of Georgia. The President of Georgia shall appoint and dismiss from the members of the Board of the National Bank the governor of NBG upon the nomination by the Board, and vice-governors upon the nomination by the governor of the National Bank. In addition, Article 7 of the NBG Law determines that the NBG governor shall be dismissed if he/she: i. is not the member of the Board of the National Bank anymore; ii. has been deprived of the right to serve the position of the member of the Board of the National Bank pursuant to Article 13 (this article regulates matters related to conflict of interests; in particular, it does not allow the Board members to accept certain other positions) of this Organic Law; iii. is unable to perform his/her duties due to his/her health issues, or the court has found him/her incapable; or iv. dies. Information on the members of the Board of the NBG is published on the NBG Website. The law does provide for the public disclosure of the reasons for the removal of Board members.

EC3	The supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives.[4]
Description and findings re EC3	The objectives of the NBG are set out in the NBG Law - Chapter VIII – Supervision of Financial Sector. Article 47 states, "The National Bank's objective shall be to support financial sustainability and transparency of financial sector, protect customers' and investors rights. To this end, the National Bank shall support stable and effective functioning of the financial system, control of systemic risk, establishment of competitive environment, reduction of potential risks." In its annual accounts, the NBG gives a descriptive account of the current issues relating to banking supervision. It is recommended that this account be augmented by a more focused description of its strategic plans and targets for the future and, particularly, for the coming year, and that it account for the discharge of these plans and targets in the next annual report.
EC4	The supervisor has effective internal governance and communication processes that enable supervisory decisions to be taken at a level appropriate to the significance of the issue and timely decisions to be taken in the case of an emergency. The governing body is structured to avoid any real or perceived conflicts of interest.
Description and findings re EC4	The supervisory "pillar" of the NBG is directly managed by one of the two vice-governors of the NBG, who report directly to the governor. The total number of employees involved in banking supervision is approximately 45, which, the NBG maintains, renders the organizational structure relatively simple, and the communication lines short. The NBG has a contingency plan (CP), which represents a framework for policymakers to coordinate their policies and actions to mitigate the systemic risks to the financial sector and, in case of the realization of such risks, to reduce the social cost of the financial distress. In case of an emergency, special teams are mobilized that advise on the powers available to the NBG, and communicate general messages from NBG about the crisis and what the NBG is doing in response. The NBG has the flexibility to respond rapidly to any stressful situations. Article 20 of the NBG Law sets out the framework of ethical behavior for NBG officers (both managerial and staff). See EC5 hereunder. Article 20 is supplemented by a code of conduct. Essentially, it requires staff not be put themselves in a conflict of interest situation, particular vis-à-vis regulated entities.
EC5	The supervisor and its staff have credibility based on their professionalism and integrity. There are rules on how to avoid conflicts of interest and on the appropriate use of information obtained through work, with sanctions in place if these are not followed.

[4] Please refer to Principle 1, Essential Criterion 1.

Description and findings re EC5	The NBG considers that the supervisor and its staff have high credibility based on the latter's professionalism and integrity. Article 20 of the NBG Law sets out the framework of ethical behavior for NBG staff and management. Subsection 6 specifies that: "The Governor of the National Bank, Vice Governors of the National Bank and employees of the organizational units of the National Bank who carry out the supervision of the financial sector based on the NBG Law, shall not have the right to be employees of financial sector's representative or of a legal entity related thereto, direct or indirect shareholders, members of Supervisory Board or Directorate. If a family member or close relative of an employee of the organizational unit of the National Bank who carries out supervision of the financial sector based on the NBG Law, is the holder of more than 10 percent share of a person being supervised and regulated by the National Bank or a person related to such, member of Supervisory Board or Directorate, he/she shall apply in writing to the National Bank in accordance with the rule prescribed by it. Moreover, he/she shall not have the right to participate in the resolution of issues related to such person. Employee of the National Bank may not be assigned to supervise the person whose shareholder, member of Supervisory Board or Directorate is his/her family member (spouse, minor child, stepchild, as well as a person permanently residing with the person) or close relative (a person being a relative of I or II class of legal hereditary line as provided for under the Civil Code of Georgia)." Further, the NBG employees are expected to meet the standards set out in a code of conduct. The NBG has issued a code of conduct which, inter alia, forbids staff members from entering compromising situation vis-à vis regulated entities. Sanctions range from a warning to dismissal. Since NBG is a legal entity of public law, the issues related to confidential information, conflicts of interests, permissible activities, sanction for violation of discipline and more are regulated by the Law of Georgia on Public Servants. The sanctions for violating the rules are not explicitly stated in this law. However, in the employment contract between the NBG and its employees, there is a relevant provision stating the obligation of the employee regarding the nondisclosure of confidential information. According to Article 37 of the Labor Code of Georgia, one of the grounds for terminating employment relations is (c) infringement of the employment agreement terms by either party. Thus, in case an employee discloses confidential information, he/she will be fired. In addition, according to the Civil Code of Georgia, based on the severity of the incident (damage to the employer), the employer is eligible to pursue the employee through the courts. In relation to NBG Board members, Article 13 of the NBG Law specifies that members of the NBG Board, except for the governor and vice-governors, shall not be simultaneously: a public servant, a legal entity's manager, employee of the Georgian financial sector or a legal entity related thereto; or a member of the Board; and his/her family members shall not be entitled to be partners of a Georgian financial sector company or a legal entity related thereto. On the question of confidentiality, Article 20 of the NBG Law specifies that no present or former employee or member of the NBG Board or any employee or auditor of the NBG shall

	be entitled to permit access to confidential information by an unauthorized person, or disclose or publicize such information or use it for personal gain. The assessors were impressed by the professionalism and integrity of the supervisory staff. This view was endorsed at meetings with external sources, e.g., commercial banks, the Banking Association, etc.
EC6	The supervisor has adequate resources for the conduct of effective supervision and oversight. It is financed in a manner that does not undermine its autonomy or operational independence. This includes: (a) a budget that provides for staff in sufficient numbers and with skills commensurate with the risk profile and systemic importance of the banks and banking groups supervised; (b) salary scales that allow it to attract and retain qualified staff; (c) the ability to commission external experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks; (d) a budget and program for the regular training of staff; (e) a technology budget sufficient to equip its staff with the tools needed to supervise the banking industry and assess individual banks and banking groups; and (f) a travel budget that allows appropriate on-site work, effective cross-border cooperation and participation in domestic and international meetings of significant relevance (e.g., supervisory colleges).
Description and findings re EC6	While the NBG appears to operate an effective supervisory regime, it is affected by resource constraints. On the one hand, as is noted in EC1 above, the NBG is responsible for setting its own budget, and Article 19 of the NBG Law states that the amount of remuneration of employees of the NBG shall be commensurate with the level of wages in the Georgian banking system. On the other hand, however, as will also be seen in EC1 above, Paragraph 2 of Article 9 of the Law of Georgia on Public Service states that the governor of the NBG determines the remuneration for employees of the NBG within the margins defined by the government for public servants generally. In practice, there is a significant salary gap between an average supervisor in the NBG and an average banker in the commercial sector. In some instances, the latter could earn three times as much as the former, and the gap is much greater for managerial positions. The situation is exacerbated by the fact that, since 2009, salary levels have been frozen, whereas salary levels in the commercial banking sector have risen. This makes it difficult for the NBG to maintain staff or hire fresh recruits. Major gaps have been identified in the recruitment of IFRS specialists, credit risk specialists, and managers. There is a very high level of turnover within banking supervision. In 2011, out of an average staff complement of 34, 8 resigned (24 percent). The corresponding figure for 2012 were 37 staff and 13 resignations (36 percent), and for 2013, 41 staff and five resignations

	(12 percent). In general, the greatest loss was among specialists. In many instances, lack of salary competitiveness was cited as the reason for leaving. In discussions with some of the banks, they commented on the professionalism, dedication, etc., of the BNG supervisory staff, but noted the high turnover, the relative lack of knowledge/experience in some of the junior staff, and the fact that there were certain delays in response times from the NBG. Some admitted recruiting from the NBG. There also seems to be some dependence on the hire of short-term staff, i.e., interns. Also, in circumstances where there is high turnover, the NBG becomes very vulnerable to over-reliance on key staff, which would exacerbate the staffing situation further if they left. Similarly, budget constraints prevent the development of external training for NBG staff and the development of technology to properly equip the staff. Instead, the NBG runs internal training courses provided by its own staff. Also, the NBG has developed a staff internal development approach whereby it recruits young employees, invests in their internal training, development and internal promotions. (Accordingly, almost all heads of units have been promoted from internal sources). With donor financing, the NBG has been, and is currently, able to commission external experts. Examples include the secondment of an expert from the Dutch Central Bank and the commissioning of a former FSA Executive Director for several specific projects funded by the ADB. In addition, there were several projects that were funded and supported by the World Bank.
EC7	As part of their annual resource planning exercise, supervisors regularly take stock of existing skills and projected requirements over the short- and medium-term, taking into account relevant emerging supervisory practices. Supervisors review and implement measures to bridge any gaps in numbers and/or skill-sets identified.
Description and findings re EC7	The NBG seeks to update its supervisory regime in response to developments in the banking sector. As indicated in EC 4 above, the NBG has recently reorganized its supervisory function by establishing two related groups – banking supervisors and specialized groups, the latter incorporating the supervisory policy department. This led to a more efficient and effective supervisory regime. Notwithstanding the budgetary constraints, as detailed in EC 6 above, the NBG has been able to fill some gaps in numbers and/or skill sets. Since 2010, staff numbers have increased from 33 to 44. On the skill side, for example, the NBG hired a real estate appraisal specialist to deal with property values during the economic crisis. It also hired an IFRS specialist and, from time to time, hired people from the 'big four' accountancy firms but was unable to retain them because of financial constraints. Specialized in-house training is used quite frequently. In-house seminars have been used to deal with Basel II and III. Special training on Pillar II was organized with help of the Dutch Central Bank. Other in-house courses dealt with credit risk, ratio analysis, and risk-based pricing. The NBG also takes advantage of overseas workshops/seminars where they are free of charge.

EC8	In determining supervisory programs and allocating resources, supervisors take into account the risk profile and systemic importance of individual banks and banking groups, and the different mitigation approaches available.
Description and findings re EC8	Toward the end of 2009, the NBG introduced the general risk assessment program (GRAPE), which determines supervisory programs and allocates resources according to an individual's bank's risk profile and its systemic importance. The key elements of this risk-based supervisory approach are risk assessment and risk mitigation. The program has been enhanced by the development of appropriate software, which incorporates risk based priorities in itself and helps maintain the effective implementation of the supervisory plan and enable effective decision-making. In order to increase the efficiency of the supervisors, in 2009 the NBG reorganized the supervisory function under a GRAPE. Under GRAPE, supervisory functions are performed by two closely related groups, bank supervisors and specialized groups. Supervisors are not separated into on-site and off-site supervisors; instead, each supervisor performs all necessary steps and activities to identify and assess risks of the banks and, where necessary, implement relevant supervisory actions. The process is continuous throughout the whole year. The bank supervisors monitor all risks of individual banks on an ongoing basis, and are involved in all bank-related tasks. In the meantime, specialized groups monitor particular risks of all commercial banks and maintain a systemic overview of the risk, develop risk assessment methodologies, and set system-wide benchmarks. The Banking Supervisors Department consists of three divisions. Banks to be supervised by each division were selected based on their systemic importance and scale/size of activities. The NBG is planning to increase the amount of divisions in line with the increasing scale and complexity of certain banks. The Specialized Groups (incorporating the Supervisory Policy department) have six divisions, and each of them is responsible for the supervision of a particular risk category. The risk categories are: retail and corporate credit risk; liquidity risk; market risk; operational risk, business model; profitability; macroeconomic environment; group structure; corporate governance; resources, and total risk.
EC9	Laws provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.
Description and findings re EC9	Article 68 (6) of the NBG Law specifies that no employee of the National Bank shall be personally liable to any person for any action done or not done, as long as such action was done or refrained from in good faith by such person and in the ordinary course of his or her duties in accordance with Georgian legislation. While this article deals with the staff of the NBG, there is no specific protection for the supervisory authority itself. There is no law that states that the supervisor and its staff will be adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith, although the NBG has stated that, in practice, it would pay such costs.

Assessment of Principle 2	Materially noncompliant
Comments	The assessors were impressed by the professionalism, integrity, knowledge, and dedication of the staff of the NBG. This notwithstanding, the NBG must be in a position to attract and retain staff of the highest caliber, particularly given the workload challenges facing it, coupled with the ever increasing complexity and specialization of banking supervision. While the NBG has been able to recruit high caliber staff at entry level, many of these leave after a number of years to pursue more lucrative jobs in the private sector. Also, the NBG should be in a position to attract staff (particularly specialists) on an ongoing basis. It should also not have to find itself over-reliant on key staff or the hire of short term staff. While acknowledging that recruitment and retention is a challenge for many supervisory authorities, the situation in Georgia seems somewhat extreme, particularly against a background where the law states that the amount of remuneration of employees of the NBG shall be commensurate with the level of wages of the Georgian banking system (Article 19 of the NBG Law). Clearly, this law is not being honored. Training policies should also be revisited. Given the increasing complexity of banking regulation, relying on donor-financed training and internal seminars is not sufficient to meet training needs. Supervisory training should be a priority for the NBG. While this will be expensive, it should be achievable, given the economic independence of the NBG (Article 4(2) of the NBG Law). Also, the Georgian authorities should consider charging for supervision. EC2: The law should provide for the public disclosure of the reasons for the removal of Board members. EC3: The NBG should publish in its annual report details of its strategic plans and targets and account for their discharge in the following annual report. EC9: There should be explicit legal provision that the supervisor and its staff will be adequately protected against the cost of defending their actions and/or omissions made while discharging their duties in good faith. EC9: 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.
Principle 3	Cooperation and collaboration. Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information.[5]

[5] Principle 3 is developed further in the Principles dealing with "Consolidated supervision" (12), "Home-host relationships" (13) and "Abuse of financial services" (29).

Essential criteria	
EC1	Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information and undertaking collaborative work, with all domestic authorities with responsibility for the safety and soundness of banks, other financial institutions and/or the stability of the financial system. There is evidence that these arrangements work in practice, where necessary.
Description and findings re EC1	Until April 2013, the NBG was the sole regulator for the financial sector in Georgia. At that date, the insurance supervision function was removed from the NBG. At the time of the mission, there was no effective collaboration framework in place with the new insurance regulator. Since (25 June 2014) an MOU has been signed between the NBG and the new insurance regulator. On the question of financial stability, the NBG has an informal collaboration framework in place with the Ministry of Finance. It is proposed to formalize this framework in the future. The NBG and the FMS have a formal MOU on sharing information regarding money laundering and illicit income issues. International cooperation is dealt with in Article 5 of the NBG Law. Subsection 2 reads : "Within the scope of its competence it shall cooperate with other country's competent financial sector supervision authority. Such cooperation may cover the exchange of information between the National Bank and other countries' competent financial sector supervision authority provided that this authority will keep the confidentiality of information obtained in this manner." It is recommended that a formal collaborative regime be established with the insurance supervisor, given that the largest bank owns the largest insurance (the latter still being very small.
EC2	Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with relevant foreign supervisors of banks and banking groups. There is evidence that these arrangements work in practice, where necessary.
Description and findings re EC2	It is NBG policy to sign MOUs with supervisory authorities of those countries where owner financial institutions of locally systemically important banks operate. There are four such countries; Germany, France, Ukraine, and the United Kingdom. It signed an MOU in 2012 with BAFIN in connection with a license issued to ProCredit Holding in Germany. Currently, the NBG is seeking to sign MOUs with France and Ukraine. It has sought to sign one with the U.K. FSA, but there was no interest from the counterparty. The NBG is a member of one supervisory college – that relating to ProCredit Bank, which is a subsidiary of a German holding company. BAFIN leads the college and the first meeting was held in Germany at which the NBG was represented. The NBG has also signed MOUs with countries whose banks would have an interest in non-systemically important banks in Georgia, e.g., Azerbaijan, Kazakhstan, and Turkey.

	MOUs have also been signed with foreign supervisory authorities where holdings of Georgian banks are located, e.g., Belarus where the BoG has a subsidiary and a holding of 19 percent in another bank. To date, there have not been any major cases where there was a significant need to cooperate with foreign supervisors. The NBG attributes this to the fact that it places great emphasis on ring fencing local subsidiaries/branches from it and other companies in the group. Part of the ring fencing is that the Georgian branches of foreign banks are required to maintain capital as if they were locally incorporated. Accordingly, they are supervised as if they were subsidiaries having to meet the same prudential requirements as a locally incorporated bank, e.g., capital, liquidity, large exposures, ratios, etc.
EC3	The supervisor may provide confidential information to another domestic authority or foreign supervisor, but must take reasonable steps to determine that any confidential information so released will be used only for bank-specific or system-wide supervisory purposes and will be treated as confidential by the receiving party.
Description and findings re EC3	Article 5 of the NBG Law states "Within the scope of its competence, it [NBG] shall cooperate with other country's competent financial sector supervision authority. Such cooperation may cover the exchange of information between the National Bank and other countries' competent financial sector supervision authority provided that this authority will keep the confidentiality of information obtained in this manner." Where the exchange of information is governed by an MOU, there is generally a provision in the MOU that any exchanged information should be treated confidentially and prior written consent from the NBG should be obtained before releasing the information to third parties. If the authority is obliged by law to disclose such information, it is required to notify promptly the other authority and should seek to preserve the confidentiality of the information as far as is legally possible. Also, both authorities are obliged to use received information for prudential purposes only.
EC4	The supervisor receiving confidential information from other supervisors uses the confidential information for bank-specific or system-wide supervisory purposes only. The supervisor does not disclose confidential information received by third parties without the permission of the supervisor providing the information and is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession. In the event that the supervisor is legally compelled to disclose confidential information it has received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to pass on confidential information is not given, the supervisor uses all reasonable means to resist such a demand or protect the confidentiality of the information.
Description and findings re EC4	It is a legal requirement for NBG to keep confidential information obtained in the course of carrying out its supervisory function. Article 20 of the NBG Law reads:

	"No present or former employee or member of the Board of the National Bank or no employee or auditor of the Georgian Financial Monitoring Office shall be entitled to permit access of an unauthorized person to confidential information or disclose or publicize such information or use it for personal gain." Also, all MOUs have special requirements about confidential information, and such information can be used only for supervisory purposes. (See CP 13 on Home-Host re MOUs).
EC5	Processes are in place for the supervisor to support resolution authorities (e.g., central banks and finance ministries as appropriate) to undertake recovery and resolution planning and actions.
Description and findings re EC5	As mentioned in CP 1, for the resolution of a bank, the NBG is the sole responsible authority. Although nothing specific has been arranged in the law for cooperation with other authorities, the NBG, in practice, will cooperate where needed (for example, with the Ministry of Finance) to achieve an orderly resolution. During the financial crisis, the NBG and the Ministry of Finance set up a contingency working group together, which was used mainly to exchange information and align the policies and actions. The collaboration between both agencies was a factor in the fact that there were no banking collapses in Georgia during the financial crisis.
Assessment of Principle 3	Compliant
Comments	No Georgian insurance company has a material equity interest in a Georgian bank, and the holdings by Georgian banks in insurance companies is relatively insignificant, the main one being BoG's ownership of an insurance (life and non-life) company, which accounts for about 1 percent of BoG's assets, but which is Georgia's biggest insurance company. Nonetheless, it is commendable that the NBG has established a formal collaborative relationship with the insurance regulator, both in connection with banks that have interests in insurance companies and, in a wider context, with a fellow regulator in the financial sector.
Principle 4	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word "bank" in names is controlled.
Essential criteria	
EC1	The term "bank" is clearly defined in laws or regulations.
Description and findings re EC1	The term 'bank' is defined in the ACB Law. Article 1 defines bank "as a juridical [legal] person licensed by the National Bank that attracts deposits and uses them on its own behalf to conduct banking activity pursuant to applicable law." Article 2 (3) further states that "No one shall use the word 'bank' or derivatives of the word 'bank' without having received a banking license issues pursuant to this law, unless such usage is established or recognized by law or international agreement, or unless it shall be clear from the context in which the word 'bank' is used, that the person using it is not engaged in banking activities, as defined by this law or by the "Law on the National Bank of Georgia."

EC2	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
Description and findings re EC2	Article 20 of the ACB Law specifies that commercial banks are authorized to engage in only the following types of activities: a) receiving interest-bearing and interest-free deposits (time, demand, and other) and other returnable means of payment; b) extending consumer loans, mortgage loans and other credits; both secured and unsecured credits and engaging in factoring operations with and without the right of recourse; trade finance, including the granting of guaranties; letters of credit acceptance finance, and forfeiting; c) buying, selling, paying, and receiving monetary instruments such as notes, drafts and checks, certificates of deposit, as well as securities, futures, options and swaps on debt instruments, and interest rates, currencies, foreign exchange, precious metals, and precious stones; d) cash and non-cash settlement operations and the provision of collection services; e) issuing money orders and managing money circulation (including tax cards, checks, and bills of exchange); f) securities brokerage services; g) trust operations on behalf of clients and funds management; h) safekeeping and registration of valuables including securities; i) credit-information services; and j) activities incidental to each of the above types of services.
EC3	The use of the word "bank" and any derivations such as "banking" in a name, including domain names, is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.
Description and findings re EC3	As indicated in EC I above, no one shall use the word 'bank' or any derivative thereof without having received a banking license pursuant to this law, unless such usage is established or recognized by law or international agreement, or unless it shall be clear from the context in which the word 'bank' is used, that that person is not engaged in banking activity as defined in law. NBG applies a strict regime re the use of the word 'bank' and other than in the case of banks, there are very few instances where the word is used.
EC4	The taking of deposits from the public is reserved for institutions that are licensed and subject to supervision as banks.
Description and findings re EC4	Only banks and credit unions are permitted to take deposits from the public. Both are regulated by the NBG. The size of credit unions is insignificant – at end-2013, the total balance sheet size amounted to GEL 7.6 million and total deposits to GEL 5.3 million. They are subject to a very light-touch regulatory regime by the NBG.

	Recently, it came to the NBG's attention that there was a loophole in the definition of deposits, which allowed institutions—termed microfinance institutions—to attract funds from the public without being authorized by the NBG. These funds, while not termed deposits, took the form of promissory notes issued to the public. Microfinance institutions are nonbank lending institutions and most are pawnbrokers. There are over 60 in existence of which less than 10 have issued promissory notes. The promissory notes represent a very small percentage of the savings of the Georgian public – about 2 percent, compared to a figure of 94 percent for banks and 4 percent for insurance companies. The microfinance institutions are required to register with the NBG, but are not subject to any meaningful supervisory regime. To date, no members of the public have lost money on the promissory notes. Although the scale is limited, the NBG has sought to close the loophole by introducing the concept of 'qualified credit institutions.' This was achieved by an amendment to the NBG Law, dated 25 May 2012 – Article 48 (1) - Regulation of Qualified Credit Institutions Under the amendment, qualified credit institutions are defined as legal persons (other than commercial banks) who attract funds from more than four hundred natural persons or the amount of funds attracted by them exceeds GEL 5 million. They are required to register with the NBG and to satisfy requirements devised by the NBG. Thus, the NBG can register and revoke registration, establish fit-and-proper criteria, minimum capital and liquidity requirements, and other prudential ratios. It can also inspect these institutions, impose restrictions thereon, and apply sanctions. To date, a limited supervisory regime has been imposed on qualified credit institutions - mainly, in the consumer protection, capital adequacy, liquidity, and FX positions (dollarization is high in the institutions) areas. The NBG can request institutions which attract funds from less than four hundred national persons or funds of less than GEL 5 million to register with it if it considers that that institution plays an important role in the financial sector or its operation and methods of attracting clients indicates an expansion of its customer base. To date, one microfinance institution has been classified as a qualified credit institution.
EC5	The supervisor or licensing authority publishes, or otherwise makes available, a current list of licensed banks, including branches of foreign banks, operating within its jurisdiction in a way that is easily accessible to the public.
Description and findings re EC5	A list of all financial institutions is published on the NBG website.
Assessment of Principle 4	Compliant.
Comments	The NBG should maintain a close watch on the development of microfinance institutions, and should consider introducing a more intensive supervisory regime for qualified credit institutions, e.g., in the areas of capital, related party lending, and large exposures.

Principle 5	Licensing criteria. The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management)[6] of the bank and its wider group, and its strategic and operating plan, internal controls, risk management, and projected financial condition (including capital base). Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained.
Essential criteria	
EC1	The law identifies the authority responsible for granting and withdrawing a banking license. The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisor are not the same, the supervisor has the right to have its views on each application considered, and its concerns addressed. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed bank. The supervisor imposes prudential conditions or limitations on the newly licensed bank, where appropriate.
Description and findings re EC1	The NBG performs the role of both the authorizing and supervisory authority for banks in Georgia. According to Article 49.1 (a) of the NBG Law "The National Bank shall be authorize to supervise the operation of commercial banks ....It covers....issuance and revocation of licenses...." The licensing process is dealt with in a number of pieces of legislation. For instance, Article 48(4) of the NBG Law stipulates that, "For the purpose of performing its supervisory functions the National Bank is authorized to request and receive within its scope of competence ... any information (including confidential information.)." Chapter II of the ACB Law sets out the details relating to license applications, the process involved, the imposition of conditions on licenses, and revocation of bank licenses. This is supplemented by Regulations on bank licensing. In accordance with Chapter II (Article 5) of the ACB Law, the National Bank is entitled to attach conditions or restrictions to a banking license upon its issuance and after issuance if the bank concerned has failed repeatedly to comply with legal provisions on any applicable regulations, guidelines, instructions or requirements issued by the National Bank. (Since 2011, the NBG has processed license applications through its Supervisory Policy and Corporate Governance Division in collaboration with the Legal And Banking Departments.)

[6] This document refers to a governance structure composed of a Board and senior management. The committee recognizes that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions. Some countries use a two-tier Board structure, where the supervisory function of the Board is performed by a separate entity known as a Supervisory Board, which has no executive functions. In contrast, other countries use a one-tier Board structure in which the Board has a broader role. Owing to these differences, this document does not advocate a specific Board structure. Consequently, in this document, the terms "Board" and "senior management" are only used as a way to refer to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction.

EC2	Laws or regulations give the licensing authority the power to set criteria for licensing banks. If the criteria are not fulfilled, or if the information provided is inadequate, the licensing authority has the power to reject an application. If the licensing authority or supervisor determines that the license was based on false information, the license can be revoked.
Description and findings re EC2	As indicated in EC 1 above, Article 49 of the NBG Law provides the NBG with the power to set criteria for issuing and revoking bank licenses. The details are set out in the ACB Law and in various Regulations. Article 3 of the ACB Law, as follows: Banking licenses shall be applied for in writing to the National Bank in such form and procedure as shall be prescribed by its regulations and shall be accompanied by the following information: (24.09.2009 N1677). a) Originals of foundation documents or their notarized or apostilled or legalized copies; b) Appropriate information about compliance of administrators with the fit-and-proper criteria set under this Law; c) A statement of the commercial bank setting forth the amounts of authorized and paid in capital of the bank, as well as the information including data on the ownership and origination of both the authorized and regulatory capital components of the respective commercial bank. Branch of the foreign bank shall submit information on the volume of financing allocated by the Head Office for such branch"; d) Fit-and-proper declaration envisaged under Article 8(1) of this Law on direct or beneficiary owners of the significant share; e) Additional information as shall be prescribed by regulations of the National Bank, which should include data on bank's authorized capital and other financial resources, the location of the bank's Head Office and all branch offices and any other information, which the National Bank shall reasonably request in the circumstances of each case; and f) Documentation proving title ownership or right to use any real estate destined to be occupied by the commercial bank or its branches. Relevant Regulations deal with such issues as Fit-and-proper Criteria for Directors, senior management, and shareholders (both immediate and ultimate). The NBG's powers to reject an application are set out in a number of sources. Under the ACB Law, applications are rejected if the NBG considers that an applicant does not satisfy the requirements prescribed in that law, including cases, when inadequate information is provided in the application, or in any additional information, requested by the NBG.

	Additionally, Article 48(3) of the NBG Law authorizes the NBG to reject an application if: • The issuance of a license can threaten the stability of the financial sector; • The issuance of a license does not comply with the requirements of the directives or recommendations of relevant international organizations; • The issuance of a license does not comply with the signed agreements between Georgia and foreign countries; and • Upon NBG's request, the applicant did not present information regarding the source of own funds. Further, Article 4(3) of the ACB Law states: "Banking licenses will be granted to commercial banks only if the National Bank deems that: a) the full amount of the minimum required issued capital established by the National Bank is paid up in cash; b) all managers are fit-and-proper pursuant to the requirements of the National Bank and are not ineligible to serve under the restrictions on eligibility provided for by Section 4 of this Article. Fit-and-proper criteria applicable for the managers of commercial banks shall be defined under normative acts issued by the National Bank ; and c) documents and information submitted are complete and reliable and serve to realistically predict the stability of the bank's profitability and its financial position." Article 6 of the ACB Law provides that the license can be revoked if it was obtained on the grounds of false statements or other material irregularities that occurred in connection with the license application. NBG licensing criteria are set down in broad terms, and it is currently seeking certain amendments to legislation that would more explicitly lay down the relevant requirements. It hopes to have these amendments in place by year-end. The intention is to align the requirements more explicitly to Basel Core Principles and relevant EU Directives. Notwithstanding the absence of explicit provisions, the current system appears to work effectively. Very few licenses have been issued in recent years and one application has been formally rejected because the NBG was not satisfied with the quality of the application. More potential applications have been rejected at the inquiry stage. • The more explicit requirements would result in more detailed information on the Supervisory Board, Audit Committee and Directors, important governance documents (such as corporate governance policy; organizational structure and job descriptions of management members; credit risk, market risk, operational and other relevant risk governance frameworks; internal capital adequacy assessment model; calculation of capital adequacy requirement; budgetary plans; accounting policy) verified by the Board, more detailed information on the ownership structure, more information on the parent company in case of subsidiaries of foreign banks. Based on the amendments project, the NBG will have the right to receive updated information that was presented to it throughout the

	licensing process from the licensed commercial bank, its shareholders, intermediary owners, and beneficial owners of significant shares. In addition, throughout licensing, The NBG will also have the right to waive certain requirements or delay their submission after having issued the license.
EC3	The criteria for issuing licenses are consistent with those applied in ongoing supervision.
Description and findings re EC3	The licensing process is designed to take account of ongoing compliance with relevant requirements following the issuing of the license. It analyzes whether the bank will be in a position to operate in a sound manner on a continuous basis. As indicted in EC 2 above, the NBG is seeking legal amendments to give it more explicit powers at the licensing stage. Such powers would grant it the right to receive updated information that was received during the licensing process from the bank, its shareholders, including the beneficial owners.
EC4	The licensing authority determines that the proposed legal, managerial, operational, and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis. The licensing authority also determines, where appropriate, that these structures will not hinder effective implementation of corrective measures in the future.
Description and findings re EC4	There is no explicit legal provision that specifies that the proposed legal, managerial, operational and ownership structures of the bank and its wider group should be such as to not hinder effective supervision on both a solo and a consolidated basis. in addition, there is no explicit legal provision that these structures should not hinder effective implementation of corrective measures. Both issues will be dealt with in the context of the proposed amending legislation referred to in EC2 above. The NBG maintains that the absence of explicit legal provisions has not impeded its ability to deal effectively with these issues and that, in practice, the NBG determines that the proposed legal, managerial, operational, and ownership structures of the bank and its wider group will not hinder effective supervision on both solo and consolidated bases. It also determines, where appropriate, that these structures will not hinder effective implementation of corrective measures in the future. There is no evidence to contradict this view. The NBG cites an example of intervention it took where it believed that the structure of an existing bank could hinder effective supervision. It related to outsourcing – the bank wanted to outsource core activities to another jurisdiction but was prevented from doing so by the NBG, as it would hinder its ability to effectively supervise the bank.
EC5	The licensing authority identifies and determines the suitability of the bank's major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure, the sources of initial capital and the ability of shareholders to provide additional financial support, where needed.

Description and findings re EC5	Article 8 (1) of the ACB Law sets out the information which prospective shareholders are required to submit. It specifies that "A person (declarer), who intends to acquire certain amount of share in a commercial bank, so that his/her or beneficiary owner's participation in the bank exceeds 10percent, 25percent, or 50percent shall submit the fit-and-proper declaration (hereinafter referee to as "Declaration") to the National Bank." Paragraph 2 specifies that the "Declarer shall indicate in the declaration: a) His/her identification data; b) Information that he/she has not been convicted for illicit income legalization, terrorism financing, economic crime and/or crime against entrepreneurial or other economic activity; c) Identification data of beneficial owner (owners) determined under Paragraph 1 of this Article, indicating that according to available information there will be no beneficial owner (owners) after implementing this transaction; d) Information that the beneficial owner determined under Paragraph 1 of this Article has not been convicted for illicit income legalization, economic crime or / and crime against entrepreneurial or other economic activity; e) If possible, the declarer shall enclose with his/her declaration a declaration filled by the beneficial owner (owners) defined under Paragraph 1 of this Article. f) Amount of share in his/her ownership if transaction is implemented; g) On the basis of available information, if transaction is implemented, the amount of share of those beneficial owners whose ownership exceeds 10percent, 25percent or 50percent; and h) Conclusion on declaration of beneficial owner (if such exists), which may confirm or not accuracy of information given in the declaration of the beneficial owner." Paragraph 3 states "If according to the information available to declarer, beneficial owner (owners) defined in Paragraph 1 of this Article does not (do not) exist, then declarer shall indicate about it in declaration and not fill those parts which pertain to beneficial owners." The above information is supplemented by additional provisions in Article 3 of the Regulation on Licensing of Banking Supervision, as follows: "Residents shareholders: • For individuals: full name, address and occupation, and abstracts from work records verified by the most recent employer; and • For legal entities: notarized copies of registration documents; annual and most recent balance sheets verified by tax authorities and information from the same authorities verifying absence of tax arrears; audit opinion; information from a servicing bank about existence of a bank account and a copy of the payment order on the amount paid in issued capital.

	Nonresident shareholders: • Passport data verified by the relevant embassy, tax declaration; • For Legal Entities: Registration documents, audit opinion; a decision of the authorized body (Supervisory Council or the Board of Directors) to participate in issued capital; when the entity is a commercial bank, and a letter of recommendation from the central bank of the country, where the entity is registered, is necessary; and • All documents shall be presented in a legally recognized form." Throughout the licensing process as well as on an ongoing basis, the NBG assesses the ownership structure and its transparency. For example, where relevant, it will look through each layer of ownership until arriving at the ultimate beneficial owner. On capital, Article 49.1 of the NBG law states that the National Bank is authorized to require and receive information on the source of origination of a commercial bank's capital and on the direct and beneficial owners of its significant shares. In addition, Article 3 of the ACB Law, bank license applicants must provide a statement setting forth the amounts of authorized and paid capital of the bank. The statement should include appropriate information on the ownership and origination of both the authorized and regulatory capital components of the proposed bank. The NBG seeks to verify the sources of initial capital. This can be done both through available public information and, where information is not available publically, through requests to the applicant.
EC6	A minimum initial capital amount is stipulated for all banks.
Description and findings re EC6	In accordance with the Regulation on Defining Minimum Capital Requirements for Commercial Banks, the minimum amount of regulatory capital for banks is GEL 12 million.
EC7	The licensing authority, at authorization, evaluates the bank's proposed Board members and senior management as to expertise and integrity (fit-and-proper test), and any potential for conflicts of interest. The fit-and-proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank. The licensing authority determines whether the bank's Board has collective sound knowledge of the material activities the bank intends to pursue, and the associated risks.
Description and findings re EC7	The governance structure of Georgian banks is as follows: a Supervisory Board appointed by the shareholders/nomination committee to oversee that the bank is being managed and run properly - the members do not have an executive role; a Management Board (Directorate) which manages the bank on an executive basis. Collectively they are known as administrators. The NBG evaluates proposed Board members and Directors' fitness and proprietary commensurate to the planned scale and complexity of banking activities. Both skills and experience as well as integrity and criminal records are assessed.

	The relevant legislation is set out in Article4.1(2) of the ABC Law: "2. An individual can be an administrator of the commercial bank only in case if he: a) has not been declared as incapable by the court; b) has not been convicted for illicit income legalization or / and terrorism financing; c) has respective education or /and experience; d) is not simultaneously administrator of another bank, except for the case when he occupies position of administrator in a bank subject to control of the given bank or in a bank which controls the given bank; e) has not been convicted for an economic crime or/and crime against any entrepreneurial or other activity." The NBG approval for appointments to the Supervisory Board, Directors and top management, as well as for their replacement, is not directly required by legislation. The NBG maintain that this authority is indirectly applied and is exercised in practice, The current amendments project to licensing (see EC2 above) will further formalize current practice and clearly set down requirements of information that are essential for performing the above mentioned analysis. In particular, the following information on the members of Supervisory Board, Audit Committee, and Directors will be explicitly sought: • Education, qualification and experience; • Criminal records; • Solvency/insolvency; • Loans and other liabilities including past due loans; and • Connection/relationship with shareholders or potential administrators.
EC8	The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.
Description and findings re EC8	Under Article 3 of the Regulation on Licensing of Banking Institutions, all applicants are required to provide a business plan and information on its organizational structure, as follows: "4. Information about the overall organizational structure of the bank including the following documents: a) Internal procedures, approved in accordance with the bylaws of the bank; and b) Abstracts from work records and recommendation letters of the members of the Board of Directors and a chief accountant, verified by the most recent employer, as well as personnel registration papers and copies of diplomas. Persons with at least three years of experience of working on administrative positions in the banking and financial system,

	who receive positive recommendations in accordance with the procedure established by the NBG, shall, as a rule, be appointed as Head of the Board of Directors and as Chief Accountant. 5. Business plan verified by the Board of Directors (management) shall include the following issues: a) Financial operations and core assets: core financial operations and banking products offered by the bank to its clients; b) Approximate structure of Assets and Liabilities: approximate structure of assets and liabilities for the first two years; total capital adequacy and its observance, liquidity sources; and credit and investment policies and procedures; and c) Projected Income Statement: projected income statement for the next two year period, based on market analysis; projected net income allocation; and the structure of expenses." Beyond this, the ACB Law gives the NBG the power to require any further information that the National Bank shall reasonably request in the circumstances of each case. In its analysis, the NBG seeks to ensure that the corporate governance, risk management, and internal controls are commensurate with the planned scale and complexity of the proposed banking activities. c) The current amendments project to licensing provisions (see EC2 above) further specifies the above requirements. In particular, requirements regarding the submission of the following documents would be explicitly stated: corporate governance policy; organizational structure and job descriptions of management members; credit risk, market risk, operational, and other relevant risk governance frameworks; internal capital adequacy assessment model; calculation of capital adequacy requirement; budgetary plans; accounting policy; and informational technology for initial and advanced periods, etc.
EC9	The licensing authority reviews pro forma financial statements and projections of the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.
Description and findings re EC9	As indicated in EC8, the NBG requires applicants to provide financial forecasts and calculations of capital adequacy. Part of this involves assessing the future financial strength of the shareholder. Also, as noted in EC8, the depth of analysis of such information is commensurate with the scale and complexity of the proposed bank.
EC10	In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For cross-border banking operations in its country, the host supervisor determines whether the home supervisor practices global consolidated supervision.
Description and findings re EC10	Article 4(e) of the Regulation on Licensing of Banking Institutions stipulates that in the case of a foreign bank proposing to establish a branch in Georgia, the consent of the home

	supervisory authority is required. There is no similar requirement where a foreign bank proposes to establish a subsidiary in Georgia. It is proposed to address this issue in forthcoming legislation. (See EC2 above). There is no legal requirement for the NBG to access whether the home supervisor practices global consolidated supervision and/or whether its supervision is equivalent to that of the NBG. It contends that license applications usually do not require cooperation with third country supervisors in order to gain a better understanding of the risks//financial or other information on the applicant. It says that in most cases required information is publically available or provided by the applicant to it and that, in any event, all branches and subsidiaries are supervised as local banks.
EC11	The licensing authority or supervisor has policies and processes to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.
Description and findings re EC11	Since 2011, new license applications are handled by the Supervisory Policy and Corporate Governance Division in collaboration with the Legal And Banking Departments. At a final stage, a supervisor from the Banking Supervision Department is dedicated to supervising the new entrant and does so in keeping with the general supervisory regime.
Assessment of Principle 5	Largely compliant
Comments	The licensing process (i.e., the acceptance or rejection of license applications) appears to work well in practice, notwithstanding some significant explicit gaps in legislation. (This is said on the basis that very few authorizations have been granted in recent times and a number of them have been rejected. Also, there is no evidence that any recently authorized banks have subsequently run into difficulties.) Currently, pending the adoption of proposed legislation, the NBG relies on broad legal principles to achieve its aims in this area (e.g., that it has the power to obtain all information necessary to carry out its statutory obligations). On the basis that the authorization process appears to operate well and the NBG carries out all relevant requirements, notwithstanding the absence of formal rules, together with the introduction of a number of specific rules following the mission, a rating of L/C is deemed appropriate for this Principle. The various weaknesses are as follows: EC4: There is no explicit legal provision that specifies that the proposed legal, managerial, operational, and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis, or that these structures will not hinder effective implementation of corrective measures in the future. Recently, the regulation has been strengthened in order to address this issue. EC5: This states that the licensing authority identifies and determines the suitability of the bank’s major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. There is no reference to “others that may exert significant influence” in the context of the legal definition of significant shareholder, but the NBG says that it takes the

	matter into consideration in its deliberations. EC7: The NBG approval for appointments to the Supervisory Board, Directors, and top management, as well as for their replacements, is not directly required by legislation. The NBG maintains that this authority is indirectly applied and is exercised in practice. However, the regulation has been amended recently in order to address this issue. EC 10: While the consent of the home supervisor is required when a foreign bank is establishing a branch bank in Georgia, no such consent was required when a foreign bank is establishing a locally incorporated bank in Georgia, although this issue was addressed recently. EC10: There is no legal requirement for the NBG to access whether the home supervisor practices global consolidated supervision and/or whether its supervision is equivalent to that of the NBG. (Currently, there are 21 banks operating in Georgia. Aggregate banking assets (per balance sheet) of the 21 banks amount to GEL 17.9 billion. Two banks account for over 57 percent of banking activity - BoG 34 percent and TBC Bank 23 percent. The next largest bank- Liberty Bank- represents less than 8 percent of total activity. The 10 smallest banks each have a market share of less than 1 percent and, in aggregate, represent about 5.3 percent of the total share. The BoG is widely owned and obtained a listing on the London Stock Exchange in 2006. TBC Bank is owned by a number of financial institutions and it too obtained a London listing recently. Liberty Bank is owned 70 percent by a Romanian individual. Most of the remaining banks are subsidiaries or affiliates of foreign banks and a small number, mainly the smaller banks, are owned by individuals, both Georgian and foreign. The number of banks has remained relatively constant over the last 10 years, hovering around the 20 mark. At one point, in the early 1990s there were over 220 banks in existence. The number has been whittled down through a rationalization scheme involving closures and mergers.
Principle 6	Transfer of significant ownership. The supervisor has the power to review, reject, and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Essential criteria	
EC1	Laws or regulations contain clear definitions of "significant ownership" and "controlling interest."
Description and findings re EC1	"Significant" and "Control" in the context of share ownership are primarily defined in the ACB Law. "Significant share" is defined as "10 percent or higher share in commercial bank's authorized or paid-in capital, owned by the person through direct or indirect participation in equity capital." It is recommended that this definition be amended to include a reference to persons acting in concert in order to capture circumstances where ownership is held by more than one person

	but those persons are acting in concert. The NBG says that, in practice, banks are aware that they must group related parties together. "Control" is defined as "authority to govern financial and economic policy of an enterprise (organization) for the purpose of deriving economic benefit from such activity." This definition is further clarified in The Regulation on Conflicts of Interest and Transactions between Bank Administrators and Related Parties which states that "control" is the capability by a person to exercise, directly or indirectly, alone or in concert with others, by using voting shares (stocks) or in any other way, strong influence over the policies or business-related decisions of other person.
EC2	There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
Description and findings re EC 2.	Article 8 (1) of the ABC Law deals with the acquisitions of a significant share in a commercial bank. Accordingly, a person who intends to acquire a certain amount of shares in a commercial bank so that his/her or beneficiary owner's participation in the bank exceeds 10 percent, 25 percent, or 50 percent shall submit the fit-and-proper declaration to the NBG, identifying the exact amount of participation in capital that would be achieved through the intended transaction. There is no obligation on a significant shareholder to seek the NBG's consent where he/she proposes to dispose of his/her significant shareholding. The NBG proposes to address this issue in forthcoming legislation, so that NBG consent would be required to conclude transactions where a beneficial owner's qualifying holding in a bank's capital would fall below 10 percent, 25 percent, or 50 percent.
EC3	The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or to prevent the exercise of voting rights in respect of such investments to ensure that any change in significant ownership meets criteria comparable to those used for licensing banks. If the supervisor determines that the change in significant ownership was based on false information, the supervisor has the power to reject, modify, or reverse the change in significant ownership.
Description and findings re EC3	The NBG analyzes applications on acquisition of significant shares in a bank based on the criteria applied under the licensing process. Where the NBG is not satisfied with the information provided and has concerns about the applicant's compliance with its requirements, it will reject the application. According to Article 8.2(4) of the ACB Law, a transaction on acquisition of a significant share shall be nullified if the person has not submitted a fit-and-proper declaration to NBG or if its proposal was rejected by NBG. As per the article 48.3(1) of the NBG Law, the NBG is authorized to reject the transfer of significant ownership if: • such transaction can threaten the stability of the financial sector;

	• such transaction of a license does not comply with the requirements of the directives or recommendations of international organizations; • such transaction of the license does not comply with the signed agreements between Georgia and foreign countries; and • upon NBG's request, the applicant did not present information regarding the source of own funds. While the NBG considers that it has sufficient powers under these broad provisions, it is seeking more explicit powers under the amendments to the licensing provisions project (Principle 5 EC2). If adopted, it would be mandatory for banks to submit information received during the application process throughout the ongoing supervision process.
EC4	The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles that might be used to disguise ownership.
Description and findings re EC4	Article 8.3 of the ACB Law provides that banks must submit to NBG details of significant shareholders on an annual basis. The precise wording is as follows: 1. Along with the annual report, commercial banks, on the basis of available data, shall provide the National Bank with the information on direct as well as beneficiary owners of 10 percent or more of the share and confirm or not accuracy of such information. 2. Beneficiary owner, who directly or indirectly holds more than 10 percent of the commercial bank's share, shall submit a fit-and-proper declaration to the National Bank in April of every year, which should include data as of December of the previous year. (Inter alia, the fit-and-proper declaration requires shareholders to confirm that they have not been convicted of an economic crime.) 3. Failure to submit requested information to the National Bank on direct as well as beneficiary owners of commercial banks shall result in the respective measures determined under the Georgian legislation. Apart from the above, the NBG has the right to request ownership details from the banks if it considers that such is necessary, According to Article 10 of the ACB Law, commercial banks are required to have full information regarding the identity of every beneficial owner, who directly or indirectly owns more than 10 percent of shares (with an indication of the amount), and submit this information, as well as information regarding any significant changes related to beneficial ownership, to the NBG, and publish this information publicly in its annual report. In addition, the Regulation on Transparency of a Commercial Bank's Financial Condition requires commercial banks to disclose and report information on shareholders owning 1 percent or more of shares of the authorized capital and beneficial owners who directly or indirectly own 5 percent or more of shares (with the indication of quotas).

EC5	The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.
Description and findings re EC5	Article 8.2 of the ACB Law stipulates that any transaction relating to an acquisition of a significant shareholding shall be nullified if the person has not submitted a fit-and-proper declaration to the NBG, or has been refused but still acquired a significant shareholding in a bank. In such circumstances, the NBG can (a) suspend the voting rights of a person for certain periods and request a reduction of an equity share in his/her shareholding to 10 percent within a 60 day period; or (b) suspend voting rights of the person for an unlimited period.
EC6	Laws or regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material information, which may negatively affect the suitability of a major shareholder or a party that has a controlling interest.
Description and findings re EC6	There are no explicit laws or regulations that require banks to notify the NBG as soon as it becomes aware of any material information that may negatively affect the suitability of a major shareholder or a party that has a controlling interest. The standing of the major shareholders is periodically (at least once a year) assessed by the NBG under the group structure risk analysis. The NBG will also check public information available on shareholders and ultimate beneficial owners to ensure that they are identified correctly. As indicated in EC 4 above, commercial banks are required to have full information regarding the identity of every beneficial owner, who directly or indirectly owns more than 10 percent of shares (with indication of the amount), and submit this information, as well as information regarding any significant changes related to the beneficial owner, to the NBG, and publish this information publicly in its annual report (Article 10 of the ACB Law). Also, banks are obliged to disclose information on the beneficial owners who own more than 5 percent shares in the bank. Beyond this, according to article 8.4 of the ACB Law, in the event of grounded suspicion, the NBG has the right to request from the commercial bank submission of declaration on direct, as well as beneficiary, owners of significant shares, suspend voting rights of the person for a certain period and require reduction of an equity share in his/her ownership to 10 percent within a period of 60 days, or suspend voting rights of the person for an unlimited period of time.
Assessment of principle 6	Materially noncompliant
Comments	There are a number of weaknesses attached to this principle. As with other principles, some of these weaknesses relate to the fact that certain requirements are not explicitly specified in law, and the NBG relies on its general broad powers to enforce them. Also, in general, draft legislation is in place with a view to addressing these shortcomings. The NBG would hope that the draft legislation would be enacted during 2014.

	EC1: The definition of "significant" as in shareholders should be amended to include reference to persons acting in concert. EC2: This criterion provides that where a shareholder proposes to acquire a significant shareholding, he/she must inform the NBG of his/her intentions. There is no such requirement when an existing shareholder proposes to dispose of his/her significant shareholding. This could result in the NBG being unaware of significant changes of the shareholding structure. Accordingly, it is recommended that the law be amended to provide that intended sellers of significant shareholding be required to inform the NBG. EC4, EC6: Both these criteria refer to significant shareholders or those that exert controlling influence…. While the relevant answers refer to the position of significant shareholders as set out in law, that same law makes no reference to those that exert controlling influence. It is recommended that the law be amended to refer to the latter as well as the former. EC6: There is no explicit legal provision that requires banks to notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party with a controlling interest. Instead, the NBG relies on the Article 10 of the ACB Law which requires the banks to have full information on significant shareholders and to submit such information to the NBG. In the interests of clarity, it is recommended that a specific provision be inserted in law requiring banks to notify the NBG as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling influence.
Principle 7	Major acquisitions. The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of) and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Essential criteria	
EC1	Laws or regulations clearly define: (a) what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval; and (b) cases for which notification after the acquisition or investment is sufficient. Such cases are primarily activities that are related closely to banking, and where the investment is small relative to the bank's capital.
Description and findings re EC1	Commercial banks may acquire acquisitions in bank and nonbank enterprises subject to certain limitations. A commercial bank may hold an unlimited equity interest in a bank (or brokerage company). Where the proposed holding would exceed 15 percent of the acquiring bank's equity capital, the prior written consent of the NBG is required. The NBG's consent is required to establish or acquire subsidiaries engaged in nonbanking activities. The authorization will define for each subsidiary the type of activities in which it may

	engage. No consent is required to hold equity interests that have been acquired in exchange for the repayment obligations for loans granted. But if the aggregate net value of all equity interests held by the bank exceeds 50 percent of the value of the bank's equity capital, the bank shall be obliged to dispose of the surplus shares within six months from the acquisition. (In special circumstances, the NBG will allow an extension of this limit.) The aggregate net value of all the above-mentioned equity interests shall never exceed 50 percent of the value of the bank's equity capital. Apart from the above, under Article 21 of the ACB Law, the NBG has the power to set limits on individual banks re particular investment types and their aggregate amounts. Within the aggregate banking system, the total amount of equity investments amounts to about 12 percent of aggregate regulatory capital or 2 percent of the aggregate total assets. This includes both banking and nonbanking investments. In essence, only the three large banks hold investments.
EC2	Laws or regulations provide criteria by which to judge individual proposals.
Description and findings re EC2	Neither the law nor the regulations set down the criteria that the NBG applies when it makes a decision on allowing a bank to establish subsidiaries or acquire significant shares in them. The NBG does, however, apply its internal criteria for analyzing the potential risks stemming from acquisitions both at the initial and on an ongoing basis, the latter through its periodic group structure analysis regime. These criteria have been publically disclosed under an article in the periodic journal of the NBG. The criteria include: • the size of the proposed investment, in terms of both the share of the equity in the investment to be owned by the bank, and the materiality of the investment as a proportion of the bank's regulatory capital; • the nature of the investment in terms of the degree of control or significant influence to be exerted by the bank, either directly or indirectly, and the extent to which the bank may have a liability for the obligations of the investment; • whether the investment is undertaking activities on behalf of, or otherwise connected to the activities of, the bank; • the business case of the bank for making the investment; • the risks to the bank arising from the investment, and the bank's ability to identify, measure, control, and mitigate these risks through the quality of its senior management, its systems and controls, and the current and prospective availability of capital, liquidity, and other resources to the bank; • the bank's ability to prevent the investment from engaging in any activities not covered by the permission from the national bank;

	• the prospective impact of the investment on the bank's ability to meet all its regulatory requirements; • the availability to the NBG of full information about each investment, including the activities it undertakes, the risks that these activities might pose to the bank, and the nature of the relationship between the investment and the bank; • whether the investment is located or operates outside Georgia; and • the amount and nature of the bank's existing investments. The NBG plans to make relevant amendments to legislation so that the criteria will have explicit statutory backing.
EC3	Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future. The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of cross-border banking operations) in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision. The supervisor takes into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis.
Description and findings re EC3	As mentioned in EC2 above, the NBG does not have a law or regulations that set down objective criteria for the assessment of relative risks of investments, although it does apply internal (non-statutory based) criteria in this respect. Neither the law, regulations nor the internal criteria provides explicitly for: the NBG to determine whether new acquisitions/investments will hinder effective implementation of corrective action; the prohibiting of banks from making acquisitions/investments in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision; NBG taking into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis. In practice, the level of acquisitions/investments made by Georgian banks is miniscule. Only two major banks have cross-border interests; the level of such investment is not significant, and it is planned to withdraw these investments in the near future. Both investments are the subject of MOUs and there is no impediment to obtaining information on them. The NBG also monitors the value of the investments based on the consolidated financial statements. Currently, all investments are deducted from regulatory capital.
EC4	The supervisor determines that the bank has, from the outset, adequate financial, managerial, and organizational resources to handle the acquisition/investment.

Description and findings re EC4	As part of the analyses carried out by it in determining the potential risk which a bank might be exposed to by virtue of an acquisition/investment, the NBG monitors: • the bank's ability to fund the acquisition, specifically the impact of the acquisition on its capital position and other regulatory requirements; • the control function of the investee in terms of the quality of its senior management and its systems and controls; and • the extent to which the bank may be obliged to provide further financial support to the investee in the future and its impact on the bank's capital, liquidity, and other resources.
EC5	The supervisor is aware of the risks that nonbanking activities can pose to a banking group and has the means to take action to mitigate those risks. The supervisor considers the ability of the bank to manage these risks prior to permitting investment in nonbanking activities.
Description and findings re EC5	As mentioned in EC above, commercial banks are not permitted to establish or acquire subsidiaries engaged in nonfinancial business without the NBG's approval. The permissible activities of those entities are clearly defined and the scope of activities is limited to the activities listed in the authorization. The NBG strictly monitors the bank's ability to prevent the investment from engaging in any activities that are not covered by permission from the National Bank. The analyses of the potential risks stemming from acquisitions are more comprehensive in the case of nonfinancial investments. The NBG also assesses the business case for the investment, the risks that the investee poses, and the bank's ability to monitor, manage, and mitigate such risks. Additionally, from a risk perspective, the supervisor also considers the bank's reputation risk as well as the strategy and objectives of the subsidiary. Once the investment has been made, the performance and the risk posed by the nonbanking investments are periodically reviewed in the supervisory risk assessment of the commercial bank under the analysis of the group structure risk category. The analysis includes the assessment of the interconnectedness and organizational complexity of the company, as well as potential risks stemming from such relations. Currently, all the investments in subsidiaries are deducted from the regulatory capital, which means any losses caused by the investment are taken into account in advance. However, when a consolidated supervision framework is introduced, such investments will require capital cover instead of being deducted from capital.
Assessment of Principle 7	Largely compliant
Comments	The NBG adopts a very conservative approach to bank investment, and the levels are miniscule. There are a number of weaknesses that the NBG hopes will be address in upcoming legislation. EC2 :The criteria used by the NBG to judge individual investment proposals are not statutorily based.

	EC3: There is no explicit legal provision for the NBG to: • determine whether new acquisitions/investments will hinder effective implementation of corrective action; • prohibit banks from making acquisitions/investments in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision; and • take into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis. While the NBG would in fact take these issues into account when assessing potential investments, in the interests of transparency and clarity it would be more desirable to have explicit requirements in place.
Principle 8	Supervisory approach. An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become nonviable.
Essential criteria	
EC1	The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, impact and scope of the risks: (a) which banks or banking groups are exposed to, including risks posed by entities in the wider group; and (b) which banks or banking groups present to the safety and soundness of the banking system. The methodology addresses, among other things, the business focus, group structure, risk profile, internal control environment, and the resolvability of banks, and permits relevant comparisons between banks. The frequency and intensity of supervision of banks and banking groups reflect the outcome of this analysis.
Description and findings re EC1	The NBG developed a methodology for banks and banking groups, GRAPE, which enables supervisors, together with an assessment of their systemic relevance, to form a view of the bank's probability of failure and impact of failure. The methodology has not yet addressed the resolvability of banks (see further EC6). Systemic relevance of every bank is determined and monitored by the Financial Risk and Macro Prudential Policy Division. It is based on the following criteria: size (exposure, client deposit) with 55 percent weight; interconnectedness (intra-financial system assets, intra-financial system liabilities; wholesale funding ratio) with 15 percent weight; substitutability (number of branches, agro sector finance) with 25 percent weight; and complexity (equity finance) with 5 percent weight. As a result, the NBG divided the bank into five classes. Class 1

	and 2 consists of, respectively, nine and six of the smallest banks. Class 3 consists of three medium-size banks. Class 1 and 2 consists of three systemic important banks that make up 65 percent of the total banking sector. Currently, the NBG uses these scores of systemic relevance only for information purposes. Although the allocation of staffs for both banking supervision and risk supervision is based on systemic relevance. The NBG is planning to develop a framework for dealing with domestic systemically important banks in the near future. GRAPE defines the following risk categories: credit risk, liquidity risk, market risk, operational risk, business model, profitability, macro-economic environment, group structure, and corporate governance. These risk categories compose the overall risk profile of a bank. AML is dealt with in a separate way (see CP 29).For each risk (except corporate governance), inherent risk, its mitigants, and net risk are analyzed. The risk levels are determined by assigning scores between one and five on a 0.5 interval. Moderate risk category corresponds to a score equal to three, relatively low risk category – scores less than three, and relatively high category – scores more than three. Weights are assigned to each risk category for each commercial bank. The sum of each weight should be equal to 100 percent. The basis for determining the weights constitutes the average weight determined by the Specialized Groups and Supervisory Policy Department and Banking Supervision Department. Potential available capital resources (for instance, shareholder support) are analyzed. Together with the internal available resources for loss absorption, the NBG forms its view on bank's probability of failure. Through the risk profile of a bank and its systemic relevance, the NBG is able to form its view on the impact of failure of particular banks. Although resolvability is not directly assessed as a separate task by the supervisors, through the assessment of various risk categories NBG is able to form its view on bank resolvability, especially because of simple group structures, minor investments, and low level outsourcing. Note that several high risk banks are considered moderate risk banks because of availability of capital resources of the shareholder. Bank supervisors (working at the Banking Supervision Department) are responsible for all the risk of one bank. Risk supervisors (working at the Specialized Groups and Supervisory Policy Department) are responsible for one risk across banks, including their risk for the system. Work is allocated through task cards. Every task card is prepared by either a bank supervisor or a risk supervisor. This person is mainly responsible for executing the task and takes the lead. If the bank supervisor prepares, then the risk supervisor reviews, and vice versa. This is done for reasons of quality assurance and cooperation between the bank and risk supervisors. The manager and the deputy manager approve the task card. One bank can have 14 different task cards: credit risk – total, credit risk - corporate, credit risk – SME, credit risk – retail, liquidity risk, market risk, operational risk, business model, profitability, macro-economic, corporate governance, market conduct, group-structure, and total risk. There are also task cards that focus on one risk across the system (systemic risk): credit risk, liquidity risk, market risk, operational risk, profitability, macro economy, and market conduct. Every task card consists of different sub-tasks: pre-assessment risk identification program, risk assessment summary (based on the actual risk assessment), post-assessment risk identification

	program and risk mitigation program. This is an ongoing supervisory circle. Every tasks card has a preparation date and a completion date, and is executed according to a certain frequency. The deadline of the RMP lies beyond the completion date of the total task card. As a result of this, the planning of the next cycle is sometimes frozen until certain findings are addressed. The execution of the task cards is supposed to be carried out according to the supervisory plan, within the framework of both cyclical (periodically recurring) and noncyclical tasks (because of a suddenly emerging risk). The supervisory plan is approved by the heads of the Banking Supervision Division, Specialized Groups and Supervisory Policy Division, the vice-governor and the governor. Currently, the NBG is in the process of implementation. So, not all task cards are uploaded in the system, and not everybody has planned their work according to this new methodology, not in the least because of other priorities. Approximately, 80 percent of the task cards are uploaded and explicitly planned according to new methodology. The NBG states that it is a priority to formalize GRAPE documents through official approvals by the Supervisory Steering Committee (comprised of the department heads and vice-governor) before the ICAAP documents (due September 30, 2014) are presented to it. Further, the following report are generated in order to support senior management to steer supervision, such as: - Risk profile of the bank (total and per risk); - Systemic risks; - Supervisory plan; and - Pending tasks (RIP, RMP). The NBG changed the organizational structure and started developing this methodology in 2010. Before 2010, supervisors were divided into on- and off-site teams and performed bank risk assessment based on CAMEL methodology, asserted scores in predefined intervals to each category and undertook supervisory action based on such scores as defined by the existing guideline on supervisory actions. Currently, for some small- and medium-size banks, the NBG still uses the CAMEL methodology. That means that there is one task card for this bank (named total risk assessment) that is based on CAMEL. The supervisor needs to assign scores between one and five (similar to GRAPE and therefore compatible) on a 1.0 interval (therefore less granular). The reason for this dual methodology is to make a gradual transition to the new methodology. Nevertheless, some supervisors do use elements of GRAPE to do their analysis. Note that NBG will leave CAMEL in the near future, but it is not clear when this is to be expected. Supervisors widely apply APRA and CAMEL manuals and other guidelines that are relevant to local context when they go on-site. There is not yet a document (besides a description of the general principles in the GRAPE document) that describes in NBG's supervisory approach and its procedures in detail.

EC2	The supervisor has processes to understand the risk profile of banks and banking groups and employs a well defined methodology to establish a forward-looking view of the profile. The nature of the supervisory work on each bank is based on the results of this analysis.
Description and findings re EC2	The process to understand the risk profile of banks is as following. Banking supervisors are responsible for understanding all the risk of one bank, and risk supervisors are responsible for understanding one risk across all banks. Work is allocated through task cards. Every task card is prepared by either a bank supervisor or a risk supervisor. This person is mainly responsible for the task and takes the lead. If the bank supervisor prepares, than the risk supervisor reviews, and vice versa. The manager and the deputy approve the task card. This approach stimulates supervisors to work together as it works in practice. One bank can have 14 different task cards: credit risk – total, credit risk - corporate, credit risk – SME, credit risk – retail, liquidity risk, market risk, operational risk, business model, profitability, macro-economic environment (including stress testing), corporate governance, market conduct, group-structure, and total risk. There are also task cards that focus on one risk across the system: credit risk, liquidity risk, market risk, operational risk, profitability, macro economy, and market conduct. Every task card consists of different sub-tasks: pre-assessment risk identification program, risk assessment summary (based on the actual risk assessment), post-assessment risk identification program, and risk mitigation program. This is an ongoing process. Every tasks card has a preparation date and a completion date, and is executed according to a certain frequency. The deadline of the RMP lies beyond the completion date of the total task card. As a result of this the planning of the next cycle is sometimes frozen until certain findings are addressed. There are different components of the methodology that are used to establish a forward looking view on the risk profile such as business model, stress test, availability of capital, monitoring early warning indicators and more emphasis on risk management (mostly the root cause of problems).
EC3	The supervisor assesses banks' and banking groups' compliance with prudential regulations and other legal requirements.
Description and findings re EC3	Compliance with prudential regulation is monitored on an ongoing basis. Daily, monthly, quarterly, and annual reporting forms are intensively reviewed by both banking and risk supervisors, as well as ad-hoc information is intensively required throughout ongoing supervision. The NBG takes corrective actions in case of a breach of a prudential limit or a weakness in the risk control (see further CP 11 corrective measures).
EC4	The supervisor takes the macroeconomic environment into account in its risk assessment of banks and banking groups. The supervisor also takes into account cross-sectoral developments, for example in nonbank financial institutions, through frequent contact with their regulators.
Description and findings re EC4	Macro-economic environment analysis is part of the risk assessment of each bank. The Financial Risk and Macro-Prudential Policy Division (part of Specialized Groups and Supervisory Policy Department) analyzes major trends of the Georgian economy and financial

	sector (such as business and credit cycles, international environment, fluctuations in exchange rate, real estate market, interest rate, and other key indicators), revises stress tests parameters based on the current stance of economy, and runs macro stress tests using these parameters. A corresponding report is usually issued monthly, discussed with NBG's Macro Economic Research Division, and finally shared with supervisors to be taken into account throughout the risk assessment process. On the task card, this is made explicit by a box on related risk categories and also works as such in practice. In addition, the specialized groups are in charge of preparing system-wide reports on commercial banks, which also incorporates macro-economic risks that can be imposed to the system as a whole (specific task cards). For instance, when certain macro-economic indicators change, the specialized teams analyze adverse developments that could potentially negative impact on the loan portfolio of a bank. All financial institutions are supervised and regulated by the NBG, except for insurance companies (very small, underdeveloped sector). Nonbanks that are supervised by the NBG are microfinance organizations, credit unions, exchange bureaus, and money transfer offices. This part of the financial sector is rather small and seems not to be of importance for the banking sector. Nevertheless, given the structure of supervision (where specialized groups also work for nonbanks) adverse developments within the nonbanking sector will be taken into account. Still, the NBG acknowledges that a cooperation framework needs to be established with the insurance supervisory authority (in 2013 separated from NBG because of political reasons). Though, the NBG has access to information on developments in the insurance sector through supervision of the bank holding an insurance company.
EC5	The supervisor, in conjunction with other relevant authorities, identifies, monitors, and assesses the build-up of risks, trends, and concentrations within and across the banking system as a whole. This includes, among other things, banks' problem assets and sources of liquidity (such as domestic and foreign currency funding conditions and costs). The supervisor incorporates this analysis into its assessment of banks and banking groups and addresses proactively any serious threat to the stability of the banking system. The supervisor communicates any significant trends or emerging risks identified to banks and to other relevant authorities with responsibilities for financial system stability.
Description and findings re EC5	The build-up of risks, trends, and concentrations within and across the banking sector as a whole are assessed by the following specialized divisions: Credit Risk Division (corporate, SME, small, and retail), Financial Risk and Macro-Prudential Policy, Corporate Governance and Supervisory Policy, Operational Risk and Information Processing Division, and Consumer Protection Division. These divisions give their input to the bank supervisors and assess risks across the system. There are many activities executed in this area such as stress tests using a wide range of factors, analyses are being made for all different risks from a perspective of systemic relevance. For example, many banks have gold as collateral in pawn-shop loans, and the volatility of the gold price can potentially have an adverse impact on the whole sector. The Financial Risk

	Division and the Credit Risk Division monitor to what extent the loan-to-value used by banks is sufficient to cover those risks and involve the bank supervisor, if necessary. Other examples of concern of the specialized divisions, besides the price of gold, are: portfolio growth rate, credit card growth, exchange rate movement (in relation to currency induced credit risk), and macro-sectoral developments, which could affect the financial condition of banks. As said in EC 4, the supervisors of nonbanks, banks, and specialized groups are in the position of sharing knowledge if needed. The lines between the deputy governor (hands on manager and Board member) and governor are short. A collaboration framework is needed still to be established with insurance supervisor.
EC6	Drawing on information provided by the bank and other national supervisors, the supervisor, in conjunction with the resolution authority, assesses the bank's resolvability where appropriate, having regard to the bank's risk profile and systemic importance. When bank-specific barriers to orderly resolution are identified, the supervisor requires, where necessary, banks to adopt appropriate measures, such as changes to business strategies, managerial, operational and ownership structures, and internal procedures. Any such measures take into account their effect on the soundness and stability of ongoing business.
Description and findings re EC6	The NBG is the resolution authority. No particular regulation or guidelines require banks to have resolvability plans. Further, a bank's resolvability is not directly assessed as a separate task by the supervisors, but through the assessment of individual risk categories. The NBG is of the opinion that this gives sufficient information to form its view on the resolvability of a bank (including the systemic important banks that are too big to fail) especially because of simple group structures, minor investments and low level outsourcing. Beyond this, all subsidiaries and branches are supervised like local banks and are ring-fenced from wider group. Cross-border activity is very limited as well. One bank has one subsidiary in Belarus and several representative offices in Greece, Israel, and United Kingdom. One bank has a very small micro finance unit in Azerbaijan. Although this high-level assessment gives some understanding on whether there will be difficulties in case of resolution, there were no detailed assessments that identified resolution barriers and its measures. The NBG required banks to set up resolution plans, but banks have not yet implemented these requirements. Several years ago, there were some discussions with a systemic relevant bank, but they didn't lead to an adequate resolution plan.
EC7	The supervisor has a clear framework or process for handling banks in times of stress, such that any decisions to require or undertake recovery or resolution actions are made in a timely manner.
Description and findings re EC7	The NBG, being both the sole supervisor and resolution authority, does not have an explicit framework or process for handling banks in times of stress that could support orderly recovery or resolution. The NBG has the (basic) powers that it can use for recovery or resolution of distressed banks. A prompt corrective matrix, which could support dealing with distressed banks, was abolished in 2010 (see further CP 11). During the last distressed period in 2008 (war against Russia; global financial crisis), the NBG applied a mix of recovery

	instruments. No major failures took place during that time (in the absence of bailouts as well). However, the system wasn't tested for orderly resolution and liquidation; these didn't take place. The focus has always been on recovering problem banks. See also findings on precondition resolution framework.
EC8	Where the supervisor becomes aware of bank-like activities being performed, fully or partially, outside the regulatory perimeter, the supervisor takes appropriate steps to draw the matter to the attention of the responsible authority. Where the supervisor becomes aware of banks restructuring their activities to avoid the regulatory perimeter, the supervisor takes appropriate steps to address this.
Description and findings re EC8	The NBG reacts on situations where bank-like activities are being performed outside the regulatory perimeter. For instance, the NBG experienced a situation where an institution accepted retail funds (promissory notes) without calling them deposits, which is only allowed to commercial banks. The NBG legalized the institution in de form of qualified credit institution.
Assessment of Principle 8	Largely compliant
Comments	The NBG is largely compliant with CP 8 Supervisory Approach. Although the NBG developed an advanced supervisory approach in many ways, there are some areas of improvement: the assessment of bank's resolvability is too high-level, in particular for systemic relevant banks (EC 1, EC 6) and there is no explicit and clear framework for handling banks in distress (EC 7). In addition, the supervisory approach is not yet fully implemented and formalized (EC 1) and there are no frequent contacts with the insurance supervisor (EC 2). **Supervisory approach** The NBG developed an advanced supervisory approach that is comprehensive, forward looking, and risk based, and proportionate to the systemic relevance of supervised banks. It is comprehensive because it addresses all risks emanating from banks and the banking system. It is forward looking because it includes elements such as stress test, business model, corporate governance, and capital and contingency planning. It is risk based because it focuses on the most important risks. However, the new approach is not yet fully implemented (just for 80 percent) and formalized. **Recovery and resolution** The NBG does not have an explicit operational framework or process for handling banks in times of stress, which could support orderly recovery or resolution (EC 7). Although the NBG has (basic) powers and tools that it can use for recovery and resolution of distressed banks, it is not made explicit how to deal with distressed banks in terms of who is doing what and when. The handling of distressed banks is done on a case by case basis. Nevertheless, during the last distressed period in 2008 (war against Russia; global financial crisis) NBG applied a mix of recovery instruments. This experience could be used to set up this framework. In addition, the NBG conducted only a high-level assessment that gave some understanding whether there will be difficulties in case of resolution, but there are no detailed assessments

	either set up by the banks or by NBG that identified resolution barriers and its measures (EC 6). The NBG required four banks to set up resolution plans, but the process of implementation has only started recently. Several years ago, there were some discussions with a systemic relevant bank, but these discussions didn't lead to an adequate resolution plan. The assessors think it is important to develop also this side of the supervisory approach, which could possibly help to resolve a problem bank if necessary. **Contact with insurance supervisor** The NBG does not have frequent contact with the insurance supervisor. Though it recently (after the mission) signed an MOU with the insurance supervisor. However, the insurance sector seems to be relatively small and the largest insurance company is a subsidiary of a bank through which the NBG monitors trends in the insurance sector and the implications for the bank. See further CP 3 on cooperation and collaboration. *Recommendation* Finish implementation of the new supervisory approach and formalize it. 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. Consider doing a crisis simulation exercise. See also precondition on resolution regime.
Principle 9	Supervisory techniques and tools. The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.
Essential criteria	
EC1	The supervisor employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks and banking groups, their risk profile, internal control environment and the corrective measures necessary to address supervisory concerns. The specific mix between on-site and off-site supervision may be determined by the particular conditions and circumstances of the country and the bank. The supervisor regularly assesses the quality, effectiveness and integration of its on-site and off-site functions, and amends its approach, as needed.
Description and findings re EC1	The NBG's bank supervision includes both off-site and on-site supervision. Under the new risk-based supervisory approach, supervisors are not separated into on-site and off-site teams. Both the supervisors (Banking Supervision Department) and the specialist risk teams (Specialized Groups and Supervisory Policy Department) undertake a mixture of on-site and off-site work. Most of the work is done off-site. The NBG is able to receive complete loan files via an e-line. This enables them to assess the quality of a loan off-site. It is, in a way, online supervision. The NBG also receives regularly very detailed information, such as credit committee decision, updates of policies and procedures, and rejection reports. This gives the NBG insight into the quality of risk management. The NBG mostly visits on-site to assess the IT

	and data accuracy in order to mitigate respectively IT risk and financial assurance risk, but also to assess other risk categories such as liquidity risk, market risk, operational risk and money laundering as well. The NBG performs all necessary steps and activities to identify and assess the banks' risks and to elaborate on relevant supervisory actions. Although risk assessments of particular banks are performed at certain non-predefined intervals, both risk supervisors and bank supervisors perform monitoring on an ongoing basis based on the monthly and daily reports submitted by commercial banks. Beyond this, both risk and bank supervisors are in touch with commercial banks (both specialists and different levels of managers) on an ongoing basis. Meetings are frequently held both at bank premises and at NBG's office and over-the-phone or email correspondence is performed on a very frequent basis. Due to established intensive communication and information exchange platform, there is no mandated frequency of inspections; however, based on supervisory judgment (combination of risk, systemic relevance, and date of last assessment) they are undertaken from time to time as well. In line with regulation on GRAPE, supervisory attention is based on the risk profile and the systemic importance of banks.
EC2	The supervisor has a coherent process for planning and executing on-site and off-site activities. There are policies and processes to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives, and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.
Description and findings re EC2	The NBG uses a supervisory cycle (pre-assessment risk identification, risk assessment, post-assessment identification, and risk mitigation) on the level of an individual risk and also on the level of an individual bank (stock taking). Corrective actions and/or recommendations to the bank are communicated in the risk-mitigation phase. It is also at this stage that the post-assessment risk identification program is developed, which, due to the shortage of time or some other relevant reason, couldn't be addressed during the supervisory process (or requires updated information and time for validation) and are transmitted to other upcoming supervisory tasks. Both risk supervisors and bank supervisors choose the particular mix of on-site and off-site inspections based on the ongoing supervisory process. Any significant findings are instantly communicated to the heads of departments and the vice-governor itself by both bank and risk supervisors. Specialized teams, as well, communicate instantly any significant systemic risk findings. Such periodic reporting can result in undertaking of non-cyclical tasks. It should be noted that the NBG switched to a new risk-based supervision framework promptly, rather than in a pre-planned manner (see principle 8 supervisory approach.) This was necessitated by the distress period and observance that major risks were not addressed under the former framework. As a result, back then, emphasis was put on dealing with the prevailing risks in the system rather than formalization of the new processes. At a later stage, the NBG started such a task.

	Further work performed in this direction was the: elaboration of the decree on GRAPE, development of the supporting software, analysis of risk-assessment methodologies beyond CAMEL by specialized teams, holding seminars for supervisors on them, performing risk assessments based on new methodologies, and reviewing them for validating purposes. Besides, last year, the NBG hired an especially dedicated person for coordination of supervisory plan. The coordinator of the supervisory plan (Deputy Head of Banking Supervision Department) periodically prepares reports for the vice-governor on ongoing risk assessment needs raised by individual supervisors and progress on approved tasks. The total supervisory plan, including all upcoming activities, is as well approved by the vice-governor who informs and agrees with the governor. Relevant tracking and monitoring functions are as well assigned to the risk assessment software.
EC3	The supervisor uses a variety of information to regularly review and assess the safety and soundness of banks, the evaluation of material risks, and the identification of necessary corrective actions and supervisory actions. This includes information, such as prudential reports, statistical returns, information on a bank's related entities, and publicly available information. The supervisor determines that information provided by banks is reliable and obtains, as necessary, additional information on the banks and their related entities.
Description and findings re EC3	The NBG uses a variety of information under which extensive prudential reporting is supplemented with ah-hoc requests. Publicly available information is actively tracked by the NBG as well. The news related to the banking sector or individual banks is shared with supervisors on a daily basis. Different kinds of research reports from banks, external rating agencies or international institutions are also being used. The NBG does cross-checks to determine that information is reliable and comprehensive (in particular for information on related parties).
EC4	The supervisor uses a variety of tools to regularly review and assess the safety and soundness of banks and the banking system, such as: (a) analysis of financial statements and accounts; (b) business model analysis; (c) horizontal peer reviews; (d) review of the outcome of stress tests undertaken by the bank; and (e) analysis of corporate governance, including risk management and internal control systems. The supervisor communicates its findings to the bank, as appropriate, and requires the bank to take action to mitigate any particular vulnerability that have the potential to affect its safety and soundness. The supervisor uses its analysis to determine follow-up work required, if any.
Description and findings re EC4	The NBG use a variety of tools to assess the safety and soundness of banks. This includes analysis of financial statements, business model assessments, horizontal peer reviews, review of the outcome of stress test undertaken by NBG and also undertaken by a few large banks, and assessment of corporate governance and group structures. Bank supervisors and risk supervisors together perform comprehensive risk assessment of the banks based on both on-site and off-site work where most activities are being conducted off-site with help of on-line possibilities (see EC 1). This analysis could be communicated to banks if necessary. The NBG uses these analyses to determine the follow-up work.

EC5	The supervisor, in conjunction with other relevant authorities, seeks to identify, assess and mitigate any emerging risks across banks and to the banking system as a whole, potentially including conducting supervisory stress tests (on individual banks or system-wide). The supervisor communicates its findings as appropriate to either banks or the industry and requires banks to take action to mitigate any particular vulnerabilities that have the potential to affect the stability of the banking system, where appropriate. The supervisor uses its analysis to determine follow-up work required, if any.
Description and findings re EC5	The NBG is the sole supervisor of the banking sector and has a clear approach for identifying (pre/post), assessing, and mitigating any emerging risks across banks and to the banking system as a whole. In order to take mitigating actions, risk supervisors and bank supervisors would not be hindered by an obligation to perform the full assessment first. Usually, as part of ongoing supervision, communication on potential vulnerabilities takes place immediately at different levels of the bank, depending upon the severity of the findings. Both banking supervisors and risk supervisors determine follow-up, if needed, both in terms of post-risk identification and risk mitigation. Stress testing is performed regularly by specialized teams to assess the impact of various external factors impacting banks' performance. The Credit Risk Division and Financial Risks and Macro-Prudential Policy Division are in charge of stress testing of banking system assets against external vulnerabilities. In particular, the FRMP defines the stress test parameters based on historical values and judgment, as well as by taking into account the current stance of the economy and financial sector. The parameters are normally revised every six months.
EC6	The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.
Description and findings re EC6	The supervisor receives and reviews the work performed by internal audit functions at commercial banks. In these instances, such documents are used as sources of information about the potential risks in the bank. Beyond this, the NBG communication with the heads of the banks' internal audits has been intensified since 2011. There have been individual meetings as well as collective ones, with meetings being held with heads of internal audit functions. Through such practices, the NBG is able to form its view on the quality of internal audit functions at commercial banks. The NBG's current agenda is to facilitate the strengthening of such functions at commercial banks through approving a new decree on internal audit functions at commercial banks.
EC7	The supervisor maintains sufficiently frequent contacts, as appropriate, with the bank's Board, non-executive Board members, and senior and middle management (including heads of individual business units and control functions) to develop an understanding of, and assess matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems, and internal controls. Where necessary, the supervisor challenges the bank's Board and senior management on the assumptions made in setting strategies and business models.

Description and findings re EC7	The NBG has a clear supervisory approach to develop an understanding of, and to assess a bank's matters, such as business model, group structure, corporate governance, profitability, credit risk, operational risk, market risk, and capital. Contact with the senior management, and other key persons in the bank, is a very intensive and ongoing, continuous process. Supervisors are in touch with them almost on a daily basis to be abreast about any new developments or changes to the bank's strategy and processes. Such communication includes, among others, sharing supervisory views, challenging their approaches, practices, and recommending certain actions. Communication with the banks' Board of Directors as well takes place from time to time and, when deemed necessary, more intensively. High-level topics are discussed usually throughout such communication. The NBG is planning to facilitate sound corporate governance practices at commercial banks that should include active involvement of the Board of Directors in setting the tone at the top (define risk appetite, monitoring major risks, etc.). The NBG is willing to intensify communication with them as well. The NBG plans to arrange such meetings, at least on every overall risk assessment phase. So far, Board assessments—under corporate governance assessment—have been performed mostly through the review of the Board of Directors meeting minutes, correspondences, and inquiries by them to management.
EC8	The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses in a timely manner by means of written reports or through discussions or meetings with the bank's management. The supervisor meets with the bank's senior management and the Board to discuss the results of supervisory examinations and the external audits, as appropriate. The supervisor also meets separately with the bank's independent Board members as necessary.
Description and findings re EC8	In practice most of the time, the NBG shares its views on identified weaknesses with commercial banks immediately via phone calls, email, or meetings. Depending on the severity of the matter, the NBG could send a formal letter. Recently, the NBG sent a letter to all the large banks to communicate the NBG's findings regarding all individual risk items. This letter is part of a process to improve the risk management of banks and will be part of the discussion on the ICAAP during the SREP. The NBG also meets, if necessary, with the independent Board members.
EC9	The supervisor undertakes appropriate and timely follow-ups to check that banks have addressed supervisory concerns or implemented requirements communicated to them. This includes early escalation to the appropriate level of the supervisory authority and to the bank's Board if action points are not addressed in an adequate or timely manner.
Description and findings re EC9	Risk-mitigation program is the follow-up phase of the risk assessment process, which is approved and tracked by the management. Every required follow-up action of the risk mitigation program has a deadline and a bank supervisor or risk supervisor is responsible for meeting the deadline. It is also made explicit which division is responsible for monitoring the deadline. Furthermore, one officer is responsible for overseeing the planning process to make

	sure that every task is recorded and deadlines are met. Currently, 80 percent of all task cards are recorded in the supervisory information system. The escalation process is rather informal, because the deputy governor responsible for supervision has a hands-on approach. That means that if the follow-up did not bring what it should bring, the supervisor can immediately change tactics after consulting the deputy governor and the department heads.
EC10	The supervisor requires banks to notify it in advance of any substantive changes in their activities, structure, and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
Description and findings re EC10	Commercial banks are obliged to notify/receive approval from the NBG on (LACB when): - opening of new branches or representative offices; - change in ownership structure; - conducting nonfinancial activities; and - all major investments. In practice, commercial banks inform the NBG about any substantive changes in their activities, and the supervisors assess the banks' capability to manage the risks associated with them. As part of ongoing supervision, commercial banks notify the NBG about any material adverse developments, including the inability to meet the prudential requirements in order to get supervisory approval. - It should also be noted that according to the regulation of external bank audits, if during the normal audit process the auditor comes across any matters of importance, as stated below, the auditor shall no later than five business days after identification of the fact must provide to the NB: bank's articles of association, charter, or by-laws, about the intention of auditor to resign or removal of the auditor from the office. - Information on any material adverse changes in the risks of the bank's business and possible risks going forward. However, so far, the NBG has not received such notifications.
EC11	The supervisor may make use of independent third parties, such as auditors, provided there is a clear and detailed mandate for the work. However, the supervisor cannot outsource its prudential responsibilities to third parties. When using third parties, the supervisor assesses whether the output can be relied upon to the degree intended and takes into consideration the biases that may influence third parties.
Description and findings re EC11	LACB Article 29 stipulates that each bank, and each of its subsidiaries, can be subjected to inspections by NBG inspectors or by auditors appointed by it. Despite the legal power to commission work by external experts, the NBG has not in practice hired third parties to perform supervisory tasks. However, through technical assistance programs, external experts visit NBG and review supervisory practices and give relevant recommendations. Where necessary, such experts are involved in bank specific tasks, as well.

EC12	The supervisor has an adequate information system which facilitates the processing, monitoring, and analysis of prudential information. The system aids the identification of areas requiring follow-up action.
Description and findings re EC12	The NBG has developed an in-house information system which facilitates both processing and monitoring of the supervisory cycle and analysis of prudential information. All divisions of the Banking Supervision Department have access to common data storage space, where they can keep bank-specific or any additional information. The accessibility to databases for different departments is determined by considering the confidentiality of information provided in different folders on a need-to-know basis. Banks supervisors have access to all information for one bank. Risk supervisors have access to all banks for one risk. This adequately supports identification of risks. With regard to follow-up action, these can be and are recorded in the supervisory system. There are three different storage spaces at the supervisors' disposal: FSA-Banks, FSA-Shares, and FSA-SGSP, where both quantitative and qualitative information are kept. FSA-banks contain information on the different risk categories per bank. Relevant documents are linked to this folder. FSA-Shares contain information on banking institutions in a classified way, most of which comprise periodic reports submitted by commercial banks.
	FSA-SGSP is used by specialized groups and supervisory departments as their daily storage area for ongoing documents and various researches undertaken by them. Beyond this, in-house developed reporting software aggregates all bank financials and enables them to derive different cross-sectional or time series data on both individual banks and the system as well.
Additional criteria	
AC1	The supervisor has a framework for periodic independent review, for example, by an internal audit function or third-party assessor, of the adequacy and effectiveness of the range of its available supervisory tools and their use, and makes changes as appropriate.
Description and findings re AC1	Within the NBG, banking supervision is subject to review by its internal audit department. Significant independent reviews are as well performed by experts commissioned through technical assistance projects.
Assessment of Principle 9	Compliant
Comments	The NBG is compliant with CP 9 supervisory tools and techniques. The NBG made enormous progress in the supervisory tools and techniques they are using. In many ways the NBG's approach is an example for other developed countries. Three elements are worth mentioning:: • First, the NBG uses a supervisory cycle (risk identification, assessment, and mitigation) at the level of each individual risk. This makes the NBG very flexible. This flexibility is

	balanced by periodical stock takes. • Second, it seems the NBG has achieved a well balanced integration and equal usage of bank supervisors and risk supervisor. Bank supervisors are responsible for banks across risks, and risk supervisors are responsible for risks across banks, including systemic risk. Both supervisors do on-site and off-site activities. It is very clear who is responsible for which task. • Third, the NBG has a very powerful supervisory information system that enables the supervisor to do "online" supervision and rigorous data analysis. For example, the NBG does not have to go on-site to do a loan review because it receives all files online, which are connected to the bank's information system. Furthermore the prudential returns have become much more granular. Both together are crucial for understanding the risk profile of a bank. All this together enables supervisors to communicate on a daily basis with each other and with the banks on different levels (from technical staff to senior management). As one banker said "the NBG Deputy Governor is everywhere." Lastly, implementation of ICAAP in 2014 should further enhance supervisory tools and techniques. There is only one important remark to be made: • The NBG runs the risk of not spending enough time on-site, because of excellent online possibilities. An important element in a bank is its risk culture. The NBG supervisors should consider if it spend enough time on-site to sense the risk culture. Recommendations: - Consider integrating identification of risk culture in the supervisory approach and spending more time on-site to sense banks' risk culture. • Consider to make more use of formal letters to communicate findings instead of emails that are difficult to trace (see EC 8).
Principle 10	Supervisory reporting. The supervisor collects, reviews, and analyzes prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or the use of external experts.
Essential criteria	
EC1	The supervisor has the power to require banks to submit information on both a solo and a consolidated basis on their financial condition, performance, and risks on demand and at regular intervals. These reports provide information such as on- and off-balance sheet assets and liabilities, profit and loss (P&L), capital adequacy, liquidity, large exposures, risk concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related-party transactions, interest rate risk, and market risk.
Description and findings re EC1	Legislation provides for the request and receipt of information on a solo and consolidated basis. However, while information is received separately for a bank and its subsidiaries, banks currently do not report on a consolidated basis, although the NBG is in the process of introducing a consolidated reporting system. At the same time, the NBG does require banks to report certain consolidated information, e.g., they are required to report large exposures on a

	consolidated basis. Article 29 of the ACB Law stipulates: "Each bank shall prepare and submit to the National Bank (both for the bank itself and separately for each of its subsidiaries) reports concerning organizational-administrative and operational activities and concerning liquidity, solvency, and profitability in order to enable the National Bank to assess their financial conditions both individually and on a consolidated basis. These reports shall be prepared in such form and detail and shall be submitted at such intervals as shall be prescribed by regulation of the National Bank." This is supplemented by Article 48(4) of the NBG Law, which establishes the NBG's right to request and receive from the banks all information (including confidential information) that is necessary for it to fulfill its statutory obligation, which allows it to collect information on an ad-hoc basis. Almost all the returns are received on a monthly basis – some relating to liquidity (e.g., LCR and reports relating to treasury activities) are received daily. The report on operational risk is received annually. The returns cover a broad range of activities, including a balance sheet and profit-and-loss account and ratios relating to liquidity, large exposures, related-party lending, asset quality, etc. While prudential reporting is solo-based, the banks are required to prepare consolidated financial statements annually based on IFRS.
EC2	The supervisor provides reporting instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
Description and findings re EC2	Prudential reporting is based on local GAAP. This local GAAP was devised in 2000 by the NBG in collaboration with Deloitte & Touche. It is closely aligned with the IFRS. Some guidance is provided for GAAP valuations, but this is not comprehensive. Where no guidance exists (e.g., real estate), the NBG requires banks to apply the IFRS. The NBG plans to fully converge local GAAP with the IFRS and to introduce appropriate prudential filters.
EC3	The supervisor requires banks to have sound governance structures and control processes for methodologies that produce valuations. The measurement of fair values maximizes the use of relevant and reliable inputs, and is consistently applied for risk management and reporting purposes. The valuation framework and control procedures are subject to adequate independent validation and verification, either internally or by an external expert. The supervisor assesses whether the valuation used for regulatory purposes is reliable and prudent. Where the supervisor determines that valuations are not sufficiently prudent, the supervisor requires the bank to make adjustments to its reporting for capital adequacy or regulatory reporting purposes.
Description and findings re EC3	For prudential reporting purposes, the use of the fair value option is very limited. Georgian GAAP is not based on fair value principles; instead, commercial banks mostly apply the so-called cost method, particularly for outstanding loans. Trading book exposures, for which fair

	value principles could be relevant, are almost non-existent in Georgia. From this perspective, valuation (fair value) related topics are not particularly relevant for Georgian banks. The main area where fair value principles are relevant is the valuation of real estate property. The NBG monitors the adequacy of fixed asset revaluations; such revaluation reserves are not part of regulatory capital. Apart from this, if the supervisor determines that valuations are not sufficiently prudent, the NBG requires the bank to make the necessary adjustments. In terms of collateral valuation, supervisors critically assess the value through either on-site or off-site inspections by using specific knowledge of the NBG-employed professional appraiser who works at the Specialized Groups and Supervisory Policy Department. The fair-value option is applied for IFRS-based reporting purposes (i.e., annual accounts). Such reports are subject to external audit requirements. The external auditors perform audits in line with international auditing standards and review compliance of financial statements with the IFRS. Management letters are available to the NBG, through which it can observe any identified shortcomings by external auditors. As indicated in EC2 above, the NBG proposes to switch prudential reporting from local GAAP to IFRS.
EC4	The supervisor collects and analyzes information from banks at a frequency commensurate with the nature of the information requested, and the risk profile and systemic importance of the bank.
Description and findings re EC4	As indicated in EC1 above, most prudential returns are submitted monthly with liquidity-related returns received on a daily basis. As part of the risk-based supervisory approach recently introduced, the analysis of these reports is proportionate to the risk profile and systemic importance of the bank. This approach also extends to reports sought on an ad-hoc basis; such information is more commonly sought from the larger, more systemically important, banks and those with higher risk profiles.
EC5	In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
Description and findings re EC5	Prudential returns are received from banks on a bank-solo basis through standardized reports carrying the same dates. This information is compiled and stored in a database from which the NBG extracts comparative data and analyzes developments over a given period. There is no formal framework established for consolidated reporting in Georgia. However, annual accounts which are prepared on a consolidated basis are analyzed by NBG, which often involves requesting additional information from the banking group to facilitate a more thorough review of the group position. The NBG points out there are no significant banking groups in Georgia, so group analysis is less significant than it might otherwise be. Nonetheless, as indicated above, it proposes to introduce a consolidated supervisory regime in the future.
EC6	The supervisor has the power to request and receive any relevant information from banks, as well as any entities in the wider group, irrespective of their activities, where the supervisor believes that it is material to the condition of the bank or banking group, or to the assessment

	of the risks of the bank or banking group or is needed to support resolution planning. This includes internal management information.
Description and findings re EC6	The supervisor is authorized by law to request and obtain all relevant information that it considers necessary for effective and sound supervision. Article 48 (4) of the NBG Law provides that for the purpose of performing its supervisory function, the NBG is authorized to request and receive from banks any information (including confidential information.) Also, Article 45 of the same law stipulates that the NBG shall be authorized to require and receive from state institutions and any other person (which would include banks) all statistical, accounting, and other information (including confidential information) necessary for discharging the duties imposed thereon.
EC7	The supervisor has the power to access all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management, and staff, when required.
Description and findings re EC7	Articles 48 and 49 of the ACB Law establish that the National Bank has the right to request and receive any information from the commercial banks, including ad-hoc information and different reports, which is requisite for the effective and sound supervision. Further, under Paragraph 3 of Article 29 of the ACB Law, in their inspections of banks and their subsidiaries, supervisors and auditors, not only have the authority to examine all accounts, files and other records of the bank, but also to require from all administrators (i.e., Supervisory Board members and Directors) and employees of banks and their affiliates to submit any information on the bank's shareholders and on the bank's operations. In addition, Article 45 of the NBG Law grants NBG the authority to request and receive all statistical, accounting and other information (including confidential) necessary for discharging the duties imposed thereon. The NBG considers that access to information is its significant strength. There are no practical obstacles in this respect.
EC8	The supervisor has the means to enforce compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines the appropriate level of the bank's senior management is responsible for the accuracy of supervisory returns, imposes sanctions for misreporting and persistent errors, and requires that inaccurate information be amended.
Description and findings re EC8	The ACB Law provides that the NBG (Article 30) is authorized to impose actions and sanctions with respect to banks, their administrators (Supervisory Board members and Directors,) and controlling persons when any or all of them are guilty of an infraction. Among these infractions (Subsection 2(c)) is the failure to meet a timeframe for the submission of reports, or the submission of incorrect reports, or of other inaccurate information. Depending on the seriousness of the infraction, the NBG has the right to impose a range of sanctions, ranging from the issuance of written warnings, to the imposition of fines, to the suspension of certain activities, to the revoking of the license.

	In practice, where the error is not material, banks will be asked to correct them immediately. Where the error is material or its commission consistent more severe sanctions will be considered including the removal of management. While Directors are responsible for the management of the bank and by implication for the accuracy of returns it is proposed to make this more explicit in future legislation.
EC9	The supervisor utilizes policies and procedures to determine the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts.
Description and findings re EC9	The NBG relies on its ongoing supervisory regime to determine the validity and integrity of supervisory information. This is achieved through the on-site and off-site inspection regime, periodic assurance testing by the NBG's operational risk and information processing division and the monitoring of bank-wide developments. Also, the NBG undertakes an annual comparison between prudential reporting and the IFRS-based annual accounts. Further, the NBG, in collating aggregate large exposures across the banking system, also compares provisioning polices in the different banks as well as the risk weightings applied by banks to the various loans. On external experts, while the NBG is allowed to do so by legislation, it has not so far commissioned external experts to perform additional checks of supervisory information.
EC10	The supervisor clearly defines and documents the roles and responsibilities of external experts,[7] including the scope of the work, when they are appointed to conduct supervisory tasks. The supervisor assesses the suitability of experts for the designated task(s) and the quality of the work and takes into consideration conflicts of interest that could influence the output/recommendations by external experts. External experts may be utilized for routine validation or to examine specific aspects of banks' operations.
Description and findings re EC10	Article 29 of the ACB Law establishes that the NBG has the authority to utilize external experts when carrying out inspections of commercial banks and its subsidiary companies. However, it has not, in practice, commissioned external experts for performing supervisory tasks.
EC11	The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.
Description and findings re EC11	As indicated in EC10 above, the NBG does not hire external experts for performing supervisory functions. Thus, the requirement is not relevant in a Georgian context. Such a requirement is in place for external auditors. The Regulation on the External Audit of Commercial Banks, adopted in 2010, regulates the activities, powers, and responsibilities of external auditors of commercial banks. Article 4 of this Regulation establishes that the

[7] These may be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions. External experts may conduct reviews used by the supervisor, yet it is ultimately the supervisor that must be satisfied with the results of the reviews conducted by such external experts.

	external auditors, during the course of the work undertaken by them for audit purposes, are required to promptly report to NBG in the following cases: - The commercial bank in question no longer qualifies for the banking license requirements as defined under the ACB Law. - There is a conflict with the decision-makers or the responsible manager leaves the country. - There are breaches of normative acts or internal statutes. - The external auditor is going to cease the process of audit. - A substantial negative change in the risks related to the bank’s activities, or possible future risks are identified.
EC12	The supervisor has a process in place to periodically review the information collected to determine that it satisfies a supervisory need.
Description and findings re EC12	Many of the reporting forms have been developed in recent years, and the NBG continues to update existing ones and introduce new ones. The NBG proposes to review the current reporting framework and update it in line with the introduction of a full IFRS regime.
Assessment re Principle 10	Largely compliant
Comments	In normal circumstances, the absence of consolidated prudential reporting would require a “materially noncompliant” rating. However, there are a significant number of mitigants in the case of Georgia which, at this time, merit it a “largely compliant” rating: The NBG will introduce a consolidated supervisory regime as from November 2014. The level of banking group activity is miniscule, with only the two biggest banks having subsidiaries/affiliates, and in both cases representing a very small portion of their respective total activities (see Principle 12-Consolidated supervision). As a result of the second bullet point, the difference between solo and consolidated prudential ratio calculations is minimal, and in fact, the solo calculations are more adverse given that investments are deducted from capital. Large exposures are calculated on a consolidated basis and the NBG has started calculating capital adequacy ratios on a consolidated. The banks’ annual accounts are prepared on a consolidated basis and the NBG analyzes these results. Given the insignificance of group activity in the banking sector, the non-submission of consolidated prudential returns fitted in with the NBG risk-based approach to supervision.
Principle 11	Corrective and sanctioning powers of supervisors. The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to

	bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.
Essential criteria	
EC1	The supervisor raises supervisory concerns with the bank's management or, where appropriate, the bank's Board, at an early stage, and requires that these concerns be addressed in a timely manner. Where the supervisor requires the bank to take significant corrective actions, these are addressed in a written document to the bank's Board. The supervisor requires the bank to submit regular written progress reports and checks that corrective actions are completed satisfactorily. The supervisor follows through conclusively and in a timely manner on matters that are identified.
Description and findings re EC1	The NBG raises supervisory concerns promptly with senior management, and where necessary, with the Board of Directors of a bank. Such concerns can be identified throughout the ongoing supervision regime. Sources of the supervisory regime can as well be public information or management letters of external auditors. In rather severe instances, such concerns are also raised at the Supervisory Board level. When the NBG perceives risks from particular activities or risk-management practices, it usually requires banks to further investigate the question and provide the NBG with its view. In different instances, when risks are obvious, the NBG raises concerns with bank's management, communicating its view and intended corrective measures. In instances, when significant violations are observed, the NBG imposes strict requirements on banks. The NBG widely applies a dialogue regime with commercial banks implying that, in various cases, its views and recommendations are shared with commercial banks through email correspondence, over the phone, or in meetings. The NBG performs follow-up monitoring of all supervisory concerns raised with banks. When significant corrective measures are undertaken, the NBG imposes written instructions on banks and requires periodic progress reports from them. Such progress reports are actively monitored by the supervisor.
EC2	The supervisor has an appropriate range of supervisory tools available for use when, in the supervisor's judgment, a bank is not complying with laws, regulations, or supervisory actions, is engaged in unsafe or unsound practices or in activities that could pose risks to the bank or the banking system, or when the interests of depositors are otherwise threatened.
Description and findings re EC2	The NBG is authorized, based on LACB article 30, to impose actions and sanctions with respect to banks, their administrators, and controlling persons if a bank, any of its administrators, or controlling persons is guilty of an infraction consisting of: - violation of a provision of the LACB or of any regulation, instruction, rule, decree, order or written guidelines of the NBG; - violation of any condition or restriction attached to the banking license of a bank; - failure to meet a timeframe for the submission of reports or the submission of incorrect reports or of other inaccurate information; and/or

	- violation of the anti-money laundering law and the payment law. When the above-mentioned violations are revealed, the NBG has the right to impose with increasing severity, depending on the seriousness of such violation and any actual or potential risk it poses to the assets of the bank, the following sanctions according to LACB article 30 (September 2009): - Issue a written warning. - Carry out special actions or issue instructions requiring that a bank must cease certain current practices and desist from future ones and other violations, and take measures to eliminate violations within a specified period. - Impose fines according to the established rules and amounts, but not in excess of bank's own funds. - Require from a commercial bank payment of fines in such amounts and pursuant to such procedures as are established by the NBG, if any action of the bank's administrators caused financial loss to the bank or permitted the violation of regulations and requirements of the National Bank. - Suspend the signing authority of the bank's administrators and require from the bank's Supervisory Board to dismiss him or her temporarily or permanently. - Require the Supervisory Board and Directorate to call a special meeting of the bank's shareholders to discuss the violations and to take necessary measures to eliminate them. - Suspend or restrict asset growth, distribution of profits, payment of dividends and bonuses, and salary increases and the acceptance of deposits. - In special cases, when the interests of the bank's depositors and other creditors are jeopardized, to suspend active operations and to place the bank in Temporary Administration. - In special circumstances when bank is not able to pay back deposits and other obligations, the National Bank is authorized to revoke bank’s operations and impose the temporary administration. - To request from the controlling persons of a bank to cease or terminate their control in case of failure to provide financial or other information to NBG or in cases when a violation has been discovered. - To revoke the bank's license. - In practice, the NBG mostly uses letters and emails to address safety and soundness issues, but also in the event of violation of law or regulation. Although written notifications are listed in article 30, the letters make no reference to this article, but are obligatory according to NBG and seem to be effective. For delayed reporting, or anti-money laundering violations, the NBG uses fines (approximately GEL 500.000 in 2013.) In some particular occasions, the NBG used the temporary administrator.

EC3	The supervisor has the power to act where a bank falls below established regulatory threshold requirements, including prescribed regulatory ratios or measurements. The supervisor also has the power to intervene at an early stage to require a bank to take action to prevent it from reaching its regulatory threshold requirements. The supervisor has a range of options to address such scenarios.
Description and findings re EC3	The NBG has the power to act where a bank falls below established regulatory requirements (OLCB article 48.3; LACB article 30). It can impose actions with respect to banks, their administrators, and controlling persons if a bank, any of its administrators, or controlling persons are guilty of an infraction consisting of a violation of a provision of the LACB or of any regulation, instruction, rule, decree, order, or written guidelines of the NBG. It is not specified in law that the NBG has the power to intervene at an early stage. However, the supervisor monitors compliance with regulatory ratios on a forward-looking basis. If a bank's current practice implies that the bank would not be able to meet regulatory requirements in the future, the supervisor establishes an intense dialogue with the bank requiring it to present a sustainable business model. Supervisors challenge assumptions made by the bank (for instance, adequacy of provisioning through intense growth plans.) Stemming from the risk-based supervisory principles the NBG has a power to impose individual prudential ratios on commercial banks. Such a power is applied to account for risky practices that have higher probability of default and can expose depositors to losses. Such an approach would be further formalized and strengthened through implementation of Pillar 2 of Basel II.
EC4	There are a broad range of possible measures that a supervisor has available to address at an early stage, such scenarios as described in essential criterion 2 above. These measures include the ability to require a bank to take timely corrective action or to impose sanctions expeditiously. In practice, the range of measures is applied in accordance with the gravity of a situation. The supervisor provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, imposing more stringent prudential limits and requirements, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from the banking sector, replacing or restricting the powers of managers, Board members, or controlling owners, facilitating a takeover by, or merger with, a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license.
Description and findings re EC4	The measures the NBG has available are described in EC 2. The applied measures that the assessors have discussed were taken commensurate to the gravity of the situation where the NBG has a preference for dialogue, email, and letters. There is no explicit escalation regime (see also CP9, EC9). Although the different measures have different severity.
EC5	The supervisor applies sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.
Description and findings re EC5	Banking legislation requires bank administrators (Directors, Supervisory Board members) to be accountable to depositors and not just to shareholders. To illustrate, according to Article 14 of LACB, members of the Supervisory Board are required to act in line with the bank's interests of

	stability. Failure to act accordingly renders them personally responsible to the bank for the damage done. Further, the NBG Regulation on conflicts of interest directly requires bank administrators to act in the depositors' interest. According to Article 30 of LACB, the NBG has the power to impose sanctions on banks, their administrators, and controlling persons; in particular, the NBG can suspend the signing authority of the bank's administrator and require the bank's Supervisory Board to dismiss him or her temporarily or permanently. Based on Article 49 of the Organic Law on NBG, in case of finding signs of criminal activities as a result of inspection, the NBG can transfer the material uncovered to competent bodies. Further, based on Article 4 of the NBG Regulation on Conflict of Interests, if violations are revealed, the NBG can transfer the case file to the relevant bodies in order to commence a criminal proceeding. As per Article 8 of Regulation on Determining and Imposing Pecuniary Penalties on Commercial Banks (Decree N242/01, 25 December 2009), in case of incompliance with the requirements set under the Law of Georgia on Facilitating the Prevention of Illicit Income Legalization, the administrator of a commercial bank will be fined GEL 2,000 if he/she fails to comply with Internal Control Procedures established in the legislation. Lastly, the NBG introduced certain pecuniary sanctions against key management positions at commercial banks to avoid serious misconduct in the future, as well as from the side of management.
EC6	The supervisor has the power to take corrective actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures, and other related entities in matters that could impair the safety and soundness of the bank or the banking system.
Description and findings re EC6	NBG has full power to take necessary supervisory actions, including ring-fencing measures, and also used these powers in practice. The sanctioning powers of NBG prescribed by article 30 of LACB can be applied under following circumstances: - Violated one of the provisions of LACB or any regulation, instruction, rule, decree, order or written guideline of NBG. - Violated any condition or restriction attached to the banking license or to a regulation issued by the National Bank. - Failed to meet a timeframe for the submission of reports, or submitted incorrect reports or other inaccurate information. - Violated the requirements of the Law of Georgia on Facilitating Prevention the Illicit Income Legalization. - Violated the requirements of the Law of Georgia on Payment System and Payment Service. Beyond this, as per article 21 of LACB, the NBG can impose individual prudential requirements on commercial banks based on risk-based supervisory principles. It should be noted that all foreign bank branches and subsidiaries are supervised like local institutions and they are

	subject to the same prudential requirements. This already implies that all active banks, including branches and subsidiaries, are basically ring-fenced from the activities of parent and other companies of the group (as they are subject to prudential limitations). Further, as per LACB, the NBG can impose individual prudential requirements on commercial banks that can assure further ring-fencing of local banks. In practice, the NBG places significant emphasis on location of liquid assets at group companies and resulting concentration levels, as well as operational independence of local subsidiaries or branches from parent and group companies.
EC7	The supervisor cooperates and collaborates with relevant authorities in deciding when and how to affect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
Description and findings re EC7	The NBG is the sole responsible authority for the resolution and liquidation process of commercial banks, and the authority that makes a decision on declaring a bank insolvent and bankrupt. The NBG has certain basic powers to take control of a problem bank, to act as a resolution authority, and to lead the liquidation process. The NBG can appoint the temporary administration and—if it determines to revoke a bank license—a liquidator. Both the temporary administrator and the liquidator—accountable toward the NBG—take over shareholders and managerial powers and may arrange for certain resolution transactions, such as a sale of assets and liabilities or the recapitalization of the bank under temporary administration. See also precondition on resolution framework.
Additional criteria	
AC1	Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.
Description and findings re AC1	There are no laws or regulations that guard against the supervisor delaying appropriate corrective actions. However, the NBG considers that absence of such provisions has not compromised taking corrections measures promptly.
AC2	When taking formal corrective action in relation to a bank, the supervisor informs the supervisor of nonbank related financial entities of its actions and, where appropriate, coordinates its actions with them.
Description and findings re AC2	The NBG is the sole supervisor of both bank and nonbank financial entities (except for insurance.) So far, no corrective measures have been taken against a problem bank that was a member of a group of both bank and nonbank financial institutions. Communication has, in practice, been performed promptly and effectively with nonbank supervisors incorporated under the NBG.
Assessment re Principle 11	Largely compliant
Comments	The NBG is largely compliant with the core principle 11. In 2010, the NBG abolished the prompt corrective action matrix, which was a rule-based approach not addressing situations of actual vulnerabilities. It was more of a conflict model. Since adopting the risk-based approach, the NBG has been more focused on the analysis of underlying factors and more

	forward looking for risks such factors lead to. It prefers dialogue through letters, emails, and meetings and seems to be reasonably effective. However, consideration should be given to imposing formal actions with clear escalation against banks in cases of resolution of safety and soundness issues, especially in cases where these issues in banks linger for a protracted period of time (EC 1 and 2). Although there are examples of successful interventions by the NBG in the area of safety and soundness, there are also examples where the NBG could have done better. The assessors wonder to what extent the NBG could have been more effective in addressing issues of risk management. This will become even more important as the focus on risk management increases with the implementation of Basel II, because implementation of Basel II will require banks to upgrade their risk management. Recommendation - Consider using an escalation framework for safety and soundness issues. - Consider reflecting to what extent NBG could have been more effective with regard to deficiencies that linger for a protracted period of time. - 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. See precondition on resolution regime.
Principle 12	Consolidated supervision. An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.[8]
Essential criteria	
EC1	The supervisor understands the overall structure of the banking group and is familiar with all the material activities (including nonbanking activities) conducted by entities in the wider group, both domestic and cross-border. The supervisor understands and assesses how group-wide risks are managed and takes action when risks arising from the banking group and other entities in the wider group, in particular contagion and reputation risks, may jeopardize the safety and soundness of the bank and the banking system.
Description and findings re EC1	Currently, the NBG has no separate reporting forms for consolidated supervision and the banks' prudential reporting is prepared on a solo basis. Annual audited statements are prepared on a consolidated basis, which allows the NBG to monitor the consolidated condition of banks including consolidated capital adequacy. The NBG has said that as there are no significant banking groups in the Georgian market, it did not regard consolidated supervision as a priority. However, in the context of its moving to Basel II and the introduction of a regime whereby prudential returns will be prepared through

[8] Please refer to footnote 19 under Principle 1.

	IFRS, it will also introduce the concept of consolidated supervision. This is expected to be in place by June 2015, with parallel runs between the existing regime and the new regime taking place in the previous six months. Subsidiaries of banks represent only a minor share of the banking sector assets – total investments on the balance sheet of banks represent only 2 percent of the total system assets and 12 percent of total regulatory capital as of December 2013. Effectively, only the two main banks lend themselves to consolidated supervision. The largest has total investments valued at less than 5 percent of its total balance sheet size. These investments include a bank in Belarus valued at about 1 percent and an insurance company in Georgia also valued at about 1 percent of total assets. The second bank owns a small Georgian bank (less than 10 percent its own size) and has an investment of less than 1 percent in a nonbank-lending institution in Azerbaijan. Notwithstanding the absence of a formal consolidated reporting structure, the NBG, under its group structure risk category analysis, assesses the ownership structure, subsidiaries, and the risks that group entities might pose to the stand-alone risk profile of the bank. The tools available to the NBG under the group structure risk category analysis include: • information submitted on the shareholders and beneficial owners of commercial banks as well as inquiries on other activities of shareholders; • information on the intra-group transactions and transactions with related entities (that include subsidiaries and business interests of the owners); and • Information on the group-wide large exposures. Monthly information on the volumes of investments and inquiries regarding the bank subsidiaries (through approval process, ongoing inquiries with commercial bank management, and financial statements) through which the NBG can become familiar with material activities of group entities and corporate governance on a group level.
EC2	The supervisor imposes prudential standards and collects and analyzes financial and other information on a consolidated basis for the banking group, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits, and group structure.
Description and findings re EC2	As indicated in EC1 above, formal consolidated prudential analyses are currently only carried out on an annual basis to coincide with the finalization of the annual accounts. The NBG contends that in the absence of complex group structures, the non-application of consolidated supervision does not pose material risks, particularly given that all investments are deducted from capital. If it became concerned about the group-wide structure, it would require the bank to submit relevant reports. The only ratio that is calculated on a consolidated basis is that of large exposures, although NBG has calculated the consolidated capital adequacy ratio for the two banks that would lend themselves to consolidated supervision. In both cases, the ratios are higher in the consolidated calculation on the basis that when calculated on a solo basis, investments are deducted from capital.

	While there is no separate reporting forms for consolidated supervision, under NBG's risk based approach to supervision (GRAPE), consolidated supervision is classified as a separate risk category which allows the NBG to take corrective action in the event of a breach. No such corrective action has taken place as there has never been such a breach.
EC3	The supervisor reviews whether the oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is adequate with regard to their risk profile and systemic importance, and there is no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. The supervisor also determines that banks' policies and processes require the local management of any cross-border operations to have the necessary expertise to manage those operations in a safe and sound manner, and is in compliance with supervisory and regulatory requirements. The home supervisor takes into account the effectiveness of supervision conducted in the host countries in which its banks have material operations.
Description and findings re EC3	Under the group structure, the NBG monitors and assesses the banks' involvement in the management of its foreign subsidiaries. It also collects comprehensive information about the subsidiaries, including their annual accounts.
	As mentioned already, none of the Georgian banks have material cross-border investments and only two have foreign subsidiaries, a bank and a non-bank-lending institution, respectively. Each represents about 1 percent of the respective total assets of each bank.
EC4	The home supervisor visits the foreign offices periodically, the location and frequency being determined by the risk profile and systemic importance of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or requires additional reporting, and has the power and resources to take those steps as and when appropriate.
Description and findings re EC4	The NBG has the power to perform on-site inspections in foreign subsidiaries, but has not exercised this power because of the relatively small amount of activity undertaken in these subsidiaries. The banking subsidiary of the biggest bank was establish in 2008 and has a balance sheet size of GEL 320 million (approximately US$160 million) compared to GEL 6 billion (approximately US$3 billion) for the parent bank. While the NBG has entered into an MOU with Belarus, communications from the Belarus regulatory authority are minimal. In specific circumstances, the NBG has requested additional information and it also reviews the reports prepared by the internal audit function of the relevant banks.
EC5	The supervisor reviews the main activities of parent companies, and of companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and takes appropriate supervisory action.

Description and findings re EC5	Throughout the licensing process (as well as through approving transfer of significant ownership), the NBG performs extensive analysis of the shareholders activities and their financial strength. The NBG considers information provided, discusses the issue with the (proposed) licensee, as well as seeking and clarifying additional details. On an ongoing basis, the NBG monitors the situation through the group structure risk assessment. Shareholder strength, reputation, and its strategic attitude and ability/willingness to support the bank when needed is part of the assessment of the overall risk of the bank. Where the NBG has concerns regarding shareholder support, the NBG expects banks to hold sufficient buffers above the minimum regulatory ratios.
EC6	The supervisor limits the range of activities the consolidated group may conduct and the locations in which activities can be conducted (including the closing of foreign offices) if it determines that: (a) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed; (b) the supervision by other supervisors is not adequate relative to the risks the activities present; and/or (c) the exercise of effective supervision on a consolidated basis is hindered.
Description and findings re EC6	As indicated in CP7—Major Acquisitions—the NBG sets limitations on total investments; i.e., a bank's ownership of equity interests should not exceed 50 percent of the bank's own equity, and all such interests are deducted from regulatory capital for the purposes of calculating capital adequacy ratios. For nonfinancial subsidiaries, approval is required for holdings in excess of 20 percent of the equity of the entity to be acquired. Approval is also required for holdings below 20 percent if the proposed holding exceeds 15 percent of the bank's equity capital. No consent is required for holdings in another bank provided the proposed holding does not exceed 15 percent of the bank's equity capital. With regard to financial subsidiaries, the NBG monitors and analyzes performance on an ongoing basis. The power to close foreign offices of banks is not explicitly provided for in legislation. However, the NBG can effectively prohibit/restrict the activities of such offices under Article 21 (2) of the ABC Law—Prudential Limits and Normatives. Subsection (b) allows the NBG to set ratios and standards concerning the maximum aggregate amount of credits and investments or specific categories thereof. Subsection (d) relates to prohibitions, restrictions or conditions regarding the types or credits and investments. If the safety of the bank is jeopardized, the NBG can implement sanctions in accordance with Article 30 of the ACB Law. These include the suspension or restriction of asset growth, the suspension of active operations, or the placing of the bank in temporary administration.

EC7	In addition to supervising on a consolidated basis, the responsible supervisor supervises individual banks in the group. The responsible supervisor supervises each bank on a stand-alone basis and understands its relationship with other members of the group.[9]
Description and findings re EC7	As indicated earlier, the NBG has yet to implement a full consolidated supervisory regime. However, it supervises banks on a solo basis, taking into account their relationship with the other members of the group.
Additional criteria	
AC1	For countries that allow corporate ownership of banks, the supervisor has the power to establish and enforce fit-and-proper standards for owners and senior management of parent companies.
Description and findings re AC1	Corporate ownership is allowed under Georgian legislation. The ACB Law stipulates fit-and-proper criteria for shareholders holding significant (more than 10 percent) share in a bank. However, there is no fit-and-proper test for the senior management of shareholder companies. Regarding EC6: The NBG should acquire explicit power to close foreign offices.
Assessment of Principle 12	Compliant
Comments	This Principle was rated Materially Noncompliant in the last FSAP assessment for a number of reasons: the absence of a consolidated supervision reporting framework, lack of coordination between different supervisory agencies, lack of analysis of risks arising from group entities, etc. Progress has been made in the intervening period. The risks posed by group companies are assessed as part of the group structure risk assessment. Large exposures are calculated on a consolidated basis and the NBG has begun to assess capital adequacy on a consolidated basis. However, there is still no consolidated supervision reporting framework, although the NBG is actively working to finalize one. It is expected to be ready by November 2014, along with the implementation of Basel II and a move to IFRS for prudential reporting purposes. The current absence of a consolidated supervisory framework should be considered in the context of the miniscule group structure in Georgian banks. The principal weakness in relation to consolidated supervision is the absence of a consolidated supervision reporting framework. This is also the main weakness under Principle 10 – Regulatory Reporting- which has been given an L/C rating as a result. In order to avoid the possibility of double jeopardy, this Principle (i.e., 12) has not been down-graded for the same weakness.

[9] Please refer to Principle 16, Additional Criterion 2.

Principle 13	Home-host relationships. Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.
Essential criteria	
EC1	The home supervisor establishes bank-specific supervisory colleges for banking groups with material cross-border operations to enhance its effective oversight, taking into account the risk profile and systemic importance of the banking group and the corresponding needs of its supervisors. In its broadest sense, the host supervisor, who has a relevant subsidiary or a significant branch in its jurisdiction, and who, therefore, has a shared interest in the effective supervisory oversight of the banking group, is included in the college. The structure of the college reflects the nature of the banking group and the needs of its supervisors.
Description and findings re EC1	No Georgian bank has a material cross-border operation. The two major banks have cross-border subsidiaries, but the investments in question are not significant. As indicated in Principle 12—Consolidated Supervision—the largest bank has a subsidiary in Belarus, which represents about 1 percent of its total assets, and the second largest bank has an investment in a nonbank subsidiary in Azerbaijan, which represents less than 1 percent of its assets. The NBG has signed an MOU with the regulators in each of these jurisdictions, but no supervisory colleges have been established. In terms of Georgian banks being owned by cross-border banks, about half of the 21 banks are so owned. The Georgian banks are very small, both in absolute terms and in relation to the size of their group parents. The location of the parent groups includes Germany, France, Turkey, Ukraine, Russia, Azerbaijan, and Kazakhstan. Georgia is party to just one supervisory college, operated by BAFIN in respect of ProCredit Bank, which is a subsidiary of a German bank holding company. As outlined in CP 3, it is the NBG's policy to establish MOUs with countries where the parents of Georgian banks are located or where Georgian banks have cross-border operations. Such MOUs provide for the exchange of information and the carrying out of inspections in cross-border countries. To date, the NBG has not carried out any inspection of the cross-border operations of its banks based, it says, on its risk-based approach to supervision and on the immateriality of those operations. Instead, it relies on information provided and the monitoring of the investment based on the annual audited consolidated financial statements. Nor has any home supervisor performed an on-site inspection in Georgia.

EC2	Home and host supervisors share appropriate information on a timely basis in line with their respective roles and responsibilities, both bilaterally and through colleges. This includes information both on the material risks and risk management practices of the banking group[10] and on the supervisors' assessments of the safety and soundness of the relevant entity under their jurisdiction. Informal or formal arrangements (such as memoranda of understanding) are in place to enable the exchange of confidential information.
Description and findings re EC2	As indicated in EC1 above, there are no official home-host supervision regimes and colleges, except in the case of BAFIN. The main tool in home-host relationships are bilateral MOUs between the NBG and supervisory authorities from other countries. Memorandums may vary from country to country, but they all have common features regarding information sharing of financial institutions, licensing, cooperation on ownership control, managing crisis situations (in some MOUs) and cases regarding financial crime. MOUs are in place with the following institutions/countries: • Azerbaijan; • Armenia; • Turkey; • Belarus (relevant since the BOG has a regulated subsidiary in Belarus); • Lithuania (for the purpose of general cooperation); • Ukraine (current MOU only applies to regulated securities activities but it is planned to sign a banking-related one in the near future); • Kazakhstan; • Germany; • Moldova; and • Qatar.
EC3	Home and host supervisors coordinate and plan supervisory activities or undertake collaborative work if common areas of interest are identified in order to improve the effectiveness and efficiency of supervision of cross-border banking groups.
Description and findings re EC3	As already indicated , the NBG plays a very proactive role in opening communications with the supervisors in those jurisdictions where a parent of one of its banks is located or the subsidiary of one of its banks is located. Because of the miniscule size of both relevant parent and subsidiary, the level of coordination and planning or the need to undertake collaborative work is not very meaningful in the face of a risk-based approach to supervision.
EC4	The home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy reflects the risk profile and systemic importance of the cross-border operations of the bank or banking group. Home and host

[10] See Illustrative example of information exchange in colleges of the October 2010 BCBS Good practice principles on supervisory colleges for further information on the extent of information sharing expected.

	supervisors also agree on the communication of views and outcomes of joint activities and college meetings to banks, where appropriate, to ensure consistency of messages on group-wide issues.
Description and findings re EC4	In almost all cases, the NBG has established an MOU with the relevant supervisory body. This provides for the exchange of information and an agreed communications strategy.
EC5	Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities, develops a framework for cross-border crisis cooperation and coordination among the relevant home and host authorities. The relevant authorities share information on crisis preparations from an early stage in a way that does not materially compromise the prospect of a successful resolution and subject to the application of rules on confidentiality.
Description and findings re EC5	A framework for cross-border crisis cooperation and coordination is contained in MOUs between the relevant supervisory authorities.
EC6	Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities and relevant host authorities, develops a group resolution plan. The relevant authorities share any information necessary for the development and maintenance of a credible resolution plan. Supervisors also alert and consult relevant authorities and supervisors (both home and host) promptly when taking any recovery and resolution measures.
Description and findings re EC6	As indicated in EC5, these issues are dealt with in MOUs.
EC7	The host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection, and regulatory reporting requirements similar to those for domestic banks.
Description and findings re EC7	Subsidiaries of foreign banks with banking licenses in Georgia must comply with the same regulatory and reporting requirements as local banks. Branches, as well as subsidiaries, must comply with the same requirements as local banks. In fact, branches (the two Turkish banks operating in Georgia operate on a branch basis) are required to maintain capital as if they were locally incorporated and are regulated accordingly, as if they were subsidiaries.
EC8	The home supervisor is given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with customer due diligence requirements. The home supervisor informs host supervisors of intended visits to local offices and subsidiaries of banking groups.
Description and findings re EC8	The inspection regime for banks in Georgia is governed by Article 29—Reports and Inspections—of the ACB Law. It reads: "Each bank and each of its subsidiaries shall be subject to inspections by inspectors of the National Bank or by auditors appointed by it. If the inspection is being conducted in a branch office or subsidiary of a foreign bank, auditors may be employees of financial or controlling

	authorities operating in a given foreign country." "Controlling authorities" is interpreted to include the home supervisor. Only institutions licensed as banks in their home countries may establish branches in Georgia.
EC9	The host supervisor supervises booking offices in a manner consistent with internationally agreed standards. The supervisor does not permit shell banks or the continued operation of shell banks.
Description and findings re EC9	Shell banks are defined in the Law on Facilitating the Prevention of Illicit Income Legislation as "a fictional bank (shell bank) which is not physically represented in the country where it is registered/licensed and which is not subject to supervision." Under that law, the establishment and existence of a shell bank, as well as establishing business relations with such a bank (including correspondent relations) is prohibited. Representatives of the financial sector must undertake reasonable measures in order to ascertain: (a) Whether the person they have business relationship with (or person with whom they are establishing business relations) belongs to the category of the shell bank; and (b) Whether the person they have business relationship with (or person with whom they are establishing business relations) has relations with the shell bank. Booking/representative offices operating in Georgia must register with the NBG. There is only one such operation.
EC10	A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action.
Description and findings re EC10	The NBG has no practical experience of a foreign regulator passing on information that would require consequential action but believes that it would take such action. Where MOUs exist, a provision to this effect is usually included.
Assessment of Principle 13	Compliant
Comments	The level of cross-border banking is very insignificant in Georgia. The legislation providing for cross-border cooperation is adequate and the actions undertaken by the NBG are commensurate with the level of activity.
Principle 14	Corporate governance. The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organizational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.
Essential criteria	
EC1	Laws. Regulations or the supervisor establish the responsibilities of a bank's Board and senior management with respect to corporate governance to ensure there is effective control over the bank's entire business. The supervisor provides guidance to banks and banking groups on expectations for sound corporate governance.

Description and findings re EC1	The LACB requires banks to have a two-tier system. Executive management (Directors) should be in charge of daily governance of a bank (LACB article 15.1) while the Supervisory Council should adequately control the operations performed by executive functions (LACB article 14.1) and the Audit Committee (LACB article 16). Regarding the Supervisory Board, LACB article 13 states that the Supervisory Board is elected by the General Meeting of Shareholders. LACB article 14 determines that the "Supervisory Boards of banks shall ensure oversight of banking activities." The same article states some of the actions that should be performed exclusively by the Supervisory Board: - "Undertaking in line with legislation. - Establishment of branches or representative offices of banks should only be performed with the authorization of the bank's Supervisory Board (LACB article 18). - Decisions of each Supervisory Board member shall be in conformity with the commercial bank's best interests. Their approach to their work shall be reasonable and independent and shall ensure election and retention of competent Directors, establishment of the commercial bank's business strategy, and formulate in writing the bank's policy." Regarding the Management Board, LACB article 14 stipulates that representation of the company shall be the duty of the Directors of a commercial bank. They shall be responsible for operating the bank and carrying out its functions." Members of Directorate are appointed by the Supervisory Board. Regarding the Audit Committee, LACB article 16 requires establishment of the Audit Committee at the Board level. The Audit Committee periodically submits reports to the Supervisory Board on the performed activities and major function of them is providing support to the effective functioning of bank's internal and external auditors. Some other provisions related with establishment of sound corporate governance practice in bank are provided under different regulations: - Law of Georgia on Entrepreneurs - Adopted in 1994, it regulates the formation, organization and dissolution of joint stock companies, including banks. The law sets out the basics for corporate governance, describing the governing bodies of companies and their responsibilities. - Regulation on Fit-and-Proper Criteria for Administrators of Commercial Banks - The regulation was issued in September 2002 and sets out detailed fit-and-proper criteria for senior management, chief accountants, and heads of branches of banks. According to the regulation, the Supervisory Board is in charge of making sure that each administrator meets fit-and-proper criteria. The regulation does not apply to the members of the Supervisory Boards and audit committees. However, their fit-and-proper criteria are defined under the LACB. New draft regulation on fit-and-proper requirements addresses those deficiencies. Its scope would be extended to members of the Supervisory Board and Audit Committee, as well as heads of internal audit. The fitness and proprietary

	should be in line with the complexity and activities for a given bank and at a given position. - Regulation on Conflict of Interests and Transactions between Bank Administrators and Related Parties - The regulation was approved in 2001 and details the mechanisms to be followed in transactions with conflict of interest, and prohibits certain behaviors of the bank administrators. According to this regulation, the Supervisory Board is in charge of controlling and avoiding conflict of interests. No transactions are allowed to be performed with related parties without the consent of the Supervisory Board. It incorporates the guidance on governance of conflicts of interest and restrictions and procedures for transactions with related parties. The NBG plans to update the regulation, as well. A working version draft has been elaborated, though some changes are still under consideration. The NBG is willing to put further emphasis on the related-party transactions governance framework, prevalence of policies and procedures, and to put inside certain reporting requirements, both to the Supervisory Board and the NBG in a way not to hinder smooth functioning of business operations and possibility of control from Board and supervisor. For instance, most of the transactions are currently approved at the Board level. In future, the significance of such transactions to be approved by the Board should be assessed by the bank and approved by the Board and the NBG. Beyond this, rather than approval obligation of such transactions, the NBG should facilitate relevant periodic reporting to the Board. At the same time, insiders must have predefined obligations and periodic reporting forms to fill out transactions with related parties (through them). The NBG is collaborating with the IFC on further enhancements to legislation on these matters. The current practice would be discussed under principle 20. - Regulation on Internal Audit Requirements for Commercial Banks - The regulation was approved in December 2011 and sets the internal audit requirements for the purposes of developing accounting, reporting, risk management, and internal control systems in commercial banks. The NBG has prepared an updated draft of the regulation as well, which increases supervisory powers that are needed to ensure effectiveness and independence of the Audit Committee and audit function. The major change would be related with mandatory regulatory approval for appointment and dismissal of internal audit heads and audit committee members. - Regulation on External Audit of Commercial Banks - requires that the annual financial statements, which need to be disclosed publicly, are audited by an (independent) external auditor and are in accordance with IFRS. - Regulation on Risk Management in Commercial Banks has been introduced in 2008 and establishes principles for effective risk management in commercial banks. It focuses on the governance of credit, liquidity, market, interest rate, operational risks, strategic, legal, compliance, and reputational risks. However, practical implementation of the regulation appeared to be rather difficult (the timing of enforcement was too early). Still, the NBG applies some provisions of the given regulation in a case by cases.

	- Regulation on Transparency of a Commercial bank Financial Condition - The Regulation was approved in 2006 and establishes the obligation for banks to publish their financial statements in compliance with the IFRS, financial ratios, list of shareholders owning 1 percent, and more of issued capital and list of beneficiary owners with 5 percent or more of equity stake. However, current disclosure requirements do not address disclosures of other qualitative information. As part of implementing the Pillar III requirement of Basel II/III, the NBG is preparing a draft of legislative amendments in the Regulation on Transparency Requirements for Commercial Banks which would incorporate both qualitative and quantitative information disclosure requirements. It should be mentioned that LACB article 19 requires banks to follow the international practice if the NBG has not issued detailed regulations. This article gives the possibility to require banks to improve their corporate governance practices in line with best practice guidelines. Beyond the legislation, certain governance provisions are included in the Corporate Governance Code for Commercial banks - Developed by the Association of Banks of Georgia with the support from IFC and adopted in 2009. It includes recommendations on shareholders rights, supervisory and Management Boards, corporate secretary, internal control and risk management, information disclosure and transparency, and conflict of interest and corporate governance of holdings. Eleven banks have signatories to the Code. In drafting the Code, the Association of Banks of Georgia took into account the OECD document Principles of Corporate Governance, the Basel Committee on Banking Supervision document "Enhancing Corporate Governance in Banking Organizations," and the experience of other countries and current Georgian legislation. For assessments of corporate governance practices, the NBG communicates sound practice expectations to banks. Such assessments were previously based only on the CAMEL manual, which included inspecting the Supervisory Board, Management Board, internal controls, IT systems, and internal and external audits. In addition, currently the NBG evaluates bank's corporate governance practices in accordance with leading supervisory agency's guidelines and bases evaluation on widely accepted principles (such as Basel, FSB), which require corporate governance practices to be matched with the complexity and nature of individual banks.
EC2	The supervisor regularly assesses a bank's corporate governance policies and practices, and their implementation, and determines that the bank has robust corporate governance policies and processes commensurate with its risk profile and systemic importance. The supervisor requires banks and banking groups to correct deficiencies in a timely manner.
Description and findings re EC2	Evaluation of corporate governance practices are part of the assessment of the overall risk profile of commercial banks. Supervisors check whether the bank has in place corporate governance policies, their adequacy, and how the bank follows them in practice. The robustness of such practices is analyzed in line with the risk profile and systemic importance of the bank. Where deficiencies are found, supervisors make recommendations or take corrective actions in line with the importance of such deficiencies.

	The assessment is performed through analysis of internal policies, interviews with bank staff and, where necessary, key personnel as well. This is an explicit part of the supervisory methodology GRAPE. Different criteria (such as composition, committees, remuneration, internal control, and risk management) are used to assess the corporate governance of each bank and benchmark the banks against each other. The NBG has started to facilitate, comply, or explain reporting by commercial banks. Such reports are analyzed by the NBG throughout the assessment as well. In addition, the NBG is intensifying its corporate governance related requirements on commercial banks. ICAAP should be an additional step forward in this process. As per NBG guidelines, commercial banks are obliged to describe governance processes in those documents, as well.
EC3	The supervisor determines that governance structures and processes for nominating and appointing Board members who are appropriate for the bank and across the banking group. Board membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile and systemic importance, Board structures include audit, risk oversight, and remuneration committees with experienced non-executive members.
Description and findings re EC3	The NBG determines that governance structures and processes for nominating and appointing Board members are appropriate. With regard to governance structure, LACB article 14 stipulates that the Supervisory Board should have an odd number of members, at least three and at most 21. The majority of the Supervisory Board members should be non-executive. The executive members shall not take part in making decisions on issues related with supervision of Directorate (executive bodies) activities, or approval and evaluation of its reports. In practice, the Boards of the largest banks are composed of non-executive members and are, overall, qualified and independent of ownership and the management function allowing for well-defined roles and responsibilities. With regard to the process for nominating and appointing Board members. The fit-and-proper requirements for members of the Supervisory Board are set by legislation. See for details CP 4 Licensing criteria (EC 7). With regard to committees, the law does not directly require the establishment of Board committees except for the Audit Committee (LACB article 16). The NBG analyzes how various Board functions are distributed among members, when there are committees in place, and how effective they are. Some banks have other Board level committees such as a Remuneration Committee, Risk Committee, and a Nomination Committee. - Audit Committee. Although audit committee membership is composed by independent members (as is defined by Law, article 16 LACB) and have a reporting line to a bank's Supervisory Board, legally, members are not held to the same accountability standards as Supervisory Board members. - See CP 15 EC 10 Risk management with regard to risk committee. In practice, corrective measures are taken based on international practice criteria as well. Beyond this, the NBG allows banks to have the same members at Board and audit committee as well in line with its view.

EC4	Board members are suitably qualified, effective, and exercise their "duty of care" and "duty of loyalty."
Description and findings re EC 4	The NBG monitors that Board members are qualified and exercise duties of care and loyalty. Such an analysis is performed throughout individual risk category assessments and corporate governance assessment of bank. Paragraph 2 of Article 4 of the LACB states that "Members of the bank's Supervisory Board shall conduct the bank's activities in an honest manner and shall exercise their duty of care in the same manner that a reasonable person in the same position and under the same circumstances would exercise, always keeping in mind the stability and best interests of the bank. Members of the Supervisory Council failing to fulfill this responsibility shall be jointly held liable for losses incurred by the bank." The NBG would take corrective actions when it observes that the Board members do not exercise duty of care and loyalty.
EC5	The supervisor determines that the bank's Board approves and oversees implementation of the bank's strategic direction, risk appetite[11] and strategy, and related policies, establishes and communicates corporate culture and values (e.g., through a code of conduct), and establishes conflicts of interest policies and a strong control environment.
Description and findings re EC5	Based on Article 14 of the LACB, the Supervisory Board shall ensure establishment of the commercial bank's business strategy, and formulate in writing the bank's policy governing credit, investment, foreign exchange, assets and liabilities management, assets' evaluation, and their classification and establishment of adequate reserves for loan losses. In addition, the Regulation on Risk Management in Commercial Banks defines general responsibilities and duties of the Supervisory Board regarding to approval of the bank's risk strategy. The NBG assesses whether banks develop strategy and risk appetite documents; what is the respective Board role in development of such documents, what is the extent of the Board's involvement in supervising executive functions, what reporting is submitted to the Board. The NBG has access to all the minutes of Board meetings, through which it is able to gain understanding on the matters of its interest. The NBG as well makes observations through the dialogue with the key personnel on such matters. From time to time, the NBG performs meetings with the Board itself as well, and in certain instances, attends the Supervisory Board meetings. The NBG plans to intensify its contact with Supervisory Boards in future. The NBG actively monitors the Board's role in governing conflicts of interest policies and procedures. In particular, whether such policies are established by the Board. The "Regulation on Conflict of Interests and Transactions Between Bank Administrators and Related Parties" Article 1 states the following: "In order to avoid conflict of interests and to cease self-serving and abusive practices, as well as other breaches of fiduciary duties by bank administrators,

[11] "Risk appetite" reflects the level of aggregate risk that the bank's Board is willing to assume and manage in the pursuit of the bank's business objectives. Risk appetite may include both quantitative and qualitative elements, as appropriate, and encompass a range of measures. For the purposes of this document, the terms "risk appetite" and "risk tolerance" are treated synonymously.

	each commercial bank shall establish, either in its corporate By-Laws or in a Code of Conduct (which is approved by the Supervisory Council) policies and procedures concerning the administrator activities. These policies and procedures would protect and promote good governance of banks and identify and prevent conflict of interests and improper actions." However, in practice, the banks' Boards seem to be less involved in setting and overseeing the risk appetite.
EC6	The supervisor determines that the bank's Board, except where required otherwise by laws or regulations, has established fit-and-proper standards in selecting senior management, maintains plans for succession, and actively and critically oversees senior management's execution of Board strategies, including monitoring senior management's performance against standards established for them.
Description and findings re EC6	The NBG monitors the processes in banks for appointing senior management. In most of the instances, the NBG inquires how new managers were selected and appointed. In some cases, the NBG conducts interviews with the candidates to be appointed at high-level positions. There have been cases when the NBG has rejected approval of candidates to positions. Beyond this, the NBG observes whether Supervisory Boards establish performance criteria for Board members and whether succession plans are in place. Under "Regulation on Fit-and-proper Criteria for Administrators (article 1(8)), the Supervisory Board is obligated to appoint to the position of a bank administrator the person who meets the fit-and-proper criteria set under given regulation. Furthermore, commercial banks are obliged to define in its internal regulations fit-and-proper criteria for bank administrators considering the requirements. Supervisory Boards need to submit the following information to the NBG when appointing administrators: - A written statement of the bank's Supervisory Board with respect to the bank's Board of Directors, and the written statement of the Board of Directors with respect to the other administrators that they have examined the information regarding the administrator, and he/she is in compliance with the established fit-and-proper criteria, and that the information submitted by them is truthful and accurate. - A written statement of the administrator that he/she fully meets the requirements of the fit-and-proper criteria established by this Regulation, and that the information provided by him/her is truthful and accurate. - A copy of the document certifying the administrator's university education. - Information certifying the administrator's qualification and professional experience (revised staff recording document as of appointment date, an extract from the work-book and-or other documents confirming previous places of employment). - Information about debts of the administrator. - Two recommendation letters (issued by persons, with whom this person worked). - Criminal record for residents issued by the Ministry of Internal Affairs, and for nonresidents – by relevant legal authority.

EC7	The supervisor determines that the bank's Board actively oversees the design and operation of the bank's and the banking group's compensation system, and that it has appropriate incentive that are aligned with prudent risk taking. The compensation system and related performance standards are consistent with long-term objectives and financial soundness of the bank and is rectified if there are deficiencies.
Description and findings re EC7	The NBG assesses the corporate governance in commercial banks, as well as inquires how the Board oversees the compensation systems in banks. This is part of the risk assessment methodology GRAPE. Supervisors analyze and monitor remuneration policy and motivation systems together with the organization staffing, independence, and adequacy of the risk governance functions. The NBG follows FSB guidelines in performing such assessments. Banks in Georgia have in place fixed salaries and premiums, performance based variable bonuses, some of which are deferred and could include share premiums. These variable bonuses include both elements of growth as asset quality for both sales officers as credit risk managers. According to the NBG, these elements are in balance for both sales officers as credit risk managers. The NBG continues individual system assessments and plans to take supervisory actions case-by-case, if necessary. For instance, one year deferrals in some cases do not suffice to catch the quality of assets, or some risk and internal control functions are underpaid relative to sector averages, which hinder effective governance. The NBG considers that there is greater room for employing diversified compensation schemes to better adjust them to risk and promote long-run performance measures. The NBG plans to further intensify oversight over remuneration practice. Recently, it has submitted updated reporting requirements on remuneration practice to commercial banks. Disclosure of remuneration policies and figures would form part of transparency regulation.
EC8	The supervisor determines that the bank's Board and senior management know and understand the bank's and banking group's operational structure and its risks, including those arising from the use of structures that impede transparency (e.g., special-purpose or related structures). The supervisor determines that risks are effectively managed and mitigated, where appropriate.
Description and findings re EC8	From time to time, the NBG performs meetings with Supervisory Boards through which it is able to check whether the Board understands on operational structures and risks. Through ongoing monitoring of the minutes of the Supervisory Board meetings, the NBG can draw conclusions on the Board's recommendations and actions related to enhancing governance and effective risk management.
EC9	The supervisor has the power to require changes in the composition of the bank's Board if it believes that any individuals are not fulfilling their duties related to the satisfaction of these criteria.
Description and findings re EC9	There is no direct and explicit power of the NBG stated in the regulation regarding the ability to require change of the Supervisory Board members. However, such power is implicitly in place. In particular, if the Board member is considered to have a lack of relevant education as per article 41 of LACB, the NBG would require his/her dismissal. If the Board member violates requirements of the legislation, the NBG can suspend the signing authority of the bank's

	administrators and require the bank's Supervisory Board to dismiss him/her temporarily or permanently (Article 30 of the LACB). In addition, Article 4 of the Regulation on Conflicts of Interest states that the NBG has the right to require the immediate removal from the Supervisory Board, or the Board of Directors, of any employee or any administrator, who, in the documented judgment of the national bank, has violated the regulation of conflicts of interests. The NBG applies such a power in practice as well, although such cases are very limited.
Additional criteria	
AC1	Laws, regulations, or the supervisor require banks to notify the supervisor as soon as they become aware of any material and bona fide information that may negatively affect the fitness and propriety of a bank's Board member or a member of the senior management.
Description and findings re AC1	Banks are not required by law or regulation to notify the supervisor as soon as they become aware of any material and bona fide information that affects fitness and propriety of a Board member. However, according to the regulation on fit-and-proper criteria (Article 1 sub 7), any administrator that fails to meet fit-and-proper criteria should be dismissed by the decision of the Supervisory Board or Board of Directors. The NBG promptly learns about dismissals of Board members. In practice, bank supervisors and the supervisory policy and corporate governance division team update information on the Board members and management through different public sources, which eliminates the risks of unknown adverse changes in fitness and propriety. The NBG has elaborated standard reporting forms on the members of the main governance functions. Banks would periodically update information on all administrators, including members of the supervisory bodies that would ensure further increase of control.
Assessment of Principle 14	Largely compliant
Comments	The NBG is largely compliant with the core principle on corporate governance. Since the NBG announced its intention to implement Basel II and III, it has put a lot of effort into determining that banks have robust corporate governance and that the policies and processes are commensurate with the risk profile and systemic importance of the bank. There are a few areas of improvement: - The Board seems to be less involved in setting and overseeing the risk appetite. See further EC 5. - There is a conflict between the law and the regulation on whether a Director can (LACB 14.1) or can't (RFP Article 2) be a member of the Supervisory Board. According to the NBG, such practice is very rare and Directors are restricted to participate in decision making where such participation creates conflict of interest. See further EC 1. - The Audit Committee exists in all banks as required by law, but the function could be enhanced if made a direct subcommittee of the Supervisory Board. Although the committees are composed of independent members and have a reporting line to a bank's Supervisory Board, legally, members are not held to the same accountability

	standards as Supervisory Board members. Still, the NBG has facilitated the banks to establish such committees as subcommittees of the Supervisory Board. See further EC 3. - The NBG does not have explicit power to change the Board composition. However, such power is implicitly in place. The NBG has the power to require dismissal of Board member (LACB article 30.3e) if it lacks experience or education (LACB article 41). See further EC 9. Recommendations: - Increase Board involvement in setting and overseeing risk appetite. - Align the legislation and regulation with regard to the role of Directors in a Supervisory Board. - Consider making an overseeing risk committee and remuneration committee required by law or regulation. - Consider stimulating the sector to make the Supervisory Committee directly responsible for the Audit Committee. - Consider initiating a law that gives the power to change the composition of a Board. NB: Some of the findings are also based on assessment of bank governance team by the World Bank conducted in May 2014 as part of the FSAP.
Principle 15	Risk management process. The supervisor determines that banks have a comprehensive risk-management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report, and control or mitigate all material risks on a timely basis, and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank.
Essential criteria	
EC1	The supervisor determines that banks have appropriate risk management strategies, which have been approved by the banks' Boards, and that the Boards set a suitable risk appetite to define the risk level the banks are willing to assume or tolerate. The supervisor also determines that the Board ensures that: a. a sound risk management culture is established throughout the bank; b. policies and processes are developed for risk taking, which are consistent with the risk management strategy and the established risk appetite; c. uncertainties attached to risk measurement are recognized; d. appropriate limits are established that are consistent with the bank's risk appetite, risk profile and capital strength, and that are understood by, and regularly communicated to, relevant staff; and

	(e) senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies and risk appetite.
Description and findings re EC1	Under the new risk assessment framework, the NBG staff assesses the inherent risk, as well as the mitigants (the quality of Supervisory Board, Senior Management, and Internal Controls & Systems). Strategies, policies, processes, and limits are analyzed in line with the bank's business model and complexity. The NBG supervises what the Board's role is in establishing bank's strategy and risk appetite and monitors which documents are approved by them. Currently, there is no direct requirement on banks' Boards of Directors to determine and issue a statement on risk appetite. However, based on Article 14 of LACB, Supervisory Boards shall ensure establishment of the commercial bank's business strategy, approve the internal policy and procedures governing credit, investment, foreign exchange, assets and liabilities management, assets' evaluation, and their classification and establishment of adequate reserves for loan losses. In addition, the NBG Regulation on Risk Management in Commercial Banks defines general responsibilities and duties of the Supervisory Board regarding the approval of the bank's risk strategy. Although a culture of elaborating written policies that define risk appetite and strategies in all banks is not yet established, still most of the Supervisory Boards have demonstrated their participation in such processes and risk taking, monitoring the bank together with the executive management. Besides the information from inspections, also the information from regulatory reporting, the minutes of the Supervisory Board (which the regulations requires to be sent to the supervisor), and possible reports from the bank's internal audit are important sources of information for this risk assessment. From the mentioned sources, the NBG observes to what extent different governance functions are involved in the bank's risk governance framework elaboration while procedures, policies, and risk limits are approved by the Supervisory Board. Regarding Basel II/III Pillar 2, the NBG has distributed guidelines to commercial banks, which emphasize the role of the Board in relation to elaboration of risk profile and a strategy of the bank and the consequent ICAAP document should describe the extent of such involvement, as well.
EC2	The supervisor requires banks to have comprehensive risk-management policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate all material risks. The supervisor determines that these processes are adequate: (a) to provide a comprehensive "bank-wide" view of risk across all material risk types; (b) for the risk profile and systemic importance of the bank; and (c) to assess risks arising from the macroeconomic environment affecting the markets in which the bank operates and to incorporate such assessments into the bank's risk management process.
Description and findings re EC2	LACB article 14 requires banks to have policies and processes governing credit, investment, foreign exchange, assets and liabilities management, assets' evaluation and their classification, and establishment of adequate reserves for loan losses. The following regulations are relevant in this regard:

	- Regulation on Calculating and Maintaining Overall Open Foreign Exchange Position Limit of Commercial Banks prescribes guidelines on calculation of FX position and sets relevant limits. - Regulation on Supervision and Regulation of the Activities of Commercial Banks prescribes guidelines on prescribes prudential ratios including liquidity ratio and their calculation rules. - Regulation on Credit Concentration and Large Risks in Commercial Banks prescribes relevant limits on concentration risk. - Regulation on Conflict of Interests and Transactions Between Bank Administrators and Related Parties incorporates governance guidelines for risks from related-party transactions and obliges each commercial bank to establish policies and procedures concerning the administrator activities to prevent conflict of interest. - Regulation on Assets Classification and Loan Loss Provisioning by Commercial Banks requires banks to have in place adequate asset classification and loan-loss provisioning in line with international standards, and they should establish and maintain written policies and procedures for credit risk management purposes. Regulation on operational risk has been recently approved after the FSAP mission. Regulation on Risk Management in Commercial Banks was introduced in 2008 to promote effective risk management in commercial banks. However, the practical implementation of it appeared to have been rather difficult then, because the regulation is very detailed and the banks were not ready. Since then, the NBG has taken a more gradual approach and started the dialogue instead of conflict model. Together with the requirement in the LACB to apply international best practice guidelines, the NBG is able to require commercial banks to improve their risk management practices. Given that the NBG is empowered to set individual requirements on banks stemming from risk-based supervision principles, where no practical impediments are in place, to request sound governance processes. The NBG plans to review and update its regulation on Risk Management in Commercial Banks and maintain a high level of corporate governance guidelines in place. - In addition, regulation on capital adequacy was enforced in 2013 and requires commercial banks to have effective and comprehensive governance processes that would enable them to assess risks and necessary capital levels in place. Under Pillar 2, they would be required to identify and assess all material risks that are not limited to Pillar 1 risks. The regulation as well prescribes that SREP processes are based on the Basel Committee framework for that. Under SREP, the NBG assesses how risks are governed by the banks and whether the capital adequacy level is commensurate with it. Banks have to submit their ICAAP documents in 2014. Through it, the NBG would have full available tools at hand to require commercial banks to have sound governance processes in place and even more, the NBG would be obliged to judge such processes based on Basel guidelines. Dialogue regarding ICAAP has already been started with commercial banks.

EC3	The supervisor determines that risk management strategies, policies, processes and limits are: a. properly documented; b. regularly reviewed and appropriately adjusted to reflect changing risk appetites, risk profiles and market and macroeconomic conditions; and c. communicated within the bank. The supervisor determines that exceptions to established policies, processes, and limits receive the prompt attention of, and authorization by, the appropriate level of management and the bank's Board where necessary.
Description and findings re EC3	The NBG determines that risk-management strategies, policies, processes, and limits are documented by the bank throughout individual risk assessments as well as corporate governance practices. Further, supervisors assess whether such policies, processes, and limits are met in practice by reviewing minutes and having interviews.
EC4	The supervisor determines that the bank's Board and senior management obtain sufficient information on, and understand the nature and level of risk being taken by the bank, and how this risk relates to adequate levels of capital and liquidity. The supervisor also determines that the Board and senior management regularly review and understand the implications and limitations (including the risk measurement uncertainties) of the risk management information that they receive.
Description and findings re EC4	The NBG runs intensive meetings and dialogue with commercial banks' key personnel to discuss the strategy and risk-taking behavior of banks. The NBG assesses the soundness of risk estimation by the management of commercial banks and assesses their projected losses from changing risk appetites. When the NBG is not satisfied with the bank's projections, it engages in further extensive discussions and dialogue. In certain instances, it makes recommendations on improving the quality of such projections. In line with the mandate assigned by the LACB, the NBG can impose additional individual capital and liquidity requirements on banks. Through the implementation of ICAAP, commercial banks would be directly required to calculate capital and liquidity levels in line with their business and risk profiles. Assessment of the Board understandings of ICAAP and ILAAP would form part of the SREP process, as well. Poor practices would result in imposing higher capital requirements on banks.
EC5	The supervisor determines that banks have an appropriate internal process for assessing their overall capital and liquidity adequacy in relation to their risk appetite and risk profile. The supervisor reviews and evaluates banks' internal capital and liquidity adequacy assessments and strategies.
Description and findings re EC5	The NBG assesses whether banks hold adequate levels of capital and liquidity in relation to their risk appetite and risk profile, and how such levels are adjusted under changing levels of risk. The NBG is allowed, according to the LACB, to impose individual incremental capital requirements on banks if it is not satisfied with the adequacy of such levels. Currently, there is no direct requirement in legislation on banks to perform internal capital adequacy assessment processes or liquidity adequacy process. However, this is mitigated with

	the conservative capital and liquidity levels as compared to Basel Minimum Capital Requirements and buffers. Besides, banks do adjust their capital levels in many instances with changing risk profiles. As of September 30, 2014, banks will be required to submit their first ICAAP as part of pillar 2 implementation. This document consists of the usual components such as analysis of individual risk categories against capital, future capital, planning, and stress test. So far, only one bank has submitted rather comprehensive documentation and consultations using draft documents have been received and NBG has held meetings with four other banks.
EC6	Where banks use models to measure components of risk, the supervisor determines that: a. banks comply with supervisory standards on their use; b. the banks' Boards and senior management understand the limitations and uncertainties relating to the output of the models and the risk inherent in their use; and c. banks perform regular and independent validation and testing of the models. The supervisor assesses whether the model outputs appear reasonable as a reflection of the risks assumed.
Description and findings re EC6	There are not many banks in Georgia that have internal risk models. However, throughout the risk assessment process, supervisors analyze banks' internal models (for instance, for interest rate risk). Currently, such models are of limited sophistication/complexity and easy to understand for internal governance structures and supervisors. Still, supervisors challenge banks regarding model validation and management judgment. It is expected that, with the introduction of the Basel II/III framework (especially Pillar II), banks in the near future will develop higher quality internal models. The NBG will monitor this explicitly in their Pillar II review. However, at this stage, the NBG would only facilitate adoption of sophisticated internal models and economic capital calculation, where banks have resources to understand them and their limitations and it would be able to perform sound validation. Otherwise, especially in the case of small banks, the NBG would expect banks to follow a simpler rule: take the Pillar 1 requirements as a starting point, and then consider the extent to which the regulatory risk weights, and similar parameters, may need to be adjusted to reflect the risks to which the bank is exposed in Pillar 2, including weaknesses in governance, systems, and controls.
EC7	The supervisor determines that banks have information systems that are adequate (both under normal circumstances and in periods of stress) for measuring, assessing ,and reporting on the size, composition, and quality of exposures on a bank-wide basis across all risk types, products, and counterparties. The supervisor also determines that these reports reflect the bank's risk profile and capital and liquidity needs, and are provided on a timely basis to the bank's Board and senior management in a form suitable for their use.
Description and findings re EC7	The NBG determines whether the information systems are adequate during the assessment of each risk category. Normally, supervisors would analyze the capabilities, comprehensiveness, and adequacy of the reports the banks produce, including the different reporting lines for different governance functions.

	In addition, information systems and information security-related controls are assessed separately as a part of operational risks under the general framework of GRAPE. In particular, the NBG's Operational Risk and Information Processing Division currently assesses information systems complexity, especially from a reporting perspective (to determine the level of accuracy of risk arising from the complexity of information systems). The above-mentioned division also provides guidance regarding information security, where the NBG communicates to banks about the need to have good information security practices. Further, the Regulation on Operational Risk Management by Commercial Banks (recently adopted after the FSAP mission) requires commercial banks to elaborate on the operational risk management framework, including the existence of information systems that are in line with the size and complexity of the financial institution in question. The division also checks how promptly the system can generate reports that are to be provided to the banks' management and the Supervisory Board. Several on-site inspections have been performed to test the report-generation ability and process. It is noted, that under Basel II/III, the NBG's approval process, both under Pillar 1 and Pillar 2, would be based on the soundness of the information systems to a significant extent. Lastly, the determination whether these reports reflect the risk profile and capital and liquidity needs will get an incentive when Basel II and 3 will be fully implemented (ICAAP and ILAAP). These processes and therefore these reports are not yet in place.
EC8	The supervisor determines that banks have adequate policies and processes to ensure that the banks' Boards and senior management understand the risks inherent in new products,[12] material modifications to existing products, and major management initiatives (such as changes in systems, processes, business model, and major acquisitions). The supervisor determines that the Boards and senior management are able to monitor and manage these risks on an ongoing basis. The supervisor also determines that the bank's policies and processes require the undertaking of any major activities of this nature to be approved by their Board or a specific committee of the Board.
Description and findings re EC8	According to the NBG, banks usually submit information to the NBG on every new product to be launched and possibly additional details such as business process and working procedures related to the new product; results of the risk assessment and the implication of the riskiness of the product; the overall risk profile of the bank and the relevant required capital; description of the risk monitoring and mitigation system(s); analysis of the marketing and positioning of the product; pricing policy and the profitability of the product; budget forecast; and accounting procedures. The quality of such analysis varies from bank to bank and from product to product. In addition, the Consumer Protection Division actively monitors all new retail products on the market. Beyond this, the NBG tracks launching of new products in the press.

[12] New products include those developed by the bank or by a third party and purchased or distributed by the bank.

	Throughout different risk category assessment processes, supervisors analyze when products are initiated and launched at banks. They also assess the adequacy of pricing and its relation to the overall risk profile and risk strategy of the bank. The NBG observed that, in general, all the main decisions taken by the banks are also discussed and need approval (based on banks internal guidelines) by their Supervisory Boards. However, simple marketing and sales-related modifications would not be subject to Board approval, but would be passed through the banks' Directorates.
EC9	The supervisor determines that banks have risk management functions covering all material risks with sufficient resources, independence, authority, and access to the banks' Boards to perform their duties effectively. The supervisor determines that their duties are clearly segregated from risk-taking functions in the bank and that they report on risk exposures directly to the Board and senior management. The supervisor also determines that the risk management function is subject to regular review by the internal audit function.
Description and findings re EC9	The NBG determines during the individual risk assessment and corporate governance practice assessment whether the risk function is adequately covering all material risks, and also whether risk management is clearly separated from risk taking. However, the model to manage credit risk that banks use in Georgia seems to be the following. The risk management function, which represents the Board's eyes and ears on risk issues, provides a level of business line oversight. However, the function itself and the CRO who heads it (or the Board member responsible for risk oversight) cannot be considered independent of the activities they monitor. The risk management function is involved in the credit approval process, and credit risk managers and the CRO have voting authority in the credit committees on which they sit. There is no obvious function responsible for a secondary level of surveillance of assigned internal credit ratings which could impact the accuracy and granularity of risk management conveyed to senior management and the Board. This finding is also based on assessment of bank governance conducted in May 2014 by the World Bank during the 2014 Georgia FSAP. Furthermore it is important to note in this regard that several banks have remuneration policies for their credit risk management that incentivize growth, speed of analysis and quality of the loan portfolio, this could provide undesirable incentives.
EC10	The supervisor requires larger and more complex banks to have a dedicated risk management unit overseen by a CRO or equivalent function. If the CRO of a bank is removed from his/her position for any reason, this should be done with the prior approval of the Board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor.
Description and findings re EC10	Having a CRO is not a formal requirement in the Georgian legislation; however, the NBG expects the large banks to have CROs. All large and complex banks have a dedicated Risk Management Unit overseen by a CRO. It should be noted that, in practice, liquidity and interest rate risks are supervised by the CFO rather than the CRO. Other risks, and primarily credit risk, would be governed by the CRO.

	Steps are warranted to evolve the Board into clear oversight function. Boards, especially in the largest banks, possess good knowledge of their banks' operations and particularly, significant credit issues. They approve limit parameters and other risk policies presented by management and have also very recently established risk committees in the largest banks, which focus largely on credit risk and larger transactions. However, there is a need to stimulate Boards to further elevate their focus on higher level issues, such as understanding the aggregate risk profile of the bank, defining the institution's risk appetite (not simply endorsing management proposals), and conveying their overall expectations for risk taking to management, in part through interaction with the CRO and the Internal Audit Department.
EC11	The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book, and operational risk.
Description and findings re EC11	*Credit Risk* Regulation on Credit Concentration and Large Risks in Commercial Banks does not prescribe requirements other than large exposures. This will be repaired under pillar 2 (see CP 19 concentration risk). Regulation on Assets Classification and loan loss provisioning by Commercial Banks requires banks to have in place adequate asset classification and loan loss provisioning in line with international standards and they should establish and maintain written policies and procedures for credit risk management purposes. Regulation on refinancing is recently developed and has been implemented after the FSAP mission. The NBG recently (May 2014) enacted guidelines on country and transfer risk. *Market Risk* Regulation on Calculating and Maintaining Overall Open Foreign Exchange Position Limit of Commercial Banks prescribes guidelines on calculation of FX position and sets relevant limits. Regulation of the trading book defines rules for classifying instruments among trading/banking book and set minimum internal standards banks should have in place to manage the trading portfolio. *Liquidity Risk* Regulation on Supervision and Regulation of the Activities of Commercial Banks prescribes prudential ratios including liquidity ratio and their calculation rules. Draft regulation of LCR has been elaborated based on Basel guidelines. The approval is under way. Despite the absence of formal regulation, the NBG requires LCR reporting from commercial banks since 2011 based on Basel Principles for Sound Liquidity Risk Management and Supervision as well as International framework for liquidity risk measurement, standards, and monitoring. *Interest Rate Risk in the Banking Book* The risk has been incorporated to some extent in the risk-based pricing guidelines and stress testing. *Operational Risk*

	Commercial banks submit operational risk-related reports to the NBG on a monthly basis. The reports incorporate operational loss reporting based on eight business lines and seven loss event categories that are based on the Basel Committee on Banking Supervision document on International Convergence of Capital Measurement and Capital Standards standardized approach of pillar 1 on operational risk. The Regulation on Operational Risk Management by Commercial Banks has been recently adopted after the FSAP mission. The regulation requires from commercial banks to elaborate on the operational risk management framework in line with their respective size and complexity. Minimum requirements for operational risk management framework, information systems, business continuity management, and outsourcing are further specified. The regulation defines the roles and responsibilities of the Supervisory Board and Directorate with respect to the sound principles on operational risk management. Based on the draft regulation, the NBG will have the authority to require commercial banks to take relevant corrective actions regarding their operational risk management framework. In addition, information about the operational risk management frameworks of commercial banks will be subject to disclosure.
EC12	The supervisor requires banks to have appropriate contingency arrangements, as an integral part of their risk management process, to address risks that may materialize and actions to be taken in stress conditions (including those that will pose a serious risk to their viability). If warranted by its risk profile and systemic importance, the contingency arrangements include robust and credible recovery plans that take into account the specific circumstances of the bank. The supervisor, working with resolution authorities as appropriate, assesses the adequacy of banks' contingency arrangements in light of their risk profile and systemic importance (including reviewing any recovery plans) and their likely feasibility during periods of stress. The supervisor seeks improvements if deficiencies are identified.
Description and findings re EC12	There are no regulatory requirements for contingency planning at this moment. With regard to liquidity risk, the NBG has evaluated the extent to which there are existing contingency funding plans and their quality. With regard to operational risk (business continuity, disaster recovery), the NBG is assessing banks contingency arrangements. The NBG is also assessing capital contingency plans under the overall risk assessment program; however, such plans are not documented in practice so far and are expected to be incorporated in ICAAP documents.
EC13	The supervisor requires banks to have forward-looking stress testing programs, commensurate with their risk profile and systemic importance, as an integral part of their risk management process. The supervisor regularly assesses a bank's stress testing program and determines that it captures material sources of risk and adopts plausible adverse scenarios. The supervisor also determines that the bank integrates the results into its decision making, risk management processes (including contingency arrangements), and the assessment of its capital and liquidity levels. Where appropriate, the scope of the supervisor's assessment includes the extent to which the stress testing program: a. promotes risk identification and control, on a bank-wide basis;

	b. adopts suitably severe assumptions and seeks to address feedback effects and system-wide interaction between risks; c. benefits from the active involvement of the Board and senior management; and d. is appropriately documented and regularly maintained and updated. The supervisor requires corrective action if material deficiencies are identified in a bank's stress testing program or if the results of stress tests are not adequately taken into consideration in the bank's decision-making process.
Description and findings re EC13	The stress testing (when performed) within the Georgian banks is often limited to credit, liquidity, and interest rate risk. The NBG is promoting enterprise-wide stress testing at commercial banks. The stress tests should be performed on the enterprise level and the impact on the financial condition of various stress scenarios should be assessed, taking into consideration all side effects of such scenarios. For instance, the impact of macro shocks should be assessed on the bank's credit risk, liquidity risk, and profitability. Throughout the assessment of the impact of FX rate shock, the impact on the revaluation of the balance sheet (market risk), asset quality (credit risk), and covenants of various liabilities (liquidity/funding risk) should be analyzed. Stress test scenarios should include systemic as well as sectoral shocks and idiosyncratic events, which have a material impact on the bank. The main stress test parameters include GDP, its sectoral distribution, and the income of households, unemployment, exchange rate, prices of immovable property, interest rates, and consumer product prices. Due to lack of statistical time-series in certain instances, analysis is performed on a transaction level. The NBG prescribes categories of balance sheet and off-balance sheet items that need separate examination. The NBG expects banks to put in place stress-testing frameworks by the end of the year as part of ICAAP. The first versions of ICAAP are to be submitted by September 30, 2014. The major challenge would be to ensure clarity on how the bank actually uses stress testing as part of its risk governance and decision-making, i.e., to highlight vulnerabilities and to enable the Supervisory Board to take its own view of whether it is comfortable with the extent to which the capital and other resources of the bank provide a defense against different levels of stress events. Adoption of all these new regulations is likely to be especially challenging for the smaller banks.
EC14	The supervisor assesses whether banks appropriately account for risks (including liquidity impacts) in their internal pricing, performance measurement, and new product approval process for all significant business activities.
Description and findings re EC14	The pricing models of banks are assessed by the bank supervisor and financial risks and macro prudential policy teams under the business model and profitability assessment. The NBG raises concerns during such assessments with banks. Guidelines have been distributed to banks on risk-based pricing as well.
Additional criteria	

AC1	The supervisor requires banks to have appropriate policies and processes for assessing other material risks not directly addressed in the subsequent Principles, such as reputational and strategic risks.
Description and findings re AC1	This is part of the Pillar II requirement of the new Capital Adequacy Regulation. The first versions of ICAAP are to be submitted by September 30, 2014.
Assessment of Principle 15	Materially noncompliant
Comments	The NBG is materially non-compliant with the core principle on risk management. Although NBG made a lot of progress to improve the quality of risk management, there are several essential criteria that are not yet (fully) met for both large, medium and small banks (EC 1, 2, 5, 7, 9, 12, 13, and 14). This comment should not be interpreted as the NBG is ineffective or is going in the wrong direction. To the contrary, the assessors believe that the NBG has a very effective approach that can be characterized as intrusive, forward looking, and risk based (see CP 8), the NBG only needs more time to make sure that all banks implement the applicable risk management requirements. It rightly focused first on the largest banks (with highest risk profile), but should also bring the small and medium banks up to standard. The implementation of Basel II an important step forward is in this regard. One remark of caution is to be made. Though the intrusive approach is highly appreciated, the NBG runs the risk of being too involved and taking over the risk management of the bank in particular credit risk management. (see details in CP 17). The findings are as follows. First, the NBG is required to determine that banks have a suitable risk appetite (EC 1). However, banks in several cases have not yet expressed their risk appetite. For instance many banks do not have detailed lending standards (see further CP 17) or explicated their interest rate risk appetite (see CP 23). It is expected that the implementation of Basel II will be the right incentive in this regard. Second, the NBG is required to determine that banks have adequate internal processes for assessing capital and liquidity adequacy in relation to risk appetite and risk profile (EC 5) and that this is also reflected in banks' internal reporting (EC 9). However, these requirements are not (yet) met because banks are in the process of implementing Basel II, under which setting up an internal process for assessing the capital and liquidity adequacy in relation to the risk profile (ICAAP, ILAAP). Banks are required to submit an ICAAP document by September 30, 2014. A few banks have already submitted their first draft of their ICAAP. In addition, the NBG has not yet developed guidelines for how to determine the adequacy of the ICAAP in the so called SREP. Third, the NBG is required to require banks to have appropriate contingency arrangement (EC 12) and forward looking stress tests (EC 13). However, these requirements have not yet been fully implemented by all banks. This is part of Basel II. Only the largest banks have capital and liquidity contingency plans (which need further enhancements according to NBG). And only 7 out of 21 banks have business continuity plans (see also CP 16, 23, and 25). Further, not all banks conduct adequate stress tests yet. The NBG expects all banks to have adequate stress tests in place at the end of this year as part of the implementation of Basel II (see also

	CP 17, 21, and 23). Fourth, the NBG is required to determine the internal pricing of banks (EC 14). Fifth, the NBG requires banks to have comprehensive risk management policies and procedures for all material risks (EC 2). However, there are different policies and procedures that are not yet required by NBG or implemented by banks. For instance, requirements for concentration risk other than large exposures will be implemented with the implementation of Basel II (see further CP 19). Also the identification of economic interdependence should yet be implemented (see further CP 19). Further, banks not yet implemented country and transfer risk guidelines (see further CP 21). Next, banks have not yet taken interest rate risk fully into account. One systemic relevant bank has a material interest rate risk position without an internal limit (see further CP 23). Lastly, most banks lack outsourcing policies and do not take local outsourcing into account (see CP 25). Sixth, the NBG is required to determine that the risk management function is clearly segregated by the risk-taking function. However, it is observed in the assessment of bank governance conducted in May 2014 by the World Bank, that the credit risk management function is involved in the credit approval process (see EC 9). In addition, it is important to note that several banks have remuneration policies for their credit risk management which combine elements of growth, volume of analysis, and quality of the loan portfolio. Recommendations - Make sure that banks express their risk appetite for the different risk categories. - Continue implementing Basel II including IAAP, contingency planning, stress testing and SREP. - Continue implementing the different regulation and guidelines (see CP 17–25). - Determine the internal pricing of all banks. Consider evaluating the role and independence of CRO and (credit) risk management, including the incentive structure.
Principle 16	Capital adequacy. The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.
Essential criteria	
EC 1	Laws, regulations, or the supervisor require banks to calculate and consistently observe prescribed capital requirements, including thresholds by reference to which a bank might be subject to supervisory action. Laws, regulations, or the supervisor define the qualifying components of capital, ensuring that emphasis is given to those elements of capital permanently available to absorb losses on a going concern basis.

Description and findings re EC1	The banking sector in Georgia is in the process of transition from Basel I to Basel II and III. In general, the OLNBG, the LACB, and the RCAR give the NBG the authority to prescribe capital requirements and define qualifying components of capital that might be subject to supervisory action. See following articles: - OLNBG article 49.3 states that the NBG is authorized to set minimum capital and rule of its calculation. - OLNBG article 49.1d states that the NBG is authorized to prohibit dividend payment, to require additional capital and increase reserve for losses. - LACB article 9 states that the NBG periodically defines minimum required amount of reserves, issued capital and regulatory capital and the rules for their creation. - LACB articles 19 and 21 require banks to maintain adequate capital in accordance with regulations issued by the NBG. - LACB article 30 stipulates that the NBG is authorized to impose actions and sanctions if a bank violates any provision of the LOCB or of any regulation, instruction, rule, decree, order or written guidelines of the NBG. - RCAR article 9.1 states that if banks fail to comply with requirements the NBG shall apply actions and sanctions. - RCAR article 9.2 states that in order to timely eliminate the violations in capital adequacy of banks NBG shall demand (and review) recapitalization plan, set special requirements and limitations for capital reduction and for carrying out the necessary measures for capital increase. - NBG article 9.3 states that the NBG is authorized to revoke banking license if tier 1 and regulatory capital ratios equal or are less than 3 percent and 5 percent; or if regulatory capital is less than minimum amount of regulatory capital set by the NBG. - Minimum requirement of regulatory capital is GEL 12 million (RDMCR article 1). Current regulation on minimum capital requirements, as stipulated in the Regulation on Capital Adequacy Requirement (RCAR 2008), is compliant with Basel I (see also minimum requirement in transition period): - Tier 1 capital ratio (tier 1 to risk-weighted assets) should be no less than 8 percent of the risk-weighted assets (RCAR 2008, article 5) - Regulatory capital ratio (regulatory capital to risk-weighted assets) should be no less than 12 percent of risk-weighted assets (RCAR 2008, article 7) - The NBG required some banks with a higher risk profile to have a regulatory capital of up to 24 percent. - In practice, the average regulatory capital ratio of the banking sector end 2013 is 17.2 percent and average tier 1 ratio of 13 percent.

	- See EC 2 for risk-weighted assets. Current regulation (RCAR 2008) defines the qualifying components of capital according to Basel I: - Regulatory capital consists of tier 1 and tier 2 capital less deductions (RCAR article 4.3). - Tier 1 capital consists of common shares less callable shares; non-cumulative perpetual preferred shares less callable shares; share premium; reserve funds (which can be applied for incurred losses); and retained earnings (loss) of previous years (RCAR article 4.6). - Tier 1 deductions: fixed assets' revaluation reserves; intangible assets (RCAR article 4.7). - Tier II capital consist of net income (loss) of current year; special reserves; general reserves, limited to 1.25 percent of risk-weighted assets; preferred shares less callable shares; debt convertible in shares (only by written approval of the NBG); subordinated debt received at least for five years and at reduction rate of 20 percent for each year during its last five years if received without any security (only by written approval of the NBG) (RCAR Article 4.8). - Regulatory capital deductions are investments in capital of resident banks and unconsolidated investment in capital of subsidiaries (RCAR article 4.9). - Tier 1 capital shall be no less than 50 percent of regulatory capital (RCAR article 4.10). - The tier 1 to regulatory capital ratio for the banking sector is 75 percent (end-2013). Current regulation (RCAR 2008) uses risk weights that are compliant with Basel I. - Risk-weighted assets are the sum of credit risk-weighted assets and market weighted assets less the proportion of general reserves (which is not included in tier 2 capital) and special reserves (RCAR 2008, article 5.4). - Assets weighted at zero percent credit risk (see details in RCAR 2008, article 4) o Cash in GEL en currencies of OECD countries; o Balances on correspondent and reserve accounts in the NBG; o Claims guaranteed by NBG; o Claims guaranteed by central governments and/or central banks of OECD countries; and o Claims secured by deposits pledged in the same bank. - Assets weighted at 20 percent credit risk (see details in RCAR 2008, article 5) o Cash equivalent in GEL or currencies of OECD countries; o Claims guaranteed by resident banks of OECD countries; o Treasury bills (and claims guaranteed by treasury bills) issued by Ministry of Finance of Georgia;

	o Claims secured by deposits in resident banks of OECD countries; o Claims guaranteed by international financial institutions (see article 2); and o Gold or claims guaranteed by gold, which meet international standard. - Assets weighted at 50 percent credit risk (see details in RCAR 2008, article 6) o Cash and cash equivalent in currencies of non-OECD countries; o Claims guaranteed by resident banks of Georgia; o Short term claims guaranteed by resident banks of non-OECD countries; o Claims secured by debt securities issued by Ministry of Finance of Georgia; and o Claims guaranteed by the local government of Georgia, and OECD countries or by debt securities issued by the local government of Georgia and OECD countries. - Assets weighted at 100 percent credit risk (see details in RCAR 2008, article 7). o Claims guaranteed by government and central banks of non-OECD countries or guaranteed by debt securities issued by government of government and central bank of non-OECD countries; o Long-term claims guaranteed by resident bank of non-OECD countries; o Corporate debt securities, investment in legal entities, gold (which not meet international standard), and fixed assets; and o Loans not reflected in category 20 percent and 50 percent. - Off balance sheet items (see details in RCAR 2008, articles 8–17). o Different financial contract are weighted between 0.5 and 5 percent (interest and FX); and o Different commitments are weighted between 0 and 100 percent depending on their risk profile. - Market risk-weighted assets shall be defined as foreign exchange risk only. o Foreign exchange risk-weighted assets are weighted 75 percent (additional to the credit risk weights). This percentage is being used as an countercyclical instrument and varies between 0–100 percent. The updated regulation (RCAR 2013) are largely compliant with Basel II and III: - Capital ratios (see also minimum requirement in transition period): o Common Equity Tier 1 Capital ratio (Common Equity Tier 1 to risk-weighted exposures) is required to be 7 percent (RCAR 2013, article 8.1a); o Tier 1 Capital ratio (Tier 1 to risk-weighted exposures) is required to be 8.5 percent (RCAR 2013, article 8.1b);

	o Regulatory Capital ratio (Regulatory Capital to risk-weighted exposures) is required to be 10.5 percent, including a conservation buffer of 2.5 percent (RCAR 2013, article 8.1c). At a later stage, the NBG will segregate the conservation buffer from the regulatory capital ratio by defining the minimum ratio at 8 percent; o There is no requirement for a countercyclical buffer, but, to some extent, an additional risk weigh of 75 percent for currency-induced credit risk (CICR), which the NBG has been using historically, works as a countercyclical buffer. The NBG plans to decrease the risk weight for CICR and introduce a countercyclical buffer in a later stage. This buffer will range between zero percent and 2.5 percent based on the credit cycle; and o There is no requirement for a buffer for domestic systemically important banks. At a later stage, the NBG is planning to introduce a framework for dealing with systemically important banks in line with Basel guidelines. - Qualifying capital components: o Regulatory capital consist of the sum of Tier 1 capital and Tier 2 capital. Tier 1 capital is going concern capital and consists of common equity tier 1 and additional elements (RCAR 2013, article 3). It is consists of instruments that unconditionally can absorb losses. Tier 2 capital is gone concern capital which consists of instruments that has the capacity to absorb losses ahead of depositors and other creditors, but only in liquidation. See RCAR 2013, article 3; o Common Equity Tier 1 Capital consists of paid in common shares (inclusive premium) and retained profits (see details in RCAR 2013, articles 4 and 28). o Additional Tier 1 Capital is equal to Additional Tier 1 Capital components (see details in RCAR 2013, article 5 and 29) less regulatory adjustments (see details in RCAR 2013, articles 5 and 7); o Tier 2 capital consists of Tier 2 Capital components less regulatory adjustments (see details in RCAR 2013, articles 6 and 7); and o Regulatory adjustments are (among others) to deduct investment in the common shares of unconsolidated banks for the amount above 10 percent of the investment (if the total of all holdings exceeds 10 percent of the bank's common equity). See details in RCAR 2013, article 7. Pillar 1: o Credit risk ▪ Banks can only apply a standardized approach according to Basel II. The following risk weights are used for different exposures and different credit quality steps, according to Basel II (see table). Some risk weights are higher than Basel prescribes. See for details RCAR 2013 articles 10-14 and

articles 32-49.

Table on Risk Weights per Exposure and Credit Quality Step (in percent)

	1	2	3	4	5	6
1	0	20	50	100	100	150
2	20	50	100	100	100	150
3	20	50	50	100	100	150
4	20	20	20	50	50	150
5	20	50	100	100	150	150
6	20	50	100	150	150	150
7	20	50	100	100	150	150

* Horizontal: credit quality steps

* Vertical: exposures

1. central government and central bank
2. regional and local government
3. banks > 3 months
4. banks <= 3 months
5. corporates > 3 months
6. corporates <= 3 months
7. collective investment undertaking.

- Unrated exposures will get a risk weight of zero percent (Georgian government paper in GEL), 50 percent (banks unless risk weight of its sovereign his higher), 100 percent (corporates unless the risk weights of its sovereign is higher). This is applicable to most parts of the corporate portfolio since they are not rated.
- Exposures fully secured by residential property that comply with certain conditions can (after assessment by NBG) apply a risk weight of 35 percent (RCAR 2013, article 38). This will be a release compared to the Basel I based approach (100 percent).
- Retail exposures that comply with certain criteria can (after assessment by NBG) apply a risk weight of 75 percent (see RCAR 2013, article 39). This will be a release compared to the Basel I based approach (100 percent).
- Off balance sheet contract (interest, foreign exchange) are weighted depending on their maturity between 0.5 percent and 5 percent.
- Past due loans (> 90 days) are weighted 150 percent when a specific provision is less than 20 percent of the outstanding amount of the loan, and 100 percent when specific provisioning is no less than 20 percent.
- Banks have the opportunity to ask permission of NBG to weigh all exposures at 100 percent until December 31, 2014. Seven banks have asked permission to make

	use of this opportunity. ▪ Credit risk mitigation is also applied: funded and unfunded (see for details RCAR 2013, articles 51–59). o Operational risk ▪ Banks may use basic indicator approach or standardized approach. This item has impact on capital requirement (higher) o Market risk ▪ Exposures subject to currency induced credit risk shall be assigned a risk weight of 75 percent (on top of credit risk weight). Pillar 2: o Banks are required to have in place an Internal Capital Adequacy Assessment Process (ICAAP) and have enough capital to cover the nature and level of all the relevant risks (RCAR 2013, article 23). o The NBG will evaluate the ICAAP through a SREP (RCAR 2013, article 24). Details how to conduct a SREP are planned to be developed before September 2014. Pillar 3 o The NBG requires banks to publicly disclose information according to the Regulation on Transparency of a Commercial Bank Financial Condition (RCAR 2013, article 26). This regulation is not yet updated according to Basel II principles. Transition from Basel I to Basel II and III (2014–2017). - Banks are required to comply with the minimum capital requirements under Pillar 1 as of June 30, 2014, and to report the outcome of their Internal Capital Adequacy Process on September 30, 2014. The NBG will decide before the end-2014 when banks need to comply with the Pillar 3 requirements. Transition period (2014–2017) banks need to comply with both the minimum capital requirements based on Basel I multiplied by an adjustment factor (see table) and the minimum capital requirements based under Basel II/III. As of January 2014, banks are required to file a parallel run. - The NBG did an impact analysis that showed that banks currently already comply with the minimum capital requirements based on Basel II and III because of the historically held high-quality capital. The NBG expects that most banks need 2015 to bring their ICAAP up to standard. For this purpose, the NBG promotes, through intense communication, that banks should analyze the level of capital that they should hold to cover their risks. - The NBG is planning to develop the Supervisory Review Evaluation Process formally before September 30, 2014.

<table>
<tr><td></td><td>
<table>
<tr><td></td><td colspan="4">Minimum Capital Requirements in Transition Period (in percent)</td></tr>
<tr><td></td><td>2014</td><td>2015</td><td>2016</td><td>2017</td></tr>
<tr><td rowspan="2">Current regulation</td><td>100</td><td>95 (2014)</td><td>90 (2015)</td><td>80 (2016)</td></tr>
<tr><td>12; 8</td><td>11.4; 7.6</td><td>10.26; 6.84</td><td>8.21; 5.47</td></tr>
<tr><td>Updated regulation</td><td colspan="4">7; 8.5; 10.5</td></tr>
</table>
For explanation of this table, see description of minimum capital requirements in current regulation and updated regulation.
</td></tr>
<tr><td>EC2</td><td>At least for internationally active banks, the definition of capital, the risk coverage, the method of calculation, and thresholds for the prescribed requirements are not lower than those established in the applicable Basel standards.</td></tr>
<tr><td>Description and findings re EC2</td><td>The banks that operate in Georgia are mainly subsidiaries of foreign banks and domestically licensed banks. One bank has one subsidiary in Belarus, which has a Basel capital regime, and several representative offices in Greece, Israel and the United Kingdom for which the capital regime is not applicable abroad. One bank has a very small microfinance unit in Azerbaijan for which the capital regime is also not applicable abroad.

The NBG uses the same definition of capital, method of calculation, and minimum requirements for all commercial banks, foreign and domestic regulation are not lower than the Basel I requirements. The updated regulation is not lower than the Basel II and III requirements (see for details EC 1).</td></tr>
<tr><td>EC3</td><td>The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures, if warranted, including in respect of risks that the supervisor considers not to have been adequately transferred or mitigated through transactions (e.g., securitization transactions) entered into by the bank. Both on-balance sheet and off-balance sheet risks are included in the calculation of prescribed capital requirements.</td></tr>
<tr><td>Description and findings re EC3</td><td>The NBG has the power to impose individual capital adequacy requirements and limit material exposures on commercial banks stemming from risk-based supervision principles (LACB article 21.3) and also used this power in practice for a few banks known to the assessors. With the updated regulation, the Pillar 2 process will be officially launched in September 2014, which would give the NBG the opportunity to assess the internal capital adequacy process and require relevant corrections when deemed necessary (see RCAR 2013, article 23).

In the current (RCAR 2008) and updated regulation (RCAR 2013), both on-balance sheet and off-balance sheet risks are included in the calculation of prescribed capital requirements (see EC 1 for details)</td></tr>
<tr><td>EC4</td><td>The prescribed capital requirements reflect the risk profile and systemic importance of banks in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector. Laws and regulations in a</td></tr>
</table>

	particular jurisdiction may set higher overall capital adequacy standards than the applicable Basel requirements.
Description and findings re EC4	**Risk profile – bottom-up** Risks under Pillar 1 - Credit risk is under the current regime based on Basel I weighting (0 percent; 20 percent; 50 percent; and 100 percent) where the NBG, in some instances, applies higher risk weights than Basel I. The risk weights will, under the updated regime, be more granular (see details under EC 1) and, in some instances, also be higher than under Basel II. The NPL ratio is approximately 3.5 percent based on the IMF definition (>90 days past due) and 7.5 percent based on the local definition (see CP 18 problem loan assets) with a coverage ratio (loan loss reserve to NPL, exclusive of collateral or recovery) of 89 percent the provisioning is fairly sufficient. However, it must take into account that the low NPL ratio is also the result of substantial growth (the denominator is relatively high), mostly short term financing (turnover is very high), and write-office practice (see further core principle 18 problem assets). - Operational risk is not taken into account under the current regime. This will change under the updated regime (details under EC 1). Banks already collect data on operational losses. - Market risk is also not taken into account under the current regime. This will also change under the updated regime (see details under EC 1). - Risks under the Pillar 2 regime are not taken into account under the current regime. This will change under the updated regime. Banks are required to take into account other risks not captured under Pillar 1, such as market risk, counterparty risk, sector concentration risk, interest rate risk, liquidity risk, strategic risk, and reputational risk. This will have an impact, although it is not clear how much. **Risk profile - top down** Under the current capital regime, the NBG sets higher capital requirements than the 8 percent required under Basel I (see EC 1). Based on the risk profile, all banks are required to have 12 percent capital adequacy and some banks even more up to 24 percent. Under the updated capital regime, the assessment of risk management will be explicitly part of the supervisory review evaluation process under Pillar 2 and can result in higher capital requirements. **Stress test** The stress test conducted during the mission in May 2014 shows that banks are relatively resilient. **Risk absorption** The quality of capital is sufficient since 25 percent of the regulatory capital under the current regime exists of tier 2 capital.

	Market and macro-economic environment NBG also takes the market and macro-economic environment into account. For instance, it imposes a capital charge on currency induced credit risk by weighting it an extra 75 percent on top of the credit risk weight for countercyclical purposes. Also, the stress test (based on macro-economic scenarios) will be taken into account by determining the capital requirements. **Systemic relevance** At a later stage (2016), the NBG is planning to introduce a framework for dealing with systemically important banks.
EC5	The use of banks' internal assessments of risk as inputs to the calculation of regulatory capital is approved by the supervisor. If the supervisor approves such use: (a) such assessments adhere to rigorous qualifying standards; (b) any cessation of such use, or any material modification of the bank's processes and models for producing such internal assessments, are subject to the approval of the supervisor; (c) the supervisor has the capacity to evaluate a bank's internal assessment process in order to determine that the relevant qualifying standards are met, and that the bank's internal assessments can be relied upon as a reasonable reflection of the risks undertaken; (d) the supervisor has the power to impose conditions on its approvals if the supervisor considers it prudent to do so; and (e) if a bank does not continue to meet the qualifying standards or the conditions imposed by the supervisor on an ongoing basis, the supervisor has the power to revoke its approval.
Description and findings re EC5	The NBG does not allow banks to use internal models, both under the current regulation and under Pillar 1 of the updated regulation. Banks may only use the standardized approach. In addition, the NBG should approve the option of applying 35 percent risk weights on exposures secured by residential property and 75 percent risk weights on retail exposures. The implementation of internal models under Pillar 1 will be considered in the future. In line with increased emphasis of credit risk teams to establish sound asset classification that incorporates credible input for sound estimation of probability of default.
EC6	The supervisor has the power to require banks to adopt a forward-looking approach to capital management (including the conduct of appropriate stress testing).[13] The supervisor has the power to require banks:

[13] "Stress testing" comprises a range of activities from simple sensitivity analysis to more complex scenario analyses and reverses stress testing.

	(a) to set capital levels and manage available capital in anticipation of possible events or changes in market conditions that could have an adverse effect; and (b) to have in place feasible contingency arrangements to maintain or strengthen capital positions in times of stress, as appropriate in light of the risk profile and systemic importance of the bank.
Description and findings re EC6	Under the current regime, the NBG facilitates banks to have a forward-looking approach to capital planning and runs communication with them regarding the sufficiency of prevailing levels and the necessity of having in place capital buffers. In addition, the NBG considers under the current risk assessment the capital availability of banks. Through such assessments, the NBG forms a view on the sufficiency of capital levels that banks actually hold. The NBG has declared to some banks that the shareholder structure can result in changing the minimum capital level that the NBG requires a bank to hold. Under the updated regime, the NBG requires banks to maintain on an ongoing basis sufficient capital to cover the risks (see RCAR article 23). This implies a forward-looking approach to capital management. In addition, the NBG provides guidance to banks to develop an ICAAP. It is explicitly stated that as a precondition for producing an acceptable ICAAP, banks should have a forward-looking approach to capital planning, including both medium term business planning and the assessment of vulnerabilities through stress and scenario testing (see G-ICAAP 2013, guideline 3). Next, it is stated that an ICAAP should cover the bank's own assessment of capital adequacy, both currently and as part of medium planning. It also should use stress and scenario tests to assess vulnerabilities, including contingency planning. See for details G-ICAAP 2013, guidelines 7 and 9.
AC1	For non-internationally active banks, capital requirements, including the definition of capital, the risk coverage, the method of calculation, the scope of application, and the capital required are broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks.
Description and findings re AC1	The capital regime in Georgia does not differentiate between internationally and non-internationally active banks. All banks have to comply with the same capital regime based on the Basel minimum requirements.
AC2	The supervisor requires adequate distribution of capital within different entities of a banking group, according to the allocation of risks.[14]
Description and findings re AC2	The NBG does not have specific requirements for adequate distribution of capital within different entities of a banking group. See further CP 12 EC 7.
Assessment of Principle 16	Compliant

[14] Please refer to Principle 12, Essential Criterion 7.

Comments	The NBG is compliant with the core principle on capital adequacy according to Basel I, and is in the process of implementing Basel II and elements of Basel III. Current regime (Basel I): The NBG used a conservative application of Basel rules such as double capital requirements on loans denominated in foreign currencies. Updated regime (Basel II/3) Banks are required to comply with the minimum capital requirements under pillar 1 as of June 30, 2014. Regarding credit risk, banks can only apply the standardized approach. Regarding operational risk, banks can only apply the basic indicator or standardized approach. Regarding market risk, banks are required by the NBG to use a simple approach to determine a capital requirement for FX risk. Pillar 2 will be in force as September 30, 2014, when banks are required to report the outcome of their Internal Capital Adequacy Process. The NBG will decide before the end-2014 when banks need to comply with the pillar 3 requirements. During the transition period (2014–2017) banks need to comply with both the minimum capital requirements based on adjusted Basel I capital requirements and the minimum capital requirements based on Basel II/III. As of January 2014, banks are required to file a parallel run. There are a few findings: - The NBG did not (yet) provide guidance to the banks on how to deal with pillar 3. It is planning to update the regulation on transparency of banks' financial condition and provide guidance at the end of 2014. - The NBG did not provide guidance to the supervisor on how to set up a SREP. It is planned to develop this before September 30, 2014. - No buffer for D-SIB (yet) However, Basel does not require this sooner than 2016. In addition: - There are no capital requirements on a consolidated level. Although unconsolidated investment in capital of subsidiaries are deducted (RCAR article 4.9). Recommendations: - Consider introducing a buffer for domestic systemically important banks. - Consider introducing a framework how to deal with domestic systemically important banks. - Consider introducing a countercyclical buffer. - Set up an implementation plan for pillar 2 and 3 for banks and supervisors, including deciding who will do the assessment. - Develop guidance for supervisors on SREP; - Develop pillar 3 requirements for banks.

Principle 17	Credit risk. The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit lifecycle is covered, including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to have appropriate credit risk management processes that provide a comprehensive bank-wide view of credit risk exposures. The supervisor determines that the processes are consistent with the risk appetite, risk profile, systemic importance, and capital strength of the bank, taking into account market and macroeconomic conditions and result in prudent standards of credit underwriting, evaluation, administration, and monitoring.
Description and findings re EC1	Laws and regulations have set explicit requirements for credit risk management. - LACB (article 14.5b) requires banks to set up internal policy and procedures that govern credit, investment, assets' evaluation and their classification, and establishment of adequate reserves for loan losses. These policies and procedures are required to be performed exclusively with the consent of the Supervisory Council. - RRG (articles 9-12) lays down specific requirements on the architecture of credit risk management, such as, the role of the Board, policies procedures, limits, risk identification, measurement and monitoring management information systems and credit risk control.. - The RAC (article 2) requires banks to classify all their assets and create adequate reserves against possible losses in accordance with written policies and procedures. The supervisor assesses the quality of credit underwriting, evaluation, administration, and monitoring. The detailed assessment of a large part of a loan portfolio helps the supervisory team evaluate the actual implementation level and functioning of the credit risk framework (limits, policies and procedures) that the bank has in place. For this purpose, the NBG uses different techniques. The corporate portfolios of the top 100 borrowers are periodically assessed fully for the SME portfolio that the NBG uses as a sample technique, and loan review of the retail portfolio is based on migration technique and sampling. Throughout the assessments, the supervisors take into account banks' risk profiles, size, and complexity. They analyze the adequacy of policies and procedures to the business model and the bank's risk appetite. In this regard, special attention is paid to the new product developments. The NBG usually expects higher standards from larger and more complex banks. In past years, the credit risk team concentrated its effort on the credit risk policies and procedures and adequacy of loan-loss provisioning. The NBG observed that banks have not yet fully implemented in practice the provisions regarding the architecture of credit risk management. Recently, the NBG has intensified its pressure on banks' risk management

	through requesting meetings with banks on this topic and sending formal letters that could be used as basis for enforcement. Through the Basel II/III implementation process, the role has been extended to the analysis of capital adequacy as well. For instance, adequacy of credit risk processes and presence of relevant information systems are important factors for giving consent to banks to use preferential risk weights under pillar 1 (75 percent on retail credit risks and 35 percent on residential mortgages). And through SREP (pillar 2) the credit team will assess the capital position in relation to credit risk (see CP 16 Capital adequacy).
EC2	The supervisor determines that a bank's Board approves and regularly reviews the credit risk management strategy and significant policies and processes for assuming,[15] identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating credit risk (including counterparty credit risk and associated potential future exposure) and that these are consistent with the risk appetite set by the Board. The supervisor also determines that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.
Description and findings re EC2	Credit risk supervisors and bank supervisors together determine the extent to which the Supervisory Board is involved in setting prudent credit risk policies and monitoring practices as is required by RRG and RAC (see EC 1). For this purpose, supervisors assess the minutes of the Supervisory Board meetings, with necessary supporting documents, they assess the reporting to the Supervisory Board, and they assess the communication between executive functions and the Supervisory Board. Supervisors also track changes to bank's internal policies and procedures and the manner in which they are undertaken. Furthermore, supervisors determine the quality of the implementation of the credit risk strategy set by the Supervisory Board by assessing the gap between the written policies and procedures (set-up) and the practice (working).
EC3	The supervisor requires and regularly determines that such policies and processes establish an appropriate and properly controlled credit risk environment, including: (a) a well-documented and effectively implemented strategy and sound policies and processes for assuming credit risk, without undue reliance on external credit assessments; (b) well-defined criteria, policies, and processes for approving new exposures (including prudent underwriting standards), as well as for renewing and refinancing existing exposures, and identifying the appropriate approval authority for the size and complexity of the exposures; (c) effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt (including review of the performance of underlying assets in the case of securitization exposures); monitoring of documentation, legal covenants, contractual requirements, collateral and

[15] "Assuming" includes the assumption of all types of risk that give rise to credit risk, including credit risk or counterparty risk associated with various financial instruments.

	other forms of credit risk mitigation; and an appropriate asset grading or classification system; (d) effective information systems for accurate and timely identification, aggregation, and reporting of credit risk exposures to the bank's Board and senior management on an ongoing basis; (e) prudent and appropriate credit limits, consistent with the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to relevant staff; (f) exceptional tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or Board where necessary; and (g) effective controls (including in respect of the quality, reliability, and relevancy of data and in respect of validation procedures) around the use of models to identify and measure credit risk and set limits.
Description and findings re EC3	Assuming credit risk - RRG article 9.3 requires banks to have sound lending standards. In practice, it seems that many banks do not have detailed lending standards that explicate their risk appetite. - External assessments are not widely available in Georgia and undue reliance on external assessments is practically absent. Approving exposures - RRG article 10 requires banks to develop criteria for approving new exposures. See also CP 18 Problem assets, provisions, and reserves for renewals and refinancing. - In practice, banks rely on the financial analysis of borrowers for the granting process. This analysis is based mostly on key ratio analysis. Assessing future cash flow is not common practice. Furthermore, the financial information from the borrowers is mostly not audited. Therefore, banks conduct extra activities to mitigate the risk that the financial information is not accurate. For instance, bankers have an intensive relationship with borrowers to verify their financial status or to conduct stock takings. Credit administration - RRG article 10 requires banks to have an effective credit administration system, with segregation of duties, including monitoring of documentation, contractual terms and conditions, loan agreements (legal aspects), and binding of collateral. - Credit files should, according to RAC (article 2.1), include the following documents: loan application, financial statement of a borrower (balance sheet, income statement and cash flow statement), a business plan, legal documentation on collateral, loan agreement (including extension and resolution), and loan monitoring. Information system

	- RRG article 11 requires that information systems generate reports of actual exposures against limits, provide accurate and timely data, and enable the Supervisory Board to identify risk concentrations in the credit portfolio. Credit limits - RRG article 10 requires banks to have lending limits. Tracking and reporting processes - RRG article 11 requires banks to have an adequate reporting process. Effective control - RRG article 12 requires banks to have effective control of credit risk, including internal and external audit. The NBG conducts several activities to determine the appropriateness of the credit risk control environment. It reviews policies and procedures on a continuous basis. Banks are required to send all changes they make to policies and procedures to the NBG. It also assesses banks' management information, limit structures, authorizations, reviews minutes of credit committees, and interviews key personnel. Further, the NBG executes loan reviews. Supervisors are required to reviews all loans to groups of connected borrowers larger than 1 percent–2 percent of the regulatory capital, and for other parts of the portfolio - smaller corporates, SME, retail (micro consumers and individual mortgages) – a sampling methodology is used to select individual borrowers for the review. This type of evaluation on the individual level varies depending on the type of borrowers. Evaluation for business borrowers includes: - Description of the borrowers' activities; - Borrowers structure, management and shareholders; - Financial analysis (mostly based on key ratio analysis); - Sector and its characteristics; - Collateral; - Stress tests; - Legal documentation verification (such as collateral documentation and contract covenants); - Summary of financial performance of the group; and - Monitoring status/minute-d decisions – based on risks. Evaluation for individual borrowers includes: - Employer type (public, private), position (managerial, worker), length of service, and size of income;

	- Creditworthiness analysis (payment to income, debt to income); - Collateral; - Stress tests; and - Legal documentation verification (such as collateral documentation and contract covenants). Lastly, the financial reporting is not based on audited figures. However, bankers conduct several mitigating activities such as on-site visit, stock taking, and reconciliation of different financial reports to mitigate this uncertainty. The NBG put a lot of effort into determining the accuracy of the financial borrowers.
EC4	The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit and any risk factors that may result in default, including significant unhedged foreign exchange risk.
Description and findings re EC4	Banks are required by regulation to have policies and procedures to determine asset quality (RAC article 2-a). They are also required to take into consideration all circumstances and foreseen possibilities which management believes, after diligent analysis, will affect the quality of assets (RAC article 2-c). Banks use different credit coefficients (for instance leverage for corporate borrowers and payment to income ratio for individuals) to base their analysis and monitoring policy on. The supervisor determines that banks have adequate policies and processes to monitor the total indebtedness through assessing the credit monitoring policy and loan reviews. This includes significant foreign exchange risk. Banks monitor large borrowers more intensively than smaller borrowers.
EC5	The supervisor requires that banks make credit decisions free of conflicts of interest and on an arm's-length basis.
Description and findings re EC5	Directive N 116 on Conflict of Interests and Transactions Between Bank Administrators and Related Parties article 3 requires banks to make credit decisions free of conflicts of interest. See details in CP 20 Related parties. In that regard, the supervisor has various tools available at its disposal. Through monthly aggregate and individual transaction-based reports, supervisors are able to assess whether such transactions are made on an arm's length basis. Supervisors check the bulks of loans that are granted below a certain interest rate to identify any potential cases of conflicts of interest, as well. It should also be noted that throughout the credit risk assessment, beneficial owners of large borrower companies are requested from banks, which gives additional supervisory assurance in terms of identifying related parties of the bank.
EC6	The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's Board or senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.

Description and findings re EC6	The regulation on risk management article 2.3 requires in general that decisions that exceed the authority of subordinated units are required to be approved by the board of directors. There are no specific requirements that prescribe that major risks exceeding a certain amount or percentage of the bank's capital, as well as exposures that are risky or otherwise not in line with the mainstream of the bank's activities are to be decided by the Board or senior management. However, according to NBG it is common practice in commercial banks that loans above a certain threshold, loans to related parties, and unusual transactions are to be escalated to a higher credit committee/senior management and/or the Supervisory Board. These authorization structures are part of the credit risk policies and procedures that are to be approved by the Supervisory Board, and which are reviewed by the bank supervisor.
EC7	The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling, and reporting on credit risk.
Description and findings re EC7	The NBG has access to all necessary (including confidential) information on commercial banks. The NBG uses this power throughout the ongoing supervision processes. Information exchange between bank employees and supervisors is a part of an ongoing supervision and collaboration process. Credit risk teams have direct communication, both with top managers, as well as with credit officers and risk analysts who promptly submit any necessary supporting documents to the supervisor. The NBG even receives meeting minutes of credit committees, rejections of credit exposures, and complete loan files for their review online. Such a mandate is supported by relevant provisions in the organic law on NBG (article) and law on activities of commercial banks (article).
EC8	The supervisor requires banks to include their credit risk exposures into their stress testing programs for risk management purposes.
Description and findings re EC8	Not all banks include their credit risk exposures in stress testing programs for risk management purposes. The NBG is currently facilitating implementation of sound stress testing framework in commercial banks, which would form an essential part of Pillar 2 processes by the end of the year. Enterprise-wide stress testing framework requires commercial banks to stress test their loan portfolio based on parameters provided by the NBG. Such stress tests have so far been performed by large banks, but the NBG would facilitate their implementation by all banks in future. See additional details on enterprise-wide stress testing framework in CP 9 Supervisory tools and techniques.
Assessment of Principle 17	Largely compliant
Comment	The NBG is largely compliant with the core principle on credit risk. It determines in detail if banks have an adequate credit risk management system. This includes both assessment of credit risk policy and procedures, management information and loan reviews. The latter is done on-line where NBG receives minutes of credit decisions (almost on a daily basis), rejections of loans, changes in lending standards and procedures, even complete loan files. Together with the detailed monthly return, the NBG has the opportunity to do cross-checks and rigorous credit risk analysis. This analysis is (for the corporate and SME portfolio) based

	mostly on key ratio analysis (derived from Moody's and S&P) and valuation of collateral. There are some areas of improvement. First, banks are required to have an adequate credit risk management framework, and the NBG determines whether banks have such a framework in place (where most effort goes to the largest banks). However, in practice, not all banks have (yet) fully implemented the specific requirements of the credit risk management framework such as adequate lending standards. Recently, the NBG has intensified its pressure on banks' risk management through requesting meetings with banks on this topic and sending formal letters that could be used as basis for enforcement. Also the implementation of Basel II will be an incentive for banks to improve their credit risk management framework. See further EC1 and EC3. Second, there are no specific requirements that impose on banks to prescribe in their credit policy that major risks exceeding a certain amount or percentage of the bank's capital, as well as risky exposures or exposures that are otherwise not in line with the mainstream of banks' activities, are to be decided by the Board or senior management. However, according to the NBG , it is common practice in commercial banks that loans above a certain threshold, loans to related parties, and unusual transactions are to be escalated to a higher credit committee/senior management and/or the Supervisory Board. See further EC 6. Third, not all banks include their credit risk exposures in stress testing programs for risk management purposes. The NBG is currently facilitating implementation of sound stress-testing frameworks in commercial banks, which would form an essential part of pillar 2 processes by the end of the year. An enterprise-wide stress-testing framework requires from commercial banks to stress-test their loan portfolio based on parameters provided by the NBG. Such stress tests have so far been performed by large banks, but the NBG would facilitate their implementation by all banks in future. See further EC 8. Lastly, though the assessors applaud the intrusive approach and the high quality of the credit risk specialists, the NBG runs the risk that the credit risk specialists are too involved and become more of a risk manager than a supervisor of the banks. There are some examples that the supervisor is approached by banks before a credit decision is made on what the NBG's opinion is. It is a fine balance of being really intrusive and keeping banks fully responsible for their risk management. Recommendations: - Keep focused on ensuring that all banks implement the credit risk management requirements under which the requirements for lending standards. - Require banks to let certain exposures exceeding a certain amount to be decided by the banks' Board and senior management. - Make sure that all banks include credit risk exposures into their stress tests and not only large banks.

Principle 18	Problem assets, provisions, and reserves. The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to formulate policies and processes for identifying and managing problem assets. In addition, laws, regulations, or the supervisor require regular review by banks of their problem assets (at an individual level or at a portfolio level for assets with homogenous characteristics) and asset classification, provisioning, and write-offs.
Description and findings re EC1	RAC (article 1) requires banks explicitly to formulate policies and processes for identifying and managing problem loans. It is formulated as follows: - A bank's financial reporting must present accurate, complete and current information on its financial condition including the quality of its assets (RAC 1.1). - Failure of a bank's management to take timely measures to correct its financial position because of unawareness of problems due to a lack of accurate, complete and current information, will be deemed an unsafe and unsound banking practice, and precipitate supervisory measures against that bank.(RAC 1.2). - Major component of such information is the risk-based self-classification of its assets by a bank, and the establishment of adequate reserve accounts to cover possible losses of these assets.(RAC 1.3). - In order to implement this classification according to International Standards and create adequate reserve accounts to cover possible losses, each commercial bank shall be obligated to establish and maintain written policies and procedures for credit risk management purposes (RAC 1.4). - This regulation is hereby issued for the purposes of setting forth and implementing the internal procedures and reporting requirements to be observed by each commercial bank for the classification of their assets and their provisioning obligations. This will facilitate the identification of a bank's realistic financial condition and its understanding by the bank's depositors, management, shareholders, potential investors, the National Bank, and other interested parties. (RAC 1.5). - For the purpose of meeting the requirements of this Regulation, commercial banks shall develop and implement relevant measures and functions. (RAC 1.7). In addition, RRG article 12.6 states that banks are required to have procedures for management of problem loans, including a written system for detecting problem loans, and apply these procedures on an effective basis. If the bank has a significant level of problem loans, the bank shall segregate the problem loan resolution function from the function responsible for lending decisions. Each strategy and effective outcome resolution of a problem loan shall be administered in documentation of data that will thereafter be used as input for the purposes of units with the

	function of disbursing or restructuring credit. Next, RAC requires banks to regularly review problem assets. It is stipulated that banks are required to self-classify their assets on a monthly basis (article 4.4) and also a monthly report to NBG about classification of assets and the reserve set aside for possible losses (article 1.8). And, it is stated that a bank's financial reporting must present accurate, complete and current information on its financial condition including the quality of its assets (article 1.1). Lastly, RAC requires banks to classify all their assets determined by the management of banks after taken into consideration all circumstances and foreseen possibilities which management believes will affect the quality of assets (article 2).
EC2	The supervisor determines the adequacy of a bank's policies and processes for grading and classifying its assets and establishing appropriate and robust provisioning levels. The reviews supporting the supervisor's opinion may be conducted by external experts, with the supervisor reviewing the work of the external experts to determine the adequacy of the bank's policies and processes.
Description and findings re EC2	The NBG determines the adequacy of a bank's policy and procedures for classification of its assets and establishing appropriate and robust provisioning levels on an ongoing basis. Supervisors analyze all large borrowers of commercial banks and are able to determine adequacy of their provisioning levels. Sampling methodology is applied for more granular portfolios. Migration analysis is applied to such portfolio, as well. As for retail loans disbursed with simplified rules and minimal documentation, migration analysis is usually performed. Through such assessments, the NBG determines adequacy of provisioning levels.
	Most banks have an automatic process (based on days overdue) for retail credit provisioning, while commercial loans above a certain threshold are assessed individually. As a result of the inspection and the regular contacts with the banks, the supervisory team is aware of principles and methodology (which indicators influence the reserve revaluation decision) of assessments used by the banks, particularly for large borrowers. If needed, the supervisory team requires the bank to adjust their loan loss provisioning policy. The NBG prescribes five loan classifications: Standard, Watch, Substandard, Doubtful, and Loss Loans. The last four categories are seen as problem loans and the last three categories are seen as nonperforming loans. Each loan has its own characteristics, including loss reserves that are between 2 percent and 100 percent of a loan (RAC article 5): Standard loans - Principle and interest are paid in a timely manner; - Borrower is financially strong, has sufficient capital to cushion unforeseen adverse impacts, is within profit targets, and produces sufficient cash flows to satisfy all liabilities in a timely fashion; - Collateral or mortgage taken shall be properly documented and registered;

	- Business plan is realistic and feasible; and - General reserves of 2 percent of unpaid principle balance are required to be created. Watch loans - Loan is adequately protected, but is potentially weak because of apparent deficiencies or trends, if not corrected it could cause concern about borrower's ability to service the loan; - Examples of deficiencies are: missing portions of credit file, inability to manage asset or relationship with borrower, improper documentation, delivery or registry of collateral or mortgage, or information about distrustful condition of the borrower; - Borrower has failed to furnish financial statements or business plan despite repeated requests by the bank; - Foreseeable developments and market trends are likely to deteriorate the borrower's financial condition; - Past-due interest has been unpaid and added to principle; - Past due on payment of less than 30 days; and - Specific reserve of 10 percent of unpaid principal balance is required to be created. Substandard loans - Loan is inadequately protected by capital, paying capability, value of collateral, or mortgage; - Weaknesses or problems jeopardize repayment or makes it questionable; there are significantly negative conditions such as absence of valuable collateral or mortgage; or there is unexplained or prolonged absence of borrowers or protracted inattention to the business; - Primary repayment sources, including capital and earnings, are becoming no longer sufficient to repay debt. Therefore, the bank must use other sources to repay, such as sale of collateral, mortgage, or other assets, or restructure other debts; - Unsecured loans (principle or interest) are past due for at least 30 days; secured loans are past due for at least 60 days; and - Specific reserve of 30 percent of unpaid principal balance is required to be created. Doubtful loans - Repayment is doubtful because of factors such as ongoing partial loan repayment, commencement of collateral (mortgage) seizure, sale proceedings to be realized in near future, or pledge of additional collateral or mortgage. - Unsecured loans are past due for at least 90 days (principle or interest); secured loans are past due for at least 120 days (principle or interest). - Specific reserve of 50 percent of unpaid principal balance is required to be created.

	Loss loans - Loan is not collectable due to insolvency; - Loans are past due for 150 days (principle or interest); - Regardless of being delinquent, a loan that is non-collectable or recovered amounts will not match the time and expenses to be incurred in collection endeavors; and - Specific reserve of 100 percent of unpaid principal balance is required to be created. For non-loan assets and inter-bank deposits the following provisions are applicable (RAC articles 9 and 10). - For inter-banks placement, a bank is required to ask for financial information upon which it will base the financial status of a bank and quarterly updates. - For non-loans assets, such as repossessed real estate owned by the bank, regardless of its value it is required to immediately be analyzed and classified as the following: o Up to market value is classified as substandard; o In excess of market value is classified as loss; or o If real estate is still owned after one year, it shall be classified as doubtful, and after three years it shall be classified as a loss and written off. After this, the transaction will be recorded off-balance. - For non-loans assets, such as repossessed movable assets, the provisions are applicable: o Up to market value is classified as substandard; o In excess of the market value is classified as loss; or o If movable property is still on balance sheet 90 days after repossession, it is classified as doubtful. Banks shall not hold movable property for more than 180 days. After that, banks are obliged to classify the repossessed movable asset loss as a write-off. There are some specific provisions on asset classification worth mentioning: - Split classification (RAC article 6) o Banks have right to classify a loan as partially substandard, doubtful or loss in cases where loan is partially secured. If unpaid portion equals market value of collateral, the unpaid loan may be classified as substandard. If unpaid loan exceeds market value of collateral, the unpaid loan may be classified as doubtful or loss. This means that banks can take the collateral into consideration with haircut of 30percent (that is the required provisioning in the class substandard). - Collateral (RAC article 7)

	o Banks cannot regard collateral or mortgage as primary repayment sources. o Collateral is important element on decision on loan classification. o There are two categories of collateral: liquid (unconditional guarantee of Ministry of Finance and other government entities, cash deposits, Georgian government paper, and precious metals) and illiquid (mortgage on immovable property, pledges of securities, unconditional guarantees, irrevocable letters of credit, and unconditional guarantees of companies or individuals). o Repossessed immovable assets are required to be written off after three years and movable assets after 180 days. - Restructured and refinanced loans (RAC article 8): o Restructured loans are loans of which the bank and the borrower have agreed to change the repayment terms because of borrower's legal and financial condition. Change because of decrease in interest rate, waiver of the right to collect accrued interest, reduction of principal or interest (including refinancing) that is not the result of payment from borrower, extension of loan maturity, or other rights or privileges granted by bank to borrower that would not ordinarily be provided under normal conditions (RAC article 3f). o Recently, the NBG submitted a draft of regulation on asset classification where it defines refinanced loans as a loan, of which the bank and the borrower has agreed to change the repayment terms, and the change of the repayment terms is not caused by financial difficulties. During refinancing, the borrower must fully satisfy terms of standard category. o It is prohibited to classify restructured loans as standard. o It is prohibited to change classification of restructured loan if substitute or additional debtor is insider. o It is prohibited to change classification of a restructured loan to a less adverse loan if substituted or additional debtor is an element of restructuring, unless substituted or additional debtor has agreed to furnish additional liquid collateral or has the financial ability to repay all amounts of unpaid principal and interest within the agreed time period. Lastly, RAC also has provisions on write-off of loss assets (article 11.7). - Banks are required to write off assets classified as loss when assets are determined to be non-recoverable

	Written-off loans are not cancellations of debt. Said debt shall continue to be maintained on a special off-balance sheet account for a period of five years. Where the debtor repays the bank, it shall debit the cash account and credit the reserve; and credit the reserve and credit the expenses on provisioning. After five years, it is removed from the special account, which does not mean termination of the loan collection.
EC3	The supervisor determines that the bank's system for classification and provisioning takes into account off-balance sheet exposures.
Description and findings re EC3	RAC article 2 states that: "Asset classifications shall be applied to all assets formed in any currency, including all items on balance sheets, as well as all of those off-balance-sheet items deemed to be such under International Accounting Standards;" Loan portfolio assessment (which, in general, is a standard part of the supervisory program) includes checking the off-balance sheet exposures. During the inspection, off-balance sheet exposures are assessed in the same way as on-balance sheet loans.
EC4	The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions.
Description and findings re EC4	Requirements on provisions and write-offs are determined by asset classification regulation (see EC 2 for details). The criteria prescribed by the regulation on asset classification reflect financial strength of borrower and considers repayment and recovery expectations, as well as market developments that can adversely impact future financial condition of the entity. The NBG is able to determine the adequacy of a bank's practices in that regard through its ongoing supervision process and comprehensive reporting by commercial banks. The NBG receives the TOP-100 Form on large borrowers from commercial banks on a monthly basis. This form, along with other information, gives the NBG data about the provision of the large borrowers. In addition, banks send credit committee decisions to NBG, as well as risk reports with the financial statement on such borrowers. As part of the ongoing supervision, the supervisors assess large exposures on a system-wide basis, and bank-wide provisioning levels are easy to compare. The NBG intensively monitors that the classification of large exposures across the system remains identical. But in very rare cases, if there is sufficient evidence and if a bank can prove that the problem of one borrower in the group will not influence the creditworthiness capacity of the other obligors, the NBG may allow a bank to assign different categories to different borrowers within the group. Supervisory dialogue regarding adequacy of loan loss-provisioning is intensive and the NBG communicates with bank's instances where such provisioning levels are not considered adequate. Furthermore, when frequent observations of inadequacy of provisioning levels is evidenced, a risk mitigation program would not be limited to only correcting levels of loan loss provisioning, but would also target the provisioning policy according to the NBG.

EC5	The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations. For portfolios of credit exposures with homogeneous characteristics, the exposures are classified when payments are contractually in arrears for a minimum number of days (e.g., 30, 60, or 90 days). The supervisor tests banks' treatment of assets with a view to identifying any material circumvention of the classification and provisioning standards (e.g., rescheduling, refinancing, or reclassification of loans).
Description and findings re EC5	The NBG determines on a regular basis whether banks have appropriate policies and procedures for early identification and problem asset management. In fact, almost all changes in policy and procedures are being reviewed by the NBG. Further, the NBG determines throughout the assessment of credit risk of commercial banks whether banks have adequate resources for early identification of deteriorating assets and the problem loan management. Next, the NBG analyzes refinancing/restructuring of large corporate borrowers on case-by-case basis and keeps such borrowers under intense monitoring. For this purpose, the NBG requires commercial banks to periodically submit committee decisions, risk reports and updated financial statements to ensure that the borrowers are adequately provisioned. When it comes to smaller corporate, SME and retail borrowers, the NBG uses a sampling methodology to review the borrowers' creditworthiness individually. The NBG assesses all together a significant amount of refinanced and renewed loans in order to get confidence on a system level and ensure that no significant risks are hidden inside the portfolio and that there are no material circumventions. Following regular monitoring, the NBG concluded that refinanced and renewed loans (because of nonfinancial problems) are, in general, classified by banks in a proper way. The NBG basis its conclusion on their analysis of the financial strength of the borrower (all large borrowers and sample of corporate, SME and retail). In addition, amendments in RAC are recently in force (after the FSAP mission) in order to enhance the practice of treatment of restructured loans through requiring every individual bank to divide the restructured loan into two parts: "problem restructuring" and "non-problem restructuring." - Non-problem Restructured loans are loans that has one of the characteristics of a restructured loan, but where the debtor fully meets the terms of "Standard" category loan, and restructuring is not caused by the financial difficulties of the debtor. Problem Restructured Loans are all other types of restructuring, when the latter is attributed to the financial difficulties of the debtor, and not to the conditions on "Non-Problem Restructuring."

EC6	The supervisor obtains information on a regular basis, and in relevant detail, or has full access to information concerning the classification of assets and provisioning. The supervisor requires banks to have adequate documentation to support their classification and provisioning levels.
Description and findings re EC6	The NBG obtains very comprehensive information on a regular basis on the classification of credits and assets and their provisioning. The supervisory team gets different types of reports every month regarding the assets classification: F-Financial, Sectoral loan and Top 100 forms. These reports give the supervisory team a picture of commercial banks total loan portfolio and reserves breakdown in many directions. Further, the NBG has full access to the loan files, risk management reports, internal and external reports, Board minutes, and other relevant reports. Most of these reports are received on-line (see further CP 8 Supervisory approach). In addition, regulation requires that decisions taken with regard to asset classification and provisioning should be documented and available for review by the supervisors. The NBG has full access to this information.
EC7	The supervisor assesses whether the classification of the assets and the provisioning is adequate for prudential purposes. If asset classifications are inaccurate or provisions are deemed to be inadequate for prudential purposes (e.g., if the supervisor considers existing or anticipated deterioration in asset quality to be of concern, or if the provisions do not fully reflect losses expected to be incurred), the supervisor has the power to require the bank to adjust its classifications of individual assets, increase its levels of provisioning, reserves, or capital, and, if necessary, to impose other remedial measures.
Description and findings re EC7	Assessment of the adequacy of the asset classification and provisioning is part of the ongoing supervisory process (see EC 2). The NBG has full power to make adjustments to asset classifications of individual assets, increase levels of provisioning, require more capital, or take other remedial measures. In practice, the NBG uses these powers in different occasions.
EC8	The supervisor requires banks to have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives, and collateral. The valuation of collateral reflects the net realizable value, taking into account prevailing market conditions.
Description and findings re EC8	Banks are required to assess the liquidity of collateral, including financial collateral. The market value is an important element in making decisions on loan classifications and in determining the loan loss provisions. Banks use internal appraisers to determine the market value. They use according to the NBG, haircuts of 15–20 percent for residential and 30–50 percent commercial real estate. The NBG hired a certified real estate appraiser in the Corporate Credit Risk division who reviews the collateral value. Although, he is mostly focused on the fixed assets of the banks (premises and repossessed assets). The first step of this appraisal process is data collection and analysis in order to determine the "Highest and Best Use" of the subject property. The following approaches are used:

	- Residential Real Estate is usually appraised by Sales Comparison Method; - Non-Residential Real Estate is appraised by both Income approach and Sales Comparison; - Industrial Real Estate is usually appraised by Cost method; and - Movable property market suffers from the lack of comparability, and considering that it is quite difficult to find similar property while appraising equipment and machines, in most cases, internal appraisers discount collateral book value by 50 percent. For nonperforming loans, banks have to provision 30 percent of the market value (RAC article 6). This means that banks are required to use a haircut of 30 percent of the market value of the immovable collateral.
EC9	Laws, regulations, or the supervisor establish criteria for assets to be: (a) identified as a problem asset (e.g., a loan is identified as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the loan agreement); and (b) reclassified as performing (e.g., a loan is reclassified as performing when all arrears have been cleared and the loan has been brought fully current, repayments have been made in a timely manner over a continuous repayment period, and continued collection, in accordance with the contractual terms, is expected).
Description and findings re EC9	RAC article 4 gives guidelines when a loan should be considered impaired. Under the existing regulation, loan classification is based on: days past due, financial strength of a borrower, collateral. Also plausible market and macroeconomic conditions are also taken into account and the loan can qualify for "Standard" category only if the borrower is able to absorb particular market/macroeconomic shocks, and meet its obligations against the bank in the future.
	Reclassification is allowed if a loan qualifies for the new category and complies with all corresponding requirement based on detailed financial analysis. Currently, amendments in the regulation on restructured problem loans and restructured non-problem loans (refinanced loans) have come in force after the FSAP mission (see for details EC 2).
EC10	The supervisor determines that the bank's Board obtains timely and appropriate information on the condition of the bank's asset portfolio, including classification of assets, the level of provisions and reserves, and major problem assets. The information includes, at a minimum, summary results of the latest asset review process, comparative trends in the overall quality of problem assets, measurements of existing or anticipated deterioration in asset quality, and losses expected to be incurred.
Description and findings re EC10	The NBG assesses, as part of their supervisory methodology, not only the inherent risk but also the risk mitigants, which includes the assessment of the bank's Supervisory Board involvement. Through the Supervisory Board minutes, as well as communication with management and Board, the NBG is able to assess Board awareness and involvement. Summary results of the latest loan review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and

	losses expected to be incurred are usually discussed with them, and conclusions are made based on their articulation of credit risks in general.
EC11	The supervisor requires that valuation, classification and provisioning, at least for significant exposures, are conducted on an individual item basis. For this purpose, supervisors require banks to set an appropriate threshold for the purpose of identifying significant exposures and to regularly review the threshold level.
Description and findings re EC11	The NBG does not require banks to conduct valuation, classification, and provisioning for significant exposures on an individual basis. However, the NBG explained that, in practice, all banks have certain thresholds above which individual assessment is required. Usually, these thresholds coincide with thresholds as determined for IFRS provisioning purposes by the external auditor. In addition, the NBG evaluates all groups of interconnected borrowers which have exposures larger than 1 percen–2 percent of regulatory capital on an individual basis.
EC12	The supervisor regularly assesses any trends and concentrations in risk and risk build-up across the banking sector in relation to banks' problem assets, and takes into account any observed concentration in the risk mitigation strategies adopted by banks and the potential effect on the efficacy of the mitigant in reducing loss. The supervisor considers the adequacy of provisions and reserves at the bank and banking system level in the light of this assessment.
Description and findings re EC12	Under the current organizational structure, credit risk teams, under specialized groups and a supervisory policy department, are responsible for system-wide assessments and monitoring the system-wide developments, such as trends in economy, real estate prices, or increases in sectoral concentrations across the banking sector and their impact on provisioning. Monthly, the credit risk division analyzes the corporate credit portfolio at the system level. This includes analysis of corporate portfolios, large exposures, and other risk trends. A report of this analysis is sent to management. Also, monthly, as part of the ongoing supervision process, every bank's Top-100 form is consolidated, which then constitutes one database about the group and individual borrowers within the country. This database covers the information of about 40percent of total loan portfolios and around 80 percent of corporate exposures. Such a practice enables supervisors to monitor the dynamics of the corporate loan portfolio on a monthly basis. This gives the supervisors valuable information about the specific issues, like causes of the increase/decrease in corporate portfolio, changes in overdue loans, and borrowers' transfer within banks (and its reasons). In general, such information gives supervisors the ability to assess the borrowers' total indebtedness within the system and analyze its macroeconomic implications.
Assessment of Principle 18	Compliant
Comments	The NBG is compliant with the core principle on problem assets, provisions, and reserves. It has put a lot of effort into identifying problem loans and maintaining adequate levels of provisioning mostly for the large borrowers (40 percent of total loan portfolio). For SME and retail borrowers, it uses for instance sample techniques to ensure adequate provisioning. This is all the result of comprehensive reporting, enhanced risk assessment skills, an intrusive

	supervisory approach, and active dialogue with the commercial banks. The NBG is intending to facilitate transition toward IFRS. When IFRS framework is adopted NBG is intending to update its guidelines on loan loss provisioning.
Principle 19	Concentration risk and large exposure limits. The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.[16]
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to have policies and processes that provide a comprehensive bank-wide view of significant sources of concentration risk. Exposures arising from off-balance sheet, as well as on-balance sheet, items and from contingent liabilities are captured.
Description and findings re EC1	The regulation on concentration and large exposures banks does not prescribe requirements for concentrations other than single counterparties or groups of connected counterparties (both on- and off-site). Although the NBG adopted general regulation on risk management that includes paragraphs on concentration risk (RRM article 10.13-16), it did not fully implement this regulation. Under the new capital regime, banks will be required to assess all significant sources of concentration risk and relevant capital levels under Pillar 2 (R-ICAAP article 23). Nevertheless, the NBG has the discretion to limit lending to particular sectors of the economy and also uses this power. According to the NBG, the LACB does require banks to set up policies and procedures for concentration risk, because, according to article 19 “if there is no specific banking rule established by the NBG, commercial banks are required to act pursuant to international banking rules and customs.”
EC2	The supervisor determines that a bank’s information systems identify and aggregate on a timely basis, and facilitate active management of exposures creating risk concentrations and large exposures to single counterparties or groups of connected counterparties.
Description and findings re EC2	The supervisor determines, during on-site inspections, the quality and ability of the bank’s systems to identify connected exposures and aggregate them. The supervisor also evaluates the bank’s ability to assign borrowers to the applicable sector. There are several examples where the NBG has requested banks to improve the sector reporting or combine certain borrowers to connected groups. The system-wide information that the NBG is gathering through the Top-100 reporting form (report about the top 100 groups of connected borrowers of the bank) enables supervisors to have detailed information on large borrowers and/or groups of interconnected borrowers regarding current on-balance and off-balance sheet amounts, origination and maturity date of

[16] Connected counterparties may include natural persons, as well as a group of companies related financially or by common ownership, management, or any combination thereof.

	the exposure, loan loss provision under local prudential approach and the IFRS, exposure classification, interest rate, accrued on-balance and off-balance interest, days in arrears, economic sector of the borrower, purpose of the exposure, etc. The sectoral form provides the supervisors with detailed information on an aggregated level regarding the banks' distribution of portfolio, current balance of each sector, weighted reserve of individual sectors, and other valuable information about the credit concentration of the financial system. Such reporting is crucial and enables the NBG to identify connected borrowers, which is sometimes difficult for the bank itself to identify.
EC3	The supervisor determines that a bank's risk management policies and processes establish thresholds for acceptable concentrations of risk, reflecting the bank's risk appetite, risk profile, and capital strength, which are understood by, and regularly communicated to, relevant staff. The supervisor also determines that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's Board.
Description and findings re EC3	According to the NBG, the supervisor evaluates the involvement of the Supervisory Board and Senior Management. He/she also assesses policies, procedures, and internal control, including limits, reporting, and IT. This assessment is part of the credit risk assessment (see also CP 17 on Credit Risk).
EC4	The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical, and currency exposures, to be reviewed.

Description and findings re EC4

The NBG receives monthly information on the top 100 groups of connected borrowers of the banks as part of the standard regulatory reporting. In addition, the banks also submit a monthly report on the sector distribution of their loans (see table).

Risk Sectors 2013 (in millions GEL)	**Share in Total Portfolio (in percent)**	**Loan Stock**	**Loan Reserves**	**Loan Reserves/ Portfolio (in percent)**
State	1.0	104.0	2.1	2.0
Financial institutions	1.3	140.0	5.3	3.8
Pawn-shop loans	3.3	346.8	9.0	2.6
Construction development, land development and other land loans	2.3	236.3	52.4	22.2
Real estate management	4.6	482.9	26.0	5.4
Construction companies	2.4	249.0	57.3	23.0
Production and trade of construction materials	2.1	222.8	18.4	8.2
Trade of consumer foods and goods	5.2	540.5	37.5	6.9
Production of consumer foods and goods	4.3	454.9	18.1	4.0
Production and trade of durable goods	1.3	132.7	6.5	4.9
Production and trade of clothes, shoes and textiles	1.2	120.6	5.4	4.5
Trade (other)	4.6	487.2	24.4	5.0
Other production	1.4	150.2	8.1	5.4
Hotels, tourism	2.9	300.0	16.5	5.5
Restaurants	1.2	121.1	7.7	6.3
Industry	3.5	371.5	29.1	7.8
Loans to oil importers and retailers	1.8	186.5	12.8	6.9
Energy	2.7	285.0	12.6	4.4
Auto dealers	1.2	127.0	12.6	10.0
Health care	2.4	255.4	11.8	4.6
Pharmacy	0.9	91.5	9.8	10.7
Telecommunication	1.8	190.1	39.2	20.6
Service	4.8	508.2	58.5	11.5
Agro	3.8	398.5	17.0	4.3
Other (including scrap-metal)	1.0	106.1	3.7	3.5
Retail	**36.9**	**3,871.4**	**188.6**	**4.9**
Car loans	0.5	56.7	6.1	10.8
Consumer loans	16.3	1,706.4	76.6	4.5
Momental installments	2.2	226.2	9.7	4.3
Payrolls (overdrafts)	0.6	67.0	4.8	7.2
Credit cards	4.8	502.5	36.3	7.2
Housing renovations	1.6	171.7	6.1	3.5
Mortgages	10.9	1,140.8	48.9	4.3

	For geographical exposures, see CP on country risk. The counterparty concentration exposures are intensively monitored and reviewed almost on a daily basis. See CP 17 on credit risk. To illustrate the relevancy, on a system level the top 100 groups of connected borrowers per bank constitute approximately 40 percent of the total loan portfolio.
EC5	With respect to credit exposure to single counterparties or groups of connected counterparties, laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.
Description and findings re EC5	The "Regulation On Credit Concentration and Large Risks in Commercial Banks" defines the group of connected counterparties as follows (Article 2.5): "Group of Interconnected Borrowers" – relations between two or more borrowers of the bank where: a) borrowers represent one risk for a bank as one of them carries out direct or indirect control over another or the others; and b) borrowers are regarded as persons belonging to one risk as they related to each other to the extent to that if one of them has financial problems another one or all of them will face financial difficulties. According to the NBG, point "b" leaves enough room for the supervisor to discuss and convince banks that certain borrowers should be grouped together. In practice, the NBG uses the broadness of the definition to require banks to group certain borrowers and LACB article 21 states that the supervisor may exercise discretion in applying this definition on a case-by-case basis. Whereas banks, in practice, use mostly the definition of control as it is stated in the regulation on conflict of interest. Banks do not use the definition on economic interdependence. The NBG identified 529 groups in Georgia based on the information it received from banks. The NBG is developing guidelines regarding economic interdependence. For this purpose, it inquires if banks have linked borrowers to certain groups based on economic interdependence. Taking into account difficulties of determining interdependence, the NBG is planning to implement such guidelines gradually.
EC6	Laws, regulations, or the supervisor set prudent and appropriate requirements to control and constrain large credit exposures to a single counterparty or a group of connected counterparties. "Exposures," for this purpose, include all claims and transactions (including those giving rise to counterparty credit risk exposure), on-balance sheet, as well as off-balance sheet. The supervisor determines that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.

Description and findings re EC6	The Regulation on Credit Concentration and Large Risks in Commercial Banks (LCL) sets the following limits for purposes of regulating credit concentration and large risks of a bank: - The total amount of loans and other liabilities, issued by the bank to a person, shall not exceed 15 percent of the bank's regulatory capital (RSR article 5e). - The total amount of loans and others liabilities, issued by the bank to a group of interconnected borrowers, shall not exceed 25 percent of the bank's regulatory capital; (RSR article 5f). - The total amount of large loans and other obligations shall not be greater than 200 percent of regulatory capital (RSR article 5g), whereas Basel uses 600 percent. Legally, the exposure to a single borrower or to the group of interconnected borrowers, which exceeds 5 percent of regulatory capital (whereas Basel uses 10 percent), is considered a large exposure (LCL article 2.3). The calculation of a large exposure should include: loans issued to a person by banks and legal obligations of banks, such as an overdraft, advances, account receivables, letters of credit, guarantees, and/or other obligations related to issuance of a loan. These are not all claims. The large exposure definition, however, only targets on- and off-balance sheet lending exposures and does not contemplate further exposure like investments in common or preferred stock of the borrowers or derivative exposures. However, it should be noted that such investments are quite immaterial. In particular, investments in subsidiaries represent only 1.76 percent of total banking sector assets (which are deducted from capital), investments in affiliates – 0.02 percent and investments with less than 20 percent stake – 0.26 percent. All the participations the banks have are also reported separately to the supervisor as a part of the standard monthly regulatory reporting. So, the total gross large exposure can be easily analyzed by the supervisor based on the large exposure and the participation report. The formal framework on consolidated supervision is not in place yet. However, the NBG has already started to monitor large exposures on a consolidated level. Consolidated large exposures changes the overall picture insignificantly, as no major large exposures are extended by bank subsidiaries to their clients and there are no significant and complex groups in Georgia (see underpinning in CP 12 Consolidated supervision).
EC7	The supervisor requires banks to include the impact of significant risk concentrations into their stress testing programs for risk management purposes.
Description and findings re EC7	Currently, the NBG only requires large banks to reflect the impact of significant concentrations in their stress-testing (see CP 9 supervisory tools and techniques). With the implementation of Basel II/3, banks are required to conduct stress tests as part of Pillar 2 (see ICAAP guideline under 9).

Additional criteria	
AC1	In respect to credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following: (a) 10 percent or more of a bank's capital is defined as a large exposure; and (b) 25 percent of a bank's capital is the limit for an individual large exposure to a private sector nonbank counterparty or a group of connected counterparties. Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.
Description and findings re AC1	Loans and other liabilities to a person or a group of interconnected borrowers are defined as large loans and other liabilities when it exceeds 5 percent of the bank's regulatory capital. Total amount of loans and other liabilities issued by the bank to a person shall not exceed 15 percent of the bank's regulatory capital. Total amount of loans and other liabilities issued by the bank to a group of interconnected borrowers shall not exceed 25 percent of the bank's regulatory capital. In addition, total amount of large exposures cannot exceed 200 percent of total regulatory capital. The NBG is considering setting limits on top borrowers (TOP-5 and TOP-10).
Assessment of Principle 19	Largely compliant
Comments	The NBG has made very good improvement in identifying connected borrowers. It receives on a monthly basis in a database from every bank of the top 100 borrowers, the large exposures and the participations. This has given the NBG the possibility to compare how banks treat groups of borrowers and if there are differences. The NBG identified several times groups of borrowers that were not identified by other banks. These loans are almost monitored on a daily basis by the NBG. However, there is room for improvement, because there: - Although banks are required by regulation to identify economic interdependence, there is limited practice at the banks of identifying economic interdependence. This means that for part of the portfolio it is not fully clear what the large exposures are from the perspective of economic interdependence. However to mitigate this uncertainty, the NBG decreased its total large exposure limit from 600 percent to 200 percent. Nevertheless banks should put more effort in identifying economic interdependence. For this purpose, the NBG is planning to submit guideline on economic interdependence. See further EC 5. - The regulation on concentration and large exposures does not prescribe requirements for concentrations other than single counterparties or groups connected counterparties. Although the NBG adopted general regulation on risk management that includes some paragraphs on concentration risk, it did not fully implement this regulation. According to the NBG, this will be repaired with the introduction of pillar 2 of Basel II that explicitly requires banks to assess all significant sources of concentration risk. See further EC 1.

	The NBG recently made preparation to change the definition of large exposures according to the new Basel standard on large exposures and concentration risk (June 2014). So, it includes all claims, including equity (although the position does not seem to be material). This amendment is not fully implemented yet. See further EC 6.Recommendations: - Develop regulation or guidelines for concentration risk beyond large exposures. - Make banks improve their identification of the economic interdependence of borrowers. Consider developing a limit for the 10 largest exposures.
Principle 20	Transactions with related parties. In order to prevent abuses arising from transactions with related parties, and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.
Essential criteria	
EC1	Laws or regulations provide, or the supervisor has the power to prescribe, a comprehensive definition of "related parties." This considers the parties identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.
Description and findings re EC1	Transactions with related parties are regulated by LACB (article 25) and the RCITRP. LACB article 25 (implemented September 2009) states that "Commercial banks are prohibited from providing any banking product or rendering any other banking services under preferential terms to any of the following persons parties regardless the type of loan, interest rate, maturity, security, value of collateral or any other terms or conditions:" - Administrators; - Controlling persons; - Affiliates; and/or - Their related parties. LACB article 1 uses following definitions: - Administrator – a member of the bank's Supervisory Board, Directorate, as well as a person who alone or together with one or more others has the authority to enter into commitments on behalf of a bank. (March 2008) - Affiliate – a subsidiary of a legal entity and/or a company subject to control of such legal entity, as well as its controlling persons and their subsidiaries and companies subject to their control. (March 2007). - Control – authority to govern financial and economic policy of an enterprise (organization) for the purpose of deriving economic benefit from such activity. (September 2009) - Controlling person – person exercising control over an entity. (March 2007)

	- Persons related to a bank – bank's administrators, shareholders and persons connected to them by kinship, representing legal heirs of first and second degree according to the Civil Code of Georgia, or related to them by common business interest. Whereas RCITRP article 3 (implemented in 2001) states that a bank is "prohibited to lend or provide financial services to any of its administrators, affiliates or any of their related interests on preferential terms …" and uses in article 2 the following definitions: - Administrator – a member of the bank's Supervisory Board, Directorate or audit committee as well as a person who alone or in concert with one or more persons is entitled to take responsibilities on behalf of the bank - Affiliate – subsidiaries and entities controlled by the legal entity, entities controlling it through an upward chain, as well as their subsidiaries and controlled persons - Control – the capability by a person to exercise, directly or indirectly, alone or in concert with others, by using voting shares *stocks) or in any other way, strong influence over policies and business-related decisions of other person. - Related interest - persons whose special inter-relations may have direct influence, including the influence on the terms of the transaction or economic results. To such specific relations belong those, where: o A person owns a significant (5 percent and more) amount of shares of the bank or of a person controlled by the bank, or controls it otherwise; o Persons are shareholders of one legal entity where the sum of their shares constitutes no less than 20 percent; o One person participates, directly or indirectly, in another person's business where the share of such participation constitutes no less than 20 percent; o One person is subordinated to another person, in terms of job position, or one person is under direct or indirect control of another person; o Persons are subsidiaries or are under direct or indirect control of a third person; o Persons together, directly or indirectly, control the third person; or o Persons are relatives. There is one remark with regard to shareholders of the bank (and the ultimate beneficiary owner). Shareholders (and ultimate beneficiary owners) in the law seems to be covered by the definition of controlling persons, where control is defined as the "authority to govern … policy of an enterprise." The wording though is somehow vague and it is not directly clear if the shareholders are included. Whereas the regulation is more explicit that it is prohibited to lend or provide financial services to any of the bank's related interest, such as a person who owns a significant (more than 5 percent) amount of shares of the bank.

	Lastly, there is no explicit provision in the law or regulation that states that the NBG could determine the definition of related parties or related transactions on a case-by-case basis. However, the NBG determines the definition on a case-by-case basis based on general powers.
EC2	Laws, regulations, or the supervisor require that transactions with related parties are not undertaken on more favorable terms (e.g., in credit assessment, tenor, interest rates, fees, amortization schedules, or requirement for collateral) than corresponding transactions with nonrelated counterparties.
Description and findings re EC2	In both legislation and regulation it is stated that transaction with related parties are not undertaken on more favorable terms. LACB article 25 (implemented September 2009) states that *"Commercial banks are prohibited from providing <u>any banking product or rendering any other banking services</u> under preferential terms to any of the following persons parties regardless the type of loan, interest rate, maturity, security, value of collateral or any other terms or conditions:"* RCITRP article 3 (implemented in 2001) states that "*a commercial bank is prohibited <u>to lend or provide financial services</u> to any of its administrators, affiliates or any of their related interests on preferential terms …"*
EC3	The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process of granting and managing related-party transactions.
Description and findings re EC3	RCITRP article 3 states that a commercial bank is prohibited to conduct any transaction with any of its administrators, affiliates, or with any related parties, unless the transaction is approved by the bank's Supervisory Board. According to the same article, none of the related parties shall take part in the decision-making process related to the discussion of the matters related to the transaction, where such related party expects to benefit, either directly or indirectly, from it and shall not, in any manner, influence the Supervisory Board decision regarding such transaction. In the event a Supervisory Board member is a related party to the transaction to be approved by the Supervisory Board, such member shall reveal his/her interest in the transaction and shall not participate in the decision making process and their attendance shall not be considered in the process of determining the Supervisory Board meeting quorum. It is also stated that the NBG receives minutes of these meetings and that all comprehensive information on such transactions shall be available to the NBG upon request. In addition, the regulation on internal audit states that the Internal Audit Department has the right, for the purpose of eliminating conflict of interests in banking, to study all transactions between bank administrators and their related parties, and in case, any violation is revealed, to report it to the Audit Committee, and, accordingly, to the Supervisory Board. Approval by the Board in relation to write-off of the related-party transactions is not directly required by legislation. The NBG considers facilitating such a practice.

EC4	The supervisor determines that banks have policies and processes to prevent persons benefiting from the transaction and/or persons related to such a person from being part of the process of granting and managing the transaction.
Description and findings re EC4	The supervisor determines whether banks have adequate policies and procedures that prevent persons from benefiting from related transactions and from being part of the process of granting and managing related transactions through reviewing policies, procedures, transaction reports and loan files.
EC5	Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. When limits are set on aggregate exposures to related parties, those are at least as strict as those for single counterparties or groups of connected counterparties.
Description and findings re EC5	NACB article 21.1d gives the NBG the authority to impose prudential limits on transactions with related parties. The following articles limit exposures to related parties (RCITRP articles 3.2-3.4, and RSR article 5)): - A bank is prohibited to make a commitment to insiders or their related interests if the commitment exceeds 5 percent of the bank's capital (RCITRP article 3.2: RSR article 5). - A bank is prohibited to make a commitment to insiders or their related interests if the total amount to all related parties exceeds 25 percent (RCITRP article 3.3; RSR article 5). - Banks are required to hold 110 percent collateral for commitments to related parties (RCITRP article 3.4; RSR article 5). However, in practice, waivers are sometimes given on such requirements; in particular, in cases where a counterparty is a subsidiary of a given bank. Besides this, waivers have been granted on collateralization of small size insider loans.
EC6	The supervisor determines that banks have policies and processes to identify individual exposures to, and transactions with, related parties as well as the total amount of exposures, and to monitor and report on them through an independent credit review or audit process. The supervisor determines that exceptions to policies, processes, and limits are reported to the appropriate level of the bank's senior management and, if necessary, to the Board, for timely action. The supervisor also determines that senior management monitors related-party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.
Description and findings re EC6	The NBG determines that banks have policies and procedures to identify transactions with related parties, exceptions are reported to the appropriate level and that senior management monitors related parties on ongoing basis overseen by the Supervisory Board.

	For this purpose, the NBG reviews internal procedures for identification of transactions with related parties, including approval procedures and limits. It reviews minutes of the Supervisory Board on approving transactions with related parties. And the NBG also analyzes various aspects of related-party transactions, under which: - Aggregated volume of related-party transactions; - Terms of related-party transactions; - Related-party transactions identification procedures, such as reporting by insiders, analysis by risk functions, approval procedures, and reporting; - Quality of loans to related parties; and - Group structure risks from related-party transactions. The NBG also reviews to what extent exceptions are reported to the appropriate level. In principle, the Supervisory Board should review and approve all the transactions with related parties. Exceptions are usually approved by the Board and the NBG as well. Waivers could be given to the bank, allowing that for certain transactions the approval of Senior Management is sufficient (for example transactions with employees not related to senior management). In most cases, banks have special designated officers for loans/financial services to employees. In addition, the NBG reviews reports on related-party transactions, both on an aggregate and individual basis, and assesses how transactions with related parties are governed in banks. Supervisors usually run communication with senior management regarding the details on related-party transactions to make sure they are paid attention to at higher levels. The NBG also cross-checks the completeness of the list of connected borrowers. For example, when reviewing the Top-100 borrowers of the bank, the supervisor checks whether or not the shareholders or Directors of these borrowers are related to administrators or shareholders of the bank. The supervisor also verifies whether or not the owner of publically registered collateral (e.g., real estate) pledged for these loans is a related party. In the case that the bank rents a building, it is also checked whether the owner of the building is a related party and whether or not the rental contract is made in conformity with market conditions. Lastly, the NBG assesses also the group wide structure of the bank. In this assessment, attention is especially paid to the identification of the shareholders, beneficial owners, and their related interests. The information from this assessment also facilitates the cross-checking of the connected lending as reported by the bank.
EC7	The supervisor obtains and reviews information on aggregate exposures to related parties.
Description and findings re EC7	On a monthly basis, the NBG receives reporting forms that contain the following information through which the NBG monitors transactions with related in particular: “Loan Amount,” “The bank's assumed liabilities by off-balance sheet transactions,” “Value of Collateral,” “Amount of Adversely Classified Assets,” “Loan Loss Reserves on Adversely Classified Assets,” and “Loan Loss Reserves Percent” on transactions with following parties:

	- Bank's administrators;
	  - Members of Supervisory Board;
	  - Members of Audit Committee; and
	  - Members of Board of Directors.
	- Persons related to the bank's administrators;
	- Bank's employees;
	- Related enterprises of the bank;
	  - Banks direct participation by 20 percent;
	  - Banks direct participation from 20 percent to 50 percent;
	  - Banks direct participation by 50percent;
	  - Repeated enterprises where the bank participates indirectly;
	  - Related enterprises to the bank's shareholders; and
	  - Other related enterprises to bank's controlling persons.
	- Bank's other shareholders;
	  - Owner of share less than 5 percent; and
	  - Owner of share more than 5 percent.
	- Related persons to the bank and its administrators.
	In addition, a new reporting form of related-party transaction has been introduced, which includes all types of transactions per related party. Beyond this, reporting forms as well contain information on the breakdown of loan amounts and volumes based on their interest rates. The NBG monitors loans with low interest rates and deposits with high interest rates, as well.

Assessment of Principle 20	Compliant
Comments	The NBG is compliant with the core principle on related parties. The NBG put a lot of effort into identifying related parties and related transactions and making sure that transactions take place on an arm's-length basis. This was a gradual process that started in 2006 and required a lot of meetings with banks' representatives. An important tool in this regard is the monthly prudential that the NBG developed. The monthly return introduced in 2009 is much more granular than before and gives the possibility to do cross-checks between banks. In addition, the supervisor reviews the pricing of both the loans and deposit side in order to look for irregularities. The latter also gives NBG the possibility to cross-check how different banks deal with related parties. Finally, it also allows during credit risk assessments whether it is a case of related parties and/or related transactions. There are two minor findings: - There is no explicit provision in law or regulation that states that the NBG could determine the definition of related parties or related transactions on a case-by-case basis. However, the NBG determines the definition on a case-by-case basis based on general powers.

	- There is no explicit provision that requires write-off of related-party exposures to be subject to prior approval by the bank's Board. Recommendations - Consider initiating legislation that gives the NBG explicit power to determine the definition of related parties on a case-by-case basis. - Consider adding a provision that explicitly requires write-off of related party exposures to be subject to prior approval by the bank's Board.
Principle 21	Country and transfer risks. The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.
Essential criteria	
EC1	The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, evaluation, monitoring, reporting, and control or mitigation of country risk and transfer risk. The supervisor also determines that the processes are consistent with the risk profile, systemic importance, and risk appetite of the bank, take into account market and macroeconomic conditions, and provide a comprehensive bank-wide view of country and transfer risk exposure. Exposures (including, where relevant, intra-group exposures) are identified, monitored, and managed on a regional and an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk, and in transfer risk, and apply appropriate countermeasures.
Description and findings re EC1	International activity of Georgian banks' is limited. The total amount of exposures exposed to country and transfer risk as of February 2014 amounts to 7.1 percent of total assets of the banking sector and approximately 39.8 percent of the system's regulatory capital. This amount consists of 5.7 percent gross interbank exposures (of which 2.1 percent is point nostro account), 0.9 percent nonresident exposures, 0.5 percent investments in foreign subsidiaries, and 0.5 percent investments in foreign securities. The most material item is foreign interbank exposures. These exposures mainly concern exposures to parent/sister banks and large international investment grade banks in the European Union and the United States. Those are mainly used for liquidity management purposes, and relevant country/transfer risks associated with this exposure are addressed under liquidity regulation. Only highly rated (corresponding to zero percent risk weight by capital adequacy regulation) foreign government bonds and nostro/deposit accounts in investment grade foreign banks are qualifying as liquid assets (in LCR). In addition to these exposures, banks also have some investments in subsidiaries. These exposures are very small: only 0.5 percent on a sector-wide level and maximum 1.3 percent on an individual level as a percentage of total assets. For prudential purposes, such exposures are deducted from capital and losses on these investments, and therefore, do not have any impact on the regulatory capital. Investments in foreign securities, both corporate and private, are

	even smaller and account for 0.2 percent of total assets of the banking system; one bank owns shares of foreign (high-quality USA, UK) mainly blue chips, exchange traded and index funds; these are only 5.1 percent of its total assets. Another bank owns coupon bonds of GEL 1.7 million, which is 3.5 percent of its assets. The NBG recently issued a guideline on country risk (May 2014) and asked them to respond to it in 10 days. According to this guideline, banks are required to have policies and procedures to manage country and transfer risks. At the moment, most banks only have limits/policies with regard to certain industry segments and per counterparty. Few banks have limits on a country basis or on the basis of OECD and non-OECD membership. The further growth of the Georgian banking system will lead to an increase of such exposures. The NBG stated that they will facilitate banks to introduce limits on a country basis, as well. Furthermore, banks are expected to assess their country and transfer risks during the ICAAP process. Since this guideline has been issued recently, banks have not changed yet to implement it. During the supervisory review evaluation process, the NBG will also evaluate country and transfer risk being part of Basel II, Pillar 2. The NBG receives prudential returns on a monthly basis. These include the total amount of nonresident exposures, investments in foreign subsidiaries, and investments in foreign securities split into: foreign government bonds, foreign nongovernment bonds, and foreign shares. The supervisor can analyze more details on a counterparty level, using monthly form on top 100 credit exposures and interbank transactions per counterparty. From these reports, the NBG generates an overview on the assets exposed to country and transfer risk. Since 2012, the NBG introduced the special forms that allow review exposures per country and main segments in that country. Reporting is monthly based and is an instrument for monitoring most of the exposures to country risk. Supervisors periodically undertake country analysis and transfer risk. In particular, supervisors analyze to what extent the exposure to country and transfer risk is material and what the quality of control is (by reviewing policy and procedures). Based on this assessment, the supervisory regime and the specific supervisory activities/strategy for a bank is determined (e.g., one medium-size bank was required to withdraw funds from another country due to potential transfer/country risk, another large bank was asked to present more detailed analyses on FX swap with foreign counterparty in a politically vulnerable country). In parallel to the risk assessment and the day to day monitoring by the supervisor, the Financial Risk and Macro Prudential Division monitors the developments of such exposures on a system-wide level and the figures on a consolidated level are updated and reviewed regularly. On top of this, ad-hoc analyses are performed based on specific market circumstances or specific developments at a bank during the year. An example of such an ad-hoc analysis (initiated by the Market Risk and Macro Prudential Policy Division) was the analysis made in 2012 of the interbank exposures which relate to the GIIPS (Greece, Italy, Ireland, Portugal, and Spain), Cyprus, and Baltic countries. Another example concerns monitoring of Belarusian and Ukrainian exposures, as some Georgian banks are related (parent/subsidiary relations) with Belarusian and Ukrainian banks, and due to unsteady economic situations in these countries,

	supervisors are carefully monitoring all exposures of Georgian banks toward Belarus and Ukraine. In another case, the NBG asked one of the banks to diversify its exposure to a country with a low sovereign rating. Furthermore, depending on materiality of risks, the NBG also performs a bank-by-bank and system level analysis of indirect country/transfer risk—assessing bank borrower's exposures against vulnerable countries (e.g., trough trade).
EC2	The supervisor determines that banks' strategies, policies, and processes for the management of country and transfer risks have been approved by the banks' Boards, and that the Boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks' overall risk management process.
Description and findings re EC2	Currently, the NBG does not determine systematically whether the bank's strategies, policies, and processes have been approved by the bank's Board, and that the Board oversees implementation by management. This is supposed to change through implementing the guideline on country and transfer risk and the regulation on ICAAP.
EC3	The supervisor determines that banks have information systems, risk management systems, and internal control systems that accurately aggregate, monitor, and report country exposures on a timely basis; and ensure adherence to established country exposure limits.
Description and findings re EC3	The NBG monitors the ability of information, risk management, and internal control systems of the commercial banks to evaluate and report the risks. In this respect, the NBG adopts a risk-based approach, implying that mainly the policies and the procedures for material exposures are assessed. Relevantly, the supervisor's main focus is on the interbank exposures of the banking system in general, and also on the nonresident exposures in banks where these exposures are material. Furthermore, for assurance purposes, the NBG has addressed interbank accounts in nonresident banks by checking the actual balances.
EC4	There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices that are all acceptable as long as they lead to risk-based results. These include: (a) The supervisor (or some other official authority) decides on appropriate minimum provisioning by regularly setting fixed percentages for exposures to each country taking into account prevailing conditions. The supervisor reviews minimum provisioning levels where appropriate. (b) The supervisor (or some other official authority) regularly sets percentage ranges for each country, taking into account prevailing conditions and the banks may decide, within these ranges, which provisioning to apply for the individual exposures. The supervisor reviews percentage ranges for provisioning purposes where appropriate. (c) The bank itself (or some other body such as the national bankers association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The adequacy of the provisioning will then be judged by the external auditor and/or by the supervisor.

Description and findings re EC4	The NBG does not impose a predefined minimum provisioning for any exposures to foreign countries. For provisioning matters, Georgian banks treat such exposures similar to the exposure to domestic clients and banks. However, industry/market developments are part of the asset classification and loan loss provisioning assessment criteria, which, to some extent, accounts for country-specific developments. At the same time, if the NBG is not satisfied with the level of provisioning and the way it has taken country risk or transfer risk into consideration, it has the power to require extra provisioning. The NBG actually used this power in a case of indirect country risk in Ukraine. In addition, (foreign) investments are deducted from capital.
EC5	The supervisor requires banks to include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis for risk management purposes.
Description and findings re EC5	Banks are required, according to the Enterprise-Wide Stress Test guidelines, to perform stress testing of material risk concentrations specific to the bank. For banks with relevant material exposure, it should incorporate country/transfer risks as well; e.g., problems with access to assets in politically vulnerable countries or bans on trade to a country where a significant number of bank's borrowers run business with. It is also included in the guideline on ICAAP under 9 to develop certain stress tests and adverse scenarios. In practice, only the largest banks conduct stress tests and take country and transfer risk into consideration.
EC6	The supervisor regularly obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of banks. The supervisor also has the power to obtain additional information, as needed (e.g., in crisis situations).
Description and findings re EC6	The NBG requires banks to file standard regulatory reporting (see EC 1). Banks' consolidated reports are provided only on an annual basis or upon a special request by the supervisor. As for the detailed information on non-resident, non-banking borrowers, they are obtained through request. The NBG has the power to request any information it deems necessary for its prudential supervision (Organic Law, Article 49).
Assessment of Principle 21	Largely compliant
Comments	The NBG monitors very actively the country and transfer risk (direct and indirect) themselves based on prudential reports and recently (May 2014) started to stimulate banks to manage their country and transfer risk through issuing guidelines on country and transfer risk. However, banks did not have time to fully implement these guidelines yet. Further, the NBG does not determine systematically whether the bank's strategies, policies, and processes have been approved by the bank's Board and that the Board oversees implementation by management. In addition, only the largest banks conduct stress tests and incorporate adverse scenarios of country and transfer risk. See further EC 1, 2, and 4. In the second half of 2014, the NBG will review the ICAAP set up by the banks (SREP) in order to stimulate an alignment between the risk profile, capital position, and the quality of risk management, including conducting stress tests (see EC 5). This will give the right incentives to the banks to manage explicitly their country risk.

	Next, the NBG does not have a formal provisioning model for country risk and transfer risk. Banks have the discretion to consider themselves whether provisioning for country risk is deemed necessary. According to the NBG, it should be part of standard analysis of a borrower. At the same time, if the NBG is not satisfied with the level of provisioning and the way it has taken country risk or transfer risk into consideration, it has the power to require extra provisioning. The NBG actually used this power in the case of one country. Recommendations: - Continue implementing guidelines on managing country and transfer risk, including stimulating the Board to explicate their risk appetite, set county and transfer risk limits, and take responsibility in overseeing the management. - Consider implementing an explicit provisioning system for country risk and transfer risk, developed either by the NBG or by the banks themselves. Consider requiring prudential return on country risk on consolidated level on a semi-annual basis.
Principle 22	Market risk. The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions, and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate market risks on a timely basis.
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to have appropriate market risk management processes that provide a comprehensive bank-wide view of market risk exposure. The supervisor determines that these processes are consistent with the risk appetite, risk profile, systemic importance, and capital strength of the bank; take into account market and macroeconomic conditions and the risk of a significant deterioration in market liquidity; and clearly articulate the roles and responsibilities for identification, measuring, monitoring, and control of market risk.
Description and findings re EC1	The NBG split their approach toward market risk in two: trading book and the banking book. Market risk in the trading book of the banks in Georgia is not material, since banks do not have trading desks. The total trading book of the system is 0.2 percent of total assets and its maximum ratio is 5.1 percent for a medium-sized bank. However, the NBG introduced very basic regulation regarding market risk in the trading book in March 2014 as a preventive measure against accumulation of such risks in the future. Besides the trading book, the NBG also considers market risk in the banking book. These are more relevant in Georgia. In that regard, the NBG distinguishes between direct exposures to market risk, such as foreign exchange risk, real estate (property for own use, investment property and repossessed assets), and indirect exposures to market risk, such as currency induced credit risk and loans collateralized with commodities or real estate. Interest rate risk is dealt with in core principle 23.

	The exposures to foreign currency are governed by the Regulation on Setting, Calculating, and Maintaining Overall Open Foreign Exchange Position Limit of Commercial Banks (RFX). The current foreign currency limit is set at 20 percent overall open position to regulatory capital (see article 2 RFX). The same regulation determines responsibilities of management of commercial banks. The exposures to real estate are either for own use or repossessed collateral. The fixed assets represents 6.0 percent of total assets of banking system, of which 0.8 percent point reposed assets, and 5.2 percent point fixed assets for own use and investments in real estate property. These exposures are governed by accounting rules. The credit risk related exposures such as currency induced loans, loans collateralized by commodities, or real estate are described in CP 17 on credit risk. In addition, the NBG is in the process of transition from a Basel I based capital adequacy framework to a Basel II/III based framework. This framework introduces capital requirement for the open currency position (OCP) under Pillar I. Banks will also be required to submit their (first) ICAAP in September 2014 (see R-ICAAP). As a part of their ICAAP, banks will be required to assess to what extent they are exposed to market risks that are not covered under Pillar I (currently limited to open currency position). The ICAAP introduces and requires that banks review all their material risks and link their position to their risk appetite and their capital in a comprehensive way. The ICAAP will be an important instrument to monitor the possible developments of other market risk (other than currency risk) in the Georgian financial system. The NBG performs regularly a risk assessment of the banks under which market risk exposures and the management of these exposures is assessed. Given the importance of FX risk management in the Georgian context, it is dedicated special attention under market risk governance assessment. In parallel, the NBG has started reviewing the relevant components of banks' ICAAPs. Lastly, there is no regulation to determine market risk on a consolidated level. However, the NBG is monitoring the market risk on a consolidated level (see further CP 12 on consolidated supervision).
EC2	The supervisor determines that banks' strategies, policies, and processes for the management of market risk have been approved by the banks' Boards, and that the Boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks' overall risk management process.
Description and findings re EC2	In article 14b, the LACB is stated that the policy regarding foreign exchange risk should be approved by the Supervisory Board. Furthermore, guidelines on ICAAP guidelines require the Board's involvement in setting the strategy, risk appetite, and risk governance framework, comprehensive review of all their material risks, including market risk.

	As a result of the risk assessments, the NBG has information on the procedures used by the banks to manage their open currency position, and market risk. Attention is paid that high-level policies and procedures are documented and overseen by the bank's Board and that such policies, including limits, are in line with the bank's strategy and risk appetite. Given the immateriality of the trading book, the NBG stated that in almost all banks the market risk framework is focused mainly on the FX risk.
EC3	The supervisor determines that the bank's policies and processes establish an appropriate and properly controlled market risk environment including: (a) effective information systems for accurate and timely identification, aggregation, monitoring, and reporting of market risk exposure to the bank's Board and senior management; (b) appropriate market risk limits consistent with the bank's risk appetite, risk profile, and capital strength, and with the management's ability to manage market risk and which are understood by, and regularly communicated to, relevant staff; (c) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or Board, where necessary; (d) effective controls around the use of models to identify and measure market risk, and set limits; and (e) sound policies and processes for allocation of exposures to the trading book.
Description and findings re EC3	The NBG determines to what extent banks have policies and procedures to establish a controlled market risk environment. For this purpose, supervisors assess policy and procedures, risk management models, internal limits, and corresponding reporting. They also arrange meetings with commercial bank representatives who are in charge of monitoring market risks. Furthermore, they assess whether management reviews the reports and is involved in decision-making where appropriate. In practice, some banks do not have a separate foreign exchange risk policy, but have incorporated it in the general risk-management process, ALM policy or ALCO procedures. Some banks are carrying out stress tests to calculate the losses that the banks may face in case of realization different market shocks.
EC4	The supervisor determines that there are systems and controls to ensure that banks' marked-to-market positions are revalued frequently. The supervisor also determines that all transactions are captured on a timely basis and that the valuation process uses consistent and prudent practices, and reliable market data verified by a function independent of the relevant risk-taking business units (or, in the absence of market prices, internal or industry-accepted models). To the extent that the bank relies on modeling for the purposes of valuation, the bank is required to ensure that the model is validated by a function independent of the relevant risk-taking businesses units. The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments for positions that cannot be prudently valued otherwise, including concentrated, less liquid, and stale positions.

Description and findings re EC4	The NBG determines the daily open currency position of banks based on a daily report it receives from the banks. Revaluation of assets and liabilities nominated in foreign currency by changes of exchange rate enter P&L on a daily basis. The trading book is only present to a limited extent in one bank. According to the NBG, their corresponding fair valuation is appropriate, as portfolio consists of highly liquid stocks/indices.
EC5	The supervisor determines that banks hold appropriate levels of capital against unexpected losses and make appropriate valuation adjustments for uncertainties in determining the fair value of assets and liabilities.
Description and findings re EC5	There are no capital requirements for market risk under the current regime. This will change with the implementation of the Basel II/III framework. Banks will be required to hold 7 percent, 8.5 percent and 10.5 percent of respectively common equity Tier 1, Tier 1 and regulatory capital for their risk weighted open foreign currency position (see R-ICAAP articles 8 and 91). The open foreign exchange position is defined as the largest amount of long and short open foreign exchange positions for all types of foreign currencies. These includes spot, futures, forward, and swap agreements. With regard to fixed assets, banks could have a revaluation reserve of fixed assets (for own use as well as investment property). Although it is included in IFRS equity, it is not included in the definition of the regulatory capital. As of February 2014, the total revaluation reserves of the banks amounts to GEL 133.7 million. This amount functions as a kind of buffer for price decreases as long as price decreases of only beyond GEL 133.7 million (generally speaking) would cause losses through P&L. This implies that the prices of fixed assets can decline by at least 15 percent of the P&L before the regulatory capital of the banks would be affected. Given the amount and the revaluation buffer, these assets expose the banking system to some risk, but not significant. Furthermore, as dollarization rate is high, currency induced credit risk is an issue. The banks are required to hold 75 percent additional capital for foreign currency denominated loans (where the borrower is not hedged), which addresses indirect FX risks as. The NBG is contemplating regulating the structural position and provisioning denomination of the banks. This is a relevant issue given the high dollarization of the financial system.
EC6	The supervisor requires banks to include market risk exposure into their stress testing programs for risk management purposes.
Description and findings re EC6	The ICAAP guideline (under 9) requires banks to conduct plausible but severe stress and scenario tests that take into account, for example, risks that are specific to the bank, the jurisdiction(s) in which the bank operates, the macro-economic environment, the impact of that new legislation, and the actions of competitors or other factors may have on the bank's performance. Currently, large banks and some of the small banks have developed stress testing tools to include market risk. Currency risk and stress tests on currency devaluation are incorporated in all the banks' models.

	Enterprise-Wide Stress Test guidelines. The NBG sets minimum stress scenarios, including devaluation of GEL, increase in interest rates, and drop in real estate and gold prices, as well as other market risks specific to the bank. In addition, the NBG itself is carrying out the macro stress tests regularly.
Assessment of Principle 22	Compliant
Comments	The market risk in the trading book is not material (including consolidated supervision). The main market risk is exchange risk. The NBG determines sufficiently whether banks have an adequate market risk management process taken into account the market and macro-economic conditions. Since June 2014, the currency risk is charged for capital under pillar 1. Pillar 2 will be implemented in September 2014, Recommendations: - Continue implementing the new capital regime, since this will enhance the risk management, incentivize all banks to conduct stress tests, and allocate capital for unexpected market risk losses. - Consider setting market limits on consolidated level (see further CP 12 on consolidated supervision).
Principle 23	Interest rate risk in the banking book. The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report, and control or mitigate interest rate risk in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile, and market and macroeconomic conditions.
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to have an appropriate interest rate risk strategy and interest rate risk management framework that provides a comprehensive bank-wide view of interest rate risk. This includes policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate material sources of interest rate risk. The supervisor determines that the bank's strategy, policies, and processes are consistent with the risk appetite, risk profile, and systemic importance of the bank, take into account market and macroeconomic conditions, and are regularly reviewed and appropriately adjusted, where necessary, with the bank's changing risk profile and market developments.
Description and findings re EC1	Regulation on risk management (RRM articles 13–17) stipulates that banks are required to have an appropriate interest rate strategy and risk management framework. This includes policies and procedures to identify, measure, monitor, and control. There is no regulation that requires banks to hold capital for interest rate risk or hold limits. However, under the ICAAP guidelines, banks are explicitly required to assess their exposure to interest rate risk. Banks are expected to link the interest rate risk to their risk appetite and economic capital. They are required to submit their (first) ICAAP by September 30, 2014.

	Regarding the interest risk management framework, in practice, according to NBG almost all banks (with the exception of a few very small banks) have an interest rate risk management policy and procedures in place. In most cases as a separate document or as part of asset and liability management procedures. The NBG currently discusses the interest rate risk management with one bank that has a material interest rate risk (and also more developed risk management). For the other banks, the interest rate risk is not material at the moment (given their balance sheet structure). The average contractual maturity of the loan book (interest maturity in Georgia approximately equal loan maturity since loans with floating interest rates are rare) in Georgia is low, because the majority of the loans are issued with a maturity of one year. In addition, refinancing of loans is also high, which results in an even lower actual maturity than contractual maturity. However, in 2011, the NBG issued a regulation, which limits the possible penalty for early repayments to 2 percent of the amount that is repaid. This significantly increases the possibilities of clients to refinance their loans at other banks, which stimulates competition. However, it reduced the possibility of the banks to mitigate their interest rate risk since it runs the risk of increased early repayments in a market where interest rates are decreasing, without the (full) ability to protect itself adequately for this risk. On the other hand, it should be mentioned that the loan and deposit contracts allow the banks to change the interest rates, even if the client fixated its interest rate for long-term years. However, so far, this possibility was used only for deposits. The average contractual maturity of the loan book is more or less in line with this average maturity of the liability side of the balance sheet (9.2 months for all deposits and 11.5 months for time deposits), which significantly reduces the potential adverse impact of interest rate changes on the banks' medium- and long-term profitability. However, with the further development of the financial sector, increasing financial stability, and the current economic growth, it is expected that the maturity of the loan book will increase over time, which, under a low interest rate environment, makes interest rate risk management a more important topic on the agenda.
EC2	The supervisor determines that a bank's strategy, policies, and processes for the management of interest rate risk have been approved, and are regularly reviewed by the bank's Board. The supervisor also determines that senior management ensures that the strategy, policies, and processes are developed and implemented effectively.
Description and findings re EC2	LACB Article 14 requires the Supervisory Board to approve policies and procedures regarding asset and liability management (which, broadly speaking, also covers interest rate risk in the banking book). The supervisors receive and review, as a basic part of ongoing supervision, the agenda and the minutes of the Supervisory Board. Also, the guidelines on ICAAP require the Board's involvement in setting the strategy, risk appetite, and risk governance framework, comprehensive review of all their material risks, including interest rate risk in banking book. This will be a subject for dialogue during the SREP process.

	As a part of the supervisory approach (GRAPE), the bank supervisor, together with the specialists risk supervisor of the Market Risk and Macro Prudential Policy Division, are required to assess the quality of the mitigants (amongst others policies and procedures, but also Supervisory Board involvement) the bank has in place with regard to interest rate risk.
EC3	The supervisor determines that banks' policies and processes establish an appropriate and properly controlled interest rate risk environment including: (a) comprehensive and appropriate interest rate risk measurement systems; (b) regular review, and independent (internal or external) validation, of any models used by the functions tasked with managing interest rate risk (including review of key model assumptions); (c) appropriate limits, approved by the banks' Boards and senior management, that reflect the banks' risk appetite, risk profile and capital strength, and are understood by, and regularly communicated to, relevant staff; (d) effective exception tracking and reporting processes which ensure prompt action at the appropriate level of the banks' senior management or Boards where necessary; and (e) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of interest rate risk exposure to the banks' Boards and senior management.
Description and findings re EC3	*Interest rate measurement* Currently, most banks use the NBG's standardized GAP analysis (on a one-year horizon) to measure their re-pricing risk. Some banks also take yield curve risk, basis risk, and option risk into account (see further) based upon their own models. Since 2012, the NBG has used duration statistics under a standardized framework to calculate the impact of a 4 percent (GEL) / 2 percent (USD) on the economic value of a bank's assets and liabilities. *Model validation* Few banks have already elaborated interest rate risk models that take into account optionality in banking products (prepayment of loans and early termination of deposits). However, in other banks, procedures are not well developed enough. All these factors are taken into account by the supervisor during assessments, including assessment of models. The assessment of interest rate risk is a part of an ongoing supervision undertaken by the bank and risk supervisors. *Limits* Some banks have detailed procedures for monitoring the interest rates risks, with appropriate internal limits and reporting triggers. However, the other banks do not use internal limits. Though their interest rate risk is not material (in nature and in substance) except for one systemically important bank. They hold extra capital as a buffer, according to the NBG.

	Reporting and exception tracking Currently, many banks use the information on the interest rate risk exposure in the banking book they provided to supervisors monthly through a special form (called A-G Form), which is incorporated in financial reporting. This form presents interest bearing assets and interest bearing liabilities allocated over time buckets by their re-pricing date (for floating, it is re-pricing date, but for fixed - maturity date) and is used to assess the effect of interest rate shock on the bank's current year P&L. However, the information provided does not have sufficient granularity in terms of time buckets for the longer maturities, and does not take into account the prepayments and refinancing of loans. Furthermore, it fails to differentiate between currencies and distinguish between on- and off-shore FX funding. It also does not allow calculating how the bank's economic value or regulatory capital is affected by standard interest rate shocks. Therefore, the NBG has already elaborated a new reporting form that covers interest bearing assets and liabilities with detailed currency (distinguishing between on- and off-shore FX funding) and maturity break down. Since 2012, the collected data is semi-yearly utilized to calculate the impact of interest rate shock on bank's economic value, according to Basel methodology (using duration statistics under standardized framework). The model needs further calibration for fitting the characteristics of the local financial sector, for instance, while making assumptions on pre-payment and usage of actual yield curve for assets/liabilities in GEL, which is a challenging process. Analogously to the OCP form, it will allow calculating the interest rate risk position, which may be subject to prudential limit against the regulatory capital and/or economic capital requirements under Pillar II. Introduction of the new reporting form for interest rate risk will allow calculating the shock effects based on more sophisticated scenarios. *Information system* Banks are required to have effective information systems for accurate and timely identification and reporting of interest rate risk exposure to the banks' Boards and senior management.
EC4	The supervisor requires banks to include appropriate scenarios into their stress testing programs to measure their vulnerability to loss under adverse interest rate movements.
Description and findings re EC4	All large banks, and some smaller banks, perform stress tests for interest rate risks on the banking book. Most stress tests have been evaluated by the supervisors and adjusted where applicable. Currently, according to the NBG, the stress test methodologies are quite satisfactory. However, in some other banks, stress testing procedures are underdeveloped. The NBG elaborated "stress test guidelines" that were provided to large banks. According to it, standard stress parameters are determined that banks should use in their stress tests. In particular, for interest rate risk, the standard shock parameter is the increase of interest by 4 percent for assets/liabilities denominated in GEL, and by 2 percent for assets/liabilities denominated in foreign currency. However, the parameters may change if needed. One bank developed several scenarios to stress their interest rate risk position. The NBG actively discusses

	concerns with commercial banks' management regarding interest rate risk. Further, commercial banks are required to assess interest rate risk as part of their ICAAPs. Stress testing and scenario analysis should be a part of this process.
Additional criteria	
AC1	The supervisor obtains from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book.
Description and findings re AC1	All banks are required to submit an interest rate GAP report with a time horizon of one year on a monthly basis. Since 2012, banks are also required to submit a more detailed report for the whole interest rate typical balance sheet once every half year. Based on this report, the NBG developed a stress test model. Some (larger) banks use internal models to estimate interest rate shock effect on a bank's economic value. Supervisors have reviewed and assessed and are gaining experience with it by trying to calculate it on system level following Basel guidelines using shocks of 4 percent in GEL and 2 percent in USD. The NBG works with the industry to further calibrate and fine-tune their model and their underlined assumptions (e.g., bank specific pre-payment ratios, the maturity and duration in long-term buckets, construction of yield curve in GEL, and estimation of potential shock level) taken into account basis risk, yield curve risk, and optionality risk. Banks are expected to further elaborate interest rate risk models (including effect on economic value) in the ICAAP.
AC2	The supervisor assesses whether the internal capital measurement systems of banks adequately capture interest rate risk in the banking book.
Description and findings re AC2	Banks are required to assess their interest rate risk and link it to their risk appetite and economic capital as part of the ICAAP (due September, 30 2014). In addition, both NBG macro stress test and the Enterprise-Wide Stress Test were sent to the banks to estimate the interest rate risk in shock scenarios and measure its effect on regulatory capital. It appeared that the impact of interest rate shock on the P&L is limited, except in one case. This bank will hold capital for this and is discussing the amount with NBG.
Assessment of Principle 23	Largely compliant
Comments	The NBG is largely compliant with the core principle on interest rate risk. Although the banks could use more guidance from the NBG to improve the quality of interest rate risk management. Despite the presence of guidelines on risk management introduced in 2008, it seems that there is further room for improving the quality of interest rate risk management of banks. However, based on the new reporting standard, introduced in 2012, most of the banks do not have a material interest rate risk position because of the nature of their balance sheet (contractual maturity of loans is approximately the same as maturity of deposits, where contractual maturity equals interest rate maturity). Except one systemic bank does have a

	material interest rate position without internal limits. This bank holds earmarked capital as a buffer for interest rate risk. The assessors think that NBG should require banks to set up an internal limit. See further EC 3. All banks should take their interest rate risk into account in relation to their capital position, including defining trigger ratios. This will be part of the implementation of Basel II, Pillar 2. Recommendations: - Require banks, through regulation, to have internal limits for interest rate risk; - Consider providing more guidance to banks on how to deal with interest rate risk in relation to ICAAP; and - Consider increasing the frequency of reporting to a quarterly basis in order to keep developments abreast.
Principle 24	Liquidity risk. The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements, or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions, and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report, and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to consistently observe prescribed liquidity requirements, including thresholds by reference to which a bank is subject to supervisory action. At least for internationally active banks, the prescribed requirements are not lower than, and the supervisor uses a range of liquidity monitoring tools no less extensive than, those prescribed in the applicable Basel standards.
Description and findings re EC1	LACB article 19.3 states that banks shall maintain sufficient liquidity resources. This is explicated in article 5i of the Regulation on Supervision and Regulation of the Activities of Commercial Banks. Here, it is stipulated that the minimum average liquidity ratio shall be no less than 30 percent. However, the NBG has the discretion to impose different ratios (see LACB article 21.2a). According to the NBG, there are three banks that have a different liquidity ratio requirement because of their risk profile, respectively two banks are rewarded because of good model and one bank has an add-on because of single concentration. Furthermore, in 2013, the liquidity ratio is adjusted to penalize banks with a high (>10 percent) share of nonresident deposits. The current liquidity ratio of the system is close to 40 percent (and the liquid assets to deposits ratio is 50 percent) and the liquidity ratio for foreign currency is close to 30 percent. The average liquidity ratio is defined as the average of month's liquid assets to the average of month's liabilities. The liabilities consist of both on- and off-balance items. The liquid assets consist of cash, amounts due to banks and central banks (partly reserve requirement), and an

	investment portfolio. The latter consists of mostly treasury bonds and treasury bills from the Ministry of Finance of Georgia and of Certificates of Deposit of central banks. A part of the investment portfolio is pledged for short-term loans from the NBG. There are two adjustments: - Total amount of government securities and certificates of deposits from the NBG shall not exceed 10 percent of total liabilities. - Liquid assets shall not include certain specific accounts: debt securities issued by non-OECD members government or central banks, blocked correspondent accounts, adversely classified inter-bank deposits, or the reserve placed at a central bank or its portion, which is pledged against a credit taken by a commercial bank. - Furthermore, the NBG has also launched the LCR calculation requirement (not yet an LCR requirement). According to the NBG, these requirements are in line with Basel III methodology with a few (more conservative) adjustments to capture characteristics of the local financial sector, such as deposit concentration, nonresident exposures, and different runoff risk of FX-denominated liabilities. So far, the NBG has been collecting such calculations for monitoring purposes since 2012. However, draft regulation has already been prepared was sent to the sector for comments in September 2013. Currently, the LCR is in all currency above 100 percent. Liquidity tools actively being used are: - Banks submit Macro-Policy Division tracks high-frequency market data on a daily basis such as equity prices, FX markets, and yield dynamics.
EC2	The prescribed liquidity requirements reflect the liquidity risk profile of banks (including on- and off-balance sheet risks) in the context of the markets and macroeconomic conditions in which they operate.
Description and findings re EC2	With regard to the market and macro-economic condition, there are two important characteristics: very high dollarization (around 60 percent of loans and deposits are denominated in dollars) and deposit concentration throughout the system (30 largest depositors have 20 percent of total deposits). The main liquidity requirement is the liquidity ratio set at minimum 30 percent. However, the NBG has the power to impose different liquidity requirements in accordance with risk appetite, business model, and liability structure, and used this power (see EC 1). Based on this, the NBG has adjusted liquidity requirements based upon the risk profiles of the banks. Another requirement that the NBG imposes is targets on the concentration of nonresident's deposits where liquid assets are in the same currency, proportional to nonresidents' share, are reduced by X=max[(A-10 percent), 0] percent of nonresident's deposits, where A represents the share of nonresident deposits in total deposits of clients. For this calculation, blocked deposits are excluded. The minimum liquidity ratio is not required for every individually foreign currency. However, if there is a liquidity problem in a foreign currency, it will intervene. Furthermore, the LCR will be

	mandatory for every individual currency and in total. The NBG shall use its discretion for deposit concentration, nonresident exposures, and runoff risk of FX-denominated liabilities to reflect the local market and macro-economic conditions. See precondition for details of systemic risk of dollarization.
EC3	The supervisor determines that banks have a robust liquidity management framework that requires the banks to maintain sufficient liquidity to withstand a range of stress events, and includes appropriate policies and processes for managing liquidity risk that have been approved by the banks' Boards. The supervisor also determines that these policies and processes provide a comprehensive bank-wide view of liquidity risk and are consistent with the banks' risk profile and systemic importance.
Description and findings re EC3	LACB article 14.5b states that the Supervisory Board is required to determine and approve internal policy and procedures governing asset and liability management. In practice, the supervisor assesses whether the liquidity management framework establishes limits that are implemented on a consistent basis to prevent liquidity shortages, GAP concentrations, and dependence on any specific counterparty, instrument, or market segment. The limits established should be consistent and appropriate to the contingency funding plan to ensure that the contingency funding plan could be applied effectively. The limits should ensure sufficient liquidity to withstand various stress events. In practice, there is room for improvement for contingency planning. Only three large banks have contingency plans; however, these plans need significant improvement according to the NBG. The other banks do not yet have contingency plans. With the implementation of Basel II and III, banks are required to set up liquidity contingency plans that will be subject to assessment by the liquidity supervisors of NBG.
EC4	The supervisor determines that banks' liquidity strategy, policies, and processes establish an appropriate and properly controlled liquidity risk environment including: (a) clear articulation of an overall liquidity risk appetite that is appropriate for the banks' business and their role in the financial system and that is approved by the banks' Boards; (b) sound day-to-day, and where appropriate intraday, liquidity risk management practices; (c) effective information systems to enable active identification, aggregation, monitoring, and control of liquidity risk exposures and funding needs (including active management of collateral positions) bank-wide; (d) adequate oversight by the banks' Boards in ensuring that management effectively implements policies and processes for the management of liquidity risk in a manner consistent with the banks' liquidity risk appetite; and (e) regular review by the banks' Boards (at least annually) and appropriate adjustment of the banks' strategy, policies, and processes for the management of liquidity risk in light of the banks' changing risk profile and external developments in the markets and macroeconomic conditions in which they operate.

Description and findings re EC4	The NBG conducts different supervisory activities to assess the liquidity management environment. This involves review of all strategies, policies, and procedures, on-site meetings with the management at least during bank's liquidity assessment (under GRAPE framework), and regular communication with the management to observe the managers' views on current risks and general dynamics in the system. In addition, the supervisors examine each set of ALCO meeting minutes to analyze how the bank follows recent trends in the system. *Risk appetite* According to relevant legislation, the liquidity management policy and procedures should be evaluated and approved by the Supervisory Board (LACB article 14b). Risk supervisors analyze, throughout the liquidity risk assessment process, whether the Supervisory Board communicates overall liquidity risk appetite reflected in liquidity management policy to the units in charge of business lines carrying liquidity risk exposure, and whether such liquidity risk appetite is consistent with the bank's business strategy and resources. In addition, the supervisor examines the Board's expertise in liquidity risk management, taking into account Board members' past experience, mainly through the observance of Supervisory Board minutes. *Day-to-day / intraday liquidity management* The risk supervisor assesses liquidity risk mitigants such as limits, liquidity management models, adequacy of internal controls, and adopted liquidity stress tests. Besides the assessment of regular overnight and intraday liquidity management during on-site inspections, special attention is applied to management/placement of liquid assets, particularly, counterparty credit risk in interbank accounts/deposits. This risk is further addressed by LCR regulation. *Information systems* Supervisors also assess if the management information system for liquidity risk is capable of providing accurate, timely information and reports on the condition of liquidity, maturity profile, and projected cash flow; whether the information system is designed and developed in accordance with significant changes in internal and external conditions; and whether the risk management information system is capable of meeting the reporting requirements of the NBG, including the obligation of the bank to provide special reports. Assurance of data and supplementary information is a regular task in this regard. Currently, corresponding team performs assurance of LCR. During the on-site visits, the entire process of LCR calculation is checked together with bank's reporting staff, from actual contract with clients to the compilation of the final form. In parallel, credit risk team performs assurance of loan portfolio forms, including actual repayment schedules, which is used in maturity gap calculation. Another part of assurance work is the bank's balance verification in resident and nonresident correspondent accounts.

	Oversight and review The NBG checks whether the Supervisory Board evaluates the reports submitted by the management on the implementation of the liquidity risk management policy periodically, and whether liquidity risk management policy is periodically reviewed and updated along with the changes in the liquidity condition, business strategy, and market condition. In practice, the supervisor inspects a few large banks on-site in order to assess the liquidity risk management framework and the accuracy of the liquidity ratios. For the other banks if necessary, the NBG invites experts on liquidity risk management to come to the NBG to talk to the responsible bank supervisor and liquidity risk supervisor.
EC5	The supervisor requires banks to establish, and regularly review, funding strategies and policies and processes for the ongoing measurement and monitoring of funding requirements and the effective management of funding risk. The policies and processes include consideration of how other risks (e.g., credit, market, operational, and reputation risk) may impact the bank's overall liquidity strategy, and include: (a) an analysis of funding requirements under alternative scenarios; (b) the maintenance of a cushion of high quality, unencumbered, liquid assets that can be used, without impediment, to obtain funding in times of stress; (c) diversification in the sources (including counterparties, instruments, currencies and markets) and tenor of funding, and regular review of concentration limits; (d) regular efforts to establish and maintain relationships with liability holders; and (e) regular assessment of the capacity to sell assets.
Description and findings re EC5	The NBG requires banks to establish and review funding structures for mostly the medium and large banks. According to the NBG, the banks consider all products, transactions, and business lines that may affect a bank's liquidity position. Assessments typically cover the funding structure (deposit structure by type), maturity, currency, interest rate, owners of funds, and concentration of fund ownership. Next, the supervisor requires the medium and large banks to employ various different scenarios and analyze their potential impact on the liquidity position. In applying different scenarios, the bank should estimate future funding needs. The bank should also consider its ability to raise liquidity on the market under both normal and stress conditions, and marketability of the liquid assets bank holds. Banks should also review assumptions used in scenario analysis and stress testing in light of changes in market conditions and customer behavior. Furthermore, the Enterprise-Wide Stress Testing Guidelines were sent to banks on how to analyze the effect of deterioration of macro environment on liquidity position (e.g., deposit withdrawal, wholesale funding outflow due to breaching covenants). Since, in practice, the NBG has observed that in times of financial distress the funding possibilities of Georgian banks are limited (mainly limited to parent banks or IFIs), the supervisor has imposed a conservative quantitative liquidity ratio, which the banks have to meet. In order to achieve this ratio, all banks have to hold a relatively large amount of liquid assets. The only assets (except cash, bank

	deposits, and nostros) that are considered to be liquid are government bonds and NBG CDs. In addition to parents and IFIs, the supervisor observes that banks maintain relationships with large deposit holders at the bank and use information to manage short-term operational liquidity more effectively. Other wholesale funding is rare in the Georgian market, and, if available, tends to "dry-up" in times of financial distress. In 2012, one of the Georgian banks issued Eurobonds on international markets and also introduced Certificates of Deposits. That is considered to be a more stable source of financing than common deposits. In the absence of variety of liquid assets (other than government bonds and NBG CDs which can be pledged at the NBG), the regular assessment of possibility to sell liquid assets is not that relevant.
EC6	The supervisor determines that banks have robust liquidity contingency funding plans to handle liquidity problems. The supervisor determines that the bank's contingency funding plan is formally articulated, adequately documented, and sets out the bank's strategy for addressing liquidity shortfalls in a range of stress environments without placing reliance on lender of last resort support. The supervisor also determines that the bank's contingency funding plan establishes clear lines of responsibility, includes clear communication plans (including communication with the supervisor), and is regularly tested and updated to ensure it is operationally robust. The supervisor assesses whether, in light of the bank's risk profile and systemic importance, the bank's contingency funding plan is feasible and requires the bank to address any deficiencies.
Description and findings re EC6	The NBG asked three large banks to develop a contingency funding plan and is planning to ask small and medium banks to do the same, adequate to their size and complexity. It is also part of Basel II, Pillar 2. So far, only a few large banks have set up a contingency funding plan. However, these plans need significant improvements according to the NBG. Communication with small- and medium-sized banks in this regard is in progress.
EC7	The supervisor requires banks to include a variety of short-term and protracted bank-specific and market-wide liquidity stress scenarios (individually and in combination), using conservative and regularly reviewed assumptions, into their stress testing programs for risk management purposes. The supervisor determines that the results of the stress tests are used by the bank to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency funding plans.
Description and findings re EC7	The NBG requires systemic banks to conduct regular liquidity stress testing which are reviewed by the supervisor. Banks base their assumptions on historical experience. Based on stress test results, banks maintain a liquidity cushion for adverse market movements, analyze the potential outflow during financial distress, and analyze LCR calculations, including foreign currency. The outflow rates of the model are calculated based on the historical figures and judgment. When running an enterprise-wide stress test, commercial banks are asked to take into account how deterioration of macro parameters (and also potential outflow of wholesale funds due to breaching covenant) will affect the bank's liquidity position instantly, as well as in the next few months. For small banks with high deposit concentration rates, the shock scenario includes 100 percent outflow (in the same currency) of large deposits (e.g., top three, top five, or other,

	depending on the actual structure of concentration). Recent adjustment in LCR addresses such overconcentration risk. When summarizing the results, operational need of liquid assets in GEL/FX is taken into account as well.
EC8	The supervisor identifies those banks carrying out significant foreign currency liquidity transformation. Where a bank's foreign currency business is significant, or the bank has significant exposure in a given currency, the supervisor requires the bank to undertake separate analysis of its strategy and monitor its liquidity needs separately for each such significant currency. This includes the use of stress testing to determine the appropriateness of mismatches in that currency and, where appropriate, the setting and regular review of limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant currency individually. In such cases, the supervisor also monitors the bank's liquidity needs in each significant currency, and evaluates the bank's ability to transfer liquidity from one currency to another across jurisdictions and legal entities.
Description and findings re EC8	Although banks attract a significant part of their funding in foreign exchange, only a few banks carry out significant currency transformation (currently, maturity transformation in foreign currency is limited). Given the importance of foreign currency (high dollarization) for the Georgian system, the supervisor monitors the risks induced (currency induced credit risk, open currency position, and liquidity risk) by foreign currency actively. The scope of measurement of liquidity risk includes analysis by currency. Monthly form "A-L" reported by banks gives contractual maturity gap by currency. Although there is no quantitative liquidity requirements separately by currency (this will change after implementation of LCR), supervisors analyze the dynamics of liquidity ratios, operational liquidity requirements by currency, the NBG's internal LCR ratio by currency, liquidity GAP positions by currency, and observe the degree of reliance on interbank market. During the assessment process, the supervisor reviews bank's procedures of FX cash management and ensures that effective contingency plan of FX cash inflow is in place if needed.
Additional criteria	
AC1	The supervisor determines that banks' levels of encumbered balance-sheet assets are managed within acceptable limits to mitigate the risks posed by excessive levels of encumbrance in terms of the impact on the banks' cost of funding and the implications for the sustainability of their long-term liquidity position. The supervisor requires banks to commit to adequate disclosure and to set appropriate limits to mitigate identified risks.
Description and findings re AC1	The NBG monitors the level of pledged assets. The largest bank has approximately 4 percent of total assets encumbered (50 percent of its investment portfolio in government and central bank paper). This is considered relatively insignificant. These assets are used for monetary operation.
Assessment of Principle 24	Largely compliant

Comments	Liquidity risk assessment by the NBG covers all aspects of liquidity. The NBG analyzes banks' inherent liquidity risk as well as its mitigants. Systemic and complex banks are required to have more developed liquidity risk management framework. The analysis takes into account covenants of borrowed funds, funding structure, funding concentration (across counterparties and time), hot money issues, risks from off-balance sheet committed liabilities, competence and awareness of Supervisory Board and Managing Board, adequacy of internal controls, adequacy of models and resources. The NBG imposes a conservative liquidity requirement and is also in the process of moving toward the Basel III framework (LCR). According to the NBG, the new regulation on liquidity risk will enter into force in September 2014. However, the NBG focuses their efforts to improve the quality of liquidity risk management of banks mainly on the three largest banks. This is understandable from a risk-based supervision point of view, but there is a risk that the quality of liquidity risk management of the other banks lags behind. See further EC 4. Currently, only the three largest banks have liquidity contingency plans (that even need significant improvement according to the NBG) and conduct stress tests. Medium and small banks do not have contingency plans (yet) and a part of them conduct stress tests. See further EC 6 and 7. The assessors believe that these shortcomings will be solved in short notice, since the NBG is in the process of implementation the new regulation on liquidity (including elements of Basel II and III). Recommendations: - Continue with the finalization and implementation of draft regulation of LCR. - Consider how to make sure that all banks have adequate contingency funding planning and conduct stress tests taking into account proportionality.
Principle 25	Operational risk. The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile, and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report, and control or mitigate operational risk on a timely basis.
Essential criteria	
EC1	Law, regulations, or the supervisor require banks to have appropriate operational risk management strategies, policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk. The supervisor determines that the bank's strategy, policies and processes are consistent with the bank's risk profile, systemic importance, risk appetite, and capital strength, take into account market and macroeconomic conditions, and address all major aspects of operational risk prevalent in the businesses of the bank on a bank-wide basis (including periods when operational risk could increase).
Description and findings re EC1	The NBG has enacted the regulation on operational risk on June 13, 2014 (after the FSAP mission) and is in the process of fully implementing it. The document includes provisions for the establishment of an effective operational risk management framework at commercial banks, based largely on the Basel II requirements for the management of operational risk. Besides the requirements on the general framework, the regulation addresses topics such as

	contingency planning (availability risk), outsourcing and information security. In addition, the draft of the regulation also makes it mandatory for commercial banks to promptly notify the NBG when a "significant" operational risk event occurs at a bank. It will be up to the commercial banks to determine what comprises a "significant" operational risk event, but once the methodology is developed by the commercial banks, it will be reviewed and approved by the NBG. Although the NBG recently enacted the regulation on operational risk, it was already actively monitoring operational risks of commercial banks. The NBG requires banks to report their operational risk on a monthly basis (number of events and losses per business lines based on Basel II). And, yearly, banks are asked on voluntary basis to report their operational losses (realized, recovered, pending over the last three years). Six banks out of 21 banks already issued this report. The Operational Risk and Information Processing Division analyzes these reports and, along with the bank supervisors of the NBG, are working closely with banks to address outstanding operational risk-related issues. The NBG is also collecting and analyzing information related to the overall ORM framework of the banks. For this purpose, the NBG conducts off-site and on-site supervision.
EC2	The supervisor requires banks' strategies, policies and processes for the management of operational risk (including the banks' risk appetite for operational risk) to be approved and regularly reviewed by the banks' Boards. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.
Description and findings re EC2	The NBG requires that banks' strategies, policies, and processes for the management of operational risk be approved and regularly reviewed by the banks' Boards. This is explicitly stated in articles 7–10 of the regulation on operational risk. The NBG interviews senior management, as well as the Board members and other key personnel at banks, to determine the level of awareness, and to also check the adequacy of relevant policies/strategies, and to make sure that these documents are approved and reviewed periodically by the Board.
EC3	The supervisor determines that the approved strategy and significant policies and processes for the management of operational risk are implemented effectively by management and fully integrated into the bank's overall risk management process.
Description and findings re EC3	The NBG interviews the management of commercial banks, and on-site inspections at selected banks are conducted to see whether significant policies and processes for operational risk are implemented effectively by the management. Both middle and senior management are interviewed.
EC4	The supervisor reviews the quality and comprehensiveness of the bank's disaster recovery and business continuity plans to assess their feasibility in scenarios of severe business disruption, which might plausibly affect the bank. In doing so, the supervisor determines that the bank is able to operate as a going-concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.

Description and findings re EC4	The NBG reviews the quality and comprehensiveness of the bank's disaster recovery and business continuity plans. The NBG observed that the seven largest banks have their policy and plans in place. The other banks have only disaster recovery plans and also need to include business continuity plans. Besides reviewing the policy and the plan, the NBG (both officers from supervision and payment systems) has initiated meetings with several of the larger banks and visited the institutions on-site to check on the quality and comprehensiveness of the institutions' contingency plans. The on-site inspection included a visual/physical inspection of some of the server rooms and other related components. It is also checked whether commercial banks conduct business continuity tests and whether the tests are effective in terms of reflecting the risk of the institution based on its size and complexity. In two cases, the NBG also attended the testing. Some of the key topics that the NBG addresses within the frames of business continuity management are the existence of a secondary data center, evacuation plans, backup recovery strategies, and the plausibility of test scenarios.
EC5	The supervisor determines that banks have established appropriate information technology policies and processes to identify, assess, monitor and manage technology risks. The supervisor also determines that banks have appropriate and sound information technology infrastructure to meet their current and projected business requirements (under normal circumstances and in periods of stress), which ensures data and system integrity, security, and availability, and supports integrated and comprehensive risk management.
Description and findings re EC5	The NBG has reviewed, as well as partially inspected, information technology policies of some of the banks. In addition, information security policies have also been reviewed. Furthermore, the complexity of banks' information systems has been analyzed to a certain extent to determine the appropriateness of existing information systems. The NBG has stated that even though the investments that have been made in the area of information systems in the case of some banks are somewhat apparent, a more detailed review is needed. Lastly, the dependence of the banking system on the information technology sector has also been the subject of discussion and review. The NBG bases its supervisory approach toward information technology (including system integrity and security) on the so-called 4A framework (availability, access, accuracy, agility), that was developed at the Massachusetts Institute of Technology by George Westerman and Richard Hunter. The NBG is currently concentrating on availability, access, and accuracy risks within the Georgian banking system. With regard to access risk, the NBG works together with the Cyber Defense Unit in Georgia, which was established during the war with Russia in 2008. While penetration tests within the broader category of information systems audits are being carried out by third parties on behalf of commercial banks, the NBG is contemplating on outsourcing the penetration testing to this unit. An MoU has been set up but has not been signed yet. Currently, banks have experienced an increase in cybercrime, i.e., card-related data was stolen from six banks and fraudulent transactions based on stolen card information were observed in several countries, including the United States and Thailand. The NBG (both supervision and payment systems) is working with

	banks and the Cyber Defense Unit to address the root cause. With regard to availability, see EC 4 on business continuity and disaster recovery. With regard to accuracy NBG (both bank supervisor and risk supervisor) has started checking the accuracy of various reporting forms and the associated business processes. Also the databases that are used to generate regulatory reports are assessed in order to determine the level of accuracy risk of commercial banks. In the NBG's Operational Risk Unit, together with the line supervisors, assesses accuracy risk from a reporting perspective. The NBG asked commercial banks to reduce the complexity of their respective information systems as much as possible in order to support the effective functioning of business processes of the organization. An information technology risk management questionnaire was drafted and submitted to commercial banks in November 2011. The main purpose of the questionnaire was to gain sense of where the banks stand in terms of managing IT risk in their respective organizations. The IT risk questionnaire included detailed sections on the IT risk environment of banks, information security, internal audit, business continuity and outsourcing.
EC6	The supervisor determines that banks have appropriate and effective information systems to: (a) monitor operational risk; (b) compile and analyze operational risk data; and (c) facilitate appropriate reporting mechanisms at the banks' Boards, senior management, and business line levels that support proactive management of operational risk.
Description and findings re EC6	The NBG determines that banks have appropriate and effective information systems. It is explicitly part of their supervisory approach and covered under the financial accuracy. For this purpose, the NBG reconciles the prudential reports with the internal financial reports of the banks, and sometimes reconcile it with the data in the databases. This is done by the operational risk supervisor and the bank supervisor. Currently, the NBG stated that banks need to do more to make the internal operational risk reports more analytical in nature, in order to improve the quality of the internal risk reports. The NBG is concerned with getting the banks to create key risk indicators and scorecards, and is also trying to communicate about the need to establish risk control self-assessments.
EC7	The supervisor requires that banks have appropriate reporting mechanisms to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.
Description and findings re EC7	The NBG has developed two regular operational risk reporting forms that are based on Basel II criteria, which help to collect relevant information on operational risk losses. These reports were introduced by the NBG in October 2011 and are submitted by the banks on monthly and annual bases. The monthly report is mandatory, but the annual report is voluntary. Seven (out of 21) banks file both. In addition, the draft of the regulation makes it mandatory for commercial banks to promptly notify the NBG when a "significant" operational risk event occurs at a bank. It will be up to the

	commercial banks to determine the notification methodology as to what comprises a "significant" operational risk event, but once the methodology is developed by the commercial bank, it will be reviewed and approved by the NBG. Furthermore, several banks created elaborate risk cards based on the recommendations from the NBG. These risk cards generally encompass "material" or significant operational risk events and contain detailed information about the abovementioned events.
EC8	The supervisor determines that banks have established appropriate policies and processes to assess, manage, and monitor outsourced activities. The outsourcing risk management program covers: (a) conducting appropriate due diligence for selecting potential service providers; (b) structuring the outsourcing arrangement; (c) managing and monitoring the risks associated with the outsourcing arrangement; (d) ensuring an effective control environment; and (e) establishing viable contingency planning. Outsourcing policies and processes require the bank to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.
Description and findings re EC8	The NBG's operational risk regulation draft includes a detailed section on outsourcing activities. Besides that, the NBG maintains a catalog of outsourced activities by financial institutions and checks whether outsourced business processes are acceptable (within confined risk limits) from an operational risk and supervisory perspective. At present, the NBG is instructing systemic commercial banks to develop credible outsourcing policies, which are one of the top priorities for the NBG's Operational Risk and Information Processing Division, as many banks lack outsourcing policies. In practice, one of the larger, systemically important banks has developed an outsourcing policy at the NBG's request. At a more advanced stage, the NBG is planning to elaborate the outsourcing policy guidelines and also to take the local outsourcing environment into account. One commercial bank's outsourcing arrangement has been deemed as having an outsourcing risk that is in excess of the existing regulatory expectations on outsourcing, and the bank is currently migrating the outsourced information systems back to Georgia.
Additional criteria	
AC1	The supervisor regularly identifies any common points of exposure to operational risk or potential vulnerability (e.g., outsourcing of key operations by many banks to a common service provider or disruption to outsourcing providers of payment and settlement activities).
Description and findings re AC1	The NBG regularly reviews common points of exposure to operational risk, as well as potential vulnerabilities that arise from the common points of exposure. In 2013, the total operational loss for the banking was GEL 5 million (without taking the recovery into account, for instance,

	as the result of insurance). For instance, one of the weaknesses the NBG identified is the overreliance on the telecom sector (internet, satellite) without having formal service-level agreements, which is a source of availability risk (business continuity risk). The NBG works together with banks to address this issue.
Assessment of Principle 25	Largely compliant
Comments	The NBG made very good progress in the area of operational risk. Four years ago, there was no dedicated operational risk supervisory unit within the NBG. Operational risk was conducted within the context of the CAMEL-based supervisory framework. The establishment of a specialized operational risk unit significantly broadened the scope of operational risk supervision and expanded supervision into key areas that were not covered directly before (i.e. business continuity management and outsourcing). Also regulation on operational risk was developed in line with the Sound Principles for Operational Risk Management (Basel). On June 13, 2014 (after the FSAP mission) the NBG enacted the regulation on operational risk that yet has to be fully implemented by the banks There are some areas of improvement also recognized by NBG. First, only seven out of twenty one banks have business continuity plans (though these are the largest banks). The other banks have only disaster-recovery plans and broaden their perspective toward comprehensive business continuity plans. See further EC 4. Second, most of the banks lack adequate outsourcing policies. Although the NBG keeps a catalog of the outsourced activities. See further EC 8. Third, banks have insufficient internal reports that should according to NBG be more analytical in nature. See further EC 6. Fourth, most of the banks do not perform IT audits. This will probably change since the new regulation requires incorporation of IT audits in the overall audit plan of commercial banks. See further EC 5. The assessors expect that these shortcomings will be solved in short notice, since the regulation on operational risk is recently enacted. This will give NBG a good legal base to enforce these requirements. In short, this will help realize that not only large banks but also medium and small banks have an adequate framework for operational risk management, but all banks. Recommendation: - Make sure that all banks report their operational loss both monthly and yearly, set-up business continuity plans and outsourcing agreements (including taking the local environment into account), and conduct mandatory IT audits.
Principle 26	Internal control and audit. The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business, taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities;

	reconciliation of these processes; safeguarding the bank's assets; and appropriate independent[17] internal audit and compliance functions to test adherence to these controls, as well as applicable laws and regulations.
Essential criteria	
EC1	Laws, regulations, or the supervisor require banks to have internal control frameworks that are adequate to establish a properly controlled operating environment for the conduct of their business, taking into account their risk profile. These controls are the responsibility of the bank's Board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments (including measures for the prevention and early detection and reporting of misuse such as fraud, embezzlement, unauthorized trading and computer intrusion). More specifically, these controls address: (a) organizational structure: definitions of duties and responsibilities, including clear delegation of authority (e.g., clear loan approval limits), decision-making policies and processes, and separation of critical functions (e.g., business origination, payments, reconciliation, risk management, accounting, audit and compliance); (b) accounting policies and processes: reconciliation of accounts, control lists, information for management; (c) checks and balances (or "four eyes principle"): segregation of duties, cross-checking, dual control of assets, and double signatures; and (d) safeguarding assets and investments: including physical control and computer access.
Description and findings re EC1	The requirement for banks to have an adequate internal control system is set out under various articles in the ACB Law, supplemented by the provisions of the Regulation on Approving Regulation on Risk Management in Commercial Banks. Article 14 of the ACB Law specifies that Supervisory Councils (as elected by the shareholders or nominated by a nomination committee) must maintain an oversight function in respect of banks. Inter alia, the Supervisory Council should ensure the selection and retention of competent Directors, the establishment of the bank's business strategy, and the formulation in writing of policy on banking activities. The following acts shall be performed exclusively by the Supervisory Board: a) Starting a new type of banking activity, or terminating a current activity; b) Determining and approving the internal policy and procedures governing credit, investment, foreign exchange, assets and liabilities management, assets' evaluation and their classification, and establishment of adequate reserves for loan losses;

[17] In assessing independence, supervisors give due regard to the control systems designed to avoid conflicts of interest in the performance measurement of staff in the compliance, control and internal audit functions. For example, the remuneration of such staff should be determined independently of the business lines that they oversee.

	c) Determining and approving the amount of minimum and maximum interest rates to be used with regard to credit resources and deposits; and d) Redemption of shares by commercial bank as provided under the law. Also, Article 16 of the ACB Law stipulates that the supervisory council must establish an audit committee (see EC4 hereunder). Article 12 of the ACB Law stipulates that each bank must have a charter and be governed by internal bylaws, which should be consistent with the charter. The bylaws should deal with the following: a) The structure of the organization and administration of the bank, including its operational and administrative units, their sub-units and functions, their management positions, and reporting relationships; b) The duties of each departmental Director and the units under his supervision; c) The functions of the Audit Committee; and d) The limits of the authority of the various administrators, and other employees of the bank, to engage in banking activities in the name and for the account of the bank. The Regulation on Approving Regulation on Risk Management in Commercial Banks further develops the concept of adequate internal controls. For instance, Article 2 (1) reads: "The bank is required to analyze and design adequate control measures against those threats which may create obstacles for the bank in achievement of specific goals. Effective risk management necessarily implies management of all risks. This can be achieved if close cooperation and open communication are established among the Supervisory Board, Directorate, internal audit, external audit, and internal units of risk management. Thus, the bank has to define clear powers and liabilities for each job level pertaining to the application of risk management." Under Article 14 of the ABC Law, Directors (executive) of a bank may be a member of the Supervisory Board. Directors cannot represent a majority on the Board and cannot take part in decision making on issues relating to the executive Board. This is contrary to good cooperative governance, as an executive would be in a position to adjudicate on his own and that of his fellow executives' actions. Two banks have Executive Directors on the Supervisory Board. It is recommended that the provision be deleted from the ACB law.
EC2	The supervisor determines that there is an appropriate balance in the skills and resources of the back office, control functions, and operational management relative to the business origination units. The supervisor also determines that the staff of the back office and control functions have sufficient expertise and authority within the organization (and, where appropriate, in the case of control functions, sufficient access to the bank's Board) to be an effective check and balance to the business origination units.
Description and findings re EC2	Under the risk assessment process, the NBG reviews the effectiveness of the back-office and risk-control functions. The relevance of skill and resources is assessed, and comparisons are made between banks, with a view to establishing best practices and improving the practices of weaker systems.

	Banks supervisors monitor resourcing and qualification of the internal audit function. They review their plans and reports/recommendations of internal audit to determine whether there is adequate internal risk assessment provided for all areas of the bank's operations.
EC3	The supervisor determines that banks have an adequately staffed, permanent, and independent compliance function[18] that assists senior management in managing effectively the compliance risks faced by the bank. The supervisor determines that staff within the compliance function are suitably trained, have relevant experience, and have sufficient authority within the bank to perform their role effectively. The supervisor determines that the bank's Board exercises oversight of the management of the compliance function.
Description and findings re EC3	There are no regulatory requirements for banks to have a compliance function. In practice, however, banks will have a compliance function or compliance will be carried out by a different department, e.g., the Legal Department. The NBG monitors that the compliance function is carried out in the banks. Recently, the regulation has been amended in order to address this issue.
EC4	The supervisor determines that banks have an independent, permanent, and effective internal audit function[19] charged with: (a) assessing whether existing policies, processes, and internal controls (including risk management, compliance, and corporate governance processes) are effective, appropriate, and remain sufficient for the bank's business; and (b) ensuring that policies and processes are complied with.
Description and findings re EC4	Article 16 of the ACB law stipulates that the Supervisory Board must establish an audit committee comprising independent members. A member is deemed to be independent if he/she is not a person connected with the bank and he/she or/and his/her relatives, who fall into the first and second orders of statutory inheritance pursuant to the Civil Law Codex of Georgia, do not have financial obligations toward the bank. Subsection 3 of Article 16 states that the major function of the Audit Committee is to provide support to the bank's internal audit function and the external auditors. The Audit Committee submits reports to the Supervisory Board on its activities on a quarterly basis. Under Article 12 of the ACB Law, each bank is required to draw up a charter and internal bylaws which will establish the internal governance of the bank. The internal bylaws must establish the functions of the Audit Committee.

[18] The term "compliance function" does not necessarily denote an organizational unit. Compliance staff may reside in operating business units, or local subsidiaries, and report up to operating business line management or local management, provided such staff also have a reporting line through to the head of compliance, who should be independent from business lines.

[19] The term "internal audit function" does not necessarily denote an organizational unit. Some countries allow small banks to implement a system of independent reviews, e.g., conducted by external experts, of key internal controls as an alternative.

	The role of the internal audit function is further elaborated upon in the "Regulation on Internal Requirements for Commercial Banks." Under Article 5 of the Regulation, the following are listed as the main functions of the internal audit function: • To review the bank's internal controls system, assess adequacy and efficiency of this system, and to prepare recommendations for improving this system and to provide its monitoring; • To verify the compliance of the bank's management system, policies and strategies with the current normative acts and requirements of the National Bank; • To periodically inspect the bank's transactions, the programs and activities of each structural unit, and to define their compliance with the bank's business plans, objectives and tasks; • To assess the efficiency of usage of the bank's own resources and to report the findings to the Audit Committee; • To assess reliability and accuracy of submitted financial information, and efficiency of the procedures used for identifying, classifying and reporting such information; and • To coordinate the bank's programs in concert with the external auditors in order to verify that they are in compliance with the requirements of internal and external audit. The NBG assesses the independence and effectiveness of the internal audit function as part of the ongoing supervisory process. Meetings are held with the internal auditor and internal audit reports are reviewed. Collective meetings are also held by internal auditors. The NBG has higher expectations of the internal audit functions of larger and systemically important banks.
EC5	The supervisor determines that the internal audit function: (a) has sufficient resources and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; (b) has appropriate independence, with reporting lines to the bank's Board or to an audit committee of the Board, and has status within the bank to ensure that senior management reacts to and acts upon its recommendations; (c) is kept informed in a timely manner of any material changes made to the bank's risk management strategy, policies, or processes; (d) has full access to, and communication with, any member of staff, as well as full access to records, files, or data of the bank and its affiliates, whenever relevant to the performance of its duties; (e) employs a methodology that identifies the material risks run by the bank; (f) prepares an audit plan, which is reviewed regularly, based on its own risk assessment and allocates its resources accordingly; and (g) has the authority to assess any outsourced functions.

Description and findings re EC5	As part of its supervisory regime, the NBG assesses the effectiveness of the internal audit function, including an assessment of its independence, adequacy of resources, quality, and materiality of its reports. Part of the assessment entails a review of the level of salaries within the function. The NBG assessment also checks that the internal auditor has access to all necessary information and aware of the business risks and operations. Where issues arise within a bank it is policy of the NBG to contact the internal auditor with a view to obtaining its view on the matter. Supervisors review the internal audit plan, as well as its reports and recommendations, particularly if its recommendations have been followed through by the bank.
Assessment of Principle 26	Compliant
Comments	EC1: As a shortcoming, an executive directive should not be on the Supervisory Board, which is charged with the oversight of the executive. Accordingly, the relevant provision of Article 14 of the ACB law should be deleted. This issue also arose in Principle 14 –Corporate Governance – for which it was rated LC. For that reason, it is not being marked down under this Principle.
Principle 27	Financial reporting and external audit. The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally, and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.
Essential criteria	
EC1	The supervisor holds the bank's Board and management responsible for ensuring that financial statements are prepared in accordance with accounting policies and practices that are widely accepted internationally, and that these are supported by recordkeeping systems in order to produce adequate and reliable data.
Description and findings re EC1	According to Article 26 of the ACB Law: "Banks and their subsidiaries shall at all times maintain accurate accounts and records, and prepare annual financial statements, adequate to their respective operations and financial conditions in accordance with sound accounting practices pursuant to international accounting standards. In addition, banks shall observe form, specification level and accounting norms prescribed by regulations of the National Bank of Georgia." For financial accounting and reporting purposes, banks are required to use the IFRS as issued by the International Accounting Standards Board (IASB). For regulatory reporting purposes, banks are required to apply regulatory accounting issued by the Georgian Accounting Standards Committee, which is based on 1998 IFRS guidelines.

EC2	The supervisor holds the bank's Board and management responsible for ensuring that the financial statements issued annually to the public bear an independent external auditor's opinion as a result of an audit conducted in accordance with internationally accepted auditing practices and standards.
Description and findings re EC2	The requirement to have the banks' financial statements issued annually to the public, audited by independent external auditor, is governed by Article 27 of the ACB Law, as follows: "1. Each commercial bank and its subsidiaries shall cause their books to be audited annually by an external auditor who shall conduct each such audit in accordance with the rule established by the National Bank. (Such rules have been issued by way of the Regulation on the External Audit of Commercial Banks.) 2. Each commercial bank shall submit to the National Bank a complete report of its annual external audit as soon as it is completed, and shall publish its annual financial statement and external audit report in the official Gazette in such form as shall be provided for by the National Bank." Article 3 of the Regulation on the External Audit of Commercial Banks specifies that a bank should select an external auditor that has professional experience commensurate with its complexity, scale, and risk profile and that the audit should be carried out in accordance with international standards Article 4 obliges the external auditor to refuse the provision of any service that would compromise its independence and impartiality in line with the International Federation of Accountants (IFAC) Code of Ethics.
EC3	The supervisor determines that banks use valuation practices consistent with accounting standards widely accepted internationally. The supervisor also determines that the framework, structure, and processes for fair-value estimation are subject to independent verification and validation, and that banks document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes.
Description and findings re EC3	The Regulation on External Audit of Commercial banks requires that the annual financial statements are prepared in accordance with IFRS and are audited by an independent external auditor. In accordance with the Law on Accounting and Auditing, external auditors are licensed by the Georgian Federation of Professional Accountants and Auditors (GFPAA). The latter is the accredited professional body for accountants in Georgia and a member of the IFAC. It is a private sector initiative. Also, as per the above mentioned Regulation, banks are required to have their annual statements audited in accordance with the International Standards on Auditing. The independent verification and validation of the regulatory reporting is the responsibility of the NBG. It has a number of IFRS-trained persons on its staff. The use of fair valuation is very limited—there is very little trading activity, so assets are valued on a hold-to-maturity basis for the purpose of prudential reporting. However, new regulations on the trading book require banks to have internal procedures for distinguishing between trading and held-to-maturity securities/instruments and relevant measurement principles.

	Real estate is valued under Georgian GAAP in the same way as under IFRS. However, for regulatory purposes, all gains from revaluations on real estate property (whether for own use of held as investment) are not taken into account for the calculation of regulatory capital. The real estate specialist within the specialized groups (Credit Risk Division) checks the valuation for IFRS purposes used by the banks. Currently, the NBG monitors the gap between regulatory and IFRS-based reporting, although as indicated above, the fair value valuation of assets/liabilities are limited for reasons stated above. With the introduction of IFRS for prudential reporting purposes, this gap will be eliminated and relevant prudential filters will be introduced.
EC4	Laws or regulations set, or the supervisor has the power to establish the scope of external audits of banks and the standards to be followed in performing such audits. These require the use of a risk and materiality based approach in planning and performing the external audit.
Description and findings re EC4	The NBG does not have the power to define the scope and guidelines of the external auditor's work, but it can require the bank being audited to request the auditor to undertake special audits, etc. However, the Regulation on the External Audit of Commercial Banks stipulates that the external audit must comply with the international auditing standards of The International Auditing and Assurance Standards Board (IAASB). Such standards require the use of a risk and materiality based approach in planning and performing the external audit. The NBG has the power to require additional explanations from the external auditor to judge whether audits were performed in line with International Standards on Auditing and whether statements are based on the IFRS. If the auditor fails to meet the requirements, the NBG has the power to require banks to replace the external auditor. The NBG has intensified the collaboration with external auditors. Through these meetings, the NBG would, for example, signal the main risk indicators and thus have an influence on the scope and quality of audit work. For all but two of the smallest banks, the banks' auditors are one of the "Big 4." In some cases, the audit team will comprise local and foreign personnel. The oversight of accounting and auditing is underdeveloped in Georgia. There is no effective quality control for either accounting or auditing. The current representative body, Georgia Federation of Professional Accountants and Auditors, is a private sector initiative and does not have the resources to carry out quality controls of either accountants or auditors. The situation regarding the banks is different in that the NBG checks adherence to IFRS rules and almost all banks are audited by the "Big 4,"which would have their own internal assurance regimes.
EC5	Supervisory guidelines or local auditing standards determine that audits cover areas such as the loan portfolios, loan loss provisions, nonperforming assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, consolidation of, and other involvement with, off-balance sheet vehicles, and the adequacy of internal controls over financial reporting.

Description and findings re EC5	The Regulation on the External Audit of Commercial Banks stipulates that the external audit should comply with the international auditing standards ensuring that the scope of the audit would cover all areas which, from a risk materiality point of view, are relevant. In practice, this implies that all the above-mentioned areas, if relevant, will be part of the audit scope.
EC6	The supervisor has the power to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject, to or does not adhere to, established professional standards.
Description and findings re EC6	Article 5 of the Regulation on External Audit of Commercial Banks gives the NBG such powers. To date, there has not been a need to exercise it.
EC7	The supervisor determines that banks rotate their external auditors (either the firm or individuals within the firm) from time to time.
Description and findings re EC7	Rotation requirements are not in place at the moment. The NBG has not yet come up with a clear view on what would be the impact of such rotation requirements in terms of the trade-off between costs and independence. It does, however, monitor the rotation pattern of the engagement partners, which in practice takes place quite frequently. The current average engagement period is two years.
EC8	The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.
Description and findings re EC8	In recent years, the NBG has intensified its communications with the external auditors. Such meetings discuss areas of common interest as well as the possibilities of collaboration. The NBG proposes to intensify such collaboration in the future. The NBG does not have the power to meet with the external auditors to discuss their reports without the bank's approval. This is only allowed with the bank's prior written approval. The NBG says that, in practice, there are no constraints in getting such approval.
EC9	The supervisor requires the external auditor, directly or through the bank, to report to the supervisor matters of material significance, for example, failure to comply with the licensing criteria or breaches of banking or other laws, significant deficiencies and control weaknesses in the bank's financial reporting process, or other matters that they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations provide that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.
Description and findings re EC9	Article 4 of the "Regulation on External Auditing of Commercial Banks" states that if during the normal audit process the auditor comes across any matters of as stated below, the auditor shall no later than five business days after identification provide the NBG with: a. Information that indicates a failure to fulfill one of the requirements for a banking license, in accordance with Law on Commercial Banks;

	b. Information on a serious conflict with the decision-making bodies or unexpected departure of a manager in a key position; c. Information that may indicate a material breach of laws and regulations or the Bank's articles of association, charter, or by-laws; d. Information about the intention of Auditor to resign or removal of the Auditor from the office; and e. Information on any material adverse changes in the risks of the bank's business and possible risks going forward. In practice, the NBG has not received any such notifications, but, recently, it communicated with banks and external auditors, reminding them of such requirements and of the NBG's expectation on what matters would be deemed necessary to notify promptly upon observance. With regard to auditors, who report to the NBG in good faith and have not been held liable for breach of a duty of confidentiality, the NBG undertakes in writing that it will not use information provided by auditors against the auditors, and that the fact that they provided it with information would not mean a breach of confidentiality.
Additional criteria	
AC1	The supervisor has the power to access external auditors' working papers, where necessary.
Description and findings re AC1	The NBG has such power.
Assessment of Principle 27	Compliant
Comments	EC8: The NBG should not have to require the permission of the bank to meet with the external auditor. While such permission seems to be invariably forthcoming, the NBG should not have to seek prior approval. However, this issue was addressed recently. EC9: The auditor has up to five business days in which to notify the NBG of any matters of serious significance that comes to his/her attention. That period is too long. Recently, the regulation has changed, which requires the auditors to report immediately.
Principle 28	Disclosure and transparency. The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies, and corporate governance policies and processes.
Essential criteria	
EC1	Laws, regulations, or the supervisor require periodic public disclosures of information by banks on a consolidated and, where appropriate, solo basis that adequately reflect the bank's true financial condition and performance, and adhere to standards promoting comparability, relevance, reliability, and timeliness of the information disclosed.

Description and findings re EC1	Disclosure requirements are dealt with in three pieces of legislation: the ACB law; the Regulation on Transparency of a Commercial Bank's True Financial Condition and Performance; and the Regulation on External Audit of Commercial Banks. Article 27(2) of the ACB Law stipulates that each bank shall submit to the NBG a complete report of its annual external audited report as soon as it is completed, and shall publish its annual financial statement and external audit report in the Official Gazette in such form as shall be provided for by the NBG. Publication must be undertaken within four and a half months after the year's end. The annual audited consolidated financial statements are based on IFRS and must incorporate the disclosure requirements of IFRS. They are published on the website of both the commercial banks and the NBG. The disclosure in the commercial banks' website includes their risk governance practices as well. The NBG requires banks to disclose certain quantitative information in the annual accounts, e.g., capital adequacy, liquidity, profitability, nonperforming loans to total loans, loan-loss reserves to total loans, foreign exchange loans to total loans, foreign exchange assets to total assets, and annual loan growth rate. However, its requirements relating to qualitative disclosures are very limited and relate only to ownership structures, i.e., details must be given on all shareholders owning more than 1 percent stake in the bank and all beneficial owners, owning more than 5 percent stake in the bank. For qualitative disclosure, the NBG relies on the fact that annual accounts are prepared in accordance with the IFRS and accordingly comply with the transparency requirements of IFRS 7 (disclosure of the significance of financial instruments, the nature and extent of the risks arising from them and how entities might mitigate these risks). In the context of the introduction of Basel II and III, the NBG will require, in addition to the IFRS, disclosures under Pillar III of Basel II and additional local disclosures relating to consumer protection issues. Apart from the annual accounts, the Regulation on Transparency of a Commercial Bank's Financial Condition requires banks to publish quarterly unconsolidated accounts based on local GAAP. These accounts contain quantitative disclosures and a limited amount of qualitative disclosures. The NBG is also encouraging banks to disclose details of certain significant risk indicators on their websites. It held a recent conference on lending standards, where the banks agreed to discuss the possibility of additional public disclosures of their lending standards in corporate, SME, and retail exposures, highlighting key ratios and limits and their importance in the overall credit risk management framework. Such disclosures would be published on the websites of commercial banks.

EC2	The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance, and remuneration. The scope and content of information provided, and the level of disaggregation and detail, is commensurate with the risk profile and systemic importance of the bank.
Description and findings re EC2	As indicated in EC1 above, the NBG requires banks to disclose quantitative information in both the annual and quarterly accounts, but only a limited amount of qualitative data. For the latter, and pending the introduction of Basel II/Pillar III, the NBG relies on IFRS 7 disclosure requirements. The supervisor monitors whether the disclosed information is comprehensive and commensurate with the risk profile and systemic importance of banks. With the implementation of Basel II/III, the NBG is working on updating the Transparency Regulation. This would entail making Pillar 3 disclosures, as well. Also, as indicated in EC1 above, the NBG is encouraging the banks to disclose additional information on their lending standards, highlighting key ratios and limits and their importance in the overall credit risk management framework.
EC3	Laws, regulations, or the supervisor require banks to disclose all material entities in the group structure.
Description and findings re EC3	The annual audit financial statements of the banks must disclose information on subsidiaries and affiliates, as well as on the ownership structure.
EC4	The supervisor or another government agency effectively reviews and enforces compliance with disclosure standards.
Description and findings re EC4	The supervisor reviews both the quantitative and qualitative information in the annual accounts.
EC5	The supervisor, or other relevant bodies, regularly publishes information on the banking system in aggregate to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).
Description and findings re EC5	The aggregated financials (balance sheet and income statement), as well as financial soundness indicators of the banking system, are published and updated on a monthly basis on the NBG website. The annual report of the NBG provides additional insights into the main trends in the banking sector, the main risks to which banks are exposed, and ongoing regulatory reforms.
Additional criteria	
AC1	The disclosure requirements imposed promote disclosure of information that will help in understanding a bank's risk exposures during a financial reporting period, for example, on average exposures or turnover during the reporting period.

Description and findings re AC1	The purpose of the disclosure requirements, as set out by the NBG and IFRS 7, is to help in an understanding of a bank's risk exposure.
Assessment of Principle 28	Largely compliant.
Comments	The banks are required to publish annual audited consolidated accounts based on IFRS and solo quarterly accounts based on local GAAP. Both must be accompanied by quantitative and qualitative commentary, the latter largely based on the disclosure requirement of IFRS 7 in the case of the annual accounts. Pending the introduction of Basel II/Pillar III, there will be a more structured approach to qualitative disclosures, which will embrace IFRS 7, Pillar III, and additional local requirements relating to consumer protection issues.
Principle 29	Abuse of financial services. The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector, and to prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Essential criteria	
EC1	Laws or regulations establish the duties, responsibilities, and powers of the supervisor related to the supervision of banks' internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
Description and findings re EC1	**Regulatory framework**. Under Article 3 (3) (i) of the NBG Law, the duties of the NBG include supporting the prevention of illicit income and terrorism financing in cooperation with the FMS - see hereunder. This is supplemented by the issue by the NBG of the "Methodology of On-Site Auditing of Banks on the Issues of Fight Against Money Laundering," which highlights the responsibility of the NBG, with respect to the supervision and inspection of the banks' procedures and policies, for the prevention of money laundering and terrorist financing. The FMS serves as the national focal point for receiving and disseminating Suspicious Transaction Reports (STR) and other money laundering related information. Banks are required (Article 9 of the AML Law) to submit STRs to the FMS. Pursuant to Article 9(5) of the AML Law, the FMS can pass on STRs and related material to the Chief's Prosecutor's Office and the Ministry for Internal Affairs (in relation to terrorist financing) where there are grounds to suspect that criminal activities related to money laundering have been carried out. The FMS is an independent body under the auspices of the NBG. Essentially that means that the NBG finances its activities but that it sets its own budget. However, legislation is at an advanced stage that will transfer the FMS from under the auspices of the NBG to the Office of the Prime Minister. This will mean that the FMS will be no longer funded by the NBG but out of general government funds.

	It was put to the assessors that the reason for the change related to the constitutional changes of 2012. Pre-2012, the state president had executive powers, one of which involved the Head of the FMS reporting to him. Post 2012, the role of the president became largely ceremonial and power was vested in the prime minister. It was logical, therefore, to have the FMS report to the prime minister. Both Transparency International and Moneyval have expressed some concerns about the move. Their concerns relate to the continued independence of the FMS. Under Article 11(1) of the AML Law and Article 14 (1) of the FMS Regulation on Commercial Banks, the NBG is responsible for the supervision and monitoring of commercial banks for AML/CFT purposes. Article 48 of the NBG Act empowers the NBG to supervise and audit commercial banks, and where signs of crime are detected, the evidence must be passed to the FMS. These powers are supplemented by Article 29 of the ACB Law, which allows the NBG to examine all books, accounts, funds, files, and other documents of banks and their subsidiaries. Implicit in these laws is the ability of the NBG to supervise banks' internal control mechanisms. The NBG has a dedicated Money Laundering and Special Inspection Department. It employs 16 persons. Apart from banks, this department is responsible for money laundering inspections of nonbanks institutions, currency exchange bureaus, insurance companies, microfinance organizations, money remittance service providers, broker companies, and securities registrars. In total, 1,150 institutions/entities are covered, of which the largest part are currency exchange bureaus. The Department uses a risk-based approach and, in consequence, a large part of its resources are used in inspecting banks. For instance, in the case of a commercial bank with a high risk category, inspections are carried out every two to three years. The requirement for financial institutions to maintain internal controls is provided for in Article 8 of the AML Law. This provision is further elaborated upon in the decree issued by the FMS for commercial banks, "Approval of the Regulation on Receiving, Systemizing and Processing the Information by Commercial Banks and Forwarding to the Financial Monitoring Service of Georgia." **Enforcement** Under Article 30 (2) of the ABC Law, the NBG is authorized to impose the following actions and sanctions with respect to banks, their administrators, and controlling persons if any of them are guilty of an infraction. See EC 8 for full details of sanctions. **Inspection regime** The AML regime is governed by two documents—an inspection manual and a policy document dealing with methodology of inspections. The inspection manual sets out the goals and scope of the inspection, inspection norms and procedures relating to internal controls, "know your client," role of internal auditor, AML staff training, etc. The methodology policy document is quite detailed about the carrying out of inspections. Inter alia, it sets down the frequency of inspections—for banks with a high level of risk, their inspection frequency is every 2–3 years; for banks with an average or low level of risk, every 3–4 years. The document also specifies the

	duration of the inspection and the numbers of inspectors that should be involved: • Large-sized bank – duration: 5–6 weeks with five inspectors. • Medium-sized bank – duration: 3–4 weeks with 2–3 inspectors. • Small sized banks- duration: 2–3 weeks with two inspectors. Both the NBG and the FMS say that these commitments are honored. The banks visited also reported frequent AML inspection visits.
EC2	The supervisor determines that banks have adequate policies and processes that promote high ethical and professional standards, and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity and reporting of such suspected activities to the appropriate authorities.
Description and findings re EC2	**Requirements for internal policies and processes** The requirement for financial institutions to establish internal policies and procedures on AML is set out in Article 8 of the AML Law ("Obligations of Monitoring Entities to Implement Internal Control"). Article 8.1 sets out that financial institutions are required to ensure the implementation of internal control for the purpose of preventing illicit income legalization. Article 8.2 further provides that financial institutions shall be obliged to develop internal regulations (internal control procedures) and take adequate measures for their enforcement. Such internal regulations shall include "established rules and procedures for identification of clients and persons willing to establish business relationship, analyzing information, revealing suspicious transactions within the monitoring entity, and rules and procedures for transfer of information to the FMS in conformance with requirements of this Law and normative acts of the FMS and with consideration of work specificity of monitoring entities." Moreover, Article 8, paragraphs. 2, 4, and 5 of the AML Law include a direct mandatory obligation for monitoring entities to identify and designate the relevant staff member in charge, or a structural unit responsible for: a) the implementation of the internal regulation, in compliance with the procedure and frequency defined under the regulation; and b) to submit written information on the transactions subject to monitoring to the management body of the monitoring entity, in compliance with the procedure and frequency defined under the regulation (Articles 8.4 and 8.5 of the AML Law of Georgia). Commercial banks under AML legislation have the obligation to report transactions above threshold of GEL 30,000— automatic reporting and to report suspicious transactions. Definition of the suspicious transaction is provided in the AML Law. **Powers to verify compliance with policies and processes**. The NBG has a range of powers to monitor and ensure commercial bank's compliance with AML measures, including powers of off-site surveillance, auditing, and on-site visits and inspections. Supervisory powers are performed in accordance with the NBG Law. The NBG's main powers and authority are defined under the NBG Law and supplemented by appropriate

	provisions from the sector-specific legislation. The NBG is authorized to receive any information within its own competence from financial institutions, even if it concerns confidential information, and is authorized to impose appropriate penalties in case of non-submission of requested information by financial institutions. Supervisory inspections are conducted on the basis of targeted AML inspections, and all inspections are carried out on a surprise basis without notification to the financial institutions. The NBG's Banking Supervision Department is responsible for supervising the banking sector, including AML/CFT risks in general. The NBG has a dedicated unit for AML on-site inspection. Currently, it has a staff of 18. The unit is responsible to conduct AML/CFT on-site inspection of a commercial bank. In order to strengthen the supervision framework, the NBG has introduced a systematic AML/CFT off-site monitoring. In 2011, the NBG adopted the AML/CFT policy document on supervision; it has set out its off-site monitoring function using a risk-based approach to monitor the ML/TF risk profile of financial institutions. The document also includes a questionnaire which financial institutions are required to complete to provide NBG with off-site information on institutions' AML/CFT policies and procedures, training programs, rules for monitoring transactions, and information on the AML/CFT officer. The policy document also sets out guidelines on the coordination between the off-site and on-site functions for more effective supervision. The requirement to develop a supervisory plan of on-site examinations was also introduced in 2011.
EC3	In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when such activities/incidents are material to the safety, soundness, or reputation of the bank.
Description and findings re EC3	There is no explicit obligation on banks to report to the NBG suspicious activities and incidents of fraud where such activities/incidents are material to the safety, soundness, or reputation of the bank. Banks are only required to report to the FMS.
EC4	If the supervisor becomes aware of any additional suspicious transactions, it informs the financial intelligence unit and, if applicable, other designated authority of such transactions. In addition, the supervisor, directly or indirectly, shares information related to, suspected or actual, criminal activities with relevant authorities.
Description and findings re EC4	The NBG closely cooperates with FMS. Before conducting an on-site visit, the NBG consults with the FMS on any issues related to the financial institution to be inspected. In case of any suspicion, the NBG will forward information to the FMS. A MOU has also been concluded between the FMS and the NBG. Also, in accordance with the ACB Law, in the event of an inspection revealing elements of crime, the NBG forwards this information to the law-enforcement agencies.

EC5	The supervisor determines that banks establish CDD policies and processes that are well documented and communicated to all relevant staff. The supervisor also determines that such policies and processes are integrated into the bank's overall risk management and there are appropriate steps to identify, assess, monitor, manage, and mitigate risks of money laundering and the financing of terrorism with respect to customers, countries, and regions, as well as to products, services, transactions, and delivery channels on an ongoing basis. The CDD management program, on a group-wide basis, has the following essential elements: (a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks; (b) a customer identification, verification, and due-diligence program on an ongoing basis; this encompasses verification of beneficial ownership, understanding the purpose and nature of the business relationship, and risk-based reviews to ensure that records are updated and relevant; (c) policies and processes to monitor and recognize unusual or potentially suspicious transactions; (d) enhanced due diligence on high-risk accounts (e.g., escalation to the bank's senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship becomes high-risk); (e) enhanced due diligence on PEPs (including, among other things, escalation to the bank's senior management level of decisions on entering into business relationships with these persons); and (f) clear rules on what records must be kept on CDD and individual transactions and their retention period. Such records have at least a five-year retention period.
Description and findings re EC5	**Relevant detailed legal requirements** Under Article 4(3) of FMS Regulation on Commercial Banks, banks are required to establish in written form internal procedures and regulations which shall contain: procedures for the identification of a bank's clients, agents, and representatives; their beneficial owners; a procedure for ascertaining PEPs and measures that should be exercised against them; special procedures for revealing transactions that require monitoring; and procedures for exercising permanent and ongoing monitoring of business relationships with the client. All employees of the bank are required to be acquainted with the internal regulation. Also, under Article 6 (22) of FMS Regulation on Commercial Banks, banks are required to have in place an appropriate risk-management system for the identification and verification of such clients whose activity may pose a high risk of money laundering/terrorist financing, and shall exercise enhanced identification, verification, and enhanced monitoring procedures with respect to them. The identification and verification procedures shall be conducted on a risk-based approach depending on the type and nature of the client, business relationship, and product/service risk or the transaction.

	Under Article 6 (23) of the Regulation, banks also have a duty to pay special attention to any threats that may arise from new technologies, products, and services that might favor anonymity, and take all measures to prevent their use in money laundering/terrorist financing. **Inspection regime** The NBG on-site inspection manual contains a section on money laundering. Specifically the section deals with: • "know your client" policy; • the evaluation of the internal control system (identification of client, analysis of information concerning the client, and the transfer of the documentation and suspicious transactions, etc.); • the evaluation of the rights and obligations of an employee/structural unit responsible for the identification and monitoring of money laundering risks; • the operations and services made; • the systemization and storage of documentation and information; • the policy and practice of internal audit; and • the study program (trainings) of bank employees. The AML regime is governed by two documents—an inspection manual and a policy document dealing with methodology of inspections. The inspection manual sets out the goals and scope of the inspection, inspection norms and procedures relating to internal controls, "know your client," role of internal auditor, and AML staff training, etc. The methodology policy document is quite detailed about the carrying out of inspections. Inter alia, it sets down the frequency of inspections—for banks with a high level of risk, their inspection frequency is every 2–3 years; for banks with an average or low level of risk, every 3–4 years. The document also specifies the duration of the inspection and the numbers of inspectors that should be involved: • Large-sized bank – duration: 5–6 weeks with five inspectors. • Medium-sized bank – duration: 3–4 weeks with 2–3 inspectors. • Small sized banks- duration: 2–3 weeks with two inspectors. Both the NBG and the FMS say that these commitments are honored. The banks visited also reported frequent AML inspection visits. The NBG verifies that the banks comply with all relevant AML laws during the inspection visits. The AML inspection annual sets out the methodology relating to such compliance. It involves, inter alia, speaking to the FMS in advance of the visit, interviewing bank management/relevant staff/money laundering officer/ internal auditor, etc., reviewing relative files, assessing training programs and their implementation. The assessors were taken through a number of AML inspection reports/presentations which provided evidence that the NBG was fulfilling its obligations in this area. Also, the banks visited were highly aware of their AML obligations and verified that inspections AML inspections had taken place in line with the NBG inspection

	program. The following AML inspections of banks took place over the last number of years: 7 in 2011; 3 in 2012; 10 in 2013; 4 in first quarter of 2014. With specific reference to the essential elements identified in EC5, the following is the position: ***(a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks;*** Under Article 4.4(a) of the FMS Regulation on Commercial Banks, banks' internal controls should include policies and procedures for the identification and verification of clients, their representatives, agents, and beneficial owners. ***(b) a customer identification, verification and due diligence program on an ongoing basis; this encompasses verification of beneficial ownership, understanding the purpose and nature of the business relationship, and risk based reviews to ensure that records are updated and relevant***; Under Article 4.4 (d, f) of the FMS Regulation, banks' internal regulations are required to contain terms and procedures for exercising the monitoring of business relationships with the client on an ongoing basis. Under Article 6 (21), the monitoring of business relationships on an ongoing basis includes: a) Maintaining current information and records relating to the client and its beneficial owner; b) Updating periodically existing identification data and ensuring their conformity with current norms; and c) Scrutiny of transactions in order to establish that the conducted transaction is consistent with its knowledge of the client, client's business, or personal activity or risk profile and, where necessary, the source of property (including funds). To strengthen the understanding of the financial sector in this area, the NBG has adopted two guidelines – Guidelines on a Risk-based Approach for AML/CFT Purposes and Procedures to Identify and Verify Ultimate Beneficial Owners. ***(c) policies and processes to monitor and recognize unusual or potentially suspicious transactions;*** AML law defines the term "unusual transaction" and "suspicious transaction." Article 5.9 of the AML Law requires all monitoring entities, *inter alia,* "to pay special attention to unusual transactions. Article 2.h (1) of the Law defines unusual transaction as "complex, unusual large transaction, also types of transactions, which does not have apparent or visible economic (commercial) content or lack lawful purpose and is consistent with the ordinary business activity of the person involved therein." A suspicious transaction is essentially defined as a transaction (regardless of its amount and operation type) supported by reasonable grounds to suspect that it has been concluded or implemented for the purpose of legalizing illicit income or/and property.

	Under Article 4.2 (d) of the FMS Regulation, banks' internal controls should include procedures for recognizing transactions which should be monitored for AML/CFT purposes. This includes the creation of an electronic database for identifying suspicious and/or unusual transactions and/or transactions aimed at partition. Article 5.9 of the AML Law and FMS decrees that banks require relevant financial institutions to "ascertain the purpose of the transaction within the scope of their capability and register obtained results in writing." Article 5.10 of the AML Law also requires the monitoring of entities to "determine themselves the principles for identifying unusual transactions of persons having business relationship with them." Moreover, Article 4.5(a) of the FMS Regulation establishes banks' obligations that decisions on considering transactions as suspicious, unusual, and/or aimed at partition of the transaction, shall be made in each particular case on the basis of the information obtained through identification and servicing clients and other relevant persons by the respective structural units of the bank, as well as on the basis of information already existing in the bank. ***(d) enhanced due diligence on high-risk accounts (e.g., escalation to the bank's senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship becomes high-risk);*** Article 2.e of the AML Law defines a watch zone or a non-cooperative zone as a "country or a part of the territory" "identified as such on the basis of the information provided by competent international organization, or if the grounded supposition exists that in such zone weak mechanisms for controlling illicit income legalization are effective." Competent international organizations are determined under Article 2.f of the AML Law as "the Council of Europe, FATF, and other organizations recognized as such by the international community." Article 5.2 requires commercial banks to monitor suspicious transactions, and those that are concluded or implemented by the person and/or series of concluded or implemented transactions resulting from partition of the transaction, if its amount or the series of transactions exceeds the threshold of GEL 30,000 or its equivalent in another currency. The AML Law requires banks to pay special attention to limited transactions related to watch (or non-cooperative) and suspicious zones. The List of Watch Zones is adopted by the NBG based on the information provided by the FMS. Under Article 6 (22) of the FMS Regulation, a bank shall conduct an enhanced due diligence on a client (whether potential or an existing client) whose activity may pose a high risk of money laundering/terrorist financing. To this end, a bank must take the following steps: a) Obtain permission from the senior management of the bank to establish a business relationship with such a person; b) Take reasonable measures to ascertain the origin of funds or property of such person; c) Perform enhanced monitoring over its business relations with such person.

	(e) enhanced due diligence on politically exposed persons (including, among other things, escalation to the bank's senior management level of decisions on entering into business relationships with these persons); Article 6(1) of the AML/CFT Law requires financial institutions to identify whether clients or their beneficial owners belong to the category of PEPs. The definition of a PEP is given in Article 2(v) of the AML/CFT Law: "Politically Exposed Person (PEP): foreign citizen, who has been entrusted with prominent public functions in a respective country and carries out significant public and political activities. They are: head of state or of government, member of government, their deputies, senior official of government institution, member of parliament, member of the supreme courts and constitutions court, high ranking military official, member of the central (national) bank's council, ambassador, senior executive of state-owned corporation, political party (union) official and member of executive body of the political party (union), other prominent politician, or their family members, as well as persons having close business relations with them; a person shall be considered as politically exposed during a year following his/her resignation from the foreign position." Pursuant to Article 6-1(2) of the AML/CFT Law, if a monitoring entity is having a business relationship with a customer classified as a PEP (or his/her beneficial owner), it is required to "obtain permission from the management to establish a business relationship with such person." In addition, the AML /CFT Law also includes a new provision in relation to the existing customers. If an existing customer (or his/her beneficial owner) becomes a PEP after the business relationship is established, Article 6(3) requires the financial institution to follow the same steps described for new customers categorized as PEPs, including with respect to management approval. The AML Law requires monitoring entities "to take reasonable measures to establish the source of wealth (including funds) of PEPs and their beneficial owners. Pursuant to amended Article 6.1.2(c) of the AML Law, financial institutions should perform enhanced monitoring over its business relationship with such persons. Under Article 4.4(b) of the FMS Regulation, banks' internal regulations are required to include a special procedure for ascertaining PEP and exercising the following measures against them: "In addition to the identification and verification requirements, banks' authorized officer shall: a) Obtain permission from the management of bank to establish business relationship with such person; b) Take reasonable measures to ascertain the origin of funds, property of such person; and c) Perform enhanced monitoring over its business relations with such person."

	Apart from that, a bank must have special procedures based on which it ensures obtaining respective information from the client, as well as from public sources or respective electronic databases for the purpose of ascertaining and verifying PEP. ***(f) clear rules on what records must be kept on CDD and individual transactions and their retention period. Such records have at least a five year retention period.*** Article 7(3) of the AML Law requires monitoring entities to retain information (documents) on transactions, as well as records related to unusual transactions and transactions from banks, insurance companies, and broker companies with watch zones and suspicious zones, regardless of whether the transactions have been executed in the name of their client or third parties, "for at least six years from the moment of concluding or implementing the transaction, if there is no request from the respective supervisory authority for retaining that information for a longer period of time." Additionally, Article 6.6 of the AML Law requires monitoring entities to record information "on the content of the transaction subject to monitoring, date, and place of the transaction," as well as the amount and the document used to identify the person involved in the transaction, and to identify the person on whose order the transaction is concluded or undertaken. In the case of a transaction made on behalf of a third person, the monitoring entity should also keep information (documents) to identify the person by whom the transaction is being undertaken. Article 7.4 of the AML Law added that the documentation should be recorded and filed "in a way where all its data fully reflect the concluded or implemented transactions and, when needed, can be submitted to the respective supervisory body in a timely manner, and in the event of criminal prosecution, is used as evidence." The AML Law and the FMS Regulation elaborates on this obligation, enumerating the sort of information necessary to be recorded on transactions. Under Article 4.4(d) of the FMS Regulation, banks' internal regulation must include procedures for recording, systemizing, and filing of information related to the monitoring. In respect of recording of information, Article 11 lays down an obligation that banks should keep information presented for identification of a client in an electronic or documentary form, as well as other information on transaction, account files of the client, and business correspondence and relevant records concerning unusual transactions and transactions in connection with non-cooperative zones, for a period not less than six years from the moment of ending a business relationship with such client, unless the NBG sets a longer term for the retention of such information or/and the Georgian legislation sets a longer term for the retention of such information. Apart from the afore-mentioned obligation, there is a requirement that the information retained in the bank shall fully reflect the performed transaction and persons involved. In addition, information shall be systemized, recorded, and maintained in a way that, when needed (in the case of submission to the NBG or FMS in a timely manner or using as evidence in criminal proceedings), it can be found and retrieved in a shortest period of time.

	(Note: the legal definition in Georgian legislation for a "Politically Exposed Person" (PEP) describes him/her as a "foreign citizen." This was the same definition used by FATF before 2012. In 2012, FATF amended the definition to include both foreign and domestic citizens. It is recommended that Georgia adopts the new definition.)
EC6	The supervisor determines that banks have, in addition to normal due diligence, specific policies and processes regarding correspondent banking. Such policies and processes include: (a) gathering sufficient information about their respondent banks to fully understand the nature of their business and customer base, and how they are supervised; and (b) not establishing or continuing correspondent relationships with those that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.
Description and findings re EC6	Under Article 8 of the FMS Regulation on Commercial Banks, in the course of establishing international correspondent relations, banks shall obtain information from public sources on the reputation of the respondent bank and the quality, adequacy, and efficiency of supervision imposed thereon, as well as ascertaining whether the bank represents monitoring entity in light of fighting against ML/TF. Banks shall request from the respondent bank information on exercising internal control by the latter, with respect to fighting against ML/TR, and assess the quality of such control. Moreover, banks shall be prohibited from establishing correspondent relations with shell banks. They shall undertake reasonable measures to identify: a) whether the person they have a business relationship with (or the person with whom they are establishing business relations) belongs to the category of the shell bank; and b) whether the person they have a business relationship with (or the person with whom they are establishing business relations) has relations with the shell bank. Article 6.6 of the FMS Decree requires Georgian banks to request from respondent banks information on internal controls, with respect to ML/FT risks. The new FMS Decree No. 4 maintains the requirement in Article 8, including the obligation to request information regarding the degree of internal controls applied to ML/FT risks. Pursuant to Article 8.4.(c) of Instruction 24 NBG, in order to open a cross-border correspondent account, it is necessary to provide "documentation that reflects the policy of the bank against the legalization of illicit income and financing terrorism, and a standard questionnaire will be developed by the bank where the account is being opened." Article 8.2 of the new FMS Decree No. 4 for commercial banks require the "authorization of the bank Directorate (curator Director) of a bank to establish a correspondent relationship," and Article 8.6 of the Instruction 24 NBG contains the same provision. Commercial banks are obliged to present information on every respondent institution to the NBG. Moreover, the NBG receives monthly reporting from each commercial bank, where all correspondent accounts are defined in detail.

EC7	The supervisor determines that banks have sufficient controls and systems to prevent, identify, and report potential abuses of financial services, including money laundering and the financing of terrorism.
Description and findings re EC7	Under Article 6(22) of the FMS Regulation, banks shall have in place the appropriate risk management system for the identification and verification of clients whose activity may pose a high risk of ML/TF and shall exercise enhanced identification, verification, and enhanced monitoring procedures with respect to them. The identification and verification procedure shall be conducted on a risk sensitive basis depending on the type and nature of the client, business relationship, product/service risk, or the transaction. Moreover, under Article 4.4(a,b,e,f) of the Regulation, a bank is required to develop an internal regulation which shall contain procedures for the identification of the bank's clients, their beneficial owners, a procedure for ascertaining PEPs and exercising measures against them as it is provided for in the Regulation, special procedures for revealing bank transactions subject to monitoring, rules for submission of reporting forms and other relevant materials to the FMS, and terms and procedures for exercising permanent and ongoing monitoring of business relationships with the client.
EC8	The supervisor has adequate powers to take action against a bank that does not comply with its obligations related to relevant laws and regulations regarding criminal activities.
Description and findings re EC8	Under Article 15(5) of the AML Law, Article 14(2) of the FMS Regulation and Article 1.2(d) of Decree N304 of President of NBG on approving "Regulation on Determining and Imposing Pecuniary Penalties on Commercial Banks" (hereinafter – Regulation on Pecuniary Penalties), the NBG is authorized to sanction (including fiscal penalties) banks, in cases where they do not fulfill their duties (including the development and implementation of internal controls) prescribed by AML Law and Regulation. Under Articles 30(2)(d) and (3) of the Law on the Activities of Commercial Banks, the NBG is authorized to impose sanctions on a bank that does not comply with its obligations prescribed by AML Law, Regulation and respective written notices of the FMS regarding to prevention of ML/TR. The range of sanctions is as follows: a) issue written warnings; b) carry out special actions or issue instructions requiring that a bank must cease certain current practices and desist from future ones and other violations and take measures to eliminate violations within a specified period; c) impose fines according to established rules and amounts, but not in excess of bank's own funds; d) to impose fiscal penalties in such amounts and pursuant to such procedures, as established by the NBG, if action of the bank's administrators caused financial loss to the bank or permitted the violation of regulations and requirements of the NBG;

	e) suspend the signing authority of the bank's administrators and require the bank's Supervisory Council to dismiss him or her temporarily or permanently; f) require the Supervisory Council and Directorate to call a special meeting of the bank's shareholders to discuss the violations and to take necessary measures to eliminate them; g) suspend or restrict asset growth, distribution of profits, payment of dividends and bonuses, and salary increases and the reception of deposits; h) in special cases, when the interests of the bank's depositors and other creditors are jeopardized, to suspend active operations, and to place the bank in temporary administration; i) in special circumstances, when the bank is not able to pay back deposits and other obligations, the NBG is authorized to revoke the bank's operations and impose the temporary administration; j) to request from the controlling persons of a bank to divest or reduce their control in case of failure to provide financial or other information to the NBG or in cases where a violation has been discovered. Such divestiture or reduction shall be undertaken in accordance with such terms and conditions the National Bank shall deem necessary in the particular circumstances; and k) to revoke the bank's license. Article 2 (8) of the Regulation on Pecuniary Penalties determines particular amounts of fines that can be imposed on a bank where it does not fulfill its obligations. The number of fines imposed on banks in recent years is as follows: 6 in 2011; 3 in 2012; 7 in 2013 and 4 in the first quarter of 2014.
EC9	The supervisor determines that banks have: (a) requirements for internal audit and/or external experts to independently evaluate the relevant risk management policies, processes, and controls. The supervisor has access to their reports; (b) established policies and processes to designate compliance officers at the banks' management level, and appoint a relevant dedicated officer to whom potential abuses of the banks' financial services (including suspicious transactions) are reported; (c) adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; or when entering into an agency or outsourcing relationship; and (d) ongoing training programs for their staff, including on CDD and methods to monitor and detect criminal and suspicious activities.

Description and findings re EC9	**(a)** ***requirements for internal audit and/or external experts to independently evaluate the relevant risk management policies, processes and controls. The supervisor has access to their reports;*** Under Article 5.1(b) of Decree N318 of President of NBG "Regulation on Internal Audit Requirements for Commercial Banks," a bank's Internal Audit Department is responsible for reviewing the bank's internal controls system, assessing the adequacy and efficiency of this system, and to prepare recommendations for improving this system and to ensure the implementation of the recommendations. Under Article 49.1(c), the NBG is authorized to request from banks any required information (including reports of the Internal Audit Department) within its competence. However, the regulations do not specify that the AML and terrorist financing related processes and policies are subject to review by internal audit. In practice, however, AML/CTF related processes and policies are in the audit scope of all Georgian banks. **(b)** ***established policies and processes to designate compliance officers at the banks' management level, and appoint a relevant dedicated officer to whom potential abuses of the banks' financial services (including suspicious transactions) is reported;*** Under Article 5.1(2) of the Regulation on Commercial Banks, banks must designate an employee as the money laundering officer. The officer's position must correspond to that of a senior manager and report solely to the chief executive. ***(c) adequately screening policies and processes to ensure high ethical and professional standards when hiring staff; or when entering into agency or outsourcing relationship;*** Under Article 4(6) of the Regulation on Commercial Banks, banks are required to have a staff recruitment policy, including provisions for fit-and-proper tests. These should be supplemented by internal rules and procedures. ***(d) ongoing training programs for their staff, including on CDD and methods to monitor and detect criminal and suspicious activities.*** Under Article 4.5.2(g) of the Regulation on Commercial Banks, the money laundering officer must educate other employees relating to issues on the prevention of money laundering and terrorist financing, including the organization of special training programs. Training should be on a continuous basis to ensure that employees are kept up-to-date on developments in the area.
EC10	The supervisor determines that banks have, and follow, clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer, or to both. The supervisor also determines that banks have, and utilize, adequate management information systems to provide the banks' Boards, management, and the dedicated officers with timely and appropriate information on such activities.

Description and findings re EC10	Under Article 4(4) of the Regulation on Commercial Banks, banks are required to have internal regulations setting out procedures for the reporting of money laundering/terrorist financing problems to the money laundering officer. Article 5.4(d) provides that the money laundering officer must submit written reports on his/her activities to the bank management. The Money Laundering Inspection Division reviews in its inspection the adequacy of the policies and processes of the bank. It also verifies the implementation and execution of the policies and procedures. Verification is done by requiring email, documents, and minutes of meetings, which prove that the required information was provided as determined by the banks policies and procedures. Also, the minutes of the Supervisory Board are read to verify their involvement.
EC11	Laws provide that a member of a bank's staff, who reports suspicious activity in good faith, either internally or directly to the relevant authority, cannot be held liable.
Description and findings re EC11	Under Article 12(4) of the AML Law, bank employees, when acting within the scope of their powers, who report AML/CTF issues to the money laundering officer, or the latter, when reporting to the FMS shall not be held liable for failure to observe the confidentiality of information so reported.
EC12	The supervisor, directly or indirectly, cooperates with the relevant domestic and foreign financial sector supervisory authorities or shares with them information related to suspected or actual criminal activities where this information is for supervisory purposes.
Description and findings re EC12	Under Article 5(2) of the NBG Law, the NBG, within the scope of its competence, shall cooperate with other country's competent financial sector supervision authority. Such cooperation includes the exchange of information, provided the receiving authority will respect the confidentiality of the information. (With regard to AML/CTF, the NBG has not to date received a request for information from a foreign supervisor. The NBG has requested such information from a foreign supervisor on only two occasions.
EC13	Unless done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities. In this case, the supervisor regularly provides information on risks of money laundering and the financing of terrorism to the banks.
Description and findings re EC13	This is carried out by the FMS. The FMS also regularly provides the banking sector with updated information on the risks of money laundering and the financing of terrorism.
Assessment of Principle 29	Largely compliant
Comments	The legislative basis for dealing with AML/CTF is quite comprehensive and the NBG and FMS seem committed to their respective tasks. From discussions with banks visited by the assessors, the banks seem well versed in their AML/CTF obligations. Each had a dedicated Money Laundering Officer and had been the subject of an NBG inspection in recent times. The

	weakness identified under this Principle relates to EC3 – there is no explicit obligation on banks to report suspicious activities and incidents of fraud to the NBG, where such activities/incidents are material to the safety, soundness, or reputation of the banks. In this respect, the NBG says that banks would report such cases and that in any event the FMS would bring them to its attention. Nonetheless, in the interests of eliminating any doubt, there should be an explicit obligation on banks to inform the BNG of any such activities/incidents. The legislation should be changed to bring the definition of PEP in line with the current FATF definition, namely, domestic as well as foreign persons. The move of the FMS from under the auspices of the NBG to the Office of the Prime Minister should not compromise its independence in any way. An IMF detailed assessment report on AML was undertaken in July 2012. It noted that the AML/CFT regime had significantly improved since the previous assessment of 2007. It also noted that the NBG had introduced many notable improvements to its supervisory framework, but it had insufficient AML resources, i.e., five people. This has since been increased to 18.