Financial Sector Monitor Georgia 2019

Alexander Lehmann

in cooperation with ISET

German Economic Team Georgia

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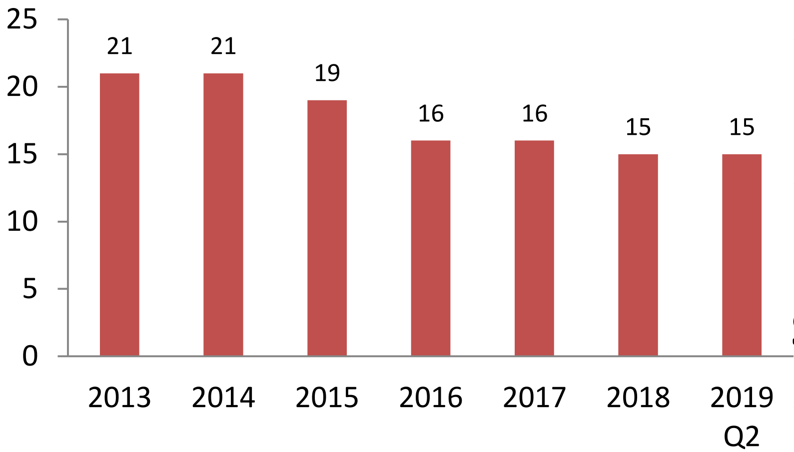
I. Key messages

- ✓ The banking sector is well capitalised and profitable. Excess debt among households, and more recently enterprises, could emerge as a risk, with corporate fx exposures the key vulnerability.
- ✓ The ‘responsible lending’ regulation has helped weed out risky lending models among micro-finance institutions.
- ✓ Dollarisation remains the key vulnerability for banks and undermines the inflation targeting regime. Following the GEL depreciation it has re-emerged as a policy concern, though prudential measures are already quite strict.
- ✓ At least three banks are ‘too-big-to-fail’ and hence prone to excess risk taking, relying on an implicit state subsidy. The new bank resolution regime will be a fundamental change, including for bank governance.
- ✓ Bond markets remain underdeveloped relative to other countries. Emerging pension fund investment and a more deliberate sovereign issuance strategy will stimulate this sector.
- ✓ Private equity should be the priority for risk capital.

II. The banking sector

- Consolidation: a further reduction in the number of banks
- Concentration and competition
- Profitability
- Corporate governance

Consolidation: a further reduction in the number of banks



Source: NBG, eop

Jan 2015: Merger of TBC and Bank Constanta

May 2015: Merger of BOG and Privatbank

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

Sep 2016: NBG revoked license of Caucasus Dev Bank; bankruptcy of mother company in AZE

Nov 2016: Closure of Capital Bank due to breach of NBG regulations (money laundering)

Mar 2017: Banking license for Credo (microfinance)

May 2017: Merger of TBC and Bank Republic

Jul 2018: The Int. Bank of Azerbaijan - Georgia cancelled its banking license

- The number of active banks went down from 21 to 15 since 2013
- TBC and Bank of Georgia acquired smaller institutions

Strong presence of foreign capital

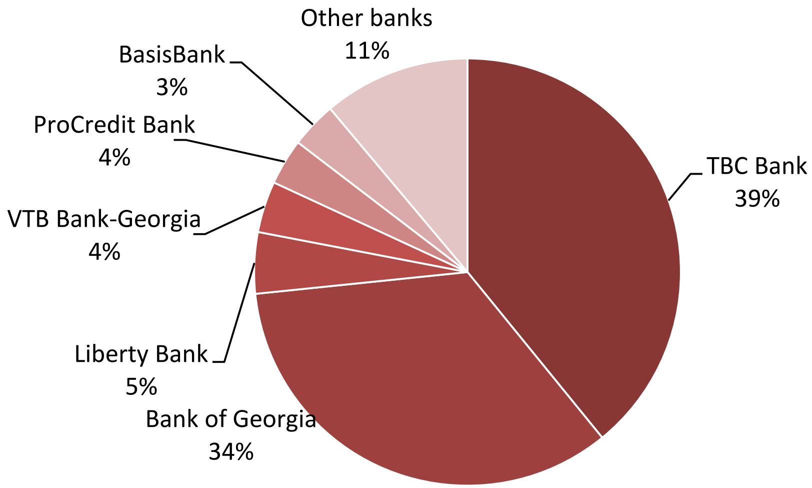
- 14 of the 15 banks with foreign-capital participation, 10 with more than 50% foreign-capital participation

Consolidation of the micro-finance sector

- Regulatory measures since early 2019 have made more aggressive business models of smaller lenders unviable
- Large banks have developed their digital platforms, but fintech challengers also emerge

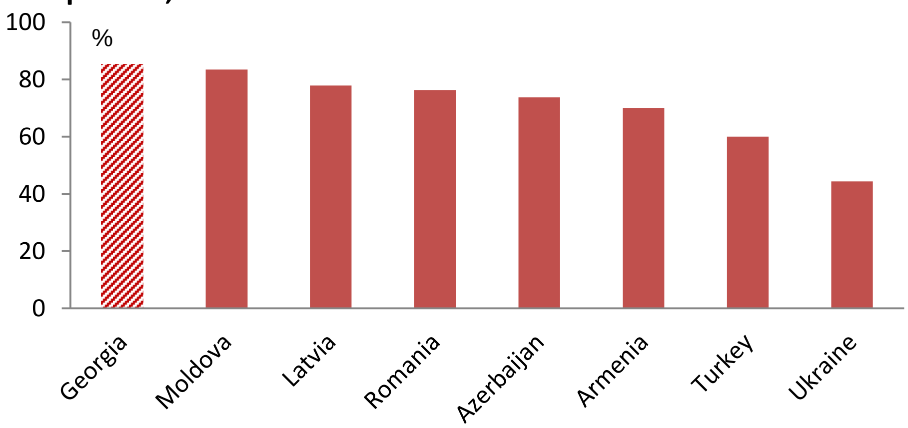
Concentration and competition

Banking sector assets, 2019 Q2



Source: NBG

Top 5-bank asset concentration - regional comparison, 2016



Source: Global Financial Development Indicators

Top 3 banks currently account for 78% of assets – a high concentration by any standard

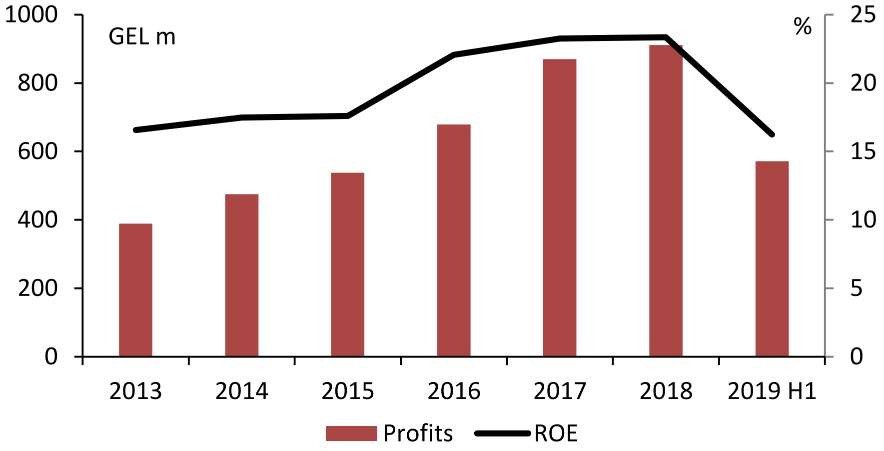
- TBC Bank: 39% of assets
- Bank of Georgia: 34% of assets
- International experience suggests that even highly concentrated banking systems provide good access to credit for firms.

But top 3 banks should be considered systemically important

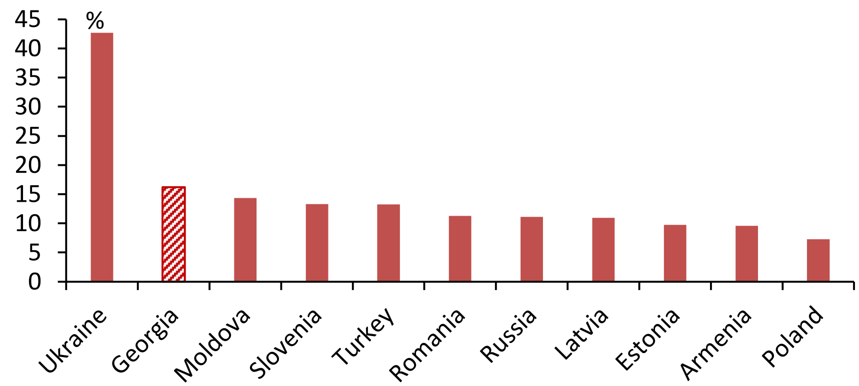
- Implicit state guarantee would undermine incentives for sound risk management
- Exposure to banking sector would create contingent risks for the budget.
- NBG should contain any abuse of market dominance
- New resolution law is timely, though will require lengthy implementation

Bank profitability

Banking sector profit



ROE, latest available data



Source: IMF Financial Soundness Indicators, data as of Oct 2019

Return on equity (ROE)

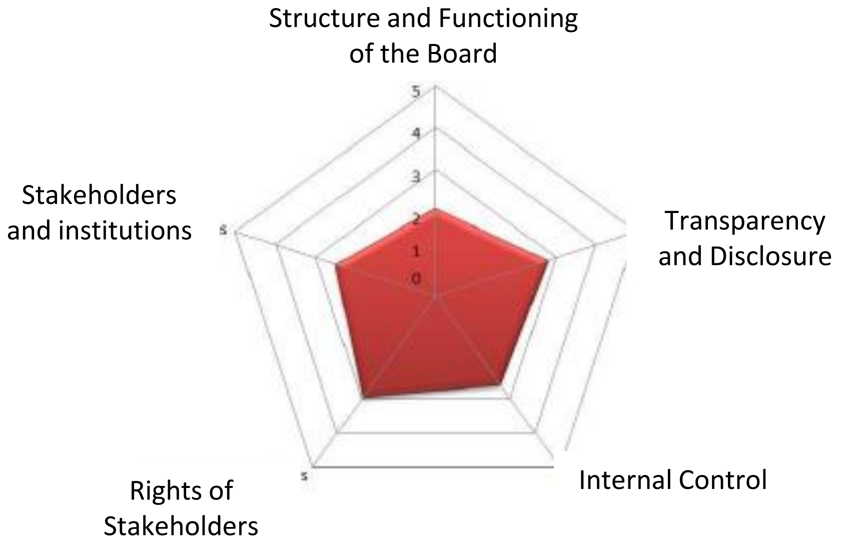
- Remains relatively high in a regional context
- Interest margins buoyed by ample fx liquidity, and falling deposit rates
- explained by good operating efficiency and low impairment charges (NPLs)
- creates further capital buffers, i.e. positive for financial stability

➢ **Should not be a policy concern if**

- there is open entry into the sector (e.g. fintech in retail lending)
- there are safeguards against abuse of market dominance and facilitate information sharing
- banks are not assumed to be ‘too-big-to-fail’ and do not benefit from implicit subsidy to funding costs

Corporate governance and foreign listings

EBRD assessment of the Georgian Corporate Governance Code



Source: EBRD

- Corporate governance code for banks adopted in September 2018
- TBC and BoG both listed on premium London Stock Exchange segment (BoG in the FTSE250), as such they comply with the UK corporate governance code and a high level of transparency
- This opens up an expanded investor base, and likely reduces risks and costs of funding, at the expense of reduced liquidity in Georgian securities markets

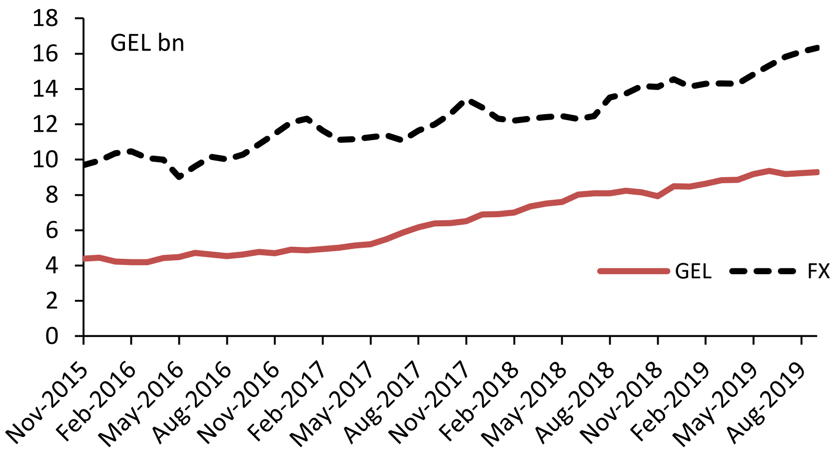
➢ **High corporate governance standards in the two sector leaders should be a benchmark for the broader framework within Georgia**

III. Bank soundness

- Liquidity and deposit funding
- Capital adequacy
- Asset quality and non-performing loans

Liquidity and deposit funding

Bank deposits, stocks (excl. interbank deposits)



Source: NBG

Structure of deposits (Sep-2019)

Current	Term
42.63%	57.37%
GEL	**FX**
36.13%	63.87%

Source: NBG, own calculations

- Deposit funding has been stable, despite major regional turbulences and GEL depreciation
- Recent further substitution of fx deposits, and increase in the GEL loan-deposit ratio
- A regulatory requirement on coverage of potential short term liquidity outflows is met, and an additional long-term liquidity ratio will be introduced.

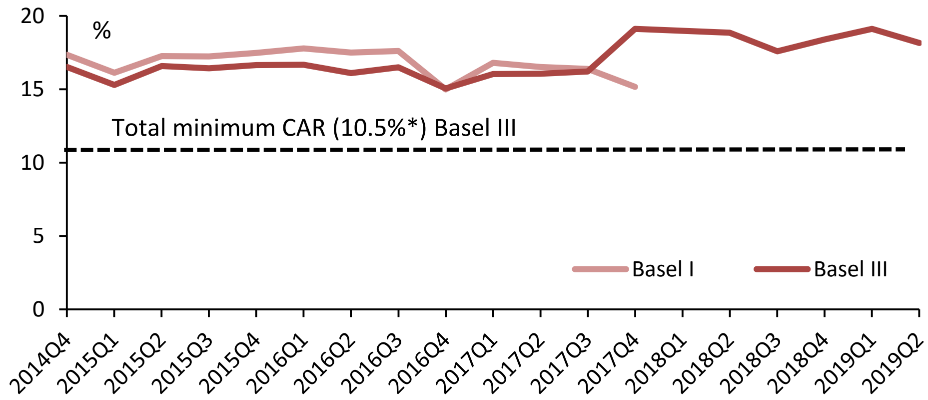
➢ **Fx deposits about USD 5.5 bn. Outflows, including by non-residents, could overwhelm NBG fx reserves (at USD 3.7 bn at end 2018)**

➢ **Depositors appear to trust the banks and the supervisor; the recently introduced deposit insurance scheme will further build confidence.**

➢ **Banks adopt conservative funding models.**

Capital adequacy

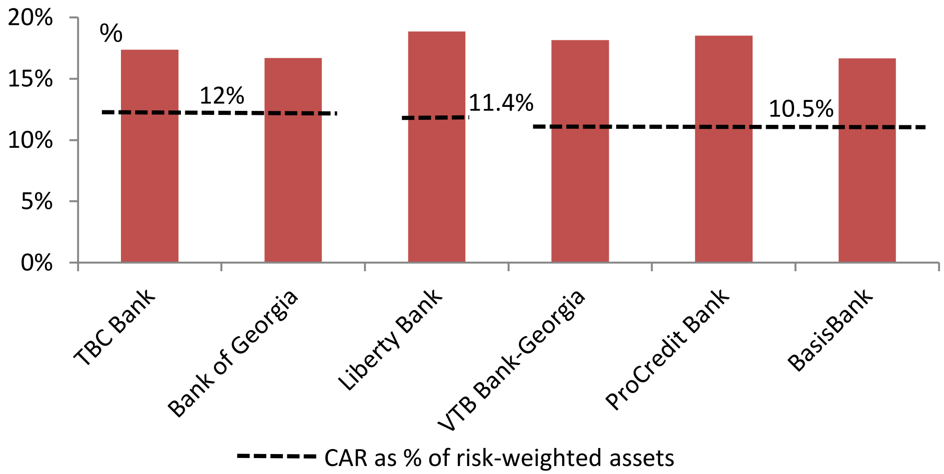
Capital adequacy ratio



Source: NBG

**including regular capital requirement of 8% and capital conservation buffer of 2.5%*

Capital adequacy ratio of individual banks



Source: NBG

In line with other emerging markets the NBG introduced a modern capital regulation aligned with Basel III:

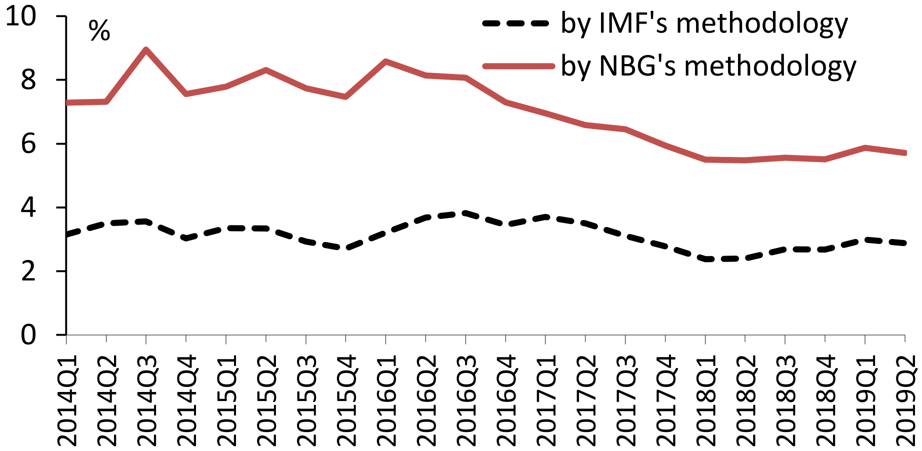
- Higher quality standard for bank capital
- Minimum capital and additional buffers are exceeded by all banks
- Additional requirement set to reflect bank-specific risks

➢ **The system is well-capitalized**

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

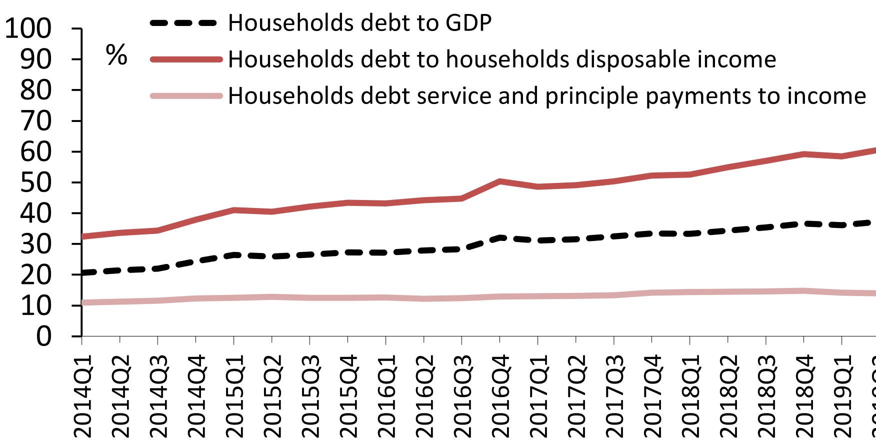
Asset quality and non-performing loans

NPLs as a share of total gross loans



Source: NBG

Households debt



Source: NBG

Non-performing loans (NPLs)

- The NPL ratio has declined further below a level seen in other CEE countries
- Good provisioning policies by the banks
- Still, the NPL ratio may have benefitted from the cyclically strong asset growth, and lack of stress in highly leveraged enterprises
- Vulnerabilities remain in relatively high household debt, and dollar debt in enterprises
- Active restructuring efforts of over-indebted companies and a new bankruptcy law should help

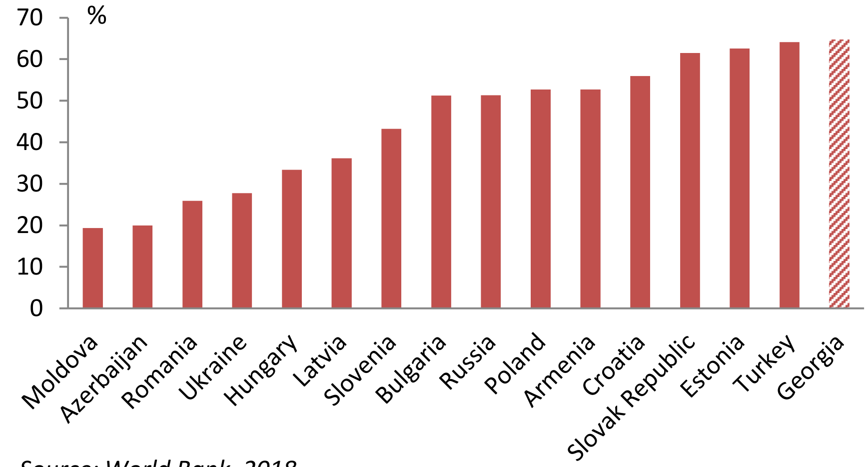
➢ **Potential risks from past growth in retail credit and FX borrowing, but various NBG safeguards are in place**

IV. Access to bank credit

- Credit to the real sector
- Growth dynamics: corporates vs retail
- Interest rates and spreads

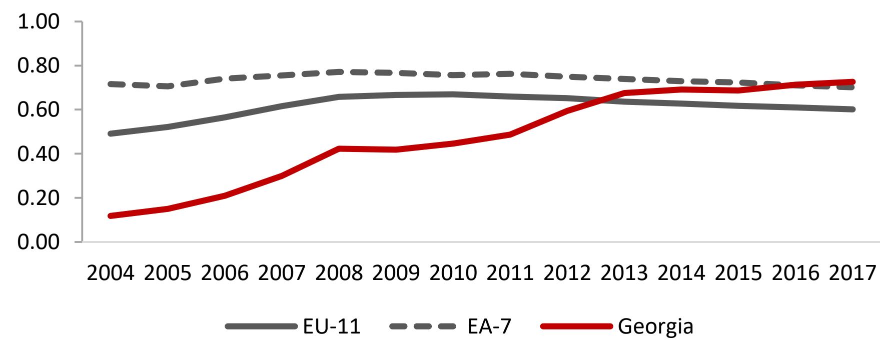
Credit to the real sector

Credit to real sector to GDP: Regional comparison



Source: World Bank, 2018

IMF Index of access to finance from financial institutions



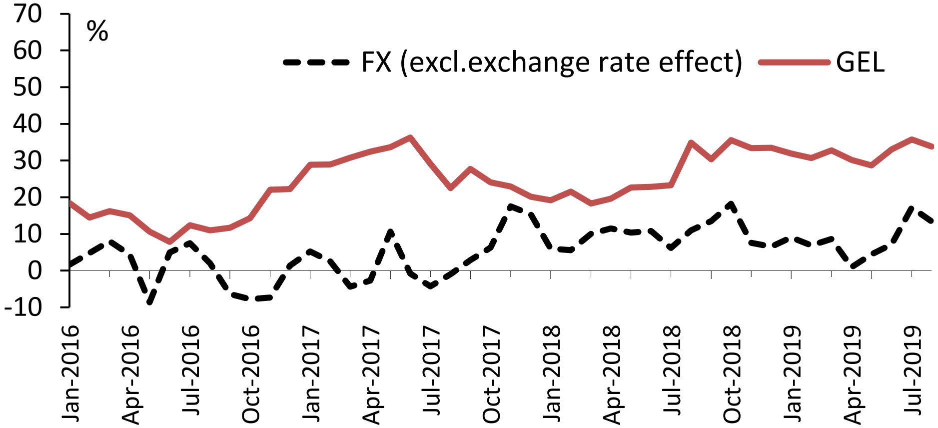
Source: IMF

- Ratio of credit to GDP reasonably high in a regional comparison
- Growth of real sector credit in excess of GDP growth, and accelerated in recent years – below a threshold this financial deepening is supportive of growth
- Indicators of financial access (based e.g. on number of bank branches) show good progress, also relative to other countries.
- The last available enterprise survey did not suggest small and medium enterprises rank lack of access to credit as an impediment to their business.

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

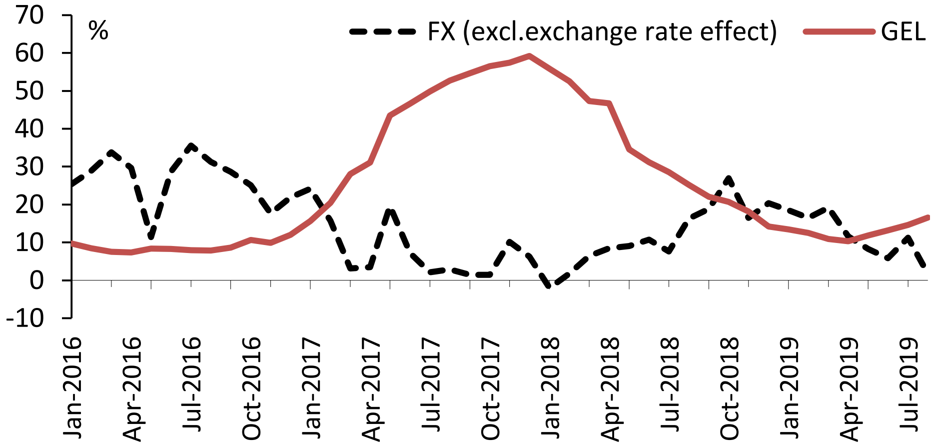
Loan growth: corporates vs retail

Corporate loan growth (excl. exchange rate effect)



Source: NBG, own calculations, eop

Retail loan growth (excl. exchange rate effect)



Source: NBG, own calculations, eop

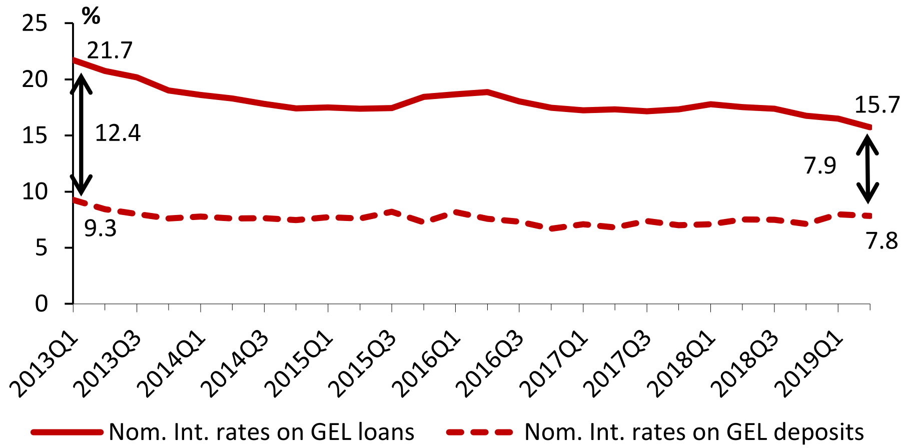
- Growth in **business credit** most dynamic as corporate leverage increases, and due to fx valuation effects
- Maturities also extending to about 4.5 yrs
- The stock of household debt is already relatively high at 37 per cent of GDP
- Growth in household credit moderated with the adoption of restrictive measures on microcredit and caps on loan-to-value (LTV) and price to income (PTI) ratios since early 2019, and earlier restrictions on household fx credit ("responsible lending regulation").

➢ **There is no evidence of a credit-driven overheating, e.g. a house price bubble**

➢ **Increasing leverage in the enterprise sector, and some indicators of excess debt should be watched.**

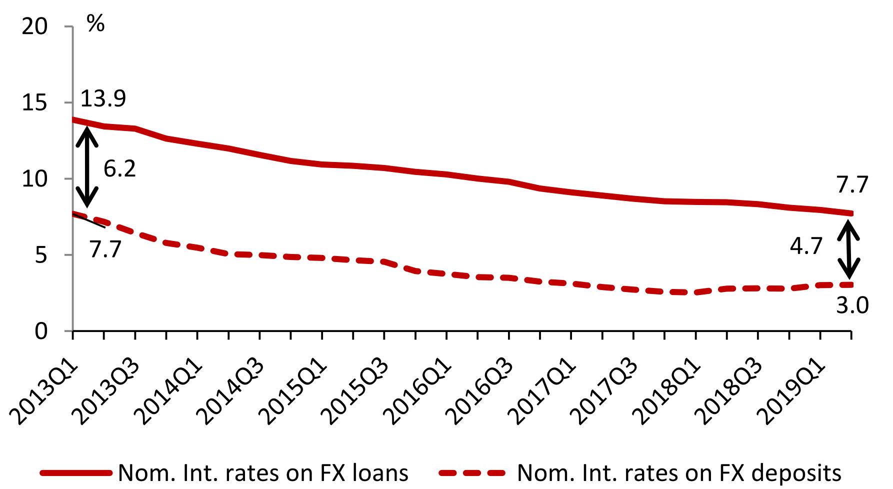
Interest rates and margins

Interest rates on GEL loans and deposits



Source: NBG

Interest rates on FX loans and deposits



Source: NBG

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

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

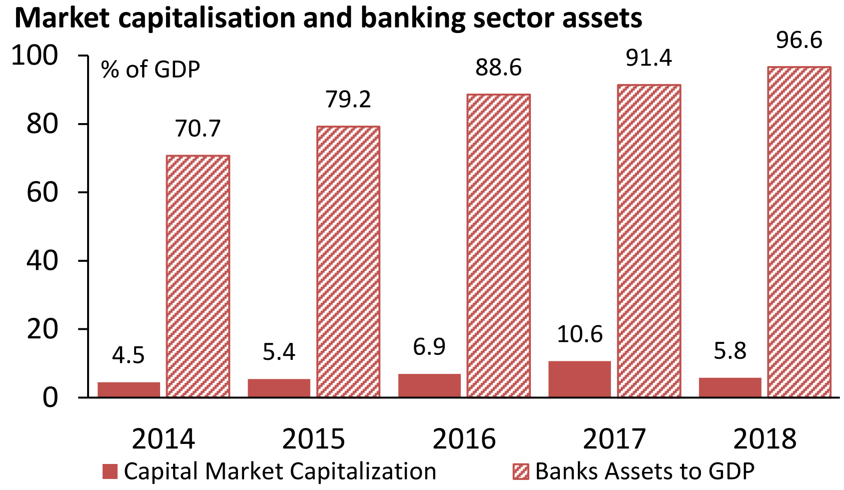
➢ **Renewed expectations of depreciation have fuelled further deposit dollarization**

➢ **With a credible inflation targeting framework GEL rates should converge further with USD rates**

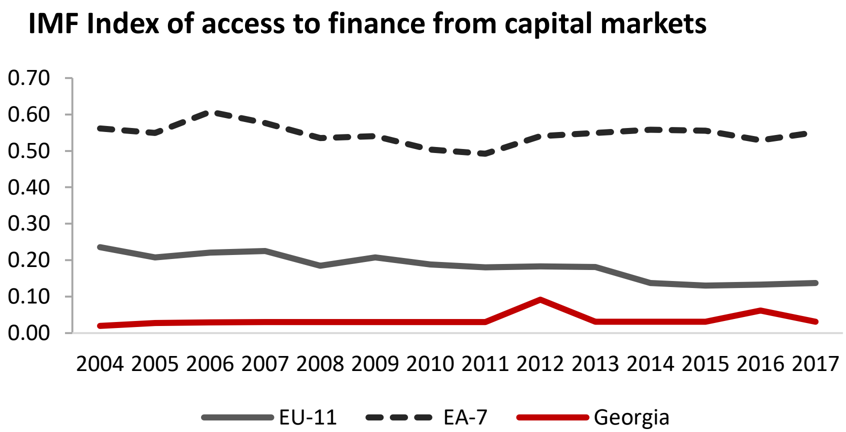
V. Capital markets

- Financial markets as a source of finance
- Emergence of the pension funds
- Recent regulatory measures

Banking sector vs capital markets in Georgia



Source: National Bank of Georgia, Georgian Stock Exchange; eop



Source: IMF

- Compared to the banking sector depth and access to finance in Georgia, capital markets are underdeveloped
- The local bond market remains shallow (7.7% of GDP) and primarily in sovereign debt. Corporate and IFI GEL bonds in Georgia only 12% of total capitalization.
- Structural obstacles until recently
  - Lack of a local institutional investors
  - Absence of clearing mechanism for foreign investors
  - Several issuers are large enough for foreign bond markets
- NBG repo facility for GEL corporate bonds as collateral an important boost to the market, though primary investors almost entirely banks.
- Retail bond investment only in fx

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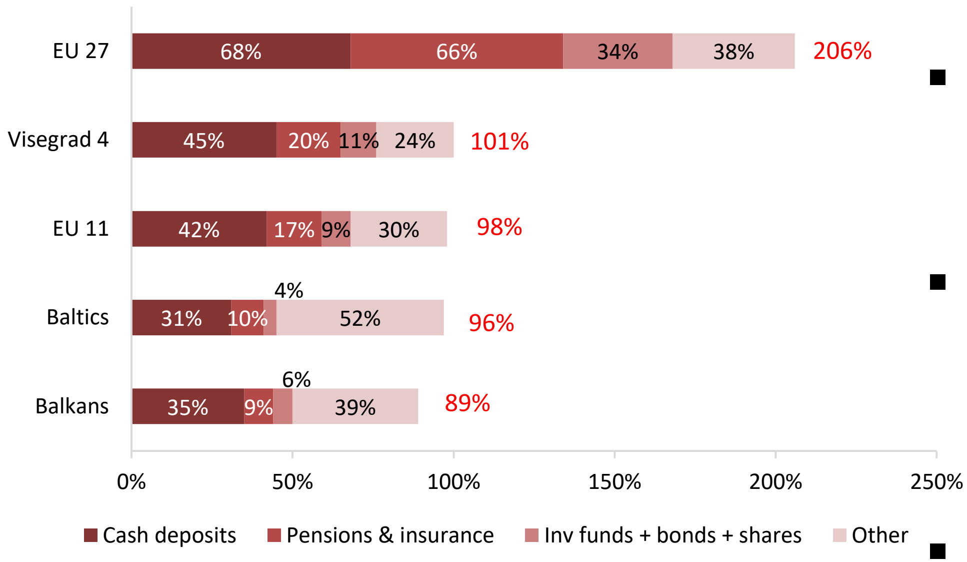
Potential impact of the pensions fund investments

Household financial assets in % of GDP in the EU and other CEE countries



Source: Eurostat

- Pension fund operational since 2019, contributions in excess of expectations.
- May represent a net addition to national savings; certainly a first local institutional investor.
- Investments will initially be primarily directed into government bonds, though investment policy based on the law is to be clarified.
- Could stimulate in particular local bond issuance.

Legal and regulatory reforms

- IOSCO associate membership in 2018 (MoU signature in process). Full membership would facilitate cooperation with other capital market supervisors
- Investment funds law (parliament approval process imminent). Adopts key principles from EU directives. Clarity on establishing pooled investments
- Law on financial collateral, netting and derivatives (crucial in hedging fx and inflation risks) – already introduced for parliamentary approval
- Securities market law: to improve transparency and investor protection: 2020
- Covered bonds law (in drafting process) will improve portfolio funding, and make pricing more efficient
- Law on securities holdings (legal basis for indirect holdings): 2020

Sovereign debt markets

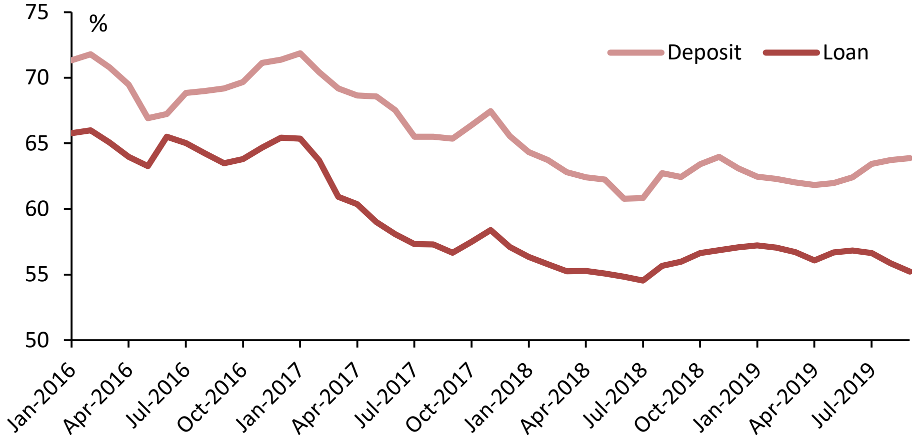
- A new government debt management strategy was adopted and envisages a substantial part of government debt financed through local bonds
- A primary dealer system is under consideration

VI. Policy challenges

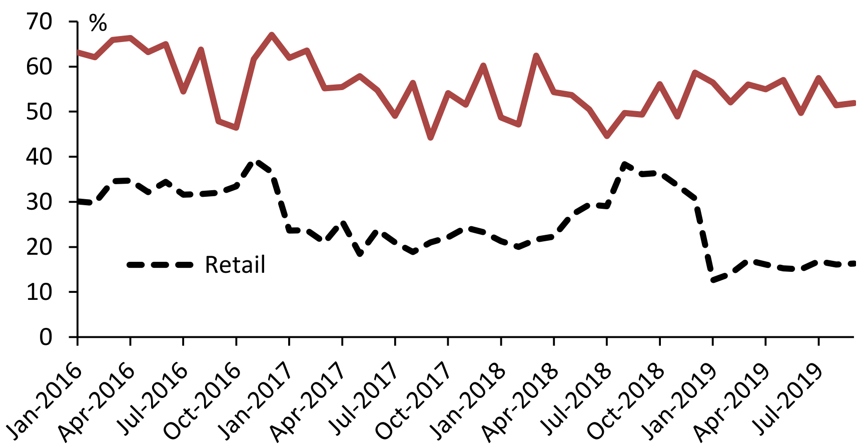
- Greater crisis resilience: tackling high dollarisation
- More diverse sources of finance: capital market development
- Ending ‘too-big-to-fail’: implementation of the resolution law

Dollarisation in Georgia

Deposit and loan dollarization ratio



Loan dollarization ratio, retail vs corporate (flows)



Source: NBG

- Dollar/fx is a natural part of payments and bank assets in an open economy such as Georgia
- But at a still relatively high level (56% for loans, 62% for deposits) dollarization in Georgia results in vulnerabilities:
  - Credit risks among unhedged borrows, in particular in the corporate sector
  - Risks of liquidity runs as fx deposits could overwhelm NBG fx reserves
  - Procyclical effects of borrower net worth
- … and constrains monetary policy (in a ‘fear of floating’).
- Recent GEL depreciation and surge in fx deposits has again accentuated fx imbalance in banking sector

De-dollarization policies

- The NBG has rightly made reducing dollarization a priority.
- A credible inflation targeting regime is the macroeconomic pre-condition for de-dollarization, as shown by experience in other emerging markets, in particular in Latin America. Flexibility in the GEL should not be put in doubt.
- Since 2016 there have also been various de-dollarization measures in prudential policy including most recently:
  - Increase in the reserve requirements on fx deposits in 2018
  - Ban on small fx loans to households
  - LTV and PTI limits further restrain household credit risks
  - Higher capital requirements for fx loans to unhedged corporate borrowers
- Such measures are always distorting, stifle in particular new entrants in the sector, and may have reached their limit
- In future active capital market development should expand GEL funding for banks and enterprises, including by:
  - Fostering the GEL bank long term funding in the local bond market
  - introduction of inflation-indexed bonds

Capital market development

- Georgia stands out in the region for underdeveloped bond and equity markets. Larger companies therefore lack long-dated local currency debt instruments, and risk-oriented capital
- Central Europe has demonstrated that corporate bond markets can become a meaningful source of long term funding, even within a relatively small economy.
- In addition to laws being prepared, next steps could be:
  - A public debt management strategy that makes target for local funding explicit; coupled with clarity on allocation of Georgia's pension assets;
  - greater liquidity around benchmark sovereign issues, and hence a yield curve that facilitates pricing of private sector issues;
  - a primary dealer system for sovereign issuance;
  - Expansion of the number of bonds that can be cleared through international security depositories;
- Innovations such as inflation-linked bonds and green bonds could further widen funding.
- Liquid equity markets are a more ambitious aim. Private equity rather than listed stocks and IPOs should be the priority.

Implementation of the NBG’s new resolution powers

- A regime for the orderly wind-down of failed banks is an important innovation for Georgia, given the high concentration of bank assets within the largest banks.
- This is now good international practice (by end-2016, about 40% of developing countries required banks to file resolution plans)
- Withdrawal of the implicit state guarantee will imply higher risk in bank debt (and correspondingly lower risk to public finance).

To implement the powers the NBG will have to:

- identify systemically important banks that would be subject to resolution rather than liquidation;
- be prepared to write-down equity claims or convert into equity certain types of creditors, possibly establishing a bridge bank;
- define bank resolution plans, and address within banks whichever impediments to resolution it identifies;
- establish the resolution fund, financed by banks

The agenda for making banks 'resolvable'

Recovery plans

- Needs to contain crisis recovery measures (e.g. designate assets available for liquidation)
- Simulate stress scenarios

Resolution plans

- Banks will need to address all potential impediments to the implementation of a resolution plan.
- Specifically, identify critical functions, and secure their continued operation and access to financial infrastructure following a resolution (e.g. separate business lines)
- Prepare a realistic restructuring scenario
- Offer some level of disclosure to investors, including those in European markets.

Aspects of 'resolvability'

Financial Resources	1. Loss-absorbing capacity 2. Valuations 3. Funding in resolution
Continuity	4. Continuity of financial contracts 5. Operational continuity 6. Continuity of access to financial market infrastructure 7. Restructuring
Coordination and communication	8. Management, governance, and communications

Source: Bank of England.

Contact

Dr Alexander Lehmann

lehmann@berlin-economics.com

Anne Mdinaradze

mdinaradze@berlin-economics.com

German Economic Team Georgia

c/o BE Berlin Economics GmbH

Schillerstraße 59, 10627 Berlin

Tel: +49 30 / 20 61 34 64 0

www.get-georgia.de

Twitter: @BerlinEconomics

Facebook: @BE.Berlin.Economics