Report and Recommendation of the President to the Board of Directors

Project Number: 41920
July 2007

Proposed Senior Loan
Republic of Georgia: Joint Stock Commercial Bank of Georgia

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 30 June 2007)

Currency Unit	–	Georgian lari (GEL)
GEL1.00	=	$0.5662
$1.00	=	GEL1.766

ABBREVIATIONS

ADB	–	Asian Development Bank
ALCO	–	Asset Liability Committee
ATM	–	automated teller machine
BIS	–	Bank of International Settlements
BOG	–	Bank of Georgia
CIS	–	Commonwealth of Independent States
DEG	–	Deutsche Investitions-und Entwicklungsgesellshaft mbH
EBRD	–	European Bank for Reconstruction and Development
EMS	–	Environmental Management System
GDP	–	gross domestic product
IPO		initial public offering
LIBOR	–	London interbank offer rate
NBG	–	National Bank of Georgia
NPL	–	nonperforming loan
PSOD	–	Private Sector Operations Department
SMEs	–	small and medium-sized enterprises

NOTES

(i) The fiscal year (FY) in Georgia ends 31 December.
(ii) In this report, "$" refers to US dollars.

Vice President	L. Jin, Operations 1
Director General	R. Bestani, Private Sector Operations Department (PSOD)
Director	W. Willms, Capital Markets and Financial Sectors Division, PSOD
Team leader	P. Bracey, Investment Specialist, PSOD
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Team members	J. Klein, Investment Specialist, PSOD
	P. Bailet, Counsel, Office of the General Counsel

CONTENTS

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed senior loan of up to $25 million to Joint Stock Commercial Bank of Georgia (BOG) for the purpose of onlending to small and medium-sized enterprises (SMEs) in Georgia (the ADB loan).

2. The ADB loan is to be part of a $125 million term loan provided by ADB and Citibank as coarrangers with Citibank underwriting $100 million. The proposed ADB loan is ADB's first transaction in Georgia since the country joined ADB as a new member in February 2007. Appendix 1 provides the design and monitoring framework.

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES

A. Georgian Economy: Overview and Outlook

3. Economic growth in Georgia continued at an impressive pace in 2006 (real gross domestic product [GDP] growth was 9.4% in 2006, 7.7% in 2005, and 6.2% in 2004),[1] despite rapidly rising energy prices; deteriorating relations with its main trading partner, the Russian Federation; and a decline in agricultural output. This strong performance was largely due to a combination of macroeconomic stability, and the dramatically improved business environment resulting from the implementation of several reforms. GDP growth was further fueled by manufacturing, services, and construction. The sanctions imposed by the Russian Federation in mid-2006 have thus far had a limited impact on the Georgian economy. Export growth remained strong in the latter half of 2006, as Russian markets were replaced by those of other countries as the main destination for most exports (except wine); remittance flows remained steady.

4. Inflation subsided by year-end 2006 to 8.8%, well below the peak of 14.5% recorded in July 2006. The current account rose to 15.2% of GDP.[2] Strong tourism receipts, reflecting a sharp increase in tourists from Armenia, offset higher than expected import volume growth, mainly in durable goods. The capital account strengthened, bolstered by foreign direct investment inflows, which increased to $890 million in 2006 (excluding privatization).

5. Georgia's fiscal performance in 2006 was more expansionary than planned. In contrast to the commitment to limit the annual deficit to reduce inflationary pressures, spending overruns of almost 1% of GDP involved mainly capital and military expenditures. As of year-end 2006, the fiscal deficit was 2.9% of GDP, exceeding projections.[3] Despite the fiscal overspending, monetary policy was on track. National Bank of Georgia (NBG) successfully intervened in the foreign exchange market to prevent a temporary surge in foreign exchange inflows related to BOG's initial public offering (IPO) from influencing the exchange rate. Georgia's total external debt continued to decline in 2006, falling to $1.6 billion (20.6% of GDP)[4] from $1.7 billion (25.8% of GDP) in 2005.

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1 Government estimate, per Central and West Asia Regional Department of ADB.
2 Ministry of Finance.
3 Statistic of 2.9% from the International Monetary Fund. Georgian Ministry of Finance statistics state 1.9% on a commitment basis, and 2.2% on a cash basis.
4 Available: http://www.nbg.gov.ge/NBG_New/Publications/Buletin/Last/B-5.2e.xls provides the NBG estimate for total external foreign debt-to-GDP ratio. The International Monetary Fund presents a slightly higher percentage (21.8%) for public and publicly guaranteed external debt (nominal), as a percentage of GDP. Available: http://www.imf.ge/aattach/272.pdf.

6. Notwithstanding the generally positive economic outlook in the medium-term, certain concerns exist. The ongoing effects of Russian sanctions, particularly the impact of higher energy prices, are expected to reduce economic growth, with real GDP growth expected to moderate in 2007 to 6.5%. Higher energy prices will also create inflationary pressure; however, this should be offset by the slowing of the economy and inflation is projected to actually fall to 7% in 2007. The ongoing challenge for the Government of Georgia will be to maintain macroeconomic stability while moving forward with ongoing reforms.

7. The World Bank named Georgia as the number one reformer worldwide[5] and the European Bank for Reconstruction and Development (EBRD) cites the country as having the third lowest corruption in the Eastern European region.[6] Georgia is rated by Standard & Poor's as B+/Stable/B and Fitch Ratings as BB-/Stable/B.

B. The Banking Sector

1. Overview

8. With the consolidation of the banking sector over the past several years (247 banks in 1995 to 21 in 2006), seven commercial banks currently dominate the market, accounting for nearly 90% of total assets and gross loans. The banking sector has experienced rapid growth over the past few years in line with overall economic growth in Georgia. Private credit grew on average by 62% year-on-year in 2006, after averaging 60% growth in 2005. Demand deposits increased by more than 70% in both 2004 and 2005, and by 58% in 2006 (Table 1). Appendix 2 provides details on the banking sector.

Table 1: Georgian Banking Sector Aggregate Figures, 2005–2006
($ million)

Aggregate Figure	**2005**	**2006**	**Growth** (%)
Total Assets	1,421	2,467	73.5
Gross Loans	965	1,565	62.1
Deposits	858	1,359	58.3
Shareholder's Equity	267	524	96.0
Net Income	35	54	57.5

Source: National Bank of Georgia.

9. Penetration of the Georgian banking system is still fairly low compared to most Central and Eastern European (CEE) and Commonwealth of Independent States (CIS) countries, and multibranch banks have difficulty attaining a critical mass of operations. Despite the system's very rapid growth over the last few years, even the leading banks have only a modest scale of operations and asset bases compared to those in more developed markets. The ratio of money supply to GDP is very low in Georgia compared with other transition countries, suggesting that lending activity can be increased, particularly to the industry and agriculture sectors, without significant overheating. The potential for market growth is further emphasized by the comparatively low ratio of gross loans to GDP (15%), the low card penetration as percentage of

[5] World Bank. 2007. *Doing Business 2007.* Available: http://www.doingbusiness.org/documents/DoingBusiness2007_FullReport.pdf
[6] GIA Georgia. 2005. *Plaudits from the World Bank, the IMF, the EBRD, and S&P*. Available: http://www.gia-georgia.ge/resent.html

population (6%), and percentage of deposits to GDP (11%).[7] Appendix 3 provides more details and a country by country comparison.

10. Appendix 4 provides a comparison and peer group analysis (by customer, return on equity, network, and net commission income) of the top seven banks. Given the high concentration among the top seven banks, consolidation is unlikely; however it is very likely outside this group. All of the top five banks have significant foreign ownership comprised of portfolio investors, as in case of Bank of Georgia, development financial institutions, and strategic investors. Bank Republic is controlled by Societe Generale, VTB Bank Georgia is owned by Russian Vneshtorgbank; Procredit Bank is controlled by a foreign holding company, which in turn is controlled by foreign investors, and HSBC recently acquired a banking license to start operations in Georgia. Further significant foreign players considering entering the market would more likely target acquiring a local bank (BOG being one of the possible acquisition targets) rather than creating greenfield operations.

11. In 2006, NBG published a development strategy for the Georgian banking system for 2006–2009, identifying several goals. Foremost among these is increasing the depth, efficiency, and sustainability of the banking system. To achieve these objectives, NBG set out a timetable for implementing the next stage of reform measures, including harmonizing domestic banking legislation with relevant European Union laws and progressively reducing reserve requirements, although reserve requirements have been gradually increased for GEL funds from 2% to 13% in 2007. Specific initiatives include (i) consolidating the banking sector by increasing the minimum capital requirement for all commercial banks to GEL12 million (approximately $6.8 million) in July 2007; (ii) amending legislation to allow for the enforcement of “fit and proper” regulations; (iii) strengthening anti-money-laundering legislation; and (iv) sanctioning the establishment of credit information bureaus.

C. Small and Medium-Sized Enterprises

12. **SME Sector**. SMEs have a significant role to play in all of ADB’s developing member country economies and are often key drivers of employment, economic growth, and development, making a significant impact on GDP. The development of SMEs is therefore an important engine of growth and a key contributor to poverty reduction by creating employment, increasing individual incomes, and generating tax revenues. In Georgia, however, the SME sector is severely constrained, representing only 10% of GDP, while a few big businesses control 90% of the country’s assets.

13. SMEs rely heavily on access to external capital to finance their operations. In most of ADB’s developing member countries, SMEs have difficulty accessing financial services and securing financing. Although bank loans are the dominant form of external financing (due to the underdeveloped corporate bond markets), only a small number of SMEs in the region have access to bank lending (mostly only for working capital). Lack of access to bank lending is considered in most of the countries as the main financing difficulty and a stumbling block for sustaining SME growth. This is no different in Georgia. Due to these financing constraints, growth in the SME sector has been severely curtailed, with only 5%–10% of potential SME borrowers receiving needed bank credit.[8] Part of the problem derives from constraints on the

[7] Data provided by People’s Bank of Georgia. ADB’s draft publication, “Georgia: 2007 Country Performance Assessment (Draft),” corroborates this level of deposit penetration, noting an increase in deposit-to-GDP ratio from 7.2% in 2003 to 17.2% in 2006.

[6] Source: http://www.georgiatoday.ge/article_details.php?id=2503. In the absence of credit from banks, SMEs have to look to alternative sources to finance their growth. Primary among these are funding from retained earnings

SMEs themselves, such as their lack of collateral and lack of proper bookkeeping and financial reporting. In addition, demand for bank credit far outstrips what banks are able to supply; indeed, in 2006, the gap between supply and demand for credit totaled $500 million. Georgian banks are, however, beginning to look increasingly at the SME sector as a promising business opportunity, a strategic move that is well-aligned with the economic needs of the country, as well as with the main drivers of economic growth (agriculture, machinery), which are often SME-led. As Georgian banks begin to look to developing the SME sector, they require increased resources to support this new growth, and ADB is committed to supporting them in this regard.

III. THE BORROWER

A. Overview

14. BOG was established in 1994 through the privatization of the state-owned housing finance bank, Binsotsbank. Operating under a general banking license, BOG developed into a universal bank, aided by technical assistance and participation in institution-building programs provided by ABN AMRO Bank and a number of international financial institutions, such as EBRD and Deutsche Investitions-und Entwicklungsgesellshaft mbH (DEG).

15. BOG is currently the largest bank in Georgia with systemic importance (25%–40% share of total assets, loans, and deposits) (Table 2). Headquartered in Tbilisi, capital of Georgia, as of year-end 2006 BOG maintained a network of 99 branches throughout Georgia and had 124 automated teller machines (ATMs). Together with its financial subsidiaries, BOG provides one of the widest ranges of financial services available in this relatively underbanked and unsophisticated market.

Table 2: Market Shares of Georgian Banks, as of 30 November 2006
(%)

Bank	Assets	Loans	Deposits	Equity
Bank of Georgia	**27.8**	**25.3**	**23.1**	**39.3**
TBC Bank	23.0	22.8	26.4	13.4
United Georgian Bank	11.6	14.5	13.1	6.0
ProCredit Bank	10.0	11.8	9.6	7.0
Bank Republic	8.7	7.6	11.6	7.9
Cartu Bank	7.1	8.2	4.0	10.7
Other Banks	12.0	9.8	12.1	15.8
Total Market	**100.0**	**100.0**	**100.0**	**100.0**

Source: ING.

16. BOG is rated by all three international rating agencies and has a long-term rating of B+ from Standard & Poor's, B3/Ba1 from Moody's, and a B+ from Fitch (Table 3).[9]

(profits) and from the informal sector (i.e. pawnshops, relatives, moneylenders, etc.). Due to the high costs often associated with financing from retained earnings and the informal sector, and the often low level of SMEs' profits, these forms of financing are not optimal, and act as constraints to growth.

[9] BOG is the only Georgian bank to have obtained ratings from all three international rating agencies. Its ratings were most recently confirmed in connection with its debut Eurobond issue in spring 2007. BOG reported that it is requesting Moody's for an upgrade, but noted that a review of Moody's rating will not happen before September 2007.

17. Moody's rating is the highest currently attainable by any Georgian bank, and reflects BOG's systemic importance and market share, and hence the likelihood that BOG would receive financial support if needed from the Government.

Table 3: Bank of Georgia's Ratings by International Rating Agencies

	Local Currency	Foreign Currency	Eurobonds due 02/2012
Fitch			
Long term	B+	B+	B+
Short term	B	B	
Outlook	stable	stable	stable
Moody's			
Long term	Ba1	B3	Ba2
Short term	P-3		
Outlook	stable	stable	stable
S&P			
Long term	B+	B+	B+
Short term	B	B	
Outlook	stable	stable	stable

S&P = Standard & Poor's.
Sources: Rating agency reports.

18. In general, the agencies indicate that the ratings reflect BOG's (i) strong domestic position, providing the widest range of financial services of any bank in the Georgian market; (ii) adequate capitalization; (iii) sound core profitability; and (iv) well-defined, albeit aggressive, strategy to develop into a universal financial services provider.

III. THE PROPOSED ASSISTANCE

A. Overview

19. ADB proposes to provide a senior loan of up to $25 million with a term of up to 3 years to BOG for the purpose of onlending to small and medium-sized enterprises (SMEs) in Georgia (the ADB Loan).

20. The ADB loan is part of a joint $125 million facility provided by ADB and Citibank as coarrangers (the ADB/Citibank Facility) with Citibank underwriting $100 million.

21. The ADB/Citibank Facility will be divided into three tranches, with tranches 1 and 2 to be underwritten by Citibank, and tranche 3 to be underwritten by ADB: (i) tranche 1 will be in an amount of $50 million with a maturity of 12 months; (ii) tranche 2 will be in an amount of $50 million with a maturity of 18 months; and (iii) tranche 3 (the ADB Loan) will be in an amount of up to $25 million and a maturity of up to 3 years.

B. Main Terms and Conditions

22. The proposed loan will be sourced from ADB's ordinary capital resources and will carry an interest rate based on the London interbank offered rate (LIBOR) plus a margin determined by ADB's Credit Enhancement and Pricing Committee. The committee will also determine the up-front and commitment fees. The loan documentation will include financial covenants

(contemplated are the NPL ratio and capital adequacy ratio) as well as covenants relating to ADB's policies. The proposed loan will be unsecured.

IV. PROJECT BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Justification

1. Development Outcome

23. The proposed ADB assistance will promote the following development:

(i) **Support the emerging banking sector**. The banking sector in Georgia is growing rapidly, but remains small. The loan-to-GDP ratio of 15%, deposit-to-GDP ratio of 11%, and card penetration of 6% indicate that banking penetration in the country is much smaller than in many of its peers. By providing additional funding to BOG to expand its banking operations, ADB will be achieving its first objective: support the emerging banking sector.

(ii) **Increase access to SME financing**. ADB's second objective is to foster BOG's SME financing operations by providing part of the debt funding needed for its expansion in this particular sector. This will in turn help to expand the SME sector itself, which is a main force behind economic growth in Georgia and contributes significantly to employment creation.

(iii) **Extend maturities for leading banks in Georgia**. ADB's third objective is to extend the maturities of loans provided to top banks in Georgia. Whereas Citibank is providing two tranches of lending at 12 and 18 months, the ADB loan will have a 3-year tenor. This will allow BOG to better match longer-term loans to borrowers with longer-term financing as provided by ADB.

(iv) **Catalyze foreign funds into Georgia**. Through ADB acting with Citibank as coarranger for this transaction, ADB is helping to catalyze foreign investment into the country by providing confidence in the transaction to other investors who are contemplating participating in the syndicated portion of the loan, and by helping to establish a visible pricing benchmark to which other investors will refer to facilitate pricing future transactions.

24. Achievement of these objectives will result in the following outcomes: (i) BOG will be enabled to conduct more business and will contribute to an expanding banking sector; (ii) SMEs in Georgia will have broader access to financing as a result of BOG's increased ability to finance the SME sector; (iii) BOG will be better able to match assets and liabilities, and the precedent may be set for other funders to provide funding of similar tenor; and (iv) more foreign investors will be attracted to provide funding to Georgian financial institutions.

2. Value Added by the Asian Development Bank

25. ADB's proposed loans will add value by (i) enabling BOG to grow its SME loan portfolio; and (ii) providing BOG with access to longer maturities, matching its assets and liabilities better. Specifically, ADB will provide a 3-year loan to BOG, thereby creating a visible benchmark for 3-year funding in a publicly syndicated loan transaction (a year-and-a-half beyond what Citibank will be offering through its involvement in the transaction).

3. Design and Monitoring Framework

26. ADB has prepared a design and monitoring framework and will measure the expected development impact of the loan, in accordance with ADB's Management Development Results Policy (Appendix 1).

4. Fit to Country and Sector Strategy

27. ADB has not yet prepared a Country Partnership Strategy for Georgia. ADB will therefore initially establish a presence in the country through its non-sovereign operations while addressing key development areas, such as SME and capital market development. The Georgian Government is fully supportive of ADB's involvement in the financial sector as its first intervention in the country, and arranged for introductory meetings between ADB staff and top Georgian commercial banks. Based on those meetings, ADB will consider providing financing to three banks (out of the group of the top seven), through debt and equity financing and technical assistance, as well as the issue of guarantees (including for securitization transactions). The proposed transaction forms an integral part of ADB's move into this new market, and is particularly important as ADB has teamed up with Citibank.

B. Environmental and Social Safeguard Policies

28. The proposed loan is classified as category FI (financial intermediary) under ADB's *Environment Policy* (2002). BOG follows EBRD's environmental and social safeguard policies, has established an environmental management system (EMS), which is in line with ADB's standards, and has sufficient capacity to implement them. Significant environmental impacts are not expected, as BOG will be using the proceeds of the ADB loan to onlend exclusively to SMEs. The proposed loan is classified as category C under ADB's *Involuntary Resettlement Policy* (1995) and *Policy on Indigenous Peoples* (1998), as no involuntary resettlement or adverse impacts on indigenous peoples are foreseen in relation to any activities of BOG.

C. Anticorruption Policy, and Combating Money Laundering and the Financing of Terrorism

29. ADB's *Anticorruption Policy* (1998) was explained to and discussed with BOG. Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the Project. To support these efforts, relevant provisions of ADB's Anticorruption Policy are included in the loan documentation. BOG has also been advised of ADB's policy on the combating of money laundering and financing of terrorism.[10] Consistent with its commitment to good governance, accountability, and transparency, ADB will require BOG through covenants in the loan documentation to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money-laundering activities or the financing of terrorism, and to covenant with ADB to refrain from engaging in such activities.

[10] ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism.* Manila.

V. EXPOSURE LIMITS

30. The proposed senior loan to BOG will be ADB's first nonsovereign investment in Georgia. Once approved, it will increase ADB's private sector investment in the banking sector from 21.58% to 22.16%. The proposed loan is within ADB's aggregate country, industry, group, and single project exposure limits for nonsovereign investments.

VI. ASSURANCES

31. ADB will enter into acceptable loan agreements and other required legal documents, following approval of the proposed loan by the Board. These agreements will be on terms and conditions satisfactory to ADB.

32. Consistent with the Agreement Establishing the Asian Development Bank, the Government will be asked to confirm that it has no objection to the proposed ADB loan to BOG. No funding under the loan will be made available until ADB receives such confirmation.

VII. RECOMMENDATIONS

33. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve a loan of up to $25 million to Joint Stock Commercial Bank of Georgia from ADB's ordinary capital resources, on such terms and conditions as are substantially set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

12 July 2007

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
Impact The GDP composition of the Georgian economy is more diversified (i.e., more SMEs in more sectors contribute to a more diversified economy)	• Percentage of GDP contributed by the SME sector rises from 15% to 20% in 5 years	• NBG statistics	**Assumptions** • Increased access to finance from banks will lead to more SMEs receiving loans and expanding their role in the economy • Stable or increased economic development in Georgia
Outcome BOG provides increased, sustainable access to finance to SMEs in Georgia	• BOG's number of SME borrowers increases (10% in next 24 months) • BOG's credit quality is high, nonperforming loans less than 4% • BOG's return on equity stays above 15% • BOG's capital adequacy ratio remains above NBG norms	• BOG's quarterly and annual financial statements • Reporting specifically requested by ADB	**Assumptions** • SME demand exists for loans • No adverse economic developments in Azerbaijan • No regulatory changes for banking • No other exogenous factors have a negative impact on banking development **Risk** • BOG breaches domestic prudential/NBG norms
Outputs • ADB provides senior loan • BOG operationalizes use of senior loan	• Loan requests received by BOG increase by 25% per annum from current levels	• BOG's quarterly and annual financial statements • Reporting specifically requested by ADB	**Assumptions** • Prevailing market conditions are stable • All regulatory approvals in place for ADB
Activities with Milestones 1.1 Provide BOG with $25 million senior loan by August 2007. • ADB and BOG enter into loan agreement 1.2 Operationalize proceeds of senior loan by BOG (ongoing). • Origination of (new) client opportunities • Due diligence on clients • Completion of loan agreements with clients • Disbursement of loans to clients			**Inputs** • ADB: $25 million

ADB = Asian Development Bank, BOG = Bank of Georgia. GDP = gross domestic product, NBG = National Bank of Georgia, SMEs = small and medium-sized enterprises.

GEORGIAN BANKING SECTOR

1. The Georgian banking sector was transformed immediately upon Georgia's independence from the former Soviet Union in 1991, when a two-tier banking system was introduced: the former GosBank (state bank of the Soviet Union) Georgia branch became the National Bank of Georgia (NBG) and various commercial banks were established. Subsequently, the five state-owned Georgian banks (Agromretsvbank, Binsotsbank, Eximbank, Mretsvmshenbank, and Savings Bank) were fully privatized from 1993 to 1995.

2. NBG was established as an independent supervisory, regulatory, and monetary body; however many of the practices in place when it was part of the former Soviet Union remained largely unchanged. In particular, it was still directly influenced by the Government and required to finance the budget deficit and provide indirect loans to state-owned enterprises in Georgia.

3. During 1991–1994, Georgia experienced intense political and economic turmoil resulting from the breakup of traditional trade relations within the former Soviet Union, followed by a military coup, civil war, and two secessionist wars. As a result, Georgia experienced one of the deepest economic recessions among the former Soviet republics. During this period, NBG pursued an overly liberal monetary policy, which, coupled with low capital requirements for the licensing of commercial banks (the minimal statutory capital for a bank in 1994 was approximately $500 in real terms), encouraged rapid growth in the number of banking institutions in the country—from five commercial banks in 1991 to 226 in 1994. By 1994, the majority of commercial banks were in financial difficulty, and as a result of hyperinflation, bank deposits had lost almost all value.

4. On 23 June 1995, Parliament adopted the Organic Law of Georgia on the National Bank of Georgia, and on 23 February 1996 it adopted the Banking Law, which strengthened the independence of NBG and granted it more authority to suspend the licenses of banks that failed to meet prudential norms. NBG's banking supervision policy was based on the 25 Key Principles of Efficient Banking Supervision developed by Basel Committee of Banking Supervision. Furthermore, new rules and procedures to regulate banking activities were introduced that envisaged the creation of a new system of assets classification to identify credit risks with greater precision, enhance external and internal auditing functions, and eliminate conflicts of interests in banking activities. As a result of these changes, the number of commercial banks in Georgia was reduced by 173 to 53 during the 3 years from 1994 to 1997. Following these reforms, the banking industry became the fastest growing industry sector in Georgia. From 1997 to 2004, financial intermediation grew by almost 8.7 times in real terms, compared with an increase in gross domestic product (GDP) of 1.6 times.

5. In 1997, additional bank industry regulations came into force. NBG lowered reserve requirements in an attempt to encourage greater financial intermediation in Georgia by reducing the intrinsic costs of high reserve requirements to commercial banks operating in the territory. At the same time, the minimum capital adequacy ratio was increased from 8.0% to 10.0% of total assets. In January 1997 NBG announced its plan to gradually increase the minimum capital requirement for commercial banks to GEL5.0 million by the end of 2000, to promote consolidation of the banking sector. Throughout 1998 NBG pursued this objective by revoking licenses of banks failing to meet minimal capital requirements and other prudential regulations.

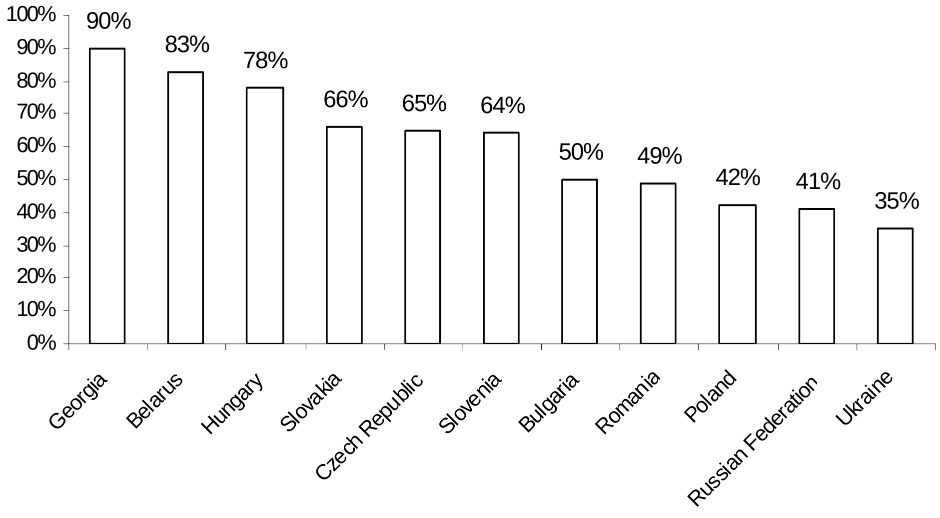
6. 1998 was marked by the Russian financial crisis, which led to a 40% devaluation of the lari, the Georgian currency; a consequent reduction in commercial bank deposits; and a significant slowdown in GDP growth. NBG introduced stricter prudential norms to stabilize the Georgian banking sector and prepared a plan to help banks maintain their liquidity by offering short-term liquidity loans. Only two Georgian banks requested stabilization loans of less than GEL4.0 million in total.

7. From 1999, new accounting rules consistent with international accounting standards were introduced and minimum capital adequacy requirements strengthened from 10.0% of total assets to 12.0% of risk-based assets of tier-one capital and 15.0% for total capital. Banks were required to appoint international audit firms to carry out external audits from February 1999.

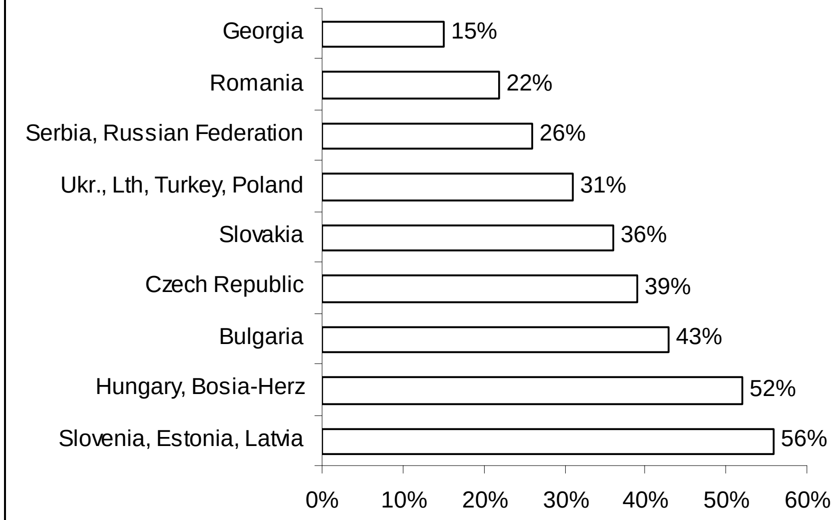
8. In 2000, NBG introduced the CAEL (capital, assets, equity and liquidity) methodology for assessing the financial condition of operating commercial banks. This system, which has evolved into and is now known as the CAMEL (capital, assets, management, equity, and liquidity) system, is routinely used by NBG analysts to assess the performance of banks and develop a set of recommendations on measures needed to induce improvements in the financial and operating results of the banking institution in question. As a result of the introduction of these policies and prudential norms, the number of licensed commercial banks decreased to 30 by 31 December 2000, 19 by 31 December 2005, and 17 by 30 November 2006.

GEORGIAN BANKING SECTOR COMPARISON

Appendix A3.1: Banking Market Shares of Top Seven Banks by Assets

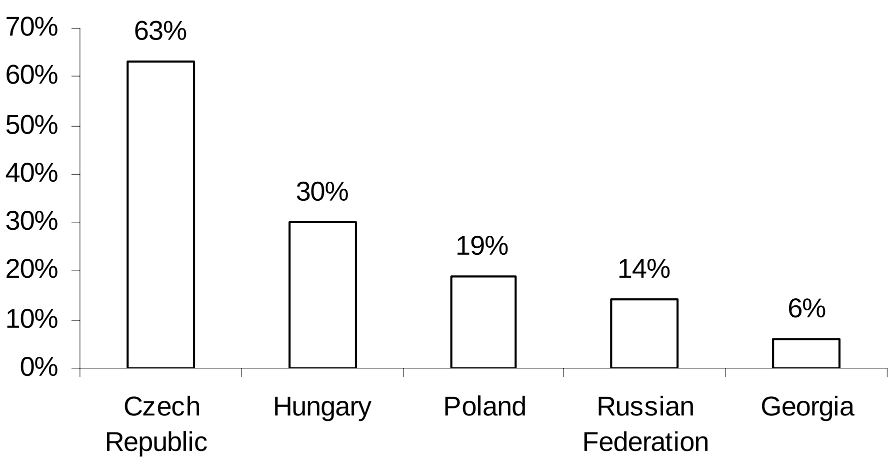


Appendix A3.2: Gross Loans to GDP (%, 2005)



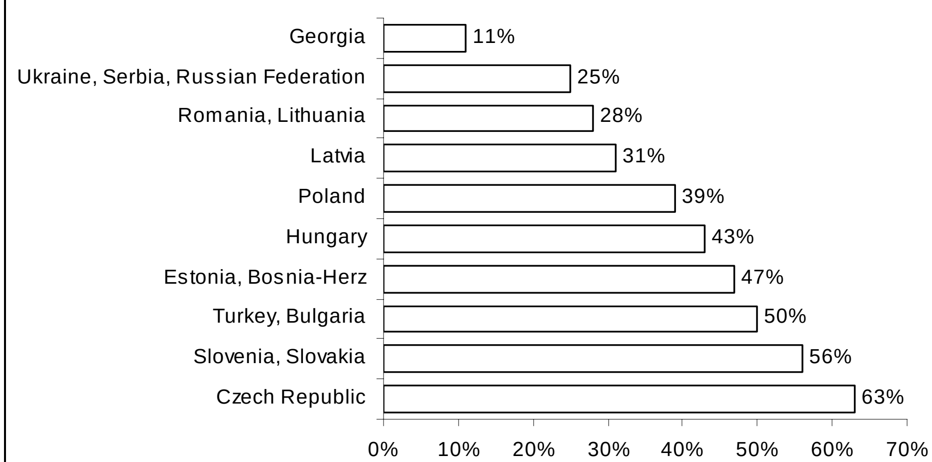
Source: People's Bank.

Appendix A3.3: Card Penetration (% of population, 2005)



Source: People's Bank.

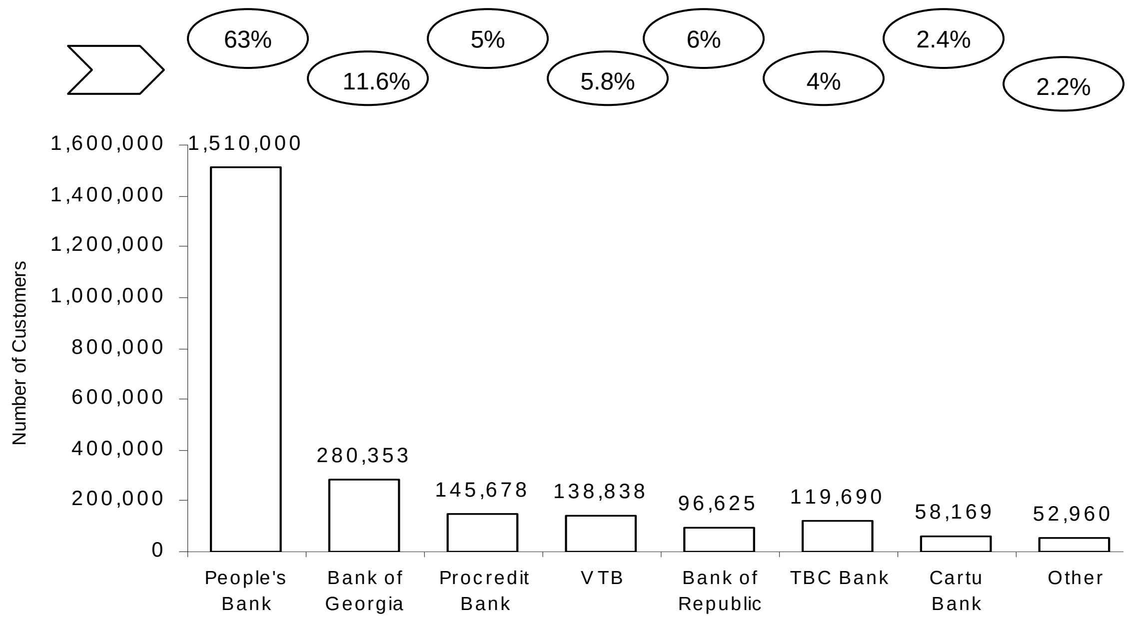
Appendix A3.4: Total Deposits to GDP (%, 2005)



Source: People's Bank.

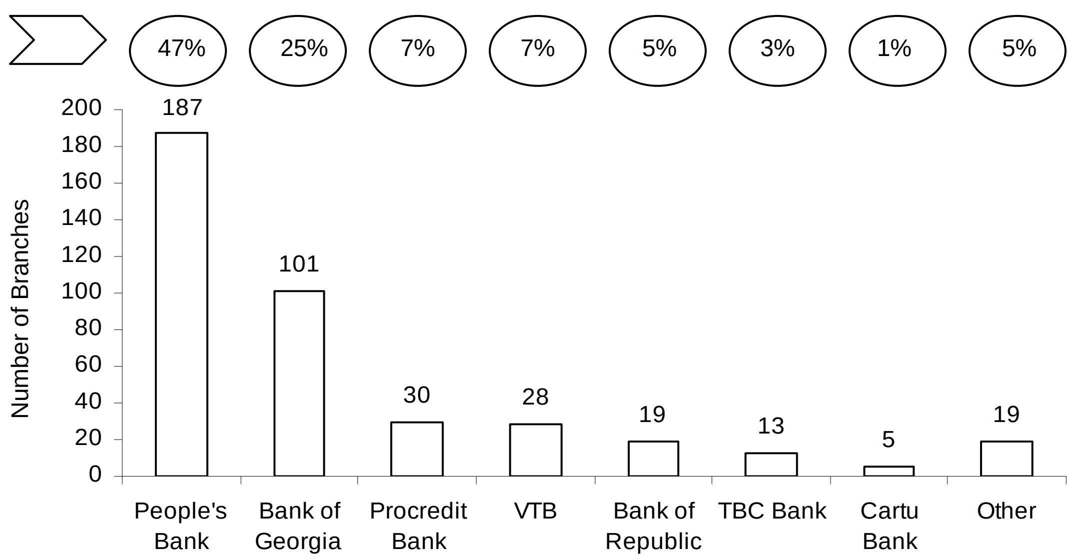
GEORGIAN BANKS PEER GROUP ANALYSIS

Figure A4.1: Georgian Banking Sector—Largest Number of Customers



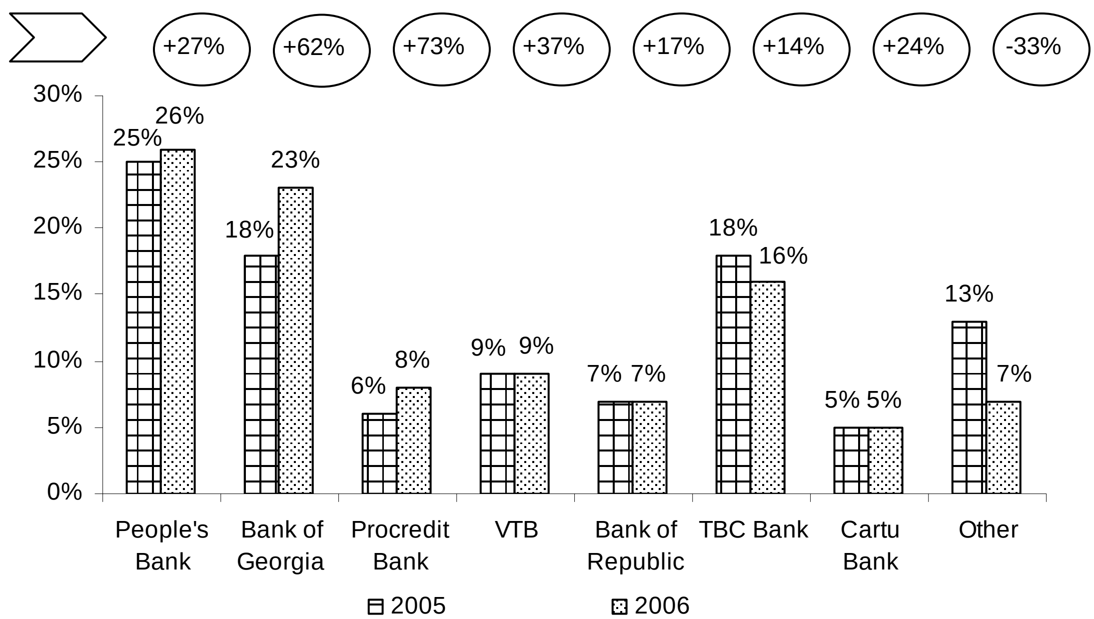
Notes: 1. All data based on standalone accounts as reported to the National Bank of Georgia and as published by the National Bank of Georgia, www.nbg.gov.ge
2. Change in peer group total assets calculations based on GEL values.
Source: People's Bank.

Figure A4.2: Georgian Banking Sector—Largest Branch Network



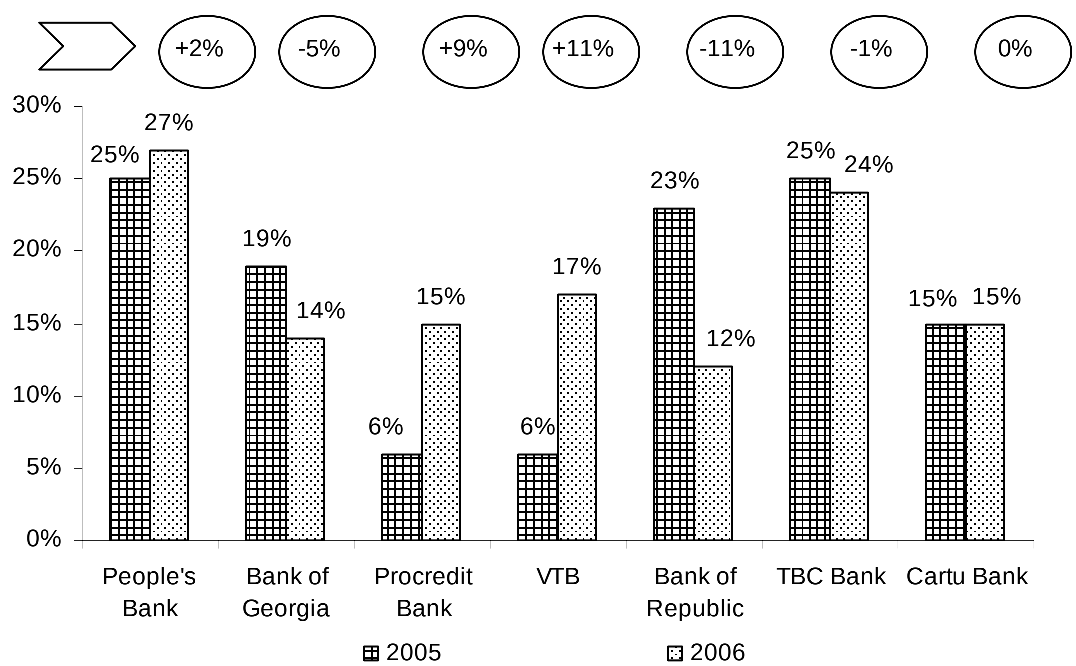
Notes: 1. All data based on standalone accounts as reported to the National Bank of Georgia and as published by the National Bank of Georgia, www.nbg.gov.ge
2. Change in peer group total assets calculations based on GEL values.
Source: People's Bank.

Figure A4.3: Georgian Banking Sector—Highest Net Commission Incomes



Notes: 1. All data based on standalone accounts as reported to the National Bank of Georgia and as published by the National Bank of Georgia, www.nbg.gov.ge
2. Change in peer group total assets calculations based on GEL values.
Source: People's Bank.

Figure A4.4: Georgian Banking Sector—Best Return on Equity Ratio



Notes: 1. All data based on standalone accounts as reported to the National Bank of Georgia and as published by the National Bank of Georgia, www.nbg.gov.ge
2. Change in peer group total assets calculations based on GEL values.
Source: People's Bank.