Development of the Banking System in Georgia

Tea KBILTSETSKHLASHVILI

Abstract: *Over fifteen years have passed since the beginning of the reconstruction of the transition countries' banking systems. The analysis of the development of commercial banking in Georgia and other transition countries points out several features, which are typical for the starting period of financial sector reforms. It turns out from this article that the success of the reconstruction of banking sector in certain countries differs substantially. Since the starting of reforms the Georgian banking sector has passed two development periods ending with banking success. The first period can be named as a "wild "and the second as a "naive-optimistic" banking period. The development cleared the banking sector of weaker links and showed both the central bank and the management of operating banks the directions for improving banking regulations and management international practices. In my article I do not deal only with the success of the reforms of a Georgian banking sector from the aspect of the growth of assets but also paid a lot of attention to the changes in quality. In this study I researched the extent of the growth of the Georgian banks' creditability, the stability of their working results, the conformity of services to clients' needs, the harmonization of banking regulations with the European Union's requirements and the implementation of good International banking practices in Georgia. For today the transition period in Georgian banking has been actually passed. The banks operate in accordance with modern market economy patterns in every respect. The cornerstones of the Georgian banking sector reforms success have been stable economic policy as well as stable currency and the central bank's policy incisiveness, which forces the reforms.*

Keywords: Georgia, Banks, financial market, credit, development.

Introduction

The main purpose of commercial banks' shareholders and executive management is to increase the value of the company, which requires both a quick rise in the range of the financial services offered and an increasing level of efficiency of the business activities. But in Georgian economy the macroeconomic risks are significantly higher than in countries with developed market economies. Therefore, the implementation of

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commercial banking in Georgian economy means first of all that banks are very ambitious and subject to risks. The risk management experience of the staff of commercial banks is short and the systems for risk management are in a forming stage. This suggests that the indicators of effectiveness of banking in Georgian economy are volatile, that bank failures occur frequently and that the probability of the occurrence of a banking system crisis is very high. Development of the financial sector in Georgia has been one of the more difficult areas of reform since at the start of transition there were virtually no free markets. The main problem is that banks in Georgia had to restructure themselves, considering the needs of market economy, and at the same time be subject to globalization process. These two developments occurred at accelerated speed and in the midst of economic, financial crises and reforms. For this reason the internationalization of banking business in Georgia has substantial differences compared to the internationalization of banking in developed countries. The Georgian banking sector has been one of the first to realize the opportunities and risks involved with the global market. As retail, domestic capital banks must guarantee their clients and their foreign partners for international banking business financial service of the same quality as international banks, their efforts towards internationalization are understandable and reasonable in every respect. Research on banking reconstruction in Georgia shows, that the major banks of a transition economy will reach the level of developed countries' banking in relation to the banks' trustworthiness, contemporaneity of products and standards. This is also a claim of global economy for survival, which has been realized generally by the banking of Georgian economies. But the disadvantage of such kind of development is the utmost concentration of banking as a result of competition, which is essential to guarantee price deflation in a banking market. For today the transition period in Georgian banking has been actually passed. The banks operate in accordance with modern market economy patterns in every respect. But in several countries the reforms are quite in the starting period. The cornerstones of the Georgian banking sector reforms success have been both active economic policy as well as low volatility currency with the help of international banking and the central bank's policy. (An Assessment and Rating of the Georgian Banking System, 1998)

Overview of the Georgian Financial Sector

For the last 10 years the financial system of Georgia has undergone significant changes. With gaining of independence, actually from zero, began creation of financial infrastructure. The National Bank of Georgia

(NBG) has been created; the national currency (Georgian Lari - GEL) has been issued; the commercial banks have been certified (thereafter the number of banks was decreased 10 times); criteria of an estimation of liquidity of banks have considerably been toughened. Because of the reasonable monetary policy of the NBG it was possible to achieve such positive macroeconomic tendencies as low inflation and stability of the national currency. Notwithstanding all those positive changes that have taken place in the Georgian financial (banking) sector, there are problems with the long-term direction of a trend and requiring structural changes in the sector and improvement of the political and economic situation in a broader sense as well. The financial system of Georgia includes banking system and other financial institutions. By the first of July 2003 in Georgia 23 commercial banks operated, from which 13 were created with the foreign capital. Besides commercial banks, there are 43 non-banking depositary institutions (credit unions), 300 exchange bureaus, 23 insurance companies, 3 pension funds and 1 stock exchange. (Shown where, did you mean to include a table?) Thus the financial infrastructure does not vary. Its basic component is the commercial banking system. For example, joint assets of Credit Unions amounted to only GEL 2 million (Migineishvili, 2005)

The minimum amount of paid-in capital for commercial banks is GEL 5 million cash. The main direction of current reforms in the banking sector is to continue banks' capitalization with a wide range of services, diversified investment portfolio, adequate risk management and high confidence among institutional investors and the population. The problem of risk is very topical, since successful banking activity means active risk management, and this is extremely important for Georgian banks with the biggest share of income from loans so that bank runs do not occur. Substantial steps towards developing the banking system were made by improvement of the supervising process over problematic banks, issuing new criteria of banking assets' classification and implementation of International Accounting Standards in commercial banks. Significant steps were made to improve the quality of top managers and shareholders in commercial banks (Georgian Economic Trends, 2003). Developing a deposit insurance system is urgent to overcome mistrust of the society towards banking system. A very important role could be fulfilled by the introduction of a deposit insurance scheme, which is planned in the next two years. To create a deposit insurance scheme, the soundness of the whole banking system should be the first priority. It is clear that commercial banks will totally or at least partly contribute to the scheme, so that this burden is distributed equally. It requires minimization of banks' insolvency risk. In other words, there must be a minimum of banks with a weak financial position. To achieve this goal the process of financial improvement of the banking system should be continued. For now the system of deposits insurance in Georgia is not developed. Indirectly, this function is performed with the following tools:

1. Meet liquidity indicators established by the NBG for commercial banks;
2. Deposit to the National Bank of Georgia (the Central Bank) the required reserves (14 percent of funds attracted by commercial banks);
3. Abide by Paragraph 7 of the Article 3 of the Law «On Activities of Commercial Banks» which, in case of bankruptcy of bank, provides a prime covering of liabilities to investors.

However, the listed measures, certainly, cannot replace a sound deposits insurance system. In future, through development of the economy, the increase in financial flows through the banking system will lead to the process of product diversification from commercial banking to investment banking . As a whole, confidence in the banking system in Georgia is low; loan portfolio management is weak; and intermediation costs are high. Spread between deposit and lending rates are large; most transactions are made in cash, reflecting the high level of the grey economy, which may indicate that fiscal reforms are needed in order to strengthen the banking system. Due to the low capitalization of the stock exchange, most banks have very limited access to market sources of liquidity. High lending rates mean a low level of credit to the private sector and many enterprises still rely on their own resources for investment financing (Laliashvili, 2002).

Transformation of Georgia's Financial System

The transformation of Georgia's financial system was going on the background of heavy economic and political crisis. In 1991-1994, the production volume dramatically dropped by 70% resulting in grave financial crisis, moreover collapse of traditional foreign economic links, unjustified monetary policy, imperfect banking legislation, weak requirements for licensing and hyperinflation increased instability of banking system. Extremely low required initial capital encouraged rapid growth of the number of banking institutions. From 1991 to 1994 number of commercial banks functioning in country increased from 5 to 226, but because of extremely low capital biggest part of them faced financial difficulties, consequently volume of deposits dropped to zero. Reforms in the banking system of Georgia were urgent and this process was launched mainly based on the assistance of the International Monetary Fund, World Bank, European Bank of Reconstruction and Development and other international financial institutions. In February 1996 Law on Activities of the Commercial Banks was approved, which strengthened the independence of the NBG and granted it more authority to suspend licensing of the banking activities to those organizations that failed to meet prudential norms. The bank supervision policy of the NBG was based on the 25 Key Principles of Efficient Banking Supervision recognized by the whole world. Establishment of worldwide accepted standards and more powerful regulations stabilized banking operation and increased their reliability. Starting from 1997, the banking system of Georgia tended to grow significantly rapidly. As a result of development of the banking system, the banking sector compared to other sectors was annually developing at a preceding rate. In 1997-2004, financial intermediation, one of the types of economic activities, grew almost 8.7-times in real terms, while the GDP only 1.6-times. According to 2005 data, broad money ratio to nominal GDP, being the measure of financial depth, comprised only 16.5%, and ratio of gross bank assets to GDP, approximately 17%. In absolute terms, gross assets of Georgia's banking sector as of December 2005 accounted to GEL 2.54 billion. This indicator grew by 50% during the year of 2005. Despite the fact that banking sector's share itself is rather small, it offers its clients all kinds of banking services currently available in the developed countries. The indicator of gross capital ratio of banks to the GDP also increased from 3.7% in 2004 to 4.2% in 2005 demonstrating strengthening of sustainability of the banking system. 2005 turned out to be very productive for the banking system demonstrated by 85%-growth of credits. The ratio of credits to the GDP in 2005 comprised 14.4% instead of 9.2% in 2004(www.nbg.ge).

Legislation of Georgian Banking System

According to the legislation on commercial banks Georgian banking system refers to two tier banking system, that means that whole system is regulated and supervised by superior bank-national bank of Georgia, which is powered with right to investigation operations of all other existing bank, set requirements and liquidate commercial financial institution in case of failing to meet obligations. Commercial banks are multi-functional banks and provide all kind services. Proper and flexible legislation is key for successful development of banking system for these purpose ineffective legislative rules were abolished and substituted with widely practiced and accepted law, thus modern Georgian banking legislation is compatible with standards of European legislation patters and imposes more stick requirements. The objectives of the Law on Commercial Banks is to raise the level of financial stability, improve safety and soundness of banking system, implementation modern bank supervision policy and practice, introduce International Accounting Standards, upgrade the qualification of banking personnel, and improve the financial sustainability of commercial banks. In order to achieve above goals several restriction are introduced:

- NBG obliges newly established commercial banks to fulfill minimum requirements for paid in capital which is determined by resent order as GEL 12 million. Moreover commercial banks are prohibited to hold non-cash authorized capital. Paid in capital assures soundness of banks and their ability to repay deposits in case crises.

- As initial capital for establishment of bank is sufficiently high only compulsory legal status of banks is a joint stock company.

- No shareholder of a commercial bank shall hold any number of shares, which exceeds 25 percent of the outstanding total capital of that commercial bank, except if shareholder is another commercial bank.

- Mergers or opening of new branches cannot take place without authorization of NBG

- Banks shall refrain from entering into transactions or engaging in practices of any kind that provide them, alone or together with others, a position of dominance on the money, financial or foreign exchange markets.

- Banks shall refrain from engaging in manipulative practices and trading of stock of other companies which could result in unfair advantages for themselves or for third parties, by contributing fostering reduced competition in banking services such as through cooperative price fixing interest rates or in brokerage fees.

- No bank shall enter into any agreement with any customer under which the granting of any loan or the provision of any other banking service to such customer is conditioned upon the purchase or use of any additional service of that bank or of any of its affiliates (www.nbg.ge).

Besides these crucial requirements Georgian legislation pursues fundamental principles and practices of international financial organizations and other developed countries demanding banks to banking confidentiality, auditing committees etc.

Current situation

Currently Georgian banking sector is represented by 19 banking institutions, of which 18 are Georgian resident private commercial banks, and 1 is branch of Turkish " Ziraat Bank" 80% of the total assets hold is concentrated among top 8 banks, who provide the most modern and flexible service to customers. Top Georgian banks refer to B+ risk group.The main direction of current reforms in the banking sector is to create stable and capitalized banks with a wide range of services, diversified investment portfolios, adequate risk management and high confidence among institutional investors and the population. Substantial progress has been achieved in the diversification of banks' activity. Several years ago, Georgian banks had the biggest share of income from loans, which made them open to injury from bad loans, though banks had developed other services, which made them less vulnerable. As the result of successful reforms in the banking sector, the role of the banks in the economy has been increasing gradually. Currently banking sector remains the most growing part of the whole Georgian economy and implemented measures are assessed positively by all international financial organizations. To characterize Georgian banking system several fundamental features should be considered, among which are profitability, risk, capital adequacy asset and deposit proportion (www.nbg.ge).

Services provided by Georgian banks

Georgian banking system offers wide range of bank and non-bank services. Actually banks provide almost all services that are introduced in developed countries, but still new innovations are adopted and competition force banks to develop more flexible and consumer oriented packages.

- Deposits

Deposit on demand - these deposits enable holder to withdraw money at any time they wish, minimum requirement is 100 Gel, and annual interest is at 2%.

Term deposit - these deposits have fixed maturity usually for Georgian banking system it has up to 2 years maturity and minimal payment should be 500 Gel, the interest differs according maturities and varies from 6% to 13% if deposit is opened in Gel.

Cumulative deposits - interest rates are in the range of 8.5% and

12%, these package is attractive because customer not just expect high returns, but additionally it enables holder to ask for discount on loans.

Deposit+ - these is very modern type of deposits, which was recently introduced and established in by Georgian Banks. It is very unique and convenient because enables to benefit from advantages of term deposit and deposit on demand i.e. get at the same time high interest, while still have allowance to use portion of deposit for current expenditures. Maturity of such deposits are up 2 years and interest are changing from 13.1% to 7.7% depending on ratios.

Saving accounts - advantages of these product are high interest rate, unlimited maturity, monthly interests, bonus payments. Minimal payments are average 100 GEL, Interests are approximately 7.5-8% for account in GEL.

- Loans

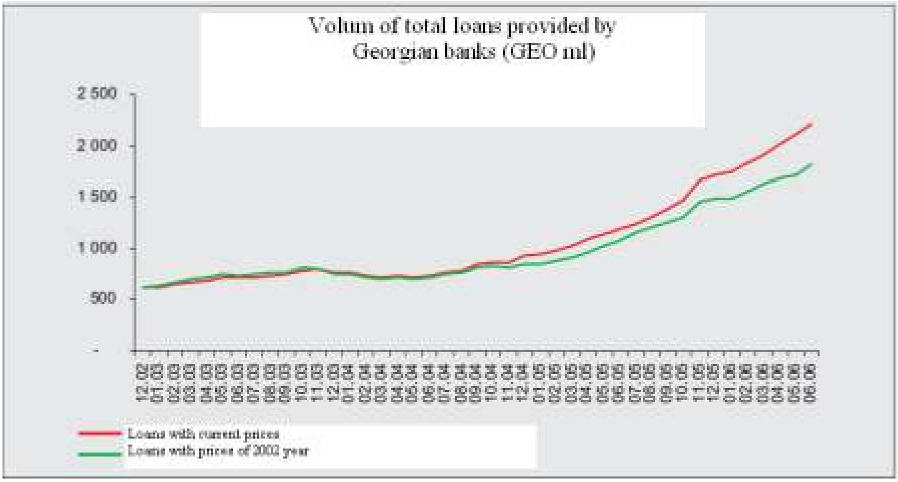
Mortgages - these loans are determined for acquisition of real estate and have maturity from 6 month to 20 years, most Georgian banks provide such loans at high interest rate about 15% because of relatively high associated risks, but very interesting and flexible service was introduced by Bank of Georgia which enable to decrease this interest rate from 15% to 10% by depositing 100 Gel monthly.

Student loans - loans are determined to finance acquisition of education, maximum maturity is up to 7 years and interest rates vary from 14-18% according to type of education, degree, location and etc.

Special purpose loans - unifies loans determined for purchasing durable goods, the maturity of such loans are mostly very short up to year with monthly interest 2-5% (www.nbg.ge).

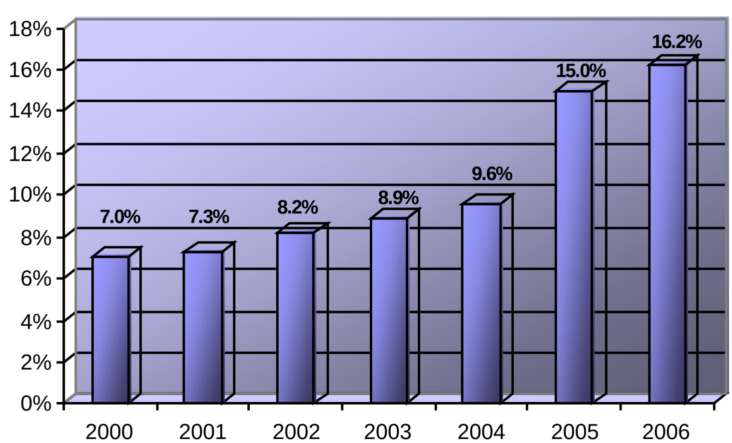
Loans

From the 2000 there is ascended tendency concerning loans, but it should be mentioned that on the background of increases loan to individuals and companies, the share of loans in total incomes decreased that has positive influence on risk associated with banking operations. According to the data situation of provided loans in 2006 is reported to be increased by 30% relatively volume of credits in 2005 and by 84% relatively to the same month of previous year. During the whole year there was stable upward trend in 2006, that is more impressive comparing to 2004 when there was sharp but temporary drop in loans.

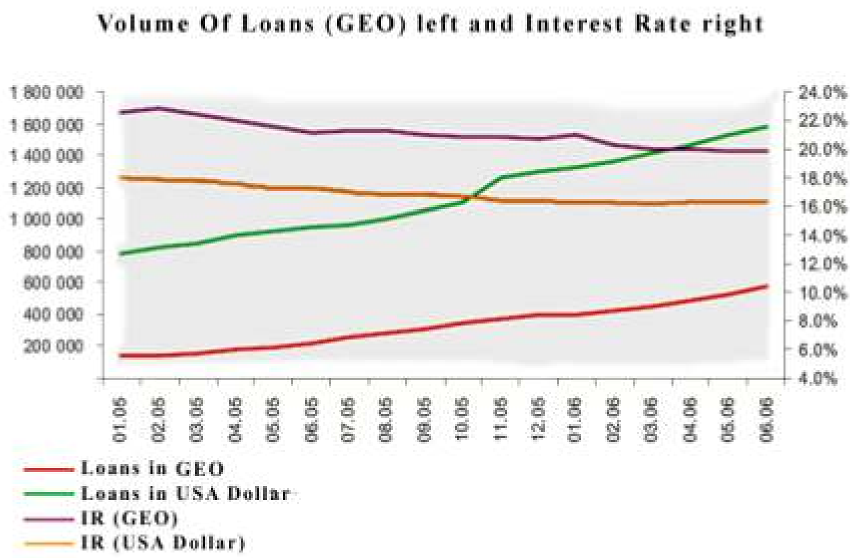


Only in 2006 total volume of credit portfolio comprised 16.2% of GDP of Georgia. This indicator is recordly high for our country, but still there is large gap in comparison with other countries, for example in Turkey share of credit portfolio in GDP is 20% and in most developed countries 150%. This indicator is crucially important as shapes integration level between financial and real sector, thus a little fluctuation in financial stability will cause serious damages in real economy and vise versa.

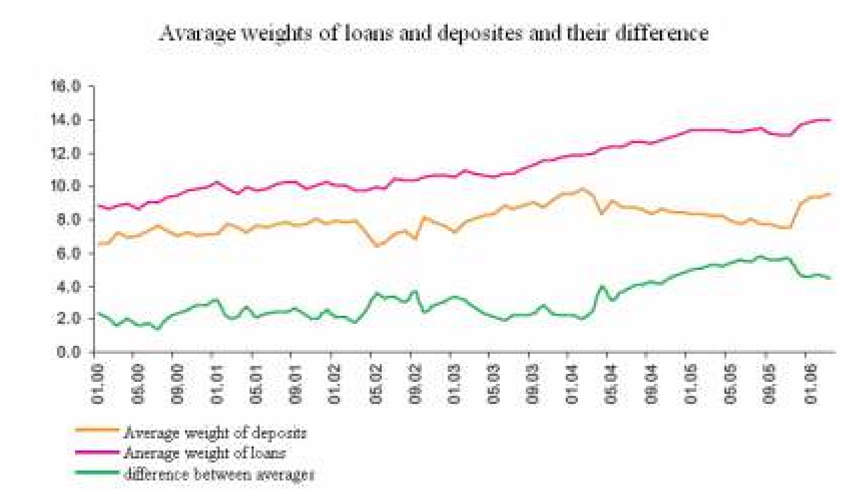
Share of credit portfolio in GDP



The credits in Lari denomination increased 3.1 times. It is worth mentioning that crediting growth in the national currency, especially in the second half of 2005, was conditioned not as much by demand from the economy as by the surplus of liquidity in the banking system. In these conditions, it is likely that banks would accommodate potentially problematic loans in more or less amount. Very important aspect is that this growth in credit abilities was not determined by rapid growth in assets' volume, but consisted only 50-55% of total assets.



Above graph indicates that dolarization still is one of the major problems of Georgian banking system. Increase trend in loans means

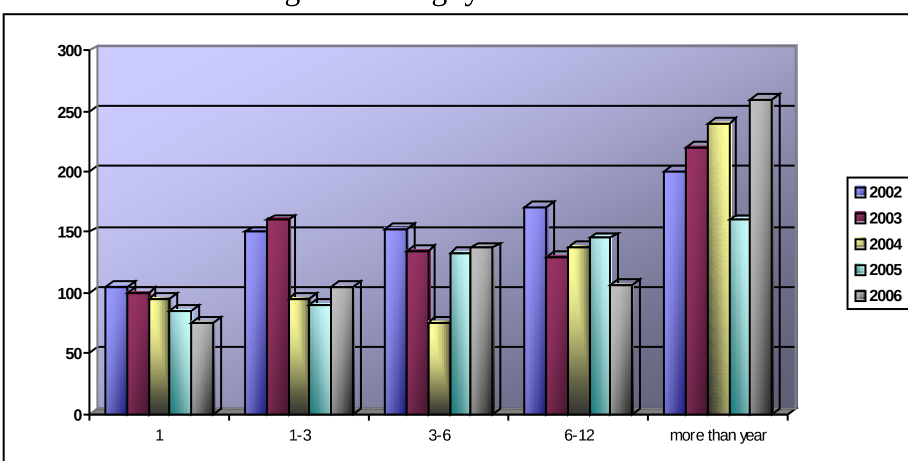


increase in liabilities of banks, that is risky factor of this trend especially when difference between weighted averages of loans and deposits are sufficiently high. In the first half of 2006 there was evidence of reduction between maturities that should be regarded as positive phenomena.

On the other hand rapid growth of loans cares several threats because accompanied by inflation it can appear to be best source for financial crises, especially when provided loans are effected by currency exchange rate and fluctuations of interest rates will seriously contribute in this negative processes. Considering current data if Rate of lari dropped by 40% in 5 largest banks balance of adequate capital would disturbed (www.nbg.ge).

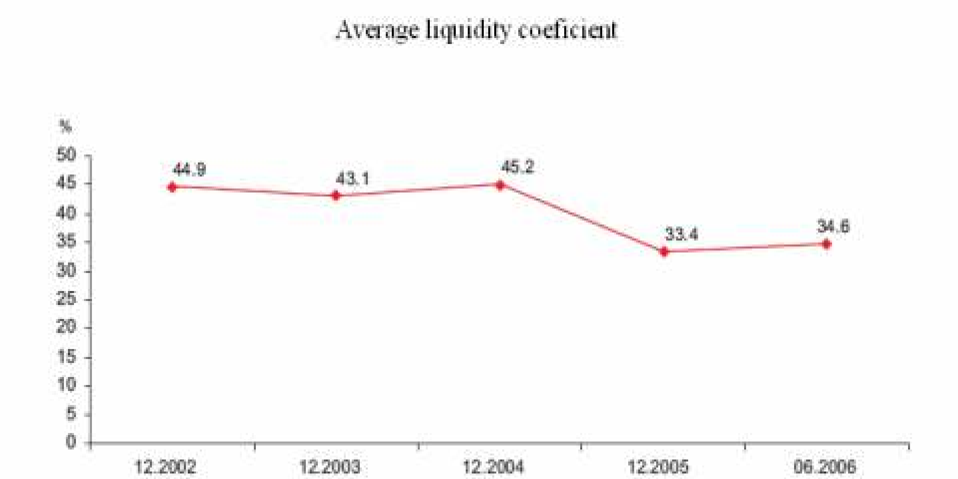
Assets

In 2006 Cash and cash equivalent financial instruments share in total actives increased slightly comparing to previous years. The share of riskless loans increased from 53% to 64.5% that is very significant change because structure of total actives is converted to more liquid but less profitable assets. The greatest portion of national currency loans are short-term loans, while dollar loans are long-term loans, that is caused by expectation that exchange rate of lari will remain same, while in long-term period banks avoid high risk related with exchange rates. As for deposits they mostly tend to be short-term that once again demonstrates low confidance rate of Georgian banking system.



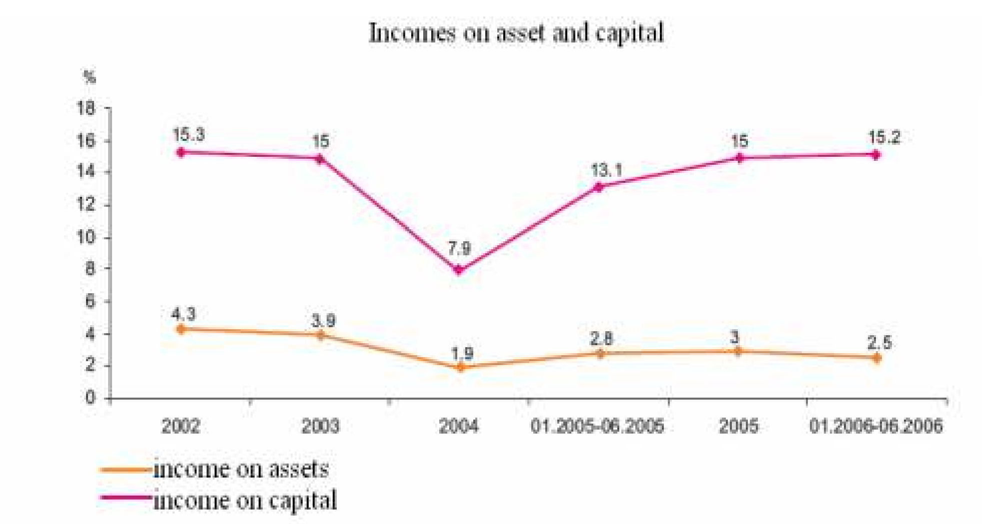
Liquidity

Liquidity of Georgian banking system is regarded as positive and remains normal from 2005 to 2006 at 34.6%, but this is visible reduction relatively to 2004 when this indicator was equal to 45.2%. While assessing liquidity of Georgian banking system we should consider that majority of liquid actives are denominated in USA dollars, it point out that exchange rate is primer factor that controls liquidity of banks.

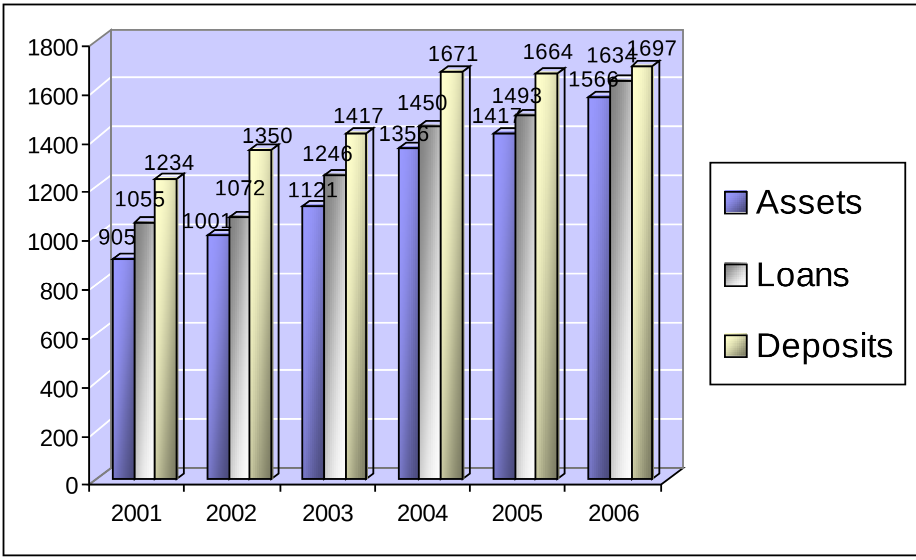


Profitability

The net income of baking sector accounted to 38 ml GEO, that is 50% more that previous data.



During this period income on asset amounted to 2.5% and on capital 15.2%, that indicates that revenues for asset are decreasing while on capital increases.



- Other services offered to customers

Credit Cards - modern trend in banking sector is to create special card designed for particular segments. These cards become more popular as gradually implementation of advantages of these payment system is becoming enable.

Online payments - modern trend in banking sector, is introduction of internet banking which enables to conduct any king of banking operation via internet, including all utility payments thus this system is very convenient.

Insurance services - these services are provided by banks because most of Georgian banks tend to be group organizations i.e. they are combined with insurance companies and their unity significantly reduces associated cost, makes it affordable to offer insurance with any other typical banking product, on the other hand increases effectiveness of insurance companies. Nowadays banks can insure not only real estate but also person's life.

Pension funds - comparatively new direction in saving plans, the advantages of these system is that it is not taxed, and withdrawal of money is available earlier than maturity date.

Money transfer - Georgian banks can transfer money to any direction, in very short period of time using Western Union, Anelic, or other international money transfer systems, with maximum commission fee 3% (www.nbg.ge).

Investment in Georgian banking system

Inflow of foreign capital into the banking service market of the country is seen as an important factor for the development of the banking sector. Entry of foreign capital is accompanies by introduction of advanced technologies and new financial products on the banking service market, increase of corporate management culture in the credit organizations, development of competition between credit organizations and improvement of banking activities. From the point of investment attraction, identification of the country's rating by the international rating companies is also significant. From this point, investment it is worth mentioning that in December 2005 Standard & Poor awarded Georgia long-term sovereign credit rating B+ and short-term sovereign credit rating B. It should be noted that positive trend in regard to the rating change is anticipated. Among the shareholders of 10 commercial banks are foreign investors including the EBRD, IFC, German Investment and Development Foundation (DEG), ProCredit Holding AG, as well as the Greek Emporic Bank, the Russian VneshTorgBank, and the Kazakh TuranAlemBank.

- TBC Bank and world's largest City Bank have signed agreement on transferring 35 million US dollar credit.

- This is foreign banks' largest credit line given to Georgian banks. TBC Bank will use this credit to satisfy the increasing demand of corporative businesses on bank services. It amounted to $132.9 million, or around 30% of the total foreign investment.

- The Russian VneshTorgBank purchased controlling shares of the United Georgian Bank in spring 2005 and the London Investment Bank Limited (LIB Ltd) purchased 25% of the shares in Georgian Investbank. Additionally, in August, the East Capital Bering Ukraine Fund bought 5.5% of Bank of Georgia for USD 2.6 million.

- 2005 was marked by an upsurge of investments in the country's banking sector. The Bank Australia Creditanstalt purchased 9.9% of the Bank of Georgia in September, though the amount of this deal was not reported.

- In August, the Kazakh bank TuranAlem (BTA) opened a branch office in Tbilisi after purchasing a controlling package at local Silk Road Group's bank for USD 5 million.

- The European bank of Reconstruction and Development (EBRD) and International Finance Corporation (IFC) are the biggest shareholders in the BTA bank.

- On 15 September 2006, Société Générale and the European Bank for Reconstruction and Development ("EBRD") entered into an agreement with Bank Republic's current shareholders to acquire respectively 60% and 10% of the share capital of Bank Republic. The acquisition is subject to the approval of the Georgian regulatory authorities (www.nbg.ge).

Problems of Georgian banking system

- Assets and liabilities of the Georgian banking system are still concentrated in foreign currency. Specifically, 80-85% of liabilities and 60-65% of assets are formed in foreign currency. This fact speaks about a weak savings function of Lari, the national currency.

- There are certain problems in the banking system, and it is one of the National Bank's priority goals to resolve them. Low level of bank capitalization, insufficient public confidence in the banking system and large-scale shadow economy significantly impairs the mobilization of money in the banking channels. This in turn creates the deficit of credit resources in the system and is negatively reflected in interest rates and provision of economy with loans.

- Taxation of income from deposits also is another restriction for development of banking system, elimination of taxation will make depositing money more attractive, it worth mentioning that incomes from deposits are not taxed elsewhere but Georgia

- Deposits in commercial banks are not insured by NBG

- There is no general inter-bank network for bad credit history (www.nbg.ge)

Modern trend in Georgian banking system

For most banks it's common to form groups and unify several services, for instance Partnership between banks and insurance companies has also developed recently. This synergy covers financial products that are focused on an amalgamated client market and create more flexible, cheaper banking and insurance services through the employment of one-stop windows. One of the most significant even in Georgian banking sector was Bank of Georgia's lounge on London stock exchange market, where stock of Georgian banks will be traded and this is unique even having no precedent earlier. This gives opportunity to Georgian banks to expand their operation area worldwide. Also the sluggish local stock exchange was refreshed thanks to first-ever corporate bonds, amounting to GEL 2 million, issued by the Bank of Georgia, with two-year maturity period and a GEL 100 face value. The first private bond emission appears as an alternative to bank deposits and an additional financial instrument in an exchange market where in only so called "treasury liabilities" circulated in the past. On 15 September 2006, Société Générale and the European Bank for Reconstruction and Development ("EBRD") entered into an agreement with Bank Republic's current shareholders to acquire respectively 60% and 10% of the share capital of Bank Republic. The acquisition is subject to the approval of the Georgian regulatory authorities (www.nbg.ge).

Goals of Georgian Banking System for 2006-2009

In compliance with the given strategy document, the key goals for the development of the banking system in 2006-2009 are the following:

- increase of the level of financial intermediation and growth of banking system efficiency;

- confidence growth towards Georgia's banking sector;

- improvement of the banking supervision efficiency;

- improvement of corporate management quality in the banking sector, increase of competitiveness of Georgia's commercial banks and ensuring sustainability of the banking sector;

- elimination of implementation of dishonest commercial activities and of an attempt to use commercial banks for unlawful purposes (such as, first of all, legalization of illegally gained income);

- promoting development of competitive environment and ensuring transparency of the credit organizations' activities;

- harmonization of the banking legislation of Georgia with the legislation of Euro Union;

- development of banking business infrastructure (www.nbg.ge).

Credit Availability

The Georgian banks are quite small by international standards. For example, the largest bank is United Georgian Bank, which has GEL 80 million, about $40 million, in assets. The larger banks have offices in the major cities outside of Tbilisi (including Kutaisi, Poti, Batumi,Rustavi, Zestaphoni, Imereti and some others) (Business Suggestions for the Economic Regeneration of the Imereti Region, 2003) but activity tends to be concentrated in Tbilisi. Credit approvals are centralized, through credit committees operating in Tbilisi. There is limited credit available from the banks in Georgia, due to the lack of deposits to lend, as described above. Since virtually all of the deposits that the banks do hold are short term, loans are for short terms as well. International donors such as European Bank For Reconstruction and Development (EBRD), International Finance Corporation (IFC), and the World Bank have focused on the problem that SMEs do need credit and accordingly have given lines of credit to certain banks for on-lending (Annual Review and Financial Report, EBRD, 2004). One advantage of the donor lines is that longer term loans, from 2 – 4 years, can be issued from these funds. These lines typically have limitations such as loan size or sector use, for instance, loans from IFC lines are not to exceed $250,000, and World Bank funds are for loans for agricultural and food processing. These lines collectively appear to constitute as much as 50% of lendable funds. Loans are frequently denominated in dollars or other hard currency, because these lines and much of the deposits are denominated in hard currency as well. Correspondent foreign banks have also granted some lines. While the banks are learning the rudiments of cash flow and credit analysis, they do rely heavily on client relationships (as one bank manager said, 'we only lend to clients we know') and on collateral. Loans to individuals are secured by possessory collateral of gold or gems in the short run; the problem of the lack of deposits is being further aggravated by the withdrawal of deposits by international agencies. Previously, agencies such as the World Bank would keep project funds on deposit in local banks, and these monies were a significant percentage of deposits. With the Russian economic crisis and resulting bank failures there, however, agency policies have been revised, and only current operating funds are available locally in Georgia. Business loans are secured with residences, firm-owned buildings, and equipment. There is no reliance on accounts receivable as collateral (however, few sales are on credit anyway), nor on inventory, although there are some instances of the banks warehousing inventory for collateral. (In other words, the bank effectively takes possession of inventory, and controls the flow of inventory in and out of the company by controlling the warehouse where the inventory is stored.) The banks require that inventory be valued by an approved independent appraiser, and seem to put a heavy reliance on that valuation. (It appears to be relatively easy to foreclose on real estate collateral.) Interest rates on the loans range from 24% to as high as 60% per annum. The banks regard small and medium-sized Georgian businesses as risky, largely for the same reasons that have been noted earlier. Bankers cited high interest rates, corruption in government, and lack of information, poor road systems, limited management skills, high tariff rates, and shortage of raw materials as typical problems facing the clients. There is a particular concern about the poor accounting and financial records, making performance and projection analysis very difficult (M. Kakulia, 2003).

The banks are taking some steps on their own to increase local deposits, including issuing debit cards and certificates of deposit, although they apparently do not charge penalties or reduce interest rates for early withdrawal. One bank indicated that it was interested in starting a micro lending program of loans ranging from GEL 1,000 – 10,000 (about $500 - $5,000) with the specific intent of encouraging more deposits. (Most of the banks indicate that the smallest loan size that administratively interests them is about $5,000, and it seems that cost structures would permit them to go down market more than this. There seems to be some emerging competition for stronger medium-sized businesses, and the banks are strategizing relative to each other's markets.

Affiliations and Partnerships with Other Institutions

The final issue to be addressed by the assessment team was the current status of and potential for affiliations and partnerships between banking and non-banking institutions. The issue is relevant to the Mission's general interests in fostering long term sustainability. To the extent that relationships can be encouraged and established between the different players in the field of business finance in Georgia, the financial sector and the products and services offered stand to be strengthened, and coverage potentially would be expanded to a broader spectrum of clients. The responses can be divided into those from banking and non-banking institutions. Non-Bank Responses: All non-bank institutions reported working with banks at the present time. At a minimum, they have bank accounts for holding unused loan and operating funds. Some disburse loans and collect repayments in cash. Others use bank services to disburse loans and collect repayments through accounts set up for this purpose. In the case of Constanta in Batumi, it has a computer link to the information system in the Microfinance Bank of Georgia's (MBG) branch, and is able to monitor borrower payments without walking to the bank. There is mutual cooperation and this relationship is likely to develop into a commercial lending relationship where Constanta could access funds from MBG for on-lending. Bank Responses: Microfinance Bank, as was indicated above with Constanta, is interested in working with Monetary Financial Institutions (MFI's), providing banking services and possibly re-financing. The other non- specialized banks are less prepared to undertake re-financing, most likely because they do not feel comfortable with small borrowers who lack hard collateral and may require costly supervision. Banks were interested in accessing international loans and USAID guarantees and they seemed to recognize these affiliations as positive for their future security and growth. The responses verify that these institutions are planning for the future and realize that affiliations or partnerships represent alternatives for them to consider when developing their strategies for medium and long term sustainability. At some point, this issue is one that all institutions will have to face as their project contracts approach their termination dates. Since most micro-loans cannot meet “conforming loan criteria” of a commercial lender, the need to find a flexible affiliation or partnership is evident. The National Rural Credit System will require access to commercial funds and there may be a formal financial sector source of funds that would want to team up with these operations to move their money to a broader spectrum of clientele (Allen, L. et. al, 2002).

Affiliations and Partnerships – further observations From our responses it seems that lenders whose focus is typically on humanitarian relief and not MSME development, as contrasted to those mentioned in the preceding three paragraphs, provided only a few responses to the Affiliation/Partnerships question. This suggests that those institutions may still be focused on the possibility of receiving increased donor financed new funding. They do not appear to believe in Affiliations/Partnerships as alternatives or opportunities. Or, perhaps, they simply have not given the prospect much thought and attention yet. Institutions that do not have good long-term prospects generally have one or both of the following problems: 1) Their management or personnel is not sufficiently adept to maintain the viability of the institution, and/or; 2) They do not have funding sufficient in quantity and tenor to reach breakeven with their overhead. During the session with institutions it was clear that occasionally projects simply were not designed to continue beyond a set date. In general, these organizations were aware of the need to find “a safe home” for their loan assets, implying the need to transfer them to another institution. In those cases, the problems need to be remedied in a way that protects the on-going integrity of the problem institution and/or loan capital, at a minimum (International Bank as Financial Manager in the Financial Services Industry of Georgia).

In some cases, affiliations or partnerships, as they are intended in this document, could be a vehicle for doing this. The team's recommendations with respect to this issue are as follows: 1. In order to sustain existing activities and have a foundation for growth, USAID should request that each institution needing additional funds to reach operational or financial sustainability, do a strategic plan. 2. USAID should take a lead role in causing each lending institution to do longer-term strategic planning that includes affiliations or partnership alternatives. 3. USAID should facilitate portfolio transfers to or mergers with complementary institutions by institutions that can no longer sustain themselves. (Constraints to Sustained Private Sector-led Growth, Volume I: Provided by USAID).

Conclusion

As a result of the banking system reform the number of commercial banks has been reduced, state-owned banks have been privatized. The volume of banking products is increasing; banking services are improving; internationally accepted supervisory practices and procedures are gradually introduced in practice. From the institutional standpoint, the Georgian banking system was developed correctly; its qualitative and quantitative indicators have improved, and competitive environment has been created. The banking system infrastructure in principle meets current market needs, and is prepared to satisfy the increasing demand of the entities interested in banking services. Despite the achieved outcomes, the Georgian banking system is still undergoing transition, therefore it is necessary to continue the reform and take appropriate measures to ensure its sustainable development.

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