Analytical Foundations Assessment – Financial Sector Assessment

Sector Assessment

ANALYTICAL FOUNDATIONS ASSESSMENT – FINANCIAL SECTOR

SECTOR ASSESSMENT

Prepared for
United States Agency for International Development (USAID/Georgia)

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Acronyms and Abbreviations

COB	Council of Bureaux (International Association of National Motor Insurers' Bureaux)
EBRD	European Bank for Reconstruction and Development
FDI	Foreign direct investment
FSAPs	Financial Stability Assessment Program
GAC	Georgia Agricultural Corporation
GCSD	Georgian Central Securities Depository
GEL	Georgian Lari (national currency)
GEPLAC	Georgian-European Policy and Legal Advice Centre (GEPLAC), a European Union-funded project
GoG	Government of Georgia
GSE	Georgia Stock Exchange
GIA	Georgian insurance Association
IAIS	International Association of Insurance Supervisors
IFC	International Finance Corporation
IPC	International Prospkt Conselt Gmbh
IPO	Initial Public Offering
MFI	Microfinance Institution
MME	Middle Market Enterprises (those with 20-100 employees and annual turnover of up to $5 million)
MTPL	Mandatory Third Party Liability (automobile insurance)
NBG	National Bank of Georgia
OTC	Over the Counter
PAYG	"Pay-as-you-go," a term for a pension system financed by incremental salary deductions from participating employees and matching contributions from employers
Pillar I	First element of national pension system: a flat, subsistence pension
Pillar II	Second element of national pension system: earnings-related pensions
Pillar III	Third element of national pension system: voluntary retirement savings
PFS Eurasia Region	Partners in Financial Stability (a regional USAID-funded program)
SME	Small and Medium Enterprises
USAID	United States Agency for International Development

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I. EXECUTIVE SUMMARY

This assessment builds upon a series of USAID-funded analyses of various aspects of Georgia's financial services sector. Its primary focus is middle-market enterprises – those mid-sized companies capable of creating the most employment and economic growth over the next five years. The assessment's principal question is whether or not the financial needs of these entities are being met by the financial sector. For the purposes of this report the term middle market enterprises as distinct from small medium enterprises (SME's) refers to the upper range of enterprises with employees up to 100 and annual volume in excess of $5 million.

The report is divided into seven sub-sectors: banking, agro lending, leasing, capital markets, pensions, insurance, and agro insurance, with assessments of each section in the form of evaluations of the demand and supply factors influencing the current financial conditions prevailing in each sub-sector. At the end of each section, there is a list of recommendations based on assessment conclusions which could be utilized by USAID in formulating its strategic plans regarding both the banking and non-banking financial sectors over the next three to five years.

Drawing from the report's conclusions, the following is a brief synopsis of the strengths and weaknesses of the main sub-sectors, and, where appropriate, recommendations for potential donor cooperation in these areas:

Banking: The strength of the Georgian banking system is its competitive nature with at least five of the 19 commercial banks of sufficient size to offer the public a variety of services at reasonable market rates. The banks are well regulated by the National Bank, and in some cases have established branch networks throughout the country. They appear to be effectively run by competent senior managements, and boards of directors, and are operating on consistently profitable basis.

The weakness of the banking system is the present failure to address the financial needs of middle market enterprises (MME's) where there is substantial opportunity for the exponential expansion of banking business. The absence of long-term financing vehicles through the banking system has inhibited the economic growth of these enterprises. This is an area that, in time, undoubtedly will be addressed and corrected as increased competition stimulates the introduction of new and innovative lending programs.

Aside from possibly providing assistance through counseling programs to potential MME borrowers in understanding the banks' lending policies, procedures, and requirements, there do not appear to be high priority projects for USAID or other donors in the commercial banking area.

<u>Capital Markets</u>: This is the primary sub-sector of the non-bank financing segment of the Georgian financial system, and is the weakest portion of that system. The stock exchange is operating at minimal capacity. There is a lack of central depository and registrar consolidation causing confusion and delays. The existing brokerage houses, aside from the four bank-related houses, have not developed substantial business volumes, and are handicapped by existing inhibiting regulatory restrictions; and the absence of imaginative and aggressive venture capital firms has stunted the growth of enterprise start up operations.

USAID can provide meaningful assistance in strengthening the capital markets by undertaking an effective review of the government's present rules and regulations of the stock exchange, securities dealings, description and authorization by the National Bank of brokerage/investment house operational mandates, including trading of treasury bills, spot and forward foreign exchange activities, issuance of corporate debt instruments and initial public offerings, and full gamut of venture capital activities. Continuing efforts should be made to encourage the government to revise these rules and regulations to provide an open and competitive securities industry. These are high priority projects that would build on the assistance that the USAID provided in 2001 in establishing a functional stock exchange through the aegis of KPMG.

<u>Leasing</u>: The strength of the leasing sub-sector is in the potential for this alternative sourcing of financing to all segments of economic activity both commercial and agricultural that would not require the pledge of the lessee's real or moveable assets as collateral. The weakness is the anemic growth of the leasing industry (less than 0.2% of GDP), and the absence of active participants in the market. This is the result of well-intended but onerous policies that were embodied in hostile and negative legal frameworks. This is considered to be a high-priority situation where donors such as USAID can play an important role in assisting the government in drafting more equitable legislation that would allow for the rapid expansion of the leasing industry to perform a much needed service resulting in continued economic growth. The new legislation could also encourage the development of lease securitization activity that not only would provide additional liquidity to lessors, but in addition avail both private and pension and insurance fund investors of another attractive capital market investment alternative.

<u>Pension and Insurance</u>: Both of these sub-sectors are experiencing evolutionary change and it is difficult to predict the extent to which the market is ready for the concepts that underpin these areas of economic activity. From the donor perspective is would appear that substantial assistance could be provided in the areas of insurance awareness for the Georgian population, and also in the agricultural finance area where some form of either public-private combination of insurance/guarantee program might facilitate increased agro financing by the commercial banks.

II. PURPOSE OF THE ANALYTICAL FOUNDATIONS ASSESSMENT

This report builds upon a recent series of USAID-financed in-depth analyses of the Georgian financial sector and seeks to project an integrated picture of issues and opportunities for the sector's further development. This assessment places major emphasis on middle market enterprises and micro-financing activities of the Georgian commercial banks and MFI's. It seeks particularly to determine the extent to which the financial needs of these entities are being met by the financial system.

For the purposes of this report the term middle market enterprises (MMEs), as distinct from small medium enterprises (SME's), refers enterprises with up to 100 employees and annual volume up to five million US Dollars. The largest corporate entities consists of those companies that have established well-regarded market reputations, have developed customer relationships with the banking community, and are considered to be prime borrowers. However, as over 60% of total market activity is comprised of MME's, this category represents the largest segment of potential future financial sector growth.

The key question this Analytical Foundations Assessment must address is: how supportive is Georgia's current financial sector of private sector development and overall economic growth? In the command economic structures of the former Soviet Union, the state-owned banks were merely conduits of the government's financial allocations to the various state-owned industries and no consideration was given to the concepts of profit, efficiency, or economic relevance. In free-market economies, commercial banks in free market economies act as the lubricant through which all segments of the body politic are able to experience economic expansion and growth. They are the essential means by which trade and commerce are able to effectively function to distribute economic opportunities and benefits to all segments of the populace. Without a well-established banking system, countries would be reduced to barter and the exchange of colorful beads.

The general analytical hypothesis for this assessment is that the institutional capacity of the existing financial sector (supply side) limits access by middle market enterprises to commercial bank lending. Also, the non-banking financial sector is underdeveloped to the extent that is does not provide an alternative source of financing to the middle market. While this hypothesis is valid to an extent, it is also the finding of this assessment that a similar problem manifests itself from the standpoint of a majority of middle market enterprises (demand side) which are either not prepared or inclined to take advantage of the existing financial services.

This Assessment will develop approaches and make recommendations as to how the existing gap between the demand and supply sides of available financial services primarily for middle market enterprises might be reduced.

III. BANKING

As indicated in previous assessments, about 95 percent of the Georgian financial sector is dominated by the 19 commercial banks with the remaining five percent allocated to the non-bank financing sector, which is comprised primarily of microfinance institutions, credit unions, Insurance companies, pension funds and brokerage companies (see Table 1 on the next page). This percentage breakdown between the banking and non-banking financial sectors is not unusual in developing and/or recently independent economies. The percentages undoubtedly will change as more non-banking institutions are created and encouraged to provide competitive services to the commercial banks.

Both the banking and non-banking sectors are under the supervision of the National Bank, and are operating under well-established legislative and regulatory strictures. There have been no major bank failures over the past several years, and in discussions with senior management of the National Bank the assessment team determined that the Bank has in place stringent supervisory and bank examination procedures to ensure sound operational procedures and capital adequacy requirements on the part of the commercial banks. The National Bank's regulatory requirements exceed those required by the Basle Core Standards (see Table 2).

The government's apparent position is somewhat laissez faire, allowing the banks wide latitude as far as free markets principles are concerned, with the National Bank a watchful overseer of prudential operational activities. In view of the continuing expansion and profitability of the commercial banking sector which, as stated above, provides about 95 per cent of the country's financial needs, a sustainable financial sector is in place and should continue to grow in the future.

Of the 19 commercial banks, 14 are foreign controlled; two are branches of foreign banks; and the remaining three are mostly locally owned. According to the National Bank of Georgia (NBG), there are several International Financial Institutions (IFIs) and donor agencies as shareholders in several Georgian banks; namely: European Bank for Reconstruction and Development (EBRD), International Financial Corporation (IFC), Kreditanstalt für Wiederaufbau - KfW (Germany), Netherlands Development Finance Company - FMO (Netherlands) and others.

The top five banks – Bank of Georgia; TBC; Procredit Bank; Liberty Bank; and Bank Republic – have more than 78 per cent of total assets, with the Bank of Georgia alone having thirty-five (34.8) per cent of total assets, and 33.6 per cent of total deposits (see Table 3). This has had a limiting effect on competition and has put corporate borrowers, particularly middle market enterprises at a definite disadvantage when addressing their financial needs.

Table 1: Financial Institutions in Georgia

Commercial Banks								Non-Bank Depository Institutions	Micrifinance organizations	Exchange Bureaus	Stock Exchanges	Insurance Companies	Pension Funds
	Total	*Foreign participation*	*o.w. Branches of non-resident commercial banks*	*Branches*	*Service Centers*	*Authorized Capital of Commercial Banks, thous. of GEL*	*Equity Capital, thous. of GEL*						
2003	24	15	2	201	162	220,636	353,751	42	x	325	1	22	3
2004	21	12	2	162	139	240,454	372,512	53	x	412	1	14	3
2005	19	12	2	159	187	296,443	479,488	40	x	556	1	16	3
2006	17	12	2	122	298	344,844	898,373	38	3	655	1	14	3
2007	18	14	2	124	416	524,576	1,471,046	24	15	806	1	15	3
2008	20	17	2	124	559	625,616	1,517,251	18	27	1030	1	13	7
2009	19	15	2	120	513	673,419	1,516,988	18	38	1352	1	14	6
2010	19	16	2	119	522	805,147	1,787,647	18	49	1624	1	16	6
2011 June	19	17	2	148	509	873,574	1,835,114	18	57	1473	1	16	6

Source: NBG

Table 2: Georgian Banking Sector (Prudential Ratios, %)

	2008	2009	2010	2011 (June)
NBG Capital Adequacy Ratio	13.91	19.08	17.38	16.47
BIS Capital Adequacy Ratio	22.95	28.12	25.06	25.89
Equity to assets	17.11	18.29	16.92	16.36
Regulatory Capital/Total Liabilities	19.63	23.11	20.12	21.82

Source: NBG

In addition in the non-banking financial sector there are 18 registered credit unions of which it is understood most are located in the rural areas. There are also 57 registered microfinance Institutions (MFIs) (see Table 1) of which only a few such as Credo, and Finca are active. These institutions primarily have concentrated their activities in the lower (smaller) segment of the enterprise market, represented by SME's and microfinance institutions, and in many cases are socially motivated towards poverty elimination. Therefore it is difficult to assess what impact they are having on the dynamics of the Georgian economy.

Table 3: Top five Georgian Commercial Banks (August, 2011)

N	Name of Bank	Market Share (%)							
		Assets	Loan Portfolio	Total Liabilities	Total Deposits	Non Banking Deposits	Deposits of Legal Entities	Deposits of Individuals	Shareholders' Equity
1	Bank of Georgia	34.78	35.53	34.75	33.60	33.75	36.77	30.54	34.93
2	TBC Bank	24.05	25.11	24.51	27.34	28.35	24.06	32.90	21.75
3	ProCredit Bank	7.29	8.23	7.55	7.08	7.80	4.17	11.65	5.96
4	Liberty Bank	6.13	4.32	6.68	8.86	9.32	12.02	6.46	3.36
5	Bank Republic	5.80	6.29	5.98	5.43	5.98	4.58	7.47	4.91

Source: NBG

A breakdown of commercial bank loan totals by category indicates that a majority of loans extended to Georgian enterprises is concentrated with the banks' corporate customers, 45%, as opposed to middle market enterprises, 20%, and retail loans, 35% (see Table 5 in the Annex B). The average interest rates charged on corporate loans was 14.3%; middle market enterprises, 16%, and retail loans, 20%. A precise definition of middle market enterprises varies with individual assessments, but a generalization for such enterprises would be up to 100 employees and an annual turnover up to five million U.S. Dollars.

Table 4: Loans by Interest Rate (August, 2011)

Annual Interest Rate	Number of Loans	% of Total Number	Amount of Loan (Thou GEL)	% of Total Amount
0%-5%	354,769	21.52	177,865	2.49
5%-10%	2,198	0.13	220,699	3.09
10%-15%	45,468	2.76	3,884,841	54.36
15%-20%	185,449	11.25	1,808,163	25.30
20%-25%	133,391	8.09	353,774	4.95
25%-30%	55,094	3.34	157,572	2.20
30%-35%	43,280	2.63	68,826	0.96
35%-40%	510,686	30.97	350,345	4.90
40%-45%	80,183	4.86	45,593	0.64
45%-50%	204,237	12.39	67,552	0.95
more than 50%	34,004	2.06	11,802	0.17
Total	1,648,759	100.00	7,147,032	100.00

Note: Corporate, MME and retail loans are dispersed in different annual interest rate categories.
Source: NBG

In discussions with three of the largest commercial banks, the assessment team determined that the average cost of funds is above 7%. The spread between the loan rate and the cost of funds varied between four and ten per cent, taking into account predominantly credit risk premium and operational expenses.

The three leading banks indicated that the best loan rate for prime corporate borrowers who enjoy a substantial overall business relationship with their banks was 11-11.5%, but that this rate probably will increase in the near future in view of declining profit margins due to the increasingly competitive costs of funding. It is understood that the prevailing interest rate for non-banking MFI financing is in the neighborhood of 36%, which is consistent with the MFI rate structure in other developing countries. Because of the small percentage of MFI loans to the total loan volume, the MFI rate structure does not have a significant impact on overall lending rates.

From the foregoing, it would appear that the interest rate structure for middle market enterprises (MMEs) is not out of line with the prevailing overall cost of borrowing from the commercial banks, which is at variance with the oft stated assertion that MMEs were precluded from utilizing the financial credit markets due to the high borrowing costs. Additional costs for fees and commissions vary from bank to bank and should be subject to negotiations between the bank and the borrower.

A survey of the financial services available through the commercial banking system indicated that the banks are offering a range of credit alternatives comparable to those of other emerging markets in the region. In addition to the usual credit facilities, such as lines of credit, short term working capital loans, letters of credit, etc., banks offer cash flow financing, inventory and accounts receivable financing for their best corporate customers, and some banks are extending plant and equipment and project financing on a limited basis. The wider range of credit options does not pertain, though, to existing or potential middle market customers in general, and is an area for development in the future.

Table 5: Georgian Banking Sector (Liquidity Ratios, %)

	2008	2009	2010	2011 (June)
Average Liquidity ratio	28.27	39.08	38.67	38.96
Total loans/non-bank deposits	167.97	131.27	114.09	119.48
Loans/Deposits (Total)	155.87	124.23	107.62	108.98
Liquid Assets /Total assets	20.88	24.38	25.30	26.04
Liquid Assets/Total Liabilities	25.19	29.84	30.46	31.14

Source: NBG

The commercial banking system presently has excess liquidity with average Liquidity Ratio around 39% (see Table 5), thus enabling it to significantly expand its lending activities, particularly to middle market enterprises. However, it is assumed that lack of strategic vision on the part of bank managements with regard to profitable long term growth potential of these enterprises as valuable customers, has resulted in a more conservative concentration on existing corporate clients and alternative investment options, to the detriment of middle market enterprises access to credit facilities. Even though the managements of the commercial banks interviewed expressed commitment, in varying degrees, to expanding their lending activities to middle market enterprises, in practice there is very little evidence that such programs are actually in place and operative to any large extent.

The following is an in-depth analysis from both the borrowers' (demand side) viewpoint and the lenders' (supply side) rationale as to the reasons for the lack of credit access by the middle market enterprise community:

Demand side:

Many MMEs do not qualify for bank financing because of:

- <u>Lack of positive operational history (market presence):</u>
  A number of potential bank customers in the middle market are denied access to credit facilities even though they might have been operating their business for a number of years because they have not created a reputation for themselves within the trading community as a viable market presence. Therefore it is difficult for a bank to make a valid credit assessment without reliable references from either vendors or customers of the enterprise as to the integrity and dependability of the potential borrower. Counseling by either an astute banker looking for new business or an advisor from a donor sponsored middle market enterprise development program could assist the entrepreneur in developing the necessary positive operational image.

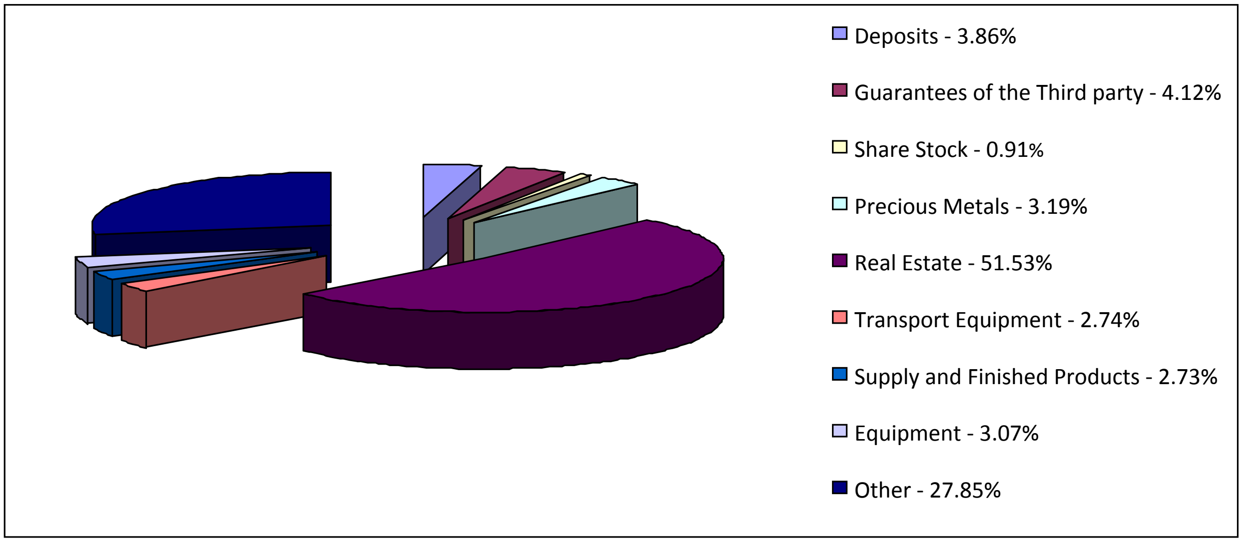
- Absence of realistic business plan:
  This is undoubtedly one of the major hindrances preventing the obtaining of bank financing by middle market enterprises, particularly among closely held family oriented operations which have conducted business primarily on an *ad hoc* basis over the years. The need for an operational road map indicating where the enterprise intends to go over a definite time frame is the most essential requirement for potentially profitable long-term results, and assures the bank lender that the enterprise management is competent in exercising good stewardship over its assets.

- Lack of adequate financial statement information:
  Although most corporations prepare audited financial statements, there is a general absence of such statements among SME's, and the submission of at least rudimentary company prepared financial statements such as a cash receipts and disbursement ledger, etc. is a necessary prerequisite for any consideration of an entrepreneurs' credit request. The presentation of balance sheet and profit and loss statement information affords the banker the opportunity to analyze the enterprises' continuing operation to make a definitive assessment of the potential borrower's credit worthiness. This is another area where outside assistance in the compilation and preparation of reliable financial data would be of great help to middle market enterprises in qualifying for bank credit.

- Insufficient collateralizable assets:
  As commercial banks at present lend to middle market enterprises primarily on a secured or collateralized basis, this has resulted in some difficulty for a number of potential middle marker enterprises to generate sufficient collateral to secure the requested credit facility.

  Real estate is the primary source of collateral for bank loans in Georgia; in fact in many instances it represents the only collateral available for potential borrowers (see Figure 1 below). The real estate is usually in the form of land and/or the borrower's home or commercial real estate. Any loan default could result in the borrower losing all of his assets, including his residence, and this scenario has resulted in the reluctance of many otherwise qualified middle market enterprises from applying for bank credit. In addition, banks discount the value of collateral up to 30-40% of appraised value so that in essence a middle market enterprise (MME) borrower will require collateral in excess of 100% of the loan amount. As in all aspects of lending to middle market enterprises there are exceptions to the general rule, but this is an area of concern and frustration for middle market enterprises.

Figure 1: Bank Loans by Collateral types (June, 2011)



Source: NBG

As MMEs gain more sophistication and experience in preparing meaningful business plans and reliable financial statements, and banks develop more confidence in financing these enterprises on a more acceptable cash flow basis, it is anticipated that the present onerous collateral requirements will be lessened.

- Lack of knowledge of commercial bank policies and procedures:
  Many MMEs have had little or no contact with commercial banks, how they operate, and what are the requirements for establishing an initial relationship and ultimately qualifying for bank credit. This is an issue that has been expressed by MMEs in a number of newly independent countries with developing free market economies. The need to educate these entrepreneurs as to the vagaries of the free market system is considered to be one of the primary business development functions of a bank account officer in order that potentially attractive new MME customers might become aware of and utilize many of the bank's services, including credit.

- Inability of the start-up enterprises to obtain bank financing:
  It is a commonly held misconception that the main reason that start-up MMEs do not succeed is the lack of bank financing. This is untrue in so far as it is not the role of commercial banks to provide seed money, which would be in the form of initial equity, to enterprises of whatever size where there is no history of profitable operations. Financing start-up enterprises is primarily the function of venture capital companies that would have a vested interest as part owners of the enterprise and would be able to introduce the enterprise to various financial sources in the capital markets. The present lack of a viable capital market in Georgia has inhibited the formation of start up middle market enterprises, and this situation will be addressed in the following capital market section of this report.

Supply Side:

The commercial banks are reluctant to lend to the middle market enterprises, especially in higher risk manufacturing sectors, because of:

- Cyclicality of available funding sources which can inhibit credit commitments to borrowers in general and middle market enterprises in particular:
  Georgia is characterized by a relatively low national savings rate which can be an inhibition to a steady inflow of deposits to the commercial banking system, and due to the cyclical nature of many of the banks' borrowers' financial needs, as well as continuing dependence of Georgian banks on foreign credit sources as described in the NBG in house analysis, there is sometimes a gap in the maturity ladder of the banks' asset/liability ratios. The term maturity ladder represents a comparison of maturity dates of the bank's investment and loan portfolios (assets) and the scheduled deposit runoff, and bond and/or indenture turnover (liabilities). If there is a significant imbalance or maturity mismatch this could result in a "lending long and borrowing short" situation that banks strive to avoid. This can lead to a rationing of lendable funds primarily to the banks' best customers to the detriment of many existing and potential middle market enterprises.

  Georgia is the only country in the PFS (Partners for Financial Stability) Eurasia region that does not have *deposit insurance*. The absence of this key feature of a normal financial safety net contributed to the public's lack of confidence in the banks during the crisis. The global financial crisis highlighted the importance of deposit insurance for maintaining financial sector stability, and Georgian authorities would be well advised to reconsider their decision not to adopt a deposit insurance system. The Government had originally proposed the introduction of a deposit insurance scheme in 2007. The idea was later dropped but remained in the Banking Strategy for the Period 2006-2009. As of now, Georgia does not have a deposit insurance scheme, and the government does not appear keen on introducing one. The large banks (Bank of Georgia, in particular) oppose the introduction of a deposit insurance scheme, as they fear that they will have to pay for the insurance of other banks, while deposits migrate to higher-yielding banks. The IMF, in the context of its 2011 Article IV consultation, advised Georgia to re-consider the merits of introducing a deposit insurance scheme, covering only Georgian lari (GEL) - denominated term deposits. The lack of deposit insurance forces banks to compete for deposits on the basis of having conservative balance sheets. Continuing efforts should be made by donor agencies to convince the government that some form of deposit insurance should be implemented as soon as possible.

- Conservative nature of bank managers restricts bank lending activities to largest, well-established corporate borrowers due to perceived lower credit risk:
Approximately 45% of bank lending is to the corporate customers of the banks, with middle market enterprise (MME) lending at about 20%. In discussions with members of managements of several of the banks the constant theme was one prudence and low risk exposure that translated into selective lending operations to best customers, and emphasis on short-term investment alternatives in international capital markets. This is a mind-set that must be changed if substantial progress is to be made in expanding middle market enterprise access to the financial markets.

- Lack of sufficiently trained lending staff for middle market enterprise borrowing requirements;
In all of the bank management interviews it was indicated that there was either an ongoing commitment to expand MME financing or such a program was in the implementation stage. At least one of the banks stated that it had assigned several loan officers to "concentrate on the development of middle market enterprise financing potential." However, it seems as though it is problematical whether or not these stated bank objectives with regard to aggressively accommodating the MMEs' financial needs are based on firm commitments resulting from well formulated bank management strategies or are merely expressions of interest for future consideration.

  In any case, for the introduction and continuing success of an MME lending program, a group of specially trained loan officer is required. MMEs differ from larger corporate customers not only in the size of their business operations but also in the wide variety of types of business and the need for much closer and continuing contact by the loan officers. It is imperative that the loan officers become intimately familiar with the enterprise management, the uniqueness of the firm's activities, and be in a position to render guidance in the preparation of the firm's business plans, and financial data. This requires loan officers with tact, patience, inquisitiveness, and wide general business knowledge.

  In view of the perceived paucity of qualified, adequately trained middle market enterprise loan officers, this is an area which could be effectively supported by intensive loan officer training programs sponsored by international donors, as indicated in previous assessment reports.

- Absence of umbrella donor guarantee programs to support commercial bank lending to middle market enterprises:
Comments were made during the interview process that if there were functional donor and/or governmental guarantee programs of the commercial banks' lending to middle market enterprise borrowers to minimize the credit risks, the banks would be more proactive in expanding their lending activities to the middle market. It is understood that there were one or two donor guarantee arrangements with

Georgian banks under the USAID DCA (Direct Credit Authority) program. It was also indicated that the government was not inclined to participate in a bank guarantee program for middle market enterprise lending.

While not necessarily considering the banks' comments as a spurious argument against more aggressive involvement in middle market enterprise lending, it does appear that the banks' lack of vision as to the future growth potential of the MME community as profitable bank customers inhibits present expansion of additional bank credit to the middle market.

Some form of donor guarantee program to stimulate bank lending to the middle market might be the catalyst to rectify the existing timidity on the part of bank managements in this regard.

- Inability of banks to provide diversity of risk management services to middle market enterprise:
  Since over 70 percent of commercial bank loans are denominated in US dollars, the cost of conversion to GELs rests with the borrowers both at the time of receipt of the loan and at the time of repayment. This places an additional financial burden on middle market enterprises which usually do not have access to the financial intermediary markets which are readily available to large corporations for currency swaps and forward transactions, etc. As a result the onerous cost of borrowing for a number of middle market enterprises is too great for them to consider utilizing bank financing. This situation could be alleviated with the concerted development of an active capital market providing a plethora of innovative financial services that would reduce the overall cost of borrowing for middle market enterprises. This is subject for discussion in the capital markets section.

Recommendations:

1. **Support the diversification of commercial banks' business development activities** to include expanded bank presence in the middle markets by:

   a. improvement of bank officer credit decision skills;

   b. introduction of middle market credit scoring mechanisms;

   c. simplification of loan procedures and documentation procedures for middle market;

   d. expanded use of cash flow lending and reduce reliance on collateral for best middle market borrowers;

2. **Encourage the development of business advisory services under the aegis of a public/private partnership** to assist middle market entrepreneurs in becoming

proficient in the creation of acceptable financial statements, such as balance sheets, profit and loss statements, cash flow projections, etc., which, even if of an unaudited nature, would be acceptable to commercial banks or other lenders;

3. **Support training for MME managers on the requirements of the commercial banks** with regard to loan application procedures and documentation, together with greater awareness as to banks' non credit services such as payroll and accounting programs which could be of assistance in improving enterprises financial control;

4. **Facilitate the development of currency risk management mechanisms (forward/swap)** markets to provide cheaper funding costs to MMEs for dollarized bank borrowings;

5. **Promote the introduction of property-related insurance products especially for assets, primarily real estate, securing collateralized loans**. This recommendation will be discussed in greater detail in the insurance sector;

6. **Promote the development of the legislative framework to introduce venture capital institutions** as an alternative source of funding to commercial banks for the financing of start-up enterprises. This could occur in conjunction with the diversification and stimulation of the present capital markets;

7. In view of the dominance of the largest commercial banks in the Georgian financial markets, and their apparent lack of firm commitments to actively expand their lending activities to middle market entrepreneurs, there would appear to be a present need for the **development of an alternative non-banking financial mechanism** that would offer an effective complement the commercial banking system. By and large the banks have failed to recognize the substantial potential of an expanding MME community as future valued customers, and instead continue to concentrate their efforts on the smaller but very profitable large corporate market. In this scenario there undoubtedly is plenty of room for forward thinking managements of investment houses, and venture capital firms to devise new and/or implement existing alternative sources of financing for the growing middle market, and at the same time revitalize the present moribund capital market to provide an effective non-banking financial competitor to the commercial banking industry. There exists opportunities for donor agencies to provide much needed financial and advisory assistance to the non-banking financial sector, and this will be discussed in greater detail in the Capital Markets sector.

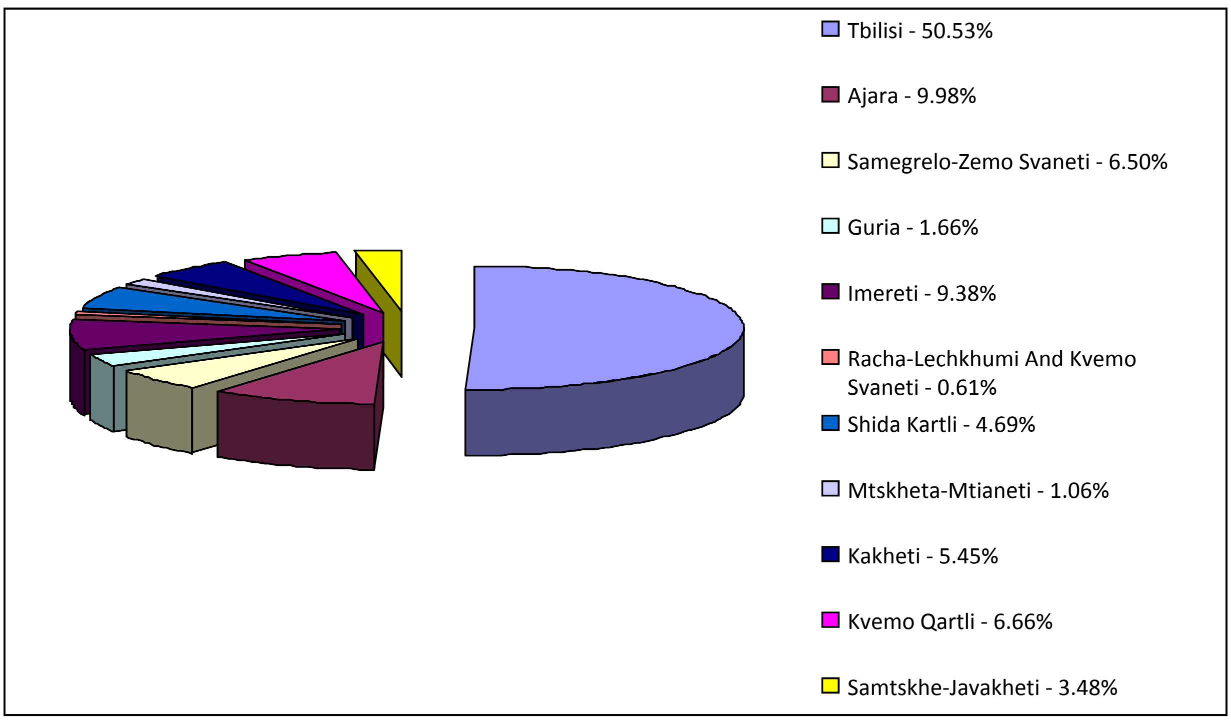
8. **Conduct campaign to urge the government to introduce some form of deposit insurance system,** either jointly with the commercial banks or initially through the establishment of a government-run deposit insurance corporation under the supervision of the National Bank. This would go a long way in developing trust of the banking system among the public, and create a stable, liquid, and reliable source of funding for expansion of the banks' asset portfolios.

IV. AGRICULTURAL LENDING

To date the commercial banks, for various reasons as outlined below, have not focused on the agricultural sector as an area for future expansion and development. Present banking activity is concentrated primarily with the larger agro-enterprises that are engaged in large scale farming operations or are providing ancillary services. The majority small or subsistence farmers are either not part of the banks' present marketing strategies or are being services by the MFI's or charitable donor agencies. It is understood that the government through a newly created agency is in the process of developing a guarantee program to encourage more agro lending, but the full details are not known as of the writing of this assessment.

Commercial banks have well established branch networks but more then half of branches and service centers are concentrated in capital Tbilisi and are note in a position to more aggressively promote agricultural lending (see Figure 2 below). According to a NBG survey, at present there are 661 branches and service centers of the 16 commercial banks throughout the country. 334 of them are located in Tbilisi. Only Liberty Bank has widespread branches - 127 in rural areas. The Bank of Georgia has 60; TBC Bank – 14; ProCredit Bank – 25; Bank Republic – 15 branches and service centers outside of Tbilisi, to name the top five banks.

Figure 2: Branches and Service Centers of Commercial Banks by Geographic Districts (July, 2011)



Source: NBG

Trends in the sector and discussions with the commercial banks revealed various bottlenecks that result in the market failure to develop the agriculture sector:

- The Georgian agriculture market is dominated by small-scale players. In many cases they lack specialized agricultural knowledge; lack financial literacy; do not own liquid collateral; and exhibit high operational costs in relation to their size. As a result, banks are often unwilling to accept the high risks resulting from these problems;

- The major constraint for large–scale borrowers is slightly different. Banks are usually unable to approve credit lines to agricultural projects because of the lack of internal expertise to price risks, and inadequate follow-up loan monitoring tools in the sector. As a result, many profitable initiatives remain unrealized. Commercial banks therefore tend to approve loans to large-scale companies only if they operate various business lines apart from agricultural so that effectively they are balancing risks in other more developed sectors;

- There are no leasing companies specializing in agriculture operating on the market;

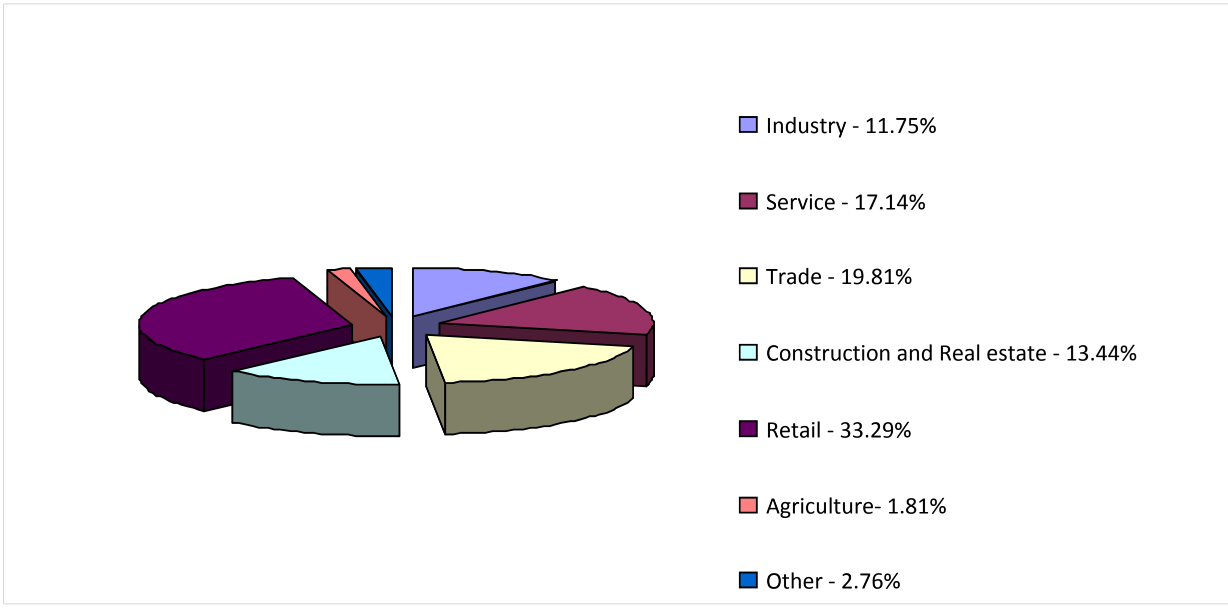
- Agriculture is no exception in terms of lack of access to long term and GEL (lari) financing. However, the term structure is particularly problematic for agricultural development as private investors would generally need to purchase fixed assets with much longer utilization periods than the available loan term;

- Besides the supply side constraints, the existing environment and the lack of efficient and competitive value chains in the agricultural sector (sometimes called "coordination failure") prevents large business initiatives that could benefit from economies of scale and support economic development. For example, a large-scale crop grower would depend upon demand from animal husbandry and crops processing and other industries for inputs and to purchase the product. A large farmer would need an assured supply of animal-feed in the country to run the business and would also need to know that there is enough demand from dairy and meat processing/slaughtering industries. Besides, the efficient sector would need modern transportation/logistics service available in order to be able to store and transport the product without any barriers; and

- Another demand-side issue results from information externalities. There are no safeguards or incentives in place to protect and encourage research and innovation for animal species or crop development. As a result entrepreneurs consider identification of cost structure and the associated loss risk too expensive compared to upside benefits that would be shared by other entrepreneurs as well (as long as no restrictions on copying is in place).

In addition to these bottlenecks, lending to agricultural enterprises presents a series of constraints and opportunities for donors such as USAID, which fall into two categories: those affecting agribusiness (the demand side) and those affecting lenders (supply side):

Figure 3: Loan Portfolio Distribution by Sectors (August, 2011)



Source: NBG

Demand Side:

The percentage of agricultural lending to total loans extended by Georgian commercial banks is small, around two per cent (see Figure 3 above) because a majority of potential agricultural borrowers do not meet the banks' credit standards. Specifically, the problems on the demand side of agricultural lending include:

- The nature of most of Georgian farming which is at a substance level resulting in little income producing product output and lack of collateralizable assets to with which to pledge as security from bank financing;

- The difficulty in establishing reliable product standards upon which to base loan value due to the wide variety of product quality pertaining in the agricultural area, coupled with unfamiliarity of the farmers with new and more efficient innovations and advances in increasing crop yields, improved fertilization and irrigation techniques, and harvest prolongation through various storage facilities;

- Bank financing, when available, is usually on a cyclical seasonal basis with short-term loans the rule rather than the exception. Because many of the farmers work on thin profit margins, they have not built up much equity in their enterprises, and consequently can only merit longer term financing by pledging their primary assets, home and land as collateral for bank loans. Should there be a catastrophic occurrence such as a natural disaster, etc., the borrower stands to lose everything if he defaults on the loan and the bank forecloses on the pledged assets. This is a major inhibiting factor in preventing access to longer term financing;

- The situation outlined above calls for an effective and affordable agricultural insurance system that will afford protection to agricultural borrowers in the instance of cataclysmic loss through natural disasters or other unforeseen events. This insurance need will be discussed further in the Insurance Sector section below, but should be noted here that this is one of the areas of expressed concern by the farming community;

- The lack of sophistication in the complexities of the free market system on the part of many farmers after decades of centralize planning is evident in the absence of knowledge as to the basics of financial planning, including rudimentary accounting and business plans, together with unfamiliarity as to the operations and variety of services available through their local banks. As a result, there is an apparent reluctance to approach the banks to determine if there are opportunities to obtain needed bank financing for their ongoing activities. This is an area that can be effectively addressed by qualified agriculturally trained advisors, to open up new financial vistas to many otherwise competent farmers; and

- Many farmers at the substance level or above have a meager or at best a limited degree of pledge-able liquid assets and aside from the few immoveable assets such as land and homes are not able to qualify for bank financing in the absence of the banks doing little cash flow financing and relying heavily on secured lending.

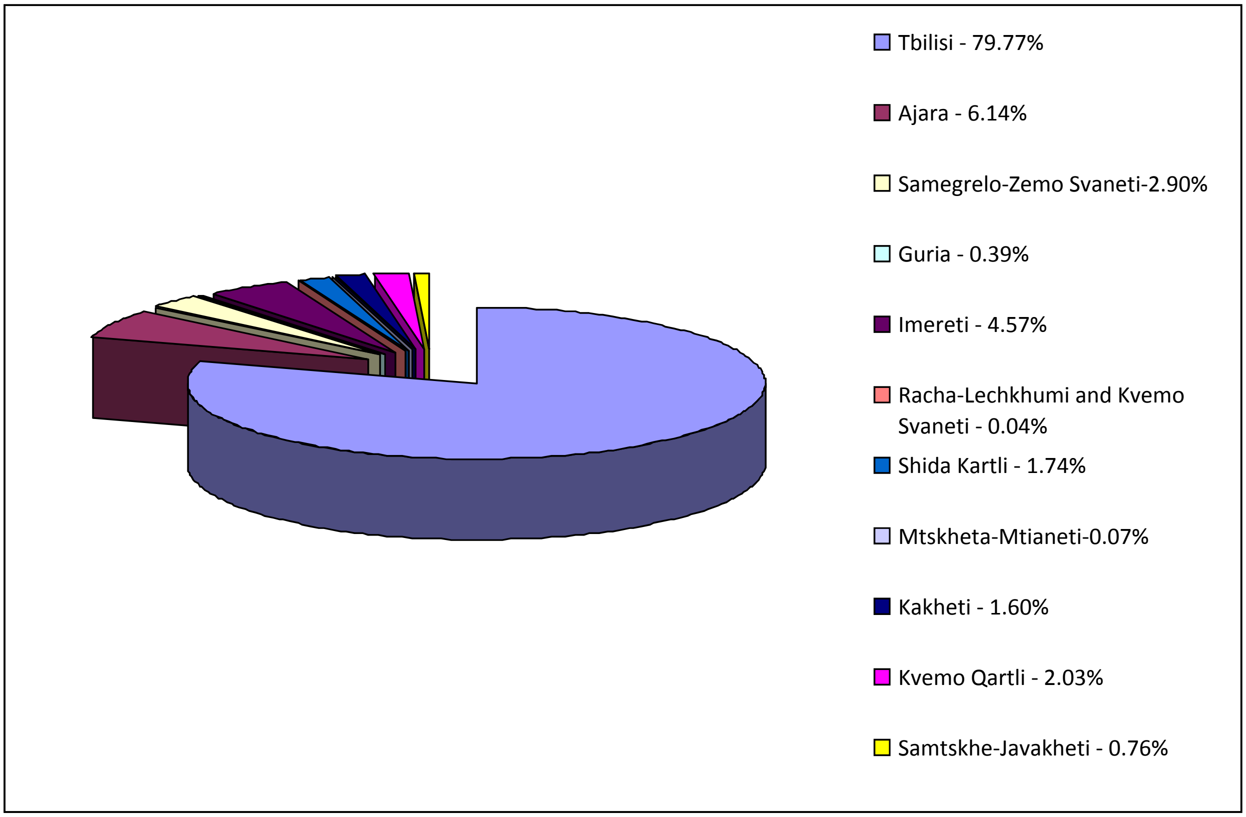
Supply Side:

The majority of commercial banks have been reluctant to make major commitments to agricultural lending for a variety of reasons, the main ones being because of:

- The higher operational loan servicing costs due to the small size of the farmers' perceived financial requirements. Typical agricultural credits are in the neighborhood of hundreds of US dollars, and the increased cost of servicing an extensive portfolio of such modest loan totals as opposed to a smaller portfolio of larger corporate loans makes agro-lending less attractive than concentrating on more profitable larger corporate borrowers. This kind of bank's attitude is reflected in the geographic distribution of loans in Georgia: almost 80% of loans are concentrated in Tbilisi where the big corporate clients are allocated.

- Lack of adequately trained bank loan personnel who can evaluate the type of credit risks peculiar to agricultural lending, and have the experience in the vagaries of the agricultural sector of the economy, together with the absence of established follow-up loan monitoring procedures within the banks has inhibited the expansion of agro lending by the banks.

Figure 4: Loans by Geographic Districts (June, 2011)



Source: NBG

- The absence of an established agricultural insurance and/or guarantee program that would induce the commercial banks to make supposedly “higher risk” loans to the agricultural community under some form of either a government/donor guarantee program, in addition to the availability of an agricultural real and chattel mortgage insurance facility has been described by a number of bankers as a major deterrent to meaningful bank commitments to agro lending. It is understood that the government has initiated an attempt the alleviate some of the financial problems of the farmers by the creation of the Georgian Agriculture Corporation (GAC), which is supposedly issuing some form of guaranty to banks for on lending to agro borrowers. However, little is known of its activities at this time.

- The paucity of reliable information, such as meteorological data, annual crop production, etc., upon which to base acceptable credit risk assessments, has also been indicated as a hindrance for the expansion of agro lending. The uncertain forecasts of farm income from year to year due to the vagaries of nature makes credit evaluation an inexact science at best and a very difficult one without adequate sources of agricultural history upon which to make informed decisions.

- A recent development is the entrance of microfinance institutions (MFI's), which have heretofore concentrated their lending activities in servicing the substance farming community, into the middle market segment of the Georgian economy as a result of minimal commercial bank penetration in this area. This could act as a stimulant for the commercial banks to take a more serious look at agro lending as an attractive addition to their over bank lending activities.

Recommendations:

1. **Support the continued development and expansion of financial training activities for the farming communities** as outlined in previous consultant reports on agriculture, to assist farmers in acquiring adequate knowledge, such as preparation of budgets, creation of basic financial statements, etc., in order to gain access to the financial markets.

2. **Promote the establishment and/or expansion of existing appraisal systems so that realistic market value assessments of real estate and moveable assets might be made** on a consistent basis in order that acceptable collateral value might be allocated to the risk assessment and pricing determination of banks' secured lending operations.

3. **Assist in the development of a reliable agricultural credit information system that would afford the banks adequate data** on potential agro borrowers upon which to make informed credit decisions.

4. **Encourage the development of an agricultural insurance program**, which would allow for greater bank agro lending activities, and facilitate in developing alternative sources of non-bank financing through possible real estate securitization options in the capital market, etc.

V. LEASING

As summarized in some detail in a previous consultant report (Rafael Castillo-Triana, “Leasing Development in Georgia,” for details, see Annex D Key Sources below), the present state of leasing activity in Georgia might be characterized as being chaotic at best. The government’s apparent ultimate goal was the creation of a multi-billion dollar leasing industry while at present there have been less than $25 million in financed leases, representing about 0.2% of Georgian GDP. An analysis of the reasons for the lack of growth in the leasing industry results in the following conclusions:

Demand Side:

Aside from the existing legislative roadblocks to the expansion of leasing options, there apparently is not a well-defined demand for leasing as a financial alternative among either the middle market entrepreneurs or the agricultural community because of:

- Lack of familiarity by the general public as to the mechanics and advantages of leasing as a financial alternative to bank financing. As the leasing picture becomes clearer with the introduction of more user-friendly legislation and the lease option is promoted by the participants in the marketplace, there should significantly increased interest, particularly among middle market enterprises, in leasing; and

- The present uncertainty of the impact of present rules and regulations is a detriment for both users and investors in leasing operations and has inhibited the growth of the industry.

Supply Side:

As indicated above the development and growth of the Georgian leasing industry has been constrained because of:

- The restrictions and harsh conditions of the present Civil Law together with draconian aspects of the Tax Code have effectively placed a stranglehold on the creation of a viable leasing industry. As stated in the USAID Georgia sponsored Deloitte report “Leasing Development in Georgia” dated 04 April, 2011, “Civil Law imposed on lessors the obligation to refund to delinquent lessees any potential excess of proceeds of sale value over the outstanding balance of the leases, disregarding the right of lessors to claim damages and to compensate the risk taken in transactions. An even more difficult issue, however, came from the Tax Code. Leasing companies were required to pay confiscatory effective tax rates due to the combination of several issues including the application of legal presumptions, misunderstandings about the economic reality of the business, and the importation of foreign accounting standards into the Tax Policy.” The onerous conditions applied to lessors, such as the requirement to refund to delinquent lessees any projected recoveries of sale value over the outstanding lease balances, and confiscatory tax rates are areas that must be addressed in any revision or issuance of new lease legislation.

- Lack of large number of market players to provide healthy competition within the leasing industry. Presently, there are three active leasing firms who are operating within the leasing regulations, while there could be a number "gray market" operator who might not be employing best practices in their leasing activities. The largest of the three TBC Leasing, which is owned by the commercial bank, TBC, has over fifty percent of the market shares, while the second largest company, GLC, has around 34 percent of the market. This is indicative of the fact that the leasing market has now and will have in the future room for the introduction of independent non-banking financial entities including affiliates of investment houses to provide direct competition to the bank-related leasing firms that should accrue to the benefit of middle market enterprises.

- The expansion of leasing activities should have a positive impact on the insurance and capital markets with the potential introduction of new financial vehicles such as lease securitization derivatives would be attractive investment alternatives through the capital market/stock exchange for the projected substantial insurance premium inflows and accumulation of pension funds.

- The anticipated re-drafting of the existing punitive leasing legislation should have a salutary effect on the operations of both lessors and lessees in freeing their transactions from the onerous restrictions of the present regulations and encouraging the growth and expansion of the leasing market. The support of donor agencies in seeing that the pending legislation is passed and implemented will be critical in reinvigorating the leasing sector.

Recommendations:

1. **Assist in the creation of new debt instruments, i.e. securitized lease transactions**, by initially backing these transactions by donor guarantees until such time as the market has accepted these instruments on their own merit, and the guarantees are no longer required. The securitized debt instruments, not only for lease transactions but also in the mortgage financing sector, would both provide an alternative financing vehicle for middle market enterprises, and also introduce additional investment alternatives to the capital markets.

2. **Become an active advocate for the passage of new leasing legislation** that would facilitate the changes as referenced above and in previous consultant reports so that Georgian lease activities become a viable on-going operation.

VI. CAPITAL MARKETS

In free market economies, the capital markets operate as both a companion and alternative to the banking sectors. Together they satisfy both the short-term and long-term financial requirements of the business communities. Capital markets, through the stock exchanges, also offer an essential mechanism through which investors, both public and private, might put their assets to work to earn favorable returns on their investments whether they be those of the small individual investor, or such funds as those of an insurance or pension nature. As the capital markets thrive benefits accrue to all segments of the economy.

At present, capital markets in Georgia are comprised primarily of the relatively inactive Georgian Stock Exchange (GSE) (see Table 6 below and Table 9 in Annex B), four bank-related brokerage companies together with several smaller independent brokerage firms. Although there are a number of Georgian companies listed on the GSE there is little trading volume on a weekly basis, and the only actively trading shares are those of the Bank of Georgia and Liberty Bank. It is understood that there are little or no share offerings, private placements or initial public offerings (IPO's), in view of the limited exchange activity and thin investment market. The government and NBG have some ability to stimulate GSE activity by recommending this system as a venue for trading foreign currencies, NBG and Treasury securities, as this is done in many neighboring countries. However, this is not the case here.

Table 6: Georgian Stock Market

	2006	2007	2008	2009	2010
Number of Trades at GSE	5,538	6,908	2,321	1,304	2,372
Average Number of Trades Per Month	462	576	193	109	198
Average Number of Trades Per Trading Session	57	51	16	9	16
Securities Traded at Georgian Stock Exchange (GSE) *(number of shares, millions)*	17	14.6	12.5	12.7	41.6
Average Securities Traded Per Month	1,430,114	1,218,319	1,040,072	1,055,663	3,470,106
Average Trade Size	3,099	2,116	5,377	9,714	17,555
Trading Volume at GSE *(GEL millions)*	61.7	38.4	10.6	3.1	5.1
Year-on-Year change *(%)*	-1	-37.8	-72.4	-70.7	64.5

Source: NBG

The existing situation apparently is largely due to the fact that:

- Mass privatization through corporatization of state-owned enterprises and the selling of shares for vouchers or cash through auctions took place in the mid 1990's, in a period directly after a severe financial crisis in the country. This was a time of multiple Ponzi scandals; poor quality of information about the auctioned companies; little existing securities legislation, regulation, and infrastructure in place; almost complete lack of understanding and trust by the public as to the functions of financial instruments.

- The establishment of proper securities legislation, regulation, and infrastructure, as a result of the USAID funded Capital Market Development Project was an attempt to improve the situation. However, in practice the GSE and capital markets were utilized only for the secondary trading of already privatized companies, which in most cases were of poor operational and moral quality. In essence the capital market became one of “control”, aiming at consolidation of ownership, rather than one of “cash flow.” With the government’s utilization of the voucher or cash system to privatize former state owned enterprises effective control of many of these companies was obtained by a few well connected “entrepreneurs” through purchase of the vouchers or the shares of those companies listed on the GSE. The exercises for control of these enterprises by the entrepreneurs did not directly contribute to increasing the liquidity of these companies or initially benefit their cash flow operations. This created the wrong perception with the public as to the general purposes and goals of the securities market.

- In addition, during this initial period the most attractive of the state-owned companies were sold to foreign direct (strategic) investors using formulas whereby no shares of the resulting companies were available to either the general public or portfolio investors. The sales were usually for 100% of the state-owned company, with little or no retention (say 51-75%) to be available through the securities market.

- This practice led to the consolidation of share ownership in relatively few hands with little public ownership in the resulting companies. This also resulted in the lack of growth and subsequent relative stagnation of the stock exchange that had been deprived of the self-sustaining activity implicit in the privatization process.

A companion result has been the consolidation of the banking community with the top five banks controlling more than 78 per cent of the financial market with a concomitant concentration of brokerage activity in the three largest bank-related brokerage companies owned by Bank of Georgia, TBC, and Liberty Bank. With the exception of the Bank of Georgia shares, which are traded on both the London and Georgian stock exchanges, these bank-related brokerage houses utilize almost exclusively foreign investment venues for the accommodation of their larger corporate customers’ longer term financial requirements. An example is the Bank of Georgia that, although listed on the GSE and is virtually the only active share traded thereon, has recently become listed on the London Stock Exchange, and is actively traded there. Other regional exchanges, such as Vienna and Warsaw are also utilized as alternative vehicles for raising long-term capital for large Georgian corporations. It is understood that BG Capital, the Bank of Georgia owned investment house, is in the process of setting up an international custodial depository which would allow it to hold Georgian companies’ shares on behalf of foreign investors, principally US and European hedge funds which are looking for high yield although higher risk graded investments, such as equity and subordinated debt of the larger Georgian corporations.

Consequently, the non-bank financial community, represented by the stock exchange, central depository and non-bank related brokerage firms are at a distinct disadvantage when competing for corporate business, especially middle market enterprises, due to their inability to make markets for potential share and bond issues as a result of lack of exchange volume, and the difficulty in devising additional market instruments, such a securitized mortgages, leases, and other derivatives.

Demand Side:

Although there are heretofore mentioned difficulties and roadblocks for the non-banking sector to service the financial needs of the middle market community, there are a number of such enterprises who are either reluctant to consider this alternative to traditional bank lending, or who do not feel qualified from a financial standpoint to utilize the existing domestic capital market opportunities because of:

- The competitive disadvantage of MMEs, as opposed to the larger corporations, in obtaining the requested bank credit commitments from the commercial banks, has resulted in increased pressure on the non-bank financial intermediaries to develop alternative sources of needed financing vehicles utilizing the unused capacity of the capital markets. The lack of bank lending alternatives for middle market enterprises beyond short term loans, often fully secured, and the relatively rare instances of cash flow financing for otherwise profitable and managerially sound enterprises, has highlighted the existing void in the Georgian financial structure and presents an excellent opportunity for the expansion of the capital markets. There is definitely a major role to be played by donor agencies in facilitating this expansion, and recommendations to this effect will be enumerated later in the report.

- Representatives of brokerage companies told the assessment team that a number of their MME clients have expressed interest in using longer term financing in the capital markets as an alternative or supplement to short term bank borrowing, but cannot justify the substantial (in their opinion) underwriting costs in the issuance of corporate bonds, or even perhaps an initial public offering (IPO). The brokers have intimated that the underwriting costs are not really prohibitive, but do sometimes represent a significant portion of a middle market enterprises' annual operating budget for the period in question. Once the middle market managers begin to realize the advantages of the financing options, the cost factor becomes less of an issue, but it takes some time to convince managements of the positive trade off over bank financing. One suggestion is to expedite middle market entrepreneurs' engagement in capital markets would be for donor agencies to provide facilities for the reimbursement of underwriting costs for qualified enterprises, at least on an interim basis. These facilities would allow enterprises to issue their corporate debts instruments or make an IPO thus establishing for them ongoing long term financing histories as well as creating both increased volume and liquidity for the stock exchange, and increasing investment opportunities for the insurance and pension funds.

- The Georgian so-called "Equity Culture" prevents many middle market entrepreneurs from considering the capital markets as an opportunity to raise long-term capital for sustainable growth. By "Equity Culture" is meant the belief that if an enterprise that is either family or closely held with regard to ownership undertakes either a corporate bond issue or perhaps an initial public stock offering, it will lose overall control of the operations and management of the enterprise to outside investors that is anathema to the founders of the enterprise. Their understanding of the upside and downside of free floating (letting out), say 10-15% of stock ownership and bond investment operation often is very poor, and intensive education as to the scope and principles of capital market operations is sometimes required by investment counselors before the benefits of this alternative mode of corporate financing is understood and accepted by middle market entrepreneurs. This also is an area in which donor agencies through contract consultants would provide meaningful assistance in this educational process.

- The passage of enabling legislation in the leasing, insurance and pension sectors will result in the need for receptacles for the placement of large amounts of investable funds, together with expanded investment options, such as securitized financial assets, diversified treasury instruments, etc., which presages vigorous efforts to breathe life into stock exchange operations, including legislation to allow for new and diversified equity and investment instruments, expanded trading activity, additional exchange participants, and instillation of modern and where necessary upgraded platform equipment, etc. These aspects will be discussed in further detail in the Institutional Mechanism section. Suffice it to say with the increased demand for domestic investment and financing requirements in the near future the capital markets infrastructure at present would need some upgrade to handle the anticipated volume.

Supply Side:

It has been suggested that the existing brokerage companies in the past have not aggressively promoted the development of a viable domestic capital market, but with the exception of the bank-related investment houses, have individually relied on a modest customer base for a relatively few traditional investment transactions. There are a number of reasons for the modest results of brokerage/investment houses solicitation efforts of the Georgian business community in general and the MMEs in particular, and these are because of:

- On the one hand, the bank-owned brokerage companies, due to exceptional relationships with parent companies, enjoy practically unlimited access to low cost financial resources. They use cross-marketing or other synergistic mechanisms, and having exclusive rights to participate in all parent bank-related investment banking transactions, and thus are enjoying sound financial positions and steady growth. However, in view of perceived potential competitive conflicts of interest in core businesses with their parent banks these bank-owned brokerage companies apparently are reluctant to explore participating in IPO's and other capital market financing mechanisms.

- On the other hand, non-bank affiliated brokerage companies, highly motivated and interested in facilitating IPO's, are financially weak because of a very thin and illiquid securities market, and consequently low revenue streams from commissions generated from such a market. Their negligible equity is not sufficient to sustain even basic marketing and educational costs necessary to convince potential investors of the attractions of the capital market as an alternative source of satisfying their financial needs.

- At present there is an apparent lack of a of a sufficient pool of institutional investors (pensions and insurance funds) to generate the necessary trading volume and turnover to increase the level of liquidity in the market to sustain continued growth which could act as an attractive inducement for middle market enterprises to utilize the capital markets as alternative sources of funding. The void in the pool of potential institutional investors as a result of the present absence of any long term, on going insurance programs or established pension schemes that would generate substantial cash throw offs through insurance premiums and pension contributions that would provide a major source of investable funds to help lubricate a much needed increase in stock exchange activity. Several members of the brokerage community have expressed the hope that proposed and pending legislation will kick-start both insurance and pension activities thus providing a continuing flow of funds to the capital markets. The projected development of a variety of long term insurance programs, might give rise to the initiation of the securitization by investment houses of insured real estate and/or lease transactions as an alternative investment vehicle.

- Concentration of investment activity with the larger bank-related brokerage companies with their emphasis on catering to the financial needs of their parent bank and major corporate customers has been a determent to the expansion of capital market involvement by middle management enterprises that have been largely ignored by the dominant brokerage companies. In discussions with managements of two of the largest bank-related brokerage/investment houses, it was indicated that the firms were receptive to expanding their activities with middle market enterprises, at least in theory, but the cost differential between servicing a major corporate customer and a smaller middle market client was not sufficient to justify a major new business solicitation program geared toward the latter market. It was a case of economies of scale.

- Lack of success of brokerage companies in persuading the government to channel privatization activities through the stock exchange and the capital markets thus depriving both the exchange and the markets from much needed volume and source of necessary liquidity for expanded operations. In contrast with some other newly independent countries' governments who directed their privatization processes through the new stock exchanges, the government conducted privatization of state-owned "Blue Chips" by means of direct sales to foreign strategic investors of 100% of shares of those companies, a practice that circumvented the capital markets entirely. This has deprived the capital markets of a significant growth opportunity. It appears as though the situation has not materially changed to date, and is an area where donor agencies might have some influence.

- The need to recruit and train up to professional standards additional personnel for the non-bank related brokerage firms to supplement the rather meager present staffing totals, to provide not only a competitive base to challenge the larger bank-related brokerage companies in the market place for new corporate business but also to promote the capital markets as an alternative source of satisfying the financial requirements, particularly of middle market enterprises, by aggressive public relations and business development activities to familiarize potential capital market borrowers and investors as to the concepts and benefits of this arena of corporate financial management.

- One way to telescope the training time frame, and at the same time ensure a high degree of educational input would be the utilization of the investment banking facilities of selected U.S. and/or European firms through an internship program, which could be sponsored and perhaps underwritten by donor agencies such as USAID. Such an internship program would rapidly create a cadre of qualified investment banker able to address the financial needs of the overall Georgian corporate community, with special emphasis on middle market entrepreneurs.

- Although the GSE and the Georgian Central Securities Depository (GCSD) were provided with modern operating procedures and equipment at the time of their start up in the 1990's there appears to be a pressing need for extensive updates in order to accommodate anticipated expansion of capital market activity.

Institutional Mechanisms:

It has been suggested that the Georgia Stock Exchange (GSE) has not been generating sufficient income due to lack of exchange activity to cover its operational expenditures. If this is indeed the case, and there does not appear to be a projected significant increase in profitable exchange volume in the foreseeable future, the exchange's long-term sustainability would be subject to question because:

- As indicated above, since the initiation of stock exchange operations in the 1990's there has little encouragement of or inclination by the government to utilize the existing capital market mechanisms for privatization purposes. If the capital markets had been designated as the appropriate vehicle through which shares in the former government-owned enterprises were offered to the public as was done in other newly independent states, this undoubtedly would have resulted in the development a vibrant exchange trading scenario.

- It is understood that existing governmental regulations practically restrict stock exchange members and participants from currency and treasury bill trading. Such trading activities are reserved for the commercial banks that are not conducted under the auspices of the stock exchange and central depository, thus depriving it of a substantial continuing flow as well as limiting the menu of investment options available to potential investors through the exchange.
- At present the central depository and registrar operation for Georgian corporate securities are conducted by seven different entities, GCSD and six securities registrars, which understandably have resulted in increased transaction costs for the exchange and capital market participants. This fragmented situation has had a negative impact on the financial performances of the central depository as well as the stock exchange, and to date it is understood that there have been little or no concerted efforts to consolidate these activities.
- The small trading volume of the Georgian Stock Exchange, and the absence of a common trading, clearing and settlement mechanism with international capital market operators, reduces interests of potential foreign investors, such as hedge funds. The streamlining and updating of the stock exchange's operational capabilities should be a priority that could be more readily facilitated with the assistance of donor agencies.

Recommendations:

As a result of the assessment of the capital markets in general, and the Georgian stock exchange in particular, the following are recommendations which it is felt would result in significant improvements in the non-banking financial sector:

Positive steps might be undertaken in improving stock exchange liquidity as a result of consideration of the following:

1. **Re-imposition of mandatory utilization of stock exchange facilities for trading of shares of companies admitted for trading on the stock exchange.** This would require the largest bank-related brokerage companies to conduct a major portion of their brokerage activities through the exchange instead of bypassing the domestic capital market facilities and making over the counter (OTC) transactions, thus inhibiting the fair price determination mechanism and liquidity for respective instruments. Together with fixing the latter problem, the resultant increase in stock exchange volume would enhance the exchange's reputation and attract more potential issuers of capital market instruments;

2. There is a perceived need to **strengthen the institutional capabilities of the smaller non-bank related brokerage firms by providing donor supported capacity building** to train and energize the existing and to be recruited staffs through both in-house training and internships with large U.S. and European investment banks. This should assist in lessening the dominance of the few large bank-related brokerage companies in the present capital market activity;

3. The mandatory requirement for members for utilization of the Georgian Stock Exchange for trading activities should be accompanied by the **imposition of at least fifty (50) per cent cap of shares traded on the dual listing with foreign exchanges of issues that are listed or admitted for trading on the GSE**;

4. In order to facilitate the orderly implementation, settlement, recording, and custodial arrangements for transactions on the stock exchange, it is considered an imperative that **all depository and registrar activities be consolidated into one central depository and registrar closely affiliated with the stock exchange.** At present these activities are fragmented among a number of such operations, with the resulting lack of efficiency and control necessary to induce both potential domestic and foreign clientele to utilize the Georgian stock market;

5. **An ancillary benefit for the expansion of capital market activity would be active donor support for legislation regarding pension and insurance development** along the lines outlined in the succeeding sections. This would enable the pension and insurance funds to avail themselves of a transparent, liquid, and readily available investment medium within Georgia that would prove to be beneficial to all participants in the country's financial sector; and

6. **There should be consideration by donor agencies to provide some sort of financial support, either guarantees/ or defrayment of partial or all of initial underwriting expenses, to middle market enterprises** in cases where they deem the cost of utilizing the capital markets for the issuance of corporate bonds, debentures, or initial public offerings too expensive to consider this long term financing alternative.

VII. PENSIONS

Pension funds or similar institutions, for example life insurance companies, are key elements for retirement provisions in developed economies and some emerging markets. They make payments to pensioners more independent from state subsidies or contributions from "pay as you go" (PAYG) pension systems, which are depending on a stable demographic perspective and are not sustainable in ageing societies. In addition, pension institutions are very important institutional investors in the national capital markets. That is why the development of funded pensions must be executed in close coordination with the development of the capital markets, to avoid frictions due to capital inflows that cannot be absorbed in a reasonable way by borrowers. Finally, experiences during the last global financial and economic crisis have demonstrated the important role of effective pension system as "automatic stabilizers" for internal demand in times of crisis.

In contrast to many emerging markets and countries in transition, Georgia has not yet developed a structured pension system, with negative consequences for the market for private pensions. Up to now the government based tax funded flat subsistence pension is quite efficient in mitigating old age poverty to a certain extent. But employment related pensions and voluntary retirement savings are small and have no significant impact.

At the time of the collapse of the Soviet Union in 1991 some republics had already started to develop separate pension systems, including the Russian Federation in 1990. After the break-up of the Union the now independent states had to find own ways. The first were the Baltic republics. Some countries followed the three pillar system developed by the World Bank with a mandatory general pay as you go (PAYG) system as first pillar and with a funded (mostly mandatory) second pillar, linked to an employment contract and a voluntary funded third pillar, generally in the form of private life or pension insurance. For example Kazakhstan has started with the implementation of a comprehensive pension system in 1998, with private pension funds as second pillar.

There is no well–designed balanced multi-pillar pension system in Georgia. The first pillar is organized in the form of a tax-financed government pension, which was raised in September 2011 from 80 GEL to 100 GEL (approximately $60). In comparison, the average monthly nominal salary of employees was in 2010 GEL 597 (approximately $350) and GEL 299 (approximately $176) in the educational public sector. Pension payments account for approximately three-fourths of the total social protection budget and come up to 3.9 percent of GDP in 2011, according to projections of the government.

The budget is the only source of income for the state pension. As a result, there is an extremely high dependency on the ability of the government to allocate the necessary part of the budget to this task and on political considerations, for example in connections with elections and/or other pressing political necessities.

The key legal basis for the so called second and third pillar (pension funds) is the Law On Non-State Pension Insurance and Security of 1998, that has been modified in 2010 together with bylaws, especially the Rules On Determining Minimum Requirements for Non-State Pension Insurance and Security Agreements and On Determining, Imposing and Enforcing Pecuniary penalties on Non-State Pension Scheme Founders, Asset Management Companies and Specialized Depositories. With the modifications of the legal framework in 2010 the legislature and the competent supervisory authority have improved the previous regulatory and supervisory system. Especially the transfer of the supervisory responsibility for private pension, and insurance to the National Bank of Georgia at the end of 2008 has brought the supervision to a new level of regulatory quality. But there is still much room for improvement if measures to radically strengthen Pillar II and III will be planed.

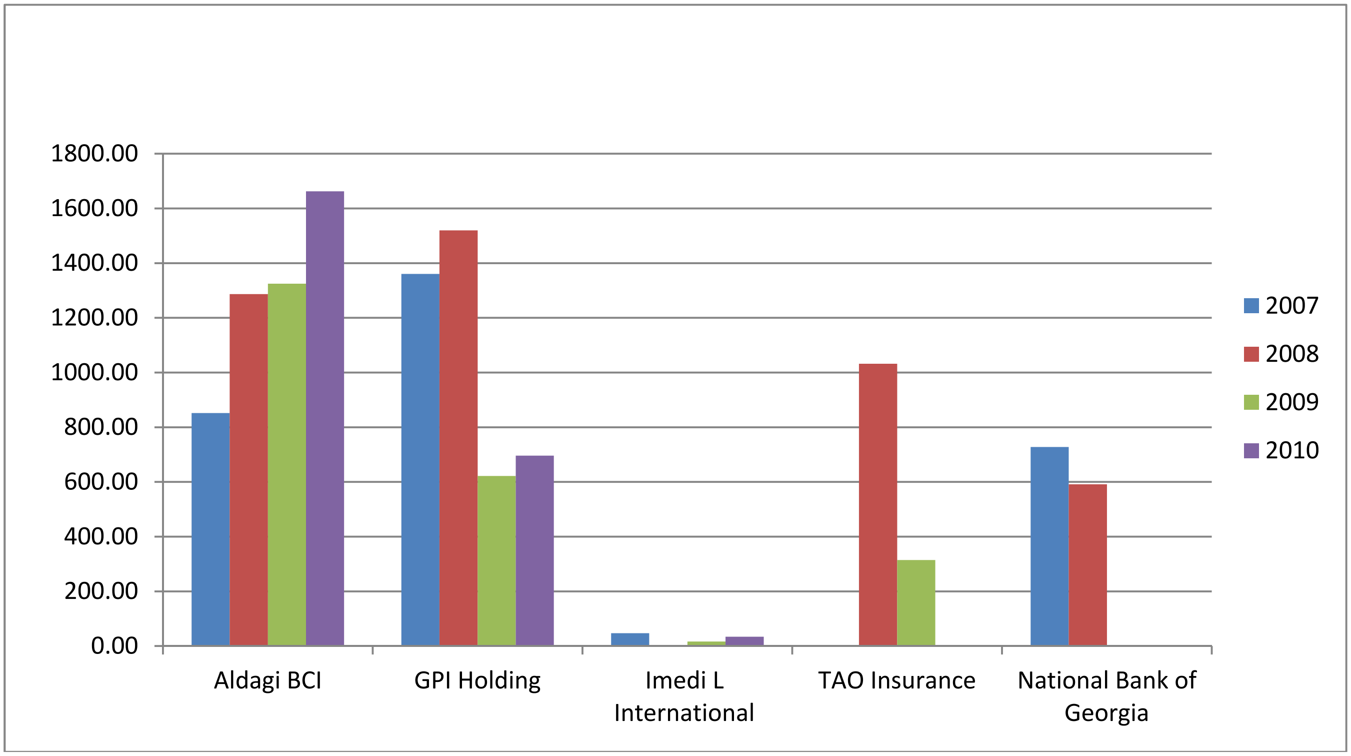
There are no tax advantages or similar incentives for the participants of pension funds / pension insurance.

At the end of 2010, six pension institutions were licensed, all of them founded by insurance companies. Only three of them were active. The market leader is the Aldagi BCI. At the end of 2010, the funds had 16,879 participants, the total liabilities to participants stood at GEL 7.9 million. The total amount of contributions reached GEL 2.4 million. Participants are mostly staff members of banks and other companies and of foreign institutions like embassies. The premium income of life and pension insurance together reached slightly more than GEL 10 million in 2010.

Table 7: Pensions: Development 2007 - 2010

(millions GEL)	2007	2008	2009	2010
Contributions during the Period	2.9 GEL	4.4 GEL	2.3 GEL	2.4 GEL
Valid policies by Dec 31st	10486	10354	9479	11664
Number of Participants	14263	15602	14175	16879
Number of Participants Receiving Pension	55	54	0	0
Withdrawals	0	0	1.5 GEL	1.2 GEL
Reserves by Dec 31st	3.4 GEL	6.7 GEL	6.3 GEL	7.9 GEL
Investment Income	0.45 GEL	-0.28 GEL	1.99 GEL	0.77 GEL

Figure 5: Contributions (Thousands GEL)



**Source NBG*

In comparison to many other transition countries, the demographic situation is works in Georgia's favor. Between 2005 and 2050 the share of elderly (65 – 79) will rise by only 5.1%, compared with 15.8% in the Russian Federation, according to a Report by the Council of Europe.

A well balanced pension system could lead to a long term reduction of the burden for the state budget and could stabilize the pension level by making it less dependent on fiscal constraints and considerations. A higher and stable pension level, strengthened by an efficient second pillar, could also contribute to the positive impact of the so-called "automatic stabilizers," especially social security expenditures, in a period of recession.

Demand side:

Up to now there is no substantial demand from the Georgian public for pension insurance and similar products or pressure to promote savings-based products due to especially the following reasons:

- <u>The problem on the demand side is the absence of interest due to alternative saving traditions:</u>
  In Georgia, as in many other emerging markets families with a sufficient savable income traditionally invest in real estate. This is seen broadly as preferred and safe type of investment.

- <u>The second important problem is the lack of a sufficiently positive image of financial services:</u>
  In Georgia as in most other emerging markets the broad public is still skeptical vis a vis financial services providers in general, partly based of experiences with collapses, periods of inflation and a general instability of the economy. And the population is especially reluctant to invest in long term cash saving products, due to expected cumulated risks in longer saving periods.

- <u>The third problem is the lack of savable income:</u>
  The average income for most citizens in Georgia is so low that at present time only a minority is able to save for old age. The GDP per capita is still low with $2,629 in 2010, with an official unemployment rate of 17% in 2010 and with a still high percentage of nearly 25% below the poverty line, only a relatively small parts of the population would invest voluntarily in cash saving products for retirement.

- <u>The fourth problem is that, in addition to the image-problem of the financial services industry, there is a lack of financial knowledge and awareness:</u>
  Most citizens are not sufficiently aware of the potential advantages of long term saving approaches like pensions or life insurance. This is typical especially for republics of the former Soviet Union, where the understanding of market systems in general and especially of financial services is still lower than for example in Central European countries like Hungary or Poland with a much shorter "Soviet" history.

- <u>A decisive uncertainty is the unclear strategy of the government: The Georgian government has in principle a perceived interest in an efficient, adequately-funded pension system, especially for the following reasons:</u>
  - A stronger private pension sector (Pillar II and III) could significantly contribute to a subsequent reduction of the resources from the budget allocated to the state pension payments. And a well-developed second pillar could help stabilize the country's social security fabric as a whole, relying now nearly exclusively on the budget. In addition this would contribute to the development of the capital market and could speed up the De-Dollarization due to the increase of GEL-denominated savings.

  - On the other hand there seems to be no clear approach of the GoG for the necessary reform of the pension system due to conflicting approaches and interests: there is on the one hand the interest to reduce the burden for the budget and there is on the other side the strategy to develop Georgia into an attractive location for foreign direct investments including work-intensive fields like textile. Here any additional burden from pension contributions could be detrimental for such an approach to encourage FDI in work-intensive industries.

Supply Side:

The pension system, as presently structured, provides no incentives as subsidies, or nor is it mandatory as in many other emerging markets. Consequently the pension sector is weak, as described above, and cannot contribute to the development of capital markets, as is the case in other emerging markets.

- <u>One problem is, bearing in mind the above described situation concerning the public, that there is no requirement for employers and employees to organize long term savings mandatory as it is the case in many emerging markets with structured pension systems:</u>
  The classical approach for pension systems, following for example the World Bank model, is to set up in addition to the basic government PAYG a mandatory Second Pillar, at least in the formal sector with an formal labor force of only 619,000 in 2010. This is not the case in Georgia.

- <u>In addition, there are no tax rebates or direct subsidies to motivate larger parts of the population to save voluntarily in Pillar II or III:</u>
  In most countries without a mandatory Pillar II are incentives in force that are designed to motivate especially lower and middle income groups to make use of pension funds and similar products. The “classical” tools are tax benefits for employees and employers, if they decide to pay into such a system. Another option is direct subsidies from the state budget, especially for low-income groups or families with children who would not benefit from tax advantages.

Recommendations:

1. **Promote, together with other international donors, the concept of a balanced Pension System,** based on a tax-financed Pillar I and a mandatory Pillar II vis a vis the GoG and other important stakeholders. If the GoG has made such a basic political decision, then:

    a. **Support the construction of an integrated Three Pillar Pension System**, especially through the creation of the necessary legislation for a mandatory Pillar II, in the first phase for the formal sector.

    b. **Support the Implementation of Pillar II in a step-by-step approach**, to enable a smooth and broadly accepted implementation.

    c. Coordinate the implementation with the resources and absorptive capacities of the financial/capital markets to avoid friction and **safeguard an acceptable return on investment** for the participants of Pillar II. Vital is a close coordination with the implementation of the recommendations for the further development of the capital markets: Precondition for the long-term success of a funded Pillar II are safe investment opportunities with a sufficient return on investment. We would recommend to develop products, especially designed for the needs of institutions, for example with a guaranteed interest rate above the inflation rate, as it has been the case in Poland. This should be supported by the development of products for longer term investments in GEL.

d. Encourage the participation of the general public in Pillar III by the development of **tax incentives for long-term life insurance and similar products**.

e. Promote the introduction of the new pension system by a **financial education and public awareness campaign** in cooperation with the National Bank of Georgia, institutions of the financial sector (associations), schools, media etc.

f. **Support improvement of the regulatory framework**, including supervisory instruments, practices and staffing.

g. Support the set up a neutral and broadly accepted **alternative dispute settlement mechanism** for insurance and pensions / the financial sector.

These recommendations are in line with approaches and recommendations of various international donors including the World Bank, which is redrafting the recommendations for sustainable social security systems and will put more emphasis on a balanced mix of funded and PAYG- or tax-based pension systems. And a discussion of the general direction of our draft recommendations with a representative of the EBRD showed that the Bank could be interested to support such a move to a stronger pension insurance system in Georgia.

VIII. INSURANCE

Insurance plays a vital role in every market-driven economy. Insurance enables companies and individuals to manage the risks they have to bear in all business activities, from the risk of losing investments by fire or of loose contracts by the breakdown or loss of equipment; of financial risks, for example by losses of products during the transport; by credit risks or by product liability, i.e. complaints. Insurance is in addition a key element of risk management for private persons, for example by protecting against liability claims in traffic accidents as well as in the fields of old age retirement provisions and health insurance. In principle, insurance is involved in all fields of economic and social activity. Insurance companies are key institutional investors in developed markets and are consequently playing a decisive role in the development of the national capital markets.

In Georgia – as in most other countries of the former Soviet Union – this decisive role of insurance is not sufficiently understood and accepted by the society. These problems are based on long term traditions from the Soviet times on the one side and on bad experiences during the last two decades of independence on the other side, in addition to the present economic constraints. And the Georgian insurance industry could not yet deliver all key services that are standard in developed market economies.

At the time of the collapse of the Soviet Union insurance in Georgia was part of the monopolistic Soviet system, characterized by the existence of two monopolistic companies, of which one was in charge of domestic insurance (GOSTRAKH) and the other of foreign an reinsurance business (INGOSTRAKH). All these institutions offered a fairly large scope of insurance cover (including life insurance and agricultural insurance), but the insurance technique in no way met international standards. For instance, the greater part of premium income was included in state budgets and insurance benefits were paid off to clients through the monopolistic companies from state budgets, organized according to the republics of the Soviet Union with the headquarters in Moscow.

This was felt in an especially painful way in the field of life assurance, when clients and regional agencies of the monopolistic company in charge of domestic business (GOSTRAKH) in the new independent states of the (former) Soviet Union including Georgia discovered, the payments had been included in the central budget of the ministerial funds in Moscow and were lost for them. This was for most Georgian citizens who had bought life assurance policies, a decisive bad experience, promoting skepticism regarding insurance.

As in many other former Soviet republics with no memory of an open-market "insurance culture," the transformation of the monopolistic structure into a market driven insurance system was and still is a complicated process. There is a wide range of micro economic, macro-economic and institutional failings, from lack of risk management within insurance companies via macro-economic frictions, high inflation rates to an insufficient regulatory and supervisory framework for the insurance companies. In addition, in Georgia as in most other emerging markets the general understanding of the role of insurance is weak.

A comparison of the present situation of the Georgian insurance market with a developed western insurance market (Switzerland) and one of the new EU member states (Slovenia) is instructive.

Table 8: Insurance: Benchmark I

	Population (ml)	Insurance density (USD)	Insurance Penetration (%)	Insurance Investments (ml USD)*
Georgia	4.4**	47**	1.90%**	234**
Slovenia	2.0	1352	5,9	6008*
Switzerland	7.8	6633	9,9	347957*

Note: in 2008   ** in 2010*

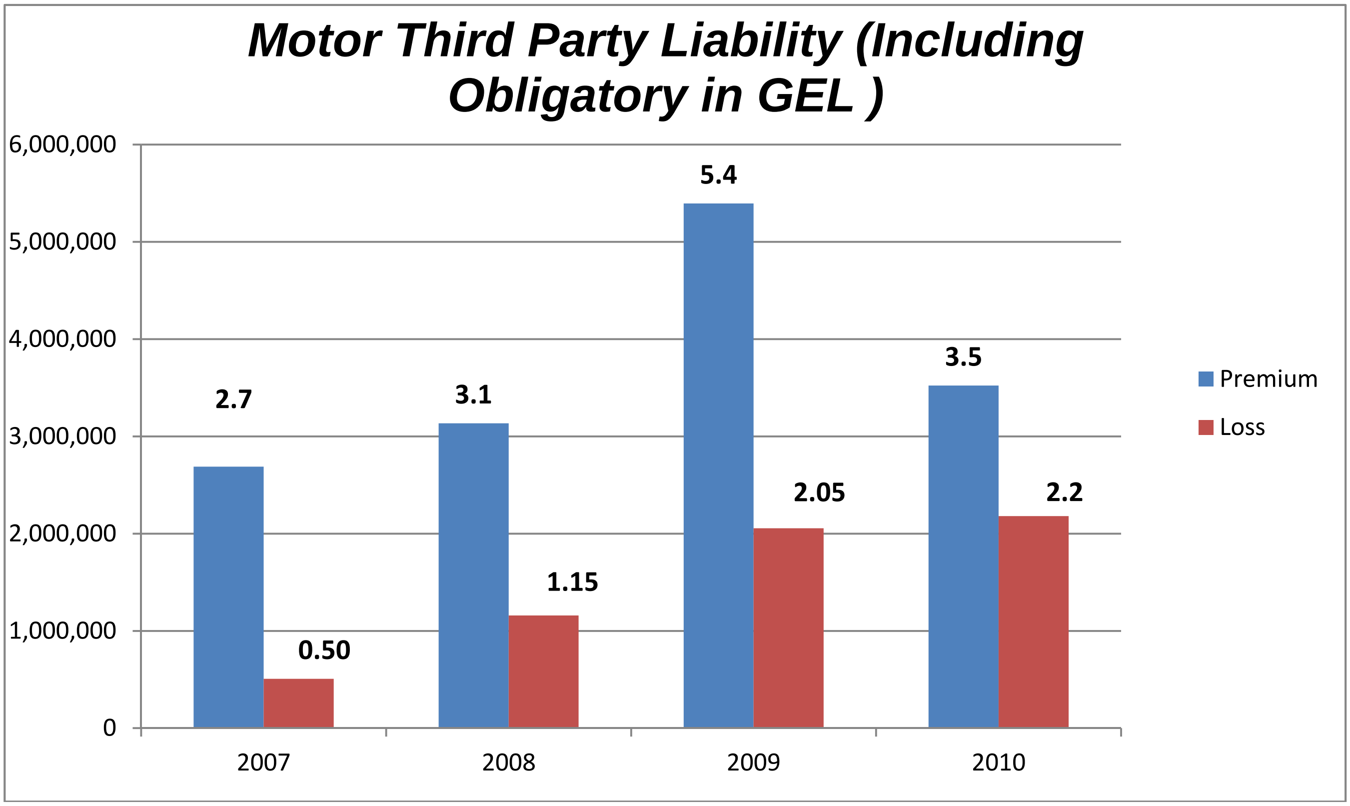
Compared to the insurance industry in Switzerland and Slovenia, the potentials for the Georgian insurance industry are far from exhausted. So far, the Georgian industry's capacity to cover important economic risks and to act as a facilitator for economic development is limited. One of the reasons is that the Georgian insurance market did not follow the typical development stages for emerging market insurance industries, with fire insurance and selected commercial lines as starting point in the field of non-life, followed by key liability classes, especially motor liability insurance (MTPL).

Table 9: Insurance: Benchmark II

	Premium total	Life total	Pension*	Health	MTPL
Georgia (ml USD)	218	5.87	1.45	144.8	2.12
Slovenia (ml USD)	2827	885	232	552	407
*voluntary II Pillar					

MTPL is the key driver for the development of non-life insurance and plays (in addition to its important social function) a vital role for the development of an insurance market. Unfortunately Georgia was one of the first former Soviet Republics that implemented mandatory MTPL cover in 1997, but failed with this approach due to decisive problems with a proper design and implementation, for example concerning the necessary broad coverage, mainly due to widespread corrupt practices within this system. Consequently the corresponding law fell out of force and was subsequently lifted. Also the third typical step of insurance market development, more sophisticated products like credit insurance, professional liability insurance classes, business interruption and reinsurance, are underrepresented, mostly due to lack of demand.

Figure 6: Insurance: Motor Third Party Liability Insurance (Including Obligatory)

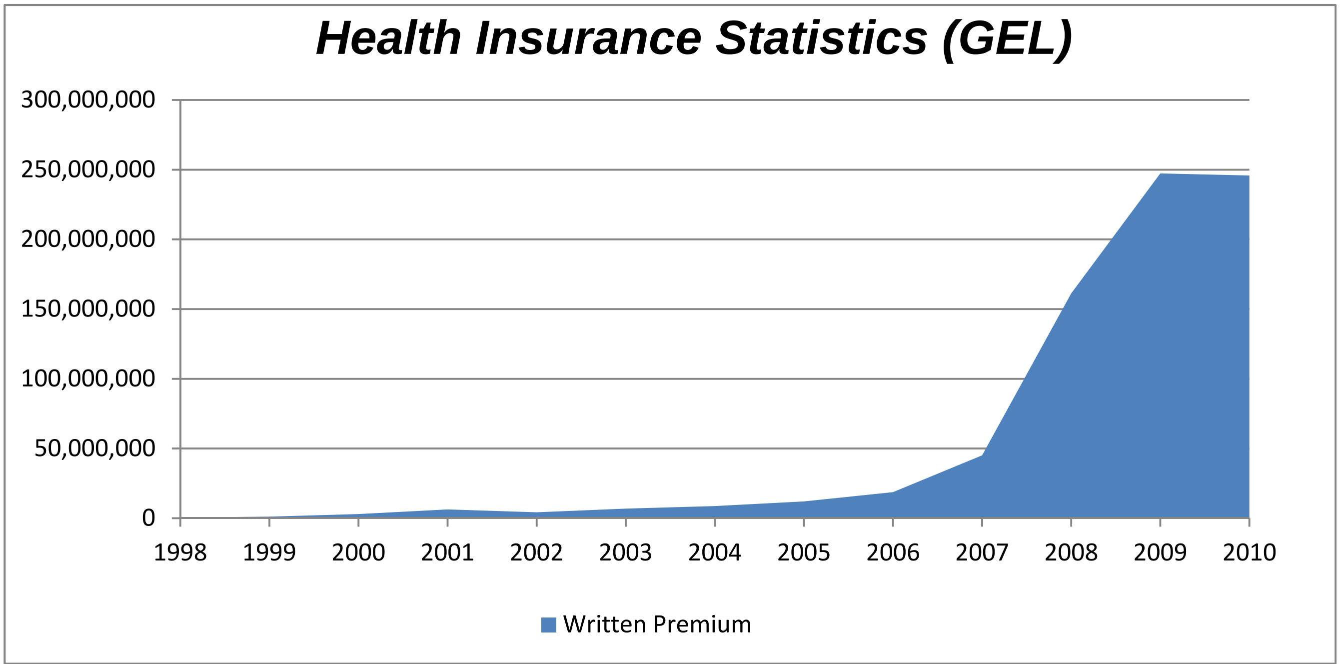


**Source NBG*

In addition the typical role as an important institutional investor on the respective capital markets can up to now not be taken over by the Georgian insurance industry. The condition for this is a developed life- and pension insurance system, what is not the case in Georgia with a share of life insurance premium of only approximately 3% and premium income in life of roundabout GEL 4 million. As described in the section on "pensions," the premium income of the insurance industry via pension scheme contributions stands at only GEL 2.4 million. The total volume of insurance companies assets reached GEL 448.4 million in 2010. Finally the present state of the Georgian capital markets concerning range of investment types, market size does not offer attractive investment opportunities.

Concerning the role of insurance in the field of social security, Georgia gives an atypical picture: On the one side life and pension insurance are as described very weak and the protection of victims of traffic accidents via mandatory third party liability (MTPL) insurance is not present. But in the field of health insurance Georgia is a very interesting example for a reasonable approach how to develop a market oriented and effective health insurance system for the low-income groups.

Figure 7: Insurance: Health Insurance Premium 1998 – 2010



Source NBG

The government health insurance program, that targets the poor, was broadly introduced in 2008. The target groups are identified on the basis of proxy means testing and comprise a significantly high number of beneficiaries (approximately 900,000 in 2011). In the program the beneficiaries are entitled to get insurance vouchers, guarantying a minimum health cover to these beneficiaries. Private health insurers accept the vouchers as payment for health insurance policies with the minimum cover set by the government.

In 2010 this program accounted for nearly one third of the GoGs health budget. The remainder of the health budget is used for specific targeted health programs.

Table 10: Insurance: Health Care Financing in Georgia

	2009	2008	2007	2006
Total National Health Expenditures (ml USD)	1102.1	1107.1	792.3	658.8
Total Health Expenditures from State Budget (ml USD)	253.7	228.4	145.9	144.57
Percentage of State Financed Health Expenditures of Total National Health Expenditures	23.02	20.64	18.43	21.94
Out of Pocket Health Expenditure (ml USD)	739.5	734.6	561.48	475.1

% of Out of Pocket to Total National Health Expenditures	67.10	66.35	70.86	72.11
Total Population	4385400	4382100	4394700	4401300
Per Capita GDP (USD)	2455	2921	2314	1763
Per Capita National Health Expenditure (USD)	251.32	252.65	180.29	149.69
National Health Expenditure/GDP	10.24	8.65	7.79	8.49
Per Capita Health Expenditures from State Budget (USD)	57.85	52.14	33.22	32.85

Source: MoLHSA

In comparison with developed insurance markets, the scope and variety of insurance products available for companies and private clients (in most property and casualty classes) is smaller, but sufficient, compared with the so-far limited demand. Georgian insurance products are in line with the standards in developed markets. The key problem is not a lack of products, but the lack of demand, based to a large extent on a lack of understanding of insurance.

A field with significant development potential is liability insurance. This is not limited to MTPL, described above. Various other products such as professional liability or liability coverage for dangerous production processes that pose risks for individuals or the environment are also underdeveloped in Georgia. This is common in most emerging markets, especially in former Soviet republics, where the legal basis for the concept of liability have been widely unknown for decades. Also in the Russian Federation the legal basis for liability and the respective insurance concepts and products are under development. In Georgia the legal framework is not yet sufficiently developed and might limit the introduction and usage for well designed and calibrated insurance products.

This is the case, for example, in the field of employer's liability/workers compensation, where the labor code only states that parties are liable for damage caused, without regulating the scope of this liability. Another example can be the medical malpractice insurance, where the demand starts to emerge as a response to the new structuring in health services, but missing implementation of medical guidelines/Protocols might strongly limit the supply. Court decisions in selected cases cannot replace a clear regulatory basis. This is a complex cross-cutting issue, because the different professional liability products require individual regulations, and – in the field of mandatory coverage – proper implementation and control.

The basic legal foundation for the insurance industry is the Law on Insurance of 1997, as amended in 1998, abolishing restriction on foreign ownership of insurance companies in connection with Georgia's accession to the WTO. An analysis of the legal and regulatory framework for the insurance by the Financial Sector Assessment Program (FSAP), based on the Insurance Core Principals of the IAIS, found that Georgia had a "basic, but workable" legal infrastructure for the insurance sector. A detailed analysis of the insurance law by an expert for the EBRD in April 2007 recommended various modifications to bring the law closer to the Insurance Core Principles. Further, an analysis by the EU-funded GEPLAC Project in 2008, concluded that the insurance legal framework was broadly compatible with EU legislation, but it made various recommendations to improve the level of approximation to international and European standards.

Parallel to the transfer of the supervisory responsibility for insurance to the National Bank of Georgia in 2007, significant changes were introduced in the Law on Insurance, for example concerning the conditions and procedures for granting and revoking licenses, concerning the financial stability of insurance companies and concerning violations, sanctions, wind-up and bankruptcy. In addition, further amendments were made in 2010, for example concerning fit and proper requirements and concerning risk management.

Various modifications have also been implemented in bylaws, for example the Regulation on Determining, Imposing and Enforcing Pecuniary Penalties on Insurers; the Regulation on Forced Administration; Wind-up and Bankruptcy of Insurers; and concerning the Regulation on Determining Minimum Capital Requirements. Also the Reporting Requirements for Insurance Companies; and the Rules on Defining and Creating Technical Provisions; and Concerning Assets Eligible for Covering Insurance Technical Provisions; have all been updated. Altogether, the legal frameworks for the insurance industry and for supervision have been improved remarkably within the last two years.

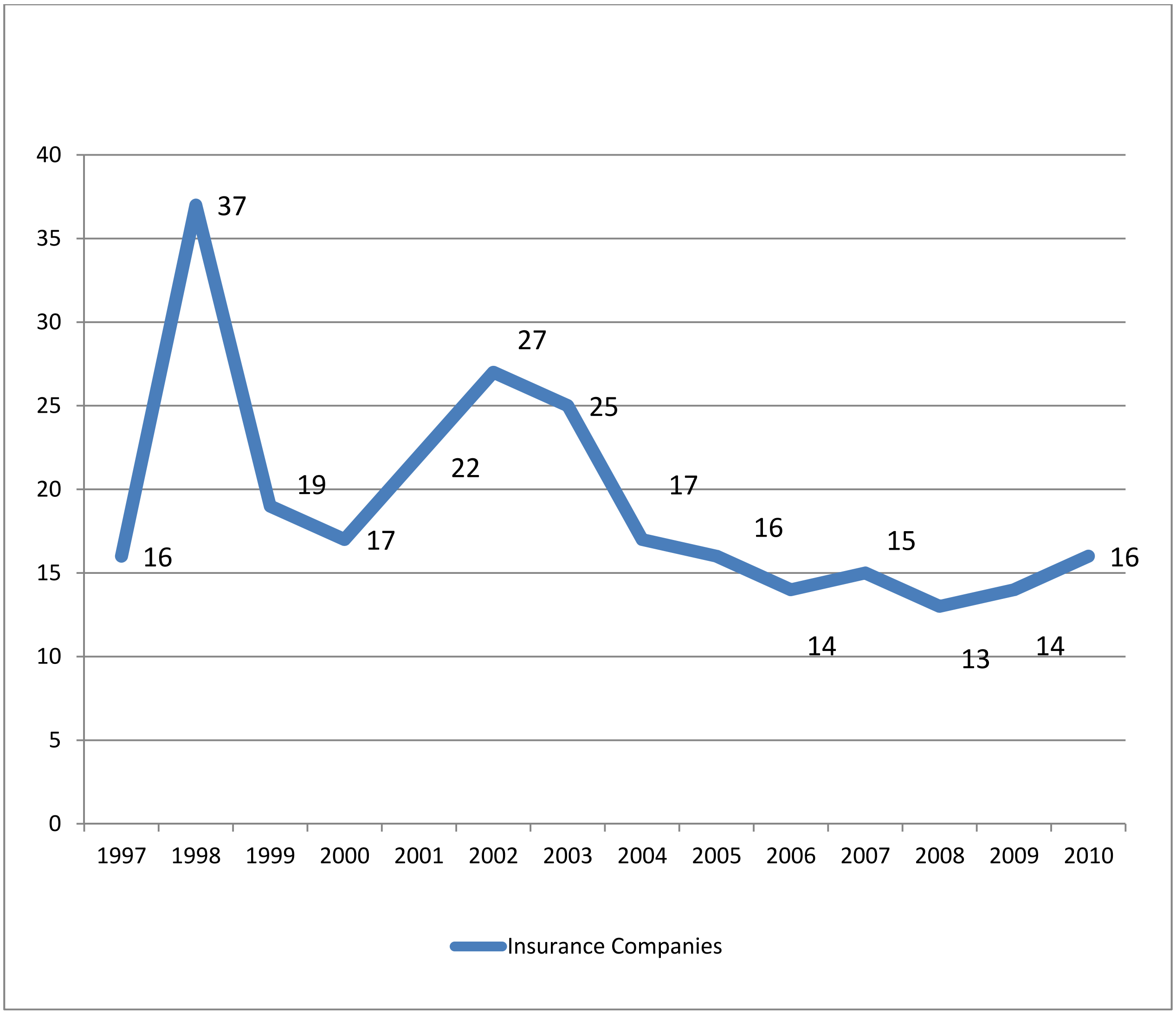
As is the case for the pension companies, the takeover of insurance supervision by the National Bank or Georgia has not only improved the legal framework but also the quality and efficiency of the supervisory work. This is an important positive factor for the further development of the insurance sector. The previous insurance supervisory authority was motivated and had tried to improve the knowhow of the staff members, but definitely lacked the financial resources and the necessary “standing” that is necessary for an effective supervision. The new financial supervisory department and the National Bank is well aware of the situation and has a clear vision how the supervisory system should be developed further, including the need for an effective and implementable Solvency system. It should be noted that the National Bank is also responsible to a safeguard a free competition in the financial sector. In the insurance sector market distortions should be observed and followed up carefully.

For some time in recent years, the Georgian government’s “market – liberal” approach in the field of financial services came in conflict with the international standards concerning financial services, for example the Insurance Core Principal of the IAIS, as mentioned used as benchmark for the internationally accepted FSAPs (Financial Stability Assessment Program), an important precondition for further financial and technical assistance in the field of financial services.

An important player in the insurance system is the Georgian Insurers Association (GIA), which is an effective body in coordinating the interests of the insurance industry, in promoting the stable and sound further development of the market. GIA can – as in developed insurance markets – takeover in future additional functions for example concerning services like statistics etc in the field of key insurance classes (MTPL) and in the fields of insurance education, insurance awareness and consumer protection.

An important problem for the further development of the insurance market is the quality and quantity of intermediaries, especially tied agents. At present there is little potential for much progress into the retail market. Most of the brokers are not interested in entering the complicated retail market and that leaves this field to the insurance companies and their limited marketing and sales capacities. There are initiatives by GIA to train intermediaries, especially for the further expansion of the health insurance market, but these are insufficient due to inadequate funding.

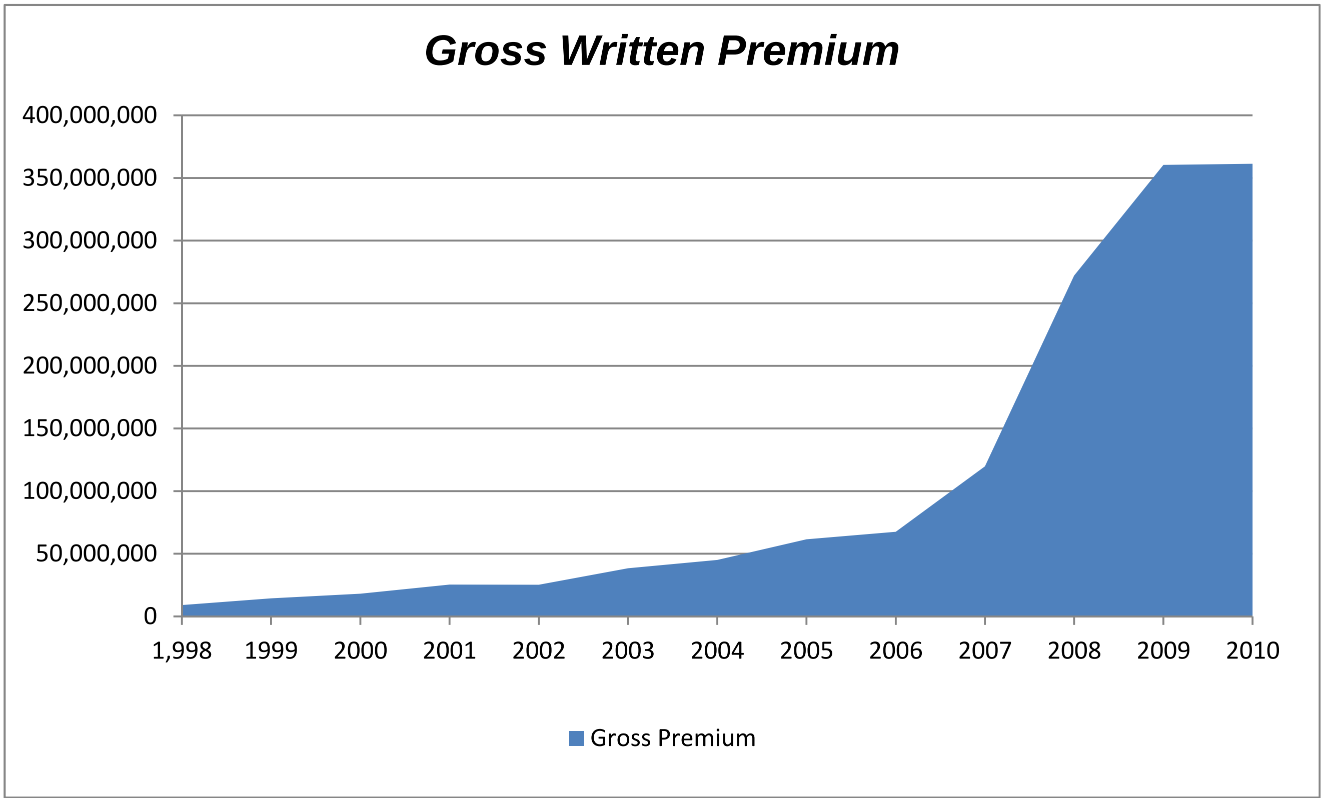
Figure 8: Number of Insurance Companies



**Source NBG and GIA*

The Georgian insurance market by the end of 2010 consisted of 16 insurance companies – 12 companies offering both life and non-life products; four companies either offering one or the other. Nine insurance companies were owned by Georgian shareholders; four companies by Georgian and foreign shareholders; two were fully owned by foreign shareholders; and one insurer is a branch of an insurance company registered in an OECD-member country.

Figure 9: Insurance: Gross Written Premium 1998 – 2010



**Source NBG and GIA*

The gross insurance premium reached GLE 372.5 million in 2010. The dominant insurance class is health insurance with 66.3% of gross premium received. Life insurance has a share of total premium income of 3%. The market share of the largest five insurers was 77.9 % in 2010 (see Figure 10 below).

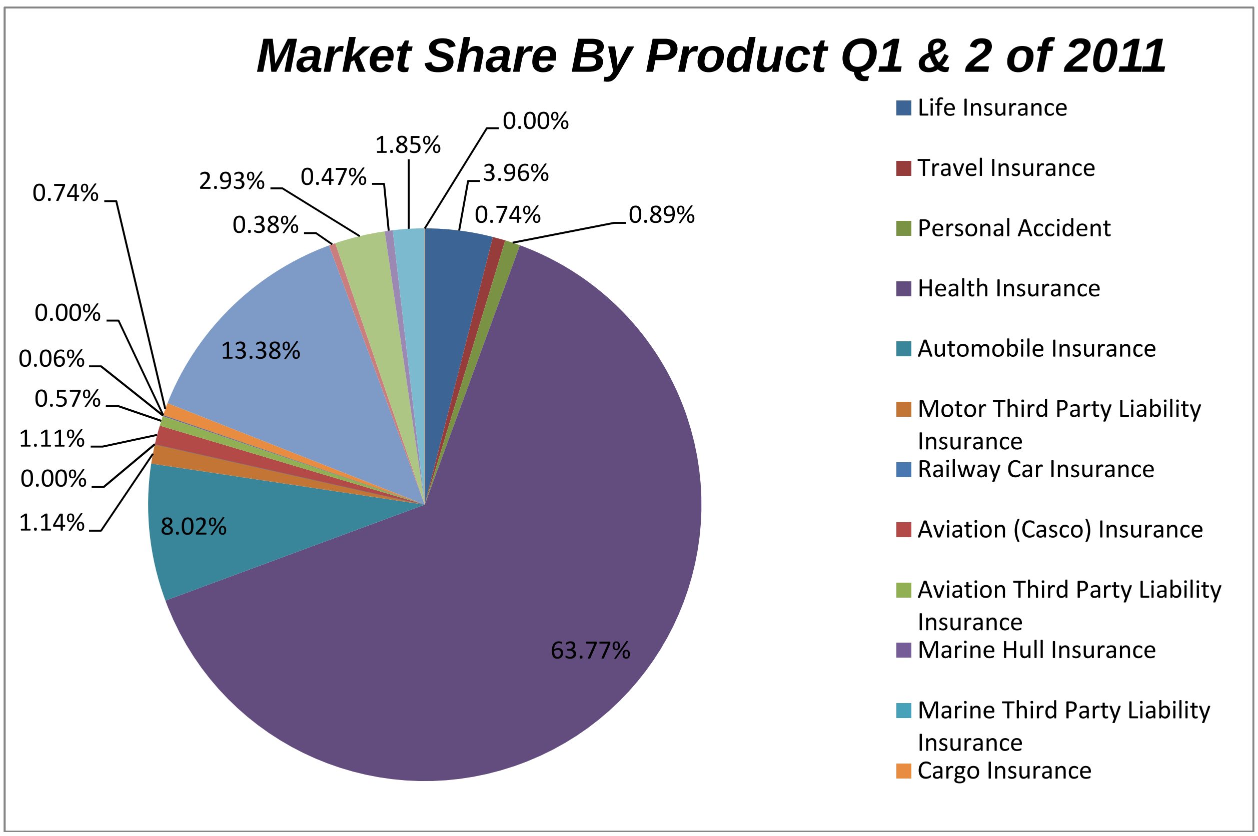
Table 11: Insurance: Written Premium by Line of Business 1998 – 2010

Thousand GEL	1998	1999	2000	2001	2002	2003	2004
Motor (incl. MTPL & MA)	4263	5376	5062	4515	5113	7058	9082
Marine & Aviation	53	0	31	3	466	979	1320
Property	1530	4377	6522	8795	8522	12658	15852
Liability (GTPL & Professional)	302	385	576	1472	2623	4658	3516
Health (incl. Accident & Travel)	1567	2549	4120	7206	5305	7952	10300
Life & Pensions	732	472	512	1192	757	1391	1417
Financial Risks	0	231	240	562	678	1050	940
Cargo (incl. Carrier's Liability)	561	982	1027	1646	1842	2671	2680

Thousand GEL	2005	2006	2007	2008	2009	2010
Motor (incl. MTPL & MA)	10833	13176	19799	30700	32931	30653
Marine & Aviation	3207	2129	3957	4943	7207	8675
Property	18693	15752	20355	33068	29619	35148
Liability (GTPL & Professional)	5525	7719	6341	6284	6837	7258
Health (incl. Accident & Travel)	14159	17833	47709	165119	251569	251020
Life & Pensions	3119	4143	7792	12602	9550	10008
Financial Risks	2496	3417	10511	16012	20322	15555
Cargo (incl. Carrier's Liability)	3549	3423	3348	3285	2415	3073

**Source NBG & GIA*

Figure 10: Insurance: Market Share Line of Business Q1 & Q2 of 2011



**Source NBG*

Demand side:

Insurance penetration in Georgia is low, and as a result households and enterprises are exposed to major personal and business risks, hampering the social and economic development. Key aspects of the situation are:

- Georgian public and entrepreneurs are not sufficiently insurance minded:
  As in many other emerging markets and countries in transition there is a lack of "insurance culture:" business community and citizens are not sufficiently accustomed to insurance products and the function for insurance in market economies and in general. In addition the mixed experiences with the political and economic transformation period have focused the interests on short-term developments and decisions less on long term perspectives, for example in the field of red-age provision (via life insurance).

- There is a lack of positive experiences with classical insurance products:
  The traditional impetus for insurance market development in emerging economies via key mandatory insurance lines, especially MTPL insurance is not present.

- A key positive aspect on the demand side are the positive effects by health insurance programs:
  The demand for and the image of insurance is positively affected by the government health insurance programs, where the services of the involved insurance companies have promoted the image of insurance. But the penetration of these programs is limited up to now to the low-income segments of the population, targeted by the government programs. Concerning the business community, performance and payment guarantees within the framework of government procurement regulations for goods and services contributed to a better understanding of the role of insurance in a market economy.

Supply Side:

The majority of the policies sold by the insurance companies depend on government funds (health insurance) or government regulations (for example concerning the performance and payment guarantees). The present state of the supply side is as follows:

- A key problem is the weak retail business:
  The retail part of the development of the insurance market in Georgia has not seen growth rates comparable to the positive development of the state–funded health insurance business due to a lack of experience and the absence of retail oriented intermediaries, motivated and qualified in marketing of insurance services to the broad public.

- The second problem is the lack of qualified staff:
  The development of human resources is inadequate, especially due to insufficient professional and academic insurance and actuarial educational facilities and teachers and academics. This is also valid for the training of qualified intermediaries. This lack will

impede the implementation of new obligatory or voluntary products, for example after implementation of a mandatory MTPL scheme or for a broader approach for health insurance, including especially middle-income families.

- The third critical point is a lack of information, especially for the development of reliable tariffs and products:
  The insurance companies are missing comprehensive and reliable information, especially statistical data necessary for appropriate assessment of risks and for the development of realistic tariffs.

- The fourth problem is the general level of economic and social development, manifested in a lack of sufficient purchasing power of the broader population:
  The low-income level of the population and the social and economic frictions are limiting the purchasing power of the individual citizens that are forced to direct their available income to basic needs like food and housing. This is intensified by erratic economic and political developments. This is a key obstacle for every medium and long term financial planning for private households and also for many companies in the middle market.

- One positive aspect, though, is the improved regulatory environment:
  The Supervisory Department of the BoG is a solid and in the market respected and accepted regulator with principally sufficient resources and authority to supervise the market with its present dimension. In addition the insurance association is remarkably effective and can help developing and promoting new products, information tools for statistics etc.

- The second positive aspect is the important experience of the insurance industry with the health insurance programs:
  This can serve as a basis to deal with new products and client groups.

- The third positive aspect is the existing basic product portfolio offered by insurance companies:
  Key types of insurance cover are offered by the insurance companies active in Georgia, especially property, liability, transport risks, legal protection, financial risk, health, transport (including Casko and voluntary MTPL) legal protection, financial risks, pension insurance.

Recommendations:

1. Support the introduction of a **mandatory motor-third party liability insurance system.** This is a vital insurance product of high social relevance and will be a decisive step for the necessary development of the retail market. Basic experiences have been gathered of the insurance industry and the companies are in quite well prepared. This should be done through:

a. Development of the necessary **legal and organizational framework** for a mandatory MTPL. The old law that has been cancelled is definitely no reasonable basis. But there has been developed a new draft by the insurance association, in cooperation with a German Motor insurance expert. This could be used by for a new law.

b. Development and implement appropriate **information systems for MTPL** including a reliable statistical database for the calculation of tariffs, exchange of information etc. This task could be taken over by the insurance association, as is the case in most developed or emerging insurance markets.

c. Development and implementation of an effective **bonus-malus (rewards-penalties) system**, using the information system. A bonus-malus system is a vital tool to educate drivers and to reduce the risks for potential victims of traffic accidents.

d. Promotion of a future membership of Georgia in the **Council of Bureaux** (Green Card System of the Economic Commission for Europe of the United Nations).

e. Setting upon a **motor bureau**, responsible for the coordination of MTPL and for claims payments to victims in cases where the driver could not identified or the driver was not insured, within the frame work of the insurance association.

Our interviews with leading representatives of Georgian insurance companies and other market participants have shown clearly that the market would be ready for such a step, after having collected sufficient experiences through the sale of voluntary MTPL in the last years. For the preparation and implementation of a mandatory MTPL the assessment team recommends a working group composed by representatives of all involved parties, (especially GIA, the insurance companies, National Bank of Georgia, Ministry of the Interior, traffic police) to save guard it`s move and coordinated implementation including a system that guarantees a sufficient high penetration rate for MTPL.

A positive example in the implementation of mandatory MTPL is the recent experience in Armenia, where the law was approved in 2009 by the Parliament and came into force on January 1st, 2011.

2. **Improve public understanding of insurance and promote general awareness of advantages and benefits of insurance coverage**. This is a key precondition for a stable development of their insurance market, having in mind the quite critical perception of insurance. Trust is the foundation of the development of insurance in all markets, but especially in emerging markets with bad experiences with promises of financial services providers. This should be done through:

    a. In cooperation with GoG, NBG, GIA, media, CSOs and educational institutions support the setup of an **"insurance information institution"** that promotes better understanding of insurance, using experience from established markets.

b. Support the developing and implementing of a **common information/education campaign** focusing on the recommended implementation of a mandatory MTPL and a widened health insurance cover by the involved institutions (GoG, GIA/insurers, CSOs etc.) There are various national organizations (insurers' associations, the Insurance Information Institute etc.) in the USA and the European Union as well as international organizations (for example OECD) that are promoting and have developed approaches, methodologies and other tools to improve public understanding and acceptance of insurance. These experiences could either be used directly or could serve as benchmarks.

3. **Strengthen and broaden the penetration of health insurance coverage**. This would be – in addition to the "big bang" of the mandatory MTPL – an "evolutionary" development, but also very important by getting access to broader client groups. This should be done through the following steps:

   a. Transfer existing targeted governmental medical assistant programs for children and elderly into an **expanded health insurance coverage**.

   b. Introduce an **employment – based health insurance system** for government employees and develop mandatory standards for special groups like students.

   c. Support the development and broad introduction by the industry of an **affordable basic benefit package**.

   d. After having assessed the impact of steps a) to c) on market penetration, quality of cover and insurance services consider the introduction of an **employment-based mandatory health insurance system**.

   The assessment team's interviews with leading company representatives and other market experts have shown that the market would be ready for such a step. Such a transfer would simplify the organization of the present complicated medical assistance programs, harmonize the involvement of the state in the health sector and would lead only to a limited raise of the allocated costs for the targeted services.

   This step would help lay the groundwork for a further penetration of voluntary health insurance coverage into middle class families. It would do so by motivating households, whose kids and elderly relatives would be covered by government insurance programs, to buy insurance or the rest of the family on their own account. The support to the insurance industry to develop affordable retail products, acquisition strategies and qualified human resources will be of crucial importance.

The proposed "organic growth" for the medical insurance sector should be coordinated with the medical services suppliers to avoid market distortions and unnecessary rises of costs for medical service.

4. Support the further **development of the regulatory system. This must be implemented in line with the above-mentioned activities, enabling the BoG to cope with the new additional responsibilities,** through:

    a. The introduction of an appropriate **capital adequacy approach** (Solvency I) by the National Bank of Georgia; and

    b. By the allocation of **sufficient financial and human resources to the supervisory department of the National Bank of Georgia** for the proper implementation and supervision of the recommended types of insurance, especially the mandatory MTPL.

The recommended expansion and development of the insurance sector and a new pension system would depend heavily for their success on a suitably reinforced regulatory framework. In the long run, the recommended strengthening of the insurance sector could only become a success if insurance companies avoid gross misbehavior such as anti-trust violations, and thereby maintain the confidence of the public.

The German supervisory authority, BaFin, has informed the assessment team that they would be ready to assist NBG in developing the necessary regulatory approach for MTPL. In addition, experts from the Council of Bureaux would also be ready to advise Georgia concerning a possible future membership.

5. **Strengthen consumer protection**. This is the next necessary step and precondition – together with the proposed insurance awareness program – and it should be implemented through the following steps:

    a. Support the introduction and operation of independent and reliable **consumer service mechanisms** including effective alternative dispute settlement systems for the entire insurance sector (or maybe alternatively for the financial sector as such) for example in the form of an Ombudsman/Mediator; and

    b. Develop **qualification standards and registration requirements** for tied insurance agents and intermediaries (in addition to the exiting registration requirement for brokers).

Especially after implementation of these recommendations that will lead to a much broader insurance coverage than at present, it will be necessary to ensure that problems between insurers and clients can be solved easily without addressing the courts. An effective instrument is a reliable insurance Ombudsman/Mediator as a respected institution whose decisions should not be influenced by political or economic considerations.

It is important to avoid gross "mis-selling" of insurance products to private clients as much as possible through the proper qualification of all insurance intermediaries. They should be trained not only about the content of the insurance cover of the products they are going to sell, but also about the requirements concerning a fair treatment of clients and should be committed to the principle of proper advice.

6. Assist the development of a **training program for insurance company sales staff** and insurance intermediaries in close cooperation with GIA and in coordination with the insurance supervision.

    a. Develop a **standard curriculum** for sales of staff and for intermediaries for the retails operation;

    b. Develop **training materials** for the various curricula; and

    c. Organize a **train-the-trainers program.**

IX. AGRICULTURAL INSURANCE

Agricultural insurance plays a vital role by stabilizing the income of the rural population living from farming. In the long run, it can improve the income level and living standards of rural Georgians.

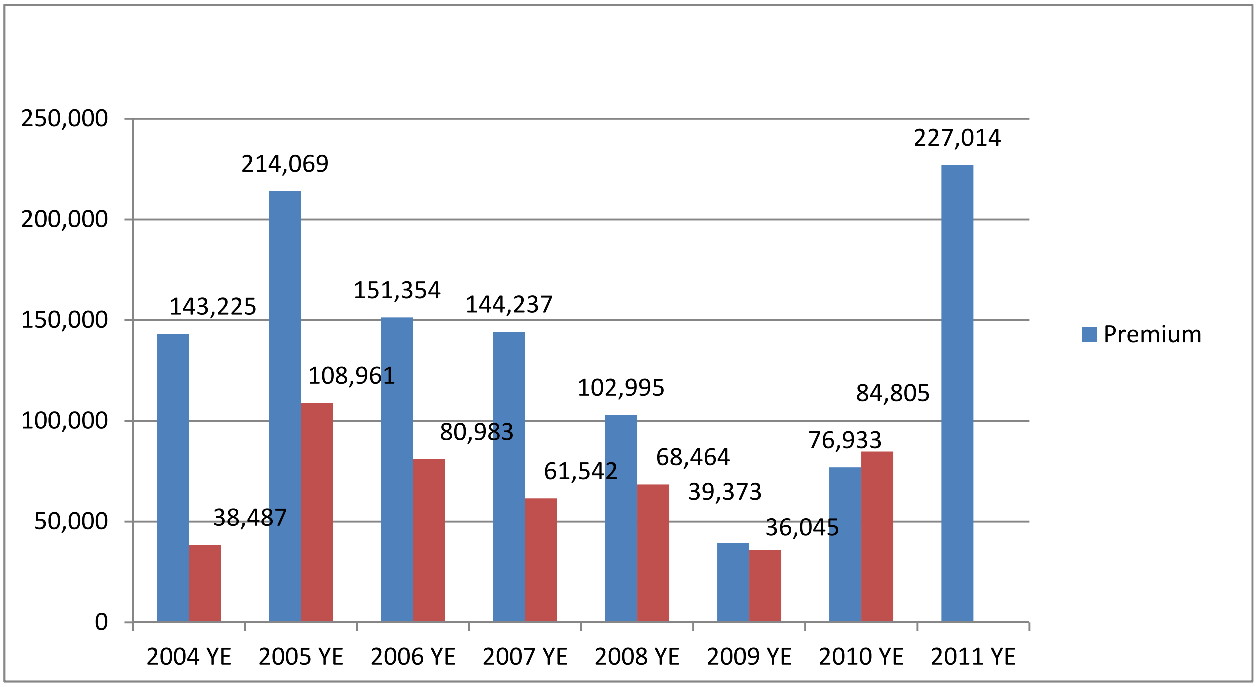
There is a wide range of as-yet uninsured risks that could be covered by insurance. For example, draught can cause substantial losses of income and can subsequently lead to reduced consumptions and finally to a drop of the overall GDP. Especially in the poorer regions of Georgia, the lack of insurance coverage against “external shocks,” like flood and draught, is a cause for persistent poverty. Families often cannot recover from these losses. Especially for subsistence and low-income farmers, the external risks are unmanageable without assistance. In addition, insurance cover is an important precondition for access to credit or to other important tools, for example to standardized seeds, delivered by government authorities or donor organizations.

Agricultural insurance is in addition a specialized type of insurance that is linked – as the whole agricultural sector – to various political, social and economic strategies. As a consequence, agricultural insurance is not market driven, but depends in nearly all countries on political decisions. One of the key reasons is, that the general high volatility in agricultural production and the fact that the external risks for agricultural insurance (flood, draught, hail etc.) are unmanageable. This fact has as a consequence – unusually high-risk premiums for insurance cover. These costs are too high at least for small farmers and there are no purely market-driven solutions for an effective risk transfer available. Consequently, government institutions must step in. This is a common problem in developed and emerging markets, but in Georgia it has a specific historical background. In the time of the Soviet Union, there was a comprehensive mandatory agricultural insurance system, but this has “faded out” and it is now extremely difficult to revive the old experiences with new concepts for coverage and especially new adequate prices.

Today in Georgia only three insurance companies are working to develop agro insurance professionally. The insurance penetration is extremely low.

Figure 11: Agro Insurance: Insurance Premiums and Claims Paid (in GEL)

2004 – 2011



To develop and implement sustainable and affordable agricultural insurance concepts is an elusive goal anywhere in the world. It depends largely on successful development of an integrated approach, coordinating a variety of stakeholders, from government institutions, direct-insurers and re-insurers, banks, large-scale farmers and their organizations like cooperatives to wholesalers, the food industry, exporters etc. In this context assistance should focus on products/crops with relevance for the agricultural sector in Georgia and should at any case include products/crops, which are also in the focus of activities of the GoG, other donors and private stakeholders. It is important to facilitate the participation of other stakeholders, especially in the financial sector, by having in mind their specific services and interests. This is decisive for the success of every planned activity in this sector, to develop synergies. International experience shows, that an effective agricultural insurance system can be developed without subsidies from the national governments or international organizations or donors.

Further, all initiatives in the agricultural sector should have a well-designed informational and educational component. The general "acceptance" problems for insurance and financial services in general are especially important outside the cities and require special attention. Explaining and training are critical success factors and need a sufficient time perspective. The following findings and recommendations are a summary of the assessment team's analysis and should be implemented in close coordination with other USAID initiatives in the agricultural sector and projects of other donors.

Demand side:

There is at present a weak demand for agricultural insurance due especially to the following problems:

- The key problem is that the agricultural sector is dominated by "subsistence farmers" without business plans, risk management, access to finance etc:
  (See the Section V. Agricultural Lending, above.)

- Consequently, the awareness of potential advantages from buying agricultural insurance cover is insufficient.

- And there is a lack of sufficient government-provided technical, financial or educational assistance.

- Finally, the unstable economic and financial situation of farmers and other business in the agricultural sector (for example wine producers) prevents most farmers from buying insurance cover.

Supply side:

The supply side is very limited, only a few insurance companies are offering agricultural insurance products, especially due to the following reasons:

- The present key problem is the lack of demand for agricultural insurance due to the above mentioned constrains for the agricultural sector. This is a decisive obstacle for insurers to invest in new concepts for cover.

- The second problem is the lack of reliable data on crop, meteorological data etc. This is an extremely important for insurers to develop realistic tariffs and concepts for insurance cover.

- The third problem is the lack of qualified staff for the special requirements in the field of agricultural insurance.

- In addition, and in absence of the above-mentioned requirements, the Georgian insurers have problems securing sufficient and reliable re-insurance cover for agricultural risks.

Recommendations:

1. Support the development of **agro-insurance** through an integrated approach, focusing on the **key problems by:**

a) Supporting the **professional qualification of staff members of insurance companies** in agricultural loss adjustment and related fields, to prepare the companies better for these specific market conditions;

b) Providing **educational assistance to the farmers** on the advantages of agricultural insurance;

c) Supporting the market in **developing and collecting reliable data** for affordable and diverse agro-insurance products; and

d) Promoting and supporting financially and with technical assistance, various **subsidized pilot schemes for agro-insurance** to create convincing examples and sufficient experiences of the mutual advantages of a closer cooperation among insurance companies and credit institutions, resulting in tangible benefits for the traditionally conservative farming communities. This is, as experiences in emerging and developing markets have proven, the only way to strengthen the agricultural sector by taking over risks, unmanageable by the farmers, and by improving the vital cooperation of the stakeholders in a coordinated approach with a realistic time horizon.

The assessment team strongly recommends optimizing the cooperation between the involved parties and the responsible state institutions to assure effective coordination. Such close coordination is vital to address effectively the complex independencies of actors and framework conditions especially in this sector.

X. CONCLUSIONS:

The following is a brief synopsis of the strengths and weaknesses of the main sub-sectors, and, where appropriate, recommendations for potential donor cooperation in these areas:

Banking: The strength of the Georgian banking system is its competitive nature with at least five of the 19 commercial banks of sufficient size to offer the public a variety of services at reasonable market rates. The banks are well regulated by the National Bank, and in some cases have established branch networks throughout the country. They appear to be effectively run by competent senior managements, and boards of directors, and are operating on consistently profitable basis.

The weakness of the banking system is the present failure to address the financial needs of middle market enterprises (MME's) where there is substantial opportunity for the exponential expansion of banking business. The absence of long-term financing vehicles through the banking system has inhibited the economic growth of these enterprises. This is an area that, in time, undoubtedly will be addressed and corrected as increased competition stimulates the introduction of new and innovative lending programs.

Aside from possibly providing assistance through counseling programs to potential MME borrowers in understanding the banks' lending policies, procedures, and requirements, there do not appear to be high priority projects for USAID or other donors in the commercial banking area.

Capital Markets: This is the primary sub-sector of the non-bank financing segment of the Georgian financial system, and is the weakest portion of that system. The stock exchange is operating at minimal capacity. There is a lack of central depository and registrar consolidation causing confusion and delays. The existing brokerage houses, aside from the four bank-related houses, have not developed substantial business volumes, and are handicapped by existing inhibiting regulatory restrictions; and the absence of imaginative and aggressive venture capital firms has stunted the growth of enterprise start up operations.

USAID can provide meaningful assistance in strengthening the capital markets by undertaking an effective review of the government's present rules and regulations of the stock exchange, securities dealings, description and authorization by the National Bank of brokerage/investment house operational mandates, including trading of treasury bills, spot and forward foreign exchange activities, issuance of corporate debt instruments and initial public offerings, and full gamut of venture capital activities. Continuing efforts should be made to encourage the government to revise these rules and regulations to provide an open and competitive securities industry. These are high priority projects that would build on the assistance that the USAID provided in 2001 in establishing a functional stock exchange through the aegis of KPMG.

Leasing: The strength of the leasing sub-sector is in the potential for this alternative sourcing of financing to all segments of economic activity both commercial and agricultural that would not require the pledge of the lessee's real or moveable assets as collateral. The weakness is the anemic growth of the leasing industry (less than 0.2% of GDP), and the absence of active participants in the market. This is the result of well-intended but onerous policies that were embodied in hostile and negative legal frameworks. This is considered to be a high-priority situation where donors such as USAID can play an important role in assisting the government in drafting more equitable legislation that would allow for the rapid expansion of the leasing industry to perform a much needed service resulting in continued economic growth. The new legislation could also encourage the development of lease securitization activity that not only would provide additional liquidity to lessors, but in addition avail both private and pension and insurance fund investors of another attractive capital market investment alternative.

Pension and Insurance: Both of these sub-sectors are experiencing evolutionary change and it is difficult to predict the extent to which the market is ready for the concepts that underpin these areas of economic activity. From the donor perspective is would appear that substantial assistance could be provided in the areas of insurance awareness for the Georgian population, and also in the agricultural finance area where some form of either public-private combination of insurance/guarantee program might facilitate increased agro financing by the commercial banks.

ANNEX A: List of Interviews

Banking, Capital Markets

Bank of Georgia | Vasil Khodeli, *Director of Corporate Banking; Vazha Menabde, Head of SME Banking*

BG Capital | Irakli Kirtava, *General Director*; George Shengelia, *Associate*

Bank Constanta | George Gachava.*Chief Risk Officer*

Credo, MFI | Ljiljana Spasojevic, *Chief Executive Officer*; Zaza Pirtskhlava, *COO*

Georgian Stock Exchange George Loladza, *Chairman of the Supervisory Board*

Lenzie Fisher Hendry | Robert H. Singletary, *Principal*

Liberty Bank | George Paresishvili, *Director, Deputy CEO*

National Bank of Georgia | Otar Nadaraia, *Deputy Governor*

ProCredit Bank| Ketevan Khuskivadze, *Director*; Natia Mikautadze, *Head Compliance Department;* Tamar Ganugrava, *Small Loans Coordinator*

TBC Bank| Thea Lortkipanidze, *Deputy CEO*; Keti Kandelaki, *Senior Corporate Banker*

Insurance and Pensions

Association of Actuaries and Financial Analysts (AAFA) | Guram Mirzashvili, *Actuary;*Shorena Jadugishvili, *Actuary*

Bafin (German Financial Services Supervisory Authority)

Peter Baier, Head of Department International Cooperation

Curatio International Consulting | Davit Gzirishvili, *Health Insurance Specialist*

EBRD | Irakli Mekvabishvili, *Senior Banker*

Georgian Stock Exchange | George Loladze, *Chairman*

GIA |Irakli Kilasonia, *Head of Property Casualty*; Tamar Gotsadze, *Head of Health Insurance Division*; Revaz Sakevarishvili, *Pension Expert*

Helmut Mueller, former Insurance Supervision President and Insurance for IMF and EBRD

Insurance Company ALDAGI BCI| Nickoloz Gamkrelidze, *General Director*

Insurance Company GPI| Giorgi Kvirikadze,*General Director*; Irakli Dvali, *Head of Risk Management and Underwriting Department*

Insurance Company IC GROUP |Tengiz Mezurnishvili,*General Directo*; Nina Kiziria, *Head of Underwriting Department*

Insurance Company IMEDI l| Alexander Lordkipanidze, *General Director*; Daisy Kutateladze, *Head of Operation Department*

Insurance Company PARTNER| Vakhtang Dekanosidze, *General Director*

International Insurance CompanyIRAO|Paata Lomadze, *General Director*

National Bank of Georgia|Manana Tsitsishvili, *Head of the Department of Insurance*Supervision

World Bank|Nino Moroshkina, *Health Specialist*

ANNEX B: Charts and Graphs

Table N 1. Georgian Banking Sector

	2008	2009	2010	2011 (June)
Assets *(GEL)*	8,865,631,297	8,292,615,285	10,564,217,045	11,220,341,262
Assets/GDP *(%)*	46.48	46.11	50.81	49.98
Loans *(GEL)*	5,992,879,844	5,185,336,022	6,260,705,391	6,900,714,650
Loans/GDP *(%)*	31.42	28.83	30.11	30.74
Deposits *(GEL)*	3,567,816,319	3,950,143,224	5,487,588,028	5,775,423,435
Deposits/GDP *(%)*	18.70	21.96	26.39	25.73
GEL/USD Exchange rate	1.667	1.6858	1.7728	1.6665

Source: NBG

Table N 2. Georgian Banking Sector (Ratios, %)

	2008	2009	2010	2011 (June)
NBG Capital Adequacy Ratio	13.91	19.08	17.38	16.47
BIS Capital Adequacy Ratio	22.95	28.12	25.06	25.89
Equity to assets	17.11	18.29	16.92	16.36
Regulatory Capital/Total Liabilities	19.63	23.11	20.12	21.82
ROE	-12.64	-4.31	9.60	15.54
ROA	-2.61	-0.81	1.67	2.57
Profitability of assets	16.68	17.98	16.00	16.90
Cost of Funds	7.37	7.55	6.95	7.18
Interest spread	8.12	9.27	7.85	8.01
Interest margin	6.85	6.78	6.28	7.07
Average Liquidity ratio	28.27	39.08	38.67	38.96
Non-bank loans/Non-bank deposits	167.67	131.16	114.01	119.33
Total loans/non-bank deposits	167.97	131.27	114.09	119.48
Loans/Deposits (Total)	155.87	124.23	107.62	108.98
Liquid Assets /Total assets	20.88	24.38	25.30	26.04
Liquid Assets/Total Liabilities	25.19	29.84	30.46	31.14
Net loans/ Non-bank Deposits	152.61	114.44	103.31	109.35
Net loans /Deposits (Total)	141.89	108.41	97.53	99.88
Net Loans/Total deposits and equity	101.74	79.51	74.60	77.44
Net loans /Total liabilities	74.24	66.78	64.65	67.39
NPL amount (NBG) *(Thous. GEL)*	766,444	925,775	784,287	713,981
NPL - Ratio	12.79	17.85	12.53	10.35
Overdue loans 91 and more days/ Gross Loans	5.49	6.35	5.39	4.36
Loan Loss reserves (LLR) / Total loans	8.97	12.74	9.38	8.35

Source: NB

Table N 3. List of the Commercial Banks by the market share (August, 2011)

N	Name of The Bank	Market Share (%)							
		Assets	Loan Portfolio	Total Liabilities	Total Deposits	Non Banking Deposits	Deposits of Legal Entities	Deposits of Individuals	Shareholders' Equity
1	Bank of Georgia	34.78	35.53	34.75	33.60	33.75	36.77	30.54	34.93
2	TBC Bank	24.05	25.11	24.51	27.34	28.35	24.06	32.90	21.75
3	ProCredit Bank	7.29	8.23	7.55	7.08	7.80	4.17	11.65	5.96
4	Liberty Bank	6.13	4.32	6.68	8.86	9.32	12.02	6.46	3.36
5	Bank Republic	5.80	6.29	5.98	5.43	5.98	4.58	7.47	4.91
6	Cartu Bank	4.54	6.07	3.91	1.82	1.45	1.55	1.34	7.74
7	VTB Bank Georgia	3.20	3.55	3.10	2.59	2.71	2.97	2.42	3.73
8	Privat Bank	3.18	3.08	3.41	3.51	1.67	1.33	2.04	2.01
9	KOR Standard Bank	3.01	2.23	2.77	3.81	3.00	3.49	2.47	4.23
10	HSBC	2.46	1.18	2.52	2.15	2.36	4.50	0.10	2.14
11	Basis Bank	1.39	1.13	1.41	1.45	1.57	1.75	1.39	1.27
12	International Bank of Azerbaijan	1.12	0.73	1.12	1.27	1.18	1.89	0.42	1.08
13	Bank Constanta	1.05	1.30	1.08	0.18	0.14	0.03	0.26	0.94
14	BTA Georgia	0.96	0.85	0.82	0.45	0.42	0.47	0.36	1.68
15	HALYK Bank	0.37	0.16	0.19	0.17	0.09	0.16	0.02	1.27
16	Ziraat Bank	0.22	0.03	0.08	0.11	0.13	0.17	0.08	0.90
17	Investbank	0.20	0.05	0.11	0.16	0.07	0.07	0.07	0.66
18	Transcaucasian Development Bank	0.13	0.03	0.01	0.01	0.01	0.01	0.00	0.77
19	Progress Bank	0.12	0.14	0.01	0.01	0.01	0.01	0.01	0.68
	Total Banking Sector	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: NBG

Table N 4. Loans by Amounts (Thousands GEL, August, 2011)

Loan Amount	Number of Loans	% of Total Number	Amount of Loan	% of Total Amount
Up to 1 000 GEL	1,238,083	75.09	401,208	5.61
1 000 - 2 000 GEL	182,753	11.08	254,709	3.56
2 000 - 20 000 GEL	193,308	11.72	971,739	13.60
20 000 - 50 000 GEL	18,967	1.15	543,926	7.61
50 000 - 100 000 GEL	7,638	0.46	495,635	6.93
more than 100 000 GEL	8,010	0.49	4,479,816	62.68
Total	1,648,759	100.00	7,147,032	100.00

Source: NBG

Table N 5. Small and Medium Sized and Agro loans as they are classified by Commercial Banks (GEL, June, 2011)

	Small and Medium Loans	Shear in Total Portfolio (%)	Agro loans	Shear in Total Portfolio (%)
Bank of Georgia	271,696,612	19.6	28,775,130	27.6
TBC Bank	175,044,289	12.6	4,027,807	3.9
Bank Republic	156,565,050	11.3	8,895,544	8.5
ProCredit Bank	531,864,126	38.3	32,520,942	31.2
Cartu Bank	51,203,856	3.7	11,325,431	10.9
VTB Bank Georgia	49,822,171	3.6	8,864,970	8.5
Liberty Bank	249,156	0.0	1,015,755	1.0
KOR Standard Bank	92,386,230	6.7	3,550,064	3.4
Privat Bank	8,967,351	0.6	1,196,111	1.1
BTA Georgia	5,973,238	0.4	2,674,283	2.6
Basis Bank	29,234,152	2.1	1,074,423	1.0
HSBC	2,564,896	0.2		0.0
Bank Constanta	3,840,834	0.3	329,713	0.3
International Bank of Azerbaijan	215,573	0.0		0.0
HALYK Bank	4,104,792	0.3		0.0
Ziraat Bank	264,394	0.0		0.0
Transcaucasian Development Bank	910,413	0.1		0.0
Progress Bank	4,106,221	0.3	75,985	0.1
Investbank	9,178	0.0		0.0
Total	1,389,022,532	100.0	104,326,158	100.0

Note: There may be overlap between Small, Medium and Agro loans
Source: NBG

Table N 6. Loans by Maturity (thousands GEL, August, 2011)

Maturity of Loans	Number of Loans	% of Total Number	Amount of Loan	% of Total Amount
Up to 1 Momth	217,995	13.22	105,591	1.48
1-3 Months	165,748	10.05	165,468	2.32
3-6 Months	162,577	9.86	307,410	4.30
6-12 Months	711,068	43.13	1,092,288	15.28
more than 12Months	391,371	23.74	5,476,274	76.62
Total	1,648,759	100.00	7,147,032	100.00

Source: NBG

Table N 7. Loans by Interest Rate (August, 2011)

Annual Interest Rate	Number of Loans	% of Total Number	Amount of Loan (Thou GEL)	% of Total Amount
0%-5%	354,769	21.52	177,865	2.49
5%-10%	2,198	0.13	220,699	3.09
10%-15%	45,468	2.76	3,884,841	54.36
15%-20%	185,449	11.25	1,808,163	25.30
20%-25%	133,391	8.09	353,774	4.95
25%-30%	55,094	3.34	157,572	2.20
30%-35%	43,280	2.63	68,826	0.96
35%-40%	510,686	30.97	350,345	4.90
40%-45%	80,183	4.86	45,593	0.64
45%-50%	204,237	12.39	67,552	0.95
more than 50%	34,004	2.06	11,802	0.17
Total	1,648,759	100.00	7,147,032	100.00

Source: NBG

Table N 8. Branches and Service Centers of Commercial Banks in Georgia

(July, 2011)

Bank	Branches & Service Centres											
	Tbilisi	Ajara	Samegrelo-Zemo Svaneti	Guria	Imereti	Racha-Lechkhumi and Kvemo Svaneti	Shida Kartli	Mtskheta-Mtianeti	Kakheti	Kvemo Kartli	Samtskhe-Javakheti	Total in Georgia
Bank of Georgia	83	13	6	2	13		5	1	5	11	4	143
TBC Bank	30	3	3		3		1		2	1	1	44
ProCredit Bank	33	7	4	1	4		2		2	4	1	58
Liberty Bank	72	23	18	4	23	4	9	6	12	18	10	199
Bank Republic	23	3	3		4		3		2			38
Cartu Bank	4	1			2		1		1			9
VTB Bank Georgia	5	1	1	1	1		1		1	2		13
Privat Bank	38	10	5	3	8		5		5	5	4	83
KOR Standard Bank	15	1	1		1		1		2	1		22
HSBC	1											1
Basis Bank	14	2							1			17
International Bank of Azerbaijan												0
Bank Constanta	7	1	1		3		3		3	2	3	23
BTA Georgia	6	1	1									8
HALYK Bank	1											1
Ziraat Bank												0
Investbank	1											1
Transcaucasian Development Bank												0
Progress Bank	1											1
Total Banking Sector	334	66	43	11	62	4	31	7	36	44	23	661

Source: NBG

Table N 9. Georgian Stock Market Statistics

	2006	2007	2008	2009	2010
Number of Trades at GSE	5,538	6,908	2,321	1,304	2,372
Average Number of Trades Per Month	462	576	193	109	198
Average Number of Trades Per Trading Session	57	51	16	9	16
Securities Traded at Georgian Stock Exchange (GSE) *(number of shares, millions)*	17	14.6	12.5	12.7	41.6
Average Securities Traded Per Month	1,430,114	1,218,319	1,040,072	1,055,663	3,470,106
Average Trade Size	3,099	2,116	5,377	9,714	17,555
Trading Volume at GSE *(GEL millions)*	61.7	38.4	10.6	3.1	5.1
Year-on-Year change *(%)*	-1	-37.8	-72.4	-70.7	64.5
Average Trading Volume Per Month	5,166,667	3,197,841	882,021	259,381	426,480
Average Trade Size	11,195	5,555	4,560	2,387	2,158
GSE Total Market Capitalisation *(GEL millions)*	1,145	2,332	546	1,236	1,879
Year-on-Year Change *(%)*	80.1	103.6	-76.6	126.4	52.1
GSE Total Market Cap/GDP *(%)*	8.3	13.7	2.9	6.9	9.2
GSE Total Market Cap *(%)* without Bank of Georgia's GDRs listed on the LSE	5.7	8.6	2.1	4.8	4.4
Number of Trading Sessions	98	136	147	148	149
Stocks Traded on the GSE	90	57	82	64	53
Year-on-Year Change *(%)*	-	-36.7	43.9	-22	-17.2
Trading Volume on the OTC Market *(GEL millions)*	113.4	126.8	246	95.3	96.1
Year-on-Year change *(%)*	-	11.8	94	-61.3	0.8
Average Trading Volume Per Month	9,451,642	10,567,340	20,498,232	7,342,325	8,004,325
Securities Traded on the OTC Market *(number of shares, millions)*	51.3	75.8	70.7	2,955.00	1,663.90
Year-on-Year change *(%)*	-	47.9	-6.8	4,081.40	-43.7
Average Securities Traded Per Month	4,271,712	6,315,964	5,889,086	246,246,090	138,661,315

**Source: NBG*

Pension: List of Licensed Pension Companies

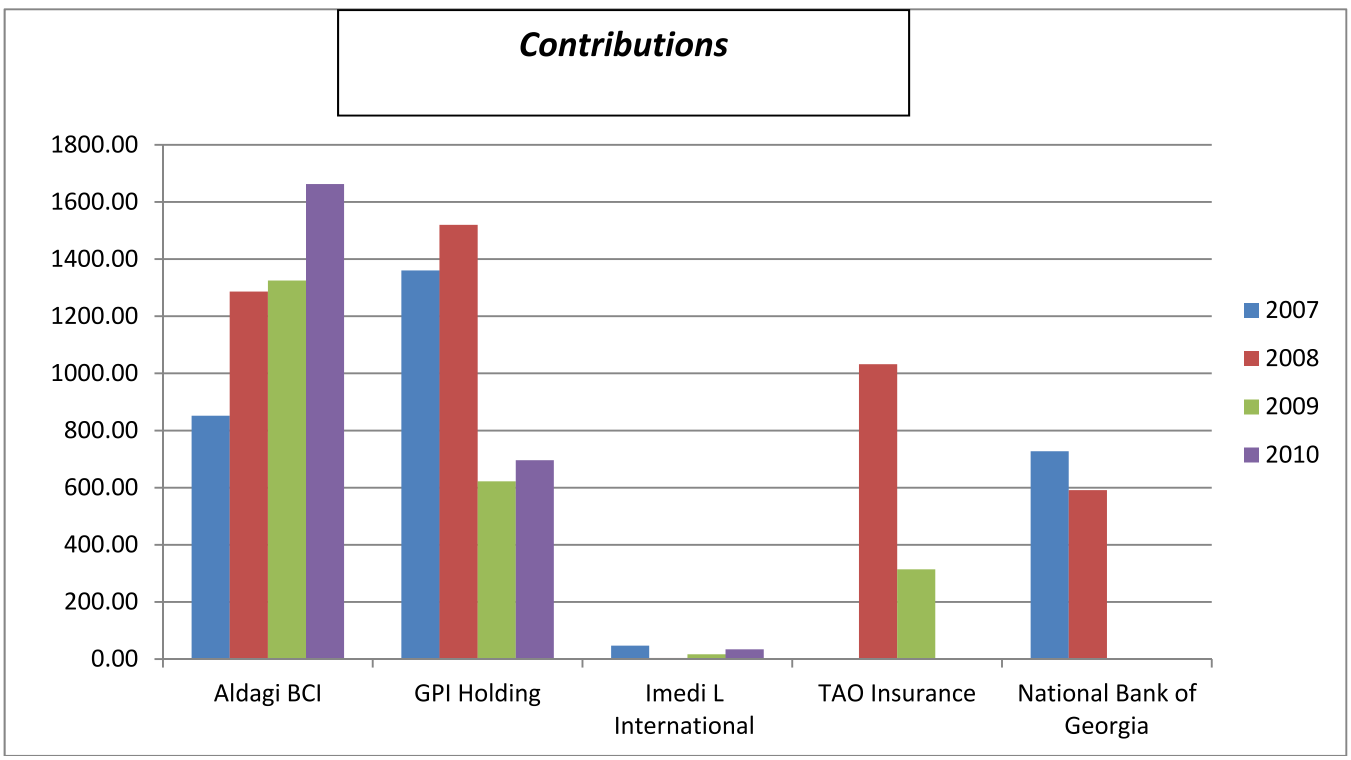
1	JSC Insurance company “Aldagi BCI”
2	JSC International Insurance Company "Imedi-L International"
3	JSC "Insurance Company GPI Holding"
4	LTD International Insurance Company “Irao”
5	LTD Insurance Company “Tao”
6	LTD Insurance Company “Partner”
7	LTD “Insurance Company Alpha”
	**Source NBG and GIA*

Pensions: Development 2007 – 2010

(Ml GEL)	2007	2008	2009	2010
Contributions during the Period	2.9 GEL	4.4 GEL	2.3 GEL	2.4 GEL
Valid policies by Dec 31st	10486	10354	9479	11664
Number of Participants	14263	15602	14175	16879
Number of Participants Receiving Pension	55	54	0	0
Withdrawals	0	0	1.5 GEL	1.2 GEL
Reserves by Dec 31st	3.4 GEL	6.7 GEL	6.3 GEL	7.9 GEL
Investment Income	0.45 GEL	-0.28 GEL	1.99 GEL	0.77 GEL

**Source NBG*

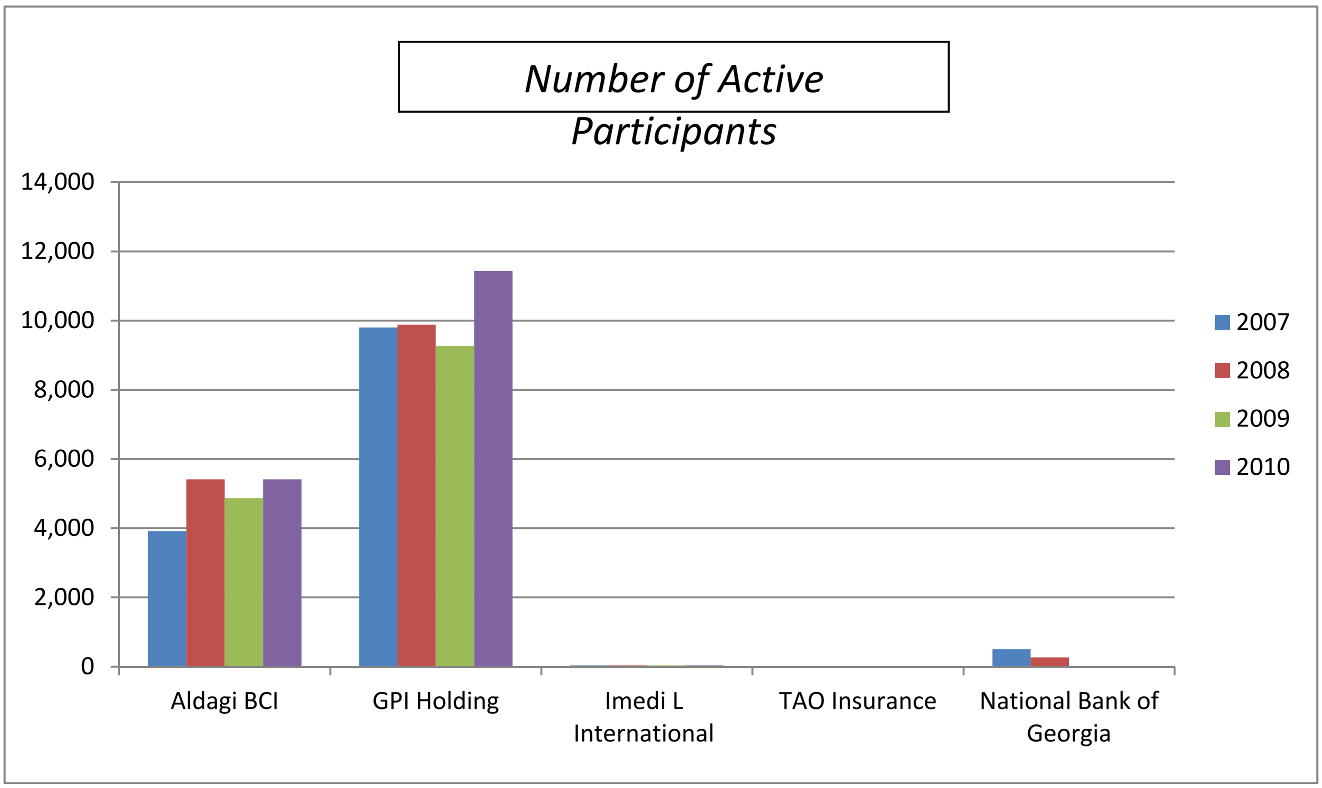
Pensions: Development 2007 – 2010



Contributions During The Period (Thousand GEL)	2007	2008	2009	2010
Aldagi BCI	851.97	1286.62	1324.88	1662.57
GPI Holding	1360.31	1519.77	622.08	696.32
Imedi L International	46.75	3.90	16.66	34.40
TAO Insurance	0.00	1032.37	314.27	0.00
National Bank of Georgia	727.61	591.20	0.00	0.00

**Source NBG*

Pensions: Development 2007 - 2010



Number of Active Participants	2007	2008	2009	2010
Aldagi BCI	3,916	5,413	4,869	5,412
GPI Holding	9,799	9,884	9,268	11,429
Imedi L International	38	38	38	38
TAO Insurance		0	0	0
National Bank of Georgia	510	267	0	0

**Source NBG*

Insurance: List of Licensed Insurance Companies

(October 2011)

1. Insurance Company ALDAGI-BCI
2. International Insurance Company IMEDI-L
3. Insurance Company GPI HOLDING
4. Insurance Company CARTU
5. International Insurance Company IRAO
6. Insurance Company Chartis Europe SA (Georgia Branch)
7. Insurance Company IC GROUP
8. Insurance Company TAO
9. Insurance Company PARTNER
10. STANDARD INSURANCE GEORGIA
11. Medical Insurance Group ARCHIMEDES GLOBAL GEORGIA
12. Insurance Company ALFA
13. Insurance Company ARDI GROUP
14. PSP INSURANCE
15. Insurance Company UNISON

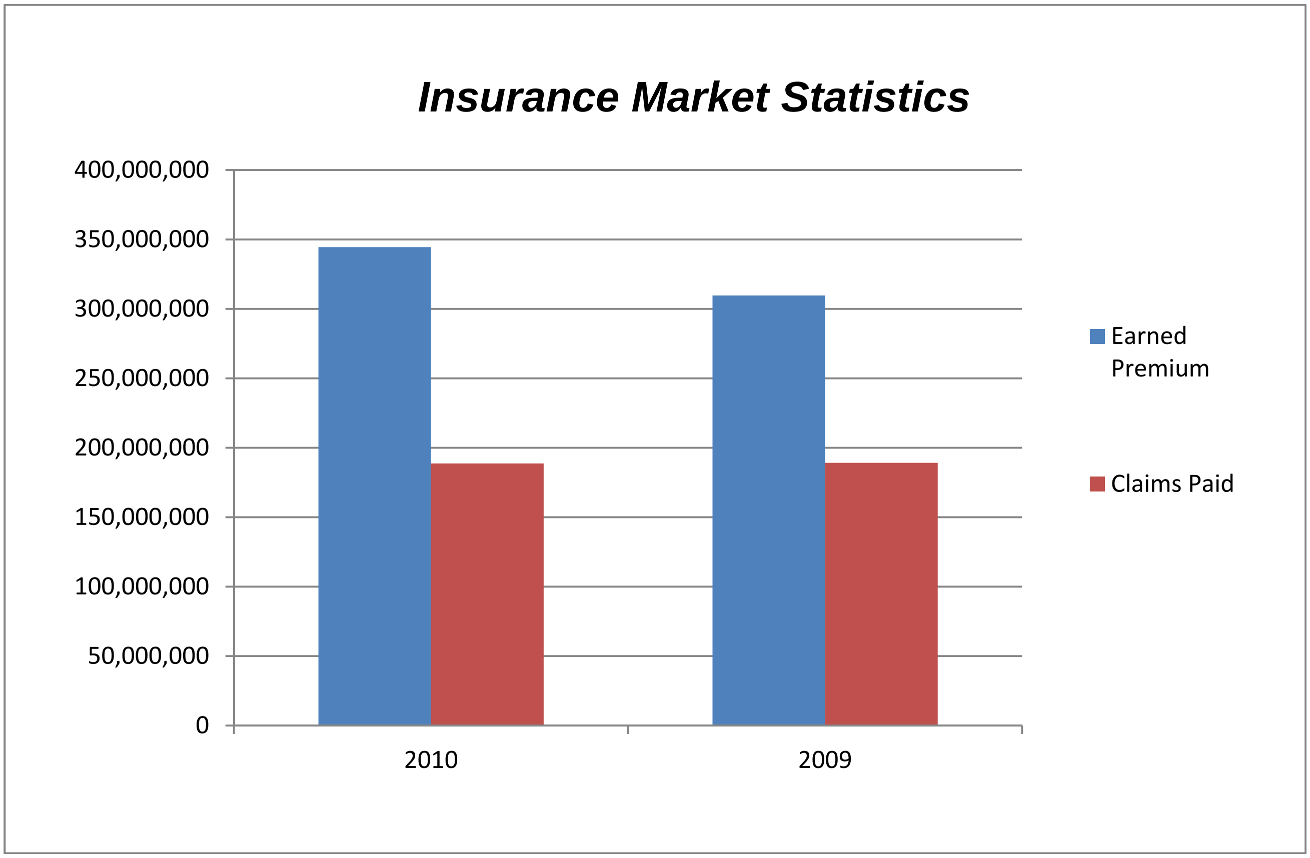
**Source NBG*

Insurance: Gross Written Premium 1998 – 2010

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross Premium (Mn GEL)	9.01	14.37	18.09	25.39	25.31	38.42	45.11	61.58	67.59	119.81	272.01	360.45	361.39

**Source: NBG & GIA*

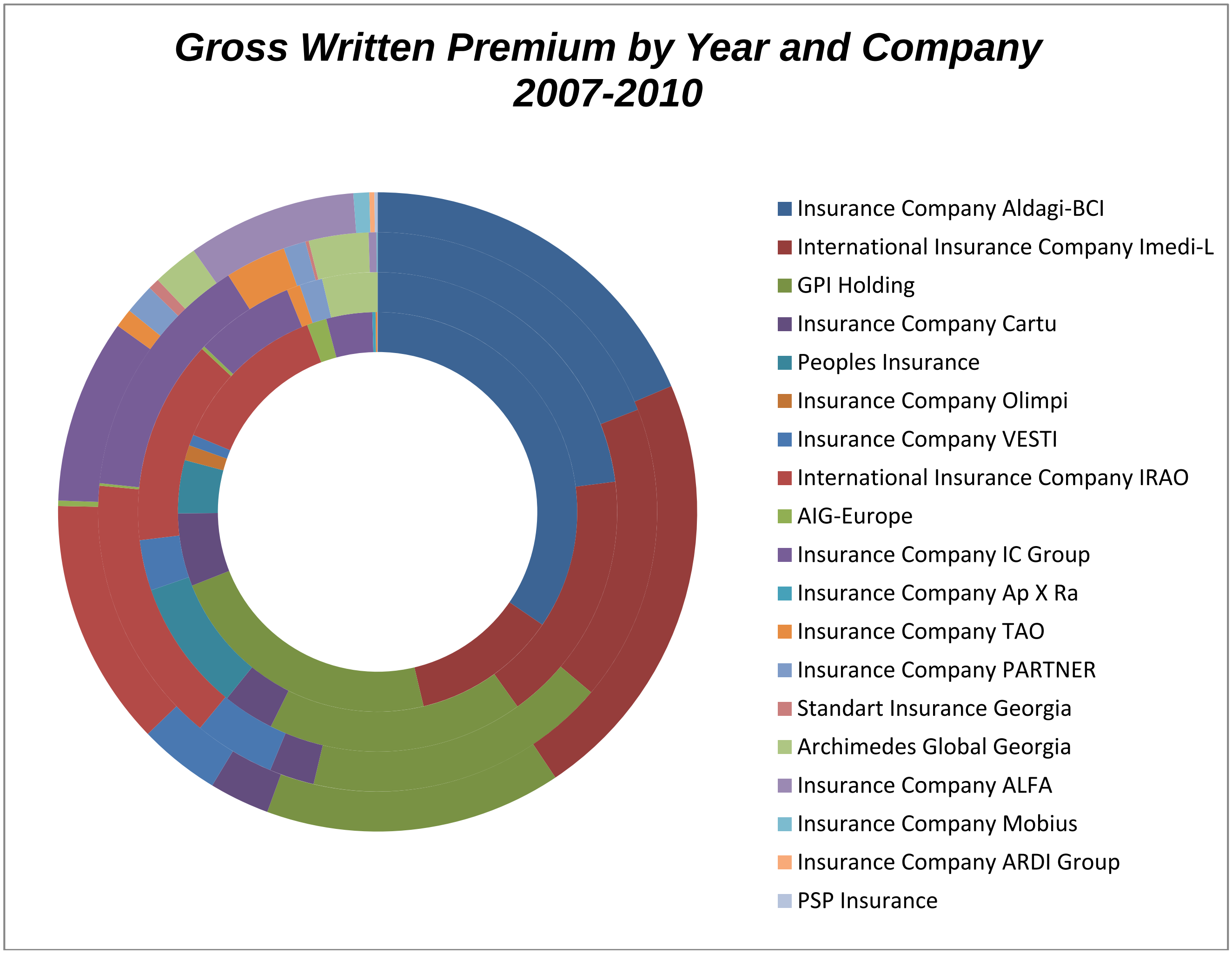
Insurance: Earned Premium and Claims Paid 2009 – 2010



(mln GEL)	2010	2009
Earned Premium	344.5	309.7
Claims Paid	188.7	189.2

**Source NBG*

Insurance: Gross Written Premium Breakdown 2007 – 2010

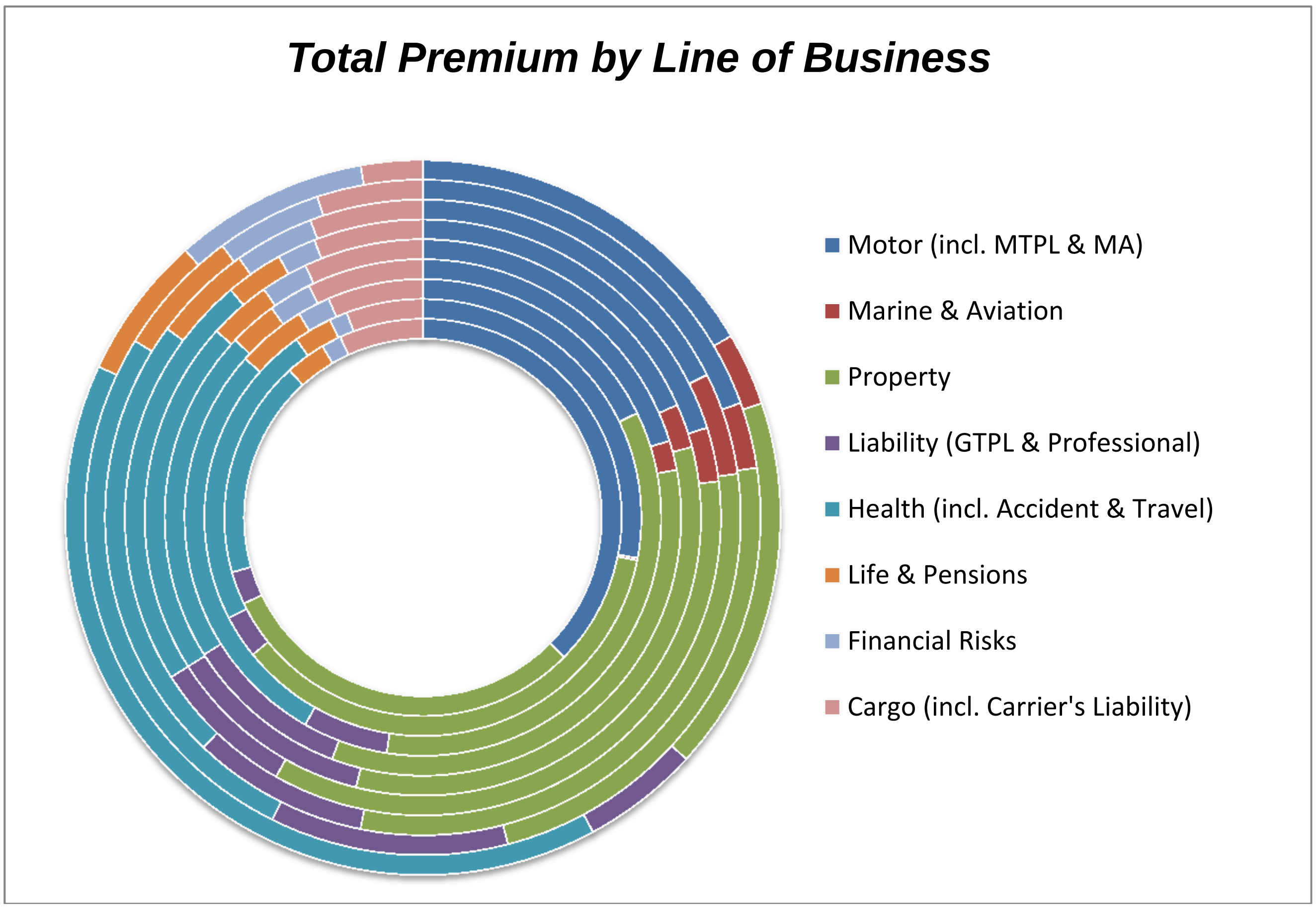


(Mln GEL)	2007	2008	2009	2010
Aldagi-BCI	40.99	62.54	68.64	67.08
Imedi -L	13.93	46.47	61.72	79.69
GPI Holding	26.91	47.00	63.12	54.24
Insurance Company Cartu	7.00	9.43	9.36	11.01
People's Insurance	5.10	24.16	0.00	0.00
Insurance Company Olimpi	1.45	0.00	0.00	0.00
Insurance Company Vesti	1.06	9.29	16.86	14.87
Irao	15.38	37.50	56.02	45.23
AIG-Europe	1.89	0.60	0.53	1.01
IG Group	4.41	18.25	51.89	33.68

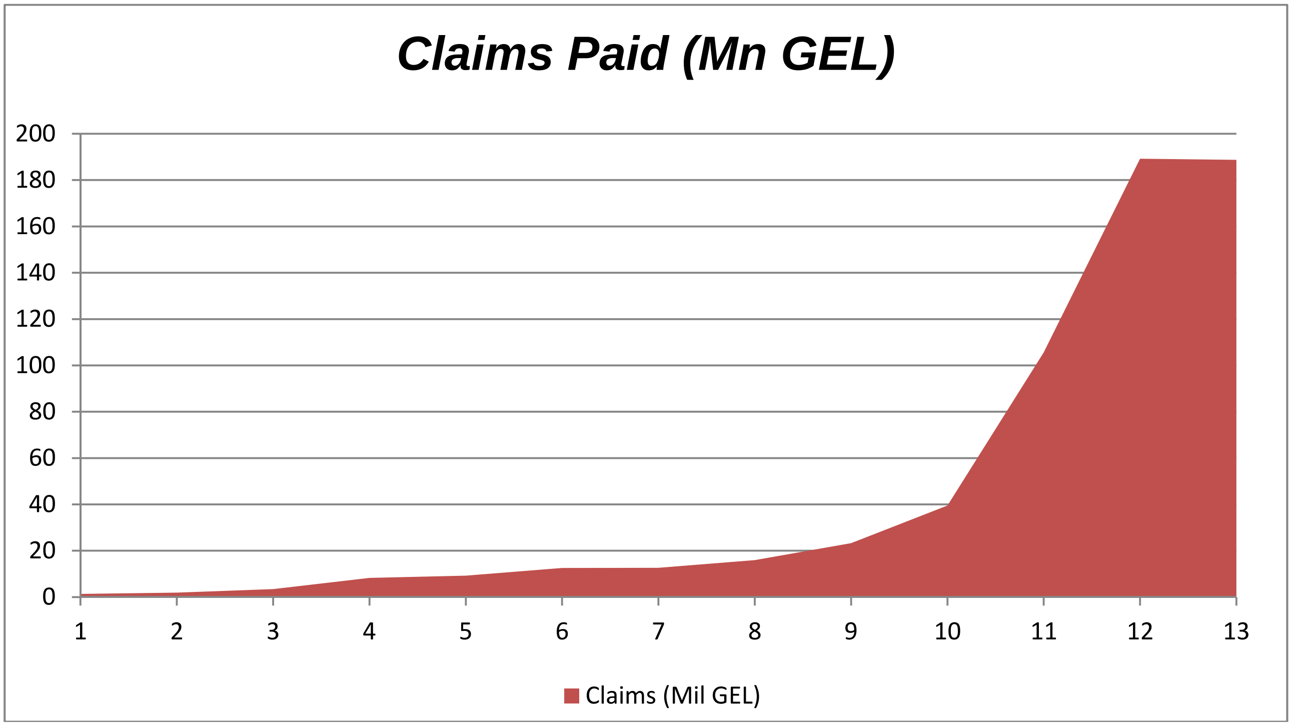
Insurance Company Ap X Ra	0.31	0.00	0.00	0.00
Tao Insurance	0.16	2.44	12.68	3.44
Partner Insurance	0.03	4.20	4.65	5.49
Standard Insurance	0.00	0.00	0.69	2.06
Archimedes Global Georgia	0.00	10.15	12.43	8.33
Insurance Company Alfa	0.00	0.00	1.63	30.92
Insurance Company Mobius	0.00	0.00	0.23	2.90
Ardi Group	0.00	0.00	0.00	0.91
PSP Health Insurance	0.00	0.00	0.00	0.58

**Source NBG*

Insurance: Total Premium by Line of Business 1998 – 2010



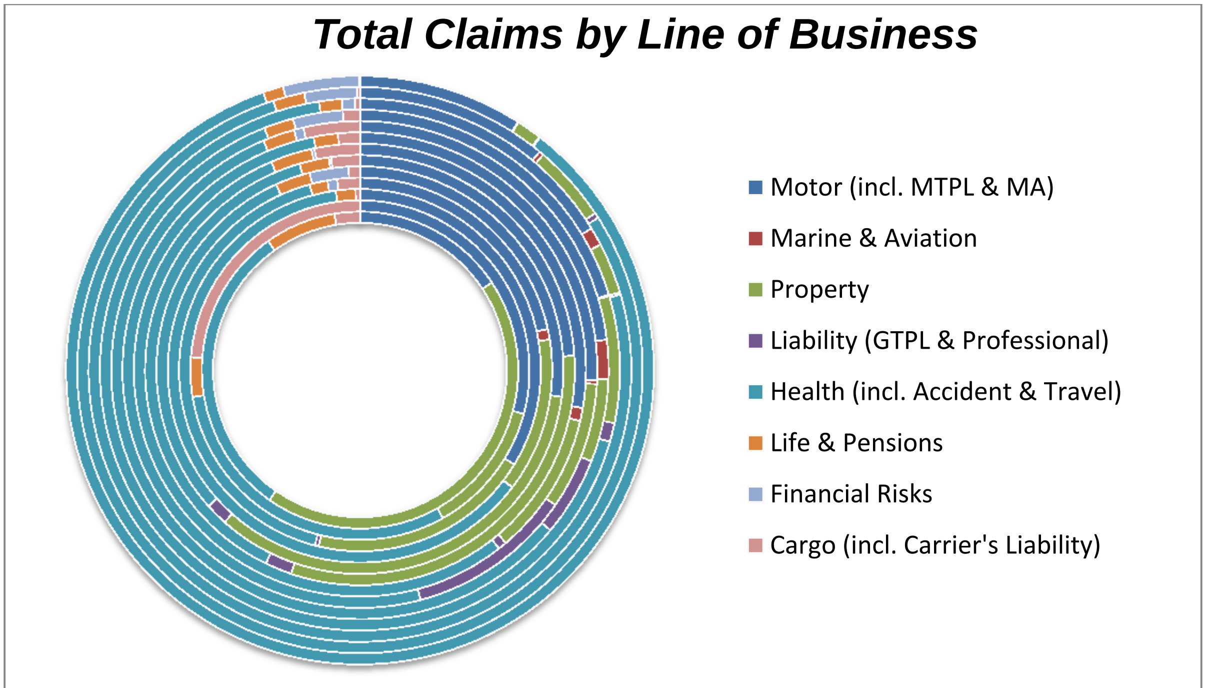
Insurance: Total Claims Paid 1998 – 2010



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Claims (Mn GEL)	1.34	1.88	3.44	8.27	9.23	12.54	12.63	15.95	23.28	39.52	105.61	189.21	188.76

**Source NBG and GIA*

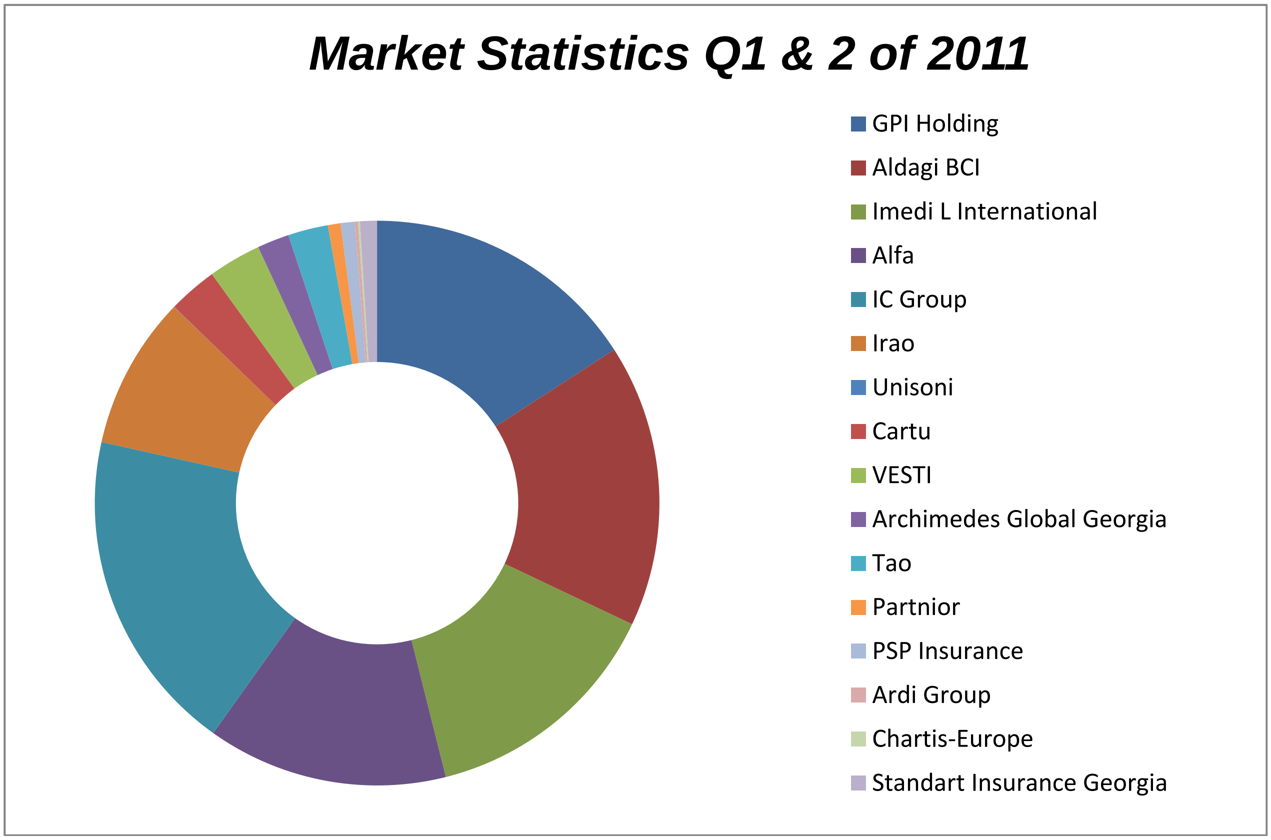
Insurance: Total Claims Paid By Type 1998 – 2010



Total Loss by Line of Business (Thousand GEL)	1,998	1,999	2,000	2,001	2,002	2,003	2,004
Motor (incl. MTPL & MA)	209.9	548.8	1159.2	1783.9	2502.3	2999.7	3496.4
Marine & Aviation	0	0	0	72.5	0	0.9	117
Property	588.2	239.3	686.1	1072.3	3184.2	3918.9	1293
Liability (GTPL & Professional)	0	0	11.7	2.5	164.6	253.8	77.4
Health (incl. Accident & Travel)	407.2	575.6	1507.2	4988.5	2758	4793.3	6836.6
Life & Pensions	97.3	70.8	60	125.1	255.9	277.6	373.2
Financial Risks	0	0	0	66.7	286.5	21.7	27.8
Cargo (incl. Carrier's Liability)	34.6	447.7	13.8	157.8	82.5	270.7	409.5
Total Loss by Line of Business (Thousand GEL)	2005	2006	2007	2008	2009	2010	
Motor (incl. MTPL & MA)	4099.7	5366.3	8031.79	17183.73	20751.51	17055.93	
Marine & Aviation	39.5	592.6	33.26	1146.69	493.72	79.1	
Property	1381.5	1249.3	3108.95	3191.55	8354.292	2584.67	
Liability (GTPL & Professional)	1800.4	1200.9	460.94	132.812	578.272	94.55	
Health (incl. Accident & Travel)	8129.9	13396.2	25514.28	81402.1	149630.4	158869.93	
Life & Pensions	263.8	483	730.67	1435.48	3404.99	2090.46	
Financial Risks	0	142.4	1220.63	796.83	5686.19	7929.095	
Cargo (incl. Carrier's Liability)	236.9	851.8	420.36	324.06	312.44	60.721	

**Source NBG and GIA*

Insurance: Market Statistics



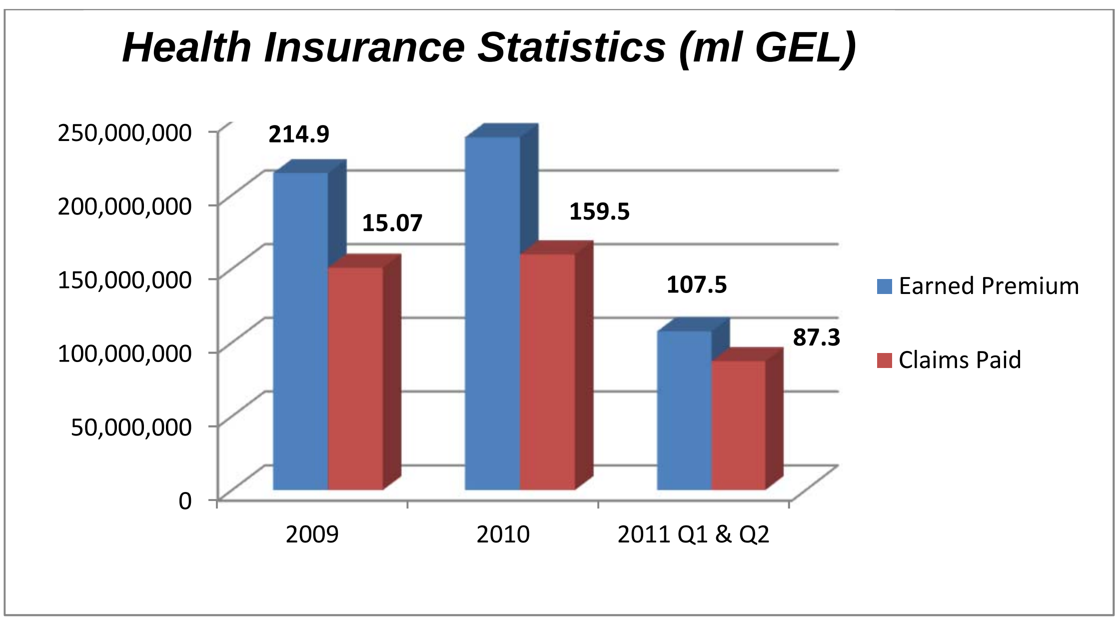
Name	Written Premium Q1 & 2 of 2011 (Million GEL	Claims Q1 & 2 of 2011 (Million GEL)
GPI Holding	33.58	18.53
Aldagi BCI	31.83	18.93
Imedi L	28.46	16.39
Alfa	22.19	16.09
IC Group	17.87	21.75
Irao	14.42	10.23
Unisoni	12.62	0.01
Cartu	9.35	3.30
VESTI	3.90	3.53
Archimedes	3.55	2.15
Tao	3.01	2.67
Partnior	2.31	0.86
PSP Insurance	2.23	0.93
Ardi Group	1.46	0.22
Chartis-Europe	0.85	0.13
Standart Insurance	0.57	1.13

Insurance: Health Insurance Premium 1998 – 2010

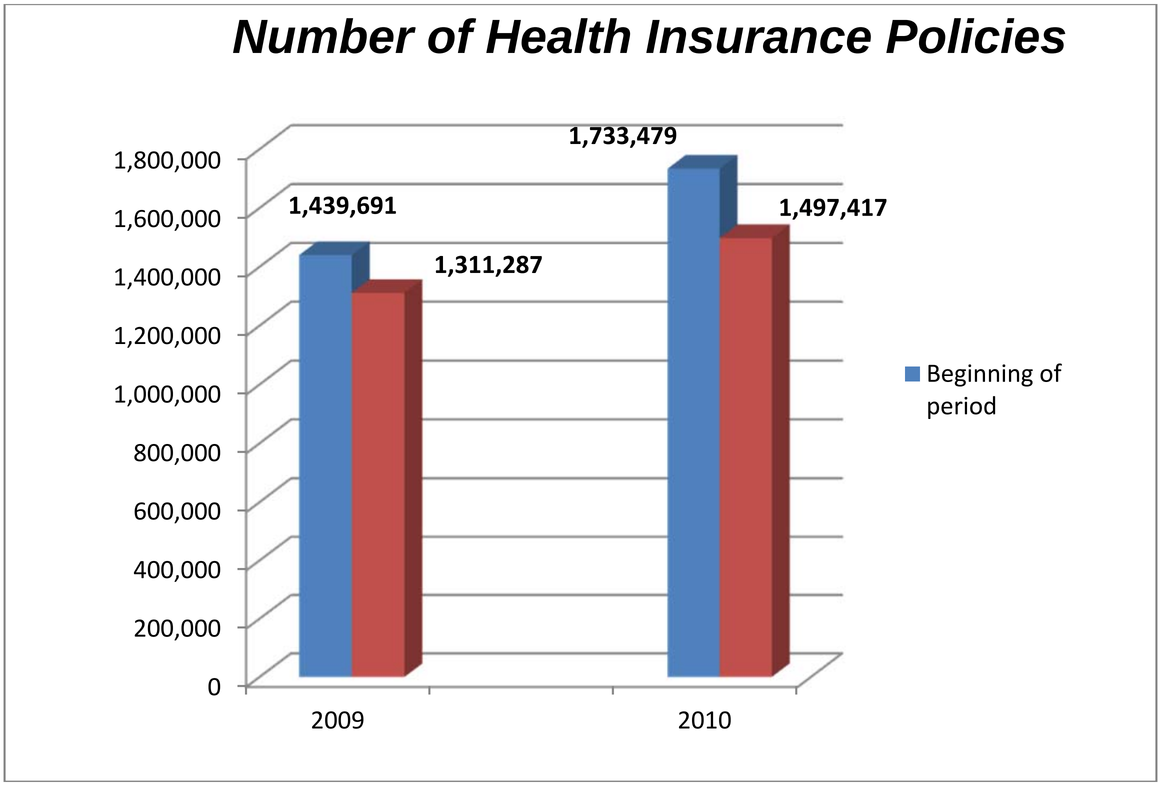
Year	Written Premium (ml GEL)
1998	0.47
1999	1.15
2000	3.01
2001	6.33
2002	4.20
2003	6.84
2004	8.71
2005	12.04
2006	18.73
2007	45.08
2008	161.23
2009	247.26
2010	245.80

**Source NBG and GIA*

Insurance: Health Insurance Statistics 2009 – 2011



**Source NBG*



Source: NBG

Agro Insurance: Agricultural Insurance Premiums and Claims Paid 2004 - 2011

Underwriting year	Premium (GEL)	Claims Paid	Loss ratio	Technical result (GEL)
2004	143,225	38,487	26.87%	104,737
2005	214,069	108,961	50.90%	105,108
2006	151,354	80,983	53.51%	70,370
2007	144,237	61,542	42.67%	82,694
2008	102,995	68,464	66.47%	34,532
2009	39,373	36,045	91.55%	3,328
2010	76,933	84,805	110.23%	-7,872
2011	227,014			

**Source: GIA*

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