ECONOMICS – REGIONAL STUDIES

Financing in Georgia:
Small and medium enterprises and the private sector

Joana Conde and Luca Gattini

European Investment Bank
The EU bank

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The mission of the EIB's Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 40 staff, is headed by Debora Revoltella, Director of Economics.

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1. Summary

Georgia is a lower-middle income country with GDP per capita of USD 4 400 or USD 11 600 in PPP terms, and a population of 3.7 million in 2018. Between 2004 and 2008 Georgia achieved a remarkable economic expansion with annual growth rates averaging around 10%. Annual growth slowed considerably as a consequence of the global financial crisis in 2008-2009. In the post-crisis period, several domestic and external factors contributed to a rather volatile economic performance including weak demand from neighbouring countries, a persistent vulnerability of the Georgian external position, regional tensions (e.g. international sanctions on Russia) and oil price swings. Real GDP growth consolidated in 2016 to reach an annual growth rate of almost 5% in 2018. GDP growth is expected to remain robust and close to 5% in 2019-2020[1].

The institutional environment in Georgia improved over the past decade. Institutions are more transparent and effective, thanks to arrangements to better align regulations to EU standards. The authorities confirmed their commitment to the reform agenda aimed at facilitating economic activity, ensuring property rights, decreasing corruption and rapidly converging the legal framework to international standards. As a result, Georgia holds a remarkable position in the World Bank Doing Business report (6th out of 190 countries).

Banks dominate the financial system in Georgia. Banking sector assets to GDP reached an all-time high of 96% in January 2019. The banking sector's loan and deposit portfolios have followed a somewhat similar trend. They stood at 64% and 56% of GDP in January 2019, respectively. Overall, the gap between the loan and deposit stock increased and the loan to deposit ratio (LTD) was around 110%. The banking sector in Georgia is well capitalised, with a capital adequacy ratio (CAR) in accordance with Basel standards of 18.4% in 2018. Return on Assets (ROA) was well above 2% in 2018. Georgian banks' liquidity positions have been relatively stable. Nevertheless, liquid assets covered only 27% of short-term liabilities in 2018, below the domestic minimum liquidity requirements of 30% for the first time in the last decade. The share of Non-Performing-Loans (NPLs) has been steadily improving and reached 5.6% in 2018 on the back of several factors including tighter regulatory requirements.

SMEs dominate the enterprise landscape in Georgia. According to Geostat's definition[2], SMEs accounted for 99.7% of all firms in 2017.[3] Indicators of production, turnover, value added and employment also reflect a significant SME outreach in the economy. In the third quarter of 2018, SMEs accounted for 59% of total production value, 53% of turnover, 62% of value added (2017) and 62% of the total number of employees in the business sector. 50% of the country's exports in 2018 came from the SME segment, a number that has been steadily rising since 2015, whilst an even greater share of imports – 58% – were intended for SMEs.

The Economics Department of the European Investment Bank recently conducted a Bank Lending Survey (BLS) involving several financial institutions in Georgia. The survey collected information on lending conditions, availability of different financial products, constraints to lending activity, rejection rates, etc., with a particular focus on the SMEs market. The survey included questions related to recent credit developments, demand and supply factors affecting credit growth, availability of various

[1] IMF World Economic Outlook (WEO), April 2019.

[2] The new methodology employed by Geostat, Georgia's National Statistics Office, defines an SME as a firm with either 50-250 employees or GEL 12-60 million in turnover.

[3] OECD (2018), Mid-Term Evaluation – Georgia's SME Development Strategy 2016-2020.

financial instruments, breakdown of loan portfolio by sector/maturity/purpose, and perception of credit conditions.

According to the EIB's BLS for Georgia, a noticeable level of loan rejections and credit-constrained firms characterise the Georgian market. According to the 2018 EIB BLS for Georgia, the reasons to reject applications can be grouped into four categories: lack of eligible collateral, lack of credit history, unmeasurable risks and poor business plans. Notably, the riskiness of either clients or projects is the main reported reason for rejecting loan applications across all business segments. The lack of eligible collateral is also reflecting the inability of firms to comply with banks' collateral requirements. This difficulty seems to be particularly heightened for smaller-sized firms. On the other hand, the lack of credit or financial history seems to be less of a concern for banks, as many of them confirmed that they were able to easily access the credit history of prospective borrowers. This reflects the good quality of Georgia's credit bureaux, and the success of the government's efforts to improve information systems, thus favouring the business environment.

Both demand and supply side factors have contributed to credit developments. About 47% of respondents reported that demand for credit is a factor constraining the expansion of the SME credit portfolio, whilst only 13% link it to supply components only. The remaining 40% reported a combination of both. The dominance of demand-related constraints is largely linked to the turbulent international macroeconomic conditions recorded in 2018. The supply-related issues mainly concern interest rates associated to the loans provided, the profitability of the projects proposed and the collateral requirement framework applied by banks. Moreover, banks also report high market interest rates and the lack of both local currency and long-term funding (in FX and LC) as limiting their capabilities to extend credit to SMEs.

Long-term loans (in foreign currency and local currency – GEL/lari) are still a minor component of the overall loan portfolio. This results from commercial banks' own funding structure and has direct repercussions on the loans available to SMEs to finance medium to long-term assets, thus constraining not the access per se to finance but the capability of matching the obtained finance with the average life of the financed projects.

SMEs and banks consider collateral requirements to be a constraining element. 95% of all loans to SMEs in Georgia are collateralised. Moreover, some of them might require more than 100% collateral. The inability of clients to comply with collateral requirements is still identified by banks as a moderate to significant constraint. 80% of the respondent banks see the shortage (in terms of either quality or quantity) of collateral assets owned by SMEs as a moderate to very significant issue. On the other hand, the legal framework for asset registration or security rights does not appear to be a major impediment for SMEs in Georgia.

Credit guarantee schemes are not a widely used product in the market due to limited availability and high cost. The regulatory framework does not seem to be the main factor hampering their development. 60% of banks find no issue in the timing of the approval or the transparency of the process. However, the cost of credit guarantee schemes, which is related to their availability, is seen by 60% of banks as a significant impediment to the development of these financial instruments, limiting the depth and size of their market.

Trade finance has gained a more relevant role, in particular for SMEs. All the respondent banks are providers or users of this alternative source of financing. It is described as widely available. Still, according to the EIB's Bank Lending Survey, the limited financial literacy of firms remains a pressing issue constraining demand for trade finance-related products.

2. The Macroeconomic Environment

Georgia is a lower-middle income country with GDP per capita of USD 4 400 (USD 11 600 in PPP terms), and a population of 3.7 million in 2018 (Figure 2.1 – Panel A). Between 2004 and 2008 Georgia achieved remarkable annual growth rates, averaging around 10%. Annual growth slowed considerably as a consequence of the global financial crisis in 2008-2009. In the post-crisis period, several domestic and external factors contributed towards a rather volatile economic performance including weak demand from neighbouring countries, a persistent vulnerability of the Georgian external position, regional tensions (e.g. international sanctions on Russia) and oil price swings. Real GDP growth solidified in 2016 to reach an annual growth rate of almost 5% in 2018. GDP growth is expected to remain robust and close to 5% in 2019-2020[4].

Georgia has a relatively well diversified economic structure. Trade, industry, construction and real estate activities, transport, communication and the agricultural sector represent the lion's share of the Georgian economy (Figure 2.1 – panel B). Notably, tourism has been booming, with numbers of international travellers reaching 8.7 million in 2018, scoring a 10% increase y/y. This has positively spilled over to several segments of the economy, including trade and industry. All in all, international trade, tourism and remittances are key sources of foreign currency revenue, like in other countries in the region. Public and private construction and related real estate activities are drivers of growth. The agricultural sector remains inefficient. It represents 6.7% of GDP and 8% of valued added. Nevertheless, it accounts for around 50% of total employment.[5] This is a symptom of the rather low productivity of the sector. Nevertheless, the agricultural sector is also a contributor to Georgian exports. The main export products were nuts, wine, mineral waters and alcoholic spirits. For example, Georgia is among the world's top five producers of hazelnuts, along with Turkey, Italy, USA and Azerbaijan (FAO 2012)[6].

Exports increased, but the current account position has been persistently negative. Export activities hovered around 30% of GDP until 2009 but have increased since then to reach around 55% of GDP in 2018. At the same time, imports of goods and services have been historically large at 50-55% of GDP reaching 67% of GDP in 2018[7]. This has generated a persistent imbalance in the Georgian economy's external position, mirrored by a current account deficit frequently above 10% of GDP over the last decade. In 2018, the current account deficit stood at roughly 8% of GDP (based on preliminary year-end data). This was largely driven by a negative trade balance. Trade in the services sector recorded a surplus, thus offsetting the goods' trade deficit. As of the beginning of 2019, Georgia's top trading partners were neighbouring countries: Russia (16.1%), Azerbaijan (11.6%), Turkey (7.8%), Ukraine (7.7%) and Armenia (7.5%).

[4] Latest IMF World Economic Outlook (WEO), April 2019.

[5] Moody's (2019) – Government of Georgia: Annual credit analysis.

[6] In this context the Deep and Comprehensive Free Trade Area (DCFTA) agreement between Georgia and the European Union supports a trade liberalisation process and encourages trade in agricultural products. According to the agreement, all tariffs and duties on agricultural products shall be removed. The agreement also calls for reforms to bring the quality of Georgian agricultural products in line with EU standards by improving safety and hygiene measures.

[7] Breaking down by major commodity groups, the largest shares of exports were copper ores, motor cars and ferro-alloys whilst coincidentally the largest imports were petroleum oils, motor cars and copper ores.

Georgia is dependent on foreign financing. Georgia has been particularly successful in attracting foreign capital. For example, net FDI inflows totalled 7.6% of GDP in 2018 (Table 2.1). Moreover, Georgia relies on remittances, averaging 11.2% of GDP between 2014 and 2018. In 2018, foreign reserves amounted to USD 3.3 billion or 3.7 months' worth of imports. On the other hand, gross external debt amounted to 109.5% of GDP in 2018. The main borrowers are financial corporations, non-financial corporations, followed by the central government. 90% of external debt was issued in foreign currency and 85% of it had a long-term[8] maturity. As a result, downside risks remain rather significant against the backdrop of a still rather dollarized economy[9].

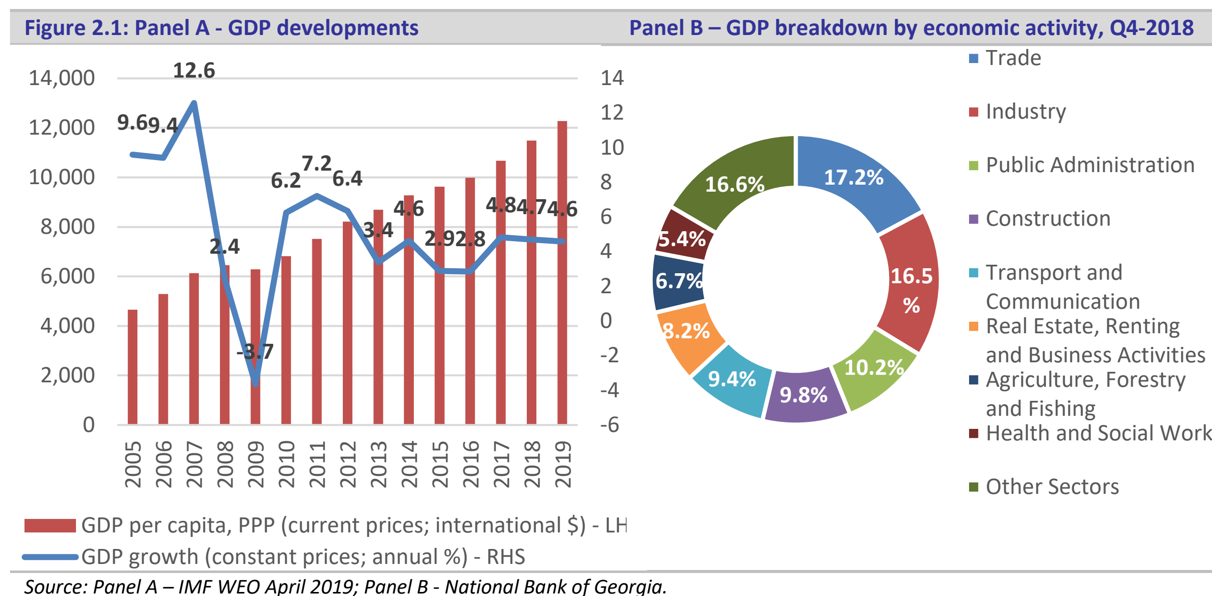


Figure 2.1: Panel A - GDP developments | **Panel B – GDP breakdown by economic activity, Q4-2018**

Source: Panel A – IMF WEO April 2019; Panel B - National Bank of Georgia.

The institutional environment in Georgia improved over the past decade. Institutions are more transparent and effective, in part thanks to reform programmes initiated after 2003's Rose Revolution as well as arrangements to better align regulations to EU standards. Specifically, Georgia holds a remarkable position in the World Bank Doing Business report: it ranks 6th out of 190 countries, with considerable advancement in structural adjustment over the years, having placed 24th as recently as 2016. In 2018, a new government and a new president took office and confirmed their commitment to the reform agenda, which is aimed at facilitating economic activity, ensuring property rights, decreasing corruption and rapidly converging the legal framework to international standards.

The National Bank of Georgia (NBG) has been able to keep inflation under control in the context of a floating exchange rate regime. In 2017, temporary supply-side factors – a rise in oil and tobacco prices – and depreciation pushed inflation above the 4% target. Throughout 2018, the consequences of this effect faded and annual inflation returned below target. Specifically, it stood at 1.5% (November 2018, Table 2.1). Current forecasts expect inflation to move to around the target level of 3% in 2019, supported by a positive economic performance and a stable lari exchange rate. Nonetheless, the country's significant level of dollarization still hampers the effectiveness of the monetary policy transmission channel and the absorption capacity of external shocks still remains

[8] Long-term funding refers to maturity of > 1 year in accordance with National Bank standards.

[9] For example, a weakening of the external environment could negatively impact foreign reserves and remittances. This would ultimately increase exchange rate volatility and depreciation pressures.

constrained. Against this backdrop, the government and the NBG have put in place credible de-dollarization plans which have started to bear concrete positive results in recent years.

Table 2.1 Selected statistics for the Georgian economy

Indicators	2013	2014	2015	2016	2017	2018	2019*	2020*
GDP (current prices, USD billion)	16.1	16.5	14	14.4	15.1	16.3	17.2	18.9
GDP per capita (current prices, USD)	4 340	4 442	3 760	3 856	4 047	4 400	4 661	5 138
GDP per capita (PPP basis, international $)	8 692	9 270	9 626	9 990	10 678	11 485	12 282	13225
Real GDP (% change)	3.3	4.6	2.9	2.8	4.8	4.7	4.6	5.0
Unemployment rate (% total labour force)	16.9	14.6	14.1	14.0	13.9	-	-	-
Inflation (CPI, % change Dec./Dec.)	2.4	2.0	4.9	1.8	6.7	1.5	3.0	3.0
Nominal Exchange Rate (USD-LC, period average)	1.7	1.8	2.3	2.4	2.5	2.5	2.7	-
Nominal Exchange Rate (EUR-LC, period average)	2.2	2.3	2.5	2.6	2.8	3.0	3.2	-
Gen. Gov. Debt/GDP* (%)	34.7	35.6	41.4	44.4	45.1	44.5	45.0	43.9
Gen. Gov. Debt/Gen. Gov. Revenue* (%)	126.0	127.1	147.5	157.1	154.4	156.7	159.7	158.6
Gen. Gov. Int. Pymt/Gen. Gov. Revenue** (%)	3.1	3.7	4.2	4.4	4.8	4.8	4.7	-
Gen. Gov. Net Lending/Borrowing (% of GDP)*	(0.5)	(1.1)	(0.2)	(0.4)	0.8	0.4	(0.3)	(1.0)
Current Account Balance/GDP (%)	(5.9)	(10.8)	(12.6)	(13.1)	(8.8)	(7.9)	(8.0)	(7.8)
External Debt/GDP (%)	83.2	84.6	109	110.4	114.4	109.5	-	-
Foreign Direct Investment/GDP (%)	6.3	11.0	11.9	10.9	12.6	7.6	-	-
International Reserves (USD billion)	2.8	2.7	2.5	2.8	3.0	3.3	3.6	-
International reserves (months of imports)	3.7	3.2	3.5	4.0	3.9	3.7	3.6	-

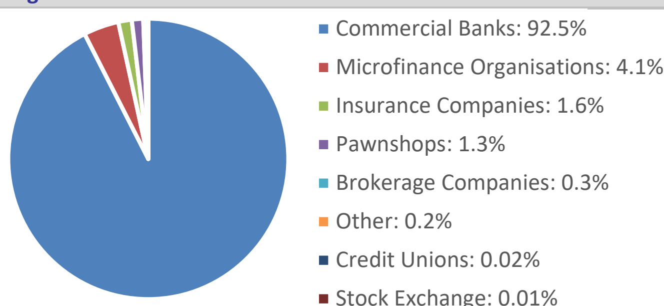
Source: National Bank of Georgia, authors' calculations.
*Notes: * Source IMF WEO database, authors' calculations; ** Source: Moody's Country Statistics*

In 2018, general government gross debt stood at 44.5% of GDP and 156.7% of total general government revenue. Government debt is not high and fiscal parameters are within the ongoing IMF programme targets[10]. The most concerning factor is the currency structure of debt. In 2017, 79% was foreign currency denominated. Therefore the debt is vulnerable to exchange rate depreciation. On the other hand, debt service is relatively low. For example, the percentage of the general government's interest payments over revenue stands at 4.7%, reflecting the prevalence of loans granted by IFIs on relatively favourable terms and with long maturities.

3. Financial Sector Overview

Banks dominate the financial system in Georgia. The financial sector is composed of 15 commercial banks, two non-bank depository institutions, 65 microfinance organisations, 1 000 exchange bureaux, 1 stock exchange, 17 insurance companies and three pension schemes. In the past eight years, the number of banks has decreased from 21 to 15. Nevertheless, banks increased their assets substantially,

Figure 3.1: Financial Sector Distribution



Source: National Bank of Georgia

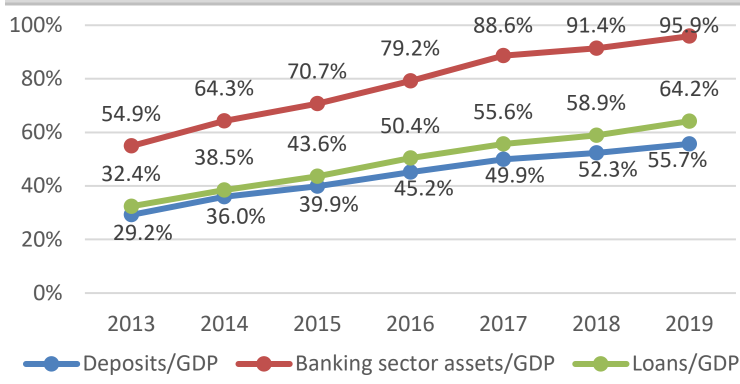
[10] The IMF-supported programme aims at helping Georgia reduce economic vulnerabilities, pursue well-coordinated policies, and promote economic growth. The programme includes ambitious structural reforms to generate higher and more inclusive growth, focusing on improving education; investing in infrastructure; making the public administration more efficient; and improving further the business environment to boost the private sector as a growth engine - IMF Country Report No 17/97.

reaching 91.4% of GDP in 2018 or total banking sector assets of over GEL 39 million (over EUR 12 million). Moreover, banks accounted for 93% of the financial sector (Figure 3.1). All banks are essentially private sector-owned. Microfinance organisations are the second largest segment within the financial sector with a 4.1% share, followed by insurance companies (1.6%) and pawnshops (1.3%).

3.1 Banking Sector

The banking sector is a two-tier market. The country's two largest banks - Bank of Georgia (BoG) and TBC Bank - jointly hold 73% of total banking sector assets. Both banks have benefited substantially from foreign support (including IFI funding) over the past decade. They are listed on the London Stock Exchange. These banks and Liberty Bank (5% of total banking sector assets) are classified as systemically-important banks in Georgia. Consequently, they are expected to progressively increase their capital buffer requirements from 1.5% to 2.5% by 2021. The Herfindahl-Hirschman index (HHI) ranged between 0.271 (for loans) and 0.284 (for deposits) in 2018[11]. All in all, taking into account the small size of the Georgian economy, the number of banks still allows for stiff competition in the banking sector. This is reflected across multiple dimensions including decreasing lending rates and margins, high marketing costs, high qualified staff costs, legal cases driven by headhunting, number of branches, ATMs and POS terminals within the same locations, the virtual non-existence of syndicated loans.

Figure 3.2: Banking Sector Indicators – as of January of each year



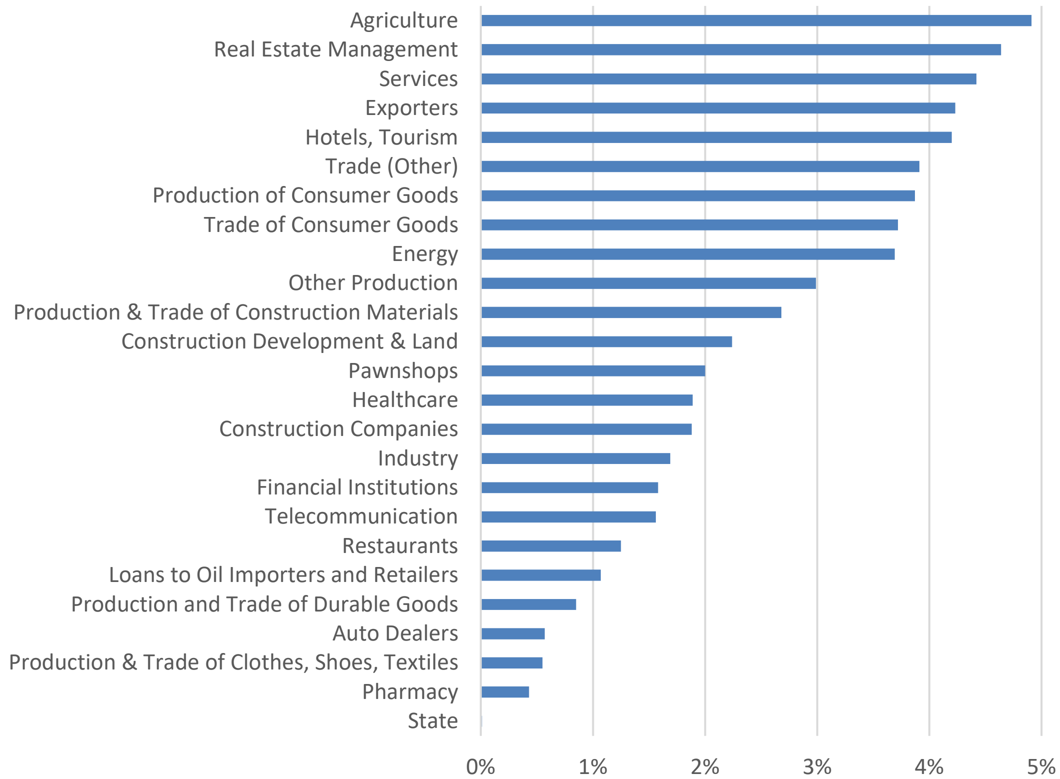
Source: National Bank of Georgia

Financial intermediation has been steadily growing in Georgia over the past decade. The banking sector assets/GDP ratio reached an all-time high at close of 96% in January 2019 (Figure 3.2). The banking sector's loan and deposit portfolios have followed a somewhat similar trend. However, the gap between the two has been slowly increasing. They stood at 64% and 56% of GDP in January 2019, respectively. Overall, the increasing gap between the loan and deposit stock points to an increase in the leverage of the banking sector, representing a loan to deposit ratio (LTD) of around 110%.

The expansion in financial activity reflects a favourable economic environment in Georgia. Credit growth reached almost 20% y/y in 2018 (18% y/y for enterprises and 20% y/y for households). Looking at loan distribution across economic sectors, agriculture (4.9%), real estate management (4.6%) and services (4.4%) account for a significant share (Figure 3.3). Additionally, the construction sector (including construction companies and materials) also accounts for a significant share of the total. Loans to hotels and the tourism sector have grown quite significantly over the recent past. Now, this segment stands at 4.2% of total loans. This is another reflection of the increasing importance of the tourism sector in total value added.

[11] The HHI is a commonly used measure of concentration. It is equivalent to the sums of the squared market shares of each competitor. In this context, it reflects the competition within the Georgian banking sector when it comes to offering loans and taking deposits. It ranges from 0-1, with the latter reflecting a very concentrated/ uncompetitive market.

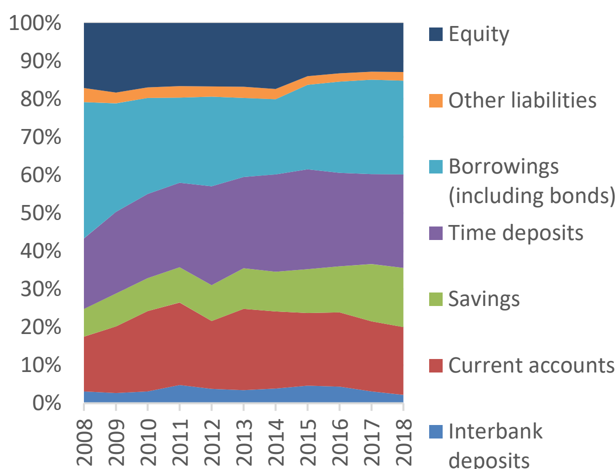
Figure 3.3: Non-Retail Loans by Economic Sectors, % of Total Loans, 2017



Source: National Bank of Georgia

3.1.1Funding

Figure 3.4: Liabilities and Capital of Commercial Banks



Source: National Bank of Georgia

Funding of Georgia's commercial banks is diversified. Non-bank deposits account for the majority of total banking sector liabilities, reaching about 60% of total liabilities in 2018 (Figure 3.4). In 2018 and compared to the previous year, all types of funding increased in volume with the exception of interbank deposits, which saw a decline of 18%. The biggest contributor to the volume of funding was borrowings (including bonds) and deposits, followed by current accounts, which make up around 25% and 18% of total liabilities, respectively. Additional data from the 2018 EIB BLS for Georgia show that the least available source of funding was wholesale debt securities. This reflects the relatively under-developed structure of capital markets in Georgia. Deposits from both retail and corporates are the most important source of financing. The EIB BLS results show that there is ample room for IFIs to continue playing a supporting role to the real economy, via the banking sector. Only 66% of banks identify IFIs as accessible sources of funding, and these include the three banks classified

as systemically important. Therefore there is a need and room for financing operations aimed at reaching out to smaller players to support their business plans and expansion strategies.

The structure of banks' funds is heavily skewed towards foreign currency and short-term maturities. More than half of all liability categories are denominated in FX (Table 3.1). Furthermore, the great majority of funding of banks is short-term. This includes deposits, as only 19% have a maturity of over one year. The shortage of long-term domestic and foreign currency funding significantly holds back credit growth for enterprises, especially in the SME segment. This highlights the enduring large need for long-term finance in order to better match the lifetime of the projects, including investment by SMEs.

Table 3.1: Liability Structure by Currency and Maturity

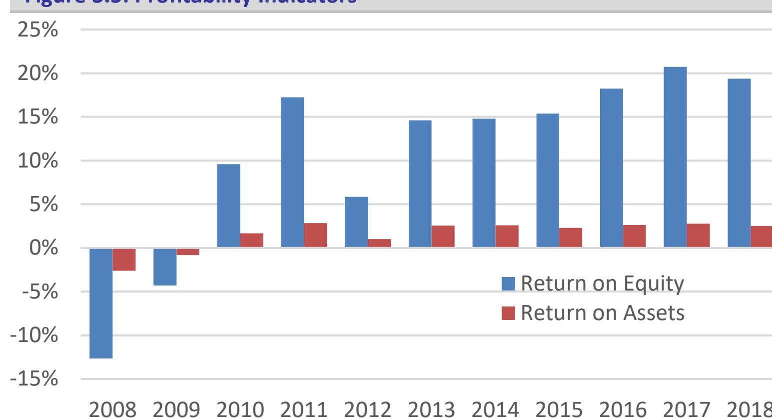
	Currency		Maturity	
	GEL	FX	<1Y	>1Y
Current Account	44.4%	55.6%	96.3%	3.7%
Savings	38.6%	61.4%	99.8%	0.2%
Time Deposits	30.5%	69.5%	81.3%	18.8%
Borrowings (including bonds)	43.4%	56.6%	33.3%	66.7%
Other	33.4%	66.6%	90.7%	9.3%
Total	38.6%	61.4%	74.5%	25.5%

Source: National Banks of Georgia, author's calculations

3.1.2 Performance of the Banking Sector

The banking sector in Georgia is well capitalised. Total capital adequacy ratio (CAR) in accordance to Basel standards was 18.4% in 2018, up from 15.2% in 2017. All banks' capital adequacy ratios are well above the 12% minimum requirement established by NBG. To consolidate and strengthen the banking sector, NBG has defined a minimum capital entry requirement, amounting to GEL 50 million (approximately EUR 15.6 million), up from the GEL 12 million approved in a 2006 legal act. The current capital adequacy framework is compliant with Basel III - Pillars I and II. Transparency reports based on Pillar III are set to be introduced. For example, higher capital conservation buffers and additional countercyclical buffers will be applied based on the individual risks of commercial banks.

Figure 3.5: Profitability Indicators



Source: National Bank of Georgia

Profitability of the banking sector has been strong but quite volatile over the post-crisis period and up until 2013. From that point on, Return on Assets (ROA) stabilised well above 2%. Return on Equity (ROE) slowly increased up until 2017 (Figure 3.5). In 2018, ROE stood at 19.4%, having experienced a slight decrease compared to 2017, whilst ROA stood at 2.5%. Moreover, banks' efficiency, as measured by the average cost-to-income ratio, followed the same trend as banks' profitability. It was 74.5% on average in 2010-2013. Thereafter, it improved steadily until 2017 (58%), thanks to economies of scale supported by digitalisation and consolidation procedures, but worsened slightly to 59.4% in 2018.

Georgian Banks' liquidity position has been stable. Nevertheless, some warning signs have emerged lately. In 2018, the ratio of liquid assets to total assets was 22%. Liquid assets covered only 27% of short-term liabilities (demand deposits) in 2018. They were not above the minimum liquidity requirements set by NBG of 30% for the first time in the last decade. This key indicator of liquidity reached its peak in 2012 with 45% of coverage and has deteriorated ever since. The sector's loan to deposit ratio is 110%. This indicates that Georgian banks are partially leveraged and their business model depends on net external borrowings, especially from IFIs (a source of stable long-term financing) and foreign commercial lenders. Within the Basel context, banks are compliant with liquidity requirements, namely the Liquidity Coverage Ratio (LCR) and the Leverage Ratio (see Annex A for details).

NPLs have been steadily improving in Georgia. The ratio reached its peak in 2010 as a result of the financial crisis. After that, it has been decreasing year after year, with the exception of 2012. By the end of 2018, it was 5.6%, the lowest recorded in the last decade. Since 2010, the NPL ratio has more than halved mainly due to relatively stable employment and economic growth, high credit standards and effective restructuring mechanisms employed by banks in recent years. It is important to note that NBG's definition of NPLs[12] is more conservative than that of the IMF[13]. For example, according to the IMF only 2.8% of loans were non-performing against 6% reported by NBG at end-2017.

Credit risk remains an essential component of overall risks to the financial sector in Georgia, mainly due to the country's high level of dollarization. As of December 2017, 57% of all loans were denominated in foreign currency, mainly in USD. This exposes Georgian banks to currency-induced credit risk, via exchange rate fluctuations. Part of the source of this issue lies in the funding structure of banks, whose main source of FX is deposits. This seems more relevant for the hospitality and real estate sectors taking the client's balance structure into account. Moreover, these sectors have seen loan extensions and their contribution to economic growth increase in recent years. In order to diminish the potential risk, NBG introduced higher risk weights on loans and stricter requirements for unhedged FX lending.[14]

The government and NBG introduced several measures to reduce the dollarization of the economy. For example, in 2017, a ten-point larization plan was phased in. The three main targets were to (i) increase access to long-term lari (GEL) loans; (ii) facilitate adequate sharing of FX risks; (iii) promote pricing in GEL. Moreover, the FX reserve requirements were increased from 20% to 25% on short-term FX liabilities up to one year in 2018. In addition, it was also defined that loans of up to GEL 100 000 to individuals could only be disbursed in local currency. Looking forward, this threshold will be increased to GEL 200 000 and extended to legal entities. Furthermore, requirements on loan-to-value and payment-to-income ratios have been introduced as additional macroprudential measures. These also have an effect in terms of favouring local currency because they are more restrictive on FX transactions and for smaller borrowers do not allow for a currency mismatch between source of income and payments, for instance. As a result, dollarization started to decline in 2017. Dollarization of loans and deposits decreased by 8.6 percentage points (from 65.4% to 56.8%) and 8.2 percentage points (from 71.5% to 63.3%) respectively – excluding exchange rate effects. Notably, no stricter requirement was imposed on long-term foreign currency liabilities. This highlights the need for and importance of this source of financing as well as the limited risks posed to financial stability by long maturities.

[12] See Annex B for the variables definitions.
[13] Which classifies NPLs as 90 days overdue.
[14] Moody's (2018), Banking System Brief: Georgia.

Box 1. A two-tier banking sector

The banking sector is comprised of 15 commercial banks. The two largest banks represent more than 70% of total banking sector assets. They are diversified in terms of business model, products palette, sophistication, client spectrum and funding structure. This box looks more in detail at the different performance ratios of Group 1 banks – Bank of Georgia and TBC Bank – and Group 2 banks - all the other 13 banks. Table 1 shows key ratios across the two groups. Many factors are similar across the two groups. Nevertheless, some differences appear to be significant:

- Average profitability is higher in Group 1. This could be linked, inter alia, to lower NPL ratios for Group 1 banks compared to Group 2 banks.
- Group 2 banks have a larger part of their portfolio denominated in GEL and lately expanded more robustly their aggregate loan portfolio.
- Group 2 banks have a thinner deposit base than Group 1 banks.
- At the same time, Group 2 banks hold more regulatory capital and have higher liquidity coverage ratios than Group 1 banks. Group 1 banks seem to be more prone to retaining less capital and less liquid assets.
- Group 1 banks are internationally listed and have access to multiple sources of direct finance, including medium-term loans and deposits. To support further expansion of their businesses, Group 1 banks may require assistance beyond traditional financing, thus possibly benefiting from alternative sources such as Credit Guarantee Schemes (CGSs) and capital market-based instruments.

Broadly speaking, Group 2 banks are less pervasive and diversified both on their assets and liabilities side. Nevertheless, these banks also have substantial retained potential in unutilised regulatory capital and an ample liquidity position. Long-term financing support could help unleash this potential, thus assisting these banks in their endeavours to increase their outreach, ultimately supporting SMEs.

Table 1. Selected key ratios of Georgian banks – Q1 2019

	Group 1	Group 2
Capital ratios as a percentage of RWA (risk-weighted assets)*		
Tier 1 ratio	13.2%	25.3%
Total Regulatory Capital ratio	18.1%	29.4%
Income		
Net Interest Margin	4.6%	5.5%
Return on Average Assets (ROAA)	2.4%	0.9%
Return on Average Equity (ROAE)	19.9%	4.9%
Asset Quality		
Non-Performing Loans/Total Loans	4.7%	8.3%
FX Loans/Total Loans	58.6%	48.8%
Loans/Total Assets	67.8%	64.9%
GEL Loans/Total Loans	41.4%	51.2%
Loan Growth-YTD	0.9%	4.6%
Liquidity		
Liquid Assets/Total Assets	22.3%	28.7%
FX Liabilities/Total Liabilities	63.4%	67.3%
Deposits (Current & Demand)/Total Assets	34.3%	24.7%
LCR ratio (%)	121.6%	213.6%

Source: National Bank of Georgia, authors' calculations

*Notes: * Based on Basel III framework. Statistics are reported as simple averages across banks, thus representing the average bank in each group*

FX risk originates from banks' assets and liabilities being heavily foreign currency denominated, mainly in USD, and the clients' balance sheets not always being hedged, with loans in FX and revenues in local currency. There are very few hedging mechanisms available, the most popular being TCX, a currency exchange fund. Under new legislation, access to FX lending is allowed only if the loans total over GEL 100 000. Therefore small and micro loans are not allowed any more in foreign currency. This does not exclude the FX risk but it mitigates it because a large part of the unhedged borrowers are usually individuals/retail customers also taking up loans for business purposes. Moreover, efforts by NBG towards de-dollarization of the economy have come through and helped mitigate this risk. The open currency position is quite balanced at bank and systemic level with regulatory limits set by NBG at 20% of regulatory capital (see Annex for details).

3.1.3 Regulation and Supervision

The NBG regulates and supervises commercial banks and other deposit-taking institutions, in accordance with risk-based principles. Banks are compliant with Basel regulatory capital requirements within Pillar 1 and Pillar 2. In addition, banks are starting to publish transparency reports according to the Pillar 3 framework. They are also compliant with liquidity requirements within the Liquidity Coverage Ratio (LCR). The Net Stable Funding Ratio (NSFR) is in the process of being implemented and should be fully adopted by September 2019. In addition, Basel's leverage ratio was introduced in 2018. Generally, risk weights and calculations are in line with Basel recommendations[15]. As for prudential regulations, commercial banks are fully compliant in Georgia. NBG reports that prudential requirements such as capital buffers for systemic banks and Pillar 2 buffers are in the phase-in process. There is a macroprudential supervision framework responsible for making systemic risk assessments, and recently a Financial Stability Department was created within NBG to further monitor business and credit cycles. The current accounting reporting falls under local standards and banks will publish their financial statements under the IFRS9 guidelines as of May 2019.

The Monetary Policy Committee of NBG sets limits for the minimum reserve requirements. These are determined separately for national and foreign currencies – 5% and 25% respectively. This policy is aimed at promoting larization. In addition, reserve requirements are also differentiated based on their remaining maturity. Borrowed funds with a remaining maturity of over one year in the national currency, and over two years in a foreign currency, are exempt from reserve requirements. For foreign currency liabilities with a remaining maturity of 1-2 years, the reserve requirement amounts to 10%.

3.2 Other Financial Institutions and Markets

Credit Organisations

Two licensed credit unions operated in Georgia in mid-2018 – with total assets amounting to GEL 2 387 457. The main contributor on the liability side is term deposits (62%). Total deposits amounted to GEL 812 576, of which 57% were above GEL 2 500. Overall, reserves were the main contributor to total capital (82%). Like the majority of other non-bank financial institutions, the supervision of credit unions falls under NBG's duties.

[15] However, there are some differences concerning the use of lower risk weights for exposures to NBG and the government (or guaranteed by either entity), and if the exposures are GEL-denominated. Another example of a deviation is the "higher-risk category" – 250% risk weight – for property held for operational lease purposes.

Insurance Companies and Pension Funds

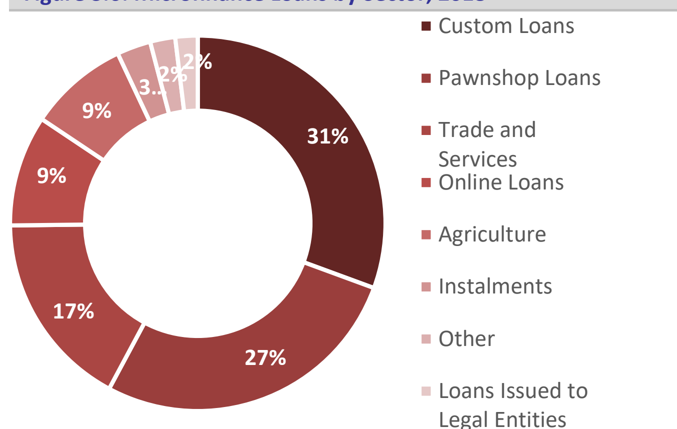
In January 2019, there were 17 insurance companies and three pension schemes in the Georgian financial sector. Altogether they represent 1.2% of total financial sector assets (2017). This share corresponds to GEL 580.2 million and reflects an increase of 7% in net assets from the previous year. The majority of assets were domestically owned. Supervision of the insurance sector has been delegated to an independent agency which reports directly to the Government.

Microfinance Organisations

As of March 2019, there were 61 microfinance institutions. In total, they employ more than 4 000 people. They have close to 400 branches spread out throughout the country. They make up 4% of the financial sector's assets. In 2018, total assets of the sector amounted to GEL 1.5 million, a decrease of 4% from the same period in the previous year. The average capital hovers around 30%. 70% of total assets were loans. The sectoral distribution of the microfinance loan portfolio was split between loans issued to individuals (92%) and loans issued to legal entities (2%) (Figure 3.6). In the loans to individuals category, custom loans represented 31%, pawnshop loans 27% and trade and services 17% of the total amount. From the beginning of 2017 to the end of Q3-2018, the dollarization of loans in microfinance organisations fell from 54% to 17%. When considering profitability indicators, 2017 ROE stood at 9.5% (down from 33.3% in 2016) and ROA stood at 2.5% (down from 8.4% in 2016).

NBG is the regulator for the microfinance sector. It is in charge of providing these organisations with licenses, auditing and sanctioning them. It was established that microfinance organisations can offer up to GEL 50 000 in microcredit to a single client. Minimum paid share capital must be over GEL 250 000. Recently, the registration processes and rules for liquidation with NBG have been made more transparent. As of December 2018, capital adequacy and liquidity ratios were introduced.[16]

Figure 3.6: Microfinance Loans by Sector, 2018



Source: National Bank of Georgia

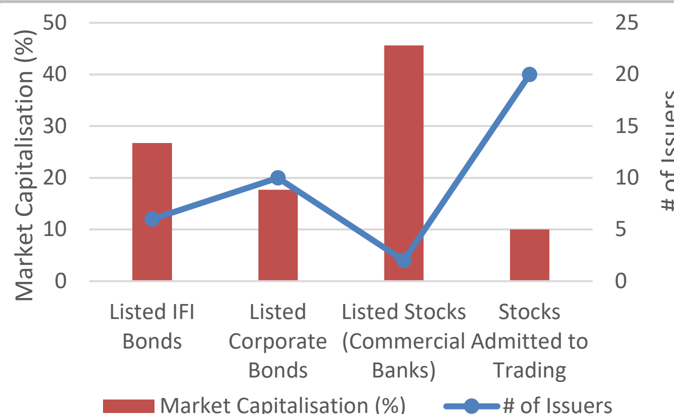
Capital Markets

The volume of capital markets is still small. The main volume of market transactions revolves around government securities. Nevertheless, activity in the bond market is gaining importance, mainly due to the presence of IFIs and their role in issuing GEL-denominated securities. Total market capitalisation is approximately GEL 3 490 million – of which GEL 1 941 million from the stock market and GEL 1 549 million from the bond market. This accounts for a 10% share of total financial sector assets.

[16] IMF (2018). Georgia: Third Review Under the Extended Fund Facility Arrangement.

In January 2019, there were 34 registered companies registered at the Georgian Stock Exchange. 14 companies were listed and 20 were admitted for trading. There are 38 securities, of which 18 are either A or B listings, two are listed equity securities and 20 are securities admitted for trading. The only active stock exchange operating is the Georgian Stock Exchange. Nonetheless, the Tbilisi Stock exchange is also licensed. The framework in place defines that there are no capitalisation requirements in order to be admitted to trading. However, to be listed the minimum capitalisation is GEL 500 000 (B listing) and GEL 1 million (A listing). At the beginning of 2019, the different contributions of each issuer to total market capitalisation were: listed stocks (commercial banks) (45.6%), listed IFI bonds (26.7%), listed corporate bonds (17.7%) and stocks admitted to trading (10%) (Figure 3.7). The lead regulator for the securities market – which includes brokerage companies, independent registrars, stock exchange and a central depository – is the NBG.

Figure 3.7: Georgian Stock Exchange



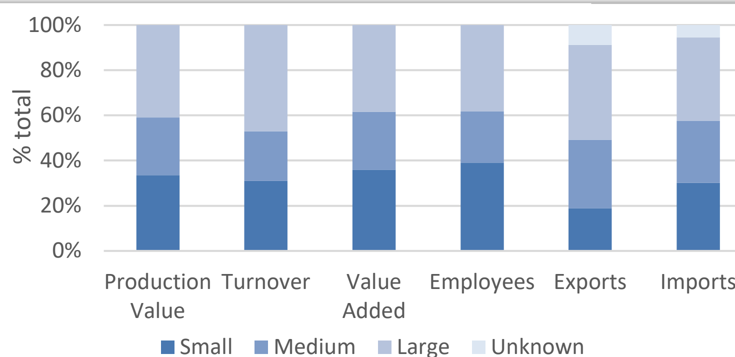
Source: National Bank of Georgia

4. The SME Segment

Georgia has an official definition of SMEs. However, different institutions or financial sector entities employ alternative definitions. The methodology employed by Geostat, Georgia's National Statistics Office, defines an SME as a firm with either 50-250 employees or GEL 12-60 million in turnover. According to the Georgian National Investment Agency, a firm can be classified as an SME either by employment levels (headcount <100) or turnover (≤ GEL 1 500 000) in a fiscal year. For taxation purposes, the threshold to identify an SME stands at a turnover of less than GEL 100 000. On the other hand, the definitions set by financial institutions depend on a combination of indicators that can include loan size (in local or foreign currency), turnover or exposure to a specific SME/borrower.

SMEs dominate the enterprise landscape in Georgia. According to Geostat's definition, they accounted for 99.7% of all firms in 2017.[17] Indicators of production, turnover, value added and employment also reflect SMEs' outreach in the economy. In the fourth quarter of 2018, SMEs accounted for 59% of total production value, 53% of turnover, 62% of value added (2017) and 62% of the total number of employees in the business sector

Figure 4.1: Macroeconomic Performance Indicators of the SME segment

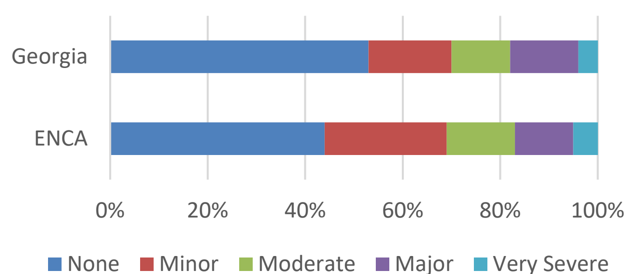


Source: Geostat, Business Statistics Database
Note: All data, with the exception of Value Added (2017), concerns Q-IV 2018

[17] OECD (2018), Mid-Term Evaluation – Georgia's SME Development Strategy 2016-2020

(Figure 4.1). In addition, the average monthly earnings of employees in the SME segment were GEL 1 222. On average, they were above employees' earnings in large firms.[18] SMEs are primarily operating in the trade sector (including vehicle repairs). This sector accounted for 14.7% of total value added in 2016. Construction and manufacturing are still key sectors for SMEs, standing at 10.4% and 7.2% of total value added respectively in 2016.[19] Moreover, SMEs' trade-related statistics show a considerable level of integration in international markets. 50% of the country's exports in 2018 came from the SME segment, a number that has been steadily rising since 2015, while an even greater share of imports (58%) was intended for small and medium-sized firms.

Figure 4.2: SME Access to Finance Seen as an Obstacle



Source: 2012 BEEPS Survey

Access to finance is one of the main constraints for SME activities in Georgia. Results from the Business Environment and Enterprise Performance Survey (BEEPS) help gauge the main obstacles in doing business as perceived by SMEs. The most prominent obstacles were political instability[20], access to finance and tax rates.[21] Over 95% of small and medium-sized firms use banking services in the form of checking or savings accounts. Nevertheless, only 30% of small firms and 41% of medium-sized firms take advantage of bank loans or lines of credit. Approximately, one fifth of SMEs find access to financing to be a major or very severe obstacle to business operations (Figure 4.2). These results are comparable with other countries in the ENCA (Eastern Neighbours and Central Asia) region. Moreover, access to foreign equity or borrowing is particularly challenging. Lastly, the availability of funding, particularly in local currency, is important for the development of the SME segment. Small and medium-sized enterprises that are credit constrained (either discouraged from applying or rejected) account for 40% of the SMEs needing a credit line in Georgia. However, this measure is even higher for the ENCA region (exceeding 60%). Among the reasons for being credit constrained, unfavourable interest rates score as high as 70%, followed by complex procedures (16%). This is further reflected in figures 5.11 and 5.14 below.

SMEs rely heavily on internal sources of funding and retained earnings. For example, over 70% of investments in fixed assets and 80% of working capital are financed with internal resources. These ratios are comparable to the ENCA regional average. Bank products are the second-largest source to finance fixed assets and working capital in Georgia. Georgian SMEs make slightly better use of bank financing and equity than in regional peer countries (Figure 4.3).

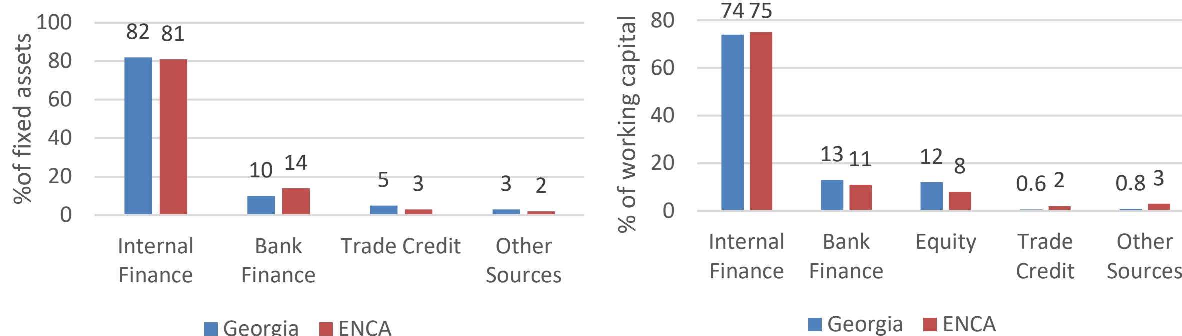
[18] Geostat (2018), Business Statistics Database.

[19] OECD (2018), Mid-Term Evaluation – Georgia's SME Development Strategy 2016-2020.

[20] [20] The BEEPS survey was conducted in 2012. The time lag may render some results obsolete. Moreover, the time window of the survey administration was rich in political events in Georgia. This may have led to an overrating of certain results. For example, the high score on political instability was probably influenced by idiosyncratic factors. During 2012-2013, when the surveys were conducted, the country was going through a democratic process of change in government. Following elections in 2012, the main ruling party – United National Movement (after being in power for about eight years) was defeated by its opponent – the Georgian Dream coalition. Many companies and businesses adopted a wait-and-see approach during this period due to increased uncertainty as to how the change in power would unfold. Consequently, political instability should be interpreted as a transitory element that cleared up after the smooth transition of powers.

[21] However, after the survey administration, amendments to the tax code introduced the possibility of having special tax rates and advantages. As a result, micro businesses became exempt from income tax and small enterprises were given special tax rates – 3% or 5% instead of the general 20% rate.

Figure 4.3: Sources of SME Financing: Fixed Assets (Panel A) and Working Capital (Panel B)



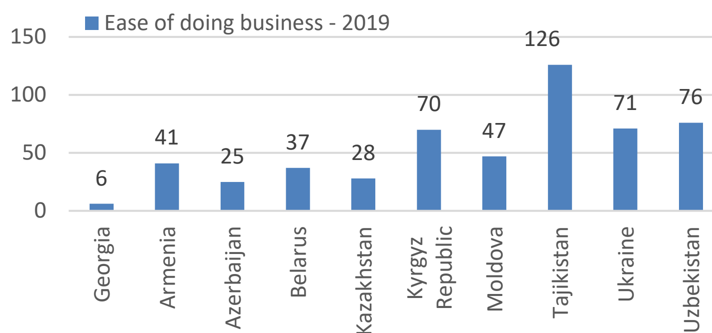
Source: 2012 BEEPS Survey

The level of innovation in the SMEs segment is low in Georgia. According to the BEEPS, around 11% of SMEs undertake innovative decisions in Georgia. This result is slightly below the average among peer countries in the region. Support for innovative approaches and new technologies is essential to boost productivity and growth, especially for SMEs. On the other hand, to encourage innovation and technological development, particularly in the SME segment, the Georgian Innovation and Technology Agency (GITA) was created in 2014.

4.1 The Institutional and Legal Environment relevant for SMEs' development

Georgia holds a remarkable position in the World Bank Doing Business report, which measures the extent to which favourable business regulations are being enforced. It is ranked 6th out of 190 countries (Figure 4.4). This reflects a longstanding tradition of favourable business practices that allowed Georgia to progress in the ranking over the years. It was ranked 24th as recently as 2016, for instance. "Starting a new business" and "protecting minority investors" are key strengths of the business environment. The government has been trying to achieve further improvements by making registration procedures simpler and increasing shareholders' rights. However, resolving insolvency is still considered as a constraint and no active measures have been taken in recent years to improve it.

Figure 4.4: Doing Business 2018 Rankings

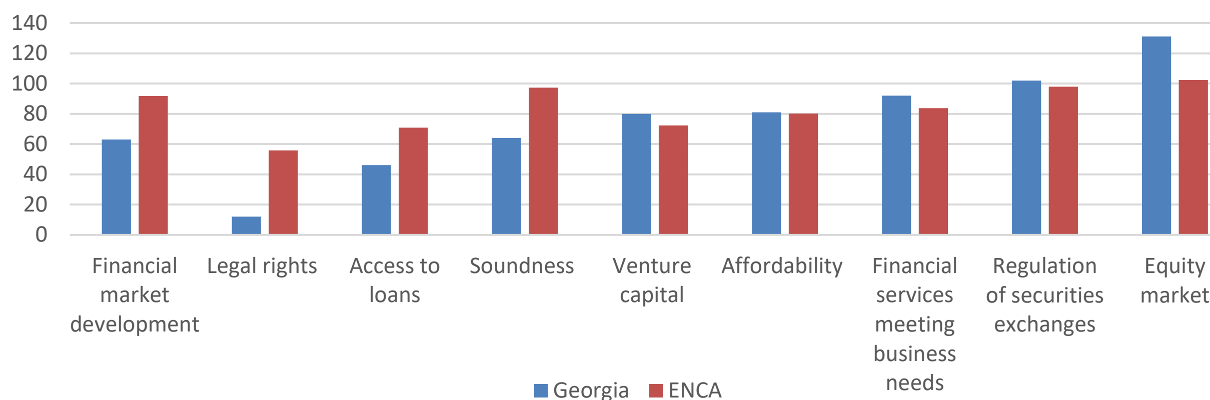


Source: World Bank Doing Business 2018

The World Economic Forum's Global Competitiveness sub-index accounting for the Development of Financial Markets places Georgia in 63rd position (Figure 4.5). This gives a first insight into firms' difficulties in accessing credit and finance. Nevertheless, on average Georgia outperforms its regional peers in this domain also. Some of the difficulties are reflected in the insufficient availability of alternative sources of financing – e.g. venture capital and equity markets. These are particularly important for young and small-sized firms, as they do not have extensive credit history availability and, most importantly, collateral. Access to credit is also described as problematic on a global scale.

Nevertheless, Georgia scores far better than its regional peers. On the other hand, from an institutional infrastructure standpoint, the ease of accessing credit has improved in Georgia. It outperforms all countries in the ENCA region. This notable position comes after several efforts to improve credit market depth and coverage over the years via measures at governmental level such as: improving credit information systems (2014, 2008), strengthening secured transaction systems (2013, 2009) and extending collateral coverage and its electronic registry (2012, 2011).

Figure 4.5: World Economic Forum's Global Competitiveness Index: Financial Market Development



Source: World Economic Forum's Global Competitiveness Index 2017-2018

SME-driven policy has been prioritised in recent years. The Ministry of Economy and Sustainable Development leads the implementation of reforms supporting the business environment and entrepreneurship. Three initiatives stand out: the Georgian Innovation and Technology Agency (GITA), Produce in Georgia and Enterprise Georgia. The main objective of GITA consists in providing young and small/mid-sized firms in Georgia with the appropriate legal framework, access to grants and other financing, technical assistance, and infrastructure so they can implement innovation and progress into the digitalisation era. Produce in Georgia and Enterprise Georgia have a special focus on manufacturing and agriculture. They aim at providing access to finance and infrastructure to stimulate and support domestic and international SME activity, thus facilitating integration in international markets and attracting foreign direct investment.

5. SMEs' Access to Finance and SME Financing

In 2018, the European Investment Bank conducted a Bank Lending Survey (BLS) involving several financial institutions in Georgia. This is an enhanced version of the previous BLS wave in Georgia in 2015. The 2018 survey collects information on lending conditions, availability of different financial products, constraints to lending activity, rejection rates, etc., with a particular focus on the SMEs market. More specifically, the survey includes questions related to recent credit developments, demand and supply factors affecting credit growth, availability of various financial instruments, breakdown of loan portfolio by sector/maturity/purpose, and perception of credit conditions. The respondents provided information according to their definition of SMEs. A comprehensive overview

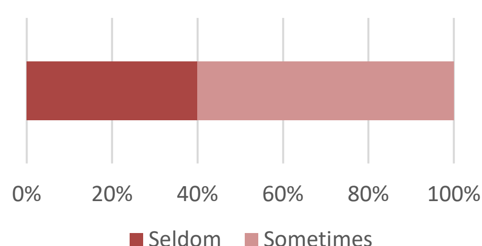
of the questionnaire is reported in Annex C. The survey covered 84% of banking sector assets. The key results of the survey are reported in the following section.

5.1 SME Access to Finance

According to the EIB Bank Lending Survey, a significant level of loan rejections persists in the Georgian market. In the previous EIB survey wave, 20% of the respondent banks still reported that they often rejected loan applications.[22] In the current round of the survey, banks report only rejecting loan applicants either on rare occasions (40%) or on a non-regular basis (60%) (Figure 5.1). Nonetheless, this still does not rule out that firms might be discouraged from applying in the first place, so distorting upwards this result.

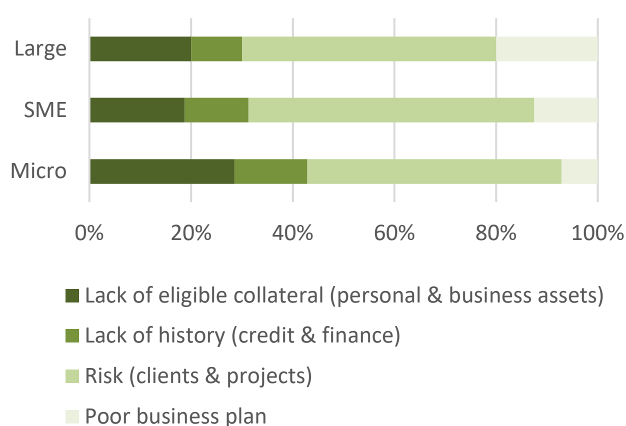
The reasons given for rejecting applications can be grouped into four categories: lack of eligible collateral, lack of credit history, unmeasurable risks and poor business plans. Notably, the riskiness of either clients or projects is the main reported reason for rejecting loan applications across all business segments (Figure 5.2). It reflects the low risk-bearing capacity of Georgian banks. It also represents the rather conservative and risk-averse strategic orientation of Georgian banks. On the other hand, this helps also to reduce risks to financial stability. It is also reflected in the rather systemically low NPLs ratio (Section 3.1.4). The lack of eligible collateral also reflects the inability of firms to comply with banks' collateral requirements. This difficulty seems to be particularly heightened for smaller-sized firms. On the other hand, the lack of credit or financial history seems to be less of a concern for respondent banks, as many of them confirmed that they were able to easily access the credit history of potential borrowers. This reflects the good quality of Georgia's credit bureaux, and the success of the government's efforts to improve information systems, thus favouring the business environment.

Figure 5.1: SME Loan Application Rejection frequencies



Source: 2018 EIB Bank Lending Survey
Note: (i) Survey question – How often did you reject loan applications over the last 12 months? (ii) Possible answers – Almost never; Seldom; Sometimes; Often; Very often.

Figure 5.2: Reasons for Loan Application Rejections by segment



Source: 2018 EIB Bank Lending Survey
Note: (i) Survey question – What are the three most important reasons for rejecting loan applications over the last 12 months? (ii) Possible answers – Lack of eligible collateral (personal & business assets – merged); Lack of history (credit & finance – merged); Risk (clients & projects – merged); Poor business plan.

[22] To access the results of the previous survey wave, please refer to Gattini, L., and Baiashvili, T. (2016). *Neighbourhood SME financing: Georgia*, EIB working paper.

5.2 SME Financing

The most widely available external source of financing for consumers and firms is loans. The results of the EIB Bank Lending Survey show that credit is widespread (Figure 5.3). Other instruments such as trade finance and leasing have progressively gained importance, unlike equity which remains underdeveloped and is not seen as an instrument easily available to SMEs.

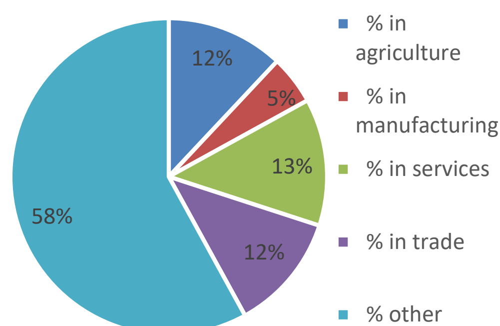
Figure 5.3: Availability of Financial Instruments to SMEs

Source: 2018 EIB Bank Lending Survey
Note: (i) Survey question – How do you rate the availability in the market of the following instruments? (ii) Possible answers – Very widely available; widely available; sometimes available; seldom available; very seldom available.

25% of all loans are provided to the SME segment and the volume of the SME portfolio has increased almost fivefold since 2010. According to the 2018 EIB BLS for Georgia, 83% of banks offer both GEL-denominated and FX-denominated loans to SMEs, while only 66% of banks reach micro firms with both types of loans although the newly introduced regulation pushed for GEL loans in the micro segment. In terms of maturity, loans provided by commercial banks to SMEs are mainly short-term and are somewhat more widely available in foreign than in local currency. This results from commercial banks' own funding structure, as examined in Section 3.1.3, which has direct repercussions on the loans that are available to SMEs. According to the same survey, 20% of banks still claim that long-term GEL-denominated loans are only sometimes available.

The sectoral distribution of loans to SMEs partly reflects the contribution of each economic sector to Georgia's GDP. Considering recent years' growth, total gross loan portfolios for SMEs was expected to grow year-on-year in 2018 by 55%. The micro portfolio was expected to grow by 23% in 2018, after recording meagre growth in 2017 (2% y/y). Across sectors, the distribution of the SME portfolio seems to be broadly balanced between services, trade and agriculture (Figure 5.4). This reflects firms' reasonable integration in international markets and the success of the Ministry of Economy's support programmes, specifically targeting agriculture and export activities.

Figure 5.4: SME Portfolio by Sector - 2018

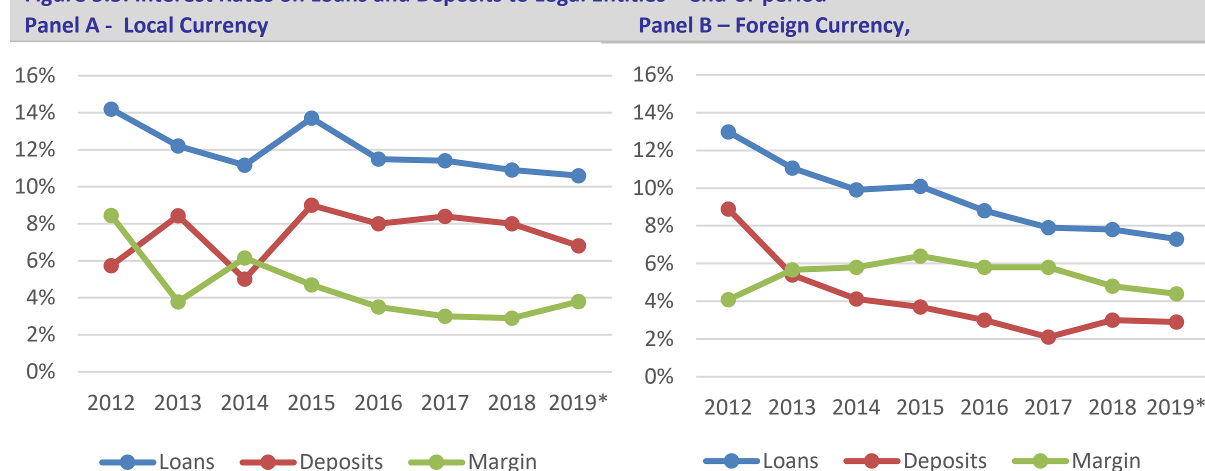


Source: 2018 EIB Bank Lending Survey - Georgia
Note: (i) Survey questions: Sector distribution by firm size; (ii) Possible answers – agriculture (%); manufacturing (%); services (%); trade (%); other (%).
Note: Banks' responses were weighted by portfolio size

65% of SMEs’ portfolio is foreign currency-denominated, of which 60% of loans were issued in USD in 2017. Dollarization is a common feature in the corporate, retail, household and SME segments, always surpassing the share of local currency instruments. Nevertheless, in the SME segment, the percentage of the USD-denominated portfolio decreased by 15% in 2017 y/y, thus allowing for an increase in the share of local currency loans. In general, GEL-denominated loans have always had higher interest rates, which partly justifies their smaller share in portfolios.

Figure 5.5: Interest Rates on Loans and Deposits to Legal Entities – end-of-period

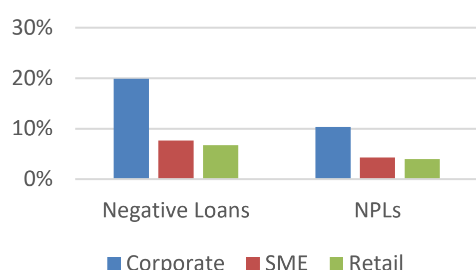
Panel A - Local Currency | **Panel B – Foreign Currency,**



Source: National Bank of Georgia, author’s calculations.
*Note: * 2019 rates as of May.*

In 2019 margins between loan and deposit rates are similar across currency denomination. Starting from 2012, rates on FX-denominated loans and deposits have been decreasing whilst rates on LC loans decreased only slightly and deposit rates did not change substantially (Figures 5.5a and 5.5b). Overall margins on LC lending have been declining on the back of reduced lending rates, whilst margins on FX lending have been increasing and stabilised again in 2019 at the same level as in 2012. On the other hand, attracting LC deposits is twice as expensive as attracting FX deposits, suggesting a scarcity of LC also in the context of regulatory limitations imposed recently as part of the larization plan. All in all, stable or decreasing margins suggest a rather competitive environment, whereby attracting clients on either the liability or asset sides requires careful management of resources and continuous funding support beyond the domestic available sources.

Figure 5.6: Credit Quality by Segment



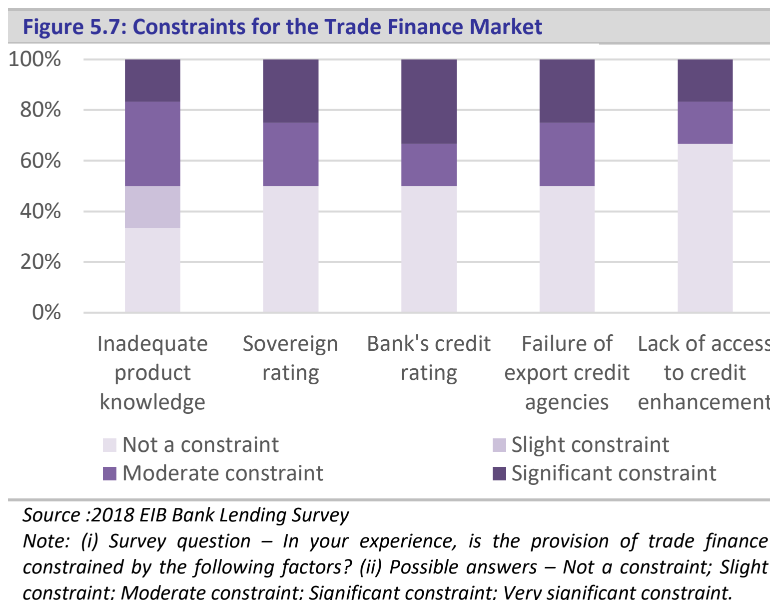
Source: National Bank of Georgia, Annual Report 2017

The quality of SME portfolios continues to improve. According to NBG, 4.3% of loans in the SME segment were non-performing by the end of 2017 (Figure 5.6). This number reflects a decrease compared to the 5.2% recorded in 2016. Still, the SME segment portfolio has historically been of higher quality than the corporate segment, which has registered 10.4% of NPLs. Furthermore, the share of “negative loans” reflects the combination of NPLs with other loans that are classified under “watch” given their potential to become non-performing. This measurement shows the features as the NPLs matrix. It is comparatively higher for the corporate sector (19.9%) than for the

SME segment (7.65%).[23] The high level of dollarization of loans coupled with some exchange rate volatility are potential sources of stress affecting NPLs via currency-induced credit risk. However, the figures concerning the share of NPLs for 2018 are likely to see an improvement as the exchange rate appreciated, and this translates into lower costs of servicing FX loans.

Alternative financial instruments have experienced different trends in Georgia's banking sector. Trade finance has gained a more relevant role, in particular for SMEs, given that all the respondent banks are now providers of this alternative source of financing and describe it as being widely available (Figure 5.3). However, according to the 2018 EIB BLS, the limited financial literacy of firms remains a pressing issue restricting demand for trade finance-related products (Figure 5.7).[24]

Figure 5.7: Constraints for the Trade Finance Market

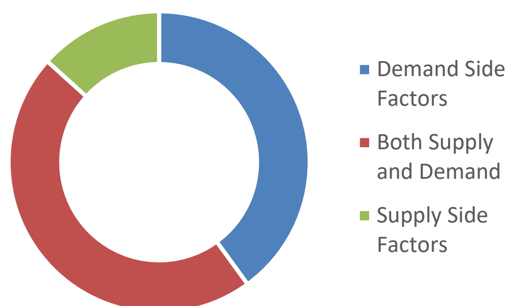


Source :2018 EIB Bank Lending Survey

Note: (i) Survey question – In your experience, is the provision of trade finance constrained by the following factors? (ii) Possible answers – Not a constraint; Slight constraint; Moderate constraint; Significant constraint; Very significant constraint.

5.3 Factors affecting Credit Extensions to SMEs

Figure 5.8: Demand and supply elements affecting credit developments



Source: 2018 EIB Bank Lending Survey

Note: (ii) Survey question – In your opinion, growth of credit to micro, SMEs and mid-caps is primarily constrained by demand or supply side factors? (ii) Possible answers – Primarily supply side factors; Both supply and demand; Primarily demand side factors.

The results of the 2018 EIB BLS for Georgia indicate that both demand and supply side effects have contributed to credit developments. In detail, about 40% of respondents reported that demand for credit is a constraining factor to the expansion of the SME credit portfolio whilst only 13% link it to supply components only. The remaining 47% reported a combination of both (Figure 5.8). The dominance of demand-related issues is largely linked to the current turbulent macroeconomic conditions globally (Figure 5.9). The supply-related issues mainly concern interest rates associated to the loans handed out, the profitability of the projects proposed and the collateral requirement framework applied by banks (Figure 5.12).

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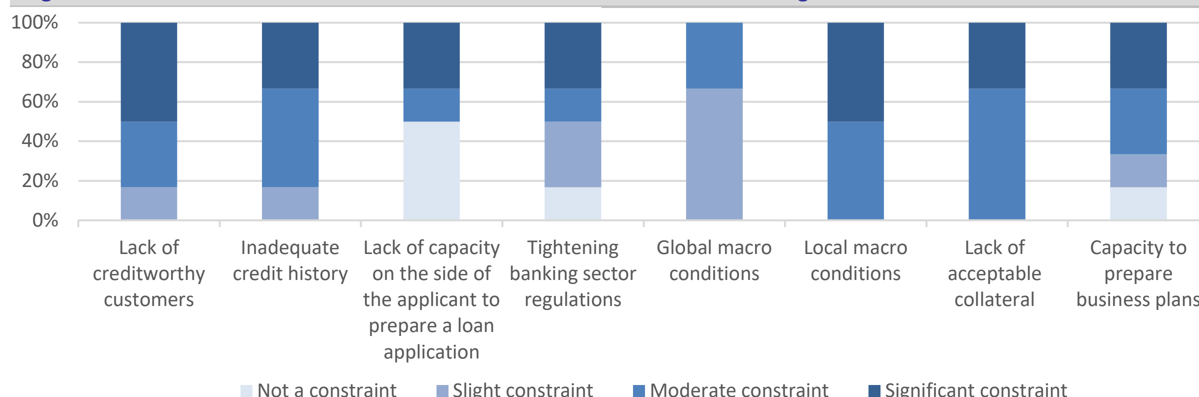
[23] According to the National Bank of Georgia, losses on loans incurred by the corporate segment have been historically higher than those of the SME and retail portfolios, which have benefited from the enlargement of the total loan portfolio itself and macroeconomic developments in neighbouring markets.

[24] It is worth noting that when weighting the banks' responses by their portfolio, it becomes clear that difficulties diverge depending on the size of the respondent. For instance, two of the country's largest banks (TBC and BoG), do not see sovereigns' or banks' ratings as a concern, while smaller-sized banks are quite constrained by the values.

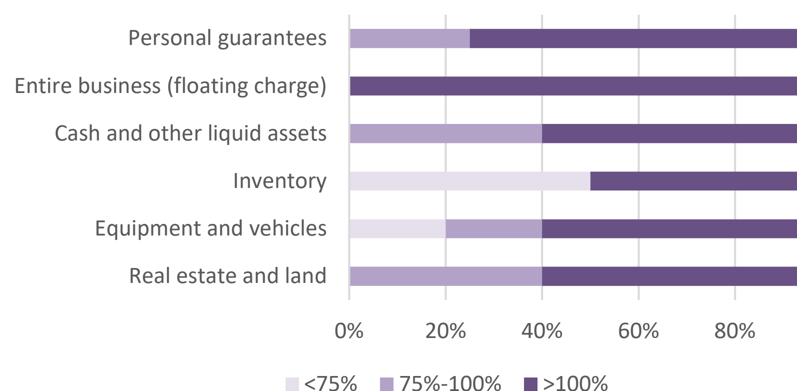
Creditworthiness of customers (based on their credit records)**, collateral requirements and local macroeconomic factors constrain credit extensions to the different sectors, including SMEs** (Figure 5.9). Nevertheless, issues related to the ability to apply for loans and prepare business plans, which partly reflect the level of financial literacy of the applicants, are more significant to smaller-sized firms. Furthermore, the inability to comply with collateral requirements is still identified as a moderate to significant constraint by all the respondents.

Figure 5.9: Macroeconomic Environment and Customer-Related Issues Limiting SMEs' Access to Credit



Source: 2018 EIB Bank Lending Survey
Note: (i) Survey question – Which of the following are acting as a constraint on the demand/supply for credit? (ii) Possible answers – Not a constraint; Slight constraint; Moderate constraint; Significant constraint; Very significant constraint.

Figure 5.10: Type and level of collateral required



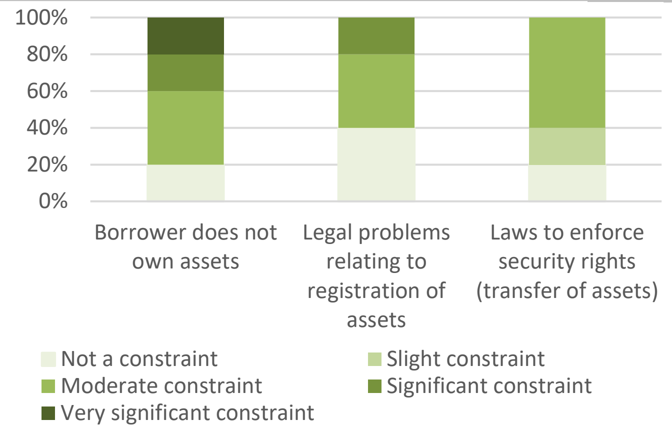
Source: 2018 EIB Bank Lending Survey
Note: (i) Survey Question – What level and type of collateral does your bank require? (ii) Possible answers by type – Personal real estate and land; Equipment and vehicles; Livestock; Inventory; Cash and other liquid assets; Entire business (floating charge); Personal guarantees; Mortgages; Finance leases; Securities; No assets (unsecured loan). (iii) Possible answers by level - <75%; 75%-100%; 100%-125%, 125%-150% and >150% (merged).

SMEs and banks consider collateral requirements to be a constraining element. 95% of all loans to SMEs in Georgia are collateralised, more than regional peers' average[25]. The EIB Bank Lending Survey helps build a more detailed narrative around collateral requirements and constraints to financing. A good share of loans requires usually more than 100% collateral (Figure 5.10). Specifically, real estate, personal guarantees, and liquid assets are normally associated with collateral ratios that start at a minimum of 75%. Lower collateral is required on inventory and partially on equipment and vehicles. Nevertheless, a loan may ask for a blending of different collateral types and also different haircut levels, thus making the overall collateralisation more stringent for these latter categories.

[25] Result derived from the 2012 BEEPS

From the banks' point of view, the main limiting factor in complying with collateral requirements derives from the shortage of assets owned by SMEs. 80% of respondents see this lack of resources as a moderate to very significant issue (Figure 5.11). The legal framework surrounding legal registration of assets or security rights does not appear to be as troublesome for SMEs in Georgia.

Figure 5.11: Beneficiaries' constraints in complying with collateral

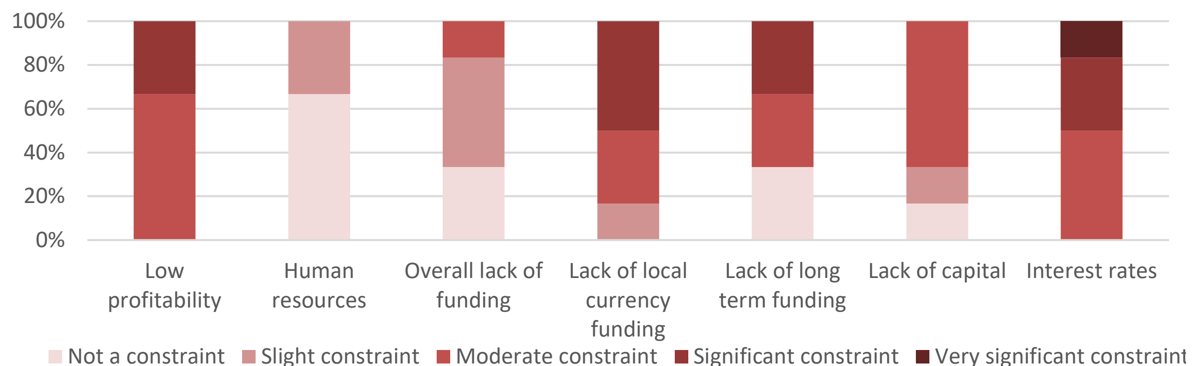


Source: 2018 EIB Bank Lending Survey

Note: (i) Survey question – The ability of final beneficiaries to put up collateral is constrained by the following? (ii) Possible answers – Not a constraint; Slight constraint; Moderate constraint; Significant constraint; Very significant constraint.

Bank-related issues: the most prevalent bank-related issues that hamper access to credit for SMEs are: high market funding interest rates; low profitability; lack of local currency funding; lack of long-term funding (Figure 5.12). Specifically, market rates have been decreasing but mainly on short-term funding, thus still leaving the need to further compress the back end of the curve to better support the financing of medium- to long-term assets. This also couples with an overall lack of long-term funding both in local and foreign currency. Low (or decreasing) profitability affects all banks but it is more evident in smaller-sized banks, which are more sensitive to international markets' volatility and local competition.

Figure 5.12 Bank-Specific Factors Limiting SMEs' Access to Credit



Source: 2018 EIB Bank Lending Survey

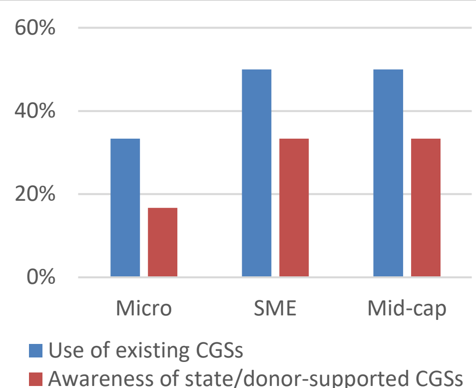
Note: (i) Survey question – Which of the following are acting as a constraint on the demand/supply for credit? (ii) Possible answers – Not a constraint; Slight constraint; Moderate constraint; Significant constraint; Very significant constraint.

Banks also point to technical assistance (TA) needs. Advisory activity related to business planning and reporting standards would support further expansion of the SMEs segment and also assist in securing financing. In addition the EIB Bank Lending Survey points to significant TA needs to meet Basel III regulatory requirements and IFRS9 standards as well as improve lending technology. The latter also includes the need to shift to new lending platforms and cloud-based lending approaches. Last but importantly, meeting higher regulatory requirements seems to be the most prominent need for the largest players in the market.

5.4 Credit Guarantee Schemes

Credit guarantee schemes (CGSs) are an instrument to alleviate the credit constraints faced by SMEs. Carefully designed guarantee products have the potential to efficiently alleviate financing constraints. In a nutshell, financial institutions can be reluctant to extend credit to SMEs, even at high interest rates. This reluctance is in part due to the high costs of obtaining adequate information on the credit quality of companies and/or the adequate collateral. As a result, SMEs with economically viable projects may not obtain the necessary financing via the regular system of financial intermediation.

Figure 5.13: Use/awareness of Credit Guarantee Schemes – positive responses as % of total – by firm size



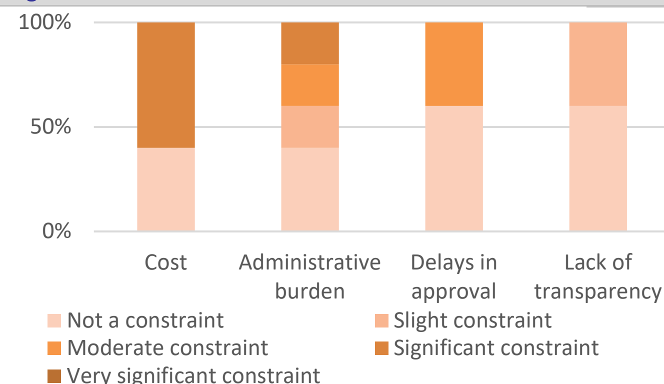
Source: 2018 EIB Bank Lending Survey
Note: (i) Survey question – Does your bank make use of an existing credit guarantee scheme? Are you aware of state/donor-supported guarantee schemes? (ii) Possible answers – Yes/No.

CGSs can help close the financing gap when the provided collateral is not sufficient. CGSs substitute the collateral provided by a borrower with credit protection provided by an external guarantor. While CGSs do not alleviate information asymmetries directly, and hence do not address the root of the market failure, they can increase the incentives of lenders to supply credit to SMEs by providing a substitute for collateral. Moreover, CGSs can also enhance risk transfer and risk diversification, thus generating more capital headroom at equal lending volume than a plain vanilla loan not backed by CGSs. Section 5.3 has shown that both collateral availability and collateral requirements have been essentially limited or constrained credit extensions. Therefore, CGSs seem to be an appropriate product to be deployed on the market.

CGSs are not widely utilised, present or known in Georgia. The EIB Bank Lending Survey detects that banks in Georgia do not widely utilise CGSs as a financing scheme. Moreover, the awareness of state and donor schemes is also rather low in Georgia (Figure 5.13). On the other hand, some state programmes providing a form of partial guarantee exist, e.g. Produce Georgia, Preferential Agri Credit and the Credit Guarantee Scheme newly introduced in 2019 under the umbrella of the Minister of Economy.

Some factors seem to be constraining the use of CGSs in Georgia. The EIB Bank Lending Survey detects that the cost of CGSs is seen by 60% of banks as a significant impediment to the development of this alternative financial instrument. Administrative burdens are also perceived to be a relevant impediment to the development of CGSs. On the other hand, the regulatory framework does not seem to be the main factor hampering its development. 60% of banks find no issue in the timing of the approval or the transparency of the process (Figure 5.14).

Figure 5.14: Constraints to the use of Credit Guarantee Schemes



Source: 2018 EIB Bank Lending Survey
Note: (i) Survey question – Which of the following factors constrain your use of credit guarantee schemes? (ii) Possible answers – Not a constraint; Slight constraint; Moderate constraint; Significant constraint; Very significant constraint.

6. Challenges and Opportunities

Challenges and opportunities co-exist in the SME financing space. A certain level of loan rejections and credit constrained firms persist in the Georgian market. According to the EIB Bank Lending Survey, the reasons for rejecting applications can be grouped into four categories: lack of eligible collateral, lack of credit history, unmeasurable risks and poor business plans. These elements pose a challenge to the development of a sustainable private sector and the strengthening of the SME segment. On the other hand, Georgia has a favourable business environment to accompany the development of the private sector and SMEs. Overcoming barriers in financing offers a real opportunity for the development of SMEs. Therefore, support to the private sector and SMEs is very much needed in Georgia, where SMEs dominate the enterprise landscape in the country. For example, SMEs accounted for 99.7% of all firms in 2017 and for 53% of turnover, 62% of value added and 62% of the total number of employees in the business sector.

Over the past ten years Georgia has progressed in improving its business environment, reaching 6th place in the WB Doing Business Report 2019. This reflects the authorities' efforts to remove the *de jure* administrative barriers and improve the regulatory environment. At the same time, the World Economic Forum's Global Competitiveness sub-index accounting for the Development of Financial Markets places Georgia in 63rd position. This gives a first insight into the difficulties faced by firms in accessing credit and finance. Some of the difficulties are reflected in the insufficient availability of alternative sources of financing – e.g. venture capital and equity markets. These are particularly important for young and small-sized firms as they do not have extensive credit history availability and, most importantly, collateral.

Georgia's authorities recognise the role of the private sector in economic development. Specifically, SME-driven policies have been prioritised in recent years. The Ministry of Economy and Sustainable Development leads the implementation of reforms supporting the business environment and entrepreneurship. Three initiatives stand out: the Georgian Innovation and Technology Agency (GITA), Produce in Georgia, and Enterprise Georgia.

Several factors have limited credit developments. Demand-related issues are largely linked to the turbulent macroeconomic conditions recorded in 2018 globally and also at the domestic level. The supply-related issues mainly concern interest rates associated to the loans handed out, the collateral requirement framework applied by banks and the assessed profitability of the projects proposed. Moreover, banks also report high market interest rates, the lack of local currency funding and of long-term funding as bank-related issues limit the capability to extend credit to SMEs.

SMEs have better access to short-term working capital loans than long-term investment finance. Long-term maturity loans (in FX and LC) are still a minor component of the overall loan portfolio. This results from commercial banks' own funding structure and has direct repercussions on the loans that are available to SMEs to finance medium to long-term assets. This constrains not the access to finance per se, but the capability of matching the obtained finance with the average life of the financed projects, thus constraining SMEs' expansionary/growth plans. All in all, SMEs' financing needs are still unmet and SMEs still rely heavily on internal funds and retained earnings.

Utilisation of instruments other than credit is limited. Banks are the main source of external funding to SMEs. Banks accounted for 93% of the financial sector. Microfinance organisations are the second-largest segment within the financial sector with a 4.1% share, followed by insurance companies (1.6%) and pawnshops (1.3%). In terms of products, loans (or associated products) made up a very large share

of the SMEs' external finance envelope. Private equity and venture capital are practically non-existent. Securing early-stage financing represents a severe problem.

Credit guarantee schemes (CGS) are not a widely used product in the market due to still limited availability. Only the largest players in the banking sector seem to be aware, and partially utilise, the few available CGS schemes. The regulatory framework does not seem to be the main factor hampering their development. 60% of banks find no issue in the timing of the approval or the transparency of the process. However, the cost of this financial product and partially the administrative burden are seen by 60% of banks as a significant impediment to the development of this financial instrument, limiting the depth and size of their market.

The two-tier banking market highlights diverging needs across banks. All banks are in need of long-term funding in FX and LC as well as local currency at any maturity. Nevertheless the two largest banks have well-developed business models already outreaching several segments of the market and stretching across a relatively wide spectrum of financing and funding instruments. Therefore, in addition to more traditional direct financial support, these banks also need support in the development of alternative products such as capital market-based funding. On the other hand, smaller banks still need to develop and solidify their banking business model. They still need to increase their outreach potential in terms of number of SMEs, economic sectors served and geographical presence. Therefore, these banks primarily need funding to increase their capabilities to reach out to SMEs. Ultimately, this will help increase the number of SMEs served in the country.

Trade finance has gained a more relevant role, in particular for SMEs. All the respondent banks are providers or users of this alternative source of financing. It is described as widely available. Nevertheless, according to the EIB's Bank Lending Survey, the limited financial literacy of firms remains a pressing issue constraining demand for trade finance-related products.

SMEs and banks consider collateral requirements to be a constraining element. 95% of all loans to SMEs in Georgia are collateralised. Moreover, a considerable share of loans requires usually more than 100% collateral. The inability to comply with collateral requirements is still identified as a moderate to significant constraint by all the respondents. 80% of the respondent banks see the shortage of assets owned by SMEs as a moderate to very significant issue. On the other hand, the legal framework surrounding legal registration of assets or security rights does not appear to be as troublesome for SMEs in Georgia.

Funding constraints vary across banks. Banks generally have good access to foreign currency funding both from domestic and external sources; however, the local deposit base is a constraint on lending in local currency. Among the bank-specific factors constraining credit growth, the most severe is the lack of local currency funding. As a result, about 75% of SME loans are in foreign currency, mostly in US dollars.

Lack of innovation and the need for infrastructural upgrades is another issue. The SME sector is a large employer. However its production share in the total economy is relatively low. Capacity and quality upgrading both in exporting and non-exporting SMEs would enable firms to get more benefit from DCFTA opportunities.

Technical assistance is of high importance for the development of the financial sector. Advisory activity related to business planning and reporting standards would support further expansion of the SME segment and also assist in securing financing. In addition, the EIB Bank Lending Survey points to significant TA needs to meet Basel III regulatory requirements, IFRS9 standards and to improve lending technology.

Annexes

A. Prudential Ratios for Banks

Ratio	Criteria
Regulatory Capital (in GEL)	≥ 50 million
Capital Adequacy Ratio (% of risk-weighted exposures)	
Common Equity Tier 1	4.5%
Total Tier 1	6%
Total Regulatory Capital	8%
Credit risk concentration (as a % of supervisory capital)	
Lending to insiders	
Individual	≤ 5%
Aggregate	≤ 25%
Lending to non-insiders	
Single borrower	≤15%
Group of interrelated borrowers	≤ 25%
Large loans	≤ 200%
Unsecured loans (as a % of loan portfolio)	≤ 25%
Liquidity	
Liquid assets (% short-term liabilities)	≥ 30 %
Liquidity coverage ratio (high-quality liquid assets as a % of total net cash outflows)	
LC	≥ 100%
FC	≥ 75%
Total open foreign currency position (as a % of regulatory capital)	≤ 20%
Systemic Risk Buffers for systemically important banks by 2021	
TBC Bank	2.5%
Bank of Georgia	2.5%
Liberty Bank	1.5%
Leverage Ratio (Tier 1 capital as a % of total exposures)	≥ 5%
Reserve Requirements (% of the unpaid portion of the loan)	
General provision	2%
Watch loans	10%
Sub-standard	30%
Doubtful	50%
Loss	100%

B. Key Banking Regulations

Category	Brief Description
Financial reporting standards	Under the Law on Activities of Commercial Banks, banks are required to publish consolidated IFRS statements, including quarterly and annual Pillar 3 reports in accordance with "Decree No 92/04 of the Governor of the National Bank of Georgia on approving the Regulation on Disclosure Requirements for Commercial Banks within Pillar 3", in addition to quarterly bank-only accounts as per NBG standards.
Corporate governance standards	The Law on Activities of Commercial Banks (Articles 13 to 16) lays out corporate governance standards, such as the general meeting of shareholders, supervisory board, directorate and audit committee.
Ownership restrictions	The Law on Activities of Commercial Banks (Article 10) places some restrictions on ownership, such as limits on the percentage of shares held without NBG approval.
Capital adequacy standards	Currently banks are compliant with Decree N100/04 of 28 October 2013 of the Governor of NBG on approving "The Regulation on Capital Adequacy Requirements for Commercial Banks".
Minimum capital requirements	The 3 May 2017 Decree N61/04 of the President of the National Bank of Georgia on "Defining Minimum Regulatory Capital Requirement for Commercial Banks" sets the minimum amount of regulatory capital at GEL 50 million for banks seeking a licence while those licensed before the decree shall update theirs to the referred amount by 31 December 2018.
Definition of NPL	The August 2017 Decree on approving the Regulation on Assets Classification and the Creation and Use of Reserves for Losses by Commercial Banks defines non-performing loans (NPL) as the sum of loans classified by the bank as watch, sub-standard, doubtful, and loss. The definitions are based on quantitative and qualitative criteria such as collateral coverage, borrower capitalisation, and risk-based judgment of the bank or NBG. As for the quantitative criteria, a loan is classified as "watch" as soon as it falls into arrears; however, the terms "overdue" or "past due" are reserved for loans in arrears for more than 30 days. The other NPL categories relate to this definition of

	"past due", i.e. the number of days indicated as a quantitative classification trigger needs to be added on top of the first 30 days past due. A partially secured or unsecured loan is classified as "sub-standard" after 30 days; "doubtful" after 90 days; and "loss" after more than 150 days. Fully secured loans have an additional 30 days before being classified as "sub-standard" or "doubtful". Many loans are classified as non-performing even without overdue days due to other financial and non-financial factors affecting their credit quality. However, all loans overdue by more than 90 days must be classified as non-performing.
Loan classification, provisioning policy and reserve requirements	The Regulation on Assets Classification and the Creation and Use of Reserves for Losses by Commercial Banks (August 2017) lays out loan classification standards.
Related party transactions	The 10 March 2015 Decree N 26/04 of the Governor of the National Bank of Georgia on approving the Regulation on the Management of Conflicts of Interest defines NBG's supervision and control of transactions.

C. Bank Lending Survey – Questionnaire Overview

Section	Overview
Background information	General information on banks' assets and ownership.
Firm size definition	Thresholds defined by each bank to classify enterprises as micro, small, medium-sized or large.
Lending activity	Products offered by banks, their portfolios, currencies, maturities and sector distribution.
Credit standards and terms	Recent developments in assessing credit applications and factors leading to loan rejections.
Credit bureaux	Availability and usage of credit bureaux.
Funding and funding conditions	Availability and recent developments in accessing different sources of funding.
Asset quality	NPL definitions and distribution.
Foreign exchange exposure and management	Foreign exchange position and foreign currency hedging.
Business plan	Evolution of loan portfolios, availability of products and planned launches.
Market situation and constraints on growth	Availability of financial instruments, their respective currencies and maturities, factors constraining the demand/supply of credit to the economy and collateral requirements.

Competition	Main competitors present in the market for lending to enterprises.
Technical assistance	Analysis of TA needs of banks.
Trade finance	Factors constraining the provision of alternative instruments, such as trade finance.
Guarantees	Use and constraints of credit guarantee schemes.
Note: The majority of information provided by banks is split by enterprise size. *For the 2018 BLS round in Georgia, four new sections and additional sub-questions were included when compared to the previous edition.*	

D. Selected References from National/International Institutions

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ECONOMICS – REGIONAL STUDIES

Financing in Georgia:
Small and medium enterprises and the private sector

Economics Department
economics@eib.org
www.eib.org/economics

European Investment Bank
98-100, boulevard Konrad Adenauer
L-2950 Luxembourg
+352 4379-22000
www.eib.org – info@eib.org

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