I-1.37: The supervisory mechanism of the Georgian financial sector: a pattern for developing countries?

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Translated Article PDF

The Georgian financial sector emerged from the global financial crisis and the domestic economic downturn in substantially good condition[1], and therefore, in the current economic context, deserves to attract a growing worldwide interest.

Indeed, after the tragic events of the year 2008, characterized both by an international financial turmoil and an armed conflict in August 2008 between Georgia on one side, and Russia and separatist governments of South Ossetia and Abkhazia on the other, the national economy of this small post-communist country experienced a period of substantial difficulties. Ever since then, the Government's successful management of the crisis has led to the stabilization of the political and economic situation, and is definitely considered as a very important stage in Georgia's economic recovery.

Today, the country, whose name stems from the famous knight of Saint George, has much more to offer than an awesome landscape to tourists. Among a wide range of investment opportunities, the relative soundness of the national financial environment could attract significant foreign investment in the near future. For instance, although the Georgian banking sector had suffered high losses of 65 million dollars during the year 2009, it finally returned to profitability in 2010 with a net profit of more than 156 million dollars[2]. Such a fast recovery would not have been possible without an efficient regulatory framework and a financial supervisory system preventing subject entities from failure. Furthermore, regarding its performances in tough times, it should be noted that the Georgian financial sector supervised by the central bank of Georgia – the National Bank of Georgia – might be considered as an example of efficiency for developing countries all over the world.

1. **The main strength of the Georgian financial sector: a unified supervision pattern provided by an independent national central bank**

In charge of oversight of the whole national financial sector since December 1st 2009, the National Bank of Georgia is the legal successor of the former Georgian Financial Supervision Agency[3]. As a result, the National Bank of Georgia is allowed to issue and revoke licenses for undertaking banking, insurance and securities market activities[4], as well as to ensure the soundness of the entire financial sector. Established in 1919, the National Bank of Georgia has become a very powerful institution within the Georgian financial landscape, especially since the reform of December 2009. The effectiveness of all its powers ensues from its independence from the government. In fact, Article 95.3 of the Constitution of Georgia expressly guarantees the independence of the Central Bank[5]. However, as any democracy, Georgia could not accept that one of its major public institutions totally escapes from any accountability. This is why Article article 96.3 of the Constitution of Georgia clearly states that "*the National Bank shall be held accountable to the Parliament and submit a report on its activities on an annual basis*". In addition, being the Georgian national financial supervisory authority, the Central Bank provides an efficient supervision model based on a consolidation of both the macroeconomic and microeconomic aspects of financial stability under the auspices of one organization. Indeed, when carrying out all on- and off-site surveillance of the safety and compliance of individual institutions, the National Bank of Georgia gathers micro-prudential data. As a matter of fact, the micro-prudential supervision particularly aims to protect depositors, insured persons and investors. On the other hand, as far as the implementation of macro-prudential analysis is concerned, this mission is traditionally assigned to central banks and encompasses the monitoring of the exposure to systemic risk representing a potential but actual threat to financial stability. Such a thorough knowledge of the national economic environment could not be provided by any other institution than a central bank. As stated above, being in charge of the supervision of the three sectors composing the financial industry – banking, insurance and securities- the National Bank of Georgia would be able, in case of an emergency and thanks to the consolidation of these two aspects, to intervene in the economy by playing its role as the lender of last-resort in the fastest manner possible. For those reasons, a financial supervisory system grounded on the preeminence of the central bank shall definitely be considered as the most efficient one, because such an institution is the only one which has at its disposal all the relevant economic information required in order to ensure domestic financial stability.

2. **The implementation of the supervisory mechanism by the National Bank of Georgia: an efficient range of tools to maintain the financial stability**

As far as the supervision of the national financial sector is concerned, Article 47 of the "Organic Law of Georgia on the National Bank of Georgia" states that the central bank has "*to support financial sustainability and transparency of the financial sector, protect customers' and investor's rights*". Therefore, in order to implement its supervisory mechanism, the National Bank of Georgia "*shall be authorized to issue relevant decrees, orders, effectuate relevant measures and impose relevant sanctions*"[6]. Such regulatory powers allow the central bank to act as an efficient supervisory authority able to make financial regulations and take disciplinary action against any supervised entity found guilty of breaking industry rules. So to say, the National Bank of Georgia possesses a broad range of regulatory instruments for ensuring the compliance of banks, insurance companies and financial market players with applicable laws and regulations. Indeed, according to Article 7 of the Georgian regulation related to the supervision of commercial banks[7], "*in case of violation of prudential standards and limits set […], the National Bank of Georgia shall have the right to use […] measures and sanctions*". The said measures and sanctions aim at ensuring the compliance of supervised entities with the regulations in force and mainly consist in fines. Nevertheless, in some extreme cases, the National Bank of Georgia can also decide to revoke the administrative license of any supervised operator. Such a sanction is equivalent to the death penalty for financial institutions, which are thereby automatically doomed to disappear following compulsory liquidation. Even though the National Bank of Georgia has the power to sanction financial entities, the latter are able to defend themselves by appealing any decision which they feel is unfounded[8]. In this way, the whole Georgian financial supervisory mechanism appears to be grounded on a democratic basis providing legal security to all operators of a domestic financial sector which is still narrow. In fact, as regards the composition of the Georgian financial sector, it should be noted that the banking sector is composed of only 19 commercial banks[9], of which 17 are resident banks and the remaining 2 are branch establishments of non-resident banks. Concerning the Georgian non-banking financial sector, it consists of 17 credit unions, 39 microfinance organizations (MFOs), 1 stock exchange, 16 insurance companies and 6 non-government funds[10].

A few words to conclude…

The financial sector in Georgia appears to have emerged from the global crisis as well as the war almost unscarred. However, needless to say that the efficiency of the current national supervisory system is definitely due to all the efforts that the government has devoted to the management of the domestic economic turmoil. As a result, a tide of reform has led to a remarkably rapid recovery of the national economy as well as the attractiveness of the Georgian business environment. For all those reasons, Georgia can be proud of itself, not only because it has managed to sort out huge economic problems on its own, but also because it could represent a potential model to follow for emerging countries in the near future, in particular for Africa[11].

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[1] National Bank of Georgia, Financial Stability Report 2010, p. 5.

[2] See the Ministry of foreign affairs of Georgia website (http://www.mfa.gov.ge/index.php?lang_id=ENG&sec_id=648).

[3] Article 70 of the "Organic Law of Georgia on the National Bank of Georgia" entered into force on September 24th 2009.

[4] Chapter VIII of the "Organic Law of Georgia on the National Bank of Georgia" entered into force on September 24th 2009.

[5] The article 95.3 of the Constitution of Georgia states: "*The National Bank shall be independant in its activities. Its rights and obligations, procedures of activities, as well as guarantee of its independance shall be determinated under the organic law*."

[6] Article 48.3 of the "Organic Law of Georgia on the National Bank of Georgia" entered into force on September 24th 2009.

[7] The "Regulation on Supervision and Regulation of the Activities of Commercial Banks" adopted on April 10th 2001.

[8] Article 8 of the "Regulation on Supervision and Regulation of the Activities of Commercial Banks" adopted on April 10th 2001.

[9] National Bank of Georgia, Annual Report 2010, p. 58.

[10] National Bank of Georgia, Financial Stability Report 2010, p. 35.

[11] The Brenthurst Foundation, Strenghening Africa's economic performance, "Economic reforms in Georgia: their relevance for Africa?", Discussion paper, Gia Jandieri, September 1st 2009.