Regulation on Capital Adequacy Requirements for Commercial Banks

Approved
under Decree # 237 September 17, 2002
of the President of the National Bank of Georgia

Amended by:
Decree #298 December 23, 2003
of the President of the National Bank of Georgia


1. One of the main tasks of the National bank of Georgia (thereafter referred to as NBG) shall be to ensure liquidity and solvency of the country’s financial and credit systems, as well as stable and market-based functioning of these systems for which the NBG shall provide supervision of the banking activities.

2. The purpose of the supervision of the banking activities shall be to ensure the stable functioning of the banking system by fostering soundness and sustainability of commercial banks and foreign branches operating in Georgia (thereafter referred to as the banks), minimization of the probability of creating the system crises in the banking sector and thus maximally protecting the best interests of depositors and other creditors, as well as the competition principles in the banking system, and the institutional interests of NBG.

3. For the purpose of supervising the banking activities, the NBG shall regulate these activities by setting various prudential standards and limits and monitoring each bank’s compliance with those standards.

4. The cornerstone of the supervision of the banking activities shall be the identification of the capital adequacy requirements for the banks and monitoring their compliance with the requirements.

5. All banks and foreign branches operating in Georgia shall comply with the capital adequacy requirements stipulated by this Regulation.

Article 2. Definitions of Terms

For purposes of this Regulation, the following terms shall have the following meanings:

1. “Minimum Regulatory Capital” – a minimum amount of the regulatory capital defined and calculated in accordance with this Regulation and set by NBG.

2. “General Reserves” – unidentified loss reserve created on anticipated losses on loans and accrued interests receivables on loans, without their classification.

3. “Special Reserves” – specific identified loss reserves created on anticipated losses on loans and accrued interests receivables on loans.
4. “Preferred Shares” - non-voting shares, which are entitled to dividends, set by contract and/or relevant stocks prospectus (if the latter is available) and which must be fully paid in liquidation before any common shares are paid.

5. “Perpetual Preferred Shares” - preferred shares, which do not state maturity dates and which cannot be redeemed at the option of their holders.

6. “Non-Cumulative Perpetual Preferred Shares” – perpetual preferred shares, on which the dividends undistributed by the bank in previous years, are not accumulated.

7. “The Debt Convertible in Shares”- loans and/or debt securities, which are converted in the preferred or common shares of the bank for the maturity date provided in the agreement.

8. “Subordinated Debt” – an unsecured debt, which, by contract is not a deposit, and has a lower priority of payment as compared with other debts and deposits; in case of grave financial condition, bankruptcy or liquidation, the subordinated debt creditor will only be satisfied after the full satisfaction of all depositors and other creditors.

9. “Intangible Assets” – assets without physical substance, having a definite value, such as patents, lease rights, trademarks, know-how, goodwill and other objects of intellectual property.

10. OECD - Organization for Economic Co-operation and Development with the following member countries: Australia, Austria, New Zealand, USA, Belgium, Germany, Denmark, UK, Spain, Japan, Ireland, Island, Italy, Canada, Luxembourg, The Netherlands, Norway, Portugal, Greece, France, Finland, Sweden, Switzerland.


**Article 3. Capital Adequacy**

1. The bank capital shall be the means to ensure the implementation, reliability and sustainability of the banking activities, and the main source to cover the bank’s financial losses and damages.

2. The primary function of the Capital shall be:
   a) To ensure a maximum protection of funds of depositors and other creditors, minimize the chances of negative outcomes of the banking activities in the banking system, prevent the possible systemic bankruptcy caused by the bank’s financial losses and failure and its affects on other banks and minimize the overall bank crises;

   b) To ensure implementation of banking activities, expand the scope of banking operations both in the current period and for future, and permit to neutralize the banks anticipated and unanticipated operating losses.
3. Capital adequacy shall be the essential element to assess a bank's financial condition, solvency, sustainability and reliability, which should comply with the essence and goals of the bank's capital.

4. Capital adequacy of a bank shall be assessed based on various capital ratios and the minimum regulatory capital of the bank.

5. Various ratios for assessing the capital adequacy - Tier I capital ratio and the regulatory capital ratio.

6. Tier I Capital ratio – a bank’s Tier I capital to Risk Weighted Assets according to which the bank’s Tier 1 capital should be no less than 8% of the risk weighted assets.

7. Regulatory Capital Ratio – a bank’s Regulatory Capital to Risk Weighted Assets according to which the bank’s regulatory capital should be no less than 12% of the risk weighted assets.

8. The minimum amount of Regulatory Capital for the banks operated in Georgia shall be set by the normative act of the National Bank of Georgia.

**Article 4. Regulatory Capital and its Structure**

1. The capital adequacy of a bank shall be determined based on the basis of a bank’s Regulatory Capital. None of its components, or their part shall be a subject of an agreement, contract or a promise that contradict the stability and sustainability of a bank.

2. Regulatory Capital is the type of capital created for implementation of banking activities, neutralizing anticipated and unanticipated financial losses/damages and protecting against various risks.

3. A bank’s Regulatory Capital shall consist of Tier 1 and Tier 2 Capital and equal the sum of Tier 1 and Tier 2 Capital less deductions.

4. The calculation of the Regulatory Capital shall include the amount of its components, except Tier I Capital and Regulatory Capital elements subject to deductions, which shall be taken at their net value.

5. A bank’s Tier I Capital shall be the primary source of the regulatory capital and shall equal the sum of Tier I Capital components less deductions.

6. Tier I Capital shall consist of the following elements:

a) Common shares less callable shares;

b) Non-cumulative perpetual preferred shares less callable shares;

c) Share premium;

d) Reserve funds created by appropriations from previous years’ retained earnings, owned by the bank, which can be applied in case of incurred losses;

e) Retained earnings (loss) of the previous years.
7. Tier I Capital deductions shall consist of the following components:
   a) The amount transferred from fixed assets’ revaluation reserves and reflected in the bank’s paid-in capital;
   b) Intangible assets.

8. “Tier II capital shall be the supplementary source of the regulatory capital and consist of the following elements:
   a) Net income (loss) for the current year;
   b) Special funds;
   c) General reserves, limited to a maximum of 1.25% of the bank’s credit and market risk-weighted assets;
   d) Preferred shares less callable shares, except non-cumulative perpetual preferred shares reflected in Tier I Capital;
   e) The debt convertible in shares, if it complies with the concept of the subordinated debt and if its modification or cancellation is allowed only by NBG prior written approval based on the terms provided in the debt agreement;
   f) Subordinated debt received at least for 5 years and at a reduction rate of 20% for each year during its last five years, if received without any security only by the NBG prior written approval based on the terms provided in the debt agreement.

9. Deductions of the Regulatory Capital shall consist of the following elements:
   a) Investments in the capital of the resident banks;
   b) Unconsolidated investments in the capital of subsidiaries.

10. Tier I Capital shall be no less than 50% of the regulatory capital.

11. If, due to the requirements of this Regulation, the amount of Subordinated Debt(s) is more than 50% of a bank’s Tier I Capital, only the amount equivalent of 50% of the Tier 1 Capital shall be used in the calculation of the Tier 1 Capital.

12. Tier II Capital is more than 100% of Tier I Capital, only the amount equivalent of 100% of Tier I Capital shall be used in the calculation of Tier 2 Capital.

**Article 5. Risk Weighted Assets**

1. Risk weighted assets shall be applied to define the capital adequacy, which includes credit- and market risks weighted assets.

2. Credit Risk shall be a risk caused by the bankruptcy or failure of a counterpart to discharge the obligation.
3. Market Risk shall be a risk of change in value in bank assets caused by the market price fluctuation.

4. Risk weighted assets shall be the sum of the credit risk weighted assets and market risk weighted assets less the portion of general reserves, which is not included in Tier 2 Capital, and of special reserves.

Article 6. Credit Risk Weighted Assets

1. The risk-weighted assets shall be divided into four categories, with following ratios on each category:

   a) Category I assets – 0% Credit risk – risk ratio 0;
   b) Category II assets - 20% Credit risk – risk ratio 0.2;
   c) Category III assets – 50% Credit risk – risk ratio 0.5;
   d) Category IV assets – 100% Credit risk – risk ratio 1.0.

2. The assets, subject to Tier I and Regulatory Capital deductions shall not be part of risk weighted asset calculation.

3. Credit risk-weighted assets shall be calculated based on the net value of assets, other than loans and accrued interest receivable on loans, which shall be calculated based on their gross value.

4. Category I assets – with 0% Credit Risk.

Cash in GEL and in currencies of OECD countries;

   a) Balances on correspondent and minimal reserve accounts in the NBG;
   b) Claims and/or their portions directly and unconditionally guaranteed by the NBG;
   c) Claims and/or their portions directly and unconditionally guaranteed by the central governments and/or central banks of OECD countries;
   d) Claims and/or their portions secured by debt securities issued and guaranteed by the central government and/or central banks of the OECD countries;
   e) Claims and/or their portions secured by deposits pledged in the same bank.

5. Category II assets - with 20% Credit Risk.

   a) Amount of the cash equivalent instruments both in the form of GEL and in currencies of OECD countries;
   b) Long and short term claims and/or their portions, guaranteed by the resident banks of OECD countries;
c) Claims evidenced by treasury bills issued by the Ministry of Finance of Georgia;

d) Claims and/or their portions guaranteed by treasury bills issued by the Ministry of Finance of Georgia;

e) Claims and/or their portions guaranteed by International Financial Institutions;

f) Claims and/or their portions secured by the deposits in the resident banks of the OECD countries;

g) Claims and/or their portions indirectly guaranteed by the securities of the central government and or the central banks of the OECD countries, which in compliance of this Regulation are not classified as the 0% risk weighted assets category;

h) Gold and other precious metals bullion, which meet international standards;

i) Claims and/or their portions guaranteed by the gold and other precious metals bullion, which meet international standards.

6. Category III assets – with 50% Credit Risk

a) Cash and cash equivalent instruments denominated in currencies of non-OECD countries;

b) Long and short term claims and/or portions of claims guaranteed by resident banks of Georgia;

c) Short term claims and/or their portions guaranteed by the resident banks of non-OECD countries;

d) Claims and/or their portions directly and unconditionally guaranteed by the Ministry of Finance (or any other State Agency considered under the legislation);

e) Claims and/or their portions secured by debt securities issued and guaranteed by the Ministry of Finance of Georgia (or any other State Agency considered under the legislation);

f) Claims and/or their portions directly and unconditionally guaranteed by the local governments (municipalities) of Georgia and the OECD countries;

g) Claims and/or their portions guaranteed with debt securities issued by local governments (municipalities) of Georgia and OECD counties.

7. Category IV assets – with 100% Credit Risk.

a) Claims and/or their portions directly and unconditionally guaranteed by governments and/or the central banks of the non-OECD countries;

b) Claims and/or their portions guaranteed by debt securities issued by governments of the central banks of the non-OECD countries;

c) Long-term claims and/or their portions guaranteed by resident banks of non-OECD countries;
d) Corporate debt securities;

e) Investments in the capital of legal entities;

f) Gold and other precious metals bullion, which do not meet international standards;

g) Claims and/or their portions guaranteed by the gold and other precious metals bullion which do not meet international standards;

h) Fixed assets;

i) Loans, which are not reflected in the categories of assets with 0, 20 and 50% credit risk;

j) Other assets, which are not reflected in the categories of assets with 0, 20 and 50% credit risk.

8. In order to weight the credit risk of the off-balance sheet items, their amount shall be converted into the credit-equivalent amount of the balance sheet, which shall be subject to weighting the credit risk according to the same criteria as used for the assets recorded in the balance sheet.

9. For conversion of the off-balance sheet items into the credit-equivalent amount of the balance sheet, considering the credit conversion factors, shall be divided into 4 categories and each off balance sheet category shall have the corresponding credit conversion factors:

a) I category off balance sheet liabilities, 100% credit conversion factor, credit conversion ratio 1.0;

b) II category off balance sheet liabilities, 50% credit conversion factor, credit conversion ratio 0.5;

c) III category off balance sheet liabilities, 20% credit conversion factor, credit conversion ratio 0.2;

d) IV category off balance sheet liabilities, 0% credit conversion factor, credit conversion ratio 0.

10. Category I off-balance sheet liabilities with credit conversion factor of 100%:

a) Issued guarantees, bank acceptances and funding commitments of the bank, with remaining maturities not exceeding one year;

b) Contractual obligations to sell an asset with the obligation of its future redemption, with remaining maturities not exceeding one year when the credit risk is taken by the bank;

c) Contractual obligations on purchase of assets, with remaining maturities not exceeding one year.
11. Category II off-balance sheet liabilities for Credit Conversion Factor of 50% shall be the liabilities subject to 100% conversion, with remaining maturity exceeding one year.

12. Category III off-balance sheet liabilities for Credit Conversion Factor of 20% shall be documentary letters of credit secured by the goods.

13. Category IV off-balance sheet liabilities for Credit Conversion Factor of 0% shall be off-balance sheet liabilities which shall be unconditionally cancelable by the bank at any time.

14. Credit risk affects the potential loss from the operation with futures, forwards, swaps, options, and the off-balance sheet liabilities originated from other similar contracts, which are connected to interest and exchange rates, shall be subject to different credit-conversion factors.

15. Futures, forwards, swaps, options, and the off-balance sheet liabilities originated from other similar contracts, which are connected to interest and exchange rate, and the term of contract of which does not exceed 14 calendar days, shall not be subject to credit risk weighting.

16. For futures, forwards, swaps, options, and the total amount of off-balance sheet liabilities originated from other similar contracts, which are connected to interest and exchange rate, the following credit conversion factors shall apply and the credit conversion factors shall be determined based on original maturity of its fulfillment:

<table>
<thead>
<tr>
<th>Contractual Term of Payment</th>
<th>Contracts on Interests</th>
<th>Currency Exchange Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than one year</td>
<td>0.5%</td>
<td>2.0%</td>
</tr>
<tr>
<td>From one to two years</td>
<td>1.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>On every additional year</td>
<td>+1.0%</td>
<td>+3.0%</td>
</tr>
</tbody>
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17. The credit risk weighted assets shall be calculated as each balance sheet asset category multiplied by corresponding risk ratio, plus each off balance sheet categories multiplied by corresponding credit conversion factor and multiplied by balance sheet equivalent risk ratio.

**Article 7. Market Risk Weighted assets**

1. Market risk is a potential risk of loss on the off-balance sheet items, resulting from the market price volatility.

2. Market risk implies the interest, equity, foreign exchange, and commodity risks. According to this Regulation, the market risk shall be defined as the foreign exchange risk only.

3. Foreign exchange risk is the risk of the devaluation of a bank’s assets formed in foreign currency due to changes in foreign exchange rates, as this change may negatively affect the profit, capital, liquidity and solvency of the bank.

4. Banks loans, accounts receivables (debtors) and accrued interest receivables denominated in foreign currency, are subject to currency risk weighing, except:

   a) Loans and accrued interest receivables on loans and/or portion, repayment source for which is represented by funds in foreign currency receivable from
borrowers’ exports during the validity period of credit agreement and if the borrower has confirmation documents for it;

b) Loans and accrued interest receivables on loans and/or portion, secured by pledged foreign currency deposits in the same bank.

5. Loans, account receivables and accrued interest receivable, subject for foreign exchange risk weighting shall be considered with its gross value.

6. Foreign exchange risk weighted assets correspond to 100% risk categories and foreign exchange risk ratio is 1.0.

7. Market risk weighted assets shall be calculated on the basis of the gross amount of foreign exchange risk weighted assets, multiplied by the foreign exchange risk ratio.

Article 8. Obligations of Commercial banks

1. The commercial banks shall be obligated to:

   a) Adhere with requirements and limits set in this regulation;

   b) Present monthly to the NBG the reports reflecting compliance with requirements of this regulation;

   c) For the purpose of inclusion in the calculation of regulatory capital, present to the NBG the contracts on unconditionally converted debt and subordinated debt, no later than within 10 days from its signature.

2. In case of violating the capital adequacy requirements set under this Regulation, the banks shall be obligated to:

   a) Submit to the National Bank the recapitalization plan satisfactory to it and ensure fulfillment of all the requirements set by the NBG for recapitalization purposes;

   b) Ensure full compliance with the actions, sanctions and limitations set by the NBG for the bank’s capital adequacy requirements.

Article 9. Sanctions and Restrictions

1. If a bank fails to comply with the requirements of minimum Regulatory Capital, Tier I Capital or the Regulatory Capital ratios set by this Regulation, the NBG shall apply actions and sanctions envisaged by Article 59 of the Organic law “On National Bank of Georgia” and Article 30 of the Law of Georgia “On Activities of Commercial Banks.”

2. In order to timely eliminate the violations in capital adequacy of the banks, the NBG shall demand and review the recapitalization plan, set special requirements and limitations for capital reduction and for carrying out the necessary measures for capital increase.

3. The NBG shall be authorized to revoke a banking license, in case:
a) If the bank’s Tier I and regulatory capital ratios equal or are less than 3% and 5%, respectively;

b) Bank’s regulatory capital is less than 80% of minimum amount of regulatory capital set by the National Bank of Georgia;

Bank’s regulatory capital is less than minimum amount of regulatory capital set by the National Bank of Georgia and greater than 80% of minimum amount of regulatory capital for more than 3 (three).