

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for July 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: Gerald Andersen**

Prepared by

**Terry L. Stroud – Chief of Party  
Martin McCormack – Legal Advisor  
Tom Gordon – Accounting Advisor  
Kwi Lee – Accounting Advisor  
Ray Mino – Accounting Advisor**

**August 21, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to

analyze the borrower's ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of July 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- The continued development and implementation of supervisory strategies for several large problem banks;
- The implementation of the recommendations and suggestions contained in the organization and restructuring plan that was submitted to the NBG's President earlier this year will continue to be implemented.

### **Off-site Surveillance**

- Continue to develop the off-site analytical report/tool, which will be prepared from the new financial regulatory reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This is one of the outputs the FinA project will provide.

### **Legal**

- Begin the preparation of two section-by-section analysis papers each one to be entitled "Explanatory Note and Advocacy Paper", the first to support a set of NBG proposed amendments to the "National Bank Law"; the second to support a different set of NBG proposed amendments to the "Commercial Bank Law". These two analysis papers are intended to assist the NBG in its lobbying discussions and debates urging the enactment of both sets of amendments before various Parliamentary Committees throughout September.
- Effectuate the issuance of the "Regulation on Internal Audit".
- Effectuate the issuance of the "Regulation on Capital Requirements of Banks".

- Engage the visiting Missions of the IMF and the World Bank in discussions and analysis of the NBG's legislative and regulatory programs.
- Engage with the Ministry of Justice in discussions and analysis of the NBG's need for an amendment to the "Law on Licensing" to exempt the licensing and regulation of commercial banks from its coverage.
- Continue policy and legal support of NBFI development efforts working with USAID and policy experts.
- Continue work on the "Regulation on Loan Concentrations and Large Exposures".
- Continue transactional support of issues involving distressed banks and examination problems.

### **Accounting Methodology – NBG**

- ◆ AA. Gordon was assigned to Help Desk from May 1<sup>st</sup> to cover for AA Mino who is on an extended vacation for family reasons. Following AA Mino's return at beginning of July AA Gordon was requested to continue working on Help Desk because of a project decision to extend technical assistance to additional banks to ensure progress towards an IMF benchmark requiring those commercial banks making up 80% of banking sector assets to adopt international accounting practices. Another reason for continuing deployment at Help Desk was that until a proposed accounting methodology unit was staffed little progress could be made to progress accounting methodology issues. The effect of this change is that there has been slippage in the year 2001 work plan for NBG support for commercial accounting reform. Specifically, it has not been possible to further develop accounting pronouncements in addition to those that have already been delivered to NBG. The latter have not yet been approved primarily because of unresolved NBG organizational and personnel issues.
- Respond to request from NBG for assistance to recruit suitable staff for proposed accounting policy assist.
- Continue discussions with personnel from NBG, commercial banks and Ministry of Revenue regarding the development of a suitable methodology to derive taxable profits from financial statements generated from an IAS compliant accounting system.

### **Accounting Technical Assistance-Commercial Banks**

- Complete documentation of *Profile and Initial Assessment of IAS Conversion at Pilot Banks* for the new pilot bank.

- Present 2<sup>nd</sup> scheduled quarterly IAS accounting and reporting training to the commercial bank accountants.
- Complete the review of the draft Accounting Policies and Procedures for a large pilot bank and provide comments and suggestions.
- For the two remaining pilot banks, obtain copies of audit adjustments proposed by external auditors for the pilot bank's fiscal year 2000 financial statement audits. Determine if the adjustments were posted by the bank and, if not, why. Analyze the nature and scope of the proposed adjustments in light of the crossover adjustments made by the banks, if any. Audit adjustments are one of the primary tools in diagnosing a bank's progress in conversion to International Accounting Standards.
- Provide on-site direct assistance and training as needed to ensure full implementation and conversion of the new chart of accounts at the transaction level at all pilot banks. This procedure may include analytical reviews of the monthly detailed trial balances, individual transaction entries, and accrual and valuation adjustments.
- As requested and warranted, provide verbal and/or written opinions on technical inquiries from the commercial banks, NBG supervision or accounting methodology departments. Train local staff accountants on this process, including: (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference.
- During on-site inspections of the pilot banks, provide on-the-job assistance to NBG inspectors in the review of accounting related matters and development of related report comments. At the completion of the inspection fieldwork, follow up with the subject bank as needed to assist the chief accountant with reporting and accounting questions. Specific areas in which assistance will be provided will vary depending on the needs of the each bank. In addition, assistance will be provided, as warranted, to adjust the accounting and reporting deficiencies noted during the inspection
- Review the Internal Audit Manual translation to Georgian language.

### **III. Tangible Results**

#### **On-site Supervision**

- RA Stroud continued to review and monitor the progress of the current status of the on-going inspection at the large bank. The inspectors have almost completed their analysis of the loan portfolio including a review of 6 large loans in which

they had some questions on the most appropriate classification under the new regulation. Two of the loans under question were made to the Chairman of the Board and his deputy and therefore some “political” issues are involved in the classification of these loans. These issues were reviewed and discussed with the inspectors and concluded in a satisfactory manner. This bank is the third largest bank in the country and has a significant amount of foreign ownership.

- A concern regarding the actual booking of reserves (in a large bank) in which an inspection was completed last month was brought to the attention of RA Stroud. Apparently the subject bank’s management did not actually establish the reserves as identified by the NBG inspectors. This process was reviewed and discussed with RA Stroud and it was decided to send the inspectors back to the bank to analyze the reason(s) for the failure to establish the required level of reserves. RA Stroud has assisted the inspectors with this process during the month of July but the inspection will continue at least into mid August.
- In conjunction with AA Lee, RA Stroud attended a meeting with the senior manager of one of the pilot banks in the accounting program. RA Stroud’s involvement in the meeting was limited to the bank’s unresolved issues with the EBRD. There are some areas in which RA Stroud will need to coordinate with the EBRD to finally arrive at some type of closure. The primary issues are the conversion of the EBRD’s debt to equity and the possible injection of an additional \$1 million in capital into this bank.

### **Off-site Surveillance**

- RA Stroud and AA Lee met with the IT Manager who is currently working on the programming issues on the FinA system. There are still some issues that need to be worked out on the programming part of this project but it was indicated that these issues could be completed in a 2-3 week timeframe. The issue of who will employ the programmer has been decided and he will remain on the payroll of this project until the end of August. The need to retain this person is of paramount importance to this process.
- RA Stroud and AA Lee met with several people from USAID, including Geoff Minott and Roshika Singh, to discuss the status of the FinA project. USAID’s involvement in this process will be limited going forward. One of the items they will help on is whether or not the NBG has the latest version of the software program. The IT staff of the NBG seems to think there is a later version that is being used at the National Bank of Armenia. The remaining concerns involve the implementation of the off-site surveillance system, including the finalization of the regulatory reports, which will be addressed by the resident advisors in conjunction with the IT Staff of the NBG.

- All banks have presented their financial information for the 6-th period, so validation of all forms for the above mentioned period was completed. The inputting of the data was started during the month.
- Testing operations are still continuing on the data base server for checking FinA's performance. A problem arises when too many users are on the system at the same time. This problem is being addressed and will be corrected shortly.
- Translation of all the CAEL Reports for the first quarter of the year was completed.

## **Legal**

- Preparation of the two analysis papers on the NBG's proposed amendments to the "National Bank Law" and the "Commercial Bank Law" were begun and the first was completed along with an Executive Summary, both of which were distributed to counterparts after incorporating the comments of the Project Chief of Party and the IMF Resident Advisor.
- The year-old draft of the "Regulation on Internal Audit" was forwarded to the Ministry of Justice.
- The Resident Legal Advisor participated in meetings on several occasions with each member of the visiting WB and IMF Missions as follows;
- LA McCormack worked with the World Bank Corporate Governance Specialist and the Chief of Party to review and discuss the current weaknesses in bank governance in Georgia and how proposed new laws and regulations can improve the situation. She was very supportive of our efforts.
- LA McCormack worked with the World Bank Senior Attorney to review and analyze the current weaknesses in the banking legislative and regulatory framework in Georgia and how proposed new laws and regulations can improve the situation. He was very supportive of our efforts.
- LA McCormack worked with the IMF Mission Leader and the Chief of Party to plan strategies for approaches to Parliament to lobby for enactment of the NBG proposed amendments to the banking laws. She was very supportive of our legislative efforts.
- The Resident Legal Advisor met with the Deputy Director of Supervision and the Head of the NBG Legal Department to advise on approaches to the Ministry of Justice to ensure the inclusion of needed amendments to the "General Licensing Law".

- The Resident Legal Advisor attended meetings sponsored by USAID for the purpose of forming An NBF Policy Development Committee to meet regularly to shape a legislative framework for financial leasing. The Committee met on two occasions to discuss the design of an appropriate law. The Resident Advisor delegated responsibility for this task to Supervisory Counsel.
- Work continued on the “Regulation on Loan Concentrations and Large Exposures”.

### **Accounting Methodology - NBG**

- A candidate proposed to NBG for recruitment the new accounting methodology unit has accepted an offer of employment and will join NBG in mid-August.

### **Accounting Technical Assistance-Commercial Banks**

- The documentation of the *Profile and Initial Assessment of the IAS Conversion at the Pilot Banks* is completed for the new 7<sup>th</sup> pilot bank. AA Lee, ACs Tsikhelashvili and RA Stroud met with the Chairman of the Board of this pilot bank to discuss the Project team’s assessment of the bank’s state of the accounting practice. This bank was added to the pilot bank program at the request of the NBG as the bank grew substantially by acquiring assets and assuming liabilities of a failed bank. The bank’s assets doubled and deposits and customer base enlarged significantly. The key messages to the Chairman based on our initial assessment of the bank’s accounting records and discussions with many accounting and reporting personnel were:
  - 1) A need to address the valuation of the assets and liabilities acquired during the year to properly apply the business acquisition accounting. Currently the difference between the purchase price and the estimated asset value is reflected as current period losses. The amount is significant and the goodwill should be considered upon valuation of the assets acquired.
  - 2) The current general ledger accounts do not reflect IAS nor accrual accounting. The income and expenses are not in line with the related assets and liabilities. Many operating expenses fluctuate significantly from month to month while the underlying operations do not.
  - 3) There is a need to review qualification, knowledge level and training of the accounting and financial reporting department staff. There exists a lack of direction and guidance on how to apply the new accounting methodology. The inquiries and responses to our questions from the department lead us to conclude that the accounting staff including the chief accountant does not fully understand the IAS accounting principles.
  - 4) There is a critical need to review the current accounting policies and procedures.

- 5) All of the above issues have been discussed in more detail with the newly hired Deputy Director in charge of financial accounting and reporting, the bank's reporting department, accounting department and Internal Audit.
- RA Stroud attended the meeting to support the Commercial Bank project team and to follow up on certain outstanding issues from the bank's assumption of a long-term debt from the EBRD.
  - The 2<sup>nd</sup> quarterly IAS accounting and reporting training scheduled for July 2001 was rescheduled to August 14 to 16, 2001. The rescheduling was to accommodate the absence of senior management of NBG and monthly closing and reporting of the commercial banks. The topics for the scheduled training are:
    - Fixed and Intangible Assets and related Depreciation and Amortization
    - Loan Accounting
    - Frequently Asked Questions
  - AA Mino, Gordon, ACs Bjalava, Kikavidze and Tskhelashvili prepared training materials for the 2nd quarterly seminar to be given August 14, 15 and 16. The materials were amplified to cover identified frequently asked questions.
  - AA Lee and AC Tskhelashvili completed the review of the draft accounting policies and procedures for a large pilot bank. AC Tskhelashvili will deliver the comments and suggestions to the management of the bank. The review of the accounting policies and procedures is planned for September-October time frame; however, it is appropriate for this bank as the IAS conversion process is most advanced among the pilot banks. In fact, it is the bank that is initiating the drafting of the internal control and accounting policies and procedures.
  - IAS audit adjustments proposed by the external auditor have been obtained and analyzed for all pilot banks. AAs Gordon, Lee, Mino, ACs Bjalava, Kikvidze, and Tskhelashvili met with senior bank management of several pilot banks to discuss issues relating to the recording of IAS audit adjustments identified during the external audit process for the financial year 2000. In one pilot bank, the proposed adjustments have been submitted to the senior management for approval, a letter of notification/advise has been sent to the National Bank of Georgia. In another pilot bank, the management began working on the process. Yet in another bank, while the bank has not yet approved a decision, its senior management has requested the advisory team to examine the matter and report on the ramifications of making the adjustments. The advisory team is encouraging all its pilot banks to book external audit adjustments so as to bring its financial records into line with IAS requirements.
  - During the month, there was one NBG inspection performed on a pilot bank. AC Tskhelashvili was on-site at the bank at least 2-3 days per week and assisted the examiners and bank accounting personnel on accounting principles related to 1)

accrual basis of accounting treatment of prepaid expenses, 2) accounting for foreign currency options, and 3) accounting for loans recovered through repossession of collateral. She has reviewed the examiners' draft report section on the Accounting, Reporting and Internal Controls and provided comments and suggestions. She will review the final draft in English when completed.

- AAs Gordon, Lee, Mino, and the Accounting Consultants visited each pilot bank at a minimum four days and up to eight days during the month to provide on-site direct assistance. The project team also performed comparative analyses of the detailed trial balances of the pilot banks to identify potential non-compliance with IAS, questions related to accounting policies and procedures, possible weaknesses in internal controls and unusual transactions. These questions and issues are in continuous discussions with the respective bank management and accounting personnel. Our highlighting of possible issues and questions lead to the discussions of banks' current practices and assessment of the propriety under IAS requirements and recommendations to correct any non-IAS treatments. The team received many inquiries from the pilot-banks on general and detailed accounting and reporting matters. The topics addressed by the team were diverse but generally predictable.
- Based on the analysis of the banks' detail monthly trial balances, AAs briefed the local accounting consultants on the significance of the results presented in the assessment and trained in its interpretation. Using the reports, ACs Kikvidze, Kokaia, Tskhelashvili, and Bjalava identified areas of weakness at each pilot bank. ACs will discuss the merits of these issues with the pilot banks on an on-going basis.
- AA Lee and AC Bjalava introduced AA Mino to a pilot bank, which is being transferred to AA Mino for the on-site assistance. AC Bjalava will continue to be the consultant for the bank. The meeting was with the First Deputy General Director and Director of Finance. A general discussion of reiterating of the importance of IAS adjustments to the opening balances of the year 2001 general ledger. The bank's objective is to have a fewer year-end audit adjustments for 2001. During the week, AC Bjalava met with an accountant to review issues identified from the June 2001 detail balance analysis.
- AA Gordon and AC Kikvidze, during weekly visits, advised a pilot bank on matters relating to internal audit function, letter of engagement format and content normally signed by external auditors and client at the conclusion of audit contract discussions and the approach to booking post audit adjustments identified during audit process. In all of the aforementioned areas the bank is very much inexperienced and the difficulties encountered will not be resolved without the assistance and support of accounting professionals.

In the same bank we identified accounting difficulties relating to a banking activity that does not have an appropriate risk-reward relationship and is likely to be detrimental to the long-term interest of the bank unless the issues are addressed in the near term.

- AA Mino responded in writing to a letter from the Chief Accountant of the small pilot bank regarding interpretation of the tax code and the appropriate method (cash or accrual) of tax accounting. AA Mino wrote a second letter to the Chief Accountant of the same bank outlining recommendations for recognizing current income tax expense.
- AA Mino met with the Internal Auditor of a small pilot bank, who provided a draft copy of the bank's 2000 audit report. The audit opinion contained one qualification related to the bank's failure to consolidate its wholly owned leasing subsidiary. The bank claimed that, according to Georgian law, banks are prohibited from engaging in leasing transactions. Thus, consolidating this subsidiary would "be a violation of the law." A lengthy session was held with credit department employees with the aim of teaching them how to calculate the weighted average return on the bank's loan portfolios. The bank is doing a poor job of accounting for interest income and it is hoped that having this information will form a basis for improvement.
- AA Gordon met with the head of the NBG's Monetary Policy Department and delivered a letter outlining the difficulties with the application of a regulation on minimum reserve requirements. The NBG official promised to address the issue after he becomes familiar with all other related matters. Provisions in the regulation covering the computation of reserve for deposits have the unintended effect of impeding the implementation of accrual accounting in some areas. The solution to this issue requires a response from NBG.
- A review, by the accounting advisors, of a proposed Internal Audit Manual to ensure compatibility and consistency with Internal Audit Regulation and Commercial Bank Law was completed. Some work needs to be done to finalize Georgian Language version and it is planned to finish this work next month. When it is done, it is planned to issue the manual to all commercial banks once the regulation is approved, and registered, by the Ministry of Justice.
- Financial Analyst Kokaia, AC Bjalava and AC Tsikhelashvili presented, in our weekly regular session, their topics on the IAS 17, *Leases*, *Basel Committee's Core Principles for Effective Banking Supervision*, IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, respectively. These presentations include an overview of IAS requirements, current regulations, proposed regulations, and applicability to the commercial banks in Georgia. These weekly one-hour sessions are for the purpose of continued development of the local staff in the IAS and regulatory issues as well

as research, writing and presentation skills. The local professionals will also learn the use and availability of reference and technical materials. The accounting consultants and translators were pre-assigned topics in relation to which they are not sufficiently knowledgeable. These topics also reflect frequently asked questions by pilot bank personnel. Generally, each consultant will make a presentation on a topic every 4 or 5 weeks. This allows an ample time for research and preparation on his/her own time. The session is mandatory for all commercial bank team members and open to the banking supervision team and NBG accounting methodology department staff.

#### **IV. Projects in Progress and not Completed**

##### **On-site Supervision**

- ◆ On-site inspections of two of three largest banks continued this month. It is anticipated that both of these inspections will continue until the middle of August.

##### **Off-site Surveillance**

- ◆ The programming for the schedules of the uniform bank performance report will continue and it is anticipated that this process will be finished by the end of August.

##### **Legal**

- Discussion of the “Regulation on the “Capital Requirements” with the Resident Law Advisor and has been indefinitely postponed by the Supervision Department which has announced that it will wait until year-end to issue it along with the Regulations on “Credit Concentrations and Large Exposures”, “Fixed Assets Limitations”, “Liquid Asset Holdings” and “Foreign Exchange Exposure Limits”.
- Transactional assistance continues on a day-to-day basis involving distressed banks and examination problems.

##### **Accounting Methodology – NBG**

- A review of the current methodology applied to the computation of taxable profits for commercial banks has begun. While some procedures have been developed by the Ministry of Revenue to derive taxable profits from an IAS based accounting system for all enterprises the system in place does not take account of the unique activities of different industries. The effect of this is that there is dearth of guidance needed to derive taxable profits of commercial banks given increasing complexity arising from developments to tax code. The objective of current discussions is to gain an understanding of tax code related regulations and

guidance papers formulated by other projects with a view to coordinating our efforts and minimizing duplication.

## **V. Concerns/Impediments to Progress**

### **On-site Supervision**

- ◆ The problems as described last month are still persistent in the NBG's supervision department. The issues are impacting the progress in the on-site and off-site departments but the delays are more pronounced in the off-site surveillance areas. COP Stroud has discussed these concerns in great detail with the President and the Vice President of the NBG. It is anticipated that a resolution of this problem will take place soon.

### **Legal**

- Intransigence, unpredictable postponements and failures of communication continue from the NBG Supervision Department, which has led to large-scale rescheduling of regulation delivery timeframes in a revised Work Plan. This problem has been communicated and recognized at the highest levels of the NBG and at USAID.
- The lack of enthusiasm for reform and cooperation continues in the NBG Legal Department as set forth in earlier Monthly Reports. This problem has been recognized at the highest levels of the NBG and at USAID.

### **Accounting Methodology – NBG**

- NBG have not yet approved three accounting pronouncements (one regulation, two instructions) delivered to it in March 2001. The main effect of the failure to ratify the proposed documents is that commercial banks are reluctant to modify accounting practices in the absence of formal instructions from NBG. Every effort is being made to bring these issues to a conclusion. The primary reason for the delay is related to unresolved organizational and personnel issues which are still under consideration.

## **VI. Administrative Issues**

- ◆ RA Stroud and AA Lee continued to work on the process of registering Bankworld in Georgia. It is anticipated that this will be accomplished during the month of August.
- ◆ For the first 10 days of July, RA Stroud was on a special assignment in Kiev, Ukraine to help the IFC perform a due diligence on the acceptability of several banks to become a possible recipient of a credit line.

- At their request, RA Stroud met with several Washington staff of the IFC to discuss the specifics of three banks in Georgia. The IFC is currently considering expanding or increasing their involvement in a couple of the Georgian Banks and they were inquiring as to the health of three specific banks and any other information that might have a negative impact on the banking system.
- AA Lee provided the USAID Tbilisi office with a summary of suggestions and ideas on the duration, general and specific topics for a proposed training of the Georgian tax inspectors on the banking specific accounting and tax compliance issues. The summary also identified certain issues for the trainers to be cautious of in terms of differences in accounting practice and systems limitations. The communication also contain RA Stroud's offer to present the NBG's new asset classification regulation given the significance of the regulation on the accounting and tax compliance for the commercial banks in Georgia.
- Advertisements to attract interest from suitable candidates for a vacant local professional accounting position at the IAS Technical Assistance to Commercial Banks were placed on two local employment website including local ACCA office. A significant number of resumes were received but all did not satisfy the predetermined candidate profile. AC Tskhelashvili provided a list and her assessments of the students currently in the ACCA program. She contacted a several individuals for availability and interest. AA Gordon, with the assistance of accounting colleagues, conducted screening interview with nine candidates during the month.
- AA Mino had a conference with Thomas Parr, of Booz, Allen & Hamilton regarding prompt calculation and payment of payroll taxes due. The firm's local attorney was contacted and a referral to GCG Audit was obtained. Booz, Allen & Hamilton Georgia's registration documents, as well as the opinion letter on potential payroll tax liability issued by GCG law firm, were obtained and reviewed. In a second conference with Mr. Parr, tentative approval to engage the services of GCG Audit to calculate payroll taxes and penalties due was obtained. Subsequently, AA Mino met with a partner of GCG Consulting regarding the calculation of payroll taxes due on behalf of Booz, Allen & Hamilton. The partner had read the legal opinion letter obtained from GCG Law Office by BAH and was familiar with the details of our situation. He provided an engagement letter outlining terms for his firm's assistance in the calculation and payment of payroll taxes, fines and penalties due from the inception of the project through February 2000. In subsequent telephone conferences Mr. Parr confirmed that the scope of GCG's engagement should be lengthened to include the period ending March 15, 2001.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for June 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: Gerald Andersen**

Prepared by

**Terry L. Stroud – Chief of Party**  
**Martin McCormack – Legal Advisor**  
**Tom Gordon – Accounting Advisor**  
**Kwi Lee – Accounting Advisor**  
**Ray Mino – Accounting Advisor**

**July 23, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate

governance program will also be developed and implemented to ensure that the banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of June 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- The continued development and implementation of supervisory strategies for several large problem banks;
- Work with the Supervisory Staff of the NBG in helping to develop the agenda for the Regional Basle Committee in which the NBG is the host.
- The implementation of the recommendations and suggestions contained in the restructuring plan that was submitted to the NBG's President earlier this year will continue to be implemented.

### **Off-site Surveillance**

- Continue to develop the off-site analytical report/tool, which will be prepared from the new financial regulatory reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This is one of the outputs the FinA project will provide.

### **Legal**

- Complete the work of the NBG Legislative Working Group (LWG) on the drafting of the new "Organic Law" amending the "Organic Law on the National Bank of Georgia"; present the new "Organic Law" in Parliamentary Decree form to the NBG Council meeting; explain to the Council the amendments contained therein and obtain the Council's approval of the new "Organic Law".
- ◆ Complete the work of the NBG LWG on the drafting of the new "Amendment Law" amending the "Law of Georgia on Activities of Commercial Banks"; present the new "Amendment Law" in Parliamentary Decree form to the NBG

Council meeting; explain to the Council the amendments contained therein and obtain the Council's approval of the new "Amendment Law".

- Deliver the NBG final draft "Regulation on Internal Audit Requirements for Banks" to the Ministry of Justice" for comment and registration.
- Attend the 3-day conference of the "Transcaucasus and Central Asia Regional Group on Bank Supervision", held in Tbilisi under the sponsorship of the NBG Supervision Department and deliver to the conference a presentation on "Conflicts of Interest and Transactions with Related Parties".

### **Accounting Methodology – NBG**

- ◆ AA. Gordon was assigned to Help Desk from May 1<sup>st</sup> to cover for AA Mino who is on an extended leave for personal reasons. The effect of this change is that there has been slippage in the year 2001 work plan for NBG support for commercial accounting reform. Specifically, it has not been possible to further develop accounting pronouncements in addition to those that have already been delivered to NBG. The later have not yet been approved primarily because of unresolved NBG organizational and personnel issues.
- Respond to a request from NBG for assistance to recruit suitable staff for proposed accounting policy assist.
- Continue discussions with personnel from NBG, commercial banks and Ministry of Revenue regarding the development of a suitable methodology to derive taxable profits from financial statements generated from an IAS compliant accounting system.

### **Accounting Technical Assistance-Commercial Banks**

- Complete documentation of *Profile and Initial Assessment of IAS Conversion at Pilot Banks*.
- For the two remaining pilot banks, obtain copies of audit adjustments proposed by external auditors for the pilot bank's fiscal year 2000 financial statement audits. Determine if the adjustments were posted by the bank and, if not, why. Analyze the nature and scope of the proposed adjustments in light of the crossover adjustments made by the banks, if any. Audit adjustments are one of the primary tools in diagnosing a bank's progress in conversion to International Accounting Standards.
- Provide on-site direct assistance and training as needed to ensure full implementation and conversion of the new chart of accounts at the transaction level at all pilot banks. This procedure may include analytical review of the

monthly detailed trial balances, individual transaction entries, and accrual and valuation adjustments.

- As requested and warranted, provide verbal and/or written opinions on technical inquiries from the commercial banks, NBG supervision or accounting methodology departments. Train local staff accountants on this process, including: (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference.
- Working with the National Bank off-site surveillance staff and Resident Advisor, follow up on the preparation of monthly financial reports and schedules to NBG by the pilot banks. Assist pilot bank personnel in any areas of difficulty in interpreting NBG instructions.

### **III. Tangible Results**

#### **On-site Supervision**

- For three days during the month, RA Stroud attended the Transcaucasia and Central Asia Regional Basle Committee on Banking Supervision. Approximately 12 countries were represented at this three-day seminar in which selected topics were discussed. These topics included conflicts of interest and electronic banking. During the conference RA Stroud made a brief presentation on the effect of the new asset classification regulation and its impact on the banking sector in Georgia.
- RA Stroud had several discussions and meetings with AA Lee and several members of the local staff to go over the Accounting Profiles of the six pilot banks. Each report was reviewed and discussed with AA Lee and the appropriate accounting advisor. These reports are intended to demonstrate the initial assessment of each bank's accounting systems and will be updated each quarter to allow the resident advisors to monitor the progress made at each bank. The initial report will also be shared with the local staff of USAID.
- Two inspections were completed during the month of May. Both inspections were on banks of significant asset size. The inspections were performed on the largest and fifth largest banks as ranked by assets. During the month, RA Stroud spent a considerable amount of his time meeting with the inspectors to discuss the inspection report on the largest commercial bank. The inspection report required a substantial amount of editing due to the poor analytical and writing skills of the inspectors. The report in its final form is approximately 170 pages and resulted in the bank receiving a composite rating of 3. In the past, the President of the National Bank has indicated that this inspection is a priority for him personally as this is the largest bank in Georgia. He is concerned about the possible impact of this bank's problems on the remaining banking sector. The quality of the other

inspection was significantly better and did not require as much editing as the previous inspection. The overall rating for the second bank was a 2.

- On the inspections noted above, RA Stroud met with the Head of On-site Inspections to have a final review of both reports to provide his overall assessment of the work of the inspectors. One of the banks had a composite rating of 2 and the other (as noted above) was given an overall rating of 3. As stated previously, RA Stroud basically rewrote the report on the bank that received a 3 rating due to its importance in the banking system and the reasons for this was explained to the Head of the On-site Department. He was in agreement with the changes that were made. In addition, RA Stroud made several significant recommendations on the other report.
- The inspection on the 3 rated large bank noted above was discussed and reviewed with the National Bank's President and Vice President. As noted previously, this bank is the largest in the country as ranked by assets and therefore the inspection report is significant for that and several other reasons.
- RA Stroud and AA Lee met with two consultants from PriceWaterhouseCoopers (“PWC”) on a large bank in which an inspection was completed. The meeting was to talk about the substantial increase in the bank’s reserve for loan losses and some issues involving the bank’s accounting practices. The PWC consultants had not seen the inspection report even though they have been in Georgia for almost two weeks and the English version had been submitted to the bank. RA Stroud strongly urged them to obtain a copy of the inspection report from the bank so that they can become more familiar with the reasons for the increase in reserves. At the start of the meeting, the PWC consultants questioned the need for such a large increase of reserves since the beginning of the year 2001.
- During the month, RA Stroud had several meetings with the NBG’s President to discuss the following issues:
  - The recently completed inspection report on the large bank with a majority of foreign ownership;
  - The status of the off-site surveillance system and the need to ensure that progress is continuing to be made in this area;
  - The status of the capital and accounting regulation and the need to arrive at some type of conclusive action on whether these regulations are ready to be sent to the Ministry of Justice;
  - And the need to develop a strategy on how to lobby the Parliament on the new laws that have recently been approved by the NBG’s Council.
- RA Stroud and LA McCormack attended a meeting of the National Bank's Supervisory Council to answer any questions they may have had with regard to the changes recommended with regard to the Law on the National Bank and the Law on Commercial Bank Activities There were only two questions and both

were answered to their satisfaction. The President of the National Bank will sign the new drafts and they will then be forwarded to the Georgian National Parliament in the nearest future.

### **Off-site Surveillance**

- The process of inputting the financial data to the FinA software is in progress. This process is conducted through a data converter. Financial information as of April 30, 2001 has been transferred from Excel spread sheets to the FinA program for approximately 15 banks.
- During the input of the data certain problems were revealed relating to the converter itself, as well as to the program's software. The converter problems are being resolved by the staff of the NBG's IT Department and the problems regarding the software have been sent to First Irish, the group who developed the software. The latest version of the program that incorporates these changes will be received in the beginning of July.
- As a result of the problems noted above, certain representatives of the First Irish Group arrived at the NBG to bring and work on a new version of the FinA program. Previously the staff of the NBG sent the First Irish Group a listing of problems that needed to be corrected. Upon their arrival it was discovered that not all program errors and problems had been taken into consideration. The major problem concerns the speed of the program when several users are connected to the system at the same time. The program slows down considerably when several users are on line.
- As a result of the problems noted about, the programmers indicated a newer version that hopefully eliminates the problems noted above would be forthcoming in approximately 10 days.
- The translation of all April 1 CAEL reports is in progress and by the end of the month 15 reports was completely translated.

### **Legal**

- On June 6, the work of the LWG on the "Organic Law" was completed and the final draft was presented to and approved by the Council.
- On June 22, the work of the LWG on the "Amendment Law" was completed and the final draft was presented to the NBG's Council meeting and it was approved by the Council.
- On June 19, the final draft of the "Regulation on Internal Audit Requirements for Banks" was delivered to the Ministry of Justice for comment and registration.

- Resident Legal Advisor, McCormack, attended the 3- day conference of the “Transcaucasus and Central Asia Regional Group on Bank Supervision” in Tbilisi. On June 18, he delivered a presentation on “Conflicts of Interest and Transactions with Related Parties”. The presentation emphasized the duty of bank supervisors in emerging markets to be principally concerned about good bank governance for the benefit of depositors rather than about the rights of shareholders, the latter being among the principle purposes of corporate governance in more developed countries.
- On June 27, 28 and 29, after further analysis with the Chief of Party and the Accounting Advisor, the Resident Legal Advisor incorporated into the final draft of the “Regulation on Capital Requirements of Banks” some new accounting related language recommended by the Chief of Party to strengthen and clarify the draft. The draft was then discussed by the Resident Legal Advisor with the NBG Deputy Director of Supervision and thereafter by the Chief of Party and the Resident Legal Advisor with the NBG Vice-President for Supervision. This latter discussion was in the general context of the responsiveness of the Director of Supervision to draft regulations submitted to her for discussion and eventual issuance.

#### **Accounting Methodology - NBG**

- AA Gordon orchestrated the advertisement campaign, the initial applicant screening process and final interviews for invited candidates. Seventeen candidates’ submitted resumes, 7 candidates were interviewed and 3 persons proposed to NBG with a recommendation. Meetings were held with Vice President Vakhtangishvili to report developments and discuss proposed candidates. NBG made an offer of employment to the recommended applicant and a response is awaited.
- AA Gordon attended the bank supervision conference of Transcaucasia and Central Asia region regional for two days. The conference highlighted some of the accounting issues common to all CIS countries. Two specific accounting issues that causes difficulty throughout the region were subject to some debate: the application of a tax code given an IAS accounting system and the creation of loan loss reserves with or without a Central Bank regulation. Georgia is addressing the confusion with regards to the application of the tax code and has implemented an Asset Classification regulation that governs the accounting treatment for loan loss reserves.

#### **Accounting Technical Assistance-Commercial Banks**

- The documentation of the *Profile and Initial Assessment of the IAS Conversion at the Pilot Banks* was completed for all six original pilot banks. The newly added pilot bank’s assessment is in progress. These reports were based on the team’s first three months activities with the banks and were reviewed and approved by

the Accounting Advisors, Resident Advisor/Chief of Party, and USAID CTO in Tbilisi. The final drafts with attachments were provided to, reviewed by and discussed with the visiting USAID CTO from Washington D.C. prior to her meetings with the selected banks.

AA Lee briefed the visiting USAID CTO on the state of the IAS conversion at the pilot banks, the status and progress of the project. AAs Lee, Gordon, ACs Tsikhelashvili, Bjalava and Gureshidze accompanied her to meet the senior management of four pilot banks. The topics of the meetings were on the general banking activities, accounting reform, IT conversion process, internal control structure and the USAID IAS Technical Assistance.

- AAs Gordon, Lee, and the Accounting Consultants visited each pilot bank at a minimum of four days and up to eight days during the month to provide on-site direct assistance. The project team also performed comparative analyses of the detailed trial balances of the pilot banks to identify potential non-compliance with IAS, questions related to accounting policies and procedures, possible weaknesses in internal controls and unusual transactions. These questions and issues are in continuous discussions with the respective bank management and accounting personnel. Examples of unusual transactions that have come to light are significant penalty income and assets from factoring activities. Our highlighting of possible issues and questions lead to the discussions of banks' current practices and assessment of the propriety under IAS requirements and recommendations to correct any non-IAS treatments. The team received many inquiries from the pilot-banks on general and detailed accounting and reporting matters. The topics addressed by the team were diverse but generally predictable. We have addressed 29 documented inquiries from the pilot banks, non-pilot banks, NBG and Bank Supervision Project during the month of June 2001.
- AA Gordon completed assessment reports following a review of accounting of share capital and reserve accounts for three pilot banks. The review focused on the completeness and accuracy of the transfer of balances from Gosplan to IAS chart as of January 1<sup>st</sup>, 2001 and accounting practices in the first three months of the current year. The report outlined the corrective action that the bank is required to take to bring about IAS compliance and other recommendations on related internal control issues.
- A Plain Language Guide to the Tax Code of Georgia, published by the Tax Department of the Ministry of Revenue was distributed to all commercial banks. The goal of the publication is to enhance understanding of the tax system as well as increasing awareness of rights and obligations under the Tax Code. A comprehensive tax regulation, proposed by the Tax Department, detailing how the significant provisions of the Tax Code are to be applied is awaited and publication is expected in the near future. As previously reported tax understanding is weak and much advisory effort is needed to enhance bank accounting staff's capacity to compute their tax liabilities.

- AA Gordon and AC Kikvidze developed, and discussed with management, a comprehensive response to enquiries from a pilot bank on a wide range of questions concerning Tax Code provisions. An internal document on frequently asked questions (FAQ's) was also finalized and distributed to all project staff.
- After many months of advising and urging, one of the large pilot banks is now willing to adjust its general ledger accounts to be in line with the IAS. The proposed action will be in several stages. Firstly, there will be opening balance adjustments as envisioned in the January 1, 2001 IAS conversion process. These adjustments will be based on those proposed by the external auditors for the year 2000 financial statements. These adjustments are to the opening balance sheet accounts and have a cumulative effect on the opening retained earnings account. Secondly, following a review of balance sheet, profit and loss accounts at the period end (March or June), adjustments will be made to the current period accounts for transactions that are not properly accounted for in accordance with IAS. The bank management is concerned with the NBG and the Tax Inspectors understanding and interpretation of the changes during their inspection process.
- AA Lee and AC Tsikelashvili had several meetings with various members of the new pilot bank. The bank personnel responsible for basic accounting of the transactions, business acquisition accounting, consolidation of the branch activities, and reporting are not functioning effectively. It is our assessment that knowledge of IAS is lacking at the accountant level, motivation for IAS accounting reform and proper acquisition accounting is low at the middle management level. The team advised the accounting, reporting and internal audit departments of non-compliance with the IAS principles and importance of addressing the issues as soon as possible. The team met with a senior management group and reiterated the importance and consequence of the IAS compliant accounting and reporting. The team is planning another discussion with the department heads and a meeting with the Chairman of the Board/General Director of the bank.
- Translators Meskhi and Bibileshvili translated the first quarter CAEL reports of the pilot banks prepared by the NBG Off-Site Surveillance Department staff. The project team will review these reports to gain more understanding of the banks' activities, results and compliance with the NBG ratios.
- AC Gureshidze presented her summary of IAS 1, *Presentation of Financial Statements* and Interpreter/Translator Meskhi presented her topic on the *Law of Georgia on Activities of Commercial Banks*. These presentations include an overview of IAS requirements, current regulations, proposed regulations, and applicability to the commercial banks in Georgia. These weekly one-hour sessions are for the purpose of continued development of the local staff in the IAS and regulatory issues as well as research, writing and presentation skills. The local professionals will also learn the use and availability of reference and

technical materials. The accounting consultants and translators were pre-assigned topics in relation to which they are not sufficiently knowledgeable. These topics also reflect frequently asked questions by pilot bank personnel. Generally, each consultant will make a presentation on a topic every 4 or 5 weeks. This allows an ample time for research and preparation on his/her own time. The session is mandatory for all commercial bank team members and open to the banking supervision team and NBG accounting methodology department staff.

## **IV. Projects in Progress and not Completed**

### **Off-site Surveillance**

- The format for the call reports and the uniform bank performance reports have yet to be approved by the NBU. The reason for this rest primarily with the Director of the Banking Supervision Department. The final draft versions, as recommended by the resident advisors, have been on her desk for several months now. The reasons for her failure to act on these are not clear at this time. This issue and other are going to be discussed with the NBG's President and Vice President.

### **Legal**

- Work continues on the drafting of the "Regulation on Credit Concentrations and Large Exposures of Banks". This work was slowed and then suspended during the previous two months due to time pressures and priorities in connection with LWG activities, which dominated the time of the Resident Legal Advisor during April, and parts of May and June.
- Work continues with the Chief of Party and the NBG President on the designing, strategizing and scheduling of mid-summer lobbying activities with relevant Parliamentary Committees in collaboration with the IMF on behalf of the NBG's legislative program. The program recommends numerous crucial amendments to the "Law on the National Bank of Georgia" and the "Law on Activities of Commercial Banks". The Resident Legal Advisor has been requested by the Chief of Party and Geoff Minott- USAID Tbilisi to prepare a paper describing the most important amendments to the above laws for use in these collaborative lobbying efforts. The relevant Parliamentary Committees to be lobbied are:
  - Financial- Budgetary Committee- Mr. Zaza Sioridze, Chair
  - Legal Issues, Legitimacy and Administrative Reforms Committee- Mr. Zurab Adeishvili, Chair
  - Economic Policy Committee- Mr. Ivane Merabishvili, Chair
  - Tax and Revenue Committee- Mr. Vitali Khazaradze, Chair

- Planning continues with the Chief of Party on the priorities for drafting numerous new regulations in addition to the “Regulation on Credit Concentrations and Large Exposures of Banks”. It is recommended that these new regulations cover the following areas:
  1. Liquid Asset Holdings
  2. Fixed Asset Limits
  3. Foreign Exchange Exposure Limits
  4. Mergers and Acquisitions
  5. Persons Who Control Banks (Changes in Bank Control)
  6. Licensing
  7. Standards for Fit and Proper Boards and Management
  8. Prompt Corrective Actions.
  9. Real Property Evaluation (Appraisal) Standards
  10. Sanctions and Penalties Against Banks, Financial Institutions and Individuals
  
- Work continues with USAID Tbilisi-Geoff Minott, Chief of Party, NBG Deputy Director of Supervision and Supervisory Counsel and the “Credit Union Development Center” of Georgia on the development of regulatory policies for Credit Unions.
  
- Work continues with USAID Tbilisi – Geoff Minott, Chief of Party, NBG Deputy Director of Supervision, Supervisory Counsel and the NGO “Women for Urban Development” on the development of regulatory policies for Credit Information Bureaus.
  
- Work continues with USAID Tbilisi – Geoff Minott, Chief of Party, NBG Deputy Director of Supervision, Supervisory Counsel and The Sibley Group on the development of regulatory policies for equipment leasing companies.

#### **Accounting Methodology – NBG**

- A review of the current methodology applied to the computation of taxable profits for commercial banks has begun. While some procedures have been developed by the Ministry of Revenue to derive taxable profits from an IAS based accounting system for all enterprises the system in place does not take account of the unique activities of different industries. The effect of this is that there is a dearth of guidance needed to derive taxable profits of commercial banks given the increasing complexity arising from developments of the tax code. The objective of current discussions is to gain an understanding of tax code related regulations and guidance papers formulated by other projects promoting accounting reform in the enterprise sector with a view to coordinating our efforts and minimizing duplication.

## Accounting – Commercial Banks

- The new pilot bank's *Profile and Initial Assessment of the IAS Conversion at the Pilot Banks* is in progress. AA Lee and AC Tsikhelashvili are in process of identifying potential IAS accounting issues of this pilot bank by reviewing detailed trial balances, comparative trial balances, and comparative ratios with other pilot banks. It should be completed during the first week of July for discussion with the bank's senior management.
- AA Lee is in process of reviewing the draft Accounting Policies and Procedures for a large pilot bank.
- A review of a proposed Internal Audit Manual is taking place to ensure compatibility and consistency with Internal Audit Regulation and Commercial Bank Law. It is planned to issue this manual to all commercial banks along with the Regulation when approved, and registered, by Ministry of Justice.
- External auditors at a pilot bank completed the year 2000 financial statements audit at the end of last month. The audit reports, management letters and summary of audit adjustments are anticipated.

## V. Concerns/Impediments to Progress

### On-site Supervision

- There are several major projects in which little or no progress has been made over the past several months. Part of this slowdown can be attributed directly to the Director of the Banking Supervision Department and her reluctance to make any decisions on recommendations given to her by the resident advisors. These items include:
  - Regulation on Internal Audit and the internal audit manual that will be provided to the commercial banks to assist them in establishing a more professional audit department. These particular items have been completed since the summer of 2000.
  - Regulation on Accounting issues involving the commercial banks and two other accounting pronouncements. These items were completed by the resident advisors in January 2001.
  - Regulation on Minimum Capital Requirements by Commercial Banks. This regulation is intended to bring the regulatory capital requirements of the Georgian Banks in line with the requirements as detailed by the Basle Committee and was completed in March 2001.
  - The formats for the regulatory reports and the uniform bank performance report have been finalized since April 2001.

## **Off-site Surveillance**

- See the above noted concerns with regard to the Regulatory and Uniform Bank Performance Reports.

## **Legal**

- Concern continues with respect to the policy of the Director of Supervision in failing to invite discussions with Advisors on regulations as she previously did. These concerns have been discussed with the NBG President and the NBG Vice-President for Supervision. This reluctance continues to be an impediment to progress as set forth in previous Monthly Reports.
- Concern continues with respect to the uneven cooperation of the NBG Legal Department. This uneven cooperation continues to be an impediment to progress as set forth in previous Monthly Reports. The most recent instance of the problem was the surprise delivery by the NBG Legal Department to the Director of Supervision on June 28 of 40 new comments on the final draft "Regulation on Internal Audit" after that draft had been transmitted by the NBG to the Ministry of Justice for comment and registration and after it had been in the Legal Department's possession for review and comment for more than a year.

## **Accounting Methodology – NBG**

- The NBG staff has not yet approved three accounting pronouncements (one regulation, two instructions) delivered to it in March 2001. The main effect of the failure to ratify the proposed documents is that commercial banks are reluctant to modify accounting practices in the absence of formal instructions from NBG. Every effort is being made to cajole NBG to conclude on these issues. The primary reason for the delay is related to unresolved organizational and personnel issues which are still under consideration.

## **Accounting – Commercial Banks**

- Some pilot banks have not received sufficiently detailed information concerning the audit adjustments they agreed to in issuing IAS compliant financial statements from the external auditors for the year 2000. The effect of this is that accounting staff, in many instances, is not benefited from the external auditors assessment of the IAS adjustments. The December 31, 2000 IAS adjustments made by the external auditors could have benefited significantly in converting to the IAS in 2001 and in bringing the bank's accounting records in line with the audited IAS financial statements. The project team is advising commercial banks to review the upcoming audit engagement letters with a view to ensuring that it contains provisions obligating the auditors to provide detailed and explanatory statements on all audit adjustments that will enable the banks to record in the general ledger.

## **VI. Administrative Issues**

- During the month, RA Stroud had several conversations with Bharat Bhargava on some administrative issues with regard to the payment of employment taxes and how the local staff will be compensated in the future. The process of registering Bankworld as a legal entity in Georgia began during the month.
- AC Gureshidze's last day with the project was effective June 27, 2001. Prior to her departure, she worked with the USAID Supervision team for a week in reviewing and editing an examination report of the NBG On-Site Supervision Department. The AAs launched a recruiting process for the open position. Financial Analyst (FA) Kokaia will be working with the commercial bank project team during the month of July to fill the gap from the departure of AC Gureshidze. This is possible as there will be only one scheduled NBG on-site examination requiring her involvement during the month. FA Kokaia will be managing the NBG inspection process at the same time.
- AC Tsikhelashvili, AC Kikvidze and FA Kokaia sat for a several examinations/papers of the ACCA professional licensing examinations during the one-week session in Georgia. It is the last stages of AC Tsikhelashvili's professional ACCA examination process, beginning of FA Kokaia, and AC Kikvidze is at the half way mark after the June examination.
- During the month, RA Stroud attended the monthly USAID Chief of Party meeting to report on the latest developments in the banking supervision and accounting programs.
- During the month, Ms. Laurie Landy (USAID-Washington) was in Georgia to assess the status of the project. As a result, RA Stroud conducted several meeting with Ms. Landy and Mr. Geoff Minott about the current status of the project and future areas of work that will be needed. There were some brief discussions on the current budget and any possible cost overruns. We also discussed any possible future work after the current contract expires in February 2002. RA Stroud also established a meeting with Mr. Minott, Ms. Landy and the senior managers of the NBG. The meeting allowed for the USAID Staff and the staff of the NBG to discuss the focus and cooperation of the banking supervision program going forward.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for May 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: Gerald Andersen**

Prepared by

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Martin McCormack – Legal Advisor  
Tom Gordon – Accounting Advisor  
Kwi Lee – Accounting Advisor**

**June 15, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the

banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of May 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- The continued development and implementation of supervisory strategies for several large problem banks;
- The implementation of the recommendations and suggestions contained in the restructuring plan that was submitted to the NBG's President will continue to be implemented.

### **Off-Site Surveillance**

- Continue to develop the off-site analytical report/tool, which will be prepared from the new financial reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This is one of the outputs the FinA project will prepare.

### **Legal**

- Complete consensus of the Legislative Working Group (LWG) on all proposed amendments to the National Bank Law and deliver a final Draft to the NBG Council preparatory to constructing a final submission to Parliament.
- Begin the discussions and analysis by the LWG of all proposed amendments to the Commercial Bank Law (to be renamed "The Law of Georgia on Banks and Financial Institutions").
- Deliver to the Ministry of Justice the "Regulation on Capital Requirements of Banks".
- Deliver to the Ministry of Justice the "Regulation on Internal Audit"
- Continue transactional legal support of distressed banks.

- Continue the drafting of the “Regulation on Credit Concentrations (Limitations on Loans to One Borrower and on Collective Large Exposures”).
- Continue examination of regulatory policies regarding the tiered regulation of Non-Banks such as Micro-Finance institutions and Credit Unions.
- Continue the exploration of policies and legal frameworks regarding Credit Information Bureaus.
- Continue participation in restructuring discussions with senior officials of the NBG.
- Brief directors and the legal counterpart of the visiting donor missions of the IMF and IBRD on all actual and proposed legal and legislative recommendations affecting the financial sector and on transactional matters of substance.

#### **Accounting Methodology – National Bank**

- Assist NBG to implement its decision to establish an accounting methodology division in bank supervision department by developing statements on division tasks and job description for the staff position to be filled and initiating recruitment process.
- Continue discussions with personnel from NBG, commercial banks and Ministry of Revenue regarding the development of a suitable methodology to derive taxable profits from financial statements generated from an IAS compliant accounting system.
- Provide mentoring and tuition support to staff of the accounting methodology department of NBG to enhance understanding of IAS practices to enable them to respond authoritatively to commercial bank enquiries.

#### **Accounting Technical Assistance – Commercial Banks**

- Complete the *Profile and Initial Assessment of IAS Conversion at Pilot Banks*.
- Provide on-site direct assistance and training as needed to ensure full implementation and conversion of the new chart of accounts at the transaction level at all pilot banks. This procedure may include analytical review of the monthly detailed trial balances, individual transaction entries, accrual and valuation adjustments.

- Commence technical assistance support to a new pilot bank identified by NBG as in need of TA support given recent business developments.
- Coordinate with the on-site inspection team of NBG during their inspection of a pilot bank. An on-site inspection is in progress and the fieldwork is expected to finish by the end of May 2001. The IAS Technical Assistance team will review the *Accounting, Record-Keeping and Internal Controls* section of the NBG examination report. At the completion of the inspection fieldwork, assistance will be provided to the subject bank as needed to enable the chief accountant to deal with problem reporting and accounting issues identified.
- Obtain and review audit adjustments proposed by external auditors for fiscal year 2000 financial statement audits on the remaining two pilot banks.
- Provide verbal and/or written opinions on technical inquiries from the commercial banks, NBG supervision or accounting methodology departments. Train local staff accountants on this process, including: (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference

### **III. Tangible Results**

#### **On-site Supervision**

- During the month, RA Stroud continued to work with the inspectors on the inspection of the 2<sup>nd</sup> largest bank as ranked by assets. Included in this work were several meetings with the bank's senior managers to discuss the report and its preliminary findings. The initial draft of the report is in excess of 175 pages and several comments and sections were poorly written as the inspectors failed to clearly state the bank's problems and the reasons for them. RA Stroud continued to reformat the report to ensure that it reads in a logical and coherent manner; however, as of the end of the month the report was still not completed. This report will go to several international donors including the EBRD and the IFC and therefore all comments are being carefully reviewed and edited. The ratings on the CAMEL components appear to be correct but will need to be better supported with specific examples, recommendations, and definite conclusions.
- RA Stroud also had a meeting with a representative of the EBRD to review the preliminary findings of the inspection on the above noted bank. A second meeting will take place at a later date to discuss the report in more detail when the initial draft has been completely reviewed and edited. The EBRD is the largest shareholder of the bank and also one of the largest creditors.
- In the absence of LA McCormack, RA Stroud attended five sessions of the Legislative Working Group. Final recommendations were made to the National Bank Law and these changes were later discussed with the National Bank's

President and Vice President. The National Bank's Council of Directors later reviewed and approved the draft with the intention to forward it on to Parliament in early June.

- At the request of the NBG's President, RA Stroud has started reviewing the initial draft of the IMF/World Bank Financial Sector Assessment Program. RA Stroud has been asked to help draft a response to several of the issues and weaknesses noted in the assessment program. During the month, RA Stroud finished his review and analysis of the Aide-Memoire. A 6-page letter detailing specific recommendations was provided to the President and Vice President.
- RA Stroud attended a meeting with the President of a commercial bank that will be added to the pilot program for the accounting assistance. The purpose of the meeting was to explain the nature of the technical assistance. This will increase the number of banks in the pilot program to 7.
- RA Stroud held a meeting with AA Gordon and one of the local accounting advisors to discuss several accounting issues as they pertain to the bank that recently acquired the assets and liabilities of a troubled bank. This particular bank was just recently added to the pilot banks that are receiving technical assistance on accounting issues. The management of the bank had several questions concerning their recent acquisition of the troubled bank's assets and liabilities.
- RA Stroud provided the senior managers of the supervisory department his written assessment of the two inspections that were completed in mid May. The letter detailed the need for the inspectors to better support their ratings with more complete and in-depth analysis of the bank's operations. As a result of these comments and suggestions the inspection reports were modified.
- RA Stroud, at the request of the NBG's President, attended a meeting with the EBRD's President and several of his deputies to discuss the current situation in the Georgian banking system. The EBRD's President indicated that the EBRD was interested in continuing to invest in the Georgian banking sector. RA Stroud answered several questions and provided his views on several questions asked of him and provided his views on the current state of the Georgian banking system.
- RA Stroud reviewed and commented on an Agreement drafted by the EBRD London office. The document was in connection with the recent merger of the large troubled bank with a relatively healthy bank. The document involved the conversion of EBRD's debt into a possible equity position and a possible injection of an additional \$1 million in cash.
- RA Stroud attended (at the request of the National Bank's President) a meeting involving a joint Mission of the IMF and the World Bank. This Mission involves a major review and assessment of all major areas of reforms involving the financial sector in Georgia. RA Stroud attended three separate meetings between

the Mission Staff and the National Bank's supervisory staff for the purpose of clarifying several questions and issues.

- RA Stroud met with the National Bank's President to discuss some reorganization issues involving the banking supervision staff. According to the President some major changes will be made involving the staff. The actions are as a result of the reorganization issues submitted to the President by RA Stroud last month. Additional details on this matter are included in the impediments section of this report.

### **Off-site Surveillance**

- RA Stroud has met with the new representative of USAID/IRM at the NBG to discuss USAID/IRM future role in the FinA project. He indicated his involvement in the FinA project would be minimal.
- RA Stroud has approved the option of obtaining temporary assistance for the programming and implementation aspects of the FinA project and provided a proposed budget for the additional help. Initially a proposed of \$3,400 was proposed by the NBG's technical staff. This budget included the hiring of three persons to assist in the project for two months. Subsequently, at RA Stroud's insistence this number was reduced to one additional programmer, at a cost of \$1,300, with the Banking Supervision Project's two Financial Analysts assisting him.

### **Legal**

- Consensus of the LWG on amendments to the National Bank Act was achieved (save for final technical definitions of terms) with the exception to Article 70. No consensus was arrived on Article 70 because the monetarists members of the LWG held firm on their view that the current approach providing for an absolute priority of NBG liquidity loans claims over depositors' claims in liquidations was a better public policy than the change recommended by the supervision staff.
- The consensus included agreements by the LWG to confer on the NBG many progressive new authorities and powers such as jurisdiction over persons who control banks; jurisdiction over non-bank-financial institutions; functional regulation of banks' securities affiliates, the provision of new corrective tools to the NBG such as bridge bank authority; due deference by courts to the regulatory expertise of the NBG and immunity from civil and criminal liability for employees and advisors of the NBG in connection with their supervisory or monetary decisions taken in good faith and in the ordinary course of their duties. The NBG's Council expressed substantial agreement with all changes recommended by the LWG.

- Transactional legal support of a distressed bank was completed with the legal effectiveness of its merger and with the expiration of the extended term of its Temporary Administrator.
- Numerous briefings were held with directors and the legal counterpart of the visiting missions of the IMF and the EBRD on all legislative and legal recommendations proposed by USAID for the financial sector as well as on transactional matters of substance. Drafts and correspondence were expansively made available to donor personnel and energetic exchanges ensued which included meetings with senior NBG Supervision Department officials and the Head of the NBG Legal Department. The donors expressed strong support for all substantive recommendations.

### **Accounting Methodology – NBG**

- AA Gordon attended a number of meetings with Vice President Vakhangishvili and other senior officials with regards to the establishment of an accounting methodology division in the bank supervision department. AA Gordon developed a number of relevant documents that were approved by NBG. A revised organizational chart, incorporating the new division, a statement on the main activities assigned to the division and a job description for the initial position was developed and approved. Additionally a profile of suitable applicants for the vacant position was developed and approved. A public advertisement was placed seeking applications from interested candidates.
- AA Gordon had phone discussions with Mr. Gary Fechmeyer who is providing technical assistance to the National Bank of Armenia concerning commercial bank accounting reform in both Armenia and Georgia. It was agreed that we would exchange information on issues common to both countries and where such exchange is approved at project level. AA Gordon sent to Mr. Fechmeyer the chart of accounts approved for commercial banks in Georgia. Mr. Fechmeyer and AA Gordon prepared diagnostic studies on commercial bank accounting in Georgia and Armenia in year 2000, respectively.
- Due to AA Mino's absence AA Gordon was assigned to the Help Desk from May 2<sup>nd</sup> to work directly with pilot banks on accounting reform.

### **Commercial Bank Accounting**

- A profile and initial assessments of IAS conversion at six pilot banks were developed by the Accounting Consultants and reviewed by Accounting Advisors. AA Lee will finalize these reports in early June.

- AA Lee and AC Tsikhelashvili began working with the new pilot bank including gathering information about the bank's activities, interviewing the bank's Chairman of the Board of Management, Chief Accountant, Economic Analysis and Reporting and Chief of Internal Audit Department. There were also introductory meetings with other accounting, internal audit and IT staff. This bank was selected as a pilot bank for the project because the NBG anticipates a need for assistance with the recent acquisition activities. The bank purchased assets and assumed liabilities of an insolvent bank that was under the NBG's temporary administration. The initial assessment indicates that the bank is in fact experiencing a lot of accounting problems with regards to the acquisition of the assets and liabilities of another bank, incompatible accounting system, disposal of a wholly owned subsidiary, and IAS conversion.
  
- AAs Gordon, Lee, Mino and the Accounting Consultants spent a minimum of four days and up to eight days at each pilot bank to provide on-site direct assistance during the month. The project team received many inquiries from the pilot-banks on general and detailed accounting and reporting matters. The topics addressed by the team were diverse but generally predictable. We have addressed 35 documented inquiries from the pilot banks, non-pilot banks, NBG and Bank Supervision Project during the month of May 2001. An example list of issues addressed are:
  - Foreign exchange positions
  - Stock subscriptions
  - Retained earnings
  - Fixed/Intangible Assets
  - Foreign currency accrued interest
  - Creditors
  - Post balance sheet events
  - Income and various other taxes
  - Valuation of shares
  - Repurchased shares
  - Nature of non-cash contributions
  - Capital in foreign currency
  - Investments outside of Georgia
  - Fines and penalties
  - Depreciation and amortization
  - Operating lease
  - Business Combination/Acquisition
  - Cash and non-cash contributions in capital
  - Overdrafts and related interest income
  - 30 days rule regarding reversal of interest
  - Revenues from previous years operations
  - Gains/losses from foreign currency revaluation
  - Advertising, utilities and building security expense
  - Capital account (ordinary shares and preferred shares)

- Interest income on loans denominated in foreign currency
  - Organization structure for accounting and internal audit departments
- ACs Gureshidze, Kikvidze, Bjalava, and Tsikhelashvili conducted comparative analyses of trial balances, as at the end of January, February, March and April for all six pilot banks to identify the areas of potential irregularities and errors. Many issues were identified and discussed with the respective banks. Meetings were also held with credit, accounting and operations departments.
  - Accounting Advisors and Consultants analyzed and had meetings concerning the reconciliation of shareholders' capital, retained earnings and special funds accounts for all pilot banks. Only one of the pilot bank's shareholders equity accounts agree with that reported in the audited IAS financial statements. Some of the other pilot bank equity accounts differed from the audited financial statements because external audit adjustments were not booked at the general ledger/synthetic account level. Two pilot bank's equity account balances in accordance with the IAS are not available as the audits are still in progress. Further meetings were held with accounting staff of three pilot banks in order to obtain information on the correctness and completeness of the transfer of relevant accounts from the Gosplan system and current compliance with international accounting practices.
  - AA Gordon and ACS Gureshidze met with personnel from the NBG accounting methodology unit concerning a proposal from a pilot bank in relation to tax code. There is a widespread confusion in the banking sector regarding the methodology to be applied to compute, and account for, taxation. Many proposals are erroneously made to amend the tax code to facilitate tax accounting. This is contrary to the international practice whereby tax computation is a task carried out in accordance with the tax code that are often different than the financial accounting. Further discussions are planned with the tax department of the Ministry of Revenue with a view to streamlining the tax computation process for commercial banks. Additionally, a soon-to-be published guide from the Ministry of Revenue on the application of the Tax Code will be distributed to commercial banks.
  - Accounting Consultants compiled, with the assistance of AA Lee, a list of frequently asked questions (FAQs) for a guide on interest income accounting developed by AA Gordon.
  - Accounting Advisors and Consultants met with the personnel, detailed below, from other international organizations involved in the pilot banks in various capacities and areas to share information:
    - A credit advisor sponsored by EBRD;

- The residential mortgage loan advisory team from the Shore Bank, a USAID project;
  - A member of the supervisory board representing the IFC equity interest.
- ACs Tsikhelashvili and Bjalava accompanied and assisted the Head of Finance and Chief Accountant of a large pilot bank in their meetings with the NBG examiners where certain accounting methodologies and practices were explained. Often, the examiners are not familiar with specific IAS requirements on certain bank transactions. The accounting consultants and advisors provide IAS interpretations, explanations, clarifications and justifications to the NBG on-site inspectors and to the bank management. AA Lee and AC Tsikhelashvili met with the Bank Supervision Project team to formulate a strategy for assisting the NBG on-site inspectors on a large pilot bank. AA Lee began reviewing the draft of *Accounting, Record Keeping and Internal Control* section of the NBG examination report for a large pilot bank.
- AC Bjalava and Translator Meskhi interviewed the Accounting, Credit, Treasury, IT department staff of a large pilot bank in a continued process of understanding the internal controls and accounting process. The team had a several meetings with the accounting staff of the same bank and new decree of NBG # 95, related to stated instances of penalties, was discussed.
- AA Gordon and Lee sent letters and flyers to the Presidents and Chief Accountants of all commercial banks reinforcing the USAID IAS Help-Desk assistance, list of advisors and consultants, and contact information. The objective of this action was to increase utilization of the Help-Desk services by the commercial banks, particularly non-pilot banks.
- During the month the following presentations were made:
  - Interpreter/Translator Daneila presented her summary of National Bank's relationship with the commercial banks;
  - AC Bjalava presented his topic "Cash Flow Statements";
  - And AC Kikvidze presented her topic on "Events after the Balance Sheet Date" at the weekly technical sessions.

These presentations include an overview of IAS requirements, current regulations, proposed regulations, and applicability to the commercial banks in Georgia. These weekly one-hour sessions are for the purpose of continued development of the local staff in the IAS and regulatory issues as well as research, writing and presentation skills. The local professionals will also learn the use and availability of reference and technical materials. The accounting consultants and translators were pre-assigned with topics that they are not sufficiently knowledgeable. These topics also reflect frequently asked questions by pilot bank personnel. Generally, each consultant will make a presentation on a topic every 4 or 5 weeks. This allows an ample time for research and preparation on his/her own time. The

session is mandatory for all commercial bank team members and open to the banking supervision team and NBG accounting methodology department staff.

- ACs Tsikhelashvili and Bjalava accompanied and assisted the Head of Finance and Chief Accountant of a large pilot bank in their meetings with the NBG examiners where certain accounting methodologies and practices were explained. Often, the examiners are not familiar with specific IAS requirements on certain bank transactions. The accounting consultants and advisors provide IAS interpretations, explanations, clarifications and justifications to the NBG on-site inspectors and to the bank management. AA Lee and AC Tsikhelashvili met with the Bank Supervision Project team to formulate a strategy for assisting the NBG on-site inspectors on a large pilot bank. AA Lee began reviewing the draft of *Accounting, Record Keeping and Internal Control* section of the NBG examination report for a large pilot bank.
- AC Bjalava and Translator Meskhi interviewed the Accounting, Credit, Treasury, IT department staff of a large pilot bank in a continued process of understanding the internal controls and accounting process. The team had a several meetings with the accounting staff of the same bank and new decree of NBG # 95, related to stated instances of penalties, was discussed.
- AA Gordon and Lee sent letters and flyers to the Presidents and Chief Accountants of all commercial banks reinforcing the USAID IAS Help-Desk assistance, list of advisors and consultants, and contact information. The objective of this action was to increase utilization of the Help-Desk services by the commercial banks, particularly non-pilot banks.
- Interpreter/Translator Daneila presented her summary of National Bank's relationship with the commercial banks; AC Bjalava presented his topic "Cash Flow Statements"; and AC Kikvidze presented her topic on "Events after the Balance Sheet Date" at the weekly technical sessions during the month. These presentations include an overview of IAS requirements, current regulations, proposed regulations, and applicability to the commercial banks in Georgia. These weekly one-hour sessions are for the purpose of continued development of the local staff in the IAS and regulatory issues as well as research, writing and presentation skills. The local professionals will also learn the use and availability of reference and technical materials. The accounting consultants and translators were pre-assigned with topics that they are not sufficiently knowledgeable. These topics also reflect frequently asked questions by pilot bank personnel. Generally, each consultant will make a presentation on a topic every 4 or 5 weeks. The session is mandatory for all commercial bank team members and is open to the banking supervision team and the NBG accounting methodology department staff.

#### **IV. Projects in Progress and not Completed**

##### **On-site Supervision**

- The inspection on the large bank was not finished during the month. The initial draft has been prepared but several issues will need to be resolved before the report is any where near ready to sent to the bank.

### **Off-site Surveillance**

- The programming work on the Uniform Bank Performance continued through the month. Several programming mistakes were noted and each one was reviewed with the First Irish Group.

### **Legal**

- Discussion and analysis of all proposed amendments to the “Commercial Bank Law” was undertaken by the LWG. The proposed amendments were contained (as was the case with the National Bank Act) in an Operating Draft prepared and distributed to all members of the LWG by the USAID Legal Advisor. Some of the amendments were recommended by the NBG Supervision and Legal Departments put forth in a June 2000 document. LA McCormack then set forth and explained in a Section-by Section Analysis the intent and reasons for the change. These changes had been presented to the NBG Supervision Department in October of 2000 and were later amplified and redistributed in February of 2001. Our recommendations call for a substantial reconstruction of the statute. This discussion and analysis of all proposed amendments to the “Commercial Bank Law” continued to be ongoing throughout May working off both the Operating Draft and the Section-by-Section Analysis. The LWG is expected to reach consensus in mid-June in time to initiate discussions with the relevant Committees of Parliament (after approval by the NBG Council) with an eye toward enactment in the fall 2001 session.
- The “Regulation on Capital Requirements of Banks” was not submitted to the Ministry of Justice because the Director of Supervision never released it for internal discussion. Despite many calls to discuss her reservations with the USAID Advisors, she instead believes that no discussions are necessary. Instead she takes the view that before the regulation can be even discussed internally much less forwarded to the Ministry of Justice for registration and no possible conflicts, the Commercial Bank Law must first be amended to eliminate a perceived conflict with the Companies Act with respect to whether banks can be prohibited from carrying in-kind capital. Further evaluation of this view and the three-month discussion delay will be undertaken in June by USAID and the NBG.
- The “Regulation on Internal Audit” was not submitted to the Ministry of Justice for reasons similar to those affecting the “Regulation on Capital Requirements of Banks”. i.e. the view of the Director of Supervision that it cannot even be discussed internally at the NBG until necessary amendments have been made to

the Commercial Banking Law. Further evaluation of this view and the 8-month delay will be undertaken in June by USAID and the NBG.

- Completion of the drafting of the “Regulation on Credit Concentrations (Limits on Loans to One Borrower and on Collective Large Exposures)” continues to be delayed due to the time press of the work of the LWG which, along with critical regulatory and transactional matters has increasingly dominated the time of the Legal Advisor for over two months due to the time constraints of the Parliamentary schedule.
- Several meetings were held by the Legal Advisor and Supervisory Counsel with a local NGO and with senior officials of the USAID Mission at which roles were assigned and scheduling established for the law framework and publicity strategies to be brought to bear later in 2001 in connection with the institution in Georgia of a Credit Information Bureau. These matters are ongoing and include discussions with an expert in the United States.
- Several meetings were held by the Legal Advisor and an expert on the regulatory policies suitable to govern Credit Unions. It was discovered that he was on the point of sending proposed credit union legislation to Parliament without consultation with USAID and the NBG. This was stopped after conferences with the USAID Project Mission Director and further meetings resulted in a decision to further study the situation with the assistance of the expert. and with the participation of the NBG and its Advisors.

### **Accounting Methodology – NBG**

- A review of the current methodology applied to the computation of taxable profits for commercial banks has begun. Whilst some procedures have been developed by the Ministry of Revenue to derive taxable profits from an IAS based accounting system for all enterprises the system in place does not take account of the unique activities of different industries. The effect of this is that there is dearth of guidance needed to derive taxable profits of commercial banks given increasing complexity arising from developments to tax code. The objective of current discussions is gain an understanding of tax code related regulations and guidance papers formulated by other projects promoting accounting reform in the enterprise sector with a view to coordinating our efforts and minimizing duplication.

### **Accounting Technical Assistance-Commercial Banks**

- Two of the pilot banks are still going through the annual IAS financial statement audits. The audit reports, management letters and summary of audit adjustments are pending the completion of the audits.

- Review of the Accounting, Record Keeping and Internal Control section of the NBG on-site inspection report for a large pilot bank.
- Review of the accounting policy statements for a large pilot bank.
- Shareholders' equity account reconciliation for three pilot banks.
- AA Lee will review and finalize the *Profile and Initial Assessments of IAS Conversion at the Pilot Banks* by June 8, 2001.

## **V. Concerns/Impediments to Progress**

### **On-site Supervision**

- There is currently a management struggle on-going within the banking supervision department between the NBG's Vice President and the Director of the Banking Supervision Department on how to work together. The situation has only become worse over the past month. This disagreement on how the department should operate and function has begun to impact the work of the supervision staff and the Resident Advisors. The issue has been discussed with the President of the NBG. The President has indicated that he is aware of the problem and that appropriate action will be taken within the nearest future. This is one of the issues that RA Stroud provided the President with during his assessment of the NBG's organizational structure and other matters to improve the efficiency of the banking supervision department.

### **Legal**

- As stated last month, there is concern about the seeming lack of enthusiasm by the Head of the Legal Department toward real legislative reform in the banking sector, particularly in the area of supervision.

### **Accounting – Commercial Banks**

- As stated last month, there is concern about the tendency of the Director of S AA Gordon had a meeting with the managing director and deputy director of one of the pilot banks in relation to difficulties experienced by the on-site technical assistance team. There was unwillingness on the part of the accounting staff to release relevant documents and provide explanations to the advisory team's inquiries. The managing director was very interested in our concerns and appreciated our request for his attention and support. Following a discussion on the objectives of our project, the need of the advisory team to carry out diagnostic procedures, the managing director bank insisted that his bank needed our expertise and committed his management team to working cooperatively with us in the future and instructing us to visit him again should any further problems arise.

- Following the meeting described above the advisory team on its next visit to the bank received a positive response to all its requests for information and explanations which enabled it to make considerable progress in the accounting area that was the subject of the team's review.
- The Chief Accountant of a small pilot bank seems to be always occupied with daily emergencies and unable to focus on the IAS issues. AA Lee discussed the situation with the Executive Director as a possible area of concern for the bank. He acknowledged that the external auditors also expressed a concern that the chief accountant is too occupied with the day to day bookkeeping and not performing an overall management of the accounting and reporting requirements. The Executive Director also was called away in the middle of the meeting and we agreed to meet again in the coming weeks to continue our discussion and some management letter points from the external auditors. He was reluctant to share the copy of the management letter to the Advisor.

## **VI Administrative Issues**

- RA Stroud worked with Office Manager Zodelava on the preparation of a spreadsheet for the local staff of this project. The spreadsheet detailed the days that all local staff has worked on this project and also projected the days through February 2002. The Booz-Allen Washington staff requested this information.
- During his visit, RA Stroud had several meetings with Bharat Bhargava to discuss the progress of the technical aspects of the program and several administrative issues. The administrative issues included the status of registering Bankworld and the issue of making the local staff employees of Bankworld. It was also agreed that RA Stroud and the office manager would submit some revised budget information to the Bankworld staff in DC. RA Stroud and Mr. Bhargava met with Geoff Minott to discuss the current status of the program and future needs of the NBG.
- RA Stroud attended the monthly Chiefs of Party Meeting with the senior manager of USAID to present the current status of the banking supervision and accounting programs.
- During the month, RA Stroud continued to work with the IMF/World Bank Mission on the Financial Sector Assessment Program. Specific items included completing numerous schedules involving financial information on specific banks and the banking sector as a whole. These schedules were then reviewed and discussed with the staff of the NBG.
- RA Stroud held a meeting with the NBG's President and Vice President to discuss the following issues:

- ◆ RA Stroud's review and assessment of the FSAP Aide-Memoire;
  - ◆ The initial draft of the inspection report on the largest bank in Georgia;
  - ◆ The Legislative Working Group's comments and suggestions on the draft Law on the National Bank;
  - ◆ And the structural changes that will be made in the banking supervision department.
- AA Gordon and AA Lee held a final meeting with the Vice President Jigauri concerning the status of the Help Desk activities and progress made in recent months. Given the NBG's recent changes on the organizational responsibility for the Help Desk activities to the Supervision Department, the future status reports will be presented to the Vice President Vakhtangishvili.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for April 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: Gerald Andersen**

Prepared by

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Martin McCormack – Legal Advisor  
Tom Gordon – Accounting Advisor  
Kwi Lee – Accounting Advisor**

**May 13, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the

banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of April 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- The continued development and implementation of supervisory strategies for several large problem banks including the bank currently operating under the regime of a Temporary Administrator;
- The implementation of the recommendations and suggestions contained in the restructuring plan that was submitted to the NBG's President will continue.

### **Off-Site Surveillance**

- Review an On-site Inspection Report for a medium-sized bank and comment upon it.
- Modify some of the old Supervisory Reporting Schedules to be included in the Monthly Financial Regulatory Reports
- Continue to develop the off-site analytical report/tool, which will be prepared from the new financial reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This is one of the outputs the FinA project will prepare.

### **Legal**

- Complete the drafting, revising, negotiation and execution of a Letter of Intent and all other legal foundation documents supporting the merger of a distressed bank with a local healthy bank. Complete research on the transferability of the Visa membership of merged bank. Complete research on legal issues surrounding negotiation of a proposed "forbearance and debt-conversion-option agreement" to restructure the merged bank's indebtedness to EBRD guaranteed by the Ministry of Finance.

- Through the Legislative Working Group, complete work on all amendments to the Law on the National Bank of Georgia.
- For purposes of assisting the Supervision Department in determining proper contingency reserving by a bank under examination, deliver to the Supervision Department and to the Chief of Party, a legal opinion on the enforceability of a material guarantee-type instrument issued by that bank
- For purposes of assisting NBG examiners in evaluating the legality and permissibility of certain penalty-generated income of a bank under examination, deliver to the Supervision Department and the Chief of Party, a legal opinion on the legality of that bank's underlying agreement with several affected customers.
- Complete the issuance of the "Regulation on Conflicts of Interest and Transactions with Related Parties".
- Complete an analysis of the roles and tasks of the NBG and BankWorld/ Booz-Allen and USAID in the development of a Credit Information Bureau in Georgia from the legal/regulatory and public awareness perspectives.
- Hire a local regulatory lawyer.

#### **Accounting Methodology – National Bank**

- Develop, translate and obtain NBG's approval of a guide to interest income accounting for commercial banks.
- Continue discussions with personnel from NBG, commercial banks and Ministry of Revenue regarding the development of a suitable methodology to derive taxable profits from financial statements generated from an IAS compliant accounting system.
- Assist in the development of case study material for use in training seminar offered to accounting personnel from commercial banks.
- Monitor NBG deliberations on restructuring plans in relation to accounting methodology unit.

#### **Accounting Technical Assistance – Commercial Banks**

- Document the results of initial assessment of the pilot banks' conversion to the new chart of accounts.
- Obtain and review audit adjustments proposed by external auditors for fiscal year 2000 financial statement audits on the remaining two pilot banks.

- Provide on-site direct assistance and training as needed to ensure full implementation and conversion of the new chart of accounts at the transaction level. These procedures may include a detailed review of individual transaction entries, monthly accrual and valuation adjustments.
- Conduct first of four scheduled training seminars for chief accountants of the banks IAS concepts and related standards, frequently asked questions, issues considered complex and relevant in implementation of the new chart of accounts.
- Provide on-the-job assistance to NBG on-site inspectors in the review of accounting related matters and development of related report comments. At the completion of the inspection fieldwork, follow up with the subject bank as needed to assist the chief accountant with reporting and accounting questions.
- Provide verbal and/or written opinions on technical inquiries from the commercial banks, NBG supervision or accounting methodology departments. Train local staff accountants on this process, including: (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference.
- Based on the insight gained from working with the pilot banks and through the issues addressed by the help desk, develop a list of needed revisions to the chart of accounts and account description manual.

### **III. Tangible Results**

#### **On-site Supervision**

- A review of the inspection reports on two banks were finished and a written assessment on the quality of the reports was given to the National Bank's Vice-President. The ratings for one of the banks were not properly supported and the reasons for this were clearly communicated in the above noted assessment. A meeting to discuss the deficiencies and concerns over the inspection reports was held with the senior management of the National Bank. Later and in a separate meeting RAs Stroud and Grimditch met with the Vice President and the Director of Supervision along with the inspectors who worked on these reports to discuss the inspection reports and the noted criticisms. The two banks were both rated a Composite CAMEL of "5", but their risk profiles are quite different. The intent of the meeting was to draw attention to the quality of the reports and to what extent the written analysis supported the ratings.
- RA Stroud reviewed and commented on an Agreement drafted by the EBRD London office. The document was in connection with the recent merger of the large troubled bank with a relatively healthy Georgian Bank. The document involved the conversion of EBRD's debt into a possible equity position and a

possible injection of an additional \$1 million in cash. Also during this same week, the shareholders of the acquiring bank deposited \$5 million dollars in an account at the NBG. This money is to be placed in an escrow account and will be used to increase the authorized capital of the acquiring bank. As a result of this injection, the resulting bank (from this merger) will be one of the best-capitalized banks in Georgia. The issue of the EBRD's involvement in the recapitalization of this bank was also discussed with the acquiring bank's owners. Later, this issue was discussed with the London representatives of the EBRD.

- In regard to the above noted transaction, RA Stroud and AA Lee worked on a spreadsheet, which provided the financial projections of the two combined banks for the merger deal discussed above. The contents of the spreadsheet were reviewed and discussed with the NBG's President and the senior managers of the acquiring bank. Later, a copy of the spreadsheet was sent to the London staff of the EBRD and a subsequent telephone conversation was held with the staff of the EBRD to discuss this proposed merger and the EBRD's potential involvement in the deal.
- RA Stroud had several meetings and a working dinner with the senior management of the National Bank and several representatives of Visa International to ensure that the Visa membership will transfer to the bank that recently acquired the large troubled bank. At the conclusion of these meetings there did not appear to be any obstacles to prevent the acquiring bank from resuming the credit card operations.
- RA Stroud attended (at the request of the National Bank's President) a general meeting involving a joint Mission of the IMF and the World Bank. This Mission involves a major review and assessment of all major areas of reforms involving the financial sector in Georgia. During the last week of the month, RA Stroud attended three separate meetings between the Mission Staff and the National Bank's supervisory staff. This issue will require a great deal of time and effort on RA Stroud's part.
- RA Stroud had several meetings with the inspectors to discuss some issues and concerns with the inspection that is currently ongoing with regard to the largest bank (as ranked by total assets) in Georgia. There are several significant concerns and issues that will need to be addressed with the inspectors and the bank's management.
- During the month, RA Stroud has several meetings with the Temporary Administrator of the troubled bank and again advised him of the need to prepare a balance sheet, which indicates the true financial condition of the bank. This document is needed if the action taken by the National Bank is ever challenged in court. This process needs to be completed no later than Friday, April 20, 2001.

## Off-site Surveillance

- RAs Stroud and Grimditch met with USAID/IRM representative at the NBG to discuss USAID/IRM future role in the FinA project. The current representative will be replaced in early May, so he will have little future input. It is not likely that his replacement will be intimately involved in the project.
- RA Grimditch met with the Head of Supervision IT Department to further discuss the FinA Project and what was required to move it along. He requested some software from Armenia to continue the update. He also proposed getting temporary assistance for the programming and implementation aspects of the project and provided a proposed budget for the additional help. Initially he proposed hiring three persons to assist in the project for two months at a cost of \$3,400. Subsequently, this number was reduced to one additional programmer, at a cost of \$1,300, with the Banking Supervision Project's two Financial Analysts assisting him. COP Stroud is currently assessing the options discussed above.
- RAs Stroud and Grimditch also met with both the Deputy Directors of Supervision IT and Policy to discuss the progress and future strategy of FinA and any missing inputs. Subsequently, Supervision Policy determined which additional supervisory schedules needed to be included in the Monthly Financial Regulatory Reports. Although he concurred with the forms and their design, he does not want to include them a part of the Financial Reporting package until the new Capital and other Regulations dealing with the prudential ratios are approved. This matter is still under review and consideration.
- RA Grimditch met several times with the Deputy Director of Supervision Policy to discuss changes in the Supervisory Reports, particularly those dealing with Liquidity and Open Foreign Exchange Position.
- RA Grimditch reviewed the inspection report of a medium size bank that received an overall CAMEL rating of 5 (critical). She also met with all the inspectors individually and discussed their respective sections of the report write-up. The individual sections of the report (especially Asset Quality and Asset /Liability Management) do not support "critical" ratings. Discussion with the respective inspectors indicated that their final ratings were based on the decision of Banking Supervision on how to treat a guarantee the bank had entered into with the Ministry of Agriculture. Banking Supervision determined that the bank was liable for the guarantee and should establish a 50% reserve for the amount owing. This determination adversely affected all four CAEL ratings. The inspectors said that most of the sections of the Report were written before Banking Supervision's decision about the guarantee and therefore were written to support a less critical rating. Recognizing the existence of the guarantee adversely changed the numbers and therefore dictated the more critical ratings. Subsequent to Banking Supervision's decision, the NBG legal division opined that the "so-called Bank guarantee" does not obligate the bank to repay the loan, but rather to render the

service of transferring money from the client's account. The enforceability of the guarantee is ultimately a legal issue for the courts to decide, but there appears to be sufficient question to warrant a reconsideration of the ratings. It has been recommended by the resident advisors to the Banking Supervision Department that this bank does not warrant a "5" or "critical" rating.

- RA Grimditch met with the newly appointed EBRD Advisor to the NBG to discuss the role of Off-site Surveillance.
- RA Grimditch and her assistant attended the daylong seminar presented for the commercial banks by the Accounting Advisors on accrual accounting. The seminar appeared to be well received by the participants.

## **Legal**

- On April 20, the drafting, revising, negotiations and execution of the Letter of Intent and other legal foundation documents supporting the merger of a distressed bank with a local healthy bank were completed. On April 20, research on the transferability of the Visa membership of the merged bank was completed.
- On April 14, a legal opinion on the enforceability of the guarantee-type instrument of the bank under examination was discussed with the Supervision Department and with the Chief of Party after which it was completed and delivered.
- During the week of April 23, the legality and permissibility of certain penalty-generated income of a bank under examination was discussed with senior officials of the Supervision Department, and the Chief of Party and was analyzed with Supervisory Counsel after which a legal opinion on the matter was drafted, reviewed, completed and delivered.
- During the weeks of April 16 and April 23, the Ministry of Justice with only minor comments approved the “Regulation on Conflicts of Interest and Transactions With Related Parties”, and after required corrections were inserted by the NBG, the final original document was returned to the MOJ for registration.
- A well-qualified local regulatory lawyer was chosen from among twenty candidates who responded to the job advertisement for a regulatory lawyer. She accepted the hire offer and began work on April 4.
- Throughout the month briefings were given to the EBRD on issues and progress of Legislative Working Group.

## **Accounting Methodology – NBG**

- AA Gordon developed a comprehensive guide on interest income accounting, and reporting, for commercial banks. Interest, and similar income, is a significant element of a commercial bank's financial statement and the intent of the guide is to bring about uniformity and consistency in accounting and reporting practices. This will facilitate inter temporal comparisons for an individual bank as well as the generation of valid data for peer group reviews focusing on performance evaluation and financial strength. The personnel of the Help Desk and the accounting methodology unit will use the guide, when assessing a bank's compliance with IAS practices and when developing seminar materials.
- The NBG accepted the recommendation of the project and approved a proposal to establish, in the bank supervision department, an accounting methodology unit that will focus on the development, and monitoring, of accounting practices in commercial banks. This is a very positive development because it will strengthen the bank's supervisory function enabling it to insist on accounting, and reporting, practices that conform to international norms and best practices. NBG have sought the assistance of the project's advisory team in recruiting suitable staff for the proposed unit. It is planned to have discussions with NBG management on this issue at the beginning of the next month to agree a selection strategy. Once the unit is established, it will initiate the approval process for three regulatory instruments, supporting commercial bank accounting activities, developed by the accounting advisor over recent months.
- The Help Desk accounting advisors, and local accounting consultants, presented a training seminar for accounting personnel from commercial banks. AA Gordon assisted in the development of the accounting-based case studies used to demonstrate IAS compliant accounting practices.

## **Accounting Technical Assistance-Commercial Banks**

- Accounting Consultants completed documentation of initial assessment of three pilot banks. The written assessments are with the Accounting Advisors for review and comment.
- AAs Lee and Mino completed the review of audited financial statements for all pilot banks. Some banks have not received a management letter or a summary of audit adjustments. We stressed the importance of obtaining all audit related documents to each bank's management; however, it appears that not all banks will be successful in receiving these documents. We concluded that this objective is complete in all intents and purposes. We plan on assisting the pilot banks in dealing with the external auditors during the next audit period.

- AAs Lee, Mino and the Accounting Consultants spend one to two full days at each pilot bank to provide on-site direct assistance each week. The project team received many inquiries from the pilot-banks on general and detail technical questions related to the changes in the accounting of the bank transactions. The topics addressed by the team were diverse but generally predictable. We have provided direct training on how to prepare cash flow statements, how to calculate current and deferred income taxes, and provided sample policies and procedures statements. We have addressed over fifty (50) documented inquiries from the pilot banks, NBG and Bank Supervision Project during the month of April 2001.
- AAs Lee, Mino and the Accounting Consultants prepared and presented a training seminar to the commercial bank accountants on introduction to IAS financial statements, accrual accounting concept, and example exercises based on the Frequently Asked Questions by the pilot banks. There were participants from 21 commercial banks, National Bank and USAID Bank Supervision Project. AA Lee presented the Help-Desk to the attendees from the commercial banks at the training and stressed the importance and benefits of using the available assistance to the non-pilot banks.
- AAs Lee and Mino met on several occasions with the NBG on-site inspectors to assist them on accounting treatments of certain complex transactions such as line-of-credit from a non-resident bank, which is in process of bankruptcy, accrual of penalty income on a breach of non-routine contractual agreement, and various other transactions. AA Lee and AC Tsikhelashvili met with the Bank Supervision Project team to formulate a strategy for assisting the NBG on-site inspectors on a large pilot bank. AA Mino reviewed the Accounting and Internal Control section of the inspection report of another pilot bank.
- AA Lee and Mino met several times with the VP of the NBG responsible for the commercial bank accounting project to discuss the status of the project; training seminar, and technical issues arose from pilot banks which may affect other commercial banks.
- ACs Gureshidze, Bjalava, Kikvidze and Translator Meskhi provided one-hour presentation on various IAS and regulatory topics for the Commercial Bank Team in our weekly Technical Issues training session. These presentations include an overview of IAS requirements, current regulations, proposed regulations, and applicability to the commercial banks in Georgia. These weekly one-hour sessions are for the purpose of continued development of the local staff in the IAS and regulatory issues as well as research, writing and presentation skills. The local professionals will also learn the use and availability of reference and technical materials. The Accounting Consultants and Translators were pre-assigned with topics, which they are not sufficiently knowledgeable. The pilot bank personnel also draw these topics from the frequently asked questions. Generally, each Consultant will make a presentation on a topic every 4 or 5

weeks. This allows an ample time for research and preparation on his/her own time. The session is mandatory for all commercial bank team members and open to the banking supervision team and NBG accounting methodology department staff.

- The Commercial Banks team started keeping a log of suggested changes to the Chart of Accounts and Account Description Manual. These suggested changes were communicated to the AA Gordon as identified.

## **IV. Projects in Progress and not Completed**

### **On-site Supervision**

- The inspection of the largest bank (as ranked by assets) will continue on into May. Due to the problems of the two inspections reports that were completed last week, some of the inspectors working on the current inspection had to excuse themselves from working on the current inspection report and resolve some of the issues on the previous reports. In addition, the IMF/World Bank FSAP Mission caused some delays due to the inspectors' involvement in answering their questions and questionnaires.
- Financial and Legal issues surrounding negotiating points surrounding the “forbearance and debt-conversion option agreement” to restructure the merged bank’s indebtedness to the EBRD are still being explored.
- The supervisory strategy with regard to a large troubled bank is still continuing. This bank’s problems present a litany of issues that involve other donor organizations and other unique “political” issues that will require substantial time and effort to complete.

### **Off-site Surveillance**

- The FinA Project will be on going for the next 2-3 months before it will produce the required outputs, including the Georgian Banks' Performance Reports (GBPR).

### **Legal**

- The Legislative Working Group nears completion of its amendments to the “Law on the National Bank of Georgia” (NBL). Completion will be accomplished on May 10. The Group will then immediately take up deliberations on the numerous recommended amendments to the “ Law on Activities of Commercial Banks” (to be renamed “The Law of Georgia on Banks and Financial Institutions”). Plans are underway by the Group to present its agreed NBL amendments to the NBG Council of Supervisors as are initial approaches to the Budget, Finance and Legal Committees of Parliament.

- With the assistance of the Resident Advisors, a Capital Note continues to be negotiated by the NBG with an Austrian bank as part of a possible the possible rescue of a long distressed bank.
- The designing of a Credit Information Bureau for Georgia continues in collaboration with the Eurasia Foundation supported NGO known as “Women for Urban Development”, the Georgia Bankers Association and USAID (the latter as both funding provider and provider of direct expert technical advice)
- The exploration of a policy of tiered NBG regulation of several types of NBFIs, particularly credit unions, is underway with USAID support and expertise.
- Collaborative efforts with the NBG IMF Representative to assist in the preparation of information to be delivered to the IMF Mission arriving in May.
- Exploration continues of possible ways of acceptably altering the draft of the “Regulation on Capital Requirements of Banks” (Draft) delivered in mid-March to the Director of Supervision. The purpose of this exercise is to induce her to release the Draft for discussion. The issue is the Director’s contention that because the Company’s Act and the Commercial Banking Law permit “in-kind” regulatory capital, the prohibition on non-cash capital contained in the Draft is illegal until these laws are amended. She has therefore taken the limited, literal and timid view that the draft cannot be moved, or even internally discussed until such amendments are enacted. Advisors disagree with her position and especially with her refusal to even discuss the matter to which creative solutions (including adding a grand fathering provision to the Draft) are readily available.

#### **Accounting Methodology – NBG**

- A review of the current methodology applied to the computation of taxable profits for commercial banks has begun. While some procedures have been developed by the Ministry of Revenue to derive taxable profits from an IAS based accounting system for all enterprises the system in place does not take account of the unique activities of different industries. The effect of this is that there is dearth of guidance needed to derive taxable profits of commercial banks given increasing complexity arising from developments to tax code. The objective of current discussions is to gain an understanding of tax code related regulations and guidance papers formulated by other projects promoting accounting reform in the enterprise sector with a view to coordinating our efforts and minimizing duplication.

#### **Accounting Technical Assistance-Commercial Banks**

- Documentation of the initial assessment and profile of the pilot banks' status of conversion to the new chart of accounts. AA Lee is to review the three pilot banks' assessment completed by the ACs Tsikhelashvili and Bjalava.
- The following are project activities which began in April but has the completion period beyond April 2001 or is on-going throughout the project period:
  - On-site direct assistance and training as needed to ensure full implementation and conversion of the new chart of accounts at the transaction level.
  - Coordination with the on-site inspections team of NBG during their inspections of the pilot banks. An on-site inspection of a pilot bank is in progress and expected to continue through May and possibly into June 2001.
  - Written or verbal response to technical inquiries from the pilot banks or from other commercial banks via help-desk.
  - Training of local professional staff on inquiry response process including (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference.
  - Summary of suggestions for modifications on the NBG decreed chart of accounts and account description manual.

## **V. Concerns/Impediments to Progress**

### **On-site Supervision**

- There is currently a management struggle on-going within the banking supervision department between the NBG's Vice President and the Director of the Banking Supervision Department on how to resolve some of the most troubled banks. The issue has been discussed with the NBG's President by RA Stroud. The President has indicated that he is aware of the problem and that when the IMF/World Bank FSAP Mission finishes its work, he is intending to address this situation. This is one of the issues that RA Stroud provided the President with during his assessment of the NBG's organizational structure and other matters to improve the efficiency of the banking supervision department.

### **Legal**

- There is deepening disappointment in the Head of the Legal Department's abandonment of interest in the critical tasks of the Legislative Working Group. He has attended two of its twelve meetings and moreover refuses to prepare a correct

Internal Decree authorizing its function. His observations on its deliberations generally reflect the view that changes sought will be difficult, impossible or inadvisable. In similar fashion, he exhibits reluctance and lack of creativity in dealing with regulatory matters initiated by the Resident Advisors, showing little interest in new ideas or possibilities. While a bright and cordial person, he remains a stern guardian of the current way of doing things. While this attitude is understandable to some extent in the case of any lawyer (all of whom are trained under a particular legal system), it is surprising that he possesses these qualities to such a degree, especially since he is still a very young man. Although it is realized that he is a product of his background, this lack of interest in reform is disheartening, in the face of many months of working amicably with Advisors on transactional issues and in spite of his day-to-day friendliness with Advisors who have worked at cultivating his support. Notwithstanding the foregoing, the work of legislative and regulatory reform is proceeding satisfactorily largely because of the determination of Advisors and because of the diligence and cooperation of the Deputy Head of the Legal Department.

- As stated in Part III above, Advisors are mystified at the reluctance of the Director of Supervision to move forward on or to even discuss the critical draft “Regulation on Capital Requirements of Banks” which was delivered to her two months ago for discussion. She has effectively frozen it and states that it is obvious to her that laws need to be amended first to permit it to be issued (a possible timeframe which could delay its issuance for many more months or even a year). Advisors disagree with her closed approach because it shows little interest in taking an advocate’s point of view of the NBG’s powers. Advisors believe that, instead, she should be discussing the problem and supporting their efforts to explore inventive solutions to it rather than taking a narrow technical view of it, “signing off” on it with a vaguely worded letter, refraining from talking about it and instructing her staff not to work with Advisors to address it. This resigned and timid attitude is particularly puzzling in view of her usual excellent cooperation with Advisors in working on other regulations and issues. In this case, she may have other motives, which are currently not known.

### **Accounting Methodology – NBG**

- Personnel engaged in the accounting function are not well versed in the requirements of international accounting standards. While none of the staff have formal qualifications that embrace an accounting discipline rooted in IAS, some are pursuing studies that lead to full membership of the ACCA, the UK professional accounting body. A considerable amount of time is used to introducing, explaining and demonstrating the requirements of various standards to NBG staff.

## **VI Administrative Issues**

- During the month, RA Stroud worked with the Office Manager on certain administrative procedures involving the payroll and established procedures to ensure that there was enough money to make the payroll for the next month.
- AA Lee and Mino met with a World Bank/IMF Mission representative to discuss the state of Accounting and Audit requirements in Georgia in context to her corporate governess topic. Prior to her arrival in Tbilisi, AA Lee, with the assistance of RA Stroud and LA McCormack, provided her with relevant laws, regulations and summary of proposed regulations. Our discussion was limited to the banking sector.
- AA Lee provided the home office of Bankworld (“BWI”) with a complete list of local employees, current pay rate and historical changes in the pay rates.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for March 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: Gerald Andersen**

Prepared by

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Martin McCormack – Legal Advisor  
Tom Gordon – Accounting Advisor  
Kwi Lee – Accounting Advisor  
Ray Mino – Accounting Advisor**

**April 16, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the

banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of March 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- The current on-site inspection procedures will be revised to reflect the new laws and regulations and the new accounting standards that have recently been implemented;
- The completion of the Risk Management Seminar that is the third course in the five course inspector accreditation program;
- The continued development and implementation of supervisory strategies for several large problem banks;
- A presentation, which details the goals and accomplishments of the banking supervision program, will be presented to USAID's Senior Staff.

### **Off-site Surveillance**

- Review timely submission and accuracy of the new monthly reports submitted by the commercial banks to the NBG and affirm their adherence to the Chart of Accounts and IAS.
- Continue to development the off-site analytical report/tool, which will be prepared from the new financial reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This is one of the outputs the FinA project will prepare.

### **Accounting Methodology – NBG**

- Finalize and make a presentation to USAID personnel on the project's component relating to commercial bank accounting reform.
- Complete regulation on Accounting and Other Records and Internal Control System.

- Deliver to NBG three completed regulatory instruments.
- Commence review of current practices with regards to taxation of commercial bank profits and interest income accounting.

### **Accounting Technical Assistance-Commercial Banks**

- Conduct initial interviews with the pilot bank chief accountants and senior management and perform an initial review of the financial statements of the pilot banks. Review off-site reports and any available on-site inspection reports. In this regard, determine whether the initial conversion has been properly accomplished at the transaction level. This procedure would include reviewing the beginning balances at January 1, 2001 confirming crossover conversion adjustments to the ending balances of December 31, 2000.
- Meet with consultants from the USAID Georgia Enterprise Support project to become familiar with their progress to date and plan future coordination.
- Review audit adjustments proposed by external auditors for the annual audit of the IAS financial statements for the year 2000. Determine if the bank for conversion to IAS trial balances posted the adjustments. Analyze the nature and scope of the proposed adjustments in light of the crossover adjustments made by the banks.
- Provide on-the-job assistance to NBG on-site inspectors in the review of accounting related matters and development of related report comments. At the completion of the inspection fieldwork, follow up with the subject bank as needed to assist the chief accountant with reporting and accounting questions.
- Provide verbal and/or written opinions on technical inquiries from the commercial banks, NBG supervision or accounting methodology departments. Train local staff accountants on this process, including: (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference.
- Based on the insight gained from working with the pilot banks and through the issues addressed by the help desk, develop a list of needed revisions to the chart of accounts and account description manual.

### **Legal**

- Deliver to the Ministry of Justice the “Regulation on Conflicts of Interest and Transactions with Related Parties”.

- Complete the Organization of the Legislative Working Group and begin its work.
- Deliver to the Director of Supervision the “Regulation on Capital Requirements of Banks”.
- Continue transactional legal support for the resolution of a distressed bank.
- Complete the drafting of the “Regulation on Loans to One Borrower and Large Exposures”.
- Hire a regulatory lawyer

### **III. Tangible Results**

#### **On-site Supervision**

- RA Stroud finished reviewing and editing the inspection report on the large commercial bank that began in February. There were some inconsistencies in the inspector’s analysis and these problems will be illustrated in a workshop where the inspection report and the bank’s operating performance will be analyzed and discussed with the inspectors.
- RA Stroud assisted the Deputy Director of the On-site inspection department draft a letter to a foreign bank about their intentions to invest in or recapitalize a troubled bank in Georgia. If this recapitalization does not take place then the National Bank will be encouraged to appoint a temporary administrator or revoke the bank’s license.
- RA Stroud had numerous visits with the inspectors at one of the commercial banks in which an inspection is on going. The inspectors are having a difficult time reconciling the bank’s capital position using the new chart of accounts. They are also having a difficult time with other parts of the inspection due to the new chart of accounts and their lack of understanding of international accounting standards. As of the end of March this inspection was still not completed.
- RA Stroud, LA McCormack and RA Grimditch attended a meeting of the international creditors for the one of the large troubled banks. The meeting was a bit contentious at the beginning but at the end that was a unanimous decision and agreement that the bank needs to be liquidated. As a result of this meeting, the National Bank signed an order to liquidate the bank.
- RA Stroud and AA Lee met with a PriceWaterhouseCoopers contractor who is working in several of the Georgian Banks. The purpose of the meeting was to give Mr. Bertrand Legendre the opportunity to met with us and discuss the particulars of our program and to see how our two programs can better exchange

information. He was also inquiring about the technical aspects of the new asset classification regulation and how it can be applied to the two banks he is currently working with; however, Mr. Legendre's knowledge of the local banking system appeared to be rather limited based on the results of this meeting.

- During the month, a large majority of RA Stroud's time was spent on trying to resolve the issues of a second large troubled bank. RA Stroud met with the President of the National Bank and the other Senior Staff of the Supervision Department to discuss the possible actions that can be taken with regard to the bank. This particular bank is a very prominent bank in the Georgian Banking sector and it has a majority of foreign ownership and therefore, the National Bank is being very cautious in dealing with any possible solutions to this bank's problems. Later in the month, the Resident Advisors, along with the Senior Managers of the Supervision Department, met the president of the bank to discuss some possible recapitalization issues. Also, in attendance was a potential investor who had expressed some interest in recapitalizing the bank. Two main issues were reviewed and discussed. These issues involved the legal structure of their proposal and whether it can be done under existing Georgian law. The second issue involved the timing and the amount of the new capital injections. These issues continued to be discussed and reviewed for several weeks.
- A second meeting with the above noted representative of the investor group took place at the National Bank. The bank's current management is currently working with an investor group who has indicated a willingness to put \$5 million in capital into the bank over the next several months. On Monday, March 26, the investor is to inject \$500,000 and an additional \$1 million on Friday, March 30. In addition, the EBRD is scheduled to convert \$1.5 million of their debt to equity according to the investor group. RA Stroud and LA McCormack supported the structure of the deal but IMF Advisor Fish was adamantly opposed to the transaction. So after numerous meetings on the legal and economic aspects of this transaction it was finally approved and a Temporary Administrator was appointed for the bank. There will still need to be some court filings and approval of the Georgian Courts before the deal can be legally consummated.
- As a result of the appointment of a Temporary Administration Program, RA Stroud spent a large amount of his time working with the Temporary Administrator on the previously mentioned commercial bank and its problems. Numerous meetings were held with the bank's staff and clients in an attempt to calm the situation and to prevent a panic or run on the bank's deposits. Later, a decision was made to freeze the bank's accounts due to the banks lack of liquidity. RA Stroud also had several meetings with the NBG's President and the senior managers of the commercial bank to go over numerous logistical matters involving the bank's operations. There were also several meetings with LA McCormack on the situation involving Visa International and how this bank's relationship with the credit card company can continue, seeing as this may be the banks most valuable asset at this time.

## **Off-site Surveillance**

### Financial Reporting and Monitoring

- RA Grimditch reviewed several of the most recent Quarterly CAEL write-ups for the last quarter of 2000 and discussed them with the respective analysts. A couple of items came to light which indicate that more training is needed in both interpreting the new asset classification regulation and understanding the meaning of "capital adequacy". Specifically, one of the analysts interpreted the new asset classification regulation as meaning that all unsecured loans would automatically be considered "substandard" and subject to the 30% loan loss reserve requirement. Another analyst rated the Tier I and Risk-based Capital ratios of 117% and 119%, respectively, as "less than adequate" and opined that the bank should improve its capital structure. When asked what could the bank do to improve its capital, the analyst replied that it should have more "funds", i.e. economic stimulation and development funds. This kind of thinking and analysis needs to be changed.
- RA Grimditch provided a draft hard copy design of the proposed Bank Performance Report to Supervision Policy and Off-site Supervision. The figures in the Report will be based on and calculated from the line items filed in the New Financial Reports and the new, unapproved, Supervisory Reports (e.g. Total Regulatory Capital, Risk-weighted assets, Loans to one Borrower (LTOB), etc.) These latter Supervisory Reports will be based on the final legal regulations derived from the previously proposed Regulation (known as #118). Supervision IT has been provided a soft copy of the Bank Performance Report in Excel format.

### FinA Project

- RA Grimditch met with Head of Banking Supervision's IT Department regarding the progress of FinA. The acceptance testing for the project has fallen behind schedule for several reasons. One of the problems was that the department has lost one staff member in December, who was subsequently replaced in April. Another reason for the project being delinquent is that the department was given a number of year-end projects. In addition the department has been programming the new financial reporting schedules and refining various elements within them. Finally, the designs of the schedules for the Supervisory Reports have not been approved for programming. A number of these reporting schedules will be based on the final approval of regulations derived from the previous Regulation #118
- Also discussed with the Head of IT was whether it would be appropriate to bring in the Implementation Team, currently located in Armenia, to Tbilisi in order to assist in the FinA acceptance testing of the data-base inputs and outputs. We will discuss this further with First Irish Consultants who have been hired for this project.

- RA Grimditch met with the USAID IRM Resident Representative at the NBG and with the Head of IT Supervision to discuss the strategy for getting the flagging FinA Project back on track. In addition to developing a work plan, with timeframes, dependencies and responsibilities for the involved parties, it was decided that the Supervision IT department would benefit by having some short-term additional manpower. RA Grimditch and the Head of Supervision IT drafted some proposed timeframes for themselves. These, along with First Irish's timeframes, will be incorporated into a draft document for further review by Booz Allen and USAID. The final document should be a work plan, approved and supported by all parties, including the NBG Bank Supervision, with a defined implementation date.
- RA Grimditch met with visiting representatives of the IMF who requested some additional information on the banking system for their Aide Memoire.
- RA Grimditch met with the USAID Georgia Bank Project CTO to discuss the progress of the Off-site Surveillance Division and some of the current issues.

### **Accounting Methodology - NBG**

- A new regulation entitled Regulation on Accounting and Other Records and Internal Control Systems was completed. The regulation gives guidance as well as outlining minimum standards in relation to a commercial bank's compliance with a statutory provision to conduct operations in accordance with sound administrative and accounting procedures. The new regulation is modeled on a regulatory paper issued by the Financial Services Authority, the banking regulator in the UK. The regulation, when approved, will not only guide commercial banks efforts to develop their accounting and internal controls systems, assisted by the project's accounting advisors, but will be a framework for the evaluation of such systems by supervision department inspection staff of NBG.
- AA Gordon presented copies of three regulatory instruments, one regulation and two accounting instructions, to the NBG. These instruments were developed in recent months and their approval are required before commercial bank accounting personnel feel compelled to modify accounting practices to ensure compliance with IAS. While the NBG have acknowledged the merits of applying these instruments, and indicated a willingness to adopt them, it has so far failed to initiate the approval process. This is primarily due to an unresolved organizational issue, involving the accounting and bank supervision departments, relating to the responsibility of formulating instructions and guidelines for accounting practices in commercial banks. As indicated in the previous months report a recommendation for the establishment of an accounting methodology unit in the bank supervision department, focusing on accounting practices in commercial banks, has been made to NBG and a decision is awaited. Until such time as a decision is taken it is unlikely that NBG will initiate the approval and registration process.

- AA Gordon reviewed and commented on a new regulation on capital adequacy proposed by LA McCormack.

### **Accounting Technical Assistance-Commercial Banks**

- AA Lee and Mino, with the help of four local accounting consultants, completed the initial assessment of the pilot banks' conversion of accounting process to the new NBG decreed chart of accounts. We had numerous interviews and meetings with the chief accountants, internal auditors and senior management of the pilot banks. We reviewed the prior or current NBG on-site examination reports, off-site CAEL reports, and prior and current annual audited financial reports and related audit adjustments. We performed analysis of the 12/31/00 trial balances based on Gosplan accounting, 12/31/00 IAS financial statements, and 1/1/01 opening balance sheet accounts. The general conclusion is that the pilot banks are at various stages of the conversion to the new chart of accounts. Some banks appear to be materially converted at the initial balance sheet level and others are far from understanding the meaning of implementing the new chart of accounts. An instruction on how to document the adjustments to convert the 12/31/00 Gosplan account balances to the new chart of accounts to create the beginning balances at 1/1/01 was issued by the NBG prior to the year-end. However, most of the pilot banks did not have such a summary of adjustments. Rather, most of the banks are still in process of making adjustments. There are numerous old account balances, which should have been adjusted, still remaining at the sub account level such as reserves of the retained earnings and expenses charged directly to these reserves.
- Although March was focused on initial assessment of the banks conversion and implementation of the new chart of accounts, the project team received many inquiries from the pilot-banks on general and detail technical questions related to the changes in the accounting of the bank transactions. The topics addressed by the team were diverse but generally predictable. They were concentrated on accrual accounting for various non-routine transactions such as income taxes, discounted government securities and other accounting issues such as credit line from a bank in restructure/bankruptcy, impairment of fixed assets, software costs for internal use, etc. We analyzed a pilot bank's fixed assets register and provided recommendations on classification and depreciation policies and procedures.
- The Commercial Banks team started keeping a log of suggested changes to the Chart of Accounts and Account Description Manual.
- AA Lee completed reviewing a recent NBG examination report and audited annual financial statements of a pilot bank as of 1/1/01 and 12/31/00, respectively. The NBG examiners concluded that the bank's overall performance to be Satisfactory. In the area of Accounting, Record-keeping, and Internal Controls, the examiners concluded that the bank has satisfactorily converted to the new

chart of accounts by the beginning of the year 2001. For the end of the year 2000 financial statements, the independent auditors opinion was qualified due to the weakness in the accounting system and to the absence of a clear record of the full set of accounting entries made in view of the transition from its accounting books to its financial statements as per IAS. The auditors' opinion was dated March 2, 2001.

- AA Lee obtained the audited annual financial statements of her three pilot banks. Two of the banks received an unqualified opinion (clean opinion) and one received a qualified opinion. The largest pilot bank, which received a clean opinion, also received an extensive management letter. Although lengthy, the management letter did not offer much of realistic recommendations. They were broad and general in nature in the credit review area and the comments and evaluations were deferred to after the conversion to the new chart of accounts in the accounting area. The bank which received a Qualified opinion did not receive any management letter comments in spite of the weaknesses found in the accounting records nor a summary of audit adjustments indicating the nature and amount of adjustments required in order to convert the year end Gosplan accounts to the IAS based financial statements.
- AA Mino reviewed the audited annual financial statements of one pilot bank. The bank received an Unqualified opinion (clean opinion). Of the other two pilot banks, one is in the final stage of negotiating with its auditors, and has provided a draft listing of proposed adjustments. The other had to postpone the beginning of its audit until May due to a NBG inspection that began in February. The results of the inspection are unavailable at this writing. Extensive consultations with pilot bank Chief Accountants were held regarding the importance of external audits, posting of audit adjustments and the benefits of getting as much information as possible from the external auditors.
- AC Lee presented the Help-Desk and On-site Direct Technical Assistance to commercial banks at the meeting of the NBG and commercial banks. A letter introducing the Help-Desk Assistance via written inquiry using an email and fax was sent to the commercial banks in the previous week by the Vice President of NBG Accounting Methodology Department.
- The pilot banks are concerned with the confidential information, which the project advisor and consultants will have access to during on-site assistance. With one of the pilot banks, AA Lee met with the deputy director, chief accountant and head of the credit department and explained the project team's commitment to maintain the confidentiality of the bank's information; the fact that each and every one signed an agreement to that affect; and that in a confirmed event of a breach, the person will be dismissed from the project immediately. In another pilot bank, the team members signed a separate confidentiality agreement with the bank and AA Lee issued a formal letter of our commitment and responsibility to a third pilot bank.

- AA Lee and Mino met several times with the VP of the NBG responsible for the commercial bank accounting project to discuss the status of the project; to present the work plan translated in Georgian; to discuss a number of administrative issues, including formal communication with the commercial banks of the help-desk assistance and upcoming quarterly scheduled training; and technical issues arose from pilot banks which may affect other commercial banks.
- AC Tsikhelashvili provided a one-hour presentation on Accounting for Income Taxes for the Commercial Bank Team in our weekly Technical Issues training session. The presentation included an overview of IAS requirements and applicability to the commercial banks in Georgia. These weekly one-hour sessions are for the purpose of continued development of the local staff in the IAS and regulatory issues as well as research, writing and presentation skills. The local professionals will also learn the use and availability of reference and technical materials. Each of local Accounting Consultants was pre-assigned with topics, which they are not sufficiently knowledgeable. The pilot bank personnel also draw these topics from the frequently asked questions. Generally, each Consultant will make a presentation on a topic every 4 or 5 weeks. This allows an ample time for research and preparation on his/her own time. The session is mandatory for all commercial bank team members and open to the banking supervision team and NBG accounting methodology department staff.

## **Legal**

- LA McCormack reviewed with the Director of Supervision several remaining points on the “Regulation on Conflicts of Interest and Transactions with Related Parties” which had been raised by the NBG Legal Department. Final agreement between the NBG Legal Department and the Supervision Department was then achieved. On March 27, after routine internal approvals had been obtained, the regulation was forwarded to K. Kubilashvili, Deputy Minister of Justice (MOJ), by the Director of Bank Supervision along with her cover letter and her Explanatory Note. It had been the wish of RA Stroud and LA McCormack to deliver the regulation personally to Deputy Minister Kubilashvili, as part of a delegation led by our USAID Project Mission Director, as had been the case with the delivery of the “Regulation on Asset Classification and Creation of Loan Loss Reserves” in December 2000. The reason for this wish was that it was their view that personal delivery with its attendant discussions would highlight the importance of this regulation and would promote the cause of its expeditious treatment in the MOJ’s review process. However, despite requests for personal delivery and discussion, the Director of Bank Supervision forwarded the regulation under normal NBG procedures. It is planned that a “follow-up” visit to the MOJ will be arranged after waiting a week or two for the regulation to find its proper channels within the MOJ.

- On March 20, the official Internal Decree authorizing the establishment of the Legislative Working Group was signed by the NBG President. The Legislative Working Group (LWG) began its work with official meetings on March 21 and March 28. Its first business was to consider several proposals by both the NBG (as presented by the Head of its Legal Department) and by LA McCormack, to amend the “Law of Georgia on the National Bank”. Formal notices, agendas and minutes were prepared and distributed for each meeting and will be used for future meetings. The official meetings of the LWG were preceded by organization meetings with the USAID Project Mission Director, RA Stroud and senior officials of the NBG Supervision Department as well as an inception lunch among LA McCormack, RA Stroud, the Project Mission Director and the Head of the NBG Legal Department.
- On March 11, the “Regulation on Capital Requirements of Banks” was delivered to the Director of Bank Supervision by LA McCormack. LA McCormack had drafted it after taking into account the comments and desires of the Chief of Party and after obtaining valuable advice from all Accounting Advisors.
- Throughout the month, LA McCormack continued transactional support of a distressed bank case working in seven meetings with that bank’s management, RA Stroud and senior NBG officials on documentation and legal analyses surrounding a recapitalization plan. In this connection LA McCormack worked on the analysis of certain Company Law issues with counsel for that bank. In addition, LA McCormack conducted extensive meetings with the manager and staff of the Credit Card Department of the bank with a view toward creating a new structure without interrupting its Visa Card Program. With regard to the proposed recapitalization plan, LA McCormack accompanied the President of the NBG, the Head of the NBG Legal Department and counsel for the distressed bank on a visit in chambers to the Chief Justice of the Supreme Court of Georgia seeking his opinion on certain legal issues raised by the plan.
- Along with RA Stroud, LA McCormack attended a creditors’ meeting of a distressed bank at the Tbilisi office of the World Bank and spoke about a proposed liquidation plan.
- LA McCormack discussed with EBRD’s Legal Advisors in London cooperative approaches to the ongoing analysis of the “Law on Activities of Commercial Banks” and possible participation by the EBRD in the work of the Legislative Working Group.
- LA McCormack met with the USAID CTO to report on the work of the legal Component of the Project and to listen to her suggestions for improvements.
- Throughout the month, LA McCormack interviewed candidates for the position of regulatory lawyer to work with him in the Supervision Department.

## **IV. Projects in Progress and not Completed**

### **On-site Supervision**

- Two inspections that were started in February were still not completed during the month of March.
- A search for a final solution to a large bank that was placed in Temporary Administration during the month is still ongoing. It is anticipated that a final resolution for this bank will happen in April or early May.

### **Off-site Surveillance**

- As mentioned in previous monthly reports, the FinA Project will be ongoing for a number of months before it will produce the required outputs and before training can begin.

### **Accounting Methodology – NBG**

- A comprehensive guide is being developed for interest income accounting. This is a response to a great number of questions raised in this area. On completion it will be presented to NBG and will be used as a resource by IAS advisors manning the Help Desk. The objective of this guide is to bring about uniformity and consistency in relation to accounting for interest income by commercial banks. Net interest income (interest income less interest expense) is a key indicator when evaluating individual bank performance and is also used widely in making inter-temporal comparisons and peer group reviews. Hence, the importance of correct and accurate accounting practices. It is planned to complete this guide in the forthcoming month.
- A review of the current methodology applied to the computation of taxable profits for commercial banks is under way. A particular issue to be addressed is the manner in which taxable profits are derived from reported accounting profit. While the Ministry of Revenue has developed a reconciliation statement for use in all enterprises it has been found that it is not totally suitable for the banking sector.

### **Accounting – Commercial Banks**

- Documentation of the initial assessment of the pilot banks' status of conversion to the new chart of accounts.

The following are project activities, which began in March but have the completion period beyond March 2001 or are on-going throughout the project period:

- Review of external audit reports, related audit adjustments and management letters on two of the six pilot banks are pending. The filing of annual audited financial statements are not due to NBG until May 1, 2001. Accordingly, some banks' audits are still in process or the auditors have not provided the banks with the audit adjustments or the management letters. We have suggested the management to continue to request all audit related documents.
- Coordination with the on-site inspections team of NBG during their inspections of the pilot banks. An on-site inspection of a pilot bank is in progress and expected to continue through April and possibly into May 2001.
- Written or verbal response to technical inquiries from the pilot banks or from other commercial banks via help-desk.
- Training of local professional staff on inquiry response process including (a) research techniques, (b) structure of written opinions, and (c) maintenance of adequate filing system and documentation for future reference.
- Summary of suggestions for modifications on the NBG decreed chart of accounts and account description manual.

## **Legal**

- The drafting of the "Regulation on Loans to One Borrower and Large Exposures".
- The continuing work of the LWG.
- The continuing work on the resolution of a distressed bank.
- The design of the next set of regulations
- The receipt of comments from the Director of Supervision on the "Regulation on Capital Requirements of Banks"

## **V. Concerns/Impediments to Progress**

### **Off-site Surveillance**

- The design and implementation of the FinA System is significantly behind schedule. RA Stroud is currently conducting some research and other fact-finding meetings to determine the precise cause(s) of these delays.

### **Accounting Methodology – NBG**

- Until a decision is made by NBG President regarding the establishment, in the bank supervision department, of an accounting methodology unit for commercial

bank accounting, minimal progress will be made on the approval of three important regulatory instruments already submitted. The accounting advisor will continue to develop other regulatory instruments so that they are ready for delivery once a decision to establish the new unit is taken.

### **Accounting – Commercial Banks**

- During a visit to one of the pilot banks, the team learned that the entire accounting staff other than the chief accountant and his deputy was fired in the previous week. The management took the action without involving the chief accountant. The replacements are expected to come from the bank's other departments in April. During this week, two people man the bank's accounting department. It is a significant concern for the banks accounting process and our project for the following reasons:
  - The current chief accountant has been in his position for less than six months. He was promoted from within but not yet fully in control of the chief accountancy position.
  - The bank is in process of implementing a new accounting system.
  - A team of 8 NBG inspectors began its annual but surprise inspection in the same week.
  - It is a week before the first quarter closing and reporting.
  - The bank is the largest in the country and growing rapidly.

### **Legal**

- The uneven cooperation of the Head of the Legal Department. This problem will be somewhat alleviated by the arrival of the newly hired regulatory lawyer.

## **VI. Administrative Issues**

- RA Stroud, LA McCormack, AA Gordon, and RA Grimditch provided the senior staff of the USAID Mission with an overview of the achievements and results of the banking supervision program during the year 2000. The reviews and discussions after the presentation indicated the presentation went very well. Ms. Laurie Landry also attended the presentation, along with approximately 20 other invited guests from the IMF, World Bank and the American Embassy.
- A meeting between the senior staff of the Georgian USAID Mission and the National Bank of Georgia ("NBG") took place for the purpose of reviewing the banking supervision program. Those in attendance from USAID included Michael Farbman, Mission Director, Gerald Andersen, Director – Office of Economic Restructuring, Geoff Minott, and Laurie Landy, USAID Washington. The NBG attendees included the President, the Vice President and the Director of the Banking Supervision Department. COP Stroud also attended. The meeting went

very well with the National Bank informing USAID that they were very pleased with the results achieved to date. The President indicated he wanted the relationship with USAID to continue and that much more work remained in the application of the new asset classification regulation and other legal reforms involving the two organic laws. The need for assistance in the accounting conversion will also continue to be a priority for the banking system. Specific items that were agreed to included the hiring of the regulatory attorney to work with LA McCormack and the need for a legislative committee to work on the changes needed in the laws and regulations.

- During the month, RA Stroud provided the President of the National Bank with a written assessment of the banking supervision department. The President asked for this with the intent to find ways to help the supervision department become more efficient and more responsive to the needs of the senior management of the National Bank and more responsive to the problems and needs of the commercial banks. RA Stroud also met with the NBG's Vice President to go over this assessment orally with him.
- RA Stroud had several meetings with Laurie Landy and Geoff Minott to go over the current status of the program and the needs of the program after the current contracts ends in February 2002. It is seems likely that USAID will continue to fund the program past the current contract's deadline.
- RA Stroud and several members of the local staff had a working lunch on Sunday, March 11<sup>th</sup>, to go over the training materials for the risk management seminar, with instructor, Tony Kummerl. This was a chance to brief Mr. Kummerl on the particulars of the Georgian banking sector and to allow the local translators to go over the materials with the instructor. There were several technical issues and others involving terminology that needed clarification.
- RA Stroud and the support staff met with the staff of the bankers training center to go over the logistics for the credit risk class that is schedule to begin on Monday, March 12<sup>th</sup>. During the next week, RA Stroud, the other Advisors, and most of the Bankworld local staff attended the above-mentioned seminar for the NBG's supervisory staff. The class was successful as evidenced by the fact that 29 people took the test and all passed.
- The President of the National Bank and the other senior managers of the Supervision Department held a meeting with the representative of all the commercial banks to talk about the new asset classification regulation and some other supervisory matters. During this meeting, RA Stroud, LA McCormack, and AA Lee made some brief remarks about the asset classification regulation and other initiatives of our program.
- AA Gordon attended the NGO Roundtable meeting on behalf of the project. The Ambassador and head of the local USAID mission attended the meeting. The

Ambassador's address focused on recent political developments in Georgia including the ratification of the 'zero option' treaty with Russia after which Georgia were allowed to join the 'Paris Club' of international creditors. Under the 'zero option treaty' Georgia dropped its claim for any FSU assets as well as not being made liable for any of FSU debt. It was also reported that the Paris Club agreed to a restructuring of Georgia's external debt. The security issue is still a major concern and is a matter continuously under discussion by relevant personnel from the Embassy, USAID and local law enforcement agencies. A Barents Group representative made a presentation on the restructuring of the inspectorate and tax collection units at the Ministry of Revenue. The presentation focused on the problems and successes of the human resource reform program designed to reduce excessive staff numbers and introduce an appropriate management structure.

- RA Stroud, at the request of the NBG's President, made a brief presentation to the NBG's Supervisory Board on the status of the banking system in Georgia. Several questions were asked on the depth of the banking problems and how they can be resolved in a timely and organized manner so as to help prevent a banking crisis.
- RA Stroud and LA McCormack met with Geoff Minott to discuss the possibility of our project hiring a candidate to serve as a regulatory attorney to work along side LA McCormack during his stay in Georgia. It was agreed that the local attorney will be on the USAID payroll for the remainder of the current contract and then he/she will resume their career with the National Bank. Mr. Minott fully supported this issue.
- The Resident Advisors continued their weekly meetings with the Vice President and Director of the Banking Supervision Department.
- AA Gordon attended two Chief of Party's meeting at USAID offices during the month. The representatives of all existing projects made brief reports at each meeting. AA Gordon inquired about the project's VAT liability arising from the procurement of goods or services from local firms. It was suggested that the project communicate with the attorney in the local USAID office who would review the relevant regulatory instruments to determine entitlements and obligations. The new director of the Office of Economic Restructuring emphasized the importance of there being adequate communication between, and coordination with, other related projects. The frequency of the chief of party meetings has been changed from a bi-monthly to a monthly basis.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for February 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: Gerald Andersen**

Prepared by

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Martin McCormack – Legal Advisor  
Tom Gordon – Accounting Advisor  
Kwi Lee – Accounting Advisor  
Ray Mino – Accounting Advisor**

**March 15, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate

governance program will also be developed and implemented to ensure that the banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of February 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- An organizational review of the entire banking supervision department will be performed to determine if the present management structure and staffing is adequate;
- The development and implementation of supervisory strategies for several large problem banks will continue;
- The preparation of a slide show to the USAID Mission Staff will be developed, which details the goals and accomplishments of the banking supervision program during the year 2000.

### **Off-site Surveillance**

- Review timely submission and accuracy of the new monthly reports submitted by the commercial banks to the NBG and affirm their adherence to the Chart of Accounts and IAS.
- Develop the off-site analytical report, which will be prepared from the new financial reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This is one of the outputs the FinA project will prepare.

### **Accounting Methodology – NBG**

- Complete a report on the efficiency of the Accounting Methodology Division including recommendations on how it's overall performance can be improved.
- Complete regulation on accounting for repossessed assets and commence the development of a regulation focusing on standards concerning accounting records and accounting controls in commercial banks.

- Investigate the possibility of modifying the current protracted approach to the approval and registration of regulations and other similar regulatory instruments.
- Review proposed amendments to accounting law and prepare response to NBG on implications for banking sector accounting reforms.

### **Accounting Technical Assistance-Commercial Banks**

- Receive a written approval for work at these pilot banks from the President of the National Bank of Georgia. Obtain written invitations from the pilot banks confirming their desire for assistance and their willingness to provide office space and other facilities as requested.
- Coordinate the transition of accounting technical assistance provided by the TACIS project. Consider and interview all TACIS Georgian accounting professional staff members expressing an interest in joining the USAID project. Obtain all documentation and information available on the six pilot banks and IAS accounting issues in general.
- Conduct initial interviews with the pilot bank chief accountants and senior management and perform an initial review of the financial statements of the pilot banks. Review off-site reports and any available on-site inspection reports. In this regard, determine whether the initial conversion has been properly accomplished at the transaction level. Make arrangements with the pilot bank management to spend significant amount of time on-site, as warranted, at each of the pilot banks to determine in more detail the actual progress of the conversion to International Accounting Standards. This procedure would include reviewing the beginning balances at January 1, 2001 confirming crossover conversion adjustments to the ending balances of December 31, 2000.
- Recruit and hire translators and local accounting professionals.

### **Legal**

- Complete and deliver to the Ministry of Justice the “Regulation on Conflicts of Interest and Transactions with Related Parties”.
- Resurrect, complete and deliver to the Ministry of Justice the “Regulation on Internal Audit”.
- Agree with USAID and the NBG upon the importance of establishing a Legislative Working Group operating out of the NBG Supervision Department to undertake the redrafting and amending of relevant banking laws and companion legislation in order that an agreed NBG legislative package may be brought to Parliament before end-June, 2001.

- Begin the drafting of the “Regulation on Capital Requirements of Banks” after convincing the Supervision Department to discontinue the amending of Decree No. 118, an omnibus prudential regulation, which was intended to include capital requirements but which needs to be broken out into several separate, dedicated regulations and to be otherwise improved.
- Provide legal support on transactional and regulatory matters surrounding distressed banks.
- Address policy-planning issues regarding the establishment of regulatory frameworks for NBFIs such as credit unions and micro-finance institutions.
- Achieve final agreement with the NBG on the need to hire a dedicated lawyer in the NBG Supervision Department to work day to day with LA McCormack and to plan the implementation strategy for this hiring.
- Complete an Organization study and review for the NBG’s legal area.

### **III. Tangible Results**

#### **On-site Supervision**

- The translation of the inspection report on the large bank was completed in its entirety during the month. RA Stroud has completed his review of the report. As of the end of February, there were still some issues that need to be discussed and concluded with the inspectors. RA Stroud felt that the inspectors did not utilize the new asset classification regulation in a proper manner and therefore some of the components of the CAMEL system were not rated in an appropriate manner. A meeting and a workshop to go over these issues with the inspectors will take place in early March to discuss these issues in detail.
- RA Stroud drafted written strategies to the National Bank's President regarding the need to take a more active stance with regard to three large troubled banks. The problems of these banks need to be addressed and a final solution should be formulated with regard to each of these banks.
- RA Stroud met with one of the commercial bankers in which an inspection was recently completed to explain the new asset classification regulation and how it should be applied to the subject bank’s loan portfolio.
- During the month an inspection began on another bank. During this period, RA Stroud visited the inspectors to review the procedures the bank was using with regard to the new asset classification regulation and how this would potentially impacts the bank’s valuation reserves. There was a lengthy discussion on the

bank's capital position and whether the bank has recorded the capital accounts correctly based on the new chart of accounts.

- RA Stroud met the President of the one of the troubled commercial banks and the Vice President of the National Bank to go over the request by the commercial bank for a line of credit to help with a potential liquidity problem. The results of this conversation were that National Bank did agree to provide a 500,000 Lari commitment for the stated purpose.
- RA Stroud has several meetings during the month with the NBG's President, Vice President, and the Director of the Banking Supervision Department to discuss the problems of a specific bank and the need for the National Bank to pursue a tougher strategy with regard to this bank's problems. The President was not inclined to do anything with regard to this issue until he returns from a business trip to London in which he was scheduled to meet with the subject bank's Chairman of the Supervisory Council. The bank is in need of a large capital injection.

### **Off-site Surveillance**

- The commercial banks were required to start using the new financial schedules on February 1, 2001 to report their monthly figures to the NBG. RA Grimditch and her assistant have been working with the IT and Policy Departments to answer questions from the banks and to clarify issues about the input data. RA Grimditch will give a workshop on using the schedules to the Banking Supervision Department.
- RA Grimditch met with the Head of Supervision IT to determine the progress that department has made on putting the new financial reporting schedules on the system and to determine what problems the commercial banks were having completing the reports. The banks had a lot of questions about such items as what value should the trading securities is carried on the Balance sheet (market or cost).
- The quarterly (December 31, 2000) written CAEL analyses for the banks were prepared and reviewed by the head of Off-site during the week of February 26<sup>th</sup> and later by the Director of Supervision. After they are translated, RA Grimditch will review a report by each of the analysts to determine if further workshops are necessary, focusing on risk related issues. RA Grimditch will meet separately with the new analysts in the department and discuss the focus of their reports.
- RA Grimditch met with the Head of Banking Supervision's IT Department regarding the progress of FinA. The acceptance testing for the project has fallen behind schedule for several reasons. The primary problem is that the department has lost one staff member and it may take a while to find an equally skilled replacement. The other reasons for the project being delinquent are that the department was given a number of year-end projects. In addition, the department

has been programming the new financial reporting schedules and refining various elements within them.

- Also discussed with Head of IT the status of the FinA project and whether it would be appropriate to bring in the Implementation Team, currently located in Armenia, to Tbilisi in order to assist in the acceptance testing of the data-base inputs and outputs. We will discuss this further with First Irish Consultants who have been hired for this project.
- RA Grimditch met with USAID IRM IT Resident Advisor who was recently placed in the NBG to assist with the Montran (payments and settlements) Project. He will also help with the FinA implementation project. We discussed the situation in the Banking Supervision IT Department and the possibility of having the Armenian Implementation Team come to Tbilisi to help with the testing and its further implementation. He is planning to develop a work plan with timeframes. He will also request that the First Irish Consultants return to Tbilisi to work on the further development and implementation of FinA.
- RA Grimditch has finished drafting a hard copy design of the proposed Bank Performance Report. The figures in the Report will be based on and calculated from the line items filed in the New Financial Reports and the new, unapproved, Supervisory Reports (e.g. Total Regulatory Capital, Risk-weighted assets, Loans to one Borrower (LTOB), etc. Supervision IT has been provided a soft copy of the Report in Excel.
- RA Grimditch met with the Acting Head of the Off-site Division to discuss developments in that department. The department has combined the two functions of "Reporting" and "Analysis" into one section, whereby each analyst will be assigned three to four banks and perform all supervisory, regulatory and analytical processes for each bank in their caseload. This reorganization reflects the advisor's recommendation for changes during 2001. The new structure is expected to give the analyst a more continuous and in depth understanding of their caseloads throughout the supervisory process, rather than a fragmented view the previous structure engendered.
- In another meeting with the Acting head of Off-site Surveillance we discussed his staffing needs as well as any future training requests. There are a number of new employees in his department that need substantial training in financial analysis. Further, as the two senior staff members were involved with the Temporary Administration of a problem bank, he reviewed all the fourth quarter CAEL reports for content accuracy and readability.
- RA Grimditch determined that the off-site analysts desired further training on cash flow analysis. She will give a workshop on this topic, as well as the use of the new reporting schedules.

- Pursuant to the request of COP Stroud, RA Grimditch initiated a review of the Banking Supervision Department's organizational and personnel structure in order to determine whether the present management and staffing is adequate for present and future workload requirements. Researched the organizational structure, management and staffing needs of the departments at the NBG where USAID Advisors are most involved. Reviewed and distilled pertinent parts of memos written by Advisors Gordon and McCormack regarding their respective counterpart departments. Determined what changes needed to be made for Bank Supervision, as well as the respective sections of the Legal and Accounting Departments. Such changes should facilitate the Departments to run more efficiently and to be more responsive to our advice and recommendations. Prepared a memo to RA Stroud proposing the recommended changes.
- Met with the Deputy Director of Licensing and On-site Supervision and the head of Licensing to discuss the structure and reporting relations of their divisions and to determine the responsibilities of the licensing department. Besides licensing banks, the licensing department deals with the operations of the foreign exchange offices.
- Reviewed and made comments on the draft Regulation on Accounting, Internal Controls and other reporting records. Discussed these with AA Gordon.

### **Accounting Methodology - NBG**

- AA Gordon completed a report on the efficiency of the Accounting Methodology Division with regards to support for commercial bank accounting reform. The report reviews the performance of the division in recent years and identifies many inefficiencies concerning its output in the period examined. The main reason for the existence of inefficiencies primarily relates to an organizational design flaw reflecting the fact that the NBG's organizational structure is not consistent with the functional responsibilities of each department. While Banking Supervision is responsible for ensuring the safety, soundness and stability of commercial banking system it does not have the authority to stipulate the accounting practices that commercial banks must apply. The accounting department lacks the motivation to develop the accounting regulatory framework for commercial bank accounting as it's main responsibility is primary related to NBG accounting and reporting matters. The establishment of an accounting methodology unit within Supervision department, staffed by suitable personnel, was recommended as this represents the best option in seeking to ensure that the appropriate accounting regulatory framework for commercial bank accounting and reporting is developed and implemented. A summary of the report's findings are being incorporated into a broader report covering all bank supervision staffing issues to be presented by COP Stroud to the President of NBG.
- AA Gordon reviewed and edited Accounting Instruction No. 2 (Accounting for Repossessed Assets) that was developed in December 2000 to ensure consistency

with the approved Asset Classification Regulation and presented it to the NBG. This document was originally developed as a regulation but in order to adhere to a project's decision concerning the hierarchical order of formal documents it was renamed an accounting instruction - a document containing statements that prescribes accounting or reporting practices.

- AA Gordon developed and presented to the Bank Supervision Department a paper detailing the accounting implications and requirements of new Assets Classification Regulations. The contents of the paper were discussed with a number of officers from the policy and off-site divisions as well as the accounting methodology unit.
- Discussions were held with the NBG's legal department concerning the possibility of avoiding the rather lengthy approval and registration procedures, involving the Ministry of Justice, experienced when new NBG regulations are introduced. The outcome of the discussion was that the Ministry of Justice's review and registration process cannot be circumvented if a regulation or other similar document is applicable to all banks. It appears such a directive is regarded as a 'normative act' and, as such is required to be registered.
- AA Gordon coordinated the response of NBG to a series of proposed amendments to the Law on Accounting and Reporting. The amendments were developed following a Presidential Decree that required a review of the accounting law for the purposes of incorporating provisions that would give the state greater control over accounting and reporting activities for all sectors. Three main changes were proposed: (a) introduction of national accounting standards and the subordination of international accounting standards to it; (b) greater self-regulation over non-government owned enterprises and (c) the re-introduction of regulations to standardize the recording of accounting data. The proposed amendments are contrary to the thrust of accounting developments in recent years and are very much opposed by all organizations, including the NBG, who have been developing the IAS infrastructure. A greater degree of awareness now exists concerning the negative impact of the proposals and a concerted effort is being made to communicate the strong opposition to the relevant authorities. USAID's local office was made aware of the potential of the proposals to thwart on-going progress with regards to accounting reform programs.
- AA Gordon met with the new accounting consultant at the Georgian Federation of Professional Accountants and Auditors who is responsible for the promotion of the ACCA training courses that leads to professional accounting accreditation. The advisory teams will encourage suitable bank employees to pursue these qualifications given their focus on international accounting standards and other contemporary accounting issues. It was agreed that we would communicate regularly so as to optimize the efforts of both projects to support and create the conditions for the long-term development of accounting activities.

## **Accounting Technical Assistance-Commercial Banks**

- AA Mino and AA Lee reviewed materials prepared by AA Gordon on the implementation plan for banks' conversion to the new chart of accounts, the Chart of Accounts and Description, various mapping guides, and the IAS and IT assessments prepared by USAID consultants. A letter approving and describing the On-Site Direct Accounting Technical Assistance Program, pilot bank selection criteria and requirements of the selected banks was sent to the six pilot banks from the NBG President's office. We have received written letters from all six pilot banks confirming their acceptance of our assistance.
- The commercial bank accounting team's work plan was completed and approved by the Chief of Party and USAID. The NBG President and Accounting Methodology review and approval is pending.
- After reviewing many resumes and conducting a number of candidate interviews, AAs Gordon, Lee and Mino selected a highly qualified staff of three additional local accounting consultants and two translators. The local accounting consultants are committed to pursuing the ACCA certification program.
- AA Mino and Lee had initial meetings with the Chief Accountants and senior management of four pilot banks. Prior to the meetings, the banks' web sites were visited and audit reports, financial statements, off-site reports and management letters were examined. The meetings were enthusiastic to cordial and arrangements were made to be on-site one to two days at each bank per week.
- In our effort to coordinate a smooth transition from the TACIS accounting technical assistance project, AA Mino and Lee had several meetings with the outgoing TACIS project manager. TACIS project provided us with binders containing files of 10 banks, which they selected and focused during the two-year period, and electronic files of periodic status reports to the project oversight board of directors. AAs Gordon, Lee, and Mino attended the oversight board meeting of the TACIS project. The oversight board consisted of representatives from NBG, Association of Georgian Banks and EU TACIS as the project was a joint venture effort between the three organizations. The board was effectively disbanded after the February meeting with the ending of the TACIS project. The final TACIS Project report was presented and a luncheon followed. We have retained two of the local accounting consultants and a translator from the TACIS project.
- AA's Mino and Lee reviewed and suggested revisions to proposed Accounting Instructions 1 and 2 and discussed the same with AA Gordon, RA Stroud and LA McCormick. AA's Mino, Lee and AC Tsikhelashvili reviewed and provided comments on the new capital regulation prepared by LA McCormack.
- AA Mino worked with the Chief Accountants, Internal Auditors and accounting department staff at the pilot banks. The diagnostic method to be used at the bank

was explained and illustrated graphically, using the MIS system developed on a previous USAID funded bank accounting project. The banks agreed with both the diagnostic method and conclusions and indicated support for using it at their banks. There were extended discussions on basic accrual accounting, accrual of property taxes, income taxes, and initial recognition of fixed assets. During the examination of specific transactions, we discovered that the conversion to the new chart of accounts process is in various stages at the pilot banks. One bank still maintains its accounting records in the old Gosplan account numbers and uses a pseudo-mapping system to prepare the financial statements while another has converted to the new account numbers. At a pilot bank, this process was hampered by the bank personnel's apparent lack of familiarity with the functional capabilities of the accounting software used by the bank. During our visits, there were a number of meetings with a bank's chief credit officer. He was provided with the contact information for the USAID funded enterprise support program, as he had previously offered that many of the bank's clients could benefit from assistance in preparing loan applications and business plans. The bank has an EBRD line and has been quite aggressive in finding SME borrowers to use this facility. AA Mino attended a meeting with the NBG inspection team to advise on accounting for regulatory capital.

- AA Mino met with the Off-Site Advisor to demonstrate the MIS system developed by USAID consultants in Kyrgyzstan. She was provided with a working copy for her further examination.
- AA Mino mapped the chart of accounts to an Excel PivotTable used to produce a balance sheet and income statement from electronic trial balances. This PivotTable will drive a MIS system for the pilot banks. The data received from three pilot banks was processed and analyzed. The examination revealed that one bank had not closed all temporary accounts at the end of 2000 and will need additional assistance in preparing its post-closing trial balance. AA Mino completed mapping of the Balance Sheet, Income Statement, Summary, ROE Model and Charts pages of the MIS system developed on an earlier USAID funded bank accounting project to suit the Georgian Chart of Accounts. This will prove a valuable tool in convincing banks of the importance of accurate accruals.
- AA Mino directed local accountants in preparation of drafts of guidance to commercial banks in the areas of Accrual of Audit Fees, Accrual of Income Tax, Write Off of Loans in Foreign Currency against Allowances in Local Currency, Transfers of Equipment Between Branches and Accounting for American Express Traveler's Checks.
- AA Lee and AC Tsikhelashvili was on-site at a pilot bank during the month to perform initial analysis of the IAS conversion, provided assistance to Chief Accountant on various issues including the new asset classification regulation, estimating useful lives of fixed assets and monthly report to NBG.

## Legal

- Important differences with NBG Legal Department on new and fundamental concepts contained in the “Regulation on Conflicts of Interest and Transactions With Related Parties” were reconciled and explained to Director of Supervision freeing up the draft for delivery to the Ministry of Justice.
- An issues paper introducing the concept of a Legislative Working Group (LWG) was discussed with the NBG and USAID. The purpose of the LWG is to establish a structured NBG internal group working in concert to produce and deliver to Parliament the NBG legislative program for 2001. The mandate of the LWG would be to draft the exact language of all needed amendments to the Commercial Banking Law, the National Bank Law and other pertinent statutes for submission to Parliament before mid-summer. It was proposed that the LWG would be co-chaired by the USAID Mission Project Director and the Head of the NBG Legal Department. The LWG would be composed of senior officials from each division of the Supervision Department, a representative from the Monetary Policy Department, the Chief of Party, the Resident Legal Advisor and support staff. It was proposed that the LWG meet twice weekly in April, May and June in drafting sessions after which, each week, its newly drafted amendments and revisions to various laws would be discussed with the Director of Supervision and, as needed adjusted, agreed and incorporated in the developing texts.

It should be noted that numerous amendments to the Commercial Banking Law and the National Bank Act, the two principal laws to be reconstructed, were proposed by the Resident law Advisor in a Section-by-Section Analysis delivered to the NBG in mid-October, 2000 and mid September, 2000 respectively and hence are already known throughout the Department of Supervision. Thus a major portion of the initial policy work of the LWG has already been undertaken. The main work of the LWG during the next three months will be to combine these proposed amendments and others separately recommended by the NBG and put them into the actual required legislative language for timely submission to Parliament. The NBG and USAID preliminarily approved the formation of the LWG and its mandate, membership and operating procedures.

- The first draft of the “Regulation on Capital Requirements” was completed and submitted to the Chief of Party for his initial comments.
- Legal support was given in several regulatory and transactional issues surrounding distressed banks as follows:
  - Formal legal opinions were sought from the Resident Legal Advisor on the legal weight of anticipated defenses to the revocation of licenses of four banks during the second week of February. These opinions were delivered along with strong encouragement to the NBG not to hesitate to take the revocation action as its clear mandate in the circumstances. The opinions included

review, comment and approval of the legal and supervisory arguments drafted by the Department of Supervision for use in court. Although the anticipated litigation was in fact instituted by three of the de-licensed banks, the Resident Legal Advisor continued to work with the NBG Legal Department toward its expected favorable outcome expected in April.

- The Resident Legal Advisor delivered a written opinion on and orally advised the NBG on the powers of a Temporary Administrator (TA), i.e. conservator, of a distressed bank, in the context of attempts by certain creditors to seek pari-passu treatment by the TA in making certain payments under its broad salvage and stability powers
- Policy planning and funding discussions were continued with regard to NBFIs such as credit unions and micro-finance institutions in meetings of the Chief of Party and the Resident Law Advisor with representatives of a local urban development NGO. The meeting included discussions on that NGO's draft credit union legislation. The Chief of Party and the Resident Law Advisor advised that NGO to suspend its "fast track" on this legislation until wider discussions on the regulatory role of the NBG were undertaken and dedicated expertise in the field could be brought to Georgia. The NGO was also advised to begin to talk about credit union legislation and regulation with the Georgia Association of Bankers.
- Agreement was achieved among the Resident Advisors, USAID and the NBG on the need for and timing of the hiring of a dedicated supervision lawyer. The selection process was undertaken.

#### **IV. Projects in Progress and not Completed**

##### **On-site Supervision**

- An inspection that was started during the month is still on going and will not be completed until the middle of March.
- The organizational study of the banking supervision department has been completed in draft form and a final copy will be given to the NBG's President in early March. The final version will be discussed with the President and then a strategy for implementing some of the recommendations will be developed in conjunction with the NBG's senior managers.

##### **Off-site Surveillance**

- Due to year-end adjustments and the implementation of IAS, the commercial banks did not submit their January 1, 2001 financial schedules in time for the Off-site Division to prepare the quarterly CAEL analyses by the middle of February. RA Grimditch will review the individual reports during the next month.

- If there is additional assistance from outside contractors, the FinA Project will be producing some outputs by August. It will take 2-3 months longer if additional assistance is not forthcoming.

### **Accounting Methodology - NBG**

- A new regulation entitled Regulation on Accounting and Other Records and Internal Control Systems is being developed. The purpose of the regulation is to detail an interpretation of a statutory provision requiring commercial banks ‘to conduct their operations in accordance with sound administrative and accounting procedures. The new regulation is modeled on a regulatory paper issued by the Financial Services Authority, the banking regulator in the UK. This regulation, when approved, will assist the commercial banks to develop their accounting and internal controls systems as well as providing guidance to supervision department inspection staff in their evaluation of such systems. It is planned to finalize this regulation in the forthcoming month as well as initiating NBG’s approval and registration process for the three regulatory instruments (one regulation and two accounting instructions) now in the pipeline.

### **Legal**

- The completion of the process of retrieving the languishing draft, already approved, of the “Regulation on Internal Audit” and move it out to the Ministry of Justice. The process entails convincing the Director of Supervision that is no need to await legislative amendments before issuing this regulation.
- The completion and delivery to the Director of Bank Supervision of the draft of the “Regulation on Capital Requirements of Banks”, after final analysis with Project Accounting Advisors.”
- The drafting of the “Regulation on Limits on Bank Loans to One Borrower on Large Credit Exposures ”.
- Final decisions on the membership and operating procedures of the “Legislative Working Group”, involving, in particular, the Project Chief of Party, the Director of Bank Supervision, the Project Mission Director of USAID and the Head of the NBG Legal Department. Planning will include collaborative contact with local outside counsel, as needed, and the identification of appropriate Finance Committee members of Parliament and the design of approaches to them.
- Selection of dedicated local supervisory lawyer and commencement of work in Supervision.

### **Accounting Technical Assistance-Commercial Banks**

- Initial interviews with and assessment of the conversion to the new chart of accounts of the remaining pilot banks are continuing. The advisors and the consultants are focusing on reviewing the beginning balances at January 1, 2001 and crossover conversion adjustments from the ending balances of December 31, 2000.

## **V. Concerns/Impediments to Progress**

### **Off-site Surveillance**

- The progress of FinA has been slower than anticipated and will set back the development of the analytical tool and training the analysts. Without additional help, this part of the project will not be complete until fall.
- The Off-site Division has reorganized from two separate units into one unit. This change was recommended, and, in the long run, will provide each analyst with a greater understanding of the banks in his/her caseload. However, there is some concern that the analysts from the previous Reporting Department have not had the same amount of training as the analysts who have regularly been doing the quarterly written analyses and it will take more time and training to bring them up to speed.

### **Legal**

- It is anticipated that the blending of the different disciplines on the Legislative Working Group will be challenging. It is planned that the design of the Group's Operating Procedures will be a tool to address this problem.

### **Accounting Methodology**

- The responsibility for promoting commercial bank accounting reform currently rests with a unit within the accounting department of NBG. The performance of this unit is weak which is partly explained by the fact that its staff is primarily experienced in central bank accounting that is quite different from commercial bank accounting. A proposal to establish an accounting methodology unit in the Supervision Department, staffed by personnel with IAS qualifications and experience and the capacity to develop accounting related regulations, has been recommended in a recent report to NBG on staffing issues.

## **VI. Administrative Issues**

- RA Stroud and USAID Representative, Geoff Minott, met with the American Embassy's Chief Economics Officer to talk about the banking system and some confidential aspects with regard to one of the large troubled banks. There were

some rumors involving this bank that proved to be false and without merit. These items were cleared up to the satisfaction of the Embassy Staff.

- RA Stroud reviewed a proposal submitted by the group, Women for Urban Development, on the creation of a Credit Information Bureau. The local USAID Mission asked that Messrs. Stroud and McCormack be involved in the process in some manner. Later a meeting was held with this group to ascertain their needs and how our program can be involved with assisting in the establishment of this bureau.
- The Resident Advisors continued their weekly meetings with the Vice President and Director of the Banking Supervision Department.
- The Resident Advisors attended the monthly meeting of the Donor Organizations, hosted by the EBRD. Although this forum was established to share information and events happening among the various donors, this agenda was comprised solely of items generated by this project, such as banking regulations, the new reporting schedules and the accounting effort at the commercial banks.
- RA Grimditch attended the Monthly USAID NGO Roundtable Meeting where the Ambassador briefed the contractors on current political and economic issues related to Georgia. The Regional Security Officer also briefed the group. There have been break-ins of American residences and some minor theft, but little of the violent crimes against Westerners that occurred during the latter part of last year. However, it was noted that outside of Tbilisi, the economic situation is getting worse and very little Donor Aid is finding its way to the Regions.
- RA Grimditch and Stroud discussed what was necessary for Bankworld to register as a representative agent in Georgia. Located and sent sample documents for registration to Bharat.
- AA Mino continued to update the project budget vs. actual report in coordination with the Booz-Allen home office. January Bank World expatriate expenses were added. AA Mino participated in a conference call with the Booz-Allen home office regarding the status of our local employees.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for January 2001**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: James Watson**

Prepared by

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Tom Gordon – Accounting Advisor  
Kwi Lee – Accounting Advisor**

**February 16, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the

banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of January 2001.

## **II. Current Month's Objectives**

### **On-site Supervision**

- Organize a meeting with the IMF and the World Bank Representatives in Washington to discuss the overall strategies in implementing the necessary reforms for the commercial banking system;
- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- An organizational review of the on-site department will be performed to determine if the present management structure and staffing is adequate;
- The development and implementation of supervisory strategies for several problem banks will be developed.

### **Off-site Surveillance**

- Review timely submission and accuracy of the new monthly reports submitted by commercial banks to the NBG and affirm their adherence to the new Chart of Accounts.
- Develop an off-site analytical tool derived from the new financial reports that will contain trends, financial ratios and peer group data (the FinA project).

### **Accounting Methodology - NBG**

- Introduce newly arrived accounting advisors to Tacis personnel and initiate dialogue to facilitate agreed hand-over arrangements prior to the departure of personnel on February 28<sup>th</sup>.
- Brief new accounting advisors on background to project; progress to date towards the achievement of project objectives and current impediments.
- Visit the six banks selected banks for USAID so as to reaffirm commitment to on-site assistance from March 1, 2001 and to obtain written confirmation of their willingness and intention to cooperate fully with advisory teams.

- Begin the recruitment process relating to the hiring of three local accounting professionals.
- Develop training materials and hold an IAS accounting seminar for bank supervision department staff of NBG.

### **Accounting Technical Assistance-Commercial Banks**

- Prepare and deliver training seminar to NBG supervision staff on new chart of accounts
- Obtain written confirmation of understanding and acceptance of On-Site Technical Assistance from each of selected commercial banks.
- Begin transition process with TACIS Technical Assistance Project.
- Recruit and hire translators and local accounting professionals.

## **III. Tangible Results**

### **On-site Supervision**

- RA Stroud had several meetings in Washington DC to discuss the status of the banking system in Georgia. The meetings were held with the IMF, World Bank, and the IFC, and they were an attempt to develop some common grounds and approaches to dealing with the problems in the banking sector. Specific attention was paid to the problems of several of the large banks and the possible solutions and remedies to resolving these issues. The intent is not to allow these bank's problems to have a negative impact on the remaining banks.
- During the month, RA Stroud had several meetings with the senior management of the National Bank of Georgia ("NBG") to review and discuss the supervisory strategy with regard to a trouble bank in which the inspection was just completed. The inspection confirmed the bank to be insolvent and therefore the need for a strong supervisory response is warranted. During these discussions it was decided a temporary administrator should be appointed and this action was consummated on January 16, 2001.
- RA Stroud assisted the President of the NBG in establishing an agenda for a creditors meeting of the international donors for the above noted bank. Two separate meetings with the creditors and the senior staff of the NBG took place. The meetings were designed to allow the NBG and the international donors to exchange information on the bank's financial condition. The creditors present at the meeting included the EBRD, the IFC, the World Bank, Dresdner Bank,

Triodos Doen Bank, and the Black Sea Bank of Georgia. However, one of the creditor's stances was particularly inflexible. In addition, some of the meetings were laced with contentiousness. At this meeting, the shareholders also attended and presented their views on how to resolve the bank's problems.

- In a separate meeting from the NBG, RA's Stroud and Grimditch attended a working lunch with the local and international creditors. The purpose of the meeting was to establish a forum of cooperation and to allow each creditor the opportunity to discuss issues or ask questions that may not have been appropriate in the presence of the NBG staff.
- Shortly after the appointment of the Temporary Administration, RA Stroud met with the Temporary Administrator to discuss his role in managing the bank's affairs. The person selected for this assignment is one of the best inspectors but the NBG's senior management has given him absolutely no guidance on how to proceed with his job. As a result, RA Stroud is working with the EBRD to secure technical assistance in this area. The London staff of the EBRD has indicated they would be willing to support and fund such a project.
- RA Stroud spent a great deal of time and effort rewriting and editing the inspection report on the bank that was placed under Temporary Administration. The revised English version of the report was then send to all the bank's creditors for their consideration.
- During the month, RA Stroud met several times with the NBG's President to go over the strategy for recapitalizing one of the large troubled banks. The President of the NBG asked RA Stroud to met with the President of the troubled bank to discuss the recapitalization plans that the bank is currently pursuing. There was also a discussion regarding the NBG's issues and concerns with the EBRD. As a result, RA Stroud will be talking with the London staff of the EBRD to search for a solution to these issues. Later a conversation was held with the EBRD staff in which they promised an answer to several issues within the next few days. A conference call was set for Monday afternoon, January 29<sup>th</sup> to try and resolve these issues but the call never materialized.
- During the last week of the month, an inspection of a large commercial bank began this week. As of year-end 2000, the bank was the sixth largest bank as ranked by assets. The activity undertaken in the month of January was spent on trying to gather information needed to begin the analysis of the bank's operations. It is anticipated that the real work will begin the week of February 5<sup>th</sup>.

## **Off-site Surveillance**

- The new Regulatory Financial and Reporting Schedules have been sent to the commercial banks and will be effective beginning February 1, 2001. The schedules should be submitted to the NBG by February 10, 2001
- RA Grimditch met several times with the Head of the Department of Supervision's IT Department to discuss the status of the acceptance testing for the FinA Project. The testing is progressing very slowly as members of the Department are working on year- end and special projects. They will be able to concentrate more on FinA testing and development beginning sometime late in February. However, a number of other projects have priority. RA Grimditch also began working with the IT Department to develop the new analytical tool (similar to the UBPR).
- On a separate matter, the Head of the IT Department suggested that the inspection manual section on examining the bank's IT systems should be expanded and that members of their department be included in the IT inspection component.
- All but seven of the commercial banks fulfilled the January 1, 2001 minimum authorized capital requirement of 5 million Lari. The NBG revoked the licenses of four of these banks, as they could not find the additional capital by the January 31, 2001 deadline.
- RA Grimditch met with the Vice President and Director of Supervision and a representative of the EBRD to discuss the NBG Supervisory approach to the banks, especially the problem banks in which the EBRD has involvement. A payment was due to the EBRD on 1/10/01 from one of the problem banks and was made last week. Also discussed was the Technical Assistance that the EBRD was prepared to give the National Bank.

## **Accounting Methodology - NBG**

- Two new accounting advisors joined the project during the month. One local accounting professional also joined. AA Gordon briefed the new hires on the project's immediate objectives, current activities and impediments. Introductions to relevant personnel in NBG, EU Tacis Help Desk and commercial banks selected for technical assistance were made. Vice President Jigauri assured the new team of his support and pledged that relevant information about commercial banks from NBG and EU Tacis project would be made available. A short induction period followed since all of the aforementioned have considerable experience of accounting conversion programs in recent years in the CIS region.
- The six commercial banks selected for on-site technical assistance formally accepted the offer of assistance and submitted written acceptance confirmations to NBG. AA Gordon visited the banks during the month in order to reassure senior

management about the project's objectives and approach, to reiterate that discussions would take place with relevant staff before any action plan would be developed and to request that the bank confirm in writing its acceptance of the offer of assistance. Having received answers to its questions concerning project issues, each bank expressed its enthusiasm for the forthcoming assistance and its willingness to be supportive and cooperative with consulting personnel. The new accounting advisors have met the senior accounting personnel in the three commercial banks for which each will be responsible. Further meetings are planned from mid-February with a view to finalizing an agreed work plan prior to going on-site on or around March 1<sup>st</sup>.

- AA Gordon, with the assistance of AA Lee and local accounting professional, presented a two-day seminar for the staff of the Bank Supervision Department (off-site and on-site divisions) and a small number from the Accounting Methodology Unit. The seminar focussed on the new chart of accounts and IAS accounting requirements applicable to commercial bank accounting as required from January 1<sup>st</sup> 2001. Twenty-nine staff attended and twenty-two took a test at the end. All but three persons achieved a pass mark. The seminar was a success in terms of achieving its objectives, detailed in last weeks report. However, it is apparent that there is a need for additional training that would enhance supervisory staff's auditing skills that would enable to them to identify, verify (or otherwise) and report accurately on the reasons for changes reported in financial statements.

### **Accounting Technical Assistance-Commercial Banks**

- A two day seminar on new chart of accounts were delivered to the NBG supervision department staff by AA Gordon, AA Lee and Accounting Staff Irina Tsikhelashvili. General overview of the IAS concepts and principles; example transactions and entries; and a case study were presented. The seminar ended with a test given to the participants.
- AA Gordon and AA Lee met with five of the six selected on-site assistance banks to discuss the accounting technical assistance program offered by the USAID through the National Bank of Georgia (letter dated). There were some questions as to the scope of the project, requirements and issues currently anticipated. Some banks expressed need for assistance with upcoming ISA audits, implementation of new asset classification regulation and reporting under new chart of accounts. All banks were enthusiastic at the proposed assistance and expressed the need for such project.
- Received from all six selected banks letters of acceptance and cooperation with the assistance project.
- AA Lee met several times with Resident Manager of the TACIS project to discuss project transition in terms of sharing the office during the transition period,

receiving TACIS analysis on the six target banks, and offer of opportunity to the TACIS local accounting staff by the USAID project. USAID Commercial Bank team officially moved to current TACIS project office on Wednesday, January 31, 2001. Provided a letter to TACIS local accounting professionals via the Resident Manager with an offer to review their statement of qualifications and interview along with candidates from other sources.

#### **IV. Projects in Progress and not Completed**

##### **On-site Supervision**

- The inspection that began in late January will not be completed until mid-February.
- The organizational study regarding the staffing and efficiency of the supervision department will not be completed until sometime in February due to RA Stroud's extensive involvement in the resolution of two large banks.

##### **Off-site Surveillance**

- The banks will start reporting on the new financial schedules beginning February 1, 2001. The new Chart of Accounts was implemented on January 1, 2001. It is anticipated that it will take a couple months of submitting the new schedules before their accuracy can be determined.
- The FinA Project will be an ongoing for the next three to four more months before it will produce the required outputs and training can begin.

##### **Accounting Methodology - NBG**

- AA Gordon met with senior staff in accounting methodology unit to review feedback from commercial concerning the changeover to new chart of accounts as from January 1<sup>st</sup>. No information was available to the department to conclude on the success, or otherwise, of the changeover project and no requests for assistance were submitted by any commercial bank. A complete picture of the completeness, or otherwise, of the IAS conversion phase is unlikely until after the external audits for year 2000 have taken place or, in the case of the six commercial banks designated for USAID assistance, until diagnostic studies are concluded.
- A recruitment process relating to three vacant positions for local accounting professionals at the Help Desk has commenced. A pool of potential candidates has been identified and a series of interviews are planned for the forthcoming month.
- A report on the efficiency of the accounting methodology division is being compiled and will be completed in the forthcoming month. This will form part of

a broader report, focusing on bank supervision department staffing issues to be presented to President of NBG.

### **Accounting Technical Assistance-Commercial Banks**

- AA Gordon, Mino, Lee and AC Tsikhelashvili began recruiting process for local accounting professionals.
- AA Lee began reviewing the draft regulation on Internal Audit Requirement and Internal Audit Manual.

## **V. Concerns/Impediments to Progress**

### **Off-site Surveillance**

- The progress of FinA has been slower than anticipated and will set back the development of the analytical tool and training the analysts.
- The Off-site Division has reorganized from two separate units into one unit. Although this change was recommended, and, in the long run, will provide each analyst with a greater understanding of the banks in his/her caseload, there is some concern that the analysts from the previous Reporting Department have not had the same amount of training as the analysts who have regularly been doing the quarterly written analyses.

## **VI. Financial Information on the Banking System**

As of January 1, 2001, the Georgian banking system consists of 32 banks. 30 of those are resident banks and two are branches of foreign banks (branch of the Turkish “Emlak Bank” and branch of the Azerbaijan “TransCaucasian Development Bank”).

Total assets of the banking system were 725,516,789 Lari, or the approximate equivalent of \$367 million. This figure increased from 579 million Lari, or by 25%, since January 1, 2000. During the same period, the loan portfolio increase by 39% (from 307 million to 428 million) Lari, while liquid assets grew by 27 million Lari. The asset growth was funded primarily by increases in deposits (99 million Lari) and capital (33 million).

The asset size of the banks ranges from four million to 109 million Lari. The number of the banks according to their size is the following:

<b>% of the Total Assets</b>	<b>Number of Banks</b>
More than 5%	8
From 1% to 5%	10
Less than 1%	14

The asset structure of the banking system is as follows:

<b>Assets</b>	<b>% of the Total Assets</b>
Cash	26.0%
Securities	0.9%
Net Loans	55.2%
Net Fixed Assets	10.6%
Investments in Affiliates and Other Enterprises	1.9%
Other Banking Operations	0.8%
Other Assets	4.6%
<b>Total</b>	<b>100%</b>

Loans are diversified in the various economic sectors in the following way:

	<b>Economy Sector</b>	<b>% of the Total Loans</b>
1	Loans to individuals	30.3%
2	Loans to trade and service	25.0%
3	Loans to light and heavy industry	17.9%
4	Loans to the other sectors	7.2%
5	Loans to construction and real estate	6.5%
6	Loans to energy and natural resources	5.3%
7	Loans to agriculture	3.6%
8	Loans to transportation and communications	2.9%
9	Inter-bank loans	1.3%
	<b>Total</b>	<b>100%</b>

During the past year, loan loss reserve to total loans increased from 4.5% to 6.65%. The share of past due loans in total loans compared to the previous year increased from 6.9% to 7.4%. Total capital to total assets declined from 30.4% to 28.8%. These figures indicate a deterioration in the financial condition of the banking system. Even so, the resident advisors believe these figures do not adequately reflect the real condition of the system's asset quality because the regulation that governed loan loss provisions and asset classifications was flawed. The new regulation, approved December 29, 2000, will not be reflected in the financial statement until the April 10, 2001 filing of the reporting schedules.

As mentioned above, the ratio of capital to assets is fairly high, with total capital to total assets being 28.8% and total capital to risk weighted assets being 35.5%. For the 15 smallest banks, capital equals more than 50% of their assets. Conversely, deposit liabilities at these banks are very low.

Total capital of the banking system amounts to 208,893,540 Lari. Compared to January 1, 2000, this figure grew by 20%. The major part (83%) of the total capital is issued capital. Compared to the beginning of the year, issued capital increased by 19%, most of which occurred during the period after 1<sup>st</sup> of June. The main reason for this increase is the requirement set by NBG, according to which the minimal issued capital should total four

million Lari by the 1<sup>st</sup> of July, and five million Lari by January 1, 2001. However, subsequent to July 2000, any increases to the system's capital, either through retained earnings or by the January 2001 capital infusion, was substantially offset by the losses at one problem bank

Net income of the total banking system for year 2000 totaled 3,392,371 Lari, which is 86% less than the previous year. Part of this decline can be attributed to a reduced net interest margin.

<b>Ratios</b>	<b>01.01.00</b>	<b>01.01.01</b>
Income from loans/Average Loans	22.2%	19.6%
Expense paid on deposits/Average Deposits	6.3%	5.1%
Margin	15.9%	14.5%

However, the main reason for the poor performance is the abovementioned losses at the problem bank, as well as the increase of non-interest expense and loan loss provisions. In addition, fourteen of the banks have experienced net losses for the year, compared to eleven banks during 1999 and the losses this year have been much greater. The lack of strong earnings is evidence that the asset quality of the system is worse than the asset quality indicators would imply.

As of January 1, 2001, annualized ROAA and ROAE total 0.5% and 1.6%, respectively. These figures decreased compared to the previous year, when they totaled 4.3% and 13.3%, respectively

Total liabilities of the banking system amount to 481,615,832 Lari. This figure increased by 25% compared to the beginning of the year. The major part of liabilities – 64.8%, is deposits; borrowings equal 30.2%. Deposits of individuals are 36% of total deposits, and those of legal entities equal 64%. However, it is important to note that 85% of all deposits are held in the 10 largest banks: 95% of the deposits are in the largest 14 banks.

As of January 1, 2001, liquid assets totaled 176,235,368 Lari, which is 24% of total assets. As of this period, liquid assets to total liabilities is 36.6%, which decreased slightly compared to the beginning of the year, when it totaled 40.3%, but is higher than the NBG requirement of 30%.

The overall condition of the banking system is not very optimistic. Asset quality is questionable and earnings are poor. However, it should be noted that the declining results, compared to the previous year, are probably as much as the result of the inspectors uncovering existing problems as they are a real deterioration in system. The continued high capital and liquidity ratios somewhat offset the bleak picture and provide a certain cushion in case of a crisis, but the health of the banking system is dependent upon sustainable earnings from productive assets. The imposition of the new asset classification regulation, coupled with the implementation of International Accounting Standards will, undoubtedly, contribute to a reduction in the number of the weaker banks.

## VII. Administrative Issues

- RA Stroud met with Messrs. Bhargava and Hersh to discuss several administrative aspects of the project. These items include the registration of Booz-Allen in Georgia and the impact this will have on the status of the local hires for this project. Other items including the arrival time of Ray Mino in Georgia.
- RA Stroud met with Geoff Minott to brief him on the issues surrounding the appointment of the temporary administrator on one of the commercial banks. Apparently Mr. Minott has to brief the American Ambassador on this matter. Later in the week, Mr. Minott called back to state that Messrs. Minott and Stroud would be meeting the embassy staff on February 2<sup>nd</sup>.
- RA Grimditch met with GCG representatives several times to discuss the ramifications (tax liabilities, increased costs and effect of labor laws) on Booz Allen becoming a registered company and employing local hires. GCG submitted their opinion on January 19, 2001. Also discussed was the need to change the Booz Allen Registered Office from the Land Market Development Project location to the NBG Offices and to open a corporate bank account.
- RA Grimditch attended the weekly meetings with the Vice President and Director of Supervision. During one of the meeting she described in some detail the new analytical tool being prepared by IT Supervision from the new financial and reporting schedules.
- RA Grimditch met with E.U. TACIS staff to determine what was needed in their office to accommodate the new Accounting Advisors and Assistants. A request for some additional computers was transmitted to Washington.
- RA Grimditch and AA Gordon met with a PricewaterhouseCoopers consultant on an IFC Technical Assistance program to two for the large banks. His area of TA is credit focused, which does not conflict with USAID support for accounting reform. He was most interested in a developing a coordinated effort between the advisors. We informed him that such a group existed and we would let him know about the next meeting when we were informed of one in advance.
- RAs Grimditch and Stroud attended the weekly meeting with the Vice President and the Director of Banking Supervision. The strategy of dealing with two large problem banks and upcoming meetings with creditors and shareholders was discussed. The Director of Supervision noted that the Asset Classification Regulation had been distributed and the banks were supposed to file their policies and procedures as to how to effect the regulation by February 25<sup>th</sup>. RA Stroud

described his Washington D.C. meetings with the World Bank, the IFC and IMF and their view of the NBG's Supervision.

- RAs Stroud and Grimditch attended several meeting with the local and international creditors of one of the larger troubled banks where a Temporary Administrator had been appointed by the NBG. At one meeting the shareholders also attended and presented their views on how to resolve the bank's problems. The purpose of the meetings was to establish a forum of cooperation. However, one of the creditor's stances was particularly inflexible. In addition, some of the meetings were laced with contentiousness.
- The advisors attended a lunch meeting to up-date them on RA Stroud's meetings in Washington D.C. and to discuss future staffing needs and salaries.
- RA Grimditch attended the bi-weekly meeting of the USAID Contractors. The USAID representative announced up-coming changes in the staffing of the Economic Restructuring Department of the Mission. During February, the Mission would be involved in reviewing the Strategic Objective (SO) and would require input from the contractors. Also, the Assessment from Walter Coles visit last summer would be available to the contractors.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for December 2000**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - February 2002**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: James Watson**

**Prepared by**

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Tom Gordon – Accounting Advisor  
Martin McCormack – Legal Advisor**

**January 19, 2001**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the

banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of December 2000.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement of an inspection on two large troubled banks;
- The completion of inspection of a small bank;
- The development and implementation of a supervisory strategy to deal with the problems of the aforementioned banks in which an inspection is on-going this month;
- Continue to work with the Director of the Banking Supervision Department to ensure that the Ministry of Justice completes its review of the recently submitted asset classification regulation;

### **Off-site Supervision**

- Introduce new monthly financial/regulatory reports and schedules based on the new Chart of Accounts, which will be submitted by the commercial banks to the NBG. Develop instructions and a mapping schedule for the reports.
- In conjunction with First Irish Consultants, the off-site department will develop an off-site analytical report/tool that will be derived from the new financial reports and will contain quarterly financial ratios and peer group data similar to the Uniform Bank Performance Reports ("UBPR"). This report can be used by both off-site and on-site analysts to monitor trends, identify potential problems at an early stage and help develop a more tailored scope for the on-site inspections
- Prepare and give six-month evaluation for the local staff working on the Banking Supervision Project.

### **Legal (insertion by McCormack)**

## **Accounting - Methodology**

- Support the NBG's decision-making process, with a view to conclusion, concerning the selection of commercial banks for on-site technical assistance for accounting reform.
- Discuss, and agree with Tacis Help Desk, transfer arrangements upon the cessation of EU Tacis support and the arrival of USAID personnel.
- Develop, reach consensus among interested departmental staff, and propose to NBG an accounting regulation that governs accounting practices for repossessed assets securing defaulted loans.
- Ensure that NBG accounting methodology department dispatches to commercial banks appropriate resources (mapping guides, accounting guidelines and financial statement formats, year-end procedures) to support the complete transfer of account balances from Gosplan to new IAS Chart and the adoption of new IAS-compliant practices.

## **III. Tangible Results**

### **On-Site Supervision**

- RA Stroud attended a meeting with the Vice President of the NBG and a representative of the IFC to discuss the IFC's line of credit at a particular commercial bank in which an inspection is currently ongoing. The IFC is concerned that some of the loan repayments from their sub-borrowers are being diverted for other purposes that appear to benefit a selected group of shareholders. After several other meetings, a tentative solution was arrived at in which a special account will be established at the NBG in which all monies received from the IFC's sub-borrowers will be placed in this special account.
- Later in the month, RA Stroud participated in a conference call between the NBG's President and several Washington based officials of the IFC. The purpose for the call was to discuss the IFC's above noted concerns about a particular bank's problem loans and the bank's reluctance to repay these loans. The IFC is concerned that approximately \$250,000 of their money has been diverted for the benefit of some of the bank's shareholders.
- RA Stroud held several meetings with the Director of the Bank Supervision Department to review the situation involving external audits of the commercial banks. Later in the month, a written proposal was prepared by RA Stroud to outline his written suggestions and requirements on the need and requirements for these types of audits to be continued in the future for all commercial banks.

- During the month, RA Stroud visited the inspectors on several occasions at one of the banks being inspected. This particular bank is insolvent and the inspection is an attempt by the NBG to document the extent of the bank's losses and problems. It is anticipated that the inspection will not be completed prior to the year-end. A meeting was held with the subject bank's President and the Representative of the IFC to discuss the various problems impacting this bank. In all likelihood this bank will be insolvent and there will be a clear need for the appointment of a temporary administrator or some other type of regulatory action.
- RA Stroud finished his final review of the Conflicts of Interest Policy. Several discussions were held with the NBG staff to ensure their understanding of the proposed regulation. Based on this review and discussions, there were no major issues left that need to be resolved on the part of the resident advisors. It is anticipated that this regulation will be presented to the Ministry of Justice by year-end provided the NBG's legal staff has no questions or issues that need to be resolved.
- The English version of an inspection report on a large bank (in which the actual inspection was completed in November) was edited and rewritten during the month. It is anticipated that the English copy will be forwarded to the Board of Supervisors and other international donors after the first of the New Year.
- A meeting was held with the President of another troubled bank to deliver and discuss the requirements of the recently signed Cease and Desist Order. A second meeting took place during the month to establish the procedures for complying with the requirements of the Order.
- RA's Stroud and Grimditch met with the Deputy Director and the Manager of the on-site inspection department to discuss several issues with regard to a current inspection of a small bank. According the NBG staff this particular bank's management and the management of a bank in Moscow may be involved in some type of illegal money laundering schemes and a large defalcation. As a result of this meeting, the inspection report comments are being translated to English so that RA Stroud can review this matter in more detail and in turn, provide a better and clearer response to the inspectors' questions. As of the end of the month, the report was 90% complete.
- RA Stroud provided a brief response to Martin Slough of the World Bank on his assessment of eight commercial banks. Mr. Slough had left this assessment with RA Stroud on his last visit to Georgia. It is anticipated that RA Stroud will meet with Mr. Slough and others members of the World Bank in early January in Washington.
- During the month, RA Stroud and LA McCormack met with the Vice President and the Director of the Bank Supervision Department several times to finalized the form and content of the asset classification regulation. All questions and

issues were finalized and a copy of the regulation was forwarded to the Ministry of Justice on December 15<sup>th</sup>.

- RA Stroud had several meetings with the officials of the ERBD (Jurgen Schramm, Hildegard Gacek, Charles Wrangham) to discuss issues involving some of the credit lines that the EBRD has with several of the banks. One bank appears to be in technical default on the repayment schedule to the EBRD. This same bank is a troubled bank and one that may eventually require the NBG to appoint a temporary administrator. There were also some discussions involving the EBRD's advancing some additional funds for technical assistance on one bank. This issue will be further discussed early next year with Mr. Wrangham.
- RAs Stroud and Grimditch met with representatives of the International Auditing Firm, Grant Thornton. Previously, the NBG had issued a letter directing that the commercial banks could be audited only by one of the "Big Five" accounting firms. The NBG, along with Grant Thornton, have inquired whether the list of acceptable auditors could be expanded to include a larger number of firms.

### **Off-site Surveillance**

- The new financial statements and subsidiary schedules were approved by the NBG and sent to the commercial banks to begin use with data as of February 1, 2001.
- RA Grimditch met with First Irish Consultants and the visiting USAID Information Technology Team to discuss the status and future strategy of the FinA Project. This group also met with the NBG's Chief of the Information Technology Department. First Irish presented the progress of the FinA Project. It has reached the acceptance testing stage at the Central Bank of Armenia (CBA) and will go "live" there during the first six months of 2001. The system is being prepared for acceptance testing at the NBG. The test will input historical data for ten banks and cover several time periods during 2000. The test data outputs will be compared to the existing data and schedules. Due to the recent introduction of the new schedules and the implementation of IAS, a second test will be run using the new data and reports. Data from the new reports will be manipulated to produce an analytical tool similar to the UBPR. First Irish has hired a group of Armenian specialists who are dedicated to assisting in the development and implementation of the project for both the CBA and the NBG until June 2001.
- RA Grimditch, First Irish, and the USAID IT Team met with Geoff Minott to discuss the progress of the FinA Project. Mr. Minott was interested in the adequacy of the technical skills of the National Bank of Georgia's IT Department and the level of maintenance necessary. First Irish represented that FinA would be self-supporting and the NBG people had sufficient technical knowledge to maintain it and even develop it further. The timeline for the first MetaData tree, its tests and acceptance of the software would be the end of February. The second

MetaData tree (based on the new schedules) could be developed independently and ready to load as the data from the new schedules came in. The second testing would take place subsequently.

- RA Grimditch and her assistant developed the new output format and ratios for the structure of the analytical tool the FinA Project will produce. This tool is based on a combination of the U.S. and Armenian formats of the UBPR.
- RA Grimditch gave an oral presentation to some commercial banks' accountants regarding the new schedules. The accountants were informed that the final version of the schedules would be sent out toward the end of the year 2000.

### **Legal (insertion is needed by McCormack)**

### **Accounting - Methodology**

- The NBG selected six commercial banks that will receive on site technical assistance from early 2001 following the arrival of two international accounting consultants and the hiring of a number of local accounting personnel. The decision was based on a recommendation from AA Gordon and COP Stroud that took account of the views of NBG supervisory staff, requests for support from commercial banks and USAID conditions pertaining to entities benefiting from technical assistance. NBG has communicated the selection decision to the relevant banks and sought written confirmation of their acceptance of the offer of technical assistance. Verbal confirmations from all banks have been received and written confirmations are awaited.
- An agreement was reached with Tacis Help Desk representatives concerning logistical arrangements when the commercial bank accounting reform project is transferred to a USAID team in early 2001. It now transpires that Tacis will end their involvement as from February 28<sup>th</sup> 2001 instead of March 31<sup>st</sup> as originally planned. This change in changeover date does not give rise to any significant difficulties since USAID consultants are arriving in mid-January 2001. Incoming personnel will use office space previously occupied by Tacis personnel. During recent discussion USAID and Tacis personnel parties made a commitment to full cooperation during the transition period, commencing mid-January. It is not envisioned that issues of a contentious nature will arise in the transition period.
- AA Gordon presented to the accounting methodology department a draft Regulation No. 2, entitled *Accounting for Repossessed Assets securing Defaulted Loans* following its review by the project's legal expert. The purpose

of the regulation is to bring about uniformity and consistency in relation to an accounting practice that can often have a material impact on a commercial bank's financial position and reported net income. NBG's accounting staff is now reviewing the draft regulation and the accounting advisor will endeavor to have NBG conclude the review, and approval, process in the forthcoming month.

- Two accounting training seminars were organized for commercial bank staff and presented by a training specialist from the Barents Group. Forty-three persons from twelve banks attended the seminars, held over a seven-day period. AA Gordon provided for the presenter position papers on accounting topics currently under review at NBG as well as delivering a two-hour presentation on the accounting implications of the new Asset Classification Regulation.
- Mapping guides and financial statement formats, prepared by AA Gordon, were approved by accounting and supervision departments at NBG and dispatched to commercial banks. These mapping guides are essential resources that support the transfer of account balances from Gosplan to IAS chart and the preparation of monthly financial statements required by the Bank Supervision Department.

#### **IV. Projects in Progress and Not Completed During the Month**

##### **On-site**

- There are currently two inspections still in process on two severely troubled banks. It is anticipated that these inspections will be completed not later than the week of January 15, 2001. At the conclusion of these inspections it is anticipated that some type of supervisory actions will be taken with regard to these banks.

##### **Off-site Surveillance**

- Preparation of the data based system for testing, providing out puts and the design an implementation of the analytical tool will be projects in progress for the next several months.

##### **Accounting-Methodology**

- Two accounting regulations (General Accounting Regulation for Commercial Banks and Accounting for Repossessed Assets securing Defaulted Loans), proposed to NBG, have not yet been approved. It is expected that senior NBG management will focus their attention on these regulations in the forthcoming month.
- Recruitment process relating to local accounting professionals and translators, supporting USAID's two-man international accounting team, has commenced. One professional accounting person has been recruited and will start in mid-

January. The recruitment process will continue in the forthcoming month so as to facilitate an input to the hiring decisions from the international accounting experts.

## **V. Concerns/Impediments to Progress**

### **Accounting - Methodology**

- A paper, developed by the accounting advisor entitled *Guidance to Commercial Banks on Conversion and Accounting Issues*, has not yet been approved for distribution by NBG. The paper includes a summary of the IAS-compliant accounting options for significant accounting areas pending the approval of individual regulations for these matters. Such a summary would be a significant benefit to senior accounting practitioners in commercial banks. The failure to approve this paper reflects management's nervousness concerning policy changes and a frequent inability, or unwillingness, to accept fully a recommended policy. The project team's pragmatic approach to such a situation is to welcome, and support, an NBG decision when a substantial part of a recommendation is adopted. The accounting advisor will continue his endeavors to conclude the approval process for the aforementioned paper or a modification of it.

## **VI. Financial Information on the Banking System**

- The financial information on the banking system will only be included on a quarterly basis and therefore will not be included again in the monthly reports until year-end 2000 financial information is available. Therefore, this information will be included in the January 2001 monthly report.

## **VII. Administrative Issues**

- During the month, a signing ceremony for the 2001 Work Plan was held with several representatives of the National Bank. The NBG's President and Vice President made some brief remarks along with RA Stroud. The event only lasted approximately 30 minutes and was very low keyed compared to last year's ceremony. Only a few members of the written press were present.
- RAs Stroud and Grimditch met with representatives of Georgian Consulting Group (GCG) to discuss the legal and tax consequences of hiring local nationals as Booz Allen employees. RA Grimditch subsequently had further discussions with GCG representatives. GCG was to draft an engagement letter and research potential liability for past contract employment and the early termination of such contracts. The local consulting firm is going to look into these issues and provide us with some alternatives to review and discuss.

- Each RA provided a job review and evaluation for their local support staff regarding their work performance for the year 2000. During the month, each advisor had an oral interview and present the evaluations to their respective staff members. Any raises given as a result of the evaluations will be effective January 15, 2001.
- RA Stroud met with the NBG's President and Geoff Minott to discuss the proposed 2001 work plan. The specifics of the work plan were discussed and agreed on. As mentioned previously the document was signed.
- RA Stroud attended the bi-monthly USAID meeting. No new major issues were noted.
- RA Grimditch met with RA Stroud and discussed the staffing budget and required equipment for the New Year, given the anticipated increase in staff and salary increases for existing staff. A cash advance request was sent to Washington, based on these discussions
- RA Stroud and AA Advisor Gordon had a conference call with Ray Mino to briefly explain the banking supervision program at the NBG and to ascertain his interest in working on this project. Mr. Mino indicated his interest in coming to Georgia and working on this project. This was later communicated to Bharat Bhargava and Marc Hersh in a conference call. A conference call was also held with Kwi Lee and Bharat Bhargava to discuss their schedules for meeting in Washington in the beginning of January 2001. It was also discussed that Ms. Lee will inquire as to the availability of some training materials that cover the basics of international accounting standards. It is anticipated that a two- day training session will take place in late January for the supervisory staff of the NBG.
- RA Stroud and LA McCormack met with Geoff Minott to brief him on the status of the two troubled banks and our continuing efforts to help the NBG implement a solution for these banks.
- RA Grimditch and AA Gordon attended the bi-monthly meeting that the TACIS representative holds with the Accounting Methodology Department. The TACIS representative expressed concerns with several smaller banks and their ability to implement IAS.
- RA's Stroud, Grimditch, and LA McCormack attended the weekly meetings with the Vice President and Director of Supervision.
- RAs Stroud and Grimditch met with representatives of Grant Thornton. Previously, the NBG had issued a letter directing that the commercial banks could be audited only by one of the "Big Five" accounting firms. The NBG (and Grant Thornton) have inquired whether the list of acceptable auditors could be expanded to include a larger number of auditors.

**USAID**

**Bank Supervision and Enforcement Program**

**The National Bank of Georgia**

**Tbilisi, Georgia**

**Monthly Report for November 2000**

**Contract No. NIS-1-00-98-00035-00**

**Task Order No. 1**

**Period of Performance: September 1999 - September 2001**

**Cognizant Technical Officer: Laurie Landy**

**Private Sector Officer: James Watson**

**Prepared by**

**Terry L. Stroud – Chief of Party  
Gloria Grimditch – Resident Advisor  
Tom Gordon – Accounting Advisor  
Martin McCormack – Legal Advisor**

**November 12, 2000**

**Booz-Allen & Hamilton**

## **I. Introduction to Project**

The requirements of the current Task Order state that the United States Agency for International Development (“USAID”) will provide technical assistance to the National Bank of Georgia (“NBG”) for the continued development of its banking supervision program. This technical assistance is intended to provide practical training and assistance in the following areas of bank supervision: 1) on-site examination policy and procedures, including the practical implementation of inspection techniques; 2) improvements in off-site surveillance and database development; 3) organizational development and structure of the banking supervision department; 4) analysis of problem banks, including remedial programs; 5) a review and enhancement of the existing legal infrastructure; and 6) an analysis and implementation of selected audit programs to help improve compliance with International Accounting Standards.

The NBG has been performing an analysis of the commercial banking system using the CAMEL system since late 1996. The International Monetary Fund, the World Bank, EU Tacis, and other international donors have made significant progress in helping the NBG improve its procedures to supervise and monitor the commercial banking system. As previously noted, the NBG’s banking supervision department has been preparing on-site inspection reports based on the CAMEL system. However, the scope of their review and the quality of their analysis needs to be improved significantly. The NBG has also developed an off-site program that consists of monthly and quarterly reports that are being submitted to the NBG. These reports are intended to allow the NBG to monitor the financial condition of the commercial banks between inspections. The quality and depth of these reports is also in need of substantial improvement.

The current phase of the banking supervision program began on October 25, 1999 with two resident advisors. The program as originally detailed was structured to reinforce the bank supervision staff’s ability to identify and control risks in the commercial banking system. The proposed technical training will include practical demonstrations of how to review and assess the management structure of a commercial bank, a review of its policies and procedures for all major functional areas, including lending, record keeping and accounting, and asset/liability management.

The supervision department has a good foundation but significant training and reinforcement of how to apply international supervisory policies/practices is urgently needed. As a result of the need to institutionalize the regulatory process, specific training programs will include how to review the bank’s quality of assets, including the adequacy of reserves for loan losses. This training will also include the proper analysis and classification of assets and will go beyond the simple number of days a loan is delinquent. The inspection staff will be instructed to analyze the borrower’s ability to repay the debt in a timely manner. A corporate governance program will also be developed and implemented to ensure that the

banks are being managed in a prudent manner and that each director is fully living up to his/her fiduciary responsibility. An in-depth analysis of the internal and external audit practices will be made and recommendations for improving the accounting and internal control functions will be made where warranted. This report is intended to document and highlight the progress made during the month of November 2000.

## **II. Current Month's Objectives**

### **On-site Supervision**

- The commencement and completion of an on-site inspection utilizing the CAMEL system;
- The development and approval of a work plan that will detail the work to be performed on this project for the year 2001.
- Begin the implementation phase of supervisory strategies for several problem banks including the development and issuance of a Cease and Desist Order on one of the troubled banks.

### **Off-site Supervision**

- Finalize the monthly financial statements and subsidiary schedules and present them to the Director of Bank Supervision.
- Work with the off-site analysts who participated in the on-site inspection of two large commercial banks. Review and edit the comments on these inspection reports.
- Review the third quarter CAEL Monitoring Reports of the commercial banks prepared by the off-site analysts.
- Develop Off-Site portion of the Work Plan for the next year.
- Co-ordinate with the TACIS accounting representative to develop guidance for Bank Supervision on accounting issues.

### **Accounting**

- Monitor the approval and registration process for the Chart of Accounts ("COA") and related documentation.
- Assist Accounting Methodology Department to formulate responses to significant accounting policy questions raised by the Tacis Help Desk and commercial banks.

- Prepare, review and have approved, mapping guides that facilitate the transfer of balances from Gosplan chart to IAS Chart and the preparation of financial statements.
- Develop, and propose to NBG, a general accounting regulation for commercial banks.

## **Legal**

- Review with the Director of Supervision her reactions to LA McCormack’s consultation paper proposing fundamental amendments to the “Law on Activities of Commercial Banks”.
- Receive and analyze the final comments of the NBG Legal Department on the “Regulation on Asset Classification and Creation of Loan Loss Reserves”, reconciling these comments with the views of the Director of Supervision.
- Receive and analyze the initial comments of the NBG Legal Department on the “Regulation on Internal Audit”.
- Receive and analyze a new marked-up set of changes to the “Regulation on Conflicts of Interest and Transactions With Related Parties” proposed by the Director of Supervision.
- Present the legislative and regulatory programs of the NBG to the First Deputy Minister of Justice and his staff.
- Agree to the final provisions of the Cease and Desist Order against a troubled bank and then assist the Legal Department in preparing its final text.
- Enter into preliminary discussions with the Director of Supervision concerning her comments on McCormack’s proposed amendments to the “Law of Georgia on the National Bank”.
- Continue the design and planning of the “Regulation on Capital Adequacy” as part of a general overhaul of the NBG’s “master” prudential regulation.
- Formulate the legal component of the Project Work Plan to be approved by USAID and agreed by the NBG.
- Initiate dialogue with USAID’s MFI liaison and local NGOs on the establishment of a Georgian regulatory policy toward depositary and non-depositary micro-finance institutions.

### **III. Tangible Results**

#### **On-site Inspections**

- During the month, several meetings were held with the Vice-President and the Director of the Banking Supervision Department to again go over the requirements of the Cease and Desist Order that was recommended by RA Stroud several weeks ago. Later in a separate meeting, the Vice-President invited the President of the subject bank to the NBG to discuss the Order.
- A meeting with NBG's President, the Vice-President and the Director of the Banking Supervision Department was held for the purpose of discussing the supervisory strategies with regard to two troubled banks. The strategy with regard to one of the banks was to issue a Cease and Desist Order. It was anticipated that the President would sign this Order by the end of the month but it was later discovered that the Order was signed on December 4<sup>th</sup>. The issues involving the other bank includes the possible appointment of a temporary administrator and the scheduling of an on-site inspection to determine the bank's "true" capital position.
- Several meetings were held with the senior staff of the NBG and two senior officers of one of the troubled banks noted above. After several starts and stops, the NBG will begin an inspection on Monday, December 4, to determine the "true" financial condition of this bank. It is the consensus of the group that this bank is insolvent but this fact must be clearly proven and thus, the purpose of the inspection. The need for the inspection is a necessity before any serious consideration can be given to the appointment of a temporary administrator for this bank.
- RA Stroud completed his final analysis and review of the inspection report on the largest bank (as ranked by assets) in Georgia. There were some noted improvements in the quality of the report; however, there were still too many careless errors and mistakes being made by the inspections. The ratings being assigned by the inspectors (still) need to be better supported and justified. In addition, there are too many instances in which the inspectors are providing information that is not relevant to the bank's operations. One of the inspection reports (that was completed in November) has been completely rewritten in English and the second one is in the process of being rewritten. It is RA Stroud's intention to have the redrafting process on the second inspection completed by no later than December 15<sup>th</sup>. These particular banks have a significant involvement with several international donors and the facts and conclusions need to be clearly and precisely detailed in the report. A copy of the Georgian and English versions will go to the banks' Supervisory Boards.
- A second in a series of meetings was held with the ownership group of another large troubled bank. These meetings were to allow the owners to explain their plans for recapitalizing the bank in face-to-face meetings with the staff of the

National Bank. A review of the bank's latest proposal reveals it to be rather vague and short on specifics. Subsequent to all these meetings, RA Stroud prepared a written response to this bank's proposals and urged the President of the National Bank to take some type of regulatory action on this bank. Two alternatives were provided in RA Stroud's written recommendation.

### **Off-site Supervision**

- RA Grimditch has been working with her assistant and the Bank Supervision Department to develop underlying supervisory reporting schedules that will conform as much as possible to the new Chart of Accounts. However, much of the information required by bank supervision is not included in the synthetic accounts presented in the Chart, therefore the commercial banks will have to develop analytical account to satisfy bank supervision reporting requirements. RA Grimditch met with Supervision Policy and Off-site to discuss the proposed new schedules. These schedules will be the basis of the data base project (FinA) that will ultimately produce an analytical report similar to the Uniform Bank Performance Report (UBPR).
- The Off-site Analysts prepared the Quarterly Surveillance Reports on the commercial banks for the third quarter of 2000. This is the second quarter that these reports have been prepared using the new CAEL methodology. Although some of the reports are better than earlier ones, the analysts need more training and guidance in analysis and writing skills. Their comments are often rambling, redundant and not risk focused.
- RA Grimditch reviewed the inspection reports for the two recently completed inspections of two large banks. Although these reports are somewhat improved from previous reports, there were factual errors, inconsistencies and confusing statements. Comments were presented to the Inspector-in-Charge to make corrections and clarifications.
- RAs Stroud and Grimditch met with the USAID Information Technology team to discuss the status and strategy of the databased FinA Project. The meeting was preparatory to the arrival of the First Irish Consultants in early December.
- RA Grimditch and AA Gordon met bi-monthly with the TACIS accounting representative to discuss what matters needed to be addressed by Bank Supervision. Due to a presentation given by RA Grimditch in October, the banks were aware that there would be changes in the reporting schedules, the final copy of which need to be approved by the Bank Supervision Department.
- RA Grimditch developed the Off-site portion of the Work Plan for the coming year.

## Accounting

- The Chart of Accounts and Accounts Descriptions Manual were finally published in the government gazette on November 15<sup>th</sup> following registration at the Ministry of Justice. These are now binding on all commercial banks with regards to the maintenance of accounting records that comply with international accounting standards. While the new chart has the capacity to support now an IAS compliant accounting, and reporting, systems there are design faults that will need to be eliminated in order to ensure that the chart can fully support evolving internal and external reporting requirements. An added impediment is the difficulty in making alterations due the requirement that all changes are subject to the approval and registration process previously described for the chart of accounts.
- AA Gordon prepared, discussed and agreed with the Accounting Methodology Department two positions statements relating to accounting policies issues that were the subject of much discussion, and debate, involving NBG, Tacis and commercial banks, over a lengthy period. The formulated positions will now be reflected in accounting regulations to be developed over the duration of the project. The agreed statements were dispatched to the Tacis Help Desk.
- A paper, entitled NBG Guidance to Commercial Banks on Conversion Issues was finalized by AA Gordon and submitted to the Chief Accountant and Vice President Jigauri. This paper stipulates the NBG's position on the significant accounting policy matters frequently questioned by commercial banks. It is envisaged that this paper will be circulated to all commercial banks once NBG approves it.
- AA Gordon developed, and agreed with bank supervision and accounting departments, a mapping guide that supports the preparation of financial statements from the accounting records rooted in the COA. Commercial banks generally, with the assistance of their IT departments, automate a process using the aforementioned mapping guide that produces a set of preliminary financial statements. In order to accomplish full IAS compliance these draft financial statements must be reviewed by the Chief Accountant and accounting adjustments made if warranted. More training is needed in this area to equip chief accountants with the skills required to complete this process. The mapping guides compliment commercial bank financial statement formats recommended to NBG.
- AA Gordon formulated an accounting regulation entitled ***General Accounting Regulation for Commercial Banks*** and following review by the project's legal advisor proposed it the NBG. This is the first in a series of accounting regulations required to be approved, and issued, by NBG so as to underpin international accounting practice in commercial banks.

## **Legal**

- Just prior to month's end, final comments were received by LA McCormack from the NBG Legal Department on the "Regulation on Asset Classification and the Creation of Loan Loss Reserves". The translation of these comments was immediately undertaken.
- The final set of comments was received by LA McCormack from the Director of Bank Supervision on the "Regulation on Conflicts of Interest and Transactions With Related Parties". These comments were evaluated by LA McCormack after which he responded with a detailed letter setting forth not only his agreement with most of these comments but also his disagreement with several of them.
- The provisions and text of the Cease and Desist Order was agreed by RA Stroud, LA McCormack and the Director of Supervision after which it was approved by the NBG Legal Department and forwarded to NBG President Managadze for signature and delivery to the bank involved.
- The NBG legislative and regulatory programs were readied for presentation to the Ministry of Justice with the presentation scheduled for December 1.
- The legal component of the Project Work Plan was completed and reviewed with RA Stroud and was later discussed with Geoff Minott.

## **IV. Projects in Progress and not Completed**

### **On-site Supervision**

- A draft of the Work Plan was completed and reviewed with USAID; however, the President of the NBG and USAID Representative has not officially signed the document.
- The supervisory strategies with regard to several troubled banks are still on going.

### **Off-site surveillance**

- RA Grimditch did not complete the review of the quarterly off-site reports for the third quarter of 2000. These will be reviewed with the analysts in December and may lead to a workshop discussing how to focus and analyze the risks rather than describe the financial data.

### **Accounting**

- An accounting regulation entitled, *Accounting for Repossessed Moveable and Immoveable Assets securing Defaulted Loans*, is near completion. It supports the proposed Assets Classification Regulation and will be commended to NBG when the latter is approved.
- In relation to accounting extension project, issues relating to bank selection, hiring of local accounting personnel and agreement with Tacis on project logistics remains outstanding but not overdue. A proactive approach to resolving these issues is being maintained consistent with time constraints. Agreement with NBG on bank selection issues is expected around mid-December.

## **Legal**

- Supervisory discussions and legal planning continue in connection with the execution and timing of a targeted examination of a distressed bank simultaneously with the appointment of a Temporary Administrator to manage its affairs.
- LA McCormack continues to await official responses from the Director of Supervision and the Legal Department on his consultation paper containing proposals for bringing the “Law on the Activities of Commercial Banks” up to international standards.
- LA McCormack continues to await official responses from the Director of Supervision and the Legal Department on his proposed amendments to the “Law of Georgia on the National Bank”.
- LA McCormack continues to await official responses and discussions with the Legal Department of the “Regulation on Internal Audit”.
- LA McCormack, after discussions with RA Grimditch at the request of RA Stroud, continues to await the scheduling of their planning consultations on drafting the “Regulation on Prompt Corrective Actions” as well as on the revisions of the NBG’s current flawed “master” prudential regulation.
- Consultations continue with USAID and NGOs on regulatory policy planning by the NBG in connection with MFIs.

## **V. Concerns/Impediments to Progress**

### **NBG - Accounting**

- AA Gordon continually emphasizes the importance of NBG playing a proactive and constantly supportive role during the conversion phase. Practically, this means sending to all banks documents that explains the

conversion process and gives guidance on new accounting practices, developing policy positions on significant accounting questions and communicating these positions, encouraging banks to document and submit to NBG details on problem issues they are encountering and NBG expeditiously responding to these requests. Without this approach commercial banks will be misinterpreting the signals from the regulator and will perceive a less than full commitment to the necessary reforms. A tendency towards procrastination underlies the current approach to reform issues.

## **Legal**

- The concerns and impediments are the same as reported last month, i.e. the general dislike of the Head of the Legal Department for banking law as to supervision issues. Based on this fact, the work plan has recommended that the NBG consider hiring a local lawyer to be dedicated to the Department of Supervision. The lawyer would assist LA McCormack on a day-to-day basis and would develop skills to be applied to legislative, regulatory and supervisory legal matters. The development of these skills could benefit regulatory reform efforts at the NBG.

## **VI. Financial Information on the Banking System**

- The financial information on the banking system will only be included on a quarterly basis and therefore will not be included again in the monthly reports until year-end.

## **VII. Administrative Issues**

- RA Stroud and AA Advisor Gordon had a conference call with Ray Mino to briefly explain the banking supervision program at the NBG and to ascertain his interest in working on this project. Mr. Mino indicated his interest in coming to Georgia and working on this project. This was communicated to Bharat Bhargava and Marc Hersh in a conference call.
- A conference call was also held with Kwi Lee and Bharat Bhargava to discuss our schedules for meeting in Washington in the beginning of January 2001. It was also discussed that Ms. Lee will inquire as to the availability of some training materials that cover the basics of international accounting standards. It is anticipated that a two- day training session will take place in late January for the supervisory staff of the NBG. Ms. Lee will be joining the commercial bank accounting team on or around January 15, 2001.
- During the month, RA Stroud and LA McCormack met with Geoff Minott to brief him on the status of the two troubled banks and our continuing efforts to help the NBG implement a solution for these banks.

- Geoff Minott provided RA Stroud with his comments on the proposed Work Plan. Mr. Minott suggestions were noted and incorporated and a copy of the report was then forwarded to Bharat Bhargava who was asked to forward a copy on to Marc Hersh.
- During the month, RA Stroud and AA Advisor Gordon conducted a telephonic interview of one the commercial bank accounting candidates, Donald Buddenbohn. Mr. Buddenbohn is just finishing up a project in Bosnia. His credentials seemed to be more suitable for enterprise accounting conversions and he seemed to be more a person who would prefer to deal with macro issues rather than specific issues that pertains to individual banks.
- COP Stroud and AA Gordon interviewed a strong local candidate for one of the five local accounting professional positions arising on the accounting project. The candidate's credentials were very impressive as well as her experience on accounting conversion programs in the private enterprise sector in recent years.
- RA Grimditch attended the monthly USAID NGO Roundtable discussion where the Ambassador presented political issues and the RSO presented security issues. There have been seven Americans (and at least as many other ex-pats) severely beaten and robbed since September. The Ambassador said that he had discussed his concerns about security with the President of Georgia.
- RA Stroud, RA Grimditch, and LA McCormack continue to attend the weekly meetings with the Vice President of NGB and the Director of Supervision. Items for discussion include the following:
  - The timeframe for implementing the new regulations, including the Asset Classification regulation,
  - Proposed enforcement actions relating to the two large problem banks,
  - The on-site inspection schedule for the rest of the year
  - And providing the international donors who are investors or creditors at commercial banks with English translations of the inspection reports. The latter issue needs further resolution.
- RA's Stroud and Grimditch met with the OSC Public Education representative to discuss a recent survey on the public perception of the banking system. As a result of the meeting, OSC was asked to give a presentation to Bank Supervision Staff using the findings of the survey to underscore the importance of its role.
- RA's Stroud and Grimditch attended a meeting with Washington Representatives of the World Bank to discuss common issues and concerns.

- RA's Stroud and Grimditch attended a meeting with EBRD and IFC to discuss how the various donor agencies could share information and promote coordination on inter-related projects.
- RA Stroud and Geoff Minott met with Chris Lane, the IMF Country Manager, to solicit his input and support for the changes that this project will be recommending to the banking laws and our attempts to have three regulations approved and enacted by year end 2000. Mr. Lane agreed with our efforts and pledged his support for these efforts.
- RA Stroud had two separate meetings with the representatives of the World Bank to talk about and discuss the situation involving the problem banks noted previously in this report. The World Bank is very concerned over the activities of these three banks. The purpose for the meeting was to go over the strategies that are being proposed to the NBG's President for resolving these problems and issues.
- RA Stroud met with Geoff Minott on several occasions during the month to discuss numerous issues, including the following:
  - The status of the work plan and the areas in which our efforts will be focused on next year. A draft of the work plan was provided to Mr. Minott for his review.
  - A status of the regulations that have been proposed to the NBG by LA McCormack and RA Stroud was discussed and reviewed. Included in these discussions were ways to ensure that the regulations are going to be implemented in a timely manner.
  - The revised budget for the project was discussed and Mr. Minott indicated he would request a copy from Washington. Certain information is needed (from the revised budget) before any new local people can be recruited for the additional accounting work.
  - The recent IMF Report was discussed and the need to get a draft of this. Mr. Minott is going to set up a meeting with Chris Lane (IMF Country Manager) to discuss this next week.
- RA Grimditch and AA Gordon attended the twice-monthly meeting with the TACIS representative and the NBG Accounting Department to discuss issues relating to implementing IAS.
- At RA Stroud's request, the OSC Public Education group presented their survey of Georgian public opinion on the banking sector to the Department of Supervision. The Advisors thought the results of the survey would underscore the importance of the Bank Supervision's work.