MANAGEMENT OF NON-PERFORMING LOANS IN GEORGIA

ANALYSIS AND RECOMMENDATIONS

The project is implemented in the framework of The East-West Management Institute’s (EWMI) Policy, Advocacy, and Civil Society Development in Georgia (G-PaC) Program, funded by United States Agency for International Development (USAID). The project is made possible by the generous support of the American people through the USAID. The content is the responsibility of the implementing organizations and does not necessarily reflect the view of USAID, the United States Government, or EWMI.
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## Abbreviations:
GoG – Government of Georgia  
IMF – International Monetary Fund  
NBG – The National Bank of Georgia  
NBE – National Bureau of Enforcement  
MoJ – The Ministry of Justice of Georgia  
MIA – The Ministry of Internal Affairs of Georgia  
NPL – Non-performing Loan  
MFI – Microfinance Institution  
LLR – Loan Loss Rate  
GDP – Gross Domestic Product  
ROE – Return on Equity  
LTV - Loan to Value  
DTI - Debt to Income Ratio
ABOUT THE PROJECT

Economic Policy Research Center’s (EPRC) study Management of Non-Performing Loans in Georgia – Analysis and Recommendations was conducted with the financial support of the Policy, Advocacy, and Civil Society Development in Georgia (G-PAC) program. G-PAC is funded by the US Agency for International Development (USAID) and implemented by the East-West Management Institute Inc. (EWMI).

The goal of the study was to analyse Georgia’s socio-economic situation in terms of Non-Performing Loans (NPL) issued by the banks and other financial and non-financial institutions, to compile international best-practices and experiences, and determine what would be the most applicable model/solution for Georgia. As a conclusion, we propose a number of recommendations for shaping the state policy and private sector strategies to mitigate the problem of non-performing loans.

KEY FINDINGS

NPLs in Georgia

- Almost 10% of all bank loans are non-performing in Georgia; more than 100 thousand natural persons and legal entities are in the list of the Debtor Register.

- Among 124 countries in the World Bank database of the share of NPLs in total loans, Georgia stands 52nd, a ranking slightly better than the average.

- A decent NPL indicator in the Georgian banking sector may be the result of an alarmingly high number of NPLs in the unofficial market of private lenders and borrowers.

- One of the most painful consequences of NPL problem is when people lose their houses and become homeless. The share of the real estate secured loans has been on the rise for the last 6-7 years, which indicates that more people are being exposed to the risk.

Causes and Consequences

- The growth of NPLs is driven by the macroeconomic (economic growth, nominal effective exchange rate, poverty rate, and income inequality), business specific (excessive risk tolerance, poor risk management), and other factors, such as the lack of information of borrowers, overindebtedness (taking a loan for covering an existing loan), inappropriate fines, and unfair enforcement legislation.
• According to the World Bank data, the average lending rate in Georgia is the 11th highest in the world, the highest in Caucasus, and the second highest among the post-soviet countries.

• Borrowing from a private lender is the last resort for the most borrowers and mostly due to the fact that they cannot manage to borrow from a commercial bank or want to cover a financial institution's bad debt already on their account.

• The survey revealed that out of all defaulted debtors surveyed in Tbilisi 40% took a loan for releasing a family member on parole from prison, 30% for financing health related expenses, 20% for financing their business operations (or start-ups), and the remaining 10% for sending their family members/relatives abroad. A different picture was observed among those surveyed in Kutaisi, where the majority (up to 80%) took a loan for business purposes and the rest for health related reasons.

**Legislation**

• The Government of Georgia (GoG) has simplified the execution of the property repossession and the sale by the auction procedures; some important changes include the creation of the private execution offices and the Debtor Registry.

• The fact that the execution can be done very quickly created additional incentives for the asset-based lending; very often collateral becomes a primary source of the loan repayment.

• In 2009 an important amendment was made to the Civil Code of Georgia, that implied an exception giving a possibility no to limit the loan dispute settlement to the collateral property only. This exception gave financial and nonfinancial institutions the right to add a new article in the contract, thus a debtor will remain in the Debtor’s Registry until the loan is fully covered, thus a debtor is liable with other property as well, even if it is bought in the future.

• As of January 2014, new amendments will come into force setting boundaries to the loan issuance, charged interest, and enforcement procedures. According to these amendments, a contract signed with a private lender has to be approved by the public notary, interest ceiling will be set and a possibility of additional auction will be established in order for the sale price to be closer to the market price.

• In 2008 the Government of the Autonomous Republic of Adjara has issued subsidized municipal loans for 95 families affected by the Russia-Georgia military conflict. The borrowers had to pay a 8 percent interest only after three years.

• Georgia’s Bankruptcy Law does not cover natural persons, only targets legal entities. In case of default, individuals do not get a fresh start once the collateral assets are repossessed.
• International experience has showed that it is a common practice to use the Asset Management Companies (AMCs) for managing and/or disposing bad debts, by disposing assets removed from a bank’s balance sheets, or restructure a corporate debt.

• Non-performing loans can also present an opportunity, as non-performing real estate loans allow investors to buy them out through AMCs and make a profit in the future.

INTRODUCTION

The problem of bad loans gets a huge attention nowadays. It has become a headache for all from bank managers to government authorities. Bad loans were basically the driver of recent world economic downturn. No different situation is in Georgia. The practice of selling off the collateral property by the banks and other finance or non-finance institutions has become commonplace since the war in 2008 and the world economic crisis. Almost 10% of all bank loans are non-performing loans (NPLs); more than 100 thousand natural and legal entities are in the list of the Debtor Register; hundreds of people have lost their property and require loan restructuring; and the government is discussing restrictions on the issue, enforcement, and execution of risky loans.

In August 2013, moratorium on enforcing the auction sales of the collateral property was passed by the Parliament of Georgia with the first hearing in August 2013. It immediately created exaggerated expectations in the society, giving them a hope that their loans would be written off, or paid by the state. At the same time, a fear of uncertainty and possible loss arose among the financial circles. It should be assessed positively that the draft law was canceled since the latter could have been a blow to the stability of the country’s financial sector.

NON-PERFORMING LOANS

The definition of NPL varies from country to country and a loan which is considered non-performing in one country might not be considered as such in another country. However, opinions do match in some cases. The following is the definition proposed by the International Monetary Fund’s (IMF) Compilation Guide on Financial Soundness Indicators 2004:

1 Payments are not made in the predetermined timeframe.
2 Debt register - is a means applied prior securing the enforcement of fiscal suit - electronic database of those individuals and legal entities, also organizations towards which the enforcement administration has been exercised since 1 January 2010.
3 The Treatment of Nonperforming Loans. Eighteenth Meeting of the IMF Committee on Balance of Payments Statistics; International Monetary Fund (IMF), Washington D.C., 2005
“A loan is nonperforming when payments of interest and/or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons—such as a debtor filing for bankruptcy—to doubt that payments will be made in full.”

According to the Basel Committee on Banking Supervision, loan is considered default when the bank declares that a borrower cannot meet its obligation and cover its debt of the bank, or similarly to the first definition, the borrower past due more than 90 days on any payment of the bank credit.5

These definitions provide a reasonable framework for identifying non-performing loans, which the rest of the report is based on.

NPLS IN GEORGIA

According to the Regulation on ‘Assets Classification and the Creation and Use of Reserves for Losses by Commercial Banks’ Approved under the Decree No. 350 of December 29, 2000 of the President of the National Bank of Georgia, commercial banks are obliged to classify each loan into one of the following five categories:

1. Standard;
2. Watch;
3. Substandard;
4. Doubtful;
5. Loss;

The following categories: Substandard, doubtful, and loss are forming NPLs according to the regulation on ‘Transparency of a Commercial Bank Financial Condition’ approved under the Decree No. 145 of May 23, 2006 of the President of the National Bank of Georgia (NBG)6.

A table below presents the five categories for loan classes, their corresponding overdue days, and the mandatory Loan Loss Provisioning Rate (LLR) (that is an expense set aside for the bad loans):

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There are several important points we should mention in this regard: first of all, overdue days are not actual overdue days. Instead, overdue loan according to the Georgian banking chart of accounts is a loan with more than 30 overdue days. Thus, 30 overdue days in the above table is actually 60 ‘real’ overdue days.

Also, we should note that the overdue days thresholds above are not the sole reasons for classifying the loan as nonperforming. Even a loan with no overdue may be classified as substandard based on financial situation of the borrower and/or some other reasons.

As Georgian legislation is not defining one particular threshold (such as 90 overdue days) NPL classification becomes more conservative in Georgia compared to IMF methodology. Just for comparison: the share of non-performing loans in the gross portfolio stood at 9.3 percent, or 4 percent if counted by applying the 90 days standard, by the end of 2012. This is due to the fact, that e.g. one of the components of NPL according to the local legislation is the substandard loans and the following may be part of it: ‘Unsecured or partially secured loans in which interest or principal is past due for at least 30 days or more must be classified as “Substandard”’ or ‘The primary repayment sources including capital and earnings are becoming no longer sufficient to repay the debt.’ In other words, even with no overdue but significantly worsened financial situation of the borrower can make the loan non-performing.

A table below shows the breakdown of banking sector loans into five classes, including the shares and the weighted average LLR as of the end of 2012.

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount (mln GEL)</th>
<th>Share in Portfolio</th>
<th>Weighted Average LLR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substandard</td>
<td>391</td>
<td>4%</td>
<td>30%</td>
</tr>
<tr>
<td>Doubtful</td>
<td>235</td>
<td>3%</td>
<td>51%</td>
</tr>
<tr>
<td>Loss</td>
<td>184</td>
<td>2%</td>
<td>87%</td>
</tr>
<tr>
<td>Total:</td>
<td>8,733</td>
<td>100%</td>
<td>7%</td>
</tr>
<tr>
<td>Non-Performing</td>
<td><strong>810</strong></td>
<td><strong>9.0%</strong></td>
<td><strong>49%</strong></td>
</tr>
</tbody>
</table>

Source: National Bank of Georgia

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8 It is very important to note that ‘overdue loan’ is defined as a loan repayment of which is delayed by 30 days or more. E.g. loan with 5 days overdue actually means a loan with 35 days overdue.
Among the 124 countries having information in the World Bank database\(^9\) about the share of the NPLs in total loans, Georgia stands 52\(^{nd}\) which is slightly better than the average.

Notwithstanding the fact that the total bank loans to NPL is not very high in Georgia compared to some other countries which were alarmed by the problem, the problem of defaults and NPLs remain a significant issue in the country. Table below presents data on the bank NPLs to total gross loans (%) in Georgia.

<table>
<thead>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NPLs (%)</td>
<td>11.6</td>
<td>7.9</td>
<td>2.4</td>
<td>2.0</td>
<td>1.2</td>
<td>2.5</td>
<td>0.8</td>
<td>4.1</td>
<td>6.3</td>
<td>5.4</td>
<td>4.6</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: The World Bank database, 2013

According to the NBG data, relative size of NPLs compared to the total portfolio is not dangerously high. However, there is another important indicator about the NPL quality – the coverage ratio. This ratio indicates what part of NPLs is already covered by the loan loss provisions. Higher NPL coverage ratio means better position for a financial institution.

The data shows that the NPL problems started after the military conflict and crisis. Portfolio quality deteriorated significantly and the banks suffered huge losses. Although, it should be mentioned, that NPL and LLR growth was observed even in the beginning of 2008 (f.1), indicating that the signs of the crisis were already present and a housing bubble which started a few years ago was already on the edge of a bust. Hence, we should not attribute the dynamics of the asset quality fully to the military conflict, although admitting its dramatic influence.

Figure 1. Total and overdue loans, Loans loss reserves www.nbg.ge

Source: National Bank of Georgia

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One of the most painful consequences of the NPL problem is when people lose their houses and become homeless. With this regard it is important to state that the share of the real estate secured loans had been growing for the last 6-7 years, which indicates more people being exposed to this risk (f.2)

**Figure 2. Real Estate Secured Loans www.nbg.ge**

The share of NPLs to total loans varies by banks. Some of them were hit more adversely by the crisis, while others were able to survive with the lower losses. Among the biggest Georgian banks, ProCredit Bank suffered the least due to having relatively noncyclical SME and Micro business borrowers (f.3).

**Figure 3. Share of NPLs in Loan Portfolio by bankswww.nbg.ge**

The tendencies of the NPL market can be easily grasped by looking at the trend of the repossessed assets in the financial sector. The NBG sets the maximum limit for the unsecured lending at no more than 25% of the total loan portfolio. This prevents taking excessive unsecured risk and contributes to building more protected portfolio. The majority of loans are secured with property (mostly real estate). In case of the default, banks are either letting the borrower sell

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the pledged property to repay the debt, or repossess it directly. Not surprisingly, volume of the repossessed property has been increasing since 2008. The charts below (f.4, 5) summarize the data about the property repossessed by the banks and the microfinance institutions (MFIs).

Figure 4. Assets Repossessed by Banks (net of reserves)

![Graph showing assets repossessed by banks from 2008 to 2013.](source: National Bank of Georgia)

Figure 5. Assets Repossessed by MFIs (net of reserves)

![Graph showing assets repossessed by MFIs from 2008 to 2013.](source: National Bank of Georgia)

We should also take into account the fact that the data about the repossessed assets includes net value, thus the total amount of property repossessed is even more. Another issue is that some of the property was sold or written off\(^{11}\) from the balance sheet, making the actual figure even higher. Although the parameter used in the charts is not fully accurate, it is still useful to capture the upward trend in the asset repossession dynamics.

\(^{11}\) The NBG's regulation on the Assets Classification and the Creation and Use of Reserves for Losses by Commercial Banks obliges banks to classify repossessed property in Substandard category. If the property is not sold for 1 year period, it should be migrated to the doubtful category and after 3 years of holding it, bank must write it off from the balance sheet.
ENFORCEMENT PROCEDURES

Reforms in Georgian public sector affected the enforcement side as well. The GoG has simplified the execution and property repossession or sale by the auction procedures. Some important changes include simplified execution and creation of private execution offices and creation of debtor registry.

According to the Georgian regulations it is the entities entitled by the Ministry of Justice of Georgia that has the legal right to conduct the enforcement procedures in the country. Primarily it is the National Bureau of Enforcement (NBE), the main legal entity securing the enforcement of the court decisions and it is the bureau that keeps the Debtor’s Register.12

The Debtors Register is a means applied prior securing the enforcement of fiscal suit - electronic database of those individuals and legal entities, also organizations towards which the enforcement administration has been exercised since 1 January 2010. The database does not include tidings about public institutions and local self-governing bodies, also debtors of secured demand. A person is registered in the Debtor Register the moment he/she becomes the target of enforcement proceeding. Those who had faced the enforcement proceedings until 1 January 2010 can be registered in the Register on the NBE initiative.

In case the initial contract between a creditor and a debtor implies the 300th article of the Civil Code of Georgia and the articles 38-40 of the Law on Public Notary, it is possible to directly address the NBE, without having the court decision to do so. In all other cases, appropriate court decision is the mandatory prerequisite for filing an enforcement claim.

The moment a citizen presents an application, the NBE instantly releases relevant information and extractions about individuals and legal entities.13 While registering, Georgia’s Ministry of Internal Affairs (MIA), Public Registry Agency of the Ministry of Justice (MoJ), and all commercial banks operating in Georgia are obliged to immediately inform the relevant enforcement bureau in case they detect cases like property registration on the debtor or opening of a bank account. All similar activities must be ceased until the debtor is removed from the register.

The NBE manages the Debtor Register. It provides constant update of the Register database and its accessibility. The Debtor Register database is public and is also available on the website of the National Bureau of Enforcement (www.nbe.gov.ge). Any interested individual can get the information about any individual registered in the database.

12 The Debt Registry https://debt.reestri.gov.ge/main.php?s=1
13 The Ministry of Justice of Georgia, the National Bureau of Enforcement (NBE) http://nbe.gov.ge/index.php?lang_id=ENG&sec_id=367#sthash.XDKGs0V.dpuf
Apart from the NBE of Georgia, the Ministry of Justice extended the right to enforcement to the private enforcement officers and Private Arbitrators on the whole territory of the country. The reason behind delegating the responsibilities of the NBE to other bodies is the high number of cases in the Debtor Register. As of December 2013, there are 39 active licensed Private Arbitrators in Georgia who are entitled to the right to register and to remove the relevant data in the Debtor Register.\textsuperscript{14}

Registration in the Debtor Register implies the restriction on the right of disposal of real estate and movables and other non-material property interests subject to registration in corresponding registry. As of January 2014, there are 107,805 entries in the register.

After the enforcement is complete, if the amount retrieved from the property sale is enough to fully cover the debt, the debtor is removed from the debt registry. Otherwise, the debtor remains on the list, unless the following occurs: a change of the fine mode, suspension of the enforcement or retrieve of enforcement paper to creditor, withdrawal of enforcement sheet, or a court decision. According to the Civil Code of Georgia article 301(1) “An asset secured loan is closed after the asset is sold even if the amount retrieved from the sale is not enough to fully cover the debt, unless otherwise stated in the agreement.” This exception from the law, that if the agreement states otherwise, a debtor’s liability is not limited to the secured asset only, gave an opportunity to financial and non-financial institutions to have a claim on other currently existing or future assets.

According to the information received from the Public Registry and the NBE, enforced sale of property has been on the rise since 2010 (f. 6, 7). Moreover, almost half of the sold real estate was residential flats.

The fact that execution can be done very quickly creates additional incentives for asset based lending and collateral in many cases becomes a primary source of loan repayment. At the same time, complicated and prolonged procedures could make the conditions and interest rates/commissions even higher for compensating difficult execution process.

*The enforcement process is as follows:*\textsuperscript{15}

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\textsuperscript{15} The National Bureau of Enforcement. Enforcement Map. www.nbe.gov.ge
According to the draft law passed by the Parliament amendments are being made to the law on Enforcement Procedures of Georgia starting from January 28th, 2014. According to the amendments, unlike the current edition, that envisages a possibility of holding the first and one additional auction on the repossessed property, an opportunity of holding the first and two additional auctions emerges. The latter makes it possible to sell an asset at a price closer to the true market value.  

The government of Georgia has already tried to resolve the problem in order to help out the affected, so that they could maintain their housing. In 2008 a three year government subsidized municipal loan has been distributed. According to the terms, 8 percent interest payment was due only after the first three years.\textsuperscript{17} The loan was issued for 95 families in Adjara region, since the region was affected by the Russia-Georgia war due to a drastic decrease in the number of tourists. The majority of the affected had taken a loan for establishing tourist infrastructure – such as family hotels, shops, cafes, etc. However, a major shortcoming of this initiative was that it was planned independently, without having preliminary negotiations with the banks, and was offered only in December 2008, when the majority of these families had already signed new contracts of loan restructuring on worsened terms with the banks. Therefore, assessing the effect of the initiative was quite hard.

Currently, there is another attempt to offer similar type of initiative. The local government of the Autonomous Republic of Adjara has promised to issue a 7 year 15\% interest loan, out of which the beneficiaries will pay 3\% for the first three years, while another 12\% is subsidized by the state, thus enabling a beneficiary to cover the original sum. It has been stated that 95 families will benefit from this initiative. EPRC got in touch with a representative of the local government of A/R Adjara and was told that the implementation scheme is currently being prepared and no additional information is available at this time.

We believe that the initiatives like the municipal loan must be implemented with caution so that they do not create further incentives for individuals to take a loan irresponsibly, thinking that the government or other private institutions will support them later. Simply stated, the government should carefully reconsider the problem of moral hazard.

**REASONS AND DRIVERS**

The growth of NPL share is driven by the following important macroeconomic factors:\textsuperscript{18}

- Economic growth (and unemployment);
- Nominal effective exchange rate;
- Poverty rate and Income inequality;

Real **Gross Domestic Product (GDP)** growth is an important macroeconomic variable affecting NPLs. This is done through various channels starting from the decreased turnover and profits of the companies deteriorating quality of business loans to worsened creditworthiness of households due to increased unemployment.

\textsuperscript{17} Personal Communication with Sophie Beroshvili on November 20th, 2013.
\textsuperscript{18} Financial Stability Review. European Central Bank. December 2011
During 2003-2007 the average real GDP growth equaled 9.6% (f.8). High growth was accompanied (and to some extent driven by) the credit boom. After the shocks of 2008-2009 serious problems with the loan quality were triggered and the NPL management became a major issue for financial sector. 2013 forecast for real GDP growth by the IMF and the World Bank is around 2-2.5% indicating that there will not be positive dynamics in NPLs.

**CASE 1** – “We were supposed to get a loan from a commercial Bank A on August 9th, 2008. Then the war started and the bank refused to grant the loan. However, our business was already on the go, we had taken on other liabilities in advance, which we had to repay. That is why we turned to a private lender who gave us the sum for a monthly 5 percent interest rate. That meant 60 percent annual interest rate. We were in a hurry and were forced to agree on any terms. After the war only private lenders were providing the credit and the interest rates were very high.”

As a result he was unable to deal with the 60 percent interest rate and the enforcement decision arrived regarding the auction sale of his apartment.

**Nominal effective exchange rate** – Georgian financial sector is highly dollarized. 63% of domestic loans (NBG data) are denominated in foreign currency, mostly in USD. While having income in GEL, majority of local companies as well as individuals bear significant currency induced credit risk. This is because depreciation of the national currency in fact makes their loans more expensive and weakens repayment capacity. This problem has also occurred in 2008 when USD/GEL rate jumped from 1.44 to 1.65 in five day period, currency induced credit risk also contributed to NPL growth.

**Poverty rate** – according to the World Bank country data, almost ¼ of Georgian population is in poverty. The poorer the country the less is the creditworthiness of the borrowers which is consequently results in NPLs and overdue loans. Extreme poverty and social hardships lead to low access to healthcare. As a matter of fact, financing basic healthcare is one of the reasons behind taking a loan.
Business specific factors resulting in NPL problems include the following:

- Excessive risk tolerance;
- Poor risk management;

**Excessive risk tolerance** – risk tolerance refers to the decision of the financial institution how much risk it is willing to bear. High risk tolerance usually leads to higher revenues but often is followed by large credit losses. If we consider risk appetite of Georgian banks during the boom of 2003-2007 it is obvious that banks were taking high risks in a rapid pace. As an illustration consumer loans more than tripled in 2006-2008. Also it was a period of introducing new products to the market such as credit cards and installment loans. Another direction of credit boom was construction sector and it was heavily financed by banking sector, finally leading to the housing bubble.

**Poor risk management** – Georgian financial market is relatively young in its modern form. Therefore its risk management culture was not well developed when the world financial crisis hit the markets. Corporate governance principles were often violated by the risk management units who did not adhere to their role of the ‘braking system’ for the sales divisions. Inadequate scoring and rating models, individual assessment and evaluation of business loans, nonexistence of lending limits, and the inability to diversify portfolios left financial institutions unprotected.

A potential drawback of collateral loans, which can contribute to the increase of the NPL ratio, is that “its protection [securitizing with assets] may induce banks to be “lazy” and screen credit seekers insufficiently.” The idea is that when something is pledged as collateral in order to receive a loan, banks lack incentives to screen and monitor their debtors sufficiently. In this scenario, banks have something as collateral and are not concerned about the loan defaulting, as they receive the collateral for an unpaid debt. This scenario still makes loans non-performing, baring adverse consequences for the debtor. If the debtor is an individual, this might leave them homeless or deprived of a valuable asset. From the standpoint of the country’s economy, it is better to avoid such exchanges, therefore creating a need for a better project evaluation before issuing a loan, something collateral loans might be affecting negatively.

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Based on the information received from the specific case studies, additional driving factors emerged:

**Access to information:** In the majority of the cases consumers are unaware of the characteristics of credit products they are offered. Therefore, without realizing the risks, consumers take the liabilities which they are unable to meet. The lack of information and consultations before signing a contract is named as the major problem by the Young Lawyer’s Association of Georgia (GYLA) Kutaisi Office Director Tamar Pachulia. According to her observation, parties seek professional assistance only after the dispute arises and the debtor has to go to the court.  

**Over-Indebtedness:** the creditor itself should also be interested in correctly assessing consumer’s creditworthiness. This would decrease the chances of consumer default, as well as positively affect creditor’s credit portfolio.

**Inadequate fines:** there is no legislation or regulation to limit the amount of fines that the debtors can be exposed to, in case they are unable to meet the contract conditions. This is especially alarming, if the inability to meet the obligations coincides with the force majeure conditions.

**Unbalanced enforcement legislation:** Sophie Beroshvili, the head of the Center of Social Programs and Development believes that the simplification of the law on enforcement in 2007 resulted in an unequal protection of the rights of lenders and borrowers. She believes that the law only protects interests of the lenders and completely neglects borrowers’ rights. Amendment to the “Law on Enforcement Procedures” was passed in 2012 and gave considerable preferences to the banks, while the borrowers were imposed to yet another regulatory body – the National Bureau of Enforcement. Moreover, before the amendment, it was prohibited to seize the property if the debtor was socially vulnerable. Since 2012, property of those living under poverty threshold can also be sold out on the auction if they are not able to repay the loan.

According to the amendment made to Law on Enforcement Procedures in 2007 – collateral on the loan can be transferred into the ownership of a creditor, if envisaged in the contract. At the same time, if the borrower does not meet the liabilities, the collateral property is transferred to the creditor’s ownership if envisaged in the agreement. If the debtor fails to meet with contract terms, the secured asset is transferred to the creditor’s ownership if the parties address the public registry with the request to do so.

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**CASE 3, KUTAISI**

An individual took a 1,500 USD loan from a microfinance institution in 2011 and had to pay 75 USD interest rate for 6 months. She took the loan to finance treatment of her child. The loan was backed up with her apartment as collateral. She was unable to cover the loan in the initially determined 6 month period and prolonged the term to 10 months. She was unable to cover the monthly payment and interest on the deadline set by the contract and was fined several times. Eventually, after restructuring the loan, monthly interest rate increased to 83 USD, while the total loan reached 2,700 USD. As a result, the enforcement decision arrived regarding the auction sale of her apartment.

SECTORAL PERSPECTIVE

Debates over the mortgage backed loans disbursed by banks, micro finance institutions (MFIs), and private lenders have become very tense during the last few years. This section analyzes the causes of current situation. It explains the chain effect starting in the banking sector and impacting the private borrowers and lenders.

BANKS

First of all, we have to state that the interest rates on loans in Georgian banking sector are among the highest in the world. According to the World Bank data, the average lending rate in Georgia is the 11th highest in the world, the highest in Caucasus, and the second highest among the post-soviet countries.

What are the causes of the high interest rates?

1. **The cost of capital**: Banks are obliged to maintain the capital adequacy ratios above the defined limits. Just for the comparison, the Tier 1 and the Regulatory capital ratios are respectively 8% and 12%, while the same ratios under Basel II capital adequacy framework set the limit to 4% and 8%. As a result, regulatory burden is relatively higher for Georgian banks. In addition, Georgia is a country of relatively high risk (Long term BB- by the Fitch Rating, the so called ‘junk’ grade), which is mirrored in shareholders’ required Return on Equity (ROE) for Georgian banks, impacting the cost of equity eventually.

2. **The cost of liabilities**: the same reasoning defines the cost of liabilities. As of the end of 2012, the average cost of funds for banking system was 6.7%, which is higher than the world average. The high cost of liabilities, negative country rating (see above), and the low domestic savings (gross savings are just 18% of GDP) are reflected in the loan interest rates.

3. **Administrative expenses**: economies of scale is an important profitability driver in the banking industry. Having a limited size of the country and the economy, the relative size of administrative expenses is quite high (the share of nonoperational to total expenses).

4. **Credit risk premium**: Based on the NBG data, on average 3.5% of all loans are lost each year. This means that the banks should charge 4.1% higher interest on loans to compensate the losses.

These factors as well as the few other aspects make the weighted average of the interest rate 22%.

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24 The World Bank Country data
There is another issue in a chain: the NBG sets quite strict conditions for the risk management and loan loss provisioning, this induces banks to be somewhat conservative in lending and apply strict limitations. This includes Loan to Value (LTV) ratio limit, Debt to Income Ratio (DTI), and some other conditions. Moreover, during 2004-2008 Georgian banks were rapidly expanding (the average annual growth) their portfolios using the aggressive lending strategy. The expansion was driven by the high economic growth (the average annual growth) and the boom in the construction and trade sectors. But since the 2008-2009 shocks, caused by the military conflict with Russia and by the world financial and economic crisis, banks became significantly cautious. Today, most of their scoring and rating models require higher risk premium due to the higher loss expectation and negative track record.

**MICROFINANCE INSTITUTIONS (MFIS)**

Next link in the chain is the microfinance sector. Development of this sector basically started from 2006. The regulatory framework for MFIs is much more relaxed than for the banking sector. Reasons behind their success are the following:

Significant share of MFIs clients are borrowers who are not able to meet the strict bank requirements and agree to borrow even with the higher interest rate (3 to 4% a month), as they do not have other options. So there is some kind of counterintuitive selection. We cannot blame the MFIs for charging the higher interest rates, as the risk of their borrowers is much higher. This is mostly a type of asset backed lending practice. That is, primary source of repayment – income or cash flow of the borrower is neglected. In contrast, secondary source – collateral is deemed as an ultimate mitigating factor of the credit risk. Applying 40% to 50% LTV ratio provides adequate collateral enough for covering all obligations.

The restrictions towards the MFIs are the following:

- **Minimum Share Capital** – Paid-in share capital in an authorized capital of a Microfinance Organization may not be less than 150,000 USD. (Above the amount, the total amount of the authorized capital, determined by the by-law, shall be filled by monetary or non-monetary operations as stipulated by the Georgian legislation);

- **Size of Micro loan** – The maximum total amount of a microcredit extended by a Microfinance Organization to a single borrower may not exceed 30,000 USD;

- **Investments** – Microfinance Organization may have investments in a legal entity, total amount of which does not exceed 15% of its own authorized capital;

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25 LTV ratio is calculated by dividing the amount of loan granted by the value of collateral.  
26 DTI ratio is calculated by dividing monthly payment of loan by monthly income of the borrower.  
27 According to the ‘Law of Georgia On Microfinance Organizations.’
• Size of Micro leasing – Leasing is allowed, if the value is no greater than 150,000 USD;

• Loan Loss Provisioning – According to the legal framework, classification and provisioning of loans is not compulsory, though a few MFIs do the portfolio classification by risks on their own;

• Deposits – Taking deposits is not allowed. Microfinance Organization may not receive a deposit from either individual persons or legal entities (though it is possible to issue bonds with characteristics of deposits; it is a common practice in Georgia).

In fact, most MFIs get their high profits from the repossession and the sale of the pledged real estate. Even with selling at a half price, collateral realization makes each loan project profitable. There is an issue of moral hazard, however – MFIs have the incentive to ignore the financial strength of the borrowers and rely solely on the provided collateral. That is basically why we consider it as an asset backed lending. Bearing in mind the extremely high costs of fund that the MFIs have to pay (annual return on their bonds is from 15%-18% to even 24%-30%), it is easy to imagine the margins they have to apply to remain profitable.

PRIVATE LENDERS

Collateral loans are common practice in Georgia. This is a highly illogical transition, at a first sight, but it is considered as an attractive way to raise funds. Collateral loan is defined as follows: “A collateral loan is a loan secured by some asset you own. You promise to hand the asset over to the lender if you cannot repay the loan as agreed. By using a collateral loan, the lender takes less risk, and it may be easier for you to get funding.”28

Collateral loans are a common practice and popular form of transaction between small firms and banks around the world.29 This sector is fully out of control of regulators. Individuals lend money to each other based on formal contracts where interest rates are even higher than offered by the MFIs. This is a completely unregulated sector and the government has little or no power to control it. Even by imposing some sanctions and restrictions, individuals may agree informally on some issues. Advertisement websites or newspapers are full of such offers, even specifying the interest rates.

For individuals the risk and the tradeoffs are immense, as in case of default, they risk losing their home or other valuable property. One & Uesugi (2009) also mention that they observed the fact that lower risk borrowers have more incentives to pledge their property as a collateral in order to gain a loan, than risky borrowers, due to the fact that there is a smaller chance of losing the collateral.

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In some of the western countries private lenders also come in forms such as “loan sharks.” “The term ‘loan shark’ has been commonly used to describe those who lend small sums at higher rates of charge than the law allows.” Since Georgia’s current legislation does not regulate the type of loan sharking activities, individuals conducting business in this field are given the full legitimacy, while in many other countries their activities would be considered as criminal.

Borrowing from a private lender is often the last resort action for the most borrowers and mostly due to the fact that they cannot manage to borrow from the commercial bank or want to cover a bad debt they already have from a financial institution. The mentioned claim may be applied to most countries, however in a country where it is very hard to get a loan from a financial institution, a private lender or a loan shark might be the only option left for citizens. Therefore, it can be claimed that a decent bank NPL indicator as a share of total gross loans, might be at an expansen of an alarming situation of the actual number of NPLs in an unofficial market of private lenders and borrowers.

The main issue with a private lender or a loan shark in Georgian reality is the fact that these loans are designed with a default in mind, i.e. a private lender prefers a borrower to default, as in most of the cases the loans are backed up with collateral properties such as housings of the borrowers. Given the fact that the private lenders lend at an unreasonably high interest rates, they also demand collateral property to back up the loan, which in value exceeds the amount of the initial loan. Therefore, if a debtor defaults on a loan, a lender gains the property making the deal very profitable for the lending party.

It is interesting to look at what makes the individuals turn to the private lenders. According to the research on driving reasons for taking a loan, that eventually ended up as a bad loan, it turned out that 40% of those surveyed in Tbilisi took a loan for releasing a family member on parole from prison, 30% for financing health related issues, such as surgeries, 20% for financing their business operations (or start-ups), 10% for sending their family members/relatives abroad (f.9). A different picture was observed among those surveyed in Kutaisi, where an absolute majority took a loan for financing their business (up to 80%), the rest took a loan for health related issues. Note that these loans were taken not only from private lenders, but also from financial institutions. It should be noted that in 2009, more than 61 million GEL was transferred to the state budget from plea bargaining. This is also the period when NPLs reached their peak.

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31 Center of Social Programs and Development,
Again, we should stress that solving this problem largely relies on the abovementioned chain of banks, MFIs and private lenders. Decreased interest rates and better conditions offered by banks accompanied by the improved living standards (meaning more creditworthiness) can eventually improve the conditions on private loans as well.

It should be noted that the current interest rates on the private lenders’ market is the result of supply-demand. Direct intervention and artificial correction of the interest rate will not bring desired results. This type of intervention is envisaged by the amendment to be made to the Civil Code of Georgia, entering into force from January, 2014. According to the amendment, a loan agreement with a private lender has to be approved by a public notary. A public notary will be obliged to duly explain to the parties their rights and responsibilities, as per the agreement, and the legal proceedings that will be followed in case the agreement is breached. At the same time, an interest rate ceiling will be imposed (except for loans below 1000 GEL), the rate shall be no higher than 12\textsuperscript{th} of 2,5 times the annual average of monthly annual base interest rates set by the NBG for commercial banks. The latter will enter into force from March 1\textsuperscript{st}, 2014\textsuperscript{33}.

There is an understanding that the public notary service will increase administrative costs of a loan that will impose an additional burden for the borrower. A public notary’s obligation to duly explain to the parties their rights and responsibilities before the agreement is signed should be assessed positively, since in majority of the cases a debtor lacks information. However, if we take into account the reason for taking a loan, even an explanation will not be enough to save a debtor from an irresponsible decision.

A Table below summarizes the requirements for loan disbursement in the three abovementioned sectors:

### Table 2. Requirements for the loan disbursement

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Bank</th>
<th>MFI</th>
<th>Private Lender</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Income</td>
<td>Required</td>
<td>Sometimes</td>
<td>Not Required</td>
</tr>
<tr>
<td>Income paid via bank</td>
<td>Required</td>
<td>Sometimes</td>
<td>Not Required</td>
</tr>
<tr>
<td>LTV and DTI ratios</td>
<td>Required</td>
<td>Sometimes</td>
<td>Not Required</td>
</tr>
<tr>
<td>Positive credit history</td>
<td>Required</td>
<td>Sometimes</td>
<td>Not Required</td>
</tr>
</tbody>
</table>

The chart below is a simple graphical illustration of borrowers’ distribution into the three sectors by their creditworthiness and charged interest rate.

**Figure 10. Interest rate and creditworthiness according to three lending sectors. EPRC.**

Having 61% of all employed people in Georgia self-employed[^34] creates an army of people with sometimes unstable and/or illegal income, or people who get their income only by cash. Similar problems redirect these borrowers to MFIs and private lenders.

Very often such loans are taken to start or enlarge small or micro businesses, but with 30% to 50% annual interest rate, very few entities will be able to generate enough return on equity to compensate such costs and remain profitable.

[^34]: Source: National Statistics Office of Georgia
INTERNATIONAL EXPERIENCE ON NPL MANAGEMENT

Based on the different international examples and precedents, the report will offer a solution which can and should be applied by the Georgian banks and the government. The solutions cover both: management of the existing NPLs, as well as offer preventive measures to decrease future loans from defaulting.

In Europe, the market of NPLs is growing. Different estimates are available; however, the market is believed to be around 1 to 1.5 trillion Euros. Some view NPLs as an opportunity, rather than a negative phenomenon. The head of the European and Asian Distressed and Real Estate Investments at Cerberus Capital Management, Lee Millstein stated the following about NPLs “By far, Europe represents the biggest opportunity worldwide.”35

Furthermore, according to Ernst & Young’s 2013 report, the total percentage of NPLs compared to banks’ total loans has increased to 6.8% in 2012 from 5.6% during the previous year36. In 2013, NPLs are expected to reach all times high for the Eurozone - 932 billion Euros, reaching 7.6% of total loans of 12.2 trillion Euros. In 2014 the situation is expected to improve with the significant drop in the total percentage of NPLs to the total bank loans. The share is expected to plummet to 5.6%.

THE CASE OF CHINA

In this section the case of China will be presented as an example of a country with a very high number of non-performing loans a decade ago, which made a huge progress over the years to decrease the amount of NPLs in the total loan portfolio. To present a brief understanding of the Chinese situation in this regard, a table below presents data on bank NPLs as a percentage of total loans.37

Table 3. Bank NPLs as a percentage of total loans. China 2003-2012

<table>
<thead>
<tr>
<th>Year</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPL</td>
<td>20.4</td>
<td>13.2</td>
<td>8.6</td>
<td>7.1</td>
<td>6.2</td>
<td>2.4</td>
<td>1.6</td>
<td>1.1</td>
<td>1.0</td>
<td>0.9</td>
</tr>
</tbody>
</table>

The case of China is a very good example of a country having a high rate of NPLs and over the years finding a remedy for it to decrease to some of the lowest levels in the world. This report will look into some of the strategies and actions implemented in China in order to resolve this massive default issue and it will also suggest what could be learned from this case by the other countries, such as Georgia.

36 Ibid
China had estimated 3.3 trillion RMB (400 billion USD) in NPLs, which was the target of Zhu Rongji’s policies. These policies can be divided into the three different areas. The first area was that the NPL policies became an issue on a state level, which led to the government intervention. The two other areas were that those policies were meant to prevent creation of the new NPLs and to take actions to find remedy for the exiting pool of NPLs.

The Reform

The Big Four state banks of China centralized their management, what substantially decreased intervention from local governments. Furthermore they adopted five-category loan evaluation and independent credit approval. Above mentioned policy changes completely reshaped the Big Four state banks compared to their form before the Zhu administration.

In order to increase the four State Banks’ capital and accelerate their joint stock reform, the government has injected public funds into them three times. In addition, four asset management companies (AMCs) were established pairing up with the four State Banks to help them accelerate their NPLs disposition. The debt-to-equity swap has been an important mean for the AMCs to dispose of the NPLs acquired from their affiliated banks. Moreover, the state banks and their AMCs proactively position themselves to decrease the total NPLs by selling them at the auctions to the foreign and domestic investors, securitizing them, and using other marketing operations.

The scope of business of AMCs in China is:

- To acquire and manage NPLs from banks and other financial institutions, including acquisition of NPLs on commercial basis;
- Debt collection;
- Asset leasing, transfer and restructuring;
- Swapping debts into equity and temporary holding the equity;
- Issuance of financial bonds and borrowing from financial institutions;
- Securitization of non-performing assets;
- Financial and legal consultancy, asset and project appraisal;
- Making further investments in the asset under management.

39 A transaction when debts are exchanged for something else (equity).
THE CASE OF GERMANY

The NPLs in Germany grew considerably in the mid of 1990s, which in case of this particular country can be attributed to the burst of the dot com bubble, the fall of the former East German real estate market, termination of public sector’s guarantor liability as well as massive pressure to consolidate due to the international competition.41

Germany’s development into a mature NPL market happened before the global recession and financial crisis during the 2003 to 2007 period. Now, it has the needed advisor and servicer network and the legal framework to attract international investors and support a high volume of the NPL transactions. However, large NPL transactions were rarely completed during the past two years, and the market activity has until now remained surprisingly low, given the amount of NPLs on the books of Germany’s banks. By the end of the year 2012, NPLs held by German banks equaled €200 billion. In 2013 given the increased sales of NPLs and an improved economy in the Eurozone, NPLs of the banks are predicted to decline to 183 billion Euros, (According to the 2012–13 winter edition of the Ernst & Young Eurozone Forecast), which is still a significant amount of NPLs for the German banking system. Banks have shown reluctance in selling NPLs partially because of the uncertain environment caused by the global financial and Eurozone crisis during the past few years. According to a market analysis by EBS Remi, when talking about a remedy for the distressed loans, more than one third of the asked bank insiders stated their intention to bring the third-party asset managers in or else, to sell the non-performing loans.42 Furthermore, Graham Martin, KPMG’s global leader in the Portfolio Solutions Group stated the following: “We frequently hear from debt funds, real estate funds, private equity, asset managers, and insurance companies wanting to purchase leveraged loans, commercial real estate-backed loans, residential mortgages or infrastructure debt.”43 Therefore, it can be stated that there is a party willing to get rid of or sell NPLs and there is a party willing to buy them or take them over.

Moreover, most of the German private and state banks (Landesbanken) have had to deleverage and shrink their balance sheets in order to reach or maintain required Basel III core capital ratios. In the process of deleveraging, banks have held on to their NPLs until investor pricing is more adequate with bank carrying values.44 In other words, the banks wait until the investors wishing to buy NPLs offer a favorable price.

While banks have refrained from selling NPLs, they have been working on improving their core capital ratios, gradually adjusting their loan book values to reflect investor pricing, and restoring or maintaining profitability. Most banks have internal units for restructuring in order to resolve or sell NPLs, as well as rid their business of non-core parts.

41 Ashurst Germany (2012), NPL REVIVAL” – Acquisition of loan portfolios in Germany: recent case law and current market developments
43 KPMG (2013), KPMG: Europe’s CRE non-performing loan market continues to polarise http://costarfinance.com/2013/03/06/kpmg-europes-cre-non-performing-loan-market-continues-to-polarise/
The NPL transactions work in a following way: “the assignment of the NPL claim requires only an agreement between the NPL-seller and the NPL-purchaser. Generally, in the case of commercial loans, a notice to the borrower of the assignment will be given. In the case of consumer loans, the giving of such notice is mandatory. A share deal can be made via two transfer structures: either the NPL are transferred to a special purpose vehicle, whose shares are subsequently sold and transferred to the NPL-purchaser, or there is a spin-off (Ausgliederung), or hive-down (Abspaltung) pursuant to the Transformation Act (Umwandlungsgesetz).”

As mentioned NPL issue has created a huge market in Germany, which involves very large transactions. One of the examples is UK’s Lloyds Bank selling the first sizable portfolio of non-performing loans secured by German retail real estate collateral. This transaction had a value of 850 million Euros and drew a number of global investors to compete for the deal.

As the country has NPLs in hundreds of billions of Euros, there is a need for its resolution. Where there is a need, there is an opportunity, which has now created a market for trading such loans, one of the ways of dealing with NPLs all over the world. Some of the additional details about the NPL transactions can be found in the AMC section of this report.

**THE CASE OF GREECE**

The NPL issue has been very prominent in Greece, which has seen very drastic growth in non-performing loans to total gross loans ratio. The trend has been increasing since 2003 reaching 17.2 in 2012 (according to the World Bank). However, according to other sources, at this time the NPLs have reached around 30% (f.11). As reported by the Wall Street Journal, Alpha Bank, which is Greece’s fourth largest lender by the assets declared, 490 million Euros in loans are past due, recording a net loss of 228.7 million Euros (311.11 million US dollars) for the three months through September, with reported income tax benefit of just 43.4 million Euros, less than a half of the recorded amount in the second quarter. Greece is one of the countries in the European Union, which has been heavily affected by the financial crisis. The NPL issue is becoming more and more relevant in Greece, to the point where it cannot be neglected and leadership of the leading banks are trying to figure out a solution appropriate for the country.

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Currently the Greek banks are dealing with the NPL issue by restructuring these loans. The banks might have to make divestments, in order to free up the capital. The restructuring is done in order to increase revenue and recoverability. According to Anthimos Thomopoulos, deputy chief executive of Piraeus Bank, restructuring is beneficial for the Greek financial sector: “We are seeing the benefits of consolidation already. We are no longer erratic players bidding up deposit costs recklessly – there is a lot more sobrieties in pricing loans and deposits” he stated.

In Spain and Ireland classic solution to the NPL problem has been the creation of a “bad” bank. Through this system the non-performing loans are sold to the separate institution at a discount, where these loans are restructured by the “bad” bank. The good banks proceed on lending to healthy businesses as well as restructured ones. Similar approach to “bad” bank solution will be discussed in the next section, as another way of dealing with the NPLs.

Greece is trying to resolve and counteract the NPL issue mainly through restructuring of the loans, effectiveness of these actions are still to be seen. Restructuring is a broad term and can vary from country to country or even from bank to bank as it changes the original debt repayment terms. Therefore this type of solution can serve as a remedy or prove as an ineffective solution.

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48 Restructuring – changing the terms of loan agreements in order to achieve some advantage and avoid default on a loan. Mostly the loans are prolonged in timeframe while increasing interest rates.


ASSET MANAGEMENT COMPANIES (AMCs)

International experience shows that publicly owned AMCs have been actively used by the governments in order to manage and dispose of bad debt, by disposing assets removed from a bank’s balance sheets or restructure a corporate debt. This method has become popular in the recent East Asian crises; however the effectiveness of the AMCs still remains questionable. Regardless of the fact, this is one of the solutions to deal and find remedy for already existing NPLs in the country and in combination with other preventing tools it could be an overall effective method to drive the amount of a country’s NPLs down. In the past AMCs have been in use to address the issues associated with bad debt in the financial system. There are two main types of AMCs: “AMCs set up to help and expedite corporate restructuring and AMCs established as rapid asset disposition vehicles.”

AMCs are recommended in order to deal with the already existing NPLs in the country in order to manage and give them a direction. AMCs are designed with the sunset provisions to operate for 10 years. In case of China, the government created four different agencies rather than one centralized entity to handle the NPLs. In China this meant that each of the Big Four state banks had their own AMCs.

It is believed that the existing NPLs should be transferred into independent AMCs to handle. An AMC as mentioned should be independent and not a state owned enterprise.

An AMC will be able to handle the debt while the banks have their balance sheets strengthened by removing their NPLs. NPLs might also present an opportunity: different types of loans, including non-performing real estate loans, allow other investors to buy out the loans through AMCs and even make a profit from this transaction. In December 2012, the German Government sold the whole company TLG Immobilien to Lone Star Funds for 1.1 billion Euro, including the company’s debt, latter being a company that owns offices, stores, warehouses and hotels in the country’s eastern states. This can be a positive solution for different parties involved: for a bank that has bad loans removed from the balance sheets, second for the borrowers who have their debt resolved one way or another and for the investor who buys out the loan with prospects of making the loan and/or the property profitable.

For banks an alternative to selling NPLs is to restructure part of their loans, which is what some of the Georgian banks have also done. The restructuring process, however can often be complicated, as it ties up resources of the bank and can be time consuming. Moreover for the borrower this usually means doubling the interest rate. On the other hand, selling provides faster and more efficient solution. Another course of action instead of selling, banks have used is

52 A statutory provision providing that a particular agency, benefit, or law will expire on a particular date, unless it is reauthorized by the legislature. Huang, Y., & Bonina, J. P. (2001). Dealing with the bad loans of the Chinese banks. Journal of Asian Economics, 197–214.
shoring up balance sheets and increasing capital reserves, for instance, by converting lower-quality capital to common equity or issuing shares, however the latter solutions do not resolve the issues as to what to do with regards to the NPLs.

In order to create a legal framework for problem asset management companies – a government could define some rules of game for problem asset companies which would buy NPL portfolios and obtain cash flow from them. It would play the role of a secondary market for loans. At the same time, financial institutions should not be given incentives to care less on portfolio quality having the options to sell problem loans. Currently there are immature forms of AMCs on Georgian market, they mostly buy NPLs that are not backed by any collateral. Major constraint to their growth is tax legislation that imposes profit tax on the initial value of NPL, rather than the actual profit that a company makes. AMCs mostly pay up to 20% of the value of NPLs to the banks depending on how problematic a loan is. With today’s situation creation and operation of problem asset management companies could become more realistic if the framework for such activities can be elaborated by collaboration of the National Bank of Georgia and respective governmental agencies based on international experience and best practice.

**LEGISLATIVE FRAMEWORK: DECLARING INSOLVENCY OR BANKRUPTCY**

Bankruptcy laws are in place to offer a protection for companies, sole proprietorships, individuals or other entities conducting a business or getting a loan from a bank. These laws are an important part of the legal framework in a country where NPLs are relevant or have been relevant in the past. These laws can be considered as a part of the solution. This report has presented some of the ways the NPLs can be dealt with by banks through actions and by governments through policy which benefit and resolve the given issue in their favor. However, the ability to claim and file for insolvency actually defend the borrowing party from extra material losses, which sometimes can even reach private funds and property. These recommendations can coexist and a valid system can be set in place, where both the debtors and the creditors can find a remedy to the NPL issue.

**German insolvency laws**

German insolvency act is comprised of two proceedings, one of them is the regular insolvency proceeding (sections 11-216) and the other one is the consumer insolvency proceeding (sections 304-314). The regular insolvency proceeding is in place for a debtor which as an individual performs own economic activities or has a legal entity. Insolvency could lead to liquidation, through sale of the debtor’s assets, or reorganization of the company. Regular
solvent proceeding involves verification meetings in order to verify the filed claims. On the other hand, in consumer insolvency the debtor has an objective to be freed from debts by giving up the insolvency property to creditors. It is considered as ‘minor proceedings’, which can only be initiated by the debtor who has no independent activity, and it involves faster and easier insolvency procedures.

Discharge of the debt

These laws are in place for protection of different parties as mentioned above. Important part of the insolvency laws and an ability to declare oneself insolvent is the act of discharge of debts, what helps individuals and organizations to avoid any extra charges and additional debts aside from the property they had to give up.

According to German Insolvency Act:

“If the debtor is a natural person, he or she may be discharged from his or her remaining obligations on the basis of a special consumer insolvency procedure; this kind of discharge from residual debt was previously unknown under German law.”

It is also stated that discharge is not guaranteed and is decided by the court of law, however as mentioned above, the laws are in place for protection:

“The Act’s rules of discharge were a reaction to this development pursuing two aims: on the one hand, the protection of the individual and on the other hand, his economical reintegration.”

It is important to have such laws in place to provide protection to all parties involved in financial transactions and avoid confusion and uncertainty, which often creates a need for actions on the go, which is often unfavorable for all or some parties involved. Moreover, when the power shift occurs, it is mostly shifted towards the stronger party, i.e. a creditor, thus leaving debtors unprotected. As mentioned in the Case of Germany, given existence of NPLs and their characteristics, the country now has the “legal framework” to deal with it.

US Bankruptcy laws

In the US there is a Bankruptcy Code that serves as a protection and a framework for situations such as a business or an individual default. In this section we shall discuss Chapters 7, 11 and 13 of this code, due to their relevance for this report.


57 Ibid.
**Chapter 7 of the Bankruptcy Code**

Chapter 7 is the liquidation part of the bankruptcy code which is a most sought after relief by the debtors. It can be filed by three parties by voluntary or involuntary petition, by debtors, trustees or creditors.58

“The trustee’s job is to take possession of and to liquidate the debtor’s nonexempt assets. The trustee distributes the proceeds to the creditors in accordance with their legal priorities.”

They also claim that one of the main purposes of the Chapter 7 is for a debtor “to obtain a discharge of debts, thereby giving an individual debtor a ‘fresh start.’”

It is not guaranteed, however if debtors honestly follow the procedures and rules of the bankruptcy act, it releases them from most of the debts existing at the time when the application was filed. This can serve as an important protection and liberating law for a debtor from NPLs. However, only individuals can gain discharge through Chapter 7 and it is not available to corporations or partnerships.

**Chapter 11 of the Bankruptcy Code**

Chapter 11 is a reorganization chapter in the Bankruptcy Code, in place for business debtors. This chapter basically allows organizations to restructure their business after reaching the point of bankruptcy. It allows “business debtor to restructure and negotiate its debts and ownership interests with its creditors and owners and then obtain court approval (confirmation) of a plan of reorganization that allows the debtor to continue operating its business after the commencement of the bankruptcy case.”59 This Chapter usually presents the optimal arrangement for creditors, as they are likely to receive larger distribution from this arrangement, given the payment of the pre-bankruptcy debt than through liquidation of their debtors business.

“Large percentage of Chapter 11 debtors actually fail to reorganize their businesses successfully, either before or after confirming a plan.”60

However, even under these circumstances the debtor would be in a position to sell their business for higher price than it would be under the case of Chapter 7 liquidation. The downside of the arrangement is the fact that in the process of being under Chapter 11 the debtor may incur new debts or squander its assets in the process of reorganization.

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60 Ibid.
Chapter 13 of the Bankruptcy Code

Individuals wishing to pay its creditors over period of time and not liquidate through the Chapter 7 should file for Chapter 13. Chapter 13 presents the following advantages over Chapter 11 for individuals: filing is less expensive and this proceeding may discharge more of the debtor’s debts, which includes tax debts. To be able to file the Chapter 13 there are eligibility requirements, meaning that the individual must have a regular income as well as meet certain debt requirements.

In Georgia, a Law on Bankruptcy does not cover individuals, and only targets legal entities. Therefore it is necessary to have similar bankruptcy code to US Chapter 13 in place in order to defend the individuals and an exact system for the individuals to be able to use and find their personal remedy, when having no other opportunity left than to default on their loan.

CONCLUSIONS AND RECOMMENDATIONS

Judging based on the official statistics only, the issue of NPLs is not very severe in Georgia. However, the problem is hidden in the shade, which is the unofficial market of private lenders. Loans are provided by the private lenders on their own specific terms, which may provide some convenience to the borrower in the short run, but in the long run, it rarely turns out favorable for the borrower, even if the borrower manages to repay the debt and not default on it.

THE SCALE OF THE PROBLEM

Due to the fact that Georgia’s private lender market is unofficial, there is no statistical data on how many people are affected by the NPLs. The most crucial recommendation directed to the GoG will be a clear investigation of the problem in order to determine its scale and measure it, especially in monetary terms.

INSOLVENCY (BANKRUPTCY) LAW

It is important that the insolvency/bankruptcy laws also protect natural persons and not just legal entities. The ability to claim and file for insolvency will defend the borrowing party from the extra material loss, which sometimes can reach beyond the repossessed collateral property and does not give a debtor a chance to have a fresh start.
Besides, an exception in the Civil Code of Georgia that implied an exception giving a possibility no to limit the loan dispute settlement to the collateral property only, makes a debtor a lifetime hostage of a creditor. We believe that this amendment was due to the 2008 crisis, however it transferred the entire burden to the borrower. It is desirable to review this amendment.

At the same time, the legislation does not set upper limits on the imposed fines that a debtor might face in case of inability to meet with the liabilities. Especially, if this inability is associated with the force majeure conditions. We believe upper limits to the imposed fines should be regulated by the state.

**SUBSIDIZED LOAN**

Initiatives like the municipal loans programs must be implemented with caution, so that they do not create further incentives for individuals to take a loan irresponsibly, thinking that the government or other private institutions will support them. Simply stated the government should carefully reconsider the problem of moral hazard. Moreover, the initiatives should be as targeted as possible, to mostly help out those living below the poverty line, and those on the verge of losing their only housing. In this regard a careful cost benefit analysis should be conducted on what would be costlier for the government – to provide the vulnerable with the subsidized interest loans, or pay the social assistance, once they lose their housing.

**FINANCIAL LITERACY**

The report has clearly highlighted the problem of financial illiteracy among the borrowers. Major problems are overestimating borrowing capacities of oneself, thus resulting in overindebtedness, and difficulty in grasping and understanding the obligations and responsibilities imposed by the contract terms. In this regard, we believe that a public awareness campaigns, particularly the ones targeting youth groups, should be a focus of both non-governmental and governmental entities. In close collaboration with the National Bank of Georgia and the Ministry of Education of Georgia, financial literacy curricula could be developed for high school children as well as other age groups.

A public notary’s obligation to duly explain to the parties their rights and responsibilities before the agreement is signed should be assessed positively, since in majority of the cases a debtor lacks information. The latter obligation could have been also imposed on the public registry office without bringing in the public notary as an additional player, that we believe will increase administrative costs of issuing a loan and be additional burden for a borrower. Moreover, if we take into account the reason for taking a loan, even an explanation will not be enough to save a debtor or from an irresponsible decision.
PRIVATE LENDERS

We believe that strict regulation of microfinance organizations and private lenders, such as licensing, or interest ceiling, as planned by the legislative amendments passed by the Parliament of Georgia, will not be effective. These initiatives shall artificially interfere into the market equilibrium and increase the risks of a shadow economy activities.

Therefore, it is crucial to increase the level of awareness among the borrowers, for example by mandatory indication of the effective interest rate in a contract.

Statistics indicate that the largest driving factor for borrowing is to release a family member on parole. The state should understand that plea bargaining is not a budgetary revenue source. The plea bargain should be adequate to the scale of a crime and partially take into account the financial abilities of a person.

A far more complex and long-term perspective is to ensure access to quality healthcare in the country, so that the population will not have to give up housing in order to get access to medical care.

ASSET MANAGEMENT COMPANIES (AMCS)

In terms of the institutional framework, the government should further develop and review an option of establishing asset management companies. An independent entities to manage and dispose of bad debt, by disposing assets removed from a bank’s balance sheets or restructure a corporate debt. Independence from bank institutions is essnetial to avoid possible conflic of interests. An AMC will be able to handle the debt while the banks have their balance sheets strengthened by removing their NPLs. NPLs might also present an opportunity: different types of loans, including non-performing real estate loans, allow other investors to buy out the loans through AMCs and even make a profit from this transaction. This can be a positive solution for the different parties involved: the bank has bad loans removed from the balance sheets, the borrowers have their debt resolved one way or another, and the investor buys out the loan with the prospect of making the loan and/or the property profitable.

Currently a very immature form of AMCs exist in Georgia that could be further improved and developed. A major constraint this to happen is the harsh tax legislation imposing profit taxes. Creation and operation of problem AMCs could become more realistic if the framework for such activities can be elaborated with the NBG and respective governmental agencies based on the international experience and best practice.
ENFORCEMENT

An amendment will be made in the Georgian Law on Enforcement starting from January 2014. According to the amendments, unlike the current edition, that envisages a possibility of holding the first and one additional auction on the repossessed property, an opportunity of holding the first and two additional auctions emerges. The latter makes it possible to sell an asset at a price closer to the true market value. There is no need to create additional obstacles to enforcement procedures. The latter might adversely affect the stability of the financial sector of the country, thus creating prerequisites for economic problems.

It is further essential to continue taking steps towards ensuring transparency of the enforcement process, to ensure realization of secured property for a market value, thus freeing a debtor from additional liabilities.