



Enterprise Risk Management Survey

Risk Intelligence in banking
on the Georgian market

Tbilisi, November 2016

Foreword

Dear Colleagues,

We are pleased to present the first Enterprise Risk Management (ERM) survey, the latest instalment in Deloitte's ongoing assessment of the state of risk management in the financial services industry. The report is developed on the basis of the periodical Global risk management survey for financial institutions. The ERM report provides detailed insights about the current state of maturity of Georgian banks' risk management practices.

The survey findings are based on the responses of the almost 50 percent of banks on the Georgian market, representing a total of more than GEL 4,79 billion in combined assets. We would like to express our appreciation to all the survey participants for their time and insights.

Risk management through organizations on the Georgian market is still undergoing a process of development, but at the same time, it is a rather rapidly developing field in financial institutions, especially banks. Georgian banks continue to make progress in many areas of risk management, undergoing a quiet revolution, slowly moving from an essentially compliance-driven control function toward more strategic decision based approach with increasingly becoming more capable in this respect.

Over the past several years, there has been a wave of far-reaching regulatory changes in the area of risk management from the side of the National Bank of Georgia (based on developing recommendations of the Basel Committee for banking regulation), which require higher quality and levels of capital and greater control of the risk management process established in the Georgian banks.

Financial institutions must not only comply with regulatory requirements and priorities, they also need the flexibility to respond to the next round of regulatory developments that are likely to occur over the coming years, which will set a higher bar for risk management across the financial services industry. This will require strong risk management capabilities, robust risk infrastructures, and timely, high-quality risk data that are aggregated across the organization to allow them to respond with flexibility to the continuing changes.

We hope that the survey results presented in this report will provide you with useful information on how financial institutions are meeting the challenges facing risk management today and will facilitate a broader dialogue on the steps that may be needed to enhance risk management in the future.

Sincerely,
Deloitte & Touche LLC

Introduction

Deloitte's ERM survey was conducted in the second half of 2016, at a time of continuing change in the financial industry and the broader economy.

Since early 2014, there have been many internal and external economic shocks affecting the country. Falling oil and commodity prices, economic sanctions against Russia, instability in the currency markets along with other factors such as reduction in foreign direct investment (FDI) rates have all played into the complexity of the economy of the country and the region more widely.

Early 2016 saw the Government set out its four-point reform program to address economic development. The government recently got re-elected to power for a further term and as such the plans started are expected to continue. The Government plans include significant changes to the tax system for companies (excluding banks and financial institutions) as well as the commencement of a number of high profile infrastructure projects. One of the main priorities established is around education and there is also a lot of effort being given to innovation and business startup activities. Harmonization and a further move towards the aims of the EU – Georgia Association Agreement also feature high on the government agenda. Many of these initiatives have significant Corporate Governance and transparency elements to them that are likely to affect organizations like banks and other financial service institutions first and with the highest level of impact.

Banks in the Georgian financial

system: The banking sector of Georgia has been developing dynamically during the last few years. Interrupted by declines during the financial crisis in 2008 and 2009,

in 2010 the economy started recovering and there are positive trends from 2010.

Since 1995 the number of commercial banks gradually declined from 102 to 17 banks in 2016. The sector is highly concentrated, with the two largest banks accounting for more than 60 percent of assets. Other financial institutions include nonbank financial institutions (NBFIs), microfinance institutions, insurance companies, and pension funds. The two largest banks, TBC Bank and Bank of Georgia, are listed on the London Stock Exchange (LSE). As a result, almost half of the Georgian banking sector is traded on the LSE.

Key events: TBC Bank has entered into a definitive agreement with Societe Generale S.A. ("Societe Generale") to acquire its 93.64 percent stake in its Georgian subsidiary, JSC Bank Republic ("Bank Republic"), one of the leading universal banks in Georgia. The transaction is expected to close before the end of 2016, following the completion of confirmatory due diligence and the satisfaction of all relevant condition precedents. TBC Bank also announced that it has reached an agreement to acquire selected assets and liabilities of JSC Progress Bank, a small, local Georgian bank. The acquisition consists of GEL 108 million of assets and GEL 108 million of liabilities post fair value adjustments. The transaction is however quite small from TBC Bank's perspective as it accounts for only 1.6 percent of gross assets, excluding the impact of the Bank Republic acquisition.

These transactions in 2016 made TBC Bank the largest Georgian bank in terms of both loans and deposits at the end of 2016.

Regulatory Environment: According to the assessment by the joint IMF and World Bank mission under the Financial Sector Assessment Program (FSAP), the National

Bank of Georgia (NBG) exhibits a very high degree of compliance with international standards. Within the last few years, international financial institutions, such as the European Bank for Reconstruction and Development (EBRD), World Bank, the European Investment Bank (EIB), FMO (the Dutch development bank), the Asian Development Bank (ADB), and many others have made significant investments in the Georgian banking industry. The participation of these organizations in the banking sector has been reflected by the advanced corporate governance and the transparency of the banking sector. Local regulation and supervision of banking activities, which are in line with the standards of the Basel Committee on Banking Supervision, are performed by the National Bank of Georgia.

Operational risk events: The focus of the regulator on such issues as capital adequacy, liquidity, operational risk, governance, and culture is driving change throughout the financial industry. The importance of strengthening risk management capabilities within financial institutions has been underscored by an increased possibility of operational risk occurrence that may result in substantial financial losses and legal settlements. Across Europe we have seen legal settlements resulting from enforcement actions, major losses from failed investment strategies, misuse of client funds, computer malfunctions, and internal and external fraud events. Recently, Georgian financial institutions identified and monitored operational risk events by using internal loss databases, but not all of them seem to be useful for smaller organizations. No external loss database exists at the moment in Georgia which may help the financial institutions to compare their risks to the risks of other organizations and more effectively identify and assess the operational risks through the periodic risk management process.

About the survey

This report presents the key findings from Deloitte's assessment of risk management practices in the Georgian banking industry. The survey gathered the views of primarily risk-management function representatives or their equivalents in more than 50 percent of banking institutions in Georgia and was conducted from August to October 2016.

The institutions participating in the survey represent the banking institutions operating in Georgia, including several institutions with a parent organization located in the United States, Europe and the CIS countries (figure 1). The institutions have a total combined book value of assets (by 30 June 2016) of GEL 4,79 billion and represent a range of asset sizes (figure 2).

Figure 1. Participants by parent company's location

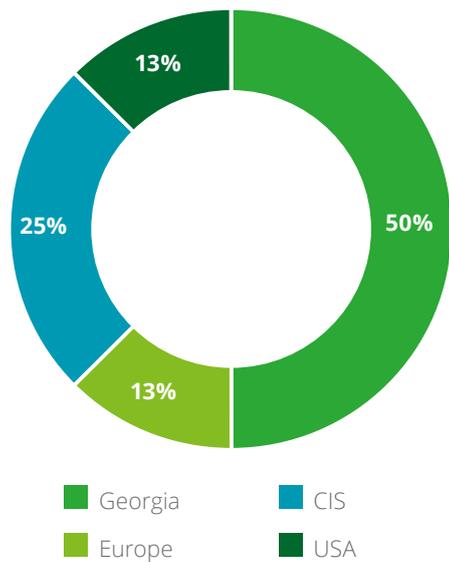


Figure 2 Participants by asset size by 30/06/2016



Risk governance

The impact that a risk event can have on a financial institution has made risk management a significant concern of the boards of directors and senior management at most financial services firms. Yet, risk management has not received such high-level attention at all firms, and many institutions may also struggle with creating a risk-aware culture throughout their organizations. The role and accountability of boards of directors vis-à-vis risk management has been debated in the financial press. Going forward, to satisfy their fiduciary responsibilities, boards of directors are likely to become more active and potentially more risk averse.

Role of the board of directors

The regulator (NBS) is paying increased attention to the role of the board of the directors in risk governance, i.e. providing direction and approval of the institutions' risk policy and strategy, overseeing their implementation by management, and development of a risk management culture at all levels of the organization.

Most institutions reported that their board of directors took an active role in the oversight of risk management. Eighty-seven point five percent of institutions said that their board of directors reviews regular risk management reports and approves overall risk management policies and internal documentation.

Risk committees

When it comes to how management of an organization assigns the primary responsibility for risk oversight, frequently, banks assign this responsibility to one or more committees that oversee risk management, including risk policies and the organization's risk appetite.

The most common approach, adopted by 50 percent of the institutions surveyed, is to place the responsibility for risk oversight with a risk management committee or make it the combined responsibility of both the risk committee and the audit committee (38 percent). Other approaches included assigning responsibility only to the Asset-Liability Committee (12.5 percent). Most of the institutions were likely to have a risk committee (88 percent) that takes an active role in the oversight of risk management. In 13 percent of cases, risk committees were under the board of directors and 75 percent of the banks had a management level risk committee.

Figure 3. Review of the reporting

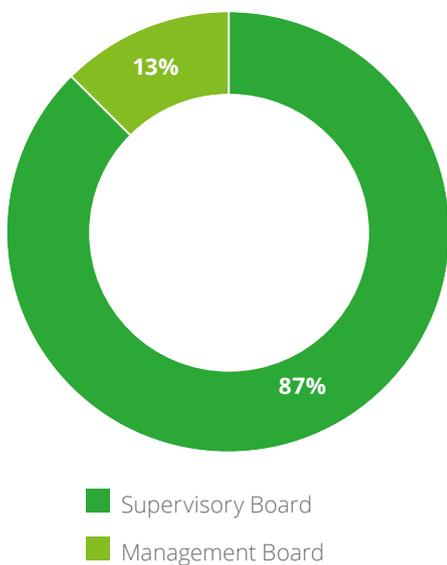


Figure 4. Review and approval of RM policies

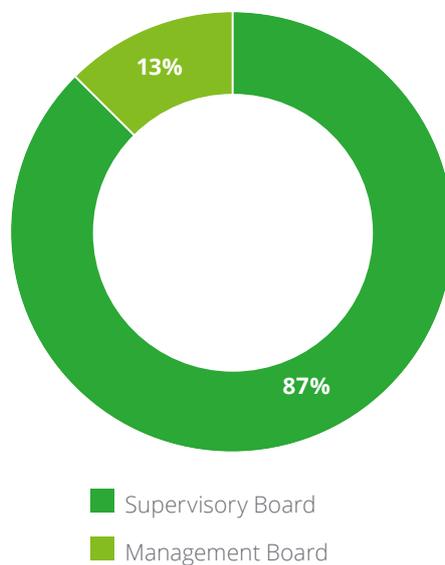
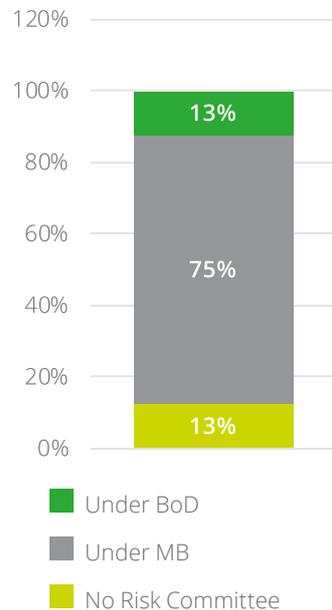


Figure 5. Risk Committee



Key role of the CRO

The CRO can play a key role as a senior executive with overall responsibility for the oversight of risk management—helping to increase senior management and the board’s attention to risk considerations and implement consistent risk management policies and practices across the organization. Sixty-two point five percent of institutions reported having a CRO or an equivalent position. Other financial institutions (37.5 percent) are not creating new management-level risk leadership positions, such as chief risk officer, they have the Chief Executive Officer (CEO) or his/her deputy as the senior level person responsible for risk management.

Risk appetite

A written enterprise-level statement of risk appetite for an organization is a key document that can inform individual business decisions regarding how much risk the organization is prepared to assume in pursuit of its business objectives. The

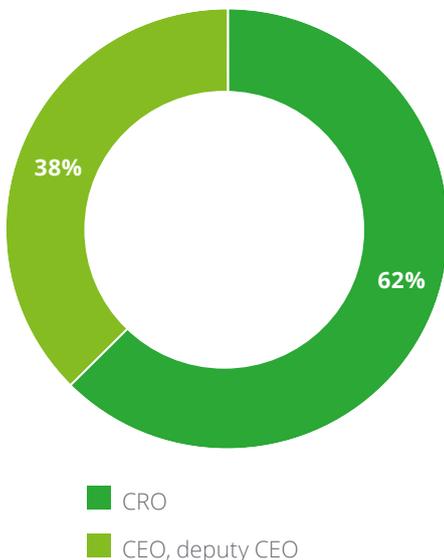
development of a written statement of risk appetite plays a central role in clarifying the level of risk an institution is willing to assume. It can serve as important guidance for senior management when setting the institution’s strategy and strategic objectives, as well as for the lines of business when seeking new business or considering their trading positions. Since the global financial crisis, the importance of a risk appetite statement has received greater attention. Given the key role of the risk appetite statement, it is a prevailing practice for it to be reviewed and approved by the board of directors or the responsible committee. Only 12.5 percent of respondents said that their institution has no written enterprise-level statement of risk appetite. The institutions that reported that they had an established risk appetite mostly had a separate risk appetite statement with qualitative and quantitative measures for risk appetite assessment (38 percent), others have risk appetite as part of the various documents established for the different types of significant risks.

decisions consistent with enterprise objectives. While individual decisions may appear appropriate in isolation, collectively they may create an aggregate amount of risk across the organization—especially when the interrelationships and correlations among different transactions or types of risk are considered—which exceeds the institution’s risk appetite. The objective is that the statement of risk appetite should become a guiding principle when making business decisions.

Striking a balance between centralized risk management and business unit risk management

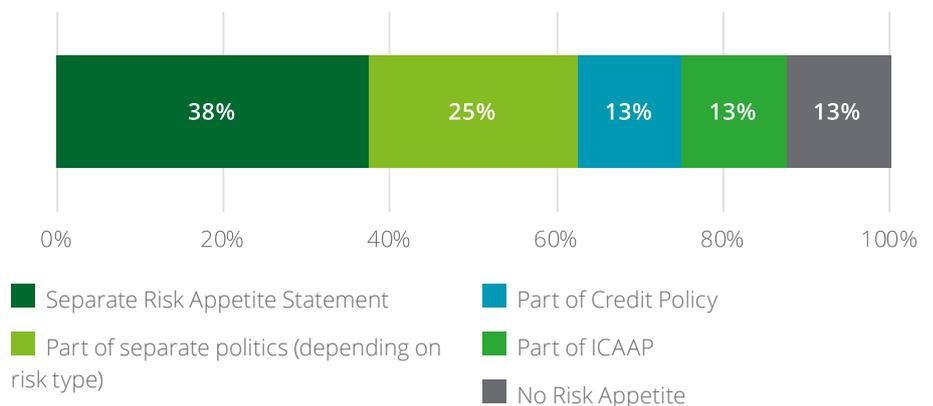
Most institutions reported that they followed a hybrid approach to risk management. For example, all of the institutions said that credit risk assessment was the shared responsibility of business units and the risk management division. For trading transaction approval, 88 percent of institutions said that the limits for treasury operations were determined by their risk management division compared to 12 percent who cited that the approval was performed by the ALCO with the participation of the head of the risk management division—a member of the ALCO.

Figure 6. Who, at executive level (CXO-level), has been assigned ERM accountability /responsibility?



However, simply having a statement of risk appetite is not enough by itself. Institutions have faced challenges in translating the risk appetite statement into risk management

Figure 7. Risk appetite

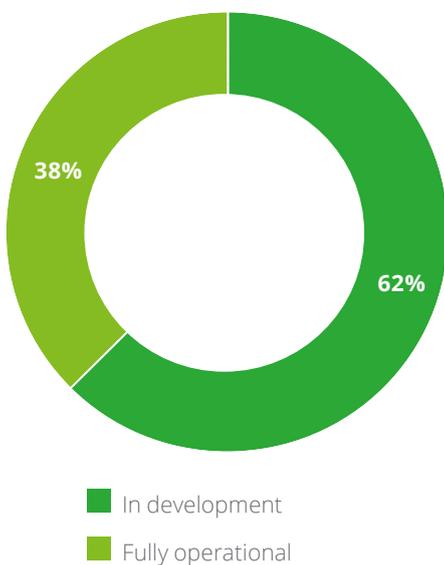


Enterprise Risk Management

An ERM program is designed to provide a comprehensive assessment of the risks an institution faces and a process for managing them. By taking an integrated view across the organization, ERM programs assist institutions in understanding the full range of risks they face and how these compare to their risk appetite. They also help identify interrelationships among risks in different lines of business or geographies that might have gone undetected. ERM allows an institution to gain a clearer picture of its overall risk level, taking into account the correlations and dependencies that can exist across different financial products and risk types. Both large and mid-size financial institutions are being encouraged by regulatory authorities to implement ERM programs and integrate their findings into business decision-making.

All of the respondents said that their institution either has an ERM program in place or is in the process of implementing one.

Figure 8. What is the operational status of your ERM program?



Key challenges

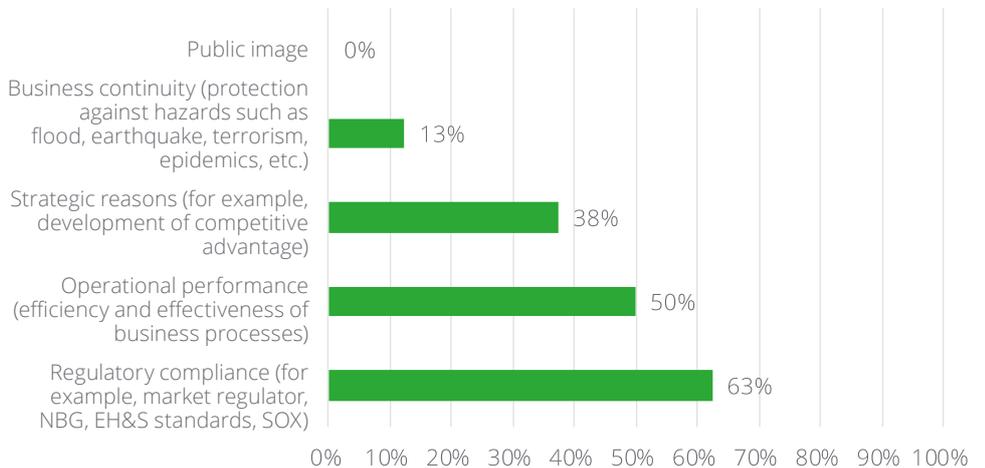
Complying with new regulations was seen by respondents as by far the greatest challenge, with 63 percent of respondents saying increasing regulatory requirements and expectations are extremely or very challenging for their institution. From the point of view of the surveyed banks, other drivers that are important for ERM implementation are considered to be as mentioned in Figure 9.

Assessing new business initiatives

The decision on which businesses to enter and which types of products to bring to the market can have a profound effect on the level and nature of risk that an organization

assumes. As a result, financial institutions have focused their attention on how risk is considered when making these decisions. Most institutions reported considering a wide range of risk types in their business and product approval process. Beyond entering new businesses or introducing new products, institutions should consider which other types of initiatives should be subject to their approval process. All of the institutions said they require approval of major changes to existing business/products. Many institutions also review the potential risks associated with new systems needed to implement products or businesses (88 percent).

Figure 9. What are the most prominent drivers for undertaking ERM activities?



Leading practices in banking Risk Management

There have been many areas where expectations have risen and banks have enhanced risk management capabilities. Some of the leading practices and other important areas for banks to consider include:

- Strengthening risk governance by enhancing the board risk committee through the inclusion of a board risk expert and independent directors;
- Effectively challenging the risk and capital management processes by the board risk committee;
- Enhancing the bank's risk appetite framework and statement in ways that clearly articulate the business activities that the firm is willing to engage in and the types and levels of risk it is willing to assume throughout the organization;
- Integrating the assumptions used in strategic planning, capital planning, and risk management;
- Improving risk culture and conducting risk management by establishing clear business practice guidance and oversight mechanisms;
- More fully integrating risk management into the compensation process by enhancing risk-based incentive structures for management and developing risk-taking personnel;
- Operationalizing enterprise-wide stress-testing infrastructure and capabilities into bank business-as-usual processes;
- Evaluating the impact of and planning for proposed revisions to regulatory capital calculation methodologies;
- Integrating liquidity and capital management planning processes;
- Strengthening the bank's three lines of defense framework by better defining the roles and responsibilities of each, including escalation procedures, in order to provide appropriate checks and balances that are well understood and implemented across the organization;
- Building capabilities to implement and operate recovery and resolution plans across business areas;
- Enhancing the model development and validation framework and capabilities to cover all models of the bank that drive finance, risk, and capital results;
- Evaluating and improving end-to-end risk and finance data from transaction origination and reference data to analytics, aggregation, and reporting.



Key Risks

Financial institutions have recognized that their risk management programs may need to expand beyond the traditional focus on market, credit, and operational risk to encompass a broader range of risk types, such as liquidity, regulatory, and reputational risk, among others. Still, the main focus in the banking sector remains the management of financial risks, such as

credit, market and operational risks. The figure below illustrates the primary risks the respondents were facing.

Overall, 100 percent of the respondents said that the most important risk for their institution is credit risk, 25 percent of the respondents said that first place belongs to information security and compliance risk.

Figure 10. The most important risks (I place)

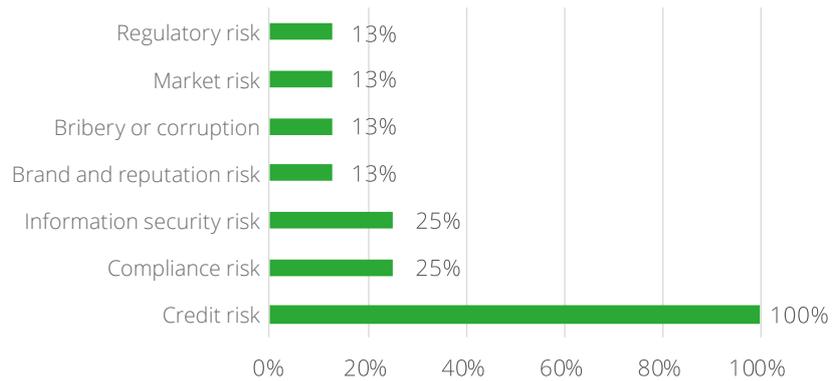


Figure 11. The most important risks (II place)

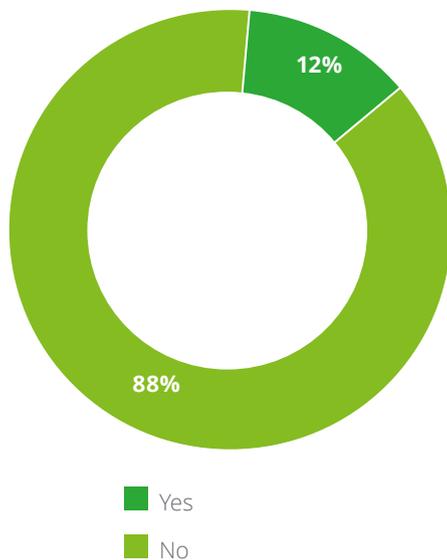


Risk management information systems and technology

Effective risk management relies on a robust technology, the capability to integrate and quickly analyze data across the institution. Risk managers perform these analyses using end-user computing tools, such as Excel spreadsheets. A lack of automation may mean that less time is available to devote to higher-value activities, such as more in-depth risk analysis or discussions with business units.

Significant work remains to be done at many financial institutions in Georgia related to the IT systems used in risk management. Almost 88 percent of respondents do not have any type of IT system that can automate the process; the only IT tool they use is MS Excel, which is used during the risk assessment process. Only 12 percent of respondents use some type of system, which is mostly used for identification and reporting of operational risks and incidents.

Figure 12. Do you have ERM software or tool(s)?



As banks transition to IFRS 9 reporting however this is likely to need to change as the use of MS Excel solutions becomes more and more complicated.

Conclusion

Risk management is facing a turbulent environment, and responses will likely require continuing enhancement of the risk management function. Financial institutions will continue to look to their boards of directors to provide strong oversight to risk management, including enhancing and approving the risk appetite statement if this has not already been done. A CRO or a similar senior-level executive position with overall responsibility for risk management across the organization can be another key element of a successful program. The board of directors or a designated board committee may meet regularly in executive session with the CRO to receive an objective appraisal of the state of their institution's risk management.

To gain a comprehensive view of all the risks they face, their linkages, and how they are being managed, more institutions may need to keep pace by regularly upgrading their risk management capabilities:

- Consider implementing ERM programs;
- Improve their ability to manage emerging risk types, such as reputation risk and liquidity risk, not only specific risks as credit and market risks;
- Risk management programs may also require more sophisticated methodologies that reflect the increasing complexity of financial products and the interdependence of financial markets. In particular, VaR may need to be supplemented by additional methodologies for institutions to assess and mitigate potential tail risks;
- Many institutions have implemented strong risk governance at the level of their board of directors and senior management, including implementing an ERM program and creating a CRO position. Senior management may need to provide additional communication reinforcing that managing risk is part of every employee's responsibilities, and take steps to incorporate risk management goals into performance objectives across the organization. They will now need to broaden their perspective to consider how they can manage conduct risk by embedding a risk culture throughout their organization that encourages ethical behavior by employees;
- Institutions will need to reassess their risk data and information systems. Many institutions will need to improve their access to high-quality and timely risk data as well as their ability to quickly aggregate risk data across lines of business and geographies.

Recent developments in the financial markets have tested the capabilities of risk management across the financial services industry. However, as the survey results help to illuminate, the continued strengthening of the risk management function allows institutions the opportunity to emerge more resilient and better able to meet the competitive challenges ahead.



Meet the authors



Natia Pkhakadze is a senior consultant in the Enterprise Risk Services (ERS) department of Deloitte Georgia. Natia has worked for two years at Deloitte Moscow in the ERS department. Natia joined Deloitte CIS in 2013. She has over three years of consulting experience for major Russian companies.

Natia focuses on diagnostic and development of risk-management (Target Operating Model design) and improving business processes.

Professional experience:

- High-level diagnostics of market risk management process, identifying gaps, development of a target market risk management operating model for the Russian subsidiary of a German bank;
- High-level diagnostics of the business processes of a bank, development of a target operating model within the bank streams: loans, operations and risk management, development of local regulatory documentation. Development of local regulatory documents regarding the risk management system of a major oil and gas company;
- Development and implementation of organizational models of a risk management system integrated on all management levels of a group of companies in the oil industry;
- Participation in project optimization and formalization of the business processes of integrating companies, development and optimization of operational control procedures;
- Participation in the analysis of existing risk management models and developing the target model of risk management in ARIS;
- Development and implementation of control procedures and strategies in order to eliminate SOD conflicts in the SAP ERP system of a major retail company;
- Assurance of a sustainability report in accordance with the GRI (Global Reporting Initiative) standards;
- Development of the Central Treasury for a major steel company;

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