

DIVERSIFICATION OF BANK EVALUATION AND ANALYSIS OF MANAGEMENT
PRACTICES IN GEORGIAN BANKS

The bank's profit is increasing along with growth of consumer demand. Despite the fact that banks are trying to maximize its utilization, the banking market is only partially used.

The banking sector faced several challenges in 2010-2011. The main challenge for 2009 was to overcome unprofitable trend and get irreversible profits. 2009 proved to be disastrous for the banking sector that was linked with recessive inheritance problems from 2008. Although the country has received substantial international aid, overdue loans growing trend in 2008 had significant influence on the banking sector. Besides, the expenses of amortization and restructuring of problematic loans eventually led the system to losses. The August war damaged the banking sector and the analysis shows that it accelerated events as the crisis in the banking sector was already close to start.

Most of the apartments owned by construction companies were sold on credit, most of the developers borrowed money from the banks. Many analysts said that strong inter-relationship between banks, insurance companies and construction companies would end with failure and this huge pyramid would create the problem.

Recently, banks were getting more and more revenue, profitability figures were diminishing. If in 2002-2007 average ROA (return on assets) was 3.1, in 7 months period in 2007 it was dropped to 1.7. As for ROE (capital gain), this rate was decreased from 13.5 to 8.3 for the same period. Since 2007, competition of the banking market has increased. For July 2007, the ratio of loan loss reserve in the banking system and the volume of lending had been lowered to 3.3%.

It is clear that before the famous events of August of 2008, the banking system was facing difficulties and these difficulties and problems were significant and obvious. The conflict of 2008 revealed all of the domestic economic (including banking) contradictions and disproportion which already existed before that period. In September - November, when the world economic crisis escalated, it became clear that those disproportions of the economy became deeper and the banking sector was significantly affected.

By 2010 the second serious challenge was the inflation that was linked with economic disasters proceeding in the entire world. Net profit of the banking system has increased significantly in 2010-2011, while in 2009 the system had a loss of 65 million GEL. After relatively low credit activity in 2009, in 2010-2011, banks became active in the credit policy of the investigation. After recession, the credit portfolio raised by 30% - very high growth rate, in addition in the case of some banks, this figure was even higher.

The priority of conjuncture of the economic development of the sector was trade development; thus, in the credit portfolio trade finances raised to 65%.

Development of regional and tourism infrastructure, together with employment growth, will contribute to transferring of the banking market and the service from the center to regions. Profit is growing with the growth of consumer demand. Growth of employment and demand for credit resources from the business will influence the profit figure for the banking sector.

There are three types of Banks in Georgia: 1. Banks that had Diversified assets and were not linked with Construction & Mining business assets ("ProCredit Bank Georgia," Cartu Bank"); 2. Large banks ("the Bank of Georgia", "T - B - TBC Bank," "Bank of the Republic / Societe Generale Group") that developed the plan of salvation and used foreign funds to remain as the leading banks; 3. Banks linked with constructions which had assets of less diversification (the Peoples bank).

In 2008, new banks joined the banking sector. Kazakhstan "Halyk Bank of Georgia" which invested 50 million dollars in 2008. On June 23, 2008 "HSBC Bank" joined the banking sector with the capital of approximately 16.7 million dollars. "First British Bank" created on the basis of the Bank "white", which bought its assets for 8.5 million GELL. In March of 2008, the owner of "Standard Bank"(Salford Capital) sold bank to "Bank of Kor" for 42 million dollars and the new owner is "Dhabi group". Experts consider that due to the current situation in the banking sector, it is not ruled out that new small-sized banks with foreign capital be skipped out from the market. Categorization of banks indicates that for the solution of problems in the banking business, encouraging of depository services and promotion of deposit placements should continue. In addition to the deposits placed by local citizen, banking industry needs to attract foreign funds to solve the liquidity problem. To overcome the problems, it is important to increase the number of banks founded by foreign capital. The biggest player in Georgian banking sector is the European Bank for Reconstruction and Development. EBRD is trying to buy shares of all large and relatively large Banks. Some experts appreciate EBRD to enter Georgian banking sector deeply, because, they believe that banks where EBRD has bought shares, management is improving; at the same time, EBRD will never buy a controlling stake. EBRD involvement in Georgian banking sector is important for customers as well, because credit resource prices will become cheaper. To support the banking sector, EBRD has allocated 351 million Euros that is distributed over three years.

Diversity in Georgian banks is very low. Banks diversify their assets mainly in construction, leasing and trading companies.

In Georgia, there are a number of problems that hinder the implementation of innovations. In our opinion, these problems are as follows: - poor packaging of a new product and lack of public awareness; - unavailability of effective communication technologies caused by insufficient knowledge; - improper consideration of the mental qualities, typical for Georgians.

Georgian banks should take in mind to:

- Consider compatibility on new product with typical mental qualities before launching the product;
- Reduce information in order to make it understandable to the user;

- Try to cover all segments of the population, develop a product that is acceptable and will be used for the entire social layer;
- Prepare basics in a high level before the introduction of new products;
- Receive information actively about new technologies and inventions from leading foreign banks and adapt them for Georgian environment.

Geographical diversification is especially important; geographically diversified banks have more profit than non diversified banks.

According to banking experts, the main institution of the country's financial area - bank must be free of ownership of development or the insurance companies, as well as any trade organizations in order to fit the international standards. The current economic crisis makes especially obvious the problems caused by different interests which, according to experts, aggravates the situation and also poses many new problems.

In terms of production diversification, discussions in the article include two leading banks and bank management.

1. "The Bank of Georgia" and its subsidiary companies are divided into three business-directions: 1) asset management, 2) Wealth Management, 3) Galt & Taggart Securities. The last implies the ownership of subsidiary companies mentioned above.

Liberty Consumer (LC) managed by a subsidiary of the Bank «galt end taggart management" is a joint stock company organized according to the laws of Georgia. It invests in Georgian companies that are interested in the retail sale of daily consumer goods, business service and real estate.

The company owns a significant share of the leading companies in the retail and everyday use, such as, retail companies, "Populi", winery "Teliani Valley" and the food processing company Nikora ".

At the end of 2007, LC acquired controlling shares of the press release company "Planet of Forte" (51 percent). In addition, the company owns interests and property shares of a "SB in real estate" which was founded in 2006 and invests in the real estate, development and property management.

The Bank of Georgia is the owner of 100% shares of Aldagi BCI. Insurance market share of Aldagi BCI is 20% of the market.

2. TBC Bank. In 1999 TBC Bank took part in establishment of Microfinance Bank of Georgia Bank that is now called as ProCredit Bank.

In 2000 the International Finance Corporation and the German Investment and Development Company bank became the owner of 10-10% share of TBC Bank; the same year TBC Bank received international rating.

In 2001, it participated in the established of Pension and Insurance Holding (GPI Holding). The company introduced a comprehensive range of innovative insurance products and specially treated to the local market. 3 years later the initiation of GPI Holding was in the list of four largest insurance companies. The company has been developing dynamically and has very ambitious plans for the future.

In 2003, TBC Leasing started operations that were established by the Bank. A year later, "TBC Leasing" managed to occupy an important position in the leasing market: In 2004, the volume of total leasing portfolio was increased 15 times. Nowadays, the "TBC Leasing" portfolio is worth of 7 million USD which is 70% of the total market. "TBC Leasing" has funded 132 projects of various types of equipment purchase, total cost of 9 million dollars. The European Bank for Reconstruction and Development (EBRD) decided to buy 10% of shares of "TBC Leasing". This is the first investment of the EBRD in Georgian leasing sector. Financial leasing is the main type of the service of "TBC Leasing".

TBC Bank is also the owner of "Elite - Electronics" controlling shares -55%.

There are several methods to measure the bank diversification level according to proceeds from investments. Among them, one of the perfect methods is to measure proceeds by Herfinal-Hirschman index which, better than other indexes, shows the income received from different spheres of the bank.

The index will be recorded as follows:

$$DIV = 1 - \left(\left(\frac{INT}{TOR} \right)^2 + \left(\frac{COM}{TOR} \right)^2 + \left(\frac{TRAD}{TOR} \right)^2 + \left(\frac{OTI}{TOR} \right)^2 \right)$$

where INT indicates the gross income from interest, COM - the total commission income, TREAD - income from other activities, OTI - all the rest net income. TOR is the total income, so it is equal to the total sum of the counters.

DIV coefficient value can be 0 - up to 0.75, depending on the bank specialization level. When the bank is specialized in fewer directions, the ratio is the closer to zero. If the bank returns are of the mixed type and consists of different areas of returns, the higher is the ratio.

Since TBC Bank has more experience in diversification of the banking system of Georgia, let us measure the mentioned index on its example.

2011 Financial Highlights: Net Income Bank - 000 43,050 - 43,050000 * 80% = 34440000; Interest income - 80% = 239,926000 * 191940800; commission income 25,069000 * 80% = 20055200; Other non-interest income 44565000; GPI Holding is 100% net profit 11.290000 - Elite Electronics 55%, 90% of TBC Leasing.

$$\begin{aligned}
 DIV &= 1 - \left(\left(\frac{191940800}{267851000} \right)^2 + \left(\frac{20055200}{267851000} \right)^2 + \left(\frac{11,290000}{267851000} \right)^2 + \left(\frac{44565000}{267851000} \right)^2 \right) = \\
 &= 1 - ((0.72)^2 + (0.07)^2 + (0.04)^2 + (0.02)^2) = 1 - (0.52 + 0.004 + 0.0016 + 0.0004) = \\
 &= 1 - 0.526 = 0.474
 \end{aligned}$$

Index is approximate value what means it does not accurately reflect the reality since the profit indicators of TBC Leasing and Elite Electronics Profit are not included in the above formula; however, some conclusions are possible. If the bank is specialized in only one direction, the mentioned ratio is closer to zero. If the bank returns are of mixed type and it consists of different areas of returns the ratio is higher. In our case, we can conclude that the diversification of the bank is at the average level. The bank has opportunities to increase diversification that will have positive impact on financial indicators.

Actually, there is no business-area in Georgia where banks and its subsidiaries do not have their own share of interest. Though this is permitted by the legislation, experts state that this legislation is written not to improve healthy banking system, but was tailored to specific interests.

Experts talk about banks' direct interest in various businesses and negatively estimate the fact that banks are shareholders of various companies, including trade organizations. When a bank is the owner of the brokerage, trading, insurance companies and property developers, we are dealing directly with the conflict of interest.

It is unacceptable Bank to set up a construction company, asks a former employee to lead this company and lend money from the bank. In fact, it is lifting a loan from one pocket to another. There is one problem: When you lend money to the company and organization you own, the main principle is violated: to invest money in the best proposal. Owing to the fact that banks have their interest in different organizations, the country's banking crisis has started.

If the bank invests in its own company, actually, a depositor who has money in the same bank is under the risk. The Development Business is in the worst situation, and it is very risky to give loans to such businesses from the side of the bank. Moreover, just after developing business companies have problems, and the owners of those companies are banks, they will have problems as well.

All the aforesaid do not mean that diversification has the only negative consequences for the bank. Diversification has always a positive result if the investment areas are properly selected. In Georgia, banks are diversifying assets mainly in three areas: insurance, construction and trade. In my opinion, it is necessary to diversify in areas that are less related with banking activities.

The diversification of the banking system of Georgia has a very short history. However, it should be noted that the diversification process is very fast growing. In 2010, according to the diversification of the sectors, only three banks had 19 commercial banks, according to the data of 2011, the situation dramatically changed. Bank of the Republic applied for the diversification strategy which now is the

shareholder of 30% of shares for Elit Electronics, Liberty Bank has two sister companies, such as Smarteksi that is offering e-mail - Courier Services in Georgia and the Bass Stop which is the exclusive operator for about 300 busses.

Owing to the lack of data it is bit difficult to make the final conclusion. However, based on these three banks financial performance, we can say that the diversification has not had have any negative results in this field so far. On the example of the Bank of Georgia, according to the data of 2010, profits from the subsidiary company were rather high. The bank's gross profit was -16.755 million GELL. Aldagi BCI's income was - 4.5 million GELL.

Today banks are offering multi-deposit accounts to their customers; the tendency of the diversification growth of banking products is visible which allows clients to insure currency and interest rate risks that are not available for the mono-deposit billing accounts. Diversification of banking products is high enough, especially in the major banks: Bank of Georgia and TBC Bank that are offering a variety of banking services to customers. Nowadays, the priority of conjuncture of economic development of the sector is trade development, so in the credit portfolio trade finances raised to 65%. If we take in mind the country's development prospects for the next years, this figure will reduce compliance and increase funding for tourism infrastructure and agriculture.

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