

## Credit and Financial Support of Functioning and Development of the Enterprises of Small and Medium Business in Georgia

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### Abstract

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The issue of sustainability, in its broad sense, is crucial not only for banks, but also for the other financial institutions in market economy. In the competitive environment it shows the correlation of the enterprises in the process of achieving the economic sustainability. The substantial contribution to building the financial sustainability of the banking system was the growth of the financial performance of the banking system that followed the decrease of banks in number and the respective increase in size. The bank deposit insuring system, as the mean of securing the interest of small deposit holders in the event of a bank going bankrupt, will be an additional factor for building trust in the banks and improving the condition of the banking system in the context of the situation in Georgia. Therefore, its introduction will have interrelated positive financial impact on the banking sector. Among the various factors effecting economic situation in the country, one of the most important components are regulations developed for building financial sustainability of the banking system. In the process of elaborating the regulations, affecting the financial sustainability of the banking system, we have to consider and create the practical mechanisms that will make these regulations actually work. It is important to consider the experience of other countries and also special characteristics of the country's economy.

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In order to analyze the financial sustainability, we have to answer some questions:

- Does the banking system correspond to the criteria of the financial sustainability when the economic environment is unstable?
- What are the regulations controlling the financial sustainability?
- What kinds of actions are required from the management in order to improve the financial sustainability?

The financial sustainability itself represents the process of stimulation and self-organization, which is characterized by the continues search of the ways to achieve better financial conditions with consideration of limited financial capabilities. In other words, the financial sustainability means stability, which is achieved by finding the balance between the internal limited financial capacity and the external environment affecting it.

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Considering the aspects of acquiring the sources of financial funds, the financial sustainability means: total amount of the capital, total of mobile and immobile actives, liquidity ratio, ratio of the owned and borrowed cash assets, potential of the capital growth, annual amount of profits, presence of qualified staff, and professional management. The financial sustainability of the banks mainly depends on the adequate risk analyses, the risks that may appear in the process of operation of financial institutions. While working on the risk management in financial banks, the aim should not be the elimination of the risks but reaching the point when the risk factors are kept at the minimum, which is possible by creating a strategy that enables to control the risks in advance. The risk factor could be described as the probability of negative results of certain actions or decisions. For every commercial bank the risk is the probability of a loss or not gaining the income which was planned in advance.

The financial sustainability of commercial banks is basically described as the overall capacity of a bank to provide its liquidity without the loss of its assets. This is done by following the economic standards set by the central bank in order to provide stable work of the financial banks. The course of defining the risks may be disadvantageous due to the following: risks are viewed only from the position of banking theory without "considering the problems" of the bank. Under "considering the problems" we mean its nature and characteristics, because no matter how perfect the standards of the regulations are in minimizing the risks of negative effects for the banks, they still do not completely and adequately respond to sudden changes on the market of banking sector. Therefore, for defining the sustainability of the bank, the classification of risks should be based on the bank characteristics. This is extremely important for Georgia, since on one hand, the formation of the banking system considering their characteristics has not been finalized yet, and on the other hand, the intense concentration of the bank assets could result in a major differentiation of the banks. When studying the sustainability of the banks, this results in defining the market risk and liquidity risk, because they show the problems of financial sustainability of the bank in context of sudden changes in the competitive environment. Thus, the practical management of the bank assets regulations defines the financial sustainability of the bank. In our opinion, no matter how strong the financial data of the bank is, it might fail if it does not react accordingly to changes in the competitive environment. Their situation might be worse than of the banks with less impressive financial situation. Consequently, when studying the financial sustainability of the banks besides considering the liabilities, we should also consider the level of regulation of major banking standards by the credit institutions.

It is vital to develop the risk management strategy, to distinguish the higher-priority and lower-priority risks, which will be determined by studying the creditworthiness of the borrower, determination of the amount of the loans per customer and insurance of the loan. Credit risks should also be considered as the higher-priority risks along with liquidity, interest rate, market, and solvency risks. Several factors should be considered when studying the credit risks: 1. analyses of the risk considering the aim of the loan; 2. analyses of the financial sources that would repay the loan; 3. analyses of the borrower's cash flow and credit portfolio; 4. portfolio investment management and using it to assist liquidity. As for the risk assessment analyses, it should be based on the crediting policy implemented by each commercial bank representing the banking system. It should consider along with the banks nature and characteristics, the level of credit operations, prospects, and parameters of the implementation. This will help to generate the necessary reserve funds to cover the bad loans instead of reinvesting part of the profits received from the financial operations. In our opinion, this will help to regulate the disputes between the shareholders and depositors on certain activities of the financial institution and at the same time it will eliminate the risk to the depositors who fear their investments are not protected.

Improvement of the financial sustainability requires an optimal balance between the risk factors and implemented banking operations, determination of the standard of sufficient capital. Depositors are interested in gaining as much profit on their investments as possible, but they are also interested in securing their money. The standard of the sufficient capital makes banks control the safety of the investments, because the bank is risking not only with the borrowed capital, but also with its own assets, which is determined by the standard of sufficient capital. Therefore, different opinions suggesting lowering the standard of the sufficient capital and therefore increasing the lending opportunities is wrong in our opinion. The main reason to that is the fact that depositor's investment cannot be considered successful just for gaining more profit, but also for remaining safe investment in general. This factor shows the correlation between the income and safety of the investment. It has to be considered when making decisions in the process of loaning.

In the period of economic instability only few can be considered as a reliable partner, who cannot on their own get the country out of the crisis, if the banks are not going to be able to finance different sectors of the economy.

This is possible only with the financial resources of high liquidity and the balanced level of financial funds in the system, effectively organized and reliable taxation system, stability of the microeconomic factors, low level of inflation, decrease of the budget deficit and development of the judicial system of the country. The trends in the banking sector development in Georgia shows that they face the complicated process of adapting to the new economic reality. Many banks do not meet the certain standards of authorized capital, financial sustainability of their assets, acceptable level of risk factor to the customers, and therefore in recent years in the environment of competitive prices we witness the decrease in the number of operating banks. In the time of the economic instability in the country, the state should play a great role in stabilizing the economy and help the process of recovery. Recently, restructuring the banks with bad credit portfolio, closing the banks that fail to meet the requirements of the authorized capital, or other economic standards, helped to stabilize in general the banking system in the country and make it financially sustainable. Despite this fact, regulation standards are insufficient to control the sustainability of the banks. In addition to that, the supervisory and regulatory system is in the process of creation. Considering these aspects, the legal regulatory framework which is in the process of developing should target two aspects: 1. creation of the system of guarantees that would gain trust of customers towards the banks, and 2. providing financial sustainability by strengthening the control over the system of commercial banks.

When studying the financial sustainability of the banks, in our opinion, we have to focus on the following aspects:

- What is the ratio of involvement of the bank's equity capital in the operations carried out by the bank?
- What are the capabilities of the bank in case they need to sell their assets in order to cover their liabilities quickly?

In 1998 the fiscal system and the economy in general were in crisis, which was aggravated and accelerated by the financial crisis in Russia. It affected the system of the commercial banks operating in that period. Increase in demand to withdraw funds from banks by private and legal entities, inability to repay the loans, increase of the loss because of lowering exchange rate of Georgian Lari caused the worsening of the financial sustainability of the banks. These factors virtually put under question the existence of the banking system. In order to overcome these problems, the National Bank, as the lender of the last resort, chose the largest banks which controlled 80% of the whole market. Several measures were taken, they put restrictions on loaning the money to the banks, and they also allowed them to use their internal reserves till the permissible level of the risk. This approach became the basis for the signing the memorandum between the National Bank and commercial banks. In our opinion, this was a positive step and good timing in order to save the banking system and improve its financial sustainability. Additionally, we have to mention that worsening the situation in the banking system was also caused by subjective factors; certain economic interests of the different political groups, who were trying to diminish the importance of the National Bank's regulatory purpose and financial sustainability in general.

The biggest obstacle appears to be stabilizing economic and financial sector in the country, which, in our opinion, should be taken into consideration at the current stage when there are various controversial statements about the major trends in the monetary and credit policy elaborated by the National Bank, and the responsibility of the bank should be defined in the event of the possible negative outcome. To be on the safe side and avoid likely decrease of the sustainability of the banking system in the future, we believe, it to be essential to implement the following: 1. fostering the development of the normative basis to strengthen the financial monitoring; in particular, following the regulations for monitoring and regulating commercial banks on the basis of responsive monitoring of the capital, in line with the international standards; 2. defining the sensitivity of the commercial bank assets to credit risks and specifically defining the major indicator of the financial state of banks – the sufficiency of the capital; 3. such measures will raise the monitoring requirements for ensuring the financial sustainability of each bank, and overall, the system of tightening the control; 4. improving the bank legislation, which stipulates the regulations for reserves in the event of the possible losses, will foster the process of liquidation of the license-withdrawn banks, as well as the process of developing the criteria for the responsibilities of persons assigned to the liquidation, and will also enhance the mechanism of the comprehensive evaluation of the bank assets and control over the improvement of the financial sustainability of the banking system. The respective practical experience can be illustrated by the example of the measures taken in the German banks, which act within the limits of law and on the basis of their significantly limited functioning. The banks are supervised by the Federal Financial Supervisory Authority.

The Federal Financial Supervisory Authority inspects banks and together with the German Federal Bank elaborates the decrees such as: the Decree on the ratio between the bank equity and the amount of the loans granted. Another interesting experience of Germany in this field is the law binding banks to keep the confidentiality about any relations between the banks and their clients; however, there are some exceptions, like the prohibition to put funds from illegal sources into the legal banking operations. The most significant factor affecting the improvement of the financial condition of the banking system is the underdeveloped legal basis, and the lack of the mechanism for factual enforcement of the adopted laws. Namely, this concerns the law on taxation, law on bankruptcy, and other legal acts. Other legal factors, which have negative impact on the financial sustainability of the banking system in large scope, comprise the legislation regulating the financial sector and ensure the bank activities throughout the entire Georgia. In spite of recently taken significant steps in terms of adopting normative acts that regulate the financial sector, the progress in efficiency of the banks' performance and their financial sustainability is hindered by the lack of normative acts stipulating the enforcement of the mortgage regulating law; and the use of the mortgage in the bank deals is hampered by the procedure of registration of the estate ownership, as well as flaws in the laws on Land, Confidentiality in the Banking, etc. Namely, the guarantee granted by the legislation eventually does not secure the right of the guarantee holder, since the guarantee conditions should satisfy first the state, the internal revenue service, and other bodies, and only after that the interests of the guarantee holder; this, being the matter of the conflict in interests, limits the coverage area for such documents.

We believe, the most crucial factor for improving the financial sustainability of the banking system is the state of the financial resources in banks and the dynamic of their loss. Banks attract funds from various sources, thereof the most important ones are as follows: equity of the banks, savings of the various population groups, and funds from the organizations and foundations. The substantial contribution to building the financial sustainability of the banking system was the growth of the financial performance of the banking system that followed the decrease of banks in number and the respective increase in size. The bank deposit insuring system, as the mean of securing the interest of small deposit holders in the event of a bank going bankrupt, will be an additional factor for building trust in the banks and improving the condition of the banking system in the context of the situation in Georgia. Therefore, its introduction will have interrelated positive financial impact on the banking sector. It also has to be mentioned that the rate of the capital growth has been uneven in the past years, though this was due to the regulations for the minimal level of the foundation capital, and consequently, shareholding capital has been increased mainly through the increase of the net profit and the net interest income of banks.

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