PRIVATE CAPITAL MOBILIZATION FOR DEVELOPMENT: GEORGIA

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INTRODUCTION AND BACKGROUND

The Government of Georgia, while successful in undertaking reforms to facilitate business and develop a market-based economy while ensuring nationwide prosperity, faces challenges to its economic development strategy. These challenges have been compounded by the recent COVID-19 crisis which has generated growing fiscal needs in Georgia, and as such, the government needs to explore more sustainable and effective ways to attract private funding. Adding to these fiscal pressures is seismic risk as the country straddles the Eurasian and Arabian plates, making the country vulnerable to a natural disaster which could impose sudden and high contingent liabilities on the government for unanticipated financing. On a positive note, the government has recently adopted new legal frameworks for public private partnerships (PPPs) and investment funds which provide a good platform for facilitating such investments. The FY19-22 World Bank Group Country Partnership Framework (CPF) for Georgia, covers three focus areas: (i) enhancing inclusive growth and competitiveness, (ii) investing in human capital, and (iii) building resilience. These areas illustrate the country’s commitment to measures to increase investment, and Georgia should combine official development financing with other funding sources such as private capital, in order to maximize financing to achieve these goals.

Maximizing finance for development (MFD), referred to in this brief as private capital mobilization (PCM), seeks to systematically leverage all sources of private sector and public finance, as well as expertise and solutions with significant private sector participation, to support a developing country’s sustainable growth.

PCM SCORECARD

Using a scorecard analysis of the sectors and subsectors germane to a PCM approach, and predicated on an in-depth assessment of three key PCM factors—developing supply, attracting demand and managing risk—the relative strength and readiness of sectors and subsectors required to support private capital mobilization, were gauged. This approach elucidates specific areas for ameliorative actions for the government to take in order to create a successful PCM enabling environment.

Banking Sector Soundness and Stability: Pensions and Insurance

The banking sector is currently well capitalized in terms of capital to risk-weighted assets: reported capital adequacy ratios (CARs) meet local regulatory requirements. Estimates for dollarization levels are 62 percent of assets in Georgia as of 2020. Private credit to GDP is low by global standards despite the presence of a range of financial institutions including microfinance institutions.

Non-banks: Pensions and Insurance

The private pension framework recently underwent a reform and is beginning to accumulate assets but is not yet a major financial sector player. The insurance market is very small and underdeveloped with only 0.67 percent of GDP penetration as of 2019, making the government the implicit insurer of last resort facing high unquantified contingent liability risk.

Depth of Stock Market and Corporate Bond Market

The stock market is shallow at just over four percent of GDP of capitalization in 2019 and is dominated by fixed income instruments and international financial institution (IFI) bonds issued locally, and still needs further growth and development to play a significant role in enterprise financing.

Georgia has a 2020 international credit rating on foreign currency and local currency long term bonds just below investment grade, at BB. The bond market’s size is 27 percent of GDP as of 2019 (i.e. outstanding amounts) and is mainly dominated by government securities. Of this market, 62 percent of bonds are issued in foreign currency to attract overseas investors, and demonstrates the difficulties in long term lari denominated funding.

Use of Credit Enhancement Tools

Privately funded credit enhancements (except for those on offer by private international banks) are not prevalent in Georgia’s financial market. The new PPP framework might offer opportunities for private players to enter into this area.
PPP Framework for Infrastructure Projects and Financing

The PPP framework was recently reformed from an earlier concessions legal model, and more public and private risk sharing provisions have been included. Additionally, the accounting and public expenditure method for regional development have improved. A Partnership Fund was set up in 2011 to help channel private capital, although it has not lived up to expectations. More experience is required under the new framework to determine if successful PPP pipeline projects can be executed as there have been implementation and governance challenges impacting past transactions and projects.

Use of Guarantees

Government guarantees have been used for large scale projects, and the new PPP law clarifies further the scope and use of guarantees. IFI funded projects are seen as promising avenues to test the new PPP and guarantee schemes but supported by a market-based approach to guarantee pricing and burden sharing of risks and liabilities. This needs to be developed as part of a modern PPP and infrastructure regulatory framework.

Investment Funds Framework

One constraint in the investment funds market is the lack of equity instruments. However, Georgia has recently approved an investment funds law in 2020. To develop this market, going forward will require the development and guidance of subsidiary regulations, and the scope of applications of types of funds and underlying instruments.

Securitization Market and Framework

Georgia has a limited securitization market which has been mainly deployed by banks with international partners but does not serve the local small and medium enterprise (SME) market. The investment funds law has clarified some applications of securitizations which may help jump start the local market.

Disaster Risk Finance and Management

The disaster risk finance (DRF) and management framework is underdeveloped and given Georgia’s high seismic exposure, more work and risk mapping/modeling is recommended. An earthquake with an annual return period of 1 in 250 years (0.4% annual probability occurrence) would result in losses representing 84 percent of GDP, and this is compounded by Georgia’s flood exposure from melting snow of the Caucasus mountains and riverine floods from excess rain.4

Priorities and Recommendations for PCM

As an upper middle-income country, Georgia’s inclusive growth challenges will require financing that is more attuned to risk management for productive investments than public debt financing. Georgia should take a sequenced approach of implementing standard instruments and projects5 that leverage the prevalent banking financial architecture. This should capitalize on the momentum of the “Georgia 2020” Platform and the country will need to generate a supply of financial market instruments while attracting investor demand and then build on both through risk management mechanisms. The government needs to undertake supportive regulatory, legal and institutional reforms for PPPs, securitizations and SME finance. It also needs to encourage the domestic and international private sector to establish financial structures for channeling capital that can support public sector sponsored or new projects to realize growth in the economy.

The PPP and Infrastructure Project Framework

With limited capital market experience and issues of governance, Georgia needs to focus on implementation under the new PPP legal framework, adjusting supporting regulations as transactions are undertaken, ensuring value-for-money in such investments, and establishing early demonstration transactions upon which to progress to more complex transactions and projects. Focus needs to be on risk management and risk sharing of contingent liabilities between the private and public sectors and the appropriate use and pricing for those liabilities, with the knowledge that not all risks (e.g., natural catastrophes) can be managed by the private and public sectors, and require additional instruments.

The financial system provides some of the preconditions to deepen financial diversification and the banking sector may help finance public sector programs under certain PPP projects.

Short term: Ensure that the contracting under the new PPP framework for the backlog of contract renewals, especially for power purchase agreements for hydropower plants, abide by strict timelines at each step of the PPP process. Focus on the country’s continued commitment to reforms and strengthening the breadth of the legal and regulatory frameworks that support all aspects of PPP transactions, with a focus on governance and transparency, all of which are critical for PPPs. Concentrate on building the capacity of the PPP staff and related PPP Unit, developing a framework for contracting and elucidating a methodology for analyzing and tracking contingent liabilities.

Medium/Long term: There is a need to elaborate definitions of contingent liabilities relating to contract delivery and debt loads, and approaches to quantify them, including how to price and manage such risks. This would include consideration of credit enhancement mechanisms (via IFI support) such as risk sharing in contracts to cover against output shortfalls and/or financial obligations, in order to diminish perceived project risks and expand the institutional investor base.

Investment Funds, Securitization for Infrastructure Projects and SME Funding

Georgia needs to build on the many useful features of the recently approved investment funds law by developing standard open-ended mutual funds or UCITS-style investment funds.6 These can lead the way to new innovative structures that can mobilize alternative sources
of capital and from which Georgia can graduate to more complex instruments such as investment funds which manage infrastructure project and/or SME assets.

Risk mitigation needs to remain a priority when adapting standard instruments into more complex ones. IFIs can play a critical role in partnering on structured finance projects for PPPs in the area of infrastructure.

**Short term:** Develop securitization vehicles for assets such as credit cards and mortgages, as well as ordinary mutual investment funds to set a track record in standard financial products that can subsequently be deployed for PCM purposes.

**Medium/Long term:** Develop and structure specialized investment funds and securitization issuances that utilize underlying assets of infrastructure projects (and revenue flows) as well as assets and earnings of SMEs to expand the application of such instruments for the purposes of PCM.

**Guarantees and Credit Enhancement**

Georgia should focus on addressing financing, risk sharing arrangements, cost sharing and unexpected liabilities that could generate losses to private investors and financiers. This can be achieved through guarantee and credit enhancement instruments that can protect private investors, wholly or partially, against such losses, thus encouraging their participation. The banking sector is relatively sound, so bank syndications could finance PPPs with IFI guarantees. Credit enhancements developed by the private capital markets could be invoked after standard instruments in this area have been well established.

**Short term:** Develop the financial and technical capabilities of Ministry of Finance (MoF) staff to estimate contingent liabilities under PPP and other PCM financing contracts in order to evaluate the coverage, effectiveness and potential loss from using guarantees and other credit enhancements.

**Medium term:** Encourage funding syndications, including foreign banks as well as bondholders, where the use of inflation-indexed bonds can be considered (for local currency instruments) to protect investors from volatility. Structure new PPP transactions applying partial guarantees to assure private investors that they have coverage of project contractual and/or credit risks.

**DRF strategy and implementation**

Georgia should enact a DRM public policy and implementation plan, and a DRF strategy based on the quantification of contingent liabilities. Additionally, the country should develop the local insurance market and strengthen insurance regulation.

**Short term:** Develop and enact a DRM public policy with a concordant implementation plan. As part of these efforts, strengthen the technical capabilities and functions related to contingent liability management within the government department(s) or unit(s) tasked with this function.

**Medium term:** Analyze, define and quantify potential contingent liabilities arising from natural disaster risk, considering the potential losses from each post-disaster phase and developing an appropriate risk-layering approach and DRF strategy. The DRF strategy should include financial/insurance coverage for public assets and infrastructure as well as for private businesses and residential assets, which may be considered a source of contingent liabilities.

**Conclusions**

In summary, reforms and development of PPP project financing structures and market instruments for PCM require a graduated approach so that basic risk-sharing structures (including, inter alia, use of investment funds and securitization issuances) can first be developed in less complex forms and tested on the markets, initially using standard market structures. This needs to be coupled with a commitment to good governance practices and transparency to ensure investor confidence in Georgia’s market and the new legal framework in capital markets. These steps will allow Georgia to establish a track record in these asset classes before moving towards more complex PPP-based financing structures for infrastructure projects. These financing structures may then include social impact objectives, as well as features overlaying guarantees and credit enhancement mechanisms to bring in the private sector (and properly allocate contingent liabilities), as well as catastrophe insurance, and other risk transfer mechanisms to protect project assets from natural hazards. All these structures and options can utilize IFI support to reduce perceived project risks and expand the institutional investor base to mobilize additional private capital for development.

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2 WBG Maximizing Finance for Development: https://www.worldbank.org/en/about/partners/maximizing-finance-for-development. This note refers to PCM and MFD interchangeably although there are differences in their definitions. This approach requires a diagnosis of country economic conditions, institutional governance aspects and adequate regulatory provisions to ensure that private sector participants can operate in financing and investing in erstwhile public projects, but with manageable risk and return parameters. If such aspects are in place, private sector financing can be maximized, and public sector debts and liabilities reduced.
3 See longer report on PCM/MFD in the South Caucasus.
4 AXCO insurance survey reports: AXCO. 2020.
5 Starting with instruments such as credit card and mortgage securitizations as well as standard mutual funds, before moving to infrastructure funds and securitizations or SME investment funds and securitizations.
6 Undertakings for Collective Investment in Transferable Securities (in the United States similar to mutual funds).