



Governance in Reserves Management – National Bank of Georgia's Framework

Session 11: Governance in Reserves Management

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Who owns the Foreign Reserves?

Organic Law of NBG - Central Bank Functions:

- Develop and implement a monetary policy and exchange rate policy, according to basic directions defined by the Parliament of Georgia;
- supervise of the financial sector under this Law;
- Ensure the functioning of the monetary system;
- **Own, keep and dispose of the official international reserves;**
- Act as a banker and a fiscal agent of the Government of Georgia;
- Facilitate secure, sustainable and effective functioning of the payment system;
- Issue currency of Georgia;
- Produce and disseminate the financial and external sector statistics of the country, according to the international standards and methodologies;
- Perform other functions defined by this Organic Law.
- Implement a resolution of a commercial bank
- Participate in the preparation for and management of crises.

Who owns the Foreign Reserves?

Central Bank Independence:

- **Article 68 of Constitution of Georgia:** "*The National Bank shall be independent in its activity. ... The National Bank shall be accountable to Parliament and shall annually submit an activity report to it.*
- **Article 68 of Constitution of Georgia:** "The... guarantees for the independence of the National Bank, shall be determined by the organic law.
- **Article 4 of Organic Law of NBG:**
 - The National Bank shall be independent in its activity. Legislative, executive and other bodies may not intervene in its activity or monitor it except as provided under the Constitution of Georgia and this Organic Law.
 - The National Bank shall be economically independent and shall provide for all its expenses. **The National Bank shall not be liable for the obligations of the State of Georgia. The State of Georgia shall not be liable for the obligations of the National Bank except as provided in this Organic Law.**
 - The National Bank, its assets, property and income, as well as activities and transactions it carries out, shall be exempt from all state taxes, state charges, fees and state duties.

Who owns the Foreign Reserves?

Protection of International Reserves:

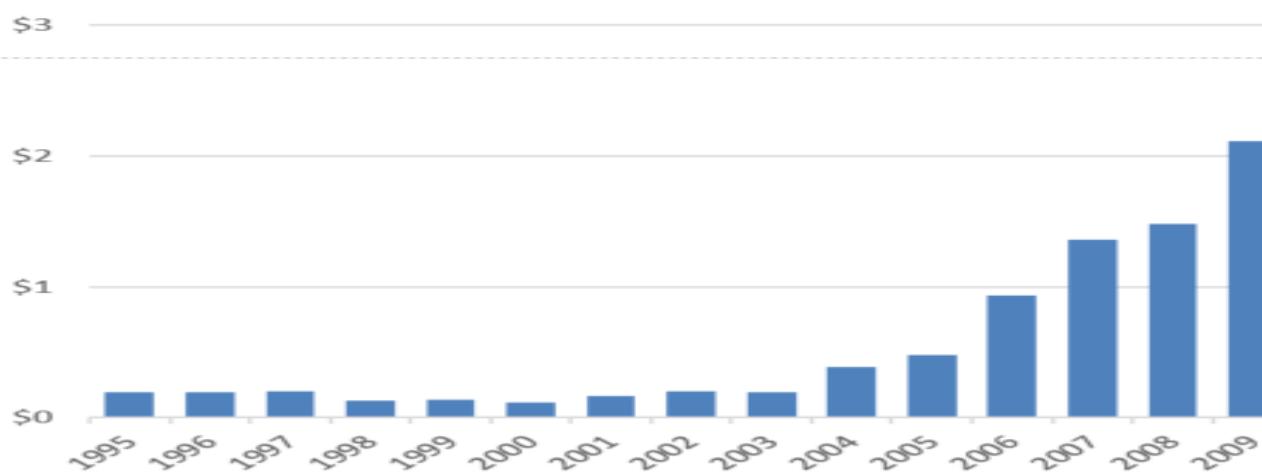
- Foreign Reserves held outside of Georgia has the protection of the Sovereign Immunity. (Unless duly waived by NBG)
 - Majority of Jurisdictions where NBG's assets are held honor this important principle of International Public Law.
 - NBG's Assets shall be immune even to the claims against the Government or other state bodies of Georgia.
 - When the central bank operates in international markets, it faces multiple risks, including legal ones. Most major financial sector jurisdictions acknowledge the special status of a central bank and its reserves. But does the legal status of the central bank in its own country determine how secure its investments are abroad? There are few well known cases of attempts of central banks being held accountable for sovereign and private obligations. It appears that not only the jurisdiction of the investment country is important, but also the local legislation.
 - *To protect the central bank reserves from international litigations against sovereign governments and local corporates, it is important that the law is explicit about central bank independence*
 - *Law on National bank explicitly mentions that the central bank is not responsible for government obligations and vice versa.*

Evolution of Reserves Management Process

How It Started

Accumulation of International Reserves

- First Tranche from IMF
- FX purchase process
- State owned assets privatization process
- Government and Private Sector external borrowing process
- FDI and International organizations increasing investment process



Reserves Management Process (1992 – 2009)

- “Buy and hold” approach
- One single portfolio
- No benchmarks
- Absolute return approach
- Limited list of eligible financial instruments:
 - ✓ Money Market deposits
 - ✓ US Treasury Bills
 - ✓ Eurozone Countries Government
 - ✓ BIS securities (FIXBIS, MTI's)
 - ✓ FX spot operations

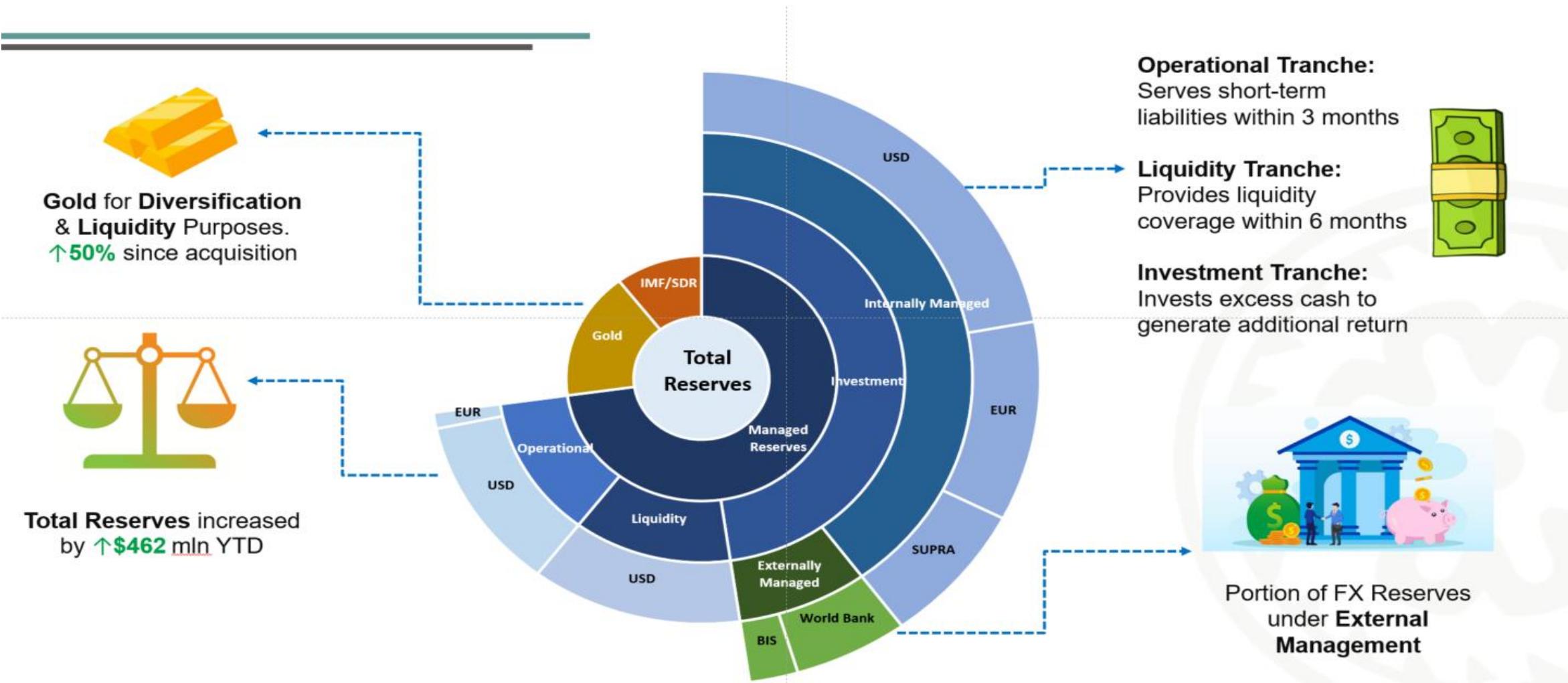
Evolution of Reserves Management Process

First Steps

- Reorganize Reserves Management Function
 - New vision and Philosophy
- Portfolio Management System Implementation
- External Manager Programme
- New Investment Strategy
- Initial SAA implemented
 - Management Awareness Exercise
 - Tranching approach adopted
 - Tranching rebalancing rules and designation
 - New benchmarks selected
 - Increase investment horizon
 - New risk measures
- Portfolio Indexation
- Global Custodian
- New Asset classes
- Active Management
 - New risk measures and tools
 - Risk budgeting



International Reserves Current Structure



Reserve Management Governance

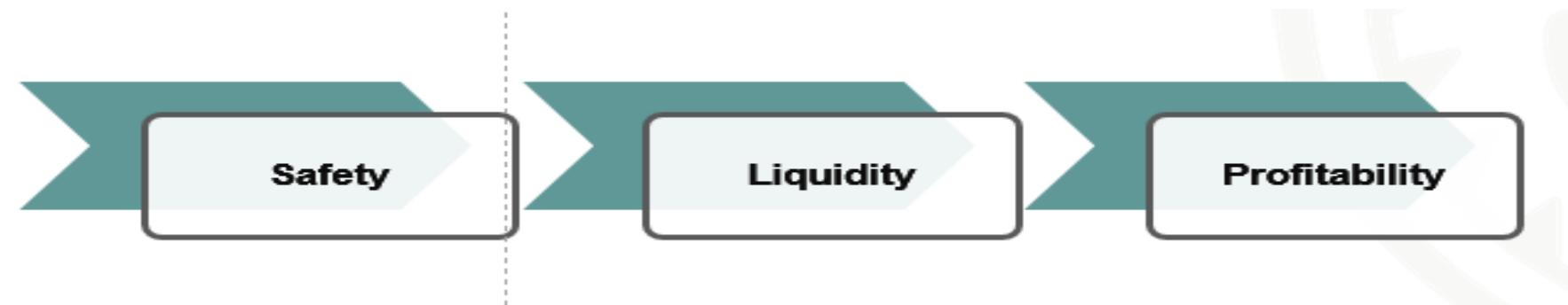
Guiding Principles for prudent management

- Governance Structure
- Delegation
- Transparency and Accountability
- Asset allocation
- Risk Management

Reserve Management Governance

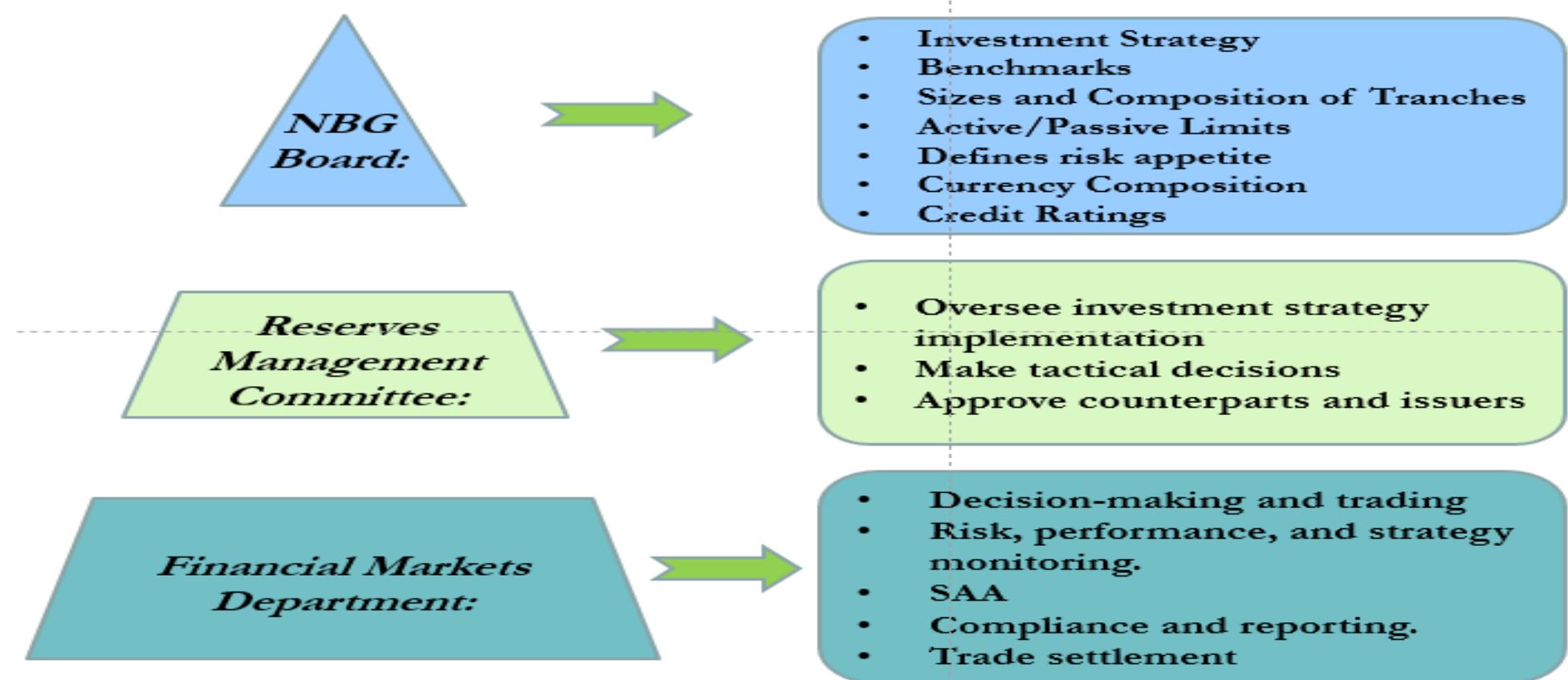
Main Principals

- The main purpose of having International FX Reserves:
 - Support the existing FX regime and policy
 - Facilitate Government of Georgia FX payments (e.g., foreign debt payments)
 - Meet the foreign currency needs during external shocks, crisis, emergencies



Reserve Management Governance

Governance Structure



Reserve Management Governance

NBG Board

The supreme body of the National Bank shall be the Board of the National Bank which consists of 9 members.

- ✓ Governor/Head of NBG Board
- ✓ First Vice Governor
- ✓ 2 Vice Governors
- ✓ 5 non executive members

The Board of the NBG shall be authorized to:

a) review and approve the key principles of managing and disposing of international reserves;

The Parliament of Georgia shall, on the recommendation of the President of Georgia, elect members of NBG Board for a period of seven years, by a majority of votes of the total number of Members of Parliament.

Governor of the National Bank shall be appointed from among the Board members of the National Bank, and dismissed by the President of Georgia upon recommendation of the Board of the National Bank. Vice-governors of the National Bank shall be appointed and dismissed by the Board of the National Bank upon recommendation of the Governor of the National Bank.

Annual report is submitted to the Parliament of Georgia on a annual bases.

Reserve Management Governance

Reserves Management Committee

Committee meetings are held at least once a month

- ✓ Governor/Head of NBG Board – Head of Committee
- ✓ First Vice Governor – Deputy Head
- ✓ Head of Financial Markets Department
- ✓ Head of reserves management division, Financial Markets Department
- ✓ Head of risk management and control division, Financial Markets Department
- ✓ Head Macroeconomics and Statistics Department

Financial Markets Department

- International Reserves Management Division (Front Office)
 - Reserves management related operations on International Markets
- Risk Management Division (Middle Office)
 - SAA
 - Market, Credit, Liquidity Risk management
 - Compliance and Reporting
- International Settlements and Corresponding Banking Division (Back Office)
 - Foreign Currency Transactions
 - Reserve Management Transactions
 - Corresponding Banking
- Critical Systems Management and Development Division
 - Systems – SWIFT; WSS; Bloomberg; GSSS
 - Static Data Management
- Monetary operations Division (Front Office)
 - Monetary Operations related operations on Internal Market

Reserve Management Governance

Open Communication: Ensuring transparency in reserves management

- ✓ Regular reporting practices
 - ✓ NBG Board
 - ✓ NBG Management
 - ✓ Reserves management committee
 - ✓ Department
- ✓ Stockholder engagement: authorities, institutions, public
- ✓ Transparency in investment decisions
- ✓ NBG Board involvement in strategic decisions
- ✓ Internal risk based and external annual audits of financial markets operations
- ✓ Critical systems “health check” audit and systems internal controls overview
- ✓ Set of rules and procedures

Reserve Management Governance

SAA Process

- Determine Risk Tolerance Level
 - **How much risk can we tolerate (afford to lose)?**
- Liquidity Tranche (low risk tolerance)
 - **Max (X)% loss with 99% Confidence Level**
- Investment Tranche, moderate risk tolerance
 - **Max (X)% loss with 95% Confidence Level**
- Investment Horizon: 1 Month; 12 months; >1 year;
- Risk Measure:
 - **Expected Return/Duration**
- Rule of Decision Making:
 - **Maximize Expected Returns Subject to Constraint on Maximum Losses given a Specified Confidence Level over Investment Horizon**

During the preparation process, we consider the **liability structure** of the central bank, government, and the broader economy, possible grants from foreign donors, ongoing and planned projects, expected inflows and outflows, projections of future local market liquidity interventions, as well as the interest rate policy outlook and predefine scenario analysis.

Before board preliminary results are reviewed at the **Reserve Management Committee**.

Preparation: Middle Office

Approval: Recommendations submitted to the Board for approval

Board reviews and approves:

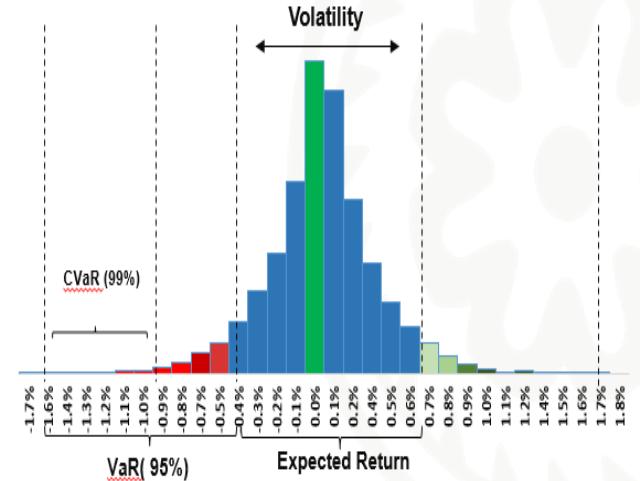
- Strategic Benchmark selection
- Risk tolerance, confidence level, and investment horizon
- Reserve **tranching** and its structure
- Currency entry/exit decisions determined at this stage
- Neutral FX currency composition
- Investments in new asset class

Review:

- Decisions remain in place until the next SAA review
- No predefined trigger events are set in the current policy

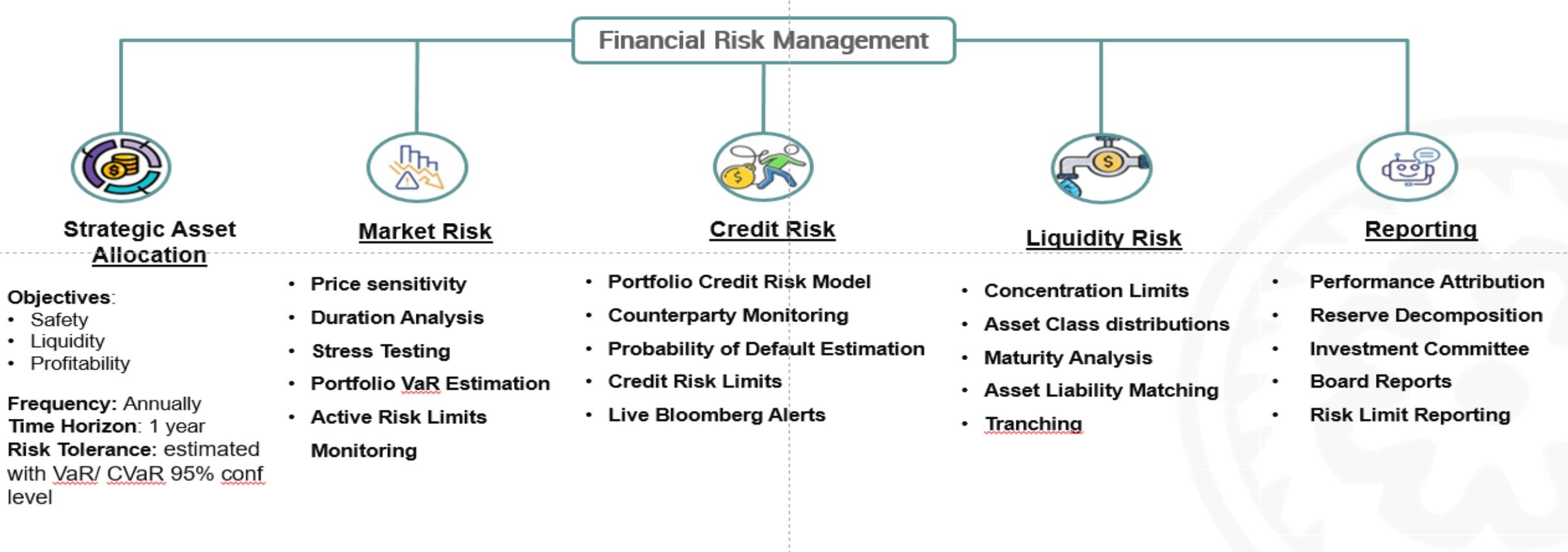
SAA Assumptions at NBG:

- Investment Horizon – 1 year
- **Tranching** – Working Capital, Liquidity, Investment
- Risk Tolerance:
 - Investment Portfolio in USD - CVaR (95%) = 0
 - Investment Portfolio in EUR - CVaR (95%) = 0
 - Investment Portfolio Supra - CVaR (95%) = 0
 - Liquidity Portfolio in USD - CVaR (99%) = 0
 - Review – Annually
 - Base Scenario – Forward looking (No consensus scenario)



Reserve Management Governance

Safeguarding stability: Risk Management



Reserve Management Governance

Safeguarding stability: Risk Management

Risk Taxonomy

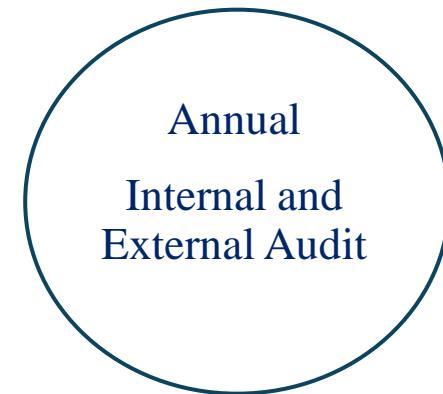
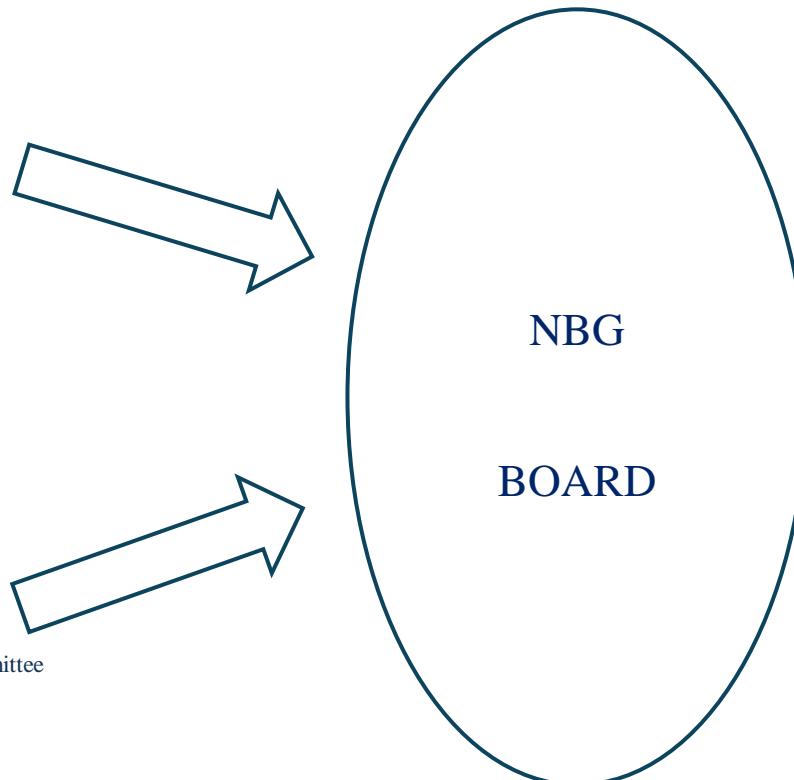
Financial Markets Department

- ✓ FX
- ✓ Market
- ✓ Credit
- ✓ Liquidity
- ✓ Active



Centralized Risks Management Department

- ✓ Reputational Risk
- ✓ Fraud risk
- ✓ HR risk
- ✓ BCP risk
- ✓ 3rd Party risk
- ✓ Information security risk
- ✓ IT risk
- ✓ Physical security risk
- ✓ Legal risk



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