
LEGISLATIVE NEWS

Revised Legal Framework of Banking Supervision

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Changes and Amendments to the Organic Law of Georgia on the National Bank of Georgia and the Law of Georgia on Activities of Commercial Banks, dated 23 October 2001

The Organic Law of Georgia on the National Bank of Georgia of 23 June 1995 and the Law of Georgia on the Activities of Commercial Banks of 23 February 1996 have played an important part in the development of the banking system in the country, and in the regulation of the activities of commercial banks and their supervision. However since these laws were first enacted five years ago a number of shortcomings in the legislation have come to light. These mainly concern the wording of certain provisions that have resulted in inconsistent interpretation and frequently became the subject of legal disputes. As a consequence it is arguable that the supervisory and regulatory functions of the National Bank have been not as they could be and in a number of cases the Bank was unable to intervene in a timely manner to address the issue.

For further perfection and development of the banking sector, it has become necessary to improve the existing legislation. Here we shall address the legislative changes aimed at the strengthening of the supervision of commercial banks and principally the changes to Article 59 of the law governing the National Bank and the major changes to the law on Activities of Commercial Banks. The changes and amendments were elaborated on the basis of the principles and standards established in international banking and mainly refer licensing the commercial banks, regulating their activities, and the management of them when in temporary administration or being wound up.

Changes to Article 59 of the Organic Law of Georgia on the National Bank of Georgia

Modifications to Article 59 of the Organic Law of Georgia on the National Bank of Georgia were to a great extent conditioned by the fact that in accordance with universally recognised principles, the regulatory powers of a country's central bank should apply to every legal person, who accepts deposits.

Unlike commercial banks the non-banking deposit institutions do not offer a full range of banking services and as a general rule they are not considered to be typical banking

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establishments. Furthermore, for the time being Georgia has a special law regulating the activities of non-banking deposit institutions. At the same time, while the activity of non-banking deposit institution is similar to that of the commercial bank, in terms of the acceptance of deposits, the law should provide the possibility to apply supervisory and regulatory functions by the National Bank to the activities of non-banking deposit institutions. To this end, the words "a non-banking deposit institution" have been added to a number of articles in the Law after the words "banks and currency exchange offices". Consequently, in as much as licensing, supervision, regulation, management in temporary administration and winding up of commercial banks, currency exchange offices and non-banking deposit institutions are different processes of a single cycle of supervision, the new version of Article 59 comprehensively embodies the main powers and responsibilities of the National Bank as an authority unilaterally regulating the banking system.

To achieve better banking supervision the National Bank under the new version of Article 59 has been granted the right to require full information not only from a commercial bank or a non-banking deposit institution, but also from persons controlling them. The above changes were conditioned by the necessity of the National Bank to have full information about a person who actually exercises control over a bank. There are rather frequent cases in the banking system, when the founders of the banks are legal persons incorporated abroad. Hence, the information obtained from commercial banks about their founders and persons backing them may not be sufficient to assess the actual situation. The new version of the law enables the National Bank to address a bank's founders to obtain the necessary information. Furthermore, it can now check who is exercising actual control over a commercial bank or a non-banking deposit establishment and make inquiries with regard to the sources of their capital. It is noteworthy, that under the new version of paragraph 3 of Article 59 if the information is not forthcoming the National Bank is entitled to demand the cancellation or limitation of the control of the controlling persons over a commercial bank. The mentioned changes are conditioned by the necessity to improve banking supervision and to prevent the use of the banking system for money laundering.

To safeguard the stability of the banking system and the interests of depositors paragraph 6 of Article 59 grants the National Bank with the right to establish and manage a temporary bank at its own expense. The establishment of such a temporary bank is justified only when a bank is facing major financial difficulties manifested in low-quality assets, low incomes, insufficient liquidity or weak management. At the same time, to establish a temporary bank, it is necessary that the latter have considerable bank assets and liabilities, including deposits, and an extensive network of branches. Thus the need to close down a bank should not produce the danger of uncontrolled processes, crises and non-liquidity in the whole banking system. The prevention of such a situation is one of the main functions of the National Bank. The activities of a temporary bank would be similar to those of a commercial bank but with the following difference. The National Bank is the sole founder and manager of a temporary bank and will carry out these functions through a supervisory council and the board of directors created by it. The major function of a temporary bank is to assume the assets and liabilities of a bank that has played a significant role in the

banking system but faces serious financial problems. The purpose here is to improve the quality of its assets, profitability, liquidity, management systems, financial standing and after this to ensure the attraction of a new investor, who will substitute the National Bank.

Changes and Amendments to the Law of Georgia on Activities of Commercial Banks

Since the changes to the Law on Activities of Commercial Banks of 23 October 2001 are quite numerous, below we shall provide an overview of the most significant changes.

The new version of the law made the definition of “capital” more precise and unified. The changes relate to the types of capital and were conditioned by the necessity to make explicit the type of capital meant within particular articles of the law. To this extent definitions of various types of capital used in the law were included in respective article.

“Supervisory capital” – under the changes to the law a bank may use this type of capital to protect itself against various risks and losses resulting from its activities. It includes authorised capital, undistributed profit and special purpose reserves. Part of the bank capital invested in the authorised capital of other enterprises, as well as other intangible assets shall not be considered as part of the supervisory capital.

“Share capital” – type of capital the amount of which is equal to bank assets minus liabilities.

“Stated capital” – this is the marginal amount of capital fixed in the bank statute according to the law on Entrepreneurs, the filled-in part of which is the so-called “paid-up capital”.

Changes to paragraph 1 of Article 2 aims for to specify the scope of application of the law. Instead of a general statement that the law shall be applicable to every person who attracts money means and grants credits on the territory of Georgia (what may include credit unions, trust companies, non-banking deposit institutions, etc.), the new version of the law limits the scope of its application to commercial banks only. According to the changes the legal form of commercial banks is limited to a joint-stock company. This is conditioned by the fact that the legal form of a joint-stock company, and particularly the standards of formation of its management bodies and of its activities are better regulated by the legislation. At the same time, this organisational form is more flexible and better corresponds to the requirements of the banking system.

Paragraph 5 of Article 2 states that in case of any contradiction with other laws, this Law shall prevail if the banking relations are involved. This is of utmost importance for its practical use and fully compatible with the established principle of prevalence of special legislation.

The changes were introduced to the licensing procedure as well. According to paragraph 1 of Article 3 an application for granting a licence should be accompanied, along with other

documents, by information about the origin of the stated authorised capital and the supervisory capital. Similar to the changes introduced to Article 59 of the Law on the National Bank, this aims to prevent use of the banking system for money laundering. This has acquired growing importance against the background of current worldwide campaign against illegal proceeds and financing terrorism. Changes to paragraph 1 of Article 4 serve the same purpose, according to which the time frame for the consideration of an issue of granting a licence has increased up to three months. The establishment of this three-month period was mainly conditioned by the necessity to verify sources of endowments to the authorised capital and their origin. To this end, taking into account practical experience, the one-month period, provided by the initial version of the law, was not sufficient in many cases.

The new version of the law provides for more comprehensive criteria and requirements for acquiring a banking licence. Paragraph 3(b) of Article 4 is dedicated to the requirements established for the Board of Directors. A director plays a particularly important part in the sound management of a bank as far as he is a person who exercises the every day management of the bank. Hence the law requires the establishment of special criteria by the supervision authority (the National Bank) for the position of the bank director. The Law sets forth a number of restrictions to avoid the concentration of bank management in the hands of persons whose professional experience may be doubted.

Paragraph 1 of Article 6 reiterates the unilateral authority of the National Bank to withdraw a bank licence and lists the exact conditions for its withdrawal. It should be mentioned that this power was disputable for a certain period. This was to some extent conditioned by the changes to the law on commercial banks of 26 June 1999. It removed direct reference to the withdrawal of a banking licence by the decision of the National Bank from Article 6, as well as by enactment of the Law on Licensing of Entrepreneurial Activities" (1 July 1999), in accordance with which a banking licence was to be withdrawn by a court of relevant jurisdiction. Irrespective of this, in some other articles of the law on commercial banks (Article 7, Article 30), as well as in the law on the National Bank there still existed the provision that the National Bank could withdraw a licence. However, this caused a dispute between the National Bank and commercial banks that ended in court. The Court confirmed the authority of the National Bank to withdraw a bank licence, although the problem was finally solved by the present changes, which restores the initial wording of Article 6 in accordance with which "a banking licence can be withdrawn only on the grounds of the National Bank decision".

A bank licence may be withdrawn through a request from a commercial bank itself. In this case, the bank should address the National Bank in written form and at the same, under the new version of Article 7 substantiate its request. In this case and with due consideration of the interests of the banking system and the depositors, the National Bank is authorised to refuse the withdrawal of a bank licence.

Changes to paragraph 3 of Article 6 provide for the mechanism of immediate commencement of the process of winding up of a legal person after the withdrawal of a bank licence by the National Bank. The mentioned mechanism is designed not to slow down the process and thus

not to injure the interest of the creditors and depositors of the bank. Until now the withdrawal of a licence was not considered as grounds for winding up of a bank as a legal person.

Changes to paragraph 3 of Article 8 improve the conditions for the publication and the enforcement of the decision on the withdrawal of a licence, as far as the publication may take some time and cause a certain delay between the adoption of a decision and its coming into force. This itself produces the danger of an illegal outflow of assets, the return of which may prove very difficult, if not impossible.

The new version of Article 9 sets forth the powers of the National Bank to establish the amount and the procedure for the formation of “supervisory capital” – the type of capital necessary for the activities of commercial banks. This is one of the main preconditions for bank stability and liquidity and one of the main instruments to protect the bank against risks.

Changes to Article 10 specify the restrictions with regard to the participation of commercial banks in other enterprises. Furthermore the term “share capital” is introduced instead of the term “reserve capital and reserves” the former being correspondent with the term established in international practice that embodies the difference between assets and liabilities.

Under the same article it is now mandatory to notify the National Bank in case of the purchase of 5% or more of a bank’s shares. The introduction of this requirement is conditioned by the situation that a person owning 5% or more shares acquires the right to exercise certain control over the bank and to exert certain influence over its activities and management. The National Bank, in its capacity as the authority responsible for the stability of the banking system must have all the information about the persons controlling the bank. According to the new version of the law failure to provide the information within an established period of time carries the penalty of depriving the shareholder voting rights at a general meeting of shareholders. According to its content these changes are similar to those of Article 59 of the law on National Bank and provide for certain restrictions on shareholder rights in favour of public interests.

Changes to Article 17 is of an editorial nature and do not change the nature of bank secrecy. Bank secrecy under the initial wording of the law was defined as the “data concerning transactions and accounts of legal and natural persons”. Under the new version it is the “data concerning accounts, transactions and balances of legal and natural persons”, which is essentially the same.

For the stable development of the banking sector it is particularly important to establish a fair competitive environment and prevent any type of manipulation by means of using economic leverages, sustainable legal framework and banking supervision. Changes to Article 22 serve this very purpose according to which all commercial banks are forbidden from entering into fettering agreements on the grounds of which a loan can be granted or some banking service rendered only on condition of the purchase of a non-banking service from a bank or its branch or affiliate.

A particularly significant innovation for the development of the banking is the introduction of a new chapter IV¹ into the law. This chapter is titled Peculiarities of the Settlement of

Some Disputes Related to Commercial Banks. It is a universally acknowledged fact that no development of the banking sector is possible unless commercial banks have the opportunity to give loans under relevant collateral and to realise this collateral rapidly when necessary to retain their liquidity. Pledge and hypothecation are major types of credit collateral, but given the inflexibility of the procedure, their realisation is often delayed. This can bring serious difficulties to commercial banks.

Under the existing civil and civil procedure law an application of a pledgee and a mortgagee on the realisation of a thing encumbered with a pledge or hypothecation is considered in accordance with a general procedure. This implies passage through three judicial instances and a major expenditure of time and effort. This is incompatible with the principles of velocity in bank transactions. These changes attempt to simplify these procedures because under the changes the applications of the commercial banks on the realisation of the encumbered property are to be considered by a district court at the first instance within a period of 20 days after their submission. The decision can then only be appealed in the Supreme Court.

However because these changes have not been introduced into respective procedure laws, the judiciary still ignores them. It is to be hoped that these changes will be followed by the appropriate regulations soon as this will have a positive impact on the development of the banking sector.

Significant changes were made to Article 30 of the law. This article is entitled Violations and Sanctions. The new version in paragraph 3 specifies the grounds for imposing sanctions on a bank. Such is based on the violations committed and the degree of possible or actual asset risk. Relevant measures and sanctions are necessary but not in any way related with a sequence, as bank violations are not of sequential nature and thus their gravity is established on a case-by-case basis. Furthermore, an important innovation is the opportunity to impose financial sanctions directly on a bank's administrators. In many cases it is their faulty or unlawful actions that cause damage to the bank and to fine a bank for this would not be reasonable.

Under changes to Article 34 the powers and responsibilities of the temporary administrator of a bank are specified and expanded. At the same time measures to be carried out by the latter to improve the financial standing of the bank are also identified.

Changes to Article 37 are rather important as they set out the restrictions upon a liquidator to ensure there are no conflicts of interests. The new version of the article expands the powers of bank liquidators to secure the unimpeded flow of the winding up process and the protection of interests of a bank's depositors with regard to the receipt of money.

The above clearly demonstrates that on 23 October 2001 significant changes and improvements were made to Georgia's banking legislation, which would facilitate the perfection of banking and financial services market in the country. However given the rapidity of change within the banking sector in the world, Georgia's legislation will soon have to be subject to further amendment and change.