# Amendments Made to Banking, Tax, Enforcement and Related Legislation of Georgia

(4th Quarter of 2011 and the 1st Half of 2012)

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*Materials were prepared with financial support of the "Open Society -Georgia" Foundation.*

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# Executive summary

The present report reviews amendments made in the 4th quarter of 2011 and the 1st half of 2012 to the banking, tax, enforcement and related legislation of Georgia, which has a significant impact on the functioning of the banking-financial sector of Georgia and the activities of banking institutions.

The banking-financial sector of Georgia encompasses an important segment of the country's economy. Any substantial changes made to this sector have a direct impact on the overall business climate and investment attraction of Georgia, in addition to the economic and political stability of the country.

The following analysis of all significant legislative and supplementary changes implemented during the reporting period clearly demonstrates that:

- **Numerous amendments were made during the last 9 months to the banking, tax, enforcement and related legislation of Georgia, as well as to the monitoring norms of the National Bank. Introduction of the ones has considerably altered the environment in the banking-financial field.**

- **"Temporary" amendments were made to particular articles of the legislation (mainly to the tax and enforcement legislation) that were applied towards just one specific commercial bank operating on the market whose beneficial owner is a leader of the opposition coalition. After all punitive measures under the new legislation were applied against this bank, the legislation was reversed to the previous regulations of 6 months earlier.**

- **The procedure for the receipt, systematization, processing, and transfer of information to the Financial Monitoring Service of Georgia ("FMS") was established and enacted in respect of all types of financial service institutions (commercial banks, microfinance organizations, securities registrars, money transfer institutions, founders of insurance organizations and non-state pension schemes, accounting and/or auditing institutions, broker companies, currency exchange points, credit unions), and has remarkably aggravated the terms of client relations and market operations for each of these institutions.**

- **The issue of a "politically active person" or "persons in direct business relations with that person" became of special concern, as a rather wide range of obligations, powers and sanctioning conditions were set for those institutions providing financial services.**

- **Non-cash payment terms existing previously were changed, making it more difficult for people to transfer amounts from their personal bank accounts on behalf of other legal entities.**

- **The Central Bank was granted the power to determine through its own normative act, additional criteria for the compatibility of the owner of a commercial bank's significant**

**share and of the administrator, which provides leverage to impose additional requirements on top of the previously existing ones.**

- **Legislation has eased the qualification requirements for the Board of the National Bank so that it is now possible to elect non-professionals in the field of economy and/or finances to the Board.**

- **Control in the financial sector has become tighter. Within the scope of this policy, the National Bank now regulates small financial service institutions. Their activities had not been previously subject to regulation by the Central Bank.**

- **A memorandum was executed between the Chamber of Control of Georgia and the National Bank, which significantly amends and reduces those norms that restrict access to a client's banking information and the confidentiality guarantees that were available before.**

## Key Findings and Trends

Georgia's banking-financial sector is a major driving force for the country's economic growth and development. Throughout its independent history, the Georgian banking system sustained numerous setbacks before it could finally become one of the foremost pillars for the country's economic sustainability.

The global financial-economic crisis and the 2008 war with Russia considerably damaged Georgia's banking sector. A substantial amount of time and investments of solid financial resources in the field were required to help overcome the crisis. In 2011, thanks to a tradition of implementing changes rather cautiously and moderately and other key factors, the banking sector witnessed remarkable, record profits.

The existence of a stable legislative area and a predictable environment for financial institutions are equally important to provide conditions that safeguard international banking institutions so they may invest in Georgia and open and operate their representative offices. Some have expressed readiness to enter and operate on the Georgian market.

In this respect special attention must be paid to an array of legislative amendments carried out in Georgian banking, tax and related fields since the end of 2011. A certain portion of these amendments substantially changes many previous norms of the financial market and has a significant impact on the activities of individual banking-financial institutions, as well as on the overall functioning of the financial sector of Georgia.

Notably, many amendments were motivated by the need to bring domestic legislation in compliance with international practice and their urgency was justified by the necessity to fulfill Georgia's international obligations and to avoid global risks (terrorism, illicit money laundering, etc.). Amendments to the legislative and regulatory norms carried out in line with this logic and

relevant context raise fewer questions.

However, a certain portion of legislative changes are closely and chronologically tied to the ongoing political processes in the country. They provide the public, expert and political circles with the grounds to directly link the implemented changes to political developments.

Amendment packages have affected the Organic Law on the National Bank of Georgia, the Tax Code and the Law on Enforcement Proceedings. At the same time, significant amendments were made to the monitoring norms of the Financial Monitoring Service of the National Bank of Georgia, which were markedly changed since the start of 2012 and have introduced new frameworks for all types of financial institutions operating on the financial market.

## The Law on Enforcement Proceedings/The Tax Code of Georgia

On 28 October 2011, the Parliament of Georgia adopted, through an expedited procedure, amendments to the Law on Enforcement Proceedings and the Tax Code of Georgia, which were put into effect immediately upon publication (November 7). These gave the tax authorities a favorable position over the secured claims of financial institutions with respect to borrowers; if the grounds for tax claims secured with a tax pledge/mortgage originated before registration of pledge/mortgage of a financial institution.

Pursuant to the amendment, if the grounds for tax pledge/mortgage belong to the period prior to registration of pledge/mortgage of a commercial bank, claims secured with tax pledge/mortgage will be satisfied first, followed by the claims of commercial banks.

This amendment has fundamentally changed the state of banks and the significance of the pledge factor in their activities. Under the previous text of the law (developed in accordance to an agreement between the Banking Association and the Revenue Service) bank claims existing prior to the registration of a tax pledge/mortgage were satisfied first, followed by claims secured with tax pledge/mortgage.

Accordingly, banks enjoyed the possibility to check a client's liability with a tax pledge/mortgage prior to issuing credit and to decide on issuing credit afterwards. The implemented amendment, however, has made it practically impossible to establish when the claims of a tax authority become superior to a bank's claims.

Meanwhile, another amendment was made to the Law on Enforcement Proceedings, pursuant to which, if enforcement proceedings are underway in the state's favor and no winner was announced at the first auction, or the winner has not paid the property price within the terms established by law, the National Bureau of Enforcement has the right to issue the order within 15 days from completion of the auction on the transfer of property in kind to the state.

It is noteworthy that this amendment has also fundamentally changed the previous setting.

According to the previous text of the law, in case of failure of the first auction, a repeated auction was arranged. Under the new text, properties may be sold faster and include the possibility to transfer property in kind to the state.

Another amendment of the law stipulates that if a compulsory auction is carried out to sell the property of a debtor encumbered with a tax pledge/mortgage, after the transfer of property in kind, all property rights registered after the liability that were the basis of tax pledge/mortgage will be revoked.

Under the previous version, following the transfer of property, all rights registered after the registration of tax pledge/mortgage would be revoked (i.e. the bank knew exactly that its pledge/mortgage would not be revoked should it precede with registering the date of tax pledge/mortgage). The new text is vague in regards to when the bank’s mortgage would be revoked. The origination date of the liability in which the tax pledge/mortgage is imposed on the property will be known only after the Public Registry registers the tax pledge/mortgage and the public auction is determined. The auction announcement does not indicate that the property for auction is encumbered in the bank's favor.

Another legislative amendment reduces the chronological frames of holding the compulsory auction. In particular, the National Bureau of Enforcement holds a compulsory auction within one month after seizing the property, although if the property to be sold is evaluated within one year of the beginning of enforcement proceedings, the National Bureau of Enforcement holds a compulsory auction within two weeks from seizing the property.

In the previous version of the law, the auction was held within two months after enforcement proceedings began. In fact, the enforcement period on enforcement cases in the budget's favor have been reduced from two months to two weeks, as the property to be sold may be evaluated under the old date, which pursuant to the new version of this article, provides the possibility to hold the auction within two weeks after enforcement proceedings are initiated.

Additionally, if no winner is announced after the first auction of seized property (or the winner does not pay the property price within the established term), the National Bureau of Enforcement is entitled to issue an order on the transfer of this property in kind to the state within 15 days from the completion of the auction, or to hold a repeated auction. In the event the repeated auction is unsuccessful, there will be a possibility to free this property from seizure in favor of the creditor selling this property and to return it to the debtor.

With this amendment, the state created the legislative basis for returning property free of all obligations (including the payment of bank loans) to the owners.

Consequently, the law gained retroactive power, as the banks issued loans in line with the old version of the law and in the new reality, they have lost the lawful rights granted prior to that.

Now banks are facing financial risk and reputation damage, as the document basis that would confirm the non-existence of tax liabilities of credited borrowers and the mortgage burden of properties free of all rights, has in fact lost its effect.

Thus, with the described legislative amendments, the collateral existing in Georgia has

practically lost the meaning of respective security for issuing loans. Leveling the notion of collateral and the status of first-rank mortgages will in all likelihood significantly reduce the degree of loan security and the need to respectively reserve additional funds.

Parliament adopted similar amendments in 2010 but through the joint efforts of the banking system and international financial institutions, this convention was revoked in three months without being ever put into effect.

This time, these institutions did not protest the implemented changes. The legislative changes that were jointly rejected in 2010 by all commercial banks and the Banking Association were accepted in 2011 without any consultations. However, one commercial bank, "Cartu" did make statements about the adverse effects of the new legal norms and the damage inflicted to the bank.

The bank's top management asserted these legislative amendments amount to an unprecedented and politically motivated campaign against "Cartu". In particular, tax pledges/mortgages were registered on the properties of clients who owned capital securing the bank's credit claims (grounds of origination preceded the registration of pledge/mortgage in favor of JSC "Cartu Bank"). The compulsory enforcement proceedings were carried out in favor of the Revenue Service, which included: a) revocation of the pledge/mortgage right registered in the bank's favor through or without "alienation" of properties on compulsory public auction; b) transfer of the properties in kind to state ownership; and c) return of the properties by the state to the original owners, who are usually represented by companies registered in off-shore zones, or by foreigners and/or legal entities established by the original owners (or persons related to them) of the said properties.

At the same time, public auctions on seized movable-immovable properties occurred in which the state (the Ministry of Economy and Sustainable Development of Georgia) became the owner of 100% of in kind and unencumbered properties, resulting in the revocation of the pledge/mortgage of JSC "Cartu Bank" on all of its property.

Of the 92 public auctions held, trading occurred in only 33. None of the auction winners (33 cases) paid the declared value of the property. When conducting repeated auctions was deemed unreasonable, the state again became the owner of these properties, in kind.

After the transfer of this property in kind, the state should have alienated/privatized it by public auction or by direct sale ("http://www.eauction.ge" www.eauction.ge and "http://www.privatization.ge are the official sources of information on public auctions). If no auctions were noted on the properties of concern, the decision on alienation of the property through a direct sale is made by the President of Georgia. The respective order must published on the "Legislative Herald of Georgia" web site. So far, this has not been done, nor has this information been made available on the President's web site.

Interestingly, six months after these amendments were passed, the regulation on the ranking of creditors' claims was reversed to the previous mode. According to a decision adopted on 19 April 2012, the regulation on the ranking of the creditors' claims existing prior to November 2011 was reinstated and the grounds of origination of pledge/mortgage in the ranking process will no longer be a determining factor.

Specifically, prior to the registration of tax pledge/mortgage, the pledge/mortgage right of commercial banks, microfinance organizations, insurance organizations, international financial institutions and financial institutions of developed countries (as stipulated in the Law on the Activities of Commercial Banks) is registered on a person's property. If this property is being sold, the generated amount will satisfy the claims of above-listed financial institutions as part of the liabilities originating before the registration of tax pledge/mortgage, followed by the satisfaction of tax liabilities.

The legislative body justified the reinstatement of previous legal norms as a demand of the "business sector." When parliament debated the need to reinstate the old norms, the parliamentary opposition emphasized that "at the end of 2011, the adopted norms damaged a number of commercial banks." However, Cartu Bank is currently the only bank that has reported damages incurred from the amended norms. The damages are estimated to be around 200 million GEL (approx. $120.5 million).

Another amendment initiated in May 2012 in the Law on Enforcement Proceedings states that by order of the Minister of Justice, the National Bureau of Enforcement may carry out any activity. In particular, the National Bureau of Enforcement is authorized to carry out activities not directly stipulated in the Law on Enforcement Proceedings.

This amendment increases the powers of the National Bureau of Enforcement by providing it with the possibilities to register and control the loans, mortgages and pledges.

**The 28 October 2011 amendments made to the Law on Enforcement Proceedings have seriously impeded bank activities in terms of real estate mortgage practices.**

**The legislative amendment has diametrically changed the state of the banks and has practically lifted the degree of the protection of credits. Banks have in fact lost the possibility to check the burden of a client's property with a tax pledge/mortgage prior to issuing the credit and to decide on issuing the credit only afterwards.**

**Meanwhile, under other amendments made to the same law, it is no longer necessary to hold a repeated auction if the enforcement proceedings were underway in the state's favor and if the National Bureau of Enforcement was granted the right to issue the order on the transfer of property in kind to the state within 15 days from completion of the auction (if no winner was announced at the first auction or if the auction winner did not pay the property price within the terms established by law).**

**As for the timeframes of holding the auction itself, the period for holding the compulsory auction is one month after property has been seized. If the property slated for sale was evaluated one year prior to the beginning of enforcement proceedings, the auction will be in two weeks. Accordingly, the period of enforcement on cases in the budget's favor has decreased by four times - from two months to two weeks.**

**Finally, the law acquired retroactive force, as the banks issued loans in line with the old version of the law, but in reality they lost the lawful rights granted prior to that.**

**Owing to this and other amendments made to the Law on Enforcement Proceedings, banks**

**operating on the market face a risk of substantial financial and reputation damage.**

**The new regime shaped by the legislative amendments was applied towards just one commercial bank operating on the market, and its beneficial owner is the leader of an opposition coalition. There is reason to believe the adoption of these legislative amendments may have been politically motivated.**

**This suspicion is further reinforced by the fact that after all punitive measures under the new legislation were applied against the opposition leader's bank, the legislation was reversed to the previous regulations of 6 months earlier.**

## Orders of the Financial Monitoring Service

In January 2012 the Financial Monitoring Service of Georgia ("FMS") issued orders under which the new procedure for the receipt, systematization, processing, and transfer of information to the FMS was established in respect of all institutions operating on the financial market of Georgia: commercial banks, micro-finance organizations, securities registrars, money transfer institutions, founders of insurance organizations and non-state pension schemes, accounting and/or auditing institutions, broker companies, currency exchange points, credit unions.

The explanatory notes of all orders and regulations state that these acts were adopted based on the Law of Georgia on Prevention of Legalization of Illicit Income and other normative acts of Georgia.

Meanwhile, concurrent to the old requirements, a new set of requirements has been established with respect to each institute, which defines the framework of necessary activities to be undertaken vis-a-vis the clients.

The provisions of the procedure on the receipt, systematization, processing and transfer of information to the FMS stipulate that the terms are defined as follows:

Legalization of illicit income – granting (purchase, use, transfer or other action) legal nature to illicit income, as well as the concealment or disguise of an illicit income's real origin, owner or possessor and/or property rights, and/or the attempt to commit such an action;

Suspicious transaction – a transaction (despite the amount and type of operation), in which there is a substantiated suspicion that it was concluded or executed with the purpose of legalizing an illicit income and/or property (including monetary means); was gained or originated from criminal activities, and/or the transaction was concluded or executed to fund terrorism (person participating in the transaction or the origins of transaction funds are suspicious, or there are other grounds owing to which the transaction may be considered as suspicious), or any person participating is on the list of terrorists or persons promoting terrorism and/or may be possibly connected to them, and/or monetary means involved in it may be related to or used for terrorism, a terrorist act or by terrorists or terrorist organizations or a person funding terrorism; or the legal or factual address or place of residence of any person participating in terrorism is in a non-cooperative zone, or the funds of this transaction are transferred to or from such a zone;

Unusual transaction – a complex, unusually large transaction, as well as the type of transactions that lack obvious economic (commercial) content or obvious legal purpose, or is inconsistent with the general activities of the party to the transaction;

Politically active person – a foreign citizen, who based on the legislation of a respective country, occupies a state (public) political office and/or is engaged in significant state and political activities. Politically active persons are the: head of the state, head of the government and government member, as well as his/her deputies, head of a governmental institution, member of parliament, member of the Supreme Court, member of the Constitutional Court, person in charge of military forces, member of the Board of the Central (National) Bank, an ambassador, head of an enterprise where a state's share participates, head of a political party (union), member of the executive body of a political party (union), other important political activist, as well as his/her family members and persons in direct business relations with him/her; a person shall be regarded as a politically active person during one year from leaving the above-described position;

Family member – a spouse, child (including step-child) and his/her spouse, parent, sibling;

Person in direct business relations with a politically active person – a physical person, who owns and/or controls the ownership interest or the voting shares of a legal entity, whose ownership interest or voting shares are owned and/or controlled by a politically active person, as well as a person in other close business relations with him/her.

As for the regulations in respect of individual financial institutions, they are as follows:

## Commercial banks (date of adopting the regulation – 18.01.2012)

Commercial banks are obliged to monitor the banking operation of any financial volume they find suspicious.

Additionally, any attempt to conclude a suspicious transaction or carry out a banking operation and/or other fact (circumstance), which pursuant to the written instructions of FMS, may be linked to the legalization of illicit income or the funding of terrorism is subject to monitoring.

Banks must pay special attention to unusual transactions and transactions that lack obvious economic (commercial) content or obvious legal purposes and examine within possible limits the purpose and grounds of the conclusion of such a transaction and report the results in writing.

However, the banks must "define the principles of attributing transactions of persons in business relations with them to unusual transactions", i.e. this approach is not based on any universal principle and each bank is authorized to establish the criteria on its own.

At the same time, the FMS enjoys the right to define the list of concrete types of transactions (banking operations or their features, such as the area of activities of those participating in the

banking operation/transaction, geographic area of their location (place of registration), essence of the transaction (banking operation), etc.), of which FMS must be notified.

Banks are obligated to enact internal control mechanisms, which includes identifying all persons in direct or indirect business relations with them, and undertaking measures with respect to politically active persons.

To reveal suspicious, unusual and/or fractured banking operations (transactions), banks are obliged to create electronic data bases.

Banks must also identify the client (his/her representative and principal, as well as third person, if the transaction was concluded for the benefit of a third person) and take reasonable measures to verify his/her identity based on information (documents) obtained from a trustworthy and independent source when the transaction exceeds 3,000 GEL (or the equivalent in other currency), or when local and international operations (wire transfers and remittances) are executed by monetary payment or notification exchange systems when the amount exceeds 1,500 GEL (or the equivalent in other currency). This means that banks have to identify quite a huge number of transaction participants.

Furthermore, the bank does not have the right to serve a client or establish business relations with one (including carrying out banking operations that do not require a person opening a bank account, send or receive remittances, buy/sell a foreign currency in banknotes, exchange banknotes, etc.), without identifying them in advance, in cases stipulated under Paragraph 1 of this article.

In addition to this, banks have to probe into the type and purpose of a client’s relations with the bank before initiating business relations with them, and to permanently examine the relations between the existing clients and the bank.

Bank relations with politically active people are regulated separately. In particular, banks are obliged to examine whether a client or their beneficial owner falls within the category of politically active person. If so, bank management must issue a permit for establishing business relations with such a person. Banks must take reasonable measures to determine the origin of such a person’s property and monetary means and carry out expanded monitoring of its business relations with such a person.

Banks are also obliged to store information in hard or soft form for identification purposes. This includes information on banking transactions, documentation on a client’s account and business correspondence for no less than 6 years from the moment business relations with the client were terminated, if the monitoring authority does not require a longer term and/or the legislation of Georgia does not impose a longer term for storing such information (documents and records). Banks must store electronic data (respective data bases, etc.) and documentary information throughout this term.

## Currency exchange points (18.01.2012)

Until 1 April 2012, currency exchange points were obliged to have functioning e-mail, establish electronic data bases for the identification of clients and other relevant persons and for transactions subject to monitoring, and to introduce a respective software program to reveal fractured currency purchases and sale operations.

This provision has expired and although the FMS has not put relevant sanctions into effect, all currency exchange points that do not meet these requirements automatically become criminal and are subject to sanctioning.

Currency exchange points are also obliged to pay special attention to unusual transactions that lack obvious economic (commercial) content or obvious legal purposes and to examine within possible limits, the purpose and grounds such a transaction was concluded and to report the results in writing. Yet, it is the currency exchange points that define the principles of attributing the transactions of people in business relations with them to unusual transactions.

Pursuant to the FMS regulations, a currency exchange point, which typically employs only one or two people, has to develop an internal instruction to determine the procedure for identifying the clients, their representatives and principals and beneficial owner, and to determine if the transaction is carried out for the benefit of a third person and other relevant persons stipulated in the Law of Georgia on Prevention of Legalization of Illicit Income. It must also identify politically active persons and develop a procedure for registration, systematization and maintenance of the monitoring related information.

The direct owner of a currency exchange point must equip an exchange with the relevant technical and programmatic means and resources to safely store information and documents; have a functional e-mail address, set up an electronic data base for the identification of clients and other relevant persons, for transactions subject to monitoring, and the owner must introduce a respective software program for revealing fractured currency purchases and sale operations.

In addition, the owner of a currency exchange point must determine, by a duly executed decision, the employee responsible for monitoring and instruct him/her to discharge respective functions. The owner must also regulate the issues related to finding a currency purchase and sale operation suspicious and/or carried out for fracturing purposes. The owner must prepare and submit reporting forms to the FMS, which grant the authority to sign other materials in connection with the monitoring process.

These requirements towards the currency exchange points are in force nation wide, including areas where internet access is not available and computer literacy is minimal.

If a transaction is suspicious or exceeds 3,000 GEL, a currency exchange point is obliged to identify the client's beneficial owner and to take reasonable steps to verify his/her identity through a trustworthy and independent source to confirm who the client's beneficial owner is. Identification procedures foreseen for a physical person must be applied towards the beneficial owner as well.

During the identification of a client and/or verification of his/her identity (his/her beneficial owner), a currency exchange point may rely on a third person/intermediary, who identifies a person and their beneficial owner and verifies their identity in line with international standards.

A currency exchange point also defines identification procedures. If a currency exchange point fails to identify a client, it is not authorized to serve the client.

The standard identification procedure is to identify a client's name and surname, citizenship, date of birth, place of residence, ID (passport) number and a citizen's personal number indicated in the ID (passport).

If a physical person is registered as an individual entrepreneur, a currency exchange point must identify the respective date and number of registration, the registering authority and the tax-payer's identification number. In the case of a legal entity – the full name, area of activities, legal address (in case of a branch or representative office – address of a branch/office and the head office), registering authority, date and number of registration, taxpayer's identification number and the identification data of persons with managerial and representative authority.

Moreover, a currency exchange point is obliged to constantly monitor business relations with a client. This includes maintaining current information and records on the client and their beneficial owner; periodic update of existing identification data and their compliance with the norms in effect; detailed examination of transactions to establish if the transaction is consistent with its knowledge of the client, commercial or personal
activities of the client and the risk group, and if necessary, the origin of the property (including monetary means).

Like large financial institutions, currency exchange points are also obliged to determine whether the client or its beneficial owner is a politically active person and to take reasonable measures to establish the origin of monetary means and the property of such a person and to exercise advanced monitoring of its own business relations with such a person.

A currency exchange point is also obliged to store the identification data of clients (their representatives) in a hard or soft form, as well as information (documents) on the currency purchase and sale operations for no less than 6 years from the moment of termination of business relations with the client, unless the respective monitoring authority does not require a longer term and/or the legislation of Georgia does not impose a longer term for storing such information (documents).

## Securities registrars (24.01.2012)

It was established for securities registrars that giving securities as a gift to a person who is not the spouse, child, grandchild, parent, grandparent or sibling can serve as grounds for finding the transaction suspicious.

The registrars must pay special attention to unusual transactions that lack obvious economic (commercial) content or obvious legal purposes, examine within possible limits the purpose and

grounds for concluding such a transaction and to report on the results in writing.

Yet, it is the registrars that define the principles of attributing transactions of persons in business relations with them as unusual transactions. The registrars determine the personal identification procedures on their own as well.

Securities registrars must identify the client as soon as an executed transaction or operation exceeds 3,000 GEL.

Furthermore, the registrar must identify the client's beneficial owner and take reasonable steps to verify his/her identity based on a trustworthy and independent source and to confirm who the client's beneficial owner is. Identification procedures foreseen for a physical person must be applied towards the beneficial owner as well.

Prior to initiating business relations with a client, the registrar has to probe into the type and purpose of a client's relations with the registrar, and to permanently examine the relations between the existing clients and the registrar.

The registrar is obliged to constantly monitor business relations with a client. This includes a "detailed examination of the transaction to establish if the transaction is consistent with their knowledge of the client, or the commercial or personal activities of the client and the risk group, and if necessary, the origin of the property (including monetary means)."

It is regulated separately that registrars are obliged to determine whether a client or their beneficial owner is a politically active person. If such a fact is confirmed, registrars must obtain a permit to establish business relations with such a person from the registrar's management. Then registrars must take reasonable measures to determine the origin of monetary means and property and closely monitor business relations with such a person.

The registrar must define the relevant procedures to establish and verify politically active persons. The registrar must seek relevant information from the client, public sources or respective electronic data bases.

## Money transfer institutions (18.01.2012)

A money transfer institution is obliged to identify its clients and take reasonable measures to verify their identities based on information (documents) obtained from a trustworthy and independent source when local and international operations (wire transfers and remittances) are done by monetary payment or notification exchange systems when the amount exceeds 1,500 GEL (or the equivalent in other currency).

The money transfer institution must identify a client's beneficial owner and take reasonable steps to verifying their identity based on a trustworthy and independent source and to confirm who the client's beneficial owner is. Identification procedures foreseen for a physical person must be applied towards the beneficial owner as well.

Money transfer institutions are also obligated to determine whether the client or their beneficial owner is a politically active person. If such a fact is confirmed, the management must issue a permit to establish business relations with such a person and to take reasonable measures to determine their origin of monetary means and property and to closely monitor business relations with them.

Money transfer institution must define relevant procedures to establish and verify politically active persons. the institution must seek relevant information from the client, public sources or respective electronic data bases.

## Microfinance organizations (24.01.2012)

A microfinance organization is obligated to identify the client and take reasonable measures to verify their identity based on the information (documents) obtained from a trustworthy and independent source when: a) the  transaction amount exceeds 3,000 GEL (or the equivalent in other currency); b) local and international operations (wire transfers and remittances) are done by monetary payment or notification exchange systems when the amount exceeds 1,500 GEL (or the equivalent in other currency); c) the transaction is suspicious.

A microfinance organization is also obligated to probe into a client's political activities and take measures to establish the origin of the client's money and property and to closely monitor relations.

## Broker companies (24.01.2012)

Broker companies are subject to monitoring when the concluded or executed transaction by the client and/or the unity of transactions is concluded or executed for the purpose of fracturing the transaction; when the transaction is suspicious, the amount or the amount of unity of transactions concluded or executed for the purpose of fracturing the transaction exceeds 30,000 GEL;when the transaction is executed through the securities with respect to the applicant; when the transaction is executed with participation of a suspicious financial institute; when the transaction is executed by a person operating with securities or registered in the concerned or suspicious zone and/or is executed through the use of a bank account of an operating bank in such a zone; when the transaction is executed in cash.

A broker company may find the transaction suspicious based on the following grounds:
**a)** The transaction price of the securities listed on the stock exchange differs from the officially listed price by 40% or more;
**b)** Giving the securities as a gift to a person who is not a spouse, child, grandchild, parent, grandparent or sibling;
**c)** The buyer broker is unable to identify the origin of the amount;
**d)** The seller broker is unable to identify the origin of the securities;
**e)** It is obvious that the transaction was concluded and/or was executed for the purposes of fracturing the transaction, and thus avoiding lawful requirements;

**f)** The legal or factual address of any person party to the transaction is in the non- cooperative zone or their amounts are transferred to or from such a zone;
**g)** All other circumstances which for the purposes of these regulations may serve for a broker company as the basis for finding a transaction suspicious.

A broker company is obligated to identify the client and take reasonable measures to verify thier identity based on information (documents) obtained from a trustworthy and independent source when the transaction amount exceeds 3,000 GEL (or the equivalent in other currency).

A broker company is also obligated to determine whether the client is a politically active person and to determine the origin of such monetary means and property.

At the same time, a broker company must define procedures to establish and verify politically active persons. The company must seek information from the client, public sources or electronic data bases.

## Accounting and/or auditing institutions (31.01.2012)

Under the new regulations, a person undertaking accounting and/or auditing activities monitors any transaction that can be discerned as suspicious and when the accounting and/or auditing institution participates with the client's assignment (for the client) or on behalf of the client in transactions in the following activities:
Purchase and sale of real estate;
Management of monetary means, securities or other property;
Management of bank, deposit, or securities accounts;
Organization of deposits for establishing a legal entity, its activities or management;
Establishment of a legal entity or partnership, its activities or management;
Share purchase and sale of a legal entity.

The accounting and/or auditing institution must pay special attention to unusual transactions that lack obvious economic (commercial) content or obvious legal purpose, examine within possible limits the purpose and grounds of concluding such a transaction and to report on the results in writing.

Yet, it is the accounting and/or auditing institutions that define the principles of attributing the transactions of persons in business relations with them to unusual transactions.

The accounting and/or auditing institution is also obligated to determine whether the client is a politically active person and to determine the origin of the client's monetary means and property.

Furthermore, in order to establish and verify politically active persons, the accounting and/or auditing institutions must seek relevant information from the client, public sources or respective electronic data bases.

## Founders of insurance organizations and non-state pension schemes

Pursuant to the new regulations, the founders of insurance organizations and non-state pension

schemes must monitor operations concluded or executed by a person and/or the unity of operations concluded or executed for the purpose of fracturing a transaction, provided there is at least one of the following circumstances:
The transaction is suspicious in accordance with Article 2(e) of these regulations, regardless of the amount.
The transaction amount or the unity of transactions exceeds 30,000 GEL (or the equivalent in other currency) and transaction type is:
b.a) Revocable life insurance;
b.b) Annuity and pension insurance;
b.c) Personal insurance with the condition of returning the premium;
b.d) The transaction executed by the person operating or registered in a concerned or suspicious zone and/or executed through the use of a bank account of an operating bank in such a zone;
b.e) Insurance contract terminated at the insurer's initiative during the first three months;
b.f) Operation carried out with the participation of a suspicious financial institute;
b.g) The transaction is carried out in cash.

The founders of insurance organizations and non-state pension schemes are obligated to identify the client (their representative and principal, as well as third person if the transaction is concluded for the benefit of the third person) and to take reasonable measures to verify their identity based on information (documents) obtained from a trustworthy and independent source, when:
a) The amount of transaction exceeds 3,000 GEL (or equivalent in other currency);
b) Doubts arise as to the accuracy or consistency of the client's identification data;
c) The transaction is suspicious.

Concurrently, founders of insurance organizations and non-state pension schemes are obligated to examine whether a client falls within the category of a politically active person and if confirmed, the management must issue a permit to establish business relations with such a person and take reasonable measures to determine the origin of monetary means and property of such a person, and to closely monitor its business relations with such a person.

## Credit unions

Credit unions monitor transactions concluded or executed by a person and/or the unity of transactions concluded or executed for the purpose of fracturing the transaction amount, provided there is at least one of the following circumstances:

The amount of the transaction or unity of transactions exceeds 30,000 GEL (or the equivalent in other currency), both in cases of cash or non-cash payments;
The transaction is suspicious (regardless of the amount).

A credit union is obligated to identify all of its partners and persons interested in establishing business relations (their representative and principal, as well as third person if the transaction is concluded for the benefit of the third person) and to take reasonable measures to verify their identity based on information (documents) obtained from a trustworthy and independent source

when:
a) The  transaction amount exceeds 3,000 GEL (or the equivalent in other currency);
b) The transaction is suspicious pursuant to Article 2(g) of these regulations;
c) Doubts arise as to the accuracy and/or consistency of the partner's identification data.

A credit union is also obligated to examine whether a client or its beneficial owner falls within the category of a politically active person and if confirmed, the management must issue a permit for establishing business relations with them and take reasonable measures to determine the origin of their monetary means and property and to closely monitor its business relations with such a person.

Credit unions must define relevant procedures to establish and verify politically active persons. The unions must seek relevant information from the client, public sources or respective electronic data bases.

*Remarkably, the new requirements imposed on all financial market participants within the two week period from January 18 to 31, 2012, include different individual requirements by the types of activities. However, most of the requirements towards them are common.*

*Most importantly, this concerns the category of politically active persons. All financial institutes are obligated to identify such a person, examine the origin their money and property and constantly monitor these issues (interestingly, the origin of the money has never been an issue of concern for Georgian legislature. In the process of privatization or direct foreign investments, money is often transferred from offshore zones. The state had never been interested in its origin. This contradicted both the legislative framework, which did not impose any restrictions in this regard, as well as the ideological approach, which asserts that "money does not have the origin, color, smell or taste."*

*At the same time, financial institutions are obligated to constantly seek information from clients, existing electronic data bases, and public sources. Such a general and unspecified list of these sources indicates financial institutions are granted a rather wide measure for forming an information profile on clients.*

*For instance, it is still vague whether often unjustified and broadly advertised information on a particular politically active person, or any other client of the bank disseminated in media outlets, can be regarded as a source of information.*

*Information mobilized from such sources can easily distort a client's business history and serve as grounds for refusing to serve the client by a financial institution.*

*Moreover, under the new regulations, it is the financial institutions that define the principles of attributing the transactions of persons in business relations with them to unusual transactions. In this respect, the FMS imposes a rather general framework for them. Accordingly, financial institutions enjoy quite a broad authority in restricting clients and their rights through principles developed at their own discretion.*

## Sanctions

It is noteworthy that the introduction of new regulations was soon followed by new financial sanctions in February 2012.

For instance, commercial banks will be fined 2,000 GEL for failing to adopt rules of internal control (which is one of the requirements of the Procedure for the Receipt, Systematization, Processing, and Transfer to the Financial Monitoring Service of Georgia of Information adopted on 18 January 2012).

In this respect, an amendment was made to the order on the "Approval of Procedure for Determining and Imposing Monetary Fines on Commercial Banks" and the said fine was designated as a new sanction.

This order was put into effect immediately upon its signature. However, a normative act usually enters into effect immediately upon publication. The reason behind the immediate enactment of the order is indicated in the order itself, which states that an immediate enactment of this order is triggered by the need to discharge monitoring functions by the National Bank of Georgia without any obstacles, as stipulated in the legislation of Georgia.

The same circumstances occurred with respect to insurers: pursuant to the amendment made to the order on the "Approval of Procedure for Determining, Imposing and Enforcing Monetary Fines on Insurers," an insurer or its administrator who fails to adopt internal control procedures and rules foreseen under the legislation and/or to observe the said internal control procedures and rules, shall be fined in the amount of 1,500 GEL.

Under the same order, the 500 GEL fine was removed, which used to be imposed on insurers for a failure to submit the changes in information indicated in the registration form to the FMS.

This order of the National Bank was put into effect immediately upon its signature. The need to discharge monitoring functions without any obstacles by the National Bank of Georgia, as stipulated in the legislation of Georgia, was specified as the reason behind an immediate enactment of this order.

**The FMS orders, issued in January 2012, introduced the procedure for the receipt, systematization, processing, and transfer of information for all financial institutions operating on the Georgian financial market (commercial banks, microfinance organizations, securities registrars, money transfer institutions, founders of insurance organizations and non-state pension schemes, accounting and/or auditing institutions, broker companies, currency exchange points, credit unions). These orders have remarkably aggravated the terms of client relations and market operations for each of these institutions.**

**The issue of a "politically active person" or "persons in direct business relations with him/her" is especially emphasized in the new rules regulating the activities of financial institutions. A rather wide range of obligations was established for any institution providing financial services to such a person.**

**Most importantly, all of them are obligated to identify a politically active person or persons in direct business relations with them, examine the origin of their money and property, and constantly monitor these issues.**

**At the same time, financial institutions are obligated to constantly seek information from clients, existing electronic data bases and public sources. Such a general and unspecified list of these sources indicates that the financial institutions are granted a rather wide means to form an information profile on clients.**

**Furthermore, financial institutions define the principles of attributing the transactions of persons in business relations with them as unusual transactions. In this respect, FMS imposes a rather general framework for them. Accordingly, financial institutions enjoy quite a broad authority in restricting clients and their rights through the principles developed at their own discretion.**

**It is also noteworthy that the FMS orders issued in January 2012, which introduced the procedure for the receipt, systematization, processing, and transfer of information for all financial institutions to the Financial Monitoring Service of Georgia, were soon followed by the enactment of sanctioning mechanisms against financial institutions.**

**For instance, concrete fines were introduced for the failure to adopt rules of internal control defined by the new regulations. Respective orders were put into effect immediately upon signature (and not upon publication), triggered by the "need to discharge the monitoring functions without any obstacles by the National Bank of Georgia as stipulated in the legislation of Georgia."**

**According to public data of the first half of 2012, the National Bank has not yet applied sanctions against financial institutions for the breach or undue fulfillment of the procedure for the receipt, systematization, processing, and transfer of information to the Financial Monitoring Service of Georgia.**

**However, both the financial institutions and their clients are currently affected by much stricter regulations, especially regarding the activities of politically active persons and putting new rules of business relations into effect .**

## Amendments to the "Regulations on Non-Cash Payments"

The regulations on non-cash payments were also changed in the first quarter of 2012. An amendment was made to the "Approval of Rules for Non-Cash Payments in Georgia."

Before, physical persons were able to make wire transfers from their own bank accounts on behalf of other physical persons or legal entities. Now, a physical person will be authorized to make wire transfers from his/her bank account on behalf of another physical person only.

In this regard, physical persons will be allowed to make wire transfers from their bank accounts on behalf of any other persons ( physical as well as legal), if the transfer is done for the benefit of

a legal entity of public law and/or the state budget.

Prior to that, a physical person had been authorized to make wire transfers without opening an account on behalf of other persons - both physical and legal. Pursuant to the amendments, physical persons will only be allowed to make wire transfers without opening the account on behalf of the physical persons. Transfers without opening the account by a physical person on behalf of any person will be allowed only if the transfer is done for the benefit of a legal entity of public law and/or the state budget.

This amendment restricts the former rights of a physical person to make wire transfers on behalf of legal entities.

Pursuant to the amendments made to the same regulations, it will be possible to transfer amounts to the state budget from the arrested accounts.

Prior to the amendments, when submitting the document on the seizure of a client's bank account by the duly authorized body to the bank serving the client, all payment collections would be suspended. Seizure of the account would exclude the execution of any active collection of payments.

It is now established when the tax authority seizes an account, it is possible to make transfers from the seized account to the state budget within the limit of amounts free from the seizure and within the limit of seized amounts, in case of a lack of such funds.

In cases when the seizure of the account is done by another authorized body, transfers from this account may be done only within the limit of amounts free from the seizure.

This means that despite the seizure, the state budget will be able to cover the payer's liabilities even from the seized property; a right that other creditors do not enjoy.

**Under the amendments to the "Regulations on Non-Cash Payments," the ability of physical persons to make wire transfers from their bank accounts on behalf of another legal entity was restricted. Currently, they are authorized to make wire transfers from their bank accounts only on behalf of other physical persons. Accordingly, the previous norm (it was allowed to make transfers on behalf of both physical and legal persons) has been apparently restricted.**

**The old norm remains in force only if the transfer is made for the benefit of a legal entity of public law or the state budget.**

**Pursuant to the amendments made to the same regulations, it will be possible to make transfers to the state budget from the arrested accounts as well. Notwithstanding the arrest, the state budget will be able to cover the payer's liabilities even from the arrested property; a right that other creditors will not enjoy.**

## Amendment to the Law on the Activities of Commercial Banks

Under the amendments made to this Law, also in the first quarter of 2012, the National Bank is authorized to determine through a normative act the additional criteria of compatibility of the owner of the commercial bank's significant share and of the administrator.

The Law was not familiar with a similar reservation before. Standard criteria were defined years ago and had been essentially unhindered.

The need to impose additional criteria was not justified. Although as of today, the National Bank has not yet used this leverage, the existing amendment enables it to interfere more in the formation or modification of both ownership and administrative structures of individual financial institutions.

Meanwhile, the absence of criteria as to when the National Bank is able to use this leverage grants it boundless authority in relations with a bank's shareholders and administrators.

**According to data of the first half of 2012, the National Bank has not yet used its lawful right to determine with a normative act the additional criteria of compatibility of the owner of the commercial bank's significant share and of the administrator.**

**However, the Central Bank of the country currently possesses one extra leverage that can be enforced against any commercial bank without any detailed justification.**

## Amendment to the Law on the National Bank

Parliament has eased the professional qualification requirements in respect to the members of the Board of the National Bank.

In the previous text of the Law on the National Bank, members of the Board of the National Bank had to be "Georgian or foreign citizens distinguished by honesty and professionalism specifically in the fields of economics and/or finances."

Under the new initiative, two members of the Board need not be professionals in the fields of economics and/or finances.

Shortly after this amendment was ratified, two candidates were nominated to the Board of the National Bank who were not qualified in economics and/or finances, and had worked within the system of the Chief Prosecutor's Office of Georgia.

**This amendment to the Law is clearly a regressive step in terms of the formation of the Board of the National Bank as a body built on professional qualifications.**

**Furthermore, integrating new members of the Board of the National Bank from the prosecutorial system is hardly consistent with the traditions and logic of forming a personal**

**staff of the supreme body of central banks.**

Under another amendment of the Law on the National Bank, the Central Bank was granted the right to exercise control over all institutes issuing the loans.

The law has introduced a new type of a financial sector representative - a qualified credit institute, which will be controlled by the National Bank.

The qualified credit institute will be a legal entity that will attract funds from over 400 physical persons or one that has attracted over 5 million GEL in funds from physical persons. If requested by the National Bank, such a person will be obligated to register and meet the requirements established by the National Bank.

However, the law also stipulates that legal entities who have attracted less than 5 million GEL or attracted the funds from less than 400 physical persons will, under certain circumstances, be still obligated to register with the National Bank.

They will have such an obligation if the National Bank considers their activities, amount of attracted funds, and region or segment of activities significant for the financial sector, or if the activities of a legal entity and the methods of client attraction meet the plans to considerably expand the circle, from which the funds are being attracted.

Under the new amendments, the National Bank will be authorized to register and de-register qualified credit institutions, establish and check their compatibility criteria and risk exposure, minimum capital, liquidity and additional requirements, and to introduce limitations and sanctions.

If the funds generated by a qualified credit institution exceed the limit set by the National Bank, the National Bank will be authorized to demand the banking license from the institution.

The law also stipulates that if the National Bank finds that the activities of a qualified credit institution or the funds generated from the physical persons undermines the stability of the financial sector, the National Bank will be authorized to demand the termination of activities related to the attraction of funds and issuing of loans from a qualified credit institution. Otherwise, the financial institution will be held liable.

A normative act of the National Bank shall define the terms of registration of a qualified credit institution with the National Bank, the minimum capital, liquidity and additional requirements towards a qualified credit institution, compatibility criteria, and the number and procedure for imposing a monetary fine. Monetary fines will be paid to the state budget of Georgia.

To carry out the monitoring functions, the National Bank will be authorized to demand and receive from the qualified credit institutions any information (including the confidential one) within the scope of its competence. Should such an entity not meet the requirements of the National Bank, it shall be fined with liquidation and a fine of 150,000 GEL.

**The chief objective of this amendment to the Law on the National Bank is to make the control over the financial sector stricter. This is a part of a policy pursued by the National**

**Bank in recent years.**

**Introducing the obligation to register any legal entity engaged in the attraction of funds with the National Bank implies active or passive control of the National Bank over all (despite the size) institutions undertaking this activity.**

**On one hand, this novelty has to be welcomed as it will help expel untrustworthy and financially unreliable institutions from the financial market, eliminating the creation of financial pyramids and new unfulfilled liabilities towards the population.**

**Meanwhile, it is obvious that the National Bank will additionally control those institutions that provide financial services, which until recently had not been subject to the control from the National Bank. This clearly speaks of harsher legislation.**

## Memorandum of Mutual Cooperation between the Chamber of Control of Georgia and the National Bank

The Memorandum of Mutual Cooperation between the Chamber of Control of Georgia and the National Bank, executed in January 2012, is one of the most significant documents of those legislative amendments made since the end of 2011.
The agencies executed the memorandum pursuant to the Law on the Political Unions of Citizens. It ensures the provision of information on the financial operations of parties and politically active persons to the Chamber of Control.
"The Memorandum ensures that the information on the financial transactions related to political parties, politically active persons and organizations is provided to the Chamber of Control. Pursuant to the new law, the Chamber of Control secures the financial transparency of a political process, carries out monitoring to this end, and the information the National Bank provides will be important for us in achieving the monitoring aims," the official statement states.
According to the Memorandum, information on all financial transactions initiated since 1 November 2011, which is at the disposal of the National Bank, shall be transferred to the Chamber of Control.

In fact, this Memorandum fully ignores the notion of the banking secret, which is described in detail in the Law on the Activities of Commercial Banks, pursuant to Article 17:

Article 17. Banking Secret

1. No one shall be permitted to disclose confidential information to anyone, and to reveal and disseminate or use such information for personal gain. Such information may be disclosed to the National Bank only, within the scope of its competence.

2. Information on any transaction (including in case of attempt to conclude a transaction), accounts, operations done from these accounts and the balance on the accounts may be disclosed

to the parties of the respective transaction, owners of the respective accounts and their representatives, as well as in cases stipulated by the legislation of Georgia - to the Financial Monitoring Service of Georgia and the persons who are authorized to enforce the acts subject to execution under the Law of Georgia on Enforcement Proceedings, during the process of their enforcement.

3. Judicial and investigative bodies, as well as tax authorities shall be prohibited from disclosing the information to other agencies including the mass media outlets and using this information in public speeches prior to rendering of a court decision."

Remarkably, the Chamber of Control does not belong to any of the listed categories. Hence, it does not have the right to directly request and receive the information from banking institutions; in view of Paragraph 3 of the cited article, the Chamber of Control cannot receive banking information from judicial, investigative and tax authorities. Pursuant to the Criminal Procedure Code and the Law on Operative-Investigative Activities, the Chamber of Control does not enjoy the right to either conduct investigative and operative measures or receive the operative data independently and directly. The only solution left is for the Chamber of Control to receive this information from the National Bank of Georgia, which was stipulated and implemented through the respective Memorandum. Consequently, publicizing information on the transactions of individual persons has blatantly violated their banking secrets.

**The Memorandum of Mutual Cooperation executed between the Chamber of Control of Georgia and the National Bank in January 2012, significantly amends and reduces previously available guarantees of access to a client's banking information, its exchange and confidentiality.**
**This circumstance is a key challenge for the banking sector, as the firm assurance of a banking secret is one of the main factors triggering irrevocable development of the country's banking system and the trust therein.**