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# Expansion of Georgian Financial Sector from Perspective of Association Agreement between EU and Georgia

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**Abstract:** *In the modern world, financial institutions, which can be combined under the concept of "financial sector", are very different entities. These differences are expressed both in different regimes of state regulation and in financial capabilities, types of activities, size (volume) and many other parameters. Until recently, the financial sector of Georgia included: commercial banks, non-bank depository institutions – credit unions, brokerage companies, independent securities registrars, central depository, specialized depository, stock exchange, investment fund, asset management company, microfinance organizations, non-state pension scheme founders, payment system operators, payment service providers, accountable enterprises and currency exchange offices.<sup>2</sup> From February 2023, a completely new category of a microbank has been added to this extensive list of financial sector entities. The purpose of this article is acquaintance with the new structure of Georgian financial sector from a legal point of view, above all, from perspective of Association Agreement between the European Union and Georgia. This implied the preparation of one of the first (if not the first) legal scientific papers related to this topic. It is worth noting and underlining the fact that due to the novelty of the topic, we are largely detached from the relevant local judicial practice or the precedents of the interpretation of current norms by the regulator. Thus, it can be said that the full-scale legal framework for the regulation of Georgia's expanded financial sector, which naturally involves the implementation of a number of subordinate normative acts by the National Bank of Georgia, is still in the process of formation.*

**Keywords:** *Commercial Banks; EU-Georgia Association Agreement; Financial Sector; Microbank; Microfinance Organization.*

## 1. INTRODUCTION

As of today, the legal framework regulating the financial sector of Georgia is in the process of expansion. Among others, this is evidenced by the fact that the regulatory body, in particular, the National Bank of Georgia, has recently issued a number of orders, above all, regarding the activities of microbanks.<sup>3</sup>

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<sup>2</sup> Paragraph "a" of Article 2 of the Organic Law of Georgia "On the National Bank of Georgia", 24/09/2009, (edition valid until February 23, 2023).

<sup>3</sup> No. 113/04 "On Approval of the Rules for Mandatory Audit of Consolidated Financial Statements of Microbanks and Disclosure of Information in Explanatory Notes", 22/06/2023; No. 108/04 "On Approving the Rule of Operation of the Common Program of Risk Assessment of Microbanks", 22/06/2023; No. 118/04 "On Approval of Real Estate Valuation Instructions for Microbanks", 22/06/2023; No. 110/04 "On Approval of the Rule of Disclosure of Information by Microbanks within the Framework of Pillar 3", 22/06/2023; No. 121/04 "On Approval of the Rule on Liquidation, Insolvency and Bankruptcy of a Microbank", 22/06/2023; No. 119/04 "On Approval of the Regulation on Suitability Criteria of Microbank Administrators", 22/06/2023; No. 106/04 "On Approval of the Regulation on Acquisition of a Significant Share of a Microbank", 22/06/2023; No. 116/04 "On Establishment of Countercyclical Buffer Rate for Microbanks", 22/06/2023; No. 114/04 "On Determining the Minimum Amount of Supervisory Capital for Microbanks", 22/06/2023; No. 115/04 "On Approval of the Procedure for Creation of Branches, Representative Offices and Other Similar Subdivisions by Microbanks", 22/06/2023; No. 109/04 "On Approval of the Regulation on Leverage Ratio Requirements for Microbanks", 22/06/2023; No. 105/04 "On Approval of Microbank Licensing Rules", 22/06/2023; No. 117/04 "On Approval of the Regulation on Concentration of Risk Positions and Large Risks in Microbanks", 22/06/2023; No. 122/04 "On Introduction of the Temporary Administration Regime in Microbank and Approval of its Operating Procedure", 22/06/2023; No. 120/04 "On Approval of the Rules for Determining Risk Categories of Financial Instruments and Expected Credit Losses for Microbanks", 22/06/2023; No. 107/04 "On Approval of the Conflict of Interest Management Regulation

Due to the fact that since June 2014 European Union and Georgia are the parties to an association agreement, it seems expedient to examine whether the growth of regulatory field of local regulator, the National Bank of Georgia is in line with the spirit and provisions of such international treaty. Currently, the mentioned expansion of financial sector occurs due to establishment of a new entity – a microbank. Nevertheless, this is not the only entity which has been established since execution of EU-Georgia Association Agreement - in 2020, the Parliament of Georgia adopted a new comprehensive law on “Investment Funds”, factually creating yet another type of a juridical person regulated by the National Bank of Georgia.<sup>4</sup> In this paper, we will refer to these two new types of entities multiple times, however, in light of novelty of its regulation, we will be especially focused on microbanks.

It will probably not be a surprise that the new law of Georgia "On Activities of Microbanks" is essentially based on the law of Georgia "On Activities of Commercial Banks". There are many similarities between probably the most important entity of the financial sector of Georgia and a microbank. Accordingly, among other topics covered in this paper, we will also try to demonstrate the differences between commercial banks, microbanks as well as other players of local financial sector.

First of all, a couple of words about the essence and legal definition of a microbank itself. Unlike commercial banks, whose status has been defined in most countries of the world for a long time and, in principle, can be brought under a single universal concept,<sup>5</sup> the category of microbanks is not harmonized at the international level and in the states whose legislation recognizes this type of financial institutions, there are mixed views about their purpose and the scope of activities. In many cases, a microbank is identified with an institution which provides small volume loans<sup>6</sup> or with a microfinance organization, i.e. with an entity that offers financial services to the low-income population,<sup>7</sup> often gives loans only to its own members and additionally trades various insurance, deposit and other products. An interesting precedent was created by the Spanish Banco Social La

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for Microbanks", 22/06/2023; No. 123/04 "On Approval of the Rules for Determining and Imposing Monetary Fines against Microbanks and its Administrators", 22/06/2023; No. 112/04 "On Approval of the Corporate Management Code of Microbanks", 22/06/2023; No. 132/04 "On Approval of the Instruction on the Requirements of the Pricing Models of Microbanks", 27/06/2023; No. 138/04 "On Approval of the Regulation of Microbank's Liquidity Coverage Ratio", 27/06/2023; No. 140/04 "On Approval of the Regulation on Operational Risk Management by Microbanks", 27/06/2023; No. 136/04 "On Approval of the Regulation on Interest Risk Management of the Banking Book of Microbanks", 27/06/2023; No. 134/04 "On Approval of the Regulation on Net Stable Funding Ratio for Microbanks", 27/06/2023; No. 137/04 "On Approval of the Regulation on Management of Dealing Operations for Microbanks", 27/06/2023; No. 133/04 "On Establishing, Calculating and Protecting the Limit of the Common Open Currency Position of Microbanks", 27/06/2023; No. 159/04 "On Approval of the Procedure for Issuing and Revoking Consent for the Brokerage Company to Carry out Activities Permitted by the National Bank of Georgia for a Microbank", 28/06/2023; No. 165/04 "On Approval of the Cyber Security Management Framework of Microbanks", 01/07/2023; No. 169/04 "On Establishment of Additional Requirements for Microbanks Based on the Law of Georgia "On the Activities of Microbanks"", 06/07/2023; No. 192/04 "On Approval of the Rules for Classifying and Reporting Loans According to the Taxonomy of Sustainable Financing for Microbanks", 02/07/2023; No. 312/04 "On Approving the Procedure for Completion and Submitting of the Microbank Money Laundering and Terrorism Financing Risk Supervision Report", 11/11/2023.

<sup>4</sup> Although the category of an “investment fund” has been introduced in Georgia back in 2013, applicable statutory regulation of this entities was somewhat superficial and inefficient what allows us to state that a comprehensive legal framework for investment funds and factual development of such institutions started only after adoption of the referred piece of legislation (*author's note*).

<sup>5</sup> A legal entity licensed by the country's central bank, which is authorized to attract deposits and use them to issue credits or to carry out other banking activities permitted by law (*author's note*).

<sup>6</sup> Compare: Danz Coleen., Students Give Small Loans to Make a Difference, *Insights on Law and Society*, Vol. 10, Issue 1 (Fall 2009), pp. 18-29.

<sup>7</sup> Compare: Chowdhury Anis, Microfinance as a Poverty Reduction Tool— A Critical Assessment, *DESA Working Paper No. 89, United Nations, Department of Economics and Social Affairs, ST/ESA/2009/DWP/89, December 2009, p. 2.*

Caixa which in 2007-2012 granted microcredits of more than one billion Euros for entrepreneurial and social projects.<sup>8</sup> If initially the purpose of microfinance organizations was more focused not on making a profit, but on creating sources of financing for specific low-income segments of the population (for example, for the population living in rural areas, for micro-entrepreneurs, families living below the poverty line, in some cases women, etc.), today the world tendency towards profit-focused microfinance, so called for-profit Micro Finance Institutions, is evident.<sup>9</sup> In this regard, the perception of microbanks essentially goes beyond the approach established by Georgian legislation, which we will discuss in the subsequent parts of the paper. Therefore, it would not be an exaggeration to say that Georgian law establishes a new concept of microbanks, the effectiveness of which has yet to pass the test of time.

As for the investment funds, such entities based in Georgia are divided into two categories:

- Authorized Investment Fund - an investment fund authorized by the National Bank (Undertakings for the Collective Investment in Transferable Securities (UCITS) or Retail Investment Fund), which has the right to make a public offering and to have more than 20 retail investors;
- Registered Investment Fund - An investment fund registered by the National Bank that has the right to make only a private offering and to have no more than 20 retail investors.<sup>10</sup>

Similar to microbanks, a unified cross-border concept for these entities seems to be absent. The scholars refer to investment funds established by the insurance companies, banking institutions, sovereign investment funds operated by states, cross-border investment funds, many of which are incorporated in the offshore zones etc.<sup>11</sup> Thus, we may say that Georgian approach to the investment funds is also to some extent peculiar and unique.

## 2. MAIN ACTIVITIES OF NEW ENTITIES IN FINANCIAL SECTOR AND THEIR COMPLIANCE WITH EU-GEORGIA ASSOCIATION AGREEMENT

It must be emphasized that Georgian legislation considers microbanks as entities whose main purpose is lending to entrepreneurial entities.<sup>12</sup> It is significant that entrepreneurial activity is understood in a broad context and includes agricultural activity as well. In my opinion, it is clear that by establishing microbanks on the financial market, the state is trying to mobilize additional financial resources, primarily for small and medium-sized enterprises i.e. SME Sector, which, in many cases, has difficulty accessing the necessary financial resources for its activities.<sup>13</sup>

The focus of microbanks on lending to entrepreneurial activities is not only a declaratory provision, but also contains a specific legislative reservation - at least 70 percent of microbank's credit portfolio shall consist of loans granted for entrepreneurial purposes and/or those loans, the source of payment of which is the income received from entrepreneurial activity.<sup>14</sup> In this regard, it is significant that in recent years the regulations of the National Bank of Georgia precisely define the types of bank credits/loans what establishes more legal clarity and significantly reduces the

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<sup>8</sup> Compare: Pellegrini Federico., Economic and Social Development, *International Scientific Conference on Economic and Social Development*, Vol. 9, 2015, p. 329.

<sup>9</sup> Compare: Downey Kenneth., Conroy Steven J., Microfinance: The Impact of Nonprofit and For-Profit Status on Financial Performance and Outreach, See: <https://www.econ-jobs.com/research/35795-Microfinance--The-Impact-of-Nonprofit-and-For-Profit-Status-on-Financial-Performance-and-Outreach.pdf>, 2010, 1, Accessed 30.10.2024.

<sup>10</sup> <https://nbg.gov.ge/en/page/investment-funds>, Accessed 30.10.2024.

<sup>11</sup> Compare: Fridman, Anton I, *Concepts of Investment Fund and Investment Legal Entity*, *Law: Journal of the Higher School of Economics*, Vol. 2017, Issue 2 (2017), pp. 68-79.

<sup>12</sup> Paragraph 1 of Article 3 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

<sup>13</sup> Compare: Gotua Levan., Some Legal Aspects of Factoring Regulation in Georgia, *Journal of Law*, TSU, Faculty of Law, 2/2018, p. 20.

<sup>14</sup> Paragraph 1 of Article 3 of the Law of Georgia "On the Activities of Microbanks", 23/02/2023.

possibility of confusing different types of this banking product and consequential disputes. In particular, according to the order of the President of the National Bank of Georgia dated 24 December 2018, No. 281/04 "On Approval of Regulations Regarding Lending to Individuals", credit granted for business purposes is defined as: "a loan the purpose of which is business activity, including trade financing, startup, agriculture and covering of current business expenses. In order for a loan to be classified as a business loan, it is necessary for the lending organization to conduct an appropriate financial analysis in accordance with internal policies/procedures."<sup>15</sup>

I also consider it a noteworthy circumstance that according to the imperative provision of the Law "On Activities of Microbanks", financial organizations of this type have the right to issue loans only in the national currency.<sup>16</sup> It is probable that in this way the state is trying to make microbanks an important tool of so-called "de-dollarization" policy which started back in 2017.<sup>17</sup>

The mentioned prohibition is even more striking in light of the currency restrictions introduced in the same period to commercial banks in respect of lending to consumers: "Unless otherwise established by the legislation of Georgia, bank credit of up to GEL 200,000 (two hundred thousand) must be granted only in GEL, except for the case when the total liabilities of the borrower to the issuer of the same bank credit, as a result of issuing the bank credit, exceed GEL 200,000 (two hundred thousand) GEL. For the purposes of this section, a bank credit issued in GEL is not considered to be linked or indexed<sup>18</sup> to a foreign currency in any way."<sup>19</sup> Therefore, the microbanks should be considered as one of the main instruments of so-called "larization" policy. This means that in respect of issuing credits in foreign currency, the priority will be given to a special norm on the ban on granting loans in foreign currency established by the law "On Activities of Microbanks" and the above quoted more general provisions of the Civil Code cannot be applied. Just like a "microfinance organization", the term "microbank" in its very name implies a kind of financial threshold, monetary upper limit, which the relevant entity has no right to exceed. The concept of a "microcredit" applies to microfinance organizations, by virtue of which "microcredit is a monetary amount provided by a microfinance organization through a credit agreement to a borrower or a group of borrowers in accordance with the conditions of maturity, repayment, cost and purpose. The maximum total amount of a microcredit issued by a microfinance organization to one borrower should not exceed GEL 100,000 (one hundred thousand).<sup>20</sup> As soon as one familiarizes itself with the law "On Activities of Microbanks", it becomes clear that the mentioned definition of "microcredit" does not apply to microbanks. The law establishes for them a much higher monetary upper limit: "...the maximum total amount of credits and other obligations issued to one borrower or a group of interconnected borrowers. It should not exceed GEL 1,000,000 (one million)."<sup>21</sup>

When covering the field of activity of microbanks, it is worth noting the fact that these types of financial institutions have the right to open<sup>22</sup> correspondent bank accounts.<sup>23</sup> Until now, only

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<sup>15</sup> Order No. 281/04 of the President of the National Bank of Georgia dated December 24, 2018 "On Approval of Regulations regarding Lending to Individuals", Article 2.

<sup>16</sup> Paragraph 4 of Article 3 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

<sup>17</sup> Compare: Gotua Levan., Commentary on Article 868 of the Civil Code of Georgia, 2020, p. 9, <http://gcc.tsu.ge>, Accessed: 30.10.2024.

<sup>18</sup> "Indexed interest rate is an interest rate that is related to a public index in a certain manner and whose change is caused by the change of the said index." - Civil Code of Georgia, Article 868, Part 3, 06/27/1997.

<sup>19</sup> Ibid., Section 8 of Article 868.

<sup>20</sup> Paragraph 2 of Article 5 of the Law of Georgia "On Microfinance Organizations", 18/07/2006.

<sup>21</sup> Article 26 of the Law of Georgia "On Activities of Microbanks", Clause "C", 23/02/2023.

<sup>22</sup> Ibid., Article 3, Clause "C".

<sup>23</sup> "Correspondent account - an account which one bank or a person authorized to open a correspondent account opens in another and which is used for settlements between the bank that opened the account and the account holder" - Order No. 24/04 of the President of the National Bank of Georgia dated April 7, 2011 "On Approval of Instructions on Opening Accounts in Banking Institutions", Article 2, subparagraph "p".

commercial banks used this kind of accounts locally while other entities issuing monetary funds in the form of a bank credit, i.e. microfinance organizations and non-bank depository institutions - credit unions, are not entitled to open correspondent bank accounts. Moreover, before the adoption of the Law of Georgia "On Activities of Microbanks", correspondent bank accounts were opened only by the head offices of commercial banks in the head offices of other commercial banks or with the National Bank of Georgia.<sup>24</sup> Correspondent bank account is one of the main tools of interbank settlement, which allows clients of different banks to quickly and efficiently transfer money to each other, which mainly moves through this type of account.<sup>25</sup> Granting the right to open correspondent accounts brings microbanks significantly closer to commercial banks and separates them from microfinance organizations and non-bank depository institutions - credit unions who do not have the right to maintain not only a correspondent but also any other type of bank account.

The similarity of the activities of commercial banks with the activities allowed for microbanks is even more striking if we consider that this new entity of the Georgian financial sector has full rights to attract deposits, that is, to open deposit-type accounts, both term and demand.<sup>26</sup> This circumstance is further noteworthy due to the fact that Georgian legislation directly prohibits microfinance organizations from attracting both deposits and other returnable funds.<sup>27</sup> So by what criteria does the microbank have such right when a microfinance organization is restricted to attract deposits by an imperative rule? The answer to this question, among others, should be sought in the differences of supervision regime by the National Bank of Georgia - unlike microbanks, microfinance organizations are not subject to licensing and the regulator only registers them.<sup>28</sup> To make it more understandable for the reader, we would to explain that today the National Bank of Georgia successfully uses both of these forms of activity authorization, although licensing is a more complex and long-term form of supervision<sup>29</sup> than registration. In compare to the latter, licensing involves a more thorough control and monitoring of responsibilities, document turnover, financial indicators and other essential parameters of a financial organization by the regulatory body.<sup>30</sup> Therefore, we should not be surprised that, compared to microbanks, the list of types of activities permitted for microfinance organizations is limited by the restriction to provide one of the most important financial services, the placement of deposits.

Unlike microfinance organizations, there are quite strict regulatory requirements towards microbanks - for example, for the purposes of their supervisory capital<sup>31</sup> the applicable legislation obliges them to allocate at least GEL 10,000,000.<sup>32</sup> In addition, the legislator is likely to be careful with the issue of attracting deposits by microbanks and seems to be trying not to make the clientele of depositors particularly broad. This is primarily expressed in the fact that although a microbank may receive deposits from individuals, this seems to be limited by a large clientele: "in case of raising returnable funds by the microbank from individuals (including individual entrepreneurs), the amount

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<sup>24</sup> Compare: Order No. 24/04 of the President of the National Bank of Georgia dated April 7, 2011 "On Approval of Instructions on Opening Accounts in Banking Institutions", Article 3, paragraph 7.

<sup>25</sup> Compare: Gabisonia Zviad, *Banking Law, 2nd revised and expanded edition*, Tbilisi, 2017, "World of Lawyers" publishing house, p. 173.

<sup>26</sup> Article 3 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

<sup>27</sup> Paragraph 3 of Article 4 of the Law of Georgia "On Microfinance Organizations", 18/07/2006.

<sup>28</sup> Ibid., paragraph 2 of Article 4.

<sup>29</sup> Compare: Gotua Levan, *Legal problems of financial leasing development in Georgia*, Georgian-German Journal of Comparative Law, 3/2021, 85.

<sup>30</sup> Ibid.

<sup>31</sup> "Supervisory capital - a type of capital that is created to carry out microbanks' activities, to neutralize expected or unexpected financial losses/damages and to protect against various types of risks"- Article 2 of the Law of Georgia "On Activities of Microbanks", Clause "q", 23/02/2023.

<sup>32</sup> Order of the President of the National Bank of Georgia N 111/04 "On Determination of the Minimum Amount of Supervisory Capital for Microbanks", Article 1, 21/6/2023.

raised from each individual (including individual entrepreneurs) should not be less than GEL 100,000 (one hundred thousand) or its equivalent in foreign currency.”<sup>33</sup> In addition, according to the same norm, it is established that "returnable funds in the amount of more than GEL 100,000 (one hundred thousand) can be raised only in relation to the supervisory capital, within the relevant limit which is determined by the normative act of the National Bank of Georgia."

Among the types of activities allowed for microbanks, we may emphasize the right of: "issuing loans, guarantees, letters of credit and leasing, implementation of factoring operations within the limits established by this law",<sup>34</sup> what allows a microbank, similar to a commercial bank, to fully use such financial instruments. According to the law "On Activities of Microbanks",<sup>35</sup> these entities have the right to open the most common form of a bank account, a current bank account,<sup>36</sup> which is very important for the purposes of attracting clients. Like commercial banks, microbanks can also carry out cash and non-cash settlement operations and provide cash-collection services; issue payment cards and organize their circulation; provide payment services, operate the payment system, perform the functions of a settlement agent, etc.<sup>37</sup>

As a general summary in respect of forms of activities allowed for microbanks, I would like to add that the relevant list is clearly based on Article 20 of the Law of Georgia "On Activities of Commercial Banks", with the difference, that commercial banks, can additionally carry out trust (trust) operations at the request of clients, raise and place funds, provide credit reference services, both store and account securities, as well as perform the function of a specialized depository in relation to such securities.

Investment funds that have the right to make a public offering in Georgia are divided into two categories: an Authorized Investment Fund and a foreign investment fund that is recognized by the National Bank of Georgia.<sup>38</sup>

Pursuant to Article 116 of EU-Georgia Association Agreement, the parties thereto "shall make available to interested persons its requirements for completing applications relating to the supply of financial services..." and "shall make its best endeavours to ensure that internationally agreed standards for regulation and supervision in the financial services sector and for the fight against tax evasion and avoidance are implemented and applied in its territory."<sup>39</sup> At the same time, "each Party shall permit a financial service supplier of the other Party to provide any new financial service of a type similar to those services that the Party would permit its own financial service suppliers to provide under its domestic law in like circumstances."<sup>40</sup>

As we were able to identify from the above, the international treaty in question does not go into details in respect of the scope of Georgia's financial sector. Having examined the relevant provisions of EU-Georgia Association Agreement, we may further state that the establishment of new entities which did not exist at the moment of signing of this document, such as microbanks and investment funds, fully complies with this international treaty. Moreover, respective norms of local

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<sup>33</sup> Ibid., paragraph 6 of Article 3.

<sup>34</sup> Ibid., Article 3, Clause 3, Sub-Clause "a".

<sup>35</sup> Ibid., Article 3, Clause 3, Sub-Clause "b".

<sup>36</sup> "Current account - a bank account on which a person's funds are recorded and which the client disposes for making payments or for other purposes. This type of account includes card accounts and reporting accounts opened by apartment owners"- Order No. 24/04 of the President of the National Bank of Georgia dated April 7, 2011 "On Approval of Instructions on Opening Accounts in Banking Institutions", paragraph "o" of Article 3.

<sup>37</sup> Paragraph 3 of Article 3 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

<sup>38</sup> <https://nbg.gov.ge/en/page/investment-funds>, Accessed 30.10.2024.

<sup>39</sup> Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part, Article 116, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A22014A0830%2802%29>, Accessed 30.10.2024.

<sup>40</sup> Ibid., Article 117.

legislation seem to duly govern the availability of requirements for completing applications relating to the supply of financial services, implementation of internationally agreed standards for regulation and supervision in the financial services sector and for the fight against tax evasion. The topic related to provision of new services by the financial institutions from EU countries is more complex, nevertheless, to the best of my knowledge the reciprocal approach of EU-Georgia Association Agreement applies without widely known complications or barriers.

### 3. LICENSING REQUIREMENTS FOR NEW ENTITIES OF FINANCIAL SECTOR AND THEIR INTERACTION WITH EU-GEORGIA ASSOCIATION AGREEMENT

A microbank carries out its activities only on the basis of relevant authorization from the state, in particular, the license. The central act of Georgian legislation in this field is the law "On Licenses and Permits" which establishes an exhaustive directory of all licenses and permits applied in the country and from 2023 such list naturally also contains the microbank activity license.<sup>41</sup> Like the banking activity license, the microbank activity license is issued for an indefinite period and its transfer to others is prohibited. This feature, i.e. the limitation of the civil turnover capacity of the license, applies not only to the mentioned license but is universal with respect to all state authorisations to the right to activity. This restriction of "activity licences" essentially distinguishes them from the so-called "usage" licenses, most of which are fixed-term and transferable.

As we mentioned above, microfinance organizations do not require licensing and operate only on the basis of registration with the National Bank of Georgia. Therefore, in this respect, microbanks have much more in common with commercial banks than with any other type of financial institutions. Along with the identity of the general license requirements, there are not many differences in the procedures for processing the license application by the regulator. It is interesting that licensing of a subsidiary of a foreign bank, which, by virtue of Article 8 of the Law "On the Activities of Microbanks", can be implemented in a simplified manner. The prerequisite for this is that the applicant for a microbank activity license must be a subsidiary of an exceptionally reliable bank as provided by the Law of Georgia "On Activities of Commercial Banks",<sup>42</sup> which has a high level of recognition, a good reputation, a high credit rating, many years of experience in the financial sector, sustainable financial indicators and a high level of transparency.

In this regard, the category of a "particularly reliable bank" can be the basis for a little ambiguity, which is not defined by the Law "On Activities of Commercial Banks", nor does any normative act regulating microbanks specify the difference between a "foreign reliable bank" and an "especially reliable bank". I deem, in order to avoid potential misunderstandings, such concepts require special precision and unambiguity. According to the current record, theoretically, only the National Bank of Georgia can additionally consider a foreign bank already recognized as reliable, as "especially reliable", whereby the criteria for being "especially reliable" are not defined separately. The competence of the regulator in relation to this type of entities is particularly wide: "The National Bank of Georgia, in order to facilitate the entry of a reliable foreign bank into the Georgian market... shall individually determine the list of information/documentation to be submitted by a subsidiary company of a foreign bank for obtaining a microbank activity license."<sup>43</sup>

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<sup>41</sup> Clause 34<sup>1</sup> of Article 6 of the Law of Georgia "On Licenses and Permits", 25/06/2005.

<sup>42</sup> "Foreign reliable bank - a bank from a developed country that has a rating of a certain level or higher, given by a competent international rating organization. The National Bank establishes a competent international rating according to the list of organizations and each competent international rating organization determines the level of rating" – paragraph "o" of the first article of the Law of Georgia "On Activities of Commercial Banks", 23/02/1996.

<sup>43</sup> Paragraph 2 of Article 8 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

In this context, it should be also noted that none of the laws on the activities of banks or microbanks and, considering the available information, neither the byelaws of the National Bank of Georgia, define the exact procedures, deadlines and list of documents to be submitted for the simplified licensing process. Thus, in this direction, the National Bank of Georgia has a particularly high degree of general discretion and interpretation of relevant legal norms.

According to article 5 of the Law of Georgia “on Investment Funds”, such entity may be established in Georgia in the form of an investment company or a common fund whereby an investment company may exist in the form of a joint stock company and a closed-end registered investment company may be established as a limited liability company or a limited partnership. Due to a broader definition of the types of entities permitted to operate in capacity of investment funds and the scope of their activities, the detailed review of peculiarities of authorisation, licensing and registration (all forms of such state approvals are envisaged in the referred piece of legislation) of each of applicable forms of investment funds would be beyond the scope of this paper. Hence, let us limit ourselves with a statement that, in general, the activities of investment funds are subject to regulation from the side of the National Bank of Georgia.

Now let us evaluate the above licensing standards from perspective of EU-Georgia Association Agreement. As determined through article 117 of such international treaty, “a Party may determine the juridical form through which the service may be provided and may require authorisation for the provision of the service.” Hence, this primary legal act governing the relations between the European Union and Georgia provides for a rather unrestricted approach in respect of type of enterprise authorised to deliver the new financial services. For the purposes of this paper the above should mean that the National Bank of Georgia, if duly entitled by means of respective legislation, may freely establish additional licensing requirements.

The last sentence of article 117 of EU-Georgia Association Agreement, in my opinion, contains a more restrictive wording: “where such authorisation is required, a decision shall be made within a reasonable time and the authorisation may only be refused for prudential reasons.” Hence, Georgia, being free to establish additional licensing requirements, shall, nevertheless, issue an applicable license within specific timeframes, obviously, to be envisaged under local statutory regulations. Another topic for consideration is a rather broad essence of “prudential reasons.” This is especially noteworthy from perspective of Georgian version of this international treaty where the terms “reasonable” and “prudential” do not vary and factually the word “reasonable” is used in respect of both timing and refusal. I believe this can be regarded as a certain flaw of Georgian translation since, the term “prudential” seems to have a more specific meaning in the field of finance and especially from perspective of EU law. Such supranational organisation defines the aim of “prudential requirements”: “to make the financial sector more stable, while ensuring that it is able to support households, firms, and other end-users of financial services.”<sup>44</sup> Accordingly, due to the fact that both Georgian and English versions are considered authentic<sup>45</sup> and obviously have the same legal power, there is a certain risk of different interpretation of the term “prudential” by the local and EU parties what clearly should not be a desirable outcome.

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<sup>44</sup> An official website of the European Union, [https://finance.ec.europa.eu/banking/banking-regulation/prudential-requirements\\_en](https://finance.ec.europa.eu/banking/banking-regulation/prudential-requirements_en), Accessed 30.10.2024.

<sup>45</sup> Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part, Article 432, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A22014A0830%2802%29>, Accessed 30.10.2024.



#### 4. IMPLEMENTATION OF NON-BANKING AND RESTRICTED ACTIVITIES

Among the issues surrounding the competence of commercial banks, the implementation of non-banking activities by these entities has always been particularly relevant. More precisely, this relates to the normative provisions established in Georgia based on international practice which impose significant restrictions on ownership of banks' shares and shares in other legal entities. Although the format of the present work does not allow us to talk about this topic in detail, for the general information of the reader, I would like to add that commercial banks are subject to the limits of their equity participation in other companies, which is why these entities must always maintain specific ratios between their own share capital<sup>46</sup> and the values of share in a respective legal entity.<sup>47</sup> It is logical that the purpose of such restrictions is to prevent commercial banks from using their own, rather large financial resources to establish financial control over other sectors of the economy, which will naturally harm entrepreneurs (especially small and medium-sized businesses) and will not promote healthy and honest competition in this or that market. To some extent, the legislator extended the restriction to non-banking activities to microbanks as well: a microbank has the right to "invest (including create or acquire a subsidiary) in a legal entity that is a financial institution or whose activities are related to the activities of the microbank or the social projects of the microbank. The share in each enterprise provided for by this subsection shall not exceed 20 percent of the microbank's share capital, and the total value of investments shall not exceed 30 percent of the microbank's share capital. The National Bank of Georgia is authorized to exempt the microbank from compliance with the percentage limits determined by this subsection for a period not exceeding 1 year.<sup>48</sup> Thus, microbanks, unlike commercial banks, are not permitted to acquire shares/shares in enterprises that do not engage in financial activities. If the amount of total investments of a commercial bank in other enterprises is limited to the value of 50% of its share capital, for microbanks, this number does not exceed 30% of the share capital.

A microbank can also acquire or create a subsidiary outside of Georgia.<sup>49</sup> The supervisory norms established in the regulated sectors of the economy, which require the necessary notification of the regulator regarding such transactions and the development of effective instruments against money laundering and terrorist financing, also apply to microbanks.<sup>50</sup>

It should be also emphasized that Georgian legislation creates favorable conditions for those microbanks that wish to expand and therefore intend to transform a microbank into a commercial bank. Until the National Bank of Georgia makes a decision on issuing a banking activity license, a microbank continuously carries out its permitted activities.<sup>51</sup> Along with the decision on issuing a banking activity license, the regulator makes a decision on the cancellation of a microbank's activity license, after which a commercial bank becomes the successor of a respective microbank.<sup>52</sup>

Since the definition of investment funds and the scope of their activities imply a broad meaning and is not focused on one particular type of entity as in case of microbanks, the legal framework regulating the investment funds makes separate references to this topic: an investment company shall not carry out activities other than those related to the management of its own portfolio,<sup>53</sup> a registered

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<sup>46</sup> "Share capital - the capital of the shareholders of a commercial bank, which is defined as the difference between the bank's total assets and total liabilities" - Paragraph "w" of Article 1 of the Law of Georgia "On Activities of Commercial Banks", 23/02/1996.

<sup>47</sup> Ibid., Article 10.

<sup>48</sup> Paragraph 1 of Article 16 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

<sup>49</sup> Ibid., Article 17.

<sup>50</sup> Ibid.

<sup>51</sup> Ibid., Article 18, clause 2.

<sup>52</sup> Ibid., Article 18, clause 3.

<sup>53</sup> Paragraph 1 of Article 8 of the Law of Georgia "On Investment Funds", 15/07/2020.

as well as a licensed asset management company shall not engage in activities other than the main activities and additional activities contemplated, save for the exceptions envisaged under the respective laws. Therefore, unlike the normative acts applicable for microbanks and commercial banks, the statutory regulations in respect of investment funds provide for more general restriction on performing the activities beyond the scope established by the law and do not contemplate specific thresholds and limits.

EU-Georgia Association Agreement seems to be silent in regards to the scope of activities of financial institutions, ownership of shares in other legal entities etc. meaning that this topic is deregulated for the purposes of such international treaty and Georgia may establish respective rules at its own discretion.

## 5. OTHER IMPORTANT PROVISIONS ON MICROBANKS AND INVESTMENT FUNDS, CONCLUSION

Above, we tried to focus on the legislative norms that establish certain innovations in Georgian law regarding new entities in the local financial sector and contain provisions that are characteristic for these entities, in some cases, only for them. I believe the reader will not be surprised that in most cases the provisions of the law "On Activities of Microbanks" are based on the existing regulations for other entities operating in the financial sector, primarily commercial banks. Accordingly, I consider it expedient not to leave the most basic issues related to our topic without attention, even though they may not contain any legal innovations.

Microbanks are joint-stock companies, whose management system includes a general meeting of shareholders, a supervisory board, a directorate, and another body typical for financial institutions, an audit committee.<sup>54</sup> The responsible individuals of the microbanks are the administrators, for whom the requirements of education, experience, honesty and professionalism are established, expressed in the criteria of the suitability of the administrators.<sup>55</sup> Ownership of more than 10% of the microbank's capital gives the relevant shareholder the status of a significant shareholder and entails certain restrictions, mainly the absence of convictions for serious, especially serious and economic crimes. Such requirements apply not only to the direct owners of a significant share, but also to the indirect and beneficial owners of such shares.

Microbanks are subject to an annual obligation of external audit,<sup>56</sup> all supervisory tools (sanctions) of the National Bank of Georgia,<sup>57</sup> which are established in the financial sector. As in case of commercial banks, decisions on solvency, bankruptcy, temporary administration and liquidation of microbanks are made exclusively by the National Bank of Georgia.

The topics reflected in this chapter are rather specific and fall out of the scope of EU-Georgia Association Agreement. As we were able to see, the referred international treaty has a very liberal approach in regards to the entities which comprise Georgian financial sector and we could not establish any significant incompliances between local statutory regulations and the standards established by the EU-Georgia Association Agreement. Respectively, further conclusion of this paper would be that the expansion of Georgian financial sector seems to be fully in line with with the provisions of EU-Georgia Association Agreement.

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<sup>54</sup> Compare: Articles 20-23 of the Law of Georgia "On Activities of Microbanks", 23/02/2023.

<sup>55</sup> Compare: *Ibid.*, Article 7.

<sup>56</sup> Compare: *Ibid.*, Article 31.

<sup>57</sup> Compare: *Ibid.*, Chapter VII.

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