

Resetting the Moldovan Banking Sector: What Can Europe Do and Why?

POLICY BRIEF

Summary

The recent financial crimes involving Moldova and the European Union (EU) financial systems shook the fragile country not just economically, but also politically and socially, and may be a cause of further instability in Moldova and in the surrounding region. Apart from causing internal turmoil, these crimes have also negatively affected EU-Moldova relations and are one of the primary causes for the Moldovan people's declining trust and support of Moldova's European path. To prevent these crimes from happening in the future, those responsible need to be brought to justice, and a credible international investigation and an asset recovery mechanism must be put in place. A sanctions list is a moral imperative and a sign that such cases cannot and will not go unpunished. An effective resolution to these cases is more in the EU's interest than may at first be thought. EU taxpayer money is directly involved and EU security itself is at stake. The EU-Moldova Association Agreement offers sufficient legal grounds for the EU to act decisively and to take initiative. Because of pervasive corruption and state capture, Moldovan institutions alone cannot, or will not act effectively.

This brief attempts to explain the main consequences of the financial crimes discussed – the “theft of the billion” and the “Laundromat”; it suggests additional measures that can be taken to solve these crimes and prevent them from happening, and argues that the EU could and should take a more active role in their resolution and that doing so is both in Moldova's and the EU's long-term interests.

Introduction

The Moldovan banking sector had been showing signs of weakness for years prior to the scandals. Due to chronic inaction from the anti-monopoly regulator, and the National Bank of Moldova, legitimate suspicions of an effective bank cartel were present for nearly a decade, and so was the issue of the lack of any transparency of ownership. The banking regulator's independence has always been under threat until this institution was finally and officially subordinated politically in 2009.

The relevant legal framework, although permanently amended, is characterized by central legislation¹ dating back to the 1990's. Moreover, the regulators have come nowhere near close to using all the tools granted by law to maintain the stability, security, and transparency of the financial system, and to protect, and safeguard it. International partners (IMF, EU, World Bank among others) have been signaling irregularities and openly expressing concerns for nearly a decade, while the will of the authorities to address these concerns effectively was under question.

The following two cases illustrate the difficult situation Moldova's financial system finds itself. The ever-present corruption within government institutions was a central element that made these crimes possible.

Case 1: The Theft of One Billion Dollars

To put the theft in perspective, it would be equivalent to 2.88 trillion USD (about 15% of EU GDP) suddenly disappearing from several EU banks, with the European Central Bank having to bail them out in order to avoid further damage. This is exactly what happened in Moldova roughly two years ago, when nearly a third of the National Bank Reserves, or the equivalent of 15% of Moldovan GDP, disappeared overnight.

Within a short period of time, three commercial banks from Moldova, acting in concert and having the same ultimate beneficiary, gave out loans, with no respect to prudential norms, in the cumulative amount equivalent to about one billion USD. This happened under the passive watch of the regulators, (National Anticorruption Agency, National Bank of Moldova) who have permanent access to information that should have triggered multiple red flags and early warnings – a mechanism that exists and should have worked. The authorities had multiple legal grounds, tools, and access to information but did not act effectively to safeguard the people's investments.

We can now assert that the loans were never intended to be paid back. In November 2014 the Government decided to bail out the banks with emergency loans taken from state reserves to protect people's savings. Coincidentally, prior to that, legislation was "adjusted" to make such bailouts possible, with laws having been amended just a few months prior. Soon after, in March 2015, a second bailout was needed. As a result, the National Bank reserves have decreased by nearly a third.

After two years of inactivity in investigating the theft, in September 2016, the government took the decision to make the taxpayers pay for the theft of the billion over the next 25 years. The Ministry of Finance issues bonds to repay the debt to the National Bank of Moldova and thus the stolen billion becomes public debt.

¹ Law on the National Bank of Moldova (<http://bnm.org/ro/content/lege-cu-privire-la-banca-nationala-moldovei-nr-548-xiii-din-21071995>) and Law on Financial Institutions both date back in 1995 (<http://bnm.org/ro/content/legea-institutiilor-financiare-nr-550-xiii-din-21071995>).

Case 2: The “Laundromat”

As part of the stolen billion, Moldova became known internationally for a larger amount of money laundered through its jurisdiction during the same period. Investigative reports show more than 20 billion USD² being stolen from the Russian Federation national budget and being moved to EU accounts through one Moldovan bank with corrupt Moldovan judges playing a central role in legitimizing the transactions.

More than two years have passed since the crimes have been committed and no genuine development has been had through either an effective investigation, or in recovering the stolen assets. The national authorities have avoided any communication on the topic, despite public interest. With that being said, the pressure on the authorities, be it from civil society or their international partners is rather modest.

The underlying causes that allowed these crimes to happen, result from a lack of any regulator independence in the financial market, anticorruption, and anti-money laundering institutions. The “operation” was only possible because a number of institutions (and, more precisely, an even more specific string of people at different levels within the hierarchy at these institutions) did not act when they were obligated to.

While the standard excuses coming from state institutions (including imperfections in legislation, insufficient capacity of a particular institution, lack of access to information, or inefficient cooperation among different institutions, etc.) are justified, the fact remains: the institutions did not do everything that could and should have been done. No one would expect the impossible from the institutions, however the legislation granted them tools they did not use. At the same time, their capacity to act is apparent in much smaller cases, when the institutions displayed they can act with effectiveness when necessary, and that the issues stated that allowed the larger schemes to transpire is not genuine. It is corruption and state capture that presents the most likely explanation.

Thus, the main causes of these crimes are a result of high-level corruption and state capture, a general sense of impunity from specific people involved, which, in turn, resulted in the political subordination of regulators that failed to act in the public interest. As is the case in other countries ravaged by corruption across the globe, politicians have always pointed to imperfect legislation and lack of institutional capacity to cover up corruption and justify the status quo.

Economic, Social and Political Impact

Consequently, the draining of nearly 30% of the National Bank currency reserves in several months has triggered multiple negative macroeconomic reactions such as: decrease of GDP, rise in inflation, interest rate hikes, increase in living costs, fall in investments, etc.³

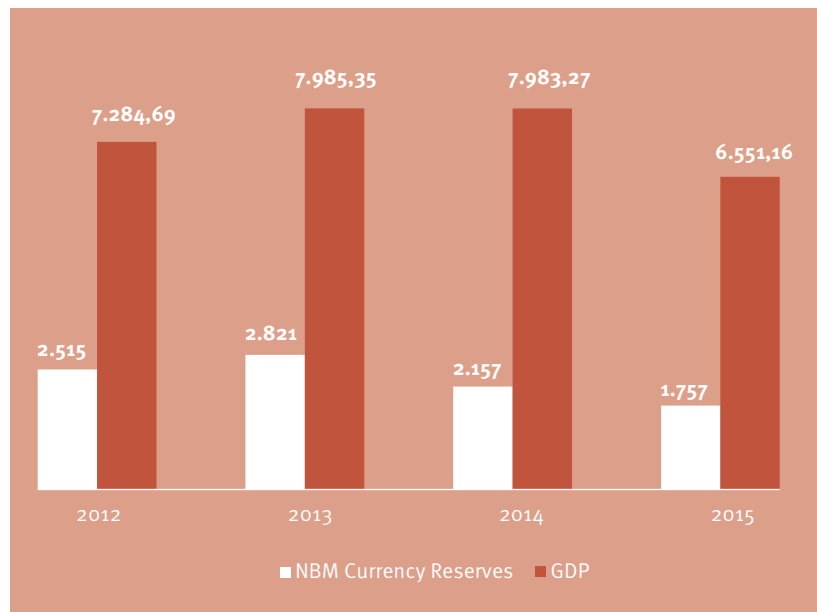
The dramatic drop in GDP output can be seen to be a result of skyrocketing inflation, accompanied by the National Bank of Moldova’s need to act in increasing the base rate.

The consequences of these financial crimes in the short and medium term can be felt in the economic, political, and social spheres. The Moldovan Leu (MDL), the national currency, saw a roughly 30% drop in value compared to the USD within the span of several months, directly affecting people’s disposable income, leading to an increase in living costs, with a hike in energy prices affecting the population and economy as a

² Organized Crime and Corruption Reporting Project: The Russian Laundromat <https://www.reportingproject.net/therussianlaundromat/>

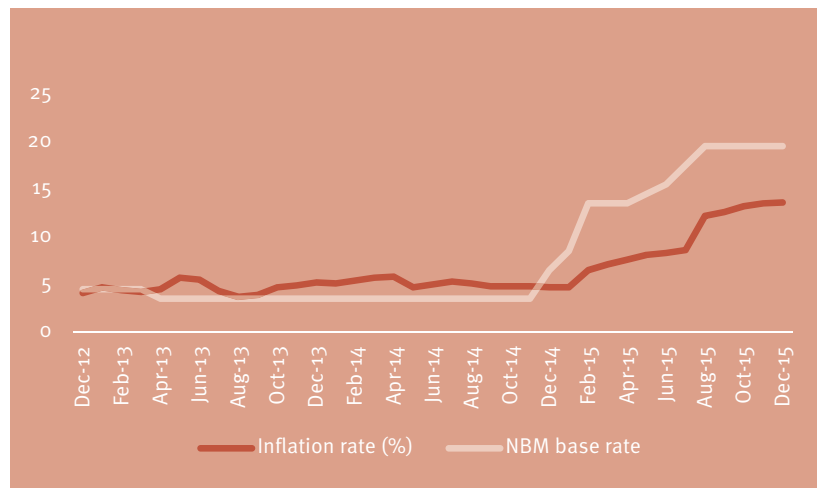
³ “The billion effect” <http://sic.md/efectul-miliardului/>

Currency Reserves and GDP 2012-2015 (mil USD)



Source:
National Bank of Moldova; World Bank.

Inflation and NBM base rate



whole, along with credit costs going to a 25% annual rate, discouraging investment and emptying the savings of businesses. These consequences led Moldova into a deep political crisis with mass protests and the money laundered continues to perpetuate corrupt and non-transparent practices, financing dubious investments in Moldova and, arguably, elsewhere⁴.

From the medium to long term, two main problems can be pointed out: (i) the theft has undermined Moldova’s growth potential and will resonate for decades and (ii) trust in the banking system and, more severely in state institutions, already shaky prior to the scandal, has been severely affected.

The liquidation of three banks, after being drained of cash, hit the banking sector with increasing difficulties. The economy is stagnating, credit is expensive and not utilized, the banking sector is paralyzed and does not fulfill its main role in an economy – to provide finance and investment to the real economy and thus lead to economic growth. Investors are now increasingly skeptical to invest in Moldova.

⁴ Rise Moldova. Dirty Money Laundered by the Russians invested in the largest Moldovan Bank. 1 August 2016. <https://www.rise.md/articol/bani-murdari-spalati-de-rusi-investiti-in-cea-mai-mare-banca-din-moldova/>

From a social standpoint, the banking scandal has made the poorest country in Europe even poorer. The effects of the missing billion have led the population to increased living costs and the decrease in value of the national currency. Protests broke out and the sentiment of injustice is perceived throughout society. The scandals have emphasized high level corruption and thus undermined any trust in the Moldovan state itself directly in front of its citizens. Internationally, Moldova's image is also compromised for years to come and substantial effort will be needed to restore it.

Politically, according to polls, trust in government institutions plummeted to single digits, and the sentiment of social injustice sharpened. A period of instability followed in 2015 with Moldova having in effect five Prime-ministers throughout the year (including two ad-interims), along with large scale street protests. Although more stable, in 2016 Moldova has witnessed perhaps the most illegitimate government the country has had with it being installed in just a few minutes with no consultation, transparency, or public scrutiny. The present coalition in parliament is difficult to classify politically. While being formally pro-European, it was formed overnight by members of the parliament from opposing ideological fronts, under suspicions of blackmail and political corruption.

Both cases – the stolen billion, and the “Laundromat”, would not have happened if the authorities ensured legitimate independence of the regulatory and anti-money laundering institutions (National Bank of Moldova, National Anticorruption Center, Prosecutor General's Office), effectively fought corruption, and implemented in a timely manner the World Bank, EU, and IMF recommendations.

Implications for the European Union

There are multiple reasons why Moldova's banking scandal is relevant to the European Union. First, **money laundering is a crime** and a cross-border issue. The funds laundered through Moldova and stolen from Moldova have been transferred mostly to Latvia and end up eventually in tax havens, where the path is lost⁵. Regardless, evidence from previous cases suggests that the same funds end up in “safe” jurisdictions, with EU countries being a preferred destination.

The Association Agreement provides clear advice as to what must be done to increase the independence of institutions, ensure they are not politically compromised, increase transparency and competition (in general and in this case – in the banking sector), and to have effective anti-money laundering measures.

Chapter 9 – Financial Services, is particularly relevant and applicable. If no serious action is taken however, most objectives stated in Article 58 are, at the moment, under threat to be compromised, notably objective c) to ensure the stability and integrity of the Moldovan financial system.

The EU must condemn and demand effective investigations, which it has the legal powers to do per the Association Agreement. The EU must insist on Moldova's full compliance with the obligations stated in the Agreement.

According to Article 18 of the Association Agreement, the two parties committed to prevent the use of their financial and non-financial systems for money laundering. The financial crimes discussed in the present paper have used both Moldova's and the EU's financial systems. This gives the EU complete legitimacy to initiate the provisions of the aforementioned article, according to which, full cooperation within **an international asset**

⁵ Organized Crime and Corruption Reporting Project: Latvian Bank Was Laundering Tool. 22 August 2014. <https://www.reportingproject.net/therussianlaundromat/latvian-bank-was-laundering-tool.php>

recovery task force is essential once financial crimes such as these become known to EU authorities.

Moreover, the Council of Europe's Convention on preventing money laundering, of which Moldova is also member, offers additional grounds for decisive action to establish an effective international investigation and asset recovery mechanism.

Secondly, the EU must regard this as a **security threat**. The stability of the Moldovan state and its security has been undermined considerably by the financial crimes in Moldova. This, in turn, can feed instability in the entire EU neighborhood.

Economic and financial stability, the integrity of the banking sector, institutions' credibility and their ability to act - have all been compromised, and thus have become a threat to Moldovan national security. The current situation leads to poverty and instability in EU neighbor countries with a permanent risk of social turmoil. **Only an effective investigation can restore stability and credibility of the Moldovan state in front of its citizens and its partners.**

When it comes to the "Laundromat", the EU must also take this as a threat to the EU itself. When vast amounts of dirty money originate from corrupt practices and end up in EU banks, markets will be distorted, anticompetitive practices are stimulated and honest (especially small) businesses will go out of business – this is the smallest threat that can be anticipated. The largest threat is that these funds being put into the European Union are being used for corrupting the system from the inside, a view recognized in the recent Motion for a European Parliament Resolution (2016/2030(INI))⁶.

With the rise of far left and right wing parties throughout different EU countries, along with the Russian Federation openly supporting anti-EU political movements inside the EU, it is not a difficult argument to make that part of this money may be put into action.

Third, **it is also EU taxpayer money**. EU assistance is incredibly helpful in helping Moldova's needs, however, we believe that **stricter oversight is necessary**. Not only has the Moldovan taxpayer been robbed with the schemes of the stolen billion, but also the EU taxpayer, and with this a third of the National Bank Reserves have been drained, equivalent to 15% of Moldova's GDP. In 2014 and 2015 the National Bank allocated the equivalent of nearly one billion USD to bail out the banks that engaged in an obvious corrupt practice handing out loans that were never intended to be paid back. This was taken from the same National Bank Reserves.

Over the years, the IMF has been fueling the Moldovan currency reserves held by the National Bank of Moldova. For example, in the last program that ended in 2013, the IMF provided around 250 million USD in cash reserves to the National Bank of Moldova. Germany, France, Spain, Italy and United Kingdom, to name a few, hold a cumulative 20% of quotas in the IMF, which equates to about 50 million of the last IMF program with Moldova. The EU taxpayer's "share" in the stolen billion is thus, about 50 million USD and this should be a topic of great interest to EU policymakers.

Moreover, in just 2014 Moldova benefited from roughly 131 million EUR in financial assistance from the EU. These funds are offered to the Moldovan people in goodwill to make the lives of Moldovans better. While the European Union is keeping the country afloat by providing non-reimbursable financial assistance, corruption is eating out growth from the other side.

⁶ European Parliament Report on EU strategic communication to counteract propaganda against it by third parties. (2016/2030(INI)), 14 October 2016. <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2F%2FEP%2F%2FTEXT+REPORT+A8-2016-0290+0+DOC+XML+Vo%2F%2FEN>

Conclusion

It would be a great mistake if Moldovan society, EU institutions, and the international community believe this was an accident. It features all the signs of a deliberate action planned and executed by corrupt politicians and their accomplices in Moldova and abroad. Since these crimes have happened it has become clear – there is not much one can expect from the Moldovan national authorities in investigating these crimes effectively. It is time for the international community to step in and take initiative, not just diplomatically demand action.

Two years after the banking theft, it is clear Moldovan institutions in their present shape are weak and do not intend to productively investigate the crimes and punish who was responsible. Moldovan society has been unequivocal in its opinion that only a credible international investigation will give real chances to identify the guilty and recover the stolen assets. Given that the EU taxpayer was robbed and EU security may be under threat, the EU must have the same interest in seeing a more thorough investigation.

Recommendations for EU Policy Makers:

Initiate credible international investigation

The Association Agreement gives full legal powers to the EU in demanding an investigation, putting the EU in a unique position. An asset recovery mechanism/team/initiative can be put in place at a higher level than that of the Moldovan national authorities. Article 18 of the EU-Moldova Association Agreement offers legal grounds to determine additional EU involvement in the process. There are precedents in which the international community has supported similar initiatives. Given that part of the stolen money belongs to the EU and the United States, they should feel it necessary to do so.

Demand reforms

The investigation into the stolen billion and money laundering scheme will not be effective with the unreformed Moldovan institutions, the same that allowed the crimes to happen. The National Bank of Moldova, the Prosecutor's Office, the National Anticorruption Center, are institutions that first and foremost must be removed from political influence and their independence guarded by local watchdogs as well as EU institutions.

Moldova has committed to reform and to build effective institutions in the most comprehensive and all-encompassing international agreement it has ever signed – the Association Agreement with the EU with clear provisions in anticorruption, anti-money-laundering, banking supervision, and protecting competition. This commitment is the best systemic approach to solving the scandal and recovering the money.

Stricter oversight

Stricter oversight is vital in making better use of EU funds, and push for real reform that will improve people's lives and thus increase pro-EU sentiment, which is in decline due to corruption. The EU must demand results, not reports. Frequently the goodwill and trust of EU institutions and EU officials are being abused. Diplomatic speeches and appeals from

EU officials are taken as a sign of weakness, and are deliberately, and out of convenience “misunderstood”, making it easier to ignore them. Often partner Governments, be it Moldova or elsewhere, tick reforms that only works on paper and are seen just in Brussels, not real life. This point also refers to the necessity of strict oversight of the efficiency and effectiveness of EU funds.

Support civil society watchdogs

Supporting a free and independent civil society, and maintaining reputable watchdogs could be a strategic investment. This may have been the greatest mistake in EU-Moldova relations after 2009. A credible independent external voice advocating for legislation amendments and changes, sounding the alarm, and raising relevant issues that authorities avoid is what is now missing in demanding swift action for the crimes committed and to take effective steps at all levels to make sure these crimes never take place again.

Sanctions list

The most important item that must be taken into account is the fact that these crimes were pulled off by real people – politicians, public servants, businessmen, who believe they have gotten away with the crime. Identifying and punishing them becomes a moral matter and a matter of justice, a core EU value. To discourage any similar crimes, action must be taken in identifying and punishing those responsible, and a sanctions list may be a strong first step. This has great potential to contribute to the recovery of pro-EU sentiment, currently in decline, being compromised by nominally pro-European corrupt politicians. The list of persons and entities is long; however, it must be made after a thorough analysis of the process step by step.