Everything about the financial system. What is money laundering and how does it affect each of us?

Analytical Commentary
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Corruption and money laundering, a vicious circle

Globally, the phrase ‘money laundering’ means the process of hiding the origin of money obtained from certain crimes, while avoiding the legal consequences for those who committed these crimes. Money laundering is often associated with illicit activities, namely financial frauds, corruption, smuggling, drug trafficking, or extortion. In the absence of global cooperation, money laundering becomes both a sizeable and dangerous phenomenon. According to figures published by the World Bank¹, corruption generates annually more than USD 1 trillion (about 2.5% of world GDP), which need to be 'laundered' somehow.

Just like corruption, money laundering affects all of us, sometimes having serious social and political consequences. It destabilizes the economy of vulnerable countries, compromises the integrity of state institutions, and destabilizes the financial system. As a result, economic growth and development is affected, the tandem of corruption - money laundering being both a cause and a consequence of poverty in many countries. Moreover, without adequate measures, corruption and money laundering can turn into a vicious circle that is difficult to break. On the one hand, money laundering is a way for organized crime groups to get the necessary financial resources for their illicit activities, thus generating corruption; on the other hand, corruption generates resources that need to be 'laundered' later.

Money laundering has become a topical issue in the Republic of Moldova as recently the national banking system has been the target of major events of this kind. With a transition economy, a high level of corruption and a poorly monitored financial system, our country has become the target of regional or even global money-laundering groups. All of them had the same starting point, namely when the banking sector was transferred almost entirely under the control of non-transparent shareholders with obscure interests. As a consequence, the most resounding cases of money laundering via domestic banks occurred during this period, specifically the Laundromat case and the frauds at Banca de Economii.² Thus, according to some journalistic investigations³, subsequently confirmed by authorities, about USD 20 billion were transited from the Russian Federation during 2010 - 2014, which transformed the Republic of Moldova into a vehicle for laundering illicit money and their subsequent transfer to countries of destination. At the same time, along with the Laundromat case, the frauds at Banca de Economii also revealed some money-laundering mechanisms, a fact internationally recognized. The involvement of politically exposed persons, high-level corruption, fraudulent financial means, or the use of off-shore entities are only the major elements that allowed establishing and operating complex money-laundering mechanisms via the national banking system.

²The Laundromat case implied the transit of about USD 20 billion of suspicious origin, originating from the Russian Federation, through the national banking system.
³"Russian Laundry": Moscow - Riga via Chisinau, https://www.rise.md/articol/operatiunea-ruseasca-the-laundromat/
Money laundering destabilizes the economy, impoverishes the population and fuels corruption

Money laundering can occur under a variety of forms, depending on the type and level of crime that generated the financial means. The most widespread forms are bribery, extortion, conflict of interest, and embezzlement of public or private funds. For the Republic of Moldova, an eloquent example of money laundering is the embezzlement of funds from the banking sector, leading to the collapse of three banks - Banca de Economii, Banca Sociala and Unibank, and the need to use huge amounts of public money to remedy the situation. To understand how money laundering is destabilizing the economy, impoverishing the population and fueling corruption, the situation will be chronologically presented.

Intermediating the flow of money from savers to investors in an economy is the core business of banks. Banks do not use their own money, but rather money coming from the population and companies, which confirms their public character and interest. Before being defrauded, most of the three banks' money consisted of private funds (money attracted from the population and companies) and public funds belonging to several state institutions (money for pensions, salaries, health insurance, etc.). These funds were stolen by the acts of corruption committed by bad-faith managers, in particular through the loans given to certain companies. To hide the trace of money and beneficiaries, an ample money-laundering process has begun, that implied the transfer of funds to a number of foreign entities and offshore jurisdictions. At the same time, in order to ensure the continuation of the lending process, some funds were returned to the three banks in order to repay the old loans and subsequently grant new loans. This mechanism, also confirmed by Kroll investigations, lasted until the three banks had depleted all the resources, which did not belong to them. In order to prevent losing the deposits in other banks, the National Bank of Moldova (NBM), with the Government's involvement, covered the missing funds using public money. Thus, the money that could have been used for roads, schools, hospitals and other state investments, in other words - the public assets, were used to cover the embezzled funds.

Once laundered, a part of the fraudulent money might return into the country, but with an unknown origin. This could further affect the population and the macro-economic equilibrium, as the available money will be used for new acts of corruption, anti-competitive investments, and other unlawful actions. From an economic perspective, the money laundering could potentially destabilize the foreign exchange market by pushing up the demand for Moldovan lei, and implicitly by compromising the inflation-targeting and exchange-rate policies. Money laundering can also have serious social and political consequences. Using the embezzled funds, entire sectors of the national economy could be taken over by suspicious persons, which would squeeze out the honest investors. Moreover, a stronger influence of groups that benefited of money laundering in the economic and political realms could weaken the social structure, the integrity of the public persons, and consequently the democratic institutions of the State. Finally, what is perhaps the most important, money laundering is directly related to the underpinning of the criminal activity, as the 'laundered' financial sources fuels its further growth and expansion.

In conclusion, frauds in the banking sector and the subsequent money-laundering process have affected the economic environment and implicitly the country’s citizens at least several times. First, public money was used to rescue the depositors of the three banks. Subsequently, the confidence in the national currency, the financial system, and the prospects of the national economy was heavily affected by the bankers’ abuses and the use of depositors’ money for unlawful purposes. Ultimately, the fraudulent money might return into the country in the form of anti-competitive investments that would distort the investment climate, or in the form of funds that would support further on corruption and illicit activities. Theoretically, the consequences of money laundering versus the advantages of a clean economic system are presented below (Figure 1).

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4The Law on Accounting No 113 of 27.04.2007 classifies banks and other financial institutions as entities of public interest
Who fights against money laundering in the Republic of Moldova and how?

In order to protect the economic system, any state needs an adequate institutional and legislative framework aimed at preventing and combating money laundering. In the Republic of Moldova, specific money laundering provisions were included in the first adopted Criminal Code. Subsequently, the legislation in this area was gradually upgraded, from the Law on Detecting Revenue from Serious Crimes, dated 1993, to the latest Law on Prevention and Combating of Money Laundering, dated 2017. Even if certain provisions evolve, the central objective remains the same - to prevent and combat money laundering in order to protect the legitimate rights and interests of individuals, businesses, and the State. To achieve this objective, a number of reporting entities have been established which have the obligation to identify individuals or legal entities, as well as the beneficial owner, and report any suspicion of money laundering to the specialized body. The most important reporting entities are the financial institutions (both banking and non-banking), foreign exchange offices, real estate agents, public notaries, etc.

By signing the European Union Association Agreement, the Republic of Moldova committed to align the anti-corruption and anti-money laundering legislation with the latest European practices in the field. At the same time, our country has pledged, in front of several international institutions, to strengthen the framework for preventing and combating money laundering, this area being under special monitoring by the MONEYVAL Committee, and the International Monetary Fund. Thus, the Republic of Moldova must implement the Directive 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, as well as the newest standards developed by the Financial

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5The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism
After several delays, the new Law on Prevention and Combating of Money Laundering was adopted only in December 2017, which prevented both the development and adoption of bylaws and the effective enforcement of the law.

The Office for Prevention and Fight against Money Laundering (OPFML) is the national institution in charge of preventing and combating money laundering. According to the law passed in late 2017, this office is a public authority that operates as an autonomous and independent central specialized body. The Office staff carry out financial investigations, which consist of checking the suspicious indications submitted by the reporting entities. Besides, the National Integrity Authority (NIC) complements the OPFML duties of preventing and combating money laundering by controlling the wealth and personal interests of public persons and public dignitaries. At the same time, the Agency for the Recovery of Criminal Assets (ARCA) seeks the recovery of the illegally obtained goods, including those resulting from money laundering. Thus, theoretically, these three institutions should ensure the implementation of a coherent Government policy against corruption and money laundering and make sure that events similar to those of 2010-2014 do not occur again (Figure 2).

Nonetheless, the institutions responsible for combating money laundering still have weaknesses, which allow for the continuation of this phenomenon. The most significant delays refer to the approval of the bylaws for the enforcement of the Law on Prevention and Combating of Money Laundering and Terrorist Financing. In addition, due to the delay in appointing the NIA management, the methodology for verifying assets and personal interests, and compliance with the legal status of conflicts of interest, incompatibilities and restrictions, has not yet been approved. Finally, without an Internal Regulation, ARCA has not actually begun its activity, either.

Figure 2. The National Framework against Corruption and Money Laundering

The Financial Action Task Force is a body that sets standards and promotes the effective implementation of legal measures to combat money laundering, terrorist financing and other threats to the integrity of the international financial system.
Pickup points!

The events occurred during the recent years prove that the Republic of Moldova was a favorable territory for cross-border money laundering groups. In the context of more high-level corruption, legislative shortcomings and political interference in the work of supervisory bodies, the national financial system has become vulnerable to the risks of fraud and money laundering. Even after reforming the national banking supervision and anti-money laundering framework, the temptation to use the national financial system as a platform for the legalization and transition of suspicious funds remains quite high. For example, in 2016 the reporting entities submitted about 600,000 forms with allegedly suspicious transactions to OPFML. Of them, 236 files were sent to the criminal prosecution bodies (Prosecutor’s Office and NAC), 19 to the Main State Tax Inspectorate, 22 to financial market regulators (NBM and NCFM) and 38 to law enforcement bodies. The most significant share is held by the banking sector, with the 11 banking institutions accounting for about 99.6% of the total number of received forms.

Although extensive investigations of the banking fraud and the Laundromat case have been launched, they still have a long way to go. Three years after these resounding money laundering cases, the damages caused to taxpayers, the economic system and the society as a whole are far from being recovered. At the same time, a number of implemented or proposed legislative measures amplify the money laundering risks in our country. Except for the Citizenship for Investments Program, which was somehow passed unnoticed, alongside other legislative initiatives, the authorities gave up most of them under the pressure from the civil society and development partners. Even so, the fact that such initiatives have emerged suggests the likelihood of them being brought up and implemented in the future.

Recent initiatives that run against the anti-corruption efforts in the public sector and generate major risks of money laundering expansion:

- **Citizenship for Investments Program (adopted)** - obtaining the citizenship of the Republic of Moldova in exchange for investments poses an imminent and direct danger to the country’s security. Such programs are characteristic of tax havens or offshore areas that often refrain from implementing international standards of transparency and exchange of information. The experience of these countries proves that corrupt politicians and suspicious businessmen, involved in scandals related to money laundering, illicit activities, or tax evasion, are the main beneficiaries of such programs. Last but not least, investing in the real estate sector is the main mechanism for integrating the previously laundered money worldwide;

- **Fiscal amnesty (withdrawn)** - although this form of tax liability cancellation is relatively common internationally, if applied abusively it can turn into a mechanism of the integrating previously laundered money. The legislative initiative of some MPs, launched at the end of 2016, is an example of such a case, when a draft Law on Capital Liberalization and Tax Incentives was proposed for adoption. It envisaged the cancellation of all fiscal penalties for individuals and legal entities, provided that they paid the outstanding liabilities. However, forbidding the tax authorities to control the accuracy of the accrued and paid taxes and duties during the period subject to fiscal amnesty creates opportunities for legalizing illicit money. Though the authorities gave up on this initiative, this instrument can be revitalised any time;

- **Capital liberalization (withdrawn)** - asset legalisation is one of the most widespread methods of integrating the previously laundered funds, used by countries with high corruption rates. In the Republic of Moldova such an instrument was proposed in late 2016, when the draft Law on Capital Liberalization and Tax Incentives was submitted. Even if the draft has not been passed, the proposed mechanism could re-appear any time on the Government’s agenda. It envisaged that any individual would be able to declare their assets (e.g. money, real estate, shares, securities, vehicles) that were registered on the name of other persons or not registered at all, guaranteeing

8 http://parlament.md/ProcesuLegislativ/Proiecteadeactelelegislative/tabid/61/LegislativId/3503/language/ro-RO/Default.aspx
full legal protection. i.e. the state authorities could neither check the origin of these assets, nor apply any sanctions for illicit acquisition or failure to declare such property provided that a tax is paid, amounting to 2% of the assets value.

- **De-criminalizing some economic crimes (withdrawn)** - this initiative envisaged a series of amendments to the criminal legislation, proposing the release of criminal liability, namely suspended imprisonment for most of the crimes on the banking, financial and insurance markets. These are crimes related to lending activity, bank management, securities market, security transactions, violations of shareholders’ rights, and anti-competitive practices, i.e. the main crimes that have facilitated bank frauds and underpinned money laundering mechanisms. Moreover, these provisions run against the most recent anti-money laundering rules that require consistent penalties in order to prevent and mitigate the associated risks.

**Last but not least, the fight against money laundering must also employ other measures related to the Government’s economic policy.** Thus, besides eliminating the institutional and legal deficiencies characteristic of this field, measures such as de-offshorisation of the economy, implementation of international transparency standards, or thorough verification of investments of suspicious origins should also be on the Government’s agenda. Also, taking into account that the banking sector remains the most vulnerable component of the increasingly sophisticated money laundering mechanisms, both banks and the NBM need to implement coherent policies to prevent, identify and manage risk associated with this phenomenon. They also refer to non-banking financial entities that are becoming increasingly present on the domestic financial market and more exposed to fraud and criminal activities. The international practice offers a series of measures for this purpose, such as:

- **Defining clear procedures for risk identification and internal coordination** - financial institutions must allocate sufficient resources to promote anti-corruption and anti-money laundering programs. Managers must communicate very clearly to their staff an attitude of zero-tolerance to corruption and money laundering;

- **Applying appropriate preventive measures, like know your customer, including the beneficial owners** – in dealing with customers, financial institutions must have mechanisms to monitor suspicious transactions and identify potential red flags. Also, KYC questionnaires or any other such tools must be tailored to the specifics and complexity of customer activity;

- **Identifying and managing, in a special way, the relationships with politically exposed people** – due to the state and political influence that certain people have, the risk of their involvement in money laundering is much higher. Thus, if the KYC procedure identifies politically exposed persons, financial institutions need to take additional reasonable steps to determine the source of their funds and monitor effectively their business over time;

- **Keeping and exchanging information with relevant responsible institutions** – as reporting entities, financial institutions need to ensure clear and rapid procedures for the dissemination of money-laundering information to responsible institutions.

- **Facilitating cross-border cooperation** - at international level, states must make sure that agreements on rapid exchange of information about the relationships between financial institutions are in place. Banks should also make sure that they assess adequately the activities involving the use of resident entities in jurisdictions that do not implement international standards on transparency and disclosure of information.

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Money laundering, how does it work?

Although money laundering techniques could vary on a case by case basis with different levels of complexity, the international practice shows that most of the times this process has three stages. Chronologically, it is about transferring the funds associated directly to crime, disguising the route to prevent tracking the money, and offering to the beneficiary the money with a legal origin already. In international practice, these steps are also called (i) placement, (ii) layering and (iii) integration of financial means (Figure 3).

(i) Placement - At this stage, funds are transferred from the generating source and put into circulation through financial institutions, shops, currency exchange offices, casinos, etc. This phase is the most vulnerable for criminals, supervising bodies and financial entities being responsible for verifying the origin of money and the detailed information on the customer.

(ii) Layering - At this stage, a series of transactions are made to bring the funds as far as possible from their origin. The most commonly used method is electronic transfer via a series of accounts from various banks worldwide, especially those in offshore jurisdictions. As the authorities of those jurisdictions often do not cooperate with the specialised crime investigation bodies, detection and discovery of a money-laundering activity is becoming more and more difficult.

(iii) Integration - If the first two stages were successful, at the third one the funds will be included in the legal economic flows. Thus, the financial means obtained illegally are invested in a way that they appear to be ordinary gains from some legal businesses. Most of the times, this money is used to buy real estate or luxury goods, make fictitious loans or false import/export activities. At the same time, as a result of this step, goods or funds with apparently legal origin are made available to the beneficiary.

Figure 3. The three steps in the money laundering process

Source: Author's compilation based on the picture from FinCEN Related Series: An Assessment of Narcotics Related Money Laundering