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Decoding the Kroll Report

Analysis on basic factors which led to the decapitalisation of Banca de Economii, Banca Sociala and Unibank

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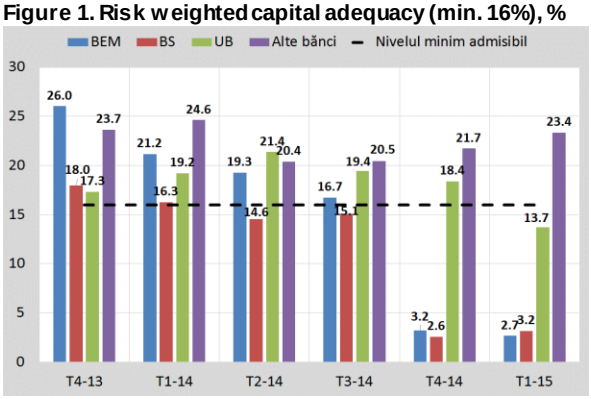
Content:

Background and purpose of analysis

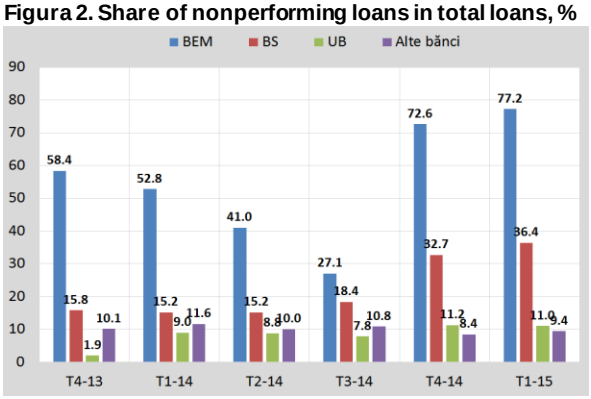
This analysis has been drawn up in the context in which 3 banks of systemic importance and which constitute about 35% of the whole Moldovan banking system assets reached insolvency limit in late 2014[1]. The Banca de Economii, Banca Sociala and Unibank (hereinafter, BEM, BS, respectively UB) have been placed under special administration of NBM at the end of November 2014, as a result of the dramatic downfall of the financial situation. Thus, the capital adequacy indicators have dropped below the minimum allowable level, and the share of nonperforming loans increased substantially (Figures 1 and 2).

Figure 1. Risk weighted capital adequacy (min. 16%), %



Source: NBM

Figura 2. Share of nonperforming loans in total loans, %



Source: NBM

It should be noted that the crisis at the 3 banks didn't become a crisis of the entire banking system. The degradation of the financial situation at BEM, BS and UB did not correlate with general developments in the system, as revealed by Figures 1 and 2. Thus, despite the critical situation reported by the 3 banks, the short-term liquidity indicator of the rest of the banks improved (25,2% in Q1-15 compared to 21.6% in Q4-14), the capital adequacy ratio reported by the rest of the banks increased (23.4% in Q1-15 to 21.7% in T4-14) and the loan portfolio quality worsened slightly (9.4% in Q1-15 to 8.4% in Q4-14).

According to the Kroll report, the volume of alleged fraudulent loans, granted in 2014 by BEM, BS and UB, came up to 13.3 billion MDL, which together with the interest of 4.7 billion MDL caused accumulated losses of about 18 billion MDL to those banks. These figures corroborate partly the amount of emergency loan granted by the NBM to the 3 banks under state guarantee in November 2014 (9.6 billion MDL) and probably in March 2015 (5.6 billion MDL).

The degradation of the financial situation at BEM, BS and UB was caused by a series of financial engineering aimed at fraudulently extracting cash from the banks concerned. The essence of the transactions was to increase artificially the level of liquidity through various financial engineering, which finally allowed the extraction of about 13.3 billion MDL through fraudulent loans. The financial engineering consisted mainly of 2 methods: (i) interbank placements with the participation of local and Russian banks which were artificially improving the liquidity indexes and concealing the black holes in the 3 banks; and (ii) conceding non-performing loans portfolios to offshore companies for equivalent sums of money thus concealing shortcomings in the quality of loan portfolios of the 3 banks, and the liquidity generated from the concession was used to grant new loans. Finally, the financial engineering allowed the granting of huge volumes of loans without affecting strongly the liquidity ratios and the quality of bank portfolios. Obviously, the transactions involved a network of banks and companies from different countries, including offshore zones, which were affiliated to a group of people, and acting in concert. In this context, it is not clear why NBM was so passive in intervening on time to prevent or block these fraudulent transactions, given that we witnessed lending and loan divestiture transactions, and interbank placements of an unprecedented magnitude in the banking history of the country.

[1] As of the situation on 31.03.2015

This study analyses the basic factors which generated the worsening of the financial situation during the last years in the 3 banks under special administration of NBM. The aim of the study is to identify legislative loopholes and key institutional weaknesses that have been used by some obscure interest groups in the decapitalisation of banks and which have to be removed in order to prevent similar situations in the future. The study also analyses the causes of NBM failure in preventing and combating fraudulent activity of the 3 banks.

The findings of the authors were based on the recently published report drawn up by Kroll company. Also, the authors took into consideration the findings of the Report of the Inquiry Commission of the Parliament for elucidating the situation on the financial and currency market, issued on March 20, 2015.

Five Fundamental Sources of the Crisis at BEM, BS and UB

The crisis at BEM, BS and UB occurred as a result of 5 fundamental factors: (i) delayed and inadequate reaction of NBM and other relevant institutions; (ii) obscure changes in the ownership structure of BEM, BS and UB; (iii) violation of basic principles of corporate governance in the 3 banks; (iv) artificial increase in lending capacity of BEM, BS and UB; and not least (v) the maladministration of BEM before the crisis. We further analyse the institutional weaknesses and shortcomings of the legal framework which fuelled these factors and finally facilitated the decapitalisation of the 3 banks.

1. Delayed and inadequate reaction of the National Bank of Moldova and other relevant institutions

The crisis at the 3 banks would not have been possible if the institutions responsible for financial stability in the country had acted promptly and effectively. Thus, NBM and the Ministry of Finance were aware of BEM problems since 2011. They have exchanged information and warned the National Committee for Financial Stability. At the same time, NBM has been analysing the problem of interbank placements since 2013 and warned BEM, BS and UB several times on credit and concentration risks related to these activities. In addition, the entire Kroll report was mainly based on the information already held by NBM, which suggests that the regulatory authority had been aware of the shady transactions from the 3 banks, but deliberately or due to constraints and lack of legal garantees did not act adequately to prevent or remedy the problems identified[2].

There were NBM attempts to prevent those transactions, but some of them were insufficient, while others were inefficient or delayed. For example, in December 2013 it was issued the Decision of the Council of Administration of NBM no. 240. According to it, NBM adjusted the normative acts in order to limit any exposure to 15% of the TNC so as to impede banks to manipulate with capital and liquidity indicators. But this decision was suspended for the period February 10, 2014 - December 1, 2014 by decision of the Riscani Court (Chisinau municipality), which was later quashed by the Decision of the Court of Appeal on December 1, 2014. At the same time, the amendments to the Criminal Code, which increase the level of management and shareholders' accountability for the performance of the banks, were enforced only in July 2014 and the level of penalties was relatively mitigating compared to the magnitude of potential violations of the law.

[2] For example, the Law on Financial Institutions (Article 38), besides issuing warnings, allows NBM to impose fines to banks, to limit or suspend bank activities, or even withdraw activity licence if it is revealed that the bank has violated the law, got involved in risky and dubious actions which affect interests, and other violations.

Not the least, the adjustment process of the legal framework to prevent future crises and similar transactions was not completed. For example, courts may continue to issue decisions that affect corporate governance and the interests of depositors, NBM decisions may be suspended by court decisions, verification of shareholders' quality still concerns only those who hold equity stake exceeding 5% of the capital, shares of commercial banks can still be pledged or purchased from loans offered by offshore companies and the notion of concerted activity remains very vaguely defined in the legal framework.

Fraudulent transactions could not go unnoticed by NBM and the crisis at BEM, BS and UB can be considered a real failure of banking regulation. Any transactions with entities from abroad is carried out through SWIFT, to which NBM has also access and payments in national currency are as well monitored in real time[3]. NBM knew that the fragmented ownership in the 3 banks can generate additional risks. The conclusions and findings of the Kroll report drawn up based on data provided by NBM, confirm that at least the Banking Authority had the information which could reasonably rise suspicions concerning the concerted actions of several minority shareholders to obtain control on the banks. It is not clear why NBM hasn't made more effort to check and block changes in ownership and prevent dubious lending activity in the 3 banks[4]. All this became imperative, taking into account several hostile takeover attempts on relevant banks from Moldova in 2011. The IMF mission report of 18 November 2014, states that in 2011 NBM still benefited from technical support under which NBM received legislative solutions to strengthen and improve the regulating function on banking governance and a more transparent bank ownership. Policy recommendations have been partially approved by the Government accountable for this.

NBM did not use all the instruments provided by law to prevent banking fraud (Table 1).

Table 1. Measures that could have been taken de jure and which have been de facto undertaken by NBM

What could NBM have done?	What has NBM done?
Issue a warning [5]	Accomplished
Enforce and undoubtedly impose a fine to bank/banks and/or to shareholders [6]	Not accomplished
Withdraw the given confirmation to the bank's administrators [7]	Not accomplished
Limit or suspend the bank's activity[8]	Not accomplished
Withdraw licence or authorization [9]	Not accomplished
Require remedial measures from the bank [10]	Not accomplished
Block the activity of shareholders acting in concert[11]	Not accomplished
Set up a special supervision [12]	Accomplished , but with delay

Source: Law on Financial Institutions No. 550-XIII of 21.07.1995

What caused the delayed and inadequate reaction of the relevant institutions?

- ***The low level of independence of the National Bank of Moldova***. Currently, most of the acts adopted by the monetary authority may be suspended as a result of the referral to courts, and the entry into force of the regulations of the central bank is subject to legal expertise by the

[3] Excerpt from the Regulation on the supervision of interbank payments: the automated interbank payment System is the system through which the interbank payments are performed in Moldovan lei in Moldova, which consists of the real time gross settlement system (RTGS) and deferred net settlement system (DNS). The monitoring of the participants' activity in the system is carried out in real time and aims at quickly identifying problems that can cause major risks to participants or could disrupt the functioning of AIPS.
[4] According to article 44, Law on the NBM and article 38, Law on Financial Institutions.
[5] According to article 38, Law on Financial Institutions No. 550-XIII of 21.07.1995
[6] Idem
[7] Idem
[8] Idem
[9] Idem
[10] Idem
[11] According to article 15, Law on Financial Institutions No. 550-XIII of 21.07.1995
[12] According to article 37^1, Law on Financial Institutions No. 550-XIII of 21.07.1995

Ministry of Justice. Therefore, NBM activity can be easily blocked by various interest groups beyond, which undermines the effectiveness of the regulatory activity of the bank and its ability to respond promptly[13].

- ***Outdated monitoring system and processes at the NBM***. The fact that NBM did not timely detect dubious lending of such a magnitude, which took place simultaneously at 3 systemically important banks, reveals major shortcomings in NBM monitoring and supervisory instruments.

- ***Inefficient coordination among key institutions***. There is missing a consolidated view of the relevant institutions (the National Committee for Financial Stability, Security Council, NBM and NCFM) on the issue of financial security and measures to strengthen it. Therefore, the problem of the 3 banks was not discussed sufficiently by targeted institutions and the level of interaction among them was a mediocre one.

2. Poor administration at BEM in the Period Before the Crisis

Although Kroll report covered the period August 17, 2012 - November 26, 2014, the investigation of the basic factors which led to the decapitalisation of BEM, BS and UB had to start at least since 2009. The origin of the crisis can be considered the moment of the substantial worsening of BEM credit portfolio after having undertaken toxic assets from Investprivatbank, which went bankrupt in 2009, but in particular after the intensification of imprudent lending which started in 2010[14]. As a result, the share of non-performing loans in total loans increased from just 9.1% in Q1-11 to 31.9% in Q4-11, at the end of 2012 it was just 55.3%, at the end of 2013 - 58.4%, and this increased to 72.6% in Q1-15. At other banks, during the relevant period, the share of non-performing loans has considerably varied, being around 12-13%.

BEM lending activity of 2010-2011 requires at least as much attention as the recent events at the 3 banks. It is not clear why the authorities have not requested the investigation of this period as well, especially if we consider the conflicts among shareholders and the hostile takeovers of shares at BEM from May 16 to August 9, 2011[15] and in spring 2012[16], which resulted into a significant equity stake coming into the property of off-shore companies and later being transferred to companies from Russian Federation. This caused many management blockages, which affected even more the prudential bank activity. Most of the nonperforming loans accumulated by BEM, worth one billion MDL were conceded on March 18, 2013 to an offshore company with dubious reputation. Subsequently, the critical situation of BEM served as the main reason for conceding the state majority stake to Russian investors with a bad reputation. Shortly after, some shareholders used BEM shares held in the bank to guarantee loans granted by BS to other companies

What led to the BEM maladministration before the crisis?

- ***The lack of political will to ensure an efficient administration of a mainly state-owned bank.*** BEM was often used on political purposes, when granting loans to state owned companies or companies related to certain groups of interest or upon absorption of toxic assets from bankrupt banks. This has always put pressure on the quality of the bank's loan portfolio. In addition, the systemic status of the bank with the capital mostly held by the state, has induced BEM management to wrong decisions because the bank always had to be „saved" from bankruptcy (the „too big to fail" effect). It should be noted that although BNM warned the

[13] The publication "MEGA", 12th edition, Expert-Grup, 2015
[14] The Court of Auditors' Report of early 2011 was warning that paying attention to the financial situation of the loan beneficiaries and the irresponsible attitude towards the evaluation, checking and maintenance of pledges were characteristic aspects of the BEM lending activity (source: "Epic of the Savings Bank or how the giant collapsed", Expert-Grup, 2014)
[15] Based on the decisions issued by the Causeni Court, BEM shares were transferred to the company "Rietel Limited" registered in New Zealand. Subsequently, Rietel Limited has transferred most of shares to "Lectom LTD" registered in the UK (source: "Epic of the Savings Bank or how the giant collapsed", Expert-Grup, 2014)
[16] Based on the court decisions the 18.54% of shares held by Rietel Limited and Lectom LTD were transferred in equal shares to four companies in Russia (source: "Epic of the Savings Bank or how the giant collapsed", Expert-Grup, 2014) .

Government and the Security Council on the risky lending activity performed by BEM, no sufficient action to remedy the situation has been taken.

- ***Loopholes in the judiciary system and inadequate protection of property rights.*** This refers to the fact that the Moldovan courts can issue decisions that may affect the interests of depositors of commercial banks, which may undermine the country's financial stability. The transfers of ownership on BEM shares in 2011, which later contributed to the worsening of the financial situation of the bank, were based on decisions issued by the Causeni Court. These weaknesses became critical as a result of the slow and poor reaction to the changes in BEM ownership structure on behalf of NBM, Ministry of Finance and the Security Council.

3. Obscure Changes in the Ownership Structure of BEM, BS and UB

Apparently, the ownership restructuring in BEM, BS and UB served as a necessary runway for the suspicious operations and financial engineering at the 3 banks. In 2013, due to several restructurings in the ownership of BEM, BS and UB, equity stakes lower than 5% were awarded to companies and individuals. At first sight, one could not notice any affiliation therein, but according to the findings of KROLL experts, there is a high probability that the new shareholders have acted in a concerted way (both shareholders within the same bank and shareholders of BEM, BS and UB). Given that the equity stakes acquired did not exceed the 5% threshold, they could not be automatically qualified as significant stakes. As such, the transactions did not require prior permission from the National Bank[17].

NBM could have reasonably suspected that the acquisition of equity stake of less than 5% in the same period and in a similar way represented a concerted acquisition in order to avoid NBM permission. In this case, NBM could have blocked the voting rights. However, it did not happen and it further undermined the quality of corporate governance in the banks, which facilitated dubious loan granting to companies apparently affiliated to certain shareholders of the three banks. NBM failure to block the rights provided by these securities could be explained by its previous practice of tolerating similar transactions with the shares of other banks.

Another issue is the way in which the new shareholders of BEM, SB and UB acquired shares in 2013. In all the three banks, the new shareholders have purchased equity stake through loans and credits contracted from offshore companies and Russian banks. At the same time, it is unclear what types of securities or other warranties the shareholders provided to obtain this funding. It is certain, however, that the origin of the money used to purchase the shares is not transparent at all, but even obscure. Nevertheless, NBM failed to take proper action to ensure the quality of banks' ownership[18].

What enabled the obscure change in the ownership structure of BEM, BS and UB?

- ***The legislation did not provide restrictions on the purchase of the commercial banks' shares through loans granted by offshore companies***. Such restrictions would probably be exaggerated considering other companies, but would be justified in the case of such companies as commercial banks. The reason is that commercial banks operate based on the resources attracted from depositors at a rate of about 70%, respectively management decisions that could be induced by shareholders could generate major negative externalities.

- ***The legislation allows, under certain conditions, pledging shares held in commercial banks***. In the context of loans granted by offshore companies and Russian banks to certain shareholders, it is likely that the shares acquired were secured against the respective creditors. Therefore, this allows the concealment of the effective beneficiaries of the bank shares. Only in

[17] According to article 15, Law on Financial Institutions No. 550-XIII of 21.07.1995
[18] According to article 15^5 (3) Law on Financial Institutions No. 550-XIII of 21.07.1995: Any direct or indirect holder of share capital of a bank shall submit to the National Bank, upon request, information related to its business, including annual financial reports, income statements and other information necessary to carry out the prudential assessment under the manner and the regulations of the National Bank.

July 2014, the Law on Pledge has been completed with a semi-restrictive provision under which substantial shares in Moldovan banks' statutory capital may be pledged only with prior permission from the NBM. Given that the most dubious transactions were specifically made by shareholders holding less than 5% of shares (which may not be considered substantial), certain obscure interests may continue to abuse of this provision.

- ***The legislation does not provide sufficient criteria and mechanisms to identify affiliation of individuals, legal entities and residents of off-shore zones***. In 2013 the Law on financial institutions has been amended to prevent ownership of banks' share capital by residents of jurisdictions that fail to implement international standards of transparency. It seems, however, that NBM has not allocated sufficient internal capacity to identify affiliation. Given that numerous purchasers of shares used similar schemes and even the same bank and nearly identical bank accounts to pay for shares, it could have been really easy to suspect such an affiliation.

- ***Checking on potential shareholders' quality applies only to holders of substantial shares***. Thus, NBM examines just the quality of the potential acquirer who makes a transaction of shares exceeding 5% of the banks' share capital[19]. This explains the large number of shareholders with shares below 5% at BEM, SB and UB, who managed to avoid NBM verification. As a result, the ownership of the 3 banks has been supplemented with individuals and entities having dubious reputation and high probability of concerted activity that could influence management decisions. However, the plan of 5% is not relevant in the case of evident concerted actions. Under Article 15 of the Law on financial institutions, NBM is entitled to block the activity of shareholders who acted in concert[20].

4. Violation of the Basic Principles of Corporate Governance at BEM, BS and UB

Restructuring ownership has essentially undermined the quality of corporate governance within BEM, SB and UB. In some cases, top management representatives were tide by family relationship with certain shareholders, which undermined the shareholders' monitoring role over the management of the bank. At the same tine, in 2013, an individual who previously held the position of vice-director of BS was appointed as director of BEM, and according to Kroll experts, the individual was consulting the management decisions at SB in 2014. In addition, certain bank managers had evident family and business affiliations to shareholders and members of the Boards in other banks (in BEM, BS and UB). This has allowed the involvement of those banks in risky and even dubious lending activities, the purpose of which was apparently different from the one normally followed by commercial banks. Finally, the violation of basic principles of corporate governance was one of the fundamental factors which led to the decapitalization of BEM, SB and UB.

What caused the violation of the basic principles of corporate governance at BEM, BS and UB?

- ***Insufficient sanctions for persons with key functions in the fraudulent activity of the banks***. This concerns the inadequacy and ineffectiveness of existing instruments of accountability of persons holding decision-making position in the Board and executive management. Only in July 2014, the Criminal Code was amended and supplemented with provisions in this regard. In particular, there have been established penalties for board members and shareholders of banks for faulty or fraudulent bank management and other violations affecting lending rules, obstructing banking supervision and embezzlement committed by the bank director[21].

[19] According to article 15^2 and15^3 of the Law on Financial Institutions No. 550-XIII of 21.07.1995
[20] Article 15 (1) and (2), Law on Financial Institutions No. 550-XIII of 21.07.1995
[21] Articles 191 (2^1), 239, 239^1 and 239^2 of the Criminal Code of the Republic of Moldova.

- ***The newly imposed sanctions remain quite mitigating compared to the magnitude of the embezzlement that may occur***. Article 239[1] of the Criminal Code, provides a penalty in the form of a fine and imprisonment up to one year for faulty or fraudulent bank management. Art. 239 of the Criminal Code provides fines of up to MDL 600,000 or imprisonment from 2 to 7 years for violation of accounting rules which have caused damage in especially large amounts or bank insolvency. For comparison purposes, a crime consisting of especially large theft is punished with imprisonment between 7 to 12 years, without the possibility of imposing fines.

5. Financial Engineering and Artificial Boost of the Lending Capacity of BEM, BS and UB

Dubious lending activity was preceded by a series of financial engineering that had artificially increased the lending capacity of the banks and allowed the concealment of the gaps regarding the liquidity and the quality of the banking portfolios. BEM, BS and UB assigned the lending portfolios in favour of offshore companies. Liquidity obtained as such, was placed in the form of interbank deposits, which subsequently turned into loans granted to companies apparently linked to each another and then were assigned to offshore companies. The purpose of these transactions was to conceal the nonperforming loans in the balance sheets, which allowed additional funds for lending (from the decrease of the expenses' fund which the banks are required to maintain in an amount equal to the proportion of nonperforming loans). It is interesting that increased lending capacity was possible with the involvement of local banks (Victoriabank, Moldindconbank, Moldova Agroindbank), as well as of the Russian banks (Metrobank, Alef-Bank, Gazprombank and Interprombank) which had opened interbank deposits in the 3 banks. It seems that in 2013 NBM warned the management of BEM, BS and UB on the risks associated with interbank deposits and increasing concentration of exposures, but no remedial actions have been taken. At the same time, NBM has not been sufficiently diligent in combating such transactions, especially because the magnitude therein was reaching historic levels for Moldova.

Increasing obscure lending at BEM, BS and UB would have been impossible without the manipulation with liquidity and exposure ratios. In particular, the banks were opening deposits of up to 30 days in certain Russian banks (which they might have had mutual agreements with), then those banks opened bank deposits in the 3 banks for a period exceeding 30 days, with similar amounts and virtually on the same days[22]. After the expiry of 30 days for the deposits in Russian banks, they were returning for a day to BEM, BS and UB, and afterwards new deposits of up to 30 days were opened in Russian banks. These transactions had at least two purposes. First, it allowed the manipulation with the liquidity indicators of the 3 banks. Taking into consideration that the deposits at BEM, BS and UB opened in Russian banks were short-term ones (for a period up to 30 days), they were considered as liquid assets, and respectively, de jure, the reported liquidity levels were not affected. Second, the deposits of the three banks opened in Russian banks were used as collateral for the obscure loans granted to apparently affiliated companies. This helped to conceal the level of exposure to a number of borrowers with poor payment capacity and dubious reputation.

What allowed the artificial increase of the lending capacity of BEM, BS and UB?

- ***Insufficient regulation on the activity of creating inter-bank deposits***. Interbank deposits are common tools in banking practice as they can solve the problem of banks needing temporary liquidity. Nevertheless, in case of the three banks, the interbank deposits were not aimed at replacing certain short-term liquidity needs, but at concealing the structural liquidity shortcomings. Therefore, the lack of clear regulations for these activities that would cap the interbank exposure level allowed BEM, BS and UB to abuse of this practice. In 2013, NBM has

[22] Apparently, these transactions were taking place without money circulation, which means that the set up of mutual fund accounts consisted in preparing the necessary documentation without transferring financial resources.

introduced stricter regulations in this regard, but they could be applied only after about a year because they had been suspended by a decision of Riscani Court, Chisinau municipality.

- ***Calculation of liquidity indicators based on the information obtained as of the reporting day***. This allowed the three banks to manipulate the liquidity indicators through the withdrawal of the deposits held abroad on the reporting day, which allowed artificial increase of the liquidity level. At the same time, it allowed avoiding the formation of provisions, which contributed, de jure, to the increase of the liquidity levels of the banks, but which de facto increased the risk of bankruptcy.

- ***Incorrect calculation of banks' exposure*.** This concerns situations where certain loans issued by some banks are secured by interbank deposits opened in other banks. In these cases, the regulatory framework did not take into account the exposure of the bank granting such loans, considering the collaterals offered by another bank. Apparently, this legal vacuum was used as a legal "loophole" for granting dubious loans, without increasing de jure the exposure of BEM, BS and UB to debtor affiliated companies.

Conclusions and Recommendations

Although, elucidating the situation at BEM, BS and UB and the prosecution of the individuals involved is absolutely necessary, the identification of institutional and legal shortcomings that have allowed the 3 banks to engage in fraudulent financial schemes is not less important. Even if the authorities have partially adjusted the applicable legal framework, a series of legal and institutional loopholes remain and continue to present risks of similar crises in the future. For example, the courts may continue to issue decisions that may affect the interests of depositors and banks' corporate governance, the verification of the quality of banks' shareholders is still applicable only to holders of 5% of the equity capital, commercial banks shares may still be pledged or purchased through loans granted by offshore companies, the concept of concerted activity remains vaguely defined by the regulatory framework and the independence and efficiency of the NBM remains affected by the possibility of court interference.

NBM did not apply all its available instruments to counter the fraud committed by BEM, BS and UB. Dubious transactions and fraud simultaneously committed by the 3 systemic banks could not remain unnoticed by the NBM. Most likely, NBM knew or at least suspected the illegalities committed by the three banks, though it has not applied the necessary instruments prescribed by law. Basically, NBM just warned BEM, BS and UB, implementation some marginal legislative adjustments which could not prevent or block bank fraud. Still, NBM could have blocked the voting rights and other actions of the shareholders of the 3 banks who had evidently acted in a concerted manner. In addition, NBM could file fines to BEM, BS and UB, limit or suspend the activity of these banks, or even withdraw their activity licence. However, NBM preferred to establish a special administration regime only by the end of November 2014, after the embezzlement in a proportion of about 12% of GDP has been done. The causes of such behaviour could be related to the lack of will or institutional capacities, low level of independence of the National Bank, inefficient internal systems and procedures for banks' monitoring and supervision by the NBM and ineffective coordination among key institutions responsible for financial stability (National Committee for Financial Stability, Security Council, NBM and NCFM). Therefore, the crisis of the 3 banks would not have been possible if the institutions responsible for financial stability in the country had been robust, independent and show enough will.

To better understand the origin of the crisis at the 3 banks it is necessary to extend the period of analysis, to include at least the period between 2009 and 2011. The origin of the crisis may be considered to have begun with the substantial worsening of BEM credit portfolio after overtaking toxic assets from Investprivatbank, which went bankrupt in 2009, but particularly from the intensification of imprudent lending from BEM since 2010 and hostile takeovers of bank shares in 2011-2012. Ultimately, the BEM maladministration up to the crisis was possible due to the lack of political will to ensure the

effective administration of a mainly state owned bank and because of shortcomings in the judiciary system and inadequate protection of property rights.

The obscure changes in the ownership structure of BEM, BS and UB, which happened through loans granted by offshore companies, served as main runway for further fraudulent activity. This was possible since the legislation was lacking restrictions on the purchase of shares in commercial banks though loans granted by offshore companies. Another problem is that the law allows, under certain conditions, using shares owned at commercial banks as collateral, which facilitated the concealment of the final beneficiaries of the bank shares. In addition, the legislation did not provide sufficient criteria and mechanisms for the identification of affiliated individuals and legal entities and residents of offshore zones, who allowed the concerted activity of the 3 banks. Finally, since the verification of the quality of potential shareholders applies only to holders of substantial stake, individuals and entities with dubious reputation easily got ownership of a stake lower than 5% of the share capital.

The violation of the basic principles of corporate governance, which followed the ownership restructuring at BEM, BS and UB in 2013, was one of the fundamental factors of the decapitalisation of the 3 banks. This was possible due to loopholes in the legal framework regarding penalties for fraudulent bank activity to individuals holding key positions. Although in 2014 the Criminal Code was supplemented with certain provisions on faulty or fraudulent bank management and other violations specific to the banking system, the penalties therein remain mild as compared to the magnitude of embezzlement that may occur.

Dubious lending activities were possible in the result of certain financial engineering that allowed the concealment of exposure and liquidity indicators. Insufficient regulation on creating interbank deposits has allowed this fact, because banks were providing mutual financing having the exclusive purpose to manipulate the exposure and liquidity indicators. The calculation methodology of liquidity indicators also contained certain loopholes, which were used on manipulation purposes.

Eliminating legislative loopholes and institutional vulnerabilities is an indispensable condition for the long-run consolidation of the banking sector and ensure its sustainable development. In particular, the following is necessary:

- to remove any possibility that allows offshore companies to interact with commercial banks: prohibiting the respective companies from owning bank shares, buying bank shares from loans granted by offshore companies, pledging bank shares of offshore companies or selling bank loans portfolios to such companies;
- to develop the legal provisions on the establishment of concerted actions of shareholders, in order to ensure more clarity for both the regulator and the society, with respect to these shares;
- to ensure a higher level of professional independence and personal protection for NBM officials who are responsible for the regulatory framework, in order to be able to exercise their responsibilities in an efficient manner;
- to consolidate the NBM level of independence, in order to prevent political interference in the bank's activity and to exclude any justification on behalf of the institution in case of regulatory failure. In this regard, it is necessary to eliminate the courts' ability to suspend NBM decisions, which is not only contrary to the international good practices, but it also creates premises for external interference to block the regulatory activity;
- to increase NBM independence while improving its accountability through regular auditing by an external counterparty that would provide independent and unbiased analysis on the effectiveness of bank regulatory activities;
- to improve communication among the main institutions responsible for financial stability in the country: NBM, NCFM, Ministry of Finance, the National Committee for Financial Stability and the Supreme Security Council. All these institutions must ensure operative exchange of information on a regular basis, to meet more often and share an integrated vision on the country's financial security.