



Ambasada Britanică
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POSITION NOTE

on Converting into State Debt the Emergency Loans Granted by NBM in 2014/15 to Certain Commercial Banks

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The position thereof is supported in the principle by the following members of the Task Force for Emergency Reforms (see the Annex for more details): Alexandru Zgardan, Alexei Buzu, Eugen Ghiletschi, Dumitru Vicol, Ion Gumene, Ion Guzun, Ion Preașca, Nadejda Hriptievschi, Sergiu Gaibu, Stas Madan, Vadim Gumene, Veaceslav Negruta (in alphabetical order).

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Preliminary note

Considering the complexity and sensitivity of the subject dealt in this note, the authors come with the following 3 clarifications:

1. The ultimate problem refers to the solution agreed by decision makers in the case of the three problematic banks. The solution consisted in empowering the Government to secretly issue state guarantees for the emergency loans granted by NBM through the procedure of assuming responsibility towards the Parliament. Respectively, the responsibility assumed by the Government on 26 September 2016 is the result of commitments undertaken along with the issuance of the guarantees in 2014 and 2015.
2. This note does not aim to directly attack the Ministry of Finance or the National Bank on Moldova, which finally were constrained to execute the provisions of guarantees issued in 2014 and 2015.
3. However, we believe that the Parliament, the Presidency and governing policymakers could have made much more effort to identify alternative solutions, at least by testing the constitutionality of guarantees issued in 2014 and 2015 and conducting consultations with civil society and relevant experts.

Defining the Issue

On 26 September 2016, the Government assumed responsibility for the draft law stipulating the conversion of guarantees granted in 2014 and 2015 to NBM loans for Banca de Economii, Banca Sociala and Unibank into state debt¹ (Government Decision No. 1085 from 26 September 2016 on assuming responsibility on the draft Law on the issuance of government bonds for execution by the Ministry of Finance of the payment obligations derived from state guarantees no. 807 of 17 November 2014 and no. 101 of 1 April 2015, (hereinafter the draft Law from 26 September 2016 on issuance state bonds in order to execute the Government guarantees) Official Monitor of the Republic of Moldova No. 329-336 from 27 September 2016).

This measure only concerns the enforcement of the legal provisions² according to which, if the loan beneficiary is not able to reimburse the debt it shall be repaid from the state budget. Thus, the guarantees turn into state debt with the appropriate fiscal implications due to bankruptcy of the three banks. In addition to the law enforcement, the Government has appealed to this measure taking into account two other essential aspects. First of all, to avoid another negative image in case of not honoring the payment obligations to the NBM, which would undermine the negotiations with the IMF on a potential financial memorandum. Secondly, this measure has assured the protection of NBM's independence. If the Government wouldn't had ensured the conversion of guarantees, NBM reserve fund would had a debit balance, which, according to Law of the NBM³ would had obliged the state, represented by the Ministry of Finance to transfer the outstanding amount to the NBM.

However, we witness at least **6 issues** related to the nature and manner how this decision was made:

¹ The draft Law on the issuance of government bonds for execution by the Ministry of Finance of the payment obligations derived from state guarantees no. 807 of 17 November 2014 and no. 101 of 1 April 2015.

² Government Decision No 938 of 13.11.2014 and Government Decision No 124 of 30.03.2015

³ Art 19, (6) of Law on the National Bank of Moldova no.548-XIII of 21 July 1995,

1. Insufficient transparency in the decision-making. The Parliament, Government, NBM and other relevant institutions did not organize any consultations or debates on the existing alternatives of overcoming the banking crisis. Generally, it is surprising that a decision with such pronounced budgetary effects (increase of the state budget by 37%, up to MDL 51 billion) was adopted in serious breach of the basic provisions on transparency in the decision-making. Presenting the draft law during meetings of parliamentary committees and placing it on Parliament's website is welcomed. However, the consultation process of such an important project should include the organization of public consultation, the assessment of its macroeconomic impact as well as the examination of international practice of other countries that had experienced similar banking crises in the recent years⁴.

2. The decision was taken avoiding the Parliament through responsibility assumed by the Government, at the expense of the basic democratic principle of division of state powers, control of the Executive by the Legislature and, respectively, with many doubts about its constitutionality (taking into account the pronounced fiscal implications). Doubts concerning the lawfulness of the last liabilities assumed by the Government are fueled by the fact that these are usually assumed in case of force majeure events that endanger the state, people's lives or when some social relations must be immediately regulated – but none of these conditions were met.

3. The decision was made on the background of weak progresses in addressing the aftermaths of the banking frauds. The process of returning the money stolen from the 3 banks is very slow and nontransparent, and the criminal investigations generated modest results, at least that is what can be seen.

4. Conversion of guarantees issued by the Government into state bonds emphasize the effect of moral hazard created by the issuance of the guarantees in 2014 and 2015. We must realize that moral hazard has been created with the issuance of the guarantees in 2014 and 2015, and the Government's Decision of 26 September was the result of the provisions enforcement. The *moral hazard* is characteristic both, for individuals who tend to not examine the financial situation of banks knowing that the state will fully recover the deposits in case of bankruptcy, and for the bank shareholders and managers of bad faith. Thus, the potential banking fraudsters will be able to act without any concern and fear, being sure that these costs will be always covered by people. The tendency to assume unjustified risks is generated by the low accountability of both those involved in the banking activity, and those in positions of accountability in state institutions.

5. The effective interest rate of 5% on bonds issued for a period of 25 years doesn't have any economic grounds. According to the previously published Information Note⁵ this rate results from the need of covering losses caused by the inflation. But, the effect of the compound rate is not taken into account. Though, an effective rate of 5% is not enough to cover the losses from the annual inflation of 5% during

⁴ Iceland offered one of the best examples of how to solve a banking crisis. This country refused to comply with the "too big to fail" rule and did not bail out banks, leaving aside all threats made by IMF and EU. The President organised a referendum to consult citizens on whether the Government should save banks and burden his own people for many years or not. Obviously, 95% of population voted against, which led to the collapse of banks. Early elections were organised and all those responsible of banking fraud were put in jail. For now, it seems to be unreal for our country, but the international practice at least must be studied to understand how the crisis from our country can be addressed.

⁵ Draft Law No 257 of 08.06.2016

25 years. Introduction of this economically unjustified rate will add about MDL 11.5 billion to the total debt that is to be paid by citizens.

6. Liability assumed by the Government is the effect of guarantees issued in 2014 and 2015 who defied basic principles of fairness. Even though a part of the debt will be covered on account of the assets recovered from the three banks, probably the largest part of it will have to be reimbursed from the taxpayers' account. In this context, the inequity is determined at least by 2 factors: (i) losses caused by bank frauds are supported by taxpayers and not by responsible individuals / institutions who failed to prevent, reveal and / or elucidate these frauds; (ii) about half of the guarantees were issued for interbank deposits, so they had nothing in common with individuals who had deposits at the bankrupted 3 banks.

What alternatives exist?

Technically, such a law had to be drafted and adopted in order to enforce Government Decisions No 938 of 13.11.2014 and No 124 of 30.03.2015, as well as the Memorandum of Understanding, signed by NBM and the Ministry of Finance. This understanding aims to confer a certain status to loans granted by NBM by issuing Government bonds that would exercise the Government's payment obligations assumed through the two guarantees. Thus, during 7 working days since the Law was published in the Official Gazette, the Ministry of Finance will issue and transmit to NBM Government bonds with a total amount of MDL 13,583.7 million at an effective interest rate of 5% and for a period of up to 25 years. In addition, the law states that this amount will be adjusted to the amount of loans unpaid by the three banks at the date of bonds issue, therefore it will be diminished by the amount recovered from the sales of assets during the liquidation process. The NBM profit available for redistribution⁶ will be also directed to the Ministry of Finance to redeem the bonds.

At the moment, the Government has chosen only the option to implement the provisions of previously adopted Decisions. However, we propose to explore three alternative options to the issue of the Government bonds, which could be at some time taken into account:

I. Challenge the legality of NBM to grant loans, implicitly of the GD No 938 of 13.11.2014 and GD No 124 of 30.03.2015

The NBM received the right to grant emergency loans under the Government guarantee according to Law No 187 of 28.09. 2014 on Amendments and Addenda to Certain Legislative Acts, which was also approved by the Government liability. Thus, three important laws were amended: Law on Financial Institutions, Law on NBM, and Law on Public Debt, State Guarantees and State On-Lending, which brought legal support to further guarantees issued by the Government. This process must take into account 3 major elements that doubt the legality of granting these loans:

1. Amendment of Article 18(3) of the Law on NBM – by Law No 187, in Article 18(3), words *state guarantees* were supplemented by words *or securities issued by the Government*, which, in case of systemic financial crisis or risk of its occurrence, actually allow issuing state securities to capitalize banks *and state securities to guarantee emergency loans granted by NBM on the basis of*

⁶ Effectively, the State Budget will lose an important source of income for many years, considering that the profit transferred to the State Budget constituted 889.4 million in 2015, 125 million in 2014 or 113 million in 2013

the decision taken by the national body in charge of managing systemic financial crises. The National Financial Stability Committee, which represents the national body in charge of managing systemic financial crises, is not empowered to take decisions, but only to make proposals. Moreover, a national body in charge of managing systemic financial crises cannot be established by a Government decision, as it has authorities that are not subordinated to the Government. The Committee decisions and proposals would be relevant and imperative for all participant parties only if it were established by the Parliament. Thus, we believe that the words *guaranteeing emergency loans granted by NBM on the basis of the decision taken by the national body in charge of managing systemic financial crises* do not have legal relevance.

2. Article 18(2¹) of the Law on NBM – this provision denotes another inconsistency in the granting of loans by NBM. Paragraph 2¹ of this Article provides that NBM can grant emergency loans to **solvent banks**, however on the date when the decision was made the three banks could no longer be qualified as solvent. The imperative legal nature of this provision is based on an elementary economic logic – it is not sound to grant a loan to a debtor known apriori not to be able to reimburse the loan.

3. The Government assuming liability towards the Parliament – By assuming liability for Law No 187, the Government avoided Parliament's involvement in guaranteeing the loans granted by NBM. Besides, assuming such guarantees is within the Parliament's mandate. Concurrently, this tool becomes an ordinary practice for our country. In the last 3 years 29 laws (some with a major impact on public finance) were adopted through such a procedure. Article 106 of the Constitution confers this right to the Government, but in these circumstances we think this is an abuse. The international practice proves that there are still democracies that maintain into the national legislation the possibility for the Government to assume liability, but this is allowed under extremely limited conditions (for example: natural disasters, war and other force majeure events).

Taking into account the above-mentioned, we believe that the Constitutional Court should express its view on the legality of the legislative provisions that allowed NBM to grant loans under the Government guarantee. In addition, it is important that the High Court expresses its view on the manner the legislative amendments were approved, as avoiding the Parliament and the President in financial areas of national interest can seriously affect the country's image. If these are found illegal, NBM will have to immediately take on the losses resulted from granting loans and adjust the balance sheet by recognizing them as losses.

The positive effect of this solution would be that loans granted by NBM will no longer be reimbursed by taxpayers, but from the future revenue of NBM. On the other side, some persons would invoke the challenge of a negative effect, stating that if NBM assumes the losses and makes the necessary accounting records, it will operate for years at a loss, which could decrease its credibility in the eyes of commercial banks. Another repercussion is that the Government anyway will be obliged to cover NBM's losses through state securities. However, this would only have happened for the negative balance amount of the reserve fund, which could be less than the value of guarantees converted into state debt. As well it would have taken place only after an external audit on the financial situation of the NBM.

II. Repayment in installments of the Government debt towards NBM

The Government proved it can be very inventive as regards the amendment or approval of the legal framework necessary *to solve* a financial crisis. More than that, acknowledging the risk of losing the Parliamentary/public support, the Government shows cleverness as to how approve the given rules. If the Government could identify a solution how to guarantee the loans granted by NBM to the three bankrupt banks, why couldn't the Government assume responsibility for the actual reimbursement of loans to NBM? Specifically, instead of issuing Government bonds that are to be settled from the collective revenue of the state budget, a new special fund could be created within the budget, which will be used to repay gradually the debt to NBM. The revenue to this fund should be expressly specified as obtained from the sales of assets of the liquidated banks, from money resulted from investigations carried out or other exceptional sources like the NBM profit annually transferred to the state budget. Respectively, the positive effect would be that debts to NBM would not be settled using budget revenues accumulated from taxpayers, but from sources related directly to banking activity and those obtained after the selling of liquidated banks assets. This could also help monitor strictly the money recovered as a result of the initiated investigations. Moreover, even if bonds are issued by the Government, a solution could be to indicate exactly the budgetary funds from which these bonds will be redeemed, thus trying to avoid the taxpayers' contribution.

III. Conversion of debt into an investment fund

According to this option, financial resources collected from the budget are not paid to NBM, but into a fund established to manage this money and to offer affordable loans (soft loans) both to the population and to small businesses. This will ensure a completely different public perception, the money being put into their service and support. In accounting terms, the NBM debt will be offset with the resources from the respective fund and should not record losses. In order to avoid abuses those resources will not be granted directly, but will be distributed via qualified commercial banks and micro-financing institutions on the basis of predefined objective criteria. Hence, this mechanism will be a lever for strengthening the financial sector and improving the portfolio. The financial institutions should observe a range of criteria to remain in the financing program. At the same time, these resources will be focused on social needs and economic development of the country, improving a range of socio-economic aspects.

Final Conclusions and Recommendations

The banking fraud is the result of corporative governance shortcomings in some banks, drawbacks in state institutions, including those responsible of ensuring the financial stability, and other malicious decision makers from state institutions and banks. Therefore, they should be responsible for the recovery of the defrauded assets, and a benevolent Government will do its best to transpose this burden on these very stakeholders.

The Law from 26 September 2016 on issuance of state bonds in order to execute the Government guarantees derives from commitments undertaken in 2014 and 2015. However, we consider that not all necessary measures have been undertaken by the competent authorities in order to prevent the activation of guarantees: there were not organize consultations/public debates with civil society and relevant experts on possible alternatives; it was not challenged the constitutionality of the 2014 and 2015

decisions to issue such guarantees and was not developed an assessment of the guarantee's macroeconomic impact. Also, a major problem is the way how the guarantees were activated - the Government assumed responsibility avoiding the clearance from the Parliament (or the Parliament avoided taking responsibility for this action).

Thus, in order to clarify all legal aspects and determine all existing solutions to minimize the impact of the banking fraud on the society we call the responsible institutions the following:

- the Constitutional Court should express its view on the legality of the legislative provisions that allowed NBM to grant loans under the Government guarantees in 2014 and 2015;
- start an inquiry to investigate how the crisis of the three banks was solved;
- expedite the investigations of thefts in the banking sector and the recovery of misappropriated funds;
- conduct an independent external audit of NBM, present it to the general public, to establish clearly the accuracy of the decisions made by it during the banking crisis;
- clearly define the individual and collective responsibilities of all those involved in triggering, boosting and "solving" the banking crisis with further appropriate actions;
- review the Memorandum of Understanding between NBM and the Ministry of Finance and the related decisions and remove the 5% interest;
- establish that the loan shall be repaid from non-fiscal budgetary revenues (e.g. recovered assets from the three bankrupt banks, NBM profit transferred to the state budget, privatization etc.);
- review / amend the legal framework to clarify the manner and cases when the Government can assume responsibility by avoiding the Parliament's clearance.

Annex: Task Force for Promotion of Emergency Reforms

Expert Group set up a Task Force for Promotion of Emergency Reforms in the Republic of Moldova. The Task Force is focused on 3 priority sectors: **(i) financial sector; (ii) energy sector; (iii) state-owned enterprises**. We think the Republic of Moldova accumulated most of its weaknesses in these sectors and the most imperative reforms of economic policies should be undertaken in these sectors namely.

The Task Force is formed of about 40 persons with an irreproachable reputation and with a rich experience in at least one of the three listed sectors.

Three objectives of the Task Force:

1. Raise the Government's awareness to reform the three priority sectors;
2. Inform the general public on the main trends / issues / risks identified in the three sectors, and on the necessary reforms;
3. Provide solutions to upgrade the three priority sectors.

The Task Force Activities:

- Permanent monitoring of trends and authorities' actions in the three sectors;
- Draw up analyses / short position notes on the trends / issues / risks identified and recommendations proposed for the three sectors (analysis will be drawn up by Expert Group and the members of the Task Force will express their views on them prior to the publication);
- Promote petitions to boost reforms in the three sectors (Expert Group will draft and coordinate petitions and the members of the Task Force will express their views on the petitions' content and will promote them publicly);
- Attend press conferences in other forms of public promotion of reforms in the three sectors.

The Task Force Coordinators

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Activity Period: The Task Force started its activity on 28 September 2016. Its activity is not limited in time.

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