

Are the Sanctions Envisioned by Law Enough to Deter the Bank's Improper Behaviour?

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Executive summary

To protect the interests of depositors and to maintain the stability of financial system, the central banks or other assigned institutions have the duty to ensure the regulation and prudential supervision of commercial banks. These objectives can't be achieved unless prudential norms and indicators are established, their compliance is monitored, and if appropriate, sanctions are imposed to prevent and limit the risks. In addition, taking into account the possibility to calibrate risks, the sanctions aim to correct the modus operandi of the bank as a whole, and individually, of key persons, who ultimately decide on the level of assumed risks. The international financial leaders have reached a consensus on the need to strengthen supervision and prudential regulation framework because of pressing negative effects and frequency of banking crises. The new Basel III Agreement is the outcome of many debates and covers a number of reference norms designed to reform and strengthen the worldwide financial industry. As regards the relevant intervention measures and sanctions, the new provisions aim to standardize both their level and implementation mode or triggering conditions. Though the new provisions fundamentally affect the bank's profitability, a number of countries started to implement them in 2011, being aware of the need to maintain the macro-prudential balance.

The Moldovan national authority assigned to supervise the banking sector (NBM) did not have the capacity to adjust in due time the relevant regulations because it was constrained by the political and judicial environments. Though the 2014-2015 banking crisis revealed the risky and fraudulent activity of some banks, the sanctioning mechanism of that time proved itself incapable of deterring some people from getting involved in extremely risky activities and, finally, of avoiding the committed frauds. Besides the low level of sanctions, the intervention levers and capacity to impose fines was significantly limited by the improper legal framework that has allowed other state institutions to cancel the NBM's decisions. As a result, the crisis, triggered by significant deviations in the prudential activity of the banks, revealed that the intervention mechanism is inefficient, the consequences of the improper behavior are momentous, activity standards are eroded and even that the banking ethics declined.

It was only in 2016 when the political decision-makers, being practically forced to rectify the situation in the banking sector and resume external financing, initiated a number of amendments to the basic banking legislation in order to harmonise it with the international practices. During the last year, a number of amendments aimed to increase the capacity of intervention and of surveillance tools, including sanctions, were made to the Law on Financial Institutions. Thus, following the approval of the aforementioned amendments and the Bank Recovery and Resolution Law, the level of sanctions increased significantly, about 10 times, and tends to correlate with Basel III. However, an important aspect is that the new sanctions cannot be imposed retroactively on acts committed before they were enacted, in other words, on the acts committed during the period of banking fraud.

Taking into account the process of reform, through this Note we intend to carry out a comparative and qualitative analysis of the existing financial sanctions from the perspective of best international practices, especially the European Community legislation. The objective consists in determining how the corrective measures stipulated by the current national banking legislation can foster a change of the culture and behaviour in the banking environment. Though in the case of banking fraud we are aware of the role of other types of sanctions, such as the criminal ones, we state however that these are rather a reaction to an already committed act. Therefore, we will further focus our attention only on the sanctions that may be imposed by the NBM under the banking legislation, or if imposed in due time they aim to rectify the identified shortcoming at an early stage and to bring the bank on a prudent activity line.

The extent to which the banking environment may be subject to financial sanctions: EU vs. Moldovan practice

The EU regulatory and supervisory authorities, along with the ones from the United States, are the benchmark in terms of financial sanctions imposed to the banking environment. In addition, the European community is one of the pioneers in implementation of the Basel III Agreement, which tends to be applied in all Member States in a harmonised manner. Thus, to appreciate the legislation on sanctions imposed on domestic banks, we find it relevant to expound the legal provisions existing in EU and the ones existing in our country. At the same time, since the EU Member States have the right to add other sanctions in the national legislation, Annex 1 comes to present a comparative analysis of sanctions applicable in the banking environment of several countries, with relatively different levels of development of.

Level of Sanctions Applied in the European Union

The EU founding treaties empower the EU community bodies to impose only administrative sanctions, which are included in the regulations and directives in force. However, given that the provisions of regulations are directly applicable to all Member States, while the provisions of directives should be transposed in the national legislation in order to have legal effects, the European Central Bank (ECB) has the competence to apply sanctions and remedial measures stipulated in the regulations, whilst the national authorities have the competence to enforce the provisions stipulated in the directives. However, the amendments made in last years to some directives and regulations governing the banking activity in Europe have standardised in a certain way the level of sanctions and remedial measures.

Thus, as regards the European banking union, the relevant regulations grant ECB the right to apply remedial actions and sanctions to supervised entities in order to achieve the key objective, particularly to maintain the collective financial stability¹. The remedial actions or sanctions are usually applied after evaluating certain stress tests indicators that would reveal shortcomings in the bank's management or financial issues. Financial sanctions may be applied to the managerial team for unsatisfying management, weak risk administration, insufficient corporate planning or improper internal controls. On the other hand, the sanctions applied for the identified financial issues are related to improper level of capital, large volume of non-performing assets, low liquidity, unjustified dividends and excessive bonuses, or non-submission/distortion of financial statements. However, at the first stage, sanctions and remedial measures tend to be applied informally in order not to destabilize the financial market, and if appropriate, they may be made publicly to ensuring a higher intervention level.

In terms of value, the sanctions applied by ECB are envisioned in the **Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the European Central Bank to impose sanctions**, (a fine of up to EUR 500 thousand levied on legal entities or a fine of up to EUR 10 thousand levied on legal entities per day of infringement for a period of maximum 6 months), and in the **Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions**

¹ The 2008-2009 financial crisis revealed the speed with which problems may spread in the financial system, especially in a monetary union, as well as how such issues directly affect people, requiring injection of public money in order to prevent systemically important banks from going bankrupt and the crisis from extending to other areas. In 2014, a new European structure was established to eliminate such shortcomings, particularly the Single Supervisory Mechanism (SSM) consisting of ECB and national supervisory authorities. The SSM aims at supervising the biggest banks in the eurozone (the rest of the banks remain under direct supervision of the national authorities), ensuring safety and soundness of the European banking system and increasing the financial integration and stability. This mechanism supervises directly over 120 systemically important banks from the participating countries¹ that hold about 80% of the banking assets in the eurozone

(a fine of up to twice the amount of the profit gained or losses avoided because of the breach where those can be determined or up to 10% of the total annual turnover, or up to any other ceiling envisioned in the relevant community acts). As a result, the phrase *any other ceiling stipulated in other relevant community acts* allows applying significant financial sanctions. The sanctions are calibrated with time period in which they occurred, financial or even social impact and aim at full rectification of the caused damages.

As regards the national banking sector supervisory authorities, the legal framework harmonising the applied sanctions is represented by the **Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms**, which aim to harmonise the prudential and supervision frameworks at the level of the entire Union. According to it, the sanctions for individuals accounts for up to EUR 5 million, while for legal entities – up to 10% of the total net annual turnover or twice the amount of the derived profit.

Level of Sanctions Applied in the Republic of Moldova

The NBM has the competence to apply financial sanctions and remedial actions to domestic banks, as provided for in the existing banking legislation. However, in addition to these administrative sanctions, there are other types of sanctions that may be applied by other state institutions to the persons in management positions, on the basis of criminal or competition legislation at the bank level. The national regulatory framework aiming to ensuring a correct conduct of the banking activity, including sanctioning and remedial tools in case of deviations, consists of three basic laws:

Law on the National Bank of Moldova – is the law regulating the NBM activity, it practically grants to the central bank the right to apply sanctions, including financial ones, and remedial measures in cases when a bank or its staff violates this law, other NBM regulatory acts or when their activity is risky and improper. The law does not stipulate expressly what sanctions and measures may be applied, making reference to the sanctions and remedial measures stipulated in the Law on Financial Institutions. However, the law describes the conditions for applying sanction, persons allowed to apply sanctions, limitation periods and circumstances in which they are applied.

Law on Financial Institutions – is the key document regulating the domestic banking activity, it contains detailed information on sanctions and measure that may be applied to commercial banks, persons in management positions (administrators) or banks' direct and indirect shareholders. These sanctions are applied depending on all relevant circumstance, such as severity and duration of the violation, degree of fault of responsible person or the caused damage. In addition, the amendments made during 2016² changed significantly the level of financial sanctions existing at that time and included sanctions for shareholders too. Thus, **the financial sanctions increased around 10 times**, as follows:

- fine for the bank – from maximum 0.5% of the capital value to maximum 5%;
- fine for administrators – from maximum 10 average salaries in financial sector to maximum 100 salaries of the administrator for the last year of activity;
- fine for direct and indirect owners of equity stakes in the bank's share capital – up to 100% of the amount of the equity stake in the bank's share capital calculated at the nominal value.

² The Law on Financial Institutions was amended in the part related to sanctions by Law No 233 of 3 October 2016 and Law No 182 of 22 July 2016

However, the amendments made to the Law on Financial Institutions make references to the Bank Recovery and Resolution Law, so that, in cases envisioned by it, the NBM may apply recovery and resolution measures or sanctions, including financial ones.

Bank Recovery and Resolution Law – as a tool for maintaining financial stability, this law creates the legal framework required to intervene in a commercial bank when its activity keeps worsening. Besides the intervention tools, this law grants the NBM the right to apply certain sanctions and remedial measures. The sanctions may be in the form of a written warning, a public warning, a fine of up to 10% of the total net annual turnover levied on banks, a fine of up to MDL 1 million levied on individuals or a fine of up to twice the amount of the profits gained because of breach and other measures in the form of temporary prohibition to hold an office in a bank by any member of the management body from that bank. The measures and sanctions may be applied simultaneously or independently, and may be made publicly and disclosed, following the personal data protection requirements and depending on the effect they might produce. At the same time, the sanctions and measures applied under this law should be efficient and proportional with the found acts and should have a deterrent effect on the banking sector.

Draft Law on Banking Activity and Investment Firms³ - for purposes of adjusting the national legislation to the best international standards and practices related to licensing, regulation and supervision, the NBM prepared a draft law that once adopted will replace the *Law on Financial Institutions*. Thus, the draft also envisages amendments related to the level of sanctions applied to banks, administrators or other key persons, their extension and adjustment to the European framework. The first draft version maintains the existing sanctions (a fine of up to 5% of the value of bank's capital levied on a bank; a fine of up to 100% of the size of the stake calculated at the nominal value levied on holders of equity stakes, and a fine of 1 to 100 average salaries of the sanctioned administrator for the last year levied on administrators), and supplements them with the ones envisioned in Directive 2013/36/EU, ⁴particularly:

- a fine of up to 10% of the total net turnover achieved in the previous financial year levied on banks or a fine of up to twice the amount of the profits gained, where those can be determined;
- a fine of MDL 5000 (five thousand) to MDL 100 (one hundred) million levied on individuals.

Though the level of sanctions stipulated in the draft law does not differ much from the one stipulated in the existing laws, the *a fine of MDL 5000 to MDL 100 million levied on individual* is a new element, needed to guarantee the impact on the risky and fraudulent banking activity. At the same time, the sanctions applied depending on the gained profit come to place a particular responsibility on administrators and reduce their appetite and moral hazard produced by banking fraud and decapitalization of the three banks during 2014-2015.

³ Draft Law on Banking Activity and Investment Firms (the transposition of Directive 2013/36/EU of 26 June 2013 and Regulation 575/2013 of 26 June 2013); <http://www.bnm.org.ro/content/proiectul-legii-privind-activitatea-bancilor-si-societatilor-de-investitii-transpunerea>

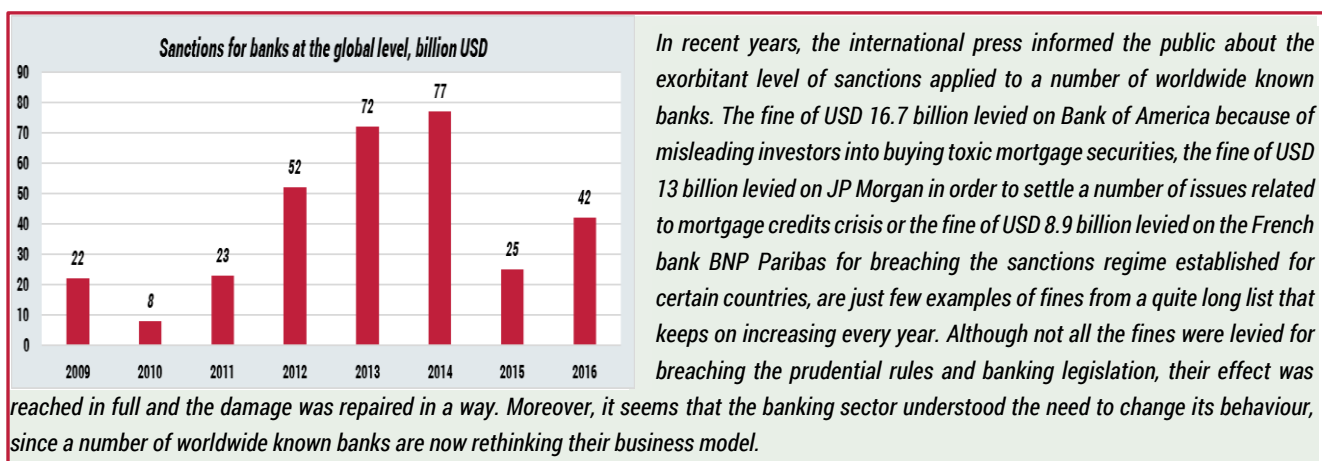
⁴ The Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

How can financial sanctions correct the banks' modus operandi and reduce bankers risk appetite?

We can say directly that the world's banking supervisory authorities needed a large-scale financial crisis to strengthen their procedures of intervention and sanctioning of banks. The international result, namely the public funds of billions of dollars injected in problematic banks, triggered lengthy discussions on the need to strengthen the supervisory and prudential regulation framework. A number of regulations were drafted and finally included in the Basel III Agreement after the governments of the G20 platform had accepted them on the basis of the commitments made under *the Declaration on Strengthening the Financial System*⁵. The provisions of this Agreement are in fact the cornerstone for the new EU regulatory and surveillance framework, and then the Agreement will be transposed in the national laws of the Member States. Thus, according to the general concept, the supervisory authorities monitor the banks' activity on the basis of a number of qualitative indicators for banks' capital and other balance-sheet items, rectify the identified shortcomings by financial sanctions and other remedial measures and interfere with the recovery and resolution mechanism at that time when the situation tends to deteriorate significantly.

All these measures aiming to strengthen the regulators' supervisory competences may be also assessed from the perspective of financial sanctions applied globally in recent years. Statistically, the figures reveal a quite strong inverse correlation between the crises periods and applied sanctions, so that, the deterioration of financial indicators leads to more intervention and remedial measures and higher amounts and levels of sanctions. According to some researches⁶, since 2008 – the year regarded as the trigger of the global financial crisis, the banks around the world were subject to financial sanctions and penalties amounting to about **USD 321 billion**, most of them were applied by the US supervisory authorities. The banks paid penalties of **USD 42 billion** (box 1) in 2016 alone, by 68% more than the previous year. Most of them were the authorities' reaction to the banks' previous behaviour. However, the biggest share of the total amount of sanctions – 63%, was applied by the US regulatory and supervisory authorities, while the authorities from Europe and Asia were more timid or more restrained in this regard.

Box 1



Source: Author's compilation on the basis of Boston Consulting Group data

⁵ Declaration on strengthening the financial system –London Summit, 2 April 2009.

⁶ Staying the Course in Banking, Global Risk 2017, Boston Consulting Group.

However, whilst the banks are now somehow bearing the consequences of their irregular and extremely risky, although imposing and quite costly activity, these amounts are much lower than the losses caused by crisis or the public funds injected by governments to save certain banks from collapse. However, in addition to these sanctions and in order to meet the new compliance requirements, the banks are now forced to change significantly their business or governance model, to reduce the amount of assets and scope of work or to register as losses some operations. The negative financial results of the European banks registered during the last years also prove the wide rethinking of the business model. The European banks' balance sheets continue to shrink, while sanction absorption increases the expenses and reduce the profit, implicitly. Besides this, since the onset of the crisis in Europe, banks incurred losses in all the following years, failing to sufficiently diminish their expenses.

That is not the case for the national banking sector which, despite a major crisis and a large-scale fraud, continued its upward trend of earning profits. Furthermore, though the crisis revealed the irregular, risky and even fraudulent activity of a number of banks, the lack of an adequate sanctioning framework at that time made it impossible to impose financial fines similar to the European or American model. Practically before and during the crisis, due to certain reasons, we did not witness any sanctions (at least they were not made public). We notice that this process has been activated only recently: sanctions are now applied to former administrators of fraudulent banks⁷ or some shareholders⁸ that still do not want to comply with the new provisions for transparency and disclosure of real beneficial owners.

Thus, in the first case, the sanction consisted of a fine of 10 average salaries in the financial sector for violating the Law on Financial Institutions and other regulatory acts while in position of bank administrator. The violations refer mainly to involving the bank in excessively risky transactions, failure to comply with the limits and requirements for concentration of risks related to bank's assets (exposures), manipulations by not reflecting certain transactions in the accounting records and distorting the bank's real situation and submitting prudential reports with inaccurate data. Finally, those 10 salaries amount to about MDL 100 thousand, which even remotely does not repair the damage caused. Although, now the sanction for the same misconduct could be up to 100 salaries of the administrator for the last 12 months, the cases presented above took place before the legislation was amended, respectively NBM has no right to apply higher sanctions. In the second case, NBM decided to levy a fine of MDL 1 million to a direct and indirect holder of equity stakes in the share capital of a bank for the failure to comply with the requirements for submitting the requested information and documents in order to supervise and assess the quality of bank's shareholders. Practically, the process of increasing the shareholders' transparency is still promoted, with NBM applying in full extent the available legal tools to achieve the set objective.

⁷ The Executive Board of NBM decided, at the meetings of 2 and 3 February 2017, to apply sanctions in the form of fines accounting for maximum - MDL 100 252 (one hundred thousand two hundred fifty two), which represents 10 average salaries in the financial sector, to former members of the Board and executive body of Banca de Economii S.A. and B.C. „UNIBANK” S.A. In addition, on 16 May 2016 the Executive Board of NBM adopted the decision to apply sanctions in the form of fines to former administrators of BC „BANCA SOCIALĂ” S.A.

⁸ The Executive Board of the National Bank decided to levy a fine to a direct and indirect holder of a significant equity stakes in the share capital of BC „Victoriabank” S.A. for the failure to comply with the requirements of the Law on Financial Institutions, namely with the requirement to submit information and documents requested by the National Bank to supervise and assess quality of bank's shareholders. The total amount of fine is almost MDL 1 million and will be paid to the state budget. The decision was passed on 14 March 2017.

Conclusions and recommendations

Both the international financial crisis and domestic banking crisis revealed the speed with which shortcomings from a bank may spread in the entire system, with a direct and long-term effect on taxpayers, economic environment and the society as a whole. The financial markets play a fundamental role in the economic development and growth, and the importance of maintaining their resistance becomes essential in the context of globalization and integration of national economies. The ability to influence the banking activity through sanctions is an important feature of supervision, especially in conditions where market discipline cannot provide enough incentives for shareholders and managers to assume liability for the consequences resulting from risks to which the bank is exposed.

Though the EU banking sectors have a different level of development and capitalisation, the new regulatory framework deriving from Basel III Agreement comes to harmonize the level of applicable sanctions and to strengthen the severity level so that these will force the banks to assume liability for the risks they take. This objective aims at improving the financial stability by stimulating the banks properly in order to manage the existing shortcoming and at the same time deterring them to engage in unsafe and fraudulent banking activities.

At the national level, the legal provisions on sanctions have been changed significantly recently. Since the second half of 2016 the sanctions increased significantly, almost 10 times, and reached a level that can be compared to the one from the Member States. However, a new law on banking activity will be approved in 2017. It also comes to strengthen the process of applying sanctions and align the entire mechanism to the rules of Basel III Agreement.

Finally, now that the necessary regulatory framework is in place to enforce a proper conduct in the banking sector, NBM should monitor closely the banks' activity and intervene in due time and safely to deter any intention of deviating from the prudential rules. The financial sanctions, along with intervention and remedial measures, should be tools for correcting the deficient banking activity and reducing the risk appetite. Respectively, **to achieve this objective, the sanctioning mechanism should meet simultaneously two key conditions: (i) the applied financial sanctions should serve as a deterrent and (ii) the sanctioning process should be fully operational.**

- (i) To ensure that financial sanctions serve as a deterrent, their level should be fully correlated with the gained profit, if it can be established, as provided for in Directive 2013/36/EU. The draft *Law on Banking Activity and Investment Firms* was prepared to transpose the provisions of the aforementioned Directive into the national legislation. This draft aims to substitute fully the Law on Financial Institutions and create a new legislative framework to regulate the activity of Moldovan banks. Even if the draft is currently at the endorsement stage, meaning that it is possible that some adjustments will be made on it, we support the approval of the part related to sanctions in the formulation presented during the public consultations. In addition, to make it more clear, we recommend to add the words "*losses produced*" in phrase "*twice the amount of profits gained as a result of violation*", so that to have ultimately the following version: the level of sanctions should correspond with up to the ***twice the amount of profits gained or losses produced as a result of violation***⁹. It

⁹ Although the Directive 2013/36/EU of 26 July 2013 does not provide for a fine and *twice the amount and losses produced*, it is included in the EU Regulation No 1024/2013 of 15 October 2013, which is applicable to all EU Member States. Thus, it comes to complement the rules transposed into the national legislations of Member States and the provisions on sanctions.

derives from the fact that it might be difficult to quantify the real profit earned in certain cases, while the losses produced in most cases have a monetary value and may be deducted from banks' balance sheets.

- (ii) As regards the mechanism and process of applying sanctions, any political or judicial interferences should be eliminated to achieve the expected effect. We recommend to strengthen the capacities of applying sanctions and the capacities of legal department, which would guarantee a high-quality result as soon as possible. Since the sanctions against banks frequently highlight the existence of certain shortcomings, their misapplication or, sometimes, their public disclosure may produce additional negative effects for the institution or even for the whole sector. Thus, the mechanism of applying sanctions should balance between the deterrent factor and mitigation of additional negative effects that could be generated. In such a case the communication with wide audience is essential.

Legislative Act		Envisioned Financial Sanctions
Republic of Moldova	Law on Financial Institutions No 550 of 21 July 1995	• fine of up to 5% of the capital, levied on the bank • fine of up to 100% of the equity stake calculated at nominal value, levied on holders of equity stakes in the bank's share capital; • fine of 1 to 100 average salaries of the sanctioned administrator for the last year, levied on administrators.
	Law on Bank Recovery and Resolution No 232 of 3 October 2016	• fine of up to 10% of the total net annual turnover, levied on the bank; • fine of up to the equivalent of MDL 1 million levied on individuals (administrators); • fine of up to twice the amount of the profits gained as a result of the act committed, where those can be determined.
Romania	Law on Banking Activity No 58 of 5 March 1998	• fine between 0.05% and 1% of the share capital, levied on the bank; • fine between 1 and 6 average net salaries/bank, levied on administrators;
	Law No 312 of 4 December 2015 on the Recovery and Resolution of Credit Institutions and Investment Firms	• fine of up to 10% of the total net annual turnover, levied on the bank; • fine of up to the equivalent of EUR 5 million in RON, levied on individuals (persons with key functions); • fine of up to twice the amount of the profits gained as a result of the act committed, where those can be determined.
Czech Republic	Law on Banks No 21 of 20 October 1991 with further amendments	• fine of up to CZK 50 million levied on the bank; • fine of up to twice the amount of the profits gained as a result of the committed act, where those can be determined, or up to CZK 130 million if the profit cannot be determined, levied on the bank;
	Law No 374 of 10 December 2015 on Recovery and Resolution on the Financial Market	• fine of up to CZK 20 million levied on individuals, administrators or other persons holding key functions; • fine of up to twice the amount of the profits gained as a result of the committed act, where those can be determined, or up to 10% of the net annual turnover, if the profit cannot be determined, levied on legal entities.
France	Monetary and Financial Code (legislative act that encompasses all the monetary and financial legislation)	• fine of up to EUR 5 million levied on individuals, administrators or other persons holding key functions; • fine of up to EUR 100 million levied on the bank; • fine of up to twice the amount of the profits gained due to the committed act, where those can be determined, or of up to 10% of the net annual turnover, if the profit cannot be determined, levied on legal entities.
European Union (at the level of union and national authorities)	Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions	• fine of up to twice the amount of the profit gained or losses avoided because of the breach, where those can be determined, or up to 10% of the total annual turnover, or up to any other ceiling envisioned in the relevant community acts;
	Regulation (EC) No 2532/98 of 23 November 1998 concerning the powers of the European Central Bank to impose sanctions	• fine of up to EUR 500 thousand levied on legal entities; • fine of up to EUR 10 thousand per day of infringement levied on legal entities in respect of a maximum period of six months;
	Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions	• fine of up to twice the amount of the profits gained due to the committed act, where those can be determined, or of up to 10% of the net annual turnover, if the profit cannot be determined, levied on individuals. • fine of up to EUR 5 million or its equivalent in national currency levied on individuals, administrators or other persons holding key functions.