

Everything about the financial system. Corruption Beyond the Public Sector

Analytical Commentary

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Corruption without limits: from public sector to the banking sector

With the aim of mobilizing available resources from depositors and orienting them towards investors, banks have a decisive role in supporting and developing the economic environment. In the absence of a developed capital market, Moldovan banks remain one of the most important source of funding the national economy, providing funds both for private companies' businesses and individuals' projects. The importance of this sector for the economy is revealed by the volume of loans granted - over MDL 32 billion at the end of 2017 or 20% of the country's GDP. Moreover, banks are also an important source of funding for Government, providing permanently about MDL 7 billion to cover the domestic Government debt. On the other hand, being practically the only financial instrument for savings, domestic banks keep about MDL 60 billion as savings from households and companies, by 20% more than the resources accumulated into the national public budget during one year.

The efficiency of mobilizing funds from those who save money to those who invest could be undermined by corruption and the obscure intentions of bankers who make this process running. Corruption is widespread in developing countries due to the prevalence of an environment characterized by weak rule of law, inefficient judiciary, or an institutional framework that cannot ensure a good governance. If defined by these characteristics, corruption can be encountered not only in public institutions, but also in private entities such as banks, which have a public character on grounds that they operate with money drawn from the population. Usually, corruption could occur during the lending activity in institutions with weak governance and inefficient risk management. Overvaluation of collateral, poor management of conflicts of interest, large volume of loans granted to related parties¹ or to politically exposed persons, and participation in money laundering schemes are corruption-prone areas. As a result, such banking activity is characterized by losses, a large volume of non-performing loans, high inefficiency and increased risks for depositors. At the same time, even if we are not the customers of such a bank, these phenomena affect each of us both in terms of expensive banking products and a unstable financial system in case of bankruptcy of a bank.

The size, severity and public character of recent bank frauds in Moldova, prove the existence of corruption with direct consequences on consumers and taxpayers. As stated in the Kroll investigation reports, massive frauds were committed mainly due to the conscious violation of the lending rules and the ethical and integrity principles by bank managers. Second, corruption expanded the scope of fraud to an unprecedented level even at the international level, generating risks to national and economic security of the country. Thus, the 2014/2015 banking crisis affected each of us, remaining a black spot for the domestic banking sector and political elite of those times. At the same time, it was a turning point and time to reflect on how the banking activity is conducted in our country.

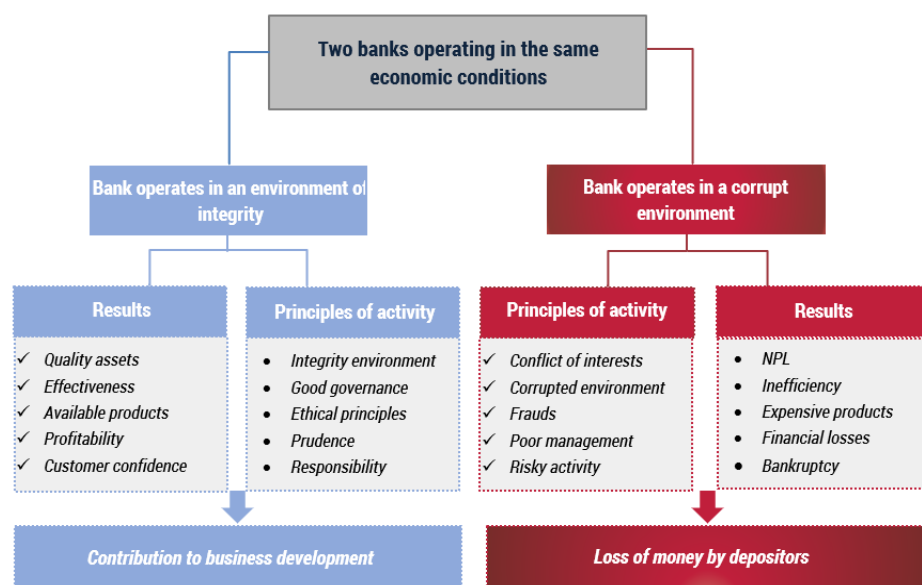
¹ Affiliated persons are those persons who, by their nature, can exercise control over the bank or over its key persons

Corruption and fraud in banks - a barrier to economic development

As proven by the 2014/2015 banking crisis, the losses generated by fraud and corruption are a significant impediment to reaching the objectives of economic growth and sustainable development. The failure of many banks to follow the ethical and integrity standards led to extensive non-performing loans and money laundering. At the same time, the obscure interests of managers and shareholders facilitated the fraudulent embezzlement of financial resources through the lending activity, leading to the bankruptcy and liquidation of three banks. As a result of these actions, about USD 1 billion was taken out of the country's financial circuit, the economy went into recession, and billions of lei from the state budget were used to cover the created hole. In addition to risks to financial stability, other related social or political risks, such as the loss of confidence in state institutions, migration and corruption of MPs, manifested themselves more strongly than ever before.

Although all local banks operate in the same economic environment, they have different results and performances. Being the core activity of banks, any shortfalls in the lending process impact the efficiency of the whole activity, while affecting the reputation and soundness of the institution. Even if it is a private business, we can say that the poor performance of banks can affect the citizen at least twice: once by the higher costs of loans and other banking services, and once again in terms of maintaining the financial stability if the bank is a systemically important one and needs to be bailed out with public money. Specifically, in the former case loan consumers and bank customers will pay more for banking services because the resulting cost will include an inefficiency margin resulting from faulty lending activity. In the latter case, money from the state budget will be used to bail out some troubled banks at the expense of public investment for better roads, renovated schools, performing hospitals, etc. At the same time, the consequences for whole society will be the same, the economic growth will be affected, and people's welfare will be affected. In order to better understand how corruption and other deficiencies in bank activity affect the ordinary citizen, Figure 1 describes a hypothetical case that compares the activity of two banks: a prudent and integer bank and a bank affected by corruption and other vulnerabilities. Thus, a bank operating in an environment of integrity and respecting the principles of prudence and accountability will have not only good results as an institution, but will also contribute to economic development. On the other hand, a bank operating in a corrupt environment will have bad results, which will ultimately affect the public finances and the entire economic environment.

Figure 1 Corruption vs. Integrity in the Banks' Activity



Source: Author's compilation

How do we prevent corruption in banks and ensure a healthy lending activity?

Any crisis is followed by a reflection on what has happened and, above all - a new vision of what should be done. A series of reforms aimed at strengthening the governance of financial institutions and correcting the bank's business model were started countrywide in 2015. They are intended to take over the latest international best practices in order to have a robust banking system that finances efficiently the national economy. Elements of governance, integrity, ethical principles and adequate risk management are prioritized. At the same time, a series of instruments need to be developed and applied to ensure integrity and prevent corruption in the activity of banks, which is the only way of ensuring the irreversibility of the initiated reforms and changing the culture and models of banking activity in the country. Here we are talking about strong rules for fighting corruption, preventing money laundering, proper management of relationships with related parties and politically exposed persons, sanctions, and measures to develop an integrity culture and professional conduct in line with banking ethics standards, as follows:

- ***Appropriate national policies to prevent and combat corruption***

Bribing and trafficking of influence are two of the key elements of corruption to which bank employees are exposed. Conducting the banking activity in a corrupt environment or any kind of interaction with related parties or politically exposed persons are among the main factors exposing the banking staff to bribery or breach of business principles. Given these risks, it is essential to have an adequate anti-corruption framework and independent institutions capable to fight with this phenomenon. At the same time, it is important to increase the accountability and punishment for acts of corruption, including prohibiting to hold any positions ever in the financial system in case of acts with serious consequences.

- ***Identification of the final beneficiaries of financial transactions***

Hiding the final beneficiaries through arrangements with interposed persons or behind off-shore companies is a method used by corrupt individuals to conceal their identity. The events of 2012-2014 resulting in a consistent volume of funds granted in violation of lending standards show that the domestic banking sector was particularly exposed to this risk. The basic concept of 'ultimate beneficial owner' implying accurate determination of the individual who owns, controls or ultimately benefits from the operations of a company. In this context, banks need to develop and implement appropriate preventive 'know-you-customer' measures until to the last final beneficiary. For the lending process, the bank staff must have procedures and mechanisms for monitoring and reporting suspicious transactions in order to prevent any attempt to obtain loans by frauds. At the same time, state authorities must ensure that banks have timely access to sufficient and accurate information on the ownership and effective control over legal entities. Thus, an effective securities recording model can provide security and integrity to holders, protect their rights and increase the shareholder transparency until the final beneficiaries are identified.

- ***Manage correctly conflicts of interest and interactions with related parties and politically exposed persons***

As banks provide financial services to the entire society, it is quite likely to have conflicts of interest in their work. There are many different conflicts of interest, depending on the behaviors and circumstances involved, but all of them have, as a basic element, competing interests and obligations of some people. In the activity of domestic banks, the most widespread forms of conflict of interests are related to loans provided to related parties and relationships with politically exposed persons. In this case, taking into account the nature of the relationships of a bank with related parties or politically exposed persons, the top management has the responsibility to implement an appropriate framework for identifying, controlling and managing conflicts of interest. Such a framework must establish a clear procedure to follow when a conflict of interest is identified, which should be known and understood by all employees. It should also guide the relationship between the bank on the one hand, and the related party or politically exposed person, on the other hand, towards and independent behavior in the interest of the bank.

- ***Promotion of integrity-oriented ethical principles and values***

At both global and national levels, there is a need to change the culture and ethical values in banks. It is becoming increasingly clear that confidence can be restored and maintained in banks only by promoting principles of integrity and good reputation. Thus, banks' management should have well-designed ethical policies, embedded into the institution's organizational processes. One of the most popular tools used recently worldwide is the assessment of compliance with fit-and-proper standards by persons working in the financial and banking environment. Although initially they are provided for shareholders and top management, their applicability should be extended to a larger proportion of bank staff most exposed to corruption, such as branch directors or credit officers.

- ***Remuneration based on long-term performance***

Like in other economic sectors, bankers' remuneration most often consists of variable payments linked to the bank's annual financial performance - bonuses and other benefits that often exceed the base salary. However, this remuneration scheme fosters a certain type of behavior oriented towards high short-term performance, which generates high risks and endangers the sustainability of the long-term profit. In order to manage correctly the risk appetite and to promote integer behavior among employees, banks must establish remuneration policies that also take into account non-financial performance criteria, such as contributing to maintaining the bank's reputation, responsibility or lack of violations. Moreover, taking into account the relatively long cycle of activity, the evaluation period should go beyond one financial year and cover 3-4 years, which is comparable to the average duration of the loan portfolio.

- ***Appropriate penalties***

In order to instill and develop a culture of integrity, both individual and collective liability needs to be in place. An efficient sanctioning regime, appropriate penalties and effective anti-corruption institutions are the most effective measure to discourage corruption and illicit activities. Although the current banking and anti-corruption law envisages pecuniary and criminal penalties for violating the lending rules, most of the cases opened for bank fraud are at a complete standstill, failing to apply any sanctions or other punishments for offenders.

- ***Transparency of the banking activity***

While all the above-mentioned measures are of particular importance for ensuring a sound banking activity, transparency and disclosure of information are essential elements in terms of providing information to the supervisory authority (NBM) and consumers. Without relevant information on the real situation in a bank, the NBM cannot take a fair decision on collective financial stability. Neither the consumers can take clear decisions that would ensure full trust and offer positive financial prospects. Under these circumstances, banks must provide sufficient, timely, accurate and relevant qualitative and quantitative information to enable users to properly assess their overall activity. At the same time, consumers need to be careful when choosing a bank as a partner, get informed about their rights, and analyze carefully the offers of several banks to make sure they make the right choice.