February 2005
IMF Country Report No. 05/64

Republic of Moldova: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision

This Financial System Stability Assessment on Republic of Moldova was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on January 14, 2005. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Moldova or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund ● Publication Services
700 19th Street, N.W. ● Washington, D.C. 20431
Telephone: (202) 623 7430 ● Telefax: (202) 623 7201
E-mail: publications@imf.org ● Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF MOLDOVA

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and European Departments

Approved by Stefan Ingves and Michael Deppler

January 14, 2005

The Financial System Stability Assessment (FSSA) is based on the work of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission to Moldova in May-June 2004. The team met with senior government officials, including the Minister of Finance and the Governor of the National Bank of Moldova (NBM), as well as with staffs of the Ministry of Finance (MOF), the NBM, agencies involved in regulation and supervision of the financial system, banks and other financial institutions, and other private sector participants.

The FSAP team consisted of Martin Slough (World Bank, Mission Chief) and Judit Vadasz (IMF, Deputy Mission Chief); Erik Lundback, Srobona Mitra, and Yuji Yokobori (all IMF); Irina Astrakhan, Victor Burunsus, Michael Edwards, Serap Gonulal, Peter Kyle, Barbara Mondestin, Yibin Mu, and Sue Rutledge (all World Bank), Svante Bågstam (Sveriges Riksbank, payment system – IMF expert), Stefan Spamer (Deutsche Bundesbank, banking supervision – IMF expert), and Walter Zunic (banking supervision – World Bank expert). Edgardo Ruggiero (IMF Resident Representative), and Edward Brown (World Bank Country Manager) participated in some meetings. The AML/CFT findings were prepared by Terry Donovan (IMF) and Peter Csonka (both IMF). Concurrently with the FSAP, the World Bank conducted detailed assessments of the corporate governance and the accounting and auditing frameworks.

Banks are the most developed part of the financial system. Quantitative indicators of financial soundness are at impressive levels. However, this is counterbalanced by serious structural weaknesses. These include in particular the governance problems stemming from the growing role of the government in the financial system and the opaque ownership of both the banks and their clients. Pressures emanating from the recent credit boom, the large inflow of workers' remittances and associated appreciation pressures, the high level of dollarization, significant exchange rate volatility, two-digit inflation, and a weak fiscal situation, if not handled properly, could also pose future risks for the financial sector.

Compliance with the Basel Core Principles and the IMF Code of Good Practices on Transparency in Monetary and Financial Policies was found to be good with many of the principles, although implementation is sometimes less so. However, full compliance cannot be reached until the underlying problem of opaque ownership has been solved and several further improvements have been made.

The main authors of this report are Judit Vadasz, Srobona Mitra, and Yuji Yokobori.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

Contents Page

GLOSSARY

AML	- Anti Money Laundering
BCP	- Basel Core Principles
CAR	- Capital Adequacy Ratio
CFT	- Combating the Financing of Terrorism
CIS	- Commonwealth of Independent States
DIF	- Deposit Insurance Fund
DNS	- Designated Net Settlement
FATF	- Financial Action Task Force
LFI	- Law on Financial Institutions
MDL	- Moldovan leu
MOU	- Memorandum of Understanding
MOF	- Ministry of Finance
NBFI	- Non-Bank Financial Institution
NBM	- National Bank of Moldova
NDA	- National Depositary Agency
NPL	- Non-Performing Loans
RFC	- Rural Finance Corporation
ROA	- Return on Assets
ROE	- Return on Equity
ROSC	- Reports on Observance of Standards and Codes
RTGS	- Real Time Gross Settlement
SCA	- Savings and Credit Associations
SME	- Small and Medium-Sized Enterprises
SSB	- State Supervision Board

Executive Summary

Moldova is the poorest country in Europe, but nevertheless it has achieved some success in building up the framework of a functioning market economy, especially in the banking sector. This framework, however, exists to a much larger degree in written rules than in practice.

Although quantitative indices of banking sector soundness appear healthy, several qualitative aspects of the banking system are less comforting. Of particular worry are:

- The governance problems stemming from the growing role of the government in the banking and insurance system;
- Other ownership problems, including the opaque ownership of financial institutions and corporations, as well as the near-absence of fit-and-proper strategic investors;
- The potential adverse impact of exchange rate appreciation (stemming from large foreign exchange inflows) on the banks' balance sheets through their clients;
- The effects of the recent credit boom, when banks may well have granted loans that ultimately could prove to be below par, but which do not yet appear in the classified categories.

The analysis of data and stress tests has to be qualified because supervisors are hampered by other extraneous, oftentimes political constraints and have difficulty in obtaining useful information about some of the ultimate beneficial owners of the banks. The banks, in turn, may have only anecdotal evidence about the shareholders that control many of their borrowers. In view of this opaque ownership structure of many banks and companies, the bank supervisor, the NBM, is unable to ensure that the prudential limits for connected lending and large exposures are observed and has no possibility to hold fully accountable the controlling shareholders of the banks. Some of these owners (or the banks themselves) also have major shares in several insurance companies, further exacerbating the problem.

In addition to the underlying structural weaknesses, there are several potential macroeconomic problems that increase the vulnerability of the financial system. These include: (i) the direct financing of the state budget by the central bank against the background of the weak fiscal and external situation; (ii) dependency on remittances; and (iii) dollarization, in combination with significant exchange rate volatility. In view of the conflicts between the government's macroeconomic stance and the steps that would be needed to handle these vulnerabilities, the ability of the central bank to alleviate the risks inherent in the above factors is limited.

On the other hand, the framework of written rules and regulations supporting banks is to a large extent consistent with international standards, although implementation is sometimes less so. In the banking sector prudential rules, accounting and auditing, and much of the legal infrastructure help underpin the positive soundness indicators. However, the prudential rules for handling the impact of exchange rate volatility are not adequate. The NBM has not established guidelines or limits and reporting requirements covering country risk and the rules on open foreign exchange positions should also be brought in line with best international practices.

Access to finance poses smaller problems than in many other countries at a similar level of development. Nevertheless, financial intermediation is lagging behind even of some of the neighbors, reflecting weaknesses in the regulatory, supervisory, and operational framework in the securities, insurance, and microfinance sectors.

Other subsectors of the financial system—the insurance and the securities sector—are in their early stage of development. Like the banking sector, these also face governance problems; have operational difficulties due to the lack of instruments and properly developed markets; and their supervision lags far behind.

From a systemic vulnerability point of view, the recommendations for the banking system (including its supervision) are of the highest priority (the key recommendations are included in Box 1). The mission proposed improving the fit and proper examination criteria, developing a privatization strategy for the state-owned bank, and encouraging the state not to interfere in the insurance sector.[1] The central bank should also support the involvement of reputable investors in the banking system. However, many of the problems faced by the financial system cannot be solved by changing the prudential regulations and might be out of the reach of banking supervisors.

[1] Subsequent technical assistance in December 2004 has been directed at addressing some of these recommendations.

Box 1: Summary of Key Recommendations

Banking system

- Develop a privatization strategy and a time-bound corrective action plan for the state-owned bank.
- Require that banks owning stakes in insurance companies set aside special reserves.

Bank regulation and supervision

- Decrease from 10 percent to 5 percent the limit of a significant ownership or controlling interest in a bank requiring a prior approval from the NBM.
- Strengthen the fit and proper provisions.
- Examine if it is feasible to issue regulations that restrict the ownership of banks to fit-and-proper strategic (i.e., financial sector) investors.
- Issue instructions addressing accounting consolidation of affiliates and subsidiaries and require that banks prepare, where required, consolidated financial reports.
- Issue regulations to require the deduction of lending to connected or related parties from capital and that address market and country risks.
- Issue regulations or recommendations requiring banks to establish systems that accurately measure and monitor market risks.
- Require from the banks analysis of their clients' currency positions.

Monetary policy

- Tighten criteria and limitations on financing the government directly by the NBM.

Payment and settlement systems

- Update rules and regulations for the new system and develop contingency plans.

Insurance sector

- Enact new insurance legislation to upgrade the institutional structure, the implementation and enforcement capacity of insurance supervision, and to improve corporate governance in the sector.
- Promote the development of the actuarial profession and establish a reliable claims base.

Capital markets

- Develop action plans to broaden the investor base, strengthen confidence, consolidate instruments, and develop the secondary market.
- Rationalize the off-market exchanges and restructure the investment fund industry.

Microfinance and leasing

- Rationalize the legislative base.
- Strengthen the supervision of the sector.
- Eliminate the tax disadvantage of lessors.

Anti-Money Laundering (AML) Issues

- Clearly define the key concept of the AML law to include combating the financing of terrorism.
- Amend the AML law to ensure its full conformity with the relevant international standards.

Financial Sector and Regulatory Context

A. Financial Sector Structure

1. **The FSAP was conducted at the time when economic activity remained buoyant, but inflation was on the rise (Table 1).** Monetary and fiscal policies became expansionary, while structural reforms stalled. Remittances play an increasingly important role as a source of funding and a driver of growth.

2. **Ownership of the sixteen Moldovan banks, which are all registered as joint-stock companies, is dispersed into several main groupings** (Table 2). One bank, the second largest, is owned by the state, which has a 56 percent share. The state exercises its shareholder oversight responsibility over this bank through the MOF (until recently oversight had been vested in the Ministry of Economy). Five banks are majority domestic owned and three more are 100 percent foreign owned, although no first-tier foreign banks are present as bank owners. The remaining banks are either majority offshore owned or have controlling minority offshore owners, some of which could in turn be owned by Moldovan residents[2]. No offshore shareholder exceeds in any of these banks the 10 percent threshold that requires NBM approval. The overall banking sector is small in assets, but the number of banks is more than adequate. To stimulate mergers, the NBM is progressively increasing the minimum capital levels to MDL 150 million (about US$12 million) from MDL 96 million.

3. **The insurance sector in Moldova is small and underdeveloped compared with those in other CIS countries, although the number of insurance companies (50) is high compared to the size of the market.** Gross premium income in 2003 amounted to MDL 290 million, of which more than 98 percent was for nonlife business. The importance of life insurance is negligible, implying that the industry cannot be considered as a major source of long-term capital for the country. Several factors have contributed to these very low levels of insurance penetration, including low-per capita income, lack of understanding of insurance among the population, and weaknesses in the policy implementation, supervision and enforcement.

4. **Small and medium-size enterprises (SMEs) have benefited little from the tremendous growth in bank lending of the last few years.** The lack of long-term resources makes even medium-term loans risky for the banks and increases the costs of lending. Virtually all loans with maturities of more than one year are financed by international donors. The role of nonbank financial institutions (NBFIs) in servicing the financing needs of SMEs remains limited and their total loan portfolio does not exceed the volume of small loans extended by the banks. Aside from the banks, other SME financing includes leasing, equity funds, and microfinance institutions. The leasing industry is at its inception stage, underdeveloped even by regional standards first of all because of tax disadvantages of

---

[2] These owners are domiciled in Bahamas, Belize, Cayman Islands, Cyprus, Dominican Republic, Panama, etc.

lessors. However, there is a strong demand for these services, especially from SMEs for leasing vehicles.

5. **Microfinance has experienced substantial growth in the last few years.** In addition to two microfinance institutions, there is a network of 530 Savings and Credit Associations (SCAs). The SCAs are set up under their own law and take deposits from individual members. As deposit-taking institutions they are presently under the supervision of the State Supervision Board (SSB) located in the Ministry of Finance. To function properly, the SSB needs to be considerably strengthened. The apex organization of the SCAs, the Rural Finance Corporation (RFC), channels to them donor funds. The recent rapid growth of the SCAs (their aggregate loan portfolio grew by 62 percent and savings by 181 percent in 2003) raises issues of growth management and the overall sustainability of the SCA system.

B. Performance of the Banking Sector

6. **Overall, the banking sector demonstrates impressive levels of earnings, capitalization, and a low level of classified or nonperforming assets.** The key financial soundness indicators (Table 3) have strengthened in the past five years, though the smaller banks' performance continues to lag behind the sector. Although the smallest five banks have much higher Capital Adequacy Ratio (CAR), they have much lower Return on Assets (ROA) and Return on Equity (ROE) than the largest five banks.

7. **Reported nonperforming loans (NPL) have fallen sharply since the Russian financial crisis.** NPLs in asset classification categories C, D and E were only 6.2 percent of total loans at year-end 2003. The low percentage of NPLs for banks overall is attributable partially to the rapid growth in gross loans and partially to the policy of writing off loans as soon as they have been fully provisioned for. However, the NPL rate of 12.7 percent at the smaller banks is double the average. The NBM has established a loan classification category "loans under supervision" as its Category B classification, requiring only a 5 percent provision: such classified loans represent 35.3 percent of total loans, which could be a leading sign of future problems. Year-end 2003 loan loss provisions cover 89 percent of nonperforming loans (loans in the C, D and E categories).

8. **In the absence of a liquid secondary market, efficient liquidity management remains a challenge, with few available instruments.** Overall, banks hold 75 percent of all government securities (although this represents only about 6.5 percent of their total assets) and their liquidity has remained well above prudential requirements for the past five years. As a result, banks hold substantial unremunerated excess reserves on accounts at the NBM, putting upward pressure on their pricing of customer loans to achieve an adequate yield on assets overall.

9. **Public confidence in the banking system, which was shaken during the 1998 Russian crisis and the subsequent collapse of numerous Moldovan banks, has been largely restored**. Growth of total deposits from 1999 through 2003 has been particularly spectacular, with deposits rising from MDL 1 billion to MDL 6.9 billion, or by nearly

600 percent over five years. During the same period, the growth of loans was about 250 percent.

10. **During the past five years dollarization of the banking system has remained relatively unchanged at just under half of total assets and deposits**. Foreign currency[3] deposits to total deposits have declined slightly to 45 percent, while foreign exchange lending has remained relatively constant at about 42 percent of total loans.

II. Systemic Vulnerabilities

A. Macroeconomic Risks and Vulnerabilities

11. **The main macroeconomic risk for the financial sector and for monetary policy is the fiscal situation coupled with external arrears.** That Moldova does not service part of its external debt has lessened pressure on the short-term fiscal situation, but has resulted in low credit ratings. This has reduced commercial banks' access to external financing and confirmation of letters of credit by their correspondents, which ultimately makes them more vulnerable to external shocks. In addition, increased spending, in particular on wages, has a direct inflationary effect.

12. **To improve the external situation, in May 2004 the authorities resorted to requiring direct financing from the NBM, to the tune of MDL 600 million**. This financing of the budget was used for sovereign external debt payments. Prior to this financing, loans previously granted by the NBM have been successively renewed at maturity, without any reduction of principal, under the annual budget laws drafted by the MOF and approved by Parliament.

13. **The NBM's direct lending to the government—permitted by the Law—endangers its independence, even though by law the NBM, in the conduct of monetary policy and prudential supervision is operationally independent**. For these reasons, there is a need to tighten conditions for NBM lending to government, if not to prohibit the practice entirely. Fiscal consolidation and appropriate debt management are important prerequisites for more effective monetary policy.

14. **A second major source of risk is related to the large inflow of workers' remittances.** During the last four years, workers' remittances have increased rapidly and are officially estimated to have reached almost 24 percent of GDP in 2003. These inflows have financed a consumption-driven GDP expansion, leading to rapid import growth and a widening trade deficit (Table 1). However, in spite of the inflow of foreign exchange, nonmarket-oriented policies in many areas and a slow pace of structural reforms have left Moldova with an unfavorable business environment that threatens the sustainability of GDP growth and prevents the channeling of these remittances into productive uses.

---

[3] The foreign currencies used are mostly the euro and the U.S. dollar.

15. **While the large inflows of workers' remittances are unlikely to dry up suddenly, they pose several risks.** First, as seen in early 2004, variations in the flows of workers' remittances will have significant effects on the exchange rate. Second, most of the Moldovan citizens abroad are working in Russia and the European Union, and the Moldovan economy could be affected if those economies weaken; if their labor laws are changed; and/or if the enforcement of those laws is intensified. Third, any attempt by the government to tax workers' remittances may cause the remitters to use channels outside the banking system and discourage individuals from using banks for their foreign exchange savings.

16. **The remittances have increasingly put the Moldovan leu under appreciation pressure, threatening competitiveness and thereby causing risks for banks' balance sheets.** In 2003 the leu appreciated by 4.5 percent vis-à-vis the dollar in nominal terms. In 2004 the leu has appreciated both against the dollar (according to staff estimates by almost 13 percent) and a trade weighted currency basket, while inflation remained relatively high. The NBM therefore faces the dual challenge of reducing inflation while preventing further appreciation of the leu in order to support short-term competitiveness. The government's external arrears contribute to the uncertainty surrounding the exchange rate.

17. **The high degree of dollarization in itself may be a source of financial vulnerability, in particular as the exchange rate in the past has proven to be quite volatile.** Banks may currently extend foreign currency loans to resident individuals or enterprises only for the settlement of payment obligations to nonresidents. While these borrowers might not have any foreign exchange revenues, banks are not permitted to extend such credits to exporters (except for official credit lines). Another risk in this context is the possibility of a drop in confidence in the domestic currency, leading to a drawdown of domestic currency deposits as happened during the Russian crisis when the leu depreciated sharply vis-à-vis the dollar.

18. **The third substantial risk to financial stability is posed by the rapid credit growth in recent years.** There is a clear risk that the process for credit approval may become routine and less rigorous, especially as in a growing economy the prospects for repayment will generally look good and the share of nonperforming loans is likely to go down, at least temporarily. The lending cycle may also be self-reinforcing, as the increasing amount of credit will make it easier for most borrowers to service their debt. However, should the Moldovan economy weaken, the process could go into reverse and the banking sector could come under considerable pressure.

B. Financial Soundness of the Banks and Stress Testing

19. **The various analytical and stress tests undertaken do not identify systemic vulnerabilities within the banking sector, though a few banks are consistently seen as more vulnerable to risks tested.** One large bank and a number of smaller banks with dispersed ownership are particularly vulnerable. As the accountability and/or ownership of these banks are difficult to establish—and thus affect through prudential means—this uncertainty gives rise to other potential vulnerabilities. The NBM could have difficulties in

regulating such institutions, holding their owners accountable, and stimulating strategic investments and knowledge transfer to the financial sector.

20. **Stress tests reveal that the capital of a few banks is consistently vulnerable to the effects of credit risk, exchange rate risk, and a possible liquidity crisis** (Table 4**).** A series of separate sensitivity and scenario analyses were undertaken to evaluate the effects on banks' CAR from sharp changes to credit risk, exchange rate fluctuations, interest rate changes and the possible effects of an illiquid government securities market. In each case, the same banks were found susceptible to the risks tested, sharply reducing the respective banks' capital in the event of strong shocks or banks' need to simultaneously sell down their government securities to meet depositors' immediate withdrawal requests. Moreover, since the insurance subsidiaries of some banks are not consolidated, for these banks the stress test results could be overly positive.[4]

21. **Despite the relative health of the banking sector implied from quantitative analysis, several key cross-cutting vulnerabilities were identified, which, if left unchecked, could undermine the strength and resiliency of the financial sector**. Of particular concern are: (i) the government's growing role in the banking system; (ii) the opaque ownership structure of a relatively large number of banks in the country; and (iii) the absence of fit-and-proper strategic investors. These three ownership-related factors could lead to numerous distortionary market practices regarding the pricing of loan risks, attracting deposits, or the placement of inter-bank credits, etc. These key vulnerabilities have the potential to impact the financial sector dramatically in the event of another crisis, as neither the state-owned bank nor the offshore controlled banks has reliable means to raise new capital if called upon. Moreover, the NBM does not have the means to hold fully accountable the controlling shareholders of these banks, or to apply full "fit and proper" standards to significant controlling shareholders. Effectively, shareholders controlling nearly 40 percent of the banking system assets—including the assets of one of its systemic banks—may be beyond the reach of the regulator.

22. **State-owned entities—banks and enterprises alike–-in Moldova and elsewhere are more susceptible to directed government policies and indirect pressures.** As the second largest bank in the country, the state-owned bank is particularly vulnerable to such pressures. Government ownership-related concerns are evident at the bank through: (i) the bank's exceptional—ten-fold—increase of its loan book over five years; (ii) the concentration of state-owned enterprise borrowers; (iii) the placement with the bank of substantial public deposits (including the Social Fund) at below market rates; (iv) the relatively recent majority stake acquisition of an insurer; and (v) the weaknesses in governance, reflected in the abrupt changes of its board membership and the ministry responsible for the bank's oversight. In addition to which—and directly affecting all banks—the recent government decision to require joint-stock companies to pay a 30 percent dividend

---

[4] The authorities, however, maintain that these banks are financially responsible for their subsidiaries only to the extent of the equity put up by them.

to shareholders will serve, among others, to reduce capitalization levels at all banks. Moreover, the vulnerabilities of the state-owned bank would be further increased if a large, state-owned enterprise borrower were to default on its obligations, as traditionally state-owned banks are reluctant to take legal action against state-owned enterprise borrowers. The bank's new board is urged to develop a time-bound corrective action plan to address the findings of the end-2003 external audit report and NBM on-site examination and to evaluate fully the bank's existing risk management practices and its business plan. To provide a fuller, longer-term solution to governance problems, the government is urged to develop a privatization strategy for the bank.

23. **Moreover, the regulation of banks' insurance subsidiaries is neither coordinated nor robust, creating a potential systemic risk in the event that a bank-owned insurer were unable to honor its commitments.** The state-owned bank holds a majority stake in a full-service insurer which provides insurance protection coverage for all spheres of activity (life, auto, commercial, etc). At present, the NBM has no regular access to data as to the insurance companies' financial condition, reserves and types of risks for which coverage is issued. Thus, if an insurer experiences a large or unexpected loss for which it does not have adequate reserves or reinsurance, it may be unable to cover the loss, in which case the shareholder bank's capital could be at risk, at least to the extent of its investment in the insurance subsidiary. Further amplifying vulnerabilities, banks carry no reserves for such activities and the NBM has no established means to exchange information with the insurance supervision to accurately evaluate the risks carried by bank-owned insurers. Banks' boards should carefully scrutinize the financial condition and risks assumed by their insurance subsidiaries. Given the potential for large liabilities, the banks should be required to set aside reserves at least of their investment, as a minimum until regular and transparent reporting of their subsidiaries' finances are available[5]. Likewise, the MOF is urged to draw up a comprehensive agreement with the NBM on the sharing of information regarding activities of all banks' insurance subsidiaries.

24. **Existing bank ownership disclosure requirements preclude the effective enforcement by the NBM of key prudential regulations on insider lending and large exposures.** Of the fifteen privately held banks in Moldova, five have the majority of their shareholders owning 9.9 percent or smaller stakes, most of which are domiciled off-shore. Moreover, at least two other banks have more than 30 percent of their capital in the form of separate share holdings of less than 9.9 percent each. None of these controlling bank shareholders is obliged to fulfill existing NBM fit and proper regulations for shareholdings of 10 percent or larger.

---

[5] This recommendation is more stringent than normally required, but is justified by the lack of proper insurance supervision coupled with the large number of existing insurance companies, which put in doubt the soundness of the banks' full investment in the insurance sector.

25. **The seven banks referred to immediately above are more susceptible to insider abuses and potentially, money laundering, with fewer resources devoted to internal controls, IT systems, and other safeguards.** These smaller banks' vulnerabilities are further heightened through their sharply lower ROAs and ROEs, higher NPL levels, and heavy loan concentrations. Indeed, as of end-2003 three of the five smallest banks exceeded the prudential limits for large borrowers prompting the NBM to require remedying of these infractions. Despite the smaller banks' high capitalization levels, the persistence of low earnings calls into question their business model and long-term viability. The NBM is urged to continue to scrutinize regularly the risk management processes, financial condition, and practices of these banks.

26. **Owing in part to the above ownership issues and more general perceptions of its macroeconomic environment, Moldova has been unable to attract reputable strategic investors into the banking sector.** Reputable foreign banks' reluctance to invest in Moldova has been exacerbated by the country's external arrears. In addition, the fact that seven of Moldova's fifteen private banks are controlled by mostly opaque off-shore entities holding less than 10 percent stakes has a further negative impact upon investors' perceptions. Consequently, much needed knowledge transfer from multinational banks has not occurred.

C. Supervision and Regulation

27. **The framework for bank supervision and regulation is reasonably comprehensive and, with some exceptions, adheres to the Basel Committee's Core Principles for Effective Banking Supervision as summarized in the Report of the Observance of Standards and Codes**. Supervisory independence—as measured by the formal assessments—exists but in practice could be constrained by the participation of the Ministers of Economy and Finance at the meetings of the Council of Administration of the NBM, where decisions of the supervision department are discussed. Legal protection for supervisors, however, is not addressed in either the framework laws or the supporting regulations. There is only a limited system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.

28. **There are deficiencies in identifying bank shareholders below the significant interest threshold.** Under the Law on Financial Institutions (LFI) and specific regulations, the NBM has the authority to grant authorization for acquisitions of holdings of 10 percent or higher in an existing bank.

29. **The essential elements for effective ongoing prudential regulation and supervision are in place, albeit with deficiencies in the areas of large exposure limits and connected lending.** In managing credit risk, the lack of information about the identity of some of the individual shareholders casts some doubt on whether total loans of groups of closely related borrowers can be accurately measured. Absence of this information obstructs the analysis to determine the extent of banks' exposures to closely related borrowers. The NBM has not established guidelines or limits and reporting requirements covering country risk. Guidance should be provided to banks in terms of the systems they need to maintain to

identify, measure, monitor and control some elements of risk, such as reputation risk. In addition, the law and a respective regulation do not include a capital charge for market risk except for foreign exchange risk.

30. **The NBM has only limited legal authority to supervise banks on an international consolidated basis.** However, the NBM has initiated formal relationships with foreign supervisors. The existing arrangements give the NBM the ability to practice consolidated supervision over foreign owned banking entities, including on-site inspections if necessary and sharing of information with the host supervisor. However, this issue is not addressed properly by laws and regulations.

III. Medium-term Challenges

A. Banking Sector

31. **Fast loan growth since 1999 calls into question the efficacy of banks' credit evaluation and monitoring capacity.** In absolute terms, total loans have risen more than three fold since 1999 from MDL 1.6 billion to MDL 6.1 billion; in particular, loans at the state-owned bank have grown by 932 percent during this period. Much of the credit growth reflects the inflow of foreign exchange that increased the liquidity of the banking system.

32. **The NBM has moved to mitigate the possible harmful effects of credit growth by requiring banks to have separate risk management units to identify and reduce specific risk exposures.** There is scope for further improvement in risk assessment, especially amongst the smaller banks, as more attention could be directed to assessing broad sectoral risks arising from movements in exchange rates and interest rates, rather than concentrating exclusively on individual borrowers' cash flows. Moreover, as NPLs are lagging indicators of borrower distress, collecting and tracking sectoral information on leverage indicators (like debt-to-equity ratios of the corporate sector and its sub sectors, household debt-to-GDP) could be used as early warning signs of major stresses. Finally, even though some banks may not be able to distinguish between importers and exporters (especially as some borrowers are both), they should factor in the borrowers' open foreign exchange positions in their analysis of credit risk.

B. Deposit Insurance

33. **A deposit insurance scheme covering individual depositors up to the modest limit of MDL 4,500 (around US$380) per depositor per bank has been introduced to be financed from contributions by banks**. However, the Deposit Insurance Law should be supplemented by regulations that define much more precisely those events that may trigger payments to depositors by the Deposit Insurance Fund (DIF). Such events could include determination by a court that a bank is insolvent, or a declaration by the NBM that a bank is unable to meet its obligations to depositors. In practice banks may suffer temporary shortages of liquidity that delay payments to depositors without leading to a total cessation of payments. It should be the NBM as regulator that determines whether such illiquidity is

sufficiently serious to justify triggering payment by the DIF, which would then be a prelude to liquidation of the bank concerned. The mission notes that the DIF, having paid out small depositors, would step into the shoes of the small depositors by right of subrogation in the liquidation of the bank thus affected, and that an amendment to the Insolvency Law was passed in June 2004 that gives the DIF claims priority over the unsecured creditors.

C. Systemic Liquidity Management

Monetary policy framework

34. **While the Law on the NBM stipulates that the main objective of the NBM is to achieve the stability of the national currency, in practice, the NBM grapples with multiple policy objectives.** These can occasionally have contradictory policy implications, such as curtailing inflation, preserving stability in the foreign exchange rate, and lowering interest rates.

Liquidity management

35. **Although some technical changes could be made to several monetary policy instruments, the main problems with liquidity management are more fundamental.** Market competition is distorted by the cheap liquidity that is provided from Social Fund money deposited with the state-owned bank. At the same time, the massive remittances supply liquidity regardless of central bank policy. The interest rate transmission mechanism is weak, due also to problems in liquidity management, lack of instruments, and the underdevelopment of markets. The NBM aims to influence the market interest rates by a "corridor" structure of policy rates, but monetary policy still operates mainly through quantitative measures (i.e., the reserve requirement).[6] In these circumstances liquidity forecasting is difficult and is further complicated because the NBM is unable to forecast whether or when the government will meet its external obligations. Many of these problems require political decisions and are thus outside the power of the central bank.

D. Access to Credit and Microfinance

36. **The regulatory framework under which SCAs were created and presently function needs to be improved to ensure the sustainability of the sector.** New prudential norms (requirements for capital, liquidity, reserves, delinquency) aimed to cover all potential risks are being developed and should be adopted by 2005. A new draft Law on Savings and Credit Cooperatives is under discussion, which envisages the participation of legal persons as

---

[6] From July 2004, the NBM introduced foreign currency reserve requirements for foreign currency deposits, at the same time decreasing the rate from 12 percent to 10 percent. The process of switching reserve currencies will take place gradually, by shifting one percentage point every month and completing in 10 months, so as not to release additional leu liquidity at once.

members and a potential broadening of their scope that would put into question the treatment of Savings and Credit Cooperatives (SCCs) as NBFIs. Generally, the various laws, both existing and proposed, need to be carefully examined to make sure that they are mutually consistent with each other and in line with the Law on Financial Institutions. In addition to legislative changes, the SCA system needs to be strengthened, particularly as regards: (i) the level of governance and management/accounting capability (to alleviate the risks inherent in their activity); (ii) the supervisory authority and capacity of the SSB to complete the liquidation of insolvent SCAs; (iii) the sanctions available to facilitate the enforcement of regulations; and (iv) alignment of the regulatory framework with good practice. To facilitate leasing development, the VAT status of lessors should be adjusted to be the same as for the banks.

E. Legal Framework

37. **The legal framework governing the regulation and supervision of Moldova's banking sector has undergone significant reform over the last decade, as have the insolvency and collateral laws.** The NBM Law and the LFI deserve particular commendation for being well-drafted, sound, and in most respects in harmony with modern central banking law practices (the exceptions are described elsewhere in this report). In the laws, the operational independence of the NBM is established, banking supervision and internal governance rules are mostly appropriate, and the NBM is given adequate powers to deal with banks in distress. The only significant variation concerns the lack of immunity. While the Governor has explicit immunity from suit, best practice is to extend such immunity from civil proceedings to other officials, including the bank supervisory staff.

38. **In contrast to the legal framework, the implementation and enforcement of the applicable laws in Moldova is uneven.** This is largely the result of limited and inadequate resources, excessive bureaucracy, state intervention, and a relatively low level of respect for the rule of law, as evidenced by surveys and rankings published by the European Bank for Reconstruction and Development and the World Bank. Recent reports and surveys have confirmed that the risks and costs of doing business are high and administrative burdens of all kinds are excessive. Regulatory compliance costs are among the highest in the region and the licensing regime remains one of the most restrictive among transition economies. The frequency of inspections is a symptom of excessive bureaucracy rather than effective enforcement. While the duration and cost of inspections have gone down, they still remain greater than in most neighboring countries.

F. Payment and Settlement Systems

39. **The systemically important existing payment system, which is run by the NBM, consists of a designated gross settlement system for both large-value payments and retail payments.** The NBM has set up an ambitious plan to reform the system with the setting up of an RTGS-system for large-value payments, a designated net settlement system (DNS) for retail payments, and an updated securities settlement system for government securities with a facility for collateralized intraday credit. One of the important tasks in the

development of the new system will be to find the right balance between the payments settled in the new RTGS system and in the DNS system, which in turn will ensure that each component is of the right dimension to be cost-effective. Rules and regulations for the new systems have to be drafted in a timely manner, as well as a brochure on the functioning of the systems and risk management. An assessment should be conducted to verify whether the present legal basis supports the new infrastructure and complies with the international payment principles and recommendations for securities settlement. The organization has to be adapted to the requirements for the continuous running of an RTGS system. A comprehensive and systematic risk analysis of the planned system also needs to be undertaken to find and take care of eventual shortcomings. Contingency plans must be updated and tested, including planning for a back up site situated at a longer distance from the production site. Crisis management and incident organization have to be established and prepared to be ready for action.

G. Insurance Sector

40. **The insurance sector exhibits a multitude of problems that need to be resolved before the sector can exhibit healthy growth.** Thus, the preferences should be withdrawn from the recently established state-owned insurance company, through which state-owned enterprises and government departments are apparently urged to channel all their insurance business. The institutional structure, implementation, and enforcement capacity of insurance supervision that is presently within the MOF has to be developed. At the same time, the supervisor has to be given the right to license new insurance companies—a function presently with the Licensing Chamber. The regulator should also promote the establishment of a reliable claims database that will help insurers and supervisors to price appropriately various products. An education campaign to explain to the public the potential advantages and uses of insurance products should be undertaken.

41. **The work on the new, modern insurance legislation has to be completed.** The new law envisages the establishment of an independent insurance regulator and supervisor, an increase in the capital requirements, and the harmonization of prudential requirements with applicable best practice standards. Based on these practices, life and nonlife activities should be separated, so that one activity cannot be required to support other. Before the separation of functions, a suitable regulatory framework for life insurance should also be developed. The presently weak coordination between the insurance sector and its regulatory body should be strengthened.

H. Capital Markets

42. **Capital markets on the whole are underdeveloped and shallow.** The primary market for government securities is well-organized but dominated by commercial banks, while the secondary market is almost nonexistent. Liquidity on the markets in constrained by the absence of nonresidents, who have sold their holdings in the wake of the Russian crisis and have not returned since then. The lack of investors on the equity market is exacerbated by fragmentation of the market. The capital markets generally would benefit from

broadening the investor base; strengthening the supervisor (the National Securities Commission of Moldova), without increasing the number of staff; and drawing up a strategic plan of how to develop the sector. Furthermore, reconfiguring the stock market into a cost-effective and operationally-efficient "light stock market" is essential to revive it.

I. Anti-Money Laundering and Combating the Financing of Terrorism[7]

43. **Moldova, with its poverty and an open economy placed in a sensitive region, remains vulnerable to illicit activities.** This vulnerability is exacerbated by the unsolved issue of Transnistria. While the country has made progress in the area of AML/CFT, considerable work remains to be done to achieve an overall effective regime, including: (i) legislative changes to the AML Law and the Criminal Code penalizing the financing of terrorism; (ii) legislative and implementation measures related to customer due diligence and the reporting of suspicious transactions; (iii) mechanisms for the coordination of national AML/CFT initiatives and measures related to international cooperation; (iv) enhancements in enforcement; and (v) improvements in the operation of the Service for the Prevention of Money Laundering, which at present does not yet appear to be in a position to add significant value through its analysis of the information it collects.

[7] The full assessment of AML/CFT, which is required in the context of the FSAP, is scheduled to be conducted in early 2005 by MONEYVAL, the FATF-type regional body for Europe. MONEYVAL will prepare an assessment of compliance with standards and codes following their mission.

Table 1. Moldova: Selected Indicators, 2000–2003 1/

	2000	2001	2002	2003
I. Real Sector Indicators	*(Percent change; unless otherwise indicated)*			
Gross domestic product				
Real growth rate	2.1	6.1	7.8	6.3
Nominal GDP (MDL million)	16,020	19,052	22,556	27,297
Nominal GDP ($ million)	1,289	1,480	1,662	1,957
CPI Inflation (average)	31.3	9.8	5.3	11.7
CPI Inflation (end of period, y-o-y)	18.5	6.4	4.4	15.7
Average monthly wage (Moldovan lei)	408	519	704	912
Average monthly wage (U.S. dollars)	33	40	52	65
Savings-investment balance	*(In percent of GDP)*			
Foreign savings	8.2	2.5	4.4	6.8
National savings	7.2	14.2	11.9	10.3
Private	5.7	12.4	9.9	7.1
Public	1.5	1.9	2.0	3.2
Gross investment	15.4	16.7	16.3	17.1
Private	12.5	14.6	13.4	14.5
Public	2.9	2.2	2.9	2.6
II. Fiscal Indicators (general government)				
Primary balance (cash)	2.9	4.1	0.4	2.8
Overall balance (cash)	-3.5	-0.1	-1.8	0.7
Overall balance (commitments)	-1.8	-0.3	-0.9	0.2
III. Financial Indicators	*(Percent change, unless otherwise indicated)*			
Broad money (M3)	40.1	36.4	36.0	30.7
Velocity (GDP/end-period M3; ratio)	4.6	4.0	3.4	3.2
Reserve money	29.8	27.9	31.1	16.6
Credit to the economy	40.1	35.4	34.3	45.4
IV. External Sector Indicators				
Current account balance (millions of U.S. dollars)	-105.7	-37.4	-73.9	-132.4
Current account balance (percent of GDP)	-8.2	-2.5	-4.4	-6.8
Gross official reserves (millions of U.S. dollars)	226.0	228.5	268.8	302.3
Gross official reserves (months of imports)	2.5	2.1	1.9	1.7
Exchange rate (MDL/$) period average	12.4	12.9	13.6	13.9
Exchange rate (MDL/$) end of period	12.4	13.1	13.8	13.2
External debt/GDP (percent) 2/	124.2	107.7	105.5	96.2
Debt service/exports of goods and services (percent)	24.2	24.2	27.3	19.1

Sources: Moldovan authorities; and IMF Staff estimates.

1/ Data exclude Transnistria.

2/ Public and publicly guaranteed debt, including IMF.

Table 2. Moldova: Structure of the Financial System, 1999–2003

	1999	2000	2001	2002	2003
Number of deposit-taking institutions	20	20	19	16	16
State-owned	1	1	1	1	1
Foreign-owned	3	4	3	3	3
Number of employees	5,345	5,594	6,173	6,714	7,351
Number of branches	156	146	147	157	161
Total assets of deposit-taking institutions					
In millions of lei	3,201.3	4,667.7	5,976.5	7,920.1	10,289.9
In percent of GDP	26.0	29.1	31.4	35.1	37.7
Number of insurance companies	44	45	44	49	50
Total assets as percent of GDP	—	—	—	—	1
Number of savings and credit associations	—	293	369	484	530
Total assets as percent of GDP		—	0.3	0.3	0.5
Number of microfinance institutions	1	1	1	1	2
Total assets as percent of GDP	—	—	—	—	0.6
Number of active leasing companies	—	—	—	2	5
Number of companies listed with the Stock Exchange	—	—	—	25	25
Total capitalization (in millions of lei) 1/	—	—	—	—	826

Source: National Bank of Moldova.

1/ Includes companies trading off the stock exchange.

Table 3. Moldova: Financial Soundness Indicators of the Banking Sector

	1999	2000	2001	2002	2003	2004 Mar. 30	2004 Jun. 30	2004 Sep. 30
Capital adequacy	*(in percent, unless otherwise stated)*							
Regulatory capital as percent of risk-weighted assets	46.0	48.6	43.1	36.4	31.8	32.4	33.3	31.9
Regulatory Tier I capital to risk-weighted assets	42.5	46.3	41.0	36.4	31.8	32.4	33.3	31.9
Capital (net worth) as percent of assets	28.9	30.6	27.5	23.0	21.1	21.4	21.8	20.2
Asset composition and quality								
Sectoral distribution of loans (as percent of total loans)								
Agriculture/food industry	27.8	27.2	26.5	27.9	28.8	28.9	28.3	27.7
Real estate/construction and development loans	10.6	8.6	7.3	7.1	6.6	6.4	6.4	6.0
Consumer loans	4.1	3.5	2.8	2.6	2.7	2.7	3.3	3.5
Energy resources and fuel loans	4.4	5.4	6.0	5.3	6.5	5.8	4.6	4.5
Loans to banks	1.5	0.9	1.1	1.0	1.2	2.0	1.1	1.0
Government loans	2.8	1.4	2.1	2.5	1.2	0.1	0.2	1.0
Industrial/commercial loans	45.5	45.4	46.5	46.3	45.6	46.1	48.2	47.1
Transportation and road construction loans	1.0	2.5	3.2	2.5	1.6	1.7	1.8	2.2
Other loans	2.3	5.1	4.5	4.8	5.9	6.2	6.1	7.0
Quality of loans								
NPLs as percent of gross loans 1/	29.3	20.6	10.4	7.7	6.2	6.2	6.3	6.5
NPL net of provisions as percent of capital	22.7	18.7	10.1	10.7	10.8	10.6	10.4	10.9
Foreign exchange loans as percent of total loans	41.2	40.8	41.1	42.4	42.8	39.3	39.3	41.5
Total large credits as percent of Tier I capital 2/	42.0	24.9	46.4	70.2	78.9	72.3	65.7	82.5
Earnings and profitability								
Gross profits as percent of assets (ROA)	4.2	7.4	4.3	4.3	4.5	4.3	4.4	3.9
Gross profits as percent of equity capital (ROE)	18.0	25.0	14.3	16.7	20.3	19.9	20.2	18.2
Net interest margin (net interest income as percent of interest bearing assets)	14.9	18.5	11.7	9.4	9.3	8.3	8.5	8.7
Personnel expenses as percent of noninterest expenses	42.7	42.3	43.1	45.3	47.1	46.5	49.2	48.5
Spread between reference loan and deposit rates 3/	7.9	8.7	7.9	8.8	6.5	—	—	—
Liquidity								
Liquid assets as percent of total assets 4/	39.0	35.5	34.7	36.0	32.1	33.1	34.1	35.4
Foreign exchange liabilities as percent of total liabilities	55.5	51.7	45.7	47.1	48.6	45.2	45.3	44.6
Sensitivity to market risk								
Average repricing period of assets (in months)	—	—	—	—	12.9	—	—	—
Average repricing period of liabilities (in months)	—	—	—	—	13.5	—	—	—
Net open FX position (on-balance sheet) to capital	10.4	20.1	21.9	15.5	17.7	11.2	6.0	3.8
Net open FX position to capital (on and off balance sheet), for euro, U.S. dollar, Russian ruble	—	—	—	—	7.6	6.9	4.5	4.9

Source: National Bank of Moldova.

1/ NPLs are loans in categories C, D, and E.
2/ Regulatory limit is 500 percent.
3/ Annual average.
4/ Under prudential regulations should exceed 20 percent.

Table 4. Effect on Capital Adequacy Ratios of various Sensitivity and Scenario Analyses
(as of December 31, 2003)

	Impact on Capital Adequacy Ratio				Number of banks below 12% CAR			
	Total	Group 1	Group 2	Group 3	Total	Group 1	Group 2	Group 3
Baseline CAR: Regulatory capital as a percent of risk-weighted assets	31.8	25.4	38.7	103.0	0	0	0	0
Credit risk								
Overall credit risk 1/	23.2	16.9	32.0	104.3	2	1	0	1
Shock to external demand for agricultural products 2/	29.7	22.8	38.4	103.1	0	0	0	0
Shock to fuel and gas prices 3/	26.0	20.2	33.9	104.2	2	1	0	1
Exchange rate risk								
Direct effect 4/	31.0	24.7	38.2	100.3	0	0	0	0
Indirect effect of deterioration of credit quality 5/	22.2	16.1	31.4	100.5	2	1	0	1
Interest rate risk								
Direct effect 6/	32.1	25.7	38.8	103.1	0	0	0	0
Indirect effect of deterioration of credit quality 7/	29.4	23.1	36.7	103.4	0	0	0	0
Indirect effect of a higher deterioration of credit quality 8/	23.4	17.2	32.1	104.3	2	1	0	1
Combination of risks in a crisis scenario								
Combined effects of exchange rate depreciation and interest rate increases 9/	20.9	14.4	29.7	105.9	2	1	0	1
Additional effect of illiquidity of government securities 10/	15.5	9.2	13.5	91.8	6	4	1	1

1/ Nonperforming loans (NPLs) as percent of gross loans equal 31 percent, the average during the 1998–1999 currency crisis. In order to achieve this, a migration of loans from categories A and B by 24 percent and 30 percent respectively with increases of 300 percent in C, 650 percent in D, and 1,050 percent in E to hold total loans constant.
2/ NPLs rise to 13 percent, achieved by a decrease in agricultural sector loans in A and B by 24 and 30 percent respectively, and an increase in C, D, and E to keep total agricultural loans in each bank constant.
3/ Loans to energy sector migrated from A and B by 39 percent and 50 percent, respectively, in the first round, and then loans to the corporate sector migrated from A and B by 24 percent and 30 percent, respectively, resulting in an NPL of 22 percent in the overall banking sector.
4/ Effect on CAR through changes in open foreign currency positions of a nominal appreciation of MDL/USD and MDL/euro exchange rates by 40 percent, and of MDL/Russian ruble exchange rate by 20 percent.
5/ Net effect of an additional indirect effect of a rise in NPLs to 31 percent achieved by a loan migration similar to footnote 1, above.
6/ Direct effect of 10 percentage point rise in interest rate on CAR through changes in net interest income within a 1-month horizon.
7/ Net effect of an additional indirect effect of a rise in NPLs to 14.4 percent achieved by a loan migration of 8 percent and 10 percent from A and B, respectively.
8/ Indirect effect assuming a deterioration of NPLs to 31 percent achieved by a loan migration similar to footnote 1, above.
9/ Combination of footnote 4 (with depreciations), footnote 6, and increase in NPL to 39 percent (maximum NPL experienced during the 1998–99 crisis).
10/ Combination of and realization value of 50 percent of government securities.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains summary assessments of Moldova's adherence to the Basel Core Principles for Effective Banking Supervision and the Code of Good Practices on Transparency in Monetary and Financial Policies. The detailed assessments have been undertaken in May–June 2004 as part of the Joint World Bank/IMF FSAP and have served as a basis for the summary assessments.

The assessments have been used to gauge the risks and vulnerabilities as well as the developmental needs of the financial sector. For the areas covered by the assessments that have not yet been fully aligned with these international codes, the FSAP team made recommendations to the authorities, who expressed their willingness to implement these suggestions as soon as feasible and hence to further strengthen the institutional and legal basis of the financial system.

Moldova is making considerable progress in observing the international standards and codes that were assessed. The NBM, in charge of banking supervision and monetary policy, also strives for transparency and openness in its policies and procedures. The overarching issue in the two standards assessed is the lack of proper protection of central bank staff for actions taken in the conduct of their official duties.

In banking supervision, assessors noted the need for further strengthening of regulations with respect to the transparency in ownership and the possibility for the NBM to conduct fit and proper evaluation of owners of banks. They recommend requiring that banks conduct a thorough examination of the ownership relations of their clients. Regulations are also needed in the areas of country, market, and reputation risk, as well as for deduction from the capital of lending to connected parties. Supervisory practices should develop further in the direction of risk-oriented supervision. Finally, steps need to be taken—including laying down the legal basis—to undertake consolidated supervision, both domestically and globally.

In general, the NBM practices a fairly high degree of transparency in most aspects of its operations, including banking supervision. The main areas for improvement relate to more clearly spelling out the primary goals of monetary policy and the conditions and limitations on the direct financing of the government by the NBM

A. Basel Core Principles for Effective Banking Supervision

General

44. This detailed assessment of Observance with the Basel Core Principles for Effective Banking Supervision is the first external comprehensive assessment of the system of banking supervision in Moldova. The assessment was conducted by Walter Zunic, World Bank, and Stefan Spamer, Deutsche Bundesbank, in May 2004. The NBM cooperated fully with the assessment team and provided extensive clarification in the form of documents and oral explanation. Their assistance is gratefully acknowledged.

Institutional setting

45. The Law on the National Bank of Moldova specifies that the NBM, through its Department of Banking Regulation and Supervision, is responsible for banking supervision in Moldova. It is the sole authority for carrying out banking supervision for banking

institutions licensed under this law. The objective of the NBM is to maintain the financial stability of the banking system with a view to protecting the interests of depositors.

General preconditions for effective banking supervision

46. The banking sector remains concentrated, underdeveloped, and less than efficient. Five large banks account for 71 percent of total banking sector assets and 75 percent of total banking sector deposits. Lack of product diversification, poor banking skills, and inadequate lending and crediting policies are de facto limiting the efficient development of new banking services. The costs of these inefficiencies are eventually transferred to the private sector as high interest margins and transaction costs.

47. Despite improvements in financial intermediation in the years following the crisis of 1998, access to finance in Moldova is constrained by weaknesses in the technical, legal, and regulatory infrastructure supporting intermediation. Hence, the median debt to asset ratio of a large sample of enterprises is a mere 9 percent, lower than in any other country in Europe, and it has shown little change since 1998. In addition, the main factors restricting access to finance are (i) the lack of long-term bank financing; (ii) legal and regulatory restrictions on transactions and lending denominated in foreign currencies; (iii) the lack of basic banking skills and a developed product base that would serve the needs of private sector efficiently; and (iv) the underdevelopment or lack of alternative forms of financing. The nonbank, capital market, and insurance sectors are embryonic.

Main findings

48. **Objectives, autonomy, powers, and resources (CP 1)**: There is no visible evidence of any government or industry interference in the work of the National Bank of Moldova. However, according to the Law on the National Bank of Moldova, the ministers responsible for economic and financial matters may attend meetings of the Council of Administration of the NBM without restriction; hence interference by the government cannot be ruled out. The NBM has, in general, adequate independence to deploy its banking supervision resources. The legal protection for supervisors, however, is currently not addressed and there is no formal NBM indemnification policy protecting employees against the costs of defending their actions while discharging their duties. There is only a limited system of cooperation and information sharing in place among all domestic agencies with responsibility for the soundness of the financial system.

49. **Licensing and Structure (CPs 2–5)**: Under the LFI, the NBM has the authority to grant authorization for acquisitions or increases of qualifying holdings in an existing bank. However, the approval by the supervisor is limited to shareholdings of 10 percent or higher. This liberal requirement has created the situation in which individual shareholders of 9.9 percent own a majority of the capital of five banks. Most of these shareholders are corporations registered in off-shore centers. The LFI defines the upper limit for investments in other companies that are not credit institutions at 15 percent of the regulatory capital and total investments not exceeding 50 percent of the banks regulatory capital without written

supervisory approval. The NBM requires that banks report all ownership in subsidiaries and affiliated companies.

50. **Prudential regulation and requirements (CPs 6–15):** Rules and regulations regarding capital adequacy generally conform to the Basel Capital Accord 1988, but they do not include a capital charge for market risk. The NBM maintains adequate systems for monitoring and evaluating banks' large exposures and connected lending, but because they have insufficient information about the financial interests of a large percentage of shareholders in the banking system, it is difficult to determine the extent of regulatory compliance in these areas. The large exposure limit (25 percent of bank or banking group capital) is consistent with international standards. Nevertheless, it is arguable that the limit may be relatively high because of the small size of the banking system and economy. The supervisor should consider establishing a limit on banks' deposit exposures to other banks, where the deposit placement (due from placement) is over 15 days in maturity. No controls or limits are established on banks' cross-border exposures and banks are not required to have in place systems that accurately measure and monitor market risk. Moldova has relatively comprehensive laws for dealing with money laundering and other financial crimes, but AML/CFT compliance will be assessed fully in 2005.

51. **Methods of ongoing supervision (CPs 16–20):** The NBM conducts full scope, comprehensive on-site examinations of banks on an annual basis. There is also a comprehensive system of off-site monitoring of banks, involving the analysis of a wide range of information provided by banks on a monthly and quarterly basis. No specific instructions addressing accounting consolidation of subsidiaries have been issued and there is no evidence that the bank supervisors utilize a group-wide approach to supervision. Supervision on a consolidated basis is not carried out in Moldova.

52. **Formal powers of supervisors (CP 22):** The Law on Financial Institutions empowers the NBM to issue the necessary decisions to restore the rightful conditions and remove abuses, develop a practice of corrective action and early intervention. The Law provides a range of remedial actions, including the withdrawal of the bank's license. Adequate enforcement powers are at the NBM's disposal and are close to the respective Basel recommendation on taking remedial measures. Since 1996, at an increasing rate, NBM has taken advantage of its powers regarding problem institutions. However, there is no mechanism for the automatic imposition of administrative or penal sanctions. The supervisor does not have the authority to publish details of the enforcement actions that it imposes.

53. **Cross-border banking (CPs 23–25):** The current regulatory and supervisory framework does not have specific provisions relating to global consolidated supervision. The NBM is responsible for granting permission for Moldovan banking institutions to operate branches or establish subsidiaries outside the country, but has only limited authority to supervise the overseas branches of locally incorporated banking institutions. There are no legal provisions for the establishment of contact and sharing of information on a reciprocity basis with other supervisors. Foreign banking institutions are subject to similar regulatory requirements applicable to all other banks operating in Moldova. The NBM has powers to

share information needed by the home country supervisors for the purpose of carrying out consolidated supervision. However, there are no legal requirements for a formalized procedure by which the host country supervisor can share information on the local operations of foreign banks with home country supervisors, as confidentiality is protected.

Main recommendations

54. Recommended Actions to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1 Objectives, Powers, and Resources	• Restrict the attendance of ministers responsible for economic and financial matters in the meetings of the Council of Administration of the NBM to matters not related to supervisory issues. • Separate the budget of banking supervision from the overall budget of the NBM. • Change the law to include legal protection for supervisors. • Implement a defined process of cooperation between domestic financial supervisors and regulators. • Clarify the legal possibilities for the exchange of confidential information and implement the necessary provisions to restrict the usage of this information.
3. Licensing Criteria	• Require a description of the corporate ownership structure to determine the suitability of major shareholders, the transparency of structure, and the source of initial capital.
4. Ownership	• Decrease the limit of a significant ownership or controlling interest from 10 percent to 5 percent.
5. Investment Criteria	• Develop procedures for banks to notify investments in nonbank entities that do not meet the thresholds defined by regulation.
6. Capital Adequacy	• Implement a capital charge for market risk and country risk.
8. Loan Evaluation and Loan-Loss Provisioning	• Adopt a robust definition of problem loan restructuring. • Issue instructions for loan loss provisioning of some of the off balance sheet accounts. • Require written bank policies to grade and estimate loan loss probability.
9. Large Exposure Limits	• Encourage banks to fully ascertain the nature of connections between borrowers and stockholders. • Establish a limit on banks' deposit exposures to other banks.

Reference Principle	Recommended Action
10. Connected Lending	• Require the deduction of lending to connected or related parties from capital or the collateralization of such loans.
11. Country Risk	• Issue a regulation or a recommendation to specifically address country risk and design a reporting system for country/transfer risk
12. Market Risks	• Issue regulations or recommendations requiring banks to establish systems that accurately measure and monitor market risk. Provide additional training to analysts and inspectors.
13. Other Risks	• Provide guidance to banks for identifying, measuring, monitoring, and controlling reputation risk and risks associated with the acquisition of business entities (both credit institutions and other businesses).
15. Money Laundering	• Appoint bank supervisors to become specialists in AML procedures and liaise with the Center for fighting Economic Crime and Corruption.
20. Consolidated Supervision	• Address in instructions accounting consolidation of affiliates and subsidiaries, and instruct banks to prepare, where required, consolidated financial reports.
22. Remedial Measures	• Indicate in regulation the specific measures used to address particular problems.
23. Globally Consolidated Supervision	• Amend the Law on Financial Institutions to acquire the power to carry out necessary on site examinations at overseas entities of Moldovan banks.
24. Host Country Supervision	• Clarify the NBM's authority to prohibit banks from operating in countries where secrecy or other laws prohibit the free flow of information. • Amend laws to ensure reciprocal information sharing with foreign supervisors.
25. Supervision Over Foreign Banks' Establishments	• Please refer to CP 24.

Authorities' response to the assessment

55. The authorities are in broad agreement with the BCP assessment and are determined to further improve the legal framework for banking and its supervision, and the supervisory methods. They have noted that the budget requirements for bank supervision are fully met from the operating budget of the NBM and it would be inconvenient to determine a budget for the supervisors outside the aggregate. Although there is no clear protection to the individual staffs, the NBM is the legal person that would be responsible for any possible legal actions. As for the handling of some risks, they requested additional technical assistance (which has already been provided in December 2004).

B. IMF's Code of Good Practices on Transparency in Monetary and Financial Policies

General

56. The assessment examined the observance by the NBM of the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code) for monetary policy and banking supervision. It was conducted by Yuji Yokobori (monetary policy transparency), and Stefan Spamer and Walter Zunic (transparency of banking supervision) during the joint IMF/World Bank FSAP. The assessment was based on the MFP Transparency Code, and has taken into account the implementation issues mentioned in the Supporting Document to the MFP Transparency Code.

Transparency of monetary policy

Legal and institutional framework—overview

57. The Law on the National Bank of Moldova was adopted in 1995 with technical assistance from the IMF, with some subsequent revisions. It defines the primary objective of the NBM as the maintenance of stability of its national currency. In the same law it is stipulated that "the NBM in cooperation with the government shall formulate and implement monetary and foreign exchange policy ... taking into account the prevailing economic and financial conditions of the Republic." It also guarantees the operational independence of the NBM with respect to the government and its administrative bodies in pursuing these objectives. The Finance Minister and the Minister of Economy is allowed to attend the meetings of the central bank but do not have voting power.

58. The responsibilities of the NBM cover, among others, the design and conduct of monetary policy, the issuance of licenses to financial institutions and the supervision of their activities; the management of foreign exchange reserves and the conduct of foreign exchange policy; the conduct of payment operations; and the issuance of banknotes and coins. The NBM has developed a range of monetary policy instruments (open market operations, overnight credits and deposits, deposit auctions, the Lombard facility, and reserve requirements) but relies mostly on reserve requirements.

Main findings

59. The institutional relationship between monetary and fiscal operations is defined in the Law on the NBM. Direct purchasing of government securities in the primary market is prohibited; however, lending to the government is permitted by the law. The NBM assumes a number of agency roles on behalf of the government, including foreign exchange reserves management, representation in the international financial institutions, international payment operations, and certain banking operations on account of the government.

60. The NBM is governed by the Council of Administration, which consists of five members, including the Governor, as chairman and four Vice-Governors. The current legislation stipulates that all members of the Council are appointed by Parliament, upon

proposal of the NBM. The terms of appointment are seven years, with the possibility of renewal. Members of the Council can be dismissed by the Parliament in the event of specific acts of criminal behavior, bankruptcy, and incapacity due to personal misconduct, with the vote of two third of the total number of deputies for the Governor, and with the simple majority of votes of the total number of deputies for other members.

61. Disclosure on the NBM's activities is achieved through a variety of means. Monetary policy decisions are announced on the same day through press releases and on the NBM's website. The NBM publishes Annual Reports, Quarterly Bulletins, and Monthly Monetary syntheses, and various announcements on the website through which it discloses the framework, instruments, and targets of monetary policy; monetary policy decisions; data reporting requirements for financial institutions; and, the rules and regulations governing various aspects of its operations with the financial and nonfinancial public. The financial accounts of the central bank are audited annually by an independent auditor, whose findings are disclosed in the Annual Report.

Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of central banks for Monetary Policy	
	Improvements could be attained by specifying what is meant by the stability of the national currency. There should be more specified criteria and limitation on financing the state.
II. Open Process for Formulating and Reporting Monetary Policy Decisions	
	It would be desirable to have a deeper explanation of the overall picture of the policy instruments and operation, with clearer descriptions of the relations between each instrument. The NBM could consider the disclosure of the minutes of the Council meetings.
III. Public Availability of Information on Monetary Policy	
	The NBM should consider publishing the summary balance sheet on a frequent (e.g., quarterly) and pre-announced schedule. The NBM should consider a general rule on publication of aggregated information on emergency liquidity support.
IV. Accountability and Assurances of Integrity by the central bank	
	The specific regulations related to the internal control system of the NBM could be disclosed to the public. A law should be enacted to provide for legal protection to the supervisory agency and its staff for actions taken while discharging their duties in good faith.

Authorities' response

62. The NBM was in general agreement with most of the assessments and recommendations, and provided some additional clarifying information that was taken into

account in this document. Meanwhile, the following comments were presented for consideration for some items that the mission had advised for further improvements. (i) The ultimate objective of the monetary policy cannot be specified given the Moldovan macroeconomic environment, but the concrete policy objectives for each year are clearly explained in the annually published statement on review and assessment of the monetary policy and foreign exchange policy, even though it is not a legal document as the assessment requests; (ii) the conditions for lending to the government are already set forth in the Law on the NBM, and are sufficient; (iii) even though there is no practice to regularly disclose minutes of the meetings of Council of Administration, the public has access to the information on the meetings when the Council decides to do so; (iv) the internal auditing process is not usually disclosed in many other countries as well; and (v) although there is no clear protection to the individual staffs, the NBM is the legal person that would be responsible for any possible legal actions.

Transparency of banking supervision

Institutional and Market Structure overview

63. The NBM, as codified in the Law on the National bank of Moldova, is responsible for the regulation and supervision of the banking sector. The institutional framework is set out in the Law on the National Bank of Moldova and the Law on Financial Institutions and relevant Regulations. The acts and regulations provide guidance on the purposes of supervision and the objectives of the NBM.

64. The financial system is largely dominated by the banking sector, as described in the main body of the FSSA. There are few banks with foreign participation (and none with majority strategic foreign ownership typical of more advanced transition economies), most of which are from neighboring countries. International financial institutions are also present in the capital of five of the banks operating in the country.

Main findings

65. The responsibility of the NBM for bank supervision is clearly stated in the relevant laws. The NBM is engaged in an ongoing consultation process involving nongovernmental bodies in the development of financial policies, e.g., consulting the bankers' association or specific banks in issuing rules and regulation.

66. There are currently no formal procedures for the sharing of information and consultation between local financial agencies in place. The Republic of Moldova concluded arrangements on the cooperation in the area of the supervision of financial institutions with foreign supervisory entities. However, there is insufficient public disclosure of the existence of procedures of such arrangements.

67. Although there is no pre-announced publication date for the NBM's reports, the public is aware that the NBM routinely publishes reports in the middle of each month. When

in the past emergency liquidity support was made available to the banks, information about such assistance was not published.

68. Internal governance procedures (including the tasks of internal audit) are in place, but are not published. No law provides for legal protection to the supervisory agency and its staff for actions taken while discharging their duties in good faith. There is no formal NBM indemnification policy protecting employees against the costs of defending their actions while discharging their duties.

Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Banking Supervision

Reference Practice	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	
	The relationship between financial agencies should be publicly disclosed.
VI. Open Process for Formulating and Reporting of Financial Policies	
	Additional information should be made available on the bilateral arrangements between domestic and international financial agencies (including central banks).
VII. Public Availability of Information on Financial Policies	
	The NBM should consider a general rule on publication of aggregated information on emergency liquidity support.
VIII. Accountability and Assurance of Integrity by Financial Agencies	
	A law should be enacted to provide for legal protection to the supervisory agency and its staff for actions taken while discharging their duties in good faith. Internal governance procedures should be publicly disclosed.

Authorities' response to the assessment

69. The NBM was in general agreement with most of the assessments, and provided some additional clarifying information that were taken into account in this document. However, it objected to the findings about the legal protection for supervisors, insisting that such provisions are not necessary, as according to Article 38 (7) banks may only complain against the National Bank of Moldova.

STRESS TESTS ON THE MOLDOVA BANKING SYSTEM

70. Sensitivity analyses on the Moldova banking system revealed **credit risk** to be the major source of vulnerability. Stress tests included:

(i) a deterioration in credit quality due to shocks to external demand for agricultural products (owing to the country's high dependence on export of agricultural products);

(ii) an increase in oil and gas prices that has a direct effect on credit portfolios of banks exposed to this sector, and an indirect ripple effect on banks' exposure to the corporate sector;

(iii) an appreciation of nominal exchange rates (as the inflow of foreign workers' remittances has a strong effect on exchange rates) with additional credit quality implications;

(iv) direct and indirect (credit quality) effects of an increase in domestic lending rates;

(v) a scenario with a combination of interest rate and exchange rate risks; and

(vi) the risk of illiquidity of government securities in anticipation of liquidity risks.

Among **market risks**, the banking system seems more vulnerable to high (yet plausible) rates of exchange rate changes, rather than to interest rate movements through deterioration in credit quality. In conducting the stress tests, balance sheet data on all 16 banks for end-December 2003 have been used; the results are summarized in Table 4.

71. In assessing **individual banks' vulnerabilities** to various types of credit risk, the tests assume a loan migration from higher to the lower credit-classification categories in response to a shock—the corresponding increase in loan-loss provisions subtracted from both regulatory capital and risk-weighted assets yields the new (adjusted) CAR. Given the high baseline CAR (Table 4)[8], a significant effect of a shock is perceivable only if we assume some migration from category A ('standard') and a substantial migration from category B ('under-supervision'), to categories C, D, and E. The first credit risk stress test pertains to an overall shock that deteriorates the quality of loan portfolios of all banks equally. In particular, the resulting NPL (as a percent of gross loans) is assumed to match the average NPL experienced during the 1998–1999 currency crisis—31 percent of gross loans on an average between September 1998 and December 1999. For purpose of the subsequent tests, this generic credit risk will be considered as a second round (and, in most cases, the maximum indirect) effect of

[8] CAR is high because some banks function as "pocket" banks, as described in the main body of the report and have a very low deposit base.

an interest rate or an exchange rate shock. In order to achieve an NPL of 31 percent, it is assumed that there is a decline in loans (in each bank) from category A by 24 percent, and from B by 30 percent (with corresponding increases in C, D, and E to hold total loans constant). As a result of this loan-migration, and the subsequent increase in provisions, two banks (one of them holding 14 percent of total assets of the banking system) move below the minimum CAR of 12 percent. The CAR of the overall banking system decreases by 8.6 percentage points, but the banks in group 3 (except for one) are unaffected by this shock owing to very small credit portfolios.

72. **Two sectoral credit risk tests were conducted**: (i) a shock to external demand for agriculture products assumes a migration of agricultural loans from categories A and B by 24 percent and 30 percent respectively, to categories C, D, and E, as a result of which, the NPL of the banking system rise to 13 percent of gross loans; and (ii) a fuel price shock assumes a primary round of migration of energy-sector loans from categories A and B by 39 and 50 percent respectively, and redistributed in C, D, and E, and a secondary round migration of overall corporate loans by 24 and 30 percent from A and B respectively to the other categories (using the generic credit risk assumptions mentioned earlier), which results in an NPL of 22 percent for the overall banking system. Sectoral credit risk tests indicate that the banking system is vulnerable to fuel price shocks, but resilient to moderate agricultural shocks. For the fuel shock, the asymmetric migration of loans considered above pushes two banks (one of them systemically important) below the 12 percent minimum CAR.

73. **Exchange rate risk** is the effect of exchange rate changes on the local currency value of banks' assets and liabilities as well as off-balance sheet items. The direct balance sheet effects of exchange rate shocks are limited by modest open foreign exchange positions that are well within the regulatory limit. However, owing to a large share of credit extended in foreign currency, the banking sector is exposed to indirect effects of credit quality deterioration due to sudden large exchange rate shocks. Credit quality of exporters will worsen with real appreciations. With NBM regulations restricting foreign exchange lending to importers—who are not naturally hedged with income in local currency—credit quality of the latter would tend to deteriorate following depreciations. It is assumed that, for the purpose of the sensitivity analysis of exchange rate movements, banks are equally exposed to exporters and importers—for both exchange rate appreciations and depreciations, the effect on credit quality is symmetric. The banking system is vulnerable to large—for example, 40 percent—exchange rate appreciations and depreciations only when accompanied by higher credit risks. Asymmetric migration of loans pushes two banks below the minimum CAR, reducing banking system CAR by almost 10 percentage points.

74. Changes in **interest rates** affect net interest income (NII) that in turn influences profits, and through retained earnings, capital of the banks. An additional effect of interest rate changes is on credit quality—an increase in nominal interest rate is assumed to have a real effect on the solvency of borrowers from the banking system. Historical data (post 1998–99 crisis) suggest that interest rate changes have a stronger effect on NPLs than do exchange rate changes, even though the size of interest rate shock considered is much smaller. The banking system has positive repricing gaps (the difference between values of assets and liabilities to be repriced at

each horizon) for most horizons—an interest rate increase would tend to raise CAR for the overall banking sector due to higher NII. The negative repricing gaps, which a few banks face, are small and do not result in significant capital losses in case of interest rate increases. The banking system in Moldova is not considered to be very vulnerable to interest rate shocks, unless it is accompanied by very large credit quality effects. In such a case, overall CAR reduces by 8.5 percentage points with two banks falling below the minimum CAR.

75. A **combination of different types of shocks** was considered to be a result of a crisis scenario—sudden depreciation of 40 percent of the USD and euro exchange rates, and 20 percent of that of the Russian ruble prompted by presumably a sudden decline in the flow of foreign workers' remittances, accompanied by an increase in borrowing rates. Assuming NPLs to rise to the maximum level experienced during the 1998–99 crisis—39 percent NPL achieved by 32 and 40 percent migration of loans from A and B respectively into C, D, and E—the CAR of the banking system would decline by 11 percentage points, and two banks would fall below the 12 percent minimum CAR. If an additional effect of illiquidity of government securities in anticipation of a liquidity crisis is included in the scenario, the total effect will be very significant. Given the thin market for such securities and the large holdings by banks, the price of such securities would decline eroding considerably the realization value of such assets. Assuming that banks are able to recover only 50 percent of the value of such securities, the banking system would lose an additional 5.4 percentage point of CAR—that of group 1 would decline to 9.2 percent. Moreover, 6 banks, 4 in group 1, and 1 each from groups 2 and 3 would be pushed below the 12 percent minimum.