



March 2005
SecM2005-0118

Moldova

FSA | Financial Sector Assessment

This volume is a product of the staff of the International Bank for Reconstruction and Development / The World Bank. The World Bank does not guarantee the accuracy of the data included in this work. The findings, interpretations, and conclusions expressed in this paper do not necessarily reflect the views of the Executive Directors of The World Bank or the governments they represent.

The material in this publication is copyrighted.

1. As part of the joint World Bank IMF Financial Sector Assessment Program (FSAP), two teams visited Moldova, one in April 2004, and another from May 12 to June 2, 2004.¹ The team focused on three broad areas: (i) the Moldovan financial system's short-term stability and its resilience to shocks; (ii) progress in meeting international standards and good practices in the regulation, supervision, and transparency of the financial system; and (iii) key medium term and developmental issues in the financial system. The FSAP team produced an Aide Mémoire and the following three detailed reports that were reviewed by and delivered to the authorities: (i) Technical Notes; (ii) Assessment of Compliance with Standards and Codes; and (iii) Detailed bank-by-bank Stress Tests.

2. The Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) section of the report was based on the report of an IMF technical assistance mission undertaken in April 2004.² The full assessment of AML/CMT that is required in the context of the FSAP is scheduled to be conducted in early 2005 by MONEYVAL, the FATF-style regional body for Europe, whose Secretariat is provided by the Council of Europe. MONEYVAL will prepare an assessment of compliance with AML/CMT standards and codes following their mission.

3. During the IMF Article IV mission in October 2004, further discussions were held with the Moldovan authorities on the main conclusions of the assessment. During those discussions, the authorities requested help from the Bank and the IMF to facilitate the implementation of several recommendations, notably those regarding the improvement of the legislative framework and supervision structure for the insurance sector, the updating of accounting and auditing standards and improvement of their implementation; and the improvement of corporate governance in the enterprise sector. To respond to the requests from the authorities, a technical assistance program has been developed which also includes advice by the IMF to the National Bank of Moldova (NBM) on banking supervision and the regulation of foreign exchange.

A. Strategic Assessment

4. **Although Moldova is the poorest country in Europe, measured by per capita GDP, the country 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.

¹ The FSAP team comprised Martin Slough (World Bank, Leader); Judit Vadasz (IMF, Deputy); Erik Lundback, Srobona Mitra, Yuji Yokobori (all IMF); Irina Astrakhan, Victor Burunsus, Michael Edwards, Serap Gonulal, Peter Kyle, Barbara Mondestin, Yibin Mu, Sue Rutledge (all World Bank); Svante Bågström (Sveriges Riksbank, Payment System); Stefan Spamer (Deutsche Bundesbank, Banking Supervision); and Walter Zunic (Banking Supervision – World Bank expert). Edgardo Ruggiero (IMF Resident Representative) and Edward Brown (World Bank Country Manager) participated in some meetings. Alex Berg (World Bank), who conducted a Corporate Governance ROSC, and Henri Fortin (World Bank), who conducted an Accounting and Auditing ROSC, both independently of the FSAP, contributed to the report.

² The AML/CFT mission was undertaken by Terence Donovan and Peter Csonka (both IMF).

5. **Although quantitative indices suggest the banking sector to be sound, several qualitative aspects of the banking system are less comforting.** Of particular concern are:

- The governance problems stemming from the growing role of the government in the banking and insurance system;
- The opaque ownership of financial institutions and corporations, as well as the near-absence of fit-and-proper strategic investors;
- The potentially 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, during which banks may well have granted loans that ultimately could prove to be below par, but which do not yet appear in the classified categories.

6. **While the team conducted an analysis of the soundness of the banking sector, the stress tests need to be qualified.** Bank supervisors who provided the data are hampered by extraneous and oftentimes political constraints. The supervisors also have difficulty in obtaining useful information about some of the ultimate beneficial owners of banks. The banks, in turn, may have only anecdotal evidence about the shareholders that ultimately control many of their borrowers. In view of this opaque ownership structure of many banks and companies, 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, exacerbating the problem.

7. **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.

8. **The framework of written rules and regulations supporting banks is to a large extent consistent with international standards, although implementation is less so.** In the banking sector, prudential rules, accounting and auditing, and much of the legal infrastructure help to 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.

9. **Access to finance poses smaller problems than in many other countries at a similar level of development.** Nevertheless, financial intermediation is lagging behind even

some of the neighbors, reflecting weaknesses in the regulatory, supervisory, and operational framework in the securities, insurance, and microfinance sectors.

10. **Non-banking sub-sectors of the financial system—the insurance and the securities sector—are in the early stages of development.** Like the banking sector, they also face governance problems; have operational difficulties due to the lack of instruments and properly developed markets; and their supervision lags far behind that of banks.

11. **From the viewpoint of systemic vulnerability, the recommendations for the banking system and its supervision are of the highest priority.** The team's key recommendations are summarized below. The team proposed improving the fit and proper examination criteria, developing a privatization strategy for the state-owned bank, and pointed out that the state intervention in the insurance sector should be discouraged.³ 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, owing to the opaque ownership of many banks and enterprises alike.

12. **The key recommendations for the financial sector comprise the following:**

Banking system

- Develop a privatization strategy and a time-bound 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.
- Determine whether 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 the 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 banks to provide an analysis of their clients' currency positions.

³ Subsequent technical assistance in December 2004 has been directed at addressing some of these recommendations.

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 improve the institutional structure, the implementation and enforcement capacity of insurance supervision, and corporate governance.
- 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 basis for Savings and Credit Associations (SCAs).
- Strengthen the supervision of SCAs by the State Supervisory Board (SSB).
- Adjust the VAT treatment of leasing companies to be the same as for banks.

Anti-Money Laundering (AML) Issues

- 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 international standards.

B. Financial Sector and Regulatory Context

Financial Sector Structure

13. **The FSAP was conducted at the time when economic activity was buoyant, however inflation was on the rise.** Monetary and fiscal policies became expansionary, while structural reforms were stalled. Remittances from abroad played an increasingly important role as a source of funding and a driver of growth.

14. **The banking sector is small in terms of assets (around US\$ 780 million as of end-2003, equivalent to 38 percent of GDP), but the number of banks (16) is more than adequate.** The banking sector is dominated by the six largest banks with about 77 percent of total assets, 80 percent of total deposits and 63 percent of total capital. To stimulate mergers, the NBM will progressively increasing the minimum capital levels for a full unrestricted license from MDL 96 million to MDL 150 million (about US\$12 million) by end-2005.

15. **The ownership of the Moldovan banks, which are all registered as joint-stock companies, is dispersed into several main groupings.** One bank, the second largest, is owned by the state, which has a 56 percent share. The state now 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 owners. The remaining seven banks are either majority offshore owned or have controlling minority offshore owners, some of which could in turn be owned by Moldovan residents.⁴ No offshore shareholder in any of these banks exceeds the 10 percent threshold that requires prior NBM approval.

16. **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 (around US\$24 million), of which more than 98 percent was for non-life 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 of the industry.

17. **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. Most loans with maturities of more than one year are financed by international donors. The role of non-bank 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 underdeveloped even by regional standards, principally owing to the tax disadvantages of lessors. However, there appears to be a strong unmet demand for these services, especially from SMEs, for leasing vehicles.

18. **Microfinance has experienced substantial growth from a low base 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

⁴ These owners are domiciled in Bahamas, Belize, Cayman Islands, Cyprus, Dominican Republic, Panama, etc.

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 donor funds to them. 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.

Performance of the Banking Sector

19. **Overall, the banking sector demonstrates impressive levels of earnings and capitalization, and a low level of classified or nonperforming assets.** The key financial soundness indicators have strengthened in the past five years, but the performance of the smaller banks continues to lag behind the sector. Although the smallest five banks have much higher capital adequacy ratios (CAR), they have a much lower return on assets (ROA) and return on equity (ROE) than the largest five banks. This raises questions about their business models, as their balance sheet structures differ from that of a typical commercial bank.

20. **Reported nonperforming loans (NPL) have fallen sharply since the Russian financial crisis.** NPLs in the lowest 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. However, the NPL rate of 12.7 percent at the smaller banks is double the average for the whole banking system. 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 covered 89 percent of nonperforming loans (loans in the C, D and E categories).

21. **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 the pricing of their customer loans to achieve an adequate yield on assets overall.

22. **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.

23. **During the past five years, dollarization of the banking system has remained relatively unchanged at just under half of total assets and deposits.** The ratio of foreign

currency deposits (mostly in euros and US\$) to total deposits has declined slightly to 45 percent, while foreign exchange lending has remained relatively constant at about 42 percent of total loans.

C. Systemic Vulnerabilities

Macroeconomic risks and vulnerabilities

24. **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 the 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.

25. **To improve the external situation, in May 2004 the authorities resorted to requiring additional direct financing from the NBM, to the tune of MDL 600 million (around US\$50 million).** This financing of the budget was used for sovereign external debt payments. Prior to this financing, loans previously granted by the NBM had been successively renewed at maturity, without any reduction of principal, under the annual budget laws drafted by the MOF and approved by Parliament.

26. **The NBM's direct lending to the government—permitted by 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.

27. **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. However, in spite of the inflow of foreign exchange, non-market 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.

28. **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.

29. **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.

30. **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 extend foreign currency loans to resident individuals or enterprises only for the settlement of payment obligations to nonresidents, typically for payment of imports. Paradoxically, while these borrowers might not have any foreign exchange revenues to hedge their risk, banks are not permitted to extend such credits to exporters (except for official credit lines). Another related risk 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 Moldovan leu (MDL) depreciated sharply vis-à-vis the dollar.

31. **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.

Financial Soundness of the Banks and Stress Testing

32. **The various analytical and stress tests undertaken did not identify systemic vulnerabilities within the banking sector, although a few banks are consistently seen as more vulnerable to the 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.

33. **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.** 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.⁵

34. **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 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.

35. **In Moldova and elsewhere, state-owned entities, banks and enterprises alike, 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 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 team recommended that the bank's new board 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

⁵ The authorities, however, maintain that these banks are financially responsible for their subsidiaries only to the extent of the equity put up by them.

management practices and its business plan. To provide a fuller, longer-term solution to governance problems, the team recommended that government to develop a privatization strategy for the bank.

36. **Moreover, the regulation of the insurance subsidiaries of banks 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. Furthermore, banks carry no reserves for such activities and the NBM has no established means to exchange information with the insurance supervisor to evaluate accurately 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.⁶ 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.

37. **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.

38. **The seven banks referred to immediately above are more susceptible to insider abuses, and potentially money laundering, with inadequate 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 these infractions to be remedied. 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

⁶ The team felt that this recommendation, which is more stringent than normally required, is justified by the lack of proper insurance supervision and the large number of existing insurance companies, which casts doubt on the soundness of the banks' full investment in the insurance sector.

to scrutinize more closely the risk management processes, financial condition, and practices of these banks.

39. **Moldova has been unable to attract reputable strategic investors into the banking sector, owing in part to the ownership issues mentioned above and more general perceptions of its macroeconomic environment.** The reluctance of reputable foreign banks 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. Among the consequences is that the much needed knowledge transfer that having multinational banks in the system would provide has not occurred.

Supervision and Regulation

40. **The framework for bank supervision and regulation is reasonably comprehensive and, with some exceptions, adheres to the Basel Committee's Core Principles (BCP) for Effective Banking Supervision.** Supervisory independence exists—as measured by the formal BCP assessments—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 is not addressed in either the framework laws or the supporting regulations. There is only a limited system of cooperation and information sharing among all domestic agencies with responsibility for the soundness of the financial system.

41. **As mentioned above, 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.

42. **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 individual shareholders casts some doubt on whether total loans of groups of closely related borrowers can be accurately measured. Absence of this information obstructed the FSAP team's ability 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. The supervisor should provide guidance to banks in terms of the systems they need to maintain to identify, measure, monitor and control some elements of risk, such as reputational risk. In addition, the law and a respective regulation do not include a capital charge for market risk except for foreign exchange risk. These shortcomings should be remedied by appropriate amendments to the regulations.

43. **The NBM has only limited legal authority to supervise banks on an international consolidated basis, although 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 should be addressed specifically by amendments to the laws and regulations.

D. Medium-Term Challenges and Development Issues

Banking Sector

44. **Fast loan growth since 1999 calls into question the efficacy of bank 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.

45. **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 (such as 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 distinguish between importers and exporters (especially as some borrowers are both), sound practice would require that they factor in the borrowers' open foreign exchange positions in their analysis of credit risk.

Deposit Insurance

46. **A deposit insurance scheme, to be financed from contributions by banks, has been introduced, covering individual depositors up to the modest limit of MDL 4,500 (around US\$380) per depositor per bank.** The team pointed out that 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 as a prelude to liquidation of the bank concerned. The team 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 passed in June 2004 gives priority to claims by DIF over unsecured creditors.

Systemic Liquidity Management

47. **While the Law on the NBM stipulates that the main objective of the central bank 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.

48. **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).⁷ In these circumstances liquidity forecasting is difficult and 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.

Access to Credit and Microfinance

49. **The regulatory framework under which Savings and Credit Associations (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 at covering all the potential risks are being developed for SCAs and should be adopted during 2005. A new draft Law on Savings and Credit Cooperatives, which envisages the participation of legal persons as members and a potential broadening of their scope that would put into question the treatment of Savings and Credit Cooperatives (SCCs) as NBFIs, is under discussion. 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) governance and management/accounting capability (to alleviate the risks inherent in their activity); (ii) supervisory authority and the capacity of the SSB to complete the liquidation of insolvent SCAs; (iii) sanctions available to facilitate the enforcement of regulations; and (iv) alignment of the regulatory framework with good practice. The leasing industry might develop faster if the VAT status of lessors were

⁷ 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, over a period of 10 months, so as not to release additional leu liquidity at once.

adjusted to be the same as for the banks, by removing the application of VAT to the interest element of leasing payments.⁸

Legal framework

50. **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 being 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, sound practice is to extend such immunity from civil proceedings to other officials, including the bank supervisory staff.

51. **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.⁹ Recent reports and surveys have confirmed that the risks and costs of doing business are high and administrative burdens of all kinds are onerous. 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.

Payment and Settlement Systems

52. **The existing systemically-important 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 ambitious plans 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 those settled 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

⁸ The correction of this anomaly is among several enabling amendments to leasing legislation prepared by the government for submission to parliament in spring 2005.

⁹ EBRD and World Bank, Business Environment and Enterprise Performance Survey, 2002

systems will have to be drafted in a timely manner, as will 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 will need 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 address eventual shortcomings. Contingency plans will need to be updated and tested, including planning for a back up site situated at a sufficient distance from the production site. Crisis management and incident organization will need to be established and prepared to be ready for action.

Insurance Sector

53. **The insurance sector exhibits a multitude of problems that need to be resolved before the sector can exhibit healthy growth.** If indeed the recently established state-owned insurance company has received preferred treatment because state-owned enterprises and government departments are urged to channel all their insurance business to that company, this practice should be ended. The institutional structure, implementation, and enforcement capacity of insurance supervision that is presently within the MOF needs to be developed. At the same time, sound practice would require that the supervisor 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 to help insurers and supervisors price their various products appropriately. The public and the insurance industry would benefit from an education campaign that would explain the potential advantages and uses of insurance products.

54. **The work on the new, modern insurance legislation remains to be completed.** The new law envisages the establishment of an independent insurance regulator, an increase in the capital requirements, and the harmonization of prudential requirements with applicable sound practice standards whereby life and non-life activities are separated so that one activity cannot be used to support other. Before the separation, a suitable regulatory framework for life insurance should be developed. Both the insurance sector and its regulatory body would be strengthened by improved coordination.

Capital Markets

55. **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 is constrained by the departure from the market of nonresidents, who sold their holdings in the wake of the Russian crisis and have not returned. The lack of equity investors is exacerbated by fragmentation of the market. For the capital markets to grow, a strategic plan addressing ways to broaden the investor base and strengthen the supervisor (the National Securities Commission of Moldova), without increasing the number of staff, is needed. Reconfiguring

the stock market as a cost-effective and operationally-efficient “light stock market” might help revive it.

Anti-Money Laundering and Combating the Financing of Terrorism

56. **The combination of poverty and an open economy in a sensitive region leaves Moldova vulnerable to illicit activities.** This vulnerability is exacerbated by the unsolved issue of the status of the Transnistria region. 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) making legislative changes to the AML Law and the Criminal Code to penalize the financing of terrorism; (ii) adopting legislative and implementation measures related to customer due diligence and the reporting of suspicious transactions; (iii) establishing mechanisms for the coordination of national AML/CFT initiatives and measures related to international cooperation; (iv) enhancing enforcement; and (v) improving in the operation of the Service for the Prevention of Money Laundering, which at present does not appear to be in a position to add significant value through its analysis of the information it collects.