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Preface

This report comprises technical notes on selected financial sector issues based on the findings of the joint World Bank/IMF Financial Sector Assessment Program (FSAP) team which undertook missions to Moldova from April 7 to 9, 2004, and from May 12 to June 2, 2004. These studies have benefited from feedback from the Moldovan authorities, as well as from World Bank and IMF colleagues at headquarters.

The team¹ would like to express its sincere gratitude to the Minister of Finance, the Governor of the National Bank of Moldova, and their respective staff, as well as representatives of other government and private sector institutions for their cooperation in this effort. The team also greatly appreciates the hospitality received during its two visits. Finally, we hope that these reports on selected issues will assist the authorities in taking steps to enhance the role of Moldova's financial sector in contributing to the country's growth and development strategy.

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I - Legal Framework²

Introduction

1. **Moldova declared its independence in August 1991 and adopted its current constitution in July 1994.** Over the intervening decade, the legal framework governing the regulation and supervision of the country's financial and business sectors has undergone significant reform. The result has been the adoption of a series of laws and regulations that are reasonably comprehensive and broadly consistent with international best practices.
2. **However, Moldova has lagged behind in the creation of a business friendly legal and tax environment.** Moreover, in common with several other CIS countries, the implementation and enforcement of the applicable laws have generally been poor. This is largely the result of inadequate resources, excessive bureaucracy and state intervention, and insufficient compliance with the rule of law³.
3. **Recent reports and surveys⁴ have confirmed that the risks and costs of doing business are high and that administrative burdens of all kinds are excessive.** Access to finance is limited and regulatory compliance costs are amongst the highest in the region. 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. Moldova might wish to emulate the practice of India, for example, where the authorities have sought to address this issue by requiring inspection officials to complete a log book at the premises of the company undergoing inspection, explaining why they are inspecting and summarizing their findings.
4. **In broader terms, the business environment in Moldova is restrictive and a high degree of state interference in economic activity persists.** The network of government bodies with control functions is complex, and their responsibilities are vaguely defined and oftentimes overlapping. The entire system of controlling bodies and their activities requires a comprehensive review and radical reform.
5. **To their credit, the Moldovan authorities have recognized many of the major areas in need of review and restructuring and have embarked upon an ambitious legal reform agenda.** Recent significant legislative reforms include a new Civil Code, Code of Civil Procedure, Criminal Code and Code of Criminal Procedure together with laws covering insolvency, licensing and tax administration. Significant efforts, however, should also be made to promote the implementation of existing laws and regulations.

² The author of this section is Mr. Peter Kyle.

³ Moldova ranked 114 out of 146 countries in the Corruption Perceptions Index (CPI) for 2004 published by Transparency International in October 2004. Moldova had a composite score of 2.3 out of 10.

⁴ Notably the second Business Environment and Enterprise Performance Survey 2002 (BEEPS II) prepared by EBRD and the World Bank, the results of which for Moldova are summarized in Figure 5 and Chapter IV of these Technical Notes.

6. **This chapter focuses on four key elements of the legislative and judicial framework governing the Moldovan financial sector⁵.** It begins with a review and assessment of the adequacy of the principal laws regulating the financial sector. The corporate sector legal environment is then discussed. The third section deals with the country's bankruptcy and secured lending regime and issues relating to debt enforcement. The final section seeks to identify the major issues affecting the judicial sector. The chapter concludes with specific recommendations. The legislative underpinnings of other sectors, including insurance and capital markets, and a detailed analysis of the regulatory aspects of banking supervision, anti-money laundering and of other financial institutions and specialized banks are dealt with in other sections of the FSAP report.

A. Financial Sector Legislation

7. **Before proclaiming independence, Moldova was part of a Soviet-style banking system which comprised a few state-owned banks operating in different business sectors.** Initial legislation restructuring the financial sector was adopted in 1991. In 1995 the Law on the National Bank of Moldova (NBM Law) and the Law on Financial Institutions (Banking Law) were passed. Both laws were drafted with significant input from the IMF and apart from small amendments in recent years they have stood well the test of time.

NBM Law

8. **The NBM Law provides that the NBM is an independent institution whose main objective is to achieve and maintain the stability of the national currency.** To meet this objective, the NBM is required by law⁶ to:

- establish and manage the monetary and foreign currency policy of the state;
- analyze the current economic situation and make recommendations;
- license, control and regulate the activity of financial institutions;
- provide credits to the government if required, and to the commercial banks;
- manage the country's foreign currency reserves; and
- issue the country's currency.

9. **The NBM is managed by a Council of Administration comprising five members, including the Governor, the First Vice Governor and three Vice Governors, all of whom are nominated by the Parliament for a renewable seven year term.** The provisions concerning their removal, duties and responsibilities are standard. The NBM Law also contains customary provisions dealing with banking supervision, relations with governmental bodies, financial institutions, foreign exchange and currency. The Law is well drafted and comprehensive in its scope. In many respects it appears to comply with modern central banking laws and practices.

⁵ Some of the recommendations regarding the legal framework of the banking system are included in other FSAP documents (the Aide-Mémoire and the Detailed Assessment of Standards and Codes).

⁶ The NBM also regulates and oversees the payments and settlement system, although this function is not explicitly stated in the objectives clause of the NBM Law.

10. **One aspect which merits review concerns the issue of immunity.** The sole reference to this subject appears in Article 24 (1) which provides that “The Governor shall have immunity status”. Modern practice is to extend immunity from civil proceedings at least to bank supervisory staff.⁷ NBM staff contended that all actions taken by staff in good faith in the normal course of their duties would be covered by the general immunity afforded to the NBM, and that it was inconceivable that an individual staff member would be sued personally. This argument is frequently advanced in transition country jurisdictions. International experience indicates, however, that at some point in time, it is highly likely that a disaffected bank shareholder or another aggrieved party will attempt to seek redress directly from the individuals who are perceived to have caused the loss or damage claimed, and that protection from such a possibility is both necessary and desirable. It is for that reason that the Basel Core Principles expressly include a provision requiring bank supervisory staff to have immunity from suit, except of course for willful default or gross negligence.

11. **Another matter for concern is that the NBM Law allows the NBM to lend directly to the Government.** This measure is customarily prohibited in most countries, except for very occasional emergency support which should be repaid within a short period of time⁸. In Moldova the NBM started lending to the Government in 1998/99 at the time of the Russian crisis and the lending has been successively rolled over and indeed increased during the last six years to a point where NBM lending constitutes nearly 75% of the government’s internal debt⁹. The FSAP team recommends that this aspect of the NBM Law be reviewed and amended, since long-term financing of the government by the NBM is contrary to the spirit of central bank independence and it is not in accordance with best international practice. It is further suggested that a schedule for repayment of the existing debt be agreed between the NBM and the Ministry of Finance.

Banking Law

12. **There are no significant gaps in the Banking Law.** The law provides the legal basis for the registration and operation of the country’s sixteen commercial banks and provides a comprehensive regime for banking supervision, appropriate fit and proper criteria, and measures necessary to manage, and if necessary, to terminate, the operations of a bank. Indeed, the Banking Law is well drafted and in many respects appears to conform to EU Directives and international banking law best practices, although some prudential rules (e.g., the handling of country risks) are missing.

⁷ The practice of different countries is discussed in www1.worldbank.org/finance/html/statutory_protection.html

⁸ In countries without a well-developed market for government securities, limited and temporary advances might be accepted (see pages 18-20 of IMF/MAE OP/98/1 “Elements of Central Bank Autonomy and Accountability, February 1998 that was sent to the authorities separately). With a view to encourage the development of the market for government securities, the limit on central bank credit to the government could be reduced over time (a transitional provision).

⁹ Direct financing of the government by the NBM as of end-July 2004 was MDL 2,744 million out of a total stock of internal government debt of MDL 3,668.6 million as of the same date.

13. **Depending on the size of their equity, banks are entitled to receive different types of operating licenses.** In November 2003, the Regulation on Licensing of Banks was amended to raise the minimum required tier-one capital for a new bank, or for an existing bank seeking a higher category license, to MDL 50 million (about US\$ 4 million). Moreover, all existing banks were required to increase their tier-one capital to a minimum amount of MDL 50 million by 12/31/2005, to be achieved in three stages commencing as of 06/30/2004¹⁰. In order to obtain an “A” category authorization, which would allow a bank to carry out financial transactions in MDL only, except for the buying and selling of foreign currency, and for the opening of bank accounts and depositing money with other banks in the Republic of Moldova, banks would be required to reach and maintain the minimum tier-one capital level (MDL 50 million as of 12/31/2005). However, banks which also wish to undertake the full range of foreign exchange business, are required to secure a “B” category authorization, which requires a tier-one capital at a level greater than double the amount of the minimum necessary level of capital (i.e. tier-one capital of at least MDL 100 million as of 12/31/2005). Finally, banks which wish to carry out the entire range of banking services (including underwriting), are entitled to receive a “C” category authorization, but to do so, such banks need a tier-one capital level higher than three times the minimum necessary amount (i.e. tier-one capital of at least MDL 150 million as of 12/31/2005).

Other Financial Sector Legislation

14. **In December 2002, the NBM approved a national payment system development strategy and a comprehensive regime to deal with anti money laundering measures.** Several new laws which will serve to strengthen the operation of the financial sector are in contemplation. A new Law on Deposit Insurance has been adopted and new regimes to govern the activities of savings and loan associations and of microfinance institutions are currently being discussed. The possible role of the NBM in serving as regulator of such entities will need to be kept under close review. New legislation governing electronic payments and providing for the use of electronic signatures which was approved in July 2004 will also have a beneficial effect on the efficiency of the financial sector. A new Insurance Law is also presently being drafted and a new Law on Investment Funds is envisaged.

B. Corporate Sector Framework

15. **The commercial legislation of Moldova is represented by a complex system of laws most of which have been subject to significant amendments in recent years and are generally satisfactory.** The current legislative basis for investment and business operations includes the following:

- Civil Code
- Law on Entrepreneurship and Enterprises
- Law on Enterprise Investments
- Law on State Regulation of Foreign Trade
- Law on Joint Stock Companies
- Regulations of Economic Societies

¹⁰ The staged increases in the minimum tier-one capital requirement are MDL 40 million (as of 06/30/2004); MDL 45 million (as of 06/30/2005); and MDL 50 million (as of 12/31/2005).

- Law on Insolvency
- Law on Privatization, and
- Program of Privatization

16. **According to the Civil Code and the Law on Entrepreneurship and Enterprises, the legal organizational forms of business entities include joint stock companies, limited liability companies, cooperatives, state and municipal enterprises, general partnerships and limited partnerships.** The most widely used corporate entities are joint stock and limited liability companies. Insurance companies can be registered as joint stock companies, limited liability companies or state companies, but banks may only be registered as joint stock companies. The shares of joint stock companies have to be registered at the National Securities Commission of Moldova (NSCM). The minimum ownership capital required for a closed joint stock company is MDL 10,000 (around US\$750) while the minimum required capital for an open joint stock company is MDL 20,000 (around US\$1,500). The supreme administrative body of a company is the general shareholders' meeting which is required to be held no less frequently than once a year. The other executive bodies include the Board of Directors and the Board of Supervision.

17. **Business registration procedures have improved and anecdotal evidence confirms that the new centralized State Chamber for Registration operates reasonably efficiently.** The registration fee is equivalent to US\$300 for enterprises with foreign capital and US\$500 for the representative office of a foreign company. Registration of local companies can generally be effected within 3 to 5 days, but foreign companies tend to take somewhat longer. The documents needed have been reduced in number and simplified. Overall, the system for business registration is generally regarded as satisfactory and not excessively complex.

18. **However, recent amendments to the Law on Joint Stock Companies are of concern.** The requirement that companies must distribute 30% of net profits by way of dividends is probably intended to provide some protection to minority shareholders, but nevertheless represents a questionable intervention by the state in the operations of the private sector. A new provision permitting a shareholder who does not receive written notice of a shareholders meeting to be able to seek annulment of any resolutions passed at such a meeting, will impose significant and inappropriate costs on corporate activity, particularly for those companies that have literally thousands of shareholders. As shareholder registers are invariably not up-to-date, the potential for abuse in this area is substantial. An appropriate remedy would be to require companies to announce shareholders' meetings in one or more approved daily newspapers with wide circulation. The commercial sector also suffers from some major weaknesses in the area of corporate governance. Particular deficiencies are outlined elsewhere in this report.

C. Insolvency and Creditor Rights

Insolvency

19. **In the area of insolvency, Moldova adopted a relatively modern Law on Insolvency in 2001 that has since been amended several times.** The new legislation combines reorganization, bankruptcy and liquidation procedures into one law, and establishes uniform bankruptcy and liquidation procedures for all commercial enterprises. Focusing on the role of the administrator during the bankruptcy proceedings,

it prescribes how the relevant creditor groups are organized and how they operate. The law also transferred responsibility for appointing bank liquidators and monitoring the progress of the liquidation process to the courts. Data on the number of companies that have been or are being wound up is not yet available, but anecdotal evidence suggests that the changes have improved the process.

20. **The provisions dealing with the initiation, hearing, opening and initial effects of an insolvency case are quite strong as are the provisions concerning the avoidance of pre-bankruptcy transactions.** The reorganization procedures also appear to provide sufficient protection for creditors. Some improvements could be made in the following areas:

- A more concise description or statement of what financial condition constitutes insolvency and what a creditor must establish;
- Removal of the penalty against creditors for failure to submit a claim in time;
- Clarifying the effect of the opening of proceedings on secured creditors;
- Clarifying the extent to which non-contractual liabilities may be claimed; and
- The provisions dealing with cross-border insolvency cases.

21. **There are, however, other weaknesses in the administration of the Law on Insolvency that reduce its effectiveness.** The number and competence of trustees is low and the prescribed level of fees is unattractive, thereby creating temptations for abuse. Furthermore, provisions in the Insolvency Law and in the Civil Code restricting the number of insolvency cases that a trustee may administer to no more than two at any point in time weaken the insolvency administration regime. The absence of any central source of information on bankruptcy proceedings hampers business activity. Finally, some inconsistencies and conflicting provisions in the law and varying interpretations by the economic court judges have also made implementation difficult and further amendments to the law are in contemplation.

22. **Insolvency of banks, formerly covered by Chapter 7 of the NBM Law, is now part of the Law on Insolvency.** Where the insolvency of a bank becomes an issue, the NBM initiates the process, notifies the court and annexes a copy of the NBM decision to the court application. The court appoints an administrator/receiver from a list of people eligible to carry out such assignments. The NBM has established criteria for this list, but the level of fees is not very high, so there is a shortage of people able and willing to take on such assignments. In practice, it is often an NBM staff member who acts as administrator or receiver. The authorities are considering the creation of a special fund to remunerate administrators and receivers, in order to facilitate the appointment of suitably qualified people. To date, only one bank insolvency proceeding has been initiated under the new Insolvency Law, namely the liquidation of a bank whose license was withdrawn by the NBM in July 2002.

Creditor Rights

23. **The country's collateral law framework appears to work reasonably well.** Land reform has largely been completed and the country has a sound and modern cadastre and land registration system, supported by local databases and information systems, developed in 39 cadastral offices that register titles and provide legal security to owners and relevant public information about real estate. The Real Estate Register is computerized and accessible, and registration can be achieved quickly. Although

Moldova lacks a specific law on mortgages, the number of registered mortgages has increased considerably in recent years whereby land is the principal form of bank security.

24. **In the case of movable property, the new Pledge Law of 2001 introduced important improvements.** A new centralized computerized registry for movables has been established at the Ministry of Justice on a pilot basis. However, so far only 5 of the 130 notaries public registered to practice in Moldova are online, and the current registration system, which is maintained by notaries public, is not functioning well. Implementation of the new computerized registry needs to be speeded up so that all notaries will be able to register pledges on behalf of creditors and banks are readily able to consult the pledge registry. There are a number of inconsistencies between the new Pledge Law and the Civil Code which are in the process of being remedied.

25. **The new simplified debt recovery procedure introduced in 2001 allows banks to obtain summary judgment in respect of most debts within five days.** Banks generally expressed satisfaction with this procedure, although enforcement of such judgments remains problematic. Inefficiencies and corruption within the Department for the Execution of Judgments are a particular problem, and there are as yet no specialized courts in Moldova. Where the security takes the form of movable property, re-possession is usually straightforward. Where land is involved, however, the auction process can be drawn-out and unpredictable. Understandably, the tax authorities require the banks, as collectors of collateral, to pay the applicable VAT when selling the collateralized asset, as the debtor is not usually in a position to pay this tax.

D. The Court System

26. **In Moldova, as in many parts of the developing world, judges and the court system attract a good deal of criticism.** Courts are regarded as excessively congested, resulting in unacceptable delays in bringing cases to closure. Court facilities and infrastructure are generally poor, judicial terms and conditions of service are unsatisfactory, and judges are frequently considered to be lacking in experience and subject to undue influence. All these criticisms apply in the context of Moldova.

27. **Moldova has a three-tiered court system consisting of the Supreme Court of Justice, the Court of Appeal and District/Municipal Courts.** The Military Court, the Economic Court of the Chisinau Circuit and the Republican Economic Court are specialized courts within the judicial system, created to examine certain categories of cases. In 2000, administrative sections were created within the common courts to review administrative acts. The Supreme Court of Justice is the highest court in the system and performs extraordinary review of judicial decisions. It operates through its civil, criminal and economic chambers or collectively through the plenum consisting of all its judges. There are 44 district and municipal courts that act as the first instance court for all criminal, civil and administrative cases not specifically entrusted to other courts. The two economic courts hear commercial disputes including bankruptcy between legal entities and individuals registered as entrepreneurs. The Chisinau Economic Court acts as a first instance court, while the Republican Economic Court is an appellate court and also has original jurisdiction over certain cases provided by law. The Supreme Court of Justice is the cassation court for decisions issued by the Economic Courts.

28. **In order to be appointed, all judges must be competent, hold a degree in law, have requisite work experience, have no criminal record, have a good reputation and be proficient in the official state language.** At the municipal or district court level judicial candidates must have reached the age of 30 years and have a minimum of 5 years' legal experience. Candidates for the other courts must have not less than 5, 7, or 10 years' experience respectively. Judges of the lower court are appointed by the President on the proposal of the Superior Council of Magistracy. Each judge is appointed for a 5 year term after which the judge may be reappointed until the mandatory retirement age of 65. Judges of the Supreme Court of Justice are appointed by the Parliament on the proposal of the Superior Council of Magistracy. They serve until mandatory retirement. There is no specific legal requirement that judges participate and continue in legal education. However, the law requires judges "to enlarge their professional knowledge, to study and generalize the case law". A Judicial Training Center was recently established within the Ministry of Justice to provide practical and theoretical training for judges.

29. **While judges are supposed to be appointed based on objective criteria, there have been complaints about the alleged preponderance of other considerations, as well as the fairness of the examination process.** Judges may be disciplined or removed from office for specified reasons that are reasonably objective. Procedures for discipline or removal are transparent and, at least theoretically, give judges accused of misconduct an opportunity to defend themselves. Because the law does not provide for an impartial and transparent method of case assignment, court presidents are free to assign cases on whatever basis they wish and to do so on improper subjective grounds. Bribery of judges is widely reported in Moldova, as are instances of political pressure on the courts.

30. **The courts appear to have adequate subpoena, contempt and enforcement powers, but in practice their ability to exercise such powers is limited by a lack of resources such as the government's failure to establish judicial police.** The judiciary has few opportunities to influence the amount of money appropriated to it by the legislature to control the administration of these funds. Once the state budget is approved, the administration of funds approved for the courts is controlled and actively supervised by the Ministry of Justice. It is reported that the budget for the courts has never been approved in accordance with the needs of the judiciary and most courts, especially the district courts, are chronically under-funded. Indeed, the present financial situation of the courts and the method of administration of their budget arguably constitute the gravest threat to the judiciary's independence and efficiency.

31. **Although judicial salaries were recently increased, they are still inadequate, making it difficult to attract and retain qualified judges.** The infrastructure for the justice system is not good. Some court houses lack court rooms or deliberation rooms, forcing judges to conduct trials in their offices. Very few courts have an adequate number of computers, access to the internet or research facilities.

32. **It is relatively simple and inexpensive to appeal cases to the Court of Appeal and to the Supreme Court, but execution of judgments is problematical.** A special department for enforcing judgments was created last year within the Ministry of Justice and so far, has not proved to be very successful. There are a very large number of outstanding un-enforced civil judgments – over 50,000 dating back in some cases to the early 1990s. A system of privately operated bailiffs has worked well in other jurisdictions and might well be emulated in Moldova. The country operates a system of

public and state notaries. Both are independent and need a license. Notaries are generally well regarded and there have been few cases of abuse. Court procedures need to be streamlined and the costs of pursuing appeals need to be increased to deter vexatious or inappropriate appeals.

33. **The authorities are well aware of the criticisms that have been leveled against the judicial system and, to their credit, have taken some steps to improve the situation with support from external donors.** A Court Administration project is addressing weak case management procedures and providing software to introduce a random case selection methodology. A Civil and Commercial Judicial project is working closely with the Economic Courts to provide training and hardware for court procedure reform. Arbitration is becoming more common. The International Arbitration Court, a division within the Chamber of Commerce and Industry, is active, although its decisions are often appealed to and reversed by the Economic Courts, leading to conflict and tension. Other arbitration initiatives also show promise, but the system has a long way to go before confidence in the ability of the judicial sector to enforce contracts on a timely and efficient basis is achieved.

E. Recommendations

34. **The FSAP team recommends the following changes to the legislative and regulatory framework in addition to those already mentioned in the aide mémoire:**

- Extend the immunity from civil proceedings at least to all NBM supervisory staff;
- Modify the paragraph(s) of the NBM Law relating to direct lending by the NBM to the government, to restrict the scope and term of such lending;
- Reduce the costs of company registrations for entrepreneurs by eliminating the paid information services;
- Remove the restriction limiting the number of company business activities to only five;
- Streamline the procedures for forming and establishing a foreign-owned company;
- Reduce the number of licenses required to carry on a business activity, reduce the costs involved in procuring a license and extend the validity period;
- Limit the number and duration of inspections;
- Strengthen and expand the opportunities for conflict mediation and arbitration to be carried on outside the courts;
- Streamline the formal resolution procedures by introducing more oral procedures, limiting the scope and duration of appeals and making them more costly to the appellant, and reducing the duration of pre-trial procedures;
- Strengthen the role and performance of bailiffs and consider introducing a system of private bailiffs.

II - Insurance Sector in Moldova¹¹

A. Introduction

35. **Non-life insurance is generally more developed than life insurance in the CIS.** With the exception of Russia, the life insurance industry is virtually non-existent in the CIS countries (Armenia, Azerbaijan, Kazakhstan, Kyrgyz Republic, Georgia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan). In Russia, the growth in life business has been dictated mainly by changes to tax regulations. The best performance in Central and Eastern Europe (albeit from a low base) came from the Baltic States, with average growth in excess of 21% per annum during the last decade. Growth trends in Poland, Slovakia, Czech Republic, Hungary and the CIS region were similar, with average growth rates of 8.4% and 7.4% respectively. CIS countries suffered a brief decline in real premium volume in 1994, and a further fall in 1998, owing to political and economic crises.

36. **In the insurance sector Moldova has come a long way in the transition from a planned to a market economy.** Within the planned economy, the insurance industry was organized in state-owned companies along with all other industries. Monopoly companies predominated. Therefore, the logical first step on the way to a free market was to privatize and de-monopolize the insurance industry, and to allow access to foreign investors. Substantial progress has been achieved in terms of regulation, privatization and price de-control. The progress achieved in privatization is of vital importance for the insurance industry.

37. **Despite de-monopolization and open market access, the premium share of the former state monopolies remains high in Moldova as in other Eastern European countries.** The market share of the former state insurance company ASITO remains high, albeit with a declining trend from year to year, but the newly created state-owned company Moldasig has already captured a substantial share of the market (estimated to be over 10% in 2004). This trend is more apparent in non-life insurance than in life insurance.

38. **Motor insurance is the most important type of insurance sold (over 20% of total premium income).** This is attributable to the rapid growth in motor vehicle density, the increase in the average value of individual vehicles insured, the increasing frequency of accidents, and the rising frequency of claims when accidents occur. However, other types of insurance are rapidly gaining in importance, notably property insurance which is gaining in significance as residential housing and companies are privatized.

39. **Nowadays most countries in Eastern and Central Europe have insurance legislation based on European Union (EU) law.** By and large, supervision in this sector functions well. Some countries, including Moldova, still lack appropriate basic legislation, and where it exists it is inadequately enforced. In Moldova, there are two draft laws related to the insurance sector that are presently under consideration. One is the General Insurance Law (GIL) which is being drafted, and the other is a Third Party Liability Law for Motor Vehicles. The draft GIL still falls far short of what would be

¹¹ The author of this section is Ms. Serap Gonulal.

required to fulfill best practice and the new IAIS¹² requirements. The FSAP team has provided extensive technical comments on both laws to the authorities which have been reflected in revised drafts of the legislation.

40. **The insurance industry is part of the overall economy in a given country and is highly dependent upon its macroeconomic and structural policies, and the basic financial and legal infrastructure.** Similarly, insurance legislation and regulation are part of the overall legal environment and depend upon other legislation such as civil law, commercial codes, company law and tax law. In Moldova there is a need for a separate **Insurance Contracts Law** to regulate legal relations among insured parties, policyholders and insurance companies.

B. Basic EU Directives in the insurance market

41. **Recently admitted EU members and other countries presently preparing for EU membership have had to overhaul their insurance legislation to comply with EU guidelines.** The FSAP team considers that it is useful to provide some information about EU standards so that these can be taken into consideration in the process of drafting the new insurance legislation in Moldova. These EU standards are explained in the succeeding paragraphs.

42. **EU insurance directives basically demand:**

- free market access for foreign investors;
- the abolition of price and product controls;
- the introduction of minimum capital requirements; and
- the establishment of a professional supervisory body for the insurance industry.

43. **To join the EU, candidate countries must:**

- implement three sets of EU insurance directives;
- allow freedom of establishment (free market access for foreign insurance companies);
- allow freedom to provide services (cross border marketing of insurance policies);
- abolish government controls on insurance products and prices.

44. **EU countries have replaced controls with solvency requirements.** This directive also requires the abolition of state monopolies. Central and Eastern European countries have made enormous advances in the abolition of state monopolies in the insurance industry.

45. **In the majority of EU and OECD countries the insurance industry is under close supervision.** The reason is that insurance companies are exposed to various technical and non-technical risks. Although reforms are in many cases urgently required, insurance markets in developing economies differ widely from one another. It is indispensable that the reform of the insurance system takes into account the particular character of each country, and be appropriately adapted to local circumstances, without losing sight of the governing principles. In addition, the regulatory and supervisory

¹² IAIS-International Association of Insurance Supervisors.

framework has to be modified from time to time in order to match changing conditions, perceptions and economic needs.

C. The Insurance Sector in Moldova¹³

46. **For more than forty years after consolidation of the Soviet rule following the Second World War, Moldova had the same insurance history as the other Soviet republics.** Domestic insurance was the monopoly of the state insurance organization Gosstrakh, mainly concerned with administering the various forms of mandatory insurance. Voluntary personal insurances were sold through Gosstrakh's agency network.

47. **In 1988, the state monopoly on insurance in the Soviet Union was abolished.** Soon after Moldova declared its independence in August 1991, the Moldovan operations of Gosstrakh were converted into a joint stock company called ASITO. The state's shareholding was issued to banks, enterprises and some 2,000 individuals, most of them ASITO employees. The State Inspectorate on Insurance Supervision (SIIS), which was established in 1991, allowed the creation of private insurance companies. In 1999 QBE International acquired a 67% shareholding in ASITO. QBE¹⁴, an Australian insurance company, was allowed to circumvent the then-prevailing 49% ceiling on foreign shareholdings by acquiring part of the company through a Moldovan subsidiary called Insurance Consultant. Subsequently, as a result of an amendment to the Law on Insurance, the 49% ceiling on foreign ownership was abolished.

48. **At independence the government withdrew from the insurance business, but it re-entered the sector in 2001.** The state insurance company ASITO was converted to joint stock status in 1991, following which the state's residual shareholding of 25% in ASITO was successively reduced to 8.5% and then 4%. However, a new state-owned insurance company was created in 2001 when the majority state-owned bank Banca de Economii¹⁵ founded a new insurance company called Moldasig with a controlling shareholding of 51%. The other shareholders of Moldasig are Calea Ferata (railways) 25%, and Posta Moldovei (post office) 24%, both of which are state-owned.

D. Structure of the Moldovan Insurance Sector

49. **The Moldovan insurance market is the smallest in Europe and is underdeveloped, even compared with those in other CIS countries.** In 2002 insurance premiums represented only 1.05% of GDP placing Moldova behind other markets in Central and Eastern Europe (Table 1). In 2002 total premium income of the market amounted to only MDL 181 million (around US\$14 million), of which compulsory insurance comprised MDL 36 million, voluntary property insurance MDL 68 million, voluntary personal insurance MDL 34 million, and voluntary public liability insurance MDL 43 million. The market has been shrinking in real terms since 1998, partly owing

¹³ The text refers to the whole insurance sector, including life insurance, unless otherwise indicated.

¹⁴ QBE (Queensland Bankers' Equitable) Insurance is one of the largest Australian insurance companies.

¹⁵ Banca de Economii is owned 56% by the government.

to bankruptcies in the industrial sector, and partly owing to the increasing evasion of the compulsory motor third party liability requirement.

Table 1 Insurance Penetration in Selected Markets in 2002

Country	Premium Volume (US\$ million)	Insurance Penetration (Premiums in % of GDP)	Insurance Density (Premiums per capita in US\$)	Population million
Russia	9,584	2.77	66.6	143.9
Turkey	2,401	1.31	35.0	68.6
Ukraine	834	2.01	17.1	48.9
Romania	498	1.09	22.3	22.3
Bulgaria	338	1.90	43.1	7.8
Latvia	161	1.91	68.5	2.3
Moldova	17	1.05	4.5	3.6

50. **Life insurance is very underdeveloped in Moldova.** Although the same minimum capital requirement covers both life and non-life business, there are presently only three companies actively writing life insurance. These are QBE-ASITO, Carat and Protect-Impex. However, from January 2005 onwards, QBE-ASITO will no longer write new life insurance policies. Presently, the very small life insurance market is dominated by QBE-ASITO (90% of premiums), largely on the strength of its inherited in-force portfolio, although this dominance will gradually decline after its withdrawal from life insurance next year. All life operations are conducted by companies that also handle non-life business, and there are no separate figures readily available for life insurance business volumes. It is recommended that the figures for different lines of business be clearly disaggregated in insurance companies' financial statements.

51. **As of end-2002 50 insurance companies operated on the market.** Of these, 1 was majority state-owned, 3 were majority foreign-owned and the remainder majority domestically privately owned. Insurance companies are mainly owned by commercial enterprises and by individuals and only four companies are partially owned by banks. Most companies are extremely small and operate as vehicles for channeling "commissions" back to client company directors. The largest company, with a market share of around 40% in 2002, was QBE-ASITO, the ex-state company bought by QBE International in 1999.

52. **Foreign investors in the insurance industry have concentrated on just a few CIS countries.**¹⁶ Foreign participation is moderately important in the Moldovan insurance market, accounting for slightly over 20% of total premium income in 2002 on the basis of weighted market share and foreign participation. There is no limitation on foreign participation and at present, six insurance companies have foreign capital participation, ranging from 39.99 percent to 98.99 percent of paid-up capital (Table 2).

53. **The insurance industry is fairly concentrated and the top seven companies have collected around 80 percent of the premiums received for the last several years.** It is clear that these 7 companies dominate the market (Table 3).

¹⁶ In 2002 almost half the investment in the CIS went into Russia, with Kazakhstan and Azerbaijan together attracting another 30%.

Table 2 Moldova : Foreign Participation in the Insurance Market

Company	Country	Capital Share %
Protect-Impex SRL	Romania	98.99
Exim-Asint SA	Canada	78.58
QBE Asito SA	Australia	50.56
Asimed-Moldova SRL	Russia	49.00
Dasc-Plus SRL	Ukraine	39.99
Garant SRL	Cyprus	48.99

Table 3 Market Share of the Largest Insurance Companies in 2002

Insurance Companies	Total direct premium income (MDL '000s)	Market share %
QBE-ASITO	71,984	39.8
AFES-M-SRL	18,053	10.0
DONARIS GROUP SA	15,800	8.7
MOLDOVA-ASTROVAZ SRL	11,628	6.4
GALAS SA	11,489	6.3
MOLDCARGO SRL	9,875	5.4
CARAT SA	6,505	3.6
Seven largest companies	145,334	80.3
Total insurance market	181,000	

54. **The presence of Moldasig, whose shareholders are all majority state owned, could potentially create distortions in the market.** Moldasig is growing very fast because a considerable share of the insurance business of state-owned enterprises and government bodies is now being channeled through the new company. This recent development has created concerns in the local insurance market as participants believe that competition may be compromised by the emergence of a new oligopolistic state-owned company.

E. Motor Insurance

55. **Motor insurance is the major line of business for insurance companies operating in Moldova and this is not unusual in developing markets.** Insurance is made compulsory out of a desire to protect the public from certain risks. Compulsory insurance is particularly recommended for automobile third party liability. Guarantee funds should be created to compensate uninsured victims caused by hit-and-run drivers and for the victims of injuries caused by uninsured motorists, as recommended by the OECD and the EU. Tariffs for TPL insurance, which is compulsory, should be based on statistical data. In this regard the regulator, together with the insurance association, should promote the establishment of a reliable claims database that will help insurers and supervisors to confirm the right price for various categories of products. The comprehensive compilation of statistical data regarding the frequency and severity of losses is an essential condition for computing TPL tariffs and technical provisions accurately.

56. **The penetration of motor insurance is determined above all by the following factors: obligatory liability insurance, minimum cover, level of car ownership, liability law, tariff system, cost level and the number of new registrations.** In those countries where motor TPL insurance is obligatory, the number of policies in force can be inferred from the number of vehicles on the road, provided the legal obligation to insure is enforced.

57. **In Moldova, compulsory motor third party liability insurance was only introduced in 1994 and it came into effect on 1 January, 1995.** In practice it seems that motorists still regard TPL as a form of tax, which they are at liberty to evade, rather than as a protection against their personal legal liability, the concept of which is not generally understood by the general public.

58. **There are no special licensing requirements for TPL insurers.** However, all motor insurers are obliged to join the National Agency of Insurers (ARCA) which acts as the Moldovan Motor Bureau. ARCA has 23 members.

59. **There is a motor guarantee fund financed by a levy on TPL insurers, but this only applies to bodily injury claims caused by hit-and-run drivers.** There is no compensation for the victims of uninsured motorists. Therefore, it is recommended that the scope of the motor guarantee fund be extended to include coverage of claims against uninsured drivers, as required by the OECD and the EU. Moldova became a full member of the International Council of the Green Card Bureau¹⁷ on August 1, 1999. Membership of the Green Card scheme requires member countries to have in force national laws that render compulsory third party liability insurance for all drivers. The compulsory insurance requirement was widely evaded in Moldova until penalties for non-compliance were imposed for the first time in August 2001.

F. Prudential Requirements for Insurance Companies

60. **There are risks unique to the insurance industry, i.e. insufficient premiums, miscalculation of technical provisions, adverse change in loss frequency, catastrophic losses, reinsurance risk.** The primary function of an insurer is to manage all these risks, in such a way as to be able at all times (or at least in the vast majority of circumstances¹⁸) to meet its commitments to policyholders and beneficiaries. It is this capability of an insurer to meet its commitments that is known as “solvency”.

61. **Investment, capital, solvency and liability determination rules are such an important issue that their basis should be clearly laid out in the law.** As in Moldova these most relevant rules are either nonexistent or expressed insufficiently (both in current legislation and in the present draft of the new law), the utmost attention should be

¹⁷ The Green Card is an International Certificate of Third Party Motor Insurance that is carried by motorists when traveling abroad in Green Card member countries. The system came into operation in 1953, following a recommendation by the Economic Commission for Europe (ECE) of the United Nations in 1949. There are at present 43 member countries, of which 38 in Europe and 5 outside Europe (Iran, Iraq, Tunisia, Morocco and Israel), with a collective vehicle population of around 220 million.

¹⁸ For example, according to IAIS guidelines, it is generally not expected that insurers should be able to meet an event where all policies claimed for a maximum amount at the same time.

paid to inserting appropriate wording in the new legislation currently under preparation. Technical provisions should ensure that the companies are in a position at all times (or at least in the vast majority of circumstances) to meet their commitments towards the insured. Developing countries like Moldova often have inadequate technical provisions owing to the lack of historical data for calculation and the underdevelopment of the actuarial system. Even if countries do have legislation on technical provisions, the rules are not always sufficiently precise and supervision may be inadequate. Inadequate supervision of technical provisions may compromise a company's solvency and the security of its policyholders. Some technical provisions are missing in the present law, and even the new provisions proposed in the draft amendments to the law are inadequate in terms of description. Although most companies comply with the present rather low solvency margins, a number of companies may have difficulty in complying with the increased solvency margins that are to be introduced by the new legislation to meet EU criteria.

62. Companies are required to establish unearned premium reserves, loss prevention reserves, outstanding reserves, but not IBNR reserves. They are also allowed to establish catastrophe reserves. The insurance law does not specify exactly how each reserve should be calculated. Companies have little experience of claims reserving, and it is not clear how reserves are calculated in practice. Most business is short-tail¹⁹, the only exception being motor third party liability, where survivors' claims and permanent disability claims are compensated by means of a monthly annuity payable for life. It seems likely that many companies have neither the expertise nor the will to capitalize these liabilities in their outstanding reserves.

63. At present, technical reserves may only be invested in Moldova. Current investment regulations are as follows:

- a. State securities - unlimited
- b. Securities that are registered with the National Securities Committee and are quotable on the stock market - not more than 30%
- c. Participating shares in the joint stock capital of a limited liability company - not more than 50%,
- d. Bank fixed deposits - not more than 50%
- e. Financial means in bank accounts - unlimited
- f. Financial means in cash - according to the provisions of the respective legislation
- g. Foreign currency in bank accounts - according to the provisions of the respective legislation
- h. Real estate - not more than 50%
- i. Premium reserves on the risk accepted for reinsurance - not more than 20%
- j. Loans by insurance and reinsurance companies to policy holders that have been created as a result of insurance and reinsurance operations - not more than 40%.

64. The largest proportion of reserves is invested in bank fixed deposits, which however decreased by 7.7% in 2002 compared to 2001. Placement of money in current accounts is a permanent feature, and although its share is small, in 2002 it grew

¹⁹ "Short-tail" business is a type of business for which insurance claims are reported and settled within a short period of time, as opposed to "long-tail" business for which claims are subject to complex verification procedures and lengthy delays in settlement.

by 55% compared with 2001. Investment in government securities is also an enduring characteristic – however its share is not significant and indeed declined by 90% in 2002. On the other hand, investments of reserves in loans to policy-holders (only in the case of life insurance) and in foreign currency bank accounts (which became authorized in 2000) grew by 50% and 101%, respectively in 2002. Investments in real estate - including in land - decreased by 8% in 2002.

65. **There is no regulation on risk management and internal control.** A system of internal controls is critical to effective risk management and is a foundation for the safe and sound operation of an insurer. Such a system provides a systematic and disciplined approach in evaluating and improving the effectiveness of the operation, and assuring compliance with laws and regulations. There is also no restriction as to who can be a shareholder in an insurance company; or as to the maximum shareholding in an insurance company.

66. **A key factor holding back the healthy development of domestic insurance and reinsurance markets in transition economies is the shortage of capital.** There is an acute shortage of domestic investment capital, owing to the weakness of local capital markets and the relatively small middle class which is able to accumulate savings. In accordance with the Law on Insurance of June 15, 1993, the minimum capital requirement was only MDL 300,000 (around US\$24,000) for life, non-life, and reinsurance business until September 25, 2004, but after September 26, 2004, the requirement increased substantially to around MDL 2 million (around US\$167,000). Companies are required to create a guarantee fund by setting aside 5% of each year's profits until the amount so reserved reaches 15% of capital.

67. **There should be strict licensing criteria for insurance companies, including minimum capital levels, and responsibility for licensing should be transferred from the Chamber of Licensing to the State Inspectorate for Insurance Supervision (SIIS).** The supervisory authority should give particular consideration to testing the adequacy of the financial resources of insurance companies, in particular through analysis of their business plans and the requirement for a relevant minimum level of capital (taking into account inflation). This is a task for which the SIIS has the necessary specialized expertise, but the Chamber of Licensing does not.

68. **The solvency reserve for life insurance is composed of the joint stock capital, the reserve fund and the long-term insurance premiums reserve, and should comprise in aggregate at least 8% of the insured amounts.** The non-life solvency margin is 1% of the previous year's net written premium. Under the draft law presently under preparation, the solvency margin will be determined by regulations issued by the insurance supervisor. The market expects the non-life solvency margin to be raised to 15% of the previous year's net written premium, subject to a 12 month transition period.

69. **In developing a yardstick for solvency monitoring, supervisors will look to tools such as the EU margin of solvency.** These are difficult to apply effectively in transition countries like Moldova, which has an embryonic market where financial reporting is weak and financial statements unreliable. Weaknesses in financial reporting can have a direct negative impact on the effectiveness of regulators to protect policyholders.

G. Reinsurance

70. **There are no professional reinsurance companies in Moldova.** Insurance companies may write inwards reinsurance without additional capital. The main writers of domestic market reinsurance are QBE-ASITO, Donaris Group, Moldcargo, Carat, and Orateh. The only company which is large enough to have a comprehensive treaty program is QBE-ASITO. Most business is either retained or reinsured abroad on a facultative basis. There is a very little local market risk-sharing; new green card and CMR liability pools have recently been established, but there is no co-insurance, and the local facultative exchange market has all but disappeared. There are no special criteria for the licensing of reinsurance companies. Any insurance company has the right to perform reinsurance operations on the basis of the licenses held. Licenses for providing reinsurance services are issued according to general rules.

71. **According to present insurance legislation in Moldova, reinsurance should only be ceded abroad after it has been offered to, and declined by the local market.** The main reinsurers for Moldova are Munich Re, General Cologne Re (Lithuania), Partner Re and Generali.

72. **Local companies have a co-operative attitude towards foreign investors' insurance requirements.** Insurance companies do not plan or even try to keep the premium inside the country; they willingly cede business to foreign re-insurers, so they work like agents. The increase in fronting²⁰ business has attracted the attention of the insurance supervisor, who has decreed a minimum local retention of 10% and minimum ceding commission of 15%. However, the lack of reinsurance capacity makes it impossible for the insurance supervisor to enforce this regulation. Companies can apply to the supervisor for exemption on a case by case basis, and this regulation does not create any difficulties in practice.

H. Intermediaries (agents and brokers)

73. **The main distribution channel for personal lines business is the branch network and direct sales force, supplemented by a smaller number of tied agents.** Market leader QBE-ASITO has the only mass distribution network - 35 branches throughout the Moldova and around 600 sales staff - the majority of whom are remunerated by a mixture of salary and commission. This network was inherited from the previous Gosstrakh monopoly.

74. **Much commercial business is tied up in quasi-captive arrangements.** When commercial accounts do change hands, it is normally on the basis of personal or political relationships which have little to do with competition. Most other insurance companies were established as quasi-captives, and have neither the means nor the ambition to expand into the personal lines market. Although 4 insurance companies have banks as shareholders, it is noteworthy that the "bancassurance" concept is entirely undeveloped.

²⁰ Fronting is an arrangement whereby an insurer issues policies at the request of one or more insurers with the intention of transferring the entire risk to the other(s) by a reinsurance agreement or otherwise. Many countries expressly prohibit the transfer of insurance risk (i.e. substantially all of the fronting insurer's business or a particular line or class of business) from an authorized insurer to one that is neither an authorized insurer nor an approved reinsurer. Fronting should be distinguished from reinsurance of risk by an insurer with an approved reinsurer.

75. **Intermediary supervision is becoming a fundamental issue in insurance markets, and is now a major concern of the EU (which has recently issued a demanding directive on this topic) and IAIS, which has recently greatly expanded the relevant core principles.** Supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with their customers.

76. **Supervisory authorities should see to it that intermediaries conduct their business as transparently as possible.** Specifically, they should disclose to their clients their status regarding any ties that they may have to insurance companies, along with providing extensive information on, and explanations of, policies to policyholders.

77. **For non-life business, underwriting performance can be measured by the claims ratio.** The claims ratio measures net accrued claims as a proportion of net earned premiums and the percentage of premiums that are paid back to the insured. A high ratio normally indicates an efficient and competitive industry. In Moldova, lack of competition and a high level of fronted business, combined with unpaid and un-requested claims by policyholders result in extremely low claims ratios. Tables 4 and 5 and Figure 1 below indicate the lines of business as well as the respective claims ratios.

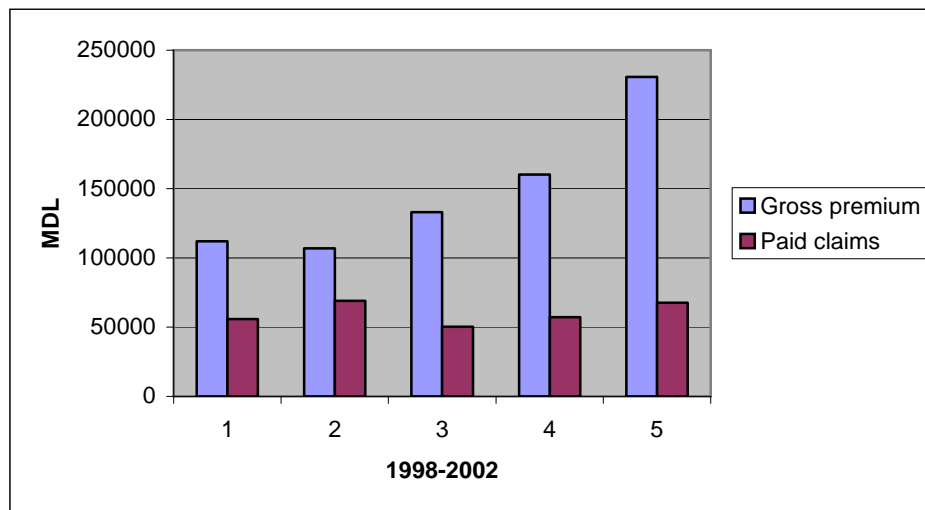
Table 4 Distribution of Insurance Types (MDL '000s) (SIIS)

Figures for 2002	Premiums	Claims	Ratio
Compulsory insurance	35,656	13,342	37%
Voluntary property insurance	68,441	18,666	27%
Voluntary personal insurance	33,530	28,030	84%
Voluntary public liability insurance	42,947	6,108	14%

Table 5 Claims Ratios for 1998-2002 (MDL '000s) (SIIS)

Years	Gross Premiums	Claims Paid	Claims Ratios
1998	111,923	59,978	50%
1999	106,830	69,063	65%
2000	132,898	50,366	38%
2001	160,184	57,248	36%
2002	230,672	67,612	29%

Figure 1 Gross Premiums and Total Claims Paid



I. Supervisory System

78. **The insurance supervisory and regulatory authority in Moldova is the SIIS, which is located within the Ministry of Finance (MOF).** The SIIS, which is responsible for approving policy conditions and premium schedules, for monitoring insurers' compliance with the law, and for ensuring that companies comply with minimum capital and solvency requirements, was established by a Government Decree dated June 12, 1991. The SIIS, which has a staff of 10, functions according to the Law on Insurance. However, the Chamber of Licensing issues licenses for insurance companies to operate. Between them the SIIS and the Chamber of Licensing share the work of regulating and supervising the insurance industry. Because of its short supervisory history, there is substantial scope for strengthening the supervisory and institutional capacity of the SIIS. The supervisors should be professionally independent, properly trained and impartial. The ideal format would be the merger of the present SIIS and the insurance licensing function of the Chamber of Licensing into a single independent insurance regulatory and supervisory agency that would be capable of paying market based salaries to its staff.

79. **Strong prudential regulations and supervisory arrangements that complement and support the operation of market discipline are indispensable to the stability of the insurance markets.** However, in the absence of effective market discipline, the entire burden of external controls falls on insurance supervisors who may not have the requisite capacity.

80. **The style of supervision in Moldova is based on a traditional control over the operations and activities of the insurers.** The audit approach appears to dominate the supervisory process, with the objective of controlling compliance with existing legislation. At the same time, the present legislative framework is weak and it does not address important internationally accepted principles, it lacks implementing regulations, and in general does not give sufficient powers to the supervisory authority to discharge fully its responsibilities.

81. **The supervisory regime was relatively lax in its early days, but has been tightened up.** The stricter policy was introduced at the beginning of 1998, resulting in

seven companies losing their licenses in 1998 and a further two in the first half of 1999. Licenses were mainly revoked either for failure to maintain the statutory solvency margin or for under-cutting the statutory minimum motor third party liability (TPL) premiums considered necessary to enable companies to create adequate reserves to meet TPL claims.

82. **The thrust of both the present and the proposed licensing legislation seems rather vague and thus may give rise to different and controversial interpretations.** There are serious gaps in the coverage of the legislation which lead to these conclusions, such as the lack of a detailed implementing regulation. Furthermore, there is no guarantee as to the objectivity and transparency of licensing. It is insufficient to base the observance of the principle mainly on the exercise of the discretion on the part of the SIIS. In sum, there is an obvious need for amendments to eliminate risks and uncertainties in the process and the authorities seem conscious of the need to introduce the necessary amendments in due course.

83. **The inadequate level of financial disclosure is also a problematic subject.** The annual information obtained by the SIIS is based on the type of information commonly published by insurance companies in other jurisdictions. This kind of reporting has little value added compared to a system whereby companies are required to submit their balance sheet, profit and loss accounts, and accompanying notes to the annual accounts. Another point is that the reporting of the information is almost entirely annual only and is in hard copy format. This hampers the capability of the SIIS to conduct off-site supervision efficiently. The frequency of supervision should be increased as a consequence of the negative findings of an on-site inspection.

84. **The most important part of the ongoing supervision is financial supervision.** In this respect, the supervisors have to examine the capital resources (solvency), the formation of technical provisions, and the existence of assets (investments) necessary to meet the insured liabilities. Therefore, supervisory authorities in all countries have the right to obtain detailed information about insurers' activities and their financial situation. Insurance companies should submit quarterly reports, annual reports, balance sheets, financial profit and loss accounts, and periodic statements of their technical reserves and solvency margins.

85. **In current operations, the SIIS relies on its desk analysis of financial information submitted by companies to monitor their financial condition.** This kind of off-site surveillance is insufficient, and should be complemented by an on-site inspection program, as in the case of the banking system. However, until now this has not been possible for the SIIS owing to its limited resources.

86. **The SIIS has the authority to order an inspection and to recruit an expert for that purpose when it has reason to believe that the company is in serious financial difficulty.** However, the present law does not provide it with the authority or the funding to conduct inspections as a matter of course.

87. **The insurance supervisor must be able to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements, and to determine the appropriateness of such reliance.** Insurance companies use reinsurance as a means of risk containment. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure.

88. **The supervisory authority should endeavor to protect insurance companies against the collapse of reinsurers.** The supervisory authority could start by monitoring reinsurance transactions through an audit of the financial statements of insurance companies. The SIIS has no authority in this respect either in the current law or in the draft law now under consideration.

J. Insurance Market Legislation

89. **Moldova already has an insurance law, but in May 2004 during the FSAP mission the government and the sector focused on the draft insurance law.** We suggest that the following paragraphs should be taken into consideration when finalizing the draft law which is currently under review. We have already provided to the SIIS detailed comments on the Third Party Liability Draft Law and General Insurance Law. Our comments are based on IAIS principles.

90. **The government is determined to develop the insurance market, and in this respect the draft law presently under consideration is an appropriate piece of enabling legislation.** However, the draft law needs to be revised in accordance with internationally accepted criteria.

91. **The SIIS is keen to finalize a new insurance law to be submitted to parliament as soon as possible.** The primary law needs to clearly lay out the key objectives of the regulatory/supervisory regime and the ongoing fundamental requirements (such as policyholder rights in the event an insurer is wound up) which will apply in the future. Ideally, the provisions of the law should comply with EU directives on insurance and satisfy the core principles of the new IAIS methodology.

92. **Given the intention to move to a new EU-based complaint methodology, the mission supports the proposed structure of the new law and associated regulations.** This involves an overriding primary, or basic, law, supported by subsidiary laws (and/or regulations) which cover the details of how the regime will be implemented in practice, and which can be relatively easily amended.

93. **The team's general recommendations, which are summarized below in bullet point format, have already been conveyed to the authorities in detailed notes delivered separately.**

- There should be only one authority responsible for insurance activities. Its roles and responsibilities should be clearly identified in the Draft Law.
- There is a need for a separate insurance contracts law.
- In order to ensure transparency, the SIIS should submit annual reports to the Parliament.
- The need for adequate technical provisions is fundamental and is made clear in the relevant IAIS Core principles and EU standards.
- Investment, capital, solvency and liability determination rules are such an important issue that their basis should be clearly laid out in the framework law.
- On-going supervision of direct insurance companies should be much clearer. In this regard, the various requirements such as accounting, reporting, general policy conditions and on-site inspection should be clearly defined in the Law.

- Auditors should be able to demonstrate a familiarity with and knowledge of the insurance sector.
- The new Law should include provisions indicating that the roles and responsibilities of actuaries will be determined via regulations.
- The new Law should include a statement indicating that the opinions of the affected parties shall be taken into consideration when issuing regulations.
- In principle, all tariffs should be freely determined and the related regulations should preferably be in compliance with the relevant EU Directives.

Detailed recommendations Based on IAIS Principles

94. **The FSAP team has set out below a series of specific recommendations for the improvement of the legislative and regulatory framework for the insurance industry, in accordance with IAIS principles.** These recommendations were sent previously to the authorities in the form of a note to facilitate the drafting of amendments to the General Insurance Law presently under preparation. The paragraphs immediately below refer to the revised IAIS Core Principles (ICPs).

95. Conditions for Effective Insurance Supervision (ICP 1)

- a) **Regulatory Authority** - The new IAIS Methodology approved in October, 2003, has significantly expanded the Core Principles dealing with the structure and operations of insurance supervisors.
- b) **Supervisory Objectives (ICP 2) and Supervisory Authority (ICP 3)** - As a rule, insurance supervision is carried out by a special institution. The insurance supervisory authority should be independent of political influences and the supervised insurance companies. Supervisors should have legally defined objectives, tasks and rights. Personally, supervisors should be professionally independent and impartial, and they should have wide knowledge and experience.
- c) **Financing** - In the majority of countries, the regulatory and supervisory body is financed by the insurance industry.
- d) **Workforce** - The number of persons employed in insurance supervision depends on the size of the country and the number of insurance companies operating there.

96. **Licensing (ICP 6).** Companies wishing to underwrite insurance in the domestic insurance market should be licensed. The powers granted to the Regulatory Body to "cancel" the license of a company are very broad. If a company fails to comply with conditions imposed with the license, then it is appropriate to cancel the license before the company issues any more policies. The law should at least set out the minimum requirements for licensing and the procedure for application.

97. Minimum Licensing Requirements:

- i) Legal Form - Joint stock company or mutual company;
- ii) Business Plan – to include at least pro forma financial statements, a capital plan and projected solvency margins);
- iii) Managerial Requirements - fit and proper requirements of company officers;
- iv) Shareholder Information - reputation of strategic shareholders;
- v) Financial Requirements – adequate capital etc.

98. **Changes in Control and Portfolio Transfers (ICP 8).** The Law should set up some rules to review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control is envisaged. These may be similar to the requirements for granting a license.

99. **Corporate Governance** (ICP 9). It is desirable that standards be established in the jurisdiction to deal with corporate governance. Preferably, the insurance supervisor should have responsibility for setting the requirements for corporate governance. The present draft law does not deal effectively with expectations in respect of corporate governance. There is no reference to the establishment of policies by the Board (investment policy; policy on risk retention; dividend policy, for example).

100. **Assets (Investments)** (ICP 21). Standards should be established with respect to the assets of companies licensed to operate in the jurisdiction. Where insurance supervisors have the authority to establish the standards, these should apply at least to an amount of assets equal to the total of the technical provisions. Maximum exposure rules for assets covering technical provisions include:

- no more than 10% of gross technical provisions may be in one property investment (including a number of pieces of land or buildings close enough to each other to be considered as one investment);
- no more than 5% of gross technical provisions may be, in aggregate, in the securities of, or as loans to, any one firm, company, or undertaking. This can be raised to 10% for public sector issuers, provided total exposure to such entities does not exceed 40% of technical provisions;
- no more than 5% of gross technical provisions may be in unsecured loans;
- no more than 3% of gross technical provisions should be in cash in hand; and
- no more than 10% of gross technical provisions may be in shares and debt securities which are not dealt in on a regulated market.

101. **Liabilities** (ICP 20). The Law should establish standards with respect to the liabilities of companies licensed to operate in the country. Liability requirements should only be established after exhaustive consultation with the actuarial profession and industry practitioners.

102. **Capital Adequacy and Solvency** (ICP 23). The requirements regarding the capital to be maintained by companies, which are licensed or seek a license in the jurisdiction, should be clearly defined, and should address the minimum levels of capital or the levels of deposits that should be maintained. Capital adequacy requirements should reflect the size, complexity, and business risks of the company in the jurisdiction.

103. **Solvency Margin**. Solvency requirements should take account of current developments in Europe. The solvency margin sets out the amount of capital funds an insurer must have at its disposal during current operations. The present EU requirement is for a capital base of the same amount as either the premium index or the loss/claim index, whichever is higher, defined as follows:

Premium Index: 0.18 or $0.16 \times$ gross premiums \times retention rate

Loss or Claims Index: 0.26 or $0.23 \times$ gross claims \times retention rate

Retention rate: Net claims/gross claims (but no less than 0.5)

104. **Reinsurance** Insurance companies use reinsurance as a means of risk containment. The supervisor must be able to review reinsurance. Reinsurance policy should be subject to supervision.

105. **Market conduct** (ICP 24 to 27) Supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with their customers. The draft law does not include any significant scope for the supervision of intermediaries. Brokers have to be licensed, but this is not a requirement under the law for agents, who also appear to be exempt from insurer disclosure requirements. Intermediary supervision is becoming a fundamental issue in insurance markets, and is an important concern of the EU and IAIS. The law should address the requirement that the Regulatory and Supervisory Body should have legal powers to publish guidance on pure premiums, to facilitate data sharing by insurers and to specify general prudential requirements in setting premiums.

III - Capital Markets²¹

A. Introduction

106. **Moldova's capital markets are thin and underdeveloped, mostly because of the lack of investor confidence due to the macroeconomic situation.** They comprise only a government securities (GS) market and an equity market.

107. **In the GS market, transparency is generally adequate and technically the primary market is well-organized.** In addition to macroeconomic steps to improve investor confidence, the key areas requiring reforms are: (i) broadening the investor base to lessen the dominance of the NBM which is presently crowding out the market for government securities by its direct lending to the government; (ii) promoting the secondary market especially by developing the market for repurchase agreements (repos and reverse repos)²²; and (iii) developing a market-determined yield curve by streamlining the structure of maturities for issuing paper in the primary market (i.e., fewer tenors for standard instruments).

108. **As for the equity market, as in many other transition economies its creation has been driven by a mass privatization program.** However while over 1,000 joint stock companies are registered on the Moldovan Stock Exchange, only 24 companies are formally listed on the exchange, and only a handful of stocks are regularly traded. Overall, this market is underdeveloped and fragmented. Reconfiguring the equity market into a cost-effective and operationally-efficient market and pursuing collaboration with regional markets are both crucial to reviving it. Moreover, this sector would benefit substantially from integrating the presently fragmented market and from restructuring the currently dysfunctional investment funds.

B. Domestic Debt Market

Market Structure and Performance

109. **The instruments of the Moldovan debt market are limited to government securities (T-bills and government bonds).** There are no corporate bonds, commercial papers, municipal bonds, or other debt instruments. T-bills are discount bills with final maturities of up to one year - 56, 91, 182, 273, and 364 days. Government bonds are fixed-coupon bonds with maturities of 1, 2, and 3 years. As of May 24, 2004, the total volume of GS outstanding was MDL 880 million, accounting for 30.12% of total public debt or 3.22% of GDP. Table 6 provides an overview of government securities in terms of amount, structure, share of public debt and share of GDP. The stock of central government domestic debt at the end of 2003 stood at MDL 2,920 million or roughly 12 percent of GDP (Table 7). However, total government debt is equivalent to around 67

²¹ The author of this section is Mr. Yibin Mu.

²² Under a repurchase agreement (repo) a security is sold, subject to a commitment to repurchase it at a later date. Under a reverse repo a security is purchased, subject to a commitment to resell it at a later date. The seller of the security is effectively taking out a collateralized loan. Any return on the security (coupon and/or dividend) goes to the buyer during the maturity of the transaction, and is reflected in the purchase price.

percent of GDP after taking into account the US\$1,440 million in external debt²³. Direct financing of the government by the NBM accounted for around 75 percent of total central government domestic debt as of end-July 2004, the remainder comprising T-bills and bonds. The interest rate for direct financing by the NBM is based on market rates (presently on the rate of the 91-day T-bills). Debt management responsibilities are shared between the MOF and the NBM, with the latter acting as an agent for the issuance of government securities.

Table 6 Moldova: Debt Market Indicators as of May 24, 2004

Items	Amount (MDL m.)	Effective yield (%)	Percentage of category	Percentage of total public debt	Percentage of GDP
T-bills (A)	804.10		100.00	27.53	2.95
56 days	20.75	9.19	2.58	0.71	0.08
91 days	273.79	15.51	34.05	9.38	1.00
182 days	185.08	15.57	23.02	6.34	0.68
273 days	171.21	15.92	21.29	5.86	0.63
364 days	153.26	16.02	19.06	5.25	0.56
G-bonds (B)	75.56		100.00	2.59	0.28
365 days	14.06	16.06	18.61	0.48	0.05
2 years	56.71	17.69	75.05	1.94	0.21
3 years	4.79	16.37	6.34	0.16	0.02
Total GS (A+B)	879.65			30.12	3.22

Source: NBM.

110. **According to international best practice, the NBM should not directly provide credit (unlimited either in its magnitude or maturity) to the Government, so an alternative market solution needs to be sought.** Directly financing the government by the NBM in this way crowds out other market participants and severely decreases the incentives to build out a functioning secondary market (aside from its macroeconomic effects, like increasing the monetary base). The government should honor the spirit of central bank independence enshrined in the NBM Law by repaying its debt to the NBM over a period of time. The NBM can consider buying government securities from the secondary market to adjust the liquidity in the banking system.

Table 7 Moldova: Structure of the Outstanding Government Internal Debt (in millions of MDL; year end figures, except for 2004 – end month)

	1999	2000	2001	2002	2003	05/2004	06/2004	07/2004
Total Securities	233.7	345.5	492.6	676.6	776.3	881.6	894.9	924.6
T-bills	232.0	345.5	492.6	676.6	730.8	806.0	819.3	847.1
T-bonds	1.7	0	0	0	45.5	75.6	75.6	77.5
Direct financing by NBM	1,644.0	1,675.9	1,907.1	2,144.0	2,144.0	2,144.0	2,744.0	2,744.0
Total debt	1,877.7	2,021.4	2,399.7	2,820.6	2,920.3	3,023.7	3,638.9	3,668.6

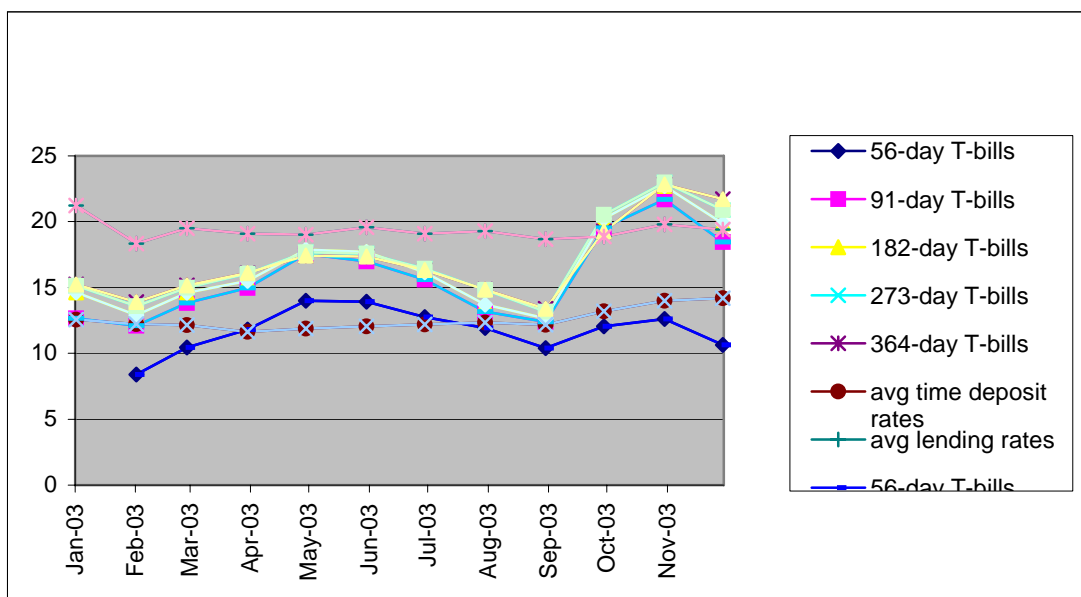
Source: NBM.

²³ The macroeconomic section of the FSAP aide mémoire discusses in detail the external debt situation (presently in arrears) and the country's rating (under investment grade). The average exchange rate in 2003 used for calculating these percentages was US\$1 = MDL 13.5.

111. **After a shock following the Russian crisis, the Moldovan GS market has shown positive growth.** Between 1995 and 1997, the GS market was characterized by rapid growth (from MDL 107.8 million to MDL 450.3 million), but the market suffered a dramatic setback in 1998. Since 1999, the market has exhibited signs of recovery, reflected in the outstanding amount of the GS growing four-fold from MDL 234 million (1999) to MDL 925 million (July 2004).

112. **The MOF is generally a price-taker in the auctions of GS, and T-bill yields might be more sensitive to the market situation than the deposit rate and bank lending rate.** The interest rates of T-bills were mostly between the average time deposit rate and bank lending rate in 2003 (Figure 2). This reflects the fact that banks are the major investors in T-bills. In addition, since September 2003, the yields of longer-term T-bills have increased significantly, while both deposit rates and lending rates have remained broadly stable. This is possibly due to the increase of the annualized inflation rate from an average of 12% during the first nine months of 2003 to around 15.5% during the last quarter of 2003. This suggests that T-bill yields may better signal the market situation than deposit rates and bank lending rates.

Figure 2 Treasury bill interest rates, average MDL deposit rates and lending rates



Primary market

113. **Transparency in the primary market is generally adequate.** The MOF publishes quarterly issuance calendars of T-bills in advance. T-bills are auctioned weekly by the NBM on behalf of the MOF. The MOF publishes the volume of each issue and the types of instruments to be offered, one week in advance. The NBM publishes the auction results shortly after each auction.

114. **The instruments of GS are too diversified, and it would be desirable to standardize instruments of the primary market, including concentrating T-bill issues among a more limited number of tenors.** Presently, the maturities of T-bills comprise 56, 91, 182, 273, and 364 days, while Treasury bonds comprise 1, 2 and 3 year issues. The government tested the market with one small issue of coupon bonds (MDL 1.7 million) in 1999, but was forced to cease further issues of bonds until 2003 owing to

low market demand. However, from 2003 onwards, the issue of government bonds has recommenced. In 2003, there were four auctions of government bonds — one issue of one-year bonds, two issues of two-year bonds, and one issue of three-year bonds. The maturities of T-bills could be consolidated into a more limited number of standard instruments, such as 91, 182, and 364 day issues. If the secondary market could be developed, the consolidation of maturities would not pose problems. Later on, when longer maturity securities are issued in more significant volumes, the government could issue standard maturity securities throughout the life of the security (a procedure known technically as “re-opening an issue”)²⁴. In addition to other steps enhancing secondary market development, standardizing the instruments, limiting the number of tenors for T-bills, and “reopening issues” at appropriate intervals should help develop a market-determined yield curve, which in turn would give new impetus to the secondary market. It is desirable that the MOF and the NBM work together to find an optimal term structure for GS.

115. The primary market is dominated by commercial banks, although during the last two years the share of domestic non-bank investors has risen sharply. All GS are issued through multi-priced auctions organized by the NBM. The 16 commercial banks are the only participants of the primary market. Twelve of them are primary dealers. The remaining four commercial banks can participate directly in the primary market for themselves (proprietary trading), but they are not allowed to purchase government securities for their customers. The 16 primary market participants send their bidding information to the NBM via e-mail with the elements of an electronic signature. The deadline for receiving bids is 10 a.m. on the auction day. Bids include both competitive and non-competitive bids. The ratio between them is usually around 65:35. All other investors must go through primary dealers in order to participate in the market. In return for exclusive access to the primary market, primary dealers are obligated: (i) to bid in every auction; (ii) to bid for no less than 3% of the average quarterly offer during the previous four quarters; (iii) to conduct at least 1.5% of the total volume of the secondary market transactions in the previous quarter; and (iv) to provide two-way quotations in the secondary market.

Investor Base

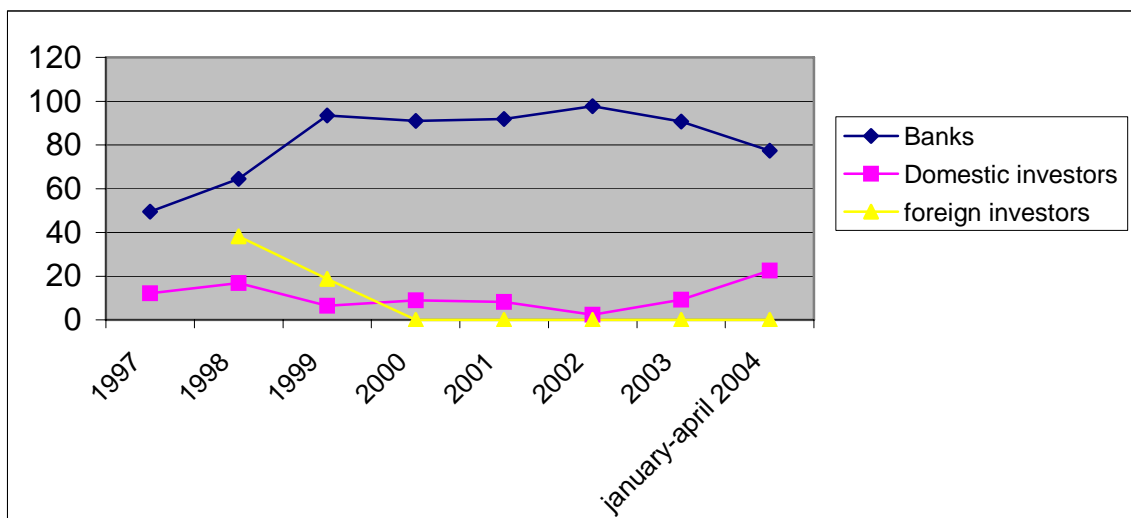
116. Before the Russian financial crisis of 1998, foreign investors played an active role in the GS market, holding as much as 38% of outstanding GS; since then, foreign investors as well as domestic individuals still lack confidence in the GS market as shown in Figure 3 below. The MOF has been unable to issue eurobonds since 1997, owing to Moldova’s foreign debt arrears and the country’s non-investment grade rating. Domestic individuals account for less than 0.2 percent of the outstanding GS, which is low compared with approximately 10% in other CIS countries (i.e., Armenia and Georgia), even though the Moldovan population has a significant amount of cash from remittances.

117. Holders of GS are principally commercial banks and the market would benefit from a broader investor base. Currently, commercial banks hold 77.4% of the total outstanding amount of GS, while non-bank financial institutions (NBFIs) hold 15.5%, enterprises 6.9%, and individuals 0.2%. The role of insurance companies in the

²⁴ So long as the remaining days left to maturity is a multiple of seven to conform to market practice, much flexibility is possible to permit smooth cash management.

GS market is small, and they should be encouraged to participate. The market could benefit from the participation of brokers because these companies generate income through fees and commissions. Consequently, they have a better incentive to market investment instruments, and it is in their interest to open up the market, to make it more transparent, and to increase turnover. On the other hand, it is not necessarily in the commercial banks' best interest to advise their clients to place money in alternative investment vehicles when they themselves are seeking to take in clients' deposits. A commercial bank's primary customary activity is to lend to private and corporate enterprises in order to stimulate growth in the economy. Its investments in the securities markets are usually of secondary importance, with the principal objective of managing liquidity. Admittedly, however, fee income could well play an important role in the banks' profits.

Figure 3 Investor structure of government securities



118. **Furthermore, as bank lending to corporate and retail clients increases, and liquidity in the banking system becomes less abundant, the government runs the risk of being forced to increase substantially its funding costs.** To avoid this, the FSAP team recommends a significant effort to broaden the investor base, targeted towards retail investors, insurance companies and non-bank financial institutions (NBFIs) other than pension funds. Box 1 below provides a more detailed discussion on broadening the investor base.

119. **The volume of inward remittances is significant in Moldova, conservatively estimated at around US\$464 million, equivalent to approximately 24% of the GDP, in 2003.** Unofficial estimates of inward remittances are much higher, at approximately US\$1 billion, or about 50% of GDP. However, this money has not been effectively mobilized because the public exhibits relatively low confidence in the local currency, which is reflected in the fact that more than half of bank deposits are in euros or US dollars, as well as the significant amount of foreign currency cash held in the country. Over one-third of inward remittances are estimated to be held in cash. In these circumstances, the alternative solutions described below may be worthy of further study.

120. **Given the high-level of dollarization and the large amount of remittances, the MOF is currently considering issuing domestic GS in foreign currency, which**

may not be appropriate. This solution would directly increase the foreign exchange debt of the government, which is in arrears on its foreign exchange obligations.

Box 1. Discussion on Broadening the Investor Base

The current structure of the Moldovan financial sector is not conducive to the wider distribution of government securities and more active trading in the secondary market. Trading will more likely take place when government securities are more widely distributed among investors with diverse investment needs and confidence in government paper improves. Commercial banks are permitted to engage in almost every financial service, and overwhelmingly dominate financial intermediation in Moldova. As a result, the distribution of GS is essentially under the control of commercial banks. However, commercial banks have little incentive either to distribute GS or make a market for the debt securities.

The government's policy for developing a GS market needs to focus, among other things, around lowering of structural entry barriers to government securities business. To this end, the government may wish to consider initiating a program of direct marketing of Treasury instruments to the population, such as the "Treasury Direct" program in Armenia which has been quite successful in attracting smaller retail investors.

121. To tap into the potential demand from holders of inward remittances, the first best option is to build out the confidence of domestic investors, who then could convert their foreign exchange holdings into domestic currency to be invested.

However, an analysis might be done of the advantages and disadvantages of issuing index-linked government bonds issued and redeemed in local currency. Such instruments would bear a yield linked to the exchange variation of the euro or US dollar against the local currency plus an interest rate appropriate to the foreign currency selected for the indexation²⁵. The downside risks of such step would be (i) for the MOF, the assumption of the exchange rate risk in case of the depreciation of the currency; (ii) for the investor, the assumption of foreign exchange risk in case of appreciation; and (iii) for the NBM, the unknown impact it may have on the money supply.

122. Another solution that might be worth analysis is issuing floating-rate medium-term securities denominated in MDL. Such securities would eliminate the exchange rate risk for the government, although it would still be exposed to the interest rate risk. In the present uncertain macroeconomic environment, however, with such low investor confidence, it might not be feasible to issue such securities.

Secondary market and market infrastructure

123. Government securities are traded on the over-the-counter (OTC) market through 12 primary dealers; while customer transactions are increasing, interbank transactions continue to prevail in total secondary market trading. The share of the former has increased from 12.3% in 2002 to 14.3% in 2003. The 91-day T-bills, which have the largest share of the outstanding amount, were traded most actively, accounting for nearly 40% of the total secondary market activities in 2003. Overall, the secondary market of GS is very limited, averaging about one trade per day, owing in part to the considerable excess liquidity in the market and the massive selling of GS by the NBM in open market transactions.

²⁵ For example, EURIBOR for euros and LIBOR for US dollars.

124. **Repo activities are presently rather limited.** However, although there is no standardized master repo agreement, most commercial banks have signed a mutual agreement that regulates all the transactions in the interbank money market, including repo transactions involving GS. It is noteworthy that the NBM is entitled to use in its open market transactions the GS that the MOF has pledged against loans received, so a shortage of supply of GS is not currently a factor constraining the growth of the repo market.

125. **To promote the secondary market, the NBM is intending to cooperate with the NSCM and the Moldovan Stock Exchange (MSE) to develop an electronic government securities trading system, while also allowing the MSE to trade GS with final maturities over one year.** The NBM's expectation for this solution may be somewhat over-optimistic because the most important factors impeding the secondary market of GS are not technical, but substantive: the lack of investor confidence and the composition of GS investors. Since the major GS investors are commercial banks, the secondary market is, in effect, a one-way market. However, the proposals of the NBM will likely contribute to broadening and diversifying the investor base and should strengthen the secondary market.

126. **The NBM, the NSCM and the Moldova Stock Exchange (MSE) should strengthen their cooperation in promoting the secondary market.** The NSCM tried to participate in the regulation of the secondary market of GS as part of the capital market. However, currently the secondary market is still under the complete charge of the NBM. With the development of the Moldovan financial system, the NBFIs will become more involved in the area of government securities. It is desirable that the NBM, the NSCM and the MSE enhance their co-operation in the secondary market of GS with a maturity over one year. It is recommended that post-trading information be reported to the MSE and the NSCM, and that this information be published by the MSE and the NSCM in time to enhance the transparency of the secondary market.

C. Equity Market

Origin of the Moldovan equity market

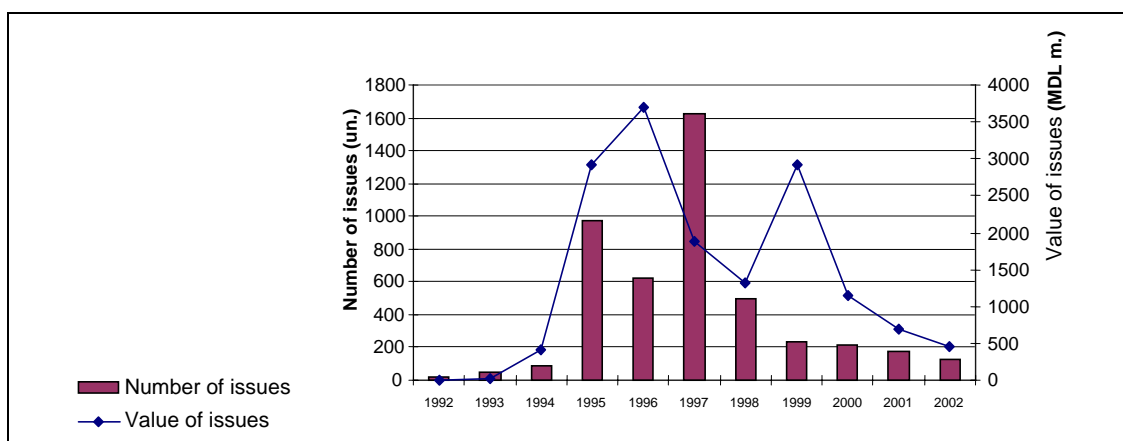
127. **As in many other transition economies, Moldova's equity market has been driven by the mass privatization program implemented in the early 1990s.** The program involved the distribution of vouchers to the Moldovan population at symbolic prices, and the subsequent use of these vouchers by the population to bid directly for enterprise shares in special auctions, or for the purchase of shares issued by investment funds. These funds could then use vouchers to bid for enterprise shares in the auctions.

128. **The Moldovan securities market contributed to concentrating the ownership²⁶ of enterprises in fewer hands, but failed to deliver its objectives of developing a well managed corporate sector and a well functioning capital market.** The voucher privatization scheme was initially acclaimed as an innovative and efficient privatization program. The program succeeded in transferring large numbers of enterprises to the private sector in a very short period of time. The Moldovan securities markets were the product of the typical experiment involving: (i) the sudden creation of a

²⁶ See the corporate governance chapter of this volume of the FSAP and the Detailed Assessment of Corporate Governance for the ownership structure of businesses.

large number of publicly tradable companies; (ii) a highly liberal regulatory framework which included, inter alia, very weak listing requirements; and (iii) the existence of several, poorly integrated trading places. These elements of the experiment were deliberately designed so as to facilitate trading and the consolidation of ownership in fewer hands. Much of the trading was conducted by a few insiders involving fraudulent practices, and was frequently followed by asset-stripping after the acquisition of control. Weak capital market regulation and supervision was, to a large extent, responsible for this disappointing result. Several financial scandals and the lack of a proper and prompt response from the authorities led to a sharp decline in the confidence of the Moldovan population in capital market institutions and hindered new share issues (Figure 4).

Figure 4 Numbers and Value of New Share Issues



Market Structure and Performance

129. **There are currently 1,048 joint stock companies registered on the MSE, but only 24 stocks are formally listed on the MSE (Table 8 below).** In 2003, total market capitalization was approximately MDL 6.8 billion (approximately US\$ 540 million), equivalent to around 25% of GDP. The annual market turnover was low, only 12.1% of market capitalization in 2003, and on a declining trend since 2000.

Table 8 Moldova Equity Market Indicators, 1999-2004

	1999	2000	2001	2002	2003	05/04
Number of companies registered in MSE	899	940	960	972	1,054	1,048
Number of publicly tradable companies listed on stock exchange	64	34	22	25	24	24
Number of licensed brokers	44	38	32	30	29	29
Market capitalization (% of GDP)	35.5	31.2	21.9	24.2	25.0	NA
Market turnover (% of GDP)	5.8	6.2	3.2	3.3	3.0	NA
Market turnover % of capitalization	16.3	19.7	14.5	13.6	12.1	NA

Source: NSCM

130. **The MSE has a three-class listing criteria.** Box 2 below shows the requirement for each tier. Among the 24 listed companies, 13 companies are listed in Class I, 7 in Class II and 4 in Class III. The listed companies are mainly commercial banks and large

wineries. Table 9 at the end of this chapter shows the capitalization, trading volume and capital turn-over ratio for all the listed companies in Moldova.

Box 2: The three-tier listing structure of the MSE

Class I – listing requirements:

- paid-in capital, at least MDL 10 million;
- equity issue, at least MDL 10 million;
- the issuer has been conducting business for at least three years and discloses financial reports for the entire period;
- the issuer must have obtained net profit in the past two years of activity; and
- the financial statements for the most recent year of activity must have been approved by an auditing institution.

Class II – listing requirements

- paid-in capital, at least MDL 5 million;
- equity issue, at least MDL 5 million;
- the issuer has been conducting business for at least two years; and
- the financial statements for the most recent year of activity must have been approved by an auditing institution.

Class III – listing requirements:

- the issuer has been conducting business for at least a year; and
- the financial statements for the most recent year of activity must have been approved by the company's auditing commission.

131. **The Moldovan equity market is small and fragmented and needs to be integrated.** At present, there are three equity markets: (i) a stock exchange trading market; (ii) a regular OTC market; and (iii) eighteen off-the exchange markets.

132. **The MSE was established in 1995 as a not-for-profit joint stock company.** It currently has 34 members (14 commercial banks, 20 brokerage firms). The National Depository Agency (NDA), established in 1998, provides depository services as well as the clearing and settlement functions for securities traded in the MSE²⁷.

133. **The regular over-the counter (OTC) market is operated by brokers and dealers who are obligated by the Securities Law to be MSE members.** However, the trading activities on the OTC market are very limited.

134. **The NSCM has licensed 18 independent registers, competing as private for-profit businesses, which can register stocks independently outside of the stock exchange.** They are also reported to trade stocks unofficially, which has significantly fragmented the equity market. The trading functions of the registries should best be transformed into a regular OTC market, in which these entities become normal brokers subject to regulations by the NSCM and MSE. In addition, their trading activities should be reported to the MSE for public information disclosure.

²⁷ Before the establishment of NDA, the MSE performed the clearing and settlement functions by itself.

135. **In recent years, the trading activities of the MSE have been limited²⁸ because the independent registers significantly under-reported their trading volume in order to reduce the associated trading costs.** The budget of the NSCM is funded from the securities industry and is realized through levying of trading and licensing fees, among other fees. In recent years the MSE has been losing trading volume and has been struggling to cover its operating costs despite raising its fees. This has in turn driven customers away to the off-the-exchange markets and made the development of MSE impossible, creating a vicious downward spiral of successively lower trading volumes.

136. **Reconfiguring capital markets in Moldova into a cost-effective and operationally-efficient stock market and pursuing collaboration with regional markets are important for reviving trading activity.** In this regard, with the rapid advancement of technology, the possibility of launching various forms of collaboration and outsourcing of back-office functions with regional markets should be studied and encouraged. This will likely make small markets like MSE more readily sustainable.

Legal Framework, Supervision and Regulation

137. **The core legal infrastructure for the securities markets comprises the Law on the Securities Market (LSM, adopted on November 18, 1998), and the Law on the National Securities Commission (LNSC, adopted on November 12, 1998), which established the NSCM.** It is noteworthy that Moldova adopted a legal structure that allows banks to provide both banking services and securities services. Although Moldova promulgated the Law on Investment Funds (LIF) on June 5, 1997, this Law, to a large extent, has not been implemented because the investment fund industry has been dysfunctional.

138. **While the number of the supervisors in the NSCM is more than adequate, the capacity of the NSCM is quite weak and needs to be strengthened urgently.** The NSCM currently has around 78 staff, which is arguably too large for the scale of its current activities.²⁹ However, the NSCM has difficulty in attracting or retaining skilled staff because of its low salary levels - on average around one-third of those of the NBM. The tools of supervision are also out-dated. The NSCM currently does not even use computers. Its information system continues to rely on paper and manual operations. Furthermore, the skills and tools of the supervision require urgent improvement. It would be advisable that NSCM streamline the number of staff and strengthen the staff quality by offering attractive salaries and ongoing professional training, although this might not be possible before trading returns to the MSE and hence fee income is increasing.

139. **The Law on the National Securities Commission provides the NSCM with complete independence from the government, but the quality of its supervision needs to be improved.** The NSCM reports directly to the Parliament and has full responsibility for the regulation and supervision of the securities market and industry. The NSCM still focuses on administrative approvals rather than concentrating on the enforcement of its prudential regulations.

²⁸ Trading in the MSE had been quite active and expanded rapidly from a small base until early 1998.

²⁹ By comparison, the Croatian Securities Commission has only 24 staff. Croatia has a similar size population as Moldova but a significantly larger economy.

140. **Cooperation among the NSCM, MSE and other professional market participants needs to be improved.** Market participants have many complaints regarding the poor quality of the supervision of the NSCM. The NSCM should focus on strengthening the quality of its regulations and supervision, such as through more consultation with market participants on policy formulation, and by providing better services to the securities industry.

Market Participants

141. **The presence of institutional investors is very limited and as a result, commercial banks play a relatively major role in the Moldovan equity market.** Fourteen of the country's sixteen banks are members of the MSE and they have strong capital bases compared to other market participants. They play the role of "dealer" and/or "broker" functions. Compared with commercial banks, the independent brokerage firms are rather small in scale in terms of both capital and customers. Although there are 49 insurance companies, they play only a minor role in the securities market. Regarding pension funds, neither pillar II nor pillar III funds exist - there is only the Moldovan Social Fund (MSF - pillar I). Most of the MSF's available funds are placed in bank deposits, with only a small part invested in government securities. There are no mutual funds. The only investment companies are non-mutual and non-specialized investment funds (IFs).

142. **The problems of the current dysfunctional investment funds, which were created to facilitate the mass privatization program, need to be addressed urgently.** There are a total of 14 investment funds (IFs) which were created in the early 1990s with property coupons (vouchers) distributed by the state to the Moldovan population. The IFs have approximately 1.74 million shareholders, owning in aggregate approximately 566 million shares issued by the funds. Since the individual minority shareholders are so dispersed, they play no role in the administration of the IFs. In turn, management of the funds are passive in bringing new investments into the companies in which they own shares, largely because they are satisfied with the positions of control that they have over such companies. Most of the IFs have been in serious financial distress and are highly dysfunctional. Their assets continue to deteriorate. However, the government still has no concrete plan to deal with IFs. The experience from other countries shows that the longer the delay in dealing with the ailing IFs, the higher the associated cost. The government needs to develop a time-bound action plan to restructure potentially viable IFs and liquidate the remainder. Meanwhile, other measures such as insurance industry reform should be accelerated to encourage the development of institutional investors.

D. Action plan

Suggested actions	Priority	Political difficulty	Technical difficulty	Implementation period
(H = High, M = Medium, L = Low)				
Broaden the investor base	H	M	M	Medium to long-term
Coordinate GS secondary market development among NBM, NSCM, MSE	M	H	M	Short to medium-term
Streamline and consolidate the instrument lines of GS	M	L	L	Short term
Study replacement of NBM direct financing by issuing more GS	H	H	L	Short to medium term
Study ways to mobilize idle remittances held by savers	M	M	M	Short to medium-term
Strengthen NSCM capacity by improving its skills through training and by offering better salaries to attract skilled staff.	H	M	M	Short to medium-term
Upgrade NSCM information system	M	M	L	Short to medium-term
Integrate the market infrastructure.	H	H	M	Short term
Restructure the investment funds	H	H	H	Short-term

Table 9 Capitalization, Trading Volume and Capital Turn-over Ratio for the Listed Companies

Company Name	Listing level	Transactions in 2003	Shares traded in 2003 (#)	Trading volume 2003 (MDL '000s)	Outstanding Shares (#)	Capitalization (MDL '000s)	Shares traded /outstanding shares (%)	Turn-over ratio (%)
BC "MOLDOVA-AGROINDBANK"	1	29	5,412	908	1,037,634	191,962	0.52	0.47
BC "BANCA DE ECONOMII"	1	10	523,465	1,665	5,851,691	46,814	8.95	3.55
BC "BANCA SOCIALA" S.A.	1	29	10,966	1,121	566,561	56,656	1.94	1.97
BC"INVESTPRIVATBANK" SA	1	1	100	10	516,000	51,600	0.02	0.01
BC "MOBIASBANCA" SA	1	12	29,799	327	7,115,850	85,390	0.42	0.38
BC "MOLDINDCONBANK" SA	1	23	1,932	206	274,380	30,731	0.70	0.67
SA "FRIGO"	1	3	1,920	36	985,675	20,699	0.19	0.17
SA "PRODUSE CEREALIERE"	1	12	1,015,245	1,605	16,523,795	5,618	6.14	28.57
SA FIN "REAL-INVEST"	1	19	1,501,772	150	22,712,281	2,271	6.61	6.61
BC "VICTORIABANK" S.A.	1	2	755	9	3,200,000	800,000	0.02	0.01
IM "EFES VITANTA MOLDOVA BREWERY"SA	1	5	1,397,536	168	1,447,922	72,396	96.52	231.47
BC "MOLDINDCONBANK"SA	1	2	100	1	33,480	401	0.30	0.30
BC SA "MOLDINDCONBANK"	1	4	8,538	86	400,000	4,800	2.13	1.80
SA IM "BALTEANCA"	2	1	23011	47	3,699,480	30,114	0.62	0.16
SA "CARIERA DE GRANIT SI PIETRIS DIN SOROCA"	2	1	349,738	651	653,225	8,165	53.54	7.97
BC "EUROCREDITBANK"	2	5	15,995	160	7,964,001	79,640	0.20	0.20

SA "HIDROPOMPA"	2	3	1,333	4	1,107,326	3,322	0.12	0.12
SA "COMLAC"	2	1	100	2	291,479	4,478	0.03	0.03
IM "SUDZUCKER-MOLDOVA"	2	1	210,205	1,896	7,855,544	78,555	2.68	2.41
SA "HIDROPOMPA"	2	1	1	< 1	1,374	14	0.07	0.02
SA "ARTICOLE DE BETON ARMAT"	3	6	103,208	1,042	396,736	4,761	26.01	21.89
SA "FABRICA DE BETON SI MORTAR"	3	31	19,106	38	391,930	784	4.87	4.87
SA "UNIVERSCOM"	3	1	5,543	6	475,544	476	1.17	1.17

IV - Microenterprise and SME Access to Finance The Role of Non-Bank Financial Institutions (NBFIs)³⁰

143. **In Moldova, as in other transition economies, micro, small and medium enterprises (SMEs)³¹ are essential for generating economic growth and meeting social challenges.** According to statistics and recent studies, SMEs constitute the only source of net job creation in the country. By end-2002 there were 21,800 small enterprises, comprising more than 92% of the total number of enterprises, of which 98% are private. The majority of small enterprises (81.2%) employed less than 10 persons. Notwithstanding a large absolute number of small businesses, their contribution to the economy was rather modest - they accounted for only 26.6% of total employment and 42.2% of annual sales. The growth potential of the Moldovan SME sector has not been fully tapped yet.

144. **Insufficient access to finance is one of the major constraints for the sustainable growth of SMEs, along with the well-known problem of over-regulation and poor investment climate.** The cost of financing, along with political instability, exchange risks, taxes and regulations remain among the key factors constraining the development of the enterprise sector, particularly the small enterprises, according to Business Environment and Enterprise Performance Surveys (BEEPS)³² (Figure 5).

145. **Economic recovery and export growth have led to a strong demand for better access to finance, particularly for investment in technical modernization, which the Moldovan financial system is not able to meet adequately.** According to BEEPS results for 2002, the median debt-to-asset ratio of Moldovan enterprises is a mere 9 percent, lower than in any other country in the BEEPS II sample. It has shown little change since 1998, suggesting that firms are not becoming more leveraged and that access to affordable finance has not improved substantially.

146. **Financing patterns of Moldovan enterprises differ to some extent from those in six other countries in the region (Table 10).**³³ Retained earnings are the most important source of financing for firms of all sizes, in all the countries – they comprise between 53% and 82% of working capital. Borrowing from commercial banks with a share of 11.8%, and loans from family and friends with a share of 8.5%, are the second and third most important sources of financing for SMEs in Moldova. While the share of commercial bank borrowing is similar in six of the seven countries surveyed (all except Azerbaijan), the importance of loans from family and friends is much higher in Moldova

³⁰ The author of this section is Ms. Irina Astrakhan.

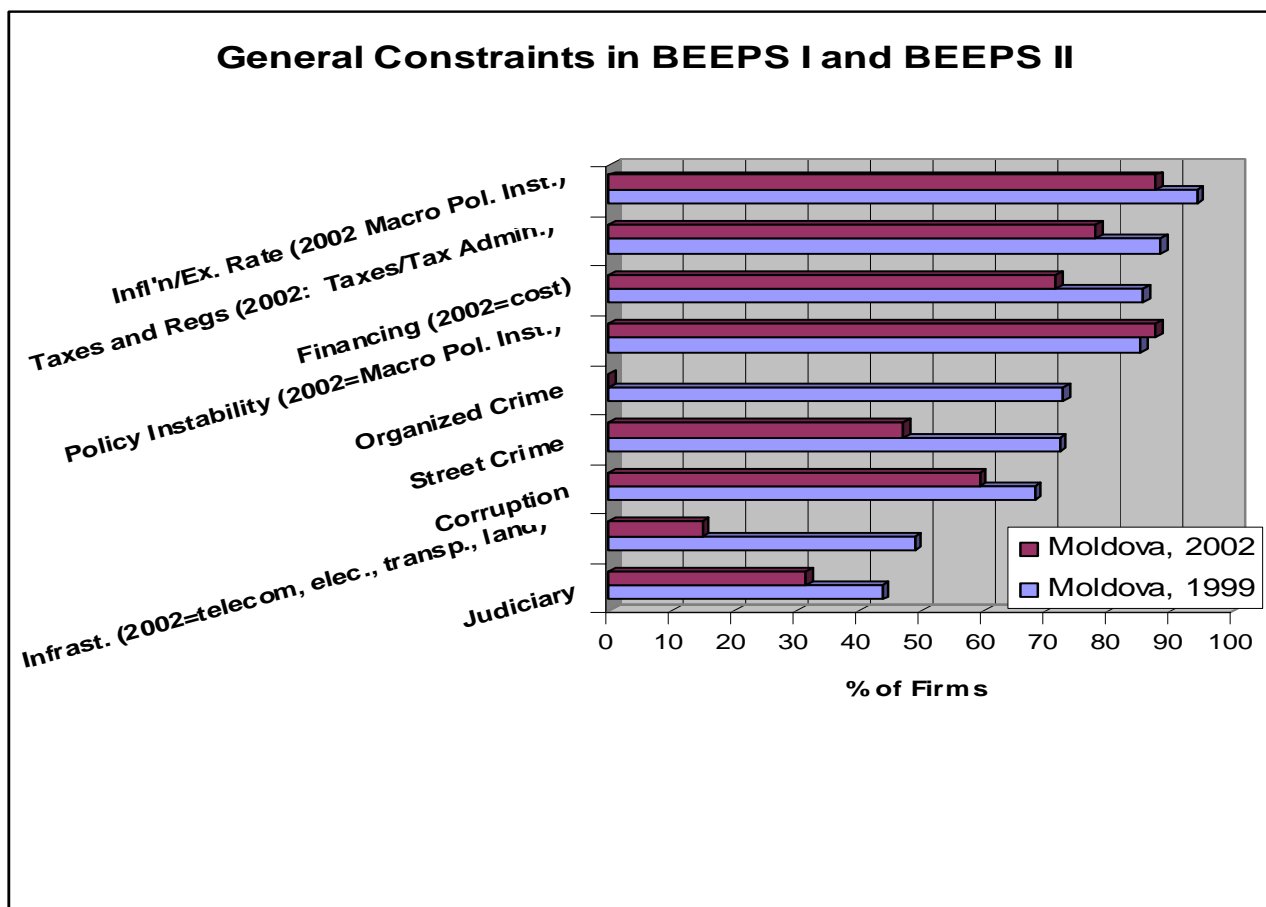
³¹ Small enterprises in Moldova are formally defined as enterprises with 10 to 50 employees, while micro-enterprises are those employing less than 10 persons. In addition the SME notion typically includes individual entrepreneurs and farmers. [Law on Support of Entrepreneurship Development, 1995, Article 1].

³² EBRD and World Bank, Business Environment and Enterprise Performance Survey, 2002

³³ *ibid*

(8.48%) than in the others. Trade credit from suppliers and customers does not seem to be well developed in Moldova – it covers only around 7% of SME working capital needs. The shares of equity and leasing as sources of finance are close to zero, and in this respect Moldova shows a similar pattern to countries in the Caucasus and to Bulgaria, but differs markedly from the more advanced countries in the region (typified by Hungary and the Czech Republic in this sample).

Figure 5 Evolution of Constraints in Moldova, 1999-2002



Source: BEEPS I and II.

147. **Some of the constraints of SME lending may be easing, but SME access to medium- and long-term borrowing is still relatively limited.** This is due to the scarcity of resources at a term longer than one year which makes even medium-term loans risky for the banks, and increases the costs of their lending. The country risk prevents the Moldovan banks from borrowing commercially from abroad. Virtually, all loans with

maturities of more than one year are financed by international donors³⁴. Donor credit lines (WB, IFC, EBRD, IFAD) have provided access for the banks to longer-term and moderately priced resources. However, such credit lines are usually quickly disbursed, leaving long unsatisfied project pipelines to wait for an indefinite time. Besides their long maturity, international sources of finance are exempt from NBM restrictions for lending to exporters in hard currency.

Table10 Sources of Finance in Various Countries

	Yugoslavia ³⁵	Hungary	Czech	Bulgaria	Moldova	Georgia	Azerbaijan
Share of working capital from:	%	%	%	%	%	%	%
Internal funds/Retained earnings	79.30	63.57	55.30	65.76	68.84	52.60	81.82
Equity (i.e. issue new shares)	1.98	14.49	7.51	0.10	0.20	0.32	0.64
Borrowing from local private commercial banks	3.13	6.97	6.21	4.55	8.83	8.04	0.96
Borrowing from state-owned banks	3.37	3.62	3.02	4.44	1.03	1.86	0.45
Borrowing from foreign banks	0.35	0.73	1.59	1.59	1.93	2.07	0.38
Loans from family/friends	4.30	2.37	4.37	6.17	8.48	5.14	4.39
Money lenders or other informal sources	0.51	0.08	2.34	1.81	0.62	1.81	2.96
Trade credit from suppliers	5.33	3.56	6.63	7.24	5.49	5.03	3.28
Trade credit from customers	0.25	0.67	1.17	1.46	1.64	2.59	1.24
Credit cards	0.00	0.53	2.04	0.00	0.00	0.29	0.00
Leasing arrangement	0.00	1.21	3.47	1.28	0.20	0.11	0.16
The government (other than state-owned banks)	1.44	0.91	2.18	3.94	0.49	3.94	2.64
Other (specify sources):.....	0.04	1.28	4.18	1.65	2.24	16.21	1.08

Source: EBRD and World Bank, Business Environment and Enterprise Performance Survey, 2002

148. **On the other hand, increased competition for the business of the corporate sector encourages commercial banks' interest in servicing SME clients.** Most importantly, small entrepreneurs and businesses have proven to be reliable borrowers, with the level of loan arrears typically lower than the arrears of large borrowers. According to NBM data, in 2003 commercial banks provided small credits for a total amount of MDL 1,642 million, which accounts for 17.6% of total credit volume. However, the aggregate total of loans below MDL 150,000 does not exceed 5% of total credit volume. A number of banks consider SMEs as an important market segment and have started to diversify their mix of products and services in order to better tailor them to

³⁴ Typically the banks fund themselves in US dollars or euros, and denominate their loans to borrowers in the funding currency, but disburse funds and collect repayments in the local currency (Moldovan lei).

³⁵ Now known as Serbia and Montenegro.

the needs of SMEs. Some of the banks have established specialized SME/retail departments and have started to apply innovative technologies for risk assessment such as credit scoring. However, these initiatives have not yet become a common practice of the banking sector. The lower end of the microenterprise-SME sector turns to microfinance institutions in search of access to credit.

149. **Many banks still do not have operational systems and procedures, retail-banking expertise or skills to properly assess risks and to customize financial products and services to meet the needs of SMEs.** SME lending is still commonly perceived by banks as more risky, and liable to incur high transaction costs. Collateral-based lending prevails. Broad dissemination of cash-flow based lending methodologies and standardized products tailored to SME needs would enable banks to decrease their costs of lending to this client group.

150. **Lack of transparency and limited information on enterprise financial statements also reduce the banks' appetite for SME lending.** Cumbersome reporting requirements and an arbitrary tax administration system create incentives for enterprises not to show full financial results on their official books, but by so doing they sacrifice their access to external financing. Further streamlining and simplification of administrative requirements and taxation of SMEs would strengthen their transparency and disclosure, and would also help to expand or facilitate banks' lending to this sector.

151. **The limited consumer and commercial credit information system also constrain lending.** Moldova has no unified system of information on enterprises' payment practices and credit history, such as an inter-bank credit information bureau. There is no instrument to share positive and negative information on debt repayment. An attempt to establish a credit information bureau undertaken by a number of banks several years ago did not yield positive results, mainly owing to the lack of trust among the banks and the reluctance of some of the largest banks to share information about their borrowers' performance. Typically, SMEs do not have well-documented credit history, and their compliance with accounting rules and regulations is uneven. They also tend to under-report sales and salaries, which distorts their trading results as shown by the books. The establishment of a credit information service could help to improve access to credit and reduce costs for creditworthy SMEs with documented histories of sound loan repayment performance.

152. **The role of non-bank financial institutions³⁶ (NBFIs) in servicing SME financing needs remains limited.** Given the limited access to formal financial markets, Moldovan firms, especially micro and small enterprises, seek to access alternative sources of financing, often provided by NBFIs. Aside from the banks, other SME financing includes leasing, equity funds, and microfinance institutions. The NBFIs sector is small and as yet underdeveloped: the range of financial products and services rendered by these institutions to SMEs continues to be limited mainly to loans and credit-related services

³⁶ The Law on Financial Institutions in Moldova does **not** include a category called "non-bank financial institutions", which is usually found in other countries' banking laws.

such as loan guarantees. The total loan portfolio of NBFIs does not exceed the volume of small loans extended by the banks, and their total outreach is remarkably small. As summarized in Table 11 below, the total outreach of NBFIs, including microfinance institutions – in terms of total number of active borrowers/clients individually and as a group - is less than 50,000, of which about 40,000 are served by the SCA network.

Table 11 NBFIs in Moldova

Institution	Number of entities/ branches	Total Portfolio Outstanding (USD, million)	Number of Clients
Micro Enterprise Credit (MEC)	12	7.6	3,400
MicroInvest	9	0.44	400
Savings & Credit Associations ³⁷	530	7.17	39,572
Rural Finance Corporation (RFC)	8	2.45	155 direct loans to individuals
(*loans to SCAs to fund their portfolio of 7.17 million)		6.88*	255 wholesale loans to SCAs
Leasing Companies ³⁸	5	15.0	N/A
Equity Funds	2	7.5 (only 0.1 mil SME related)	5
Loan Guarantee Schemes:	3		
(i) Loan Portfolio Guarantee Program	Loan Guarantee Programs target	(i) 5.0 Facility, of which 2.5 availed	(i) 250 (more) borrower clients
(ii) Credit Enhancement Program	Moldovan banks and financial institutions as participants to cover loans to their eligible borrowers	(ii) 8.0 Facility [no availment reported]	(ii) n.a.
(iii) Microinvest		(iii) 0.2	
(iv) State Fund for Support of Entrepreneurship and Small Business Development (under preparation)		(iv) Not exceeding 0.75	(iii) 12 (iv) n.a.

153. **The leasing industry is at inception stage of development.** In many developing countries leasing is an important source of investment finance, especially for SMEs and emerging businesses, as the lessor in case of default already possesses legal ownership title to the underlying asset. There is a strong demand for leasing services in Moldova. However, this sector remains largely underdeveloped, even by regional standards. It is difficult to estimate the exact volume of leasing operations. There are five active companies in the market with a total portfolio not exceeding US\$15 million. Most of the companies were established in 2002-2003 (three of them by the banks) and they are predominantly engaged in the leasing of motor vehicles. The development of leasing is

³⁷ As of December 31, 2003.

³⁸ Estimate

restricted by two major obstacles: the limited access of leasing companies to long-term financial resources and several regulatory provisions. The latter include, *inter alia*, VAT taxation applied to the interest component of leasing payments and a 5% service tax. The existence of such tax provisions puts this type of financing at a disadvantage in comparison with bank lending. To facilitate leasing development, the VAT status of lessors should be adjusted to be the same as for the banks. The work on the amendments to the Leasing Law of 1996 and the related legislation is underway with the support of the EBRD and Ernst & Young. These legal reforms, if accomplished, would serve as a catalyst for the development of financial leasing. While leasing companies, as long as they do not take deposits from the general public, do not have to be explicitly regulated and supervised by the NBM, the limits on bank credit to affiliated entities (including leasing companies) which have been established and are supervised by the NBM, do provide certain safeguards against regulatory arbitrage.

154. **Equity funds are virtually non-existent.** Until recently the only actor in this field was the donor-funded Western NIS Fund. It made 5 investments in Moldova for the total amount of USD 14.2 million, mainly in relatively large and well-established enterprises and financial institutions. As of May 2004, after exiting from two of the investments, its portfolio amounts to USD 7.5 million. Since 2004 Microinvest started to pilot small equity investments up to USD 50,000 and has made two investments so far.

155. **There is some positive experience with functioning loan guarantee schemes.** As a rule, such schemes are designed and supported by international donors. The best known of them – the Loan Portfolio Guarantee Program (LPG) and the Credit Enhancement Program – are supported by the USAID. The purpose of both guarantee facilities is to assist the financial sector in mobilizing credit to qualifying micro-enterprises, farmers and small and medium-sized enterprises through a risk-sharing arrangement. The LPG facility of US\$5 million for Moldova covers up to 50% of the financial institutions' net loss on the principal amount of loans made to qualifying businesses. The term of facilities is up to five years. Moldovan financial institutions participating in the LPG include Agroindbank, Fincombank, and Victoriabank. In the first fifteen months of operation, the LPG made 250 loans to small businesses for a total sum of US\$2.5 million. The Credit Enhancement Program (US\$8 million) is building on the success of the LPG and is opening up the guarantee facility to four new financial institutions – Mobiasbank, Moldincombank, Banca Sociala and the Rural Finance Corporation. In addition, Microinvest has recently started a small guarantee program covering up to 50% of the credit value for small loans up to US\$20,000 each. DFID has recently started the project aimed at supporting the establishment of a guarantee mechanism for small loans extended in rural areas with the use of the Rural RISP funds.

156. **The State Fund for Support of Entrepreneurship and Small Business Development also plans to use the limited resources allocated by the state budget for establishing loan guarantee mechanisms that would address the problems with collateral of small business start ups.** While the State Fund's shift from the previous failed attempts of direct lending to enterprises to loan guarantees is a positive development, the use of public money for the establishment of new credit guarantee

mechanisms in Moldova should be treated with extreme caution. International and local experience, and the lessons learned in this area, should be taken into consideration.

157. **The MFI sector, which provides access to credit for micro-enterprises and SMEs in Moldova, has been evolving into a tiered structure.** In this, financial institutions specialize in developing their own market niches, based not only on loan amounts, but on their product mixes, including their terms, collateral requirements, etc. The Micro Enterprise Credit Corporation and MicroInvest focus on loans and related financing facilities to individual enterprises in the large microenterprise and small business categories. The Rural Finance Corporation, which was originally established to serve as a central finance facility for on-lending to Savings and Credit Associations (SCAs), has also developed a loan product to cater to the larger loan amount needs of individual borrowers. SCAs, which are membership-based, not-for-profit organizations, provide micro-credit services to their members, whose loan needs are in the smaller loan amount category. Finally, there are a few institutional providers of non-financial services for microfinance institutions such as technical assistance for management training, record-keeping, operations and capacity-building. The microfinance segment of the NBFIs sector has demonstrated dynamic development and flexibility in addressing microenterprise and SME credit needs, experiencing substantial growth in the last few years. Several types of institution comprise this microfinance segment: the typology is highlighted in Table 12 below.

Microfinance Institutions

Micro Enterprise Credit (MEC)

158. **Micro Enterprise Credit (MEC) was established in 1999 by IMI (Germany) the Western NIS Enterprise Fund (USA), the DOEN Foundation (Netherlands), the EBRD and the IFC.** MEC extends loans from \$100 to \$50,000 in leu, indexed to the dollar and euro. As of March 2004, MEC had more than 3,400 loans outstanding with a total portfolio of about US\$7.6 million, of which 60% comprised microloans below US\$10,000. Most of these loans were for trading activities, services, and agriculture. MEC provides cash-flow based lending, focusing on the assessment of the business and its owner, processing loan applications in 1-3 days, thereby addressing micro-enterprise financial needs promptly. MEC is expanding fast, with two offices in Chisinau and 10 regional offices, and it had total assets of US\$10.5 million as of December 2003. The reported loan repayment rate so far has been very high at 99.8 %.

159. **Although its primary corporate objective is to provide credit facilities to micro and small businesses, MEC is neither regulated nor supervised by the NBM. This is due to the fact that MEC uses only funds provided by donors or borrowed from international financial institutions and does not take deposits or use any public money.** MEC's organizational structure and operational focus are similar to the micro-enterprise banks (the ProCredit network) that have been set up by the same international financial institutions and agencies in many countries in ECA, Latin America and Africa. Its shareholders plan for MEC to grow significantly in market size, assets and

capitalization, but have dropped their plans to apply for a commercial bank license owing to the high related costs associated with obtaining a license (primarily the high minimal capital requirements) and the relatively small size of the market.

Table 12 Microfinance and other Non-Bank Financial Institutions in Moldova

Institution	Legal Entity Status	Shareholder Ownership	Market Niche / Client Base	Sources of Funds
<i>Providers of Credit</i>				
Micro Enterprise Credit (MEC)	Joint-stock company	International agencies / development institutions	Micro, small and medium loans to individual enterprises	Shareholder capital & loans, loans from IFIs & ProCredit network
MicroInvest	Limited Liability Company	Soros Foundation Moldova	Loans, guarantees & equity investments to micro and small enterprises	Loan and equity capital from shareholders, grants from other IFIs, retained earnings
Savings & Credit Associations (SCAs)	Registered as non-commercial organization of citizens	Members united by common bond (village residency or occupation)	Microenterprises owned by individual members	Wholesale onlending loans from RFC and Agroindbank, members contributions, retained earnings, saving deposits
Rural Finance Corporation (RFC)	Joint-stock company	SCAs and Government of Moldova (0.36%)	SCAs (80%) and individual enterprises and farmers (20%)	Onlending funds from World Bank and IFAD; statutory reserves; retained earnings
<i>Providers of non-financial services (technical assistance, capacity building, promotion, advocacy)</i>				
Moldova Microfinance Alliance (MMA)	NGO	Founded by Open Society Institute, Soros Foundation Moldova, Finance pour Developpement Economique et Social, 48 of the first SCAs	Creation and promotion of SCAs, cooperatives, micro- and small-scale enterprises	Grants and Donations
National Federation of SCAs (NFSCAs)	Registered as non-commercial organization of SCAs	350 SCAs (end-2003)	SCAs	Membership fees, grants and donations from international agencies, RFC funding of particular activities
Rural Development Center	NGO		SCAs and farmers' organizations	Grants and donation, RFC funding

MicroInvest

160. **MicroInvest is another MFI whose business is directed towards individual small enterprises, established in 2003 by the Soros Foundation Moldova.** Microinvest has total assets of around US\$500,000 and has so far provided 394 loans up to US\$10,000 each for a total of US\$439,000. In addition, MicroInvest pilots a loan guarantee mechanism and equity investments in small private companies. Both MEC and MicroInvest were established and are operated with donors' support and they apply the most advanced microlending technologies and products in their operations. Neither MEC nor MicroInvest take customer deposits to fund their loans, although MEC may occasionally require deposits to collateralize loans.

Rural Finance Corporation

161. **The Rural Finance Corporation (RFC) was organized in 1997 to serve as a central finance facility for rural SCAs, indirectly providing farmers and rural entrepreneurs access to financial services.** It was registered by the first batch of SCAs and the government as a joint stock company with limited liability. The RFC considers itself a NBF, although it is neither regulated by, nor is it under the supervision of the NBM. Majority ownership of RFC is currently vested with the 298 shareholder SCAs, while the government's ownership has been reduced to only 0.4% from 20% initially. RFC intermediates concessional borrowings and credit lines from international donors and agencies into wholesale on-lending loans and credit lines to SCAs (from credit lines provided by the World Bank and International Fund for Agricultural Development) and, more recently, investment loans with matching grants to private farmers and small rural entrepreneurs (from special credit lines provided by the World Bank under the Rural Investment and Services Project or RISP). RFC recently became part of the existing USAID Credit Enhancement Program along with a number of commercial banks, through which it offers a loan portfolio guarantee facility to cover 50% of up to US\$1 million in loans to the SME sector (limited to US\$5,000 for individual loans funded from RFC's own resources and excluding loans funded from World Bank and IFAD credit lines).

162. **While most of RFC's portfolio comprises wholesale lending to SCAs, about 22% of its lending assets comprise direct loans by RFC to individual farmers, small businesses and commercial clients (around MDL 34 million as of end-2003).** Interestingly, about 20% of direct loan borrowers among RFC's individual client and small business categories are also members of SCAs. The bulk of RFC's on-lending has been directed towards SCAs. Over a six year period from its inception, RFC had a cumulative loan volume of over MDL 300 million (around US\$25 million) comprising some 100,000 loans serving more than 40,000 individual borrower-members of SCAs. Currently, RFC has 71,200 active individual members in 530 SCAs, with the average loan amount per SCA at MDL 373,000 (US\$27,000).

163. **At the end of 2003, RFC had MDL 5.4 million (US\$0.4 million) in net profit, MDL 62.7 million (US\$5.3 million) in loans outstanding, MDL 62.1 million (US\$5.2 million) in government bonds, and MDL 128 million (US\$10.7 million) in**

borrowings. Shareholder's equity stood at MDL 17.5 million (US\$1.5 million).³⁹ The 7.35 to 1 debt-equity multiple for 2003 is high (up from 6 to 1 in 2002), considering that the ability of the SCA shareholders to step forward quickly if and when substantial additional capital infusion might be required is rather limited.⁴⁰ The lending resources available to RFC are summarized in Table 13 below (source: RFC Annual Report, 2003).

Table 13 The Lending Resources of RFC

Source of Funds	Year Available	Funding Type	Amounts (MDL millions)	Purpose	Status
IDA (World Bank)	1998	Loan	50.0	Lending to SCAs	100% availed, 2001
Dutch Government	1997	Grant	0.37	Lending to SCAs	100% availed, 1997
CNFA / USAID	2000	Loan	0.49	Purchase money mortgage loans through SCAs	100% availed, 2000
IFAD	2001	Loan	6.8	Lending to SCAs in Ungheni region	100% availed, 2003
IDA (World Bank)	2002	Loan	64.5	Lending on individual & group-based basis to private rural businesses and SCAs	100% availed, 2003
Own Resources			13.4	All types of lending	100% placed
Total (Approx.)			135.5		

Savings and Credit Associations

164. **The Savings and Credit Associations (SCA) movement is small in financial impact, but caters to the financial needs of households and entrepreneurs in rural areas that often cannot access bank credit.** Since 1997 SCAs have been created and assisted in their development by a number of donor organizations, including the World Bank, IFAD, USAID, DFID, GTZ, and the Soros Foundation Moldova. The network of SCAs channels donor and commercial bank (mainly, Agroindbank) funding through a network of 530 associations to more than 71,000 members. SCAs are extending small loans (average size MDL 4,000), which are mostly seasonal, with typical maturities of 9-

³⁹ The shareholders' equity of RFC comprised share capital of MDL 1.5 million (US\$0.1 million), reserves of MDL 10.4 million (US\$0.9 million) and retained earnings of MDL 5.5 million (US\$0.5 million).

⁴⁰ For MEC, which has very strong institutional shareholders with established international reputations, the comparable debt-to-equity multiple is 16:1, while the ratio of equity to loans is 6.4% for 2003 (source: MEC Annual Report 2003).

11 months. The SCAs accept personal guarantees and partial collateral for the loans up to MDL 10,000; larger loans are required to be fully collateralized.

165. **The Law on Savings and Credit Associations of Citizens** (passed by Parliament on February 18, 1998, and amended several times since) **governs the organization, business and operations of a SCA of natural persons.** An SCA is run as a non-commercial (i.e., not-for-profit) organization, with a special legal status, with the capability of accepting personal savings of its members and offering them special purpose loans. As provided by the law, an SCA does not distribute profits/operating surpluses to members, but uses them for development. The Banking Law and the Law on Public Organizations specifically do not apply to the SCAs.

166. **Under the SCA Law, an SCA can be created and organized by at least 10 members.** The current size of SCAs ranges from 16-18 members in a newly created SCA, to over 800 members in a typical SCA with 4-5 years of operations, depending on the size and economic potential of the village; the approaches used in organizing the SCA; technical competence of management; age of the SCA; and other factors. In principle, the activities and operations of an SCA are limited to the boundaries of a village in which the SCA is located. This limit on geographical market and residency as the basis of the closed common bond of members protects SCAs from risks related to lack of information about member clients and is a key factor in the use of social pressure. On the other hand, it holds back the quantity and quality of growth and development of those SCAs that potentially could mitigate these risks. This built-in constraint to growth and diversification of market risk is one of the major issues currently under discussion within the SCA system. However, in practice these limits are becoming looser and are not invariably applied.

167. **The SCA movement is growing rapidly: in 2003 alone, the number of SCAs increased by 10%, membership by 36%, loan portfolio by 62% and total savings by 181%.** During the peak of the agricultural season, lending has reached a level of US\$16 million equivalent in disbursements. The SCA segment has grown rapidly with the assistance and support of donors and local umbrella organizations such as the National Federation of SCAs and Moldova Microfinance Alliance.

168. **The recent rapid growth of the SCA portfolio raises issues of growth management, management capacity and the overall sustainability of the SCA system.** The SCAs are supervised and regulated by the State Supervisory Board (SSB) under the MOF. The majority of SCAs are the members of the National Federation of SCAs, the apex organization supporting their capacity building. According to the data of the Federation and the SSB, the SCA system has performed relatively well throughout these years with an impressive loan repayment rate of over 98%. Total deposits of MDL 3.3 million (US\$0.25 million), though small, tripled during 2003, and a similar growth rate is reported to have occurred during 2004. Present estimates by the SSB are that the aggregate deposits of the SCAs will exceed US\$1 million equivalent by the end of 2005.

169. **The SCAs' portfolio quality is a key factor in long-term sustainability.** There have been some fluctuations in portfolio quality between the early years and the present,

and hence this issue is closely monitored by the RISP team. Though delays were mostly in the overdue (up to 2 months) category, timely and appropriate measures need to be taken by the SSB, as well as by creditors regarding lending limits, the close monitoring of loan funds usage, and more training in client selection and loan evaluation techniques for staff of the SCAs.

170. **The SCAs still depend heavily on donor funding accessed through wholesale onlending of funds by the RFC, although recently some larger SCAs have accessed credit lines from commercial banks, notably from Agroindbank.** Sustainable development is not attainable without adequate capitalization and especially without savings mobilization, which currently covers less than 1% of the SCAs' financing needs. Adequate capitalization and standards for capital adequacy may need to be reviewed and adjusted in order for commercial institutions to be attracted to and willing to work with SCAs as retail outlets. Work on improvement of the regulatory framework and environment for SCAs is presently underway, with new prudential norms (requirements for capital, liquidity, reserves, delinquency) to be introduced by 2005.

Legal and Regulatory Framework Issues

171. **Microfinance institutions, such as MEC and MicroInvest are governed by the new Law on Microfinance Organizations, according to which they will be monitored (not supervised) by the SSB.** These two entities (MEC and MicroInvest) currently fund their operations from foreign shareholders and investors, whereas RFC from government/donor onlending funds and accumulated earnings. Since MEC and Microinvest do not mobilize and intermediate retail deposits, they are not prudentially supervised by the NBM. Although the founders, investors and shareholders of MEC and Microinvest apply best practices and internationally-accepted performance standards in their financial operations, reliance on self-regulation and internal governance mechanisms may not be an acceptable long-term approach to protecting the interests of all concerned.

172. **The recently approved Law on Microfinance Organizations provides that the legal status of a registered microfinance institution may be obtained by non-deposit-taking microfinance institutions, subject to meeting certain prescribed standards and requirements.** However, the Law on Microfinance Organizations is merely a framework law, which leaves the issue of SCA regulation to the SCA Law. In order to update, simplify and make more coherent the legislative and regulatory framework applicable to SCAs, the government is in the process of finalizing a new draft of the SCA Law (the present version dates back to 1998) and their accompanying prudential regulations. However the FSAP team understands that the new draft SCA Law is unlikely to be approved by the government for submission to the parliament until the middle of calendar year 2005⁴¹.

⁴¹ The speed of the legislative process will be affected by the timing of the forthcoming elections that are expected to take place during the first half of 2005.

173. **The legal status of the RFC is not adequate to its objective and functions of supporting the rural sector through a variety of credit instruments.** In addition to on-lending donor funds, the RFC has also started to lend aggressively directly to SMEs. Considering that the institution is growing rapidly (with total assets of about US\$12 million and capital of US\$1.3 million), that it manages public money, and that the financial health of RFC determines the financial health of the entire network of SCAs, which themselves are taking deposits, it is advisable that the RFC be supervised and regulated to indirectly protect SCA members. This supervisory role could be assumed by the SSB,, provided that the SSB can be considerably strengthened.

174. **At present, the supervisory authority and capacity of the SSB is insufficient to allow for a proper supervision of the industry.** The SSB is under-budgeted, and it has an extremely high turnover of staff (mainly due to low salaries), which impedes sustainable capacity building and renders training efforts ineffective. The sanctions available to facilitate the enforcement of regulations are insufficient and need to be increased. The SSB should be provided with resources to complete the liquidation of a dozen poorly managed SCAs. This problem is becoming increasingly acute as deposits with the SCAs are likely to reach well over US\$1 million equivalent by the end of 2005.

175. **Under a 2001 agreement with the SSB, the National Federation of Savings and Credit Associations (NFSCA or Federation) assists in fulfilling the financial reporting required of SCAs.** In this capacity it collects data and reports from individual SCAs, computerizes the information, and prepares the consolidated reports periodically. The Federation also internally audits the SCAs. Organized in 1998 as an umbrella organization by 48 of the first batch of 60 SCAs, the NFSCA membership stood at 350 SCAs (or about 80% of the total number of SCAs) at end-2003. About 20% of NFSCA's operating budget is financed by membership dues paid in by SCAs, and the Federation continues to depend on funding from donors such as CORDAID Holland, the Soros Foundation Moldova, the World Bank/CAPMU, and USAID. The Federation has 9 regional centers through which it provides technical consulting and support services in SCA management, operations, accounting and record-keeping and membership strengthening and promotion as well as savings mobilization. Like most federations of membership-based SCAs and credit cooperatives in other countries, the NFSCA is not a source of funding for SCAs, and focuses its activities on representing and promoting the interests of the SCA sector. Information about NFSCA, RFC, RDC and SSB is available on the website: <http://www.microfinance.md/main>.

176. **The various roles of the government and other stakeholders in the SCA system (the RFC, the National Federation of SCAs, the SSB, the Rural Development Center) need to be revised to ensure proper governance, accountability, and sustainability of the system, and to protect members' fast growing deposits.** The SCA system needs strengthening, particularly regarding: (i) the level of governance and management/accounting capability of the SCAs (to alleviate the risks inherent in their activity); (ii) the supervision of SCAs; and (iii) alignment of regulatory framework with best practice.

177. **Credit associations could potentially be misused unless a more effective regulatory and supervisory regime is introduced.** Member-based microfinance institutions, including credit associations funded by members' money and savings, are often assumed to be self-regulating through their self-governance structure. However, this assumption may be untenable as institutions become larger. The pace of growth of the SCAs and the necessity for protection of mostly poor rural depositors will require strengthening the supervisory capacity of the SSB, and the extension of its mandate to include also the regulation and supervision of the RFC. The government may want to investigate the possibility of setting up a small quasi-government independent entity to take on these functions. This should be accompanied by ever closer collaboration with the National Federation of Savings and Credit Associations which presently performs the internal auditing for SCAs and monitors their financial situation and reporting on a regular basis.

178. **The regulatory framework under which SCAs were created and function needs to be improved to meet the new requirements and to ensure the sustainability of the sector.** At present the level of losses is very low, but as the level of deposits grows, more risks will be involved. The SCA Law and related regulations, adopted in 1998 and subsequently amended, are increasingly unequal to the task of effective regulation. However, through the proposed new Law on SCAs and related prudential norms which are being finalized. The government is working on improving the SCA regulatory environment with new prudential norms (requirements for capital, liquidity, reserves, delinquency) aimed to cover all potential risks, improved reporting formats. The above-mentioned amendments should be enacted during 2005.

179. **At the same time, the recent proliferation of new legislative initiatives in the area of microfinance is worrisome.** The draft Law on Savings and Credit Cooperatives, which is being discussed at present, seems to be premature. There is no real demand for such a law, which partially duplicates ground covered by the existing Law on Savings and Credit Associations (presently undergoing revision) under which the SCAs operate. More importantly, the envisaged participation of legal persons as cooperative members⁴², by potentially broadening the range and scope of cooperatives services, will increase tremendously the risks and supervision challenges of the already strained SSB. Any further work on a Savings and Credit Cooperatives Law should be postponed indefinitely. The Law on Microfinance Organizations, recently adopted by the Parliament, seems to be more neutral. Its main objective is to legitimize the existence of the very few non-deposit taking microfinance institutions and require that they be monitored by SSB.

Summary of Recommendations:

180. **Several measures can be taken to facilitate micro-enterprise and SME access to affordable finance.** Micro-enterprises (especially the larger ones) and SMEs need to be able to justify their creditworthiness to banks and to make certain that their capital

⁴² In accordance with the existing Law on Savings and Credit Associations, the membership is limited to physical persons only.

structure and cash flow are appropriate. A sound framework for secured lending is essential, to ensure that banks and other creditors are willing to take the risk assumed in SME lending. Specific measures to contribute to increased lending for viable micro-enterprises and SMEs include:

- Broad dissemination of cash-flow based lending methodologies and standardized financial products tailored to microenterprises and SMEs that would enable banks to decrease the costs of lending and to deal profitably with SME clients.
- Facilitation of access to long-term financial resources that would enable the banks to meet the growing enterprise demand for investment funds for technical modernization and upgrading.
- Establishment of a unified credit information and exchange service, and the introduction of necessary legislative changes, so that creditworthy SMEs (and indeed all other companies) with documented histories of sound loan performance are able to build on that history to increase access and reduce cost.
- Further streamlining and simplification of administrative requirements and taxation for microenterprises and SMEs that would strengthen their transparency and disclosure, and facilitate banks' lending to this sector.
- Improvement of the regulatory framework for leasing to facilitate its development, including *inter alia* adjustment of the VAT status of lessors so as to be the same as for the banks. In that regard the team notes that work on the amendments to the Leasing Law of 1996 and the related legislation is presently underway.
- Development of an adequate regulatory framework and institutional setup for regulatory oversight ("non-prudential regulation") and prudential supervision based on the risk profile of financial institutions, and strengthening the capacity for SCAs supervision. In the short term, this implies (i) strengthening SSB's supervisory capacity; (ii) introduction of new prudential norms and improved reporting formats for SCAs; (iii) improving the SCAs Law; (iv) postponing new legislative initiatives related to the regulation of new microfinance institutions such as the Law on Savings and Credit Cooperatives; and (v) ensuring better coordination in the drafting of the new laws related to the regulation of microfinance institutions.
- The government should consider appropriate mechanisms and structures for the regulatory oversight of the RFC. The FSAP team recommends that the RFC be supervised directly by the SSB.
- For the purpose of better regulating SCAs, the team recommends that the SSB work ever more closely with the NFSCA which already monitors the individual and collective financial situations of the SCAs on a regular basis.
- Facilitation of the institutional capacity building of SCAs, expansion of their training efforts and improvements in the quality of training and certification of the SCAs' key staff.

Table 14 Details of the activity of the SCA network

Reporting date	No of SCA s	Short term external loans	Long term external loans	No of SCA members	No of borrowers	Capital (B/S line 330), lei	Short term loan outstanding to members	Long term loan outstanding to members	Total delinquent loans, lei	Risk fund at bank deposit, lei	Short term savings from members, lei	Total assets, lei
01/01/2001	293	18,140,605	1,193,477	25,114	19,085	9,348,109	22,458,075	1,031,143	2,242,85	2,225,709	170,463	-
01/01/2002	369	32,632,209	1,342,197	37,766	23,088	15,505,853	39,761,221	1,416,116	5,960,763	4,209,040	611,597	50,975,054
01/01/2003	484	33,673,489	10,681,410	52,539	26,446	24,532,987	44,374,935	10,008,987	3,286,243	7,632,551	1,176,462	70,894,932
31/12/2003	530	55,451,053	26,051,402	71,177	39,572	37,811,967	72,748,200	26,476,641	3,685,518	12,788,994	3,306,066	124,490,055

Source: Based on financial reports presented to the State Supervisory Body.

V – Corporate Governance

Introduction

181. This note reviews the governance of both the financial sector (banking, insurance and investment funds) and the corporate sector in Moldova. The report was prepared by Ms. Sue Rutledge, Regional Corporate Governance Coordinator for the Europe and Central Asia Region of the World Bank, based on meetings conducted from May 6-21, 2004 in Chisinau as part of the FSAP mission. In addition to discussions with the regulatory agencies, the mission met with seven of the 16 licensed banks, representing 73 percent of the total assets of the Moldovan banking sector, and two asset-management companies, responsible for management of a substantial share of investment fund assets in Moldova.⁴³

182. **Governance of the financial sector has emerged as an important factor in financial stability.** As seen in the financial crises of East Asia in 1997, Russia in 1998, and Turkey and Argentina in 2001-02, corporate governance of the financial sector has emerged as a key issue in determining the ability of a country's banking sector to weather domestic crises—and its capability to withstand contagion from global financial crises. Corporate governance has become recognized as an important factor in establishing trust in the financial system—and in ensuring that bank depositors, insurance policy-holders and small shareholders alike have confidence that their funds have been entrusted to competent and honest administrators. Poor governance erodes customer confidence and deters potential customers from placing deposits with a bank, transferring savings to an investment fund, or purchasing an insurance policy. Poor corporate governance also makes it more difficult for financial institutions to raise additional equity capital, especially from investors outside the group of current shareholders.

183. **Governance of the corporate sector is an important issue in determining the quality of a country's investment climate.** In many transition countries weak governance of the corporate sector has emerged as a key issue following a decade of privatization. All potential investors, but particularly foreign investors when reviewing transition economies, place heavy emphasis on a country's corporate governance framework in deciding among countries in which to invest their capital. Effective corporate governance ensures that company managing directors and controlling shareholders take into account the interests of all stakeholders, not only large and small shareholders, but also creditors, suppliers, customers and other stakeholders.

184. **A strong corporate governance framework also improves the quality of the enterprise sector.** Well-governed companies are more likely to be credit-worthy as bank borrowers. In addition, the equity shares of well-governed corporations can provide solid

⁴³ The review of governance of the corporate sector is provided in the Detailed Assessment of Implementation of the OECD Principles of Corporate Governance and its findings are reflected in this note. The Detailed Assessment was prepared by Alex Berg of the Private Sector Department of the World Bank during a mission to Chisinau from May 10-14, 2004, concurrently with the FSAP mission. The Detailed Assessment will be available in due course on the World Bank's website [http://www.worldbank.org/ifa/rosc_cg.html.]

investments for investment funds, pension funds and insurance companies. Where weak corporate governance is associated with insufficient competition in the business sector, improved corporate governance practices can open the way for new entrants and increased competition for customers and new markets.

Key Findings

185. **By comparison with other transition countries, corporate governance in Moldova is considered very poor.** According to the Transition report 2003 of the EBRD, enterprise restructuring and governance in Moldova is rated “1” (the minimum ratings out of a possible 4+ for transition countries). Moldova is also the only country in EBRD’s survey where corporate governance is considered to have declined from 2002 to 2003. Of the transition countries, only Belarus and Turkmenistan are similarly ranked at “1”. Thus corporate governance in Moldova ranks as weaker than that of Ukraine, Georgia, Armenia or Azerbaijan, and considerably weaker than corporate governance in Russia.

186. **The Detailed Assessment of Corporate Governance also found a weak corporate governance framework in Moldova.** In the Detailed Assessment of Corporate Governance Moldova received relatively low scores compared to other transition countries.⁴⁴

187. **At the same time, market capitalization in Moldova is negligible.** Although the official statistics estimate the capitalization of Moldova’s stock market at 18 percent of GDP, the MSE notes that some listed companies have not traded within the last two years and that the market capitalization of the equity shares on the MSE is actually negligible. By comparison, Ukraine’s stock market represents about 8 percent of GDP and Russia’s about 36 percent of GDP, although the stock markets of the countries of the south Caucasus are also considered to be negligible.

188. **In the transition economies, the most common problems of corporate governance are three-fold:** (1) asset-stripping where company assets are sold to friends and family at fire sale prices; (2) share-dilution, where new shares are issued for the deliberate purpose of diluting the shareholding positions of targeted minority shareholders without their consent; and (3) transfer-pricing, where the company’s products (often oil and gas-related) are sold to loosely affiliated companies at below-market prices and then resold at international prices and sometimes re-imported at world prices. Based on discussions with market participants, it appears that in Moldova all three forms of corporate governance abuses are present.

Background

189. **A corporate governance framework encompasses three areas:** (1) laws, regulations and decrees that provide the legal framework for the commercial sector; (2) regulatory agencies

⁴⁴ Two OECD Principles of Corporate Governance were scored as “Not Observed”, 12 Principles as “Materially Not Observed”, seven as “Partially Observed”, and only one as “Largely Observed”.

responsible for enforcement of legislation; and (3) common market-place practices (or business culture), that in some countries are as important as legislation and institutions.

190. **Since the privatization period of the mid-1990s, the legal and regulatory framework of corporate governance has improved substantially in Moldova.** In particular, the 1997 changes to the Law on Joint Stock Companies restricted the previously unlimited ability of companies' boards of directors to issue new equity as a means of aggressively diluting the interests of targeted shareholders. Legislative changes also attempted to make asset-stripping more difficult. Copying the improvements in the Russian joint stock company legislation at that time, the 1997 Moldovan Law on Joint Stock Companies stated that sales of more than one-quarter of a company's assets required unanimous consent of the supervisory board (called in Moldova a "board of directors"). More than one-half of the sale of the company's assets required the approval of the shareholders' meeting. Complementing this provision was the mandatory use of "cumulative voting" procedures. Such procedures ensured that a 20 percent shareholder was guaranteed at least one representative on a five-person board—sufficient to block the stripping of the majority of the company's assets. The period of 1997-98 also saw the establishment of the NSCM and related legislation.

191. **Improvements have also been seen in the governance of the banking and financial sector.** New banking legislation established an effective banking regulator (the NBM) with extensive powers concerning corporate governance of banks and the NBM also increased the minimum requirements for the regulatory capital of banks.⁴⁵ Similarly, the 1997 investment fund legislation required the establishment of dedicated—and well-capitalized—asset-management companies for the investment funds.

192. **However, by comparison with the speed of improvements in other eastern European countries, the legal and regulatory framework for corporate governance in Moldova has lagged.** Specific weaknesses were introduced, e.g., retrograde changes to the commercial legislation in 2000 that eliminated the obligation for all joint stock companies to have independent audits. The main issue is that the Moldovan corporate governance framework has not materially improved during a period when virtually all the countries of the Europe and Central Asia Region have strengthened their governance framework.

Corporate Governance of the Banking Sector

193. **On several levels, the banking sector has a reasonably strong corporate governance framework.** All banks must be incorporated as joint stock companies. Nine out of the 16 banks are open joint stock companies with their shares publicly traded on the MSE. The corporate charters of banks are subject to the approval of the NBM and all significant shareholders with 10 percent or more of the bank (held directly or through intermediaries) must be approved in

⁴⁵During the period 1996-2004, the NBM withdrew its authorization for 14 banks to operate. Of these, ten banks became insolvent owing to poor bank management (and in some cases, connected lending or outright fraud), another three were voluntarily liquidated by their owners (branches of 2 Romanian banks and one Greek bank), while one bank lost its license to operate owing to severe violations of the banking legislation and normative acts of the NBM.

advance by the NBM. In line with international practice, shareholders must meet “fit and proper” tests, which include meeting standards of integrity. Where significant shareholders cannot meet the requirements, the NBM has the clear legal authority to suspend the voting rights of the shareholder or, in extreme cases, to oblige the shareholder to sell his or her shareholding in the bank. Compared to other transition countries outside of the European Union, the provisions are very strong and important in ensuring good corporate governance of the banking sector.

194. **However, the key weakness is the ownership structure of the banks.** In addition to being a precondition for the supervision of several prudential rules (e.g., large exposures or connected lending), the ownership structure of banks is important since in times of financial crises, the regulator needs to look to the existing controlling shareholders to invest additional capital. Unlike other transition countries, none of the western European or international banks is a strategic investor in any of the Moldovan banks. Foreign banks are limited to one Romanian and one Russian-owned bank. Banca Commerciala Romana (BCR), the Romanian state bank undergoing privatization, maintains a local branch in Moldova. Similarly, Petrocommerts Bank of Russia, owned and controlled by the Russian oil giant Lukoil, owns 100 percent of Unibank. As noted in Table 15 below, together BCR and Unibank account for about 5 percent of banking assets in Moldova. About 40 percent of bank assets are held by banks controlled by individuals and non-financial corporations, many of which are located in offshore zones (and tax havens) for which little information on the true ownership and control structures is publicly available. Another 15 percent of the sector is represented by Banca de Economii, which is state-controlled, with the Privatization Department of the Republic of Moldova holding the single largest control block.

195. **Furthermore, the ownership of more than half of the banks lacks sufficient transparency to the public.** In total, almost half of all banking assets are held by companies in off-shore zones, for which little information on ownership and control of the corporations is publicly known. Banks controlled by individuals and non-financial corporations are considered by the market-place to be “pocket banks” in one form or another, whose interests serve primarily those of the controlling shareholders and affiliated companies. The strong presence of non-financial companies as bank shareholders highlights the importance (and to some degree the impossibility) of diligent bank supervision. In times of economic crisis, such close ties between banks and non-financial enterprises may result in “temporary” violations of the lending limits in order to provide liquidity financing for enterprises loosely affiliated with the bank’s shareholders.

196. **The “fit and proper” provisions for shareholders and key administrators of the banks have proven difficult to enforce in practice.** The law allows for the NBM to take action where shareholders fail to meet adequate standards of professional experience or lack integrity. However, at least two, and perhaps three, banks have shareholders who may fail to meet the full fit and proper requirements. Another bank is thought to be controlled by off-shore shell companies, whose focus is not necessarily on making loans to credit-worthy clients. The situation is not a rarity in transition economies, where at the beginning of the transition the choice for banking shareholders lain among only three options: (1) foreign banking corporations,

(2) state-owned banks and (3) banks owned by the local business community, some of whom are less than fully transparent in their ownership and control relationships.

Table 15 Ownership of the Banking Sector in Moldova

(MDL Millions)	Social Capital	Total Assets	% of Assets	Controlling Shareholders	Country of Controlling Shareholders
<i>Banks Controlled by Domestic Individuals & Non-Financial Companies</i>					
Moldincombank S.A.	31.8	1,071.9	10.5%	Offshore trading companies	Gibraltar, USA, Belize & Bahamas
Banca Sociala S.A.	57.6	989.5	9.7%	Main Investment Company Ltd (unknown company)	Russia
Fincombank S.A.	41.6	457.7	4.5%	Oleg Voronin & domestic companies within group	Moldova
Eximbank S.A.	40.7	376.8	3.7%	Royal HTM Group (associated with Boris Birshtein)	Canada
Investprivatbank S.A.	54.0	203.8	2.0%	Offshore trading companies	USA, UK & Belize
Universalbank S.A.	60.0	196.9	1.9%	Offshore trading companies	Ukraine, Romania & Russia
Businessbank S.A.	59.7	156.3	1.5%	Offshore shell companies	UK & Luxembourg
Commertbank S.A.	20.4	133.7	1.3%	Small domestic companies	Moldova
Eurocreditbank S.A.	<u>79.6</u>	<u>96.0</u>	0.9%	Mariana Zisi (indirectly Marian Zisi)	Greece
	445.4	3,682.6	36.00%		
<i>Banks Controlled by Management with Capital from Foreign Investment Funds</i>					
Agroindbank S.A.	51.9	2,146.3	21.1%	Western NIS Fund & EBRD	USA & UK
Victoriabank S.A.	32.0	1,487.2	14.6%	Danube Fund, Alpha Bank Romania, EBRD	Cyprus, Romania & UK
Mobiasbanca S.A.	71.2	604.5	5.9%	Development Capital Corp Moldova	Cayman Islands
Energbank S.A.	<u>58.3</u>	<u>274.0</u>	2.7%	Chisinau Municipal Electric Co (indirectly EBRD)	Moldova
	213.4	4,512.0	44.3%		
<i>Subsidiaries & Branches of Eastern European Banks</i>					
Unibank S.A.	51.0	323.0	3.2%	Petrocommert	Russia
B.C.R. S.A.	<u>58.5</u>	<u>180.7</u>	1.8%	BCR	Romania
	109.5	503.7	4.9%		
<i>Banks Controlled by Government of Moldova</i>					
Banca Di Economii S.A.	<u>29.3</u>	<u>1,591.7</u>	<u>14.6%</u>	Privatization Department of the Rep. of Moldova	Moldova
	29.3	1,591.7	14.6%		
Total	797.6	10,290.0	100.0%		

Source: Data Prepared by the National Bank of Moldova for FSAP Mission. Data as of February 29, 2004.

197. **The banks with equity investment from investment funds or international financial institutions receive valuable capital but not necessarily the management expertise of large commercial banks.** About 45 percent of bank assets are held by banks with capital investments by foreign investment funds, the EBRD or the American-Congress funded Western NIS Enterprise Fund.

198. **Continued government control of Banca De Economii also presents a risk for corporate governance.** Active government ownership of one of the major Moldovan banks leaves the bank open to criticism that it finances state enterprises or the private business activities of members of parliament or senior government officials—and alleged preferential treatment in government tenders.

199. **Weaknesses in transparency of the corporate sector also undermine the quality of bank assets.** Weak public transparency of the ultimate beneficial owners of companies makes it difficult for external auditors—and bank supervisors—to accurately monitor related party transactions. Since bank loans to shareholders represent a major vulnerability, accurate information on connected lending is a key bank governance issue.

Corporate Governance of the Insurance Sector

200. **Substantial corporate governance weaknesses are seen in the insurance sector.** The introduction of mandatory third-party liability insurance for motorists and the increasing use of life insurance create some governance risks for the Moldovan insurance sector. For insurance companies the major weaknesses are: (1) inadequate disclosure of the ownership and control structures; (2) weak internal corporate governance structures; (3) lack of “fit and proper” provisions for shareholders and key administrators; (4) inadequate development of the actuarial profession able to evaluate the adequacy of insurance reserves; and (5) a weak regulatory body for the sector.

201. **Ownership of the insurance sector is not sufficiently transparent.** Insurance companies are not required to disclose their major ownership and control structures to the regulatory body, the SIIS. Nor is approval of significant shareholders of insurance companies required. For the FSAP mission, the SIIS asked all insurance companies to provide a listing of investors with five percent or more shareholdings. As noted in Table 16, 7 of the 49 licensed companies failed to provide the information. Voluntary compliance was high, at 85 percent, but insurance companies should be legally required to provide such information.

202. **It is also not clear whether the quality of ownership of the insurance sector is adequate.** While the largest insurance company is owned by the Australian insurance company, QBE, four companies are partially-owned by banks as noted in Table 17. Moldasig SRL is controlled by Banca de Economii, which is in turn controlled by the Privatization Department of the Republic of Moldova. Exim Bank, affiliated with a Canadian citizen, owns one-quarter of Exim-Asint with a Canadian banking service organization. Victoriabank, and the state railways enterprise together own 20 percent of another insurance company, while a fourth company is

almost half-owned by a Cyprus-based company. In total, 13 companies, representing a substantial proportion of the sector’s total assets, are fully owned by individuals rather than by commercial enterprises. The ability of shareholders to provide additional capital in times of trouble is an important issue for governance of any financial institution and care should be taken in allowing individuals without extensive wealth to act as controlling shareholders of insurance companies. However, the regulatory body should have sufficient legal authority to refuse a license (or otherwise impede the operations) of an insurance company where the shareholders cannot meet the necessary fit and proper standards.

Table 16 Ownership of insurance companies

Ownership	Number
Owned partially by banks	4
Fully owned by commercial enterprises	25
Fully owned by individuals	13
Failed to report ownership	7
Total	49

Source: Data prepared for the FSAP mission by the Insurance Supervision Department of the MOF.

203. **Weak governance structures are also seen in Moldovan insurance companies.** Of the 43 companies that reported to the SIIS, about two-thirds are incorporated in the form of limited liability companies rather than as joint stock companies. Even for joint stock companies, the Moldovan law provides insufficient authority—and insufficient accountability—for the company’s supervising board of directors (as discussed below under Governance in the Corporate Sector). Nevertheless, the Law on Joint Stock Companies provides for at least minimum internal governance structures not used in limited liability companies. Under current best practices for insurance supervision, reliance on the internal governance structures of insurance companies (and in particular, the work of the supervising board of directors) is a key element in adequate supervision and regulation of the sector. At a minimum, insurance companies should take the legal form of joint stock companies.

204. **Financial reporting for insurance companies is also not adequate.** While insurance companies are required to have an annual independent audit, the financial audit does not include an actuarial review of the adequacy of the company’s financial reserves. With short-term revenue sources and long-term financial obligations, insurance companies should be subject to annual actuarial reviews of the quality of the company’s reserves. There is an absence of adequate historical data upon which an actuary can base his or her review, but Moldovan insurance companies should be required to have on their staff a qualified actuary who can report any deficiencies to the regulatory body. At the same time, consideration should be given to measures to develop the local actuarial profession.

205. **The regulatory structure is not sufficient to meet the needs of a modern insurance sector.** As recommended elsewhere in the FSAP, the insurance sector needs an independent regulatory body either as a separate institution or as part of an integrated financial regulator.

Table 17 Insurance Companies with Banks as Partial Shareholders

Insurance Company	Total Assets (MDL 000s)	Shareholders Holding 5% or More
Moldasig SRL	26,996	Banca de Economii SA-51% Întreprinderea de Stat Calea Ferată a Moldovei-25% Întreprinderea de Stat Poșta Moldovei-24%
Orateh SRL	16,191	B.C. Victoriabank SA-9.984% Î.S. Calea Ferată a Moldovei-9.846% Baboglo D.D.-21.288% Crivonojchin I.I.-21.288% Pospelova I.I.-21.941%
Exim-Asint SA	6,680	Scollard Banking Services Inc (Canada)-78.57% B.C. Eximbank-21.43%
Garant SRL	857	Filiala Traist Estind-42.87% B.C. MoldInconBank-2.71% Firma Dapinia Nicosia Cyprus-49% Feodorova Ludmila-5.42%

Source: Data prepared for the FSAP mission by the Insurance Supervision Department of the Ministry of Finance

Corporate Governance of the Investment Fund Sector

206. **The legacy of the privatization investment funds has created difficulties for governance of the investment fund sector.** From the Czech Republic to the Russian Federation, corporate governance abuses were seen in the investment funds created from privatization coupons. A primary basis for investment fund governance is that fund managers should be unequivocally required by law to set the interests of the investors ahead of those of the fund manager. The existing Moldovan fund legislation does not require this. Of the 38 privatization investment funds that were originally established in the early 1990's from privatization vouchers, only 14 investment funds still operate. Apart from the successors to these funds, no new investment funds have been created.

207. **Weak corporate governance has also been seen in the minimal returns to investors.** The NSCM estimates that over the last decade, investors in Moldovan investment funds have received on average a total of MDL 12 (or less than a few pennies a year per investor). At the same time, substantial fees and expenses have been paid to the asset-management companies responsible for the managing the investment funds. However, a still more serious area of concern is where the fund manager has not segregated the fund's assets from those of the fund manager—or where the manager has used the fund's shares as collateral for loans extended to the bank affiliated with the fund. This was the case, for example, with the CAIS Fund and Bancosind, both of which have since been closed.

208. **The size of the investment fund sector has been declining since 2000.** As noted in Table 18, both the net assets of the investment funds and the number of participating investors have fallen between 2000 and 2003.

Table 18 Investment Funds

	2000	2001	2002	2003
Net Assets (MDL millions)	833.5	798.0	719.7	701.2
Number of Investors (thousands)	1,751	1658	1,525	1,518

Source: NSC. Data prepared for the FSAP Mission

209. **In well-developed capital markets, collective investment funds (also known as mutual funds) provide a potentially attractive investment option for investors.** They provide individual investors with access to a diversified investment portfolio, potentially benefiting from efficient sales and purchases of large blocks of equity shares. However, collective investment funds also somewhat risky. Individual investors lack direct information regarding the investment assets and are therefore obliged to trust the fund managers—and the sector’s governance framework—to ensure that their interests are protected. The government has to ensure that this trust is warranted and that investors can feel confident that their interests will be placed ahead of those of the investment managers.

210. **Based on their market reputations, the remaining 14 funds can be grouped into three categories.** According to market participants, five funds are considered to have fund managers who place the interests of the investors ahead of those of the asset-management company responsible for portfolio investments. Another seven funds are in the process of being liquidated. In the middle category are five funds, where the loyalties of the fund managers are considered neither to be in favor of the investors nor the manager. Table 19 summarizes the three categories and their governing institutions.

211. **The existing legislation provides for two types of collective investment vehicles:** (1) investment funds which are joint stock companies and are managed by asset-management companies and (2) investment trusts, which are pools of assets and are also managed by asset-management companies. For both types of structures, the investors in the funds may number in the tens or hundreds of thousands and individual shareholders have no real input into the investment funds. A further important weakness is that while the current Law on Investment Funds provides for some regulations of investment funds, only the broad provisions of the Civil Code cover investment trusts.

212. **Investors are obliged to rely on the quality of supervision by the regulatory bodies.** However, under the legislation, the NSCM lacks sufficient legal authority to regulate and supervise the sector adequately, and especially the asset-management companies. The law provides for no provisions that would hold a natural person, working for the management company, liable for violations of the law by themselves, or other persons acting on behalf of the management company. The issue is important because in most situations, abuses of corporate governance in investment funds are committed by individuals for personal gain.

Table 19 Governing Institutions for the Investment Fund Sector

	Asset- Management Company	Registrar	Depository	Auditor
<i>Top Category</i>				
Agrofund	AD-Manager SRL	Sconta SRL	Soliditate SRL	Audit ARC SRL
Asito-Invest	Gest-Capital MF SRL	Sconta SRL	Soliditate SRL	Audit ARC SRL
Dividend	Gest-Capital MF SRL	Sconta SRL	Soliditate SRL	Audit ARC SRL
DAAC Hermes	Daac-Prom	Registrar-Centru SA	Agroindbank BC	Audit Concrete SRL
Mandatar	Vertexia-Manager SRL	Dep Fondului-Registru Ind SRL	Registru-A SA	Audit Victor SRL
Real-Invest	Real-Econ SA	Real Reghistru	Banca Sociala BC	Audit Victor SRL
<i>Middle Category</i>				
Asito-Invest Prime	Manager Prim SRL	Comitent SRL	Victoriabank BC	Moldauditing SRL
D-Invest	SNM MF SRL	D-Nica Dep. Fond.	Banca Sociala SA	Audit Victor SRL
Telecom Invest	Manager Capital Grup MF SRL	Grupa Financiara SRL	Moldindconbank BC	Moldauditing SRL
Viitorul Invest	DoCrad MF SA	Registru-A Dep. Fond.	Registru-A Dep. Fond.	Audit ARC SRL
Credo-Invest	Direct-General SRL	Grupa Financiara SRL	Victoriabank BC	Audit Victor SRL
<i>Bottom Category</i>				
Exiton-Invest	Principal-E SA	Regint SA	Sibila-Dep. Fond. SA	Audit Victor SRL
Exiton-Bon	Profit-E MF SA	Regint SA	Sibila-Dep. Fond. SA	Audit Victor SRL
Nord Invest	Consiment-L SRL	Registru SA	Banca Sociala SA	Audit Victor SRL
Bucaria-Invest	n.a.	n.a.	n.a.	n.a.
Bucaria-Invest-Prime	n.a.	n.a.	n.a.	n.a.
Income Invest	n.a.	n.a.	n.a.	n.a.
York Invest	n.a.	n.a.	n.a.	n.a.

Source: Data prepared for the FSAP mission by the National Securities Commission

213. **The law also requires that investment funds have a depository, share registrar and external auditor.** However, the legislation does not require that any of the external parties be “independent” of the investment fund or asset-management company. Individual natural persons or financial conglomerates may be controlling shareholders in all of the asset-management company, the depository, the share registrar and the external auditor.

214. **Weaknesses remain in the investment funds legislation regarding the treatment of conflicts of interest.** The legislation provided for insufficient parameters for requiring that fund

managers put the interests of investors as a first priority. Fund managers are not legally obliged to avoid conflicts of interest. There are no statutory prohibitions against the fund manager “front-running”, that is, taking advantage of his or her knowledge of the fund’s planned share sales and purchases. Nor are there any provisions against “market-timing” or other abuses seen even in well-developed investment fund sectors. Indeed, the legislation provides for few restrictions to prevent asset-management companies from stripping valuable assets from the companies in which the funds have invested.

215. **An even more fundamental issue is the illiquidity of the investment portfolios.** The equity shares received by privatization investment funds often had little market value, since many of the privatized companies were enterprises with poor economic future and the shares given to the funds were in small portions, insufficient for the funds to gain control over the companies. According to market participants, some of the fund managers also suffered from weak ethics and the companies’ assets were sold or transferred without corresponding cash being contributed to the investment fund. The result has been poor treatment of the funds’ investors.

216. **The legislation for the investment fund sector should clearly establish the loyalty of the fund manager in favor of the investors in the fund.** According to market-participants, some funds do not even provide to investors an annual listing of the securities in the portfolio and their market values.

217. **Disclosure of the controlling shareholders of the asset-management companies should also be made public.** Without knowing who owns and controls the asset-management company for a fund, investors will be hard-pressed to make informed decisions about their investments and again, will be obliged to rely on the diligent supervision of the regulatory authorities. Since the current legislation includes no provisions regarding “fit and proper” shareholders (or administrators) for investment funds, even the most effective regulator would have difficulty in ensuring that the asset-management companies for the investment funds can meet international standards of good corporate governance. Furthermore, according to market participants, three of the funds are “linked” with Moldovan banks.⁴⁶ Although the banks’ relations with the funds is regulated, the close ownership connections between some banks and funds could be of concern, as was seen the collapse of the Bancosind and the CAIS investment fund.

218. **Draft revised legislation has been prepared for the investment fund sector.** Although the assessors were not able to review the text, they were advised that the legislation would allow investment funds to choose one of three options: (1) holding company structures; (2) self-liquidation; or (3) to restructure into a form of mutual fund. The self-liquidation option provides for some measure of investor protection, requiring that the redemption prices be no less than the nominal value of the portfolios. The option for establishing holding company structures is undermined by the lack of legislation on “holdings”, and some of the asset-management companies are uncomfortable choosing a holding company structure when the underlying

⁴⁶ They are: Agrofund with Commerts Bank, Dividend-Asito with Petrocommerts Bank, and Nord-Invest with Moldincombank.

legislation is not yet in place. The choices would be left not to the investors in the funds, but would be made by those who control the asset-management companies for the funds.

219. **Additional research on the governance of the Moldovan investment fund sector is recommended.** In light of the complexity of the investment fund issues and the weak level of investor confidence in the investment funds, a systematic review of governance issues for the investment fund sector is recommended. In particular, the revised law should be carefully analyzed. The revised investment funds legislation should provide an adequate legal and regulatory framework to encourage the development of well-governed and professionally-managed investment funds. It is not clear that the proposed draft legislation would achieve that objective. The authorities should also study experiences of other countries (e.g., the Czech Republic), which overcame similar difficulties.

Governance of the Corporate Sector

220. **Underpinning weak corporate governance in the financial sector are weaknesses in the governance framework for the corporate sector.** Most financial institutions are required by law to be incorporated as joint stock companies and fall under the governance provisions of the Law on Joint Stock Companies.⁴⁷ For some institutions, such as the banks, the regulatory body has set specific corporate governance requirements, which e.g., establish minimum authority and responsibilities for the supervisory board. The NBM also requires that all banks obtain an annual independent audit from an auditing firm approved by the NBM. Other financial institutions, however, notably insurance companies and investment fund managers, are not subject to such additional governance requirements.

221. **In all markets an effective corporate governance framework requires that the best balance be found between the interests of the majority and the minority investors.** Major strategic investors commit not only their investment capital but also the time and energy of their senior management to reorganize and restructure their investments, as necessary. By contrast, portfolio minority investors invest their capital but must rely on the quality of the company's governance structures to ensure that the minority shareholders' interests are respected and maintained. Too weak a set of rules for investor protection will diminish the interest of portfolio investors. Too strong a set of rules in favor of minority investors opens the door for abusive use by portfolio investors of "greenmail" tactics, where the minority investor in effect blackmails the strategic investor into paying cash to silence the minority investors' complaints.

222. **Some provisions of the Moldovan corporate governance framework meet international standards.** For example, joint stock companies are not permitted to use in-kind contributions as a means of funding capital increases (the use of real estate and other non-cash assets to fund capital increases has been widely abused in transition economies). In addition, the Law on Joint Stock Companies requires that very large asset-sales (more than 25% but less than

⁴⁷ Where financial companies are permitted to organize themselves as limited liability companies, the governance structures are still weaker. Financial organizations with public service obligations should, at a minimum, be established as joint stock companies.

50% of the company's total assets) require the unanimous approval of the company's supervising board of directors. At the same time, members of the board of directors must be elected using "cumulative" voting.⁴⁸ Where the asset sales are substantially abusive to the company's own interests, an independent-minded director can block the unanimous vote required for the asset sale. Furthermore, the Law on Joint Stock Companies also provides for extensive financial and operating information on the company to be provided to shareholders.

223. However, numerous other provisions allow for substantial corporate governance abuses, particularly those regarding new capital increases. Importantly, the Law on Joint Stock Companies allows the supervising board of directors to issue new capital—up to 50% of the existing capital at each board meeting. Admittedly, the limitation of 50% represents an improvement over the absence of any limits on share issuance, as was permitted by law prior to the 2000 revisions to the joint stock company legislation. However, any provision that allows the board of directors to issue new shares without the explicit approval of a general shareholders' meeting leaves substantial opportunities for companies to engage in share dilution—namely the issuance of new shares in an effort to dilute existing shareholders who may not be informed (or may not have available cash) to participate in the capital increase. Provisions that allow companies to issue capital increases without the approval of existing shareholders are a violation of one of the OECD Principles of Corporate Governance.

224. Also of concern are provisions that allow joint stock companies to avoid having an external audit of their financial statements. Although the listing rules of the stock exchange require independent audits, the Law on Joint Stock Companies provides for no requirements for annual external audits for all joint stock companies. Instead, the Law relies on the revision commission, a body appointed by the shareholders' meeting. However, the work of the revision commission is done without reference to any international (or even domestic) standards. Although most transition (and even some well-developed) markets suffer from a weak domestic auditing profession, the obligation—at least for publicly traded companies—to obtain an annual independent audit of their financial statements is a minimum requirement of the OECD Principles of Corporate Governance. It is recommended that all publicly traded companies, and all other large⁴⁹ joint stock companies, be required to obtain an annual independent audit.

225. Other corporate governance weaknesses are also important, notably the lack of public disclosure of the real owners of major corporations. Legislation requires that shareholders with 25% of direct or indirect shareholdings disclose their holdings. While all countries, both transition and developed, struggle with adequate definitions of indirect and ultimate beneficial shareholders, the Moldovan legislation is particularly weak. Furthermore, the minimum reporting threshold of 25 percent exceeds international standards. Requirements for

⁴⁸ Cumulative voting means that for a five-person board, a 20% shareholder would be guaranteed at least one board seat.

⁴⁹ The definition of "large" would have to be determined, based on a review of the characteristics of joint stock companies in Moldova, in order not to place an undue burden upon small and medium enterprises, or indeed upon the local accounting and auditing profession.

disclosure of direct and indirect shareholdings is set at 10% in the EU (with some countries using a test of just 3%) and 5% under the securities legislation of the United States.

226. **At the cornerstone of adequate disclosure of investor information is easy public access to the records of the company registry.** The Chamber of Registration is in the process of providing electronic access to its records. As of May 2004, the records for about 45,000 out of the 115,000 legal entities had been converted into electronic form. However, the records registered with the Registration Chamber fail to provide adequate information. The records include, e.g., copies of the company charters and the list of founders, but do not include copies of resolutions of the shareholders' meetings (unless the decisions of the meeting resulted in changes to a company's charter). Nor do they include copies of the company's financial statements or the current list of shareholders. Furthermore, some information is available only to a restricted audience. This includes for example the home address of company founders where the founder is related to senior government officials. Such restricted access to information that should be made publicly available also undermines the quality of corporate governance.

227. **In most transition countries, any shareholder can obtain a copy of the full shareholder list once a year at the time of the shareholders' meeting.** However, in Moldova, the shareholders' registry is considered a commercial secret and not publicly available, even to the other shareholders in the company. The shareholder list will generally not disclose the full ownership and control relationships within the company since Moldovan legislation allows for nominee shareholders (to facilitate trading on the stock exchange, shares can be registered in the name of the depository or broker or other nominee). In addition, many shareholders conceal their identity through the use of offshore companies. Nevertheless, the full shareholder list is an important starting point for disclosure of the ownership and control structures of major corporations.

228. **Members of Parliament and senior government officials should be required to publicly disclose their shareholdings, at least in joint stock companies.** Strengthening of governance in the public sector is an important element in corporate governance and one key issue is a requirement for parliamentary and government officials to provide public disclosure of their holdings in major corporations.

229. **Consideration should also be given to providing easy public access to key information regarding publicly-traded companies.** The Law on Joint Stock Companies requires that joint stock companies make available to shareholders extensive information, including copies of the company's financial statements. In practice, however, few companies give copies of such information to investors or other stakeholders who request it. The only recourse for investors is a court case—a lengthy process of at least a year. An alternative would be to have the NSCM open a public reading room for which open joint stock companies were obliged to provide copies of the information required by law. Investors or other stakeholders could then visit the reading room (and at their own expense) make photocopies for their own records. At a minimum, the reading room should include copies of each company's annual financial statements, including the notes to the financial statements. The information in the

reading room should also include copies of the company's charter, and any changes made by decisions of the shareholders' meetings.

230. Another major weakness relates to the fiduciary obligations of members of the supervisory board of directors. Establishing the fiduciary obligations of board members is a difficult task in all transition economies and in many developed markets, but at a minimum the legislation should require that board members conduct their duties with due care, due diligence and in the interests of the company. Such provisions are missing in the Moldovan legislation.

231. A corporate governance code (or code of corporate conduct) is needed to establish specific market practices that should be followed by members of boards of directors. The general fiduciary obligation gives general provisions on the requirements for board members. However, more specific guidance is needed and in particular, a corporate governance code can provide an industry-accepted standard of behavior on corporate governance issues. It would also be helpful if specific training were provided to board members so that they understood the nature and extent of their obligations and statutory liability under the law. The training program would also assist in developing the necessary shareholder culture.

232. An additional weakness in the corporate governance framework is weak enforcement by the NSCM. The commission is hampered by a number of factors but one important issue is the maximum fine of MDL 3,600 (around US\$300) that can be imposed by it. The maximum is set under the legislation on administrative sanctions and applies to all regulatory agencies. A nominal fine of less than MDL 4,000 can hardly be expected to influence corporate behavior.

233. Measures should be put in place to increase both the transparency and accountability of the NSCM. A critical factor in building investor confidence in the capital markets is a transparent, coherent and fair system of enforcing laws and regulations. In particular all decisions of the NSCM, including detailed instructions by the Chairman, should be published. The public information should include not only the final decisions taken by the NSCM but also the reasoning behind the decisions.

Summary of Recommendations

234. The recommendations for improving corporate governance are summarized below under several separate headings.

For banking governance:⁵⁰

- Consider measures to restrict the activities of banks whose controlling shareholders have been subject to investigations by law-enforcement bodies.

For insurance governance:

⁵⁰ Further banking governance recommendations are included in other FSAP documents.

- Revise the insurance legislation to provide the same governance provisions as are applicable to banks in Moldova.

For investment fund governance:

- Conduct a review of the fund governance framework compared to international standards of fund governance.

For corporate sector governance:

- Require that the ultimate beneficial owners of traded companies disclose their control positions.
- Require that all publicly traded companies and all large joint stock companies obtain an annual independent audit.
- Establish minimum fiduciary duties (conduct one's duties of due care and due diligence & in the company's interest) for boards of directors and administrators.
- Require that all capital increases be approved by the shareholders' meeting.
- Provide a central location for public access to information on traded companies, or provide other mechanism for easy public access to information on joint stock companies.
- Increase the authority (but also the transparency and accountability) of the NSCM.
- Prepare a corporate governance code.
- Establish a training program on corporate governance (for example, through the International Finance Corporation as has been done in Ukraine, Russia and Georgia.)

For government governance in the corporate sector:

- Require that all Members of Parliament and senior Government officials publicly disclose their shareholdings in joint stock companies.