RETHINKING THE INSTITUTIONAL FRAMEWORK FOR FINANCIAL STABILITY IN THE REPUBLIC OF MOLDOVA

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Abstract

The aim of this article is to identify the arrangements of the accountability of regulatory institutions and the deficiencies in pursuing financial stability within the banking system of the Republic of Moldova. Financial stability policies are a missing ingredient from the current policy framework, and there is a too huge gap between banking supervision and the goal of financial stability assuring. The article have highlighted an intense need for strengthening financial stability framework in the country through three main actions: redefining the central bank's role, strengthening the crisis management and strengthening the deposit insurance system. This article offers policy recommendations in building a stronger institutional framework for financial stability in the Republic of Moldova.

Keywords: financial stability, institutional framework, banking system

JEL classification: G28, G21

1. Introduction

The integrity of the banking system depends on the functionality of the institutional framework for financial stability. This framework should ensure the quality of preserving the financial stability. Oosterloo and Haan have distinguished five different elements that make up a framework for the financial stability function (Oosterloo and Haan, 2003, p. 5):

1.the *objective* of maintaining financial stability,
2.the *assessment* of risk to financial stability,
3.the *instruments* that can be used in case of a misalignment between the assessment and the objective,
4.the *decision-making process*, and
5.the *accountability* of the institution that is responsible for maintaining financial stability.

The process of ensuring financial stability involves public institutions that share responsibilities. The responsibility for financial stability is widely considered as an essential characteristic of central banking. Historically a dominant concern for central bankers has been not just price stability, but also *financial stability*. Goodhart argues that the original motivation for creating central banks in many countries was to temper the financial crises associated with unregulated "free banking" regimes (Goodhart, 1987). Achieving monetary and financial stability requires that appropriate anchors be put in place in both spheres (Borio and Lowe, 2002). The role for financial stability policy arises because the private choices of unregulated banks with respect to money creation are not in general socially optimal (Stein, 2011). Ojo argues the need for redefining the central bank's role in the aftermath of the financial crisis, through the extension of central banks' roles in macro prudential supervision. The need to address systemic risks in a more efficient manner is one the reasons attributed to why greater emphasis on prudential supervision at macro level is of vital importance (Ojo, 2010).

Financial stability policy and prudential supervision at macro level is a missing ingredient from the current policy framework in the Republic of Moldova, and there is a too huge gap between banking supervision and the goal of financial stability ensuring. This gap has induced the necessity of extension of central bank's role in the management of financial system and the need for rethinking the present institutional framework for financial stability. Also there is no *assessment* of risk to financial stability made by the NBM. Many countries (24 advanced and 36 emerging economies) provide such assessments through Financial Stability Reports or Financial Stability Review published annualy or semi-annualy (according to the Center for Financial Stability).

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The paper is organized as follows. Section 2 describes the main problem regarding maintaining financial stability. Section 3 describes the situation of the Moldovan banking system and the effects of a deficient institutional framework for financial stability. Section 4 describes the structure of the institutional framework for financial stability and its shortcomings. Conclusions detail the main policy recommendations.

The situation in the country on the institutional framework for financial stability is evaluated based on the review of existing official documents and laws regarding the institutional framework of the banking system, review of IMF assessments, review of Kroll Inc. Report[25], analysis of statistical data related to the banking system and macroeconomic situation, as well as qualitative judgments. Macroeconomic data used for the analysis come from Moldovan statistical database and the Ministry of Economy reports - all available online. Banking data are taken from the database of the National Bank of Moldova and includes data on 14 Moldovan banks.

2. Description of the problem

The main problem regarding maintaining financial stability is that there is no unambiguous definition of financial stability and that the responsibility for financial stability is not explicitly formulated in laws. Also the *accountability* of the institution that is responsible for maintaining financial stability is not stipulated in laws.

According to Subbarao explicit inclusion in laws of the responsibility for financial stability would be redundant, because financial stability is a necessary condition for achieving the conventional central bank objectives relating to inflation, output, and employment. On the other hand, there is a growing view that unless financial stability is explicitly included in the mandate of central banks, it is likely to not be taken into consideration (Subbarao, 2010, p. 27). Another problem regarding the responsibility for financial stability is that defining financial stability in a precise, comprehensive, and measurable manner is proving to be difficult.

According to the questionnaire provided by Oosterloo and Haan, from 28 questioned Central Banks (CBs), only the Canadian CB has an official definition (as stated in law) of financial stability and systemic risk. The rest 27 CBs have un-official working definitions provided via their publications.

In the survey provided by the Bank for International Settlements (BIS, 2008, p. 33), 90% of central banks considered that they had full or shared responsibility for financial stability policy and oversight of the financial system. But the legal basis for this responsibility is less clear. The relevant legislation does not specifically mention financial stability or synonyms for a large number of central banks. The responsibility for financial stability is usually inferred from the existence of functions that relate to it: bank regulation and bank supervision, deposit insurance, the provision of safety nets through emergency liquidity assistance, provision of honest broker services, and involvement in the payment system in general. Nevertheless, the CBs indicate in the Oosterloo and Haan's questionnaire that there is a difference between prudential supervision and overseeing financial stability. The most important difference mentioned between both concepts is that prudential supervision is aimed at the proper management of individual financial institutions (*micro-prudential approach*), while maintaining or overseeing financial stability is primarily concerned with systemic risks, i.e. threats to the financial system as a whole or threats to individual institutions that may be contagious to other parts of the financial system (*macro-prudential approach*).

From 28 questioned CBs by Oosterloo and Haan, only for 2 CBs the responsibility for overall financial stability has been stated explicitly in law or some other documents. Republic of Moldova is not an exception on that point. The legislation does not stipulate the objective and the accountability for safeguarding financial stability of the banking sector by the National Bank of Moldova (NBM). Only one official document mentions that NBM contributes to the maintaining of the stability of the banking system and the supervised financial institution through available legal powers - the Memorandum of Understanding on Maintenance of Financial Stability (Memorandum). Also, in the Memorandum is stated the definition of financial stability: "A systemic financial crisis

[25] On 28 January 2015 Kroll Inc. (a corporate investigations and risk consulting firm) was engaged by the National Bank of Moldova to conduct a scoping phase of investigation into certain transactions involving Banca de Economii S.A., B.C. "BANCA SOCIALĂ" S.A. and B.C. "UNIBANK" S.A.

emerges when problems in one or more financial institution are serious enough to have a significant adverse impact on the real economy. Financial stability can be defined as a situation in the economy, characterized by the absence of the disproportions, which may cause a negative correction of the financial markets, emergence of a systemic financial crisis or inability of the financial institutions to maintain smooth financial system operations. Financial stability is maintained by adequate regulations of the current and potential risks, by the effectiveness of the risk management and risk redistribution mechanisms, and by the assurance of the public's confidence to the financial system". According to the Memorandum the National Committee for Financial Stability (NCFS) is established with the overall duty and responsibility of managing and dealing with systemic financial crisis and it will be active until further notice of the Government. However, the NCFS has failed in assuming its main responsibility. The problems that have occurred in 2014 within three financial institutions in the Republic of Moldova have had a significant adverse impact on the real economy and have generated a systemic financial crisis.

3. The situation of the Moldovan banking system for the period 2014-2015

Financial sector of the Republic of Moldova is dominated by the banking system, it accounted for 94.16% of total financial assets and 95.6% of total loans provided by the financial sector at the end of first quarter of 2015[26]. The number of banking institutions during the recent years remained unchanged, with a number of 14 commercial banks, including 4 international banks.

On August 5, 2015, National Committee for Financial Stability has decided to liquidate three local banks (Banca de Economii S.A., B.C."BANCA SOCIALĂ" S.A. and B.C. "UNIBANK" S.A.). Banca de Economii S.A. (BEM) is the bank with the largest network, it was a systemic bank with a state ownership of 56,13%. It was the bank of public sector enterprises and it provided all social payments (pensions, allowances etc.). B.C."BANCA SOCIALĂ" S.A. (BS) also provided banking services to a part of public sector enterprises. B.C. "UNIBANK" S.A. was a small bank affiliated to those two banks. All three affiliated banks comprised 28 percent of banking system assets, equivalent to about 20 percent of GDP. The main problems recorded at these banks were related to deficient corporate governance and deficient credit portfolio management. A significant law infringement took place in the second quarter of the year 2014. According to data provided by NBM, BEM exceeded the limits regarding the exposure to affiliated persons[27], reaching at the end of June a significant share of 34.93%. During the next three months, this value was almost doubled, reaching the amount of 66.22% by the end of the third quarter of 2014. According to Kroll Inc. Report from April 2, 2015, a significant amount of money (750 million US dollars) was provided fraudulent to 5 local companies by these banks with the implication of several off-shore companies in November 2014. Later this amount of money was transfered on off-shore companies' acounts in Latvia.

Approximately for one year NBM has tried to provide a financial restructuring of these three banks, by establishing the special administration regime in November 2014[28] and providing emergency loans. Being aware regarding the situation of the exposure to affiliates, the supervisor has not imposed any remedial action or sanctions. However, prompt corrective action is a key ingredient of successful banking reform (Dziobeck and Pazarbasioglu, 1998, p. 2).

Until august 2015 the NBM has provided emergency loans to these banks in an amount equivalent to 27,1 percent of GDP (an amount of 6,5 billion lei[29]), guaranteed by the Government[30]. The credits

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[26] According to IMF data base

[27] According to the NBM regulation total bank exposure to any affiliated person shall not exceed 10% of the bank's Total Regulatory Capital and the aggregate amount of bank's total exposure shall not exceed 20%.

[28] NBM established special administration regime at Banca de Economii S.A. on November 27, 2014, at B.C. "BANCA SOCIALĂ" S.A. - on December 12, 2014, and at B.C. "UNIBANK" S.A. - on December 30, 2014 for a period of 9 months.

[29] In accordance with the Court of Auditors' public hearing of June 25, 2015, the amount of emergency loans provided by the NBM under Government guarantee to those three commercial banks, reached the amount of 6.5 billion lei.

were not reimbursed by the banks. These credits were granted without an assessment of recovery risks and could significantly influence the resistance of the entire budget system, with possible impact on state budget. These costs will be put on the shoulders of taxpayers.

Since end-October 2014 until end-June 2015 the NBM sold 862,34 million US dollars of international reserves[31] (reducing the reserves by 32,5%), about two-thirds of which occurred following the intervention in BEM and BS. As a result the nominal exchange rate has been changed significantly against the US dollar, and total reserves in months of imports have dropped drastically. During the first semester of the year 2015 the national currency has depreciated sharply by 20% against the US dollar. As a result of this depreciation, external state debt in lei increased by 28.8%[32]. The inflation has increased reaching the rate of 8.6% in July 2015 compared to July 2014, thus exceeding the target level of inflation set by the NBM (5% +/-1.5%). The costs generated by the inflation and by the national currency depreciation will have to be supported by the population as a consequence of the eroded value of deposits and as a consequence of a decrease of standard of leaving.

4. Shortcomings of the institutional framework for financial stability in the Republic of Moldova

The institutional structure of maintaining financial stability has been changed in the last decade in several countries (Norway (1986), Canada (1987), Denmark (1988), Sweden (1991), Hungary (2000), Australia (1998), UK (1998), Japan (1999), Korea (1998), Iceland (1999), Austria (2002), Germany (2002)). The financial supervision has been consolidated in a separate agency and there is a clear institutional difference between prudential supervision and maintaining financial stability. Within these countries the CB focuses primarily on the systemic risk issues of financial markets and systems, and supervisory authorities supervise the legal aspects of operations and the individual institutions' risks.

In the Republic of Moldova the institutional structure of maintaining financial stability is the following:

1. The *National Bank of Moldova* (NBM) is responsible for banking supervision. However, the tasks related to financial stability are carried out by the NBM through prudential supervision, through the transmission of monetary and foreign exchange policy measures and through the supervision of the payment system's functioning.
2. The *National Committee for Financial Stability* (NCFS) has the aim to ensure an adequate coordination among the public authorities for taking prompt actions in case of extraordinary financial shocks. Following the creation of the NCFS, the duties of committee members[33] have been established based on the Memorandum from February 28, 2011. The parties have signed the Memorandum regarding the maintenance of financial stability, which determines the measures to fight the causes of systemic financial crisis, to establish the effective procedures of authorities' interaction and to realize a coordinative approach to bring full confidence in financial institutions.
3. The *Deposit Guarantee Fund in Banking System* (DGFBS), a legal person of public law, which compensates the payment of deposits if they become unavailable.

The recent decision regarding the liquidation of three insolvent Moldovan banks is a consequence of several deficiencies in the present institutional framework for financial stability. This decision taken by the National Committee for Financial Stability in August 2015 has revealed a systemic

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[30] According to the Government Decision No. 938 as of November 13, 2014 on ensuring macroeconomic stability in the context of regional conjuncture

[31] According to the NBM data base

[32] According to the Ministry of Economy data base

[33] Committee members: the Government of the Republic of Moldova (Government), the National Bank of Moldova (NBM), Commission on Economy, Budget and Finance of the Parliament of the Republic of Moldova, National Commission for Financial Market (NCFM) and Deposit Guarantee Fund in Banking System (DGFBS).

crisis situation in the Moldovan banking system. Once one of the biggest Moldovan commercial banks, with an important role in the banking sector, with the largest network, is declared to be insolvent by the authorities, there should be identified the causes and the preconditions of this event. This is the main argument for rethinking the institutional framework for financial stability in the Republic of Moldova and finding solutions for eliminating the existing deficiencies.

Shortcomings regarding the activity of the National Bank of Moldova

The basic element that make up a framework for financial stability function stated by Oosterloo and Haan - the objective of maintaining financial stability - is not explicitly formulated in laws in the case of Republic of Moldova. According to the Law on the National Bank of Moldova[34], art. 4. the primary objective of the NBM is to ensure and maintain the price stability. The same article stipulates that without prejudice to the primary objective, the National Bank shall promote and maintain a financial system based on market principles and shall support the general economic policy of the state. The legislation does not stipulate the task of safeguarding financial stability of the banking sector by NBM. Only the Memorandum of Understanding on Maintenance of Financial Stability (Memorandum) mentions that NBM *contributes* to the maintaining of the stability of the banking system and the supervised financial institution through available legal powers[35].

The main preventative instruments for safeguarding financial stability are considered to be the assessments of risk to financial stability (macro-prudential measures) and the regulatory framework and the enforcement of banking supervisory measures (micro-prudential measures). There are serious reasons for elaborating and publishing the assessment of financial stability, (Oosterloo and Haan, 2003, p.18):

1.they contribute to the overall stability of the financial system;
2.they strengthen cooperation on financial stability issues between the various relevant authorities;
3.they increase the transparency (and accountability) of the financial stability function.

In the Republic of Moldova the regulator does not provide and not publish an assessment of risk to financial stability. NBM does not elaborate a Financial Stability Report which would assess the main risks to financial stability. None macroprudential measures or early warning systems are described or published by the regulator. CBs should pay attention to macroprudential analysis in order to identify systemic indicators and trends that usually provide an early warning of banking fragility.

The only preventative instrument for mantaining financial stability that the NBM uses is the enforcement of banking supervisory measures. Article 5 (d) of the Law on the National Bank of Moldova stipulates that one the task of the NBM is "to license, supervise and regulate the activity of financial institutions".

The Memorandum from February 28, 2011, article 9 (a), stipulates that „The NBM contributes to the maintaining of the stability of the banking system and the supervised financial institutions by: setting prudential norms, other provisions and limits regarding the activity of financial institutions, supervising their activity, including the quality of financial services offered to the consumers".

Despite of these stipulations the events discribed in previous section revealed a *law quality of banking supervision*. There were ignored the following Basel Core Principle for Effective Banking Supervision (Basel Committee on Banking Supervision, 2012):

- The first Principle (*Responsibilities, objectives and powers*): NBM has not undertaken timely corrective actions to address compliance with laws and to address safety and soundness concerns especially in the situation of those three banks (Banca de Economii S.A., B.C. "BANCA SOCIALĂ" S.A. and B.C. "UNIBANK" S.A.).

- Principle 2 (*Independence, accountability, resourcing and legal protection for supervisors*): The accountability determinant towards the NBM tasks' discharge was ignored. One of the essential criteria for effective banking supervision indicates that the supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives.

[34] Law on the National Bank of Moldova No.548-XIII of July 21, 1995.

[35] This document establishes the duties of National Committee for Financial Stability members.

- Principle 6 (*Transfer of significant ownership*): Until now the NBM has not obtained the identities of all beneficial owners of shares being held by nominees, custodians and other vehicles that might be used to disguise ownership in banks. Risks to systemic financial stability are significant due to governance problems in the banking system.

- Principle 8 (*Supervisory approach*): NBM has not developed until now a forward-looking assessment of the risk profile of individual banks, proportionate to their systemic importance. It has not identified, assessed and addressed risks emanating from the system as a whole. The authority does not have a framework in place for early intervention; and does not have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.

- Principle 9 (*Supervisory techniques and tools*) and Principle 11 (*Corrective and sanctioning powers of supervisors*): The NBM should have required BEM to take action to mitigate any particular vulnerability that could have the potential to affect its safety and soundness, what has not happened. The supervisor could have used a variety of tools to regularly review and assess the safety and soundness of banks and the banking system.

Shortcomings regarding the activity of the National Committee for Financial Stability

Crisis management should involve joint cooperation. According to the Government Decision[36], in 2010 was established the NCFS, in order to ensure an adequate coordination among the public authorities and in order to achieve prompt actions in case of extraordinary financial shock. This Decision stipulates that one of the responsibilities of the NCFS is managing extraordinary financial crisis. However, the NCFS has failed to manage the systemic financial crisis which occurred in the Republic of Moldova and to ensure an adequate coordination among the public authorities for taking prompt actions. Only one action has been taken by the NCFS during the period of rescuing those three commercial banks: the recommendation to provide emergency loans to banks by the NBM in case of necessity in the amount of 9500 mil. lei (an equivalent of 678 mil. US dollars) and to guarantee those loans by the state[37]. In august 2015 NCFS has taken the decision to liquidate three local banks (Banca de Economii S.A., B.C. ”BANCA SOCIALĂ” S.A. and B.C. ”UNIBANK” S.A.).

The last Country Reports carried out by the IMF in 2014 (IMF, 2014) in the Republic of Moldova have revealed the following deficiencies regarding the activity of the NCFS:

NCFS lacks focus and is not forward looking;

There is little evidence of contingency planning and testing of processes and powers;

Coordination between the member agencies is limited;

There are significant gaps and deficiencies in the statutory powers required for cost-effective bank crisis resolution.

Shortcomings regarding the activity of the Deposit Guarantee Fund in Banking System

The DGFBS[38] could contribute to public confidence in the system and thus limit contagion from banks in distress. However this key element of the framework for systemic protection is weak. Several aspects of the deposit insurance scheme require strengthening.

First, there is no clear mechanism stipulated in the legislation on providing a line-of-credit to the DGFBS from the Ministry of Finance according to international standards. Although the list of funding sources includes the possibility of contracting loans from the Ministry of Finance by the DGFBS. Second, there are no mechanisms on including the NBM as an additional source of back-up funding for the DGFBS. Third, the limit of the guaranteed amount of deposits is insignificant.

[36] According to the Government Decision No.449 as of June 2, 2010 on the establishment of the National Committee for Financial Stability

[37] According to the Government Decision No. 938 as of November 13, 2014 on ensuring macroeconomic stability in the context of regional conjuncture

[38] It was established in 2004 according to the Law on guaranteeing deposits of individuals in the banking system No. 575-XV of 26.12.2003.

Currently in accordance with the law[39], if the deposits of an authorized bank become unavailable, the Fund under article 19, guarantees their payment to each depositor, regardless of their size, number and the currency, in an amount of 6000 MDL (equivalent of 285 EUR).

At the end of June 2015, the total amount of financial resources of the DGFBS was 231,8 mil. lei (equivalent of 10.5 mil. EUR). This amount of resources could compensate only a part of guaranteed deposits of the banks under liquidation. These resources are sufficient for compensating the guaranteed amount of deposits of BS and B.C."UNIBANK" S.A. and compensate only 34.2% of guaranteed deposits of BEM.

In conclusion, the current institutional framework for financial stability of the banking system in the Republic of Moldova has serious *shortcomings*:

- the lack of the *objective* of maintaining financial stability,

- the lack of a *macroprudential surveillance* and of a periodic *assessment of risk* to financial stability,

- the lack of the *accountability* of the NBM that are responsible for banking supervision,

- the lack of a clear *institutional framework for crisis management and resolution*, an appropriate level of systemic protection.

5. Conclusions

Recent events that took place within the Moldovan banking system suggest an intense need for strengthening financial stability framework in the country through three main *actions*:

a)redefining the central bank's role,
b)strengthening the crisis management, and
c)strengthening the deposit insurance system.

In order to strengthen the current institutional framework for financial stability in the Republic of Moldova the following policy recommendations should be put in place:

1. Redefining the NBM role. Undertaking by NBM the task of safeguarding financial stability of the sector which it oversees. It is necessary to make relevant amendments to the Law on NBM (Article 5), by stipulating that "the licensing, supervision and regulation of financial institutions are provided for promoting the soundness of the banking system". This amendment will increase the accountability of NBM towards this objective.
2. NBM should pay attention to macroprudential surveillance (though elaborating and publishing Financial Stability Reports) in order to identify systemic indicators and trends that usually provide an early warning of banking fragility.
3. Raising the accountability of NBM through a transparent framework for the discharge of its duties. Although there are stipulated the basic tasks of the NBM in the Law on NBM (Article 5), there are no statements about the accountability of the NBM. The accountability is the degree to which institutions are responsible for their own actions, decisions and performances and are required to explain and justify them to market participants and to the institutions that delegated authority to them.
4. Developing a comprehensive financial crisis resolution contingency plan, and identify necessary amendments to the legislation, by making from the National Commission for Financial Stability a functional body.
5. Enhancing funding of the DGFBS by developing a target fund methodology; amending legislation to provide a line-of-credit to the DGFBS from the Ministry of Finance; and amending the Law on DGFBS Law and the Law on NBM to include the NBM as an additional source of back-up funding for the DGFBS. Also in order to assure the confidence in the banking system should be increased the limit of the guaranteed amount of deposits through increasing the annual contribution of banks to the DGFBS.

[39] Law on guaranteeing deposits of individuals in the banking system No. 575-XV of 26.12.2003

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