QUALITY OF BANKING SUPERVISION AND ITS DETERMINANTS: THE CASE OF REPUBLIC OF MOLDOVA

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Abstract
Recent events which have taken place within the Moldovan banking system have highlighted significant weaknesses regarding banking supervision. As a consequence the financial integrity and stability of the Moldovan banking system has been shaken and the confidence in it has been seriously affected. These deficiencies have induced the necessity of revising the central bank's role in regulating the Moldovan banking system and increasing the quality of banking supervision. This is the main argument for addressing the determinants of bank supervision quality and finding solutions for enhancing it.
The quality of banking supervision depends on several factors and preconditions which are addressed in this article. There has been highlighted the need for a greater focus to be put on independence, accountability and transparency of the supervisor for increasing the effectiveness of banking supervision. There are identified banking supervision's deficiencies and their determinants in the Republic of Moldova and made an analysis of country's compliance with the Basel Committee's Core Principles. The evaluation of the quality of banking supervision in the Republic of Moldova includes statistical analysis of data related to the banking system, review of IMF assessments, as well as observations and qualitative judgments. This paper presents the policy recommendations in institution building for stronger banking system in the Republic of Moldova.
Keywords: *banking supervision, central bank, financial stability*
JEL Classification: G21, G28

1. INTRODUCTION

The recent global financial crisis has highlighted significant weaknesses regarding risk management and banking supervision. Regulation and supervision of financial markets arises as a primary issue due to the importance of timely regulation and supervision to fix the deficiencies in the financial markets. In the light of developments that emerged during the last few years of market turmoil Basel Committee on Banking Supervision (BCBS) has emphasized:

- the need for greater supervisory intensity to deal with systemically important banks;
- the importance of applying a macro perspective to the microprudential supervision of banks;
- an increasing focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of a bank failure.

The concern for the health of the global banking and financial markets has produced a growing consensus that the development and compliance with standards and codes of best practice can improve financial system integrity and stability (Demirguc-Kunt *et al.*, 2006; Aysan, Huseyin, 2006; Arnone *et al.*, 2007). The first initiative in this sense was set up in 1997 by the BCBS, issuing the Core Principles for Effective Bank Supervision (Core Principles), with the last revised version in 2012. The basic principles are the de facto standard minimum for a strong prudential regulation and supervision of banks and banking systems. The principles are used by the IMF and the World Bank in conducting Financial Sector Assessment Program, through joint evaluations of member countries' compliance with these standards. It is a unique source of information about the quality of supervision and regulation around the world. The primary objective for banking supervision set by the Core Principles is the promotion of safety and soundness of banks and the banking system. Core Principles address supervisory powers, responsibilities and functions, and cover supervisory expectations of banks, emphasizing the importance of good corporate governance and risk management, as well as compliance with supervisory standards (BCBS, 2012, p. 2).

As a response to the lessons learnt in the financial crisis a wave of studies have been developed in addressing the enhancement of quality of banking supervision (Ojo, 2010, Randle, 2009, BCBS, 2012, European Central Bank, 2014, PwC's Central Bank Forum, 2014). There is a common opinion on the interdependence and the complementary nature of the macroprudential and microprudential elements of effective supervision. In their application of a risk-based supervisory approach, supervisors and other authorities need to assess risk in a broader context than that of the balance sheet of individual banks (*compliance supervision*).

The central objective of regulatory activity and bank supervision is to achieve a sound and viable banking system by establishing rules, following strict adherence to them, and ensuring the elimination of unviable banks. Recent events which have taken place within the Moldovan banking system have highlighted significant deficiencies regarding observance of rules by distinct banks and weaknesses of bank supervision. As a consequence the financial integrity and stability of the Moldovan banking system has been shaken and the confidence in it has been seriously affected. This is the main argument for addressing the determinants of bank supervision quality and finding solutions for enhancing it. The quality of bank supervision activity depends on several factors and preconditions which are addressed in the section 2. Section 3 identifies banking supervision's deficiencies and their determinants in the Republic of Moldova. Section 4 details the main conclusions and policy recommendations.

2. DETERMINANTS OF BANKING SUPERVISION QUALITY

The quality of banking supervision determines the integrity and stability of the banking system. Good regulatory governance in the financial and banking sector has received considerable attention in the recent past (Lybek, 1998, De Haan *et al.*, 1999, Quintyn and Taylor, 2002, Das and Quintyn, 2002, Demirguc-Kunt *et al*., 2006, Arnone *et al.*, 2007).

Demirguc-Kunt et al. examined the banking systems within 39 countries in the context of compliance with the basic principles of the Basel Committee and have found that banks that largely correspond to those principles are stable banks. The authors found a significant and positive relationship between bank soundness (measured with Moody's financial strength ratings) and compliance with principles related to information provision. Countries that require banks to report regularly and accurately their financial data to regulators and market participants have sounder banks.

Arnone et al. have investigated the relationship between the components of regulatory governance and the quality of banking supervision. They have found a positive correlation between the transparency of the supervisor and the effectiveness of banking supervision. Moreover, better accountability and integrity practices of the banking supervisors are associated with higher independence, which in turn is associated with better compliance with the Basel Core Principles. They have identified three main *components* of good regulatory governance in the financial sector considered as prerequisites to regulatory and supervisory agencies' successful supervision of financial institutions or activities: independence, accountability and transparency. These components constitute key elements in achieving and maintaining the objective of financial sector stability.

Independence address to the degree to which the regulatory/supervisory agencies (RSA) are separated from inappropriate interference both from the political sphere and from the supervised entities in order to take decisions belonging to their sphere of competence without undue outside interference.

Accountability is the degree to which RSA 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.

Transparency of the RSA is a measure of the degree to which the information about its official activities (objectives, legal, institutional and economic framework, decisions, actions, practices, data and information over the regulatory and supervisory policies and the accountability of the senior executives) is constantly verifiable and communicated to the interested parties on a timely basis (Arnone *et al.*, 2007, p. 6).

An effective system of banking supervision needs to be able to effectively develop, implement, monitor and enforce supervisory policies under normal and stressed economic and financial conditions. There are a number of preconditions highlighted by Basel Committee (BCBS, 2012, p. 14) that have a direct impact on the effectiveness of banking supervision in practice, which are mostly outside the direct or sole jurisdiction of banking supervisors: sound and sustainable macroeconomic policies; a well established framework for financial stability policy formulation; a well developed public infrastructure; a clear framework for crisis management, recovery and resolution; an appropriate level of systemic protection (or public safety net); and effective market discipline. Supervisors should work with the government and relevant authorities to address concerns regarding the impact of these preconditions on the efficiency or effectiveness of regulation and supervision of banks.

Upgrading bank regulation and supervision, in the context of assuring the integrity and stability of banking system, is a complex and difficult process, especially for developing countries, where the required expertise is scarce, the legal environment weak, and governance problems could generate regulatory capture.

3. DEFICIENCIES OF BANKING SUPERVISION IN THE REPUBLIC OF MOLDOVA

The Republic of Moldova is a small country with a financial sector dominated by the banking system: it accounted for 93% of total financial assets and 96% of total loans provided by the financial sector at the end of 2014. National Bank of Moldova (NBM) is the central bank of the Republic of Moldova and has the primary responsibility for bank supervision. The major concern that affects the integrity and the stability of the banking system in the Republic of Moldova remains the corporate governance within banks and significant deficiencies in the legal and regulatory framework. Risks regarding financial stability are significant due to limited capacity of authorities to act. Ultimate beneficial ownership of several large banks has been actively concealed, which has disguised credit to related parties and large exposures. The latter already exceed regulatory norms by a wide margin in some banks. The liquidity position of some banks may also be worse than reported since some assets may be encumbered through undisclosed side agreements. In general, governance structures and internal oversight processes are not well developed, blurring the roles and responsibilities of owners and managers, and so put at risk safe banking operations.

The *preconditions with the main negative impact* on the quality of banking supervision which contribute to the weakening of banking supervision, and frustrate its improvement in Moldova are:

- the lack of a clear framework for macroprudential surveillance and financial stability policy formulation,
- the lack of an efficient and independent judiciary,
- the lack of a clear institutional framework for crisis management and resolution, an appropriate level of systemic protection,
- the lack of an effective market discipline with the corporate governance issue to be addressed.

As the main prerequisites to regulatory and supervisory agencies' successful supervision of financial institutions are: independence, accountability and transparency, it is imperative to address them in the context of Moldovan banking supervision.

According to Basel Core Principles the primary objective of banking supervision is to promote *the safety and soundness of banks and the banking system*. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it (BCBS, 2012, p. 21).

Recent developments that took place at Banca de Economii S.A. (BEM), a state owned bank with an important role in the banking sector, with the largest branch network, affected seriously the *safety and soundness of the Moldovan banking system. These events* put under doubt the capacity of NBM in achieving the primary objective of banking supervision, acting effectively and in due time.

In August 2013 a dilution of the government's share following its recapitalization took place at BEM. Through an additional issue of shares of 80,2 mln. lei, private shareholders have doubled their share in the bank's capital, and the state share has been diminished to 33%. Until this event the share of the state in this bank was 56,13%. During the next year several developments have disrupted financial condition of the bank and the situation deteriorated till the possibility to withdraw the license. A possible BEM bankruptcy could have generated rough adverse effects on financial stability and could have irretrievably hit the economic security of the state. However, the most influencing factor regarding the deteriorated situation belongs to *defective lending*, contrary to any principle of prudence and an efficient management. In November of 2014 BEM has been returned to the state (following the decision of the Supreme Court on the quashing the decision of General Meeting of Shareholders on the additional share issuance). The condition of BEM, a systemically-important bank that has large public sector deposits, still remains fragile.

In the case of BEM's supervision were ignored the following Basel Core Principle for Effective Banking Supervision:

- The first Principle (*Responsibilities, objectives and powers*): the NBM has not undertaken timely corrective actions to address compliance with laws and to address safety and soundness concerns.
- Principle 2 (*Independence, accountability, resourcing and legal protection for supervisors*). One of the essential criteria 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. The accountability determinant towards the NBM tasks' discharge was ignored.

- 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.
- 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 BEM and 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. In 2010 was established the National Committee for Financial Stability (NCFS) in order to ensure an adequate coordination among the public authorities for taking prompt actions in case of extraordinary financial shocks. Unfortunately, this Committee has only a formal function, and has not taken action in case of the situation with BEM.
- Principle 9 (*Supervisory techniques and tools*) and Principle 11 (*Corrective and sanctioning powers of supervisors*). According to these principles the supervisor should use a variety of tools to regularly review and assess the safety and soundness of banks and the banking system. 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, which has not happened.

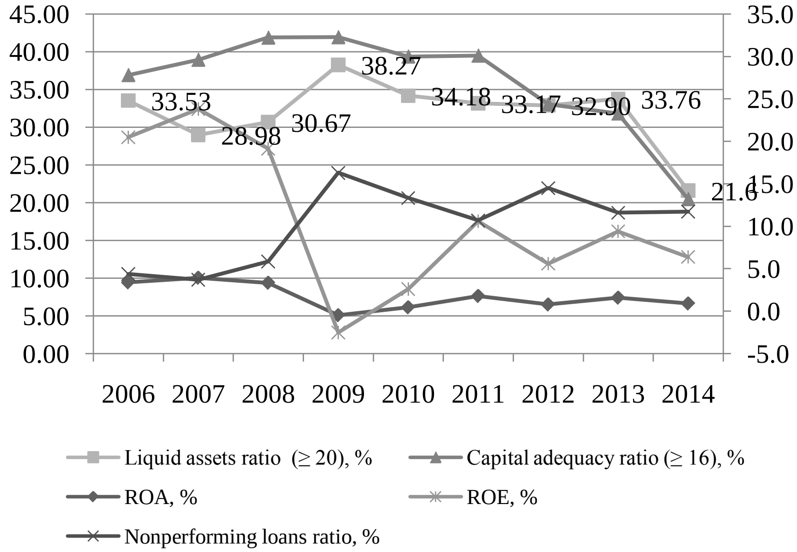
The political decision to take over a failing bank in full crisis, corporate raids, delayed and contradictory actions of public institutions and dilution of shareholder all are events that reveal a low quality of b*anking supervision*.

As a consequence, the 2014 year has ended with a very unstable financial situation of the banking system, especially because of the situation within three commercial banks. These three banks, BEM, B.C. ”BANCA SOCIALĂ” S.A. and B.C. ”UNIBANK” S.A., considered to be affiliated, which combined comprise 28 percent of banking system assets, equivalent to about 20 percent of GDP, have large interbank exposures among themselves and also large exposures to several Russian banks. The level of capitalization and liquidity of these banks declined drastically under the minimum required level (≥ 20%) at the end of 2014. The level of capitalization collapsed at BEM to 3.2% and BC „BANCA SOCIALĂ” S.A. to 2.5%. The current liquidity indicator has decreased at all three banks: at BEM it has decreased to the level of -1,71%, at B.C. ”BANCA SOCIALĂ” S.A. to 5,85% and at B.C. ”UNIBANK” S.A. to 11,54%.

A high rate of non-performing loans has been recorded. The worst situation was recorded at BEM where this indicator has reached 72%. Also the profitability indicators have dropped. This situation has been the consequence of serious deficiencies existing in corporate governance within these banks and the incapacity of the National Bank of Moldova to prevent and eliminate them. According to data provided by NBM, BEM's exposure to affiliated persons has exceeded the required limits (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%). In accordance with its quarterly reports, BEM exceeded these limits since the second quarter of the year 2014, reaching at the end of June a significant share of aggregate exposure to affiliates 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. It is evident that NBM has failed in preventing capital from falling below the minimum levels and in requiring remedial actions in these cases. Moreover, being aware regarding the situation of the exposure to affiliates, the supervisor has not imposed any remedial action or sanctions. Only in November 2014, after detecting extremely large transactions between those three banks, NBM has established the special administration regime within these banks for a period of 9 months.

All these events have affected the level of capitalization and liquidity indicators of the banking system at the aggregate level. On 31.12.2014 the aggregate level of capitalization has fallen under the minimum required level, reaching 13.21% and the liquidity has fallen with 12,6 p.p. (fig. 1).

Figure 1. The main financial soundness indicators of the Moldovan banking system, for the years 2006-2014



(Source: elaborated by the author based on NBM data base)

In line with the last Financial Sector Assessment Program (FSAP) carried out in 2014 in Republic of Moldova, significant weaknesses in the legal and regulatory frameworks must be urgently addressed to ensure stability and soundness of the Moldovan financial sector (IMF, 2014). Financial stability has been preserved, although the condition of BEM continued to deteriorate and subsequent steps to stabilize its financial situation were not in line with IMF's advice. Although amendments to the Law on Financial Institutions were passed in line with Fund program understandings, their implementation has been slow, in part because of legal challenges. The regulatory framework for banks still has a number of *shortcomings*:

- The ability of the NBM to enforce regulations has been seriously hampered by a series of court challenges. A Constitutional Court (CC) ruling issued in 2013 substantially reduced the powers of the NBM by authorizing any court to suspend decisions of the NBM (except the ones on liquidation of banks and cancelation of licenses) until the end of the court process. In December 2013, Parliament approved legislation that addressed the implications of the CC ruling on NBM decisions with a more specific focus on those related to monetary and exchange rate policies. A separate CC ruling limits the independence and effective operation of the National Commission for Financial Markets (supervisor of nonbank financial institutions) (IMF, 2014).
- There is inadequate legal protection for supervisory staff. Even allowing for the legal constraints, the NBM has on some occasions failed to take corrective actions when faced with serious or persistent infringements by the banks.
- The crisis management framework is weak. The National Commission for Financial Stability 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 also significant gaps and deficiencies in the statutory powers required for cost-effective bank crisis resolution.
- A key element of the framework for systemic protection – the Deposit Guarantee Fund (DGF) - which could contribute to public confidence in the system and thus limit contagion from banks in distress is weak.

4. CONCLUSIONS

Despite some progress in addressing the recommendations of the previous FSAP update from 2008, there are serious governance problems in several banks, including the largest ones, the ability of the regulators to take action is constrained, and the crisis management framework is weak. In order to enhance the quality of banking governance in the Republic of Moldova the following policy recommendations should be implemented:

1. 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 (Art. 5), by stipulating that the licensing, supervision and

regulation of financial institutions are provided for promoting the safety and soundness of banks and the banking system. This amendment will increase the accountability of NBM towards this objective.

2. Restoring the independence of NBM in carrying out its functions. Although it is stipulated in the Law on NBM (Art. 6) that the National Bank shall be independent in exercising its tasks conferred upon it by the present law, and shall neither seek nor take instructions from public authorities or from any other authority, it has became a product of the socio-political system. Legal protection of board members and employees of NBM in case of lawsuits for action in good faith should also be strengthened. Amend the Law on NBM, and other legislation as required, to provide NBM with the ability to enforce supervisory and regulatory actions in a timely manner (addressing, for instance, problems ensuing from the Constitutional Court rulings of October 2013).

3. Conducting monthly analyzes of the banking system stability based on a set of financial and prudential indicators, quarterly assessment of system vulnerabilities to potential credit risk, currency and interest risk, based on a simulation model response to extreme conditions (stress test). Drafting Financial Stability Reports (taking into consideration the experience of the EU's member countries) on an annual basis, by highlighting the developments of the financial system and its related risks, risks related to domestic economic and financial developments, risks generated by non-financial corporations and households, addressing the stability of payment system.

4. Enforcing resolutely the regulatory requirements by NBM and re-evaluating banks' shareholders to ensure disclosure of ultimate beneficial owners and controllers. Anti-Money Laundering and Combating the Financing of Terrorism framework needs to be strengthened.

5. Maintaining by NBM a high level of scrutiny of BEM's operations, and monitor developments in liquidity indicators in the affiliated banks on a daily basis, including interbank exposures. NBM should carry out an assessment of the financial situation in all other banks. Any bank found in breach of regulatory requirements based on these studies should expeditiously submit time-bound plans to address any shortcomings.

6. 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.

7. Enhancing funding of the DGF by developing a target fund methodology; amending legislation to provide a line-of-credit to the DGF from the Ministry of Finance; and amending the Law on DGF Law and the Law on NBM to include the NBM as an additional source of back-up funding for the DGF. Several aspects of the deposit insurance scheme require strengthening, for example, a back-up funding facility for the Deposit Guarantee Fund should be put in place.

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