

IMPLEMENTATION OF BASEL AGREEMENTS IN THE BANKING SECTOR OF THE REPUBLIC OF MOLDOVA

Stela CIOBU¹⁹
Victoria IORDACHÎ²⁰

Abstract

Basel III Agreement is a framework of bank regulation which aims to strengthen the stability of the financial system by applying stringent standards designed to improve its ability to absorb shocks from the economic and financial sector and to reduce the risk of contamination from the financial sector to the real economy.

The National Bank of Moldova approved the Basel III Implementation Strategy in the light of the European legislative framework in April 2016. The reform plan will focus on continuing the process of promoting reforms in the banking sector, in particular establishing a transparent shareholder structure attracting new solid investors, adequately assessing the bank's management and identifying transactions with affiliated banks.

The purpose of the article consists in the identification, analysis, monitoring the actions required to be undertaken by the Central Bank and banks in order to implement the Basel III requirements and to harmonize the legislative framework in the banking field with EU directives.

Key words: *Basel III Agreement, banking system, financial crisis, bank regulations, macro prudential supervision.*

JEL classification: *E52, E58*

Introduction

The National Bank of Moldova (NBM) approved the strategy to implement the Basel III through the European legislative framework in April 2016. At that time the document was intended to identify the measures necessary for the implementation of the package of European banking regulation and supervision, and raising the banking sector for the purpose of proper compliance. In the period 2015 - 2017, the National Bank of Moldova has benefited from assistance provided by central banks from Romania and the Netherlands, through a twinning project related to capacity building of NBM regulation and banking supervision in the context of the provisions of Directive 2013/36 / EU and Regulation 575 / 2013 related to the banking sector (the so-called CRD IV package). At that time, the Basel III implementation strategy was relevant to meeting the commitments made under the EU-Moldova Financial Services Association Agreement.

Basel III tries to combine micro- and macro-prudential supervision, while being a risk-management framework at the bank level (taken from Basel I and Basel II) and a systemic risk management framework at the banking system level.

The Basel III brings changes to capital both in quantitative and qualitative terms. In simple terms, more qualitative capital will be requested (the quality reflects the availability of capital to absorb risks). Banks will have to significantly extend their planning horizon per components until the moment of their complete implementation in 2019. As a result of new recommendations of Basel III relating to optimization of bank capital, banks will face a more efficient environment and an increase of reduced profitability, while the banks stability will be ensured through the coverage of all risks related to bank activity.

The scope of research is identification, analysis, monitoring of actions necessary to be taken by the Central Monetary Authority and banks to implement the Basel III requirements and harmonize the legislative framework in the banking sector to the requirements of the EU directives. The investigation was performed in base of the analysis of the Moldovan banking sector.

¹⁹ *Investments and Bank Activity Department, Academy of Economic Studies of Moldova, Banulescu Bodoni 61 str., Republic of Moldova, stela.ciobu@gmail.com.*

²⁰ *Financial and Monetary Research Department, Institute for Economic Research, Ion Creanga 45 str., Republic of Moldova, timush_v@yahoo.co.uk*

Methodology of research. For the elaboration of the article general scientific knowledge of economic principles was applied, as well as concrete historical approaches that would allow the consideration of development phenomena and processes. The techniques used were: induction, deduction, comparison methods, synthesis and analysis.

Strategies of banking supervision that will be implemented by the Central Bank

The modernization of the banking sector in the Republic of Moldova through the implementation of the Basel III requirements that already was applied by many countries, including the EU states through the CRD IV and CRD package, will be performed through the efficient use of resources, with the support of donors and external partners, optimal solutions for the development of internal risk management systems in banks, as well as by filing relevant information about this process for the banks involved.

In accordance with the banking legislation, the NBM has created the banking supervision and regulation mechanism by establishing a series of specific requirements stipulated in national normative acts, which banks are obliged to observe. These requirements are constantly improved to ensure compliance with the provisions of the legislation, with generally accepted international principles and best practices, in particular with the recommendations of the Basel Committee on Banking Supervision and European Union Directives.

Based on generally accepted standards, the NBM promotes an active policy in the field of regulation and supervision of banks' activity through:

- Establishing banks' authorization criteria, capital requirements, exigencies with owners and their shares, and bank managers;
- Establishing the requirements to ensure the high quality and functionality of banks' internal control systems, including procedures for preventing and combating money laundering;
- Establishing and supervising compliance with prudential requirements to ensure banks' exposure to risks;
- Undertaking actions related to the application of corrective measures, sanctions, the introduction of special supervision or, as the case may be, special administration for solving problems with banks with increased vulnerabilities.

The reform plan, as well as the changes in the regulation in the field of banking supervision in the context of the implementation of the Association Agreement between the Republic of Moldova and the European Union, the National Bank of Moldova will focus its efforts to implement the following priority banking supervision strategies:

- transparency of shareholders;
- implementing BASEL III requirements by focusing on the bank's internal governance and risk management;
- credit risk;
- exposures to affiliated persons;
- the risk associated with information and communication technologies (ICT);
- combating money laundering and terrorist financing.

Transparency of shareholders

Transparency of shareholders is one of the basic elements for establishing robust corporate governance in the banking sector and attracting investors that meet the high quality requirements. During 2017, in the framework of performing the transparency of shareholder attributions, the NBM imposed sanctions in the form of fine to holders of substantial quotas in the share capital of two licensed banks.

In 2018, the National Bank continued the previously initiated transparency exercise and worked with state-owned institutions and overseas supervisory authorities to complete the control of all final owners of Moldovan banks. In particular, the NBM will continue its enhanced effort to ensure that the largest banks' shares are held by investors meeting the criteria of quality and transparency.

Implementing BASEL III requirements by focusing on the bank's internal governance and risk management.

Checking the compliance of banks with the new prudential standards (Pillar I). Another priority is the verification of both the on-the-spot checks and the ex-officio information available on the compliance of banks with the legal provisions in the context of the implementation of Basel III standards. Thus, the reports submitted by banks according to the COREP / FINREP reporting framework, as well as the compliance of the internal regulations elaborated in the context of the new legislative framework, will be checked.

Supervision and evaluation process (Pillar II). The National Bank of Moldova will ensure the verification of the management framework for the activity, strategies, processes and mechanisms implemented by each bank in order to comply with the provisions of the new law and the normative acts issued in its application and will carry out its own assessment of the risks to which the banks are exposed.

At the same time, the NBM will require banks to have a rigorous management framework including a clear organizational structure with well-defined, transparent and coherent responsibility lines, effective processes for identifying, managing, monitoring and reporting the risks to which they are exposed (ICAAP), stress-tests, adequate internal control mechanisms, including strict administrative and accounting procedures. Increased attention will be given to management decisions of banks, to the existence of specialized committees of banks' councils, to the collective and individual knowledge of the knowledge and skills of members of management bodies, key personnel, etc. At the first stage, the NBM asked all banks to carry out a self-assessment of corporate governance and to take all necessary measures to comply with the legal framework.

Credit risk

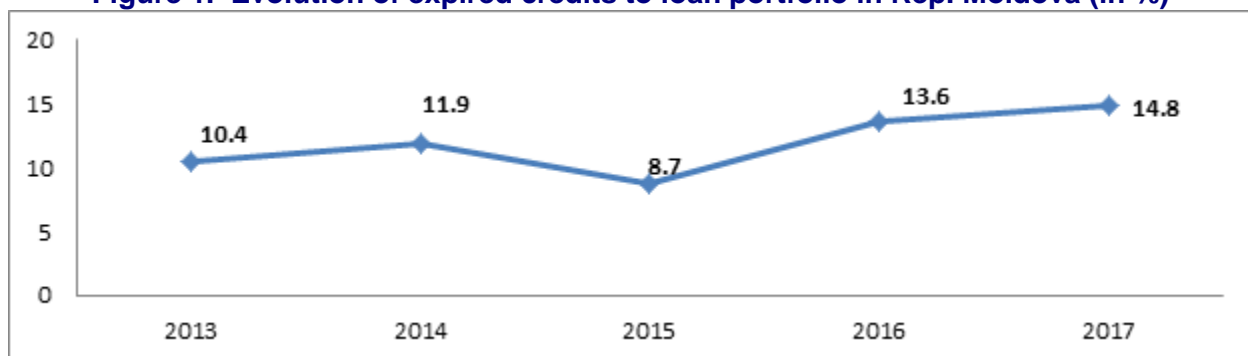
In the structure of assets the largest share belongs to the loan portfolio, which as of 31.12.2017 constituted 42.3%. The year 2017 was characterized by problems related to the high share of non-performing loans in total loans (18.5%).

Thus, as in the previous year, in 2018 credit risk remains the most significant and important area of supervisory priorities. In particular, increased attention will be given to the timely creation of asset and conditional asset write-downs, lowering the level of bad loans, management and valuation practices, and existing lending renegotiation policies.

Expired credits to loan portfolio registered an increasing trend during 2013-2017, from 10,4% to 14,8% (see fig. 1) and this is due to the fact that the amount of expired loans increased at a higher rate than the loan portfolio increased.

The banks that recorded the highest level in 2017 of this indicator are: B.C. "EXIMBANK - Gruppo Veneto Banca" JSC - 43%, B.C. "VICTORIABANK" JSC - 26%, B.C. "ENERGBANK" JSC - 12.5%. The banks that recorded the lowest level of this indicator are: B.C. "FinComBank" JSC - 1.9%, B.C. "MOBIASBANCA Groupe Societe Generale" JSC - 3.0%, B.C. "COMERTBANK" JSC - 3.7%.

Figure 1. Evolution of expired credits to loan portfolio in Rep. Moldova (in %)

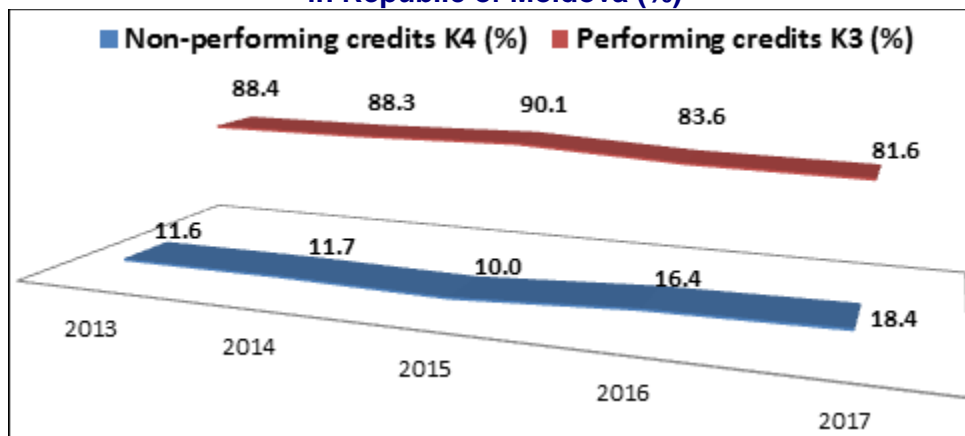


Source: Elaborated by authors in base of data retrieved from the official site of the NBM, www.bnrm.org

We note that the quality of the credit portfolio of the banking sector worsens per year, in 2013 the ratio of bad loans to total portfolio was 11.6% and in 2017 the level of this indicator increased to 18.4% (see fig. 2). This increase is due to the fact that the following banks worsened their credit portfolio considerably: BC "Moldindconbank" JSC this indicator rose from 16% in 2016 to 29.4% in

2017, BC. "EXIMBANK - Gruppo Veneto Banca" JSC level of this indicator rose from 28.9% in 2016 to 34.05% and BC. "COMERTBANK" JSC increased this indicator from 16.1% in 2016 to 20.26% in 2017. The banks with the worst non-reforming loan portfolio are: BC "EXIMBANK - Gruppo Veneto Banca" JSC - 34%, BC "VICTORIABANK" JSC - 33% and BC "Moldindconbank" JSC - 29.4%. The banks with the highest credit portfolio are: BC "FinComBank" JSC - 4.02%, BC "MOBIASBANCA - Groupe Societe Generale" JSC - 7.4% and BC "EuroCreditBank" JSC - 8.82%.

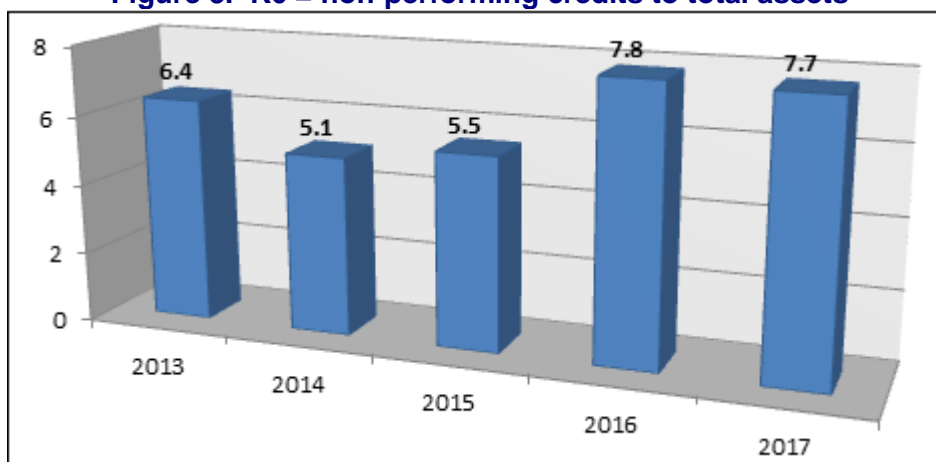
Figure 2. Evolution of the quality of credit portfolio in the banking sector in Republic of Moldova (%)



Source: Elaborated by authors in base of data retrieved from the official site of the NBM, www.bnm.org

An increasing trend of non-performing credits to total assets indicator is also observed, so that in 2013 this indicator reached 6.4 and in 2017 rose to 7.7 (see fig. 3). This is due to the fact that non-performing loans have increased to a greater extent than the bank's assets.

Figure 3. K6 = non-performing credits to total assets



Source: Elaborated by authors in base of data retrieved from the official site of the NBM, www.bnm.org

The NBM has considerably tightened bank supervision and reporting standards, including the ones against compromised loans. However, a number of systemic problems persist, among them: issues of transparency of shareholders and effective beneficiaries, corporate governance and inefficient management, weak internal control procedures and audits. Although the NBM stopped creating new, dubious and compromised loans, the solution of the existing ones is difficult. The NBM will also assess the credit risk management framework by carefully analyzing banks' procedures, policies, strategies and practices in the context of identifying, quantifying, monitoring and diminishing over time. At the same time, the NBM will examine ex officio each year the credit portfolio of each bank on the basis of the Credit Risk Register for the purpose of supervising and identifying imprudent practices.

It will also be continuously realized the identification of groups of people acting concerted to report real "large" exposures and complying with the prudential limits set.

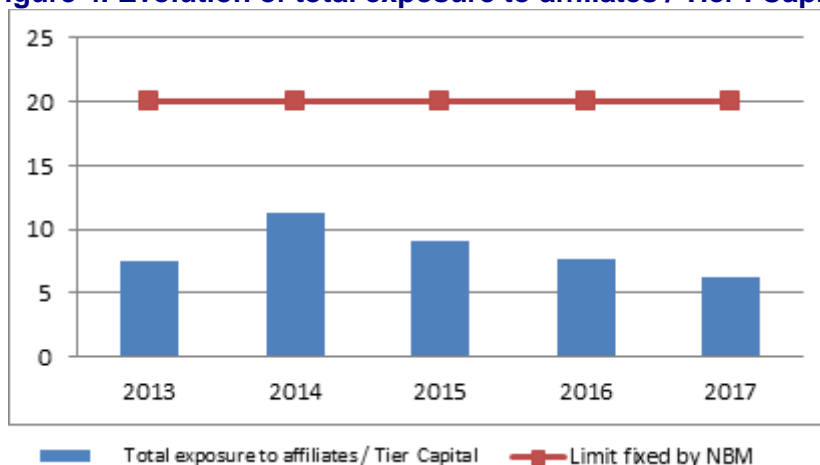
Exposures to Affiliates

Throughout 2017, the National Bank of Moldova stepped up its efforts to identify affiliated banks. In this context, implementing changes to the Bank's Transaction Regulation with its affiliated persons

has contributed to banks' efforts to identify their affiliates as well as their transactions. At the same time, NBM was given the right to presume the affiliated banks. Additionally, the Credit Risk Register has been adjusted, which has made it possible to collect the presumption characteristics in a single database within the field controls.

During 2017, the analysis of exposures to affiliates in the three largest banks with the assistance of an international audit firm was carried out, while the analysis of exposures in non-systemic banks is carried out by NBM inspectors as part of the complex land.

Figure 4. Evolution of total exposure to affiliates / Tier I Capital



Source: Elaborated by authors in base of data retrieved from the official site of the NBM, www.bnm.org

Over the years banks have respected the limit fixed by the NBM as regarding the total exposure to affiliated persons to Tier I Capital (see fig. 4), so the level of this indicator is on a declining trend from 11.28% in 2014 to 6.28% in 2017. Banks with the highest values are BC. "ENERGBANK" JSC - 13.9%, BC "Moldindconbank" JSC - 9.01% and BC "MOLDOVA - AGROINDBANK" JSC - 8.98%.

Throughout 2018, the National Bank of Moldova continued the process of identifying affiliated persons and examining the bank's transactions with them (including some features indicating a possible affiliation), which will facilitate the pursuit of compliance by banks with legal provisions related to those transactions, including prudential limits on exposures to them. The NBM will also develop a guidance on the management of related party risks to help banks strengthen their internal processes. In addition, the NBM will adopt the internal methodology and procedures for situations in which the bank's exposure to related parties is presumed. On the basis of these measures and the results of the related parties' assessment, banks will be required to submit action plans with concrete deadlines to ensure full compliance with the decisions of the NBM Executive Board to remedy the situation of affiliated parties .

The risk associated with Information and Communication Technologies (ICT)

The risk associated with information and communication technologies (ICT), especially cyber-risk, remains one of the main priorities of supervision over 2018, as its materialization may lead to disruption of banking activity, compromising the confidentiality and integrity of information. These risks can generate significant costs and may negatively impact the bank's image. In connection with their continuous development, in order to ensure information security, protect customers and banks from possible fraud, prevent cyber attacks, the National Bank of Moldova requested banks in 2017 to conduct a complex external audit in the field of ICT and to present its results to on March 31, 2018. In order to ensure that the exercise proceeds uniformly for all banks, the National Bank of Moldova has developed a set of minimum requirements on the areas to be assessed and the main processes on which it is going to expose its opinion. The complex external auditing in the ICT field will allow to assess the adequacy of the information systems and the continuity of activity and will determine whether the banks have information security management (SMS) systems in compliance with legal and regulatory acts (including NBM recommendations) in the field of information and security technologies information in force. In the future, the NBM will continue to take measures to prevent and limit the risk associated with Information and Communication Technologies (ICT).

Combating money laundering and terrorist financing

During 2018, the NBM focused on the implementation of the requirements of the new Law on the prevention and combating of money laundering and terrorist financing, approved on 22.12.2017, and ensured the modification of the secondary regulatory framework, in particular of the regulations and recommendations related to the field. At the same time, the NBM carried out its actions according to the Plan of Measures approved by the Government Decision in 2017 to reduce the identified risks in the field of combating money laundering and terrorism financing. NBM also verified whether banks and other entities monitored comply with relevant legislation, apply customer knowledge policies and increased precautionary measures, monitor transactions, etc. and has timely informed the authority responsible for preventing and combating money laundering and terrorist financing of identified risks.

At the same time, the National Bank will undertake surveillance measures to monitor banks and entities monitored to strengthen their internal control system in order to ensure their ability to adequately identify and assess the risks of money laundering and terrorist financing. In this context, appropriate training will be organized and materials and information will be provided to help identify money laundering typologies and terrorist financing. In addition, the NBM will continue its efforts to improve remote surveillance by implementing an IT tool and will intensify field inspections in order to establish the compliance of banks and entities monitored with the rules on preventing and combating money laundering and terrorist financing.

Similarly, ***an important aspect for the implementation of Basel III is the modernization of the banking sector according to the provisions of the EU-Moldova Association Agreement.*** So, a new stage in the evolution of Moldova-EU relations was the signing of the Moldova-EU Association Agreement, which is an integral part of the Eastern Partnership policies. Thus, under the precedent of the Association Agreement, the Republic of Moldova, with the support of the EU, will adopt rules and practices to ensure the stability and integrity of the financial system in general and of financial services, in particular through the appropriate cooperation between the actors of the financial system, regulation and supervision. Achieving these goals is necessary to build a functioning market economy and stimulate trade between the Republic of Moldova and the EU.

The effort of the Republic of Moldova to harmonize its legislation with EU legislative acts in the field of financial services will range from one year to five years. During this period, the Republic of Moldova will have to assimilate the European standards set out in 40 directives and recommendations, which concern: prudential policies on acquisitions and increases in financial sector holdings; the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate; initiating and pursuing the activity of credit institutions; access to activity, conduct and prudential supervision of the activity of electronic money institutions; Deposit Guarantee Schemes; the annual accounts and the consolidated accounts of banks and other financial institutions; reorganization and liquidation of credit institutions.

Moreover, the Republic of Moldova needs to strengthen its efforts to implement Basel III provisions in a timely manner. In December 2017, the Basel Committee published a proposed package of reforms to regulate and implement Basel IV. The implementation of the Basel IV framework is already a remarkable challenge for the European banking sector, as the methodologies for determining the capital requirements are to be reviewed. By doing so, capital calculations for all types of risks will be fundamentally altered. Basel IV includes updates to how banks are calculating their capital requirements so that the results become more comparable globally among banks.

Recommendations

It is necessary to continue the process of promoting reforms in the banking sector, in particular establishing a transparent shareholder structure in order to attract new solid investors, adequately assessing the bank's management and identifying transactions with affiliated banks. At the same time, the implementation of the Basel III standards will increase the safety and soundness of the banking sector, as well as the strengthening of its resistance to shocks and crises.

To implement Basel III in the Republic of Moldova, the following recommendations are proposed:

- Establishing a sound basis for prudential regulation, including capital adequacy, financial leverage and liquidity, development of supervisory processes, market discipline, and risk management principles and maintenance of financial stability.
- Employing qualified staff or training existing staff not only within the NBM but also at the level of each bank to ensure that the new requirements are implemented in an efficient and qualitative manner.
- Providing banks with detailed plans to implement the new requirements and identify the necessary resources for this process and report on the internal capital adequacy assessment process, assessing the adequacy of internal liquidity.
- In order to ensure a harmonious implementation at the level of the banking system, it is necessary to create transient provisions specific to each regulated area, which will allow for the timely distribution of regulatory pressure on banks. Transitional arrangements will be discussed and negotiated with banks both at the start of the transposition process and before the implementation phase.
- Banks should assess how the changes resulting from the application of the new requirements correspond to the risk profile and the possibility for banks to discuss any issues that arise during the implementation of the new requirements with the NBM as supervisor to ensure a fair and consistent interpretation of the new rules.
- The NBM must continuously ensure bilateral dialogue with banks in the implementation of Basel III requirements and aim to communicate the expectations of the NBM on a regular and effective basis.
- Banks should review profitability indicators in the context of a higher regulatory environment. Also, some business segments will be evaluated on "accessibility" criteria, given the funding and capital deficit in the future. Redesigning products and services to ensure that they continue to meet customer needs, while optimizing capital and bank liquidity.
- Banks must strive to improve their ability to pass on risks. One way is the closer cooperation between the bank and the creative institution of the product so that both teams are engaged in increasing the volume of credits that can be securitized, sold or syndicated. Another way of transferring risk is to expand the bank's partnerships on trade union and securitization issues, both geographically and by industry.

Bibliography

- ACCENTURE. Basel III and its Consequences. Confronting a new regulatory environment. [online]. http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture_Basel_III_and_its_Consequences.pdf, p 25.
- ACHARYA, V. V., Hasan, L., & Saunders, A. (2002). Should Banks Be Diversified? Evidence from Individual Bank Loan Portfolios. Bank for International Settlements Working Papers, 2002, p 118.
- BORIO, C. Towards a Macroprudential Framework for Financial Supervision and Regulation. BIS Working Paper 128, 2002.
- Decision on the approval of the draft law on the ratification of the Association Agreement between the Republic of Moldova on the one hand and the European Union and the European Atomic Energy Community and their member states on the other hand signed in Brussels on June 27th 2014 nr. 487 from 28.06.2014. In: Monitorul Oficial nr.178-184/543 from 11.07.2014.
- Law on National Bank of Moldova nr. 548-XIII from 21.07.1995. Republished: Monitorul Oficial al R.Moldova nr.297-300/544 from 30.10.2015.
- Regulation on Exigencies to the Administrator nr. 203 from 27.07.2017. Monitorul Oficial nr.289-300/1544 from 11.08.2017.
- Regulation regarding the holding of the participation shares in the bank's share capital, approved by the DAC of NBM nr.127 from 27.06.2013. <https://www.bnm.md/ro/content/lista-regulamentelor>.
- The Regulation on investments of banks in tangible assets, approved by DAC of the NBM no.384 of December 23, 1999. <https://www.bnm.md/ro/content/lista-regulamentelor>.
- The regulation on the sufficiency of risk-weighted capital, approved by DAC of the NBM nr. 269 from 17.10.2001. <https://www.bnm.md/ro/content/lista-regulamentelor>.
- Regulation on the Bank's Holding of Shares in the Capital of Legal Entities, approved by DAC of the NBM No.330 of 01.12.2016. <https://www.bnm.md/ro/content/lista-regulamentelor>.
- WALTER, S. Basel III and Financial Stability. Speech at the 5th Biennial Conference on Risk Management and Supervision, Financial Stability Institute, Bank for International Settlements, Basel, 2010. <http://www.bis.org/speeches/sp101109a.htm>.