

WEAKNESSES OF CORPORATE GOVERNANCE WITHIN THE BANKING SECTOR OF THE REPUBLIC OF MOLDOVA

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Abstract: *The article is a continuation of the research initiated by the author on corporate governance challenges for the stability of the banking system and destabilizing effects of weak corporate governance structures within banking institutions in the Republic of Moldova. The article has the purpose to identify weaknesses in corporate governance arrangements in the current banking system and presents the main recommendations for eliminating these deficiencies. In order to achieve this goal was performed an analysis of the legislation that regulates the banking system and of the corporate governance code currently in place. Despite some progress on implementing recommendations of the International Monetary Fund and the reported satisfactory performance of banks, the following deficiencies of corporate governance in the banking system were identified: opaque shareholders' structures and the issue of ultimate beneficial owners disclosure; deficient quality of bank boards; the current corporate governance code does not consider essential elements recommended by the Basel Committee; the lack of a consistent concept on corporate governance in the banking system in Moldova aligned with Basel Committee's recommendations.*

Keywords: *banks, supervisory authority, code of corporate governance, board of directors, audit committee, stakeholders.*

JEL Classification: *G21, G32, G38.*

1. Introduction

Cadbury code, which has established for the first time basic rules of governing a company, defines corporate governance as the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies (Committee on the Financial Aspects of Corporate Governance, 1992). Organization for Economic Co-operation and Development (OECD) defines corporate governance as a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently (OECD, 1999). The basic principles of the OECD on corporate governance were recognized in 1999 by the Financial Stability Forum as one of the 12 basic conditions for the stability of financial systems.

Poor corporate governance entails risks for any economic entity. Corporate governance weaknesses that have emerged with the onset of the global financial crisis in 2007 are the following: insufficient oversight of senior management by the board of directors of financial institutions, inadequate risk management and banking activities and organizational structures unduly complex or opaque. Good corporate governance underpins growth performances of institutions, effective risk management, as well as the basis for public confidence in these institutions.

From banking industry perspective, corporate governance involves the way in which the affairs of banks are governed by boards of directors and executive management (Basel Committee on Banking Supervision, 2010). Bank board and executive management are primarily responsible for bank performance and for protecting the interests of depositors, as well for conforming activities and corporate behavior to society's expectations regarding banks functioning in a safe and a sound way (Figure no. 1).

Therefore, board members and executive management should be persons of integrity and have adequate powers for a sound management of the bank. A special role has banks' shareholders, which should comply with certain criteria of integrity and transparency, to ensure an adequate level of capitalization that could cover emerging risks of the banking activity. A key role lies with the supervisory bodies - to ensure that banks implement good corporate governance practices.

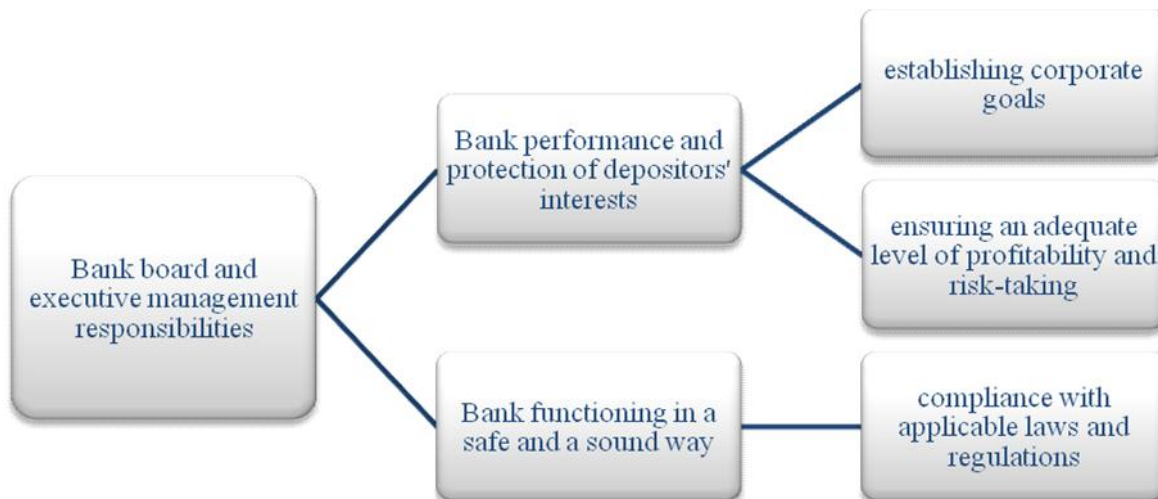


Figure no.1. Responsibilities of the board and executive management of the bank

Source: authors' elaboration

Poor corporate governance may cause bank failures, which may pose significant public costs, a potential impact on deposit insurance systems and possible macroeconomic implications, such as the risk of contagion and the impact on payment systems. Moreover, weak corporate governance can generate loss of market confidence in the bank's ability to properly manage its assets and liabilities, including deposits, which could in turn trigger a run of bank deposits (bank run) and a liquidity crisis. Therefore, in addition to their responsibilities to shareholders, banks also have a special responsibility to their depositors and other stakeholders.

The decision on liquidation of three insolvent Moldovan banks taken by the National Committee for Financial Stability of the Republic of Moldova in August 2015 (Banca de Economii S.A., B.C. "BANCA SOCIAL" S.A., B.C. "UNIBANK" S.A.) is a consequence of corporate governance deficiencies and inadequate oversight by supervisors. This decision has revealed the existence of a systemic crisis in the banking system of the Republic of Moldova. And the liquidation of the largest Moldovan commercial bank, with an important role in the banking sector, with the largest network of branches, revealed the need to analyze the background of this event.

Until August 2015, the National Bank of Moldova (NBM) has provided emergency loans to these banks in an amount equivalent to 27,1 percent of GDP (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.), guaranteed by the Government (According to the Government Decision No. 938 as of November 13, 2014 on ensuring macroeconomic stability in the context of regional conjuncture.). The credits 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 (reducing the reserves by 32.5%), about two-thirds of which occurred following the intervention in Banca de Economii S.A. and B.C. "BANCA SOCIAL " S.A.. 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%. 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 living.

2. Corporate governance weaknesses in the banking sector of the Republic of Moldova

Republic of Moldova is at the stage of updating its legal and regulatory framework to meet international standards of corporate governance. In 2004, under the joint program of the World Bank and International Monetary Fund regarding Reports on the Observance of Standards and Codes was developed the Report on Corporate Governance Country Assessment for Moldova. At that time the most important challenges for Moldova were (World Bank, 2004):

1. Strengthening legal requirements regarding the disclosure of the final beneficiaries of shares and of controlling positions, removal of the boards of directors' right to increase the capital without shareholders' approval, establishing clear responsibilities for board members and requesting independent annual audit reports for joint stock companies.

2. Developing a corporate governance code in order to raise awareness and to identify the responsibilities of the board. Establishing a training program on corporate governance to assist the formation of a culture of ownership in Moldova.

Until present some work has been done in both directions mentioned in the Report on Corporate Governance Country Assessment for Moldova. There were recently made a series of legislative amendments aiming to reveal the final beneficiaries of shares. It was removed the boards' right to raise the capital without shareholders' approval (Law on Joint Stock Companies art. 42 al. (2) The decision to amend the capital shall be taken by the general meeting of shareholders only).

There is a lot of work to do regarding the responsibilities of board members and annual independent audit reports which are required only for JSCs of public interest (Law on Joint Stock Companies art. 89, p.1). National Commission of Financial Market (NCFM) has developed a Corporate Governance Code in 2007, but the code is not yet finally understood by the governing bodies of the Moldovan banks.

The analysis of the legislation that regulates the banking system and of the corporate governance code currently in place has revealed the following *weaknesses of corporate governance mechanisms* in the banking sector of the Republic of Moldova:

A. Opaque shareholder's structure and the issue of disclosure of the final beneficiaries of shares

In the case of Moldova this issue has already become a threat to the orderly functioning of the economy as a whole. An opaque ownership structure poses a substantial risk that translates on depositors, minority shareholders and other stakeholders.

Transparency of shareholders in banks with authentic foreign capital remains the highest in the system (World Bank, 2013). According to NBM, 39% of banking assets are owned by foreign banks, and some 43% are partially in foreign possession. But not all of them are truly foreign owned, a large part of "foreign" capital participates through offshore entities and there are assumptions that these entities are held indirectly by local actors.

Recently there have been made amendments to the Law on financial institutions in order to improve the transparency of the shareholder structure, but so far there is insufficient information about the beneficial owners. This type of capital participation is not a transparent one, while rejecting foreign investors to cooperate with such banks. For example, European Bank for Reconstruction and Development (EBRD), which is one of the shareholders of the commercial bank Victoriabank SA (with a share of 15%), has not participated at the General Meeting of Shareholders from 2007, when several off-shore companies became shareholders. Currently, only 4 from 11 authorized Moldovan banks have a capital formed totally of foreign investments (Table no. 1).

Table no. 1. Foreign strategic investors in the banking system

Bank name	Shareholders	Market share, %
1. Mobiasbanca–Groupe Soci�t� G�n�rale	1. BRD - Groupe Soci�t� G�n�rale (France) (acquisition of share package in 2007) 2. EBRD (European Bank for Reconstruction and Development), (acquisition of share package in 2008)	67.85 32.15
2. EXIMBANK-Gruppo Veneto Banca	Gruppo Veneto Banca (Italy) (acquisition of full share package in 2006)	100
3. ProCredit Bank	1. ProCredit Holding AG (Germany) 2. KfW (Germany) 3. DOEN Foundation (Netherlands)	82.89 10.19 3.99
4. BCR Chi in u	Romanian Commercial Bank (RCB), member of ERSTE Group (Austria)	100

Source: authors' elaboration

Due to an opaque shareholders' structure of commercial banks in Moldova, the EBRD has restricted lending of domestic banks in 2014. Thus, the volume of loans granted to Moldovan commercial banks by EBRD has decreased from 43 mln. euro in 2010 to 23 mln. in 2013. This means that international lenders want to work with transparent and predictable banks, without being affected their image (in order to avoid reputational risks).

In this context, it is necessary to reassess the bank's shareholders to ensure disclosure of the final beneficiaries. National Bank of Moldova must implement strong and effective legal norms on the identification requirements and adequacy of the final beneficiaries and on the banks internal control, actions that would contribute to improve monitoring of related party transactions and the overall framework of risk management in banks. It is also necessary to eliminate the concept of nominal holder from the legislation related to banking, a form of property which promotes to the lack of transparency of shareholders. This type of property allows unveiling only the first level of shareholders - of nominee ownership, with offshore ghost companies often used to hide the identity of the real owners.

B. Deficient quality of bank boards

Best practices in corporate governance have revealed that the board must have both at the level of individual members and collectively, appropriate experience, skills and personal qualities, including professionalism and personal integrity. In this context, the Basel Committee on Banking Supervision (2010) considers that the board collectively should have adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue in order to enable effective governance and oversight. Examples of areas where the board should seek to have, or have access to, appropriate experience or expertise include finance, accounting, strategic planning, communications, governance, risk management, bank regulation, auditing and compliance. Basel Committee's Principles on Corporate Governance (2010) state that board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank. Regarding the bank's board, which has a key role not only in the bank's activity, but also in promoting the principles of sustainable corporate governance, NBM makes the following provisions: The board of directors is the administrative body of the bank exercising control functions, which develops and ensures the implementation of the bank policy. Bank Council is composed of an odd number of members, but no less than three (Law on Financial Institutions, 1995). According to the Regulation on the requirements to bank administrators, members of the bank's Board shall have: 1) higher education or at least 1 year of studies in economic sciences in international organizations, multilateral development banks or international financial and banking groups; 2) at least 3 years of accumulated service over the past 10 years in positions of administrator and/or similar experience and/or academic experience in the field of economics.

Previously board members were required to have higher education, without mentioning the field of study, allowing the election to the board of people without adequate knowledge and experience. A well taking into account the recommendations of the International Monetary Fund revealed in the latest Report of the Program on Financial Sector Assessment, in order to improve the system of continuous promotion of persons that correspond to the fit and proper principle within banks, NBM initiated in April 2015 a Draft Resolution "On amending and supplementing the Regulation on the requirements to bank administrators". This project includes amendments and additions related to the evaluation of managers' experience in banking and finance field, knowledge of specifics of banking activities and risks etc. According to the draft, it was added an additional requirement for Board members: 7¹. The majority of members of bank's Board shall be persons with experience in banking and financial market or non-banking financial market of at least 3 years over the past 10 years in positions of administrator and / or similar experience to the position of administrator.

In these circumstances, the effective exercise of board powers is threatened, especially those related to developing and ensuring the implementation of the bank's strategy and the supervision of executive managers. As a result, banking system's performance and stability are threatened.

Basel Committee (2010) suggests that board members must be able to commit the necessary time and effort to fulfill their responsibilities. Serving as a board member or senior manager of a company that competes or does business with the bank can compromise board independent judgment, as can cross-membership of boards. However, cases when board members are at the same time directors and senior managers of other businesses are very common in the Republic of Moldova, positions which by definition are time committed.

C. The current legislation and corporate governance code does not consider essential elements recommended by the Basel Committee

According to the Regulation on Internal Control Systems within Banks (2010) banks must draw up corporate governance codes. In this regard, all Moldovan banks have developed and published respective codes. However, an analysis of these codes revealed that most often there is no clear understanding of the content of such a code in banks and essential elements recommended by the Basel Committee are not considered.

Recently, the National Commission for Financial Market (NCFM) has developed a draft Decision "On approval of the Code of Corporate Governance" (2015) which aims to make amendments to the previous code and to develop further the policy on corporate governance in line with international standards. But there are several problems associated with this project:

- The concept "corporate government" used in the draft Decision (2015) is not appropriate. There is a distinction between the concept of "government" and "governance" (Stoker, 1998; Campos and Nugent, 1999). The concept of "government" refers to the central intervention based on authority, referring to the official institutions of the state. Government is the state mechanism invested with the authority and legitimacy to act on citizens by three powers - legislative, executive and judicial - and through institutions that concentrate power and applies decisions, essentially referring to the official institutions of the state, and *government* refers to the intervention based on authority and fits the model of rational and comprehensive decision in the policy-making process. Instead, *governance* is a different kind of government, an alternative to government action, which aims to distribute the power within the public space. Governance refers to the management of collective action without the mandatory intervention of the state, it is an involvement of institutions and actors who do not belong to the sphere of government, involving networks of local actors, particularly civil society, business and beneficiaries (stakeholders). And once the process of companies' management involves partnership networks between the company board, the executive, shareholders and other stakeholders (employees, partners, lenders, local authorities etc.) of the company, then the process cannot be named an intervention based on central authority, i.e. government, but one based on distribution of power through an authority's negotiation, namely *governance*, which is based on collective bargaining (deliberative) of decisions.

- Board responsibility for ensuring sustainable development of the bank and towards other stakeholders (e.g. depositors, employees, creditors, investors, etc.) is not clearly stipulated within the code. According to the draft Decision of the NCFM (2015), the board represents the interests of shareholders in the period between shareholders' meetings and controls and regulates within its competences the activity of the company. It is responsible to the general meeting of shareholders. These definitions do not correspond to international standards and do not take into account the interests of the stakeholders, which is a vital factor for ensuring confidence in the banking system. It was found only the role of stakeholders that is mentioned within the draft Decision, which is a non-mandatory document: "it is in the interest of the company to promote long-term cooperation between stakeholders, which will lead to value creation." Studying the Corporate Governance Codes of current 11 commercial banks, could be concluded that most of them do not clearly understand the responsibility of their boards for the bank's business, risk strategy and financial soundness, and the accountability towards stakeholders. Only B.C. „MOLDOVA-AGROINDBANK” S.A.'s Code provides that board members must act in the major interests of the bank and that they should take into account interests of all shareholders and other stakeholders - customers, partners and bank employees.

In relation with principle I of the BCBS, “The members of the board should exercise their “duty of care” and “duty of loyalty” to the bank under applicable national laws and supervisory standards.” This recommendation is important for engaging actively in the major matters of the bank and keeping up with material changes in the bank’s business and the external environment, as well as acting to protect the interests of the bank. There are no stipulations on this matter in the actual Law on Financial Institutions or in the Regulation on the requirements to bank administrators.

- In relation with principle 3 of the BCBS (2010), for large banks and internationally active banks, an *audit and a board-level risk committee* or equivalent should be required. It is advisable that the audit committee consists of a sufficient number of independent non-executive board members. There are no stipulations within the current legislation and draft Decision of the NCFP (2015) about the obligation of establishing an audit or a risk committee by bank boards. According to the legislation of the Republic of Moldova, one of the governing bodies of a company is the *commission of censors* (the revision commission). It exercises control of financial and economic activity of the company and it is accountable only to general meeting of shareholders (Law on Joint Stock Companies, 1997). It is a separate body from the board or senior management. The NBM uses the term of the audit committee in the Law on Financial Institutions, but in the Regulation on Internal Control Systems within Banks it uses for this purpose the term of commission of censors. They has the same characteristics and functions as a *commission of censors*. According to NBM it shall consist of members elected by the general meeting of shareholders of the bank and members of the board of directors shall not simultaneously be members of this committee (Law on Financial Institutions, 1995). According to BCBS the audit committee typically is responsible for the financial reporting process; providing oversight of the bank’s internal and external auditors; approving, or recommending to the board or shareholders for their approval, the appointment, compensation and dismissal of external auditors; reviewing and approving the audit scope and frequency; receiving audit reports; and ensuring that senior management (with the appropriate involvement from the control functions) is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations and other problems identified by auditors. In addition, the audit committee should oversee the establishment of accounting policies by the bank.

The Regulation on Internal Control Systems within Banks states that the evaluation of internal control systems adequacy and efficiency shall be carried out by the unit of internal audit in accordance with. It shall independently evaluate the bank’s activity adequacy and compliance with a set of policies and procedures, with effective legislative provisions, and shall communicate the evaluation results to the board of the bank, commission of censors and to the executive body. All these legal provisions highlight that is no clear understanding on the role of an audit committee for the board in the Republic of Moldova. A part of the *functions of an audit committee are assigned to the commission of censors and a part to the unit of internal audit*.

However, considering international standards on corporate governance, a *commission of censors* (also called revision commissions) is not an audit committee (International Finance Corporation, 2008). *Commission of censors* cannot substitute for the board audit committees. Their composition and functions are different. An audit committee is formed by a company's supervisory board of directors, while a revision commission is appointed at the general meeting of shareholders. While the members of a revision commission can be both shareholders, as well as others, excepting members of the board of directors; remuneration/salary of the revision commissions’ members is determined by general meeting of shareholders.

- In addition to all mentioned above, nor the current legislation neither the governance code does stipulate the *type of the board system* (one-tier or two-tier board system) which companies should have. However, it states that governing bodies of a company are the general meeting of shareholders, board of directors, executive body and commission of censors. In accordance with the legislation a member of the board of directors could not be a member of the executive body of the company (Law on Joint Stock Companies, 1997), which is a characteristic of a two-tier board system. In a one-tier board, all the directors form one board, called the board of directors. All bank boards in the Republic of Moldova are *composed* from non-executive members. All banks have as governing bodies the general meeting of shareholders, the commission of censors, the board of directors, and the executive body called in different ways by banks (management committee, direction committee, general direction, executive committee). Only one bank's organizational structure consists from a supervisory board and an executive body, called executive board (BCR Chisinau S.A.). Thereby a clear understanding of the governing system of a company is missing in the Republic of Moldova. For enhancing the efficiency of corporate governance in banks, the provisions regarding the types of board systems should be included in the current legislation (as they are included in the Law on commercial societies and Regulation on prudential requirements for credit institutions in Romania).

3. Conclusions

During the last years major steps have been made toward the elimination of deficiencies in corporate governance mechanisms of the Moldovan banking system. But the events that took place recently in the banking system - the liquidation of three commercial banks - were passed with considerable negative effects on public and investor confidence in the banking system. Moreover, actual legislation regarding corporate governance practices within banks of the Republic of Moldova and the current **corporate governance code** disregards the essential elements recommended by the Basel Committee on Banking Supervision.

For eliminating corporate governance deficiencies identified within this study the following recommendations should be taken into account:

a) Policy makers need to establish as a top priority of the regulatory framework the disclosure of ownership and control structures, develop an action plan, and investigate alternative approaches to require disclosure of ownership and control positions. Disclosure of agreements between shareholders is also required. It is also advisable to remove the concept of nominal property / nominee holder. Nominee ownership is allowed by law, which contributes to the lack of transparency of shareholders. This type of property allows unveiling only the first level of shareholders - of nominee ownership, with offshore ghost companies often used to hide the identity of the real owners.

b) Eliminating deficiencies related to bank boards. To support board performance, it is a good practice for the board to carry out regular assessments of both the board as a whole and of individual board members; the evaluation report should be public available. This is important to ensure that the board and its individual members discharge their duties properly and that the board includes individuals of integrity and of adequate competence. In order to help board members acquire, maintain and deepen their knowledge and skills and to fulfil their responsibilities, the board should ensure that board members have access to programmes of tailored initial and ongoing education on relevant issues. The board should dedicate sufficient time, budget and other resources for this purpose.

c) Implementation of the Basel Committee's recommendations in the process of developing a corporate governance code. Issues to consider are related to: accountability of

the board to ensure the bank's sustainable development and to other stakeholders (e.g. depositors, employees, creditors, investors, etc.); ensuring an effective system of risk-based internal audit; ensuring board independence and a balance between executive and non-executive members so that no person or group of persons cannot dominate the decision making process of the board.

d) Development of a consistent concept regarding corporate governance by NBM aligned with the Basel Committee guidelines and harmonization of banking regulations in line with this concept. In the context of Basel Committee's Principles, banking supervisors should put more emphasis on promoting good corporate governance in banks. Banking supervisors should assess whether the banks implemented effectively sound corporate governance practices. OECD recommends (2008) in this respect to elaborate a code of corporate governance for banks by banking supervisors in conjunction with the capital and stock market supervisors, as a template, under which banks will develop their own codes.

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