

**CORPORATE GOVERNANCE –
DETERMINANT OF MOLDOVAN BANKING SYSTEM STABILITY**

*Dorina CLICHICI¹, PhD, NIER
Iulia LUPU², PhD, Financial and Monetary Research Centre “V. Slavescu”
Romanian Academy, Romania*

Recent events recorded in the banking sector of the Republic of Moldova – establishing special administration in three commercial banks by the National Bank of Moldova (NBM) – have highlighted the significant role which the quality of corporate governance presents for banking system. The aim of this paper is to identify the challenges of corporate governance for the stability of the Moldovan banking system and destabilizing effects of weak corporate governance structures within banking institutions and analyze the consequences of corporate governance deficiencies. For achieving the goal the author conducted a detailed analysis of normative acts regulating the banking system in order to identify the existing gaps regarding this subject and analyzed recent performances of commercial banks in Moldova. Despite some progress in addressing the recommendations of the International Monetary Fund (IMF) and the satisfactory reported performance of banks, there are serious governance problems in several banks including the largest ones.

Key words: *corporate governance, banking sector, financial stability, financial performance, capital adequacy, non-performing loans.*

Evenimentele recente înregistrate în sectorul bancar al Republicii Moldova – instituirea administrării speciale în cadrul a trei bănci comerciale de către Banca Națională a Moldovei (BNM) – au scos în evidență rolul deosebit pe care îl prezintă calitatea guvernării corporative pentru sistemul bancar. Scopul prezentei lucrări este de a identifica provocările de guvernare corporativă pentru stabilitatea sistemului bancar și a efectelor destabilizatoare ale structurilor slabe de guvernare corporativă în instituțiile bancare din Republica Moldova și a analiza consecințele guvernării corporative deficiente. Pentru atingerea scopului a fost realizată o analiză detaliată a actelor normative ce reglementează sistemul bancar în vederea depistării lacunelor existente la acest capitol și o analiză a performanțelor recente ale băncilor comerciale din Moldova. În pofida unor progrese înregistrate privind realizarea recomandărilor Fondului Monetar Internațional (FMI) și performanțelor înalte raportate de bănci de până acum, se atestă probleme grave de guvernare în mai multe bănci, inclusiv în unele din cele mai mari.

Cuvinte cheie: *guvernare corporativă, sector bancar, stabilitate financiară, performanțe financiare, suficiența capitalului, credite neperformante.*

Последние события, отмеченные в банковском секторе Республики Молдова – установление специального управления Национальным Банком Молдовы (НБМ) в трех проблемных коммерческих банков – выявили особую роль качества корпоративного управления для банковской системы. Целью данной работы является выявление проблем корпоративного управления для обеспечения стабильности банковской системы и определение дестабилизирующего воздействия слабых структур корпоративного управления в банковских учреждениях Молдовы, а также анализ последствий неэффективного корпоративного управления. Для достижения поставленной цели был проведен детальный анализ нормативных актов, регулирующих банковскую систему в целях выявления существующих пробелов в данной сфере и анализ текущего финансового состояния коммерческих банков Молдовы. Несмотря на некоторый прогресс в выполнении рекомендаций Международного Валютного Фонда, а также высокие финансовые результаты банков до настоящего времени, существуют серьезные проблемы корпоративного управления в нескольких банках, в том числе в некоторых из крупнейших.

Ключевые слова: *корпоративное управление, банковский сектор, финансовая устойчивость, финансовые результаты, достаточность капитала, проблемные кредиты.*

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¹ © Dorina CLICHICI, dorina.clichici2@gmail.com

² © Iulia LUPU, iulia.s.lupu@gmail.com

Introduction. The financial intermediation role of banks in the economy, their high degree of sensitivity to potential difficulties arising from ineffective corporate governance and the need to protect the interests of depositors, make corporate governance for banking institutions of particular interest for their stability.

Researches regarding corporate governance issues within banks have been carried out in the early 2000s by Devriese et al. [1], Caprio et al. [2], Morgan[3] etc. Following the recent financial crisis, bank governance has become the topic of much recent academic works (Walker et al. [4], Mehran et al. [5], Mehran and Mollineaux [6], Heremans [7], Marcinkowska [8], Adams et al. [9]) and policy discussion. They differ in the objective that must pursue corporate governance within financial institutions: some of them [4] arguing the need to implement the shareholder-based approach, others (European Commission [10], OECD [11], Basel Committee on Banking Supervision [12]) – that of stakeholder-based approach in the process of corporate governance. Main research results on bank governance explain why governance of banks differs from governance of nonfinancial firms, focus on four areas of governance: executive compensation, boards, risk management, and market discipline (Mehran et al. [5]). Heremans [7] investigates the specific characteristics of banks, how these specificities affect agency problems for banks as well as the functioning of the governance mechanisms put in place in order to cope with agency distortions.

The worsening of financial performances of Moldovan banking system in the last period and excessive accumulation of risks was mostly caused by *poor corporate governance of financial institutions*. And the lack of effective control mechanisms eventually led to excessive risk-taking by most banking institutions. As banks are crucial to the economy of a country they must operate in a prudent and transparent way in order to minimize the possibility of failures and systemic risks.

The consequences of corporate governance deficiencies on the banking sector performances

Corporate governance (specifically bank ownership) is a significant source of financial sector vulnerability in the Republic of Moldova. The main *weaknesses of corporate governance* within the Moldovan banking sector are:

1. Opaque shareholders structures and the issue of ultimate beneficial owners disclosure;
2. Deficient quality of banks councils;
3. The lack of effective conditions for law applying.

In accordance with IMF report carried out in July 2014 [13] there were indications of active concealment of banks ultimate beneficial owners and controllers. Some ultimate beneficial owners might be able to disguise their control in order to circumvent NBM's vetting process and to conceal related party lending. There were also concerns that reported liquid assets of some banks might actually be encumbered, which would make the liquidity ratios worse than reported. The IMF concerns unfortunately came true and at the end of 2014 the financial performances of the banking system worsen.

In November 2014 were recorded a number of extremely large transactions between three banks: the largest one Banca de Economii S.A. (with a state ownership share of 56,13%), B.C."BANCA SOCIALA" S.A. and B.C."UNIBANK" S.A. Governance deficiencies within these banks affected crucially their prudential indicators (capital adequacy, liquid assets ratio, non-performing credits/to total credits, return on asset, return on equity), which have a great impact on financial stability and credibility of the banking system as a whole. In 2014 Banca de Economii S.A. exceeded more than three times the limit (20% of the bank's Tier One Capital) of exposure to affiliated persons, recording an amount of 66,22% on September 2014. As a result, the NBM has initiated the necessary verifications and pursuant to art. 374 of the Law on Financial Institutions has established special administration regime within them¹.

Financial stability indicators of the banking system have been affected substantially due to the situation within these three banks. The level of capitalization has dropped for the first time under the minimum requirement (16%) recording 13.21%. Also, has decreased significantly the liquidity level of the system (Figure 1).

¹ *Special administration regime was established within Banca de Economii S.A., B.C. "BANCA SOCIALĂ" S.A. and B.C. "UNIBANK" S.A. on 27 November 2014, 30 November 2014 and 30 December 2014 respectively.*

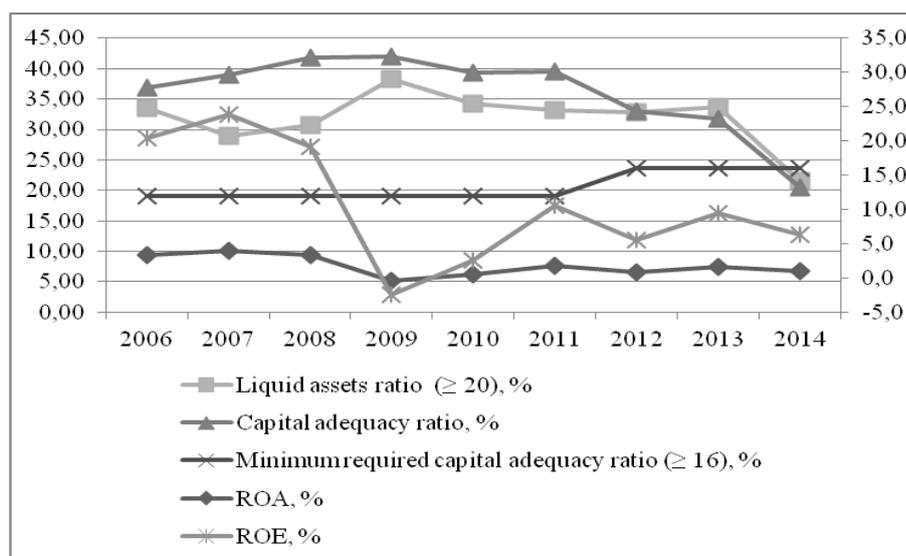


Fig. 1. The level of capitalization and liquidity of the Moldovan banking system, %
 Source: Elaborated by the author based on NBM data base, www.bnm.md

The profitability indicators (ROA and ROE) at the aggregate level have decreased at the end of 2014. The quality of credit portfolios has been affected too. The worst situation was attested within Banca de Economii S.A. which has recorded in its portfolio more than 72% non-performing loans at 31.12.2014 (Figure 2).

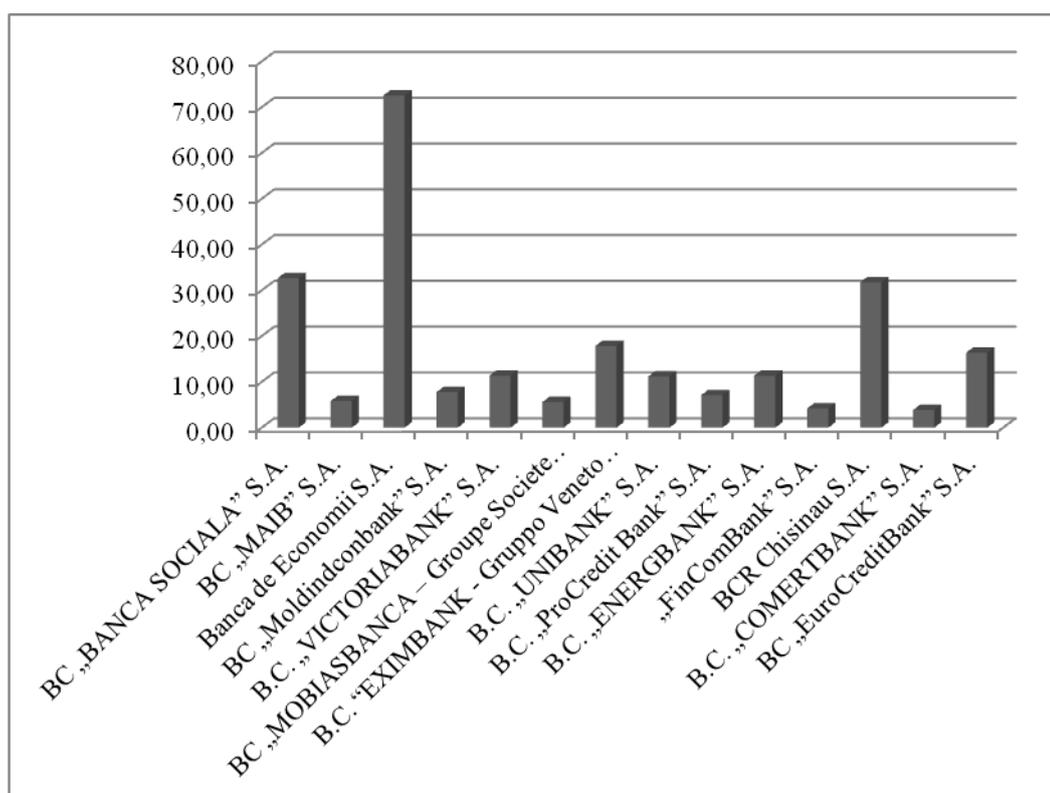


Fig. 2. The quality of credit portfolios of Moldovan banks (non-performing credits to total credits), %

Source: Elaborated by the author based on NBM data base, www.bnm.md

According to the IMF, National Bank has provided Banca de Economii S.A., B.C. „BANCA SOCIALĂ” S.A. an assistance amounting to over 3 billion MDL, which is about 3.5% of the country's Gross Domestic Product (GDP). By the end of October, the National Bank sold 324 million USD of

foreign exchange reserves, 2/3 being sold during the special administration regime. This intervention has influenced negatively the evolution of Moldovan Leu and has caused a rise in inflation.

Results and conclusions. Financial stability indicators of the banking system have been affected substantially due to the situation within three Moldovan banks. One of them, the largest, is partially owned by the state with a share of 56,13%. Governance deficiencies within three banks affected crucially their prudential indicators (capital adequacy, liquid assets ratio, non-performing credits/to total credits, return on asset, return on equity), which have a great impact on financial stability and credibility of the banking system as a whole. Therefore, effective corporate governance practices are essential for achieving and maintaining public trust and confidence in the banking system, features which are critical for the proper functioning of the banking sector and the economy as a whole. Weak corporate governance may contribute to bank failures, which can in turn generate significant public costs and macroeconomic implications such as contagion risk. This was illustrated by the financial crisis that began in mid 2007. In addition, poor corporate governance can make markets lose confidence in the ability of a bank to manage properly its assets and liabilities, including deposits, which in turn could trigger a run on bank deposits or liquidity crisis. And banks should have responsibilities to depositors and other relevant stakeholders out of their responsibilities to shareholders. Moreover, transparency and disclosure have long been recognized as a useful tool for improving corporate governance of state-owned banks [14], which helps minimizing political influence and preventing lack of board and management policy.

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