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REPUBLIC OF MOLDOVA

FINANCIAL SYSTEM STABILITY ASSESSMENT

February 2016

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REPUBLIC OF MOLDOVA

FINANCIAL SYSTEM STABILITY ASSESSMENT

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This report summarizes the work of the Financial Sector Assessment Program (FSAP) mission that visited the Republic of Moldova in February and March 2014. The FSAP findings were discussed with the authorities during the Article IV consultation mission in April 2014.

- The Financial Sector Assessment Program (FSAP) team was led by Simon Gray (IMF) and Brett Coleman (World Bank) and included Katharine Seal, Carlos Caceres, Armine Khachatryan, Tanai Khiaonarong, and Abdul Naseer, (all IMF), Geof Mortlock, Lucretia Paunescu, (IMF Experts), Uzma Khalil, Laura Ard, Pierre-Laurent Chatain, Leif Clark, Jose Garrido, Jean-Michel Lobet, Irit Mevorach, Craig Thorburn (all World Bank), and David Walker (World Bank Expert).

- The mission met Finance Minister Anatol Arapu, National Bank of Moldova Governor Dorin Draguţanu, President of the National Commission for Financial Markets Dr. Artur Gherman and the Director General of the Deposit Guarantee Fund, Mr. Eduard Usatii. The mission also met with private sector representatives.

- The mission assessed financial sector risks and vulnerabilities, evaluated the quality of financial sector regulation and supervision, and assessed financial safety net arrangements. The mission found significant risks in the banking sector arising from non-transparent ownership of financial institutions, weak governance, connected lending and weaknesses in regulatory powers, and enforcement. The IMF and the World Bank are working with the authorities on necessary enhancements to regulatory legislation and crisis preparedness.

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Glossary

AIPS	Automated Interbank Payment System
AML/CFT	Anti-money Laundering and Combating the Financing of Terrorism
BCP	Basel Core Principles
BES	Book Entry System
BRSD	Banking Regulation and Supervision Department
CAR	Capital Adequacy Ratio
CEO	Chief Executive Officer
CIS	Commonwealth of Independent States
CML	Capital Market Law
CPSS-IOSCO	Committee on Payment and Settlement Systems/International Organization of Securities Commissions
CSD	Central Securities Depository
DGF	Deposit Guarantee Fund
DvP	Delivery versus Payment
ELA	Emergency Liquidity Assistance
EU	European Union
FMI	Financial Market Infrastructure
FX	Foreign Exchange
GDP	Gross Domestic Product
GRAM	Global Risk Assessment Matrix
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
JSC	Joint Stock Company
LCR	Liquidity Coverage Ratio
LEL	Regulation on Large Exposure Limits
LFI	Law on Financial Institutions
LNBM	Law of National Bank of Moldova
MDL	Moldovan Lei
ML/TF	Money Laundering/Terrorism Financing
MOJ	Ministry of Justice
MSE	Moldova Stock Exchange
NBM	National Bank of Moldova
NCFM	National Commission for Financial Markets
NCFS	National Committee for Financial Stability
NPL	Nonperforming Loan
NSD	National Securities Depository
RM	Risk Management
RWA	Risk-Weighted Asset
STeM	Stress Testing Matrix
UBO	Ultimate Beneficial Owner
USD	United States Dollar

EXECUTIVE SUMMARY

Moldova has made some important advances since the 2008 FSAP Update. On the positive side, inflation has been brought down to single digits, the payment system has been upgraded, and important enhancements have been made to financial sector regulation and supervision.

However, risks to banking sector stability have become severe. Large credit concentration and concealed connected lending, questionable cross-border exposures, and important data gaps mean that regulatory data likely significantly understate the system's vulnerability. Non-transparent ownership, weak governance, connected lending and weaknesses in regulatory powers and enforcement further exacerbate these risks and could limit the scope for an effective policy response to shocks. Governance structures, internal oversight processes, and risk management practices are poorly developed. In some cases, cross-border exposures are substantial and the pattern of some (particularly cross-border) financial transactions suggest a serious risk of money laundering.

Although stress tests suggest the banking sector is well capitalized and liquid, important pockets of weakness remain and vulnerabilities may be masked by fraud or misreporting. Reported nonperforming loans (NPLs) for some banks are remarkably high, while in other cases a reduction in NPLs may reflect regulatory arbitrage rather than a substantive reduction in risk. Large exposures in some cases exceed regulatory norms by a wide margin. Also liquidity risk is hard to measure, as the high reported level of liquid assets appears unreliable: some assets may be encumbered through undisclosed side agreements.

The impact of recent regional geopolitical developments on the Moldovan economy will depend on whether the crisis spreads beyond Ukraine, trade tensions with Russia escalate, and trade routes and gas supplies are disrupted. Financial and trade relationships with Ukraine are modest but a further slowdown in the Russian economy and/or an escalation of trade tensions with Russia would have a significant impact, not least given some significant cross-border bank exposures to Russia.

Against this background, the independence and effectiveness of the regulatory bodies needs to be substantially strengthened. Enforcement has been seriously hampered by a series of court challenges, including Constitutional Court (CC) rulings that have allowed the suspension of supervisory actions. Moreover, National Bank of Moldova (NBM, banking supervision) and the National Commission for Financial Markets (NCFM, nonbank supervision) board members and staff do not have sufficient protection against lawsuits, even while discharging their duties in good faith. While the authorities are generally supportive of reform, progress in obtaining parliamentary approval has been slow and the authorities have been unable to address fraudulent raider attacks on banks, to limit large bank exposures, or to address serious weaknesses in the privately-run securities registries. And in the meanwhile, there have not been sufficiently forceful actions taken in response to violations of existing regulatory obligations.

The crisis management framework is weak, and cooperation between regulatory authorities requires improvement. A National Committee for Financial Stability (NCFS) was set up in 2010 to bring together key stakeholders in financial sector stability, though its remit is focused on crisis management. However, while the NCFS proved useful in addressing problems which arose in 2012, it could do more in the areas of contingency planning, testing of processes and powers, and coordination between the member agencies. There are also significant gaps and deficiencies in the statutory powers required for cost-effective bank crisis resolution. If systemic pressures were to emerge, it would be critical for the NCFS to ensure a focus on managing the situation in a coordinated and collegial manner.

There is room also to strengthen the financial safety net. The Deposit Guarantee Fund (DGF) is reasonably funded for the current level of coverage, which includes foreign exchange deposits, although depositor protection is the lowest in Europe at MDL 6,000 (about USD 445). But the DGF lacks the capacity for rapid payout in anything other than very small cases, and there are no established funding lines available, which could impede the ability to make rapid payouts. The DGF also needs better access to sufficient and timely data for more rapid and accurate payouts. In addition, there are some small financial entities supervised by the NCFM that accept deposits which are not insured.

The two securities settlement systems are in need of updating, though plans to take this forward are not finalized. The corporate securities registry system displays governance and infrastructural weaknesses, which are not expected to be addressed in the near term. Settlement of government and central bank securities, and of equities, is delivery versus payment (DVP) in central bank money. But the settlement systems are old and ill-suited to any expansion of trade. Registration of equities is split between 11 private registries, which run manual systems—in some cases with no reliable data back-up—and are vulnerable to fraud and abuse of data. The recently adopted law on capital markets does not provide a forceful or timely framework for addressing these shortcomings.

The insurance sector is small and almost entirely restricted to motor insurance. There have been few new entrants to the market for some years, and anticompetitive practices deter entry and growth. The NCFM is keen to move to risk-based supervision. This is a worthwhile goal, but resource constraints suggest it will be a difficult challenge.

Weaknesses in the insolvency and creditor/debtor regime create uncertainty and may deter some stakeholders from engaging in financial transactions. There is no rescue culture for distressed enterprises, and the system incentivizes administrators to liquidate rather than reorganize.

The team's key recommendations are summarized in Table 1. Especially in light of the weaknesses described above and recent geopolitical uncertainties, urgent action is needed to address these and mitigate the risks to which the financial system appears to be exposed.

Table 1. Key Recommendations

Recommendation	Responsible Parties	Time[1] Frame	Priority
Financial Stability Framework			
Amend the LNBM and LNCFM, and other legislation as required, to provide NBM and NCFM with the ability to enforce supervisory and regulatory actions in a timely manner. [#41]	NBM, NCFM	ST	High
Establish a formal body e.g. a Council of National Regulators to conduct a system-wide financial stability assessment. [#37]	Financial regulatory authorities	MT	Medium
Bank Governance			
Re-evaluate bank shareholders to ensure disclosure of ultimate UBOs; and ensure continuous monitoring of owners and UBOs. [##9, 44]	NBM	ST	High
Amend the LFI and the JSC Laws to enumerate the distinct roles of owners, board members, and senior management. [#11]	NBM, MOF	MT	High
Require that bank board directors sign attestations annually, affirming that the bank complies with all prudential requirements. [##13]	NBM	MT	Medium
Banking Supervision			
Amend the NBM Law to provide full legal protection and assistance to all NBM employees in case of lawsuits for actions in good faith. [#42]	NBM	ST	High
Amend the NBM law to remove MoJ power to amend the content of regulations. [#41]	NBM	ST	Medium/ High
Progressively increase intensity of supervision and severity of corrective actions, including fines and restrictions, against banks in the case of persistent violation of laws and regulations. [#43]	NBM	MT	Medium
Increase intensity of AML/CFT supervision of banks by performing more targeted, risk-based on-site inspections in key areas. [#46]	NBM	ST	Medium/ High
Crisis Resolution			
Develop a comprehensive financial crisis resolution contingency plan, and identify necessary amendments to the legislation. [#62]	NCFS members	ST	High
Implement resolvability assessments, and recovery and resolution plans, for at least the systemically important financial institutions.[#61]	NCFS members	ST	High
Develop a program of capacity-building on crisis resolution, including strengthened coordination arrangements. [#64]	NCFS members	ST	High
Deposit Insurance System			
Clarify legislation to assure the DGF has earlier access to detailed depositor information and to allow it to verify such information on-site. [#69]	DGF, MOF	MT	Medium

[1] Short-term (ST) indicates action should be taken within 6 months; medium-term (MT) indicates action should be taken within 6–24 months. Where legislative change is required, it is understood that Parliament needs to approve such changes.

Table 1. Key Recommendations (concluded)			
Recommendation	**Responsible Parties**	**Time Frame**	**Priority**
Enhance funding by developing a target fund methodology; provide a line-of-credit to the DGF from the MOF; and include the NBM as an additional source of back-up funding for the DGF. [#67].	DGF, MOF, NBM	MT	Medium
Insurance Supervision			
Take forward implementation of a risk-based approach to insurance supervision. [#51]	NCFM	ST-MT	Medium
Develop key elements of group supervision, particularly with agencies outside Moldova. [#52]	NCFM	ST	Medium
Complete the resolution regime by finalizing the arrangements for the compensation scheme. [#53]	NCFM	MT	Medium
Financial Market Infrastructure			
Amend the LNCFM to provide the NCFM with all necessary regulatory and supervisory powers, and then consolidate the corporate securities registration function into an appropriately regulated and governed central securities depository. [#73]	NCFM	ST	High
Insolvency and Creditor/Debtor Regime			
Assign insolvency cases to designated members of the Court of Appeals who are specially trained in the management of insolvency cases. [#75]	Council of Magistracy, Supreme Court of Justice, MoJ	MT	Medium

FINANCIAL SYSTEM STRUCTURE

1. The Moldovan economy remains highly vulnerable to developments in the economies of its trading partners and reliant on remittances and donor support. Remittances from Moldovan workers abroad are around 24 percent of GDP (on a declining trend), and donor support to the budget is equivalent to 10 percent of total spending (Figure 1). Inflation is within the NBM's target range of 5 percent ±1.5 percent. With nominal exchange rate depreciation (9 percent since end-2012), the MDL has depreciated by 1 percent in real terms. In per capita GDP terms, Moldova is the poorest country in Europe.

2. The financial system is dominated by the banking sector, which in turn appears to be controlled by a small number of individuals. There are 14 commercial banks (four are subsidiaries of foreign banks) with assets equivalent to about 77 percent of GDP—small compared with neighboring peers. Five of the six largest banks reportedly form two de facto groups, and have a combined 60-70 percent share of the banking system, giving rise to a "too big to fail" problem. Similarly, the owners of these groups also reportedly control much of the nonbank financial sector—insurance companies, securities registries, etc. Funding is primarily from retail deposits, while credit appears to be mainly to commerce and industry (Figure 2).[1] FX assets and liabilities account for around 45 percent of balance sheet totals. Since end-2011, cross-border financial linkages have increased sharply and have become more complex. (Figure 3). During this period, foreign placements by Moldovan banks more than doubled to 11 percent of GDP—with most of this growth occurring in 2013—while their liabilities increased more slowly, to 10 percent of GDP.

3. Nonbank financial institutions and markets are still small and underdeveloped. The insurance sector is small at 3.5 percent of total financial sector assets and is growing only in line with GDP. Microfinance institutions and some small deposit-taking credit associations—regulated by the NCFM—are increasing in number but their reach and size is not growing.

4. The capital market is small: the Moldova Stock Exchange, controlled by the banks, is illiquid. Turnover in 2013 represented less than 1 percent of GDP, and market capitalization was around 6 percent of GDP. Domestic government debt is around 5 percent of GDP,[2] and government securities are limited to short-term issues, with a maximum maturity of three years. The secondary market is thin; banks are the primary dealers and investors in this market. The NBM regularly issues 14-day bills, on a fixed-rate full allotment basis, to drain excess reserves. There are no significant private investment undertakings.

[1] Credit expansion in 2013 is much lower when the rapid lending growth of one bank is excluded.

[2] Total government debt stands at some 30 percent of GDP.

FINANCIAL STABILITY RISK

5. The most significant financial risks are hard to quantify and stem from deep and interconnected weaknesses. Gaps in the authorities' legal powers and protections leave them poorly placed to address significant shortcomings in governance of both banks and non-bank financial institutions. Failure to identify and assess the integrity and competence of the control and ultimate beneficial ownership of the banks and other financial institutions means the scale of concentration and potential for contagion within the financial system may be considerably underestimated.

A. Legal System

6. A CC ruling in December 2012 critically constrains the NCFM's supervisory powers, including its ability to revoke authorization. The ruling permits any court to suspend NCFM's decisions pending a final court decision, and a number of NCFM regulatory actions have been suspended since then. A draft law is in Parliament; however there is no clear view among the authorities if the NCFM should be given greater powers.

7. A similar CC ruling on October 1, 2013[3] curbed the NBM's powers to effectively carry out its functions. The decision permitted any court to suspend key actions and decisions of the NBM before final settlement of the case, with two exemptions to the ruling, namely decisions to revoke a license or to liquidate a bank. A December 2013 legislative amendment partly restores some of the powers of the NBM, in particular protecting its monetary authority, and putting some constraints on court orders to suspend regulatory actions.[4]

8. A number of other factors hinder the NBM's effective regulatory and supervisory actions. These include (i) need for procedural consistency and clarity on preliminary appeal of NBM decisions; (ii) need for clarity on scope of the judicial review process particularly relating to NBM supervisory decisions, so that the courts should focus on the legality of NBM actions, rather than contesting the substance; (iii) allocation of the burden of proof to the plaintiff; (iv) need for detailed procedures of appeal of the administrative authorities' normative decisions to shorten the current unlimited timeframe; and (v) limitation of court powers to issue an injunction to prevent the adoption of a decision by the NBM. While the government in principle supports the legislative changes necessary to restore the NBM's powers, it is unclear if timely Parliamentary approval of the necessary amendments will be obtained.

[3] The Constitutional Court ruling declared Article 11(4) of the prevailing Law on National Bank of Moldova (LNBM) unconstitutional. Article 11(4) says: "Until the final settlement of the case by the court, the enforcement of the NBM acts… shall not be suspended." The ruling means that NBM regulatory actions can now be suspended immediately.

[4] It establishes a legal framework to avoid the immediate suspension of NBM decisions at the request of the plaintiff and provides for a special court-based procedure for any such suspension.

B. Bank Governance

9. Many bank ownership structures are unduly complex, using shell companies, often offshore, to disguise the identity of ultimate beneficial owners (UBOs). Major changes in the ownership structure of the largest banks in the past two years have been accomplished by acquisition of voting shares in parcels below the 5 percent threshold for regulatory consent, as well as through fraudulent "raider attacks" that undermine the interests of existing bank shareholders.[5]

10. Ownership changes have resulted in nontransparent changes in board members and CEOs. Controlling shareholders—through the new management—are in some cases promoting imprudent activities, notably exceptional balance sheet growth funded by high-cost deposits, including interbank placements channeled via offshore banks. There are indications that a substantial portion of this funding has gone to finance owners' related-party transactions which—as the UBOs' identity is disguised—cannot be identified as such under NBM regulations.

11. The roles and responsibilities of ownership, internal oversight (board), and management are substantially blurred, undermining governance. All banks indicated that the controlling shareholders nominate and appoint board members, creating boards that have as their primary goal representation of the shareholders and no acknowledgement of the interests of the depositors, public and taxpayers despite fiduciary duty imposed by the Law on Financial Institutions (LFI). The ambiguity of the UBOs and their nontransparent actions masks the board member nomination processes. There are no independent board members and the minimum number of three directors is unusually low. Furthermore, the controlling shareholder typically appoints the CEO, who is vested with substantial decision-making authority, providing a channel for direct access by the shareholder(s).

12. Boards lack independence, and are not well qualified to oversee financial institution operations. Board members can exhibit conflicts of interest, and few have substantial financial institution experience. Members are appointed for a term of four years, they can be renewed an unlimited number of times.

13. Boards do not fulfill their proper role of strategic planning, oversight or risk management. Planning is insufficiently focused on risk and risk control as evidenced by the under-development of critical functions such as compliance and independent risk management as well as internal audit. Neither board audit committees nor other board committees, such as board risk committees, are in place. The risk management mechanisms necessary to identify, measure and report existing and potential risks are not formalized and are not effectively independent. Boards are not made explicitly responsible, by law, for the truthfulness and integrity of their banks' financial reporting.

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[5] A "raid" is where hostile control of substantial shareholdings is gained, possibly illegally, through use of non-transparent offshore vehicles to evade regulatory scrutiny and approval, or even through fraudulent transactions that are facilitated by corruption in the judiciary.

14. Internal audit functions lack independence. Although auditors meet with the board, none indicated that they regularly meet without management present. Consistently, audit departments are understaffed, and in many cases, auditors lack training.

C. Asset Quality

15. Sector wide asset quality is deteriorating and is of significant concern in some banks. While NPLs were trending down in 2013, reaching 11.6 percent by year end, they rose to 13.2 percent in the first quarter of 2014. Some banks, including systemic institutions, have NPL ratios exceeding 60 percent of total loans. Despite the Insolvency Law of 2013, which sought to encourage restructurings, the insolvency culture remains weak and the general tendency is to reschedule or enforce. Foreclosure, when it occurs, is a prolonged process. An NBM regulation requires collateralized lending except for enhanced creditworthiness. This risks placing too much emphasis on collateral rather than good credit appraisals.

16. Incorrect use of low risk weights for loans secured on residential property[6] and numerous cases of loan misclassification undermine the reported capital adequacy figures. Reliance on asset quality is further undermined by weak governance, which allows a significant degree of connected lending by banks, some of which is to insubstantial shell companies, while concentration risk arises from breaches of large exposure limits. In some cases, very large deposits are placed cross-border in obscure transactions, which may combine fictitious creation of 'liquid' assets[7], tax evasion, and money laundering. Additionally, a few commercial banks have substantial reliance on sizeable (largely FX) deposits placed by the government and state-owned companies.

17. Dollarization is not a particular concern at present. The proportion of FX assets and liabilities on commercial bank balance sheets has been stable over the last six years. FX loans—predominantly provided to businesses with cross-border trade or to individuals with demonstrable FX inflows from remittances—ranged from 40 percent to 46 percent during this period and FX deposits from 44 percent to 54 percent. The continuing high level of remittances and sufficient level of foreign exchange reserves mitigate the risks of FX lending—the annual level of remittances is roughly the same as the stock of FX loans. It will be important for the NBM to ensure that banks maintain vigilance and do not provide FX or FX linked loans unless the borrower has a reliable FX income.[8] Moreover, banks need to take due account of the credit risks involved, as well as the FX exposure. It will also be important to ensure that FX assets placed in banks abroad are freely available: there are indications that some balances, while notionally overnight deposits, are in fact encumbered.

[6] The lower risk weight should only be applied when the loan is granted for the purpose of purchasing the house.

[7] A notionally overnight deposit may be placed cross-border in one bank, and reappear as a term deposit in a sister bank in Moldova; while the original deposit may in practice be encumbered e.g. by being pledged as cash collateral against loans to connected companies.

[8] FX loans extended to households resulted in NPL problems in 2008–09.

D. Insurance Sector

18. The insurance market has consolidated and improved its financial strength since the 2007 Law on Insurance was introduced. The number of insurers has reduced—from 28 to 16—in the nonlife sector but actual concentration may be greater than this, as unidentified UBOs obscure the picture. Capital and solvency requirements based on the "Solvency I" regime have been introduced and enforced. Reported technical provisions have improved in strength.

19. The small size and absence of development of the insurance sector implies no material systemic risk. Insurer investments in the banking sector appear manageable compared to capital levels. Cash and bank deposits represent just 3 percent of life insurance assets and 9 percent of nonlife assets but ownership linkages with the unknown bank UBOs are widely suspected. It will be important to address governance and transparency issues before the sector grows substantially.

E. Financial Market Infrastructure Risks

20. The opaque share registry system has compromised the effective regulation of banks and insurance firms. The securities records of joint stock companies (JSCs) are scattered across 11 registrars, which operate independently and have outdated standards and practices, while effective supervision is constrained. Reforms to replace independent registrars with a central depository have failed to date but there are attempts to reform the Capital Market Law (CML), mandating the transfer of the registries of securities of Public Interest Entities (PIEs) to a central securities depository (CSD). Adoption by parliament is targeted by mid-2014. To strengthen oversight, a new database system is being developed by the NCFM to provide daily backups of all corporate securities transactions, once the legislation is passed. Data verifications will be performed based on the risk profile of the participant or the register.

21. Legal uncertainty regarding the settlement of government and central bank securities are being addressed through new draft laws. Specific legal provisions are needed to protect finality, collateral, and netting arrangements in case of insolvency proceedings and investors' rights in the Book-Entry System (BES). The adoption of such laws is important, although currently trade volume is low. There are plans to allow trading of government bonds onto the Moldova Stock Exchange (MSE), though trading on the Bloomberg platform will continue.

22. Liquidity and general business risks are apparent at the National Securities Depository (NSD), which require greater oversight. Liquidity risk arises from a three day settlement standard, although there has been no participant default since operations started in 1998. The size of the guarantee fund (fixed at MDL 30,000 per participant) appears to be insufficient to handle potential settlement risks. A history of losses by the NSD suggests little scope to raise funds for investment in new infrastructure and there appears to be no comprehensive risk management framework. Operational disruptions could impact liquidity for participants in the Real-Time Gross Settlement System (Automated Interbank Payment System (AIPS)), where the cash leg is settled.

23. Regulatory fragmentation between NBM and NCFM could undermine the effective oversight of FMIs. The authorities need to adopt and apply consistently the CPSS-IOSCO Principles for FMIs, and allocate or share responsibilities according to their mandates and competencies. A joint committee should be established for this purpose to deepen regulatory cooperation under the existing memorandum of understanding.

STRESS TESTING

24. The stress testing exercise was comprehensive and illustrated a number of potential vulnerabilities, but some results need to be interpreted cautiously, due to data issues. The stress test findings complemented the FSAP analysis on concentration risks, liquidity risk and contagion concerns; the existence of unidentified UBOs in the system leads to the potential for even greater concentration risk than is reported. However, weaknesses in the coverage and reliability of data mean that the indicators of resilience in the financial system may be overstated.

25. The stress tests focused on the banking system and covered all 14 banks. Top-down solvency stress tests were conducted jointly by the FSAP team and staff from NBM, using supervisory data. These were complemented by bottom-up stress tests conducted by individual banks using the macroeconomic scenarios provided by the FSAP team. In addition, liquidity stress tests, together with complementary sensitivity analysis, were carried out on all banks.

26. Four macroeconomic scenarios were considered. In addition to a baseline scenario using the latest IMF staff projections, two external scenarios were based on the GRAM of September 2013. Macroeconomic projections were quantified for each scenario (Table 3). [9]

- A deeper-than-expected slowdown in major emerging markets, combined with implied lower oil prices, result in a moderate slowdown of the Russian economy, with consequences on Moldova's trade, remittances, and capital inflows.
- A severe global shock, caused by the disorderly unwinding of unconventional monetary policies, triggers an increase in sovereign spreads and re-intensification of stress in the Euro Area periphery. This is accompanied by fall in global oil prices, causing Russia's GDP growth to fall sharply. Overall, this scenario has severe consequences for Moldova's economy due to the combined trade, remittances and capital inflow shocks.[10]

[9] Although the triggers of our two external adverse scenarios are not directly related to the current geopolitical situation in the region, both are based on a potential crisis impacting the Russian economy, with significant consequences for Moldova owing to trade, remittance and capital flow linkages. These scenarios can thus be used as a proxy for quantifying the potential impact that heightened current regional geopolitical tensions might have on the Moldovan banking system.

[10] In terms of economic losses, this scenario entails a fall in Moldovan output larger than that observed in the country during both the Russian crisis (1998–99) and the global financial crisis of 2008–09.

- A severe drought in Moldova, in combination with restrictions on Moldovan exports to Russia, adversely affecting agriculture output and exports. Overall GDP growth falls, the domestic currency depreciates and interest rates rise.

27. The stress tests include a comprehensive assessment of risk factors (see STeM—Appendix IV). The scenario-based stress tests were complemented with sensitivity analysis to assess other risks, such as concentration risk and contagion risks from the interbank market. Finally, liquidity stress tests were conducted to assess the system's overall liquidity; these assessed FX liquidity separately.

28. Potential credit risk losses on the loan book represent the most important risk factor captured by the stress tests. Top-down stress tests found that NPLs (and loan migrations) are sensitive to macroeconomic conditions and FX risk is still important despite greater conservatism in banks' FX lending since the financial crisis.[11] Potential loan losses due to credit risk were estimated to range from MDL 1.7 billion (2 percent of GDP) in the first adverse scenario to MDL 5 billion (7.5 percent of GDP) in the most severe scenario (Table 3). Other sources of credit risk remain contained, owing to low levels of exposure to government and corporate bonds and equity investments.

29. Floating rate lending practices limit vulnerability to interest rate movements; exchange rate risk and other sources of market risk appear to be contained. Re-pricing of instruments is timely and banks make moderate interest income gains when interest rates rise. The potential for valuation volatility is limited, again due to low exposure. All banks comply with regulatory market risk limits which are consistent with international practice, and exhibit modest net open FX positions (Table 5). Moreover, given the absence of trading instruments, and the limited amount of securities on the banks' investment portfolios, other sources of market risk are contained.

30. Concentration risks are high in specific segments of the banking sector. Sensitivity analysis shows that the potential losses remain manageable at the system level, but a couple of banks could become insolvent if a small number of their largest exposures were to default, and the difficulties in identifying UBOs suggests that risks arising from large exposures to related parties may be unidentified and understated.

31. Contagion risks in the domestic interbank market appear small on the whole, but some banks present sizeable interbank and cross-border exposures. The limited amount of domestic interbank transactions suggests that the hypothetical default of any individual bank would not trigger "cascade effects" on the rest of the system. However, a few domestic banks exhibit significantly large exposures to banks outside Moldova. Should these placements become impaired (e.g., if they represented cash collateral against weak credits), certain domestic banks could become

[11] Under the most severe scenario, system-wide NPL-ratio increase considerably, from 11.6 percent (starting point) to 33.2 percent in the top-down stress test. In general, the implied increases in aggregate NPLs from the top-down stress test are noticeably larger than those of the bottom-up stress tests estimated by the banks. The main differences relate to those loans denominated in foreign currencies (EUR and USD).

insolvent. These losses would be contained within the banks in question, but spillover risks through other channels (e.g., depositor confidence) could be significant.

32. Most bank liquidity positions appear to be sound, but there are important exceptions.[12] Liquidity stress tests, based on Basel III LCR-type proxies, show that the banking system as a whole has ample liquidity, with the system-wide liquidity coverage ratio exceeding 100 percent (Table 5) and similar results for foreign currency. However, some banks are dependent on large scale cross-border interbank placements, making them highly vulnerable to a potential shock.[13]

33. The stress tests identified significant vulnerabilities in some specific segments and in some specific banks. On the basis of supervisory data, aggregate stress losses, mainly related to increased provisions in the loan book remain manageable although non-negligible. Similarly, reported system-wide liquidity ratios appear broadly adequate, in both local and foreign currencies. However, major vulnerabilities for some banks include: large concentration risk, significant cross-border interbank exposures, and questionable quality of some liquid assets. Nevertheless, while this group of banks is highly interconnected among themselves, they present low interconnectedness with other domestic banks, and potential losses are likely to have limited direct spillovers to the rest of the banking system, although indirect contagion effects may be unpredictable.

EFFECTIVE SUPERVISION

A. Conditions for Effective Supervision

34. Certain fundamental conditions for effective supervision in the financial sector are not in place in Moldova. Such conditions include the rule of law, market discipline, safety nets and resolution capacity, and financial stability architecture. Failure to provide these conditions undermines the actions and effectiveness of the supervisory authorities (the NBM and the NCFM), as well as weakening overall financial stability in Moldova.

35. There is an absence of the impartial and predictable rule of law. A range of issues contribute to grave concerns relating both to framework and practices. Market participants, government officials and stakeholders have raised concerns about the levels of corruption in the judiciary.[14] Court rulings against the supervisory authorities have overturned or suspended enforcement actions and decisions. CC rulings in 2012 and 2013 (see paragraphs 6 and 7) also have

[12] Four banks exhibit an LCR below 100 percent using Basel III assumptions on haircuts and potential run-off rates. The combined assets of these banks represent 20.6 percent of total banking system assets.

[13] Interbank assets receive a 50 percent haircut under the domestic liquidity stress test methodology, but 100 percent haircut under Basel III rules.

[14] Moldova is ranked 102 out 177 countries according to Transparency International.

a substantial impact on the effectiveness of supervisory actions. Legal certainty is further undermined by weaknesses in the financial regulation legislation relating to lack of clarity in drafting as well as gaps in coverage. One notable deficiency in the legislation concerns underlying legal protection afforded to the staff of the NBM and NCFM in pursuit of their duties.

36. Institutional architecture to support system-wide financial stability is not fully in place. The National Committee for Financial Stability (NCFS) was created in June 2010, tasked with defining and managing crisis events; but there is not yet an effective and fully operational framework for financial stability policy formulation. While changes to the mandate of the NCFS may be needed, it is important that the members of the NCFS and the technical subcommittee, as appropriate, can make independent decisions related to their areas and functions as designated in legislation.

37. Crisis coordination should be supplemented by consistent system-wide assessment during non-crisis periods. Some stability analysis is carried out at individual institutions, including the NBM and NCFM, but transparency and coordination between individual authorities and institutions need to be enhanced. A specific body, for example, a Council of National Regulators chaired by the NBM, should be granted a mandate for the regular exchange of information between financial regulators and to perform system-wide financial stability assessments.

B. Banking Supervision

38. The NBM has made significant progress in reinforcing its prudential and supervisory framework and has taken several initiatives to address a number of key recommendations from the 2008 FSAP. Interviews with NBM staff showed a strong professionalism within the Banking Regulation and Supervision Department (BRSD) and strong awareness of deficiencies in the banking sector. The quality of internal analysis is high and the inspection reports are also noteworthy. However effective banking supervision is still handicapped by a series of external and internal factors.

Developments and enhancements in supervision

39. The NBM has designed two successive medium-term strategies since 2008 to set a forward-looking approach for supervision.[15] Moldova is also in the process of transitioning from Basel I to Basel II and has tightened capital requirements to increase banks' resilience. In the context of an Association Agreement to be signed with the European Union,[16] the NBM plans to implement the standard approach for credit, market, and operational risk under Basel II as well as other elements of Basel III.

[15] The second spans 2013–17.

[16] European Neighborhood and Partnership Instrument," Strengthening the NBM's capacity in the field of banking regulation and supervision in the context of Basel III requirements."

40. The NBM has enhanced both regulations and practice of on-site supervision. The NBM has also adopted new regulations and recommendations in key areas. The stress-testing framework has been improved, and regulations on asset classification and equity holdings in banks were enhanced as well as recommendations on anti-money laundering and combating the financing of terrorism (AML/CFT). Banks' accounting and reporting standards have benefited from the recent adoption of IRFS. Efforts have been made to increase transparency in banks' ownership and control structure, to devise methodologies for identifying vulnerabilities in the banking sector and for conducting AML/CFT on-site inspections.[17]

Outstanding weaknesses and vulnerabilities

41. NBM powers have been seriously hampered in many respects. Amendments to NBM regulations by the Ministry of Justice (MOJ) undermine the NBM's autonomy and create delays, sometimes up to a year. NBM recommendations are not binding instruments. Further, as noted above, all actions and decisions of the NBM, with the exception of revocation of license and bank liquidation, can be challenged in court and suspended pending decision on the case. Despite amendments to the LNBM, there are still concerns about the capacity of the NBM to take prompt corrective measures in the area of supervision, not least given the recent suspension of parts of the NBM's revised regulation on large exposures.

42. The law needs to provide greater independence and protection to the NBM. The conditions for dismissing the governor and other board members are unclear and the LNBM permits political interference. NBM board members and employees, including staff appointed as a bank's liquidator, have insufficient protection against lawsuits while discharging their duties in good faith. Lastly, staff does not receive any legal assistance in case of lawsuits. Draft legislation to address this issue is with parliament, but there are indications that the provision of enhanced legal protection for NBM staff may be postponed or compromised as a quid pro quo for restoring the NBM's legal powers which were weakened by the CC ruling.

43. Enforcement of prudential regulations should be more forceful, and the current legal regime contains serious limitations and flaws. While the NBM has pursued multiple infringements over recent years, it has not acted forcefully when faced with persistent deficiencies - although this may reflect inhibitions due to lack of effective legal protection. Existing legal sanctions may not be dissuasive enough, particularly when it comes to fines. Lastly, the timescale for action is inappropriately short. Under the NBM law[18] the NBM must pursue sanctions within 3 years of the violation and the process must be completed within 6 months.

44. Non-transparency of banks' ownership and control structure is a major concern with cascading effects in several areas. Despite enhanced regulations, internal processes, and

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[17] With the technical assistance of the U.S. Treasury.

[18] Article $75^2(4)$

reporting mechanisms most recent changes in ownership of Moldovan banks have been conducted in an opaque manner and were not subject to NBM scrutiny. As a result, undisclosed "raiders" acting in concert have been able to acquire or accumulate significant controlling stakes in banks which can impact the nature of the banks' business and, potentially, their safety and soundness. Supervision of related-party lending and large exposure limits cannot be effective if the identity of the UBOs is disguised, and banks may thus be exposed to excessive concentration risks.

45. The risk management culture is very poor, insufficiently supported by regulatory standards, and compliance functions in banks are almost nonexistent. Although the NBM has issued some regulations addressing elements of risk management, there are notable gaps, such as market risk and an over-arching risk management framework. Practice within banks is variable and the quality of implementation is doubtful. The independence and effectiveness of internal audit has also been questioned. Similar concerns about risk management exist for other financial institutions, particularly in the insurance sector.

46. Although Parliamentary approval of the National Strategy to combat Money Laundering/Terrorist Financing is a significant advance, and the intensity of supervision largely meets the BCP standards, AML/CTF issues warrant close scrutiny. The AML/CFT unit of the NBM seems to be understaffed; and difficulties in identifying UBOs together with weak compliance functions call into question the effectiveness of the AML/CFT preventive measures, including customer due diligence applied by banks, and so expose the financial sector to significant money laundering risks. Two issues demand maximum attention: cross-border transactions and transactions with Transnistria, where flows of funds of MDL 1 trillion and MDL 2 billion respectively have been identified.[19] In each case the potential for tax evasion and Money Laundering/Terrorism Financing (ML/TF) is high. Against this background, it is essential to increase the intensity of AML/CFT supervision of banks including targeted, risk-based on-site inspections.

47. Banking supervision would benefit from increased resources. Given the demands of problematic banks and future efforts needed to migrate the banking system to EU requirements and Basel II/III standards, current staffing and skill levels are insufficient. Moreover, in the absence of a clear and sufficient budget allocated to supervision, effective forward planning is frustrated.

C. Insurance Supervision

48. The 2007 Law on Insurance and the transfer of supervision to NCFM has strengthened regulation, but much remains to be done. Few of the Insurance Core Principles (ICPs) are fully met, with better performance in the establishment of the NCFM, licensing, oversight of

[19] Transnistria is a region of Moldova designated as an autonomous territorial unit with special legal status. It has been de facto independent of the Moldovan government for nearly 20 years, but is unrecognized by any United Nations member state. From an AML/CFT standpoint, the lack of authority and of reporting led the Moldovan authorities to declare every transaction between Moldovan and Transnistrian banks to be suspicious.

intermediaries and consumer protection. Shortcomings arise from a lack of effective regulatory powers, lack of transparency in ownership impacting supervision of change of control, limited cooperation and coordination especially with respect to the expectations for supervision of groups, and risk management and governance.

49. The restoration of the NCFM's powers to supervise the insurance sector and other sectors under its authority is crucial and urgent. Ensuring the credibility of the regulatory regime will rely on transparent and sustained enforcement of laws and regulations. The sector's transparency, risk management capacity, public awareness and trust all require improvement. The restoration of NCFM powers, avoiding court suspension of decisions, is an essential element.

50. The insurance law is dependent on enabling regulations. NCFM initiatives have strengthened the solvency and provisioning requirements and practices of insurers, reinforced the role of actuarial advice, improved financial reporting and introduced International Financial Reporting Standards (IFRS). The NCFM's progress however also reflects the constraints in conditions (discussed in the section on Conditions for Effective Supervision, above), the nature, scale and complexity of the sector, and sector capacity.

51. The planned transition to risk-based supervision should address many current shortcomings. The NCFM has recently made a decision to move from a pure compliance approach to a more risk-based methodology. Implementation will need to be phased given the technical capacity constraints but improvements in supervision of governance, internal controls, suitability of key persons, risk management, and capital assessment, would seem areas for early gains.

52. Group supervision, particularly operational level cooperation and communication with other supervisors, is a priority. The NCFM has few MOUs with supervisors outside Moldova and does not proactively engage with such supervisors despite growing complexity of ownership structures with non-domestic linkages.

53. Although the resolution and wind-up processes are operational, the arrangements for the compensation scheme remain incomplete. The insurance law includes provision for a compensation scheme which has not yet been implemented and should be acted upon.

CRISIS MANAGEMENT AND SAFETY NETS

A. Financial Stability Framework and Crisis Management

54. Moldova has made progress in strengthening its financial crisis resolution framework. The NCFS was established in June 2010 by the Government to promote a coordinated framework for responding to a financial crisis. It is chaired by the Prime Minister and comprises: the Government; the Parliamentary Commission on Economy, Budget and Finance; the NBM; Ministry of Finance (MOF); the Ministry of the Economy; the Deposit Guarantee Fund (DGF); and the NCFM.

55. Some of the laws required for bank crisis resolution are in place. In particular, the LFI provides the NBM with a range of powers. These include the ability to place a bank under special supervision, the power to give binding directions to a bank in certain circumstances, and the ability to appoint a special administrator to assume control of a bank. Once a bank is in administration, the NBM has a number of resolution options, including facilitating recapitalization, transferring some or all of its business to another bank, and liquidation. In addition, the NBM Law permits emergency lending to solvent banks, against collateral, while NBM regulations and guidelines specify the procedures and terms for any such lending. If the NCFM determines that a systemic problem has arisen, the NBM may lend against a government guarantee instead of collateral.

56. Nevertheless, there are gaps and deficiencies in the framework which warrant high priority. These fell into three broad categories: legal powers; crisis resolution strategies and procedures; and cross-agency crisis resolution capacity and coordination. Moreover, the concentration of large (de facto connected) banks gives rise to a potential too big to fail problem, compounded by the lack of viable alternatives to government-funded bailout under existing resolution arrangements.

Legal powers

57. Deficiencies in the LFI limit the options for responding to a banking crisis and potentially hinder timely resolution. Although the LFI empowers the NBM to issue directions to a bank, there is uncertainty as to the scope of the direction power, including the NBM's ability to require a bank to restructure its business to enable a least-cost resolution (e.g., through pre-positioning for the separation of systemically important business functions). Moreover the direction powers apply only to banks, not their subsidiaries. The same limitation applies to the powers of a special administrator. This could impede a timely and effectively group resolution if important business functions are located in subsidiaries. The inability to appoint a special administrator to a subsidiary also means that the moratorium protection under administration does not apply to subsidiaries.

58. There is uncertainty in the scope and protections associated with business transfer powers. Although the LFI permits the transfer of business for a bank under administration, it is unclear whether the power applies to all of a bank's contractual rights and obligations, IT systems, and staffing contracts. There is also uncertainty as to whether a transfer of business could trigger rights of termination of contracts by counterparties, given that there is no statutory override to such contractual provisions.[20] Indeed, there is a considerable risk that the appointment of a special administrator would trigger the termination or close-out of financial contracts and the exercise of set-off rights by counterparties.

[20] The preferred approach, consistent with the FSA Key Attributes, is for early termination rights to be subject to a temporary stay (no more than two days).

59. A major concern relates to the risk of judicial challenges to the exercise of resolution powers. This is particularly the case with the exercise of direction powers, the appointment of a special administrator, and the restructuring of a bank under administration.

60. There are other significant deficiencies in legal powers for resolution. It is unclear that the NBM, or MOF, has the legal authority to establish a bridge bank or any other legal entity for resolution purposes. Moreover, the LFI includes no specific power to implement a bail-in, neither are there statutory powers to enable the government to provide funding, guarantees, or indemnities quickly (without prior Parliamentary approval). These deficiencies further impede the ability to implement an effective and timely resolution.

Crisis resolution strategies and procedures

61. Although the NBM has made progress, there are substantial gaps in crisis resolution strategies and procedures. To date, general resolution options have not been adequately identified. Resolvability assessments of systemically important banks have not yet been undertaken, and there are no bank-specific resolution plans in place. No internal guidance has been developed to assist in the rapid assessment of bank solvency: although the NBM's stress testing methodology would be of some assistance in this context, it is not a substitute for a proper asset quality review. While the NBM has issued guidance on providing liquidity support to banks, there has been little consideration given to the legal and process aspects necessary to enable the NBM to take collateral (other than government or NBM securities).

62. A contingency plan for crisis resolution covering all elements of the resolution process is urgently needed. This plan needs to include solvency assessments, systemic impact assessment of different resolution options, resolvability assessments, and bank-specific resolution plans. It also requires a renewed focus by the NBM on banks' recovery plans and banks' capacity to implement recovery actions quickly and credibly in the event of a banking crisis.

63. Each relevant agency needs to take responsibility for and develop resolution plans. The MOF would be responsible in particular for recapitalization or funding or guarantee arrangements provided by the government. The DGF also needs to strengthen plans to facilitate prompt pay-out and to access funding from the MOF if required. The NCFM needs resolution plans to enable it to respond quickly and decisively to the distress or failure of institutions under its jurisdiction. All of these resolution plans need to be coordinated under the framework provided by the NCFS.

Coordination and capacity building

64. The NCFS MOU provides a helpful framework for coordination; there is a need for further capacity-building on crisis resolution across the agencies. Some progress towards developing a coordinated approach to resolution has been made through the meetings of the NCFS Technical Sub-Committee. A much more intensive process of regular, collegial interagency coordination is needed at senior management and working levels. A crisis resolution exercise held across some member agencies after the FSAP mission should be followed by the development of a program of regular crisis testing, both within each agency and across the all agencies via the NCFS.

B. Deposit Insurance

65. **The DGF established in 2004, has dealt effectively with two recent bank failures.** It has a paybox mandate focused on depositor reimbursement, although it may also provide financial assistance on a least-cost basis. Membership is compulsory for all banks, but coverage is limited to MDL 6,000 (USD 445) per depositor (but not legal entities) per bank; foreign currency deposits as well as MDL deposits are covered. A variety of funding mechanisms is in place and a fund equal to 7.1 percent of insured deposits has been accumulated.

66. **The coverage limit should be raised to increase depositor protection and better contribute to financial stability.** The coverage limit, defined in law, is very low (i.e., 72 percent of individual depositors and 8 percent of the total value of deposits). Prior to changing the coverage limit, a thorough analysis should be undertaken on the impact of raising coverage on (i) the proportion of depositors and the total value of deposits covered; (ii) fund adequacy; and (iii) required premiums. Any increase in coverage should come after the banks complete paying special assessment obligations related to an existing bank resolution, in 2015.

67. **A target fund methodology and greater assurance of back-up funding should be developed.** The DGF utilizes an ex-ante funding model with the ability to charge ex post assessments. The existing fund size appears adequate and would allow for the payout of the six smallest banks combined or a single medium-sized bank. However, there is no methodology to establish target funding ratios. Emergency back-up liquidity funding can be obtained from special premium assessments on banks or borrowing from the MOF, which requires parliamentary approval. Consideration should be given to (i) providing the DGF with a pre-defined line-of-credit from the MOF; and (ii) amending the DGF and NBM laws to include the NBM as an additional source of emergency liquidity back-up funding.

68. **The DGF and those working on its behalf require legal protection and appropriate codes of conduct/ethics.** Conflict-of-interest codes for DGF staff need to be made comprehensive.

69. **Enhanced information sharing would improve payout performance.** Information sharing and coordination arrangements (through legislation and MOUs) have been developed between the DGF and the NBM. The reimbursement period, which ranges from 17–30 days for the majority of depositors, could be reduced by legal clarifications to provide the DGF with access to more detailed information and the ability to verify such information on-site. In addition, the DGF Law should be amended to allow the DGF to share information related to deposit insurance with insurers in other jurisdictions, subject to appropriate confidentiality provisions.

70. **The creditor ranking of the DGF in an insolvency is too low.** The DGF has a lower status as a creditor in an insolvency than other unsecured creditors, leading to low or nonexistent recoveries for the DGF from failed banks.

DEVELOPMENT AND MARKET STRUCTURE

A. Financial Market Infrastructure

71. The legal framework for FMIs needs to be strengthened. Apart from efforts to adopt settlement finality and financial collateral rules in line with international standards, there is also a need to fully dematerialize the transfer of corporate securities rather than require the intervention of the registrar.

72. CSD reform efforts require a strategy and should include a cost analysis. A four part approach could be considered, starting with the establishment of a Working Group on CSD Reform, co-chaired by the NBM and NCFM, formed under the National Payments Council (NPC). Cost analysis should assess the economic feasibility of different approaches to a single CSD. Third, the financial and risk management and capital adequacy of the private sector should be assessed. Finally, the working group should develop a well-sequenced reform strategy, approved by the NPC, to guide implementation and minimize industry impact.

73. The planned transfer of corporate securities registration into a single CSD is an incremental change that should aim for full consolidation. The NCFM plans, using CML amendments, to consolidate the registration system for corporate securities issued by PIEs (primarily financial intermediaries) and traded on the stock exchange into a single CSD. The exclusion of nonpublic interest entities (i.e. over half of all registered JSCs) from mandatory transfer to the new CSD hampers efforts to prevent fraud risks. The NCFM should weigh the benefits of detecting fraud against the cost of moving additional securities to the planned new CSD. In the interim, the authorities could strengthen oversight by increasing the frequency of registrar inspections.

74. Loss-sharing mechanisms should be considered in the move from a registrars-based system to a fully dematerialized system for all securities' transfers. As the process of reconciling securities records could reveal possible data inconsistencies (more securities recorded than securities effectively issued), loss-sharing arrangements could appropriately be organized ex ante, whether using pro-rata loss allocation or the investors' protection fund.

B. Insolvency and Creditor/Debtor Regime

75. A range of improvements to the insolvency regime would support the preconditions necessary for effective financial supervision and stability. The insolvency process, including access to court records, should be more transparent to the public. The system for judicial appointment and supervision lacks adequate assurances for integrity and credibility and the judicial system for managing insolvency proceedings is not perceived as reliable. Administrators and liquidators lack sufficient independence, training and supervision.

76. Moldova has enacted far-reaching reforms for the regulation of credit and insolvency regimes. Yet continuing challenges remain. There is limited use of restructuring techniques when debtors experience financial distress and there is very limited use of out-of-court collective restructuring tools. While lending by financial institutions is largely secured, use of financial collateral is undermined by issues in the operation of share registries, as described in other parts of this report, which severely constrain the use of pledges over shares as a viable form of collateral for lending. Moreover, the regime for secured transactions over movable assets requires improvement as there is lack of confidence in taking security over pools of assets. Overall, there is little unsecured credit for enterprises, and secured lending against certain important types of movable assets (inventory, receivables) is rare. While the mortgage regime works well, the regime for secured transactions over movable assets, although modern, needs improvement. The current project to reform the law of pledge should allow improvements in registration and enforcement.

Appendix I. Financial System Structure

Figure 1

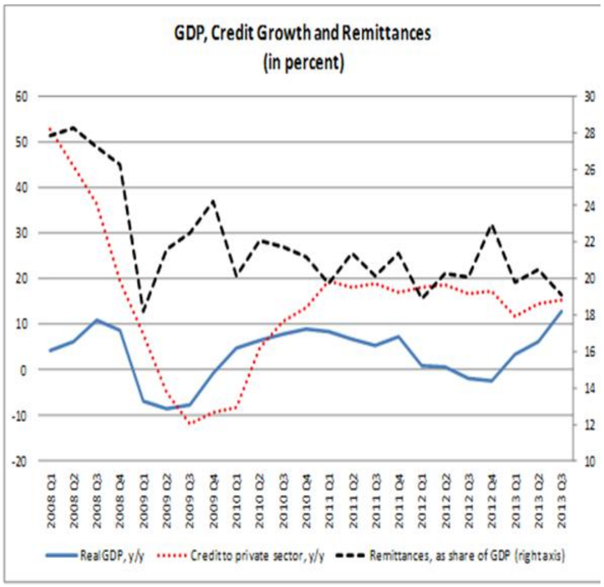


Figure 2

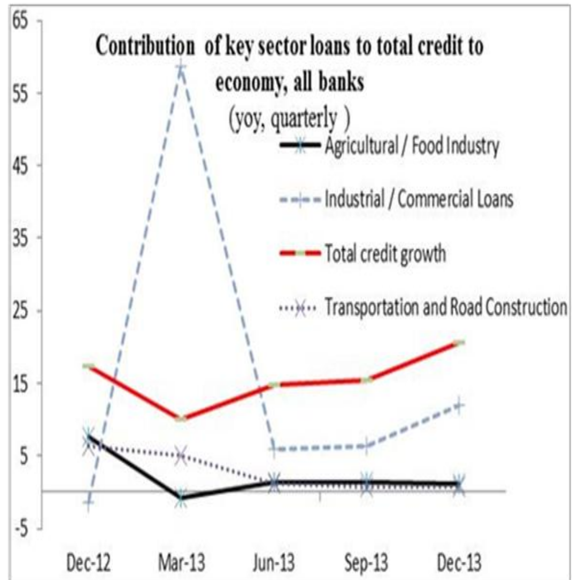
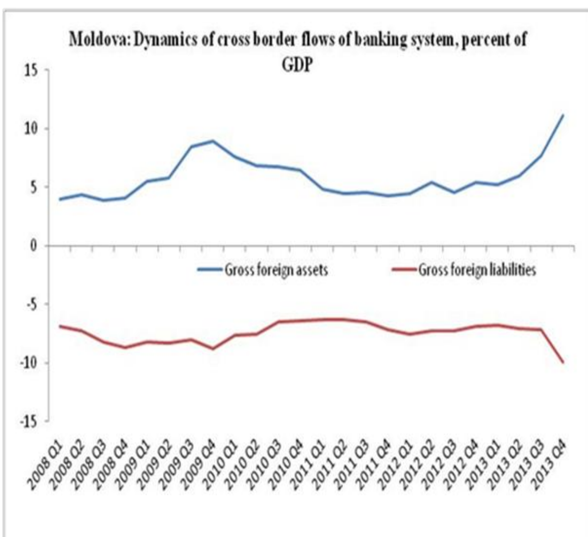


Figure 3



Appendix II. Selected Indicators and Summary Stress Test Results

Table 1. Financial Soundness Indicators, 2009–13

	Dec-09	Dec-10	Dec-11	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Size								
Number of banks	15.0	15.0	15.0	14.0	14.0	14.0	14.0	14.0
Total bank assets (billions of lei)	39.9	42.3	47.7	58.3	59.9	63.5	69.1	76.2
Total bank loans (percent of GDP)	0.0	35.5	36.2	39.6	35.3	38.1	39.4	42.5
Total bank assets (percent of GDP)	0.1	58.9	57.9	66.1	60.4	64.0	69.7	76.8
Capital adequacy								
Total capital (billions of lei)	6.9	7.3	8.1	10.2	10.2	10.7	11.1	11.4
Capital adequacy ratio	32.3	30.1	30.4	24.8	25.4	23.3	23.3	23.3
Liquidity								
Liquid assets (billions of lei)	15.3	14.4	15.8	19.2	19.8	19.8	22.3	25.7
Total deposits (billions of lei)	24.4	28.7	32.6	39.8	40.5	43.6	46.1	51.8
Liquidity ratio (liquid assets in percent of total deposits)	62.6	50.3	48.5	48.2	49.0	45.4	48.4	49.6
Liquid assets in total assets	38.3	34.2	33.2	32.9	33.1	31.2	32.3	33.8
Asset quality								
Gross loans (billions of lei)	22.4	25.5	29.8	35.0	35.0	37.8	39.1	42.18
Nonperforming loans (billions of lei)	3.7	3.4	3.2	5.1	4.6	4.8	4.9	4.9
Substandard		2.3	2.4	1.7	1.6	1.4	1.4	1.6
Doubtful		1.0	0.7	2.2	1.5	1.6	1.5	1.2
Loss		0.1	0.1	1.1	1.5	1.8	1.9	2.1
Loan loss provisions (billions of lei)	2.2	2.1	2.1	3.7	3.7	3.9	4.0	4.1
Nonperforming loans as a share of total loans	16.3	13.3	10.7	14.5	13.0	12.7	12.4	11.6
Substandard	9.6	8.9	8.0	5.0	4.5	3.7	3.7	3.7
Doubtful	6.5	3.9	2.2	6.4	4.3	4.2	3.8	3.0
Loss	0.2	0.6	0.5	3.2	4.3	4.8	4.9	4.9
Provisions to non-performing loans	59.2	63.2	65.0	73.5	80.4	80.5	82.3	83.6
Loan-loss provisioning/gross loans	9.7	8.4	6.9	10.7	10.5	10.2	10.2	9.7
Profitability								
Return on equity	-2.1	3.0	11.5	5.6	10.9	9.3	10.5	9.4
Return on assets	-0.4	0.5	2.0	1.1	1.9	1.6	1.8	1.6
Foreign currency assets and liabilities								
Total liabilities (billions of lei)	33.0	35.0	39.6	48.1	49.8	52.8	57.9	64.8
Foreign currency liabilities (billions of lei)	17.1	17.7	20.0	23.5	24.0	25.5	29.3	33.0
Foreign currency denominated liabilities in total liabilities	51.7	50.7	50.4	48.9	48.2	48.3	50.6	51.0
Foreign currency denominated assets	0.0	17.2	19.3	23.8	24.4	26.2	28.9	34.1
Foreign currency denominated assets in total assets	40.2	40.8	40.5	40.9	40.7	41.3	41.9	44.7
Foreign currency deposits in total deposits	49.3	45.6	42.2	40.2	40.3	39.1	43.1	44.7
Foreign currency denominated loans in total loans	44.7	42.3	44.5	42.6	43.4	42.9	42.8	40.4

Source: National Bank of Moldova.

GDP (millions of lei)	60,430	71,849	82,349	88,228	99,173	99,173	99,173	99,173

Table 2. Selected Economic Indicators, 2009–19 1/

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Prel.			Projection			
I. Real sector indicators					(Percent change, unless otherwise indicated)						
Gross domestic product											
Real growth rate	-6.0	7.1	6.8	-0.7	8.9	2.2	3.5	4.0	4.0	4.0	4.0
Agricultural	-9.9	7.4	5.2	-20.1	40.6	0.0	4.0	4.0	4.0	4.0	4.0
Non-agricultural	-5.6	7.1	7.0	2.0	4.9	2.5	3.4	4.0	4.0	4.0	4.0
Demand	-15.1	9.2	8.3	0.4	6.2	2.1	2.4	2.6	3.2	3.2	3.3
Consumption	-6.9	7.3	7.5	0.9	5.2	2.8	3.0	2.8	3.1	3.2	3.2
Private	-8.0	9.6	9.4	1.0	6.5	1.9	1.9	2.6	2.9	3.1	3.1
Public	-2.0	-1.1	-0.7	0.6	-0.8	7.2	8.3	3.5	3.7	3.9	4.0
Gross capital formation	-30.9	17.2	13.0	1.8	3.3	3.8	2.2	1.5	4.0	2.7	3.4
Private	-32.1	18.5	11.3	-3.9	-3.7	0.5	1.0	3.5	4.0	4.0	4.0
Public	-26.4	12.4	19.3	21.6	22.4	11.0	4.5	-2.2	4.1	0.2	2.2
Nominal GDP (billions of Moldovan lei)	60.4	71.9	82.3	88.2	99.9	108.7	118.8	130.6	143.3	156.6	171.1
Nominal GDP (billions of U.S. dollars)	5.4	5.8	7.0	7.3	7.9	7.6	8.1	8.7	9.2	9.8	10.4
Consumer price index (average)	0.0	7.4	7.6	4.6	4.6	5.7	6.0	6.3	5.8	5.3	5.0
Consumer price index (end of period)	0.4	8.1	7.8	4.0	5.2	5.4	6.5	6.0	5.5	5.0	5.0
GDP deflator	2.2	11.1	7.3	7.9	4.0	6.5	5.6	5.7	5.5	5.1	5.0
Average monthly wage (Moldovan lei)	2,748	2,972	3,194	3,478	3,765	4,080	4,450	4,880	5,330	5,820	6,355
Average monthly wage (U.S. dollars)	247	240	272	287	299	286	304	325	344	364	387
Unemployment rate (annual average, percent)	6.4	7.4	6.7	5.6	5.1	6.0	5.8	5.6	5.5	5.5	5.5
Saving-investment balance					(Percent of GDP)						
Foreign saving	9.5	9.6	12.3	7.7	5.5	7.4	8.2	8.1	8.0	7.9	7.7
National saving	13.1	13.0	11.0	16.0	17.1	16.0	14.8	14.3	14.4	14.3	14.3
Private	14.8	10.4	8.1	11.7	11.7	10.6	11.5	11.7	12.1	11.9	11.9
Public	-1.7	2.6	2.9	4.3	5.3	5.4	3.3	2.6	2.4	2.3	2.4
Gross investment	22.6	22.6	23.3	23.6	22.6	23.3	23.0	22.4	22.4	22.2	22.0
Private	17.6	17.9	18.1	17.4	15.5	15.5	15.1	15.0	15.0	15.0	15.0
Public	5.0	4.8	5.2	6.3	7.1	7.9	7.9	7.4	7.4	7.2	7.1
II. Fiscal indicators (general government)											
Primary balance	-5.1	-1.8	-1.6	-1.4	-1.3	-1.9	-3.9	-4.0	-4.0	-3.7	-3.4
Overall balance	-6.3	-2.5	-2.4	-2.2	-1.8	-2.6	-4.6	-4.8	-5.1	-4.8	-4.7
Stock of public and publicly guaranteed debt	32.4	30.5	29.0	31.1	29.9	31.8	32.8	34.7	36.7	39.4	41.5
III. Financial indicators					(Percent change, unless otherwise indicated)						
Broad money (M3)	3.2	13.4	10.6	20.8	26.5	15.9	16.4	...	...	...	...
Velocity (GDP/end-period M3; ratio)	1.8	1.9	2.0	1.8	1.6	1.5	1.4	...	...	...	...
Reserve money	-10.1	15.9	18.4	22.9	31.9	13.4	14.0	...	...	...	...
Credit to the economy	-4.9	12.7	15.0	16.1	18.8	11.3	11.4	...	...	...	...
Credit to the economy, percent of GDP	39.5	37.4	37.6	40.7	42.7	43.7	44.6	...	...	...	...
IV. External sector indicators					(Millions of U.S. dollars, unless otherwise indicated)						
Current account balance	-516	-559	-863	-559	-438	-564	-662	-700	-737	-774	-806
Current account balance (percent of GDP)	-9.5	-9.6	-12.3	-7.7	-5.5	-7.4	-8.2	-8.1	-8.0	-7.9	-7.7
Remittances and compensation of employees (net)	1,124	1,273	1,549	1,745	1,913	1,864	1,839	1,892	1,950	2,010	2,073
Gross official reserves	1,480	1,718	1,965	2,515	2,820	2,751	2,621	2,599	2,551	2,511	2,409
Gross official reserves (months of imports)	3.9	3.4	3.9	4.7	5.0	4.7	4.3	4.0	3.7	3.4	3.1
Exchange rate (Moldovan lei per USD, period avge)	11.1	12.4	11.7	12.1	12.6	...	...	...	...	...	...
Exchange rate (Moldovan lei per USD, end of period)	12.3	12.2	11.7	12.1	13.1	...	...	...	...	...	...
Real effective exch.rate (average, percent change)	5.4	-7.4	5.3	4.5	-3.4	-3.5	0.4	0.8	0.3	0.0	0.0
External debt (percent of GDP) 2/	80.2	82.0	77.6	82.5	83.6	90.0	87.8	86.2	84.9	84.2	82.3
Debt service (percent of exports of goods and services)	20.1	17.6	15.7	15.6	17.5	18.6	19.5	22.5	21.2	22.4	24.1

Sources: Moldovan authorities; and IMF staff estimates.

1/ Data exclude Transnistria.

2/ Includes private and public and publicly guaranteed debt.

Table 3. Macroeconomic Projections in the Stress Tests Scenarios

	mean*	s.d.*	2007	Historical 2008	2009	2010	2011	2012	2013	2014	Projection 2015	2016	2017	2018	"instantaneous shock"
Baseline scenario:															
Real GDP growth (%)	**3.2**	**5.0**	3.0	7.8	-6.0	7.1	6.8	-0.8	5.5	4.0	5.0	5.0	5.0	5.0	**4.0**
Agriculture GDP growth (%)	**0.6**	**17.3**	-35.0	41.1	-9.9	7.4	5.2	-23.3	*23.0*	1.8	5.0	5.0	5.0	5.0	**1.8**
Non-agriculture GDP growth (%)	**4.1**	**5.9**	12.8	2.8	-5.2	7.0	7.1	3.5	3.3	4.3	5.0	5.0	5.0	5.0	**4.3**
CPI inflation (%)	**12.0**	**9.6**	12.4	12.8	-0.1	7.5	7.7	4.5	4.5	4.6	5.6	5.8	5.0	5.0	**5.6**
Interest rates:															
Short-term money market rate (%)	**14.2**	**9.1**	12.4	16.0	10.9	5.6	8.4	5.4	6.8	6.9	7.8	8.0	7.3	7.3	**7.8**
Long-term lending rate (%)	**23.0**	**7.1**	18.8	21.1	20.5	16.4	14.4	13.4	12.3	12.8	13.4	13.8	13.3	13.1	**13.4**
Exchange rates:															
MDL/USD	**11.35**	**2.62**	12.09	10.37	11.19	12.38	11.71	12.13	12.60	13.10	13.50	13.80	14.00	14.30	**13.50**
MDL/EUR	**13.61**	**3.58**	16.55	15.25	15.61	16.42	16.30	15.59	16.68	17.34	17.87	18.27	18.54	18.93	**17.87**
MDL/RUB	**0.46**	**0.11**	0.47	0.42	0.35	0.41	0.40	0.39	0.39	0.40	0.40	0.40	0.40	0.41	**0.40**
NEER (increase = appreciation)	**115.5**	**26.0**	95.8	108.1	113.9	103.2	106.4	109.8	107.2	104.4	102.2	100.7	99.8	98.4	**102.2**
REER (increase = appreciation)	**108.4**	**19.7**	111.5	132.8	135.4	127.2	134.7	140.0	137.5	134.3	131.7	131.7	131.7	131.7	**131.7**
Real estate prices:															
NIKA index growth (%)	**18.8**	**23.5**	15.6	14.9	-13.1	-4.1	0.2	-7.4	3.9	1.0	3.4	3.5	2.6	2.1	**1.0**
Unemployment rate (%)	**6.5**	**2.4**	5.2	4.0	6.5	7.6	6.7	5.6	5.9	5.7	5.3	5.0	5.0	5.0	**5.7**
Domestic credit growth (%)	**24.0**	**16.9**	51.7	20.3	-4.9	12.7	15.0	16.1	13.6	12.7	10.9	11.1	10.3	10.3	**12.7**
Alternative scenario 1 - External (I):															
Real GDP growth (%)	**3.2**	**5.0**	3.0	7.8	-6.0	7.1	6.8	-0.8	5.5	-2.2	3.0	5.0	5.0	5.0	**-2.2**
Agriculture GDP growth (%)	**0.6**	**17.3**	-35.0	41.1	-9.9	7.4	5.2	-23.3	23.0	-1.0	3.0	5.0	5.0	5.0	**-1.0**
Non-agriculture GDP growth (%)	**4.1**	**5.9**	12.8	2.8	-5.2	7.0	7.1	3.5	3.3	-2.4	3.0	5.0	5.0	5.0	**-2.4**
CPI inflation (%)	**12.0**	**9.6**	12.4	12.8	-0.1	7.5	7.7	4.5	4.5	5.4	8.9	6.8	5.0	5.0	**8.9**
Interest rates:															
Short-term money market rate (%)	**14.2**	**9.1**	12.4	16.0	10.9	5.6	8.4	5.4	6.8	7.6	10.6	8.8	7.3	7.3	**10.6**
Long-term lending rate (%)	**23.0**	**7.1**	18.8	21.1	20.5	16.4	14.4	13.4	12.3	11.9	17.3	15.1	13.3	13.1	**17.3**
Exchange rates:															
MDL/USD	**11.35**	**2.62**	12.09	10.37	11.19	12.38	11.71	12.13	12.60	14.62	15.63	15.98	16.21	16.56	**15.63**
MDL/EUR	**13.61**	**3.58**	16.55	15.25	15.61	16.42	16.30	15.59	16.68	19.36	20.70	21.16	21.46	21.92	**20.70**
MDL/RUB	**0.46**	**0.11**	0.47	0.42	0.35	0.41	0.40	0.39	0.39	0.41	0.42	0.42	0.42	0.42	**0.42**
NEER (increase = appreciation)	**84.9**	**22.5**	95.8	108.1	113.9	103.2	106.4	109.8	107.2	95.8	91.4	90.1	89.2	87.9	**91.4**
REER (increase = appreciation)	**108.4**	**19.7**	111.5	132.8	135.4	127.2	134.7	140.0	137.5	123.8	119.9	120.4	120.4	120.4	**119.9**
Real estate prices:															
NIKA index growth (%)	**18.8**	**23.5**	15.6	14.9	-13.1	-4.1	0.2	-7.4	3.9	-7.2	0.9	4.4	2.9	2.1	**-7.2**
Unemployment rate (%)	**6.5**	**2.4**	5.2	4.0	6.5	7.6	6.7	5.6	5.9	7.2	7.3	7.0	7.0	7.0	**7.3**
Domestic credit growth (%)	**24.0**	**16.9**	51.7	20.3	-4.9	12.7	15.0	16.1	13.6	3.1	12.2	12.1	10.3	10.3	**3.1**
Alternative scenario 2 - External (II):															
Real GDP growth (%)	**3.2**	**5.0**	3.0	7.8	-6.0	7.1	6.8	-0.8	5.5	**-12.2**	-2.8	6.5	5.8	5.0	**-12.2**
Agriculture GDP growth (%)	**0.6**	**17.3**	-35.0	41.1	-9.9	7.4	5.2	-23.3	23.0	-5.5	-2.8	6.5	5.8	5.0	**-5.5**
Non-agriculture GDP growth (%)	**4.1**	**5.9**	12.8	2.8	-5.2	7.0	7.1	3.5	3.3	-13.1	-2.8	6.5	5.8	5.0	**-13.1**
CPI inflation (%)	**12.0**	**9.6**	12.4	12.8	-0.1	7.5	7.7	4.5	4.5	6.0	14.1	9.3	4.1	4.5	**14.1**
Interest rates:															
Short-term money market rate (%)	**14.2**	**9.1**	12.4	16.0	10.9	5.6	8.4	5.4	6.8	8.1	15.1	11.0	6.5	6.8	**15.1**
Long-term lending rate (%)	**23.0**	**7.1**	18.8	21.1	20.5	16.4	14.4	13.4	12.3	9.9	22.9	19.2	12.3	12.5	**22.9**
Exchange rates:															
MDL/USD	**11.35**	**2.62**	12.09	10.37	11.19	12.38	11.71	12.13	12.60	17.69	21.35	21.10	21.05	21.50	**21.35**
MDL/EUR	**13.61**	**3.58**	16.55	15.25	15.61	16.42	16.30	15.59	16.68	21.40	24.50	24.30	24.26	24.62	**24.50**
MDL/RUB	**0.46**	**0.11**	0.47	0.42	0.35	0.41	0.40	0.39	0.39	0.43	0.46	0.46	0.45	0.46	**0.46**
NEER (increase = appreciation)	**84.9**	**22.5**	95.8	108.1	113.9	103.2	106.4	109.8	107.2	83.7	74.3	74.8	74.9	74.0	**74.3**
REER (increase = appreciation)	**108.4**	**19.7**	111.5	132.8	135.4	127.2	134.7	140.0	137.5	108.6	100.3	103.9	104.7	104.7	**100.3**
Real estate prices:															
NIKA index growth (%)	**18.8**	**23.5**	15.6	14.9	-13.1	-4.1	0.2	-7.4	3.9	-20.7	-6.9	7.9	4.6	1.8	**-20.7**
Unemployment rate (%)	**6.5**	**2.4**	5.2	4.0	6.5	7.6	6.7	5.6	5.9	9.6	11.0	10.4	10.2	10.2	**11.0**
Domestic credit growth (%)	**24.0**	**16.9**	51.7	20.3	-4.9	12.7	15.0	16.1	13.6	-6.9	10.9	16.5	10.1	9.7	**-6.9**

Table 4. Summary of the Solvency Stress Test Results
(In MDL, unless otherwise noted)

	Baseline Scenario		Adverse Scenario 1		Adverse Scenario 2		Adverse Scenario 3	
	Top-Down	Bottom-Up	Top-Down	Bottom-Up	Top-Down	Bottom-Up	Top-Down	Bottom-Up
Actual data as of 30-Sept-2013 - before any shock:								
Total regulatory capital - before shock	7,766	7,766	7,766	7,766	7,766	7,766	7,766	7,766
Total risk-weighted assets (RWAs)	33,376	33,376	33,376	33,376	33,376	33,376	33,376	33,376
Total assets	69,094	69,094	69,094	69,094	69,094	69,094	69,094	69,094
Total regulatory capital-ratio (CAR) - before shock (in percent of RWAs)	**23.3**	**23.3**	**23.3**	**23.3**	**23.3**	**23.3**	**23.3**	**23.3**
Stress test estimated losses after shock:								
Credit risk:								
Changes in provisions due to loan migration	(267)	41	(1,720)	(550)	(5,021)	(1,892)	(2,527)	(821)
Expected gains/losses on government bond holdings due to issuer default risk	(19)	(4)	(32)	(16)	(72)	(47)	(43)	(36)
Expected gains/losses on corporate bond holdings due to issuer default risk	(9)	(1)	(15)	(3)	(31)	(9)	(19)	(7)
Risk related to equity instruments:								
Expected gains/losses on equity instruments	(13)	1	(22)	(1)	(48)	(12)	(29)	11
Market risk:								
Expected gains/losses on interest income	50	48	198	211	432	544	260	295
Expected gains/losses on government bond holding due to interest rate risk	(4)	1	(19)	1	(39)	(5)	(29)	(3)
Expected gains/losses on corporate bond holding due to interest rate risk	(0)	-	(0)	0	(0)	0	(0)	-
Expected gains/losses on net open FX positions	4	4	14	13	68	50	28	33
Total expected losses:	(257)	89	(1,595)	(345)	(4,712)	(1,370)	(2,358)	(528)
Stress test estimated capitalization after shock:								
Total regulatory capital - after shock	7,509	7,855	6,195	7,445	3,054	6,396	5,408	7,238
Total regulatory capital-ratio (CAR) - after shock (in percent of RWAs)	**22.5**	**23.5**	**18.6**	**22.3**	**9.2**	**19.2**	**16.2**	**21.7**
Implied capital shortfall (in percent of GDP) 1/	**0.1**	**0.1**	**0.6**	**0.1**	**2.9**	**0.5**	**1.0**	**0.2**
Number of banks with a CAR below regulatory minimum (16 percent)	**1**	**1**	**5**	**2**	**9**	**6**	**6**	**3**

Source: Individual banks (bottom-up stress tests); IMF staff and NBM staff calculations (top-down stress tests).

Notes: 1/ Implied capital shortfall is the amount of system wide recapitalization needs so that the CAR of each bank in the system is equal to or above 16 percent of risk-weighted assets.

Table 5. Summary of the Liquidity Stress Test Results
(In MDL, unless otherwise noted)

	LCR - MDA 1/	LCR - Basel III 2/	LCR - FX 3/	LCR - CR 4/
Liquid assets	21,941,563,184	17,769,843,907	9,819,595,677	17,769,843,907
Potential outflows	13,130,155,177	16,133,990,538	6,119,226,749	15,743,933,289
System-wide LCR (in percent)	**167.1**	**110.1**	**160.5**	**112.9**
Liquidity shorfall 5/	-	1,631,320,909	1,163,746,596	1,200,733,944
Number of banks with LCR below 100 percent	0	4	4	3

Source: IMF staff and NBM staff calculations.
Notes:
1/ LCR-proxy based on haircut on liquid assets and deposit run-off rate assumptions from the existing NBM methodology.
2/ LCR-proxy based on haircut on liquid assets and deposit run-off rate assumptions suggested in Basel III rules.
3/ LCR-proxy based on haircut on liquid assets and deposit run-off rate assumptions from the existing NBM methodology, to assess FX liquidity.
4/ LCR-proxy, where bank specific haircut on liquid assets and deposit run-off rate assumptions are linked to the results from the solvency stress tests.
5/ Liquidity shortfall is the amount required so that the LCR in each bank in the system is equal or above 100 percent.

Appendix III. Risk Assessment Matrix (Scale—High, Medium, or Low[1])

Source of Risks	Relative Likelihood[2]	Impact if Realized	Policy Response
1. **A sharp increase in geopolitical tensions surrounding Russia/Ukraine that creates significant disruptions in global financial, trade and commodity markets**	**Medium** The intensification of geopolitical tensions related to the developments in Ukraine and any related slowdown of the Russian economy would inevitably worsen the external outlook for Moldova	**High** A disruption of trade routes and gas supply and a decline in remittances could severely impact the economy	• Accelerate diversification of external trade products and markets, and energy sources. • Let the exchange rate adjust to facilitate absorption of the external shock. • Continue prudent macroeconomic policies to further strengthen external buffers; allow automatic fiscal stabilizers full play. • Strengthen monitoring of bank exposures to exchange rate and cross border risks.
2. **Protracted period of slower European growth**	**High** Larger than expected deleveraging or negative surprise on potential growth	**High** Lower export demand (from EU and CIS), falling remittances and other financial flows (e.g., trade credits) would induce lower growth, higher budget deficit, exchange rate pressures, and banking sector difficulties	• Let fiscal automatic stabilizers work. • Let the exchange rate adjust to facilitate absorption of the external shock. • Speed up structural reform to increase competitiveness.
3. **Deterioration of Moldova's banking system soundness e.g. as a consequence of weak governance**	**High** Reemergence of problems at individual banks, and/or soaring system-wide NPLs can undermine the banking system soundness	**High** Credit supply would dwindle, and the government might need to intervene to prevent or resolve bank failures	• Enforce shareholder and beneficial ownership transparency and suitability requirements. • For banks in trouble, intervene in large systemically important ones and liquidate small ones. • Step up anti-corruption and AML/CFT efforts.
4. **Decline in official external financing**	**Low** Budget cuts in Europe or setbacks in Moldova could worsen donor's sentiment and curtail donor aid	**Medium** Scaling down of development projects and budget financing	• In the context of prudent fiscal policy look for alternative funding sources for priority projects.
5. **Political cycle**	**High** Intensifying political competition ahead of the 2014 parliamentary elections could lead to populist initiatives, delaying or reversing structural reforms	**Medium** Deteriorating growth prospects and business climate would harm investment, competitiveness, and defer poverty reduction and would lead to fiscal slippages	• Restore prudent macroeconomic policies. • Accelerate structural reforms.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

[2] In case the baseline does not materialize.

Appendix IV. Stress Testing Matrix (STeM) for Solvency

Domain	Assumptions		
	Bottom-up by Banks (if applicable)	Top-Down by Authorities (if applicable) 1/	Top-down by IMF Team (if applicable) 1/
Institutions included	• All banks (14 banks)	• All banks (14 banks)	
Market share	• Share of total sector assets: 100 percent	• Share of total sector assets: 100 percent	
Data and baseline date	• Supervisory data • Banks' own data	• Supervisory data	
Methodology	• Combination of banks' own models and pre-defined benchmarks.	• IMF stress testing framework (tailor-made for the Moldova FSAP; along the lines of Cihak, 2007); complemented with NBM stress testing models (when applicable).	
Stress test horizon 2/	• 1 year/period (instantaneous shocks).	1 year/period (instantaneous shocks)	
Shocks	• Shocks based on GDP trajectories, and translated in a consistent manner to all other variables in the macro-scenarios. • Three adverse scenarios: moderate external shock (1.25 StD in historical terms); severe external shock (3.25 StD in historical terms; larger output losses than those recorded during the "Russian crisis" and the "global financial crisis"); domestic shock to agriculture sector (2.25 StD for agriculture GDP in historical terms).		
Risks/factors assessed	• Comprehensive coverage of solvency risks: • *Credit risk*: credit risk on loan book; issuer risk on government and corporate bond and other debt instrument holdings. • *Market risk*: interest rate risk impact on net interest income, government and corporate bond and other debt instrument holdings; FX risk. • *Equity investment-related risk* (includes both credit and market risk components).	• Comprehensive coverage of solvency risks: • *Credit risk*: credit risk on loan book; issuer risk on government and corporate bond and other debt instrument holdings. • *Market risk*: interest rate risk impact on net interest income, government and corporate bond and other debt instrument holdings; FX risk. • *Equity investment-related risk* (includes both credit and market risk components). • *Concentration risk* (name concentration risk). • *Contagion risk* (interbank market).	

Domain	Assumptions		
	Bottom-up by Banks (if applicable)	Top-Down by Authorities (if applicable) 1/	Top-down by IMF Team (if applicable) 1/
Calibration of risk parameters	• Loan migration (downgrades) and changes in provisions based on banks' internal models. • Estimation of expected gains/losses on government and corporate bond holdings and equity investments based on banks' internal models.	• Loan migration (downgrades) and changes in provisions based on satellite models. • Estimation of expected gains/losses on government and corporate bond holdings and equity investments based on satellite models (including gap and duration analysis).	
Behavioral adjustments	• Total assets and RWAs assumed constant during "instantaneous shock" (constant balance sheet assumption). • No management actions considered. • No additional income sources, dividends, and taxes are considered.	• Total assets and RWAs assumed constant during "instantaneous shock" (constant balance sheet assumption). • No management actions considered. • No additional income sources, dividends, and taxes are considered.	
Regulatory standards	• Hurdle rates based on regulatory minimum for total capital (minimum CAR of 16 percent). • Basel I rules.	• Hurdle rates based on regulatory minimum for total capital (minimum CAR of 16 percent). • Basel I rules.	
Results	• CAR, shortfall (if applicable). • Pass or fail; percentage of assets that fail.	• CAR, shortfall (if applicable), and buffer changes; system-wide. • Pass or fail (number of banks); percentage of assets that fail.	

Source: IMF staff.

Appendix V. Stress Testing Matrix (STeM) for Liquidity

Domain	Assumptions		
	Bottom-Up by Banks	Top-Down by Authorities	Top-down by IMF
Institutions included	• N/A	• All banks (14 banks)	
Market share		• Percent of total sector assets: 100	
Data and baseline date		• Supervisory data	
Methodology		• Basel III LCR-type proxies, based on NBM existing liquidity stress test framework, following the methodology proposed by Csajbok, A. (2003), World Bank TA report. • Liquidity tests by currency.	
Risks		• Market liquidity • Maturity and currency mismatches.	
Regulatory standards		• Liquidity ratio (“Second Principle of Liquidity”): liquid assets should exceed 20 percent of total assets. • LCR proxy should exceed 100 percent (not a legal requirement).	
Results		• Pass rate, remaining buffers, and liquidity shortfall (if applicable); system-wide.	

Source: IMF staff.

Annex I. Report on the Observance of Standards and Codes—Basel Core Principles—Summary Assessment

A. Overview of the Institutional Setting and Market Structure[1]

1. The financial sector in Moldova is dominated by banks. The banking sector comprises 14 commercial banks with assets equivalent to about 77 percent of GDP—small compared with its neighboring peers. The structure of the Moldovan banking system is based on universal banking.

2. There is a high degree of interconnectedness on the interbank market and significant exposure to Russian banks. In effect, cross-border financial linkages have increased dramatically since 2011 and have become more complex. During this period foreign placements of the Moldovan banking system almost doubled as a percent of GDP, while foreign liabilities increased by more than 50 percent. The increased interconnectedness, particularly in the context of geographical and historical factors, and increasing bank governance problems, makes the Moldovan banking system prone to systemic risks.

3. There is significant concentration in the banking system at the end of December of 2013. Out of 14 operating banks, the largest 6 banks (Peer group 1) hold about 77 percent of total assets, 74 percent of outstanding loans and 77 percent of deposits. In contrast the three smallest (Peer group 3) hold three percent of total assets.

4. Foreign ownership appears to dominate and there is considerable sectoral concentration in credit. Almost 72 percent (end 2013) of the capital in the banking system is reported to be in foreign ownership—0.5 percent more than in 2012—but this feature reflects disguised ownership of banks. There are 7 banks with majority foreign shareholding, out of which four are subsidiaries of foreign banks. At the end of December 2013 these foreign subsidiaries represent about 17 percent of total banking sector assets. These subsidiaries are principally operations of European banks, with the largest presence held by French and Italian banks. Bank credit is concentrated in the corporate sector, representing 88 percent of loans at the end of 2013, and funded by local deposits. Loans to households are primarily consumer loans.

5. The sector wide average rate of nonperforming loans (NPLs), at 11.6 percent at the end of 2013, is trending down since 2012 but disguises a wide variation in individual bank portfolios. Specific banks have NPL ratios exceeding 60 percent of total loans. Additionally, very sharp volatility in NPLs has been witnessed in certain banks, reflecting banks' attempt to manage the situation with the use of collateral, both by requiring the lodging of cash collateral and by allocating residential property as collateral against loans showing signs of distress.

[1] This Report has been prepared by Pierre-Laurent Chatain, World Bank and Lucretia Paunescu, IMF (consultant) in the context of an FSAP assessment led by Simon Gray, IMF, and Brett Coleman, World Bank, and was overseen by the Monetary and Capital Markets Department, IMF, and the Financial and Private Sector Development Vice Presidency, World Bank

6. Liquidity and capital adequacy ratios of Moldovan banks are high based on reported prudential data. In December 2013, the aggregate capital adequacy ratio (CAR) stood at 23.4 percent, above the required minimum of 16 percent, with both liquidity ratios (0.7 for long-term liquidity and 33.8 percent for short-term liquidity) within the required limits (1 for long term liquidity ratio and 20 percent for short-term liquidity ratio). The CAR might be inflated due to the fact that risk excess is not deducted from eligible capital (for example risks related to large exposures and related parties from undisclosed ultimate beneficial owners). Also, NPLs net of provisions as a percentage of regulatory capital were 16.6 percent. As the NBM is still using the Basel 1 framework for capital adequacy, there are limited options for recognizing the impact of collateral practices in the capital ratios but it is clear that reported capital adequacy depends heavily on collateral being in place and the solvency of the banks in some cases may be heavily dependent on the ability to execute such collateral successfully. Liquidity risk is hard to measure, however, as in some cases the high reported level of liquid assets appears unreliable: some assets may be encumbered through undisclosed side agreements.

II. Preconditions for Effective Supervision

Financial stability framework

7. The NBM is exclusively responsible for the licensing, supervision and regulation of the (bank) financial institutions' activity. Its main responsibilities are (i) to conduct economic and monetary analyses and, based on them, to submit proposals to the government, to publish the results of the analyses; (ii) to license, supervise and regulate the activity of financial institutions; (iii) to provide credits to banks; (iv) to supervise the payment system of the country and to facilitate the efficient functioning of the interbank payment system; and (v) to undertake obligations and perform transactions resulting from the participation of the country in the activity of international public institutions in the banking, credit and monetary areas pursuant to conditions of international agreements.

8. The NCFM is responsible for supervising and regulating the non-banking financial institutions. The NCFM was created in 2007 as the non-bank financial regulator to regulate and authorize the activity of professional participants to the non-banking financial market and supervise observance of legislation by them.

Public infrastructure

9. The general framework for debtor/creditor relationships has been the object of numerous reforms in Moldova. Most of the laws are less than 10 years old. Some have either been or are in the process of being further reformed. Despite those reforms, the insolvency and debtor/creditor regimes are not functioning as they should. A "rescue culture" will need to be developed and the institutional framework strengthened to make such procedures effective.

10. The lending activity of financial institutions is essentially based on secured lending. In Moldova, lending is based primarily on collateral value rather than on the viability of the borrower.

The lack of a functional share registry severely constrains the use of pledges over shares as a viable form of collateral for lending. Overall, access to financing is consistently listed as a major constraint on entrepreneurial activity in Moldova.

11. The mortgage regime is generally adequate and effective. However, the regime for secured transactions over movable assets requires further improvement. There is lack of confidence in taking security over pools of assets. Many economic and legal actors misinterpret basic concepts of the law, such as the requirement of sufficient description of the collateral, or the interaction between secured transactions law and data protection law. It is also relatively easy for debtors to challenge court orders for enforcement of security interests over movable assets. The current project to reform the law of pledge presents an opportunity to solve a number of technical issues in this area, in particular improving the registration system and introducing more efficient enforcement mechanisms.

12. A privately owned Credit Bureau is operational since 2011, and it already provides information on most bank borrowers. However, given that it is presently the only provider of these services, vigilant oversight of the bureau and the reliability of data provided to it would be advisable. The bureau could usefully include other non-bank lenders, utilities and other service providers as its clients and information providers (loans from leasing companies, microfinance institutions, and savings and loans associations are not yet reported).

13. The legal framework for auditing and accounting has also undergone several reforms. The adoption by banks of IFRS in 2012 was a major improvement. In effect, the NBM issued a regulation and promoted amendments to applicable legislation, whereby IFRS reporting became mandatory for banks.

Crisis management recovery and resolution

14. Moldova has made progress in strengthening its financial crisis resolution framework. Significant in this respect was the establishment in June 2010 of the NCFS. The Committee was established to promote a coordinated framework for responding to a financial crisis. In addition to this cross-agency framework, the NBM has established an internal committee on financial stability chaired by one of the Vice Governors, with responsibility for coordinating the NBM's crisis resolution policies and procedures.

15. Some of the laws required for bank crisis resolution are in place. In particular, the Law on Financial Institutions provides the NBM with a range of powers to deal with bank distress situations. These include the ability to place a bank under special supervision to assist in identifying the bank's difficulties and formulating response options, the power to give binding directions to a bank in certain circumstances and the ability to appoint a special administrator to assume control of a bank. Nonetheless, there are significant gaps and deficiencies in the law that would impede the ability to implement a bank resolution cost-effectively and with appropriate credibility and certainty.

16. The NBM has made some progress in developing the internal frameworks needed for crisis resolution within the limitations of its powers. It has required banks to develop recovery plans. It has also developed internal guidance on aspects of crisis resolution policies and procedures. However, there is a need for much more to be done if the NBM is to achieve readiness for effective crisis resolution. In particular, it needs to refine its solvency assessment capacity (especially under time pressure), more closely assess the ability of banks to action their recovery plans, undertake resolvability assessments of all systemically important banks, develop crisis resolution strategies (including for bail-in, bridge bank and recapitalization), and develop bank-specific resolution plans.

Market discipline

17. Moldova's corporate governance framework and practice exhibit major weaknesses. Recent ownership shifts have resulted in nontransparent changes in Board members and CEOs. Moreover, the roles and responsibilities of ownership, oversight (Board), and management are substantially blurred, resulting in no clear accountability. While most banks report that the CEO is accountable to the Board, in practice the CEO reports to the controlling shareholder either directly or indirectly, depending on operating practice. Boards lack objectivity and independence, and are not well qualified to oversee financial institution operations.

18. Transparency in banks' ownership structures is still a concern. The NBM led the drafting of amendments aimed at enhancing transparency of shareholders. The proposed legislation regulates ownership disclosure, including affiliated persons, their transactions, volume and quality of information to be supplied to the NBM by bank shareholders, and contains strict provisions on mandating banks and non-banking financial companies to publicly disclose their UBOs. In practice however, the identity of the UBOs of some of the largest banks in Moldova is not clear, and the control that they exert over these banks and their apparent motivations and actions do not seem to be in the best interest of the financial system, or banks' other stakeholders, including minority shareholders, depositors, and the public.

19. Although Moldova has a policy framework for tackling corruption and the country has made strides in closing the large implementation gap, serious issues related to governance and corruption remain. The country continues to face significant challenges in improving the enforcement and implementation of legislation adopted largely because of European Union accession requirements. Moldova ranks 105 out of 178 countries in Transparency International's corruption perception index 2010, which is better than almost all former Soviet republics, yet lower than other countries in Eastern Europe. Corruption in the judiciary has stemmed from malpractice by multiple stakeholders and as a result, the rule of Law does not apply.

III. Main Findings

Objectives, powers, independence, accountability and cooperation (CPs 1–3)

20. NBM powers have been seriously hampered in many respects. The Ministry of Justice (MOJ) interferes in secondary legislation. Before coming into force, NBM regulations have to be registered by the MOJ which performs a legal revision, leading sometimes to substantial amendments. Not only does this interference undermine greatly NBM's powers and autonomy but it also creates unnecessary delays in implementing prudential policies.[2] NBM recommendations are not binding instruments and as a result not enforceable. Further, according to a recent CC ruling (October 1, 2013), all acts and decisions of the NBM—including those relating to safeguard measures, resolution, assessments of shareholders—can be challenged in court, leading to the suspension of the decision under certain circumstances,[3] by the lowest court in the country. Despite amendments made to the LFI to mitigate the impact arising from the ruling, there are still concerns about the capacity of the NBM to take prompt corrective measures in the area of supervision.[4]

21. The current legal regime does not provide enough independence to the NBM. The condition for dismissing the Governor and other Board members are unclear. The NBM law contains a provision[5] that leaves the door open to potential political interference. Even though in practice no such cases have been reported,[6] some revision to the law would be advisable to reinforce the NBM Board's independence. NBM Board members and employees, including staff appointed as a bank's liquidator, do not enjoy enough protection against lawsuits while discharging their duties in good faith. Some amendments were made to the LFI as recommended by the 2008 FSAP but the new language is too general and does not include specific protection for Board members. Further, the current law does not indicate the nature of the liability for employees, civil and/or criminal. Lastly, staff does not receive any financial assistance in case of lawsuits.

22. Despite notable progress, cooperation with relevant domestic authorities and foreign supervisors should be improved. The Memorandum of Understanding (MOU) signed between the NBM and a wide range of public authorities for the establishment of the NCFS should be revisited to clarify and confirm that there will not be any political interference in the decisions to be made by the NBM. The NBM may wish to consider expanding its cooperation agreement with other relevant bodies such as the Deposit Guarantee Fund and the Credit Bureau. At the international level, it is

[2] As a result, it may take about one year for a regulation to be issued.

[3] Until January 2014, the suspension of actions by the NBM was immediate. In order to mitigate this problem, amendments were made to the Law in respect of making administrative contention and the resulting LNBM entered in force on January 24, 2014. Actions by the NBM can be suspended by the court, under the LNBM at the request of the plaintiff, with the compulsory summoning of the parties, and after the act has been challenged before the Council of Administration of the NBM (art. 11^1 of the revised LNBM).

[4] For example, some provisions of the regulation on Large Exposure Limit have been suspended.

[5] According to which the Governor and other members of the Council of Administration "*shall be removed from office (…) if they are* *<u>incompatible</u>*, *as established by a definitive act*" (LNBM, art. 27, f).

[6] The previous NBM governor enjoyed several successive mandates, spanning 18 years in one case, which indicates a fair degree of stability and autonomy.

also advisable to pursue efforts to finalize MOUs with home supervisors of foreign subsidiaries operating in the country; for example, Italy, France, Germany, and Austria.

Ownership, licensing, and structure (CPs 4–7)

23. **Transparency in banks' ownership structure is still a major problem that has cascading effects on several risk exposures**. For several years, the NBM has been struggling to get a clear vision of banks' ownership structures. Regulations, internal processes, and reporting mechanisms have been designed or reinforced to capture meaningful information and data on shareholders. Unfortunately, most of the recent changes in ownership of Moldovan banks have been conducted in an opaque manner[7] and did not receive prior NBM clearance.

Methods of ongoing banking supervision (CPs 8–10)

24. **The supervisory approach tends to be compliance-based and should move more towards risk-based supervision**. The current supervisory inspection planning does not take into consideration the risk profile of each bank nor their systemic importance. However, the NBM used different elements of risk-based supervision, such as a risk matrix and a recently developed methodology for identifying systemic banks. A new supervisory methodology aligned with Basel II is planned to be implemented together with a new supervisory cycle that has yet to be developed. The human resources allocated to both on-site and off-site supervision does not appear adequate and consequently need to be addressed.

25. **The NBM has an appropriate mix of on-site and off-site supervision to evaluate the condition of the banks.** However, there are some weaknesses that need attention. First, it takes sometimes up to one year to issue an examination report. These delays may affect the ability of a bank to take timely corrective measures and frustrates prompt formal action if needed. Second, the frequency and intensity of supervision should depend more on the systemic relevance of the banks and the risks identified. Risk-based supervision will help in this direction.

26. **There is an extensive array of reporting requirements for banks that provides a wide range of data on a solo basis, but prudential returns are not collected yet on a consolidated basis.** The relevant secondary regulations should be amended in order to require banks to submit on a consolidated basis their prudential ratios and other important information. In the absence of proper IT application, the Banking Supervision and Regulation Department devotes excessive resources to perform manually several off-site activities. An automated platform is necessary to be introduced for a better execution of the off-site function.

[7] In many cases, ownership was acquired piecemeal through stock market operations, in transactions just under 5 percent of the subject bank's capital, thus avoiding NBM vetting.

Corrective and sanctioning powers of supervisor (CP 11)

27. Enforcement of prudential regulations is not optimal and the current legal regime contains serious limitations or flaws. Under Art. 38 of the LFI, the NBM can use a wide range of instruments to address problems in banks or violations of regulatory obligations. In practice, the NBM has adopted over the past years several measures as a result of multiple infringements, particularly in relation to (i) insufficient size of Tier I capital; (ii) asset quality; (iii) misreporting, (iv) deficiencies in internal control systems; and (v) violations in preventing and combating ML/TF. However, in case of persistent deficiencies in the same institutions, the NBM should have taken more forceful actions. Further, in certain circumstances, the lack of protection as discussed above may lead NBM's management to refrain from taking tougher measures. On the other hand, sanctions contemplated in relevant law (e.g., the LFI, Law of National Bank of Moldova (LNBM), and AML/CFT law) do not seem dissuasive enough, particularly when it comes to pecuniary sanctions. Lastly, according to the NBM law, sanctions taken by the NBM (art. 75^2(4)) are subject to a legal prescription of six months[8] after the NBM report is submitted to the bank and the violation itself to a prescription of three years.

Consolidated and cross-border banking supervision (CPs 12–13)

28. The NBM's approach to consolidated supervision is not comprehensive and effective. Thus, the NBM should develop consolidated prudential supervision rules for the domestic groups and pursue its efforts to conclude agreements with home supervisory authorities.

29. MOUs are not in place with all relevant home supervisors. The lack of MOUs with some foreign bank supervisors appears not to have been an impediment to the NBM to supervise banks effectively. Still, the NBM is encouraged to seek ways to facilitate a more formal exchange of supervisory information.

Corporate Governance (CP 14)

30. Banks and banking groups do not have robust and effective corporate governance policies and processes. Thus, the Corporate Governance regime exhibits important weaknesses. First, there are no binding specific requirements such as: independent risk management and compliance functions; specialized committees at the level of the Board. Second, there is a lack of shareholder transparency in banks which impede sound governance. In this context, the NBM should foster the implementation of the amendments to the Regulation on internal controls as soon as possible to promote corporate governance and be more intrusive by challenging the risk appetite for all risk categories of banks and their alignment with policy and procedures.

[8] After six months, it is understood that application of sanctions is not possible.

Prudential requirements, regulatory framework (CPs 15–25)

31. There are no binding requirements for banks to establish an independent risk management (RM) function. Currently, RM functions have not been established in a large number of banks and there is no explicit legal requirement for the appointment of a dedicated risk officer. The legal and regulatory frameworks assign responsibility to the executive body for the effective management of the major types of risks but certain types of risks difficult to measure are not covered. Moreover, the NBM approach for evaluating RM in banks is heavily reliant on the on-site monitoring process which is not deemed sufficiently robust to capture efficiently all qualitative aspects of risk management. Therefore, NBM needs to increase oversight intensity in banks where risk-management processes are poor.

32. In terms of capital adequacy, a few issues deserve attention. In particular, exposures secured by real estate mortgages should receive a proper capital charge and foreign exchange (FX) exposures (open positions) should also be subject to a capital charge. The NBM also needs to make sure that the risk-weighted capital ratios (maintained in average at 23 percent) are not inflated by deducting risk excess from eligible capital (for example, on large exposures and related parties from undisclosed UBOs).

33. Banks have inadequate credit risk management practices. While supervisors require banks to have policies and processes for credit risk management, in practice banks excessively rely on collateral rather than on the financial capacity of the debtor. Moreover, the current financial situation of some banks is weakened by the poor loan portfolio quality which stems from inadequate underwriting policies. Thus, violations of regulations related to lending activity and credit risk management are by far the most frequent. In this context the NBM should enhance its scrutiny of credit underwriting policies.

34. Starting January 1, 2012, new IFRS accountancy framework was introduced. Nonetheless, the former regulation on the assets and conditional commitments classification continued to be applied for prudential reasons. Consequently, allowances for loan losses are calculated based on banks internal methodologies, which are expert based and their level is certified by the external auditors on a biannual basis, while the NBM supervisors examined only the accuracy of the specific provisions for assets and conditional commitments.

35. Several flaws in the field of problem assets, provisions, and reserves were identified. First, despite a very clear classification regime, in practice, the NBM has observed multiple cases of misclassifications. Second, the periodicity for classification is too long; as a result, prudential ratios might be inflated. Third, while the NBM is expecting banks to solve their problem assets by a restructuring process based on economic grounds and borrower's ability and willingness to repay under the new terms of the debt, banks' restructuring practices scope seems to be mainly the delay in losses' recognition and consequently in foreclosure or collateral execution. Fourth, there is a large gap between IFRS allowances for loan losses and allowances for debts on loans calculated for prudential purpose. In practice, the level of IFRS loan loss allowances is determined by banks mainly using cash flows that may result from foreclosure minus costs for obtaining and selling the collateral, whether or not foreclosure is probable, instead of future cash flow generated by the debtor activity. As a consequence heavily reliance on collateral could undermine the adequate level of IFRS provisions.

36. Surveillance of concentration risk and large exposure limits (LELs) needs to be strengthened. In effect, observance by banks of the risk concentration limits is questionable. Moreover, the lack of transparency in ownership structure of certain banks undermines the understanding by the NBM of connected lending and as a result concentration risks. Lastly, the current regulation on LEL does not contain a specific definition of risk concentration.

37. There are still concerns about the effectiveness of the current supervisory regime for related parties, due in large part to the recent developments in the market. In effect, most of the recent changes in ownership of Moldovan banks have been conducted in an opaque manner[9] and did not receive previous NBM clearance or disapproval. As a result, undisclosed "raiders" acting in concert have been able to acquire or accumulate significant controlling stakes in banks which can impact the nature of the bank's business and potentially, their safety and soundness. The issue of transparency in bank's ownership is a widespread problem; according to a reputable external audit company, only 2 banks out of 10 (excluding the subsidiaries of foreign banks) "*have more or less a clear, transparent shareholder structure*." The lack of information on the ultimate beneficial owner of these stakes is directly affecting the surveillance of related parties[10] and large exposure limits alike.

38. The NBM stipulates clear provisions within the Regulation on internal control and in the Recommendation on country/transfer risk management that banks should have in place internal procedures for managing such risk. However, several banks have been excessively exposed through inter-bank placements to banks from one neighboring country. It seems that these banks either breached the internal counterparty limits or these limits were set up without any sound internal assessment of the related risks. The NBM should address this issue by requiring banks to implement more stringent limits.

39. The NBM implemented market risk regulation for FX risk and for interest rate risk in the banking book, but not for FX risk in the trading book. Also, a capital charge on market risk has not yet been implemented.

40. The management of the interest rate risk needs to be strengthened. The NBM is encouraged to promote adequate policies and practices for interest rate risk management and to have in place adequate risk management processes, including an independent risk management

[9] In many cases, ownership was acquired piecemeal through stock market operations, in transactions just under 5 percent of the subject bank's capital, in order to intentionally circumvent the law and escape NBM vetting.

[10] BCP assessors were told during their interviews with an external audit company that three banks will receive for 2013 a qualified opinion for not complying with the regulation on exposure to affiliated and connected parties.

function. Also, requirements for banks to compute and submit to NBM the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, inclusively by using a standardized interest rate shock on the banking book need to be implemented.

41. The regulatory framework for liquidity management is generally adequate, providing a good mix of qualitative and quantitative requirements and also for conducted stress test scenario. However, the off-balance sheet commitments are not included in the prudential liquidity requirements and the capacity to sell liquid assets is not required to be assessed by banks; consequently the risk profile of banks does not capture risks arising from off-balance sheet exposures. Also, there is a high interconnectedness between liquidity risk and counterparty risk, since in few banks the liquidity buffer mainly consists in placements with foreign banks. Moreover, in practice, a few banks circumvented the NBM Regulation on liquidity by taking deposits from cross-border banks on a long-term basis and placing them short term just in order to meet the requirements of Liquidity Principle II (short-term liquidity).

42. The regulation on Operational Risks has not been issued. Operational risk management is captured through the regulation on internal control only. With the exception of a detailed regulation on outsourced activities and an NBM letter on detailed requirements for contingency plans and operational risk management, the country is still lacking a comprehensive regulation on this matter.

Internal control, internal and external audit, financial reporting, market disclosure and transparency (CPs 26–28)

43. The NBM regulation on internal control strengthens the requirements for establishing a strong internal control environment. However, there are no specific requirements with respect to (i) the existence of a separate compliance function and (ii) professional qualification and compulsory fit and proper standards for the head of the audit function. Improvements in the internal audit function are needed in order to enhance overall effectiveness.

44. External auditors are subject to professional and ethical standards. The NBM is empowered to approve the external auditing firm that is retained by a bank, and requires rotation of audit firms periodically. However, in the last two years, the vast majority of banks' financial statements were audited by a single audit company. Banks pay little consideration to qualified opinions, indeed preferring a qualified opinion to making the appropriate provisions. This "culture" undermines the impact of external audits.

45. Disclosure requirements have been tightened and cover a broad range of information. The banking system prepares its accounting records and reports financial information in accordance with IFRS, which have to be published.

Abuse of financial services (CP 29)

46. **Moldova has taken several initiatives to address ML/TF related issues.** The approval by the parliament, of the National Strategy to combat ML/TF is a significant step forward in this regard. Also, key amendments made to the penal code will enter into force in 2014, reinforcing sanctions in case of AML/CFT violations. In addition, the Office for Preventing and Combating ML requested in November 2013 technical assistance to carry out the ML/TF National Risk Assessment of Moldova based on the World Bank methodology. Efforts to equip NBM staff with advanced AML/CFT methodology have also been pursued.

47. **Despite these positive steps, the situation regarding ML/TF warrants close scrutiny.** The NBM is still facing important challenges that hamper the effectiveness of ML/TF surveillance in banks. The AML/CFT unit of the NBM is understaffed. In addition, the issue of the lack of transparency in bank ownership and the difficulties faced by banks in identifying UBOs are serious concerns. Moreover, two particular issues already well known by the NBM warrant maximum attention. According to the Financial Intelligence Unit, cross-border transactions of major proportions (amounting to about 1 trillion lei[11]) involving Moldovan banks have been detected. These transfers seem to be performed by companies operating from off-shore centers with undisclosed UBOs, likely for tax evasion purposes. The second matter of concern relates to the situation with Transnistria.[12] Unrecognized by any United Nations member state, Transnistria is designated by the Republic of Moldova as an Autonomous territorial unit with special legal status; but de facto the Moldovan government has not been able to exercise any authority in this region for some years. From an AML/CFT standpoint, the status of the region has led the authorities to declare suspicious any single transaction, irrespective of the amount, between Moldovan banks and Transnistrian banks. Besides, these outbound financial flows are quite significant (MDL 2 billion in 2013) and are operated by companies with unknown beneficial owners. The authorities, at least at the NBM level that monitors on a daily basis these transactions, have little room for maneuver and to adopt remedial actions as it would bring immediate political reaction. Lastly, in 2012, Moneyval assessed the AML/CFT regime of Moldova and noted that in the absence of a risk assessment, the implementation of "adequate risk-based supervision was not demonstrated."

A. Authorities' Response

48. **The National Bank of Moldova, as a banking regulation and supervision authority**, highly appreciates the contribution of the International Monetary Fund and World Bank within the Financial Sector Assessment Program performed in the Republic of Moldova regarding the alignment with international standards in the respective area.

[11] According to the NBM, this figure seems to be exaggerated.

[12] Located mostly on a strip of land between the River Dniester and the eastern Moldovan border with Ukraine. Assessors did not evaluate BCPs in this region.

49. The mission's results and recommendations have helped to receive an independent and objective opinion on the real position of the banking sector in the Republic of Moldova, as well as to highlight the issues that require maximum attention and action from the banking regulation and supervision authority.

50. At the same time, it seems necessary to comment on the following issues:

51. As regards the independence of the National Bank of Moldova, since the last FSAP mission from 2008 and till now, the legal framework has been completed and amended as to strengthen the independent and autonomous statute of the National Bank of Moldova, including with regard to banking regulation and supervision activities. It is obvious that a series of issues shall be aligned to the best international practices in the nearest future, but at the same time the present situation demonstrates the existence of a positive tendency in ensuring the highest level of independence of the banking regulation and supervision authority as it is provided by the Basel Core Principles.

52. Furthermore, the National Bank of Moldova would like to point out that according to the mission's recommendations, the transparency in ownership structure represents a subject of major importance in the supervision process. Hence, the National Bank of Moldova acknowledges the need to increase the level of knowledge on the banks' ownership structure that could be performed by applying the measures required to comply with the best international practices in force.

53. Additionally, a major objective of the National Bank of Moldova is to create and implement regulations on banking risks management, both financial and non-financial, which at the moment is an ongoing process. Simultaneously, the positive results in achieving the respective objective shall lead to a significant improvement of the normative framework related to the corporate governance, which, also, represent a key area within the banking regulation and supervision process.

54. In conclusion, the National Bank of Moldova will continue to develop and improve the normative framework and financial institutions' supervision methodologies as to comply with the Basel Core Principles.

Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments	
Core Principle	**Comments**
1. Responsibilities, objectives and powers.	NBM powers have been disminished by the country's Constitutional Court. The recommendations issued by the NBM are not binding. It is not clear whether the NBM has the power to increase banks' prudential requirements. There is no explicit provision in the law stipulating that the objective of banking supervision is to promote safety and soundness of the financial system. Objectives of banking supervision may conflict with other objectives.
2. Independence, accountability, resourcing and legal protection for supervisors.	The corporate governance structure of the NBM is not satisfactory. The conditions for dismissing the governor and other Board members are unclear. NBM Board members and employees do not enjoy enough protection against lawsuits while discharging their duties in good faith. NBM staffing seems to be insufficient in the context of growing activities. The Banking and Regulation Supervisory Department (BRSD) budget allocation process is not transparent. Sanctions for breaching the Code of conduct and the Anti-fraud Policy are not specified. NBM staff is allowed to hold shares in banks. There is no requirement for the NMB to render an account of its performance in regard to its supervision activities.
3. Cooperation and collaboration.	Delineation of responsibilities among members of the NCFS (including the NBM) is not clear.
4. Permissible activities.	
5. Licensing criteria.	Full ownership details of certain banks licensed in the past, including details on the UBO, are still missing. Regulations do not specifically require individual Board members or the Board collectively to have a sound knowledge of the material activities that the bank intends to pursue, and the associated risks.
6. Transfer of significant ownership.	Ownership structure is still opaque in several banks. Questionable rulings by Provincial courts undermine the integrity of the regime applied to transfer of ownership.
7. Major acquisitions.	

Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments (continued)

Core Principle	Comments
8. Supervisory approach.	The current supervisory inspection planning does not take into consideration risk profile of each bank nor their systemic importance. The human resources allocated to both on-site and off-site supervision does not appear adequate.
9. Supervisory techniques and tools.	It sometimes takes up to a year to issue an on-site inspection report (this was the case in 2013). These delays may affect the ability of a bank to take timely corrective measures. The frequency and intensity of supervision should depend more on the systemic relevance of the banks and the risks identified.
10. Supervisory reporting.	In the absence of proper IT application, the BRSD devotes excessive resources to perform manually several off-site activities. Prudential returns are not provided on a consolidated basis.
11. Corrective and sanctioning powers of supervisors.	The enforcement powers of the NBM have been diminished. Fines contemplated in relevant laws (e.g. LFI, LNBM, and AML/CFT law) do not seem dissuasive enough. The NBM does not have in-house methods that could provide management with guidance on how to apply criteria for sanctions as defined in the law. The prescription regime applicable to sanctions diminishes effectiveness of enforcement.[1] The NBM response is not increased in case of persistent breaches. The Special Supervision regime does not seem well designed.
12. Consolidated supervision.	The NBM's approach to consolidated supervision is not comprehensive and effective.
13. Home-host relationships.	The ability of NBM to develop a resolution plan to address evolving bank problems and possible resolution in a cross-border situation, especially for the existing four subsidiaries of non-domestic banks, has not been developed due to the inaction of the home supervisor.
14. Corporate governance.	The CG regime exhibits important weaknesses.
15. Risk management process.	No clear RM framework. RM functions have not been established in a large number of banks. The NBM approach to evaluating risk management in banks is heavily reliant on the on-site monitoring process.

[1] Sanctions taken by the NBM (Article 75^2 (4)) are subject to a legal prescription of 6 months after the submission of the report to the bank and the violation itself to a prescription of 3 years. Beyond this period of 6 months, sanctions cannot be applied. Also, if the commission of the violation is older than 3 years, it cannot be sanctioned.

Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments (continued)

Core Principle	Comments
16. Capital adequacy.	Exposures secured by real estate mortgages do not receive proper capital charge. There is no capital charge for FX exposures (open positions).
17. Credit risk.	Excessive reliance on collateral rather than on the financial capacity of the debtor.
18. Problem assets, provisions, and reserves.	There are multiple cases of misclassification. The periodicity for classification is too long.
19. Concentration risk and large exposure limits.	The current regulation on LEL does not contain a specific definition of risk concentration. Interbank exposures are not captured by the regulation on the LEL. Observance by banks of the risks concentration limits is questionable. Lack of transparency in ownership structure of certain banks undermines the understanding of connected lending and as a result concentration risks. Some provisions of the LEL regulations have been suspended by a Court.
20. Transactions with related parties.	The lack of information on the ultimate beneficial owner of banks' stakes is directly affecting the surveillance of related parties. There are still concerns about the effectiveness of the current supervisory regime for related parties.
21. Country and transfer risks.	Several banks are excessively exposed through inter-banking placements in cross-border banks.
22. Market risk.	Market risk from trading book not captured.
23. Interest rate risk in the banking book.	There are no requirements for banks to compute and submit to NBM the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book.
24. Liquidity risk.	Off-balance sheet commitments are not included in prudential liquidity requirements; consequently the risk profile of the bank did not capture risks arising from these exposures.
25. Operational risk.	OR not well captured in current regulation.
26. Internal control and audit.	Compliance functions nonexistent in banks. No professional qualification requirements and fit and proper assessment for head of internal audit.
27. Financial reporting and external audit.	Banks disregard qualified opinion expressed by external auditors.
28. Disclosure and transparency.	

Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments (concluded)

Core Principle	Comments
29. Abuse of financial services.	Massive cross-border operations originating from and/or flowing to off-shore centers. All operations with Transnistria have been declared suspicious. Banks have not yet performed their own risk assessment of ML/TF risk.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles	
Reference Principle	**Recommended Action**
Principle 1	• Strengthen NBM power by removing any interference of the MOJ in the process of secondary legislation. • Include an explicit provision in the law stipulating that the objective of banking supervision is to promote safety and soundness of the financial system. • Include in the LFI an explicit stand-alone provision to grant NBM the power to increase the prudential requirements for individual banks and banking groups based on their risk profile and systemic importance.
Principle 2	• Reform the Corporate Governance structure of the NBM to ensure clear segregation of functions. • Restore full independence of the NBM by protecting members of the board from external influence. • Add in the NBM law a provision stipulating that no member of the NBM's Board can be replaced for reasons or following a procedure other than those stipulated in Article 27. • Provide full legal protection to all NBM employees in case of lawsuits for actions in good faith. • Provide full indemnification benefits to NBM staff in case of litigation for action performed in good faith. • Specify in the law the types of liability NBM employees are subject to. • Improve transparency in budget allocation for Supervision activities. • Include clear sanctions in the code of conduct in case of breach. • Prohibit NBM's employee from holding an equity interest in banks. • Increase NBM manpower, particularly with respect to the transition to Basel II/Basel III and the establishment of an enhanced banking resolution mechanism • Reinforce transparency by issuing a publication setting out the NBM's plans for a forward period (e.g., for two years) showing how it will achieve its mandate and the related costs (and funding thereof).
Principle 3	• Expand the NBM cooperation agreement with other relevant bodies such as the Deposit Guarantee Fund and the Credit Bureau. • Clarify the conditions of exchange of confidential information among all members of the NCFS. • Explore the possibility for the Head of BRSD to attend meetings of the NCFS, at least as an observer, or, at the minimum provide him access to the minutes of the committee meetings.
	• Pursue efforts to finalize MOUs with home supervisors of foreign subsidiaries located in Moldova e.g. Italy, France, Germany and Austria.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles (continued)

Reference Principle	Recommended Action
Principle 4	
Principle 5	• Increase efforts in establishing full ownership details of certain banks licensed in the past, including details on the UBO. • Include in the regulation a provision requiring individual Board members or the Board collectively to have a sound knowledge of the material activities that the bank intends to pursue, and the associated risks.
Principle 6	• Intensify pressure on the NCFM about its duties and accountability vis-à-vis the national depository to ensure identification of the UBO. • Ensure alignment between the LFI and other NBM regulations on significant holdings in banks' capital and the law governing market activities. • Increase penalties in case of fraudulent acquisition of shareholdings. • revisit the language of art. 156 (4) of the LFI1 by setting a specific timeframe for the prohibition contemplated under this article 2 and by banning the person from holding interest, directly or indirectly in other banks. • Perform due diligence to ensure that entities located in NCJ no longer hold directly or indirectly equity interest in the capital of a bank. • Explore the possibility to subject private registrars to systemic reporting obligations to NBM on shareholder transfers (and not only to the NCFM as planned).
Principle 7	
Principle 8	• Adopt a more risk-based approach, instead of relying on compliance based procedures. • Explore the possibility to enhance off-site and on-site resources. Implement the framework for crisis management.

[1] Stipulating that a person who no longer meets the requirement for holding equity in a bank (e.g. when exercising an influence that might jeopardize bank's sound management), "*cannot further hold directly or indirectly new shares in that bank.*"

[2] The law does not indicate whether the prohibition will expire after a certain period of time.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles (continued)	
Principle 9	• Improve the examination process by shortening the delay between the end of the on-site visit and the official submission of the report to the bank. • Enhance on-site and off-site supervision for systemic important banks. • Improve supervisory methodologies to enable a timely intervention in banks. • Take a more active stance in influencing the quality of internal audit in banks and establishing a regular dialogue with the bank's internal auditors. • Engage more actively in a dialogue with external auditors.
Principle 10	• Amend the relevant secondary regulations in order to require banks to submit on a consolidated basis their prudential ratios and other important information, such as: capital adequacy, large exposure, transactions with affiliated parties. • Implement a new IT application for a better execution of the off-site function.

Principle 11	• Take more forceful action in case of persistent problems, and apply gradual response, including stricter remedial measures.
	• Amend the law to increase the level of fines that can be applicable to individuals.
	• Reconsider the prescription regime for sanctions, in particular by expanding the 6 months timeframe.
	• Set internal guidelines to assist NBM management in determining the most adequate response in case of breach or violation.
	• Monitor the application of the new LNBM law by judges to assess whether the new legal amendments introduced to mitigate the consequences of the Constitutional Court ruling are having the desired effects and do not lead to major restrictions to NBM powers.
	• Distinguish between remedial measures/or corrective actions (that could apply when, in the NBM opinion, the risk exposure is too high) and sanctions that should apply if and only if a bank breached the law or a regulation.
	• For the Special Supervision regime:
	    • establish objective criteria for subjecting banks to the special supervision regime;
	    • set a time frame for adopting the SSC recommendations by banks; and
	    • Apply this regime with discernment, e.g., when the financial condition of the bank is not compromised.

Principle 12	• Develop consolidated prudential supervision rules for the domestic groups and pursue NBM's efforts to conclude agreements with home supervisory authorities.
Principle 13	• NBM to pursue its efforts to conclude agreements with home supervisory authorities.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles (continued)

Principle 14	• Foster the implementation of the amendments to the Regulation on internal controls as soon as possible to promote Corporate Governance. • Amend the LFI in order to broaden the executive functions (e.g., key executives—categories of staff whose professional activities have a material impact on the credit institutions' risk profile; heads of internal control functions-risk management, compliance, internal audit), that need prior approval of the NBM based on fit and proper standards. • NBM to take more intrusive action by challenging the risk appetite and risk tolerance of a bank and evaluate tone at the top. • Continue assessing the balance of power, the incentive system and the risk appetite of a bank using instruments such as assessing the leadership profile of an administrator. • Introduce a legal or regulatory obligation that calls for the banks to notify the supervisor as soon as they become aware of any material information that may negatively affect the fitness and propriety of a Board member or a member of senior management.
Principle 15	• Increase oversight intensity in banks where risk-management processes are poor. • Ensure that all banks continue to develop their risk management policies and processes. • Introduce a legal or regulatory obligation for banks to draw up annually a report about the conditions on which internal control is performed, with a distinct presentation of the aspects related to the risk management function, compliance function and internal audit function.
Principle 16	• Require banks to apply the correct RWA for loans secured by properties.

Principle 17	• Enhance supervisory scrutiny of financial analysis and valuation of collateral through loan reviews;
	• Focus more on determining if banks credit underwriting policies are prudent;
	• Introduce in the Regulation on lending activity provisions requiring:
	    • banks to have in place procedures for assessing collaterals, especially tangible ones, based on International Valuation Standards by certified evaluators; and
	    • banks to identify, assess and frequently monitor indirect foreign exchange risk as part of the credit underwriting and monitoring process;
	• Consider stricter collateral requirements (loan-to-value ratios), different indebtedness ratio for unhedged individual borrowers, more restrictive requirements for unhedged legal entities and lower limits on concentration of large borrowers subject to foreign exchange risk.
	• In the new regulation on internal controls, define and distinguish between FX risk arising at the level of the borrower and the risk arising from the banking activity.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles (continued)	
Principle 18	• Amend the provisions of the regulation on assets and conditional commitments classification to require a more frequent classification at least monthly and to increase the monitoring period from three to six months in case of extended or renegotiated assets and conditional commitments. • Revise banks' accounting policy on impairments of financial assets. • Perform more oversight over compliance with IFRS, particularly for impairments.
Principle 19	• Increase level of knowledge on banks' ownership structure. • Enforce, through greater sanctions, observance of risks concentration limits. • Improve language in the regulation on LEL with defining in more details the concept of risk concentration.
Principle 20	• NBM to pursue its effort to identify shareholders and UBO who own controlling interest in banks. • Enforce the regulation more forcefully in case of grave deviations from the rules; • Increase NBM monitoring on the terms and conditions applied to deposits of related parties.
Principle 21	• Continue to promote adequate policies and practices for country/transfer risk management, • Implement and require more stringent limits in terms of individual exposure lower than those related to large exposure.
Principle 22	• Continue to promote adequate policies and practices for market risk management, including an independent risk management function. • Include in the draft Regulation on internal control system requirements on managing market risks from the trading book.
Principle 23	• Prescribe clearer provisions for banks to calculate potential changes in their economic value resulting from changes in the levels of interest rates, in accordance with their risk profile and risk management policies. • Require banks to compute and report to the NBM the change in their economic value as a result of applying a sudden and unexpected change in interest rates standard shock prescribed by the NBM (for example, a 200 basis point shock, in both directions, regardless of the currency).
Principle 24	• Complete amendments to the Regulation on internal control system and in the liquidity risk management to prescribe banks to: (i) regularly assess their capacity to sell liquid assets; (ii) have in place an adequate liquidity buffer aligned with the risk tolerance of the bank; (iii) establish formal alternative funding plans; (iv) set limits to manage day-to-day liquidity; and (v) set limits on correspondent banks. • Amend the regulation on liquidity to take into account the off-balance sheet commitments when determining liquidity ratios.

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles (concluded)

Principle 25	• Speed up the issuance of the regulation on Operational Risks and subject banks to more detailed reporting obligations on OR, beyond the reporting of frauds.
Principle 26	• Require improvements in the internal audit function to enhance overall effectiveness. • Speed up the approval process of the new Regulation on internal controls. • Introduce in the regulation on internal controls an explicit requirement for professional qualification and fit-and-proper assessment for heads of internal audit and impose an obligation on banks to notify the NBM of the dismissal of the Head of internal audit. • Exchange, on a regular basis, views on the quality and independence of internal audit with the external auditors during tri-partite meetings.
Principle 27	• Take more forceful action for ensuring audit quality by actively challenging external auditors and banks' management when understatement of provisions is identified. • Arrange more frequent periodic meetings with the auditors to discuss issues of common concerns and exchange information on important accounting, financial and auditing matters. • Give NBM examiners the power to access external auditors' working papers, where necessary. • Increase level of expertise among NBM staff to deal with IFRS issues.
Principle 28	
Principle 29	• Perform targeted on-site visits—preferably in conjunction with the Office for Prevention and Control of Money Laundering—to determine the nature, magnitude and economic rationale of the cross-border transactions identified by the financial intelligence unit and determine proper supervisory response. • Increase level of scrutiny in banks by doing more targeted on-site inspections in the area of politically exposed persons, UBOs, correspondent banking relationships. • Instruct banks to perform their internal ML/TF risk assessments. • Increase sanctions in case of recurrent violations of AML/CFT regulation by the same institution. • Equip NBM examiners with proper software to conduct AML/CFT on-site visits. • Implement without delay aspects of the AML/CFT National Strategy that relates to the NBM mandate. In effect, this strategy for 2013–17 that was approved by the parliament in June 2013 contains several activities that are directly under the ambit of the NBM.