

REPORT NO. 9

Financial Monitor

Five Development Goals for the National Financial System

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Abbreviations

NBM	National Bank of Moldova
BDGF	Banking Deposit Guarantee Fund
IMF	International Monetary Fund
NDS	National Development Strategy
EU	European Union
GS	Government Securities

About the Financial Monitor

The Financial Monitor is a periodical developed by Expert-Grup aiming to present to the general public the main actions undertaken (or not undertaken) by the authorities in order to reform and develop the financial sector in Moldova, to provide analytical assessments of the undertaken measures, as well as to make recommendations on how to enhance the efforts of reforming this sector.

Since 2016, Expert-Grup made the commitment to monitor the developments in the financial system and also presented a plan to strengthen the banking sector, which was based on two fundamental principles: (1) an independent central bank, well-equipped with modern banking monitoring and regulation tools; (2) commercial banks managed and owned by professional and impartial persons, using an exemplary corporate governance, capitalised enough to be able to independently absorb any mistake in management. Most of the supported actions were implemented, as a result the financial and banking system became more stable and able to cope with potential shocks. Reforms over the past years have resulted in stabilized banking sector, upgraded and adjusted to international standards legal framework.

With the start of a new electoral cycle, we believe that the financial system should remain on the Government's

agenda, with a focus on development and upgrade. To continue this process, it is necessary to define some main directions of development around which the efforts of the relevant authorities should be concentrated. In this regard, the current issue of the Financial Monitor provides 5 system development goals and a set of actions that once implemented could transform the financial environment into a catalyst for economic growth.

The ninth issue of the Financial Monitor is structured in three parts and starts with the executive summary outlining the financial system development goals and how they are anchored in the country's main strategic development document - "Moldova 2030" NDS. It is followed by a description of the main trends characteristic for the financial environment, which is an innovation for the publication. The trend description will be found in each subsequent issue of the Financial Monitor, which will allow the reader to form a continuous and overall picture of the field. Finally, the main part of the report outlines the financial system development goals, including their widely described motivation and the capacity to support the goals set out in the national development strategy. At the same time, the focus is on a number of specific actions that once implemented will be able to contribute to the achievement of set goals.



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Executive Summary

The parliamentary elections of February this year marked the end of a full cycle in the country's economic, social and political development. At the same time, this corresponds virtually with the expiry of the country's strategic development framework set out in the 'Moldova 2020' Strategy, but also with the approval of some new goals for the next 10 years[1]. With regard to the financial system, recent events have shown that it is a key sector not only in terms of contribution to the financing of the economy but also in terms of national stability and security. Thus, irrespective of the political 'color' that will prevail in the next government, the financial system should remain a key element of the Government Plan, with priorities based both on the implementation of the reforms achieved so far and on the crystallization of new directions of development and upgrade.

Current trends in the financial system are largely driven by the reforms applied to the banking sector after the 2014-2015 crisis. Initiated in the form of stabilization measures aimed, inter alia, at resuming cooperation with the main external partners, they continued with reviewing and adjusting the legislation. Most of the actions were assumed by the Government under a Memorandum with IMF, placing a particular focus on the transparency of bank shareholders and strengthening of the corporate governance mechanism. The transition to Basel III regulatory and supervisory standards was also initiated in accordance with the timetable negotiated under the EU Association Agreement and involves the implementation of new capital adequacy requirements, transactions with related parties, risk assessment and management, sanctions regime, etc. Eventually, the reforms included other sectors such as non-bank lending organizations or the insurance sector, but they could not reach the intensity of the sectors listed above.

The current conditions of the financial system provide the right time for further reforms towards development and upgrade. Thus, unlike 10 years ago, most of the system is controlled by banks or foreign financial groups. Shareholders with reputation and experience on a regional and even international level entered the market, such as Banca Transilvania at BC Victoriabank, the European Bank for Reconstruction and Development at BC Moldova Agroindbank or Intesa Sanpaolo at BC Eximbank.

At the same time, banks' financial position has also improved, whereby they became much better capitalized, liquid enough, and remained profitable. Moreover, macroeconomic conditions show a stable situation, with inflation within the limits of the targeted corridor and low interest rates on loans. However, besides these positive trends, there is also a number of difficulties that have their roots in the banking crisis as well. Granting guarantees for crediting the banks that were eventually liquidated is one of the main causes that led to an excess of liquidity in the monetary market, a situation that involves costly interventions for the NBM. Moreover, these interventions have a double effect because they significantly diminish the interest of banks that is already low to credit the real economy. Additionally, reviewed lending policies and low public confidence in the banking institutions have created premises for rapid growth of the microfinance and leasing sector. The uncontrolled growth of this segment without strengthening the consumer protection framework can lead to over-indebtedness of the population, with contagion risks to the banking sector.

Based on the identified constraints, the current issue of the Financial Monitor comes up with a number of policy recommendations on the directions of development of the national financial system. Firstly, they aim to strengthen the capacity of financial institutions to meet the demands and expectations of the business environment, government, or households in mobilizing the capital. It also focuses on eradicating the informal economy by increasing financial inclusion, improving payment systems and enhancing the financial skills of the population. Last but not least, we believe that the financial system should become a sound source of protection for consumers of financial services, a stability factor for public finances and generator of credibility for the international environment.

[1] On 8 November 2018 the 'Moldova 2030' National Development Strategy was approved by the Government, pointing out to the direction of development of the country and society to be followed over the next decade. <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=377985>.

The directions for upgrading the financial system should be anchored in the strategic vision of the country's and society's development for the next decade as set out in the "Moldova 2030" Strategy. Thus, in order to become a society adapted to changes, uncertainties and challenges, the Republic of Moldova needs to adopt a well-correlated policy framework for a long-term systemic approach to sustainable development. As a result, the financial system is a key policy sector that can support the national economy and contribute to the development of society, and this study proposes five goals and a number of actions to be undertaken in this respect. They are even part of the first pillar of the "Moldova 2030" Strategy, oriented towards a sustainable and inclusive economy.

Thus, in order to contribute to the first three specific goals of the "Moldova 2030" NDS: (i) increasing incomes from sustainable sources and reducing economic inequalities; (ii) increasing access of people to physical infrastructure, public utilities and living conditions, and (iii) improving working conditions and reducing informal employment[1], decision-makers should focus on the following goals and actions:

1. Maintain the stability of the financial system

- maintain stability by preventing over-indebtedness of the population
- improve the supervision mechanism of the non-banking financial system
- develop the deposit guarantee mechanism

2. Ensure the integrity of the financial system

- build credibility externally
- assess citizenship-by-investment programs and capital amnesty
- exclude interaction with off-shore areas

3. Develop long-term maturity resources

- reform the pension system
- develop the Government securities market
- make the intermediation mechanism more efficient

4. Involve the financial system in the eradication of the informal economy

- increase the financial inclusion of the population
- promote electronic payments and diminishing the use of cash in the economy
- encourage initiatives to develop financial instruments through technologies

5. Increase the level of financial education and protection of the consumers of financial services

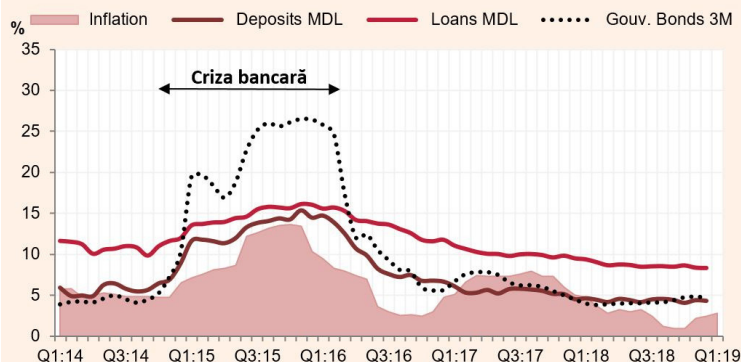
- increase the level of financial education among the population
- improve the protection measures for the consumers of financial services
- supervise and regulate the trading platforms for financial instruments

[1]The three goals of the first pillar 'Sustainable and Inclusive Economy' of the 'Moldova 2030' Strategy

Financial system at a glance Q1:19

INTEREST RATES

Favourable monetary conditions and decrease in inflation rate beyond expectations in 2018 caused a continuous reduction in interest rates. The rates on bank deposits in MDL and on Government securities decreased continuously until Q4:18. Likewise, rates on credits reached historical lows. However, return of inflation to a positive growth trend since Q1:19 could lead to a slight strengthening of them.



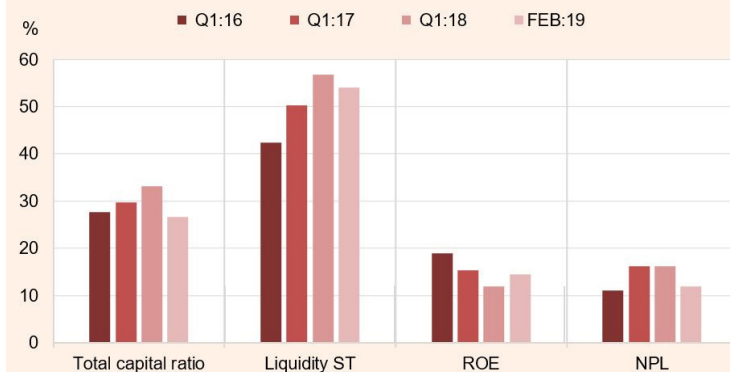
FINANCIAL INTERMEDIATION

Intermediation activity showed growth rates, especially based on demand from individuals. The expansion of the monthly volume of bank loans was due to the loans granted for the purchase/construction of property or for consumption. On the other hand, non-bank credit organizations (microfinance and leasing companies) have also expanded their activity, especially since 2014.



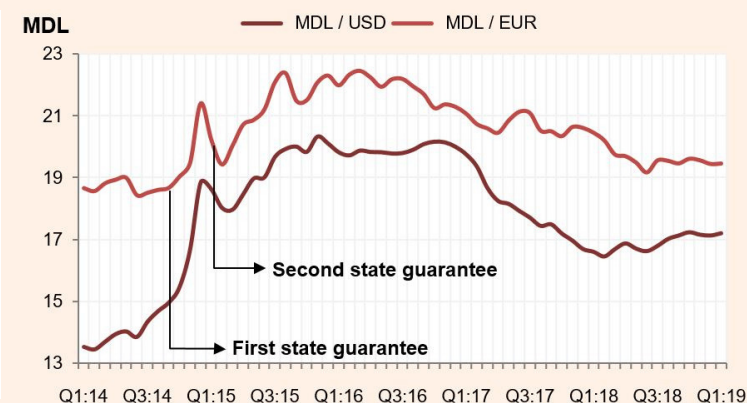
BANKING SECTOR INDICATORS

Aggregate indicators for the banking sector remain at an appropriate level, showing the stability in the system. Lower rates on Government securities had a negative impact on banks' profitability. Excessive short-term liquidity persists, although the trend seems to have reversed since the beginning of 2018. This still requires costly sterilization actions from NBM.



EXCHANGE RATE

Exchange rate volatility was exacerbated due to money issued by NBM in 2014 and 2015. Signing the agreement with the IMF and the moderate relaunch of the local economy contributed to national currency appreciation - a trend started in Q1:17, which seems to be over in Q1:18. From the moment the local minimum was reached, the national currency depreciated by 5.1% against USD.



Source: Developed by authors with data from the NBM, NCFM, NSB

1. Ensure the Stability of the Financial System

During the banking crisis of 2014-2015, the national financial environment felt for the first time what real financial instability was and how the systemic risk looked like. Regardless of the underlying causes, the consequences proved to be the most serious for the real economy and entire society. The scope of events gave rise to a strong focus on the concept and mechanism of financial stability aimed at preventing possible systemic crises and reducing the contagion effect. A starting point was the reform of the National Financial Stability Committee, the establishment of a specific division within the NBM and the development of tools for monitoring, quantifying and managing systemic risk. Even so, a number of priority actions related to maintaining the financial stability have not yet been implemented, which can create obstacles to increasing the levels of income and reducing poverty, which are strategic priorities for the country. The main actions in this regard are the following:

- Maintain the stability by preventing over-indebtedness of the population. Uncontrolled increase in the indebtedness of the population may pose a risk to the stability of the financial system. At the same time, it is also a social problem as excessive indebtedness coupled with financial deterioration in the population's position has a strong negative effect on the well-being and growth of poverty. There is currently few statistical data that could provide an objective picture of the indebtedness of citizens, a holistic assessment being impossible. Having analyzed aggregate data, Moldova is not currently at a critical point, but strong growth in consumer loans, both in the banking and non-banking sectors, requires the implementation of immediate actions. It is essential to start collecting data to monitor the indebtedness of the population by the National Bureau of Statistics and to extend the obligation to report to the Credit Bureau of all sectors granting loans to the population. At the same time, in terms of protection of citizens, it is important that annual percentage rate of charge (APR) is included in any credit advertising and that the credit agreement is provided to the client before signing it.

- Improve the supervision mechanism of the non-banking financial system. The situation in the banking sector over the past years, characterized by the increase in the level of regulation and supervision, has stimulated the non-banking financial activity. The lack of prudential requirements for microfinance or leasing companies has fueled a rapid increase in loans granted by these market participants. Almost over the past few years these companies have quickly expanded their activity to a market share of about 22% of the credit market (twice higher than in 2014). These figures, which should by no means be neglected, have showed the need to supplement the regulatory and supervisory mechanism so that any expansion of the intermediation level takes place in a sustainable way and in the interest of maintaining financial stability. However, until the level of regulation of the non-banking market is increased, the interventions should focus on the close knowledge of the activity of the participants and the testing of different stress situations. In this regard, before assessing the degree of intervention, a detailed assessment of the micro-credit system is needed to understand the specific risks.

- Develop the deposit guarantee mechanism. The current deposit guarantee system in the banking system has shown its inefficiency in the context that the 2014-2015 crisis could not only be prevented, but even solved through BDGF. Although the recent amendments to the current legislation have extended the coverage level up to MDL 50,000, the mechanism still has a modest role in preventing crises and penalizing the risky activity of banks. Against this background, it is important that the Fund Reform continues so that banks with a higher risk appetite are properly charged for possible implications upon the entire financial system. In addition, the protection of depositors should extend to a wider group of people, such as legal entities or other categories of individuals (e.g. individual entrepreneurs). Last but not least, guarantee schemes should be developed for other forms of saving as well, such as deposits within Savings and Loan Associations that have become quite active lately.

2. Protect the Integrity of the Financial System

For the Republic of Moldova, the need to ensure the integrity of the financial system has become a matter of utmost importance that was, relatively recently, the target of large-scale money laundering and frauds. All these events have already shown how dangerous corruption, money laundering and interaction with off-shore areas can be for the society. Consequently, following the events occurred during the banking fraud, the feeling towards the Republic of Moldova is rather uncertainty and lack of trust. Besides, a number of programs that do not come within the logic of the financial system upgrade have been lately adopted, which casts doubt on the authorities' intention to ensure a clean financial system that will contribute to the development of legal economic activity. In addition, these initiatives were included neither in the governmental program adopted by Parliament. The responsibility and transparency of the state institutions are the main pillars on which the "Moldova 2030" NDS is grounded. To ensure the country's sustainable development, the citizen should be certain that, before being implemented, public policies are assessed objectively, with the interest of citizens being a priority. In this context, actions for upgrading the banking system should take into the safeguarding of the domestic financial system's integrity, bearing in mind the following aspects:

- Build credibility externally. Even if the reforms in the banking sector improved to some extent both its image and resilience, the events of 2012 could still have a negative impact on investor sentiment. Besides, in the absence of clear results of the bank fraud investigation, the country's main foreign donors could also revise their strategies towards the country. The Moldova-IMF Agreement, which is the main anchor of the Government in the dialogue with external partners and investors, expires in 2019. The termination of the agreement is even more unsettling as the Government has manifested times and again the desire to move beyond the assumed commitments, having adopted a number of initiatives that could undermine the capacity of banks to prevent the arrival of dubious money (e.g. capital amnesty). Against this background, even if the fiscal situation does not require it, in order to provide credibility externally, Moldova needs an extended dialogue with IMF. At the

same time, these concerns, including an extensive review of this topic, were expressed in the Issue #57 of the 'Economic Reality' publication focused on the main economic challenges of 2019[1].

- Assess the citizenship-by-investment and capital amnesty programs. Contrary to criticism from society and external partners, 'Citizenship-by-Investments' and 'Capital Amnesty' programs were launched by the Government. The secrecy and lack of information on possible outcomes draw attention to possible legalisation of dubious funds, especially in the context of slow recovery of embezzled funds during bank fraud. At the same time, a dubious investment process stood out over the past period, whereby important state assets were sold to non-transparent investors and in exchange for some funds whose origin was questionable to say the least. Hence, in order to reduce money laundering risks, a broad analysis of the impact of implementation of the two programs is required. It is crucial that reports are submitted on the results achieved by each program, as well as on the amounts subject to amnesty or invested.

- Exclude interaction with off-shore areas.

Implementation of international transparency standards in the national legislation, knowing the real owners of the public interest entities and thorough verification of investments of exotic origins should be on the Government's agenda. Bringing the business environment inside the normal boundaries of the market economy, as well as fair competition, competition and free initiative depends on the achievement of these actions. At the same time, although national legislation transposes the latest practices in combating corruption and money laundering, a number of deficiencies in the institutions responsible for such actions creates preconditions for the persistence of this phenomenon. If we also add the gaps in the justice system, then we still have a combination of risk factors for the financial system.

[1] Economic Reality #57, Top 5 Positive and Negative Trends of 2018 and Top 5 Economic Challenges for 2019, Expert-Grup, December 2018, <https://www.expert-grup.org/ro/biblioteca/item/1720-realitatea-economica-decembrie-2018-editie-speciala&category=179>

3. Develop long-term maturity resources

Like most developing countries, the Republic of Moldova faces a lack of financial resources with long maturity.

This can be noticed both within the budget deficit financing structure and the intermediation mechanism supported by banks and other market participants. The situation is determined simultaneously by the small long-term capital supply from the savers and the lack of instruments that are sufficiently adapted to the saving and investment needs of the population. More than 75% of all new deposits attracted by banks are up to 1 year and only about 4% have a maturity of more than 5 years. This market characteristic limits banks' capacity to finance the real economy and extensive infrastructure projects. An eloquent example of this constraint is the rapid deterioration of the long-term liquidity indicator[1]. With higher real estate credit portfolio, including due to the 'Prima Casa' government program, some banks depleted the already few available long-term resources. Ensuring a favorable framework for the emergence of these resources will be decisive in achieving progress on the 'level of income' dimension included in the "Moldova 2030" NDS, especially in terms of enterprises' access to financing. Under these circumstances, a number of actions are needed, including:

- Reform the pension system. Due to the relatively short maturity of bank deposits and limited access to foreign financial markets, the most viable solution for boosting the supply of long-term financial resources is pension funds. The full pension system reform should provide for the addition of the second pillar - based on the principle of accrual of individual contributions and upgrade of the legal framework for the third pillar - optional pension system. The main difficulty for implementing the second pillar is the liquidity shortage that had occurred upon the removal of part of the resources from the joint system. An earlier analysis carried out by Expert-Grup[2] has showed that although the introduction of the second pillar will lead to higher deficit in the redistributive system in the short and medium run, the pressures on it will decrease substantially in the long run. On the other hand, the development of the third pillar should be boosted by providing tax deductibility of contributions, tax treatment that would be equivalent to that applied to state social insurance contributions.

- Develop the Government securities market. A developed GS market can create the preconditions for the emergence of financial resources with long maturity. Issued five year maturity GS have been an important step taken by authorities that has to base a long-term trend. GS are the most important instruments of the capital market, their rate being the reference for determining the cost of other instruments. The current GS placement and trading mechanism favors the banks holding more than 70% of the GS balance in circulation. Thus, it requires increasing the number of people having access to primary tenders of GS and their trading on free secondary market (stock exchange).

- Make the intermediation mechanism more efficient. Despite excessive liquidity and favorable macroeconomic conditions, banks are reluctant to credit the business entities. Harsher credit requirements after the crisis, increase in the volume of non-performing loans and the lack of a viable demand from the business environment lead to modest trends in the intermediation process. The persistence of a high volume of non-performing loans in the banks' balance sheets is an element that slows down the lowering of risk premium and, implicitly, the expansion of lending activity. Starting a coordinated clearance process can have positive implications on reducing the rates. The current model of enforcement of the pledge generates additional costs that increase the risk premium and implicitly the interest rates. Thus, besides the upgrade of the banking legislation, the pledge legislation (e.g. the maximum term within which the pledged values can be transmitted into the lender's ownership) should be revised. Moreover, Credit Bureaus can become a more reliable source of knowing the customers with expanding the volume of customer debt information.

[1] Long-term liquidity indicator for some banks reached the allowable limit of 1.00 .

[2] Adrian Lupusor, 2012: https://www.expert-grup.org/media/k2/attachments/Pretul_solidaritatii_intre_generatii_si_mo_delul_optim_de_reforma_a_sistemului_de_pensionare.pdf

4. Involve the financial system in the eradication of the informal economy

The informal economy comprises all economic activities that the state authorities are not aware of. According to official statistical data, it is conservatively estimated at about 24.5% of Moldova's GDP, showing an increase in the last years[1]. Population engaged in non-observed economy has low productivity and people doing informal entrepreneurial activities do not have any incentives to invest and pay taxes. These things have a negative impact on the country's development prospects because the low tax collections to the public budget affect the infrastructure, public services and social incomes of the population. Extending the coverage of the formal financial system can play a positive role in eradicating the informal economy, which will affect the quality of population employment and empower more people to demand that their rights be respected by preventing the attempts of discrimination from employers. Simultaneously, the increase in government revenue will enhance the capacity of the authorities to ensure access of the population to physical infrastructure and public utilities. To achieve these priorities deriving from the "Moldova 2030" NDS, the following actions need to be implemented:

- Increase the financial inclusion of the population.

Access to financial services has a positive impact on the formalization of the economy and can increase the welfare of the population. Having access to bank accounts, people can save and use safely the payment electronic platforms. According to World Bank data[2], the share of Moldovan citizens holding at least one account in a financial institution was 44% in 2017. This indicator is 2 percentage points higher among women compared to men. This is an important achievement, since traditionally in developing countries women face limited access to financial services, the number of women holding at least one account being on average 9 percentage points less than the number of men[3]. The lack of savings, the high cost of banking services, and the lack of trust in the financial system are the main reasons why people hesitate to open accounts in Moldova, according to the same data. Reducing the transaction costs, making all government transfers exclusively through the banking system, and promoting the information and protection of consumers of financial services should become an imperative.

- Promote electronic payments and diminish the use of cash in the economy. During 2018, cardholders made over 50 million transactions across the country, recording a 25% increase y-o-y. In the fourth quarter of 2018, for the first time in history, the number of non-cash payments exceeded the number of cash withdrawals from the card. However, by volume, cash withdrawals exceed 6 times non-cash payments. Building an internal payment system could be a solution to lower costs associated with the use of international payment systems (Visa or MasterCard), but taking into account the small size of the market, the costs of creating the infrastructure may well outweigh the benefits. Alternative payment methods such as the use of e-wallet or the integration of services with online banking platforms can catalyze the transformation of the payment system and reduction of cash in the economy.

- Encourage initiatives to develop financial instruments through technologies (Fintech). Regulators need to be more open to digital innovations in the area of payments and financial services. The European practice provides in this regard for the creation of sandboxes, which is a framework enabling newly-established FinTech companies to conduct experiments under real conditions, in a controlled environment and under the supervision of regulatory authorities. Subsequently, after the testing period, if the product is found to be suitable for the market, the participants submit the dossier to obtain all the authorisations according to the legislation in force. This will considerably reduce the costs of launching businesses by stimulating innovation.

[1] National Bureau of Statistics:
http://www.statistica.md/public/files/serii_de_timp/conturi_nationale/serii_anuale/Dinamica_econom_neobservate.xls

[2] Global Findex World Bank database:
<https://globalfindex.worldbank.org/>

[3] IDEM

5. Increase the level of financial literacy and protection of financial services consumers

Increasing the complexity of the financial system often hinders the correct understanding of concepts and products in this field. The emergence of new financial instruments and the increased digitization of payment systems, while developing the related legal framework, determine additional individual capacities and skills for the population. On the one side, they are necessary to guarantee the individual protection of people, which can enhance the quality of personal and family life. On the other side, increased skills of the population can accelerate the financial inclusion, which is so necessary in the context of maintaining the trust in the financial and banking system and ensuring its stability. As a result, there is a need to achieve two goals for sustainable and inclusive economic development, namely: increasing the level of financial education among the population and increasing the level of protection from the state authorities, respectively. The "Moldova 2030" NDS puts a special emphasis on the development of life skills that directly influence people's ability to integrate into community life and labor market, and the financial skills are indispensable for people's professional achievement. In this train of thoughts, the following policy actions are needed to be undertaken:

- Increase the level of financial education among the population. Sustainable development is based on a well-informed community with a high level of education. In the context of the financial system, the capacity of individuals to make intelligent and risk-adjusted decisions contributes to the financial well-being of the society and the stability of the system in whole. Moreover, increased financial education of the population becomes imperative for individual protection against the adverse activities of business entities. Thus, the need to educate the population by learning the concepts and products related to the given field should become a priority for the next period and materialize through extensive campaigns of financial education. They should focus on passing on the necessary knowledge to the people that can ensure they are sufficiently literate to take the right decisions on managing financial events.

- Improve the protection measures for the consumers of financial services. The need to upgrade the national financial and banking system led to a change in the approach to the role of consumers in the national financial circuit. Market economy, including the financial and banking sector, is based on both well-informed and well-protected community by the state authorities. A rapid extension of the financial services to individuals has been noticed over the last period, materialized mainly through consumer or mortgage loans, however without enhanced level of protection. Under these circumstances, without any intervention by state authorities, the number of consumers exposed to abuses by service providers could increase. To prevent these fears from becoming real, it is important that the authorities responsible for supervising the financial system and those responsible for consumer protection clearly divide their competencies.

- Supervise and regulate trading platforms for financial instruments (forex, derivatives, binary options, etc). Increased incomes and savings of the population, coupled with a severe shortage of saving or cost-effective investment instruments, enhance the risk aversion among the population. In the hope of quick and higher earnings, an increasing number of people decides to invest their savings through forex platforms or other digital/virtual coin instruments, etc. However, as financial history has shown, high earnings are associated with corresponding risks, thus many people fall victim to the aggressive promotion of relevant providers. As a result of these practices, both consumer protection and the image of intermediaries regulated and authorized to operate on the capital market are jeopardized because most people do not differentiate between authorized and unauthorized participants to conduct certain financial activities. As a consequence, given that such operations are not currently subject to any national regulations, policymakers should come up with initiatives targeted at preventing the above risks.