# PREPARING THE BANKING SECTOR FROM THE REPUBLIC OF MOLDOVA FOR THE IMPLEMENTATION OF BASEL III

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**Abstract:** *Basel III Agreement is a framework of bank regulation which aims to strengthen the stability of the financial system by applying stringent standards designed to improve its ability to absorb shocks from the economic and financial sector and to reduce the risk of contamination from the financial sector to the real economy. The purpose of the article consists in the identification, analysis, monitoring and control of risks according to international standards in conditions of bank exposure to diverse risks. The research was made in base of analyzing the banking sector of the Republic of Moldova. For this the following measures were taken: identification of background of current situation of the banking system; disclosure and justification of credit risk; analysis of the European experience of implementing the Basel III Agreement and the identification of strategies for implementing this agreement in the banking sector of the Republic of Moldova.*

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

## 1. Introduction

Basel III is a fundamental review of the regulatory and supervisory framework of the banking industry with the objective to strengthen the stability of the financial system, by applying the required standards to improve its ability to absorb economic and financial shocks and to reduce the risk of contamination from the financial sector to real economy.

The major difference from the previous agreements is the much broader covering area, the measures being both micro-prudential (covering individual bank risks) and macro-prudential (covering the entire banking system).

Full implementation of the Basel III Standards, in line with the strict deadlines, is essential for strengthening the financial system. Implementation responsibility falls not only to regulatory bodies, but extends the scope of specialists to risk managers of banks and implicitly to auditing, which has a key role in the independent and disciplined review of management efforts. The challenge is that implementation takes place during an uneven and uncertain post-crisis recovery of states.

***The scope of research*** is risk identification, analysis, monitoring and control according to international standards, in the context of diversified risks exposure by banks. The investigation was carried out on the basis of analysing the banking sector of the Republic of Moldova.

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

## 2. The quality of regulation and supervision of the banking system in the Republic of Moldova

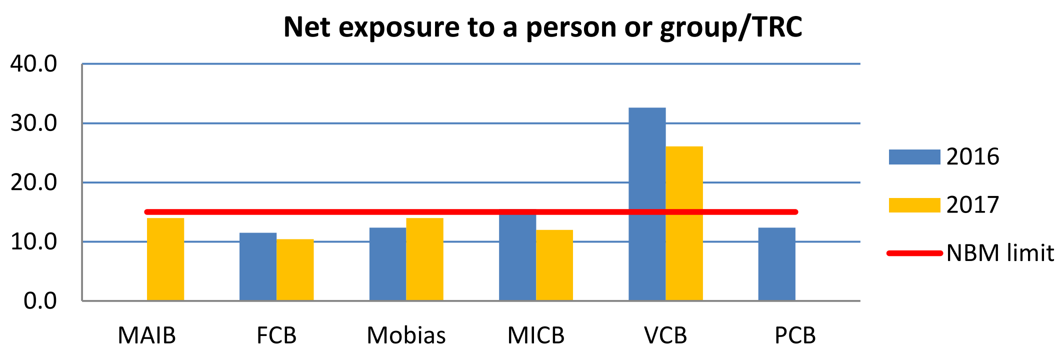
The banking sector of Moldova is in a recovery phase after the crisis from 2014 and is characterised through severe systemic problems: insufficient transparency of shareholders and actual beneficiaries, vague lending procedures, poor management, poor internal control procedures and audits, and so on.

As a result of this crisis 3 banks stopped their activity and were declared bankrupt due to non-compliance with the National Bank of Moldova (NBM) regulations; also, the crediting activity of the banking sector was reduced from 40,842 million MDL in 2014 to 33,473 million MDL in 2017, as a result the short-term liquidity increased from 33,76% in 2013 to 55,48% in 2017. At the same time, the NBM managed to stop the process of developing new dubious and compromised loans, so the level of this indicator reduced from 11,7% in 2014 to 10% in 2015. However, the loan portfolio has deteriorated since 2016, so that in 2017 the level of this indicator has reached 18,4%.

The NBM imposes the banking sector a number of limits to be respected, further a retrospective of the implementation of these regulations is realized:

1) ***Large exposures: The net exposure assumed by the bank towards a person or group of connected persons must not exceed 15% of the bank's total regulatory capital (TRC)***.

Fig. 1. Evolution of Net exposure to a person or group/TRC, Rep. Moldova



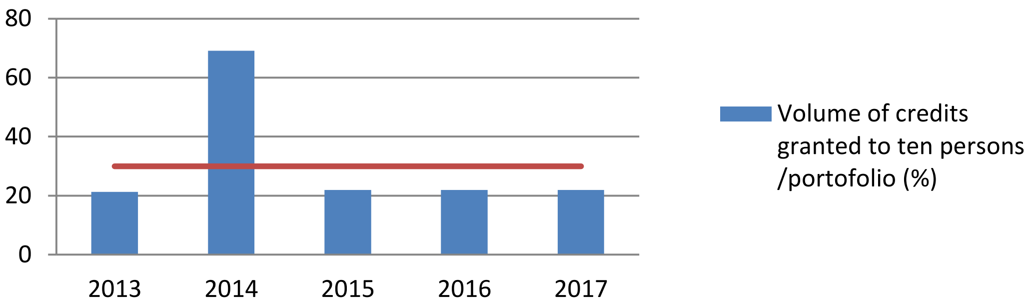

*Source:* elaborated by authors in base of data retrieved from the site of NBM

During 2013-2015, no bank records values for this indicator. In 2016-2017 all the banks respected this imposed limit except for the BC "VICTORIABANK" JSC, which in 2016 registers 32,6% and in 2017 its value decreases to 26,1%. The recorded values in the banking system are well above the limit imposed by NBM (see fig. 1).

***The amount of net debt on loans granted to ten persons,*** including groups of connected persons, which are by size the first net credit, minus credit losses and provisions on those contingent liabilities, shall not exceed 30% of the total amount of the bank loans and contingent liabilities to ten individuals, including groups of connected persons, which are by size the first net debt on credit minus the provision for the contingent liabilities.

It is noticed that the value of this indicator is approximately static over the years, except for 2014 (see fig. 2). In 2014, two of the three problematic banks did not respect this imposed limit, namely: BC “Banca de Economii” JSC – 39,7%, BC "Social Bank " JSC – 1216,1%. In 2017 the banks with the highest values of this indicator were: BC “BCR Chisinau” JSC – 29,9%, BC "EXIMBANK - Gruppo Veneto Banca" JSC – 29,3% and BC "VICTORIABANK" JSC – 27,5% .

Fig.2. Evolution of net debt on loans to ten persons minus losses on loans / total portfolio indicator, Rep. Moldova

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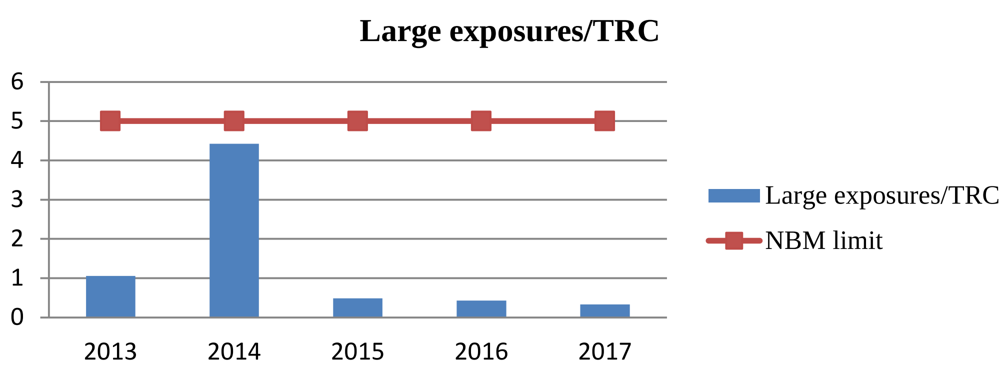
***The sum of all "large" exposures should not exceed more than five times the TRC.***

Fig. 3. Evolution of large exposures/TRC indicator, Rep. Moldova

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It is noticed that over the years the banking sector shows a decreasing trend of this indicator from 1,06% in 2013 to 0,33% in 2017 (fig. 3). In all years, the limit of large exposures imposed by the NBM is respected. In 2014, the value of this indicator is distorted by the values recorded at the three problematic banks, as follows: BC "Banca Sociala" JSC registered 40,71%, BC "Banca de Economii" JSC - 32,15 % and BC "UNIBANK" JSC – 5,94%. In 2017 the banks with the highest level of this indicator were: BC "Moldindconbank" JSC – 0,76%, BC "VICTORIABANK" JSC – 0,71% and BC "MOBIASBANCA - Groupe Societe Generale" SA – 0,35% %.

The total amount of the bank's net exposures in Moldovan Lei to foreign currency exchange in respect to natural persons, including those engaged in entrepreneurial activity or other type of activity, must not exceed 30% of the TRC, of which the total amount of net exposures, other than mortgages, must not exceed 10% of the TRC.

The aggregate amount of net debt on loans granted and contracted with the bank by shareholders directly or indirectly controlling or controlling less than 1% of the bank's share capital, including their affiliated persons, must not exceed 20% of Tier 1 bank capital.

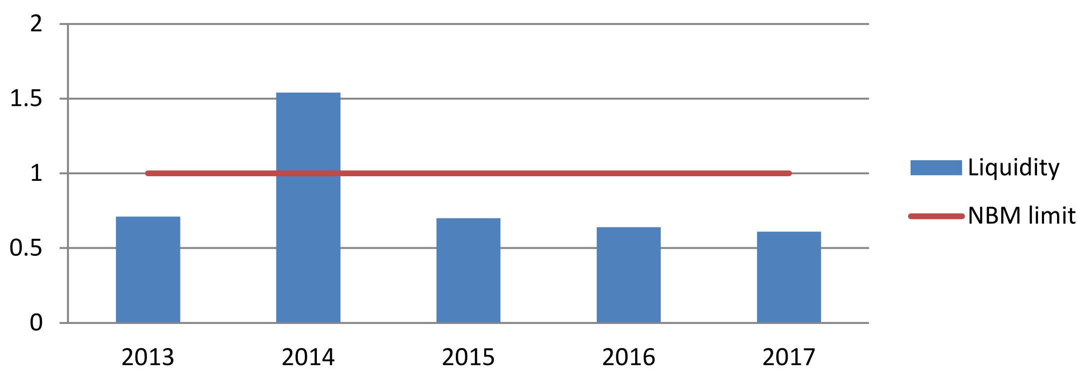
The aggregate amount of net debt on ***loans granted*** and contracted with the bank by shareholders directly or indirectly controlling or controlling less than 1% of the bank's share capital, including their affiliated persons, must not exceed ***20% of the Tier I capital of the bank.***

Banks from the domestic banking sector have respected this limit over the years, so the level of this indicator registeres a declining trend from 11,28% in 2014 to 6,28% in 2017. Banks with the highest values are BC. "Energbank" JSC – 13,9%, BC "Moldindconbank" JSC – 9,01% and BC "Moldova - Agroindbank" JSC – 8,98%.

**2) Liquidity.**

***The bank's long-term liquidity (principle I) indicator*** must not exceed 1. A downward trend of this indicator is recorded over the years, from 0,71 in 2013 to 0,61 in 2017 (fig. 4). The value of this indicator in 2014 was not respected because some banks recorded violations (for example, BC "Banca Sociala" JSC – 19,69).

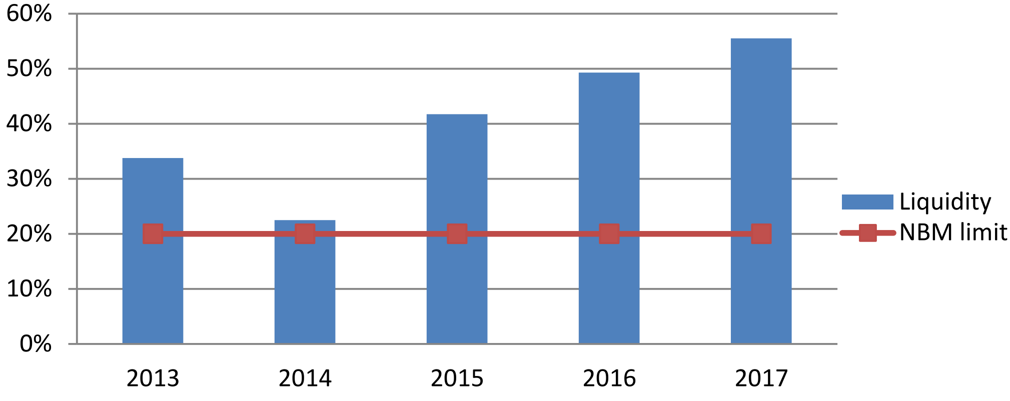
Fig. 4. Evolution of long-term liquidity (principle I), Rep. Moldova




*Source:* elaborated by authors in base of data retrieved from the site of NBM

From November 30, 1998, banks must achieve and maintain the current liquidity ratio ***(principle II) of at least 20%.***

Fig. 5. Evolution of short-term liquidity (principle II), Rep. Moldova



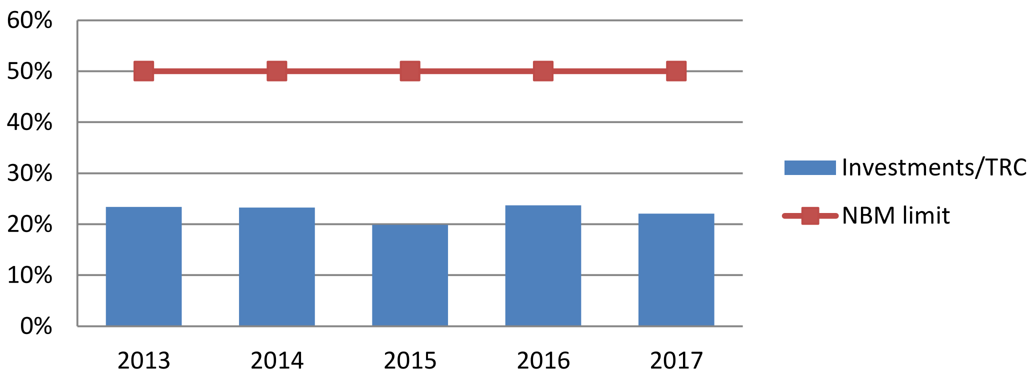

*Source:* elaborated by authors in base of data retrieved from the site of NBM

It is noticed that there is a steady upward trend in short-term liquidity from 33,76% in 2013 to 55,48% in 2017, so over the years the banking sector respects this limit (fig. 5). In 2017, the banks with the highest liquidity level were: BC "Victoriabank" JSC – 68,09%, BC "Comertbank" JSC – 61,08% and BC. "Energbank" JSC – 60,5%.

**3) Investments' limit.**

***A bank's investment in tangible assets*** should not exceed ***50% of its TRC [7].***

Fig. 6. Evolution of bank's investments in tangible assets/TRC indicator, Rep. Moldova




*Source:* elaborated by authors in base of data retrieved from the site of NBM

During 2013-2017, banks comply with the limit imposed by the National Bank of Moldova (fig. 6). This indicator fluctuated from 23,38% in 2013 to 22,08% in 2017. In 2017 the banks with the highest level of this indicator were: BC "FinComBank" JSC – 46,14% BC "EXIMBANK - Gruppo Veneto Banca " JSC – 38,93% and BC "ENERGBANK " JSC – 30,28%.

The total value of a bank's investment in tangible assets and participation rights in the capital of legal entities, except for banks, should not exceed 100% of its TRC [7].

It is noticed that banks in the banking sector have respected this limit over the years. There is an increasing trend of this indicator from 23,38% in 2013 to 27,06% in 2017. The banks that recorded the highest level of this indicator in 2017 were: BC "FinComBank"

JSC – 48,21% BC "VICTORIABANK" JSC – 40,23% and BC "EXIMBANK - Gruppo Veneto Banca" JSC - 39%.

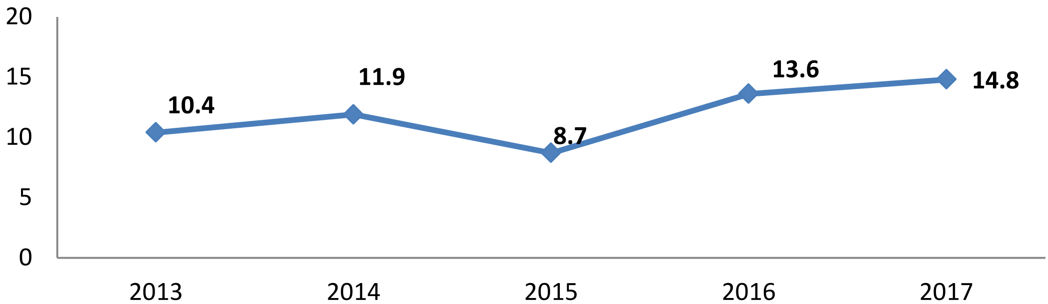
**4) Bank' shareholders**

Without the prior written permission of the National Bank of Moldova: No potential acquirer can in any way acquire a substantial share in the bank's share capital or increase its substantial share so that its proportion (s) of voting or shareholding in the share capital to reach o r exceed the level of 5%, 10%, 20%, 33% or 50%, or so that the bank becomes a branch of it [6].

**5) Bank performance indicators:**

- *K1=expired credits/credit portfolio*

Fig. 7. Evolution of K1 indicator, Rep. Moldova

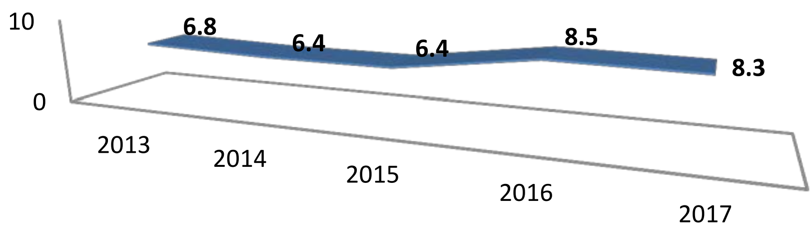



*Source:* elaborated by authors in base of data retrieved from the site of NBM

It is noticed that K1 indicator has grown from 10,4 in 2013 to 14,8 in 2017, due to the fact that the volume of expired loans increased at a higher rate than the value of credit portfolio (fig. 7). The banks that recorded the highest level in 2017 of this indicator were: B.C. "EXIMBANK - Gruppo Veneto Banca" JSC - 43%, B.C. "VICTORIABANK" JSC - 26%, B.C. "ENERGBANK" JSC – 12,5%. The banks that recorded the lowest level of this indicator were: B.C. "FinComBank" JSC - 1.9%, B.C. "MOBIASBANCA Groupe Societe Generale" JSC – 3,0%, B.C. "COMERTBANK" JSC – 3,7%.

- *K2= provisions for loan losses/Total Assets*

Fig. 8. Evolution of K2 indicator, Rep. Moldova



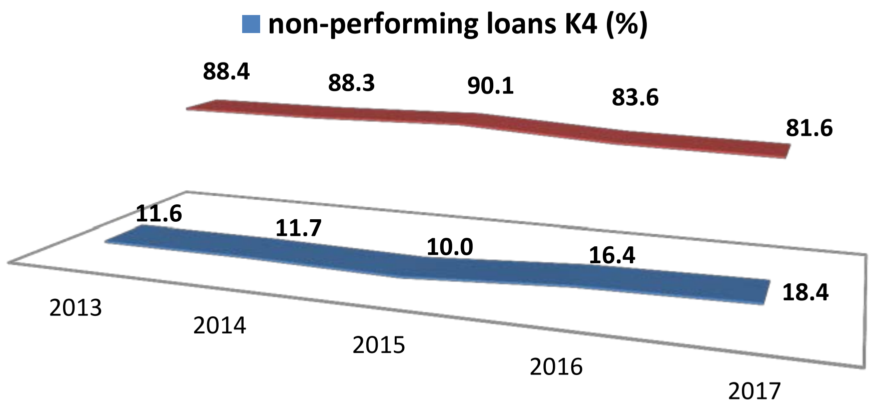

*Source:* elaborated by authors in base of data retrieved from the site of NBM

This indicator registers a growing trend so that in 2013 it reached 6,8 while in 2017 it increased to 8,3 (fig. 8). This is due to the fact that banks recorded more provisions for loan losses than in previous years.

- *K3 = performing loans/credit portfolio*

- *K4 = non-performing loans/credit portfolio*

Fig. 9. Evolution of K3 and K4 indicators, Rep. Moldova

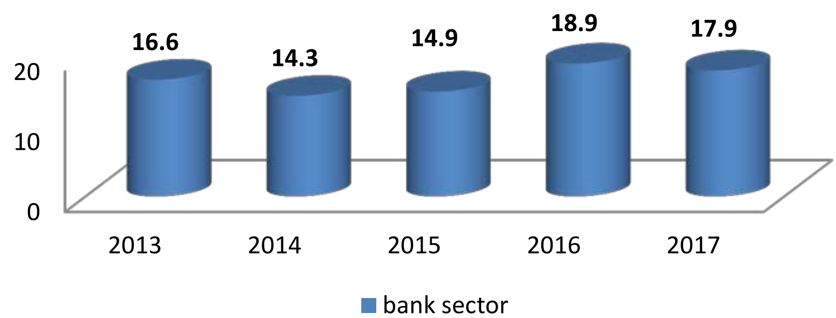



*Source:* elaborated by authors in base of data retrieved from the site of NBM

We note that the quality of the credit portfolio of the banking sector worsens year by year, in 2013 the ratio of non-performing loans to total portfolio was 11,6% and in 2017 the level of this indicator increased to 18,4% (fig. 9). This increase is due to the fact that the following banks worsened their credit portfolio considerably: BC "Moldindconbank" JSC this indicator rose from 16% in 2016 to 29,4% in 2017, BC. "EXIMBANK - Gruppo Veneto Banca" JSC level of this indicator rose from 28,9% in 2016 to 34,05% and BC "COMERTBANK" JSC increased this indicator from 16,1% in 2016 to 20,26% in 2017. The banks with the most non-reforming loan portfolio are: BC "EXIMBANK - Gruppo Veneto Banca" SA - 34%, BC "VICTORIABANK" JSC - 33% and BC "Moldindconbank" JSC – 29,4%. The banks with the highest credit portfolio are: BC "FinComBank" JSC – 4,02%, BC "MOBIASBANCA - Groupe Societe Generale" JSC – 7,4% and BC "EuroCreditBank" JSC – 8,82%.

- *K5 = non-performing credits/TRC*

Fig. 10. Evolution of K5 indicator, Rep. Moldova



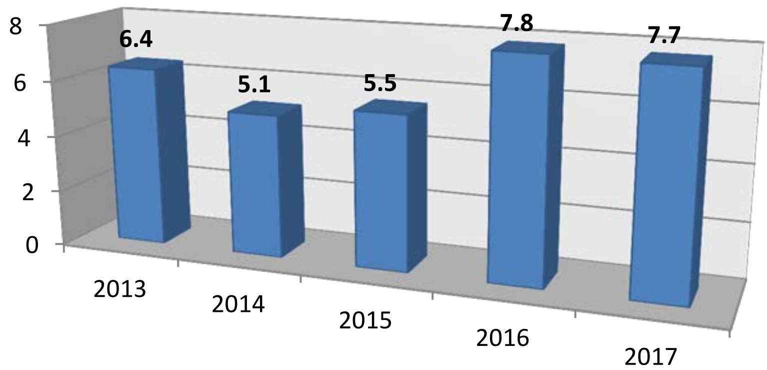

*Source:* elaborated by authors in base of data retrieved from the site of NBM

We observe an increasing trend of this indicator, so that in 2013 this indicator reached 16,6 and in 2017 rose to 17,9 (fig. 10). Banks with the highest level are: BC

"Moldindconbank" JSC – 46,6%, B.C. "COMERTBANK" JSC – 18,8%, BC "MOBIASBANCA - Groupe Societe Generale" JSC – 18,7%. The lowest level is recorded by BCR Chisinau JSC -3,8%. This is due to the fact that non-performing loans have increased to a greater extent than TRC.

- *K6 = non-performing credits/Total Assets*

Fig. 11. Evolution of K6 indicator, Rep. Moldova




*Source:* elaborated by authors in base of data retreived from the site of NBM

An increasing trend of this indicator is observed, so that in 2013 this indicator reached 6,4 and in 2017 rose to 7,7 (fig. 11). This is due to the fact that non-performing loans have increased to a greater extent than the bank's assets.

The NBM has considerably tightened bank supervision and reporting standards, including those related to compromised loans**.** However a number of systemic problems persist, among them: issues of transparency of shareholders and effective beneficiaries, corporate governance and inefficient management, weak internal control procedures and audits. Although the NBM stopped creating new, dubious and compromised loans, the solution of the existing ones is difficult.

The intervention of the NBM at the three largest commercial banks, MAIB, MICB and VictoriaBank, which hold about 75% of the total assets in the banking system, highlighted a number of systemic problems of the banking sector. These problems have determined NBM's banking regulatory and supervisory policy for the next 2-3 years [4]. These issues can be grouped into five categories: *shareholders' transparency; credit risk, including bad loans, "large" exposures and exposures to affiliated persons; operational risk; internal governance; combating money laundering and terrorist financing*.

The success of overcoming these vulnerabilities of the banking system depends on how quickly banks will be able to recover from the crisis and will operate normally. Regarding shareholders 'transparency, most banks have long been facing problems with the opaque structure of shareholders, which can significantly affect corporate governance and jeopardize banks' financial standing. In this context, more attention should be paid to interacting with affiliated persons and exposures to affiliated banks, in order to avoid a negative influence on the bank's financial condition. In 2016, the NBM found two largest groups of two groups of shareholders operating in concert and holding substantial shares without the prior written permission of the NBM. The NBM has proposed that, by the end of June 2017, all banks should carry out the exercise of shareholders' transparency [4]. For this purpose, exhaustive information on the shareholders' reputation, criminal history, professional activity, financial soundness, including the provenance of the financial resources used to acquire the share of participation in the bank's capital, was requested. At the same time, the transparency of the banking sector could be achieved by attracting high-quality investors with an impeccable reputation at local and international level, demonstrating financial soundness capable of ensuring the bank's financial resistance to internal and external shocks and a strong corporate governance.

Credit risk is another major vulnerability in the banking sector. During the years 2016-2017 both bad loans and the loan portfolio had a negative trend. Thus, non-performing loans increased by 12% in 2016 vs 2017, accounting for 18.4% of the loan portfolio in 2017. In 2017, credit risk continues to be the most significant. The NBM aims to carry out controls to verify asset quality, "large" exposures, exposures to affiliated persons, and assess credit risk policies and practices. Particular attention should be paid to non-performing loans, the modalities of their primary reimbursement, and the quality of the secondary reimbursement source, namely the quality and value of credit provision. In this context, banks' procedures, policies and strategies for managing and diminishing the level of non-performing loans, identifying groups of people acting in concert to determine "large" exposures and not allowing the set limits to be exceeded should be thoroughly examined.

Operational risk is another danger to banks. Potential losses may be caused by operational risks such as human factors, including scams, security of IT systems, misconduct of the bank's internal processes, external environment, etc. The NBM proposed in 2017 to assess banks' policies and practices in identifying and preventing these risks. Thus, policies and practices will be evaluated through the minimization of the impact on capital as a result of the damage, the allocation by banks of the means to ensure data security, cyber-prevention, etc. Additionally, on-the-spot controls should address bank compliance with internal policies on operational risk management.

## 3. Estimation of the degree of preparing the banking sector from the Republic of Moldova for the implementation of Basel III

In the case of the Republic of Moldova, the degree of preparation of the banking sector for the implementation of Basel III is primarily focused on the fact that the national banking system, through decision-makers at the central bank and credit institutions, needs to know the provisions of the new agreement. The new situation requires the national banking system:

- transposition of Directive 2013/36 / EU of 26 June 2013 and of Regulation 575/2013 of 26 June 2013, acts included in the EU-Moldova Association Agreement and, respectively, in the National Implementation Plan of the Association Agreement;
- transposing of the provisions of the Basel III Capital Requirements and, at the same time, regulate the prudential treatment of the various risks (credit, market, operational, etc.) for the calculation of risk-weighted exposure.

Based on the analyzed situation, we underline that the implementation of the Basel III Agreement implies the need to act on two main directions, namely [1]:

- Revision of the capital requirements in qualitative and quantitative terms;

- developing short and long term requirements for liquidity.

Revision of the qualitative aspect of capital consists in the elimination of the third tier capital. Another requirement regarding the qualitative aspect of capital is the restriction of the Tier II capital. Thus, the requirements for capital adequacy will amount to 4,5%, and to the first tier capital - 6% [3].

The review of capital requirements in quantitative terms implies three types of surplus (buffer) for the risk-weighted capital adequacy indicator. These are overcapacity to cover procyclical risk (+ 2,5%), overcapacity to maintain capital (+ 2,5%) and additional over-provision to systemically important financial institutions (+ 2,5%).

The new requirements for short-term bank liquidity refer to the maintenance of liquid resources required to honour all one-month obligations and long-term obligations to maintain the necessary resources for obligations fulfilment over a year.

Although the implementation of Basel III regulations is projected for the next 5-7 years, banks' compliance with capital requirements and liquidity requirements will not be difficult for some reasons. First, banks, in accordance with current bank capital regulations, do not have third tier capital. Second, the indicators of the capital adequacy of the social and the first grade banks are at a level that allows them to meet the eventual requirements for that purpose. Thirdly, banks' compliance with liquidity indicators reveals the existence of adequate sources of funding to meet potential needs both in the short and long term.

Similarly, the degree of preparation of the national banking system for the implementation of Basel III results from the approval of *the Law on Banking Activity no. 202 of 06.10.2017.* This normative act attests to the fact that the Moldovan banks will no longer operate after the Basel I system, which was approved in 1988, but will pass to Basel III.

Banks will have a period of three years until 2020 to fully comply with the new rules. The document will come into force on January 1, 2018. According to the law, the rights and powers of the NBM in the process of assessing and supervising banks will be extended, including the sanctions applied to them. At the same time, the law provides for the improvement of the corporate governance framework in banks and their obligation to have adequate capital in relation to the risks to which they are exposed. The new law will also allow the harmonization of national banking legislation with international standards and principles.

In order to improve corporate governance in banks, the regulation on the bank's activity management framework came into force on July 1, 2017, with provisions for risk management, requirements for risk and risk management policies on appetite and risk profile, which ensures a gradual transition to the Basel III framework transposition package.

At the same time, in order to improve the system of continuous promotion in the position of administrator in the banks of the persons who correspond to the appropriate and appropriate principle and, respectively, to ensure the efficient management of the bank, on 27 July 2017 the new regulation was approved in the new regulation towards the administrators [8]. The amendments provide for the improvement of the qualification and experience criteria of the proposed person for the position of administrator, the assessment being carried out by the bank and the supervisor for each person, by applying the judgments on the basis of the significant information related to all the evaluation criteria and taking into account any other relevant circumstances, including the size of the bank, the nature and complexity of its business.

For the final analysis of the banking sector's level of preparedness in the context of the transition to Basel III capital requirements, the National Bank initiated an impact assessment of the Basel III capital change, the first pillar, which aims to determine the quantitative and qualitative impact of regulations on the regulated capital requirements of banks.

Following the publication of the new bank law in the Official Gazette of the Republic of Moldova, the draft secondary normative framework under the Law on the activity of banks (more than 20 regulations) and the COREP reporting framework, which will enter into force on stages. These regulations were elaborated within the Twinning project of the European Union to strengthen the capacity of the NBM in the field of banking regulation and supervision in cooperation with the Central Bank of the Netherlands and the Central Bank of Romania.

At the level of the RM, the NBM endorsed the Basel III Implementation Strategy in the light of the European legislative framework in April 2016. At that time, the document aimed at identifying the measures needed to implement the European Banking Regulation and Surveillance Package and raising awareness of the sector banking for the purpose of proper compliance [3].

The strategy outlined describes how the European Union's legislative package will be transposed and implemented between 2016-2020. Thus, it is now necessary to establish a timetable for entry into force and implementation of the provisions of the new legislative framework after its elaboration. These clarifications will give the banking sector more predictability of the measures and actions that will be undertaken by the NBM as a supervisory authority.

## 4. Conclusions

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

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

1) Creating a sound basis for prudential regulation, including capital adequacy, financial leverage and liquidity, development of supervisory processes, market discipline, and risk management principles and maintenance of financial stability.
2) Employing qualified staff or training existing staff not only within the NBM but also at the level of each bank to ensure that the new requirements are implemented in an efficient and qualitative manner.
3) Presentation by banks of the detailed plans for the implementation of the new requirements and identification of the necessary resources for this process and reporting on the process of assessing the adequacy of the internal capital, the process of assessing the adequacy of internal liquidity.
4) At the same time, in order to ensure a harmonious implementation at the level of the banking system, it is necessary to create transitional provisions specific to each regulated area, which will allow for the timely distribution of regulatory pressure on banks. Transitional arrangements will be discussed and negotiated with banks both at the start of the transposition process and before the implementation phase;

5) Banks should assess how changes resulting from the application of the new requirements correspond to the risk profile and the ability of banks to discuss any issues arising during the implementation of the new requirements with the NBM as supervisor to ensure correct interpretation and coherent new rules.
6) The NBM must continuously ensure bilateral dialogue with banks in the implementation of Basel III requirements and aim to communicate the expectations of the NBM on a regular and effective basis.
7) Adjusting the business model. Banks should review profitability indicators in the context of a higher regulatory environment. Also, some business segments will be evaluated on "accessibility" criteria, given the funding and capital deficit in the future. Redesigning products and services to ensure that they continue to meet customer needs, while optimizing capital and bank liquidity [9].
8) Banks must strive to improve their ability to pass on risks. One way is closer cooperation between the bank and the creative institution of the product so that both teams are engaged in increasing the volume of credits that can be securitized, sold or syndicated. Another way of transferring risk is to expand the bank's partnerships on trade union and securitization issues, both geographically and by industry.

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