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Annual Report 2017

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Foreword by the Governor of the National Bank of Moldova (NBM)



The activities carried out by the NBM in 2017 were in line with the reforming strategy embraced by the Bank in 2016, among the main goals of which can be listed the stabilisation of monetary conditions, the strengthening of the banking sector and the improvement of the national legislative and regulatory framework. These objectives aim at preventing the recurrence of law violations that resulted in a bank fraud during 2012 - 2014 and triggered the financial crisis that followed. A catalyst to the implementation of these reforms is the Agreement signed by the Republic of Moldova with the International Monetary Fund (IMF) on 7 November 2016.

In 2017, the NBM, in cooperation with the country's authorities, successfully fulfilled its commitments made

to the IMF, the latter having declared as successful the first and the second reviews of the progresses achieved in programme implementation, the fact that was confirmed in the IMF decisions of 1 May and 20 December 2017.

Developments that took place on the international market produced mixed effects on the Moldovan economy and, consequently, on the monetary policy of the NBM. On the one hand, a positive evolution of global economy (+3.7% in 2017) created favourable conditions for economic growth in the Republic of Moldova. In the European Union – the main trading partner of our country – the economic growth reached 2.5% and the historically high unemployment rate has decreased. In the East, after two consecutive years of recession, the economy of the Russian Federation grew by 1.5% in 2017. On the other hand, the increase in global demand was the main cause of the rise in international commodity prices, including food and energy. A faster rise in oil prices was partially driven by the cut in extraction quota approved under the agreement of the Organisation of Petroleum Exporting Countries (OPEC).

Against this background, the Republic of Moldova recorded a robust economic growth as well as a temporary increase in domestic consumer prices.

- Thus, in 2017, the gross domestic product (GDP) grew by 4.5%, being driven by the increase in domestic consumption and agricultural production output. The economic growth, recorded in the main countries of emigration of Moldovan citizens, increased the volume of remittances, which in turn contributed to the increase in the purchasing power of local consumers. In the second half of the year, a revival of industrial activity and a strong growth of exports were also recorded.
- In 2017, the average annual growth rate of consumer price index (CPI) recorded 6.6%, 0.2 p.p. higher than in the previous year. Annual inflation of consumer prices rose from 3% in January to 7.3% in December 2017, being driven by the rises in energy prices, food prices and tariffs for regulated services. However, annual core inflation continued to fluctuate within the inflation target range, recording an average level of 4.8%. At the time of drafting this report, the annual consumer price inflation fell to 3.7%, according to April 2018 statistics.

In 2017, as forecasts suggested a steady decline of the inflation rate, the NBM maintained its policy of lowering the base interest rate, yet at a slower pace than in 2016: from 9.0% in early 2017 to 6.5% at the end of the year. At the same time, in order to absorb the liquidity surplus and improve the transmission mechanism of monetary policy, the NBM increased the minimum level of required reserves held in Moldovan lei from 35% to 40%. The minimum level of required reserves held in freely convertible currencies (FCC) was maintained at the same level of 14%. The NBM's monetary policy, the decline of inflation projections as well as the favourable conditions existing on the money market led to a significant improvement in the level of borrowing by the Ministry of Finance on the domestic capital market. Thus, in 2017, the average interest rate on government securities (GS) recorded 6.7% compared to 15.8% in 2016.

The liquidity surplus, recorded in the system, was largely the result of the increased inflow of foreign currency remittances to Moldovan individuals, totalling 1.2 billion U.S. dollars, which represents a growth of 11.2%, compared to the previous year. As a result, during 2017, the Moldovan lei strengthened by 14.4% against the US dollar and by 2.3% against the euro. The appreciation of the Moldovan lei against the U.S. dollar was partially driven by the weakening of the U.S. currency against the euro, which fell from 1.0454 at the beginning of the year to 1.1935 against the euro in December 2017. Therefore, in order to prevent the excessive volatility and appreciation of the Moldovan lei, the NBM, throughout 2017, intervened on the forex market by purchasing the equivalent of 434 million U.S. dollars. As a result, the official foreign currency reserves reached a record level of approximately 2.8 billion U.S. dollars by the end of 2017, thus amply

ensuring the equivalent of 5.5 months of imports of goods and services.

Along with the measures aiming to stabilise monetary conditions, the NBM has taken decisive actions for strengthening the banking sector. To this end, the NBM conducted targeted inspections to check the quality and transparency of the banks' shareholders, verified related party transactions, as well as performed asset quality assessments. Full-scope on-site inspections have been conducted and completed at seven out of the eleven licensed banks. Those inspections uncovered and eliminated the main uncertainty sources affecting the banking sector, whereas the applied remedial measures, including those targeting capital retention, have significantly increased the sector's resilience. Thus, during the reporting period, capitalisation and liquidity of the banking sector reached 31% and 55%, respectively. The implementation of prudential supervision measures helped to restore the stability, transparency and credibility of the banking sector, both on the internal and the external market.

For the first time in the last ten years, a reputable foreign investor entered the Moldovan banking market. In November 2016, Banca Transilvania (the second largest commercial bank by assets in Romania) together with the European Bank for Reconstruction and Development (EBRD) announced its intention to acquire 39.2% of shares in BC "VICTORIABANK" S.A. The deal was closed in January 2018, thus clearing the way for the NBM to end the intensive supervision of one of the three systemic banks, which operate under the special supervision regime since 2015. In cooperation with international experts, the NBM developed a strategy for the sale of the blocked shares of the other two banks, to ensure their stability and good governance. The Parliament of the Republic of Moldova backed the strategy of attracting foreign investors by amending the Law on the Administration and Privatisation of Public Property, the updated version of which entered into force on January 1, 2018. The legislative amendments provide the possibility of State interference, under prescribed conditions, in the purchase and sale of the shares issued by systemic banks to reputable investors. At the time of drafting this report, an international consortium filed a formal request with the NBM to acquire a stake of 41.09% in BC "MOLDOVA - AGROINDBANK" S.A.

On January 1, 2018, a new Law on Banking Activity, which was adopted on October 6, 2017, was finally enacted. It has a major role for the Moldovan banking system as it aligns the national legislation with the EU Directives and introduces the best international practices (also known as "Basel III" standards) in the field of prudential supervision. The law has been drafted during 2015-2017 in cooperation with experts from the central banks of Romania and the Netherlands under the European Twinning programme. In order to allow licensed banks to adapt gradually to the new rules, the law provides for a 2-year transition period. During this time, the NBM will issue about 30 regulatory acts to align the local regulatory framework with the new banking law. The impact study, which was carried out by the NBM based on financial statements as of 30 June 2017, confirms that all banks comply with the new prudential requirements. In order to prevent a possible erosion of own funds before the implementation of the new rules, the NBM recommended to a number of banks to refrain from paying out profits for 2017.

In 2017, the aggregate profit of the banking sector recorded approximately 1.5 billion Moldovan lei, having increased by 8.6%, compared to 2016. The balance of bank loans, expressed in MDL, continued to decrease, though at a slower rate, having dropped to 33.5 billion lei in December 2017, thus recording a decrease in value of 3.7%, year-on-year. This apparent decrease can be partly explained by the effect of the exchange rate difference, as approximately 40% of loans were extended in foreign currencies, which have depreciated against the Moldovan lei. At the same time, the annual volume of the newly extended loans increased by 8.9%, compared to 2016, amounting to 24.5 billion lei. The annual growth rate of the new loans extended in domestic currency reached approximately 20%. The positive dynamics of lending was driven by lower average interest rates and increased demand from individuals. The evolution of the lending activity will

continue to depend on the revival of demand generated by the corporate sector. The balance of non-performing loans recorded 18.4%. Based on the recommendation of the NBM, the licensed banks created additional reserves and ensured an 80% coverage rate of non-performing loans in December 2017. Banks continued to take deposits, the balance of which reached 59.9 billion lei at the end of 2017, thus having increased by 9%, year-on-year. Corporate deposits recorded the fastest growth rate, having increased by over 18% in one year. The deposit structure, analysed by currencies, denotes a steadily increasing confidence placed by local population and economic agents in the domestic currency: as of December 2017, 57.2% of deposits were placed in MDL, compared to 53.5% as of December 2016 and 42.4% as of September 2015, in the midst of the financial crisis.

The increased confidence of the population in the Moldovan lei and the stability of the exchange rate allowed the NBM to launch, in June 2017, the project to introduce in circulation metal coins with denomination of 1 lei and 2 lei. After an in-depth analysis of cash circulation in the Republic of Moldova and of existing international practices, the project was extended to include coins with denomination of 5 lei and 10 lei. Under this project, the NBM organised public consultations with consumers, economic agents, local and central authorities. New metal coins were put into circulation on February 28, 2018. The introduction of metal coins will allow the NBM to generate savings in production costs, which are estimated at approximately 300 million lei in 20 years.

Without prejudice to its fundamental objective and its core competencies, the NBM pursues to optimise spending. The increase of the minimum level of required reserves held in Moldovan lei from 35% to 40% had as its corollary objective the reduction of the monetary policy expenditures. At the same time, a significant increase in the volume of certificates issued by the NBM had a reverse effect. Revenues gained from foreign currency transactions recorded a decrease, being driven by the appreciation of the Moldovan lei. As a result, in 2017, the NBM recorded a loss of 95.31 million lei, which decreased by 64%, compared to 2016. At the end of 2017, the NBM's statutory capital of 2.35 billion lei accounted for approximately 5.1% of total monetary bonds.

The year 2017 was the first fully operational year of the NBM's Supervisory Board. It consists of seven members, of which four members are independent advisors who do not hold executive positions at the NBM. The Supervisory Board had an intensive year having held 10 meetings during the year. Three independent members of the Supervisory Board form the Audit Committee, which monitors the financial reporting process, the efficiency of the internal control system, the activity of the Internal Audit Department, as well as performs other duties that ensure the NBM's effective supervision of the banks. During 2017, the Executive Board has held 77 meetings at which 369 decisions were examined and approved.

In 2017, in order to improve the decision-making process, to streamline business processes and to eliminate potential conflicts of interest, the NBM reorganised a number of departments according to the best international practices. Simultaneously, the NBM reduced the number of managerial positions by 4%, compared to 2016, and launched a strategy aiming at reducing the number of support positions as opposed to core activity functions. In cooperation with a foreign consultancy company, the industry leader on international market, the NBM has launched a reform of the human resources management system. The bank's internal reform and reorganisation were meant to strengthen the institutional and human capacities of the NBM in order to provide a proactive and high-quality public service.

We are determined to continue strengthening the banking sector and promoting its increased transparency, as well as to implement reforms in other areas, such as monetary policy, financial stability, payment

systems, improving the quality of the domestic currency among others. These goals were included in the NBM's Strategic Plan for 2018-2020. The new strategy aims at consolidating the achievements of 2017 and focusing efforts in areas that require further improvement. A key objective of the new strategy is to enhance external communication and financial education of population through media, web page publications, and social networking.

Looking at the tasks ahead, there is still plenty to do. However, 2017 has certainly represented a year of significant breakthrough in the consolidation of the banking sector, which today is increasingly regarded by population as more safe and reliable.

Sergiu Cioclea

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