CORPORATE GOVERNANCE DEVELOPMENT IN THE MOLDOVAN BANKING SECTOR

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Abstract: *Corporate governance is becoming increasingly important and noticeable in the banking system of the Republic of Moldova. The existing serious weaknesses in the national regulatory environment and the ineffective corporate governance in banks of the Republic of Moldova, which led to the famous bank fraud of 2014, have committed the national authorities of the Republic of Moldova to take significant steps in enhancing the corporate governance framework in the banking sector by initiating in 2015 the reform of the national banking legislation. In this context, with the entry into force on January 1, 2018 of the new banking law, the banking sector in Moldova has undergone a major transformation process by implementing a comprehensive set of provisions on corporate governance. To date the current state of corporate governance in the banking sector of the Republic of Moldova and the correlation between corporate governance in banks since 2018 and the performance of the sector have not yet been sufficiently studied. In this context, this paper proposes an analysis of current corporate governance practices and mechanisms in Moldovan banks and the correlation between the quality of corporate governance and bank performance through quantitative and qualitative indicators.*
Keywords: *corporate governance, OECD principles, Basel principles, ESG, economy, financial indicators, performance, banking sector, National Bank, Moldova, conflicts, bank performance.*
JEL classification: *G21, E 58, G34*

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Introduction

Corporate governance policies and practices have significantly evolved over the past years. New trends and insights have occurred, like the increasing orientation toward stakeholder-oriented business practices or the integration of ESG performance within the corporate governance. Specific to banks, corporate governance determines the allocation of authority and responsibilities by which the business and affairs of a bank are carried out by its board and senior management, including how they: (i) set the bank’s strategy and objectives; (ii) select and oversee personnel; (iii) operate the bank’s business on a day-to-day basis; (iv) protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders; (v) align corporate culture, corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations; and (vi) establish control functions. [6] Indeed, banks are special in comparison to ordinary companies due to the nature of the banking business, the complexity of its organisation, the uniqueness of banks' balance sheets, the need for protection of the weakest party in the chain (i.e. the depositors). Moreover, the potential negative effects of bank failures are very damaging for the economy and society, as was demonstrated vividly by the global financial crisis of 2007-2008.

The way that banks fund their operations means that, in comparison to other companies, their corporate governance needs to provide protection to a much broader pool of stakeholders, particularly depositors who do not usually have the possibility to influence the banks' business decisions. This requires a much deeper involvement of the board in strategic issues and risk oversight, as it must fully understand the risks the bank is exposed to and be able to monitor them effectively. As a result, this requires that the balance of skills at the board level and the expertise of its members are regulated in detail and closely scrutinised by bank supervisors. There is greater emphasis and more detailed guidance on the internal control functions of the so-called "second and third line of defence". Banks are also subject to stricter disclosure requirements management, compliance and internal audit, which are becoming mandatory. [7]

Corporate governance has captured the interest of researchers, regulators, investors, the corporate sector and society throughout the world in the aftermath of corporate scandals in the 1990s and 2000s and again after the failure of a large number of mature investment banks during the global financial crisis of 2007-2008. Actually, these failures have pointed out, that a bad corporate governance could undermine not only the business sustainability of the corporation but also the proper functioning of financial and capital markets overall and lead, in turn, to the investors losing confidence, which could translate in a systemic economic crisis. That is why in the aftermath of the financial crisis international regulatory bodies took significant actions to improve the regulation framework of corporate governance, in order to force corporations to be more accountable and transparent. Corporate governance is also becoming increasingly important and noticeable in the banking system of the Republic of Moldova. It is widely acknowledged that serious weaknesses in the national regulatory environment and the ineffective corporate governance mechanisms in commercial banks of the Republic of Moldova, led to the famous bank fraud of 2014, and have committed the national authorities of the Republic of Moldova to take significant steps in enhancing the corporate governance framework in the banking sector by initiating the reform of the national banking legislation in 2015. In this context, with the entry into force on January 1, 2018 of the new banking law, the banking sector in Moldova has undergone a major transformation process by implementing a comprehensive set of provisions on corporate governance. However, aspects of the current state of corporate governance in the banking sector of the Republic of Moldova and the correlation between corporate governance practices implemented in banks since 2018 and the performance of the sector have not yet been sufficiently studied.

Thus, the current paper analyses the banking sector of the Republic of Moldova and its corporate governance for the period of 2018-2021, since the new banking legislation entered into force.

Literature review and methodology

Corporate governance of companies is commonly defined as the "…the system by which companies are directed and controlled. It involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." (Cadbury Code, 1992). [16] At the same time, according to Shleifer and Vishny (1997), "corporate governance deals with the ways in which suppliers of finance to corporation assure themselves of getting a return of their investment.". [20] Leblanc (2015) states that "corporate governance is the control of management in the best interests of the company, including accountability to shareholders who elect directors and auditors and vote. How a company is governed influences rights and relationships among organizational stakeholders, and ultimately how an organization is managed, and whether it succeeds or fails. Companies do not fail: boards do.". [20]

At the same time, Goergen and Renneboog (2006) define "corporate governance system as a combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business."[12] Moreover, according to Goergen (2012), corporate governance "deals with the conflicts of interests between the providers of finance and the managers; the shareholders and the stakeholders; different types of shareholders (mainly the large shareholder and the minority shareholders); and the prevention or mitigation of these conflicts of interests.[11]

The OECD Principles of Corporate Governance (2015), which have been taken as a benchmark by many countries and organisations to create their own corporate governance guidance and rules, state that, "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.".[20] Implementing good bank governance is of particular significance in creating a robust and stable banking sector in support of sustained financial and private sector development, and economic growth. [8]

According to the 2015 Basel Guidelines on Corporate Governance Principles for Banks "Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. Banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole." [5]

The mentionned subject was researched also by Moldovan economists like Cociug V. (2017), Mihaila S. (2018), Pisaniuc M. (2020), Timus A. (2020), Cobzari L. (2021), Busmachiu E. (2021), Ciobu S. (2020, 2021)) in their researches, publications, reports and articles regarding the concept, definitions, theories, models, principles and regulations of the corporate governance.

The methodological and informational support of the paper is based on specialized literature related to the concept, theories, models, current trends of corporate governance, the international and national corporate governance regulations, financial data related to the banking system published by the National Bank of Moldova, and information related to corporate governance published by the Moldovan banks on their official website. In order to perform the analysis of corporate governance aspects in banks there was developed a survey comprising 16 questions and interviews with representatives of licensed banks of the Republic of Moldova, conducted in February 2022. The data obtained based on the survey were compared with the data published by the banks in April 2022 in the Report on management framework, own funds and capital requirements, and capital buffers for the situation of 12.31.2022 (in accordance with the provisions of the Regulation on the requirements for publication of information by banks, approved by the Decision of the Executive Board of the National Bank of Moldova, No. 158 of 9 July 2020).

Challenges of corporate governance in the banking sector of the Republic of Moldova

Sound corporate governance practices enable the banks to cultivate a culture of integrity and ethical business practices, to effectively control risks and assure compliance, to increase the access to capital, to improve the relations between the management of the banks and its shareholders, to achieve positive performance and ensure long-term shareholder value, thus providing banks with a strong reputational and competitive advantage. The banking system in the Republic of Moldova has long suffered from serious governance weaknesses and ineffective corporate governance mechanisms, including serious weaknesses in the regulatory environment and oversight. The banking legal framework in the Republic of Moldova reflected the rules set out in the Basel I international standards, which were relatively simple and covered only the credit risk associated with the bank's business. Thus, the lack of effective corporate governance mechanisms in the banking sector have been pointed out as the main factor that contributed to the massive bank fraud of 2014. As acknowledged, in 2014, US$1 billion disappeared from Moldova's banking system following a coordinated effort involving three banks to fraudulently provide large amounts of financing to various related entities and parties. Much of these funds were moved outside the country.[18] In its aftermath, these banks have been resolved at a public cost of 12 percent of GDP; external concessional financing has been largely frozen, international reserves fell by one-third, and monetary conditions had to be tightened significantly through increasing policy rates and mandatory reserves.[17]

The bank fraud also exposed serious weaknesses in the national regulatory environment. Enforcement actions by the supervisor were rare and, when taken, were not commensurate with the seriousness of the deficiencies. Although the dubious lending activities of three banks participating in the bank fraud were largely known, supervisory action was slow to come. That is why strengthening financial institutions governance and the banking regulatory and supervisory framework became a key priority for the national authorities in order to enhance the resilience of the banking sector and address the weaknesses that gave rise to the 2014 bank crisis. Moreover, there is increasing evidence showing that sound corporate governance is associated with better financial performance of the firm. In addition, new risks arising from the COVID-19 pandemic and Russia's invasion of Ukraine, have highlighted the importance of having in place good corporate governance practices to face such challenges.

Since 2015 the Republic of Moldova has taken significant steps in enhancing its corporate governance framework in the banking sector by initiating a large reform of the national banking legislation. The reform has been conducted with the support of foreign development partners of the Republic of Moldova with the aim to harmonize the banking legislation with international standards, including in the context of fulfilling the commitments assumed within the Association Agreement of the Republic of Moldova with the European Union in 2014. According to these commitments, the legislation of the Republic of Moldova in the banking sector was to be harmonized with the European Union acts and the international standards related to Basel III. Consequently, in April 2016 the National Bank of Moldova approved the Strategy for implementing the Basel III standards in the Republic of Moldova by transposing the European Union's legal provisions in this regard (CRD IV/ CRR package[15]. The main two objectives of the Strategy were: (i) to develop the primary (new law) and secondary legislative framework related to banks' activity; and (ii) to develop the NBM's institutional capacity and on-site and off-site banking supervision instruments.

Thus, the new law on banks' activity entered into force as of 1 January 2018. The law extended the rights and attributions of the National Bank of Moldova in the process of assessing and supervising banks. At the same time, the law provided for the improvement of the corporate governance framework in banks and their obligation to have adequate capital in relation to the risks assumed in accordance with international standards and principles.[13] Key changes in risk management have emerged since 30 July 2018, when eight regulations entered into force to implement, at first stage, the law on the activity of banks. The new reporting framework provides for the calculation of own funds requirements based on a new methodology that reflects not only the impact of credit risk, but also market and operational risk. At the same time, with a view to preventing and mitigating macro-prudential or systemic risk, additional requirements have been set for the own funds that banks have to hold for the creation of capital buffers. Thus, in addition to the 10% minimum own funds requirement, banks are required to maintain common equity tier 1 capital essential to meet the requirements related to the capital conservation buffer (2.5%), the countercyclical capital buffer (0.0%), the systemic risk buffer (1%/3%) and, where applicable, other systemically important institutions buffer (0.25%/0.75%) (O-SII buffer).

In addition, in 2020, an important programme with the International Monetary Fund was completed, which focused on shareholder transparency in licensed banks and the implementation of higher governance standards in commercial banks and the National Bank of Moldova. [14] As a result of these reforms, starting with 2018 the new banking legislation put an increased emphasis on the corporate governance by providing for the establishment of an interaction between risk management system and a solid corporate governance in banks. Besides, commendable progress has been achieved in rehabilitating the banking sector, including by securing bank shareholder transparency via fitness and probity of bank owners, improved supervisory and regulatory frameworks, unwinding bank related-party exposures, and strengthening financial safety nets. [21]

The analysis of corporate governance in the Moldovan banking sector

Challenges of corporate governance in the banking sector, are related to the compliance of the banks with the legal framework for corporate governance and the extent to which banks follow good corporate governance practices given the importance of an effective corporate governance to the proper functioning of the banking sector. Aspects of corporate governance particular for banks are including: (i) Commitment to corporate governance; (ii) Implementing good Board practices; (iii) Role of Board's committees; and (iv) Remuneration policy practices.

The commitment to corporate governance acknowledges that the implementation of strong governance practices in the sector is essential to have effective bank system as well as to achieve and maintain a higher level of public confidence in the banking system. In order to achieve this objective, pursuant to Article 38. Management framework of activity of the Law on the activity of banks, the banks must have a solid clear-cut governance framework that includes a clear organizational structure and according to Article 91. Scope of publishing requirements, banks must disclose the information related to the management framework of activity. According to the results related to the commitment to corporate governance mechanism (Table 1), banks are well aware of and committed to corporate governance principles, demonstrating good knowledge of the legal framework of corporate governance.

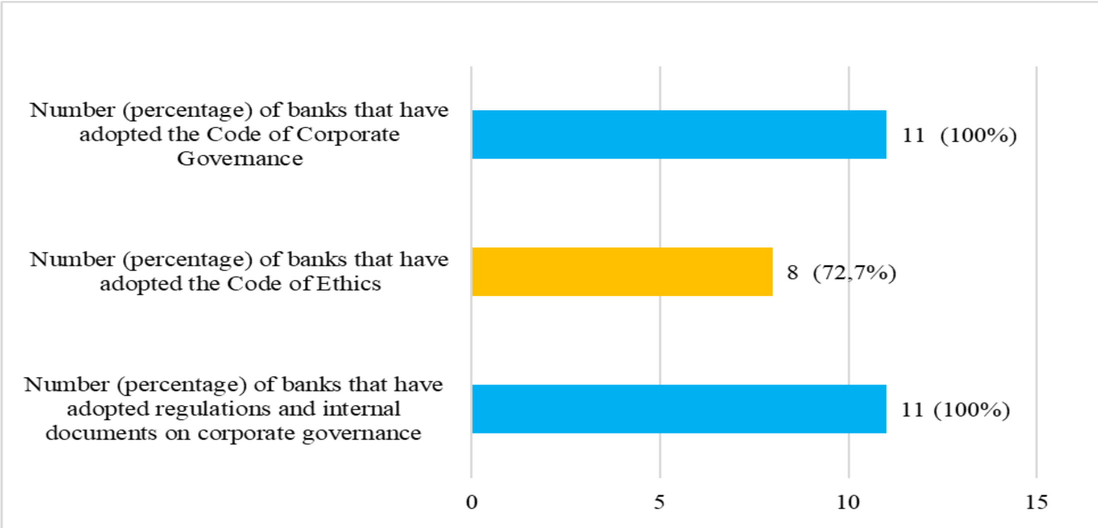
Table 1. Commitment to corporate governance of Moldovan banks

Findings of the analysis	
Commitment to corporate governance	100% of banks have adopted and published the Code of Corporate Governance, and 72.7% (8 banks) have publicly disclosed their own Code of Ethics, although in the remaining three banks, which did not publish its Code of Ethics on the website, the main principles of the code of ethics are disclosed in their Code of Corporate Governance.
	In 100% of banks, the annual report of the bank's executive body contains a chapter on corporate governance.
	In 55% (6 banks) of banks, there is a position of Corporate Secretary. In 45% (5 banks) of banks the function of Corporate Secretary is performed by an employee that combines his/her functions with other responsibilities in the bank or by the secretary of the Board.
	All surveyed banks (100%) provide training on corporate governance for members of the Board of Directors.

Source: Elaborated by the authors based on the survey conducted in February 2022

Besides, Figure 1 shows the level of formalization of internal documents required on corporate governance in accordance with legislation in the banking sector of the Republic of Moldova.

Figure 1. Corporate governance documents implemented in Moldovan banks



Source: Elaborated by the authors based on the survey conducted in February 2022

Implementing good Board practices refers to the fact that the corporate governance structure of Moldovan banks is based on the stakeholder model of corporate governance, specific to the Continental Europe, with a two-tier corporate board structure: (i) a supervisory board; and (ii) a management one. Thus, the management body of a bank shall be represented by its Board and the executive body. Given the essential role the Board plays in corporate governance and its overall and ultimate responsibility for the bank, the survey placed an emphasis on the analysis of Board practices. Undoubtedly, rules and requirements are very important for the implementation of strong governance practices in the company, but on their own they will not deliver behavioural change. The change needs to begin at the top of organisations. This makes the Board the most important element in corporate structure. The tone at the top determines the tune in the middle, as Boards are expected to drive the corporate governance agenda of their companies. As primary stewards of risk and guardians of long-term enterprise value, the Board is collectively responsible for ensuring that the necessary mechanisms for corporate governance are in place. The Board of the bank is a body that perform the supervisory and monitoring role of the management decision-making process and is responsible for the bank's overall activity and financial soundness.

According to Article 41 of the Law on the activity of banks, the main duties of the Board shall include:

- to be fully responsible for the bank’s activity; to approve and oversee the implementation of strategic objectives, the risk management strategy and the bank's business management framework, including the corporate governance code; to ensure the performance standards are maintained in accordance with the bank’s long-term financial interests and applicable capital requirements;
- to nominate, appoint and revoke members of the executive body, and to determine their duties;
- to exercise effective and efficient oversight of the executive body;

- to report, at least annually, to the General Meeting of Shareholders on the supervisory activity carried out;
- to scrutinize, discuss and challenge, in a constructive way, the suggestions, explanations and information provided by the members of the executive body, opposing their decisions, if required;
- to monitor and periodically evaluate the effectiveness of the business management framework, including the bank's governance principles, and to take appropriate actions to address any deficiencies;
- to approve the annual financial statements and ensure the integrity of accounting and financial reporting systems, including financial and operational controls, and the compliance with relevant legislation and standards;
- to decide on the setting up of specialized committees;
- to adopt and review, at least annually, the general principles of remuneration policy and be responsible for overseeing its implementation;
- to oversee the process of publication of information and external communication.

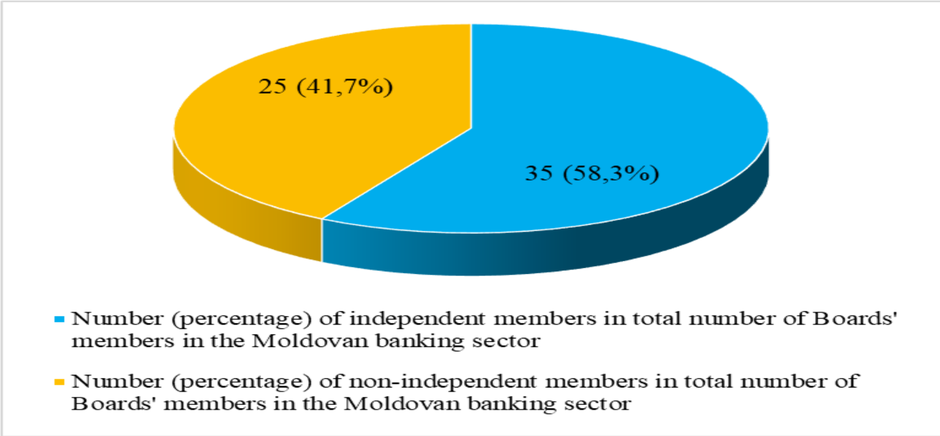
According to Article 40: Management body, of the Law on the activity of banks, the Board of the bank shall consist of an odd number of individuals, but not less than three. The members of the Board shall be elected by the General Meeting of Shareholders of the bank for up to 4 years, and may be re-elected for a new term.

Given that the presence of independent directors contributes to the good working of the board by bringing new ideas and objectivity, improves the monitoring function and reduces self-interested actions by managers, by minimizing agency costs, the Board of the banks shall be composed of a sufficient number of independent members, but not less than one- third of all members elected in the Board. Thus, based on the analysis of implementing good board practices mechanism it can be observed that all surveyed banks comply with the provisions of the legal framework regarding the Board of the bank, as follows:

- The number of members in the Boards varies from 3 to 7 people, with the lower limit (3) being defined by the law. The total number of Boards' members of Moldovan banks is 60 persons as of the end of February 2022.

In 54.5% (5 banks) of banks, the Boards consist of 5 members. In 36.4% (4 banks) of banks, the Boards consist of 7 members. The Boards in two banks (9.1%) consist of 3 members and, respectively, 4 members (in a bank under special administration of the NBM). The independent directors are well represented on the Boards in line with the requirements of the law and good international practices. According to Figure 2 the share of independent members in total number of Boards’ members is 58.3%.

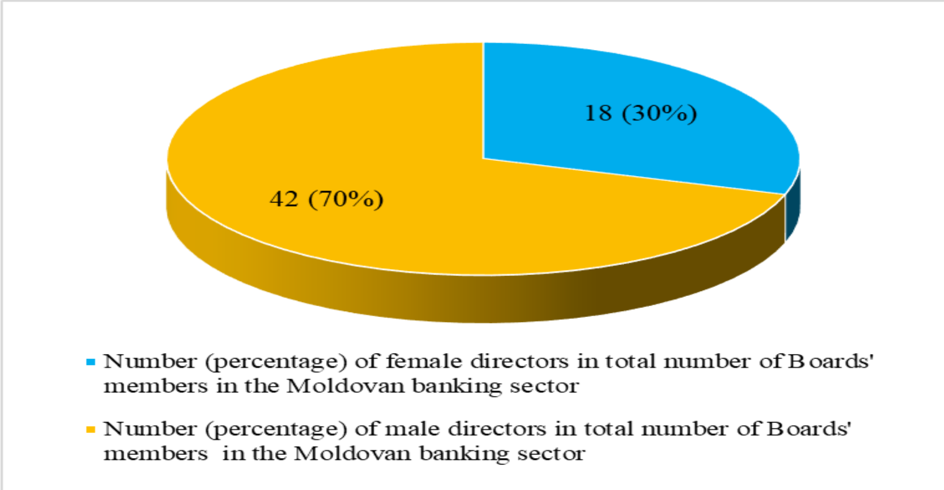
Figure 2 Board independence level in Moldovan banks



Source: Elaborated by the authors based on the survey conducted in February 2022

The percentage of independent directors on the Boards of the surveyed banks is higher than the lower limit which is one third of all members elected in the Board and ranges from 33.3% (1 bank), 40.0% (1 bank), 42.9% (3 banks), 60.0% (3 banks), 71,4% (1 bank), to 100.0% (2 banks), the weighted average of the independent directors representing 59.4% per total surveyed banks. According to Figure 4.3 the percentage of female directors on the Boards constitutes 30.0% and varies from 0% (in 2 banks), 14.3% (in 1 bank), 28.6% (in 2 banks), 33.3% (in 1 bank), 40.0% (in 2 banks), 50.0% (in 1 bank), to 60.0% (in 2 banks), the weighted average of the female directors representing 32.3% per total surveyed banks.

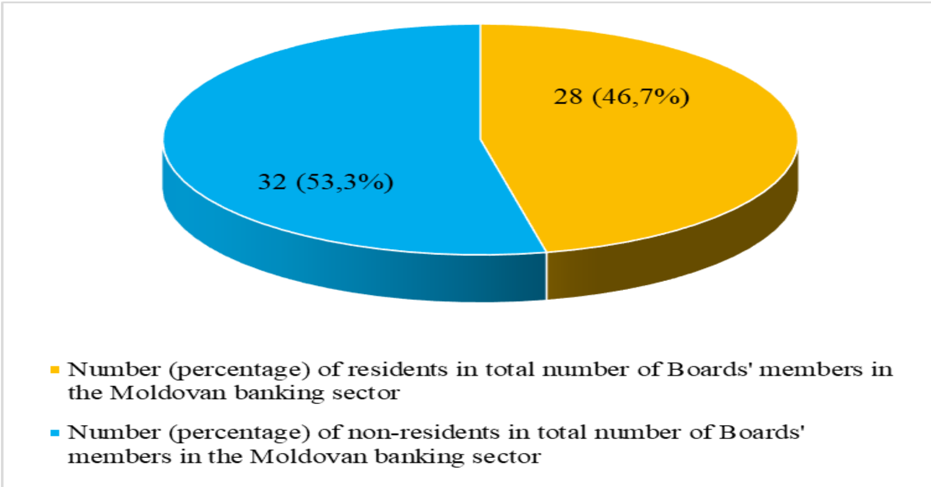
Figure 3 Board gender composition in Moldovan banks



Source: Elaborated by the authors based on the survey conducted in February 2022

It is known that the foreign investors' share in Moldovan banks' capital is almost 88% of total capital. Thus, according to Figure 4.4 the percentage of non-resident directors on the Boards constitutes 53.3% and ranges from 0.0% (3 banks), 20.0% (1 bank), 57.1% (1 bank), 60.0% (1 bank), 66.7% (1 bank), 71,4% (1 bank), 80.0% (1 bank), 85.7% (1 bank) to 100.0% (1 bank), the weighted average of the non-resident directors representing 49.2% per total surveyed banks.

Figure 4 Representation of non-residents on Boards in Moldovan banks



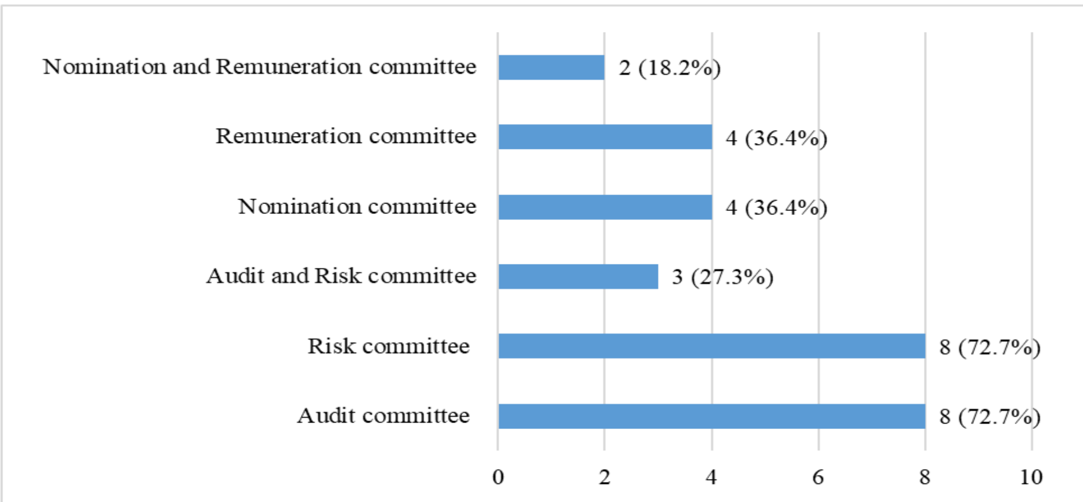
Source: Elaborated by the authors based on the survey conducted in February 2022

Role of Board’s committees: According to Basel Committee corporate governance principles for banks, in order to increase efficiency and allow deeper focus in specific areas, a Board may establish certain specialised board committees, the number and nature of which will depend on many factors, including the size of the bank and its Board, the nature of the business areas of the bank, and its risk profile. However, the existence of committees shall not in any way exonerate the Board of the bank from the collective fulfilment of its duties and responsibilities. Thus, according to Article 44: Specialized committees of the Board, of the Law on the activity of banks, each bank shall have an Audit committee and a Risk committee set up by the Board of the bank. Where a bank is significant in terms of size, internal organization and nature, extent and complexity of its activities, the Board of the bank shall establish at least the following 2 committees: a) Nomination committee and b) Remuneration committee. Where a bank that is not considered significant, it may combine the risk committee and the audit committee.

Pursuant to art. 63 par. (7) of the Law on the Activity of Banks, the National Bank of Moldova identifies banks that are systemically important institutions (O-SIIs). Thus, the NBM has established the following 4 banks that are systemically important as of 31 December 2021: B.C. Moldova-Agroindbank” S.A.; B.C. “Moldindconbank” S.A.; B.C. “Victoriabank” S.A., and B.C. “OTP Bank” S.A. Accordingly, these four banks must have a Nomination committee and the Remuneration committee set up by the Board of the bank. According to legal provisions of corporate governance, the special committees shall be formed exclusively of the members of the Board, the majority of whom shall be independent, and may not comprise less than 3 members. Committees report directly to the Board of the bank and should have a general or separate regulation for each committee, approved by the Board, regarding their role, purpose and manner of operation. The chair of the committee shall be appointed by the Board out of the elected members of the committee.

According to the results of the analysis related to the role of Board's committees mechanism, and to Figure 5, it can be observed that banks comply with the provisions of the legal framework regarding the appointment of specialized committees of the Board. In addition, it was found that banks comply with the principle of establishing the number of specialized committees depending on the size of the bank or the systemic importance of the institution. 72.7% (8 banks) of banks have an Audit committee and a Risk committee set up by the Board of the bank. In the remaining 3 out of the 11 surveyed banks (27.3%) the Audit committee and Risk committee are combined into a single Audit and Risk Committee. 36.4% (4 banks) of banks have a Nomination committee and a Remuneration committee set up by the Board of the bank. In 2 out of the 11 surveyed banks (18.2%) the Nomination committee and the Remuneration committee are combined into a single Nomination and Remuneration committee.

Figure 5 Specialised committees under the Boards in Moldovan banks (number of banks, and percentage in total banks' number)



Source: Elaborated by the authors based on the survey conducted in February 2022

A comparative analysis related to specialised Boards committees in Moldovan banks is presented in Table 2.

Table 2 Comparative analysis of specialized Boards committees in Moldovan banks

	Bank	No. of members of the Board	No. of Committees	Audit Committee	Risk Committee	Nomination Committee	Remuneration Committee	Audit and Risk Committee	Nomination and Remuneration Committee
1	Moldova Agroindbank	7	3						
2	Moldindconbank	7	4						
3	Victoriabank	7	4						
4	OTP Bank	5	4						

5	ProCredit Bank	5	2							
6	Eximbank	7	3							
7	FinComBank	5	2							
8	Energbank	4	2							
9	BCR Chisinau	3	1							
10	Comertbank	5	1							
11	EuroCreditBank	5	2							

Source: Elaborated by authors based on the data from the bank's websites.

Remuneration policy practices: It is acknowledged that the bank's remuneration structure should support sound corporate governance and risk management. Remuneration systems form a key component of the governance and incentive structure through which the board and senior management promote good performance, convey acceptable risk-taking behaviour and reinforce the bank's operating and risk culture. Thus, pursuant to best practices of corporate governance and according to the Regulation on Banking Activity Management Framework No.322 of December 20, 2018, the bank shall have a remuneration policy that contributes to prudent risk management and does not favour risk-taking that exceeds the level of risk acceptable to the bank. In addition, according to Article 91: Scope of publishing requirements, of the Law on the activity of banks, the bank should disclose the information related to remuneration policy of the bank. The remuneration policy of the bank for all staff shall be linked to the objectives of the business strategy and risk strategy of the bank, including the business model, corporate culture and values, the bank's long-term interests and measures preventing conflicts of interest. Changes to these objectives and measures shall be considered in the process of updating the remuneration policy.

The remuneration policy shall contain, at a minimum, the following provisions: bank's performance objectives, areas of activity and staff; performance measurement methods, including performance criteria; structure of variable remuneration, including instruments in which parts of variable remuneration are provided; ex-ante and ex-post measures to adjust variable remuneration according to the level of risk assumed. Moreover, according to Article 39. Remuneration policy, of the Law on the activity of banks, each bank is required to establish and implement remuneration policies for the members of the executive body and key personnel of the bank as well as for any other employee who receives a total remuneration in the amount equal to the remuneration received by executive officers or key personnel respecting, in a manner and approach appropriate to the size and internal organization of the bank, its nature, scale and complexity of its activities, the following principles:

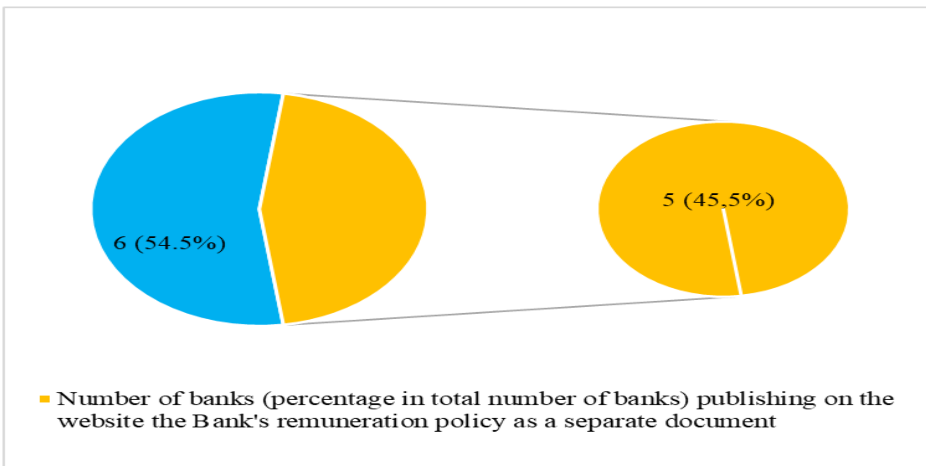
- the implementation of remuneration policy shall be subject, at least annually, to an independent and centralized internal assessment of compliance with remuneration policies and procedures adopted by the bank's Board;
- the employees with control functions must be independent from the bank's operational units they control, have the appropriate authority and be remunerated

according to the achievement of the objectives set for them, regardless of the performance of the operational units which they control;
- the remuneration of persons responsible for the coordination of risk management and legal compliance must be supervised directly by the remuneration committee or, when the latter does not exist, by the Board of the bank;

The remuneration policy of the bank is elaborated and approved by the Board of the bank. Instead, the remuneration policy of the Board's members is adopted by the general meeting of the shareholders of the bank. According to the results of the analysis related to remuneration policies mechanism it can be concluded that banks comply with the provisions of the legal framework regarding the settlement of the remuneration policy of the bank and the disclosure of the information related to remuneration policy of the bank. 100% (11 banks) of banks have set out the Bank's remuneration policy which is disclosed within the Report on management framework, own funds and capital requirements, and capital buffers published on the Bank's official website;

As it is illustrated in Figure 6, 45,5% (5 banks) of banks have published the Bank's remuneration policy (as a separate document) on the Bank's official website.

Figure 6 Remuneration policy disclosure in Moldovan banks



Source: Elaborated by the authors based on the survey conducted in February 2022

In addition to the above findings, it was noted that in all banks the corporate governance code provides for the general principles regarding protection of shareholders' rights, clarification of the roles of the governing bodies, relations with stakeholders (employees, creditors, investors, suppliers), social responsibility policies, as well as regarding transparency and disclosure of information. Besides, according to the results of the survey, it was found that in general banks rated the legal and regulatory framework on corporate governance as sufficient and comprehensive. However, according to some responses, the current national legislation, has gaps and inconsistencies with regard to corporate governance issues and sometimes does not help to prevent and resolve corporate conflicts. Given the increased focus on ESG worldwide, we also investigated the existence of practices in integrating environmental, social and governance factors into banks' risk management processes, business strategies and investment policies, as well as into the banking regulatory framework in the Republic of Moldova. Although, it is increased evidence of the importance of ESG as a factor associated with the development of a well-functioning market for green finance and sustainable investment, as well as the importance of ESG as a prerequisite for the banks seeking for an IPO (Initial Public Offering) perspective, the findings show that the banking legal framework do not currently provide some requirements regarding corporate ESG issues and their disclosure by the banks. However, in our view, given the aim for aligning the national banking regulation with European standards, which actually provide ESG policies for the EU banks, it could be an option for the national authorities to consider, at some stage, introducing ESG compliance requirements for Moldovan banks.

In conclusion, the analysis of corporate governance in the Moldovan banking sector and the survey findings show that Moldovan banks are compliant with the provisions of the legal framework on corporate governance and the existing corporate governance mechanisms in Moldovan banks are in line with sound corporate governance practices. Given the favourable conclusions regarding the state of corporate governance in Moldovan banks, it is interesting to assess how new corporate governance practices implemented in banks since 2018 affected the performance of the banking sector. In this context, we assume that the presence of a sound corporate governance mechanisms, such as the level of formalization of the corporate governance principles within banks, Board size and composition, sound and effective Board practices, role of Board committees, determines the adoption of sound risk management-related corporate governance mechanisms like the presence of a risk committee, the percentage of independent directors in the risk committee, the effective procedures for risk management, and, in turn, positively affects the bank performance.

Thus banks with sound corporate governance practices are likely to show higher effectiveness and better performance, based on the evolution of key financial indicators by Moldovan banking sector during 2018-2021. In this regard, there were assessed capital adequacy indicators, such as own funds and own funds ratio, asset quality indicators like total assets, loan portfolio, nonperforming loan ratio, and main profitability indicators as are return on assets (ROA); return on equity (ROE), efficiency ratio (ER), based on the data from the official website of the National Bank of Moldova. However, before presenting the results of the analysis, the following two important impact factors on the evolution of the banking sector in 2018-2021 should be highlighted. On the one hand, with the entry into force on January 1, 2018 of the new banking law, starting with 2018, the banking sector in Moldova has undergone a major transformation process. This process involved the implementation by the banks of a comprehensive set of provisions on corporate governance, size of banks' capital and capital buffers, risk assessment and prevention framework, internal and external control of banks' operations. Besides, due to commendable progress achieved in rehabilitating the banking sector – a process which started in 2015 in the aftermath of the banking crisis, including by securing bank shareholder transparency and improved supervisory and regulatory frameworks, the market has registered the entry of several reputable foreign investors with sound corporate governance, which has contributed to stronger governance practices in the sector.

On the other hand, the evolution of the banking sector was impacted by a major shock represented by the COVID-19 pandemic. However, due to the transformation process in banks and measures adopted by the supervisory authority in order to ensure an adequate level of banks own funds, which allows for a sound management of risks, the banking sector entered into the COVID-19 crisis with strong capitalisation and liquidity. Therefore, according to the results of key financial indicators of the Moldovan banking sector (Table 3) the recorded sound levels at the end of 2021, were considerablybetter than as at end-2017 and showing steady year-on-year increases over 2018-2021 period.

Table 3 Key indicators by the banking sector of the Republic of Moldova in 2017-2021

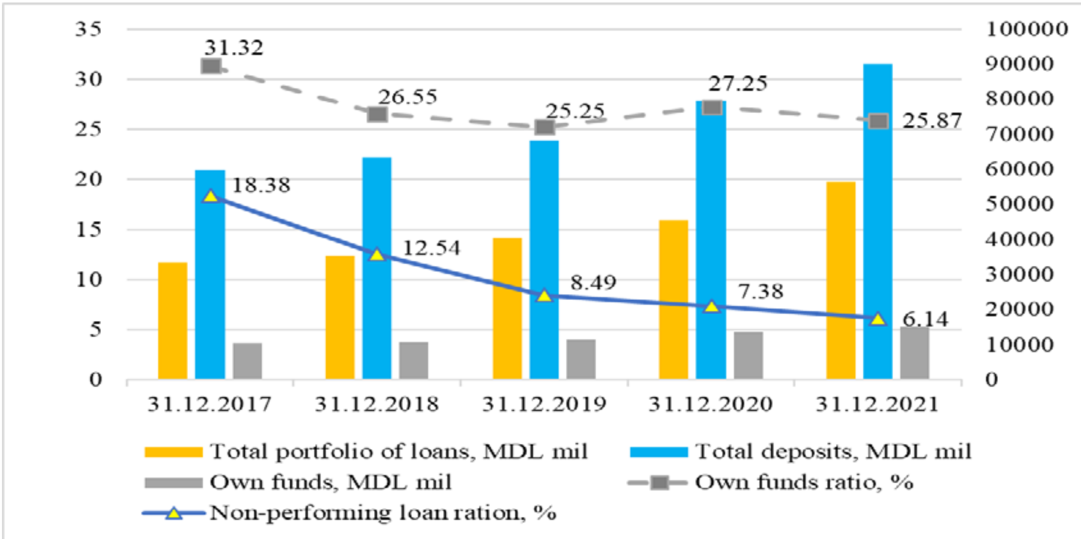
Indicators	2017	2018	2019	2020	2021
Capital adequacy					
Total own funds, MDL mil	10 586.3	10 826.2	11 500.5	13 618.1	15 158.4
Own funds ratio (≥ 10%), % *	31.32	26.55	25.25	27.25	25.87
Asset quality					
Total assets, MDL mil	79 464.8	83 215.0	90 678.2	103 773.6	118 534.2
Total loan portfolio, MDL mil	33 473.3	35 452.7	40 375.5	45 643.2	56 359.2
Non-performing loan ration, %	18.38	12.54	8.49	7.38	6.14
Profitability					
Net profit, MDL mil	1528.1	1451.6	2259.9	1501.2	2306.3
ROA (Net income/Average assets), %	1.91	1.90	2.47	1.53	2.01
ROE (Net income/Average equity), %	11.42	11.60	14.63	8.89	12.35
ER (Net income/Non-interest costs), %	139.32	142.65	159.25	130.82	142.41
Liquidity					
Total deposits, MDL mil	59 896.9	63 462.5	68 357.6	79 644.7	90 081.9
Principle I - Long-term liquidity ratio (≤ 1)	0.61	0.72	0.72	0.71	0.74
Principle II - Current liquidity ratio (≥ 20%)	55.46	54.64	50.65	50.62	48.54

* before 2018 - risk weighted capital adequacy ratio

Source: Elaborated by the authors based on the NBM official data available at https://www.bnm.md/ (quote on April 4, 2022)

According to data presented in Table 4.3, the total own funds amounted to MDL 15.2 billion at end-2021, registering a 43.2% increase compared with the end of 2017. Throughout the entire period, the total own funds ratio remained at a high level, recording a value of 25.87% at the end of 2021, the indicator being observed by all banks (limit for each bank ≥ 10% as well as additional requirements imposed by supervisory measures). The analysis of the evolution of total own funds ratio outlines two specific observations (Figure 4.7). First, the data show a decrease by 4.77 percentage points of this indicator to 26.55% in 2018 compared to risk weighted capital adequacy ratio in 2017 (31.32%). The decrease was mainly due to the transition of the banks to Basel III in 2018 and, respectively, to the change in the methodology for calculating own funds and the total own funds ratio, which differs from the calculation of the total regulatory capital and the sufficiency of risk-weighted capital. Practically, the calculation of the total own funds ratio takes into account not only the credit risk, but also the market and operational risk.

Figure 7 Dynamics of own funds, own funds ratio, loan portfolio, non-performing loan ratio and deposits by the banking sector of the Republic of Moldova in 2017-2021



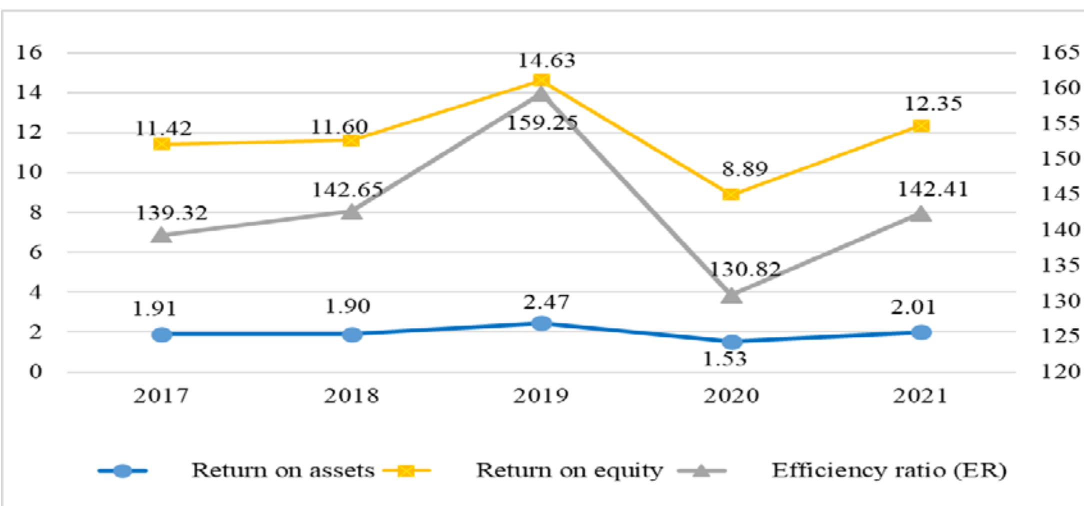
Source: Elaborated by the authors based on the NBM official data available at https://www.bnm.md/ (quote on April 4, 2022)

Secondly, according to the data shown, despite the economic impact of the COVID-19 pandemic in 2020, the banking sector registered an increase of the own funds ratio – by 2.0 percentage points to 27.25% at end-2020 as compared to end-2019. That was mainly favoured by early actions taken by the NBM in response to pandemic risks. For example, the NBM discouraged dividend payments and share buybacks and allowed banks to temporarily make use of capital previously held to meet the capital conservation buffer requirement. Thus, policies adopted by the central bank have undoubtedly helped to ease the challenges faced by banks' as a result of the COVID-19 crisis. Further, the analysis shows that the relevant asset quality indicators remained at adequate levels and continued to improve throughout the entire period of 2018-2021. Thus, total assets amounted up to MDL 118.5 billion as of 31 December 2021, rising by 49.2% in the course of the analysed period. The balance of the gross loan portfolio accounted for 47.6% of the total assets or MDL 56.4 million, showing a cumulative increase by 68.4% over the period of 2018-2021. At the same time, against growing loans, the share of non-performing loans (NPL) in total loan portfolio recorded a constant downward trend over the period. Thus, at end-2021 the share of NPL accounted for 6.14%, registering a 3-times reduction as compared to the level at end-2017 (Figure 4.7). Funds raised from the local market remain the main financing source of the Moldovan banks' assets. Specifically, the total deposits amounted to MDL 90.1 billion at end-2021, expanding by 50.4% compared with the end of 2017.

Additionally, the investigation posted improved liquidity indicators, in the context of effective measures adopted by the banks in order to fulfil new legislation requirements. Thus, according to the data shown in Table 4.2, the liquidity reserves of the banking sector constantly stayed above the minimum requirement throughout the 2018-2021 period. The value of the long-term liquidity indicator for the banking sector (principle I of liquidity, assets with a repayment term of more than two years/financial resources with a withdrawal term of more than two years ≤ 1) was 0.7 annually in 2018-2021. The value of the current liquidity indicator by sector – principle II of liquidity (liquid assets, expressed as cash, deposits with the NBM, liquid securities, net interbank funds with maturity up to one month/total assets x100% ≥ 20%) constantly stood above the double of regulatory requirement. Banks have also proved to be highly liquid according to the newly introduced indicator of the Liquidity Coverage Ratio (LCR). According to the Regulation on liquidity coverage requirements for banks which entered into force at 01.10.2020, banks have to meet only 70 percent of the requirement in 2021, rising to 80 percent in 2022, and 100 percent starting from 2023. In 2021 the LCR average by sector amounted to 358.5% (limit ≥ 70% in 2021).

And finally, the analysis of the banking sector's evolution over the 2018-2021 period posted a continued improvement of key profitability indicators. Thus, the net profit across the banking sector amounted up to MDL 2306.3 million in 2021, all banks reporting positive financial results at 31 December 2021. This indicator increased by 50.1% as compared to 2017. In this context, the return on assets (ROA, calculated as profit after taxes divided by total assets of a bank) and the return on equity (ROE, calculated as profit after taxes divided by total equity of a bank) stood at 2.01% respectively 12.35% at the end of 2021, above the levels of 1.91% respectively 11.42% recorded at the end of 2017 (Figure 8).

Figure 8. Dynamics of return on assets, return on capital and efficiency ratio by the banking sector of the Republic of Moldova in 2017-2021 (%)



Source: Elaborated by the authors based on the NBM official data available at https://www.bnm.md/ (quote on April 4, 2022)

The highest levels of ROA and ROE were registered in 2019, given a high growth rate of net profit in that year (55.7%). It should be mentioned the notable fluctuation from the upward trend of the profitability indicators registered in 2020, when the banking sector's capacity to generate profit was influenced negatively by worsening macroeconomic conditions in the COVID-19 pandemic context. Thus, despite banking sector profitability remained in positive territory throughout 2020, the financial result was however weaker – by 33.6% than that in the year before. Practically, these returns have significantly improved during 2021, as can be seen from the Figure 4.8. The dynamics of the efficiency ratio (ER) which is used as a quick test of efficiency and reflects the non-interest costs as proportion of net income outlines the same trend as the ROA and the ROE.

Conclusions and recommendations

The analysis of corporate governance in the banking sector and the results obtained from the survey suggest that licenced banks are compliant with the provisions of the legal framework on corporate governance. The existing corporate governance mechanisms are in line with sound corporate governance practices. Banks are well aware of and committed to corporate governance principles, demonstrating good knowledge of the corporate governance regulation. Banks are implementing good Board practices. Independent directors are well represented on the Boards in line with the requirements. Though the national legislation does not provide minimum quotas for women representation on boards, the female directors are well represented on the Boards. Banks comply with the provisions regarding the appointment of specialized committees of the Board and with the provisions regarding settlement and disclosure of the remuneration policy of the bank. According to the survey in all banks, the corporate governance code provides the general principles regarding protection of shareholders' rights, clarification of the roles of the governing bodies, relations with stakeholders (employees, creditors, investors, suppliers), social responsibility policies, as well as regarding transparency and disclosure of information.

The investigation showed a positive evolution of key financial indicators in the Moldovan banking sector during the implementation by the banks of the new corporate governance framework. The banking sector has recorded positive performances, at the same time fulfilling prudential requirements and preserving the adequate levels of indicators. Banks are sufficiently capitalized proving high level of liquidity (above the minimum requirement) and profitability. Thus, the implementation of sound corporate governance practices in Moldovan banks had positively impacted the effectiveness and performance of the sector. Moreover, the banking sector has proven resilient against pressures from the COVID-19 pandemic. On the one hand, this was due to the early actions taken by the NBM in response to pandemic risks. On the other hand, the impact of the pandemic on the banking sector has been mitigated by strong governance, effective risk management and high levels of capital in banks. Thus, considering the positive evolution of the main financial indicators of the banking sector in the analysed period, the authors could conclude that the implementation of sound corporate governance practices in Moldovan banks has positively impacted the performance level of the sector. In addition, the improved quantitative and qualitative mechanisms of bank corporate governance in banks contributed to promoting a secure and stable banking sector, increasing transparency, trust and attractiveness of the domestic banking sector for investors and creditors and facilitated the development of new financial products and services, including by accelerating the digitalization.

In order to improve further the corporate governance system in the Republic of Moldova, the following recommendations are proposed:

- While the banking sector has made substantial progress in implementing sound corporate governance practices, within the context of newly emerging risks arising from the war in Ukraine and downgraded outlook for the economy, which could represent an unprecedented challenge to corporate governance in the banking sector and a practical exercise of “tone at the top” principle for the corporate leadership in Moldovan banks, the banks should continue their efforts to improve further their internal governance and the resilience of their risk management strategy.

- Given that transparency is one of the principles for a sound and effective corporate governance, banks should continue to improve their practices related to disclosure of information, including information related to board independence, board composition, and board specialised committees. The information may include the number of independent board members, the number of non-resident board members, the number of board committees, their mandates and their composition (including members who are considered to be independent), the number of times key standing committees have met. In this context, shareholders, depositors, relevant stakeholders and market participants will obtain the necessary information for assessing the effectiveness of the board and senior management in governing the bank.
- In order to improve the quality of the management body, of the shareholders' rights, but also of the bank's corporate governance in general, the banks should improve the quality of the process of identification, selection and delegation for approval by the general meeting of shareholders of the members of the bank's board. This measure will primarily increase the rate of approval by the National Bank of Moldova of board members selected and submitted to the supervisory authority for approval. At the same time this measure will make the board and shareholders more responsible, and will increase confidence in the banks’ reputation.
- Protecting the rights of shareholders, including of minority shareholders, is one of the most important principles of corporate governance. According to this principle, shareholders have the right to obtain relevant information on the corporation, which is essential in guaranteeing openness and transparency about important issues regarding company policy. In this context, in order to ensure the compliance of the bank with this principle, the banks should strengthen the role and operation of the Board and its specialised committees. With this view, the board may consider the need to contract external consultants and firms in relation to the preparation of evaluation reports regarding the bank internal governance, strategic goals, business process management, etc., in order to improve the banks performance and to present such reports at the general meetings of the shareholders.
- It is acknowledged, that the board is chiefly responsible for guiding corporate strategy, monitoring managerial performance and achieving an adequate return for shareholders. In this regard, the board must be able to exercise objective, professional and independent judgement. In order for the board to be able to meet its obligations, the chairman, should ensure that members regularly update and improve their knowledge on matters relevant to the banks’ activity as well as ensure that the special knowledge and competencies of each individual member are used in the best possible manner for the benefit of the bank. Moreover, board audit committee members, who should have experience in audit practices, financial reporting and accounting, are likely to require considerable training in this field in order to effectively perform their duties. In addition, to increase value creation, within the annually performed evaluation of its activity and

composition of its members, the Board may consider the integration of new talent, while maintaining continuity.

- Considering the increased focus on ESG worldwide and increased evidence of the importance of ESG as a factor associated with the development of a well-functioning market for green finance and sustainable investment, as well as the importance of ESG as a prerequisite for the banks seeking for an IPO (Initial Public Offering) perspective, it could be an opportunity for the banks to consider integrating environmental, social and governance factors into banks' risk management processes, business strategies and investment policies.
- The long-run viability of a business depends on its strategic positioning, which includes developing the economy and community in which it operates, working with government and regulatory authorities to facilitate better regulatory regimes, or integrating environmental breakthroughs into assets to reduce costs and improve efficiency. In this context, enhancing relations with communities and regulators could further improve the corporate governance of commercial banks.

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