Republic of Moldova
Enterprise Access to Finance
Background Note

June 2013

ECSPF
EUROPE AND CENTRAL ASIA
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### List of Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>NBS</td>
<td>National Bureau of Statistics</td>
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<td>NCFM</td>
<td>National Commission for Financial Markets</td>
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<tr>
<td>MFI</td>
<td>Microfinance Institutions</td>
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<tr>
<td>MSE</td>
<td>Moldova Stock Exchange</td>
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<tr>
<td>LOC</td>
<td>Lines of Credit</td>
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<td>SCA</td>
<td>Savings and Credit Associations</td>
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</tbody>
</table>
EXECUTIVE SUMMARY

1. **Access to finance is a key facilitator of economic growth and competitiveness.** Most enterprises need access to finance at a reasonable cost in order to invest in equipment and other assets that will help them improve their productivity, finance short-term needs throughout the business cycle (for instance, bridge the gap between issuing an invoice and being paid), and adjust to changing market needs.

2. **Moldova’s core financial depth indicators have improved markedly over the years, and are now broadly in line with countries on similar levels of development.** There are currently 14 banks operating in the country, as well as 361 member-owned savings and credit associations, and 73 microfinance institutions (MFIs). The number of financial service points has increased greatly, and geographic outreach has ceased to be an impediment to accessing financial services. Furthermore, credit to the private sector as a share of GDP increased between 2005 and 2012, from 24 percent to 38 percent, and deposits increased from 30 percent of GDP in 2005 to 41 percent in 2012.¹ Both ratios are roughly in line with average ratios for countries at similar stages of development, but continue to lag behind a number of countries in Central and Eastern Europe.² Competition for commercial bank credit to medium-sized and large enterprises has increased. There is some indication that the market for large borrowers is becoming saturated, and some commercial banking institutions are now reaching out to smaller enterprises through less traditional lending techniques.

3. **Despite this progress, access to finance continues to be identified as one of the most pressing issues for enterprise development in Moldova.³** Available surveys and market feedback suggests that enterprises depend strongly on retained earnings and bank loans for funding.⁴ Specific constraints identified by the private sector and government include:

   a. Limited availability of longer loan maturities for funding capital investments.
   b. High collateral requirements of up to 200 percent of the loan value in banks and 70 percent in non-bank financial intermediaries, which particularly affects smaller and new enterprises that do not yet have collateral to pledge.
   c. Relatively high levels of interest rates and commissions on borrowing, which make borrowing difficult to afford, given inconsistent enterprise profitability and the volatile economic situation.

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¹ Based on IMF data
² CEE countries include: Albania, Montenegro, Macedonia, Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Slovenia, Croatia, Bosnia-Herzegovina, Serbia, and Kosovo. CIS countries include Russia, Belarus, Ukraine, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.
⁴ According to the 2009 Enterprise Survey (2009)⁴, only 30 percent of enterprises in Moldova reported not needing a loan, compared to 40 percent in the ECA region and worldwide. However, only 39 percent of enterprises in Moldova have a loan or a line of credit. The average capacity to finance investment internally stood at 56 percent of the funding needed, compared to 60 and 69 percent in the region and worldwide. This dependency leaves enterprises more vulnerable to the drying up of bank credit, as has been observed in 2009.
This report has identified a number of demand- and supply-side barriers driving the bottlenecks identified above:

4. Both exogenous and endogenous factors weigh in on enterprises’ profitability, and reduce the business opportunities that can be financed through formal channels. Exogenous factors include: (i) the volatile macro-economic environment, with economic growth strongly dependent on remittance income and demand from a few export markets, and ii) the noted deficiencies in the business environment and investment climate in Moldova. Endogenous factors include: (i) gaps in enterprises’ financial management capabilities, including the poor quality – or absence – of business and investment plans, (ii) the lack of horizontal and vertical integration or cooperation along value chains, and (iii) limited focus on the quality of products. All of the above translates into volatile and lower average rates of returns, and reduces enterprises’ eligibility for loans, or the amount that they can borrow. Moreover, gaps in financial planning and management increase information asymmetries between borrowers and lenders, and lead to high rates of rejection of loan applications. In addition, there are indications that enterprises do not sufficiently understand the available financial products and associated costs, which contributes to suboptimal product and term decisions that can elevate the costs of borrowing.

5. On the supply side, the market for enterprise financing continues to be segmented, and competition is limited. Banks have remained comparatively liquid over the past few years (benefiting from the high remuneration paid on government bonds), and out of the 14 banks operating in Moldova, only five cater to more than 3,000 borrowers. The vast majority of bank credit currently goes to a few large clients, while 97 percent of borrowers (individuals and legal entities borrowing for business purposes) have an average loan size of USD 5,000, and account for only 20 percent of the total loan volume in the banking sector. Micro- and smaller enterprises are frequently not “banked”, and rely on savings and credit associations as well as microfinance institutions for external financing. This confines them to smaller amounts, shorter loan maturities, and higher borrowing costs. Despite attempts made in the past few years to factor in market risks and improve credit evaluation, banks’ internal risk assessment and management continue to be limited, which – along with some issues in internal governance – has contributed to elevated levels of non-performing loans in the system and the abovementioned strong reliance on collateral for lending. Finally, as small and not yet banked enterprises are not a primary target of the banks’ business, suitable credit assessment techniques, products, and conditions have not been developed for this market segment.

6. Another core constraint on the supply side is the relatively high funding costs and limited availability of liabilities with longer maturities. The capital market and the institutional investor base are not well-developed, which eliminates an important and potentially cheaper source of long-term funds for both banks and larger enterprises. Furthermore, few people are formally saving up for retirement. The culture of accumulating retirement savings on an ongoing basis is almost entirely missing; suitable pension plans are not available, and – given past experience with bank failures and deposit insurance coverage of only USD 500 – the population also lacks the trust that is necessary for it to place savings and remittances into longer maturities in the banking sector. Lines of credit provided by international institutions to the
banking sector have helped bridge some of these gaps in the past few years by providing the equivalent of six percent of the banks’ long-term credit portfolio for on-lending, but this is not a sustainable solution in the long run.

7. Considerable progress has been made in establishing the necessary financial infrastructure, but further steps forward are needed to broaden the coverage of the credit bureau, and foster better implementation of the legal frameworks. The legal and regulatory frameworks provide for the use of a variety of collateral, although leasing, accounts receivables, and warehouse receipts currently cannot be registered as collateral, which is a distinct disadvantage for smaller enterprises. Registries for both movable and immovable assets exist, but costs and the administrative burden of registering collateral still pose a burden particularly for smaller borrowers, and repossessing and selling collateral remains difficult. A private credit bureau was established in 2011, and already includes the credit history for most bank borrowers. Efforts are underway to expand the database by incorporating information from nonbank credit institutions, which would help many micro- and small enterprises establish a credit history. Reforms of creditor rights are ongoing, with a new insolvency law recently coming into effect. Its success depends on the actual implementation of the new legal framework, and the establishment of adequate guidance and good practices. Finally, new accounting standards are being introduced, which – if implemented consistently and homogeneously – will solidify financial information on the enterprise sector.

8. Though the regulatory framework for banks and savings and credit associations has been significantly improved, some fine-tuning could be considered to close gaps in oversight, strengthen consumer protection, and balance stability and financial deepening considerations. The banking sector is regulated and supervised by the National Bank of Moldova (NBM), which has been strengthening the regulatory framework since 2008 by introducing tighter exposure limits, enhancing transparency (in particular in ownership and pricing), improving risk management in banks, and revising prudential regulations to increase banks’ resilience to the current volatile economic environment. While the reforms have helped strengthen the banking sector, more in-depth analysis is needed to ensure a sound supervisory framework that fully enables financial deepening and competition is in place. Non-bank financial institutions are supervised by the National Commission of Financial Market (NCFM), which was created in 2007 through a merger of various non-bank supervisory agencies. The capacity of the NCFM to supervise the savings and credit associations, and monitor the remaining entities, has been considerably strengthened over the past few years, which has helped consolidate the savings and credit association (SCA) sector. However, microfinance institutions only have to report their financial data to the NCFM, which lacks the legal power and capacity to monitor them in more breadth and depth. Leasing entities do not have to provide any information, and are thus excluded from monitoring. As both leasing and microfinance institutions play an increasingly important role in providing financial services, strengthening – mostly non-prudential – supervision would be warranted. This would safeguard their sound development, and deepen the authorities’ understanding of cross-linkages between various financial institutions in the system. Furthermore, it would be helpful to create a development path for the various financial entities to facilitate their upward mobility. Finally, more progress is needed in the area
of consumer protection, especially to enhance transparency in all entities, and to increase the ease of placing a complaint.

9. **Moving ahead, it will be important to improve coordination between existing programs and reform efforts to enhance their targeting, efficiency, and outreach.** The government has already launched and implemented a number of reform measures and programs to address the above-mentioned bottlenecks, and facilitate access to financing for firms. These are supplemented by further initiatives undertaken by national and international stakeholders. As many of these initiatives that are providing direct support to enterprises are small and dispersed among numerous implementing agencies and stakeholders, the targeted beneficiaries often find it difficult to get an overview of the support instruments available to them. The multitude of efforts can also lead to inefficiencies in implementation and sub-optimal outreach. It would thus be beneficial to identify a national body that would monitor progress on enterprise access to finance, and coordinate and guide the various public and private initiatives. Moreover, given the persistent gaps in data, this body should also devise measures to close the data gaps, and use the upgraded data to monitor effectiveness and efficiency of access to finance reforms and programs. More attention also should be paid to making programs and reforms self-sustainable in the medium and long term.

10. **Following the “guiding principles” of enhancing coordination, collaboration, and sustainability, this report highlights a number of reform measures that would help improve the affordability of loans, raise the eligibility of borrowers, and stimulate competition in the financial system.** The policy recommendations, presented in more detail and depth in the main report, and summarized in Table 1, generally pertain to five core areas:

- Support for enhancing the profitability and formality of enterprises, and for fostering business linkages. Efforts should focus on building sound financial management and planning capacities.

- Support for the development of alternative long-term funding sources, including the capital market and institutional investors, as well as innovative lending products.

- Support for further legal and regulatory reforms to bring leasing companies and MFIs into the system of oversight, improve consumer protection, enhance transparency, fine-tune regulations to reduce connected lending, and adjust the regulatory balance to reflect both stability and access to finance concerns.

- Further improve the existing financial infrastructure in the country by increasing the coverage of the credit bureau; improving the availability, affordability, and quality of accountants and auditors; improving the legal framework for secured transactions; and supporting the actual implementation of the legal frameworks for collateral and creditor rights.

- Create a comprehensive financial consumer protection framework, promote financial education to foster a culture of savings, increase market transparency, and improve the availability of financial information.
<table>
<thead>
<tr>
<th>Suggested reform measures (Note: Priority reforms are in bold)</th>
<th>Timeframe</th>
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</thead>
<tbody>
<tr>
<td><strong>1. Recommendations pertaining to enhanced targeting and coordination:</strong></td>
<td></td>
</tr>
<tr>
<td>Design and implement a baseline survey on the demand for and use of financial services by enterprises.</td>
<td>Short-term</td>
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<tr>
<td>Identify a national coordination body to monitor progress</td>
<td>Short-term</td>
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<tr>
<td>Develop sunset clauses for temporary programs, and enhance the sustainability of the remaining programs.</td>
<td>Short- to medium-term</td>
</tr>
<tr>
<td><strong>2. Recommendations aimed at enhancing the profitability of enterprises:</strong></td>
<td></td>
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<tr>
<td>Launch a coordinated and holistic effort to foster business linkages, financial management, and business planning skills of enterprises.</td>
<td>Short- to long-term</td>
</tr>
<tr>
<td>Continue to work on attracting FDI and improving the business environment.</td>
<td>Medium- to long-term</td>
</tr>
<tr>
<td>Enhance transparency in government procurement, and increase the scope for bidding for smaller enterprises.</td>
<td>Medium- to long-term</td>
</tr>
<tr>
<td>Enhance the provision of cross-cutting services, including market information and education to increase labor force skills.</td>
<td>Short- to long-term</td>
</tr>
<tr>
<td><strong>3. Recommendations focused on increasing the availability of term funding sources for banks and enterprises:</strong></td>
<td></td>
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<tr>
<td>Broaden the domestic investor base for government securities, and develop the secondary market.</td>
<td>Short to long-term</td>
</tr>
<tr>
<td>Eliminate bottlenecks, and facilitate issuance of corporate bonds from private sector entities, especially banks, on the regional or local capital market.</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Develop the necessary legal and regulatory framework for a second (private) pillar in the pension system.</td>
<td>Short- to medium-term</td>
</tr>
<tr>
<td>Help establish a culture of savings and planning for retirement among the general public.</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Enhance the capacity and functioning of the Deposit Guarantee Fund. Increase the coverage limit.</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Ease out the provision of lines of credit to overcome gaps in available maturities.</td>
<td>Medium-term</td>
</tr>
<tr>
<td><strong>4. Recommendations pertaining to upgrading the legal and regulatory framework for financial institutions:</strong></td>
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<tr>
<td>Establish a legal and regulatory framework for microfinance and leasing companies, commensurate with the activities and size of the respective sector, which will level the playing field between financial players.</td>
<td>Short- to medium-term</td>
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<tr>
<td>Strengthen the capacity of the supervisory agency to enforce the new framework.</td>
<td>Medium- to long-term</td>
</tr>
<tr>
<td>Fully enforce the amendments to the Law on Financial Institutions (enacted in April 2013) to improve ownership/shareholder transparency in the financial sector.</td>
<td>Short-term</td>
</tr>
<tr>
<td>Develop and enact further legal amendments to facilitate disclosure of the ultimate beneficiary owners in the financial sector. Assess and implement options to further tighten regulations on connected lending (including for consolidated supervision).</td>
<td>Short-term</td>
</tr>
<tr>
<td>Analyze the regulatory and supervisory framework in more depth to ensure that it facilitates financial sector deepening and competition, while</td>
<td>Medium-term</td>
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</table>
maintaining financial stability.

5. **Recommendations aimed at strengthening the available financial infrastructure in the country:**

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timeframe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incorporate information on borrowers from non-bank credit institutions into the Credit Bureau, and set regulatory incentives for reporting and usage of the data.</td>
<td>Short- to medium- term</td>
</tr>
<tr>
<td>Assess and implement needed reforms to include information from utility and telecommunication companies into the database of the Credit Bureau.</td>
<td>Medium-term</td>
</tr>
<tr>
<td><strong>Continue pursuing reforms of the legal and regulatory framework for auditing and accounting, and support their enforcement.</strong></td>
<td>Short- to long-term</td>
</tr>
<tr>
<td>Implement reforms in the area of collateral and creditor rights, including amending the Pledge Law and other relevant legislation.</td>
<td>Medium-term</td>
</tr>
<tr>
<td>Assess the operation and long-term sustainability of the credit risk guarantee facility.</td>
<td>Short- to medium-term</td>
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</table>

6. **Recommendations focused on enhancing consumer protection and financial capabilities of enterprises:**

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timeframe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assess the consumer protection framework of the entire financial sector, and implement necessary reforms to increase price and product transparency, and establish adequate complaint mechanisms.</td>
<td>Short- to medium-term</td>
</tr>
<tr>
<td>Launch targeted financial education campaigns to support all of the reforms above.</td>
<td>Medium- to long-term</td>
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</tbody>
</table>

*Note: Priority reform areas are highlighted in bold.*
I. Introduction

11. The Government of the Republic of Moldova (GoM) is aiming to change Moldova’s development paradigm from a remittance- and consumption-driven economy to a model based on exports, innovation, and competitiveness. In 2012, the GoM presented its national development strategy “Moldova 2020”, in which it identified four core priority areas for broad-based economic growth: (i) education, (ii) roads, (iii) business environment, and (iv) access to finance. The strategy also identified three additional reform areas: (v) the judicial sector, (vi) consumption of energy resources, and (vii) the pension system. Furthermore, Moldova 2020 highlighted spurring innovation and competitiveness in the private sector as one of the priorities for the economic transition. The donor community broadly supports the government in implementing this agenda, and it has already provided a number of lines of credit (LOC) to support growth in selected economic sectors, and to help design and implement policy reforms to foster investment activity in the country.

12. In support of the ongoing dialogue on private sector development, the World Bank has carried out an assessment of priority areas that should be addressed in order to facilitate further private and financial sector development in Moldova. This note is a part of this broader assessment, and aims to identify and assess the core barriers related to enterprises’ access to finance, as well as offer actionable reform recommendations. Particular focus will be placed on assessing collateral requirements, loan maturities and interest rates, issues that are repeatedly mentioned in reports and interviews with businesses and other stakeholders as constraining factors. The note will also pay special attention to the two broad financial sector policy challenges identified by the government in the Moldova 2020 strategy: (i) to increase competition in the financial sector, and (ii) to foster the development of risk management tools.

13. The rest of report is divided into five chapters. Chapter III provides a brief overview of the core indicators of access to financial services and the perceived bottlenecks, and compares these with other countries and the ECA region. Chapter IV assesses the underlying demand- and supply-side constraints to enterprise access to finance. Chapter V reviews the existing financial infrastructure in Moldova and provides a brief assessment of the regulatory framework. Finally, Chapter VI provides an overview of ongoing government and donor-supported reforms, assesses remaining gaps, and formulates recommendations for future reforms.

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5 See Government of the Republic of Moldova (2012), p. 8
II. Brief Overview of the Current Situation

A. The Private Sector

14. **Like in most developing countries, the enterprise sector in Moldova largely consists of micro- and small enterprises.** According to data from the National Bureau of Statistics (NBS), micro- and small enterprises currently account for 94 percent of the 48,541 enterprises registered in Moldova that present their financial statements to NBS.\(^6\) They provide jobs for roughly 40 percent of the formal sector employees, and represent 23 percent of the total reported turnover. The remainder of the private sector consists of medium and large enterprises. In addition, there is a large number of micro- and small enterprises on which data is unavailable.\(^7\)

15. **The number of formal enterprises has grown dynamically in recent years, increasing by 50 percent since 2005.** While micro- and small enterprises accounted for the brunt of the increase in numbers (+ 15,000 enterprises), large enterprises displayed the highest rate of growth. The 507 additional large enterprises represented a growth rate of 73 percent from 2005. The growth in large enterprises can mostly be attributed to Foreign Direct Investment (FDI) activity,\(^8\) as well as “graduation” of medium-sized enterprises into large ones (see Figure 1). Large enterprises now account for 65 percent of the total turnover (2011), compared to 57 percent in 2005. This trend was not mirrored in formal employment. Productivity gains and shifts in composition reduced the number of formal employees in large and medium-sized enterprises by 100,000 employees, or 25 percent, between 2005 and 2011, while micro- and small enterprises, on which data is available, added 30,000 new employees to the workforce in the same period. As highlighted by IFC (2010), net job creation will largely hinge on the capacity of start-ups and small enterprises to become drivers of innovation and growth, and on the removal of the bottlenecks that are hindering their development.

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6 According to the 2006 law on SMEs, enterprises are classified based on the number of employees, turnover, and total assets as: (i) micro: less than ten employees, maximum turnover and assets of up to LEI 3 million; (ii) small: less than 50 employees, and maximum turnover and assets of LEI 25 million; (iii) medium: less than 250 employees, and turnover and assets of up to LEI 50 million; and (iv) large: anything above. The data in the NBS only includes those enterprises that present annual financial statements. According to the Auditing and Accounting ROSC (2013, forthcoming), the number of registered enterprises is currently 163,000.

7 There are currently around 155,000 formally registered companies, but some of them are likely dormant, while others are registered as limited liability companies, cooperatives, etc., which are not required by the accounting law to prepare and submit financial information to the authorities. The NBS only collects information from those entities that are required to submit their information, and shares it within the government.

8 See Gucci 2012
16. Economic growth strongly depends on remittance income and demand from Moldova’s main trading partners, the EU and Russia. Between 2005 and 2007, average real economic growth fluctuated between 3-7 percent, and it was supported by strong remittance inflows, investments (including FDI), and exports. The growth rate dropped sharply in 2009 due to the worldwide financial crisis, but it eventually recovered again in 2010. As is typical for countries with strong remittance inflows, the service sector is the strongest sector in the Moldovan economy, while agriculture and industry account for around 13 and 23 percent of GDP. Overall, average economic growth rates have remained behind those of other countries in the region, as have income levels, and the gap in income per capita that exists between Moldova and neighboring countries still persists.
B. Access to Financial Services

17. Moldova’s financial sector is dominated by commercial banks. There are currently 14 commercial banks operating in the country, which account for 93 percent of total financial sector assets. At the end of 2012, they provided loans to 131,000 borrowers, (slightly over 60 percent of all borrowers reported in the financial system), and represented 96 percent of total loans by volume. In addition, 361 member-based savings and credit associations (SCAs) as well as 73 for profit microfinance institutions presently operate in the country. They cater to around 80,000 borrowers, and with 4 percent of total loans by volume, they play an important role as lenders to micro- and smaller enterprises. They provide mostly short-term and small loans. Moldova’s insurance sector is small (4 percent of assets), and no private pension funds operate in Moldova.

18. Moldova’s core financial depth indicators have improved markedly over the years, and are now broadly in line with countries on similar levels of development. Credit to the private sector as a share of GDP increased from 24 percent to 38 percent in 2005-2012. Credit growth was particularly dynamic up to 2008, displaying annual growth rates of 20-30 percent, eventually reaching 36 percent of GDP in 2008. Since then, credit growth has been slower due to the vulnerability created by the financial crisis. Deposits also increased significantly over the same period, and accounted for 41 percent of GDP in 2012, up from 30 percent in 2005. Both ratios are roughly in line with average ratios for countries at similar stages of development, but still lag behind those in most Central and East European (CEE) countries (see Figure 3).

![Figure 3: Financial Depth – A Comparison, 2012](image_url)

Source: IMF

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9 This period of credit growth was identified as a credit boom by the German Economic Team Moldova (2011).
19. **Substantial progress has also been made in terms of outreach indicators, and geographic access is no longer perceived as a constraint.** Data as of end 2012 shows that the number of service points has surged: banks now operate 327 branches and 936 representative offices, compared to 212 and 271 in 2005, respectively. The number of ATMs grew by 20 percent in the last two years alone, and the number of deposit accounts has increased by 13 percent since 2007. As depicted in Table 2, Moldovan outreach indicators now compare favorably to countries at similar stages of development. A positive evolution has also been noted in the proportion of borrowers relative to the population within the domestic financial system: the number has increased from 26 borrowers per 1,000 adults in 2005 to 46 in 2012. While the data in the table indicates that Moldova still lags behind other countries in this respect, data on enterprise access to finance from the 2009 Enterprise Survey shows that 40 percent of formal sector enterprises had a loan or line of credit from a financial institution, compared to 43 and 36 percent in the region and worldwide, respectively. The gap thus mostly stems from the low consumer lending activity of banks in comparison to other countries.

<table>
<thead>
<tr>
<th>Table 2: Financial Access Outreach Indicators - A Comparison, 2011</th>
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<tbody>
<tr>
<td><strong>Commercial Bank branches (per 1,000 km²)</strong></td>
</tr>
<tr>
<td>CEE</td>
</tr>
<tr>
<td>22</td>
</tr>
<tr>
<td><strong>ATMs per 1,000 km²</strong></td>
</tr>
<tr>
<td>44</td>
</tr>
<tr>
<td><strong>Deposit accounts with commercial banks per 1,000 adults</strong></td>
</tr>
<tr>
<td>1726</td>
</tr>
<tr>
<td><strong>Loan accounts with commercial banks per 1,000 adults</strong></td>
</tr>
<tr>
<td>492</td>
</tr>
<tr>
<td><strong>Formal sector enterprise with a loan or line of credit from a financial institution (%)</strong></td>
</tr>
<tr>
<td>43% (ECA region)</td>
</tr>
</tbody>
</table>

*Source: IMF Financial Access Survey*

20. **Despite these achievements, access to finance continues to be identified as one of the primary constraints for companies in Moldova.** Detailed data on access to finance is not regularly collected, but available sample surveys and interviews suggest that enterprises depend heavily on retained earnings and bank loans as sources of funding. According to the 2009 Enterprise Survey, only 30 percent of formal companies interviewed reported *not* needing a loan, compared to 40 percent in the region and worldwide. However, only 39 percent of enterprises in Moldova have a loan or line of credit. Furthermore, the average capacity to finance investments internally stood at 56 percent of the funding needed, compared to 60 and 69 percent in the region and worldwide. This comparative dependency leaves enterprises more vulnerable to the availability of bank credit. In 2009, for example, when credit from the banking sector dropped by 10 percent, 39 percent of the enterprises interviewed for the Enterprise Survey (2009) identified access to financing as a core constraint, compared to 24 and 33 percent for the region and worldwide.

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10 See, for example, the Global Competitiveness Report (2012-2013), and a recent survey conducted as part of the Moldovan German Forum. See also KFW et al. (2012). The participants of the forum highlighted lack of price transparency, and lack of adequate products for SMEs as barriers.
countries worldwide. The drying up of credit particularly affected the large enterprises\textsuperscript{11}, which account for the vast majority of bank credit. For example, at the end 2012, 60 percent of loans by volume went to only 1,203 borrowers, and another 20 percent went to 3,000 borrowers. The remaining 97 percent of the total borrowers only account for 20 percent of the loan volume, and have a relatively small average loan size of USD 5,000.

![Figure 4: Concentration of Loans in the Banking Sector](image)

*Source: NMB, December 2012*

21. **Three main barriers in access to finance have been highlighted:**

   - **Shortage of long maturities:** Many stakeholders (both from the enterprise sector and the financial sector) report that maturities of five years and above, which are needed for long-term investment projects, are not sufficiently available, and that even maturities of 3-5 years are difficult to obtain. Thirty-seven percent of the loans (by volume) in the commercial banking system had a maturity of three years and longer as of end 2012. A more detailed breakdown of maturities was not available.

   - **High collateral requirements:** Banks often require collateral valued at up to 200 percent of the loan size, according to data from NBM and private companies. This contrasts with the 140 percent collateral value reported in the 2009 Enterprise Survey. This is above the average for the ECA region, and also on the higher side worldwide.\textsuperscript{12} These requirements particularly affect start-ups and small enterprises, which do not yet have much to pledge and thus may be unable to borrow.\textsuperscript{13} Although not a constraint for all enterprises, medium-sized and small firms face a challenge to fulfill banks’ collateral requirements. For larger enterprises, which in general are already banked, this mostly affects the size of the credit that they can obtain.

\textsuperscript{11} 50 percent of large enterprises reported that access to finance was a major barrier, compared to 25 and 32 percent for large enterprises in the region and worldwide.

\textsuperscript{12} According to the enterprise surveys, the average for the Eastern European and Central Asia region is 136 percent, for the OECD countries 124 percent, and for the other regions between 160 and 210 percent (http://www.enterprisesurveys.org/Data/ExploreTopics/finance)

\textsuperscript{13} These are also the most risky, and hence, again, prudent risk management will restrict lending to them, even in advanced countries.
- **Costs of loans**: Real and nominal interest rates in Moldova are in line with those common in comparator countries, and spreads have fallen after a brief surge in 2009-2010. Yet, nominal lending rates of currently twelve percent in local currency and seven percent in USD continue to pose a constraint to enterprises. Loan interest rates are usually variable, and have fluctuated widely due to inflation, risk perception and competition. This introduces uncertainty into the financial decision-making process of most enterprises, and makes the affordability of loans more difficult to calculate. Furthermore, firms face a number of additional costs such as bank commissions, costs for collateral evaluation and registration, costs and time needed to prepare the required documentation, and early repayment fees. Just as importantly, enterprises’ low and inconsistent profitability makes interest rates that are in line with regional average seem unaffordable to managers and entrepreneurs.
III. Demand- and Supply-side Constraints

22. This chapter assesses the underlying factors that weigh on Moldovan companies’ access to financing from formal financial institutions. First, the availability of data is discussed, to determine its quality. Second, demand-side bottlenecks are assessed to determine whether deficiencies in the business environment and investment climate adversely affect enterprise eligibility for and the affordability of bank lending. Third, supply-side constraints are analyzed, with a particular focus on competition in the financial system, available products and overall productivity and efficiency in the system. Finally, the regulatory framework and the available financial infrastructure are considered in an attempt to pinpoint potential gaps in these two core backbones of financial intermediation.

A. Data on Enterprise Access to Financing

23. Limited data is available on the sources of funding used by enterprises, and the evolution of firm access to finance over time. A number of demand-side surveys have been conducted by donors in the last few years, but they are not comparable over time; they are often based on different sub-segments of the private sector, and/or they do not go more in depth on the funding sources and concrete needs of Moldovan businesses. On the supply side, the National Bank of Moldova collects a broad range of data on the banking sector. While it has also started collecting data on loan sizes, maturities and the number of borrowers, so far, only the data for 2012 is available, and the granularity of the data is not yet sufficiently refined to extract information by type of borrower.14 With regard to non-bank financial institutions, data on the member-based institutions has been improved over the years, and now provides an overview of the general soundness and outreach of the sector. However, vast information gaps exist with regard to the microfinance institutions and leasing entities.

24. Overall, the available data does not yet paint a reliable picture of the actual level of access to finance for Moldovan enterprises, or its evolution over time. The information points to enduring gaps in access to finance, but it is not sufficient to identify constraints or trends by market segment (i.e. sector, type of company), missing financial products, or affordability aspects. It also does not allow for an assessment over time, which could show how companies’ access to finance has evolved, how the crisis impacted it, and how demand and supply have shifted over time. The data gaps make the formulation of well-targeted policy measures more difficult. The lack of data also make it difficult to monitor the effectiveness and efficiency of reform measures – for instance, whether they have reached targeted beneficiaries and/or alleviated core barriers. It should also be noted that there is no government body in charge of coordinating data collection and policy measures on access to finance (especially for small and medium-sized enterprises).

14 It would in particular be helpful to have loans to enterprises reported separately, and to be able to differentiate by size of enterprises.
B. Demand-side Constraints: Business Environment and Management Capacity

25. There are a number of bottlenecks on the demand side that adversely affect enterprise access to loans. These can be summarized as: (i) the volatile macro-economic situation, affected by the Eurozone crisis and other factors, which has made companies generally reluctant to invest; (ii) deficient financial planning and reporting; and (iii) volatile and sub-standard profitability due to a lack of stable business linkages, and low product quality as a result of outdated production techniques. These aspects will be discussed more in depth in the following paragraphs.

Exogenous Factors: Volatile Macroeconomic Environment and Deficiencies in the Business Environment

26. The profitability of Moldova’s enterprises fluctuates based on the developments in its main export markets and the inflow of remittances. Fluctuations in remittance income, which accounts for around 30 percent of GDP, have a strong impact on demand for local goods and services. Export performance depends on the economic developments in a few core export markets, namely the EU and Russia.15 This dependency was particularly visible after the global financial and economic crisis, which led to a sharp drop of 40 percent in remittance income in 2009, while exports plummeted from 47 percent to 37 percent of GDP from 2007 to 2009, due to lower external demand for domestic goods.16 GDP contracted by 6.4 percent in 2009, affecting enterprises of all sizes. Companies’ reliance on one or two export markets also makes them vulnerable to changes in the legal and regulatory frameworks in these partner countries. For instance, wine exporters were severely hit by embargoes applied by Russian authorities in 2006-2007 and 2010. Thus, uncertainties in the macroeconomic environment can negatively affect enterprises’ ability to repay loans.

27. Economic volatility has translated into reduced investment activity and correspondingly into lower loan demand. The severity and abruptness of the economic downturn highlighted the vulnerability of the economy, and investment and FDI activities have since remained subdued despite a return to growth rates of around 6 percent. Fixed capital formation, which had reached 34 percent of GDP in 2007, decreased after 2008, and now only accounts for 23 percent of GDP (lower than the 24 percent reported in 2005). While the overall level of gross capital formation is still higher than the CEE and CIS averages, it falls short of levels common in other low- and middle-income countries, and is likely to slow down Moldova’s transformation into a more advanced economy. The low rates of investment reduce funding requirements and therefore the demand for loans.

15 For example, over 50 percent of the apple production is sold right after the harvest, and 93 percent of it goes to Russia (see USAID / DAI 2011)
16 World Development Indicators database
28. **Additional costs are also incurred through uncertainty and complex procedures in the country’s overall business environment.** These reduce real returns, and the most pressing constraints are discussed in detail in the report on Policy Priorities for Private Sector Development in Moldova, which this background note supports. In taxation, procedures for compliance are time-consuming, and the cost of taxes plus penalties and fines can be unpredictable. With regard to customs, the reported 32 days needed to prepare the documentation required for an export shipment are above average for the region (26 days) as well as for the EU (10 days). Furthermore, the elevated number of procedures needed for individual authorizations, permits, certificates, etc., increases costs, and can foster petty corruption. Finally, frequent changes in regulations and procedures have also been mentioned by private sector companies and associations in documents and interviews as factors affecting profitability, and thus loan affordability and financial uncertainty. All these factors increase the cost of doing business, and decrease the profit margins of companies.

29. **While enterprise sales reported to the National Bureau of Statistics (NBS) have shown a positive trend, there are considerable risks and uncertainties weighing in on enterprise performance.** For the past two years, enterprise turnover grew at an average nominal annual rate of 18 percent, and average gross profit margins were around 7 percent. Yet, although sales show a positive trend, net income suggests a more mixed picture. Data from the NBS suggests that roughly half of the enterprises with financial statements report net losses annually. An impact assessment of the World Bank’s Competitiveness Enhancement Project provides additional evidence, showing that only 15 out of a sample of 49 participating enterprises were able to exceed the initially expected sales volumes. Most of the 49 companies reported sales that were lower than expected, and 9 companies did not achieve even half of the expected sales volume. Although the design of the matching grant scheme and the application

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17 The turnover and profitability are likely understated, as the data mostly comes from unaudited financial statements collected by NBS (see footnote 5), and presented to the tax authorities.
18 Impact assessment, forthcoming in June 2013
process may have given firms incentives to over-estimate their expected sales, the fact that sales were so off-target highlights both the considerable variability and vulnerability of income, as well as potential difficulties in financial planning (see discussion below).

**Deficiencies in Financial Planning and Reporting**

30. **One of the core factors constraining enterprises’ eligibility to borrow is the low quality of financial information presented by borrowers when they apply for a loan.** In the 2012-2013 Global Competitiveness Report, Moldova's auditing and accounting standards have a rating of 4.2 on a scale of 1 to 7 (with 7 being the highest rating), and Moldova ranks 98th out of 144 countries on this indicator. Audited financial statements are currently mandated for around 600 of the 2,700 medium and large enterprises19, and the quality of the available audits is frequently perceived as low. The 2009 Enterprise Survey indicates that only 18 percent of medium-sized enterprises, and 30 percent of large enterprises, have audited financial statements. This is far below the average of 44 percent reported for medium-sized enterprises, and 71 percent reported for large enterprises, in the region. For the remaining enterprises, interviews with stakeholders20 suggest that the available information on turnover and profitability is not very reliable, and that even enterprises with 200 or more employees frequently lack a financial management function. Furthermore, the data may not reflect the full extent of business activity, as it may be put together with the aim of minimizing the tax burden and formal labor costs for the enterprise. It is worth noting that the informal economy has been estimated to represent 42 percent of GDP in Moldova.21 While this is the case in many countries with a similar level of development, the problem appears to be more pronounced in Moldova, mainly due to a general lack of understanding of the relevance and benefit of having solid financial management and business planning in place.

31. **The information asymmetries described above could be overcome through triangular relationships between companies and larger suppliers, buyers, producers, and/or banks, but these are not well developed in Moldova.** Asymmetric information, as well as the high transaction costs of banks’ identification of new creditworthy borrowers could be overcome by using innovative value chain financing products. In many countries, innovative lending techniques are being developed based on strategic alliances between larger suppliers/buyers and small enterprises, or through working capital based on warehouse receipts. In Moldova, however, value chain financing is not yet developed. Relationships between value chain actors tend to be weak and uncoordinated. There are only a few larger buyers/suppliers on the market, and those are reportedly not eager to collaborate with financial entities in this respect, or they prefer providing their own funding sources to their strategic partners.

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19 The legal framework foresees that public interest entities, as well as joint stock companies with over 50 employees, have their financial statements audited. However, most medium- to large enterprises are registered as limited liability companies and according to the legal framework, do not have to present audited financial statements. Thus, as a result, only 22 percent of the 2,700 medium- and large enterprises are required to have their financial statements audited. For a more in-depth assessment of the auditing and accounting situation in Moldova, see the forthcoming ROSC.

20 Including international financial institutions, business planning consultant firms, and banks.

21 World Bank 2012 (shadow economy report)
32. **Deficiencies in internal financial management and financial literacy also lower the investment planning capacity of enterprises, which results in unviable loan applications.** Based on information received from financial institutions that were visited for the purpose of this assessment, rejection rates for business loans ranges between two to four out of five applications in rural areas, compared to around one out of five applications in urban areas. The investment projects presented are frequently not sufficiently elaborated or deemed unprofitable. Some loan applications, mostly in urban areas, are also rejected because the business has already reached its repayment capacity as calculated by the bank. Stakeholders from the private and financial sector reported that investment plans are frequently developed without a broader long-term vision for the enterprise or a solid assessment of the viability, risk, or expected cash flow of the investment. This partly reflects a general tendency for companies to “live in the short-term”\(^{22}\) without having a long-term strategy, as well as political and economic vulnerabilities. It also reflects low financial management capacities. Working capital and investment needs are often articulated based on a one-time opportunity, and are not yet well-thought through. Companies prepare business plans as part of loan applications, but reportedly often do not consider using the exercise to improve the internal planning, strategic orientation, or efficiency of their enterprises. Even larger enterprises reportedly lack business plans and solid internal financial management practices that would enable them to supply the required information in sufficient quality, or enable them to assess liquidity and investment needs with sufficient anticipation. This leads to inefficiencies in investment decisions and translates into lower profitability of enterprises.

33. **Gaps in financial management and investment planning capacity can also increase lending costs.** As careful planning and mapping of the cash flow is usually absent (see paragraph 32), enterprises can end up with larger loan sizes than they need, or face costly surprises when repayments of principal are due. A number of stakeholders reported that companies struggle to keep up with payments after a grace period, as they had forgotten about these upcoming payments, and had already spent the funds elsewhere. The banks then charge late fees, usually a premium of a few percentage points on top of the interest rate. In other situations, when not all funds from the credit are needed, or the credit could be repaid earlier, enterprises shoulder an additional 1-2 percent in fees for early repayments. Furthermore, during interviews, it was mentioned that donor-supported credit lines may be taken because firms want to benefit from the grant element or the grace periods, not because the underlying expense is truly needed or foreseen as a part of the business strategy. All these factors increase the *de facto* costs of a loan, and contribute to companies’ general perception that loans are not affordable.

34. **Deficiencies in the availability and quality of information needed for loan applications are factors that contribute to the banks’ elevated collateral requirements** and

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\(^{22}\) A number of stakeholders reiterated that there is a general tendency in the population and in enterprises to not plan ahead for longer than a year. For instance, this is apparent when it comes to remittances, of which limited amounts are channeled into formal savings to plan ahead for retirement, or a general reluctance of enterprises to develop a long-term business or market strategy.
continued reliance on relationship banking methodologies. As shown in the figure below, collateral requirements as reported by the World Bank Group Doing Business methodology tend to be higher than other countries in the region. This report finds that these demand-side deficiencies are a major driver of relatively high collateral requirements.

Figure 6: Value of Collateral Needed for a Loan (% of the Loan Amount)


Integration into Value Chains and Quality of Products

35. Production techniques in many enterprises are deficient, and Moldovan firms are not well-integrated into value chains. A World Bank and two recent USAID studies on value chains in Moldova suggest that agricultural production in Moldova continues to suffer from low quality and efficiency due to the absence of vertical collaboration between farmers, as well as insufficient investment in post-harvest infrastructures. As a result, high-value buyers often encounter difficulties finding the needed quantity and consistent quality of produce on the market. Produce is predominantly sold directly from small farmers to small wholesalers, who, in turn, sell the products at a low price on the local or Russian truck markets, or for juice making/canning, with very low margins. Moldovan entrepreneurs appear to have a limited understanding of the benefits of collaboration with strategic partners, and they tend to have little interest in collaborating in with peers, who are seen as competitors and not as potential partners. The lack of collaboration prevents them from reaching sufficient scale, and the limited usage of

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23 Relationship banking refers to the relationship that a bank and a client have developed based on a number of financial transactions that the client has already carried out with the bank. The client thus already has a “history” with the bank, and the bank provides a range of services to the client based on this history.

24 A value chain describes the full range of value-added activities that are required to bring a product to market, and includes, among other things, the strength of established business linkages between local and global players along this production chain. Examples of strong relationships along value chains include a supplier that regularly provides seeds and other inputs to the farmer, or a micro-enterprise that delivers custom parts to a limited set of buyers.
enhanced production techniques lowers their profitability, turning producers into price takers. Similar issues are also raised by businesses in other sectors and industries. The main underlying concern here is thus not the cost of loans, but the firm’s low profitability due to low product quality, inefficient production techniques, and the position of the smallest player on a competitive market. In addition, FDI inflows after the crisis have remained below the levels of FDI reached in other countries in the region (see Figure 5). This reduces the potential for knowledge transfer and capacity building in the country that FDI usually brings with it, thus yielding a negative effect on efficiency gains in production and profitability in the medium term.

C. Supply-side Constraints in Banks and Non-Bank Financial Institutions

36. There are also constraints on the supply side that impede enterprises’ access to finance. Competition remains limited, and the market segmented. Banks continue to rely on relationship lending methodologies, and largely cater to medium-sized and larger enterprises, while MFIs and SCAs focus on micro-and small enterprises in rural and peri-urban areas. Firms’ perceptions that interest rates are high can partly be explained by banks’ elevated funding costs. These costs can in turn be attributed to the early stage of development of the local capital market, lack of institutional investors, and the short-term bias of both individuals and businesses. These underlying barriers are discussed in more detail in the following paragraphs.

Competition in the Financial Sector

37. Competition in the financial sector is limited. Standard concentration ratios for volume of assets, deposits, and credit range between 50 and 70 percent for the largest three and five banks in the system, which – together with a Herfindahl-Hirschman Index of between 1,200 and 1,350 for three variables – suggests that Moldova has a moderately competitive system. However, considering the borrowers and depositors in the banking system, the largest three and five banks account for 75 and 90 percent of borrowers and depositors, respectively. Out of the 14 banks operating in Moldova, only five have more than 3,000 borrowers, while the rest caters to a limited number of borrowers and has larger exposures to a few select clients.

38. Large differences in average loan and deposit sizes indicate that the market is segmented, and that not all 14 banks are competing across the market. The average loan size is around USD19,000. However, this varies from USD 4,000 for banks with a larger borrower base and a retail focus, to up to USD 142,000 for banks with a small borrower base. A similar pattern emerges in deposits, where some banks have less than 10,000 depositors and larger average deposit amounts. This indicates that different banks have different business strategies, and serve different client segments, which limits competition amongst them.

39. There are some signs that increased foreign ownership has helped create more competition within the banking system. According to data from the NBM, 39 percent of the assets are now formally majority-owned by foreign banks, and another 43 percent are partially foreign-owned. Not all of these banks are truly foreign-owned, however, as much of the
“foreign” capital participates through off-shore entities, and these entities are assumed to be indirectly owned by local players. The entry of Procredit Bank in 2007 (a German/Dutch micro- and SME-focused financial entity), take-overs of local banks by Italian Gruppo Veneto Banca and the French Société Générale (in 2007), and the opening of Austrian Erste Bank’s BCR branch (in 2006), have helped to increase competition. Procredit, Erste Banca, and Société Générale have also been credited with bringing more focus to small and medium-sized enterprises and retail lending, and fostering the development of these market segments. These three banks together currently account for 12 percent of banking assets in Moldova and already have a share of well over 40 percent in terms of the number of borrowers.

40. **Reforms to improve risk management and increase transparency have likely also helped foster competition.** After a number of raider attacks in 2011, as well as two bank failures due to over-exposure to a few clients, reforms were undertaken by the NBM and the government to make ownership structures in banks more transparent, and reduce exposure limits in financial institutions (see Section 4.2). Not all of the reforms have been fully implemented, but they provided some initial incentives that increased competition in the market, as banks needed to diversify and enhance their internal risk management capacities. There is also some indication that lending to larger, well-known clients has reached a point of saturation, with competition for those clients being fierce. Finally, a credit bureau is now operational (see paragraph 66). All of these elements can serve to encourage banks to look more seriously into expanding their lending to smaller clients, and develop new skillsets internally to expand their retail and SME business. However, these developments are still in their infancy, as will be discussed in paragraph 59.

41. **As banks begin to look to move down-market, they are facing competition from the SCAs and MFIs:**

- There are 361 SCAs, which operate mostly in rural areas and currently have 35,000 borrowers. Sixty-eight of the SCAs are authorized to take deposits, and now have close to 6,000 depositors. The SCAs provide mostly small, short-term loans to their members. Average loan sizes are below USD 800. SCAs are an important source for working capital loans for rural smallholders; 70 percent of their loans go to the agricultural sector. Being formally supervised by the National Commission of Financial Markets (NCFM), the SCAs have seen some consolidation in recent years. They are mostly dependent on external funds from national financial entities and international donors.

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25 Amendments to the Law on Financial Institutions aimed at enhancing ownership transparency have been passed recently, but so far, the information on final ownership remains limited.

26 Erste Bank purchased the Romanian BCR Bank in 2006, making BCR Moldova part of the Erste Group.

27 In 2011, a number of raider attacks shook Moldova. Victoria Bank, the second largest bank in the country, had 5 percent of its shares alienated. Significant shareholdings in two other banks, the public Banca de Economii and the private Universal Bank, were transferred to off-shore companies. An attempt to transfer shares of some prominent EU shareholders in the Moldova Agroind Bank, the largest bank in the system, was eventually averted. A number of insurance companies were also affected. As all were approved via court rulings, the recent amendments to the Law on Financial Institutions mandated that changes in ownership have to be initially approved by the NBM, and can no longer be carried out via court rulings alone.

28 In 2009, Investprivatbank failed; in 2011, Universalbank failed. Most recently, the NBM had to intervene with on-site supervision in the majority state-owned Banca de Economii. All three banks had high NPLs due to exposure to a few large loans and connected clients, and an opaque ownership structure.
- There are also now 73 licensed MFIs, up from only eight in 2005. They are for-profit organizations, and focus on commercial and consumer lending in peri-urban and rural areas. They currently cater to 44,000 clients, up from 23,000 in 2009. The loan maturities are short- to medium-term, and the average loan size is USD 2,700. Some of the larger entities, like the Rural Finance Corporation and Microinvest, are also lending larger amounts and longer maturities to their clients, which brings them more closely into competition with SME lending by Procredit and Moldova AgroindBank. MFIs are not authorized to take deposits, and are thus not subject to prudential oversight, but they have to regularly report their financial situation for monitoring purposes to the NCFM. Based on available data on 31 of the MFIs, the largest 10 entities account for 93 percent of the market. The remaining entities are very small, and not all of them might be fully operational.

Financial Intermediation Activity and Profitability

42. Likely as a result of the limited competition described above, broad differences exist between individual banks in terms of financial intermediation activity, as well as credit evaluation and risk management capacities. Figure 7 suggests that banks have a strong preference for maintaining liquidity. This is mostly due to the uncertain macro outlook and the recent history of banking sector instability. The banking system’s share of lending to assets fluctuated around 60 percent of assets from 2005 to the beginning of 2012, with the remaining assets being held as liquid assets (see paragraph 44). Around 90 percent of bank deposits are transformed into loans, but there are substantial deviations between the banks. Some banks, mostly the smaller ones, channel only 50 percent of the deposits into loans, and report non-performing loans of over 20 percent. On the other hand, the three of the four foreign banks mentioned above, as well as two of the larger domestic banks, have loan-to-deposit ratios of 1 and above, and show non-performing loans lower than 7 percent. Although these differences partly stem from different market strategies, they also reflect differences in credit evaluation and risk management capacities, as well as connected lending and large exposures to individual companies. Provisioning levels are generally low, with provisions over loans currently standing at 50 percent for the banking sector.29 An undisclosed amount of loans is restructured.30 The data also suggests that banks are conservative with regard to term transformation. The ratio of assets with a maturity of over two years to term liabilities has remained low over the years, and currently stands at 68 percent (the relevant prudential regulation requires a ratio of below 100 percent).31

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29 However, it should be mentioned that the loans are highly collateralized, which is not factored into the calculation of the provisioning, and that the calculation of the capital adequacy ratio is based on a corrected capital figure, which takes into account the required provisioning.

30 Some of the banks visited for the purpose of this study indicated that up to 15 percent of their loans were probably restructured at one point.

31 Please see Footnote 49 on the calculation of the two-year term requirement.
Efficiency indicators vary considerably between banks, with some of the niche banks showing room for efficiency increases. Based on data provided by the NBM, a few banks with a concentrated client basis have an average of two loans per employee. This is low, and contributes to the high operational expenses of up to 11 percent of assets. On the other hand, the larger banks and the four banks with “true” foreign ownerships have efficiency indicators more in line with international standards.

Moldovan banks have been comparatively profitable until 2008, despite their high levels of liquidity and low leverage. Their return on assets (ROA) stood at over three percent in 2006-2008, reflecting manageable NPLs, high on-lending interest rates, as well as elevated interest rates on holdings of government bonds and minimum reserves (see Figure 8). This has translated into a high average return on equity (ROE), which remained at around 20 percent despite average capital to asset and capital adequacy ratios of 17.5 and 29.7 percent, respectively. Both ROA and ROE are high compared to international benchmarks (see Figure 9). Since 2009, however, overall profitability has fallen. The heightened economic volatility along with considerable exposures to connected parties and politically-motivated lending has translated into
non-performing loan ratios of up to 20 percent in 2008-2009. Furthermore, spreads on government bonds and interest on minimum reserves has come down, reducing another important source of income. This has led to a drop in average ROA and ROE, which are now at approximately 1.9 and 11 percent, respectively.\(^{32}\) The reduced profitability is an incentive for banks to expand into new market segments, and improve their risk management, which would spur competition.

**Figure 8: A Comparison of Yields**
(Deposits versus Liquid Assets)

![Graph showing yields comparison](source: NBM)

**Figure 9: Profitability, ROE and ROA - International Comparisons**

![Graph showing profitability comparison](source: World Bank)

45. **Indicators in the microfinance and SCA sector have evolved in a similar fashion, but their level of financial intermediation is generally stronger.** MFIs and SCAs mostly rely on retained earnings, as well as funding from donors, financial institutions and institutional investors, which has been volatile in the last few years. They have higher levels of financial intermediation than banks, with 77 percent (MFIs) and 85 percent (SCAs) of their respective

\(^{32}\) This data excludes the majority state-owned Banca de Economii.
assets invested in loans. MFIs and SCAs play an important role for small and micro-enterprises in peri-urban and rural areas, which otherwise would not be able to obtain loans. Their non-performing loans display a pattern of development in line with that of the banking sector, reaching double-digit numbers between 2009 and 2012. Based on available data, this has led to losses in the SCA sector in 2009 and 2010, and revisions in SCAs’ credit evaluation and management practices. Non-performing loans have since decreased again to five percent for both SCAs and MFIs, well below the 14 percent observed in the banking system.

Sources of Funding

46. A recurrent problem in the banking sector is the shortage of long-term funds for on-lending. Secured debt only accounts for a minuscule fraction of the banks’ liabilities and does not yet serve as a source of long-term funds. As in most banking systems in developing countries, deposits constitute the majority of bank liabilities, accounting for 82 percent of total liabilities (down from over 91 percent in 2005). In order to be able to satisfy some of the demand for longer-term credit, banks presently offer interest rates of about 7-10 percent for term deposits of over six months. Figure 10 shows that the average interest rates offered for term deposits have fluctuated in recent years, reflecting changes in demand and supply for term financing. For example, they were very high in 2007 and 2008, when demand for credit and lending increased rapidly, and they have fallen in recent years due to investment activities of enterprises and a degree of risk aversion in banks. Depositors seem to be responsive to higher interest rates and have in the past shifted their deposits into term deposits. However, the average maturity of the deposits is still only around one year.

Figure 10: Evolution of Deposit Interest Rates and Share of Demand Deposits

![Graph showing evolution of deposit interest rates and share of demand deposits](source)

Source: NBM

33 It should be noted that the MFIs did not report losses, but as their financial statements are not audited, and they are not formally supervised, the quality of this information has to be questioned, given non-performing loans of up to 22 percent.
47. Several underlying issues limit the availability of long-term liabilities in banks. Most importantly, the institutional investor base in the country remains small, as the insurance sector is limited, and no private pension funds exist. The capital market remains tiny, so banks do not place bonds on the national market to raise long-term funds. The narrow institutional investor base also limits the availability of long-term bank deposits. As for term deposits from individuals, the core issue is the lack of trust in financial institutions, gaps in financial literacy, and the prevalent “short-term living” culture (see earlier discussion of this concept). Many people still keep their savings at home, and the general population generally does not accumulate savings for retirement or as a cushion for larger expenditures. Furthermore, over the last two decades, the population has seen a number of banks fail – two in the last four years alone – and it has lost a share of savings due to the low coverage limit of approximately USD 500, provided by the deposit guarantee fund. This is not sufficient to cover the elevated minimum balances of USD 2,000 and more required by some banks for savings accounts, or to help build trust that would encourage the population to bring savings and received remittances into the financial system.

48. Hence, own capital and donor funds continue to be the main source of long-term funding. There is no official data available to allow for a differentiation between the remaining sources of funding, but banks repeatedly stated during interviews that they depend on their own capital and donor funds to satisfy the demand for long-term credit of over three years, as opposed to bond placements or other more sophisticated products. For example, donor lines of credit administered by the government represent around 6 percent of the current loan portfolio of most banks, and 15 percent of the credit portfolio with maturities of over three years. Furthermore, individual banks have direct loans from the EBRD, IFC, the Black Sea Trade and Development Bank, and other bilateral donors, which provide an important source of long-term funds for on-lending. These funds are usually provided in foreign currency; thus, banks continue to depend on their own capital and deposits for local currency loans. Banks’ capital, donor credit lines, and other non-deposit-based liabilities currently cover 134 percent of long-term lending of (over three years), and cover 56 percent of the credits with a maturity of over one year.

Figure 11: Loans by Maturity

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34 In 2009, Investprivatbank failed, and in 2011, Universalbank went through liquidation procedures.
35 The NBM does not differentiate between liabilities to foreign and domestic financial institutions, but instead only uses the debt securities issued, and other financial liabilities.
36 Based on the initial maturities of the remaining credit balance.
49. The elevated deposit interest rates for term funds increase the costs of financial intermediation, particularly for loans in local currency. Loans with a maturity of over one year currently carry an average interest rate of 12.8 percent (MDL) and 7.63 percent (foreign currency), while interest paid on term deposits is 8.6 percent (MDL) and 4.79 percent (FX). This translates into a spread of three to four percent to cover costs and risks. No bonds are placed on the domestic capital market, but given the interest paid on government bonds in the last few years, this would likely also come at an elevated cost (see Figure 8 for a comparison of yields).

50. Donor lines of credit, whether directly provided to individual institutions or as on-lending via the government, are available at much cheaper rates, which has the potential to distort the market. The Credit Line Directorate, for example, reported that its funds are on-lent with an average interest rate of Libor plus 1.3 percentage points (equivalent to around two percent), and that banks are requested to add a margin of no more than four percent (in line with the market spread), which results in average interest rates that are two percentage points below the current market rates. The availability of these resources has not only helped provide term funding to clients, but also helped them benefit from below market interest rates. The latter was frequently cited as a core gain by LOC beneficiaries. Experience in countries like Bolivia show that subsidizing interest rates can distort borrowers’ expectations, and slow financial markets’ outreach to new clients in the medium to longer term.

51. The growth of the microfinance and SCA sector depends on external funding sources and retained earnings, both of which have dried up in the wake of 2009. There is limited information on the ownership structure of the MFIs, but anecdotal evidence indicates that regulated financial entities and private sector enterprises are amongst the shareholders and/or funders of smaller MFIs, while international donors play an important role in funding the larger MFIs. Donor funds channeled through one large MFI and loans from a few banks represent the core external funding source for SCAs. Funding for MFIs and SCAs has dried up since 2008, limiting the sector’s lending capacity. Only those SCAs that based on their size and solid
financial standing are authorized to take deposits, have found a more stable funding resource: member deposits have increased by over 60 percent since 2009, and now account for 41 percent of liabilities, compared to 24 percent of liabilities prior to 2008. This is a positive development, and should be encouraged to help the SCA sector to become truly member based. The net losses incurred by the sector during 2009/10 eliminated the possibility of compensating for the lack of external funds with retained earnings, and led to a drop of 25 percent in the capital base of SCAs. The assets in the microfinance sector dropped by a third after 2008.

Available Financial Products

52. **Companies’ funding needs vary throughout their life-cycle.** A well-functioning financial system provides a variety of financial products that can meet companies’ needs at different stages of their development. This includes start-up capital and risk-sharing tools for nascent enterprises; working and investment capital loans, trade financing, leasing and factoring services for a variety of operations; and eventually private equity funds and the use of capital markets for mature enterprises. As will be shown in the following paragraphs, not all of these types of funding are available in Moldova.  

53. **As in most countries at a similar stage of development, enterprises rely predominately on banks and microfinance institutions for external funds.** Although comprehensive information on companies’ sources of funding does not exist, information can be gathered from various places. The Credit Bureau currently has information on about 7,000 enterprises, and the 80,000 borrowers from microfinance institutions are largely micro- and small enterprises. There is no information available that would help determine to what extent the remaining formal and informal enterprises voluntarily abstain from getting a loan, or to what extent they do not borrow because they do not need external funds. Interviews conducted for this study did not point to any resentment of entrepreneurs towards financial institutions, although one owner of a family business stated he had never tried to get, nor wanted, a bank loan because it was too risky. During other interviews, it was suggested that some businessmen might have a preference for relying only on retained earnings and remittances in order to avoid paperwork, or making information transparent to third parties.

54. **Financial institutions’ preferences regarding the characteristics of enterprises they lend to are likely making it difficult for newer companies to get financing.** Most banks prefer lending to enterprises that have been in operation for two or more years, have reached a certain size, and have already established a relationship with the financial institution. This reliance on clients with an established relationship with a financial institution is common in many countries at a similar stage of development.

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37 It should be noted that start-up capital, risk-sharing tools, as well as the availability of capital markets to finance mature enterprises are frequently underdeveloped even in “well-functioning financial systems”.

38 Even banking institutions with an initial strong focus on micro- and small enterprise financing now prefer catering to enterprises with 3-4 years of operation. Their experience suggests that newer micro- and small enterprises quickly disappear, or change their business focus, which makes recovery of loans more cumbersome, and thus increases the risk of lending.
55. **While banks do offer multiple lending products to the enterprise sector, transparency in pricing is limited.** Most of the larger banks offer lines of credit, loans for working and investment capital, factoring, guarantees, and letters of credit. Many also provide a range of payment frequencies, such as weekly, monthly, and annual repayments, and grace periods. For most of these products, information on documentation requirements, available amounts, and eligibility requirements are accessible on the internet. However, not all banks include information on the range of interest rates or the commissions charged for the respective products. Banks tend to charge 2-3 percent of the credit amount upfront for administrative and processing costs, apply annual fees, and charge 1-2 percent for credit renewals. In case of late payments, hefty additional percentage points are added to the interest rate, and in the case of early repayment 1-2 percentage points are charged on outstanding credit balances. As there is no effective annual percentage rate published by banks or the Central Bank on a regular basis, and uniform “loan fact sheets” are not used across financial institutions, it is difficult to compare the interest rates charged by banks. This makes shopping for cheaper credit more cumbersome for companies.

56. **Trade financing and leasing exist in Moldova, but their role in enterprise financing is difficult to determine due to insufficient data.** As discussed in section 2.2, business linkages and value chains are not well-developed. This naturally limits the role that trade financing and factoring can play in funding smaller enterprises. Although both products exist, there is no data available that would help determine the importance of this financing source for enterprises. There are a number of leasing companies registered in the system, but they are not required to report any financial or market information to NCFM, and they are not formally supervised. Many of the leasing companies are affiliated with national or international banks, which can potentially benefit from the lack of supervision and prudential oversight to spin their leasing activities off into separate entities. Efforts are currently underway to bring the leasing companies into oversight, and level the playing field among the financial institutions, protect consumers, and eliminate opportunities for regulatory arbitrage.

57. **As for other sources of financing, the capital market in Moldova is not well-developed.** Based on a recent World Bank study on capital market development, the capital market remains illiquid, with only 12 companies formally listed and traded on the Moldova Stock Exchange (MSE), and corporate bonds not yet being issued. The local stock market is generally only used to purchase controlling stakes in local companies, or to consolidate the shareholdings of strategic investors. The platform of the MSE is outdated, and does not satisfy transparency and security requirements. Furthermore, deficiencies in the requirements to be listed reduce institutional investors’ trust in the MSE. These investors still prefer depositing their funds in banks over investing them on the exchange.

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39 One financial entity indicated that it levies 0.1 percent daily on the overdue credit tranche, another reported adding 3-5 percent to the overall interest rate.
40 One bank lists nine pages full of commission charges for lending, deposit, and transaction fees for enterprises.
41 World Bank 2012
42 The World Bank report points out that there are no requirements for a free float, the use of standard accounting principles, the number of prior years with audited financial accounts, the distribution of dividends in prior years, or ongoing reporting.
58. **Larger companies still favor bank loans over tapping into the capital market.** To place stocks or bonds, most companies would have to improve their accounting standards and disclosure practices to instill a more confidence in the data presented. Furthermore, no benchmark interest rates are available to help determine the price of a bond, as only government securities with a maturity of below two years are issued on the domestic market, and no formal secondary trading is taking place to establish this benchmark.\(^{43}\) Until recently, seeking external funding on the capital market also did not seem very attractive compared to the alternatives. The actual interest rates on short-term government securities fluctuated between 11-13 percent in 2011, while average bank lending rates stood at 13 percent.\(^{44}\) Factoring in the costs for complying with the requirements for issuing a bond, bank credit provided a less complicated alternative. Finally, the World Bank study also highlights that dividends received from stocks are subject to taxation, while interest received on deposits is not. Taken together, it is understandable that even larger companies prefer using bank credit as their main source of financing, instead of graduating to financing via the capital market. With the exception of 2008 and 2009, when banks curtailed their lending due to the increased economic volatility, bank funding to these core clients was sufficiently available to satisfy the needs of these larger enterprises. If these larger enterprises begin to harness capital markets in the future, this could help open up the market, freeing bank resources and increasing competition for bank lending to smaller and medium-sized enterprises.\(^{45}\)

59. **The vast majority of companies in Moldova is too small to tap into the capital market, and would rather need private equity, venture capital, or other risk-sharing options to support their growth in the initial years.** Some equity fund options are available in the system, but stakeholders report that entrepreneurs at times prefer bank loans to equity investments, as are unwilling to cede controlling equity stakes in their companies, and often have had negative experience with joint ventures and collaborating with business partners in earlier years. Some other initiatives have been launched by the government and donors; however, these are mostly limited to matching grants for the development and implementation of innovative business plans and concessional loans or grants for SMEs to fund eligible individual investments.\(^{46}\) These programs do not offer the equity financing options or management support that seed or venture capital would.

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\(^{43}\) Banks and the Central Bank are only allowed to purchase bonds on the primary market, and mostly hold the bonds to maturity, or directly sell the bonds to institutional investors at a price determined by the banks themselves.

\(^{44}\) The interest rate on government bonds dropped to around 5 percent in 2012, while bank lending interest rates to commercial entities only came down to 11 percent. If this differential is to prevail, it could become an important incentive for larger enterprises to seek capital market funds.

\(^{45}\) According to the IFC (2010), some countries have tried to stimulate the listing of SMEs on their stock exchanges, but most of these attempts have been unsuccessful. This has worked only in higher income countries with a much larger market size, such as India. It is highly questionable whether this would work in Moldova, as the country does not yet have a culture of transparency in reporting and financial management, making it extremely difficult to find SMEs that would be able to instill the needed trust from investors.

\(^{46}\) A number of these options are listed on www.businessportal.md. Examples include: PARE 1+1 program for remittances invested in businesses (government matches remittances invested up to MDL 200,000), and the PNAET youth empowerment
Credit Evaluation and Risk Management in Banks

60. Lending methodologies in most banks are not sufficiently refined to overcome information asymmetries of smaller and informal enterprises in a cost-effective way. While most banks have separate units for retail and commercial clients, their SME lending is done either as part of the commercial loan unit, or as a part of the retail unit. Only a small number of banks use differentiated lending methodologies for smaller enterprises that reduce the burden of documentation, and few banks use standard and cost-effective evaluation methodologies. The majority of lending decisions are taken at headquarters, as branch officers frequently lack sufficient experience. Financial institutions verify the collateral, assets, and cash flow on-site, but require a preliminary balance sheet as well as business and investment plans from the enterprises. Many enterprises do not have these readily available, so this represents an extra step in order to apply for a loan, and increases the costs and the administrative burden of loan applications. The credit evaluation and decision-making process can take a few weeks, depending on the availability of supporting documents.

61. Collateral requirements and procedures continue to be a core determinant of lending. As in many countries, new borrowers are usually only eligible for a loan if they have sizeable collateral over the loan value to pledge. For existing clients, the collateral usually determines the maximum loan size that they can afford. Although available statistics suggest that banks accept a wide range of collateral, stakeholders (including companies and government officials) interviewed for this study stated that banks typically require real estate as collateral, and that the collateral is not accepted, or the value of the real estate can be significantly discounted (especially if it is not located in the capital, Chisinau).

62. The business and cash flow assessment capacity in many banks reportedly remains low. The loan officers frequently overestimate the loan amount that a client can afford, and the cash flow that they can generate to service the debt on time. Furthermore, potential market and price risks have not been properly assessed in the past, as highlighted by an example from the wine sector, where the strong dependence on the Russian market was not factored in. All three factors were mentioned in the context of non-performing loans, which eventually ended up being restructured.

63. In the absence of qualifying for bank loans, many small enterprises seek funding from microfinance institutions, which limits them to smaller credit amounts and shorter maturities. The value of collateral needed in relation to the loan is reportedly lower in MFIs than in banks. MFIs accept a variety of collateral, such as real estate, equipment/machinery, vehicles, and personal guarantees. For SCAs, collateral requirements are negligible, as lending is conducted within a narrow community, and social pressure can be relied upon as the core enforcement mechanism. MFIs and SCAs also have a faster turnaround of credit decisions, which in many instances only take a few days. Interest rates charged in the large microfinance program, which provides credit for business start-ups (amount of up to MDL 300,000, of which 40% can be a grant; the interest rate on the credit for the remainder is 7-8%).
institutions are reportedly only 2-6 percentage points higher than in banks, but there is some indication that smaller MFIs charge much higher interest rates, and also apply hidden fees.
IV. **Assessment of the Regulatory Framework and Financial Infrastructure**

64. The G20 SME finance sub-group recently reiterated the importance of establishing an adequate legal and regulatory framework for financial systems, and improving financial infrastructure. Its report, prepared by the IFC in 2010, highlighted that deficiencies in the financial infrastructure and regulatory framework of a country significantly affect access to financial services for smaller enterprises, and can lead to their exclusion from the financial system. Reforms in those two areas were thus flagged as key priorities for reform facilitating SME financing. This chapter assesses the results of on-going reforms, and pinpoints remaining bottlenecks.

**A. Availability of Financial Infrastructure**

65. In the last few years, the government introduced a number of reforms to enhance the financial infrastructure in the country. Substantial progress was made in upgrading the legal and regulatory framework for the financial infrastructure, and in putting some of the hardware and software in place. Moving ahead, focus has now to be placed on actual enforcement of the framework and quality control.

**Credit Reporting Infrastructure**

66. A privately-owned Credit Bureau became operational in 2011. The Credit Bureau is licensed and supervised by the NCFM, and currently includes information from banks and two leasing companies. Reporting is voluntary, and requires prior consent of the borrower. To foster the use of the bureau, NBM has put in place differentiated provisioning rules of 2 percent for borrowers that are already covered by the Credit Bureau and have a clean record, and 30 percent for those on whom no information is available from the Credit Bureau or other contractual obligations, or for those who did not give consent to have their information reported to the Credit Bureau. The vast majority of individual clients have already given consent, but not all enterprises have done so, either because their loans were approved prior to the launch of the Credit Bureau, or due to performance and indebtedness concerns. A legal amendment to mandate reporting of all commercial loans to the Credit Bureau is currently under discussion. This would help increase the reliability of information on legal entities.

67. The existence of the Credit Bureau has already helped establish a credit history for most borrowers, which should particularly benefit micro- and small companies seeking credit. The bureau currently stores data on 130,000 borrowers and 250,000 loans, compared to 131,000 active borrowers and 148,000 active loans in the banking system at the end of 2012. An estimated 7000 loans are with enterprises\(^\text{47}\); the rest is with individuals (likely also some micro-enterprises). Despite its short existence, the data provided by the Credit Bureau is very

\(^{47}\) In relation to the roughly 48,000 enterprises presenting their financial statements to the NBS, this equates to 15 percent of those firms.
comprehensive, and the hit ratio\(^48\) stood at 72 percent in the last quarter of 2012. This is a significant achievement, given the limited time frame. The Credit Bureau has already helped clients establish a credit history, and made the actual level of bank debt transparent. The information is stored for seven years, and borrowers have a right to verify the data.\(^49\) The Doing Business Credit Information index now assigns 4 out of 6 points to Moldova.

68. **To foster outreach to unbanked clients, in particular micro- and small enterprises, it would be beneficial to incorporate credit information from additional sources.** Especially, information on loans from leasing companies and microfinance institutions should be included. These financial institutions lend to banked as well as unbanked companies, so this data would provide a better picture of the overall debt level of clients that are already banked, and could help foster creditor competition for smaller enterprises. The Credit Bureau is already in talks with microfinance and leasing institutions to add their data, but achieving full coverage will likely also require a revision of the legal and regulatory framework to set sufficient incentives for reporting. Additionally, to facilitate lending to new clients without a credit history, positive and negative information from utilities and telecommunications should be included, which is not possible at the moment, as according to its legal framework only information from bank and non-bank financial institutions can be used by the Credit Bureau. In the long run, it would be beneficial to develop scoring models and market research services, as the database captures a longer credit history for clients.

**Creditor Rights and Secured Transactions**

69. **As mentioned before, collateral requirements are relatively high** Depending, among other factors, on the type of company and the established track record, banks request collateral of up to 200 percent of the loan amount for lending. The relatively high collateral requirements are mostly the result of the unstable economic environment, unreliable financial information, and deficiencies in creditor rights and the insolvency regime. Many banks reported that, for instance, enterprises close or change their line of business when things are not going well, or that the owner emigrates to another country. Problems of this nature were particularly pronounced in 2008 and 2009, and made loan enforcement practically impossible. This led to a substantial tightening of the collateral requirements, to ascertain that the borrower had sufficient incentives not to walk away from loan repayment.

70. **The legal framework allows for the use of a broad range of collateral.** Most forms of collateral can be used as a pledge, but leasing, inventory, and accounts receivables cannot yet be registered as collateral, which can prevent smaller enterprises in particular from accessing working capital. As can be seen in Table 3, banks are using the full range of collateral to secure a loan, which lowers the impact of the high collateral requirements on an enterprises’ eligibility to borrow.

\(^{48}\) Number of information requests for which data could be provided.

\(^{49}\) However, it has not been done very frequently. Most borrowers are probably not aware of this option, and the information is only accessible at the Credit Bureau office itself, which inflicts travel costs, and raises time concerns for borrowers.
### Table 3: Collateral Used to Secure Loans in the Banking System, December 2012

<table>
<thead>
<tr>
<th>Collateral Type</th>
<th>Share (based on underlying loan value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial properties</td>
<td>40.2%</td>
</tr>
<tr>
<td>Other collateral</td>
<td>16.4%</td>
</tr>
<tr>
<td>Residential properties</td>
<td>14.9%</td>
</tr>
<tr>
<td>Equipment and machinery</td>
<td>9.8%</td>
</tr>
<tr>
<td>Livestock, agriculture, food</td>
<td>5.5%</td>
</tr>
<tr>
<td>Unsecured</td>
<td>4.4%</td>
</tr>
<tr>
<td>Bank deposits</td>
<td>3.6%</td>
</tr>
<tr>
<td>Investment securities</td>
<td>2.9%</td>
</tr>
<tr>
<td>Personal vehicles</td>
<td>1.6%</td>
</tr>
<tr>
<td>Personal items, including jewelry</td>
<td>0.4%</td>
</tr>
<tr>
<td>State securities</td>
<td>0.1%</td>
</tr>
<tr>
<td>Government guarantee</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

*Source: NBM*

71. **While infrastructure for the registration of both movable and immovable assets is in place, the overall process remains time-consuming for the borrower.** The 2010 World Bank assessment of secured transactions highlights weaknesses in the legal framework, as well as several outstanding issues pertaining to the IT infrastructure of the registries, the ability to submit documentation electronically, and the direct access to the databases. In general, the information in the registries is reliable, and stakeholders only mentioned a few issues with the lack of clarity over owners and disputes between previous and current owners. The process of registering collateral is comparatively efficient, with the Doing Business indicators showing that registering only takes five days and costs 0.9 percent of the value of the collateral, compared to 25-30 days and 2.7 and 4.5 percent of the collateral cost for OECD countries and countries in the region, respectively, but stakeholders and banks still commented on the processes and costs. For example, the client has to personally register movable collateral, and then leave the original receipt with a notary. Immovable securities need to be notarized, with some notaries requesting proof of insurance, and requiring the client to arrange and pay for an evaluation of the collateral’s value by a third party. The latter not only comes at a high cost for the borrower, but banks also complain that the estimated value of the collateral is frequently inflated. So overall, the borrower has to pay for collateral registration, evaluation of assets, and notarization, which makes loans less affordable and less attractive for smaller enterprises in particular.

72. **The repossession and sale of collateral has so far been problematic.** The 2010 World Bank study on secured transactions mentions a number of procedural issues that complicate the repossession process, in particular the need to get a court judgment to be able to repossess the collateral. This has reportedly now changed for loans secured by real estate, and a further clause can be added to the secured transaction agreements, stipulating that the real estate collateral can be repossessed upon the borrower’s default. This has the potential to significantly ease the
process, but has yet to be tested in practice. Another core problem is related to the sale of the collateral. Once collateral is repossessed, banks are required to sell the repossessed item within twelve months. This has been difficult so far, as no true market for repossessed collateral exists\footnote{For example, Moldova lacks an active market for repossessed agricultural land. Banks are consequently reluctant to use rural farm land as collateral.}, particularly for immovable collateral, so such a sale has been close to impossible. Many banks thus abstain from repossessing collateral, and instead focus on addressing any repayment problems early on, and restructuring the loan. The requirement to sell at market value was reportedly recently dropped. This should ease the process burden.

73. **A new insolvency law approved in 2012 should simplify the cumbersome bankruptcy procedures, and improve creditor rights.** Moldova performs poorly with regard to insolvency procedures, ranking 91\textsuperscript{st} out of 185 countries on the Doing Business indicator in 2013. In particular, the amount of time needed for an insolvency proceeding – 2.8 years compared to 2.4 and 1.7 for the ECA region and OECD – is high, and the recovery rate is only 32 percent of the underlying value, which compares unfavorably to the ECA and OECD averages of 37 and 71 percent, respectively. The 2012 insolvency law addresses some of these issues. The new law introduces new options for the creditor to initiate insolvency proceedings\footnote{Creditors can now mandate the undertaking of a cash flow test to open insolvency procedures by showing that the client has an unpaid claim, or did not pay despite notification of the overdue payment, and they can attach a court confirmation to uphold the validity of the claim.}, and also introduces a number of new options for simplified or expedited restructuring and liquidating procedures. It also allows for out-of-court settlements, but does not provide any additional guidance on acceptable forms and procedures. Thus, there is notable room for interpretation by the judiciary, and court decisions are required along the way, which also potentially creates opportunities for discretion in the actual implementation. As the law only came into power in March 2013, its implementation has not yet been tested.

**Auditing and Accounting**

74. **Efforts are underway to improve the accounting framework in the country, which – if fully implemented – should help improve the quality of available financial statements.** The 2008 accounting law sets out the framework for preparing and submitting financial accounts. It specifies three levels of accounting (in function of company size), and provides a chart of accounts. The authorities recently revamped the accounting standards, introducing IFRS for so-called public interest entities (including banks)\footnote{50 companies come under the definition of “public interest entity”.}, and are in the process of developing new national accounting standards that will replace the current ones in 2014. The law has also established a national oversight system, which, however, remains weak. The IT platform of the public registry, which is managed within the NBS, faces some capacity constraints. This limits public availability of the information. In general, however, these reforms move in the right direction, and should be continued. If they are fully enforced, they should enhance the quality of available information considerably in the medium term. Successful implementation will also require considerable effort to train accountants, and raise entrepreneurs’ awareness of the benefits of solid financial management.
75. **As for auditing, a number of reforms were undertaken to enhance the legal framework, establish quality standards, and create an oversight structure; hence, the focus will now have to be on enforcing compliance.** A new auditing law came into effect in 2008. It created an Audit Oversight Council, and introduced a Code of Ethics for professional accountants. The requirements for certification and professional development of auditors were also strengthened. Yet, the forthcoming assessment of the auditing and accounting standards in Moldova, undertaken by the World Bank, suggests that the quality of audits remains uneven, the oversight mechanism weak and dispersed between a number of entities, and the technical capacity of auditors varied. As a result, national audits do not inspire much trust. International audits are more expensive, thus they are only an option for larger companies. Given the above, more effort has to be channeled into implementing the legal framework.

B. **The Regulatory Framework**

76. **The financial system is supervised by two independent regulatory and supervisory agencies.** NBM regulates and supervises the 14 banks currently in the system. Oversight of the non-bank financial institutions lies with the National Commission for Financial Markets (NCFM), which was created in 2007 through a merger of various non-bank supervisory agencies. It has the mandate to oversee savings and credit associations (SCAs), microfinance institutions (MFIs), pension and investment funds, securities and insurance entities, mortgage vehicles, and the Credit Bureau. Leasing institutions are not yet formally monitored. Both the NBM and the NCFM are legally independent bodies with separate budgets, reporting directly to the parliament.

77. **The authorities have undertaken a number of legal and regulatory reforms to strengthen the resilience of the banking sector.** Exposure limits have been tightened\(^5\), but the actual enforcement of lending to related parties is still difficult due to the general lack of information on ownership in the country. Further amendments to the Law on Financial Institutions, approved by parliament in April 2013, are expected to increase shareholder transparency and facilitate disclosure of the ultimate beneficiary owners. The capital adequacy ratio was increased from 12 to 16 percent, and is to reach 20 percent in mid-2014. Minimum capital requirements were also increased, and risk management regulations were tightened to strengthen the resilience of banks to external shocks, and the generally volatile economic context. The NBM also increased its liquidity requirements,\(^5\) and excluded term deposits with maturity of over two years from the minimum reserve of 14 percent (up from 10 percent in 2005). The latter is particularly relevant, given the limited availability of term deposits in the system, and will facilitate term transformation. Finally, further improvements were made with regard to consumer protection, where requirements and templates for price information on loans and deposits were specified. Yet, additional work needs to be done in this area to further

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\(^5\) 5 percent of total regulatory capital for individual large exposures, five times the regulatory capital for all large exposures combined, and no more than 30 percent of the loan portfolio for the ten largest borrowers.

\(^5\) The banking system has to adhere to two liquidity measures: (i) the ratio of liquid assets to total assets has to be at or over 20 percent, and (ii) long term assets with a maturity of over two years should form no more than the equivalent of all liabilities with a maturity of over two years, plus a determined percentage of short-term liabilities.
facilitate comparisons across the different financial institutions, in particular the calculation of annual percentage rates, which include the non-interest rate related costs of a loan.

78. However, these regulatory issues do not seem to have posed binding constraints on bank lending in Moldova in recent years. Banks have voluntarily kept higher liquidity and capital adequacy ratios than required since 2005. This is likely due to the high returns received on government bonds, perceived lack of lending opportunities, and the economic crisis starting in 2008.

79. Substantial progress has also been made in developing an oversight framework for SCAs. In 2007, a comprehensive legal and regulatory framework for SCAs was approved. It makes NCFM the sole institution responsible for approving and withdrawing SCAs’ licenses, initiating corrective actions, and setting prudential and non-prudential regulations. Minimum corporate governance structures, as well as the scope of activities, were determined. Larger SCAs are now mandated to have their accounts audited, and can be authorized to take deposits (in which case the SCA must contribute to a stabilization fund to protect the deposits). The activities and responsibilities of central associations are defined by the new law. NCFM has already taken a number of measures against insolvent institutions, including the suspension of licenses and the suspension/cancellation of deposit-taking activities. In doing so, it has helped the sector consolidate from 485 entities in 2006 to the current 361. Nevertheless, the implementation of the regulatory framework remains a challenge due to the large number of SCAs in the system, and the NCFM’s constrained financial and human resources. This is a common problem in the oversight of member-based institutions worldwide. To overcome it, sector-specific support structures, such as joint accounting functions via central associations or sound external audit capacity, will need to be fostered. This would facilitate the regulator’s task of creating a cost-efficient set of SCA internal incentives to adhere to prudent financial management, while at the same time helping create economies of scale within the sector, and encouraging its further consolidation and competitiveness.

80. In contrast to the framework for SCAs, the legal framework for MFIs is rudimentary, and there are no provisions for oversight or monitoring of leasing entities. The law on MFIs, approved in 2004, mandates MFIs to be licensed as limited liability companies, and defines the activities that they are allowed to pursue. No formal prudential regulations are foreseen, but the law stipulates that MFIs should create the necessary provisions to adhere to the guiding principles of financial sustainability, transparency, and loyal competition. The supervisory agency has a monitoring function, which it can execute jointly or via delegation to a central association of the sector. However, in the absence of actual enforcement power, monitoring of the sector is a daunting task. A complete set of financial information is for example currently available for only 31 of the 70 MFIs. Leasing companies are not monitored or supervised, so information on them is scarce. NCFM has already initiated

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55 The current regulations set minimum capital to asset requirements, liquidity ratios, large exposure limits, and rules for connected lending
56 The SCA division within the NCFM, for example, has 11-member staff for the supervision of the 361 SCAs currently in the system.
reforms in this respect. A draft law on supervision of MFIs that sets minimum capital adequacy ratios and exposure limits for MFIs, and strengthens regulations pertaining to governance, transparency and consumer protection, has been elaborated. Furthermore, some draft laws and regulations were formulated for leasing entities with the aim of bringing the sector into the system of oversight. Both reforms are still pending parliamentary approval, but would be urgently needed to help the sector grow in a sound manner. Once approved, substantial effort will be required to actually implement and enforce them.

81. **The standing legal and regulatory framework for banks and non-bank financial institutions does not create a level playing field.** Some differences, which cannot be justified by the different risk profiles and funding sources, exist with regard to prudential regulations.\(^57\) For example, SCAs have tighter provisioning standards for their loans than banks, and there are no regulations in place for MFIs or leasing entities (see Table 4). This creates different costs of lending in the respective institutions, and can lead to regulatory arbitrage through cross-holdings or provision of funding for on-lending. Thus, when implementing the microfinance and leasing frameworks, it would be advisable to pay more attention to improving the regulatory level playing field between the financial intermediaries, and also to facilitating the upward movement of financial institutions via transformation into banks, provided that there is compliance with the stringent prudential regulations applicable to banks. Finally, possible cross-holdings and inter-linkages between the different types of financial entities have to be transparent, so that potential spill-over effects and ensuing vulnerabilities are understood. Strong collaboration between the two supervisory entities is required in this respect.

<table>
<thead>
<tr>
<th></th>
<th>Banks</th>
<th>SCAs</th>
<th>MFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Provision (%) of remaining balance</td>
<td>Definition</td>
<td>Provision (%) of remaining balance</td>
</tr>
<tr>
<td>Standard</td>
<td>2</td>
<td>&lt; 30 days late</td>
<td>1</td>
</tr>
<tr>
<td>Supervised</td>
<td>5</td>
<td>&lt; 90 days late</td>
<td>10</td>
</tr>
<tr>
<td>Substandard</td>
<td>30</td>
<td>&lt; 180 days late</td>
<td>30</td>
</tr>
<tr>
<td>Doubtful</td>
<td>60</td>
<td>&lt; 360 days late</td>
<td>75</td>
</tr>
<tr>
<td>Loss</td>
<td>100</td>
<td>over 360 days late</td>
<td>100</td>
</tr>
</tbody>
</table>

*Source: Own compilation based on legal and regulatory frameworks.*

82. **Greater collaboration and more specific rules would also be helpful in the area of consumer protection for financial services.** Clients of both banks and MFIs, whether

\(^57\) SCAs have to keep 10 percent of their assets in the form of liquid assets, while the equivalent for banks is 20 percent. Leverage ratios for SCAs are supposed to reach 6 percent after six years, while banks have to adhere to a CAR of 20 percent starting July 2014.
individuals or legal entities, complain about lack of transparency in services, fees and contract information, and deficiencies in support and knowledge-building provided to customers. The current regulations foresee that banks have to post information on interest rates and fees on their websites, and have it “available” in their branches. While this is a substantial improvement, there is no requirement for banks to calculate the effective annual percentage rate to facilitate the comparison of true costs, i.e. interest rates plus commissions. Few enterprises and individuals know how to distill the relevant information from a bank’s website, or ask for information at a branch. Similar requirements are missing for non-bank financial institutions. As the latter are an important source of funding for smaller enterprises, it is important to put these requirements in place to allow for upfront comparison of loan conditions, and reduce the incidence of hidden fees. Furthermore, neither the supervisory agencies, nor the sector, have a formal and visible consumer protection complaint mechanism that would help customers voice their complaints, resolve disputes, and provide ongoing feedback on actual practices.
V. Ongoing Reforms and Recommendations for Moving Forward

83. To mitigate some of the obstacles related to enterprise access to finance, the government – with the support of international donors – has already implemented a number of support programs and reforms over the past few years. As discussed throughout the report, these have helped address some of the underlying core issues, and have contributed to an increase in the depth of the financial system (as discussed in Chapter 1). This following section will first highlight a few of these reforms (without aiming to provide a full list), and then present recommendations for future reforms.

A. Ongoing Efforts

84. A variety of technical assistance and business development support has been provided to improve the competitiveness of individual enterprises. The focus has mostly been on providing business and investment planning services as part of targeted technical assistance or in tandem with access to a line of credit, and on fostering innovation. For instance, the PARE 1+1 project seeks to mobilize the human and financial resources of emigrants by providing a one-to-one matching grant for productive investment of remittance resources. Business platforms, incubator programs, innovation competitions, and the like, have also been put in place, and there has been some effort to foster value chain development, and create sustainable strategic alliances. Enterprises and financial institutions have found the business development services to be helpful in facilitating access to credit. However, the programs have not yet reached the scale and visibility that would be needed to bring about the needed change in management practices in the enterprise sector itself. This has partly been due to the “parachuting in” nature of some of the services provided, which did not aim to build internal capacity or deepen the understanding of the value that business development services add to enterprise owners and managers. Furthermore, the available services were spread across various stakeholders and participants, which reduced access to information on available assistance. Overall, the supply of high-quality business development services continues to depend on donor funds, and is not yet sustainable on its own.

85. To overcome the reported shortage of credit to the private sector, the government and donors have implemented 14 Lines of Credit projects since 1996, with a total funding envelope of approximately USD 340 million (including revolving instruments). The funds were on-lent through financial institutions to qualifying borrowers in targeted sectors of the economy. Some donors have also offered technical assistance to enhance credit evaluation and management capacity in banks. The bulk of the LOCs financed agricultural projects, and another large share of LOCs was dedicated to investment and working capital for SMEs. The majority of the funds were on-lent for maturities of between three and five years, but a large share also went into longer maturities. Thus, the LOCs played an important role in facilitating the provision of longer maturities. The LOCs also reportedly helped introduce some new clients, who benefitted

58 For example, see the webpage www.businessportal.md, launched with the aid of Norwegian and EU funds. It provides an overview of existing support structures, business opportunities, and government and donor programs.
from business support services aimed at enhancing their business management capabilities, to the financial system. Overall, roughly 7,000 loans were approved under the government-administered LOCs, which – with an average loan size of around USD 50,000 – mostly supported small and medium-sized enterprises.

86. **However, the dispersed nature of the various programs and types of assistance has made them less effective than they could be.** It remains unclear to what extent small enterprises are aware of the various programs and tools, or their eligibility criteria. For instance, a risk guarantee fund was set up in 2007 under ODIMM\(^{59}\) to facilitate smaller enterprises’ access to bank loans, given that these enterprises usually do not have sufficient collateral to pledge. However, so far, the use of the ODIMM facility has been limited, as no direct marketing to target beneficiaries has been undertaken. Banks did not actively promote the facility, and procedural problems made its use less attractive.\(^{60}\)

87. **Finally, as discussed in chapter 3 in more depth, substantial progress has been – and continues to be – made in enhancing the legal and regulatory framework for the financial sector, and in establishing the necessary financial infrastructure.** Some of this progress was made with donor assistance – for instance, through the Financial Sector Reform Program funded by the Government of the Netherlands, and administered through the World Bank. The World Bank is also currently helping the authorities draft legal amendments to the Pledge Law that would address weaknesses in the legal framework for moveable collateral. It is expected that these amendments and follow-on work to implement them well would substantially improve the companies’ ability to use moveable assets as collateral.

**B. Reform Recommendations**

88. The reform recommendations focus on addressing the underlying market barriers and failures as discussed in this report. This approach seeks to provide sustainable solutions that support long-term improvements in enterprise access to finance, and strives to avoid subsidies and other potentially market-distorting interventions that would not have this long-term impact.

89. **Moving ahead, it will be important to improve coordination and collaboration between the various reform efforts.** Moldova lacks a national coordination body that could monitor the reform process, centralize information on the various programs, identify gaps, and strive to fill those gaps. As discussed above, the on-going reform initiatives to directly support targeted enterprises are mostly small-scale and dispersed among numerous implementing

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\(^{59}\) ODIMM is a small government agency that administers a number of government and donor programs fostering SME development in Moldova.

\(^{60}\) So far, only 80 enterprises have used the risk guarantee scheme. Banks are generally reluctant to use the scheme, as they first have to exploit all other recovery options before they can be reimbursed by the guarantee scheme. This has made it unattractive for them. Furthermore, the premium is not a part of the interest rate or loan package that the beneficiary receives from the bank, but is instead claimed by ODIMM separately. This increases the cost and administrative burden for ODIMM. Not all the borrowers understand the importance of paying the premium. Finally, MFIs are not yet eligible for submitting loans for risk-sharing.
agencies and stakeholders, which makes it difficult for targeted beneficiaries to get an overview of the available support instruments and their benefits. Moreover, the efforts are not well-coordinated and targeted, which leads to inefficiencies and sub-optimal outreach. Given the persistent gaps in data, it is difficult to assess the true scope of the problem of excluded enterprises, and thus target the reform measures, and assess their effectiveness and efficiency. Finally, more emphasis should be placed on making the reforms and available programs self-sustainable in the medium and long term, and eliminate programs like the Lines of Credits, that only aim to serve as a temporary fix of a market deficiency or failure.

90. Following the “guiding principles” of coordination and collaboration, below we present a number of reforms that would help lower the costs of loans, improve borrower eligibility, and enhance competition in the financial system. The reform recommendations generally pertain to five core areas:

- Support for enhancing the profitability and formality of enterprises, and for fostering business linkages. Particular emphasis has to be placed on developing sound financial management and planning capacities.

- Support for the development of alternative long-term funding sources, including the capital market and institutional investors, as well as innovative lending products.

- Legal and regulatory reforms to bring leasing companies and MFIs into the system of oversight, improve consumer protection, and increase transparency; and fine-tune regulations to reduce connected lending, and adjust the regulatory balance between stability and developmental aspects.

- Further upgrade the existing financial infrastructure in the country via enhancing the coverage of the Credit Bureau; improving the availability, affordability and quality of accountants and auditors; and supporting actual implementation of the legal framework for collateral and creditor rights.

- Create a comprehensive consumer protection framework that would include all financial institutions, and promote financial education to foster a culture of savings, increase market transparency, and widen the pool of available financial information.

1. Recommendations to Enhance Targeting, Coordination, and Sustainability of Reforms

91. A baseline survey should be designed and implemented to deepen the understanding of the current situation in enterprise funding, and identify remaining gaps. The survey should ideally differentiate between the various types and sizes of enterprises, and inquire about:

- Actual use of financial services (volume and frequency of general payments, transactions with clients, savings and credit, etc.), and length of affiliation with the financial entity;
- Available sources of funding and the relative importance of each over time;
- Experience with applying for loans, and differentiating between working capital and investment capital;
- Feedback on loan conditions and required timelines;
92. **To maximize the efficiency and effectiveness of the reforms, a national body should be given responsibility for monitoring efforts to enhance enterprise access to financial services.** This could be a unit at the level of the Deputy Prime Minister that is responsible for economic issues (a position which is also currently shared with the position of Minister of Economy), or another level that is able to effectively foster collaboration between different entities in government. The unit should use an existing structure. This body should work with both public and private sector stakeholders (including donors), and be responsible for:

- Assessing data gaps, and coordinating / initiating data collection;
- Bringing the various stakeholders and donors together to coordinate and consolidate the ongoing reform efforts into larger and well-communicated initiatives;
- Monitoring reform results, and revising reforms as needed;
- Identifying gaps, and bringing stakeholders (including donors and the private sector) together to fill them.

93. The government should also consider: i) in the longer term, establishing sun-set clauses for programs that are only deemed as temporary bridges for overcoming the barriers that have been identified, in particular donor-supported lines of credit, and ii) measures to improve the sustainability of the remaining programs over time. Some suggestions along these lines are provided in the recommendations below.

2. Recommendations to Enhance the Profitability of Enterprises

94. **More coordinated and holistic efforts to foster business linkages and financial management and business planning skills should be launched.** This could include the creation of business development centers and/or enhancement of existing centers, possibly on a regional level, which would provide access to services such as business and investment planning, and financial management training; help foster collaboration and strategic alliances between businesses; link enterprises to available donor and government programs; enhance market transparency and availability of information on latest research; and facilitate information on available financial services. Some steps to centralize information on business development support programs have already been made. For instance, [www.businessportal.md](http://www.businessportal.md) provides information on companies active in certain areas, and highlights available government programs. The OECD is currently finalizing a review of the supply of and demand for business development services in Moldova. Furthermore, particular attention needs to be paid to the direct involvement of enterprises in the business and investment planning process – as opposed to outsourcing the whole process to service providers – in order to build capacity for this type of work within the enterprise, and help business owners and managers appreciate its value.

95. **There are also several cross-cutting activities and services that the government should engage in or provide to enterprises, in order to foster increased competitiveness.** These include:
a. **Promoting increased foreign direct investment (FDI):** FDI has been shown to help increase management practices and quality standards in enterprises, through knowledge sharing and the introduction of good practices into local value chains. Moldova currently has two entities that have been tasked with attracting FDI; this structure should be streamlined when the political will exists to do so. In addition to attracting new FDI, focus should also be placed on fostering linkages between foreign investors and national businesses.

b. **Providing information on business opportunities with foreign partners:** Market information is a critical input into companies’ business planning processes. Information on trends, opportunities, and requirements for entering priority markets for priority products is beneficial to producers of those products. Information on companies in foreign markets seeking to establish partnerships with producers elsewhere is also very valuable. One core function of successful export promotion agencies is to make sector-specific market studies, assessments, and information on potential partnerships available to enterprises in priority sectors. This function should be taken up and expanded by the Moldovan Investment and Export Promotion Organization (MIEPO), or another appropriate entity that the government designates. It should start with a strategic identification of priority products and priority markets for those products, based on Moldova’s comparative and competitive advantages. This can be conducted in conjunction with the sector-specific value chain analyses that are planned under the Regulatory Reform Strategy Action Plan.

c. **Improving the technical skills of the labor force:** As mentioned in the introductory chapter of the accompanying report on “Policy Priorities for Private Sector Development”, the availability of workers with appropriate technical skills is a major concern for foreign investors and national companies. The 2011 Country Economic Memorandum produced by the World Bank also examines this issue. It identifies several important weaknesses, including, “in secondary vocational schools learning outcomes are adversely affected by obsolete skills and ineffective teaching methods of many teachers; outdated curricula (typically leftover from the Soviet period); lack of involvement of social partners in curriculum development; and lack of modern equipment, manuals, and teaching materials.” Addressing the skills mismatch will help attract FDI, help domestic companies grow, and lead to more employment opportunities in Moldova.

96. **To remove overarching constraints that are reducing investment returns, more attention must also be paid to improving the business environment across the board.** The most pressing areas for reform are highlighted in the report on the “Policy Priorities for Private Sector Development”, which this study supports. These areas are: customs administration; tax administration; business regulation, which includes licensing, authorizations, and inspections;

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61 World Bank 2011, p. 72
and the framework for competition, which includes market entry, competition policy, and state aid. The work on tax administration should also focus on encouraging firms to become formalized (as opposed to remaining in the “shadow economy”). These efforts should draw on the e-government platform wherever possible, to increase transparency and predictability of rules, as well as the methods used to apply them. Finally, justice sector reform is an important component underlying the improvements in the business environment and access to finance, as described in the “policy priorities” report.

97. **Finally, the government has an important direct role to play in aiding the development of small enterprises, by transparently enhancing SMEs’ access to government contracts.** Success in this area has been achieved in Panama, for instance, through an e-government platform (see Box 2). This example and other experiences show that the government can both reduce its own expenditures, and create important business opportunities that would help the SME sector grow, through improvements in public procurement. In order for such a platform to work, clear bidding procedures, as well as product specifications and quality standards, will be required.

**Box 1: E-government Reform in Panama**

In 2006, the government of Panama, with the World Bank’s support, developed the e-government platform PanamaCompra, which increased transparency in government procurement, facilitated the bidding procedures, and helped decrease the costs of procurement through enhanced competition. The platform is currently used by 137 public and semi-public agencies and entities as a sole source of information on upcoming purchases and tenders, and 15,000 companies are now affiliated with it to receive updated information, and bid on contracts. Since its launch in December 2006, close to 700,000 contracts valued at approximately USD 35 billion were made publicly available through PanamaCompra.

*Source: Annual Report (2011-12) of the Dirección General de Contrataciones Públicas de Panama.*

3. **Recommendations to Improve the Availability of Term Funding and Innovative Products**

98. **As a longer-term objective, the access of banks and larger enterprises to a regional or local capital market should be fostered.** This would help banks access term funding, help larger enterprises graduate from their dependence on bank credit, and free some of the available lending envelope of banks for lending to smaller companies. World Bank reports produced in 2010 and 2012 already highlighted a sequenced reform agenda for the development of the capital market, suggesting measures to: (i) develop the government bond market, (ii) continue to enhance the legal and regulatory framework, (iii) foster equity and bond financing options for the private sector, (iv) develop the institutional investor base to create demand, (v) revise taxation to create a level playing field, and (vi) improve financial literacy among possible institutional and private investors. In terms of fostering access to external funding sources, three reform areas are of particular importance:

- **The government should issue bonds of longer maturities.** This would help the development of the market of long term finance by developing a full yield curve as market reference.
- **The share of government bonds held by non-bank institutional and private investors should be increased.** This would reduce the crowding out of lending by government bonds, help establish a benchmark interest rate on the secondary market, and make the launch of bonds from banks and private enterprises easier over time. Financial education campaigns would have to be launched in parallel to increase trust, and foster private sector demand for these types of investment vehicles.

- **To help make launching bonds on regional / national capital markets attractive, options for reducing the costs of these instruments should be explored.** Furthermore, requirements for launching bonds on regional capital markets could be communicated to larger enterprises that currently lack the knowledge on raising capital in ways other than via bank credit. Moldovan banks should also consider issuing medium to long term corporate bonds, on the local or regional capital markets.

- **Reforms would have to be implemented to instill public trust in these instruments and create demand.** Such reforms should focus on auditing and accounting, corporate governance and transparency.

99. Furthermore, as a part of the efforts to increase the availability of long-term funds for intermediation, it would be beneficial to foster a culture of long-term savings in the general population:

- **As a first measure, the amount guaranteed by the deposit insurance fund should be increased.** In 1994, the European Union established deposit insurance coverage of EUR 20,000, recently increased to EUR 100,000 in some member states. These coverage levels likely too high for Moldova, given the lower average savings capacity of the population and affordability considerations for banks and the government. Hence, an assessment should be done to determine an adequate coverage level. In addition to the coverage level, the capacity and functioning of the deposit guarantee fund more broadly should also be assessed and enhanced. Finally, the increased deposit guarantee coverage should go hand in hand with a public information campaign that raises awareness of the existence of the fund and the protection offered by it, and that also provides information on what to look for when opening an account.

- **Reforms of the pension system, in particular the establishment of a private pillar, should be pursued.** This is already a reform area foreseen in the government’s Moldova 2020 strategy, and efforts are underway to create an enhanced legal and regulatory framework. Crucially, the establishment of private pension funds would also support the above-mentioned recommendation to broaden the investor base for government bonds.

- **Consideration could also be given to developing innovative, long-term savings schemes.** The population appears intrigued by “free” goods, or special sales. Attractive options to the current interest rate-based solutions could include lottery schemes in combination with long-term savings products or savings plans, in which the bank or the government would pay the monthly quota in the final year. Further efforts could be channeled into transforming a greater share of remittances into savings, by, for example, targeting expatriates with remittance-financed retirement options protected by
international insurers. These efforts should go hand in hand with financial education campaigns to spread knowledge about these products, and deepen the understanding of the importance of creating long-term savings.

100. **In the short term, donor resources are likely to continue to play an important role in providing funding for longer-term bank lending.** However, over time, as the recommendations above are successfully implemented, this dependence should be eased out. The following recommendations could help prepare for, and ease, the transition process:

- **Careful assessments of available and needed funds should be undertaken.** The Credit Line Directorate already has data on the current amount of donor and revolving funds available, but it should to further refine its projection of the funds that will be available over time, and conduct a scenario analysis to determine different options for phasing out the dependence on donor funds over time.

- **Based on these assessments, donor funds could be used in incentive schemes that aim to improve the longer-term outlook for access to finance.** For instance, donor/line of credit funds could be linked to efforts to issue bonds or raise funds through long-term savings schemes. Similarly, the development and use of new and innovative lending techniques, the inclusion of new clients, and the share of target beneficiaries “banked” from own funding sources could be designated as output-based performance indicators for receiving these resources.

- **Overall, the costs of funds from a line of credit should be fully in line with market interest rates for term deposits,** in order to not distort the incentives for financial institutions to seek term funding in the market.

4. **Recommendations to Strengthen the Financial Infrastructure in Moldova and Overcome Information Asymmetries**

101. **Given the noted deficiencies in Moldovan enterprises’ financial management, continuing auditing and accounting reforms, in particular their implementation / compliance, should be a priority.** The forthcoming 2013 Auditing and Accounting ROSC of the World Bank suggests that the legal and regulatory framework should be fine-tuned to fully adapt to European standards, and to reduce the cost of compliance for smaller entities by allowing for a simplified scheme that would cater to them. It also concludes that the GoM will have to focus on ensuring compliance with the new framework, which requires strengthening of the public registry and the Audit Oversight Council, implementing measures to enhance the capacity and technical knowledge of auditors and accountants, and doing quality control. These reforms should be undertaken in tandem with the above-mentioned initiatives aimed at fostering financial management in enterprises on the demand side.

102. **To facilitate access of hitherto unbanked enterprises to finance, and to spur competition for clients among financial institutions,** further efforts could be undertaken to increase the coverage of the Credit Bureau:
- Mandate the reporting of credit of legal persons to the Credit Bureau to further enhance the coverage and reliability of the database;

- Incorporate data from MFIs, SCAs, and leasing companies to offer a holistic picture of the level of debt among individuals and enterprises, and to help more enterprises establish a credit history. It is warranted to strive to keep the costs for individual credit reports low so that the service is attractive for MFIs and SCAs, and to allow for meaningful representation of MFIs and SCAs in the ownership structure of the Credit Bureau to get their buy-in.

- Add positive and negative information from utilities and telecommunications companies to provide information on enterprises and individuals who are not yet borrowers at any of the financial entities.

103. **To foster the use of secured transactions, a number of reforms could be undertaken.**

A number of other recommendations to foster creditor rights were made in the 2010 World Bank report, some of which have already been implemented. The World Bank is currently working with NBM on legal amendments and other efforts to eliminate the remaining bottlenecks. Moving ahead, consideration could be given to:

- Eliminating the requirement that external evaluators have to assess the value of immovable collateral, and instead leave the decision on the use of external evaluators to the borrowers and the banks. This could help reduce costs and the time needed for registering collateral.

- Gather experience with the implementation of the simplified process for repossessing and selling collateral, assess persisting bottlenecks, and provide guidance to balance consumer protection with creditor rights.

- The same applies for out-of-court settlements, where further guidance on acceptable forms and procedures might have to be developed to facilitate actual use.

- Implement the recommended amendments to the Pledge Law, to improve the legal framework for secured transactions. Analyze, and appropriately amend, other laws that are affected by these changes – including the Civil Code and others.

104. **To help integrate new and small enterprises into the “banked” population, an assessment of the risk guarantee facility should be made, and options for improvement should be considered.**

It is advisable to conduct an in-depth assessment of the risk guarantee facility’s current business model, pricing, processes, and available guarantee envelope, to determine if they are adequate. Particular attention would again have to be placed on making sure that it works according to market principles, and becomes fully financial self-sustainable over time, in order to reduce its dependence on subsidies and prevent distortions in the market. Recommendations should be made to improve/streamline its operations, and put it on sound footing in the long term, or to pursue a different pathway, if reform of the existing structure does not bring about the required improvements. If the government maintains the guarantee facility in some form, in addition to improvements in its operations, its availability should also be marketed more widely among enterprises.
5. Recommendations to Enhance the Regulatory Framework for Financial Institutions and Promote a Level Playing Field

105. To eliminate room for arbitrage, and create an adequate framework for growth of the various financial players, it will be important to enhance the regulation of microfinance institutions and leasing entities. As these institutions are not taking deposits, prudential oversight can be kept at a minimum, but regulations are needed in the following areas: information and transparency requirements, in particular ownership and price transparency; corporate governance, financial management, and reporting; and credit evaluations standards and risk management. Efforts are already underway to introduce such a framework, but have not yet been approved by the parliament. Attention should be paid to creating a level playing field between the various financial players, striking a balance between adequate oversight, and bearable burden of information requirements and compliance aspects for smaller entities in particular.

106. Once the legal framework for leasing and microfinance institutions is approved, emphasis will need to be placed on the capacity of the supervisory agency to enforce the regulatory framework, and to provide the newly-supervised entities with the necessary guidance to understand, implement, and comply with the requirements in the initial phase. Furthermore, close coordination with ongoing reforms in the area of auditing and accounting is advised. The availability of qualified external auditors that provide affordable and well-targeted assessments of a financial entity’s financial situation, and the quality of accounting in these entities, are both crucial for efficient and cost-effective supervision of such a large number of small entities.

107. To facilitate the transformation of microfinance institutions that wish to convert into deposit-taking banks in the long term, it is important to design a development path for them. Examples from Latin America show that the transition from NGOs to MFIs and eventually full-fledged banks can help stimulate competition for lending to smaller enterprises. In the Moldovan context, at the minimum, coordination between the regulatory and oversight bodies (NBM and NCFM) would have to be increased, in order to help reduce the cost of upward transformation.

108. Finally, over time, it would be good to analyze the relevant regulations in the banking sector in greater depth to allow for further financial deepening and competition, while maintaining financial stability. The banking regulations on exposure limits could likely be tightened in the short term to foster competition, reduce vulnerabilities in the system, and facilitate consolidated supervision.\(^\text{62}\) This would increase the banks’ incentive to reach out to new clients, while at the same time it could reduce the unsustainably large exposures and ensuing

\(^{62}\) Despite the progress made, difficulties remain with ascertaining the “true” owners of banks and selected enterprises in Moldova. This makes the determination of related parties more difficult. It is a problem that has in the past led to bank failures or vulnerabilities, and hindered consolidated supervision of connected groups. The latter pertains not only to the ownership structure of banks per se, but also to their participation and involvement in unregulated leasing companies, MFIs and other financial intermediaries.
vulnerabilities. It could also be used as an incentive to make ownership information more transparent. In the short term, the following should be implemented:

- The amendments to the Law on Financial Institutions enacted in April 2013, that aim to increase shareholder transparency\(^{63}\) should be fully enforced.

- Further legal amendments to enhance ownership/shareholder transparency and facilitate disclosure of the ultimate beneficiary owners in the financial sector should be developed and enacted. This will help improve competition in the sector and mitigate systemic risks related to the possible high concentration of ownership in multiple financial institutions by related parties.

6. Recommendations to Improve Consumer Protection and Financial Education

109. An assessment of the consumer protection framework should be carried out to identify legal, institutional, and outreach gaps for both banks and non-bank financial institutions. Regulations on price transparency could be further strengthened for banks, and introduced for non-bank financial institutions. Dissemination of the information should be improved to stimulate competition and protect clients. Further reforms should be undertaken to make prices comparable across institutions. Price information should be presented in a uniform format – on one page if possible – and visibly displayed at branches, in newspapers, and on the Central Bank webpage. This would help smaller enterprises, which are not in a position to negotiate their loan conditionality, to compare the true costs of borrowing from different financial institutions. Reforms steps are also required to establish suitable complaint mechanisms and feedback loops that would help supervisors rate current practices. Efficiency gains could be reaped by bringing the various private and public stakeholders together to pool initiatives, and harmonize the legal frameworks. In addition, increasing the maximum deposit amount guaranteed by the Deposit Guarantee Fund is also an important step.

110. Finally, education campaigns will be key throughout the implementation process of the above-mentioned reforms. Developing a common understanding in the population that savings are an important tool for maintaining a minimum living standard during retirement and for cushioning unexpected circumstances should be a priority. Education campaigns should also cover a broader spectrum of investment alternatives in order to avoid creating market distortions; support the development of institutional investors; and provide information on prices, available resources for comparing prices, and “what to look for”. Stronger collaboration and clearer division of labor between private and public sector stakeholders could help provide broader and more accessible financial education in a cost-effective way.

\(^{63}\) The Law on Modification and Supplementing Certain Legislative Acts no. 31, dated 7 March 2013, Monitorul Oficial no. 69-74/223 as of 05.04.2013,
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