PRUDENTIAL REGULATION OF THE BANKING SECTOR IN THE CONTEXT OF ENSURING ECONOMIC SUSTAINABILITY

Ph.D. Lecturer Victoria POSTOLACHE
State University "Alecu Russo" of Bălti, Republic of Moldova
Email: tatiana270206@mail.ru

Abstract: *Regulating banking activity is an integral part of the regulation of financial sector and the economy in general. The banking sector's prudential regulation main objective is to ensure the stability of the banking sector under the circumstances of fulfillment bank's functions and their contribution to the economic growth. The purpose of this article is research and evaluation of current prudential regulation of the banking sector in order to ensure a sustainable economic growth. In this context were analyzed prudential regulation elements and their approach to economic literature. To evaluate the effectiveness of prudential regulation are recommended quantitative and qualitative indicator, which are calculated on the basis of financial stability indicators.*

Keywords: *banking activity, prudential regulation, banking stability, banking performance.*
***JEL Classification**: G21.*

1. Introduction

Research into the current situation and state of banking sector regulation highlights the need to assess prudential regulation to ensure a sustainable growth in the economy. The regulation in the field of prudential supervision was imposed by a necessity in order to ensure a banking system, which, through the capitalization, the quality of the shareholders and the administrators, the ability to cover the risks specific to the banking activity, does not endanger the stability of the financial and banking sector in Moldova. For this purpose, in the development of banking prudential regulations, their alignment with international standards was pursued, based on the principles established by the Basel Committee on Banking Supervision, according to the specificity and the economic and financial framework characteristic of our country.

2. Description of the problem

Prudential banking supervision means regulation that involves a system of limits and restrictions imposed on banks to ensure their stability and to protect the interests of depositors. It is always intended to protect the interests of the system and is therefore of a macroeconomic nature.

Prudential regulation on the one hand represents a complex system of interdependent relationships between different components: the regulator - the National Bank of Moldova (hereinafter NBM) and the licensed banks, and on the other hand it has its own structure with a set of elements to which we can attribute:

- systemic elements (ensuring the financial stability of the banking sector and harmonizing the interests of the banking sector and the needs of the national economy);
- functional-organizational (subject, object and infrastructure regulatory elements);
- regulatory (methods and tools, impact on the state of the banking system);
- resource items (appearing as initial operating conditions for the entry system);
- reactive elements, which provide the results of the operating system, transmitted in the external environment (outputs).

The regulatory model for the banking sector can be represented by two interconnected subsystems: control and management, for each of them can be defined efficiency criteria evaluation, including assessment of infrastructure elements, regulatory methods and tools. In our opinion, the basic criteria for assessing the efficiency of prudential regulations in the banking sector of the Republic of Moldova are: functional efficiency, operational efficiency and social and economic efficiency. Both qualitative and quantitative indicators may be recommended for each of these criteria, the modification of which may be used to assess the effectiveness of prudential regulation.

The normative acts in force on the basis of which the banking system functions effectively ensure the prudential supervision of financial institutions by establishing rules and indicators of banking prudence and monitoring compliance with them and other requirements laid down by law and applicable regulations in order to prevent and limit specific banking activity risks, especially credit risk.

By reviewing legislative acts that directly address to credit risk regulation and bank prudence limits to assess the existence of the national credit risk regulatory framework, we seek to find reasoning that could allow us to implement in the future new financial instruments in order to reduce the losses of the banking sector in general and of the banks in particular.

Table no. 1. Identify the existing regulatory framework for credit risk in the Republic of Moldova

Regulatory scope	Regulatory subjects	Impact mechanism
The Law of Financial Institutions no. 550-XIII of 21.07.95 (republished: Official Gazette of the Republic of Moldova No. 78-81 / 199 of 13.05.2011), art.28	The amount of risk assumed by TRG	a) the maximum indices and positions to be respected by the bank in respect of its assets, risk-weighted assets, off-balance sheet items and different capital and reserves; b) the maximum amount of credits granted and contracted, related to the regulated capital, which a bank is entitled to give to a person or a group of persons in special relations with the bank; c) the maximum amount of loans granted and contracted, based on the total amount of bank loans, to which 10 largest debtors (including groups of persons in special relationship with the bank) can benefit.
Regulation on Classification of Assets and Conditional Engagements "(Official Gazette of the Republic of Moldova No. 216-221 of 09.12.2011)	Credit risk	Formation and maintenance of write-downs / provisions for asset losses / contingent liabilities in the following amounts from the sum of assets / contingent liabilities in each class of classification: 1. Standard - 2%; 2. Supervised - 5%; 3. Substandard - 30%; 4. Doubts (doubtful) - 60%; 5. Compromise (loss) - 100%.
Regulation on Bank Transactions with its Affiliates "(Official Gazette of the Republic of Moldova, 27-28, art.102 of 19.02.2010)	The amount of credit risk possible to the transmission	- the bank's total exposure to an affiliated person and / or a group of persons acting jointly with the person affiliated to the bank must not exceed 10% (ten percent) of the bank's total regulatory capital; - the total amount of the bank's exposures to affiliated persons and / or groups of persons acting jointly with the affiliated persons of the bank shall not exceed the amount of the bank's first-tier capital.
Regulation no. 3/09 on "large" exposures (Official Gazette of the Republic of Moldova No. 70/31 of 14.12.95)	The amount of potential credit risk for transmission	- the bank's net exposure to a person or group of persons acting jointly must not exceed 15% of the total regulatory capital of the bank; - the amount of net debt on loans granted to ten persons, including joint-venture groups, which represent the first net credit amount by size less losses for loan losses, and the provisioning for those conditional commitments shall not exceed 30% of the total portfolio of Bank loans;

		- the sum of all "large" exposures shall not exceed five times the total regulatory capital.

Source: elaborated by the author based on sources listed in the table.

Table no. 1 suggests that banks are fully dependent on the NBM to determine the credit risk assessment method and customer credit analysis. Thus, in order to create an effective credit risk assessment system in the Republic of Moldova it is necessary to:

- review the methods of credit risk assessment imposed by the NBM, reduce the degree of independence of banks in choosing the method of financial analysis of borrowers, assessing the credit risk of consumer loans;

- develop new methods of credit risk assessment for protection vendors, ie those methods that will not require specific information on the debtor's financial situation. The ability of the NBM and of banks to adapt to the current requirements under the conditions of EU integration has played a decisive role in assessing the role and effects of the recent financial crisis and has allowed the avoidance of bankruptcies and other disastrous consequences.

3. Methodology and evaluation

Generally speaking, prudential regulation is one of the important mechanisms by which regulators of the activity within the banking sector contribute to ensuring financial stability, implicitly banking sector. Regulatory activity, in other words, has the role of preventing insolvency risk, as well as ensuring the stability and viability of banks through the adoption of security strategies.

Prudential constraints of prime importance greatly influence the banking strategy and balance sheet management. From a strategic point of view, the most obvious effect of prudential regulation was the creation of a strong constraint on the size of the balance sheet, leading to banks' focus on objectives such as profitability and risk control.

In recent years, banking regulation has become less comprehensive and has been geared to structurally regulating banking activity towards other forms of regulation geared towards the banking sector in essence. Thus, the main normative provisions are related to the aspects mentioned in Figure no. 1.

Figure no. 1. Influence aspects of new prudential regulations

Source: elaborated by the author.

So from a methodological point of view, prudential regulation has always sought to protect the interest of the system and in this respect has a macroeconomic character. The objectives of prudential regulation determine its functions, which ultimately will act as a form of implementation of operational objectives. In this context, taking into account the above, and summarizing the point of view, the following three prudential banking regulatory functions are described in the literature:

- the preventive function, designed to minimize the risk from banking activities;
- a protection function designed to protect the interests of depositors in the event of the liquidation of a particular bank;
- the support function called to provide financial support to certain banks in the event of a crisis provided by the central bank as a lender of last resort.

According to the legislation in force, imposed by the NBM, the system of restrictions on the bank's activity provides:

- restrictions on capital adequacy, the value of which must not be less than 16% [3];
- restrictions on the liquidity limit that includes 2 principles:

a) principle I - the long-term liquidity coefficient ≤ 1;

b) principle II - current liquidity factor ≥ 20% [2];

- restrictions on assumed risk (limitation of credit risk);
- restrictions on involvement in fraudulent operations (money laundering) [3];
- general (fiscal, judicial) restrictions, etc.

Taking into account the performance criteria recommended in the study revealing the actions of the regulator (NBM) and the state of the banking sector both in terms of financial stability and social and economic efficiency, we intend to analyze the effectiveness of prudential regulations based on financial stability indicators According to the data presented in Table 2.

Table no. 2. Evaluation of financial stability indicators

Indicators	The analyzed period				
	2012	2013	2014	2015	2016
Risk-weighted capital adequacy, %	24,4	23,02	13,92	26,16	28,34
Non-performing loans/TRG, %	25,9	16,59	14,26	15,05	19,04
Tier I capital/Risk-weighted assets, %	24,0	22,34	13,41	25,36	27,94
Long-term liquidity, points	0,7	0,71	1,54	0,7	0,62
Current liquidity, %	32,9	33,76	22,48	41,55	50,36
Balance of deposits of individuals/Total deposits, %	64,1	60,41	52,84	69,75	68,48
Non-performing loans/Total credits, %	14,5	11,6	11,73	9,95	16,82
Discounts for loan losses/Total credits, %	10,7	9,7	10,37	8,5	13,54
ROA, %	1,1	1,6	0,9	2,1	2,92
ROE, %	5,6	9,4	6,4	12,78	17,61

Source: elaborated by the author based on: www.bnm.md/md/financial_indices_of_bank_system (visited on 25.02.2017)

According to the data presented in Table no. 2 we can note the following:

- the financial stability indicators calculated on the basis of bank capital decrease during the period 2012-2014 under conditions of banking instability and in response to the delayed world banking crisis in the Republic of Moldova. The situation is changing for the end of 2016 when all indicators are growing;
- the liquidity ratios evolve differently from the previously analyzed indicators because of the existence of rigorous prudential limits in this chapter. Thus, long-term bank

liquidity per banking sector is rising from 0.7 points to 1.54 points in 2012-2014, after which it suddenly drops to 0.7 points due to the "exit" of the billion euro, continuing The trend of decreasing in 2016 to the value of 0.62 points. The current liquidity presents a non-uniform evolution during the period under investigation due to the unstable economic situation and the deficiencies found in 3 banks in the banking system "Banca de Economii" JLC, "Banca Sociala" JLC and "Unibank" JLC. However, for the end of 2016, current liquidity is 50.36%, which is about 2.5 times more than the 20% norm;

- the balance of deposits of individuals relative to total deposits is decreasing in the years 2012-2014 due to the decrease in the population's confidence in the banking sector and low interest rates. For the year 2015, the situation is improving, explaining the rise in the basic interest rate, which has conditioned the increase of the interest on the deposits of individuals;
- the credit risk indicators show an oscillatory trend during the analyzed period due to the changes in the banking sector, but for the year 2016 the situation is more dangerous, as there were considerable increases for both the non-performing loans ratio and the total loans And reductions for loan losses on total loans;
- performance indicators are positive in the 2012-2013 period, indicating a favorable situation in the banking sector, while in the years 2013-2014 we are witnessing a reduction due to the theft. For the years 2014-2016, the situation is improving, with an increase in both indicators being confirmed.

Thus, the results show that the banking sector complies with the prudential rules, with values meeting the limits imposed by the NBM, but there is a possibility to improve the financial stability indicators calculated on the basis of CNT by reducing the risk-weighted assets and the portfolio Of non-performing loans in the banking sector.

In our opinion, the level of financial stability of the banking sector as a target is purely formal, but it is not clear what steps the NBM will take in unpredictable cases. The functional efficiency of the regulations, where part of the financial stability of the banking sector appears, is reached at a macro level with an impact on the level of inflation and the ability of the banking sector to maintain financial stability.

The events at the end of 2015 to close 3 licensed banks invoke the need for a more in-depth study of the effectiveness of micro-prudential regulation by the NBM. Thus, the NBM did not prevent the closure of Banca de Economii JLC but, on the contrary, created favorable conditions for this bank to be closed.

Theft at the end of 2014 and the banking crisis of 2015 point to a pressing need to create the Financial Stability Fund. The funds of this fund are to be formed on account of the contributions of the licensed banks, and in the perspective of the funds of the private pension funds or the CNT account. Such an approach will allow:

- ensuring the protection of taxpayers;
- demonstration of bank solidarity;
- increasing depositors' confidence in the banking sector.

The evaluation of the micro-prudential instruments indicates a permanent development of these instruments in response to the new risks and phenomena that arise in the banking field. The implementation of the BASEL III provisions in the banking sector of the Republic of Moldova will lead to a weakening of the macro-prudential supervision based on the diminution of the prudential indicators observed by the licensed banks. Under these circumstances, small banks may be struggling to attract new customers with a negative impact on performance indicators.

4. Conclusions

The fundamental issues that are in the banking sector concern both the development and the increase of its efficiency, as well as the restructuring and resolution of the identified deficiencies. Thus, all these limits set forth the establishment of restrictions that come to solve the specific problems of the banking sector, the violation of which can affect the activity of the bank and ultimately serves as a threat to the banking sector of the Republic of Moldova.

Acknowledging the particular importance of establishing a robust legal framework can have on the emergence of viability and confidence in the banking system, the banking regulators continue to introduce new rules specific to banking activity in line with international legal provisions. At the same time, the implementation of these rules also seeks to pave the way for convergence in the field of prudential supervision, in order to guarantee a transparent and competitive framework for all internationally active banks. An important criterion for assessing the effectiveness of prudential regulations is the socio-economic criterion, which is quantified through GDP, the volume of credits granted and the investments made. For Moldova, the dynamics of GDP is not a positive one, because economic growth still has ground. A better situation is in terms of loans granted, as there has been a reduction in the interest rate on loans in recent years.

During the last 15-10 years, the NBM has continued and continues to pursue a prudent policy in the field of domestic banking activity, placing a special emphasis on the qualitative side of this process, following the adherence to the international prudential rules specific to the banking sectors In Europe and America, in order to ensure the existence of an efficient sector that can compete not only at the regional level but also at the international level. In order to be more closely aligned with the Community requirements and to address the problems specific to the domestic banking system, these prudential rules will be further improved to allow market risk control, the issuance of internal control rules for banks, the issuance of accounting regulations on consolidation Accounts and balance sheets, etc. It follows that one of the objectives pursued by the NBM is the achievement of a higher efficiency, in which purpose the prudential norms were aimed at encouraging competition in the domestic banking system.

So the underlying purpose of any prudential regulation is to ensure the protection of the banking system against risks and unpredictability that may affect the national economy in general. In other words, the optimum level of protection is ensured by the early absorption of any unforeseen losses that may occur during a bank's lending activity, which will allow for a decrease in bank probability of bankruptcy and an implicit increase in the degree of Population confidence in the national banking system.

References

1. Law of Financial Institutions no. 550-XIII from 21.07.95. Republished in the Official Gazette of the Republic of Moldova no. 78-81/199 form 13.05.2011.
2. Regulation of the National Bank of Moldova on the liquidity of commercial banks of the Republic of Moldova no. 24 of 9.08.1997. In: Official Gazette of the Republic of Moldova. 1997, no. 64-65 of 02.10.1997 (with subsequent amendments and completions).
3. The Regulation on Sufficiency of Venture Capital, approved by the Decision of the Council of Administration of the National Bank of Moldova no. 269 of 26.10.2001. In: Official Gazette of the Republic of Moldova. 2001, no. 130/310 of 14.12.2001 (with subsequent amendments and completions).
4. Allen, W. and Wood, G., 2006. Defining and Achieving Financial Stability. *Journal of Financial Stability*, 2(2), pp.152-172.