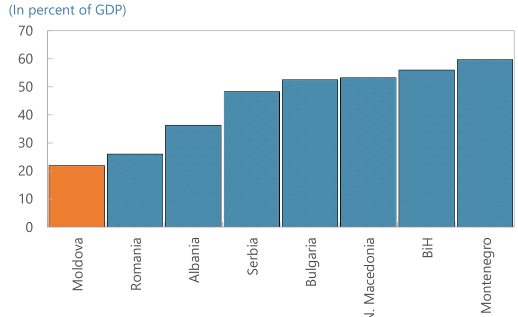
NON-BANK CREDIT ORGANIZATIONS AND FINANCIAL INCLUSION: OPPORTUNITIES AND CHALLENGES[1]

Moldova lags many of its peers in important metrics of financial inclusion, affecting especially consumers and small- and medium-sized enterprises (SMEs). The high-profile 2014 banking fraud saw a retreat of the banking sector from the credit market, while the role of nonbanks, especially of Non-Bank Credit Organizations (NBCOs) as a source of credit for consumers and for SMEs has significantly increased since 2014. The planned transfer of the regulation and supervision of Non-Bank Financial Institutions (NBFIs) to the National Bank of Moldova (NBM) provides an opportunity to make regulation and supervision more consistent across banks and NBCOs. At the same time, Moldova's authorities should ascertain that this reset in financial oversight responsibilities will not result in an inappropriate tightening of credit provision to consumers and SMEs. The streamlining of the supervisory framework also presents an opportunity to strengthen financial consumer protection as it applies to credit provision.

A. Challenges to Private Sector Access to Credit

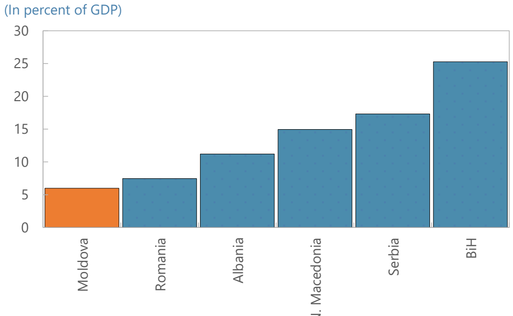
1. **Moldova lags peers on key financial inclusion metrics, including those relating to the private sector's access to credit.** Credit extended by commercial banks as a share of GDP at around 22 percent of GDP is the lowest amongst regional peers. Limited access to commercial bank loans applies to the low volume of lending to both households and SMEs relative to the size of the economy, with Moldova trailing peers on both metrics.

Outstanding Loans From Commercial Banks, 2020
(In percent of GDP)



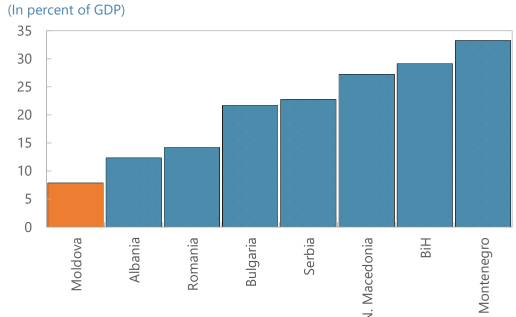
Sources: IMF Financial Access Survey

Outstanding Commercial Bank Loans to SMEs, 2020
(In percent of GDP)



Sources: IMF Financial Access Survey

Outstanding Commercial Bank Loans to Households, 2020
(In percent of GDP)



Sources: IMF Financial Access Survey

2. **While access to credit has been historically low, the current situation also reflects the legacy of the 2014 banking fraud episode.** The aftermath of the 2014 banking fraud incident saw appropriate actions being taken that resulted in significant tightening of lending standards,

[1] Prepared by Fazurin Jamaludin and Peter Lindner.

including a more stringent loan application process, submission of quarterly financial reports by commercial borrowers to banks, minimum requirements for loan amortizations, and limitations on refinancings (see Box 1). However, an increase in the cost of credit administration and the need for borrowers to provide collateral and proof of financial history have emerged as key barriers for consumers' and SMEs' access to bank credit after 2014.

3. **Complex credit application and credit maintenance processes impose a particularly heavy burden on SMEs.** Failure to comply with quarterly financial reporting requirements is penalized, with delays of 30 days or more in submitting these documents resulting in the reclassification of affected loans to a reduced quality category requiring 30 percent provisioning. These financial statements are generally only prepared for no other purpose than for submission to banks and are disproportionately costly for smaller firms. The NBM's prudential provisioning requirements are about one-third higher than those stipulated by the International Financial Reporting Standards (IFRS), increasing the cost of lending further. Against the totality of these requirements, SMEs are discouraged from applying for loans, while commercial banks are disincentivized from extending credit to many SMEs. When they do, SMEs are often required to pay higher interest rates vis-à-vis larger companies.

4. **Complicated processes and procedures also hamper credit access on the part of consumers.** For individuals and households, onerous paperwork and a complex and lengthy loan approval process have been cited by market participants as key barriers to credit access. Online onboarding of new clients, which could simplify the credit application process, reportedly remains cumbersome and difficult to operationalize. A combination of these sectors contributes towards limiting access to financial services, particularly among low-income consumers whose financial literacy is often limited.[2]

5. **Challenges to the private sector's access to credit are exacerbated by the high level of informality in the economy.** Transactions by microenterprises and consumers are mostly conducted on a cash basis, outside the formal structures of the economy and the financial system.[3] Despite recent progress, tax compliance is low, accounting practices are weak, and general record-keeping on income and earnings is limited. These factors render the assessment of creditworthiness of potential borrowers difficult, thus further contributing to the low provision of, and access to, credit.

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[2] However, some customers can have relatively easy access to credit. For instance, one bank reported that it provides selected retail customers with a credit line starting at €15,000. Maturities of consumer loans can range up to five years for standard consumer loans to 20 or 25 years for mortgages with and without government guarantees, respectively.

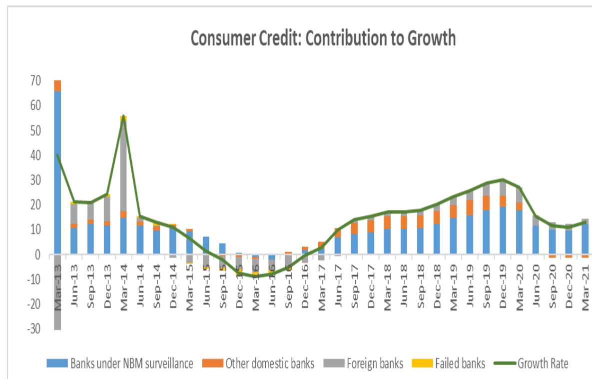
[3] 25 percent of Moldova's labor force works in the informal economy, with the agricultural sector providing employment to 64 percent of those individuals. See: The International Labor Organization, *Overview of the Informal Economy in the Republic of Moldova*, 2018.

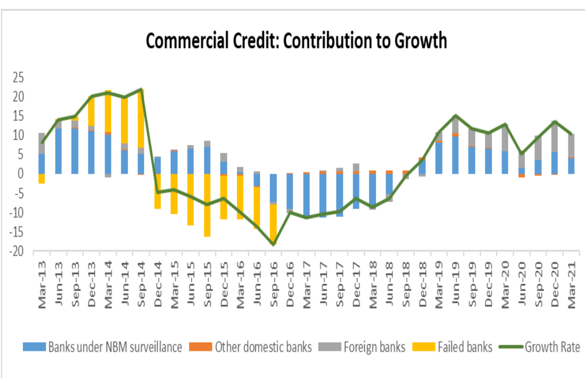
Box 1. The Impact of the 2014 Banking Fraud Episode on Bank Lending

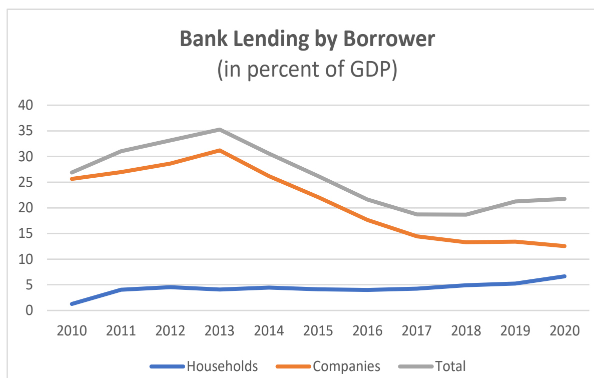
In 2014, US$1 billion disappeared from Moldova's banking system following a coordinated effort involving several banks to fraudulently provide large amounts of financing to various related entities and parties. Much of these funds were moved outside the country. The total loss from this incident was estimated to be equivalent to 12 percent of Moldova's GDP at the time.

The National Bank of Moldova responded to the fraud by tightening lending standards for commercial banks, including by requiring commercial borrowers to provide quarterly financial statements to banks (or risk having their loans classified as substandard), and for all commercial loans to start amortizing no later than three months after disbursement. Refinancing or repaying existing loans through a new loan with the same lender was also prohibited, hampering the consolidation of loans. The credit application process was also made more stringent to better safeguard the quality of bank assets. While the regulatory and supervisory actions taken after 2014 were appropriate, they had some unintended consequences.

With the closure of three banks at the center of the scandal, lending to corporates declined notably. Against a backdrop of strengthened regulations and supervision; the NBM closely supervising three other large banks; and foreign investors increasing their activity in Moldovan banking, the remaining market players adjusted their strategies, with a resultant de-emphasis on commercial lending, Commercial bank lending as a share of GDP went from above 30 pecent to below 15 in recent years. Growth in consumer lending by banks turned positive again in 2017 with consumer lending driving an increase in banks' total lending as a share of GDP.





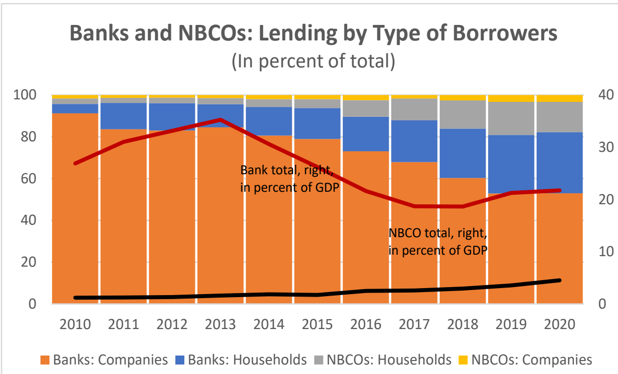


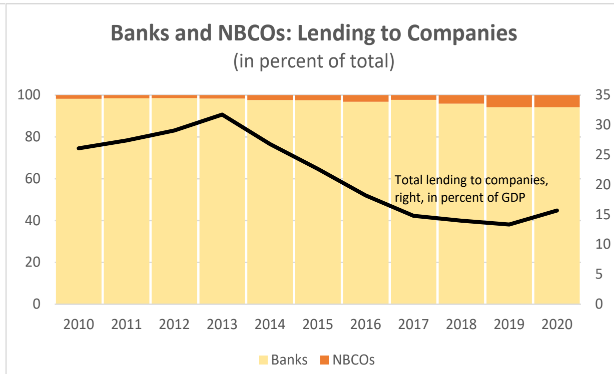
B. Non-Bank Credit Organizations: Trends and Drivers

Against the backdrop of a banking sector that underwent a significant adjustment, latent credit demand by consumers and SMEs, and an abundant supply of capital, NBCOs became a major force in the financial system.

6. Non-Bank Credit Organizations (NBCOs) have become an increasingly important source of financing in Moldova in recent years, especially for consumers and SMEs.[4] NBCO lending grew by an average of around 20 percent annually over the last decade, accelerating in 2019 before slowing in the wake of the COVID-19 pandemic. Between 2010 and 2020, NBCOs have gained a growing share of Moldova's credit market—from around 7 percent in 2010 to almost one-fifth at end-2020. At the end of 2019, 570,000 individuals and firms in Moldova had established a credit relationship with an NBCO.[5]

7. NBCOs' gains in market share occurred across consumer and commercial markets. Most of the gains have been made possible by in-roads into the consumer lending market: NBCO lending to consumers as a share of total lending to consumers grew from under 2 percent in 2010 to around one-third in 2020.[6] Commercial lending by NBCOs, while notable, grew far less, from a 2 percent share of all commercial lending in 2010 to 6 percent in 2020. Similar gains in market share by NBCOs can be seen in both the local currency and foreign currency-linked segments of the credit market.

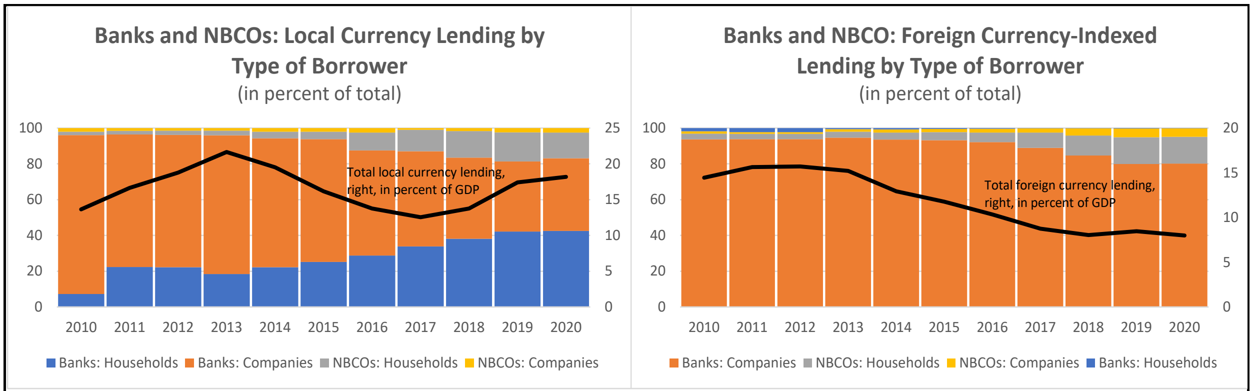




[4] "Non-banks" in Moldova include non-bank credit organizations (NBCOs) and Savings and Credit Associations (SCAs). Given the SCAs' small footprint, this paper only focuses on NBCOs. In some contexts, NBCOs are also referred to as "microfinance organizations."

[5] This means that about 20 percent of Moldova's citizens had borrowed from one or more NBCOs.

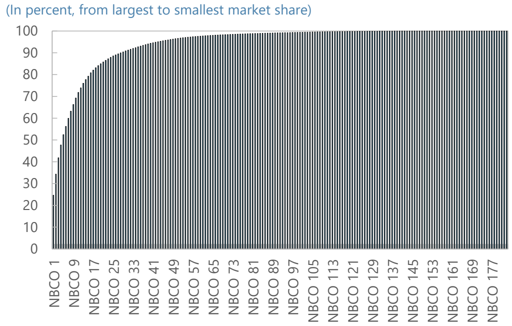
[6] Some consumer loans may actually be used to fund small businesses, blurring the lines between consumer and commercial lending. For instance, a car purchased on credit could be used for both personal and business purposes.



8. The vast majority of NBCOs have low levels of capital and assets, and lending is concentrated among a relatively small number of players. Out of almost 200 NBCOs on record, 144 NBCOs have equity amounting to less than MDL 10 million (USD 569,000), and of these, 63 have less than MDL 1 million (USD 56,900) in equity, and 12 have negative equity. Fewer than 40 NBCOs have assets exceeding MDL 30 million, and of those below this threshold, total assets average less than MDL 5 million. NBCO lending is concentrated among the largest institutions: the 30 NBCOs with the largest market shares account for around 90 percent of the market. The remaining NBCOs have market shares below 1 percent, with an average that is smaller than 0.1 percent. Of those, around 40 have zero loan assets at the end of the first quarter of 2021.

NBCOs: Cumulative Market Share

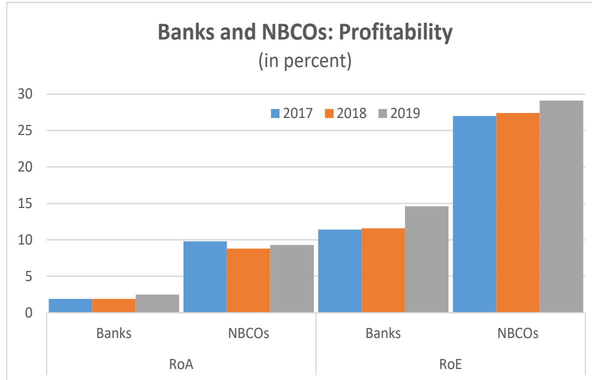
(In percent, from largest to smallest market share)



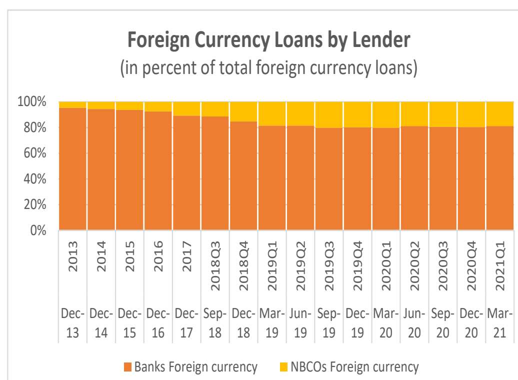
Sources: NCFM, IMF staff calculations

9. On the demand side, the growth of NBCO lending was spurred by increasing credit-financed consumption spending. As alluded to above, access to credit in Moldova has historically been low, even by regional standards. Reduced bank lending in the wake of the 2014 banking fraud scandal further constrained access to credit, in contrast to the greater willingness of consumers to finance consumption with debt amid strong GDP per capita growth (averaging 4 percent during 2009–2020). This growth in consumer credit was further bolstered by the cooperation between some NBCOs and retailers in the origination of consumer loans at the time of purchase. Supporting this growth in NBCO consumer loan origination was the NBCOs' willingness to provide relatively small-sized loans, with an average size of MDL 20,800 (about USD 1,200, or a quarter of GDP per capita) in 2020.

10. The supply of NBCO credit was driven by the high profitability NBCOs enjoyed, which in turn, attracted additional funding for the industry. The differences in profitability between banks and NBCOs were sizeable: banks' returns on assets and on equity during 2017–19 averaged around 2.5 percent and 14.6 percent, respectively, compared to the 9.3 percent and 27.8 percent reported by NBCOs. The key cause of this difference was interest income, with interest rates on NBCO loans averaging almost *four* times the average rate on bank loans as of early 2021. NBCOs' profitability also benefited from high fees, including large penalties for late payments compared to those charged by banks. The NBCOs' large profit margins attracted further funding, with much of it coming from non-residents (see below).



11. NBCOs' high profitability can be partly explained by regulatory arbitrage, which arguably enabled NBCOs to pursue aggressive business strategies compared to banks. For a start, banks and NBCOs are supervised by different regulatory bodies (National Bank of Moldova (NBM) for banks; National Commission for Financial Markets (NCFM) for NBCOs).[7] Until 2020, loan loss provisioning rates that applied to NBCOs were appreciably lower than those that obtained for banks. To expand their market share, NBCOs targeted mainly the underbanked part of the population and enterprises, who, due to a lack of collateral and proof of income faced difficulties in qualifying for bank credit.[8] Credit provision to segments of individuals and firms not eligible for bank credit was naturally much riskier and included simplified loan application and approval procedures. For instance, while NBCOs do provide secured loans, most consumer loans are extended without collateral. Some NBCOs base their assessment of borrowers' creditworthiness on proprietary credit scores. In some cases, consumer loan applications are swift, taking up as little as 10 minutes. NBCOs have also shown a greater willingness than banks to extend foreign currency-indexed loans, which expose borrowers to exchange rate risks. NBCOs' share of the foreign currency-linked credit market has grown, reaching as much as one-fifth of the total foreign currency-linked market in 2020.[9]



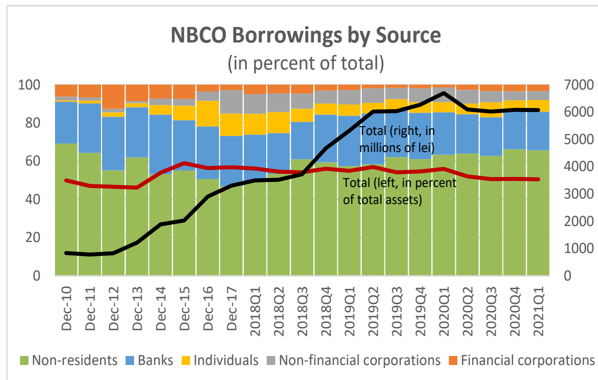
[7] Plans are currently underway to transfer the supervision of non-banks from the National Commission of Financial Markets under the purview of the National Bank of Moldova. The transition is expected to be completed in 2023.

[8] Many smaller enterprises as well as individuals in Moldova participate in the informal economy, hampering their access to bank services. See also paragraph 5 and footnote 2.

[9] Providing FX-linked loans can constitute a natural hedge for some the NBCOs that provide FX-linked loans.

12. In their expansion drive, some NBCOs have targeted consumers with low financial literacy, raising consumer protection concerns in the process. Conversations with market participants and the expert community point to significant reliance on abusive practices by NBCOs. Consumers are reportedly not always informed of the full cost of their loans, or those costs were buried in the 'fine print' of loan agreements. Penalty interest rates and fees for late or non-payments were not disclosed. A recent example includes the advertising of zero interest rates on loans, not disclosing the 'all-in' loan costs that include fees or future interest rate increases, as required by law. Also, many loan contracts and lenders' promotional materials leave borrowers in the dark about their repayment responsibilities, taking advantage of those with limited financial literacy.

13. Borrowing is the single largest source of funding for NBCOs, with nonresidents as the largest group of creditors. Borrowed funds have long been an important source of NBCO funding, equivalent to roughly 50 percent of NBCOs' assets over the last ten years. In terms of absolute value, NBCO borrowing has risen by a factor of more than seven in the last decade, rising from MDL 832 million in 2010 to almost MDL 6.1 billion at end-2020. Non-residents have consistently been the largest source of lending to NBCOs, with an average share of around 60 percent of the total, while banks have been the second largest source at an average of 24 percent.



C. Regulation and Supervision

While the regulation and supervision of NBCOs has been significantly strengthened in recent years, the planned move of regulation and supervision under the auspices of the NBM can provide additional benefits for the regulation and supervision of the sector, as well as for macro-financial stability.

14. A law regulating NBCOs was enacted in 2018, with later amendments that came into effect in April 2020, strengthening the NCFM's powers. The amendments provided for an increase in the minimum capital requirement of an NBCO from MDL 100,000 to MDL 1,000,000 from 2021 onwards, with further increases being envisioned. This resulted in a reduction in the number of active NBCOs to 144 that were active as of the end of the first quarter of 2021. Other measures included in the amendments eliminated the ability of NBCOs to accept deposits and strengthened consumer protection. Key provisions include:

- Lending by individuals to NBCO's is restricted to existing shareholders. The lending must be subordinated to other debt, have a maturity of at least three years, and be for a minimum of MDL 600,000 (around USD 34,000);

- The total payments—interest plus fees—that a consumer makes on debt with an original maturity of two years or less, or an original principal value of MDL 50,000 or less, cannot exceed the original loan principal;[10] and

- Marketing materials and loan documentation have to contain the all-in cost of a loan, inclusive of all fees.

15. NBCOs are subject to different capital and provisioning requirements versus banks. Given that NBCOs cannot accept deposits, it is appropriate to tailor regulations accordingly vis-à-vis banks. NBCOs are not subject to some requirements that apply to banks, including large exposure supervisory review and evaluation process, and capital buffer requirements. However, they must hold capital of at least 5 percent of assets, or a 10 percent minimum if they borrow from banks.[11] If information from credit bureaus is not used in the provision of credit, a loan must be classified as substandard from the outset. Loans that are 30 days or more overdue are subject to higher provisioning rates than for banks.

16. The current framework that places banks and NBCOs under different regulatory entities has clear shortcomings. A fragmented approach to supervision may limit visibility over systemic vulnerabilities stemming from lending activity in the economy, including the true extent of leverage among borrowers. Under the current arrangement, financial stability measures that cover banks, NBCOs, and insurers must be agreed on by the Financial Stability Council, which in the past has led to implementation delays. Supervisory fragmentation has also created space for regulatory arbitrage.

D. Consumer Protection and Financial Inclusion

17. While the consumer protection measures included in the amendments to the NBCO law are beneficial, notable deficiencies regarding their enforcement exist. Oversight responsibilities are distributed across the NCFM and the Consumer Protection Agency (CPA). The latter handles consumer complaints relating to all sectors of the economy and does not have the capacity to appropriately address complaints related to often more complex financial sector issues. The NCFM or the CPA often do not possess the necessary enforcement powers, and dispute resolution processes are underdeveloped. Overlap between CPA and NCFM has led to duplicative and uncoordinated efforts in the past.

18. The lack of effective channels to adjudicate financial consumer protection (FCP) complaints has led to deficiencies in enforcement. Consumers with limited financial literacy may end up signing contracts that are not in line with the law. Debt collectors visit family members of borrowers who are not current on their debt service, often outlining consequences for the defaulters

[10] With the bulk of NBCO loans carrying maturities of two years or less, most outstanding loans are covered by this provision.

[11] With most NBCOs using bank funding, this provision covers the bulk of the industry. With NBCOs' capitalization generally exceeding 10 percent of assets by a large margin, this provision is not binding.

that have no legal basis. While the aggressive collection practices kept defaults relatively low, even during the pandemic, they come at a social cost, potentially affecting debtors who are unable to pay, as well as their families, with detrimental effects at a personal level. Banks, on the other hand, generally exhibit close compliance with legal provisions governing FCP.

19. Financial inclusion gaps in Moldova have a strong regional dimension. While wealthier consumer and large firms generally have access to formal banking services, there also exists a regional divide in regard to financial inclusion. Moldova's population has declined from a high of 2.98 million in 1992 to a low of 2.66 million in 2019, with a disproportionate decrease in population occurring outside the greater Chișinău area. This has led to a general decline in economic activity in the rural areas, reducing banks' incentives to operate actively in these areas.[12] As a consequence, many banks' business strategy is regionally focused on the greater Chișinău area and a few other urban hubs. With rural employment relationships to a greater degree informal in nature than in other sectors of the economy, NBCOs have moved to fill the resulting gap in credit provision.

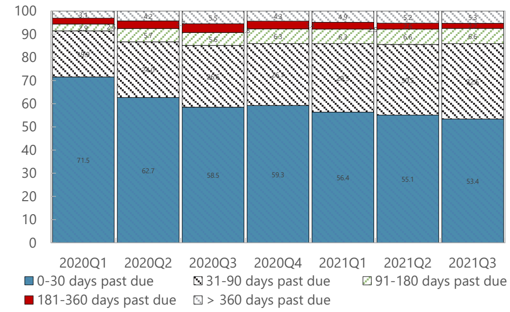
20. Moldova has no national financial inclusion strategy. With Moldova lagging on many financial inclusion measures versus peers (see paragraph 1), Moldova's lack of a national financial inclusion strategy represents an important policy gap. Given banks' tendency to focus on financially better-positioned customers and certain regions within Moldova where informality is lower, the large underbanked part of the population will likely have to rely increasingly on credit provided by NBCOs and SCAs for the foreseeable future.

21. Inconsistent use of credit bureaus by NBCOs can lead to overindebtedness among certain segments of borrowers, potentially posing financial stability risks. Currently, three credit bureaus operate in Moldova, with a fourth slated to be approved for operation soon. Each bank has to report credit information to at least one bureau, with NBCOs and SCAs required to do the same since April 2021. While the credit bureaus are supposed to exchange information with each other since July 2021, it is unclear whether full and timely information sharing is taking place. The current system, in which NBCOs are not required to consider information from the credit bureaus, and where no overall limits on debt-to-income ratios exist, implies the risk of large numbers of borrowers becoming overindebted. This could have systemic implications during an economic downturn that leaves many individuals unable to service their debts.

[12] Mortgages will be hard to obtain since bankers fear an erosion of housing prices due to reduced demand.

E. Risks

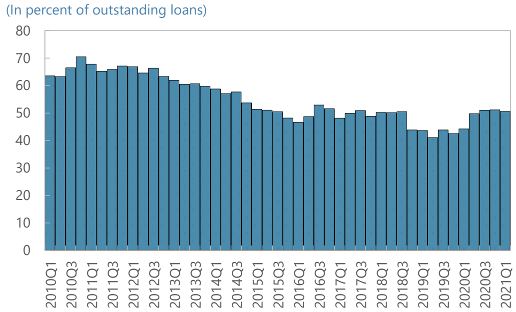
NBCOs: Credit Outstanding by Quality
(In percent of total NBCO loan outstanding)



Sources: Moldovan authorities, IMF staff calculations

22. NBCO asset quality has deteriorated during 2020 but the full impact of the pandemic on loan quality remains to be seen. The share of loans between 31 and 90 days past due has increased by more than 10 percentage points since the March 2020 through end-2021Q3, a reflection of the continuous erosion in the quality of the top-performing loan category. While the shares of loans that reflect delinquencies above 90 days have also increased, their increase have so far remained relatively contained.[13]

NBCOs: Buffer Against Loan Losses
(In percent of outstanding loans)



Sources: Staff calculations
Note: Buffers consist of loan loss provision and shares and other assets

23. However, there are factors that can help mitigate borrower risks. For instance, NBCOs tend to extend loans with relatively short maturities—between 1 and 2 years—thus limiting prolonged exposure.[14] Aggressive collection practices on non-performing debt that leverage on close-knit family connections of borrowers also help limit loan losses. At the aggregate level, NBCOs appear to have relatively high buffers against loan losses, with total buffers (including equity capital and loan loss provisions) accounting for around half of outstanding loans, although differences exist at the company level.

24. With NBCOs unable to accept deposits, a potentially important source of systemic risk has been removed. Moldova's NBCOs cannot accept deposits from the general population, contrary to the situation in some other countries.[15] Systemic risks from substantial deposits used to finance highly risky NBCOs that may go under in a crisis cannot emerge in Moldova.

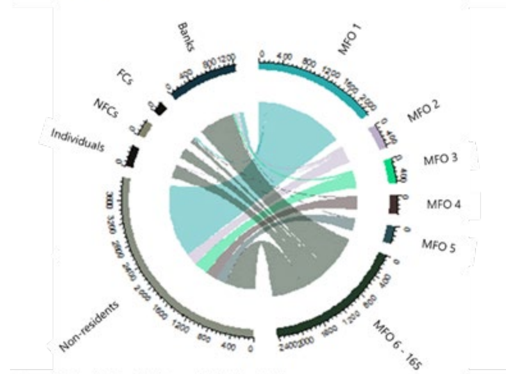
25. While risks stemming from lending activities appear broadly contained, NBCOs' heavy reliance on borrowing and especially on non-resident funding represent sources of vulnerabilities. The considerable dependence on borrowing exposes NBCOs to maturity mismatch

[13] These numbers reflect a more serious impact from the pandemic on NBCO loan portfolios than on bank loan portfolios. While both types of institutions were guided by their respective regulators to offer payment deferrals to their borrowers if needed, the greater risk exposure of NBCO clients might have led them to cease debt service. Industry representatives also mentioned the possibility that the ability to forgo debt service was overused, with borrowers who had made use of loan deferments unable or unwilling to resume payments in early 2021.

[14] For instance, in a 2-year loan that carries a 20 percent interest rate, 50 percent of the loan's principal will be repaid at month 13, reducing the damage from default to the lender, while also reducing the incentive to default on the part of the borrower.

[15] The law on NBCOs that came into effect in early 2020 prescribed that individuals are very much restricted in their ability to provide loans to NBCO's. See paragraph 14 for details.

Funding Sources for Microfinance Organizations, 2021Q1
(Million Lei)



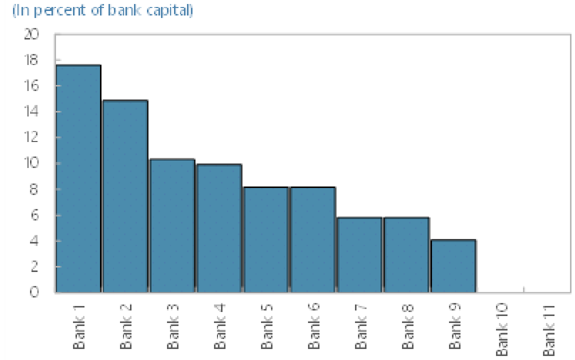
Sources: National Bank of Moldova and IMF staff calculations.
Note: Non-financial corporations (NFCs), Financial corporations (FCs).
Microfinance organizations include MICROINVEST (MFO1), IUTE CREDIT (MFO2), BT LEASING (MFO3), SEBO CREDIT (MFO4), MIKRO KAPITAL COMPANY (MFO5).

risks, and the role played by nonresidents suggests potential vulnerability to changes in global financial conditions. The NBCOs' high reliance on external funding can make them subject to the "risk on, risk off" mood prevailing in foreign markets. A sudden stop could lead many NBCOs to lose the ability to roll over debt during times of crises or tightened liquidity. However, the flow of nonresident funding is not evenly spread among NBCOs, with a handful of entities receiving the lion's share of nonresident lending, suggesting that risks are concentrated in specific segments of the market. The large flow of funds from non-residents into NBCOs also could give rise to AML/CFT concerns. While the NCFM has received UBO information from NBCOs, it is far from clear that the high level of foreign equity and debt funding that many NBCOs receive could not provide reasons such concerns.

26. **Exposure to exchange rate fluctuations is also a potential source of risk.** NBCOs' reliance on nonresidents' funding potentially exposes them to currency mismatch risks, a fact that is partially mitigated by NBCOs' growing share of the foreign currency-indexed credit market (see paragraph 12.

27. **Bank funding represents a source of risk for both the banks as well as the NBCOs involved, potentially presenting an important supervisory challenge.** In aggregate, banks' total lending to NBCOs is very small, equivalent to under 2 percent of the banking system's total assets as at the end of the first quarter of 2021. However, in the case of three banks, lending to NBCOs constitutes 17.6, 14.9, and 10.4 percent of their regulatory capital respectively (as of the end of the first quarter of 2021). This lending is very concentrated, with 93 percent going to the top 14 NBCOs by assets. In the cases of five NBCOs, loans from a single bank exceeds 60 percent of their bank borrowing. While this represents notable single-borrower exposure, a close-up view shows that some large loans are extended to financially very healthy NBCOs, leading to low incremental risk. For some NBCOs, the potential remains that their bank funding could cease on short notice based on the decision of one bank. The complexity stemming from these bilateral funding relationships, combined with FX-related risks, suggests that supervisors responsible for banks and NBCOs should cooperate when assessing institution-specific as well as systemic risks posed by NBCOs' activities (see paragraph 17 and footnote 12).

Bank Financing of NBCOs, end-2021Q1
(In percent of bank capital)



Sources: National Bank of Moldova, IMF staff calculations

28. A stress test of NBCOs' balance sheets suggests that despite potentially high-risk exposure, most NBCOs have sufficient capital to weather a number of downside scenarios (Box 2). Among the largest NBCOs accounting for around 80 percent of total market share, loan portfolios with significantly deteriorated asset quality appear to be concentrated in only a handful of players, with most NBCOs having sufficient capital to handle negative shocks. While some NBCOs will potentially fail during a downturn—with some ending up with their entire equity wiped out—these institutions are estimated to account for a relatively small portion of the market (around 6 percent of the total market share). However, adverse market events can be expected to increase leverage at the industry level drastically, suggesting increased vulnerability during prolonged downturns.

Box 2. NBCOs: A Stress Test

Due to data limitations, dynamic multiperiod simulations of adverse events affecting NBCOs are not feasible in the context of this paper. However, as a starting point, it is useful to consider the potential impact of different degrees of deterioration of NBCOs' loan portfolio under selected downside scenarios.

For this exercise, we consider delinquent loans with a duration exceeding 90 days, which for the purposes here will be referred to as "bad loans". This category was chosen since loans in this category require 100 percent provisioning compared to loans subject to shorter periods of delinquency. Higher levels of "bad loans" would sap NBCOs' equity as they need to make provisioning for these loans.

We consider five downside scenarios, in which the existing levels of "bad loans" at each individual NBCO increase by different magnitudes. In the first three scenarios, it is assumed that specific portions of better-performing loans deteriorate into "bad loans". To consider truly extreme conditions, the last two scenarios involve the simple assumptions of the level of "bad loans" doubling and tripling, respectively. In these scenarios, NBCOs with an exisiting low-quality loan portfolio will experience greater portfolio deterioration and higher relative increases in loan loss provisions. These assumptions align well with the experience during past credit crises. Specifically, the five downside scenarios are summarized as below:

- Scenario 1: 25 percent of loans delinquent for 60 to 90 days turn into "bad loans"
- Scenario 2: 50 percent of loans delinquent for 60 to 90 days turn into "bad loans"
- Scenario 3: 75 percent of loans delinquent for 60 to 90 days turn into "bad loans"
- Scenario 4: "Bad loans" double in level
- Scenario 5: "Bad loans" triple in level

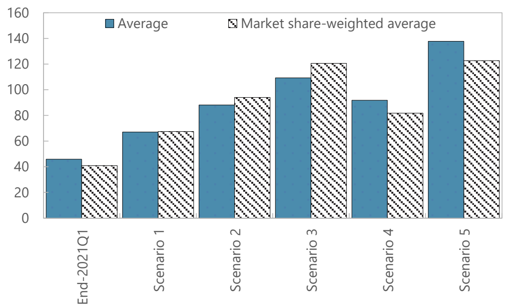
For the most part, the stress test focused on the 15 and 30 largest NBCOs, which accounted for around 80 and 90 percent of NBCOs' total market share, respectively, as of at the end of the first quarter of 2021. The impact on individual banks' equity is then estimated and aggregated. The key findings are:

- At the aggregate level, NBCOs in Moldova have sufficient equity to absorb further deterioration in asset quality, with the exception of extreme losses (scenarios 3 and 5);

Box 2. NBCOs: A Stress Test (concluded)

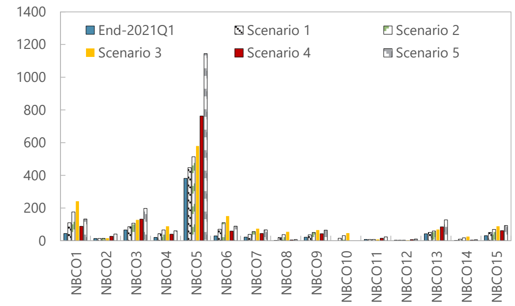
- The impact of the downside scenarios is mainly concentrated in NBCOs with high levels of lower-quality loan portfolio or limited equity currently;
- In the most extreme scenarios, a few NBCOs would see their equity wiped out, but these NBCOs are likely to account for a relatively small portion of the market share (around 6 percent).
- While NBCOs at the aggregate level are expected to be able to withstand most economic downturns, extreme shocks would increase leverage at the industry level measurably.

NBCOs: NPLs > 90 Days Under Various Scenarios
(In percent of equity)



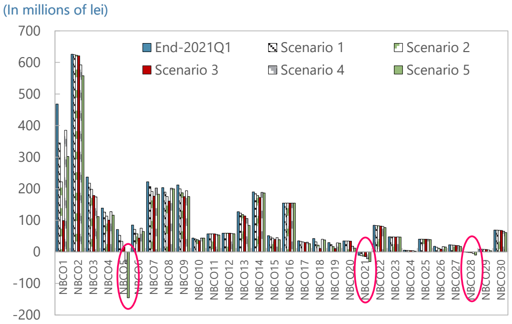
Sources: Staff calculations

NBCOs: NPLs Exceeding 90 Days Under Various Scenarios
(In percent of equity)



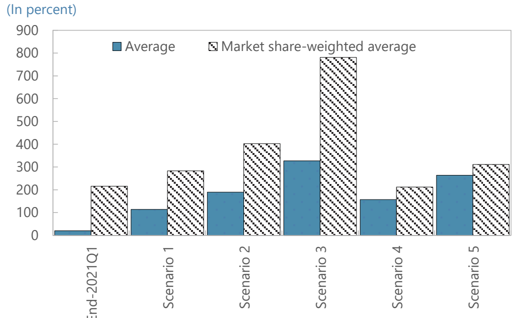
Sources: Staff calculations

NBCOs: Equity After Provisioning Under Various Scenarios
(In millions of lei)



Sources: IMF staff calculations

NBCOs: Debt-Equity Ratio Under Various Scenarios
(In percent)



Sources: IMF staff calculations

F. Policy Considerations

29. The role of NBCOs as a source of credit for the private sector can help address financial inclusion gaps, with further growth welcome as long as related risks are managed. Large swathes of consumers and enterprises in Moldova remain financially underserved and have limited access to credit. The fast growth in NBCOs' market share over the last 10 years reflects the large demand for credit in the economy that was not met by traditional banks, including in the rural areas, where banks are less active. NBCOs' increased activity however may generate new risks that need to be monitored and managed.

30. Plans for making the NBM as the sole regulator of banks and non-banks mark a step in the right direction. Having the NBM as the sole regulator of commercial banks and NBCOs can increase the consistency and speed in the implementation of macroprudential measures. Having a single regulator can lead to improved information sharing and better pooling of data and IT

resources, which will bring greater clarity regarding systemic risks and vulnerabilities, as well as help foster a unified approach to financial consumer protection across banks and non-banks.

31. Forthcoming changes to the regulatory and supervisory regime governing NBCOs however should not lead to reduced access to credit for financially underserved consumers and firms. So far, NBCOs have operated safely and successfully. Subjecting NBCOs to the same regulations governing banks could jeopardize their current business model, likely leading to a mass exodus from the industry. As no substitutes for the services currently provided by NBCOs are likely to emerge in the short-to-medium term, curtailing NBCOs' role in credit provision would drive some underserved borrowers into the arms of shadow lenders completely outside the authorities' regulatory purview. In the worst-case scenarios, many consumers and SMEs probably would not be able to receive credit at all. With the integration of the underserved parts of the population and firms likely a long-term process that depends on reducing economic informality and increasing financial literacy, NBCO supervision and regulation should be tailored to that particular sector, distinct from the regime that governs banks.

32. The transition of the NCFM's oversight responsibilities to the NBM should follow a set of key principles that preserve credit access while strengthening NBCO regulation and supervision:

- Regulate and supervise NBCOs distinctly from banks, to preserve their positive impact on credit provision.
- Do not subject NBCOs' borrowers to the same strict credit approval and reporting requirements that some bank borrowers are subject to.
- Develop capital and provisioning requirements that reflect the higher risks of NBCO loans.
- Develop macroprudential and systemic risk-related requirements that are aligned between banks and NBCOs.
- Develop procedures that help to track and analyze certain NBCO-specific risks, including risks caused by FX- and maturity-misalignments between loans and funds, sudden stop risks from foreign funding, as well as risks emanating from the NBCO-bank nexus.
- AML/CFT concerns should be addressed by analyzing UBO and the ultimate source of foreign funding of NBCOs.
- Prioritize on-site supervision once pandemic-related restrictions have been removed. Supervision should put appropriate emphasis on governance and risk management of the institutions.

33. Further consolidation of the NBCO sector can be considered, with the view to increasing NBCOs' resilience and efficiency. The proliferation of NBCOs, many of which are undercapitalized and have inadequate capital and negligible assets may exert strains on regulators

with relatively limited resources. Consolidating the market into a smaller number of players can potentially simplify supervision as well as ensure that borrowers are catered to by NBCOs with adequate resources, expertise, and capacity, which can provide high-quality services and are able to better withstand shocks. A significant reduction in the number of NBCOs—for example to the 30-40 large players that account for 90 or more percent of market share—can be done while maintaining a healthy level of competition.[56]

34. The authorities should develop a targeted approach on FCP that should be integrated into a national financial inclusion strategy. A national financial inclusion strategy that covers all financial market participants is urgently needed, given the lack of integration of many citizens and SMEs into the formal economy and the formal financial system. The consolidation of financial sector supervision under the auspices of the NBM can also facilitate planning and implementation of such a strategy, which should properly address FCP concerns. Data on indebtedness should be compiled and analyzed in ways that allow for easy sharing with the CPA or other agencies that partake in consumer protection. Common requirements on the sharing of information across banks, NBCOs, SCAs, and the credit bureaus, as well as caps on debt-to-income ratios could become more easily enforced under a common supervisor.

[56] Consolidating the industry to the top 30 players would have a limited impact on market concentration as measured by the Herfindahl Hirschman Index, which currently stands at around 9 percent and would increase to 11 percent, still significantly below, for instance, the 25 percent threshold used in the US in assessing oligopolistic conditions.