

IMPLEMENTATION OF RESPONSIBLE LENDING PRINCIPLES IN THE REPUBLIC OF MOLDOVA: DRAWBACKS AND OPPORTUNITIES

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Abstract: *The huge negative effects of the global financial and economic crisis that increases significant credit risk prompted international community and financial organizations to launch and to promote responsible lending practices, to develop a set of principles and practices in order to minimize credit risk through responsible lending. Responsible lending benefits consumers and minimises the risk of abusive practices and over-indebtedness and this implies lower credit risk for the creditor. In the Republic of Moldova this subject is very actual due to a high level of non-performing loans. According to data presented by the National Bank of Moldova, in recent years the volume and the ratio of non-performing loans in total credit portfolio is continually increasing. The purpose of the research is to establish responsible crediting principles, identify factors, methods and techniques that will minimize credit risk for both debtors and creditors.*

Key-words: *responsible lending, credit procedures, credit risk, non-performing loans, credit portfolio, banks, creditor, debtor.*

JEL Classification: *E52, E58, G21.*

1. Introduction

The global banking crises from 2008-2009 has revealed that an unsustainable financial services' offer based on irresponsible lending implies risks not only for the related debtor and creditor, but for the whole financial sector and country. In this context, the authorities and credit institutions need to take into consideration that irresponsible lending of consumers and unthinking use of retail credit products significantly increase the credit risk because over-indebtedness is one of the most serious cause of default, endangering social impact and stability.

The huge negative effects of the mentioned global financial and economic crisis that increases significant credit risk prompted international community and financial organizations to launch and to promote responsible lending practices, to develop a set of principles and practices in order to minimize credit risk through responsible lending.

Internationally, there is an increasing interest in the topic of responsible lending. At the request of the G20, the Financial Stability Board produced a report "Consumer finance protection with particular focus on credit" (2011), which includes the results of a survey of its membership on regulatory approaches to consumer credit.

A handful of countries have also passed legislative and regulatory guidelines on the topic (for ex. Australia, Malaysia and South Africa). However, the content of the measures and whether the will and resources are available to support enforcement.

The purpose of the research is to establish responsible crediting principles, identify factors, methods and techniques that will minimize credit risk for both the debtor and the creditor.

Methodology of research: study of the profile literature, systemic method, logical method, analogy, analysis and synthesis, induction and deduction, graphical method, comparison, method of analytical tables.

2. Overview on responsible lending

Financial institutions that offer loans and credits to the consumers is quite diversified. Principles that creditors provide also can be different. Generally, if during lending process the creditor takes into consideration the interest of the debtors, it is known as responsible lending. From the opposite side, when creditors mislead the needy debtor for their own advantage, this is known as irresponsible lending. Consumers face an aggressive, predatory selling practice pushing expensive, complex products that debtors can ill afford and do not understand. Disclosures are either after the fact, or hidden in legal jargon in fine print in contracts which consumers are pressured to sign in haste (Consumers International, November 2013). Failing to achieve the moment's gain, in a long term irresponsible lending is a destructive process that leads to losses for all the involved parties and cannot lead to sustainable development.

In economic literature, the responsible lending concept is presented in a different way and perspective. As there are no internationally recognized standards on responsible lending, individual countries have used a wide range of regulatory approaches. Some rely primarily on regulating information disclosure, expecting consumers to be capable of making adequate decisions. Other countries place the burden for responsible lending primarily on creditors, requiring them to assess the suitability of the loan for each consumer. Others opt for more prescriptive solutions, defining interest rate ceilings, maximum debt-to-income or loan-to-value ratios or limits for penalties and late fees (World Bank, October 2013).

The responsible lending is understood as the development of lending activities of credit institutions where credits are granted in compliance with certain provisions creating preconditions for the proper assessment of the debtor's solvency and preventing from assuming the excessive credit risk.

In summary, these three simple principles — driven by common sense, good business practice and support for the customer's needs, guide credit officers to use the following rules:

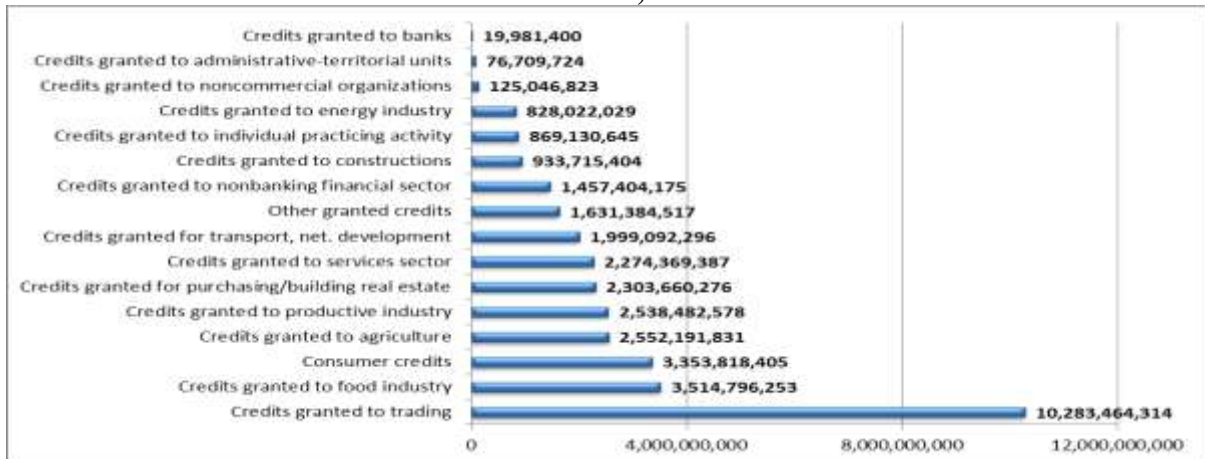
- the customer must have the ability to repay the loan according to its terms and conditions and the customer's financial circumstances.
- the loan transaction must deliver benefit to the customer.
- credit officer should support the customer's goal of making informed choices.

3. Analysis of debtors on the credit market of the Republic of Moldova

On the credit-banking market of the Rep. Moldova debtors are legal entities and private persons. The volume of legal entities' credit portfolio in amount of 28.346,92 million lei is much bigger than private persons' credit portfolio in amount of 6.414,35 million lei, as of December 31, 2016 (NBM, 2016).

Analyzing figure no. 1, we observe the distribution of the demand for credit products and the concentration by brunch.

Figure no. 1. Volume of total credit portfolio by the credit products, as of December 31, 2016.



Source: BNM, 2016

Analyzing the credits from the banking system by branch of activity, it was established that the largest share of credits is for trade. For private persons the biggest demand is for the consumption credit, with the share of 10%, then credits granted for purchasing/building real estate with the share of 7%, followed by other granted credits with the share of 5%, that is including loans granted to individuals, except individuals performing an entrepreneurial activity, that are classified under "Other loans" according to the characteristics of the group of accounts. The smallest share for the private individuals is for credits granted to individual practicing activity with the share of 3% (NBM, 2016).

From data presented above, we can conclude that individuals in Moldova are consumer-oriented, which is also shown on the demand part of entities in case of credits granted for trading. Usually, a credit product for consumption is easier to obtain, especially for short term maturities and for small amounts as contrary to real estate loans. Still, the negative aspect is that consumption loans are more risky for both participants – debtor and creditor due to the following reasons:

- the debtor does not pay attention to some important details such as the effective annual interest rate, whether or not there are some hidden commissions. Thus, the client can simultaneously request more small credits and thus significantly increase his debt level;
- the creditor does not make a detailed financial analysis and does not check the payment potential of the debtor because it is considered that a small amount involves lower risks that will not influence too much the financial situation of the creditor. But this attitude can provide over-indebtedness and increase of non-performing loans.

The low share of 7% for credits granted for purchasing/building real estate is the result of low revenues of consumers, as well as tougher creditors' official requirements and conditions for credits' granting. The positive side is that a real estate loan can be less risky for both participants – the creditor and debtor, due to the following reasons:

- before granting a real estate credit, the creditor should make a detailed examination of the customers' financial situation and establish the payment potential, thus the debtor's default is less probable to be produces;
- it is a guaranteed credit. On the other hand due to the fact that it is a long-term credit, the risk that the debtor's revenues will be reduced over time may appear, thus some unexpected major expenses may result.

As it was mentioned above, besides the conditions imposed by the credit product, the financial situation of the customers influence their preference to choose or not some credit products. Moldova is the poorest country in the Europe with low monthly income for population, and often the borrowed amount just cover some minimum necessary things.

The most important sources of revenues are: salaries – 43,5%, social benefits - 25,8% and remittances – 14,6% according to data presented by official statistics for 2016 (Moldovan Economic Trends, Q III, 2017).

The most paying types of economic activities are: information and communications, financial and insurance activities, production and supply of electricity, heat energy, gas, hot water and conditioned air. As regarding the least paid activities, the lowest salaries were paid in the following domains: art, leisure and recreation, accommodation and food service and agriculture, forestry and fishing.

The self-employment activities with a weight of 12,4% of the total average monthly revenue per capita of which: from agricultural individual activities – 8% and from non-agricultural individual activity – 4,4% also contributed to the creation of revenues.

Another barrier that stops the implementation of responsible lending principles in Moldova is low level of financial education of population. In fact, financial education is an important factor that reduces the credit risk and should be part of responsible lending policy.

In Rep. Moldova, national authorities understood the importance of population financial education, thus some important reforms have already been implemented:

- The Ministry of Education of Republic of Moldova introduced in the Curriculum optional lessons on financial educations for secondary school students and some methodological guides;
- the National Bank of Moldova started discussions on the elaboration of the National Strategy concept on Financial Education. These were held at a conference bringing together representatives of the public authorities, the educational environment and civil society, educational experts and market participants, financial analysts from the Republic of Moldova, economic analysts, as well as external partners. The event was eloquently featured in the International Financial Education Week and The project initiated by the National Bank on this occasion - "Opens the heart to financial education";
- the National Bank of Moldova organizes Financial education courses on International Savings Day;
- in the context of options for financial education, the National Bank of Moldova in partnership with the European Fund for Southeast Europe (EFSE) has edited and proposed to children the books: "A trip to the world of money" and "Financial Education Guideline";
- almost 400 children, accompanied by teachers, are admitted to the National Bank of Moldova during the International Financial Education Week 2017, which takes place under the heading "Learn. Save. Win.". The purpose of the action is to encourage entrepreneurship, especially among young people, to widely inform the public about the role, functions and functions of a financial-banking institution and to explain the basic principles of the economy.
- during the Global Money Week banks were very active in promoting various activities. For example, in order to support the Financial Education Program, a commercial bank launched a new type of bank deposit "Young." Another banks organized financial education lessons for teaching staff, pupils and students.

All these actions aimed at informing the consumer about the financial education, importance and the benefits consumers have. There were presented to the customers of different age and knowledge. If these actions continue to be carried out with a joint effort, the level of financial education of the consumers will increase.

4. Analysis of creditors in the Moldovan banking sector

In 2017 credit risk continues to be the most significant one. Thus the National Bank of Moldova will carry out on-site inspections at banks in order to assess the quality of the assets, 'large' exposures, exposures towards affiliated persons and will examine the policies and practices on credit risk.

A particular attention will be granted to non-performing loans, to their primary reimbursement modalities and to the quality of secondary reimbursement source, and in particular to the quality and value of loan-granting process. During these inspections, there will be also assessed the impact of deterioration of the quality of assets on the bank's capital, as well as the practice of restructuring or extension of loans' maturity.

At the same time, the risk control is continuing to be subjected to examination along with the risk level analysis. Thus, the banks' procedures, policies and strategies on the management and decrease of non-performing loans will be thoroughly assessed. In order to minimize the impact over the banks' capital caused by a possible deterioration of the loan quality, the National Bank of Moldova, as the supervisory authority, has requested the revision of the policies and strategies for the purpose of efficient monitoring and management of the level of non-performing loans. Thus, the NBM will assess the fulfillment by banks of the aforementioned request. At the same time, there are assessed, on daily basis, the loans granted by licensed banks during the off-site inspections in order to identify and supervise the loan portfolio, being also used the opportunities of the Credit Risk Register (NBM, 2017).

During this inspection, there will be also identified the groups of connected persons in order to determine the 'large' exposures and to prevent the exceeding of the established limits, taking into account that the excessive concentration may lead to losses registration by the bank and as a result, this may significantly influence the bank's capital in the context of the amendments made to the Law on financial institutions.

At the same time, following the amendments made to the "Regulation on bank transactions with its affiliated persons" in force as of November 2016, the inspections will be carried out taking into account the new provisions on loans granted to affiliated persons. Thus, as bank supervision priorities for the NBM will continue to be: assessment of the nature of relationships and transactions with the bank, using the new features for identifying the individuals who have relations or conduct transactions with the bank and/or with its affiliates, which will facilitate the monitoring of the compliance by the bank with the legal provisions on the transactions with its affiliated persons, including the exposure limits thereof (NBM, Banks supervision priorities, 2017).

During 2016, the National Bank of Moldova carried out quality assessments of the banks' shareholding and applied some remedial measures on large banks to ensure a transparent ownership structure. Thus, the assets recorded an increase and the banks became more resistant, being capitalized with a high liquidity level, which provides for the possibility to finance more actively the country's economy. At the same time, the banking sector has faced certain issues related to the high level of non-performing loans, maintaining the downward trend of the lending activity. In this regard, the banks continued to enhance their corporate governance and risk management framework to which they are subject.

The total volume of gross loans portfolio granted by banks decreased during the last years. As of December 31, 2016, gross loan portfolio amounted to 47,7% in total assets or MDL 34,8 billion, decreasing by 9,0% during 2016. Total volume of new loans decreased also by 12,8% than the similar period of last year. The decrease was determined mainly by the lack of loan demand and a more prudential approach applied by banks against potential debtors.

At the same time it is attested the migration of loans from legal entities to individuals and from foreign in national currency (44,86%). This tendency has an explanation – the stabilization of national currency in relation to reference currencies. Thus, the total volume of loans granted to individuals registered an increase by 154,61 mln. MDL, while credits provided to legal entities decreased by 727,70 mln. MDL, in the total volume of loans. This increasing trend in loans granted to individuals (from 15,61% in January 2016 to 21,99% in September 2017) demonstrates that Moldova is a largely consuming economy, as individuals are those that are mainly credited by consumption loans, while business is not willing or is not able to be credited (MET, Q III, 2017).

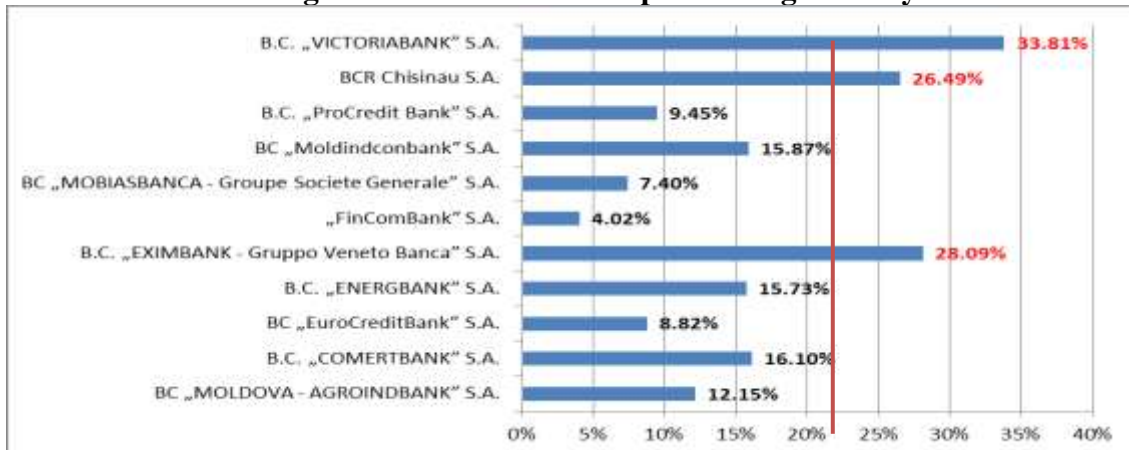
Figure no. 2. Loans dynamics by currency and debt category



Source: Moldovan Economic Trends, Q III 2017, p. 45

The two banks placed under intensive (special) supervision (out of three banks) recorded the highest upward trend of non-performing loans, also due to the requirements issued by the National Bank of Moldova for loan reclassification on the basis of the prudential approach applied by the National Bank of Moldova, these loans being granted prior to the establishment of the intensive (special) supervision by the National Bank of Moldova, thus: B.C. “Moldincombank” JSC – 23,07%, B.C. “Victoriabank” JSC – 30,11% (see figure no. 3).

Figure no. 3. Share of non-performing loans by bank.



Source: NBM, 2016

As of December 31, 2016, the share of non-performing loans (substandard, doubtful and compromised) in total loans portfolio at the banking sector was 16.31%, increased by 6.4% compared to the end of December 31, 2015. This indicator varies from a bank to another, as is presented in figure 3.

A high rate of non-performing loan denotes a less prudent attitude to the lending process of those banks, with the high credit risk portfolio and high probability of debtors default. Another reason can be a high risk of concentration on a large group of connected clients feeling difficulties or on a segment that indicates a significant decrease or can be a fraud. Anyway this denote a less responsible attitude and low risk management ability.

With reference to the prudential limits on maximum exposure of 15%, it should be mentioned that following the efforts made by the National Bank of Moldova, BC „Moldindconbank” S.A has taken a number of remedial measures and as of December 31, 2016, the bank has complied with the provisions of Regulation on large exposure.

The high level of the risk-weighted capital adequacy allowed the banks to absorb losses from worsened loan quality. In order to avoid the risk capital inadequacy for covering the potential losses in the case of further deterioration of the assets' quality, the National Bank of Moldova as the supervisory authority has requested the banks to review the policies and strategies for the efficient monitoring and management of the non-performing loans level and for strengthening the capital. The policies/strategies submitted to the National Bank of Moldova are in process of examination.

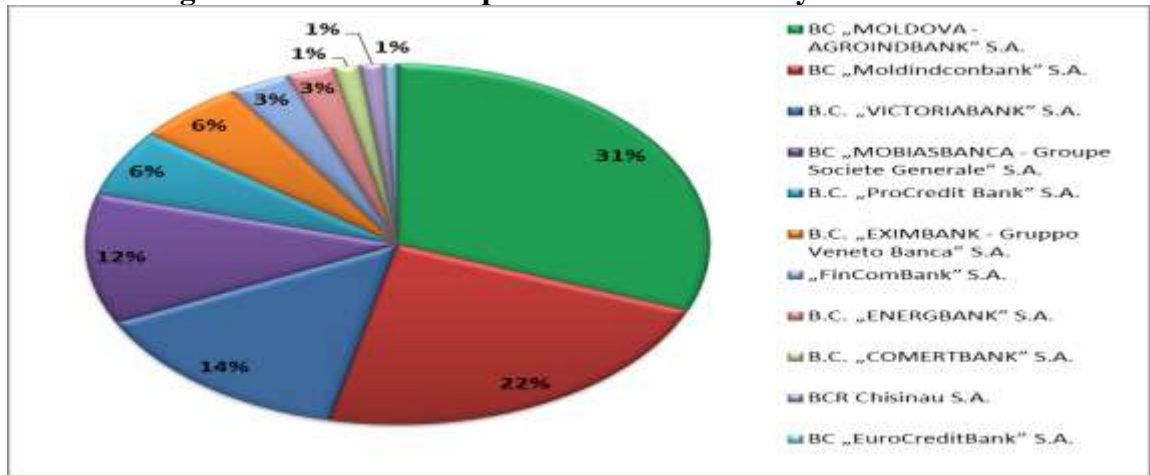
Considering that the capital is the main source of covering losses incurred in case of risks materialization, National Bank has previously requested the banks to adopt a more prudent and conservative policy relating to the distribution of dividends.

Thus, in order to strengthen the banks' capital, the National Bank of Moldova initiated some amendments to Regulation on risk-weighted capital adequacy, which refer to the redirection of the profit registered during the previous years, exclusively for the capital increase.

It should be mentioned that only the well capitalized banks are able to absorb all risks that could arise/materialize and participate actively in financing the entire economy.

As of December 31, 2016 the total balance of credit debt was 34,761.27 million lei. More than 85% of them are in portfolio of the biggest 4 banks. The bigger portfolio has BC “Moldova-Agroindbank” JSC with the volume of 10,774.66 million lei and share of 31%.

Figure no. 4. The credit portfolio distribution by the bank



Source: NBM, 2016

Weighted average interest rate on new loans in national currency granted in December 2016 was 11,74%, decreasing by 3,84% compared to the same period of last year. As compared to the previous month, the weighted average interest rate on loans in national currency decreased by 0,82%.

Loans with terms from 2 to 5 years are the most attractive. In December 2016, their share accounted for 40,94% of the total volume of loans in national currency and was granted at an average rate of 11,28%, in decreasing by 1,09% compared to the previous month.

5. Recommendation on implementation of responsible lending principles in Moldova

The importance of responsible lending is aware in Moldova and the first steps were taken by:

➤ Approving on May 29, 2008 the Law nr.122 on credit history bureaus, in force from March 01, 2009, in order to create the conditions for the formation, processing, storage and presentation by credit bureaus of the information characterizing the compliance by debtors of their obligations under the credit agreements, taking into account the need to increase the level of protection of creditors and debtors on the account of the general diminution of credit risks, in order to increase the efficiency of the activity of financial institutions and other lending companies.

➤ Approving on July 12, 2013 the Law no.202 on credit agreements with consumers, in force from March 06, 2014. This law creates the legal framework required to apply the provisions of Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, published in the Official Journal of the European Union no. L 133/66 of 22 May 2008 and its purpose is to develop the legal framework necessary to ensure the protection of consumers' economic interests by creating fair conditions for obtaining consumer credits, as well as by establishing responsible behaviour rules for creditors in granting credits to consumers.

On the other hand, lack of any regulation act, guidance and procedures on the field of responsible lending makes difficult to apply legislation in practice. There is no

legislative or normative act that would clearly set out and treat the principles of responsible lending. Also an impediment is the lack of adequate enforcement of the current legal provisions. Now the content of the measures and accessible resources is not available to support enforcement of the process of implementation of responsible lending principles.

The Government of Republic of Moldova is concentrated in solving economic problems and macroeconomic issues and draws less attention to social questions.

The National Bank of Moldova now is focused on issues related to prudential regulation and in the field of banking regulation and supervision financed by the European Union in the context of the European Union Directive 2013/36/EU (Basel III) and Regulation 575/2013 (CRD IV) and not on the subject of responsible lending. However the good part is that National Bank of Moldova requested to all banks to create and approve a Strategy to reduce the share of non-performing loans.

Absence of progress in launching of responsible lending principles is caused by the relative lack of concerns that government and regulatory have for consumers, concentrating instead on macro-economic issues and prudential regulation.

The challenge remains in the details, too often regulatory action has been late in coming or ineffective, thus we recommend the following:

- all creditors should be subject to oversight by a single effective regulator;
- all creditors should be licensed and regulated by a single effective regulator;
- this regulator should have sufficient powers and resources to effectively control all creditors' market behaviour;
- regulator should monitor data about complaints and levels of consumer debt at the national level;
- regulator should have the power to apply sanctions proper to the degree of transgression, including withdrawal of license for serious gaps.

On the consumer rights field is recommended to create a responsible authority for consumer rights regarding financial activity. We consider that such authority should be created, as it is very important especially for the debtors and all the lending market. Where there is worry about high rates of credit products, this competition authority should investigate whether markets are competitive and, if required, take action to promote competition. If the market fails to keep rates at a reasonable level, regulator may consider the use of rate caps. For other fees and charges should be able to present their reasonableness confirmation.

Also in the content of consumers rights, creditors should have access:

- to the effective complaint mechanisms and dispute creditor's resolution;
- to independent advice if they are concerned that they may have not been treated fairly by a creditor;
- to expedient, inexpensive and efficient third-party mechanisms for dispute resolution in case those consumers are not satisfied with a creditor's response.

Taking into consideration the international practice, we suggest to introduce into national regulation and to apply the concept of financial consumer ombudsman - an official appointed to investigate individuals' complaints against maladministration in finance and for dealing with specific complaints concerning regulated financial service providers.

Regarding to the marketing and advertising practise on local credit market is to mention that often creditors do not comply with the legal provisions in this field. There for

we consider that should be a specific marketing code for financial institution, especially for credit products, enforceable with sufficient penalties to prevent abuse and noncompliance.

This code should include also the following request:

a) Creditor should comply with the general practices to ensure that advertising is not confusing for consumers. In this field creditor has to make sure that the key information is legible, audible and take care to disclose information in a level of detail that is commensurate with its importance, set out advertisements in a way that allows them to be readily understood by the intended audience, offered information can be readily understood by consumers without specialist knowledge.

b) When advertisements refer to fees or costs creditor ensure avoidance of giving an unrealistic impression of the overall levels of fees and costs of the credit products.

c) When advertisement refers to an interest rate or an amount of interest, creditor should display an annual percentage interest rate at least as prominently as any other interest rate or amount of interest, note if that rate is fixed, variable or capped and inform the consumer about applied fees that the debtor must pay when entering the agreement.

On financial education field, the following recommendations would be appropriate:

a) In order to support the existing initiative of customer information and financial education, the government in common with the National Bank of Moldova should be actively involved in the process of financial education and informing about responsible lending, while the developing consumer's abilities to use in practice that information.

b) Introduction of compulsory lessons in financial education into the school curriculum instead of optional lessons available now with the aim of increasing the level of consumer education starting from the young. Another question is the qualification of the teacher. In our opinion it should be a specialist in the field of economics, while the ability to explain quite difficult topics into the understandable mode for each age.

c) Including into market research questionnaires topics about financial education and responsible lending of the respondents in order to establish the level of knowledge an existing gap in this field.

6. Conclusion

➤ According to the actual regulation of consuming lending, creditors are not directly responsible for consumers' decisions, considering that debtors possess all information about credit products and other relevant data.

➤ If the responsible lending principles will be approved and come into force, the creditors will have to take a much more active role when considering the customer's ability to repay a loan and this is one of significant change in approach to the regulation of consumer lending. It has the potential to significantly change the processes and compliance obligations of creditors in the consumer's lending. This will result in a decreasing of credit risk and thus of the share of non-performing loans.

➤ National Bank of Moldova should elaborate and approve regulations on responsible lending field, should define over-indebtedness for their authority, the methodology how to avoid over-indebtedness situations and solutions to apply in case of debtor's entrance into over-indebtedness. Also the National Bank should take reasonable steps to require and monitor compliance with the regulatory acts in

the field of responsible lending and should establish or support the establishment of independent debt counselling centres which also mediate on behalf of consumers.

➤ All categories of licensed lending institutions in the Republic of Moldova should develop and implement the policies, procedures and provide trainings for their employees that are necessary to ensure compliance with the principles of responsible lending.

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