

Banking systems dominate the financial sectors of PDMCs. This chapter examines the performance of these systems during the late 1990s and the prudential frameworks within which they operate. Recommendations are made concerning supervisory systems.

BACKGROUND

Financial systems in PDMCs covered in this report consist largely of a small number of mostly foreign banks and, excepting Kiribati, a central bank performing the regular central banking functions, including issuing currency, formulating and implementing monetary policy, managing foreign exchange reserves, and fulfilling prudential regulatory functions. In some PDMCs, in addition to supervising the banking and insurance industries, central banks also supervise nonbank financial institutions (NBFIs). In other cases, NBFIs are supervised by the Ministry of Finance. In Kiribati, the commercial bank is supervised by its parent company in Australia, and NBFIs are self-supervised and overseen by the Ministry of Finance. The level of autonomy of central banks varies from country to country. The Fiji Islands' central bank probably has had the most autonomy and PNG's the least.

The Fiji Islands and PNG each have six commercial banks (five foreign and one domestic in the Fiji Islands, and four foreign and two domestic in PNG). Vanuatu has four banks; Samoa,

Solomon Islands, and Tonga have three; and Kiribati has one. All PDMCs except Vanuatu have one state-owned development bank; all except Tonga have a national provident fund (NPF); and all have one or two housing finance corporations, pension funds, life and nonlife insurance funds, a few housing finance corporations and (in the Fiji Islands and PNG) merchant banks. PDMCs also have credit unions, other emerging microfinance institutions (MFIs), and a network of informal financial institutions. The Fiji Islands and Vanuatu also have asset management banks to recover restructured banks' debts. Samoa and Vanuatu have offshore financial centers that are not examined in this report (but see Hughes 1998). In terms of the range of products, the Fiji Islands' finance sector is the most advanced, followed by PNG's. Each of these two countries has a functioning stock exchange.

Commercial banks held almost half the total assets of the financial sectors of PDMCs during the period 1994–1999, ranging from a low of about one third in the Fiji Islands to a high of 84 percent in Vanuatu (Table 3.1). All the foreign commercial banks are highly profitable because of their strong systems and dominant market positions. While data availability is limited, the spread between interest charged on loans and that paid on deposits is indicative of large profits, even allowing for high unit costs due to diseconomies of scale. The average nominal interest spread approached 8 percent in 1999, up from just over 6 percent in 1994 (Table 3.2). Spreads rose in all PDMCs except Samoa and Tonga, where there were slight reductions. This suggests a decline in competition in the banking sector, which may be part of the explanation. However, it is also likely that greater spreads reflected more effective pricing for risk. Countries with the highest risk—PNG and Solomon Islands—had the highest spreads (Table 3.2).

The measurement for access to banking—number of people per branch or agency—varied considerably across PDMCs in 1998–1999: 32,889 for PNG, 13,364 for Solomon Islands, 10,500 for Samoa, 8,463 for Vanuatu, 8,300 for Tonga, 6,010 for the Fiji Islands in 1997, and 3,248 for Kiribati. Bank operations are concentrated in urban centers, so that these figures do not reveal urban-rural disparities in access to banking facilities. Access for rural populations is especially poor in the

Table 3.1
Assets of Commercial Banks, NBFIs, and Provident Funds,
1994–1999

	1994	1995	1996	1997	1998	1999
Assets of Commercial Banks	(Percent of Total Assets of Financial Sector)					
Fiji Islands	36.8	36.5	35.9	33.1	30.9	32.6
Kiribati	47.7	46.4	45.0	43.1	42.4	41.6
Papua New Guinea	46.1	46.6	45.7	46.8	47.8	–
Samoa	36.5	37.4	38.8	40.8	40.4	42.4
Solomon Islands	45.7	44.6	42.8	40.9	37.6	39.2
Tonga	49.2	51.9	52.5	54.4	56.5	57.9
Vanuatu	78.6	78.0	79.6	79.4	83.5	83.3
Average	48.7	48.8	48.6	48.4	48.4	49.5
Assets of Nonbank Fin. Insts.						
Fiji Islands	51.1	52.1	51.3	54.6	53.9	51.5
Kiribati	52.3	53.6	55.0	56.9	57.6	58.4
Papua New Guinea	19.7	20.2	19.3	18.7	19.7	–
Samoa	41.9	41.0	39.6	38.1	40.4	40.5
Solomon Islands	35.0	35.9	34.3	34.6	34.4	34.5
Tonga	21.6	23.1	23.2	22.9	20.9	18.5
Vanuatu	6.1	6.9	7.1	7.6	1.2	2.1
Average	25.2	25.8	25.5	25.5	24.9	25.7
o/w Provident Funds						
Fiji Islands	30.3	30.8	31.4	34.5	34.5	33.3
Kiribati	47.8	49.0	50.4	52.2	53.0	53.9
Papua New Guinea ^a	10.8	11.9	12.1	11.4	12.1	–
Samoa	21.5	21.4	21.3	21.6	23.2	23.5
Solomon Islands	31.2	31.8	30.1	30.0	29.8	28.4
Tonga ^b						
Vanuatu						
Average	19.6	20.2	20.2	20.5	19.9	21.6
o/w Development Banks						
Fiji Islands	6.1	6.4	6.3	6.6	6.9	5.8
Kiribati	4.5	4.6	4.6	4.7	4.6	4.6
Papua New Guinea	1.6	1.6	1.5	1.5	1.5	1.5
Samoa	10.5	10.0	9.3	7.8	8.1	8.2
Solomon Islands	3.8	4.1	4.2	4.6	4.6	4.6
Tonga	19.9	21.3	21.6	21.4	19.5	15.2
Vanuatu	2.3	2.1	1.7	–	–	–
Average	7.0	7.2	7.0	7.8	7.5	6.7

a. Pension Funds.

b. Tonga does not have a Provident Fund.

Sources: Central banks, Fiji Islands, PNG, Samoa, Solomon Islands, Tonga, and Vanuatu; commercial bank, Kiribati.

Table 3.2
Nominal and Real Returns on Savings and Lending, 1994–1999

	1994	1995	1996	1997	1998	1999
Average Deposit Rates						
						(percent)
Fiji Islands	6.70	6.78	5.77	5.18	4.01	2.88
Kiribati	4.40	3.80	3.20	1.80	1.60	1.20
Papua New Guinea	4.50	9.40	4.00	5.10	8.70	8.50
Samoa	5.50	5.50	5.50	5.50	5.50	5.50
Solomon Islands	7.66	7.39	4.76	1.84	4.36	3.28
Tonga	4.50	4.90	5.20	5.30	5.00	4.80
Vanuatu	5.35	4.90	4.95	4.35	5.45	4.14
Average Lending Rates						
Fiji Islands	11.29	11.10	11.57	10.17	9.11	8.47
Kiribati	9.70	9.70	9.70	9.70	9.70	9.70
Papua New Guinea	10.00	15.40	10.20	10.60	20.20	18.20
Samoa	12.00	12.00	12.00	12.00	11.38	11.13
Solomon Islands	16.23	16.64	16.39	14.54	14.13	13.74
Tonga	9.00	9.00	9.00	9.00	9.00	9.00
Vanuatu	13.80	12.70	12.70	13.20	15.00	14.10
Real Average Deposit Rates						
Fiji Islands	6.10	4.60	3.40	2.70	-1.70	0.90
Kiribati	-0.90	0.20	5.40	0.30	-2.10	0.80
Papua New Guinea	1.70	-7.80	-7.90	1.20	-4.80	-6.50
Samoa	-6.60	8.40	0.10	-1.30	3.25	4.90
Solomon Islands	-5.66	-2.19	-7.00	-6.24	-8.04	-4.72
Tonga	4.10	2.10	3.20	2.30	1.10	-0.50
Vanuatu	3.10	2.70	4.10	1.60	2.10	2.14
Real Average Lending Rates						
Fiji Islands	10.70	8.90	8.50	6.80	3.40	6.50
Kiribati	4.40	6.10	9.00	9.40	4.70	9.30
Papua New Guinea	7.20	-1.80	-1.70	6.70	6.70	3.30
Samoa	-0.1	14.90	6.60	5.20	9.18	10.53
Solomon Islands	2.91	7.06	4.63	6.46	1.73	5.74
Tonga	8.60	6.20	7.00	6.00	5.10	3.70
Vanuatu	11.50	10.50	11.80	10.40	11.70	12.10
Nominal Interest Spread						
Fiji Islands	4.60	4.30	5.80	5.00	5.10	5.60
Kiribati	5.30	5.90	6.50	7.90	8.10	8.50
Papua New Guinea	5.50	6.00	6.20	5.50	11.50	9.70
Samoa	6.50	6.50	6.50	6.50	5.88	5.88
Solomon Islands	8.57	9.25	11.63	12.70	9.77	10.46
Tonga	4.50	4.10	3.80	3.70	4.00	4.20
Vanuatu	8.45	7.80	7.75	8.85	9.56	9.96
Average	6.20	6.26	6.88	7.16	7.70	7.76

Sources: Central Bank Quarterly Bulletins; commercial bank, Kiribati.

Melanesian countries, where population is dispersed and physical geography is a hindrance.

In some PDMCs, financial systems came under stress in the 1990s. State-owned commercial banks in the Fiji Islands, PNG, and Vanuatu almost failed, and have been restructured and recapitalized. One foreign-owned commercial bank in Tonga failed to make profits and was under threat of closure. As discussed in the next chapter, stress in financial systems is still reflected in the precarious financial situation of government-owned development finance institutions (DFIs) in all PDMCs, and in problems with the management of provident funds in PNG, Solomon Islands, and Vanuatu.

FINANCIAL DEEPENING AND INTERMEDIATION

Economies that have enjoyed a higher level of financial development and intermediation, as measured by assets and liabilities of the banking sectors, have also tended to experience faster growth. Several ratios are used here to measure financial deepening and the level of financial development.

There was very little progress in financial deepening between 1994 and 1999. Indeed, during this period, the ratio of broad money to GDP fell in the Fiji Islands, Kiribati, Solomon Islands, and Vanuatu, indicating a reversal of financial deepening (Table 3.3). Much of this reversal was due to the near failure and restructuring of some state-owned commercial banks because of the high proportion of government loans on the books (for example, the restructuring of the NBF in 1996 and 1997); the precarious financial situation of government-owned DFIs (Solomon Islands and Vanuatu); poor management in the Development Bank of Kiribati; and problems with the management of provident funds (Solomon Islands and Vanuatu). The ratio of broad money to GDP rose slightly in PNG and Samoa, and more substantially in Tonga. The reversals and increases are revealed, respectively, in rising and falling ratios of narrow money to broad money. Countries experiencing a reversal also exhibited rising ratios of currency in circulation to narrow money.

The Fiji Islands' measurement of financial deepening of around 50 percent is the highest of all PDMCs, reflecting a

Table 3.3
Financial Deepening Statistics, 1994–1999

	1994	1995	1996	1997	1998	1999
Currency	(percent of GDP)					
Fiji Islands	5.0	4.9	4.9	5.1	5.7	6.1
Kiribati	0.7	1.0	1.3	1.2	1.2	1.7
Papua New Guinea	3.0	2.9	3.0	3.3	3.6	3.7
Samoa ^a	3.6	4.5	4.0	4.1	3.9	2.8
Solomon Islands	4.4	4.9	4.6	5.1	5.6	5.8
Tonga ^b	3.4	3.0	2.7	2.5	3.0	3.1
Vanuatu	5.5	5.9	5.6	5.6	6.9	5.9
Narrow Money						
Fiji Islands	15.0	16.1	17.9	17.0	17.6	22.5
Kiribati	10.3	12.7	15.6	15.2	12.8	14.1
Papua New Guinea	10.3	10.2	12.5	13.5	13.2	13.3
Samoa ^a	10.0	12.8	11.6	11.4	10.3	9.9
Solomon Islands	13.6	15.2	15.3	15.2	15.2	14.6
Tonga ^b	11.5	9.8	10.1	9.7	10.4	10.6
Vanuatu	23.4	23.6	23.1	22.4	25.6	24.7
Broad Money						
Fiji Islands	61.6	61.4	58.3	51.9	48.2	50.0
Kiribati	58.9	51.0	55.8	48.5	50.9	51.7
Papua New Guinea	30.0	29.2	35.2	38.1	34.3	31.1
Samoa ^a	29.3	35.3	33.4	33.1	32.6	31.3
Solomon Islands	27.2	30.5	30.4	30.1	30.3	24.2
Tonga ^b	32.7	31.9	36.7	35.6	37.8	37.2
Vanuatu (vatu) ^c	42.0	39.6	38.9	36.6	41.0	40.2
Vanuatu (vatu plus foreign currency)	94.1	106.6	111.6	106.0	119.2	112.8

a. Data for Samoa are only to June 1999.

b. Tonga's data are on a fiscal year basis.

c. For Vanuatu, broad money is shown in both vatu liquidity and total liquidity; the latter include foreign currency deposits. The share of local depositors in foreign currency deposits appears to be small, given a minimum deposit requirement of US\$5,000. Therefore, the stage of financial deepening in Vanuatu is better measured by vatu liquidity.

Sources: Central bank bulletins.

more developed financial sector. Kiribati's high ratio reflects the impact of large net overseas income flows rather than true financial deepening; and the ratio has fallen over the period, partly because of diminishing nominal and real interest rates on time deposits.

In terms of total domestic credit expansion measured in percent of GDP, the Fiji Islands and Vanuatu are the most advanced, followed by PNG and Tonga (Table 3.4). However, the low ratio for countries such as Kiribati and Samoa reflects large payments by the Government to the banking system; hence private sector credit as a percentage of GDP is a more meaningful statistic. This ratio shows considerable increase in Samoa, Tonga, and Vanuatu.

The ratio of credit to banking assets shows considerable variation across PDMCs (Table 3.4). This ratio is a good indicator of a lack of bankable projects (bearing in mind that the high ratios for PNG and Solomon Islands reflect the high ratio of government borrowing from the banking system rather than a high level of bankable projects). The Fiji Islands' ratio has fallen over the period, reflecting the problems of the NBF and the poor quality of some of its loans. The very low and falling ratio for Kiribati indicates an increasing difficulty in finding lending possibilities: Kiribati's financial resources are being used to generate economic activity overseas rather than at home. This latter outcome is understandable, given the limited opportunities for domestic investment and the fact that most bankable projects are already serviced. In general, the ratio of credit to banking assets is a reflection of the foreign commercial banks' lending only to low-risk projects, and of the high level of liquidity that exists in most PDMCs.

Interest rates on deposits fell during 1994–1999 in the Fiji Islands, Kiribati, Solomon Islands, and Vanuatu (Table 3.2). They rose in PNG and remained fairly stable in the other PDMCs. Lending rates fell in the Fiji Islands and Solomon Islands; remained comparatively stable in Kiribati, Samoa, and Tonga; and rose in PNG and Vanuatu. The spread between average deposit and average lending rates widened considerably for all PDMCs except Samoa and Tonga. As noted above, these spreads are indicative of the large profits commercial banks are making, despite the high operation costs arising from geographical factors, small size of loans, high default risk, and limited availability of collateral. The Samoan figures are for base rates only; and if allowance is made for pricing according to risk, the spread is likely to have increased. In the case of Tonga, there was increased competition in the

Table 3.4

Domestic Credit Statistics, 1994–1999

	1994	1995	1996	1997	1998	1999
Total Credit						
						(percent of GDP)
Fiji Islands	54.7	52.8	51.7	45.3	43.9	41.6
Kiribati	8.3	7.1	6.2	-23.9	-7.9	—
Papua New Guinea	31.6	28.2	27.4	34.0	35.2	31.0
Samoa	8.5	13.1	12.5	10.8	9.7	12.4
Solomon Islands	33.2	31.4	27.6	26.5	24.6	22.2
Tonga	26.2	28.3	32.8	37.3	35.0	34.3
Vanuatu	30.1	31.6	22.6	31.7	38.6	38.0
Private Sector Credit						
Fiji Islands	47.1	46.3	45.6	39.0	38.2	37.0
Kiribati	4.6	4.5	3.9	6.8	4.7	—
Papua New Guinea	15.4	13.4	11.3	15.6	17.8	16.4
Samoa	16.3	21.0	22.4	23.0	25.7	26.1
Solomon Islands	11.1	11.1	10.1	10.2	12.3	11.3
Tonga	24.4	25.7	28.3	32.9	32.9	33.1
Vanuatu	34.9	35.9	35.2	32.9	36.3	43.4
Total Credit/Banking Assets						
Fiji Islands	75.3	71.2	70.5	68.9	62.8	54.7
Kiribati	12.5	11.6	9.8	-36.9	-12.8	—
Papua New Guinea	82.9	78.1	68.8	75.7	80.7	—
Samoa	38.6	56.0	53.7	49.3	48.5	72.6
Solomon Islands	98.5	101.9	89.0	86.8	78.6	69.0
Tonga	41.7	45.5	49.3	54.3	42.8	48.1
Vanuatu	24.9	25.1	26.2	24.1	28.3	28.1
Broad Money/GDP-Total Credit/GDP						
Fiji Islands	6.9	8.6	6.6	6.6	4.3	8.4
Kiribati	50.6	43.9	49.6	72.4	58.8	51.7
Papua New Guinea	-1.6	1.0	7.8	4.1	-0.9	0.1
Samoa	20.8	22.2	20.9	22.3	22.9	18.9
Solomon Islands	-6.0	-0.9	2.8	3.6	5.7	7.4
Tonga	6.5	3.6	3.9	-1.7	2.8	2.9
Vanuatu (vatu)	11.9	8.0	16.3	4.9	2.4	2.2

Sources: Central bank bulletins.

banking sector as a result of the entry of two new banks in 1993, although the effects of this were diminishing by 1999.

To promote financial deepening, most PDMCs have made efforts to promote savings by maintaining positive real deposit rates. Some have been more successful than others. Samoa's real deposit rates reached almost 5 percent in 1999, reflecting the move toward market determination of interest rates.

However, it has been difficult for PNG and Solomon Islands to maintain positive real interest rates, because of inflationary pressures caused by large government borrowing.

One approximate means of assessing the extent of excess liquidity in the banking system is to calculate the gap between the ratios of broad money to GDP and domestic credit to GDP. Broad money as a percentage of GDP shows the amount of liquidity available; domestic credit as a percentage of GDP provides an indication of the number of bankable projects in the economy (although government borrowing also is a source of credit growth). Kiribati has the largest gap, almost 59 percentage points in 1998. Samoa has the next largest, almost 23 percentage points in 1998 (reflecting large government deposits with the banking system), followed by the Fiji Islands, Solomon Islands, Tonga, Vanuatu, and PNG (Table 3.4). The relatively low gaps in PNG, Solomon Islands, and Vanuatu reflect large net government financing from the central banks.

Restrictions on foreign exchange transactions have also been a cause of high liquidity in PDMCs. For all except Kiribati and Vanuatu, the external position, particularly the foreign reserve position, has been the major focus of central banks. The average reserve position of PDMCs in 1999 was over 4 months of imports of goods and services (Table 3.5). Measures to preserve foreign reserves have been and still are in place. Restrictions are placed on foreign exchange transactions. All governments except those of Kiribati and Vanuatu require proceeds from exports and invisibles to be repatriated and surrendered to authorized foreign exchange dealers. As to capital transactions, all PDMCs except Kiribati and Vanuatu control outward investments by residents, though most have relaxed these controls in recent years. Kiribati has a very high level of foreign reserves because of its trust funds. The Fiji Islands, Samoa, and Vanuatu have had comfortable levels of foreign exchange, whereas PNG, Solomon Islands, and Tonga have had lesser degrees of comfort.

High levels of liquidity in PDMCs at base reflect a scarcity of bankable projects, which is partly the result of a lack of profitable investment opportunities, and partly the result of the inability of potential borrowers to access finance effectively (see chapter 8). Difficulty of access to finance is caused in part

by poorly prepared loan applications and the absence of track records, but a more problematic cause is the inability of potential borrowers to use land as collateral. In addition, high default risks and problems in using legal systems for collecting on nonperforming loans constrain bank lending.

Table 3.5
Gross Official Foreign Exchange Reserves, 1994–1999

	1994	1995	1996	1997	1998	1999
	(in months of imports of goods and services)					
Fiji Islands	2.9	3.7	4.0	3.8	4.8	4.8
Kiribati	64.8	61.2	60.0	69.6	88.8	127.2
Papua New Guinea ^a	0.9	3.0	5.4	3.3	2.2	2.0
Samoa	5.4	4.9	5.3	6.0	6.0	6.0
Solomon Islands	0.8	0.8	1.6	1.2	2.7	2.7
Tonga ^b	3.8	3.8	3.2	2.4	3.3	2.3
Vanuatu	7.4	7.6	6.7	5.9	6.2	6.7
Average excluding Kiribati	3.5	4.0	4.4	3.8	4.2	4.1

a. Nonmineral imports of goods and services.

b. In fiscal years.

Source: Central banks; commercial bank, Kiribati.

COMPETITION

Banking sectors in PDMCs are oligopolistic and dominated by foreign banks. A lack of competition has permitted them to maintain high interest margins and high profitability, locating operations mainly in urban areas and showing little interest in provision of banking services to rural areas. The lack of effective competition is not due to restrictions on interest rates, product innovations, branching, or the entry of new institutions, so much as to the smallness and narrowness of PDMC financial markets. National provident funds (NPFs) deposit funds with commercial banks and make some loans to members, but their competition with commercial banks is very limited. DFIs, with their low quality assets and low profitability, are in no position to compete effectively with commercial banks.

As expected in an oligopolistic market structure, there is little price competition, particularly on the deposit side, because of the high levels of liquidity. The evidence on existing product differentiation and price differentiation in banking sectors supports this observation. When local banks are operating (for example, NBF), or when new foreign banks have entered the market (for example, when ANZ Bank [ANZ] and MBf Bank of Malaysia [MBf] started operating in Tonga), there have been periods of more competition. In the Fiji Islands, the competitiveness of the banking environment declined temporarily as a result of the collapse of NBF; in Tonga, as a result of the effective demise of MBf. Nonprice competition (mainly in the form of banking services) seems to be the main form of competition, but there are signs that this form of competition is declining and that the quality of services in banks is deteriorating.

Limitations on foreign investment by NPFs in most PDMCs have compelled them to invest in government paper, and to deposit excess liquidity in commercial banks. This has exacerbated the excess liquidity situation, as well as hindering financial market development. With liquid funds in hand, commercial banks have no need to borrow from central banks, do not need to compete for deposits, and do not need to develop interbank financing. The high level of liquidity held by NPFs also makes it very costly for central banks to mop up liquidity. This constrains the development of market-oriented monetary policy, and prevents properly functioning primary and secondary money markets from developing.

With few traded securities, small or nonexistent capital markets, no traded government bonds, no specialized intermediaries, and no ability to invest overseas, people's savings take the form of demand deposits and savings accounts with commercial banks. The absence of competition for savings leads to low interest rates on deposits, which are a disincentive to save.

The lack of efficient and competitive NBFIs has also inhibited competition. Apart from NPFs, NBFIs are small and do not appear to be capable of providing effective competition to banks in most of the deposit-related products. In some cases (especially NPFs), certain loan products and services to members

are offered, such as drawing on savings, housing and vehicle loans, leasing and agricultural loans. This puts a little competitive pressure on commercial banks, most notably in the cases of Samoa's National Provident Fund for residential housing and commercial properties and Vanuatu for housing loans. Price discounting on home loans in the Fiji Islands also reflects the competitiveness of NBFIs. However, for the most part the NBFIs do not compete for a large enough number of products offered by the banks to have a significant overall impact. Similarly, credit unions and other MFIs are too small to be able to compete.

Poor dissemination of information in most banking sectors also indicates a lack of competitiveness, as does the lack of adequate complaints systems or mechanisms to handle disputes. In addition, there are indications that spending on infrastructure and staff training is lower than in more competitive systems.

The exit of banks from the market and the entry of new ones are facilitated in most PDMCs by their licensing and supervision policies. Nonetheless, entry and fixed costs may be quite high because of the smallness of markets, the length of time needed to build up a business, and the need for capital investment in highly concentrated markets dominated by ANZ, Westpac Banking Corporation (Westpac), and the Bank of Hawaii. Perhaps official transfers and concessional loans, which finance a large portion of investment in PDMCs, constitute the biggest competition for commercial banks.

Even given the diseconomies of scale in PDMC banking sectors, it should be possible to promote competition for loans to large borrowers, and for deposit taking in urban areas, by encouraging the development of specialized intermediaries. For example, finance and leasing companies could spur competition in the market for loans. Small, specialized institutions can force even big, oligopolistic banks to behave competitively. For example, the foreign exchange bureaus that have been operating in Samoa and Vanuatu have markedly increased competition in foreign exchange transactions.

Box 3.1
Best Practice for Competition Among Financial Institutions

Promotion of healthy competition should be the guiding objective in decisions with regard to entry and exit of financial institutions. Free entry should be facilitated, subject to fulfillment of prudential requirements and avoidance of conflict of interest due to nexus with potential borrowers. Supervisory actions regarding failing banks should be mandatory and well specified, and competitive considerations should weigh in decisions on mergers. For PDMCs' private sector growth, more nonbank financial intermediaries and market-oriented money markets are important to competition, because they will lead to larger financial markets and more competition for foreign banks.

Governments should ensure that all financial institutions are placed on an equal and competitive basis. This implies that PDMCs should not reserve any specific functions or business activities to wholly or substantially state-owned financial institutions and should not provide funding or other assistance on preferential terms, including government guarantees, to such institutions. If governments wish to support social services through development banks, this should be explicitly shown in the budget.

**PRUDENTIAL FRAMEWORK, SUPERVISION, AND
CENTRAL BANK AUTONOMY**

An effective supervisory authority needs a comprehensive and effective set of banking laws and regulations, adequate financial and human resources to carry out its obligations, and independence from government. The prudential framework varies in degree of maturity across PDMCs, depending on the level and scope of reporting, the degree of competition in the market, and the degree of

independence of the respective central banks from government. Central banks have the authority and responsibility to supervise commercial banks, as set out in central bank acts (or reserve bank acts) and, more recently, in financial institutions acts. The development of a supervisory capacity began at different times in different PDMCs—in the early 1990s in the Fiji Islands, Samoa, and Tonga, and in the latter half of the 1990s in PNG, Solomon Islands, and Vanuatu.

The PDMCs' financial institutions acts pertain to licensing, capital requirements, limits on lending to related parties, and limits on risks to single borrowers. Amendments have given central banks the ability to flexibly issue prudential regulations in line with international standards. These amendments generally follow the Basle conventions in establishing the capital adequacy ratios required for banking institutions, and allow central banks to issue guidelines setting out broad policies that banks are required to adhere to. Regulations on loan classification, loan loss provisioning, and interest accrual have also been issued, in line with international practices. Most central banks have adopted risk-weighted capital adequacy guidelines (most of which are above the 8 percent norm for risk-weighted assets set by the Basle Committee for developed economies).

Most central banks monitor and evaluate the overall strategies, policies and performance of commercial banks through a regular reporting system. The banks are monitored for compliance with the terms of their license and with prudential standards, such as capital adequacy limits and credit exposures. The majority of regulations are properly functional and banks can generally comply. All PDMCs are carrying out off-site supervision, which consists of the analysis of monthly reports that banks are required to submit on their financial condition. PDMCs are also carrying out some on-site supervision. Central banks are receiving assistance from ADB and IMF to develop policies (including those on classifying loans and strengthening risk weighting) on prudential supervision and on strengthening reporting to central banks.

Foreign-owned banks in PDMCs are small affiliates of large banks—ANZ and Westpac in Australia and the Bank of Hawaii in the United States—and are subject to supervision in the home country. The international management controls

of these banks have presumably ensured that, despite weak supervisory capacity in most PDMCs, these foreign banks have been adequately supervised. However, the locally owned banks and NBFIs have had fewer internal management controls and less experience on which to draw, and many of them have become susceptible to political influence and encumbered with low-quality assets. As a result, several locally owned banks have failed through lack of capital and have had to be restructured, taken over, or closed down. For similar reasons, DFIs in many PDMCs have also become encumbered with low-quality assets, forcing them to amalgamate with commercial banks or to be restructured. Most are now looking at mobilizing their own funds and strengthening their systems to price loans according to risk. Some NPFs have also been poorly managed and have become susceptible to political influence. The assets of members have been badly invested and rates of return have been low, even negative.

There is a need to enhance the capacity of central banks to conduct banking supervision effectively, through adequate enforcement of prudential regulations and through more autonomy from governments. In most PDMCs, the central bank has some legal autonomy, but governments still have the power to overrule the central bank. Disputes have occurred mostly when banks are being licensed, or when failing banks are being closed or restructured. In a number of PDMCs, the government has not allowed the central bank to act without its approval. The near failure of a few locally owned commercial banks has brought into question whether central banks have the necessary autonomy to effectively force restructuring or closing down of insolvent commercial banks. In the Fiji Islands, for example, the Reserve Bank of Fiji (RBF) first raised warnings about NBF's solvency in 1991, but lacked the political support necessary to enforce a solution. The losses and illiquidity continued to mount until, in 1995, the Government was forced to admit that the bank was in difficulty. In Tonga, there is considerable concern about the financial status of a foreign bank (MBf) that suffered losses as a result of credit card fraud and foreign exchange losses. The performance of the foreign bank has brought to light the weaknesses in the capacity of the central bank to license commercial banks and to deal with

Box 3.2

NBV's Failure and ADB's Response

In response to the difficulties experienced by NBV, ADB undertook a strategic review of Vanuatu public sector financial institutions, to help the Vanuatu Government develop a comprehensive strategy toward them. The review, which was part of the Comprehensive Reform Program, revealed that there had been serious mismanagement at all these institutions, particularly with regard to the granting and monitoring of loans and to the quality of information about any action being taken. In addition, the system within NBV was inadequate for a modern retail bank, and the local management team was poorly equipped to manage a retail banking operation. Following the strategic review the following actions were implemented.

- NBV and the Development Bank of Vanuatu (DBV) were integrated.
- A separate and independent Asset Management Unit (AMU) was established to manage all the bad and outstanding loans of NBV, DBV, and VNPF. All these loans were transferred to the AMU, which took responsibility for the recoveries from these loans.
- The good loans of DBV were transferred to NBV.
- A senior management team of expatriate banking specialists was recruited for NBV for a limited period,

cont. next page

insolvent commercial banks without Government approval. The National Bank of Vanuatu (NBV), a State-owned bank with a history of unprofitability, became technically insolvent in 1997; the Reserve Bank of Vanuatu was forced to establish a supervision department in 1997 and to pass a Financial Institutions Act in 1999.

Box 3.2 (cont.)**NBV's Failure and ADB's Response**

to take responsibility for the implementation of the strategic plan that had been prepared as part of the review.

- NBV was recapitalized by injecting equity of 400 million vatu. This was to ensure that NBV met its capital adequacy requirements.
- The administrative and investment functions of VNPF were separated. The investment function was subsequently outsourced to an international fund manager.
- An independent monitoring team, chaired by an independent chairman and consisting of senior representatives of the financial, commercial, and private sectors of Vanuatu, was established. It succeeded in carrying out the above actions and bringing about an improved performance by NBV.

At the present time, NBV is running profitably and VNPF returns are improving.

However, a consequence of these actions has been the almost total lack of any development lending taking place. In response to this situation, ADB has been examining alternative approaches and at the present time is working to introduce a small loan scheme that will be administered through the NBV, using its extensive branch network and outreach to the rural communities and outlying islands.

The various legislative acts covering the operations of the central banks need to be strengthened to ensure their independence. RBF has the strongest framework in place, in conjunction with the size and level of development of its financial sector, but the autonomy of other central banks, for example in both PNG and Solomon Islands, has been

compromised. In PNG, there has been a history of intervention by the Government, including interference with the membership of the Board of the PNG Central Bank. Regulatory concerns have included political intervention, termination of senior managers, requests for political loans, large and highly risky exposures, strong incentives for higher lending growth, and uncertainty about future profits. A 1999 World Bank study of the financial sector in PNG observed: "Prudential supervision of the sector remains minimal with formal arrangements only in place for the commercial banks and some licensing and reporting requirements for other entities" (World Bank 1999). The new Government elected in August 1999 is taking steps to address these concerns, including amending its banking act to require greater central bank independence. The amendments will allow enhanced regulation of banks, financial institutions, and bank holding companies, while permitting a focus on stopping the setting up of pyramid schemes. Central bank procedures are also being strengthened in Samoa through a reorganization of the Central Bank of Samoa (CBS), which will allow departmental responsibilities to be focused more tightly on a liberalized financial system.

NBFIs often do not come under the central bank's supervisory framework, despite the fact that a considerable portion of outstanding credit is attributable to NBFIs. In most PDMCs, the legislation covering the respective NBFIs does not contain prudential guidelines; sometimes NBFIs are supervised by ministries of finance or are self-supervising. There is also a great deal of ambivalence by the supervising authorities about the validity of having NBFIs as part of the prudential supervision regime.

A similar ambivalence exists regarding prudential supervision of DFIs, even though supervision is critical to ensuring and maintaining stability of financial systems. DFIs, however, are very different institutions from commercial banks, and it may not be entirely appropriate to impose the same criteria for prudential for both. While a number of DFIs raise funds from the market at the present time, none of them accepts retail deposits and certainly not demand deposits. Therefore, they are not under the same potential liquidity pressures as commercial banks, and do not risk a run on funds. At the same

time, DFIs are at the high-risk end of the lending spectrum, and are vulnerable to falling capital and equity as a result of nonpayment of loans. Thus some supervision is required.

Most reporting relationships between central banks and development banks are on an informal basis. For example, Tonga Development Bank (TDB) reports informally to the National Reserve Bank of Tonga, although there is no formal requirement under any banking act. There were no formal requirements for Rural Development Bank of PNG (RDBPNG) to report to the Central Bank, prior to its incorporation into the Finance Pacific Group. The National Bank of the Solomon Islands holds shares in the Development Bank of Solomon Islands (DBSI); it therefore has a conflict of interest when it comes to supervising DBSI. There is also only informal reporting by DBSI as to the adequacy of its provisioning and its loan classifications. In Samoa, DBS has been reporting informally to CBS and is now moving to formalize its reporting. The Samoa National Provident Fund has also recently started reporting to CBS. This should materially assist CBS in its management of the financial sector.

There are also wide variations in the level and timing of disclosure contained in official publications, such as annual reports of DFIs; many DFIs are reporting very dated information, often more than 12 months old. With such slow reporting, the relevance and significance of the information is questionable. As to disclosure, it is impossible for the public to have confidence in a financial institution that reports its results one to two years late. Moreover, the information disclosed often does not allow for a proper analysis of the DFI's performance, as in the area of provisioning for bad and doubtful loans. It is clear, from the amount of extra provisioning that many DFIs have been required to make following an independent review of the existing provisioning, that there has been some serious underdisclosure of provisioning in the past. This reflects the insufficient attention that has been paid to adopting appropriate provisioning. There is little or no information available on the directors of DFIs, such as information about any associated business or dealings that a particular director may have with the DFI. This will become increasingly relevant as DFIs move to greater levels of self-

funding, and as and when they wish to attract institutional investors.

Common policies are needed on prudential supervision for DFIs in PDMCs. Common minimum standards for disclosure should be agreed upon, including information on all loans above a certain size. Transactions with directors, including details of any loans to directors, should also be divulged. Not all central banks in the region see it as part of their role to supervise DFIs. Nonetheless, DFIs are an integral part of the financial sector, and have the same potential for bringing instability to the sector if they get into difficulties. In addition, PDMCs are too small to have fractured supervision: there should be one institution to supervise banks and nonbanks. Most ministries of finance are poorly equipped to supervise NBFIs, and prudential regulation for NBFIs needs to be consistent with that for banks, while at the same time providing sufficient flexibility to accommodate differences between the operations of NBFIs and banks.

The central banks of some PDMCs also need to develop supervision arrangements for financial conglomerates. For example, the establishment of the Pacific Finance Group in PNG has led to the creation of a major financial conglomerate that includes banking, insurance, development banking, and finance; it raises questions about the best way of supervising such organizations. The operations of the life assurance, general insurance, and superannuation industries in PNG are not subject to any supervisory control. A similar situation has arisen in the Fiji Islands, with the purchase of the NBF by the Colonial Group. PNG is proposing that the Bank of Papua New Guinea (BPNG) become a super-regulator, with a role similar to that of the Australian Prudential Regulation Authority (APRA); APRA was established in response to the number of commercial banks moving into insurance, securities, and funds management. Banking supervisors in the Fiji Islands are also considering using the APRA model to supervise its more complex financial institutions.

While there is a need to enhance the capacity of central banks to supervise banks and NBFIs, financial institutions departments or banking supervision departments in the central banks of PDMCs are too small, and the average length of

experience of staff (except in the Fiji Islands) too short, to enable the departments to operate efficiently. Some central banks have had difficulty in recruiting sufficient numbers of staff with appropriate skills. Despite the considerable amount of training already provided by ADB and IMF, both internally and externally, and through a number of courses and workshops for supervisors conducted by the Pacific Finance Technical Assistance Centre, all financial institutions and supervision departments of central banks still need more training. The recently established regional association of supervisors has identified training as the first priority. Work has also progressed on the design and use of manuals for both on- and off-site supervision. There is also a need to analyze the amendments to the financial institutions acts to see how they compare with internationally accepted norms.

PDMCs should continue to enhance and strengthen the process of regional cooperation and consultation in regulatory and supervisory matters, as initiated in their regional Declaration on Cooperation. They should formally analyze their compatibility with internationally accepted norms and work cooperatively toward establishing a regional supervisory body to supervise foreign banks. This would free up scarce resources in individual PDMCs to supervise local banks, and in particular to unify banking supervision with supervision of NBFIs, particularly DFIs and NPFs. Since poor management has contributed to the difficulties of locally owned banks and NBFIs in some PDMCs, improvements must be made in the skills of management and in the banks' internal systems. Supervisory authorities should focus on these issues.

Box 2.1

Best Practice for Supervision

PDMCs should ensure that the supervisory body is operationally independent, while remaining accountable to the political process. The supervisory body should not inhibit market-led structural change.

PDMCs should give high priority to implementing the Basle conventions on minimum levels of capital adequacy and to following internationally accepted practices for classification of, and provisioning for, nonperforming loans. The capital adequacy levels should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for local banks in PDMCs, these requirements should be higher than those established in the Basle core principles (minimum of 8 percent total capital in relation to risk-weighted assets) and its amendments. NBFIs should also come under central banks' supervision.

The supervisory body must gain and keep the confidence of the industry, by following a clearly defined strategy for achieving the overall objective of creating a sound and efficient financial sector. It should have highly qualified, experienced, and well-remunerated staff. Its financial structure should promote a high standard of performance and independence.