

VI. Financial Markets in the Pacific

There is increasing awareness of the importance of financial markets for promoting economic development. If the financial system does not intermediate between savers and investors, the private sector has no means of financing projects (except for retained earnings and savings, which are generally limited, particularly for small businesses). Furthermore, the financial sector is a vital means of allowing wealth (assets) to be mobilized to provide liquidity for financial capital. Without intermediation, private sector development is hampered in its ability to take advantage of opportunities to invest in profitable projects, which in turn leads to reduced economic growth and poverty reduction. Therefore, the economic development of the Pacific depends largely on financial markets.

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Financial Markets and Economic Development

Since the early 1970s, revolutionary work in information economics has shown that inefficiencies can arise when one of the transacting parties has superior information concerning the value of any transaction. In such circumstances, intermediaries play an important role. Akerlof (1970), Stiglitz and Weiss (1981), and Bernanke (1983) developed the foundation of the modern theory of financial intermediation, based on the ability of banks and other financial institutions to resolve the problems arising from the asymmetries in information between transacting parties.

The absence of financial intermediation makes evaluating the quality and performance of firms costly for investors. Because many firms and entrepreneurs solicit capital, banks and other financial intermediaries can realize scale economies in obtaining detailed information regarding firms' profitability and investment prospects, thereby greatly reducing verification and monitoring

costs. With the most promising firms and managers getting funds, improved capital allocation fosters growth.

The increasingly detailed theoretical analysis of the close relationship between financial development and economic growth has been confirmed by numerous empirical studies. See for example, Goldsmith (1969) or King and Levine (1993). Findings confirm that financial development and economic growth are closely linked and that the former may actually predict the latter. King and Levine (1993) also found that in 1960, the level of financial development in 80 different countries was correlated with the subsequent average rate of economic growth across these countries over the next 29 years. Their findings provided positive empirical evidence for the argument that financial development predicts economic growth.²⁵

Financial Markets in the Pacific

Structure

Commercial banks predominate in the financial sectors of the Pacific. In many countries, they are foreign-owned. Australian banks are especially active in the region. Banks in general only lend to larger, well-established firms. The effect of this approach on a small firm's flow of funds is worth spelling out. Since all sources of funds—except equity, retained earnings, and trade credit—are unavailable to a small business that wishes to expand, it cannot grow as fast as it would if financial markets were better developed. Moreover, it may have to economize on inventory of all kinds and on investment in capital equipment. Therefore, decisions such as which technology to adopt in production, how much inventory to hold, and whether to expand or not, are determined by personal circumstances and not by the track record of the person running the business and his or her ability to convince lenders of sound ideas.

Compounding the problem for entrepreneurs in the Pacific is that the owner's real estate holdings usually cannot be used as collateral because of uncertainties

²⁵ There are, however, two possible sources of error that prevent researchers from using evidence that finance predicts economic growth to conclude that it determines economic growth. First, a common omitted practice could drive both financial development and economic growth variables (e.g., the propensity of households to save). Second, financial markets may anticipate future economic growth and simply be a leading indicator rather than a casual factor. See Rajan and Zingales (1998a) and Rajan and Zingales (1998b).

Box 4. Lender/Borrower Transactions in Financial Markets

Several key concepts underlie the financial market structure and determine lender and borrower behavior. Relationships between borrowers and unsecured lenders are fraught with moral hazard issues, arising in situations when the parties in a contract have conflicting interests, and circumstances make monitoring difficult or costly. Self-interest then increases the likelihood that one of the parties will distort information or engage in expedient behavior. For moral hazard to be present, three conditions must be met. First, the parties undertaking the transaction must have divergent interests (e.g., a lender to be repaid and a borrower not to repay). Second, there must be opportunities for transacting that lead to a situation where the divergent interests come into play (e.g., a loan contract). Third, there must be asymmetric information—one of the parties must have better access to the facts of the situation than the other. Borrowers and lenders have asymmetric information about loans—it is impossible for a lender to know the business as well as the borrower. The borrower, therefore, has a much better idea than the lender regarding whether the loan can actually be repaid. In circumstances where the borrower bears no cost of defaulting, the likelihood of default rises. Although lenders could charge higher interest rates to compensate for the risk, problems of adverse selection then occur. That is, since higher interest rates require a higher rate of return—which is in turn associated with greater risk—there would be a tendency for people who are risk takers to predominate among the borrowers. The risk structure of the banks' loan portfolio would be biased towards high-risk borrowers. Under such circumstances, banks generally do not lend to businesses whose owners do not have clear title to large real estate holdings.

regarding land tenure. The limited alternatives available to entrepreneurs with modest personal asset holdings have profound consequences on the efficiency of their businesses and for resource allocation.

The general perception of financial markets in the Pacific is that they do not function effectively. This was confirmed by the research undertaken as part of the four PSAs examined for this publication. However, observations on the banks' manner of intermediation and the companies' financing requirements present a paradox. Several apparently contradictory factors appear to be present.

- Various reports on countries in the region as well as background documents prepared as part of external funding indicate there is a shortage of financing, especially for smaller businesses.
- The financial institutions interviewed for the PSAs stated that they had excess liquidity and that there is a severe shortage of bankable projects.
- The business communities in the countries visited complained about the high levels of real interest rates, which average around 12% per year.

- Most of the larger countries in the Pacific have had net outflows of FDI in several of the past few years (Table 3), implying that the rates of return on investment are modest at best, perhaps supporting the claims of the commercial banks regarding bankable projects.

These observations are consistent with a private sector environment that has a low rate of return on financial capital. It is not necessarily true that all potential investments have low rates of return because government may be crowding out potentially profitable projects or there are profitable projects that cannot be financed. However, the rates of return within the current private sector environment are incapable of attracting or retaining significant private capital, a situation that creates policy implications for private financial markets.

Observations on the banks' manner of intermediation and the companies' financing requirements present a paradox.

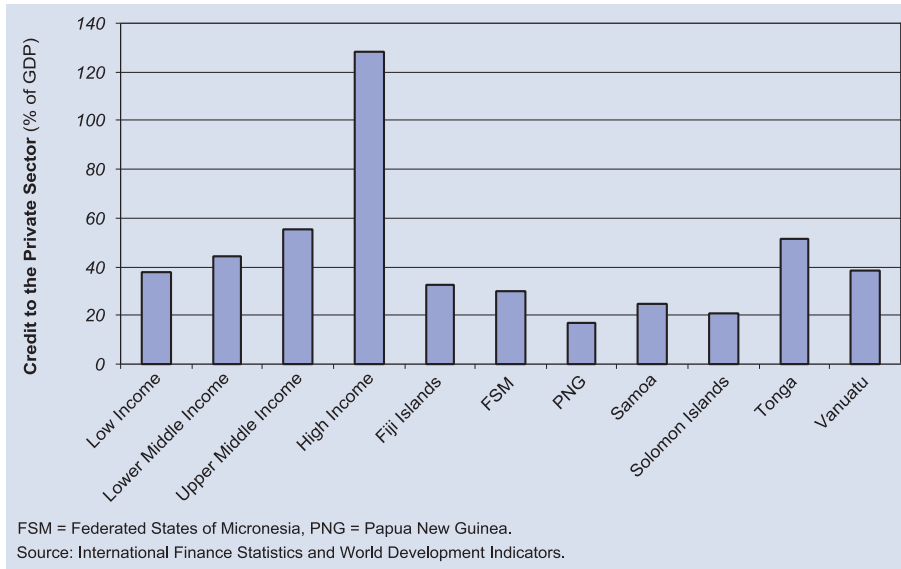
Characteristics of Financial Markets in the Pacific

The financial markets of the Pacific countries are dominated by commercial banks, which tend to lend to established businesses. With the exception of Tonga and Vanuatu, the credit to GDP ratios in the region are below the average for developing countries with similar per capita GDP levels. However, in most countries (with the exception of Samoa) the bankers interviewed indicated that they have excess liquidity and could lend significantly more if there were more bankable projects.

In most cases, banks in the Pacific countries are governed by risk criteria established primarily in Australia, since commercial banking operations are dominated by ANZ²⁶ and Westpac, both Australian banks. As a result, banking practices tend to emulate those in Australia. In line with risk averse banks in the developed world, there is little lending without collateral. Since neither land nor chattel mortgages provide reliable security, the banks do not lend to any but the larger businesses and tend not to lend to locals since the bulk of their assets are in the form of communally owned land. Therefore, commercial banks in the Pacific prefer to lend against collateral, and confine the bulk of their lending to urban areas because this is where most land leases and freehold

²⁶ Australia and New Zealand Banking Group Limited.

Figure 11. Comparative Average Credit to the Private Sector (1996–2000)



land are concentrated, and most businesses, as well as most private households, are located.

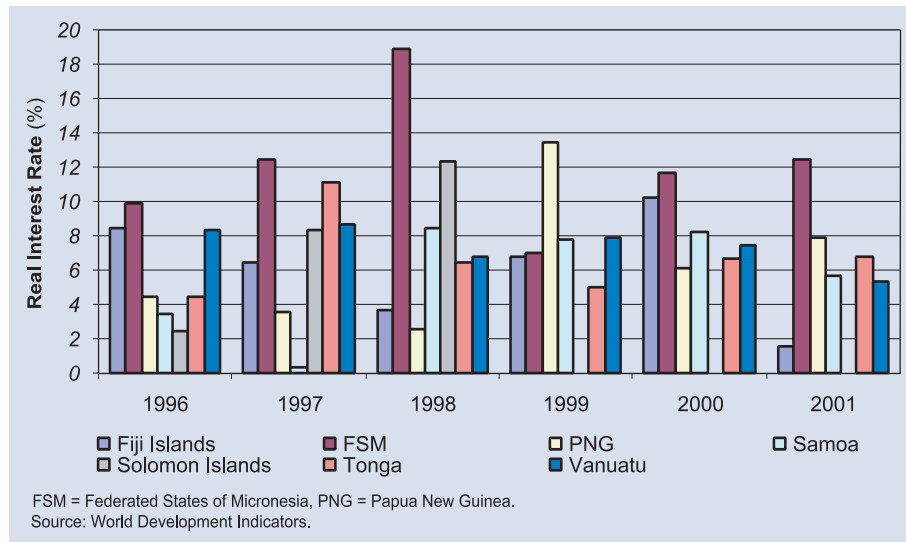
In general, the foreign-owned banks characterize the Pacific as an area where debt recovery is not easy. For example, one of the commercial banks characterized Samoa as its most difficult lending environment because of repayment issues.

For the most part, banks are interested in longer term business financing. Nevertheless, those interviewed indicated that such loans are risky given the combination of a culture where debt repayment is not accorded high priority and securing loans against assets is costly.

Credit information is another problem identified by commercial banks in the Pacific. With some exceptions (e.g., Marshall Islands), competition among the banks have resulted in little sharing of credit histories, with the result that borrowers of dubious quality can often get loans from a succession of financial institutions.

A combination of difficult lending environments combined with the inability to use collateral as security for loans has resulted in conditions in which indigenous people find it especially difficult to obtain finance from commercial banks in the region. Typically, development banks and national provident funds (NPFs) have been the main suppliers of loans to the local population. However,

Figure 12. Real Interest Rates (%), 1996–2001, Select Countries



this situation carries substantial risks for the lending institutions and the viability of pension funds, in the case of NPFs. Arrears at both types of institutions are far higher than at commercial banks, confirming that concerns regarding lending without collateral are warranted. Secured lending is the only means of dealing with the moral hazard issues. Intentions to repay must be backed up with incentives to repay.

Interest Rate Issues

Interest rates in the Pacific are not high by the standards of many developing countries. In most countries in the Pacific, real interest rates charged by commercial banks to their borrowers are in the region of 10–12% per year. In some countries in the region, development banks and NPFs charge interest rates that are two or three percentage points lower than commercial bank rates. These interest rates are misleading, however. The theme of this chapter is that many people in Pacific countries are excluded from access to finance because of the inadequate institutions underlying financial markets in the region. The interest rates charged are not indicative of the available borrowing opportunities, as they are the rates charged to prime borrowers.

Intentions to repay must be backed up with incentives to repay.

In general, nominal interest rates embody different factors that reflect the incentives and risks faced by lenders. Commercial banks accept deposits and invest these in alternative assets. The first factor, therefore, is the cost of funds, or the rate that banks pay depositors for their funds. The second reflects the alternative investment channels open to banks. Most banks in the region invest

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some of their funds in foreign securities, primarily denominated in either US or Australian dollars. Since the alternative is to invest locally, local interest rates must reflect exchange risk—except in cases where the US dollar is their currency (e.g., Marshall Islands and the Federated States of Micronesia). A further alternative is to invest in a country's government securities—usually the most secure of the alternatives available locally. Finally, the bank can also invest in local loans. The spreads between each type of investment embody the risk of lending. An additional factor in the Pacific is that lending and deposit rates embody some element of oligopolistic pricing because of the limited number of banks.

As noted earlier, banks are highly risk averse, which is quite understandable and probably reflects sound business practices. All the financial institutions visited indicated that in the event of default, recovery of debt presented major problems. In some countries, such as the Marshall Islands, there are no bankruptcy provisions in the commercial code, and legal proceedings can last

Figure 13. Interest Rate Spread (%), 1996–2001, Select Countries

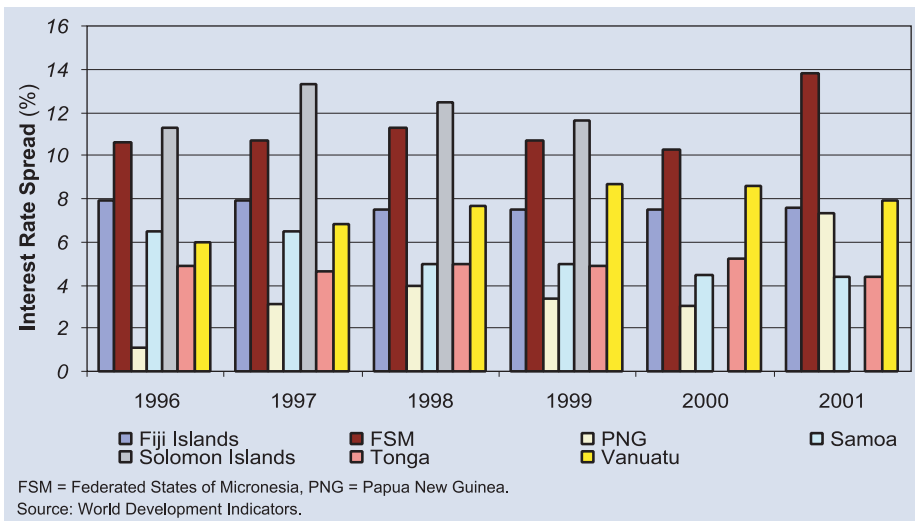
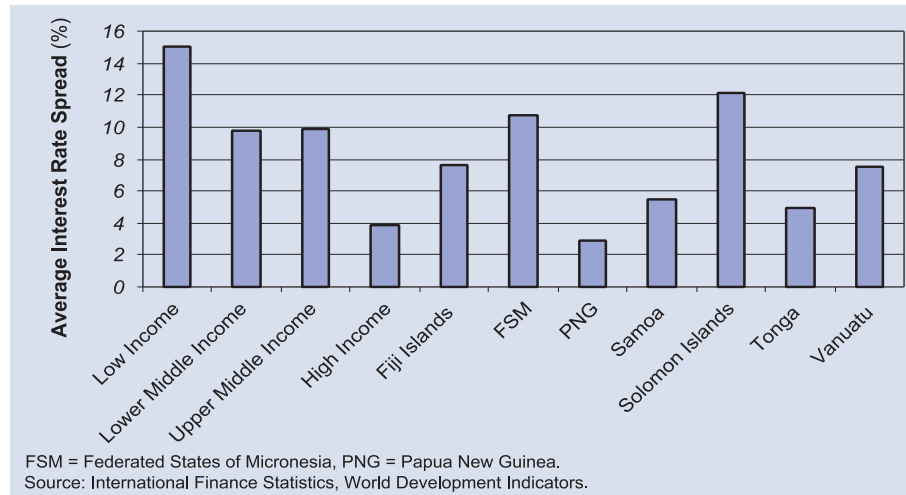


Figure 14. Comparative Average Interest Rate Spreads, 1996–2000



for many years in the event of a company's inability to discharge its debt obligations. In all the other countries visited, bankers reported lengthy proceedings to recover debt.

The result is that most banks require real estate as security. A further idiosyncrasy in the institutional structure that underlies lending in the Pacific is that most countries have a constitutional prohibition of foreigners owning land.

Interest rate spreads in the Pacific are high but less than the average for countries at similar stages of development. In most countries, the difference between borrowing and lending rates average about seven percentage points. While spreads in developed countries averaged less than four percentage points at the end of 2000, it was above 15 percentage points for the group of low income countries, which is about double that of the Pacific countries' (Figure 14). Furthermore, the data reflect lending to the most secure borrowers, as lending rates are usually much higher for smaller enterprises. This substantial interest rate spread reflects a combination of inefficiencies in intermediation and risks on loans. Overall, financial systems in many developing countries appear to be inefficient.

In the absence of detailed research, any explanations as to why Pacific countries have lower spreads can only be speculative. But as competition is not intense among the financial institutions in these countries, there must be some element of oligopolistic market power built into interest rates. The combination of lower overall lending rates and lower spreads, in contrast to other developing

countries, probably reflects the risk aversion of financial institutions in the Pacific, and shows that significant portions of the population are excluded from access to the lending aspect of the financial system.

Expanding Collateral

Under the current institutional framework for lending, there is no credit available to farmers or fishermen. For agriculture, there is no legal framework in which to pledge future crop harvests, because farmers have no standing under the law to make such a pledge. Confusion over customary law and its interface with formal sector law excludes the land owned by farmers from serving as collateral.

The economic impact of collateral is powerful.

For rural enterprises, inventories and accounts receivable cannot serve as collateral unless the borrower is a corporation. This lack of access to credit prevents the growth of an important sector. It also prevents rural businesses from refinancing their unsecured sales through credit, thereby constraining potentially important

financial intermediaries from providing unsecured credit in rural areas. It also biases the system against those whose primary asset is land, which is the majority of the Pacific population. The incentives therefore increase the tendency of rural populations to move to towns, adding to the strain on already stretched infrastructure and social services in the urban areas.

Secured Lending

The economic impact of collateral is powerful (Fleisig 1996 and Fleisig et al 2000). The more and better the collateral offered by the borrower, the lower the interest rate, the longer the time to repay, and the larger the loan relative to income. While detailed legal assessments of the secured transactions framework were not provided by the private sectors of the four Pacific countries analyzed here,²⁷ their conclusions show that major problems exist. Most importantly that in urban centers

- rural property—whether movable or fixed—cannot serve as collateral for loans; and
- large and economically costly gaps exist in what can be offered as collateral and who can offer it.

²⁷ ADB 1999. Table 8.1, sets out a convenient assessment of the economic usefulness of land as collateral in different South Pacific countries and recognizes the importance of problems in the legal framework for collateral in limiting access to credit.

Box 5. The Power of Collateral

The lending terms of credit unions illustrate the effect of a secured transactions framework. In the United States, credit unions offer different loans at different terms depending on the collateral the borrower offers. For instance, they would offer a borrower without collateral a loan with an annual interest rate of about 12.5%, repayable in about 33 months, amounting to as much as 50% of the borrower's income. For a borrower offering movable property as collateral, these lenders would charge lower interest rates and offer longer repayment periods and larger loans relative to the borrower's income. For a borrower offering real estate as collateral, interest rates would drop even more, while repayment terms become longer and loans even larger relative to the borrower's income. Broadly, the more and better the collateral offered by the borrower, the lower the interest rate, the longer the time to repay, and the larger the loan relative to income. Overall, when borrowers offer better collateral to lenders, borrowers pay interest rates about 50% lower, have as much as 11 times more months to repay, and receive loans as much as 9 times greater relative to income. These changes in terms illustrate, unambiguously, the power of collateral. For exactly the same borrower—with the same income, the same credit record, the same loan committee, and often, the same credit officer—these institutions will lend more at lower interest rates for a longer period of time, if collateral is offered, than if it is not.

Overview

For secured lending, the four Pacific countries that were the subject of the PSAs share a British common law tradition inherited through Australia, New Zealand, or the United States. In addition, Vanuatu also has some French civil code heritage. In all cases, the commercial codes are outdated. Typically, Pacific laws reflect the state of these laws in their parent country at about the time of independence.

The main instruments for providing security on a loan in these countries include the following.

Statutory and Equitable Mortgages in Real Estate. A statutory mortgage is filed in the real estate registry. An equitable mortgage is a contract known to both borrower and lender in which the borrower turns over ownership papers to the lender but does not transfer them or register the transaction in a real estate registry. Usually, equitable mortgages have been upheld in case law.²⁸

²⁸ In Vanuatu, liens on property appear to be covered by the French Civil Code, which appears to still apply by virtue of section 93 (2) of the Constitution.

Company Charge,²⁹ including the *Bill of Sale*. This device applies to movable property owned by corporate entities.

Hire Purchase. This device applies mainly to new identifiable equipment.

Leasing. This device applies mainly to new identifiable equipment.

In the Pacific countries examined for this publication, lenders in urban areas sometimes used the company charge, but would not take collateral located outside town limits. Similarly, land could serve as collateral within large cities, but seldom outside.

It appears that the Pacific economies lack systems for effectively using important classes of property as collateral for loans. In particular, bankers and other lenders do not accept most real estate and any agricultural products (e.g., beef, cocoa, coffee, copra, fish, kava, and timber) as security. The legal framework for secured transactions does not seem to address the key stages for securing loans. In other words, no adequate system exists for allowing lenders to determine the priority of a pledge of assets nor to publicize and enforce security interests in property as collateral for loans.

The Pacific economies lack systems for effectively using important classes of property as collateral for loans.

The lack of such a system presents a major obstacle to linking savers and investors in these economies. Even when countries received substantial inflows from activities like offshore financing (e.g., in Vanuatu), or foreign remittances (e.g., in the Marshall Islands and Samoa), these possible sources of financing cannot reach most small enterprises or rural borrowers. To permit such credit delivery, the legal system must offer an efficient domestic legal framework for debtor-creditor relations in general, and for secured transactions in particular. Even if foreign

investment laws or international conventions appear to cover secured lending, these international business transactions must still use the enforcement system within the country to collect against funds or properties located there.

This section relates a preliminary analysis of the secured lending systems in the Pacific. Broadly, Pacific country legislation does not support an effective framework for secured transactions, and in fact, the secured transactions framework seems incomplete and expensive to use. Further studies should

²⁹ The company charge is the use of a claim against a company's equipment or movable property as security for a loan. The company pledges those items as a "charge" to collateralize the loan.

Box 6. The Inherent Problem of Offshore Ventures

The smaller the economy, the more likely is it that large domestic investors will spread their risk by investing in offshore ventures. If the rate of return on capital is low, as it appears to be in the Pacific, this trend will be accelerated. Both explanations are consistent with the observed export of private capital that has occurred in most Pacific economies over the past decade.

A corollary of this phenomenon is that indigenous people with the bulk of wealth that cannot be used as collateral will neither be able to finance investment projects nor diversify their risk. They are unable to raise capital using land as collateral because the land has no value to a financial institution in a customary tenure system where collecting a debt through foreclosure is impossible.

examine this problem in detail. For instance, in Papua New Guinea, Samoa, and Vanuatu, it appears that collateral outside the main cities was unacceptable for loans. In the Marshall Islands, collateral is generally unacceptable to secure credit. Pinpointing the actual deficiencies is a specialized task for experts in security interests and, surely, more research on the details is needed. Interviews should go beyond determining permissible legal transactions and more deeply examine the economic aspects of secured financing.

The preliminary findings in the study countries show that problems in the legal framework for secured lending in Pacific economies result in the exclusion of most equipment, future crops, and much real estate as collateral because they have no economic value to lenders. This has serious implications for private sector borrowers. They typically cannot purchase such property assets on credit, and once they save to buy it, they cannot pledge it to get loans for other property or working capital. The result is that the financing of investment in either fixed or working capital is unavailable to those without substantial liquid resources. And it implies that those who have capital can choose to either continue to accumulate capital, or invest in other countries to spread their risk.

When the legal system inhibits borrowers from offering collateral, operators get much less credit than they need.

When borrowers cannot offer collateral to private lenders, Pacific lenders will react the same way as lenders elsewhere, charging higher interest rates, offering smaller loans, and lending for short periods. As a consequence, when the legal system inhibits borrowers from offering collateral, operators get much less credit than they need. In fact, operators of small farms and businesses may get no credit at all. The refusal of Pacific lenders to alter loan terms when borrowers

offer local collateral is not proof of collateral's ineffectiveness. Rather, this situation arises from problems in laws and legal institutions that govern the use of collateral in these countries.

Secured Transactions in the Pacific Economies

The fundamental distinguishing trait of a secured lending system lies in its ability to grant priority to a particular lender or credit seller by collecting against some property of the debtor. Without such a security interest, a creditor is unsecured. An unsecured creditor has only a general claim against a debtor's property—a claim that gives that creditor no better right to payment than any other unsecured creditor. A legal system that supports only unsecured lending will lead creditors to lend less to any given borrower, for shorter periods, and at higher interest rates. For a system of secured lending to work, it is insufficient for property to just have value. In place must be a legal system that permits the secured party (the lender) to recover and sell the property in a way that realizes as much of the property's market value as possible.

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In theory, in all Pacific countries, a creditor can create such a secured loan by creating a security interest against a debtor's property. If the debtor defaults, the collateral can be sold or exchanged, and the security interest of the secured creditor will be satisfied (paid) ahead of the general claims of unsecured creditors. But the mere possibility of such a security interest cannot alone secure the benefits of the system. Rather, the economic usefulness of a legal system for security interests will depend on how well that system fulfills certain key criteria. In particular, the law must provide for the following (Spanogle 1992).

The creation of enforceable security interests. This interest should be enforceable against all economically important property—tangible and intangible—by all economic agents and for all significant transactions. The cost of creation must be low, relative to the value of the property.

Priority that is easily ascertained. There must be an unambiguous assignment of the order in which secured parties satisfy their claims against the property. The law must protect the secured lender against hidden claims, including those of other secured and unsecured lenders, the government, and the bankruptcy procedure.

The availability of information on the prior property pledging. A simple and inexpensive system must make available to the public, information about the priority of any secured party in any security interest against any property.

Enforcement that is rapid and inexpensive. Repossession and sale of the collateral must be fast, cheap, and preserve as much of the value of the collateral as possible.

A preliminary analysis of the legal framework for secured transactions in the Pacific indicates that their legal framework does not meet these conditions. Often the features that cause problems have no obvious justification in public policy. Even when they do have a public policy objective, the means of achieving the objective (e.g., tax collection and the protection of workers, debtors, and tenants) can impose a high interest and other fixed fees and reduce the borrower's potential access to credit. Other policy measures could achieve these worthy objectives without compromising credit access.

Each of these stages poses legal problems that limit the system's economic usefulness in the Pacific countries. We discuss these in turn for the main security devices for movable and immovable property.

Problems in Creation

Movable Property

Movable property accounts for about 40% of the nonresidential capital stock in industrial countries. Changing the legal framework to permit this type of property to serve as collateral can provide a quick basis for secured lending as well as sales on credit to various credit-starved areas. Leasing, warehousing, the company charge, and mortgages are all examples of security devices—agreements whereby a borrower offers collateral to a lender.

For the Pacific countries, the company charge provisions comprise the main statute on security interests for movable property. This framework has several important limitations. The provisions only deal with registration rules and some narrow priority rules. The law does not address the other stages of a security interest (creation, priority with other security devices, and enforcement). These problems are common to unreformed common law jurisdictions in the industrial countries as well as in the developing world. For instance, Canada, before its reform, had a secured transactions framework based on the company charge filling some of the gaps with case law.

The company charge, moreover, cannot be used by microenterprises or most small- and medium-scale enterprises. The company charge covers only the collateral offered by corporations. It does not apply to using the property of individuals and unincorporated debtors, such as most farmers or informal enterprises, as collateral for loans.

From a preliminary assessment of these laws, the following are typical.

- Businesses can only secure loans with one lender.
- Unincorporated businesses or individuals that make up the large portion of the private sector in the Pacific countries cannot use their inventory as collateral for loans.
- No lender can safely take a business' accounts receivable as collateral.
- Large companies can secure loans with inventory that limits their financing with other lenders.

What is left for secured lending? Large and small companies can use hire purchase provisions to buy new identified equipment on credit, either under a bill of sale or a lease.³⁰ Because problems arise in determining whether prior encumbrances on equipment exist, equipment financing is largely limited to new equipment. It is possible to undertake international business transactions with borrowers, collateral, or guarantors, abroad, so long as a legal framework governs the transaction. Property located in Australia or New Zealand, for instance, could be used as collateral for operations in Pacific countries. This possibility, however, does little to help locally owned farms and businesses. In many of the Pacific countries, even lease financing is not available because there are no vehicle registries.

Real Estate

Basic issues in the borrower's rights to the underlying property. The basic premise of the following discussion is that customary-owned property cannot be freely transferred outside the indigenous community and in some cases within the indigenous community despite secure knowledge that the transaction will not be challenged. In most Pacific countries, it is against constitutional provisions for foreigners to buy land. Since land is also "inalienable," security interests or liens cannot be enforced against it.

These restrictions can make real estate useless as collateral. The concerns regarding clear identification of private property underlies much donor support

³⁰ The hire purchase system lacks the conceptual structure that will provide for modern features such as automatic attachment of security interests in future property and security interests in proceeds.

for land and real estate registration in the Pacific. However, focusing on identification of property treats only part of the problem. To serve as collateral with economic value, the right to land must be alienable (i.e., transferable to another's ownership). The typical project, therefore, focuses on titling and its rights of alienability. In many customary settings, however, fee simple titles do considerable harm to traditional practices. Conventional approaches to land rights ignore the fact that many land rights have value besides title. In the United States, for example, grazing, mining, and drilling rights to federally owned offshore land, have value as collateral. Similarly, lease rights have value: much of the land³¹ in Hawaii, London, and New York is leased by those developers wishing to build buildings, striking down the common claim that buildings and the land under them must be transferable together (ADB 2001a³² and ADB 1999³³) Moreover, title alone will usually not permit the use of land as collateral. Without a clear system of priorities under the law, an eviction system, and a system of publicizing priorities, owners may have clear title to well-identified land that will never serve as collateral.

For foreign investors, the lack of tenure security is a major constraint to investment.

Local citizens. Most Pacific nations give local citizens superior status to foreigners in land ownership as a form of land tenure. Under circumstances where land is “homestead” and cannot be taken away from the occupant, a mortgage cannot be enforced. Many previous reports on land tenure issues in Pacific countries have stated that land held under customary tenure cannot normally be used as collateral for securing a loan. This inhibits investment and the development of a capital market.

Foreigners. For foreign investors, the lack of tenure security, either through leases—the only form of tenure permitted to foreigners—or through corporate shares, is a major constraint to investment, especially large-scale investment. Secure tenure requires that rights be clearly specified and enforced. There are numerous examples of threats and some forms of sabotage on tourist resorts that highlight the problem (World Bank 1998d).

Nevertheless, even with security of tenure for foreigners, the secured transactions framework needs to permit land tenure rights other than ownership to serve as

³¹ Lack of clear title as an impediment to credit is emphasized in ADB 1999. However, as noted here, addressing title problems without fixing the underlying legal framework for using real estate as collateral for loans will not substantially change access to credit.

³² Calls for a mortgage system for lease rights. Such a system is set out in modern systems of secured transactions, such as those used in Canada and the United States.

³³ Calls for reforming and clarifying customary treatment of leases in South Pacific countries.

Box 7. Low Nonperforming Loan Rates: Cook Islands, an Outlier

The Cook Islands stands out as an example where banks have few nonperforming loans—less than 1%. Land can be, and is, foreclosed by banks. The legal system is perceived as providing protection to banks against default. There is, however, a growing local concern that too much land has been transferred through foreclosure. The potential for pressure from the local population to reduce the banks' ability to foreclose exists—a pressure that must be resisted to avoid negative impacts on private sector development.

Source: ADB 2003. *Cook Islands 2001 Economic Report: Policies for Progress*. Manila.

collateral for loans. However, the primitive stage of development of the secured transactions framework in the four examined countries does not provide that. For instance, it is unclear how mortgages on leases may be possible, when case law does not seem to have addressed this yet. In countries like Vanuatu that have a hybrid common law/civil code heritage, there is considerable potential for conflicting interpretation of issues related to the integration of mortgagee rights under equity mortgages, versus lien rights under the French civil code. In many instances, the claims of the landlord with a lien for rents due demote the claim of a mortgagee to a second position. In other words, the rights of the lender are subsumed by the landlord's lien.

Problems in Priority

Priority plays a key role in a secured transactions system. It establishes the order in which claims against the goods serving as collateral will be satisfied in the enforcement procedure. For instance, the creditor with the first priority will have its claim satisfied on sale of the collateral, before a creditor with second priority. Unsecured systems have no system of priority. For lenders, however, establishing their priority against the collateral is crucial. Even valuable property cannot serve as collateral if a lender cannot determine the value of claims secured by the property that have a higher priority than the claim that the lender contemplates.³⁴ In other words, if there is no registry that records claims on property and the relative priority of those claims, property cannot serve as an effective collateral for loans.

³⁴ For example, a future kava crop with a minimum value of \$10,000 may be excellent collateral for a \$6,000 loan if no prior claims exist. However, the same crop will be inadequate collateral for a loan of \$3,000 if a prior claim for \$9,000 exists.

How “Priority” Affects Credit Systems

Priority—the process by which the lender establishes the priority of the security interest—lies at the center of a legal system for secured transaction. It represents a crucial element in determining a property’s value as collateral. Where conflicts of priority exist, as they do in many Pacific countries, secured financing will not take place at all. In default, loans without priority will become portfolios of uncollectible loans. Many development banks in the region take security in the form of collateral when making loans. Their large portfolios of uncollected debts are a testimony to the inadequacy of the collateral framework in the region. By contrast, commercial banks only secure loans with movable collateral when they have substantial additional security amounting to a multiple of the loan’s value.

A secured loan by definition cannot have a conflict of priority. In most Pacific countries, a series of key priorities are not spelled out in the law. A preliminary investigation indicates several possible conflicts, as noted below.

All the alternative security devices that exist—mortgages in law and equity, installment sales, trusts, and leases—have different rules governing the manner in which they operate. This fragmented approach to security interests with various laws covering priority and publicity in different ways for diverse security devices, both increases risk and reduces the value of collateral. Even for company debtors, priority rules are troublesome. The company regulations seem to permit only one charge at a time and do not resolve ranking of priority issues vis-à-vis other security devices, such as legal and equitable mortgages.³⁵

Other priority conflicts affecting important economic transactions also remain unaddressed (e.g., priority for loans secured by inventory versus priority given to loans secured by accounts receivable and priority in future crop versus priority of the holder of a warehouse receipt). Some countries such as the Marshall Islands have no bankruptcy laws at all.

If there is no registry that records claims on property and the relative priority of those claims, property cannot serve as an effective collateral for loans.

³⁵ See, for example, the Vanuatu Company Law section 100 (1), which provides that, “Subject to the provisions of this Part of this Act, every charge created by a company and being a charge to which this section applies shall, so far as any security on the company’s property or undertaking is conferred thereby, be void against the liquidator and any creditor of the company, unless the prescribed particulars of the charge together with the instrument, if any, by which the charge is created or evidenced, are delivered to or received by the registrar of companies for registration in the manner required by this Act within 21 days after the date of its creation, but without prejudice to any contract or obligation for repayment of the money thereby secured and when a charge becomes void under this section the money secured thereby shall immediately become payable.”

Such confusion about priority creates uncertainty and ultimately enormous risk for secured lenders. Any reforms to the system should consider development of a comprehensive secured transactions framework rather than attempt to repair the present system.

Problems in Registration

The law specifies how priority is established. Two basic legal systems have evolved regarding priority. One establishes priority by possession, the other by publicity. Priority by publicity is the most important system as it allows the debtor to retain possession and use the collateral during the loan's term. The principal system of publicity is that of registration in a public registry.

A first-to-file registration system requires that the law designate the place for filing the security interest. This allows any potential lender to determine quickly whether the collateral offered by the borrower has prior security interests. Knowing these prior security interests permits the lender to assess the collateral value of the property. The typical practice in Pacific countries is to rely on two main registries for security interests, the company registry, and the land registry.

The Rules for Registering

The typical pattern under versions of the British company law in these countries provides for various types of charges to be registered. The registration list leaves many gaps in information about registration. For instance, it is unclear whether account receivables financing, in the form of small loans, are covered with priority by registration rules, and whether any assignment of accounts receivable must be filed and where. Therefore, setting a ranking of priority against a loan secured with portfolios of accounts receivable collateral appears to require transferring of each individual loan to the lender. It is unclear whether a security interest can have its priority set by registration or whether such registration positions a lender vis-à-vis any other encumbrance. In tourism, for example, where credit card payments commonly comprise the businesses' account receivables, it will be costly to use accounts receivable as collateral for loans.

As a second example, the company registry includes the mortgage, which is also filed at the land registry. Further assessment of the registry system should look into this potential conflict and determine which registration gives priority.

The Functioning of the System

There appear to be no recent studies of the registry system in the Pacific economies.³⁶ Whatever the findings, it will be difficult to build technically efficient systems under the requirements of the existing law. An alternative model on which to base reform is provided by examples of viable and sustainable privately operated filing archives such as those in Colombia or Romania. The models from Australia, New Zealand, or the United States should not be blindly adopted, because state-operated solutions that work acceptably in those countries will not necessarily operate as well in Pacific countries. The Romania reform, for instance, used an Internet-based filing system run by nongovernment organizations under the supervision of the Ministry of Justice. Filing is cheap, fast, and efficient.

Regulatory Framework for Publicity

Some key issues must be settled with regard to the registry regulatory framework in any successful reform of publicity. These include decisions regarding

- private versus public or mixed operation;
- limits on the total fees charged;
- expanded Internet-based inscription and search;
- expanded private supply of filing services; and
- the regulation and expansion of filing real estate security interests in the corresponding registry.

Problems with Enforcement

Essential to any system of secured lending is the ability of the creditor, in the event of debtor default, to repossess and sell the property the debtor gave as collateral. A lender will focus on the value of collateral after the costs of sale and seizure. Lenders who face slow and expensive enforcement processes will simply adjust the size of the loan downward relative to the value of collateral.

In developed countries, a borrower could expect to borrow 95% of the value of a new car, 80% of the value of any other type of machinery, and 80–95% of the value of real estate. Similarly, a credit buyer would expect to purchase a car with a down payment 5% of the market value, and a house with a down

³⁶ Although a legal review of the secured transactions framework has begun in Samoa.

payment of 5–20%. In such a system, the lender or credit seller expects enforcement of the loan at a cost ranging between 1% and 5% the value of collateral, and in a period ranging between 5 days and 2 months. Such a lender expects to have the full value of the loan covered by the collateral at the end of the enforcement process. There is little systematic analysis of the duration of debt collection in the Pacific. Anecdotal evidence indicates that repossession of movables could take from several months to 2 years. In rural areas, neither movable nor fixed property was acceptable as collateral because it was not possible to repossess and dispose of it.

Previous studies do not appear to have analyzed the applicable collection rules and their costs in terms of the time it takes and fees involved (e.g., notaries, lawyers, court fees, etc.). This information is crucial to determining whether the collection time and costs support the value and the depreciation time of much property. Eviction costs need to be known when real estate is used as collateral, whether fee simple (i.e., the owner has maximum control over the sale, financing, or use of the property), or leases.

Taxes that Affect Registration and Enforcement

The framework for secured transactions is also heavily taxed either at the security interest's time of creation and registration, or at the time of enforcement (i.e., with the sale of collateral). For instance, in Vanuatu, documents that require stamping include bills of sale (0.6%), declarations of trust (0.25% or 0.5%), and transfers of movable property, such as shares (0.6%) and immovable property (5%). Since modern financing techniques may involve such transactions on a monthly basis, these charges at annual rates can become quite substantial. Taxes set to cover only the system's cost of operation would be preferable and recommended.

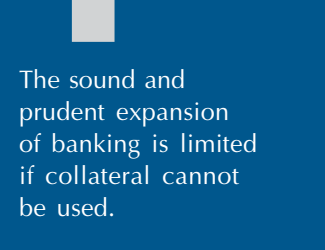
Implications of a Defective Secured Transactions Framework

The problems in the framework for secured lending affect every important part of the private sector in these countries. Commercial enterprises, whose assets are nearly entirely inventory and accounts receivable, cannot use these assets as collateral to obtain secured credit and thus have no formal provision for secured credit. Unfortunately, most microenterprise and noncorporate SMEs are particularly impacted by this situation, one that limits development of the banking system in the Pacific.

The sound and prudent expansion of banking is limited if collateral cannot be used. This legal situation forces banks to issue more risky unsecured loans, or more frequently, to lend only to a small fraction of the population. Alternatives

such as development banks and other public sector lenders function poorly and usually result in large losses—for example, NPFs that lend to individuals and companies in the Pacific. These lenders frequently have numerous nonperforming loans in their portfolios, which threaten the foundation of the region's pension systems.

Many foreign banks often complain of excess liquidity and shortage of bankable projects. The result is that they frequently invest significant amounts offshore. A major cause of this problem is the inability of businesses and individuals to pledge assets effectively as collateral for borrowing. Unsecured loans are risky because it is difficult or impossible to liquidate the borrower's assets in the event of default. Collection of an unsecured loan requires that a court action result in the seizure of the property of the unsecured debtor. Many problems that obstruct the collection of the property providing collateral for a secured loan also block the seizure and sale of property of unsecured lenders. Banks are under constant political pressure to make loans to politically important groups like farmers or operators of microenterprises. In a well functioning financial sector, nonbank financial intermediaries—dealers, cooperatives, and finance companies—would finance such borrowers and banks would refinance these intermediaries. Such loans have considerably less risk than loans made directly to small clients of such organizations.



The sound and prudent expansion of banking is limited if collateral cannot be used.

Need for Intermediation

While specific structures of reformed financial systems vary from country to country, clearly they would be significantly different from the current structure. In most countries, few commercial banks collect deposits and lend to well-established businesses. Riskier projects obtain funds from development banks and NPFs that both have significant portions of their loan portfolios overdue. A reformed system would encourage additional intermediaries such as those described in the previous section to lend to equipment dealers, wholesalers, cooperatives, and microfinance institutions, using the accounts receivable and inventories as security. Since equipment dealers would be in a position to provide capital equipment on leases repayable over several years, the need for longer term financing would be partly satisfied. In addition, microfinance lenders would be able to replenish liquidity through pledging their portfolios as security for loans. The efficiency of intermediation would be greatly enhanced. While these reforms require several years to have their full effect, they do hold the promise of access to finance for the local populations in the Pacific.

Microcredit

One of the most remarkable developments in financial markets in developing countries over the past 15 years has been the rapid growth in the number of microcredit institutions. They first appeared, almost spontaneously, in several different countries—especially in Bangladesh, Bolivia, and Indonesia in the 1980s and their numbers have since expanded rapidly. Although reliable statistics are unavailable, it appears that there are by now in excess of 10,000 micro-lending institutions around the world.³⁷ They vary widely in size, from serving a few hundred borrowers to having millions of customers, and there is a wide divergence in operating practices. Microfinance institutions (MFIs) appear to be most developed in Indonesia and Latin America. In the Pacific, microcredit is in its infancy, with few examples so far. Samoa is one country where micro-lending is developing well, but the volume of loans is still small.

In the Pacific, microcredit is in its infancy, with few examples so far.

MFIs provide a wide range of services. The best-known activity of MFIs is providing credit to poorer households and small enterprises, although many also take deposits from households and small enterprises. In addition, some MFIs provide other services, such as insurance or advice and training for their clients. This training is often closely linked to the MFIs' lending activities (e.g., training in

business management, which might make a loan more valuable to the borrower and enhance the chances of repayment). Sometimes MFIs are used as a vehicle to provide nonfinancial services and education (e.g., in health awareness). Samoa has taken the lead in this area, having in place the structure to address one of the critical problems associated with the microfinance movement, namely the failure to develop ways in which borrowers can “graduate” to the next level of funding.

MFIs have attracted widespread support from various funding agencies, including multilateral development institutions, national aid agencies, and private foundations. There is, however, a wide divergence in how they assist MFIs. Some attempt to ensure that the recipients of their assistance achieve “sustainability,” which usually means that the institutions gain the prospect of eventually graduating from donor assistance. Others attempt to ensure MFIs lend at rates that are comparable to, or even below those of commercial banks in the country where the MFI is located. The justification is that the poor should not be forced to borrow at “usurious” rates.

³⁷ Lack of systematic data is one of the features of the microcredit movement.

The latter approach virtually ensures that MFIs will not become self-sustaining. There is substantial evidence that MFIs that charge less than 30% in real terms per annum will not be successful without continued support. Furthermore, if funding agencies support institutions that lend at rates that are lower than those that are required to ensure sustainability, they “crowd out” the development of financially sustainable microcredit lenders.

Well-designed microfinance schemes that are developed as an integral part of a country’s financial system are an instrument that holds promise in the Pacific where distances are not large, yet sufficiently large population clusters allow transaction costs to become low. The smallness of the Pacific nations and the fact that individuals are known in communities is a point in favor of successful MFIs. On the other hand, family and church obligations that could potentially undermine the prudent use of loaned funds must be considered a risk. The frequent group counseling, peer pressure, and the clear expectation of repayment that is practiced in Samoa are elements of a successful scheme, and to some extent, mitigate the risk of family and church obligations. Given certain conditions, microfinance in PDMCs has the potential to help develop small enterprises and communities move beyond subsistence production and to promote entrepreneurship in urban areas where rural people have migrated. The conditions for success include secured transactions reform, which would allow well run MFIs to replenish their capital base, and integrate into the financial system, so that microbusinesses can graduate to other forms of borrowing. It is for these reasons that a case can be made for encouraging the existence of MFIs within the constellation of financial institutions in the Pacific.

There is substantial evidence that MFIs that charge less than 30% in real terms per annum will not be successful without continued support.

The Role of Funding Agencies in Supplying Capital

Attempts to Substitute for the Lack of Financial Intermediation

Frustrated by the inability of Pacific financial markets to finance private sector activity, funding agencies have intervened in an attempt to set up institutions that fund business. Various efforts are under way to supply investment capital to companies in the region. For example, the Kula Fund provides equity financing to medium and larger companies in the region. The South Pacific

Project Facility invests in small businesses throughout the region and provides technical assistance. In addition, individual countries, such as Samoa, have externally funded initiatives that supply capital, loans, or loan guarantees.

Loan Guarantees

Given that reform cannot be accomplished overnight, are government-backed loan guarantees an alternative to a well-functioning secured transactions framework? The answer to this question rests on how guarantees differ from loans in promoting access to credit and how these guarantees change the behavior of borrowers and lenders. If banks refuse to lend because risks are too high, then any guarantor will be assuming risks that banks were unwilling to take. If loans are guaranteed fully and cannot be secured against collateral, then banks lose their incentive to vet loans carefully and borrowers lack a strong incentive to repay. All the problems of moral hazard and adverse selection discussed earlier would still apply.

None of the problems that exist with financial systems in the Pacific are solved by guarantees.

Guarantees shift the risk from primary lenders (i.e., banks), to guarantors. In addition, if banks do not bear some portion of any possible loss, their incentives to carefully process loan applications are greatly weakened. If banks bear a portion of the risk, they will insist on evaluating the loan, thereby raising the transaction costs of loan processing. Processing costs are doubled, unless the institutional guarantor is prepared to pass the responsibility of processing to the institution that stands to lose a smaller portion of the loss in the event of default. In other words, none of the problems that exist with financial systems in the Pacific are solved by guarantees. There is simply no substitute for reform of secured transactions systems if financial markets are to adequately fund small- and medium-sized businesses. The efforts of reformers and the international financial institutions should strongly support financial reform.

Promoting Microfinance

Initial efforts have begun to assist in establishing microfinance in the Pacific. Two interesting microfinance schemes have developed in Samoa: the South Pacific Business Development (SPBD) and the Women in Business Foundation (WIBF). Both lend primarily to women,³⁸ the former using group guarantees

³⁸ However, cultural and equality considerations notwithstanding, restricting lending to a particular group is always distortionary and damages financial market development.

Box 8. Promoting Microfinance: The Multilateral Investment Fund

The Multilateral Investment Fund (MIF), a fund attached to the Inter-American Development Bank, has directly supported microfinance institutions in Latin America and the Caribbean, the process having had a profound impact on the development of microfinance. It has been involved in over 50 projects to promote sound and efficient microfinancing practices. This microcredit program has been innovative and successful. The MIF has had a history of identifying microcredit institutions that have the potential for success, providing them with support to ensure that their potential is fulfilled. So good has the MIF been at the activity that it can justly claim to have shaped microfinance in the region and beyond. In several countries, commercial for-profit financial institutions have begun lending to informal entrepreneurs, implying that the mandate for MIF projects to attain sustainability has been achieved.

modeled along the lines of the Grameen Bank.³⁹ Lending has grown rapidly and there are now many success stories. What is especially interesting about the WIBF scheme is that it has been structured in partnership with another initiative, the small business guarantee fund, run by the Small Business Enterprise Center (SBEC), which allows it to avoid the pitfalls of most such efforts, namely the inability to assist participants in graduating from MFIs. When participants in the microfinance program reach a stage where they require more funding than the program can provide, they may become eligible for assistance from SBEC, which provides loan guarantees and training for small business entrepreneurs. SBEC works with commercial banks to obtain funding for its participants by providing an 80% guarantee against loans. In addition, it has a very “hands-on” approach toward working with participants, regularly visiting their business premises and insisting on their successfully completing courses in all aspects of business management.

Regional Development Funds

Because of the problems outlined in the earlier sections of this chapter and because of the small size of capital markets in individual countries, longer-term finance is rarely available in the Pacific. To fill this gap, a private equity fund and two regional funds sponsored by international financial institutions (IFIs)

³⁹ In Latin America, where microfinance is mostly highly developed and where there is the largest number of self-sustaining microfinance institutions, group guarantees are rarely used because of the high transaction costs for borrowers and because they are increasingly seen as ineffective. The high losses experienced by Grameen itself are an illustration of this (Wall Street Journal 2001).

have been established. The private equity fund, the Kontiki Fund, is based in the Fiji Islands. Its capitalization is below that of the larger, IFI-sponsored institutions, but it has been successful, having roughly a 9–10% annual positive rate of return over the past 4 years.

The funds supported by IFIs and other funding agencies are aimed at providing longer-term finance to companies in need of capital. The two most prominent of these are the South Pacific Project Facility (SPPF) located in Australia, and the Kula Fund in Papua New Guinea. Although evaluation of these externally-supported funds is beyond the scope of this publication, from the financial statements of both facilities, it appears that neither is close to achieving sustainability. In fairness, it must be pointed out that operating costs in the Pacific are extremely high and are especially burdensome on organizations that for political reasons are required to engage in ventures over a wide range of countries. Nevertheless, the business model on which these funds are based should be examined to determine whether this is the best way to operate.

There are several options for increasing the flow of investment funds to the region. One is to establish venture funds in individual countries. For example, there is currently a proposal to establish a venture fund in Samoa to address a pressing need for longer term financing, in a country where most businesses appear to be undercapitalized, and therefore, vulnerable to even small downturns in business conditions. In the case of the Samoa venture capital fund, two main challenges must be overcome.

- There is currently no exit mechanism whereby the fund could liquidate its investment for a substantial multiple of its original contribution, although the International Finance Corporation (lead sponsor) expects to develop a self-liquidating instrument.
- The skills necessary for the management of a successful fund are scarce and command rates of remuneration that are much higher than the highest salaries in Samoa. Successful operation of such a fund will probably require employing an expatriate manager at a correspondingly high salary, which will substantially raise the overhead of such a fund.

In other countries, the involvement of IFIs, bilateral funding agencies, and the public sector, in similar types of investment funds has usually been a recipe for failure (Holden 1999a).

In the absence of exit mechanisms and strong management systems, investments of such venture funds are essentially equivalent to subordinated long-term loans

and are usually subject to the same problems as loans from development banks. In general, the loss rates are high, and there have been no cases where such funds have been self-sustaining. One promising mechanism, however, is the establishment of a unit trust vehicle to hold the fund's investments and from which investors could exit through sale of the unit trust shares. At this point, however, there are no such vehicles in the region, apart from the Fiji Islands. But there may be mitigating factors within the Samoan context. If the envisaged fund is a substitute for the Development Bank of Samoa (DBS)'s involvement, loss risks could be reduced through the increased oversight and expertise of the manager as well as the involvement of the board of directors. Even so, losses are likely to be high. There are also significant moral hazard and asymmetrical information issues inherent in the structure of such a fund. Even if it were to go ahead, the longer-term issues regarding financial and capital market development in each Pacific country should be investigated more fully to identify how to address the issues related to financial deepening and intermediation.

Making Financial Markets Work

The conclusion of the preceding discussion indicates that financial markets in the Pacific are not effective in supplying capital to enterprises, and in particular, are biased against smaller enterprises, rural businesses, and the indigenous people's ability to finance their investments and businesses.

The discussion also emphasized, however, that this situation was not the result of most financial institutions' unwillingness to engage in business financing. On the contrary, most senior personnel interviewed indicated that they are anxious to lend to businesses, but that risks are too high. There are many anecdotes of failed investments and unsettled loans.

The experience of the many state-owned development banks supports these observations. Loan loss rates in development institutions (which often lend at subsidized interest rates) are well in excess of what fiscal soundness would dictate. Furthermore, there are some worrying trends in several NPFs that have lent to businesses in the region. In many cases, they carry a significant quantity of overdue loans in their portfolios. Simply making more loanable funds available will not result in previously unfunded projects being implemented. Since loans are often at interest rates that are below market rates, it is clear that interest rate subsidies are not the answer. Furthermore, rates of return on capital appear to be low, as evidenced by the outflow of private capital and the failure to attract FDI.

Box 9. Lowering the Threshold or Raising the Rates

A recent paper by the Commonwealth Secretariat, *Lowering the Threshold*, suggests that remoteness and high transaction costs imply that funding agencies should develop interest rate subsidies for foreign investors using subsidies provided by commercial banks, but funded by the donors through a new financial instrument. However, the suggestion is based on several questionable assumptions and perceptions. First, the problems in attracting foreign investment to the region appear to result from a number of factors associated with low rates of return on capital, not an unreasonably high “threshold.” Second, the threshold is greatly raised by the various administrative problems associated with regulation of foreign investment that make it difficult and expensive to invest in the region. Third, subsidizing interest rates will not reduce risks to lenders but merely transfer them. Without changing incentives to repay, such a scheme will be little more than a development bank under another guise, with the attendant potential for defaults and bad debts. Shortage of liquidity is not the issue in the region—rather, it is the risks of lending, the costs of investing as well as the limited opportunity within the existing set of constraints. Donor efforts need to be directed at these problems, not supplying more subsidized credit.

Attracting foreign investment depends not on more subsidies, but rather, on reform that improves the investment climate.

The earlier discussions on secured transactions and land issues lead into the direction of improving the security of lending. Other recommendations on reducing the cost of infrastructure services and other factors that currently add to the effects of distance and isolation will reduce the costs of doing business and raise the rates of return on capital. Making the Pacific countries more flexible, allowing them to take advantage of opportunities, will also raise the rates of return. Attracting foreign investment depends not on more subsidies, but rather, on reform that improves the investment climate.

Reforms that Are Needed

The above analysis shows that several improvements in the operation of financial markets are needed to deepen financial intermediation:

- legally defining rights in both fixed and movable property;
- clarifying aspects of land rights, particularly leasehold arrangements, so land can be used in credit transactions;
- simplifying procedures for registering movable property;
- streamlining the courts and developing the system of summary judgment outside the court;

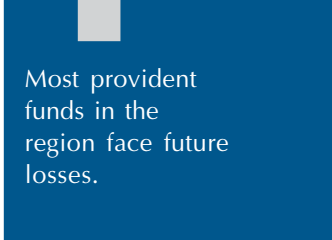
- improving enforcement;
- developing an effective system of credit bureau information; and
- improving or, in some cases, providing bankruptcy procedures.

Analysis of these problems, apart from land, is still in its infancy in the Pacific. Furthermore, implementing them and having patience as the reforms take hold require fortitude and determination, for the process is time consuming.

Integration with World Capital Markets

The Fiji Islands and Papua New Guinea stock markets are among the few sources of liquidity for companies outside the banking systems of the Pacific countries. One option for reform is to integrate the markets of other Pacific countries with these two financial centers. Whether it is realistic to expect other Pacific countries to put aside regional rivalries and cooperate in forming a regional stock exchange is open to question and can only be answered by consultation and discussion.

An alternative technical solution would be to integrate the region through an electronic trading system that would combine the region's embryonic capital markets to form a much more powerful entity. Currently, there are barriers to merging, the most important of which include exchange controls, extremely high telecommunications costs, and problems related to cooperation among Pacific countries. Even so, given the potential for such operations, this possibility is worth exploring further.



Most provident funds in the region face future losses.

National Provident Fund Reform and Second-Tier Institutions

An issue that was raised earlier in this chapter is the dangerous exposure of many national provident funds to loan losses from imprudent investments. With the exception of the Fiji Islands, most provident funds in the region face future losses. For example, the Vanuatu National Provident Fund has a large exposure to the domestic air carrier that is now effectively bankrupt. The Samoa National Provident Fund has arrears in excess of 20% of its portfolio. Similarly, the Marshall Islands Provident Fund carries large potential losses.

The behavior of the funds typifies principal-agent problems. The agent—the manager of the fund—is unable to withstand political pressures from politicians anxious to win the approval of constituents, especially since there is certainty that the principal—the state—will recapitalize the fund. There are extreme

moral hazard issues at work. The interests of the National Provident Fund managers are to make loans using the fund capital, while the interests in favor of the country's long-term benefit is to have a viable pension pool.

A promising alternative mechanism is the privatization of pensions as in Chile, where the national pension fund was divided into numerous competing private funds investing in certain proscribed securities on behalf of members. Each contributor to pensions in general, holds some portion of the contribution in several pension funds, to minimize risks. An appropriate regulatory regime must be in place, but the model holds promise. Further benefits could materialize if this reform were combined with securitization and secured transactions reform. The pension funds could then become second-tier institutions supplying liquidity to direct lenders such as commercial banks, equipment dealers, and microcredit institutions. Such a model has the potential to increase the supply of long-term capital while at the same time reducing systemic risks. Another suggestion is to pool capital to a single regional provident fund that is professionally managed, possibly offshore, and is independent of political influence from any one country.