

IV. ISSUES RELATED TO THE FINANCIAL SECTOR

A. The Structure of the Financial System

66. As Palau uses the US dollar as its currency, it has no Central Bank and no scope for monetary policy. The money supply is determined by the balance of payments, and the rate of inflation is closely tied to that of the United States. A further implication of the use of the US dollar is that there is no lender of last resort in the event of a banking crisis, a factor that makes adequate supervision of the banking system especially important.

67. There are eight banks in Palau, plus the Development Bank of Palau. Four of the commercial banks are foreign-owned, and dominate the financial system, holding about 80% of total deposits. These deposits are insured under the FDIC. Local banks account for 25–30% of banking system assets, with the majority being in the form of small loans.

68. The financial status of the Development Bank has improved markedly over the past few years. It had been basically insolvent, but was restructured in 1999. Additional capital was injected in 2004 and it is now run on a professional, commercially-oriented basis. Its main business is lending for housing; the outstanding loan portfolio is now some \$12 million, equivalent to about 10% of GDP. It has a healthy profitability, and although there are still a substantial number of non-performing loans (about 15% of its portfolio), there is improved provision and losses should be limited by the fact that most of the loans are collateralized.¹³

69. Data on the extension of credit to the private sector do not exist, so it is difficult to judge the extent to which the banking system is financing investment and entrepreneurship in the economy. Currently, the Financial Institutions Act does not require banks to provide audited balance sheets to the Supervisor of Banks. The Bank Regulator estimates that there is about \$80–85 million in bank loans outstanding, about 20% of which are to the central government and about \$55 million to the state governments and public utilities. Interviews with bankers revealed that a substantial part of commercial bank lending to the private sector consists of consumer credit, secured by salary deductions.

B. Lending and Debt Repayment

70. Bankers describe the culture of debt repayment in Palau as very weak. Borrowers often strenuously resist repayment of their loans and not infrequently bounce checks. Knowingly writing a check with insufficient funds is a criminal offense in Palau, but lawyers in Palau could not recall a recent instance of prosecution. However, lawyers involved in debt collection claim that a substantial number of people in Palau have been sued for non-payment of debt.

71. One of the consequences of legal action to collect debts is high legal fees. Under common law, the debtor is deemed to be liable for fees to collect the monies that they owe, resulting in very high legal bills. For example, if debtors who owe no more than a few hundred dollars fail to pay, a judgment can be lodged against them, with legal fees easily equaling the amount owed. If they are then delinquent on subsequent occasions, additional legal fees could accrue, amounting to thousands of dollars. As one attorney

¹³ This improvement in the solvency of the Development Bank will not continue, however, if periodic efforts to control lending rates legislatively are successful. This paper strongly opposes the implementation of any ceilings on interest rates being charged.

interviewed observed, “the law allows debtors to be pursued to the grave.” Concerned about the impact of legal fees on small debtors, the OEK passed a law limiting legal fees on any debt due to 25% of the original principle. This has been proven ineffective, however, due to loopholes in the law that still allow for high legal fees to be imposed. This penalizes smaller borrowers. As with any law that tries to directly influence economic behavior, there are unintended consequences, which could include a reduction in loans to small borrowers by the formal financial system. In many cases, this forces all small borrowers to resort to loan sharks, who lend at far higher interest rates and often use unpleasant methods of debt collection.

72. A far preferable system for dealing with chronic overburdened debtors is bankruptcy, a process that discharges debtors from at least part of their liabilities but which restricts their ability to borrow in the future. If combined with an effective means of recording credit information, such a system reduces legal fees associated with credit default by discharging debt once and for all. This issue is raised in a later chapter.

C. The Collateral Framework in Palau

73. Interviews with bankers, regulators, and businesses indicated that there are many deficiencies in the collateral framework that impact negatively on the ability to borrow and increase the risks of lending. Deficiencies exist in all phases of the process of collateralization: creation, prioritization, perfection, and enforcement. The result is that pledging collateral is expensive, and lenders insist on substantial excess collateral to secure loans. As the appendix discusses in detail, reform of the collateral process could substantially enhance the ability of businesses to borrow and reduce the incentive to default.

D. Credit Information

74. Credit information, which provides lenders with a means to assess the risk of lending to a company or to an individual, is an important component of a well-developed financial system. Without a means to evaluate lending risk, lenders tend to over-collateralize loans to those with assets and refuse lending to those without assets, forcing poorer borrowers to borrow from loan sharks.

75. The lack of credit information harms the lending framework in Palau. US-owned banks have a competitive advantage because US credit bureaus supply these banks with credit information on potential borrowers, which is not available to Palauan banks because of consumer privacy protection. The competitiveness of US banks is further increased by the international nature of the system: if a borrower leaves the country and goes to a former Trust Territory, or the US, the adverse information will be on record if they attempt to obtain credit in their new place of residence.

E. Lending on Land

76. Mortgages on fixed property are available in Palau. The legal basis is the Deed of Trust system that was introduced in the 1950s. Typical mortgage loan terms are based on 75% of the assessed value of the property for a 15–20 year term and at a fixed interest rate of 10% for the life of the loan.

77. Restrictions on land holdings limit the number of lenders who are prepared to lend using land as security. As non-Palauans may not own land, repossession becomes complicated and expensive for foreign-owned lenders in the event of default on mortgages. A foreign-owned lending institution cannot directly repossess a property on

which there is a mortgage default, but must apply to the courts to be allowed user rights until a purchaser can be found. This is not the case for locally-owned banks and the Development Bank. The latter dominates mortgage lending. Locally-owned banks are a minor supplier of mortgage, probably because their liquidity problems make them reluctant to tie up their loanable funds in long term assets.

F. Bank Regulation in Palau

1. Problems with the Regulatory Framework

78. The regulatory framework for bank regulation in Palau is weak. Until comparatively recently there was no bank supervision. The Financial Institutions Act now provides for regulation, but does not assure adequate funding for the Office of the Supervisor of Banks, which is staffed only by the Supervisor and a secretary. Although banks pay a fee for financial supervision, the collected funds go into general government revenue rather than to fund the Office of the Supervisor.

79. Banks are required to maintain a minimum capital of \$500,000. This very small amount would not be acceptable to most bank regulators around the world. Even so, there are reports of strong lobbying by local banks to relax the enforcement of this requirement.

80. Severe gaps in the regulatory framework remain, including the fact that although banks are required to report to the Supervisor of Banks, they are not required to submit audited balance sheets. As a result, the basic tools of bank supervision are not in place, and the public has no way of determining the financial soundness of banks.

81. Supervision problems are partially ameliorated because foreign banks are subject to supervision in their home countries, which have more comprehensive regulation. Local banks are, however, under-regulated. When combined with their under-capitalization, this could lead to severe moral hazard issues. Local banks probably operate under the assumption that the authorities will not allow them to fail, which could result in risky lending practices.

82. There are grounds for concern regarding the liquidity of some banks, especially those that are owned locally. The IMF reports that local banks are not retaining sufficient capital to meet withdrawals. There are, in addition, numerous anecdotes regarding cash shortages. Several depositors recounted that they are often not able to withdraw cash at will if the amounts are over \$2,000. When they ask for withdrawals, they are told that the bank does not have enough in their vaults to pay them immediately. Customers are asked to return a few hours later (the term used by the locally-owned banks is "we need to buy some money"). The domestically-owned banks also offer substantially higher deposit rates for larger amounts of money than do the foreign-owned banks, with rates being negotiated with individual depositors.

83. The Pacific Savings Bank went into receivership in late 2006. The bank has been closed, with smaller depositors being guaranteed a repayment of \$2,500 each, which is being financed by a soft loan from Taipei, China. In spite of political opposition to the closing of the bank, it continued to be wound up as of the end of February, 2007.

2. Tightening Regulation

84. Attempts are being made to tighten regulation. There are 12 regulations governing the implementation of the Financial Institutions Act, pending approval by the

OEK.¹⁴ These relate to a range of issues, such as Capital Adequacy Requirements and the reporting obligations of financial institutions. There are also money-laundering provisions among the amendments that have not been passed. Because these statutes are not yet incorporated into the law, some foreign financial institutions (such as Deutsche Bank, Hong Kong and Shanghai Bank, and some Dutch banks) will not deal with Palauan banks, and this is having a negative effect on the tourist industry. However, legislative action has not been taken, and in the future no regulations relating to financial institutions can be passed without a joint resolution from both houses in the OEK.

3. Lending, Cultural Issues and Private Sector Development in Palau

85. Palauans have extensive family commitments, which require many to regularly contribute what may be substantial sums to relatives and friends within their social network. While these obligations are difficult for outsiders to understand, they can often result in excessive borrowing, beyond the means of a borrower to repay. This partially explains the high default rate on bank loans, indicating that while the structure of interlocking social commitments provides a safety net, that net is not without cost. Some Palauans are perpetually in debt.

86. As an analysis of Palauan enterprise observed:

To succeed, modern enterprise needs the understanding and cooperation of all its enterprise constituencies. The struggle between cooperation and competition and between the vested interests of the traditional and modern together fashion a changing set of values and expectations that greatly influence whether or not indigenous enterprise can survive and if so in what form. Modern society needs enterprise and this enterprise needs the support of its constituents but if these constituents succeed in demanding more immediate distributions of enterprise profits, cash flow will suffer and enterprises may not succeed.¹⁵

87. The transition from a traditional subsistence economy, in which surpluses are distributed as cultural obligations, to a modern cash economy, in which retained earnings are reinvested in businesses, is a gradual process. Certain changes, including those discussed, for instance, in the sections on collateral reform, credit information, and bankruptcy, will contribute to this modernization process. Various other factors are working against this evolution. The learning process of adapting to new social and commercial realities will be slowed if the Government—rather than business and commerce—is regarded as the traditional employer of the Palauan community. Learning tends to be greatest in companies owned by foreign investors, and encouragement and expansion of foreign investment will contribute greatly to the modernization of Palau's economy.

¹⁴ These were identified in the Financial Institutions Act.

¹⁵ Pollard, Stephen. 1995. *The Culture of Successful Palauan Enterprise*, Pacific Islands Development Series, No. 8. Honolulu, Hawaii: East-West Center Working Papers.