

Chapter 6

Increasing Access to Finance

Constraint: *After reforms are implemented, a lack of access to finance will lead to some investment opportunities being lost.*

A. Financial Markets

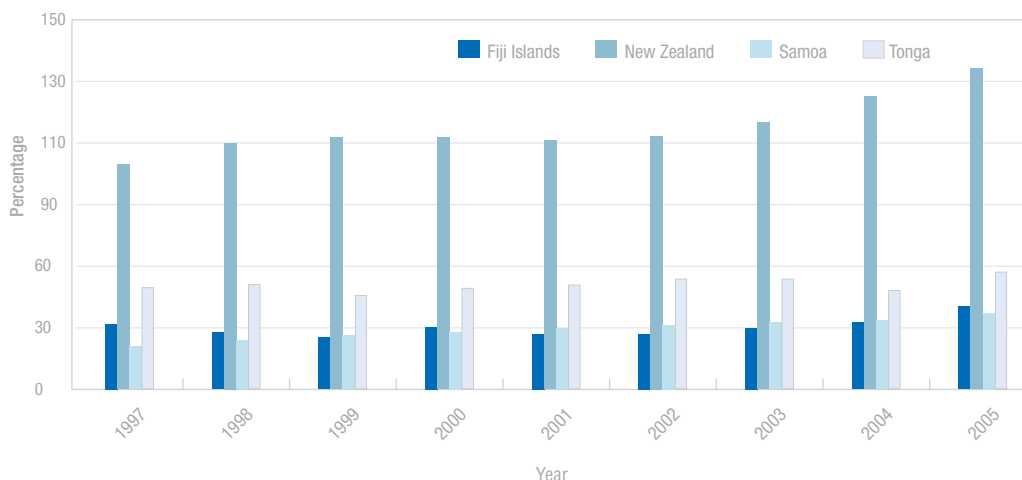
By several measures, Tonga has the best-developed financial market in the Pacific region.²⁵ Over the past few years there has been a rapid expansion of credit to households, much of it to finance construction. While the banks themselves complain of tight liquidity, the Reserve Bank of Tonga believes the tightness in the system is appropriate, given current macroeconomic circumstances. Existing limits are probably appropriate—there is currently enough liquidity to sustain business activity. So apart from the capital required for rebuilding Nuku’alofa, which needs to come from outside the country, increases in credit would probably not result in increased real growth over the short

term. Under present circumstances, access to finance is probably not a problem for business growth.

But if the barriers to private sector development identified in this report are removed, returns to capital will increase, and many more investment and business opportunities will arise. At that point, economic growth could be increased by a greater availability of finance. Without improved financial markets, many investors and entrepreneurs will not be able to find financing, and opportunities will go to waste. Since financial market reforms frequently involve changes in the law, planning horizons are normally long. To ensure that access to finances does not become a constraint, actions to initiate change should start soon.

Tonga has four licensed financial institutions: two foreign-owned commercial banks (ANZ and Westpac),²⁶ a locally incorporated

Figure 10: Domestic Credit to the Private Sector (% of GDP)



Source: World Development Indicators.

²⁵ The World Bank Doing Business indicators currently rank Tonga as having the least-developed financial market in the Pacific. This ranking is not consistent with our findings presented in this chapter.

²⁶ The government owned 40% of Westpac until recently, when this share was sold to the Westpac group.

commercial bank, and the government-owned Development Bank of Tonga. All four are profitable, but profit rates are lower than those of banks in other Pacific Island economies.

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B. The Collateral System

To deepen the financial system, the way in which assets are pledged as collateral for loans needs to be strengthened. Such a change would probably increase the demand for money and improve the potential for growth, especially if combined with the introduction of a credit information bureau (see the next section). This suggests that credit could expand more rapidly without causing inflation.

The collateral framework in Tonga (also known as the secured transactions framework or the personal property securities framework) is complicated, costly, and does not provide lenders with confidence that they can repossess and sell pledged assets in the event of default. This makes lending risky, especially to smaller businesses. While it is possible for banks to take security interests over leases and company assets, if the borrower fails to repay the loan, the process of repossession is costly and lengthy, and the final outcome is uncertain.

Because of the uncertainty and expense, banks insist on businesses providing collateral equivalent to several times the value of the loan, thereby raising the risk of borrowing

as well.²⁷ The mechanism for businesses to pledge collateral is the company charge,²⁸ which is costly because it requires hiring a lawyer to draw up the documents.

The creation of charges over assets occurs through provisions of the Companies Act in the case of corporations, but since the Companies Registry was destroyed in the civil disturbances, there is no reliable and comprehensive record of existing charges. Determining whether assets have already been pledged to another lender is also difficult. For example, banks reported having to call other financial institutions to ensure that automobiles are unencumbered as collateral. There is little or no lending to sole proprietors unless they have real estate leases to pledge as security.

One good thing about the legal system in Tonga is that lawyers can serve notices related to civil procedures, obviating any need to wait for bailiffs to do so. This speeds up the process. However, it can take a long time to get a court order to repossess pledged assets. Bankers did indicate that there is a good repayment culture, and they have found that announcing defaulting debtors' names on the radio is often enough to prompt repayment. However, shaming debtors into repayment is a poor solution to the problem of overdue loans. While the repayment culture probably accounts for the willingness of financial institutions to lend, all the people interviewed who deal with financial markets in Tonga strongly supported an initiative to reform the secured transactions framework.

A further hindrance to financial market development arises from the Land Act's prohibition of the mortgaging of crops (Chapter 7). In countries with flourishing agricultural sectors, crop mortgages are a major source of financing for farmers. Since agriculture is a large part of the economy and has great

²⁷ If the business fails, the borrower risks losing much more than the value of the loan because lenders typically cannot sell the repossessed assets for their full value.

²⁸ A company charge is a collateral interest in company property created in favor of a creditor to secure the amount owed to the lender. In Tonga, the Registrar of Companies registers most charges.

potential to expand, this prohibition adds to the difficulties of obtaining financing for the development of the sector (Chapter 8).

C. Credit Information

Currently no records on the credit worthiness of loan applicants in Tonga are available. Banks are therefore unable to assess the likelihood of being repaid. In addition, some people move to other countries in the hope of not having to repay the loans they already have. Tongans move with ease between Tonga and New Zealand, as well as between Tonga and the United States and Australia. Banks, therefore, generally turn down most loan applications that are not secured by collateral. As a result, those remaining in Tonga who would be a good credit risk are excluded because of the behavior of a small number of defaulters. The lack of credit information raises the risks of lending.

As pointed out in the chapter on laws and regulations, the Financial Institutions Act (2004) requires financial institutions to get the permission of customers before providing information on them. This clause inhibits the establishment of a credit bureau, which is an important part of a modern financial system.

A credit bureau should be established in Tonga, and it should be connected to the ones in New Zealand and Australia so credit information can be shared. This would reduce the risk of default because leaving the country would not be as easy a way to avoid debt. The result would be that interest rates on borrowing in Tonga would decline for those who are creditworthy. This would expand access to finance for Tongans, particularly for microbusinesses and small businesses. The provision in the Financial Institutions Act (2004) would have to be abolished for this to work.

D. Microloans

The success of small-scale lending initiatives in countries such as Vanuatu and Papua

New Guinea shows microloans to be a good way to assist farmers, microbusinesses, and women's groups. While some microfinance is available in Tonga, the practice is still in its infancy. We strongly recommend investigating the feasibility of introducing a pilot scheme in Tonga that is similar to the initiatives in Vanuatu. If such a scheme were combined with new technologies, such as smart cards and mobile phone payments systems, there would be added benefits, including the ability to transfer remittances at much lower cost than is now possible. But a legal foundation for the electronic transfer of funds (whether for microfinancing or remittance transfers) would have to be created by modifying the exchange control regulations and passing an electronic transactions act.

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E. Remittances

Migrants send home the equivalent of 40% of Tonga's GDP as remittances. They are not only an essential buttress to living standards, but also a source of finance for small businesses and agricultural enterprises. The extent to which remittances are invested rather than consumed depends directly on rates of return that can be realized from investing in Tonga. There is anecdotal evidence that a large amount of the building that has been taking place in Nuku'alofa has been financed by remittances. (This risks remittances being used to bid up prices for land and buildings, resulting in a housing bubble that could be damaging in the long run.)

The Chamber of Commerce has targeted the Tongan diaspora as a source of outside investment and know-how. It is too soon to know how successful this initiative will be,

but other countries with large diasporas have been able to harness the energy and knowledge of its citizens living overseas. Ireland and India are notable examples. However, such successes usually only occur when the originating country is growing rapidly enough to provide expatriates with opportunities. The initiative could have a positive effect if reform is successful because it would provide places to invest other than real estate.

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Currently, the cost of transferring remittance funds is high—more than 10% of the average amount transferred. This benefits the financial institutions making the transfers, but not Tonga. Freeing up more of this money would promote savings and make more finances available.

In other parts of the world, reform and heightened competition have lowered the costs of remittance transfer. The recent experience of a number of Latin American countries in bringing down the costs of transfer is illuminating. The important lessons from the Latin American experience are:

- Technology can make a big difference. Mobile phone penetration in Tonga is high and will probably expand now that Digicel has started operations in the country. This provides an opportunity to use cellular-based payment systems, such as those that have arisen in the Philippines and South Africa, where using mobile phones as devices to receive remittances has brought down the cost of transfer dramatically.
- The use of credit unions in both the sending and the receiving countries can inject much-needed competition. In several Latin American countries, central bank involvement was instrumental in modifying regulations and in assisting with clearing

facilities that allowed credit unions to enter this sector. Similar measures could be considered in Tonga.

- Funding agencies can play a major role in highlighting the problem at conferences on financial markets and microfinance.

To use new technology for remittances and microfinance, it is necessary to reform the exchange control regulations and pass an electronic transactions act.

F. Other Sources of Finance

The National Economic Development Council, a committee chaired by the Prime Minister, has established a T\$15 million fund to assist in the financing of businesses that will be lent through commercial banks. In other countries such initiatives have been no more than marginally successful. The long-term solutions to lack of access to finance are rather

- a well-functioning collateral framework
- an effective credit information system
- a commercially based microcredit industry

G. Summary of Recommendations

- Pass a new law that reforms the personal property securities framework.
- Establish an electronic registry that records what collateral has been pledged, by whom, and to which lenders.
- Establish a credit information system that is linked to credit bureaus in Australia and New Zealand.
- Investigate the feasibility of introducing a microfinance pilot scheme.
- Promote competition between institutions transferring remittance funds and use modern technologies, such as smart cards and mobile phones, as ways to lower remittance fees.
- Reform exchange control regulations.