

## BACKGROUND

Solomon Islands is the second largest of the PDMCs, with a total land area of almost 29,000 square kilometers dispersed among six main islands and more than 900 others, and an exclusive economic zone of 1.3 million square kilometers. About 80 percent of the land is rugged mountain terrain, and less than 25 percent is suitable for agriculture; but there is a relatively rich endowment of forest and mineral, as well as marine, resources. The fast-growing population was estimated to be close to 460,000 in 2000. Over 95 percent are Melanesian; 85 percent live in rural villages; and 40 percent live on Guadalcanal and Malaita. There is considerable cultural and linguistic diversity. More than 90 languages are spoken.

After Papua New Guinea, Solomon Islands has the lowest living standards of any PDMC. Although economic and social progress has been made since independence in 1978, the country remains in the "low human development" category, as measured by the Human Development Index. GDP per capita was around US\$700 in 1999. Life expectancy is relatively high at 65 years, but the infant mortality rate is 38 per 1,000, and the adult literacy rate is a low 30 percent. On average, a Solomon Islander receives less than three years of schooling, and the population per doctor is 7,300. Malaria is still a major health problem.

Solomon Islands is a parliamentary democracy within the British Commonwealth. The Head of State is the British monarch, represented by the Governor-General (a Solomon Island citizen).

The Head of Government is the Prime Minister, who is elected by a majority of the 50 members of the unicameral parliament. Elections are held under a first-past-the-post system every four years, the last being in 1997, when a coalition known as the Solomon Islands Alliance for Change won office. Coalitions have proven to be fragile, with no-confidence votes causing Parliament to dissolve. There have been eight governments since independence. In addition to the national Government, there are nine provincial assemblies, each led by a premier.

About 87 percent of land in Solomon Islands is communally owned and has been held by the villages and clans without title for generations. The other 13 percent is divided between Government and private owners who have acquired land largely for urban use. Customary land may not be sold for any purpose, especially to nonindigenous persons and institutions. Private interests can obtain access to land through leases, where the Government acts as agent; but the process can be long and costly.

## THE MACROECONOMIC ENVIRONMENT

Limited national accounts data that take no account of natural resource depletion and environmental damage suggest that Solomon Islands had an average annual rate of economic growth of 4 percent in the period 1980–1995 (ADB 1998). The relatively narrow primary product export base of logs, fish, and oil palm and the vagaries of climate made that growth erratic. Per capita income growth, however, was less than 1 percent annually because of an annual population growth rate in excess of 3 percent. Growth accelerated to over 5 percent per year in the first half of the 1990s, largely as a result of harvesting the forests at an unsustainable rate.

The growth rate fell in the second half of the 1990s, as the economy moved into an economic crisis induced by years of chronic economic mismanagement and the collapse of log markets following the Asian financial crisis. Real GDP grew by 3.5 percent in 1996, and then declined by 2.3 percent in 1997. There was a temporary recovery in 1998, when growth was 1.1 percent; but recession followed in 1999, real GDP contracting by 1.3 percent (Table 6.1). The loss of log export markets

unfortunately occurred just as a new Government won office (in August 1997) on a platform of restoring macroeconomic stability and implementing an economic and public sector reform program (with financial support from the Asian Development Bank [ADB]).

Previous governments had run unsustainable budget deficits that had led to balance of payments and inflationary pressures and discouraged private investment. The Minimum Liquid Assets Ratio had been set at the statutory limit of 40 percent and included Treasury bills, thus forcing commercial banks to fund the deficits. The legal limit on borrowing from the central bank was reached in 1994 and exceeded in 1995, forcing suspension of trading in Government securities and creating great stress in the financial system. Budget deficits were then funded by accumulating arrears. The inflation rate averaged close to 11 percent in 1990–1997; and foreign reserves fell to as low as two weeks of import cover. At the end of 1997, domestic and external public debt (including arrears) were each approximately 26 percent of GDP.

In an effort to restore macroeconomic stability, the new administration devalued the Solomon Islands dollar by 20 percent in December 1997, and took a number of initiatives to increase revenue and contain expenditure. There was an immediate cancellation of tax exemptions and remissions that did not involve legally binding agreements. A simplification of the tariff system was completed and introduced. Income taxes were revised in order to broaden the tax base and improve equity, and a range of other revenue-raising measures was adopted. On the expenditure side, the Government instituted a public service wages freeze, restricted payment of allowances, and froze all recruitment in advance of further actions aimed at downsizing and streamlining the civil service. It also began a limited clearance of domestic and external arrears.

The Central Bank of Solomon Islands (CBSI) tightened monetary policy in 1998 by raising its call deposit rate, and by raising yields on central bank short-term securities (Bokolo bills) and making them available to the public. This had some effect on deposit rates, but they remained negative in real terms. Commercial banks continued to earn negative real returns on their substantial holdings of Treasury bills: even with the

**Table 6.1**  
**Macroeconomic Indicators for Solomon Islands, 1994–1999**

	1994	1995	1996	1997	1998	1999
<b>Output and inflation</b>						
Real GDP growth	5.2	10.5	3.5	-2.3	1.1	-1.3
Change in CPI (end period)	13.3	9.6	11.8	8.1	12.4	8.0
Public Savings/Investment (% of GDP)	-5.5	-5.3	-4.4	-4.8	0.2	-0.6
Private Savings/Investment (% of GDP)	5.9	9.4	7.8	-5.4	5.3	4.1
National Savings/Investment (% GDP)	0.4	4.1	3.4	-10.2	5.5	3.5
<b>Money and Credit</b>						
						(annual percent change)
Net foreign assets	-16.5	-1.0	152.4	41.9	49.1	—
Net domestic assets	34.6	11.7	-3.6	-6.9	-20.1	—
Total domestic credit	24.7	8.5	1.9	3.3	-3.5	—
Private sector credit	22.3	14.1	6.3	8.4	25.3	—
Broad money growth	24.1	9.9	15.7	6.3	4.8	5.4
						(percent of total credit)
Private sector credit	33.4	35.2	36.7	38.5	50.0	49.1
Government credit	66.6	64.8	63.3	61.5	50.0	50.9
<b>Central Government</b>						
						(percent of GDP)
Revenue and Grants	47.1	39.9	39.2	33.7	37.1	38.6
o/w Grants	18.4	11.3	14.8	10.7	12.7	15.7
Total Expenditure	52.6	45.3	43.6	38.5	37.0	40.9
Recurrent expenditure	31.5	29.4	26.4	26.2	22.8	21.1
Wages and salaries	12.6	10.9	10.4	11.1	10.9	8.7
Interest payments	4.0	4.0	4.3	3.2	2.1	1.8
Development expenditure	21.1	15.9	17.2	12.2	14.2	19.9
Current Balance	-2.8	-0.7	-2.0	-3.2	1.7	1.9
Overall Balance	-5.5	-5.3	-4.4	-4.8	-2.5	-2.4
Domestic borrowing (incl. arrears)	6.0	3.4	2.7	4.0	-3.5	-1.2
Foreign borrowing (incl. arrears)	-0.4	1.9	1.8	0.8	3.4	3.5
<b>Balance of Payments (US\$ mn)</b>						
Exports, f.o.b.	142.2	168.1	162.4	173.9	140.8	149.6
Imports, f.o.b.	-142.3	-154.3	-151.2	-209.4	-146.9	-140.1
Services, net	-65.3	-48.0	-47.5	-42.1	-15.0	-30.8
Private transfers, net	15.1	14.0	9.6	8.9	-0.8	0.1
Official transfers	51.5	33.7	38.6	30.8	38.3	56.3
Current Account (incl. grants)	1.2	13.4	12.0	-37.9	16.4	35.1
(In percent of GDP)	0.4	4.1	3.4	-10.2	5.5	9.9
Medium & Long-term capital	-2.2	-8.8	-17.0	44.5	21.0	-25.5
Overall Balance	-2.4	-4.2	9.5	-6.2	20.9	1.8
Gross Official Reserves (US\$ mn)	16.6	15.1	32.2	31.5	48.6	50.6
(in months of imports of goods and services)	0.8	0.8	1.6	1.2	2.7	2.7
External debt (US\$ mn)	182.6	165.8	166.9	196.0	145.6	175.0
(In percent of GDP)	61.8	50.7	46.9	52.6	48.4	49.4
Exchange Rate (SI\$/US\$) end of period	3.33	3.48	3.62	4.77	4.90	5.10
Real Effective Exchange Rate (1990=100)	105.4	103.0	110.1	120.1	112.8	—

— Not available

Source: Solomon Islands authorities; ADB 2001; IFS

Government's effective commitment to servicing its debt for the first time in more than two years, the 6-percent rate on bills was half the inflation rate. The banks maintained wide intermediation margins of 10 percent. A rise in Treasury bill rates was precluded by the budgetary implications of a rate rise.

The limited economic recovery in 1998 was interrupted in mid-1999 by the effects of an insurgency on the island of Guadalcanal. This forced the Government to declare a state of emergency between June and October, led to the displacement of 25,000 Malaitans who had settled on the island, and caused the indefinite closure of the country's major oil palm producer, Solomon Islands Plantations Limited (SIPL). Several tourist resorts were also closed, cocoa and copra production were disrupted, and market gardening was severely curtailed. Business confidence, which was already low, sank further. The insurgency derailed the expected privatization of SIPL and threatened the rehabilitation of public finance. The overall fiscal deficit increased to 2.4 percent of GDP, compared with the improved outcome of 1.6 percent recorded in 1998.

Monetary policy eased a little in 1999. CBSI lowered the minimum liquid asset ratio from 40 to 7.5 percent and redefined it to exclude Government securities. The Government securities market was reactivated in May 1999, following a restructuring of Government debt that involved the conversion of frozen Treasury bills into medium-term bonds and the gradual phasing out of Bokolo bills. Commercial banks invested some of their excess reserves in Treasury bills offered at auction, but still retained free liquidity of 10 percent of assets at the end of the year. The interest rate spread remained at 10 percent, with average deposit rates negative in real terms. The rates on CBSI short-term securities and Treasury bills were unchanged as the emphasis shifted to bills as the main monetary policy instrument. The growth rate of the money supply remained at around 5 percent, and the inflation rate fell to 8 percent.

The balance of payments position strengthened in 1999, as a result of a 6-percent rise in merchandise export receipts, a 5-percent decline in imports, and an increase in capital receipts attributable to official bilateral and multilateral inflows. The rise in export receipts reflected greater earnings from gold, copra, and log exports, while a decline in imports occurred

across all import categories. The exchange rate remained relatively stable in 1999, with the Solomon Islands dollar (SI\$) depreciating slightly against the US and Australian dollars and appreciating slightly against the New Zealand dollar. External reserves increased from SI\$234 million at the end of 1998 to SI\$276 million, equivalent to 3.5 months of import cover.

Social unrest continued into 2000 and escalated, with the emergence of the Malaita Eagle Force, which claimed to represent the interests of Malaitans forced off land in Guadalcanal by the Guadalcanal Revolutionary Army, and the Isatambu Freedom Movement. On 5 June, the Eagle Force and disaffected police officers seized key installations in Honiara and kidnapped the Prime Minister, demanding and getting his resignation. On 13 June, a new Government was formed with a new Prime Minister, but considerable further damage had been done to the economy. The Gold Ridge mine closed in June, and the operations of tourist facilities and the Solomon Taiyo fish cannery were disrupted.

It is estimated that real GDP fell 14 percent in 2000, with inflation dropping to 6.6 percent despite higher world oil prices. As tax revenue dropped and external assistance was suspended, the Government experienced severe cash flow difficulties, which intensified toward the end of the year despite expenditure cuts. The overall fiscal deficit was projected to be 4.5 percent of GDP, which was financed by central bank credit to an extent that the statutory limit (increased in August 2000) was almost reached. Broad money grew by 9.5 percent as banks curtailed credit to the private sector. Foreign reserves were safeguarded by delays in releasing foreign exchange; and in order to avoid exchange rate uncertainty, the Solomon Islands dollar was pegged to the US dollar in the period June–November (as opposed to the usual practice of pegging it to a basket of currencies of major trading partners). Foreign reserves recovered to two months of import cover at year end.

A peace accord was signed in October 2000, offering a basis on which to end ethnic violence, restore political stability, and rehabilitate the economy. The latter requires strong Government commitment to sound macroeconomic management, considerable external assistance (including an ADB post-conflict rehabilitation loan of US\$10 million), and a

revival of investor confidence. Even more fundamentally, a long-term strategy is needed that addresses the causes of economic inequality and tensions between regions and ethnic groups. In the meantime, there are no signs of a short-term revival of investor confidence. Major enterprises in agriculture, fishing, and mining remain closed.

## THE STRUCTURE OF THE FINANCIAL SECTOR AND INSTITUTIONS

The financial system of Solomon Islands comprises CBSI; three commercial banks (the National Bank of the Solomon Islands [NBSI], the ANZ Bank [ANZ] and Westpac [Westpac Banking Corporation]); the Development Bank of Solomon Islands (DBSI); the Solomon Islands National Provident Fund (SINPF); the Home Finance Corporation; the Investment Corporation of Solomon Islands (ICSI); and four life insurance firms. NBSI is 51-percent owned by the Bank of Hawaii and 49-percent owned by SINPF.

CBSI was set up under the Central Bank Act of 1977 and the Monetary Authority Act of 1981. Its functions are to conduct monetary and exchange rate policy, exercise prudential regulation and supervision of the licensed financial institutions, and manage the country's foreign exchange reserves. The policy objectives for CBSI are to maintain an adequate level of foreign exchange reserves and to maintain low inflation. A new Financial Institutions Act was passed by Parliament in 1998. The thrust of the new Act was to provide for the regulation and supervision of financial institutions carrying on banking business in Solomon Islands, and to repeal the Banking Act of 1976. The new act specifically stipulates that other financial institutions be brought under the supervisory functions of CBSI. The Minister of Finance has directed that DBSI and SINPF should come under CBSI supervision, but the decision was not gazetted because of the civil unrest, and therefore does not yet have legal status.

SINPF, a statutory body under the supervision of the Ministry of Finance, is the largest single financial institution, with 28 percent of the total assets of the financial system in 1999 (Table 6.2). It is responsible for collecting the compulsory

**Table 6.2**  
**Total Assets/Liabilities of the Financial System, 1994–1999**

	1994	1995	1996	1997	1998	1999 <sup>a</sup>
	(in percentage of Total Assets/Liabilities)					
Central Bank of Solomon Islands	19.3	19.5	22.9	24.5	28.0	26.3
Commercial Banks	45.7	44.6	42.8	40.9	37.6	39.2
National Bank of Solomon Islands	21.8	22.9	24.5	24.4	20.3	23.2
ANZ Bank Ltd				11.6	11.8	10.4
Westpac				4.8	5.5	5.6
Nonbank Financial Institutions	35.0	35.9	34.3	34.6	34.4	34.5
Solomon Islands National Provident Fund	31.2	31.8	30.1	30.0	29.8	28.4
Development Bank of Solomon Islands	3.8	4.1	4.2	4.6	4.6	4.6
Credit Unions						1.6

a. To September 1999.

Source: CBSI 1998, 1999.

social security taxes levied on employers and employees. Funds raised are invested in commercial enterprises and Government securities. SINPF has lent money to the Solomon Island Electricity Authority, Solomon Taiyo Limited, ICSI and several provincial governments. Loans to provincial governments and State-owned companies are all guaranteed by the national Government. Loans to the Government were in arrears in 1997/98. However, in 1999 the Government swapped 48.1 percent in Telekom for loans. Other arrears that the Government had with SINPF were converted into Treasury bills and bonds.

The assets of the three commercial banks amounted to almost 40 percent of the assets of the financial sector in 1999 (Table 6.2). NBSI held 23 percent, ANZ 10 percent, and Westpac almost 6 percent. Because of the scattered nature of Solomon Islands, the lack of transportation and communication networks, and the cost of servicing all the provinces, the banks' outreach is limited. There is only one bank branch or agency for every 13,364 people. Banking services are concentrated on Guadalcanal and Malaita. NBSI maintains its head office in

Honiara and has 11 branches: four in Honiara, three in the Western Province, one in Central Province, one in Malaita Province and one in Temotu Province. It also has three agencies. ANZ has its main office in Honiara and operates a branch on Malaita, and Westpac maintains its head office in Honiara with a branch on Guadalcanal. All the commercial banks, as well as the Post Office, have agencies at the airport for foreign exchange transactions. DBSI has branches/agencies in each of the nine provinces.

As of September 1999, the commercial banks' outstanding portfolio was dominated by business loans; with 53 percent in industry, business and professional, and other services; 33 percent in personal loans; and 14 percent in other types of loans. The commercial banks as a group showed a net profit after tax at the end of 1998 of 6.2 percent of average assets. Their net margin on loans was 17 percent; and the net margin on other assets increased from 3.4 percent to 16.7 percent at the end of 1998, in large part due to the effect of interest received on Government securities. In 1999, the banks collectively showed a pretax profit of 7.4 percent of average assets. As expected in an oligopolistic industry, there is limited competition among the banks. NBSI provides commercial loans, overdrafts, housing loans, and personal loans. ANZ and Westpac tend to lend to corporations with foreign links.

ICSI activities involve taking equity positions in domestic companies, with income derived by way of dividends from the investments. The Government's privatization program, under which the Government equity in ICSI companies is to be sold, is aimed at raising funds to pay debt arrears and to restrict Government to its core functions. In 1998, some SI\$9.9 million was received in dividends by ICSI, principally from the two profitable operations of Solomon Islands Plantation Limited (SIPL) and Solomons Telekom.

DBSI is 100-percent Government-owned, and was established under the Development Bank of Solomon Islands Ordinance of 1977 as an independent statutory body. It had almost 5 percent of the assets of the financial system in 1999. It was established to provide short- and medium-term loans to local commercial and rural agricultural enterprises using resources obtained mainly from concessional external

borrowing and from bilateral assistance grants. It accepts deposits.

Credit unions were first introduced to Solomon Islands in 1968, went out of existence for a time, and then were reintroduced in the early 1980s. The Solomon Islands Credit Union Act was passed in 1986, and in 1987 all credit unions were required to register under the umbrella organization, the Solomon Islands Credit Union League (SICUL), whose chairman is the Governor of CBSI. Credit unions are a small component of the financial sector: in 1999, total assets were estimated at SI\$21 million (1.6 percent of the assets of the financial system), and total membership was estimated at 17,000. They have not, however, been an unqualified success. Of the 164 listed credit unions, 77 percent were described as dormant.

## FINANCIAL DEEPENING AND INTERMEDIATION

There was very little financial deepening during the 1990s. After being crowded out by Government borrowing in the period 1990–1996, private sector credit grew by 10 percent in 1997 and 25 percent in 1998, before civil unrest caused a loss of investor confidence. Bank claims on the private sector were 11 percent of GDP in 1994 and remained at 11 percent in 1999. The ratio of narrow money to GDP increased from 13.6 percent in 1995 to 14.6 percent in 1999, while the ratio of broad money to GDP fell from 27.2 percent to 24.2 percent. Consequently, the ratio of narrow money to broad money actually rose, from 50 percent in 1995 to 60 percent in 1999. People were less inclined to use the formal financial system for saving. They were also making less use of demand deposits, with currency in circulation outside the banks rising from 4.4 percent of GDP in 1995 to 5.8 percent in 1999 (Table 6.3).

Interest rates on both deposits and lending have fallen over the 1990s. The rate on deposits dropped from an average of 9 percent in 1992 to 3.3 percent in September 1999. The weighted average rate for lending fell from 18.3 percent in 1992 to below 14 percent in September 1999. Although lending rates have been positive in real terms over the 1990s, real deposit rates have been negative, averaging around –4 percent per year

**Table 6.3**  
**Financial Intermediation Statistics, 1994–1999**

	1994	1995	1996	1997	1998	1999
	(in millions of Solomon Island dollars)					
Money Supply (M2)	309.4	340.1	393.5	418.3	438.5	421.7
Narrow Money (M1)	160.4	169.6	198.2	211.4	220.6	254.4
Currency outside banks	50.3	55.0	59.7	70.8	81.3	101.0
Demand Deposits	110.2	114.7	138.5	140.5	139.2	153.4
Banks	109.3	113.6	136.8	139.3	135.7	—
CBSI	0.8	1.1	1.7	1.3	3.5	—
Quasi Money	148.9	170.5	195.3	206.9	217.9	167.3
Savings Deposits	60.6	64.3	64.3	77.1	74.8	—
Time Deposits	88.3	106.1	131.0	129.8	143.2	—
	(in percent)					
Growth of Demand Deposits		4.1	20.8	1.5	-0.9	10.2
Growth of Time Deposits		20.2	23.4	-0.9	10.3	—
Currency in percent of GDP	4.4	4.9	4.6	5.1	5.6	5.8
Narrow Money in percent of GDP	13.6	15.2	15.3	15.2	15.2	14.6
Broad Money in percent of GDP	27.2	30.5	30.4	30.1	30.3	24.2
Private Sector Credit (percent of GDP)	11.1	11.1	10.1	10.2	12.3	11.0
Private Sector Credit (percent of total credit)	33.4	35.2	36.7	38.5	50.0	59.5
Currency (per cent of broad money)	16.3	16.2	15.2	16.9	18.5	18.0
Narrow Money (percent of broad money)	51.9	49.9	50.4	50.5	50.3	60.4
Quasi Money (percent of broad money)	48.1	50.1	49.6	49.5	49.7	39.7
Demand Deposits (% of narrow money)	67.0	67.6	69.9	66.5	63.1	60.3
Total Domestic Credit/ Banking Sector Assets	98.5	101.9	89.0	86.8	78.6	69.0

— Not available.

Sources: CBSI 1998, 1999; ADB 1998; IFS (for 1999 data)

(Table 6.4). Net interest income as a percentage of average earning assets for the commercial banks averaged around 10 percent over the decade. However, the spread between deposit and lending rates, which reached its maximum in 1996 and

**Table 6.4**  
**Nominal and Real Returns on Savings and Lending, 1992–1999**

	Weighted Average Deposit Rates	Average Lending Rates	Inflation Rate	Real Savings Rates	Real Lending Rates	Nominal Interest Spread
1992	9.57	18.32	10.72	-1.2	7.6	8.75
1993	8.42	17.50	9.17	-0.8	8.3	9.08
1994	7.66	16.23	13.32	-5.7	2.9	8.57
1995	7.39	16.64	9.58	-2.2	7.1	9.25
1996	4.76	16.39	11.76	-7.0	4.6	11.63
1997	1.84	14.54	8.08	-6.2	6.5	12.70
1998	4.36	14.13	12.32	-8.0	1.8	9.77
1999 <sup>a</sup>	3.28	13.74	7.00	-3.7	6.7	10.46

a. To September 1999.

Source: CBSI 1999 and Table 6.1.

1997, fell to lower levels in 1998 and 1999. Commercial bank margins nonetheless remained quite high in comparison to international and regional standards. This mainly reflects higher transaction costs and risks.

## NONBANK FINANCIAL INSTITUTIONS

### Solomon Islands National Provident Fund

Members' contribution accounts with SINPF stood at SI\$336 million as at the end of 1998, an increase of 9 percent over the previous year. At present, the fund pays out a lump sum when members retire, which they may do at age 50. It is understood that, in most cases, these sums are spent within a very short time. They do not, therefore, perform the function of providing support for members' old age. The provision of a pension would require an actuarial review.

The cumulative value of loans outstanding to statutory authorities and the private sector totaled SI\$117 million at the end of 1998, 19 percent higher than the previous year. SINPF invests in property; loans to Government companies such as

the provincial shipping company and the electricity authority; equity; and Government bills and bonds. The property investments are largely domestic. However, there is one overseas investment, a property in Brisbane. The purchase of this property has been the subject of a report by the ombudsman, who criticized virtually every aspect of the investment decision. The rental returns received are not commensurate with the price paid, and consideration is being given to selling and absorbing the loss. The provincial shipping company is in arrears and the electricity company is not making profits. The equity investments were brought directly from the Government and are making a profit. These investments are in the NBSI, which is managed by the Bank of Hawaii; and Solomon Islands Telecom. In theory, Government paper gives a better rate of return than term deposits with the banks. But for a number of years, SINPF was saddled with a large, nonperforming component in its investment portfolio, because of the suspension of the securities market in 1995 and nonpayment of interest on Government securities.

Politically directed investments and effectively coerced acquisition of Government securities are evidence of substantial Government involvement in the management of SINPF. The act under which it is established requires that investments be made in the members' interests. This has not always been the practice. The SINPF board has been dominated by Government officials who understandably have been subject to political pressure.

SINPF generally holds excess funds with the commercial banks, although one of the banks has refused to accept any further deposits, as it already has excess liquidity. SINPF is running out of domestic investment opportunities and is considering investing abroad. This would generally be desirable, if it were conducted according to strict investment guidelines in a good corporate governance environment, and using the services of a professional fund manager (as recommended in an AusAID-funded review of SINPF). However, the fragile state of the external accounts precludes automatic permission and provision of foreign exchange from the CBSI. SINPF is also considering whether to allow members to use their funds to start small businesses, but is wary because of their lack of business skills.

## Development Bank of Solomon Islands

DBSI was established with an initial capital of SI\$5 million (subsequently increased to SI\$10 million) under the Development Bank of Solomon Islands Act of 1977, as an independent statutory body under the direction of its own Board. ICSI holds 51 percent of the share capital on behalf of the Government. CBSI is also a shareholder. Under its act, DBSI's primary role is to foster economic development and the production of the private sector. DBSI may also provide financial assistance to State-owned enterprises. The role and purpose of DBSI has not been amended since the Act was passed in 1977.

DBSI provides primarily medium-term fixed-asset financing for local commercial and rural agricultural enterprises. Its collateral requirements are less stringent than those of commercial banks, which require cash deposits as collateral. DBSI borrowers are mostly start-up, relatively high-risk businesses. As table 6.5 shows, the lending portfolio grew rapidly in the late 1990s, and was close in size to the average for the three commercial banks. Almost 41 percent of outstanding loans in 1998 were to the services sector, followed by 22 percent to the industry sector and 18 percent to agriculture, forestry and fisheries.

The growth in lending did not reflect implementation of sound strategies, however. During the period 1995–1999, a growing arrears problem led to deterioration in DBSI's underlying financial position (Table 6.6). Lending was not appropriately priced for risk: the lowest interest rates were charged for agricultural loans, which are the riskiest, smallest, and hardest to supervise in the economy, and exhibit the highest level of arrears. DBSI's funds were obtained at relatively high cost. DBSI was paying 10 percent on its term deposits, which was significantly higher than commercial bank rates for similar terms. DBSI also borrowed from SINPF at 14 percent per year and issued development bonds at 10–10.75 percent. Not surprisingly, DBSI recorded low profits followed by large losses. Shareholders' funds declined from a high of SI\$14 million in 1995 to a little over SI\$10 million in 1998 (Table 6.6).

**Table 6.5**  
**A Comparison of Commercial Bank and DBSI Lending,**  
**1995–1998**

COMMERCIAL BANK LOANS	1995	1996	1997	1998
	<b>SI\$'000</b>			
Agriculture, Forestry, Fisheries	11,617	8,717	10,914	15,668
Commerce & Distribution	27,710	36,347	334,762	54,256
Industry	18,197	22,075	31,900	35,680
Services	28,507	23,795	22,063	20,723
Others	39,469	42,316	46,417	51,649
Total	125,000	133,250	146,056	177,976
Average per Bank (3 banks)	41,833	44,417	48,685	59,325
	<b>SI\$'000</b>			
DBSI LOANS	1995	1996	1997	1998
	<b>SI\$'000</b>			
Agriculture, Forestry, Fisheries	6,443	7,264	7,789	9,430
Commerce & Distribution	4,579	6,427	9,954	4,374
Industry	4,104	3,783	4,311	11,540
Services	12,964	16,881	20,838	21,482
Other	1,826	2,294	3,925	5,792
Total	29,916	36,648	46,817	52,618

Sources: Commercial banks and DBSI 1997, 1998, 1999

DBSI has experienced governance and management problems. The board of DBSI, like many of the boards of development finance institutions in the region, is a balance between public and private sector representatives. Under the act, the DBSI board consists of the manager and eight other members, with the requirement that at least four not be public officers. The Minister of Finance appoints the members, the Deputy Chairman, and the Chairman; and has final approval on the appointment of the manager. The act provides for the Minister to give directions to the board, which is required to act on such directions. In practice, the Board is made up of political appointees, notwithstanding that some are from the private sector. It has not been effective in establishing a clear direction for DBSI or in monitoring operating performance.

DBSI is in noncompliance with a number of stipulations of the act. The most immediately serious include failure to have

**Table 6.6**  
**Operating Performance of DBSI, 1995–1999**

	Actual 1995	Actual 1996	Actual 1997	Actual 1998	Forecast 1999
Total Income (SI\$'000)	5213	4,764	6188	5653	6030
Total Expenses (SI\$'000)	4327	3,932	6,833	8519	9063
Net Profit/(Loss)					
Before Tax (SI\$'000)	656	240	-2,738	-676	-1,304
Total Assets (SI\$'000)	31,190	39,133	48,133	55,471	59,490
Share Capital (SI\$'000)	8,280	8,280	8,561	9,061	8,561
Shareholders Funds (SI\$'000)	14,575	14,494	11,200	11,607	10,166
Provisions for Loan Losses (SI\$000)	-3,940	-3,955	-4,306	-6,144	-5,165
Interest Spread ( % )	7.77	8.71	7.82	10.21	7.30
Earnings Spread ( % )	2.72	1.39	2.07	0.80	0.22
Loan related Expenses to					
Total Expenses ( % )	48	51	60	72	48
Staff Expenses to					
Total Expenses ( % )	26	23	20	14	28
Administration Expenses to					
Total Expenses ( % )	27	26	21	14	24
Capital Adequacy ( % )	49.4	40.0	24.7	20.3	17.1
Profit/Loss to Average Shareholder Funds	4.7	-4.0	-21.3	-4.6	-10.5

Source: DBSI 1997, 1998, 1999.

an audit performed on a timely basis and failure to maintain adequate liquidity /deposit ratios. In the absence of an audit, the adequacy of the provisions for bad loans could be seriously understated. As of September 1999, DBSI's savings and deposits totaled SI\$22 million. Under the CBSI liquidity requirement that 7.5 percent of assets be held in liquid form, the DBSI would be required to hold SI\$1.65 million in liquid assets; DBSI had only SI\$1.3 million in cash and securities.

Thus, by the end of the 1990s, DBSI was in serious financial difficulty, lending only from funds generated by collections. Without capital injections, survival seemed unlikely. The capital adequacy ratio was 17 percent in 1999, which was too low for a small development bank. Given that risk weighting of the assets was not part of the capital adequacy calculation, the real status of DBSI could have been even worse. However, the European Union funded the preparation of a strategic plan for DBSI in December 1999 (DBSI 1999), and funds of SI\$20 million were provisionally allocated to restructuring. The latter was disrupted by the political events of 2000.

## LEGAL AND REGULATORY FRAMEWORK AND SUPERVISION

The Financial Institutions Act was passed in 1998, replacing the Banking Act of 1976 and extending the supervisory role of CBSI to include SINPF and DBSI. As noted above, in May 1999 the Minister of Finance issued an order under the 1998 Act for this extension to take place; but the order does not yet have the force of law because it has not been gazetted. There may also be a need for amendments to the individual acts governing the operations of the two NBFIs; appropriate supervisory guidelines may also need to be developed. The minister had decided in 1999 to transfer the insurance comptroller's office to CBSI, though this too had not been effected by mid-2000. Under the 1998 act, the minister may require CBSI supervision of credit unions with assets in excess of SI\$100,000.

In the past, CBSI has had difficulty in fulfilling its role, as a result of inadequate central banking skills and a high level of Government intervention in its operations. Technical assistance in the development of a strengthened supervisory framework was provided during late 1999/early 2000, but was interrupted by the civil unrest. The assistance included establishing prudential policies, which were being progressively issued to the banks. CBSI is committed to best-practice international prudential supervision of the banking system as well as the nonbanking system. In order to enhance its regulatory powers and supervisory capacity, a Financial

Institutions Department was set up in November 1999. Further staffing and recruiting were taking place, but the need remained for a considerable amount of training.

During 1998, a number of pyramid finance schemes were carried out in the Solomon Islands and, despite warnings issued by CBSI about the fraudulent nature of the schemes, people continued to hand over their savings to the promoters. The schemes subsequently collapsed and many people lost their savings. CBSI was handicapped in taking appropriate action by the absence of adequate legal provisions. Amendments to the Financial Institutions Act were made in 1999 to require promoters of such schemes to obtain a license from CBSI.

At the present time, CBSI holds a 10–11 percent share in DBSI. This creates a potential conflict of interest when it comes to supervising DBSI. CBSI is seeking a means of disposing of its shares, perhaps by paying them as a dividend to the Government, and giving up its seat on the DBSI board.

## DEVELOPMENT OF MONEY AND BOND MARKETS

In 1995, the Government securities market collapsed, as Government borrowing from CBSI reached its legal limit and CBSI could not extend any further loans to the Government to service its debts. Government arrears on domestic debt increased from SI\$18.7 million in 1994 to SI\$45.5 million in 1995 and SI\$51.7 million in 1997. The Government started to pay its arrears in 1998, reducing them to SI\$18.5 million by the end of 1998 and to SI\$7 million by April 1999. The Government also negotiated a debt-restructuring plan with the holders of Government securities. In early 1999, more than SI\$200 million in Treasury bills, or 88 percent of total holdings, were converted to two- to six-year medium-term bonds. The remainder was frozen and continuously rolled over for 91 days at 6 percent. Then, after February 2000, these bills were gradually unfrozen (that is, redeemed).

It was agreed that the SI\$75.2 million of Government advances with CBSI would be auctioned as Treasury bills, commencing in May 1999. Since then auctions have taken place on a weekly basis and Treasury bills have been rolled over.

The maturities are up to 182 days. The buyers are the commercial banks, insurance companies, individuals, and various groups, such as church funds. CBSI announces a quantity for auction each week, without being obligated to accept any or all bids. It has an overall target interest rate and specific target rates for each maturity. On some occasions, CBSI has rejected bids outside the target range, and on others it has accepted bids greater than the amount available. In early 2000, after discussion with the commercial banks, CBSI agreed to limit any attempts at determining both quantity and price.

Following the introduction of the Treasury bill auction, CBSI Bokolo bills were phased out as they matured. The last bills matured just before June 2000, after which CBSI policy was to conduct open market operations with Treasury bills. CBSI provides a rediscount window for the banks. It is intended as a disincentive and is little used.

## **DEVELOPMENT OF DEBT AND CAPITAL MARKETS**

Prior to the unrest of 2000, the Companies Act 1961 was being reviewed, with a view to simplifying the administration process, reviewing compliance provisions to ensure tougher penalties for noncompliance, and generally updating the legislation.

Under the existing act, company directors are required to file annual returns, but only about 25 percent actually do so. The rest could be as much as five years behind. Public companies and private companies that have a body corporate as a member are required to file audited annual accounts: there are 40 to 60 of these, mostly subsidiaries of international companies. The registrar has the power to require returns to be made and to strike from the register any companies that do not comply. However, no steps to enforce compliance have ever been taken, and generally the company register is outmoded and unreliable.

Solomon Islands does not have a domestic stock exchange. There are only a relatively small number of companies that are not owned by the Government. Chinese businesspeople own and operate most of the retail businesses, and engage in some

industrial joint ventures with Malaysians. These companies tend to be very secretive, and it is doubtful if they would consider selling equity to outsiders or opening their books, preferring to rely on internal sources of finance. Two companies that own extensive assets in the Solomon Islands have listed on the Australian Stock Exchange, and might consider a secondary listing on a regional exchange. The brewery company, which is owned by both domestic and foreign shareholders, might also be interested in listing on a regional exchange.

All utility companies are either wholly or partially owned by the Government. The State Owned Enterprises Monitoring & Privatization Unit is charged with restructuring and privatizing Government entities, and in 1999 had anticipated being able to privatize SIPL, which was profitable. However, following the unrest, SIPL ceased operations and the managing agents left the country after selling off vehicles and other saleable assets. Since the signing of the October 2000 peace accord, it is hoped to privatize Solomon Printers and the Home Finance Corporation. The biggest hurdle will be finding genuine investors.

Foreign direct investment proposals are screened by the Foreign Investment Board in accordance with the Foreign Investment Act. Any foreign entity wishing to do business in Solomon Islands must register and obtain prior approval from the Board. In addition, any significant transfer of ownership must be registered and receive approval. Historically, the process has been relatively unfriendly; it was a second tranche condition of the World Bank's 1999 structural adjustment loan that this be changed. The Foreign Investment Advisory Service suggested guidelines for a more promotion-oriented foreign investment agency. Again, the events of 2000 have overtaken this initiative, at least temporarily.

Funds from both the Kula Fund, a regional venture capital fund operated by Commonwealth Development Corporation and funded by it and ADB, IFC, EIB and other aid agencies, and regional governments; and Pacific Islands Investment Facility are available to Solomon Island companies; but the qualifications in terms of minimum size and required return are seen as too high by the local business community.

## MICROFINANCE

A major challenge facing Solomon Islands is how to create enough income-generating opportunities for a population growing at the rate of 3.4 percent per year. It has been estimated that formal private sector employment would have to grow at the rate of 30 percent per year to absorb all new entrants to the labor market (ADB 1998). Since this cannot happen, village work and self-employment will have to occupy a larger proportion of the economically active population—or else the pool of young urban unemployed will have to be allowed to expand to an unacceptable extent. Microfinance can play a crucial role in stimulating the growth of the informal sector, by providing credit to people with limited access to formal banking services. In a survey involving 18 entrepreneurs from Honiara in 1999, all responded that obtaining credit from the banks to start a business was very difficult. Even the lending requirements of DBSI are regarded as too stringent and the grace period for loan repayments too inflexible.

The supply of microfinance services comes from the informal financial system, a semiformal sector consisting of credit unions and one nongovernment organization (NGO) scheme, and the formal sector.

## FORMAL SECTOR

In the formal sector, while no commercial bank has opened a special window for microfinance, DBSI has administered a Women's Credit Scheme. This was a pilot project operating for six months, from September 1998 to February 1999, and targeting women from Honiara and Guadalcanal. The loan criterion was 100-percent collateral, with the equity contribution reduced from the usual 35 percent to 10 percent of the total project costs. Interest was charged at the below-market rate of 12 percent per year. A fee of SI\$30 was charged upon application, which had to include the projected income and expenses. If the loan was for the expansion of a business, past records of business also had to be submitted. DBSI allocated a total loan portfolio of SI\$ 500,000 for the project. The demand was high: a total of 300 applications was received during the six months, of which

127 were funded. In fact, total loans disbursed exceeded the allocation by SI\$160,000. The majority of the borrowers (72 percent) were from Honiara and the rest from Guadalcanal; they used the funds for poultry farming, trade stores, fish selling, and sewing projects. The scheme was suspended because of the ethnic tensions.

### **Informal Sector**

In the informal financial sector, the most common source of credit is the *wantok* (friends and family network) system, which involves interest-free loans paid back in cash or kind. Self-help groups in formal workplaces rarely exist, but they do operate in communities and villages in the form of community housing and loan schemes and savings clubs. Savings clubs are being nurtured by SICUL to register eventually as credit unions. There are 21 savings clubs, though only six are active. Pyramid schemes also operate as informal financial systems. Applied research on the informal financial sector is needed in order to formulate appropriate strategies of support.

### **Semiformal Sector**

The semiformal financial system includes credit unions that are regulated and supervised by a regulatory body, and the NGO scheme endorsed by the Government. Registered finance companies and moneylenders do not exist in Solomon Islands.

**Credit Unions.** Credit unions, established under the 1986 Solomon Islands Credit Union Act and operating under SICUL's umbrella, are owned, managed, and controlled by their members. Their savings and loan schemes are funded by members' contributions and are available only to members. Lending and savings terms vary across the credit unions as agreed by the members. Commonly, the majority of savings are in the form of shares that earn no interest and cannot be withdrawn. Interest is 1 percent per month on outstanding balances, as prescribed in the Credit Union Act. Loans must be fully secured pursuant to the act, with no minimum or maximum prescribed. Urban loans range between SI\$200 and SI\$10,000, while rural loans

range between SI\$10 and SI\$1,000. SICUL encourages a three-year maximum loan repayment period. Employee-based credit unions collect loan repayments from their members' pay packets, whereas rural unions collect monthly payments. Very few credit unions charge fees for service.

To help strengthen the movement, the Government obtained a project loan from International Fund for Agricultural Development in 1991 that was used primarily to strengthen SICUL as the supervisory body responsible for coordination and supervision of credit unions. With the termination of the project in December 1998, SICUL has been operating without core funding and has been constrained in its support of field officers. This has resulted in diminished access and support to credit unions, especially in rural areas, and the gradual slowdown of the movement. At the end of the 1990s, SICUL records showed 36 active and 124 dormant credit unions.

In early 1999, CBSI and SICUL embarked on a Nonbonding Financial Institutions Monitoring and Supervision Project with assistance provided by AusAID and the Credit Union Foundation of Australia. This project had four broad objectives:

- (i) to review the current NBFIs monitoring methods;
- (ii) to recommend, where appropriate, alternative or new methodologies for monitoring the NBFIs sector;
- (iii) to develop a methodology to monitor the formal and informal economy; and
- (iv) to transfer research skills to CBSI and SICUL.

The project had barely begun before political and social turmoil interrupted implementation.

**NGOs.** The only microfinance scheme operated by an NGO—the YWCA—is known as the Solomon Islands Microfinance Scheme for Women (SIMIWODS). SIMIWODS is funded by the United Nations Development Programme (UNDP) and aims at providing sustainable microfinance services to women's solidarity groups for the purpose of supporting income-generating projects of individual group members. The project is implemented in partnership with the Government and is coordinated by the Women's Development

Division of the Ministry of Youth, Women and Sports. The YWCA is responsible for administering the day-to-day activities of the project. A microfinance specialist from a regional UNDP program, the regional UNDP/UNOPS Pacific Sustainable Microfinance and Livelihoods through Empowerment (SMILE) Program, serves as a liaison officer between the implementing Ministry and the YWCA, and is also responsible for providing technical guidance to the project. Technical support is provided by UNDP in Suva, Fiji Islands. The project was allocated total funding of US\$245,000 for technical backstopping, institutional capacity building for YWCA, and on-lending seed money.

The first 10 loans were disbursed in February 1999 to two low-income communities in Honiara. As of February 2000, a total of 86 women clients from these communities had benefited, and there were 10 second-time borrowers and two third-time borrowers. Loans disbursed to that date totaled SB\$81,700.

SIMIWOODS adopts the Grameen Bank solidarity group-based lending concept, with slight modifications to fit to the conditions in Solomon Islands. Women have to organize themselves into groups of five; each member has to guarantee the loans of other group members. This is to instill group accountability and responsibility. Only those groups that have satisfactorily completed the SIMIWODS training on microfinance and business development are eligible to borrow small amounts that do not exceed SI\$1,000 and that are payable in 12 weekly equal installments. Loans are charged interest at 18 percent. Members are also required to save weekly. Loan proceeds are to be used exclusively for financing income-generating activities by the member or by the family. Groups meet weekly in their communities, where savings and loan repayments are collected by the field officer hired under the project.

Clients of microfinance schemes frequently misuse funds and lack business management, accounting, and marketing skills. On the other hand, their participation in these schemes can increase their entrepreneurial skills, savings habit, credit discipline, and income. Women can gain in self-esteem.

Some credit union operations (especially employee-based and larger credit unions) may have been viable due to a low

cost of operations, with services of staff on a voluntary basis. SICUL, however, is currently faced with financial constraints; and other microfinance schemes are totally dependent on subsidies from donors or the Government for survival. Sustainability for all schemes depends on the ability to get additional funding for on-lending and administrative costs.

There is an unmet demand for microfinance in Solomon Islands, as shown by the turnout of applicants for DBSI's women's credit scheme, past growth of the credit union movement, and the expansion of the SIMIWODS scheme. The DBSI and SIMIWODS schemes show that by targeting the right clients, and utilizing continuous client support and pressure, high repayment rates can be achieved. Long-term commitments of both financial and technical assistance are also needed, and social preparation and mobilization activities are essential. Exploration of alternative microfinance models, such as village banks, is desirable.

## LAND TENURE ISSUES

About 87 percent of the land in Solomon Islands is owned by indigenous Solomon Islanders under customary tenure. Eight percent of the land area is vested in the Crown for Government purposes (public land); and five percent is owned by individuals (perpetual estates and fixed term estates).

### **Public Land**

Powers for the Government to acquire land were first provided for in 1896 legislation under the British protectorate and currently appear in Part V of the Land and Titles Act. The Constitution of Solomon Islands, which came into force in 1978, requires that reasonable compensation must be paid for any land compulsorily acquired. All land that is vested as a perpetual estate in the Commissioner of Lands on behalf of the Government is known as public land. Since 1981, some of this land has been devolved to provincial assemblies under the Provincial Government Act. Public land may be let on a periodic tenancy under the Land and Titles Act. Land owned

by a provincial Government may be leased, but if the land is to be leased to a non-Solomon Islander, the consent of the Commissioner of Lands is required.

### **Individually Owned Land**

During protectorate times, the Government granted freehold estates on customary land that it had voluntarily or compulsorily acquired. However, the protectorate Government became dissatisfied with freehold estates because they did not allow for sufficient control or financial return. Therefore, perpetual and fixed-term estates were introduced under the Land and Titles Ordinance 1959. These estates provide extensive rights to occupy, use, and enjoy land, but they are not absolute, and are subject to a number of conditions, some imposed by statute and some imposed by the Commissioner of Lands.

In 1977, freehold estates held by Europeans were abolished; and existing freeholds, perpetual estates, fixed-term estates, and leases for more than 75 years held by non-Solomon Islanders were converted into fixed-term estates for 75 years. Since then, freehold estates owned by non-Solomon Islanders have ceased to exist, and perpetual estates can be owned only by Solomon Islanders and certain Gilbertese and Solomon Islands institutions. Non-Solomon Islanders cannot own fixed-term estates for more than 75 years.

It was originally envisaged by the protectorate administration that many Solomon Islanders would wish to convert their customary ownership, which was normally joint and shared with other members of the clan, line, or family, into perpetual estates, which could be held by individuals. Consequently, a number of provisions were inserted into the Land and Titles Act to regulate the procedure for the conversion of customary land into perpetual estates. However, tenure conversion became very controversial, and in the early 1980s, it was abandoned, although the legislative provisions remain in Part IV of the Land and Titles Act. Some observers still promote conversion from customary land tenure to perpetual estate.

Perpetual estates must be registered with the Register of Lands established by the Land and Titles Act. When so registered, the title is guaranteed by the Government, except in the case of

fraud, and subject to some other minor exceptions. Perpetual estates may be leased, but the consent of the Commissioner of Lands is required if the lessee is a non-Solomon Islander. Perpetual estates may be mortgaged, and no prior approval by the Commissioner of Lands is required. Mortgages must be registered, and when they are registered they take effect as a charge, not as a transfer. If the mortgagee defaults in repaying the loan secured by the mortgage, the mortgagor may recover the amount of the loan by entry into possession and sequestration of any rents paid in respect of the mortgaged property, sale of the mortgaged property, and foreclosure. The latter is only available if the mortgagee is a Solomon Islander. All the above remedies for the enforcement of a mortgage require the approval of the High Court and are subject to any conditions which it may impose. A few occasions have arisen where it has been necessary to enforce a mortgage on a perpetual estate, but no difficulties appear to have been experienced.

A fixed-term estate grants the right to occupy, use, and enjoy land for a fixed period of time. There is no specified period of time that may be fixed, but non-Solomon Islanders cannot hold a fixed-term estate for longer than 75 years. Fixed-term estates, like perpetual estates, are subject to certain conditions prescribed by the Land and Titles Act, such as maintaining all boundary marks and keeping all existing roads in good repair. When granting a fixed-term estate, the Commissioner of Lands may impose other conditions as to the payment of a premium, payment of a rental, and conditions for the development of the land. Fixed-term estates, like perpetual estates, must be entered in the Register of Lands established under the Land and Titles Act. When so registered, the title is guaranteed by the Government, except in the case of fraud and subject to some minor exceptions. Fixed-term estates may be leased by non-Solomon Islanders, with the consent of the Commissioner of Lands.

Fixed-term estates may be mortgaged, and no prior approval by the Commissioner of Lands is required. Mortgages must be registered, and when registered they take effect as a charge, not a transfer. If the mortgagor defaults in repaying the loan secured by the mortgage, the mortgagee may recover the amount of the loan by entry into possession and

sequestration of rentals, sale of the mortgaged property, and foreclosure. The last remedy is only available if the mortgagee is a person entitled to hold a perpetual estate, that is, a Solomon Islander or a Gilbertese or Solomon Islands institution specified in the Land and Titles Act. All the remedies require the approval of the High Court.

### **Customary Land**

Customary rules normally provide for joint ownership of land, although there are certain areas where custom accepts individual ownership. The exact basis of customary land ownership is a matter of considerable debate. Since 1995, customary land can be registered under the provisions of the Customary Land Records Act by any customary landholding group or any person claiming an interest in customary land. The act provides that "every entry or note in, or on, any finalized record or recording map shall be received in all proceedings as conclusive evidence of the matter or transaction on record." Few Solomon Islanders have availed themselves of the opportunity to record customary land, probably because of disputes about ownership and uncertainty about the advantages of recording.

In 1999, the Government appeared to favor registering customary land, but the exact scope of its policy was unclear. A draft bill, the Tribal Land Bill, had been prepared by the Recorder of Customary Lands, which provided only for recording the original tribes and tribal lands before the advent of Europeans. If this view were accepted, it would overturn many court decisions in the last 20 years. Indeed, the bill expressly provides for the quashing of previous court decisions that are in conflict with tribal boundaries. Whether this bill, and the principle which underlies it, will be endorsed as Government policy and, if so, whether it will receive parliamentary approval and acceptance by Solomon Islanders generally, remains to be seen.

The respective roles of national and provincial governments with regard to customary land are unclear. The Provincial Government Act states that one of the matters within the legislative competence of provincial assemblies is "codification and amendment of existing customary law about land. Registration of customary rights in respect of land

including customary fishing rights." Yet little has been done by provincial assemblies with regard to customary land, and what initiatives have been taken so far have emanated from the national Government.

Customary land can be disposed of in accordance with the rules of custom under the Land and Titles Act. Customary land can also be sold or leased to the Commissioner of Lands, representing the national Government, or to a provincial assembly under the Land and Titles Act. When customary land is sold to the Commissioner of Lands or a provincial assembly, the commissioner and provincial assembly acquire a perpetual estate in the land. The Commissioner of Lands can grant a periodic tenancy of a perpetual estate, for example, from month to month or year to year, but is not authorized to grant a lease or sublease of such land. Provincial assemblies, however, are authorized to grant leases or subleases of customary land that has been leased to them, but if the prospective lessee is a non-Solomon Islander, the permission of the Commissioner of Lands must first be obtained.

It appears that the leasing of land by provincial assemblies is mostly to non-Solomon Islanders, and there is very little leasing of customary land to Solomon Islanders. The concept of customary land being leased back to some or all of the owners does not seem to be well known or practiced in Solomon Islands.

Customary land cannot be mortgaged, but leases of customary land can be mortgaged. This can be done without prior permission from the Commissioner of Lands or any other Governmental authority. Mortgages of leaseholds of customary land must be registered in the Register of Titles to be enforceable. Mortgages of leases of customary land can be legally enforced in the same way as mortgages of perpetual and fixed-term estates, with the same provisos applying.

Both lessees and lending institutions believe that there could be difficulties in practice in enforcing a mortgage of a leasehold of customary land, because of opposition by neighbors or kinspeople of the mortgagors. Therefore, lending institutions are not favorably disposed to accepting leasehold customary land as collateral security for a loan.

There is no legislation that allows lenders to take charges over crops and livestock as collateral for a loan.

## Disputes

Disputes relating to public land, perpetual estates, and fixed-term estates are decided solely by the High Court, and appeals of such decisions are heard by the Court of Appeal. There seem to have been few disputes relating to these kinds of land, or to the enforcement of security over such lands, that have caused serious difficulties.

There are, however, some serious issues with regard to disputes relating to aspects of customary land, including enforcement of security.

Although it is clear that custom normally provides for ownership of land jointly by groups of Solomon Islanders, the exact composition of these groups is a matter of acute debate, as noted above. Some argue that the true customary landowning unit is the original tribe that existed in the country before the arrival of Europeans. Others argue that there has been a breakdown of these tribes into smaller landowning groups, such as clans, lines, or families. The latter view seems to have been largely accepted in the decisions of the courts set up to determine customary land ownership. This view has been opposed by the Recorder of Customary Lands and by some influential Solomon Islanders.

Even assuming that the correct basis for ownership of customary land can be ascertained, there are questions as to whether it is necessary or desirable that the owners and the boundaries of the land be recorded in written form and marked out physically on the ground. Since the Customary Land Records Act of 1955, custom owners have been able to record their land, but so far few have done so, mainly it seems because of disputes about ownership and uncertainty about the consequences and the implications of registration. Such a process is likely to spark off disputes about both the titles to, and boundaries of, customary lands, and become a lengthy, difficult, and expensive task.

The law in Solomon Islands permits only perpetual estates, fixed-term estates, and registered leaseholds to be mortgaged or charged. Customary land cannot be directly mortgaged or charged. However, if the customary land has been converted into a perpetual estate (which is no longer encouraged or

facilitated by the Government), or if the customary land has been leased and that lease has been registered, as may be done with any lease for a period longer than two years, then mortgaging is possible. Solomon Islanders cannot, however, lease customary land to whomever they please. They can lease it in custom to another Solomon Islander, or they can lease it to the Commissioner of Lands on behalf of the national Government, or to a provincial assembly.

If these leases are for a fixed term exceeding two years they can be registered, and then subleases of the leaseholds can be granted by the Commissioner of Lands or a provincial assembly, for some period shorter than that of the original lease. Such a sublease, if it is registered, can then be mortgaged by the sublessee. If the lessee or the sublessee is a non-Solomon Islander, the consent of the Commissioner of Lands must first be obtained. There is no express provision in the legislation for customary land to be subleased back to the custom owners, as in Papua New Guinea, so that they could acquire a leasehold interest that they could mortgage under Land and Titles Act.

The legislation allows for mortgages to be enforced by entry into possession, sale to some other person, or transfer into the name of the mortgagee, provided the mortgagee is a Solomon Islander or Gilbertese or Solomon Island institution specified by the legislation. All of these remedies require the approval of the High Court and are subject to any conditions which it may impose. However, because mortgaging of leases of customary land is not common, attempts by a mortgagee to enter into possession of such lease or to sell the lease are likely to be met with some lack of understanding, resentment, or hostility by neighbors and kinspeople of the owners of the mortgaged land.

## KEY CONSTRAINTS ON FINANCIAL SECTOR DEVELOPMENT

### **Political Unrest and the Resulting Macroeconomic Instability**

The unstable macroeconomic and financial conditions of the 1990s were the major constraint on the development of a healthy and competitive financial sector. The most binding constraint is ethnic tension, civil unrest, and political instability.

If the October 2000 peace accord holds, it will take some time for economic recovery to occur. Production of gold and silver at the Gold Ridge mine was to start six months after a return of management. SIPL will probably need two years to start producing palm oil and associated products again. Similarly, there would be a delay in bringing Solomon Taiyo fish production back to preconflict levels. Restoration of investor confidence is a long-term process, as is the education of children that has been severely disrupted.

Development opportunities are constrained by the country's small size, fragmentation, dispersion, and remoteness from major markets. The limited human resource endowment is also a major constraint, especially in the rural areas, where 85 percent of the population resides. But the natural resource endowment, carefully managed, can provide the basis for sustainable growth with equity. To realize the opportunities, the Government must play its role efficiently and effectively. This is especially the case now that there are the additional challenges of postconflict reconstruction.

Sound macroeconomic management is crucial. Achieving it is made more difficult by a shortage of skilled human resources and an inadequate database. The quality of national accounts and fiscal and balance of payments data is especially poor, and hampers both the analysis of recent developments and formulation of estimates and projections.

### **Problems with Customary Land Tenure**

Customary land tenure arrangements retard private sector development. Only Solomon Islanders or the Government may buy or lease customary land. Other parties must sublease from the Government, which acts on behalf of the owners. Although the nature of the procedure is clear, its implementation is lengthy, costly, and uncertain. Lack of security of property rights restricts investment in land improvement. Difficulties in enforcing claims against land preclude its acceptability as collateral.

These concerns about land tenure arrangements have been voiced often in the past. However, they are not easily amenable to solutions, even less so after the ethnic violence of 1999. This

erupted because of Guadalcanal people's resentment against Malaitans who had migrated over many years to Guadalcanal and gained control of an increasing amount of land, as well as jobs. There was already profound disagreement as to the basis upon which rights of ownership of customary land should be recognized. The presence of a successful migrant population inevitably increased the frequency of land disputes.

### **Government Interference in the Financial Sector**

The dominance of the Government in the financial sector constrained the development of a functional money market: it is difficult to deepen the money market and encourage secondary trading because of the large debt that commercial banks hold in two- to six-year bonds, which cannot be traded because of the already large portfolios of bonds. The dearth of alternative savings instruments, the relative lack of efficient and competitive NBFIs, and the lack of a capital market also inhibit competition. The credit union movement and savings and loan societies are too small at present to provide much competition.

The high level of Government interference in the operations of NBFIs remains a prime concern. Cross-ownership of a number of the institutions is not conducive to transparency.

### **LACK OF A SUITABLE POLICY AND LEGISLATIVE FRAMEWORK FOR MICROFINANCE**

The fundamental constraint facing NGOs in microfinance is that they have no legal basis on which to extend savings and lending services. Credit unions are restricted to charging interest rates of no more than 1 percent per month on a reducing balance. Support services are usually directed to small-scale businesses, but rarely to microenterprises. Limited entrepreneurial skills, a lack of credit discipline, and poor savings habits also constrain the development of microenterprises.

## RECOMMENDATIONS

### **Ameliorate ethnic conflicts.**

For economic growth to resume, the problem of ethnic tension must be solved by Solomon Islanders and their Government, with external financial and technical support. A platform on which to develop a solution was outlined in the October 2000 peace agreement between the Malaita Eagle Force, the Isatabu Freedom Movement, the national Government, and the provincial governments of Guadalcanal and Malaita. This created a Peace Monitoring Council of representatives from Malaita and Guadalcanal, and an International Peace Monitoring Team of foreign civilian policy and military personnel. A general amnesty for all participants in the conflict was granted, subject to the surrender of their weapons and the return of stolen property. Commitments were made to enact a constitutional amendment granting greater autonomy to Malaita and Guadalcanal provinces; to improve health, education and infrastructure in both provinces; and to restructure the police force in order to ensure balanced provincial representation. A moratorium was placed on all land transactions on Guadalcanal, pending appointment of a commission of inquiry by non-Guadalcanal people into all pre-October 1998 transactions.

### **Resolve Land Tenure and Use Issues.**

Resolution of land ownership and use issues will take time and concerted effort from all parties. Nonetheless, in order to generate income and employment growth, a practical solution to the problem of uncertain land titles is needed to provide secure and certain access to land. Marketable land use rights would allow exchanges to be made in the open market without permanent alienation (sale) of land. At an appropriate time in the future, a conference/workshop should be convened to discuss and agree on

- (i) ownership of customary lands: whether they are to be owned by original tribes according to pre-European boundaries, or by clans, groups, or lines as they have

- developed today, and who should determine the landowning units and the boundaries of lands;
- (ii) registration of customary land; and
  - (iii) land use exchange systems or markets: a conference/workshop could also be convened to discuss, and reinforce public awareness of, the fact that leaseholds of customary land can be mortgaged and provide finance for the development of customary land, and the fact that lenders must be able to recover the money that they have loaned by enforcing the mortgage.

There would be advantages in joining the two conference/workshops into a series under the general theme of "Customary Land Issues in Solomon Islands."

Legislation should be introduced to allow crops, trees, and livestock, whether on customary or noncustomary land, to be used as security for loans.

### **Maintain Macroeconomic Stability.**

The maintenance of macroeconomic stability is essential to ensure external support for reconstruction, to facilitate a return of investor confidence, and to promote financial sector development. Prudent fiscal management is especially important if price stability and foreign reserves are to be maintained. In this regard, the new Government must control expenditure and avoid central bank financing of the budget deficit, settle arrears, and cease the renewed practice of granting selective tax exemptions on a nontransparent basis. Customs and tax administration will also need improvement, in order to increase revenue.

### **Focus Public Sector Activity on Core Areas.**

A shift in the role of the public sector needs to take place to focus on core areas. This should include an improvement in governance across the public sector, and support for private sector growth through creation of a Foreign Investment Agency that is facilitative in intent and function.

## **Enhance Competition in the Financial Sector.**

Competition in the financial sector would be enhanced by

- (i) liberalizing the financial sector, particularly NBFIs that are owned or influenced by the Government;
- (ii) enhancing the supervisory capability of CBSI;
- (iii) improving the functioning of the money market, by increasing Treasury bill yields so that interest margins are positive;
- (iv) gradually liquidating two- to six-year bonds held by commercial banks, without using CBSI financing, in order to encourage commercial banks to increase savings rates to a positive level; and
- (v) developing capital markets.

Implementation of these recommendations will have to take due account of the severe, postconflict budgetary and administrative capacity constraints within which Government must operate.

There is a need to clarify financial sector development objectives and to rationalize Government involvement. In regard to Government-owned NBFIs, board independence and improved corporate governance are required. It would also be desirable to establish an independent asset management unit to work out the bad and doubtful loans of the various Government-owned institutions. DBSI's strategic plan can inform future restructuring. There has also been a review of SINPF that could similarly inform the determination of its future role. It is recommended that SINPF be allowed to invest overseas, provided this is conducted according to strict investment guidelines in a good corporate governance environment, utilizing the services of a professional fund manager, and provided foreign exchange reserves permit.

CBSI should be granted enough autonomy to conduct monetary and exchange rate policy, to perform its supervisory functions effectively, and to ensure that the governor and members of the board of directors do not come under political influence. Monitoring procedures, including on-site inspections and off-site surveillance, need strengthening

through short- and long-term training programs, in order to ensure that supervisors are capable of identifying weaknesses in financial institutions, including commercial banks, NBFIs, and credit unions.

The general adoption of clear international accounting and auditing standards within an updated commercial law should be encouraged. The Companies Act was under review before the civil unrest, with the intention of establishing efficient mechanisms for company registration and monitoring compliance.

Solomon Islands should continue to participate in the process of regional co-operation and consultation in regulatory and supervisory matters, as begun by the Pacific Islands Prudential Regulation and Supervision Initiative. In the same way, a formal analysis is needed of the regulatory system and supervisory practices for their compatibility with international accepted norms, to lay the foundation for the timely harmonization of financial sector regulation and supervision on a regional basis.

Once the Treasury bill market is running with positive yields, the focus should turn to building secondary markets in Government paper. This could be assisted by requiring banks to act as market makers. Interest rates on two- to six-year bonds should also eventually be set under market conditions, so that a continuous yield curve throughout the short- and medium-term range can occur. The major priority for the development of a secondary market in Government and quasi-Government bonds is an improvement in the management of Government finances, central bank regulation, and banking competition. Development of a market in corporate securities is a very long-term proposition.

### **Consider participating in a regional venture capital fund and stock exchange, if and when these develop.**

The concept of a venture capital fund had been raised in Solomon Islands prior to the outbreak of ethnic tensions. Such a fund should be established on a regional basis. Similarly, it has been suggested that a regional stock exchange facility be developed (see volume one of these reports). The latter would

require the Government to address a range of issues, including the foreign exchange control implications.

### **Promote a policy and regulatory framework for microfinance development.**

Activities that would promote microfinance development include

- (i) a review of policies and regulations that may hinder the development of microfinance, especially the involvement of NGOs and the restriction on the interest rate that credit unions can charge on loans to members;
- (ii) a review of policies and regulations that may impede the development of microenterprises (e.g., business licensing, health regulations); and
- (iii) formulation of a policy and legislative framework for microfinance through proper consultation with all stakeholders.

A national conference could initiate action on these matters.

In addition, a coordinating mechanism for microfinance and related schemes (grants and credit schemes sponsored by Government and donors) should be established. This could be initially assumed by CBSI, since it already carries on the monitoring and supervising of nonbank institutions. Eventually, establishing a coordinating or microfinance unit outside Government machinery could be explored, where responsibilities encompass other support services.

Social preparation and mobilization activities should be conducted to create awareness of the benefits of savings and good credit discipline. This could be done through the media and community workshops. Group formation and strengthening should also be undertaken for potential clients who demonstrate a capacity to undertake projects by mobilizing their own resources.

Poverty mapping to identify areas of demand for microfinance and cash-earning opportunities should be undertaken, building on ongoing work by the Government in

partnership with UNDP. DBSI, the Business Development Division of the Department of Indigenous Business Development, and other small business support providers should be involved. The Commodity Export Marketing Agency has a potential role to play, since it is active in rural areas and could provide a means of ensuring loan repayment through assignment of crop proceeds.