

Nonbank Financial Institutions

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In 1994–1999, NPFs in PDMCs held an average of about 20 percent of financial sector assets (Table 3.1). They are financed by contributions from earnings of employees (matched by employers), and invest in private and public corporations, local real estate, long- and short-term government instruments, and stocks, as well as holding banking deposits. NPFs therefore are important vehicles for domestic savings mobilization and investment, especially in Kiribati, Samoa, Solomon Islands, PNG, and the Fiji Islands (the Fiji Islands has the widest range of financial institutions, but still only a few in each category). In most PDMCs, a large percentage of the NPF is invested in government securities (government bonds and treasury bills), because of the lack of other investments and because most PDMCs (except Kiribati and Vanuatu) have capital account restrictions on investments abroad. Because of the scarcity of instruments in which to invest and the lack of capital markets in all PDMCs except the Fiji Islands and PNG, NPFs usually hold government securities until maturity. This has hindered the development of money and bond markets. NPFs, with their large liquid assets, are largely responsible for the high degree of liquidity in most commercial banking systems.

Development banks are a relatively small part of financial systems, with assets averaging less than 7 percent of total financial sector assets in 1999 (Table 3.1).³ There is considerable variation

³ Central banks hold most of the remaining assets, with capital markets and MFIs accounting for very little.

across countries, however. Tonga's development bank accounted for a little over 15 percent in 1999, down from a high of 22 percent in 1996. At the other end of the spectrum, PNG's development bank accounted for less than 2 percent of financial sector assets. Vanuatu's bank ended operations in 1997. Development banks were established precisely to perform a financial intermediation function aimed at accelerating economic development; but they have not been able to grow as other institutions have, because they have been encumbered with low-quality assets and low profitability. The share of development banks is expected to decline as they are restructured; some are starting to raise funds through bonds and promissory notes. These banks and NPFs are examined more fully in the next chapter.

DEVELOPMENT FINANCE INSTITUTIONS

Overview

The major thrust for establishing development finance institutions (DFIs) in the Pacific Islands occurred in the early 1970s. Initial equity capital was provided by bilateral donors and was supplemented by low-cost funds (for on-lending to clients) from the World Bank, ADB, European Investment Bank (EIB), and other donor agencies. In addition, there was considerable support for capacity building in the form of technical assistance programs, particularly in the area of training for improved loan and project analysis. It was expected that the DFIs would spearhead and accelerate economic development through provision of long-term credit to priority industries, particularly in rural areas where commercial banks had been reluctant to take on projects with high risk.

In the event, although DFIs focused on development project lending as planned, lending policy and project selection were subject to political interference and determined by boards composed of government officials who paid insufficient attention to risk. As a result, by the mid-1980s, most DFIs were in financial distress, exhibiting high arrears ratios, poor cost-benefit evaluations, mismanagement, inability to price loans

in accordance with risk criteria, and inability to enforce loan repayments. ADB and the World Bank have ceased funding DFI lending operations, though EIB continues to provide credit lines to DFIs.

Some common problems with the internal systems of DFIs (which also existed in local commercial banks) can be identified. The most important are the poor governance environments and the lack of an enabling environment: DFIs were operated without the benefit of formal planning or strategic processes. For most of them, financial plans and budgets did not exist, and there was little awareness of the need to control costs. DFIs therefore reacted to, rather than anticipated, changes in the external environment, which made them very vulnerable to changes in government policies, commodity prices, and weather-related shocks. Information available to management was rarely up to date and was often incomplete. Without timely information, it was difficult for management to take action to correct policies related to credit extension, problem loans, or risks. The lack of policies on risk was the source of many problem loans: DFIs would often advance a large proportion of the required capital to borrowers without ensuring that the borrowers had invested an adequate amount of their own funds.

DFIs also had, and some still have, lax accounting and auditing procedures. It was standard practice to continue to accrue income long after loans were nonperforming; loan recovery was rarely tried; and on occasion, new lending would be used to hide debt-servicing problems. In fact, accountability has been a problem for many DFIs because of unnecessarily complicated organizational structures, and because of poorly defined responsibilities for most of the staff.

Poor management in DFIs was most often reflected in poor (often unwritten) lending policies. Especially common was excessive concentration of risk, which meant that too many loans went to one borrower, or an affiliated group, or borrowers in one industry, with the result that the quality of those loans was often jointly damaged by a single factor. For example, Tonga Development Bank (TDB) was highly exposed to the squash industry, which was wiped during one year in the late 1990s because of bad weather. As a result, TDB's equity fell considerably.

Faced with the reduction of low-cost financing from aid organizations, the PDMCs have undertaken reform of their DFIs. Fiji Development Bank (FDB) is contemplating converting into a full-scale commercial bank; in Samoa, DBS has moved to a policy of completely market-based interest rates and to less dependence on loans from aid agencies. As a part of Vanuatu's Comprehensive Reform Program, VDB and NBV were merged (see Box 3.2). In Tonga, the Government is restructuring and strengthening the management of TDB; the governments of PNG and Solomon Islands are doing the same with their development banks. It is therefore timely to take stock of experiences to date and, based on available best practices, to design a strategy for dealing with DFIs.

DFIs' Performance

Despite considerable support, DFIs continued to decline in profitability over the 1990s, some incurring substantial losses. Table 4.1 shows that only FDB made steady profits over the period 1995–1999. RDBPNG had losses in every year; DBSI, in three out of five years. The profitability of development banks in the other PDMCs was poor. These results reflected substantial increases in

Table 4.1
Profitability of Development Finance Institutions, 1995–1999^a

	1995	1996	1997	1998	1999
FDB F\$'000	1,857	307	522	316	106
TDB T\$'000	667	107	-746	-3,778	600
RDBPNG K'000	-3,753	-1,165	-929	-20,866	—
DBSI S\$'000	656	240	-2,738	-676	-1,305
DBS ST'000	1,200	875	700	-1,200	—
DBK 2/ A\$'000	—	—	173	-146	—
DBV 3/ Vt million	-80	-130	-140	—	—

— Not available.

a. The figures shown in the table may not be directly comparable, due to different accounting practices adopted by the different PDMCs.

b. For 1997, DBK data reflect the government's revenue grant.

c. DBV merged with NBV in 1998.

Source: DFI Annual Reports, ADB Country Reports.

the level of provisioning for nonperforming loans and a slowdown in lending resulting from a lack of funds.

Further analysis of the operating performance of DFIs (Table 4.2) shows the following additional trends; (i) increasing provisions; (ii) extremely high debt-to-equity ratios for some DFIs prior to restructuring; and (iii) narrowing interest margins.

The share of DFIs in total financial sector assets fell in the late 1990s (Table 4.3), but lending continued because of increased collections, borrowing from government, drawdowns from existing facilities, or support from donor agencies. In most cases, by providing further funds, governments or donor agencies actually exacerbated the DFIs' arrears problems.

Each of the DFIs has a similar product and market mix (Table 4.4), typically a broad range of lending products, with term loans the most dominant form. There is a something of a trend towards diversification, but given the weak financial position of many of the institutions, there are limits to what can be achieved.

The Role of DFIs: Ownership and Funding

In the 1970s, government policy in PDMCs was geared to the development of rural communities, and state-owned DFIs were seen as the instrument to implement these policies. Because DFIs did not attract commercial capital, the provision of funding through donor agencies was seen as the means of providing access to credit for individuals and businesses that could not access the normal banking channels, because they had no security against which to borrow. It was felt that without the formation and continuation of DFIs, there would be little possibility for many individuals and entities, particularly in agriculture, to develop sustainable businesses. They would be forced to turn to more expensive sources of funds, such as moneylenders.

It was originally thought that in measuring the performance of a DFI, its role in delivering noncommercial financial services should be taken into account; profit as the major criterion of success was not seen as the most appropriate way to assess effectiveness. However, DFIs without sound operating policies or strong prudential supervisory controls

Table 4.2
Comparison of Performance Ratios of Development Banks,
1995–1998

Financial Years	1995	1996	1997	1998	1995	1996	1997	1998
	Fiji Development Bank				Development Bank of Samoa			
Interest Spread	2.5	2.4	2.1	1.8	5.3	5.5	8.1	6.6
Earnings Spread	3.1	3	2.7	2.5	5.0	6.8	10.2	-8.2
Admin Costs/Ave Assets	8.3	8.7	1.2	1.6	5.1	5.5	6.6	6.7
Total Expenses/ Total Income	77.8	79.1	23	23	77.6	78.1	54.0	63.0
Provisions/ Lending Portfolio	8.5	7.3	10.1	10.1	11.9	12.3	9.6	12.3
Net Profit/Equity	2.8	0.4	0.72	0.11	3.6	4.4	4.0	-3.6
Debt/Equity	31.2	30.9	2.78	3.39	54.6	54.3	54.8	2.0
Borrowing Costs/ Ave Assets	5.4	5.9	6.22	5.92	2.6	2.4	2.5	2.5
	Tonga Development Bank				Rural Development Bank PNG			
Interest Spread	6.4	3.7	4.3	2.7	3.3	5.2	6.1	5.4
Earnings Spread	2.7	1.3	0.8	0.2	-1.8	-1.5	-2.1	-4.0
Admin Costs/Ave Assets	5.1	4.9	6.2	5.9	7.8	7.8	—	—
Total Expenses/ Total Income	75.8	88.7	41.0	28.0	93.0	70.3	41.0	28.0
Provisions/ Lending Portfolio	22.0	25.5	13.0	14.7	61.9	63.1	63.2	77.2
Net Profit/Equity	3.0	0.9	-4.5	-37.0	-22.0	-3.3	-1.6	-47.0
Debt/Equity	138	139	1.9	2.4	500	509	1.7	1.2
Borrowing Costs/ Ave Assets	2.8	3.1	3.9	5.2	8.8	1.0	—	—
	Dev'mt. Bank of Solomon Islands				Kiribati Development Bank			
Interest Spread	7.7	8.7	10.2	7.3	—	8.4	7.4	8.5
Earnings Spread	2.1	1.1	0.8	0.2	—	—	0.5	-0.6
Admin Costs/Ave Assets	7.6	7.3	14.2	19.3	—	9.4	9.5	10.1
Total Expenses/ Total Income ^a	66.0	61.5	28.0	52.0	—	140.5	74.2	129.7
Provisions/ Lending Portfolio	13.4	10.9	9.4	8.7	—	10.6	10.7	11.5
Net Profit/Equity ^b	4.5	1.6	0.5	-4.6	—	-5.1	6.5	-4.8
Debt/Equity	72.6	81.8	70.0	97.8	—	68.2	49.9	43.8
Borrowing Costs/ Ave Assets	28.3	25.6	4.4	3.6	—	1.6	2.1	2.0

— Not available.

a. 1996–without government revenue grant; 1997 includes prior period government revenue grant of AUD\$209 million.

b. 1998 includes additional provisions for prior years.

Source: DFIs, Annual Reports.

Table 4.3
Assets of Development Finance Institutions, 1995–1999

	1995	1996	1997	1998	1999
FDB F\$'000	362,270	343,658	356,014	356,393	363,993
TDB T\$'000	46,505	46,639	47,023	45,957	45,694
RDBPNG K'000	77,931	92,722	97,626	87,493	—
DBSI SI\$'000	31,190	39,133	48,133	55,471	59,490
DBS ST'000	45,300	48,800	46,200	54,632	—
DBK A\$'000	—	4,104	4,025	4,432	5,142
DBV ^a Vt million	932	896	850	—	—

— Not Available.

a. DBV merged with NBV in 1998

Source: DFI Annual Reports

Table 4.4
Comparison of Investment and Lending Products

	TDB	DBK	FDB	DBS	DBSI	RDBPNG
Investment Facilities						
Promissory Notes	x		x			
Bonds-Govt. Guaranteed	x		x		x	x
Small Savings Passbook	x					
Term Deposits						x
Lending Facilities						
Loans-Long, Medium, Short	x	x	x	x	x	x
Equity Investment	x		x	x	x	x
Guarantee Finance	x	x	x	x		x
Business and Technical	x	x		x		
Advisory Services						
Credit Guarantee Scheme						
Leasing Finance			x			
Rural Training Centers						x
Credit Lines	x		x			
Working Capital Finance	x	x	x	x		
Women in Rural Areas			x		x	x
Microfinance				x	x	x

Source: DFI Annual Reports; ADFIP 1999.

were delivering loans that often could not be repaid, and at the same time were operating at a loss because of their own high cost structure and inefficient processes.

These developments brought into contrast the dual objectives of DFIs: to be profitable and thus sustainable on the one hand, and to be socially responsible on the other. The question posed was: "If the core function of a DFI is still considered to be lending to rural and outlying areas, then shouldn't the outcomes that result from these measures be the criteria against which they are measured, rather than profit?" Today, acceptable levels of profitability are seen as necessary to generate retained earnings and build the capital base. Faced with difficulties in raising low-cost funds, DFIs have gradually moved closer to the commercial banking model. It has thus become increasingly difficult for them to achieve the social objectives that were intended in their original charters. Many governments in the region have been led to question the current direction of their DFIs and to place ongoing pressure on them to focus on the social objectives originally envisaged.

Ownership. From discussions with governments, and from the experience of Vanuatu, it seems likely that were development banks to be closed down, governments would seek to reintroduce some other organization that would fulfill a similar role. Governments throughout the Pacific islands still want credit services provided to rural and outlying areas. The issue to consider is the best way to deliver such noncommercial financial services. The alternative delivery channels for noncommercial lending could include greater use of credit union and cooperative networks, where these are found to be operating effectively. It could also include partnerships with commercial banks, as contemplated in Vanuatu. The effectiveness of such arrangements would depend on the extent of the branch network of the commercial banks, or the availability of other agencies (for example, post office agencies). Very strict criteria would need to be set, and it is unlikely that the agencies would actually approve loans.

In addition to the above channels, there may be an opportunity to work with emerging microfinance organizations and nongovernment organizations (NGOs) that are successfully

targeting specific areas of need. It is quite likely that in the future, relatively more development finance lending will be provided through other intermediaries, although the appropriate mix of delivery channels will vary from market to market according to the infrastructure in place. It will be more a matter of utilizing the existing delivery channels than of creating new ones.

In any case, development banks will need to improve their profitability significantly in order to survive, while adapting to the changes expected by governments and other stakeholders. They will need to be properly supervised and subject to strong review procedures.

Given the current levels of profitability, it is unlikely that investment in a development bank in the region would be attractive to private investors. The strategies that have been used to date to privatize DFIs have included either merging the DFI into the state bank (Vanuatu and the Cook Islands), or integrating it into a group of all government financial institutions (PNG). However, there is little evidence internationally of small development banks being successfully privatized. This being the case, and bearing in mind the need for governments to maintain a focus on encouraging economic development in rural areas, it seems more likely that government ownership will continue to be the dominant form of ownership in the immediate future.

Funding. This is not to say that DFIs cannot do much to improve their attractiveness as a potential privatization prospect. Most could significantly reduce their operating costs—by 30 percent or more—through an increased focus on reducing costs and rightsizing the organization to be consistent with its level of activity. Such cost reduction is imperative in order to minimize the level of subsidies and self-funding requirements, and requires

- (i) strong internal controls including risk management;
- (ii) effective boards;
- (iii) formal prudential supervision; and
- (iv) skilled staff and management.

Self-funding by DFIs will be increasingly required because of government budgetary constraints and the reduction of funds available from traditional sources. Many DFIs are moving toward self-funding, either through the issue of bonds and promissory notes by regular tender, or through accepting term deposits. FDB fully funds from the domestic market by raising F\$70–F\$80 million annually through monthly bond tenders of three-, five-, and seven-year maturities. Other development banks partially fund from the market (excepting DBS, which is evaluating its feasibility). The growth of microfinance is another reason for an increase in the level of self-funding. A number of microfinance programs are developing throughout the region, The Government of the Fiji Islands, for example, is to increase its support for microfinance by funding a scheme through the Microfinance Unit of the Ministry of Commerce, Business Development and Investment. At the same time, the Government is removing FDB board members on the grounds that FDB is insufficiently profitable.

The issues that arise from self-funding center around the interest rates that the market is prepared to accept for the paper of fairly high-risk institutions, the willingness of government and central bank authorities to back the paper through guarantees and/or buyback facilities, and the size and structure of the domestic market. If DFIs were self-funded, they would need to come under the central banks' prudential supervision. The range of options available to support a self-funded strategy includes (i) domestic savings deposits; (ii) domestic term deposits; (iii) bonds and promissory notes; (iv) cofinancing; or (v) a combination of some or all of the above.

Savings deposits. Although practiced by TDB, the acceptance of savings deposits from the public is not a viable financial option for most DFIs. The systems and support network required for administering a savings product is a relatively expensive way to raise funds, and the increased regulatory and governance requirements also add compliance costs. A significant base would also need to be established (with the inherent costs involved) before a reasonable level of funds could be generated. Against this, such deposit mechanisms present an opportunity to fulfill a broader social responsibility by providing savings facilities for individuals who would not

normally have access to this type of facility. TDB, for example, offers a savings mobilization scheme, which is expected to support its lending program to the outer islands, and which will ultimately replace special credit projects for the outer islands.

Term Deposits. As an extension to the existing programs for issuing bonds and promissory notes, the acceptance of term deposits from the public would seem logical. At present, FDB is seeking approval from RBF to accept deposits from the public; it is expected that a minimum deposit of F\$5–F\$10,000 will be set, which should minimize some of the costs associated with collecting retail deposits.

Bonds and Promissory Notes. Of all the domestic sources of funds available to DFIs, bonds and promissory notes are the most cost-effective and the most commonly used, as noted above. The mix of bonds and promissory notes allows DFIs to maintain liquidity. The main market for these instruments is domestic institutions, such as provident funds, resulting in an expanded financial sector, which in turn promotes the objectives of the DFIs.

Cofinancing. Cofinancing is increasingly being considered as a means of attracting funding from other lenders, and has the advantages of being project specific and of limiting exposure. The reputation of the DFI can be enhanced by its relationship with other lenders, since it is likely that cofinanciers will be substantial lenders in their own right. For example, DBS has recently undertaken a project to build a hospital and medical center, which was cofinanced with Samoa's National Provident Fund.

Self-Funding and the Cost of Funds. A comparison of interest margins, administration, and profitability ratios illustrates very clearly the impact of self-funding on DFIs' cost of funds (Table 4.5). FDB operates on much smaller margins than does DBS or DBSI. While there are some benefits from economies of scale, this cannot explain entirely the major divergence of the statistics. DBS has operated on an interest margin of between 6.6 and 8.5 percent over the last three years, whereas FDB operates on a margin of 2.5–1.8 percent. This is mostly a function of the cost of funds for the two organizations.

DBS has enjoyed funding costs less than half those of FDB. In 1998, the respective borrowing costs as a percentage of average assets were 2.51 percent for DBS and 5.92 percent for FDB. More than any other, this statistic demonstrates the impact of borrowing from the domestic market.

FDB has a much smaller interest margin on which to run operations, and therefore its administrative costs, as a percentage of average assets, are significantly lower than those of DBS. DBS's ratio of average cost to average assets was 6.7 percent in 1998, whereas FDB's was 1.6 percent. Lower interest margins force institutions to operate more efficiently, and are one of the major thrusts behind reforms in the banking sector internationally.

The ratio of net profit to equity shows that higher costs of funds will impact on the return on equity, irrespective of the size of the financial institution. The nature of DFI business is to lend to individuals and organizations that would not normally have access to credit through regular commercial channels. This type of lending carries a much higher risk, because it is relatively likely that some of the loans may not be repaid. Normal banking practice would require that where a loan is in default, or where there are serious questions as to its repayment, a provision must be held by an institution against that possibility. The level of provisioning has a direct impact on profitability: for example, RDBPNG incurred an operating loss of 23.3 million kina in 1998, and a major contributor to this loss was an increase in their provisions for nonperforming loans of 26.5 million kina.

In order to attract funds from the market, it is necessary to pay market rates. Depending upon the economic well-being of the PDMC and the stability of the financial market, there will be a substantial premium (perhaps 4–5 percent) on the interest rate a DFI will have to pay. This reduces interest margins and profitability.

The success of a DFI at utilizing market funding will, to a large extent, depend on its government's attitude toward providing a government guarantee for securities issued by the DFI. Where a guarantee is not provided, there is a cost to the recipient organization. Research by FDB demonstrated that institutions now investing with FDB would require an interest

Table 4.5
Comparison of Interest Margins and Administrative Costs for
Development Finance Institutions, 1997–1998

	FDB		DBK		DBS		DBSI		TDB		RDBPNG	
	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998
Interest												
Spread	2.1	1.8	7.4	8.5	8.1	6.6	10.2	7.3	4.3	2.7	6.1	5.4
Admin. Costs / Ave												
Assets	1.2	1.6	9.5	10.1	6.6	6.7	14.2	19.3	6.2	5.9	—	—
Net Profit/ Equity ^a	0.72	0.11	6.6	-4.8	4.0	-3.6	0.5	-4.6	-4.5	-37.0	-1.6	-47.0

— Not available.

a. DBK – 1997 reflects government revenue grant.

Source: Table 4.2.

rate premium of 2–3 percent in the absence of a guarantee. Even with that premium, it was by no means certain that the institutions would continue to invest.

The size and maturity of the domestic market have a significant bearing on the acceptance of, and participation in, any financial instruments issued by DFIs. For example, if the existing market structure indicated that there were no term deposits longer than 12 months, then a financial instrument with a more than 12-month maturity would not be readily accepted. A market would in effect need to be created. The size of the market will therefore have a direct impact on the level of funding available to a DFI.

Although funding from the market involves higher costs, there are offsetting benefits. It stimulates improvements in governance and reporting (Skully 1999), and subjects the institutions to the supervision of the regulatory authorities (central banks). Prudential supervision imposes further disciplines on management in terms of reporting the institutions' financial status and policies on capital adequacy, loan classification, and provisioning. This should increase market confidence and provide DFIs with better management.

In addition, management will also have greater flexibility as to the positioning of the DFI. The broader social responsibility role carried out by the DFI can still be supported under the self-funding model. Moving into the market with

some form of guaranteed bonds and promissory notes holds the best opportunity for penetrating the investment markets. The advantages of the bond are that it is simple to administer and understand and that it is an attractive instrument to the institutions, particularly where it can be government-guaranteed. Once the market for bonds has been established, it is appropriate to seek some level of diversification in funding by adding other instruments, such as retail term deposits.

DFIs and Governance

One of the critical components of successful development banking is the establishment and maintenance of strong governance processes, beginning with the appointment of a strong board. The board's key role is to ensure that management is continuously and effectively striving for above-average performance, taking account of risk and protecting shareholder interests. Each board should clearly define above-average performance in its particular situation, monitor performance so defined, and fulfill four key functions:

- (i) appointing a chief executive and providing support and guidance to senior management;
- (ii) ensuring that a clear strategic direction and policies have been established by management and monitoring their implementation;
- (iii) ensuring that there are appropriate budgets in place to support the corporate direction; and
- (iv) reporting to shareholders and ensuring regulatory compliance.

Current structures for all DFIs in the study indicate that the board structures follow a similar pattern. They are made up predominantly of government representatives, usually from agriculture, fisheries, trade/industry/commerce, and tourism, with the senior finance officer chairing the board. The size of the boards ranges from six to 10 (Table 4.6). Since the government representatives generally reflect the wishes of the 100- percent shareholder (the government) rather than the broader interests of the business community and civil society,

Table 4.6**Characteristics of Development Bank Boards**

	DBK	DBS	DBSI	FDB	RDBPNG	TDB
Members	6	8	9	8	10	6
Public Sector						
Members	5	4	Members all	2		4
Private Sector			have			
Members	1	4	political	6		2
Chair	Secretary for Finance	Secretary for Finance	connections	^a	^b	Minister of Finance
Means of Appointment	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance
Reporting to Central Bank	No Central Bank Reports to Min of Finance	Formally Reporting to CBS	No reporting	Informal	Informal	Informal

a. The FDB Board of Directors was dismissed by the Government in early 2000.

b. Prior to the merger with the Pacific Finance the chair was the Minister of Finance. At the time of writing this report, the decision regarding the future of the board had still to be determined.

Source: DFIS.

more private sector representation and expertise are needed. In a review of the TDB, for example, it was suggested that there should be a change in the mix of nonexecutive directors on the board from three private sector representatives to four, along with two Government representatives.

The respective legislative acts establishing each DFI allow for the appointment of the board and the chairperson to be at the discretion of a minister, usually the minister of finance. No performance criteria are set down, and the removal of a board or board member is at the discretion of the same minister. The Government of the Fiji Islands, for example, unilaterally removed directors of the Fiji Development Bank in 2000 without any due process. Legislative amendments are needed to make performance the sole criterion by which the board is judged.

The boards of DFIs have fallen well short of any reasonable performance measure. They have not ensured that proper monitoring and control procedures are in place, so that the true position of the institution often does not become known until its financial position has deteriorated to the point of crisis or insolvency. For example, as mentioned, the RDBPNG incurred a 23-million kina loss in 1998, largely resulting from the need to make extra provisions for bad and doubtful loans. Yet the 1998 Annual Report was still not available in February 2000. The board was not carrying out the key roles of compliance and reporting to shareholders.

Such poor board performance in part reflects constraints on board members' ability to fulfill their responsibilities. Evidence suggests that given the demands of their primary portfolios, it is often difficult for senior public servants to maintain an effective meeting schedule. There is also the perennial issue of political pressure on development banks to lend directly to the government's priority areas. With strong government representation on boards, it is extremely difficult for management to resist such pressure.

Considerable attention needs to be paid to improving the effectiveness of boards. There is a need for stability at the board level, because frequent changes in the composition of boards disrupt institutional development. Proposed actions include

- (i) strengthening the legislation covering the DFIs to reduce the power of ministers to intervene on any grounds other than performance;
- (ii) strengthening the provisions regarding appointment and dismissal of directors so as to reduce volatility;
- (iii) reinforcing provisions for nonattendance to allow for stronger sanctions in the event of regular nonattendance by board members; and
- (iv) increasing the level of private sector and banking experience on the boards to permit greater diversity of input into decision making.

The importance of strong governance procedures cannot be emphasized enough. Without these, there will be a tendency for any institutional strengthening to be negated.

DFIs and Strategic Planning

The capacity of DFIs to undertake strategic planning varies, with DFIs in the Fiji Islands and PNG having relatively strong planning processes. In recent years, DBS and TDB have both also developed strategic plans. It would be useful to develop some best practice principles, based on institutions in the region rather than international institutions whose performance bears little comparison with DFIs in PDMCs. In either case, strategic plans should be developed and owned by those who will be responsible for their implementation, and should be driven by the chief executives of each DFI.

Many of the problems associated with lack of disclosure and provisioning are related to inadequate management information systems. Loan officers are often not aware that a borrower has defaulted on a payment until several weeks after the due date. This makes the collection of outstanding debt very difficult, as many small businesses do not have sufficient discretionary cash flow to make up the arrears. The earlier a debt is followed up, the more likely it is that a full recovery can be made. The development of best practices for loan systems would permit some standardization of reporting to boards on the critical information that boards need. It would also address some issues relating to standard policies and procedures: in some DFIs, there are at present no formal policies and procedures; while in others, policies and procedures lack sufficient detail to be useful for effective management.

All DFIs have, at one time or another, experienced problems with their debt management and collections. This has been due to the lack of clear policies and procedures and to the lack of enforcement of the procedures that are in place. Sometimes the level of outstanding loans reaches the point where the solvency of the institution is threatened; without significant capital injections, it is difficult to see how it will recover. For example, RDBPNG's bad and doubtful loans stood at 76 percent of the total loan portfolio in 1998. This is close to the level of bad and doubtful loans in the DBV in 1997, when it was decided to merge it with NBV. The Vanuatu Government established a separate Asset Management Unit (AMU) to specialize in collecting the DBV's outstanding loans. The AMU

had considerable early successes, and the broad concept of establishing specialist units is being increasingly adopted by the DFIs in the region. However, many PDMCs have kept recovery units as part of DFIs rather than establishing separate AMUs, which have greater autonomy and thus capacity to pursue recovery of bad debts from prominent individuals and businesses.

In summary, governments can consider several strategic options for improving performance of DFIs: (i) privatizing the DFI, by selling its shares to a private sector organization; (ii) integrating it into another organization; (iii) contracting out the management of the DFI; and (iv) developing strategic alliances.

Privatization. As discussed above, the privatization option does not appear to be a realistic one for development banks. It is difficult to see how a DFI in a small and narrowly based economy could be an attractive investment to private investors today, given the high-risk and low-return quality of their loans. In addition, no private sector investor would be attracted to making decisions about representation in rural areas. Commercial banks might be attracted to specific target clients or projects, or where there is a history of consistent levels of profitability, but to increase the returns of DFIs would probably require significant restructuring, which may not be a politically popular choice.

Merging with another institution. This is another option to which there is some logic, particularly if a banking institution were the other partner: it would bring some professional banking experience to the management of the development bank. However, the experience of Vanuatu is not encouraging: development banking stopped when DBV was merged with NBV. NBV had to focus on consolidating its financial position following bankruptcy, and was unfamiliar with the nature and benefits of development banking. In general, where commercial bankers are responsible for administering loan funds for development lending, they will naturally look to their background training in commercial banking to support their decision making; there will be a tendency to direct the better loans towards the commercial banking arm rather than leaving them with the development

bank operations, thereby exacerbating the weaknesses in the portfolio. This raises the matter of the need for specialist training in development lending and the encouragement of institutions that can provide it.

Apart from the difficulties associated with holding loans with a high risk of nonpayment, there is the relatively high cost of maintaining branch networks to service rural and outlying areas. While there is some logic to working with agencies such as credit unions and other MFIs to deliver services to rural and outlying areas, in general these agency networks are themselves not sufficiently well developed. This limits their capabilities to provide viable services, particularly financially sensitive services such as banking services. It may well be that funding to assist the strengthening of credit union movements and other MFIs could offer some potential for addressing the key problem of the cost of distribution.

Contracting out DFI management. This option involves the same issues as merging. A management group that was charged with running the DFI would in all probability also seek to close down unprofitable representation points. Given the nature of DFI operations, it is also likely that the cost of obtaining professional managers would be prohibitive.

Developing strategic alliances. Another option for DFIs is to develop strategic alliances with key organizations involved in providing services to their target markets, such as credit unions and provincial cooperatives; or to establish alliances with manufacturers of primary goods such as foodstuffs, which are very close to their growers and which could best determine the credibility of a particular grower. By entering into wholesale funding arrangements with manufacturers, DFIs could minimize the client risk element of the lending assessment process. This arrangement could also enhance DFIs' relationships with manufacturers. The choice of the right manufacturer would be crucial to the success of this particular strategy. Strategic alliances with commercial banks also offer opportunities for expanding the range of services to development bank clients. DFIs could also explore the possibility of entering into arrangements with organizations that already have representation points, such as credit unions or provincial cooperatives, as alternatives to maintaining rural

networks. In the long term, arrangements with other institutions could be more sustainable than retaining branch networks.

These options have been considered from a general perspective. Each PDMC government would need to make an assessment with reference to its own DFI.

DFIs and Training

In all PDMCs there is a continuing demand for upgrading staff skills, and a need to ensure that such skill development is undertaken to provide a long-term sustainable basis for ongoing capacity building. The types of training being undertaken seem to be consistent across DFIs, the main areas being credit, project, and loan appraisal, with less attention being placed on areas such as management development and business and market planning. The focus of most training is on the technical aspects of loan appraisal, with very little attention given to the development of interpersonal skills. Interpersonal skills are as important as the technical component of a loan officer's activities, as it is often the breakdown in communications or misunderstandings with clients that can aggravate deteriorating loan positions. There is also a need for greater attention to the development of managers. Management skills and understanding are very poor. In general a more professional approach to training is long overdue.

There is a lack of specialized facilities for staff training in PDMCs. There is also considerable variability in training when a number of different training providers are used. If there is to be an overall improvement in skills in the region, then a different approach to training is needed. This issue could be examined in the broader context of building a regional network of DFIs. Currently there is limited cooperation between the DFIs in the region, although there is an Association of Development Finance Institutions in the Pacific based in Suva, Fiji Islands, which acts as a secretariat for the DFIs in the region. Its principal activity is the organization and administration of the ADFIP annual conference, which is held on a rotating basis around the various PDMCs of the region.

Box 4.1**Best Practice for DFIs**

PDMCs need to promote good corporate governance through providing greater independence for DFI boards from potential political intervention by governments in decision making, through strengthening company law provisions on the responsibilities of the board of directors and management, and through appropriate prudential supervision by central banks. Internal and external auditing should focus on strengthening risk assessment.

PDMCs need to develop the capability for strategic planning and options along with adequate management information systems, which should be owned and driven by the CEO of each DFI. PDMCs also need to commit additional resources to training for DFIs, including strengthening professional management and business development skills.

PDMCs should establish best practices for DFIs for

- (i) standards of disclosure;
- (ii) minimum capital adequacy ratios;
- (iii) strengthening legislation;
- (iv) market-determined interest rate policies;
- (v) accrued interest policies;
- (vi) provisioning policies;
- (vii) lending policies, including policies on concentration of risk, connected lending, and maximums for any one organization or individual; and
- (viii) harmonizing training requirements through the region.

However, there has been no attempt by the institutions to formulate any coherent regional approach to DFIs, nor does any consideration appear to have been given to determining if there are potential synergies to be obtained by stronger cooperation or a sharing of resources.

NATIONAL PROVIDENT FUNDS

NPFs were set up in most PDMCs as statutory corporations, to provide pensions for employees and civil servants and to mobilize domestic savings for national development. Members' contributions vary across PDMCs from 5 to 10 percent of wages and salaries and are matched by employers' contributions. All the selected PDMCs except Tonga have such a fund. In PNG, the funds are split: the Public Officers' Superannuation Fund is for civil servants and the National Provident Fund for private sector workers. In PNG, private sector employers are permitted to opt out of the fund and some larger employers have done so. In Tonga, the Government established a Civil Service Pension Fund in 1999 to provide funded pensions for the public sector; the scheme may be extended to the private sector in the medium or longer term.

The boards of NPFs are usually tripartite, consisting of two representatives of the public service, two representatives of employers, and two representatives of employees. The power to make decisions is generally vested in the board, though most funds were set up under their own acts, which state what kinds of investments are allowed. In Kiribati, the act does not allow for lending to local businesses, and the only instruments for investment are offshore stocks and bonds and local buildings. In other PDMCs (except Vanuatu), NPFs are permitted to invest only a small percentage of their portfolios offshore. In some PDMCs, NPFs have large holdings of government bonds (the Fiji Islands, PNG, Solomon Islands).

The performance of NPFs has varied widely across PDMCs. Poor governance has been a problem for some. In the Fiji Islands, FNPF has been successful in ensuring that members (residents who have been employed for at least some of their working life) have assets to provide a degree of security when they retire. Kiribati Provident Fund has been highly successful, with returns on members' investments of 11 percent per year in the 1990s, and has assets to pay members a lump sum when they retire. Samoa's National Provident Fund has been more conservative, with average returns of around 5 percent per year, and also has assets to pay members lump sums when they retire. The provident funds in the other PDMCs have been

much less successful. In PNG, Solomon Islands, and Vanuatu, the assets of members have been badly invested, so that the rate of return to members is very low (and may even be negative). In Vanuatu, following a 1998 riot related to badly invested NPF funds, the Government paid monies out to all the members. In PNG, an actuarial review of the National Provident Fund and the Public Officers Superannuation Fund is to be undertaken, following on the series of poor investment decisions that have resulted in a serious decline in the underlying asset value of the funds.

The degree to which members can access their funds varies across PDMCs. In some, members can borrow from funds against their contributions; in others they can use funds as collateral to purchase a house or land. It is entirely consistent with the objective of the schemes to allow members to withdraw funds (or to borrow against them) to provide themselves with housing, education, etc. It is also considered desirable to develop an investment habit. The majority of funds allow members to withdraw lump sums on retirement or earlier. These lump sums are intended to give members the capital to start small businesses, although anecdotal evidence suggests that the funds are being spent largely on consumer goods or to meet family obligations.

Although the FNPF has been successful in terms of return to members and is generally meeting its objective of providing retirement income for members, it dominates the capital market in the Fiji Islands to an undesirable extent. FNPF is the main buyer of Government and RBF bills and bonds, which it holds to maturity. It has also enabled the Government to dispose of the bulk of its holdings in Amalgamated Telecom Holdings Limited without using the local stock exchange. The commercial banks also allege that the size of FNPF's cash holdings with them results in huge swings in bank liquidity. This causes them regulatory problems with parent companies because of country risk. It also necessitates their holding excess margins in case the funds are suddenly withdrawn.

The major difficulty is to provide competition for NPFs in the region. Competition in the provision of investment products would provide more investment options and lead to a more educated investor population. Each investment provider would

be motivated to tell the public about its product, thus creating wider dissemination of the concept of investing; media organs could fill space quite cheaply by commenting on the different products and generating tables of comparison; and the results achieved by different investment organizations could be compared.

In spite of the record of mismanagement and the inability of some NPFs to meet objectives, all governments in the region are committed to the concept of a national provident fund. It is crucial that steps be taken to ensure that these operate to the advantage of their members.

Box 4.2

Best Practice for NPFs

PDMC governments need to

- ensure the independence of NPF boards from political interference, especially in regard to holding of government debt (sometimes at below-market rates);
- appoint board members and managers on the basis of professional competence and personal integrity;
- ensure accountability of boards and managements to members through timely and clear reporting and annual meetings;
- focus on professional investment management for the benefit of members, as opposed to expenditure on NPF offices and staff;
- Allow for overseas investment of funds where this is currently not permitted, and allow for greater overseas investment where this is restricted; and
- Place supervision of NPFs under the central bank where this is not currently the case.