

**FINANCIAL SECTOR
DEVELOPMENT
IN THE
PACIFIC DEVELOPING
MEMBER COUNTRIES**

**Volume One
The Regional Report**

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Abbreviations

ADB	Asian Development Bank
AMU	Asset Management Unit
ANZ	The ANZ Bank, Australia and New Zealand Banking Group of Australia
APRA	Australian Prudential Regulation Authority
CMDA	Capital Market Development Authority (Fiji Islands)
DBK	Development Bank of Kiribati
DBS	Development Bank of Samoa
DBSI	Development Bank of Solomon Islands
DBV	Development Bank of Vanuatu
DFI	Development finance institution
EIB	European Investment Bank
FDB	Fiji Development Bank
FNPF	Fiji National Provident Fund
GDP	gross domestic product
IFC	International Finance Corporation
MBf	MBf Bank of Malaysia
MFI	Microfinance institution
NBF	National Bank of Fiji
NBV	National Bank of Vanuatu
NBFI	nonbank financial institution
NGO	nongovernment organization
NPF	national provident fund
NZODA	New Zealand Overseas Development Assistance
PDMC	Pacific developing member country
PIIF	Pacific Islands Investment Facility
POMSoX	Port Moresby Stock Exchange
PNG	Papua New Guinea

RDBPNG	Rural Development Bank of Papua New Guinea
RERF	Revenue Equalization Reserve Fund (Kiribati)
SCPNG	Securities Commission of Papua New Guinea
SEED	Social and Economic Equity for the Disadvantaged (Fiji Islands)
SIMIWORDS	Solomon Islands Microfinance Scheme for Women
SMILE	[Pacific] Sustainable Microfinance and Livelihoods through Empowerment
SPPF	South Pacific Project Facility
SSE	Suva Stock Exchange (Fiji Islands)
TDB	Tonga Development Bank
TNYC	Tonga National Youth Council
UNDP	United National Development Programme
VANWORDS	Vanuatu Women's Development Scheme
VNPF	Vanuatu National Provident Fund
WIBF	Women in Business Foundation (Samoa)
WOSED	Women's Social and Economic Development Program
YWCA	Young Women's Christian Association (Solomon Islands)

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Foreword

The Pacific Islands Economic Report series aims to assist regional governments in their policy formulation and to provide analytical support to donors in developing their assistance programs. This regional report is the first of two volumes providing a comprehensive analysis of financial sector development in seven Pacific region countries that are members of the Asian Development Bank. The report consolidates the findings of individual country studies that are presented in a second volume, and identifies possible strategies for accelerating financial sector, and thus economic development. It is a product of a regional technical assistance project funded by the Asian Development Bank and co-financed by the government of New Zealand. The regional and country reports were prepared by a team of consultants led by Marian Bond (financial sector economist) and consisting of Ofelia Eugenio (microfinance specialist), Valerie McFarlane (capital markets specialist), Don Paterson (legal specialist), and Colin Stringer (development finance institution/banking sector specialist). Government comments on first drafts have been incorporated in the final reports, which were prepared for publication by Bruce Knapman (consultant economist). Preparation of the draft and final reports was supervised by Eugene G. Zhukov, Economist, Programs Department – West.



Basudev Dahal

Director

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Asian Development Bank

Executive Summary

Executive Summary

This regional report assesses the state of financial sector development in seven of the 12 Pacific Developing Member Countries (PDMCs) of the Asian Development Bank (ADB). It consolidates the findings of individual country reports on the Fiji Islands, Kiribati, Papua New Guinea (PNG), Samoa, Solomon Islands, Tonga, and Vanuatu (presented in a second volume); and makes recommendations on strategies for the sustainable development of sound financial systems.

MACROECONOMIC ENVIRONMENTS

Macroeconomic stability is a necessary condition for successful and durable financial sector development. The condition has not always been satisfied in the open, vulnerable PDMC economies. In the 1990s, PNG and Solomon Islands, in particular, suffered from unsustainable fiscal expansions and governance problems. In contrast, Samoa improved its economic growth rate, lowered inflation, moved into and sustained overall fiscal surplus, and improved the external current account balance.

Fiscal crises, concern over sluggish economic growth and/or increasing inequality, and widespread public disillusionment with the quality of governance all contributed in varying degrees to a new commitment to the design and implementation of economic and public sector reform programs in the late 1990s. Some of the reforms, especially in Samoa and Vanuatu, aimed specifically and directly at financial sector development.

BANKING SYSTEMS

Banking systems dominate the financial sectors of PDMCs, accounting for almost half the total assets of the sectors. These systems are characterized by foreign ownership, a focus on urban operations, excess liquidity, limited competition, generally high profitability, and large interest rate spreads that rose from just over 6 percent in 1994 to almost 8 percent in 1999. The latter rise reflected some decline in competition but also more effective pricing for risk.

State-owned commercial banks in the Fiji Islands, PNG, and Vanuatu almost failed in the late 1990s, requiring restructuring and recapitalization. In Tonga, another foreign-owned commercial bank was in distress.

There was very little progress in financial deepening between 1994 and 1999, due to bank restructuring, poor management of some financial institutions, and falling nominal and real interest rates on time deposits.

High levels of liquidity reflect a scarcity of bankable projects, which is partly the result of a lack of profitable investment opportunities, and partly the result of the inability of potential borrowers to access finance effectively. A major reason for difficulty of access to finance is the inability of potential borrowers to use land as collateral. In addition, high default risks and problems in using legal systems for collecting on nonperforming loans constrain bank lending.

Central banks have the authority and responsibility to supervise commercial banks (except in Kiribati, where the Australian dollar is used). Legislative amendments have given central banks the power to flexibly issue prudential regulations in line with international standards. There is a need to enhance the capacity of central banks to conduct banking supervision effectively, through adequate enforcement of prudential regulations, the granting of more autonomy from governments, and training of staff.

NONBANK FINANCIAL INSTITUTIONS

National provident funds (NPFs) held an average of about 20 percent of financial sector assets in 1994–1999. In most PDMCs, a large percentage of NPF funds is invested in 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. These securities are usually held until maturity. NPFs have also been largely responsible for the large amounts of liquidity in most commercial banking systems.

The performance of NPFs has been very varied across PDMCs. Poor governance and inadequate investment strategies have led to serious declines in asset values of NPFs in PNG, Solomon Islands, and Vanuatu.

Development banks are a relatively small part of financial systems, with assets averaging less than 7 percent of total financial sector assets in 1999. Lending policy and project selection have been subject to political interference and have been determined by boards composed of government officials who paid insufficient attention to risk. As a result, development banks continued to decline in profitability over the 1990s. In the late 1990s, restructuring and management strengthening efforts began.

DEVELOPMENT OF FINANCIAL MARKETS

PDMCs made considerable progress in the 1990s in moving from direct to indirect instruments of monetary policy. First, all PDMCs liberalized interest rates. Second, all PDMCs introduced open market type operations. However, the development of money and bond markets has been hindered by illiquid interbank markets, insufficient central bank earnings, a shortage of instruments, and an absence of secondary trading.

There are some unmet financing needs for equity and debt financing, but very few requests for assistance from the South Pacific Project Fund (SPPF) and the Kula Fund turn into feasible investment opportunities. Many businesses rely on finance

from family and friends. Public issuance has been a little-used source of finance: without a stock exchange, investors find themselves locked into their investment; and where there is a stock exchange (the Fiji Islands, PNG), trading is thin. There seems little likelihood of developing a domestic stock exchange in other PDMCs.

All PDMCs covered by the report except Samoa have an ambivalent attitude to foreign investment. This discourages overseas investors and hinders disposal of loss-making state-owned enterprises.

Successful development of capital markets and stock exchanges in PDMCs depends on the existence of sufficient effective demand for equity. Given the constraints of small economy size and the structure and performance of PDMC economies, such development must be seen as long-term.

MICROFINANCE

Microfinance is at an early stage of development in PDMCs; no microfinance institution (MFI) has yet achieved operational self-sufficiency. Nonetheless, such institutions are critical to achieving rural and equitable urban development.

LAND OWNERSHIP ISSUES

Land tenure systems in PDMCs are complex and varied. In many cases, constitutions and legislation have been designed to protect indigenous people from unwise disposition of their rights in their customary land. In all cases, disputes about customary land, and about customary titles related to customary land, are very common. The result is that gaining secure title to land in PDMCs is difficult. This is a serious impediment to the development of customary land and its utilization as collateral for commercial loans. Reliable leasehold regimes need to be established.

KEY CONSTRAINTS ON FINANCIAL SECTOR DEVELOPMENT

The most important constraint on financial sector development is slow economic growth that has been skewed toward urban areas. Faster growth requires increased private sector investment. The major reasons for the relative lack of private investment are (i) the lack of access to finance caused by potential borrowers' lack of a track record and/or poorly prepared loan applications, and by their inability to use land as security for loans; and (ii) a lack of profitable investment opportunities, which in part reflects the impact of (changeable) government policies and behavior on the costs and risks of investing.

Financial sector development also has been retarded by intrasectoral constraints, some of which can be eased through appropriate policy changes. Poor governance has been a general issue in all PDMCs and has increased the risk for, and affected the performance of, government-owned financial institutions. Supervisory functions and enforcement of prudential standards are particularly important in small, uncompetitive financial sectors. The development of money and bond markets has been hindered by the lack of autonomy and low profitability of central banks and the high liquidity of NPFs. Privatization of profitable public enterprises is potentially an important means of stimulating the development of capital markets.

STRATEGIES FOR FINANCIAL SECTOR DEVELOPMENT

The key recommendations emerging from the analysis of PDMC financial sectors have three general themes. The first is that much more emphasis should be placed on managing risk. The second is that the small skills bases in most PDMCs require a more regional orientation to some parts of the financial services industry. The third theme is that microfinance institutions must be developed and more effectively integrated into formal financial systems.

To promote more effective competition for foreign commercial banks, governments of PDMCs should encourage

the development of nonbank financial intermediaries by ensuring a level playing field. Governments should also allow national provident funds to invest more of their money offshore. This would permit mopping up of some of the excess liquidity in financial systems, encourage competition by commercial banks for deposits, and reduce the costs to central banks of issuing instruments to mop up liquidity. Allowing citizens of PDMCs to utilize financial services through the Internet could also lead to more competition in financial sectors.

Strengthening supervisory systems and developing financial sector infrastructure would promote development of sound and efficient financial systems. Central Banks in PDMCs must have more autonomy, both for monetary operations and for effective supervision. Where this has not been done already, acts must be strengthened so that development banks, national provident funds, and other nonbank financial institutions can also come under the purview of central banks' supervisory systems.

It is recommended that PDMCs continue to enhance and strengthen the process of regional cooperation and consultation in regulatory and supervisory matters. A key initiative already taken is the recent regional Declaration on Cooperation to establish the Pacific Islands Prudential and Supervision Initiative. On and off-site supervision capacities should be strengthened through long-term training on a regional basis.

It is recommended that PDMCs work on a regional basis, with a view to enforcing internationally accepted accounting and audit standards for all financial institutions and for public sector accounting systems. PDMCs should also strengthen their judicial systems, so that supervisory decisions are promptly adjudicated, and the ability of banks to enforce the contractual obligations of their customers is enhanced. This will require more training for the judiciary on a regional basis.

Efforts should be made to improve the performance of development finance institutions (DFIs) by increasing both their commercial orientation and independence from governments. The former means taking risk into account when pricing, developing the capacity for strategic planning based on adequate management information systems, and committing additional resources to training. Increasing board

independence requires legislative change in some instances, and more private sector representation. Common regional policies for DFIs based on best practices should be established. DFIs should move towards self-funding through bonds and promissory notes, while any subsidies from government should be allocated on a transparent and targeted basis.

NPFs should operate independently of government and should set up rules concerning the nature of permitted investments, as well as procedural safeguards to ensure that monies are not diverted from their intended use. Development of the capital market in PDMCs can potentially provide an alternative to the commercial banks.

In order to facilitate capital market development, there is a need to ensure that sound companies acts are in place, along with efficient mechanisms for registering companies and monitoring compliance with ongoing filing obligations. Where required, the infrastructure for the registration process should also be improved, with staff and companies receiving training adequate to their ongoing responsibilities. PDMC governments should consider passing simple securities acts, or appropriately amending companies acts, so that persons who offer investment services in the domestic market are required to obtain a license.

It is recommended that consideration be given to establishing a distributed, networked regional facility that uses Internet technology to link the existing exchanges (Suva Stock Exchange and Port Moresby Stock Exchange) to companies and investors in all the PDMCs, and that makes provision for other domestic exchanges to be added to the network as they are developed. It is further recommended that the various privatization bodies in the PDMCs should, where possible, identify and privatize profitable companies through the mechanism of a public offer of a significant proportion of the shares.

It is recommended that the possibility of establishing a new venture capital fund on a regional basis be considered.

Microfinance development requires the building of management expertise and institutional capacity; a compulsory savings requirement; the charging of market rates of interest; provision of a comprehensive package of support services, including business skills training and on-demand advisory

support services; networking of microfinance practitioners; mobilization of resources in order to reduce dependency on grants and subsidies; and government creation of a conducive policy and legislative environment.

It is recommended that governments review the possibility of amending their relevant land acts to enable customary lands to be mortgaged or leased for business and commercial purposes, or to enact legislation to authorize the conversion of customary land to a form of freehold land that can be mortgaged or leased. In addition, it is recommended that some PDMCs take steps to remedy the uncertainty about the ownership and boundaries of customary lands, which hampers the mortgaging and leasing of such lands. Actions in these areas should emerge from a process of consultation with all stakeholders that involves an open and public discussion of problems and possible solutions.

It is also recommended that governments in PDMCs give consolidation to setting up a nonpolitical public agency to manage, or supervise and facilitate the management of, customary land.