Chapter 6

The Financial System

Key Points

- Availability of funds in the domestic banking system is not a constraint on development in the RMI—the banks have substantial unlent reserves (and could attract more deposits if lending opportunities justified it) and there are no restrictions on borrowing from outside the RMI.
- Problems with the use of land as security for loans, and difficulties in legal process in case of default, have restricted commercial bank lending.
- Orthodox domestic banking supervision in the RMI's small economy is unlikely to be cost-effective.
- By themselves, commercial banks will not extend services to remote areas nor develop micro-financing products.
- Political intervention in the Marshall Islands Development Bank's (MIDB's) lending decisions caused the loss of public funds and undermined the bank's viability.
- International pressure is making the governance of small offshore financial centers prohibitively costly.

Issues

- Enabling interests in land to be used as security for bank loans—*draft legislation is before the* Nitijela *to provide for this.*

- Making greater use of the domestic banking system in financing growth—*enabling registered land to be leased, and supplementing borrower security with MIDB/government collateral may together provide an answer.*
- How to make financial services more widely available—*some form of government sponsorship of financial service outposts and microfinance techniques will probably be required.*
- Devising appropriate and cost-effective means of banking supervision—*a regional source of shared supervisory services looks to be the best solution.*
- Can MIDB be made into an effective development finance institution?—*this may need a radical re-appraisal of its role in providing developmental credit and shifting from direct lending to credit enhancement, linked to business advisory services.*

The System and its Supervision

The economic role of the financial system is to provide efficient payment services for domestic business and overseas trade, to collect and safeguard the public's financial savings, and to make those resources available to borrowers, all at competitive cost and profitability. The soundness and stability of the RMI's financial institutions—and particularly the commercial banks, because they take deposits from the public that can be withdrawn on demand—is crucial to the smooth operation of the economy.

As the RMI uses the US dollar as its currency, there is no central monetary authority and no restriction on the movement of funds into or out of the country. The RMI financial system is an extension of that of the US. This effectively precludes the use of monetary policy in the RMI's economic management. If RMI residents do not like local financial conditions they can hold reserves and borrow money overseas without restriction, and clearly many do so. By the same token, the Government cannot print money to finance a budget deficit, debasing the currency and fuelling inflation in the process. (Box 2.3 discusses the consequences of using the US currency).

The RMI's financial system has both informal and formal sectors, which together cater to the community's needs. The informal financial sector is, almost by definition, officially unknown to the authorities, but virtually everyone uses it at some time, and some people use it all the time. There is no credit union or similar organization in the RMI, and only one moneylender on Majuro has a business license, but informal personal credit is a widespread feature of economic life. Given the unusually wide disparity—for the Pacific islands—of initial income distribution, lending by the wealthy to the less affluent, usually among relatives and friends, is said to be of special importance in the RMI. The conditions of lending are reported to be generally short-term, flexible and often much more expensive than formal-sector credit, but attractive and widely used because of immediate availability: these are common characteristics of informal credit anywhere.

The formal financial sector—where the moneylenders do their banking—consists of two US commercial banks, the Bank of Guam and the Bank of Hawaii, and one domestically incorporated commercial bank, the Bank of the Marshall Islands. Each of the three banks has branches on Majuro; the Bank of Guam and the Bank of the Marshall Islands also operate on Ebeye. The sector also includes the government-owned Marshall Islands Development Bank. The Bank of the Marshall Islands is majority owned by the Government. The deposits of the US banks are protected (up to $100,000 per depositor) by the Federal Deposit Insurance Corporation, which supervises their operations, alongside the Federal Reserve Bank and the US Treasury. The Bank of the Marshall Islands is supervised under RMI law, and its depositors do not benefit from US Federal Depository Insurance Corporation (FDIC) cover. Nevertheless it has the biggest share of deposits in the RMI, and its supervision presents the RMI authorities with an awkward responsibility.

The Banking Act of 1987 provides the legal framework for the conduct of banking and established the Office of the Banking Commissioner. The act envisages the establishment of prudential banking standards through regulations and policy directives; the codification of rules for accounting and reporting; promotion of understandings in relation to credit risk appraisal; licensing of banks; analysis of the financial condition of banking institutions; and formal procedures for inspection of banks and enforcement actions.

This orthodox supervisory regime demands much greater resources than the RMI, in common with most small developing countries, can justify allocating to it. Commonly in the Pacific islands, as in the RMI, only one or two commercial banks are locally incorporated, the others being branches of banks incorporated and supervised in much bigger and better-equipped jurisdictions. The difficulty and cost of installing and maintaining competent local supervisory capacity is out of proportion to the likely benefits. Some form of regional cost sharing seems the obvious answer, and attention is currently being given to this with the help of the Pacific Financial Technical Assistance Centre (PFTAC).[44] The RMI should stay close to this exercise, as it has the potential to ease the country's supervisory concerns.[45] Meanwhile, the services of PFTAC will be needed to assist RMI authorities to supervise the Bank of the Marshall Islands and monitor the health of the sector as a whole.

Banking Sector Performance

The ratio of total bank assets to estimated GDP has stayed around 60% for several years. In 1997–99 lending to (claims on) the private sector was fairly constant at $30–33 million, around 55% of the banks' total assets. Lending to the public sector was only 5–10% of bank assets, while as much as 35–40% of total assets, or $20–25 million, was held as overseas reserves. This is three times as much in reserves as might be expected if the banks were fully engaged in financing the RMI economy.[46] Consumer

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[44] PFTAC is a joint program of IMF, ADB, and UNDP, based in the Fiji Islands.

[45] There has been a suggestion that MIDB should be brought within the Banking Commissioner's supervision to help protect it against political interference. This is also a region-wide problem for which a region-wide supervisory arrangement offers a possible way forward. But see also, below, on changing the nature of MIDB's activities.

[46] By mid-2000, the banks' unlent reserves held outside the RMI had reached $30 million, amounting to 44% of their assets.

loans account for about two-thirds of bank lending, primarily for building construction, travel, and education. Most loans are made to public servants and repayments are made directly through payroll deductions. Loans for commercial purposes to public enterprises and the private sector are mainly for working capital and equipment.

The 3-year period 1997–99 saw total assets of the three banks rise from $55 million to $63 million, an increase of 13.5%, but more than half of this was in a 19% rise in foreign assets, or unlent reserves, which went up from $21 million to $25 million (see Table A3.13). Total lending to the private sector rose by only 8%, from $30.5 million to $33 million over 3 years—including $2 million to the tuna loining plant. These asset increases were funded on the liabilities side mainly by rises in private sector demand, savings and time deposits. Total claims of the private sector on the banks rose from $28 million to $37 million, an increase of 31% over the 3-year period. The expansion in lending activity was accompanied by an improvement in the overall quality of the loan portfolio, with a decrease in the proportion of non-current private sector loans for all three banks.

The average rate of interest on savings and time deposits fell over the period from 4.3% to 2.8%, as the banks acquired more deposits than they could lend and inflation remained low. Lending rates also declined from 11–18% to 10–16%, but these high real rates and the continuing wide spread between deposit and loan rates suggest that there is no great competition among the banks to increase lending, in part at least because of the difficulty of obtaining adequate security and effecting foreclosure in the event of default. At no time have the banks' abundant unlent reserves come under any pressure—let alone had to be supplemented by funds drawn in from overseas.

Marshall Islands Development Bank

MIDB was established in 1988 to promote the development and expansion of the economy of the Marshall Islands in order to improve the standard of living of the people. MIDB aimed to strengthen the nation's economic base, increase employment and production, improve the standards of housing, promote exports, and reduce the country's dependence on imports and foreign aid through the approval of viable development loans. These objectives have not been fulfilled. A 1997 study concluded that much of this failure is because MIDB is a state-owned enterprise, and has been subject to political interference in its decision making, with the predictable result of bad lending decisions and unrecoverable loans.

MIDB received $10 million from Compact funds along with direct contributions from the Government and funds from the US Department of Agriculture under the Rural Housing and Community Development Service Housing Preservation Grant. MIDB also assumed the assets and liabilities of the former Marshall Islands Economic Development Loan Office, Inc. MIDB has total nominal assets of about $20 million, of which loans make up $15 million, including around $9 million for commercial purposes. In MIDB's audited accounts of 1998, its assets were valued at $8.5 million, the result of writing off a substantial amount of non-performing loans. The 1999 accounts are not yet available.

In November 1999, Taipei,China approved a loan to MIDB of $5 million at 5% interest, to be repaid over 15 years including a 3-year grace period. Half of this money was quickly allocated and disbursed to a mixture of housing, domestic shipping and consumer loans. Of the balance, $1.8 million was borrowed on a temporary basis by the Government to settle MISSA's overdue obligations for overseas referrals.

MIDB makes loans and takes deposits, but offers no other banking services. It provides loans for housing (15 year maximum term, at 8.5%, formerly 4%), commercial purposes (10 years at 8.5%, formerly 6.5%) and consumer loans (3 years and between 12%–14%, dependent on the purpose). The bank has provided loans for fishing, agriculture, housing, tourism and manufacturing, but its main focus has been retail trade and consumer loans. Interest rates have in the past been prescribed by the Government on an arbitrary basis rather than by the board's view of commercial considerations.

A 1997 study on institutional strengthening of MIDB was funded by ADB. The study found that the fundamental problems of MIDB are "structural rather than stemming from inherent deficiencies of …staff." It concluded that MIDB needed to undergo structural transformation to place majority control in the hands of the private sector, thereby allowing MIDB to move on and recover the loans it can, without political hindrance, and make all future loans on their commercial merit. It was believed that such restructuring would be essential for MIDB to raise new capital from offshore. As noted above, Taipei,China has since provided $5 million with no conditions for restructuring the bank, but that seems an exception, and further external funding is likely to depend on a thorough reform of the bank.

Reform should be preceded by a review of the 1997 study in the light of events since then. The terms of reference for this review should additionally require study of the option of cessation of direct lending by MIDB, accumulation of reserves as its loans are repaid, and conversion of MIDB to a collateral-enhancing institution to enable borrowers to access the unlent funds of the commercial banks. MIDB might operate fee-based partial-guarantee and risk-sharing schemes, linked to compulsory use of business advisory and training services, to reduce the credit risk of the commercial banks—which would deal with the borrower and provide the loan funds.[47] This may be a more efficient use of the complementary strengths and weaknesses of the public and private sector institutions. If successful in a risk-sharing rather than a direct lending role, the new-style MIDB may also be relevant to the need for a local source of risk capital, discussed below.

Property as Collateral in Commercial Financing

The absence of exchange controls and the integration of the Marshall Islands into the US monetary system are positive factors in the investment environment. However, difficulties in obtaining development finance, which are related to the absence of adequate bankable security, are widely considered a major

[47] The experience and possible role of US federal programs that link credit to business advice should be examined in the MIDB review.

hindrance to investment. All three commercial banks have funds that could be made available for loans but are presently invested offshore. This is partly because of the lack of viable business projects, but the banks report that they are constrained from lending in many instances by the lack of realizable collateral. The land tenure system in the RMI does not allow land to be pledged as security, or to be seized and sold for satisfaction of debt, without the clear support and agreement of the senior land interest holders. Such agreement is naturally hard to obtain.

The law on the leasing of land for development purposes needs to provide, and be seen to provide

- the lessee with security of tenure and undisturbed occupation for the duration of a lease, provided the agreed conditions of tenure are fulfilled,
- the customary owners with a return on leased land commensurate with market conditions, and protection from or compensation for any degradation of the leased land,
- financial institutions and other lenders with access and use rights to mortgaged land as security for loans.

There is understandable concern about enforced sale of land in case of default on debt. Over time, this could lead to landlessness and emergence of a new landlord class. But the rights of the secured lender could stop short of ownership, provided the lender is enabled to recover the debt by 'statutory leasehold' use of the land. Legislation could provide for a secured lender to be able, in the event of default on a loan, to enter, exclusively occupy, and use (including subleasing) the mortgaged property, receiving all income from the property until such time as the loan is paid off or the lease expires, whichever comes first, and then to be required to return possession of the property to the lessor or owners.

The authorities in the RMI are aware of the importance of this problem. Draft legislation exists to facilitate land leasing, and is under parliamentary review. The plan is to establish a Marshall Islands Development Land Registration Authority that will facilitate the registration of land whose owners are willing to lease it for development by investors. A database of land that is available for lease and that has free and clear title will be created and administered by the authority. This arrangement will go some way to enabling land to be used as security. As noted above, the connected issue of the rights of the lender in the event of default should be considered. If these issues can be resolved, a substantial pool of private deposits can be tapped by the banks to finance commercial development in the RMI.

Equipment Leasing

Leasing offers a business opportunity in the RMI. A leasing company would offer items such as equipment, machinery, vehicles, and boats for lease (or hire-purchase) rather than buying with bank credit. Leasing has the advantage of providing 100% financing quickly, with the possibility of purchase for a nominal sum after the lease expires. The lessor provides credit through the lease agreement at a profit, and has security through continuing ownership of the item leased if the lessor is unable to service the lease payments. In the RMI context, where land and buildings do not presently provide adequate collateral, leasing could become an attractive form of business finance. A leasing company could be established as a subsidiary of one or more banks, perhaps with a number of individual shareholders. The Banking Act of 1987 permits this. The training of a Marshallese person with a financial management background to run the business is not likely to present a problem.

Investment Funds and Venture Capital

There is no domestic institution providing a source of equity capital. The banks are of the view that this makes overseas sources of equity capital difficult to access because no local matching funds are available. Vehicles can be taken as security, but have an acceptable collateral life of only 2 to 3 years. Other equipment cannot be used as security because there is no register of liens. The commercial banks consider that the establishment of a venture capital fund would help to provide viable financial structures for small and medium private sector enterprises, but it is not yet clear where the money for such a fund would be found. The lack of a uniform legal framework governing the creation, prioritization, and foreclosure of security interests constitutes a significant impediment for investors wishing to obtain commercial financing on reasonable terms. The banks believe this situation could be rectified by the introduction and implementation of a Uniform Commercial Code, a body of laws defining private and personal property rights and rules governing transactions and business practices, such as the requirement to record or file any chattel mortgage, conditional sales, or other type of security agreement.

Offshore Banking, Company and Shipping Registration

The sale of sovereignty services was noted in Chapter 2 as an economic opportunity area, but one subject to certain constraints. In the past, a number of offshore banks were registered in the RMI, but in the face of increasing US and other governments' concern about their operations this is winding down. Given the growing opposition among the world's wealthier governments to the role that offshore banking plays in hiding and converting the proceeds of crime and tax evasion, the indirect costs of hosting an offshore center, unless it is large and well regulated, can easily outweigh the economic benefits. These are usually small. Money passing through the books of offshore banks does not "stick" in the local economy. The benefits to the domestic economy are the creation of a small number of jobs and consumption of local goods and services. The damage to the country's reputation for good governance that results from allegations of crime-related transactions passing through one or more of its banks is intangible but potentially real. With the help of IMF and others, the RMI is now moving to bring its offshore regulatory arrangements in line with international best practice for small financial centers. In the RMI's case this probably means effectively going out of the offshore banking business.

The RMI has, however, an established and profitable activity in the registration of offshore companies and ships. This is carried out by the Trust Company of the Marshall Islands, Inc. (TCMI). This Marshall Islands corporation is wholly owned and controlled by a US parent company and its affiliates, from whom TCMI purchases management and other services, including representation around the world. TCMI operates the companies and shipping registries under a joint venture agreement with the RMI Government that was made in 1990 and amended in 1995. The two registries are linked. The shipping registry offers shipowners a legal nationality in a politically stable, US-connected jurisdiction that requires internationally-recognized vessel safety and crew standards, at competitive registration and certification rates.

The register has been growing steadily, with about 300 vessels now registered, the average size of which is increasing as new registrations come on. TCMI reports that the RMI register is now the eighth largest in the world, and has a good record for its ships passing port inspections. But only vessels owned by RMI citizens or RMI-registered companies can be registered in the RMI, and that is what drives the companies register. Most of the 5,000 registered and 3,000 active companies on the RMI companies register are involved in or related to the ownership of vessels on the RMI shipping register—ownership of a vessel is often shared among many registered companies, which may in turn be under the control of one person or organization. TCMI pays 25–28% of its operating revenue to the Government in quarterly installments. In 2000, it expects to pay about $1 million, slightly higher than in 1999, in line with its growth of business. This is a competitive and well-informed market, in which TCMI appears to be successfully marketing the linked facilities of the two registers. The RMI is following the footsteps of several other developing countries that have turned aspects of sovereignty into income in this way.

Extending Financial Services

Majuro and Ebeye have full-service banks, and Jaluit is soon to have a bank branch. Beyond that there are no branches or agencies, and persons wanting to deal with the banks must do so by radio or by visiting Majuro. As part of the examination of the rural atolls' stock of infrastructure and services proposed later in this report, and again in the proposed examination of the distribution of access and income between atolls and social groups, access to financial services will be examined. There is valuable experience in other small and island developing countries of ways to bring financial services closer to rural and less affluent people—often referred to as microfinance[48]—without endangering the stability of the financial system. It is very likely there will be a role for national and local governments in reducing the costs and risks of banking in remote areas, by provision of premises, telecommunications and suitable part-time staff.

As the RMI's diaspora continues and Marshallese communities in the US expand, the ability to send and receive money becomes increasingly important. The recent opening of a Western Union office on Majuro, soon to be followed by one on Ebeye, has greatly improved money transfer services. After a year's operations, outflows—almost all intra-family transactions with the US—are reported to average around $40,000 a week and inflows $10,000, for a net outflow of about $1.5 million per year. The service is quick and easy to use, and for amounts up to $1,000 the rates are competitive with wire transfers through the banking system.

[48] The term microfinance is commonly applied to provision of credit services in communities much poorer than the RMI, such that $100 would be a substantial loan and $1,000 a major investment. Nevertheless, the principles of borrower self-discipline and embedding of credit institutions in the community may have useful application in the RMI. The possibility is worth exploring.