SECTOR ASSESSMENT (SUMMARY): FINANCE

Sector Road Map

A. Sector Performance, Problems, and Opportunities

1. Timor-Leste’s financial sector remains underdeveloped, with a limited number and range of financial service providers, products, and services. Financial intermediation is undeveloped, and there is a lack of available long-term finance. Financial sector outreach and participation are low. Payment systems are inefficient, and the sector’s institutional foundations need to continue to be strengthened. Households and businesses have limited access to finance and financial services. People on low incomes cannot save securely to invest, pay bills, or move beyond subsistence living standards. Entrepreneurs and firms are unable to obtain finance for investment and productivity improvements. Private sector development is thus constrained, and opportunities to grow the non-oil economy and create jobs are missed.

2. Sector overview. The financial system comprises the Central Bank of Timor-Leste (BCTL), four commercial banks, two microfinance institutions, two general insurance companies, nine money transfer operators, and at least 27 credit unions. There is no equity market, corporate bond market, or stock exchange.

3. Banking. The financial system is dominated by the banking subsector, the total assets of which were $665.3 million at the end of 2013 (an increase of 19.8% from $555.2 at the end of 2012). The ratio of private sector credit to non-oil gross domestic product was very low at 11.9% at the end of 2012, and estimates for the end of 2013 range from 12.6% to 13.2%. Credit to the private sector grew 13.5% in 2013, and 5.0% year-on-year to the end of June 2014. Credit to individuals accounted for the largest share of the portfolio (48.8%), followed by construction (20.5%); trade and finance (12.3%); transportation (11.3%); tourism and services (4.6%); industry and manufacturing (1.7%); and agriculture, water, and forestry (0.7%). The distribution across these sectors reflects the role of government expenditure in driving economic activity. In terms of asset quality, the nonperforming loan ratio remained high at 27.9% at the end of June 2014 (a decrease from 30.8% at the end of 2012). At the end of December 2015, the loan-to-deposit ratio was 26.3%, the weighted average lending rate was 13.9%, and the spread between lending and deposit rates was 13.4%. Rates have risen gradually since January 2011, when the lending rate was 10.5% and the spread was 9.9% (footnote 2).

4. The four commercial banks are Australia and New Zealand Banking Group (ANZ), Bank Mandiri, Caixa Geral de Depósitos (CGD), and Banco Nacional de Comércio de Timor-Leste (BNCTL).3 ANZ, CGD, and Bank Mandiri are branches of well-established foreign banks, which are subject to supervision in their respective home jurisdictions. The Timor-Leste operations of each of these banks contribute less than 0.3% of the total assets of the groups to which they belong. ANZ and Bank Mandiri have branches only in the capital, while CGD has a network of nine branches. The banks primarily serve the international community, and businesses and nationals from their respective home countries.

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3 CGD operates in Timor-Leste under the trading name Banco Nacional Ultramarino Timor.
5. The government-owned BNCTL is the only locally owned bank. It has the largest outreach, with 13 branches across all districts and more than 150,000 deposit accounts. BNCTL accounted for about 7% of commercial bank assets and 12% of commercial bank credit at the end of 2013 (footnote 1). Formerly the Instituição de Micro Finanças Timor-Leste (IMFTL), BNCTL was granted an unrestricted banking license in 2011. Historically, BNCTL has mainly provided loans secured by public sector salaries, but its portfolio is diversifying with business loans to small and medium-sized enterprises, seasonal crop loans, and microfinance group loans. Its narrow product offering has contributed to a low nonperforming loan ratio compared to the foreign banks. Civil servants and social benefit recipients comprise approximately 70% of BNCTL’s clients.

6. **Nonbank financial institutions.** There are two microfinance institutions, Moris Rasik and Tuba Rai Metin, which together cover all districts and have more than 16,000, primarily female, clients. Both institutions are undergoing a transformation to fulfill the licensing requirements for other deposit-taking institutions. This will enable them to expand and will bring them under the BCTL’s purview. The nascent insurance industry comprises two general insurers, National Insurance Timor-Leste and Sinar Mas, which primarily serve the international community. National Insurance Timor-Leste has piloted a credit life microinsurance product, in partnership with the two microfinance institutions. There are at least 27 credit unions and a savings group movement, promoted primarily by nongovernment organizations.

7. **Central Bank of Timor-Leste.** The Banking & Payments Authority of Timor-Leste, which was established at independence in 2002, was converted into the BCTL in 2011. The BCTL currently has responsibility for the licensing and supervision of commercial banks, other deposit-taking institutions, insurance companies, and money transfer operators. It also manages the credit registry information system, houses the recently established financial intelligence unit, and has responsibility for the payments system and management of the Petroleum Fund. The BCTL does not regulate and supervise credit unions, which are under the purview of the Ministry of Commerce, Industry and Environment.

8. **Constraints and reform opportunities: access to credit.** Financial intermediation is undeveloped, with limited credit growth to support development of the nascent private sector. Lenders are currently unwilling to take the risk associated with lending to many potential borrowers, which has particularly affected small and medium-sized enterprises. The non-performing loan ratio for the banking sector has remained consistently high. This is mainly due to problem loans at one bank that date back to the 2006 crisis and its aftermath. Foreign banks routinely place excess deposits offshore, and the banking system is a net exporter of capital (footnote 1).

9. A number of factors have raised lending risks. Lending secured by collateral is inhibited by legal and other institutional weaknesses, including uncertainty around land titles and the absence of a framework for the use of moveable assets as collateral. Contract enforcement systems are weak, and the absence of a bankruptcy law creates uncertainty about lenders’ rights. To address the gaps in the legislative framework, the government has drafted a land law that is expected to be introduced to Parliament, committed to developing a framework for bankruptcy and insolvency, and began a secured transactions reform to unlock the collateral value of moveable assets.

10. Risk assessment by lenders is made difficult by (i) businesses’ poor record keeping and accounting, and (ii) the limited availability of credit information. The BCTL plans to review its credit

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4 In 2006, divisions emerged within Timor-Leste’s defense forces, which contributed to a security crisis with political and humanitarian dimensions.
registry information system, launched in 2009, to increase functionality and coverage.

11. **Diversity of financial products and providers.** The provision of finance to businesses, where available, is largely short term and self-liquidating. There is a lack of long-term finance available in the country for investment. The nonbank financial sector is underdeveloped. The government plans to establish a national development bank to address this gap, although the timetable for establishment, mandate, ownership structure, and extent of ongoing government support are yet to be determined.

12. **Financial sector participation.** It is estimated that fewer than one in six economically active adult Timorese actively use banking services. Increasing access to financial services for the general population is a policy priority for the government. Apart from a few CGD and BNCTL branches, there are few access points outside Dili and the district capitals. Commercial banks have plans to introduce and expand branchless banking initiatives, including mobile money and agent banking services, but these efforts are constrained by limited infrastructure, the high cost of moving cash around the country, and the small number of established businesses outside Dili that could function as agents. Financial inclusion efforts are hindered by low financial literacy, and the small number and limited capacity of microfinance and cooperative institutions.

13. **Payments system.** The majority of transactions are conducted in cash, and the payments system is inefficient. There is currently no real-time system for interbank clearing and settlement of electronic payments, and there is no interbank interoperability across payment infrastructure. The BCTL has plans to modernize the payment system, including the introduction of a national payment system law and real-time gross settlement system. Following the liberalization of Timor-Leste’s telecommunications sector in 2012, support infrastructure for electronic transactions has improved and a small number of ATMs and merchant point of sale devices are available.

14. **Regulatory foundations.** As the financial sector develops, further steps are needed to strengthen regulation. The main priority is to continue to strengthen the BCTL’s capacity for effective prudential supervision. In addition, the BCTL is working to ensure compliance with international standards, such as those related to anti-money laundering and combating the financing of terrorism. After the government passed an anti-money laundering law in 2011, it established a financial intelligence unit in 2014, housed in the BCTL and under the oversight of the National Commission for the Implementation of Measures on the Fight against Money Laundering and Terrorism Financing. With Asian Development Bank (ADB) support, the commission has drafted a national strategy on anti-money laundering and combating the financing of terrorism, and conducted a national risk assessment. In addition, the financial sector regulatory regime will have to be strengthened in response to sector innovations and emerging issues, such as with respect to branchless banking and consumer protection.

B. **Government’s Sector Strategy**

15. The Strategic Development Plan, 2011–2030 commits the government to the development of domestic financial markets, including the operation of a national development bank to provide long-term finance to businesses by 2015 and the provision of loans and banking services to people in every district by BNCTL by 2020. As of April 2016, establishment of a National Development Bank remains under consideration.

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16. The BCTL’s Financial Sector Development Master Plan lays out broad principles and policy actions to guide the financial sector development agenda in the short, medium, and long term (footnote 1). It focuses on (i) developing greater depth of financial intermediation, (ii) developing the payments system, (iii) developing insurance and risk management products, (iv) increasing financial inclusion and public confidence, and (v) developing financial sector capability.

C. ADB Sector Experience and Assistance Program

17. Sector experience. ADB assisted in establishing the IMFTL, which was granted a restricted banking license by the Banking and Payments Authority in 2002, through a grant from the Trust Fund for East Timor. ADB provided technical assistance to help the IMFTL grow and attain operational and financial self-sufficiency. By 2008, the IMFTL’s restricted banking license was limiting its growth. With support from the Pacific Private Sector Development Initiative (PSDI) technical assistance projects, the IMFTL was granted an unrestricted banking license in 2011. ADB continues to provide technical assistance to support BNCTL’s institutional strengthening and commercial transformation, with additional support from the PSDI on strengthening BNCTL’s internal audit capability.

18. Since 2012, the PSDI has supported BCTL to review laws and policies affecting branchless banking operations, and to assess the potential for introducing a third-party branchless banking services provider. The PSDI completed a legal diagnostic for secured transactions reform in 2014 and is providing ongoing support for this reform and the development of a legal framework for bankruptcy. In 2014, the BCTL requested PSDI support for drafting regulations for bank agents and completing a national risk assessment related to anti-money laundering and combating the financing of terrorism. This work is ongoing.

19. Expected activities. ADB will support financial sector development by working closely with the government and private sector. ADB’s technical assistance will support the commercial transformation of BNCTL. This will likely include long-term institutional capacity building in operations, credit and treasury functions, risk management, product development, information technology enhancement and roll-out of delivery channels, and staff capacity building. The PSDI technical assistance will mainly focus on developing linkages within the financial system to improve intermediation between savers and borrowers to increase availability of loans, securities, and other financing instruments. This will include strengthening the institutional foundations for finance and selected financial institutions, providing advice on the establishment of a development bank or other options for providing long-term financing, and helping financial service providers to design and implement new products. The PSDI will (i) support implementation of the secured transactions reforms, (ii) work closely with lenders to help them make full use of the secured transactions framework, and (iii) support the BCTL to strengthen its regulatory capacity.

20. ADB will also consider private sector investment opportunities in Timor-Leste through its Private Sector Operations Department, including the potential roll-out of the Trade Finance Program to narrow the trade finance gap and support international trade.

Problem Tree for Finance

Lack of broad-based economic growth that equitably increases incomes

Limited access to finance and financial services for households and businesses

Underdeveloped financial sector

Financial intermediation undeveloped as financial institutions unwilling to take risk

- Difficulty in assessing risk
- Poor record-keeping/accounting by businesses
- Limited credit information
- Institutional weaknesses inhibit collateral-secured lending (land law/secured transactions reform)
- Weak contract enforcement systems
- No bankruptcy legislation

Lack of diversity of financial products and providers

- Difficulties with collateral/recovery
- Underdeveloped non-bank financial sector
- No providers of long-term and development finance

Low financial sector participation

- Low financial literacy
- Few points of access/poor presence in rural areas
- Small number of microfinance and cooperative institutions with severe capacity constraints and weak balance sheets

Inefficient payment systems

- Lack of interoperability
- No platform for clearing/settlement of electronic payments

Regulatory foundations need to be strengthened

- Regulator's capacity and financial reporting need to be enhanced
- Compliance with international standards – e.g. AML/CFT
- Regulatory regime needs to evolve gradually – e.g. branchless banking and consumer protection

AML = anti-money laundering, CFT = combating the financing of terrorism.