

ASIAN DEVELOPMENT BANK

TAR: TON 29179

TECHNICAL ASSISTANCE

TO THE

KINGDOM OF TONGA

FOR

PREPARATION AND IMPLEMENTATION OF A STRATEGIC PLAN

FOR THE

TONGA DEVELOPMENT BANK

September 1997

CURRENCY EQUIVALENTS

(as of 14 August 1997)

Currency Unit		Tongan Dollar or Pa'anga (T\$)
T\$1.00	=	US\$1.2694
US\$1.00	=	T\$0.7878

ABBREVIATIONS

BOT	-	Bank of Tonga
TA	-	Technical Assistance
TDB	-	Tonga Development Bank

NOTES

- (i) The fiscal year (FY) of the Government ends on 30 June. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY1997 begins on 1 July 1996 and ends on 30 June 1997.
- (ii) The financial year of the Tonga Development Bank ends on 31 December.

I. INTRODUCTION

1. In November 1996, at the sixth donor coordination meeting of the Tonga Development Bank (TDB), TDB Management reiterated its earlier request for Bank advisory technical assistance (TA) to prepare a five-year Strategic Plan (1998 - 2002). At that time, discussions were held by the Loan Review Mission¹ on the objectives and scope of the TA. A Fact-finding Mission for the TA was fielded in May 1997 and an understanding was reached with TDB on the objectives, scope, cost estimates, and implementation arrangements of the TA. The TA is in the Bank's 1997 Technical Assistance Program for Tonga.²

II. BACKGROUND AND RATIONALE

2. The Bank's strategy for the Pacific region emphasizes the importance of making its assistance more effective in helping create an environment that will improve productivity, increase private sector investment and sustain economic growth. In Tonga, the TDB is the main provider of credit to the private sector; it has been at the forefront of private sector development, achieving a 70 percent share of total lending. The Bank was instrumental in the establishment of TDB, and has channelled through it funds for development.³ Capacity building assistance to TDB enabled it to improve its management and operations over the years⁴.

3. TDB is at the cross-roads of its corporate life. Faced with conflicting expectations about its role and objectives and concerns about its long-term viability, TDB needs to chart its strategic directions, striking a balance between performing its traditional development financing role and achieving financial sustainability in an expanding and increasingly competitive financial sector. Also, it needs to respond to competitive pressures, mainly arising from the entry of two foreign commercial banks, and changes in its environment, which because of the small size of its economy, has become increasingly vulnerable to developments in the region and the global economy. TDB must seize new opportunities for mobilizing resources and financing development activities. While seeking to ensure its commercial viability, TDB must enhance its developmental role, for which the formulation of a new strategic plan is crucial. However, to be able to pursue its new strategic objectives, TDB must overcome its internal weaknesses, particularly in its lending operations and management of its loan portfolio, and enhance its capacity to support its lending functions with advisory services, and undertake new activities.

4. TDB has made a major contribution to the economic and social development of Tonga by providing credit for development purposes, and responding to the financing needs of small businesses, outer island dwellers, women, and other disadvantaged groups. It is the main financial institution addressing the needs of the agriculture and fishery sector, accounting for over 90 percent of aggregate lending to this sector. About two thirds of TDB's portfolio consists of agricultural loans. TDB has given full support to the production of squash for

¹ Loan No. 990-TON(SF): *Fourth Tonga Development Bank*, for US\$ 5.0 million, approved on 21 November 1989.

² This TA first appeared in *ADB Business Opportunities* in July 1997.

³ TDB was established under the Tonga Development Bank Act of 1977 as an independent statutory body with Bank assistance. TA No. 174-TON: *Development and Finance Corporation*, for US\$240,000, approved on 22 July 1976. Since its establishment in 1977, the Bank has provided four credit lines to TDB in the aggregate amount of US\$ 8.3 million.

⁴ TA No. 265-TON: *Tonga Development Bank*, for US\$88,000, approved on 7 December 1978; TA No. 777-TON: *Third Tonga Development Bank*, for US\$160,000, approved on 19 June 1986; and TA No. 1230-TON: *Tonga Development Bank*, for US\$328,000, approved on 21 November 1989.

export. Over the years, it has also financed nearly 60 percent of tourist accommodation, in line with the high priority given by Government to the tourism and hotel sector. Although loan approvals granted by TDB to this sector has dropped, its share in TDB's portfolio remains significant, at about 15 percent. During the past three years, TDB's lending to the manufacturing, mining, construction, and commerce sectors has been stagnant, because of lack of foreign investments, weak manufacturing base and slowdown in business. Together, these sectors account for less than 20 percent of the loan portfolio of TDB.

5. Because of strong Government pressure to lend to the squash and tourism/hotel sectors, TDB became aggressive in its lending operations, resulting in severe strains on its management. Also, its operating policies were contravened and exposure limits exceeded.⁵ The lending level reached a peak of T\$24 million in 1994, but delivered to T\$15 million in 1996, primarily due to the decline in squash production and inactivity in the industry and tourism/hotel sectors. The vulnerability of TDB to the country's overdependence on a very narrow export base (squash, vanilla, and tourism/hotel) and limited markets (Japan for squash, New Zealand for papaya) is reflected in its declining loans and mounting arrears. TDB's arrears steadily increased to T\$8.2 million as at the end of April 1997, representing 19.8 percent of the loan portfolio, and the outstanding balance of all accounts in arrears amounted to T\$15.6 million or 37.9 percent of the portfolio amount. Over 70 percent of arrears are hard core, i.e., accounts overdue by more than 12 months. TDB's profits declined from a peak of T\$524,000 in 1994, to T\$138,000 in 1996, giving a return on equity of merely 1.3 percent. The steep drop in profits was due to the decrease in gross income and a doubling of loan loss provisioning in relation to the large arrears in its portfolio.

6. To deal with the arrears problem, TDB set up in April 1996 a 12-person Arrears Task Force to manage all problem accounts in Tongatapu that are in arrears by 3 months or more, except those already being handled by TDB's Legal Unit; a smaller task force of four staff was also set up in Vava'u. The two task forces have had some success, but to further improve their effectiveness, greater effort is needed to set in place a comprehensive loan review system and rigorous collection process. The collection rate for hard core accounts that do not have adequate collateral is only around 10 percent of the loan principal. In the case of hard core arrears with realizable collateral that are handled by the Legal Unit, less than 50 percent collection rate is achieved. Loan portfolio monitoring and debt recovery are clearly weak areas of TDB. A related weakness is the inadequacy of its loan classification system and of its loss provisioning and debt write-off policies.

7. In order to diversify its assets and improve profitability, TDB has gone beyond traditional development financing into commercial lending. Since 1994, it has been granting housing and personal loans and currently has a small market share of 4 percent. The justifications given by TDB for entering into commercial lending are: (i) it cannot ignore clients seeking full-banking services because they may transfer to competing banks; (ii) the securities already pledged by its borrowers, i.e., land title or lease and salaries, cannot be split up with another bank; and (iii) commercial banks have become active lending to sectors traditionally serviced by TDB, such as squash production and construction of hostels and motels for tourists.

8. TDB's commercial lending is at market-competitive rates, although highly valued clients are lent at the prime rate which is 1 percentage point lower than its usual rate. For its development lending operations, TDB seeks to provide credit at low interest rates, often at

⁵ TDB's prudential guidelines limit exposure to any one industry or commodity to 25 percent of TDB's shareholders funds. Both squash and tourism/hotel sectors have exceeded this limit.

rates lower than its cost of funds and intermediation costs, inclusive of loan loss provisions. The provision to priority sectors of cheap credit that is not commensurate to the associated risks, and the extent of cross subsidy involved, lead to distortions in the allocation of credit resources and stifle initiatives by other banks to provide credit and services in areas that have been the exclusive domain of TDB in the past. To be competitive with the commercial banks and also be financially sustainable, TDB's intermediation costs, e.g., administrative cost, cost of collection and debt recovery, have to be reduced and lending rates aligned closely with the costs and risks involved.

9. TDB is contemplating expansion into other areas of commercial banking, possibly by setting up a banking subsidiary. In particular, it wants to provide trade financing for import and export businesses. It already has a nascent savings mobilization scheme for the outer islands by which it is able to raise deposits (currently about T\$80,000). This will likely be complemented by other ways of expanding deposit generation. Introduction of new products and services, such as lease financing and credit guarantees, will be under consideration. TDB's venture capital financing needs to be strengthened and expanded. TDB has received from the Australian Agency for International Development a venture capital fund of T\$370,000, out of which only a handful of projects, mostly for longline fishing and papaya exports, have been funded.

10. Out of TDB's capital and reserves of T\$14 million, about T\$9 million equity has been injected by the Government from Australian and New Zealand grants. However, no additional equity from the Government is forthcoming because of budget constraints. Furthermore, external credit lines from the Bank, the World Bank, European Investment Bank and International Fund for Agricultural Development, amounting to about T\$20 million, are almost fully used up.

11. Promissory notes and long-term bonds issued in Tonga by TDB have been a source of financing since 1993, primarily to fund lending to the squash industry which was not eligible to borrow from the external credit lines. The total amount issued so far is almost T\$20 million and the outstanding borrowing is about T\$8.5 million. However, the cost of raising such funds is relatively high, compared with deposit rates of commercial banks and the Government's relending rate to TDB for loans drawn from the Bank and the World Bank credit lines. On a positive note, the introduction of the TDB notes and bonds was an important innovation in the financial sector for mobilizing savings and provided a means for banks to place excess funds. In view of the demand for such market instruments, TDB could assume a longer term lead role in responding to this demand and moving towards developing a market for debt securities.

12. TDB needs to improve its customer relations and business development. TDB staff needs to be more service-oriented in their relations with prospective borrowers. While TDB provides some training to borrowers, these are not very effective. Business advisory support services, especially in the rural areas and outer islands, have to be developed. TDB has not effectively used cooperatives, credit unions, and Nongovernment Organizations (NGOs) for credit delivery and business advisory and training. There is also lack of coordination with other Government offices in promoting new business ventures and investments and in training.

13. An issue that will have a significant bearing on the strategic repositioning of TDB is whether it can best operate as a Government-owned institution, or as one that is restructured along business principles, with a view to Government divesting its shares to a minority holding and TDB eventually being privatized. Already, TDB is partly privately owned,

although private holding is very small, at 2.2 percent. This is the result of the 3.7 percent shareholding of the Bank of Tonga (BOT), which is 60 percent owned by private foreign banks. As attested by the Minister of Finance who chairs the TDB board of directors, membership by BOT in the TDB board has been beneficial because of the private sector perspectives that the BOT representative brings into the board deliberations. However, there is increasing pressure to divest BOT's shareholding in TDB caused by growing uneasiness with competition between BOT and TDB in commercial lending. The Government prefers that in case the shares of BOT are sold, their ownership remains in the private sector. In the preparation of the strategic plan, the Government wants to consider the strategic option of restructuring and eventual privatization of TDB.

14. TDB has to address the challenges and related issues discussed above in redefining its long-term developmental role in an increasingly competitive environment, while at the same time ensuring its financial viability to be able to operate on a sustainable basis. These have to be considered in its strategic planning process and formulation of its second five-year strategic plan, as well as in gearing up the organization to be able to achieve its strategic objectives and action programs.

III. THE TECHNICAL ASSISTANCE

A. Objectives

15. The advisory TA will assist TDB in the formulation and implementation of a five-year strategic plan covering the period 1998 - 2002 based on considerations of TDB's developmental role, its participation in an expanding and increasingly competitive financial sector, and its long-term financial viability. The TA will assist TDB in redefining its role, recommend changes in its activities, and address the resulting organizational and financial implications. In addition, the TA will provide support to TDB to prepare it for implementation of the strategic plan.

16. The TA is expected to benefit TDB by providing both an external review by consultants with relevant experience, and assisting TDB in strengthening its strategic planning process and its organization, systems, and procedures for implementation of its strategic plan.

B. Scope

17. The TA will involve a review of the TDB Act and TDB's past strategies and operations, a reassessment of its role, strengths and weaknesses, and an evaluation of opportunities. The TA will identify strategic options, evaluate each option's advantages and disadvantages as well as resource and organizational implications, and advise the TDB Board in choosing the options. The TA will also provide advice and training in improving the quality of TDB's loan portfolio, with focus on principal areas of weaknesses, namely lending and portfolio monitoring, loan classification and loss provisioning, debt recovery, and business advisory support. Furthermore, the TA will enhance TDB's capacity to undertake activities that will promote business development, particularly in rural communities and outer islands, for small and medium enterprises.

C. Cost Estimates and Financing Plan

18. The TA is expected to cost US\$310,000 of which US\$280,000 is in foreign exchange and US\$30,000 equivalent in local currency. A summary of the cost estimates is in Appendix 2. The entire foreign exchange cost of US\$280,000 will be financed by the Bank on

a grant basis from the Bank-funded TA program. The balance of US\$30,000 equivalent of local currency cost will be financed by the Government through provision of counterpart staff, office facilities, and support services.

D. Implementation Arrangements

19. The Executing Agency for the TA will be the Ministry of Finance, and overall supervision will be under the Secretary of Finance. The international consultants will be selected in accordance with the Bank's *Guidelines on the Use of Consultants*. The consultants will coordinate closely with TDB Management throughout the assignment to ensure close identification with, and ownership of, the resulting strategic plan. The consultants will maintain close consultation with the Managing Director of TDB, who has responsibility for business planning.

20. A team of three international consultants, preferably from a consulting firm, will be engaged under the TA, comprising: (i) a Strategic Planning Expert, with relevant experience in strategic review and corporate planning, and in organizational restructuring and positioning for implementation of strategies for financial institutions, for 3 person-months; (ii) a Credit Specialist, with experience in credit management and debt recovery, for 3 person-months; and (iii) a Business Development/Venture Capital Adviser, with broad experience in business advisory services, venture capital assistance, and microcredit, credit guarantee, and other specialized and innovative schemes to improve credit access for bankable projects, for 2 person-months. The consultants' terms of reference are detailed in Appendix 1.

21. The TA will commence with the fielding of the consultants in mid-September 1998 and its completion is expected six months afterwards. The consultants will submit to the Bank and the Government an inception report upon commencement of the TA, a mid-term report at the end of three months, a draft final report five months after start of the TA, and a final report on completion of the consulting engagement at the end of six months. The mid-term report will be a draft strategic plan, together with a corporate plan and an operational action program for FY 1998 and recommendations on improvements in lending and portfolio monitoring. The final report will comprise the strategic plan approved by the TDB board and a summary of recommendations on lending, portfolio review, loan classification, credit rating, loss provisioning, debt recovery, business advisory support, and new products and services. The consultants will also prepare monthly progress reports to the Bank, with copies furnished to TDB management and the Executing Agency. A tripartite meeting will be held to discuss the draft final report and the comments thereon by the Bank and the Government shall be incorporated in the final report.

IV. THE PRESIDENT'S DECISION

22. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance, on a grant basis, to the Government of the Kingdom of Tonga in an amount not exceeding the equivalent of US\$280,000 for Strategic Planning and Implementation Preparation of the Tonga Development Bank, and hereby reports such action to the Board.

TERMS OF REFERENCE FOR CONSULTANT SERVICES

A. Objective

1. The technical assistance (TA) will assist Tonga Development Bank (TDB) in a comprehensive review of the institution's strategy and operations, that will provide the basis for a revised Strategic Plan. This will include consideration of TDB's developmental role, its participation in an expanding and increasingly competitive financial sector, and the means of improving and maintaining the quality of its loan portfolio. The TA will identify and recommend any necessary changes in the role and activities of TDB, and address the resulting organizational and financial implications. The TA will also provide support to prepare TDB for implementation of the Strategic Plan and assist, through advice and training, in enhancing TDB's capacity in principal areas of weaknesses, namely, lending and portfolio monitoring, loan classification and loss provisioning, debt recovery, and business advisory support.

2. The TA is expected to benefit TDB by providing both an external review by consultants with relevant experience, and assisting TDB in strengthening its strategic planning process as well as its organizational capacity to implement the Strategic Plan.

B. Detailed Terms of Reference

1. Strategic Planning Expert (Team Leader)

A Strategic Planning Expert will be engaged for three person-months to undertake the following tasks:

- (i) Assist TDB Management to develop a clear statement of its vision, mission, and general objectives.
- (ii) Undertake a review of Tonga's current and potential private sector investment activities, including consideration of Government policies and incentives for investment; development prospects in key sectors like tourism and agriculture; developments in the financial sector; and TDB's project pipeline. Assist TDB in macroeconomic and sectoral analyses and in formulation of sectoral strategies for consideration by the Government, that will serve as input to TDB's strategic planning.
- (iii) Review the performance of TDB, including consideration of: TDB's developmental impact; the range of activities undertaken; the applicability of, and compliance with, TDB's established policies, operations and procedures; and the interest rate structure applied to TDB lending and deposit taking (bond issue, promissory notes and saving deposits in the outer islands).
- (iv) Together with the Credit Specialist, review TDB's loan portfolio and current efforts to improve loan collection performance and portfolio quality.
- (v) In close consultation with TDB Board and Management, review TDB's existing strategic plans and its strategic objectives and propose, where appropriate,

revised objectives and strategies for TDB. Define the role of TDB in a developing an increasingly competitive financial sector. With assistance of the Credit Development/Venture Capital Adviser, review and assess TDB's existing and potential new products/services and the need for any change in the mix of product/services and interest rate structure. Give due consideration to the strategic option of restructuring TDB for privatization before the end of the five-year planning period. Consider the possibility of Government divestment of its shares to a minority shareholding and entering into a joint-venture partnership with a private bank and selling of shares to employees and Tongan nationals.

- (vi) Assess the restructuring option to establish a commercial banking subsidiary in order to separate its development banking operations and its commercial banking business, thereby avoiding the risk of mismatch of funds and concerns about TDB reneging on its developmental role and encroaching into the commercial banking area. Consider also other options, including a savings bank for the outer islands and a venture capital window or subsidiary.
- (vii) Prepare specific operational objectives for the period 1998-2002, in terms of TDB's funding, lending and advisory services, profitability, portfolio quality (i.e., collection and arrears ratios), portfolio mix (i.e., by region, type of borrower and type of financial facility), financial structure, and the economic benefits deriving from TDB's operations.
- (viii) Develop annual projections of a lending mix (i.e., the range and value of finance provided by sector, loan-size and type of facility) that TDB could realistically achieve during the period 1998-2000 and that will offer the best prospects for achieving the operational objectives. Propose appropriate diversification of TDB's activities.
- (ix) Review TDB's current organization structure and identify changes that should be made to enhance TDB's capabilities for meeting the operational objectives in a fully efficient and effective manner. Identify the staffing needs and requirements for other non-financial resources to undertake the range and scale of the proposed operations.
- (x) Develop detailed financial projections for the planning period, comprised of annual balance sheet, income statement and cashflow statement. Estimate the net asset value of TDB for purposes of valuation. Compare key financial ratios with those of the commercial banks in Tonga and other Development Finance Institutions (DFIs) in the Pacific. Assess if and when TDB's condition is attractive enough for privatization.
- (xi) Prepare a detailed staffing plan to guide TDB Management in its staff recruitment and training activities for the period. Review TDB's policies on compensation and benefits, and recommend changes designed to enhance and protect TDB's capabilities for recruiting and retaining top-quality staff for all key positions.
- (xii) Incorporate the business development, financial and staffing plans into a cohesive corporate plan, in a form suitable for submission to TDB Board of Directors, following close consultation with TDB Management.

- (xiii) In close consultation with TDB Management, devise a simple system for the regular monitoring and evaluation of the Strategic Plan.
- (xiv) At appropriate times, conduct staff training and workshops aimed at creating awareness and better understanding by TDB staff of its Strategic Plan and objectives.

2. Credit Specialist

A Credit Specialist will be engaged to assist in lending operations and debt recovery. The Credit Specialist's tasks will include, but not be limited to, the following:

- (i) Develop any necessary changes to TDB's policies, operations and procedures aimed at preventing a recurrence of major portfolio problems.
- (ii) Review TDB's lending manual and recommend necessary changes.
- (iii) Propose improvements in the processes of client evaluation, documentation, disbursement, collection, monitoring, and control.
- (iv) Develop a suitable loan classification and credit rating system for TDB, with regular cycles of account reviews and establish controls for arrears and defaults.
- (v) Propose appropriate rules for loan provisioning and write-offs.
- (vi) Provide training for a selected group of TDB staff in basic loan recovery strategies and techniques.
- (vii) Develop suitable follow-up and review procedures for controlling the recoveries of bad loans.
- (viii) Oversee the recovery action for selected large accounts, including some in the tourism and hotel sectors.

3. Business Development/Venture Capital Advisor

A Business Development/Venture Capital Advisor will be engaged to assist in improving business advisory services of TDB as well as provide guidance in introducing new products and services, including microcredit, trade financing, foreign currency deposits, special saving schemes, leasing, guarantee, and venture capital financing. The tasks of the Business Development/Venture Capital Adviser will include, but not be limited to, the following:

- (i) Review TDB's business advisory services including conducting interviews of customers and observing staff in action.
- (ii) Evaluate capability of TDB's staff to advise and help prospective borrowers in preparing a proposal for financing worthwhile projects.
- (iii) Assess the specific needs for training of TDB staff as well as client's borrowers and propose how these needs could be met. Prepare training materials for TDB

staff, as needed, and information kits on project proposal preparation for prospective borrowers.

- (iv) Draft a proposal for networking with the institutions that provide training for investment promotion and business development, including the Ministry of Labour, Commerce and Industry, Cooperatives Department, Ministry of Agriculture, private cooperatives, and credit unions. Discuss in the proposal the merits of networking and the mechanisms for consultation, liaison, coordination, information and resource sharing, collaboration, and joint undertaking. Explore the possibility of linking up TDB with intermediary organizations in the Pacific region that have experience in delivery of microcredit and financial services to borrowers in rural areas and outer islands, and devise some appropriate mechanisms to develop such links.
- (v) Evaluate the equity investments made by TDB using the AusAID Venture Capital Fund, and suggest ways of how to better utilize the Fund. Assess the need for venture capital in Tonga and determine the constraints and limitations both in developing venture proposals and providing funds for high-risk projects. Assist in compiling information on sources of information, advisory support, and supplementary funding for venture capital projects.
- (vi) Visit cooperatives and make an assessment if, and how, cooperatives can be used to reach out and more effectively channel credit and provide business advisory and training, to small farmers and fisherman, and women borrowers, in the rural areas and outer islands.
- (vii) Provide information on alternative microcredit schemes and advise what schemes could be introduced by TDB in Tonga.
- (viii) Provide information on credit guarantee schemes and their operation. Advise on the feasibility of a credit guarantee scheme for Tonga and if feasible, how such a scheme could be designed and implemented.

COST ESTIMATES AND FINANCING PLAN
(US\$)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing ^{a/}			
1. International Consultants			
a. Remuneraton and Per Diem	212,500	—	212,500
b. International Travel	25,000	—	25,000
c. Communications	11,000	—	11,000
2. Government Observers during Contract Negotiations	6,500	—	6,500
3. Training Materials	10,000	—	10,000
4. Contingency	15,000	—	15,000
Subtotal (A)	280,000	—	280,000
B. Government Financing			
Counterpart Staff, Office Facilities and Support Services	—	30,000	—
Subtotal (B)	—	30,000	30,000
Total	280,000	30,000	310,000

^{a/} Financed by the Bank on a grant basis from the Bank-funded TA Program.