



▲ Farmer working at a farm near Baucau, Timor-Leste.

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FINANCE SECTOR BRIEF

TIMOR-LESTE

Timor-Leste has a simple open economy. Approximately 70% of the country's people live in rural areas and rely on agriculture for their livelihoods. Subsistence production is prevalent in the agriculture sector; yields of key staples are low, and many households lack food security. Formal employment opportunities are concentrated in Timor-Leste's public sector and in businesses that supply the government. There is almost no local manufacturing and most goods are imported. The resulting trade deficit is financed by official development assistance, taxes and royalties from offshore petroleum production, and investment income from the country's sovereign wealth fund.

Petroleum wealth provides a unique opportunity to accelerate Timor-Leste's development.

The country receives taxes and royalties from petroleum production in the Timor Sea. Production from current fields peaked in 2012 and is forecast to end around 2021, while the prospects for new developments are uncertain. Petroleum revenues have resulted in large fiscal and current account surpluses. These surpluses have been saved in The Petroleum Fund of Timor-Leste, a sovereign wealth fund that is invested in offshore assets and is modeled on the Norwegian Oil Fund. In December 2018, the Petroleum Fund balance was \$15.80 billion (approximately \$12,200 per capita), however, the International Monetary Fund (IMF)(2019b) noted that withdrawals from this balance would continue to fund most fiscal spending in the near future due to low domestic revenue sources. This is primarily due to the adverse effect of political uncertainty on Timor-Leste's economic activity during 2017 and 2018.

Developing productive sectors is crucial for growth and prosperity. Timor-Leste has a narrow economy and a challenging business environment. The IMF noted in 2017 that, to enable employment opportunities for its young workforce, Timor-Leste faces a pressing need for economic diversification, and that accelerated structural reforms are vital to achieve this. The government's strategy is to improve the business environment while supporting agriculture, tourism, and petrochemical production as leading sectors. Coffee is the only significant merchandise export and is grown by approximately 25% of households. There is clear potential to increase coffee production

TIMOR-LESTE AT A GLANCE

Population

1,296,300 (2017)^a

GDP (current \$)

\$1.62 billion (2018)^b

GDP per capita

\$1,279 (2018)^b

GNI per capita

\$1,790 (2017)^a

GDP = gross domestic product,
GNI = gross national income.

Note: GDP figures and associated calculations do not include oil sector revenues.

^a Source: Asian Development Bank. 2018. *Key Indicators for Asia and the Pacific*. Manila.

^b Source: Asian Development Bank.

Table 1: Nominal Gross Domestic Product, 2011–2017

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|------------------------------------|---------|---------|---------|---------|---------|---------|---------|
| GDP (\$ million) | 1,058.1 | 1,193.7 | 1,415.4 | 1,454.4 | 1,608.7 | 1,701.5 | 1,676.9 |
| M2 (\$ million) | 322.4 | 406.9 | 500.2 | 599.8 | 642.4 | 733.9 | 822.9 |
| M2/GDP (%) | 30.5 | 34.1 | 35.3 | 41.2 | 39.9 | 43.1 | 49.1 |
| Private sector credit (\$ million) | 132.8 | 160.1 | 181.8 | 191.8 | 211.9 | 208.0 | 259.6 |
| Private sector credit/GDP (%) | 12.5 | 13.4 | 12.8 | 13.2 | 13.2 | 12.2 | 15.5 |

GDP = gross domestic product, M2 = broad money.

Sources: Asian Development Bank and International Monetary Fund.

and to develop other high-value agricultural exports such as fresh produce, timber products, spices, and seafood. Developing tourism and petrochemical production may prove more challenging, given competition from other tourist destinations in Southeast Asia and the Pacific along with the uncertain prospects for new oil and gas production.

FINANCE SECTOR OVERVIEW

The finance sector of Timor-Leste is progressing, yet critical constraints remain. From 2011 to 2017, monetization in Timor-Leste improved, with the ratio of broad money (M2) to gross domestic product reaching 49.1% in 2015. Private sector credit is likewise growing, although the latest available figure indicates only a 15.5% share in the country's output (Table 1). However, the IMF (2016) observed that a very large portion of Timor-Leste's economy is cash-based, which can make payments inefficient and insecure. Challenges remain in expanding bank credit to small and medium-sized enterprises as well as rural businesses. Limited access to affordable long-term credit also appears to constrain private sector development, which explains the low ratio of private sector credit to gross domestic product.

FINANCE SECTOR STRUCTURE

Timor-Leste has a relatively diverse financial system. The country has five commercial banks, four of which are branches of foreign-owned banks. The financial system also includes insurance companies, microfinance institutions, money transfer operators, financial cooperatives, and credit unions (Table 2). Meanwhile, the Banco Central de Timor-Leste (BCTL) serves as the monetary authority and regulator of most financial institutions.

Table 2: Financial System of Timor-Leste

| Type of Institution | Number |
|---|------------|
| Commercial banks | 5 |
| Money transfer operators | 9 |
| Foreign exchange dealers | 3 |
| Insurance companies | 3 |
| Other deposit taking institutions | 1 |
| Microfinance institutions | 2 |
| Financial cooperatives and credit unions ^a | |
| Village savings groups ^a | |
| Total | 23+ |

^a Exact figure is not available.

Source: Banco Central de Timor-Leste.

Timor-Leste's nonbank finance sector is undeveloped, and lacks diversity in financial products and providers. In 2015, the Asian Development Bank (ADB) observed that Timor-Leste does not have equity and bond markets, and no government bonds are issued.

Although foreign-owned banks dominate Timor-Leste's finance sector, the only local bank still plays a crucial role.

The four international banks operating in Timor-Leste are ANZ Banking Group,¹ PT Bank Mandiri, BNU Timor – Grupo Caixa Geral de Depositos, and PT Bank Rakyat Indonesia.² The branches of these banks primarily serve international organizations and their staff, and businesses and nationals from their respective home countries. The only local bank, Banco Nacional de Comercio de Timor-Leste is owned by the government. Although Banco Nacional de Comercio de Timor-Leste is relatively a small bank compared to its foreign-owned counterparts, it has a large and predominantly local customer base, making it strategically important in Timor-Leste's pursuit of a more inclusive finance sector. It also has the widest outreach and branch network in the country.

Insurance companies in Timor-Leste have a small consumer base. While insurance providers have expanded their product range in recent years, only a small number of people from Timor-Leste are insured and/or have access to some form of insurance product. Governance issues—including a number of serious financial irregularities and misappropriation of funds—at National Insurance Timor-Leste led to the imposition of sanctions and a management takeover by Banco Central de Timor-Leste in November 2017. These events may have had an adverse impact on consumer confidence in insurance providers.

¹ In mid-2018, ANZ Timor-Leste discontinued offering personal banking products and services, including ATMs, and currently provides only commercial banking services.

² PT Bank Rakyat Indonesia was given license by the BCTL to operate in Timor-Leste only on 24 February 2017.

Table 3: Finance Sector Performance Indicators

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|--|-------|-------|-------|-------|-------|-------|-------|
| NPL ratio (%) | 36.3 | 30.8 | 28.0 | 26.8 | 22.9 | 15.3 | 14.0 |
| Deposits (\$ million) | 322.1 | 414.6 | 507.1 | 585.6 | 724.5 | 916.7 | 989.6 |
| Commercial bank loans to the private sector (\$ million) | 132.8 | 160.1 | 181.8 | 191.8 | 211.9 | 207.0 | 259.0 |
| Deposit rate (%) | 0.8 | 0.9 | 0.9 | 0.9 | 0.8 | 0.8 | 0.7 |
| Lending rate (%) | 11.0 | 12.2 | 12.4 | 12.9 | 13.5 | 14.1 | 13.3 |

NPL = nonperforming loans.

Sources: International Monetary Fund and Banco Central de Timor-Leste.

Table 4: Financial Access Indicators

| Access Indicators | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|--|---------|---------|---------|---------|---------|---------|---------|
| Number of bank branches | 21 | 24 | 29 | 31 | 32 | 32 | 34 |
| Number of ATMs | 18 | 23 | 21 | 37 | 48 | 46 | 92 |
| Number of depositors with commercial banks | 169,037 | 249,132 | 258,259 | 317,087 | 393,227 | 369,599 | 417,281 |
| Number of borrowers at commercial banks | 19,524 | 23,561 | 24,655 | 26,315 | 26,872 | 30,404 | 33,608 |

Source: International Monetary Fund. 2019. *Financial Access Survey*. Washington, DC.

Out of an estimated 1.2 million individuals in Timor-Leste, there are only 18,199 insurance policies, including both individual and group accounts.³ Insurance covering microfinance loans represents the biggest share of all insurance policies at 93%, followed by motor vehicle insurance at just 3.92%.

FINANCE SECTOR PERFORMANCE AND INCLUSION

Both private sector credit and bank deposits in Timor-Leste have improved over time. Private sector credit grew at an average of 12.2% a year from 2011 to 2017, the figure for 2017 indicating that total loans reached \$259 million (Table 3). The nonperforming loan ratio consistently declined, registering a much lower ratio at 15.3% at the end of 2016 than the 36.3% at the end of 2011. Similarly, the value of deposits continued to rise, despite continued low deposit rates. Bank deposits increased at an average of 21% a year from 2011 to 2017, while deposit rates remained at an average of 0.8%.

However, lending in Timor-Leste remains limited. Despite the growth over time, the ratio of private sector credit to national output averaged only 13.3% from 2011 to 2017. ADB (2015) observed that foreign-owned banks routinely place excess deposits offshore, rather than providing additional capital to the domestic economy, implying that deposits from Timor-Leste are financing investments overseas. Higher lending risks related to difficulties with collateral and recovery, along with an inability to

accurately assess risk, have made domestic lending a less-attractive venture for Timor-Leste's formal banking sector. In fact, formal financial institutions concentrate their efforts on large and well-established businesses in sectors that rely on government contracts and public investments, and on consumer loans against paychecks.

There is low domestic participation in Timor-Leste's finance sector. In 2014, BCTL estimated that fewer than one in six economically active adults in Timor-Leste actively uses financial services. ADB (2015) noted that financial literacy in Timor-Leste is very low. The small number of microfinance and cooperative institutions in the country have capacity constraints and limited product offerings, which does very little to help expand financial inclusion. However, the National Switch Project, announced by the governor of BCTL in 2017, is working to enable bank interoperability by integrating ATM, point of sale, and mobile banking functionality among four of the country's licensed commercial banks. This project will increase the functionality of Timor-Leste's financial services and, as a result, should increase the use of financial services.

Financial inclusion is one of the key areas for reform of the finance sector. There is limited competition in Timor-Leste's banking sector, with only five banks operating and the latest addition receiving a license to operate as recently as February 2017. Only 11 new bank branches were added to the network from 2011 to 2017, although the ATM network has grown more than twofold during the same period. Sluggish network expansion may have contributed to slow growth in the rate of access to credit.

³ The figure accounts for the sum of 1,264 policies for different types of insurance products and 16,935 microfinance loans, which are all covered by insurance (in case the borrower dies).

After a huge jump in 2012, there were only marginal increases in the number of borrowers at commercial banks from 2013 to 2016, averaging 9.5% annual growth over the period, compared to around 21% expansion from 2011 to 2012 (Table 4).

The promotion of financial inclusion has made significant progress. The IMF highlighted in 2016 some of the key advances made by Timor-Leste in the area of financial inclusion. The BCTL launched a Finance Sector Master Plan in August 2014, which established a finance sector development strategy to 2025. Two major recent milestones toward a more efficient and secure interbank payments system have been achieved: the passage of the Law on National Payments System and the installation of an automatic payment system for the country. A bank-based model for mobile banking has also been recently adopted, and banks are currently working toward branchless banking facilities. The central bank also recently published a Financial System Review, which is a further progress in reviewing financial system stability and assessing progress toward a sound finance sector.

CHALLENGES IN THE FINANCE SECTOR

Expanding credit access to a broader base entails addressing institutional constraints. As in most developing nations, using land as collateral for loans is problematic because of insecure property rights. Moreover, the laws and customs that restrict foreigners from owning land make it difficult for foreign-owned banks to hold security interests in land. An outdated bankruptcy framework and weak contract enforcement systems also add uncertainty about lenders' rights.

There is a need to provide diversified financial products in Timor-Leste. ADB (2015) observed that Timor-Leste lacks long-term financing for investment as well as financing for small and medium-sized enterprises and crucial sectors such as agriculture and manufacturing. Moreover, the country does not have providers specializing in asset finance.

The government intends to establish a national development bank in Timor-Leste to address the inadequacy of long-term financing.

Improving the regulatory framework of Timor-Leste's finance sector is crucial to its stability. The country's regulatory framework will need to keep pace with the development of its finance sector to be effective in identifying, monitoring, and addressing new and emerging risks. Some of the recent moves by the BCTL include broadening its regulatory scope to monitor and regulate the activities of microfinance institutions, as well as working to comply with international standards pertaining to anti-money laundering and countering the financing of terrorism.

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