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)
SIMIWODS	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
VANWODS	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.

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Executive Summary

Executive Sumary

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.

Introduction 1

FINANCIAL SECTOR DEVELOPMENT IN SMALL ECONOMIES

The important roles that money and credit play in the functioning and growth of market economies have been analyzed in a large literature. The specialization, trade, and investment that drive economic growth require the parallel development of money and of a credit mechanism that stimulates voluntary saving and efficiently allocates it to productive uses.

The use of money allows exchange of goods and services to be split into the separate transactions of sale and purchase, and also allows these transactions to be separated in time. A person holding money is able to purchase any item of choice at any time: money is thus the most liquid of financial assets, serving as a unit of account, medium of exchange, and store of value. However, where money is the only financial asset, there are constraints on deficit spending (that is, expenditure in excess of current income) and saving, and these constraints retard economic growth. Deficit spenders can only finance expenditure by running down saved money balances or selling tangible assets (such as land or jewelry); or by convincing suppliers to wait for payment, in which case the suppliers themselves spend less or run down their stocks of wealth. The result is that deficit spending is confined largely to the rich, while poorer households, farmers, and potential entrepreneurs are unable to acquire the durables, equipment, and buildings needed for increasing future income. In the money-only exchange economy, savings are in the form of money itself or of assets with marketability and, therefore, a degree of liquidity. Savings held as idle money balances or in the form of land, houses, precious metals, or other goods do not add to an economy's productive capacity. Nor is there much of an incentive to save, since idle money balances and idle land or jewelry offer no rate of return.

Financial innovation eases the constraints of the simple exchange economy by stimulating saving and linking it to the provision of credit, defined as the means by which transactors are enabled to acquire commodities against a promise to pay later. This innovation takes two main forms. One is the development of financial instruments or primary securities (bonds, bills, and shares) and of markets in which such instruments can be exchanged. These instruments provide an attractive means of accumulating savings, while allowing real investment by those with entrepreneurial ability. Transactions occur directly between savers and the users of finance.

The second main form of financial innovation is the development of financial intermediaries. These intermediaries offer savers claims on themselves (so-called secondary securities) that are safer, more convenient, and of shorter maturity than primary securities; and they lend money to deficit spenders quite independently. Credit facilities are usually cheaper and more convenient than direct issue of primary securities. Financial intermediaries thus stimulate and mobilize saving and reduce the cost to investors of borrowing. Financial intermediaries also offer valuable technical advice to potential borrowers, and support other credit mechanisms by trading in primary securities and acting as a source of borrowed funds. In all these ways, financial development stimulates the economic growth process.

As Furness (1975, 25–26) notes:

> In Western countries financial innovation evolved in response to the needs of expanding economic activity. Rapid economic growth created a demand for better credit provision and, as saving rose with real income, there was also a demand for convenient ways in which saving could accumulate. It was therefore profitable to meet these needs by establishing financial institutions and markets.

The financial innovation stimulated by economic growth in turn had a crucial feedback effect on growth by further boosting savings and investment.

Financial innovation in the developing world has also been driven by economic growth. However, governments anxious to reduce poverty have promoted financial innovation as a means of accelerating economic growth. They have sought to stimulate domestic savings facilities, domestic demand for credit, and the necessary financial infrastructure, rather than waiting for a "natural" evolution. Public ownership of financial institutions therefore became more common in developing countries than was historically the case in the West. Such institutions offered a wide range of technical services, and often had to lend at rates that did not cover costs, despite high risks of default and poor security. Governments and central banks generally played active roles in financial market development.

Financial development in the small island states of the Pacific follows the broad pattern of economic growth stimulating financial innovation, with governments seeking to strengthen the reverse feedback loop; but the extent of that development has been limited by the specific nature and performance of the island economies. These economies are small in terms of land area, population, and gross domestic product (Table 1.1); and nonmonetary production is significant, accounting for perhaps 20 percent or more of GDP in some countries. Almost all households have some involvement in the cash economy, but for the many households in remote rural areas and outer islands, subsistence production for home consumption is dominant. Growth in the monetary component of GDP, driven by primary product exports and aid-supported public sectors, has varied substantially across countries and time. Generally, however, it has been disappointingly slow, despite investment ratios in the range of 25–35 percent of GDP (ADB 2000a).

The small size of the economies of the Pacific developing member countries (PDMCs), the semisubsistence lifestyles of their rural populations, and their modest economic growth rates are reflected in relatively simple financial systems. Fry (1994, 11–12) reports a "strong correlation" between strength and breadth of financial systems and economy size, and goes on to observe that:

For some small economies, economy size, training and know-how deficiencies leave no room for choice. Either financial intermediation is undertaken by foreign banks or there will simply be none at all.

Six PDMC economies use the currencies of larger, developed economies. The Australian dollar circulates in Kiribati, Nauru, and Tuvalu; the New Zealand dollar in the Cook Islands; and the US dollar in the Federated States of Micronesia and the Marshall Islands. The other six PDMCs have central banks that issue their own currencies and manage money, banking, and foreign exchange. Otherwise, PDMC financial systems consist of a small number of commercial banks (mostly branches of foreign banks); a state-owned development bank; a housing or home finance corporation (usually state-owned); a national provident fund (NPF); some credit unions; perhaps some private merchant banks and leasing and finance companies; and various informal savings and borrowing mechanisms. There has been very little development of capital markets.

The simplicity of PDMCs' financial systems has neither guaranteed their stability nor facilitated the creation of a virtuous circle of economic growth-financial sector development-economic growth. Hughes (1998) notes that there were signs of stress in some PDMC financial systems during the 1990s, including failure of state-owned banks, the weak state of development banks, and high proportions of government debt in the asset portfolios of commercial banks and provident funds. Identifying the causes of stress, and formulating and implementing strategies to strengthen and develop financial systems, constituted a major policy challenge for governments and their development partners at the start of the new millennium.

PURPOSES OF THE REPORT

This report seeks to make a useful contribution to meeting the policy challenge of strengthening and developing PDMC financial systems. It is the product of a regional technical assistance (TA) project funded by the Asian Development Bank

Table 1.1
Key Indicators of Pacific Developing Member Countries of ADB

Country	Land Area ('000 sq. kms.)	2000 Population ('000)	1999 GNP/GDP ($USmillion)	Trade/GDP 1999 (%)	Aid/GDP 1998 (%)[a]
Cook Islands	0.2	17.9	75	57.6	10.8
Fiji Islands	18.3	811.0	1,848	81.1	1.8
Kiribati	0.7	89.8	81	42.3 (1998)	17.1
Marshall Islands	0.2	51.7	99	79.1	52.4
Fed. States of Micronesia	0.7	118.5	212	25.2 (1998)	39.3
Nauru	0.02	11.8	48 (1995)	164.0 (1995)	5.2 (1995)
Papua New Guinea	462.8	5,100.0	3,834	88.4	7.3
Samoa	2.8	170.7	181	56.1	17.6
Solomon Islands	28.9	458.6	320	110.0 (1995)	13.2
Tonga	0.8	100.3	172	55.5	13.2
Tuvalu	0.02	11.0	14	52.1	2.3
Vanuatu	12.2	187.7	227	54.0	17.6
Total	**527.64**	**7,129.0**	**7,111**		

Sources: ADB 2001a; Hughes 1998.
a. For Fiji Islands, PNG, Samoa, and Vanuatu, refers to net flows of long-term public and publicly guaranteed debt from official creditors and grants, including technical cooperation grants. For other countries, refers to official development assistance only.

(ADB) and cofinanced by the Government of New Zealand.[1] The objectives of the TA were to

- Assess the state of financial sector development in selected PDMCs; and
- Formulate a strategy for the sustainable development of sound financial systems, taking into account the specific characteristics of PDMCs.[2]

The suggested strategy was to form the basis of a policy dialogue between ADB and the PDMCs and of future ADB

[1] TA 5853-REG, Technical Assistance for the Financial Sector Study in Selected Pacific Developing Member Countries, August 1999.
[2] The issues of offshore financial centers and money laundering are to be addressed in a separate study.

assistance to the financial sector in PDMCs. (Appendix 1 summarizes past assistance and its changing nature).

Seven PDMCs were selected for study in late 1999 and early 2000. They included the six countries issuing their own currencies (Fiji Islands, Papua New Guinea [PNG], Samoa, Solomon Islands, Tonga, and Vanuatu), and one representative of the group of very small states using the currency of a larger economy (Kiribati). This selection ensured coverage of the current diversity of monetary arrangements, financial system sophistication, economy size, and income levels. Individual country reports were prepared as the basis of this regional report, and appear as a second volume. Drafts of all reports were circulated for comment to the governments of participating PDMCs and concerned external agencies (most notably the Pacific Financial Technical Assistance Centre). Findings were also presented and discussed at the Pacific Governors' Meeting at ADB's annual general meeting in Chiang Mai, Thailand, in May 2000; at the 15th annual conference of Development Financial Institutions in the Pacific held in Pohnpei, Federated States of Micronesia, 4–6 July 2000; at the Forum Secretariat's Financial Sector Reform Workshop in Nadi, Fiji, 28–30 November 2000; and during the seminar on Financial Sector Stability and Development: The Case of the Pacific Island Countries, organized by the International Monetary Fund (IMF)and the Pacific Financial Technical Assistance Centre, held in Apia, Samoa, 20–21 February 2001. Comments received have been incorporated into the revised versions of the regional and country reports.

The next six chapters (2–7) present the assessment of the state of financial sector development in PDMCs, starting with the macroeconomic environments that are critical determinants of the efficiency of financial intermediation, and proceeding to the banking sector, nonbank financial institutions (NBFIs), financial markets, microfinance, and the impact of land tenure systems. Chapter 8 then provides an overall assessment of the key constraints on financial sector development. The final chapter presents the recommended strategies for promoting financial sector development.

Macroeconomic Environments

2

Two observations concerning the relationship between the macroeconomic environment and financial sector development have universal application. The first was made in the introductory chapter: economic growth promotes the emergence of savings and investment and the financial intermediation that links them. The second observation is that macroeconomic stability is a necessary condition for successful and durable financial sector development:

> *A reasonable degree of price stability is possibly the most crucial prerequisite for effective and efficient domestic resource mobilization and allocation through the financial sector* (Fry 1988, 326).

Modest and stable inflation rates require responsible monetary policies, which in turn require fiscal discipline combined with credible exchange rates and tariff policies. Financial development in PDMCs therefore depends fundamentally on economic growth outcomes and on the ability of governments to adopt and implement sound growth-promoting and macroeconomic stabilization policies. This chapter briefly reviews the macroeconomic performance of the seven PDMCs during the 1990s and assesses what progress has been made in improving economic policies, governance, and macroeconomic management.

MACROECONOMIC PERFORMANCE

An examination of growth performance must acknowledge that, to varying degrees, PDMCs' growth potential is constrained by remoteness from world markets, small domestic markets, and narrow production bases. They exhibit a high degree of openness, which has brought the benefits of specialization and trade (Table 1.1), but which also has left them vulnerable to external economic changes. Aid dependency is high, especially in the Micronesian states. In addition, many PDMCs are susceptible to natural disasters: cyclones, droughts, and volcanic eruptions have at times devastated economies and populations. PDMC governments therefore have a long-standing familiarity with the forces of nature and of globalization, and specifically with adjustment to economic and export instability.

The key macroeconomic aggregates for the period 1994–1999 are presented in Tables 2.1 and 2.2. The general impression is of low and erratic growth, modest inflation outcomes, a slight improvement in overall fiscal balances, and little sustained change in external (current account) balances.

An examination of individual country statistics reveals economic slowdowns during the period 1994–1998 for all PDMCs except Kiribati and Samoa, followed by economic recovery in 1999 (except for Vanuatu). This recovery stalled in 2000, when PNG's real GDP virtually stagnated, and political instability and social unrest in Fiji and Solomon Islands saw respective real GDPs fall by an estimated 13.0 percent and 14.0 percent, respectively. Real GDP in Kiribati also fell (by 4 percent) in 2000; but positive growth rates were recorded in Samoa (7.0 percent), Tonga (5.3 percent), and Vanuatu (2.8 percent). Following its recovery from the impact of taro blight in 1994, Samoa is the only PDMC showing significant and reasonably steady growth through the late 1990s and into 2000. This in part reflects the impact of tax, tariff, and financial liberalization policies implemented from 1996. Growth in the largest economy, PNG, was especially disappointing, given its natural resource endowments and location; the Asian financial crisis and severe drought had major adverse impacts.

The low level of development of financial sectors in PDMCs and the limited progress in financial deepening documented in chapter 3 reflect these low growth rates. Among the reasons for the low growth are large, inefficient public sectors, and excessive regulation and price and wage controls that have distorted market signals and discouraged investment. Cumbersome foreign investment regulations have also discouraged foreign investment.

The inflation record varies considerably between countries. Annual consumer price increases were kept to less than 6 percent in Fiji, Kiribati, Tonga, and Vanuatu, and were lowered substantially in Samoa towards the end of the 1990s. Inflation rates in PNG and Solomon Islands were much higher, reflecting monetary financing of expansionary fiscal policies and currency depreciations forced by external economic shocks, most importantly the Asian financial crisis of 1997–1998. The latter hit log exports very hard in Solomon Islands and adversely affected PNG to a lesser extent. In 2000, inflation rates were less than 3 percent for Fiji, Kiribati, Samoa, and Vanuatu. Rates rose to 5.3 percent for Tonga and almost 18 percent for PNG, and fell to 6.6 percent for Solomon Islands (ADB 2001).

There were marked differences in fiscal performance between countries. Fiji ran overall budget deficits throughout the late 1990s (if privatization receipts are excluded from the 1998 "headline" balance). The deficit blew out in 1997 as a result of the costs associated with restructuring the State-owned National Bank of Fiji (NBF), which was declared insolvent in 1995; generous tax incentives also resulted in low effective tax rates, thus restricting revenue growth. The accumulation of domestic debt as a result of financing consistent deficits inevitably increased expenditure on interest payments and, with the wages bill (Table 2.3), left less room for other expenditure.

PNG was plagued by bouts of macroeconomic instability and governance problems in the 1994–1999 period. The overall fiscal position deteriorated from a small surplus in 1997 to deficits of 2.2 percent and 1.8 percent of GDP in 1998 and 1999, respectively. The deficits largely were funded by borrowing from the central bank in excess of legal limits, resulting in inflationary, balance of payments, and currency pressures. There was some recovery in the fiscal and external accounts in the latter half of 1999, following the formation in July of a new administration committed to macroeconomic stabilization and implementation of a Structural Reform Program. This recovery continued into 2000.

In Solomon Islands, governments ran unsustainable budget deficits from the late 1980s and throughout the 1990s, despite favorable external economic conditions in the first half of the decade. By 1995, the legal limit on borrowing from the central bank had been exceeded and trading in Government securities was suspended, leaving commercial banks and the National Provident Fund with large holdings of nonperforming assets. The election of a reformist government in August 1997 led to improvements in fiscal management in 1998 and 1999, but these were disrupted by civil unrest in 2000. An October 2000 peace accord provided some hope of economic recovery.

Samoa achieved a sustained improvement in the overall fiscal balance through the 1990s, on the back of a relatively strong growth performance and sound economic management. In contrast, Tonga recorded fiscal deficits in most years, as a result of economic recession and slow growth combined with growth in the wage bill (Table 2.3). Vanuatu's budget deficit reached almost 8 percent in 1998. This was the result of civil unrest following an Ombudsman's report on anomalies in the Vanuatu National Provident Fund (VNPF), and the Government's subsequent decision to allow unconditional withdrawal of retirement savings from VNPF. Since VNPF itself could provide less than half the required funds, the Government as guarantor had to make up the shortfall. A new Government committed to implementation of a Comprehensive Reform Program began to restore fiscal discipline in 1999.

For Kiribati, Table 2.1 shows very large fluctuations in fiscal outcomes in the 1990s, but the figures are exclusive of drawdowns from the country's Revenue Equalization Reserve Fund (RERF). This fund was established in the late 1950s with colonial Government savings from phosphate mining revenue and subsequently grew through sound investment management and prudent fiscal policy. RERF now explicitly serves as a mechanism for smoothing variability in Government revenue, returning an investment income of about one third of GDP. Recurrent expenditure, which includes a large wage bill (Table

Table 2.1

Key Macroeconomic Indicators, 1994–1999

	1994	1995	1996	1997	1998	1999
Real GDP Growth			(percent change)			
Fiji Islands	5.1	2.5	3.1	-0.9	1.4	8.0
Kiribati	7.2	3.5	4.3	1.0	7.3	2.3
Papua New Guinea	5.2	-3.3	7.7	-3.9	-3.8	3.2
Samoa	-0.1	6.4	7.3	1.0	3.4	5.3
Solomon Islands	5.2	10.5	3.5	-2.3	1.1	-1.3
Tonga	2.9	-0.2	-0.1	1.6	3.1	6.2
Vanuatu	1.3	-2.9	4.8	0.2	-0.1	-3.0
Consumer Price Inflation			(period average)			
Fiji Islands	0.6	2.2	3.1	3.4	5.7	2.0
Kiribati	5.3	3.6	-0.2	1.5	3.7	0.4
Papua New Guinea	2.8	17.2	11.9	3.9	13.5	14.9
Samoa	12.1	-2.9	5.4	6.8	2.2	0.6
Solomon Islands	13.3	9.6	11.8	8.1	12.4	8.0
Tonga [a]	0.4	2.8	2.0	3.0	3.9	5.3
Vanuatu	2.3	2.2	0.9	2.8	3.3	2.0
Growth in Broad Money						
Fiji Islands	0.1	4.3	0.9	-8.7	-0.3	14.2
Kiribati	10.1	-0.9	11.7	-3.1	11.1	5.1
Papua New Guinea	2.4	10.7	32.0	6.9	1.8	8.8
Samoa	13.0	21.8	5.1	13.3	4.9	9.1
Solomon Islands	24.1	9.9	15.7	6.3	4.8	15.4
Tonga [a]	17.1	2.8	14.1	2.4	15.0	8.3
Vanuatu	3.5	11.4	11.1	-0.3	12.6	-9.2
Overall Fiscal Balance [b]			(percent of GDP)			
Fiji Islands [c]	-1.5	-0.6	-5.0	-6.6	4.6	-0.7
Kiribati [d]	-1.5	-10.2	-40.5	5.1	24.6	-6.4
Papua New Guinea	-2.2	-0.5	0.5	0.1	-2.2	-1.8
Samoa	-7.7	-2.8	0.9	1.1	1.1	-1.5
Solomon Islands	-5.5	-5.3	-4.4	-4.8	-2.5	-2.4
Tonga	-3.5	0.8	-4.8	-2.5	-0.2	-0.4
Vanuatu	-1.6	-2.7	-1.8	-0.7	-7.5	-1.3
Grants						
Fiji Islands	0.2	0.2	0.2	0.2	0.1	0.04
Kiribati	30.8	27.7	31.7	39.2	47.2	39.1
Papua New Guinea	2.9	4.0	2.5	4.4	6.1	5.8
Samoa	11.3	16.9	15.0	10.8	11.2	10.2
Solomon Islands	18.4	11.3	14.8	10.7	12.7	15.7
Tonga	14.5	15.7	8.9	9.1	13.3	10.4
Vanuatu	1.1	2.9	1.7	2.0	1.3	1.9
Average Grants	11.6	11.8	11.6	11.2	14.2	10.8

Sources: National income accounts and Ministry of Finance data; IFS.
Notes: a. Data refer to the fiscal year beginning 1 July and ending 30 June of the following year; b. Including grants; c. Including NBF restructuring costs and privatization receipts; d. Excluding Revenue Equalization Reserve Fund drawdown.

2.3), has been underpinned by the RERF without a decline in the real value of the fund, although a sustained increase in Government spending would threaten to undermine its value.

Because of their narrow production base, PDMCs are all dependent on imported goods, mainly from Australia and New Zealand. Except for PNG and Solomon Islands, trade deficits are a regular feature of PDMCs' balance of payments. Private transfers and remittances from nationals living overseas have made a major contribution to offsetting trade deficits, particularly in Kiribati, Samoa, and Tonga. Official transfers have provided substantial import coverage in all PDMCs, and in PNG have been necessary to offset deficits on net services that result from high interest and dividend payments. Table 2.2 shows current account balances as a percentage of GDP for the period 1994–1999. Fiji moved from deficit to surplus, largely as a result of tourism growth. Kiribati exhibited large fluctuations in line with windfall rises in fishing license fees followed by falls. PNG's position deteriorated, while Samoa's showed a sustained rise in the current account surplus. Solomon Islands' current account moved into deficit as log exports fell dramatically in 1997. Tonga's current account remained in deficit throughout, as did Vanuatu's, except in 1998 when tourism receipts expanded.

Five of the six PDMCs issuing their own currencies continued to peg their exchange rates to a basket of major trading partners' currencies, while PNG adopted a floating exchange rate system in 1994 and a screen-based interbank trading system. Maintenance of international competitiveness through real effective exchange rate stability was a guiding principle of exchange rate policy in the Fiji Islands, Samoa, and Solomon Islands; but required nominal devaluations, backed by domestic wage and price restraint. The latter was not achieved for much of the 1990s in Solomon Islands, where the real exchange rate appreciated despite substantial nominal devaluations (ADB 2000c). PNG's floating exchange rate has reflected the country's economic performance, with the currency depreciating during periods of macroeconomic instability and remaining stable during periods of tighter fiscal conditions. Limited adjustment in pegged exchange rates may have led to overvaluation of exchange rates in the cases of

Vanuatu and Tonga; in the latter case, this had a potentially serious dampening effect on flows of remittances and private capital coming into the country.

Table 2.2

Current Account Balances, 1994–1999[a]

	1994	1995	1996	1997	1998	1999
			(percent of GDP)			
Fiji Islands	-3.5	-0.9	3.0	1.6	-0.4	1.5
Kiribati	3.0	-5.3	-33.0	1.2	29.7	-14.0
Papua New Guinea	11.0	18.0	5.4	-2.8	0.4	1.5
Samoa	2.0	4.5	5.1	8.4	10.3	8.0
Solomon Islands	0.4	4.1	3.4	-10.2	5.5	9.9
Tonga	-13.2	-5.9	-0.8	-11.1	-0.6	-6.3
Vanuatu	-9.7	-8.0	-1.8	-7.7	2.1	-4.9

a. Inclusive of official transfers.
Sources: Central Banks (Fiji Islands, PNG, Samoa, Solomon Islands Tonga, Vanuatu); Ministry of Finance (Kiribati).

The importance of foreign aid to PDMCs is evident from data presented in Tables 1.1 and 2.1. Official transfers have provided the import coverage already referred to, and also have been a major source of finance for public investment, which has been maintained or increased while private sector investment has dwindled. The concern in this context is that aid in the Pacific has had perverse effects, substituting for rather than supplementing domestic savings.

The extent of foreign aid dependence varies widely, as shown in Table 2.1. The Fiji Islands is the least dependent on external grants and Kiribati the most dependent, with grants averaging almost 40 percent of GDP over the period 1994–1999. Samoa, Solomon Islands, and Tonga are also substantially dependent on grants to the budget. In general, however, as concern over declining aid and the desire for greater self-reliance increase, PDMCs will need to do more to foster domestic savings and channel them into productive investment. This does not preclude encouraging foreign direct investment. Most PDMCs (with the exception of Kiribati and Vanuatu) still maintain some controls over capital receipts and outflows, including investment liquidation, though these controls are gradually being relaxed.

The size of the public sector is relatively large in every PDMC, accounting for between 25 and 50 percent of GDP, and absorbing a disproportionate share of resources, including skilled labor. Fiscal situations reflect the large public sector wage bills (Table 2.3) and numerous public enterprises often drawing budget support and enjoying monopoly privileges. These enterprises are involved in commercial activities, competing (sometimes with unfair advantage) against private enterprises. Their operations are generally inefficient and lack transparency and accountability. In particular, poor public enterprise performance has contributed to high water, power, and telecommunications charges that discourage private sector investment. Some corporatization, liquidation, and privatization of public enterprises occurred in the late 1990s, particularly in the Fiji Islands, PNG, and Samoa. However, for the most part it has been difficult to find private sector buyers, and so-called "privatization" has actually meant sales of 51 percent of enterprises to provident funds. Where privatization of a monopoly has occurred, new demands for effective regulation have had to be addressed.

Table 2.3

Public Sector Wages and Salaries, 1994–1999

	1994	1995	1996	1997	1998	1999
			(percent of GDP)			
Fiji Islands	11.1	11.7	11.0	11.7	11.7	11.3
Kiribati	22.4	28.5	30.9	31.3	27.8	32.3
Papua New Guinea	7.9	6.5	8.7	9.3	9.0	9.2
Samoa	9.8	9.4	8.8	10.2	9.7	9.2
Solomon Islands	12.6	10.9	10.4	11.1	10.9	8.7
Tonga	—	—	—	15.1	14.9	14.2
Vanuatu	11.6	12.0	11.8	11.5	12.2	12.0

Sources: Ministries of Finance.

Box 2.1
Best Practice for Macroeconomic Policy

The pursuit of a sound macroeconomic policy is essential for maintaining strong financial systems and for the development of stable capital and long-term debt markets. PDMCs should adopt well-coordinated economic policies that foster financial stability and encourage long-term confidence in the economy.

PDMCs should undertake wide-ranging structural reforms to deal with practices that distort financial-real sector linkages, such as price and wage controls and large public sector enterprises. PDMCs should encourage separation, in terms of ownership, between real and financial sector entities, and regulatory authorities should be provided with complete independence in pursuing any violations. PDMCs also need to remove policy distortions in the real sector that cause problems in the financial sector.

ECONOMIC MANAGEMENT

At the beginning of the 1990s, "economic management was in disarray and disrepute in most Pacific island states" (Hughes 1998, 51). However, the tide turned during the decade. 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 sound economic management (Knapman and Saldanha 1999). Small groups of reformist politicians and officials sought to adapt global ideas to local circumstances, specifically ideas about the role of the state in economic development as a facilitator of private sector development. These local champions of reform drew technical and financial support from external development agencies for the formulation and implementation of economic and public sector reform programs, many of which placed their initial emphasis on macroeconomic stabilization.

Fiji Islands

During the 1990s, the Fiji Islands "made reasonably good progress in achieving a more flexible, more competitive, market-friendly economy" (ADB 2000d, 1). A new Government elected in June 1999 committed itself to poverty alleviation and better social outcomes, but emphasized the importance of private sector-led economic growth as the central means to these ends. The civil unrest and political instability of 2000 at least temporarily dashed any hopes of a revival of private investment, which averaged just 5 percent of GDP during the 1990s. But the interim Government maintained fiscal discipline in the face of a substantial fall in revenue, and the central bank tightened monetary policy to protect international reserves and the exchange rate (ADB 2001a). The 2001 budget presented a comprehensive structural reform program that included reduced tariffs on business inputs, lower business taxes, a review of price controls, removal of rice import quotas, and compliance with World Trade Organization guidelines. There was also a commitment to a public financial management reform project. Political stability was a prerequisite for effective action on all these fronts.

Kiribati

The medium-term development strategy adopted by the Government of Kiribati in late 1997 identified three key macroeconomic issues: near-static GDP per capita since independence in 1979, the need to create employment for the 60 percent increase in the workforce expected during the 15 years to 2012, and the capacity to sustain growth in public services. Five strategies for addressing these issues were proposed: a reduction in the relative size of core government, public enterprise reform, facilitation of private sector development, encouraging foreign investment, and ensuring consistency between sectoral and national policies. The Government confirmed its commitment to these reforms in the next medium-term strategy (2000–2003). Implementation of the reform program has been slow, investment opportunities are extremely limited, and it is likely that growth and financial sector development will also be modest. The main challenge for macroeconomic management will be to ensure that the real per capita value of RERF is not eroded.

Papua New Guinea

The PNG Government originally committed itself to economic and public sector reform in 1994, and outlined medium-term reforms in its development strategy for 1997–2002. The Structural Reform Program (SRP) 2000 was presented when a new Government won office in July 1999. Domestically designed and subsequently endorsed by the World Bank, the IMF, and ADB along with other external agencies, the SRP has the following objectives and associated policy actions:

- Promoting good governance, through improving policy-making procedures; making decision making more transparent; strengthening capacity for drafting legislation; presenting legislation on the Government's web site; reviewing and enforcing Government procurement procedures; extending and enforcing requirements for public sector agencies to report to Parliament; strengthening key governance agencies (Auditor-General, the Ombudsman Commission, the Parliamentary Accounts Committee); strengthening the capacity of the National Statistics Office; enforcing a Code of Conduct for the public service; and introducing a moratorium on all new forestry licenses, extensions and conversions.
- Sustaining macroeconomic stability, through strengthening debt management, enacting legislation ensuring the independence of the central bank to manage monetary policy and the exchange rate, and improving public financial management and expenditure controls.
- Improving public sector performance, through reviewing public expenditure, designing and gradually implementing a public service reform program, reviewing and strengthening provincial and local government roles, increasing coordination between all levels of government, and narrowing the scope of the Rural Development Fund and linking it to District Development Plans.

- Removing barriers to investment and economic development, through continuing tariff reform and trade liberalization, deregulating to stimulate agriculture and informal sector activity, completing a taxation review, simplifying and streamlining business registration and work permit approvals, increasing the scope for competition in coastal shipping and aviation, privatizing public enterprises, and reforming the financial sector, including actuarial reviews of the National Provident Fund and the Public Officers' Superannuation Fund, and introduction of legislation to improve regulation and supervision of the banking and insurance industries.

Samoa

In 1996, the Government of Samoa revived a previous commitment to economic reform, issuing the first of a series of statements of economic strategy. These statements emphasized macroeconomic stability, public sector efficiency, improved education and health standards, and a range of measures to support private sector development (agriculture, tourism, fisheries, and village economy). Considerable consultation occurred in the preparation and implementation of the statements. In this context, an ADB-supported Financial Sector Program was begun in 1998 that aimed at establishing and promoting sustainable market-based financial sector policies, and at corporatizing or privatizing public enterprises. Key actions were financial sector liberalization and the strengthening of the Central Bank of Samoa (CBS), the National Provident Fund, the Development Bank of Samoa (DBS), and the prudential and regulatory framework. The Samoan reform program is deservedly regarded as exemplary in that it is designed, owned, and driven by Samoans (Knapman and Saldanha 1999). There is still a need for faster public enterprise reform, improved access to land and its use as collateral, and simplification of regulatory and administrative requirements for domestic and international business (ADB 2000e).

Solomon Islands

The Solomon Islands' Public Sector Reform Program (PSRP) began in 1998 and covered macroeconomic stabilization, public service reform (including the mitigation of the social impact of civil service downsizing), public enterprise reform, and improved public sector governance. PSRP was supported by a loan from ADB and technical assistance. ADB's 1999 review of the PSRP's implementation concluded: "Progress has been made in difficult circumstances and against considerable resistance from opponents of reform" (Knapman and Saldanha 1999, 140). Ethnic unrest derailed the reform process in 2000, but it is expected that the October 2000 peace accord will lay the foundation for reconstruction and a return to effective economic and public sector reform. A core requirement is the need for fiscal management that supports price stability and adequate international reserves.

Tonga

The Government of Tonga was the only PDMC not to formally commit itself to, or begin implementation of, a wide-ranging reform program in the 1990s. However, a commitment to a reform program was reaffirmed in mid-2001. The program encompassed civil service and public enterprise reform, and a range of measures to encourage private sector-led development.

Vanuatu

The Vanuatu Government began implementation of its Comprehensive Reform Program in 1998, with financial and technical support from ADB. The CRP encompasses governance, fiscal management, public service reform, reform of public financial institutions, private sector development, and the mitigation of the social impact of reforms. It is expected to deliver improved public financial management

Thus there was in the 1990s a strengthening commitment from PDMC governments to redefining the role of the public sector, improving the enabling environment for the private sector, and ensuring sound macroeconomic management. Some of the reforms aimed specifically and directly at financial sector development. Effective implementation of the vast range of policy actions promised to improve economic growth outcomes in stable macroeconomic environments, and thereby to facilitate financial sector development, within the constraints imposed by smallness.

Banking Systems 3

Banking systems dominate the financial sectors of PDMCs. This chapter examines the performance of these systems during the late 1990s and the prudential frameworks within which they operate. Recommendations are made concerning supervisory systems.

BACKGROUND

Financial systems in PDMCs covered in this report consist largely of a small number of mostly foreign banks and, excepting Kiribati, a central bank performing the regular central banking functions, including issuing currency, formulating and implementing monetary policy, managing foreign exchange reserves, and fulfilling prudential regulatory functions. In some PDMCs, in addition to supervising the banking and insurance industries, central banks also supervise nonbank financial institutions (NBFIs). In other cases, NBFIs are supervised by the Ministry of Finance. In Kiribati, the commercial bank is supervised by its parent company in Australia, and NBFIs are self-supervised and overseen by the Ministry of Finance. The level of autonomy of central banks varies from country to country. The Fiji Islands' central bank probably has had the most autonomy and PNG's the least.

The Fiji Islands and PNG each have six commercial banks (five foreign and one domestic in the Fiji Islands, and four foreign and two domestic in PNG). Vanuatu has four banks; Samoa, Solomon Islands, and Tonga have three; and Kiribati has one. All PDMCs except Vanuatu have one state-owned development bank; all except Tonga have a national provident fund (NPF); and all have one or two housing finance corporations, pension funds, life and nonlife insurance funds, a few housing finance corporations and (in the Fiji Islands and PNG) merchant banks. PDMCs also have credit unions, other emerging microfinance institutions (MFIs), and a network of informal financial institutions. The Fiji Islands and Vanuatu also have asset management banks to recover restructured banks' debts. Samoa and Vanuatu have offshore financial centers that are not examined in this report (but see Hughes 1998). In terms of the range of products, the Fiji Islands' finance sector is the most advanced, followed by PNG's. Each of these two countries has a functioning stock exchange.

Commercial banks held almost half the total assets of the financial sectors of PDMCs during the period 1994–1999, ranging from a low of about one third in the Fiji Islands to a high of 84 percent in Vanuatu (Table 3.1). All the foreign commercial banks are highly profitable because of their strong systems and dominant market positions. While data availability is limited, the spread between interest charged on loans and that paid on deposits is indicative of large profits, even allowing for high unit costs due to diseconomies of scale. The average nominal interest spread approached 8 percent in 1999, up from just over 6 percent in 1994 (Table 3.2). Spreads rose in all PDMCs except Samoa and Tonga, where there were slight reductions. This suggests a decline in competition in the banking sector, which may be part of the explanation. However, it is also likely that greater spreads reflected more effective pricing for risk. Countries with the highest risk—PNG and Solomon Islands—had the highest spreads (Table 3.2).

The measurement for access to banking—number of people per branch or agency—varied considerably across PDMCs in 1998–1999: 32,889 for PNG, 13,364 for Solomon Islands, 10,500 for Samoa, 8,463 for Vanuatu, 8,300 for Tonga, 6,010 for the Fiji Islands in 1997, and 3,248 for Kiribati. Bank operations are concentrated in urban centers, so that these figures do not reveal urban-rural disparities in access to banking facilities. Access for rural populations is especially poor in the

Table 3.1

Assets of Commercial Banks, NBFIs, and Provident Funds, 1994–1999

	1994	1995	1996	1997	1998	1999
Assets of Commercial Banks	(Percent of Total Assets of Financial Sector)					
Fiji Islands	36.8	36.5	35.9	33.1	30.9	32.6
Kiribati	47.7	46.4	45.0	43.1	42.4	41.6
Papua New Guinea	46.1	46.6	45.7	46.8	47.8	–
Samoa	36.5	37.4	38.8	40.8	40.4	42.4
Solomon Islands	45.7	44.6	42.8	40.9	37.6	39.2
Tonga	49.2	51.9	52.5	54.4	56.5	57.9
Vanuatu	78.6	78.0	79.6	79.4	83.5	83.3
Average	**48.7**	**48.8**	**48.6**	**48.4**	**48.4**	**49.5**
Assets of Nonbank Fin. Insts.						
Fiji Islands	51.1	52.1	51.3	54.6	53.9	51.5
Kiribati	52.3	53.6	55.0	56.9	57.6	58.4
Papua New Guinea	19.7	20.2	19.3	18.7	19.7	–
Samoa	41.9	41.0	39.6	38.1	40.4	40.5
Solomon Islands	35.0	35.9	34.3	34.6	34.4	34.5
Tonga	21.6	23.1	23.2	22.9	20.9	18.5
Vanuatu	6.1	6.9	7.1	7.6	1.2	2.1
Average	**25.2**	**25.8**	**25.5**	**25.5**	**24.9**	**25.7**
o/w Provident Funds						
Fiji Islands	30.3	30.8	31.4	34.5	34.5	33.3
Kiribati	47.8	49.0	50.4	52.2	53.0	53.9
Papua New Guinea [a]	10.8	11.9	12.1	11.4	12.1	–
Samoa	21.5	21.4	21.3	21.6	23.2	23.5
Solomon Islands	31.2	31.8	30.1	30.0	29.8	28.4
Tonga [b]						
Vanuatu						
Average	**19.6**	**20.2**	**20.2**	**20.5**	**19.9**	**21.6**
o/w Development Banks						
Fiji Islands	6.1	6.4	6.3	6.6	6.9	5.8
Kiribati	4.5	4.6	4.6	4.7	4.6	4.6
Papua New Guinea	1.6	1.6	1.5	1.5	1.5	1.5
Samoa	10.5	10.0	9.3	7.8	8.1	8.2
Solomon Islands	3.8	4.1	4.2	4.6	4.6	4.6
Tonga	19.9	21.3	21.6	21.4	19.5	15.2
Vanuatu	2.3	2.1	1.7	–	–	–
Average	**7.0**	**7.2**	**7.0**	**7.8**	**7.5**	**6.7**

a. Pension Funds.
b. Tonga does not have a Provident Fund.
Sources: Central banks, Fiji Islands, PNG, Samoa, Solomon Islands, Tonga, and Vanuatu; commercial bank, Kiribati.

Table 3.2
Nominal and Real Returns on Savings and Lending, 1994–1999

	1994	1995	1996	1997	1998	1999
Average Deposit Rates			(percent)			
Fiji Islands	6.70	6.78	5.77	5.18	4.01	2.88
Kiribati	4.40	3.80	3.20	1.80	1.60	1.20
Papua New Guinea	4.50	9.40	4.00	5.10	8.70	8.50
Samoa	5.50	5.50	5.50	5.50	5.50	5.50
Solomon Islands	7.66	7.39	4.76	1.84	4.36	3.28
Tonga	4.50	4.90	5.20	5.30	5.00	4.80
Vanuatu	5.35	4.90	4.95	4.35	5.45	4.14
Average Lending Rates						
Fiji Islands	11.29	11.10	11.57	10.17	9.11	8.47
Kiribati	9.70	9.70	9.70	9.70	9.70	9.70
Papua New Guinea	10.00	15.40	10.20	10.60	20.20	18.20
Samoa	12.00	12.00	12.00	12.00	11.38	11.13
Solomon Islands	16.23	16.64	16.39	14.54	14.13	13.74
Tonga	9.00	9.00	9.00	9.00	9.00	9.00
Vanuatu	13.80	12.70	12.70	13.20	15.00	14.10
Real Average Deposit Rates						
Fiji Islands	6.10	4.60	3.40	2.70	-1.70	0.90
Kiribati	-0.90	0.20	5.40	0.30	-2.10	0.80
Papua New Guinea	1.70	-7.80	-7.90	1.20	-4.80	-6.50
Samoa	-6.60	8.40	0.10	-1.30	3.25	4.90
Solomon Islands	-5.66	-2.19	-7.00	-6.24	-8.04	-4.72
Tonga	4.10	2.10	3.20	2.30	1.10	-0.50
Vanuatu	3.10	2.70	4.10	1.60	2.10	2.14
Real Average Lending Rates						
Fiji Islands	10.70	8.90	8.50	6.80	3.40	6.50
Kiribati	4.40	6.10	9.00	9.40	4.70	9.30
Papua New Guinea	7.20	-1.80	-1.70	6.70	6.70	3.30
Samoa	-0.1	14.90	6.60	5.20	9.18	10.53
Solomon Islands	2.91	7.06	4.63	6.46	1.73	5.74
Tonga	8.60	6.20	7.00	6.00	5.10	3.70
Vanuatu	11.50	10.50	11.80	10.40	11.70	12.10
Nominal Interest Spread						
Fiji Islands	4.60	4.30	5.80	5.00	5.10	5.60
Kiribati	5.30	5.90	6.50	7.90	8.10	8.50
Papua New Guinea	5.50	6.00	6.20	5.50	11.50	9.70
Samoa	6.50	6.50	6.50	6.50	5.88	5.88
Solomon Islands	8.57	9.25	11.63	12.70	9.77	10.46
Tonga	4.50	4.10	3.80	3.70	4.00	4.20
Vanuatu	8.45	7.80	7.75	8.85	9.56	9.96
Average	**6.20**	**6.26**	**6.88**	**7.16**	**7.70**	**7.76**

Sources: Central Bank Quarterly Bulletins; commercial bank, Kiribati.

Melanesian countries, where population is dispersed and physical geography is a hindrance.

In some PDMCs, financial systems came under stress in the 1990s. State-owned commercial banks in the Fiji Islands, PNG, and Vanuatu almost failed, and have been restructured and recapitalized. One foreign-owned commercial bank in Tonga failed to make profits and was under threat of closure. As discussed in the next chapter, stress in financial systems is still reflected in the precarious financial situation of government-owned development finance institutions (DFIs) in all PDMCs, and in problems with the management of provident funds in PNG, Solomon Islands, and Vanuatu.

FINANCIAL DEEPENING AND INTERMEDIATION

Economies that have enjoyed a higher level of financial development and intermediation, as measured by assets and liabilities of the banking sectors, have also tended to experience faster growth. Several ratios are used here to measure financial deepening and the level of financial development.

There was very little progress in financial deepening between 1994 and 1999. Indeed, during this period, the ratio of broad money to GDP fell in the Fiji Islands, Kiribati, Solomon Islands, and Vanuatu, indicating a reversal of financial deepening (Table 3.3). Much of this reversal was due to the near failure and restructuring of some state-owned commercial banks because of the high proportion of government loans on the books (for example, the restructuring of the NBF in 1996 and 1997); the precarious financial situation of government-owned DFIs (Solomon Islands and Vanuatu); poor management in the Development Bank of Kiribati; and problems with the management of provident funds (Solomon Islands and Vanuatu). The ratio of broad money to GDP rose slightly in PNG and Samoa, and more substantially in Tonga. The reversals and increases are revealed, respectively, in rising and falling ratios of narrow money to broad money. Countries experiencing a reversal also exhibited rising ratios of currency in circulation to narrow money.

The Fiji Islands' measurement of financial deepening of around 50 percent is the highest of all PDMCs, reflecting a

Table 3.3

Financial Deepening Statistics, 1994–1999

	1994	1995	1996	1997	1998	1999
Currency			(percent of GDP)			
Fiji Islands	5.0	4.9	4.9	5.1	5.7	6.1
Kiribati	0.7	1.0	1.3	1.2	1.2	1.7
Papua New Guinea	3.0	2.9	3.0	3.3	3.6	3.7
Samoa [a]	3.6	4.5	4.0	4.1	3.9	2.8
Solomon Islands	4.4	4.9	4.6	5.1	5.6	5.8
Tonga [b]	3.4	3.0	2.7	2.5	3.0	3.1
Vanuatu	5.5	5.9	5.6	5.6	6.9	5.9
Narrow Money						
Fiji Islands	15.0	16.1	17.9	17.0	17.6	22.5
Kiribati	10.3	12.7	15.6	15.2	12.8	14.1
Papua New Guinea	10.3	10.2	12.5	13.5	13.2	13.3
Samoa [a]	10.0	12.8	11.6	11.4	10.3	9.9
Solomon Islands	13.6	15.2	15.3	15.2	15.2	14.6
Tonga [b]	11.5	9.8	10.1	9.7	10.4	10.6
Vanuatu	23.4	23.6	23.1	22.4	25.6	24.7
Broad Money						
Fiji Islands	61.6	61.4	58.3	51.9	48.2	50.0
Kiribati	58.9	51.0	55.8	48.5	50.9	51.7
Papua New Guinea	30.0	29.2	35.2	38.1	34.3	31.1
Samoa [a]	29.3	35.3	33.4	33.1	32.6	31.3
Solomon Islands	27.2	30.5	30.4	30.1	30.3	24.2
Tonga [b]	32.7	31.9	36.7	35.6	37.8	37.2
Vanuatu (vatu) [c]	42.0	39.6	38.9	36.6	41.0	40.2
Vanuatu (vatu plus foreign currency)	94.1	106.6	111.6	106.0	119.2	112.8

a. Data for Samoa are only to June 1999.
b. Tonga's data are on a fiscal year basis.
c. For Vanuatu, broad money is shown in both vatu liquidity and total liquidity; the latter include foreign currency deposits. The share of local depositors in foreign currency deposits appears to be small, given a minimum deposit requirement of US$5,000. Therefore, the stage of financial deepening in Vanuatu is better measured by vatu liquidity.
Sources: Central bank bulletins.

more developed financial sector. Kiribati's high ratio reflects the impact of large net overseas income flows rather than true financial deepening; and the ratio has fallen over the period, partly because of diminishing nominal and real interest rates on time deposits.

In terms of total domestic credit expansion measured in percent of GDP, the Fiji Islands and Vanuatu are the most advanced, followed by PNG and Tonga (Table 3.4). However, the low ratio for countries such as Kiribati and Samoa reflects large payments by the Government to the banking system; hence private sector credit as a percentage of GDP is a more meaningful statistic. This ratio shows considerable increase in Samoa, Tonga, and Vanuatu.

The ratio of credit to banking assets shows considerable variation across PDMCs (Table 3.4). This ratio is a good indicator of a lack of bankable projects (bearing in mind that the high ratios for PNG and Solomon Islands reflect the high ratio of government borrowing from the banking system rather than a high level of bankable projects). The Fiji Islands' ratio has fallen over the period, reflecting the problems of the NBF and the poor quality of some of its loans. The very low and falling ratio for Kiribati indicates an increasing difficulty in finding lending possibilities: Kiribati's financial resources are being used to generate economic activity overseas rather than at home. This latter outcome is understandable, given the limited opportunities for domestic investment and the fact that most bankable projects are already serviced. In general, the ratio of credit to banking assets is a reflection of the foreign commercial banks' lending only to low-risk projects, and of the high level of liquidity that exists in most PDMCs.

Interest rates on deposits fell during 1994–1999 in the Fiji Islands, Kiribati, Solomon Islands, and Vanuatu (Table 3.2). They rose in PNG and remained fairly stable in the other PDMCs. Lending rates fell in the Fiji Islands and Solomon Islands; remained comparatively stable in Kiribati, Samoa, and Tonga; and rose in PNG and Vanuatu. The spread between average deposit and average lending rates widened considerably for all PDMCs except Samoa and Tonga. As noted above, these spreads are indicative of the large profits commercial banks are making, despite the high operation costs arising from geographical factors, small size of loans, high default risk, and limited availability of collateral. The Samoan figures are for base rates only; and if allowance is made for pricing according to risk, the spread is likely to have increased. In the case of Tonga, there was increased competition in the

Table 3.4

Domestic Credit Statistics, 1994–1999

	1994	1995	1996	1997	1998	1999
Total Credit			(percent of GDP)			
Fiji Islands	54.7	52.8	51.7	45.3	43.9	41.6
Kiribati	8.3	7.1	6.2	-23.9	-7.9	—
Papua New Guinea	31.6	28.2	27.4	34.0	35.2	31.0
Samoa	8.5	13.1	12.5	10.8	9.7	12.4
Solomon Islands	33.2	31.4	27.6	26.5	24.6	22.2
Tonga	26.2	28.3	32.8	37.3	35.0	34.3
Vanuatu	30.1	31.6	22.6	31.7	38.6	38.0
Private Sector Credit						
Fiji Islands	47.1	46.3	45.6	39.0	38.2	37.0
Kiribati	4.6	4.5	3.9	6.8	4.7	—
Papua New Guinea	15.4	13.4	11.3	15.6	17.8	16.4
Samoa	16.3	21.0	22.4	23.0	25.7	26.1
Solomon Islands	11.1	11.1	10.1	10.2	12.3	11.3
Tonga	24.4	25.7	28.3	32.9	32.9	33.1
Vanuatu	34.9	35.9	35.2	32.9	36.3	43.4
Total Credit/Banking Assets						
Fiji Islands	75.3	71.2	70.5	68.9	62.8	54.7
Kiribati	12.5	11.6	9.8	-36.9	-12.8	—
Papua New Guinea	82.9	78.1	68.8	75.7	80.7	—
Samoa	38.6	56.0	53.7	49.3	48.5	72.6
Solomon Islands	98.5	101.9	89.0	86.8	78.6	69.0
Tonga	41.7	45.5	49.3	54.3	42.8	48.1
Vanuatu	24.9	25.1	26.2	24.1	28.3	28.1
Broad Money/GDP-Total Credit/GDP						
Fiji Islands	6.9	8.6	6.6	6.6	4.3	8.4
Kiribati	50.6	43.9	49.6	72.4	58.8	51.7
Papua New Guinea	-1.6	1.0	7.8	4.1	-0.9	0.1
Samoa	20.8	22.2	20.9	22.3	22.9	18.9
Solomon Islands	-6.0	-0.9	2.8	3.6	5.7	7.4
Tonga	6.5	3.6	3.9	-1.7	2.8	2.9
Vanuatu (vatu)	11.9	8.0	16.3	4.9	2.4	2.2

Sources: Central bank bulletins.

banking sector as a result of the entry of two new banks in 1993, although the effects of this were diminishing by 1999.

To promote financial deepening, most PDMCs have made efforts to promote savings by maintaining positive real deposit rates. Some have been more successful than others. Samoa's real deposit rates reached almost 5 percent in 1999, reflecting the move toward market determination of interest rates.

However, it has been difficult for PNG and Solomon Islands to maintain positive real interest rates, because of inflationary pressures caused by large government borrowing.

One approximate means of assessing the extent of excess liquidity in the banking system is to calculate the gap between the ratios of broad money to GDP and domestic credit to GDP. Broad money as a percentage of GDP shows the amount of liquidity available; domestic credit as a percentage of GDP provides an indication of the number of bankable projects in the economy (although government borrowing also is a source of credit growth). Kiribati has the largest gap, almost 59 percentage points in 1998. Samoa has the next largest, almost 23 percentage points in 1998 (reflecting large government deposits with the banking system), followed by the Fiji Islands, Solomon Islands, Tonga, Vanuatu, and PNG (Table 3.4). The relatively low gaps in PNG, Solomon Islands, and Vanuatu reflect large net government financing from the central banks.

Restrictions on foreign exchange transactions have also been a cause of high liquidity in PDMCs. For all except Kiribati and Vanuatu, the external position, particularly the foreign reserve position, has been the major focus of central banks. The average reserve position of PDMCs in 1999 was over 4 months of imports of goods and services (Table 3.5). Measures to preserve foreign reserves have been and still are in place. Restrictions are placed on foreign exchange transactions. All governments except those of Kiribati and Vanuatu require proceeds from exports and invisibles to be repatriated and surrendered to authorized foreign exchange dealers. As to capital transactions, all PDMCs except Kiribati and Vanuatu control outward investments by residents, though most have relaxed these controls in recent years. Kiribati has a very high level of foreign reserves because of its trust funds. The Fiji Islands, Samoa, and Vanuatu have had comfortable levels of foreign exchange, whereas PNG, Solomon Islands, and Tonga have had lesser degrees of comfort.

High levels of liquidity in PDMCs at base 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 (see chapter 8). Difficulty of access to finance is caused in part by poorly prepared loan applications and the absence of track records, but a more problematic cause 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.

Table 3.5
Gross Official Foreign Exchange Reserves, 1994–1999

	1994	1995	1996	1997	1998	1999
	(in months of imports of goods and services)					
Fiji Islands	2.9	3.7	4.0	3.8	4.8	4.8
Kiribati	64.8	61.2	60.0	69.6	88.8	127.2
Papua New Guinea [a]	0.9	3.0	5.4	3.3	2.2	2.0
Samoa	5.4	4.9	5.3	6.0	6.0	6.0
Solomon Islands	0.8	0.8	1.6	1.2	2.7	2.7
Tonga [b]	3.8	3.8	3.2	2.4	3.3	2.3
Vanuatu	7.4	7.6	6.7	5.9	6.2	6.7
Average excluding Kiribati	3.5	4.0	4.4	3.8	4.2	4.1

a. Nonmineral imports of goods and services.
b. In fiscal years.
Source: Central banks; commercial bank, Kiribati.

COMPETITION

Banking sectors in PDMCs are oligopolistic and dominated by foreign banks. A lack of competition has permitted them to maintain high interest margins and high profitability, locating operations mainly in urban areas and showing little interest in provision of banking services to rural areas. The lack of effective competition is not due to restrictions on interest rates, product innovations, branching, or the entry of new institutions, so much as to the smallness and narrowness of PDMC financial markets. National provident funds (NPFs) deposit funds with commercial banks and make some loans to members, but their competition with commercial banks is very limited. DFIs, with their low quality assets and low profitability, are in no position to compete effectively with commercial banks.

As expected in an oligopolistic market structure, there is little price competition, particularly on the deposit side, because of the high levels of liquidity. The evidence on existing product differentiation and price differentiation in banking sectors supports this observation. When local banks are operating (for example, NBF), or when new foreign banks have entered the market (for example, when ANZ Bank [ANZ] and MBf Bank of Malaysia [MBf] started operating in Tonga), there have been periods of more competition. In the Fiji Islands, the competitiveness of the banking environment declined temporarily as a result of the collapse of NBF; in Tonga, as a result of the effective demise of MBf. Nonprice competition (mainly in the form of banking services) seems to be the main form of competition, but there are signs that this form of competition is declining and that the quality of services in banks is deteriorating.

Limitations on foreign investment by NPFs in most PDMCs have compelled them to invest in government paper, and to deposit excess liquidity in commercial banks. This has exacerbated the excess liquidity situation, as well as hindering financial market development. With liquid funds in hand, commercial banks have no need to borrow from central banks, do not need to compete for deposits, and do not need to develop interbank financing. The high level of liquidity held by NPFs also makes it very costly for central banks to mop up liquidity. This constrains the development of market-oriented monetary policy, and prevents properly functioning primary and secondary money markets from developing.

With few traded securities, small or nonexistent capital markets, no traded government bonds, no specialized intermediaries, and no ability to invest overseas, people's savings take the form of demand deposits and savings accounts with commercial banks. The absence of competition for savings leads to low interest rates on deposits, which are a disincentive to save.

The lack of efficient and competitive NBFIs has also inhibited competition. Apart from NPFs, NBFIs are small and do not appear to be capable of providing effective competition to banks in most of the deposit-related products. In some cases (especially NPFs), certain loan products and services to members are offered, such as drawing on savings, housing and vehicle loans, leasing and agricultural loans. This puts a little competitive pressure on commercial banks, most notably in the cases of Samoa's National Provident Fund for residential housing and commercial properties and Vanuatu for housing loans. Price discounting on home loans in the Fiji Islands also reflects the competitiveness of NBFIs. However, for the most part the NBFIs do not compete for a large enough number of products offered by the banks to have a significant overall impact. Similarly, credit unions and other MFIs are too small to be able to compete.

Poor dissemination of information in most banking sectors also indicates a lack of competitiveness, as does the lack of adequate complaints systems or mechanisms to handle disputes. In addition, there are indications that spending on infrastructure and staff training is lower than in more competitive systems.

The exit of banks from the market and the entry of new ones are facilitated in most PDMCs by their licensing and supervision policies. Nonetheless, entry and fixed costs may be quite high because of the smallness of markets, the length of time needed to build up a business, and the need for capital investment in highly concentrated markets dominated by ANZ, Westpac Banking Corporation (Westpac), and the Bank of Hawaii. Perhaps official transfers and concessional loans, which finance a large portion of investment in PDMCs, constitute the biggest competition for commercial banks.

Even given the diseconomies of scale in PDMC banking sectors, it should be possible to promote competition for loans to large borrowers, and for deposit taking in urban areas, by encouraging the development of specialized intermediaries. For example, finance and leasing companies could spur competition in the market for loans. Small, specialized institutions can force even big, oligopolistic banks to behave competitively. For example, the foreign exchange bureaus that have been operating in Samoa and Vanuatu have markedly increased competition in foreign exchange transactions.

Box 3.1
Best Practice for Competition Among Financial Institutions

Promotion of healthy competition should be the guiding objective in decisions with regard to entry and exit of financial institutions. Free entry should be facilitated, subject to fulfillment of prudential requirements and avoidance of conflict of interest due to nexus with potential borrowers. Supervisory actions regarding failing banks should be mandatory and well specified, and competitive considerations should weigh in decisions on mergers. For PDMCs' private sector growth, more nonbank financial intermediaries and market-oriented money markets are important to competition, because they will lead to larger financial markets and more competition for foreign banks.

Governments should ensure that all financial institutions are placed on an equal and competitive basis. This implies that PDMCs should not reserve any specific functions or business activities to wholly or substantially state-owned financial institutions and should not provide funding or other assistance on preferential terms, including government guarantees, to such institutions. If governments wish to support social services through development banks, this should be explicitly shown in the budget.

PRUDENTIAL FRAMEWORK, SUPERVISION, AND CENTRAL BANK AUTONOMY

An effective supervisory authority needs a comprehensive and effective set of banking laws and regulations, adequate financial and human resources to carry out its obligations, and independence from government. The prudential framework varies in degree of maturity across PDMCs, depending on the level and scope of reporting, the degree of competition in the market, and the degree of independence of the respective central banks from government. Central banks have the authority and responsibility to supervise commercial banks, as set out in central bank acts (or reserve bank acts) and, more recently, in financial institutions acts. The development of a supervisory capacity began at different times in different PDMCs—in the early 1990s in the Fiji Islands, Samoa, and Tonga, and in the latter half of the 1990s in PNG, Solomon Islands, and Vanuatu.

The PDMCs' financial institutions acts pertain to licensing, capital requirements, limits on lending to related parties, and limits on risks to single borrowers. Amendments have given central banks the ability to flexibly issue prudential regulations in line with international standards. These amendments generally follow the Basle conventions in establishing the capital adequacy ratios required for banking institutions, and allow central banks to issue guidelines setting out broad policies that banks are required to adhere to. Regulations on loan classification, loan loss provisioning, and interest accrual have also been issued, in line with international practices. Most central banks have adopted risk-weighted capital adequacy guidelines (most of which are above the 8 percent norm for risk-weighted assets set by the Basle Committee for developed economies).

Most central banks monitor and evaluate the overall strategies, policies and performance of commercial banks through a regular reporting system. The banks are monitored for compliance with the terms of their license and with prudential standards, such as capital adequacy limits and credit exposures. The majority of regulations are properly functional and banks can generally comply. All PDMCs are carrying out off-site supervision, which consists of the analysis of monthly reports that banks are required to submit on their financial condition. PDMCs are also carrying out some on-site supervision. Central banks are receiving assistance from ADB and IMF to develop policies (including those on classifying loans and strengthening risk weighting) on prudential supervision and on strengthening reporting to central banks.

Foreign-owned banks in PDMCs are small affiliates of large banks—ANZ and Westpac in Australia and the Bank of Hawaii in the United States—and are subject to supervision in the home country. The international management controls of these banks have presumably ensured that, despite weak supervisory capacity in most PDMCs, these foreign banks have been adequately supervised. However, the locally owned banks and NBFIs have had fewer internal management controls and less experience on which to draw, and many of them have become susceptible to political influence and encumbered with low-quality assets. As a result, several locally owned banks have failed through lack of capital and have had to be restructured, taken over, or closed down. For similar reasons, DFIs in many PDMCs have also become encumbered with low-quality assets, forcing them to amalgamate with commercial banks or to be restructured. Most are now looking at mobilizing their own funds and strengthening their systems to price loans according to risk. Some NPFs have also been poorly managed and have become susceptible to political influence. The assets of members have been badly invested and rates of return have been low, even negative.

There is a need to enhance the capacity of central banks to conduct banking supervision effectively, through adequate enforcement of prudential regulations and through more autonomy from governments. In most PDMCs, the central bank has some legal autonomy, but governments still have the power to overrule the central bank. Disputes have occurred mostly when banks are being licensed, or when failing banks are being closed or restructured. In a number of PDMCs, the government has not allowed the central bank to act without its approval. The near failure of a few locally owned commercial banks has brought into question whether central banks have the necessary autonomy to effectively force restructuring or closing down of insolvent commercial banks. In the Fiji Islands, for example, the Reserve Bank of Fiji (RBF) first raised warnings about NBF's solvency in 1991, but lacked the political support necessary to enforce a solution. The losses and illiquidity continued to mount until, in 1995, the Government was forced to admit that the bank was in difficulty. In Tonga, there is considerable concern about the financial status of a foreign bank (MBf) that suffered losses as a result of credit card fraud and foreign exchange losses. The performance of the foreign bank has brought to light the weaknesses in the capacity of the central bank to license commercial banks and to deal with

Box 3.2

NBV's Failure and ADB's Response

In response to the difficulties experienced by NBV, ADB undertook a strategic review of Vanuatu public sector financial institutions, to help the Vanuatu Government develop a comprehensive strategy toward them. The review, which was part of the Comprehensive Reform Program, revealed that there had been serious mismanagement at all these institutions, particularly with regard to the granting and monitoring of loans and to the quality of information about any action being taken. In addition, the system within NBV was inadequate for a modern retail bank, and the local management team was poorly equipped to manage a retail banking operation. Following the strategic review the following actions were implemented.

- NBV and the Development Bank of Vanuatu (DBV) were integrated.
- A separate and independent Asset Management Unit (AMU) was established to manage all the bad and outstanding loans of NBV, DBV, and VNPF. All these loans were transferred to the AMU, which took responsibility for the recoveries from these loans.
- The good loans of DBV were transferred to NBV.
- A senior management team of expatriate banking specialists was recruited for NBV for a limited period,

cont. next page

insolvent commercial banks without Government approval. The National Bank of Vanuatu (NBV), a State-owned bank with a history of unprofitability, became technically insolvent in 1997; the Reserve Bank of Vanuatu was forced to establish a supervision department in 1997 and to pass a Financial Institutions Act in 1999.

Box 3.2 (cont.)
NBV's Failure and ADB's Response

to take responsibility for the implementation of the strategic plan that had been prepared as part of the review.

- NBV was recapitalized by injecting equity of 400 million vatu. This was to ensure that NBV met its capital adequacy requirements.
- The administrative and investment functions of VNPF were separated. The investment function was subsequently outsourced to an international fund manager.
- An independent monitoring team, chaired by an independent chairman and consisting of senior representatives of the financial, commercial, and private sectors of Vanuatu, was established. It succeeded in carrying out the above actions and bringing about an improved performance by NBV.

At the present time, NBV is running profitably and VNPF returns are improving.

However, a consequence of these actions has been the almost total lack of any development lending taking place. In response to this situation, ADB has been examining alternative approaches and at the present time is working to introduce a small loan scheme that will be administered through the NBV, using its extensive branch network and outreach to the rural communities and outlying islands.

The various legislative acts covering the operations of the central banks need to be strengthened to ensure their independence. RBF has the strongest framework in place, in conjunction with the size and level of development of its financial sector, but the autonomy of other central banks, for example in both PNG and Solomon Islands, has been compromised. In PNG, there has been a history of intervention by the Government, including interference with the membership of the Board of the PNG Central Bank. Regulatory concerns have included political intervention, termination of senior managers, requests for political loans, large and highly risky exposures, strong incentives for higher lending growth, and uncertainty about future profits. A 1999 World Bank study of the financial sector in PNG observed: "Prudential supervision of the sector remains minimal with formal arrangements only in place for the commercial banks and some licensing and reporting requirements for other entities" (World Bank 1999). The new Government elected in August 1999 is taking steps to address these concerns, including amending its banking act to require greater central bank independence. The amendments will allow enhanced regulation of banks, financial institutions, and bank holding companies, while permitting a focus on stopping the setting up of pyramid schemes. Central bank procedures are also being strengthened in Samoa through a reorganization of the Central Bank of Samoa (CBS), which will allow departmental responsibilities to be focused more tightly on a liberalized financial system.

NBFIs often do not come under the central bank's supervisory framework, despite the fact that a considerable portion of outstanding credit is attributable to NBFIs. In most PDMCs, the legislation covering the respective NBFI does not contain prudential guidelines; sometimes NBFIs are supervised by ministries of finance or are self-supervising. There is also a great deal of ambivalence by the supervising authorities about the validity of having NBFIs as part of the prudential supervision regime.

A similar ambivalence exists regarding prudential supervision of DFIs, even though supervision is critical to ensuring and maintaining stability of financial systems. DFIs, however, are very different institutions from commercial banks, and it may not be entirely appropriate to impose the same criteria for prudential for both. While a number of DFIs raise funds from the market at the present time, none of them accepts retail deposits and certainly not demand deposits. Therefore, they are not under the same potential liquidity pressures as commercial banks, and do not risk a run on funds. At the same time, DFIs are at the high-risk end of the lending spectrum, and are vulnerable to falling capital and equity as a result of nonpayment of loans. Thus some supervision is required.

Most reporting relationships between central banks and development banks are on an informal basis. For example, Tonga Development Bank (TDB) reports informally to the National Reserve Bank of Tonga, although there is no formal requirement under any banking act. There were no formal requirements for Rural Development Bank of PNG (RDBPNG) to report to the Central Bank, prior to its incorporation into the Finance Pacific Group. The National Bank of the Solomon Islands holds shares in the Development Bank of Solomon Islands (DBSI); it therefore has a conflict of interest when it comes to supervising DBSI. There is also only informal reporting by DBSI as to the adequacy of its provisioning and its loan classifications. In Samoa, DBS has been reporting informally to CBS and is now moving to formalize its reporting. The Samoa National Provident Fund has also recently started reporting to CBS. This should materially assist CBS in its management of the financial sector.

There are also wide variations in the level and timing of disclosure contained in official publications, such as annual reports of DFIs; many DFIs are reporting very dated information, often more than 12 months old. With such slow reporting, the relevance and significance of the information is questionable. As to disclosure, it is impossible for the public to have confidence in a financial institution that reports its results one to two years late. Moreover, the information disclosed often does not allow for a proper analysis of the DFI's performance, as in the area of provisioning for bad and doubtful loans. It is clear, from the amount of extra provisioning that many DFIs have been required to make following an independent review of the existing provisioning, that there has been some serious underdisclosure of provisioning in the past. This reflects the insufficient attention that has been paid to adopting appropriate provisioning. There is little or no information available on the directors of DFIs, such as information about any associated business or dealings that a particular director may have with the DFI. This will become increasingly relevant as DFIs move to greater levels of self-funding, and as and when they wish to attract institutional investors.

Common policies are needed on prudential supervision for DFIs in PDMCs. Common minimum standards for disclosure should be agreed upon, including information on all loans above a certain size. Transactions with directors, including details of any loans to directors, should also be divulged. Not all central banks in the region see it as part of their role to supervise DFIs. Nonetheless, DFIs are an integral part of the financial sector, and have the same potential for bringing instability to the sector if they get into difficulties. In addition, PDMCs are too small to have fractured supervision: there should be one institution to supervise banks and nonbanks. Most ministries of finance are poorly equipped to supervise NBFIs, and prudential regulation for NBFIs needs to be consistent with that for banks, while at the same time providing sufficient flexibility to accommodate differences between the operations of NBFIs and banks.

The central banks of some PDMCs also need to develop supervision arrangements for financial conglomerates. For example, the establishment of the Pacific Finance Group in PNG has led to the creation of a major financial conglomerate that includes banking, insurance, development banking, and finance; it raises questions about the best way of supervising such organizations. The operations of the life assurance, general insurance, and superannuation industries in PNG are not subject to any supervisory control. A similar situation has arisen in the Fiji Islands, with the purchase of the NBF by the Colonial Group. PNG is proposing that the Bank of Papua New Guinea (BPNG) become a super-regulator, with a role similar to that of the Australian Prudential Regulation Authority (APRA); APRA was established in response to the number of commercial banks moving into insurance, securities, and funds management. Banking supervisors in the Fiji Islands are also considering using the APRA model to supervise its more complex financial institutions.

While there is a need to enhance the capacity of central banks to supervise banks and NBFIs, financial institutions departments or banking supervision departments in the central banks of PDMCs are too small, and the average length of experience of staff (except in the Fiji Islands) too short, to enable the departments to operate efficiently. Some central banks have had difficulty in recruiting sufficient numbers of staff with appropriate skills. Despite the considerable amount of training already provided by ADB and IMF, both internally and externally, and through a number of courses and workshops for supervisors conducted by the Pacific Finance Technical Assistance Centre, all financial institutions and supervision departments of central banks still need more training. The recently established regional association of supervisors has identified training as the first priority. Work has also progressed on the design and use of manuals for both on- and off-site supervision. There is also a need to analyze the amendments to the financial institutions acts to see how they compare with internationally accepted norms.

PDMCs should continue to enhance and strengthen the process of regional cooperation and consultation in regulatory and supervisory matters, as initiated in their regional Declaration on Cooperation. They should formally analyze their compatibility with internationally accepted norms and work cooperatively toward establishing a regional supervisory body to supervise foreign banks. This would free up scarce resources in individual PDMCs to supervise local banks, and in particular to unify banking supervision with supervision of NBFIs, particularly DFIs and NPFs. Since poor management has contributed to the difficulties of locally owned banks and NBFIs in some PDMCs, improvements must be made in the skills of management and in the banks' internal systems. Supervisory authorities should focus on these issues.

Box 2.1

Best Practice for Supervision

PDMCs should ensure that the supervisory body is operationally independent, while remaining accountable to the political process. The supervisory body should not inhibit market-led structural change.

PDMCs should give high priority to implementing the Basle conventions on minimum levels of capital adequacy and to following internationally accepted practices for classification of, and provisioning for, nonperforming loans. The capital adequacy levels should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for local banks in PDMCs, these requirements should be higher than those established in the Basle core principles (minimum of 8 percent total capital in relation to risk-weighted assets) and its amendments. NBFIs should also come under central banks' supervision.

The supervisory body must gain and keep the confidence of the industry, by following a clearly defined strategy for achieving the overall objective of creating a sound and efficient financial sector. It should have highly qualified, experienced, and well-remunerated staff. Its financial structure should promote a high standard of performance and independence.

Nonbank Financial Institutions

4

In 1994–1999, NPFs in PDMCs held an average of about 20 percent of financial sector assets (Table 3.1). They are financed by contributions from earnings of employees (matched by employers), and invest in private and public corporations, local real estate, long- and short-term government instruments, and stocks, as well as holding banking deposits. NPFs therefore are important vehicles for domestic savings mobilization and investment, especially in Kiribati, Samoa, Solomon Islands, PNG, and the Fiji Islands (the Fiji Islands has the widest range of financial institutions, but still only a few in each category). In most PDMCs, a large percentage of the NPF is invested in government securities (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. Because of the scarcity of instruments in which to invest and the lack of capital markets in all PDMCs except the Fiji Islands and PNG, NPFs usually hold government securities until maturity. This has hindered the development of money and bond markets. NPFs, with their large liquid assets, are largely responsible for the high degree of liquidity in most commercial banking systems.

Development banks are a relatively small part of financial systems, with assets averaging less than 7 percent of total financial sector assets in 1999 (Table 3.1).[3] There is considerable variation

[3] Central banks hold most of the remaining assets, with capital markets and MFIs accounting for very little.

across countries, however. Tonga's development bank accounted for a little over 15 percent in 1999, down from a high of 22 percent in 1996. At the other end of the spectrum, PNG's development bank accounted for less than 2 percent of financial sector assets. Vanuatu's bank ended operations in 1997. Development banks were established precisely to perform a financial intermediation function aimed at accelerating economic development; but they have not been able to grow as other institutions have, because they have been encumbered with low-quality assets and low profitability. The share of development banks is expected to decline as they are restructured; some are starting to raise funds through bonds and promissory notes. These banks and NPFs are examined more fully in the next chapter.

DEVELOPMENT FINANCE INSTITUTIONS

Overview

The major thrust for establishing development finance institutions (DFIs) in the Pacific Islands occurred in the early 1970s. Initial equity capital was provided by bilateral donors and was supplemented by low-cost funds (for on-lending to clients) from the World Bank, ADB, European Investment Bank (EIB), and other donor agencies. In addition, there was considerable support for capacity building in the form of technical assistance programs, particularly in the area of training for improved loan and project analysis. It was expected that the DFIs would spearhead and accelerate economic development through provision of long-term credit to priority industries, particularly in rural areas where commercial banks had been reluctant to take on projects with high risk.

In the event, although DFIs focused on development project lending as planned, lending policy and project selection were subject to political interference and determined by boards composed of government officials who paid insufficient attention to risk. As a result, by the mid-1980s, most DFIs were in financial distress, exhibiting high arrears ratios, poor cost-benefit evaluations, mismanagement, inability to price loans in accordance with risk criteria, and inability to enforce loan repayments. ADB and the World Bank have ceased funding DFI lending operations, though EIB continues to provide credit lines to DFIs.

Some common problems with the internal systems of DFIs (which also existed in local commercial banks) can be identified. The most important are the poor governance environments and the lack of an enabling environment: DFIs were operated without the benefit of formal planning or strategic processes. For most of them, financial plans and budgets did not exist, and there was little awareness of the need to control costs. DFIs therefore reacted to, rather than anticipated, changes in the external environment, which made them very vulnerable to changes in government policies, commodity prices, and weather-related shocks. Information available to management was rarely up to date and was often incomplete. Without timely information, it was difficult for management to take action to correct policies related to credit extension, problem loans, or risks. The lack of policies on risk was the source of many problem loans: DFIs would often advance a large proportion of the required capital to borrowers without ensuring that the borrowers had invested an adequate amount of their own funds.

DFIs also had, and some still have, lax accounting and auditing procedures. It was standard practice to continue to accrue income long after loans were nonperforming; loan recovery was rarely tried; and on occasion, new lending would be used to hide debt-servicing problems. In fact, accountability has been a problem for many DFIs because of unnecessarily complicated organizational structures, and because of poorly defined responsibilities for most of the staff.

Poor management in DFIs was most often reflected in poor (often unwritten) lending policies. Especially common was excessive concentration of risk, which meant that too many loans went to one borrower, or an affiliated group, or borrowers in one industry, with the result that the quality of those loans was often jointly damaged by a single factor. For example, Tonga Development Bank (TDB) was highly exposed to the squash industry, which was wiped during one year in the late 1990s because of bad weather. As a result, TDB's equity fell considerably.

Faced with the reduction of low-cost financing from aid organizations, the PDMCs have undertaken reform of their DFIs. Fiji Development Bank (FDB) is contemplating converting into a full-scale commercial bank; in Samoa, DBS has moved to a policy of completely market-based interest rates and to less dependence on loans from aid agencies. As a part of Vanuatu's Comprehensive Reform Program, VDB and NBV were merged (*see* Box 3.2). In Tonga, the Government is restructuring and strengthening the management of TDB; the governments of PNG and Solomon Islands are doing the same with their development banks. It is therefore timely to take stock of experiences to date and, based on available best practices, to design a strategy for dealing with DFIs.

DFIs' Performance

Despite considerable support, DFIs continued to decline in profitability over the 1990s, some incurring substantial losses. Table 4.1 shows that only FDB made steady profits over the period 1995–1999. RDBPNG had losses in every year; DBSI, in three out of five years. The profitability of development banks in the other PDMCs was poor. These results reflected substantial increases in

Table 4.1

Profitability of Development Finance Institutions, 1995–1999 [a]

	1995	1996	1997	1998	1999
FDB F$'000	1,857	307	522	316	106
TDB T$'000	667	107	-746	-3,778	600
RDBPNG K'000	-3,753	-1,165	-929	-20,866	—
DBSI SI$'000	656	240	-2,738	-676	-1,305
DBS ST'000	1,200	875	700	-1,200	—
DBK 2/ A$'000	—	—	173	-146	—
DBV 3/ Vt million	-80	-130	-140	—	—

— Not available.
a. The figures shown in the table may not be directly comparable, due to different accounting practices adopted by the different PDMCs.
b. For 1997, DBK data reflect the government's revenue grant.
c. DBV merged with NBV in 1998.
Source: DFI Annual Reports, ADB Country Reports.

the level of provisioning for nonperforming loans and a slowdown in lending resulting from a lack of funds.

Further analysis of the operating performance of DFIs (Table 4.2) shows the following additional trends; (i) increasing provisions; (ii) extremely high debt-to-equity ratios for some DFIs prior to restructuring; and (iii) narrowing interest margins.

The share of DFIs in total financial sector assets fell in the late 1990s (Table 4.3), but lending continued because of increased collections, borrowing from government, drawdowns from existing facilities, or support from donor agencies. In most cases, by providing further funds, governments or donor agencies actually exacerbated the DFIs' arrears problems.

Each of the DFIs has a similar product and market mix (Table 4.4), typically a broad range of lending products, with term loans the most dominant form. There is a something of a trend towards diversification, but given the weak financial position of many of the institutions, there are limits to what can be achieved.

The Role of DFIs: Ownership and Funding

In the 1970s, government policy in PDMCs was geared to the development of rural communities, and state-owned DFIs were seen as the instrument to implement these policies. Because DFIs did not attract commercial capital, the provision of funding through donor agencies was seen as the means of providing access to credit for individuals and businesses that could not access the normal banking channels, because they had no security against which to borrow. It was felt that without the formation and continuation of DFIs, there would be little possibility for many individuals and entities, particularly in agriculture, to develop sustainable businesses. They would be forced to turn to more expensive sources of funds, such as moneylenders.

It was originally thought that in measuring the performance of a DFI, its role in delivering noncommercial financial services should be taken into account; profit as the major criterion of success was not seen as the most appropriate way to assess effectiveness. However, DFIs without sound operating policies or strong prudential supervisory controls

Table 4.2

Comparison of Performance Ratios of Development Banks, 1995–1998

Financial Years	1995	1996	1997	1998	1995	1996	1997	1998
	Fiji Development Bank				Development Bank of Samoa			
Interest Spread	2.5	2.4	2.1	1.8	5.3	5.5	8.1	6.6
Earnings Spread	3.1	3	2.7	2.5	5.0	6.8	10.2	-8.2
Admin Costs/Ave Assets	8.3	8.7	1.2	1.6	5.1	5.5	6.6	6.7
Total Expenses/ Total Income	77.8	79.1	23	23	77.6	78.1	54.0	63.0
Provisions/ Lending Portfolio	8.5	7.3	10.1	10.1	11.9	12.3	9.6	12.3
Net Profit/Equity	2.8	0.4	0.72	0.11	3.6	4.4	4.0	-3.6
Debt/Equity	31.2	30.9	2.78	3.39	54.6	54.3	54.8	2.0
Borrowing Costs/ Ave Assets	5.4	5.9	6.22	5.92	2.6	2.4	2.5	2.5
	Tonga Development Bank				Rural Development Bank PNG			
Interest Spread	6.4	3.7	4.3	2.7	3.3	5.2	6.1	5.4
Earnings Spread	2.7	1.3	0.8	0.2	-1.8	-1.5	-2.1	-4.0
Admin Costs/Ave Assets	5.1	4.9	6.2	5.9	7.8	7.8	—	—
Total Expenses/ Total Income	75.8	88.7	41.0	28.0	93.0	70.3	41.0	28.0
Provisions/ Lending Portfolio	22.0	25.5	13.0	14.7	61.9	63.1	63.2	77.2
Net Profit/Equity	3.0	0.9	-4.5	-37.0	-22.0	-3.3	-1.6	-47.0
Debt/Equity	138	139	1.9	2.4	500	509	1.7	1.2
Borrowing Costs/ Ave Assets	2.8	3.1	3.9	5.2	8.8	1.0	—	—
	Dev'mt. Bank of Solomon Islands				Kiribati Development Bank			
Interest Spread	7.7	8.7	10.2	7.3	—	8.4	7.4	8.5
Earnings Spread	2.1	1.1	0.8	0.2	—	—	0.5	-0.6
Admin Costs/Ave Assets	7.6	7.3	14.2	19.3	—	9.4	9.5	10.1
Total Expenses/ Total Income [a]	66.0	61.5	28.0	52.0	—	140.5	74.2	129.7
Provisions/ Lending Portfolio	13.4	10.9	9.4	8.7	—	10.6	10.7	11.5
Net Profit/Equity [b]	4.5	1.6	0.5	-4.6	—	-5.1	6.5	-4.8
Debt/Equity	72.6	81.8	70.0	97.8	—	68.2	49.9	43.8
Borrowing Costs/ Ave Assets	28.3	25.6	4.4	3.6	—	1.6	2.1	2.0

— Not available.

a. 1996–without government revenue grant; 1997 includes prior period government revenue grant of AUD$209 million.

b. 1998 includes additional provisions for prior years.

Source: DFIs, Annual Reports.

Table 4.3

Assets of Development Finance Institutions, 1995–1999

	1995	1996	1997	1998	1999
FDB F$'000	362,270	343,658	356,014	356,393	363,993
TDB T$'000	46,505	46,639	47,023	45,957	45,694
RDBPNG K'000	77,931	92,722	97,626	87,493	—
DBSI SI$'000	31,190	39,133	48,133	55,471	59,490
DBS ST'000	45,300	48,800	46,200	54,632	—
DBK A$'000	—	4,104	4,025	4,432	5,142
DBV [a] Vt million	932	896	850	—	—

— Not Available.
a. DBV merged with NBV in 1998
Source: DFI Annual Reports

Table 4.4

Comparison of Investment and Lending Products

	TDB	DBK	FDB	DBS	DBSI	RDBPNG
Investment Facilities						
Promissory Notes	x		x			
Bonds-Govt. Guaranteed	x		x		x	x
Small Savings Passbook	x					
Term Deposits						x
Lending Facilities						
Loans-Long, Medium, Short	x	x	x	x	x	x
Equity Investment	x		x	x	x	x
Guarantee Finance	x	x	x	x		x
Business and Technical	x	x		x		
Advisory Services						
Credit Guarantee Scheme						
Leasing Finance			x			
Rural Training Centers						x
Credit Lines	x		x			
Working Capital Finance	x	x	x	x		
Women in Rural Areas			x		x	x
Microfinance				x	x	x

Source: DFI Annual Reports; ADFIP 1999.

were delivering loans that often could not be repaid, and at the same time were operating at a loss because of their own high cost structure and inefficient processes.

These developments brought into contrast the dual objectives of DFIs: to be profitable and thus sustainable on the one hand, and to be socially responsible on the other. The question posed was: "If the core function of a DFI is still considered to be lending to rural and outlying areas, then shouldn't the outcomes that result from these measures be the criteria against which they are measured, rather than profit?" Today, acceptable levels of profitability are seen as necessary to generate retained earnings and build the capital base. Faced with difficulties in raising low-cost funds, DFIs have gradually moved closer to the commercial banking model. It has thus become increasingly difficult for them to achieve the social objectives that were intended in their original charters. Many governments in the region have been led to question the current direction of their DFIs and to place ongoing pressure on them to focus on the social objectives originally envisaged.

Ownership. From discussions with governments, and from the experience of Vanuatu, it seems likely that were development banks to be closed down, governments would seek to reintroduce some other organization that would fulfill a similar role. Governments throughout the Pacific islands still want credit services provided to rural and outlying areas. The issue to consider is the best way to deliver such noncommercial financial services. The alternative delivery channels for noncommercial lending could include greater use of credit union and cooperative networks, where these are found to be operating effectively. It could also include partnerships with commercial banks, as contemplated in Vanuatu. The effectiveness of such arrangements would depend on the extent of the branch network of the commercial banks, or the availability of other agencies (for example, post office agencies). Very strict criteria would need to be set, and it is unlikely that the agencies would actually approve loans.

In addition to the above channels, there may be an opportunity to work with emerging microfinance organizations and nongovernment organizations (NGOs) that are successfully targeting specific areas of need. It is quite likely that in the future, relatively more development finance lending will be provided through other intermediaries, although the appropriate mix of delivery channels will vary from market to market according to the infrastructure in place. It will be more a matter of utilizing the existing delivery channels than of creating new ones.

In any case, development banks will need to improve their profitability significantly in order to survive, while adapting to the changes expected by governments and other stakeholders. They will need to be properly supervised and subject to strong review procedures.

Given the current levels of profitability, it is unlikely that investment in a development bank in the region would be attractive to private investors. The strategies that have been used to date to privatize DFIs have included either merging the DFI into the state bank (Vanuatu and the Cook Islands), or integrating it into a group of all government financial institutions (PNG). However, there is little evidence internationally of small development banks being successfully privatized. This being the case, and bearing in mind the need for governments to maintain a focus on encouraging economic development in rural areas, it seems more likely that government ownership will continue to be the dominant form of ownership in the immediate future.

Funding. This is not to say that DFIs cannot do much to improve their attractiveness as a potential privatization prospect. Most could significantly reduce their operating costs—by 30 percent or more—through an increased focus on reducing costs and rightsizing the organization to be consistent with its level of activity. Such cost reduction is imperative in order to minimize the level of subsidies and self-funding requirements, and requires

(i) strong internal controls including risk management;
(ii) effective boards;
(iii) formal prudential supervision; and
(iv) skilled staff and management.

Self-funding by DFIs will be increasingly required because of government budgetary constraints and the reduction of funds available from traditional sources. Many DFIs are moving toward self-funding, either through the issue of bonds and promissory notes by regular tender, or through accepting term deposits. FDB fully funds from the domestic market by raising F$70–F$80 million annually through monthly bond tenders of three-, five-, and seven-year maturities. Other development banks partially fund from the market (excepting DBS, which is evaluating its feasibility). The growth of microfinance is another reason for an increase in the level of self-funding. A number of microfinance programs are developing throughout the region, The Government of the Fiji Islands, for example, is to increase its support for microfinance by funding a scheme through the Microfinance Unit of the Ministry of Commerce, Business Development and Investment. At the same time, the Government is removing FDB board members on the grounds that FDB is insufficiently profitable.

The issues that arise from self-funding center around the interest rates that the market is prepared to accept for the paper of fairly high-risk institutions, the willingness of government and central bank authorities to back the paper through guarantees and/or buyback facilities, and the size and structure of the domestic market. If DFIs were self-funded, they would need to come under the central banks' prudential supervision. The range of options available to support a self-funded strategy includes (i) domestic savings deposits; (ii) domestic term deposits; (iii) bonds and promissory notes; (iv) cofinancing; or (v) a combination of some or all of the above.

Savings deposits. Although practiced by TDB, the acceptance of savings deposits from the public is not a viable financial option for most DFIs. The systems and support network required for administering a savings product is a relatively expensive way to raise funds, and the increased regulatory and governance requirements also add compliance costs. A significant base would also need to be established (with the inherent costs involved) before a reasonable level of funds could be generated. Against this, such deposit mechanisms present an opportunity to fulfill a broader social responsibility by providing savings facilities for individuals who would not normally have access to this type of facility. TDB, for example, offers a savings mobilization scheme, which is expected to support its lending program to the outer islands, and which will ultimately replace special credit projects for the outer islands.

Term Deposits. As an extension to the existing programs for issuing bonds and promissory notes, the acceptance of term deposits from the public would seem logical. At present, FDB is seeking approval from RBF to accept deposits from the public; it is expected that a minimum deposit of F$5–F$10,000 will be set, which should minimize some of the costs associated with collecting retail deposits.

Bonds and Promissory Notes. Of all the domestic sources of funds available to DFIs, bonds and promissory notes are the most cost-effective and the most commonly used, as noted above. The mix of bonds and promissory notes allows DFIs to maintain liquidity. The main market for these instruments is domestic institutions, such as provident funds, resulting in an expanded financial sector, which in turn promotes the objectives of the DFIs.

Cofinancing. Cofinancing is increasingly being considered as a means of attracting funding from other lenders, and has the advantages of being project specific and of limiting exposure. The reputation of the DFI can be enhanced by its relationship with other lenders, since it is likely that cofinanciers will be substantial lenders in their own right. For example, DBS has recently undertaken a project to build a hospital and medical center, which was cofinanced with Samoa's National Provident Fund.

Self-Funding and the Cost of Funds. A comparison of interest margins, administration, and profitability ratios illustrates very clearly the impact of self-funding on DFIs' cost of funds (Table 4.5). FDB operates on much smaller margins than does DBS or DBSI. While there are some benefits from economies of scale, this cannot explain entirely the major divergence of the statistics. DBS has operated on an interest margin of between 6.6 and 8.5 percent over the last three years, whereas FDB operates on a margin of 2.5–1.8 percent. This is mostly a function of the cost of funds for the two organizations.

DBS has enjoyed funding costs less than half those of FDB. In 1998, the respective borrowing costs as a percentage of average assets were 2.51 percent for DBS and 5.92 percent for FDB. More than any other, this statistic demonstrates the impact of borrowing from the domestic market.

FDB has a much smaller interest margin on which to run operations, and therefore its administrative costs, as a percentage of average assets, are significantly lower than those of DBS. DBS's ratio of average cost to average assets was 6.7 percent in 1998, whereas FDB's was 1.6 percent. Lower interest margins force institutions to operate more efficiently, and are one of the major thrusts behind reforms in the banking sector internationally.

The ratio of net profit to equity shows that higher costs of funds will impact on the return on equity, irrespective of the size of the financial institution. The nature of DFI business is to lend to individuals and organizations that would not normally have access to credit through regular commercial channels. This type of lending carries a much higher risk, because it is relatively likely that some of the loans may not be repaid. Normal banking practice would require that where a loan is in default, or where there are serious questions as to its repayment, a provision must be held by an institution against that possibility. The level of provisioning has a direct impact on profitability: for example, RDBPNG incurred an operating loss of 23.3 million kina in 1998, and a major contributor to this loss was an increase in their provisions for nonperforming loans of 26.5 million kina.

In order to attract funds from the market, it is necessary to pay market rates. Depending upon the economic well-being of the PDMC and the stability of the financial market, there will be a substantial premium (perhaps 4–5 percent) on the interest rate a DFI will have to pay. This reduces interest margins and profitability.

The success of a DFI at utilizing market funding will, to a large extent, depend on its government's attitude toward providing a government guarantee for securities issued by the DFI. Where a guarantee is not provided, there is a cost to the recipient organization. Research by FDB demonstrated that institutions now investing with FDB would require an interest

Table 4.5
Comparison of Interest Margins and Administrative Costs for Development Finance Institutions, 1997–1998

	FDB		DBK		DBS		DBSI		TDB		RDBPNG	
	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998
Interest Spread	2.1	1.8	7.4	8.5	8.1	6.6	10.2	7.3	4.3	2.7	6.1	5.4
Admin. Costs / Ave Assets	1.2	1.6	9.5	10.1	6.6	6.7	14.2	19.3	6.2	5.9	—	—
Net Profit/ Equity [a]	0.72	0.11	6.6	-4.8	4.0	-3.6	0.5	-4.6	-4.5	-37.0	-1.6	-47.0

— Not available.
a. DBK – 1997 reflects government revenue grant.
Source: Table 4.2.

rate premium of 2–3 percent in the absence of a guarantee. Even with that premium, it was by no means certain that the institutions would continue to invest.

The size and maturity of the domestic market have a significant bearing on the acceptance of, and participation in, any financial instruments issued by DFIs. For example, if the existing market structure indicated that there were no term deposits longer than 12 months, then a financial instrument with a more than 12-month maturity would not be readily accepted. A market would in effect need to be created. The size of the market will therefore have a direct impact on the level of funding available to a DFI.

Although funding from the market involves higher costs, there are offsetting benefits. It stimulates improvements in governance and reporting (Skully 1999), and subjects the institutions to the supervision of the regulatory authorities (central banks). Prudential supervision imposes further disciplines on management in terms of reporting the institutions' financial status and policies on capital adequacy, loan classification, and provisioning. This should increase market confidence and provide DFIs with better management.

In addition, management will also have greater flexibility as to the positioning of the DFI. The broader social responsibility role carried out by the DFI can still be supported under the self-funding model. Moving into the market with some form of guaranteed bonds and promissory notes holds the best opportunity for penetrating the investment markets. The advantages of the bond are that it is simple to administer and understand and that it is an attractive instrument to the institutions, particularly where it can be government-guaranteed. Once the market for bonds has been established, it is appropriate to seek some level of diversification in funding by adding other instruments, such as retail term deposits.

DFIs and Governance

One of the critical components of successful development banking is the establishment and maintenance of strong governance processes, beginning with the appointment of a strong board. The board's key role is to ensure that management is continuously and effectively striving for above-average performance, taking account of risk and protecting shareholder interests. Each board should clearly define above-average performance in its particular situation, monitor performance so defined, and fulfill four key functions:

(i) appointing a chief executive and providing support and guidance to senior management;
(ii) ensuring that a clear strategic direction and policies have been established by management and monitoring their implementation;
(iii) ensuring that there are appropriate budgets in place to support the corporate direction; and
(iv) reporting to shareholders and ensuring regulatory compliance.

Current structures for all DFIs in the study indicate that the board structures follow a similar pattern. They are made up predominantly of government representatives, usually from agriculture, fisheries, trade/industry/commerce, and tourism, with the senior finance officer chairing the board. The size of the boards ranges from six to 10 (Table 4.6). Since the government representatives generally reflect the wishes of the 100- percent shareholder (the government) rather than the broader interests of the business community and civil society,

Table 4.6

Characteristics of Development Bank Boards

	DBK	DBS	DBSI	FDB	RDBPNG	TDB
Members	6	8	9	8	10	6
Public Sector Members	5	4	Members all have political connections	2		4
Private Sector Members	1	4		6		2
Chair	Secretary for Finance	Secretary for Finance		[a]	[b]	Minister of Finance
Means of Appointment	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance	Approval by Minister of Finance
Reporting to Central Bank	No Central Bank Reports to Min of Finance	Formally Reporting to CBS	No reporting	Informal	Informal	Informal

a. The FDB Board of Directors was dismissed by the Government in early 2000.
b. Prior to the merger with the Pacific Finance the chair was the Minister of Finance. At the time of writing this report, the decision regarding the future of the board had still to be determined.
Source: DFIS.

more private sector representation and expertise are needed. In a review of the TDB, for example, it was suggested that there should be a change in the mix of nonexecutive directors on the board from three private sector representatives to four, along with two Government representatives.

The respective legislative acts establishing each DFI allow for the appointment of the board and the chairperson to be at the discretion of a minister, usually the minister of finance. No performance criteria are set down, and the removal of a board or board member is at the discretion of the same minister. The Government of the Fiji Islands, for example, unilaterally removed directors of the Fiji Development Bank in 2000 without any due process. Legislative amendments are needed to make performance the sole criterion by which the board is judged.

The boards of DFIs have fallen well short of any reasonable performance measure. They have not ensured that proper monitoring and control procedures are in place, so that the true position of the institution often does not become known until its financial position has deteriorated to the point of crisis or insolvency. For example, as mentioned, the RDBPNG incurred a 23-million kina loss in 1998, largely resulting from the need to make extra provisions for bad and doubtful loans. Yet the 1998 Annual Report was still not available in February 2000. The board was not carrying out the key roles of compliance and reporting to shareholders.

Such poor board performance in part reflects constraints on board members' ability to fulfill their responsibilities. Evidence suggests that given the demands of their primary portfolios, it is often difficult for senior public servants to maintain an effective meeting schedule. There is also the perennial issue of political pressure on development banks to lend directly to the government's priority areas. With strong government representation on boards, it is extremely difficult for management to resist such pressure.

Considerable attention needs to be paid to improving the effectiveness of boards. There is a need for stability at the board level, because frequent changes in the composition of boards disrupt institutional development. Proposed actions include

(i) strengthening the legislation covering the DFIs to reduce the power of ministers to intervene on any grounds other than performance;
(ii) strengthening the provisions regarding appointment and dismissal of directors so as to reduce volatility;
(iii) reinforcing provisions for nonattendance to allow for stronger sanctions in the event of regular nonattendance by board members; and
(iv) increasing the level of private sector and banking experience on the boards to permit greater diversity of input into decision making.

The importance of strong governance procedures cannot be emphasized enough. Without these, there will be a tendency for any institutional strengthening to be negated.

DFIs and Strategic Planning

The capacity of DFIs to undertake strategic planning varies, with DFIs in the Fiji Islands and PNG having relatively strong planning processes. In recent years, DBS and TDB have both also developed strategic plans. It would be useful to develop some best practice principles, based on institutions in the region rather than international institutions whose performance bears little comparison with DFIs in PDMCs. In either case, strategic plans should be developed and owned by those who will be responsible for their implementation, and should be driven by the chief executives of each DFI.

Many of the problems associated with lack of disclosure and provisioning are related to inadequate management information systems. Loan officers are often not aware that a borrower has defaulted on a payment until several weeks after the due date. This makes the collection of outstanding debt very difficult, as many small businesses do not have sufficient discretionary cash flow to make up the arrears. The earlier a debt is followed up, the more likely it is that a full recovery can be made. The development of best practices for loan systems would permit some standardization of reporting to boards on the critical information that boards need. It would also address some issues relating to standard policies and procedures: in some DFIs, there are at present no formal policies and procedures; while in others, policies and procedures lack sufficient detail to be useful for effective management.

All DFIs have, at one time or another, experienced problems with their debt management and collections. This has been due to the lack of clear policies and procedures and to the lack of enforcement of the procedures that are in place. Sometimes the level of outstanding loans reaches the point where the solvency of the institution is threatened; without significant capital injections, it is difficult to see how it will recover. For example, RDBPNG's bad and doubtful loans stood at 76 percent of the total loan portfolio in 1998. This is close to the level of bad and doubtful loans in the DBV in 1997, when it was decided to merge it with NBV. The Vanuatu Government established a separate Asset Management Unit (AMU) to specialize in collecting the DBV's outstanding loans. The AMU had considerable early successes, and the broad concept of establishing specialist units is being increasingly adopted by the DFIs in the region. However, many PDMCs have kept recovery units as part of DFIs rather than establishing separate AMUs, which have greater autonomy and thus capacity to pursue recovery of bad debts from prominent individuals and businesses.

In summary, governments can consider several strategic options for improving performance of DFIs: (i) privatizing the DFI, by selling its shares to a private sector organization; (ii) integrating it into another organization; (iii) contracting out the management of the DFI; and (iv) developing strategic alliances.

Privatization. As discussed above, the privatization option does not appear to be a realistic one for development banks. It is difficult to see how a DFI in a small and narrowly based economy could be an attractive investment to private investors today, given the high-risk and low-return quality of their loans. In addition, no private sector investor would be attracted to making decisions about representation in rural areas. Commercial banks might be attracted to specific target clients or projects, or where there is a history of consistent levels of profitability, but to increase the returns of DFIs would probably require significant restructuring, which may not be a politically popular choice.

Merging with another institution. This is another option to which there is some logic, particularly if a banking institution were the other partner: it would bring some professional banking experience to the management of the development bank. However, the experience of Vanuatu is not encouraging: development banking stopped when DBV was merged with NBV. NBV had to focus on consolidating its financial position following bankruptcy, and was unfamiliar with the nature and benefits of development banking. In general, where commercial bankers are responsible for administering loan funds for development lending, they will naturally look to their background training in commercial banking to support their decision making; there will be a tendency to direct the better loans towards the commercial banking arm rather than leaving them with the development bank operations, thereby exacerbating the weaknesses in the portfolio. This raises the matter of the need for specialist training in development lending and the encouragement of institutions that can provide it.

Apart from the difficulties associated with holding loans with a high risk of nonpayment, there is the relatively high cost of maintaining branch networks to service rural and outlying areas. While there is some logic to working with agencies such as credit unions and other MFIs to deliver services to rural and outlying areas, in general these agency networks are themselves not sufficiently well developed. This limits their capabilities to provide viable services, particularly financially sensitive services such as banking services. It may well be that funding to assist the strengthening of credit union movements and other MFIs could offer some potential for addressing the key problem of the cost of distribution.

Contracting out DFI management. This option involves the same issues as merging. A management group that was charged with running the DFI would in all probability also seek to close down unprofitable representation points. Given the nature of DFI operations, it is also likely that the cost of obtaining professional managers would be prohibitive.

Developing strategic alliances. Another option for DFIs is to develop strategic alliances with key organizations involved in providing services to their target markets, such as credit unions and provincial cooperatives; or to establish alliances with manufacturers of primary goods such as foodstuffs, which are very close to their growers and which could best determine the credibility of a particular grower. By entering into wholesale funding arrangements with manufacturers, DFIs could minimize the client risk element of the lending assessment process. This arrangement could also enhance DFIs' relationships with manufacturers. The choice of the right manufacturer would be crucial to the success of this particular strategy. Strategic alliances with commercial banks also offer opportunities for expanding the range of services to development bank clients. DFIs could also explore the possibility of entering into arrangements with organizations that already have representation points, such as credit unions or provincial cooperatives, as alternatives to maintaining rural networks. In the long term, arrangements with other institutions could be more sustainable than retaining branch networks.

These options have been considered from a general perspective. Each PDMC government would need to make an assessment with reference to its own DFI.

DFIs and Training

In all PDMCs there is a continuing demand for upgrading staff skills, and a need to ensure that such skill development is undertaken to provide a long-term sustainable basis for ongoing capacity building. The types of training being undertaken seem to be consistent across DFIs, the main areas being credit, project, and loan appraisal, with less attention being placed on areas such as management development and business and market planning. The focus of most training is on the technical aspects of loan appraisal, with very little attention given to the development of interpersonal skills. Interpersonal skills are as important as the technical component of a loan officer's activities, as it is often the breakdown in communications or misunderstandings with clients that can aggravate deteriorating loan positions. There is also a need for greater attention to the development of managers. Management skills and understanding are very poor. In general a more professional approach to training is long overdue.

There is a lack of specialized facilities for staff training in PDMCs. There is also considerable variability in training when a number of different training providers are used. If there is to be an overall improvement in skills in the region, then a different approach to training is needed. This issue could be examined in the broader context of building a regional network of DFIs. Currently there is limited cooperation between the DFIs in the region, although there is an Association of Development Finance Institutions in the Pacific based in Suva, Fiji Islands, which acts as a secretariat for the DFIs in the region. Its principal activity is the organization and administration of the ADFIP annual conference, which is held on a rotating basis around the various PDMCs of the region.

Box 4.1

Best Practice for DFIs

PDMCs need to promote good corporate governance through providing greater independence for DFI boards from potential political intervention by governments in decision making, through strengthening company law provisions on the responsibilities of the board of directors and management, and through appropriate prudential supervision by central banks. Internal and external auditing should focus on strengthening risk assessment.

PDMCs need to develop the capability for strategic planning and options along with adequate management information systems, which should be owned and driven by the CEO of each DFI. PDMCs also need to commit additional resources to training for DFIs, including strengthening professional management and business development skills.

PDMCs should establish best practices for DFIs for

(i) standards of disclosure;
(ii) minimum capital adequacy ratios;
(iii) strengthening legislation;
(iv) market-determined interest rate policies;
(v) accrued interest policies;
(vi) provisioning policies;
(vii) lending policies, including policies on concentration of risk, connected lending, and maximums for any one organization or individual; and
(viii) harmonizing training requirements through the region.

However, there has been no attempt by the institutions to formulate any coherent regional approach to DFIs, nor does any consideration appear to have been given to determining if there are potential synergies to be obtained by stronger cooperation or a sharing of resources.

NATIONAL PROVIDENT FUNDS

NPFs were set up in most PDMCs as statutory corporations, to provide pensions for employees and civil servants and to mobilize domestic savings for national development. Members' contributions vary across PDMCs from 5 to 10 percent of wages and salaries and are matched by employers' contributions. All the selected PDMCs except Tonga have such a fund. In PNG, the funds are split: the Public Officers' Superannuation Fund is for civil servants and the National Provident Fund for private sector workers. In PNG, private sector employers are permitted to opt out of the fund and some larger employers have done so. In Tonga, the Government established a Civil Service Pension Fund in 1999 to provide funded pensions for the public sector; the scheme may be extended to the private sector in the medium or longer term.

The boards of NPFs are usually tripartite, consisting of two representatives of the public service, two representatives of employers, and two representatives of employees. The power to make decisions is generally vested in the board, though most funds were set up under their own acts, which state what kinds of investments are allowed. In Kiribati, the act does not allow for lending to local businesses, and the only instruments for investment are offshore stocks and bonds and local buildings. In other PDMCs (except Vanuatu), NPFs are permitted to invest only a small percentage of their portfolios offshore. In some PDMCs, NPFs have large holdings of government bonds (the Fiji Islands, PNG, Solomon Islands).

The performance of NPFs has varied widely across PDMCs. Poor governance has been a problem for some. In the Fiji Islands, FNPF has been successful in ensuring that members (residents who have been employed for at least some of their working life) have assets to provide a degree of security when they retire. Kiribati Provident Fund has been highly successful, with returns on members' investments of 11 percent per year in the 1990s, and has assets to pay members a lump sum when they retire. Samoa's National Provident Fund has been more conservative, with average returns of around 5 percent per year, and also has assets to pay members lump sums when they retire. The provident funds in the other PDMCs have been much less successful. In PNG, Solomon Islands, and Vanuatu, the assets of members have been badly invested, so that the rate of return to members is very low (and may even be negative). In Vanuatu, following a 1998 riot related to badly invested NPF funds, the Government paid monies out to all the members. In PNG, an actuarial review of the National Provident Fund and the Public Officers Superannuation Fund is to be undertaken, following on the series of poor investment decisions that have resulted in a serious decline in the underlying asset value of the funds.

The degree to which members can access their funds varies across PDMCs. In some, members can borrow from funds against their contributions; in others they can use funds as collateral to purchase a house or land. It is entirely consistent with the objective of the schemes to allow members to withdraw funds (or to borrow against them) to provide themselves with housing, education, etc. It is also considered desirable to develop an investment habit. The majority of funds allow members to withdraw lump sums on retirement or earlier. These lump sums are intended to give members the capital to start small businesses, although anecdotal evidence suggests that the funds are being spent largely on consumer goods or to meet family obligations.

Although the FNPF has been successful in terms of return to members and is generally meeting its objective of providing retirement income for members, it dominates the capital market in the Fiji Islands to an undesirable extent. FNPF is the main buyer of Government and RBF bills and bonds, which it holds to maturity. It has also enabled the Government to dispose of the bulk of its holdings in Amalgamated Telecom Holdings Limited without using the local stock exchange. The commercial banks also allege that the size of FNPF's cash holdings with them results in huge swings in bank liquidity. This causes them regulatory problems with parent companies because of country risk. It also necessitates their holding excess margins in case the funds are suddenly withdrawn.

The major difficulty is to provide competition for NPFs in the region. Competition in the provision of investment products would provide more investment options and lead to a more educated investor population. Each investment provider would be motivated to tell the public about its product, thus creating wider dissemination of the concept of investing; media organs could fill space quite cheaply by commenting on the different products and generating tables of comparison; and the results achieved by different investment organizations could be compared.

In spite of the record of mismanagement and the inability of some NPFs to meet objectives, all governments in the region are committed to the concept of a national provident fund. It is crucial that steps be taken to ensure that these operate to the advantage of their members.

Box 4.2

Best Practice for NPFs

PDMC governments need to

- ensure the independence of NPF boards from political interference, especially in regard to holding of government debt (sometimes at below-market rates);
- appoint board members and managers on the basis of professional competence and personal integrity;
- ensure accountability of boards and managements to members through timely and clear reporting and annual meetings;
- focus on professional investment management for the benefit of members, as opposed to expenditure on NPF offices and staff;
- Allow for overseas investment of funds where this is currently not permitted, and allow for greater overseas investment where this is restricted; and
- Place supervision of NPFs under the central bank where this is not currently the case.

Development of Financial Markets

5

A supply of bonds and equities is necessary for the development of a wide range of savings and investment opportunities. Bonds issued by governments generally provide risk-free investment and thus establish a benchmark for yield versus risk. Government bonds also provide long-term investment opportunities that are essential for the development of life insurance and pension funds. Long-term risk-free debt enables the suppliers of these products to match maturities with investments. A supply of equities provides risk investments that should enable the investor to enjoy capital growth in line with economic growth.

MONEY AND BOND MARKETS

In the early stages of development, central banks usually use direct instruments of monetary policy to control the balance sheets of commercial banks, generally interest rate and credit controls. When countries move to a market-based system, central banks rely on indirect instruments to influence the level of bank reserves through financial markets. The main indirect instruments are reserve requirements, lending facilities such as rediscount facilities, and open market operations.

PDMCs have made considerable progress in the 1990s in moving from direct to indirect instruments of monetary policy. First, all PDMCs have liberalized interest rates. Second, since the late 1980s, all PDMCs have at different times introduced open market-type operations: in most cases, central bank securities are used for auctions, while some central banks also auction Treasury bills and bonds.[4] These operations have been supplemented by liquid asset or statutory reserve requirements (Table 4.1).

However, illiquid interbank markets and insufficient central bank earnings have hindered the full development of money markets in PDMCs. Although indirect instruments have been partly successful in restraining growth in monetary aggregates, some PDMCs (Fiji Islands and Solomon Islands) have had to increase liquid asset reserve requirements to high levels in order to prevent rapid declines in foreign reserves. Others, for example Tonga, have had to use moral suasion and resort to credit ceilings from time to time, because funds were lacking to pay the interest bill on securities. Because of the high excess liquidity in some banking systems, there has been little use of discount windows and lending facilities for banks.

In most PDMCs, there is a shortage of instruments and markets for them have not developed; most do not have much commercial paper or negotiable certificates of deposit in their money markets. The combination of high levels of liquidity and provident funds that hold onto both short-term central bank instruments and short- and long-term government instruments has led to a lack of secondary trading in these instruments, and has prevented the development of proper yield curves through the issuance of primary instruments and secondary market trading.

The lack of active secondary markets in either bonds or money market instruments in any of the PDMCs can generally be attributed to

(i) lack of a critical mass of fungible paper with different maturities;

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4 Bonds are defined as instruments with an initial maturity of more than one year. Money market instruments (central bank bills and treasury bills) may have a maturity that ranges from one day to one year. Money market instruments are generally issued on a discount basis, whereas bonds are normally issued at par value, with interest paid annually, semiannually, or quarterly.

(ii) excess liquidity in the banking sector, which means that banks do not need to minimize their asset ratios;
(iii) excess demand, particularly in the Fiji Islands from the FNPF, but also in other PDMCs[5]; and
(iv) interest rates that do not properly reflect the repayment risk.

Interest rates in the PDMCs (other than PNG) are very low compared with those in developed markets; investment in these bonds is thus unattractive to organizations that have other investment options. There is no cross border cooperation, although in general there are no restrictions on foreign buyers of bonds.

In developed markets, the commercial banks normally own a clearinghouse that provides an automated system for recording and clearing checks. They may also operate a high value interbank payment system. Central banks in many developed countries have also developed or are developing real time gross settlement systems that enable banks to settle with each other, across their accounts at the central bank, on an immediate basis. This system is frequently linked with bond settlement systems, normally operated by the central bank, and in some cases with the equity settlement system.

None of the PDMCs has implemented any automation in the payments process. Checks are cleared manually (listed and lodged at the clearing bank) and balances are reported physically to the relevant central bank. No PDMC has a high value payments network (although some banks will provide special clearance at a bank for a fee) or any real time gross settlement across accounts at the central bank. ATMs are being introduced into the PDMCs, but they generally operate on different systems and are not compatible.

[5] In Fiji Islands, bonds and bills are listed on the Suva Stock Exchange, but not actively traded.

Table 5.1

Issues of Bonds, Treasury Bills, and Central Bank Bills

	Bonds		Money Market Instruments		Other
	Government Bonds	Other Bonds Guaranteed by Government	Treasury Bills	Central Bank Bills	
Fiji Islands	Reserve Bank of Fiji (RBF) auctions bonds on a monthly basis.	Government-guaranteed Bonds are issued by Fiji Broadcasting Commission, FDB, Fiji Electricity Authority, Fiji Pine Limited, Housing Authority.	No Treasury bills are issued. However, the Government does issue some 14-day Treasury bonds.	The RBF auctions Reserve Bank Notes, with maturities up to six months, on a weekly basis.	FDB and the Credit Corporation issue promissory notes.
Papua New Guinea	There is some Government debt in issue, but no new bonds have been issued since 1993/4.	RDBPNG issued one bond in the late 1980s; this will mature in 2001.	Treasury bills with maturities of 28, 91, and 182 days are auctioned on a weekly basis. Kina notes with a maturity of 7 days are also issued.	BPNG does not issue its own bills.	Some companies issue bonds to pension funds.
Samoa	None	None	None	The Central Bank of Samoa (CBS) issues 91- and 182-day bills on a weekly basis.	

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Table 5.1 (cont.)

Issues of Bonds, Treasury Bills, and Central Bank Bills

	Bonds	Money Market Instruments			Other
	Government Bonds	**Other Bonds Guaranteed by Government**	**Treasury Bills**	**Central Bank Bills**	
Solomon Islands	In 1995, the Government defaulted on its bonds. The outstanding bonds were restructured in 1998. These bonds are being rolled over as they fall due.	None	Treasury bills, with maturities up to 182 days, are auctioned on a weekly basis.	CBSI issues such bills on an irregular basis to absorb excess bank liquidity.	
Tonga	Medium-term bonds are issued on an "as needed"' basis.	TBD issues bonds when it needs funds and when it can obtain Government approval.	None	Short-term notes (mainly 30 days) are auctioned on a weekly basis.	TDB issues short-term notes every two or three months.
Vanuatu	The bonds currently in issue (Vt30 million) are being rolled over.	None	None	Reserve Bank of Vanuatu issues notes with maturities of 28 and 92 days.	

Source: Central banks.

Box 5.1
Best Practice for Money and Bond Markets

Governments of PDMCs should attempt to issue medium- to long-term domestic currency bonds to deepen capital markets; such longer-term instruments could provide a viable alternative to short-term capital flows and minimize the currency and maturity mismatch. Central banks should attempt to ensure that there is a regular supply of fungible debt instruments of varying maturities to facilitate the development of a lengthening yield curve.

EQUITY AND DEBT FUNDING

An assessment of the financing needs of small and medium-sized businesses in PDMCs concluded that there were some unmet financing needs above US$100,000, and considerable unmet need for equity and debt financing between US$10,000 and US$100,000 (Admiralty Group Partnership 1998). However, the assessment did not make the important distinction between the need for development financing and the opportunity for venture capital funds to make profitable investments. Many development projects need to be funded through soft loans, grants, and technical assistance, with the objective of creating infrastructure and, probably, employment. These projects do not anticipate a substantial financial return within a five- to seven-year timeframe. On the other hand, venture capital should only be provided on the basis that within a five- to seven-year period the investments, as a whole, will provide a good return; in developed markets, that would normally be defined as a return above 25–30 percent compound growth per year.

In most PDMCs, few investments will be capable of meeting this criterion for return. The reasons for a difficult investment climate include

(i) sluggish economic growth;
(ii) the land tenure issue;
(iii) cultural issues that inhibit entrepreneurial drive, make it difficult to recruit and retain good staff, and, through dissipation of the assets, often lead to the failure of businesses run by indigenous peoples;
(iv) small, scattered populations, which make import substitution difficult;
(v) the remoteness of the PDMCs, which makes production for export expensive;
(vi) governance and management issues, which have subverted some of the more promising ventures;
(vii) social and security problems, particularly in Solomon Islands and PNG, which add to costs and make investment by overseas organizations unattractive; and
(viii) a lack of management expertise among many of the indigenous peoples, allied with difficulties in bringing in foreign capital and management.

The above constraints and issues make the provision of venture capital a highly risky operation. In many cases, it will be impossible to justify investment, and it may be better to recognize that the development of infrastructure in PDMCs is better achieved by the provision of well-administered grants and technical assistance. The experiences of the South Pacific Project Facility (SPPF) and the Kula Fund[6] are instructive in this respect. Both receive many requests for assistance/funding, of which only a very small number turn into feasible investment opportunities.

Sources of equity and debt finance

Sources of equity and debt finance for organizations that are starting or expanding productive enterprises in PDMCs are (i) family and friends; (ii) commercial banks; (iii) development banks; (iv) other domestic providers; (v) the

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[6] For more on these two institutions, see *vii./viii. Regional/International Funding Agencies* below.

general public who have bought securities made available through a public offering; (vi) foreign direct investment; (vii) regional sources; and (viii) various international funding agencies.

Family and Friends. In PDMCs many urban businesses are family-run by people who may be long-term residents or even second- or third-generation citizens, but who are not generally one of the indigenous peoples. In Fiji Islands, the industrial and commercial businesses are frequently run by Indians, and in most of the other places they are run by Chinese or Malays. These businesses have often grown through financing from family, friends, remittances from overseas members of the extended family, and retained earnings; they tend to be highly secretive. The Kula Fund has tried to invest in some of these businesses, as they are good quality, but discussions have not reached a satisfactory conclusion, because the owners/managers did not want outside interference or to have to provide information to third parties. With these businesses, when the original sponsor becomes too old to run the business, unless there is a family member to take over, the family would rather close the business down than bring in either outside management or outside investors. Banks and accountants confirm that external investment in these businesses would be difficult: their financial records are often poor or nonexistent, and the businesses keep multiple sets of accounts.

In Vanuatu, there is no income or corporation tax, because of the wish to develop an offshore financial center. There are thus virtually no incentives for owners of enterprises to incorporate. In other PDMCs, most enterprises are operated as private companies. The companies acts require all companies to make annual returns and generally to file audited accounts. However, in many PDMCs, private companies can opt out of this requirement with the authority of their shareholders; in general, minimum filing requirements have not been enforced.

The reliance on finance from family and friends and the reluctance to bring in outside management means that the growth of productive companies is limited by their internal resources, in both money and management expertise. It would be better if successful companies could be encouraged to be both more professional and more dynamic. The development of domestic capital markets and a regional stock exchange are clearly key parts of this process.

Commercial Banks. In most PDMCs, the commercial banks are highly liquid and have funds to lend, but cannot lend them all due to a lack of bankable propositions. Sometimes they are also unable to lend because of the need to maintain a portfolio that is not unduly weighted by one industry. There is therefore a limit on the number of investments that can be made in, for example, tourist projects. In general, when lending to businesses, commercial banks will require a combination of the following:

a) security, in the form of land, capital goods, or perhaps a government guarantee;
b) a company track record with good financial accounts;
c) a management track record by the principals; and
d) a relatively low risk, which means they will tend to avoid investments in agriculture, fisheries, and other industries that are viewed as inherently risky, and will rarely be involved in "start-ups".

In most cases, the commercial banks are governed by country, industry, and project risk criteria laid down in Australia or the USA. Their lending policies are thus similar to those of commercial banks in developed markets: they lend to long-term company management, are extremely risk averse, and try to take collateral whenever possible. In PDMCs, the lack of freehold or leasehold land that can be used as security for loans makes the taking of collateral more difficult and thus restricts banks' lending opportunities. Commercial banks have specific problems in lending because local companies and potential borrowers lack management experience and knowledge of how to develop business plans. Commercial banks lend to projects funded by SPPF, which often provides crucial input into the business plan. At present, none of the commercial banks makes equity investments in the PDMCs.

Development Banks. As discussed in the previous chapter, development banks have been important sources of finance for development projects, but have not always been successful in using their funds for the development of sustainable businesses. It is important to reiterate that if the development banks become more commercially oriented, there will be a financing gap in rural development. If governments are to use funds to facilitate rural development, they will need to channel those funds through an organization with good corporate governance, clear objectives, and professional management. Without these attributes, the desired infrastructure development in the rural areas will not take place.

Other Domestic Providers. NPFs do not provide venture capital for domestic industries, nor should they be expected to do so. They are, in most cases, lenders of last resort to governments, but not providers of significant investment funds to the private sector. Tonga has a trust fund, but it is largely invested overseas and does not provide funds for domestic private sector development (although it has been a source of funds for public investment projects).

Some NBFIs in the Fiji Islands provide funds for private sector development. These include Colonial Life Fiji Ltd and Colonial First State Investments, Fijian Holdings Limited, and Unit Trust of Fiji.

Colonial Life Fiji Ltd. This branch of a local conglomerate has investments in all the companies listed on the Suva Stock Exchange (SSE) and in some unlisted securities. Colonial First State Investments has a minimum investment of F$250,000 (approximately US$125,000) in companies listed on the SSE; it takes a seat on the boards of companies it invests in, and in this way can add management expertise. It has recently established three unit trusts. These are open-ended funds, which will invest in liquid assets. Colonial First State Investments also invests in blue chip long-term investments; however, it is not a venture capital fund, and will therefore generally invest only in companies with a good record of profitable trading.

Fijian Holdings Limited. This is an investment company, established in November 1994 to enhance the participation of indigenous Fijians in the economy. Ownership of shares is limited to indigenous Fijians and an individual's holding is limited to 100,000 shares. Its investment policy is generally risk averse, and focuses on companies with records of profits and dividend payments. Fijian Holdings has a window for green-field projects, but this is capped at F$2 million (less than 3 percent of 1999 net assets of F$73 million) and is fully utilized. Its main responsibility is to its shareholders and it proactively seeks to make investments in successful companies. As a known source of finance, they are often a first stop for companies seeking investments, and are often viewed as the natural partner for overseas investors. In general, an investment by Fijian Holdings is seen as a good indicator of investment potential by other investors.

Unit Trust of Fiji. Established 21 years ago by FDB, the Unit Trust of Fiji separated from FDB in 1997, although it is still Government-owned. The trust is open-ended and aimed primarily at retail investors. Its investment policy is risk averse, with considerable emphasis on liquidity; and it invests primarily in listed securities. Few investment opportunities meet the trust's requirements; however, if more listed securities were available, it would adopt a higher profile in trying to attract investors. No other PDMC in the study had institutional providers of funds for private sector development.

General Public. In all the PDMCs in the study, some companies had obtained funds through a public offering. In all cases, except Tonga, companies making a public offering are required to register a prospectus. In Samoa, the Solomon Islands, and Vanuatu, the prospectus must be registered with the Registrar of Companies. In PNG, the prospectus must now be registered with the Securities Commission of PNG (SCPNG), which has indicated that, in the future, it would be unlikely to register a prospectus unless the company planned to list on the Port Moresby Stock Exchange (POMSoX). In the Fiji Islands, the prospectus requires the prior approval of the Capital Market Development Authority (CMDA) before a company can make a public offer.

Without a stock exchange, investors would find themselves locked into their investments and are thus unwilling, except in special cases, to provide funds. Public issuance has therefore been a little-used source of finance.

Foreign Direct Investment. All the PDMCs in the study except Samoa have an ambivalent attitude to foreign investment. PDMCs follow universal practice in requiring organizations wishing to do business to obtain a license, but draw distinctions between wholly domestic companies and companies with some foreign investment. The imposition of requirements for domestic control of companies in certain industries, such as Tonga's requirement that funds put in by foreign partners must be matched by domestic investors, leads to the companies' having small equity bases relative to the size of business undertaken. This can lead to very high gearing and lack of working capital for firms in the affected industries. Political uncertainly in the event of a change of ruling party is also a discouragement for foreign investment in PDMCs. One government may welcome foreign investment, whereas the next may take a very different view. There are also other restrictions on foreign investments in the PDMCs (Table 5.2).

Regional/International Funding Agencies. In almost all PDMCs, governments are looking to reduce their involvement in the economy by disposing of loss-making state-owned enterprises. They will, in most cases, need foreign partners, as there is insufficient capital and expertise within most PDMCs to buy and manage these enterprises. This will be difficult to achieve, and governments will not get value for any concessions, if the general attitude to foreign investment is restrictive and ambivalent. Restrictions increase the perceived risk of doing business in a particular country and lead to a lack of investors for the ailing industries.

There have been a number of attempts by international aid agencies to provide finance for private sector development through government or quasi-government organizations, such as development banks or small business centers. These attempts generally have been unsuccessful: either the business has failed totally or the fund providers have not received the level of return that was anticipated. Organizations structured as banks or lending institutions are not the best equipped to identify or manage opportunities for equity investment; in addition, a mixture of equity and debt lent through one monitoring agency can easily lead to conflicts of interest. Once a business begins to go wrong, the agency has the problem of either trying to force repayment of the debt, by providing more equity, or calling in the debt and losing the equity. This route is not recommended for the provision of equity venture capital.

SPPF. SPPF was founded in 1990 by the International Finance Corporation (IFC) and is funded by IFC and the governments of Japan, Australia, New Zealand, Fiji Islands, Samoa, and Kiribati. Its role is to provide business advice to private sector companies in the Pacific, including help with market research, developing business plans, and the sourcing of finance. It has access to funds from IFC for debt or equity investment in some cases. These activities generally lead to some participation in the formulation of the project and product development. The target clientele are sound domestic sponsors who have a track record but lack the experience to put together a business plan. SPPF originally provided services free of charge, but now charges a US$100 application fee and then a completion fee of 1–2 percent of the funds raised. The funds received partly meet their costs but are also regarded as a commitment test of the sponsors.

Once a business plan is completed, SPPF assists the sponsor with finding financing. The preferred approach is to find it in the market in which the company is operating. SPPF, with the company, approaches the local development bank and commercial banks, and in nine out of ten cases, these approaches are successful. The unsuccessful approaches are normally the result of the banks' taking policy decisions about not investing in certain industries or because the banks' risk management criteria will not permit further investment in that industry. The banks and NBFIs in the region are all enthusiastic about the contribution being made by SPPF. This is the case in all markets, but the less sophisticated the national environment, the more significant the assistance is seen to be.

Pacific Islands Investment Facility. Where it is not possible to find domestic finance, SPPF will approach the Pacific Islands Investment Facility (PIIF). This is a venture capital facility provided by the IFC. The facility started at US$2 million and

Table 5.2

Current State of Restrictions on Foreign Investment

	Foreign Investors
Fiji Islands	Fiji Trade and Investment Board must vet all incoming investment. The new Government is reportedly very wary about foreign investment and has indicated to some companies that expatriate management should be replaced. Renewal of work permits has, in some cases, proved difficult and the period of renewal has been reduced.
Papua New Guinea	The Investment Promotion Authority is responsible for promoting foreign investment in PNG. Companies that are more than 50-percent owned by foreigners need approval from the authority. Certain activities are reserved for citizens, and either limited or zero foreign investment is permitted in specified industries: e.g., companies that operate service stations and fast-food outlets may have no foreign investors, whereas companies that operate supermarkets may have no more than 49% foreign investment. The Companies Act differentiates between domestic and foreign (or joint venture) companies in terms of fees. The registration fee for a purely domestic company is K115, for a company with one or more foreign investors it is K515. Foreign personnel require work permits, and businesses that employ foreign personnel must submit training and localization plans to demonstrate their commitment to local employment. Some occupations are reserved for citizens.
Samoa	In most industries except fishing, the Government encourages foreign investment. A new Foreign Investment Act is planned; it has been drafted in conjunction with the private sector to ensure that time for approvals is reduced as far as possible and that the opportunities for conflicts of interest between ministries are minimized.
Solomon Islands	The Foreign Investment Board screens foreign investments in accordance with the Foreign Investment Act. Any foreign entity wishing to do business must obtain prior approval from the Board.

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has subsequently been topped up to US$6 million. The terms on which this finance is provided are very flexible, in that both equity and debt are possible. There is neither an official minimum investment level nor a maximum percentage

Table 5.2 (cont.)

Current State of Restrictions on Foreign Investment

	Foreign Investors
	In addition, any significant transfers of ownership must be approved. The screening is more concerned with control than promotion. Some people in the Government are reported as being very nervous about foreign involvement, but others are starting to recognize that foreign investment is needed.
Tonga	Foreign ownership is not encouraged, although the Ministry of Labour, Commerce and Industry is currently reviewing the Foreign Investment Act. Distinctions between domestic and foreign (joint venture) companies have been removed from the new Companies Act, which has made it easier to register a company with some foreign ownership. However, obtaining a license to do business is much more difficult, as Government policy does not permit foreign ownership of businesses concerned with agriculture, fisheries, import/export, retail/wholesale, or "anything that can be done by Tongans". On the other hand, the regulations are administered with some flexibility, so it is not possible to determine which businesses will and which will not receive a license. Work permits for expatriates are also reported to be very difficult to obtain.
Vanuatu	The Ministry of Trade, Tourism and Business Development screens foreign companies and joint ventures that apply for licenses to do business. Domestic companies apply to the Ni-Vanuatu Development Agency. About two years ago, a swing against foreign investment was noted and some foreign investors tried to sell their interests. However, some changes have been made to the act and the economy is becoming more open, although the following criteria must be met before a foreign company can obtain a license: i) more than Vt5 million must be put up by the foreign investor; ii) some local employment must be created; iii) the company must not operate in a restricted industry, for example, telecoms. Obtaining work permits for expatriates is apparently quite difficult.

investment. Any decision depends on the nature of the investment. In practice, the projects generally have a value of around US$500,000; the maximum investment is around 25 percent of the total required, and is made mainly in the form of debt. The decision as to whether or not to approve an investment lies with IFC rather than SPPF.

Debt rather than equity funding is usually provided, because it is easier to administer remotely. Specific reporting obligations and required ratios, for example to prevent excessive dividend distribution, can be built into a lending agreement, and ultimately the loan can be foreclosed if these are not met. With equity investments, there is no way to impose such restrictions, and even if a minority shareholder holds a seat on the board, the ability to force the production of meaningful financial statements, or to control or even influence events, could be very limited. There is also the cost and time factor of attending board meetings and undertaking site visits. Many sponsors prefer debt financing, as they do not wish to share the ownership of assets. To date, PIIF has had no problems with bad debts. However, the lengthy procedures apparently necessary to obtain funds from PIIF are seen, in many places, as a disincentive to trying to obtain them. The investment decisions are made in Washington, and are thus subject to the normal IFC scrutiny.

The availability of finance is not the major problem experienced by the companies assisted by SPPF. However, the existence of a regional venture capital fund would be useful for smaller investments; and additional funding on basically the same terms as PIIF, but with faster, regional decision making, would be a welcome addition to the range of funding options available to SPPF clients.

The Kula Fund. The Kula Fund is a regional venture capital fund operated by the Commonwealth Development Corporation, ADB, IFC, FNPF, EIB, regional governments, and Societe de Promotion et de Participation pour la Cooperation Economique/Proparco. It has offices in the Fiji Islands and PNG and is able to provide both equity investments and loans, but tends to concentrate on the former. It has a minimum investment level of US$200,000 and looks for an annual return of 25–30 percent. The Kula Fund will take only a minority stake but is an active board member, has a regional scope, and has investments in the Fiji Islands and PNG. The main problems for the Kula Fund are that potential investments in the smaller PDMCs either fall below the Kula minimum or do not offer the necessary level of return.

The Kontiki Fund. The Kontiki Fund Limited is an investment company, incorporated in 1998 in the Cook Islands, whose purpose is to invest in companies and businesses located in, or connected with, the Pacific islands. The principal objective of the fund is to achieve above-average, long-term capital growth for its investors. This is the only fund of this type that has been identified.

There are many international sources of investment that might seem available to the private sector within the PDMCs, as they are to other developing countries. However, these sources of finance are often tied to joint ventures with nationals from specific countries, have minimum levels of investment in dollar terms and maximum levels in percentage terms, and have funding terms that may be difficult and lengthy to negotiate. In general, these funds are not readily available.

LEGAL AND REGULATORY FRAMEWORK

Company law establishes the responsibilities of directors and the basic registration and filing requirements for companies. Each of the PDMCs has a companies act, under which their companies are incorporated. These acts set out the basic responsibilities of directors. In addition, each PDMC has a Registrar of Companies, who is responsible for registering companies and monitoring their compliance with the requirements of the companies act. The status of these measures in the six PDMCs in the study (not Kiribati) is shown in table 5.3.

A securities regulator, in addition to overseeing public issues by companies, is responsible for overseeing intermediaries and exchanges. Oversight involves licensing, which allows the organization to operate; monitoring, on an ongoing basis, to ensure that intermediaries have sufficient capital to meet their current and potential obligations; and monitoring, on an ongoing basis, to ensure that the investor is being protected from illegal or unfair practices, and that intermediaries are placing the interests of investors before their own interests.

Table 5.3
Current Status of Companies Acts and Registrars of Companies

	Companies Act	Registrar of Companies
Fiji Islands	Companies Act The Companies Act is being reviewed under the auspices of the Law Reform Commission.	Registrar of Companies The current status is not known. However, it was not possible for the registrar to provide a list of public companies for the SSE, when such a list was requested in 1998.
Papua New Guinea	A new Companies Act has recently been passed. It is based on the New Zealand act.	A system for recording the registration of companies is in place, and the Registrar is beginning to chase outstanding returns. The situation is improving.
Samoa	A new Companies Bill 2000 was approved by Cabinet in mid-2001.	The Companies Act requires the filing of annual accounts. There is a register of domestic and overseas companies operating in Samoa.
Solomon Islands	The Companies Act dates from 1961 and at present is under review by a representative committee.	The Registrar of Companies does not have an automated system and is understaffed; staff lack training and experience.
Tonga	A new Companies Act has recently been passed, modeled on the New Zealand act. However, practitioners have some problems with some provisions of the act; the Government is considering changes to it.	Compliance with the new act, which requires all companies to reregister, will be monitored by the Ministry of Labour, Commerce and Industry. The New Zealand Government is assisting by providing software and training for the team of inspectors.
Vanuatu	There is a Companies Act 1988, which was amended in 1990, 1992, 1993, 1997, and 2000.	Organizations wishing to do business in Vanuatu must register with the Financial Services Commission either as a business name or as a public or private company. All companies must make an annual return and companies with a turnover of more than Vt20 million must file audited accounts.

In the Fiji Islands, the Capital Market Development Act 1996 established the CMDA. It is fully funded by the Government, but the board includes representatives of the private sector. The broad purpose of the authority is "to develop an efficient and thriving capital market in Fiji and to develop and regulate the activities of the various market participants". CMDA has issued a wide range of regulations and rules, as permitted and required by the act. The operation of the act and the regulations were subject to review in 2000 and some major changes were proposed. These included

(i) separation between the owners of the exchange and organizations using the exchange, in line with modern international practice;
(ii) the granting to CMDA of the power to approve all public offers and companies that list their shares;
(iii) the introduction of new regulations relating to prospectus requirements, takeovers, and mergers; and
(iv) introduction of a new Managed Investments Act and associated regulations.

In PNG, the Securities Act of 1997 established the SCPNG, with responsibility for licensing stockbrokers and stock exchanges, regulating the public issue of securities, and regulating takeovers and mergers. Under the act, the chairman of the SCPNG board reports to the Minister of Commerce and Industry. At present, however, the commission forms part of the Investment Promotion Authority, and has neither an independent source of funding nor an independent board; commission staff members also have departmental responsibilities within the authority. This is not in accordance with sound practice; SCPNG should have an independent board, independent budget, and full-time staff.

There is an urgent need for training and institutional strengthening within the SCPNG. The relationship between regulators and self-regulatory bodies is a complex one and needs well-trained and experienced people on both sides. At present, POMSoX has an experienced chief executive and a board that is very concerned about the maintenance of standards and independence, but there is no guarantee that this situation will continue indefinitely. The SCPNG needs to use this period for training and for gaining knowledge and experience.

In Vanuatu, the Prevention of Fraud Act requires dealers in securities to apply for a license to the Ministry of Finance through the Financial Services Commission. There is no securities regulation in Samoa, the Solomon Islands, or Tonga.

Box 5.2
Best Practice for the Development of Capital Markets

PDMCs should ensure that they have modern, simple companies acts and efficient mechanisms for registering companies and monitoring their compliance with their ongoing filing obligations.

Regulators should ensure that securities firms have strong internal controls and compliance procedures in place. Investor protection should be provided through effective surveillance systems established in stock exchanges, and through independent surveillance by regulators.

PDMCs should promote the development of fair, orderly, and efficient capital markets, governed by strict standards of operational safety and efficiency, in which securities can be bought and sold by foreign as well as domestic investors at fair transaction costs. Economies need to develop clearance and settlement systems, with centralized securities depositories or registries and guaranteed settlement.

STOCK EXCHANGES

Companies and investors in PDMCs need access to a capital market for a number of reasons. First, in the absence of capital markets, companies are using bank finance for expansion purposes, which is likely to cost more than financing through the issuance of equity. Second, successful domestic businesses could raise capital for expansion through such a market, and could realize some of the value they have built up through listing. Third, without a capital market, foreign investors do not have an exit method available to them, which makes them less willing to invest. A company's ability to make a public offering associated with a listing on a stock exchange or to sell its shares in the secondary market would enable foreign investors to realize some of the value they have built up. Fourth, there is a lack of domestic investment opportunities, high net worth individuals are investing in government bonds and on overseas markets, and PDMCs are missing out on using this capital productively within the domestic economy. Fifth, companies that raise capital domestically are required to pay high dividend rates to compensate investors for the illiquidity of their investment.

The two stock exchanges currently in operation in the PDMCs—SSE and POMSoX—are established in the most developed market and the largest market, respectively. Their operations are summarized in Table 5.4. There seems little likelihood of developing a domestic stock exchange in another PDMC: first, there are few public companies and most of these would be reluctant to list, as they are essentially family companies; changing this attitude will be a slow process. Second, there is no habit of equity investment, and it would take a considerable marketing effort to convince the general public that it is a good thing. Third, there are no indigenous intermediaries, and to try to develop them in the absence of any investors and products would be all but impossible.

It has been suggested that companies in the PDMCs do not need access to a national or regional exchange, as they can list on an existing international exchange. Most developed markets permit foreign companies to list on their exchanges, provided they meet the same listing requirements as the domestic companies. In general, many companies have taken advantage of this. For example, many technology-related companies have listed on Nasdaq; many companies that operate internationally have listings on a number of exchanges, for example the New York Stock Exchange, the London Stock Exchange, and the Tokyo Stock Exchange; and many mining companies are listed on the London, Australian, and South African stock exchanges.

Table 5.4
Ownership, Funding, Listing, Trading, Settlement, and Payments Systems in Stock Exchanges in the Fiji Islands and Papua New Guinea

	POMSoX	SSE
Ownership	Two brokers and the Central Bank. There are only two brokers, who are both owners. POMSoX would like to attract overseas brokers to use the exchange facilities. The relationship between ownership of the exchange company and access to the exchange facilities is not clear.	A combination of private sector and State enterprises. The Act originally envisaged that all owners would be members and all members would be owners. Proposed changes will remove that requirement and provide a separate status for owners and members.
Funding	Original funding by owners plus fees.	A grant from the Government (through the CMDA) plus fees.
Listing	Rules based on the rules of the Australian Stock Exchange (ASX), with minor changes to reflect the smaller size of companies in PNG. The rules envisage the secondary listing of companies that have a primary listing on an overseas exchange, but do not preclude other overseas listed companies. There are nine listed companies. Eight have primary listings on the ASX. The ninth is a Canadian company.	New listing rules were drafted last autumn to integrate with the revised CMD Act and Regulations. These rules will come into effect when the new law is passed. The rules are aimed at listing domestic Fiji companies, although they do not preclude listing companies incorporated overseas. There are nine listed companies. SSE also lists Government bonds and other debt instruments. None of these is listed on any other exchange.
Trading	Trading takes place through an automated trading system. POMSoX has adopted the ASX Business Rules to the extent that they are appropriate to PNG. Detailed volumes were unavailable but they are understood to be similar to those of SSE.	Trading takes place by open outcry during trading sessions that are held three times per week. New business rules were drafted last autumn. These are in process of being brought into effect. Trades are currently averaging about 70 per month.
Settlement	Physical settlement through exchange of share certificates. At present a single registrar is used for all listed companies, but this is not a requirement.	Physical settlement through exchange of share certificates. Companies continue to maintain their own registers.
Payment	Payment is by check.	Payment is by check.

However, such a company listing on an overseas exchange is rarely successful. The cost of compliance with overseas listing requirements is usually high, and it is difficult to raise the interest of investors in the overseas company. In almost all cases, once the initial listing publicity has died down, the volume of trading is very small. In the case of securities issued by companies incorporated in the PDMCs, there is nothing in the rules of the overseas stock exchanges to prevent them from seeking a listing. But the nature of the companies and the ownership restrictions in the PDMCs themselves make this difficult, and it is unlikely to prove a viable route for many companies in the near future: the companies are generally too small to meet the minimum size criteria for listing; the quality of their accounts is often inadequate; the lack of an audit history will generally make the securities ineligible; the number of shares the company is prepared to offer for public ownership is likely to be below the required minimum; the governments of the PDMCs place restrictions on foreign ownership, which will mean that the companies' shares are not freely transferable; and investors in the listing country are unlikely to be aware of, or particularly interested in, the shares of PDMC companies.

Many PDMC investors already take advantage of foreign exchange permissions to invest abroad.[7] This is likely to be an advantage to investors, as they can at present obtain better returns abroad than in the PDMCs. While investors should be encouraged to spread their investments, the overseas investments mean that, first, such funds are not available to support the expansion of business in the PDMCs; and, second, the investor is exposed to exchange rate risk and cannot match investments with obligations.

An alternative to the development of national or regional markets would be to persuade either the Australian Stock Exchange or the New Zealand Stock Exchange to emulate the relationship between the Hong Kong Exchange and the

[7] It is also very likely that some citizens receive funds abroad and leave them and invest them abroad without the permission of the PDMC authorities. This is invariably the case where there are restrictions on acquiring and holding funds in foreign currencies, but the extent of this practice in the PDMCs is not known.

People's Republic of China (PRC) by establishing a Pacific Board. The Hong Kong Exchange developed special listing rules to permit the listing of shares issued by PRC companies; these are known as "H" shares. These rules recognized not only that the country of incorporation of the shares was not Hong Kong, but also that the accounting and corporate governance standards of PRC companies were different from (and inferior to) those of Hong Kong companies. It was nevertheless felt that, on balance, investors should be able to invest in PRC companies, and that the companies would benefit from exposure to the standards prevailing in an established market. However, it should also be noted that, first, Hong Kong investors are familiar with Chinese companies and the Chinese way of doing business; and second, that the "H" share market operated alongside the domestic PRC markets in Shanghai and Shenzhen, which list shares that do not meet the more rigorous "H" share standards.

This proposal is unlikely to be attractive to either of the Australasian exchanges, which are moving toward more of a profit focus and away from the "club" environment. A Pacific Board would likely prove expensive to establish and is unlikely to produce significant profits in the short to medium term. Such a proposal is also unlikely to be welcomed by the Fiji Islands or PNG, both of which have spent monies in developing a national facility. The development of a Pacific Board in Australia or New Zealand would be aimed at the same companies that SSE and POMSoX are trying to attract.

A regional facility could be established either as a single development with a head office and regional offices, with SSE and POMSoX incorporated into this development; or as a network that links the existing exchanges to companies and investors in all the PDMCs. These alternatives can be compared to the development of a central mainframe computer system versus the development of a system that relies on distributed processing. A distributed, networked regional facility could be established that uses Internet technology to link the SSE and POMSoX 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. The advantage of this approach is that no PDMC would need to enact extensive legal changes in order to bring the system into operation: joining the service would not prevent any PDMC from enacting legislation to govern public issues or to offer investment services to the public, or from developing a domestic stock exchange if and when the time came. The development of the trading mechanism would be relatively inexpensive.

An Internet-based trading mechanism would permit the service to be offered through licensed intermediaries in the countries that have enacted the relevant legislation, but it could also be offered directly to investors in the others. An Internet-based trading mechanism would also enable the service to be offered to investors in remote locations, without the need for a physical presence in that location. The front end of the Internet service could be customized and presented as a regional facility to potential investors.

As part of the development of a regional exchange, companies would list on SSE, POMSoX, or other exchanges as they develop. The choice of exchange would depend on the type of company and the requirements of the listing rules. Investors would trade in these companies through an Internet trading mechanism that would allow them to access the relevant market for prices and order execution.

Ultimately, the prospects for successful development of capital markets and stock exchanges in PDMCs depend 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 6

Microfinance, broadly defined as the provision of financial services to low-income clients including the self-employed (Ledgerwood 1999), is recognized as a potentially powerful tool to promote economic growth, to reduce poverty, to support human development, and to improve the status of women (ADB 1998b). Providing the poor with financial services, especially credit, is a basic means of increasing their productivity and incomes (Gulli 1998). This chapter examines the need for microfinance in PDMCs and documents the current supply of microfinance. Current modalities, capacity and performance, and the viability and sustainability of microfinance schemes are investigated. Lessons learned from past experience are also summarized.

Microfinance in the Pacific islands is at an early stage of development. There are a limited number of institutions providing microfinance in both urban and rural areas, mostly relying on government and donor subsidies for survival. MFIs in the seven PDMCs reviewed have yet to achieve operational self-sufficiency. Nonetheless, they offer the possibility of access to financial services that can enable rural and poor urban people in PDMCs to save and borrow small amounts of money. MFIs are therefore critical to achieving rural and equitable urban development.

DEMAND FOR MICROFINANCE SERVICES

ADB's *Pacific Strategy for the New Millennium* (ADB 2000, 20) notes that the "single biggest challenge is to generate wage-and income-earning opportunities for rapidly growing labor forces". The inability to generate enough formal and informal sector jobs and livelihood opportunities is beginning to show in the rising incidence of poverty, income inequality, and unemployment reported in the region (UNDP1999; ADB 2001b).

In the Fiji Islands in 1991, 25 percent of households were living below the poverty line, with half of all households receiving one-fifth of all income (UNDP and Government of Fiji 1997). Traditional safety nets and systems of exchange were no longer able to provide for the majority of rural households. Welfare organizations claim that the situation has worsened since 1991. In the Solomon Islands, a series of household income and expenditure surveys during the 1990s also revealed very marked inequality in household incomes, with less than 1 percent of Honiara households receiving 50 percent of total income (Government of Solomon Islands 1992). In Samoa, where an increasing number of households have less than one acre of land, there is growing concern over income inequality and a rising incidence of malnutrition, especially among children. In Tarawa, the main urban center of Kiribati, the findings of a 1996 survey of household incomes and expenditures revealed that many households lived in overcrowded conditions. Only 16 percent of the people surveyed had jobs, usually one per household, yet this was the main source of household income. A large proportion of cash income was spent on food, principally rice, fish, frozen meat, and sugar (Statistics Office 1996).

Job growth is continually outstripped by the demand for paid employment. Young people are particularly at risk of unemployment, and in some PDMCs, there are more than seven times as many young people seeking work each year as there are new jobs available (UNDP 1997). In the Fiji Islands in 1995, for example, only 1,100 jobs were available for 13,000 school-leavers. Demographic and economic trends suggest that the gap between the availability of and demand for formal sector employment is likely to grow in the coming years. In the light of this almost inevitable shortfall, it is necessary to stimulate the informal sectors in PDMCs to increase opportunities for self-employment.

Informal sectors include people in rural areas who are engaged in semi-subsistence production either for traditional exchange or for cash, and those people in urban areas who operate small-scale businesses or microenterprises. They are growing, as evidenced by the swelling number of market vendors and the growing numbers of peddlers and street hawkers in most PDMCs; and they are projected to grow further over the next decade. The challenge is to stimulate informal sectors by finding ways to increase productivity and opportunities to earn cash.

One important means of strengthening informal sectors is to meet their growing demand for microfinance. The access of poor and relatively low-income persons to formal financial services is very limited. For example, the Papua New Guinea Banking Corporation estimated in 1997 that only 30 per cent of the population held deposit accounts and less than 1 per cent had loans from commercial banks. In the Fiji Islands, it has been estimated that more than 83 percent of poor communities have no access to credit or savings facilities (UNDP and Government of Fiji 1997). It is likely that other PDMCs experience the same problems. Reliance must then be placed on family, friends, and moneylenders. By providing credit and savings facilities to individuals who do not have access to formal financial services, and by providing accompanying management, accounting and marketing skills, microfinance schemes can help people to meet their economic and social needs.

SUPPLY OF MICROFINANCE SERVICES

Microfinance in the Pacific is at an embryonic stage. Current providers can be broadly classified into the three sectors shown in Table 6.1.

Informal microfinance sector

This sector includes individuals or groups of people involved in collective savings and individual or collective lending practices, not registered or supervised by any

Table 6.1

Current Providers of Microfinance

Informal	Semi-formal	Formal
Friends and relatives	Credit unions or savings and loan societies	Development banks
Unregistered moneylenders	Registered moneylenders or finance companies	Commercial banks
Self-help groups operating savings and loans schemes (e.g., workers/ employees, women and youth, villagers, sectoral groups such as farmers and fishermen, and church/religious groups)	NGOs implementing microfinance schemes Registered village banks Government agencies directly implementing microfinance schemes	

regulatory body (UN-ESCAP 1997). Despite their diversity, they share some features:

(i) small-scale operations with limited sources of funds;
(ii) ease of entry, with no regulations to govern operations or other barriers to entry;
(iii) simple lending requirements and quick processing of loans;
(iv) limited geographical coverage;
(v) transactions at the community level; and
(vi) specific purposes, such as saving for Christmas expenses or paying school fees.

Generally, management capacity is limited. Informal financial systems are the most common source of credit for poor and disadvantaged people living in both urban and rural areas.

It is difficult to determine precisely the level of informal financial sector activity, since it is not captured in official statistics. Suffice it to say that the "rich variety" of informal saving and borrowing mechanisms is of great practical importance and is well integrated into rural and urban life

(Hughes 1998). Informal financial services operate outside the structure of government regulation and supervision, although, with the exception of unregistered moneylenders in countries where legislation governing moneylending exists, their activities are legal. The services of informal providers vary, with some intermediaries extending only credit, others only savings, while most extend both credit and savings.

Informal financial systems thrive because they offer quick, convenient, and affordable ways of accessing credit and saving money, compared to formal financial institutions. They address the need for "quick money" to meet traditional obligations such as funerals, birthdays, weddings, school fees, and pressures to meet traditional and family obligations, for which many people have to borrow. Informal financial providers include friends and relatives, unregistered moneylenders, and self-help groups, commonly referred to as savings and loans clubs.

Friends and Relatives. The most common sources of informal credit are friends and relatives. This is akin to *kerekere* in Fiji; *bubuti* in Kiribati; *wantok* in Solomon Islands, Vanuatu, and Papua New Guinea; and *fa'aSamoa* in Samoa. A person may not be required to pay back in cash, but would be obliged to reciprocate in other forms; this is consistent with the cultural reciprocity that is well entrenched in the Pacific region.

Unregistered moneylenders. These are the usual source of "quick credit". They generally operate outside the law and often charge high rates of interest. In Tonga and Samoa, finance companies approximate the role of moneylenders, but these companies are required to obtain business licenses. In Vanuatu and PNG, moneylending activity is not regulated, but individuals or companies engaging in moneylending are required to secure a business license.

Self-Help Groups. Within communities and work environments, a wide range of self-help groups operates savings and loan schemes. Some offer only loans, others only savings, but the majority offer both. These self-help groups include women's groups, youth groups, farmers and other sectoral groups, employee/staff associations, and church or religious groups. Most self-help groups maintain savings accounts in commercial banks, often held as a group account; one member or the treasurer of the group keeps individual savings records.[8] Self-help groups are widespread in Tonga, active in Fiji and Kiribati, and apparently less active in other PDMCs.

Institutions in the informal sector provide only a limited outreach, as they serve only members or a specific community. The loan amounts are limited and the timing of loans is inflexible, as collecting loans or funds only takes place when there is a person available to do so. There is also a risk of loss of investment or savings of members due to mismanagement of funds.

Semiformal Financial Sector

The semiformal financial sector consists of individuals or institutions whose financial activities are licensed and supervised by government agencies, but who are not regulated by banking authorities. It includes credit unions or savings and loan societies, registered moneylenders, small-scale finance companies, NGOs implementing microfinance schemes, village banks, and government agencies involved in microfinance activities. The institutions in this sector are either governed by specific legislation (credit unions, savings and loan societies, village banks, and moneylenders), or are licensed or registered under an Act of Parliament (finance companies extending small-scale loans), or by municipal or town councils. NGOs implementing microfinance schemes in the Fiji Islands, Samoa, Solomon Islands, and Tonga are registered by an Act of Parliament, while NGOs in Kiribati are registered with the municipal or town councils. NGOs in PNG have to secure a license to operate.

Credit Unions. The most common and longstanding semiformal financial intermediaries are credit unions. The

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[8] In Samoa, a review of one bank's accounts, requested by the Central Bank, found 9,000 group accounts, most of which were held by self-help groups; there are probably similar numbers of accounts in other banks in Samoa.

credit union movement in the Fiji Islands dates back to the enactment of the Credit Union Act in 1954. Samoa passed similar legislation in 1960, PNG in 1962, the Solomon Islands in 1968, Tonga in 1977, Kiribati in 1990, and Vanuatu in 1999. In each country, an apex body for credit unions or savings and loans societies, referred to as the Credit Union League, has been established to supervise and monitor member credit unions. The unions are self-financing organizations composed of groups of people (members) united by a "common bond" of association. They are primarily organized to aid collective saving by encouraging thrift among members, and to provide members with credit for both productive and provident purposes. Both community-based credit unions and employee-based credit unions operate in urban and periurban areas of PDMCs. In some remote rural areas, access to financial services is possible only through credit unions. Credit union members in urban areas are mainly workers from government and private companies. In rural areas, members include salary- and wage-earning workers, such as teachers and hotel workers; farmers; fishers; and women, church, and youth groups.

The number of credit unions has dwindled over the years because of mismanagement, but efforts are now being made to strengthen them. There are more than 600 credit unions in the seven PDMCs, about one third of them active (Table 6.2).

Finance companies and registered moneylenders. These are also semiformal financial intermediaries. They include village banks (in Kiribati), Five Star Finance Co. Ltd. (in Tonga), Co-operative Savings and Loans Society Ltd. (in Melanesia), and registered moneylenders (in Vanuatu). Where there is no legislation on moneylending, as in Samoa, Solomon Islands, and Tonga, finance companies approximate the role of moneylenders. In the Fiji Islands and Kiribati, moneylenders are regulated pursuant to the provisions of the Moneylending Act, and in PNG, moneylenders are required to secure a license. Vanuatu is drafting legislation on moneylending.

A substantial number of lending transactions takes place through finance companies. For example, a finance company in Vanuatu disbursed total loans to the amount of Vt10 million within six months and boasted a total membership of 1,400. A

Table 6.2

Existing and Dormant Credit Unions/Savings and Loan Societies [a]

Country	Active	Dormant	Total
Fiji Islands	52	15	67
Kiribati	60	70	130
Papua New Guinea	21	76	97
Samoa	20	55	75
Solomon Islands			
Credit Unions	36	128	164
Savings Clubs	6	15	21
Tonga	23	46	69
Vanuatu	6	45	51
Total	224	450	674
Credit Unions	218	435	653
Savings Clubs	6	15	21

a. In some PDMCs, data on dormant credit unions are not available. For these countries, data are estimated by subtracting the existing number of credit unions compared to the year with the highest number of registered credit unions.
Sources: Credit Union League or Credit union; ILO 1999.

finance company in Tonga had weekly loan releases between T$30,000 to T$40,000 and estimated having 400 regular customers, mostly from Government offices. Tonga has the highest number of registered small-scale finance companies (around 300), and Kiribati has the lowest number of registered moneylenders (11, of which eight are registered with Tenaina Urban Council and three with Betio Town Council).

Though finance companies usually charge higher interest rates than banks, their quick service is highly valued. Many people prefer to borrow from finance companies and moneylenders because of the relative ease in accessing credit. Collateral requirements are relatively easy to comply with and take the form of household assets, salary or bank deposits, or traditional items such as fine mats (in Tonga and Samoa) and *tabua*, or whales teeth (in Fiji Islands). A one-page application suffices for paperwork, and funds are normally released in an hour or two. Some finance companies also operate through a network of agents, usually staff in government and private companies.

NGOs. In PDMCs, the involvement of NGOs is limited. At present, there are only 11 NGOs undertaking various microfinance schemes in the seven PDMCs.

Village banks. These exist only in Kiribati. The Government launched the Village Bank program in June 1995 in support of its development policy—*kamaeroan te i-Kiribati*, which literally means "the improvement of the living standards of i-Kiribati"—and in response to the demand for microcredit, especially in the outer islands. The Government allotted a total of A$450,000 from the Kiribati National Development Fund to establish 182 village banks nationwide, covering 23 of 24 inhabited islands, including South and North Tarawa. The Rural Planning Unit of the Ministry of Home Affairs and Rural Development, through its cadre of Island Project Officers based in each island, is responsible for overseeing the implementation of the Program.

Village banks are the most common sources of credit, especially in the outer islands. They are owned and managed by village people through a village committee, with minimal supervision by the Government. Village banks provide loans to members at a reasonable rate of interest not exceeding 10 percent per year for a maximum term of eight months, though the term is sometimes reduced to one month. They do not accept savings from their members. The Village Bank Act of 1998 regulates the Village Banks, requiring them all to be registered.

Government agencies. There has been increasing interest in, and support by, governments for microfinance. Government agencies either directly operate or coordinate microfinance schemes in all PDMCs except Samoa and Tonga (Table 6.3). Funds for government-initiated microfinance schemes are either provided by governments themselves or by donor agencies, notably New Zealand Overseas Development Assistance (NZODA) and the United Nations Development Programme (UNDP). The governments of Samoa and Tonga have both been involved in microfinance schemes. With the exception of the Women's Grants Scheme in PNG, started in 1988, government microfinance schemes are relatively new.

Table 6.3
Government Agencies' Current Involvement in Microfinance

Country	Government Agency Directly Implementing Microfinance Program	Government Agency Coordinating Microfinance Program	Title of Microfinance Program	Modality
Fiji Islands	Department for Women and Culture		Women's Social and Economic Development Program (WOSED)	Grameen Bank Replication (Modified)
		Microfinance Unit, Ministry of Commerce, Business Development and Investment	Fiji Microfinance Program	Grameen Bank Replication (Modified)
Kiribati	None	Rural Planning Unit, Ministry of Home Affairs and Rural Development	Village bank Program	Village Bank Individual lending (Modified)
PNG	None	Women's Division, Department of Religion, Women's Affairs and Youth	Women's Grant Scheme	Wholesale lending to provincial associations
Samoa	None	None		
Solomon Islands	None	Women's Development Division of the Ministry of Youths, Women and Sports	Solomon Islands Microfinance Scheme for Women (SIMIWODS)	Grameen Bank Replication (Modified)
Tonga	None	None		
Vanuatu	Department of Culture, Religion, Women's Affairs and Archives	None	Vanuatu Women's Development Scheme (VANWODS)	Grameen Bank Replication

Sources: Credit Union Leagues & Credit Union Registrars, project implementers and relevant reports

They were introduced in the middle of the 1990s, mostly as pilot programs that were later expanded.

The Government of the Fiji Islands has given the most substantive support in facilitating the development and growth of microfinance. A National Microfinance Conference has been conducted, with participation by Government representatives, NGOs, donor agencies, microfinance practitioners, staff of the University of the South Pacific, and resource persons from well-known MFIs such as the Grameen Bank, the Foundation of Development Corporation, and the Asian Development Centre. A draft National Action Plan on Microfinance resulted, which outlined strategies to promote awareness and understanding of microfinance, and to improve the access of the poor and disadvantaged to financially viable and sustainable financial services. A Microfinance Unit within the Ministry of Finance was established (recently transferred to the Ministry of Commerce, Business Development and Investment), with F$3 million in funding from the Government. The unit is currently pilot-testing a microfinance scheme through the provision of grants to the Fiji Council of Social Services, an apex organization of NGOs, which in turn on-lends to target clients.

More recently, in September 2000, the PNG Cabinet approved a Microfinance and Employment Policy whose objective is to provide sustainable microfinance services to viable formal and informal enterprises and savings services to the general population. Achieving this objective will involve capacity building of MFIs through a Microfinance Competence Center; the development, testing and implementation of new savings and loan products and delivery methods; and the provision of a Revolving Finance Facility. This initiative is supported by an ADB loan approved in October 2000.

Formal Financial Sector

The formal financial sector comprises financial institutions that are chartered by government and are subject to banking regulations and supervision, mostly development banks and commercial banks.

Commercial banks. Most poor and disadvantaged people have limited access to financial services from commercial banks in PDMCs. Commercial banks extend personal loans to those with regular sources of income and those who are able to comply with security and other banking requirements. They also offer savings services targeted primarily at wage and salary earners. Banks are oriented toward providing large loans, which are beyond the absorptive capacity of poor borrowers. Banks' paper requirements are often too complicated for poor borrowers, who typically have low levels of education. Mostly, banks perceive poor people and microentrepreneurs to be too high a risk, and too costly to serve because of the small loan size and their inability to meet security requirements. With their offices and branches concentrated in urban and periurban areas and the bigger islands, most commercial banks have limited outreach.

Development banks. These may extend microloans, either as part of their regular lending activity or through a special window with funding from donor agencies. Otherwise, their services may be inaccessible to the majority of disadvantaged people, because the usual banking requirements concerning collateral are enforced and because a substantial amount of paperwork is involved. The size of their loans is usually also beyond the absorptive capacity of low-income earners.

PERFORMANCE OF SELECTED MICROFINANCE INSTITUTIONS

Microfinance providers or institutions (MFIs) adopt various modalities or methodologies: (i) individual lending; (ii) Grameen-style solidarity lending and its derivatives; (iii) village banking; (iv) revolving loan funds; and (v) savings and loan associations (Table 6.4).

Geographical and Client Coverage

Credit unions, widely present in both urban and rural areas, have the widest geographical and client coverage (Table 6.5). They are often the only source of financial services to people in remote areas. They had 109,578 members at the height of the movement's popularity. With the decline of the movement in the 1990s, membership has dropped dramatically, although the exact figure cannot be determined. The two largest PDMCs have the most members.

The village banks in Kiribati are effectively nationwide. Development banks have also endeavored to expand their geographical outreach to rural areas and outer islands in the seven PDMCs, in keeping with their mandate to contribute to the development of rural areas. However, they have been constrained by the considerable cost of delivering financial services to rural areas, and have had to rely on donor funding or government subsidies to continue operations. The microloan schemes of development banks in Samoa, Solomon Islands, and Tonga have been terminated because funds have been exhausted. FDB's scheme is still operating with bilateral donor funds.

Microfinance schemes implemented by NGOs and government agencies have limited geographical coverage. Most of them are concentrated in urban and periurban areas and are mostly pilot projects with limited funds. The Women's Social and Economic Development Program (WOSED) in the Fiji Islands is an exception, and has been able to expand its outreach to rural areas, because it has a network of staff and because the operational costs are subsidized from the regular budget operation. It is clear that geographical outreach for NGOs is dependent on the availability of funds. Given donors' limited financial assistance, schemes usually cover only the urban and periurban areas; expanding their outreach to rural areas would be too costly.

NGOs with long-running microfinance schemes, such as Liklik Dinau Abitore Trust (LLDAT) in PNG and the Tonga National Youth Council (TNYC), have reached more clients than NGOs with newer microfinance activities, such as Young Women's Christian Association (YWCA) in Solomon Islands, Social and Economic Equity for the Disadvantaged (SEED) Foundation in Fiji Islands, and Women in Business Foundation (WIBF) in Samoa. Except for TNYC, which targets youth groups, the NGOs target mainly disadvantaged women.

NGOs that replicate the Grameen Bank model utilize means tests to screen potential members. Loans are small and

Table 6.4

Modalities/Methodologies Adopted by Existing Microfinance Providers/Institutions

Principals/ MFIs	Individual Lending	Grameen – style Solidarity Group Lending	Village Banking	Revolving Loan Funds	Savings and Loan Associations
Existing MFIs	Development banks offering microloans (FDB, TDB, SDB, SIDB)	Fiji: Dept. for Women & Culture/ WOSED & SEED Foundation PNG: Liklik Dinau Abitore Trust Fund Samoa: WIBF Solomon Is.: YWCA/ SIMIWODS Vanuatu: Dept. of Culture, Religion, Women's Affairs and Archives/ VANWODS	Kiribati: village banks	Tonga: TNYC	In Fiji Islands, Kiribati, Samoa, Solomon Islands, Vanuatu: Credit unions In PNG: Savings and loan societies In Fiji Islands: UNDP/ SMILE initiated savings and loan Scheme
Clients	Individual	Individual, through groups	Individual, through village banks	Groups	Individual, through credit union or SLS
Credit officers' relation to client	Close, with individualized attention	Very close, through weekly/ fortnightly meeting	Distant, focus on committee members	Distant, focus on group officers	Distant, focus on officers of committees
Loan Approval	Based on analysis of project viability and client's capacity to repay Centralized loan approval	Group involved in loan appraisal and approval	Committee-appraised loan applications & loans approved by members	Appraised and approved by agent/ TNYC	Appraised and approved by credit committees

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Table 6.4 (cont)

Modalities/Methodologies Adopted by Existing Microfinance Providers/Institutions

Principals/ MFIs	Individual Lending	Grameen – style Solidarity Group Lending	Village Banking	Revolving Loan Funds	Savings and Loan Associations
Loan Characteristics	Loans usually large & beyond the absorptive capacity of the poor Stringent loan requirements and procedures Longer loan processing Loans geared more for small-scale enterprises	Small loans taking into account paying capacity of clients Simplified requirements and streamlined procedures Loans mainly for income generating projects	Small loans Minimal loan requirements Loan disbursement depends on availability of funds Loan for productive or provident purposes	Group loan based on criteria Endorsement from umbrella organization Loan strictly for income generating activities	Loan size varies based on certain percentage of savings Simple loan requirements Fast disbursement of loan Loan for productive and provident purposes
Guarantees	Collateral and/or co-signers	Mutual guarantee of group/ center members (in some cases group guarantee not enforced)	Easy to comply with collateral, at times not required -village pressure	Peer pressure Endorsement by umbrella organization	Collateral required most of the times but easy to comply with Peer pressure
Savings	Not essential	Key part of methodology	Not essential	Not required	Fundamental principle—save before borrow

Sources: Credit Union Leagues & Credit Union Registrar, project implementers, and relevant reports.

Table 6.5
Geographical Outreach of Selected Microfinance Institutions

Microfinance Institutions	Country	Name of Microfinance Project	Geographical Coverage
1. Credit Unions	Fiji Islands	Credit Union	Key urban areas: Suva, Nadi, Lautoka, Singatoka, Labasa; and rural areas of Vatukula, Nmosi, Ovalau, Bua, and Taveuni
	Kiribati	Credit Union	18 out of 23 inhabited islands
	PNG	Savings and Loans Association	8 out of 17 regions nationwide
	Samoa	Credit Union	Upolu and Savaii (two largest islands)
	Solomon Islands	Credit Union	Central, Guadalcanal, Honiara, Isabel, Makira, Malaita, Temotu, Western, and Choseui
	Tonga	Credit Union	Three main islands: Tongatapu, Vavau, and Ha'apai
	Vanuatu	Credit Union	Port Vila, Pentecost, Ambae, Maewo, and Ambrym
2. NGOs			
a. Replicating Grameen Bank			
LLDAT	PNG	LLDAT Trust Fund	Four districts of Eastern Highland Provinces [a]
YMCA	Solomon Islands	Solomon Islands Microfinance Scheme for Women (SIMIWODS)	Two low-income settlements in Honiara: Lord Howe and White River Settlements
SEED	Fiji Islands	SEED Foundation Microfinance Scheme	Five squatter areas in greater Suva: Tacirua, Saika, Naiyala, Namadi, Wailea; and three low-income communities in suburb of Suva: Kinoya, Bagasau, and Valelevu

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Table 6.5 (cont.)
Geographical Outreach of Selected Microfinance Institutions

Microfinance Institutions	Country	Name of Microfinance Project	Geographical Coverage
Fiji Council of Social Services Women in Business Foundation	Fiji Islands Samoa	Microfinance Scheme of National Microfinance Unit WIBF/UNDP Microenterprise Financing & Savings	Drekena Village is Rewa (pilot site); other sites identified for expansion Island of Savaii
b. Operating Revolving Fund TNYC	Tonga	TNYC Credit Scheme	Tongatapu, Ha'apai, and Vavau
3. Village Bank	Kiribati	Village Bank Program	182 wards covering 23 islands
4. Development Banks	Fiji Islands Samoa Solomon Islands Tonga	New Zealand Loan Scheme IFAD Pilot Credit Fund Women's Credit Scheme Outer Islands Credit Project NZODA Outer Island Rev. Fund and Women's Dev.	Nationwide Urban and mainly rural areas Honiara and Guadalcanal Major islands except Tongatapu Major island groups except Tongatapu
5. Government agencies Dept. for Women & Culture	Fiji Islands	Women's Social & Eco. Dev. (WOSED)	Caukadrove, Bua, Macuata, Central & Western Divisions
Dept. for Culture, Religion, Women's Affairs & Archives	Vanuatu	Vanautu Women's Dev. Scheme	Low-income communities in Port Vila
6. UNDP/SMILE Program	Fiji Islands	Enterprise-based and community-based S&L	Greater Suva area (14 factories; three low-income communities; two religious groups)

a. As of December 1999 for Goroka and Kainatu branches
Sources: Credit Union Leagues & Credit Union Registrar, project implementers and relevant reports

within the absorptive capacity of poor clients, requirements are simple, and services are rendered quickly and at the community level. Peer guarantee is used as a substitute for collateral. Loans are short-term and are renewed or increased based on repayment records. Clients are characterized by low levels of education and no formal employment outside the home. They are mostly women with very limited entrepreneurial skills and experience, who want to earn money to augment meager household incomes. Access to credit is more important than the rate of interest, as shown by the experiences of Fiji Islands' SEED Foundation and Women's Social and Economic Development Program (WOSED), Solomon Islands Microfinance Scheme For Women (SIMIWODS), and Vanuatu Women's Development Scheme (VANWODS), which all charge interest higher than 10 percent per year. Clients are willing to save small amounts of money when the motivation and convenient and affordable savings mechanisms are present. The client outreach of NGOs' microfinance schemes is limited by funding, by civil unrest (in Solomon Islands), by slow training processes and by the low educational level of clients.

Government agencies replicating the Grameen Bank model are gradually expanding their outreach to disadvantaged women. WOSED, under the Fiji Islands Department of Women and Culture, has gained a total outreach of 534 clients since it was pilot-tested in April 1993, while VANWODS has served a total of 405 disadvantaged women in Port Vila since it started in 1996.

Institutional Capacity

Most MFIs have limited institutional capacity for expansion and sustainability, as they have weak governance structures, inadequate staffing, and no business plan. This situation results partly from the lack of training in microfinance, and is being remedied to some extent through the UNDP Pacific Sustainable Microfinance and Livelihoods Through Empowerment (SMILE) Program, which has assisted WOSED, SIMIWODS, VANWODS, SEED Foundation, and WIBF in preparing their viability plans. Grameen Bank replicators do not necessarily share the same institutional weaknesses, because of the varying technical support of donor agencies. This is especially true for those with full-time microfinance specialists like LLDAT, VANWODS and SIMIWODS.

Credit unions and Grameen Bank replicators like Liklik Dinau Abitore Trust and SEED Foundation focus only on microfinance, whereas some other MFIs administer other projects and programs. This can lead to a lack of focus that adversely affects the performance of microfinance schemes. For example, although TNYC and WIBF have staff assigned to microfinance projects, they administer other projects as well and their resources, time and focus are consequently dissipated. Government agencies also carry out other programs while implementing microfinance schemes. Development banks do not treat microfinance schemes separately from regular banking services, and the staff are responsible for the delivery of all these services as well as microfinance.

Because they are at an early stage of development, most MFIs in PDMCs need technical assistance to strengthen their institutional capacity to deliver efficient ongoing microfinance services. Several MFIs have expressed this need for technical assistance, including the Microfinance Unit in the Fiji Islands, the Village Bank Program in Kiribati, TNYC, and most development banks operating microfinance schemes.

Credit unions in villages with few educated people have problems maintaining good financial records. Boards of directors for credit unions and for credit union leagues also do not have sufficient financial management capability to make sound financial decisions. There is a high turnover of officers and a shortage of full-time staff is a perennial problem that constrains service delivery, especially field visits to affiliated members. The leagues also face financial constraints, some receiving minimal support from government.

Most MFIs, except those receiving technical assistance, have no accurate management information systems. Even those receiving technical assistance have difficulty in producing timely reports. Some credit unions do not regularly submit reports to their credit union leagues, which is why data are not available to assess the various microfinance schemes. Some leagues, for lack of manpower and technical capability, are not able to use the data in making decisions, addressing problems and issues, or assessing the accountability of credit unions. Village banks in Kiribati encounter the same problem: even when monthly progress reports have been regularly submitted by the Island Project Officers to the Rural Planning Office or the Ministry of Home Affairs, which oversees the village banks, the data are collated but not analyzed or used to make decisions or address problems.

Financial Self-Sufficiency

The review of selected MFIs in the seven PDMCs established that not one has yet achieved financial self-sufficiency. This is certainly partly because the MFIs are in the early stages of development, where the operational costs of delivering microfinance services far exceed incomes. Experience in other developing countries shows that operational efficiency can be achieved in three to seven years and financial self-sufficiency (costs equal income) within five to ten years (Committee of Donor Agencies 1995). Achieving self-sufficiency will probably take longer in PDMCs. VANWODS posted a 46 percent operating self-sufficiency rate, WOSED posted 13 percent, while LLDAT fared better with 18.2 percent. The TDB Outer Island Project registered 22.3 percent (McGuire 1996). However, these rates fall well below the standard of 100 percent.

The failure to achieve financial viability makes MFIs heavily dependent on government subsidies and donor assistance, both financial and technical. Credit unions tend to show a greater degree of self-reliance, because they are able to lower their costs of operations by using the volunteer services of members, and are also able to mobilize members' savings. Nonetheless, no MFI has yet demonstrated financial viability. Measures to increase revenue and reduce costs need to be adopted to hasten the achievement of self-sufficiency. These should include charging higher interest rates: many MFIs, particularly credit unions, are charging interest rates equivalent to only 1 percent per month on a declining balance.

Grameen Bank replicators tend to charge higher interest rates and have better portfolio quality than other MFIs. VANWODS has an exemplary record, with consistent 100 percent repayment over more than four years. Similarly, SIMIWODS posted a high repayment rate of 96 percent. Other schemes have lower repayment rates: SEED at 86 percent, WOSED at 83 percent, WIBF at 80 percent, and LLDAT at 71.1 percent (in 1998). The International Fund for Agricultural Development project executed by the Development Bank of Samoa has the lowest at 65 percent.

Networking

Networking among MFIs within countries and within the region has been minimal. To date, there has been only one regional microfinance conference sponsored by NZODA in 1995, followed by a microfinance conference in the Fiji Islands, and microfinance workshops conducted by Pacific SMILE in Solomon Islands, Samoa, Fiji Islands, and Vanuatu. SMILE has established linkages with various MFIs in the Pacific, particularly schemes that are funded by UNDP such as VANWODS, SIMIWODS, SEED Foundation, and WIBF. Close coordination also exists between WOSED and SMILE, with technical assistance provided upon request. Linkages have also been established with Vanuatu's village bank program and TNYC, where assistance has been sought from SMILE to evaluate the schemes. Some MFIs indicate that they do not know where to seek advice concerning microfinance.

EXPERIENCES AND LESSONS IN MICROFINANCE

Microfinance is surrounded by myth. Some of the most common beliefs are shown, and dispelled, in Table 6.6. The general truths—that microentrepeneurs are knowledgeable, creditworthy people with viable projects, that the poor do save, that microfinance interest rates can and should reflect operating costs, and that care must be taken in packaging credit with other services—apply in the Pacific Islands.

Table 6.6

Common Myths and Realities about Microfinance

MYTH	REALITY
Microentrepreneurs need to be cared for because they are poor.	Microentrepreneurs are knowledgeable about doing business in their local economy. They often have years of experience in their trade, working with dedication and determination. Belief in the intelligence and business knowledge of clients is critical.
Microenterprises are redundant activities that should be replaced by larger businesses employing many people.	While often marginal, microenterprises are viable, locally important activities that should be upgraded. These small-scale economic activities are valid business activities to be taken seriously.
Interest rates to the poor need to be subsidized.	Microfinance rates of interest must reflect operating costs to achieve sustainability. Organizations making large numbers of small loans will have high transaction costs and thus need to charge interest rates that are higher than commercial rates. However, microfinance rates are still significantly lower than those charged by moneylenders and other sources from which the poor borrow.
Credit alone is useless. It must be packaged with training, marketing, technology, and other services.	Although programs that package credit with other services may seem ideal, they require large subsidies and have proven to be largely unsustainable. The minimalist approach used by the Grameen Bank and many others has shown that clients can use credit in small amounts to start or improve the profitability of their microenterprises. Providing marketing and many other types of services is worthwhile, but best managed separately.
The poor cannot be trusted with credit. The consumption needs of the poor are so pressing that any loan will find its way quickly to consumption.	The high repayment rate of millions of microfinance clients is empirical proof that the poor are creditworthy.
The poor are unable to save.	The high rate of savings reported by many microfinance organizations demonstrates that the poor can value savings as much as credit.
Poverty has crippling effects rendering the poor unable to improve their condition.	The remarkable success of institutions lending to more than 10 million clients around the world, the vast majority of whom are below the official poverty line (usually defined by caloric intake), proves beyond doubt the ability of the poor to improve their lives with their own ingenuity and drive.

Source: UNDP and Citicorp Foundation 1997.

Specific lessons learned from experience with microfinance schemes in the Pacific, typically involving loan amounts in the range of US$50 to US$500, are summarized below.[9]

- MFIs often lack the institutional capacity, management expertise, and resources to operate sustainable schemes. Microfinance schemes therefore should be carefully designed, and all essential elements for successful implementation considered. Expert technical assistance is essential.
- Microfinance schemes should be tailored to meet the financial needs of potential clients, while retaining a focus on viability. These needs may extend beyond income-generating activities/enterprises to encompass social purposes.
- Some microfinance schemes are not compatible with the local culture. Many schemes, especially those targeting women and the poor, are undermined by the lack of support from men, other family members, or local elites, who feel that they have been excluded from the scheme. Therefore, a thorough study of the local situation must be carried out to assess the suitability and acceptance of the scheme. Participatory appraisal approaches should be adopted.
- Schemes that charge relatively low interest rates and do not require compulsory savings generally do not foster a sense of sacrifice and ownership, and tend to lead to poor repayment rates and eventual depletion of the lending capital. Compulsory savings, even in small amounts, should be required where feasible.
- Many schemes do not carry out a realistic assessment of the income generation potential in a particular locality before implementation. This has been the reason for failure of many outer island and rural village schemes, where the population is small (about 100 to 200 people) and where there is little or no regular source of income. There is a need to conduct a market assessment to identify viable projects.

[9] These lessons were drawn mainly from Liew 1997 and validated during fieldwork.

- Credit alone is not sufficient to ensure that borrowers succeed in their income-generating projects. There is a need for a comprehensive package of support services, including business skills training and on-demand advisory support services. More deliberate, officially sanctioned, and reliable linkages between credit schemes and other development services are important to ensuring the sustainability and pertinence of microlending schemes for the poor.
- The "copy cat" syndrome is very prevalent in most Pacific communities. Coming up with a good moneymaking idea is extremely difficult, especially in small islands and the rural areas; but experience elsewhere shows that successful repeat borrowers more frequently invest in another new activity rather than expanding an existing one. The reason for this is that in small communities, the potential for expansion is very limited and there is more potential for doing something new. A continuous injection of new ideas, of making and doing something different, is important. In many cases such new ideas will come from outside.
- These lessons were drawn mainly from Liew 1997 and validated during fieldwork. There are no national and regional networks of microcredit programs that distill the wealth of knowledge and systematically share it among microcredit practitioners. Consequently, every new scheme struggles on its own, making the same mistakes as other schemes. Networking and information sharing should be strengthened and a mechanism such as a national or regional association of microfinance practitioners set up.
- Many microfinance schemes fizzle out because of lower-cost competition from grant-in-aid programs implemented in the same location. Having a national policy on microfinance and more careful planning and location of projects would avoid such unnecessary and unproductive competition and duplication.
- Little effort has been made to build capacity at the community level and to use community-based organizations to manage microfinance schemes. The prevailing attitude among government officials is that grassroots organizations are made up largely of poorly educated and rural people who cannot handle microfinance schemes. However, several

schemes that are managed entirely by local communities have worked well. Some have shown great creativity and responsibility in coming up with sound solutions to their problems. Such initiatives should be encouraged.

- Most PDMCs do not have NGOs with the staff, experience, or resources to manage a microfinance scheme. As a result, some schemes are implemented through government departments, such as women's affairs and rural development departments. However, these departments are often also inadequately staffed and resourced; the staff members operating the schemes sometimes become over-authoritarian and preoccupied with loan collection instead of helping the beneficiaries to better manage their finances and livelihood projects. NGOs should be encouraged to participate in microfinance and, whenever possible, governments should eventually pass on the scheme to them if there is corresponding capacity building provided within the scheme.
- Most donor funds for microfinance are channeled through governments and follow established accounting and disbursement procedures, generating much paperwork and a trail of approvals. Although this is good for accountability, many schemes pass these bureaucratic requirements on to the borrowers, who have to fill in many forms, wait long periods of time for approvals, and sign legal documents giving the State the right to prosecute if they default on a loan. Streamlining of procedures and release of funds is needed, subject to full assessment of profitability.
- People in positions of influence often do not attach much importance to micro-finance schemes, mainly because they involve relatively small amounts of money, are largely grassroots-oriented, and target primarily women and the poor. They are not as glamorous as large development banking and investment financing schemes, which attract political support. Serious government support is vital for microfinance to flourish and to benefit the large majority of the poor.
- Most microfinance schemes utilize very low interest rates that are often set quite arbitrarily. Where schemes are donor funded, seed capital is often considered to be "free" money.

However, the poor are able and willing to pay market rates of interest as long as they get good, quick service. Donor funds could be well spent on training and capacity building for MFIs. Borrowing from commercial banks should be explored, where costs can be passed on to the borrowers.

THE FEASIBILITY OF MICROFINANCE IN SMALL PACIFIC ECONOMIES

In making an assessment of the feasibility of microfinance in selected PDMCs, the central question is: "Do the conditions in PDMCs warrant the development of sustainable microfinance systems that can provide efficient and responsive services to the majority of low-income households?" The answer to this question requires an examination of the following: (i) the achievements of microfinance in the Pacific; (ii) factors contributing to sustainable microfinance; (iii) factors hindering sustainable microfinance; and (iv) the preconditions for sustainable microfinance.

Achievements

Microfinance has helped clients develop good savings habits, shattering the myth that the poor are unable to save and that the cultural environment in the Pacific is not conducive to cash saving. The accumulated savings of clients of schemes such as LLDAT, WOSED, SIMIWODS, and VANWODS and of credit unions demonstrate that low-income households can save small amounts of money on a regular basis. The high repayment rates registered by Grameen Bank replicators such as VANWODS (100 percent loan repayment) and SIMIWODS (96 percent) demonstrate that the poor, especially women, can be creditworthy.

MFIs have also enhanced the process of broadening and deepening rural financial markets, helping successful clients to earn income and to invest in improved nutrition, housing and household assets, education, and health care for the family. They have also enabled clients to gain experience in managing microenterprises.

Contributing Factors

The growing support of development agencies and governments aids the development of sustainable microfinance in PDMCs through the provision of technical assistance. The increased participation of institutions in microfinance, and especially the emergence of new institutions like NGOs, is gradually building the institutional capability to deliver microfinance services. The liberalized policy on interest rates being adopted by PDMCs also enables MFIs to charge interest rates that will help to cover their operational costs, while meeting the huge unsatisfied demand for microfinance services.

Hindering Factors

On the other hand, MFIs must contend with the high cost of delivering services, especially to people in rural areas and outer islands. Small and highly dispersed populations make it difficult to obtain a critical mass of clients. Some MFIs have poor loan repayment performances. The lack of self-sufficiency, limited institutional capacity, inadequate financial resources to expand outreach, and lack of policy and legal frameworks all constrain the sustainability of MFIs. Other conditions, such as weak support services for business development, poor market linkages and extension, limited cash income opportunities (especially in rural and remote areas), and limited entrepreneurial skills of clients, also act as constraints to MFIs' viability.

Preconditions for Successful Microfinance

The constraints that small size imposes on the viability of MFIs are less severe for the larger PDMCs (Fiji Islands, PNG, and Solomon Islands); but in general, viability depends on five factors:

(i) the availability of cash income opportunities in rural areas;
(ii) the strength of the commitment of MFIs to outreach and sustainability;
(iii) the long-term commitment of governments and donor

agencies to provide financial and technical assistance to MFIs for institution strengthening, and funds for administrative costs and related support services;

(iv) the provision of a policy and legislative environment that is conducive to facilitating the growth of microfinance; and

(v) improved viability through the provision of support services, especially in microenterprise development and management and social mobilization.

Achieving self-sufficiency for MFIs in the Pacific is a longer-term proposition than the five to ten years in the Guiding Principles agreed to by donor agencies, because of the need to build the infrastructure for markets to develop and for cash income opportunities in rural areas to increase. There is no one best model for microfinance in PDMCs, given the differences in population density, infrastructure and other factors. Whatever modality is adopted, practice should be informed by the lessons outlined above.

Box 6.1

Best Practice for Microfinance

Market rates of interest should be charged to clients to ensure sustainability of microfinance schemes. Compulsory saving through such schemes helps to inculcate good savings habits and to improve loan repayment performance. Peer pressure through solidarity groups fosters group accountability and responsibility and results in high rates of loan repayment; in particular, mobilizing women into groups deepens their commitment to microfinance schemes.

Measures must be taken to ensure the efficient operation of microfinance schemes, including training of microfinance specialists and provision of technical advice at both management and staff levels.

Microfinance schemes need a policy, legal, and regulatory environment conducive to facilitating their growth.

Land Ownership Issues 7

Gaining secure title to land in PDMCs is difficult because of the pervasiveness of traditional customs of land tenure and the limited development of reliable leasehold regimes (Duncan et. al. 1999). Insecurity of tenure discourages potential investors, especially those considering site-specific mining and tourism projects. In addition, land cannot be used as collateral for loans from financial institutions, which restricts private sector access to finance for investment. Economic growth and financial sector development are therefore retarded. At the same time, traditional or neotraditional land tenure systems have served to protect indigenous ownership and to provide a secure basis for subsistence living, although in places the latter is now under threat from population expansion and/or a breakdown in mechanisms allocating rights to land. Adapting land tenure systems to the needs of a market economy based on private property rights is a sensitive issue and a major challenge confronting PDMC governments. This chapter reviews the various land tenure systems and makes some recommendations aimed at facilitating adaptation of traditional arrangements to contemporary development needs.

The land ownership structures in six of the seven PDMCs under review (Fiji Islands, Kiribati, PNG, Samoa, Solomon Islands, and Vanuatu) are similar and fall into three basic categories: customary land, individually owned land, and government-owned land. In Tonga there is no customary land, and all the land is either owned by individuals or by the Government. These structures of ownership, as well as the different kinds of property that can be used as collateral security for commercial loans, are examined below.

CUSTOMARY LAND

In six of the seven PDMCs reviewed in this report—Fiji Islands, Kiribati, PNG, Samoa, Solomon Islands, and Vanuatu—nearly all the land, some 80 to 90 percent of the total land area, is owned by indigenous people in accordance with traditional customs of land tenure. The traditional customs of these PDMCs are basically similar, in that customary land is generally owned by a group of people, usually related by kinship as descendants of the first occupier(s) of the land. In all six countries, group ownership of land under customary traditions is joint and undivided. In some PDMCs, especially Samoa, the leaders of the kinship group*, matai*, will often be spoken of as owners of the land, but the leader holds the land on behalf of all members of the group. In some other PDMCs, for example Vanuatu, chiefs are similarly described. This group ownership of land has serious implications for the leasing and mortgaging of customary land.

The constitutions and legislation in many PDMCs have been enacted and designed to protect indigenous people from unwise dispositions of their rights in their customary land. These legislative provisions also have serious implications for the leasing and mortgaging of customary land.

Boundary and Entitlement Disputes

In all PDMCs, there are disputes about the boundaries and entitlement to interests in customary land. These are particularly widespread and serious in Kiribati, PNG, Solomon Islands, and Vanuatu, but in all cases, measures need to be taken to ensure that disputes can be adjudicated promptly and correctly and that the resulting decision is accurately and permanently marked on the land.

Mortgages

In PNG, Samoa, and Solomon Islands, the law prohibits the mortgaging of customary land by the custom owners. In the Fiji Islands, mortgaging of customary land is permitted, but only the Native Land Trust Board (NLTB), in which the management and control of customary land is vested, may do so. In Kiribati, mortgages are permitted, but only to certain Kiribati institutions—the State, the Housing Corporation, and the National Loans Board—and only for certain purposes. In Vanuatu, mortgages are permitted, but are subject to the approval of the Minister of Lands; there is no provision for independent review of decisions about the mortgaging of customary land.

The fear in PNG, Samoa, and Solomon Islands is that allowing custom owners to mortgage their land would lead to unwise decisions that would ultimately result in mortgagees' acquiring ownership of customary lands by exercise of the power of sale or foreclosure. This fear could be assuaged by requiring that mortgages be given only to lending institutions approved by the state, as in the Fiji Islands and Vanuatu, and be enforced only by entry into possession, and not by sale or foreclosure.

Leasing

In all six PDMCs, customary land can be leased, but leasing is closely controlled by the state. In the Fiji Islands, leases of customary land can only be granted by the NLTB[10]; in Samoa, by the Minister of Lands; and in Vanuatu, where ownership is in dispute and the land is held by the Minister of Lands, by that Minister. In Kiribati, the Minister of Lands must approve leases to persons who are not i-Kiribati, or leases of areas that exceed five acres or that are for periods exceeding 21 years. In Vanuatu, the Minister of Lands must approve leases to nonindigenous persons. In Solomon Islands, customary land

[10] Thirty-year leases in the sugar industry, held mostly by Fijian-born Indians, began expiring in the late 1990s and have not been renewed, because Fijian landlords want the land back. As a consequence, investment in land development has virtually ceased.

can be leased only to the national or provincial government, which can then lease it to others.

In none of the six PDMCs is there provision for an independent review of the leasing decisions made by agencies of the State, except through investigations and recommendations by the Ombudsman in the Fiji Islands, Solomon Islands, and Vanuatu.

In PNG and Solomon Islands, leasehold interests in customary land can be mortgaged without any legal restrictions. In the Fiji Islands, Kiribati, and Vanuatu, leasehold interests in customary land can be mortgaged, but are subject to legal restrictions. In the Fiji Islands, the NLTB must approve the mortgage. In Vanuatu, the Minister of Lands must approve the mortgage; and in Kiribati, customary lands can only be mortgaged to the Housing Corporation or to the National Loans Board for certain prescribed purposes that do not include business or commerce. In Samoa, the mortgaging of leasehold interest in customary lands is prohibited.

In PNG, mortgages of customary land and of leasehold interests in customary land can be enforced without legal impediment, but in other PDMCs that allow for such mortgages (the Fiji Islands, Kiribati, Solomon Islands, and Vanuatu), there are legal restrictions on enforcement. In the Fiji Islands, NLTB consent is required for a mortgagee to sell a leasehold interest or to enter into possession. In Solomon Islands and Vanuatu, the approval of the High Court or Supreme Court is required to enforce a mortgage; and in Solomon Islands, applications to the High Court for an order to enforce a mortgage cannot be made by a person who is not a Solomon Islander. In Kiribati, a leasehold interest in customary land cannot be sold to a person who is not i-Kiribati or to a body other than the State, the Housing Corporation, or the National Loans Board.

In the Fiji Islands, Kiribati, PNG, Solomon Islands, and Vanuatu, there can also be practical difficulties about enforcing a mortgage by sale or entry into possession: the entry of the mortgagee or the purchaser of the leasehold interest may be physically resisted by the mortgagor, or the family, neighbors, or friends of the custom owners.

Use and Conversion of Customary Land

Decisions by custom owners about the use of customary land, particularly about whether it should be leased or mortgaged, are frequently difficult to make, because usually there are many joint owners of the land, who must be party to the decision and who must all agree. In some PDMCs in the study, this difficulty has been overcome by authorizing an agency of the State to act for the custom owners and make decisions on their behalf, e.g., the NLTB in the Fiji Islands and the Minister of Lands in Samoa and Vanuatu. But there is no provision for independent review of the decisions of these state agencies.

In some PDMCs, the difficulty of obtaining a decision by custom owners has been addressed by providing that the custom owners can appoint some of their own members to act on their behalf. In PNG, groups of landowners may be incorporated and decisions made by committees established under the constitution of the corporation. In Solomon Islands, custom owners who register their land may nominate certain owners as the registered owners able to deal with the registered land. However, there is little clear evidence as to how these statutory agents for the custom owners are operating. Nor is there any provision for independent review of the decisions of these agents.

In Kiribati and (where land is not under dispute) in Vanuatu, there is no statutory provision for any person or body of persons to act on behalf of the custom owners. In practice, the larger landowning groups often appoint trustees or land committees to act on their behalf. There is no statutory regulation of their activities and little clear evidence of how they are functioning.

In only two of the PDMCs in the study, PNG and Solomon Islands, is there provision for the conversion of customary land into a limited form of freehold or perpetual estate. In both countries, though for different reasons, tenure conversion is not proceeding very quickly. In PNG, it is because shortages of funds and staff prevent the Land Titles Commission from dealing with all the applications made to it for tenure conversion. In Solomon Islands, there has been reluctance on the part of custom owners to apply for tenure conversion. In the Fiji Islands, Kiribati, Samoa, and Vanuatu, there is no provision for the conversion of customary land into any form of land ownership that can be more readily mortgaged.

In the Fiji Islands, Kiribati, PNG, Samoa, and Solomon Islands, owners of customary land have often left the area or the country. This means that they do not contribute to the physical development of the land, and are difficult to contact for any decisions about the land, which all owners should consider. On the other hand, they may help to support some of the remaining owners by sending remittances and items of value from time to time. In the Fiji Islands and Kiribati, there is legal provision for the Minister of Lands to cancel the interests of absentee landowners, although this is something that a minister of an elected government is reluctant to do. In fact, these legislative provisions have very rarely been used.

Registration

There has been much debate as to whether it is desirable and useful to provide for the registration of customary land, and if so, what system of registration should be provided. The main advantages of registration of customary land are said to be that registration will provide certainty of title and boundaries, and that this will reduce the number of disputes and encourage the registered custom owners to develop the land more fully than they otherwise would. Furthermore, if a system of registration of customary land were introduced, it would provide an accurate basis for the imposition of a land tax.

The main disadvantages of registration of customary land are that it might not record accurately those entitled to the land and/or the boundaries of that land, and might lead to more rather than fewer disputes. In addition, the very initiation of registration of customary land might provoke disputes; and registration could be a very expensive process, with the cost being borne by the taxpayer and/or custom landowners. Finally, it is argued that registration is unnecessary because over large tracts of customary land there is no dispute about ownership, and no possibility of developing such lands because of their rugged or infertile terrain.

Registration could be systematically adopted throughout the whole country or a whole region or district, or adopted only in certain circumstances or occasions. It could be either compulsory or voluntary. The advantage of systematic registration is that it enables all entitlements to land ownership in a certain area to be determined, without the possibility of their being subsequently disturbed by later determinations of adjoining or nearby land. Likewise, the advantage of compulsory registration over voluntary registration of customary land is that all entitlements would be dealt with at the same time, so that there would be no possibility of their being subsequently disturbed by later determinations of nearby or related land.

In the late 19th and early 20th centuries, the colonial administration in the Fiji Islands and the Gilbert and Ellice islands (now Kiribati and Tuvalu, respectively) undertook a compulsory, systematic registration of all the land in the two colonies. This took many decades to complete, but these two countries do have systems of compulsory systematic registration of entitlements to customary lands and boundaries. Unfortunately, in neither country was the systematic registration followed up by systematic surveys. Instead, reliance was placed upon impermanent natural features, such as rocks and trees, to delineate the boundaries. Moreover, it is now clear that there were serious errors and omissions, not only in the original registration, but also in the subsequent updating of the register.

In the Fiji Islands, PNG, Solomon Islands, and Vanuatu, a form of compulsory occasional registration of customary land has been introduced. Fixed-term leases of customary land for more than 1–3 years must be registered. In Solomon Islands, provision was made in 1978 for compulsory systematic registration of customary land in selected areas—areas designated by the Minister of Lands, usually because of their potential for development. However, this did not prove popular with custom owners, who feared that their rights to the land would be curtailed or removed, and registration has now been all but abandoned. Subsequently, provision has been made in Solomon Islands for the voluntary registration of customary land. This has provoked a deep debate as to the basis upon which ownership rights to customary land should be recorded: should they be recorded on the basis of the tribes as they existed before the arrival of the Europeans, or on the basis of the subdivisions of tribes, clans and lines that developed later? This has placed a question mark over the voluntary registration of customary land in the Solomon Islands.

Whatever the advantages of compulsory systematic registration of customary land in theory, there are serious practical problems:

(i) Compulsory systematic registration now of all customary land in a country would take a very long time and would be very expensive.
(ii) Compulsory systematic registration of customary land in mountainous areas or areas that have no foreseeable potential for development is probably unnecessary.
(iii) The registration must be accurate initially, and the register must be maintained accurately, both as to entitlements to ownership to customary land, and also as to the boundaries of that land.
(iv) To be fully effective, the registration should be followed by a survey.

For these reasons, if systematic registration, either compulsory or voluntary, is to proceed, it would seem that it should be only in selected areas—areas selected on the basis of the usefulness of registration and of the practicality of ensuring an accurate registration of interests and determination of boundaries.

INDIVIDUALLY OWNED LAND

In all seven PDMCs, there are some areas of land that are not subject to customary land tenure arrangements and can be owned by individual persons or bodies. In the Fiji Islands, Kiribati, PNG, and Samoa, these areas constitute a small proportion of total land area: less than 15 percent. In Solomon Islands and Tonga, they are more significant. In Vanuatu, the legislation to allow for the creation of such land, which was enacted in 1994, has not been brought into effect, and so the example may be disregarded for practical purposes.

In the Fiji Islands, Kiribati, PNG, and Samoa, the form of individually owned land is the same: freehold land. In PNG, Solomon Islands, and Tonga, there are other forms of individually owned land: converted customary land in PNG, perpetual estates and fixed estates in Solomon Islands, and hereditary estates and allotments in Tonga. Although the forms of individually owned land are different, there are some issues in common.

Except in the Fiji Islands, PNG, and Solomon Islands, there are restrictions on the power of the registered proprietor of individually owned land to mortgage such land. In Kiribati, there is no local legislation permitting such land to be mortgaged. In Samoa, mortgages of freehold land cannot be granted to overseas corporations, or to persons who are not resident citizens, without the approval of the Head of State. In Tonga, the Minister of Lands must approve the mortgage of a hereditary estate or allotment, and there are certain statutory limitations: mortgages can be only with lending institutions approved by the Government, and only for the purpose of improving the estate or allotment.

Except in the Fiji Islands and PNG, there are restrictions on the leasing of freehold land. In Kiribati, the State has the preemptive right to acquire, voluntarily or compulsorily, any freehold land that the owner is proposing to lease. In PNG, converted customary land that constitutes a form of limited freehold cannot be leased for more than 25 years without the consent of the Land Board, unless the Minister of Lands agrees to waive the limitations. In Samoa, freehold land cannot be leased for more than 20 years to an overseas corporation, or to a person who is not a resident citizen, without the consent of the Head of State.

In Solomon Islands, perpetual estates and fixed-term estates can be leased only to Solomon Islanders, or to certain bodies and institutions defined in the Lands Act as able to own perpetual estates, unless the Commissioner of Lands gives consent. In Tonga, hereditary estates and hereditary allotments may be leased, but are subject to certain statutory restrictions, and the Cabinet or the Privy Council must approve if the lease is for more than 99 years. No more than 5 percent of a hereditary estate may be leased, and no part of the estate that in the opinion of the Cabinet is likely to be required for allotments. Leases of allotments may not exceed 20 years and the allotment must not be subject to a mortgage.

Except in the Fiji Islands, PNG, and Solomon Islands, leasehold interests in individually owned land cannot be mortgaged without restriction. In Kiribati, there is no local legislation in force to permit the mortgaging of leasehold interests in individually owned land. In Samoa, mortgages of leasehold interests for more than 20 years cannot be granted to an overseas corporation, or to a person who is not a resident citizen, without the consent of the Head of State. In Tonga, mortgages of the leasehold interest in hereditary estates and hereditary allotments may be mortgaged, but only with the approval of the Minister of Lands and subject to certain statutory restrictions: the mortgage must be by way of an assignation of the lease, and for a period not exceeding the unexpired term of the lease; and only with Government-approved lending institutions.

Except in the Fiji Islands, there are significant restrictions on the enforcement of registered mortgages of freehold land, or of leasehold interests in freehold land; such mortgages can be enforced by sale and by entry into possession, or by foreclosure, subject to public advertisement and the approval of the Registrar of Lands. In Kiribati, there is no local legislation in force to empower the enforcement of such mortgages. In PNG, mortgages of freehold land and of leasehold interests in freehold land may be enforced by entry into possession and by sale. But because the Constitution provides that only citizens and citizen corporations as defined in the Land Act can acquire freehold, the enforcement of mortgages by sale of freehold is, in effect, restricted to sale to citizens and citizen corporations. Also in PNG, mortgages of converted customary land can be enforced by sale, and by entry into possession for a period exceeding 25 years, only with the approval of the Land Board, unless the Minister agrees to remove these restrictions.

In Samoa, mortgages of freehold land and of leasehold interests in freehold land may be enforced by sale and by entry into possession. But the Alienation of Freehold Act, 1972, prohibits the transfer of land, or the leasing of land for more than 20 years, to a person who is not a resident citizen or to an overseas corporation, unless the transfer is approved by the Head of State. Hence, the enforcement of such a mortgage is subject to the approval of the Head of State.

In Solomon Islands, mortgages of perpetual estates and fixed-term estates, and mortgages of leasehold interests in such estates, can be enforced by sale, by entry into possession, and by foreclosure or vesting the estate or interest into the name of the mortgagee. However, all these remedies require sanction by an order of the High Court, and such an order can only be made in respect of a Solomon Islander. A Solomon Islander is defined as a person who was born in the Solomon Islands and has two or more grandparents indigenous to Solomon Islands.

In Tonga, mortgages of hereditary estates and allotments, and of leasehold interests in hereditary estates and allotments, can be enforced only by entry into possession, not by sale or by vesting the estate or interest into the name of the mortgagee. The approval of the Minister of Lands or of the Land Court is not, however, required to exercise this enforcement.

In addition to these legal restrictions on the enforcement of mortgages on individually owned land or leasehold interests in such land, there are in some PDMCs serious practical difficulties in the way of enforcing mortgages by sale or entry into possession. Particularly in PNG and Solomon Islands, there is often physical resistance to the exercise by a mortgagee of the power of enforcement by sale or entry into possession—resistance that is manifested not only by the mortgagors and their families, but also by their friends and neighbors.

GOVERNMENT-OWNED LAND

In all seven PDMCs in the study, the government of the country owns a proportion of the land. In the Fiji Islands, Kiribati, PNG, Samoa, and the Solomon Islands, the area of land so owned is less than 15 percent of total land area. In Tonga, the Government owns a much larger proportion of the total land. Nominally, all the land in the country is owned by the Crown, but about two thirds of that land has been granted to nobles as hereditary estates that will only revert to the monarch if there is a failure in the prescribed line of succession. Realistically, therefore, it is appropriate to say that about one third of the land of Tonga is owned by the Crown. Of this total, which is called Crown land, some lands are designated as Royal Estates, for use by the monarch for the time being; the remainder as Royal Family Estates, for use by persons nominated by the monarch.

In the Fiji Islands, land owned by the Government was called Crown Land, but is now more often called State land, as it is in Kiribati and PNG. In Samoa, Solomon Islands, and Vanuatu, this land is called Public Land.

In Kiribati and Vanuatu, there is no local legislation providing for the lease of government-owned land. In the Fiji Islands, the Minister of Lands may lease State land without restriction. In other countries, government-owned land can be leased, but the leasing is subject to some restrictions: in PNG, Samoa, and Vanuatu, it can be leased by the Minister of Lands for periods not exceeding 99 years, 20 years, and 75 years, respectively. In Solomon Islands, perpetual and fixed-term estates owned by the national Government cannot be leased, only let on a periodic tenancy. Provincial governments may grant leases of perpetual and fixed-term estates owned by them, but the consent of the Commissioner of Lands is required if the lessee is not a person born in the Solomon Islands and having two or more indigenous grandparents. In Tonga, both Royal Estates and Royal Family Estates can be leased, but only for projects of general public interest and benefit.

In Kiribati and Vanuatu, there is no local legislation providing for, or regulating, the mortgaging of leasehold interests in government-owned land. In the Fiji Islands, leases of State lands, except those that have been designated as "protected leases," may be mortgaged. In PNG, Samoa, Solomon Islands, and Vanuatu, leasehold interests in public land can similarly be mortgaged without restriction. In Tonga, leasehold interests in Royal Estates and Royal Family Estates can be mortgaged, but only with the consent of the Minister of Lands, only by way of assignation of the lease, and only to lending institutions approved by the Government.

In the Fiji Islands, registered mortgages of leasehold interests in Government-owned land can be enforced without significant restrictions—by sale, foreclosure, or entry into possession, with the approval of the Registrar of Lands. This is also the case in PNG and Vanuatu (in the latter instance, subject to the consent of the Supreme Court). In Tonga, mortgages of leaseholds can be enforced by entry into possession. In Solomon

Islands, mortgages of leasehold interests in Government-owned land may be enforced by sale of the interest, entry into possession, or foreclosure, but only with the consent of the High Court, and only in respect of a Solomon Islander.

CROPS AND LIVESTOCK AS COLLATERAL SECURITY

In the Fiji Islands and PNG, legislation permits the mortgaging of crops and/or livestock. In Kiribati, Samoa, Solomon Islands, Tonga, and Vanuatu, no such legislation exists. In Tonga, in fact, there is a statutory prohibition on the charging of crops.

Although there seems to be a general awareness of the utility of the Crop Liens Act in the Fiji Islands, the act has been in existence since 1904 and may need revising. In PNG, the Instruments Act is little known. The Commission of Inquiry into Land Matters, 1973, reported that the Instruments Act was difficult to follow and recommended that it be simplified, especially with respect to livestock.

In countries where there are significant cash crops or livestock, such as Solomon Islands, Tonga, and Vanuatu, it would seem to be advantageous to introduce legislation that permits these items of value to serve as collateral security for loans.

DISPUTES

Disputes About Customary Land

The customs relating to customary land normally provide that land is to be owned by the person who first occupied the land and the legitimate descendants of that person. The customs variously trace legitimate descent through men, through women, through both men and women, and through either men or women. In addition, customs usually provide for illegitimate descendants, adopted persons, and spouses to be regarded as part of the kinship group and to acquire some rights of ownership, although probably subject to some limitations that do not attach to other members of the group. In some communities, two or more kinship groups may be regarded by custom as forming the landowning group, possibly as a result of original occupation by more than one person, possibly as a result of subsequent fusion of the groups.

The customs of most communities recognized, especially in earlier times, that rights of ownership of land could be lost. They could be seized in warfare by the victors; they could be voluntarily transferred, usually in consideration of some special services: either outright, or for a limited period of time, or subject to certain conditions. Rights of ownership to land could be exchanged for rights of ownership to other land, again, either outright or subject to certain conditions. Ownership rights could become dormant or extinct if the owners left the community for a period of time, and they could be extinguished as a punishment for very serious wrongdoing. In more recent times, as land has acquired a financial value, and as populations have increased, some of these customs about the alienability of ownership rights have come to be disputed.

The customs of most communities also recognize that other people who are not members of the landowning group might be allowed to use part of the land of that group for certain purposes: for example, collection of fruit, nuts, and firewood; hunting for birds, flying fox, and fish; or passing through to another area. These subsidiary rights might be allowed without conditions, or they might be subject to conditions.

The boundaries of land owned by indigenous people were neither accurately surveyed nor identified by any unique or permanent form of demarcation. Usually they were described by reference to natural landmarks, such as rivers and streams, prominent rocks, or trees. These landmarks were often referred to by names that might change, or become confused with others; and the physical landmarks themselves might be altered or destroyed by nature or by people in the course of time.

Customs relating to ownership of land and other rights to land, like other customs in Pacific Island countries, were not recorded in writing or in any other permanent form: they were held in the minds of the current generation and passed on to the next generation by word of mouth and by actions. It is only in more recent times, since the expansion of literacy among indigenous people, that the idea of recording customs has been developed, and even today the recording of customs is unusual.

Moreover, even the recording of customs, either in writing or on tape, does not remove uncertainty; often customs are recorded in terms that are very general, or ambiguous, or are stated to be subject to exceptions that are themselves expressed in general or ambiguous terms.

During colonial times in the Fiji Islands and Kiribati, several attempts were made by colonial administrators to systematically register all rights of ownership to customary land. After many years and much labor, the task of registration was completed. But the utility of what was registered is open to question. In the Fiji Islands, for example, for the sake of uniformity and simplicity, the land commissioners adopted a uniform landowning group, *mataqali*, for the whole country, whereas there was very clear evidence that there were other kinds of landowning groups in different parts of the country. In Kiribati, the results of the first registration were so disputed that they had to be abandoned, and the results of a second registration gave rise to so many disputes that legislation had to be enacted to render them indefeasible, or unchallengeable. In Solomon Islands, systematic registration in selected areas was introduced, but was not continued, and now a system of voluntary recording of customary land has been introduced. However, as already noted, there are acute differences of view as to whether the recording should be based on the traditional tribal areas that existed before the arrival of the Europeans, or on the smaller kinship groups of clans or lines that have developed since then.

It is not surprising, then, that many disputes can arise about rights of ownership and interests in land. This inevitable development has been made much more pervasive and acute as a result of two developments: first, in some areas, increases in population have made land very valuable for the maintenance and support of its owners; second, increases in the value of land for commercial development have made it a prized financial resource for those entitled to rights in it. The result is that nowadays, in all countries under review, but especially in the Fiji Islands, Kiribati, PNG, Solomon Islands, and Vanuatu, disputes about customary land, and about customary titles related to customary land, are very common. These disputes constitute a serious impediment to development of the customary land and its utilization as collateral security for commercial loans.

In the six PDMCs where there is customary ownership of land, legislation has been enacted for many years to provide bodies to adjudicate disputes about customary land (Table 7.1).

In the Fiji Islands, PNG, Samoa, and Solomon Islands, there are bodies established by law that adjudicate disputes about customary land. In Vanuatu, however, these bodies either do not operate at all or operate only in certain parts of the country. The Island Courts, which are authorized by the Island Courts Act to determine customary land disputes at first instance, operate at present in only eight of the 18 larger islands in an archipelago of 80 islands. The Supreme Court, the body authorized to hear appeals of Island Courts' decisions on matters relating to land, has heard no appeals for the last three years because of lack of judicial time. Since almost all decisions of the Island Courts about customary land are appealed to the Supreme Court, there has effectively been no adjudication of customary land disputes for the last three years. It is estimated that there are more than 6,000 appeals awaiting decision. Although the bodies authorized by law to determine disputes about customary land are operating in the Fiji Islands, Kiribati, PNG, Samoa, and Solomon Islands, there are certain deficiencies about their operation. They include the following:

Delays in Hearing Cases. The most often heard complaint about the operation of the courts and tribunals authorized to adjudicate disputes about customary land is the length of time that the hearing of cases takes. This complaint is heard in all six countries, but especially in those where the ordinary courts or reconstituted ordinary courts are the ones authorized to adjudicate disputes about customary land, that is, Kiribati, PNG, Solomon Islands, and Vanuatu.

Expense of Proceedings. There are also complaints about the cost of proceedings to adjudicate disputes about customary land. These complaints are justified in countries where the body authorized to adjudicate disputes conducts its hearings in only one or two locations (Samoa and Vanuatu); where a decision about customary land may be appealed more than once (Solomon Islands); or where an appeal from a decision of a local court on a matter relating to customary land may be taken first to a customary land appeal court and then, on a matter of written law, to a high court and court of appeal.

Ignorance of the Customs Relevant to the Dispute. The complaint is frequently made that the bodies established to adjudicate disputes about customary lands do not have a sufficiently expert or precise knowledge of the customs applying to the land in question, or of the backgrounds of the disputing parties. In Kiribati, Solomon Islands, and Vanuatu, some members of the bodies determining land disputes at first instance are required by law to have some knowledge of custom, but there is no requirement that they must be knowledgeable about the customs relating to the land in dispute. In the Fiji Islands, two assessors elected by the provincial council must assist the Native Lands Commission, which hears disputes in the first instance, but there is no requirement that such assessors must be knowledgeable about the customs relating to the land in dispute. In Samoa and Solomon Islands, there is no requirement that the members of the Land and Titles Court or the Island Courts be knowledgeable about the customs relating to the land in dispute.

The same comment can be made of the bodies authorized to hear appeals of customary land disputes. In Kiribati, the High Court is required to sit with four magistrates drawn from the Land Magistrates' Panel, but there is no requirement that they be knowledgeable about customs relating to the land in dispute. In Vanuatu, two assessors who are knowledgeable in custom must assist the Supreme Court, but there is no requirement that they be knowledgeable in the customs relating to the land in dispute. In the Fiji Islands, PNG, Samoa, and Solomon Islands, there is no requirement that the appellate body have either members or assessors who are knowledgeable about custom, much less knowledgeable about the customs relating to the land in dispute.

Lack of Accurate Recording of Decisions. In those PDMCs where ordinary courts or reconstituted ordinary courts are authorized to determine disputes about customary land—that is, Kiribati, PNG, Solomon Islands, and Vanuatu—the decisions made by these courts are recorded by the staffs of these courts. These staffs are not required to have any special training in the recording of decisions relating to land. For example, errors in the recording of court decisions have been very prevalent in the Magistrates' Courts (Lands) of Kiribati.

Lack of Formal Publication of Decisions. In none of the six countries reviewed is there any statutory requirement that the decisions of the bodies adjudicate disputes about customary land be published. Consequently, there is no record available to the public of the details of decisions, nor of the manner in which the bodies are performing their functions.

Lack of surveying or permanent marking of boundaries. In the Fiji Islands, the legislation requires that boundaries of adjudicated customary land must be surveyed. In Solomon Islands, if custom owners choose to register the land under the Customary Land Records Act 1994, the land must be surveyed. But a survey of the boundaries of the land as determined by the bodies authorized to do so is not required in Kiribati, PNG, Samoa, or (unless the owners choose to register the land) Solomon Islands. No doubt surveying of boundaries is not required because of the limited number of technically qualified surveyors available and the cost of undertaking a survey. However, it does leave the way open to many disputes in the future. In PNG, legislation attempting to address this problem requires that the court adjudicating disputes over customary land must visit the site of the land with the parties and, with not less than five witnesses from the same or an adjacent area, so far as is practicable walk the boundaries, and satisfy itself that the parties and the witnesses understand the decision, the scope of the land, and the boundaries. Such a process is predictably time-consuming and expensive.

Lack of power to adjudicate disputes about customary titles. In the Fiji Islands and Samoa, the tribunals authorized to adjudicate disputes about customary land are also authorized to adjudicate disputes about customary titles. In Kiribati, PNG, Solomon Islands, and Vanuatu, there is no provision for the adjudication of disputes about customary titles, although entitlements to customary land are often clearly linked with customary land.

Disputes About Individually Owned Land

In five of the six countries where there is individually owned land (the Fiji Islands, Kiribati, PNG, Samoa, and Solomon Islands), disputes about ownership are adjudicated by the High Court or Supreme Court, with appeal to the Court of Appeal and, in the case of the Fiji Islands, subject to a further appeal to the Supreme Court. In Tonga, a Land Court is authorized to hear disputes about land, and decisions by that Court are appealed to the Court of Appeal of Tonga, except for appeals relating to the estates and titles of nobles, which are determined by the Privy Council.

Disputes About Government-Owned Land

In the Fiji Islands, PNG, Samoa, and Solomon Islands, the High Court or the Supreme Court adjudicates disputes about government-owned lands, with appeal to the Court of Appeal. In the Fiji Islands, there is provision for further and final appeal to the Supreme Court. In Tonga, a Land Court is authorized to hear disputes about Government-owned land; the Court of Appeal determines appeals from the Land Court.

This chapter has explored the complexities of PDMC land tenure systems and the pressures to which they are subject as a result of growing populations and increasing monetization of subsistence economies. Reconciling the twin needs of protecting indigenous people's key asset and allowing land to be exchangeable and usable as collateral is a difficult task. But innovative solutions, mostly involving leasing through an agency acting on behalf of the owners, have been found.

Table 7.1
Legislation on Adjudicating Disputes about Customary Land

Fiji Islands	***Native Lands Commission (NLC)*** – one or more commissioners appointed by the Minister of Fijian Affairs, who sits with the *Roko* or Fijian provincial administrator, assisted by one or more assessors elected by the provincial council: Native Lands Act. ***Appeals Tribunal*** to hear appeals from NLC, i.e., three persons appointed by the Minister; the chairman must be qualified to be a judge or have academic or other qualifications, and the other members also must have academic or other qualifications and experience. Decisions of the Appeals Tribunal are final and not challengeable in a court of law: Native Lands (Amendment) (Appeals Tribunal) Act 1998.
Kiribati	***Magistrates' Courts (Lands)*** – five magistrates, at least three of whom are selected from a panel of land magistrates selected by the Chief Justice, after consultation with the chief lands officer: Magistrates' Courts. Ordinance. Decisions are to be by a majority: Magistrates' Court Ordinance. ***High Court*** to hear appeals from Magistrates' Court (Lands), i.e., Chief Justice or judge sitting with four magistrates selected by the Chief Justice from the land magistrates' panel. Decisions are to be by a majority and to be final and not challengeable in a court of law: Magistrates' Court Ordinance.
PNG	***Land Titles Commission*** – Chief Commissioner and such other commissioners as Governor-General shall appoint, assisted by assessors if Commission wishes. A single Commissioner may exercise power of Commission. Jurisdiction to determine whether land is customary land, water, or reef, and also to determine claims for compensation: Land Titles Commission Act 1962. ***National Court*** – Chief Justice, Deputy Chief Justice, four to six Judges, approved by the Head of State on the advice of the Judicial and Legal Services Commission, except for the Chief Justice, who is appointed on the advice of the National Executive Council. Jurisdiction to hear appeals from Land Titles Commission, Constitution of PNG. ***Local Land Courts*** – Local Land Magistrate sitting with two or four land mediators to adjudicate disputes as to interests in land, after referral to mediation. Decision of Court to be by a majority: Land Disputes Settlement Act. ***Provincial Land Courts*** – three Provincial Land Magistrates (i.e., senior land magistrates) Jurisdiction to hear appeals from

cont. next page

Table 7.1 (cont.)
Legislation on Adjudicating Disputes about Customary Land

	decisions of Local Land Courts in the province: Land Disputes Settlement Act.
Samoa	***Land and Titles Court*** – President (Chief Justice or Judge of the Supreme Court) Deputy Presidents (Senior Samoan Judges), Samoan Judges and Assessors, appointed on the advice of the Judicial Service Commission. Decision by a majority. Jurisdiction to determine disputes relating to Samoan names and titles and to customary land: Land and Titles Court Act 1981.
	Land and Titles Court (Appeals) – President and two Samoan Judges appointed by the President. Jurisdiction to hear appeals from Land and Titles Court: Land and Titles Court Act 1981. Decisions to be final: Land and Titles Court Act 1981.
Solomon Islands	***Land Courts*** – President, Vice President, and two to ten members appointed by Chief Justice. Decisions by a majority. Jurisdiction to adjudicate disputes about customary land: Land Courts Act, Land and Titles Act.
	Customary Land Appeal Courts (CLAC) – President, Vice President, and at least three other members, of whom at least one is a magistrate appointed by Chief Justice. Jurisdiction to hear appeals from Land Courts relating to customary land: Land Titles Act.
	High Court – Chief Justice or judge of the High Court. Jurisdiction to determine appeals from CLAC on points of law, not including customary law, or failure to comply with procedural requirements of written law: Land and Titles Act.
	Court of Appeal – President and Judges of Appeal, and Chief Justice and Judges of Supreme Court. Jurisdiction to hear appeals from High Court, with leave, on a matter that is not a matter of fact: Land and Titles Act.
Vanuatu	***Island Courts*** – at least three justices knowledgeable about custom, of whom at least one must be a custom chief. Jurisdiction to adjudicate disputes relating to customary land: Island Courts Act.
	Supreme Court – Chief Justice and Judges of the Supreme Court appointed by the President on the advice of the Judicial Service Commission, except the Chief Justice, who is appointed after consultation with the Prime Minister and Leader of the Opposition. Jurisdiction to hear appeals from the Island Courts on all matters concerning disputes as to the ownership of land: Island Courts Act.

Box 7.1

Best Practice for Land Systems

All reform efforts in regard to land tenure must be based on an understanding of the complexities involved in each case, and must be formulated with sensitivity to the cultural issues involved.

Governments need to facilitate the leasing and mortgaging of customary land, government-owned land, and private land. They also need to facilitate the mortgaging of leasehold interests in customary, government, and private land.

Appropriate tribunals should be established to adjudicate disputes about customary land and titles in those PDMCs currently without tribunals. They should operate independently, efficiently, and economically, based on principles that are fully acceptable in the community.

Mortgaging of crops and livestock should be permitted in those PDMCs that now prohibit it.

Key Constraints on Financial Sector Development

8

A well-developed financial sector plays a central role in promoting economic growth in a country. It raises the savings rate and improves the transformation of savings into more productive investments, by efficiently allocating these resources among competing investment projects. The productivity of an economy's aggregate investment is thereby increased, and the incentive created by the improved returns to savings in turn inspires higher savings and investment rates. Not only is growth likely to be spurred by the greater availability of capital made possible by financial development, but the development of the financial sector itself is in turn driven by economic growth, high income, and savings. This gives rise to a virtuous circle of economic growth and financial sector development (McKinnon 1989).

The review in the preceding chapters shows that virtuous circles of economic growth and financial sector development have yet to be established in PDMCs, though this is not to deny that progress in financial sector reform was made in the 1990s. All PDMCs moved from direct to indirect instruments of monetary control and liberalized interest rates, and most have maintained positive real deposit rates. Weekly auctions of Treasury bills or central bank notes became the primary method for influencing banking systems' liquidity. PDMCs also passed legislation to give central banks more authority to supervise financial institutions, for the most part upgraded their prudential regulations to bring them in line with international standards and the Basle conventions, and made considerable progress in improving banking supervision activities.

On the down side, domestic savings mobilization remains low because there are few incentives to save, with foreign aid allowing high levels of consumption and supporting public sector investment. Liquidity is high because of a limited number of bankable projects and a lack of alternative investments for NPFs. Commercial banks finance at the low-risk end of the market, or require considerable collateral that is not readily available, given the nature of land tenure systems. DFIs are of limited effectiveness, capital markets are virtually nonexistent, and MFIs have not yet developed. In some PDMCs, substantial amounts of overseas remittances bypass the formal financial system, further narrowing the scope for financial intermediation. In this situation, even entrepreneurs with viable projects can find it difficult to get financing.

This chapter summarizes and further examines the key constraints on the development of the financial sectors in PDMCs.

THE REAL SECTOR

The most important constraint on financial sector development is slow economic growth, which has limited the demand for improved credit provision and for convenient means of accumulating savings. If financial sectors are to develop faster, the rate of growth in real sector activity must accelerate; and if financial sector development is to extend beyond the urban areas, the growth in real sector activity must include the semi-subsistence rural areas and outer islands. At present, financial intermediation in PDMCs is limited by the fact that a large part of the population remains outside the formal, monetized economy; a substantial part of scarce savings in the form of commodities cannot effectively be allocated towards investment opportunities. Growth in the real sectors in rural areas is needed if their financial services are to be improved. Without production for markets, rural people will have little or no cash to save, or with which to pay back a loan.

Faster sustained economic growth requires increased private sector investment, to be supported by good quality public investment in physical and human capital (Duncan et. al. 1999). In general, the relative lack of private investment in PDMCs cannot be attributed to the unavailability of finance at competitive real interest rates, although in Solomon Islands and PNG, as a result of fiscal mismanagement, the public sector has notably been crowding out the private sector. More important 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 a loan; and (ii) a lack of profitable investment opportunities, which in part reflects the largely immutable constraints of small economy size and remoteness, but which also reflects the impact of government policies and behavior on the costs and risks of investing.

Lack of Access to Finance

Lack of access to finance that is attributable to poor loan applications and lack of a track record in borrowing can be alleviated, through provision of business services and improved monitoring by financial intermediaries. Some commercial banks now assist potential small-scale borrowers with development of a business plan. The land issue is much more problematic. As discussed in the previous chapter, land tenure systems in PDMCs have served to protect indigenous ownership of a key asset that has been permanently alienated in many other developing countries. However, the protection has come at the price of impeding domestic and foreign investment; and traditional land tenure systems are increasingly suffering the dual pressure of providing a subsistence base for growing populations, while adapting to the demands of the cash economy.

Although a leasehold title system is seen as the way forward, there are difficulties. In most PDMCs, the period of time allowed for the leasing of customary land is inadequate for large-scale development. There is also considerable uncertainty as to whether leaseholds of converted customary land should be mortgagable, and whether mortgages should be enforced against leaseholds of converted customary land. Even leases and mortgages of freehold land and government-owned land present difficulties for investors: in some PDMCs, there are restrictions on the mortgaging and leasing of freehold land; in many cases, long-term leases and mortgages of freehold land cannot be granted to persons who are not resident citizens. Land and titles commissions and courts have been set up to deal with claims for tenure conversion and disputes over land tenure, but most PDMCs are not able to deal with the number of claims and disputes. There are substantial delays in the courts, especially with regard to disputes about customary land and customary titles. Some commercial banks work within the system, using leases as collateral. However, this is not always sound security, as there are sometimes restrictions on transferring leases to financial institutions, particularly foreign institutions that by definition are not resident citizens.

The inability to use land as collateral and to obtain predictability of land tenure for investors constitutes a major deterrent to private investors. But reform of land tenure systems will of necessity proceed slowly. The challenge for banks and other financial institutions is how to work within the existing systems to utilize land to provide greater security for investors and lenders, possibly by extending the length of transferable leases. There are also cases where private investors have made arrangements with tribal groups for sustainable land tenure. This has usually occurred because of extra facilitative effort on the part of governments.

Lack of Profitable Investment Opportunities

Profitable investment opportunities are limited by varying degrees of smallness, geographic isolation and fragmentation, limited physical and human resource endowments, and climatic shocks. Potential domestic and foreign investors must come to terms with these constraints and risks, just as Pacific Islanders in general have done for many years. Other identifiable causes of the lack of investment include specific cultural or social issues, and government policies that raise the costs and risks of investing (Duncan et. al. 1999).

In addition to the impact of land tenure systems on the viability of investment projects, there may be instances where the cultural and religious customs of Pacific Islander populations preclude or constrain investment. Customs vary considerably between and within PDMCs, so that generalization is not possible beyond Hughes' observation that "Strategies to promote growth have to take account of the chaotic but dynamic flexibility of the way people actually arrange their lives" (Hughes 1998, 104).

The operation of government business enterprises crowds out private sector activity. Complex government rules and regulations, and their discretionary application, have resulted in high transaction costs for business. This has been especially true for foreign direct investment, which has been regarded with ambivalence and occasionally with hostility. More generally, poor governance environments and macroeconomic instability have deterred private sector investment. The first requirement in McKinnon's optimum order of liberalization is that countries have balanced government finances and deregulated domestic economies with predictable and consistent policies (McKinnon, 1993). As observed in Chapter 2, significant progress has been made in reducing policy-induced restrictions on private investment through implementation of economic and public sector reform programs. But not every country has adopted a reform program; implementation is ongoing where programs have begun; and political instability has derailed implementation, at least temporarily, in some instances. As Bruno (1994, 15) notes: "the most important—and hardest—service for a government to deliver is the irreversibility of a new policy environment and the credibility of the reform effort." Sustained service delivery is nonetheless essential if private investment is to become the engine of accelerated economic growth, and thus of financial sector development.

THE FINANCIAL SECTOR

Financial sector development also has been retarded by intrasectoral constraints, some of which can be eased through appropriate policy changes.

Lack of Competition in Banking Sectors

Competition is hindered by the high level of concentration of foreign banks and by the large amount of excess liquidity in the banking systems, which is reflected in high net interest margins. The perceived scarcity of bankable projects even in urban areas has also hindered competition. There is an unsatisfied demand for loans, but the risk involved is too high for commercial banks, especially when land tenure systems make it difficult to reduce the risk by using land as collateral. The lack of efficient and competitive nonbanking financial sectors has also inhibited competition. Microfinance systems offer very little competition for commercial banks. The low level of development of money and capital markets has meant that there are very few savings instruments such as Treasury bills, unit trusts, or stocks to compete with bank deposits. For specialized institutions, such as insurance companies, there is often no competition at all. Even though most PDMCs have fairly open banking sectors, the small size of the markets remains a constraint to the entry of more banks.

Poor Governance

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. One major governance issue relates to the independence of central banks, which in some PDMCs has been compromised through government interference and directives. Such interference has on occasion prevented the development of appropriate prudential supervisory processes and monetary policy.

Governance has been a particular issue for development banks in most PDMCs. There has been a high level of government involvement, and in some cases political interference, in the appointment of development bank boards, as well as in some areas of lending. Such interference has combined with poor management, inadequate pricing of risk, a lack of appropriate supervision, weak loan appraisal and accounting systems, and an acute shortage of requisite human resource skills (particularly numeracy and quantitative ability), to push DFIs into financial difficulties. Greater private sector representation on boards is desirable but difficult to achieve, because of the small number of private sector individuals who could effectively serve on such boards without incurring conflicts of interest.

With one or two exceptions, DFIs continue to incur losses, some of a magnitude that puts their solvency into question. Across the region they confront

(i) the high cost of raising funds on domestic markets, compared with commercial banks;
(ii) the narrow skill base among executives and staff, especially in dealing with risk and new areas of business;
(iii) high-risk lending propositions, since the commercial banks have already secured the available better-quality lending;
(iv) lack of any formal prudential supervision, in most PDMCs;
(v) high costs of maintaining branch networks in outer islands and rural areas; and
(vi) susceptibility to arrears and recovery problems.

Nonetheless, because commercial banks will not undertake any significant levels of lending to rural/outer island sectors, or for development projects in urban areas, there is a need for development banking to promote economic growth with greater equity, to expand indigenous involvement in the market economy, and to generate employment growth (Skully 1999).

Poor corporate governance also has adversely affected the performance of some NPFs. In these cases, political interference in fund management has been highly counterproductive, and supervision has been inadequate. With the exception of the Fiji Islands and Solomon Islands, supervision has been the responsibility of ministries of finance rather than central banks.

Inadequate Supervision and Enforcement of Prudential Standards

Supervisory functions and enforcement of prudential standards are particularly important in small, uncompetitive financial sectors. Despite an improved legislative environment for supervision and strengthened supervision activities, the quality and effectiveness of central banks' supervisory capacities still needs upgrading. For the most part, the financial institutions departments of the central banks are too small, and the average length of experience of staff too short, to enable the departments to function efficiently. The lack of experience and adequate training is an obstacle to supervisory capacities for both off-site and on-site supervision of commercial banks. These capacities need strengthening through long-term training and specialized external assistance, especially since the supervisory role should extend to nonbank financial intermediaries, MFIs, and, for the Fiji islands and PNG, large financial conglomerates. Improved supervision capacities will increase the scope for adding financial products and services and improving financial intermediation.

Hindrances to Development of Money and Bond Markets

The lack of autonomy and low profitability of central banks, together with the high liquidity of national provident funds, has hindered the development of money and bond markets. In most cases, absorbing the large amounts of excess liquidity in financial systems has been costly for central banks, both because of the number of instruments needed to mop up the liquidity and because sometimes it requires high interest rates to clear the market.[11] Liquidity has continued to grow, while the profitability of central banks has remained stagnant and the potential cost of mopping up liquidity has increased. Because some central banks do not have sufficient income (they rely almost entirely on interest earnings on external reserves), their autonomy in the conduct of monetary policy has been compromised.[12] Interest rate distortions have sometimes resulted: central banks have been compelled to pay below-market rates on their securities. Monetary policy has then been conducted through the raising of reserve requirements, moral suasion, and direct credit controls. Illiquid interbank markets in PDMCs have also hindered the development of money markets.

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[11] The cost of mopping up an estimated SAT$40 million in excess reserves in Samoa was calculated to amount to SAT$2 to SAT$6 million for an auction interest rate between 5 and 15 percent.

[12] During 1994–95, for example, Tonga experienced a surge in credit to the private sector, which resulted in a decline in foreign reserves. With a large amount of central bank securities outstanding, the National Reserve Bank of Tonga could not raise interest rates on the securities to respond to the situation, because the interest costs were too large compared with the bank's small profit.

Hindrances to Development of Corporate Bond Markets

The development of a corporate bond market has been constrained by

(i) the lack of an active government bond market and thus the lack of a base yield curve;
(ii) the relative liuidity of the banks, which means that loans are probably cheaper and easier for most companies than the issuance of a debt instrument;
(iii) the lack of sophisticated intermediaries, banks, and NBFIs that could manage, place and underwrite debt issues;
(iv) the lack of developed NBFIs looking for long-term, high-yielding investments (except in the Fiji Islands and PNG); and
(v) the small number of companies with good historical audited financial accounts, without which risk assessment is not possible.

The issue of government bonds and bills, bank liquidity, and competition in the provision of bank and nonbank financial services must be addressed in order to ease these constraints.

Hindrances to Development of Capital Markets

To develop a capital market, there must be companies that wish to raise finance through the market. The major problem for both the current PDMC stock exchanges, SSE and POMSoX, is lack of volume, which is due to a lack of shares available for trading. A major reason for this lack is the high levels of bank liquidity and the availability of bank finance, which generally has discouraged companies from issuing shares. Another reason is the extent to which governments control large state enterprise sectors, and the lack of private companies large enough, or with accounts adequate enough, to meet listing requirements. The lack of appropriate legal, regulatory, and tax frameworks in most PDMCs is also a constraint. In particular, the lax enforcement of corporate income tax collections in some PDMCs makes it possible for closely held corporations to avoid taxes by showing low accounting profits; this would not be possible if the corporations were traded publicly. Owners of private companies are sometimes reluctant to dilute their family ownership and control by issuing stock, or to comply with requirements to disclose information about their operations. In some PDMCs, the systems for recording the registration of companies and for monitoring ongoing compliance with the companies act filing requirements is inadequate, and is a constraint to the development of capital markets. Governments also need to define the operational scope of underwriters, brokers, dealers, merchant banks, and mutual funds.

Privatization of profitable public enterprises is potentially an important means of stimulating the development of capital markets. Such privatization refers to transfer of the ownership of a public enterprise to the private sector, whether by trade sale to a local or foreign buyer, or sale to the general public through an initial public offering (IPO). However, an IPO is usually not an option for most public enterprises in PDMCs because of their size, profitability status, and lack of proper audits. Where an IPO appears feasible, its effective implementation may be inhibited by restrictions on foreign ownership and/or on foreign exchange.

As-Yet Unrealized Impact of Microfinance Institutions

Almost 80 percent of PDMC populations live in rural and outer island areas, engage in semisubsistence economic activity, and are poorly served by formal and informal financial institutions. MFIs therefore have a potentially important role to play in furthering economic and financial sector development of these areas. However, MFIs have had little impact to date. Given the small populations and limited cash incomes involved, it is difficult to obtain a critical mass of clients to reach the scale where viability of operations can be achieved. Competition from government or donor grants for income-generating projects also impedes microfinance development. Some MFIs emphasize credit rather than saving, which has led them to perform badly. Others charge artificially low interest rates. Weak governance structures, coupled with limited institutional capacity and the lack of a proper legal and supervisory framework for microfinance, have also led to poor performance.

Although government agencies, business advisory centers, NGOs, and business development units of development banks provide training and business advice to microentrepreneurs, these services have a number of shortcomings. Support services are often provided on a piecemeal basis, with no follow-up or ongoing service. There is a lack of coordination between the suppliers of services, resulting in duplication of effort by providers and confusion and misinformation for clients. Services are available only to a relative few. Most training is done in large groups, in English, and for short periods (e.g., half a day), lessening the effectiveness of the training and group interaction. Training is designed for small-scale enterprises and relatively well-educated participants, and employs materials that are frequently outdated and insufficiently client-focused. Where fees are charged, access to training is confined to those who can afford to pay. New and innovative products need to be introduced using local resources and indigenous skills, and with appropriate technical assistance, in order to prevent the use of inappropriate imported models.

Strategies for Financial Sector Development

9

Financial sector development is both a function and a determinant of economic development. Promotion of economic development through creation of an enabling environment for the private sector, public enterprise reform, and efficient and effective fulfillment of the core functions of government (including the maintenance of macroeconomic stability) will also promote financial sector development. At the same time, economic development depends, among other things, on creating efficient, competitive, and responsive financial systems, capable of mobilizing savings for the funding of investment projects. Direct means of facilitating financial sector development in PDMCs are the focus of this final chapter. The key recommendations emerging from the analysis of PDMC financial sectors and of best practice are presented for each of the areas covered in chapters 3 to 7.

The recommendations have three general themes:

1. **Place much more emphasis on managing risk.** Governments should pursue financial and economic policies that reduce country risk. They should promote sound and efficient financial systems through strengthened supervision, and improve their corporate governance environments. Governments can also help to reduce the credit risks to lenders by reforming land tenure systems. Creating an appropriate environment for NBFIs and capital market development will also help to reduce risks by diversifying investment products.

Governments should not cover the market risks for the private sector, however. Procedures for improving risk assessment also need to be put into place, perhaps by establishing a regional center of excellence that could provide training and undertake specific risk assessments or reviews of risk assessments. A small venture capital fund could also help by assessing risk and putting up funds, thus reducing the risks for financial institutions providing debt finance.

2. **Impart a regional orientation to upgrading of skills bases in most PDMCs.** Countries have much to gain from cooperating on a regional basis, particularly in the legal, regulatory, and supervisory areas, but also in terms of developing capital markets to trade securities across national boarders. The Pacific Islands Prudential Regulation and Supervision Initiative (see below) has already been established to further strengthen PDMCs' domestic regulatory environment and supervision, and includes a commitment to the establishment of more formal and extensive arrangements for closer cooperation and coordination among the members of the Initiative.
3. **Develop MFIs and integrate them more effectively into formal financial systems.** Small MFIs are clearly an appropriate means of facilitating a greater involvement of rural and outer island populations in the monetized economy. They can provide a savings mechanism for small savers, who then can borrow against their savings; and they can also be a means of transferring marketing, management, and accounting skills. However, there will ultimately be a need for successful enterprises to move from microfinance to development finance institutions and commercial banks.

BANKING SYSTEMS

Promote more effective competition for foreign banks.

To promote more effective competition for foreign commercial banks, governments of PDMCs should encourage the development of nonbank financial intermediaries—finance companies, development finance institutions, investment banks, mutual funds, unit trusts, leasing and factoring companies, insurance companies and pension funds—by ensuring a level playing field. Governments should also enhance competition in financial sectors by allowing NPFs to invest more of their money offshore, and perhaps by requiring them to invest a minimum amount overseas. This would allow for mopping up 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. This policy would also encourage the development of interbank markets.

Competition would be enhanced if central banks would adopt effective monetary policies. To do this would require the following measures:

(i) the solution of central bank funding problems, so that the interest costs of monetary policy do not prevent effective open market operations;
(ii) the establishment of open market operations based on government securities or central bank bills; and
(iii) close cooperation between monetary and fiscal authorities for liquidity projection purposes.

Pricing of securities by central banks should be market oriented and consistent with deposit and lending rates, so that they do not distort interest rates and hamper the development of secondary markets. In PDMCs where it is not possible to develop an active secondary market, the central bank should consider conducting open market-type operations through repos and reverse repos,[13] rather than through outright purchases and sales. It might be possible to develop an active repo and collateralized interbank market at a lower cost than that of secondary markets.

[13] "Repo" is short for repurchase agreement. The holder of a security sells the security and agrees to buy it back from that party at an agreed future date at an agreed price. In theory, it can be used for any securities; in practice it is mainly used in government bond markets by banks needing cash to manage their accounts at the central bank. The repo could be for one day, i.e., sell today and buy back tomorrow. Reverse repos are used when a bank has excess cash and buys government paper from a bank with too little and agrees to sell it back at an agreed price on an agreed date. For every repo there is a reverse repo.

Allowing citizens of PDMCs to utilize financial services through the Internet could also lead to more competition in financial sectors. For example, in PDMCs such as Kiribati, which uses the Australian dollar, citizens could use Australian banks through the Internet. One or two offices could be set up in the PDMC and citizens could go to the Internet office to bank, or could use their own Internet connection. They would have several foreign banks to choose from, creating much more competition than they could have in their small domestic market.

The development of capital markets to provide new opportunities and more alternatives to savers and investors would also bring competition to commercial banks, as savers would have an opportunity to invest in equity products as well as bank deposits (see below).

It has been suggested that where financial sectors are imperfectly competitive, "regulations can be designed and implemented to simulate competitive conditions, as in the case of setting minimum deposit rates of interest" (Fry 1994). However, such price regulation would go against the general financial liberalization actions taken in the 1990s, and assumes there would no problem of government failure, when in fact such regulation would place additional demands on already scarce administrative capacity. It also would reduce the operational flexibility of banks, which is important to financial system soundness. The preferred option is to encourage contestability of markets through the maintenance of existing open entry policies, to ensure that banks provide standardized information on their loan and deposit rates, and to strengthen prudential regulation (see also Chand 2001 and Rosales 2001).

Strengthen supervisory systems and develop financial sector infrastructure.

These measures 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 DFIs, NPFs, and other NBFIs can also come under the purview of central banks' supervisory systems. PDMCs are too small to allow fragmented systems of supervision of financial institutions in which ministries of finance supervise government-owned enterprises. NBFIs should be subject to the same disclosure requirements as banks as to entry and exit requirements. In the long term, banking supervisors might consider the APRA model,[14] the United Kingdom Financial Services Authority, or a variant as a means of fulfilling the prudential supervision function, including the regulation of more complex financial institutions.

On a longer-term perspective, 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 PIPRSI. Related to this is the need for a formal analysis of the regulatory systems and supervisory practices of PDMCs for their compatibility with internationally accepted norms (Basle Core Principles), in order to lay the foundation for the timely harmonization of financial sector regulation and supervision on a regional basis. On- and off-site supervision capacities should be strengthened through long-term training organized regionally.

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. This would make on-site and off-site supervision more evenly applicable, and errors and weaknesses more easily identifiable.

It is also recommended that PDMCs 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, possibly organized regionally.

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[14] The Australian Prudential Regulation Authority (APRA) was established in 1998 to take over the prudential supervision roles of the Insurance and Superannuation Commission and the Reserve Bank, which covered life and general insurers, superannuation funds, and banks. In July 1999, APRA also took over responsibility for the State-regulated building societies, credit unions, and friendly societies. More than 85 percent of the assets in Australia's financial system are now APRA's direct responsibility.

NONBANK FINANCIAL INSTITUTIONS

Increase DFIs' commercial orientation and independence from government.

Efforts should be made to improve DFIs' performance by increasing both their commercial orientation and their independence from government. Where necessary, the acts governing DFIs should be strengthened to provide greater independence for boards, and, in particular, curtailment of the power of ministers to intervene on any grounds other than performance. The provisions regarding appointment and dismissal of directors should be strengthened to reduce volatility. Provisions for nonattendance should also be reinforced to allow for stronger sanctions in the event of blatant nonattendance by board members. The composition of the boards should also be reviewed to increase the level of private sector representation, and consideration should be given to capping directors' fees. Government ownership could continue subject to the latter changes, but the following options could also be considered: merging with another institution, contracting out the DFI's management, and developing alliances with other organizations, such as credit unions and provincial cooperatives.

DFIs need to ensure that they operate in a way that minimizes the likelihood of continuing losses from poor practices and procedures. This 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. Common regional policies based on best practices should be established for DFIs.

These policies could include

(i) setting standards for disclosure;
(ii) setting minimum capital adequacy requirements;
(iii) setting levels of provisioning;
(iv) advising on strengthening of legislation;
(v) harmonizing training requirements throughout the region; and
(vi) establishing loan systems.

DFIs should move towards self-funding through bonds and promissory notes, while any subsidies from governments should be allocated on a transparent and targeted basis. DFIs should formally report to their respective central banks, providing the following information:

(i) loan classification by sector and type;
(ii) connected lending and concentration of loans to individuals and corporations;
(iii) level of provisioning by types of loans;
(iv) capital adequacy to reflect the risk of DFIs;
(v) policies on interest accrual, suspension of interest on outstanding loans, and the moving of interest rates to market levels;
(vi) policies on DFI officers, especially those dealing with conflicts of interest as a result of lending to board members;
(vii) policies on common minimum standards for disclosure, including information on all loans above a certain size; and
(viii) policies on disclosure of relevant information on directors.

Give NPFs greater autonomy and procedural safeguards.

National Provident Funds (NPFs) should operate independently of governments 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. Greater allowance for overseas investment of funds should be made. Consideration should be given to developing a model investment strategy that could be adopted (or adapted) by all the provident funds in the region. In countries with a stock exchange, these rules are likely to involve stock exchange-listed securities. In PDMCs without a domestic stock exchange, the model rules may refer to recognized local investments or recognized overseas stock exchanges. In these cases, it will be necessary to ensure that such investments can be made in accordance with the relevant exchange control regulations. NPFs must have an adequate system for recording members' assets, which includes facilities for recording members' loans and direct investments. Where model rules for withdrawals and loans are not in place, they should also be developed.

CAPITAL MARKETS

Develop effective, efficient infrastructure for company registration and monitoring.

Development of the capital market in PDMCs can potentially provide an alternative to the commercial banks. Given the small size of the PDMCs, this can be best achieved on a regional level. 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 training for staff and companies as to their ongoing responsibilities. Harmonization of the relevant laws is not a prerequisite for the development of a regional stock exchange, but it would be of considerable assistance.

Create an appropriate investment environment.

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. The law should differentiate between organizations that are already licensed in recognized overseas countries and those that wish to obtain a license in the PDMC concerned without any overseas backing.[15] In the former case, a simple registration procedure should suffice. In the latter

[15] Regulators simply determine which countries to "recognize". In general terms, the members of the International Organization of Securities Commissions are automatically recognized, and other regulators are recognized on a case-by-case basis. Often the domestic regulator will attempt to obtain a Memorandum of Understanding (MOU) with the other regulator. This MOU would enable the two regulators to share information. Bonds are defined as instruments with an initial maturity of more than one year. Money market instruments (central bank bills and treasury bills) may have a maturity that ranges from one day to one year. Money market instruments are generally issued on a discount basis, whereas bonds are normally issued at par value, with interest paid annually, semiannually, or quarterly.

case, more detailed regulations would be needed. A list of licensed persons should be kept, and the regulator should advise the public to only deal with registered services, thus providing a degree of protection. It is recommended that the regulator of persons offering investment services should be the relevant central bank.

Establish a regional capital market.

To promote capital markets on a regional basis in PDMCs, it is recommended that a distributed, networked regional facility be established that uses Internet technology to link the existing exchanges (SSE and POMSoX) to companies and investors in all the PDMCs. This facility could make provision for other domestic exchanges to be added to the network as they are developed. There are several advantages to this proposal:

(i) The facility can be recognized by governments, but no government has to enact extensive legal changes before the system can be brought into operation.
(ii) Joining the facility does not prevent any of the PDMCs from enacting legislation to govern public issues, or the offering of investment services to the public (indeed this would be encouraged in terms of developing the domestic industry and investor protection).
(iii) Joining the facility does not prevent any of the PDMCs, when the time is right, from developing a domestic stock exchange, which could form another "node" on the network.
(iv) Companies that list will make themselves subject to the listing rules and disclosure requirements of the chosen exchange, thus providing a degree of investor protection.
(v) Development of the trading mechanism should be relatively inexpensive, which is important, given the low level of awareness of capital markets in all the PDMCs and the fact that the service cannot be expected to produce significant income in the short term.

Privatize state-owned enterprises through a public share offering.

It is further recommended that the various privatization bodies in the PDMCs should, where possible, identify and privatize profitable state-owned companies through the mechanism of a public offer of a significant proportion of the shares. In addition, they should ensure that sufficient shares are offered to the public to enable the creation of a liquid secondary market (which would provide the public with experience in using a market), and support the privatization by a significant publicity campaign that would encourage the public to buy shares and also to create public awareness of the stock exchange.

An Internet-based trading mechanism would allow the service to be offered through licensed intermediaries in the countries that have enacted the relevant legislation, and directly to investors in the others. Services can be offered without the need for a physical presence in that location. An Internet-based trading facility would also be attractive to young professionals, who are probably the target audience of the future, and the front end of the Internet service could be customized and presented as a regional facility to potential investors.

Set up a regional settlement facility.

Because a facility to settle trades by book entry transfer will be essential when volumes increase (currently both SSE and POMSoX settle in physical form), it is recommended that the following implications for setting up a regional clearing and settlement facility such as "PacifiClear" be considered:

(i) the necessary legal changes;
(ii) the ownership of such a facility;
(iii) the functionality required of such a facility, bearing in mind both current and future regional and national developments; and
(iv) the potential cost of development and operation.

It is also recommended that SSE investigate the options for implementing an automated trading system, including reviewing the feasibility, costs, benefits, and risks of SSE's using the same trading system as POMSoX.

Organize a regional venture capital fund.

The establishment of a new regionally organized venture capital fund should be considered. This fund would make finance available to development enterprises in the PDMCs through local private sector entities (fund managers). These managers would be organizations that are willing to commit themselves to managing the funds for an annual fee and have an interest in the outcome through a profit bonus. They should be entirely from the private sector, with no government affiliations or board appointments. In addition, they should be well established and experienced in the local market. Examples of suitable local organizations would be commercial banks, accountants, lawyers, management consultants, and portfolio managers. Where relevant, these managers should have licences or recognition from domestic regulators and/or international professional bodies. It might be possible for the local administrator to consist of a consortium, for example, a firm of accountants plus the local chamber of commerce as advisors. The basic investment criteria for the fund should be set regionally and a regional administrator hired who would perform due diligence on the potential private sector managers to ensure that they have both local standing and experience. However, investment decisions should be left with the local manager, with a reporting line to the regional administrator.

It is also recommended that any new venture capital fund aim for a specified return, and that any excess earned over and above the specified annual return accrue to the fund manager until the maturity date of the fund. That way the local manager would have a significant financial incentive in the outcome of the investments. Such a manager should be asked to provide, either from his own or his clients' resources, a matching investment. If this is not possible, it is recommended that the domestic provider suffer at least risk of reputation if the investments go wrong, possibly by widely publicizing the existence of the fund together with the identity of the approved domestic manager.

An exit strategy should be part of the investment strategy of the venture capital fund. A venture capital fund normally has a time horizon of around five to seven years and is not intended to be a source of long-term finance for companies. Within this time frame, the fund should have been able to realize its capital and have made a profit for use in other developing companies. The development of a regionally based stock exchange would assist by providing at least one exit strategy in those PDMCs that cannot support a domestic market.

MICROFINANCE

The major challenge of microfinance in the PDMCs is how to provide financial services efficiently, effectively, and on a sustainable basis to those who do not have access to the formal financial system. The review of MFIs in the seven PDMCs studied has shown that not one has yet achieved operational self-sufficiency; and indicative timetables for achieving self-sufficiency in the Guiding Principles agreed on by donor agencies (three years for operational self-sufficiency, five to ten years for financial self-sufficiency) appear unrealistically short.

The feasibility of microfinance in PDMCs hinges on the following:

(i) the strong commitment of MFIs to outreach and sustainability;
(ii) achievement of a critical mass to achieve profitability, which itself depends on building markets and opportunities for cash incomes in rural areas;
(iii) the strong commitment of governments to establishing a conducive policy and legislative environment for microfinance;
(iv) the long-term commitment of government and development agencies to provide technical assistance to MFIs for capacity building and institutional strengthening; and

(v) provision of support services, especially in microenterprise development, management, public education, and social mobilization.

Perhaps the most important feasibility feature of an MFI is that it clearly emphasize savings mobilization before considering providing credit.

Given the differences between PDMCs, a single model for microfinance is unlikely to be applicable. The existing modalities—Grameen Bank replication, individual lending by development banks, savings and loan associations/credit unions, revolving funds, and village banks—have their own strengths and weaknesses and must be assessed in each specific context. However, some general recommendations can be made.

Create a policy and legislative environment to encourage the development of sound and efficient microfinance systems.

Actions toward such an environment would include

(i) enacting specific policies that will allow MFIs (especially NGOs) to function as legal financial intermediaries;
(ii) setting standards for MFIs, and for the protection of clients;
(iii) providing appropriate regulation and supervision; and
(iv) providing an environment where institution building and training can occur, among other means by establishing linkages with other programs and projects that have similar objectives.

MFIs need to expand their outreach, to adopt best organizational and management practices and innovative delivery approaches, to form and empower groups, and to mobilize resources in order to reduce dependency on grants and subsidies.

Support capacity building for MFIs, including capacity building on a regional basis.

Such capacity building for MFIs should focus on

(i) building institutional capacity (policies, structures, procedures);

(ii) developing human resources to enhance technical competence of MFI staff;
(iii) building technical, financial, managerial, product development, and marketing skills;
(iv) developing information and education strategies to build awareness and share best practices; and
(v) developing participatory and consultative processes.

PDMCs should consider setting up a regional institution that can provide support services to MFIs in the Pacific and provide linkage/networking with donor agencies, governments, NGOs and other related institutions for capability building programs. An initial consultation has been based on UNDP's document regarding an MFI regional association. Ten countries in the Pacific have already expressed interest: Fiji Islands, Samoa, Solomon Islands, Papua New Guinea, Vanuatu, Palau, Kiribati, Cook Islands, Niue, and Tuvalu.

Direct donor aid to support financial viability for MFIs.

Strategic interventions by external agencies should support only those MFIs with the potential for financial viability and effectiveness in delivering microfinance services to target groups. Interventions could include

(i) spearheading consultations and dialogue regarding microfinance development;
(ii) mobilizing technical resources, including cost sharing in programs and division of tasks/areas in technical assistance;
(iii) negotiating with governments to facilitate the implementation of key areas of policy, legal, and institutional regulation of MFIs;
(iv) strengthening the institutional and local capacity of MFIs;
(v) initiating pilot studies and qualitative and quantitative research that can assess the viability of different modalities of microfinance, as well as the impact of microfinance on people's lives;
(vi) assisting with development of information, education, and communication modules for information campaigns

and grassroots development, so that local leaders/managers have tools to promote policies on best practices; and

(vii) assisting with establishment of a regional secretariat for an MFI support structure that could provide technical and program services.

LAND TENURE AND USE OF LAND FOR COLLATERAL

Enact or amend legislation to permit mortgaging and leasing of customary land.

PDMC governments should review the possibility of amending their relevant land acts to permit customary lands to be mortgaged or leased for business and commercial purposes, or to enact legislation authorizing 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 uncertainty about the ownership and boundaries of customary lands, which hampers the mortgaging and leasing of such lands. Action 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.

PDMCs governments should also set up a nonpolitical public agency, such as a land trust board, land use commission, or customary land development authority, to manage, or supervise and facilitate the management of, customary land. The administrative costs of these nonpolitical public agencies would need to be kept as low as possible, so that as much of the benefits as possible go to the owners of the land. Systems for processing applications for land tenure conversion and compensation for compulsory acquisition need to be improved. These recommendations are elaborated below.

Mortgages of Customary Lands. In the Fiji Islands and Vanuatu, provision should be made for an independent review of decisions made by the NLTB and the Minister of Lands, respectively, as to the granting or withholding of consents to mortgages of customary land.

In Kiribati, the purposes for which customary land may be mortgaged should be expanded to include business or commercial purposes.

In PNG, Samoa, and Solomon Islands, consideration should be given to allowing custom landowners to mortgage their land, but mortgages should be subject to certain limitations, that is, they should be only to certain approved institutions, for certain approved purposes, and enforceable only by entry into possession.

In the Fiji Islands, Kiribati, PNG, Samoa, Solomon Islands, and Vanuatu, there should be some established mechanism for an independent review of decisions made by state agencies as to whether customary land should be leased.

Mortgages of Leasehold Interests in Customary Land. In the Fiji Islands and Vanuatu, there should be an established mechanism for independent review of decisions made by the NLTB and Minister of Lands, respectively, with regard to the approval of mortgages of leasehold interests in customary land.

In Kiribati, the purposes for which leasehold interests in customary land can be mortgaged should be extended to include business or commercial purposes.

In Samoa, the prohibition against the mortgage of leasehold interest in customary land should be lifted; but it is contained in an article of the Constitution, which cannot be amended without a two-thirds majority in the Legislative Assembly and in a national referendum, so it is impracticable to attempt to change it under the present Constitution.

Enforcement of Mortgages on, and Mortgages of Leasehold Interests in, Customary Land. In the Fiji Islands, there should be an independent review of decisions by the Native Land Trust Board to grant or refuse consent to the enforcement of mortgages on customary land.

In Kiribati, it should be possible to sell the leasehold interest in customary land to persons other than i-Kiribati, the State, the Housing Corporation, and the National Loan Board.

In Solomon Islands, it should be permitted to sell mortgages of leasehold interests in customary land to persons other than Solomon Islanders. Custom owners wishing to mortgage customary lands should be required to be sponsored by family members and neighbors, in order to demonstrate their understanding that if the owners default on their payments under the mortgage, the mortgagee is entitled to enforce the mortgage by entry into possession. Lessees of customary land wishing to mortgage their leasehold interest should be required to be sponsored by members of the customary owners' family and their neighbors, in order to demonstrate their understanding that if the lessee defaults on payment under the mortgage, the mortgagee is entitled to enforce the mortgage by entering into possession.

Management and Use of Customary Land. In the Fiji Islands, Samoa, and Vanuatu, there should be provision for some independent review of decisions made by the NLTB or the Minister of Lands with regard to the use of customary land.

In PNG and Solomon Islands, a careful review should be undertaken of the incorporated land groups and of the registered custom owners, to determine whether the way in which they manage and use customary land should be subject to some legislative regulation.

In Kiribati and Vanuatu (where land ownership is not under dispute), a careful review should be undertaken of the operation of the land committees and trustees to determine whether the way in which they manage and use customary land should be subject to some legislative regulation.

Other Customary Land Tenure Problems. In PNG, additional funding and staffing should be provided to the Land Titles Commission to enable it to deal more promptly with applications made to it for land tenure conversions.

In Solomon Islands, a review should be undertaken of the legislative provisions enabling conversion of customary lands to perpetual estates, to see why custom owners are reluctant to avail themselves of tenure conversion.

In the Fiji Islands, Kiribati, Samoa, and Vanuatu, discussions should be held with governments to explore the possibility of providing for custom owners to convert their land into a form of limited freehold or perpetual estate.

In the Fiji Islands, Kiribati, PNG, Samoa, Solomon Islands, and Vanuatu, there should be provision for the automatic cancellation of the participation rights of absentee landowners after a certain period of absence, say two years; and automatic cancellation of all rights of owners after a period of, say, five years or 10 years.

In PNG, Samoa, Solomon Islands, and Vanuatu, systematic registration of customary land should be attempted in selected areas, where this would contribute to the development of customary land.

In Kiribati, PNG, Solomon Islands, and Vanuatu, legislation should be enacted to authorize the lands tribunals to adjudicate disputes about customary titles.

In Vanuatu, the Island Courts and Supreme Court should be replaced as the bodies to adjudicate disputes about customary land.

In the Fiji Islands, Kiribati, PNG, Samoa, and Vanuatu, with regard to the bodies authorized to determine disputes about customary land, the government should ensure that

(i) delays in the hearings of proceedings are reduced;
(ii) expenses of such proceedings are reduced;
(iii) members of the bodies making decisions about customary land have an adequate knowledge of the customs relating to the land in dispute;
(iv) decisions of such bodies are accurately recorded and publicized;
(v) decisions of such bodies are permanently recorded on the ground; and
(vi) such bodies have jurisdiction to determine entitlement to customary title as well as to customary land.

Simplify and rationalize the mortgaging of individually owned land.

In Kiribati, local legislation should be enacted to provide for and regulate the mortgaging of freehold land.

In Samoa, guidelines should be drawn up and published as to the basis upon which the Head of State should consent to a mortgage to a person not a resident citizen or to an overseas corporation.

In Tonga, mortgages of hereditary estates and allotments should be allowed for business or commercial purposes, as well as for the improvement of the estate or allotment.

In PNG, the term of a lease of converted customary land that does not require the permission of the Land Board or the minister should be extended from 25 to 50 or 75 years.

In PNG, Samoa, Solomon Islands, and Tonga, guidelines should be drawn up and published as to the basis upon which approval will be given to the granting of a lease that is otherwise prohibited.

In Kiribati, local legislation should be enacted to provide for and regulate the mortgaging of leasehold interests in individually owned land.

In Samoa and Tonga, guidelines should be drawn up and published as to the basis upon which consent would be granted by the Head of State and Minister of Lands, respectively, for the granting of approval to mortgages of leasehold interests in freehold land and hereditary states and allotments.

In Kiribati, local legislation should be enacted to empower and regulate the mortgaging of freehold land, and of leasehold interests in freehold land.

In PNG, guidelines should be drawn up and published for Land Board approval of the enforcement of a mortgage of freehold by sale of the freehold, and for the Minister of Lands' agreement to a mortgage of more than 25 years.

In Samoa, guidelines should be drawn up and published for the Head of State's consent to the enforcement of a mortgage by the sale of freehold land to a person not a resident citizen or to an overseas corporation.

In Solomon Islands, the restriction against non-Solomon Islanders' application to the High Court for an order to enforce a mortgage should be removed.

In Tonga, a mortgagee wishing to enforce a mortgage by entry into possession should be required to obtain an order from the Land Court sanctioning that remedy, to ensure that there is no resistance by the mortgagor.

In PNG and Solomon Islands, individual landowners and lessees of individually owned lands should be required, when applying for a mortgage, to be sponsored by family members and neighbors, in order to demonstrate their understanding that if there is a default under the mortgage, the mortgagee will be entitled to sell or enter into possession.

Simplify and rationalize the leasing and mortgaging of government-owned land.

In Kiribati and Vanuatu, legislation should be enacted to facilitate and regulate the leasing of Government-owned land.

In Samoa, the terms of Public Land leases should be longer than 20 years.

In Solomon Islands, it should be possible to lease land owned by the national Government for a fixed term, rather than only as a periodic tenancy.

In Tonga, it should be possible to lease land within the Royal Estates and Royal Family estates for agricultural, pastoral, or commercial purposes, and not only for projects of general public interest and benefit.

In Kiribati and Vanuatu, legislation should be enacted to facilitate and regulate the mortgaging of leasehold interests in Government-owned land.

In Kiribati, legislation should be enacted that provides expressly for the granting and enforcement of mortgages of leasehold interests in Government-owned land.

In Solomon Islands, non-Solomon Islanders should be permitted to enforce mortgages of leasehold interests in Government-owned land.

In the Fiji Islands and PNG, legislation relating to the mortgaging of crops and livestock should be reviewed and revised where necessary. Public awareness of the existence of such mortgage facilities should also be raised.

In Solomon Islands, Tonga, and Vanuatu, legislation should be enacted to authorize the mortgaging of crops and livestock, and public awareness of the existence of such mortgage facilities should be raised.

Implementation of the above recommendations on land tenure systems would ease a major constraint to financial sector development in PDMCs. An effective leasehold title system with full transferability would permit the use of land as security for a loan from a commercial bank or NBFI, and thus stimulate the private investment needed for sustained economic growth.

Appendix 1

ADB's Assistance to PDMC Financial Sector Development

ADB has assisted financial sector development in the PDMCs since the 1970s, through both loans and technical assistance (TA). Between 1970 and the end of 1999, ADB extended 32 loans totaling US$193.0 million, and 62 TA grants for US$15.7 million (Appendix Tables 1 and 2). However, the success rate of these initiatives was limited. Of 14 lending projects supporting development finance institutions and evaluated by the Bank's Operations Evaluation Office, only two (14.5 percent) were rated as generally successful, while 10 were rated as partly successful (71 percent), and two as unsuccessful (14.5 percent). In terms of overall lending to the PDMCs, 48.6 percent of projects were rated as successful, 29.7 percent as partly successful, and 21.7 percent as unsuccessful.

With the virtual cessation of lending to development financial institutions (DFI), present ADB involvement in the financial sectors is mainly through TA and policy lending:

- In the Fiji Islands, TA has been provided in support of capital market development and the establishment of the Capital Market Development Authority.
- In PNG, TA support is being provided for microfinance development.
- In Nauru, under the Fiscal and Financial Reform Program, ADB is assisting the Government in restoring confidence in banking and reviving the function of financial intermediation.

- In Samoa, under a Financial Sector Program Loan, ADB is assisting the Government in implementing financial sector liberalization in the areas of (i) development of financial markets, (ii) strengthening of the central bank, (iii) improvement of financial sector supervision, and (iv) strengthening of the National Provident Fund and Development Bank of Samoa.
- In Vanuatu, as a part of the Comprehensive Reform Program, the ADB is assisting in strengthening the Reserve Bank, restructuring and supporting the merger of National Bank of Vanuatu and Development Bank of Vanuatu, and restoring the viability of the Vanuatu National Provident Fund.

Appendix Table 1
Lists of ADB Loans to PDMCs' Financial Sectors, 1970–1999

Country	Title	Amount Approved US$	Approval Date
Cook Islands	Cook Islands Development Bank	1,500,000	25 Mar 1982
	Second Cook Islands Development Bank	1,500,000	14 Jan 1992
	Third Cook Islands Development Bank	3,000,000	26 Sept 1995
	Economic Restructuring Program	5,000,000	5 Sep 1996
	Fiji Development Bank	2,000,000	21 Dec 1973
Fiji	Second Fiji Development Bank	7,000,000	16 July 1985
Kiribati	Development Bank of Kiribati	1,000,000	18 Oct 1990
Papua New	Papua New Guinea Development Bank	4,500,000	14 Dec 1971
Guinea	Second Papua New Guinea Development Bank	7,000,000	1 June 1978
	Third Papua New Guinea Development Bank	11,000,000	9 Dec 1982
	Financial Management for Development Bank	25,800,000	21 Oct 1999
Marshall Islands	Public Sector Reform Program	12,000,000	30 Jan 1997
Micronesia, F.S.	Public Sector Reform Program	18,000,000	29 Apr 1997
Nauru	Fiscal and Financial Sector Program	5,000,000	25 Nov 1998
Samoa	Development Bank of Western Samoa	1,000,000	18 Mar 1975
	Second Development Bank of Western Samoa	3,000,000	16 Dec 1976
	Third Development Bank of Western Samoa	4,000,000	21 Nov 1978
	Fourth Development Bank of Western Samoa	4,000,000	29 Sep 1981
	Fifth Development Bank of Western Samoa	4,000,000	15 Nov 1984
	Financial Sector Program	7,500,000	19 Feb 1998
Solomon Islands	Development Bank of Solomon Islands	2,000,000	19 Apr 1979
	Second Development Bank of Solomon Islands	2,000,000	22 Dec 1980
	Public Sector Reform Program	25,000,000	27 Aug 1998
	Public Sector Reform Program - TA Loan for Privatization of State-Owned Enterprises	1,000,000	27 Aug 1998
Tonga	Small Industries Center	370,000	27 Dec 1977
	Tonga Development Bank	1,500,000	7 Dec 1978
	Second Multiproject and Second Tonga Development Bank	840,000	17 Nov 1981
	Third Multiproject and Third Tonga Development Bank [a]	1,500,000	19 Jun 1986
	Fourth Tonga Development Bank	5,000,000	21 Nov 1989
Vanuatu	Development Bank of Vanuatu	1,000,000	14 Dec 1982
	Development Financing	5,000,000	24 Oct 1991
	Comprehensive Reform Program	20,000,000	16 Jul 1998
	Total for Development Bank Loans	**72,210,000**	
	Total	**193,010,000**	

a. 50 percent of the Loan was assumed to be for Multiproject and 50 percent for TDB.

Appendix Table 2
List of ADB Technical Assistance to PDMCs' Financial Sectors, 1970–1999

Country	Title	Amount Approved US$	Approval Date
Cook Islands	National Development Corporation	91,000	17 May 1977
	Improving the Mechanism for Delivering Development Finance to Private Sector	97,000	9 Oct 1989
	Strengthening of Business Advisory Services	250,000	26 Sept 1995
	Institutional Support to the Development Investment Board	251,000	26 Sept 1996
	Management of the Cook Islands Development Bank and Business Ventures Development	740,000	26 Sept 1996
Fiji	Fiji Development Bank	90,000	22 Dec 1970
	Fiji Development Bank - Extension	37,000	8 Aug 1972
	Fiji Development Bank	100,000	21 Dec 1973
	Review of the Role and Function of Fiji Development Bank	100,000	16 Feb 1983
	Privatization of Government Shipping Fleet and Commercialization of Government Shipyard	346,500	2 Jun 1986
	Study of Development of Capital Market	71,000	19 Jun 1986
	Institutional Support to Fiji Development Bank	290,000	9 Oct 1989
	Preparation of Operational Strategies and a Corporate Plan for Fiji Development Bank	130,000	31 Dec 1992
	Development of the Capital Market	450,000	23 Dec 1993
	Capital Market Development Authority	600,000	5 Nov 1996
	Strengthening Public Enterprise Report (Phase I)	150,000	5 Jan 1999
	Public Enterprise Reform Program (Phase II)	600,000	16 Aug 1999
Kiribati	Technical Assistance to Development Bank of Kiribati for External Training of Dep. Gen. Manager	12,500	5 Apr 1990
	Institutional Strengthening of the Development Bank of Kiribati and the Office of Director of Audit	234,000	18 Oct 1990
	Commercialization and Privatization of Public Enterprises	589,000	20 Apr 1992
	Commercialization and Privatization of Government Enterprises (Supplementary)	11,000	14 Dec 1993
Marshall Islands	Small Enterprise Development	297,000	23 Nov 1994
	Institutional Strengthening of the Marshall Islands Development Bank — Phase II	202,000	23 Nov 1994
	Support of the Private Sector Unit	760,000	30 Jan 1997
Micronesia	Institutional Strengthening and Staff Development of Federated States of Micronesia Development Bank	153,000	26 Dec 1990
	Institutional Strengthening of the Federated States of Micronesia Development Bank	385,000	2 Dec 1994
	Privatization of Public Enterprises and Corporate Governance Reforms	450,000	9 Jun 1999
	Private Sector Development Program	150,000	19 Oct 1999
Papua New Guinea	Development Bank Staff Training Scheme	3,600	15 Feb 1973
	Papua New Guinea Development Bank	210,000	9 Dec 1982

cont. next page

Appendix Table 2 (cont.)

List of ADB Technical Assistance to PDMCs' Financial Sectors, 1970–1999

Country	Title	Amount Approved US$	Approval Date
	Institutional Strengthening of Agricultural Bank of Papua New Guinea	582,000	15 Jan 1992
	Microfinance and Employment	150,000	29 Nov 1999
Samoa	Development Financing Institution	217,000	11 Jan 1973
	Development Bank of Western Samoa	90,000	18 Mar 1975
	Second Development Bank of Western Samoa	40,000	16 Dec 1976
	Review of the Role and Functions of the Development Bank of Samoa	100,000	30 Mar 1984
	Fifth Development Bank of Western Samoa	300,000	15 Nov 1984
	Privatization of State-Owned Enterprises	365,000	28 Nov 1989
	Rehabilitation of Development Bank of Western Samoa	203,000	25 Oct 1990
	Banking Supervisory Assistance to the Central Bank of Samoa	222,500	2 Apr 1991
	Implementation of Privatization Exercise	320,000	24 Dec 1991
	Implementation of Privatization Strategy	600,000	7 May 1997
	Institutional Strengthening of Government Financial Institutions	950,000	14 Feb 1998
	Small Business Development	150,000	24 Sep 1999
Solomon Islands	Agricultural and Industrial Loans Board	45,000	23 May 1974
	Second Agricultural and Industrial Loans Board	250,000	25 Mar 1976
	Development Bank of Solomon Islands	130,000	19 Apr 1979
	Privatization and Commercialization Policies and Strategies	267,000	3 May 1988
	Institutional Strengthening of the Development Bank of Solomon Islands	263,000	20 Feb 1991
	Privatization of State-Owned Enterprises	150,000	20 Apr 1998
Tonga	Tonga Development Bank	135,000	26 Apr 1983
	Third Tonga Development Bank	160,000	19 Jun 1986
	Tonga Development Bank	328,000	21 Nov 1989
	Privatization of the Commodities Board	385,000	18 Oct 1990
	Privatization of the Commodities Board (Supplementary)	55,500	23 Jan 1992
	Creating Banking Supervision Unit in National Reserve Bank of Tonga (NRBT)	100,000	30 Sep 1993
	Preparation & Implementation of a Strategic Plan for Tonga Development Bank	280,000	2 Sep 1997
Tuvalu	Development Bank of Tuvalu	100,000	23 Aug 1993
Vanuatu	Development Bank of Vanuatu	100,000	14 Dec 1982
	Technical Assistance to Development Bank of Vanuatu for Preparation of Operating Strategy and Business Plans for 1991–1993	58,000	6 Jun 1990
	Institutional Development of the Development Bank of Vanuatu	650,000	24 Oct 1991
	Strategic Plan for the National Bank of Vanuatu	150,000	12 Dec 1997
	Total for Development Finance Institutions	**8,793,600**	
	Total	**15,746,600**	

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