ADB

ACCESS TO FINANCE

Finance is important for growth

Well-functioning financial markets are essential for promoting economic growth. Without finance, businesses cannot start or grow. The difference between repressed financial markets and those that work effectively can vary growth rates by as much as two percentage points a year—more than the average economic annual growth rate of Pacific island countries over the past two decades. Well-functioning financial markets provide not only investment finance to large businesses, but also assistance to home buyers, financing for automobile purchases, working capital for small businesses, loans for education to improve human capital, and loans to farmers and others in the rural sector to improve crops and access new markets.

Access to finance is low, and credit is costly

A good measure of access to finance is the ratio of private sector credit to gross domestic product (GDP). While developed financial markets have ratios of 100% or more, in the Pacific region, only Tonga has a ratio above 50%. In Papua New Guinea (PNG), it is only 17%. These ratios (Figure 1) are much lower than those in Australia and New Zealand.

There is, however, no shortage of liquidity in most Pacific island countries. Many banks are highly liquid, and bankers, in general, lament the shortage of "bankable projects"—particularly local ones. It is often suggested that many citizens from the region do not have the necessary business skills to formulate business plans and run businesses effectively. Moreover, the relatively high cost of doing business in the Pacific region contributes to the shortage of sound lending opportunities.

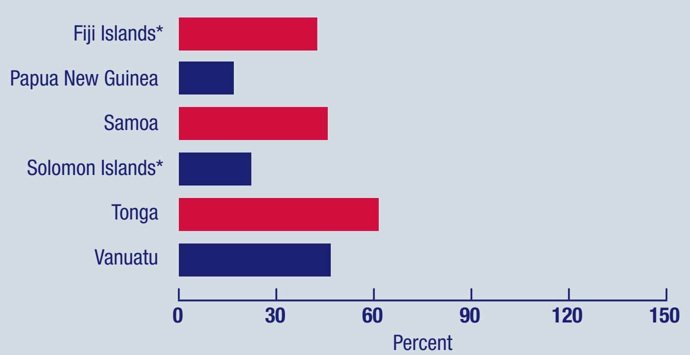
Access to financial services is also limited

While financial markets tend to focus on lending, improving access to financial services is equally important—especially for poorer members of the community that are forced to hold cash with the risk of loss through theft and other causes. The experience of ANZ's Rural Banking Initiative in the Fiji Islands is one example of the pent up demand for deposit-taking facilities. In PNG, microfinance institutions that accept deposits find that the demand for bank accounts often exceeds the demand for loans.

Although in some countries such as PNG, credit unions and microfinance institutions are steadily gaining market share and playing a useful role in complementing traditional banks, the dominance of commercial banks is unlikely to decline in the foreseeable future. This is because in most Pacific island countries, the provision of financial services by specialist institutions is relatively unprofitable as small market size limits the potential for economies of scale. Moreover, high cost and unreliable telecommunications and transport services add to the expense of providing financial services.

The cost and ease of making remittances is one area where a pressing need for improved financial services exists. In the Pacific

Figure 1: **Domestic Credit to the Private Sector, 2006**



**Data is for 2005*
Source: World Development Indicators database

region, remittance flows are often equivalent to a significant percentage of GDP. However, high fixed charges for transferring relatively small sums of money often consume a large portion of the total amount remitted. In other parts of the world, such as the Caribbean, technology and increased competition have dramatically brought down the costs of transferring remittances. In this area, initiatives in the Pacific region are commencing, but much more progress is needed in a region where the ratio of remittances to GDP is among the highest in the world.

Collateral and Business Credit

Finance enables entrepreneurs to start new businesses and expand existing businesses. Businesses need credit to buy equipment and inventory, and to allow them to extend trade credit to their customers. Farmers need credit to fertilize land, plant seeds, as well as raise crops and livestock. Credit may come from banks or from sellers of equipment, inventory, seed and fertilizer. Whatever the source, creditors want to know that they will be repaid. Collateral (i.e. property of the debtor pledged to the creditor to secure payment) provides an important part of the assurance creditors require. Credit flows more freely when the law and supporting institutions on collateral are strong and inexpensive. Credit is scarce when they are weak and costly, as is the case in most countries in the Pacific.

Land, land leases and buildings are the favored collateral for banks, but laws governing them are weak in many countries in the region, especially where the majority of property is communally owned. Many people do not have property ownership or rights in a form that lenders can use as collateral. Further, non-bank creditors, such as inventory suppliers and equipment sellers, do not generally take collateral in the form of mortgages on land.

With proper legal support, movable property in the form of equipment, inventory, accounts receivable, crops, livestock, shares, and the like may serve effectively as collateral. The law on movable property is weak in most countries in the Pacific region, however, with the result that most business credit is unsecured, if credit is available at all. Compared to unsecured credit, loans secured by collateral are easier to obtain and typically feature lower lending rate and longer tenors. The more a country needs economic development, the more it needs modern laws defining and protecting property rights of all types, including legislation on the use of movable property as collateral.

Why is more credit available where movable property may effectively be pledged as collateral? First, the cost of creating agreements to pledge collateral is lowered. Second, the rights and duties of borrowers, lenders, and others who may lay claim to the collateral are clearly established, reducing risk and enforcement costs. Third, costs are minimized through streamlined rules on foreclosure upon default of the borrower.

Until recently, virtually no country in the Pacific region had a well-functioning system for the use of movable property as collateral. More recently, however, substantial progress has been made. New Zealand enacted comprehensive reform in 1999. The Federated States of Micronesia implemented full-scale reforms in 2005. Effective law has been adopted (but is not yet implemented) in the Republic of the Marshall Islands in 2006. In 2008, similar legislative reform proposals are under consideration in Samoa, Solomon Islands, Tonga, and Vanuatu.

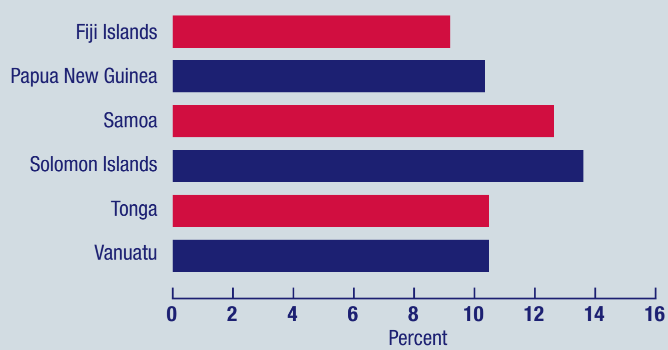
The need for credit information

Information on the credit histories of potential borrowers reduces the risks of lending—the more lenders know about the businesses and individuals that are applying for credit, the greater their ability to judge the risk of default. The availability of credit information also increases borrower incentives to repay because they know that bad credit histories affect their chances of borrowing in the future. In addition, if credit histories can be shared among lenders in different countries, the probability of default is further reduced as borrowers cannot default on their debts by leaving a country. Credit bureaus, which facilitate the access to such information, are therefore a prominent and essential feature of all developed financial markets, and play an invaluable role in mitigating the risks of lending.

High interest rate spreads

In the Pacific region, borrowing is costly, and there is a large margin between lending and deposit rates. The high interest rate spreads that characterize finance in the Pacific region result

Figure 2: **Pacific Lending Rates[1], 2007**



Source: Pacific country central bank bulletins.
[1] Lending rates are for small business borrowing

from limited competition in the banking sector and laws and regulations that raise the costs associated with borrowing. Because of the high transactions costs arising from pledging collateral to secure loans, it may not be worthwhile for borrowers to change banks, even when they are offered lower borrowing rates. These costs result from: having to pay stamp duties on the value of pledged assets; the need for lawyers to search company records and draw up loan documents; and delays and uncertainties in the registration of security interests. Furthermore, the excess liquidity in the banking sector reduces the deposit rates paid by financial institutions, while the risk factors from weak collateral frameworks keep lending rates high. More recently, however, there has been some downward pressure on the lending rates in the region as banks have pursued business customers more aggressively (Figure 2).

Technology can facilitate access to finance

The limited use of technology in the Pacific region has contributed to the slow growth of the financial sector, but there is great potential for the introduction of such services as cell phone and internet banking. The recent success with the use of cell phones for electronic banking in countries like the Philippines and South Africa illustrates how the demand for such services can spread rapidly. Work is commencing in 2008 on a branchless banking initiative for rural access to finance in Vanuatu, using bank agents equipped with Electronic Funds Transfer at the Point of Sale (EFTPOS) terminals, which will provide an interesting pilot program for the region.

A law governing electronic transactions is, however, a precondition for their use. Without the necessary legal framework, electronic transactions cannot be made with confidence that they are legally binding. Most countries in the Pacific region lack such a law. New laws governing electronic commerce are, therefore, needed urgently.

Another important factor that hinders the introduction of technology-based solutions is the embryonic state of technology development in the region, often held back by government or private sector monopolies which impede competition and the expansion of services.

What can governments do to help?

It is natural that governments should want to implement policies that increase access to finance. But until recently, the typical response to the lack of lending was to introduce directed credit, subsidized interest rates, guarantees, and other initiatives that attempt to broaden credit access. These measures have rarely been successful, and are often characterized by substantial loan losses and the crowding out of market-based lenders. When interest rates are subsidized, commercially viable lending opportunities for commercial banks and other financial intermediaries are greatly reduced.

Nevertheless, governments have a key role in promoting financial market development. In high-income countries, financial systems have a complex structure of legal and regulatory institutions that provide the foundation for the operation of financial markets. To establish the laws and regulations necessary for well-functioning financial markets is the primary role of government in ensuring that investment and entrepreneurship are adequately funded. Priority actions should focus on:

- Collateral or secured transactions reform, which will require new secured transactions laws and the establishment of personal property registries.
- Promoting credit information systems and establishing the institutional structure within which credit bureaus can evolve.
- Promoting new banking technologies, which could require coordinated action to broaden the availability and reduce the cost of telecommunications technology.

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