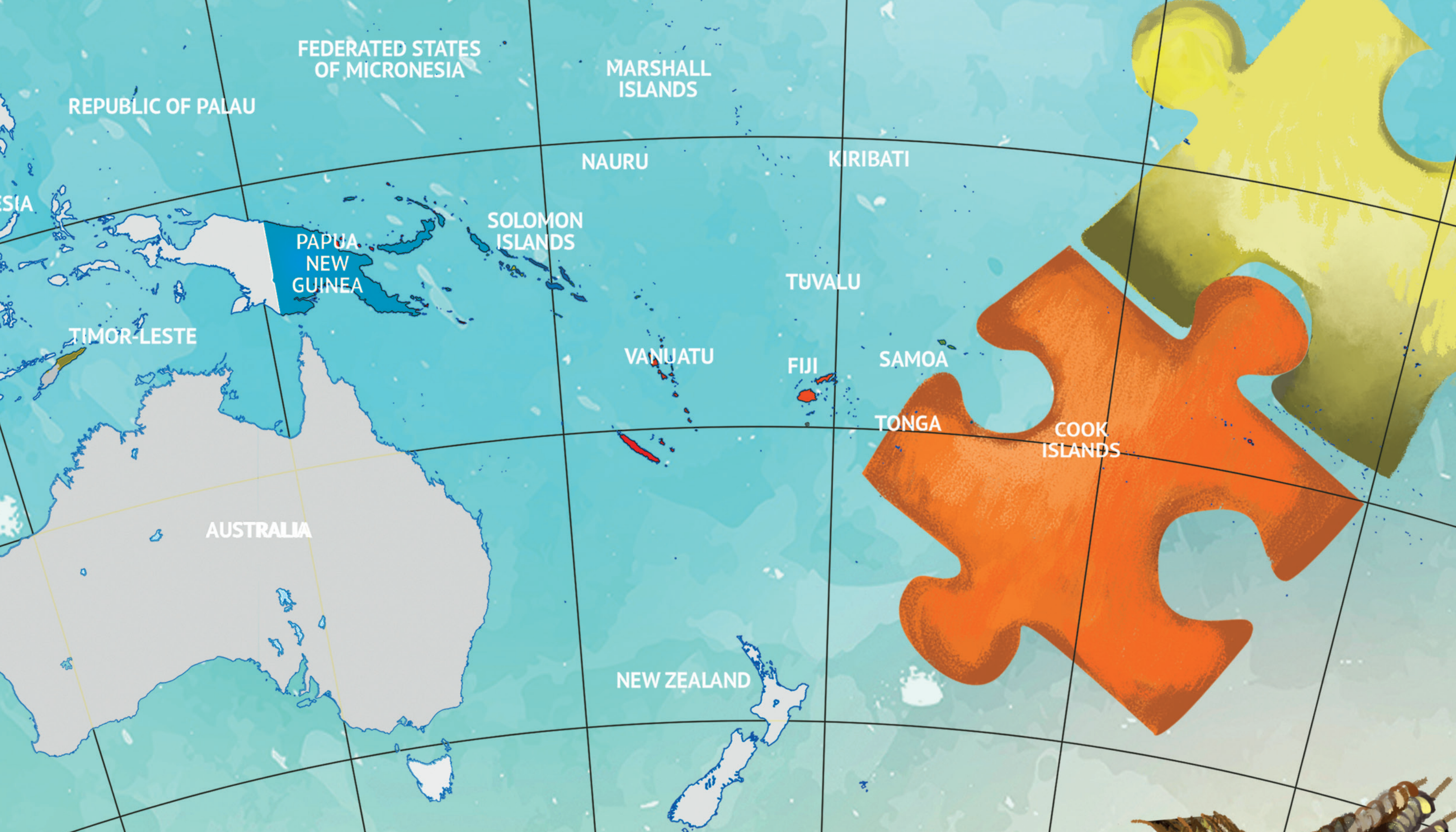

FINDING BALANCE 2019

BENCHMARKING THE PERFORMANCE OF STATE-OWNED BANKS IN THE PACIFIC

AUGUST 2019

NEW ZEALAND
FOREIGN AFFAIRS & TRADE
Aid Programme

Australian Aid

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ISBN 978-92-9261-704-2 (print), 978-92-9261-705-9 (electronic)
Publication Stock No. TCS190360-2
DOI: http://dx.doi.org/10.22617/TCS190360-2

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Cover design by Cleone Baradas.

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FOREWORD

Pacific island countries have long recognized the importance of private sector development to achieving their goals for sustainable and inclusive economic growth. To this end, many of the policy and legal reforms they have undertaken in recent years have sought to strengthen the enabling environment for small business by removing barriers to formalization and improving access to finance.

State-owned banks, which are present in almost every Pacific island country, can play an important role in channeling finance to the private sector—and in some countries, they already do. As is the case with state-owned enterprises (SOEs) more broadly, the effectiveness and sustainability of state-owned banks depend on their ability to operate commercially and provide services on a non-distortionary basis. In this regard, Pacific state-owned banks are no different to the more than 250 state-owned banks around the world; their core challenge is to demonstrate additionality—that is, to provide financial services that would not otherwise be provided and do so profitably, or through their presence make their respective banking systems more competitive.

Despite their shared purpose, this study illustrates the heterogeneity of state-owned banks in the Pacific as well as globally. At the same time, it identifies the key feature of the most successful state-owned banks: a strict adherence to commercial principles. These banks demonstrate that a development mandate is not only compatible with commercial results, but that the sustainability afforded by operating commercially deepens development outcomes.

This is the sixth comparative study of SOE performance in the Pacific undertaken by the Asian Development Bank's (ADB) Pacific Private Sector Development Initiative (PSDI), and the first to focus exclusively on state-owned banks. It reflects ADB's commitment to increasing cooperation and sharing knowledge and best practices among its member countries, and advances the thought leadership on finance and SOE reforms that PSDI has provided over its 12 years of operation.

The number of countries participating in the *Finding Balance* studies has grown with each edition, with this edition assessing 13 state-owned banks in 10 countries. The participating countries (Cook Islands, Fiji, the Federated States of Micronesia, the Marshall Islands, Palau, Papua New Guinea, Samoa, Tonga, Tuvalu, and Vanuatu) were selected for their comparability and willingness to share the challenges faced by their state-owned banks.

I thank the participating state-owned bank management teams for their extensive inputs, without which this study would not have been possible. I also wish to thank the authors, Laure Darcy and Peter Dirou, financial analyst Minh Vu, and legal expert Alma Pekmezovic for their efforts, and the Government of Australia and the Government of New Zealand, which cofinance PSDI.

I am confident this study will provide thought-provoking insights and stimulate useful discussions on the role that state-owned banks can play in addressing the financing gaps in the Pacific.

Carmela D. Locsin
Director General, Pacific Department
Asian Development Bank

ABBREVIATIONS

ADB	—	Asian Development Bank
BCI	—	Bank of the Cook Islands
BDC	—	Business Development Bank of Canada
BFSM	—	Bank of the Federated States of Micronesia
BSP	—	Bank South Pacific
CEO	—	chief executive officer
CIIC	—	Cook Islands Investment Corporation
DBS	—	Development Bank of Samoa
DBT	—	Development Bank of Tuvalu
DFCC	—	Development Finance Corporation of Ceylon
DFI	—	development finance institution
FDB	—	Fiji Development Bank
FDIC	—	Federal Deposit Insurance Corporation
FSM	—	Federated States of Micronesia
FSMDB	—	Federated States of Micronesia Development Bank
GDP	—	gross domestic product
IFC	—	International Finance Corporation
KCH	—	Kumul Consolidated Holdings
MIDB	—	Marshall Islands Development Bank
MSMEs	—	micro, small, and medium-sized enterprises
NBV	—	National Bank of Vanuatu
NDB	—	National Development Bank (Papua New Guinea)
NDBP	—	National Development Bank of Palau
OSFI	—	Office of the Superintendent of Financial Institutions (Canada)
PAL	—	Republic of Palau
PMB	—	People's Micro Bank
PNG	—	Papua New Guinea
PSDI	—	The Pacific Private Sector Development Initiative
RBV	—	Reserve Bank of Vanuatu
RMI	—	Republic of the Marshall Islands
ROA	—	return on assets

ROE	—	return on equity
SAM	—	Independent State of Samoa
SCI	—	statement of corporate intent
SMEs	—	small and medium-sized enterprises
SOE	—	state-owned enterprise
TDB	—	Tonga Development Bank
TUV	—	Tuvalu

CURRENCIES AND EXCHANGE RATES

Currencies and exchange rates to the United States dollar (annual average)

	Currency	Symbol	Exchange Rates								
			2010	2011	2012	2013	2014	2015	2016	2017	2018
Canada[a]	Canadian dollar/s	Can$	1.0	1.0	1.0	1.0	1.1	1.3	1.3	1.3	1.3
Cook Islands	New Zealand dollar/s	NZ$	1.4	1.3	1.2	1.2	1.2	1.3	1.5	1.4	1.4
Fiji	Fiji dollar/s	F$	1.9	1.8	1.8	1.9	1.9	2.1	2.1	2.1	2.1
Papua New Guinea	kina	K	2.7	2.3	2.1	2.2	2.4	2.8	3.1	3.2	3.3
Samoa	tala	ST	2.3	2.3	2.3	2.3	2.3	2.6	2.6	2.6	2.6
Sri Lanka	Sri Lanka rupee/s	SLRe/ SLRs	113.1	110.6	127.6	130.0	130.6	135.9	145.6	152.0	163.0
Tonga	pa'anga	T$	2.0	1.7	1.8	1.8	1.8	1.9	2.2	2.2	2.3
Tuvalu	Australian dollar/s	A$	1.1	1.0	1.0	1.0	1.1	1.3	1.3	1.3	1.3
Vanuatu	vatu	Vt	97.2	94.6	92.6	96.9	102.4	116.3	110.8	109.0	111.5

[a] OzForex. *Yearly Exchange Rates.* https://www.ofx.com/en-au/forex-news/historical-exchange-rates/yearly-average-rates/
Source: Asian Development Bank. 2019. *Asian Development Outlook 2019*. Manila.

EXECUTIVE SUMMARY

Finding Balance 2019 profiles the roles, performance, market context, and regulatory framework of 13 state-owned banks in 10 Pacific island countries. This is the sixth in a series of state-owned enterprise benchmarking studies launched by the Asian Development Bank (ADB) in 2009, and the first to focus solely on the banking sector.

The study reveals that state-owned banks in the Pacific mirror the heterogeneity of state-owned banks globally. There is no standard size, product mix, funding model, or governance structure. The banks range in asset size from $2 million to $280 million and represent 0.3%–54% of total loans outstanding in their respective banking sectors. Not surprisingly, the banks in the smallest economies in this survey (e.g., the Federated States of Micronesia, Palau, and Tuvalu) tend to represent a larger share of their respective banking sectors than those in the larger economies. While some of the state-owned banks in this survey are licensed commercial banks, most are nonlicensed development banks, which do not fall under the supervisory authority of a financial or banking sector regulator. This has made it more challenging for governments to maintain the strength of the balance sheets of the state-owned banks and manage their contingent liabilities.

The surveyed state-owned banks have a range of mandates, which vary in specificity, but none explicitly require the banks to demonstrate additionality, i.e., show that their lending activities do not crowd out private sector banks but instead improve competition and deepen the credit markets. The Business Development Bank of Canada, one of two successful state-owned development banks from outside the Pacific region profiled in this study, has additionality at the core of its mandate, which drives its focus on market gaps. There is a growing consensus among policy makers and state-owned banks in the Pacific region that this focus on additionality is core to the rationale for maintaining the state-owned banks.

The economic sectors served by the surveyed banks were primarily consumption, followed by housing, tourism, and agriculture/fisheries. Within the subset of development banks, the largest proportion of credit was allocated to tourism, followed by agriculture, construction, and housing, consistent with their mandates to lend to these sectors. State-owned commercial banks, in contrast, allocated the majority of their credit for consumption. Exposure to state-owned enterprises was limited, representing only 2.2% of total credit outstanding for all of the surveyed banks in 2017.

In those countries with modern secured transactions laws and registries (the Federated States of Micronesia, the Marshall Islands, Palau, Papua New Guinea, Samoa, Tonga, and Vanuatu), the development banks are the most active users of movable property as collateral. This has created new financing products for agribusiness and illustrates the market-making function that state-owned banks can play by extending credit to new clients in important economic sectors and demonstrating the value of the new financing products.

Overall, the state-owned banks in this study generated a very low financial return on investment for their shareholders. Taken as a group, the banks generated an average return on assets of 1.2% and average return on equity of 2.8% during the 2010–2017 period. Surprisingly, the development banks were more profitable than the commercial banks, despite their lower interest rate spreads. These returns can be compared with those of the Bank South Pacific, a private bank operating in seven Pacific countries with the largest branch network in the region. Over the 2012–2017 period, Bank South Pacific generated an average return on assets of 3.1%, compared with 0.4% for the state-owned commercial banks and 1.0% for the development banks.

The low rates of profitability of the state-owned banks is driven by a range of factors, most notably weak credit risk assessment practices and the absence of a pervasive commercial culture. In particular, the development banks have suffered high levels of nonperforming loans and limitations on their funding sources, which have pushed down profitability.

A surprising finding of this study is that formal, subsidized lending programs represent only a small proportion of the portfolios of state-owned banks. Five of the development banks and three of the licensed commercial banks implemented some form of subsidized lending program in 2017, and in all but two cases these programs represented less than 15% of their outstanding credit portfolio.

Despite the relatively small scale of the formal concessional lending programs, the surveyed banks report that they inhibit the development of effective credit assessment skills. Compounded by an often larger problem of informal, political pressure on lending and restructuring decisions, this impedes the banks from building sustainable lending practices. In contrast to successful lenders such as the Business Development Bank of Canada, which prices all of its loans to fully reflect risk, banks using risk-share facilities do not need to be as thorough nor accountable for their credit decisions. The result is that businesses that represent very different levels of risk receive similar pricing, a practice that would be unsustainable for the banks without ongoing subsidization.

Pacific state-owned banks recognize that sustainable development finance must be market-based. The financing gap for small and medium-sized enterprises is not the result of a lack of funds, as the large cash and liquid asset balances of the Pacific banks attest, but rather a result of weak credit assessment practices and poorly designed government support programs. Lending to small and medium-sized enterprises in the Pacific is difficult and risky, particularly in sectors such as agriculture and fisheries, which employ large segments of the workforce. International commercial banks are generally absent from this market, leaving unmet demand to be addressed by national financial institutions with the right skills.

If state-owned banks are to contribute to economic development in the Pacific, they must pursue their commercial transformation. This includes improving credit assessment and risk management skills, and building capability both across the bank and at the board level. Any effort aimed at strengthening capability needs to be supported by a comprehensive set of internal policies covering all aspects of a bank's operation and compliance with prudential standards. Development banks, which are not currently subject to banking sector regulation, should be brought under these frameworks, with capital adequacy requirements that reflect the risks associated with their lending strategies.

The *Finding Balance* benchmarking studies have illustrated the inherent risks with government ownership of commercial businesses. Banks are no exception. Therefore, the case for any state-owned bank needs to be periodically reviewed and validated. Pacific policy makers agree with the international consensus that state-owned banks should only exist where they can demonstrate additionality, e.g., provide services in a commercial manner that would not otherwise be provided by private banks, or make the banking system more competitive. As the financing needs of businesses evolve in each country, so too must the financial service providers, including these state-owned banks.

I. INTRODUCTION

This study reviews the roles, performance, market context, and regulatory context of state-owned banks[1] in 10 Pacific island countries, identifies selected drivers of performance, and addresses the question of whether and how the state-owned banks can deliver domestic financial services in a non-distortionary, sustainable manner. The study comes at a critical time as governments and state-owned banks throughout the Pacific rethink their approach to sustainable finance in light of the new tools available to manage risk and expand sources of capital. It also comes at a time when—for some countries in the survey—international private banks are retreating and state-owned banks lack the financial capacity to address the growing need for business credit.

There are 17 state-owned banks—7 commercial banks and 10 development banks—in the 15 Pacific developing member countries of the Asian Development Bank (ADB). This study examines the performance of a subset of 6 commercial banks and 7 development banks in 10 Pacific countries. The commercial banks examined are (i) Bank of the Cook Islands (BCI); (ii) Bank of the Federated States of Micronesia (BFSM); (iii) MiBank and (iv) People's Micro Bank (PMB), both in Papua New Guinea (PNG); (v) National Bank of Vanuatu (NBV); and (vi) Tonga Development Bank (TDB). The development banks examined are (i) the Federated States of Micronesia Development Bank (FSMDB); (ii) Fiji Development Bank (FDB); (iii) Marshall Islands Development Bank (MIDB); (iv) National Development Bank of Palau (NDBP); (v) National Development Bank (NDB) of PNG; (vi) Development Bank of Samoa (DBS); and (vii) Development Bank of Tuvalu (DBT). Participating banks were selected based on their willingness to share their financial accounts and other operational data.

There is an important distinction between commercial and development banks. While their product offerings can overlap, they differ in terms of their regulatory framework, funding sources, and, to a lesser degree, the specificity of their mandates. The six commercial banks and two of the seven development banks must comply with a range of prudential standards and reporting requirements that are not imposed on the five other development banks. The commercial banks source more than 70% of their funding from customer deposits, and generally have broader mandates than the development banks.

This study also profiles the structure and operations of two successful development banks from outside the Pacific: the Business Development Bank of Canada (BDC) and the DFCC Bank in Sri Lanka.

The financial analysis covers the period from 2010 to 2017. The study was prepared with the active participation of each of the banks, which completed a detailed questionnaire and reviewed drafts of the analysis specific to their institution. A range of sources were used for the market analysis, including finance sector statistics prepared by the central banks; ministries of finance or other sector regulators; and data from multilateral institutions, including ADB, the World Bank, and the International Monetary Fund.

[1] In this study, state-owned banks include commercial banks and development banks in which the public sector holds a majority share.

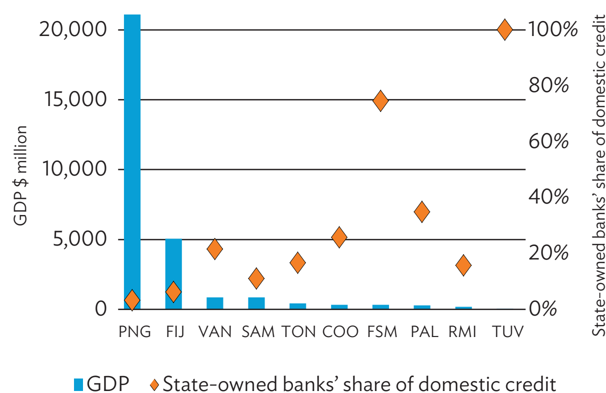
II. OVERVIEW OF PACIFIC STATE-OWNED BANKS

The state-owned banks in this benchmarking survey mirror the heterogeneity of state-owned commercial and development banks globally. There is no standard size, product mix, funding model, or governance structure. This chapter surveys the role of state-owned banks in their respective banking sectors, their mandates, corporate governance arrangements, regulatory frameworks, financial performance, and relationship with their shareholders.

A. SIZE AND MARKET SHARE

The state-owned banks in this benchmarking survey range in asset size from $2 million to $280 million and represent from 0.3% to 54.0% of total loans outstanding in their respective banking sectors (Table 1). While no generic Pacific model has emerged, there are similarities in the challenges faced by these banks and in their aspiration to become effective and sustainable lenders to their domestic markets. In each country, private sector demand for finance exceeds supply, and—with the exception of Bank South Pacific (BSP)—the international commercial banks, which represent the majority of banking sector assets in the Pacific, continue to pursue very conservative lending practices, leaving large segments of unmet demand for financial services.

Figure 1: Market Share of State-Owned Banks, 2017



COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, PAL = Palau, PNG = Papua New Guinea, RMI = Republic of the Marshall Islands, SAM = Samoa, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Sources: GDP: Asian Development Bank (ADB). ADB Data Library. https://data.adb.org/; World Bank. World Bank Open Data. https://data.worldbank.org/. State-owned banks' share of domestic credit: Graduate School USA. 2018. *RMI Economic Brief 2018*. Honolulu; International Monetary Fund. 2018. *Staff Report Tuvalu 2018*. Washington, DC.; Government of Cook Islands, Ministry of Finance and Economic Management; Reserve Bank of Fiji; FSM Division of Statistics; Palau Financial Institutions Commission; Bank of PNG; Central Bank of Samoa; Reserve Bank of Tonga; and Reserve Bank of Vanuatu.

State-owned banks have a larger share of the domestic credit market in the smaller countries in this survey than they do in the larger ones (Figure 1). In most of the medium-sized economies in this survey, state-owned banks provided 7%–22% of total domestic credit in 2017. This increases to 70%–100% in the microstates of the Federated States of Micronesia (FSM) and Tuvalu.[2] This reflects the limited attractiveness of these credit markets to private banks and supports the prevailing government view that state-owned banks play a vital role in finance sector development.

B. LEGAL FRAMEWORKS AND SUPERVISION

The banks in this survey are heterogeneous in terms of size, business models, operational strategies, and ownership. Yet their legal and regulatory environments share three common features. First, the majority of the banks are steered by establishing acts and the public policy goals set by their respective governments.[3] The two banks whose establishing legislation has been repealed—MiBank and the NBV—still retain development mandates, largely due to the presence of the state as a majority shareholder. Second, the majority of the banks surveyed are incorporated as limited liability companies under company legislation. Third, all of the banks must comply with the specific requirements of their respective public enterprise statutes (where these exist), which typically regulate the appointment of directors, reporting requirements, and community service obligations.

Beyond these commonalities, the regulatory regimes of the banks differ substantially. The key differences are whether the banks are licensed financial institutions[4] and subject to the supervision of a central bank or finance sector regulator (Table 2).

[2] Tuvalu has two banks—the National Bank of Tuvalu and the Development Bank of Tuvalu—both of which are 100% state-owned; only the Development Bank of Tuvalu is included in this survey.

[3] All but one bank (PMB) in the survey were established through Acts of Parliament; today, only three banks— PMB, MiBank, and NBV—no longer operate under an establishing act.

[4] Banking licenses require banks to comply with a range of prudential standards, such as capital adequacy ratios, solvency requirements, restrictions on credit concentration, and reporting and disclosure requirements.

Table 1: Size and Ownership of Surveyed State-Owned Banks, 2017

	Public Ownership (%)	Total Assets ($'000)	Domestic Banking Sector Assets (%)	Total Loans ($'000)	Total Domestic Credit (%)
State-owned commercial banks					
Bank of the Cook Islands	100	84,469	15.0[b]	52,066	25.8
Bank of the FSM[a]	76	148,025	40.2	50,664	54.4
MiBank (PNG)	59	26,769	0.1	16,751	0.5
People's Micro Bank (PNG)	100	31,352	0.2	11,387	0.3
Tonga Development Bank	100	60,515	21.3	27,220	16.7
National Bank of Vanuatu	70	280,397	24.8	129,230	21.5
State-owned development banks					
FSM Development Bank[a]	100	55,921	15.2	18,757	20.1
Fiji Development Bank	100	197,009	4.1	173,862	6.2
Marshall Islands Development Bank	100	36,144	13.8	19,129	15.7
National Development Bank of Palau	100	33,187	10.3	19,136	34.9
National Development Bank of PNG	100	178,345	0.9	81,316	2.4
Development Bank of Samoa	100	76,790	10.1	55,044	11.1
Development Bank of Tuvalu	100	1,806	3.1	1,299	10.9
Total		**1,210,729**	**4.2**	**655,861**	**7.6**

FSM = Federated States of Micronesia, PNG = Papua New Guinea.

[a] 2016 figures.

[b] 2015 figures.

Sources:
Public Ownership, Total Assets, and Total Loans: financial accounts of each bank.

Domestic Banking Sector Assets and Total Domestic Credit: Graduate School USA. 2018. *RMI Economic Brief 2018*. Honolulu; International Monetary Fund. 2018. *Staff Report Tuvalu 2018*. Washington, DC; Government of Cook Islands, Ministry of Finance and Economic Management; Reserve Bank of Fiji; FSM Division of Statistics; Palau Financial Institutions Commission; Bank of PNG; Central Bank of Samoa; Reserve Bank of Tonga; and Reserve Bank of Vanuatu.

Table 2: Supervision of State-Owned Banks

	Establishing Legislation	Commercial Banking License	Supervised by Central Bank / Finance Sector Regulator	Supervised by the Shareholding Ministry	No supervision
National Bank of Vanuatu		❇	❇	❇	
People's Microbank		❇	❇	❇	
MiBank (Papua New Guinea)		❇	❇		
Bank of the Federated States of Micronesia	❇	❇	❇		
Bank of the Cook Islands	❇	❇	❇	❇	
Tonga Development Bank	❇	❇	❇	❇	
Development Bank of Tuvalu	❇			❇	
Fiji Development Bank	❇			❇	
Development Bank of Samoa	❇		❇	❇	
National Development Bank of Papua New Guinea	❇			❇	
Marshall Islands Development Bank	❇			❇	
Federated States of Micronesia Development Bank	❇				❇
National Development Bank of Palau	❇				❇

❇ = yes.
Source: Pacific Private Sector Development Initiative.

Of the 13 banks in this survey, 6 have commercial banking licenses. This means that these banks must comply with the prudential standards and reporting requirements issued by the finance sector regulator,[5] and which are the same as for private commercial banks in their countries. The remaining seven banks—all of which are development banks— generally rely on their establishing legislation and shareholding government ministries to monitor and report on their financial health. Two hybrids are the Development Bank of Tuvalu, which has a banking license and the Development Bank of Samoa (DBS), which is considered a nonbank institution under Samoa's Financial Institutions Act, and as such must comply with banking, supervision and prudential guidelines set by the Central Bank of Samoa.[6] The Fiji Development Bank (FDB), which is not a licensed financial institution under the Fiji Banking Act, has voluntarily elected to comply with the prudential regulations issued by the Reserve Bank of Fiji. Two banks—FSMDP and NDBP—do not come under the purview of any designated supervisory authority.

A common challenge for regulators is how to provide an adequate regulatory framework that is supportive of the special nature and role of development banks, while ensuring that these banks do not crowd out the private sector, or cause distortions or instability in the financial market. Placing the development banks on a similar commercial footing as licensed financial institutions and subjecting them to prudential standards that reflect the risk characteristics of their business models should not be incompatible with pursuing a development mandate, as has been demonstrated by the state-owned commercial banks in this survey. Moreover, most of the countries in this survey have state-owned enterprise (SOE) legislation that supports the pursuit of development goals in a commercial manner and provides for the use of community service obligation contracts to support any noncommercial activities. The introduction of specialized banking licenses for development banks is explored further in section IV of this report.

C. MANDATES

All of the banks surveyed in this study pursue development-related mandates and objectives, which for all but one of them—People's Micro Bank—were initially articulated in their establishing legislation. Two banks—NBV and MiBank—have subsequently seen that legislation repealed and become fully commercial banks with self-prescribed development objectives.

The banks' mandates typically fall into two categories: (i) generic mandates expressed in fairly broad and ambitious terms, often referring to multiple policy objectives, and (ii) more narrowly drafted mandates, specifically setting out the sectors, activities, or types of customers which the development banks are expected to support. Seven of the banks in the survey pursue broad development mandates assigned to them by statute. These are BCI, MIDB, FSMDB, NDBP, NDB, TDB, and DBT. For instance, the mandate of NDBP is to "be the central financial institution responsible for initiating and promoting economic development" in the country. Four of the banks surveyed have more narrowly defined, specialized mandates. These mandates may specify the scope of financial services to be provided (e.g., DBS), or the sectors of focus (e.g., FDB).[7]

Interestingly, all five state-owned commercial banks provide banking services to market segments that privately owned banks would typically avoid due to their high cost or risk.[8] In this way, the state-owned commercial banks are pursuing a similar mandate to the development banks, but without the constraints inherent in a development banking act, and within the tighter prudential standards required of their banking licenses.

Generally, the legislative mandates of the banks do not incorporate explicit profitability targets. For example, the establishing legislation of BCI, DBT, FDB, and NDB do not require the banks to achieve a commercial return on capital. In some cases, such requirements may be found in other

5 An exception to this is DBT, which is under the supervision of the minister of finance. Tuvalu passed a Banking Act consistent with the Basel Core Principles in August 2010, but there has been limited progress in terms of establishing the necessary supervisory and prudential requirements. The amendment of the Banking Commission Act of 2011 allowed the minister of finance of Tuvalu to serve as the de facto Banking Commissioner, with supervisory authority over DBT.

6 Following the 2001 amendments to the Financial Institutions Act 1996, section 30A(4), the supervisory authority of the Central Bank of Samoa was extended to nonbank financial institutions such as the DBS. The Central Bank of Samoa requires DBS to: (i) hold the minimum level of the regulatory capital of 12.5%, and (ii) maintain a ratio of total regulatory capital to the risk-weighted asset (the Basel ratio) at or above the minimum of 25%.

7 FDB's mandate requires it to focus its activities on particular sectors such as transport, natural resources and agriculture; and to give special consideration and priority, among these sectors, to the rural and agriculture sectors of the economy.

8 These segments include rural customers and SMEs in the agriculture sector.

legislation (usually, legislative acts which apply to SOEs more generally, including state-owned banks).[9] In the case of NDBP, the requirement is more oblique: although not mandated by law to achieve a specified commercial return on equity (ROE), it is required to "aggressively identify projects for development financing that appear to have the potential to generate a reasonable return on invested capital."[10] The bank's "financial objective is not to maximize profit but to attain sufficient financial strength to achieve its objectives."[11]

In some countries, broader SOE policies may require the banks to achieve a minimum rate of return on equity. For example, the Government of Samoa specifies an ROE of 7% for all of its SOEs, although it is rarely achieved. In the Cook Islands, the government informally expects BCI to achieve an ROE of 10%. Similarly, the Ministry of Finance of the Government of Tonga expects TDB to achieve an ROE of 10%. The requirement for banks to achieve a commercial rate of return is essential for their financial sustainability, and can be fully compatible with government policies to extend subsidies to selected recipients. Moreover, imposing profitability targets on state-owned banks, as is the case with SOEs more broadly, facilitates government's oversight role in holding the SOEs accountable for results.

None of the banks surveyed incorporate the principle of "additionality" in their development mandates. That is, the banks are not mandated by statute to avoid "crowding out" private sector banks by undercutting their products or services. This may be contrasted with BDC (discussed in section III of this report) whose legislative mandate expressly provides that the bank's "loans, investments, and guarantees are to fill out or complete services available from commercial financial institutions."[12] This has guided BDC in filling a very specific market gap not served by private banks, and in so doing deepening the Canadian financial sector. Since BDC is free to price loans to fully reflect risk, clients eventually "graduate" and are able to access cheaper finance from private commercial banks.

The statutory acts governing the banks in this study do not provide for a formal review requirement or any review procedures. Nevertheless, some banks have expanded their initial mandates over time to include new areas such as sustainable development, supporting climate change-related projects, or enhancing financial inclusion. If state-owned banks are to remain relevant and focused on addressing emerging market gaps, their mandates should be refined to specify this core function, allowing credit products that finance different risk characteristics to be introduced and discontinued as needs change.

D. OWNERSHIP AND CORPORATE GOVERNANCE

Three of the 13 banks in this survey have partial private ownership. For example, BFSM is 27% owned by the national Government of the FSM, 24% by the state governments, 24% by the FSMDB, and 22% by individual private shareholders.[13] MiBank is 41% privately owned, while NBV has sold 15% of its shares to the Vanuatu National Provident Fund and 15% to the International Finance Corporation. MiBank and NBV operate as hybrid institutions that mix characteristics of both development and commercial banks, while BFSM focuses entirely on commercial operations, leaving development banking functions to FSMDB.

The introduction of private shareholders has been driven by a desire to attract additional capital, while strengthening the commercial orientation of the banks. A number of the banks in this survey are considering diversifying their shareholding in similar ways, looking first to pension funds and other institutional investors with similar development goals.

The benefits of partial privatization of SOEs has been widely demonstrated internationally and applies also to development banking. The case of DFCC Bank of Sri Lanka, which is detailed in section III of this report, shows how a development banking mandate can be successfully pursued under majority private ownership. It is an example of how government can deliver policy outcomes through regulations and incentives rather than through direct ownership and operation of banking institutions.

1. Composition of the Board of Directors

As SOEs, all of the banks in this survey face a key corporate governance risk of politicized board appointments and the resulting lack of operational autonomy from government. With few exceptions, the banks with large nonperforming loan balances have made noncommercial decisions at the

[9] For example, TDB is required to maintain its general purpose to operate as a profitable business under section 4 of the Tongan Public Enterprises Act.

[10] Public Law Number 1-27 as codified in Title 26 of the Palau National Code Annotated, para. 22, section (h).

[11] NDBP. *Financial Statements and Independent Auditors' Report 2016 and 2017.* Airia, Palau. p.3.

[12] Business Development Bank of Canada Act (1995). https://laws-lois.justice.gc.ca/eng/acts/b-9.9/page-1.html#h-1.

[13] The rest of the shares are dispersed between various shareholders, including the Pohnpei Port Authority (1%) and the Yap Cooperative Association (2%).

direction of government, through their representatives on the board. These practices not only jeopardize the sustainability of the banks but, in some cases, also violate the prevailing SOE statutes, which require noncommercial services to be formally contracted through a community service obligation framework.

Both the commercial and development banks in this survey have the same percentage of their boards composed of civil servants. The main distinction between these two categories of banks lies in the presence of elected officials on the boards and in the number of board chairs who are civil servants. On these measures, the development banks had stronger ties to government ministries. While the presence of elected officials on boards is seen as positive by their respective governments, in terms of giving the banks a direct link to their constituents, it also creates conflicts of interest as these directors are forced to reconcile political considerations with the commercial imperatives necessary for the banks' sustainability. In most countries in this survey, elected officials are specifically prohibited from serving on SOE boards.

The percentage of independent directors on boards is higher among the development banks than it is with the commercial banks. These independent directors are neither employees of the bank nor of the government shareholder, and may serve to moderate the risk of conflicts of interest on the board. In some cases, such as BFSM, which has a majority of civil servants on its board, the bank's charter limits the powers of the board over credit decisions, thereby mitigating the risk of directed lending.

Women are generally underrepresented on the boards of directors of the surveyed banks. Exceptions are BCI and DBT, which have a majority of female directors, and FSMDB and NDBP, with 43% of their boards composed of women. In contrast, PMB, NDB, and FDB had no female directors as of the third quarter of 2018.

2. Board Appointments

Board members of state-owned banks are usually appointed by the relevant government ministry responsible for overseeing the banks, or the head of state, acting on advice of the cabinet or senate. However, this is not the case for some banks with mixed private and public ownership structures, where directors are elected by a majority of shareholders voting at the annual general meeting. For example, the board of directors of BFSM is elected by shareholder majority vote.

The respective legislative acts establishing each bank generally do not lay down specific eligibility criteria for appointing board members, and directors can be removed at the discretion of the relevant government minister.[14] However, the prerequisites for such removal are usually stated in the legislative acts, which prescribe that certain grounds for removal must be established. The legislative acts also generally determine the procedure for appointing board members. In this regard, some acts are more prescriptive than others. The board chairperson is generally selected from among the board of directors by the relevant government minister. Similarly, in most banks surveyed, the chief executive officer (CEO) is selected by the board of directors, and then approved by the relevant government minister or cabinet.[15]

3. Director Performance Appraisal

Only 5 (DBS, FDB, NBV, NDB, and TDB) of the 13 banks have formal director performance appraisal processes in place. In the case of NDB, a performance appraisal process was approved in 2016 but has yet to be implemented. DBS has its own policy for director performance review, in addition to

Table 3: Board Composition of State-Owned Banks, 2018

	Development Banks	Commercial Banks
Percentage of directors who are civil servants	26%	26%
Percentage of directors who currently hold elected office	2%	0%
Percentage of directors who are women	26	34%
Number of boards with civil servant as chair	2	0
Percentage of directors who are independent[a]	70%	51%

[a] Independent directors are those who are neither civil servants, nor elected officials, nor employees of the bank.
Source: Author's survey of participating banks.

[14] In the case of BCI, an appointed director may be removed from office by the Cook Islands Investment Corporation at any time for disability, neglect of duty, misconduct, or if he or she becomes a bankrupt or makes any arrangement or composition with his or her creditor.

[15] In the case of NBV, no ministerial approval is required, and the full board selects the CEO after advertising widely for the position.

the review undertaken by the Ministry of Public Enterprises. As for the other banks, PMB has developed a proposal for a performance appraisal policy; MiBank has a board meeting appraisal process in place, but not a formal director appraisal process; while BCI utilizes an informal process to periodically review the performance of its directors.

Most of the banks appear to follow codes of corporate governance. These are either formal codes of corporate governance, which are followed by FSMDB, NDB, or PMB, or codes of conduct for directors.[16] The directors of BCI are expected to participate in the New Zealand Institute of Directors training programs.

4. Risk Management, Disclosure, and Corporate Planning

While most banks in this survey have established various board committees, such as risk management and audit committees, two banks—MIDB and NDBP—do not have risk management committees. However, NDBP is in the process of establishing one.

The licensed banks disclose information about their activities and risk exposures through regular filings with their respective supervisory institutions. In contrast, the nonlicensed banks rely primarily on their annual accounts to report on financial performance. These are generally made available on the banks' websites.[17] Both licensed and nonlicensed banks usually supply the annual reports to the relevant oversight government ministries and supervisory bodies.[18] For example, the annual accounts of NDB can be accessed online as part of the PNG company registry filings. However, unlike its subsidiary PMB and most of the state-owned banks in this survey, NDB does not make its annual accounts available on its website. BFSM, which is supervised by both the FSM Banking Board and the FDIC, makes its accounts available to both regulators,[19] but does not have its own website.

Most state-owned banks are required to prepare an annual plan or statement of corporate intent (SCI) that is used by their respective oversight government ministries to monitor performance.[20] Where banks prepare such statements, they are typically required to report against their SCI on a quarterly or annual basis.[21] BCI, for example, reports formally to the Cook Islands Investment Corporation on an annual basis and informally on a semiannual basis. The bank does not make its SCI publicly available, however, as it views the disclosure of such information as prejudicial to its ability to compete with other banks. Similarly, DBT reports on progress against its annual plan to its board and the Public Enterprise Reporting Monitoring Unit, but does not make the plan otherwise publicly available. FDB prepares an annual corporate plan and a 3-year strategic plan. NDB prepares an annual corporate plan, which is used by its trustee shareholder Kumul Consolidated Holdings to monitor performance. In practice, however, the extent to which the oversight government ministries or bodies actively monitor the performance of the banks against their annual plans differs.

Box 1: Central Bank Supervision and Disclosure

Banks that are supervised by central banks must regularly provide financial information and reports to their respective central banks, in addition to whatever reporting they provide to their shareholders. The central banks may issue directives, collect statistical data and information, conduct meetings with bank management, and carry out on-site inspections to ensure that the banks are well-managed. For example, the Central Bank of Samoa has supervisory authority over the Development Bank of Samoa and can compel the bank to submit periodic reports and other information that it finds necessary.

In Vanuatu, the Reserve Bank of Vanuatu (RBV) requires the National Bank of Vanuatu to submit monthly and quarterly data on its assets, liabilities, profitability, loan (asset quality) classification, foreign exchange turnover, large credit exposures and deposits, maturity profile of assets and liabilities, capital adequacy, and equity investments, among other things. In addition, the National Bank of Vanuatu is required to comply with various other compulsory public disclosure requirements and must submit audited copies of its annual accounts to the RBV. The RBV also has the power to conduct on-site reviews and, with respect to domestic banks, typically does so every 2 years.

Source: Pacific Private Sector Development Initiative and Reserve Bank of Vanuatu.

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[16] NDB has a code of ethics and board charter, but not a code of corporate governance.

[17] The exception is DBT, which does not have a website nor make its accounts available on any other government website.

[18] For example, the annual reports of DBS can be accessed on the website of the Parliament of Samoa: http://www.palemene.ws/new/parliament-business/annual-reports/development-bank-of-samoa/ (last accessed 26 October 2018).

[19] The FDIC insures the deposit accounts of BFSM, which in turn requires BFSM to submit to FDIC supervision.

[20] NBV prepares a strategy and business plan, which must be approved by all shareholders, as per the Shareholder Agreement. MIDB does not produce a corporate plan on an annual basis; its last corporate plan was developed in 2016 and is in effect for 5 years.

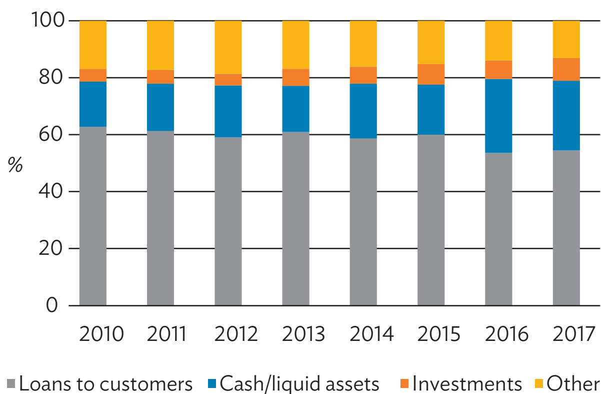
[21] Some, such as DBS, must report on both a quarterly basis and an annual basis.

E. BANKING SERVICES AND CUSTOMERS SERVED

The banks in this survey are all retail lending institutions, and offer a standard range of products and services, such as consumer loans, vehicle loans, mortgages, corporate loans, and savings accounts.[22] Retail lending remains the core business of the banks, representing 55% of total banking assets in 2017 and accounting for 69% of total revenue. Only six banks provide guarantee products, and four provide insurance.[23]

While lending remains the primary business of the banks, it has been on a downward trend from its peak of 63% of total banking assets in 2010 (Figure 2). As lending has decreased over the survey period, it has not generally been replaced with higher income-generating activities. Instead, the banks have increased their cash and liquid asset balances, reaching 25% of their total assets in 2017.[24]

Figure 2: Composition of State-Owned Bank Assets 2010–2017



Sources: Financial statements of participating banks.

In 2017, approximately 62% of the total loan portfolio of the banks was allocated to large corporations and individuals (Table 4). The large percentage of lending to corporations, most of which was from the development banks, is due to the proportionally high impact of FDB, which allocated 72% of its lending to corporations.[25] The development banks were much more active in lending to micro, small, and medium-sized enterprises (MSMEs) than the commercial banks, reflecting their generally higher appetite for risk.

Within the subgroup of commercial banks, 68% of total credit was allocated to individuals for housing or consumption purposes.[26] These banks have developed their branch networks to grow their customer base and, in the larger markets of PNG and Vanuatu, compete directly with a number of private commercial banks for this consumer business.

Only five banks in this survey lent to SOEs, and these loans represented only 2.2% of total credit outstanding in 2017. This is a surprising finding given the influence of portfolio ministers in the operations of SOEs, and may demonstrate the increasing ability of the banks to make independent credit assessment decisions.

The economic sectors served by the banks were primarily consumption, followed by housing, tourism, and agriculture and fisheries. Within the subset of development banks, the largest proportion of credit was allocated to tourism (23%), followed by agriculture (17%), construction (16%), and housing (11%). This is consistent with their development mandates, and contrasts with the commercial banks' focus on consumption (Table 5).

Within the development bank subgroup, the allocation of credit by economic sector varied quite substantially, with MIDB allocating 78% of its credit for consumption, and NDB allocating 31% and FDB 20% to agriculture. The rationale for development bank consumer lending can be questioned, as this is a market segment already addressed by private commercial banks and finance companies. MIDB is an anomaly in the development bank group in this regard. The appetite for agriculture lending varies among the development banks and is virtually inexistent among the commercial banks. Given the importance of agriculture and fisheries to the economies of the Pacific and the livelihoods of so many of its inhabitants, there is an opportunity for the development banks to further expand their lending to this market.

Among the development banks, DBS, FDB, and FSMDB are the most heavily weighted in tourism, making up 65%, 25%, and 22% of their respective gross loan portfolios. In the case of

22 Retail banking primarily serves individuals and businesses through a branch network, compared with wholesale banking which focuses on transactions between banks.

23 Guarantees are provided by FDB, MIDB, FSMDB, NDBP, TDB, and DBT. Insurance is provided by NDB, DBT, PMB, and MiBank.

24 From 2010 to 2017, the cash/liquid asset holdings of banks rose from 15% of total assets to 25%. Of the increase in cash and liquid assets observed in 2016, 70% is attributable to NBV, which increased customer deposits by $100 million in 2016, $87 million of which were held as liquid assets at the end of fiscal year 2016.

25 If FDB is excluded from the development bank group, the percentage of total credit to corporations drops to 25% and that to MSMEs increases to 47%.

26 The demand for consumer loans is attributable in part to the low penetration of credit cards in the Pacific region.

Table 4: Allocation of Credit by Customer Group, 2017

Customer Group	Total Credit[a] (%)		
	All State-Owned Banks	Commercial Banks	Development Banks
Individual/consumer	29.9	63.9	9.9
MSME	22.8	7.5	31.8
Sole trader	4.3	3.9	4.5
Vehicle loans	2.0	5.4	0.0
Large corporate	32.2	4.0	48.7
State-owned enterprises	2.2	0.4	3.2
Other	6.7	14.9	1.9

MSMEs = micro, small, and medium-sized enterprises, SOE = state-owned enterprise.
[a] Excluding Bank of Cook Islands and Development Bank of Tuvalu where data are not available.
Source: Author's survey of participating banks.

Table 5: Allocation of Credit by Economic Sector, 2017

Economic Sector	Total Credit[a] (%)		
	All Banks	Commercial Banks	Development Banks
Agriculture/fisheries	11.3	1.4	18.0
Tourism	17.2	6.9	24.1
Transport	4.6	1.6	6.5
Housing	15.2	23.2	9.8
Consumption	22.7	44.8	7.8
Construction	11.8	4.0	17.1
Other	17.3	18.0	16.8

[a] Data do not include MiBank PNG.
Source: Author's survey of participating banks.

DBS, tourism loans linked to disaster recovery have depressed the bank's overall asset quality. Moreover, loan terms have not been fully priced for risk or costs. The tourism loans of FDB are largely performing and, in many cases, were obtained from customers who turned to FDB after unsuccessfully seeking credit from private commercial banks. In this way, FDB is providing additionality in the market rather than crowding out private banks.

Interestingly, 9 out of the 13 banks in the survey offer housing loans, in many cases in direct competition with private commercial banks and in three countries in competition with state-owned housing lenders.[27] This raises the risk of the state-owned banks crowding out other lenders in these small markets. In the smallest economies in this survey (Cook Islands, Palau, and Tuvalu), the state-owned banks allocated the majority of their credit to housing loans (BCI: 43%, NDBP: 56%, and DBT: 33%). In Palau and the FSM, the prohibition on foreign ownership of land and housing has minimized the involvement of foreign banks in this market. BFSM, while majority state-owned, has some foreign shareholders, and as such is similarly excluded from owning land or housing assets.

The banks in this survey provide longer-term loans than those available from private sector banks. In 2017, 35% of loans provided by the surveyed banks were for 11–20 year terms, 18% for 6–10 year terms, and 40% for 1–6 year terms. Only 7% of outstanding loans were for terms of less than 1 year.[28]

[27] These are the Samoa Housing Corporation, the Housing Authority of Fiji, and the Palau Housing Authority.
[28] Data do not include figures for BCI, DBS, or DBT.

While the range of collateral taken by the banks continues to be dominated by fixed assets (e.g., land and/or buildings) or cash, opportunities to use movable property are growing.[29] In the countries with modern secured transactions laws and registries,[30] the state-owned banks are the most active users of movable property as collateral. For example, FSMDB has secured 37% of its lending portfolio with movable property. Other state-owned banks actively using these new collateral frameworks are TDB (10% of portfolio), NDBP (8%), and PMB (12%).[31] In late 2018, MiBank became the newest bank to launch an agribusiness financing product secured with movable property.

Box 2: Innovative Agriculture Value Chain Financing

The Tonga Development Bank (TDB) was one of the first banks in the Pacific to introduce small agriculture loans secured with movable property.

Under this facility, TDB advances loans to proven vanilla growers so that they can increase their planting. The average loan size is around $2,000–$3,000, and the loan is secured against the individual grower's vanilla bean crop and contract with the buyer of the vanilla beans. Previously, TDB would only take land as collateral, but as most growers do not own the land they farm, they could not access the finance needed to expand their production.

This innovation was made possible with the enactment of the Tonga Personal Property Securities Act 2010, which allows lenders to register security interests over movable assets, and to have certainty as to their priority over these interests, when there are competing claims. The act specifically covers farm products.

In launching the vanilla farmer financing facility, TDB is playing a quintessential development banking role, assuming risks that private commercial banks are not ready to take and expanding access to credit on a sustainable, non-concessionary basis.

Source: Pacific Private Sector Development Initiative.

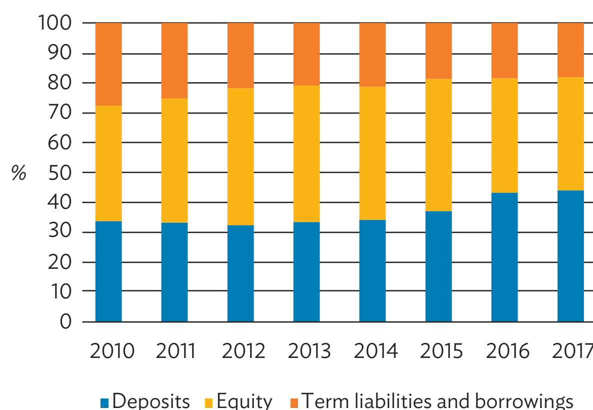
The role of the state-owned banks in using these new forms of collateral illustrates the market-making function that they can play; once these new agribusiness clients establish their creditworthiness, it is expected that other banks will seek to enter this market, and interest rates will decline. In this way, the state-owned banks are not only extending credit to new clients in important economic sectors, but also demonstrating the value of the new financing products.

F. FUNDING SOURCES

The state-owned banks rely primarily on deposits to finance their lending operations, and this reliance has increased over time (from 34% in 2010 to 44% in 2017) as borrowings dropped from 28% to 18%, with equity representing the same proportion of total funding in 2017 as it did in 2010 (Figure 3).[32] This shift to more deposits has reduced the cost of funds of the banks from an average of 3.9% in 2010 to 2.2% in 2017 (Table 6).

The consolidated funding source figures mask significant diversity within the sample. For example, the six licensed commercial banks in this survey are the only banks that can accept demand deposits, and five of them heavily depend on these deposits for their funding. Of the six development banks that do not accept retail deposits, three are heavily reliant on government equity and grant contributions (FSMDB, MIDB, and NDB), while the other three (DBS, FDB, and NDBP) rely on promissory notes and debt facilities, some through multilateral institutions (FSMDB, DBS, and NDBP).

Figure 3: Funding Sources of State-Owned Banks, 2010-2017



Sources: Financial accounts of participating banks.

[29] In 2017, fixed assets represented approximately 62% of total security issued by all banks, 55% for the development banks, and 79% for the commercial banks. Data does not include figures for BCI or DBT.

[30] These are the FSM, Palau, PNG, the Marshall Islands, Samoa, Tonga, and Vanuatu.

[31] These figures are diluted by the high value of housing loans; if only business loans were being counted, the percentages secured by movable property would be higher.

[32] The sharp increase in deposits in 2016 was largely attributable to NBV, which added $100 million of deposits during the fiscal year 2016/2017.

Table 6: Sources of Bank Funding, 2017

	Total Assets (%)			
	Deposits[a]	Debt	Equity	Cost of Funds[b]
NBV	94	1	4	2
BCI	84	0	15	3
BFSM	84	0	15	0
MiBank	80	0	13	2
PMB	62	0	33	1
DBT	29	5	56	4
TDB	29	47	19	2
MIDB	4	2	93	3
NDB	3	–	96	0
FSMDB	0	3	97	5
NDBP	0	38	56	3
FDB	0	61	37	4
DBS	0	71	28	3

BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, DBS = Development Bank of Samoa, DBT = Development Bank of Tuvalu, FDB = Fiji Development Bank, FSMDB = Federated States of Micronesia Development Bank, MIDB = Marshall Islands Development Bank, NBV = National Bank of Vanuatu, NDB = National Development Bank of Papua New Guinea, NDBP = National Development Bank of Palau, PMB = People's Micro Bank, TDB = Tonga Development Bank.

[a] Includes both term and demand deposits.

[b] Cost of funds calculated only on interest-bearing liabilities, excluding equity and reserves.

Sources: Financial accounts of participating banks.

Only two of the banks in this survey (MIDB and NDB) receive ongoing grant contributions from their shareholders. In both cases, the grant funds are to be used for onlending at fixed interest rates and, in the case of NDB, represent 83% of total funding sources. While the grant funds have kept NDB's cost of funds at 0% over the 2010–2017 period, they also appear to have been associated with low repayment expectations. During this same period, NDB's nonperforming loan rate averaged 51%.[33]

Five of the banks in this survey borrow from multilateral development banks and national pension funds for the purposes of onlending, and carry the full value of the respective loans as liabilities and assets on their balance sheet (Table 7). In addition, some (e.g., FDB and TDB) act as agents for specific government concessional loan schemes, but do not carry the funding and loans on their balance sheets; they are paid a fee by government for the administration of these loans.

Table 7: Borrowing from Multilaterals and Pension Funds, 2017

	ADB	EIB	World Bank	Pension Funds
FSMDB		❇		
NDBP		❇		❇
DBS	❇	❇	❇	❇
TDB	❇	❇	❇	
DBT		❇		

ADB = Asian Development Bank, DBS = Development Bank of Samoa, DBT = Development Bank of Tuvalu, EIB = European Investment Bank, FSMDB = Federated States of Micronesia Development Bank, NDBP = National Development Bank of Palau, TDB = Tonga Development Bank.

Source: Financial accounts of participating banks.

[33] Nonperforming loans are defined as loans that are more than 90 days past due.

G. PROFITABILITY AND EFFICIENCY

Overall, the state-owned banks in this survey generated very low financial returns on investment for their shareholders. Taken as a group, the banks generated an average return on assets (ROA) of 1.2% and average return on equity (ROE) of 2.8% during the 2010–2017 period (Figure 4). Surprisingly, the development banks were more profitable than the commercial banks, despite their lower interest rate spreads. They generated an average ROA of 1.5% for the 2010–2017 period compared with 0.7% for the commercial banks. These returns can be compared with those of BSP, which operates in seven Pacific countries and has the largest branch network in the region. Over the 2012–2017 period, BSP generated an average ROA of 3.1%, compared with 0.6% for the state-owned commercial banks and 1.6% for the development banks (Figure 5). The average ROE of BSP during this same period was 29%, 10 times the 2.8% average of the state-owned banks in this survey.

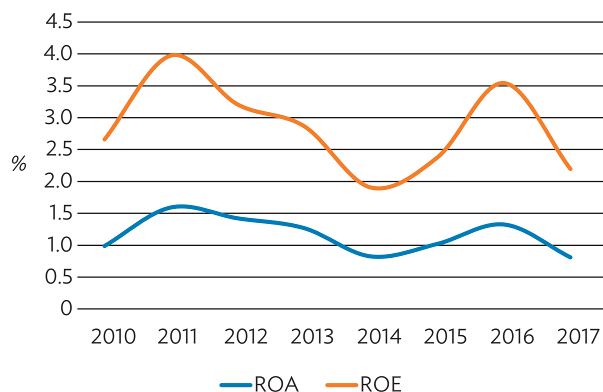
Among the state-owned commercial banks, TDB was the best performer, returning an average of 2.1% on assets, respectively, over the 2010–2017 period (Table 8). The drop in profitability among the commercial banks in 2017 is largely due to the losses incurred by NBV, which wrote off $7.8 million in impaired loans in that year. Without NBV, the consolidated ROA of the commercial banks in 2017 would have been 1.3% instead of 0.0%.

Among the development banks, there was also substantial disparity in profitability, with the smallest bank (DBT) generating losses in 5 of the 8 survey years, while FSMDB and MIDB generated average ROA of 4.7% and 7.7% over the 2010–2017 period. Surprisingly, the nonlicensed banks were more profitable than the licensed institutions, averaging a 2.6% ROA during the 2010–2017 period, compared to -0.8% for the licensed banks.[34] This is even more surprising given the much higher average level of nonperforming loans among the nonlicensed banks (28%) than the licensed banks (16%) during the same period.

While the average cost of funds of the banks declined from 2012 to 2017, the average interest rates on loans remained relatively stable. The banks' profit margins showed a corresponding recovery from 2014 to 2017, but relatively poor asset quality has continued to erode profitability.

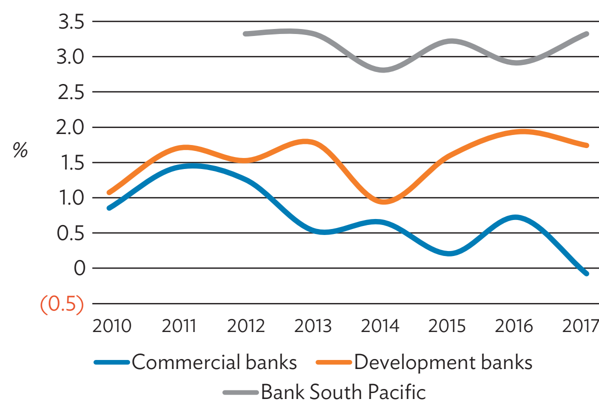
The average interest rate spreads were much higher for the commercial banks than for the development banks (Figure 6). While this may reflect the higher proportion of consumer loans in the commercial bank portfolios, and lower cost of funds, it also suggests that the commercial banks are more effective at pricing their loans to reflect risk. Some of the development banks lack interest rate policies, leaving them without the necessary guidance to price risk.

Figure 4: Profitability of State-Owned Banks, 2010–2017



ROA = return on assets, ROE = return on equity.
Source: Financial accounts of participating banks.

Figure 5: Return on Assets of State-Owned Banks, 2010–2017



( ) = negative
Source: Financial accounts of participating banks.

[34] The average ROA of the licensed banks is lowered by DBT; if it were included as a nonlicensed institution, it would make the average ROA of the two groups roughly the same at just under 1%.

Table 8: Return on Assets of State-Owned Banks, 2010–2017 (%)

	License	2010	2011	2012	2013	2014	2015	2016	2017
Commercial banks									
BCI	❇	2.0	1.9	1.9	2.1	1.2	1.4	0.7	0.8
BFSM	❇	1.6	1.8	1.5	1.2	1.1	1.0	1.3	1.5
MiBank	❇	(7.1)	0.2	0.5	0.6	(0.3)	(0.1)	1.4	(0.1)
PMB	❇				(13.5)	(3.5)	1.9	0.3	2.2
TDB	❇	2.5	2.8	2.2	2.4	1.7		1.7[a]	1.7
NBV	❇	1.3	1.0	0.8	0.1	0.6	(1.1)	0.2	(1.8)
Development banks									
FSMDB		4.1	3.1	4.4	9.5	3.4	1.5	5.9	5.7
FDB		0.6	0.7	0.9	1.2	1.4	1.7	1.9	2.0
MIDB		6.5	4.7	7.6	0.3	8.1	10.2	7.6	16.4
NDBP		(0.3)	1.0	0.6	5.5	(1.3)	4.8	2.9	(0.1)
NDB		0.7	3.7	2.3	1.4	1.0	0.6	0.4	(1.8)
DBS		0.3	(0.3)	(0.7)	(2.0)	(2.5)	(0.8)	(0.4)	0.0
DBT	❇[b]	(5.2)	(4.4)	(28.5)	(17.6)	(24.1)	2.7	4.2	4.4

❇ = licensed. ( ) = negative – = not available

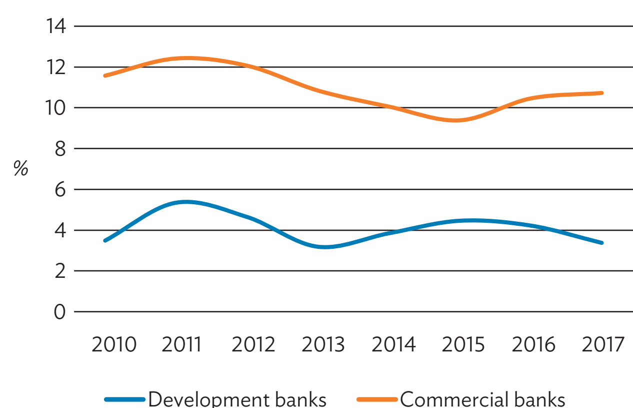
BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, DBS = Development Bank of Samoa, DBT = Development Bank of Tuvalu, FDB = Fiji Development Bank, FSM = Federated States of Micronesia, FSMDB = FSM Development Bank, MIDB = Marshall Islands Development Bank, NBV = National Bank of Vanuatu, NDB = National Development Bank of Papua New Guinea, NDBP = National Development Bank of Palau, PMB = People's Micro Bank, TDB = Tonga Development Bank.

[a] This figure includes 18 months (Jan 2015–Jul 2016) as TDB changed its fiscal year.

[b] DBT has a banking license which is more restrictive than a full commercial banking license

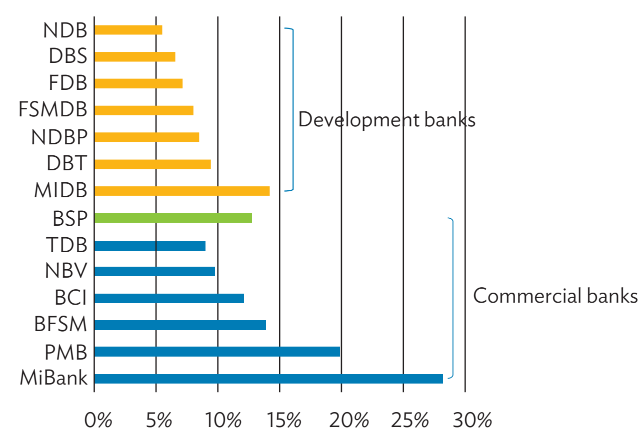
Source: Financial accounts of participating banks.

Figure 6: Interest Rate Spreads, 2010–2017



Sources: Financial accounts of participating banks.

Figure 7: Interest Income on Loans / Loans, 2017



BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, DBS = Development Bank of Samoa, DBT = Development Bank of Tuvalu, FDB = Fiji Development Bank, FSMDB = Federated States of Micronesia Development Bank, MIDB = Marshall Islands Development Bank, NBV = National Bank of Vanuatu, NDB = National Development Bank of Papua New Guinea, NDBP = National Development Bank of Palau, PMB = People's Micro Bank, TDB = Tonga Development Bank.

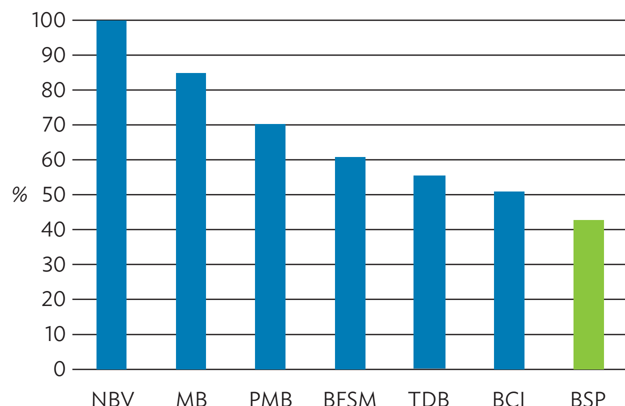
Sources: Financial accounts of participating banks.

Income on loans in 2017 was substantially lower for the development banks (9%) than it was for the commercial banks (16%) (Figure 7). This is a result of two factors: (i) the higher proportion of nonperforming loans among the development banks, and (ii) the lower interest rates that they charged. Four of the eight development banks in this survey were subject to explicit interest rate caps imposed by regulation.[35] In other cases, loan terms are influenced by government policy or through informal political pressure. The degree to which the development banks have been free to fully price for credit risk is unclear. PMB and MiBank, which both serve rural customers and offer small loans, reflect the high cost and risk of this market segment in their pricing, with average interest income of 20% and 28%, respectively, in 2017. In contrast, NBV also serves rural customers, but generated average interest income of only 10% in 2017. NBV's nonperforming loan rate was substantially higher than that of MiBank and PMB over the survey period, and all three banks had very low average profitability (ROA of 0.14% for NBV, -0.6% for MiBank, and -2.5% for PMB).[36]

With few exceptions, banks with branch networks had the highest operating costs in the benchmarking sample. Seven of the 13 banks in this survey offered savings accounts to customers, and 10 of banks had a network of branches to service their customers. For banks like NBV, PMB, and MiBank, the branch network represents a net cost, as they are not able to generate sufficient income from the deposits collected to offset the operating costs of the branches. While NBV considers the network part of its self-imposed development mandate, it expects the profitability of the branches to improve over time, as credit to rural customers increases. This is a risk that other rural banks such as PMB and MiBank are also taking. As with NBV, they see their branch networks as primarily serving a financial inclusion objective, which comes at a very high cost. In 2017, NBV, PMB, and MiBank had the highest ratios of expenses to total income of the commercial banks in this survey.[37] This could be compared with the efficiency of BSP, which had 45 branches in PNG, and an expense ratio of 42% (Figure 8).

Some of the development banks also had very high expense ratios despite the absence of a branch network (Figure 9). For example, over the 2010–2017 period DBT and DBS maintained comparatively high expense ratios for banks without a branch network. MiBank, NDB, and PMB all averaged expense ratios of over 90%, reflecting the high cost of doing business in PNG. In the case of NDB, this was compounded by its low revenue yield and comparatively low percentage of income-earning assets. In contrast, FDB was the most efficient of all of the banks, due in part to its ability to extract revenue from over 80% of its total assets, while keeping operating expenses low.

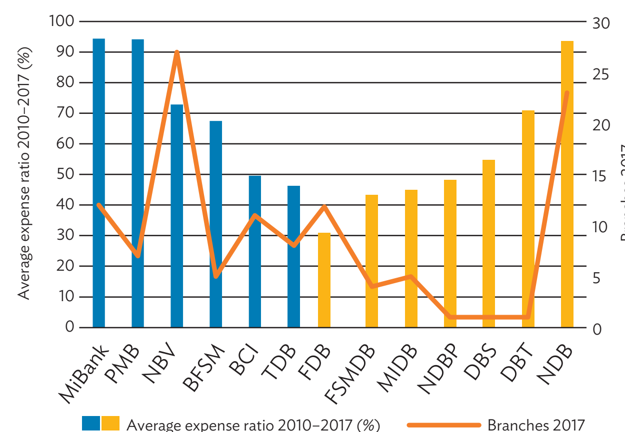
Figure 8: Expense Ratio of Commercial Banks, 2017



BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, BSP = Bank South Pacific, MB = MiBank, NBV = National Bank of Vanuatu, PMB = People's Micro Bank.

Sources: Financial accounts of participating banks.

Figure 9: Average Expense Ratio / Number of Branches



BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, DBS = Development Bank of Samoa, DBT = Development Bank of Tuvalu, FDB = Fiji Development Bank, FSMDB = Federated States of Micronesia Development Bank, MIDB = Marshall Islands Development Bank, NBV = National Bank of Vanuatu, NDB = National Development Bank of Papua New Guinea, NDBP = National Development Bank of Palau, PMB = People's Micro Bank, TDB = Tonga Development Bank.

Source: Financial accounts of participating banks.

[35] All NDB loans are capped at 6.5%; NDBP housing loans are capped at 8%; usury laws in the Marshall Islands and the FSM cap interest rates on consumer loans.

[36] PMB figures are only from 2013 to 2017.

[37] Expenses do not include interest expense.

H. ASSET QUALITY AND CAPITAL ADEQUACY

The asset quality of the banks varied substantially but, with few exceptions, improved over the 2010–2017 period. Overall rates of nonperforming loans are very high, but for different reasons (Table 9). In the case of NBV, a recent spike in NPLs reflected the impact of tropical storms on asset values used to secure a large portion of its loan portfolio. In the case of DBS, the terms of disaster-recovery lending in the tourism sector were driven more by political imperatives than cost and risk assessments, and several large loans now need restructuring. Other banks, such as NDB and DBT, have maintained very high average levels of NPLs (51% and 41% respectively) over the 2010–2017 period, largely due to weak credit risk assessment practices.

MIDB has had the most dramatic improvement in asset quality, reducing its NPLs from 92% of total loans in 2011 to 17% in 2017, which has contributed to its healthy profitability. This has occurred as the bank has shifted its client focus away from commercial lending (including SOEs) and increasingly toward consumer loans, which represented 76% of its loan portfolio in 2017. While consumer lending has proven to be more profitable and less risky than business lending, MIDB competes directly with two private banks in the consumer segment, raising questions about its additionality. It is also inconsistent with the bank's core mandate of business lending. MIDB intends to reenter the commercial lending market and has developed its Strategic Plan 2016–2020 to guide this transition.

In 2017, all but one of the regulated banks had capital in excess of 10% of risk-weighted assets, and most were well above the requirements set by their banking supervisors. In most cases, however, the capital adequacy (CET1) ratios[38] have been on the decline since 2013, and banks such as BCI, MiBank, and NBV are seeking additional capital to strengthen their balance sheets and enable the financing of new classes of risk (Figure 10).

Table 9: Nonperforming Loans of State-Owned Banks, 2010–2017[a] (%)

	2010	2011	2012	2013	2014	2015	2016	2017
Commercial banks								
BCI	10	14	13	11	10	9	7	7
BFSM	–	–	–	–	–	2	1	18
MiBank	18	10	8	7	8	8	7	7
PMB						1	6	8
TDB	–	–	3	6	3		6	3
NBV	14	13	14	20	18	24	23	31
Development banks								
FSMDB	23	13	13	11	14	17	8	8
FDB	15	16	17	15	16	13	14	13
MIDB	83	92	57	42	78	10	17	17
NDBP	16	14	11	12	16	12	3	4
NDB	64	58	53	46	46	47	55	41
DBS	16	48	42	4	10	18	50	38
DBT	32	35	60	49	54	30	36	34

– = not available

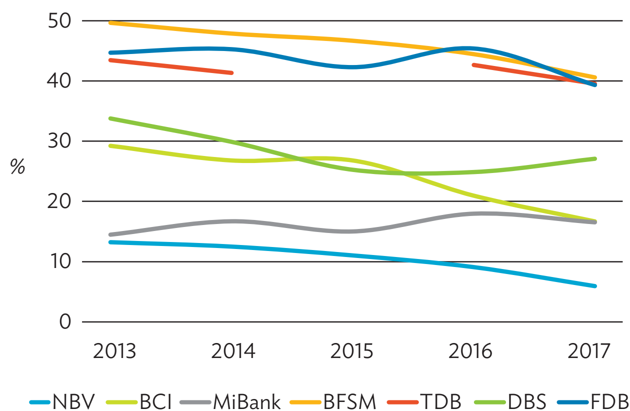
BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, DBS = Development Bank of Samoa, DBT = Development Bank of Tuvalu, FDB = Fiji Development Bank, FSMDB = Federated States of Micronesia Development Bank, MIDB = Marshall Islands Development Bank, NBV = National Bank of Vanuatu, NDB = National Development Bank of Papua New Guinea, NDBP = National Development Bank of Palau, NPL = nonperforming loan, PMB = People's Micro Bank, TDB = Tonga Development Bank.

[a] NPLs are defined here as loans that are at least 90 days past due. Some banks also include loans that are less than 90 days past due but where there is insufficient security to cover a loss as an NPL; the figures in this table may therefore differ from those in the Appendix.

Source: Author's survey of participating banks.

[38] Common equity tier 1 (CET1) is the sum of retained earnings and paid-in capital.

Figure 10: Capital Adequacy (CET1) Ratio, 2013–2017



BCI = Bank of the Cook Islands, BFSM = Bank of the Federated States of Micronesia, CET1 = common equity tier 1, DBS = Development Bank of Samoa, FDB = Fiji Development Bank, NBV = National Bank of Vanuatu, TDB = Tonga Development Bank.

Source: Author's survey of participating banks.

I. CONCESSIONAL LENDING

A surprising finding of this study is that formal, subsidized lending programs represent only a small proportion of the portfolios of state-owned banks. These subsidized lending programs take various forms, for example: (i) service contracts to administer funds (in which case the funds are off-balance sheet), (ii) directed lending to target groups at below market rates, and (iii) risk-share mechanisms with donors or government partners. Five of the development banks and three of the licensed commercial banks implemented some form of subsidized lending program in 2017, and in all but two cases these programs represented less than 15% of their outstanding credit portfolio. The exceptions are NDB and DBS, where an estimated 100% and 68% of gross loans in 2017, respectively, were subject to concessional terms. For these two banks, the absence of effective credit assessment mechanisms to support the loans has resulted in high levels of NPLs.

Despite the relatively small scale of the formal concessional lending programs, the surveyed banks report that they inhibit the development of effective credit assessment skills. Compounded by an often larger problem of informal, this political pressure on lending and restructuring decisions impedes the banks from building sustainable lending practices. In contrast to successful lenders such as the Business Development Bank of Canada, which prices all of its loans to fully reflect risk, banks using risk-share facilities do not need to be as thorough nor accountable for their credit decisions. The result is that businesses that represent very different levels of risk receive similar pricing, a practice that would be unsustainable for the banks without ongoing subsidization.

Pacific state-owned banks recognize that sustainable development finance must be market-based. The financing gap of small and medium-sized enterprises (SMEs) is not a result of a lack of funds, as the large cash and liquid asset balances of these banks attest, but rather a result of weak credit assessment practices and poorly designed government support programs. Lending to SMEs in the Pacific is difficult and risky, particularly in sectors such as agriculture and fisheries which employ large segments of the workforce. International commercial banks are generally absent from this market, leaving unmet demand to be addressed by national financial institutions with the right skills. The potential role of state-owned banks in developing this opportunity is discussed in section IV of this report.

III. INTERNATIONAL EXPERIENCE WITH DEVELOPMENT BANKS

A. GLOBAL FINDINGS

While development banks are often treated as a homogenous class of financial institutions, the reality is that there are a wide variety of credit providers that can be categorized as development banks or development finance institutions. This variety means that any attempt to generalize the experiences of development banks is more an exercise in explaining differences rather than identifying a general model. There are an estimated 250 national development banks around the world with total assets of $4.9 trillion, 75% of which are in the developing world.[39] Not surprisingly, there is no one-size-fits-all funding model, policy mandate, ownership structure, size, or business model. This is also the case in the Pacific region. Key features of the international experience are:

(i) Two types of mandate prevail: (a) a broad mandate with multiple policy objectives, or (b) a narrow, specific mandate focused on a particular sector (e.g., agriculture or housing) or a particular type of customer (e.g., micro, small, and medium-sized enterprises (MSMEs) and other financial institutions). The most common specific mandates are for agriculture and MSMEs.

(ii) Development banks are typically state-owned, -administered, and -controlled, although the extent of government ownership varies.

(iii) Development banks are generally small relative to the overall size of a country's banking system, but there are some notable exceptions (e.g., China Development Bank and Brazil Development Bank). In smaller countries, development banks can have a dominant position in the banking system or in a particular sector.

(iv) Most development banks are expected to be financially self-sustainable and profitable. If this expectation is to materialize, gross lending margins must be large enough to cover operating costs and build capital through retained earnings.

(v) Most development banks make long-term loans and working capital loans, and some make syndicated loans and unsecured loans. These loans may be made to retail customers (individual businesses or persons), or wholesale customers (other financial institutions), or both. Many development banks also offer loan guarantee products, and it is not uncommon for development banks to offer leasing and factoring products, securitization, and advisory services.

(vi) It is not unusual, but far from universal, for development banks to provide credit at subsidized rates, as well as at market rates of interest. The subsidy can be funded through government transfers, multilateral development banks, and internal transfers from profitable operations. Regular transfers from the government are the most common way to fund subsidies, but are also the least sustainable. In addition to providing funding for lending operations—subsidized or otherwise—it is common for governments to provide balance sheet support through guarantees of development bank debt and other liabilities.

Meeting any expectation of sustainability in practice has not been straightforward, and several development banks have been plagued by operating losses and substantial nonperforming loans. The fundamental causes of these problems are poorly defined mandates, poor corporate governance arrangements, and inadequate regulation and supervision. These have been exacerbated by operational weaknesses in credit assessment, risk management, and loan recovery. However, there is a broad consensus among public shareholders of development banks that their overriding objective is to address market failures in a market-friendly way.

B. PROFILES OF SUCCESSFUL STATE-OWNED BANKS

If a successful state-owned bank is one that provides finance to clients not served by private banking institutions, or makes the private banks more competitive, and does this sustainably, then both the Business Development Bank of Canada (BDC)

[39] The Economist. 2019. National Development Banks are Back in Vogue. 7 March.

and DFCC Bank can be considered successful state-owned banks. Both were founded more than 50 years ago and have successfully evolved to maintain their relevance and impact. They demonstrate how development banking mandates can be delivered in a fully commercial—and therefore sustainable—manner.

1. Business Development Bank of Canada

Founded in 1944, BDC is a federal crown finance corporation[40] providing a full range of financial (loans, subordinate financing, and venture capital) and business advisory services to Canadian SMEs. The bank is the successor to the Canadian Federal Business Development Bank (1975–1995) and the Industrial Development Bank (1944–1975) and is wholly owned by the Government of Canada. It adopts professional risk assessment practices and prices its services to fully reflect their underlying risk. In 2017, BDC supported 56,000 clients, focusing on SMEs and innovative firms that have a higher risk profile than other categories of borrowers and whose financing needs would not otherwise be met by private banks.

BDC represents a small but important part of Canada's SME credit market. As of December 2017, Canada's banks had authorized an estimated Can$225 billion in credit to SMEs throughout the country, of which BDC represented approximately 10%.[41]

BDC's mandate is to finance gaps in the SME credit market. It is articulated in the Business Development Bank of Canada Act (BDC Act) 1995 as follows:

> "The purpose of the bank is to support Canadian entrepreneurship by providing financial and management services and by issuing securities or otherwise raising funds or capital in support of those services….In carrying out its activities, the Bank must give particular consideration to the needs of small and medium sized businesses….The loans, investments, and guarantees are to fill out or complete services available from commercial financial institutions."

BDC adopts a range of policies to support its additionality and avoid crowding out private banks:

(i) First, it is active in sectors such as innovative industries, technology, export, and sustainable cleantech where private banks are insufficiently engaged, and which are generally regarded as higher-risk market segments. BDC's role within the Canadian entrepreneurial ecosystem is to ensure that domestic firms, regardless of their location, sector, size, or demographic, have access to financing opportunities and remain competitive. BDC must give particular consideration to the needs of SMEs and extend finance to a range of underserved markets such as rural and remote areas; specific demographics (e.g. youth, Aboriginal, or women entrepreneurs); sectors in transition; seasonal or cyclical businesses (e.g., manufacturing and tourism), start-ups with limited collateral, and firms with export activities. The bank supports innovation, with a special focus on high-growth, high-impact firms.

(ii) Second, in providing financing for higher risk transactions, it prices for risk on a commercial basis. BDC does not offer grants or subsidized loans, effectively managing risk across all its operations. The bank average interest rates are higher than those of private commercial banks, reflecting the higher risk profile of its clients.

(iii) Third, it requires borrowers to obtain financing from commercial banks after they graduate from BDC credit. The bank only assists borrowers until they can obtain private funding via commercial banks at lower rates.

(iv) Fourth, it works in partnership with a range of Canadian institutions, including other crown corporations, federal and provincial governments, as well as industry stakeholders, the private sector, and financial institutions. BDC receives most of its clients through referrals from commercial banks. As a complementary lender, the bank actively collaborates with other lenders and financial intermediaries (including alternative data lenders) to increase credit availability in the market for Canadian entrepreneurs and provide continued support to Canadian SMEs. Collaborative arrangements include co-lending, syndicated loans and other indirect financing facilities. BDC also co-invests in a number of technology companies alongside private sector partners.

(v) Fifth, it regularly tracks changes in the credit conditions of SMEs. As a development bank, BDC continuously seeks to identify the unmet needs of entrepreneurs and deepen its understanding of

[40] "Crown corporation" is the term used in Canada to refer to 100% federal- or provincial-owned organizations structured like private or independent companies, i.e., the same as SOEs.
[41] Canadian Bankers Association, Database of Domestic Banks' Financial Results Fiscal Year-End 2012-2017 website. https://cba.ca/.

financing gaps (both structural and cyclical) in the credit market that are not being filled by the private sector. BDC regularly conducts reviews of its own products and their impact on the SME market and commercial financial institutions, to avoid crowding-out effects and improve complementarity vis-à-vis commercial banks.

BDC has five main business lines, of which credit generates more than 75% of net income:

(i) Credit/financing provides loans with a focus on SMEs, and purchases investments in asset-backed securities.

(ii) Advisory services are delivered by a network of external consultants, which offer entrepreneurs advisory solutions, online educational content, and special programmers targeted at high-impact firms.

(iii) Growth capital provides specialized financing and minority equity investments into high-growth mid-market companies.

(iv) Venture capital invests in every stage of a technology-based company's development cycle, from seed funding to expansion.

(v) Cleantech provides subordinate financing and venture capital investments to promising clean technology firms.[42]

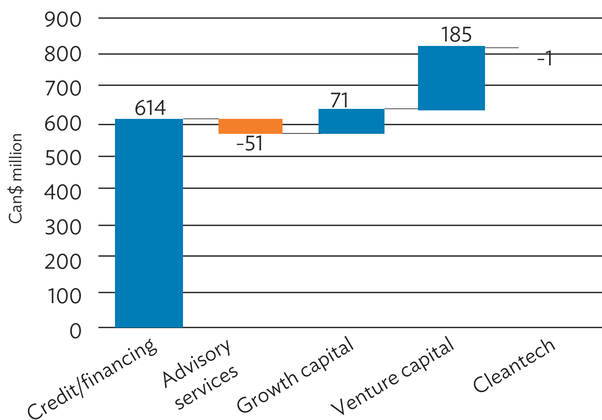
In addition to its lending and investment operations, BDC provides technical assistance to entrepreneurs and SMEs.[43] According to Statistics Canada, firms taking advantage of these services are more successful than firms which simply take out a loan from the bank.[44]

BDC's establishing legislation requires it to operate in a financially sustainable manner, earning a ROE at least equal or greater than the government's long-term cost of capital. BDC benchmarks itself against the 10-year moving average returns for the 3-year and 5-year Government of Canada bonds. BDC's ROE was 12.1% in fiscal year 2018, higher than the 10-year moving average of 9.8%. Its ROA averaged 2% between 2013 and 2017, outperforming all but three of the Pacific banks in this survey.

BDC operates as a long-term commercial lender and does not provide regular banking services or accept deposits. It obtains its funding from two sources: (i) short-term bonds (75%) and (ii) capital and retained earnings (24%).[45] BDC does not receive any government grants nor concessional funds for onlending.

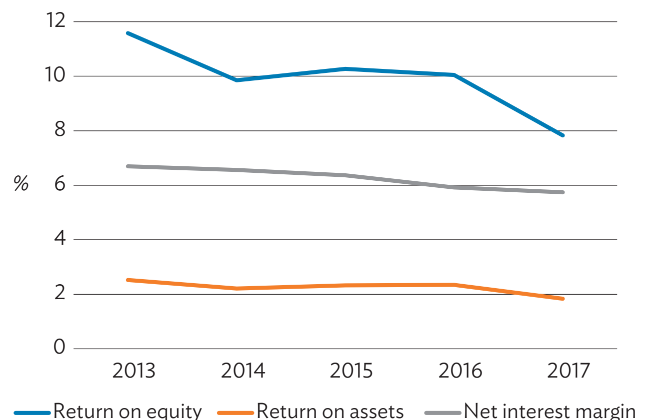
BDC operates at arm's length from the government and reports to the minister of innovation, science, and economic development. As the minister responsible for BDC, the latter must conduct a review of the provisions and operation of the

Figure 11: Business Development Bank of Canada Business Unit Net Income, 2018. Total: Can$818 million.



Source: Business Development Bank of Canada *2018 Annual Report*. Montreal.

Figure 12: Business Development Bank of Canada Financial Performance, 2013–2017



Source: Business Development Bank of Canada. 2018. *2018 Annual Report.* Montreal.

[42] BDC. 2018. *Annual Report*. Quebec. p.108

[43] BDC consulting services cover analysis, strategy development, business planning, diagnostic services, guidance for management, training, and market research. BDC's consulting services are not tied to the purchase of other BDC products or services.

[44] *BDC at a glance.* Presentation by Noel Asmar, President and CEO Noel Asmar Group.

[45] The BDC Act prohibits the Government of Canada from injecting more than $3 billion into the BDC.

BDC Act 5 years after its creation and every 10 years thereafter, in consultation with the minister of finance, and report on the review to the Parliament.[46] This ensures that the legislative mandate of the bank reflects evolving market conditions.

Unlike most banking and financial institutions in Canada, BDC is not prudentially regulated or supervised by the Bank of Canada or the Office of the Superintendent of Financial Institutions (OSFI).[47] The Government of Canada has mandated OSFI in the past to review BDC's operations, management, and oversight of risks, but only on an ad hoc basis.[48]

BDC's legislative framework consists of its establishing legislation and the Financial Administration Act[49] (1985). Part X of the *Financial Administration Act*, requires BDC to: "(i) maintain financial and management control and information systems and management practices that provide reasonable assurance that its assets are safeguarded and controlled; (ii) ensure that its financial, human, and physical resources are managed economically and efficiently; and (iii) ensure that its operations are carried out effectively." BDC must also ensure that a special examination of these systems and practices is carried out at least once every 5 years.[50]

BDC has a robust corporate governance structure, with director appointments based on an open, transparent, and merit-based selection process. The bank is governed by an independent board of directors. The BDC Act provides that no more than two directors, excluding the chairperson and president, may be appointed from the federal public administration.[51] Both the president and the chairperson are appointed by the Government in Council, while the other directors are appointed by the government minister responsible for the bank, with approval of the Government in Council. Directors are expected to comply with a Board Code of Conduct,[52] the bank's establishing statute; the Financial Administration Act; the Conflict of Interest Act; and the BDC Code of Conduct, Ethics and Values.

BDC regularly reports to the government on its operations and performance. It is required to submit an annual 5-year corporate plan to the government outlining its objectives and expected performance. The corporate plan is an important component of BDC's governance structure and is the focal point of the Parliament of Canada's accountability process for crown corporations. In addition, the bank publishes an audited annual report each year, and holds a yearly public meeting to share information on BDC's mandate, operations, results, and plans for the future.

The strong commercial culture and risk assessment practices of BDC have allowed it to sustainably address financing gaps in the market. The government has allowed BDC to price its loans and services to fully reflect their costs and risks. Its close relationship with other banks in the market facilitates client referrals and ensures that the BDC remains a complementary lender. In the absence of a formal banking supervisory framework, the government has used regular examinations and its crown corporation accountability processes to monitor the bank's risk exposure.

2. DFCC Bank

DFCC Bank (previously Development Finance Corporation of Ceylon) is one of the oldest development banks in Asia, and one of the few privately owned banks in the world to implement a development mandate. Established in 1955 as a public-private partnership with the aim of enhancing private sector access to medium- and long-term capital, DFCC Bank initially focused on providing long-term finance with tenors of at least 5 years.[53] At the time of the bank's establishment, Sri Lanka's banking sector was dominated by commercial banks which mainly provided short-term finance. DFCC Bank currently operates as a private commercial bank blending development and commercial lending.

Through its diversified ownership and effective corporate governance framework, DFCC Bank has maintained a development focus while remaining profitable. The bank's

46 The review studies the provisions and operations of the act, examines how BDC has responded to the needs of SMEs over the relevant period, and how BDC might best respond to SME challenges over the next legislative period. BDC Act 1995, section. 36(1).

47 OSFI functions solely as a prudential supervisor and its primary object is the safety and soundness of financial institutions. See OSFI Act (1985), Sec. 4(2). https://lois-laws.justice.gc.ca/eng/acts/O-2.7/FullText.html.

48 BDC Corporate Plan Summary 2016–2017 to 2020–2021, p. 44.

49 Financial Administration Act (1985). https://laws-lois.justice.gc.ca/eng/acts/f-11/.

50 For a sample Special Examination Report, see https://www.bdc.ca/en/documents/other/Board_FINAL%20SE-Report-BDC%20English.pdf.

51 BDC Act 1995, s 5(2).

52 https://www.bdc.ca/en/documents/about/corporategovernance/board_code_of_conduct.pdf (last accessed 20 November 2018).

53 DFCC was established through the Development Finance Corporation of Ceylon Act No. 35. of 1955. https://www.lawnet.gov.lk/1949/12/31/development-finance-corporation-2/. The bank was established as a limited liability public company, receiving a license to operate as a specialized bank in Sri Lanka. The ordinary shares of the bank were listed on the Colombo Stock Exchange in 1956. Under the bank's founding statute, the Government of Sri Lanka did not become a direct shareholder of DFCC. The act provided for private sector shareholders who also had the right to elect the bank's board of directors. The government reserved for itself the right to nominate one director.

Box 3: DFCC Bank: Diversified Ownership

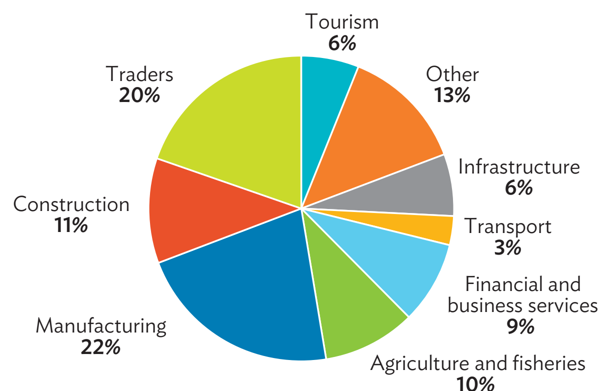
DFCC Bank is publicly traded and has been listed on the Colombo Stock Exchange since 1956. As of 31 December 2017, DFCC Bank had 8,728 shareholders. The Government of Sri Lanka does not own direct equity in the bank; however, entities over which the government exercises control hold a minority stake. The government indirectly controls 35.1% of the shares through the Bank of Ceylon's pension fund (14.4%), Sri Lanka Insurance Corporation (10.0%), the Employees' Provident Fund (9.9%), and the Employees Trust Fund (1.5%). Other major shareholders of the DFCC Bank include the Hatton National Bank (12.2%), five funds of Aberdeen Asset Management PLC (United Kingdom) (aggregate 9.5%), Melstacorp (8.4%), Renuka Group (6.1%), and Seafeld International (5.8%). Muzaffar Ali Yaseen owns 9.9%. Pursuant to the DFCC Bank's Articles of Association, the government retains the right to appoint one board member.

Source: Pacific Private Sector Development Initiative.

equity capital has grown from SLRs8 million ($47,000) in 1955 to SLRs49 billion ($275 million) in December 2017. DFCC Bank's mandate is to "assist the promotion, establishment, expansion and modernization of industrial, agricultural and commercial ventures and to encourage and promote participation of private capital, both domestic and foreign in such enterprises."[54] In 2015, the development banking portfolio represented 41% of DFCC Bank's total assets.[55]

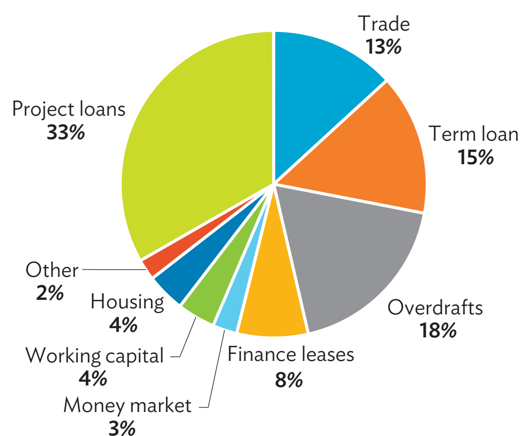
The transformation of DFCC Bank into a licensed commercial bank in 2015 did not change or dilute its core development mandate. In adhering to this mandate, DFCC Bank (i) offers a broad range of financial products and services to industrial, agricultural, and commercial enterprises (Figure 13); (ii) secures long-term funding through credit lines from bilateral and multilateral development institutions;[56] (iii) addresses social and environmental issues;[57] (iv) supplies credit in the domestic market for entrepreneurial activities, with an emphasis on SMEs (Figure 14); (v) promotes rural economic development; and (vi) plays an essential role in advancing financial inclusion.

Figure 13: DFCC Bank Loan Portfolio by Sector, 2017



Source: DFCC Bank. 2018. *Annual Report 2017.* Colombo.

Figure 14: DFCC Bank Product Distribution, 2017



Source: DFCC Bank. 2018. *Annual Report 2017.* Colombo.

Commercial banking is viewed as an important and necessary supplement to DFCC Bank's development lending portfolio, allowing it to expand its customer base, cross-sell products, and offer full-service banking services through a unified

[54] DFCC Bank. 2015. *Annual Report 2014/2015.* Colombo. p. 6. https://www.dfcc.lk/en/investor-relations/annual-reports

[55] DFCC Bank. 2016. *Annual Report 2015.* Colombo. p. 34.

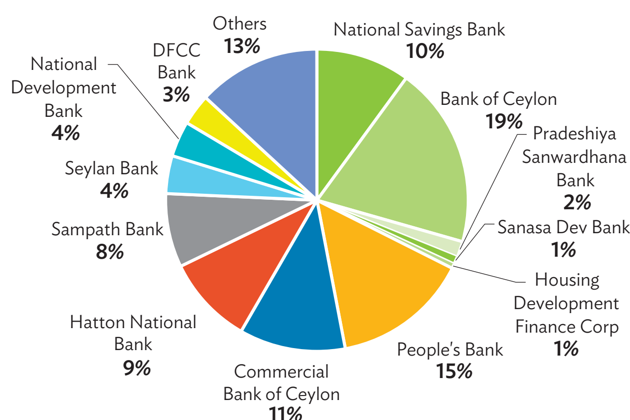
[56] Key business partners include ADB, the World Bank, KfW (Germany), The Netherlands Development Finance Company (FMO), and European Investment Bank. For example, DFCC Bank participates in ADB's Small and Medium-Sized Enterprises Line of Credit Project. ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Small and Medium-Sized Enterprises Line of Credit Project in Sri Lanka.* Manila. Also, in 2018, ADB approved additional financing for the SME Line of Credit Project which will increase the available loans for participating banks in Sri Lanka to $175 million by 2020, from the original loan figure of $100 million approved in February 2016. https://www.adb.org/news/adb-provides-additional-funds-support-sme-development-sri-lanka (last accessed 22 October 2018).

[57] For example, DFCC Bank has established a revolving loan scheme under its Environmental Friendly Solution Fund to facilitate enterprises to comply with environmental standards, encourage pollution control, and resource recovery initiatives. DFCC Bank. 2018. *Annual Report 2017*. Colombo. p. 44.

distribution channel.[58] Currently, DFCC Bank delivers its services through a nationwide branch network consisting of 102 branches and 36 service points at postal outlets, through which it offers retail savings accounts and a range of other banking services.[59] In this way, the commercial banking activities have complemented rather than compromised the development mandate.[60]

DFCC Bank represents a small percentage (3%) of total domestic banking sector assets. Sri Lanka has a fairly diversified and well-capitalized banking sector, with 25 licensed commercial banks, including 12 branches of foreign banks and 7 licensed specialized banks.[61] Total banking sector assets were SLRs10.3 trillion ($57.8 billion) in 2017, of which 47% were state-owned. As of 31 December 2017, DFCC Bank had a total asset base of SLRs333 billion, accounting for 3% of the total assets of the banking sector (Figure 15).

Figure 15: Sri Lanka Banking Sector Assets, 2017



Note: The state owns the two largest commercial banks (Bank of Ceylon and People's Bank), and four of the seven licensed specialized banks (in green).
Source: KMPG. *Sri Lanka Banking Perspectives 2018*. Colombo.

Private commercial banks, including DFCC Bank, have played a leading role in raising the levels of overall lending to SMEs in Sri Lanka. According to a 2010 World Bank study, the three state-owned banks—the Bank of Ceylon, the People's Bank, and the National Development Bank—allocated only 3.2%, 1.6%, and 6.3%, respectively, of their loan portfolios to SMEs.[62] Despite controlling 47% of the total assets in the banking sector, the state-owned banks were not actively engaged in SME lending. This is similar to the practice among state-owned banks in the Pacific. In contrast, private banks such as DFCC Bank, Hatton National Bank, and the Commercial Bank of Ceylon allocated 41.3%, 49.4%, and 30.2%, respectively, of their loan portfolios to SMEs. In 2017, the Hatton National Bank, Sampath Bank, and the Commercial Bank of Ceylon accounted for 74% of loans disbursed to SMEs, with DFCC Bank adding 4%.

DFCC Bank's return on assets has matched that of most other commercial banks in Sri Lanka over the 2013–2017 period, averaging 2%, but its return on equity was among the lowest in the country, averaging only 9% (Figure 16). Within this benchmarking study, DFCC Bank's return on equity was lower than BDC, but still compares favorably with those of the Pacific banks, which averaged an ROE of 2.8% and an ROA of 1.2% during the period. DFCC Bank had the highest efficiency ratio of all of the banks in this survey, with expenses representing only 20% of revenue over the 2010–2017 period.[63]

DFCC Bank has devised several concessionary loan schemes,[64] mobile banking products, and training and development programs targeted at entrepreneurs and SMEs. According to DFCC Bank's 2017 Annual Report, new loans and liens granted through concessionary schemes amounted to SLRs3,800 million ($22 million) during the year, or 14% of new credit. The concessionary loans have been used to finance projects in key development sectors and emergency relief situations, rural areas, and emerging provinces.[65] DFCC Bank relies on its own funds, credit lines provided by bilateral and multilateral agencies, and government funding to finance the concessionary loan schemes.

58 DFCC Bank. 2016. *Annual Report 2015*. Colombo. p. 7. DFCC Bank sees "development banking as a continuing need for Sri Lankan businesses, at least in the medium-term, but with commercial banking as a necessary addition."

59 DFCC Bank is expanding its branch network and delivery channels to reach the unbanked and underbanked populations across the country. Between July 2017 and July 2018, it added nine branches to its branch network.

60 DFCC Bank. 2016. *Annual Report 2015*. Colombo. p. 9. To date, DFCC Bank's development mandate remains "at the core of DFCC's full-service banking business model."

61 Government of Sri Lanka Central Bank. 2018. *Annual Report 2017*. Colombo. The number of commercial banks increased to 26 in March 2018, when the Bank of China began operations in Sri Lanka.

62 World Bank. 2010. *Sri Lanka—Small and Medium Enterprises Development Facility Project (English)*. Washington, DC.

63 The efficiency ratio is a measure of a bank's overhead as a percentage of its revenue.

64 These include IB, SMILE III (RF), SMELoC, Saubhagya, Jaya Isuru, and Ran Aswenna. For example, DFCC offered Vardhana Sahanaya, a DFCC-funded concessionary loan scheme, to both DFCC Bank customers and noncustomers affected by the 2017 Sri Lanka floods and landslides to help them rebuild business and personal assets. DFCC also introduced the Sahanaya loan scheme that offered personal, housing, education, and business loans at a concessionary interest rate of 7% to flood victims and those affected by the fire in Kosgama in 2016. DFCC. 2018. *Annual Report 2017*. Colombo. p. 44.

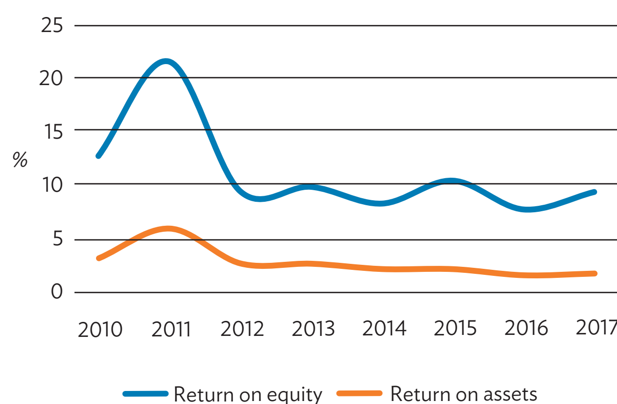
65 Facilities under the Athwela concessionary loan scheme funded by the government were offered by DFCC Bank to the business community affected by natural disasters.

In May 2017, the DFCC Bank was recognized by the Association of Development Financing Institutions in Asia and the Pacific for setting up a specialized unit for micro, small, and medium-sized enterprises (MSMEs). The MSME unit offers a range of financial products (including loans, leases, bank guarantees, and other commercial facilities) to businesses in key sectors of Sri Lanka's economy, including agriculture, livestock, manufacturing, services, and trading. The unit typically lends below SLRs3 million ($17,500) to such enterprises, which are considered too complex for most microfinance institutions) and too risky or costly for traditional commercial banks.[66] In 2017, DFCC Bank granted loans to approximately 1,000 MSME customers using the risk assessment methodologies developed by the unit.

DFCC Bank operates within a robust commercial banking regulatory framework. As a licensed commercial bank, it is supervised by the Central Bank of Sri Lanka and subject to the prudential requirements of the Basel III regulatory regime. The bank is registered as a public limited company under the Companies Act, No. 07 of 2007; and as a corporation listed on the stock exchange, it must follow the Listing Rules of the Colombo Stock Exchange. In preparing its financial statements and disclosures, DFCC Bank follows the formats prescribed by the Central Bank of Sri Lanka.[67] DFCC Bank is rated AA- (lka) by Fitch Ratings Lanka Ltd.

DFCC Bank places special emphasis on following internationally accepted corporate governance principles and ensuring systems and processes are in place to satisfy robust corporate governance requirements. It follows the corporate governance guidelines for commercial banks issued by the Central Bank of Sri Lanka.[68] In addition, it adheres to the Principles of Corporate Governance established by the Organisation for Economic Co-operation and Development (OECD) and complies with the requirements set out in the Code of Best Practice on Corporate Governance issued by the Institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission of Sri Lanka.

Figure 16: DFCC Bank Profitability, 2010–2017



Source: DFCC Bank Financial Accounts 2010-2017.

The primary responsibility for the governance of DFCC Bank rests with a fully independent board of directors. In 2017, the board had nine directors, a majority of whom were independent.[69] Directors are appointed or removed by the shareholders of the bank. According to the bank's Articles of Association, nonexecutive directors are required to have professional backgrounds; strong track records; and high-level managerial experience in banking, business, industry, law, finance or auditing.[70] The government retains a right to nominate one director to the board, as long as any guarantees issued by the Central Bank and/or the Government of Sri Lanka on behalf of the bank to national or international organizations are valid and in force.[71] The development mandate of the board is enshrined in its establishing legislation, and as such can only be amended through an act of Parliament.

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66 DFCC Bank has observed that the small business enterprise, an emerging subsegment within the SME segment, has significant potential. DFCC Bank. 2018. *Annual Report 2017*. Colombo. p. 44. http://dfcc2017.annualreports.lk/download/pdf/DFCC_annual_report_2017.pdf.

67 Financial statements are prepared in accordance with the Sri Lanka Financial Reporting Standards issued by the Institute of Chartered Accountants of Sri Lanka.

68 Banking Direction No. 11 of 2007 on Corporate Governance for Licensed Commercial Banks.

69 The Articles of Association of the Bank provide that the board should be composed of 7–13 directors, with at least one-third or 3 directors being independent. In 2017, the board consisted of 5 independent directors, 3 nonexecutive directors, and 1 executive director who was also the CEO of the bank. No one has held the position of a director for more than 9 years.

70 DFCC Articles of Association, Rule 3.2 (vi).

71 Articles of Association, Rule 36 (ii). "As long as any guarantee/s issued by the Central Bank and/or the Government of Sri Lanka for and on behalf of the Company to national or international organisations are valid and in force, the Minister in charge of the subject of Finance shall be entitled to appoint one (1) Director of the Company. Immediately upon the lapse of the said guarantee/s, the Director so appointed by the Minister shall ipso facto cease to be a Director of the Company."

IV. THE WAY FORWARD FOR STATE-OWNED BANKS IN THE PACIFIC

This benchmarking survey has outlined the various approaches to state-owned banking in the Pacific and around the world, the results obtained, and the common lessons emerging from this experience. The analysis points to three core challenges to reforming the Pacific banks:

(i) clarifying their role;

(ii) providing the structural and financial foundations to allow the banks to play the ascribed role; and

(iii) improving their operational performance.

A. CLARIFYING THE ROLE OF STATE OWNED BANKS

This study has highlighted the heterogeneity across both state-owned commercial banks and development banks in the Pacific region, particularly with respect to mandates and banking structures. That experience challenges policymakers to clarify the role that has been given to these various banks. There are two related policy issues:

(i) the mandate, or role, of state-owned banks as credit institutions, and

(ii) the contribution these credit institutions make to wider finance sector development.

Ascribing a role to a new state-owned bank implies that there is a case for that bank to fill an otherwise unmet need in the country it operates in. For existing state-owned banks, the challenge is to reaffirm or reevaluate that case. In its basic form, that case rests on being able to demonstrate additionality—that the state-owned bank is providing financial services that would not otherwise be provided, and it is providing these services profitably, or that its presence makes the banking system more competitive, lowering the cost of financial services to consumers. The implication in both cases is that these outcomes would not be achieved through privately owned banks.

It is relatively straightforward to assess whether that case can be made for a state-owned commercial bank. Additionality and/or competition are critical to the case, as is profitability; additionality and/or a lower cost to consumers coupled with profitability over time equates to a net economic benefit. The type of financial service provided, however—consumer, housing, or business loans, for example—is not critical to the case. The six commercial banks in the survey—BCI, BFSM, MiBank, NBV, PMB, and TDB—have different histories and operate in different market segments, but each has been willing to introduce new products, provide credit where other lenders have been unwilling to do so, or expand their geographical footprint to underserviced areas. Several of these banks are also critical to underpinning competition in the domestic market, as the larger privately owned banks have been able to restrict services or provide these services at highly profitable rates in the absence of this competition. Whatever the justification, operating profitably has been challenging for these banks, and the underlying pressures on profitability need to be addressed if these banks are to play a longer-term role.

Making the case for a state-owned development bank is much less straightforward. The survey demonstrated the diversity across Pacific development banks, in line with international experience. There is no general model: mandates vary, business models vary, funding structures vary, and the composition of loans varies. On the surface, what binds development banks in the Pacific is their identification with development finance institutions (DFIs)—most are members of the Association of Development Financing Institutions in the Pacific—but that identification tends to overemphasize "development," at times losing sight of what constitutes sound finance. Being able to describe the financing role of this heterogeneous category of banks in the language of finance is a fundamental challenge.

To better understand the lending role of a development bank, it is useful to reorient the discussion away from "development" to "risk." The reason is that "development" is a loose term that can be used in a number of subjective ways. Further, all financial institutions contribute to economic development in some way through their financing activities, so it is not that helpful to foster the illusion that development banks are essential to economic development. It is more helpful to consider whether there is a distinction between the type of finance a development bank provides, or could provide, and the type of finance provided by other lenders in that financial system. There is, and that distinction is essentially based on differing risk appetites. The key point is that DFIs are willing to finance

activities that have important economic impacts, but which other financial institutions are reluctant, or perhaps even unwilling, to finance. The review of the Business Development Bank of Canada (BDC) highlights this point. The direction of that lending is country-specific and depends on the economic and business structure of the country—the sectors that are important to a country (e.g., agriculture or tourism), and the type of business that need to be financed (e.g., SMEs or larger employers).

Focusing on a state-owned bank's risk-taking role means that the strategic direction of a development bank will change over time. The role will evolve to take on new classes of risk as private banks lend to new clients and sectors and as the demand for other types of financing emerges (e.g., equity, hybrid credit-equity instruments, and venture capital finance). In some cases, this evolution could be supported through the introduction of private shareholders, such as pension funds and other financial institutions.

Development banks can be instrumental to finance sector development. In essence, describing the architecture of a financial system is an exercise in mapping structures that provide financial services onto different classes of risk. Focusing on the type of risks development banks should finance also opens up a discussion on how this risk-taking role can change over time. If development banks demonstrate that a class of risk can be profitably financed, then it is a reasonable expectation that other banks will start to compete for this business. Already, it is not uncommon for development bank customers to graduate to other banks where they can obtain cheaper finance once they have established a stable credit history: the borrower has become less risky to the more risk-averse lenders. This is clearly illustrated among the clients of BDC. It is also not unreasonable to expect that the market share of a development bank in specialized classes of risk, such as agriculture lending, will erode over time. Rather than foreshadow the demise of a development bank, these changes can also foreshadow a changing role for a development bank. That is, a development bank can be repositioned to finance, in a disciplined way, other risks that are not being addressed by private lenders. BDC also provides insights into this transition: it has added riskier types of lending—equity financing, wholesale financing, and venture capital financing—to its product mix, building on the foundations of profitably providing less risky types of finance.

B. PROVIDING STRONG FOUNDATIONS

Whatever role is ascribed to a development bank, it must have the financial capability to adequately perform that role. The core associated challenges involve:

(i) widening funding sources to meet loan demand,

(ii) strengthening the balance sheets of these banks, and

(iii) regulating development banks where they currently operate outside a formal regulatory framework.

Development banks need additional sources of funding. As licensed banks, state-owned commercial banks can compete for retail deposits and access money markets. That is not the norm for development banks and most of those surveyed for this report relied on longer-term borrowings from multilateral development banks, among others. This form of funding constrains development banks' operations and is expensive relative to other forms of funding. Typically, these term borrowings are dedicated to specific sectors (e.g., agriculture or housing) and there may be a requirement for the loan to be fully drawn down from the commencement of the loan, or there are only a small number of tranches compared with the flexible drawdowns available under a credit line. Borrowing in this way is more expensive than taking deposits—both current and term deposits—or borrowing from domestic financial institutions: the carrying cost is high as the bank is borrowing more than would be justified by the expected loan demand. For some sectors, the loan demand might not materialize for several years. Conversely, when loans are close to being fully drawn down, the bank may not have the capacity to finance additional loan demand.

There is no strong case for taking retail deposits. Allowing development banks to compete with other banks for retail deposits is sometimes advocated as a solution to existing inflexible funding arrangements. But most Pacific development banks are too small to be able to service retail customers, and it would be very expensive for them to develop this capability, both in terms of additional staffing and the costs of purchasing and implementing new information technology systems. Existing commercial banks already have this capability and, provided there is adequate competition across retail banks, it is difficult to see any net economic benefit from allowing development banks to compete on the provision of current accounts and smaller-value term deposits.

Larger-value term deposits would provide additional funding and flexibility. The funding constraints that the development banks face could be alleviated through greater use of larger-value term deposits. This would give development banks greater control over the timing, amount, and cost of any funding. The threshold for individual deposits would be set to attract relatively large deposits to avoid the costs of servicing a large

number of smaller-value term deposits. The target market would comprise, for example, pension funds, central and local governments, larger businesses, and SOEs. The interest rate offered on these deposits would likely be higher than that offered by private banks, but this would still provide a lower cost of funds to a development bank than existing funding arrangements. Additional flexibility could be obtained through substituting domestic term loans, including borrowing from other banks and issuing corporate bonds, where possible, for more expensive foreign term loans.

Reorienting the discussion away from development to risk also opens up a discussion on balance sheet diversification. Any concentration of a lender's balance sheet structure carries inherent risks, which can be mitigated through a more diversified asset structure or through additional capital protection. Given the proposition that the basic rationale of a development bank is to finance risks other lenders will not, it follows that any concentration of assets magnifies the underlying risk exposure. The implication is that development banks, which are highly specialized lenders to SMEs, housing, or agriculture, for example, have to be better managed and have higher levels of capital than more diversified banks.

Development banks should be regulated. One of the features of the international experience with development banks is that regulation was the norm, in contrast to the lack of uniformity in the other aspects of development bank operations. While the majority of development banks in the Pacific are regulated, that requirement should be extended to all. The gains from bringing development banks under the regulatory umbrella are compelling, and include: both individual banks and the banking system are strengthened, the direct fiscal costs and contingent liabilities governments carry are reduced, the cost of capital in the economy is lowered, and there is increased confidence in the broader economic management of the government, which in turn gives confidence to other banks that they can participate in that market on equal terms. It does not seem defensible to argue that development banks can operate outside a formal regulatory framework, even where they operate under their own specific legislation. If it was defensible, then the conclusion is that development banks are better managed than regulated financial institutions.

Regulation confronts capital adequacy. To be sustainable, a development bank should operate off its own balance sheet without recourse to government funding. It can accumulate capital through retained earnings, but only if it is consistently profitable, which, in turn, requires a bank to operate in a commercial manner. The key question is how much capital is needed at any time. The answer is usually specified as a percentage of assets, or a percentage of risk-weighted assets, and a standard on capital adequacy is a key component of any regulatory framework.

Capital has a dual role in providing an injection of funds to establish an enterprise or finance continuing operations, and to provide a buffer to absorb unanticipated financial pressures. For some Pacific development banks, this second role has not been adequately addressed. In some cases, government loans to a bank are regarded as an injection of capital but they are not. This type of funding is a borrowing—whether directly from the government or borrowing from a third party that has been arranged by the government. It is not equity funding, where the shareholders carry the risks of the business, but are also rewarded through distributions of profit and increases in the value of the business.

The nature of the risks that the development banks are taking qualifies the regulatory discussion. Given that development bank lending is inherently riskier than the financing undertaken by most non-DFIs it follows that there should be some regulatory adjustment for this risk. Capital adequacy standards need to be higher than for non-DFIs and this should be welcomed because it means that the economic impact of development bank lending is valued within a structured risk-return framework. Other forms of capital reserves might be justified, as might more stringent provisioning requirements. The key point is that the nature of the risks being taken should be accepted and regulated accordingly.

Additional capital could be raised from new shareholders. Ideally, the value of a government finance sector business will increase over time to reflect its profitability and make it easier to attract equity partners or sell the business. Governments should be open to private minority shareholding partners at any stage, with a view to full privatization at some future point. This pathway would free up scarce government capital for alternative uses, including a repositioning of the state-owned bank to take on a new class of risk not being financed by private lenders: state-owned investment and equity vehicles might be needed in some cases. Finance sector institutional investors are the more obvious potential partners, and they will be attracted by any commercial reorientation of development banks with an associated track record of profitability. Multilateral development banks are also potential shareholders, as are foreign banks looking to expand their Pacific regional footprint. In addition to improving capital strength through reducing the reliance on government as a shareholder, and the financial limitations of that shareholding, new shareholders can be expected to strengthen a development bank's board. Their skills will be important to developing risk management capability, insulating

the bank from political pressures, and generally improving bank performance.

C. IMPROVING PERFORMANCE

The five previous *Finding Balance* benchmarking studies have all emphasized the importance of improving the governance and financial performance of SOEs to strengthen the government fiscal position and improve the allocation of resources within an economy. Those themes are equally relevant to state-owned banks. Improving performance strengthens the government fiscal position by reducing reliance on direct government funding and recourse to additional capital from government. An additional consideration for state-owned banks is a reduction in contingent liabilities associated with any funding guarantees. If state-owned banks are operating profitably, they can make a positive contribution to the government budget through dividend and tax payments. In broad terms, international experience illustrates increased interest from policy makers in modernizing and improving the performance of development banks so that they can operate profitably off their own balance sheets. This is also true in the Pacific but the results, in practice, have been mixed at best.

Improved credit assessment and risk management skills will be the foundation of any commercial transformation. This involves building capability across the bank as well as at the board level. Any effort aimed at strengthening capability needs to be supported by a comprehensive set of internal policies covering all aspects of bank operations and compliance with prudential standards.

The stated role of any bank needs to be translated into risk appetite and risk tolerance. If the business of development banks is inherently riskier than most commercial bank lending, then development banks have to approach their risk taking in a disciplined way. They have to generate consistent profits, but at the same time be prepared to put capital at risk and be able to absorb any losses from bad loans. Understanding risk appetite and risk tolerance is critical; risk appetite captures the extent and type of risk that a bank is generally prepared to accept in line with its strategic and financial objectives. Risk tolerance is the amount of risk a bank is prepared to accept beyond that basic appetite at any point in time. Any bank has to have a thorough understanding of all the risks it is exposed to, including operational risk, in addition to credit, liquidity, and market risks, which is only possible if risks are mapped, owned, monitored, and reported.

State-owned banks should be required to meet financial performance targets. For a number of countries in the Pacific, SOEs are required by law to operate profitably. Acting commercially means that, in addition to operating profitably, state-owned banks should adopt financial performance targets, such as ROA, ROE, or return on capital employed, as top-line indicators of a bank's performance—for both commercial and development banks. These targets would underpin a commercial transformation of a bank, directing board and management toward the ongoing profitability of the business. Financial performance targets are superior to other quantitative targets, as these distract from commercial performance and, in any case, are implicit in the general mandates of development banks to finance risks other lenders are unwilling to lend against.

Subsidized lending programs—where they exist—must be implemented through this commercial framework. Most Pacific countries with modern SOE laws have explicit regulations for managing noncommercial activities (often referred to as community service obligations). Where a state-owned bank provides concessional loans to specific clients at the direction of government, the program must be fully financed to allow the bank to achieve a commercial return, in keeping with its overall commercial targets.

Benchmarks need to be developed for establishing financial performance targets and monitoring the performance of state-owned banks. This is a more straightforward exercise for state-owned commercial banks than it is for development banks, but more research is needed on the appropriate benchmarks for both. Bank South Pacific has been used as a benchmark for both types of banks in this study, in the absence of alternatives. Ideally, there would have been several private banks that could have been used as an industry benchmark for state-owned commercial banks and, again ideally, there would have been several development banks that have completed a commercial transformation and adopted a risk-financing mandate, which could have been used to gauge the performance of other development banks. But even then, the interpretation of any comparison with a benchmark is likely to be heavily qualified by the differences across banks, such as population size, the cost of servicing remote locations, and the type of businesses financed and the sectors in which these businesses operate.

Intermediate targets can be adopted in the absence of suitable benchmarks. At this point, the most important consideration is arguably the need to set banks on a path to clarifying their roles and the commercial reorientation of their operations. This suggests that the most productive route to effecting change is through the preparation of strategic plans in line with the role and business plans to support that strategic direction. Intermediate targets for implementing

strategic changes could be set accordingly, and subsequently monitored. For example, there could be targets around changes to funding arrangements, or the pricing of loans consistent with the inherent risks, or the adoption of a comprehensive risk management framework. And the key assumptions underlying any strategic plan need to be regularly reviewed.

D. MAINTAINING RELEVANCE

The case for any state-owned bank needs to be periodically reviewed and validated. Policy makers in the Pacific agree with the international consensus that state-owned banks should only exist where they can demonstrate additionality, e.g., provide services in a commercial manner that would not otherwise be provided by private banks, or make the banking system more competitive. As the financing needs of businesses evolve in each country, so too must the financial service providers, including these state-owned banks.

Appendix

PROFILES OF STATE-OWNED BANKS IN THE PACIFIC

A. COOK ISLANDS

1. Finance Sector Composition

The financial system of the Cook Islands includes both a domestic sector and an offshore sector. The domestic sector includes four domestic commercial banks: Bank of the Cook Islands (BCI), Australia and New Zealand Banking Group (ANZ), Bank South Pacific (BSP), and Capital Security Bank. The Government of the Cook Islands does not publish statistics on the business volume of each bank, so it is not possible to determine individual market shares. BCI is the only bank to publish an annual report that records its volume of business in the Cook Islands. As of 30 June 2017, BCI was estimated to hold a 26% market share of outstanding bank credit, with the balance made up by ANZ and BSP.[1]

The financial system also includes a national superannuation fund, domestic insurance company, and money-changing and remittance businesses. The offshore finance sector is composed mainly of Capital Security Bank—a private offshore bank with limited products catering mostly to international clients—trustee companies specializing in asset protection, and several insurers. The Cook Islands does not have an equity market, corporate bond market, or stock exchange. The Financial Supervisory Commission (FSC) serves as the primary regulator of the finance sector. The value of credit to the private sector as a percentage of gross domestic product (GDP) (65%) is in the upper range of the 10 Pacific countries in this survey.

2. Bank of the Cook Islands

The Bank of the Cook Islands (BCI) was established under the Bank of the Cook Islands Act 2003, following the merger of the Cook Islands Savings Bank and the Cook Islands Development Bank. BCI carries a commercial banking license and is incorporated under the Cook Islands Companies Act 1970–1971, and complies with the Banking Act 2011, the various Banking Amendment Acts (passed in 2012, 2013, and 2015), the Banking Fees Amendment Regulations 2014, the Financial Transactions Reporting Act 2017 (as amended), the Financial Transactions Reporting Regulations 2017, and the Companies Act 1970–1971 (as amended). BCI is a wholly owned subsidiary of the Bank of the Cook Islands Holdings Corporation, which is 100% owned by the Government of the Cook Islands.

BCI describes its mandate as a "state-owned enterprise ... committed to [its] role in the sustainable development of the Cook Islands."[2]

The board of BCI is appointed by the Cook Islands Investment Corporation (CIIC), following a "fit and proper" approval from FSC. Directors are expected to meet the qualifications and experience required by section 8(1)(b) of the Banking Act 2003 and are appointed for an initial term of 3 years. As of April 2019, the board was composed of six directors, five of whom were independent.[3] Five of the six directors are women. BCI follows an informal director appraisal process in line with the BCI Board Charter. Over the course of 2017 and 2018, a majority of the directors completed courses in governance, risk, and finance essentials. The board has one subcommittee for risk oversight, internal audit, and compliance.

BCI prepares an annual plan and formally reports on progress against this plan to the CIIC. Various informal and formal reporting occurs on half-yearly and quarterly bases. Within 3 months after the end of each financial year, the board is required to deliver its annual report to the CIIC. BCI also makes its annual reports available on its website. In addition, the board is obliged to deliver to the Ministry of Finance and Economic Management fiscal updates, financial reports, and statements of responsibility as the ministry may request from time to time. BCI's financial statements are audited by an independent auditor, as required by the Banking Act 2003. The Ministry of Finance and Economic Management is required to provide both the annual report and the auditor's report to Parliament.

1 Government of the Cook Islands, Ministry of Finance and Economic Management Banking Statistics (December 2017) lists the total loans and advances made by the four licensed banks to the private sector and public enterprises at NZ$288.8 million as of 30 June 2017. http://www.mfem.gov.ck/statistics/economic-statistics/banking-stats/827-banking-statistics-december-quarter-2023.

2 BCI. *Our History*. Avarua District, Cook Islands. https://www.bci.co.ck/take-a-look-at-our-history.html (accessed 21 May 2019.)

3 Independent directors are those who are neither civil servants, elected officials nor employees of the bank. The only non-independent director of BCI is the managing director.

Loan Portfolio

The housing sector accounts for the largest proportion of BCI's loan portfolio, followed by various small businesses, consumers, and the tourism sector. BCI competes with ANZ and BSP in all of its market segments. Agriculture and fisheries represent less than 0.002% of its portfolio (Figure A.1).

Financial Performance

BCI's profitability, as measured by return on equity (ROE) and return on assets (ROA), declined from 2013 to 2016, as the bank invested in its digital strategy and information technology infrastructure, but improved in 2017 (Figure A.2). Its interest rates on business, housing, and consumer loans are consistently lower than those of ANZ and BSP. Loan growth has not kept pace with the growth in interest-bearing deposits. This initially eroded the bank's net income. However, improved liquidity management and segmented cost-of-funds customer pricing have begun to correct this trend. BCI relies almost entirely on consumer deposits for its funding base. In 2017, deposits represented 84% of the bank's total assets. The ratio of expenses-to-income declined from 55% to 51% between 2010–2017, and was the lowest of the commercial banks in this survey. This is a notable achievement as BCI operates 11 branches throughout the Cook Islands, more than any other bank.

BCI has maintained high capital adequacy levels, far exceeding the 5% tier 1 minimum set by the FSC. Its nonperforming loans have decreased from 10% in 2010 to 7% in 2017, as it has undertaken effective recovery efforts.

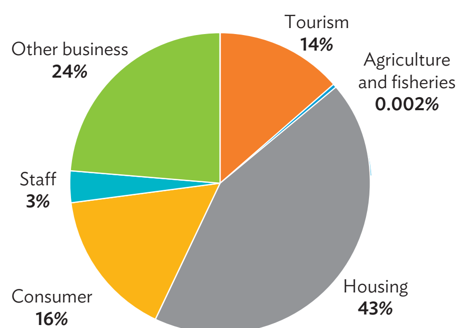
Relationship with the Government

Under the government's social obligation policy, BCI receives an annual appropriation to support the operation of its outer island branches, which is disbursed following a rigorous invoicing and review process. BCI does not implement any subsidized lending programs on behalf of the government, but has a self-prescribed objective of offering low-cost home and business loans for Cook Islanders, in keeping with its vision, mission and values,[4] and the goals of the Cook Islands National Sustainable Development Plan. The government grants BCI the independence and autonomy required to operate as a commercial bank and achieve a commercial return. In this way, it competes on an equal footing with the private commercial banks.

Core Challenges and Opportunities

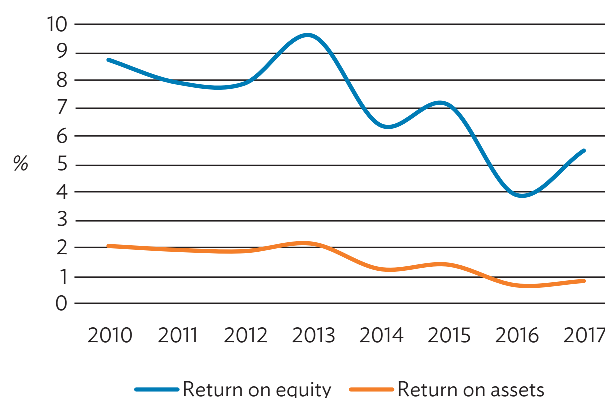
BCI faces increasing competition from ANZ and BSP in all of its market segments, and a self-imposed obligation to maintain low interest rates for the housing and business sectors. This has placed increasing pressure on its profitability. Financial sustainability will depend on the bank's ability to price its credit products to fully reflect their risk and cost of administration. As is the case with many of the countries in this survey, the Cook Islands' agriculture and fisheries sectors appear underserviced by the banks. In 2017, these sectors generated 5% of GDP, but received only 0.08% of bank credit. There may be an opportunity for BCI to further develop its lending in these sectors, with the use of specialized products and risk assessment methodologies.

Figure A.1: Bank of the Cook Islands Loan Portfolio by Sector, 2017 (total: $56.4 million)



Source: Responses to questionnaire sent by the Asian Development Bank to Bank of the Cook Islands management.

Figure A.2: Bank of the Cook Islands Profitability, 2010–2017



Source: Bank of the Cook Islands, Financial Accounts 2010-2017.

4 BCI has a "self-prescribed objective of offering low-cost home and business loans for Cook Islanders." Bank of the Cook Islands. *Our History*, Avarua District, Cook Islands. https://www.bci.co.ck/take-a-look-at-our-history.html (accessed 21 May 2019.)

Table A.1: Bank of the Cook Islands Performance, 2010–2017 (%)

Bank of the Cook Islands	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	65	64	63	66	62	65	64	62
Loan growth rate		0	7	18	13	11	17	14
Earning assets/assets	65	64	63	66	62	65	64	62
Equity/assets	24	24	24	22	19	19	17	15
Interest income on loans/ total loans	13	13	13	12	13	12	12	12
Interest expense/interest-bearing liabilities	4	3	3	3	3	3	3	3
Net interest income/earning assets	9	9	9	9	9	8	8	8
Efficiency ratio (expenses/income)	55	50	47	47	54	45	48	51
Deposits/total assets	75	74	74	75	78	79	82	84
Short-term funding/total assets	0	0	0	0	0	0	0	0
Long-term notes/total assets	0	0	0	0	0	0	0	0
Retained earnings/total assets	8	8	9	10	9	10	9	8
Issued capital/total assets	15	15	13	12	10	9	8	7
Proportion of total portfolio classified as nonperforming loans[a]	10	14	13	11	10	9	7	7
Capital adequacy (CET1 ratio)	–	–	–	29	27	27	21	17

– = not available, CET1 = common equity tier 1.
[a] Nonperforming loans are those that are 90 days or more past due.
Sources: Bank of the Cook Islands, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to Bank of the Cook Islands management.

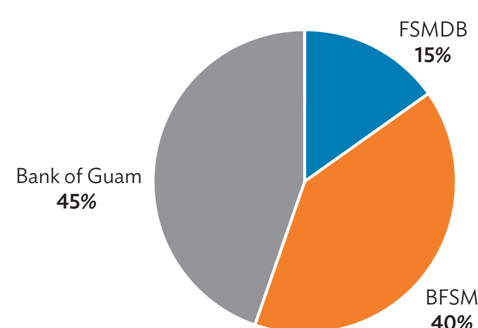
B. THE FEDERATED STATES OF MICRONESIA

1. Finance Sector Composition

The Federated States of Micronesia's (FSM) banking sector comprises one development bank (Federated States of Micronesia Development Bank [FSMDB]), two commercial banks (Bank of the Federated States of Micronesia [BFSM] and Bank of Guam), and several small credit unions. FSMDB and the credit unions are not supervised, while the two commercial banks are co-supervised by the FSM Banking Board and the Federal Deposit Insurance Corporation (FDIC) of the United States (US). This supervisory arrangement has allowed the commercial banks to maintain their correspondent banking relationship with the US and has generally supported banking stability in the FSM. Both FSMDB and BFSM are majority-owned by the Government of the FSM, and FSMDB has a 24% equity stake in BFSM.

While the banking sector is large and well-capitalized—the two commercial banks maintained a capital adequacy ratio[5] of 25% of risk-weighted assets in 2017—it is not effectively intermediating.

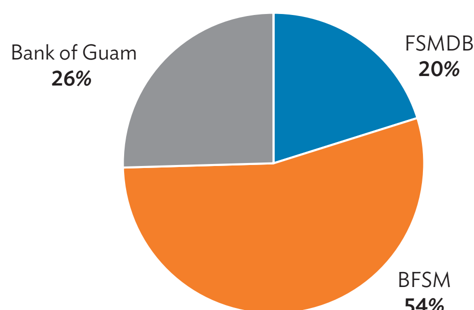
Figure A.3: Federated States of Micronesia Banking Sector Assets, 2017 (total $368 million)



BFSM = Bank of the Federated States of Micronesia, FSMDB = Federated States of Micronesia Development Bank.
Sources: Bank of the Federated States of Micronesia, 2017 Financial Accounts; Federated States of Micronesia Development Bank; Federated States of Micronesia National Statistics Office; and Pacific Private Sector Development Initiative analysis.

[5] Common equity tier 1.

Figure A.4: Federated States of Micronesia Banking Sector Loans, 2017 (total: $93 million)



BFSM = Bank of the Federated States of Micronesia, FSMDB = Federated States of Micronesia Development Bank.
Sources: Bank of the Federated States of Micronesia, 2017 Financial Accounts; Federated States of Micronesia Development Bank; Federated States of Micronesia National Statistics Office; and Pacific Private Sector Development Initiative analysis.

In 2017, the loan-to-deposit ratio of the banking system was only 20%, one of the lowest in the Pacific region. The Bank of Guam places most of its FSM deposits in its head office in Guam. Banks are reluctant to lend, due to restrictions on collateral and their assessment of the risks. A usury law caps interest rates at 24%.[6] However, there is high demand for consumer lending due to the absence of credit cards in the FSM. Despite their reluctance to lend, all banks are responding to this demand. Restrictions on foreign ownership of land have meant that any bank with even partial foreign ownership is prohibited from taking title to fixed property, effectively removing this asset as a potential form of collateral. Both the Bank of Guam and BFSM, which have foreign shareholders, are subject to this restriction. The value of private sector credit as a percentage of gross domestic product (GDP) in the FSM is 28%, which is low compared to the average of 44% for the Pacific countries in this survey.[7]

2. Federated States of Micronesia Development Bank

FSMDB was established in 1979 by the Development Banking Act (Title 30), which was subsequently amended in 1994 to allow for the corporatization of the bank.[8] FSMDB does not hold a commercial banking license nor come within the supervisory and regulatory authority of the FSM Banking Board. It is one of only two banks in this survey that are not actively supervised by a financial regulator or shareholder ministry. The government is the principal shareholder of FSMDB, owning 98.8% of the shares, with the states of Chuuk and Kosrae owning 0.9% and 0.3% respectively.

The Development Banking Act establishes FSMDB's broad mandate, stating that it is an "independent financial institution operating under its own board of directors but conducting its activities within the framework of the National Government's general economic plans, policies and priorities."[9] Further, the bank "is authorized to engage in all banking functions that will assist in the economic advancement of the Federated States of Micronesia."[10]

The board of directors is comprised of seven members. Six directors are elected at the annual shareholders meeting by a plurality of votes of the bank's shareholders. The seventh member is the president and chief executive officer (CEO), who serves ex officio to the board. In 2018, only one of the board members was independent.[11] Membership on the board is not restricted to shareholders or to citizens of the FSM. FSMDB follows a corporate governance code of practice, but does not have a formal director performance appraisal process.

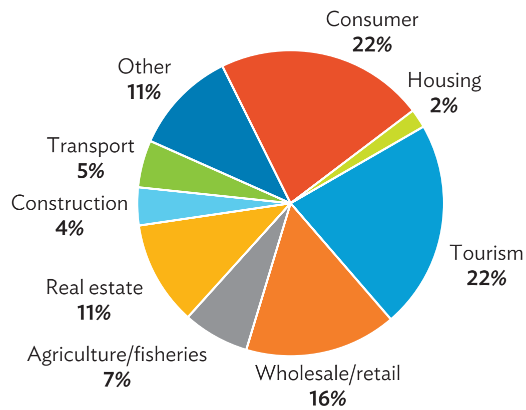
FSMDB prepares and submits annual corporate plans to the Department of Finance and Administration, and makes them available on its website, along with its annual reports. The bank's annual financial statements must be audited by a qualified auditor appointed by the board, which may be the public auditor.

Loan Portfolio

FSMDB's loan portfolio is diversified (Figure A.5). Business loans represented 76% of the total portfolio in 2017, consistent with the bank's mandate (Figure A.6). Loans to small and medium-sized enterprises (SMEs) tend to be large, averaging $137,000, compared with $23,000 for sole trader loans and $8,000 for consumer credit. Loans to state-owned enterprises (SOEs) were the largest in the portfolio, averaging $1.4 million. FSMDB is not constrained by any regulatory interest rate caps other than the usury cap of 24%. FSMDB is the most innovative lender in the FSM, using movable property to secure 38% of its loans, more than any other bank in the Pacific.

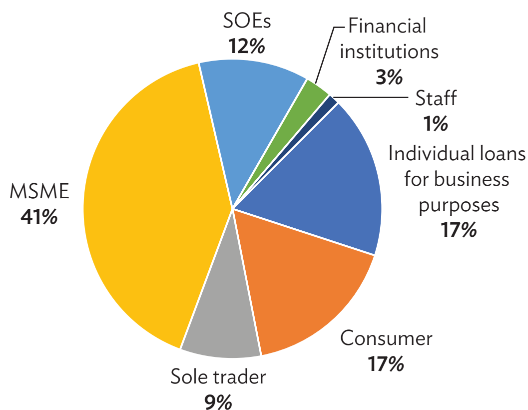
6 Trust Title Code 1980, Title 33; Public Law 2-33 § 3; Public Law 7-135 § 2; and new subsection (3) added by Public Law 10-52 § 2.
7 2017 figures.
8 Amended by Public Law 8-47.
9 FSMC. *Development Banking Act (Title 30). Section 102.* Federated States of Micronesia.
10 FSMC. *Development Banking Act (Title 30). Section 104.* Federated States of Micronesia.
11 Independent directors are those who are neither civil servants, elected officials, nor employees of the bank. For FSMDB, four of the seven directors are selected to represent the interests of the four states of the FSM. Currently all four representatives are non-independent.

Figure A.5: Federated States of Micronesia Development Bank Loan Portfolio by Sector, 2017 (total: $34 million)



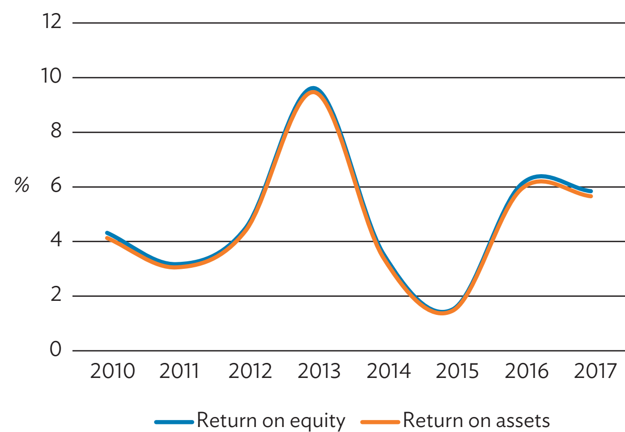
Source: Responses to questionnaire sent by the Asian Development Bank to the Federated States of Micronesia Development Bank management.

Figure A.6: Federated States of Micronesia Development Bank Loan Portfolio by Client Size, 2017



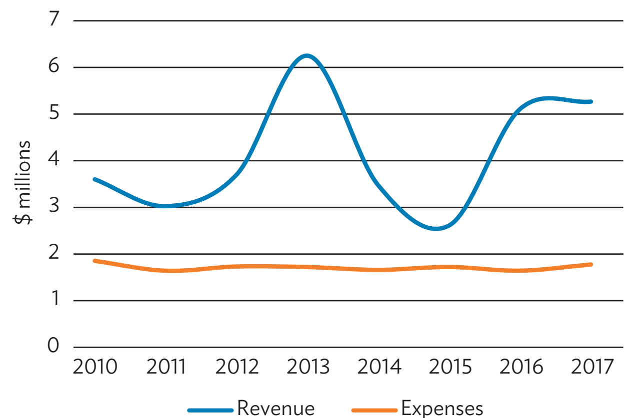
MSME = micro, small, and medium-sized enterprises, SOEs = state-owned enterprises.
Source: Responses to questionnaire sent by the Asian Development Bank to the Federated States of Micronesia Development Bank management.

Figure A.7: Federated States of Micronesia Development Bank Profitability, 2010–2017



Source: Federated States of Micronesia Development Bank, Financial Accounts 2010-2017.

Figure A.8: Federated States of Micronesia Development Bank Revenue/Expenses, 2010–2017



Source: Federated States of Micronesia Development Bank, Financial Accounts 2010-2017.

Financial Performance

The Federated States of Micronesia Development Bank (FSMDB) has been the most profitable bank in this benchmarking survey, averaging returns on equity and assets of 5% over the 2010–2017 period (Figure A.7). Operating profit has remained constant, averaging 1.6% of assets during the period, but spikes in investment income and loan loss recoveries in 2013, 2016, and 2017 resulted in higher net profitability. The bank has been funding its operations entirely from equity and retained earnings, which represented 98% of funding sources over the 2010–2017 period. It has a $1 million loan from the European Investment Bank, which will be fully paid in 2025.

Loans and investments have represented an average of 36% and 32%, respectively, of total assets over the 2010–2017 period. While loans have yielded average interest income of 14% over the period, the investment portfolio has yielded 7%. Investments have been in the BFSM, US equities and treasury bonds. FSMDB has kept a low expense ratio, averaging 43% over the 2010–2017 period, while maintaining branches in each of the four FSM states (Table A.2). Asset quality has been improving over the same period, from 23% of the portfolio classified as nonperforming in 2010 to 8% in 2017. 100% of the bank's loan portfolio is secured, either with fixed assets, cash, payroll, or movable property.

Table A.2: Federated States of Micronesia Development Bank Performance, 2010–2017 (%)

Federated States of Micronesia Development Bank	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	40	36	33	31	33	30	34	50
Loan growth rate		(9)	(4)	2	13	(1)	17	58
Earning assets/assets	66	61	64	66	69	67	70	84
Equity/assets	96	96	98	98	96	97	97	97
Interest income on loans/total loans	14	15	15	15	14	14	13	8
Interest expense/interest-bearing liabilities	8	6	7	5	2	7	5	5
Net interest income/earning assets	8	9	8	7	6	6	6	5
Efficiency ratio (expenses/income)	49	52	46	27	47	62	31	33
Short-term funding/total assets	2	2	1	1	3	2	2	1
Long-term notes/total assets	1	4	3	4	3	3	3	3
Proportion of total portfolio classified as nonperforming loans[a]	23	13	13	11	14	17	8	8

( ) = negative.

[a] Nonperforming loans are those that are 90 days or more past due.

Sources: Federated States of Micronesia Development Bank, Financial Accounts 2010–2017; and responses to questionnaire sent by the Asian Development Bank to the Federated States of Micronesia Development Bank management.

Relationship with the Government

FSMDB retains a strong link to both the federal and state governments of the FSM through their representatives on the board. The bank has been able to maintain a commercial focus despite the risk of political considerations influencing risk assessments, and received only $1 million in equity contributions from the federal government over the 2010–2017 period. FSMDB does not implement any subsidized lending programs at the request of government, and can therefore operate and be held accountable for commercial results. Consistent with its development mandate, however, the bank implements energy, scholarship, and microfinance programs that represent a net cost, but are undertaken at the bank's own initiative.

Core Challenges and Opportunities

The low rate of lending in the FSM would suggest that there is unmet demand for credit. While FSMDB is the most active business lender in the country, its ability to grow is constrained by its limited sources of funding. Without a commercial banking license, and arguably without an FDIC guarantee as well, it cannot access retail deposits. Its equity stake in BFSM and other investments have provided a good revenue stream, but have also tied up 32% of the bank's assets over the 2010–2017 period. To raise additional funding, FSMDB would need to rely on new equity contributions, debt finance, or possibly institutional term deposits. Capital-raising efforts should explore opportunities to capture a share of the domestic savings currently flowing offshore, as is the case with BFSM's loan portfolio (see below). As per section 137 of the Development Banking Act (Title 30), FSMDB cannot diversify its shareholding to foreign investors as this would cause the bank to lose its "legal capacity to acquire, own title to, dispose of, and otherwise deal in land and waters in the Federated States of Micronesia." The secured transactions framework could provide a mechanism to assist with borrowing,[12] and state governments could be a potential source of institutional term deposits.

The Green Climate Fund represents another potential opportunity. FSMDB is seeking Green Climate Fund accreditation, which would grant it access to a significant pool of funds to be used for lending to infrastructure and other climate adaptation or mitigation projects.

3. Bank of the Federated States of Micronesia

The Bank of the Federated States of Micronesia (BFSM) is a licensed commercial bank established in 1986. It is regulated by the Commercial Banking Act (Title 29),[13] the FSM Banking Board Regulations, and the FDIC Regulations enacted by the US Federal Reserve.[14] The bank has a diverse shareholding,

[12] Using the framework, FSMDB could use its existing loan portfolio, which represents a secure and substantial asset, as security for borrowing from one of the other domestic banks.

[13] Subtitle I of the act is exclusively dedicated to the Bank of FSM.

[14] FDIC regulation is a requirement for banks with cross-border activities and correspondent bank relationships in the US.

which includes 24% private ownership,[15] 24% ownership by FSMDB, and the balance of 52% split between the Government of the FSM (27%)[16] and the FSM's four state governments (25%). The Commercial Banking Act 1980 does not specify an explicit mandate for BFSM.

Bank directors are elected by shareholder majority vote. In 2018, the board included five civil servants and two independent directors. The chairperson and CEO are elected by majority vote of the board members. The board follows a code of corporate governance, but does not have a formal director appraisal process.

BFSM draws up an annual plan each year, which is not publicly available. It also prepares an extensive annual report, which is shared with all regulators, shareholders, major vendors, and key stakeholders.

Loan Portfolio

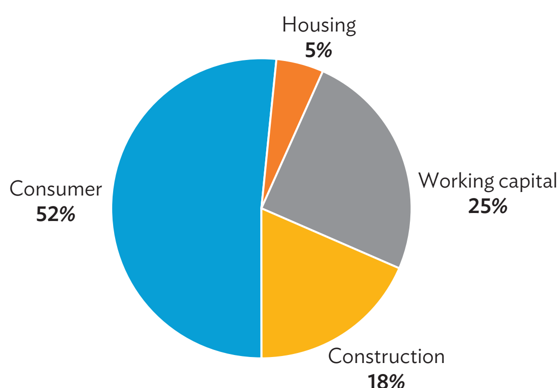
BFSM's loan portfolio is heavily weighted to consumer loans and lending offshore to businesses and individuals in Saipan, which bank management sees as a more attractive credit market than the FSM (Figure A.10). Loan growth has averaged only 3% over the 2010–2017 period and, in 2017, loans represented just 31% of total assets and 37% of total deposits. Overall, only 18% of the loan portfolio was allocated to business loans in FSM. This compares with 76% for FSMDB. In 2017, most of the bank's assets (64%) were held in cash, liquid deposits, and securities.

As per BFSM management, this is a deliberate strategy to (i) keep liquidity high in the event of a discontinuation of FDIC deposit insurance; and (ii) manage interest rate risk, given the short-term nature of most of its deposits. Due in part to the regulatory constraints on title transfer for land, only 5% of the BFSM loan portfolio was housing loans (Figure A.9). According to BFSM management, housing loans represent a market opportunity, which the bank would more actively pursue if it could secure longer-term funding and was given the right to take title on foreclosed assets. In 2017, 66% of BFSM's loan portfolio was secured with land, buildings, or cash, with the balance either secured with movable property, or unsecured.

Financial Performance

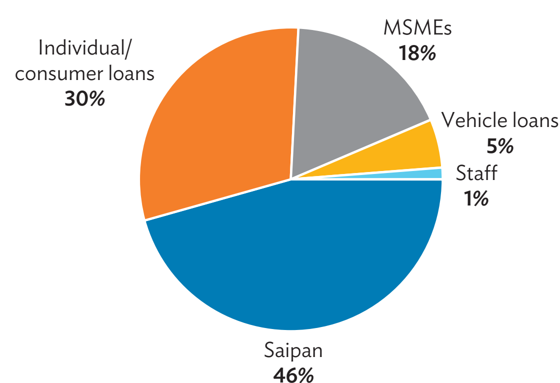
BFSM has averaged 8.3% ROE and 1.4% ROA over the 2010–2017 period (Figure A.11), allowing it to pay an annual dividend to its shareholders. Average interest income on loans over the same period was 12.6%, slightly lower than FSMDB's 13.6%. With a cost of funds approaching 0%, BFSM's net interest margin averaged 13.2% over the 2010–2017 period. The bank has a small capital base (15% of total assets in 2017), and relied on a combination of retail and short-term government deposits for 83% of its funding over the 2010–2017 period. It maintains branches in each of the four FSM states, in addition to Hawaii, and has a comparatively high expense ratio, averaging 67% over the 2010–2017 period. Despite its low capital base, conservative lending practices have resulted in high capital adequacy levels, averaging 49% over the 2010–2017 period.

Figure A.9: Bank of the Federated States of Micronesia Loan Portfolio by Sector, 2017 (total: $47 million)



Source: Responses to questionnaire sent by the Asian Development Bank to Bank of the Federated States of Micronesia management.

Figure A.10: Bank of the Federated States of Micronesia Loan Portfolio by Client Size, 2017



MSMEs = micro, small, and medium-sized enterprises.

Source: Responses to questionnaire sent by the Asian Development Bank to Bank of the Federated States of Micronesia management.

15 This represents more than 5,000 individual shareholders.

16 The Government of the Federated States of Micronesia owned 80% of the shares when the bank was founded, but has been gradually selling down its stake.

Table A.3: Bank of the Federated States of Micronesia Performance, 2010–2017 *(%)*

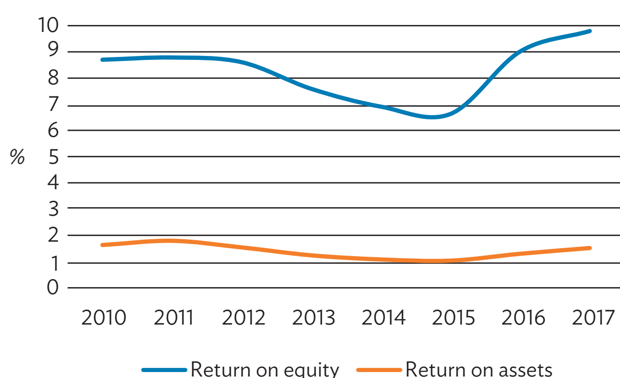
Bank of the Federated States of Micronesia	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	43	43	40	38	33	43	34	31
Loan growth rate		(4)	8	3	(3)	34	(8)	(11)
Earning assets/assets	43	43	40	38	33	43	34	31
Equity/assets	19	20	18	16	16	16	14	15
Interest income on loans/ total loans	14	14	13	12	12	10	12	14
Interest expense/interest-bearing liabilities	1	0	0	0	0	0	0	0
Net interest income/earning assets	12	13	13	11	12	9	12	13
Efficiency ratio (expenses/income)	66	67	69	71	71	70	66	61
Debt funding/total assets	0	0	0	0	0	0	0	0
Deposits/total assets	81	79	82	83	84	84	85	84
Retained earnings/total assets	5	5	4	4	4	4	3	3
Issued capital/total assets	5	5	4	4	4	4	3	3
Proportion of total portfolio classified as nonperforming loans[a]	–	–	–	–	–	2	1	18

– = not available ( ) = negative.

[a] Nonperforming loans are those that are 90 days or more past due.

Sources: Bank of the Federated States of Micronesia, Financial Accounts 2010–2017; and responses to questionnaire sent by the Asian Development Bank to Bank of the Federated States of Micronesia management.

Figure A.11: Bank of the Federated States of Micronesia Profitability 2010–2017



Source: Bank of the Federated States of Micronesia, Financial Accounts 2010-2017.

Relationship with the Government

BFSM retains a strong link to both the federal and state governments of the FSM through their representatives on the board. The bank has been able to maintain a commercial focus despite the majority of government officials on the board. The board's influence over credit decisions is minimized by their lack of authority over loans under $750,000 in value. The bank does not undertake any subsidized lending programs on behalf of the government and, therefore, can operate and be held accountable for commercial results.

Core Challenges and Opportunities

BFSM's ability to attract retail deposits is largely due to its FDIC insurance cover. In turn, this is linked to the Compact of Free Association with the United States, which the Government of the United States has declared will end in 2023. If BFSM loses FDIC cover, depositors are expected to move their savings to the Bank of Guam, reducing BFSM's balance sheet and driving up the cost of funds. This could also lead to BFSM losing its Hawaii branch and correspondent banking relationships in the US. To mitigate this risk, BFSM is increasing its liquidity and exploring other sources of funds, including debt and equity. Loss of the compact agreement is also expected to sharply reduce the amount of government deposits with BFSM, and lead to an economic recession in the FSM.

A further question is whether there is a business case for two state-owned banks in the FSM, in particular if one is focused on domestic business credit but lacks funding, and the other has short-term funding but provides only limited domestic business credit. If the objective of the government is to ensure that there is a sustainable mechanism to convert intermediate savings into domestic credit, it should explore whether the current sector structure is the most suited to this goal. An alternative could be

a single, strengthened state-owned commercial bank, regulated by the Banking Board of the FSM and with a clear mandate to support domestic businesses, thereby drawing on the strengths of both FSMDB and BFSM. The existing equity stake of FSMDB in BFSM could be seen as a step toward consolidation.

C. FIJI

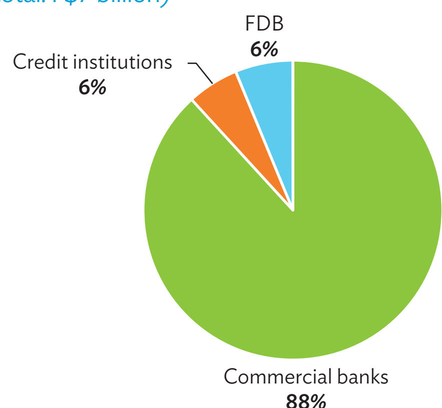
1. Finance Sector Composition

Fiji has one of the more developed financial markets in the region.[17] It is composed of banking, credit, insurance, foreign exchange industries, money changers, the Fiji National Provident Fund (FNPF), South Pacific Stock Exchange, stock brokers, unit trusts, investment advisers, Housing Authority, Fiji Development Bank (FDB), and a range of smaller market participants. The Reserve Bank of Fiji (RBF), the country's central bank, licenses, supervises, and regulates all these entities with the exception of some nonbanking financial institutions such as the Housing Authority and FDB.

There are six licensed commercial banks and four licensed credit institutions.[18] Both FDB and the Housing Authority also provide retail loans and compete in the commercial credit market. The value of commercial credit as a percentage of GDP (70%) is one of the highest in the Pacific.

In 2017, FDB accounted for 6.2% of gross loans issued by commercial banks and credit institutions, a market share which has been in decline for most of the past decade (Figure A.12).

Figure A.12: Fiji Banking Sector Credit, 2017
(total: F$7 billion)



FDB = Fiji Development Bank.
Source: Reserve Bank of Fiji.

2. Fiji Development Bank

The Fiji Development Bank was established in 1967 under the Fiji Development Bank Act (Cap 214). It is an autonomous statutory body, with a board of directors appointed by the minister for economy . The Ministry of Economy monitors the bank through periodic reporting to the minister.

FDB voluntarily ensures compliance with the Banking and Supervision Act of Reserve Bank of Fiji as part of RBF's prudential supervision requirements. This includes providing prudential returns and periodic reports to the RBF for the purpose of banking statistics consolidation. The bank is not subject to income tax in accordance with section 17(29) of the Income Tax Act 1985.

The FDB Act (section 5) mandates the bank to "facilitate and stimulate the promotion and development of natural resources, transportation and other industries and enterprises in Fiji and, in the discharge of these functions, the Bank is required to give special consideration and priority to the economic development of the rural and agricultural sectors of the economy of Fiji."

FDB's directors are appointed by the minister of economy, for an initial period of 3 years and are eligible for reappointment thereafter. The minister has powers to determine the size of the board, which as of the first quarter of 2018, was composed of four directors, all of whom were independent. FDB has a board charter that describes the board's role and responsibilities and regulates internal board procedures supported by a strong corporate governance framework.

Loan Portfolio

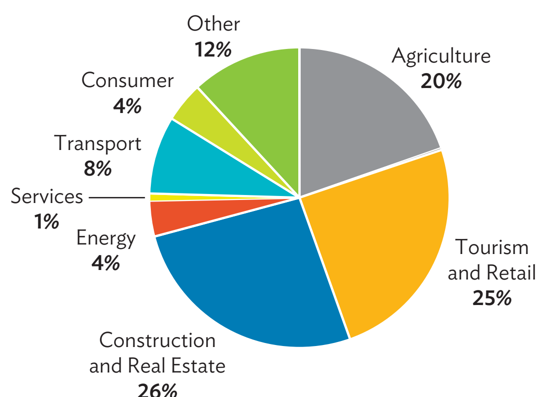
The FDB loan portfolio is diversified, with the majority of the bank's credit allocated to tourism/retail, construction/real estate, and agriculture (Figure A.13). Although 53% of FDB's total number of loans are to the agriculture sector, most of these are small, averaging only $15,000, meaning they represent just 20% of the overall portfolio. In 2017, FDB had an estimated 47% market share of total outstanding credit to the agriculture sector, more than any other bank. This reflects the reluctance of commercial banks to lend against agricultural leases, and assume the weather-related risks associated with agriculture. While FDB competes with commercial banks in almost all of its market segments, it does take some risks that other commercial banks are unwilling to take, such as start-up and second-tier businesses. In this way, it is playing the development role that is prescribed in its establishing mandate. Surprisingly, the largest share of its outstanding credit is to large corporate customers,

[17] ADB. 2013. *Re-invigorating Private Sector Investment: A private sector assessment for Fiji.* Manila.

[18] The six commercial banks are the Australia and New Zealand Banking Group, Bank of Baroda, Bank South Pacific Limited, BRED Bank (Fiji) Limited, Home Finance Company Bank, and the Westpac Banking Corporation.

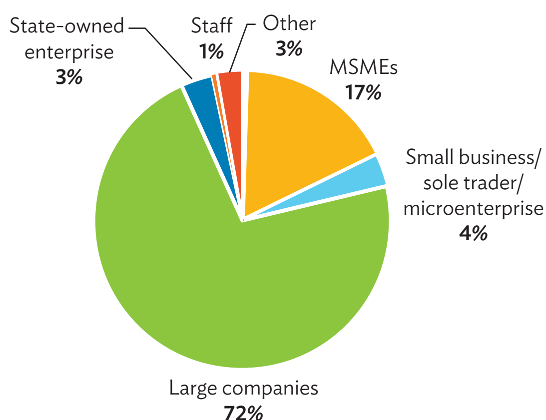
perhaps reflecting a strategy to diversify portfolio risk, and lend to projects considered important to economic development (Figure A.14). According to FDB, its streamlined credit assessment practices have made it an attractive alternative to commercial banks for large corporate customers, in particular those in the tourism sector. Pricing of FDB credit is largely driven by competitive market pressures in the wider Fijian credit market, including its cost of funds.

Figure A.13: Fiji Development Bank Loan Portfolio by Sector, 2017 (total: F$438 million)



Source: Responses to questionnaire sent by the Asian Development Bank to Fiji Development Bank management.

Figure A.14: Fiji Development Bank Loan Portfolio by Client Size, 2017



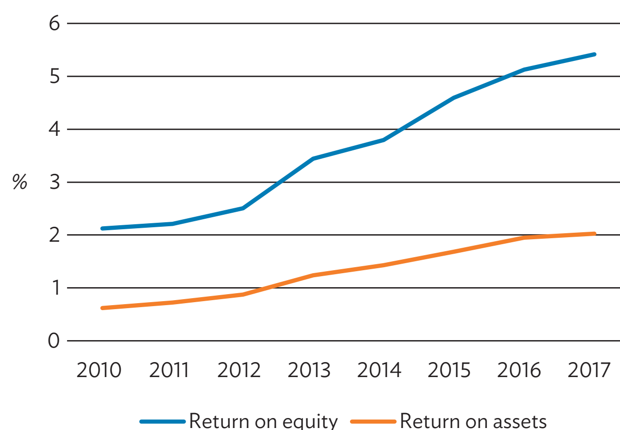
MSMEs = micro, small, and medium-sized enterprises.

Source: Responses to questionnaire sent by the Asian Development Bank to Fiji Development Bank management.

Financial Performance

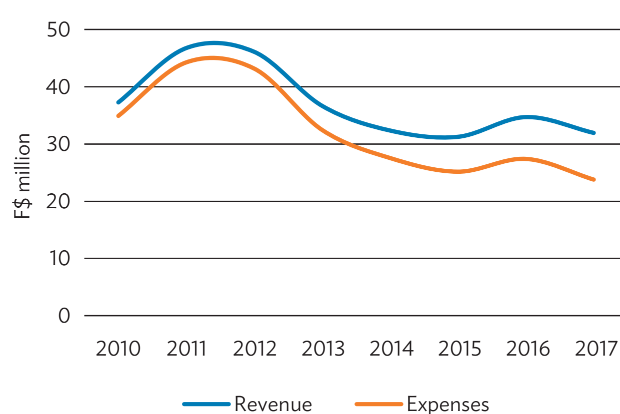
FDB's profitability has been on an upward trend since 2010 (Figure A.15), despite decreases in its volume of business and its net interest margin. Its ability to maintain this profitability can be attributed to a general improvement in loan quality, a steady decrease in allowances for credit impairment since 2011, and improved operating efficiencies.

Figure A.15: Fiji Development Bank Profitability, 2010–2017



Source: Fiji Development Bank, Financial Accounts 2010-2017.

Figure A.16: Fiji Development Bank Revenue/Expenses, 2010–2017



Source: Fiji Development Bank, Financial Accounts 2010-2017.

FDB had the lowest average expense ratio of the state-owned banks in this survey, indicating high efficiency (Table A.4). This is especially notable given that it operates 12 branches. Its loan portfolio contracted between 2010 and 2014, but has grown steadily since then, contributing to an average ROA of 1.9% from 2015 to 2017. This compares with an average ROA of 2.4% for Fiji's six commercial banks over the same period.

Like most of the development banks in this survey, FDB relies on bond issues and promissory notes to fund its operations. Around 60%–70% of all paper is subscribed for by FNPF, with Bank of Baroda often taking up the balance. All of the bonds carry a government guarantee.

FDB has maintained high capital adequacy levels, averaging 44% from 2010 to 2017. This far exceeds the 14%–16% average of the commercial banks during this period, as well as the 12% minimum required by the RBF for deposit-taking institutions. Nonperforming loans, while steadily decreasing from 27% to 17% between 2010 and 2016, jumped to 22% of total loans at the end of 2017, more than 40% of which was held by two large debtors. In 2017, Fiji's commercial banks held an average of 3% nonperforming loans.

Relationship with the Government

FDB participates in one government-mandated loan scheme, the Seed Capital Revolving Fund program, and receives a subsidy of 6% on loans to the agriculture sector and 6%–8% on loans to the northern region. These subsidies are applied to agricultural loans of up to $50,000. The bank proposes a rate and subsidy amount to the government following an assessment of the uptake of the subsidized loans from the previous years. The government then determines the actual value and the rate. Internally, the subsidy to the individual borrower is applied based on the client quality rating.

The Seed Capital Revolving Fund program represents only 0.2% of the bank's outstanding credit, while loans to the agriculture sector and northern region account for more than 20% of the portfolio. FDB is able to earn a commercial interest rate spread on these programs, so it does not consider them as an unfunded community service obligation.

FDB also assists the Ministry of Industry, Trade and Tourism in the disbursement and administration of the Micro and Small Business Grant Scheme. Since the inception of the scheme, FDB has disbursed F$18 million of grants to 17,970 recipients.

FDB benefits from a government guarantee on its bond issues, the bulk of which are taken up by the FNPF. FDB's loan portfolio has limited exposure to SOEs, which represent only 2.37% of total loans outstanding as of November 2018.

Table A.4: Fiji Development Bank Performance, 2010–2017 (%)

Fiji Development Bank	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	86	79	78	82	79	81	79	88
Loan growth rate		(16)	(5)	7	(4)	10	1	20
Earning assets/assets	89	81	78	82	80	81	79	89
Equity/assets	29	33	35	36	38	37	38	37
Interest income on loans/total loans	9	13	13	10	10	8	8	7
Interest expense/interest-bearing liabilities	7	8	9	6	4	3	4	4
Net interest income/earning assets	4	6	6	5	6	6	5	4
Efficiency ratio (expenses/income)	27	22	24	27	33	38	35	39
Short-term funding/total assets	10	17	29	20	22	22	1	2
Long-term notes/total assets	58	47	33	41	37	38	59	59
Retained earnings/total assets	11	13	15	16	17	18	19	20
Issued capital/total assets	15	16	17	17	17	15	15	14
Proportion of total portfolio classified as nonperforming loans[a]	27	27	21	19	18	17	17	22
Capital adequacy (CET1 ratio)	36	49	48	45	45	42	45	39

( ) = negative, CET1 = common equity tier 1.

[a] Nonperforming loans are those that are 90 days or more past due.

Source: Fiji Development Bank, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to Fiji Development Bank management.

Core Challenges and Opportunities

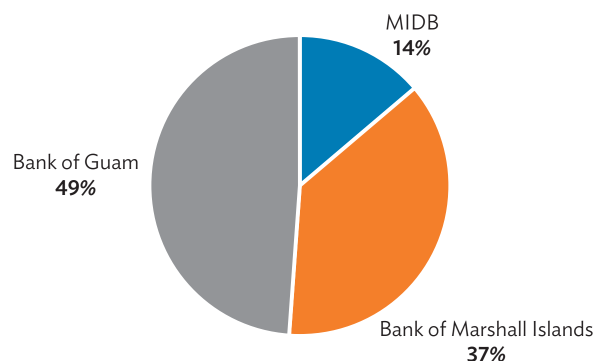
In addition to its narrow funding base, which is almost entirely dependent on the FNPF, FDB is facing increased competition from commercial banks which have a lower cost of funds.[19] It has recently introduced a term deposit product and is looking at other ways to diversify its funding sources. FDB has strong experience in financing risks that the commercial banks are not willing to take, and recently received accreditation from the Green Climate Fund, giving it access to a new source of funding and the potentially large market of climate risk financing. The bank already has a strong commercial culture, which could support its further specialization into classes of risk not addressed by the private commercial banks, and in sectors where FDB has developed core expertise. This would be consistent with the bank's own strategy and should be supported by more formal regulatory oversight, in the interests of the finance sector as a whole. Moreover, Fiji's recent adoption of the 2019 Public Enterprise Bill, which has robust provisions for community service obligations, together with a possible diversification of the bank's shareholding, would foster greater commercial autonomy and accountability, which is essential to FDB's sustainability.

D. REPUBLIC OF THE MARSHALL ISLANDS

1. Finance Sector Composition

The banking system of the Marshall Islands comprises a local private bank (Bank of Marshall Islands),[20] a branch of a foreign-owned bank (Bank of Guam), and a development bank (Marshall Islands Development Bank [MIDB]). The sector also has two large money transfer operators (MoneyGram and Western Union), two insurance companies, and a pension fund. Several private companies offer loan financing through auto dealers, and the US Department of Agriculture provides residential loans. A Bank of Marshall Islands-operated microcredit scheme issues loans up to a value of $10,000, and there are several small money-lending services. The Marshall Islands does not have any savings and loans companies or credit unions, nor does it have a securities market. Since 2012, businesses in the Marshall Islands have had access to the Pacific Islands Development Bank (PIDB), which is based in Guam. It provides commercial, consumer, and residential loans to clients in its member countries, as well as

Figure A.17: Marshall Islands Banking Sector Assets, 2017 (total: $262 million)



MIDB = Marshall Islands Development Bank.

Source: Bank of Marshall Islands Financial Statements; International Monetary Fund (IMF). 2018. *2018 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Republic of the Marshall Islands. IMF Country Report No. 18/270,* Washington, DC. (Table 5, p. 26); and Marshall Islands Development Bank Financial Statements.

loan guarantees.[21] Bank of Marshall Islands and Bank of Guam are under the supervision of the Marshall Islands Office of the Banking Commission and comply with its prudential regulations as provided in the Banking Act 1987. In 2017, the Marshall Islands cabinet authorized the Banking Commission to conduct prudential supervision of and establish new prudential guidelines for Marshall Islands Development Bank.[22]

The value of private sector credit as a percentage of the Marshall Islands' GDP is 55%, which is at the median of the Pacific countries in this survey. In 2017, MIDB held 14% of the Marshall Islands' total finance sector assets and an estimated 14% of total credit outstanding to the private sector.[23] The two commercial banks, which dominate the banking sector, hold the balance. By cabinet decree issued in 2006, all consumer lending is capped at 15% per annum interest rate. Consumer credit in the Marshall Islands is high and rising, representing 40% of GDP and 61% of compensation of employees in 2017.[24] Meanwhile, MIDB has identified potential unmet commercial loan demand of $35 million–$40 million in areas such as virgin coconut oil production, aquaculture, fish processing, shipping, and infrastructure development.[25]

[19] The cost of funds for commercial banks in Fiji was less than 2% in 2017, compared with 4% for FDB.

[20] The Bank of Marshall Islands is 100% owned by the Marshall Islands Holdings, Inc. Marshall Islands Development Bank has a 15% share in the Marshall Islands Holdings, Inc.

[21] The membership of PIDB includes Guam, the Commonwealth of the Northern Mariana Islands, the Marshall Islands, and the FSM. The Marshall Islands owns 23% of the shares in PIDB. The minimum allowable amount for commercial loans is $20,000, with the maximum not to exceed 20% of the total assets of the business. As of end-2016, PIDB had a total of eleven outstanding commercial loans in the Marshall Islands with a total value of $1.8 million, representing 15% of its total loan portfolio. PIDB. *2016 Annual Report*. Guam. http://pacificidb.com/wp-content/uploads/2017/05/2016-Annual-Report.pdf.

[22] Cabinet Minute (C.M. 133).

[23] International Monetary Fund (IMF). 2018. Marshall Islands: 2018 Article IV Consultation. *IMF Country Report No. 18/270*. Washington DC, (Table 5, p.26). As per Table 5 of the IMF Country Report, total banking sector assets were estimated to be $261.8 million in 2017 and credit to private sector was estimated to be $119.7 million.

[24] IMF. 2018. Marshall Islands: 2018 Article IV Consultation. *IMF Country Report No. 18/270*. Washington DC.

[25] MIDB. 2015. *Strategic Plan 2016–2020*. Majuro.

2. Marshall Islands Development Bank

The Marshall Islands Development Bank (MIDB) was established in 1988 by the Marshall Islands Development Bank Act. The bank does not hold a commercial banking license. It complies with its establishing statute and the Marshall Islands Procurement Code. It is exempt from income tax, customs duty, or any other tax or duty. MIDB is 100% owned by the Ministry of Finance and, as of 2017, is supervised by the Marshall Islands Office of the Banking Commission.

The Marshall Islands Development Bank Act 1988 (section 810, part III) describes the functions of the bank:

> "to strengthen the nation's economic base, increase employment and production, improve standards of housing, promote exports, and reduce the country's dependence on imports and foreign aid. In carrying out its functions the Bank shall have due regard for the general economic policies and plans of the Government of the Marshall Islands and to the general objectives of the Investment Development Fund."

Section 811 of the act also states that MIDB has the power to provide nonfinancial assistance to enterprises operating in the Marshall Islands

> "by taking the initiative in the identification of investment opportunities, the undertaking of feasibility studies, the promotion and formation of new enterprises, as well as the expansion of existing enterprises with the objective of enlarging the economic base of the country" and "by managing or taking part in the management of, supervision, or conduct of the business of enterprises."

The cabinet of the Marshall Islands appoints the members of the bank's board of directors, nominates the chairperson of the board, and, on advice of the board, appoints its managing director. As of 2018, the board was composed of seven directors, two whom were independent.[26] The bank does not have a formal policy for director performance reviews and does not follow a corporate governance code of practice.

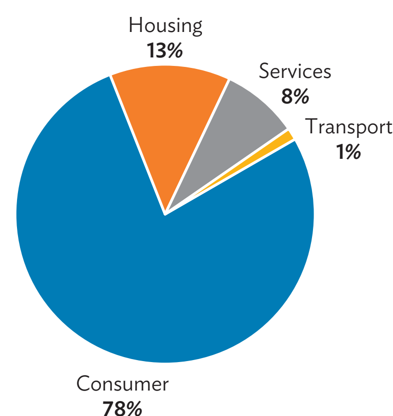
MIDB produces a corporate plan every 5 years, the most recent of which was in 2016. Its annual financial statements are audited by an independent firm and are publicly available via the website of the Marshall Islands Office of the Auditor General.

In its 2017 decision to place MIDB under the supervision of the Banking Commission, the Marshall Islands cabinet also authorized the Banking Commission to conduct a compliance examination of MIDB's adherence to the Marshall Islands Development Bank Act and to report all findings to the minister of finance and the Marshall Islands cabinet. These actions reflect the intent of the government to strengthen the operations and prudential practices of the bank.

Loan Portfolio

MIDB's loan portfolio is dominated by housing and consumer loans, accounting for 91% of its loan book in 2017 (Figure A.18). It is the only bank in the Marshall Islands to offer mortgage loans, and holds an estimated 20% of all outstanding consumer loans. Of its loans, 89% are provided to individuals and sole traders, compared with 7% for large corporations, and 4% for staff (Figure A.19). Its emphasis on consumer loan programs represents a distinct shift from its previous strategy to lend to larger businesses and SOEs, and has contributed to improved asset quality, with the percentage of nonperforming loans (those classified as 90 days or more past due) dropping from a high of 92% in 2011 to 17% in 2017. While consumer lending has improved the profitability of MIDB, it is inconsistent with its core mandate of business lending. Moreover, the bank's additionality in this segment is unclear given the dominance of the two existing commercial banks. The government caps consumer lending rates at 15% per year for all banks, loans financed by the Investment Development Fund and Compact Section 211[27] loans are capped at 6.5%, loans financed by the Marshall Islands are capped at 14%, and Housing Preservation Grant loans are fixed at 2%–6%. In 2017, over 90% of MIDB's loan portfolio was subject to interest rate caps. MIDB has the highest rate of unsecured loans in the Pacific, with 88% of loans lacking collateral in 2017.

Figure A.18: Marshall Islands Development Bank Loan Portfolio by Sector, 2017 (total: $25 million)

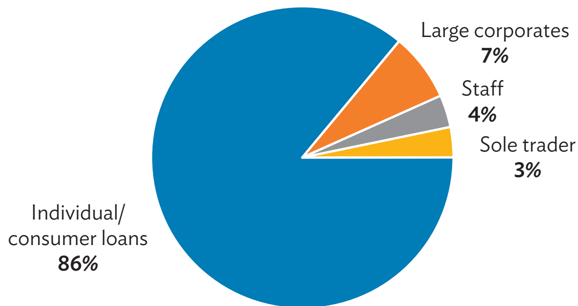


Source: Responses to questionnaire sent by the Asian Development Bank to Marshall Islands Development Bank management.

26 Independent directors are those who are neither civil servants, elected officials, nor employees of the bank.

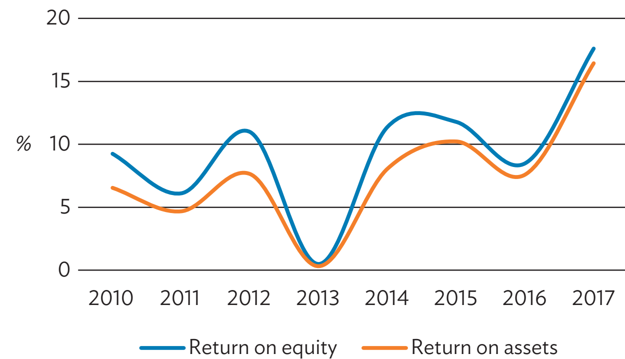
27 Section 211 of the RMI's Compact of Free Association with the US provides for a range of financial assistance and trade facilities.

Figure A.19: Marshall Islands Development Bank Loan Portfolio by Client Size, 2017



Source: Responses to questionnaire sent by the Asian Development Bank to Marshall Islands Development Bank management.

Figure A.20: Marshall Islands Development Bank Profitability, 2010–2017



Source: Marshall Islands Development Bank, Financial Accounts 2010-2017.

Financial Performance

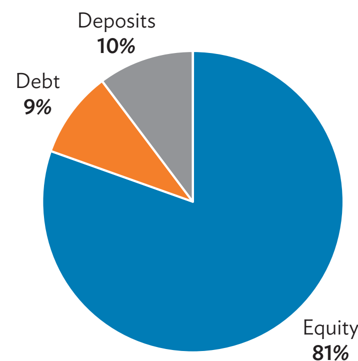
MIDB's financial performance fluctuated substantially over the 2010–2017 period, rising to an ROE of 18% and ROA of 16% in 2017 (Figure A.20). This sharp increase is largely due to a $2.8 million deposit from the Government of the Marshall Islands in 2017, designed to support a lending program for struggling business. Discounting this cash injection, ROE in 2017 would have been 9%, at par with 2016. In its 2016 annual report, the bank notes that it generates the majority of its income through interest from its loans, and that it does not have sufficient resources to meet demand for new loans. The bank has been funding its operations largely from equity (81% of total), with government deposits representing an average of 10% and debt an average of 9% of funding sources from 2010 to 2017 (Figure A.21).

In 2017, MIDB had the highest rate of interest income as a percentage of total loans (14%) of the development banks in this survey, and the lowest expense ratio (23%) of all of the banks, suggesting highly efficient operations. MIDB operates four branches in addition to its head office, and has one of the highest average ROA of the banks in this survey for the 2010–2017 period.

Relationship with the Government

Historically, MIDB has received funds under section 211 of the Compact of Free Association with the United States, contributions in the form of equity and interest-bearing deposits from the Government of the Marshall Islands, and funds from the US Department of Agriculture.[28] In 2017, MIDB received a

Figure A.21: Marshall Islands Development Bank Funding Sources, 2010–2017 (average)



Source: Marshall Islands Development Bank, Financial Accounts 2010-2017.

$2.8 million deposit from the government to finance loans for "small to medium and struggling businesses."[29] As of December 2017, this subsidized loan program included six loans with a total balance of $315,000, or less than 1.5% of outstanding loans. This is the only noncommercial program or service requested of MIDB by the government, and the government does not provide MIDB with any other financial support. Of its own initiative, MIDB is reducing its interest rates on all commercial and housing loans, a strategy which it expects will broaden its customer base and help increase economic development. In addition to this, MIDB budgets $30,000 annually for donations to the community.

28 Under the Rural Housing Community Development Service Housing Preservation and Self-Help Housing Program Grants.

29 The grant funding is designed to expand the capacity of MIDB to lend to the target market segment; the funds are provided at no cost to MIDB, interest rates are not subsidized, and MIDB retains 100% of interest income, thereby allowing it to make a commercial return on the program. Therefore it is not considered as a community service obligation.

Table A.5: Marshall Islands Development Bank Performance, 2010–2017 *(%)*

Marshall Islands Development Bank	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	84	84	85	86	85	72	65	53
Loan growth rate		(1)	25	9	2	1	(5)	(5)
Earning assets/assets	86	87	87	87	87	93	85	73
Equity/assets	71	77	70	65	71	87	89	93
Interest income on loans/ total loans	16	16	13	14	14	13	14	14
Interest expense/interest-bearing liabilities	5	4	3	4	5	6	4	3
Net interest income/earning assets	14	14	12	13	12	9	10	10
Efficiency ratio (expenses/income)	52	56	53	56	43	29	48	23
Short-term funding/total assets	12	9	18	22	16	4	3	2
Long-term notes/total assets	4	0	0	0	0	0	0	0
Retained earnings/total assets	61	68	62	58	65	83	86	88
Issued capital/total assets	8	7	7	5	5	3	2	2
Proportion of total portfolio classified as nonperforming loans[a]	83	92	57	42	78	10	17	17

( ) = negative.
[a] Nonperforming loans are those that are 90 days or more past due.
Sources: Marshall Islands Development Bank, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to Marshall Islands Development Bank management.

Core Challenges and Opportunities

Recognizing that its shift to consumer lending is a departure from its mandate to support businesses, MIDB intends to reenter the commercial lending market. Its Strategic Plan 2016–2020 was developed to guide this transition, and calls for the bank to raise $23 million during the plan's 5-year period, the majority of which will address this commercial lending demand. The bulk of the capital is expected to come from long-term borrowing from multilateral development agencies, alongside a capital injection from the government.

While a strengthened MIDB could potentially play a valuable role in improving SME access to credit, this will require substantial capacity-building efforts to improve risk management practices. Like other SOEs, MIDB is also subject to political interference, which places further constraints on its ability to operate commercially. Other options to commercialize MIDB could also be considered, including partial privatization or a public-private partnership. If providing services to address unmet financing demand cannot be done on a purely commercial basis, the government could also competitively tender for the provision of these services on a subsidized basis. If MIDB is deemed to be the most appropriate vehicle to play this role, a realistic action plan could be developed. Any capital-raising efforts should explore opportunities to capture a share of the domestic savings currently flowing offshore. The secured transactions framework provides a mechanism to help achieve this.[30]

E. PALAU

1. Finance Sector Composition

The banking system of Palau is composed of five foreign-owned commercial banks[31]—three of which are branches of foreign banks[32]—and the National Development Bank of Palau (NDBP). The five commercial banks are supervised and regulated by the Palau Financial Institutions Commission (FIC). The three foreign bank branches are US-chartered and insured by the US Federal Deposit Insurance Corporation. The NDP is not currently under the supervision of the FIC, but will become so if it becomes formally licensed.[33]

[30] Using the secured transactions framework, MIDB could use its existing loan portfolio, which represents a secure and substantial asset, as security for borrowing from one of the other domestic banks.

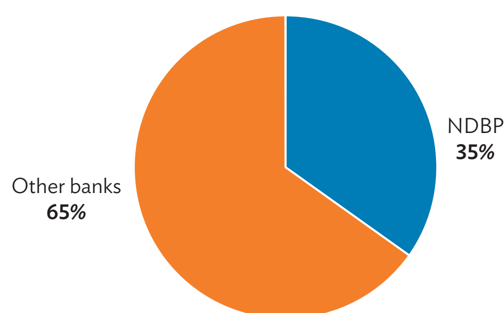
[31] These are the Asia Pacific Commercial Bank; Bank of Guam; Bank of Hawaii; BankPacific, Ltd.; and the Palau Investment Bank.

[32] Bank of Guam; Bank of Hawaii; and BankPacific, Ltd.

[33] Following amendments to Public Law Number 1-27, which allows NDBP to take larger-value term deposits, NDBP plans to apply for a banking license. As required by Republic of Palau Public Law 9-41, which was signed into law on 5 December 2014, NDBP will come under the supervision of FIC once it is licensed.

The US bank branches account for 90% of the banking sector's assets, but only 58% of sector credit. Palau has one of the lowest rates of banking sector credit as a percentage of GDP (19%) in the Pacific. This is due to a restrictive usury law and the generally low risk appetite of the foreign-owned banks, which are more focused on selective lending to the few larger businesses in Palau.[34] In 2017, NDBP accounted for 35% of Palau's total banking sector credit (Figure A.22).

Figure A.22: Palau Banking Sector Credit, 2017
(total: $55 million)



NDBP = National Development Bank of Palau.
Source: Palau Financial Institutions Commission.

2. National Development Bank of Palau

The National Development Bank of Palau (NDBP) was established in February 1982[35] and is wholly owned by the government through the Ministry of Finance. Its establishing legislation specifies that the bank is to

> "provide guaranteed loans and direct financing:
>
> (i) to persons for housing and for the development within the Republic of Palau of industry, agriculture, tourism, marine resources, and other ventures, with priority emphasis given to those ventures which involve the development of new enterprises and import substitutes; and
>
> (ii) to the National Government of the Republic of Palau for any purpose that is:
>
> (a) requested by the President; and
>
> (b) authorized and approved by the Olbiil Era Kelulau."[36]

Therefore, the government is able to direct NDBP to lend to any project considered of national interest. While the law does not require NDBP to operate profitably, it does specify that "the Bank shall aggressively identify projects for development financing that appear to have the potential to generate a reasonable return on invested capital."[37]

Subject to Senate confirmation, the President of Palau appoints six of the bank's seven board members for 3-year terms. The seventh member is the president of the bank, who is appointed by the board. The board elects its own officers to the posts of chairperson, vice chairperson and secretary/treasurer. In 2018, five of the seven board members were independent (footnote 26). All of the bank's operations are conducted from its main office in Ngetkib Village, Airai State. There were no branches, other offices, or subsidiaries operating in 2018. The bank's annual accounts are audited by an independent firm and made available to the public on its website.

Loan Portfolio

The majority of NDBP's loan portfolio are housing loans, accounting for 56% of the total (Figure A.23). The demand for NDBP mortgage loans reflects its position as the only bank in Palau that can accept land as collateral.[38] NDBP also lends to a range of SMEs involved in tourism, construction, agriculture and other commercial services. The majority of its clients are individuals for housing loans, followed by MSMEs (Figure A.24). NDBP is one of the few lenders in Palau to have developed credit products using movable property as collateral, under the 2012 Secured Transactions Act.

Financial Performance

The financial performance of NDBP has fluctuated substantially since 2010, with sharp drops in profitability in 2014 and 2017 (Figure A.25). Operating expenses have remained within $1.0 million–$1.5 million between 2010 and 2017, while revenue swings have been largely driven by loan loss recoveries and provisioning. With no branch network, NDBP is able to keep expenses comparatively low, with an average expense ratio of 48% from 2010 to 2017, at the median for the development bank group in this survey (Table A.6).

[34] Per chapter 3 of the Republic of Palau Law on Business and Business Regulation/11 PNC, the interest rate on lending to individuals is capped at 18% per annum, and the interest rate on lending to businesses is capped at the prime rate on corporate loans at large US money center banks plus 4 percentage points.

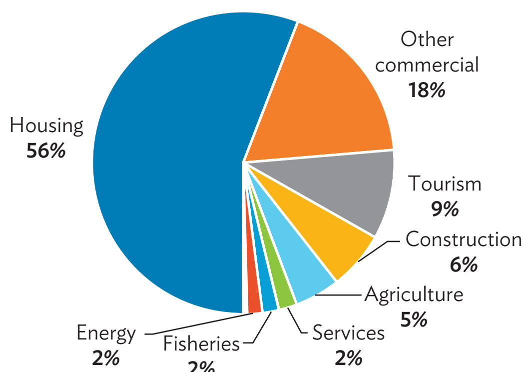
[35] NDBP was established by Public Law Number 1-27 as codified in Title 26 of the Palau National Code Annotated, as amended.

[36] Olbiil era Kelulau is the Palau National Congress.

[37] Section (h) of §122 of Title 26 of the Palau National Code Annotated, as amended.

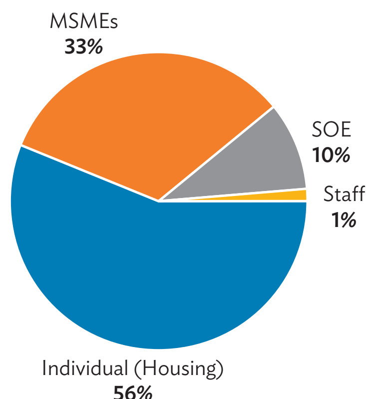
[38] Non-Palauans—and foreign-owned financial institutions fall in this category—cannot take title to fixed property, thereby making mortgage lending unattractive to foreign banks.

Figure A.23: National Development Bank of Palau Loan Portfolio by Sector, 2017 (total: $21 million)



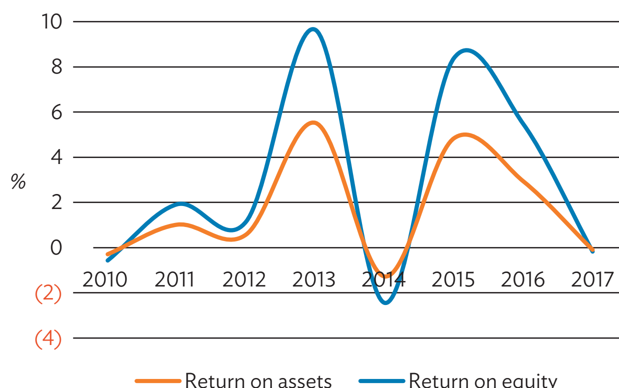
Source: Responses to questionnaire sent by the Asian Development Bank to National Development Bank of Palau management.

Figure A.24: National Development Bank of Palau Loan Portfolio by Client Size, 2017



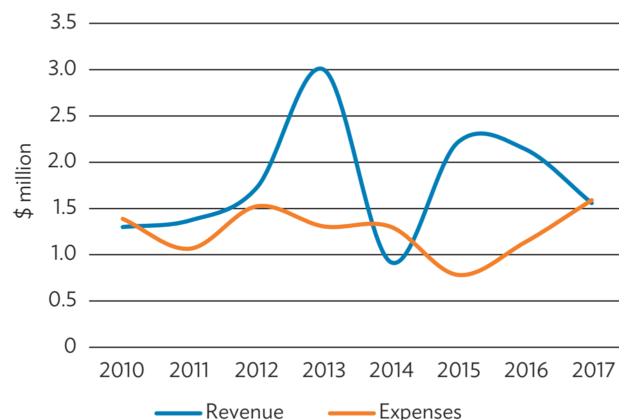
MSME = micro, small, and medium-sized enterprises, SOE = state-owned enterprise.
Source: Responses to questionnaire sent by the Asian Development Bank to National Development Bank of Palau management.

Figure A.25: National Development Bank of Palau Profitability, 2010–2017



( ) = negative.
Source: National Development Bank of Palau, Financial Accounts 2010-2017.

Figure A.26: National Development Bank of Palau Revenue/Expenses, 2010–2017



Source: National Development Bank of Palau, Financial Accounts 2010-2017.

NDBP funds its operations from two main sources: (i) retained earnings (54%) and (ii) borrowed funds (37%).[39] Loans outstanding are to the European Investment Bank, the government, the Mega International Commercial Bank, and the Republic of Palau Social Security Retirement Fund. NDBP is looking to increase its funding position and is considering a capital injection, long-term financing, and possibly larger-value term deposits.[40] Amendments to Public Law Number 1-27 are being prepared to allow this.

NDBP has maintained high capital adequacy levels, well above international standards. The total loan portfolio classified as

[39] 2017 figures.

[40] As permitted by Republic of Palau Public Law 9-41 of 2014.

Table A.6: National Development Bank of Palau Performance, 2010–2017 *(%)*

National Development Bank of Palau	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	86	80	62	69	64	62	53	58
Loan growth rate		(8)	(11)	(1)	(10)	(5)	(1)	6
Earning assets/assets	88	82	64	71	66	63	54	59
Equity/assets	51	53	50	57	52	58	54	56
Interest income on loans/ total loans	8	9	9	10	10	9	8	8
Interest expense/interest-bearing liabilities	4	4	3	4	4	4	3	3
Net interest income/earning assets	5	7	7	8	7	7	6	6
Efficiency ratio (expenses/income)	63	35	48	25	89	16	34	75
Long-term notes/total assets	48	46	48	41	40	33	39	38
Retained earnings/total assets	49	51	48	41	50	56	52	54
Issued capital/total assets	2	2	2	2	2	2	2	2
Proportion of total portfolio classified as nonperforming loans[a]	16	14	11	12	16	12	3	4
Capital adequacy (CET1 ratio)	64	71	60	77	70	76	83	86

( ) = negative, CET1 = common equity tier 1.

[a] Nonperforming loans are those that are 90 days or more past due.

Source: National Development Bank of Palau, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to National Development Bank of Palau management.

nonperforming has decreased significantly through successful recovery efforts and loan loss provisioning, a process which has continued in 2018.

Relationship with the Government

NDBP manages a range of loan programs at the direction of the government, including a $5 million program to finance agriculture and aquaculture projects. In compliance with government policy, NDBP loans are all provided at fixed interest rates, including 3% for agriculture loans, 6% for microfinance and predevelopment, 8% for fishing and first-time homeowners, 10% for commercial, and 8% for housing loans. Interest rates have not been regularly reviewed and, as such, do not always reflect the underlying credit risks and cost of funds. This is now being addressed, with a review process launched in 2018. NDBP also implements a range of renewable energy programs financed through international donors, such as the Energy Efficiency Subsidy Loan Program, and Renewable Energy Subsidy Loan Program. NDBP is able to generate a commercial return on the administration of the renewable energy programs, but faces challenges with the government-directed programs where it incurs higher cost of funds and the risks of variability.

Core Challenges and Opportunities

NDBP plays a major role in providing credit to Palau business and housing loans to individuals. It competes with commercial banks for the larger business loans, and with the Palau Housing Authority for mortgages. Its reliance on a mix of fixed and variable rate loans to fund its operation and an 8% cap on housing loan interest rates present a clear risk to its profitability. A rebalancing of its funding mix, which may include term deposits, will provide needed security for future lending. Reduced exposure to government-directed lending,[41] or a mechanism to compensate the bank for these noncommercial lending decisions, will also facilitate a more sustainable growth path.

[41] These loans amount to $2.5 million, or 12% of the total portfolio of NDBP.

F. PAPUA NEW GUINEA

1. Finance Sector Composition

Papua New Guinea (PNG) is the largest economy in the Pacific with one of the fastest-growing financial services sectors. However, it also has one of the highest rates of financial exclusion, with an estimated 63% of Papua New Guineans lacking any form of banking or financial accounts.[42] Using the Bank of Papua New Guinea (BPNG) nomenclature, the sector is composed of 4 licensed commercial banks, 12 licensed financial institutions, 9 authorized money changers, 22 savings and loan societies, 4 superannuation funds, 5 licensed investment managers, 3 licensed fund administrators, 5 insurance companies, 5 insurance brokers, and a stock exchange. Both commercial banks and licensed financial institutions offer credit and deposit services, although only commercial banks offer checking or current accounts. BPNG regulates all of these financial institutions, with the exception of the capital markets and non-superannuation fund managers, which are regulated by the Securities Commission.

The four commercial banks operating in PNG accounted for 28% of finance sector assets in 2017,[43] with the other financial institutions representing 34% (Figure A.27).[44] Bank South Pacific (BSP) dominates domestic banking as the largest bank with the widest branch network and customer base. Among the four commercial banks, BSP accounts for 67% of total assets.

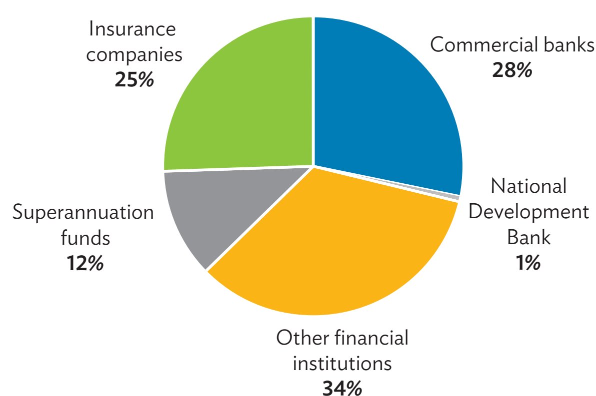
The state-owned banks represent a very small share of sector assets, with the National Development Bank of PNG (NDB) holding 0.9% and People's Micro Bank (PMB) and MiBank accounting for 0.15% and 0.13% respectively. These banks also represented a small proportion of the K11 billion of outstanding banking sector loans, with NDB representing 2.39% and PMB and MiBank accounting for 0.34% and 0.49%, respectively.

In 2017, the value of banking sector[45] credit to the private sector as a percentage of GDP was 16%. This is well below Pacific island averages and consistent with the low level of access to financial services in PNG. Agriculture was the most acutely underserved economic sector for credit, with just 1.6% of total loans, despite representing 17.6% of GDP.

2. MiBank (Nationwide Microbank Ltd)

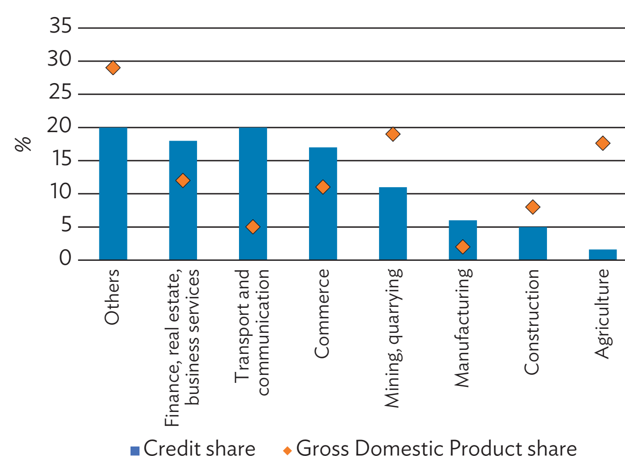
MiBank was established in 2004 as Wau Microbank, under a microfinance project cofinanced by the Asian Development Bank, Australian Aid, and the Government of Papua New Guinea. In 2007, it was incorporated as a limited liability company under the Companies Act. In June 2008, it received a banking license,[46] marking its transition from a small microfinance bank to a commercial bank focused on micro and small businesses. It registered the trading name of MiBank in 2013. It is the only majority state-owned bank in PNG to have some private shareholding, with Lihir Sustainable Development

Figure A.27: Papua New Guinea Finance Sector Assets, 2017 (total: K104 billion)



Source: Bank of Papua New Guinea.

Figure A.28: Papua New Guinea Credit Share by Sector, 2017



Sources: International Monetary Fund. 2017. Papua New Guinea : 2017 Article IV Consultation. *Country Report No. 17/411*. Washington, DC.

[42] Center for Excellence in Financial Inclusion and BPNG. 2016. *Second National Financial Inclusion Strategy*. Port Moresby.

[43] ANZ, BSP, Kina Bank, and Westpac Bank.

[44] This group includes the 12 licensed financial institutions (which include PMB and MiBank) and the 22 savings and loans societies.

[45] Using BPNG nomenclature, the banking sector is composed of commercial banks, licensed financial institutions, savings and loan societies, and NDB.

[46] MiBank is now supervised by BPNG and regulated by the Banks and Financial Institutions Act 2000.

Ltd. owning 15.76% and Melanesian Trustee Services Ltd 24.98% of its shares.

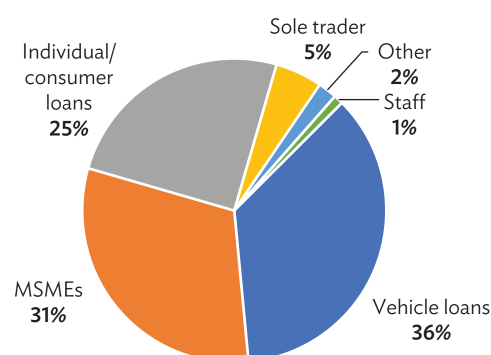
MiBank operates with a self-prescribed development mandate, with a vision “to be a commercially sustainable Bank that contributes to financial inclusion.”[47] Its target customers are those “at the bottom of the economic pyramid; farmers, low-income people from the informal sector, women, microentrepreneurs.”[48] MiBank was one of the first banks in PNG to offer mobile phone-based services, including payment and money transfer, and its network of 12 branches and more than 100 agents allow customers to access cash throughout the country.

The board is composed of six directors, all of whom are independent (footnote 26). The board’s Appointments and Remuneration Committee endorses certain candidates before making a recommendation to the full board of directors for approval. Once the board approves an applicant, the bank is required to obtain the approval of the central bank, BPNG, before appointing a board member. In contrast to NDB and other SOEs, where the National Executive Council has a prescribed role in director selection and appointment, it has no involvement in the case of the MiBank board. The bank does not have a formal director appraisal process but has a Board Charter[49] and follows a code of conduct. MiBank’s annual reports are available on its website.

Loan Portfolio

The MiBank loan portfolio has been transitioning away from vehicle loans and toward individual or consumer lending since 2014. Vehicle loans, which include buses, represented 60% of the portfolio in 2014, but only 36% in 2017. Consumer lending, which has higher margins, increased from 1% to 25% over the same period (Figure A.29). MSME lending has remained at 28%–31% over the 2014–2017 period, but is considered a growth area, in particular, agriculture value chain financing. In 2017, 74% of loans were secured with land, buildings, or cash, with the remaining 26% secured with payroll. MiBank has recently introduced a new value chain financing product that uses movable property as collateral. The product, aimed at the agriculture sector, launched with a pilot group of cocoa farmers in May 2019.

Figure A.29: MiBank Loan Portfolio by Client Size, 2017
(total: K54 million)



MSMEs = micro, small, and medium-sized enterprises.
Source: Responses to questionnaire sent by the Asian Development Bank to MiBank management.

Financial Performance

MiBank underwent operational and financial restructuring in 2010, writing off problem loans and introducing a new management information system. Average return on assets during the 2011–2017 period was 0%, while ROE was 3% (Figure A.30). In 2017, MiBank had the highest rate of income on loans as a percentage of total loans (28%) of the 13 banks in this survey. This compares with 20% for PMB, 5% for NDB and 13% for BSP. Revenue and operating income grew steadily over the 2010–2017 period, with the exception of a sharp drop in fee revenue in 2014. The bank’s loan portfolio has grown rapidly from K15 million in 2010 to K54 million in 2017, while deposit volume has varied from K55 million to K70 million during the same period. MiBank sourced 89% of its funds from deposits over the 2010–2017 period, for which it paid an average interest rate of 1.5%. This compares with 0.7% for PMB.[50] The balance of MiBank’s funds are from equity, as it does not hold any long- or short-term debt facilities. MiBank’s loan-to-deposit ratio was 78% in 2017, which contributed to a comparatively high percentage (68%) of earning assets to total assets. MiBank’s asset quality steadily improved over the 2010–2017 period, with nonperforming loans decreasing from 18% of total loans in 2010 to 8% in 2017. This is the same level of NPLs as PMB in 2017 and considerably lower than NDB’s 41%.

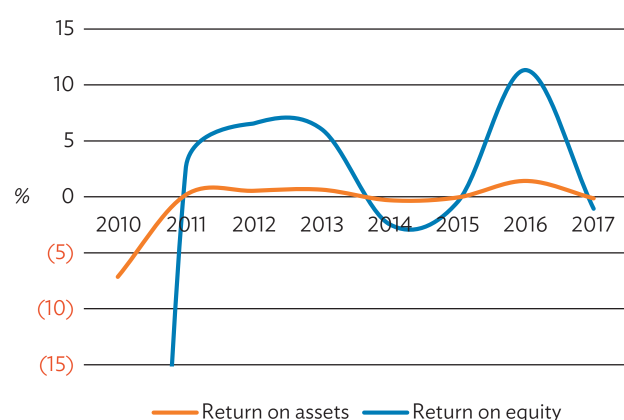
[47] MiBank. *Vision and Mission.* Port Moresby. www.microbank.com.pg/about_us/vision_mission.html (accessed 22 May 2019.)
[48] MiBank. 2018. *Annual Report 2017.* Port Moresby.
[49] The Board Charter governs the board’s role, function, responsibilities, compliance, communication, and disclosure of interests.
[50] Calculated over the 2013–2017 period.

The bank had the highest expense ratio of the 13 banks in this survey, averaging 94% over the 2010–2017 period. Discounting for the financial restructuring year 2010, MiBank's average expense ratio for 2011–2017 was 85% (Table A.7), equivalent to PMB and lower than NDB (92%). All three banks illustrate the comparatively high cost of operating in PNG.[51] Despite its small capital base, MiBank has maintained a tier 1 capital adequacy ratio of 16% over the 2010–2017 period, well above the BPNG minimum requirement.

Relationship with the Government

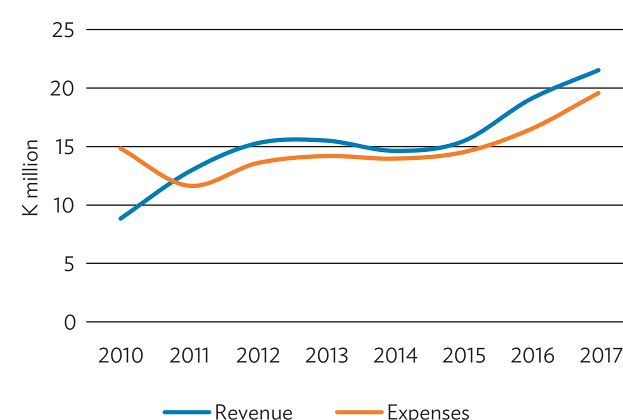
Despite the government's 59% shareholding, MiBank is able to operate largely independently. Unlike NDB and PMB, whose shares are held by Kumul Consolidated Holdings, MiBank's shares are held by PNG Treasury. MiBank manages one subsidized lending program to the fisheries sector through a commercial agreement with the National Fisheries Authority. This program, which had 32 loans in 2017, is financed and

Figure A.30: MiBank Profitability, 2010–2017



( ) = negative.
Source: MiBank, Financial Accounts 2010-2017.

Figure A.31: MiBank Revenue/Expenses, 2010–2017



Source: MiBank, Financial Accounts 2010-2017.

Table A.7: MiBank Performance, 2010–2017 *(%)*

MiBank	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	19	26	36	56	57	61	57	63
Loan growth rate		61	25	42	5	13	16	9
Earning assets/assets	33	41	54	75	66	69	63	68
Equity/assets	6	7	8	11	12	12	13	13
Interest income on loans/ total loans	67	60	59	42	26	23	26	28
Interest expense/interest-bearing liabilities	1	1	2	1	2	1	1	2
Net interest income/earning assets	35	35	37	30	20	19	21	24
Efficiency ratio (expenses/income)	158	83	82	87	89	89	81	85
Debt funding/total assets	0	0	0	0	0	0	0	0
Deposits/total assets	91	90	90	86	84	78	78	80
Retained earnings/total assets	0	0	0	0	(5)	(4)	(2)	(2)
Issued capital/total assets	12	12	13	15	17	16	14	15
Proportion of total portfolio classified as nonperforming loans[a]	18	10	8	7	8	8	7	7

( ) = negative.
[a] Nonperforming loans are those that are 90 days or more past due.
Source: MiBank, Financial Accounts 2010–2017; and responses to questionnaire sent by the Asian Development Bank to MiBank management.

[51] BSP, whose balance sheet was 200 times larger than MiBank, had an expense ratio of 43% in 2017.

guaranteed by the Fisheries Authority, but administered by MiBank. MiBank also delivers financial literacy training to various groups[52] at its own initiative and cost, and participates in the Centre for Excellence in Financial Inclusion.[53]

Core Challenges and Opportunities

MiBank competes with a range of banks and microfinance operators, including BSP, Fincorp, MoniPlus, PMB, and PNG Microfinance. It has demonstrated that a state-owned bank can operate on a fully commercial, independent basis, without relying on grant financing or being subject to directed lending without compensation. A strong, independent board and management team have been critical to MiBank's success. While operating costs are high, MiBank's investments in mobile money products could facilitate the expansion of its lending portfolio at relatively low marginal cost. Its equity base—at 13% of assets—is low. Further growth is likely to require longer-term funding sources, such as additional equity or longer-term debt.[54] This would allow the bank to further leverage its rural presence and customer base into further MSME lending. MiBank's pilot of supply chain financing with cocoa growers in East New Britain, using movable assets as security, has the potential for broader expansion, furthering MiBank's mandate to provide finance to farmers and micro entrepreneurs.

3. National Development Bank of Papua New Guinea

The National Development Bank of Papua New Guinea (NDB) was established in 2007 by the National Development Bank Act and incorporated as a company under the Companies Act 1997. NDB is the successor bank to the former Rural Development Bank (1994–2007), the Agriculture Bank of PNG (1984–1994), and the PNG Development Bank (1967–1984). It is wholly owned by the government of PNG through Kumul Consolidated Holdings (KCH). NDB is not currently a licensed financial institution in PNG and, as such, is not regulated under the Banks and Financial Institutions Act 2000. In 2013, NDB established PMB as a wholly owned subsidiary.[55] NDB operates 23 branches throughout PNG.

Section 5 of the NDB Act 2007 establishes the broadest possible mandate for the bank, stating that its function are to:

(i) "mobilize savings and provide credit and other banking and financial services to the people of PNG;

(ii) carry out such other functions as are given to it under this Act or any other law; and

(iii) generally to do such supplementary, incidental, or consequential acts and things as are necessary or convenient for the Bank to carry out its functions."

The NDB board of directors had nine members in 2018, seven of whom were independent (footnote 26). The board includes two ex officio directors (the managing director of NDB, and the departmental head of treasury or his or her nominee); as well as five representatives nominated by peak bodies.[56] In addition, the board includes two independent directors who must be appointed by the Governor-General, acting on advice from the National Executive Council (NEC). Since the 2015 amendments to the Kumul Consolidated Holdings Act 2002, the NEC is responsible for all SOE board appointments based on nominations presented by the oversight minister; in the case of NDB, this is the minister for public enterprise and state investment. The NEC also selects the bank's board chairperson from among the members of the board.

NDB approved a formal director performance appraisal process in 2016, which includes an assessment to be conducted annually by an external party. This has yet to be implemented, however. NDB does not have a corporate governance code of practice. It currently follows a board charter which includes a code of ethics.

NDB prepares a corporate plan each year. KCH, the trustee shareholder, uses this plan to monitor progress and report on performance against the plan to the NEC on a quarterly basis. Section 33 of the NDB Act 2007 requires the board to prepare and send an annual report to the Public Enterprise and State Investment Minister. The annual report is classified as a public document, but is not available on the NDB website, or through KCH. The minister can request NDB to provide a report on the operations of the bank in addition to the annual report. The annual report must be audited by a reputable accounting firm, which is a registered company auditor under the Accountants Act 1996. The annual report is distributed to the National Parliament and filed as part of the PNG company registry filings.

Loan Portfolio

The NDB loan portfolio is diversified, with the majority of its credit allocated to housing, agriculture, and construction

52 For example, the PNG Women's Chamber of Commerce and Industry, United Church of PNG, and the Niugini Strategic Services.

53 The Center for Excellence in Financial Inclusion was established under the Association Incorporation Act and officially launched on 24 April 2013. Its key role is to coordinate, advocate, and monitor financial inclusion activities in PNG.

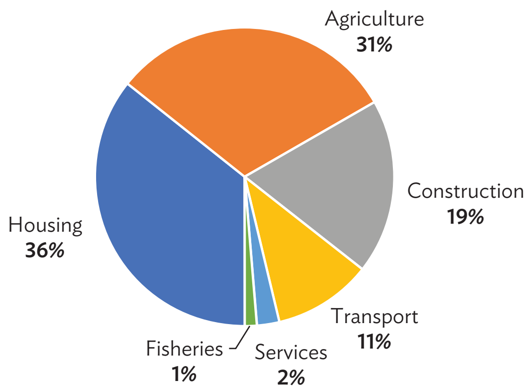
54 Additional equity from private sources could further consolidate the commercial focus of the bank.

55 PMB is regulated as a licensed financial institution.

56 Rural Industries Council (two representatives), the PNG Law Society, the PNG Chamber of Commerce, and Certified Practising Accountants Papua New Guinea.

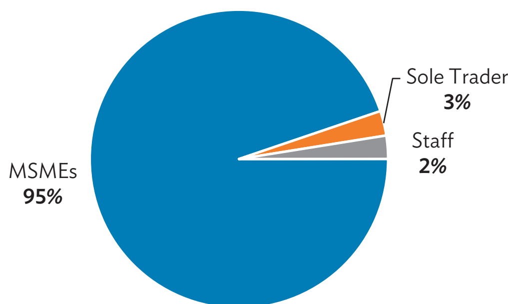
(Figure A.32). The agriculture portfolio had by far the largest number of loans, representing 79% of the total, all of which were to micro and small enterprises (Figure A.33). In 2017, NDB had an estimated 39% market share of total credit outstanding to PNG's agriculture sector, more than any other bank. Most of these loans were very small, averaging $7,000.

Figure A.32: National Development Bank of Papua New Guinea Loan Portfolio by Sector, 2017
(total: K222 million)



Source: Responses to questionnaire sent by the Asian Development Bank to National Development Bank of Papua New Guinea management.

Figure A.33: National Development Bank of Papua New Guinea Loan Portfolio by Client Size, 2017



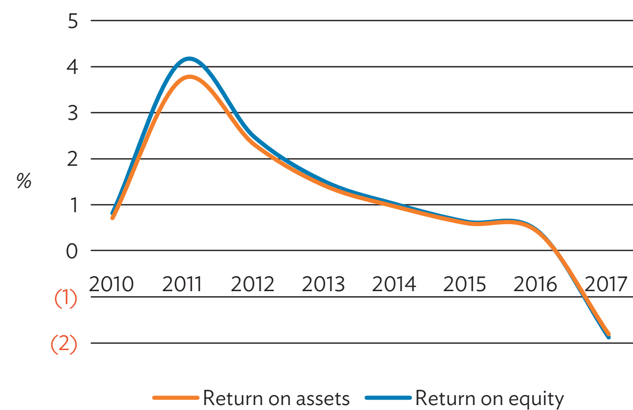
MSMEs = micro, small, and medium-sized enterprises.

Source: Responses to questionnaire sent by the Asian Development Bank to National Development Bank of Papua New Guinea management.

Financial Performance

The financial performance of NDB has steadily declined since 2011, despite its low cost of funds (Figure A.34). Its operation is funded entirely through government grants, a condition of which is that all of its loans must be capped at a 6.5% interest rate, regardless of the underlying risk.[57] Revenue growth has not kept pace with rising operating expenses. In 2017, a substantial loan provision of K11.5 million resulted in an overall net loss of K10.4 million.

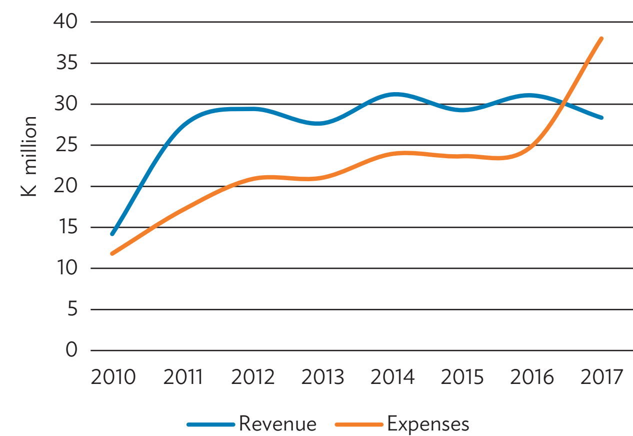
Figure A.34: National Development Bank of Papua New Guinea Profitability, 2010–2017



( ) = negative.

Source: National Development Bank of Papua New Guinea, Financial Accounts 2010-2017.

Figure A.35: National Development Bank of Papua New Guinea Revenue/Expenses, 2010–2017



Source: National Development Bank of Papua New Guinea, Financial Accounts 2010-2017.

[57] As directed by the national government as part of the Stimulus Package of 2013.

Table A.8: National Development Bank of Papua New Guinea Performance, 2010–2017 *(%)*

National Development Bank of Papua New Guinea	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	41	49	46	48	48	46	48	46
Loan growth rate		37	37	31	18	(3)	6	(1)
Earning assets/assets	44	53	49	56	56	57	61	60
Equity/assets	87	90	93	94	95	95	96	96
Interest income on loans/ total loans	8	11	11	5	5	6	6	5
Interest expense/interest-bearing liabilities	0	0	0	0	0	0	0	0
Net interest income/earning assets	8	10	10	4	4	5	4	4
Efficiency ratio (expenses/income)	106	72	75	86	98	116	103	93
Short-term funding/total assets	3	3	1	1	1	1	1	0
Long-term notes/total assets	0	0	0	0	0	0	0	0
Retained earnings/total assets	(50)	(39)	(25)	(18)	(14)	(18)	(17)	(18)
Issued capital/total assets	56	48	33	27	22	22	22	21
Proportion of total portfolio classified as nonperforming loans[a]	64	58	53	46	46	47	55	41

( ) = negative.

[a] Nonperforming loans are those that are 90 days or more past due.

Source: National Development Bank of Papua New Guinea, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to National Development Bank of Papua New Guinea management.

NDB has suffered from poor asset quality over the years, with NPLs averaging 51% of gross loans over the 2010–2017 period. This reflects NDB's comparatively weak risk assessment practices, and absence of hard budget constraints. This interest rate cap has led to NDB's comparatively low-income yield from its loan portfolio, which averaged only 7% over the 2010–2017 period, the lowest of the banks in this survey. The bank maintains 23 branches throughout the country to service its MSME customer base. The branch network has contributed to high operating costs: NDB had the highest expense ratio of the 13 banks in this survey, averaging 94% over the 2010–2017 period (Table A.8).

Relationship with the Government

The NDB business model relies entirely on government grants. In 2017, it received K35 million to fund SME and agricultural loans, and is the government's primary mechanism for directly channeling credit to the agriculture sector. The high rates of NPLs raise the question of the effectiveness and sustainability of this credit, however, in particular in view of the other banks and microfinance institutions, which are providing agriculture credit on a commercial basis. NDB considers the operation of some of its rural branches as a community service obligation (CSO), but does not account for the associated costs through the government's CSO Policy for SOEs.[58] In addition to its core business of MSME lending at 6.5% interest rate, NDB also implements several small credit schemes at 10.5% interest rates, at the request of the government. In 2017, these programs represented less than 2% of total loans outstanding.

Core Challenges and Opportunities

The NDB competes with a range of microbanks, commercial banks, and other financial institutions for the MSME market. Its reliance on grant funding and caps on loan pricing have inhibited the development of robust risk assessment practices. Its business model is inherently unsustainable. Recognizing these limitations, NDB management and board are seeking government approval to restructure the NDB and place it on a more commercial footing, focusing on the administration of the government's concessional loan programs on a fee-for-service basis. This would allow NDB to comply with the government's CSO Policy,[59] and place it on a more sustainable pathway. NDB management also hopes to position NDB to be the preferred bank for a range of government departments and SOEs. For

[58] The National CSO Policy for SOEs requires SOEs to identify and cost CSOs so that a funding agreement can be reached with the government agency requesting the CSO.

[59] Compliance with the CSO Policy would also encourage the government to seek out the most efficient administrator of its development loans, including private banks and financial institutions.

this to happen in a fully fair and non-distortionary manner, NDB would have to develop products, services, and pricing that are more attractive than existing banks and licensed financial institutions in PNG.

4. People's Micro Bank

The People's Micro Bank (PMB) was established in 2013 as a wholly-owned subsidiary of NDB to "mobilise savings and provide credit and other banking and financial services to the people of PNG."[60] PMB operates as a licensed financial institution under the Banks and Financial Institutions Act 2000, and is supervised and regulated by the Central Bank of PNG. It is incorporated under the Companies Act 1997.

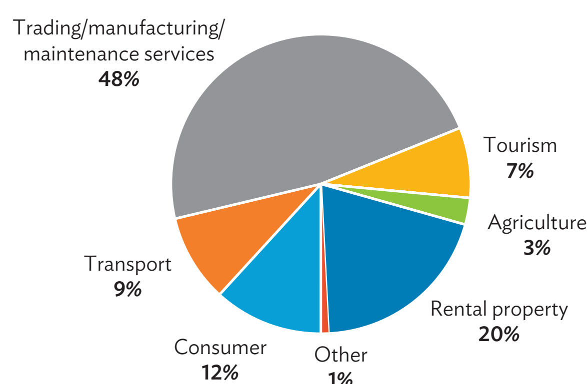
PMB is focused on rural outreach and the unbanked, and operates in seven provinces[61] throughout the country. In its first 5 years of operation, it mobilized an estimated K63 million in deposits from 90,000 bank customers, most of whom are microsavers. During this same period, it financed approximately K112 million in new and repeat loans to over 12,000 clients. PMB operates with an explicit profitability target, and is not constrained by caps on its interest rates. As of 2017, it was the largest microfinance institution in PNG, as measured by assets.

In 2018, the board was composed of five directors, four of whom were independent (footnote 26). The criteria for appointing directors are set out in the PMB constitution and board charter, and are subject to the applicable prudential standards issued by the Central Bank of PNG. PMB does not have a director performance appraisal process in place. PMB prepares an annual corporate and operating plan, and its board reports to the NDB board of directors on a quarterly basis. Unlike its parent company, NDB, the audited annual reports of PMB are available on its website.

Loan Portfolio

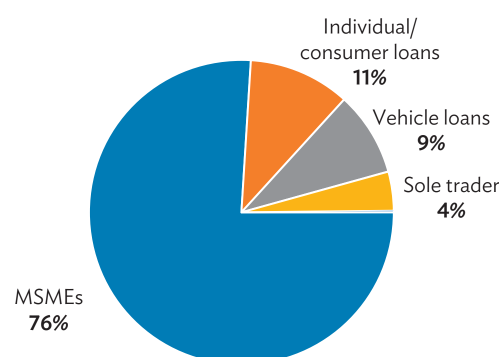
The PMB loan portfolio is heavily weighted in trading, small manufacturing, and maintenance services, which represented 48% of total loans outstanding as of September 2018 (Figure A.36).[62] PMB classified 89% of its gross loans in 2017 as business loans, which are for "business start-up or supporting the growth of an existing commercial activity."[63] Lending to agriculture and fisheries remains limited, but has been identified as a growth area in the future. PMB reports that its lending fees and interest rates are the lowest in the microfinance industry, and the lowest among financial institutions in PNG.[64] All of PMB's credit is allocated to customers who also hold savings accounts. The bank has experienced very rapid loan growth, with its portfolio expanding from K2 million in 2013 to K38 million in 2017, but retains high liquidity, with loans representing only 36% of its total assets in 2017. Cash and liquid securities represented 58% of total assets in 2017.

Figure A.36: People's Micro Bank Loan Portfolio by Sector, 2018 (total: K39 million)



Source: Responses to questionnaire sent by the Asian Development Bank to People's Micro Bank management.

Figure A.37: People's Micro Bank Loan Portfolio by Client Size, 2017



MSMEs = micro, small, and medium-sized enterprises.

Source: Responses to questionnaire sent by the Asian Development Bank to People's Micro Bank management.

[60] Section 5 (a) of the NDB Act 2007.

[61] Boroko, Madang, Wewak, Popondetta, Kimbe, Mt. Hagen, and Mendi.

[62] Figures for December 2017 were not available.

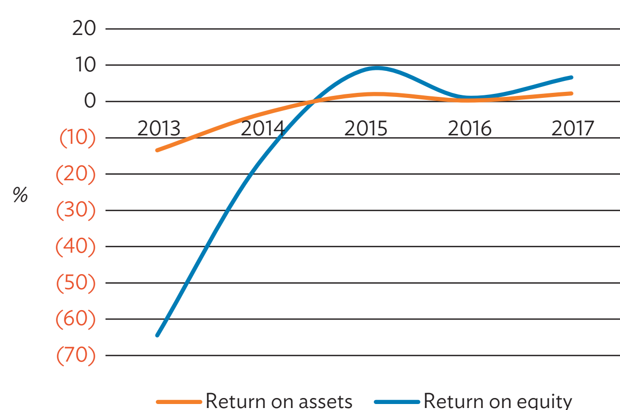
[63] People's Micro Bank Ltd. 2018. *Financial Accounts 2017*. Port Moresby. p. 11.

[64] People's Micro Bank Ltd. 2017. *Strategic Plan 2018 and Beyond.* Port Moresby. p. 3.

Financial Performance

PMB has generated positive returns since its third year of operation, despite having the highest expense ratio (94%) of the commercial banks in this survey over the 2014–2017 period. By way of comparison, the average expense ratio of MiBank during the 2014–2017 period was 86% (Table A.9). Both banks illustrate the comparatively high cost of operating in PNG. PMB's interest income on loans averaged 20% in 2017, compared with income from investments at 6%. PMB's funding has been dominated by retail deposits (73% of total deposits from 2013 to 2017) and equity contributions from its parent company, NDB (Figure A.39). The bank had no term liabilities. In 2017, its cost of funds was 2%, one of the lowest in this benchmarking sample. Asset quality is comparatively high but deteriorating, with 8% of total loans classified as NPLs.

Figure A.38: People's Micro Bank Profitability, 2013–2017



() = negative
Source: People's Micro Bank, Financial Accounts 2013-2017.

Relationship with the Government

While PMB does not formally recognize any of its activities as noncommercial and thus subject to PNG's Community Service Obligation Policy, it does implement a subsidized lending program with the Yangoru-Saussia District Development Authority in East Sepik Province. Under the program, which has had limited uptake, loans are jointly secured by a Credit Scheme Guarantee Fund and by the borrowers' savings. In 2018, PMB and Talasea District Development Authority established a dedicated credit facility for the people of Talasea District, West New Britain. The PMB branch in Kimbe offers commercial lending products for the target population operating within Talasea District, with funding from Talasea District Development Authority.

Core Challenges and Opportunities

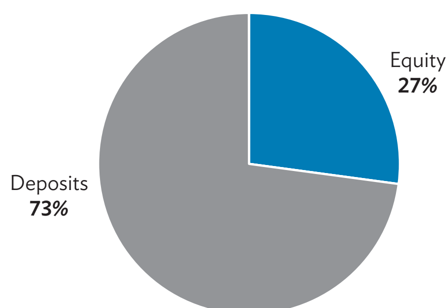
According to PMB's Strategic Plan 2018, PMB hopes to become a fully licensed commercial bank and expand its operation in the next 5–10 years through the opening of branches in all 22 provinces of PNG. This will require substantial additional technical capacity and financial resources, the latter of which PMB hopes to raise through further equity contributions from the government, a partial divestment and/or long-term debt. A related challenge for PMB will be its ongoing fit with NDB, given its more commercial business model and scope for further growth.

Table A.9: People's Micro Bank Performance, 2013–2017 *(%)*

People's Micro Bank	2013	2014	2015	2016	2017
Outstanding loans/assets	6	29	30	37	36
Loan growth rate		741	32	44	17
Earning assets/assets	78	84	90	88	83
Equity/assets	6	29	30	37	36
Interest income on loans/ total loans	0	15	23	17	20
Interest expense/interest-bearing liabilities	1	0	1	1	1
Net interest income/earning assets	1	7	10	10	12
Efficiency ratio (expenses/income)	810	143	76	87	70
Deposits/total assets	65	75	75	72	62
Long-term notes/total assets	1	0	1	1	1
Retained earnings/total assets	(13)	(11)	(7)	(5)	(2)
Issued capital/total assets	34	32	29	30	36
Proportion of total portfolio classified as nonperforming loans[a]	–	–	1	6	8

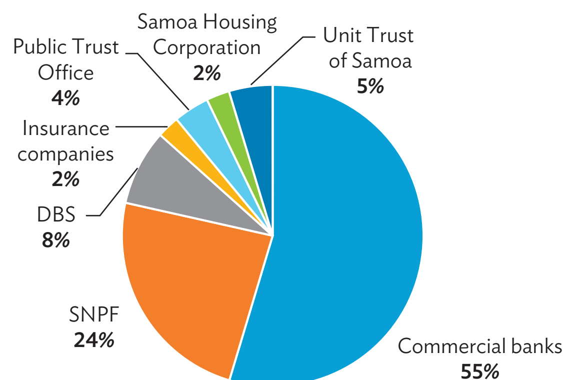
() = negative, – = not available. [a] Nonperforming loans are those that are 90 days or more past due.
Source: People's Micro Bank Financial Accounts 2013-2017; and responses to questionnaire sent by the Asian Development Bank to People's Micro Bank management.

Figure A.39: People's Micro Bank Funding Sources, 2013–2017 (average)



Source: People's Micro Bank, Financial Accounts 2013-2017.

Figure A.40: Samoa Finance Sector Credit, 2017 (total: ST1.8 billion)



DBS = Development Bank of Samoa, SNPF = Samoa National Provident Fund.
Source: Central Bank of Samoa.

G. SAMOA

1. Finance Sector Composition

The domestic financial sector includes a range of banking, nonbanking, and insurance service providers. There are four commercial banks,[65] six insurance companies, and four major nonbank financial institutions.[66] The Central Bank of Samoa (CBS) is the country's monetary authority and regulator of financial institutions. The value of private sector credit as a percentage of GDP (47.7%) is in the midrange of the ten Pacific countries in this survey.

In 2017, DBS accounted for 8% of total finance sector credit (Figure A.40), and 11% of banking sector credit. The sector is dominated by the four private commercial banks and Samoa National Provident Fund, which provides credit to its beneficiaries and some businesses.

2. Development Bank of Samoa

The Development Bank of Samoa (DBS) was established in 1974 under the Development Bank of Samoa Act 1974. DBS is subject to the Development Bank of Samoa Act 2010, the Public Bodies (Performance and Accountability) Act 2001, the Public Bodies (Performance and Accountability) Amendment Act 2015, the Public Bodies (Performance and Accountability) Act Regulations 2002, the Composition of Boards of Public Bodies Act 2012, the Income Tax Act 2012, the Financial Institutions Act 1996 (as amended) and certain provisions of the Companies Act 2001.

The core business of DBS is to provide credit financing to enable sustainable economic and social inclusive development. The DBS Act 2010 states that the mandate of the bank is "to promote the expansion of the economy of Samoa for the economic and social advancement of the people of Samoa."

DBS is fully owned by the government thorough the Ministry of Public Enterprises which exercises an ownership monitoring role, and imposes a target ROE of 7%. It is classified as a nonbank financial institution under the Financial Institutions Act and has been supervised by the CBS since 2001. The DBS complies with the same capital requirements as commercial banks and follows prudential guidelines set by the CBS, filing relevant information with the CBS on a quarterly basis.[67] In 2018, DBS proposed a revision to these capital requirements and prudential guidelines to recognize the specific risk appetite and nature of development lending. These proposals are under consideration by the CBS.

The board of DBS is appointed by the Samoan head of state, acting on the advice of cabinet. The selection and appointment of directors is administered by the Ministry for Public Enterprises, with the cabinet determining which member of the board shall be the chairperson. Under the Development Bank of Samoa Act 1974 and 2010, the CEO of the Ministry of Finance served as the chairperson. Since the passage of the Composition of Boards of Public Bodies Act 2012, this is no longer a requirement, but the CEO of the Ministry of Finance has remained the chairperson. As of 2018, the board was

[65] ANZ Bank (Samoa Ltd), the Bank South Pacific (Samoa) Ltd., the National Bank of Samoa Ltd., and the Samoa Commercial Bank Ltd.

[66] Development Bank of Samoa, Samoa Housing Corporation, Samoa National Provident Fund, and the Unit Trust of Samoa.

[67] The CBS requires the bank to (i) hold the minimum level of the regulatory capital of 12.5% and (ii) maintain a ratio of total regulatory capital to the risk-weighted asset (the "Basel ratio") at or above the minimum of 25%.

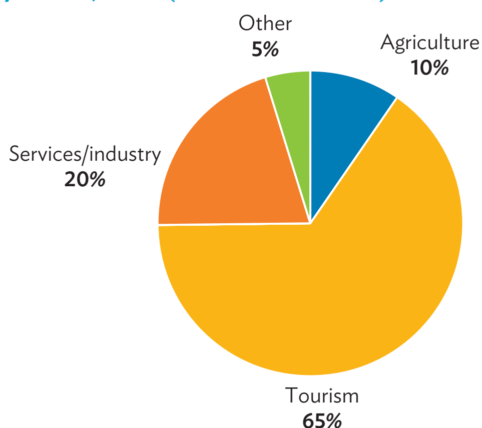
composed of seven directors, six of whom were independent (footnote 26). DBS has approved a formal policy for director performance reviews and adheres to a corporate governance code of practice.

Loan Portfolio

The loan portfolio of DBS is heavily weighted in favor of the tourism sector, followed by agriculture and a range of other small businesses (Figure A.41). This is partly a result of the decision of the government to use DBS to finance disaster recovery efforts, many of which were directed at the tourism sector. While DBS operates in the same economic sectors as private commercial banks, it considers its risk appetite to be higher than those of these banks. The government relies on DBS to implement a range of concessional credit programs, only a small portion of which are fully priced to reflect risk. In 2017, approximately 68% of the DBS loan portfolio was composed of concessional credit and covered by a government guarantee. This includes ST39 million for businesses affected by Cyclone Evan, and ST30 million for hotel and private home owners under the Commonwealth Youth Games and Small Island Developing States programs. In addition, DBS implements the government stimulus program, which provides repayment relief to major clients in tourism and other sectors. In 2017, DBS estimates the lost interest associated with this program at ST7.7 million, of which only 50% was paid for by the government.

While DBS is active in working with SMEs, the total value of its loan portfolio is heavily weighted toward large corporate clients, most of whom are in the tourism sector (Figure A.42). This is also the sector which accounts for 60% of the bank's nonperforming loans.

Figure A.41: Development Bank of Samoa Loan Portfolio by Sector, 2017 (total: ST150 million)

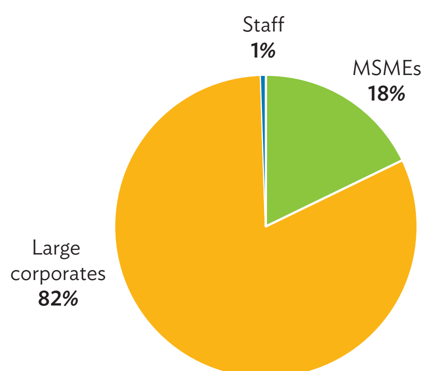


Source: Responses to questionnaire sent by the Asian Development Bank to Development Bank of Samoa management.

Financial Performance

The poor financial performance of DBS reflects the constraints under which it operates. It provides concessional finance as a form of community service obligation, with terms that do not reflect the project or client risks. While Samoa has a CSO policy which allows the costs of CSOs provided by SOEs to be financed by the government, DBS has not received this type of support. This has contributed to the inability of DBS to return a profit in more than two of the eight years between 2010 and 2017 (Figure A.43).

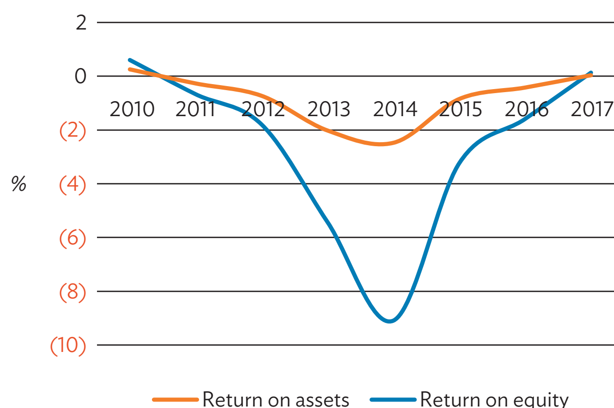
Figure A.42: Development Bank of Samoa Loan Portfolio by Client Size, 2017



MSMEs = micro, small, and medium-sized enterprises.

Source: Responses to questionnaire sent by the Asian Development Bank to Development Bank of Samoa management.

Figure A.43: Development Bank of Samoa Profitability, 2010–2017



( ) = negative.

Source: Development Bank of Samoa, Financial Accounts 2010-2017.

Table A.10: Development Bank of Samoa Performance, 2010–2017 *(%)*

Development Bank of Samoa	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	54	59	56	61	67	71	73	72
Loan growth rate		15	(6)	15	43	12	3	(3)
Earning assets/assets	55	59	56	61	68	71	73	72
Equity/assets	42	40	41	37	27	26	27	28
Interest income on loans/ total loans	12	9	9	8	3	6	6	7
Interest expense/interest-bearing liabilities	4	4	4	4	3	3	3	3
Net interest income/earning assets	7	5	5	4	0	3	3	4
Efficiency ratio (expenses/income)	44	52	56	61	88	49	46	42
Short-term funding/total assets	15	14	13	12	8	7	6	5
Long-term notes/total assets	41	45	45	50	64	66	67	66
Retained earnings/total assets	(1)	(2)	(2)	(4)	(6)	(6)	(7)	(7)
Issued capital/total assets	24	22	37	35	27	26	26	26
Proportion of total portfolio classified as nonperforming loans[a]	8	25	21	2	5	19	25	24
Capital adequacy (CET1 ratio)	47	43	39	34	30	25	25	27

( ) = negative, CET1 = common equity tier 1.
[a] Nonperforming loans are those that are 90 days or more past due.
Source: Development Bank of Samoa, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to Development Bank of Samoa management.

DBS relies on term borrowings to fund 66% of its operations. These are sourced from the Central Bank of Samoa (70%), Samoa National Provident Fund (14%), and multilateral donors (16%). Over the 2010–2017 period, the cost of these funds averaged 3% per year. Interest income on loans, during the same period, has declined from a high of 12% in 2010 to 7% in 2017. This erosion, exacerbated by the rising level of nonperforming loans (NPLs), has brought DBS to a precarious position. In its current form, DBS cannot operate sustainably. Continued reliance on government funding, coupled with a requirement to underprice risk, is likely to erode the remaining equity base.

DBS has maintained capital adequacy levels in line with CBS requirements (25% of risk-weighted assets), although deteriorating asset quality has reduced the CET1 ratio from 47% in 2010 to 27% in 2017.

Core Challenges and Opportunities

DBS is facing increased competition from commercial banks, a large NPL portfolio, and a funding base which is almost entirely dependent on the government. The government's continued reliance on DBS to implement concessional funding programs that represent an unfunded CSO for DBS has eroded its profitability and credit assessment capacity. The impact of unfunded CSOs can be seen throughout Samoa's SOE portfolio, which has consistently underperformed against the 7% ROE target of the Ministry of Public Enterprises. DBS could play a role in Samoa's finance sector, but if this role is to be both sustainable and non-distortionary, it will require financial restructuring, loan pricing which fully reflects risks, and a review of the way in which the government seeks to provide concessional finance. This means more transparency and adherence to the Public Bodies Accountability Act in the administration of community service obligations, and the possible entry of new shareholders that could bring capital and increased focus on commercial operations.

Samoa's ongoing finance sector reforms are expanding the use of movable property as collateral and reducing the need for government risk-sharing. DBS could be at the forefront of implementing these new forms of lending, which could address the ongoing financing needs of the agriculture sector, in keeping with its development mandate. Several pilots are currently under development and could help DBS to build up its portfolio of agribusiness loans.

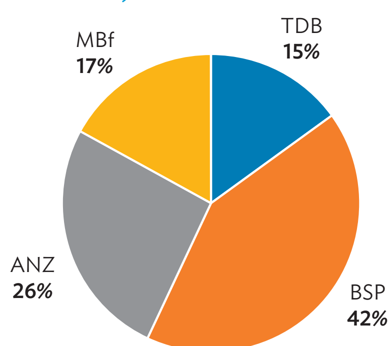
H. TONGA

1. Finance Sector Composition

The Tonga finance sector is composed of a range of banking and nonbanking financial institutions including retirement funds, credit unions, cooperative societies, credit institutions, money lenders, foreign exchange dealers, microfinance providers, and investment companies. Tonga's central bank, the National Reserve Bank of Tonga (NRBT), is responsible for the licensing and supervision of all financial institutions. The value of credit to the private sector as a percentage of GDP was 41% in 2017. This falls in the midrange of the 10 countries participating in this survey.

The Tonga Development Bank (TDB) is one of four licensed commercial banks, together with ANZ, Bank South Pacific, and MBf Bank. In June 2018, TDB represented an estimated 15% of total banking sector credit (Figure A.44).[68]

Figure A.44: Tonga Banking Sector Credit, 2018
(total: T$428 million)



ANZ = Australia and New Zealand Banking Group, BSP = Bank South Pacific, MBf = MBf Bank, TDB = Tonga Development Bank.
Source: Reserve Bank of Tonga.

2. Tonga Development Bank

The Tonga Development Bank was established in 1977 under the Tonga Development Act (Cap. 106), and incorporated as a commercial bank in 2014 under a new Tonga Development Bank Act, which repealed the previous TDB Act. TDB is registered as a company under the Companies Act 1995, and is a licensed banking institution under the Financial Institutions Act 2004. TDB complies with the prudential guidelines issued by the National Reserve Bank of Tonga,[69] and is also subject to the Public Enterprise Act 2002, the Public Enterprise Amendment Act 2010, and the Financial Institutions Act 2004. While TDB is currently monitored by the Ministry of Public Enterprises, as is the case with all public enterprises, a 2019 amendment to the TDB Act will transfer oversight responsibility for the bank to the minister of finance, who holds 100% of its shares.[70]

The TDB Act mandates the bank to "promote the social and economic development of the people and enterprises in Tonga through loans, savings, investments and advisory services which are provided on sound professional banking principles and ensuring such loans are repaid." Over the past decade, the government has viewed TDB as an increasingly critical part of Tonga's finance sector, and a safeguard against the possible retreat of foreign-owned banks.

The new amendment to the TDB Act will bring the director appointment process in line with commercial banking practices, where directors are appointed by shareholders. Prior to this amendment, directors were appointed by the minister of public enterprises, with the approval of cabinet.. As of the first quarter of 2019, the board was composed of four directors, one of which was independent (footnote 26). The bank has a formal director performance appraisal process, and a corporate governance code of practice. The bank publishes a business plan before the commencement of each financial year, as well as annual and half-yearly reports. The annual reports are available on its website.

Loan Portfolio

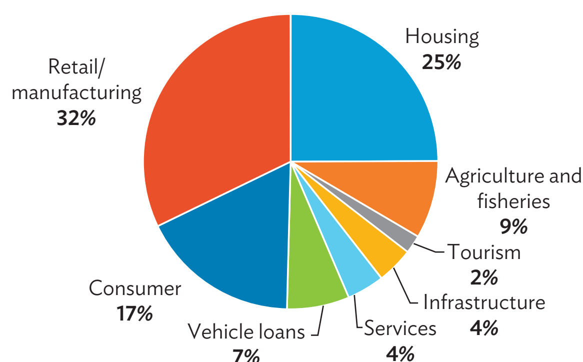
TDB's loan portfolio is diversified, with the majority of its credit allocated to retail/manufacturing, housing, and consumer loans (Figure A.45). The bank competes with other commercial lenders in almost all of its market segments, and with the Retirement Fund Board for some consumer loans. TDB is the only commercial bank that lends to the agriculture and fisheries sectors. Some of these loans include a partial subsidy component under the Government Development Loan Program. In June 2017, 34% of TDB's credit outstanding was to large corporate borrowers, due in part to one large loan that exceeded the NRBT's single borrower limit of 25% of its capital base (Figure A.46).

[68] TDB's financial year close is 30 June.

[69] The NRBT requires TDB to: (i) hold the minimum level of regulatory capital and (ii) maintain a ratio of total regulatory capital to the risk-weighted asset at or above the agreed minimum of 18%.

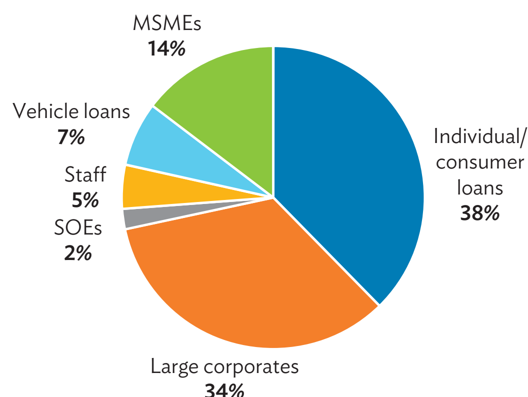
[70] Proposed amendments to the TDB Act are expected to be submitted to Parliament in the first quarter of 2019; at present, the minister of finance is acting as the responsible minister for TDB in anticipation of this amendment.

Figure A.45: Tonga Development Bank Loan Portfolio by Sector, 2017 (total: T$62.8 million)



Source: Responses to questionnaire sent by the Asian Development Bank to Tonga Development Bank management.

Figure A.46: Tonga Development Bank Loan Portfolio by Client Size, 2017

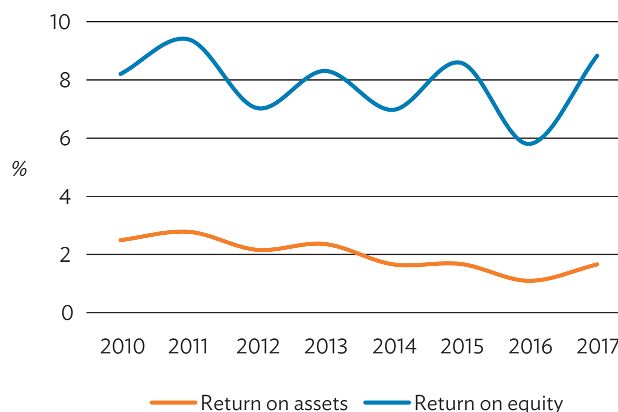


MSMEs = micro, small, and medium-sized enterprises, SOEs = state-owned enterprises.
Source: Responses to questionnaire sent by the Asian Development Bank to Tonga Development Bank management.

Financial Performance

The profitability of TDB, which averaged 2.1% ROA over the 2010-2017 period, was the highest of the 6 commercial banks in our sample, despite a steady decline from 2011 to 2017 (Figure A.47). Net interest income has been under pressure, and growth in operating expenses has outpaced revenue. The bank's loan/ asset ratio declined by 33% from 2010 to 2018, as competition intensified, it transitioned to its commercial license, and noninterest-bearing cash balances increased from

Figure A.47: Tonga Development Bank Profitability, 2010–2018



Source: Tonga Development Bank, Financial Accounts 2010-2017.

2% to 35% of total assets. Since 2016, TDB has been required to keep a minimum of 10% of its total assets in a noninterest-bearing account with the NRBT. In 2018, it relied on promissory notes (45%),[71] demand deposits (29%), and multilateral donors (2%) to fund its operations. In September 2018, the National Retirement Benefit Fund board converted T$7.5 million of TDB promissory notes into a 15% equity stake. The ratio of expenses-to-income rose from 49% to 55% between 2010 and 2018 (Table A.11), yet remained in the lower range among the development banks in this survey. TDB operates eight branches throughout the country, more than any other commercial bank.

TDB maintained high capital adequacy levels from 2010 to 2018, far exceeding the 18% minimum set by the NRBT. This has been driven by TDB surpassing the single borrower limit in 2016, which triggered a government guarantee for the amount of the loan that exceeded TDB's single borrower limit.

In 2017, TDB began a capital restructuring program, which included converting promissory notes and retained earnings to equity, with the aim of improving TDB's competitiveness.

Nonperforming loans fluctuated between 3% and 6% from 2012 to 2018, and remained low compared with other development banks in this survey. In 2018, 36% of its total loans outstanding had been restructured, up from 27% in 2017 mainly due to a 3-month moratorium on loan repayments after Tropical Cyclone Gita hit Tonga in February 2018.

[71] The stake held by the National Retirement Benefit Fund Board represented 24% (T$15 million) of the T$62 million in promissory notes issued by TDB as of 30 June 2018.

Relationship with the Government

TDB receives an annual payment from the government to support the operation of two of its remote branches in the Niuas Islands, a service that is considered a Government Policy Obligation under the Tonga Public Enterprise Act. The government also requires TDB to manage its Government Development Loan (GDL) program, which provides funds for subsidized loans to targeted sectors (e.g. agriculture, fisheries, and tourism). In 2018, GDL loans represented 7.5% of TDB's total loan portfolio.[72] The GDL implementation agreement requires the government to pay an administration fee of 6.5% of disbursements, a fee which TDB considers insufficient to cover the costs of implementing the program. Moreover, GDL funding has the effect of crowding out TDB's own loans to these clients, as many GDL borrowers also borrow from TDB once they reach the credit limit in the GDL program.[73]

Core Challenges and Opportunities

TDB is facing increased competition from commercial banks for loans, and has struggled to generate income from its growing asset base. Since 2014, it has maintained large, noninterest-bearing cash balances which have eroded its profitability. Its experience in the agriculture and fisheries sectors, and in the use of new credit products secured with movable property, could create excellent opportunities for growth in these sectors, including horticulture. TDB has a successful pilot lending program for vanilla growers that has a good potential for replication and expansion, demonstrating that TDB can sustainably take on risks that other commercial banks are unwilling to take. As is the case with most of the development banks in this survey, its future sustainability depends on its ability to operate commercially and price risk accordingly. This will require ongoing skills development and full independence from political influence over credit decisions. Subsidized loan programs such as the GDL, if they are to be maintained, should be implemented according to the Government Policy Obligation rules,[74] ensuring that the full costs of administration are covered, including the costs of capital. In the future, other banks could be invited to participate in the program.

Table A.11: Tonga Development Bank Performance, 2010–2018 (%)

Tonga Development Bank	2010	2011	2012	2013	2014	2016[a]	2017	2018
Outstanding loans/assets	64	63	66	65	58	47	45	43
Loan growth rate		6	4	12	8	4	16	6
Earning assets/assets	80	80	80	75	63	55	51	50
Equity/assets	30	30	31	28	24	19	19	19
Interest income on loans/ total loans	13	12	11	10	10	14	9	9
Interest expense/interest-bearing liabilities	5	4	3	3	2	4	3	2
Net interest income/earning assets	6	6	7	6	6	7	4	4
Efficiency ratio (expenses/income)	49	50	54	53	50	59	60	55
Deposits/total assets	10	10	11	13	13	19	23	29
Short-term funding/total assets[b]	46	46	43	45	52	50	47	45
Long-term notes/total assets	8	8	8	6	5	3	2	2
Retained earnings/total assets	12	13	14	13	7	6	6	7
Issued capital/total assets	18	17	17	15	16	13	11	10
Percentage of total portfolio classified as nonperforming loans[c]	–	–	3	6	3	6	5	3
Capital adequacy (CET1 ratio)	48	47	47	43	41	43	38	40

– = not available, CET1 = common equity tier 1.

[a] Figures are for 18 months as Tonga Development Bank changed its fiscal year between 2015–2016.

[b] Includes all promissory notes (short and long term)

[c] Nonperforming loans are those that are 90 days or more past due.

Sources: Tonga Development Bank, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to Tonga Development Bank management.

72 The GDL is managed as a revolving credit line, with up to T$14 million available for lending.

73 The GDL program provides loans at either 1% or 4% interest rate to a range of sectors, capped at between T$10,000 and T$200,000, and depending on the sector, the maximum term ranges from 1 year to 4 years.

74 As specified in the Public Enterprise Act 2007 and Public Enterprise Amendment Act No. 40 of 2010.

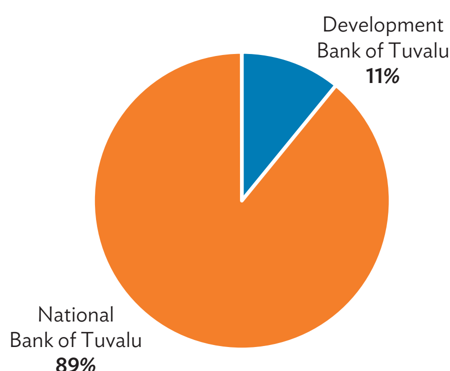
I. TUVALU

1. Finance Sector Composition

Tuvalu's finance sector is the only one in this survey to be composed solely of government-owned institutions: two banks—the National Bank of Tuvalu, and the Development Bank of Tuvalu (DBT)—and a pension fund, the Tuvalu National Provident Fund. DBT is the smaller of the two banks, holding an 11% market share of total loans outstanding in 2017 (Figure A.48). The Banking Commission Act of 2011 calls for DBT to be regulated by the Banking Commission. However, as this institution has yet to be staffed, DBT is submitting quarterly reports to the minister of finance, who has been delegated the powers of the Banking Commission. Prudential regulations have yet to be established for the banking sector.

Credit to the private sector is estimated at 20% of GDP, one of the lowest rates in the Pacific. Bank lending is constrained by high levels of nonperforming loans (NPLs) accumulated through weak risk assessment practices. At end-2017, NPLs constituted 41% of total banking sector loans, primarily to the Tuvalu Electricity Corporation, as well as impaired housing loans.[75]

Figure A.48: Tuvalu Banking Sector Credit, 2017 (total: $12 million)



Source: International Monetary Fund. 2018. Tuvalu: 2018 Article IV Consultation. *Country Report No. 18/209.* Washington, DC.

2. Development Bank of Tuvalu

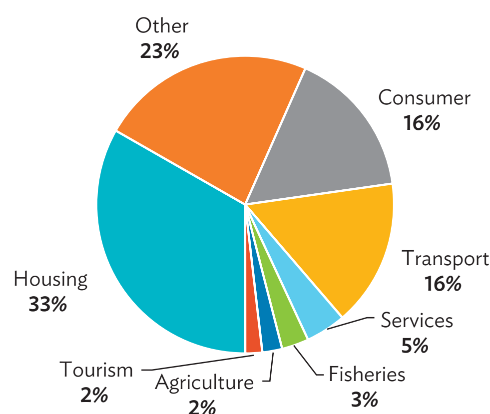
The Development Bank of Tuvalu was established through the Development Bank of Tuvalu Act 2008. Its functions are to "provide finance by making loans for the long-term economic and social development of Tuvalu, in accordance with government plans, programmes, strategies, and priorities."[76] In carrying out its duties and functions under its enabling legislation, DBT is subject to policy directions in the national interest that may be given to it from time to time by the minister of finance. The European Investment Bank has a 10.46% shareholding in the bank, with the balance owned by the Government of Tuvalu.

The minister of finance appoints the bank's board members and determines the period they will serve. In 2018, there were five directors, all of whom were independent (footnote 26). DBT prepares annual accounts, which are audited by the auditor general but not available online.

Loan Portfolio

DBT's loan portfolio is diversified, with housing loans representing the largest segment at 33%, followed by retail and wholesale at 23%, and transport and consumer lending at 16% each (Figure A.49). Agriculture and fisheries represented only 5% of the portfolio in 2017. Data on the loan portfolio by client size were not available for this study.

Figure A.49: Development Bank of Tuvalu Loan Portfolio by Sector, 2017 (total: A$1.7 million)



Source: Responses to questionnaire sent by the Asian Development Bank to Development Bank of Tuvalu management.

[75] IMF. 2018. Tuvalu: 2018 Article IV Consultation. *IMF Country Report No. 18/209.* Washington, DC.

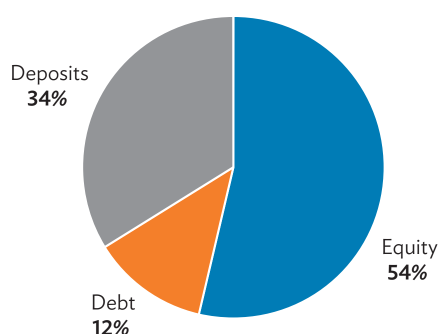
[76] *Development Bank of Tuvalu Act 2008, Part III Section 4.* Tuvalu.

Financial Performance

DBT has struggled with poor profitability, with ROE dropping to -80% in 2012 (Figure A.51). However, since 2015, ROE and ROA has been positive. This is due to a sharp reduction in expenses, while revenue remained flat. For the period 2010–2017, operating income has exceeded operating expenses, although efficiency has been tracking lower due to decreasing revenue from interest income and fees and rising staff costs (Table A.12). The provisions for impaired loans have further driven down profitability. In particular, DBT recorded $1.3 million and $0.6 million in doubtful loan provisions for 2012 and 2014, compared with operating revenue of $0.7 million and $0.5 million respectively.

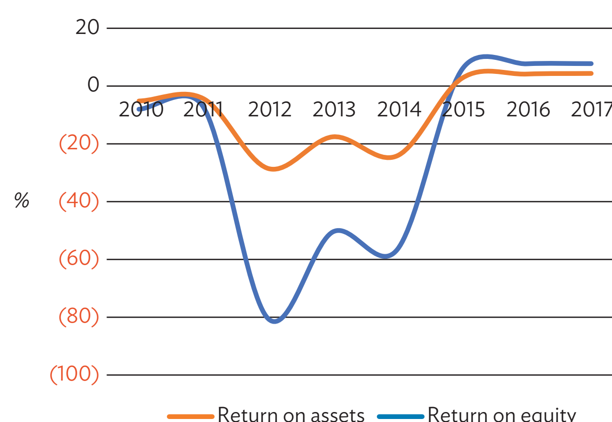
DBT's financial position is weak. While it has diversified its funding base into customer deposits and debt, it is still largely dependent

Figure A.50: Development Bank of Tuvalu Funding Sources, 2010–2017 (average)



Source: Responses to questionnaire sent by the Asian Development Bank to Development Bank of Tuvalu.

Figure A.51: Development Bank of Tuvalu Profitability, 2010–2017



( ) = negative.
Source: Development Bank of Tuvalu, Financial Accounts 2010-2017.

Table A.12: Development Bank of Tuvalu Performance, 2010–2017 (%)

Development Bank of Tuvalu	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	78	76	57	67	58	61	79	72
Loan growth rate		3	(31)	(20)	(17)	1	22	(5)
Earning assets/assets	78	76	57	67	58	61	79	72
Equity/assets	65	60	35	35	43	47	54	56
Interest income on loans/ total loans	12	17	26	21	24	22	10	9
Interest expense/interest-bearing liabilities	6	5	4	6	7	5	4	4
Net interest income/earning assets	9	14	21	16	19	19	8	8
Efficiency ratio (expenses/income)	52	53	61	82	79	69	84	88
Deposits/total assets	16	24	49	40	35	33	30	29
Long-term notes/total assets	18	15	14	21	1	0	9	5
Retained earnings/total assets	(43)	(45)	(77)	(131)	(161)	(164)	(170)	(159)
Issued capital/total assets	107	104	112	166	203	211	224	215
Proportion of total portfolio classified as nonperforming loans[a]	32	35	60	49	54	30	36	34

( ) = negative.
[a] Nonperforming loans are those that are 90 days or more past due.
Source: Development Bank of Tuvalu (DBT), Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to DBT management.

on the government for periodic capital injections. This means that DBT is not well-placed to finance business start-ups or expansions, and its lending growth comes mainly from personal loans. The total loan portfolio classified as nonperforming is high, peaking at 60% in 2012 and at 34% in 2017.

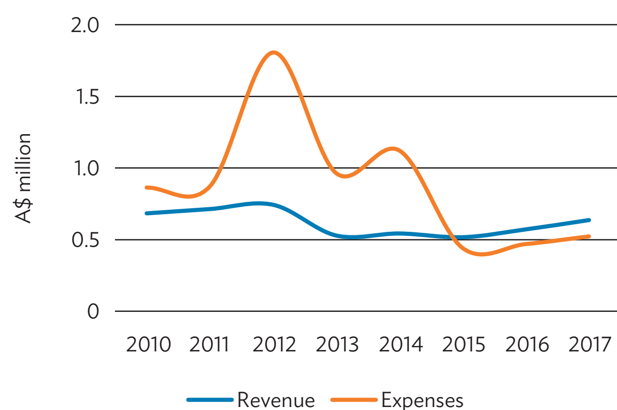
Relationship with the Government

DBT is implementing a loan scheme for low-income people, guaranteed by the government. The total value of loans outstanding is estimated at A$60,000, or 3.5% of DBT's total loan portfolio. DBT reports that the loan scheme is able to generate a commercial return. To support the loan scheme, the government also provides business training to remote areas and grants. The government's need to prudently manage expenditure has restricted its ability to provide capital injections to DBT to improve its financial position. DBT's accumulated losses over the survey period has eroded the government's shareholder equity, which has fallen from A$2.5 million in 2010 to A$1.3 million in 2017.

Core Challenges and Opportunities

There is some competition between the National Bank of Tuvalu and DBT for deposits and personal loans, but to a very limited extent. The Tuvalu National Provident Fund also provides credit to its members. Government ownership of both banks is being reassessed, which appears sensible given the small size of the economy and business base. It is unclear that the market needs both a state-owned development bank and a commercial bank, or that their competition for deposits has a positive impact on the economy. If the banks are to be consolidated, it would need to be preceded by a restructuring of the DBT loan portfolio to reduce its NPL balance and strengthen its risk assessment practices.

Figure A.52: Development Bank of Tuvalu Revenue/ Expenses, 2010–2017



Source: Development Bank of Tuvalu, Financial Accounts 2010-2017.

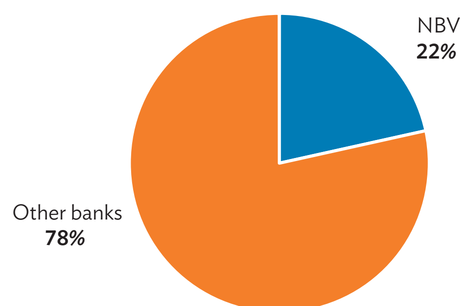
J. VANUATU

1. Finance Sector Composition

There are 13 deposit-taking institutions licensed by the Reserve Bank of Vanuatu (RBV): 5 commercial banks,[77] a credit institution,[78] and 7 banks providing offshore banking services.[79] Vanuatu also has a state-owned Agriculture Development Bank, insurance companies, and a pension fund. The RBV is the monetary authority and regulator of financial institutions in the country, which includes banks, the Vanuatu National Provident Fund, and the Agriculture Development Bank. A second regulator, the Vanuatu Financial Services Commission, regulates credit unions, mutual funds, and incorporated companies, whether domestic or offshore.

The value of private sector credit as a percentage of GDP (67%) is one of the highest in the Pacific. As of December 2017, the National Bank of Vanuatu (NBV) accounted for 22% or about Vt13 billion of total Vt60 billion total domestic private sector credit in Vanuatu (Figure A.53).

Figure A.53: Vanuatu Domestic Credit, 2017
(total: Vt60 billion)



NBV = National Bank of Vanuatu
Source: Reserve Bank of Vanuatu. 2017. *December Quarterly Economic Review.*

77 ANZ, BRED Bank, Bank South Pacific Vanuatu, National Bank of Vanuatu, and Wanfuteng Bank.
78 Credit Corporation Vanuatu.
79 Offshore banks are licensed as financial Institutions to carry out banking business with the exception of checking accounts.

2. The National Bank of Vanuatu

The National Bank of Vanuatu (NBV) was first established in 1989 under the NBV Act Cap 209. In 2012, the NBV Restructuring Act No. 3 was passed, providing for its conversion from a statutory corporation to a company incorporated under the Companies Act Cap 191. The NBV Restructuring Act No. 3 does not outline a specific mandate for the bank. Nevertheless, the bank continues to pursue financial inclusion and development objectives, consistent with the goals of its private and public shareholders.

NBV has a commercial banking license to carry on banking business and operates as a deposit-taking institution. It operates under a well-defined legal framework which includes the Companies Act No. 25 of 2012, the Financial Institutions Act Cap 254, the Reserve Bank of Vanuatu (Amendment) Act No. 35 of 2010, the Anti-Money Laundering and Counter-Terrorism Financing Act No. 13, as well as relevant regulations made under these laws. NBV is one of only three state-owned commercial banks in the Pacific with a diversified share ownership, with the Vanuatu National Provident Fund and the International Finance Corporation of the World Bank each holding 15% of share capital. The bank is supervised by the RBV.

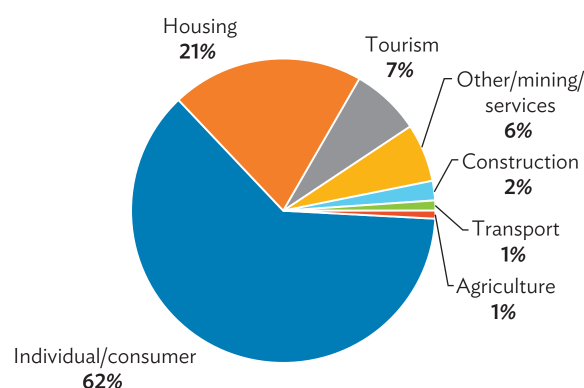
The bank's Articles of Association and the Shareholders Agreement allow the International Finance Corporation and the Vanuatu National Provident Fund to nominate a director each, while the Government of Vanuatu nominates two directors. As of 2018, the board was composed of six directors, three of whom were independent (footnote 26). The bank has a formal policy for director performance reviews and a corporate governance code of practice.

NBV prepares a strategy and business plan each year and provides this plan to all shareholders for required approval. It makes its annual reports available on its website, and its financial statements are prepared and audited in accordance with the provisions of the Vanuatu Companies Act No. 25 and Financial Institutions Act Cap 254. The RBV may require advance copies of the statements and may inspect the books and accounts of the bank. NBV complies with the prudential standards and guidelines issued by the RBV.

Loan Portfolio

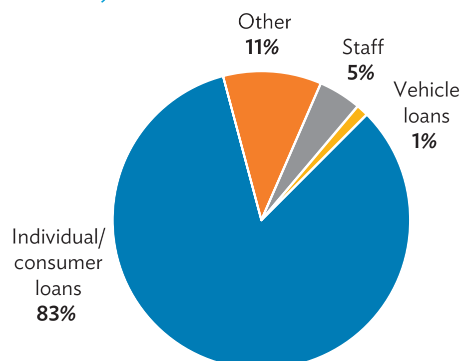
The NBV loan portfolio is heavily weighted in individual/consumer loans, which account for 63% of total loan values, and 83% of loan numbers (Figures A.54 and A.55).[80] The high number of individual and consumer loans is illustrative of the bank's focus on rural banking, and support to microlending in Vanuatu's primary sectors. From 2016 onwards, following the devastating impact of Cyclone Pam in 2015, the percentage of the NBV loan portfolio classified as impaired has been steadily increasing. Rising from a base of about 14% in 2012, the proportion of impaired loans was 31% in December 2017. This compares with an average of 16% nonperforming loans to gross loans ratio for all domestic banks in December 2017.

Figure A.54: National Bank of Vanuatu Loan Portfolio by Sector, 2017 (total: Vt13 billion)



Source: Responses to questionnaire sent by the Asian Development Bank to National Bank of Vanuatu management.

Figure A.55: National Bank of Vanuatu Loan Portfolio by Client Size, 2017



Source: Responses to questionnaire sent by the Asian Development Bank to National Bank of Vanuatu management.

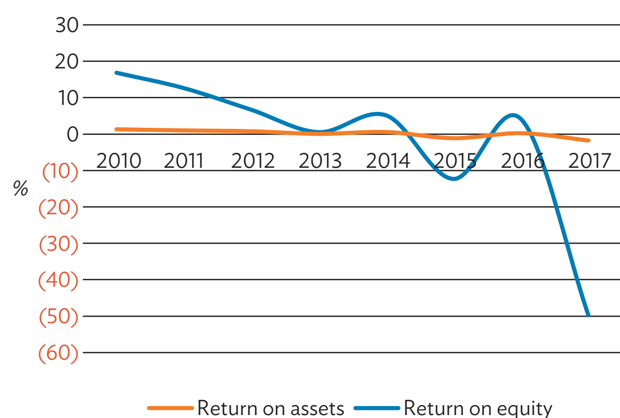
[80] NBV uses the RBV industry codes, which classifies small loans to business owners in the agriculture, transport, or other sectors as individual. Therefore, the data illustrated may not provide the true nature of NBV's loan diversification.

Financial Performance

NBV's profitability, as measured by ROE and ROA, experienced a sharp decline in 2017 (Figure A.56). This was due to significant write-offs reflecting readjusted property values following the 2008 global financial crisis and the impact of Cyclone Pam, which hit the nation in 2015.

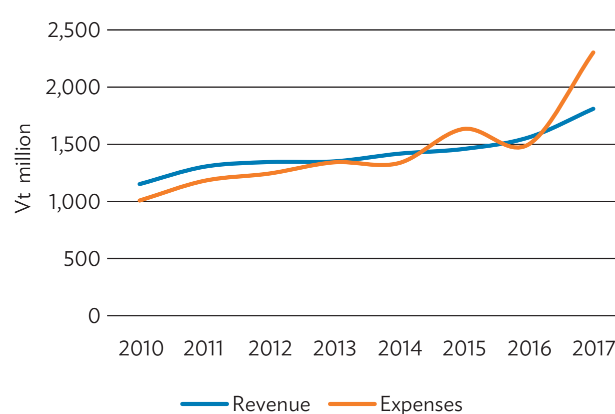
Over the 2010–2017 period, NBV has maintained a comparatively high expense ratio, averaging 73% (Table A.57). This is attributable to its extensive network of 27 branches across all 6 provinces, and investments in financial literacy programs nationwide.[81] It is expected that this investment has provided positive outcomes where ni-Vanuatu around

Figure A.56: National Bank of Vanuatu Profitability, 2010–2017



() = negative.
Source: National Bank of Vanuatu.

Figure A.57: National Bank of Vanuatu Revenue/Expenses, 2010–2017



Source: National Bank of Vanuatu.

Table A.13: National Bank of Vanuatu Performance, 2010–2017 (%)

National Bank of Vanuatu	2010	2011	2012	2013	2014	2015	2016	2017
Outstanding loans/assets	67	69	74	76	72	71	48	46
Loan growth rate		16	13	5	5	6	9	7
Earning assets/assets	71	73	77	79	76	75	50	54
Equity/assets	8	8	12	11	11	9	6	4
Interest income on loans/ total loans	12	12	11	10	10	9	9	10
Interest expense/interest-bearing liabilities	4	4	3	3	3	3	2	2
Net interest income/earning assets	11	11	10	10	10	9	9	8
Efficiency ratio (expenses/income)	58	61	65	76	69	84	69	100
Short-term funding/total assets	1	1	2	2	2	2	1	1
Long-term notes/total assets	0	0	0	0	0	0	0	0
Retained earnings/total assets	2	3	4	4	4	3	2	(0)
Issued capital/total assets	5	5	7	6	6	5	3	3
Proportion of total portfolio classified as nonperforming loans[a]	14	13	14	20	18	24	23	31
Capital adequacy (CET1 ratio)	13	12	15	13	12	11	9	6

() = negative, CET1 = common equity tier 1.
[a] Nonperforming loans are those that are 90 days or more past due.
Source: National Bank of Vanuatu, Financial Accounts 2010-2017; and responses to questionnaire sent by the Asian Development Bank to National Bank of Vanuatu management.

[81] In 2015 and 2017, expenses were inflated by large loan loss charges.

the country are now able to access financial credit and more effectively manage their financial resources.

NBV's funding base is substantially comprised of customer deposits, which accounted for 94% of total assets in 2017. 2016 saw customer deposits grow by 75% from the previous year, as clients participating in the government's passport sale program[82] deposited the required funds with NBV, and a new business client also made a large foreign currency deposit. Customer loans grew only 10% over the same period. The percentage of earning assets has been in decline, from a high of 79% in 2013 to 54% in 2017, eroding profitability. NBV's equity as a percentage of total assets has also been declining since 2012, while risk-weighted assets have increased. Consequently, NBV's capital adequacy ratio has been below RBV's regulatory requirement of 12% since 2015. NBV is currently rebuilding its capital base to meet the requirement and reports healthy profitability in 2018, which will further improve its capital adequacy.

Relationship with the Government

NBV operates as a private commercial bank. It does not implement subsidized lending programs at the direction of the government, or rely on the government for debt financing. Despite its independence from the government, NBV does pursue a development mandate, offering rural banking services and financial literacy programs in regions where these services are not currently profitable.

Core Challenges and Opportunities

NBV's main competitor is BSP, which also operates in rural areas and provides microcredit to ni-Vanuatu engaged in primary sectors. The other two commercial banks, BRED Bank Vanuatu and ANZ, are limited to two branches and do not prioritize rural banking operations. The rise in impaired loans remain a core challenge for NBV, and the bank is taking proactive steps to recover and restructure these loans. NBV will need to rebuild its capital base to meet the RBV's regulatory requirements, which will require improved profitability and possible further diversification of ownership. NBV remains committed to its strategy to target lending to rural customers, who have an excellent loan servicing rate,[83] despite the high cost of servicing these clients.

[82] Since 2015, Vanuatu has offered honorary citizenship to people willing to pay a $165,000 application fee.

[83] Average arrears rate for rural loans was 4% in 2017.

Finding Balance 2019
Benchmarking the Performance of State-Owned Banks in the Pacific

This report profiles the roles, performance, market context, and regulatory frameworks of 13 state-owned banks in 10 Pacific countries. A key finding is the considerable business financing gap in the region, particularly for small-medium enterprises and sectors such as agriculture and fisheries. The report suggests that state-owned banks could address this demand, but would need to do so on commercial terms and without distorting local markets. These institutions would need to strengthen their balance sheets and risk assessment practices and operate under the same market disciplines as private banks.

Finding Balance 2019 is the sixth comparative study of state-owned enterprises in the Pacific and the first to focus on the banking sector.

About the Asian Development Bank

ADB is committed to achieving a prosperous, inclusive, resilient, and sustainable Asia and the Pacific, while sustaining its efforts to eradicate extreme poverty. Established in 1966, it is owned by 68 members —49 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

About the Pacific Private Sector Development Initiative

Finding Balance 2019 was produced by the Pacific Private Sector Development Initiative, a technical assistance program undertaken in partnership with the Government of Australia, the Government of New Zealand, and the Asian Development Bank. PSDI supports ADB's 15 Pacific developing member countries to improve the enabling environment for business and to support inclusive, private-sector led economic growth. The support of the Australian and New Zealand governments and ADB has enabled PSDI to operate in the region for 13 years and assist with 300 reforms.

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