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Vanuatu: Selected Issues

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VANUATU

Selected Issues

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Approved by the Asia and Pacific Department

February 9, 2007

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I. WHY HAS VANUATU'S GROWTH PERFORMANCE BEEN HISTORICALLY WEAK?[1]

A. Introduction

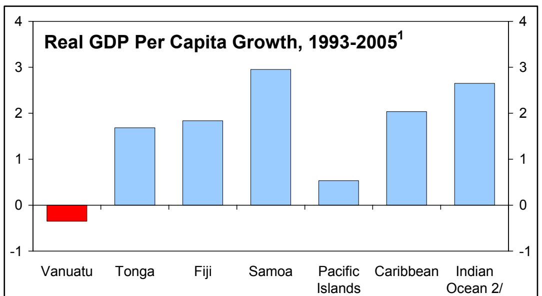
1. **Vanuatu's growth performance until very recently has been weak, despite preconditions for growth and substantial aid to the country.** Vanuatu fulfills many of the theoretical conditions for higher growth, in particular a wealth of natural resources, and growth opportunities in agriculture, fisheries, and tourism. The society is more homogeneous than in Papua New Guinea, Solomon Islands, and Fiji. There is currently less urban poverty and its associated problems than in many other island countries. Yet despite a relatively stable stream of aid flows, real income per capita has been falling for most of the past decade and remains at a level below that in 1990.

2. **This paper focuses on the reasons for the historically weak performance.** Among the key factors, growth has been hindered by substantial barriers to private sector development.[2] Impediments include political uncertainty, high costs of doing business, poor and costly infrastructure, incomplete secured transactions framework, and weak land and property rights. Although these problems are not uncommon in the Pacific island region, Vanuatu's progress in these structural reforms has been particularly slow, deterring foreign investment and reducing external competitiveness.

3. **The paper also discusses policies to achieve higher growth on a sustained basis.** Measures should focus on reducing the high costs of business operations; upgrading and maintaining infrastructure; strengthening the regulation of utility monopolies; improving the legal framework to allow for a wider range of securitization and more efficient debt collection; and reforming the land tenure system to ensure transparent, fair and enforced property rights.

B. Barriers to Private Sector Development

4. **Vanuatu's growth performance has been particularly poor compared to other Pacific island countries.** In the past decade, real GDP growth averaged only 2 percent, while relatively rapid population growth led to a decline in per capita terms. Average growth of real GDP per capita was negative, compared to small positive growth for the Pacific island countries as a whole, and good growth performances in the island economies



Sources: IMF, WEO database; and IMF staff calculations.
[1] Simple average.
[2] Maldives, Mauritius and Seychelles.

[1] Prepared by Varapat Chensavasdijai.

[2] See Browne and Lee (2006) for a discussion of impediments to private sector growth in the Pacific islands.

of the Caribbean and the Indian Ocean. As a result, Vanuatu's GDP per capita of $1,560 in 2004 was only one-half of Fiji's and one-fourth of the Caribbean average. At the same time, the country's standard of living remains below many of its neighbors. In 2006, Vanuatu ranked 119th out of 177 countries on the United Nations Human Development Index (HDI), among the lowest of the Pacific island countries.[3] Other social indicators such as infant mortality, adult literacy, and secondary school enrollment also reveal poorer conditions of health and education.

Social Indicators, 2004

	Fiji	Samoa	Tonga	Vanuatu
Life expectancy at birth (years)	68	70	73	69
Fertility rate (births per woman)	2.8	4.0	3.4	4.0
Mortality rate (infant, per thousand live births)	16	25	20	32
Mortality rate (under 5, per thousand live births)	20	30	25	40
Measles immunization rate (percent, ages 12-23 months)	62	25	99	48
Adult literacy rate (percent, 2004 or most recent year)	89	98	99	74
Gross enrollment ratio (percent of school age population)				
Primary	106	100	115	118
Secondary	88	80	98	41
Tertiary	15	…	6	5

Sources: World Bank, *World Development Indicators* (2006); and UNDP, *Human Development Report* (2006).

5. **Political uncertainties have retarded structural reforms.** Beginning in the early 1990s, Vanuatu has witnessed a series of short-lived coalition governments, comprising numerous parties and involving frequent changes of ministers. There have been eleven governments in power since 1990, with most lasting only about one year. This constant turnover has delayed reforms as coordination of policies and obtaining consensus for needed reforms have proved difficult. Indeed, Chand (2002) and Henckel (2006) conclude that the Comprehensive Reform Program (CRP), which was launched by the Vanuatu government in 1997 to address structural weaknesses in the economy, has had limited success. Moreover, political instability and the associated changes in government policy have deterred potential investors, lowered the quality of public service, and eroded governance standards (Sugden and Tevi, 2004).

Political Environment, 1990–2006

	Change in number of governments	Change in number of governing parties
Fiji	3	4
Papua New Guinea	6	6
Samoa	2	0
Solomon Islands	5	6
Vanuatu	11	5

Source: World Bank, The Database of Political Institutions.

[3] Only Solomon Islands and Papua New Guinea rank behind Vanuatu in the Pacific region.

6. **Firms are faced with high costs of doing business.** According to the World Bank's Doing Business Report, in 2006 Vanuatu ranked 58th out of 175 countries in terms of the ease of doing business, below Fiji, Samoa and Tonga. Compared to its Pacific island neighbors and the East Asia and Pacific region, Vanuatu's costs of business startups and contract enforcement were higher, property registration more time-consuming, and access to credit more difficult. Hughes and Sodhi (2006) cite high company registry costs and cumbersome regulations for obtaining permits for investment and foreign workers as additional business costs. Chand (2002) points to shortages of skilled labor as another constraint. These factors discourage new firms from entering the market and make Vanuatu a less attractive place for private investment.

Competitiveness Indicators

	Fiji	Samoa	Tonga	Vanuatu	East Asia and Pacific
Ease of doing business (rank)	31	41	51	58	
Starting a business					
Procedures (number)	8	9	4	8	8
Time (days)	46	35	32	39	46
Cost (percent of income per capita)	26	46	10	61	43
Registering property					
Procedures (number)	3	5	4	2	4
Time (days)	48	147	108	188	86
Cost (percent of property value)	12	2	10	7	4
Obtaining credit					
Legal rights index[1]	7	7	5	5	5
Credit information index[2]	4	0	0	0	2
Enforcing contracts					
Procedures (number)	26	30	30	24	32
Time (days)	397	455	510	430	477
Cost (percent of debt)	62	15	47	64	53

Source: World Bank, *Doing Business Report* (2006).

[1] Index ranges from 0-10, with higher scores indicating better laws designed to expand access to credit.

[2] Index ranges from 0-10, with higher scores indicating more available credit information from public registry or private bureau.

7. **Infrastructure is weak and expensive.** The cost of electricity, telecommunication, and transportation remains high by regional standards, while sanitation and water supply are inadequate. Physical infrastructure, including roads, bridges, ports and airports, is in poor condition. Understandably, one of the main reasons for the limited access to and high cost of services is Vanuatu's larger geographic spread compared with Samoa and Tonga, for example, which makes it harder to exploit scale economies or generate effective

competition.[4] At the same time, Vanuatu faces inadequate government provision of public services outside of the capital and especially to the outer islands, which partly reflects the high public sector wage bill crowding out spending on new infrastructure and maintenance. This problem, as noted by Henckel (2006) and highlighted in the Asian Development Bank's (AsDB) report (2003), is compounded by long-term monopoly concessions given to utility providers who are poorly regulated, resulting very high costs for utility services. In the case of electricity, UNELCO has a 40-year concession as the sole power supplier for Vanuatu's two largest cities. In addition, competition in transportation services is still limited, resulting in expensive air fares which hamper tourism activity.

Structural Indicators

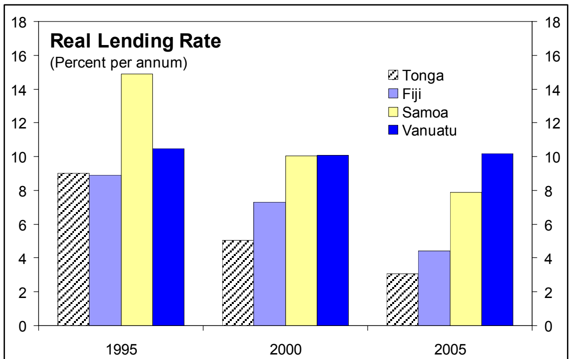
	Fiji	Samoa	Tonga	Vanuatu
Paved roads (in percent of total roads) (2000)	49	42	27	24
Aircraft departures (2004)	45,669	10,538	1,336	1,477
Telephone mainlines per 100 residents (2005)	12	7	11	3
Mobile phone subscribers per 100 residents (2005)	17	13	16	6
Cost of three-minute call to U.S., U.S. dollars (2004)	3	1	1	7
Electricity costs, U.S. dollars per kwh (2003)	0.16	0.18	0.31	0.26
Electricity consumption per capita, kwh (2004)	904	547	374	189
Improved sanitation facilities (percent of population with access)	72	100	96	50
Improved water facilities (percent of population with access)	47	88	100	60

Sources: Vanuatu authorities; Energy Information Administration; International Telecommunication Union, *World Telecommunication Development Report* (2006); and World Bank, *World Development Indicators* (2006).

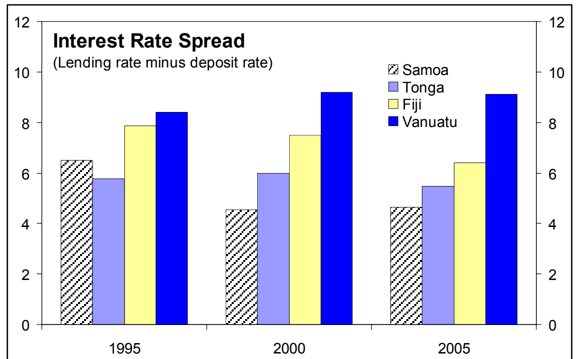
8. **The legal framework for secured transactions is incomplete.** According to the AsDB (2003), the legal system does not allow for property—fixed or moveable—to be used as collateral for loans, particularly outside of Port Vila (the capital) and Luganville (the second largest city). Thus borrowers can neither purchase property on credit nor obtain loans against their own assets. This accounts for the high borrowing costs—higher interest rates, smaller loans offered, and loans of shorter maturity—which limit the private sector's access to credit and entrepreneurship. Indeed, real lending rates have remained at around ten percent during the past decade, while those in other neighboring Pacific island countries have declined substantially and are now lower than in Vanuatu. In addition, wider interest rate spreads reflect higher cost of financial intermediation associated with greater risk perception by lenders (Chand, 2002). Finally, current laws do not support an efficient system of debt

[4] Vanuatu's population of 220,000 is dispersed over 80 islands, covering an area of about 12,000 square kilometers, much larger than Samoa's 2,800 square kilometers and Tonga's 750 square kilometers.

collection in the event of default by debtors, with considerable time and costs entailed in the resolution of legal cases, particularly those involving real estate.[5]



Sources: IMF, IFS database.



Sources: IMF, IFS database.

9. **Land and property rights are weak.** Land-sharing arrangements enshrined in the Constitution make it difficult to use land as security for borrowing and for productive investment opportunities, and often give rise to ownership disputes. About 97 percent of land is under customary tenure, with the exception of Port Vila and Luganville where most of the land is legally owned and leased for up to 75 years by the government and some is privately owned. Income-earning opportunities are forgone for 80 percent of the population who lives in the rural areas where land cannot be used for agricultural and other development. Moreover, since land generally does not have clearly mapped boundaries and is not registered and titled, disputes over ownership among competing custom owners are common. The uncertainty surrounding land tenure rights is a major concern for foreign investors as well as local businesses, particularly in cases involving customary-owned land.

C. What Can Be Done to Improve Vanuatu's Growth Prospects?

10. **Moving forward, a series of reforms can be taken to improve the private sector environment and increase competitiveness.** Aid alone has not succeeded in improving the growth performance, despite Vanuatu's position as one of the largest aid recipients of the Pacific island countries (Box I.1). For aid to become more effective in boosting growth, it needs to be accompanied by several key reforms to promote private sector development.

11. **Infrastructure needs to be upgraded and maintained.** The U.S. Millennium Challenge Account is an important source of funding for the expansion and upgrading of road networks and bridges as well as other infrastructure over the next several years. For this to have a lasting effect, it will be essential to ensure that both existing and new facilities are well maintained so that the benefits to the poor, rural population and the tourism industry are sustained.

[5] According to the AsDB (2006), there is no bankruptcy law in Vanuatu and the UK Bankruptcy Act (1914) is used as a guideline for dealing with insolvent businesses.

12. **The cost of basic service provision could be reduced by strengthening the regulation of utility monopolies.** This will help to lower utility prices, improve the quality of services, and increase access to basic services, particularly for low-income segments of the population (Sugden and Tevi, 2004). The expected reduction in the costs of inputs will also make businesses more competitive. The World Bank, with the support of AusAID, is currently providing technical assistance in setting up a Utilities Regulation Authority (URA), an independent regulatory body that will exercise oversight over monopoly service providers in the telecommunications, electricity and water sectors.

13. **Some limited progress has been made in promoting competition in utilities and transportation.** In 2006, a second telecommunication license was granted, removing the monopoly position of Telecom Vanuatu Limited (TVL). However, TVL, which is one-third owned by the government, still has exclusive rights to domestic and international phone services until 2012. Competition among telecom providers needs to be increased and, once in place, the URA could ensure fair pricing of telephone services. In the transportation sector, international shippers have been allowed to supply some inter-island services, while Pacific Blue, a wholly owned subsidiary of Australia-based Virgin Blue, began providing international flights from Australia from September 2004, bringing an important element of competition to Air Vanuatu, the state-owned national airline. The government could enhance air transportation services by improving the poorly-performing Air Vanuatu through restructuring, possibly including divestiture. Samoa's recent sale of 49 percent of the state-owned Polynesian Airline to Virgin Blue provides a good example. The new joint-venture airline, Polynesian Blue, which started operations in October 2005, has recorded profits, reduced the cost of travel to Samoa, and boosted tourism.

14. **The secured transactions framework should be improved.** The legal framework should allow for a wider range of securitization, including the use of moveable and intangible assets as collateral, and more efficient debt collection. According to the AsDB (2003), the essential elements of an efficient secured transactions system include; (i) laws providing for the creation of enforceable security interest against both tangible and intangible assets (for example, by permitting lease rights as collateral for loans); (ii) low costs of creating and enforcing the security interest relative to the value of the asset; and (iii) clear priority on creditor claims against assets serving as collateral in the event of default by the debtor. A framework with these features will not only improve investment opportunities by increasing entrepreneurs' access to credit and creating a more certain and less costly environment in which borrowers and lenders can operate, but will also foster financial market development.

15. **Reforming the land tenure system is required to release land for productive uses.** Following the recommendations by the AsDB (2003), key reforms include: (i) introducing a more secured and less expensive system of land registration, which will help to identify the rightful claimants to each piece of land; (ii) putting in place a clear, transparent and systematic legal framework for the transferability and use of land and land tenure rights such as land leases; and (iii) designing an efficient mechanism for resolving land disputes based on local practice, given that land disputes are settled locally in Vanuatu. These steps will allow the transfer of rights to property while ensuring that these rights are transparent, fair

and enforced. Coupled with a better secured transactions framework, land reforms will provide more access to land, while reducing borrowing costs and increasing access to capital, which will help reduce the cost of doing business in Vanuatu.

Box I.1. Aid Effectiveness in Vanuatu

Vanuatu is among the highest aid recipients of the Pacific island countries. Aid flows to Vanuatu have been relatively stable, averaging close to $40 million per year ($220 on a per capita basis) during the past fifteen years. Australia has been the largest bilateral donor, accounting for 30 percent of total aid flows since 1990, and up to 50 percent in the last five years, with priority given to economic reform and governance, and education and health. France, New Zealand and Japan are also important donors, together comprising 40 percent of aid flows. The United States has recently increased its prominence in Vanuatu, with the Millennium Challenge Account expected to contribute up to $66 million over the next five years for infrastructure projects.

Average Annual Aid Flows and Real GDP Growth

	1990–99			2000–05		
	Aid flows (In millions of U.S. dollars)	Aid flows (U.S. dollars per capita)	Real GDP growth (per capita)	Aid flows (In millions of U.S. dollars)	Aid flows (U.S. dollars per capita)	Real GDP growth (per capita)
Fiji	47	62	2.3	45	53	1.2
Kiribati	18	110	1.6	19	107	2.7
Samoa	42	255	1.6	36	203	2.7
Solomon Islands	45	122	1.5	89	194	-3.6
Tonga	28	290	1.2	23	230	2.6
Vanuatu	40	246	1.5	36	175	-1.7

Sources: OECD; and IMF, WEO database.

Despite receiving significant financial aid, Vanuatu's growth performance has been poor. Average real GDP growth per capita was only 1½ percent in the 1990s and became negative in the first half of this decade, comparable to the Solomon Islands but in stark contrast to Samoa which received similar amounts of aid per capita but achieved impressive growth throughout the period. In addition, Vanuatu lags other countries in the Pacific region in terms of social development and is still some way toward achieving the UN Millennium Development Goals.

Some argue that the realignment of donors' priorities may have limited the effectiveness of aid. Sugden and Tevi (2004) point out that the shift in donors' strategy from infrastructure and agricultural development to governance in the 1990s may have reduced direct support to the rural population. According to this argument, as the CRP shifted emphasis to improving public sector efficiency and governance, funding for basic service delivery was limited. In the end, donors subsequently curtailed funding for the CRP due to the slow implementation of economic reforms (Hughes and Sodhi, 2006).

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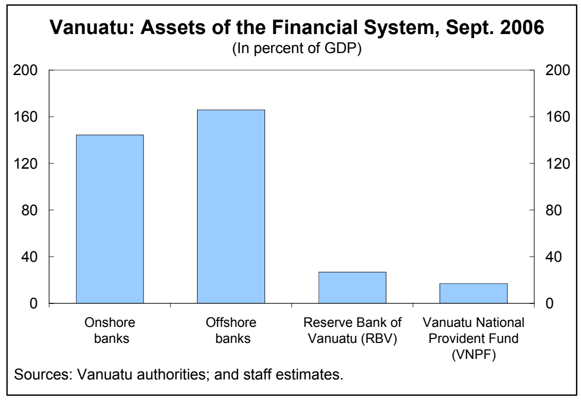
II. Vanuatu's Financial Sector[6]

A. Introduction

16. **Vanuatu has long had a dual financial system with onshore and offshore activities.** The domestic financial system consists of three commercial banks and a nonbank system which includes the Vanuatu National Provident Fund, insurance companies and microfinance schemes. Among the three banks, two are Australia-owned and one is government-owned, with all providing similar retail and commercial services. The dominant bank has a 50 percent market share, and the other foreign bank has a share of about one-third. The government-owned National Bank of Vanuatu maintains the largest branch network throughout the country. The offshore banks are mostly simple investment banks managing the funds of private clients. Supervision of the offshore sector has been strengthened greatly in recent years.



17. **Vanuatu's financial sector has undergone a number of important changes in recent years which have improved financial soundness.** This chapter describes recent developments in the financial system and discusses financial sector priorities going forward:

- Progress has been made on *financial sector supervision* for both onshore and offshore sectors, although staffing concerns remain a barrier to full implementation.

- *Microfinance* has made a good start, but it remains small and needs time to expand its reach to the agriculture sector and rural areas.

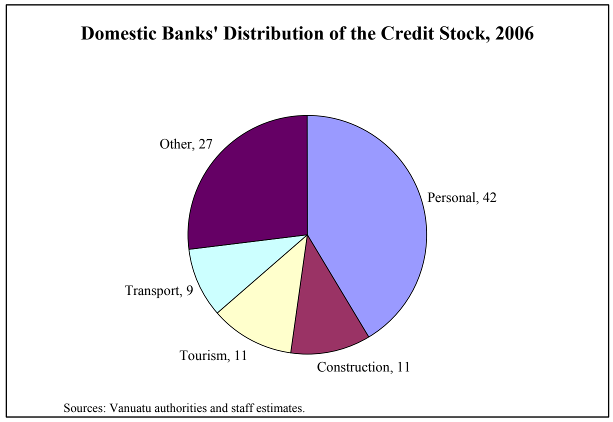
- The proposed establishment of the *Vanuatu Agriculture Development Bank* raises a number of concerns, given the experience of Vanuatu's former development bank, as well as cross-country experiences with similar banks in the Pacific region.

- *AML/CFT infrastructure* and legislation of *insurance supervision* are now in place, but implementation in both areas is lagging.

[6] Prepared by Shinichi Nakabayashi.

B. Domestic Commercial Banks and Vanuatu National Provident Fund

Domestic Commercial Banks



18. **The commercial banks serve a broad range of customers from micro-business persons to high net worth clients.** Their main business activity is for nonresidents, to whom they provide transaction services for trust accounts and property purchases, with foreign currency deposits representing 60 percent of total deposits in the domestic banking sector. Foreign currency assets are a similar share of total assets, with little currency mismatch on their balance sheet, and banks are very liquid. Resident business is mainly directed to personal lending (housing and school fee loans, over 40 percent of total lending) followed by the tourism and construction sectors. In contrast, lending to the agriculture sector is minimal (less than 2 percent of total lending).

19. **Vanuatu's domestic banking sector has broadly maintained its profitability in recent years, despite increased nonperforming loans and a high level of excess liquidity.**

- *Bank profitability* as measured by the return on assets is low, but has been broadly maintained at about 1 percent in recent years.

- *Asset quality,* as measured by nonperforming loans (NPLs), deteriorated from 2002 to 2005, largely due to problem loans in one foreign bank and the downgrading of large exposures. Asset quality improved in 2006 due to sales of collateral, but the NPL ratio remains high.

- *Capital adequacy*, as measured by risk-weighted assets, has been maintained above 30 percent since 2001, well above the standard 8 percent prudential requirement. Tier 1 capital accounts for nearly 98 percent of total capital, and its growth is largely driven by retained earnings.

- *Liquidity requirements* have been largely met, exceeding the liquidity-asset ratio benchmark of 15 percent during 2000–03, and a reduced 12 percent beginning in 2004.

Vanuatu: Financial Soundness Indicators of Commercial Banks, 2000–06
(In percent)

	2000	2001	2002	2003	2004	2005	2006
Capital adequacy							
Regulatory capital to risk-weighted assets	21.6	32.2	32.8	39.8	30.4	25.0	28.3
Regulatory tier 1 capital to risk-weighted assets	19.5	30.9	31.6	38.7	29.6	24.2	27.5
Asset quality							
Nonperforming loans to capital 1/	10.1	8.1	20.8	32.2	34.6	66.4	52.2
Nonperforming loans to total gross loans	4.5	3.8	3.9	8.4	13.3	19.5	16.7
Vatu loans to total loans	91.9	91.4	91.0	90.6	90.4	90.2	87.5
Earnings and profitability							
Return on assets	2.0	0.7	1.1	0.8	0.9	1.0	0.9
Return on equity	4.5	4.4	6.0	7.7	7.2	10.1	8.3
Interest margin to gross income	76.8	73.0	70.8	61.9	62.6	67.5	69.4
Non-interest expenses to gross income	29.4	37.1	34.1	36.2	35.6	30.4	30.7
Liquidity							
Liquid assets to total assets	26.5	27.9	21.9	18.1	23.4	17.2	26.9

Source: Reserve Bank of Vanuatu (RBV).

1/ Nonperforming loans net of provisions.

20. **The Reserve Bank of Vanuatu has made progress in recent years in improving its supervisory system for domestic financial institutions.** Domestic bank supervision has been brought to international standards, and is now largely compliant with all of the Basel Core Principles. Legal requirements and prudential guidelines, as well as effective supervisory practices for both onsite and offsite examination are now in place. Nevertheless, staff training is required both for further development and to address the current lack of supervisory skills. The Bank Supervision Department, which in addition to domestic banks supervises the Vanuatu National Provident Fund and offshore banks, currently has only four bank supervisors, with high staff turnover.

Vanuatu National Provident Fund

21. **The Vanuatu National Provident Fund is an important safety net.** For most households the accumulated contributions to the Fund are the primary source of savings and income upon retirement. Members are generally eligible to withdraw their accumulated contributions from the Fund at age 55.

22. **The Fund's financial position has strengthened considerably over the past decade.** While the contribution rate from members was reduced in 2004 to 8 percent of gross salary, the Fund's assets increased steadily, from a low of less than 1 percent of GDP in 1998 to over 16 percent at end-2006, due to strengthened enforcement of contributions and prudent investment of its assets. The Fund mainly invests in fixed term bank deposits, government bonds, and loans to government. The Reserve Bank of Vanuatu has conducted onsite inspections since 2003 and regularly monitors the Fund's financial health.

C. Development Finance

23. **Microfinance has emerged as a promising source of small-scale project financing.** The National Bank of Vanuatu has recently started microfinance schemes on a commercial basis through its extensive branch networks, nurturing a credit culture in rural areas which, although small in scale, is steadily expanding. Another microcredit project launched in 1996, with assistance from the UNDP, has been successful in providing women with credit for their small businesses. Returns on the National Bank's scheme roughly cover costs, and the other scheme aims to achieve full financial sustainability by the end of 2007. While growing, these institutions are facing constraints from a small cash economy in the rural areas where developing a credit culture takes time.

24. **The establishment of the Vanuatu Agriculture Development Bank, if not carried out carefully, could pose risks to the financial system and public sector debt.** Vanuatu's previous experience with a development bank did not end well—poor lending practices, political interference, and gross mismanagement led to the Development Bank of Vanuatu's liquidation in 1998, requiring a public sector bailout (Box II.1).

25. **Cross-country experience in the Pacific region shows that development banks have been particularly weak institutions.** They are susceptible to political interference, extend loans on noncommercial basis, accumulate nonperforming loans, and repeatedly rely on public funds as capital injections. Their poor overall financial performance, especially when unsupervised, has led to insolvency and resolution using public funds (Box II.2).

Box II.1. The Failure of the Development Bank of Vanuatu (DBV)

From its inception in 1979, the DBV consistently recorded operational losses. The bank was mismanaged and run by politically-appointed boards of directors who generally lacked adequate financial skills. The Government repeatedly recapitalized the bank, offering no incentives for the bank to achieve commercial viability or improve the return on equity; there was no support for a strong financial governance structure, nor any reward for achieving higher efficiency. In addition, the fraudulent use of public funds was reported.

The DBV ceased operations on September 30, 1998. The Asian Development Bank review in early 1998 concluded that there was no point in continuing support for the DBV (as well as the National Bank of Vanuatu which was also experiencing losses) and recommended that the DBV be merged with the National Bank, with performing loans transferred to the National Bank and nonperforming loans transferred to the Asset Management Unit. While the direct fiscal cost of liquidating the DBV amounted to less than 0.2 percent of GDP, the National Bank subsequently suffered a deterioration of asset quality related to nonperforming legacy loans, and asset recovery by the Unit has been very slow.

Box II.2. Regional Experiences with Development Banks

Kiribati: The banking sector of Kiribati is very small, consisting of one private, foreign-owned commercial bank, and a development bank. While the private bank is well managed, the nonperforming loan ratio of the development bank is around 20 percent, mainly arising from government guaranteed loans to public enterprises and loans to farmers. The bank is subject to inadequate supervision, and there are no plans at present to restructure its operations or balance sheet.

Marshall Islands: Beginning in 1998, the unsupervised development bank, which takes deposits, moved beyond its original mandate of providing development assistance and expanded its consumer and commercial loan portfolios. Improving the governance of the bank is a crucial priority, including by placing it under the supervision of the Banking Commission, appointing independent board members, limiting permitted activities, and shifting the focus of its lending from consumer loans to more traditional development lending.

Micronesia: The development bank accounts for nearly half of domestic credit, while private banks do little domestic lending, with three-fourths of their assets invested overseas. It mainly provides loans to support new businesses, with longer terms than those offered by commercial banks. More than 70 percent of the bank's loan portfolio is allocated to fisheries, tourism, and other commercial enterprises. It remains a nondepositary institution and relies on the national government for funding through annual budget appropriations. The bank has a higher nonperforming ratio than the commercial banks and has received several capital injections from the national government during the last three years. Currently, its competition with the commercial banks is limited, as the bank mainly offers loans that commercial banks view as unduly risky.

Palau: The performance of its development bank following restructuring in 1999, new management in 2000 and 2003, and new funding from a Taiwan Province of China loan in 2004, has improved but a large number of problem loans remain on its portfolio. While its return on assets has been steady at around 5½ percent for the last four years, the bank's portfolio continues to be heavily concentrated in the housing sector. The bank has recently increased its provisions for bad loans, intensified efforts to recover delinquent loans, strengthened its operating procedures, and subjected its accounts to an external audit.

Papua New Guinea: The Rural Development Bank declared insolvency in 2004. The deterioration of its financial position reflected poor loan management due to weak governance. The financial recovery plan: (i) replaced the previous board of directors and managing director; (ii) temporarily stopped lending activity; (iii) recapitalized the bank with an injection amounting to 0.3 percent of GDP; (iv) cut staff by one-third with assistance of a retrenchment grant; and (v) brought in experienced commercial lending officers to manage the bank's portfolio. New draft legislation would allow the bank to expand into microfinance without adequate oversight and accountability.

Solomon Islands: The development bank's assets are severely impaired, reflecting weak governance and a poor credit culture. The bank's provisions for bad debt are reportedly understated, and its deposit liabilities and borrowing obligations are in default. In 2004, the High Court assigned the central bank as the provisional manager for the bank. Nearly all depositors were repaid by end-2006. The bank's negative net worth is estimated at ½ percent of GDP.

26. **The current legislation establishing the Development Bank incorporates several important provisions aimed at avoiding problems experienced in the past**. Of the law's provisions, key are those allowing the Finance Minister to subject the bank to central bank supervision, establishing a diverse board, providing for external audits, and prohibiting government intervention in credit decisions. Nevertheless, as in other Pacific island countries, rural finance in Vanuatu is severely constrained by unreformed land tenure systems and poor saving and credit culture. While it is important to alleviate these constraints over the long term through land use reform and financial education, rural finance will remain highly risky for the foreseeable future. At the same time, government-sponsored large-scale projects risk lowering the accountability of borrowers and giving rise to nonperforming loans.

D. Other Domestic Financial Sector Issues

27. **The legal infrastructure for insurance supervision is largely in place.** The Insurance Act came into force in June 2006 which, together with the accompanying regulations, provides the necessary legal authority for effective insurance regulation, including minimum capital requirements and supervision with onsite inspections. All insurers were required to apply for relicensing, although some offshore insurers did not apply by the deadline of December 2006. The staff of the Vanuatu Financial Services Commission is committed to implementing the strengthened regulations and intends to start formal onsite inspections in 2007. Fund technical assistance has been provided to help the Commission examine applications and develop the Procedure Manual for Insurance Supervision. There remains a need to train and develop insurance supervisory staff, and realize the transfer of insurance supervision to the Reserve Bank.

28. **Vanuatu has ratified the relevant AML/CFT conventions, but has not yet taken all the steps required for full implementation.** The appropriate legislation in accordance with the Mutual Evaluation Report made by the Asia and Pacific Group of the Financial Action Task Force is now in place. The Report makes recommendations for improving the legislative framework, which were recently endorsed by the government and its implementation plan adopted. Further amendments to the Financial Transactions Reporting Act relating to the proceeds of crime and cross-border currency movement will be submitted to the parliament early 2007. The Financial Intelligence Unit, a part of the State Law Office, is operational. The Unit has only limited power to impose sanctions for noncompliance with AML/CFT requirements by financial institutions, but carries out onsite examinations of banks together with the Reserve Bank. Other financial institutions and designated nonfinancial businesses and professions require guidance specifically tailored to their activities and consistent with the requirements of the Financial Transactions Reporting Act.

E. The Offshore Financial Center

29. **The supervision of the offshore financial center has seen a dramatic improvement since the last assessment in 2002**, a result of the authorities' desire to improve Vanuatu's reputation as a financial center. Businesses are mainly attracted by the absence of taxes on income, and Vanuatu's proximity to Australia and New Zealand. As of 2002, however, the supervision of offshore banks and the insurance sector fell well below

international standards, and the legal and regulatory framework for improving standards was not in place. Despite some progress, further measures were needed to make the system of combating money laundering and terrorist financing robust. Since then the authorities have taken steps to improve the offshore legal and supervisory framework, and backed these by strengthening the supervisory enforcement. The results have been impressive. With stronger supervision and the elimination of licenses for shell banks (those lacking a physical presence in Vanuatu), the number of offshore banks fell from some 100 in the early 1990s, and 34 banks in 2002, to 7 by end-2006. Trust business also declined and insurance business remained steady.

30. **These developments have significantly improved Vanuatu's reputation as a financial center.** With revised Offshore Financial Center regulations in place, it is important to continue implementing them rigorously to build on Vanuatu's improved reputation. The offshore sector is still small compared to many centers around the world, with the majority of government revenue generated by international company registrations. Nevertheless, there may be scope for Vanuatu to develop a niche market over time in the offshore banking and insurance sectors on a sound basis, with a corresponding increase in the sector's contribution to GDP and employment. Any growth should take place in an environment of strict enforcement of the current regulation to preserve and build on the reputational gains Vanuatu has made over the past several years.