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The National Bank of Fiji

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A brief history

The Colonial government established the Fiji Government Savings Bank in 1907. The bank was later converted into the Post Office Savings Bank which operated as part of the Post Office Department. This was a convenient arrangement: post offices were located in the towns and in the outlying areas of the country and members of the public were able to deposit and withdraw savings readily.

The focus of the Post Office Savings Bank was on the encouragement and collection of savings, not on lending to businesses and members of the public and foreign exchange transactions which called for banking expertise and experience. Accumulated savings provided a convenient source for government and public sector enterprise financing.

Depositors were happy with the Post Office Savings Bank. Their deposits were in fact loans to the government which could always be relied on to meet its obligations. And it played an important role in fostering domestic savings and in providing basic banking services to a large section of Fiji's population.

Following independence in 1970 the Post Office Savings Bank, while continuing to use the post office facilities, was separated from the post office and became the Savings Bank of Fiji. In 1974 under an Act of Parliament (the *National Bank of Fiji Act*), the Savings Bank became a commercial bank, called the National Bank of Fiji. The Act empowered the Bank, which took over the assets and liabilities of the Savings Bank, to undertake the whole range of banking businesses.

The National Bank of Fiji

Under the provisions of the Act, the Minister of Finance appoints six members of the Board of the National Bank of Fiji including the Chief Executive and the Permanent Secretary for Finance. No requirement, as in the case of the Reserve Bank, is prescribed in the Act as to relevant experiences and professional or academic qualifications for the four other members of the Board. Members of Parliament, the Governor of the Reserve Bank, other employees of the Reserve Bank and employees of the National Bank of Fiji and other banks are specifically excluded by law from serving as members of the Board. The rationale for these exclusions are sound. The Reserve Bank cannot be represented on the Board as it supervises the activities of all commercial banks. And parliamentarians were excluded so as to help minimise undue political influence on the operations of the National Bank of Fiji.

Over the years the Bank has had experienced and qualified professionals appointed to its Board. But this desirable practice has not been consistent, and the Board has, from time to time, unfortunately had members who had difficulties with formulating the most basic banking questions which might be usefully raised at its meetings.

Under the *National Bank of Fiji Act*, parliament provides a government guarantee for all deposits in the bank. If the National Bank of Fiji were wound up and assets proved insufficient to pay the creditors (of which depositors are the largest in terms of debt holdings) government would be duty bound, without further parliamentary authorisation, to pay the depositors fully for balances owing to them.

The legislative framework governing the Bank's operations

Under its statute, the National Bank of Fiji is granted powers to 'carry on banking business as if it were licensed under the provisions of the Banking Act'. The Bank was, in 1985, made subject to the Banking Act of that year, but with one significant exception. This exception was in respect of the provision against debt concentration in the Banking Act.

Commercial banks are required to avoid concentrating their lending, or guarantees, to any one person or group of related persons (including companies). The maximum that such concentration may take is 25 per cent of the sum of issued capital and published reserves. This requirement did not affect the other banks operating in Fiji as they are branches of international banks incorporated outside Fiji with capital and reserves running into hundreds of millions of dollars. But it did have fundamental impact upon the Bank. Under the *Banking Act*, the National Bank of Fiji, as a bank incorporated in Fiji, need only have capital and reserve of one million dollars to secure a banking license. This would of course mean that its total lending to any borrower or group of related borrowers would be severely limited; in the current example to only F$25,000.

The avoidance of loan concentration is a basic prudential requirement for all banks. A bank with concentrated exposure could be quickly brought to its knees if one or two of its large borrowers were to run into difficulties and unable to meet their debt obligations. The exemption of the National Bank of Fiji from this important prudential provision was motivated by the restricted ability of the government to inject substantial capital into the Bank and could be justified by the guarantee which government has in place for all depositors.

The wording of the exemption in the Banking Act is not open-ended at all. It says 'that the National Bank of Fiji may, in the national interest and with the approval of the Minister, exceed the limit on advances, credit facilities, financial guarantees'. It is clear that the Board of the Bank has to make the initial judgment of national interest (not defined in the Act) and recommend cases meriting exemption to the Minister of Finance. The use of this exemption provision, along with other issues, gave rise to intense debates when the Bank suffered irreparable damages to its balance sheet. It was suggested, with some justification in the wake of the auditor's reports which appeared later, that the Bank did have difficulties with knowing its true positions including the capital and reserve position on which the

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25 per cent limit is computed. There were also doubts as to whether the Minister's approval was sought and granted or even that the Board was, in all cases, privy to the relevant decisions.

The other exemption introduced later in 1985, may have had an equally significant impact on the Bank. The *National Bank of Fiji Act* nominated the Auditor General, who audits all accounts of the central government and of most statutory corporations, as Auditor of the Bank.

Against the objections of the Auditor General, the Ministry of Finance and the Central Monetary Authority (predecessor to the Reserve Bank) proposed changes to the law under which the National Bank of Fiji accounts were to be audited by firms of accountants familiar with the intricacies of domestic and international banking and which can call readily on external expertise when needed. This change was implemented through the Banking Act of 1984. But it was to be short-lived. In the face of mounting pressures by the Auditor General and a number of parliamentarians, and without consultation with the Reserve Bank which administered the Banking legislations, Act 4 of 1985 amending the Banking Act was enacted by parliament. The amendment states, 'section 30 of this Act (the section of the Banking Act which deals with audit) shall not apply to the National Bank of Fiji, and in the event of any contradiction or inconsistency between this act (the Banking Act) and Part VI of the National Bank of Fiji Act (which appoints the Auditor General as auditor) the provisions of that Part shall prevail'.

The Banking Act was reviewed in 1994. Comprehensive changes, mainly in the light of mounting prudential problems in the National Bank of Fiji, were enacted in the new *Banking Act of 1995*. This Act removes the Auditor General as Auditor of the Bank which is again given the power to choose its auditor from among the firms of accountants operating in Fiji. The provision which exempts the Bank from strict limitation on loan concentration has been tightened. The approval of the Minister for such exemptions is now required to be in writing.

The National Bank of Fiji Board is duty bound under the *National Bank of Fiji Act* to 'ensure that policy of the Bank is directed towards the national interest and has due regard to the stability and enhanced development of the economy of Fiji'. This provision and that on the Minister's discretion to exempt the Bank from restrictions on loan concentration were potentially useful if handled delicately and wisely. It meant that the Bank had to pursue profitability and financial stability while cautiously supporting the wider development objectives of the government. It was, for instance expected to widen its branch network in the interest of affording banking services to the outer areas and fostering national savings. This activity did impose a heavy burden on the Bank's profit and loss accounts and the government did attempt to offset it through capital injections to the Bank in the annual government budgets.

But the provisions also opened possible avenues for abuse by weak management and accommodating boards of directors. Observations by the Auditors suggest that the National Bank of Fiji pursued a vigorous policy of rapidly increasing its share of the loan market with apparent total disregard for the quality of its assets. In an interview with the former Chief Executive of the Bank following suspension from his position, he declared with some pride that his greatest achievement was to transform the National Bank of Fiji from what it was in 1987 to its position in 1995. His overriding objective, he said, was to help targeted groups of the population

(Fijians and Rotumans) with large and rapid loan approvals and disbursements. Although a large number of these loans predictably resulted in heavy debt burdens for the recipients, they were apparently packaged and justified under the national interest provisions of the *National Bank of Fiji Act*.

As in other countries, Fiji has three avenues for avoiding bank and financial institution failures and the systemic and wider economic risks that can flow from them. The Reserve Bank may provide short-term loans to a bank experiencing temporary liquidity difficulties. The government provides an insurance scheme which is, however, limited to the government guarantee for the National Bank of Fiji's depositors. The depositors of international banks which operate in Fiji would be covered under insurance schemes in countries where such banks are head-quartered.

The activities of banks are regulated and supervised under the provisions of the Banking Act. Since the Reserve Bank relies heavily on close supervision of the international banks by their own supervising authorities, the focus of supervision in Fiji has in fact been on the National Bank of Fiji.

As supervisor, the Reserve Bank is given wide powers under the repealed and the new Banking Act. Section 14(1) of the Banking Act empowers the Reserve Bank to subject a bank and any associated persons to the supervision, regulations, rules, orders or other directives of the Reserve Bank. The Reserve Bank, under Section 3, may investigate, with or without prior notice, the books, accounts and transactions of a bank. And, the Reserve Bank must investigate if it has reason to believe that a bank

- is carrying on its business in a manner detrimental to the interests of its depositors
- is insolvent or is likely to become unable to meet its obligations or is about to suspend payment
- has contravened or failed to comply with, or may contravene or fail to comply with, any of the provisions of the Banking Act.

Wide powers are vested by Section 30 in the Reserve Bank to take bold actions when deemed appropriate. It may for instance

- require the relevant bank or associated person to take any action in relation to its business
- appoint a person to advise the bank
- with the consent of the Minister, assume control or appoint a person to assume control of the bank where any provision or directive under the Act is breached
- present a petition to the High Court for the winding up of the bank
- revoke or suspend the license of the bank.

It is of interest to note that the above powers were essentially provided under the Banking Act of 1984. They enabled the Reserve Bank to take the initiative, undertake investigations and institute a range of determined actions, without reference to, or endorsement by, the government.

Restrictions against acquisition of shareholdings in companies are also provided in the Banking Act. In 1990 an amendment to the *National Bank of Fiji Act* was passed by parliament to allow the National Bank of Fiji to become the majority shareholder in National MBF, a finance company. The other shareholder was MBF Holdings Berhad of Malaysia. Under the joint venture agreement between the two partners, the National Bank of Fiji was apparently required to provide an open ended credit facility for National MBF. Auditors were to observe during investigations that all the prudential practices which should govern the relations between a bank and its subsidiaries were not observed by the Bank.

The banking business

Like other businesses, banks aim to make profits for their owners and for the future expansion of their activities. Banks borrow funds (on which they pay interest) mostly from many depositors. These funds are lent to borrowers at higher rates of interest. The bulk of the gross income of a bank such as the National Bank of Fiji comes from the difference between what they earn from lending and what they pay to those, such as depositors, from whom they borrow.

The main sources of funds or liabilities of the National Bank of Fiji are borrowings from the public, mainly demand, savings and time deposits, borrowings from other banks and from the Reserve Bank and capital which for the National Bank of Fiji was consistently less than 5 per cent of the total assets of the bank. These funds feature on the asset side of the bank as cash in the vault, the Bank deposits with other banks and with the Reserve Bank, investment in government and public sector corporation securities such as bonds, treasury bills and promissory notes, loans and advances to individuals and businesses and bills receivable. The latter is only another form of short-term lending to businesses.

Banks take great care to maintain the total of cash holdings, demand deposits at the Reserve Bank and short-term securities at comfortable levels. These constitute their liquid assets. A level of liquid assets equal to 30 per cent of total assets would be considered prudent since a bank must be able to provide cash to depositors who wish to withdraw. A bank faced with long queues of depositors it cannot satisfy, will be forced to borrow from other banks, the Reserve Bank or call in its own loans and advances to its customers. The latter is generally impossible to do. If a bank's liquidity position is high it can expand its lending. This will reduce its cash and security holdings while increasing its total loans and advances. It may of course increase lending if its total deposits and capital were to increase. So a bank which sets out to expand loans and advances rapidly without corresponding growth in deposits and capital will soon face increased dependence on the short-term, volatile and sometimes expensive wholesale loan market. Ultimately it will face acute liquidity difficulties involving inability to meet demands for withdrawals by depositors and mounting pressures to call on its borrowers to repay their loans early.

Banks have to ensure that periods over which they lend are not too lengthy as the deposits and other borrowings which supply them with funds are essentially short term. Assets holdings have to be carefully matched against the composition of liabilities of the bank if liquidity difficulties are to be avoided. This is the reason banks confine themselves to financing working capital, international trade transactions and short-term securities which can be readily converted into cash with minimum capital loss.

Banks normally take pains to ensure that all loans and advances are made only after sound credit procedures and guidelines are meticulously followed. They have to be sure that the borrower has integrity, commitment, industry, determination, capacity to repay, and that there is reasonable certainty that the project to be financed will generate the cash flow needed to service the loan comfortably. Without such caution, streams of repayments to the bank will rapidly fall below expectation, problem and non-performing loans will emerge, liquidity difficulties will be experienced, provision for doubtful debts and bad debts will increase, losses will mount, the capital base will be eroded and the creditors, mainly depositors, will be increasingly exposed. Ultimately difficult restructuring measures will be unavoidable.

Banks, in addition to providing liquidity and investment funds to commerce, operate the payments system within an economy. Cheques regularly pass between parties who may bank with different banks. Such cheques are passed on to the relevant banks who record matching amounts owed to each other after debiting or crediting the accounts of their own customers who issue or receive the cheques. At the end of each day banks will total up the net amounts owed to each other and advise the Reserve Bank to credit or debit the relevant settlement accounts which they hold with the Reserve Bank. In international transactions for customers, banks will, each day, either accumulate or be short of foreign exchange balances. They will attempt to satisfy each other's needs by selling and buying foreign exchange among themselves. Final net positions at the end of each day are then settled with the Reserve Bank. So the smooth operation of the payments system within a country depends critically on the individual and collective strength of the banks.

Systemic problems in the financial system, which may be generated by difficulties in any one bank are a source of continuing concern to the Supervisory Authority. If depositors worry about the liquidity position or the quality of the loan portfolio of a bank, they may decide to line up and encash their deposits. A 'run' on a bank, can become difficult to contain if depositors of other banks become aware of what is happening. The ramifications of such a chain reaction, if it happens, are enormous. Liquidity in the banking system will dry up, loans will be called up, the window for new loans will close and the economy will contract with accompanying economic and social difficulties rapidly emerging. The cost to the government of reparation to the system, for a small country, could be unbearable.

The National Bank of Fiji veers off track

The National Bank of Fiji established close relationships with the Commonwealth Bank of Australia soon after it was established. The Chief Executive and selected professional bankers were seconded to the Bank by the Commonwealth Bank of Australia which regularly assisted with the training of staff members. This arrangement was of immense value as most of the employees were formerly civil servants who staffed the Post Office Savings Bank and who did not have the benefit of exposure to, and experience in, commercial and international banking.

In 1987 the management of the National Bank of Fiji was abruptly changed. The Chief Executive was replaced. His position was filled by a person who had run a small branch and did not have the breadth of knowledge, experience and management expertise required to run the whole bank.

Neglecting sound banking practices, the Bank soon embarked on quickly raising its share of loans and advances in Fiji. It was announced that the National Bank of Fiji wanted to be a 'big player' amongst banks within the country.

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By 1992 the Reserve Bank and the Auditor General were already pointing out that

- proper accounting practices were neglected
- sound credit policies and procedures were ignored
- the quality of loan and advance portfolio left much to be desired
- internal controls expected of a well managed bank were very weak
- management was generally weak.

Following the policy of increasing market share without regard to sound liability management, it was also observed that between 1989 and 1993

- new lendings were escalating rapidly in the face of advice for caution by the supervisor
- problem loans had increased very quickly
- the liquidity position had worsened to critical levels forcing the National Bank of Fiji to depend increasingly on expensive and volatile wholesale funds from other organisations
- capital was rapidly disappearing in the face of inevitable loan provisioning which the Bank had not sufficiently allowed for.

The Reserve Bank was in close touch with management and the Board of the National Bank of Fiji and kept the Minister briefed on developments from 1992 onwards. It also provided short-term accommodation to the National Bank of Fiji. But attempts by the Reserve Bank to restrain the misdirected enthusiasm of the National Bank of Fiji did not meet with success.

The Auditor started airing his concern about the ‘goings on’ in the bank in 1993. In 1995 the new Minister of Finance insisted on an audit by two eminent Chartered Accountants. The details of the extent of mismanagement, incompetence and possible fraudulent practices which they unearthed were worse than what most had feared. Additional problem loans were identified at more than F$90 million. It was estimated that after making appropriate provisions, the capital of the National Bank of Fiji has completely disappeared; worse it may have been of the order of minus F$70 million to F$100 million.

The advice of the World Bank was subseequently sought by the Minister. Following receipt of the World Bank’s report and the findings of a comprehensive investigation by the Reserve Bank, the Minister announced on 29 March 1995 in parliament that

- the Board of the National Bank of Fiji had been very weak in setting policy direction and in supervising the activities of the bank
- management and staff were inexperienced and did not have the required knowledge and expertise
- there were several cases of abuse of office, some of them involving possible criminal activities
- there were cases of loan conversions
- some people borrowed without the intention to repay or in situations when it was difficult to foresee how repayment obligations could possibly be met.

He also advised that problem loans were estimated at F$220 million, possibly higher.

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The rescue and restructuring phase

The National Bank of Fiji is now insolvent. There is no way it can possibly satisfy all its creditors without outside assistance. It has had to stop giving new loans and advances; in fact it cannot do so as all requirements on liquidity ratios and capital which the Reserve Bank imposes cannot possibly be satisfied.

Under the guarantee to depositors, government has to make up the shortfall between assets and liabilities—an extremely large amount. But if the government wishes to rescue the bank, it will have to impose and support a rehabilitation program which will call for substantial capital injection from the annual budgets.

The government has announced a rehabilitation regime for the National Bank of Fiji. The details of this have not been fully divulged to the public but the components of it will inevitably include the following

- a detailed review of all the outstanding loans and advances and the rating of each of these into risk categories
- for each loan, careful assessment of support documentation, collateral valuation, adequacy of information flows, and provisioning in accord with sound banking practice
- assisted by personnel with required professional expertise, a vigorous program of loan liquidation and collection, employing all available legal channels, will have to be pursued
- a review and update of credit policies and procedures and dissemination of these to all staff members and strict observance of them in future operations of the National Bank of Fiji—manuals on procedures should be prepared and kept current
- review of the organisation and finalisation of a Corporate Plan for the National Bank of Fiji, staff found incapable of measuring up to undertake relevant training, and those who are incompetent dismissed
- the unavoidable reduction of the level of activity of the bank implies substantial downsizing in the total number of employees
- an internal audit unit staffed with competent professionals should be established and should regularly update Manuals on Policies and Procedures and ensure that they are strictly followed by all staff members
- a separate loan review unit should be established and should be responsible for an independent report on loans to a loan review committee of the Board
- financial statements and projections should be prepared monthly and discussed by the Board
- discretions on granting loans by management should be carefully specified, and any variations should be approved by the Board and featured in the Manual and Policies and Procedures
- annual budgets should be carefully prepared, approved by the Board and revised every quarter
- members of the Board should have qualifications and professional experience which should be written down, preferably in an amendment to the *National Bank of Fiji Act*
- the supervisor will need to monitor the activities of the Bank even more closely and be prepared to employ

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> the considerable powers endowed it whenever the need for determined action emerges.

The National Bank of Fiji, the Reserve Bank and the Fiji Government are examining the 'good bank, bad bank' approach as part of the program for rehabilitating the National Bank of Fiji. The first phase of this involves the establishment of a unit in the bank charged with restructuring, and collection and liquidation of all troubled debts. Separate financial statements will be prepared for this operation, the so-called 'bad bank'. A further step might require the acquisition by the government of the assets of the 'bad bank' in exchange for a bond issued by the government valued at something less than the face value of such assets. This bond could be for a period of say five years with a Coupon of say 5–8 per cent. The bond is to be progressively retired out of the proceeds of loan liquidation and collection by the 'bad bank'.

The Coupon on the bond implies that the Bank will have a source of income which partly replaces what it would have received out of its non-performing loans. The cost to the government remains, but this arrangement phases the burden on government over time while allowing the 'good bank', the new National Bank of Fiji, some hope of starting a new life, hopefully a successful one, earlier.