Development of the financial system in the Solomon Islands[1]

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An efficient, responsive and reliable financial system is essential to the functioning of a modern economy. The mobilization and custody of savings, the channelling of credit into its most productive uses, and the operation of a prompt and efficient payments system—all this using a reasonably stable currency as the medium of exchange and store of short-term value—lie at the heart of investment and trading activity. The Central Bank is charged with supervision and, where necessary, regulation of the financial system, to ensure its suitability to the needs of the economy and people of the Solomon Islands.

The Solomon Islands has a financial system that works well for the government, small and medium-sized established enterprises, and urban wage-earning households; the system works less well for very large enterprises needing long-term capital, and small, new businesses short of owners' equity; and it works in a very limited way, if it works at all, for village people and lower-paid urban workers. The technical capability of the system is therefore still deficient in terms of national economic objectives; and under pressure from persistent domestic savings–investment imbalance its performance has been less than adequate.

It is of little comfort that these problems are not unique to the Solomon Islands, but are shared by most small, open financial systems. The last forty years have shown that extensive state intervention in, and direction of, the economy is ultimately inefficient and unaffordable in both industrialized and developing economies. Governments everywhere are dismantling the machinery of intervention. Yet the developing system is too frail to be left unsupported by official commitment to its survival. In the financial sector as elsewhere, the authorities need to concentrate on providing the environment, including the infrastructure, in which private, commercial and community initiatives and resources can be put to work and be rewarded. Adequate protection for depositors against fraud and incompetence has to be combined with freeing up the opportunities and financial markets, and the strengthening of beneficial ties between the tiny Solomon Islands financial system and the vast resources of the Pacific basin and the international community.

The main tasks now facing the Solomon Islands financial system are:

- raising the domestic savings rate and promoting the orderly growth of the domestic capital market, including an enhanced role for locally-owned equity as a source of capital;
- improving institutional machinery for longer-term financing of major investments, tapping external equity and concessionary loan funding alongside local capital;
- improving the access of very small enterprises and rural and lower-paid urban households to the financial system; and
- preserving systemic and institutional stability during a period of rapid social change and growth of the monetary sector.

Financial institutions in the Solomon Islands

The existing financial institutions can be broadly grouped by legal form and are discussed below.

1 This article is an edited version of a consultative paper issued by the Central Bank of the Solomon Islands in December 1990 and published in the Bank's *Quarterly Economic Review* for the first quarter of 1991.

Statutory institutions

The government itself, the Central Bank (CBSI), the National Provident Fund (NPF), the Development Bank (DBSI), the Investment Corporation (ICSI) and the Home Finance Corporation (HFC) are all subject to powers, duties and restrictions imposed on them by Acts of Parliament. The credibility of these institutions is ultimately tied up with the financial reputation of the national government. The government itself borrows large amounts at home and abroad to finance its operations, and is a substantial lender to provincial governments and statutory corporations. The government is a heavyweight player in the financial system, but is generally insensitive to the costs and yields of its borrowing and lending activities. The Central Bank takes deposits from, and lends to, the government and other financial institutions, and holds the official external reserves.

As issuer of the currency and lender of last resort to the financial system, CBSI is the ultimate source of SI dollar liquidity; but it is constrained in supplying funds to other institutions by the impact such funding, not backed by domestic savings or foreign exchange, has on domestic demand, prices and the balance of payments. Like central banks in most developing countries, CBSI has to balance the needs of financial stability and faster economic growth.

NPF's primary source of funds is the compulsory contributions of virtually all formal wage and salary earners, which respond immediately to changes in wage levels and numbers employed. NPF's investments are a major source of deposits for the commercial banks and long-term financing of the government and other financial institutions, while providing the secure income stream that assures the flow of benefits to NPF's contributors. DBSI and HFC rely on government funding and long-term borrowing domestically and overseas, with or without government intermediation, to fund their lending to commerce, industry and home purchases. DBSI in particular has the ability to draw in foreign savings, via institutions such as the Asian Development Bank (ADB), the European Investment Bank (EIB) and the World Bank, for on-lending to industry and agriculture in the Solomon Islands.

ICSI, previously the Government Shareholding Agency, holds the government's investments in major commercial ventures. It has incurred heavy losses in its wholly-owned subsidiaries and has had difficulty meeting its obligations as a shareholder in joint venture companies. Originally funded by foreign aid, ICSI has needed substantial domestic borrowings and transfers from government funds in recent years. As a result it is currently the subject of restructuring proposals, from which it is likely to emerge as a more efficient vehicle for the maintenance of national shareholding in key economic sectors, with potential for divestment of profitable shareholdings to the Solomon Islands public.

Commercial banks

Heavy government borrowing in recent years has led to the imposition by CBSI of a high (currently 35 per cent) liquid assets ratio, forcing the banks to hold substantially more government securities and thus lend less to the private sector, than commercial prudence would have required.

Multiple bank failures overseas have led to worldwide upgrading of supervision standards, particularly as to levels of capital held against risk assets. Such standards are usually monitored by central banks, that are also the potential, though not automatic, rescuers of illiquid or insolvent banks. So far, the commercial banks in the Solomon Islands have been branches or subsidiaries of major international banks, for which the main supervisory burden falls on overseas regulators (the Reserve Bank of Australia for the three banks presently operating). It seems likely that one or more locally-owned and locally-incorporated banks may be licensed in the foreseeable future, in which case the supervisory role of CBSI will be the main source of external protection for depositors against imprudent or dishonest management.

Meanwhile, the three existing commercial banks are responding to the growth of the monetary economy by extending their branch and agency network into provincial centres and rural areas. There are now 14 bank offices and 62 agencies, twice as many as there were six years ago. Further expansion by the commercial banks is restrained by rigid institutional procedures, inexperienced national staff, high fixed costs and low throughput of most of their rural outposts. Progress, though steady, is slow and unlikely to accelerate substantially. Faster and deeper expansion of the system will have to come through development of less formal, more flexible intermediation between end users (savers and borrowers) and the formal institutions.

Non-bank non-statutory financial institutions

Finance companies. Presently only one such enterprise is licensed, and it has the same Australian parent as one of the three commercial banks. Paying higher rates for fixed deposits than the commercial banks, unregulated as to lending rates, and targeted on short-maturity financing of transport and consumer durables, this business has become firmly established in the last three years. There may be scope for further such enterprises, under local ownership, provided they are prudently managed.

Credit unions, cooperatives and less formal financial intermediaries. This sector is largely unstudied and unmeasured. It is certainly larger than its recorded size, and it appears to have great potential for further expansion. It includes 86 registered credit unions, about 100 cooperative societies, several hundred trade stores engaged on the side in credit and deposit operations, about a dozen revolving funds sponsored by non-government organizations or churches, and an unknown number of informal group savings-and-loan operations and individual money-lenders, operating full- or part-time. There are at present no pawn-shops in the Solomon Islands, at least not officially.

Financial institution liquidity

The institutions can also be ranked according to the liquidity of their liabilities, i.e. how readily can the providers of funds take them away, forcing the institution simultaneously to acquire other matching liabilities, or liquidate a corresponding amount of its assets. Liquidity is a crucial consideration for the managers of a financial institution. Its non-observance has frequently had fatal consequences for such institutions and, on occasion, for their managers.

Central Bank

The Central Bank is unique among the financial institutions. It issues its own liabilities in the form of the national currency, which is then interchangeable with bank deposits (they add up to the money supply). As long as people are willing to use and hold the currency, the Central Bank can adjust the level and composition of the economy's stock of money by changes in its own liabilities. As already noted, the Bank is constrained in doing this by the interlocked nature of the banking system balance sheets and the balance of payments: autonomous increases in currency issue or its deposit liabilities, linked on the assets side to funding of the commercial banks or the government, will increase pressure on domestic prices and the balance of payments. On the other hand, increases in money supply reflecting increased domestic output and a rise in the external reserves are necessary for the continued growth of the economy. This ability to issue its own liabilities enables the Central Bank to provide funds in the form of loans or deposits, to the commercial banks and the government, subject always to the constraints of prudent monetary policy. Without those constraints, infinite liquidity beckons forth the spectres of galloping inflation and disappearing reserves.

Commercial banks

The commercial banks are the next most liquid of the institutions. They have the ability to create their own liabilities too, but only up to the point where public confidence in their soundness, i.e. ability to go on doing it, is maintained. A bank lending money to a customer credits his account, thus creating an asset and a liability at the same time. But the liability (deposit) can be withdrawn, according to its terms, requiring a matching increase in another liability, by an outside borrowing or deposit not originating on the lending side; or a reduction in assets, for example drawdown on call deposits with the Central Bank, sale of securities, or the calling in of loans (with the potential of a knock-on effect through the system). It is the very high liquidity, the immediate availability, of a bank's deposit liabilities to its customers that testifies to its soundness and attracts more deposits; at the same time, that liquidity requires the bank to keep a proportion of its assets also in liquid form, and to have ready access to other liabilities that can provide liquidity, such as a line of credit with the Central Bank, in case of need.

Other financial institutions

DBSI, NPF, ICSI, HFC and any other institutions that have non-liquid liabilities, and consequently are able to make long-term loans on the assets side, are grouped together here. These institutions are funded by capital subscriptions, long-term loans, and deposits in contribution accounts that cannot be removed for many years. Relieved of the threat of liquidating liabilities, they become long-term lenders for capital formation in commercial enterprises, homes and infrastructure, and (in the case of NPF) to provide non-liquid liabilities to the commercial banks to underpin their loan portfolios. Provided they appear financially sound, they can readily obtain liquidity when they want it, by borrowing from the next layer up in the hierarchy, the commercial banks. The credit unions, mostly operating on a much smaller scale, are protected against liquidity crises by rules on maintaining deposits, and limiting the amount that members can borrow. The case of ICSI, which built up a large portfolio of non-liquid assets on a liability structure that included a significant amount of more liquid borrowing —albeit medium-term—points up the need to match maturity and liquidity on both sides of the book. ICSI's problems have been compounded by the failure of several of its investment assets to generate funds to liquidate liabilities as these fall due.

In the hierarchy of liquidity, it is the institutions with the least liquid liabilities—a high ratio of capital, long-term loans and fixed deposits—that can support non-liquid, multi-year loan and equity investment portfolios. The institutions with more liquid liabilities, that may be withdrawn or must be repaid soon, cannot safely take on long-term assets.

The development of the capital market

The two main requirements for a higher rate of savings are that potential savers should have ready access to, and understanding of, facilities for holding financial assets; and that saving money should be seen as financially rewarding, compared with spending it. Improved access and understanding will come from:

- extension of the physical coverage of the banking system through the bank and agency network;
- more competent and diversified services at provincial offices and agencies. Consideration will be given to making DBSI a deposit-taking institution, to strengthen its customer relationships; and
- specific publicity by individual banks, and generalized information by the Central Bank, aimed at schools and the general public.

Assurance that saving is worthwhile will come from:

- the maintenance of relatively low rates of domestic inflation, and public confidence in this continuing; and
- clearly positive real rates of interest (i.e. nominal rate minus expected inflation rate) on financial assets, including savings, time deposits and government securities.

The development of the capital market will require a coordinated, step-by-step approach, involving NPF, ICSI, DBSI, the commercial banks, statutory and large private corporations. Vehicles for smaller private investors, in the nature of unit trusts, may be needed and could be established by, for example, ICSI, or independently. NPF will need to resume its historic role as key provider of long-term deposits to the banking system and long-term loans to statutory and large private corporations. The issue of securities by such corporations, with the aim of eventually developing a secondary market in these and government securities will be encouraged. An institutional vehicle, such as an equity fund to be operated by DBSI, will probably be needed to provide venture capital. This would supplement private equity in projects with good prospects but insufficient owner's funds to support a prudent equity/loan structure. Foreign participation in such a fund would be useful.

Equity, local or foreign, is the best form of enterprise finance from almost all points of view; but 100 per cent equity funding of large projects is unusual. Most owners/sponsors will look to arrange a reasonable level of gearing, and some will wish to arrange a significant part of this in the Solomon Islands.

The low level and slow build-up of accumulated savings in private hands means that longer term, larger financing, over and above what project owners/sponsors can reasonably provide, will probably require the involvement of official institutions to mobilize domestic and foreign savings. The most powerful domestic tool for this is NPF, which annually steers 12.5 per cent of formal sector payroll costs into savings in the form of bank deposits and other financial assets, distributing the cash flow from new contributions and existing investments. This makes NPF potentially a major influence on the embryonic capital market. The most effective intermediaries for channelling foreign savings into domestic lending will be the Central Bank, acting as 'apex borrower' of long-term funds from the World Bank or similar lenders. This will support the developmental lending of commercial banks and the Development Bank, as the disburser of more precisely targeted funds provided by overseas official sources and semi-official lenders such as the Commonwealth Development Corporation. In a more limited role, the HFC also has the potential to use foreign long-term loans, intermediated by the government, for domestic lending.

Furthermore, DBSI and the HFC's predecessor Housing Authority have both used long-term loans from the NPF, blended with concessional or equity-type funding from the government, to finance domestic fixed capital formation, and have the potential to do much more of this.

High overhead costs mean that DBSI and the commercial banks will have great difficulty dealing cost-effectively with very small urban and rural accounts. Several developing countries are experimenting with the use of less formal intermediary institutions to deal directly with the end-user (saver or borrower) of relatively small individual packets of money.

The credit union movement is the main policy vehicle for this in the Solomon Islands. With 86 registered unions, membership in excess of 10,000 and SI$4 million total assets, the movement is still in its infancy, and experiencing many growing pains. These must be overcome by the League of Credit Unions, with the support of the government, CBSI and overseas sources of assistance. At present CBSI is the main source of support, but this needs to be diversified. External sources are willing to assist if asked.

The cooperatives, women's clubs, Non-Government Organization revolving funds and a number of other schemes, characterized by minimal formality and strong participation in ownership and decision-making by the savers and borrowers themselves, are alongside the credit unions. With intelligent encouragement by the authorities and greater exchange of information and experience among all concerned, these less formal methods of intermediation appear to have great potential for development. A study is needed of this potential, to identify the methods now in use, find out where gaps exist and why, and indicate how these could best be filled. CBSI proposes to sponsor such a study in 1991, with participation from one or more overseas sources with relevant experience. Meanwhile the existing Rural Financial Services Working Party will continue in its broad coordinating and information-exchange role.

Threats to the financial system

As the monetary economy enters more deeply into people's lives, the structure of the domestic economy becomes more complex, and growing relations with the outside world increase the exposure of the Solomon Islands economy to external shocks, it becomes more important to take adequate precautions against threats to the financial system or its component parts. These threats may come from stress in the real economy—falls in commodity prices, crop failures, natural disasters, collapse of mismanaged enterprises —leading to non-repayment of debt or loss of capital; or from problems of incompetence, mismanagement or fraud within the financial system itself, leading to loss of owners' funds and, if unchecked, loss of depositors' funds and erosion of public confidence in the system. The most common cause of institutional failure is mismanagement, leading to over-lending, over-borrowing, inability to meet obligations, illiquidity, insolvency and closure; but large-scale fraud can pose equally great dangers, and come as an even greater shock. These threats also affect much larger and older financial systems than that in the Solomon Islands.

To guard against these and related dangers, more up-to-date and detailed legislation is required to replace the present Banking Act, to give the Central Bank wider powers of system and institutional supervision and, if necessary, intervention; and to spell out more clearly the standards to be met by financial institutions and the punishments to be imposed for failure to do so. The new legislation should usefully make provision for matters on which the present Act is silent, e.g. banking for non-residents in foreign currencies (offshore banking), the treatment of off-balance sheet assets and liabilities, the standard of care to be applied in ascertaining the nature of transactions, and the procedures for enforcement. The Central Bank will develop its supervisory capabilities in step with its legal responsibilities, drawing on regional and international resources for technical training and assistance with specific issues.