Economic survey

The financial sector in Vanuatu: reform and new challenges

Patrick de Fontenay

The financial sector in Vanuatu is relatively large for a country at its level of development. In 1998, financial services, including insurance, accounted for 7.5 per cent of GDP and 10.6 per cent of foreign exchange receipts from exports of good and services. About half of this was contributed by the offshore centre, the largest in the region.

This survey describes the structure of the financial sector and the weaknesses which necessitated a major reform and restructuring effort. The offshore centre is analysed, and outstanding issues for the future of the financial sector are discussed.

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The financial sector[1]

The Vanuatu financial sector, which includes the central bank and all financial intermediaries, is comprised of a broad range of institutions, from affiliates of large international banks to micro-credit systems.

The Reserve Bank of Vanuatu

The Reserve Bank of Vanuatu (RBV) was established in 1980, the year Vanuatu became independent. The Bank's main objectives, according to the Central Bank of Vanuatu Act, are to issue currency, promote monetary stability, manage the country's official reserves, advise the government on banking and monetary matters, supervise the banks, promote a sound financial structure, and foster economic conditions conducive to the orderly and balanced economic development of Vanuatu.

The act strictly limits the independence of the RBV. The government owns all of the RBV's capital and is entitled to its profits. The Governor of the RBV is appointed by the Prime Minister on the recommendation of the Minister of Finance. Of the four members of the Board of Directors of the RBV, one is a representative of the Ministry of Finance, two others are appointed by the Minister of Finance, and the fourth is the Governor of the RBV, who is chairman of the board.

If conflict arises between the bank and the Minister of Finance, 'the Council of

Ministers may, by directive, determine policy to be adopted by the Reserve Bank'. The Minister of Finance can thus revoke decisions taken by the board. The most publicised of such actions took place in 1998. On 27 March, following 20 per cent exchange rate devaluations by Fiji, Papua New Guinea, and Solomon Islands, the RBV announced a 20 per cent devaluation of the vatu,[2] but the government revoked the decision and dismissed the Governor. Conflicts are, however, unusual. 'Shared responsibility' for monetary policy and close consultation is the usual practice.

The commercial banks

Vanuatu has five banks with domestic banking licenses. Three are foreign owned—ANZ, Westpac, and Banque d'Hawaii. One, the National Bank of Vanuatu, is state owned. The fifth and smallest, European Bank Limited, operates almost entirely in the offshore market. At the end of 1999, the total assets of these five banks amounted to VT38.2 billion.

The National Bank of Vanuatu (NBV) commenced operations at the end of 1991 with a view to providing banking services to the local population—including those in the rural areas—by creating a network of branches capable of serving small communities and supporting local entrepreneurship. The bank's operations expanded rapidly, and it is the only bank currently operating outside the urban areas of Port Vila and Luganville. This expansion was accompanied, however, by an increase in non-performing loans, which came to represent more than half the bank's loan portfolio, ultimately leading to restructuring.

All the commercial banks operate in the offshore market (although only to a limited extent in the case of NBV) and it is difficult to draw a clear line between their offshore and domestic business.

There are two other distinguishing features of commercial banking in Vanuatu. First, the bulk of deposits recorded as residents' deposits, which excludes deposits of offshore institutions, are denominated in foreign currencies. At the end of September 1999, these deposits represented 71 per cent of total deposits. Some of the foreign currency deposits, mainly time and savings deposits, are believed to be owned by non-residents and offshore companies. The degree of currency substitution for domestic transactions appears to be relatively small. Second, the interest spread—the difference between the weighted averages of interest rates on loans and deposits—is high, fluctuating around 9 per cent throughout the 1990s. Possible explanations include the low cost of funds due to the absence of taxation, the high risk of loans (due to the shortcomings of the legal and land ownership systems), and insufficient competition in the banking sector.

Development Bank of Vanuatu (DBV)

The DBV, which succeeded the Development Bank of the New Hebrides, was established as a statutory corporation in 1983 to promote the development of the natural resources of Vanuatu. Poor lending practices led to mounting losses and the bank closed in 1998.

Vanuatu National Provident Fund (VNPF)

The VNPF covers all salaried workers in Vanuatu. Its funding comes from contributions from employers and employees. Following an Ombudsman's report criticising the lending practices of the VNPF, riots broke out in Port Vila and the government allowed the VNPF members to withdraw their accumulated savings from the Fund. Subsequently, the VNPF was restructured (see next section) and its charter amended.

Other institutions

Other institutions in the Vanuatu financial system include a lease finance company, credit unions, a micro-credit scheme (VANWODS), savings clubs and other self-help groups in the informal economy. There are about 20 active credit unions, mainly in the rural areas, with total assets in excess of VT30 million. Loans are made (in order of importance) for school fees, agriculture, business, housing, and other purposes. The Vanuatu Credit League provides training, auditing, and other financial services to credit unions, and generally promotes and supports the credit union movement (with financial assistance from various donors). Until the Credit Union Act of 1999, credit unions were unregulated. The Act legally establishes the credit union system in Vanuatu and provides a framework for the formation, operation, and regulation of credit unions. The Financial Services Commission is now responsible for the registration and supervision of credit unions.

Reform and restructuring of the financial sector

During the period 1996–98, Vanuatu experienced severe political instability and financial turmoil. The ombudsman brought to light serious governance problems in public enterprises and financial institutions, whose losses were still mounting. In early 1998, macroeconomic stability was threatened by the government's decision to allow VNPF members to withdraw their contributions. This, combined with exchange rate devaluations in three other Pacific islands states, led to expectations of a devaluation of the vatu, capital outflows, and large losses in official reserves. The RBV, which had until then displayed a rather passive stance and allowed banks to hold sizeable excess reserves, acted forcefully to tighten monetary policy and impose capital controls.[3] This more active style of monetary management required changes in the instruments used by the RBV to influence bank liquidity and to defend the currency.

In February 1997, the government and the RBV had reached an agreement on the need for comprehensive reform of the public sector, promotion of private sector development, as well as the need to involve the funding agencies in the formulation and implementation of a comprehensive reform program. The Asian Development Bank (ADB) took the lead role in this process. The comprehensive reform program came into

Box 1
The Vanuatu Women's Development Scheme (VANWODS)

VANWODS is a successful micro-credit scheme for low-income women sponsored by the Department of Women's Affairs and financed by the United Nations Development Programme. It consists of 17 'centres' of no more than 30 women each. Total membership had reached 405 by the end of 1999. Each centre surveys the needs of its area and selects a group of five women, who, after some training, prepare a project that will bring enough income to repay a loan, and decide on the first two women to receive the loan. First loans are for VT 5,000–15,000 at an interest rate of 16 per cent. At the end of 1999, the amount of loans disbursed was VT11.2 million and the repayment rate was 100 per cent. Loan repayments totalled VT8 million. Since the inception of the scheme, the minimal staff of four has been maintained and, as a consequence, total expenditures have only reached VT 155,000.

effect in mid July 1998 and was supported by a US$20 million loan commitment from the ADB. The comprehensive reform program focuses on governance and public sector reform, reform of the financial sector and the tax system, private sector development, social equity, and sustainability. It was an ambitious program, requiring a number of new laws to be passed.[4] The financial reform program included introduction of indirect market-based instruments for monetary management, strengthening of bank supervision, and restructuring of public financial institutions.

Reform of monetary policy instruments

In a small open economy with a fixed exchange rate, monetary policy can be used solely for maintaining the exchange rate. Given the well-known problems associated with direct controls on bank credit and interest rates, practically all countries have adopted so-called indirect instruments of monetary policy, such as open-market operations and repurchase agreements, to affect interest rates and both the capital and the current accounts of the balance of payments. Rediscounting is now viewed more as a lender-of-last-resort measure.

Since 1998, the RBV has pursued a more active policy of influencing the liquidity of the banking system and interest rates through new monetary instruments. It reintroduced a revised Statutory Reserve Deposit (SRD), now set at 10 per cent of all residents' demand, saving and time deposits denominated in vatu, plus 5 per cent of demand deposits in foreign currency. In March 1998, it began to auction Reserve Bank of Vanuatu notes with a 91-day maturity, followed by 28-day notes in June. Auctions take place every other week. The sale of RBV notes is coordinated with sales of government bills and bonds, which are also purchased mainly by the banks. Finally, at the end of 1998, the RBV introduced two new credit facilities for banks—the Rediscount Facility and the Repurchase Agreement—which replaced the existing Advance Facility in May 1999. The effectiveness of the new instruments has been limited, however, by the absence of an active inter-bank market and a secondary market for RBV notes and government securities.

Regulation and supervision of domestic banks

The failure of a domestic bank, Olilian Bank, in 1996, the mounting problems of the National Bank of Vanuatu, and the lessons of banking crises in Asia and elsewhere made it imperative to strengthen the prudential supervision of Vanuatu banks. In 1996, the RBV, with the help of the International Monetary Fund, set up a Bank Supervision Unit which is responsible for the regulation and supervision of banks and credit institutions operating in the domestic economy. At present this includes the five commercial banks and AGC. The Financial Institutions Act of 1999 formalises this arrangement. *Inter alia*, it gives the RBV the power to take control of troubled banks to safeguard assets and protect depositors (there is no deposit insurance in Vanuatu).

The RBV is also responsible for issuing new licenses for domestic banking and it can revoke licenses for contraventions of the provisions of the Financial Institutions Act. The RBV carries out its responsibilities by issuing prudential guidelines and by conducting both on-site and off-site inspections to assess the risk management capabilities of the banks and their observance of regulations. These include a Liquid Asset Ratio of 15 per cent (introduced in April 1999), a Capital Adequacy Ratio of at least 8 per cent of risk weighted assets (since September 1998), an asset quality guideline, issued in May 1997, on the reporting of impaired assets, and a credit risk management guideline (February 1997).

In February 2000, eight Pacific island countries, including Vanuatu, agreed to establish a process of consultation and cooperation in regulatory and supervisory matters with a view to strengthening confidence and stability in their financial sectors and to reducing the risk of contagion.

Restructuring of public sector institutions

Starting in 1998, the government began restructuring the National Bank of Vanuatu (NBV), the Development Bank of Vanuatu (DBV) and the Vanuatu National Provident Fund (VNPF). The bad loans of the three institutions, amounting to about VT2 billion, were sold to an asset management unit, which was given the mandate to recover as much as possible from more than 1,000 borrowers. The good loans of the DBV and the housing portfolio of the VNPF were transferred to the NBV and the DVB was closed.

The NBV was recapitalised by an injection of VT400 million by the government, which raised its capital adequacy ratio to 10 per cent. It paid for the housing portfolio of the VNPF with its holdings of government securities. A new management was installed (including the Managing Director, a former Westpac manager), and the composition of the board was changed. The new board and management put in place new policies, a new structure, and improved information technology. They emphasised the need for training and staff development, and a new culture based on integrity and normal commercial practices. Cost limitation was also pursued, new equipment (ATMs) was purchased and staff levels were reduced—30 per cent of DBV's staff was retrenched.

The VNPF Act was amended to bring qualified individuals to its Board of Directors, provide for offshore management of 50 per cent of the portfolio, and raise employers' and employees' contributions from 3 to 4 per cent each. New contributions are invested in bank term deposits and government bonds. The VNPF still has a large accumulated deficit (due to the fact that past income, minus operating expenses, was insufficient to pay the required 3 per cent interest on contributions). In effect, this represents an unfunded liability for the government which, although not legally obliged to do so, is likely to guarantee the obligations of the fund, including the three per cent minimum rate of return.

The Asset Management Unit has recovered about VT200 million on the loans received from the NBV, the DBV and the VNPF. Its running costs are covered by the budget. The Unit has had recourse to the courts on rare instances and only as a last resort.

The offshore centre

The offshore centre includes a number of financial institutions, corporations, trust companies, accounting and law firms that are established in Vanuatu but are not allowed to transact business with Vanuatu residents (see Dwyer, this issue). It is difficult to distinguish offshore business from the purely domestic operations of the financial sector, especially as regards the commercial banks. Consequently, Table 1 includes all bank operations.

Although it is the largest in the area, the Vanuatu offshore centre is small by comparison with other centres such as Bermuda or Mauritius. Individuals and businesses come to it for its privileged tax status, and banking secrecy.[5] Vanuatu has the advantage of being in the same time zone as Australia, New Zealand, and some Asian countries. A large part of its offshore business comes from the first two of these countries, as well as Hong Kong.

The Vanuatu offshore centre is supervised by the Financial Services Commission, that is also responsible for registering new offshore entities and for collecting registration fees for the government. For banks, the final decision on registration is taken by the Minister of Finance. Vanuatu has recently been shaken by allegations that it was being used for money laundering (see Box 2). This led some US banks to impose a ban on transfers with financial institutions in Vanuatu. Following a visit to the United States in February 2000 by several officials from the Ministry of Finance and the Financial Services Commission and the CEOs of two commercial banks to explain what Vanuatu was doing to fight money laundering, the ban appears to have been lifted.

Vanuatu's offshore banks and companies are mainly 'booking businesses'. That is, they are used to record profits in Vanuatu, taking advantage of the absence of corporate income tax, capital gains tax and estate duties there. Very few conduct any real business in Vanuatu. Some are even Internet outfits with no clearly identifiable location.

What is often misunderstood is that none of the offshore businesses, including banks, transfer funds into or out of Vanuatu themselves. To do so, they must have an account with a domestic bank. If they have bank accounts in other countries, however, they can transfer funds into or out of those countries, but such transfers are outside Vanuatu's jurisdiction and are not subject to control by the Vanuatu authorities. The term 'tax haven' does not necessarily imply money laundering, unless bank secrecy is so strict as to prevent the disclosure of transactions that may involve money laundering.

Challenges for the future

Vanuatu's financial sector cannot remain unaffected by political and economic developments in the country. Political and macroeconomic instability and weak governance, among other things, could impact adversely on it.

The main issues for the future are sustainability and vulnerability. Sustainability relates to the continued commitment to the comprehensive reform program, consolidation of the reform and restructuring of the financial sector. Vulnerability encompasses possible threats to macroeconomic stability and the risks associated with the misuse of the offshore centre.

Sustainability

Much has been accomplished in the area of financial sector reform in the past two years. Progress should now be consolidated and extended. In particular, reform of the legal system would strengthen financial institu-

Table 1 **Vanuatu offshore centre: main indicators**

	1995	1996	1997	1998	1999[1]
Total local expenditure (million vatu)	2,2481	2,102	2,019	2,141	1,657
(of which: banks)	1,355	1,055	963	956	732
Foreign exchange earnings[2]	1,474	1,621	1,567	1,950	1,063
Total employment[3]	386	424	409	393	400
Number of non-local companies registered[3]	1,445	1,201	1,856	2,048	2,624
(of which: banks)[3]	79	74	77	66	68

Notes: [1] First three quarters
[2] Includes government registration fees and other revenue
[3] End of period
Source: Reserve Bank of Vanuatu. *Quarterly Economic Review*, Port Vila (various issues).

tions by giving them greater certainty as to their rights vis-à-vis borrowers and easier and more predictable access to courts to recover debts and liquidate collateral. The adoption of the Financial Institutions Act in 1999 was, in this respect, a step in the right direction.

One important issue is whether closure of the DBV and the restructuring of the NBV have left a gap in the credit system that requires setting up a new institution. It is argued that the stricter commercial criteria of the NBV have made it difficult for small indigenous businesses to get credit, and that there are no sources of credit for long-term investments in primary activities. One proposal would be to set up a 'rural finance unit' within the NBV for such activities. This, however, could jeopardise the progress made in restructuring the bank and the possibility of privatising it or 'twinning' it with a strong financial institution. It would also be incompatible with present efforts to develop a new 'culture' within the bank based on best commercial banking practices.

Fortunately, there are other options. Micro-finance schemes, like VANWODS, and credit unions can play a useful role in promoting and assisting small business. The government has also set up a small business development centre, which would not only provide training and technical assistance for project preparation and business plans, but also operate a guarantee fund. The fund would guarantee 80 per cent of the loan to commercial banks. It would be financed up to VT110 million by a grant from the Chinese government and operate on an experimental basis for an initial period of three years. This cautious approach and the absence of a potential liability for the budget make the proposal attractive.

Aid agencies are also filling the 'gap'. For example, the New Zealand High Commission's Small Projects Fund and the Direct Aid Program, managed by the Australian High Commission, aim to promote social and economic development in rural areas. The French Development Agency's Belaru project on the island of Espiritu Santo has organised a rural cooperative whose members cultivate individual plots on 'custom' land and receive a line of credit guaranteed at a commercial bank.

For larger projects, the Kula Fund, financed by the Commonwealth Development Fund, the Asian Development Bank, the International Finance Corporation (IFC), the Fiji Provident Fund and Proparco, provides investment capital (US$200,000 to US$2 million in any one company) for the Pacific islands. The South Pacific Project Facility, managed by the IFC and cofinanced by the ADB, IFC, and five countries, provides technical assistance to small and medium enterprises. It helps them prepare bankable projects ranging from US$100,000 to US$5 million and raise the financing from local banks. One of its projects in Vanuatu, a tourism-based project, has been brought to completion, and others for agri-processing and fishing are under discussion.

The Vanuatu government has also approved the establishment of a Cooperative Development Fund to support the business activities of cooperative societies in the islands, especially for agriculture, fisheries, livestock and forestry. Under the by-law prepared by the Department of Cooperatives and Business Development Services, the Fund will be managed by that department and a Board of Directors. The balance of the Chinese government grant—about VT300 million—will be used for the initial funding. As in the case of the guarantee fund, a cautious, well-monitored experimental phase of this project may be justified.

From a long-term perspective, the VNPF should be converted to a pension fund, whose members receive an annuity after a certain age and are permitted to take out only a part of their accumulated savings as a lump sum, instead of the current 100 per cent. As this is not feasible for current members, the change should apply to new entrants and

Box 2
Money laundering

Money laundering refers to the introduction of the proceeds from criminal activities into the payments system of a country and/or the international financial system. Concern about money laundering comes from the fact that 'dirty money' can be more easily apprehended at the point where it enters a legitimate financial institution. It is also feared that once it is inside the financial system, dirty money may harm some legitimate business, including financial institutions.

The fight against money laundering can only succeed with international cooperation. Without it, criminal elements can find the weakest link in the chain to break into the payments system. In December 1988, the countries represented on the Basle Committee on Banking Regulations and Supervisory Practices agreed on a 'Statement of Principles' outlining some basic procedures that banks should adopt to curb money laundering. Subsequently, the G–7 Summit in 1989 set up an inter-governmental body, the Financial Action Task Force (FATF), to coordinate the efforts of legal, financial and law enforcement experts of 26 countries to fight money laundering. In 1990, FATF issued a list of 40 recommendations (revised in 1996) which all countries are encouraged to adopt. The recommendations set out the basic framework of efforts to counter money laundering, covering issues such as law enforcement, the financial system and its regulation, and international cooperation. FATF has a regional office in Sydney, which acts as the Secretariat for the Asia–Pacific Group on Money Laundering.

On 14 February 2000, FATF issued a 'Report on Non-cooperative Countries and Territories' defined as 'jurisdictions offering financial services without appropriate control and regulation and protected by strict banking secrecy'. The report includes a list of 25 criteria to identify countries as 'non-cooperative'. The criteria are grouped under 4 headings—loopholes in financial regulations, impediments set by other regulatory requirements (such as inadequate requirements for registration of business and legal entities), obstacles to international cooperation (at the administrative and judicial levels), and inadequate resources for preventing, detecting and repressing money laundering activities. A list of 'non-cooperative countries and territories' will be drawn up 'focusing on financial centres whose activities are of such character or significant size that, if there are shortcomings in their systems, they could undermine existing anti-money laundering regimes.' FATF would then attempt to convince such jurisdictions of the need to improve legislation and domestic practices and to participate actively in international cooperation. If this should fail, FATF members could take counter-measures to protect their financial systems and economies, including reporting financial transactions with individuals or legal entities having their account at a financial institution established in a 'non-cooperative jurisdiction', or restricting or prohibiting transactions with such jurisdictions.

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should be introduced at the earliest opportunity, since it will take a long time to affect a substantial share of the labour force.

Vulnerability

Vanuatu is not only vulnerable to natural disasters, but also to macroeconomic imbalances and the infiltration of its offshore centre by disreputable elements—both major threats to its financial sector.

The macroeconomic environment. As a small open economy with a fixed exchange rate, Vanuatu is vulnerable to shifts of confidence in its currency. In February 2000, following losses in its official reserves (due in part to the foreign portfolio investments of the VNPF) and rumours of an impending devaluation, the RVB reintroduced the exchange restrictions on capital account transactions that had been in effect for part of 1998. This obviated the need for a sharper rise in interest rates—rates had already reached 7 per cent in RBV 28-day note auctions—but can only be seen as a temporary measure, because exchange controls produce distortions, discourage foreign investment, and lose their effectiveness over time. Macroeconomic stability—low inflation and sustainable external payments position—ultimately depends on following appropriate fiscal and monetary policies.

Fortunately, fiscal policy is likely to be more consistent with this objective than had been feared around the end of 1999. The 2000 Budget Statement describes one of the government's economic and financial performance targets as 'net domestic financing of the deficit to be negative or at worst zero over a 3-year cycle'. It also provides for a balanced recurrent budget and an overall deficit of 3 per cent of GDP (6.4 per cent if the likely roll-over of externally financed capital expenditures already committed is included). The deficit is to be entirely financed by foreign concessionary loans. (Vanuatu's dependence on external assistance is another aspect of its vulnerability).

A prudent fiscal policy would reduce interest rate volatility and ease the burden on monetary policy of safeguarding macroeconomic stability. Nevertheless, monetary policy is the predominant tool for maintaining the exchange rate peg, and a significant reduction in official reserves must be allowed to contract the liquidity of the banking system.

Cooperation between the RBV and the Ministry of Finance has been good, but there is a risk that the Ministry may balk at high interest rates, however necessary they may be to defend the exchange rate, because of their impact on the refinancing costs on the public debt and on economic activity. 'Shared responsibility' may be difficult to maintain.

The offshore centre. Although it is unlikely that money laundering on a large scale would have taken place through Vanuatu, given the relatively small amount of funds transferred by Vanuatu's commercial banks (estimated at US$6 billion per annum), a strengthening of anti-money laundering efforts is necessary. The small gain to the country from letting in disreputable operators is not commensurate with the risk to its reputation as a financial centre and tax haven.

The authorities in Vanuatu are aware of this and are preparing new legislation to curb money laundering. An International Banking Act, already in the drafting process, deals with banks in the offshore centre and their obligations to disclose their operations periodically. The United Kingdom has offered to fund technical assistance that would help organise supervision of the banks by the Financial Services Commission (FSC). The licensing process, however, is essential for ensuring that management and shareholders are 'fit and proper' and that only legitimate businesses, financial or other, operate in the offshore centre. This process could be made stricter and insulated from political pressures. Strict regulation and supervision of Internet gambling, as proposed in the draft Internet Gambling Act, is also important, given that gambling can be used for money laundering. At present, operators based in Vanuatu are unregulated and unsupervised.

The other piece of legislation that is under consideration deals with the monitoring of fund transfers in and out of Vanuatu—the foreign transactions of the domestic banks. Commercial banks have statutory obligations under the Financial Institutions Act of 1999, which require them to report illegal or suspicious transactions to the RBV (as well as to the police, under the Serious Offences legislation). They also have the Code of Conduct of the Bankers Association and the Finance Centre Association. These obligations, however, may not meet the criteria of the Financial Action Task Force on Money Laundering, which will determine whether Vanuatu should be listed as a 'non-cooperative country'.

A working group, which includes the law enforcement agencies and representatives of the Bankers' Association, the Ministry of Finance, the Reserve Bank, Customs, and the Finance Sector Association, has been set up to examine these issues and to consider the creation of an intelligence unit. Strengthening of institutional measures to counter money laundering is in Vanuatu's own interest, but it would also benefit other countries by reinforcing the protection system around them. These countries should, therefore, be prepared to assist Vanuatu in its efforts to limit money laundering—it is, after all, in their interests too.

Notes

1 This section and the next are in large part based on Reserve Bank of Vanuatu (forthcoming).

2 The vatu, is pegged to a basket of currencies. As of February 28, 2000, one Australian dollar was worth VT82.17.

3 The controls took the form of 'guidelines' to commercial banks, restricting their purchases of foreign exchange from the central bank to finance current transactions. Banks were also required to meet requests for capital transfers out of their own foreign assets. The controls were lifted in October 1998 and reintroduced in February 2000.

4 For an assessment of the preparation and implementation of the comprehensive reform program see ADB 1999.

5 Strictly speaking, there is no statutory bank secrecy. Secrecy provisions are in the International Companies Act and the Trust Companies Act. Banks maintain bank/customer confidentiality.

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