

The financial sector in Papua New Guinea — A good case of reform

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This paper contains a review of the institutions, markets and regulation involved in the financial sector in PNG. An assessment is made of recent reform in the sector and some conclusions are drawn from this case regarding further reform in public policy.

These conclusions note the success in PNG in improving the financial sector: business has been revitalised with restored trust, profits and increasing services. Furthermore reforms are continuing in the sector.

There appears much to learn from the reforms of the PNG financial sector, from its genesis in crisis, the comprehensive approach to reform, and the Government setting down clear rules and roles for players, and delegating responsibility to a regulator.

Publicly available information about the sector is improving. This article is based on published material and information on websites of the Bank of Papua New Guinea and of commercial businesses in the sector.

1 The author is from Pacific and Assistance Division, the Australian Treasury. This article has benefited from comments and suggestions provided by Satish Chand, Glen Maher, Steve Morling, Neil Motteram, Andrew Oaeke, Rob Stewart and Greg Taylor. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

‘The financial markets of the Pacific are underdeveloped and do not provide support for the private sector’, *Swimming Against the Tide*, ADB 2004.²

Papua New Guinea’s financial sector plays a key role in people’s lives as they save for major expenses such as education, health or retirement or as they strive to expand their incomes and businesses. More generally a sound financial sector is an essential foundation for a market economy, such as PNG, to prosper in good times and overcome bad times.

Recent years have seen profound changes in PNG’s financial markets. This article discusses those changes and what could be learned from them. Relative to the rest of the economy, the financial sector contributes less than 4 per cent of GDP, however reform in the sector is bringing encouraging results.

This article reviews the institutions, markets and regulation involved in the financial sector. An assessment is made of recent reform in the sector and some conclusions are drawn from this regarding further public policy reforms.

Institutions³

The Bank of Papua New Guinea (BPNG) regulates commercial banks, finance companies, merchant banks, savings and loan societies, superannuation funds, life insurance companies and other licensed institutions in PNG. There are also general insurers and a stock exchange.

Commercial banks are the largest part of the financial sector. However, the BPNG reports that non-bank financial intermediaries have assets as big as commercial banks and contribute to the growth in private sector credit in PNG.⁴ The BPNG is expanding its financial sector survey to include these institutions.

Banking and credit

There are four commercial banks in the PNG financial sector: Bank South Pacific Limited (BSP), Australia and New Zealand Banking Group (PNG) Ltd, Westpac Bank (PNG) Limited and Maybank (PNG) Limited. The largest of these — BSP — has

2 See report by Holden, Bale and Holden.

3 Information for this section has been obtained from www.bankpng.gov.pg, www.bsp.com.pg, www.posf.com.pg, www.nasfund.com.pg, www.anz.com.au/png, www.westpac.com.pg, www.maybank2u.com.my and www.iccc.gov.pg.

4 Bank of Papua New Guinea, *Quarterly Economic Bulletin*, June 2006.

around 40 branches throughout PNG, and a branch in Niue and has recently acquired other banks in Fiji and Solomon Islands. ANZ and Westpac, subsidiaries of Australian banks, operate some nine and 15 branches respectively in PNG. Maybank, a subsidiary of a Malaysian bank, has two branches in PNG.

Table 1: PNG commercial banks' measures of size, October 2006

Commercial banks	Assets per cent of total	Deposits per cent of total	Lending per cent of total	Service points: branches and ATMs (no.)
BSP	53	53	48	52
ANZ	29	30	32	13
Westpac	16	15	19	19
Maybank	2	1	1	2
Total Kina million	7,172	5,054	2,348	-

Source: BPNG, *Statistics Update*, Volume 6 No. 24.

Other deposit-taking institutions include 21 savings and loan societies and 10 licensed financial institutions. Savings and loan societies are mainly linked to groups of employees, or are regionally based. Licensed financial institutions include credit providers that also provide limited deposit facilities such as term deposits and some microfinance entities.

There are also some very small microfinance groups that are not presently covered by the prudential regulator.

While not a licensed deposit-taking institution, PNG Government's Rural Development Bank lends to rural and regional borrowers from capital provided by the Government.

Regulation of banking is done under the Banks and Financial Institutions Act 2000 and the Savings and Loan Societies Act 1995. The BPNG – the central bank and major PNG financial regulator – is established under the Central Banking Act 2000 as an independent agency with defined statutory roles so that it operates independently from the day-to-day influences of government.⁵

5 For the advantage of the people of Papua New Guinea, the objectives of the Central Bank are:
 (a) to formulate and implement monetary policy with a view to achieving and maintaining price stability;
 (b) to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea;
 (c) to promote an efficient national and international payments system; and
 (d) subject to the above, to promote macro-economic stability and economic growth in Papua New Guinea.

Box 1: Bank reconstruction

A major bank reconstruction in PNG followed unsound conditions in a government-owned bank and a nationally owned commercial bank in the late 1990s and early 2000s. Attempts to recapitalise the nationally owned Bank South Pacific (BSP) had not brought success and the larger recently government corporatised Papua New Guinea Banking Corporation of (PNGBC) was in poor shape. The central bank removed its board in 2001 and the Government offered 51 per cent of the ownership of PNGBC to private buyers. This privatisation led to a domestic consortium of financial institutions amalgamating BSP and PNGBC to form a publicly listed BSP on the Port Moresby Stock Exchange with a minority Government holding of almost 25 per cent of the shares. The Government's motor vehicle insurance company (MVIL) owns a further 12 per cent.

The bank reconstruction occurred when the regulations empowering the central bank as the banking regulator had been reformed to give it clear roles as an independent authority. This reform, the reform of the superannuation legislation and the establishment of the stock exchange created conditions that facilitated the bank reconstruction.

In the reformed environment the BSP emerged as a bank with a sound governance structure operating under the prudential oversight of an independent regulator away from the political pressures of the day. The new board and managers of the bank are required to meet the 'fit and proper person' test and to meet the prudential standards of the banking regulations in their daily operations. Furthermore the bank has to meet the public reporting requirements of the stock exchange on its financial activities and its shareholding structure. The bank's dealings are thus open to direct scrutiny by the public and its shareholders, away from the damaging directions that a government can impose on banks.⁶

At the time BSP was listed on the Stock Exchange, the Government was putting in place a fiscal strategy to limit the growth of its debt and its need to borrow. Implementing this has led to a more stable economic policy environment in PNG and, with favourable commodity prices, BSP has prospered. At the end of 2005 it had total assets of K2.95 billion and has gained a credit rating of B+ Stable from Standard and Poors. As a sound bank, BSP is using its position to lend more to support private business growth in PNG and to increase the access that it provides to depositors. The BSP has now started to expand its operations in PNG, has invested in PNG Microfinance Limited and owns and operates banks in Niue, Fiji and Solomon Islands.

6 For information on the record of government failure in banking see the World Bank's report on *Finance for Growth*.

Superannuation

PNG has 10 authorised superannuation funds, 10 licensed trustees, 2 licensed investment managers, and 7 licensed fund administrators. The Public Officers Superannuation Fund⁷ (POSF), and the National Superannuation Fund (NASFUND) are the two largest authorised funds with over 86,000 members each and net assets of K1.517 and K851 million respectively at the end of 2006. Regulation of superannuation is done by the BPNG under the Superannuation (General Provisions) Act 2000 and the Superannuation Regulation 2002.

Life insurance

There are five licensed life insurance companies: Kwila Insurance Corporation Ltd, Life Insurance Corporation (PNG) Ltd, Workers Mutual Insurance (PNG) Ltd, Pacific MMI Insurance Limited, and Capital Life Insurance Company Limited, formerly Pan Asia Pacific Assurance (PNG) Ltd.

Regulation of life insurance by the BPNG is done under the Life Insurance Act 2000.

General insurance

The general insurance industry includes 12 insurers, 6 brokers, 5 loss adjusters and 1 reinsurance company. Companies providing general insurance in PNG include QBE Insurance (PNG) Limited, American Home Assurance Co, Tower Insurance Limited, Pacific MMI Insurance Ltd, Mitsui Sumitomo Insurance Co Ltd and the Government-owned Motor Vehicle Insurance Limited (MVIL) which provides compulsory third party motor vehicle insurance. For 2005 the net worth of the general insurance industry was reported as K292 million with total premiums of K201 million.⁸

Regulation of general insurance is done by the Insurance Commissioner under the Insurance Act 1995.

⁷ In June 2007 the name of the POSF was changed to Nambawan Super Limited.

⁸ Details of the general insurance industry have been released recently by the Independent Consumer and Competition Commission (ICCC).

Box 2: National Provident Fund restructure

The National Provident Fund (NPF) was established in 1982 under the National Provident Fund Act 1982 to provide mandatory retirement savings for employees in companies with more than 20 employees. The NPF Board included representatives of the government and was subject to ministerial investment guidelines. The NPF was required to report annually to the Parliament and was subject to audit by the Auditor-General's office, but was not subject to formal supervision. By the late 1990s concerns were being raised about the NPF's exposure to the PNG government, real estate and mineral sectors.⁹

During 1996–97, the NPF approved large illegal borrowings from foreign and domestic commercial banks to finance acquisition of equity (mostly in mining companies), a land purchase, and the construction of a large commercial building. With adverse economic conditions NPF became overburdened by its debt with estimated cumulated losses of K153 million, and a restructure package was legislated in the National Provident Fund (Financial Reconstruction) Act 2000. This involved :

- member account balances being written down by 15 per cent;
- a quarterly government grant to NPF of K1 million, indexed to the CPI, until 2016; and
- an additional employer levy of 2 per cent (ceased 31 July 2004).

Also, interest credited to member accounts in 1998 was reversed as the profit and loss statement for that year was found to be incorrect so that the average effective write-down on members' accounts was about 18 per cent.

The National Provident Fund (Financial Reconstruction) Act 2000 also provided retrospective authority for state borrowings from the NPF through nominee borrowers and conversion of those borrowings into inscribed stock (long-term bonds) issued to the NPF. In May 2002 the renamed NPF — as the National Superannuation Fund (NASFUND) — became the first superannuation fund to comply with the new superannuation legislation.

9 Further details about the NPF's investments are presented in BPNG's *Money and Banking in PNG*.

Box 2: National Provident Fund restructure (continued)

Building on the reforms begun in mid-1999, the restructure package, and wide-ranging improvements in governance, NASFUND returned to profitability. The resulting turnaround in financial performance between 2000 and 2003 was impressive. Outstanding debt was eliminated, and net assets grew from K223 million in 2000 by an average of 26 per cent a year, while net after-tax profits jumped from K16 million in 2001 to K53 million in 2003, enabling a rebuilding of reserves and a resumption of interest credits to member accounts.¹⁰ NASFUND membership has increased and net assets have continued to grow to reach K851 million by December 2006.

Markets

Financial markets in PNG have been evolving from the structure common in the Pacific where Australian commercial banks predominate.¹¹ Not only is domestic banking dominated by a PNG-owned bank but other developments are occurring so that non-banking institutions provide financial services covering savings, lending, securities, foreign exchange, money transfer, funds management, insurance and pensions.

Savings

Financial institutions supply a range of savings services in PNG.

The commercial banks offer transaction and savings accounts and these provide for the bulk, over 90 per cent, of reported deposits by depository institutions. Savings and loan societies account for almost 4 per cent of reported deposits and micro finance less than 1 per cent. Finance companies and merchant banks offer term deposits and non-bank account services in which they hold almost 3 per cent and 2 per cent of reported deposits respectively. Deposits in the banking institutions have grown in recent years as the state of the economy has improved, with a rise in the level of deposits from 23 per cent of GDP in deposit accounts in 2003 to a level of 35 per cent in late 2006. However, this level remains below that of other Pacific countries such as Fiji, Samoa and Vanuatu.

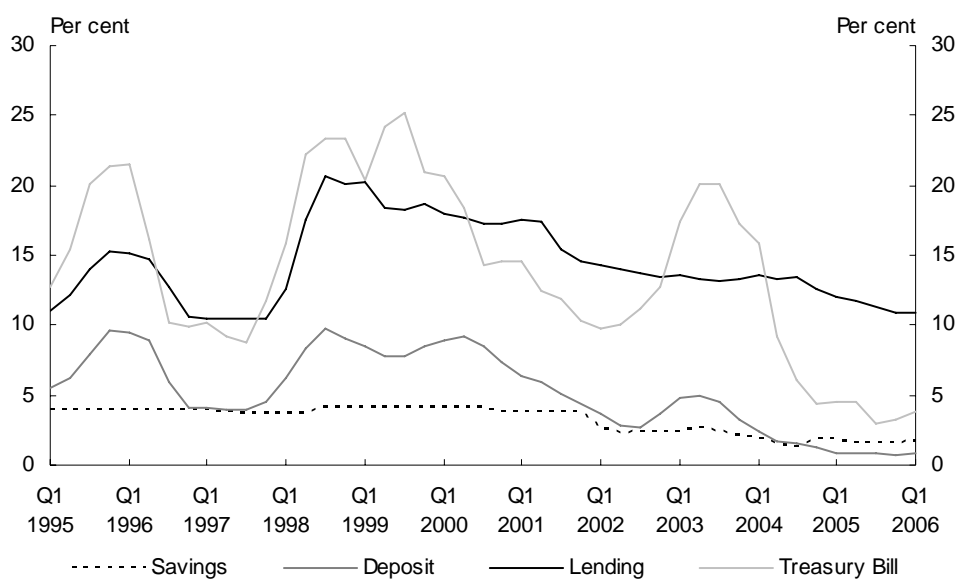
The BPNG reported that weighted average deposit interest rates paid by commercial banks averaged 1.1 per cent in the third quarter of 2006 per annum, ranging from

10 In 2004 the IMF provided a comprehensive assessment of PNG's financial reform of pension funds.

11 Holden, Bale and Holden characterise financial markets in the Pacific in this way.

0.43 per cent for cheque accounts to 7.9 per cent for term deposits longer than one year. Since the latter part of 1999 interest rates have generally trended downwards, although 182-day Treasury Bill rates spiked markedly in 2003 (see Chart 1). Savings and deposit rates are all low historically and in comparison with the central bank's indicator, the Kina Facility rate of 6 per cent. Interest rates have shown some reflection of the Treasury Bill rates during the last 10 years.

Chart 1: PNG selected interest rates



Source: International Financial Statistics.

The PNG superannuation funds provide another major repository for savings. These funds now hold over K2 billion in accumulated savings for their members from largely mandatory superannuation contributions and earnings. This amount is about 40 per cent of the value of deposits in depository institutions. The superannuation funds POSF and NASFUND credited their members' accounts with an average nominal return of 14.6 per cent annual for each of the five years 2001 to 2005.¹²

Competition by the PNG financial sector for savings can occur among the banks savings and loan societies, and those licensed financial institutions such as microfinance groups that take deposits. Less directly it can also occur among the above group and the super funds and the securities markets for those savers who can access such other forms of licensed financial services.

¹² PNG superannuation funds operate accumulation funds for their members with the accumulated savings being paid out as a lump sum on termination of membership; they do not generally offer pensions to their members. Some funds administer grandfathered government pension schemes for a limited group of public officers.

Box 3: Microfinance in PNG

There have been various initiatives to increase access to both saving and lending services to people in PNG who have difficulties in accessing other financial services. Initiatives taken several years ago are discussed in the BPNG book *Money and Banking in Papua New Guinea*.

More recent initiatives include the establishment of two licensed institutions, PNG Microfinance Ltd and Wau Microfinance. The former is a 60 per cent owned subsidiary of PNG Sustainable Development Program Limited in which BSP owns 40 per cent. It operates five branches and an agency in two provinces with over 46,000 deposit accounts in total. Wau Microfinance operates in Wau and Lae and was developed with support from the Asian Development Bank, the Australian Government and commercial banks in Papua New Guinea.

One of these microfinance institutions now reports to the BPNG and by December 2006 its assets had grown to K31 million from just under K6 million in May 2005.

Other initiatives to expand access to microfinance services include support for 'grassroots microfinance initiatives' in Bougainville with support from the Australian Government.

For savers in PNG, improving regulation and restructuring financial institutions in banking and superannuation have restored soundness to much of the financial sector and its capacity to increase financial services across PNG. Such soundness has restored business confidence in PNG's financial institutions, which is essential for the sector to operate effectively.

The financial sector reforms and those in competition policy are bringing more publicly available information about financial institutions and products to savers and investors in the financial sector. This helps them make sound choices about where to save and invest.

New entrants such as the Nasfund Contributors Savings and Loans Society, established by NASFUND, and PNG Microfinance Ltd, established by PNG Sustainable Development Program Limited, are examples of legitimate competition to increase the range of options open to savers.

'Fast money' schemes and other scams of various forms are not part of the financial sector in PNG. Under the reformed legislation, the BPNG provides information and

takes action to drive out such schemes so as to help savers avoid losing their money, as some have already done.¹³

Securities

The stock exchange is run by a private company Port Moresby Stock Exchange Limited (POMSoX) and lists public companies some of which are also listed on the Australian Stock Exchange. There are two share brokers who are members of the exchange and in 2005 some 15 companies were listed. The stock exchange operates under the Companies Act 1997 and Securities Act 1997 and its rules are used under licence from the Australian Stock Exchange.

The market for government securities is operated by the BPNG. In 2005 Treasury Bills to the value of K1.94 billion were on issue as were inscribed stock (government bonds) of maturities up to 10 years to the value of K1.57 billion. Information on this market is made available on the Government's Treasury website and by the BPNG through its website. The market has been restricted largely to wholesale activity. PNG financial institutions are holders of a large proportion, around 85 per cent of the government securities on issue domestically.

The market was described in the PNG 2007 Budget in the following terms, 'PNG has a rudimentary primary market for Treasury Bills and Inscribed Stock, with weekly competitive auctions of Treasury Bills and Central Bank Bills, and monthly competitive auctions of Inscribed Stock. However, there is almost no secondary market, and no effective repo market.'¹⁴

There are some moves being considered to expand the domestic government debt market as explained in the PNG 2007 Budget, including a pilot listing of some Government debts on the Port Moresby Stock Exchange.

Lending

There has been an increase in lending during the last two years along with growth in the economy and more stable macro policy conditions (see Chart 3). However, as deposits have been growing more rapidly there is a capacity for lending to increase more rapidly. The ratio of domestic credit (provided by the financial sector) to GDP has been around 22 to 24 per cent of GDP in recent years. Other Pacific countries such

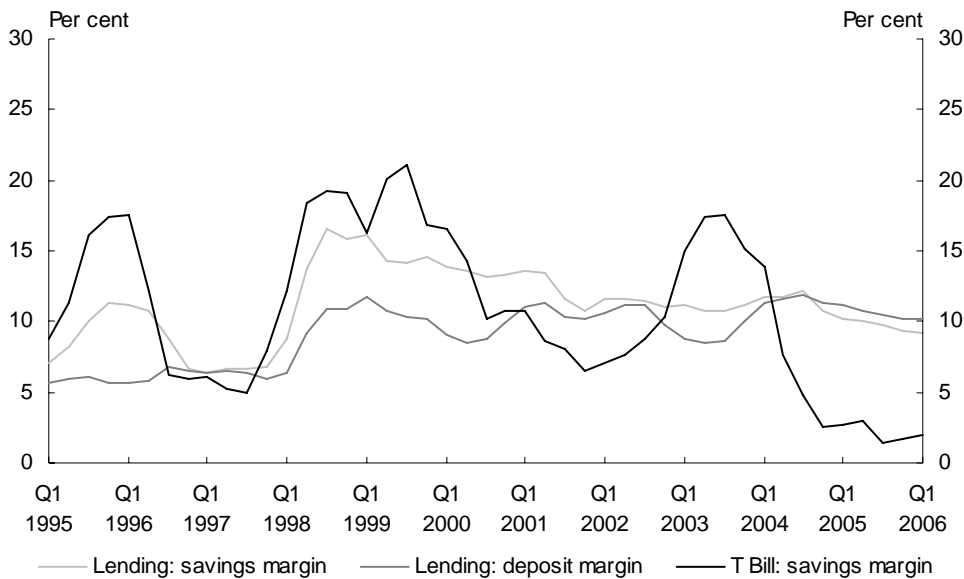
13 As BPNG pointed out in October 2006, it behoves others also to take a stand against such schemes.

14 The 2007 Budget Volume I also reports the establishment of a Treasury/BPNG project team to implement improvements to develop the market for inscribed stock.

as Fiji and Vanuatu have ratios almost double that of PNG, and New Zealand and Australia have ratios twice as high again.

Interest rates on lending declined in 2005 and fell further in late 2006 to reach a weighted average level of 10.4 per cent in the third quarter (see Chart 1). Consistent with this, the BPNG reports the annualised growth in largely private domestic credit in the 12 months to September 2006 being 35.4 per cent.

Chart 2: PNG selected interest rate margins



Source: IMF International Financial Statistics.

Margins between lending rates on the one hand, and rates paid for funds in savings accounts and term deposits on the other, are lower than they were in the late 1990s (see Chart 2). However, these margins are still above the levels achieved earlier in the 1990s. This suggests there is still scope to improve the performance in the financial sector, particularly in the competitiveness of savings and loan products.¹⁵

In the last few years we see low rates for Treasury Bill, savings and deposit rates below the Kina Facility rate, which have been associated with a low margin between the Treasury Bill rate and the interest rates offered for savings. Commercial banks are the major holders of Treasury Bills and maintaining competitive access to the Treasury Bill market will be important in keeping this margin low if Treasury Bill rates increase to the Kina Facility rate. The BPNG announcement on 13 April 2007 to reduce the

¹⁵ Conditions for business may have to be more conducive to new entrants and business expansion for this to occur; see for example Faal or Kavanamur, Yala and Clements.

minimum bid in Treasury Bill and Inscribed Stock auctions from K1 million to K100,000 should help foster this competition.

Foreign exchange

Under the floating exchange rate, the value of the Kina against the US dollar is set by the activity of commercial and retail buyers and sellers of foreign exchange. The BPNG uses market operations to provide some stability to the Kina exchange rate, and under the current exchange control regulations PNG banks are authorised dealers for foreign currencies in PNG. Exchange controls were liberalised in 2005 to provide exemptions from central bank approval for a range of transactions.

As noted in the PNG 2007 Budget the foreign currency market is relatively illiquid, and there are no currency swaps or other sophisticated financial instruments available that can be used to hedge financial risks.

The margins between the buy and sell rates for the Kina appear high relative to those offered for other currencies, which is consistent with a thinly traded market for foreign exchange.

The volume of trade in the foreign exchange market may well be limited by arrangements for payment of mineral and petroleum taxes in US dollars rather than in Kina.

Competition

As can be seen from the above, there are relatively few organisations supplying financial services in the PNG financial sector. In this environment it is likely that the competitive pressure is relatively light. Retail foreign exchange rates show that the margins in that market are high relative to the margins on rates elsewhere, suggesting limited competition in that market. Similarly, the margins between lending and deposit rates are higher than they have been in earlier periods and these could be expected to decline as increased competition occurs in the markets for deposits and for lending.

The Independent Consumer and Competition Commission (ICCC) is currently conducting a review of the general insurance industry in Papua New Guinea. The involvement of this organisation in the financial sector could be an important influence in helping to encourage a regulatory climate that not only ensures prudential soundness, but also fosters competition to ensure the financial industry operates and develops efficiently.

Regulation and reform¹⁶

Major reform of the financial sector was prompted by the financial crisis and near collapse of some major financial institutions in the 1990s. Many people lost wealth and their trust in the financial system. This, combined with a depreciated currency, rising public debt and low levels of foreign reserves, led to demands for reform.

Ministerial leadership in the PNG Government commenced the structural reform, drove it through parliamentary processes and marshalled PNG resources and other assistance to develop and implement detailed policy changes. In its resolve to reform the regulatory structure the Government was supported with finance and technical assistance from external lenders and donors.

There were three key areas of reform: (i) the central bank's role; (ii) government fiscal policy; and (iii) superannuation legislation and restructuring.¹⁷

Central bank role

The reform of the central bank's legislation gave it an independent role as the monetary policy authority and financial regulator. Importantly, with its unambiguous role as financial regulator it used its authority to improve the governance and performance of the PNGBC (see Box 1) and savings and loan societies. The central bank was also in a strong position as monetary policy authority which helped it to establish a sound macroeconomic environment. Furthermore the limitations on its role as lender to the government helped improve fiscal policy.

Fiscal policy

Government policy to adopt a medium-term fiscal strategy, to limit the increase in government debt and to insert borrowing restrictions in the Central Banking Act 2000 through a limit of K100 million on a temporary advance facility and preclude central bank financing of government budget deficits, reduced the scope for excessive borrowings. It also set the basis for an improved public debt management strategy and the creation of a broader market in longer term public debt securities. The improved fiscal policy of government and the central bank's monetary policy created a more

16 While the BPNG is the predominant regulatory agency in the financial sector, the Insurance Commissioner and his office have a role in regulating general insurance, and other regulators such as the Independent Consumer and Competition Commission and the Investment Promotion Authority can also impact on the establishment and operations of businesses in the financial sector.

17 Satish Chand, in his 2007 paper on governance for growth, notes government initiatives that had a critical role in the recuperation of the financial sector.

stable macroeconomic environment to increase trust in financial assets and the business environment for the financial sector.

Superannuation reform

The general reforms of superannuation legislation and the restructuring packages of the NPF (see Box 2) reinvigorated the superannuation industry and set it in a new direction.

At the end of the 1990s PNG's compulsory pension and retirement savings schemes were suffering from mismanagement at both the government level and the fund management level. A broad reform was begun to bring in general superannuation legislation to cover such schemes. This legislation set down principles for continuing mandatory superannuation for employees (with some exceptions) with these principles applying across all funds and to public and private employers. The key features of the superannuation legislation are that it requires:

- mandatory participation in licensed corporate accumulation funds by employers and employees;
- that these funds are to be managed by trustee companies which are responsible for proper appointment of investment managers and fund administrators; and
- that the funds be under the prudential supervision of a superannuation regulator, the central bank – the BPNG.
 - The BPNG authorises the establishment of new funds and issue of annually renewable licences for trustees, fund administrators, and investment managers. It also has the power to obtain any information about the affairs of the funds, intervene in the management of the funds in cases of wrong-doing, and enforce sanctions and penalties.
 - In its authorisation the BPNG applies a 'fit and proper person' test to members of a fund's board and management.

The requirement that only corporate entities can be licensed under the Act and the separation between, and outsourcing of, investment management and fund administration have erected barriers against political interference, and thereby provide better protection of members' funds.

Under this legislation and supervision members of the fund have a separately identifiable interest in the fund. The funds are required to report publicly their operations and details of their assets and liabilities and to follow proper business principles in their dealings. With these arrangements and some competition between

the funds for members, there are incentives for funds to behave in the interest of the members.

Commenting in 2004 on superannuation reforms, the IMF concluded that:

The main reasons for the sharp deterioration in the financial performance of the main pension funds in the late 1990s were bad governance and inadequate supervision. Flaws in the original architecture of the pension system and excessive government influence also contributed. The near collapse of the NPF, the formation of a new government in mid-1999, and the public deliberations of the Commissions of Enquiry provided both the impetus and rationale for fundamental and far-reaching reforms. The introduction of comprehensive legislation emphasizing a strict division of labour between trustees, fund administrators, and investment managers, combined with strong and independent regulatory and supervisory powers of the BPNG, helped reduce the scope for inappropriate government intervention and fostered dramatic improvements in governance. As a result, performance improved quickly and sharply. The implications for reforms in other areas of the public sector are obvious.¹⁸

Consequent reform

These three areas of reform were fundamental to restructure of the local banks, improving superannuation governance and reinvigorating the financial sector more generally. These changes combined to bring about a greater separation between the government on the one hand and the central bank and the financial sector on the other. This has improved the quality of government debt instruments through limiting the scope for irregular borrowings from not only the central bank but also superannuation funds.

Positive changes in the financial sector occurred as business conditions improved, with very favourable prices for several of the commodities PNG produces and a more general improvement in the macro policy settings in PNG. Consequently, the financial performance of the banks and superannuation funds and the values of listed companies on the stock exchange have shown a general improvement over the last few years.

In the 2007 Budget the Government noted that regulatory supervision in the financial sector continues to be fine-tuned, especially in the superannuation industry. In late 2006, the Government decided on implementation of the recommendations of the Joint

18 Further comment on the reforms can be found in the IMF 2004 report.

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Superannuation Task Force, to improve and strengthen the effectiveness of the prudential regulation and administration of the superannuation industry. Some of the recommendations adopted are directed at improving prudential supervision. Others, with wider community implications, are about enforcement of employers' obligations, withdrawals of members' contributions to finance housing and requirements for superannuation funds to make annual reports and disclosures to members. Legislation to implement these changes is reported to have passed Parliament on 19 April 2007.

The Government announced that the Department of Treasury and the Bank of Papua New Guinea will further review several related issues, including extension of superannuation coverage to the self-employed and the informal sector, group cover life insurance, and the three-month waiting period for mandatory contributions.

Reform in insurance has led to prudential regulation of life insurance being done by the BPNG. A reform initiative has begun through the Insurance Commissioner to introduce legislation on general insurance contracts. However, the split responsibility can mean that one entity offering both general insurance and life insurance is covered by two regulators.

The PNG Government announced in the 2007 Budget an inquiry concerning competition and premium levels in fire and general insurance and foreshadowed the potential for undertaking regulatory reform in fire and general insurance. In March 2007 the ICCG, as part of consultations for developing reform proposals, released its review of the general insurance industry in Papua New Guinea and issues for discussion.

Other financial sector reforms have been initiated by the BPNG to improve the performance of the savings and loans societies (S&L societies). The BPNG reports that dormant S&L societies have been liquidated and their numbers have fallen from 101 in the year 2000 to 22 in 2006 while over the same time their total assets have increased from K126 million to K356 million.

Reforms that were mentioned as part of the way forward by the Governor of the BPNG in October 2006 included broadening of the foreign exchange markets to allow licensed financial institutions (non banks) to operate as foreign exchange dealers, ongoing review of the remaining foreign exchange controls and review of the Savings and Loans Societies Act 1995.

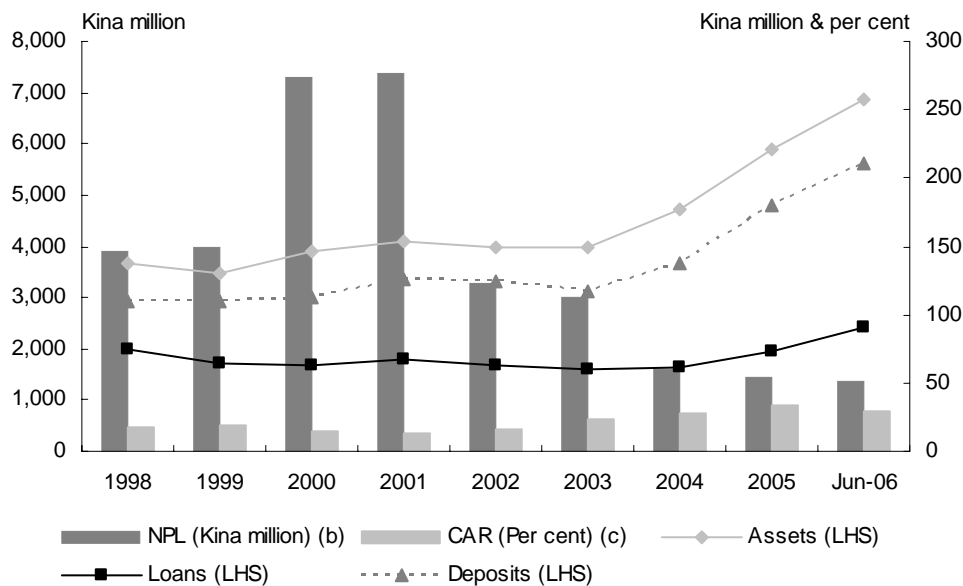
With hindsight, carrying through the financial sector reforms can be seen to be less ambitious than was originally planned; for example the restructure of the PNGBC did not involve a 100 per cent privatisation. However, the process did allow for an evolution of an acceptable reform, which in the example of the bank led to a domestically owned and publicly listed bank that is operating successfully. The

evolution of the reform in superannuation was fostered by the statutory establishment of a taskforce that consulted publicly and worked with industry, government and the regulator to bring about a necessary regulatory change. In both cases of reform the participants had an interest in seeing the reforms through and the Government had taken a stance that did not prevent, but encouraged, evolutionary change consistent with generally accepted principles that apply to an open economy like that of PNG.¹⁹ As economic conditions remained unfavourable to PNG a strong financial imperative also kept the pressure on moving reforms ahead.

Banking sector performance since recent reforms

PNG's banking sector has been improving its performance, as data from the BPNG show (see Chart 3). The health of the sector improved as non performing loans were reduced to less than five per cent of total lending and the capital adequacy ratio rose well above the minimum requirement of 12 per cent set out in the prudential guidelines by the BPNG. This performance is favourable to those reported for other small countries such as those in the Caribbean.²⁰

Chart 3: Status of Papua New Guinea's banking sector^(a)



(a) Source: Bank of Papua New Guinea, 19 October 2006.

(b) Non-performing loans.

(c) CAR: Capital adequacy ratio, which is capital divided by risk-weighted assets.

¹⁹ PNG has a floating currency, depends on exports of commodities and on average has relatively low trade barriers against imports of goods.

²⁰ See Jingqing Chai's report.

The PNG finance sector has recently increased its level of lending to the private sector, however it remains heavily involved in financing government debt. Concerns about crowding out of private lending by the government were raised in 1998 and with holdings of government debt in 2006 being a higher share of depository corporation assets than lending to the private sector, there is still scope for government to take a part in addressing such concerns.²¹

Access to banking services has been limited in PNG and was described in 2002 along the following lines:

85 per cent of the population of Papua New Guineans who live in rural areas have access to basic and intermittent banking services. In the urban areas, queues at banking outlets extend to hundreds on paydays. The PNG banking sector, as of 1997, accounted for a relatively low proportion of domestic credit provided. These observations are symptomatic of communities being deprived of competitively priced banking services.²²

Attempts have been made to expand access and competition in the banking sector including through a government sponsored initiative. In cooperation with some commercial banks and Post PNG, the PNG Government implemented a District Treasury/Finance Office Rollout Scheme that aimed to bring basic services including banking, postal and finance office access to over 80 rural districts throughout Papua New Guinea. Some 42 such offices have been opened.

There has also been expansion of banking facilities from existing institutions such as through new branches, agencies, ATMs, electronic funds transfer at point of sale and microfinance initiatives (see Box 3).

Conclusions

PNG financial markets have developed well from their pre-reform situation. The sector is profitable and beginning to expand its services across the country and the Pacific. Securities markets are developing and the Government and the financial regulator are working to further reforms to improve the sector's performance.

21 This concern is raised in the BPNG book *Money and Banking in PNG*.

22 These comments are summarised from Satish Chand's paper, and suggest a greater level of access in rural areas than what may currently prevail.

Efficiency in the sector can be expected to increase if the good governance under existing and new regulations continues in the positive direction that has been followed. While more is to be done, regulatory reforms in the sector alone will not be the only factors impacting on its performance. As can be seen from the impact of the Government's fiscal strategy reforms, continued sound fiscal policy can be expected to be a key to the future evolution of the financial sector.

In view of the small size of PNG financial markets, ensuring strong competition to drive innovation and increase efficiency is a challenge facing the BPNG as prudential regulator and the Government when setting market access policies. Modern telecommunications are an integral part of the financial sector as can be seen from the use of ATMs, EFTPOS, credit cards, money transfer services, Internet banking, transferring market information, security and so on. The growth of the PNG financial sector is thus likely to be closely linked to developments in the country's telecommunications as well as general economic policy and conditions.

When the opportunity for reform was grasped, major advances were initiated in PNG's financial sector. This augurs well for future reforms where similar conditions exist. In this regard it is worth recalling certain points:

- The financial crisis that preceded and gave impulse to the reforms of the PNG financial sector was a high-cost genesis that might be better avoided in other situations. There may be a lesson here for reforming before a crisis arises.
- Reform by government clearly benefits from ministerial leadership. Carrying through reform also depends on the leadership and the skills of departmental policy and administrative officers. This was the case in PNG where leaders took action to reform, with assistance where they needed it.
- A well-structured and sequenced process of reform is essential. This can be seen, for example, from the initial reform of the powers of the central bank and regulator and the setting down of the main pillars of superannuation reform with a taskforce to develop the more detailed provisions in consultation with stakeholders.
- The scope of the reform was comprehensive in as much as it covered the role of the central bank, the financial regulator and specific financial business, such as banking, superannuation and life insurance. Moreover, it extended to reforms in competition policy, fiscal policy and financial responsibility. This coverage has been sufficient to set the financial sector in a sound direction. There remains, however, the challenge of more reforms that are needed to increase further the performance and competitiveness of the PNG financial sector.

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- Financial sector reform shows the benefits of clear governance structures in terms of roles and responsibilities. It is important to establish in legislation, in regulations, in government strategies and behaviour, a clear delineation and separation of the roles and responsibilities of government and other participants in industry.
 - This point of government setting down clear rules and roles for players and delegating responsibility to a regulator might equally be applied to other sectors of an economy such as telecommunications.

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