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Financial Services Sector Assessment:

Kiribati, Tuvalu, Samoa, Solomon Islands, Vanuatu

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EXECUTIVE SUMMARY

The objective of this Financial Services Sector Assessment (FSSA) is to document the results of an appraisal of access to financial services in five least developed countries (LDCs)[1] in the Pacific and make recommendations to the United Nations Development Programme (UNDP), United Nations Capital Development Fund (UNCDF), and their stakeholders regarding programme initiatives that will improve access for the currently unbanked population.

The FSSA document presents three key findings to justify a regional programme of support to expanding the reach of financial services. The assessment of the individual countries are included in the annex.

- The vast majority of Pacific Islanders suffer economically from lack of access to financial services. This observation reflects the reality of low service coverage rates as well as anecdotal evidence of the costs that the unbanked population incur conducting transactions without adequate financial service infrastructure.

- Access to financial services has been constrained primarily by economic inefficiencies that limit the reach of traditional institutional models for delivering financial services. For the most parts, donor support to traditional microfinance institutional models has floundered on these inefficiencies.

- There are new opportunities, primarily driven by communications technology, for achieving efficiencies in the delivery of financial services to the currently unbanked population.

The document concludes with strategic and operational recommendations designed to exploit these opportunities. The proposed programme is designed to play a catalytic role by supporting the champions that will lead these initiatives. To fulfill that role effectively, the programme will integrate three primary activities: knowledge generation, knowledge dissemination, and financial and technical support to champions during implementation.

<u>The Setting for Financial Services</u>

Only around 20% of the population of the five LDCs have access to financial services. This meager coverage reflects both the formidable challenges that financial service providers face as well as the economic inefficiency of the infrastructure and systems providers use to deliver financial services. Geographic isolation, demographic dispersion, limited income-generating opportunities, financial illiteracy and traditional socio-economic structures create formidable challenges to any service provider in the LDCs, financial services in particular. Traditional approaches to financial service delivery have been ineffective, largely because of inefficiencies in transport and communications infrastructure, payment system infrastructure, conventional financial

[1] The Solomon Islands, Vanuatu, Kiribati, Tuvalu and Samoa.

institution models, service delivery models, and a general lack of understanding about the cash flows of rural households.

The Supply of Financial Services

Commercially viable banking has been confined to large population centres. Bank lending practices are generally timid. Bank managers report that there are few "bankable" projects. Collateral requirements are generally conservative. This imposes significant restrictions on lending because land titles in the region are rarely secure enough to serve as collateral, none of the countries have a usable secured transactions regime for movable property, and the court systems are too cumbersome for enforcing loan contracts.

Banks have begun to experiment with branchless delivery models and some of these early stage initiatives are showing potential for extending services well beyond the current access frontier. The impact of these developments is small when measured by numbers of clients served but they represent nevertheless the most likely drivers of pro-poor services from the banking sector.

There are very few institutions in the five LDCs that specialize in providing financial services to the unbanked populations. There are only two organizations, VANWODS in Vanuatu and South Pacific Business Development (SPBD) in Samoa, that have attempted to create a sustainable microfinance institution. Both of the organizations have adapted the solidarity group model (of the Grameen Bank) to their respective environments and appear to have successful lending programs with low arrears rates.

The financial performance of VANWODS and SBDP reflect the high cost structure associated with stand-alone institutions. VANWODS continues to receive substantial subsides and even though SBDP has achieved self-sufficiency, efficiency is still a challenge. SPBD's expenses were equal to 55% of the portfolio in 2006. Their effective interest rates are around 60% per annum; VANWODS charges close to 90%.[2] The cost structure of SPBD is a sobering reminder of how challenging it is to gain efficiencies in microfinance operations when housed in stand-alone institutions. The conditions in Samoa are already the most favorable of the five LDCs; the challenge is significantly greater in the other countries.

Very little remains of what is reported to have once been, in Vanuatu, the Solomon Islands and Samoa, a wide-spread credit union movement. The remaining credit unions provide little, if any, benefits that their members cannot already get in a bank. Member loyalty may be residual sentiment from an era when banks were less accessible because member benefits today are meager. The credit unions generally do not offer a favorable interest rates and members can only borrow amounts equivalent to 100% of their savings.

[2] There are many village bank programmes that charge these kind of interest rates to clients. COMPARTAMOS, for example, is an MFI that just listed its stock in the US and Mexican markets. It has over US$250 million in assets and still charges its village bank clients over 100% interest. The average of interest yield of village banking MFIs reporting to the MIX Market is 41%.

Therefore, credit unions do not intermediate funds between net savers and net borrowers, and members effectively pay to borrow their own money.

The governments of all of the five LDCs have experimented with various credit delivery schemes. Repayment performance is generally perceived to be poor and in any case the initiatives are short lived. These programmes are typically housed in some public sector institution for their duration and are not designed to create sustainable institutions. Most of the government-owned development banks of the region have proven to be little more than temporary credit schemes on a larger scale.

The Demand for Financial Services

Precise assessments of demand are impossible in markets where supply is constrained or the population is uninformed about the possibility of services they have never encountered. This is the case with consumers of financial services in the LDCs. It is possible, however, to interpret the potential demand that is reflected in current consumer behavior and in their response to pilot initiatives. Consumer responses to savings options, for example, provide some clues about broader demand for the service. Broadly speaking, there are indications that the populations of the LDCs are eager to access savings instruments *when they can do so readily and without great cost.*

The demand for credit is more complex. Just because people borrow and repay loans does not mean that they realize a net benefit from the transactions. In Samoa, consumption borrowing is wide spread. Banks report that many salaried workers maintain loan obligations that consume their entire paycheck. In the four archipelagic countries, the question about borrowing capacity arises more from the economic conditions that prevail in remote areas.

The demand for person-to-person transfer services is very evident in all of the countries. All of the countries receive significant foreign remittances from nationals living abroad. This money is transferred back to relatives by various channels, most of them expensive and unreliable. Domestic remittances are likely even more important.

Meso-level Support Organizations

The organizations that support the financial industry typically evolve in proportion to the scale of the retail level. This is the case in the LDCs and consequently there are few meso level institutions. Donors have played the primary role in supporting retail initiatives and organizations. Most donor support has been ad hoc, however.
Overall, donor views on pro-poor financial market development in the region reflects the low programming priority assigned to this area as well as a certain resignation about past failures. For the most part, donor efforts have floundered on the challenges to creating sustainable MFIs and credit unions. The handful of qualified success stories are not auspicious enough to warrant a dedicated support programme. The recently created Microfinance Pasifika Network (MPN) constitutes a forum for dialogue and coordination between actors supporting pro-poor financial market development in the region.

The Policy Environment for Pro-poor Financial Services

At the 2006 Forum Economic Ministers Meeting, government representatives from the region officially encouraged member countries to take action to extend access to financial services for the majority of their populations. At this high level of collective policy articulation, regional governments acknowledge the importance of building inclusive financial systems. At the country level, however, governments of the LDCs have focused most of their attention on credit initiatives and state-owned development banks.

With the help of the Asian Development Bank (ADB), the governments of the Solomon Islands, Vanuatu and Samoa have launched comprehensive initiatives to establish a legal, judicial, and institutional framework for using moveable property as collateral in loan contracts. This is extremely important in the LDCs because of the complex problems associated with land titling and liens. Measurable results will come far on the horizon but these initiatives represent sound policy for building more inclusive financial systems.

The regulatory environments of the LDCs are generally conducive to commercial banking and financial services. However, there are several issues that will need to be addressed as financial service providers work out new channels for reaching the unbanked.

Opportunities for Extending the Access Frontier

The access frontier in the LDCs has been defined primarily by the limits of traditional institutional models that rely on economies of scale to cover the costs of vertically integrated organizations. Banks, non-profit organizations and credit unions have all attempted to create organizations that perform all of the functions related to financial service provision and organizational management. Reliance on branch-based service channels is another limiting factor. As a result, financial service providers have struggled to find viable economies of scale outside of principal cities and remote populations have developed other mechanisms for managing their cash resources. The current reach of financial services is a reflection of the limits of branch banking. However, new technologies are creating opportunities for extending the access frontier beyond the limits of branch banking. Collectively, these opportunities demonstrate that the access frontier is no longer defined by branch locations; the reach of telecommunications technology now defines the access frontier.

Emerging technologies are creating new opportunities in the areas of branchless banking, specialized organizational models, and product innovation. Moreover, most of these technologies are provided by telecommunications companies that are well positioned to participate in ventures to provide financial services to their mobile phone clientele. This process is already advancing rapidly in Vanuatu and Samoa.

Recommendation for a Support Programme

The central finding of this assessment is that telecommunications technology is creating new opportunities to extend financial services to the unbanked. However, it is important to note that the actors that are positioned to exploit these opportunities are different in significant ways than the usual stakeholders in traditional development finance initiatives. The champions of the new initiatives will come from a diverse cross-section of private, non-governmental and public sector entities to create partnerships out of very different business models and social and economic motives. In simple terms, the key players that will push the access frontier are currently unassociated. And some of them lack access to pertinent knowledge and capacity development support. This makes it difficult for different players in the market to build on each other by copying successes, exploiting niches, and creating partnerships.

This condition has strategic implications for any organization that aspires to support the development of an inclusive financial system. Affecting change in the financial markets of the LDCs will require a catalytic agent that identifies and supports champions of innovative initiatives. The catalytic role consists of three basic activities: knowledge creation, dissemination, and implementation.

The agent that executes this catalytic strategy will have to work throughout the Pacific region, playing all three roles opportunistically as champions emerge. The regional scope is important because the markets are small and isolated. No single country would provide enough opportunities to support a programme. More importantly, however, is that the catalytic agent must be able to nurture the most promising initiatives as they emerge. Early successes will create future champions and initiatives.

The catalytic agent must also be able to respond immediately when opportunities emerge. Most of the important players in these new initiatives will be commercial enterprises that will not respond to delays or requirements that compromise their timelines. Opportunities to assist a commercial enterprise in evaluating a new initiative may be short lived and the catalytic agent must be able to respond with whatever resources are required to advance the project.

The programme will require a dedicated management unit and resources to finance programme activities. The funding vehicle should have an investment committee capable of making quick decisions on proposals presented by the management unit. This programme structure creates a mechanism for donors to coordinate their funding in support of pro-poor financial service initiatives. Donors that pool funds can provide adequate oversight by participation in the investment committee.

This programme structure lends itself to a programme of measurable outputs related to knowledge creation and dissemination that can be monitored for performance purposes. The ultimate objective of programme activities will be to facilitate implementation of pro-poor financial services, which can also be measured in terms of efficiency and outreach. Importantly, the programme structure in itself provides a vehicle for donor coordination and alignment with policy makers from the respective countries.

1. INTRODUCTION

1.1. Study Objectives

The objective of this Financial Services Sector Assessment (FSSA) is to document the results of an appraisal of access to financial services in five least developed countries (LDCs)[3] in the Pacific and make recommendations to the United Nations Development Programme (UNDP), United Nations Capital Development Fund (UNCDF), and their stakeholders regarding programme initiatives that will improve access for the currently unbanked population.

More specifically, the FSSA:

- provides an analysis of how well the financial service industries in the five LDCs provide access to services to their respective populations;
- characterizes the challenges that currently constrain access to financial services;
- identifies the most promising opportunities for expanding the access frontier in each respective country and the region;
- proposes a strategy for exploiting those opportunities; and
- outlines an investment vehicle that is in line with the Paris Declaration on Aid Effectiveness[4] and its call for greater national ownership, donor alignment with national strategies, harmonization of donor support and management for results.

The FSSA responds to a mandate issued by the 2006 Forum Finance and Economic Ministers Meeting, calling on member countries to take appropriate actions in extending access to financial services for the majority of its people. The Forum declaration was formulated upon consideration of the PIFS/UNDP report on *Successful Microfinance In the Pacific : Achieving Financial Inclusion*[5]. That document, as well as the Forum declaration, reflects the consensus view that improving access to financial services is an important step towards achieving the Millennium Development Goals by 2015: "*Microfinance is a powerful instrument against poverty. When poor people have access to financial services, they can earn more, build their assets, and cushion themselves against external shocks. Poor households use microfinance to move from everyday survival to planning for the future: they invest in better nutrition, housing, health, and education"*[6].

Given its development mandate, FSSA is driven by a measurable definition of *inclusive financial systems:* [7]

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[3] The Solomon Islands, Vanuatu, Kiribati, Tuvalu and Samoa.

[4] Paris Declaration on Aid Effectiveness, Ownership, Harmonisation, Alignment, Results and Mutual Accountability, OECD-DAC, March 2, 2005 http://www.oecd.org/dataoecd/11/41/34428351.pdf

[5] Pacific Island Forum Secretariat and UNDP Pacific Sub Regional Centre, Out of session paper for Forum Economic Ministers Meeting, Honiara, 3-5 July 2006

[6] G8 and CGAP endorsed 11 key principles of microfinance: Key principle 2. www.cgap.org/keyprinciples.html

[7] Building Inclusive Financial Sectors for Development, United Nations, NY, 2006, page 17. http://www.uncdf.org/bluebook/

- Access by all bankable households and enterprises to a full range of financial services at a reasonable cost, including savings, short and long-term credit, mortgages, insurance, pensions, payments, local money transfers, international remittances, leasing and factoring;
- Soundness of institutions, which is maintained through performance monitoring by stakeholders and, where required, sound prudential regulation;
- Financial and institutional sustainability as a means of providing access to financial services over time;
- Multiple providers of financial services, wherever feasible, to bring cost-effective alternatives to customers, including sound private, non-profit and public providers.

To achieve this goal, financial services for poor and low-income people should be seen as an important and integral component of the financial sector and various types of financial institutions, based on their own comparative advantages, should see it as an emerging business opportunity.

1.2. Methodology

A team consisting of Mark Flaming/Consultant & Team Leader, Jeff Liew/UNDP, , Stewart Mathison/Consultant, and Antonique Koning/European Union-ACP carried out the FSSA between April and May of 2007. The team reviewed background documents, conducted interviews and research in Solomon Islands, Vanuatu and Samoa, and extensive desk studies of Tuvalu and Kiribati. In each of the three countries visited, the team concluded with a presentation and consultation with the stakeholders interviewed during the mission. A final stakeholder meeting was held in Suva, Fiji on May 03, 2007.

1.3. Document Organization

The main document presents recommendations for a programme for building inclusive financial systems in the Pacific region, supported by the general findings and rationale derived from the country assessments. Given its regional scope, the main document synthesizes the findings from the individual assessments of the five countries. These assessments are included in the annex. They include country specific details, including sources of information and names of people interviewed.

Chapter three of the main document presents an overview of the financial service sectors in the five LDCs. This includes an inventory of the factors that have constrained the supply of financial services in the region and an assessment of the supply and demand for financial services. The chapter also provides an assessment of the meso level institutions and macro level policies that effect the sector.

Chapter Four identifies opportunities for expanding the access frontier to include the currently unbanked population. Chapter Five presents recommendations for a programme of activities designed to exploit those opportunities. Finally, Chapter Six discusses issues relevant to donors that would fund such a programme.

1.4. Key Findings

The FSSA document presents three key findings:

- The vast majority of Pacific Islanders suffer economically from lack of access to financial services. This observation reflects the reality of low service coverage rates as well as anecdotal evidence of the costs that the unbanked population incur conducting transactions without adequate financial service infrastructure.

- Access to financial services has been constrained primarily by economic inefficiencies that limit the reach of traditional institutional models for delivering financial services. For the most parts, donor support to traditional microfinance institutional models has floundered on these inefficiencies.

- There are new opportunities, primarily driven by communications technology, for achieving efficiencies in the delivery of financial services to the currently unbanked population. The document concludes with strategic and operational recommendations designed to exploit these opportunities.

2. FINANCIAL SECTOR ASSESSMENT

2.1. The Setting for Financial Services

Financial service providers face formidable obstacles in the LDCs of the Pacific. In different contexts and with different analytical frameworks, published economic assessments tend to treat these obstacles as "binding constraints" on economic activity in general and on financial service delivery in particular.[8] Financial service providers do indeed face formidable challenges and the modest coverage of both regulated and unregulated institutions is an indication of how constraining these challenges have been on past attempts to provide financial services to the unbanked. This chapter will provide an overview of these challenges and review the primary economic inefficiencies affecting the financial service industry. This provides a background for understanding the forces that have shaped the financial service industry, which is treated in the subsequent sections.

2.1.1. Challenges to Financial Service Delivery

- **Geographic Isolation**

Most of the economic weaknesses of the five LDCs are related in some way to the challenges imposed by geography. With the exception of Samoa, the landmass of all of the countries is spread over archipelagos of small islands and atolls, ranging in number from 9 in the case of Tuvalu and 992 in the Solomon Islands.

- **Demographic Dispersion**

Likewise, the population is dispersed in small villages over a large area. This means that any service provider struggles to find enough demand in one area to cover the high costs of delivery.

- **Limited Income-generating Opportunities**

[8] See Bazeley and Mullen's discussion of an alternative to conventional views of binding constraints in growth theory in *Vanuatu, Economic Opportunities Fact-Finding Mission. 2006*

The cumulative effect of these geographic and demographic challenges is visible at the microeconomic level. All forms of trading, even in the subsistence economy, have to contend with limited transportation and communications options. This makes it very difficult for small farmers in isolated areas to supply exporters or even domestic markets. Even local merchants have to manage unpredictable and costly island transportation channels to get basic goods to isolated villages. In these conditions, an aspiring micro entrepreneur has limited options for delivering a product or service that the accessible population can support.

- **Traditional Socio-economic Structures**

The cultures of the 5 LDCs are heterogeneous and affect the economics of households in many ways that are beyond the scope of this assessment. Nevertheless, it is still relevant to note that the vast majority of the population lives in small villages under village authority structures that influence the way households generate and accumulate wealth. In Samoa, for example, the social obligations referred to generally as fa'alavelave, together with the financial demands of church membership, claim significant portions of household income. Individual decisions to engage in business or acquire assets are subject to the collective will of the village, headed by a chief. The relevant point here is that economic decisions are profoundly influenced by social structures.

Traditional forms of land ownership present the single most significant challenge to financial service providers. In some cases, land is held collectively at the village level. Where land is held by individuals, the documentation of ownership is inadequate to use land as collateral in a binding contract. This means that individuals are unable to leverage the economic value of their single most important asset.

- **Financial Illiteracy**

Most of the populations of the five LDCs are quite simply unfamiliar with modern banking services. They have accumulated wealth and conducted transactions without using financial institutions for generations and these patterns are ingrained in household money management practices. This means that the population that might benefit from a financial service likely does not have the knowledge to use it effectively. Individual calculations of the net benefit of savings versus borrowing, or even just the interest-related costs of borrowing, are likely more influenced by their traditional perceptions than by financial calculations.

2.1.2. Economic Inefficiencies Effecting the Financial Service Industry

The concept of "economic inefficiencies" refers to whether the infrastructure and systems used in the economy are efficient enough to overcome the inherent challenges in the region. In the financial sector, the question is whether the systems that financial service providers use are efficient enough to reach the population. Some of these systems are external to the financial system and therefore out of the control of the service providers; many are internal and under the direct management of financial institutions.

- **Infrastructure**

The lack of transportation, communication and power infrastructure has limited the reach of financial service providers. Branch-based banking is limited to large population centres, which excludes the vast majority of the population in most of the five LDCs. Mobile banking has extended services beyond the cities, but this model is limited to populations accessible by roads. Poor telecommunications coverage has become the most acute impediment to extending the reach of financial services beyond large population centres. This is because the technologies that enable banks and non-banks to extend services beyond their own branches rely heavily on telecommunications coverage.

- **Payment System Infrastructure**

The payment system infrastructure includes all of the channels by which the population conducts monetary transactions (e.g. cash, checks, cards, etc) as well as the systems that the banks and central banks use to manage transactions between themselves. Technology-enabled infrastructure, such as ATMs or EFTPOS terminals for card payments, is very recent and either limited to population areas or not widely used by populations that are still accustomed to cash transactions. As mentioned previously, the reach of the transaction infrastructure is ultimately limited by telecommunications coverage. However, the possibilities for offering more efficient and useful payment services are limited by the ways that banks and central banks conduct transactions with each other.

The systems that banks use to transfer funds and clear and settle transactions are not well interlinked and therefore require banks to set up "closed" transaction systems. For example, banks issue debit cards to their account holders and then install ATM machines and provide EFTPOS to merchants. In many cases clients with cards from one bank cannot use them on the terminals installed by another bank. This means that individuals have to have multiple accounts to be able to conduct transactions everywhere, or banks and merchants have to have parallel systems. A unified system would create more possibilities for achieving economies of scale while allowing multiple providers to participate in creating a system with broader reach than any organization could achieve alone.

- **Conventional Financial Institutional Models**

Until recently, banks and non-banks have created institutions that are not efficient enough to extend financial services beyond the population centres in the LDC markets. Almost all institutions, whether banks, credit unions, or non-profit MFIs have created self-contained, financial service organizations that support their retail channels with the necessary back office systems, management and governance structures. There are at least two aspects of this organizational model that struggle to cover costs with the income that can be derived from a dispersed population. The first is that the governance, management, back office systems and client interface channels required to run a financial service company requires significant expertise and fixed costs that cannot be supported at a small scale. The second is that companies that only provide financial services have no way of generating other types of income.

Most banks in the LDCs are profitable with the conventional organization model. This is because banks earn income from multiple revenue streams that can be generated from the main branch. But banks have not been willing or able to extend their branch networks beyond population centres. Some banks, like the National Bank of Vanuatu and ANZ/Solomon Islands, have established branch networks in more remote areas but these need to be financially supported from other revenue streams.

For non-bank companies like credit unions and non-profit MFIs, the conventional organizational model has proven to be extremely difficult to sustain. Both types of institutions have struggled to acquire the necessary human and technological resources much less cover their costs with service revenues.

- **Service Delivery Models**

Experimentation with ways to extend financial services to the unbanked is incipient in the region. Some banks have extended their reach by mobile branches and agencies, but there is still much ground to be gained in developing financial products that this newly accessible populations will use and pay for. Two organizations have been successful at adapting the Grameen village banking model in Vanuatu and Samoa. The National Bank of Vanuatu has recently launched a micro lending program that provides individual loans in the US$2000 range. Otherwise, there are very few examples of local organizations adapting the kinds of service delivery models that have been successfully replicated in many parts of the world.

- **Knowledge of Household Cash flows**

There is much about the cash flow of households and remote settlements that financial service providers do not know. That kind of knowledge typically comes from years of interaction between providers and their clients; in MFIs that knowledge is also related to years of experimentation and innovation. The financial service providers in the LDCs simply have not accumulated that knowledge.

It may also be the case that it is more necessary to study household cash flows in the LDCs than it has been in other markets where MFIs' have launched and learned as they grew. This is because financial service providers in the LDCs do not have the luxury of learning-by-doing in concentrated urban populations, and any attempt to reach isolated populations is costly and time consuming.

2.2. The Supply of Financial Services

The following section summarizes the primary financial service providers in the region, focusing on their role in providing services to poor, marginalized or isolated populations.

2.2.1. Banks

Commercially viable banking has been confined to large population centres. With the exception of Samoa[9], this means that only around 20% of the other LDC populations

[9] The archipeligo countries of the Solomon Islands, Vanuatu, Tuvalu and Kiribati share many of the same challenges related to geography and demographics. In this regard, Samoa is an exception since most of its

access a bank for any kind of services. This number is a reasonable measure of the proportion of the population that is unbanked as well as an indicator of how little of the population can be reached through traditional branch-based banking[10]. Banks have begun to experiment with branchless delivery models and some of these early stage initiatives are showing potential for extending services well beyond the current access frontier. But by any count the banking sectors have served only a small portion of their respective populations.

In the five LDCs, it is especially important to note that aggregate data from the banking sectors reveal very little about what part of the population is getting access to which banking service. For example, in Vanuatu, total deposits in the banking sector and total credit to the private sector are 99% and 46%, respectively. In the Solomon Islands, those same indicators are 32% and 18%. Clearly, a higher percentage of money is intermediated through the banking system in Vanuatu. However, this does not provide any indication of what percentage of the population is accessing the banks. In both countries, most of the banking is conducted in the capital cities (though Luganville is also significant in Vanuatu). Banking activity in Port Vila and Luganville (Vanuatu) is certainly more robust than Honiara (Solomon Islands), but this does not mean that services are accessible to provincial populations in either country.

Bank branch numbers can be similarly unrevealing. In the Solomon Islands, for example, there are 7 bank branches in Honiara and 24 branches or agencies in the provinces. However, around 90% of all savings accounts and loans are based in the Honiara branches.[11] Moreover, the percentage of the rural population that can access those provincial branches is small because of logistic constraints.

A more useful map of the access frontier would show how many clients are accessing the different transaction channels (branches, ATMs, EFTPOS, etc), and for what services. This information is not available because the banking supervisors do not collect the data and individual banks do not disclose the information for competitive reasons.

Bank lending practices are generally timid. In the Solomon Islands and Vanuatu, the combined portfolio of the banks is around 5,000 loans in each country. That number is higher in Samoa, but not significantly. Bank managers report that there are few "bankable" projects. Collateral requirements are generally conservative. This imposes significant restrictions on lending because land titles in the region are rarely secure enough to serve as collateral, none of the countries have a usable secured transactions regime for movable property, and the court systems are too cumbersome for enforcing loan contracts. Banks do make personal loans for vehicles, or for salaried employees, but uncollateralized lending is limited to very small loans.

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population is located on two islands that have, in comparison to the other four LDCs, developed road and communications infrastructure.

[10] The term "branch banking" refers to the deposit, withdrawal, credit and transfer service a bank might offer to customers that walk into the branch to conduct transactions.

[11] Based on numbers provided by bank managers in interviews.

There are about 15 times more savings accounts than loan accounts in the Solomon Islands and Vanuatu; the ratio is lower in Samoa where there are many more salary-based loans. In all of the countries, the majority of savings accounts are used to receive salaries and are typically withdrawn by the end of each pay cycle.

There are signs in the region of bank interest in developing business channels to reach the currently unbanked. ANZ, after a successfull pilot in Fiji, has a mobile branch service in Samoa and the Solomon Islands, and is launching the initiative now in Vanuatu. In all four of the archipelago countries, at least one bank provides some services via a provincial branch network – both the Bank of South Pacific (formerly National Bank of Solomon Islands) and ANZ have a provincial branch/agency network in the Solomon Islands[12], the NBV has the same in Vanuatu, ANZ uses the Village Council offices as agents in Kiribati, and the National Bank of Tuvalu has recently established branches in the outer islands. The NBV has a small microcredit program they have developed in the provincial branches with the assistance of the Asian Development Bank (ADB). In Samoa, the two nationally-owned, private commercial banks are more aggressive about providing services to the poorer end of the retail market because they cannot compete with the regional banks for corporate and high net worth clients. The impact of these developments is small when measured by numbers of clients served but they represent nevertheless the most likely drivers of pro-poor services from the banking sector.

Banks have just begun to expand the electronic transaction network in their countries. Westpac and ANZ have led the introduction of ATM machines and EFTPOS merchant terminals. The reach of these new channels is limited by available infrastructure and lack of a critical mass of consumers using bank cards for withdrawals and merchant transactions. Moreover, the electronic fund transfer systems are not interlinked in ways that create unified transaction systems for customers. Nevertheless, the expansion of the electronic transaction networks will be an important step in extending the access frontier, for reasons that are explored later in the document.

2.2.2. MFIs and Non-bank Financial Service Companies

There are very few institutions in the five LDCs that specialize in providing financial services to the unbanked populations. There are, of course, foreign exchange bureaus, money transfer agents, and a handful of private lending companies that provide personal loans. There are only two organizations, VANWODS in Vanuatu and South Pacific Business Development (SPBD) in Samoa, that have attempted to create a sustainable microfinance institution.

Both of the organizations have adapted the Grameen solidarity group village banking model to their respective environments. VANWODS is less restricted than SPBD with regards to deposit mobilization and therefore has a more developed savings program. In fact, VANWODS clients save about twice as much as they borrow. At the end of March 2007, VANWODS had 1,800 savings accounts with about US$500,000 in deposits, and 1,700 borrowers with a portfolio of $240,000. SPBD in Samoa had around 2,700

[12] The National Bank of Solomon Islands also has branch network. The bank has been recently sold to Bank South Pacific, which has a track record of operating remote branches in Papua New Guinea.

borrowers with a portfolio of around US$1 million. Both organizations appear to have successful lending programs with low arrears rates.

The financial performance of VANWODS and SBDP reflect the high cost structure associated with stand-alone institutions. VANWODS continues to receive substantial subsidies from the Government of Vanuatu, UNDP and other donors in ways that preclude an accurate calculation of their cost structure. SBDP publishes transparent financial statements that show the organization recently achieved financial self-sufficiency. Efficiency is still a challenge at this scale, however. SPBD's expenses were equal to 55% of the portfolio in 2006.[13] This means that SPBD has to earn at least that much from clients to break even. Their effective interest rates are around 60% per annum; VANWODS charges close to 90%.[14]

SPBD aspires to expand to Savaii in Samoa and then beyond to other Pacific islands. As the only self-sustaining MFI in the LDCs, it serves as an important model. At the same time, the cost structure of SPBD is a sobering reminder of how inefficient microfinance operations will be when housed in stand-alone institutions. The conditions in Samoa are already the most favorable of the five LDCs; the challenge is significantly greater in the other countries.

2.2.3. Credit Unions

Very little remains of what is reported to have once been, in Vanuatu, the Solomon Islands and Samoa, a wide-spread credit union movement. The Solomon Islands Credit Union League reports 164 registered credit unions and 200 savings clubs (groups of less than 10 members). However, the Central Bank only confirms 10 active and reporting credit unions with combined assets of US$4.7 million. In Vanuatu, the Credit Union League has ceased to function and the Melanesian Savings and Loan Cooperative, with 600 members, is the only finance company operating at any significant scale under the Cooperative Act. In Samoa, the assessment team was unable to locate the Credit Union League or any individual credit union. Kiribati also has a handful of credit unions. All of the existing credit unions identified during the assessment serve memberships of public sector employees, except for the newly established Women In Business Credit Union servicing low income women in Honiara.

The credit unions provide little, if any, benefits that their members cannot already get in a bank. Member loyalty may be residual sentiment from an era when banks were less accessible because member benefits today are meager. In the Solomon Islands, credit union members also have bank accounts where they receive their pay checks. Members then withdraw some money from their bank account and deposit it in their credit union. The credit unions do not offer a favorable interest rates and members can only borrow amounts equivalent to 100% of their savings. Therefore, credit unions do not

[13] The average expense ratios of large MFIs rated by Microrate is around 15%.

[14] There are many village bank programmes that charge these kind of interest rates to clients. COMPARTAMOS, for example, is an MFI that just listed its stock in the US and Mexican markets. It has over US$250 million in assets and still charges its village bank clients over 100% interest. The average of interest yield of village banking MFIs reporting to the MIX Market is 41%.

intermediate funds between net savers and net borrowers, and members effectively pay to borrow their own money. The Melanesian Savings and Loan Cooperative only requires a 70% deposit:loan ratio of public sector employees, but this only improves member benefits by a slight margin. Moreover, members have to use the banking system to transfer money and have no access to cash in/out transactions away from the branches in Port Vila and Santo.

The Solomon Islands Credit Union League is currently in discussions with the World Council of Credit Unions about a country-wide modernization programme. Initial discussions of the programme have posited an aggressive consolidation of the sector. Such a programme may succeed in strengthening the largest credit unions. However, conditions in the five LDCs are not conducive to the traditional credit union model. Even if credit unions succeed in creating institutional infrastructure required to deliver financial services, they will struggle with the same efficiency problem as the MFIs. Moreover, banks are better positioned to offer the range of savings, credit, transfer and payment services that the population wants.

2.2.4. Government Credit Schemes

The governments of all of the five LDCs have experimented with various credit delivery schemes. Repayment performance is generally perceived to be poor and in any case the initiatives are short lived. These programmes are typically housed in some public sector institution for their duration and are not designed to create sustainable institutions.

Most of the government-owned development banks of the region have proven to be little more than temporary credit schemes on a larger scale. The development banks in the Solomon Islands and Vanuatu failed in the late 1990s. The Government of Tuvalu maintains a development bank in addition to the state-owned commercial bank, the National Bank of Tuvalu. The development bank is funded from outside sources, has lost money every year since it was founded in 1993 and has a portfolio impaired by non-performing loans. The Government of Kiribati also has a development bank, but no reliable performance information was available. The Development Bank of Samoa recently opened its new headquarters. Performance data was not available, but the bank's role in the ongoing micro lending program revealed very little capacity to originate a portfolio of small unsecured loans.

Regardless of where any of the development banks are today in the typical cycle of capitalization, decapitalization and recapitalization, there is no observable evidence to suggest that they are making a significant contribution to extending the access frontier for the unbanked. In addition to the perverse incentives that plague most government-sponsored credit operations, the net benefit of the development banks is particularly problematic in the LDCs because of larger questions about the impact of credit in these economies (this is discussed below in the section *Demand for Financial Services*).

2.3. Demand for Financial Services

Precise assessments of demand are impossible in markets where supply is constrained or the population is uninformed about the possibility of services they have never encountered. This is the case with consumers of financial services in the LDCs. A comparison of demand assessments in the mobile phone market helps to illustrate this point. There are less than 9,000 mobile phone accounts in the Solomon Islands and the government-owned telecommunications monopoly insists that viable demand is saturated. The monopoly position of the operator in Vanuatu is less secure and the company is decidedly more aggressive, opening over 10,000 new accounts in 2006 alone. Samoa has a competitive market and mobile phones are ubiquitous. The operators expect close to 100% coverage of the population. The point is that demand can only be measured reliably as a response to supply, and the aggressiveness of the suppliers is typically correlated with competition.

It is possible, however, to interpret the potential demand that is reflected in current consumer behavior and in their response to pilot initiatives. Consumer responses to savings options, for example, provide some clues about broader demand for the service. Banks report uniformly that their small savings branch accounts are typically fully withdrawn within days of a deposit. Yet VANWODS clients are net savers. ANZ has seen robust response to its mobile branch savings initiative in Fiji and is enthusiastic about progress in Samoa and Vanuatu. Even credit union membership, despite its meager benefits, is an indication of demand for some unmet need. Broadly speaking, there are indications that the populations of the LDCs are eager to access savings instruments *when they can do so readily and without great cost.*

The demand for credit is more complex. Just because people borrow and repay loans does not mean that they realize a net benefit from the transactions. In Samoa, for example, consumer credit is clearly part of a national appetite for over-consumption. At a national level, the county consumes three times more than it produces, paying for the difference with foreign aid and foreign remittances. Village and church obligations make extraordinary financial demands on household income and individuals tap relatives abroad and loans to meet those obligations. Consumption borrowing is wide spread. Banks report that many salaried workers maintain loan obligations that consume their entire paycheck.

The experience of Samoan development organizations provides some perspective on this phenomenon. Women Business Development (WBD), an organization that provides assistance to women entrepreneurs, eventually declined its role in channeling government credit to women because WBD has observed that most of its clients are unable to invest the funds profitably. The Small Business Enterprise Centre has seen less than 20% of businesses grow despite their access to long term loans from a government guarantee programme.

In the four archipelago countries, the question about borrowing capacity arises more from the economic conditions that prevail in remote areas. Credit is only beneficial if the borrower is able to generate a surplus from the investment that is greater than the interest. In most remote areas of the LDCs, there are limited opportunities for generating that return on investment.

The demand for person-to-person transfer services is very evident in all of the countries. All of the countries receive significant foreign remittances from nationals living abroad. This money is transferred back to relatives by various channels, most of them expensive and unreliable. Domestic remittances are likely even more important. Public employees are typically paid into their bank accounts. If they live in remote areas, they have to travel to the nearest bank branch to withdraw their pay. Stories abound of employees paying “up to half of their paycheck” to cover the travel and transaction costs. The same is said often of people who receive money from relatives working in the capital.

2.4. Meso Level Support Institutions

The organizations that support the financial industry typically evolve in proportion to the scale of the retail level. This is the case in the LDCs and consequently there are few meso level institutions.

Donors have played the primary role in supporting retail initiatives and organizations. With the exception of the Asian Development Bank (ADB), donor support to expanding the access frontier has been ad hoc, however. None of the donors interviewed during the assessment have a specific programme with a mandate to build more inclusive financial systems. Although some donors, notably UNDP, ascribe to the conceptual framework associated with inclusive financial systems, support to relevant initiatives is linked to broader programme areas. Collectively, the ADB-supported projects reflect a strategy for creating enabling legal and regulatory environments as well as commercially-oriented retail initiatives focusing on the unbanked.[15]

Overall, donor views on pro-poor financial market development in the region reflect the low programming priority assigned to this area as well as a certain resignation about past failures. For the most part, donor efforts have floundered on the challenges to creating sustainable MFIs and credit unions. The handful of qualified success stories are not auspicious enough to warrant a dedicated support programme for NGO-MFIs or Credit Unions only.

The recently created Microfinance Pasifika Network (MPN) constitutes a forum for dialogue and coordination between actors supporting pro-poor financial market development in the region.

2.5. Macro Level Policies and Regulations

At the 2006 Forum Economic Ministers Meeting, government representatives from the region officially encouraged member countries to take action to extend access to financial services for the majority of their populations. At this high level of collective policy articulation, regional governments acknowledge the importance of building inclusive financial systems. At the country, however, governments of the LDCs have focused most of their attention on credit initiatives and state-owned development banks.

[15] The rationale for ADB support to government development banks and credit schemes is less clear, however.

With the help of the ADB, the governments of the Solomon Islands, Vanuatu and Samoa have launched comprehensive initiatives to establish a legal, judicial, and institutional framework for using moveable property as collateral in loan contracts. This is extremely important in the LDCs because of the complex problems associated with land titling and liens. Ability to pledge personal property that is not real estate is especially important to the poor, since they have less access to land titles. Measurable results will come far on the horizon but these initiatives represent sound policy for building more inclusive financial systems.

The regulatory environments of the LDCs are generally conducive to commercial banking and financial services. However, there are several issues that will need to be addressed as financial service providers work out new channels for reaching the unbanked.

- The Credit Union Act in the Solomon Islands places interest rate restrictions on credit union loans of 12% per year. At that rate, credit unions are unable to cover the costs required to run a sustainable institution, much less offer their members a positive return on their savings. The Act will have to be modernized if credit unions are to play a relevant role in the Solomon Islands financial market.

- Banking regulators in the LDCs do not allow non-licensed companies to take deposits from the public. Credit unions are granted special status as member-owned organizations through the respective cooperative or credit union acts. In Vanuatu, the banking regulator has not objected to the savings component of VANWODS's solidarity group banking operation. However, in Samoa, the regulator places tight restrictions on any savings mobilized by SPBD. SPBD is required to maintain the global amount of savings in a local bank and the money cannot be used or pledged.

  The regulators' caution about allowing unlicensed institutions to mobilize deposits is well-grounded in international standards for prudential regulation. However, the unlicensed organizations like VANWODS and SPDB have proven to be the most effective financial service providers at reaching unbanked populations with credit. Future partnerships between these organizations and banks may spawn innovative savings service delivery channels for the unbanked.

- "Know Your Customer" rules that require banks to collect and verify identification documentation on customers are creating barriers to access in the LDCs. Those barriers will become increasingly evident as banks expand services to poorer populations.

- Prudential regulations related to the role of third-party agents that conduct transactions on behalf of banks will become increasing important to pro-poor initiatives. For reasons explained in the *Opportunities* section of this document, third-party agents will likely play an important role in expanding services beyond the scope of bank branches.

2.6. The Access Frontier

The frontier that connects the points of access to financial services is still very close to the principal population centres in the LDCs. In the four archipelago countries, this includes only about 20% of the population. Despite some innovation on the outside of that frontier, financial service providers have yet to implement a commercially viable model for reaching significant numbers of the unbanked.

The access frontier in the LDCs has been defined primarily by the limits of traditional institutional models that rely on economies of scale to cover the costs of vertically integrated organizations. Banks, non-profit organizations and credit unions have all attempted to create organizations that perform all of the functions related to financial service provision and organizational management. Reliance on branch-based service channels is another limiting factor. Financial services delivered through a physical location will always be expensive and inconvenient to anyone who doesn't live in close proximity. As a result, financial service providers have struggled to find viable economies of scale outside of principal centres and remote populations have developed other mechanisms for managing their cash resources.

The current reach of financial services is a reflection of the limits of branch banking. The following chapter discusses the emerging opportunities for extending the access frontier beyond the limits of branch banking. Collectively, these opportunities demonstrate that the access frontier is no longer defined by branch locations; the reach of telecommunications technology now defines the access frontier.

3. OPPORTUNITIES FOR CREATING ACCESS TO FINANCIAL SERVICES

The opportunities for expanding the access frontier are all based on new approaches to creating more efficient organizational structures and branchless delivery channels. All of the opportunities make use, in some degree, to communications technology-enabled financial transaction channels. These channels are still inicipient in Pacific financial markets and therefore the programme will need to address a broader set of issues that cut across all of the individual initiatives. These issues are treated first in the following section.

3.1. Cross-cutting issues related to communications technology-enabled financial services

Innovation in communications technology-enabled delivery channels will be driven primarily by financial service providers. They will develop these channels only if they percieve this to be the most efficient means to reaching more clients with more services. Therefore, the programme must have the mandate and resources to support financial service providers through the innovation process.

These initiatives will inevitably encounter limitations in existing telecommunications infrastructure. Therefore, most of the first experiments will necessarily require partnerships with the telecommunications companies. At a minimum, the telecommunications companies will have to provide the channels to run the technology solutions. The programme should be prepared to incorporate the telecommunications companies into the projects, even providing them with support if necessary. Alternatively, the programme may be able to support financial service providers to develop independent communications channels, for example satelite link ups.

Finally, the programme may have to eventually address the concerns of banking regulators who will need to sort out the regulatory implications of these emerging service delivery channels. In some cases, existing regulations may impede progress and the programme will need to help regulators address these situations.

3.2. Branchless banking

Service delivery channels that enable customers to conduct transactions in convenient locations will drive the expansion of the access frontier.

- **Mobile branches**

ANZ's mobile branch initiative is a significant experiment in creating access points in remote locations. In Fiji, ANZ reports around 50,000 clients. Once the access point is established, ANZ will be able to innovate with products and methodologies for attracting and managing customers. The reach of mobile branches will likely be limited by road infrastructure in the long run, at least in the archipelago countries. However, in the near future, the mobile branches will create one of the first remote access points and early experimentation with service delivery models.

- **Remote agencies**

Banks can build from initial experiments with establishing remote mini-branches or agencies in collaboration with another organization with a physical location. For example, both ANZ in the Solomon Islands and the NBV in Vanuatu have created agencies in rural telecom stations and/or post offices. The potential of these agencies will be tapped by efficient administrative systems that link the agencies to the head office and by finely tuned services to the local populations. NBV's microfinance programme is an example of such an initiative.

- **ATMs and EFTPOS networks**

ATMs provide an immediate benefit to customers who want to withdraw cash without visiting the branch office. This benefit can be expanded as far as the telecommunications network and the logistic costs of cash transport allow. In addition, the ATMs play the important role of introducing the population to card-based banking.

The merchants who place EFTPOS terminals in their establishments and take card-based payments build a transaction network that extends well beyond the reach of ATMs. The EFTPOS terminals allow customers to transact without cash. This eliminates the costs and risks to individuals associated with transporting cash for every transaction. It also makes funds in a bank account more convenient, and this effectively makes bank-based savings more beneficial. However, probably the most interesting potential created by the

EFTPOS technology is that it creates a channel for merchants to conduct transactions on behalf of banks.

3.3. Specialized Organizational Models

- **Third-party agents**

Even when banks create efficient agency models, there will be large numbers of the population that are too dispersed to support the costs of an agency and the transport of cash. However, local merchants can partner with banks to provide basic services on the bank's behalf and this opens the possibility of extending banking services as far as the reach of cash-based commerce. For example, a merchant in a remote village currently collects cash from customers, stores the cash, and then transports the cash when he or she needs to acquire more inventory. Such a merchant could, with an EFTPOS terminal, allow customers to make cash withdrawals from their bank accounts. The merchant could also take cash deposits and cash-in payments for money transfers, and even sign up customers for bank accounts. This scenario could minimize or eliminate the bank's need to transport money to the location, since the merchant would be intermediating local cash.[16] For the merchant, the service generates revenues and draws customers into the store. The efficiency gain comes from the merchant's ability to provide this service with minimal marginal cost compared the expense of maintaining a bank agency.

This model functions to different degrees in Kiribati, as local councils perform some transactions on behalf of the banks.

- **Specialized service-delivery companies**

There are good reasons to believe that MFIs like VANWODS and SPBD that specialize in delivering financial services to the unbanked can exploit that core competency more efficiently by outsourcing their back office operations to banks or similar partners. By themselves, these organizations have to pay for and manage the information and financial control systems necessary to manage client accounts. However, banks have excess capacity in their back office systems to manage all of the clients and transactions generated by MFIs in the LDCs. And some banks may well see an opportunity to expand services by leveraging the core strength of a partner that specializes in service delivery. This conversation is in fact occurring between a bank and VANWODS in Vanuatu.

This kind of partnership could significantly reduce the management challenge and cost structure of microfinance institutions or credit unions. They could focus on developing financial services and leave the back office administration to a bank that would assume the task for very low marginal costs. This arrangement can create efficiencies in the value chain that reduce the costs and build organizational capacities associated with reaching the unbanked.

3.4. Telecommunications Technology and Telecommunications Companies

[16] This kind of role for third-party agents requires robust clearance and settlement arrangements between the bank and the agent. There are also significant regulatory issues related to managing the risk of third-party agents performing service in the name of the bank.

Most of the opportunities for extending services to the unbanked will be enabled by communications technology. For example, the efficiency of bank agency models will be largely determined by whether the agency can transfer most of the back office administration back to headquarters. This can be done with broad band linkage or even mobile phone technology. The technology now exists for banks to create a simple menu-driven, mobile phone linked terminal in an agency or agent that can transfer all necessary information back to the bank's information system.

Mobile phone technology can also expand the reach of ATMs and EFTPOS terminals beyond the limit of fixed telephone lines. Individual phones can be populated with menu driven applications that allow banks to offer their customers the ability to conduct banking transactions with their phones.

Technological innovation has also inserted the telecommunications companies themselves into the market that supplies financial services. Unbanked populations have proven to be eager adopters of mobile phone technology and therefore telecommunications companies are making great effort to reach this population with phone sales and periodic pre-paid minute sales. In addition, the mobile phone operators are storing their customers' prepaid minutes on a technology platform that can enable the phone holder to conduct bank-like transactions. In the Philippines, for example, Globe Telecoms enables its phone customers to deposit money into an account that is attached to their phone minutes account and then conduct various payment transactions with their mobile phones.

Telecommunications companies may be the primary providers or partners to a financial service company; in either case, the telecommunications companies now have resources and incentive to participate in ventures to provide financial services to their mobile phone clientele. This process is already advancing rapidly in Samoa and to a lesser extent in Vanuatu.

3.5. Product Innovation

The aforementioned opportunities create new space to develop the financial services and client management methodologies that will work for unbanked populations in the LDCs. The dearth of such experimentation has been due mostly to a lack of institutions positioned to carry the process through. That is now changing. For example, ANZ's mobile branch initiative now creates an opportunity to develop products suitable to the mobile branch customers. Likewise, NBV's experimentation with individual micro loans has created incentive for the bank to discuss a possible partnership with VANWODS about introducing the village banking model for a complementary clientele.

Product innovation has lagged in the LDCs for lack of institutions to support it. As new service providers create the transaction channels to reach the unbanked, it will be necessary to accelerate the product development process to design financial services the unbanked will use.

4. RECOMMENDATIONS FOR SUPPORT PROGRAMMES

4.1. Preliminary Observations

The central finding of this assessment is that telecommunications technology is creating new opportunities to extend financial services to the unbanked. However, it is important to note that the actors that are positioned to exploit these opportunities are different in significant ways than the usual stakeholders in traditional development finance initiatives. Historically, donors have funded initiatives driven by development organizations. The champions of the new initiatives will come from a diverse cross-section of private and public industries and create partnerships out of very different business models and economic and social motives.

In simple terms, the key players that will push the access frontier are unassociated. The group includes commercial banks, both public and private, nationally-owned and regional. Telecommunications companies will play a critical role; some are private, some public, the companies have different types of association with international mobile operators, and their markets range from monopolies to competitive. Much of the expertise in product development with the unbanked is still in non-profit development organizations. And donors continue to be important funders and champions of inclusive finance initiatives. Each of these actors is accountable to different markets, has different objectives, business models and different resources pools.

In addition, each of these primary markets – banking, telecommunications, pro-poor finance, donors – is fragmented and scattered. This makes it difficult for different players in the market to build on each other by copying successes, accessing knowledge, exploiting niches, and creating partnerships. To illustrate this point, consider the relative ease of innovating in microfinance markets of Latin America where there is an abundance of business models, technical expertise and market information.

4.2. Strategic Implications

The aforementioned observations have strategic implications for any organization that aspires to support the development of an inclusive financial system. Affecting change in the financial markets of the LDCs will require a catalytic agent that identifies and supports champions of innovative initiatives.

The catalytic role results from three basic activities. First, knowledge has to be created in a form that is useful to the companies and organisations that will champion initiatives. The relevant knowledge may be market information, a profile of technology-enabled banking models, a catalogue of emerging best practice in banking, telecommunications, legal and regulatory regimes or financial literacy training.

The second role is information dissemination. The information needs to be packaged and delivered to the agents that are likely to become champions. For example, a mobile phone operator might see new opportunities if exposed to case studies of other companies. In a more advance stage of feasibility analysis, a well-timed technical consultant might help the same mobile phone company evaluate its technical options for rolling out a new service. The same is true, of course, for commercial banks thinking about how to reach new markets.

Finally, the catalytic agent has to be positioned to build capacity for implementation when the champion decides to launch. The funding opportunities will likely be strategic placements of technical support and covering a portion of initial operational losses in a larger initiative.

4.3. Operational Implications

The agent that executes this catalytic strategy will have to work throughout the Pacific region, playing all three roles opportunistically as champions emerge.

The regional scope is important because the markets are small and isolated. No single country would provide enough opportunities to support a programme. More importantly, however, is that the catalytic agent must be able to nurture the most promising champions and initiatives as they emerge. Early successes will create future champions and initiatives. It is also the case that the individual companies, banks for example, tend to look at similar companies in other markets when searching for relevant models to explore. The catalytic agent needs to be able to network markets across country boundaries.

The catalytic agent must also be able to respond immediately when opportunities emerge. Most of the important players in these new initiatives will be commercial enterprises that will not respond to delays or requirements that compromise their timelines. Opportunities to assist a commercial enterprise in evaluating a new initiative may be short lived and the catalytic agent must be able to respond with timely support to fill knowledge and capacity gaps to advance the initiative.

4.4. Programme Recommendations

The following recommendations outline a support programme built on the aforementioned strategic and operational implications. See the chart in the annex for a summary of activities, outputs, and outcomes.

4.4.1. Programme Strategy

The Programme aims to play a catalytic role in expanding access to financial services for low income people in the Pacific that will improve their lives. The Programme will do this by playing the role of a strategic enabler of champions, adding value by accelerating their process of acquiring relevant knowledge, formulating business plans and implementing them.

4.4.2. Program Objectives

The programme work plan will be built around three main activity clusters: knowledge creation, dissemination and implementation. While each of the activity areas will have output targets and performance metrics, the ultimate objective of all of the activities is to accelerate the implementation of new initiatives. Therefore, the relevance of knowledge products or their dissemination will be measured ultimately by their contribution to new initiatives.

This means that the work plan – specifically the choice of studies and how and to whom information is distributed – will need to evolve as opportunities develop. The work plan presented below is based on opportunities identified during the assessment exercise and should be seen as an informed starting point.

4.4.3. Program Structure

The programme will require a dedicated management unit and resources to support programme activities. The funding vehicle should have an investment committee capable of making quick decisions on proposals presented by the management unit. This programme structure creates a mechanism for donors to coordinate their funding in support of pro-poor financial service initiatives. Donors that pool funds can provide adequate oversight by participation in the investment committee.

4.4.4. Programme Management Unit

- **Programme Management.** The programme needs to be managed by a fulltime, dedicated specialist with relevant career experience. The manager must have the credibility to network with banks, telecommunications companies, MFIs and other non-bank financial institutions, central banks, governments and donors. The manager must also have primary responsibility and authority to adjust the work plan to ensure that the project activities succeed in enabling champions to launch initiatives. Much of the manager's time will be spent networking in the region. This will require periodic travel to the countries and follow up email and telephone contact with relevant contacts. The management unit will then define specific activities to support the opportunities identified during this networking.

  It is important that the Programme Manager be unencumbered by programme administration responsibilities and be free to provide responsive support to country partners in identifying knowledge and capacity gaps and assisting partners to develop the scope of work that will be supported by the programme. This will also entail active relationship building with regional and international organizations and policy advocacy through Pacific Island Forum Secretariat (PIFS) regional policy development mechanisms (like FEMM).

- **Programme Administration.** Programme administration functions will entail the usual work planning, financial management and monitoring and evaluation together with reporting to donors. This will also entail regional donor coordination and resource mobilization.

- **Communications :** Much of the programme will be dedicated to work plan of knowledge generation and dissemination. The studies can be contracted out to specialists. However, the programme will likely require a fulltime communications assistant to coordinate the studies and development of content that can be disseminated through documents, presentations, and the web.

- **Independent Consultants**: Specialists can be hired to conduct research or assist project champions with specific feasibility studies. These activities will require specialize expertise and are best executed by individuals under short term contract.

- **Knowledge Management:** The programme will need to be able to distill and package project experience in suitable forms for targeted dissemination. An independent organization, involved in microfinance, that already manages a knowledge and networking electronic portal may be best positioned to carry out this important function Microfinance Pasifika, for example, would have the capacity and network of constituency to carryout this task.

4.4.5. Programme Activities

4.4.5.1. Knowledge Creation

Objective:

To build knowledge in the region regarding opportunities for providing access to a range of financial services for low income people that can contribute to improving their livelihoods.

Scope of work:

- Document financial service sector profiles for the largest countries.
  Targe t output: 6 (Papua New Guinea, Fiji, Vanuatu, Tonga, Solomon Islands, Samoa)
- Document findings from studies on rural household cash flows and rural value chains.
  Target output: 3
- Document case studies on emerging organizational and product delivery models that expand the access frontier in the region:
  Target output: 5 briefing notes; potential topics – mobile banking, bank-agent relationships, mobile-phone enabled EFTPOS technology, savings products.
- Document best practice in the region with financial literacy programmes.
  Target output: 1 study.
- Collect existing specialised knowledge related to technology-enabled, pro-poor financial services relevant for the region.
- Develop and implement other targeted research and learning questions that can drive change. [17]

4.4.5.2. Knowledge Dissemination

Objective:

To distribute relevant information to potential champions of pro-poor initiatives.

Scope of work:

- Provide relevant actors with specialized knowledge and assistance on demand through a Technical Assistance (TA) facility and access to experts

[17] This will include topics realted to the gender dimension of financial exclusion and issues related to regulation and supervision.

- Distribute documents and information sources through a website, targeted mailing and one-on-one meetings with key partners.
- Sponsor presentations and workshops at regional conferences.
- Distribute documents and deliver presentations to policymakers. It will be especially important to engage the banking authorities regarding new delivery channels and institutional models.

4.4.5.3. Implementation

Objective:

To assist institutions and partnerships to implement projects and feed back lessons learned into knowledge creation and dissemination activities.

Scope of work:

- Develop a pipeline of opportunities in the broader Pacific region
- Support specific pilot projects with a strong action research component providing grant funding and Technical Assistance.
- Develop Strategic Partnerships with other sources of funds in the region to facilitate scaling-up successful models

The following projects constitute a preliminary pipeline of possible projects to launch the program:

VANWODS-NBV (Vanuatu)

VANWODS and the NBV have initiated discussions about a partnership that would implement VANWODS Grameen Bank methodology within NBV's branch network. NBV would benefit from VANWODS client management methodology while VANWODS would be able to expand operations and migrate its account management to NBV's information technology platform. This opportunity comes in the final year of VANWODS current support agreements with the UNDP and the Government of Vanuatu, and provides an innovative solution to VANWODS' chronic need for subsidy and struggle to develop reliable back office operations.

The project would have a component of support to VANWODS during the transition period, and possibly to assist NBV to adapt their information technology platform to accommodate VANWODS clients.

NBV-Telecom operator VTL (Vanuatu)

NBV and VTL are currently discussing how the bank can transfer information from a mobile terminal back to the information platform in headquarters. The mobile terminal is NBV's "bank-in-a-box" that they hope will enable remote bank agencies to operate profitably at a small scale. The project would support the development and integration of the technology solution.

ANZ/Solomon Islands

ANZ/Solomon Islands has a broad branch/agency network in remote provinces as well as a mobile branch on Guadalcanal. This infrastructure is underexploited, however. ANZ is interested in developing financial products and delivery methodologies that will attract more clients to these remote transaction channels. The first phase of the project would focus on the mobile branches in order to develop the products and methodologies as close to the headquarter resources as possible. In a second phase, the project would adapt the products and methodologies to the remote agencies.

<u>Deposit Initiative/Samoa</u>
Commercial banks in Samoa are expanding their reach in a competitive environment. The two locally-owned, private commercial banks, National Bank of Samoa and Samoa Commercial Bank, are eager to expand their retail services with the lower end of the market to create an advantage over the regional banks in that market niche. Both of these banks are potential champions for an initiative to develop savings services in the poorer market niches. Most of knowledge of that market segment is housed in SPBD, who may be a potential partner for the banks. The project would support SPBD in partnering with the banks and to make available to the banks relevant knowledge on savings mobilisation methodologies for poor and rural markets.

5. DONOR ISSUES

5.1. Measuring Effectiveness

The point was made earlier in this document that the proposed programme strategy aspires to mobilize the resources and initiative of a wide range of actors that respond to very different incentives. This has implications for how the programme can measure its effectiveness.

Regarding execution performance, the metrics need to measure how well the programme performs its role as a pro-poor change agent in the financial service sector. There are quantitative and qualitative dimensions to this assessment. The number of outputs related to knowledge creation and dissemination can be counted and, if necessary, their quality can be verified by credible third-party evaluators. The question of how those activities effect the decisions of the champions that implement projects can be addressed with narrative accounts and credible endorsements. And finally, the significance and impact of initiatives supported by the project can be assessed with both quantitative and qualitative methods. Concerns about donor coordination and alignment with national development policies can be addressed by including donors and relevant government authorities in programme networking activities. More detail is provided below.

5.1.1. Quantity and Quality of Activity Outputs

The programme can track the number of outputs related to knowledge generation and dissemination. The generation outputs would include: studies, short-term technical assistance missions, and all documentation. Dissemination can be measured by number of documents distributed, web traffic, and by surveys of sample surveys of relevant target groups (donors, policy makers, bankers, mobile phone operators, etc). Programme stakeholders can decide how much measurement will be adequate for monitoring program administration performance.

The number of initiatives – the intended outcome of the other activities - can also be measured, subject to the following observations about attribution.

5.1.2. Outcomes of Activities

The expected outcome of the knowledge generation and dissemination activities is behavioral change, and specifically, the launch of an initiative to extend financial services to the unbanked. The measure of programme effectiveness in this outcome has to account for at least two aspects of the change process.

First, knowledge dissemination informs a broad range of actors that influence, in both direct and indirect ways, the decisions and behavior of the champions that actually implement initiatives. These influences are not easily detected or measured. Nevertheless, the programme can use surveys and ad hoc consultations to gather anecdotal evidence of how programme activities has shaped the understanding of a range of actors that are relevant to the outcome.

Secondly, it is difficult to attribute success or failure to programme activities when the outcome is influenced by factors much more important to the champions that will ultimately make the important decisions. Moreover, it is difficult to measure the impact of information that, for example, convinces a champion to change course, or even abandon a poor idea. The assessment of attribution will be necessarily subjective, but this can be instructive nevertheless. The program can document and catalogue cases where programme activities have influenced behavior. The catalogue does not need to be exhaustive to be useful. A handful of well documented cases help illustrate the effect of program activities. Even though anecdotal and subjective, the credibility of such accounts is remarkably transparent in practice, especially when programme impact is acknowledged by significant people involved in the process.

5.1.3. Performance of Implementation Initiatives

Since the ultimate objective of the programme is to expand access to financial services, the initiatives themselves should be assessed by that measure. The following indicators are relevant to that assessment.

➢ **Clients and services**

The most concrete measure of whether an initiative expands the access frontier is to measure the increase in clients *and* transactions. It is very important to measure both. The fact that a person currently has an account with a bank or credit union does not reveal anything about whether the person uses the account for any purpose that improves their livelihood. In fact, banks in the region report that many of their saving accounts are inactive. Therefore, it is important to capture the impact of an initiative that makes it possible for more people to use their account to conduct transactions.

➢ **Impact at household level**

The proposed programme is based to a significant degree on the assumption that access to financial services improves household livelihoods. Moreover, client willingness to access and pay for a service is typically accepted as an indication of value. The programme may want to test the impact further by conducting studies that quantify the value of different financial services at the household level.

- **Potential of organizational model or technology innovation**

Successful initiatives will have downstream effects. For example, more efficient organizational models can be adapted and replicated around the region. Technology-enabled transaction channels can also be replicated. The efficiency of the model or technology that can measured in financial return should be assessed and supplemented with an appraisal of the potential for downstream impact.

5.1.4. Donor Coordination

The programme will have two channels for ensuring coordination with other donors supporting similar objectives in the region. The first is the programme structure itself. Donors and funders who desire to channel their support through the programme structure will have that option. The second channel is the networking and information dissemination activities targeted at donors. This will engage the programme with all relevant donors on an ongoing basis.

5.1.5. Alignment with National Policy

The program will target national policy makers as well with networking and information dissemination activities. This will keep programme staff and stakeholders in dialogue with policy makers as opportunities emerge.

5.2. Gender Dimensions

The programme strategy addresses the underlying efficiencies that have stymied past attempts at including marginalized groups in the financial system. The focus on technology-enabled transaction channels is seen as an important foundational achievement in creating inclusive financial systems, and a building block for future initiatives that might target specific vulnerable populations. In this sense, the programme does not give preference to any particular population. The proportion of the population that is currently excluded is so large that the goal of creating the instruments to overcome the obstacles to inclusion is the primary objective of this programme.

It is also relevant to note that the appraisal team found very little information on the gender dimensions of access to financial services in the region. The team assumes that the dearth of information is related to the long history of exclusion. In other words, not much is known about the demand for financial services of most of the population, men and women. However, taking into consideration the generally unequal social and economic status of women (in relation to men), discriminatory practices and laws affecting women's ownership of assets and the unequal numbers of women in paid employment, it is reasonable to expect that, generally, women have less access to financial services.

The programme will be conducting studies and collecting data that will help define gender dimensions in the household economy and access to financial services.

ANNEXES

Programme Matrix

	Knowledge Creation	Knowledge dissemination	Implementation/ adoption
Objectives	Build knowledge in the region regarding opportunities for providing access to a range of financial services for low income people that can contribute to improving their livelihoods	Distribute relevant information to potential champions of pro-poor initiatives	To assist institutions and partnerships to implement projects and feed back lessons learned into knowledge creation and dissemination activities.
Activities	- Document financial service sector profiles for the largest countries. - Document findings from studies on rural household cash flows and rural value chains. - Document case studies on emerging organizational and product delivery models that expand the access frontier in the region. - Document best practice in the region with financial literacy programmes. - Collect existing specialised knowledge related to technology-enabled, pro-poor financial services relevant for the region. - Develop and implement other targeted research and learning questions that can drive change.	- Provide relevant actors with specialized knowledge and assistance on demand through a TA facility and access to experts - Distribute documents and information sources through a website, targeted mailing and one-on-one meetings with key partners. - Sponsor presentations and workshops at regional conferences. - Distribute documents and deliver presentations to policymakers. It will be especially important to engage the banking authorities regarding new delivery channels and institutional models.	- Develop pipeline of projects incl. on islands in the broader Pacific region - Support specific pilot projects with a strong action research component providing grant funding and TA. Pipeline: 1. VANWODS-NBV 2. NBV-Telecom operator VTL 3. ANZ/ Solomon Islands 4. Deposit Initiative/Samoa
Outputs	- 6 Financial services profiles for largest countries (PNG, Fiji, Vanuatu, Tonga, Solomon Islands, Samoa) - 3 Rural household cash flow studies	- Champions - Key partnerships that lead to pilot projects - Mailings, conferences, workshops, meetings, website, exposure visits	- 6 projects representing new delivery models and organisational models - Achievement of project objectives

	- 5 Brief notes on emerging models - 1 Report on financially literacy programmes - Relevant links and information from other experiences gathered on a website	- Financial literacy programmes adapted to demand and supply profile	
Outcome	- The industry has access to market intelligence on the demand for and supply of financial services - Reliable information about rural cash flows, economic opportunities and potential benefit of financial services that can inform product design	- Financial service providers and telecom operators have an increased interest to serve low-income clients with range of financial services - Key partners are willing to engage in pilot projects to test new delivery channels and institutional models	- Clients have access to new services or products - Service providers participating in pilot projects show improved outreach, efficiency levels and sustainability - Regulatory framework allows experiments and policymakers understand importance of appropriate legislation that supports new delivery channels and institutional models - Lessons learned and replicable results result from pilot projects
Performance indicators	- # knowledge products: studies, briefing notes - Website regularly updated and quality and amount of information - Informal assessment by informed stakeholders	- # and quality of informed champions - Recognition as the “go-to” place for microfinance development measured by demand on time - Interest expressed by microfinance actors in publications, participation in events, experimentation and co-funding - # mailings, conferences, workshops, meetings, stats of site visits;	- Financial and social performance indicators of financial service delivery - # new products and services offered - # alternative delivery channels used - Publication of key lessons and project results - A structured and targeted plan to disseminate lessons

Financial Service Sector Assessment
Solomon Islands

1. THE SETTING FOR FINANCIAL SERVICES
1.1. Country Profile

Solomon Islands is an archipelago of 992 islands and atolls with a total land area of 29,000 km^2. The capital Honiara is located on the island of Guadalcanal. The country is divided into 10 administrative areas, of which nine are provinces administered by elected assemblies. The 10th administrative area is the town of Honiara, administered by the Honiara Town Council. The provinces are: Central, Choiseul, Guadalcanal, Isabel, Makira-Ulawa, Malaita, Rennell and Bellona, Temotu, and Western.

Province / Town	Population
Honiara	65,000
Guadalcanal	80,000
Western	83,000
Choiseul	20,000
Isabel	27,000
Temotu	19,000
Makira	41,000
Central	28,000
Malaita	162,000
Rennel Belona	3,000

The total population is approximately 530,000 of which 80 percent live in isolated rural communities depending heavily on agricultural and subsistence activities. The annual population growth rate since 2000 has been 2.6 percent, which is producing a 'youth bulge' that will have an increasingly significant impact on the already high rate of unemployment.

The Solomon Islands was already one of the poorest countries in the Pacific when ethnic and political violence, known locally as "the tensions", broke out in 1998. The conflict was caused by a clash between traditional and non-traditional authority structures, unequal access to economic opportunities, and unequal access to government services and information between the Guadalcanal and Malaita people. The tensions continued until 2003 and had a devastating impact on the private sector, infrastructure, and the administration and facilities of government. With the arrival in July 2003 of the Regional Assistance Mission to Solomon Islands (RAMSI), the security situation immediately improved and more regular forms of government resumed with substantial technical assistance from RAMSI to restore budgetary and fiscal control.

Population	
Total population	530,000
Total population, urban	110,000
Total population, rural	420,000
Annual population growth rate (%)	2.6
Health	
Estimated life expectancy at birth, females	61.6
Estimated life expectancy at birth, males	60.6
Infant mortality rate per 1,000 live births (under 1)	66
Economy	
GDP Per Capita (US$, current)	650
GDP Growth (%)	5.3
Labour force	
Labour Force Participation Rate (%)	46
Number of wage and salary earners employed	60000
Unpaid workers, subsistence workers (% employment)	138,981

Solomon Islands is now one of the fastest reforming economies in the region. The improving business environment created by significant economic and business regulation reforms are resulting in strong business investment, high rates of economic growth and steadily rising living standards. The Asian Development Bank's Outlook for 2007 estimates economic growth of 5.3 percent in 2006 and strong growth prospects for 2007. In addition living standards are forecast to rise by 2.6 percent this year. Total tax revenue increased by 17 percent in 2006.

Notwithstanding the current reform agenda and the increasingly positive economic outlook, the Solomon Islands faces some difficult economic challenges. As most job opportunities are in Honiara, there has been an increased migration to the urban areas in the hope of finding paid employment. In Honiara, it is estimated that each wage earner supports 25 people, some of whom might be in Honiara or in the home village. It is also important to note that about 50 percent of the population is below 25 years of age and unemployment rates among young people have already affected crime rates (NZAID 2007). The creation of employment opportunities, especially in provincial and rural areas is therefore an important challenge.

1.2. National Policies for Poverty Alleviation & Economic Development
1.2.1. Millennium Development Goals

	$1/day poverty	Underweight children	Primary enrolment	Reaching grade 5	Primary completion rate	Gender primary	Gender secondary	Gender tertiary	Under 5 mortality	Infant mortality	HIV prevalence	TBC prevalence	TBC death rate	Water urban	Water rural	Sanitation urban	Sanitation rural
Fiji			●	●	●	●	●	●	●	●	▲	●	●			▼	▼
Kiribati				▲	●	●	●		■	■		●	●	■	▲	▲	■
PNG				▲	▼	▼	▲		■	■	▼	●	●	▼	▼	▼	▼
Samoa			▲	▲	●	●	●	▼	●	●		●	●	▼	▼	●	●
Solomons			●			●	▲		■	●		●	●			●	
Tonga			●		●	▼	●	●	●	●		●	▼	●	●	●	●
Tuvalu				▼	●	●			■	▲		●	●	▲	▲	●	▲
Vanuatu			▲		▲	●	▼	▼	●	●		●	●	▼	▼		

●: early achiever ▲: on track ■: slow ▼: regressing

Table 1: Progression of Solomon Islands on the MDGs

The tensions have had a significant impact on the country's ability to meet the Millennium Development Goals. They have also affected the ability to collect and monitor data in order to assess the current situation of the country properly.

The Solomon Islands is one of the poorest countries of the world, with a HDI ranking of 128 out of the 177 countries. The poverty situation has been exacerbated by law and order problems, the financial crisis, the contraction of economic activities and rising unemployment, compounded by high population growth.

Education indicators are very low. Primary enrolment rates are the lowest of all Pacific Island Countries. The gender gap has narrowed but remains noticeable in school enrolment and literacy rates.

Health indicators are poor. Available data suggest that child mortality rates and malaria prevalence have decreased slightly. Maternal mortality rates are very high. Access to water and sanitation has improved slightly but urban-rural disparities are extremely high.

1.2.2. National Development Plans

Following the arrival of RAMSI in 2003 and subsequent efforts to restore the machinery of government, significant economic reforms have been achieved. The current government has implemented economic and business regulation reforms, resulting in stronger business investment, high rates of economic growth and steadily rising living standards.

Since coming to power in May 2006 the Solomon Islands Government (SIG) has:

- implemented a new foreign investment act, allowing investors to have their applications processed within five days and opening up most previously banned areas of the economy to foreign investors
- reduced tariffs by half to a maximum rate of 10 percent
- introduced competition to the aviation sector resulting in a reduction in the cost of international travel
- commenced the introduction of competition in the telecommunications sector, resulting in the current monopoly provider improving its services throughout the country
- streamlined the Work and Residency Permit application process, reducing processing times from up to several months to as little as 5 days for a Work Permit and a few weeks for the whole process
- reduced the granting of tax exemptions as well as improving the transparency of the tax exemption application process, broadening and making fairer the tax load; and
- delivered a responsible Budget and reduced inflation to below 8 per cent.

Current reforms underway and to be implemented in 2007 include:

- the expansion of commercial banking into rural areas, in particular, through a competitive SD$5 million innovation fund to support the expansion of rural banking services by registered financial institutions
- the abolition of most business license fees
- increased business skills training for Solomon Islanders so as to improve their ability to start a business
- a new Companies Act to modernise the business legal environment
- a new Companies Registry to streamline the registration process
- a new State Owned Enterprises Act to make these companies more accountable and to improve their management structures
- a major rebuilding of important infrastructure like roads and wharves, and
- ongoing tax reform.

2. FINANCIAL SECTOR ASSESSMENT

Bank services were reduced during the tensions but commercial banks maintained a presence during this difficult period. With the return of relative stability, the re-establishment of a stable financial sector has been the immediate priority. In the long-term, the Government's challenge is to encourage the willingness and capacity of commercial banks and other financial service providers to make further inroads in the provinces and rural populations where economic development is lagging behind. However, geographic isolation, population dispersion, poor infrastructure especially telecommunications coverage, and lack of bankable projects all conspire to make financial intermediation in the rural areas a very challenging task.

In March 2005, the Central Bank organized a National Conference on Revitalizing Rural Finance in Solomon Islands with the objective of building widely represented consensus towards the preparation of a rural credit and financial policy. The conference highlighted that the lack of financial services to the rural communities has resulted in the disparate and low level of economic development experienced by the 80 percent of the country's people who live in rural and remote villages. The conference also recognized the importance of financial literacy training in building an inclusive financial sector.

2.1. Micro Level

2.1.1. Supply of Financial Services

There are three commercial banks in Solomon Islands: National Bank of Solomon Islands (NBSI), ANZ Bank and Westpac Bank. Historically, NBSI has had the most presence in rural areas but in recent times, ANZ has also made significant efforts to extend its network. Westpac focuses on high-end commercial lending, although it does offer retail services in Honiara, where it maintains its two branches. There is currently sparse coverage in the provinces, with banking services accessible to only 20% of the population. The banks report low loan-to-deposits ratios, indicating a lack of bankable projects. The ATM and EFTPOS networks are in early stages of rollout. However, whether services are delivered by traditional banking methodologies including branches and agencies or through electronic means, retail banking operates at a net loss for all of the commercial banks.

NBSI currently has seven branches and eight agencies. Rural agencies are located in selected churches and businesses, and are placed in areas where there is at least some form of telecommunication and regular transport to allow cash delivery and removal. The primary service in rural areas is basic deposit/withdrawal and since these accounts are generally low fee with minimal balances, the service is provided at significant cost to the bank. NBSI has recently initiated a new loan product where a rural family receives a loan against the guarantee of a family member that has a regular income through formal wage employment and a savings history, and this may be a workable way to extend credit in rural areas. NBSI does not yet have ATMs or an EFTPOS network.

NBSI is currently being purchased by Bank of South Pacific (BSP) and this may result in further emphasis and innovation in rural banking, given BSP's particular experience and success in Papua New Guinea and the financial strength of a larger, regional bank.

ANZ Bank is approaching the challenge of rural banking with commendable enthusiasm by emphasizing electronic delivery mechanisms. It currently has fifteen branches including a presence in every province except Rennel Belona. The outer branches are 'light branches', located in a post office, including a single ANZ employee, an ATM, an

EFTPOS terminal to facilitate cash-in and a computer terminal for Internet banking. Seven of its 16 ATMs are solar powered. It also has around 50 EFTPOS merchant outlets. ANZ has an Internet Banking service to support the ATM and EFTPOS network, which allows customers to check account balances, initiate transfer of funds and make payments via the Pacific-wide eBIZ service.

ANZ also has a mobile bank with immediate plans for three more. The mobile banks are fully-equipped branches, modeled on the Fiji Rural Mobile Bank initiative which includes a strategic partnership with UNDP-Pacific to deliver parallel financial literacy training to mobile bank clients. In April 2007, it made its first 'microloan' through the mobile bank. Microloans are unsecured but are approved on the basis of a demonstrated six month saving commitment. ANZ has tentative plans to streamline the application process by decentralizing loan approval and it sees some potential in incorporating loan application processes into the eBiz platform.

Credit Unions have been active in the Solomon Islands since 1986. The Solomon Islands Credit Union Act of 1986 was passed and a year later the Solomon Islands Credit Union League (SICUL) was formed to coordinate the development and growth of credit unions. SICUL is the umbrella organisation for all credit unions and its Registrar is the Central Bank. According to SICUL, in the 1990s the total number of registered credit unions reached around 170 with a total membership, including members of smaller savings clubs, of more than 60,000.

Despite the large numbers quoted above, it is also true that few of the credit unions are active, with the exception of some of the larger industry-based employee credit unions. SICUL has been inactive for some time, and the sustainability of credit unions are constrained by the Credit Union Act that imposes an interest rate cap of 1 percent per month. Furthermore, since the credit unions only lend to a member against their own share capital, there is no intermediation between savers and borrowers. Finally, the credit unions depend upon the commercial bank outlets to deliver cash to members located outside of Honiara.

Apart from the credit unions, there are no significant non-bank microfinance providers in the country.

2.1.2. Demand for Financial Services

While there is no quantitative data with respect to unmet demand for financial services in rural areas, it is nevertheless possible to make some observations that may guide further innovation and experimentation in the rural finance sector.

Since the credit union movement can boast a membership of more than 60,000, even if most of this membership is inactive, it does indicate demand for *something*, presumably a desire to accumulate some cash savings and to be able to borrow against one's savings to meet lifecycle and cultural commitments.

Despite the sometimes enthusiastic calls for the delivery of microcredit, it remains that over the long term a household that borrows money will not be economically better off unless it can generate surplus from debt. This is no easy task in a rural economy that does not have a thriving informal sector. There is no firm data to indicate how many microenterprises or households would benefit from access to credit. While there would certainly be some demand, it is unlikely that there is enough concentrated demand to support the establishment and sustainable operation of a specialist microcredit provider. In any case, given the range of microfinance products that might be of benefit to rural populations, there are other products that would likely be of greater value to the rural population and could be delivered through the formal banking system.

There is, however, strong anecdotal evidence to suggest that there is significant unmet demand for money transfer services in the Solomon Islands context. It has been estimated that the average wage employee based in Honiara supports up to 20 people in his or her home village (NZAID, 2007). These wage employees need inexpensive and efficient ways to get cash to their families in the outer provinces. Where there is a bank presence at the provincial end of the transaction, people utilise the banking system as best they can. Where there is no bank presence, many people send cash 'with people they trust' that, coincidentally, might be traveling to the province.

The other common situation is where a wage employee based in a rural area is paid into a bank account rather than cash-in-hand (as is the case with public servants), and needs to spend a significant portion of their wage getting to a cash-outlet to access their money.

In both of these situations, extending the formal cash-out system, for example through ATMs or EFTPOS facilities, would be a high value financial service to many people in rural areas.

Electronic payment services are an allied service that could be of similar benefit. Indeed, ANZ Bank offers an online payment system ('eBiz'). This, however, would require a critical mass of customers who have bank accounts and of merchants who are enabled with electronic payment facilities. There might be latent demand, for example, from provincial traders, wage employees, and perhaps within the agricultural commodities markets.

2.2. Meso Level

<u>SIG Support for Innovation in the Expansion of Rural Banking Services</u>: SIG recently announced a competitive SBD$5 million fund calling for innovative proposals from registered financial institutions that will result in the expansion of financial services to rural communities. SIG intends to provide grant funding in partnership with the institution to help share the cost of delivering rural financial services over a three year period. Proposals were to be evaluated according to the following criteria:

- Geographical spread
- Numbers of people to be reached

- Cost (affordability) of financial services to rural people
- Range of services offered including micro credit facilities
- Quality and simplicity of service offered
- Viability and long term sustainability of the service

Rural Development Program: AusAID, SIG, the World Bank and the European Community are jointly developing an Agriculture and Rural Development Strategy and accompanying Rural Development Program. The strategy will be medium to long-term in support of Solomon Islands rural development framework. The accompanying program will support reforms in local governance and rural service delivery for around four to five years. The proposed program aims to improve the level and security of rural peoples' livelihoods through increased participation of rural communities in sustainable economic development, improved local governance and improved provision of rural services and infrastructure. The program will be developed in 2007.

Credit Union Foundation of Australia (CUFA): CUFA is the Australian Credit Union Movement's development agency. It is a not-for-profit organisation whose goal is to expand the outreach of microfinance services and products to people denied such access and to develop their skills and ability to finance and manage their own microenterprise activity. CUFA has a long-standing partnership with SICUL. In the past, CUFA has provided funding and technical assistance to support both the League, and individual credit unions and savings clubs in the Solomon Islands. CUFA is committed to the strengthening of the League and will continue to work in partnership with SICUL.

Microfinance Pasifika Network (MPN): The Microfinance Pasifika Network is an alliance of institutions committed to supporting disadvantaged people in the Pacific to improve their quality of life, through the provision of inclusive and sustainable financial services such as savings, credit, remittances and payment services and insurance. MPN was launched in June 2006 in Port Vila following over a year of consultation led by the Australian-based Foundation for Development Cooperation.

UNDP Regional and Country Support: Both UNDP Solomon Islands and UNDP Regional Office in Suva maintain programs in support of economic development in the Solomon Islands, including support for strengthening of the rural financial sector.

2.3. Macro Level

The Central Bank of Solomon Islands (CBSI) conducts monetary and exchange rate policy, exercises prudential regulation and supervision of the licensed financial institutions, and manages the country's foreign exchange reserves.

CBSI is also the registrar of Credit Unions and supervises the credit union movement through the apex organisation, SICUL.

3. CONSTRAINTS TO ACCESS TO FINANCIAL SERVICES

Financial service institutions, whether banks, credit unions or community-based organizations, have struggled against a set of self-reinforcing conditions that have confined the delivery of financial services to Honiara and a handful of provincial population centers. The geographic isolation of the Solomon Islands archipelago and dispersion of the population, with meager infrastructure and telecommunications coverage, diminishes economic opportunities and raises the cost of traditional financial service operations to levels that cannot be supported by the sparse population.

Banks have managed these conditions by confining branch operations to Honiara and a handful of provincial centers. Even then, bank managers report that most of their branches and agencies have to be subsidized from revenues from Honiara operations. Credit unions have not extended services farther than the banks and very few of the credit unions have managed to sustain their meager operations. All other types of financial service organizations – typically credit programs – have failed to sustain costs or achieve scale, and many of those operated within the same geographic reach of the banks.

Since virtually no institution has successfully overcome these challenges, rural populations and urban-based financial institutions know very little about each other. Financial illiteracy is high in provincial areas, as the population has no experience with institutional sources of financial services. Also, very little is known about the cash flow patterns and money management practices of isolated populations. This knowledge gap is in itself another constraint to the innovation required to overcome the logistic challenges.

Thus until recently, the financial access frontier has been defined by the reach of commercial bank branch services. However, banks have begun to use technology-enabled transaction channels such as ATMs and EFTPOS terminals to deliver services beyond their branches. There are reasons to expect that these channels will enable banks to reach latent demand for services in more remote areas. This means that the access frontier is no longer tied to bank branches. But it also means that the access frontier is now limited by the reach of the telecommunications network because technology-enabled transaction channels require communications connections to work. Unfortunately, the telecommunications infrastructure is poorly developed and in its current state constitutes a significant obstacle to bank innovation at the frontier.

Telekom is a state-owned monopoly that provides fixed lines, radio, mobile phone and satellite communication services. At the end of 2006, Telekom was providing services to less than 14,000 subscribers and charging high rates for the service. Coverage outside of Honiara is non-existent except in a handful of provincial centers; mobile phone coverage is only in the Honiara region of Guadalcanal, with the recent exception of a small area near Gizo in the New Georgia Islands. More importantly, the last SIG granted Telekom a 15 year monopoly that prohibits private satellite hookups, and Telekom has threatened to defend its monopoly position in the courts. Therefore, although the financial access frontier is technically capable of extending as far as the communications frontier, that frontier is not much farther than existing bank infrastructure. *Ultimately, the cost and* *coverage of the telecommunications network is the most formidable obstacle to the expansion of financial services.*

4. OPPORTUNITIES FOR CREATING ACCESS TO FINANCIAL SERVICES

4.1. Strategic Assumptions

The opportunities for overcoming constraints where previous attempts have failed are linked to technologies that reduce the costs of managing the logistic challenges. Extending the electronic payment system creates an infrastructure for delivering pro-poor financial services to unbanked populations. To make this happen, banks need access to telecommunications channels. And when cash in/out transactions are in place in remote areas, institutional models and financial services that have failed before can be developed around this infrastructure.

A description of specific opportunities follows.

4.2. Branchless Banking

ANZ's experimentation with mobile branches in the Guadalcanal plains demonstrates on model for extending bank services beyond the reach of the branch. While the mobile branch is limited by road infrastructure and population density, it still represents a significant extension of the access frontier.

However, banks can engage third-party agents to extend services virtually anywhere a telecommunications connection can be established. For example, a merchant in a remote village with a VSAT connection and an EFTPOS terminal could provide cash in/out functions on behalf of the bank. Local area bank customers could deposit or withdrawal cash, and conduct any transactions enabled on the EFTPOS terminal. Likewise, the merchant could also house an ATM machine.

4.3. Technology-Enabled Transaction Channels

Most of the opportunities for branchless banking will be made possible by EFTPOS terminals, ATMs, and mobile-phone banking (m-banking). And in most of the provinces, these devices will only be possible via VSAT linkup. Private VSAT is not allowed under current legislation, and Telekom has no plans for developing m-banking services or enabling the banks to do so. Nevertheless, the SIG is resolved to introduce competition into the telecommunications sector, and the technology for m-banking is already available and evolving rapidly in other countries.

4.4. Specialized Roles for Organizations Reaching the Unbanked

As banks extend the payment system infrastructure, it becomes possible for banks, or other organizations, to develop service delivery models for acquiring and managing new clients. If banks can support the branchless transaction infrastructure with fee revenues, then it is possible that other organizations can develop specialized operations to manage client services using that bank infrastructure. This means that organizations that want to provide financial services to the unbanked do not have to develop the entire institutional infrastructure of a financial institution. And this opens the possibility that smaller organizations could support specialized client services by charging fees to customers or sharing revenues with banks.

5. RECOMMENDATIONS FOR SUPPORT INITIATIVES

5.1. Pilot Initiatives to Deliver Financial Services Through Branchless Channels

Even when transaction infrastructure is extended to within reach of unbanked populations, some institution has to develop the financial services and operational capacity to acquire and manage these new clients. This initial experimentation is best conducted within the current reach of bank infrastructure, for example where physical branches or agencies, mobile branches, ATMs, or EFTPOS agents already exist. The pilot could be led by the bank itself or in partnership with another organization that assumes the client management role. Development of the pilot will require more rigorous study of population centers and financial support from a donor willing to subsidize the start up costs.

5.2. Pilot ATM or EFTPOS-assisted Agency Model in a remote VSAT Location

A similar pilot can be done to test the feasibility of delivering financial services in a remote area where the cash in/out function is handled by an ATM or agent with a EFTPOS terminal enabled by a VSAT linkup. The most likely areas for such an experiment would be communities that receive remittances from relatives in Honiara and that have other sources of cash flow that households might be inclined to save. A successful pilot of this model would be relevant to similar community centers throughout the provinces.

5.3. Regulatory Reform of Telecommunications to Allow Private Operators to Install Own VSAT Service

The telecommunications network can be extended beyond the aspirations of a monopolistic provider in at least two ways. The SOI may decide to introduce competition in the market and experience from other countries suggests that service would expand and prices would come down. There will likely always be populations that live outside the range of a commercially viable telecommunications network. However, if regulations are changed to allow individuals or companies to install their own VSAT infrastructure and purchase the service from foreign providers, this would all those individuals the opportunity to establish communications channels based on their own cost/benefit analysis. Banks, for example, could enable branches, ATMs, or agents beyond the reach of the commercial telecommunications provider.

5.4. Financial Regulatory Reform to Support Financial Service Providers

The Credit Union Act will have to be revised if credit unions are to have any chance to play a role in expanding services to unbanked populations. Specifically, the credit unions must be liberated from interest rate restrictions.

The aforementioned agency relationships with banks will also require regulatory action. Agents that disburse funds on behalf of banks with the use of EFTPOS terminals pose no significant regulatory risk. However, agents that take deposits on behalf of banks create risks that must be managed to protect depositors. The Consultative Group to Assist the Poor specializes in advising banking regulators on this matter and provide assistance when necessary.

5.5. Studies on Rural Markets

More information is needed on rural markets to develop the opportunities cited in this report into commercial initiatives. Empirical research would accelerate the innovation process and enlighten the policy debate about what financial services are likely to produce the most benefit for currently unbanked populations.

5.5.1. Community-based Cash Flow Studies

Methodologies exist for studying the cash flows of rural communities and households. These exercises map the flow of money in and out of communities as well as the transactions that occur in the households and in the course of daily commerce. This provides a basis for understanding demand for specific financial services.

5.5.2. Agricultural Value Chains

The value chains that link rural producers to urban markets or exporters provide possible access points for banks to provide services that will develop the rural economy. For example, in many countries cocoa exporters lend money to buyers who advance money to farmers to purchase inputs during the growing season. Banks may be able to finance the agents at the top of these value chains in ways that benefit the producers. Studies on individual value chains can help identify these opportunities.

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Financial Service Sector Assessment
Vanuatu

1. THE SETTING FOR FINANCIAL SERVICES

1.1. Country Profile

Vanuatu is an archipelago of 83 mostly volcanic islands with a total area of 12,000 km^2. The country extends over 800 km from north to south and the Exclusive Economic Zone covers an area of 680,000 km^2. The largest towns are the capital Port Vila, which is situated on Efate, and Luganville, on Espiritu Santo. Since 1994, Vanuatu has been divided into six provinces.

Vanuatu has a population of around 210,000, 98 percent of whom are Melanesian. The population is growing rapidly at 2.6 percent per annum and at this rate the population will double by 2030. There is negligible out-migration to other countries.

The Vanuatu economy is typified by a high cost and price structure, an undeveloped infrastructure, large subsistence sector, a small private sector dominated by expatriates, and real shortages of people with adequate skills to participate in a modern economy.

Vanuatu's economy is primarily agricultural; around 70 percent of the rural population is actively engaged in agricultural activities that range from subsistence to smallholder farming of coconuts and other cash crops. Copra is the most important cash crop making up around 30 percent of the country's exports, followed by timber, beef, and cocoa.

The economy is highly dualistic with access to, and quality of, infrastructure and services declining dramatically outside the main urban centres of Port Vila and Luganville. Around 80 percent of the population lives in the rural areas and they are at a considerable disadvantage to those who live near the two major towns. However, urban drift has resulted in the growth of squatter settlements where conditions of living are often worse than in the rural areas.

Real GDP grew for the third successive year in 2005 by an estimated 2.7 percent compared with 3.7 percent in 2004. Growth was led by the services sector, with the tourist sector recording particularly strong expansion. The industry sector grew by 4.3

percent due primarily to increased construction activity but, in contrast, primary production contracted. As a result, economic growth in 2005 remained concentrated rather than broad based, and barely exceeded the high population growth.

Population	
Total population	210,000
Total population, urban	42,000
Total population, rural	168,000
Health	
Estimated life expectancy at birth, females	69
Estimated life expectancy at birth, males	65.6
Infant mortality rate per 1,000 live births (under 1)	53
Total fertility rate	4.8
Economy	
GDP per capita (US$)	2900
GDP Growth (percent)	2.6
Labour force	
Economically active population (age 15-64)	97,642
Total Employed	75,110

Key development constraints include: a widely scattered and mountainous island geography; vulnerability to natural disasters; a small domestic market with little potential for economies of scale; an increasingly competitive international markets for tourism and investment; and social and cultural systems with limited understanding and experience with business concepts and practices.

One of the major constraints to job creation is the low numbers of skilled workers. Education levels are very low in Vanuatu compared to its neighbors. Consequently, poorly prepared youth are entering a tight job market that offers them few opportunities. Less than 500 jobs are created each year in the formal sector, while around 3,500 school leavers seek employment annually. Some efforts have been made to develop the skills of adults and school leavers by providing basic training in plumbing, carpentry, sewing and agro processing. However, most efforts have been concentrated in the two principal urban centres, leaving the outer islands with limited opportunity to progress.

1.2. National Policies for Poverty Alleviation & Economic Development

1.2.1. Millennium Development Goals

	$1/day poverty	Underweight children	Primary enrolment	Reaching grade 5	Primary completion rate	Gender primary	Gender secondary	Gender tertiary	Under 5 mortality	Infant mortality	HIV prevalence	TBC prevalence	TBC death rate	Water urban	Water rural	Sanitation urban	Sanitation rural
Fiji			●	●	●	●	●	●	●	●	▲	●	●			▼	▼
Kiribati				▲	●	●	●		■	■		●	●	■	▲	▲	■
PNG				▲	▼	▼	▲		■	■	▼	●	●	▼	▼	▼	▼
Samoa			▲	▲	●	●	●	▼	●	●		●	●	▼	▼	●	●
Solomons			●			●	▲		■	●		●	●			●	
Tonga			●		●	▼	●	●	●	●		●	▼	●	●	●	●
Tuvalu				▼	●	●			■	▲		●	●	▲	▲	●	▲
Vanuatu			▲		▲	●	▼	▼	●	●		●	●	▼	▼		

●: early achiever ▲: on track ■: slow ▼: regressing

Table 1: Progression of Vanuatu on the MDGs

Vanuatu is the third poorest Pacific Island Country. About 50 percent of its population lives below the $1-per-day poverty line, and 23 percent of children under five suffer from malnutrition. Despite this, the country is making some progress toward the targets of the Millennium Development Goals (MDGs). Net primary school enrolment is reported at 95 percent. However, only about 70 percent of pupils starting grade one reach grade five. Net secondary enrolment is only 23 percent and only 75 percent of adults are literate. The low rate of secondary enrolment and high levels of adult illiteracy are substantial obstacles to modernisation and development.

Although gender inequality is being addressed in primary education, in secondary education it remains substantial. Girls are less likely than boys to finish their schooling, or even to continue into secondary school. The geographic isolation of most of the population makes it difficult to send children of either gender to secondary school, but females seem to be particularly disadvantaged. Continuing urban migration has given rise to slum communities with inadequate water, sewerage, or waste management systems.

Current social, economic and political indicators highlight the disadvantaged position of women in all areas. Vanuatu has a high fertility rate, with each woman bearing an average of five to six children. Average birth rates are higher in rural areas. Poor nutrition of both mothers and infants is a major health concern. Infant and child mortality is declining, but maternal mortality is persistent.

1.2.2. National Development Plans

In the late 1990's, poor standards of governance had resulted in political instability, macroeconomic instability and a collapse of investor confidence. To assist in overcoming these problems the Asian Development Bank (ADB) supported the implementation of a Comprehensive Reform Programme (CRP). In September 2003, the Government presented a Priorities and Action Agenda (PAA) intended to more effectively link the long-term CRP with government's medium-term investment program and annual budget. In June 2006, the Government released a revised PAA (2006-2015). Seven strategic priorities have been identified in the current PAA for the allocation of development resources:

1. Private sector development and employment creation
2. Macroeconomic stability and equitable growth
3. Good governance and public sector reform
4. Primary sector development
5. Provision of better basic services, especially in rural areas
6. Education and human resource development, and
7. Economic infrastructure and support services.

The PAA makes note of uneven development between rural and urban areas and the need for renewed emphasis on strengthening the rural economy. Further, under the 'private sector development and employment creation' strategy, the PAA identifies an underdeveloped financial system especially in the rural areas as one of the principal structural weaknesses in the economy. Improving access to rural financial services is therefore a key objective.

Millennium Development Goal targets and indicators have been included as Performance Indicators in the relevant sections of the PAA.

2. FINANCIAL SECTOR ASSESSMENT

2.1. Retail Level

2.1.1. Supply of Financial Services

Vanuatu has three commercial banks - ANZ and Westpac, both foreign-owned, and the National Bank of Vanuatu (NBV), a 100% government-owned institution. Collectively, commercial bank deposits and loans to the private sector are 96% and 46% of GDP, respectively. While these aggregate numbers suggest a growing level of financial intermediation in the economy, they are distorted by large borrowers and depositors in a small population. In April 2007, the three banks had approximately 4500 loans and

75,000 savings accounts.[18] Banks are liquid, with less than 50% of deposits invested in loans to the private sector. And interest margins are high, with deposit rates ranging from 1.5% - 4% and lending rates from 9% - 18%.

The three commercial banks play distinctive roles in the domestic Vanuatu financial market. **<u>NBV</u>** has recovered from insolvency in 1998 with the support of the ADB. NBV now has 21 branches or agencies on 13 islands. Though NBV reports operating losses in its branches it is committed to maintaining the network and expanding services to the rural population. Between 2004 and 2006, the NBV developed a microfinance program with the technical assistance of the ADB. The initiative has been based in the rural branches and has extended 1215 loans for a total of Vt278 million (US$2.78 million). NBV has extended individual loans averaging US$2,300 per loan. Unlike all other loans in the commercial banking sector, NBV's micro loans are unsecured by real assets. NBV requires an endorsement from the village chief for each loan, and relies on the chief's authority to intervene in cases of repayment failure. The arrangement has been successful, as the current portfolio in arrears > 60 days is 1.5%. The current portfolio is 415 loans with an outstanding balance of Vt97 million (US$970,000).

<u>ANZ</u> has two branches, one in Port Vila and one in Luganville on the island of Santo. The bank reports that most of its current savers are wage employees that live within easy access distance to the two branch offices. In May 2007, ANZ will launch a mobile bank initiative on the island of Efate, employing the same model that ANZ has used in Fiji. ANZ expects to reach under-banked customers on Efate, and if successful the operation could be replicated on Santo. However, lack of road infrastructure will likely confine the mobile banking initiative to those two islands. Although ANZ has launched innovative initiatives to reach under-banked populations in other South Pacific islands, its opportunities are limited in Vanuatu by the presence of the NBV.

<u>Westpac</u> branches are also confined to Port Vila and Vanuatu and the bank focuses primarily on business clients and wealthier retail clients.

Beyond their branch networks, the commercial banks have started to expand the payment system through ATMs and EFTPOS terminals. There are currently only 14 ATMs, confined to Port Vila and Luganville. ANZ has been the leader in this field with 9 of the ATMs and plans for 3 more in 2007. Banks are issuing debit cards to account holders but the merchant network with EFTPOS terminals is still small, estimated at about 250 locations.

The **<u>Vanuatu credit union movement</u>** began in the early 1980s and appears to have declined to the point of extinction. Credit unions were first introduced in Vanuatu

[18] Estimates from information provided in interviews with two of the banks.

through the Roman Catholic Church in 1981. The Vanuatu Credit Union League (VCUL), the apex organization of credit unions, was formed in 1992 with 34 affiliated credit unions. By 1997, there were reportedly 60 credit unions and savings clubs.[19] In 1999, the Credit Union Act established a legal framework for the credit unions and the VCUL, requiring them to register with the Department of Cooperatives in the Ministry of Trade. However, the VCUL is no longer functioning and no information was available to confirm the existence of any credit unions.

The **Melanesian Co-operative Savings and Loans Society** (MCSLS) was formed in 1984 by a group of people in Ambrym, who organized themselves into a cooperative in order to have access to credit for agricultural development. In 1996, the cooperative was registered as a finance company, but is not regulated by the Reserve Bank. The main office is in Port Vila, with one-staff branches in Luganville and one in Ambrym. The MCSLS has about 600 members, the majority of which are public sector employees in Port Vila; there are less than 10 members in Ambrym. Loans between Vt40, 000 and Vt1 million are offered against security of a 70-percent deposit for government employees and 100 percent for all other borrowers. Deposit rates are 2.75% per year, marginally higher than current bank savings rates, and loans rates are 16% per year.

The MCSLS claims to offer its members more personalized service, allowing smaller account balances and transaction sizes than the commercial banks. Closer examination of MCSLS services reveals low marginal benefits for the clients, or the financial system. Most of MCSLS clients have bank accounts where they receive their salaries; they transfer balances into MCSLS to serve as cash collateral for loans. This reliance on cash collateral denies the basic function of financial intermediation, to transfer funds from net savers to net borrowers. In effect, clients pay interest to borrow their own money, except that they may receive 30% more if they are employed. MCSLS clients also have to rely on the commercial banking system for all other payment and transfer services, since MCSLS does not have the technology infrastructure to provide these services.

Vanwods is the only specialized MFI operating in Vanuatu that has successfully adapted best practice microfinance models to the Vanuatu context. Vanwods was launched as a project within the GoV's Department of Culture, Religion, Women's Affairs and Archives, but has since been established as an independent organization under the Charitable Organizations Act. Vanwods still received operating subsides from the GoV and from the UNDP; both projects will terminate at the end of 2007.

Vanwods has adapted a Grameen Bank style service delivery model to provide savings and loan services to poor women in Port Vila and, recently, Luganville. The women form solidarity groups federate into centers and weekly meetings are held to discuss problems as well as to collect weekly loan repayments and individual and group savings. The group and center members guarantee the loans of the members.

As of April 2007, Vanwods reported a client base of 1800 savers with a collective balance of Vt50 million (US$500,000) and 1707 loans for outstanding loan portfolio of

[19] Savings clubs have less than 10 members.

Vt. 24 Million (US$ 240,000). Vanwods pays interest on clients' savings of 4% but loan interest rates are equivalent to about 100% per year. Vanwods has in the past reported sustainability rates approaching 100%, but these do not include significant subsidies, and current financial reports are unreliable for assessing the financial position of the organization.

2.1.2. Demand for Financial Services

Very little is known about the potential demand for financial services from the currently unbanked population. Until very recently, access to commercial financial services was limited to the reach of commercial bank branches, and their service options, in Port Vila and Luganville. NBV's revival after 1998 likely improved services in the outer branch offices, but NBV reports that the volume of services in those branch offices is not yet enough to sustain operating expenses.

The most relevant indications of latent demand for financial services comes from the anecdotal evidence from recent public response to the pilot or small-scale initiatives identified above. The success of Vanwods and the NBV Microfinance initiative reflect demand from a previously unbanked population. Vanwod's experience suggests a strong demand for savings as well as loans from relatively poor clients. NBV's success suggests demand for micro loans from viable enterprises in branch locations.

Demand for payment and transfer services are likely the most widespread in the population. The story is often repeated that public sector employees in remote islands sometimes spend a significant portion of their salary on the transportation expenses required to withdrawal their pay from the closest bank branch. Families receiving transfers from a member working in Port Vila face similar conditions.

2.2. Meso Level

The bulk of support to financial service institutions has been delivered through bilateral agreements between individual donors and institutions. The Asian Development Bank (ADB) has provided support to the NBV Microfinance initiative and to an initiative to develop a legal and institutional framework for secured transactions.

Other than its support to Vanwods, the GoV's support to expanding financial services has been spread across a long history of failed credit schemes, including a development credit institution that was declared insolvent in 1998.

Microfinance Pasifika Network (MPN): The Microfinance Pasifika Network is an alliance of institutions committed to supporting disadvantaged people in the Pacific to improve their quality of life, through the provision of inclusive and sustainable financial services such as savings, credit, remittances and payment services and insurance. MPN was launched in June 2006 in Port Vila following over a year of consultation led by the Australian-based Foundation for Development Cooperation. Vanwods and NBV are members of the MF Pasifika Executive Committee.

UNDP Regional and Country Support: The UNDP Regional Office in Suva maintain programs in support of economic development in the Vanuatu, including support for Vanwods. UNDP is also supporting ANZ's mobile-banking initiative through a regional partnership agreement.

3. CONSTRAINTS TO ACCESS TO FINANCIAL SERVICES

Geography and demographics create the most significant challenges to expansion of financial services. Vanuatu's population is spread thinly across an archipelago of 80 islands and the inhabitants are isolated and inaccessible because of meager transportation and communication infrastructure. These conditions raise the cost of service delivery outside of Port Vila and Luganville to a level that no financial service provider in Vanuatu has been able to compensate with sufficient income. Only the NBV maintains branches outside of the two main population centres, but has to subsidize the operating costs. Vanwods is so far unable to cover the full cost of operations while operating in Port Vila and Luganville.

The geographic and demographic conditions are often sited as binding constraints to rural economic development in general and financial service delivery in particular. Without doubt, these conditions define significant parameters for the structure of the market and the financial institutions. For example, it is unlikely that population centres outside of Port Vila and Luganville could support more than a single service provider and therefore NBV will likely be the only bank operating in many areas. But the notion that these conditions impose binding constraints on the access frontier is misleading, because it fails to account for the economic inefficiencies that encumber current service delivery models and for the possibility that the geographic and demographic challenges could in fact be overcome with more efficient approaches.[20]

A closer examination of the operating environment reveals several sources of economic inefficiency which can be addressed.

3.1. Telecommunications

The lack of telecommunications infrastructure is the primary constraint to delivering financial services beyond the traditional branch network. Without adequate communications channels, even simple daily operations are burdened with additional logistic and coordination expenses. Ultimately, the most significant cost-savings opportunities are impossible. The costs of branch operations can only be reduced by centralizing back office functions at headquarters and communications infrastructure provides the channels for this centralization. In Vanuatu, many of NBV's branches do not have ready access to a phone line. Equally importantly, banks cannot extend the payment system through EFTPOS terminals with merchants for lack of fixed or GSM connections.

3.2. Organizational Inefficiency

[20] See Bazeley and Mullen 2006 for a well-reasoned distinction between "economic inefficiencies" and "binding constraints" in their assessment of the Vanuatu economy.

Operational costs must be reduced to extend financial services beyond current limits. This has different implications for banks and for specialized institutions like Vanwods. For banks, efficiency will come from reducing "branch expense structures" to more streamlined "agency" models. ANZ's upcoming launch of its mobile-banking program is an example of a branchless model for reaching clients. Most of NBV's branches or agencies are already streamlined, for example, by creating a one-staff office in the local post office. But the cost-savings measures need to be complemented with measures to increase the volume of business in the branch, and will mean experimenting with new financial services or service delivery models that satisfy the local unbanked population. Here again, NBV has started this process with its microfinance program but more products will be needed to reach a wider economic range of the population.

For specialized organizations like Vanwods, or even the credit unions, the cost and challenge of managing all of the back and middle office systems to support their retail credit and savings services have so far been unsustainable. This should provoke consideration of partnerships with banks that have the systems in place. If banks provided the account management other transaction services, specialized organizations could focus on client acquisition and management without the cost burden of maintaining the administrative systems.

3.3. Cash management

The logistics of cash transfers have been costly for banks and individuals. The spread of ATMs will be limited for this reason. ANZ's mobile-banking initiative provides a promising solution, but only for the islands of Efate and Santo that have adequate road infrastructure. This has been a problem for NBV's remote bank branches as well. The problem will persist until remote branches can intermediate local cash flows by capturing savings or using the cash flow of local merchants.

3.4. Knowledge of the unbanked population

The initiative of ANZ, NBV and Vanwods represent initial engagement with a population that has been previously unbanked. Financial illiteracy is high in provincial areas, as the population has no experience with institutional sources of financial services. And very little is known about the cash flow patterns and money management practices of isolated populations. This knowledge gap is in itself another constraint to the innovation required to overcome the logistic challenges.

4. OPPORTUNITIES FOR CREATING ACCESS TO FINANCIAL SERVICES

4.1. Strategic Assumptions

The opportunities for overcoming constraints where previous attempts have failed are linked to technologies that reduce the costs of managing the logistic challenges in Vanuatu. Extending the electronic payment system creates an infrastructure for delivering pro-poor financial services to unbanked populations. To make this happen, banks need access to telecommunications channels. And when cash in/out transactions are in place in remote areas, institutional models and financial services that have failed before can be developed around this infrastructure.

A description of specific opportunities follows.

4.2. The NBV Branch Network

NBV's network of 21 branches constitutes the most extensive infrastructure available for extending financial services to unbanked populations beyond the access frontier. Fortunately, NBV acknowledges this potential and has launched its microfinance program to reach unbanked clients in branch areas. There is more potential to be tapped. Vanwod's success with the Grameen Bank model near Port Vila suggests that a similar service would be well received in NBV's branch areas. This would be one lending product that could reach clientele below the $2,300 average individual loans of NBV's microfinance program. Likewise, Vanwod's success in mobilizing savings is also a relevant reference for rural areas. In addition to the intrinsic value of savings services for rural clients, NBV could reduce some of its cash-transfer expenses by intermediating resources at the branch level.

4.3. Mobile Banking

ANZ's will launch the mobile branch program it developed in Fiji in the rural areas surrounding Port Vila in May of 2007. The mobile branch initiative will be limited to Efate and Santo because of road infrastructure and population density, but it still represents a significant extension of the access frontier and an opportunity to experiment with financial products.

4.4. Technology-Enabled Transaction Channels

Most of the opportunities for branchless banking will be made possible by EFTPOS terminals, ATMs, web-based applications, and mobile-phone banking (m-banking). For example, NBV plans to use either EFTPOS or web-based computers to develop its "bank-in-a-box" communication modules for its branches. This will enable NBV to process branch transactions centrally while providing cost-effective administrative systems at the branch level. Banks may also use EFTPOS terminals with merchants to provide cash in/out services beyond the reach of the branch. Obviously, all of these opportunities rely on access to reliable telecommunications. While this is currently a constraint, VTL is promising to cover 70% of the population by 2009. VSAT linkups may be used to reach areas outside of the cell phone coverage area, or to provide web access.

4.5. Specialized Roles for Organizations Reaching the Unbanked

As banks extend the payment system infrastructure, it becomes possible for banks, or other organizations, to develop service delivery models for acquiring and managing new clients. If banks can support the branchless transaction infrastructure with fee revenues, then it is possible that other organizations can develop specialized operations to manage client services using that bank infrastructure. This means that organizations that want to provide financial services to the unbanked do not have to develop the entire institutional infrastructure of a financial institution. And this opens the possibility that smaller organizations could support specialized client services by charging fees to customers or sharing revenues with banks. There is obvious potential for such a relationship between Vanwods and NBV, or Vanwods and the ANZ mobile banking program.

5. RECOMMENDATIONS FOR SUPPORT PROGRAMMES

5.1. Pilot Initiatives to Deliver Financial Services Through Branchless Channels

Even when transaction infrastructure is extended to within reach of unbanked populations, some institution has to develop the financial services and operational capacity to acquire and manage these new clients. This initial experimentation is best conducted within the current reach of bank infrastructure, for example where physical branches or agencies, mobile branches, ATMS, or EFTPOS agents already exist. The pilot could be led by the bank itself or in partnership with another organization that assumes the client management role. Development of the pilot will require more rigorous study of population centers and financial support from a donor willing to subsidize the start up costs.

5.2. Pilot ATM or EFTPOS-assisted Agency Model in a remote VSAT Location

A similar pilot can be done to test the feasibility of delivering financial services in a remote area where the cash in/out function is handled by an ATM or agent with a EFTPOS terminal enabled by a VSAT linkup. The most likely areas for such an experiment would be communities that receive remittances from relatives in Honiara and that have other sources of cash flow that households might be inclined to save. A successful pilot of this model would be relevant to similar community centers throughout the provinces.

5.3. Studies on Rural Markets

More information is needed on rural markets to develop the opportunities cited in this report into commercial initiatives. Empirical research would accelerate the innovation process and enlighten the policy debate about what financial services are likely to produce the most benefit for currently unbanked populations.

5.3.1. Community-based Cash Flow Studies

Methodologies exist for studying the cash flows of rural communities and households. These exercises map the flow of money in and out of communities as well as the transactions that occur in the households and in the course of daily commerce. This provides a basis for understanding demand for specific financial services.

5.3.2. Agricultural Value Chains

The value chains that link rural producers to urban markets or exporters provide possible access points for banks to provide services that will develop the rural economy. For example, in many countries cocoa exporters lend money to buyers who advance money to farmers to purchase inputs during the growing season. Banks may be able to finance the agents at the top of these value chains in ways that benefit the producers. Studies on individual value chains can help identify these opportunities.

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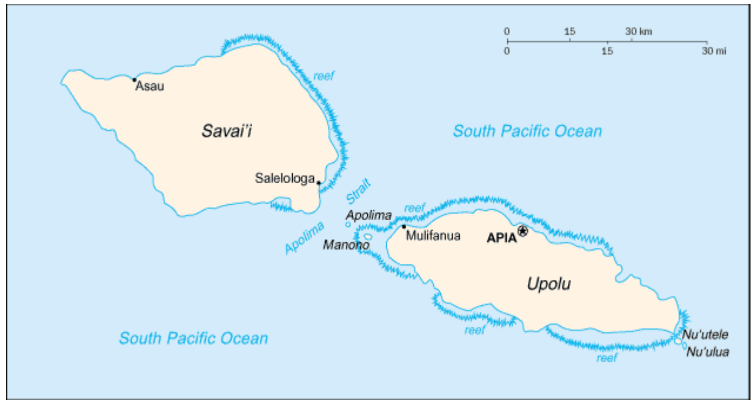
Financial Service Sector Assessment
Samoa

1. THE SETTING FOR FINANCIAL SERVICES
1.1. Country Profile



Samoa is located in the central South Pacific, 2,900 km northeast of New Zealand and a little over 4,000 km southwest of Hawaii. It comprises two main islands, Upolu and Savai'i and seven smaller islands, making a total land area of 2,800 km^2. Its exclusive economic zone covers 120,000 km^2. The capital is Apia on the main island of Upolu.

Samoa's current population is around 180,000. The total population increased by 9.6 percent in the period between the last two censuses in 1991 and 2001. This figure is influenced by out-migration to New Zealand, Australia and the United States.

Almost 41 percent of the population was under 15 years of age in 2002. With about 54 percent of the population aged from 15 to 65 years, Samoa has a high dependency ratio of about 0.82.

Internal migration raises significant development planning issues. Between 1991 and 2001, the number of people living in north-west Upolu increased by 35 percent. North-West Upolu is now home to more than half of the Samoan population, with about 25 percent each in the rest of Upolu and on Savai'i respectively. This has implications for the delivery of economic infrastructure and social services. It also has significant social impacts as more people reside outside of the village setting with its related traditional administration and governance.

The economy of Samoa has been dependent on foreign aid, government borrowings overseas, foreign remittances and agricultural exports. Agriculture remains the backbone of the local economy with two-thirds of households engaged in some form of agricultural activity, often a mixture of subsistence and commercial agriculture. Many wage-earning households also engage in supplementary subsistence production. The population census of 2001 showed that about 49 percent of the population is economically inactive, while about 5 percent of the economically active population was unemployed. GDP per capita at end of September 2006 was around US$2390.

Population	
Total population	180,000
Total population, urban	90,000
Total population, rural	90,000
Health	
Estimated life expectancy at birth, females	72
Estimated life expectancy at birth, males	65
Infant mortality rate per 1,000 live births (under 1)	12
Total fertility rate	4.8
Economy	
GDP per capita (US$)	2390

Samoa has a small, nascent private sector made up largely (80 percent) of many small enterprises that have fewer than five employees. A number of factors, natural and introduced, constrain business activity. Natural constraints, which cannot be changed, include the country's remoteness and susceptibility to natural disasters, narrow resource base, and small domestic market. However, the private sector business environment has improved over the past few years, with the Government giving increasing priority to stimulating private sector development. While progress has been slow and lacking in depth, recent and continuing reforms are designed to facilitate a more open and accessible enabling environment for business. This has made Samoan economy one of the few bright spots in the Pacific region in terms of economic policy and institutional reforms.

About 20 percent of Samoan households have incomes below the basic needs poverty line. There are significant gaps between the two islands in terms of economic growth and human development indicators, with Savai'i lagging significantly behind. The greater Apia urban area generates an estimated 70 percent of the national income.

Traditional village culture in Samoa can constrain business development. The accumulation of individual wealth, including through business initiative, is often interpreted negatively. Samoan's share wealth with family, the community and the church, which can prevent the accumulation of capital needed to start a business. This system, known as *fa'alavelave*, also consumes a significant portion of remittances and many also seek consumer credit, sometimes on a virtually continuous basis, to meet these commitments.

Remittances have long been a feature of the Samoan economy, supported by substantial out-migration to countries such as Australia, New Zealand and the United States. Samoan migrants are known for their longstanding sense of obligation to support relatives in their home country – it is part of the *fa'alavelave* system. There are now more Samoans living abroad than within Samoa itself. In Q3 2006, remittances reached record levels of 25 percent of GDP. This generated high domestic liquidity and pushed up import demand, requiring the central bank to tighten monetary policy to slow consumption.

Samoa is heavily reliant upon remittances from a balance of payments point of view. Remittances are equivalent to the trade deficit for Samoa. The inflow of remittances in

2005 for Samoa exceeded the entire foreign exchange reserves held at the central bank. The implication for Samoa is that there is little room for remittances to decline, as continued inflows are required to retain hard currency at the central bank given the size of the trade deficit and the lack of other significant sources of foreign exchange inflows into the economy.

Remittances are mostly used by recipients for *fa'alavelave* commitments such as life-cycle events including weddings and funerals, church projects, medical and education expenses, and also general consumption. Remittances could theoretically be used for investment in income-generating activities but, in light of the daunting challenges associated with business development in rural villages, remittances tend to reduce incentive to invest time and money in such activities, leading to a cycle of dependency upon overseas migrant workers.

1.2. National Policies for Poverty Alleviation & Economic Development

1.2.1. The Millennium Development Goals

	$1/day poverty	Underweight children	Primary enrolment	Reaching grade 5	Primary completion rate	Gender primary	Gender secondary	Gender tertiary	Under 5 mortality	Infant mortality	HIV prevalence	TBC prevalence	TBC death rate	Water urban	Water rural	Sanitation urban	Sanitation rural
Fiji			●	●	●	●	●	●	●	●	▲	●	●			▼	▼
Kiribati				▲	●	●	●		■	■		●	●	■	▲	▲	■
PNG				▲	▼	▼	▲		■	■	▼	●	●	▼	▼	▼	▼
Samoa			▲	▲	●	●	●	▼	●	●		●	●	▼	▼	●	●
Solomons			●			●	▲		■	●		●	●			●	
Tonga			●		●	▼	●	●	●	●		●	▼	●	●	●	●
Tuvalu				▼	●	●			■	▲		●	●	▲	▲	●	▲
Vanuatu			▲		▲	●	▼	▼	●	●		●	●	▼	▼		

●: early achiever ▲: on track ■: slow ▼: regressing

Table 1: Progression of Samoa on the MDGs

Samoa has made steady progress towards the Millennium Development Goals. It has already achieved certain targets such as universal primary education. Gender disparity in primary and secondary education has been eliminated. Child and maternal mortality rates have decreased. Nevertheless, efforts need to be strengthened and further attention directed to ensuring that all parts of the population have access to essential and quality education, health care services and safe water supply.

There is no extreme poverty or hunger in Samoa. However, pockets of hardship exist in various areas and need to be addressed. About 20 percent of Samoan households are experiencing some degree of financial hardship, with incomes below the basic needs poverty line. There are significant gaps between the two major islands in terms of economic growth and human development indicators, with Savai'i lagging significantly behind. Continued attention will be needed to ensure that all parts of the population have access to essential and high-quality basic education, health care services, and safe water supply.

1.2.2. National Development Plans

Samoa's development plans are defined in the Strategy for the Development of Samoa (SDS) 2005–2007. This document is the fourth in a continuation of the program implemented over the previous periods, which began in 1996. The preparation of the SDS was widely consultative, involving consultations with a wide range of stakeholders including Church Leaders, Pulenuu, women's committees, farmers and fishermen, NGOs, youth groups, tourism industry, education and health stakeholders, the business community as well as government ministries and corporations. Consultations were carried out in Savai'i to facilitate participation of Savai'i residents, with the final National Stakeholder Summit held in Upolu.

Six broad focal areas are identified as priority areas for Samoa's development over the three year period. These include:

1. *Private sector development:* including strengthening the enabling environment, and promoting investment.
2. *Agricultural development:* including enhancing agricultural activity, promoting commercial investment, and strengthening the ministry of agriculture.
3. *Tourism:* including the marketing strategy, developing infrastructure, and developing human resources.
4. *Community:* including increasing village production, maintaining social coherence and harmony, and enforcing law and order.
5. *Education:* including strengthening community support in education, improving teacher quality, improving curriculum and assessment practices, improving teaching materials, improving school facilities and equipment, strengthening the ministry of education, developing sports
6. *Health development:* including strengthening health preventive programs, developing human resource – medical personnel, improving health facilities and equipment, financing health service, and strengthening the ministry of health.

The implementation of these priority strategic areas and associated activities, is expected to realize the National Vision which is: *'For every Samoan to achieve a better quality of life'*.

2. FINANCIAL SECTOR ASSESSMENT
2.1. Micro Level

Supply: There are four commercial banks in Samoa: ANZ Bank, Westpac Bank, National Bank of Samoa, and the Commercial Bank of Samoa. Other financial service providers include the Development Bank of Samoa, the National Provident Fund, one specialist microfinance institution, a moribund credit union movement and a number of private finance companies.

ANZ Bank is the oldest bank in Samoa. It opened in 1959 and became a wholly owned subsidiary of ANZ Banking Group in 1995 after the government relinquished its 25 percent share. It has five branches in Samoa - three in Apia, one at the airport and one in Savai'i. It has ten ATMs in and around Apia and another in Savai'i, and nearly 300 EFTPOS terminals with merchants. ANZ does not issue credit cards in Samoa. It has an Internet Banking service to support the ATM and EFTPOS networks, which allows customers to check account balances, initiate transfer of funds and make payments via the Pacific-wide eBIZ service, although this is restricted by limited Internet connectivity and limited awareness by customers.

As part of its contribution to banking the unbanked in Samoa, ANZ has implemented a mobile bank. The mobile bank serves 31 villages in Upolu on a daily basis, and it does a full trip around Savai'i once per week. Daily tasks for the mobile bank include:

- Open new accounts in the rural villages and at primary and secondary schools (minimum balance ST$1)
- Handle customer transactions such as deposits and withdrawals
- Loan applications / referrals. Micro loans of ST$500-1500 are available to customers who demonstrate a consistent savings pattern over at least six months
- Provide updated Bank passports, and loan statements
- Financial literacy.

ANZ also has a well-equipped van that operates in Apia and its outer edge areas. The van is a convenient way for tourists and the community to do their banking as it is also opens outside the normal banking hours. The van is also available to attend conferences, sporting events, church gatherings, etc.

ANZ holds around 45,000 personal savings accounts. Most of these hold minimum balances, as wage employees generally withdraw all of their salary on payday. There is very little actual savings. This is true for each of the four commercial banks.

In addition to its mainstream lending activities, ANZ provides loans to clients of the Small Business Enterprise Centre against a loan guarantee provided by GoS and ADB.

Westpac began operations in Samoa in 1987 as the Pacific Commercial Bank (PCB), in a joint venture with the Bank of Hawai'i. PCB served the corporate market but, since assuming full ownership of the bank in 2001, Westpac has sought to transform the bank into a broader, consumer-oriented institution. Westpac has its main branch in Apia, and sub-branches at the airport, in Vaitelle and Savai'i. It has five ATMs with another three to be installed over the next six months, and 110 EFTPOS terminals with merchants. Westpac is also the only bank in Samoa that issues a Tala-based personal credit card.

Westpac currently holds 8000 personal savings accounts and 5000 business cheque accounts. Consumer credit represents the biggest financial service demand. Westpac has around 9000 current loan accounts.

To facilitate transfer of international remittances, Westpac is a super-agent for MoneyGram. Westpac also reports that some of its customers are using debit cards attached to savings accounts held at Westpac branches in New Zealand and Australia to access 'remittances' through local ATMs. This is a relatively cost effective way to access remittances.

In addition to its mainstream lending activities, Westpac provides loans to clients of the Small Business Enterprise Centre against a loan guarantee provided by GoS and ADB.

Westpac reports that it is keen to provide services in rural areas but on a cost effective basis. For example, Westpac is considering 'reverse EFTPOS' which allows cash-in at EFTPOS merchants. This will require the participation of merchants and, depending on the transaction protocols employed, might also require the agreement of the Central Bank. In the meantime, Westpac is set to commence a financial literacy program in secondary schools, which will be delivered in conjunction with opportunities to open transaction accounts.

The **National Bank of Samoa (NBS)** commenced operations in late 1995 when the government sold its shareholding in the former Post Office Savings Banks. NBS is now privately-owned by local Samoan investors and the International Finance Corporation. NBS has its main office in Apia, another two agencies in Upolu, and two external agents in Savai'i that are based in the SamoaTel and Western Union offices respectively. NBS offers a range of retail and commercial services. It does not have its own ATM or EFTPOS network, although it does issue a debit card that can be used through ANZ ATMs.

NBS holds around 5000 savings accounts and more than 1000 term deposits. Consumer credit represents the biggest financial service demand. For loans less than ST$3000, NBS has nearly 2300 loan accounts. Compared to the other commercial banks, NBS's share of the lending market has doubled from around 8 percent to 16 percent over the last five years. In addition to its mainstream lending activities, NBS provides loans to clients of the Small Business Enterprise Centre against a loan guarantee provided by GoS and ADB.

NBS operates a school-based savings program they call the 'five-to-life' program. NBS bank officers visit primary schools, open accounts for pupils, and collect deposits. NBS currently holds nearly 6700 accounts and more than ST$600,000 in deposits through this program.

The **Samoa Commercial Bank (SCB)** commenced operations in 2003. SCB is a privately-owned bank. It has its main office in Apia, three more agencies in Upolu, and three agencies in Savai'i. SCB offers a range of retail services, focusing on household and small business clients. It does not have ATMs or an EFTPOS network.

SCB holds around 8500 individual savings accounts and around 5000 loan accounts. Around 80 percent of its loans are less than ST$5000 in size, and virtually all of these are provided to wage-employees. Most loans are used for *fa'alavelave* purposes. In addition to its mainstream lending activities, SCB provides loans to clients of the Small Business Enterprise Centre against a loan guarantee provided by GoS and ADB.

The state-owned **Development Bank of Samoa (DBS)** finances projects in selected priority sectors, including agriculture, fishing, tourism and small business. It has one branch in Apia. The rest of Upolu as well as Savai'i are serviced by field officers who inspect projects and follow up problem loans.

In addition to its mainstream lending activities, DBS provides loans to clients of the Small Business Enterprise Centre against a loan guarantee provided by GoS and ADB.

DBS has also participated in an ADB-funded, ST$800,000 **Microenterprise Financing and Savings Mobilization Project**, in partnership with the Women in Business Foundation (WiB). This program has stalled because WiB has, not unreasonably, taken a cautious approach to the disbursement of credit in rural communities.

In 2004, DBS lending made up less than 11 percent of total domestic credit from all sources.

South Pacific Business Development is a Grameen Bank replication that targets poor women in Upolu. It was established in January 2000. It is the only financial institution in Samoa that delivers large-scale unsecured credit to the poor in Samoa. The project adheres to the Grameen methodology of forming solidarity groups comprising four to seven women members. Solidarity groups federate into centres, and weekly meetings are held to conduct financial transactions.

By end-2006, SPBD had 3592 outstanding loans and a loan portfolio of around ST$4 million, with portfolio-at-risk of 1.3 percent.

SPBD has also developed a micro-savings program. Any member can open a savings account with a minimum deposit of ST$10, which compares favorably with the typical bank minimum of ST$50 but is more than the ANZ mobile bank minimum of ST$1. SPBD deposits collected savings in a segregated account at Westpac. Since SPBD is not a regulated financial intermediary it may not use client deposits for on-lending. SPBD provides monthly reports of savings to the Central Bank. As of December 2006, SPBD had approximately ST$60,000 in 2290 bank accounts (av. ST$26). This is low in comparison to the average loan balance of ST$500.

SPBD is financed through a mixture of quasi-equity, grants, soft loans and commercial loans.

The **National Provident Fund (NPF)** is the only pension fund in Samoa. Participation is compulsory for all public and registered private sector workers. NPF's investment framework is constrained by the lack of long-term investment opportunities in the domestic market. In response to this situation, NPF allows members to borrow from the NPF about 50 percent of their balances, using balances as collateral. However, non-performing loans at NPF are high and its assets are now skewed toward short-term loans to members and public sector projects. NPF's share of the total domestic credit stands at around 30 percent, which is marginally less than ANZ's share and more than the share of the other three banks combined.

Federal Pacific is a private finance company that provides credit exclusively to wage employees and successful business people. It commenced operations in 2000 and currently has around 1300 loan accounts. Loans are secured through a third-party personal guarantee, mortgage on freehold land and/or chattels. Loans size may be anywhere between ST$500 to ST$100,000. Interest rates are a flat 11-14 percent. Around 70 percent of current customers are repeat borrowers; some customers have had as many as seven loans in succession.

2.2. Meso Level

International funding support for development of the financial services sector has been received from **ADB**, **NZAID**, **UNDP**, **EIB** and various **specialised MFI funders**. **GoS** has also provided direct support to the sector, with the assistance of various international donors particularly ADB, for the Small Business Loan Guarantee, funding for implementing organisations such as the Small Business Enterprise Centre and Women in Business, and for the Microenterprise Financing and Savings Mobilization Project

Microfinance Pasifika Network (MPN): The Microfinance Pasifika Network is an alliance of institutions committed to supporting disadvantaged people in the Pacific to improve their quality of life, through the provision of inclusive and sustainable financial services such as savings, credit, remittances and payment services and insurance. MPN was launched in June 2006 in Port Vila following over a year of consultation led by the Australian-based Foundation for Development Cooperation. SPBD is a member of MPN and they also serve on the Executive Committee.

UNDP Regional and Country Support: Both UNDP Samoa and UNDP Regional Office in Suva maintain programs in support of economic development in the Samoa, including support for strengthening of the rural financial sector.

2.3. Macro Level

Over the last decade, **GoS** with support from **ADB** has implemented a series of reforms to establish market-based policies to encourage financial intermediation, mobilize and allocate financial resources efficiently, and foster private sector-led economic growth and employment generation. The prudential and regulatory framework has been improved substantially. The Financial Institutions Act (FIA) was passed in 1996 to strengthen CBS's role in exercising prudential supervision over the country's financial institutions. In 2001, further FIA amendments empowered CBS to extend supervisory guidelines to non-bank financial institutions such as NPF, DBS, and the insurance sector. GoS has also begun the process of removing legal impediments to the economic use of customary land, improving debt recovery mechanisms, and facilitating secured transactions.

Pursuant to its mandate under the Central Bank of Samoa Act 1984, the Financial Institutions Act 1996 and the Money Laundering Prevention Act 2000, the **Central Bank of Samoa (CBS)** has the following main functions:

- regulating the issue supply availability and international exchange of money;
- advising the Government on banking and monetary matter;
- promoting internal and external monetary stability;
- promoting a sound financial structure;
- promoting credit and exchange conditions conducive to the orderly and balanced economic development of Samoa;
- supervising and regulating banking business and the extension of credit; and
- implementing counter measures against money laundering such as to deter, detect and criminalized money laundering activities.

The Central Bank is responsible for the registration and prudential supervision of commercial banks. It also acts as banker for the commercial banks, provides a facility for the clearing and settlement of inter-bank payments, and is also custodian of the commercial banks' statutory minimum cash reserves.

The Financial Institutions Act 1996 appoints the Central Bank as the authority that issues licenses to financial institutions and, shall undertake further scrutiny of any information suggesting money laundering taking place.

2.4. Demand for Financial Services

The patterns of over-consumption in Samoan society are reflected in, and will continue to shape, the demand for financial services.

2.4.1. Net Demand For Credit

At a macroeconomic level, Samoa consumes more than it produces. Foreign remittances are about one-third of GDP, and remittances combined with foreign assistance funds about two-thirds of national consumption. The same imbalance is reflected in the financial markets. Banks mobilize about T$400 million from the private sector, but lend T$813 million. The additional funds come mostly from the deposits of the state pension system, government and state-owned enterprises, and foreign borrowing. At an individual level, this propensity for over-consumption is reflected in the high level of consumer lending by all types of financial institutions

2.4.2. Consumption borrowing

There is a considerable body of anecdotal evidence that most borrowing is for consumption, and that the practice is widespread in society. For banks and non-bank lenders alike, most of their loans are to salaried employees. These borrowers tend to borrow serially, taking new loans as soon as they make their final payments. Banks report that for many people, their wages are barely enough to make their loan payments.

The lenders that do loan to microbusinesses, or at least to non-employed borrowers, do not observe substantial growth of the business activities as a result of the borrowing. The commonly held view is that when entrepreneurs acquire loans and increase their business activity, social claims on their assets simply increase.

Finally, savings account balances are generally very low. Many bank customers have savings accounts because this is a condition to getting a loan. And most savings accounts are used for cash in/out activities.

2.4.3. Household Microeconomics

This pattern of over consumption appears to be driven primarily by the external demands on household incomes that are peculiar to Samoan society. The population lives in villages governed by chiefs and this entails and endless sequence of claims on village households to contribute to the chief's court, village projects, weddings, funerals, and similar events. In addition, virtually all Samoans are very involved in their churches and this requires significant contributions that are scrutinized in very public ways.

Both of these demands on household income create a disincentive for households to accumulate "private" wealth. Like land that is held by the village, most of household wealth is absorbed by the external community structures.

At the same time, the pressure to meet these obligations creates an incentive for over-consumption. Specifically, households turn to foreign family members and loans to meet their social obligations.

There are at least 70,000 transaction / savings accounts held by the commercial banks. However, total domestic savings of ST$400 million is less than half the total domestic credit of ST$813 million. The great majority of household credit is applied to *Fa'alavelave*, church contributions or consumption. The demand for credit is massive, and this credit is, for the most part, a drain on household wealth. Consequently, despite the sometimes enthusiastic calls for the delivery of microcredit products to facilitate enterprise development, it is clear that delivery of microenterprise credit will be challenging in this context and should be undertaken with a high degree of caution.

3. CONSTRAINTS TO ACCESS TO FINANCIAL SERVICES

3.1. Net borrowing drains household income

The most significant challenge to building household wealth with financial services is not for lack of access to those services, but rather the consumption borrowing patterns of poorer populations. Households that borrow money to pay for consumption, whether that is food or paying social obligations, lose income in the form of interest payments. Since the loans do not generate wealth, the interest expenses constitute a net drain on the household. Overtime, habitual use of consumption borrowing drains a substantial portion of household income.

3.2. Rural environment challenges income-generating initiatives

The small size and social structure of Samoan villages limits business opportunities. First, many villages have less than 200 people and therefore there are limited opportunities for the usual retail and trading businesses that microentrepreneurs typically cultivate. The populations on Upolu and Savai’i live in villages that are still with a couple of hours from larger population centres where they make most of their purchases. In addition, individuals have to have the consent of the village leaders to engage in businesses, and this adds a social/political dimension to economic opportunities even at a micro scale.

3.3. Mixed impact of remittances on individual initiative

There is debate in Samoa about the effect of remittances on the national psyche and in particular insofar as it might contribute to individual dependence on outside resources rather than personal initiative.

3.4. Low financial literacy

Individual understanding of wealth accumulation is heavily influenced by the aforementioned social practices and as a result individuals are generally uninformed about how financial services affect their household income. Individual rely on credit to meet obligations without a clear understand of the long term net effect of consumption borrowing. The popular understanding of individual savings is very undeveloped.

3.5. Current delivery channels do not inspire savings

Banks are the only institutions in Samoa licensed to capture savings, and they have done little to encourage savings with innovative products of service delivery models. To be clear, most Samoans can access a bank if they want to, and banks will attend to them. But the current supply channels have not inspired savings.

3.6. Lack of reliable information on household cash flows

Samoans speak openly about the realities of village and church life, and that fact that these social milieu make demands on household incomes. However, very little is known about the cash flow patterns and money management practices of households and what sort of costs and benefits are associated with it. This knowledge gap is in itself another constraint to innovation and development of services that will work in the Samoan context.

4. OPPORTUNITIES FOR CREATING ACCESS TO FINANCIAL SERVICES

4.1. Households can access financial service infrastructure

Most of the Samoan population can access some service delivery point of the financial service sector. This creates opportunities for financial service providers to experiment with service delivery channels and financial products for the unbanked population, and to expand the reach of those services through existing infrastructure.

4.2. Remittances are a significant resource for building household wealth

The volume of foreign remittances to Samoan households is a substantial economic resource. The volume of transactions is sufficient to generate substantial revenues for service providers interested in innovating with delivery channels and reaching the recipients with financial services.

4.3. Growing bank interest in deposit mobilization and customer expansion

At least two forces are spurring bank interest in mobilizing retail deposits from the public. Public sector borrowing and tight monetary policy has driven up the cost of bank borrowing and term deposits. In these conditions, all banks are considering expanding their retail deposit services to access a cheaper and more stable funding source. The two nationally-owned private banks are particularly interested in establishing their position in the retail market because they believe they can exploit the niche that has been ignored by the foreign-owned banks. Both of these trends give banks, nationally-owned banks in particular, incentive to innovate with services to the unbanked.

4.4. Partnerships between banks and specialized organizations

The role of the Small Business Enterprise Centre in supporting clients that benefit from government guarantees of bank loans is an example of a partnership between banks and a specialized business support organization that can be replicated. Banks eager to reach new customers could be interested in partnering with organizations like SPBD or WiB to immediately acquire specialized knowledge of unbanked populations and assistance with the product innovation process.

4.5. Mobile phone technology

Samoa has by far the most developed mobile phone market of the five LDCs, due in large part to the aggressive expansion of DIGICEL, a private operator. Most of the population lives within the mobile phone coverage area. This creates an opportunity for developing transaction channels that use mobile phone technology. Equally important, DIGICEL is a dynamic company that is already studying ways to provide financial services through their network.

5. RECOMMENDATIONS FOR SUPPORT PROGRAMMES

5.1. Support a pro-poor initiative with one of the private commercial banks

There are several reasons to assign highest priority to bank-based initiatives to expanding financial services the unbanked. It was mentioned previously that the banks, the nationally-owned banks in particular, have incentive and resources to expand their service to this market. Banks are also the only financial institutions capable of achieving efficient economies of scale. And finally, banks are the only institutions that can take deposits from the public.

A bank-led initiative may well be best implemented in partnership with a specialized organization. This would unite the installed capacity of a bank with the client group knowledge of the organization.

5.2. Foster financial service innovation

Savings service delivery deserves special attention in Samoa, given the cultural circumstances that make it difficult for households to accumulate wealth outside of a bank.

5.3. Generate better understanding of household cash flows

More information is needed on household cash flows to support the product innovation opportunities cited in this report. Empirical research would accelerate the innovation process and enlighten the policy debate about what financial services are likely to produce the most benefit for currently unbanked populations.

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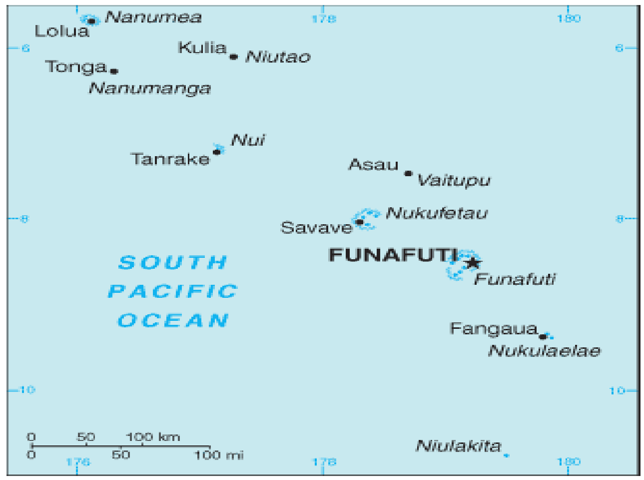
Financial Service Sector Assessment
Tuvalu

6. THE SETTING FOR FINANCIAL SERVICES

6.1. Country Profile

Tuvalu, is an independent island nation in the southwest Pacific Ocean, located about half way between Hawaii and Australia. Tuvalu consists of nine low-lying atolls - its highest point is 3m above sea level. The atolls have a total land area of just 26km^2. With a total population of around 12,000, Tuvalu is one of the smallest countries of the world. About half of the people live on the main island of Funafuti.



Tuvalu's isolation, dispersed population, lack of exploitable resources, and dominating public sector severely limit prospects for long-term economic growth and development. Tuvalu's atolls - flat ribbons of sand, with limited fresh water, supporting a very narrow range of vegetation - make transport and communications both difficult and costly.

While the economy grew at a real rate of around 7 percent p.a. from 1996 to 2002, almost all of the growth resulted from expansion in the public sector arising from a larger civil service wage bill, public construction projects and growth in the public enterprises. The public sector now contributes approximately 70 percent of GDP and employment.

The majority of the population, however, has traditionally been dependent on subsistence activities such as farming and fishing. The amount of people engaged in subsistence activities declined significantly from 70 percent in 1991 to 53 percent in 2002, which has had a negative impact on food security. The main reason for this decline is the migration of people from the outer islands to Funafuti in the hope of finding wage employment.

The opportunity to work as a seaman on foreign marine vessels is important for Tuvaluan men. As of early 2006, 15 percent of the adult male population was on-ship. Total cash remittances generated by this employment are of the order of A$2-4 million per year. According to census data, 34 percent of all Tuvalu households received remittances from abroad in 2002.

While the large public sector provides substantial employment, the high level of subsidies provided to state-owned enterprises and a protective environment towards the public sector has given little opportunity for significant private sector development. The public sector has a direct crowding out effect because it undertakes jobs that could be done by private business. Extensive public sector employment also establishes a benchmark for pay rates and work effort that adversely affects what the private sector is required to pay and how staff work.

The large public sector also has significant effects on income distribution. The portion of the Funafuti adult population formally employed is more than twice that on the outer islands. Almost all fishing, agriculture and handicraft manufacture takes place on the outer islands. This distribution of economic activity underpins much higher cash incomes in Funafuti than in the outer islands.

The creation of more private sector economic activity, especially in the outer islands, is therefore high priority for Tuvalu.

6.2. National Policies for Poverty Alleviation & Economic Development

6.2.1. Millennium Development Goals

	$1/day poverty	Underweight children	Primary enrolment	Reaching grade 5	Primary completion rate	Gender primary	Gender secondary	Gender tertiary	Under 5 mortality	Infant mortality	HIV prevalence	TBC prevalence	TBC death rate	Water urban	Water rural	Sanitation urban	Sanitation rural
Fiji			●	●	●	●	●	●	●	●	▲	●	●			▼	▼
Kiribati				▲	●	●	●		■	■		●	●	■	▲	▲	■
PNG				▲	▼	▼	▲		■	■	▼	●	●	▼	▼	▼	▼
Samoa			▲	▲	●	●	●	▼	●	●		●	●	▼	▼	●	●
Solomons			●			●	▲		■	●		●	●			●	
Tonga			●		●	▼	●	●	●	●		●	▼	●	●	●	●
Tuvalu				▼	●	●			■	▲		●	●	▲	▲	●	▲
Vanuatu			▲		▲	●	▼	▼	●	●		●	●	▼	▼		

●: early achiever ▲: on track ■: slow ▼: regressing

Table 1: Progression Tuvalu on the MDGs

Available data suggests that certain MDG targets have already been achieved or have almost been achieved. The country has achieved universal primary education and has eliminated gender disparity in primary and secondary enrolment rates. However, social pressure discourages women from pursuing postsecondary education. Literacy appears to be declining due to the deteriorating quality of education, decreasing morale of teachers, weak school management and deterioration in the level of English proficiency.

Though absolute poverty is not considered an issue, the Government acknowledges that there are wide disparities in access to services and cash income opportunities between the population on Funafuti and on the outer islands. Poverty on the outer islands, where primarily the old, the very young, and women reside, is growing, and among the people who have immigrated to Funafuti, pockets of poverty are emerging.

6.2.2. National Development Plans

The National Summit for Sustainable Development (2005-2015) defines the priorities and strategies for the development of Tuvalu over the prescribed ten year period. There are eight focal themes for national development:

1. *Good Governance*: inspired leadership and sound management, as well as honesty, transparency and consistency in the rule of law.
2. *Macroeconomic Growth and Stability*: developing the right economic policy environment (fiscal, monetary and regulatory), strong and well-managed institutions and a high standard of governance providing a cost-effective, efficient and customer oriented public sector.
3. *Social Development*: Health, Welfare, Youth, Gender, Housing and Hardship and Poverty Alleviation.
4. *outer island Development*: identifying strategies that will reverse the out-migration and falling output from the outer islands and to help ensure that the outer island economies are sustainable in the long term.
5. *Employment and Private Sector Development*: including in tourism, agriculture and fisheries; creating an environment in which economic opportunities can be created; creation of economic wealth through employment and economic activity in both the formal and informal sectors.
6. *Human Resource Development*: education and training, targeted towards meeting the skill and manpower demands in the different sectors of the economy.
7. *Natural Resources*: Agriculture, Fisheries, Tourism and Environmental Management; enable and manage sustainable use of limited natural resources in the fragile atoll eco-systems.
8. *Support Services and Utilities*: provision of support services which provide the people with a satisfactory quality of service at a reasonable price.

Under item 5 – employment and private sector development - the strategy identifies *'strengthening of financial intermediation and domestic resource mobilisation for investment'* as a priority. Further, under item 4 – outer island development – the strategy calls for *'establishment of micro-financing schemes'*. That is, financial service delivery is an explicit development priority.

7. FINANCIAL SECTOR ASSESSMENT

7.1. Micro Level

7.1.1. Supply of Financial Services

The financial sector consists of the National Bank of Tuvalu (NBT), the Development Bank of Tuvalu (DBT), Tuvalu National Provident Fund (TNPF), and Colonial Insurance. NBT, DBT, and TNPF are all state-owned.

The Tuvalu private sector is capital starved at present. This is in contrast to the situation through the 1990s when internal savings exceed the volume of bankable projects available. The current situation is a result of imprudent lending practices rather than an excess of bankable loans.

The National Bank of Tuvalu (NBT) is one of only two of the nine state-owned-enterprises that return a profit to the government. The NBT loan portfolio is dominated by personal borrowing with only about 30 percent lent for business purposes. Only a few well established, long-term customers are still receiving new business credit; all others are referred to the DBT. Housing loans, previously an important component of the portfolio have stopped completely. Security is limited to automatic payroll deductions from individuals employed by the Government or liens on individual accounts in the TNPF. The latter mechanism is of limited value unless the borrower is close to retirement or otherwise entitled to receive benefits from TNPF.

As of February 2006, the NBT was lending at 7.5% for housing loans, 10.5% for personal loans and 13.0% for business loans. Cheque accounts held with the bank receive no interest. Rates on other deposit accounts range from 3-4%. Account fees are generally low.

The Government acts as NBT's agent in the outer islands. Bank transactions are made with the Government office on the outer island and NBT records the transactions on Funafuti. When deposits are made by customers, the NBT credits the member's account and debits the Outer Island Agency Account. The Government should then deposit the cash collected into the Outer Island Agency Account to clear this debit. Instead, cash has being deposited into the general account and spent. This has resulted in a rising liability in the Outer Island Agency, which stood at A$4.6 million by the end of 2005.

In early 2006 administrative changes were made to ensure cash collected from the outer islands is deposited into the Outer Island Agency Account. This should cap the liability in this account and result in any continued government over-spending being funded through the normal overdraft facility.

The 2003 financial statements show the alarming growth in lending and drop in deposits, offset by a 90 percent reduction of term deposits with overseas banks during 2003. This trend continued until a recent change of management recognized the problem and took steps to address it. Outstanding loans, at 93 percent of deposits as of October 2005, recently reached well in excess of 100 percent and need to be trimmed back to a more prudent 75 percent of deposits. NBT is doing very little new lending now, a situation likely to continue for some time to come.

The Development Bank of Tuvalu (DBT) has lost money on it operations almost every year since its inception in 1993 and has a high incidence of non-performing loans. Its purpose is to loan money for economic and social development plans of the Government and to provide business advice to customers. No more than 10 percent of net share capital may be lent at once, in effect capping loans at around A$100,000. While it is developing a policy on microfinance, DBT's smallest loan remains at A$1,000. Most loans are in the A$30-50,000 range.

Since repayment of existing loans runs far short of the perceived need for new lending, the Bank has depended on a constant flow of funds from the government or outside donors. Its largest source of funds is loans from the European Investment Bank (EIB) – the first of which may never need repaying as repayment was conditioned on achieving profitability - but the second of which carried serious albeit concessionary terms. These loans, together with a recent grant of A$350,000 from ROC (Taiwan), have temporarily left the Bank with about A$1 million available for new lending on top of the A$2.3 million in loans already outstanding. At the projected rate of lending, DBT expects to need more money by 2008. In 2010, loan repayments to the EIB on A$700,000 must commence at 6 percent interest.

The Tuvalu National Provident Fund is the other profitable state-owned-enterprise. Until recently, virtually all of the Fund's investments were abroad, but a program is now in place for allowing members to borrow up to a certain percentage of the amount in their individual accounts. That percentage was 15 percent when the program began in June 2004 but is now 30 percent as of June 2006. At the end of 2005, the Fund had total members' credit in excess of AU$22 million, of which A$3.4 was lent to members.

In addition to this small loan scheme, the Fund is looking for other domestic investment opportunities. Thus what has traditionally been invested offshore for the purpose of risk minimization and diversification is increasingly being exposed to the exigencies of Tuvalu's economy.

Virtually all of the new borrowing by Fund members is for personal reasons. This fuels current consumption at the risk of future consumption and personal insolvency, as little if any of the current spending can be expected to yield improvements in future earnings.

Colonial Insurance is part of the Colonial Group, a large and financial services group based in Australia. The Tuvalu operation was started in 2000 with limited product offerings—life insurance (over 1,000 policyholders now in Tuvalu) and investment management services. The latter amounts to a small number of managed unit trust funds invested mainly in Fiji and Australia.

Money transferors, such as Western Union, serve primarily to bring remittances into the country and offer no other financial services.

7.1.2. Demand for Financial Services

Demand for financial services increases with the growth of cash-earning activities. A key challenge for Tuvalu is to generate sufficient cash-earning activities for the rapidly growing labour force, particularly in the outer islands. Outer island economic development will be constrained unless a range of relevant, affordable, efficient and sustainable financial services are delivered.

Most bank accounts are owned by wage employees, since all public sector employees have their salaries paid into a bank account. There is, therefore, no indication of unmet demand for savings services in the outer islands, although if demand was increased as a result of informal sector development there is a basic banking infrastructure that could accommodate increased demand for savings.

Despite the sometimes enthusiastic calls for the delivery of microcredit products, it remains that over the long term a household that borrows money will not be economically better off unless it can generate surplus from debt. This is no easy task in a remote island economy that does not have a thriving informal sector.

There is no firm data to indicate how many microenterprises or households would benefit from access to credit. In 2002, around 33 percent of adults were engaged in wage employment. The remainder are engaged in subsistence activities (19 percent), informal selling (2 percent), home duties (26 percent), unemployed and 'other' (20 percent). A significant number people do or could participate in the informal sector to supplement both subsistence activities and wage-based employment. Furthermore, creation of employment opportunities in the outer islands is vital. A sober and best-practices approach to microcredit could play an important role in supporting further informal sector growth.

Given the range of microfinance products that might be of benefit to outer island populations, there are other products such as money transfer that would likely be of greater value - including for supporting development of informal sector microenterprise. Wage employees based in Funafuti and seamen who remit funds need inexpensive and efficient ways to get cash into the hands of their families in the outer islands. The wage employee based in an outer island who is paid into a bank account also needs a facility to withdraw cash. These money transfers are delivered through the NBT Outer Island Agencies, but the process is inhibited significantly by poor communications infrastructure and the very high costs associated with transportation between the islands.

7.2. Meso Level

The **Falekaupule Trust Fund (FTF)** was established in 1999 as a way to fund community-chosen projects while strengthening each island's stewardship of its development. It was designed on the understanding that rural communities in Tuvalu did not need a few large-scale capital investment projects but rather many small facilities or investments relevant to their social and economic activities; that they were in a better position to identify these than the central Government; and because the projects would be demand-driven, they were much more likely to be maintained. Government and foreign donors contributed to the fund along with substantial amounts raised by each island. The FTF grew from AU$6 million in 2000 to AU$14 million in 2005. The total return to the island communities so far amounts to a 95% return on their own contributions.

The FTF Trust Deed specifies four uses of its proceeds:

1. assisting the acquisition and development of skills and self-reliance in the communities through local training
2. enabling the communities to acquire, maintain and improve community assets and resources in order to further education and self-reliance
3. funding community projects that improve the living conditions of the communities, and
4. increasing the ability to generate revenue within the community for the good of the community.

The first two FTF distributions were used on buildings and equipment for the Kaupule and then on farming, water and various community projects. It may be that these projects were the ‘low-hanging fruit’ and once they are dealt with the Kaupule will turn to projects that contribute more to economic and social development for the whole community. The FTF aims, among other things, to focus support to entrepreneurial outer-island women.

Microfinance Pasifika Network (MPN): The Microfinance Pasifika Network is an alliance of institutions committed to supporting disadvantaged people in the Pacific to improve their quality of life, through the provision of inclusive and sustainable financial services such as savings, credit, remittances and payment services and insurance. MPN was launched in June 2006 in Port Vila following over a year of consultation led by the Australian-based Foundation for Development Cooperation.

UNDP Regional and Country Support: UNDP Regional Office in Suva maintains programs in support of economic development in the Tuvalu, including support for strengthening of the rural financial sector.

7.3. Macro Level

Tuvalu uses the Australian dollar as its currency. This has eliminated the need for a central bank to conduct monetary and exchange rate policy. There is no money market and interest rates in Australia are used as reference rates.

8. CONSTRAINTS TO ACCESS TO FINANCIAL SERVICES

Geography, Population Dispersion and Poor Infrastructure: The remoteness of Tuvalu combined with its geographic fragmentation and population dispersion, with meagre infrastructure (transport, power, and telecommunications) diminishes economic opportunities and raises the cost of traditional financial service operations to levels that cannot be supported by the sparse population.

Limited Natural Resource Base: The very limited natural resource base and infertile soil constrain agricultural development. Tuvalu does, however, possess abundant and extensive ocean resources, principally fish, seaweed, and manganese.

Dominance of the Public Sector: Private sector development is constrained by the presence of large, subsidised public enterprises, with which the private sector cannot compete. Many of these businesses could be run in the private sector.

Small and Under-developed Private Sector: The Private Sector accounts for only one-quarter of GDP. The domestic market is small and has little potential for economies of scale.

Communal Culture: The Tuvalu social and cultural system, with limited understanding and experience of business concepts and practices, constrains business development.

Land Tenure Uncertainties: There is widespread and continuing uncertainty about the boundaries of customary land, and about who is entitled to what rights in customary land. These are serious disincentives to investment. Furthermore, because land cannot be alienated, it is very difficult for foreign investors to get access to land other than that owned by the Government.

9. OPPORTUNITIES FOR CREATING ACCESS TO FINANCIAL SERVICES

9.1. Strategic Assumptions

The realities of geography, population dispersion and poor infrastructure are quite overwhelming and there are no simplistic solutions to overcoming these constraints. However, opportunity exists within this infrastructure to apply new institutional models and technological innovations to deliver pro-poor financial services to unbanked communities.

9.2. The NBT / Village Council Agency Network

The agency partnership between NBT and Island Councils is an excellent starting point for improvements in the current level and quality of service. The presence of a NBT agency on each island constitutes an extensive infrastructure base for extending financial services to unbanked populations.

9.3. Existence of Satellite Communications in Outer Islands

Satellite communications services in the outer islands provides the necessary connectivity necessary for e-banking experiments.

9.4. Specialized Roles for Organizations Reaching the Unbanked

As banks extend the payment system infrastructure, it becomes possible for banks, or other organizations, to develop service delivery models for acquiring and managing new clients. If banks can support the branchless transaction infrastructure with fee revenues, then it is possible that other organizations can develop specialized operations to manage client services using that bank infrastructure. This means that organizations that want to provide financial services to the unbanked do not have to develop the entire institutional infrastructure of a financial institution. And this opens the possibility that smaller organizations could support specialized client services by charging fees to customers or sharing revenues with banks.

9.5. Experimentation and demonstration in other locales

Experimentation of the type of systems described above is pending in other Pacific Island locations and can form the basis for further implementation in Tuvalu.

10. RECOMMENDATIONS FOR SUPPORT INITIATIVES

10.1. Pilot 'Bank-in-a-Box' Agency Model

The project would involve upgrading an existing Outer Island Agency with a bank-in-a-box installation.

10.2. Studies on Community-based Cash Flow Studies

Methodologies exist for studying the cash flows of rural communities and households. These exercises map the flow of money in and out of communities as well as the transactions that occur in the households and in the course of daily commerce. This provides a basis for understanding demand for specific financial services. A study such as this should be undertaken in conjunction with the above pilot.

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Financial Service Sector Assessment:
Kiribati

1. THE SETTING FOR FINANCIAL SERVICES

1.1. Country Profile

The Republic of Kiribati is one of the most isolated countries in the world, consisting of 32 low-lying atolls (21 inhabited) and one island. The islands straddle the Equator and lie roughly halfway between Hawaii and Australia. The three main island groups are: the Gilbert Islands, Phoenix Islands, and the Line Islands. South Tarawa is the capital island, where almost half the population lives. Kiritimati (or Christmas Island) is the biggest atoll and is also the fastest growing population centre. It lies 3500km east of Tarawa.

Kiribati's growing population and uneven population distribution is central to the development challenges facing the country. Current total population is around 90,000 but modelling by SPC[21] demographers suggests that the population will reach 140-145,000 by 2025, with around 70,000 persons in South Tarawa, 20,000 in Kiritimati and 50-55,000 spread among the rest of the Gilbert, Line and Phoenix groups. The higher relative rate of population growth in Tarawa is due to migration from the outer islands, and this is driven by the scarcity of wage employment and a lower standard of social service delivery in the outer islands.

In the 2004-07 National Development Strategy, the Government recognised that population growth and inequitable distribution of services are priority development challenges that need to be addressed. The 2004 Population Policy suggests three core strategies to slow the population growth rate and balance the population distribution: (i) promoting a smaller family size, (ii) developing alternative growth centres, and (iii) facilitating permanent emigration to other countries (ADB 2006). Notwithstanding these strategies and some improvement in social services, people living in the outer islands remain the most disadvantaged.

[21] Secretariat of the Pacific Community.

Population	
Total population	84,494
Total population, females	42,848
Total population, males	41,646
Total population, urban	36,717
Total population, rural	47,777
Health	
Estimated life expectancy at birth, females	67.3
Estimated life expectancy at birth, males	58.2
Infant mortality rate per 1,000 live births (under 1)	43
Total fertility rate	4.3
Economy	
GDP Per Capita	574
Labour force	
Labour Force Participation Rate (%)	81
Human Development Index	0.515
Human Poverty Index	12.7%

In 2000, Kiribati's GDP per capita was around US$550, one of the lowest in the world. GNP, however, is significantly higher because of investment income from trust funds, revenue from fishing licenses, and worker's remittances. Kiribati seamen working on foreign ships sent money and goods valued at over US$11 million home to their families in 2005 (ANZ 2007).

The low GDP reflects the fact that the private sector is moribund due to limited natural resources; poor infrastructure including power, telecommunications and transport; lack of business know-how; and little potential for economies of scale. Domestic economic activity depends on government expenditure, and much of this is financed by foreign aid.

In 2000, the labour participation rate was 81% although only 20% of employment is wage-based. The public sector accounts for 70% of all wage employment but offers limited scope for expansion. Also, 70% of public sector employment is based in South Tarawa.

More than 40% of the population is under 15 years of age and the number of people in the work force is expected to increase from 45,000 in 2002 to 68,000 in 2012. Almost 2000 young persons leave school each year but only around 500 jobs become available. This demographic ensures increasing pressure for both school places and jobs, and internal migration means that most of that pressure will be in South Tarawa and Kiritimati. Furthermore, where there are four times as many young people seeking work each year as there are new jobs available, the social challenges associated with increasingly large numbers of unemployed youth will intensify over time.

There are significant differences in cash incomes between people living in South Tarawa and the outer islands. The 1996 household income and expenditures survey (HIES) showed that for the lowest quintile average expenditure per head on outer islands was A$95 per annum compared with A$309 on South Tarawa. Also, the disparity of incomes between those best off and those worst off was much wider on outer islands, with a H20/L20 ratio of 20.5 compared with 5.7 for South Tarawa.

1.2. National Policies for Poverty Alleviation & Economic Development

1.2.1. Millennium Development Goals

	$1/day poverty	Underweight children	Primary enrolment	Reaching grade 5	Primary completion rate	Gender primary	Gender secondary	Gender tertiary	Under 5 mortality	Infant mortality	HIV prevalence	TBC prevalence	TBC death rate	Water urban	Water rural	Sanitation urban	Sanitation rural
Fiji			●	●	●	●	●	●	●	●	▲	●	●			▼	▼
Kiribati				▲	●	●	●		■	■		●	●	■	▲	▲	■
PNG				▲	▼	▼	▲		■	■	▼	●	●	▼	▼	▼	▼
Samoa			▲	▲	●	●	●	▼	●	●		●	●	▼	▼	●	●
Solomons			●			●	▲		■	●		●	●			●	
Tonga			●		●	▼	●	●	●	●		●	▼	●	●	●	●
Tuvalu				▼	●	●			■	▲		●	●	▲	▲	●	▲
Vanuatu			▲		▲	●	▼	▼	●	●		●	●	▼	▼		

●: early achiever ▲: on track ■: slow ▼: regressing

Table 1: Progression Kiribati on the MDGs[1]

Universal primary education has almost been achieved and the focus now is shifting to higher levels. Gender equality in education has almost been attained at primary level, and has been achieved at secondary level. AusAID and NZAID have provided assistance to support education in Kiribati, including construction of new schools, curriculum development and teacher training.

Health, poverty, and environment indicators need to improve to meet the MDG targets. While child and maternal mortality have decreased, they are still high relative to other Least Developed Countries (LDCs) in the Pacific. HIV infections have increased sharply in recent years, due to larger numbers of seafarers becoming infected overseas and returning home to infect others. Diseases associated with diet and lifestyle, such as diabetes and hypertension, are increasing. Less than half the population has access to safe drinking water and sanitation.

The outer islands remain disadvantaged in terms of access to health services, general Government services and communications. The services provided to the outer islands are also of distinctly poorer quality than those available in Tarawa. These disparities lead to increased migration to South Tarawa, where population density is increasing the pressure on water resources and sanitation services.

1.2.2. National Development Plans

The 2004-2007 National Development Strategy (NDS) is a plan for sustained growth in the income and welfare of the people of Kiribati. It is the third in a series that began in 1996. The four-year period of the NDS coincides with the parliamentary election cycle. The NDS is a strategic plan to '*enhance and ensure the equitable distribution of development benefits to the people of Kiribati according to principles of good governance'***.** A Multi-Year Budget Framework was developed to tie the NDS and the annual budget together, to demonstrate that development strategies and financial policies are mutually consistent.

There are six Key Policy Areas (KPAs) in the NDS. They are: economic growth, fair distribution, public sector performance, equipping people to manage change, conservation of physical assets, and sustainable use of financial reserves. All the issues facing the Government, and the strategies it intends to use to deal with them, fit into one or other of these clusters or KPAs.

With respect to the 'sustainable use of financial reserves', the issue is stated as follows: *How to make greater use of domestic credit in financing development, while protecting financial stability and safeguarding public deposits*. Strategies identified to achieve this include to:

1. Increase funding of successful Village Banks (VBs) and to improve supervision and training of all VBs
2. Promote use of commercial loans for financially viable infrastructure projects
3. Promote access of small businesses to credit from Development Bank of Kiribati and Bank of Kiribati
4. Establish prudential supervision and regulation of financial institutions.

With respect to the first strategy, the Government of Kiribati did invest lending capital in successful VBs. It has not invested further lending capital in the Village Bank program for the last two years. The Rural Development Unit of the Ministry of Internal and Social Affairs continues to provide facilitation and monitoring of the VB program.

The plan to establish prudential supervision and regulation of financial institutions was not implemented. However, it is felt that this does not appear to have resulted in any particular difficulties with respect to the operation of the financial sector.

The current NDS is now drawing to a close and a review process is underway. A new NDS for 2008-2011 is due by the end of this year. The goal of mobilising domestic financial resources and improving access to credit is likely to be retained as an important feature of the new strategy.

2. FINANCIAL SECTOR ASSESSMENT

2.1. Micro Level

2.1.1. Supply of Financial Services

The formal financial sector consists of the ANZ Bank of Kiribati (BOK), the Development Bank of Kiribati (DBK), the Kiribati Provident Fund (KPF), the Kiribati Insurance Corporation (KIC), and the National Housing Corporation (NHC). With only one commercial bank, there is virtually no competition in the banking system - DBK provides very little competition. A struggling government-facilitated village bank program provides micro-credit.

The **ANZ Bank of Kiribati (BOK)** is the only commercial bank in Kiribati. It was established under its own Act of Parliament in August 1994, and was a joint venture between the government (49 percent) and Westpac Bank (51 percent). In September 2000, Westpac gave one year's notice of its intention to withdraw. In 2002, the Government and ANZ formed a new joint venture, with ANZ taking a 75 percent stake.

BOK has its head office and two branches on Tarawa, and another branch on Kiritimati. It has four ATMs, all located in Tarawa. BOK also operates agencies located in the Village Council offices. Island treasurers manage deposits and withdrawals. The agencies cannot extend loans, though they may accept loan applications. Most agencies do not have telephone communication and use radio, ship and mail, so that it is difficult for them to obtain and provide up-to-date information. Through this network, ANZ maintains more than 12,000 savings / transaction accounts.

BOK offers checking accounts, overdraft facilities, term loans, and housing loans. It accepts deposits, exchanges foreign currency, and arranges letters of credit and fund transfers. Most of BOK lending is short-term, relatively high interest loans that are used to finance social obligations and consumer durables, such as video machines, motor vehicles, and outboard motors. For the most part, loans are available only to people who have a regular source of income. Majority foreign ownership means that BOK cannot accept land as security.

The **Development Bank of Kiribati (DBK)** is wholly owned by the government and operates autonomously under its own board, which consists of five members from the public sector and one from the private sector appointed by the Minister of Finance. The Secretary of Finance is the board chairman. DBK's mandate is to provide efficient, customer-focused financial and advisory services using sound banking and management principles; to assist with the development of private sector business; and to improve living standards of the people of Kiribati. DKB is undercapitalized, which limits its ability to lend. DBK has made small loans to existing businesses, which can be secured by a mortgage or guarantee from a Government employee. DBK does not take deposits.

DBK's minimum loan of AUD$ 1,000 is beyond the needs and absorptive capacity of micro-entrepreneurs, especially the first-time borrowers. Though DBK can lend below the stipulated minimum, this flexibility is rarely exercised.

Despite the efforts of DBK and BOK to make their services available to all I-Kiribati, it is likely that the majority of the people who are not working and who have limited assets will have difficulty in accessing banking services from the two formal financial institutions.

Various microfinance services including financial services for households living on outer islands are provided through (i) BOK in partnership with Island Councils and the Ministry of Finance, (ii) a Village Bank scheme facilitated by the Rural Planning Unit of the Ministry of Internal and Social Affairs, and (iii) Credit Unions overseen by the Kiribati Credit Union League.

Village banks and credit unions are governed by specific legislation - the Village Bank Act and the Credit Union Act respectively.

The government launched the <u>**Village Bank**</u> Program in June 1995, partly in response to the popular clamour for microcredit. AUD$ 460,000 was allotted from the Kiribati National Development Fund to establish village banks. The Rural Planning Unit (RPU) of the Ministry of Home Affairs and Rural Development was appointed overseer of the nationwide implementation. More than 180 village banks were established throughout the outer islands and in the urban and periurban areas of North and South Tarawa. Each Village Bank is managed by the village through a committee, supported by an Island Project Officer seconded at the Island Council (with minimal supervision by the RPU). In most rural areas, village banks are the only source of institutional credit. When first established, the maximum loan size was AU$200. Loans of AU$500-$1000 are now common.

Pursuant to the Act, a village bank is authorized to extend loans only to members who are registered as electors in the ward in which a Bank is registered. The act specifically prohibits the provision of credit for the following purposes:

- to pay for or contribute to the costs of a funeral
- to enable the applicant to repay a debt or give a gift of donation
- to pay for or contribute to the costs of feast, fete or celebration, or
- to acquire goods for use otherwise than in the course of his business.

For the most part, the village banks are not well-managed and suffer from poor loan repayment.

The **credit union** movement was first introduced into Kiribati in 1986. Credit unions are governed under the 1990 Credit Union Act. They can be formed by any group of 15 or more people who are residents of Kiribati and have a common bond; they must be registered with the Registrar of Credit Unions. The main objectives of credit unions are to promote thrift among members by encouraging savings, either as payment on shares or as deposits, and to provide credit to members for either provident or productive purposes. Each credit union prepares its own bylaws to govern operations. The Kiribati Credit Union League (KCUL), established in 1995 and housed at the Ministry of Labor and Cooperatives, is the apex organization for credit unions in Kiribati. However, following an initial flurry of enthusiasm for credit unions, the credit union movement has contracted significantly so that there is now only a couple of employee-based credit unions located in South Tarawa.

2.1.2. Demand for Financial Services

Demand for financial services increases with the growth of cash-earning activities. A key challenge for Kiribati is to generate sufficient cash-earning activities for the rapidly growing labour force, particularly in the outer islands. Outer island economies will not improve significantly until and unless a range of relevant, affordable, efficient and sustainable financial services are delivered.

Every island council serves as an agent for BOK, and BOK holds more than 12,000 savings / transaction accounts. Therefore, it is possible to estimate that around half of households have a bank account. BOK indicated that most bank accounts are owned by wage employees, since all public sector employees have their salaries paid into a bank account. The numbers reflect this. In general, non-wage employees do not have bank accounts. There is, therefore, no indication of unmet demand for savings services in the outer islands, although if demand was increased as a result of informal sector development, there is a basic banking infrastructure that could accommodate increased demand for savings.

Despite the sometimes enthusiastic calls for the delivery of microcredit products, it remains that over the long term a household that borrows money will not be economically better off unless it can generate surplus from debt. This is no easy task in a remote island economy that does not have a thriving informal sector.

There is no firm data to indicate how many microenterprises or households would benefit from access to credit. Census data indicates that at least 30,000 people currently earn their income from 'village work'. However, this does not distinguish between subsistence activities and informal sector business. The former dominates the outer island economic activities, which suggests that there is probably not enough demand for microcredit to justify a village bank in every village.

Nevertheless, many people do participate in the informal sector to supplement both subsistence activities and wage-based employment. Furthermore, creation of employment opportunities in the outer islands is vital. Informal sector activities include street vendors or hawkers, copra cutters, commercial fishermen, bakers, pastry cooks, sour toddy sellers, other food sellers, and local cigarette sellers. While most microenterprises are funded initially from informal sources including savings or loans from family or friends, a sober and deliberate approach to microcredit could play an important role in supporting further informal sector growth.

Given the range of microfinance products that might be of benefit to outer island populations, there are other products such as money transfer that would likely be of greater value - including for supporting development of informal sector microenterprise. Wage employees based in Tarawa and seamen who remit funds need inexpensive and efficient ways to get cash into the hands of their families in the outer islands. The wage employee based in an outer island who is paid into a bank account also needs a facility to withdraw cash. These money transfers are delivered through the BOK village council agents, but the process is inhibited significantly by poor communications infrastructure, and the very high costs associated with transportation between the islands.

2.2. Meso Level

Government of Kiribati has invested directly in microfinance services through the Village Bank program.

The **Business Advisory Centre (BAC)**, established in 2000, is a division of the Centre for Commerce, Industry and Investment Policy Promotion (CCIIPP). The CCIIPP falls under the Ministry of Commerce, Industry and Tourism (MCIT). BAC provides individual management advice to the I-Kiribati business community and conducts training courses in business development.

Objectives of BAC include:

- to promote and create the capacity of I-Kiribati entrepreneurs to initiate, improve and sustain their business activities
- to promote the development and establishment of new businesses that use indigenous raw materials, create employment and use environmentally friendly and commercially tested technologies
- to promote the development of sustainability of economic activities in the outer islands, and
- to enhance the capacities of self-help entrepreneurial groups and strategic clusters to effectively participate in the industrial development planning and implementation processes.

All local entrepreneurs and companies are eligible for assistance, including government and non government-owned enterprises, cooperatives and non-government organisations. The services offered by the BAC include:

- individual business advice;
- market research, both domestic and export;
- business consultancies;
- advice on developing business plans and cases for finance;

- training courses (both Start Your Business and Improve Your Business programmes); and
- other business services to local companies/entrepreneurs on an as-needs basis.

At this stage there are no fees for the assistance provided. Training is fully subsidised by MCIT. Training courses are held on a regular basis in Tarawa and on the outer islands. Individual business counseling is provided either on the spot or within a relatively short timeframe.

Microfinance Pasifika Network (MPN): The Microfinance Pasifika Network is an alliance of institutions committed to supporting disadvantaged people in the Pacific to improve their quality of life, through the provision of inclusive and sustainable financial services such as savings, credit, remittances and payment services and insurance. MPN was launched in June 2006 in Port Vila following over a year of consultation led by the Australian-based Foundation for Development Cooperation.

UNDP Regional and Country Support: Both UNDP Solomon Islands and UNDP Regional Office in Suva maintain programs in support of economic development in the Solomon Islands, including support for strengthening of the rural financial sector.

2.3. Macro Level

Kiribati uses the Australian dollar as its currency. This has eliminated the need for a central bank to conduct monetary and exchange rate policy. There is no money market and interest rates in Australia are used as reference rates. The Government allows free movement of funds into and out of the country.

With no supervisory authority there is consequently no published financial data and no external monitoring of risk-weighted ratios for financial institutions. There is no Financial Institutions Act to define entry and exit standards; each of the government-owned financial institutions was established under its own Act of Parliament and these contain some prudential aspects. The financial system is therefore largely unregulated, with controls imposed by the boards of the institutions. Although this does not appear to result in any undue difficulty with respect to the management of the financial sector, it does make licensing of new institutions difficult.

3. CONSTRAINTS TO ACCESS TO FINANCIAL SERVICES

Geography, Population Dispersion and Poor Infrastructure: The remoteness of Kiribati combined with its geographic fragmentation and population dispersion, with meagre infrastructure (transport, power, telecommunications) diminishes economic opportunities and raises the cost of traditional financial service operations to levels that cannot be supported by the sparse population.

Limited Natural Resource Base: The very limited natural resource base and infertile soil constrain agricultural development. Kiribati does, however, possess abundant and extensive ocean resources, principally fish, seaweed, and manganese.

Dominance of the Public Sector: Private sector development is constrained by the presence of large, subsidised public enterprises, with which the private sector cannot compete. Many of these businesses could be run in the private sector.

Skills Shortage: However, the low level of education, combined with the ability of many professionals to earn higher salaries overseas, has left Kiribati with a chronic shortage of people with technical qualifications and business skills. The main activities of the private sector are limited to retailing and a few service industries.

Bureaucracy: Red tape discourages foreign investment - there are only discretionary guidelines and procedures are very bureaucratic. High taxes also discourage foreign investors. Foreigners cannot own land and have to negotiate leases.

Communal Culture: The communal culture of Kiribati makes business development difficult for two reasons: first, the stock of private or family equity can be depleted by the need to meet family cultural commitments. Second, the customs of sharing make it difficult to accumulate assets.

Credit for Women: The constraints faced by women pursuing credit and business opportunities include limited access to credit due to inability to provide collateral or any form of security. BOK and DKB require security in the form of a physical asset or a guarantor, and women have difficulty complying with this requirement because they possess no physical assets or have to have a working husband or a working relative to guarantee the loan. However, the perceived role of women as subservient household workers not engaged in any business activity is an impediment that is slowly changing, especially in Tarawa.

Land Tenure Uncertainties: There is widespread and continuing uncertainty about the boundaries of customary land, and about who is entitled to what rights in customary land. These are serious disincentives to investment in customary land. In addition, because land cannot be alienated, it is very difficult for foreign investors to get access to land other than that owned by the Government.

No locally enacted legislation expressly provides for the granting of mortgages of freehold land or of customary land or lease of customary land. There is also no locally enacted legislation that expressly provides for the granting of mortgages or charges over crops, trees, or livestock.

4. OPPORTUNITIES FOR CREATING ACCESS TO FINANCIAL SERVICES

4.1. Strategic Assumptions

The realities of geography, population dispersion and poor infrastructure are quite overwhelming and there are no simplistic solutions to overcoming these constraints. However, opportunity exists within this infrastructure to apply new institutional models and technological innovations to deliver pro-poor financial services to unbanked communities.

4.2. The BOK / Village Council Agency Network

The agency partnership between BOK and Island Councils is a potential starting point for improvements in the current level and quality of service. The presence of a BOK agency on every island constitutes an extensive infrastructure available for extending financial services to unbanked populations.

4.3. ANZ / BOK Expertise in Electronic Banking

ANZ Pacific is a leader in electronic banking solutions and has demonstrated its willingness to experiment with extension of electronic banking services, including ATMs and EFTPOS, in challenging Pacific contexts, notably Solomon Islands. With a small computerised device, a card swipe device and a communications link – known as a 'bank-in-a-box' – it is now possible to deliver banking services in remote locations with the full support of the bank MIS.

4.4. Emergence of New Communications Technologies

Technologies such as VSAT make it increasingly possible to provide broadband telecommunications services in even the most remote locations.

4.5. Specialized Roles for Organizations Reaching the Unbanked

As banks extend the payment system infrastructure, it becomes possible for banks, or other organizations, to develop service delivery models for acquiring and managing new clients. If banks can support the branchless transaction infrastructure with fee revenues, then it is possible that other organizations can develop specialized operations to manage client services using that bank infrastructure. This means that organizations that want to provide financial services to the unbanked do not have to develop the entire institutional infrastructure of a financial institution. And this opens the possibility that smaller organizations could support specialized client services by charging fees to customers or sharing revenues with banks.

4.6. Familiarity with Village Banking methodologies

The I-Kiribati are familiar with microfinance methodologies through the Village Banking scheme. With much caution, it might therefore be possible to consolidate and rebuild a more robust Village Banking system in partnership with the BOK branch network, beginning in the most populated areas of Tarawa and Kiritimati.

4.7. Emergence of New Communications Technologies

Technologies such as VSAT make it increasingly possible to provide broadband telecommunications services in even the most remote locations.

4.8. Experimentation and demonstration in other locales

Experimentation of the type of systems described above are pending in other Pacific locations and can form the basis for further implementation in Kiribati.

5. RECOMMENDATIONS FOR SUPPORT INITIATIVES

5.1. Pilot a 'Bank-in-a-Box' Agency Model

This initial experimentation is best conducted within the current reach of bank infrastructure, for example where a physical agencies already exist with a telecommunications link to the main branch. This could occur close to one of the BOK branches – either in South Tarawa or perhaps Kiritimati. The pilot could be led by the bank itself or in partnership with another organization that assumes the client management role. Development of the pilot will require more rigorous study of populations centers and financial support from a donor willing to subsidize the start up costs.

5.2. Studies on Community-based Cash Flow Studies

Methodologies exist for studying the cash flows of rural communities and households. These exercises map the flow of money in and out of communities as well as the transactions that occur in the households and in the course of daily commerce. This provides a basis for understanding demand for specific financial services. A study such as this should be undertaken in conjunction with the above pilot.

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