



# Interest Rates and Bank Profitability in the South Pacific



This paper was prepared by Matt Davies and John Vaught. The views expressed are those of the authors and do not necessarily represent those of the IMF or IMF policy. The authors are grateful for the detailed guidance and insights of the South Pacific Central Bank Governors and for comments received from commercial banks and IMF colleagues.

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## INTEREST RATES AND BANK PROFITABILITY IN THE SOUTH PACIFIC

### I. INTRODUCTION

**The structure of the banking sector in the South Pacific has remained relatively stable over the last decade.** The banking sector in most countries is limited to three to four commercial banks, dominated by large Australian-owned banks (ANZ and Westpac), either in the form of branches or wholly-owned subsidiaries. Local banks generally hold relatively low market shares. In recent years, a new regional player has emerged in the shape of Bank of the South Pacific, a Papua New Guinean bank which now has operations in three of the South Pacific countries.

#### Structure of banking sector in South Pacific 2000-2009

	2000		2005		2009	
	Number of commercial banks	Broad money as percent of GDP	Number of commercial banks	Broad money as percent of GDP	Number of commercial banks	Broad money as percent of GDP
Solomon Islands	3	22	3	24	3	19
Samoa	3	40	4	37	4	35
Vanuatu	4	100	3	105	4	89
Tonga	3	38	3	47	3	35
Papua New Guinea	6	31	4	33	4	40
Fiji	5	42	5	45	5	48

Source: Central bank information and IMF staff reports.

**Interest rate levels have been an issue of increasing political and public attention in the South Pacific,** particularly as the effects of the global economic crisis pressured incomes and living standards in the vulnerable small open economies of the Pacific. As a result, the region's central banks have been tasked with assessing the cost of financial services to the general public, particularly interest rates being paid on deposits and being charged on loans. Forum Economic Ministers in their 2009 meeting considered interest rates in the context of the broad range of financial services (see Annex A for the relevant section of the outcomes).

**This paper aims to inform policy makers by providing comparative information on interest rate levels, and other key profitability indicators.** It has been prepared in response to a request made to PFTAC by South Pacific Central Bank Governors in their April 2009 meeting and Forum Economic Ministers in their October 2009 meeting. The paper reflects discussions with regional Governors at two meetings over the last year. The analysis focuses on the six South Pacific countries with central banks—Solomon Islands, Fiji, Tonga, Samoa, Vanuatu and Papua New Guinea—and uses data provided by them to compare to other countries and regions derived from IMF databases. Data availability and reliability is a major constraint in cross country analysis of this type. To ensure comparability the analysis attempts to work wherever possible from disaggregated prudential data so that ratios can be derived on a similar basis.

**The analysis attempts to draw regional conclusions where possible.** However, there has been a broad range of experiences in the six countries over the last decade, despite the similarity in their banking systems. Regional averages can obscure as much as inform and so results for individual countries are the main focus of discussion. The paper begins with a brief review of the key determinants of interest rates in the Pacific. It then reviews reported interest rates, which have the broadest range of international data available but are difficult to compare on a like-for-like basis. Section III therefore derives comparisons from disaggregated prudential data for the South Pacific and other selected regions. Section IV reviews bank profitability in the Pacific and section V reviews the contribution of non-interest operations to bank profitability. Section VI discusses the policy implications, focusing in particular on the scope for regional coordination.

## II. INTEREST RATE DETERMINANTS

**Like elsewhere, interest rates in the South Pacific reflect a wide range of factors.** Interest rates are the centerpiece of commercial banks' core business of financial intermediation. They are the key price in the financial sector, the main transmission mechanism of monetary policy, the main vehicle for matching supply and demand and, normally, the key determinant of profitability. Their level reflects banks' perception of risk (country and creditor), market liquidity conditions, and the depth of financial markets—which affects banks' ability to spread their risk, the cost of doing business, and the level of competition in the financial sector.

**Economic risk is relatively high in the Pacific.** This is the case for many small, open economies. South Pacific economies have relatively low and volatile growth and are vulnerable to shocks on both the growth and inflation front. Inflation is a particularly important risk to the financial sector. Exchange risks are also significant. Although most countries in the South Pacific operate a fixed exchange regime, their vulnerability to external shocks is high, which can rapidly impact market liquidity. Periodic devaluations are a risk to overseas investors—such as in Fiji in 2009 and the Solomon Islands in 1997. There is also vulnerability to movements in cross rates, such as the recent abrupt movements of the Australian and US dollar. Capital and exchange controls also add to economic risk.

**Broader country risk is also perceived to be elevated in the Pacific.** Country risk can

come from a number of sources, including: political instability; the potential for social unrest and violence, and vulnerability to natural disasters. South Pacific countries are perceived to be vulnerable to all of these to a greater or lesser degree which affects the way in which international banks may price products in the region. As an illustration, the text table provides comparisons from one index to other countries used in the analysis of subsequent sections.<sup>1</sup> It shows that outsiders perceive the Pacific to have considerably higher country risk than emerging market countries but somewhat better than the countries selected in South Asia, the Caribbean and Africa.

	Perception of Country Risk 1/					
	Export transactions			Commercial Risk 2/	Direct investments	
	Political Risk		Special Transactions		War Risk	Transfer Risk
	Short term	Medium Term				
Fiji	5	4	5	C	5	4
Papua New Guinea	2	5	3	B	3	4
Samoa	5	5	5	C	2	5
Solomon Islands	5	5	5	C	4	5
Tonga	5	5	5	C	3	3
Vanuatu	2	4	3	B	3	4
Australia	1	1	1	B	1	1
New Zealand	1	1	1	C	1	1
Brazil	2	3	2	C	2	3
Indonesia	2	5	2	C	2	3
Kazakhstan	3	5	4	C	2	5
Malaysia	1	2	1	B	2	2
Mexico	1	3	1	C	2	2
Philippines	1	4	2	B	2	4
Uruguay	3	4	3	B	2	3
Pakistan	4	7	5	C	6	6
Bangladesh	3	6	3	C	4	4
Sri Lanka	5	6	5	B	3	5
Grenada	5	6	5	C	2	6
Guyana	6	7	6	C	3	7
Barbados	3	4	3	C	1	4
Jamaica	5	6	5	C	2	5
Bahamas	2	3	2	C	1	3
Dominica	5	6	5	C	2	6
St Kitts	5	6	5	C	3	5
Seychelles	7	7	7	C	2	7
Rwanda	6	7	6	C	5	6
Tanzania	3	6	4	C	3	5

Source: ONDD Belgian Export Credit Agency  
 1/ Seven point scales with 1 being lowest risk. 2/ A=lowest risk

**The depth of financial markets and the cost of complying with prudential regulations also affect interest rate levels.** The more

financial products that are available the easier it is for banks to diversify their risk. However, in the markets of the South Pacific, where products such as foreign exchange futures, corporate bonds, leasing, and collateralized interbank lending are not widely available, banks’ assets tend to be concentrated in lending products. The lack of high quality, readily marketable instruments (i.e. government and corporate bonds) also means that liquid assets are often placed in non- or low-earning deposit accounts or even held in cash, thereby requiring higher lending rates or spreads and increasing the costs of banking services. There are few opportunities for diversification.

**Credit risk is a key determinant of interest rate levels.** When setting their interest rates, banks need to take into account the likelihood of interest and principal payments being received and the ability to access and liquidate collateral in a timely manner when loans go

<sup>1</sup> The source is the ONDD Belgian Export Credit Agency which provides one of the most comprehensive publicly available listings of country risk. The ratings are highly regarded internationally and broadly reflect OECD consensus. They do not reflect the views of the regional central bank governors or the IMF, but are provided as an illustration of outside perceptions of the region as they affect investors.

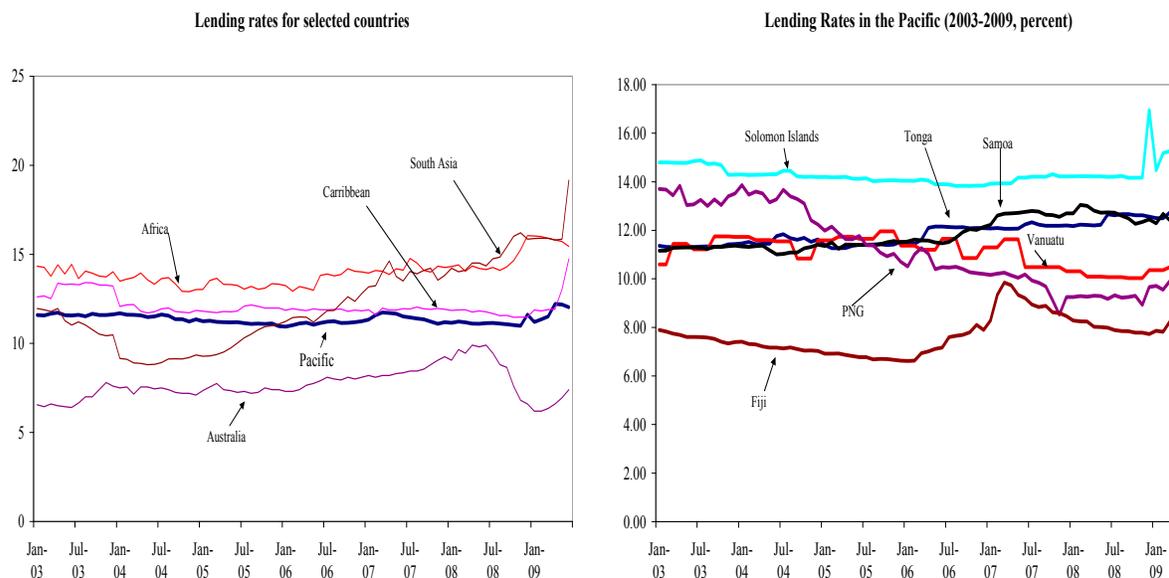
bad. A number of factors that can moderate credit risk are not present in many South Pacific economies, including: secured transactions laws, collateral registries, rapid and reliable contract enforcement through the legal system, credit reporting bureaus, and bankruptcy laws. Additionally, in many jurisdictions, there are inadequate markets to liquidate collateral in a timely manner or without significant loss.

### III. INTEREST RATES COMPARED TO OTHER REGIONS

#### A. Headline rates

**The IMF interest rate database allows a broad international comparison of interest rates.** All members report headline interest rates, at varying levels of disaggregation, to the IMF on a regular basis. This allows comparisons to be made between the Pacific and a broad range of other countries. However, the data is vulnerable to mistakes in reporting and reported interest rates are not always directly comparable. The illustrative results below select relevant countries with available comparable data between 2003 and 2009.

**Lending rates in the Pacific vary widely both in level and trend.** The chart below shows interest rates in the Pacific as reported to the IMF—rates are, wherever possible, weighted average lending rates. The chart shows that there is a wide range of interest rate levels in the Pacific, with the highest rates consistently in the Solomon Islands, at around 15 percent and the lowest in Fiji, averaging around 8 percent. Other countries consistently lie between these two extremes, with PNG showing the most marked decline over the period and Tonga and Samoa increasing slightly.

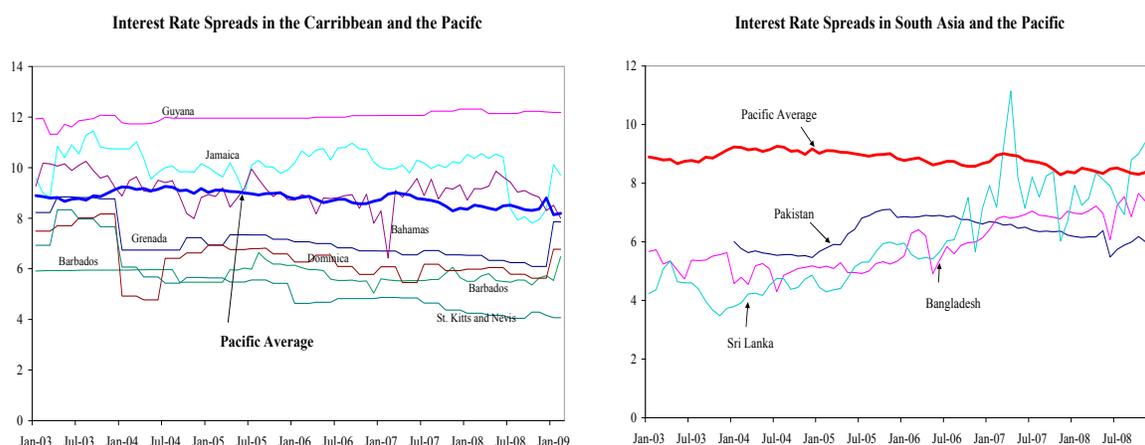


Source: Country Data as reported to IMF. Africa (Rwanda, Tanzania, Seychelles), South Asia (Bangladesh, Sri Lanka, Pakistan), Caribbean (Jamaica, Barbados, Bahamas, St Kitts and Nevis, Grenada, Guyana, Dominica)

**On average, lending rates in the Pacific appear in line with comparator economies.**

Chart 2 shows that while rates are higher than Australia, on average they lie below countries in Africa and South Asia and broadly in line with the Caribbean. African lending rates are broadly at the level of the Solomon Islands while South Asian rates have climbed from being broadly comparable with Vanuatu, Tonga and Samoa at the start of the period to levels similar to the Solomon Islands in recent years. Rates in the Caribbean, in many ways the most pertinent comparison, are on average below the Solomon Islands but in line with other South Pacific countries.

**Spreads follow a similar pattern.** The Charts below show that average spreads—weighted average lending rates less the standard savings deposit rate—in the South Pacific are in the mid-range of Caribbean countries and somewhat higher than in South Asia though the gap between the South Pacific Region and others in South Asia has been narrowing significantly in recent years. Interest rate spreads should be considered in the context of investment options. Where banks have lower investment options (i.e. less loan demand or loans of acceptable credit risk as well as other investment options for liquidity), higher interest spreads are required to compensate for higher non-earning asset levels. In the small financial sectors of the South Pacific large institutions such as the publicly owned Provident Funds that hold large lumpy deposits can introduce distortions into the level of deposit rates.



Source: Country Data as reported to IMF. South Asia (Bangladesh, Sri Lanka, Pakistan), Caribbean (Jamaica, Barbados, Bahamas, St Kitts and Nevis, Grenada, Guyana, Dominica)

## B. Analysis from Prudential Data

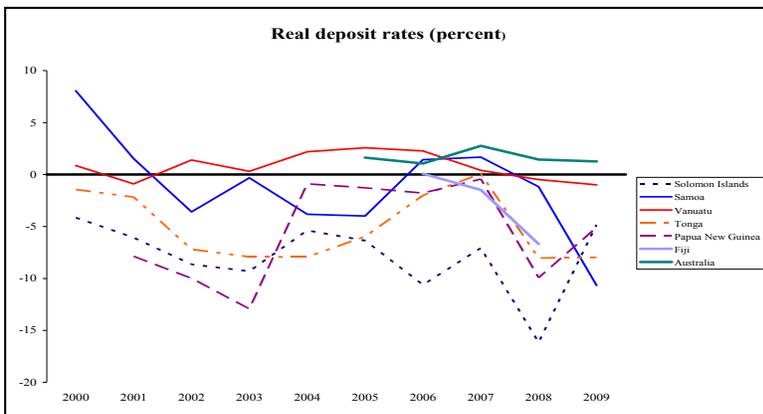
**Prudential data allows a more rigorous comparison of interest rates.** The data used in the previous section allow for a broad international comparison but do not give any certainty that fully valid comparisons are being made. They also do not provide a full picture of interest and other operations, including actual flows of interest income and expenses as opposed to published rates. This section therefore uses prudential data provided by South Pacific central banks to build up a more complete picture of income and expense.

**The comparative analysis uses Australia as a main reference point.** Many of the large banks in the region are branches or subsidiaries of Australian banks so there is a clear relevance in this comparison.<sup>2</sup> New Zealand is also used for comparison. However, acknowledging that market conditions are very different in Australia and New Zealand than the South Pacific, comparisons are also drawn from the IMF's Financial Soundness Indicators (FSI) database which has a far more restricted coverage than the interest rate database—it focuses on advanced and emerging markets—but allows comparison on a broader set of analytical ratios derived from commercial banks' balance sheets. The paper uses a selection of emerging market countries from Latin America (Brazil, Mexico, Uruguay), Asia (Malaysia, Phillipines, Indonesia) and Central Asia (Kazakhstan). Where possible, FSIs from a broader range of countries are also drawn from the IMF's Global Financial Stability Report.

**Prudential data is broadly in line with interest rate data provided to the IMF (Table 1).**

Loan yields in the region are highest in the smaller countries, with Solomon Islands consistently having the highest yield (averaging 15 percent) and Fiji and Papua New Guinea the lowest.<sup>3</sup> Australian loan yields are broadly in line with those in Fiji and PNG but

consistently below other South Pacific countries. Despite inflation volatility, loan yields have remained quite stable over the past decade in many South Pacific economies, particularly the smaller ones. Cost of deposits, broadly equivalent to the



<sup>2</sup> IMF FSI data for Australia was supplemented with detailed data available from the APRA website (see [www.apra.gov.au/statistics/](http://www.apra.gov.au/statistics/))

<sup>3</sup> The loan yield is total interest income for a calendar year divided by the average stock of outstanding loans for that year net of specific provisions for bad loans. It should, in the absence of large non-performing loans, be equivalent to the reported weighted average interest rate.

weighted average deposit rate, are generally very low, particularly in Fiji and PNG. They are on average below Australian levels in nominal terms, and much lower in real terms given the lower inflation in Australia. As a result spreads, the difference between yield and cost of deposits, are 2-3 times the levels in Australia.

**Net interest income (NII) is a conventional indicator of the contribution of core bank services to profitability.** The simple

spreads discussed above are analogous to the public understanding of interest rates but do not reflect the profits that banks derive from their core lending operations. The NII takes into account the fact that a bank cannot hold all of its assets in loans, which are typically the highest yielding asset category. Regulatory and prudential operating requirements mean that banks must also hold lower or non-earning assets such as statutory reserve deposits, deposits with other banks and cash in addition to fixed assets. The NII is preferable to the more often used Net Interest Margin, which considers net interest income (interest

Net Interest Income as a proportion of average assets (2008, percent)	
	Net Interest Income 1/
Solomon Islands	8.6
Samoa	6.1
Vanuatu	3.6
Tonga	5.8
<b>Average Small Island States</b>	<b>6.0</b>
Papua New Guinea	3.8
Fiji	5.2
Australia	1.6
New Zealand	1.9
Brazil	4.0
Indonesia	5.4
Kazakhstan	2.8
Malaysia	2.3
Mexico	1.2
Phillippines	1.6
Uruguay	0.0

Source: Central Bank Data, IMF Financial Soundness Indicators Database and staff estimates.

income from all sources less all interest expenses) as a percentage of average earning assets and which may overstate a bank's "spread" since average earning assets will always be less than the average total assets of a bank. Recognizing that bank's must maintain assets other loans to operate prudently and efficiently, the NII should be considered as a more appropriate reflection of the "spread". On this measure, spreads in the South Pacific in 2009 range between 3½ percent in PNG and Vanuatu up to 8½ percent in the Solomon Islands

**The NII in the South Pacific is, as expected, generally higher than emerging markets.**

The 2008 NII in Indonesia is in line with the majority of South Pacific countries and in Brazil is in line with the lower levels of the South Pacific. Australia and the other selected emerging markets, with NIIs between 1 and 3, are considerably below the South Pacific average and the bottom of the range in the Pacific. Although it is hard to quantify exactly, these differentials are broadly in line with what one might expect given the country risks discussed in Section II and the greater size, sophistication and depth of financial markets in these emerging economies.

#### IV. NON-INTEREST OPERATIONS

**Interest rates are, however, not the only source of bank profitability, even in the relatively shallow markets of the South Pacific.** Fees, charges and foreign exchange activities are significant contributors to bank income and profitability. The high level of income from foreign exchange activities is not surprising given the highly open nature of the the South Pacific economies leading to a large volume of international trade transactions supplemented by tourism transactions and remittances. A number of central banks in the South Pacific have become increasingly focused on these issues, in part because of the cost of sending remittances in the Pacific, which has been found to be extremely high by international standards.

**Non-interest income in the Pacific is higher than in most other regions (Table 6).** As a proportion of total assets, it was, on average around five times more than in Australia in 2008 and well above emerging market comparators (with the exception of Brazil). There is, however, a reasonably wide range with Solomon Islands the highest at around 8 percent and Fiji, PNG and Vanuatu the lowest at below 3 percent—still significantly higher than Australia’s 1¼ percent.

**Foreign exchange operations are the largest source of non-interest income in the South Pacific.** They account for roughly two-thirds of

non-interest income in many jurisdictions. For those jurisdictions which allow for disaggregation of this income source, profits from foreign exchange activities are on average equally split between revaluation profits/losses and services charges/fees on foreign exchange transactions. Using data provided on these spreads by the regions’ central banks, which are subject to the quality of reporting by the commercial banks, the average spread in the Pacific is around 8 percent.

**Data constraints hamper further analysis of non-interest income.** It is possible, however, that fees and charges on loans, such as commitment and transaction fees, could make up much of the remaining non-interest income. This has certainly been a concern in a number of jurisdictions. Work in Tonga has suggested that when fees and charges are consolidated into an effective interest rate, it increases the rate by large amounts, particularly for small loans.

	Gross Non Interest Income 1/	Non Interest Expense 2/	Net non-interest income 3/
Solomon Islands	8.6	5.9	2.7
Samoa	4.9	4.8	0.2
Vanuatu	2.9	4.0	-1.0
Tonga	6.3	6.4	-0.1
<b>Average Small Island States</b>	5.7	5.2	0.4
Papua New Guinea	3.0	2.7	0.3
Fiji	2.6	3.4	-0.8
Australia	1.3	1.7	-0.4
New Zealand	0.8	1.2	-0.4
Brazil	5.5	6.7	-1.3
Indonesia	3.1	4.1	-1.0
Kazakhstan	1.3	2.6	-1.3
Malaysia	1.6	1.5	0.1
Mexico	0.6	0.9	-0.3
Phillippines	0.8	1.6	-0.8
Uruguay	1.7	5.1	-3.4

Source: Central Bank Data, IMF Financial Soundness Indicators Database and staff estimates.

Further investigation of data will be required however to support this view. In some jurisdictions, loan related fees and charges are consolidated into interest income, however, work thus far in the South Pacific suggests that this is not generally the case in the region. If true, this could indicate that true interest rates are higher in the Pacific than indicated in previous sections.

**Non-interest expenses are also high in the Pacific.** It is not clear why this should be the case in the Pacific, as labour and building costs, while high, are less than in countries such as Australia. In this regard, it is notable that “other” non-interest expense—expenses other than salary and depreciation—reported by banks is on average more than half of total non-interest expenses. More disaggregated data is required to better understand the operating expenses of South Pacific banks. Central banks should review and ensure that all non-interest expenses are properly reported and supported. This should include management and outsourcing service fees being paid by foreign-owned banks to their parent and/or related parties which will contribute to non-interest expenses.

**Nevertheless, in some cases, net non-interest income is positive.** Generally, supervisors expect this indicator (non-interest income less expenses) to be negative. The fact that it is not in a number of Pacific countries only serves to highlight the particularly high levels of non-interest income, particularly on the foreign exchange side. It could also reflect problems in reporting, particularly if loan-related fees that should be incorporated into interest income are reported as non-interest income.

## V. BANK PROFITABILITY

**At first sight, overall bank profitability in the South Pacific is very high.** Return on assets (RoA)—total pre-tax profit as a proportion of average assets—is a standard measure for comparing not only individual bank profitability but also bank profitability across jurisdictions. RoA in the South Pacific ranges between -6 and 9½ percent in 2009, and averages close to 5 percent, which is high by international standards.<sup>4</sup> Advanced banking systems generally yield RoAs of around 1-2 percent, as seen in Australia. Pacific RoAs generally exceed averages in other regions and in some cases—the Solomon Islands in particular—are well in excess of levels observed in other regions. Returns have remained broadly at these levels over the last decade, but have been on a declining trend in most countries (Table 4).

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<sup>4</sup> Profits are averages across all commercial banks in a country and may have wide variation. Banks that have large branch networks in rural areas tend to have lower profitability.

**However, profits from interest operations are broadly in line with international norms.** In order to analyse the contribution of interest operations to overall profitability, Table 9 illustrates the RoA of South Pacific banking systems excluding the contribution of the very high foreign exchange earnings identified above. The tables clearly illustrate that foreign exchange activities contribute significantly to the income and profits of commercial banks.; without them, RoA would be more in line with international comparators. However, it is not possible from current data sources to identify whether foreign exchange income is a significant element in profitability in other regions other than those identified in section III above.

		2006	2007	2008	2009
South Pacific	average	5.2	4.9	4.0	2.8
	high	7.7	8.6	10.5	9.3
	low	3.5	2.9	-2.5	-5.7
South Pacific (excluding FX income)	average	2.5	2.1	1.0	0.4
	high	3.5	3.1	3.9	3.3
	low	2.0	1.2	-6.6	-8.2
Australia		1.5	1.4	0.7	0.9
New Zealand		1.7	1.6	1.3	...
Latin America	average	2.2	2.1	1.9	1.9
	high	3.5	3.1	3.5	5.5
	low	1.0	1.2	1.0	0.4
Sub-Sahara Africa	average	3.0	2.5	3.3	...
	high	5.8	3.9	4.2	...
	low	1.5	1.6	2.2	...
Mid East & Central Asia	average	2.2	2.1	1.4	...
	high	4.0	3.4	3.2	...
	low	0.7	0.9	-2.6	...
Emerging Europe	average	1.6	1.7	1.3	0.3
	high	3.4	3.9	3.5	1.6
	low	0.9	0.7	-0.6	-3.3

Source: South Pacific Central Bank data, APRA and Global Financial Stability Report (2009)

**Profits from foreign exchange operations account for at least half of total profits.** They are particularly high in the Solomon Islands (a return of 6 percent on average assets). Data on non-interest expenses are not sufficiently disaggregated to identify expenses associated with foreign exchange activities which may overstate the returns slightly. However, expenses for conducting foreign exchange activities are not believed to be significant as FX operations do not require separate fixed asset investments or significant additional personnel, outside of perhaps foreign exchange traders whose services may be outsourced to a parent or subsidiary.

**Credit risk does not appear to have been excessively high in the Pacific in recent years.** In recent years, banks' provision expenses—the precautionary expenses banks

	Return on Assets 1/	Return on equity 2/	Provision expense 3/	Leverage 4/
Solomon Islands	10.5	66.8	1.2	19.1
Samoa	5.5	31.1	1.0	19.4
Vanuatu	2.3	19.9	0.6	14.3
Tonga	-2.5	-16.8	10.4	17.7
<b>Average Small Island States</b>	<b>3.9</b>	<b>25.3</b>	<b>3.3</b>	<b>17.6</b>
Papua New Guinea	3.9	32.3	0.6	13.4
Fiji	4.3	49.4	0.2	10.2
Australia	0.7	15.0	0.8	5.3
New Zealand	1.3	...	0.2	...
Brazil	...	12.7	3.4	8.2
Indonesia	...	25.3	3.1	9.4
Kazakhstan	...	12.8	-0.1	12.4
Malaysia	...	17.6	1.6	8.4
Mexico	...	6.9	0.6	9.0
Philippines	...	12.0	-0.8	10.0
Uruguay	...	16.5	0.9	9.7

Source: Central Bank Data, IMF Financial Soundness Indicators Database and staff estimates.  
1/ Net income before taxes as a proportion of average assets.  
2/ Net income before taxes as a proportion of average equity.  
3/ As a proportion of average assets.  
4/ Equity to average assets.

make against loans that are not performing as expected or which are believed to pose more than a normal degree of credit risk—have remained at around 1 percent of average gross loans (Table 3). The ratio has, however, been much higher in Tonga in recent years, demonstrating the impact of high credit risk manifesting itself in a sharp increase in non-performing loans. Even excepting Tonga’s recent experience, South Pacific banks’ provision expenses are significantly above those in Australia and some selected emerging markets. They are though lower than in Brazil and Indonesia. A similar conclusion comes from the proportion of the total loan loss reserve—the amount banks have over a number of years put aside to cover bad loans—to total loans.

**Significant losses in Tonga demonstrate the downside risk.** Tonga has losses well in excess of those observed in other regions in recent years. This is a demonstration of the potential credit risk in the Pacific and that profits in good years protect against.

## VI. POLICY IMPLICATIONS

### Summary

**Banks in the Pacific are sound and profitable.** From a financial sector stability perspective, this is a critically important outcome. It has enabled the Pacific to withstand the global financial crisis without significant shocks to its financial systems or significant government intervention/financial support. The dominance of Australian banks, that were able to withstand the crisis better than most international banks, contributed to this successful outcome. Where banks have made losses and capital has fallen below required levels, the strong position of parent institutions has enabled swift and appropriate re-capitalization.

**However, although interest operations are in line with expectations, banks do make in some cases very high profits.**

- Lending rates and spread, the original motivation behind this paper do not appear to be out of line with comparable economies after taking into account likely determinants of interest rates such as country and credit risk and shallow financial markets. Over time, their levels have stayed broadly constant with a slight downward trend. These findings are consistent with the findings from an IFC study that assessed interest rate levels from a microeconomic perspective.<sup>5</sup>
- Foreign exchange income and other non-interest flows add substantially to profits. This reflects the high level of international trade in goods and services.

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<sup>5</sup> Credit Markets in the Pacific: A Review of Loan Pricing in 4 Pacific Countries. (IFC 2010)

- Banks have generally remained highly profitable over the last decade, with an average RoA of 4.8% since 2001, the majority of which is based on income received from foreign exchange activities. The healthy profits may also reflect the limited competition in South Pacific financial systems.

## Regulatory Responses

**South Pacific policy makers have been considering whether a policy response is required, particularly given the economic pressures arising from the global economic crisis.** Some central banks have taken actions and others are considering whether their regulatory frameworks provide an appropriate framework to allow interventions.

- Fiji, in early 2009, imposed restrictions on the growth of lending rates (constraining them to end 2008 levels for each commercial bank) and a ceiling on the interest rate spread of 4 percent for all banks. These formal restrictions were lifted in late 2009, but banks are still strongly encouraged to keep spreads within the 4 percent guideline.
- Tonga, in mid 2009, gained voluntary agreements from banks to reduce exchange rate spreads charged to customers and through regulation required banks to begin disclosing effective interest rates (including all fees and charges) to customers. The agreements came alongside reducing reserve requirements as part of a monetary policy move aimed at encouraging credit growth.
- Samoa, in the context of revising its central bank act, has been considering introducing provision for the central bank to have a more active role in regulating fees and charges of commercial banks

**The need for a response depends on the ultimate policy objective.** There are a number of possible objectives that policy makers in the South Pacific may have, including increased access to affordable credit for domestic businesses, moderating bank profitability and enhancing consumer protection. These are not exclusive to each other and many can and should be addressed through institutions other than the central bank.

**In central banking terms, the long term means to achieve these objectives is clear and is already being pursued by all South Pacific countries.** It lies in:

- **A credible and effective monetary policy framework.** This is vital for providing central banks tools to address interest rates. It will, however, require better transmission mechanisms than currently exist in most Pacific economies.
- **Well functioning financial markets.** Deeper financial markets will improve transmission mechanisms and increase the efficiency of the financial sector. Priorities include the development of securities markets, foreign exchange

trading and other financial products. This will require building better market infrastructure—credit bureaus, secured transactions laws and collateral access.

- **Competitive financial markets.** Maintaining the space for new market entrants and monitoring actions through high quality supervision within an appropriate prudential framework and effective competition policy will boost competition.
- **Reduced country risk.** This requires maintaining a stable macroeconomic and political environment and continuing progress on structural reforms to improve the business environment.
- **Improved consumer protection and financial literacy.** Consumer protection bodies such as financial ombudsmen can help protect customers from predatory practices. However, the vital requirement is a population that is financially competent, which requires progress on a number of fronts, in particular building financial literacy and developing clear business guidelines that protect the interests of both consumers and banks.

**Taking additional short term measures to control interest rates or profitability is risky and requires careful consideration of costs and benefits.** In particular, the potential for them to act against progress on the long term agenda out lined above. Short-term regulatory measures that control bank profitability or interest rates can frustrate market development and the short-term benefits need to be substantial to justify them. The following paragraphs set out the costs and benefits of some of the measures that have been proposed for the South Pacific.

**Interest rate regulation can influence rates in the short term, but has many challenges and can lead to unintended outcomes.** As shown recently in Fiji, direct regulation of rates can achieve the immediate aim of ensuring banks charge interest rates at the required level. However, this may not achieve longer-term policy objectives and can undermine the effectiveness of the banking sector. Some possible outcomes are:

- **Reduced efficiency.** The financial sector is particularly reliant on price signals and restricting banks' ability to price their services to include risk is likely to lead to other, less efficient, means of allocation such as rationing.
- **Increased charges in other areas.** For instance, loans can be priced at the same effective rate through fees and charges rather than using interest.
- **Contractions in credit,** particularly to higher risk sectors such as SMEs. Banks may achieve reductions in interest rates by reducing credit to higher risk customers rather than by reducing the interest rates across the board.

- **Slower market development and disincentives to potential market entrants.** If current market participants are unable to control their prices they are less likely to invest in new products and services. Similarly, potential new entrants will have less incentive to invest.
- **Pressure on supervision services.** Supervision departments, which in the Pacific are already stretched, are placed under additional strain through having to monitor interest rate practices.

**Regulation and/or increased taxation of profits is less damaging to market development but remains challenging.** Regulating profits and/or taxing profits at higher levels has the advantage of not interfering with the pricing mechanism and therefore has less damaging impacts on efficiency. It can, however, share the problems of interest rate regulation in terms of discouraging market development and deterring new investors. It also has significant challenges in terms of identifying target or maximum levels of profits and monitoring compliance. This is particularly relevant given the limited capacity in many supervision departments in the South Pacific and the absence of well formed competition policies and supporting institutions.

**Stepped up action on the longer term agenda may yield better and more sustainable short-term outcomes.** Given the policy and administrative challenges inherent in the short-term regulatory actions available to address price and profit levels, scarce resources may be better devoted to more aggressive actions to build deep and competitive financial markets.

### **Regional actions to support financial sector development**

**While the focus of efforts must necessarily be at the national level, coordinated regional action may also be able to contribute.** The underlying regulatory system is very similar across the South Pacific as are the main actors in the banking system. This provides scope for adding to national policies through regional coordination. The following paragraphs identify a number of areas that could be considered, mostly building on activities already taking place.

**Enhanced dialogue can lead to substantial improvements.** Regular and frank dialogue between central and commercial banks can lead to improvements in market functions and in outcomes. Commercial banks are likely to be willing to discuss amending their pricing structures in a cooperative environment that takes account of their own constraints. Ultimately, financial deepening, which is the underlying aim of many of the measures proposed above, is to the benefit of the industry and banks should be keen to engage in discussions. These discussions will predominately be at the national level but can also make use of regional fora. Given the strong regional network of the main banks in the Pacific, it may be valuable to establish a regular dialogue between regional managers and governors attached to the annual governors meeting.

**Transparency and disclosure provide important support and accountability.** Measures such as ensuring banks disclose effective interest rates (as recently implemented in Tonga), allows customers to better determine and compare the cost of borrowing. Dissemination of financial data, including interest rates and financial soundness indicators can also contribute to accountability. There has been some movement towards this at both national and regional levels, through central bank and AFSPC websites. These initiatives could be built on by improving the breadth and timeliness of published data.

**Enhanced supervision is also critical.** Effective supervision not only helps monitor and assess the health and condition of the banking industry but also provides vital information to policy makers, including financial soundness data and indicators. Supervisors need to understand the risks that banks are facing, and to be able to identify what is driving banks' costs and profits. Significant progress has been made in improving supervision and regulation in the South Pacific, but many improvements can still be made. Priorities include: updating prudential regulations; enhancing and automating bank reporting to allow easier and more comprehensive analysis; improving on-site inspection techniques; and deepening capacity in supervision departments. Given the similarity of the regulatory environment and the main players in the banking system in the region, formal and informal interaction in the context of the AFSPC should continue to benefit supervisors in the South Pacific. Harmonizing returns and systems across jurisdictions could yield economies of scale to regional banks and help reduce the cost of banking. Enhanced cooperation with APRA may also yield benefits given the dominance of Australian supervised banks in the South Pacific.

**Increased competition is also likely to lead to lower consumer costs.** However, prospective entrants into South Pacific banking markets have to consider competing with established players with the advantages of a regional network, with accompanying efficiencies of scale, and large market shares. The available returns, while potentially high in proportionate terms, will be low in absolute terms given the smallness of the individual national markets. This could deter additional large regional-level players from entering. Addressing this issue at a regional level is, however, difficult and will be limited to information sharing and cooperation on effective competition frameworks while efforts to encourage and foster private, local bank ownership continue at the national level. Competition, however, can come from outside the banking sector, particularly given the influence of non-core banking operations on banks' profits. Promotion of efficient foreign exchange rate markets and non-bank financial institutions may also broaden consumer choice and lower costs.

**Strengthened consumer protection will still be required.** While this will primarily be an issue to be taken forward at the national level, central banks and other consumer protection bodies can cooperate regionally with the aim of having broadly similar regimes. This would facilitate low-cost compliance by banks with large regional presences. For example, regulators could require that loan and deposit contracts clearly specify the frequency and basis of any adjustments to the interest rate and any fees. To prevent predatory practices,

adjustments to loan interest rates and fees should be required to be calculated against an independent index specified in the loan contract and the loan contract should clearly specify how and when adjustments (both increases and decreases) are to be calculated. The loan contract should also require repayments to be increased or decreased to reflect any adjustment in interest rates or fees and ensure that the loan amortizes within the contractual period.

**Building financial competence and inclusion is fundamental to long term financial sector development.** South Pacific central bank governors and finance ministries have already recognized this at a regional level through the Coombs Declaration, the endorsement of the Money Pacific goals, and their active support for Microfinance Pasifika and the Pacific Financial Inclusion Program. These support many national and regional programs implemented by Governments, central banks (RBF's recently implemented microfinance regulation), development partners (measures to support RSE workers) and the private sector (Westpac's partnership with AusAID). Increased investment in physical and technological infrastructure will also be required to bring the unbanked into the financial sector in a cost-effective manner. The challenge at the regional level is to ensure that the coordination of these many initiatives at the regional level is manageable and does not cause unsustainable demands on financial sector managers.

**Table 1: Simple interest ratios (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Average
A. Average loan yields											
Solomon Islands	14.5	13.8	14.8	15.7	17.8	15.3	15.1	13.7	13.7	16.1	15.0
Samoa	24.8	12.3	12.4	11.7	11.9	12.3	12.5	12.9	12.7	11.1	13.5
Vanuatu	19.2	7.8	12.4	12.7	12.0	12.3	13.4	12.3	11.8	11.0	12.5
Tonga	10.5	11.9	10.7	10.4	12.8	10.6	11.4	11.6	12.5	10.5	11.3
<b>Average Small Island States</b>	17.2	11.5	12.6	12.6	13.6	12.6	13.1	12.6	12.7	12.2	13.1
Papua New Guinea	...	6.5	8.8	10.2	8.2	7.7	6.7	6.6	6.8	7.0	7.6
Fiji	...	...	7.9	7.6	7.2	6.9	8.1	9.3	8.1	7.8	7.9
Australia	...	...	...	...	...	7.4	7.9	8.4	8.9	6.3	7.8
B. Average cost of deposits											
Solomon Islands	2.7	1.4	0.9	1.2	1.5	0.7	0.5	0.6	1.1	3.2	1.4
Samoa	7.9	3.4	3.8	4.0	4.0	3.8	4.6	6.2	5.0	3.7	4.6
Vanuatu	3.4	2.8	3.4	3.3	3.6	3.8	4.3	4.3	4.3	3.3	3.6
Tonga	3.9	4.7	3.2	3.2	3.8	3.7	5.0	5.2	6.5	4.3	4.3
<b>Average Small Island States</b>	3.9	4.7	3.2	3.2	3.8	3.7	5.0	5.2	6.5	4.3	4.3
Papua New Guinea	...	1.4	1.8	1.8	1.2	0.5	0.6	0.5	0.8	1.1	1.1
Fiji	...	...	0.9	0.8	0.8	0.8	2.6	3.3	1.1	2.4	1.6
Australia	...	...	...	...	...	4.3	4.6	5.1	5.8	3.1	4.6
C. Simple spread											
Solomon Islands	11.8	12.5	13.9	14.5	16.3	14.6	14.6	13.1	12.6	13.0	13.7
Samoa	16.9	8.9	8.6	7.8	7.9	8.5	7.9	6.7	7.7	7.4	8.8
Vanuatu	15.8	5.1	9.0	9.4	8.4	8.6	9.1	8.0	7.5	7.7	8.9
Tonga	6.6	7.2	7.5	7.2	9.0	7.0	6.4	6.4	6.0	6.2	6.9
<b>Average Small Island States</b>	12.8	8.4	9.8	9.7	10.4	9.7	9.5	8.6	8.4	8.6	9.6
Papua New Guinea	...	5.1	7.0	8.4	7.0	7.1	6.1	6.1	6.0	5.9	6.5
Fiji	...	...	7.0	6.8	6.5	6.1	5.5	6.0	6.9	5.3	6.3
Australia	...	...	...	...	...	3.1	3.3	3.3	3.1	3.2	3.2

Source: Central bank prudential data and Fund staff estimates.

**Table 2. Net Interest Income to Average Assets (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Average
Solomon Islands	6.8	6.7	6.8	6.4	5.7	5.2	6.8	7.6	8.6	8.5	6.9
Samoa	9.5	5.6	5.7	5.4	5.6	5.9	6.6	6.0	6.1	5.5	6.2
Vanuatu	5.8	2.6	3.5	3.2	3.1	3.5	3.9	3.6	3.6	3.6	3.6
Tonga	5.8	6.1	6.5	6.5	7.3	6.5	6.1	6.0	5.8	4.9	6.2
<b>Average Small Island States</b>	7.0	5.2	5.6	5.4	5.4	5.3	5.8	5.8	6.0	5.6	5.7
Papua New Guinea	...	4.8	6.5	7.0	4.6	4.1	3.7	3.6	3.8	3.6	4.6
Fiji	8.3	4.5	4.6	4.5	4.5	4.6	4.5	4.6	5.2	4.2	5.0
Australia	...	...	...	...	...	1.8	1.8	1.6	1.6	1.7	1.7

Source: Central bank prudential data and Fund staff estimates.

**Table 3. Credit Risk Indicators (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Average
<b>A. Provision expense to Gross Loans</b>											
Solomon Islands	1.2	0.5	1.3	0.0	0.1	0.3	0.7	1.5	1.2	1.2	0.8
Samoa	0.0	0.0	0.0	0.0	0.0	0.8	0.2	0.4	1.0	0.5	0.3
Vanuatu	0.5	0.5	0.8	1.3	0.8	0.1	0.4	0.5	0.6	0.0	0.6
Tonga	1.1	0.5	1.2	1.1	1.6	0.4	1.1	3.2	10.4	11.0	3.2
<b>Average Small Island States</b>	0.7	0.4	0.9	0.6	0.6	0.4	0.6	1.4	3.3	3.2	1.2
Papua New Guinea	...	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.6	0.0	0.1
Fiji	2.4	0.7	0.5	0.6	0.5	0.4	-0.1	1.0	0.2	1.1	0.7
Australia	...	...	...	...	...	0.4	0.2	0.2	0.8	0.9	0.5
<b>B. Loan loss reserves to Gross Loans</b>											
Solomon Islands	3.9	5.1	5.6	3.5	3.9	1.1	1.1	2.0	2.3	3.9	3.3
Samoa	3.4	3.4	3.4	3.7	4.1	3.3	2.8	3.3	4.1	5.1	3.7
Vanuatu	3.0	2.4	3.5	4.0	5.0	4.6	5.1	4.4	4.5	4.0	4.1
Tonga	4.7	4.5	4.5	4.6	4.8	2.5	2.4	3.6	6.4	12.7	5.1
<b>Average Small Island States</b>	3.7	3.8	4.2	4.0	4.4	2.9	2.9	3.3	4.3	6.5	4.0
Papua New Guinea	...	4.6	7.6	5.9	4.8	3.2	2.6	2.3	2.0	2.6	4.0
Fiji	3.3	3.8	3.9	3.5	2.6	1.6	1.6	2.7	2.2	1.5	2.7
Australia	...	...	...	...	...	0.8	0.7	0.6	1.0	1.2	0.8

Source: Central bank prudential data and Fund staff estimates.

**Table 4: Profitability indicators (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Average
A. Return on average assets 1/											
Solomon Islands	4.6	5.0	7.2	8.7	7.7	6.6	7.7	8.6	10.5	9.3	7.6
Samoa	10.5	6.2	6.2	5.0	4.6	5.6	6.3	5.0	5.5	4.3	5.9
Vanuatu	5.0	2.8	3.5	3.5	3.8	3.8	4.0	3.5	2.3	2.9	3.5
Tonga	5.2	6.1	5.6	6.0	6.0	7.0	5.7	4.7	-2.5	-5.7	3.8
<b>Average Small Island States</b>	6.3	5.0	5.6	5.8	5.5	5.8	6.0	5.5	3.9	2.7	5.2
Papua New Guinea	...	5.7	7.5	8.0	3.9	4.7	3.5	4.4	3.9	3.5	5.0
Fiji	5.2	3.3	3.7	3.6	3.8	4.0	3.9	2.9	4.3	2.8	3.7
Australia	...	...	...	...	...	1.6	1.5	1.4	0.7	0.9	1.2
B. Return on equity (pre-tax) 2/											
Solomon Islands	30.0	28.4	35.4	48.7	48.0	41.5	50.8	65.1	66.8	52.6	46.7
Samoa	68.2	39.4	34.9	27.7	26.5	33.6	37.5	28.1	31.1	23.3	35.0
Vanuatu	64.3	30.1	42.1	37.1	34.0	36.3	38.8	36.0	19.9	21.7	36.1
Tonga	36.1	41.9	34.4	37.6	40.5	52.7	42.2	35.0	-16.8	-36.2	26.7
<b>Average Small Island States</b>	49.7	35.0	36.7	37.8	37.3	41.0	42.3	41.1	25.3	15.3	36.1
Papua New Guinea	...	56.7	74.7	68.8	30.3	37.5	30.0	39.5	32.3	28.5	44.3
Fiji	78.1	43.4	49.0	51.0	54.4	58.5	51.3	37.4	49.4	...	52.5
Australia	...	...	...	...	...	24.2	25.8	25.8	15.0	16.9	21.5
C. Return on equity (post-tax)											
Solomon Islands	19.0	18.6	23.9	32.7	30.5	27.2	33.2	42.1	43.0	34.4	30.4
Samoa	48.0	27.5	24.3	19.4	18.7	23.5	26.3	20.2	22.6	16.7	24.7
Vanuatu	64.3	30.1	42.1	37.1	34.0	36.3	38.8	36.0	19.9	21.7	36.1
Tonga	24.7	29.4	23.7	26.8	26.4	32.4	28.3	24.3	-16.8	-28.4	17.1
<b>Average Small Island States</b>	39.0	26.4	28.5	29.0	27.4	29.9	31.6	30.7	17.2	11.1	27.1
Papua New Guinea	...	39.9	52.7	49.6	23.3	39.2	20.6	27.4	22.3	19.6	32.7
Fiji	47.3	30.2	34.7	38.2	37.9	41.4	36.1	26.3	34.8	17.3	34.4
Australia	...	...	...	...	...	16.7	17.7	18.6	11.9	11.0	15.2

Source: Central bank prudential data and Fund staff estimates.

1/ Net income before taxes as a proportion of average assets. 2/ Net income as a proportion of average equity.

**Table 5. Equity to average assets (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Average
Solomon Islands	15.3	19.0	21.0	18.5	17.5	18.5	16.5	13.9	19.1	16.5	17.6
Samoa	16.3	16.5	18.7	18.9	17.9	17.3	18.9	19.0	19.4	19.4	18.2
Vanuatu	8.8	10.0	9.7	10.6	11.9	10.3	11.1	10.0	14.3	13.3	11.0
Tonga	13.6	16.5	16.4	16.9	13.0	14.1	13.5	15.6	17.7	14.6	15.2
<b>Average Small Island States</b>	13.5	15.5	16.4	16.2	15.1	15.1	15.0	14.6	17.6	15.9	15.5
Papua New Guinea	...	11.4	11.9	13.3	13.4	14.4	13.0	13.4	13.4	13.8	13.1
Fiji	7.0	8.5	7.9	8.5	7.9	8.3	8.4	8.2	10.2	12.7	8.8
Australia	...	...	...	...	...	6.8	5.6	5.6	5.3	5.5	5.8

Source: Central bank prudential data and Fund staff estimates.

**Table 6: Non-Interest Income (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*	Average
A. Non-interest income to average assets											
Solomon Islands	4.4	5.2	8.8	10.1	9.7	8.0	7.6	8.5	8.6	7.6	7.8
Samoa	10.1	5.8	6.0	6.3	5.0	5.6	5.1	4.4	4.9	3.6	5.7
Vanuatu	1.7	1.8	2.3	3.0	3.1	3.2	3.0	3.2	2.9	2.9	2.7
Tonga	4.5	5.1	4.6	5.7	6.0	5.6	5.2	6.7	6.3	3.7	5.3
<b>Average Small Island States</b>	5.2	4.5	5.4	6.3	6.0	5.6	5.2	5.7	5.7	4.5	5.4
Papua New Guinea	...	4.9	6.5	7.1	4.2	4.6	3.0	3.4	3.0	2.4	4.3
Fiji	5.2	3.3	3.7	3.5	3.5	3.5	2.9	2.5	2.6	2.8	3.3
Australia	...	...	...	...	...	2.0	1.7	1.7	1.3	1.1	1.6
B. Foreign exchange income to average assets											
Solomon Islands	3.4	3.9	7.0	8.2	7.9	6.2	5.5	6.4	6.6	6.0	6.1
Samoa	4.9	2.9	2.6	2.7	2.6	3.3	2.8	1.9	2.3	2.3	2.8
Vanuatu	0.7	0.7	1.0	1.8	1.7	1.9	1.6	1.6	1.6	1.7	1.4
Tonga	3.6	4.2	3.6	3.9	3.7	3.1	3.2	3.5	4.0	2.5	3.5
<b>Average Small Island States</b>	3.2	2.9	3.5	4.2	4.0	3.6	3.3	3.4	3.6	3.1	3.5
Papua New Guinea	...	4.1	5.2	5.7	3.1	2.8	1.5	2.2	2.0	1.3	3.1
Fiji	2.1	1.3	1.6	1.4	1.3	1.2	1.2	1.1	1.2	1.1	1.4
C. Other non-interest income to average assets											
Solomon Islands	1.0	1.2	1.8	2.0	1.8	1.8	2.0	2.1	2.0	1.6	1.7
Samoa	5.2	2.8	3.4	3.6	2.4	2.3	2.3	2.5	2.6	1.3	2.8
Vanuatu	1.0	1.0	1.3	1.2	1.4	1.3	1.3	1.5	1.4	1.2	1.3
Tonga	0.9	1.0	1.0	1.7	2.3	2.5	2.0	3.2	2.3	1.3	1.8
<b>Average Small Island States</b>	2.0	1.5	1.9	2.1	2.0	2.0	1.9	2.3	2.1	1.4	1.9
Papua New Guinea	...	0.8	1.2	1.4	1.1	1.7	1.5	1.2	1.1	1.1	1.2
Fiji	3.1	2.0	2.1	2.1	2.2	2.2	1.7	1.4	1.4	1.7	2.0

Source: Central bank prudential data and Fund staff estimates.

**Table 7: Non-Interest Expense (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*	Average
A. Gross non-interest expense to average assets											
Solomon Islands	6.0	6.6	7.9	7.8	7.7	6.5	6.3	6.6	5.9	6.1	6.7
Samoa	9.1	5.2	5.5	6.7	5.9	5.4	5.2	5.1	4.8	4.4	5.7
Vanuatu	2.4	1.4	2.0	2.3	2.2	2.9	2.6	3.1	4.0	3.6	2.6
Tonga	4.4	4.9	4.6	5.3	6.2	4.7	4.7	5.5	6.4	6.1	5.3
<b>Average Small Island States</b>	5.5	4.5	5.0	5.5	5.5	4.9	4.7	5.1	5.2	5.0	5.1
Papua New Guinea	...	4.1	5.5	6.1	4.8	4.0	3.2	2.5	2.7	2.5	4.0
Fiji	6.8	4.0	4.2	4.0	3.9	3.8	3.5	3.6	3.4	3.5	4.1
Australia	...	...	...	...	...	2.1	1.9	1.9	1.7	1.5	1.8
B. Non salary, non-interest expense to average assets											
Solomon Islands	2.8	2.9	3.9	4.0	4.2	3.2	3.3	3.3	3.6	3.7	3.5
Samoa	4.7	3.2	3.4	4.1	3.5	2.7	2.8	2.7	2.7	2.5	3.2
Vanuatu	1.4	1.2	1.5	1.5	1.4	1.6	1.4	1.6	2.2	1.7	1.5
Tonga	2.0	2.3	2.5	2.7	3.7	2.6	2.6	3.2	3.8	3.7	2.9
<b>Average Small Island States</b>	2.7	2.4	2.8	3.1	3.2	2.5	2.5	2.7	3.1	2.9	2.8
Papua New Guinea	....	3.0	3.4	4.0	3.0	3.7	3.0	1.6	1.8	1.6	2.8
Fiji	2.1	1.2	1.8	1.7	1.6	1.6	1.5	1.7	1.5	1.7	1.6
Australia	...	...	...	...	...	1.1	0.9	1.0	1.0	0.8	1.0

Source; Central bank prudential data and Fund staff estimates.

**Table 8: Net non-interest income to average assets (percent)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009*	Average
Solomon Islands	-1.6	-1.5	0.9	2.3	2.0	1.5	1.2	1.9	2.7	1.6	1.1
Samoa	1.0	0.6	0.5	-0.4	-0.9	0.3	-0.1	-0.7	0.2	-0.8	0.0
Vanuatu	-0.7	0.3	0.2	0.7	0.9	0.3	0.3	0.0	-1.0	-0.7	0.1
Tonga	0.1	0.2	0.0	0.3	-0.2	0.9	0.6	1.2	-0.1	-2.4	0.1
<b>Average Small Island States</b>	-0.3	-0.1	0.4	0.8	0.4	0.7	0.5	0.6	0.4	-0.6	0.3
Papua New Guinea	...	0.8	1.0	1.0	-0.7	0.6	-0.2	0.9	0.3	-0.1	0.4
Fiji	-1.6	-0.7	-0.5	-0.5	-0.4	-0.4	-0.6	-1.0	-0.8	-0.7	-0.7
Australia	...	...	...	...	...	-0.1	-0.2	-0.2	-0.4	-0.4	-0.3

Source: Central bank prudential data and Fund staff estimates.

Table 9. Return on Assets - Composition and trends (percent)

<b>SOLOMON ISLANDS</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Average</b>
<b>ROA - Deposit &amp; Lending Activities</b>	<b>1.2</b>	<b>1.1</b>	<b>0.2</b>	<b>0.6</b>	<b>(0.3)</b>	<b>0.4</b>	<b>2.2</b>	<b>2.2</b>	<b>3.9</b>	<b>3.3</b>	<b>1.5</b>
Net Interest Income	6.8	6.7	6.8	6.4	5.7	5.2	6.8	7.6	8.6	8.5	6.9
Less Loan Loss Provision Expense	0.5	0.2	0.5	0.0	0.0	0.1	0.3	0.8	0.8	0.8	0.4
Plus Non-interest Income											
Svc Chgs & Fees on Dep Accts	0.9	1.0	1.3	1.1	1.1	1.1	1.0	0.9	0.9	0.9	1.0
Other Non-interest Income	0.1	0.2	0.5	0.8	0.7	0.8	1.0	1.2	1.1	0.7	0.7
Less Non-Interest Expenses											
Salary & Benefits	2.8	3.3	3.2	3.2	2.8	2.5	2.2	2.5	1.8	1.8	2.6
Other Expenses	3.2	3.4	4.6	4.6	5.0	4.0	4.1	4.1	4.1	4.2	4.1
<b>ROA - Foreign Exchange Activities</b>	<b>3.4</b>	<b>3.9</b>	<b>7.0</b>	<b>8.2</b>	<b>7.9</b>	<b>6.2</b>	<b>5.5</b>	<b>6.4</b>	<b>6.6</b>	<b>6.0</b>	<b>6.1</b>
<b>ROA - All Activities</b>	<b>4.6</b>	<b>5.0</b>	<b>7.2</b>	<b>8.7</b>	<b>7.7</b>	<b>6.6</b>	<b>7.7</b>	<b>8.6</b>	<b>10.5</b>	<b>9.3</b>	<b>7.6</b>
<b>Non-Int Income / Gross Income</b>	<b>39.5</b>	<b>43.6</b>	<b>56.4</b>	<b>61.3</b>	<b>62.8</b>	<b>60.7</b>	<b>52.8</b>	<b>52.7</b>	<b>49.8</b>	<b>47.4</b>	<b>52.7</b>
<b>FX Income / Gross Income</b>	<b>30.5</b>	<b>33.3</b>	<b>45.1</b>	<b>49.5</b>	<b>51.3</b>	<b>46.7</b>	<b>38.6</b>	<b>39.6</b>	<b>38.3</b>	<b>37.3</b>	<b>41.0</b>

<b>SAMOA</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Average</b>
<b>ROA - Deposit &amp; Lending Activities</b>	<b>5.6</b>	<b>3.3</b>	<b>3.6</b>	<b>2.3</b>	<b>2.1</b>	<b>2.2</b>	<b>3.5</b>	<b>3.1</b>	<b>3.2</b>	<b>2.1</b>	<b>3.1</b>
Net Interest Income	9.5	5.6	5.7	5.4	5.6	5.9	6.6	6.0	6.1	5.5	6.2
Less Loan Loss Provision Expense	0.0	0.0	0.0	0.0	0.0	0.5	0.1	0.3	0.8	0.4	0.2
Plus Non-interest Income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Svc Chgs & Fees on Dep Accts	4.9	2.6	2.6	2.8	2.2	2.3	2.2	2.5	2.6	1.3	2.6
Other Non-interest Income	0.4	0.2	0.8	0.8	0.3	0.0	0.1	0.1	0.1	0.0	0.3
Less Non-Interest Expenses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Salary & Benefits	3.2	1.6	1.7	2.1	1.9	2.2	2.0	1.9	1.6	1.4	2.0
Other Expenses	5.9	3.5	3.8	4.6	4.0	3.2	3.3	3.2	3.1	3.0	3.8
<b>ROA - Foreign Exchange Activities</b>	<b>4.9</b>	<b>2.9</b>	<b>2.6</b>	<b>2.7</b>	<b>2.6</b>	<b>3.3</b>	<b>2.8</b>	<b>1.9</b>	<b>2.3</b>	<b>2.3</b>	<b>2.8</b>
<b>ROA - All Activities</b>	<b>10.5</b>	<b>6.2</b>	<b>6.2</b>	<b>5.0</b>	<b>4.6</b>	<b>5.6</b>	<b>6.3</b>	<b>5.0</b>	<b>5.5</b>	<b>4.3</b>	<b>5.9</b>
<b>Non-Int Income / Gross Income</b>	<b>51.6</b>	<b>50.7</b>	<b>51.1</b>	<b>53.8</b>	<b>47.5</b>	<b>49.1</b>	<b>43.6</b>	<b>42.4</b>	<b>44.7</b>	<b>39.2</b>	<b>47.4</b>
<b>FX Income / Gross Income</b>	<b>24.9</b>	<b>25.8</b>	<b>22.2</b>	<b>23.3</b>	<b>24.4</b>	<b>29.0</b>	<b>24.2</b>	<b>18.4</b>	<b>21.0</b>	<b>24.8</b>	<b>23.8</b>

<b>VANUATU</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Average</b>
<b>ROA - Deposit &amp; Lending Activities</b>	<b>4.3</b>	<b>2.0</b>	<b>2.5</b>	<b>1.7</b>	<b>2.0</b>	<b>1.9</b>	<b>2.4</b>	<b>1.8</b>	<b>0.8</b>	<b>1.3</b>	<b>2.1</b>
Net Interest Income	5.8	2.6	3.5	3.2	3.1	3.5	3.9	3.6	3.6	3.6	3.6
Less Loan Loss Provision Expense	0.2	0.2	0.2	0.4	0.2	0.0	0.1	0.2	0.2	0.0	0.2
Plus Non-interest Income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Svc Chgs & Fees on Dep Accts	1.0	1.0	1.2	1.0	0.6	0.6	0.6	0.9	0.6	0.6	0.8
Other Non-interest Income	0.0	0.0	0.1	0.2	0.8	0.7	0.7	0.7	0.7	0.6	0.5
Less Non-Interest Expenses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Salary & Benefits	0.8	0.3	0.5	0.6	0.7	1.0	1.0	1.2	1.5	1.5	0.9
Other Expenses	1.6	1.1	1.6	1.6	1.5	1.9	1.6	1.9	2.5	2.1	1.7
<b>ROA - Foreign Exchange Activities</b>	<b>0.7</b>	<b>0.7</b>	<b>1.0</b>	<b>1.8</b>	<b>1.7</b>	<b>1.9</b>	<b>1.6</b>	<b>1.6</b>	<b>1.6</b>	<b>1.7</b>	<b>1.4</b>
<b>ROA - All Activities</b>	<b>5.0</b>	<b>2.8</b>	<b>3.5</b>	<b>3.5</b>	<b>3.8</b>	<b>3.8</b>	<b>4.0</b>	<b>3.5</b>	<b>2.3</b>	<b>2.9</b>	<b>3.5</b>
<b>Non-Int Income / Gross Income</b>	<b>22.7</b>	<b>41.0</b>	<b>39.4</b>	<b>48.6</b>	<b>49.9</b>	<b>47.7</b>	<b>43.4</b>	<b>46.8</b>	<b>44.9</b>	<b>44.4</b>	<b>42.9</b>
<b>FX Income / Gross Income</b>	<b>9.7</b>	<b>16.9</b>	<b>17.4</b>	<b>29.2</b>	<b>28.1</b>	<b>28.2</b>	<b>23.9</b>	<b>24.2</b>	<b>24.0</b>	<b>25.8</b>	<b>22.7</b>

<b>TONGA</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Average</b>
<b>ROA - Deposit &amp; Lending Activities</b>	<b>1.6</b>	<b>1.9</b>	<b>2.0</b>	<b>2.1</b>	<b>2.2</b>	<b>4.0</b>	<b>2.5</b>	<b>1.2</b>	<b>(6.6)</b>	<b>(8.2)</b>	<b>0.3</b>
Net Interest Income	5.8	6.1	6.5	6.5	7.3	6.5	6.1	6.0	5.8	4.9	6.2
Less Loan Loss Provision Expense	0.7	0.3	0.8	0.8	1.1	0.3	0.9	2.5	8.2	8.3	2.4
Plus Non-interest Income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Svc Chgs & Fees on Dep Accts	0.8	1.0	1.0	1.7	2.2	2.3	1.9	2.0	2.2	1.3	1.6
Other Non-interest Income	0.1	0.0	0.1	0.0	0.1	0.2	0.1	1.1	0.1	(0.0)	0.2
Less Non-Interest Expenses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Salary & Benefits	1.9	1.9	1.8	1.9	1.9	1.7	1.6	1.7	2.2	1.9	1.8
Other Expenses	2.5	3.0	2.8	3.4	4.3	3.0	3.0	3.8	4.2	4.2	3.4
<b>ROA - Foreign Exchange Activities</b>	<b>3.6</b>	<b>4.2</b>	<b>3.6</b>	<b>3.9</b>	<b>3.7</b>	<b>3.1</b>	<b>3.2</b>	<b>3.5</b>	<b>4.0</b>	<b>2.5</b>	<b>3.5</b>
<b>ROA - All Activities</b>	<b>5.2</b>	<b>6.1</b>	<b>5.6</b>	<b>6.0</b>	<b>6.0</b>	<b>7.0</b>	<b>5.7</b>	<b>4.7</b>	<b>(2.5)</b>	<b>(5.7)</b>	<b>3.8</b>
<b>Non-Int Income / Gross Income</b>	<b>43.9</b>	<b>45.6</b>	<b>41.5</b>	<b>46.4</b>	<b>45.3</b>	<b>46.2</b>	<b>46.3</b>	<b>52.7</b>	<b>52.1</b>	<b>42.8</b>	<b>46.3</b>
<b>FX Income / Gross Income</b>	<b>35.2</b>	<b>36.8</b>	<b>32.3</b>	<b>32.3</b>	<b>28.2</b>	<b>25.6</b>	<b>28.3</b>	<b>27.7</b>	<b>33.4</b>	<b>28.3</b>	<b>30.8</b>

<b>PAPUA NEW GUINEA</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Average</b>
<b>ROA - Deposit &amp; Lending Activities</b>		<b>1.6</b>	<b>2.3</b>	<b>2.3</b>	<b>0.9</b>	<b>1.9</b>	<b>2.0</b>	<b>2.2</b>	<b>1.9</b>	<b>2.2</b>	<b>1.9</b>
Net Interest Income		4.8	6.5	7.0	4.6	4.1	3.7	3.6	3.8	3.6	4.6
Less Loan Loss Provision Expense		0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.0	0.0
Plus Non-interest Income											
Svc Chgs & Fees on Dep Accts		0.7	1.2	1.3	1.0	1.6	1.2	0.8	0.8	0.8	1.0
Other Non-interest Income		0.1	0.1	0.1	0.2	0.1	0.3	0.3	0.3	0.3	0.2
Less Non-Interest Expenses											
Salary & Benefits		1.1	2.1	2.1	1.8	0.3	0.2	0.9	1.0	0.9	1.2
Other Expenses		3.0	3.4	4.0	3.0	3.7	3.0	1.6	1.8	1.6	2.8
<b>ROA - Foreign Exchange Activities</b>		<b>4.1</b>	<b>5.2</b>	<b>5.7</b>	<b>3.1</b>	<b>2.8</b>	<b>1.5</b>	<b>2.2</b>	<b>2.0</b>	<b>1.3</b>	<b>3.1</b>
<b>ROA - All Activities</b>		<b>5.7</b>	<b>7.5</b>	<b>8.0</b>	<b>3.9</b>	<b>4.7</b>	<b>3.5</b>	<b>4.4</b>	<b>3.9</b>	<b>3.5</b>	<b>5.0</b>
<b>Non-Int Income / Gross Income</b>		<b>50.5</b>	<b>49.8</b>	<b>50.4</b>	<b>47.7</b>	<b>52.5</b>	<b>44.6</b>	<b>48.3</b>	<b>44.6</b>	<b>39.7</b>	<b>47.6</b>
<b>FX Income / Gross Income</b>		<b>42.1</b>	<b>40.2</b>	<b>40.3</b>	<b>34.9</b>	<b>32.6</b>	<b>22.4</b>	<b>31.8</b>	<b>28.7</b>	<b>21.5</b>	<b>32.7</b>

<b>FIJI</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Average</b>
<b>ROA - Deposit &amp; Lending Activities</b>	<b>3.1</b>	<b>2.0</b>	<b>2.1</b>	<b>2.2</b>	<b>2.5</b>	<b>2.7</b>	<b>2.7</b>	<b>1.7</b>	<b>3.1</b>	<b>1.6</b>	<b>2.4</b>
Net Interest Income	8.3	4.5	4.6	4.5	4.5	4.6	4.5	4.6	5.2	4.2	5.0
Less Loan Loss Provision Expense	1.5	0.5	0.3	0.4	0.3	0.3	(0.0)	0.7	0.1	0.8	0.5
Plus Non-interest Income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Svc Chgs & Fees on Dep Accts	0.0	0.0	0.6	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.4
Other Non-interest Income	3.1	2.0	1.4	1.4	1.6	1.6	1.2	1.0	0.9	1.3	1.5
Less Non-Interest Expenses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Salary & Benefits	4.0	2.4	2.0	1.9	1.8	1.8	1.7	1.7	1.6	1.6	2.0
Other Expenses	2.7	1.6	2.2	2.2	2.1	2.0	1.8	1.9	1.8	2.0	2.0
<b>ROA - Foreign Exchange Activities</b>	<b>2.1</b>	<b>1.3</b>	<b>1.6</b>	<b>1.4</b>	<b>1.3</b>	<b>1.2</b>	<b>1.2</b>	<b>1.1</b>	<b>1.2</b>	<b>1.1</b>	<b>1.4</b>
<b>ROA - All Activities</b>	<b>5.2</b>	<b>3.3</b>	<b>3.7</b>	<b>3.6</b>	<b>3.8</b>	<b>4.0</b>	<b>3.9</b>	<b>2.9</b>	<b>4.3</b>	<b>2.8</b>	<b>3.7</b>
<b>Non-Int Income / Gross Income</b>	<b>38.6</b>	<b>42.4</b>	<b>44.4</b>	<b>44.0</b>	<b>43.7</b>	<b>42.6</b>	<b>38.9</b>	<b>35.7</b>	<b>33.3</b>	<b>40.1</b>	<b>40.4</b>
<b>FX Income / Gross Income</b>	<b>15.6</b>	<b>16.7</b>	<b>19.5</b>	<b>17.4</b>	<b>16.5</b>	<b>15.4</b>	<b>15.7</b>	<b>15.7</b>	<b>15.4</b>	<b>15.9</b>	<b>16.4</b>

## **Annex A: FEMM 2000 Outcomes Relevant to the Financial Sector**

### **Regional Initiatives to Support Financial Development**

38. Ministers **agreed** that despite the importance of consumer protection and the attractions of regionalising the role of an Ombudsperson, the practical obstacles to it having a substantial impact mean that it should not be a priority in the immediate term.

#### ***Financial literacy and capability***

39. Ministers **noted** the range of regional initiatives already being pursued in Forum Island Countries, largely focused on improving consumers financial knowledge and awareness (literacy), but also including efforts to improve the range of products and information available to consumers.

40. Ministers **noted** the research findings that suggest exposure to financial education has a persistent effect both on the likelihood of using the financial sector and on overall economic well being in Forum Island Countries, and **referred** this issue to Forum Education Ministers' Meeting, who could consider the development of a regional action plan for improving the teaching of financial literacy in Forum Island Countries.

41. Ministers **noted** the need for developing a set of best practices to build adult financial capability and **invited** the MoneyPacific Advisory Group to undertake this work.

42. Ministers **endorsed** the proposed set of goals (that: all schoolchildren to receive financial education through core curricula; all adults to have access to financial education; simple and transparent consumer protection be in place; and to halve the number of households without access to basic financial services) to be achieved by 2020, and the need for the development of a set of indicators to assess progress against these goals.

43. Ministers **acknowledged** the efforts of the Coombs Declaration Working Party to develop the update report, **encouraged** further co-ordination of regional financial capacity building activities through the newly established Money Pacific Advisory Group, and **welcomed** their offer for ongoing updates and advice to be provided through the Secretariat.

#### ***Financial sector supervision and development***

44. Ministers **noted** the importance of a private financial sector to the sustainable development of Forum Island Country economies through the provision of general banking, other banking, insurance, broad based access to finance, retirement income products and other financial services.

45. Ministers **expressed concern** over costs associated with private lending, including interest rates, in the Pacific and note that an examination on the causes of this is being undertaken by the Pacific Financial Technical Assistance Centre. They **invited** the Pacific Financial Technical Assistance Centre to report on the results of the study on interest rates undertaken for Reserve Bank Governors and the decisions reached by the Governors at their meeting in the Solomon Islands;

46. Ministers **noted** that the recent global economic crisis has further highlighted the need for the financial sector to be appropriately regulated and supervised, including where appropriate prudentially regulated.

47. Ministers **noted** the range of capacity building and technical assistance programs already underway across the region by development partners, including the Pacific Financial Technical Assistance Centre.

48. Ministers **noted** the potential for greater private sector provision of capacity building and technical assistance in the financial services sector.

### ***Remittances***

49. Ministers **emphasised** the important role of remittances as a source of national income and economic growth for many Forum Island Countries, and **agreed** that remittance fees and charges are generally too high which reduces the level of funds received.

50. Ministers **noted** the region-wide interest in having a system of low-cost, easy access remittance options, and the work underway in the region to lower remittance costs.

51. Ministers **endorsed** the work presented to FEMM of the SendMoneyPacific.org website to raise awareness and increase competition through transparency of fees and charges when sending remittances to Forum Island Countries.

52. Ministers **highlighted** the importance of competition amongst remittance service providers in reducing costs. Ministers also **noted** a range of other factors including regulatory settings can affect remittance costs.

53. Ministers **agreed** that Australia and New Zealand will:

- work with Forum Island Countries and other development partners, including the World Bank, to examine ways in which Forum Island Countries can best position themselves to maximise opportunities for growth through remittances; and
- build on existing work to monitor trends in remittance fees and charges, including how such costs compare in the international context, and report back to FEMM 2010.

## PFTAC Publications

### **Handbooks**

- 1 : Medium Term Frameworks in Public Finance
- 2 : Pacific Bank and Pension Fund Supervisors : Off-Site and On-Site Work
- 3 : Selecting Cases for Audit : A Risk Management Approach
- 5: Working with Large Taxpayers : Getting Started
- 6: Containing the Civil Service Wage Bill in Pacific Islands

### **Regional Papers:**

- 1 : A Public Financial Management Roadmap for Forum Island Countries
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