



RESERVE BANK OF VANUATU

PRESS RELEASE

Press Release No : 2003-03

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Date : 11th August 2003

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THE RESERVE BANK AS A REGULATORY AUTHORITY

Overview

This article provides an overview of the role of the Reserve Bank of Vanuatu as a regulatory authority. One of the roles of the Reserve Bank of Vanuatu (RBV), as defined under Reserve Bank of Vanuatu Act [CAP 125] is to supervise domestic, and more recently offshore (or international) banks. (Offshore banks are prohibited from dealing with residents of Vanuatu). The RBV's role has evolved overtime in response to domestic and international developments and requirements. Banks play an important role in society and it is important that Vanuatu, as a participant in global financial markets, has in place a regulatory structure that is consistent with accepted international practices. The Bank's role as supervisor is therefore founded on the need to maintain a stable and sound banking system. A sound banking system is in the interest of depositors and investors alike and also important for the maintenance of macroeconomic stability in the economy.

Another of the Bank's roles is to foster financial conditions conducive to the economic development of Vanuatu. Some recent developments in Vanuatu, particularly in relation to offshore banks need to be seen against this background. If the RBV does not ensure that regulatory arrangements covering banks that are licensed by Vanuatu are consistent with international expectations, Vanuatu's economy could suffer as banks and investors in other countries decide not to deal with Vanuatu. Such actions would undoubtedly feed through to undermine confidence in both Vanuatu's domestic and offshore financial sectors.

The supervisory framework for banks licensed to operate in or from within Vanuatu is consistent with international standards applied in other countries that offer domestic and offshore banking services. In brief the RBV has the power to license banks, set rules (prudential guidelines), issue directives, collect statistical data and conduct on-site inspections to ensure that the banks are being well managed. The performance of banks is monitored through the collection of information, meetings with bank management and on-site inspections. With the events of September 11, the RBV like other supervisory authorities has taken a more active role in ensuring that banks have in place policies and procedures to detect and stop money laundering. The Bank, in conjunction with Vanuatu's Financial Intelligence Unit (FIU) has been conducting on-site inspections of

Vanuatu's domestic banks and these inspections will be extended to Vanuatu's offshore banks. Such measures are necessary to ensure that Vanuatu is not seen as a safe haven for money launders or those involved in the financing of terrorism. The damage to Vanuatu's international reputation would be significant and Vanuatu has, in recent years experienced the problems associated with concerns about its reputation.

The Evolution of Vanuatu's Banking Legislation

Since independence, the supervision of banks in Vanuatu has been shared between the RBV and the Vanuatu Financial Services Commission under the auspices of the Banking Act [CAP 63]. The arrangement was unsatisfactory, particularly in relation to the supervision of domestic banks, as no one agency was in a position to adequately supervise the activities of domestic banks. The inadequacies of the arrangements were highlighted with the failure of a domestic bank, Olilian Bank, in 1996, and the inadequate management of the National Bank of Vanuatu. The failure of Olilian Bank resulted in depositors losing their funds.

Following this failure, and in response to increasing financial turmoil with the onset of the Asian crises, the Government decided to give the RBV supervisory responsibility for domestic banks while the supervisory responsibility for offshore (international) banks would be given to the Financial Services Commission. To effect this change in supervisory arrangements it was necessary for key enabling legislation to be enacted; the Government agreed to the passage of this key legislation. In relation to the supervision of domestic banks, the Financial Institutions Act was passed in 1999 and it was developed in consultation with Vanuatu's domestic banks. The Financial Institutions Act has provided a sound basis for the RBV to supervise domestic banks in Vanuatu. In November 2002, the Act was amended and one of the amendments gave the Bank additional powers to ensure that people who own, direct and manage the affairs of banks are fit and proper people to hold such important positions. If the Bank determines that a person is not fit or proper to be involved in the management of bank, it can direct that bank to remove that person from office. So far the Bank has only had to use this power on one occasion.

However, legislation that would provide for the effective supervision of offshore banks was not passed and the efforts of the Vanuatu Financial Services Commission to effectively supervise the activities of offshore banks were severely hampered by the dual problems of inadequate legislation and limited capacity. To address problems related to

the supervision of the offshore banking sector, the Government decided that supervisory responsibility for all offshore banking activities should be transferred to the RBV. The decision to make the RBV the regulator for all banks reflects the fact that the expected standards of supervision are precisely the same for both domestic and offshore banks, and that a suitable framework already exists within the RBV.

With the enactment of the International Banking Act No 4 of 2002, which took effect from 1 January 2003, the RBV was given supervisory oversight for the offshore banking sector. Prior to enactment of the International Banking Act participants of Vanuatu's finance sector were given the opportunity to comment on the legislation, which was first drafted in 1996. A number of industry comments were taken on board in the finalization of the legislation. However, as is the case with all legislation a balance must be struck between the interests of Government and the private sector and ultimately it is the Government that must make policy decisions.

The International Banking Act included a number of requirements to ensure that Vanuatu's reputation as an offshore centre remains in tact and some of these changes have generated considerable discussions and claims that the Act will result in the closure of Vanuatu's offshore banking sector. It acknowledged that the introduction of the Act will result in a decline in the number of licensed banks. However, it must be noted that the number of offshore banks licensed in Vanuatu has been steadily declining for a number of years despite many of the weaknesses in the old arrangements.

The Act introduced several new requirements that are based on international expectations and consistent with developments in other offshore finance centres which are also under increased pressure to strengthen their supervisory frameworks. One of the more significant requirements is that offshore banks in Vanuatu are required to maintain a physical presence in Vanuatu. That is, banks must have an office in Vanuatu and employ staff in Vanuatu and have management and directors in Vanuatu who are responsible for the day-to-day operation of the bank. The physical presence requirement does not extend to a bank's shareholders. This decision reflects international concerns about banks that have no physical presence; these so called 'Shell Banks' could not be subject to adequate supervision as there were no staff or records in the jurisdiction. The continued existence of 'shell banks' could leave Vanuatu open to abuse by money launderers and those involved in the financing of terrorism. It must be noted that the Basel Committee on Banking Supervision argued, through a paper entitled "Shell Banks and Booking Offices" for the closure of shell banks on the basis that they cannot be supervised in accordance with accepted minimum standards. "Shell" financial institutions pose a fundamental obstacle to implementing effective supervision in line with international standards. It

must be clarified that Shell Banks, lacks the presence from the jurisdiction of any real “mind and management” or the primary books and records of the institutions, which can prevent the supervisory authority from undertaking most of the key procedures that form part of the core principles for effective banking supervision.

In addition to responding to international concerns, the development of Vanuatu’s offshore finance centre is seen as a vehicle for economic development. Previously, Vanuatu could be described as a “name plate” offshore financial centre that provided a place for a bank to be established. Such centres can be described as *notional* finance centres as the institutions operating from there are little more than ‘brass plates’ that add limited value to the economy and tend to contribute to less than 10% to economic growth. Vanuatu wants to become a *functional* offshore finance centre if the offshore centre is to truly become a vehicle for the wider economic benefit of Vanuatu. Such centres have been successful in terms of both growth of the offshore centre itself and the sector’s contribution to the economy in terms of employment, services, development of offices etc. This strategy will require Government, regulatory authorities and industry to work together to build a reputation, clientele and linkages to other sectors of the economy.

At present, it is hard to accurately determine the size of contribution of the offshore banks to Vanuatu’s economy however the entire offshore finance centre’s contribution to Government revenue is very limited. Over the period of 1999 to 2002, revenue from offshore sector accounted for 3% of total government revenues, while employment generated by the sector was about 1.4% of total employment. Ni-Vanuatu employment in the offshore sector, which includes offshore banks, trust companies and exempt insurers, is around 150 staff while employment of Ni-Vanuatu in the domestic banks is close to 300.

Another important aspect of the new Act is the requirement that existing banks re-apply to the RBV. The implementation of the Act was taken as an opportunity for institutions to upgrade their current standards of integrity, and to require remaining institutions to reach proper levels of financial standing. Government have automatic “grandfathering”

for the existing institutions for a period of one (1) year and existing licenses will have to reapply for a new one.

The Act also requires that offshore banks maintain a minimum amount of capital of USD0.5 million. This compares with domestic banks which are required to maintain a minimum capital amount of Vatu 200 million. Under previous supervisory requirements the VFSC asked that offshore banks maintain capital of USD150 000 however it had no supervisory power to enforce this 'requirement'. Under the new supervisory arrangements, a bank's capital requirements are determined in reference to the nature of business and risks the bank undertakes. As the level of business increases so will the level of capital required to support the business. Similar capital adequacy requirements are applied to Vanuatu's locally incorporated domestic banks.

With the introduction of the new Act, the decision was also taken to revise the level of fees paid by offshore banks. The annual licensing fee paid by offshore banks in Vanuatu had remained unchanged for 20 years and was low in comparison to fees charged in other offshore jurisdictions. The new annual fee of USD8 000 is still low in comparison to other offshore centres.

By enhancing supervisory oversight of the offshore banks, the RBV is not chasing away offshore banks or attempting to close the sector. Rather, it is trying to impose stringent directions to the offshore banks to protect the reputation of the country's financial industry. The RBV has had positive feedback from a number of existing participants who see the new Act as giving Vanuatu increased credibility and this will therefore allow them to increase the scope and nature of their activities. It should also be noted that when the Financial Institutions Act was first introduced in 1999, there were claims that it would result in all the domestic banks closing their operations; this has not happened.

Vanuatu is committed to increasing its supervision of offshore banks after September 11 and it is simply a case of due diligence and improving internal regulations to ensure our international banking reputation is not tarnished. The US Patriot Act passed on 26

October 2001, by President George W Bush, in response to the September 11 incident had an adverse impact on Vanuatu. Domestic banks had their US correspondent accounts closed and this impacted the ability of banks to make payments. US banks sought more assurances from banks in Vanuatu about the nature of payments and the settlement of transactions was delayed. Given the small and concentrated domestic banking system, the Vanuatu economy is particularly vulnerable to a disruption in the operations of any of its three large commercial banks.

The Bank's approach to supervision

As noted earlier, there is no difference to the techniques applied to supervise domestic and offshore banks. Monitoring is conducted through both on-site inspections and off-site analysis of data submitted to the RBV. Domestic and offshore banks are required to submit monthly and quarterly data on assets and liabilities, profitability, large credit exposures and deposits, maturity profile of assets and liabilities, country exposures, exposure to related entities, capital adequacy, loan (asset quality) classification, and equity investments. In addition, domestic banks are also required to comply with compulsory public disclosure requirements designed to facilitate monitoring of the financial condition and to enhance market discipline. All banks must submit audited copies of their annual accounts to the RBV, and in the case of domestic banks published in the press, and made available to members of the public. The RBV also conducts on-site reviews of banks. To date such reviews have been confined to domestic banks. Typically these are held at least every two years and are largely confined to reviews of credit exposures and policies, and anti-money laundering practices and policies. In addition, the RBV conducts annual prudential consultations with the senior management of banks to discuss issues arising from on- and off-site analysis. Such consultations will become a feature of the Bank's supervision of offshore banks.

The RBV has also issued a number of guidelines that are applicable to both domestic and offshore operations. The guidelines, which were circulated to members of industry prior to finalisation, include:

- 1) *Minimum capital requirement.* The Reserve Bank has introduced a capital adequacy framework that is consistent with the international standard set by the Basel Committee on Banking Supervision. The Reserve Bank has the power to require a bank to maintain a higher capital ratio if it considers this appropriate when considering factors such as the bank's risk appetite and profile. From the supervisor's perspective, capital is the last line of defense in a bank. When risk management is not enough, when provisions are exhausted, capital is a bank's last hope. But when capital fails, the bank itself fails.
- 2) *Maximum exposure limits.* The maximum exposure limit to single client or group of related clients is 25 per cent of capital in relation to exposures to non-bank, non-government counterparties. This limit also applies to banks' subsidiaries and associates. The RBV has the discretion, in exceptional circumstances, to approve exposures above this level.
- 3) *Restrictions on shareholdings.* Banks require the approval of the RBV to have aggregate shareholdings in non-financial business in excess of 25 per cent of their capital. Amounts in excess of this amount are deducted from a bank's capital base. The approval of the RBV is required prior to the establishment of a subsidiary either in Vanuatu or abroad.
- 4) *Customer Due Diligence.* The objective of this guideline is to ensure that banks have in place know-your-customer (KYC) policies. KYC is most closely associated with the fight against money laundering. The RBV's approach to KYC is from a wider prudential, not just anti-money laundering or financing of terrorism, perspective. Sound KYC procedures must be seen as a critical element in the effective management of banking risks.
- 5) *Constraints on lending to persons connected with the bank's owners.* This guideline is introduced to guard against the bank engaging in lending that, whilst beneficial to the bank's owners, could be prejudicial to the interests of its depositors.
- 6) *Credit Risk Management and Guidelines for Loan Classification and Provisioning for impaired assets.* These guidelines set out the RBV's minimum requirements for the classification of assets and provisions for losses.
- 7) *Supervision of the Adequacy of Liquidity of Banks.* This guideline sets out the RBV's approach to the supervision of the liquidity of banks. Under this guideline, banks are required to maintain at all times a minimum proportion of its balance sheet in specified liquid assets. At present the ratio is set at 15 per cent for domestic banks. Offshore banks are expected to have appropriate liquidity management policies to ensure that they can meet depositors' demands.

- 8) *Relationship between banks, their external auditors and the Reserve Bank.* This guideline requires banks to provide, on an annual basis, a statement from their external auditors that data provided to the RBV can be relied upon and that the bank complied with all prudential standards and requirements. Under these arrangements, the Reserve Bank may also request the bank's external auditor to conduct a specific review of an aspect of a bank's risk management systems or operations.
- 9) *Management of Financial Institutions.* This Guideline aims to ensure that a financial institution licensed by the RBV is well managed and that persons occupying key positions within the institution must have the degree of probity and competence commensurate with their responsibilities. The RBV may direct that a financial institution remove persons from key positions where they no longer meet the criteria for fitness and propriety.

Conclusion

While there has been some negative comment about the new supervisory arrangements for offshore banks it is important to note that context in which change is being made and a fundamental question is, how much is your reputation worth? The Reserve Bank of Vanuatu will continue to ensure that Vanuatu's international reputation is not tarnished and will be seeking to ensure that the supervision of banks licensed in Vanuatu is consistent with international best practices. The Reserve Bank does not want to see Vanuatu being placed in a list for not complying with international standards in relation to bank supervision, money laundering or financing of terrorism. In today's world of global financial markets it is important that participants comply with the norms. The failure to do so can result in other banks simply deciding not to deal with Vanuatu because the impact on a bank's reputation in the market is significant. One of the most important things that countries have is their reputation if they wish to attract investors and maintain economic stability in the long run.

Reserve Bank of Vanuatu

11th August 2003