



▲ Souvenir shop, Palau.

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# PACIFIC FINANCE SECTOR BRIEFS

ADB PACIFIC LIAISON AND COORDINATION OFFICE

## PALAU

**Palau is an archipelago of over 500 islands, part of the Micronesia region of the Western Pacific.** Its economy is driven mainly by the tourism sector, with annual tourism receipts estimated to represent about 50% of gross domestic product (GDP). The overall service sector, which incorporates tourism, accounts for 88% of the country's total output, while industry (mainly construction) accounts for only 9% of GDP, and agriculture (including fisheries) just 3%.

**The Government of Palau depends on grants to meet its revenue needs**, in particular financial assistance from the United States (US) under the Compact of Free Association (the Compact). This assistance amounted to 11% of Palau's total revenues in fiscal year 2017. Compensation to employees and spending on goods and services make up about 66.5% of the government's recurrent expenditure. While the overall budget balance has recorded surpluses since fiscal year 2011, this has been achieved mainly by limiting spending on capital investment.

**As in some other Pacific island countries, the forthcoming expiration of the Compact in 2024 is a major concern for Palau.** In early 2018, US Congress authorized the 2010 Compact Review Agreement, which included the deferred payment of \$123.8 million in Compact grants. While the renewed economic terms of Palau's Compact Trust Fund mean it is projected to fare better than its sister North Pacific countries post-Compact, considerable uncertainty remains regarding the continuation of various federal programs and services Palau currently benefits from.

### FINANCE SECTOR OVERVIEW

**Palau has one of the most monetized economies in the Pacific, yet credit growth is sluggish** (Table 1). From 2012 to 2017, Palau's ratio of broad money (M2) to GDP averaged 77.8% and is still trending upwards, reaching 98.4% for 2017. However, over the same period, demand for credit expanded at an average of only 6.2% because of certain legal prohibitions and structural deficits.

### PALAU AT A GLANCE

<b>Population</b>
17,900 (2017) <sup>a</sup>
<b>GDP (current \$)</b>
\$295 million (2018) <sup>b</sup>
<b>GDP per capita</b>
\$15,982 (2018) <sup>b</sup>
<b>GNI per capita</b>
\$12,530 (2017) <sup>a</sup>

GDP = gross domestic product,  
GNI = gross national income.

<sup>a</sup> Source: Asian Development Bank. 2018. *Key Indicators for Asia and the Pacific 2018*. Manila.

<sup>b</sup> Source: Asian Development Bank.

**Table 1: Nominal Gross Domestic Product, 2012–2017**

	2012	2013	2014	2015	2016	2017
GDP (\$ million)	214.6	225.3	245.6	293.1	302.7	291.5
M2 (\$ million)	133.7	144.2	174.9	230.9	278.2	286.8
M2/GDP (%)	62.3	64.0	71.2	78.8	91.9	98.4
Private sector credit (\$ million)	27.1	30.1	32.1	31.0	31.8	36.3
Private sector credit/GDP (%)	12.6	13.3	13.1	10.6	10.5	12.4

GDP = gross domestic product, M2 = broad money.

Sources: Asian Development Bank and Graduate School USA. 2018. *Palau FY2017 Statistical Compendium*. Honolulu.

**Table 2: Financial System of Palau**

Type of Institution	Number
Commercial banks	5
Pension funds	2
Development bank	1
Insurance companies	
Micro-lending facilities	
Credit unions	
<b>Total</b>	<b>8+</b>

Source: Palau Financial Institutions Commission.

While the presence of foreign-owned banks contributes to the vibrancy of Palau's economy, government intervention is needed to take corrective actions to encourage credit expansion.

## FINANCE SECTOR STRUCTURE

**Palau's financial system is reasonably diverse** (Table 2).

Of the five commercial banks operating in the country, three (the Bank of Guam, the Bank of Hawaii, and BankPacific) are foreign-owned and insured by the Federal Deposit Insurance Corporation (FDIC), while the remaining two (the Asia Pacific Commercial Bank and the Palau Construction Bank) are domestic banks. The FDIC-insured banks provide a full range of banking services, while those not insured by the FDIC are limited to operating savings accounts only. The assets of Palau's commercial banks grew at an average of 20.5% from 2012 to 2016, standing at \$281.7 million in 2016. The country also has its own development bank, the National Development Bank of Palau (NDBP), as well as access to the services of the regional development bank, the Pacific Islands Development Bank. The Social Security Administration Retirement Fund and the Civil Service Pension Fund manage pensions in Palau. The Financial Institutions Commission supervises the commercial banks and the NDBP. However, insurance providers, micro-lending facilities, pension funds, and credit unions with assets of less than \$500,000 are exempt from regulatory oversight.

## FINANCE SECTOR PERFORMANCE

**Deposits in Palau grew steadily from 2012 to 2017** (Table 3).

Deposits grew at an average of 17%, driven by several factors. The Financial Institutions Commission (2017) reported that deposits of nonfinancial corporations remained the biggest contributor to total deposits. Expansion in the country's tourism sector drove profits higher and, consequently, there were higher

deposits by businesses. The boom in tourism has likewise driven growth in government deposits, due to higher receipts for tourism-related fees, while growth in individual savings accounts reflects the increasing profitability of small businesses and receipt of large lease payments for land used by foreign investors (Graduate School USA 2016).

Private sector credit fluctuated from 2012 to 2017, averaging only 6.2% growth a year over that period. In 2017, the Asian Development Bank (ADB) observed that the huge gap between loans and deposits indicates low financial intermediation in Palau. With \$210 million—out of a total \$213 million—of excess liquidity invested offshore, ADB argued that Palau's financial system is, in fact, disintermediating. Instead of using deposits to lend to businesses inside the domestic economy, the financial system acts as a source of funds and the pooled funds are invested overseas, where risk is lower. The risk-averse behavior of banks in Palau clearly reflects the steady decline in the sector's nonperforming loans ratio, which was down to 0.6% in 2017.

## FINANCIAL INCLUSION

**The total number of depositors reported by banks declined from 2012 to 2017** (Table 4).

The number of depositors had been increasing until 2014, before falling from 2015 to 2017. Meanwhile, the total number of deposit accounts with commercial banks fell marginally from 22,176 in 2016 to 21,123 in 2017.

**In 2016, both the number of borrowers and the number of loan accounts declined.**

From 4,950 borrowers in 2012, the figure rose for 3 years, reaching 6,265 borrowers in 2015, before falling to 5,810 in 2016, and falling further to 5,465 in 2017.<sup>1</sup> While the number of loan accounts rose from 6,272 in 2015 to 6,354 in 2016, in 2017 it fell to 5,971. With year-on-year increases generally diminishing, banks in Palau have added only 995 loan accounts since the figure of 4,976 accounts in 2012.

<sup>1</sup> Please refer to the note on Table 4 regarding the number of depositors and borrowers.

**Table 3: Financial System Performance Indicators**

	2012	2013	2014	2015	2016	2017
Commercial bank assets (\$ million)	135.7	140.4	175.9	231.8	281.7	290.9
Deposits (\$ million)	130.9	136.0	171.2	225.8	275.3	283.8
Private sector credit (\$ million)	27.1	30.1	32.1	31.0	31.8	36.3
NPL ratio (%)	3.6	3.4	3.2	2.1	0.8	0.6
Deposit rate (%)	0.3	0.1	0.1	0.1	0	0
Lending rate (%)	11.5	11.6	11.3	11.1	10.8	9.7

NPL = nonperforming loans.

Sources: Graduate School USA. 2018. *Palau FY2017 Statistical Compendium*. Honolulu; and Palau Financial Institutions Commission.

**Table 4: Financial Access Indicators**

Access Indicators	2012	2013	2014	2015	2016	2017
Number of ATMs	7	7	8	8	8	8
Number of depositors with commercial banks	20,800	21,379	22,231	19,919	19,761	19,534
Number of deposit accounts with commercial banks	22,308	22,968	23,902	22,155	22,176	21,123
Number of borrowers at commercial banks	4,950	5,841	6,220	6,265	5,810	5,465
Number of loan accounts with commercial banks	4,976	5,859	6,232	6,272	6,354	5,971

Note: The number of depositors and borrowers are aggregated from figures reported by the banks. As such, there will be overlaps as there are customers with accounts at different banks.

Sources: International Monetary Fund and Palau Financial Institutions Commission.

## CHALLENGES IN THE FINANCE SECTOR

**Weak growth in commercial bank lending may be attributed to certain structural and legal impediments in Palau.** The hesitancy of banks to lend to businesses is largely due to the country's usury law and asymmetric information on small business performance.

- (i) **Usury law.** Palauan law imposes a ceiling on the interest rates that banks can charge potential borrowers. Under the country's Law on Business and Business Regulation, banks can charge up to 18% interest per annum on loans to individuals, while the cap on business lending is at 4% above the corporate lending rate at large US money center banks. As of October 2015, the prime interest rate was 3.25%, implying that the maximum interest rate a commercial bank in Palau can charge on a business loan is 7.25% per annum. However, in a survey cited by the Graduate School USA Pacific Islands Training Initiative (2016), internet lenders indicated they were averaging rates of between 8% and 40% per annum for loans to small businesses in Palau, far above the cap rate imposed by the usury law. This clearly discourages banks from lending money in Palau.
- (ii) **Asymmetric information.** There is a lack of reliable and objective information about the performance of small businesses in Palau, which is exacerbated by the weak informational requirements of the country's tax system.

The system does not require the record-keeping usually mandatory in other economies that collect business and value-added taxes. For example, businesses filing taxes in Palau are only required to state their gross receipts, which do not indicate profitability (Graduate School USA Pacific Islands Training Initiative 2016). This lack of detailed financial data makes it difficult for lenders to evaluate the performance and growth potential of small businesses, and to assess the creditworthiness of each.

**Mortgage lending in Palau is complicated and expensive for foreign-owned banks.** ADB (2017) observed that, while some banks in Palau offer loans on fixed property such as land and buildings, the ability to use it as collateral is difficult given the country's restrictions on land ownership. Those who are not citizens of Palau, including foreign-owned financial institutions, are prohibited from possessing title to fixed property, and this makes repossession of property complicated and expensive when there is a default on a loan. On the other hand, locally owned banks are not covered by restrictions on title possession. As such, the NDBP dominates lending for the purposes of purchasing fixed property. Despite the restriction, some foreign-owned banks are still able to engage in mortgage lending under certain circumstances. For instance, ADB (2017) cited the agreement that the Bank of Guam entered into with the NDBP for the latter to hold repossessed land through a trust agreement. This mechanism, however, raises transaction costs and complicates legal processes.

## Despite efforts to enhance lending capacity, secured transactions reform in Palau has had limited impact.

The government introduced a new secured transactions framework for chattel mortgages in 2012 and the electronic registry was launched in 2013, allowing lenders to check information on existing loans and lenders. However, registration has been limited: by the end of 2015, the registry contained a total of only 663 security interests, with only 76 new security interests added in 2015. ADB (2017) noted that, when banks lend, they prefer to take business cash flow rather than movable property as security. Reasons for the underutilization of the secured transactions scheme include:

- (i) Banks are already limited by Palau's usury laws.
- (ii) Many consumer loans are unsecured.
- (iii) Foreign-owned banks' credit decisions are determined by head office regulations, which do not appear to consider the use of the framework by their local office.
- (iv) Some lenders do not appreciate the implications and uses of the framework.

**The NDBP has faced funding constraints because it has been unable to take deposits and has been funded primarily through loan repayments.** Such a financial structure has limited the NDBP's capacity to make new loans. However, legislation was passed in 2014 to allow the NDBP to take savings accounts deposits and issue bonds, with the objective of increasing the development bank's capacity to lend. Further, ADB (2017) has proposed that another way to increase NDBP funding is for commercial banks to lend to NDBP which will reduce financial disintermediation as more Palauan deposits will now be used to finance the domestic economy. It would allow NDBP to increase or reduce its borrowing against its portfolio, depending on the demand for loans, which will give it more control and flexibility in managing its liquidity.

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